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Mahesh C. Purohit

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Mahesh C. Purohit

The author is Professor at the National Institute of Public Finance and Policy, New Delhi-110 067 (India). He is indebted to K. Srinivasan and B.V. Kumar for helpful discussions and very useful comments on the original draft of the paper. However, the author alone remains responsible for the errors, if any.

I. INTRODUCTION

Transfer pricing refers to the value attached to the transfer of goods or services including technology between related entities. The issues related to it are currently one of the most important subjects in the area of international taxation.

The enactment of Section 482 (Final Regulations) by the United States[1] in July 1994 and the publication of the revised Guidelines on Transfer Pricing by the OECD in July 1995[2] are the two most significant events related to the subject. Following these developments, many countries from the different trade blocks such as the European Union, the North American Free Trade Agreement (NAFTA) and the ASEAN Free Trade Area (AFTA) have tried to harmonize their transfer pricing regulations. However, transfer pricing remains a vexing problem for most developing countries, including India.

In the context of the growing importance of transfer pricing issues and considering the fact that almost half of the transactions in international trade are potentially susceptible to transfer pricing,[3] this paper aims at presenting a critical analysis of the existing transfer pricing provisions under different statutes in India and at making suitable recommendations on the issues relating to this subject.

The scheme of presentation is as follows: Section II examines the significance of the issues in transfer pricing in the context of the globalization of the Indian economy. The next section reviews the theoretical developments of transfer pricing in different countries. Section IV analyses the existing provisions under Indian statutes. These provisions include regulations under different taxes viz., income tax, customs duty, and union excise duties. The following section puts forth the suggested reforms to the regulations. Finally, Section VI presents a summary of conclusions and recommendations.

II. SIGNIFICANCE OF THE ISSUES

The importance of issues related to transfer pricing has long been recognized. The issues have, however, become critical in India during the last five years due to three important factors. Firstly, since 1991-92 India has embarked upon a course of structural reforms. This has paved the way towards globalization of the Indian economy and resulted in the removal of barriers such as prohibitive customs duties. The reforms have also done away with most of the other fiscal and regulatory restrictions in order to enable foreign enterprises, especially the multinational corporations (MNCs) to participate in the economic development of the country through their capital and technology.

Secondly and more importantly, as the prevailing trends suggest, there is a feeling that, in general, the MNCs pay less tax than comparable domestic organizations.[4] In the Indian context it is felt that since the tax administration is lax and the management information system (MIS) in the tax departments is practically non-existent, the MNCs would certainly not pay the tax due to the country.

Thirdly, with the expansion of the export sector, the Indian undertakings engaged in exporting their products could increasingly exploit transfer pricing to reduce their tax liabilities through undervaluing their exports to their related or affiliated counterparts located in foreign low-tax regimes. These related enterprises would in turn transfer their products back to the same or a related enterprise in India at higher prices and thus avoid the incidence of tax. In order to protect India's tax base it is therefore important that the laws are tightened.

As the inflow of direct foreign investment is increasing over time, the above issues raised by transfer pricing are achieving a higher profile.

III. THEORETICAL DEVELOPMENTS IN TRANSFER PRICING

Transfer pricing concerns the valuation of transfers of goods or services between related entities, i.e. parent and subsidiary corporations, or sister corporations. To illustrate, domestic company A has a subsidiary or an associate multinational

1. Internal Revenue Service Final Regulations (TD 8552), relating to intercompany transfer pricing under Sec. 482 (referred to as US (1994)) published in Federal Register on 8 July 1994.
2. OECD (1995), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, Report of the OECD Committee on Fiscal Affairs*, Paris. Part I of the Draft titled "Principles and Methods", addresses the issues related to the transfer of goods. Part II relates to the areas of transfer pricing for intangibles and services.
3. Quoted in CCH *Australian Master Tax Guide* (1996), at 1234.
4. In a Report from Price Waterhouse it is shown that 30 per cent of the worldwide sales and 43 per cent of the reported book profits of the US MNCs originate from their foreign offices.

company B. Company A transfers some products (inputs or finished goods) or assets to B. The value attached to the products transferred by A to B is the transfer price. It is important that the transfer prices of the products in question were fairly set when determining the tax revenues due to countries A and B.

To find an answer to this problem, the approach of the OECD emphasizes that the guiding principle is the arm's length criterion. The OECD Guidelines are intended to suggest mutually acceptable solutions. Accordingly, the Guidelines indicate different pricing techniques, as set out below.

First, there is the principle of arm's length (elaborated in chapter I of the Guidelines) which states that if the price or the margin is not within the arm's length range, adjustment should be made by the tax administration. However, the taxpayer must be given the opportunity to present additional evidence. The US regulations are more rigid than the OECD Guidelines.

Secondly, the Guidelines present the technique of comparable uncontrolled prices (CUP). Since in a related party transaction price can be controlled, there must be a reference to a comparable situation where price is not controlled, i.e. a benchmark.

