Chapter 1 What is Transfer Pricing?

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SYNOPSIS

1. Basic Concepts underlying Transfer Pricing (TP)

The role of Multinational Enterprises (MNEs) in world trade has continued to increase dramatically. This reflects the increased pace of integration of national economies and technological progress, particularly in the era of communications. Commercial transactions between the diverse parts of the MNEs may not be subject to the same market forces, shaping relations between the two independent enterprises. One party transfers goods or services to another party for a price; that price is known as 'transfer price'. Transfer price is, thus, a price which represents the value of goods or services between independently operating units of an organisation.

However, the expression 'transfer pricing' generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities.

Various countries have experienced that transfer pricing is used by MNEs to shift profits out of the countries where they operate and into tax havens for reducing income taxes. This involves the MNEs pricing the transfer of goods and services at prices which benefit them.

MNEs in order to reduce effective rate of global tax often use transfer pricing of goods and services within the group to shift profits from high tax jurisdictions to low or no tax jurisdictions, commonly referred to as tax havens. This can be illustrated as below.

Company A, is located in a high tax jurisdiction, it manufactures product X say at a cost of INR 500. Product X is then sold to A's affiliate company B, in a low tax jurisdiction at INR 510, resulting in low profits accruing to A. B then onward sells product X to another affiliate company C located in high tax jurisdiction, where the market exists, for INR 600, earning a resultant profit of INR 90. Company C will earn normal profit, i.e., distributor's margin. The illustration brings out that under normal circumstance if A had directly sold the product X to company C, it would have earned a profit of INR 100. However, the MNE by interposing the transaction through an entity in a tax haven, A's profit has restricted and hence, there is lower tax outflow for A. This also results in inflating profits in the hands of B, which has to pay low or no tax.

In this way, MNEs use transfer pricing to manipulate prices and shift profits from one jurisdiction to another, to lower effective global tax outflow. This results in erosion of the tax base and loss of tax revenue and may also affect the foreign exchange reserves of the tax jurisdiction where the real economic activity is carried out.

The Organisation for Economic Co-operation and Development (OECD) has been publishing the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines) since 1995 updated from time to time, the latest being in 2022. The Guidelines which acts as a guide for countries to legislate on TP and also acts as the guiding principle for TP globally. The Guidelines specify that the price of a **controlled transaction** entered into between related companies must follow what is known as the **arm's length principle**. This principle specifies that a company must charge a similar price for a controlled transaction as an **uncontrolled transaction** made by a third party. In other words, the transaction amount must be at a fair market price.

2. Relevance of Transfer Pricing

Commercial transactions namely sale of finished goods, purchase of raw material, purchase of fixed assets, sale or purchase of machinery etc., sale or purchase of intangibles, reimbursement of expenses paid/received, IT enabled services, support services, software development services, technical service fees, management fees, royalty fees, guarantee fees, loan received or paid and interest thereon, etc. between different entities of the multinational groups may not be subject to the same market forces as between two independent enterprises, that is, the price set by related parties/ associated enterprises may not always reflect the market prices.

The increased foreign investment and integration of India into the global economy has resulted in various business models being implemented by the MNEs, which in essence may be valuable propositions for their organisation, but could be diametrically opposed to the revenue authorities' perspective of source-based taxation. The revenue authorities are usually apprehensive that the growth in globalisation and resultant cross border transactions has opened up possibilities of transfer pricing abuse. Consequently, to protect the tax base of the country, the tax authorities felt the need to have an appropriate transfer pricing regulation in place.

Purpose

The general key objectives behind having transfer pricing policies in any organisation are:

- Generating separate profit for each of the divisions/ companies and enabling performance evaluation of each division/company separately.
- Transfer prices would affect not just the reported profits of every centre, but would also affect the allocation of a

company's resources (cost incurred by one centre will be considered as the resources utilized by them).

Importance

MNEs have some amount of discretion while defining how to distribute the income and expenses to its subsidiaries located in various countries, for the purpose of management accounting and reporting. Sometimes a subsidiary of a company might be divided into segments or might be accounted for as a standalone business. In such cases, transfer pricing helps in allocating revenue and expenses to such subsidiaries in the right manner.

The profitability of a subsidiary company depends on the prices at which the inter-company transactions of income and expenses take place. In recent times, inter-company transactions of income and expenses are facing increased scrutiny by revenue authorities resulting in higher transfer pricing adjustments. When transfer pricing adjustment is made, it could also impact shareholders' wealth as this influences company's taxable income and its after-tax, free cash flow.

It is important that a company having cross-border intercompany transactions should understand the concept of transfer pricing, particularly for the compliance requirements as per law and also to understand the effective treatment and taxability of transactions between related parties and therefore eliminate the risks of non-compliance.

Transfer Pricing Regulations (TPR) should be seen in the backdrop of the Double Taxation Avoidance Agreements (DTAAs), which aims to avoid international double taxation and to facilitate the resolution of tax disputes between countries. The aim of all countries to protect their tax base has to be finely balanced with the above tax principle.

The 2017 OECD Guidelines tries to enunciate international standards which forms the basis of the transfer pricing regulations (TPR) worldwide. This has helped to create global standards for Revenue Authorities (RA) to correctly assess the effect of the transfer pricing policies of MNEs, with the aim to attribute arm's length profit in their jurisdiction, based on the separate entity approach.