Transfer Pricing Method

Introduction

Transfer pricing can be simply defined as a theory of pricing the contributions (Tangible & Intangible assets, Funds, Services, Goods, etc.,) transferred within the organization. Since prices are controlled within the organization, the rules that apply to transactions with third party may not apply. The choice of transfer pricing will affect the allocation of profits among parts of the Organization i.e., the part of the organization in tax heaven will show a huge profit and the other part of the Organization located in a Country with huge tax burden shows nil or a meager profit thereby reducing the Overall tax liability of the Organization.

This has become a major concern for Revenue authorities in most of the Countries which has led to the rise of Transfer pricing regulations and enforcement in federal laws. Transfer pricing regulations were first introduced in the US in 1994. Now it has been enforced by around 60 countries worldwide.

Example

For example a company established in Mauritius has a subsidiary company, resident in India (which has a tax rate of, say, 30%) which manufactures goods and transfers them to its parent company in Mauritius (which has a tax rate of 15%) for trading. In order to increase the overall profits of the group company, it will seek to supply the goods at prices which are lower than the market price. So, in effect, the subsidiary company in India will have lower profits and hence, a lower tax incidence whereas the parent company in Mauritius is affected in the opposite manner - higher profits due to low costs, but lower taxes because of the tax rate.

'Arms Length Principle'

All that the revenue authorities require, is to test the transfer pricing transactions for "**ARMS LENGTH" Principle**. The Arms Length Principle states that the parties to the transaction:

- Are unrelated or independent of each other.
- Are on equal footing i.e., one party is not in a position to influence the decision of the other.

The price charged in a transaction carried out using Arm's length principle is called **Arm's length price**.

In the Indian Scenario, although there existed section 92 under the Income tax Act 1961, there were no relevant rules which could help tackle the issue of transfer pricing. Section 92A to 92F had been inserted to deal with transfer pricing by the Finance Act, 2001. Some views are expressed in this article, as given below, explaining provisions under the Income Tax Act 1961 dealing with arms length principle of transfer pricing under Section 92C of the Indian Income Tax Act.

Methods to determine arm's length price

- **Comparable Uncontrolled Price Method** ("CUP"): CUP is a method by which the price charged or paid for contributions is transferred within the parts/ components of the organization (including transactions between associated parties) is compared with comparable uncontrolled transactions. This method is wholly based on the principle of "Comparability Analysis".

a) **Comparability Analysis:** Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

b) **Comparable Uncontrolled Transactions:** A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("**internal comparable**") or between two independent parties, neither of which is a party to the controlled transaction ("**external comparable**").

- **Resale Price Method ("RPM"):** Under the RPM, the price at which property purchased or services obtained by an enterprise from an Associated Enterprise are resold or is provided to an unrelated enterprise, is identified. The resale price is thereafter reduced by the normal gross profit margin and the expenses incurred by the reseller. The price so arrived at, is required to be further adjusted to take into account the functional and other differences which could affect the amount of gross profit margin in the open market. The adjusted price so arrived at, is taken to be the arm's length price for the property / services.

- **Cost Plus Method ("CPM"):** Under the CPM, the direct and indirect costs of production incurred by an enterprise in respect of property transferred or services provided to an Associated Enterprise, are ascertained. The amount of normal gross profit mark-up for provision of such property / services in a comparable uncontrolled transaction is determined. Such normal gross profit mark-up is adjusted to take into account the functional and other differences, which could materially affect the profit mark-up. The costs are thereafter increased by the adjusted profit mark-up, which are taken to be the arm's length price for the property / services.

- **Profit split method ("PSM"):** The PSM has been prescribed as being applicable mainly for transfer of unique intangibles or any inter-related multiple International Transactions, each arm of which cannot be separately evaluated. For applying this method, the combined net profit arising to the Associated Enterprises engaged in the transaction is determined. The relative contribution made by each of the Associated Enterprises is then evaluated, taking into account the functions performed, assets employed and the risks assumed, to determine the value of such contribution had it been performed by an unrelated enterprise performing comparable functions in similar circumstances.
  The combined net profits are thereafter split in proportion to the relative contribution by each enterprise and the profit so apportioned is taken into account to arrive at an arm's length price. The split will be as under:

  a) In the first place the split will be of the basic return appropriate for the type of transaction;
  b) Thereafter the residual net profit is required to be split in the prescribed manner.

- **Transactional Net Margin Method ("TNMM")**: Under this method, the net profit margin realized by an Associated Enterprise from an International Transaction is computed in relation to a particular factor such as costs incurred, sales, assets employed, etc. The net profit margin realized by the assessee or an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed. With regard to the same, base and adjustments are made to the profit margin to take into account the differences between:

a) The International Transaction and the uncontrolled transactions; or
b) The enterprises entering into such transactions, which could materially affect the open market net profit margin.

The net profit margin realized by the Associated Enterprise is established in conformity with the net profit margin of the uncontrolled transaction.

- **Any other method prescribed by the CBDT:** W.e.f 01-04-2012, the CBDT has issued a notification to insert Rule 10AB in the Income Tax rules, 1962 (Rules), which describes a new method (sixth method) for computation of ALP in relation to an International Transaction. The sixth method is applicable from the F.Y.11-12 and subsequent years. The scope of the Sixth method appears to be broad and allows taxpayers to choose any method to determine ALP provided it can establish that such method satisfies the arm's length test.

  The sixth method contains the following two broad scenarios:
  - Any method which takes into account the price, which has been charged or paid. This necessitates the existence of real or actual, same or similar uncontrolled transaction. This method is similar to the existing CUP method but in a broader sense.

  - Any method which takes into account the price, which would have been charged or paid. The term would have been charged or paid appears to recognize the concept of Hypothetical arm's length test. In other words, it allows the comparison of a controlled transaction with a proposed third party transaction.

  While the assessee has a choice of following any of the methods, it has to be the most appropriate method with regard to the prescribed factors.