Transfer Pricing

Outline of Provisons

- Section 92:
- - “Any income arising”
- - “International transaction” (or “specified domestic transaction”) between “associated enterprises”
- - “arm’s length price”

Rationale

- Part of Chapter X: “Special Provisions Relating to Avoidance of Tax”
- Particularly intended to combat erosion of tax base from shifting profits from a high-tax to a low-tax jurisdiction by arrangements between associated enterprises
- Such base erosion sought to be tackled by considering the “arms’ length price”, i.e. the price at which the relevant transaction would be carried on by unrelated parties

Illustration: Inbound

- Suppose that X Inc. (USA) has subsidiary X India P. Ltd. (India)
- X Inc. manufactures engines at cost of $100; and sells in the market generally at $125. On each market sale, X has profit of $25.
- But: X India P. Ltd. purchases the engines at $150. Now, the X Inc. Will generate greater profits on intra-group sales; but X India will claim higher expenditures (resulting in income of X India decreasing)

Illustration: Outbound

- Conversely, X India develops a software product and licenses it to third parties at Rs. 100000. But it licenses the same software to X Inc. for Rs. 90000. X Inc may then in turn license the same to third parties for Rs. 100000: X Inc. thus makes profits
- Here, X India is not claiming a higher expenditure but it foregoing income which it ordinarily could have earned

Erosion of base

- In both the situations; result is that the Indian tax base is affected (either because X India has higher expenditures; or because X India does not earn full income)
- Cardinal principle of tax law: it is for the businessperson to arrange affairs according to their commercial wisdom; income tax is a tax on real income; income tax applies to income which has actually been earned and not income which could possible have been earned (*CIT v. Raman & Co.* etc.)

Erosion of base

- But, particularly when there are transactions within the same group between companies in different jurisdictions / where different rates of tax may apply:
- Opportunities for companies/groups to engage in tax arbitrage; which can result in erosion of tax base due to artificial shifting of profits between group entities

Arm's length price

- Arm's Length price as an antidote: s. 92F r.w.s. 92C
- Arm's length price is substituted for the actual price of the transaction
- But danger that determination of ALP becomes an exercise of guesswork/surmises: hence, specific methods provided and the most appropriate method must be followed based on the circumstances of the case (s. 92C read with Rules 10AB and 10B).

Illustrative Methods: CUP/TNMM

- Comparable Uncontrolled Price: comparison with comparable uncontrolled transaction in comparable circumstances. *What is "comparable" traqnsaction?*
- Transactional net margin method: Examination of net profit against appropriate base (rather than the price itself); and comparison with the profit level of comparable entities. *What is the appropriate manner of computing profit: should the base be gross turnover, or operating costs, etc? What entities are "comparable"?*

Application

- If on comparability analysis, it is found that X India ought to have paid only $125 for the engines; the actual expenses of $150 incurred by X India may be disallowed. However, the full expenses cannot be disallowed: adjustment only to the extent necessary to reflect the arm's length price (i.e. $25 expenses)
- So too, if X India is found to have charged only Rs. 90,000 when in comparable uncontrolled transaction it was charging Rs. 100,000, then addition of Rs. 10000 (difference between actual and arm's length) may be made

Scope for subjectivity

- Inherently a fact-intensive exercise; but involves hypothetical considerations and comparisons, and reasonable minds may differ on interpretations of hypothetical facts
- Scope for subjectivity: will always be difficult for assessee to justify the price it has charged with mathematical precision; and tax authorities may seek to interfere in the commercial wisdom of assessees.
- Hence, important to keep in mind safeguards

Safeguards

- There must be chargeable income from an international / specified domestic transaction in the first place (Bombay HC in *Shell*)
- Transfer pricing should not be taken to override commercial decisions of parties: transfer pricing additions should not become a tool for discouraging legitimate commercial transactions (Delhi HC in *CIT v. EKL Appliances*)

Safeguards

- Once assessee indicates how it has carried on its comparability analysis (through the documentation/study reports etc.), onus is on Revenue to show why assesee's comparability analysis is wrong; and further, to determine the appropriate arm's length price by one of the methods. In comparability analysis, Revenue must keep in mind the nature of the assessee's business and legitimate commercial considerations. Cannot simply disallow entire expenditure without this analysis

Safeguards

- Procedural safeguards equally important: procidure requires a draft assessment order, appropriate references to transfer pricing officers etc.
- In appropriate cases, when *ex facie* proceedings are without jurisdiction (eg., when demonstrably no income at all has arisen and there is no relevant international transaction at all), the reference to TPO itself may be amenable to challenge in writ jurisdiction.