MODULE -1

Basics of Transfer Pricing
&
Arm's Length Principle

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Coverage

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5	International Transaction and deemed International Transaction

What is Transfer Pricing?

UNTP Manual explains "The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group."

Rationale for Transfer Pricing?

- Chennai ITAT in Iljin Automotive Private Ltd. v. Asstt. CIT [2011] 16 taxmann.com 225 (Chennai), explained the concept of 'transfer pricing' as follows :
- MNE group companies seek to achieve the best tax results not only by manipulating export and import prices, but also by manipulating category of income.
- Business income is taxed at the normal rates in a given country on a net basis whereas royalty, interest and dividend are taxed at reduced rates on gross basis. Therefore, a non-resident taxpayer can categorize business income as royalty or technical fee. Thus, the tax manipulation among the related corporations not only involves the use of arbitrary prices, but also conversion of returns on equity, investment to royalty and interest.

- Mumbai ITAT in Indo American Jewellery Ltd. [2012] 18 taxmann.com 303 (Mum.) held that
  - The rationale behind Chapter X is that India must get due tax from the international transactions of the assessee with its AEs.
  - It is quite possible that the two AEs may agree in such a manner that the price in the international transactions is cooked up so as to siphon off the due tax from India.
  - We are not concerned with the taxation of the entire group as one unit on an international level where some associated enterprises may be subjected to tax in other countries at higher or lower rates.

Rationale for Transfer Pricing

The Finance Act, 2001 introduced Transfer Pricing Regulations for curbing tax avoidance and manipulation of intra-group transactions by abusing transfer pricing. Specifically, the memorandum to the Finance Act, 2001 stated that:

"*The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income-tax Act.*"

Evolution of Transfer Pricing

- **The United States of America (USA)**
  - First country to adopt a comprehensive transfer pricing legislation in 1968
- **The Organisation for Economic Co-operation and Development (OECD)**
  - Reports on transfer pricing in 1979 and 1984
  - Issued the TP Guidelines in 1995 as amended by 2010/2017 version
- **United Nations (UN)**
  - Report on "International Income Taxation and Developing Countries" in 1988
  - The UN Conference on Trade and Development (UNCTAD) also issued a major report on Transfer Pricing in 1999
  - The UN is again taking a leadership role, through its Transfer Pricing Manual, in trying to arrive at updated global transfer pricing guidance which can be used by countries all over the world in developing (or calibrating) their transfer pricing regulations
- **European Commission (EC)**
  - Proposals on income allocation to EC members of MNEs

Transfer Pricing Regulations in India

- ❖ Section 92 to 92F had been included in Chapter X of the Income-tax Act, 1961, through the Finance Act, 2001, providing for a transfer pricing mechanism based on computation of income from cross-border transactions.

- ❖ Chapter X applies to international transactions entered into with effect from 1st April, 2001.

- ❖ Rules 10A to 10E have been inserted in the Income-tax Rules, 1962 by a notification dated 21st August, 2001. Section applies to all non-corporate and corporate assesses who have dealings with non- residents for import or export of goods, properties or services.

- ❖ All assesses have to keep detailed records as prescribed under the Rules and will have to furnish audit report every year with the return of income about their international transactions.

Objectives of Transfer Pricing

- Prevent shifting of profits from high tax jurisdiction to a low tax jurisdiction
- Fair share of taxes among jurisdictions
- Fair apportionment of Income of MNEs between the countries concerned
- Principles underlying the regulation to be internationally acceptable
- Avoidance of conflicts with home and host governments over tax issues and repatriation of profits

Features of TP Regulations

- TPR does not levy any tax. TPR is not charging provision.
- TPR is not a provision to disallow expense.
- The word 'transfer price' should not mislead one to conclude that an international transaction sans consideration is out of the ambit of TPR. It would fall within the ambit of TPR if it is taxable under any provision of the Act or if parties dealing at arm's length would not have transacted without consideration. - Vodafone India Services (P.) Ltd. v. Dy. CIT [2018] 89 taxmann.com 299 (Ahmedabad - Trib.)
- TPR in Chapter X is SAAR (Specific Anti-Avoidance Rule) as distinguished from GAAR (General Anti-Avoidance Rule) in Chapter XA.
- Re-write or re-characterisation of deal not permitted. TP is deal price re-write and not deal re-write.
- Primary onus on taxpayer to prove that transacted value of IT/SDT is at arm's length by maintaining documentation and getting audit done.

