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# TRANSFER PRICING: AN INTERNATIONAL STANDPOINT

***Ms. Marinal Gupta****

***Assistant Professor,***

***Sri Aurobindo College of Commerce and Management, Ludhiana***

## ABSTRACT

Since 1991, with the liberalization of trade and foreign exchange policy India has started integrating its economy with global economy which led to increased cross border flow of goods, services, funds and even intangibles. There was a large inflow of Foreign Direct Investment (FDI), monetary controls were relaxed and quantitative import barriers were lifted. With the growing MNEs interested in India, it has become imperative for tax authorities in India to take cognizance of transfer pricing issues. Transfer pricing in an economy is very significant to corporate policy makers, economic policy makers, tax authorities, and regulatory authorities. Transfer pricing manipulation (fixing transfer prices on non-market basis as against arm's length standard) reduces the total quantum of organization's tax liability by shifting accounting profits from high tax to low tax jurisdictions. It changes the relative tax burden of the multinational firms in different countries of their operations and reduces worldwide tax payments of the firm. Changes in manufacturing processes, increased data communication, ever enhancing contribution of intangibles and various services have facilitated businesses to operate effectively across nations. While on the one hand, a large number of multinational corporations (MNCs) have come into existence in the Indian shores, many of the Indian companies have also expanded their worldwide operations. As a result, related party trade has grown both in volume and in scope. International transfer pricing is now considered as an important factor in corporate strategic planning and decision making.

**Keywords: transfer pricing, arm' length principle, low tax jurisdiction etc.**

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## INTRODUCTION

Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or pro-vides services to an associated enterprise. The internationally agreed standard for setting prices is the "arm's length principle". According to this principle, intra-group (related party) transfer prices should be equivalent to those which would be charged between independent persons dealing at arm's length in other- wise similar circumstances. This principle has been incorporated in Article 9 of OECD's Model Tax Convention on Income and on Capital. Section 92 of the Income Tax Act 1961 also provides that any income arising from an international transaction or where the international transaction comprises of only an outgoing, the allowance for such expenses or interest arising from the inter- national transaction shall be determined having regard to the arm's length price.

## REVIEW OF LITERATURE

Swenson (2000) is an econometric study that found that reported prices increased when the combined effect of taxes and tariffs provided an incentive for firms to overstate their prices. He found that while the results were statistically significant, they were economically small, implying that a 5 per cent decline in foreign tax rates caused the reported price of affiliated firm imports to rise by 0.024 per cent.

Shah (2001) examined transfer pricing regulations in India introduced by The Finance Act 2001. The study stated that the objective of the introduction of transfer pricing regulations in India was to check the manipulation in prices charged and paid in intra-group transactions. It was felt that the assessee would have to review the methods for negotiations in respect of import-export transactions and collect basic data about market prices and other evidence to justify that the prices paid or received in the transactions with associated enterprises are on arm's length basis. The study concluded that onerous responsibilities have been put on the persons entering into international transactions.

Reeb and Hansen (2003) explored whether income shifting had decreased with increased governmental regulations in recent years and found that international firms continued to shift income during the 1990s to minimize taxes. They also found evidence to suggest that tax minimization schemes were more aggressively pursued in small firms; and firms based in low tax countries were more likely to shift income home than firms in high tax countries were to shift income abroad.

Srivatsan (2004) theoretically examined some economic aspects such as extension of Value Added Tax (VAT) in transfer pricing; bridging of fiscal *vs* economic tax base; and the multiplier effect of transfer pricing. The study stated that by adopting tax/profit shifts from higher tax jurisdictions to lower tax jurisdictions, the firm could go on building the profits and multiplier concept would hold true for transfer pricing. Further, the multiplier would be limited and dependent on tax rates prevailing in each shift; and the quantum of corpus that is shifted each time. The study concluded that despite all issues and propositions, transfer pricing, no doubt, is a welcome legislation given the winds of change blowing all across nations to protect their tax share in global tax wealth.

