CHAPTER-III
Transfer Pricing regulations and Indian Rules on Transfer pricing
CHAPTER 3

3.01. Introduction

The origin of the word “Tax” is from “Taxation” which means an estimate. These were levied either on the sale and purchase of merchandise or livestock and were collected in a haphazard manner from time to time. In India the system of direct taxation as it is known today, has been in force in one form or another since ancient times. There are references both in ManuSmriti and Arthasastra to a variety of tax measures. Manu, the ancient sage and law-giver stated that the king could levy taxes, according to Sastras. The wise sage advised that taxes should be related to the income and expenditure of the subject. He however, cautioned the king against excessive taxation and stated that both extremes should be avoided namely either complete absence of taxes or exorbitant taxation. According to him, the King should arrange the collection of taxes in such a manner that the subjects did not feel the pinch of paying taxes.

It is Kautilya’s Arthasastra, which deals with the system of taxation in a real elaborate and planned manner. A major portion of the Arthasastra is devoted by Kautilya to financial matters including financial administration. Kautilya described in detail, the trade and commerce carried on with foreign countries and the active interest of the Mauryan Empire to promote such trade. Goods were imported from China, Ceylon and other countries and levy known as avaranam was collected on all foreign commodities imported in the country. During that period collection of Income-tax was well organized and it constituted a major part of the revenue of the State. According to Kautilya’s Arthasastra “the powers of the government depend on the strength of its treasury”. He states “From the treasury, comes the power of the government and the Earth whose ornament is the treasury, as acquired by means of the Treasury and Army”. He regarded the revenue and taxes as the earning of sovereign for the services which were to be rendered to him, to the people and to afford them protection and to maintain law and order.

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106. Kautilya’s norms of Taxation an Interpretation visited the website www.google.comKautilyasArthasastra on 02.02.2015 time 7.58pm -- according to kauutilya High tax rate erode their own bases and thereby affect the Tax Revenue. This general idea which is referred to as the LafferCurve, which can be traced back to Kautilya’s famous treatise in Economics. Arthasastra and even before that to the Ancient Indian books of laws called the manusmrithi.
The present day tax system is in many ways similar to the system of taxation in vogue about 2300 years ago. According to the Arthasastra each tax was specific and there was no scope for arbitrariness. Precision determined the schedule of each payment and its time, manner and quantity being all pre-determined. The Cannons of taxations were first given by Adam Smith which says that the objective of public finance is to raise funds for the government expenditure to fulfill the wants of its citizens\textsuperscript{107}. The public economic aims at maximizing equality of distribution of income and social welfare. In doing this the tax system has to be so designed that there is no excess burden to any one and it facilitates equal distribution of income by taking more tax from the higher income group of the society and lesser from the lower income group. The government cannot carry out its welfare responsibilities if the citizens do not pay taxes. The government also requires the tax for administration and governance. These days governments have taken up additional responsibilities than the traditional ones of defence and law and order. In addition planning and development, infrastructure, social construction, investment in human capital, etc are also part of government functions for which funds are required. These responsibilities are integral part of the governance. Government also requiresto invest and spend for infrastructure and other facilities for the private sector to flourish. These expenses require revenue for the government. \textit{Tax is one of the important mechanisms for revenue generation for the governments.} Thus the governments strive to collect the rightful revenue from the corporate and the public to fulfill their duties.

After independence the government of India imposes a progressive income tax on taxable income of individuals. Hindu Undivided Families (HUFs) Companies, firms Co-operative societies and trusts. Since 1991 tax system in India has undergone a radical change, in line with liberal economic policy and WTO commitments of the Country. The hallmark of Good Tax system is equity, efficiency and simplicity.

Multinational corporations realized that India offered a big market for their goods and also cheap labour that could help them to carry on manufacturing activities and develop service sector. All this led to increased inflow of foreign direct investment into the country and growth of inbound and outbound investments. At the same time opportunities for increased cross border business increased in this period.

\textsuperscript{107} Mithani, D.M \textit{“Public Finance Theory and Practice”} Himalaya Publishing House. Mumbai (India), (2006) 1\textsuperscript{st} Ed.
Liberalization policies pursued by the Government resulted in removal of controls on outbound investments into joint ventures and wholly owned subsidiaries. There was a general feeling that multinational companies pay less tax as compared to domestic companies because of absence of transfer pricing provisions. It was also felt that Indian companies could abuse transfer pricing mechanism and ancillary goods to associated enterprises that in turn could sell finished goods back to these companies at prices higher than market prices.

Due to structural reforms and growth of cross border transactions, transfer pricing issues had assumed significance for the country. Government therefore considered it necessary to examine the existing provisions to judge their adequacy in dealing with transfer pricing issues. Transfer pricing issues concerning allocation of income in international transactions though had been recognized in tax laws; there was no comprehensive legislation on the subject till passing of Finance Act, 2001. The subject can be understood under two tier systems. One is under the position prior to introduction of Finance Act 2001 and the other after the introduction of new legislation.

3.01.1 Liability in special cases under old law of Income Tax Act, 1922.

Under Section 42(2) of Income Tax Act, 1922- there is a special provision that the business profits accruing from carrying on business between a resident and non-resident or not ordinarily resident, where due to close connection between persons either there were no profits or less than ordinary profits which could be expected in that business.