Applicability of Transfer Pricing

- In Vodafone India Services (P.) Ltd. v. UOI [2015] 53 taxmann.com 286/231 Taxman 645 (Bom.)
- Section 92 nowhere states that if there is a difference between arm's length price and transaction price in any such transaction, the difference will be deemed to be an income.
- All that these provisions say is if income arises in an international transaction, the amount of such income will be computed with reference to the arm's length price.
- This income should be chargeable under the Act before Chapter X can be applied.
- Chapter X of the Act is a machinery provision to arrive at the ALP of a transaction between AEs.
- The substantive charging provisions are found in sections 4, 5, 15 (Salaries), 22 (Income from house property), 28 (Profits and gains of business), 45 (Capital gain) and 56 (Income from other Sources).
- Even Income arising from International Transaction between AE must satisfy the test of Income under the Act and must find its home in one of the above heads i.e. charging provision.
- CBDT has accepted the above decision in Vodafone (supra) vide Instruction No. 2/2015, dated 29-1-2015.

Applicability of Transfer Pricing

- On issuance of shares by an Indian entity to its non-resident AEs, no income arises; hence, transfer pricing provisions under Chapter X would not be applicable - Shell India Markets (P.) Ltd. v. Asstt. CIT [2014] 51 taxmann.com 519/[2015] 228 Taxman 99 (Bom.)
- Issue of shares at a premium by assessee to its AE at Mauritius did not give rise to any income from an international transaction and Chapter X could not be applied in such a case in absence of charging provision to tax issue of shares at premium to a non-resident - ATC Telecom Tower Corporation (P.) Ltd. v. Addl.CIT [2015] 57 taxmann.com 249/154 ITD 95 (Mumbai-Trib.)
- If there is an international transaction in capital field, which does not otherwise give rise to any income in itself, then even though its ALP may be computed in consonance with provisions, but no adjustment can be made for difference between declared value and ALP of such international transaction.
- In case of purchase of fixed assets from AE, it is amount of depreciation on purchase of such fixed assets which will be considered for making addition and not difference between transacted value and ALP determined at Nil - Ciena India (P.) Ltd. v. ITO [2015] 59 taxmann.com 92 (Delhi-Trib.)
- Since the intention underlying section 92 is "to prevent avoidance of tax by shifting taxable income to a jurisdiction outside India by an associate enterprise controlling the prices charged in intra-group transactions", section 92(3) provides that the provisions shall not apply in a case where the application of arm's length price results in reduction of income chargeable to tax in India.

Applicability of TP: Section 92

Section 92(1)

- Income/Allowance For Expense/ Interest
- From An International Transaction

Section 92(2):

- In Case Of International Transaction + Specified Domestic Transaction
- Where 2 Or More Associated Enterprises Enter Into A Mutual Agreement Or Arrangement
- For The Allocation/ Apportionment Of/ Contribution To Any Cost Or Expense Incurred
- In Connection With A Benefit, Service Or Facility Provided To Any One Or More Of Such

Section 92(2A):

- Income
- Allowance Of Expense
- Allocation Of Cost Or Expense
- Interest

From Specified Domestic Transaction

*S*hall Be Computed Having Regard To Arm's Length Price

Applicability of TP: Section 92

TP provisions shall not apply in case where the adoption of Arm's Length Price (ALP) shall result in:

- ❖ Decrease in the overall Taxable Income
- ❖ Increase in the Loss

It is pertinent to note that the TP provisions are intended to avoid erosion of tax base in India through claiming of expenses and losses. However, in case, where by applying ALP, there is reduction in taxable income or increase in loss, TP provisions shall not apply.

It is pertinent to note that transfer pricing adjustment cannot be made while computing book profits under MAT u/s 115JB.

Mercer Consulting India (P.) Ltd. v. Deputy Commissioner of Income-tax, Circle 16 (2), New Delhi

- ❑ **Due computation of income on basis of arm's length price, income of assessee is lowered or loss is increased, provisions of computation of income on basis of arm's length price would not be applicable?**

- It was held that when, as a result of computation of income on the basis of arm's length price, the income of the assessee is lowered or the loss is increased, the provisions of computation of income on the basis of arm's length price do not come into play.