**TRANSFER PRICING REGULATIONS IN INDIA**

The Transfer pricing Regulations (TPR) were introduced in India vide the Finance Act, 2001 by substitution of the existing 92 and introduction of new sections 92A to 92F in the Income Tax Act and relevant rules 10A to 10E in the Income Tax Rules, 1962. The regulations are applicable to relevant international transactions entered into from 1st April 2001. TPR was introduced with a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the cases of multinational enterprises, and also introduced new s 92A to 92F in the Act, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of international transaction, computation of arm's length price, maintenance of information and documents by persons entering into international transactions and definitions of certain expressions occurring in the said sections. The legislative intention is to prevent the shifting of profits by manipulating prices charged or paid in international transactions, thereby eroding India's tax base. The following are the important statutes of the law.

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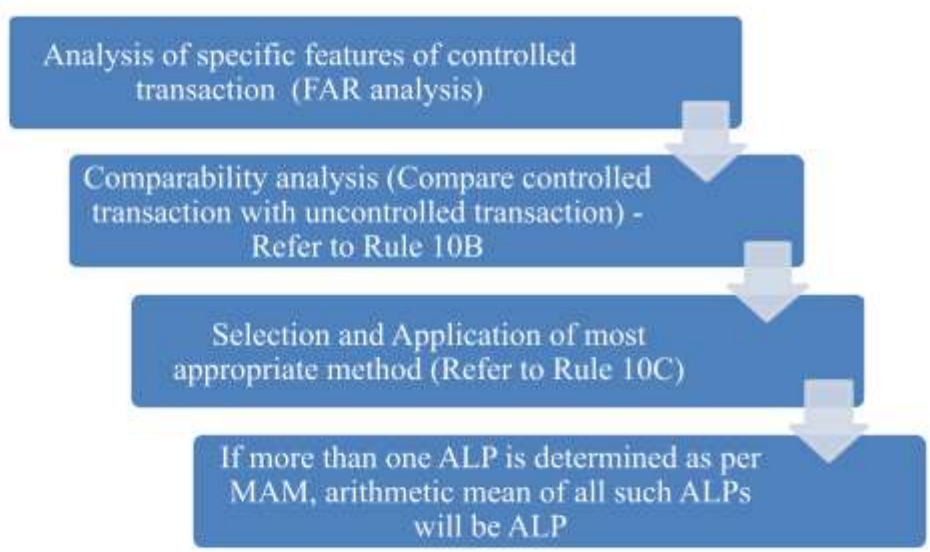
- Each person or association who is involved in an international transaction should maintain an up-to-date record of each transaction as prescribed by the legislation.
- All income acquired by the company by means of any international transaction shall be calculated at arm's length price. There are various methods to calculate the arm's length price, depending on the nature and type of the transaction, the nature of the group or the association involved, or any other features of the transactions involved.
- If there are two or more appropriate prices assumed for a certain transaction, the arm's length price will be calculated as the average of the prices.
- At the end of a financial year, the person or group involved in an international transaction should submit the report of it in Form 3CEB under the guidance of a Chartered Accountant. This form has to be filed before he files the Income Tax return of the same period.

In order to determine ALP, following is the process that needs to be followed:




In case difference between ALP (or arithmetic mean of ALPs) and actual price of the international transaction does not exceed such percentage as notified (1% for wholesale traders and 3% for others notified for AY 2013-14), actual price is to be accepted and no adjustments to be made for computation of income from international transactions.

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Analysis of specific features of controlled transaction (FAR analysis)

Some methods are more appropriate and indicative to provide for an arm's length result for certain transactions than others. Starting point to select a method is **functional analysis** which is necessary regardless of what transfer pricing method is selected. Functional analysis helps:

- To identify and understand the intra- group transactions
- To have a basis for comparability
- To determine any necessary adjustments to the comparables
- To check the accuracy of the method selected and
- To consider adaptation of the policy if the functions, risks or assets have been modified.

As such functional analysis is a major part of the documentation. Major components of a functional analysis are:

**Functions performed**: It describes the activities performed such as design, purchasing, inbound logistics, manufacturing, Research and development, assembling, inventory management, outbound logistics, marketing and sales activities, after- sale services, supporting activities, services, advertising etc. It must be specified which party performs each activity and in case both parties are involved in performing an activity it should provide for the relevant differences.

