Transfer Pricing in India

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Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. The expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. The effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction.

Hence, to avoid this situation, Transfer Pricing Regulations in India mandate international transaction between related parties (term used in the regulations in Associated Enterprises) to be carried out at Arm’s Length Pricing (ALP) principles. In simple terms, ALP requires international transactions among related parties to be priced in the same way as a transaction between independent / unrelated enterprises.

Definitions of certain terms relevant to Transfer Pricing

Arm's Length Price

A price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions;

Associated Enterprise

In relation to another enterprise, means an enterprise—

a. which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or

b. In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

For the purposes of above **two enterprises shall be deemed to be associated enterprises if**, at any time during the previous year:-

a. one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise; or

b. any person or enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in each of such enterprises; or

c. a loan advanced by one enterprise to the other enterprise constitutes not less than 51% of the book value of the total assets of the other enterprise; or

d. one enterprise guarantees not less than 10% of the total borrowings of the other enterprise; or

e. more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

f. more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

g. the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or

h. 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

i. the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or

j. where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

k. where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or

l. where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or

m. There exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

Permanent Establishment

Includes a fixed place of business through which the business of the enterprise is wholly or partly carried on;

Group
Includes a parent entity and all the entities in respect of which, for the reason of ownership or control, a consolidated financial statement for financial reporting purposes,—

a. is required to be prepared under any law for the time being in force or the accounting standards of the country or territory of which the parent entity is resident; or

b. would have been required to be prepared had the equity shares of any of the enterprises were listed on a stock exchange in the country or territory of which the parent entity is resident;

Parent Entity
A constituent entity, of an international group holding, directly or indirectly, an interest in one or more of the other constituent entities of the international group, such that,—

a. it is required to prepare a consolidated financial statement under any law for the time being in force or the accounting standards of the country or territory of which the entity is resident; or

b. it would have been required to prepare a consolidated financial statement had the equity shares of any of the enterprises were listed on a stock exchange,

Constituent Entity

a. any separate entity of an international group that is included in the consolidated financial statement of the said group for financial reporting purposes, or may be so included for the said purpose, if the equity share of any entity of the international group were to be listed on a stock exchange;

b. any such entity that is excluded from the consolidated financial statement of the international group solely on the basis of size or materiality; or

c. any permanent establishment of any separate business entity of the international group if such business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory, tax reporting or internal management control purposes;

International group
Any group that includes,—

a. two or more enterprises which are resident of different countries or territories; or

b. an enterprise, being a resident of one country or territory, which carries on any business through a permanent establishment in other countries or territories;

Computation of arm's length price

In India following 5 methods are used to determine Arm Length Price (ALP) –

Comparable Uncontrolled Price (CUP) Method
Under this method, the price charged for property or services transferred in a controlled transaction between associated enterprises is compared with the price charged for comparable property or services transferred in an uncontrolled transaction between independent enterprises under comparable circumstances.

Resale Price Method
This method determines the appropriate transfer price by ascertaining the price at which a product that has been purchased from a related enterprise is resold to an independent enterprise.

Cost-plus method
Under this method, the arm's length price is determined by adding an arm's length mark-up to the costs of the supplier supplying goods to a related purchaser.

Profit Split Method
This method seeks to eliminate the effect on profits of special conditions made or imposed on a controlled transaction by determining the division of profits which the independent enterprises would have expected to realise from engaging in the transaction or transactions.

Transactional net margin method (TNM)
This method determines the net profit margin relative to a base of costs, sales, or assets, etc. that a taxpayer realises from a controlled transaction.

Meaning of international transaction

Transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of:

1. the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing;

2. the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;

3. capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;

4. provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;

5. a transaction of business restructuring or reorganization, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.

Maintenance, keeping and furnishing of information and document

Taxpayers are required to maintain information related to international transactions undertaken with AEs. The rules prescribe detailed information and documentation that must be maintained by the taxpayer. Such requirements can broadly be divided into two parts.

The first part includes information on the ownership structure of the taxpayer, a group profile, and a business overview of the taxpayer and AEs, including prescribed details such as the nature, terms, quantity, and value of international transactions. The rules also require the taxpayer to document a comprehensive transfer pricing study.

The second part of the rules requires that adequate documentation is maintained to substantiate the information, analysis, and studies documented under the first part of the rule. It also contains a recommended list of such supporting documents, including government publications, reports, studies, technical publications, and market research studies undertaken by reputable institutions, price publications, relevant agreements, contracts, and correspondence.

The 7 steps Approach to documentation

1. Understanding the Business Model of the Corporate Body
2. Analyzing the Transaction(s)
3. Functional & Economic analysis
4. Assessment of comparable
5. Selection and application of methodology
6. Benchmarking the transaction
7. Reviewing the process

Taxpayers having aggregate international transactions below the prescribed threshold of INR 10 million and specified domestic transactions below the threshold of INR 50 million are relieved from maintaining the prescribed documentation. However, even in these cases, it is advised that the documentation maintained should be adequate to substantiate the arm's-length price of the international transactions or specified domestic transactions.

Furnishing of report

The Indian government has proposed to introduce three-layered transfer pricing documentation requirements. Taxpayers will now be required to prepare a master file, local file, and country-by-country (CbC) reporting.

A master file containing standardized information relevant for all multinational enterprises (MNE) group members;

A local file referring specifically to material transactions of the local taxpayer; and

A country-by-country report (CbC Report) containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

While the detailed contents of these documents is provided through tax rules, the reporting requirements are aligned with the Organization for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Action 13 on transfer pricing documentation and CbC reporting.

Report from an accountant to be furnished

Every person who enters into an international transaction during a previous year is required to obtain an audit report in Form 3CEB from a Chartered Accountant certifying correctness of the international transactions; documents maintained and other allied aspects. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. Furthermore, the accountant is required to certify the correctness of an extensive list of prescribed particulars. The Time limit for furnishing Form No. 3CEB is on or before 30th November of the relevant Assessment Year.

Penalty

Stringent penalties are provided for non-compliance with the transfer pricing regulations. The penalty for under-statement of profits is minimum 100% and maximum 300% of tax on differential profits. Failure to file CA's report under Form 3 CEB attracts penalty of Rs. 1 Lac. Further, penalty@2% of the value of the international transaction entered into by him, if the person:

- fails to keep and maintain any such document and information as required;

  fails to report such international transaction which is required to be reported; or

- maintains or furnishes any incorrect information or document.

Advance pricing agreement (APA)

The Indian authorities have introduced unilateral, bilateral and multilateral and there are no monetary or other conditions prescribed under the Indian APA rules for a taxpayer to be eligible for applying for an APA. The validity of an APA (once entered into) shall not exceed five consecutive years and shall be binding on the taxpayer as well as the Revenue authorities in respect of the international transactions for which the APA is sought.

APAs can be one-sided, two-sided/bilateral, or multilateral.

How can we help you?

No matter if it's a small or large scale business, transfer pricing has raised international tax issues for many businesses. Lately, India has seen significant litigations in the area of international transfer pricing. This necessitates a careful analysis and planning before entering into international transactions with associated enterprises to mitigate transfer pricing adjustment risk. You can use transfer pricing for cost-cutting while ensuring that your business is in compliance with global regulations. Reviewing your transfer pricing strategy and documentation is essential to maintain the transparency in an organization.

Our multidisciplinary approach can help you manage your company's transfer pricing issues by providing advice on planning, compliance and documentation, compliance dispute resolution as well as the practical implementation of your transfer pricing policy.

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