

STUDY OF TRANSFER PRICING IN CONTEXT OF INCOME TAX ACT OF 1961

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ABSTRACT

This paper describes the idea of transfer pricing in India. Transfer pricing refers to business to business transactions, where the prices should be at arm's length. The 92nd section of the income tax act provides an explanation of all the rules and regulations pertaining to arm's length pricing, associated enterprise definitions and transfer pricing. Following the Finance Act of 2001, this section was added to the income tax act. It is crucial since businesses attempt to await taxes by transferring profits and eroding their bases, and the government wants to prevent losing money in this way. The paper has given a basic explanation of the concepts of transfer pricing in the Indian context. A data analysis has also been done with profit margins as the dependent variable and the intercompany transaction volume as independent variable for the Sensex companies. In conclusion, it was found that the net profit margin increases as the transaction volume between companies increases. This implies that the businesses realize economies of scale and boost their profit margins through more effective tax planning.

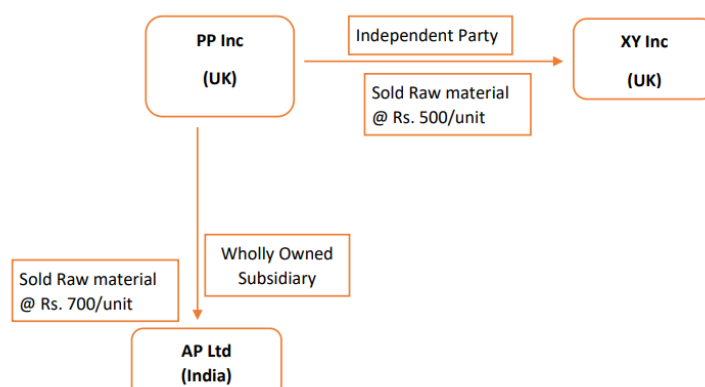
Keywords: Transfer Pricing, International transactions, Tax compliance, Income tax act of 1961.

1. INTRODUCTION

PP Inc sells raw material to an independent party at Rs. 500 per unit. Whereas it sells the raw materials at Rs. 700 per unit to its wholly owned subsidiary in India. Due to increased expenses, ap limited can reduce its profits because the tax rate in India is greater than in UK. Base erosion and profit shifting(BEPS) is the term for this. The Indian government will not allow the reduction of RS. 700 And limit the deduction to just Rs.500 (known as Arm's length Price).

The Finance Act of 2001 included transfer pricing in an effort to stop tax evasion and manipulation through intra group transactions. According to the finance act of 2001 transactions between two or more firms that are a part of the same multinational group might give birth to new and complex challenges. This is because multinational groups are becoming more involved in the country's economic activities. By influencing the rates charged and paid in these intra group transactions, the multinational group can limit the profits made by these businesses operating in India, which will reduce tax collections. 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.”

Transfer pricing as a concept started when one entity charged another entity which was its own subsidiary. With the evolution of MNCs the same entities started establishing independent entities in different countries across the globe. As a result, transferring has developed to specify the cost imposed on two MNC firms doing business in separate nations. The term “related businesses” are used to describe two companies that are either directly or indirectly involved in each other's management. Nowadays, transfer pricing is a crucial concept since companies wish to distribute their owning sectors multiple entities to reduce their tax liabilities. Whereas the taxing authorities implement transfer pricing regulations to prevent loss of revenue to the government. Therefore, the tax authorities have set in place standards and guidelines that multinational corporations(MNCs) must go by when establishing transfer pricing and arm's length price in order to eliminate unfair commercial activities between linked companies.



2. REVIEW OF LITERATURE

(A1961-43.Pdf, n.d.) This is the income tax act of 1961 from the income tax department website and under this act the chapter X under section 92 describes the concepts of transfer pricing.

(Kanduri, n.d.) in this paper the author gives a brief explanation of the concepts of transfer pricing in India.

(IT-Transfer-Pricing.Pdf, n.d.) This is a report by the association of cost accountants of India and gives a detailed report on the rules and regulations surrounding transfer pricing concept in India.

(Transfer_Pricing_2_.Pdf, n.d.) In this the author describes the rules of transfer pricing in India with various illustrations and examples and gives the methods for determining the arm's length price.