Associated Enterprise [Section 92A]

Definition of AE	
Section 92A(1)	**Section 92A(2)**
Direct relationship	**Deeming relationship**
Two entities will become AEs if one entity participates in • capital, • control or • management of the other enterprise or if any common entity participates in CCM of the two entities	Expands section 92A(1) & provides for various circumstances of participating in CCM for two enterprises to be deemed as AEs (13 circumstances) as mentioned in section 92A(2) of the Act.

- ★ **Enterprise means person engaged in activity relating to production, supply etc. of goods, know-how, patents etc. of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights/provision of service/carrying out work/investment/loan/ business of dealing in shares etc.**

- ★ **Enterprise includes the term Permanent Establishment. the term "Permanent establishment" is defined in section 92F(iiia) to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.**

Associated Enterprise [Section 92A]

1.Enterprise ownership	One enterprise holds 26% or more of the voting power, directly or indirectly, in the other enterprise. Example: A Ltd. holds 33% of voting power in B Ltd. and B Ltd. holds 80% voting power in C Ltd. In above situation, A Ltd. holds 26% or more voting power in B Ltd., directly and in C Ltd. indirectly (i.e. through B Ltd.). Therefore, both B Ltd. & C Ltd. are deemed associated enterprises of A Ltd.
2.Substantial voting power in two entities by common person	Any person or enterprise holds 26% or more of the voting power, directly or indirectly, in each of two different enterprises. Example: Mr. A holds 40% of voting power in both X Ltd. and Y Ltd. where neither X Ltd. has any holding in Y Ltd. nor Y Ltd. has any holding in X Ltd. In this situation, since Mr. A directly holds 40% of voting power in both X Ltd. and Y Ltd., X Ltd. & Y Ltd. will be deemed associated enterprises.
3.Advancing of substantial sum of money	One enterprise advances loan to the other enterprise of an amount of 51% or more of the book value of the total assets of such other enterprise. Example: Book value of total assets of Y Ltd. is Rs. 100 crores. X Ltd. advances loan of Rs. 60 crores to Y Ltd. Since, in this case, X Ltd. advances loan of Rs. 60 crores to Y Ltd, which is 60% of the book value of total assets of Y Ltd. Hence, X Ltd. & Y Ltd. are deemed associated enterprises.

Associated Enterprise [Section 92A]

4.Guaranteeing borrowings	One enterprise guarantees 10% or more of the total borrowings of the other enterprise. Example: P Inc. has total loan of 1 million dollars from XYZ Bank of America. Out of that, A Ltd., an Indian company, guarantees 20% of total borrowings in case of any default made by P Inc. In such scenario, since A Ltd. guarantees 20% of total borrowings of P Inc., P Inc. and A Ltd. are deemed associated enterprises.
5.Appointment of majority directors of other enterprise	One Enterprise appoints 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 another enterprise. Example: X Ltd. has 15 directors on its Board. Out of that, Y Ltd. has appointed 8 directors. In such case, X Ltd. and Y Ltd. are deemed associated enterprises.
6.Appointment of majority directors of two different enterprises by same persons	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. Example: Mr. A appointed 9 directors out of 15 directors of X Ltd. and appointed 2 executive directors on the board of Y Ltd. In such case, since a common person i.e. Mr. A appointed more than half of the directors in X Ltd. and appointed 2 executive directors in Y Ltd., both X Ltd. and Y Ltd. are deemed associated enterprises.

Associated Enterprise [Section 92A]

7.Dependence on intangible	The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent (i.e. 100%) on the 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 entity is the owner or in respect of which the other enterprise has exclusive rights.
8.Dependence on raw material supplied by other enterprise	90% or more of raw materials and consumables required for the manufacture or processing of goods or articles or business carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, where the prices and other conditions relating to the supply are influenced by such other enterprise.
9.Dependence on sale	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
10.Control by common individual	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 his relatives. Example: Mr. A and Mr. B are relatives. Mr. A has control over X Ltd. and Mr. B has control over Y Ltd. Therefore, both X Ltd. and Y Ltd. will be deemed associated enterprises.

Associated Enterprise [Section 92A]

11. Control by Hindu Undivided Family or member thereof	Where one enterprise is controlled by a Hindu undivided family (HUF) and the other enterprise is controlled by a member of such HUF or by relative of a member of such HUF or jointly by such member and his relative.
12.Interest in a firm, association of persons or body of individuals	Where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds 10% or more interest in firm/AOPs/BOIs.