“Where a person non-resident or not ordinarily resident in the taxable territories carries on business with a person resident in taxable territories, and it appears to the income tax officer that owing to close connection between such persons, the course of business is so arranged that the business done by the resident person with the person not resident or not ordinarily resident produces to the resident either no profits or less than the ordinary profits which might be expected to arise in that business, the profits derived there from or which may reasonably be deemed to have been derived there from shall be chargeable to income tax in the name of the resident person who shall be deemed to be, for all the purposes of this act, the assessee in respect of such income tax”
The wordings can be analyzed as under:

1. This is between a resident and non-resident.
2. There was close connection.
3. Non resident was regarded as carrying business with a resident.
4. The subject of charge was the “business”.
5. What was taxed is “the profits derived there from or which may be reasonably be deemed to have been derived there from”.
6. The use of the phrase ‘there from’ connotes the meaning business of the resident and the non-resident
7. In these circumstances the Income Tax officer was empowered to make adjustments like in case of resident by re-determining income which may reasonably be deemed to have been derived there from.

Section 42(2) of Income Tax Act, 1922(called as I T Act, 1922) in a way recognizes the well established arm’s length principle though indirectly in determining taxable profits of resident. Here, the profits subject to tax was not the one earned and shown in the books but it is parties could have expected to have earned in such business. This can be clearly understood by studying the fact and decision of the case, Mazagaon Dock Ltd v CIT & EPT\(^{108}\), the facts of the case is as follows

The assessee is company registered under Indian company’s Act under Section 42(2) of Income Tax Act, 1922. It carried on business as marine engineers and ship repairers. Share capital is owned by two non-resident companies. An agreement was entered into with non-resident wherein the resident company agreed to repair their ships at cost, and charge no profits. The issue is whether the Indian company was chargeable to tax under section 42(2) I T Act, 1922 of the Act for the profits derived or deemed to have been derived from arrangement.

The Apex court held that the Resident Company was chargeable to tax under section 42(2) of the Income Tax Act, 1922. In respect of the profits it would have made but for the arrangement. The reason is the fact that the non-resident companies

\(^{108}\). (1958) 34 ITR 368(SC)
carried on their business in such a manner that no profits could accrue to them was irrelevant. The activities of the non-resident companies in sending their ships for repairs to the assessee company under an agreement that the repairs should be done at cost were trading activities, organized and continuous in character and constituted business. Thus the profits which the Indian company could have received but had foregone were liable to tax in the hands of the Indian company under section 42(2) of the Income Tax Act, 1922.

The aforesaid discussion makes clear that under the I T Act, 1922 the arm’s length principle is indirectly recognized in determining taxable profits of a resident. A resident enterprise as such could be taxed in respect of profits which it would have normally made but for its business arrangement with nonresident.

### 3.01.2 Income from Transactions with Non resident

**Section 92 of the Income Tax Act 1961**\(^{109}\) *(prior to amendment)*

Section 92 of the Income Tax 1961 Act as stood before its amendment incorporated special provisions relating to avoidance of tax and cross border transactions. This section is in line with section 42(2) of I T 1922 Act and tried to deal with the practice of “parking profits”\(^{110}\) in an off shore tax haven.

The provision which remained on statute for more than five decades was basically an anti-avoidance provision. *It remained un-amended for several years as there was hardly any transfer pricing issue in this period because India had closed economy and few international transactions between related entities.*

The erstwhile section 92 of IT Act, 1961 provided that, if tax authorities believed that a transaction between a resident and nonresident\(^ {111}\) resulted in less than


\(^{110}\) The term profit as defined under Income Tax Act 1961 under section 2(22)- profit in the commercial sense, that is to say the profits made by the company in the real and true sense of the term and placed in a pocket or corner

\(^{111}\) Section 2(30) of the Income Tax Act 1961 defines non- resident as a person who is not a resident. The term resident in turn is defined under section 6 of the Income-tax Act 1961 as follows:
1. An individual is resident in any year if he is in India for a period of one hundred and eighty-two days or more in that year; or is in India for a period of sixty days or more in that year and three hundred and sixty-five days or more in the preceding four years.
2. A company is said to be a resident if it is incorporated in India or the control and management of its affairs is situated wholly in India.
3. A Hindu undivided family is said to be a resident if the control and management of its affairs is situated wholly or partly in India
‘ordinary profits’ for the resident owing to a close connection between the two, they could re-compute the income of the resident. Section 9(1) (i) of the Act, read with Explanation 1 provides that where a business connection exists in India, the income that is reasonably attributable to the business operations carried out in India shall be taxed in India. Further rule 10 of the Income tax rules 1962(Rules) provides guidance upon how income of a non-resident taxpayer may be apportioned to the business operations carried out in India in the event it cannot be definitely ascertained. The old Section 92 applied in case of business income and aimed at reconstructing profits rather than income or expenditure. The matter of concern was computation of business profits and not the arm’s length price of the transaction. Arm’s length principle though was not explicitly used in this section or other provisions, it was implicitly recognized in the concept of “fair market value” as contained in section 2(22) (b) and 40A (2) (b) of the Income Tax Act, 1922. It was accepted that business profits should be computed as per prevailing business principles and market conditions and tax authorities had no right to disturb them. Section 92 of Income Tax Act, 1961 as it stood prior to amendment reads as under:

“Where business is carried on between a resident and a non-resident and it appears to the Assessing Officer that, owing to the close connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than ordinary profits which might be expected to arise in that business, the Assessing Officer shall determine the amount of profits which may reasonably be deemed to have been derived there from and include such amount in the total income of the resident”

This section lays down a general principle in respect of business carried on between a resident and a non-resident who have a close connection which is explained earlier u/s 42(2) of Income Tax Act 1922 of old law discussed above. This provision applies to the business carried on between a resident and non-resident. According to Section 2(13) of the Act the term business included any trade, commerce or

112 The term “Fair market Value” in relation to capital asset means as defined in section 2(22B) of IT Act 1961 year 2014) (a) the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and (b) where the price referred to in sub-clause (a) is not ascertainable such price as may be determined in accordance with the rules made under this Act;

manufacture or any adventure or concern in the nature of trade, commerce or manufacture. The term adventure in the nature of trade explained in the case law *P.M Mohammed Meerkhan v CIT*. The Hon’ble Supreme Court held that an adventure in the nature of trade need not be business itself but any activity akin to business may be taken to be an adventure in the nature of trade. However, any activity to be treated as an adventure in the nature of trade should be carried on with the object of earning of profit.

Rules 10 and 11 of Income Tax Rules, 1962 provided three alternative modes for allocating profits in case where section 92 of I T Act 1961 was invoked. The prescribed modes of allocating profits are as under:

1. Such percentage of turnover so accruing or arising as assessing officer may consider to be reasonable, or

2. An amount which bears the same proportion to the total profits and gains of business as receipts so accruing or arising bear to the total receipts of the business, or

3. An amount determined by the assessing officer in a manner deemed suitable.

In practice it is very difficult to invoke this section as the expression “close connection” was not defined in the Act. The reasonableness test was difficult to apply, as assessing officer was required to collect the requisite material to invoke the provision. This pre-amended section 92 of Income Tax Act 1961 did not prescribe any specific type of documents to be provided by a taxpayer. The assessing officer had the power to call for any information which was considered necessary in facts of the case. Also the Taxpayer under old law was not required to indicate the method of accounting adopted and therefore had the liberty to choose any method of accounting such cash, mercantile or hybrid method. But this position was changed after amendment of section in the post scenario.

3.01.3. Shortcoming of provisions of Section 92 of Income Tax Act, 1961

1. The old section 92 of the Income Tax Act, 1961 was not sufficient to deal with complex cases of Transfer pricing.

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114. (1969)73 ITR 735 SC
115. Wahi V S *op cit.* p. 23
2. This section applied to transactions between a resident and a non-resident. Since business demands a continuity of relationship, isolated transactions were not covered.

3. The scope of section is not wide enough to cover cases involving transfer of services or intangible assets.

4. This provision does not cover between a non resident entered into a transaction with non-resident. Therefore the business transaction between a permanent establishment of a non-resident company and non-resident were not covered.

5. Here the emphasis was on profit rather than adjustment of prices or income derived by the parties. Here, the term profit means business receipts net of expenses. When a taxpayer enters into large number of transaction it was difficult to apportion expenses in respect of each of them. This provision was not effective to curb tax avoidance.

6. The term ‘close connection’ was not defined in law and revenue authorities applied it arbitrarily

7. Under old law penalties could be imposed if adjustment made by the assessing officer to the income declared in return of income reflected concealment of income. Section 271(1)(c) of Income Tax Act, 1961 provides that ‘where an assessee has concealed or furnished inaccurate particulars of his income, the assessing officer may impose penalty ranging from 100 per cent to 300 percent of the amount of tax sought to be evaded by the taxpayer. Here, the expression ‘has concealed the particulars of income’ and ‘has furnished inaccurate particulars of income’ are not defined in the Act and therefore, their meaning has to be understood in a generic sense.

8. Whether mensrea is necessary ingredient to impose penalty under section 271(1)(c) of IT Act 1961 has always been under dispute. Several amendments have

116. Section 271(1)(c) of Income Tax Act 1961 prescribes that penalty other than penalty imposable for concealed income under 271(1)(C) can be levied by initiating penalty proceedings for concealment of income must be initiated by issuing a show cause notice by (a) the Assessing Officer before the completion of the assessment; of (b) the first appellant authority before passing an order under section 250 of I T Act, 1961 (Section 250 denotes appeal procedure) (c) the Commissioner of Income Tax before passing the order under section 263 of Income Tax Act 1961 (section 263 means Revision of orders prejudicial to revenue) the quantum of penalty for concealment should be worked out on the basis of law in force at the time of filing the return, whether original and or revised which contained the alleged concealment or misstatement.
been made in the section to bring out that *mensrea* is not the consideration for imposing the penalty. As it is civil wrong. This issue was viewed in other manner that penalty is considered only on additional tax for evading taxes and is imposed when tax administration makes any addition due to difference in perception with the taxpayer on any matter relating to determination of taxable income.