**Risks undertaken**: The functional analysis should identify risk undertaken. For example financial risk (currency, commodity, interest rate, funding risks etc), credit and collection risk (trading credit risk, commercial credit risk), operational risk (systems failure risk, reliability of customers, inventory risk and carrying costs, research and development risk, environmental and other regulatory risks), market risk ( country political risk, reliability of customers, fluctuation in input cost and output price fluctuations), product risk ( product liability risk, warranty risk and costs, contract enforceability).

**Assets used or contributed**: Functional analysis must identify and distinguish tangible assets and intangible assets. Tangible assets such as a property, plant and equipment have to be financed and capital assets would usually be expected to earn a long term rate commensurate with the business risk assumed. Some assets could be specific and must be identified and quantified whenever possible. It should be specified which party bears the risk in the legal terms

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and which party bears the risk based on the economic substance of the transaction. Intangible assets are very important as sustainable competitive advantage is often achieved by the use of intangible assets. Some intangibles have legal protection (patents, trademarks, trade names) but others without legal protection may be equally important and valuable (know- how, trade secrets, corporate goodwill, exclusive import or export rights, etc). A party that developed the intangibles should be able to obtain benefit from the intangibles either through a sale or licensing of the intangibles or through an increase in prices of products or services with imbedded intangibles. It is important to determine which party has developed the intangibles and in what capacity, which has the legal ownership and which receives the benefit of the intangibles.

The functional analysis includes reference to the industry specifics, contractual terms of transaction, the economics circumstances and the business strategies. It helps to identify if the operations are complex justifying a higher level of profit or more limited and consequently generating a lower profit. Once the functional analysis is performed and the functionality of the entity has been completed, it can be determined what transfer pricing method is most suitable to determine the arm's length price for the transactions under the review.

The tested party normally should be the party in respect of which reliable data for comparison is easily and readily available and fewest adjustments in computations are needed. It may be local or foreign entity that is one party to the transaction. Generally least of the complex controlled taxpayer should be taken as a tested party.

<u>Comparability analysis - Refer to Rule 10B</u>

The OECD Transfer Pricing Guidelines define comparability analysis as "A comparison of Controlled transaction with an uncontrolled transaction." ALP principle is based on:

- A comparison of conditions in a controlled transaction with the conditions in uncontrolled transaction between two independent enterprises
- Subject to adjustments to the price of uncontrolled transaction to carve out differences between two types of transactions.

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So locating proper comparables that is comparable uncontrolled transaction is at the root of ALP mechanism.

Selection and Application of most appropriate method

According to Sec 92C read with rules 10B and 10AB, ALP should be determined by any of the following methods, being the most appropriate method (MAM) in give circumstances:

I. Comparable Uncontrolled Price Method (CUP)
II. Resale Price Method (RPM)
III. Cost Plus Method (CPM)
IV. Profit Split Method (PSM)
V. Transactional Net Margin Method (TNMM)
VI. Any other method specified by CBDT

The first five methods listed above are OECD recognized methods. Methods prescribed by OECD for computation of ALP in case of international transactions which can be divided into two broad categories:

I. Traditional transaction methods (also known as transaction based approach)
    i. Comparable Uncontrolled Price Method (CUP)
    ii. Resale Price Method (RPM)
    iii. Cost Plus Method (CPM)
II. Transactional profit method
    i. Profit Split Method (PSM)
    ii. Transactional Net Margin Method (TNMM)

**Comparable Uncontrolled Price Method - Rule 10B(1)(a)**

- CUP method compares the price charged for the property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.
- Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP Method is preferable over all other methods.

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**ICAIs views on CUP Method:**

As per ICAIs revised guidance note on transfer pricing, the following points are important in application of CUP Method:

- All adjustments required should be made to the price charged in uncontrolled transaction
- No adjustment should be made in price of international transaction
- Presence or absence of any special feature in uncontrolled transaction as compared to international transaction are to be quantified in mathematical terms and adjusted to price of uncontrolled transaction
- Adjustments to be made only for differences that would materially affect the price in open market. Open market though not defined would mean transaction between knowledgeable and willing purchaser and knowledgeable and willing seller where neither of them is influenced or compelled to act in a particular manner.