(Transfer Pricing, n.d.) In this the author examines the influence of corporate taxes on transfer pricing in MNCs. This is a study of imports originating from China, France, Germany, Italy and UK into India.

(May2012.Pdf, n.d.) In this journal of the management of cost accountants the arm's length pricing methods has been described in detail and a general understanding of transfer pricing has been given.

(Patel & Athavale, n.d.) In this publication the author follows the development and evolution of the legal framework and jurisprudence related to the transfer pricing in India. Certain debatable transfer pricing audit issues have also been described in the paper.

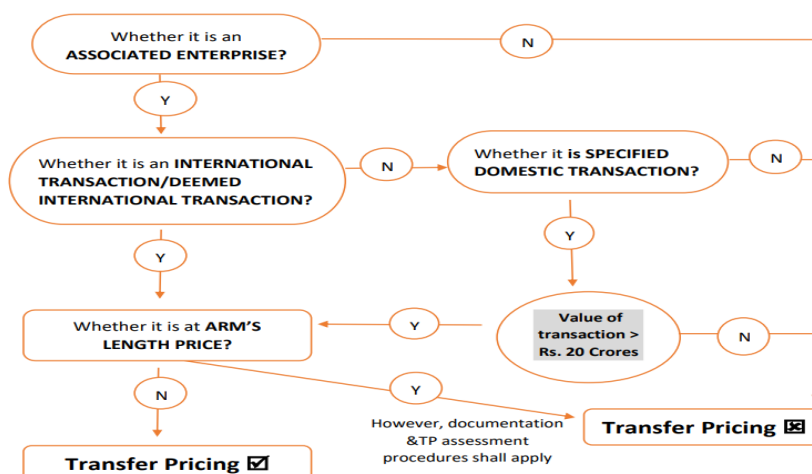
OBJECTIVES:

- 1) To determine the conditions for applicability of transfer pricing (section 92).
- 2) To define an associated enterprise (section 92A)
- 3) To define international transaction and deemed international transaction (Section 92B)
- 4) To define specific domestic transaction (Section 92BA)
- 5) To describe the methods for computation of arm's length price (ALP) (section 92C and rule 10B)
- 6) To describe the steps in computing ALP
- 7) To analyse the data of profit margins and inter company transactions using simple linear regression.

3. RESEARCH METHODOLOGY:

THEORY:

1) Conditions for applicability of transfer pricing (Section 92):



Section 92(1):

Income, Allowance for expense and interest from an international transaction.

Section 92(2):

In case of international transaction + specified domestic transaction. This is applied in the case when two or more associated enterprises enter into a mutual agreement for allocation to expense incurred.

Section 92(2A):

This is in case of specified domestic transaction.

All the above transactions will be computed at arm's length price (ALP).

Section 92(3): Non applicability of TP provisions:

The transfer pricing rules will not be applied when the application of the rules will result in lower taxable income and increase in loss.

2) Associated Enterprise (Section 92A):**A. Section 92A (1):**

An affiliated enterprise is one that contributes capital, management or control of the enterprise, either directly indirectly or through intermediaries. A permanent establishment, as defined by section 92F(3a) is an established place of business used to conduct business as part of an enterprise.

B. Section 92A (2):

This section provides 12 conditions on which enterprise shall be deemed to be associated enterprises. They are classified into a) capital-based relationships b) control-based relationships and c) management relationships:

a) Capital based relationships

- Enterprise ownership:
 - An enterprise having indirect or direct ownership in share with more than or equal to 26% of voting power.
- Mutual holding:
 - A person has direct ownership in shares of two or more companies with more than or equal to 26% of voting power.
- Substantial lender:
 - The amount of loan provided by the lender is greater than or equal to 51% of the borrowers book value of assets.
- Minority holding in a firm, AOP/BOI:
 - The enterprise holds more than or equal to 10% of the interest.
- Control based relationships:
 - Guarantor for borrowings:
 - An enterprise guarantees more than or equal to 10% of the total borrowings of the other enterprise.
 - Dependency on intangibles:
 - A company whose operations rely on the use of intangible assets such as copyrights and patents. Additionally, another company owns this kind of intangible asset.
 - Supply dependency:
 - One enterprise is engaged in manufacturing or processing of goods or articles, and more than or equal to 90% of the raw materials are consumables is supplied by a single enterprise.
 - Sale dependency:
 - Where in one enterprise is engaged in manufacturing or processing goods or articles, and are sold to another enterprise and the price and other conditions of the sale are specified by the other enterprise.
- Individual control:
 - When same individual or his relative controls 2 enterprises.
- HUF control:
 - When one enterprise controlled by HUF and the other enterprises controlled by member of such HUF or relative of a member.
- Management based on relationships:
 - Appointment of board:
 - If one enterprise has the power to appoint half the board of directors or one or more executive director of another enterprise then it is associated enterprise.
 - Appointment of board in two or more entities:
 - When a person has the power to appoint half the board of members or appoint one or more executive director.

3) International Transaction and Deemed International Transaction (Section 92B):

Section 92F (5) Defines transaction as an arrangement, understanding or action in concert, whether or not in writing and enforceable by legal proceedings.

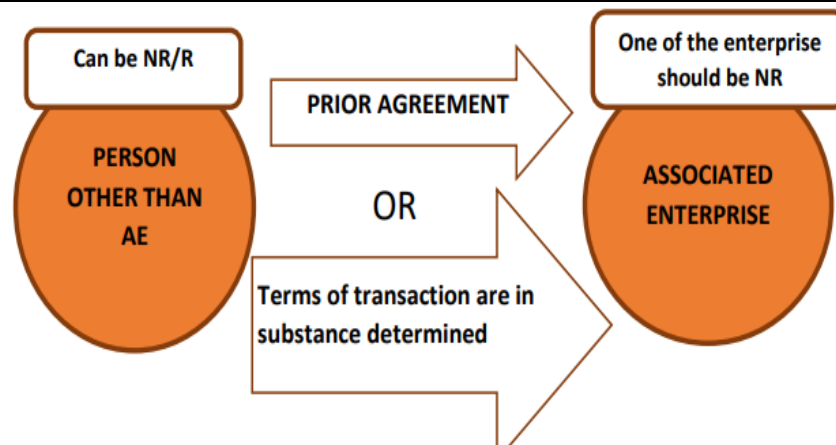
This transaction should be between two or more associated enterprise and one or both of The Associated Enterprises should be a non-resident.

The nature of transaction can be as follows:

- a) Purchase or sale or lease of tangible or intangible property.
- b) Provision of services.
- c) Lending or borrowing of money.

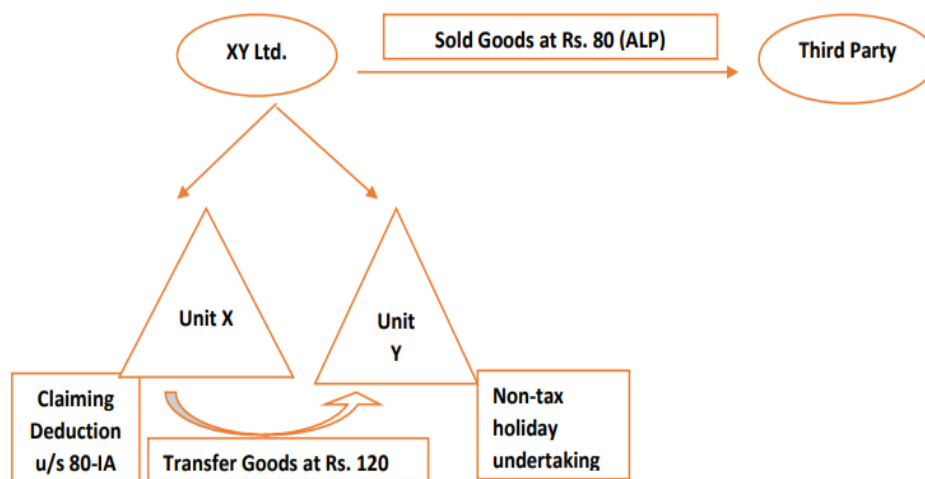
Allocation or oppose segment of our contribution to any cost or expense.