Thirdly, there is a cost-plus technique. The starting point in this method is the cost incurred by the supplier of the goods in a transaction between the related enterprises. A profit mark-up is added to the costs. It is ideal in a sellers' market, where the international norms vary between 5 and 10 per cent. Disputes may however occur since it is possible that the cost is likely to include a fair return on investment. What is a fair return is not a matter of law but of commerce and may be hotly contested.

Fourthly, the Guidelines refer to a technique called resale minus. According to this technique, the fair price is the price at which the product is sold to an independent third party by a related enterprise, which subsequently resells the product. This resale price is reduced by a gross profit margin which takes into account the relevant costs and expenses and also a reasonable profit in the light of the functions performed, assets used and risks assumed. It is possible that the product sold by a company may not be sold by any other company but the point here is not the price of the product but the margin of the dealer. For example, generally speaking, a distributor earns a 15 per cent commission. If the commission substantially exceeds 15 per cent, the issue may require investigation by the tax officials.

Fifthly, there is the method called transactional profit method or the profit split method. In such a method, the profit to be split must be identified. Following this, the profit could be split between the related enterprises. The Guidelines state that this method is useful in the absence of comparables.

Finally, there is a method called the net margin method. This method examines the net profit margin in relation to the costs, sales, or assets, which a taxpayer realizes from a transaction or aggregated transactions with a related party.

The above approaches suggest various arm's length solutions to the problem of transfer pricing. There is no one multilaterally applicable solution to cover all situations. National rules differ with regard to the priority of the methods.

IV. PROVISIONS UNDER THE INDIAN STATUTES

Various tax statutes, the company law regulations, and the foreign exchange regulations in India have dealt with the issues related to transfer pricing. The following are the main provisions related to the issues.

A. Provisions under income tax

Under the income tax laws, if a business transaction between a resident and a non-resident is so structured that it results in no profit or less than the ordinary profit, the tax authorities may determine a "reasonable" amount of profit from the transaction. The profit which has been so "deciphered" is added to the taxable income of the resident assessee. The profit may be determined with reference to the value of the transaction by applying the ratio of total business receipts or by using any other appropriate method.

Section 92 of the Indian Income Tax Act, 1961,[5] covers transfer pricing among other devices designed to avoid tax between a resident and a non-resident.[6] When 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 profit or less than the ordinary profit which might be expected to arise in that business, the Assessing Officer shall determine the amount of profit which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident." Rules 10 and 11 of the Income Tax Rules, 1962, prescribe the methods for determining such income. Normally, it is calculated as a percentage of the turnover. These provisions have, however, rarely been invoked by the tax authorities.

In *Mazagaon Dock Ltd. v. Commissioner of Income Tax and Excess Profits Tax*[7] the Supreme Court considered the application of the provisions. In this case the appellant was a private limited company incorporated under the Indian Companies Act and was carrying on business as marine engineers and ship repairers. Its registered office was in Bombay and it was resident and ordinary resident in India. Its entire share

5. The provisions of the Income Tax Act are amended from time to time. The Act and the rules presented here are as amended by the Finance (No. 2) Act, 1996.
6. Some related provisions also exist in Sec. 93 concerning income from an asset transferred to a non-resident as income of the resident under certain situations and Sec. 94 relating to avoidance of tax on certain transactions in securities. However, the mere fact that the transfer resulted in the avoidance of tax liability cannot be the proof of the intention to avoid the liability. See *CIT v. Mohammed Ibrahim Sahib* (1962) 45, *Income Tax Reporter*, 301, (Cal).
7. *Commissioner of Income Tax/Excess Profits Tax v. Mazagaon Dock Ltd.* (1955) 28 I.T.R. 35 affirmed.

capital was beneficially owned by two British companies, the P&O Steam Navigation Corp. Ltd. and the British Indian Steam Navigation Co. Ltd., whose businesses consisted in plying ships for hire. Under an agreement, entered into with these two companies, the appellant repaired their ships at cost, and charged no profits. Now, the point of determination was whether on these facts, the appellant was chargeable to tax under Section 42(2) of the Income Tax Act, 1922.[8]

The Income Tax Officer, Bombay, who dealt with the matter took the view that the appellant company had so arranged its business with the non-resident companies that it did not produce any profits, and that was because it was those companies that really owned its share capital, and that, therefore, the profits which it could ordinarily have made but for their close financial connection were liable to be taxed under Section 42(2), and computed the same at INR 680,000 for the account year 1943-44, etc. On the basis of the above findings, orders of assessment of income tax were made. Against these orders the appellant preferred appeals to the Appellate Assistant Commissioner who confirmed the same. The matter was referred to the Appellate Tribunal and the orders were set aside. On appeal by the Department before the High Court it was held that Section 42(2) was applicable and that the appellant was liable to be assessed to income tax. The taxpayer appealed. Finally, the Supreme Court dismissed the taxpayer's appeal on the basis that the charge was on the business of the appellant and not on the non-resident company.[9]

Section 142 (2A) of the Income Tax Act further envisages that

> if, at any stage of the proceedings before him the Assessing Officer, having regard to the nature and complexity of the accounts of the assessee and the interest of the revenue, is of the opinion that it is necessary so to do, he may with the previous approval of the Chief Commissioner or Commissioner, direct the assessee to get the accounts audited by an accountant as defined in the Explanation below subsection (2) of Section 288, nominated by the Chief Commissioner or Commissioner in this behalf and to furnish a report of such audit in the prescribed form duly signed and verified by such accountant and setting forth such particulars as may be prescribed and such other particulars as the Assessing Officer may require.