9. There was no detailed methodology to compute ‘ordinary profits’.

10. The alternative prescribed in Rule 10 of the Income Tax rules 1962 also suffers from several defects. One of the biggest drawback is it fixes a fixed rate of profit per currency unit of each component to every member of the group regardless of the differences in functions, assets and risks. This section later leads to Formulary Apportionment Method.

11. The re-computation of expenditure or revenue are limited in scope to deal with transfer pricing issues. Section 40A (2) of I T Act 1961\(^\text{117}\) applies to business expenditure only, thereby ignoring the re-computation of receipts on a realistic basis.

**3.01.4 Avoidance of income tax by transactions resulting in transfer of income to non residents (section 93)**

Section 93 of the Income Tax Act, 1961 provides to prevent residents from evading the payment of tax by transferring their assets to non–residents. Taxpayers sometimes transfer ownership over an asset situated outside India in favour of non-resident entity or person while contriving to secure benefits to himself or his own men, relations, dependents and the like. Section 93\(^\text{118}\) is incorporated to discourage

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\(^{117}\) Section 40A(2) of Income Tax Act 1961 states that “where the assessee incurs any expenditure in respect to which payment has been made to a relative or close associates of the assessee referred to in section 40A(2) (b) and the Assessing officer is of the opinion that such expenditure is excessive and unreasonable having regard to (a) the fair market value of the goods services or facilities for which the payment is made; or (b) the legitimate needs of the business; or (c) the benefit derived by accruing to thereof and also no disallowance, on account of any expenditure being excessive or unreasonable having regard to the fair market value, shall be made in respect of a specified domestic transaction referred to in section 92BA (specified domestic transaction) if such transaction is at arm’s length price as defined in clause(ii) of section 92F( means definitions of certain terms related to transfer price like Accountant, Arm’

\(^{118}\) Section 93 of Income Tax Act 1961- sub section (1) of section 93 reads as under; “(1) where there is a transfer of assets by virtue or in consequence whereof, either alone or in conjunction with associated operations, any income becomes payable to a non-resident, the following provisions shall apply-
such schemes aimed at reducing tax liabilities of the resident taxpayer. This provision is incorporated to counteract evasion of tax by residents by way of transferring their assets to non-residents while enjoying the income by adopting dubious methods. The ingredients of the section are;

1. There must be transfer of assets;
2. The income from the transferred assets becomes payable to the non-resident on account of such transfer either alone or in conjunction with associated operations;
3. By means of such a transfer the resident has acquired any rights by virtue of which he has power to enjoy any income of the nonresident transferee, whether forthwith or in the near future;
4. Such income of the non-resident would be chargeable to tax as if it had been the income of the resident.

3.02. An overview of New Legislation

By studying above it was amply clear that India needed to strengthen the statutory law to deal with challenges posed by the term “Transfer price”. There was no comprehensive legislation on transfer pricing in the country for a long time. In November 1999 the Government constituted an expert group under the Chairmanship of Mr. Raj Narain to examine the issues relating transfer pricing and suggest suitable framework for the transfer pricing legislation. Based on the recommendations made by the group a comprehensive legislation on the subject was introduced by incorporating the provisions in Finance Act, 2001. The existing section 92 was amended and new provisions were incorporated in sections 92 to 92F of the I T Act 1961. The Central Board of Direct Taxes also issued Rules 10A to 10E and

(a) Where any person has, by means of any such transfer, either alone or in conjunction with associated operations, acquired any rights by virtue of which he has, within the meaning of this section power to enjoy, whether forthwith or in the future, any income of a non-resident person which, if it were income of the first mentioned person, would be chargeable to income tax, that income shall, whether it would or would not have been chargeable to income-tax apart from the provisions of this section, be deemed to be income of the first-mentioned person for all the purposes of this Act
(b) Where, whether before or after any such transfer, any such first-mentioned person receive or is entitled to receive any capital sum the payment whereof is in anyway connected with the transfer or any associated operations, then any income which, by virtue or in consequence of the transfer, either alone or in conjunction with associated operations, has become the income of a non-resident shall, whether it would or would not have been chargeable to income-tax apart from the provisions of this section, be deemed to be the income of the first-mentioned person for all the purposes of this Act”
clarificatory circulars regarding these provisions\textsuperscript{119}. (See Appendix X and XIII of this thesis). Later some more amendments were made in Finance Act, 2002 to bring clarity on the subject. Further the Government created group in 2002 to recommend Transfer pricing Guidelines.

“The principle of equity and efficiency demands that all taxpayers pay their due taxes, as required by law to the exchequer. They should not take advantage of their location in more than one tax jurisdiction to shift profits or income from high tax to low tax jurisdiction”.

The objective of the legislation was explained by the Finance minister in his budget speech and in the memorandum explaining the provisions of the Finance Act 2001. The same are extracted below;

“The presence of multinational enterprise in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance bill based on these recommendations\textsuperscript{120}.”

The new Transfer pricing legislation attempts to follow the well-accepted canons of taxation by having simple and equititious provisions. It aims to provide a statutory framework that will create reasonable, fair and equitable tax base and prevent abuse of transfer pricing in regard to cross border transactions between associated enterprises.

