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Issues Involving Transfer Pricing in India

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ABSTRACT

The global business landscape is dominated by multinational enterprises (MNEs) with intricate networks of subsidiaries operating across borders. This interconnectedness presents a unique challenge as how to determine the appropriate price for goods and services exchanged internally between these affiliated entities. This is where the concept of transfer pricing comes into play.

Transfer pricing refers to the process of establishing prices for transactions between related parties under common control. Unlike typical market transactions, these internal transfers lack the arm's length principle, where unrelated buyers and sellers negotiate a fair price based on market forces.The revenue of both parties to a cross-border transaction is ascertained via transfer pricing. Therefore, the tax bases of the nations involved in cross-border transactions tend to be shaped by the transfer price. In business economics, a transfer price is defined as the price that one division of an organization charges another division of the same organization for a good or service that the former division provides. Recognizing the potential for profit shifting, governments around the world have implemented transfer pricing regulations based on the OECD's arm's length principle. Tax authorities closely scrutinize transfer pricing practices to ensure compliance and collect their fair share of tax revenue. This has led to increased international cooperation and efforts to establish standardized transfer pricing guidelines.

Keywords*: transfer pricing, cross border transaction, arm's length principle, BEPS.*

I. INTRODUCTION

The term Transfer Price is defined under section 92CE of the Income-Tax Act, 1961[2]. The term transfer pricing is used as part of the definition of Transfer Pricing Officer as mentioned under section 92CA. Despite appearing with significant importance, these two terms lack elaborate definitions under the Act. In a transaction involving related entities that belong to the same Multi National Enterprises (MNE) group, the transfer price is the actual amount paid between the transaction. Countries have different tax rates. Therefore, a MNE group has an incentive to determine transfer prices for transactions among its members so as to minimize the group's overall tax liability. In order to do this, transfer prices must be set so that less earnings are

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[2] 92CE of the Income-Tax Act, 1961 - Secondary adjustment in certain cases.

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booked in nations with higher tax rates.

For example, consider a group corporation that produces goods in a nation with high taxation. The business would thus take them to nations that impose taxes at a much lower rate or no tax at all for profit. These tax rates would have been exorbitantly high had they done the business from their source country at arm's length principle. Moving to a tax haven therefore provides a convenient route with less tax burden. In most of the cases, transfer pricing, is used by multinational enterprises to evade taxes by adjusting the transfer prices of intragroup transactions to a lesser number.

II. Applicability of transfer pricing

Many MNEs have emerged as a result of quick developments in field of technology, communication, and logistics. MNEs are able to locate their businesses and operations anywhere in the world. Additionally, a rapidly increasing percentage of an MNE's commercial interactions comprise intangibles and multi-tiered services, which has substantially raised the complexity of analyzing and comprehending such transactions.

The reality is that a sizable portion of today's global trade consists of cross-border transfers of capital, or money, intangibles, or intellectual property, and products and services within a multinational enterprise group, these transfers are referred to as intra-group transactions. Transfer pricing fixes the price of goods and services interchanged between related parties, such as subsidiaries falling under the same parent company. It serves as an important tool for tax purposes, as it has a direct impact on the allocation of income and expenses of different jurisdictions. In India, Arm's Length Principle (ALP) is used to determine transfer pricing. Arm's Length Principle means the price of transaction of a relatively same party should be comparable to the price of similar transaction between independent parties.

III. Working mechanism of transfer pricing

The economic rationale for linked entities subject to transfer pricing on intra-group trade is to assess each member of a multinational group's performance on independent basis. In a business transaction, buyers and sellers behave independently of one another without any influence from the other, according to the arm's length principle Within a multinational corporation group, various companies operate and they function as distinct profit centers, and the profitability of each entity is ascertained through transfer pricing. A rational entity would only allow purchase of goods or services from a related entity if the price was the same as, or less than, what unrelated suppliers were charging for the same goods or services. This is in the interest of an independent legal entity. It is a fundamental idea in international taxes that guarantees related

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party transactions are carried out at fair market value. The goal of the idea is to shield taxpayers from tax evasion and maintain fairness in the marketplace. The arm's length principle is predicated on the notion that unrelated parties will bargain for a transaction's terms and conditions in a way that takes into account their different risks and economic interests. Applying the arm's length principle, different transfer pricing techniques under section 92C (1) of the Income-Tax Act, 1961[3], can be used to calculate the arm's length price, with the techniques chosen based on which ones are most appropriate for the parties engaged in a given transaction.