This is a powerful tool given to the Assessing Officer by the Income Tax Act.

B. The role of tax treaties

Tax treaties are useful in handling the issues related to transfer pricing. These treaties could affect transfer pricing in two different ways. First, by providing specific clauses, the treaties define a specified base for allocation of income. And secondly, the treaties identify the transaction to which the basis would apply and provide for resolution of disputes.

So far India has entered into more than 60 Double Taxation Avoidance Treaties.[10] These treaties provide a safeguard against transfer pricing abuse by the "Associated Enterprises". Therefore, each treaty incorporates an article on this aspect, primarily following the OECD and the UN Models. It stands as follows:

> 1. Where – (a) an enterprise of one of the States participated directly or indirectly in the management, control or capital of an enterprise of the other State, or (b) the same person participates directly or indirectly in the management, control, or capital of an enterprise of one of the States, and an enterprise of the other State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
>
> 2. Where one of the States includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the States shall if necessary consult each other.

The above clause makes the following important points relating to arm's length transactions:

- it addresses the question of the apportionment of profits and commercial and financial relations;
- its scope is not limited to transactions or their pricing; and
- it refers to certain pre-conditions to the application of the article, such as the degree of association or inter-connection between taxpayers, and whether the arrangements or dealings provided are different from those that would have been entered into in an unrelated situation.

However, it is important to note that the word "association" is capable of a wide meaning and may be interpreted subjectively. It refers to "direct" or "indirect" participation as well as "management, and control".

8. The corresponding section in the current Act is Sec. 92, which deals with the determination of profits. In addition there are provisions governing calculation of income through Secs. 37(1), 40A(2), and 44 C, each dealing with aspects relating to expenses for calculating income.

9. *Income Tax Reports* (1958), Vol. 34, at 368-378. Here it is important to note that for preventing evasion of tax, sufficient powers are provided by the Income Tax Act for the assessing officer to determine the taxable income of a business or profession. Sec. 37(1) entitles the assessing officer to examine whether or not expenditure has been incurred wholly and exclusively for the purpose of the business. Sec. 80 I or 80 IA, empowers the Assessing Officer to determine the deduction allowable to reduce the total income of the company. Sec. 40A(2) specifically states that "where the assessee incurs any expenditure in respect of which payment has been or is to be made to any persons referred to in clause (b) of this sub-section, and the Assessing Officer is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is considered by him to be excessive or unreasonable shall not be allowed as a deduction." Also, Sec. 44C imposes a ceiling on the allowances of the head office expenditure in the case of non-residents. However, the Calcutta High Court has held that the above restriction does not apply to a foreign company having its entire business in India. *Rupanjuli Tea Co. Ltd. v. CIT* (1991) 92 CTR (Cal) 37: (1990) 186 ITR 301 (Cal).

10. See for details, Srinivasan K. (1997), *Guide to Double Taxation Avoidance Treaties*, Vidhi Publishing, New Delhi-110 002.

Notwithstanding the above limitation, the article embodies the essentials of a "fair price". It suggests that the adjustments should be made in such a way that the profits are derived and taxed in the hands of the enterprise, as if the concerned enterprise was not dealing with an associated enterprise. However, the matter is not so simple. The profit that would have arisen to that enterprise itself is likely to create a problem of transfer pricing. The two contracting states may themselves not agree on what is an arm's length price. The potential for disagreement is much more when one of the contracting states has an aggressive approach to transfer pricing and may operate a system of determining profit allocation which may not be strictly in accordance with the arm's length principle.

In addition, double taxation avoidance treaties derived from the OECD/UN Models in general lack teeth. The article provides for a consequential rate adjustment, based on an adjustment that the enterprise in the other contracting state has made.

It is also important to note that paragraph (2) of the article does not specify the method for making the adjustment. It is possible that some states would make corresponding adjustments by reducing the taxable profits whereas others would prefer simply to give a tax credit.

Where the profits of a subsidiary taxable in India are artificially reduced India may take recourse to Section 92 of the Indian Income Tax Act, 1961, to adjust the profits of the subsidiary upwards. The parent company should via the treaty make an application to the appropriate tax authorities in its own home country. The newly drafted OECD Guidelines for transfer pricing[11] have attempted to reconcile the tax regimes of various countries; whether it has been successful in its attempts is not yet clear.

C. Company law on transfer pricing

The effect that transfer pricing may have on the profitability of a company is also considered in the provisions of the Indian Companies Act, 1956.

Section 211 dealing with the form and contents of the balance sheet and the profit and loss account requires that every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto: Provided that nothing contained in this subsection shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company.