The rationale of the new transfer-pricing provisions is explained in the CBDT Circular No. 14 relating to Finance Act, 2001 as under;

“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 same multinational group. The profits derived by such enterprises carrying on business in India can be

\textsuperscript{119}Mukesh Butani “Transfer Pricing An Indian Perspective” (including ‘Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations’) Lexis Nexis, Butterworths (2007) 2nd Ed., p.42

\textsuperscript{120}Mukesh Butani “Transfer Pricing An Indian Perspective” (includes ‘Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations’) Lexis Nexis, Butterworths (2007)
controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues.”

“Under the existing Section 92 of the Income Tax Act 1961, which was the only section dealing specifically with cross border transactions, an adjustment could be made to the profits of a resident arising from a business carried on between the resident and non-resident, if it appeared to the assessing officer that owing to the close connection between them, the course of business was so arranged so as to produce less than expected profits to the resident. Rule 11 prescribed under the section provided a method of estimation of reasonable profits in such cases. However, this provision was of general nature and limited in scope. It did not allow adjustment of income in the case of non-residents. It referred to a close connection, which was undefined and vague. *It provided for adjustment of profits rather than adjustment of prices, and the rule prescribed for estimating profits was not scientific. It also did not apply to individual transactions such as payment of royalty etc, which are not part of regular business carried on between a resident and non-resident. There were also no detailed rules prescribing the documentation required to be maintained*.”

The idea purpose behind implementation of Transfer pricing is to prevent shifting out profits by manipulating prices charged or paid in international transactions, thereby eroding the country’s tax base. The object of these provisions is to ensure that profits taxable in India are not understated or losses are not overstated by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances.

### 3.02.1 Feature of New legislation

The provisions or set of codes formed after Finance Regulations 2001 is itself a form of code. The main object of implementation of provisions of the Transfer pricing is to ensure that profits taxable in India are not understated or losses are not overstated by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances. The provisions of Transfer pricing apply to international transactions. The international transactions include:

1. Transactions of purchase, sale or lease of tangible or intangible property; or
2. Provision of Service, or

3. Lending or borrowing money; or

4. Agreement or arrangement for sharing of cost, expenses for mutual benefit.

5. The Arm’s length principle is the core principle followed for computing transfer prices in respect of transactions between related entities. The law provides that any income arising from or expenses and interest payments relating to an international transaction, shall be computed having regard to the arm’s length price. The rule is based on the concept that market forces are the best way to allocate resources and profits of the enterprise and therefore all transactions between associated enterprises should be considered as if these transactions between independent parties.

6. Under Transfer pricing regulations the arm’s length price is arrived at by following the most appropriate method considering the nature of transactions or class of transactions or class of associated enterprises or functions performed by such enterprises.

The Finance Act, 2001 introduced the provisions in Income tax Act, 1961. The provisions relating to Transfer pricing regulations are as under:

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<td>92F</td>
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The following diagram explains the basic components of the transfer pricing provisions incorporated in sections 92 to 92F of the I T Act 1961.

3.02.2 Arm’s length principle

Once we have established a need to have rules in place to check the transfer pricing policies of related parties, one has to arrive at an understanding as to how this could be done. Primarily countries adopt the “Arm’s Length Standard” this basically implies that prices are considered to be acceptable if the transactions are at a arm’s length distance (i.e., at a distance which is considered to be acting independently and not being influenced by the other)

If the transactions are not at an arm’s length, in that case the prices are recasted on determine the arm’s length price value. As laid down in Section 92 of I T Act, 1961income arising from an international transaction has to be computed having regard to the arm’s length price. The explanation to Section 92 clarifies that an expenses which comprises an international transaction also needs to be computed having regard to the arm’s length price.
The Arm’s length price has been defined in the I T Act 1961 under Section 92F(ii) to mean ‘a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions’.

Accordingly, arm’s length price means a price which is applied between two unrelated persons. Further, the price between unrelated persons would constitute an arm’s length price only if such persons have transacted in uncontrolled conditions.

Section 92(1) provides that any income arising from an international transaction shall be computed having regarded to arm’s length price. A transaction is considered at arm’s length if it is between persons or entities which are not influenced by any special relationship and its terms and conditions are as prevailing between independent parties. This principle provides a broad parity of tax treatment for multinational and independent enterprises and avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive position of either type of entity.

3.02.3 International transaction

International transaction is a transaction between two or more associated enterprise, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property or provision of services or lending or borrowing money, or any other transaction having a bearing on income, losses or assets of such enterprise. The important condition is that either both or at least one party to the transaction should be a non-resident. With the insertion of section 92BA

(a) The purchase, sale transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment tools, plant, furniture, commodity or any other article product or thing
(b) The purchase, sale, transfer, lease or use of intangible property including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licenses, franchises, customer list, marketing channel, brand, commercial secret, know-how industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;
(c) 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 of deferred payment or receivable or any other debt arising during the course of business;
(d) Provisions of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design consultation agency scientific research legal or accounting service;
(e) A 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;
by the Finance Act, 2012 the regulations besides international transactions have also been made applicable to specified domestic transactions.