**Steps to be followed in CUP Method**

i. Identification of price charged or paid in comparable transaction(s)
ii. Such price is adjusted to account for differences if any between international transaction and comparable uncontrolled transaction(s) which could affect the price in open market
iii. Adjusted price arrived above taken to be arm's length price

**Comparables**

i. Transfer price is set/ defended using data from comparable transactions
ii. Comparable transaction should be independent and similar to tested transactions
iii. Factors for judging comparability:
    - Nature of transactions undertaken (type of goods or service etc)
    - Functions performed
    - Risks assumed
    - Contractual terms (similar credit terms)
    - Economic and market conditions

CUP may be Internal CUP or External CUP

**Internal CUP:** Price paid or charged in a Comparable Uncontrolled Transaction *by the Taxpayer with a Independent Party*

**External CUP:** Price charged/paid in a Comparable Uncontrolled Transaction between *Independent Parties*

**Reliable adjustments may be possible for:**

- Difference regarding the source of the products
- Difference in delivery terms
- Volume discounts
- Product modifications
- Risk incurred

**Reliable adjustment may *not be possible for:***

- Trademarks
- Effects of geographical differences
- Major product differences

**Strengths of CUP Method:**

- It is not a one- sided analysis as the price is arrived at between two parties to transaction
- It involves a detailed transactional comparison.

**Weaknesses of CUP Method:**

- It will be hard to find closely comparable uncontrolled transactions as strict comparability standard is required particularly with respect to product Comparability
- Internal comparables frequently don't exist and external comparables are difficult to find in practice.

**Resale Price Method- Rule 10B(1)(b)**

RPM is normally used in cases which involve the purchase and resale of tangible property in which the reseller does not add substantial value to the tangible goods by way of physically modifying the products before resale. *Thus typically applied to sales or distribution activities*

**ICAIs Views on RPM**

- RPM method is to be used for determining ALP only when goods purchased from associated enterprise are resold to unrelated parties
- Gross profit margin to be reduced from resale price
- Deduction for expenses from resale price: Expenses incurred in connection with purchase from AE should be reduced from cost of sales (freight, duties etc but not purchase price)
- Resale in any financial year may be out of opening stock. Goods may remain in closing stock. Just reducing margin and expenses without adjusting for opening and closing stock of goods purchased from AEs will give only cost of sales and not value of purchases. Therefore closing stock of goods purchased from AEs be added and opening stock of goods purchased from AEs be reduced.
- Some of the differences in accounting practices which may require adjustments are:
    a. Sales and purchases accounted for inclusive/exclusive of taxes
    b. Method of pricing: FOB/CIF
    c. Foreign exchange fluctuations

**Steps to be followed in RPM**

i. Identification of resale price by tested party
ii. Resale price reduced by normal gross profit with reference to uncontrolled transaction(s)
iii. Such price reduced by expenses incurred in purchase of the product/ service
iv. This price may be adjusted to account for functional and other differences if any

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v. Adjusted price arrived above taken to be ALP

To compute ALP, price charged by Associated Enterprise 2 from independent enterprise will be taken into consideration. The mechanism of the resale price method reduces the price of product that related company charges to an unrelated customer by an arm's length gross margin, which the sales company uses to cover its selling, general and administrative expenses and still make an appropriate profit, taking into account its functions performed and risks incurred. Balancing figure is regarded as an arm's length transfer price for intercompany transactions.

$$\mathbf{TP = RSP \times (1- \ GPM)}$$

Where TP = Transfer Price of a product sold

RSP = the Resale Price at which a product is sold by AE to unrelated customers

GPM = Gross Profit Margin that a specific sales company should earn, defined as ratio of Gross profit to net sales