In addition, the Government of India, under the Companies Act has the power to direct a special audit in certain cases. Section 233A states that

> (1) Where the Central Government is of the opinion
> (a) that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
> (b) that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
> (c) that the financial position of any company is such as to endanger its solvency;
>
> the Central Government may at any time direct that a special audit of the company's accounts for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order appoint either a chartered accountant as defined in clause (b) of subsection (1) of Section 2 of the Chartered Accountants Act, 1949 ... to conduct such special audit. Provided that the special auditor shall, instead of making his report to the members of the company, make the same to the Central Government. The expenses of, and incidental to, any special audit under this section (including the remuneration of the special auditor) shall be determined by the Central Government and paid by the company.

In addition, the central government is empowered under Section 233B of the Companies Act to order the audit of cost accounts in certain cases.

Section 227 of the Companies Act specifies the duties of the auditors. Accordingly, an auditor is required to report under the Manufacturing and Other Companies (Auditor's Report) Order, 1988 (MAOCARO) whether purchases of goods and materials and sales of goods, materials and services between associated parties are made at prices which are reasonable having regard to comparable market prices for transactions with other parties.[12]

The above provisions have enough teeth to look into the problem of transfer pricing of resident as well as non-resident companies, as and when the need arises.

D. Provisions under FERA

The Foreign Exchange Regulations Act (FERA), 1973, incorporates further checks relating to the misuse of foreign exchange. Section 18(16) under FERA provides that

> where the value of the goods specified in the declaration furnished under that subsection is less than the amount which in the opinion of the Reserve Bank, in a case falling under sub-clause (i) of clause (a) of that subsection, represents the full export value of those goods, or in a case falling under sub-clause (ii) of that clause, the value which the exporter can, having regard to the prevailing market conditions, expect to receive on the sale of the goods in the overseas market, the Reserve Bank may issue an order requiring the person holding the shipping documents to retain possession thereof until such time as the exporter of the goods has made arrangement for the Reserve Bank or a person authorized by the Reserve Bank to receive on behalf of the exporter payment in the prescribed manner of an amount which in the opinion of the Reserve Bank represents the full export value of such goods or the value which the exporter, having regard to the prevailing market conditions, can be expected to receive on the sale of the goods in the overseas market.

These are additional checks on any party entering into transfer pricing to avoid payment of due tax.

11. See for details, *supra* note 2.
12. As per para 4 (A) (xi) of MAOCARO the auditor is required to certify the reasonableness of the price charged/paid for the transactions.

E. Transfer pricing under customs duties

Transfer prices are directly relevant in determining the quantum of customs duties where the duty is charged on an *ad valorem* basis. Under arm's length principles, the value of imported goods should reflect an open market price. However, where the taxpayers are related the importer may be induced to declare a value which is lower than the fair market price to enable the importer to pay a reduced amount of duties.

To examine whether the importer has declared the correct transfer prices, the authorities are armed with the powers derived from the Indian Customs Act, 1962. Also, there are specific provisions for valuation under the Customs Valuation (Determination of the Price of Imported Goods) Rules, 1988. If need be, the General Agreement on Tariffs and Trade (GATT)[13] could also be used to invoke the relevant powers of the authorities. The GATT which has been signed by more than 120 countries, is binding upon all of them.[14] India and all the other signatories of GATT therefore have an obligation to review, upon a request by another contracting party, the operation of their domestic law relating to valuation of goods for domestic purposes.

In the Indian context, Section 14 of the Customs Act, 1962, provides that the assessable value of imported goods shall be

> deemed to be the price at which such or like goods are ordinarily sold or offered for sale, for delivery at the time and place of importation or exportation, as the case may be, in the course of international trade, where the seller and the buyer have no interest in the business of each other and the price is the sole consideration for the sale or offer for sale.[15]

In this context the case of *Orson Electronics Pvt. Ltd. v. Collector of Customs Bombay* is an important illustration showing the modus operandi of evasion under this section. In this case the transaction took place between Indian and Japanese companies. Higher value was declared to the Japanese Customs House and lower value was declared to the Indian Customs. The importing company had a 51 per cent share in the supplier firm. The revaluation was done on the basis of the documents seized by the Japanese Customs at the insistence of the Indian Customs.[16]

The valuation rules under the Customs Valuation (Determination of the Price of Imported Goods) Rules, 1988, provide an exhaustive list of the circumstances in which the transaction value between the two parties needs to be examined carefully before it is accepted as the transfer price on the basis of which assessable value can be determined. However, the transaction value will not be accepted where the buyer and the seller are related.

The circumstances where the buyer and the seller are deemed to be related are given in Rule 2(2) which states that it

> includes where
> (i) they are officers or directors of one another's business;
> (ii) they are legally recognized partners in business;
> (iii) they are employer and employee;
> (iv) any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;
> (v) one of them directly or indirectly controls the other;
> (vi) both of them are directly or indirectly controlled by a third party;
> (vii) together they directly or indirectly control a third person; or
> (viii) they are members of the same family.
>
> Explanation:
> 1. The term person also includes legal persons.
> 2. Persons who are associated in the business of one another in that one is the sole agent or sole distributor or sole concessionaire, however described, of the other shall be deemed to be related for the purpose of these rules, if they fall within the criteria of this sub-rule.

