Volume : 1 | Issue : 6 | June 2012 ISSN - 2250-1991

Research Paper Accountancy

ARM'S Length Price : An Overview with Special Reference to Indian MNCs

* Dr. Pranam Dhar ** Dr. Manideep Chandra

* Associate Professor, West Bengal State University, Barasat.

** Associate Professor, Saheed Anurupchandra Mahavidyalaya, Burul.

ABSTRACT

There is a need to introduce a uniform and internationally accepted mechanism of determining reasonable, fair and equitable profits and tax base in India in the case of multinational enterprises. One of the burning issues in this regard, is Transfer Pricing (TP). Traditionally, Arm's Length Price (ALP) is associated with TP, which has been defined as the price at which goods are transferred from one division/department of an enterprise to another division/department of the same enterprise. The sheer complexity of the determination of ALP has made it a widely debated topic among the accounting professionals, with diverse views floating around. The present study aims to provide a brief overview on the role of Cost Accountants in India so far as the applicability of TP vis-à-vis ALP regulations, methodology of determining the TP vis-à-vis ALP and the documentation procedures are concerned.

Keywords : TP, ALP, International Taxation, IFRS

1. Introduction

Increasing participation of multi-national corporates in different economic ventures in India has given rise to new and multifaceted issues rising from transactions entered into between two or more enterprises belonging to the same group. Hence, there is a need to introduce a uniform and internationally accepted mechanism of determining reasonable, fair and equitable profits and tax base in India in the case of such multinational enterprises. One of the burning issues in this regard, is Transfer Pricing (TP) vis a vis Arm's Length Price (ALP).

2. Arm's Length Price (ALP) – Definition And Concept

As per the 'Draft Cost Accounting Standard 6' ALP means the price, which is applied in a transaction between persons other than related parties in uncontrolled conditions. Here, in the context of a corporation, 'related parties' are the parties connected to the corporation through relation with directors and persons having significant controlling interest in the corporation, companies under the same management and subsidiaries.

In other words, It means a price which is functional or proposed to be functional in a transaction -

(a) Between persons other than associated enterprises,
(b) In uncontrolled conditions.
It implies that ALP is a 'fair price' - fair and reasonable to both transferor and transferee. ALP is the TP based on some logical methods, which have been modified by various tax legislations in the country under Income tax, Customs, Excise and sales tax, etc. Further, Proper Corporate Governance demands that the TP is unchanging based on generally accepted principles in order to ensure that there is an ingredient of fairness in the financial results and financial position of the enterprise.

3. Scope And Applicability of ALP Regulations

TP vis-à-vis ALP regulations are pertinent to the all enterprises that enter into an 'International Transaction' with an 'Associated Enterprise'. Therefore, generally it applies to all cross-border transactions entered into between associated enterprises. It even applies to transactions involving a simple book entry having no noticeable financial impact. The aim is to arrive at the analogous price as available to any unrelated party in open market situation.

4. Calculating Arm's Length Price

OECD introduced the transfer pricing guidelines for multinational enterprises and tax administrations in 1995. OECD guidelines are appreciated globally. In the transfer pricing system, the transfer pricing has to be resolute on the basis of the arm's length principle so price determined is the Arm's Length Price (ALP). According to Section 92C of the Income Tax Act, 1961, there are two types of transfer pricing methods :

Traditional Transaction Method : a)Comparable Uncontrolled Price Method, b)Resale Price Method, c)Cost Plus Method
Non-Transactional/Transactional Profit Method : a)Profit Split Method, b)Transactional Net Margin Method

5. ALP-the Indian Status

5.1. Overview

In India TP vis-à-vis ALP authority is Income Tax Department and laws governing TP vis-à-vis ALP are Section 40A (2), 92-92F, 271, 271AA, 271BA and 271G of the Income Tax Act, 1961. TP vis-à-vis ALP regulations and rulings are governed by Rule 10 to 10E of the Income Tax Rules, 1962. Rule 10D (1) of the Income Tax Rules, prescribes the detailed list of mandatory documents The Indian legislation in conformity with the OECD guidelines, prescribes the same 'five methods' to compute the arm's length price.

2.2. India-specific Issues on ALP

2.2.1. Convergence to IFRS

The adoption of IFRS in India will going to affect the selection and application of transfer pricing policies of different companies in different ways, depending on each company's exact circumstances, functions, and risks. A company may change their transfer pricing suitably so that the change in accounting standards does not affect their overall taxable results. However, both the actions will be under tax scrutiny.

5.2.2. Revised Discussion Paper on Direct Tax Code

The Central Board of Direct Taxes in the Department of Revenue released a revised discussion paper on the Direct Tax Code (DTC) containing several stipulations regarding transfer pricing. June 2010.

5.2.3. Authority for Advance Rulings Rules on Transfer Pricing Provisions
The Authority for Advance Rulings held that transfer pricing provisions are only computational provisions and in the absence of tax charges under the Income Tax Act, 1961, transfer pricing provisions are not applicable. November 2009.

4.4.4. Documentation of ALP as per TPR in India
The provisions contained in the TPR are exhaustive as far as the maintenance of documentation is concerned.

5.5.5. Draft Cost Accounting Standard 6 (CAS 6)
The Draft was issued by the Council of the Institute of Cost and Works Accountants of India on "Determination of Arm's Length Price". The standard deals with the principles and methods of apportionment of determination of Arm's Length Price.