★ **Control” means that an individual, either himself or along with his relatives has the power to make major decisions regarding the management of both the enterprises. “Relative” u/s 2(41): means spouse, brother, sister or any lineal ascendant or descendant of that individual.**

Interplay between Section 92A(1) & 92A(2)

- Criterion under Section 92A(1) & (2) needs to be satisfied for establishing the AE relationship. However, there are divergent views on relationship of the two sections; whether the two sections are mutually exclusive or harmonious.
- Divergent views arise in different judicial rulings

Kaybee Pvt Ltd.

Section 92A(1) – Satisfied

Section 92A(2) – Not satisfied

Section 92A(1) cannot be applied on stand alone basis and has to be essentially considered in conjunction of section 92A(2)

Diageo India Pvt Ltd.

Section 92A(1) – Satisfied

Section 92A(2)– Satisfied

Basic rule of de-facto control satisfied, hence the entity is said to be controlled by the other entity & hence the two entities are **regarded** as AEs

De-facto control

Page Industry Ltd. & Veer Gems

Section 92A(1) –Satisfied

Section 92A(2) – Not Satisfied

92A(1) and (2) have to be read together

Orchid Pharma Ltd.

Section 92A(1) – Not Satisfied

Section 92A(2)(i) – Not Satisfied

Conclusion from all the above rulings is that *de-facto* control needs to exist to create AE relationship

International Transaction [Section 92B]

Section 92F(v): Transaction Arrangement/understanding/action in concert whether or not:

- ➔ In writing
- ➔ Enforceable by legal proceeding

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- Between 2 Or More Associated Enterprises[Sec.92AA]
- One Or Both AE should be Non-Resident

Nature of transaction

- Purchase/sale/lease of tangible/intangible property
- Provision of services
- Lending/ Borrowing of money
- Allocation/ Apportionment of/contribution to any cost/expense

International Transaction [Section 92B]

International Transaction shall include:

- ➔ Capital financing, borrowing, guarantee, sale/purchase of marketable securities/receivable & advances/ debt arising in course of business.
- ➔ 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.
- ➔ Transaction between foreign head office and indian branch or permanent establishment shall be international transaction.
- ➔ Further, if a transaction has effect on profits/losses/assets of enterprise, such transaction shall be classified under international transaction.
- ➔ However, it is pertinent to note that business restructuring transaction would get classified as international transaction even if does not have any bearing on profits/losses/assets of enterprise.

AMP whether an International Transaction?

