

An Overview about Transfer Pricing Practices of Mnc's In India

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Abstract: “Multinational Corporations (MNCs) use transfer pricing practices to reduce taxable profit with a view to recommend how such practices could be minimized, to enhance the tax revenues of their host countries. The various MNCs take advantage of different tax rates charged in different jurisdictions to minimize the groups’ tax liabilities. Using transfer pricing practices to shift profit from high-tax jurisdictions to low-tax jurisdictions. Multinational corporations as integrated entities exploit international differentials and generate integration economies by setting transfer prices that are unlikely to be the same prices arms length parties would negotiate. Tax authorities should be aware of the need to publish documentations requirements concerning transfer pricing, so as to improve on monitoring of MNCs transfer pricing compliance. Transfer pricing must be provided to tax authorities for computation of both border, and corporate income taxes. This is necessary since the activities of MNCs cut across national borders”.

Keywords: *Transfer Pricing , MNC , Taxable profit*

I. Introduction:

“Transfer Pricing (TP) has assumed lot of importance today. It is one of the important tools in the hands of management for performance evaluation of a division or department. TP has become necessary in highly decentralized companies where number of divisions/ departments is created as a part and parcel of the decentralized organization. In the modern days, production is on the mass scale due to technological advancement and upgradation. Organizations grow in course of time and for such growing organization, decentralization becomes absolutely necessary. It becomes inevitable for such growing organizations, decentralization becomes absolutely necessary. It becomes inevitable for such organizations to establish separate divisions and departments to ensure smooth working. However it is also necessary to evaluate the performance of these departments/divisions. Transfer Pricing is one of the tools in the hands of management for measuring the performance.

A Transfer Price (TP) is that **notional value** at which goods and services are transferred between divisions in a decentralized large business organization. Some companies have the problem of pricing of goods and services which are transferred to other divisions/units of the same company; such pricing is referred to as ‘**intracompany**’, ‘**intradivisional**’, or ‘**transfer pricing**’. As explained in the above paragraph, in large organizations, each division is treated as a ‘**profit centre**’ as a part and parcel of decentralization and transfer of goods and services amongst the independent profit centre take place, the problem of intracompany transfer pricing arises. Geographically dispersed or international companies often face the problem of pricing goods and services, which are transferred to other divisions or units of the same company.

An intermediate product is a product transferred from one sub-unit to another sub-unit of the same organization. This product may be processed further or sold to an external customer. A TP is the price one sub-unit (segment, department, division, and so on) of an organization charges for a product or services supplied to another sub unit of the same organization. The TP creates revenue for the selling division and purchase costs to the buying division, affecting operating income for both divisions. The operating incomes can be used to evaluate the performance of each division and to motivate managers. Some companies have the problem of pricing TP are normally set for intermediate products, which are goods, and services that are supplied by the selling division to the buying division. Their profitability is measured by fixation of TP for inter divisional transfers”.

How the transfer price is fixed?

“A question arises as to how the transfer of goods and services between divisions should be priced. The transfer price can have impact on the divisions performance and hence lot of care is to be taken in fixation of the same. The following factors should be taken into consideration before fixing the transfer prices.

- ❖ TP should help in the accurate measurement of divisional performance.
- ❖ It should motivate the divisional managers to maximize the profitability of their divisions.
- ❖ Autonomy and authority of a division should be ensured.

- ❖ TP should allow 'Goal Congruence' which means that the objectives of divisional managers match with those of the organization."

Qualities of Transfer Pricing

The following are the "qualities of a good transfer pricing policy as postulated by ICAN (2009) and Adeniyi (2008);