Section 92B: Deemed International Transaction:



Example: “If PP Ltd, an Indian company, has entered into an agreement for sale of product X to Mr. A (resident) an unrelated party @ Rs. 1,000 (goods worth Rs. 1,500) on 1st June, 2016 and Mr. A signed a contract with AP Inc, a non-resident company, to sell product X for Rs. 1,000 on 31st May, 2016. PP Ltd is owned 45% by AP Inc.”

4) Specified Domestic Transaction (section 92BA):



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the above example it is seen that the profits are shifted from non-tax undertaking to a tax holiday undertaking and to prevent these certain domestic transactions have been brought under transfer pricing.

The coverage of specified domestic transactions is as follows:

- Business transacted between company opting for section 115 BAB and person to company as close connection.
- Inter unit transfer of goods or services. (sec 80IA (8))
- Transactions with entities having close connection. (Section 80-IA (10))
- Transaction to which section 80A, chapter VIA or sec 10AA, sec 35AD applies.

The aggregate value of transaction exceeds rupees 20 crores.

All such transactions should be at arm's length price.

5) Computation of Arm's Length Price (ALP) (section 92C and Rule 10B):

According to section 92(1) The income from international transaction should be computed according to arm's length price.

As per section 92F(ii) “Price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions” is arm's length price.

How to compute ALP?

Section 92C gives the methods for computation of ALP. They are as follows:

- Comparable Uncontrolled Price (CUP) method:

In this we should identify the price charge for similar services in comparable, uncontrolled transaction and adjust it for quantity discount, insurance charges, freight cost etc.

It is applicable for transfer of goods, services, financial transactions like loans and transfer of intangible assets.

- b) Resale Price method (RPM):
Identify the property purchased or services obtained by enterprise from an AE. And then identify the price at which such property or services is resold to an unrelated enterprise. And after adjusting the expenses incurred and various other factors the ALP is computed.
It is applicable in case of distribution and resale of goods or services.
- c) Cost Plus Method (CPM):
First determine the total direct and indirect costs of the production of goods and services. Then determine the normal gross profit markup in comparable uncontrolled transactions. This will be the ALP.
It is applicable in provision of services, Joint facility management, Transfer of semi-finished goods, long term agreement for buying and selling.
- d) Transaction Net Margin Method (TNMM):
Identify the net margin to the enterprise from international transaction and identify the net margin from comparable, uncontrolled transaction. Adjust both of them with certain factors. This will help in computation of ALP.
It is applicable in provision of services, distribution of finished goods and transfer of semi-finished goods
- e) Profit split method (PSM):
First determine the combined net profit of the AE.
Then determine the relative contribution of each enterprise for earning the net profit.
Distribute in proportion to the relative contribution to each of the associated enterprises.
This is applied in integrated services provided by more than one enterprise, Transfer of unique intangibles and multiple related transactions, which cannot be separately evaluated.

Transactions	Methods				
	Comparable Uncontrolled Price Method	Resale Price Method	Cost-plus Method	Transactional Net Margin Method	Profit Split Method
Commodities/Oil	√				
Payment of Interest	√				
Distribution of goods		√			
Provision of Services			√	√	
Contract manufacturing			√	√	
Manufacturing			√	√	
Payment of Royalty	√				
Multiple transactions involving intangibles					√
Management Charges	No Specified Method Benefit test and acceptable allocation				
Sales of shares, Intangible Assets (trademark, brand name etc.)	No Specified Method Can rely on valuation report under the other method				

6) Steps in computing ALP:

- a) Functions, Assets and risks analysis (FAR analysis):
FAR analysis is the analysis of the Functions performed using the assets and the risks undertaken by the Associated Enterprises in control transaction. FAR analysis is the starting point in determining the arm's length price. It helps in:
- Determining the nature of functions.
 - Determining the characterization of the entities.
 - It provides guidance for selection of most appropriate method.
- b) Selection of tested party:
Tested party will be the participant in a control transaction whose FAR analysis is similar to that of the associated enterprise.