3.02.4 ASSOCIATED ENTERPRISES

The term Associated enterprises (meaning parent-subsidiary companies and sister-companies) which differ from those comparably placed unrelated enterprises is defined in section 92A of the IT Act, 1961. An associated enterprise in relation to another enterprise means an enterprise which participates directly or indirectly in the management or control or capital of other enterprise. The deeming provision in the section provides circumstances where two enterprises shall be deemed to be associated in specific situation like holding shares carrying voting power exceeding 26% advancing loans exceeding 50% of the book value of the total assets, power of appointing more than half of the board of directors etc.,

3.02.5 Arithmetic Mean

The concept of arithmetic mean is unique to Indian transfer pricing regulations. The law provides that where more than one price is determined by the most appropriate method, the arm’s length price shall be taken to be the arithmetical mean of such prices or, at the option of the taxpayer, a price that may vary from the

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122. Section 92A of the Income Tax Act 1961 defined the term Associated Enterprise. For the purpose of this section and sections 92, 92B 92C 92D 92E and 92F “associated enterprise”, in relations to another enterprise, means an enterprise-

(a) Which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or

(b) In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

123. Wahi V S “Transfer pricing Law, Procedure & Documentation An Indian and Global analysis” Snow white Publication, (2013)5th Ed. p. 33 para 2.49. The term Arithmetic Mean belongs to the branch of Mathematics which deals with an arithmetic progression, lying between the first and the last terms. For example arithmetic mean of a and b is taken as =a+b/2. The arithmetic mean of n different quantities is represented as =a1,a2,a3,......an is a1+a2+a3+a4+......an/n For illustrations; X an Indian company sold goods to Y ltd of Germany an associated enterprise @ 2800 per piece as the most appropriate method the following arms length prices have been determined:

Situation 1  2950  Situation 2  2850 Situation 3  2750  Situation 4  3050Compute the arm’s length price assuming the Central Government has notified the various to be 3%Arithmetical mean of prices determined by most appropriate method:

2950+2850+2750+3050/4=11600/4= Rs. 2,900

3% of the actual international transaction price=288X3/100=Rs. 85.5

Difference between the Arithmetic mean of arms length price—actual international transaction price is Rs. 2900-2800=Rs. 100 here the arm’s length price shall be taken as Rs. 2800- since the difference between the arm’s length price and the actual transaction price does not exceed 3% of actual transaction price. Hence arm’s length price shall be taken as Rs 2,800/-
arithmetical mean by an amount not exceeding five percent of such arithmetical mean. The principle of arithmetic mean is not followed when more than one price is obtained under different methods prescribed in law. Since, transfer pricing is not an exact science and it is difficult to arrive at a single price under particular method, the benefit of plus minus five percent (±5%) is allowed on satisfaction of prescribed conditions. As there has been controversy in application of this provision an amendment was made as per which if the variation between the arm’s length price so determined and price at which international transaction was undertaken did not exceed five percent of the latter, the price at which international transaction was actually undertaken is deemed to be the arm’s length price. This provision has been amended by the Finance Act, 2011 as per which the Central Government is given power to fix such percentage of the variation by notification as it may consider appropriate.

3.02.6 Documentation

Transfer pricing rules require maintenance of extensive information and documentation relating to international transactions entered with associated enterprises. Section 92D of the Income Tax Act, 1961 provides that every person entering into international transaction shall keep and maintain such information and documentation as may be prescribed. The documentation required is as under;

124. Wahi V S *Ibid.*, pp 35-36 Section 92D of Income Tax Act, 1961 states that Every person who has entered into an international transaction(specified domestic transaction inserted by the Finance Act 2012 w.e.f. 1-04-2013) shall keep and maintain such information and document in respect thereof as may be prescribed. The information and documents are as under: (a) a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises; (b) a profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them; (c) nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction (d) description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction; (e) a record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee; (f) description of the methods considered for determining the arm’s length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected and how such method was applied in each case; etc., As per Rule 10D(1) of Income Tax Rules 1962 every person who has entered into an international transaction shall keep and maintain 13 different types of information and documents, but according to Guidance note of Institute of Chartered Accountant of India these may be classified into 4 types.
1. Ownership structure of the taxpayer’s enterprise.
2. Profile of the multinational group.
3. Record of economic market analysis.
4. Broad description of the business of the assessees and associated enterprises with whom the assessees have transacted.
5. Details of property transferred or services and quantum and value of each such transaction.
6. Description of functions performed, risk assumed, and assets employed and details of adjustment made to transfer price to align them with arm’s length prices.
7. Record of uncontrolled transactions taken into account in analyzing the comparability of the international functions entered into.

3.02.7 Adjustments

The Transfer pricing Officer has the power to make appropriate adjustment to Transfer price declared by the assessees if the transactions are not at arm’s length price on the basis of data of comparable transactions. The benefit of deduction pertaining to exemption of the profits from tax in respect of profits of units established under the specified zones or export oriented units as stipulated in Section 10A or 10B of Income Tax Act, 1961 or other incentives and deductions as prescribed in Deductions of Chapter VI A of Income Tax Act 1961 is not available when adjustments are made to the income consequent to determination of arm’s length price.