- ❖ **Goal Congruency:** There is a need to select the transfer pricing method that will ensure that any optimal decision taken by the division will also be optimal from the corporate perspective. In other words, any method chosen must reduce sub-optimality to the barest minimum. This is also known as the concept of uniformity of objective. The condition implies that a good transfer pricing policy must be used to sacrifice the long term corporate objectives of the entire organisation for personal or divisional objective.
- ❖ **Performance Evaluation:** An ideal transfer pricing must be capable of being relied upon as a premise for evaluating divisional performance in terms of efficiency level and effectiveness. There is a need to select the transfer pricing method that management would be in a position to adopt in evaluating the performance of each divisional manager as effectively as possible. Sequel to this, the contribution made towards the corporate profit by each division should be distorted by the transfer pricing method chosen.
- ❖ **Autonomy:** There is a need to select the method that will preserve the independence of each division so that the failure of one division will not affect the success of another division. The transfer price must be set such that it guarantees the independent nature of all the divisions involved.
- ❖ **Motivation:** The agreed transfer price must be capable of motivating both the buyer and the seller or the transferor and the transferee. This objective or quality of transfer pricing has to do with an in-house issue. The price that is fixed is to be accepted by the parties involved; this is as a result of what the organisation seeks to achieve by fixing such transfer price:".

II. Methods of Transfer Pricing

It will be relevant to conceive at the onset that it may not be possible for a particular method of transfer price to simultaneously achieve all the listed qualities or objectives above. As a result of this fact, the quality of performance evaluation will contradict goal congruence and it is also doubtful if a particular method of transfer can simultaneously motivate both the buyer and the seller. The following are the different types of "transfer pricing method in use by organization:

- ❖ **Cost Based Transfer Method:** Under this approach, the relevant transfer price to charge between the transferring division and the receiving division will depend on the actual cost of production to the manufacturing division (Adeniyi, 2008). The selling division sells the goods to the buying division at the cost of production incurred by the selling division. It should be noted that cost is viewed in different ways and as such ICAN (2009) and Adeniyi (2008) posit that cost based transfer pricing method is further categorized into relevant cost, total cost, mark-up and standard cost transfer prices. Cost based transfer pricing have advantages of it being useful in decision making analysis, especially where the organization is using the marginal costing approach; also, it assists in measuring production efficiency by comparing actual cost with budget. Cost based transfer pricing has no unrealized profit involved in its stock computation and it offers the only available opportunity for products that have no market. The major disadvantage of this method is that, managers who are supposed to be autonomous are not allowed to use their initiative in the pricing decision, which may result to encouraging sub-optimality among the divisional managers. The approach cannot be used to evaluate divisional performance especially those identified as a profit or an investment centre.
- ❖ **Negotiated Transfer Pricing:**
Under this method the selling division and the buying division agree in advance to use a mutually acceptable transfer price. The relevant transfer price to charge between the selling and buying divisional managers will represent the outcome of negotiation between the two divisional managers. The central management will encourage the two divisional managers to agree on the appropriate transfer price because many factors have been effectively considered to reduce disputes on the transfer price fixed. With the use of this method, the motivational impact among managers will be stronger and the method is not prone to market fluctuations. The method is not encouraging as negotiation may be time consuming. The price to be fixed may be influenced by the negotiating ability, personality and fluency of the managers involved which may result to the corporate interest being subordinated to individual divisional interest and goal dissimilarity. It is not a good method of evaluating performance as it can be used to conceal inefficiency on the part of the managers involved.
- ❖ **Arbitrary Transfer Pricing:** Under this method the transfer price is determined centrally based on what top management conceived to be the most beneficial to the company as a whole. Individual divisional managers may have some say but no control over the price set. In other words, the relevant transfer price to

charge between the selling and buying divisional managers will be determined by the central management with or without the consent of divisional managers. The time spent in negotiation is saved, and uniformity and stability tend to prevail. The approach is considered ideal for planning purpose because of its specific nature and will guarantee the concept of goal congruency. It does not grant the divisional managers autonomy and the profit and cost consciousness may suffer if the fixed price is not considered realistic.

- ❖ **Market Based Transfer Price:** Under this approach, the relevant transfer price to charge between the selling and buying divisional managers will represent the prevailing market price within the market as at the date of the transaction. This implies that both the selling and buying divisional managers are expected to operate at arm's length. A major plus for using this approach is that it guarantees divisional autonomy and allows for divisional managers to use their initiative in the pricing decision, which in the long run allows for performance evaluation among the managers. Its shortcoming is that, because of its market nature, it is prone to market fluctuations and will complicate the process of stock valuation as a result of the need to eliminate the unrealized profit on stock".