IV. TRADITIONAL METHODS OF TRANSFER PRICING

1. Comparable Uncontrolled Price Method

Comparing the terms and prices of goods or services in a controlled transaction with those of an uncontrolled transaction involving unrelated parties is known as the Comparable Uncontrolled Pricing (CUP) technique. Comparable data are needed for the CUP technique to perform this comparison. The uncontrolled transaction must satisfy strict comparison requirements in order to be regarded as a similar pricing. Put another way, under this approach, transactions cannot be deemed comparable unless they are strikingly similar. Using this method, the price charged in an uncontrolled transaction between independent parties under similar conditions is compared to the price charged in a related party regulated transaction. It is the exchange price for nearly equal or identical property made by two independent parties in a situation that is either the same or comparable. When there is a high level of comparability between the markets and the transactions, this strategy is preferred.

According to OECD, this approach is regarded as the safest and most dependable method for incorporating the arm's length concept into a regulated transaction system. CUP approach is most commonly applied when a sizable quantity of data is available for comparison.

2. Resale Price Method

The selling price, also referred to as the resale price, of a good or service is used in the resale price method (RPM). The gross margin, which is calculated by contrasting the gross margins in comparable transactions conducted by similar but unrelated firms, is then applied to minimize this amount. After then, the total is reduced by the expenses related to buying the commodity, such as customs charges. The total is regarded as the arm's length price for a regulated transaction between connected businesses. Because third-party selling prices may be

[3] section 92C (1) of the Income-Tax Act, 1961 – Computation of Arm's Length Price.

very straightforward to find, the resale price approach can be a highly effective way to establish transfer prices when properly comparable transactions are available. But the resale price approach needs to be compared with similar economic conditions and bookkeeping practices. It is exceedingly challenging to match the requirements of the resale pricing technique due to the uniqueness of each transaction.

3. The Cost Plus Method

The gross profits of a business are compared to the total cost of sales to determine how the cost-plus method (CPLM) operates. The first step is to calculate the supplier's expenses in a regulated transaction between related businesses. Then, to provide for a suitable profit, a market-based markup in cost plus is applied to the total. A business must determine the markup charges for comparable transactions between unrelated firms in order to apply the cost-plus approach. Assessment of transfer pricing for regular, low-risk activities, such as the production of tangible items, is greatly aided by the cost-plus method. This approach is simple to comprehend and easy to apply for a lot of firms. A drawback of the cost-plus method is the lack of accounting consistency and comparable data availability.

4. The Comparable Profits Method

By examining the net profit of a regulated transaction between related businesses, the comparable profits technique (CPM), often referred to as the transactional net margin method (TNMM), assists in determining transfer pricing. The net earnings in similar uncontrolled transactions of independent businesses are then contrasted with this net profit. The most popular and widely applicable kind of transfer pricing mechanism is the CPM. Benefit-wise, the CPM is quite simple to apply because it just needs financial data. Since it is easy to obtain comparable data, this approach works quite well for product makers with relatively simple transactions. The CPM is a one-sided approach that frequently disregards transaction counterparty information. Tax authorities are likely to adopt the stance that enterprises with complicated business models, like high-tech firms possessing intellectual property, are not a good fit for the CPM. Using data from businesses that don't adhere to the OECD's comparability requirements exposes enterprises to audit risk.

5. The Profit Split Method

Associated companies can participate in interrelated transactions, which make it impossible to observe them separately. For instance, the profit split method (PSM) might be employed by two businesses that are part of the same brand. Usually, the affiliated businesses concur to divide the earnings, which is where the profit split approach is useful. By calculating the profit

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sharing between third parties involved in similar transactions, this method looks at the terms and conditions of connected, controlled transactions. The PSM's ability to see profit distribution holistically as opposed to transactionally is one of its key advantages. This may contribute to a more thorough and precise evaluation of the business's financial performance. This is particularly helpful when handling intangible assets, like intellectual property, or when several controlled transactions are taking place at once.

But because it only applies to highly connected firms that equally provide value and assume risk, the PSM is frequently viewed as a last alternative. This method has a higher chance of being contested by the relevant tax authorities as a non-arm's length outcome due to the highly subjective nature of the profit allocation criteria.