When the customs value cannot be determined under the Customs Act, a process of consultation between the customs administration and the importer is initiated and the valuation is determined under the Customs Valuation Rules, 1988. However, the interpretative notes to the Rules indicate the following relevant aspects related to transfer pricing:

(a) the sale price used between related buyers and sellers needs to be scrutinized only where there are doubts about the acceptability of the price;
(b) where related buyers and sellers buy from and sell to each other as if they are not related, this would demonstrate that the price has not been influenced by the relationship;
(c) where it is shown that the price is adequate to ensure recovery of all costs plus profit, the cost-plus formula could be accepted as a satisfactory estimate of transfer price;
(d) in determining whether one value closely approximates to another value, various factors such as the nature of the imported goods, the nature of the industry, the season in which the goods are imported, etc. are required to be taken into consideration; and
(e) in comparing the prices both the commercial level and the quantities in which the goods are sold are considered relevant.

Recognizing the difficulty in arriving at an acceptable transfer price for the imported consignment, the best judgement of the officer could be adopted using "reasonable means consistent with the principles and general provisions of the Customs Rules".[17] However, in arriving at such a price some principles have been enunciated through different judgements of the Supreme Court. First, the transactions must be between related persons. Secondly, there should be mutuality of interest among these related persons. The Supreme Court has held that it is not sufficient to show that the parties are

13. It is however important to note that the rules of the GATT are not specifically meant to safeguard the problem of transfer pricing. Nonetheless, it does give guidelines for valuation of the imported goods. See GATT (1994), *Guide to GATT Law and Practice*, at 233-242.
14. GATT provides for principles for valuation for customs purposes. These are set forth in Art. VII of the Agreement.
15. The Act does not accept as the basis for determination of assessable value a transfer price where the seller and the buyer have an interest in the business of each other or where the price is not the sole consideration for the sale.
16. 1996 (82) *Excise Law Times*, 499 (Tribunal) in the CEGAT, Court I, old special bench A, New Delhi, at 499-503.
17. In the recent case of *Poonam Leather Industries v. Collector of Customs, Cochin* it has come to light that for want of careful investigation the transfer price could be reduced considerably, and the goods could be mis-declared. See, 1996 (82) *Excise Law Times*, 493 (Tribunal) in the CEGAT, special bench A, New Delhi, at 493-499.

related; it is also necessary to show that the related parties have some mutual or common interest. Finally, it has to be proved that the related persons flow back the differential in price to the concerned parties. The flow back could be direct through cash flow (an amount being deposited in a bank or being paid to someone at some other place) or indirect in the form of doing some service for the related party (for example, advertisement expenditure to be incurred for the concerned party). By enunciating these principles the Supreme Court has diluted the concept of related persons considerably.

It is useful to consider the rules as given in GATT. For example, Article 5 relating to deductive value or Article 6 concerning computed value could be important. These methods correspond to the Resale Price Method and Cost-Plus Method, respectively. Similarly, Article 2 (dealing with the transaction value of identical goods) or Article 3 (dealing with the transaction value of similar goods) resemble the Comparable Uncontrolled Price Method (CUPM) used to determine the arm's length transfer price for income tax purposes.[18]

The law also provides for an anti-dumping levy. This is in response to one aspect of the abusive use of transfer pricing. The aim of the anti-dumping levy is to offset or prevent dumping. Thus, the anti-dumping levy works as a backstop to abusive transfer prices.

F. Provision under the union excise duties

The concept of transfer pricing is equally important for the revenue generated by the government from the union excise duties. The tax is charged on an *ad valorem* basis on the price of the commodity despatched by the manufacturer, in the form of sale, or for storage to any other place or for captive consumption. When the goods are sold to another manufacturer for use as input, the problem of transfer pricing is not very serious because the concept of value added has been introduced under the union excise duties.[19] Since the chain of transactions is properly traceable under VAT, transfer prices do not create any serious problem. For instance, when the goods are transferred from Company A to Company B at a lower price than the market price, the set-off available to B would be the same as the amount of tax paid by A. The balance of the tax would have to be paid by Company B, when it finally sells the goods.

The problem still remains for the four commodities not covered under MODVAT.[20] Also, the issue remains important when the goods are sold for resale or consumption where the next transaction is not under the purview of MODVAT.[21]

The Central Excise Act, 1944, provides for determination of assessable value on the basis of the normal price which is defined as

> the price at which such goods are ordinarily sold by the assessee to a buyer in the course of wholesale trade for delivery at the time and place of removal,[22] where the buyer is not a related person and the price is the sole consideration for the sale.