III. International Transfer Pricing

"As the number of multinational enterprises increases, the number of transactions between entities belonging to the same multinational group rises as well. Intercompany transactions generally offer the opportunity to shift income from one jurisdiction to the other. Income shifting can be driven by tax aspects, for instance a tax rate differential, or by firm-specific tax attributes like tax losses. At the same time, profit shifting imposes risk to governments as it may reduce tax revenues.

The correct transfer price for decision-making may conflict with the price which is used to determine profits for the assessment. This conflict may arise when the supplying and receiving divisions are located in different countries with different taxation rates. International transfer pricing policies became increasingly complex as companies increase their involvement in international transactions through foreign subsidiaries, joint ventures, and parent-owned distribution systems".

Objectives of International Transfer Pricing Regulations

"The increasing participation of multi-national groups in economic activities in the Country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multi-national group. The profits derived by such enterprises carrying on business in India can be controlled by the multi-national group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues.

In order to comprehend the tax implication of **Sec.92**, has to study the meaning of the following important terms/ expressions:

- i. Associated Enterprise - **Sec.92A**,
- ii. International transaction - **Sec.92B**,
- iii. Specified domestic transaction – **Sec.92BA**,
- iv. Arm's length price – **Sec.92F(ii)**
- v. Enterprise – **Sec.92F(iii)**
- vi. Permanent establishment – **Sec.92F(iiiia)**, and
- vii. Transaction - **Sec.92F(v)**"

International Transactions

"A transaction which satisfies the following criteria:

- (i) It is a transaction between two or more associated enterprises, either or both of whom are non-residents. In other words, if both or all the enterprises executing the transaction are residents, then it is not an "International transaction" for the purpose of these provisions;
- (ii) Such transactions is in the nature of:
 1. It is :
 - (a) A purchase, sale or lease of tangible or intangible property; or
 - (b) Provision of services; or
 - (c) Lending or borrowing money; or
 - (d) Any other transaction having a bearing on the profits, income, losses or assets of such enterprises; and
 2. a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution, to any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to anyone or more of such enterprises.
 3. A transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be an international transaction entered into between two associated enterprises, if:

- i. There exists a prior agreement between such other person and the associated enterprise in relation to the relevant transaction; or
- ii. The terms of the relevant transaction are determined in substance between such other person and the associated enterprise.”

International Transaction Matrix:

Transaction by	Transaction with	
	Resident	Non-resident
Resident	NO	YES
Non-resident	YES	YES

Arm’s length price

A price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

Enterprise

“A person (including a permanent establishment of such person) who is or has been or proposed to be engaged in:

- (i) Any activity, relating to the production, storage, supply, distribution, acquisition or control of:
 - a) Articles or goods, or
 - b) Know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or
 - c) Any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- (ii) Any activity, relating to:
 - a) The provision of services of any kind; or
 - b) In carrying out any work in pursuance of a contract; or
 - c) In investment; or
 - d) Providing loan; or
 - e) In the business of acquiring, holding, underwriting, dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries; or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.”

Permanent Establishment

It includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

Transaction

“It includes an arrangement, understanding or action in concert:

- i. Whether or not such arrangement, understanding or action is formal or in writing; or
- ii. Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceedings

According to Rule 10A of the Income-tax Rules the meanin of the expressions used in the computation of arm’s length price shall be as follows:

- (i) ‘**Uncontrolled transaction**’ means a transaction between enterprises other than associated enterprises, whether resident or non-resident;
- (ii) ‘**Property**’ includes goods, articles or things, and intangible property;
- (iii) ‘**Services**’ include financial services;
- (iv) ‘**Transaction**’ includes a number of closely linked transactions”

Computation of arm’s length price

“The arm’s length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods;

- I. Comparable uncontrolled Price method
- II. Resale Price Method
- III. Cost Plus Method
- IV. Profit Split Method
- V. Transactional Net Margin Method
- VI. Such other method as may be prescribed by the Board”

Comparable Uncontrolled Price (CUP) Method

“Under the CUP method, the price of an uncontrolled transaction is compared with the price of a controlled transaction. An uncontrolled transaction implies that the parties involved are not affiliated and are themselves not part of a group. The major requirement of the CUP method is the comparability of transactions. The OECD outlines several characteristics which have to be comparable, i.e. among others, product type, quality, availability, assets used and risks assumed, contractual terms, and economic circumstances (e.g. level of market, geography, and timing). If such a comparable transaction can be identified or if differences can be accounted for by reasonably adjusting the price, tax administrations usually prefer the CUP method.