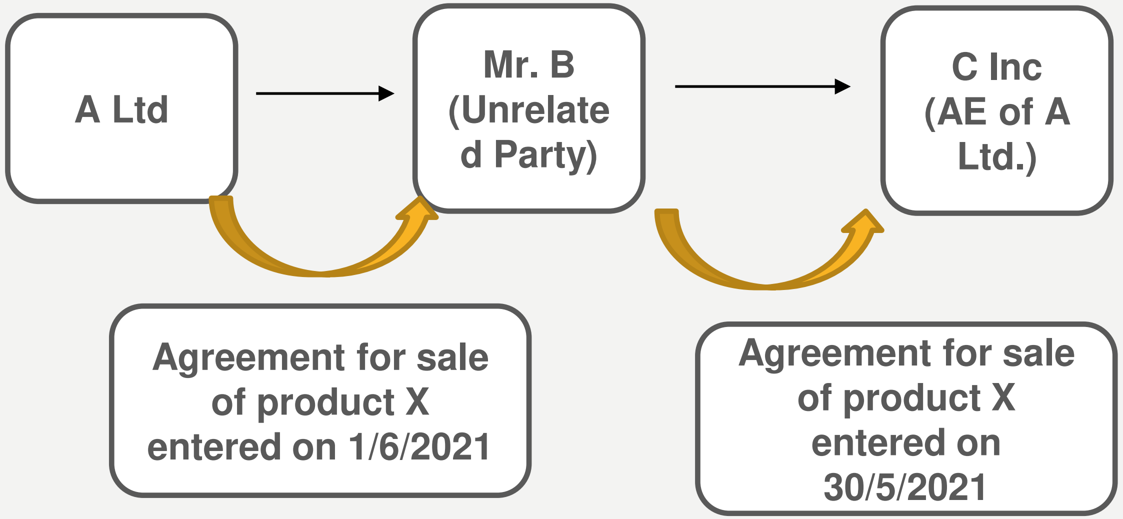
- Licensed manufacturers or distributors, often incur advertising, marketing and promotional expenditure (AMP expenditure) to sell their products in the local market. These products typically carry the brand or trademark which is legally owned by a group company outside India.
- The Indian tax authorities have been of the view that such Indian affiliates need to be compensated for intangibles created through excessive AMP expenditure, and for the situation where they bear risks and perform functions beyond what an independent distributor with similar profile would incur or perform.
- This has been alleged on the premise that excess AMP expenditure above a reasonable level (also called a bright line) tantamount to a service being provided to the group company; and this service being a separate international transaction requires an arm's length compensation.
- Origin of this dispute can be traced back to the United States Tax Court in the case of United States v. DHL Corporation
- From Indian context, Delhi HC in Maruti Suzuki India Ltd. v. Additional Commissioner of Income Tax [(2010) 328 ITR 210] held that Advertisement, Marketing and Promoting Expenses will be considered as an international transaction only in cases where it exceeds the costs and expenses that have been incurred by comparable domestic entities which are similarly situated.
- Special Bench in LG Electronics India Pvt. Ltd. v Assistant Commissioner of Income Tax [(2013) 140 ITD 41 (Delhi) (SB)] held that the AO can make adjusting using bright line test
  - line drawn within the total expenditure for the purposes of AMP which signified the average spending for the same purpose by comparable entities and any amount which would exceed the line would be considered as an international transaction which would represent the expenses that were drawn by the domestic entity for the building the brand value of the Foreign Associated Entity’s product.
- Delhi HC in Sony Ericsson Mobile Communications India (P.) Ltd. [2015] 55 taxmann.com 240 (Delhi) held that incurring excessive AMP expense is an international transaction u/s 92B
- However, Court rejected the application for the Bright line test in determining the part of the expenses towards AMP that would be considered as an international transaction.
  - Bright Line Test did not have legislative or statutory backing and thus the precedent in LG Electronics was overruled

Corporate Guarantee whether an international transaction?

- Corporate guarantees, an important part of intra-group financing, may help a subsidiary secure a loan or a specific contract at favorable terms and conditions (e.g., lower interest rate on a loan or lower reserve requirement for a higher risk project)
- Corporate guarantees were eventually included within international transactions by retrospectively inserting an explanation to the section pursuant to Finance Act, 2012.
- The explanation to Section 92B explicitly mention that the expression "international transaction" shall include-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
- In the case of Videocon Industries Ltd. v. Addl. CIT, ITAT has held since corporate guarantees do not result in any profit, losses, income, losses or assets to the AE, they should not be treated as international transaction.
- Micro Ink Ltd. v. Addl. CIT [2015] 63 taxmann.com 353/[2016] 157 ITD 132 (Ahd. - Trib.) where going by the OECD Guidance, the Tribunal felt that the corporateguarantees issued by the assessee were not in the nature of 'provision for services' and but rather a shareholder activity which are mutually exclusive in nature.
- In Asstt. CIT v. Nimbus Communications Ltd., the Tribunal concluded that a financial loan guarantee is a commitment entered into by the assessee-company with a third party lender of its AE which obliges the assessee-company to cover the risk of default by its AE and this act thus involves performance or carrying out of service to cover the risk of default for which "price" has to be charged.