V. (TNMM) Transactional Net Margin Method

In an uncontrolled transaction between independent parties, this method compares the net profit margin earned by a comparable party under similar circumstances, to that of a tested party in a regulated transaction between linked parties. When several transactions need to be aggregated or comparability at the transaction level is required, this method can be helpful.

1. Issues Causing Transfer Pricing

The multinational organization as a whole and the tax authorities of the two participating nations are the three parties in any cross-border tax scenario. The tax base of the other nation is impacted when an MNE group unit is subject to taxation by one nation's tax authority. Stated differently, cross-border tax scenarios entail matters pertaining to jurisdiction, allocation, and valuation.

2. Issues With Respect To Jurisdiction

In the event that two governments assert an identical right, which one should tax the MNE's income, is the main issue of transfer pricing. In the situation that the tax base is derived from many countries, should one of the governments provide tax relief to avoid taxing the income of the MNE twice. These are a few of the jurisdictional problems that come up in cross-border business.

The potential for transfer pricing manipulation is a further aspect of the jurisdictional problem, since certain multinational enterprises engage in activities aimed at lowering their overall tax obligations. This could entail using transfer pricing to move profits in order to lower a multinational group's overall tax burden. It should be acknowledged that, while it may play a significant role in an international business's decision to set transfer prices for intra-group

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transactions, tax reduction is not the sole element influencing an international business's transfer pricing policies and practices.

By shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under charging or over charging the associated entity for intra-group trade, the goal in such cases is typically to reduce a multinational group's worldwide taxation. Maximizing an international business's after-tax profitability is the end goal. For instance, if an international business has a 30% tax rate in its home nation and a 20% tax rate for its subsidiary entity located in a different nation, the parent company would be enticed to transfer profits to the subsidiary in order to lower its 30% tax rate on these amounts to 20%. The parent business will save $10 million in taxes if it transfers $100 million in taxable profits to its subsidiary. This could be accomplished if the parent pays too much for the goods and services it purchases from its subsidiary.

A multinational corporation may be motivated to minimize its worldwide taxes, but there are other reasons as well, like benefits from imputation taxes in the parent company's home country, that could encourage the manipulation of transfer pricing. A multinational business may also take such actions in order to take advantage of tax benefits, such tax losses, in the countries in which it conducts business. This could be a loss incurred in the current year or one that an affiliated company has carried over from a previous year. When tax losses can only be carried forward for a limited number of years, a foreign business may want to benefit from the losses before they expire through an affiliated company. The multinational corporation has an incentive to use the losses as soon as possible even if there are no limitations on carrying forward tax losses by an affiliated firm. To put it another way, profits may occasionally be moved to particular nations in order to take advantage of particular tax advantages.

To put it succinctly, foreign taxation, particularly when it comes to transfer pricing, raises a number of difficulties whose complexity and scope can be particularly intimidating for smaller governments.

3. Allocation Issues

MNEs are multinational organizations that share overhead and resources. These resources must be distributed as efficiently and optimally as possible from the standpoint of the MNE.

According to the government, in order to determine the tax, the distribution of expenses and revenue from MNE resources must be taken into consideration. Sometimes, nations have a tendency to engage in a competition over the distribution of expenses and resources with the goal of maximizing the tax bases inside their own nation states. From the multinational

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enterprise's point of view, trade or tax barriers in the nations in which it conducts business increase the MNE's transaction costs and cause distortions in the distribution of resources. Moreover, for taxation purposes, a lot of the shared resources that provide multinational enterprises a competitive edge cannot be separated from their overall revenue, this is particularly true for intangibles and intra-group transactions pertaining to services.

4. Valuation Issues

It is insufficient to just assign income and expenses to one or more MNE group members, the income and expenses also need to be appraised. This brings us immediately to the valuation of intra-firm transfers, a crucial problem in transfer pricing. The transfer prices inside the group are unlikely to be the same as the prices unconnected parties would negotiate, as the MNE is an integrated entity that may take advantage of economies of integration and international differentials that are not available to domestic enterprises.