However, in some cases, the CUP method may not be applicable, e.g. if the market is not competitive or if assets are so unique that a comparable transaction cannot be identified. This holds especially true for transactions involving intangible assets as they usually base on substantial negotiations and contract terms and bargaining power can in most cases not be observed”.

Resale Price Method (RPM)

“Under the resale price method, in order to find an arm’s length price, the resale price obtained by a distributor is reduced by an appropriate gross margin. The appropriate gross margin can be found with reference to transactions with unaffiliated companies (internal comparable). In case, such a comparison is not possible, the gross margins of other individual distributors of similar products may be used (external comparable).

The method is based on the assumption that gross margins are comparable for all products. This implies that products and circumstances of the transaction must be similar - under US regulations even higher standards of comparability are required than for the CUP method. However, it is questionable whether this assumption is true even if comparability prevails because it also suggests that gross margins are equal over firms, which does not seem a realistic assumption. For those reasons, the OECD guidelines state that adjustments are needed under several circumstances which increase the documentation effort and complexity of the RPM method”.

Cost Plus Method

“The cost plus method is very similar to the resale price method, but takes the perspective of a manufacturer selling similar products to affiliated and unaffiliated companies. It adds an appropriate cost plus mark up to the costs of goods sold to find an arm’s length price.

The same critique as to the resale price method can generally be applied to the cost plus method. Especially whether cost plus mark ups are similar over different products and different firms and whether costs are even an appropriate starting point”.

Profit Split Method

“Under the profit split method total profits accruing from controlled transactions are identified and split between all associated companies using ratios that would have been utilized in an uncontrolled transaction. The method can be applied using ex ante or ex post profits, i.e. projected or actual profits. The split of profits should take into account the circumstances of the transaction and consider assets used and risks assumed by the associated companies. This can be done by using comparables or by applying a residual approach. The residual profit split method, in a first step, allocates profits to the associated companies using one of the other methods (traditional transaction method or TNMM/CPM), not accounting for individual contributions. In a second step, the residual profit is split according to the relative value of each partner’s contribution. The comparable profit split method, on the other hand, uses comparable transactions between independent parties for the allocation of profits. This is done by defining key allocators which are based on assets/capital, costs, headcounts, or time spent.

The profit split method allows an analysis of transfer prices for more complex business structures, e.g. highly integrated processes. Due to the two-sided approach, cases where both parties of a transaction contribute unique and valuable components can be accounted for. However, the measuring of total profits may be a difficult task, especially if considering foreign affiliates. As the residual profit split method makes use of a second method, the shortcomings of that method have to be considered as well. Furthermore, it is questionable, whether the profit allocation of independent companies with reference to key allocators provides appropriate ratios”.

Transactional Net Margin Method (TNMM) and Comparable Profits Method (CPM)

The TNMM, as outlined in the OECD guidelines, and the CPM, which is part of US transfer pricing regulations, are both based on the comparison of the taxpayer with a group of similar, standalone companies. “The companies in the sample have to operate in the same field, perform similar functions, and distribute comparable products. For each company, a profit level indicator (PLI), e.g. operating profits to sales or gross profits to operating expenses, is calculated, which is then applied to the respective denominator of the taxpayer’s accounting results. While the CPM applies a “top-down”-approach, which means that the entire operations of the company are broken down to transactions, the TNMM uses a “bottom-up”-approach and starts on the

transactional level. If the profit level indicator of a controlled transaction lies within a range of indicators of uncontrolled transactions, the transfer price is assumed to be appropriate.