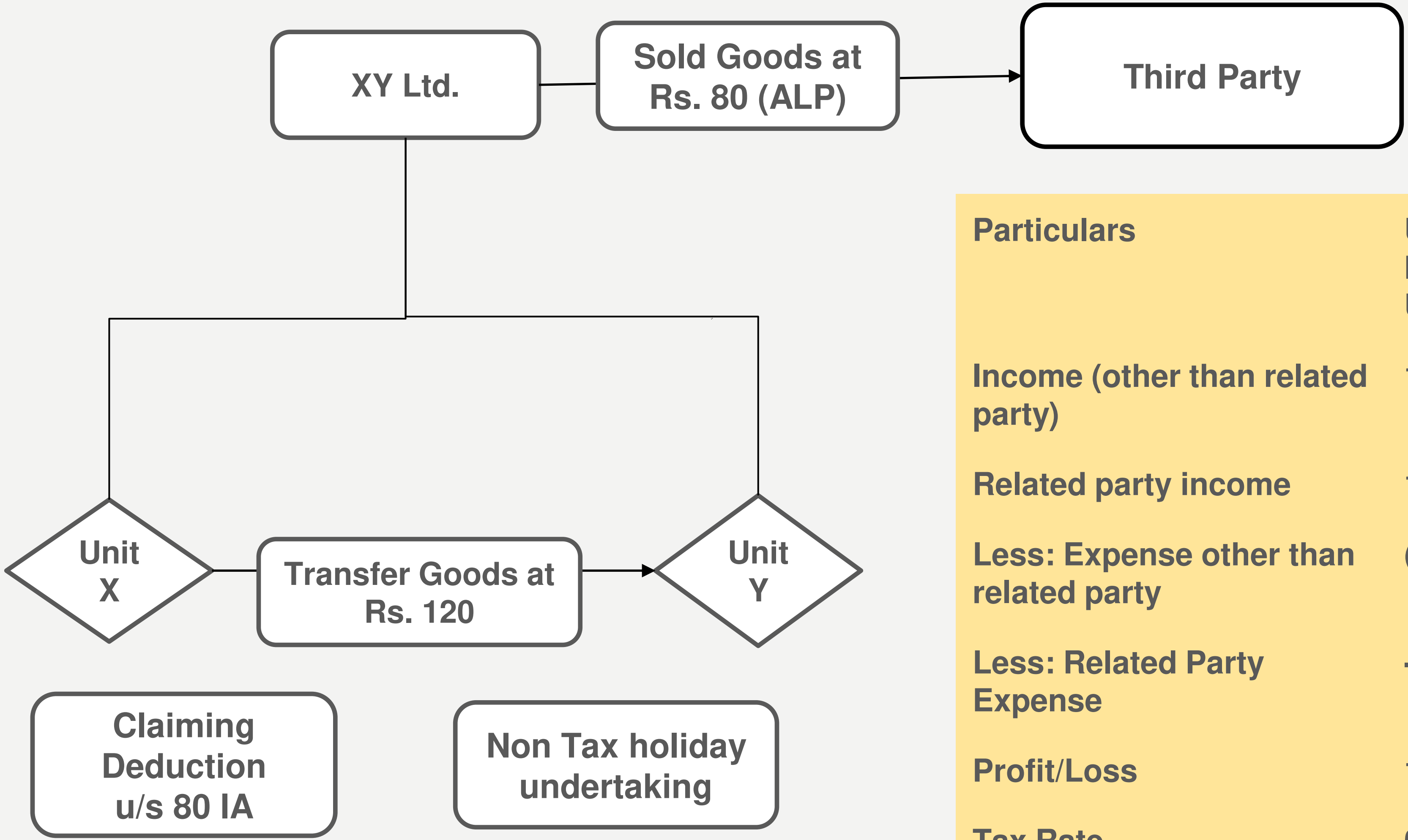
Deemed International Transaction [Section 92B]

- A transaction with an unrelated company (resident or non-resident) is deemed to be an international transaction and subject to transfer pricing regulations if
  - a **prior agreement** exists between A's AE and unrelated party in relation to services rendered by A to the 3rd party; or
  - **terms of transaction** are determined in substance by A's AE and 3rd party
- Amendment in Finance Act, 2014.



Transaction between A Ltd. and Mr. B is deemed to be an International transaction between AEs, whether or not Mr. B is a non-resident

Specified Domestic Transaction [Section 92BA]



Particulars	Unit X (Tax Holiday Undertaking)	Unit(Non-tax Holiday Undertaking
Income (other than related party)	100	250
Related party income	120	
Less: Expense other than related party	(50)	(60)
Less: Related Party Expense	-	(120)
Profit/Loss	170	70
Tax Rate	0%	30%
Tax Payable	Nil	21

Specified Domestic Transaction [Section 92BA]

- It can be seen that the profits are shifted from a non-tax holiday undertaking to undertaking claiming deductions. To prevent this avoidance of tax, specified domestic transactions have been brought into scope of Transfer Pricing.