More generally, there appears to occasionally be a conflict between the MNEs' shared objectives and the nation's overarching economic and social objectives. This is due to the fact that businesses are frequently viewed as having a responsibility to use their resources to maximize profits while abiding by the law. This appears to occasionally be at odds with national social, economic, and political considerations. It is evident that foreign taxes is an unresolved issue at its core, with transfer pricing at the center due to the numerous intricate factors involved. To put it briefly, countries need transfer pricing legislation to safeguard their tax bases, get rid of double taxation, and promote international trade. Transfer pricing policies must be precise in order to protect developing nations from missing out on vital tax revenue while simultaneously creating an environment of predictability and greater cross-border trade.

VI. Risks involved in transfer pricing

Transfer pricing gives rise to the following risks:

- Possibility of disputes between various departments or businesses within a group that have performance metrics
- Risk of fines, litigation with income tax authorities, or double taxation.
- A control framework is necessary for transfer pricing risk management in order to effectively organize, classify, and manage risks and controls.
- Strong tax governance and a decided-upon transfer pricing strategy based on transfer pricing procedures and controls, in line with internal tax policy, are also necessary for transfer pricing risk management.

- Financial controls and technological tools should be used in transfer pricing risk management to streamline and automate procedures and track results.

VII. STEPS TO MINIMISE TRANSFER PRICING

- **By encouraging intra group treaties**

As the foundation for all transfer pricing analyses, written intra-group agreements have grown in significance. A straightforward method of binding the relevant group firms and, if needed, informing the tax authorities of the conditions of any intra-group relationships is to put important terms in writing in a signed agreement. Nonetheless, the written agreements serve a purpose only if they are followed and remain current. As a result, businesses should periodically check the terms of their intra-group agreements and revise them as needed to reflect any modifications to intra-group transactions.

- **By monitoring the results if they fulfill the inter-quartile range:**

Businesses commit to using transfer pricing strategies that follow the arm's length concept. A great deal of work goes into creating, or at least drafting, transfer pricing documentation that includes a detailed description of the group's operations, the roles, assets, and risks of its group entities, as well as the conditions of related party transactions. This is insufficient, though, as transfer prices ought to be reasonable. In order to achieve this, the examined group companies' actual results or their intra-group transactions must be at arm's length levels, meaning that in reality they should fall within the benchmark studies' inter-quartile ranges. To truly achieve the arm's length results, companies need make the required year-end adjustments or true-ups to the transfer pricing.

- **By identifying tangibles:**

For the purpose of transfer pricing, intangibles are broadly defined. Trade secrets, know-how, and other intangible assets that can be controlled and have value that is, ones that would not be revealed to a rival or a third party without compensation as well as registered intangible assets and intangibles recognized for accounting purposes are also considered intangibles for transfer pricing purposes. For instance, sharing best practices typically doesn't require separate pay because the advantages to group companies are proportionate to their contributions to the group's overall welfare. However, in order to prevent needless and onerous inquiries from the tax authorities, all intangibles should be correctly identified and thoroughly documented.

- **Charging interest on delayed payments**

Aside from charging arm's length interest on intragroup loans, other financial transactions

involving transfer pricing require that other items meet certain requirements, such as trade receivables and accounts payable. Group firms must be assessed interest on late payments if it is levied against third-party clients. The non-charged interest income or unpaid interest expenses are not deducted from the transfer pricing adjustments on goods or services, even though limited risk entities typically earn a guaranteed return. This is because financial income and expenses are reported below the operating profit level for accounting purposes, which is important when it comes to product pricing. Businesses should keep an eye on the amount of trade receivables from sales inside the group and think about adding interest to late payments.

VIII. Conclusion

Transfer pricing plays a critical role in ensuring fair and transparent allocation of profits among related entities operating in different tax jurisdictions. By adhering to arm's length principles, multinational corporations can achieve compliance with tax regulations and prevent artificial shifting of profits to low-tax countries. This fosters a level playing field for all businesses and generates a stable tax base for governments. While navigating the complexities of transfer pricing, it's important to remember its role as a management tool. By strategically setting transfer prices, companies can optimize resource allocation, incentivize desired behaviour within subsidiaries, and secure a steady supply chain within the group. Finding the right balance between tax efficiency and business objectives is key to maximizing overall group profitability. transfer pricing is a multifaceted practice with significant implications for MNEs. It requires a careful balancing act between tax efficiency, operational effectiveness, and adherence to international regulations. Understanding the methods, benefits, risks, and regulatory landscape of transfer pricing allows MNEs to navigate this complex area with greater confidence and transparency.

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