The advantages of both methods are that information is more easily available and that the documentation effort is reduced compared to other methods. However, operating profits can be affected by several factors which are hard to identify and to quantify. Therefore it is often argued that transfer prices found are not at arm's length".

Selection of Method

"The OECD generally prefers the traditional transaction methods as they are a more direct way of identifying a transfer price. However, ultimately the facts and circumstances of the transaction are crucial. In cases where no or not sufficient information on third parties is available or where business processes are very complex and a two-sided approach is needed, the transactional profit methods can be more appropriate. Other countries, including the United States, do not define a priority of methods, but take several factors into account in order to identify the most appropriate method (also called best method). The process of identifying the most appropriate method differs between countries, but it often includes the testing of each single method.

Regarding the different transfer pricing methods, there is only little variation across countries. With the exception of Brazil, the OECD transfer pricing methods are widely accepted. Since Brazil did not base transfer pricing regulations on the arm's length principle, the available methods differ and include fixed margins applied on resale price or costs. In an international context, this causes large problems as the methods will vary in both countries involved in the transaction which may in turn lead to double taxation. Another exceptional method which uses the market value established in transparent markets of certain goods on the day of their shipment was introduced by Argentina in 2005. The method is mandatory if certain conditions are fulfilled.

Only few countries (e.g. Chile, Greece, or Russia) have limited their acceptable methods to the traditional transaction methods (CUP, RPM, and Cost Plus). In Russia, the limited number of methods comes along with a strict hierarchy of methods which makes the regulation very difficult and inefficient in practice.⁴⁰ In Greece, the acceptable methods were even more limited until 2009. Only the CUP method could be used to determine arm's length prices causing great difficulties in identifying comparable transactions as the required data was not always available.⁴¹ Also with respect to the priority of methods, the great majority of countries follows the approach by the OECD and prefers the traditional transactions methods over the transactional profit methods. Some countries apply, in addition, a strict preference for the CUP method (e.g. Australia, Italy, or Mexico). Nine countries use a best method rule for the selection of the applicable method (e.g. Argentina, Peru, China, India, or the USA). Out of the OECD member countries, only Greece and Ireland do not follow the OECD guidelines. In Ireland only a very general anti-avoidance rule is in place which does not require the definition of methods".

Advance Pricing Agreements

In the course of the application of transfer pricing regulations, disputes may arise between taxpayers and tax authorities. An adjustment of transfer prices by one jurisdiction can lead to double taxation as the other jurisdiction may not always agree with the adjustment. Thus, several approaches exist in order to prevent double taxation and minimise transfer pricing disputes which the OECD has outlined in its Transfer Pricing Guidelines.

"The OECD Model contains two Articles which include approaches for dealing with tax disputes: the mutual agreement procedure and corresponding adjustments. The mutual agreement procedure (Article 25 OECD Model) can be used to eliminate double taxation. In Art.25 para. 3 OECD Model, it is stated that "tax authorities should try to solve by a mutual agreement any difficulties or doubts which arise as to the interpretation or application of the Convention". As provided for in Paragraph 10 of the Commentary on Article 25, this explicitly applies to transfer pricing adjustments following Art. 9 para.1 OECD Model. The tax administrations are obliged to solve the case within two years, otherwise the taxpayer may choose to solve the case through an arbitration process. Article 9 para. 2 OECD Model deals with requests for corresponding adjustments which may be subject of a mutual agreement procedure. It especially refers to adjustments between associated companies and demands tax authorities to coordinate adjustments so that no double taxation occurs".

"The European Union has also made an attempt to simplify the solution of transfer pricing disputes. In 1990, the Member States signed a convention which deals with the elimination of double taxation due to income adjustments between associated entities. This Arbitration Convention was amended in 2008 and now covers all 27 Member States. It applies to cases where transfer prices are not deliberately wrong, i.e. where no serious penalties arise. In addition, the convention sets a time limit for mutual agreements between two or more Member States on transfer pricing issues. In an advance pricing arrangement (APA), a set of characteristics for controlled transactions is determined in advance and for a fixed period of time. Some countries offer unilateral APAs that are concluded between the taxpayer and the tax administration in the same jurisdiction and do not take other parties into account. But since unilateral APAs also affect the tax liability of the related party, there may still be a need for an agreement procedure. Therefore, bilateral or multilateral APAs are more favourable. In those cases, taxpayers of at least two jurisdictions negotiate with the responsible tax administrations and identify a transfer pricing strategy that is more equitable to all participants in the agreement. Such arrangements