The Excise Act thus takes an extreme position of disregarding as unreliable, the transfer price adopted by the two associated concerns or related persons. It is, however, important to note that in many cases the "normal price" under Section 4 of the Central Excise Act is determined by the Excise Authorities on the basis of available evidence. In *Air Control & Chemical Engineering Co. Ltd. v. Controller of Central Excise* "complete compressors were manufactured by the assessee but compressors and its parts were packed and billed separately". Such splitting up of the price between the compressor and its parts was not done for commercial reasons but merely to evade excise duty.[23]

The term "related person" is defined to mean "a person who is so associated with the assessee that they have interest, directly or indirectly, in the business of each other and includes a holding company, a subsidiary company, a relative and a distributor of the assessee and any sub-distributor of such distributor". Considering the objective of safeguarding the revenue, the scope of the term "related person" has been cast fairly wide. Judicial interpretations have, however, narrowed down the concept. For example, in *Union of India v. Atic Industries Ltd.* it was held that the two persons should be considered related only when each has an interest in the business of the other. That is, where Company A holds some part of the equity of Company B and vice versa, but not in a case where company A holds some part of the equity of B, but Company B does not hold any part of the equity of Company A.[24] Similarly, in *Union of India v. Bombay Tyres International P. Ltd.* it was held that a relative is considered to be a related person only when he is both a relative and a distributor of the assessee. Similarly, a distributor is to be considered a related person only where he is both a relative and a distributor of the assessee.[25]

In view of various judgements and the policy decisions of the department, where the first sale is to a related person, the assessable value is determined on the basis of the price at which the goods are ordinarily sold by the related person (i.e. buyer) in the wholesale trade; the given sale price of the first sale is ignored. The effect is to assume that the price of the first sale to a related person does not indicate the arm's length price and consequently the transfer price should be the price charged to an unrelated person. However, it is important to note that where a manufacturer sells his goods through say

18. Art. 2 is similar to the use of the exact comparable and Art. 3 approximates to the use of the inexact comparable. See GATT, *supra* note 13.
19. The union excise duties are levied by the Union Government. They follow the principles of value added tax. It is known as Modified Value Added Tax (MODVAT). Over the years the coverage of MODVAT has increased and now it covers almost all items, yielding more than 85 per cent of the revenue from duties.
20. The commodities not covered under MODVAT include petroleum products, tobacco (including cigarettes), cinematographic films, and matches. These items yield approximately 15% of the total revenue from the union excise duties.
21. The tax on sale is a state matter. Hence the sales tax is levied by the state governments on all transactions of sale by the manufacturer, wholesaler or retailer.
22. The basis of the tax is the "clearance" of goods from the factory. This is also known as the time of removal of goods.
23. During investigations it was found that the appellant was manufacturing complete compressors but after testing them packing the compressor and its parts separately. 1994 (72) *Excise Law Times*, 291 (Tribunal) in the CEGAT, special bench A, New Delhi, at 291-306.
24. 1984 (17) *Excise Law Times*, 323, 327 (SC).
25. 1983, *Excise Law Times*, 1986 (SC).

four distributors, one of whom is a relative and the price charged to each of the distributors is uniform, the assessable value would be determined by the price charged to the unrelated distributors.

The Central Excise (Valuation) Rules, 1975, provide detailed procedures for estimating the transfer price. The different circumstances under which the transfer price would be recalculated are as follows:

(i) where the price charged is not the sole consideration the money value of any additional consideration is included in determining the assessable value (Rule 5):
  - the salaries of the chief executive and the works manager borne by the holding company;[26]
  - expenditure on sales promotion publicity;[27] and
  - expenditure incurred by the buyer on advertisements and after sales service, during the warranty period.[28]

(ii) Where the goods are captively consumed and also sold (the same or comparable goods) the transfer price is based on the value of the comparable goods which should be based on the arm's length selling price or the normal price, as defined in the Act.

(iii) Where the goods are captively consumed and there are no comparable goods on the basis of which value can be determined, the transfer price is taken to be the cost of production or manufacture including profits, if any, which would have normally been earned on the sale of such goods [Rule 6(b)(ii)].

In *Madurai Soft Drinks (P) Ltd. v. Collector of Central Excise, Madurai*, it was held that various expenses incurred by the assessee were not included in the sale price. These charges were recovered by a separate debit note and not disclosed to the department. Hence, as per Rule 5 of the Central Excise (Valuation) Rules, 1975, these have to be included in the value of the commodity.[29]

V. SUGGESTED REFORMS

India's existing provisions on transfer pricing have not kept up with global developments. The efforts of the Indian Government to liberalize the economy and to put the country on the international trade map, will significantly increase the number of MNCs coming to India. Already in most sectors there is a positive trend in the inflow of direct foreign investment. Transfer pricing issues will therefore become increasingly important. In future it might be all the more difficult to face the issues with the given provisions of different taxes. It is suggested that the following reforms are needed to protect India's tax base.

Income tax: As regards income tax, it is essential that the existing provisions under the Indian Income Tax Act, 1961 are revitalized to take care of the intricate issues involved in the transfer pricing by the MNCs.

Firstly, measures recommended in the OECD Guidelines for Multinational Enterprises and Tax Administration (1995) should be adopted wherever relevant and applicable, as has already been done by the United States and many Asian and European countries.