3.02.8 Accountant’s Report

Section 92E of the Income Tax Act, 1961 requires that every person entering into an international transaction shall obtain an accountant’s report in form 3CEB which is issued by the Chartered Accountant after examination of the accounts and records of the assessees.

3.02.9 Safe Harbours

With a view to provide relief in satisfying the compliance requirements specified in the tax legislation, as well as ensuring administrative simplicity for the tax administration, certain countries provide ‘Safe harbour’ or “Safe haven”. These are the provisions outline a simple set of rules which if satisfied by the taxpayer,
enable the taxpayer to be relieved from certain regulatory obligations otherwise imposed by the tax legislation. Under safe harbor, taxpayers know in advance, the range of prices or profit rates within which the corporation must fall in order to qualify for safe harbor. Here, the taxpayer would not be required to search for comparables but rather apply a simple method that would predominantly be a measure of profitability and be accepted by the Tax administration. It shields the assessee from not subjecting the income of the assessee to any audit or reassessment. It acts as a shelter to the MNEs(Tax payers).

3.2.10 Burden of proof

As per the existing law the onus to satisfy the assessing officer regarding absence of any intention to avoid taxes squarely lies on the taxpayer. The mere fact that assessee had knowledge that the effect of transfer would result in avoidance of tax cannot be construed that sole purpose of transaction was avoidance of tax125. The law provides that the primary onus is on the taxpayer to prove that transfer prices are at arm’s length and determined by most appropriate method. When assessee is liable for penalty, the onus to prove the existence of good faith and due diligence lies on the taxpayer. In certain cases the assessee has discharged the initial burden of proof that transfer prices are as per arm’s length principle, there can be no intervention by the Assessing Officer unless he has material or information or document in his possession, which may show that the price charged in the international transaction has not been determined in accordance with sub-sections (1) and (2) of Section 92C or information and documents relating to the international transaction have not been kept or maintained by the assessee.


Under the Companies Act 1956, the effect of transfer pricing on the profitability of a company is considered in provisions dealing with financial statements and disclosure requirements. Section 211 of the Companies Act, 1956 deals with the form and contents of the balance sheet and the profit and loss account. It provides that financial statements of the concerned financial year should give a true and fair view of the state of affairs and the profit and loss of the company. The law also makes certain obligations on companies to disclosure of transactions in which

125. Commissioner of Income Tax vs A. M.M. Mohmd Ibrahim Sahib 45 ITR 166(Mad)(1961)
directors or persons having substantial interest are interested. The provisions requiring disclosures of transactions with companies in which the directors have interest are relevant for taxation purpose though their utility is limited in transfer pricing issues.

3.02.12 Position under Central Excise Act 1988

Under the Central Excise Act, the excise duty is payable on the transaction value at which a related person sells goods to an unrelated party. The rules regarding clubbing of value of clearances apply if the entities have common management or control through relatives or common manufacturing facilities. The common test applied here is mutuality of interest between two entities and common ownership and control of units.

3.02.13 Position under Customs Act, 1988

Under Customs Act, the subject of transfer pricing is dealt in valuation rules, which recognize the fundamental principle of arm’s length price. The rules provide for determination of the correct price of the goods imported in the country or exported out of the country uninfluenced by relationship existing between the parties. The law contains valuation rules for determination of assessable value of goods. The rules are based on the concept of deemed value and transactions value of goods. The methods recognized in the rules namely transaction value, deductive value, computed value and residual value are comparable to transfer pricing methods and thus help in analyzing the transfer pricing issues.


The transfer pricing rules are wider in scope than the Customs Valuation Rules 1988 in as much as the former covers international transactions involving both tangibles and intangibles between associated enterprises. The CVR 1988 on the other hand are limited for purposes of customs valuation to import of tangible goods only. The definition of associated enterprises under TP Rules are wider than those specified related parties under the CVR 1988. The notes to the CVR 1988 prescribes that it is upto the importer to establish the acceptability of the price in terms of the means prescribed in the CVR rules 1988. In the case of Transfer pricing rules it depends upon Arm’s length price of International transaction to be determined by the
application of any of the methods as per section 92C(3) of the Income tax Act 1961. Under CVR 1988 customs may or may not accept the transaction value if after examining the circumstances surrounding the sale, and in the light of the information provided by the importer, they still entertain reasonable doubts about the acceptability of price. There is considerable discretion allowed to the customs officer unlike the transfer pricing rules, which specify the circumstances in which the tax officer may determine the transfer price. The CVR 1988 mandates the hierarchy of valuation methods to be applied in the event that the transfer price is rejected\textsuperscript{126}. The means by which the customs officer can do so are provided for in the interpretative notes to the CVR 1988 and this approach is distinctly different from the approach under the Act. The difference between the valuation methods to be applied under the CVR 1988 and Transfer pricing are shown in the Table as under:

**TABLE -1**

<table>
<thead>
<tr>
<th>Sl No</th>
<th>CVR 1988 methods of valuation have to be used in sequential order</th>
<th>Transfer pricing : Most appropriate method is used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Identical value method</td>
<td>Comparable uncontrolled price method</td>
</tr>
<tr>
<td>2</td>
<td>Similar value method</td>
<td>Resale price method</td>
</tr>
<tr>
<td>3</td>
<td>Deductive value method</td>
<td>Cost plus method</td>
</tr>
<tr>
<td>4</td>
<td>Computed value methods</td>
<td>Profit split method</td>
</tr>
<tr>
<td>5</td>
<td>Best judgment methods</td>
<td>Residual- to be prescribed by the Central Board of Direct Taxes</td>
</tr>
</tbody>
</table>

The Income Tax Act 1961 provides for the application of the most appropriate method from those mentioned therein, whereas the CVR, 1988 provide that once the Transfer price is rejected, the customs must apply the alternative methods of valuation in their hierarchical order. The transfer pricing rules draw upon the OECD Guidelines whereas the CVR are based on the GATT Valuation Code.

\textsuperscript{126} MukjeshButani “Transfer Pricing An Indian Perspective (Includes ‘Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations’)” Lexis NexisButterworths (2007) 2\textsuperscript{nd} Ed pp.171-173
The most important and crucial point of difference, the two taxes are driven by diametrically opposite approaches to valuation. Customs invariably scrutinize the value of goods for suspected undervaluation, and wherever possible, seek to lay/enhance the transaction price with the obvious objective of maximizing customs duty. The direct tax authorities would seek to detect whether the price declared is overvalued, with a view to shift profits out of the country, and wherever possible, reduce the price of the transaction in the quest for higher tax revenue. Not surprisingly such an approach could result in conflict for the taxpayer, as the two authorities would take opposite paths to achieve their objective. In these situations it is possible that a firm may find itself in a situation of having paid higher customs duties on the same goods on which the direct tax officer may take a different view and lower their value for enhancing the profits to assess a higher tax.

Example I Customs authorities may accept the declared value of the assessee without loading or enhancing it where the assessee is able to prove that the price has not been influenced by the relationship as prescribed under interpretative Note rule 4(3) (a) of the Customs Valuation Rules 1988. Further the assessee can prove that the declared value has not been influenced by the relationship by resorting to the test value methods prescribed under r 4(3)(b) ibid. there is no need for an inquiry into the circumstances of sale, if any of the prescribed tests is applicable to the transaction value. Here the peculiar problem is Income tax authorities are not bound by the assessment made by Customs, and may in fact determine that the value has been influenced by the relationship between buyer and seller, and may determine the lower value based on the most appropriate method prescribed under the Income Tax Act 1961. In such a situation the assessee to avoid higher duty to the customs and income-tax authorities on the same goods the assessee will have to demonstrate to the income-tax authorities the basis on which Customs have accepted his declared value. He should be able to furnish to the income tax authorities the same data and method on which customs accepted his declared price, and request the income tax authorities to accept the same. The assessee has to demonstrate the same criteria which he has applied for customs and the same to Income tax authorities and he has to adopt the most appropriate method of valuation under customs Act as well.

Example II if the customs declined to accept the method in which the assessee adopted for determination then the assessee resort to any one of the valuation
methods in prescribed order for arriving at the transaction value. For this purpose the
customs authorities maintain a Data bank of prices and quantities of goods imported.
Though this data bank is not shared by the Customs with the income-tax authorities or
with the trade, the customs authorities have to convey the basis on which they arrived
at the transaction value to the asseessee in the speaking order that the asseessee would
be informed about the party whose imports provided the basis for determination of the
transaction value by the authorities.

3.03. Conclusions

The subject of Transfer pricing received enormous attention after 1990s when
several countries introduced extensive reporting obligations and stiff penalties for
pricing manipulations and non-compliance of the regulations. Globalization has
encouraged convergence around the arm’s length principle, but relatively few
corporations dominate global trade and independent prices for intermediate goods
are not easy to formulate. As low/no tax jurisdictions, tax havens have little direct
interest in monitoring transfer pricing practices to ensure that they comply with the
arm’s length principle. International trade has the capacity to provide increased
investment, employment and economic development. The use of Transfer prices to
shift capital and avoid taxes also poses some fundamental questions about the quality
of national economic statistics. Most government seek to steer the economy by using
data on imports exports national income, corporate profitability, balance of payments
and terms of trade.

Transfer pricing laws in most developed countries have been influenced by the
Organization for Economic Cooperation and Development (OECD) guidelines and
US law on the subject, which in turn are based on arm’s length principle. The arm’s
length principle means that transactions should be valued at prices which a company
would have charged another unrelated company based purely on market
considerations. The income tax authorities may seek a lower transfer price on imports
to avoid diversion of profits to the exporting country, the Customs authorities may
seek higher transfer price to avoid under-valuation and consequent loss of customs
duty. The trade ministry of the importing country in charge of administering anti-
dumping and countervailing duty laws would also like that the transfer price of
imports is set higher so that there is no dumping or unfair trade.
Article VII of GATT, 1994 clearly makes a case for arm’s length price for customs valuation. In the case of related party transactions it favors an arm’s length price to test values arrived from sale of identical or similar goods. If there is no sale, as would be the situation in respect of transfer of goods between branches, arm’s length price for sale of identical or similar goods provides the basis. In other words ACV provides a method of valuation akin to the CUP method.