5.2.6 Accounting Standard Ind AS 18
Experts recognize that the introduction of AS 18 has greatly enhanced the quality of disclosure about transfer pricing and thereby potentially limited the abuses in this area.

7.7.7. Report of Expert Group on Transfer Pricing Guidelines
The Group recommends that the proposed transfer pricing guidelines may be based on the core principles that all transactions between a company and a related party or between two business segments of a company shall be at arm's length transfer prices.

5.3. Who is to Shoulder the Burden of Evidence - Taxpayer or Tax Officer?
The primary onus is on the taxpayer to determine an ALP in accordance with the TPR and to substantiate the same with the prescribed documentation.

6. ALP-the Indian Context
6.1. Case Studies on ALP

Author/ Source	Year	
Ernst & Young	2009	Global Transfer Pricing survey - India
Neeraj K. Jain,	2010	Arm's length price determination With reference to FAR analysis
Monica Singhania	2010	Analyzing Indian Transfer Pricing Regulations: A Case Study

6.2. Tribunal/High Court rulings on ALP

Mentor Graphics India (Ind Co) v. CIT	The ITAT held that the approach adopted by the TPO in selecting comparable data had serious defects.
DCIT v. Ekla Appliances	The Delhi ITAT ruled that that Arm's length price (ALP) of royalty payments cannot be determined to be "NIL" merely because the taxpayer incurs losses.
Deloitte Consulting India Private Limited v. CIT	The ITAT held that a company cannot be rejected as a comparable as the taxpayer has accepted it in its transfer pricing study report.
Amadeus India Pvt. Ltd. V. CIT	The Delhi High Court determined that transfer pricing officers cannot take up cases on their own, unless it is referred by a regular assessing officer
Galileo International Inc. v. Director of Income Tax	The high court held that India's tribunals has final say on the issue.
Sony Private India Ltd. v. Delhi Income Tax Appellate	The tribunal held that any taxpayer may choose the option of determining the appropriate transfer price by making adjustments within a 5 percent range of the uncontrolled price.
Philips Software v. ACIT	The Bangalore ITAT held that any monetary exchange from a related party transaction, no matter how small, requires that a comparable be rejected.
E-Gain Private Ltd. v. Income Tax Officer	The Pune ITAT held that the size and scope of operations, stage and business, or product cycle should be considered in determining comparability.

7. The Role of Cost Accountant in Dealing with ALP
From the foregoing discussion it is obvious that the Cost Accountant is supposed to ponder over the following research questions and to apply his mind and brain in order to perform his duties up to the professional mark.

7.1. Research Question 1 : Is There a Single Principle on ALP?
It goes without saying that the emergence of ALP is closely associated with the development of international taxation. Globalization of economies has made it imperative for the countries to address international elements in the country's tax base. There is an important changeover in the history of the arm's-length principle that needed to be discussed.

7.2. Research Question 2 : Is There a Convincing Underlying Theory on ALP ?
The OECD guidelines justify the arm's-length principle on the basis of equality between related and unrelated firms. The use of market prices for transactions between separate but related companies produces the same tax outcomes as for transactions between unrelated companies.

7.3. Research Question 3 : Who Gets The share?
The interplay between source and resident based taxation is the core of international taxation. In fact the whole of international taxation revolves around the question " in a cross-border transaction, which country gets what portion of the pie?" Jinyan Li in her seminal work enumerates three possibilities:

Exclusive source taxation , Primary source taxation and residual residence taxation and Exclusive residence taxation.

8. Conclusion
Taxes on international income are imposed by national tax laws whereas in reality International tax law is "domestic law rules of a given state applied to cross-border flows, taking into account (or not) that such flows may be subject to taxation in more than one jurisdiction" The international tax system of a country is an integral part of its income tax system and is developed keeping in mind the country's policy objective. The basic idea, though, is always to draw as much as possible a territorial 'slice' out of the international income 'pie'. The development of treaty law is influenced by the aim of minimizing the overlap of territorial circles drawn by competing countries in order to promote cross-border trade and investment"

REFERENCES

1. Mitchell B. Carroll, Methods of Allocating Taxable Income, vol. 4 of League of Nations, Taxation of Foreign and National Enterprises, Studies of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country, League of Nations document no. C.425(b).M.2176(b).1933.II.A. (Geneva: League of Nations, 1933). | 2. Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length" (1986)vol. 30, no. 7 Tax Notes 625-81. Vann, supra note 2, | 3. Sol Picciotto, International Business Taxation: A Study in the Internationalization of Business Regulation (New York: Quorum Books, 1992). | 4. Organisation for Economic Co-operation and Development, The Taxation of Global Trading of Financial Instruments (Paris: OECD, 1998); Organisation for Economic Co-operation and Development, | 5. The Taxation of Global Trading of Financial Instruments: A Discussion Draft (Paris: OECD, February 14, 1997) (available at http://www.oecd.org/dataoecd/9/62/2090200.pdf). | 6. Organisation for Economic Co-operation and Development, Discussion Draft on the Attribution of Profits to Permanent Establishment (Paris: OECD, 2001) (available at http://www.oecd.org/dataoecd/46/14/1923028.pdf) (herein referred to as "the 2001 discussion draft"). | 7. Organisation for Economic Co-operation and Development, Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions: A Discussion Paper from the Technical Advisory Group on Monitoring Applications of Existing Treaty Norms for the Taxation of Business Profits (Paris: OECD, February 2001) (available at http://www.oecd.org/ dataoecd/46/25/1923312.pdf).