reduce the risk of double taxation and lead to a greater certainty in international trade, which is supported by the result of a survey conducted by Ernst & Young, where 90% of multinationals that have entered into advance pricing agreements indicated that they would use them again. Some countries offer sophisticated procedures for the set-up of an APA, others do not allow for binding agreements between the tax administration and the taxpayer. In such cases, an APA can only be concluded between tax authorities through a mutual agreement procedure on a case-by-case basis. APAs are common in the considered countries. Only ten countries do still not allow for such agreements. Unilateral agreements are generally easier to administer as they only consider one country and can be dealt with in an existing rulings process. Bilateral agreements, on the other hand, require an extensive procedure that has to be set up in most tax administrations. It is therefore not surprising that most countries start with the availability of unilateral agreements and later extend the procedure to bilateral agreements. By the end of the considered time period, more countries offer uni- and bilateral agreements than only unilateral agreements”.

Where advance pricing agreements were newly introduced in the considered time period, three countries have introduced the possibility for unilateral agreements “(i.e. Czech Republic, Ecuador, and Peru), while six countries have introduced an agreements procedure offering uni- and bilateral agreements (i.e. Hungary, Malaysia, Poland, Portugal, Romania, and Venezuela). For most of those countries, the introduction took place after transfer pricing regulations and documentation requirements were in place. An exception is Malaysia, where no transfer pricing rules exist and Venezuela where all aspects were introduced at once. Besides Malaysia, there are only few countries where the possibility for a bilateral agreement existed before transfer pricing rules were introduced (i.e. China, the Netherlands, and Thailand). Another seven countries have extended the scope of their agreements procedure to uni- and bilateral agreements. As an exception, Germany only allows for bilateral agreements. Surprisingly there are still a number of countries that have comprehensive transfer pricing regulations in place, but do not offer the possibility to enter into an advance pricing agreement. Those countries are Argentina, Greece, India, Indonesia, Norway, the Slovak Republic, Slovenia, and Sweden”.

Nevertheless, the overview shows that countries are increasingly offering advance pricing agreements. This may be an answer to the need of multinational companies to reduce their risk in transfer pricing matters as awareness is rising. But it can also be argued that the introduction of APAs functions as a tax incentive, giving the tax authorities a possibility to agree on rather flexible terms and thereby attracting investment”.

IV. Conclusion

“As intercompany profit shifting offers opportunities for international tax planning, many countries focus on transfer pricing regulations in order to secure tax revenues. The majority of countries introduced transfer pricing regulations in the last two decades. Only 7 out of the 44 considered countries do not impose transfer pricing regulations which may be explained by them being either low-tax or developing jurisdictions. Where present, transfer pricing regulations usually apply to foreign related parties only. An exception holds for those countries offering tax incentives where also domestic related parties are subject to the rules. In South America, also third parties in tax havens are often treated as related parties. Regarding transfer pricing methods, there is only little variation between countries. The methods outlined by the OECD are mainly accepted. Only differences exist, however, in the priority of methods. While the majority of countries prefers the traditional methods over transactional profits methods, nine countries apply a best method rule. Documentation requirements were introduced to a great extent in the considered time period. Southern American and Asian countries introduced them in connection with the transfer pricing regulations, and European countries mainly extended the scope of existing rules by documentation requirements. A disclosure of documents is mainly required in South America and Asia, in Europe only few countries require information included in the tax return. Only twelve countries impose special transfer pricing penalties, especially with respect to documentation. The design of penalties is similar - usually a certain percentage on the tax adjustment, a late interest, and a fixed monetary fine on noncompliance - but the amounts vary notably. In case of fraud, penalties are often at least doubled. The possibility to enter into advance pricing agreements is increasing with only nine countries not allowing for such agreements”.

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