Secondly, "where necessary" special rules should be adopted to strengthen the hands of the assessing officer "to enable him to apply a special clause of The Scheme of DIV 13, based on the pattern of the Australian Income Tax Law".[30] This provision could take a superior place in the statute and remain in addition to the existing laws. It is significantly different from the existing provisions in as much as it is not limited to arrangements which have a dominant tax avoidance purpose. These provisions could be applied to transactions where transfer pricing could be one among many reasons. The discretion would be left to the assessing officer. The provisions of DIV 13 could be applied to attribute income to a resident company if a non-arm's length agreement has resulted in the shifting of income from India regardless of the motive or purpose. An important feature of the DIV 13 is that an additional tax is attracted if this provision is applied. The level of additional tax depends on the extent to which tax avoidance played a part in the transfer pricing arrangement concerned and on whether it is reasonably arguable that the transfer pricing provisions are not applicable.[31]

Here it is important to note that recognizing the prevailing practices of avoidance of tax through the mechanism of transfer pricing, the Report of the Expert Group to Rationalise and Simplify Income Tax Law[32] has suggested that the following subsections be added to Section 92 of the Indian Income Tax Act:

> Subsection (1)
> Where the Assessing Officer is satisfied that the purpose or effect of any arrangement is directly or indirectly –
> (a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person;
> (b) to relieve any person from any liability to pay tax or to make a return under this Act; or
> (c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act, he may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustment as he considers appropriate, including the computation or re-computation of gains or profits, or the imposition of a liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement.
>
> Subsection (2)
> In this section, "arrangement" means any scheme, trust, grant, understanding, covenant, agreement, disposition, transaction and includes all steps by which it is carried into effect.

26. This refers to *Kerala Electric Lamp Works Ltd. v. CCE*, 1988 (33) *Excise Law Times*, 771 (T).
27. *Eddy Current Control (India) Ltd. v. CCE*, 1989 (39) *Excise Law Times*, 147 (T).
28. *CCE v. R. Gas Electrodes Pvt. Ltd.*, 1988 (33) 485 (T).
29. 1994 (74) *Excise Law Times*, 647 (Tribunal) in the CEGAT, special bench A, at 647-655.
30. See for details CCH (1996), *Australian Master Tax Guide*, Sec. 30-500 at 1234-1244.
31. Notwithstanding the overriding provisions, the DIV 13 does not prevail over the International Agreements or any of the provisions of a double taxation treaty.
32. See Government of India (1997), *The Report of the Expert Group to Rationalise and Simplify Income Tax Law*, Department of Revenue, Ministry of Finance, New Delhi, at 74-75.

Subsection (3)
This section shall apply to any arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act but, shall not apply to any arrangement carried out for bona fide commercial reasons which had not as one of its main purposes the avoidance or reduction of tax.

Proviso: Provided that the Assessing Officer cannot take any action under this section without the previous approval of the Commissioner.

The proposed provision is however not to be applied in case of ordinary commercial transactions.[33] Notwithstanding the above recommendations of the Committee it is felt that the Australian provisions would better be able to combat the menace of transfer pricing in India.

Company law: Although many powers are provided under the Companies Act, most of these are of an investigative nature. It would be useful if an amendment was made to impute an adverse inference in the event of non-production of necessary information by foreign companies under Section 239 of the Act.

Customs duty: The rules related to customs duty have basically endorsed the regulations of GATT and the resolutions of the WTO. The provisions have been based on the principles of related persons, the mutuality of interests and direct or indirect flow back. Over the years the Supreme Court has diluted the concept of related persons considerably. However, no major change in the law could be enacted without having requisite changes made to the GATT or WTO provisions. Nevertheless, it is important to follow the Australian system of better investigation and in particular to have a well-researched price list. On the basis of these lists the valuation could be done by the customs authorities because they would be backed by the flow of information from many countries. In addition, their own staff could provide research support.

Union excise duties: The provisions under the union excise duties (MODVAT), as they currently stand, are strong enough to take care of the issues on valuation. The rules define the normal sale price and also take care of the "cost" and "profit". For this purpose they concentrate on the condition of comparability.[34] Nevertheless, it is important to gear the excise department to cope with a larger share of the MNCs in the manufacturing and service sector.[35] For this reason it must develop a research wing in order to have a complete marketing pattern of goods and services available to it. In addition, it must independently establish the pattern of invoices and the prices of the commodities/services supplied.