**Strengths of RPM:**

- It is based on the resale price, a market price, and thus represents a demand driven method
- It can be used without forcing distributors to make unrealistic profits. The distributor should earn an arm's length gross profit margin, however, it can make operating losses due to high selling expenses caused by strategies such as a market penetration strategy

**Weaknesses of RPM:**

- It is a one- sided analysis, as its focus is on the related sales company as tested party in transfer pricing analysis. It is possible that the arm's length gross profit margin and hence transfer price, which is based on a benchmarking analysis, can lead to an extreme result
- Data on gross margins may not be comparable due to accounting inconsistencies

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**Cost Plus Method Rule 10B(1)(c)**

CPM is a preferred method for transactions relating to:

- Transfer of semi-finished goods
- Provision of services
- Joint facility arrangement
- Long term buying and selling arrangement

Related customer involved in controlled transaction will generally be much more complex than contract manufacturer in terms of functions performed (e.g., conducting marketing and selling functions, coordination of production and sales, giving instructions to contract manufacturer about the quantity and quality of production, and purchasing raw materials in some cases), risks incurred (e.g., market risk, credit risk and inventory risk) and assets owned (product intangibles). The contract manufacturer is thus the less complex and as such should be the tested party in the transfer pricing analysis.

In case of Contract manufacturer or low risk assembler which does not own product intangibles and incurs lesser risks, CPM may be used.

The cost plus method is usually not a suitable method to use in transactions involving a fully fledged manufacturer which owns valuable product intangibles as it will be very difficult to locate independent manufacturers owning comparable product intangibles. That is, it will be hard to establish a profit mark- up that is required to remunerate the fully- fledged manufacturer for owning the product intangibles.

**ICAIs views on CPM**

- Identify direct as well as indirect costs of production (a reference may be made to industry practice)
- Any deviation made by enterprise as compared to industry practice will have to be justified
- Following factors to be kept in mind while identifying cost:
    i. Plant utilization (whether under or over utilization)

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ii. Method of absorbing costs: absorption costing method is normally to be preferred

**Steps to be followed in CPM**

- Identification of direct and indirect costs of production incurred in tested party transactions
- Identification of normal gross profit with reference to comparable uncontrolled transaction(s)
- After FAR analysis, Normal gross profit adjusted to account for functional and other differences if any
- Adjusted gross profit added to total costs identified in step 1
- Sum arrived above is taken to be arm's length price

Gross profit mark up is defined as ratio of gross profit to Cost of goods sold (excluding operating expenses) for comparable uncontrolled transaction.

**Computation of ALP with CPM:**

Formula for transfer price is:

**TP = COGS * (1 + COST PLUS MARK UP)**

Where

TP = Transfer Price

COGS = Cost of goods sold of manufacturing co.

Cost Plus mark up = Ratio of Gross profit to COGS

Gross profit mark up will not be comparable if accounting principles differ or inventory valuation methods vary between controlled and uncontrolled transactions. Thereby need arises to make reasonable accurate adjustments to adjust for the effect of such variations.

**Strengths of CPM**

- Based on internal costs, the information of which is available
- Third parties are found that indeed use CPM to set prices

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**Weaknesses of CPM**

- There may be no link b/w level of costs and market price
- Accounting consistency is required
- One sided analysis as focus is on related party only

**Profit Split Method-Rule 10B(1)(d)**

PSM is a preferred method for transactions involving to:

- Transfer of unique intangibles
- Integrated services provided by more than one enterprises
- Multiple inter related transactions which can't be evaluated separately

PSM can be applied in cases where the associated enterprises engage in several transactions that are interdependent in such a way that they cannot be evaluated on a separate basis using a traditional transaction method. Transactions are so interrelated that it is impossible to identify comparable transaction.

PSM is typically used in complex cases where both sides to controlled transaction own valuable intangible properties (e.g., patents, trademarks). If only one of the associated enterprises own valuable intangible property, the other associated enterprise would have been the tested party in the analysis using CPM method. However, if both sides own valuable intangible properties for which it is impossible to find comparables, then the profit split method might be the most reliable method.