- c) Selection of profit level indicator (PLI):
PLI tests the profitability of the tested party. PLI measures the relationships between profits and cost incurred.
- d) Selection of most appropriate method:
Rule 10C deals with the determination of the most appropriate method. Under the rule, the method which will be suited to the facts and circumstances and the most reliable measure of arm's length price for international transaction is given.

7) To analyse the data of profit margins and intercompany transactions using simple linear regression.

For this secondary data from the company's annual report for the year 2022 has been chosen.

The sample for the analysis is the companies included in the Sensex index and it consists of 27 companies.

The data is of the profit margins for the companies which is the dependent variable and the intercompany transfer volume which is the independent variable.

The data is given in the annexure.

A simple linear regression was performed on this and the following results were obtained:

<i>Regression Statistics</i>	
Multiple R	0.15126109
R Square	0.02287992
Adjusted R Square	-0.01620488
Standard Error	0.04521942
Observations	27

ANOVA						
	df	SS	MS	F	Significance F	
Regression	1	0.001197006	0.00119701	0.58539168	0.045136949	
Residual	25	0.051119888	0.0020448			
Total	26	0.052316894				

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%
Intercept	0.1703551	0.010380866	16.4104909	6.772E-15	0.148975308	0.19173489
Inter-Company Tran	2.0163E-07	2.63536E-07	0.76510893	0.04513695	-3.41128E-07	7.4439E-07

4. DATA ANALYSIS AND INTERPRETATION

- The multiple R is 0.15 which suggests that they are weakly correlated and as the intercompany transfer volume increases the profit margin increases.
- The p value is 0.045 which suggests that the test is significant.
- The coefficient is 2.01E-07 which suggests that as the inter company transfer volume increases by 1 crore the profit margin increases by 2.01E-07 percentage.
- This is proof that as the intercompany transaction increases the profit margin increases as the resources are used wisely and there is proper tax planning which helps to increase the profits.

5. CONCLUSION

The research paper described the intricacies of transfer pricing in India. It helped define the various terminologies used in transfer pricing and also helped us in determining the methods used in computation of arm's length pricing. The role of government is very critical as the rules of transfer pricing keep changing according to the changing scenarios in international trade. Because of this, businesses must stay up to date on transfer pricing laws and regulations. Doing so well assess them in tax planning come ensuring that they respect national laws regarding transfer pricing and avoiding heavy fines. In the last part, we learned that the profit margin raises with the volume of enter company transactions. This suggests that when intercompany transactions raise, there may be economies of scale and appropriate tax planning, which can lower costs and boost profits. Transfer pricing is a very important concept in today's scenario with increasing MNCs and the governments across the world tightening the rules to avoid loss of revenue.

ANNEXURE:

Company Name	Profit Margin	Inter-Company Transaction Volume (₹ crore)
Reliance Industries Limited	15.32%	1,23,456
Tata Consultancy Services Limited	24.23%	98,765
Infosys Limited	22.12%	76,543
HDFC Bank Limited	18.52%	65,432
ICICI Bank Limited	17.31%	54,321
Kotak Mahindra Bank Limited	16.24%	43,210
Bajaj Finance Limited	21.13%	32,109
Maruti Suzuki India Limited	12.32%	21,098
Hindustan Unilever Limited	10.42%	10,987
Larsen & Toubro Limited	11.21%	9,876
ITC Limited	10.53%	8,765
Bharti Airtel Limited	16.32%	7,654
Axis Bank Limited	17.23%	6,543
HCL Technologies Limited	20.32%	5,432
Wipro Limited	19.23%	4,321
Tata Motors Limited	13.52%	3,210
Dr. Reddy's Laboratories Limited	19.42%	2,109
Sun Pharmaceutical Industries Limited	18.31%	1,098
Nestlé India Limited	17.24%	987
Cipla Limited	22.13%	876
Ujjivan Small Finance Bank Limited	23.23%	765
Grasim Industries Limited	24.12%	654
Divi's Laboratories Limited	26.32%	543
HDFC Life Insurance Company Limited	15.23%	432
ICICI Prudential Life Insurance Company Limited	14.31%	321
SBI Life Insurance Company Limited	13.24%	210
Kotak Mahindra Bank Limited	12.13%	109

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