VI. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

The above analysis of the existing provisions of different laws in India indicates that provisions already exist to combat the evasion of tax through the procedures of transfer pricing. The Income Tax Act provides for the assessment of reasonable profits derived by residents from transactions with non-residents under Section 92, although the provision has rarely been invoked. The provisions of Section 142(2A) of the Income Tax Act further envisages that the Assessing Officer is empowered to order a special audit of any company, if he so wishes. Section 211 of the Indian Companies Act dealing with the form and contents of the balance sheet and profit and loss account requires that "every profit and loss account of a company shall give a true and fair view of the profit or loss of the company". In addition, the central government has the power under the Companies Act to direct a special audit under Section 233A and to order an audit of cost accounts in certain cases, under Section 233B. These provisions are supported by Section 18(16) under the Foreign Exchange Regulations Act 1973, which provides that the Reserve Bank of India could issue an order requiring the person holding the shipping documents to retain possession until such time as the exporter of the goods has made arrangements to make good any underpayment where the value of the goods specified in the declaration furnished is less than the due amount. These are additional checks on any party entering into transfer pricing to avoid payment of due tax. With all these provisions the corporate veil can be pierced when there is a fraud or attempted evasion of tax.

However, with the structural adjustment programme, India has liberalized its economy. As a player in the global market, the available fiscal instruments might not be strong enough. It would be useful to adopt necessary clauses from the OECD 1995 Guidelines. Alternatively, we could adapt the provisions of the Australian Income Tax Laws.

The rules related to customs duty have basically endorsed the regulations of GATT and in turn the resolutions of the WTO. Nevertheless, it is important to follow the Australian system of better investigation which is facilitated through maintaining a well-researched price list. The valuation could be made by the Customs authorities on the basis of these lists.

In regard to the union excise duties it is important to develop a research wing in order to have a complete marketing pattern of the goods and services administered by the excise department. It must establish the pattern of invoices and the prices of the commodities/services supplied.

It is also necessary to appreciate the importance of the emerging trade blocks that provide a movement towards economic integration. India should play a key role in harmonizing the tax systems of all the ASEAN countries who have signed the AFTA Agreement in 1992.[36] This would help in the creation of a common market and the strengthening of economic cooperation. It could also be used to facilitate the exchange of information and experiences in tax matters between ASEAN countries.

33. This provision is adapted from Sec. 33 of the Singapore Income Tax Act.
34. For example, the liquid and dry chlorine are not comparable. Hence, Rule 6(b) will not be applicable. See *Dharangadhara Chemical Works Ltd. v. CCE*, 1988 (34) *Excise Law Times*, 656, 661 (T).
35. The excise department levies a service tax and administers it. See for details Purohit, Mahesh C., "Taxation of Services: Some Policy Imperatives for India", 51 *Bulletin for International Fiscal Documentation* 1 (1997), at 35-46.
36. See for details Sy Dante V. (1996), "Transfer Pricing and Fiscal Incentives: Issues for Coordination and Harmonization", *NTRC Tax Research Journal*, Vol. 8, No. 5, Sept.-Oct., at 1-14.

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Conference diary

For fur'ʰer details of the events listed below p.ease write to the organizers at the addresses indicated.

OCTOBER 1997

International Tax Aspects of Electronic Commerce, Amsterdam, the Netherlands, 3 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

Corporation Tax Compliance, London Park Lane Hilton Hotel, the United Kingdom, 9 October 1997 (English):

IBC UK Conferences Ltd, Gilmoora House, 57-61 Mortimer Street, London, W1N 8JX, Tel.: 44-171-453 2707, Fax: 44-171-453 2036, E-mail: julietneckar@ibcuklon.-ccmail.compuserve.com

51st Congress of the International Fiscal Association, New Delhi, 19-24 October 1997 (simultaneous translations into French, English, German and Spanish):

IFA General Secretariat, World Trade Center, Beursplein 37, 3011 AA Rotterdam, the Netherlands, Tel.: 31-10-405 2990, Fax: 31-10-405 5031.

Taxation for International Companies in Russia and the CIS, The Marriott Hotel, Vienna, 22-23 October 1997 (English):

Business Seminars International Ltd, Sussex House, High Street, Battle East Sussex, TN33 OAL, United Kingdom, Tel.: 44-171-490 3774, Fax: 44-1424-77 3334, E-mail: 1004513120@compuserve.com reference number XBA03

E-ATI 20th Annual Congress, Carlton Inter-Continental Hotel, 58, La croisette, BP 155, 06406 Cannes Cedex, France, 27-29 October 1997 (English):

The European-American Tax Institute, Falmer Court, London Road Uckfield, East Sussex TN22 1HN, United Kingdom, Tel.: 44-1825-760 901, Fax: 44-1825-760 903

Expatriate Management Conference, Hyatt Regency Scottsdale at Gainey Ranch, Scottsdale, Arizona United States, 27-29 October 1997 (English):

Mr Michael J. Bisshko, Ernst & Young, 787 Seventh Avenue New York, NY 10019, United States, Tel.: 1-212-773 2595, Fax: 1-212-773 2550.

Non-Discrimination, Amsterdam, the Netherlands, 30-31 October 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

NOVEMBER

Transfer Pricing Audits, Amsterdam, the Netherlands, 20-21 November 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl

DECEMBER

Double Taxation Relief, Amsterdam, the Netherlands, 11-12 December 1997 (English):

International Tax Academy, Sarphatistraat 500, P.O. Box 20237, 1000 HE Amsterdam, Tel.: 31-20-626 7726, Fax: 31-20-620 9397, E-mail: mlw@ibfd.nl