Coverage of Specified Domestic Transaction:

Undertaking claiming profit linked deduction

- **Business transacted between company opting for Sec. 115BAB and person with whom company has close connection**
- **Interunit transfer of goods/ services [Sec 80 IA(8)]**
- **Transactions with entities having close connection & generating more than ordinary profits [Sec 80 IA(10)]**
- **Transaction to which Sec 80A, Chapter VIA or Sec 10AA, Sec 35AD applies**

If aggregate value exceeds Rs. 20 Crores

Arm’s Length Price

- ❑ The Arm’s Length Principle is explained in the OECD Model Tax Convention. ALP principle is needed in order to arrive at the proper transfer pricing range between associated enterprises. The ALP seeks to adjust the profits between two associated enterprises by comparing the same as if the transaction is carried out between two independent enterprises.
- ❑ Arm's Length Price is defined as a price applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions. [Section 92F(ii)]

Significance Of Arm’s Length Principle

- ❖ Equality between MNCs and independent enterprises
- ❖ Determines real taxable profits
- ❖ Minimization of double taxation
- ❖ Accurate measurement of economic contribution

Difficulties In Application Of ALP

- ❖ True comparison difficult in certain cases
- ❖ Availability of data and reliability of available data
- ❖ Absence of market price
- ❖ Absence of comparable market price for intangible transactions
- ❖ Administrative burden
- ❖ Time lag

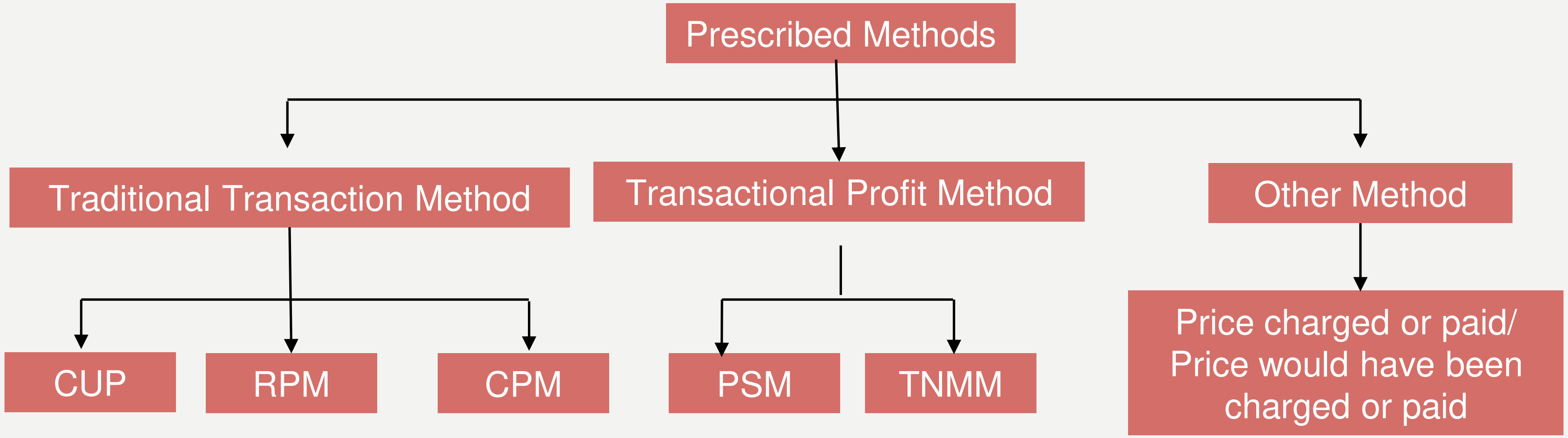
Arm’s Length Price

- **Steps involved in the determination of the ALP:**

- Identification of the “international transaction”
- Functions, Assets and Risks (“FAR”) analysis and characterization
- Selection of Most Appropriate Method – MAM
- Identification of tested party
- Identification of an “uncontrolled transaction”
- Comparability analysis:
  - Identification and comparison of specific characteristics of the two transactions
  - Finding out whether differences, if any, between the two transactions can be reconciled/resolved
  - Ascertaining the most appropriate method
  - Determination of the arm’s length price by applying the method chosen

Methods for computing ALP

- Income Tax Rules prescribes six methods
- **‘Most appropriate method’** to be used to determine ALP



No hierarchy or preference of methods prescribed under the Act

Article 9 of OECD Model – Associated Enterprise

- Key concept of the ‘arm’s length principle’ given expression in Article 9 (1) of the OECD Model on Tax Convention. The relevant extract from the same are mentioned below:

“1. Where

a) *an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*

b) *the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Thanks !

THANKS !

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