**ICAIs views on PSM**

- What is to be determined is profit from a transaction with Associated enterprise
- If there are other transactions, which contribute to profits. Profits from transactions with AEs will be arrived at on the basis of approximations.

**Steps to be followed in PSM**

- Determination of combined net profit of the associated enterprises arising out of international transaction

- Evaluation of relative contributions by each enterprise on the basis of functions performed, risks assumed and assets employed
- Splitting of combined net profit amongst enterprises in proportion to their relative contributions
- Profit thus apportioned to the tested party is used to arrive at the arm's length price

**Strengths of PSM:**

- Suitable for highly integrated operations for which one sided method may not be appropriate
- Suitability in cases where traditional methods prove inappropriate due to a lack of comparable transactions
- Better results as all parties to the controlled transaction are being analyzed
- Its ability (in fact unique among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale.

**Weaknesses of PSM**

- Relative theoretical weakness of the second step that synergy value is divided pro rata to the relative value of inputs in unclear (although this approach is arguably consistent with the way interests are divided between joint ventures)
- Its dependence on access to data from foreign affiliates. Associated enterprises and tax administrations may have difficulty obtaining information from foreign affiliates.
- Third parties in general do not use the profit split method to establish transfer prices (maybe only in joint ventures)
- **C**ertain measurement problems exist in applying the profit split method. It may be difficult to calculate combined revenue and costs for all the associated enterprises taking part in the controlled transactions due to, for example, differences in accounting practices.

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**Transactional Net Margin Method-Rule 10B(1)(e)**

Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties

Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction. Applicable for any type of transaction and often used to supplement analysis under other methods. Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method/ cost plus method/ resale price method

**ICAIs views on TNMM**

TNMM may be used for:

- Provision of services
- Distribution of finished products where RPM cannot be applied
- Transfer of semi finished goods where CPM cannot be applied
- Transactions involving intangibles where PSM cannot be applied

**Steps to be followed in TNMM**

- Computation of net profit as a percentage of a certain base realized from the international transaction
- Computation of net profit realized by the tested party or an unrelated enterprise in a comparable uncontrolled transaction
- Net profit from uncontrolled transaction adjusted to account for differences if any
- The net profit thus established is taken into account to arrive at an arm's length price for the international transaction

**Strengths of TNMM:**

- Net margins are less affected by transactional differences (than price) and functional differences (than gross margins). Product and functional comparability are thus less critical in applying the TNMM
- Less complex functional analysis needed, as TNMM is applied to only one of related parties involved

- Because TNMM is applied to the less complex party, it can be used even though one of related parties holds intangible assets for which comparable returns cannot be determined
- It is applicable to both sides of the controlled transaction (i.e. either the related party manufacturer or distributor)
- Results resemble the results of a modified resale price / cost plus method of analysis

**Weaknesses of TNMM:**

- Net margins are affected by factors (e.g. variability of operating expenses) that do not have an effect, or have a less significant effect on price or gross margins. These factors affect net profits and hence the results of the TNMM.
- Information challenges, including the unavailability of information on profits attributable to uncontrolled transactions
- Measurement challenges may make it difficult to determine sales revenue, operating expenses and assets relating only to the relevant controlled transactions or functions in order to calculate the selected profit level indicator.

**Conclusion**

In India the Transfer Pricing Regulations are still at a nascent stage and it will take some time for the same to evolve into a substantive law. Unless and until such complete law is evolved, it is advisable to be cautious and to follow the evolution closely.

- Accept the headache arising out of transfer pricing regime as an additional cost
- Comply transfer pricing regulations in Letter and Spirit, negotiate hard with Associated Enterprises to ensure fair price for receipt / payments
- Treat transfer pricing as an issue as decision making stage rather than as a mere compliance issue
- Review inter company transactions and arrangements on an ongoing basis
- Maintain proper documents as required in Law
- In case of double taxation, use DTA provisions especially Article 9 and
- Mutual Agreement Procedure [MAP] under Article 25 of model convention to eliminate the double taxation
- If the transfer prices fall short of ALP, accept the adjustment and PAY TAX
- If not, be prepared to Pay Tax, Interest as well as Penalty !

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