

LAW ON TRANSFER PRICING IN INDIA

The Finance Act, 2001, has introduced, with effect from April 1, 2001, detailed transfer pricing regulations vide sections 92 to 92F of IT Act, to compute income from international transactions between associated enterprises.

An “enterprise” means a person (including a permanent establishment of such person) who is, or has been, or proposes to engage in any activity relating:

- (i) to the production, storage, supply, distribution, acquisition or control of articles or goods;
- (ii) to know-how, patents, copyrights, trade marks, licenses, franchises, or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the associated enterprise is the owner or in respect of which the other enterprise has exclusive rights;
- (iii) to the provision of services of any kind;
- (iv) to investment or providing loans; or
- (v) to the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, regardless of whether the business is carried on by a unit or subsidiary of the enterprise and regardless of its location. (Section 92F(iii) of the IT Act)

This definition is very wide and covers almost all types of business and activities that an entity would normally engage in, including the business of provision of software development services.

The transfer pricing provisions become applicable only if the enterprises are associated enterprises. The term “associated enterprises” is defined in two parts, one, enterprises which are regarded as associated enterprises (section 92A(1)); and two, enterprises which are deemed to be associated enterprises (section 92A(2)).

An enterprise is regarded as an associated enterprise of another enterprise, if–

- (i) it participates, directly or indirectly, or through one or more intermediaries, in the management, control or capital of the other enterprise; or
- (ii) the persons participating, directly or indirectly, or through one or more intermediaries, in its management, control or capital also participate in the management, control or capital of the other enterprise.

Two enterprises are, *inter alia*, deemed to be associated enterprises if at any time during the previous year—

- (i) one enterprise holds, directly or indirectly, shares carrying at least twenty-six (26%) of the voting power in the other enterprise;
- (ii) any person or enterprise holds, directly or indirectly, shares carrying at least twenty-six percent (26%) of the voting power in both these enterprises;
- (iii) a loan advanced by one enterprise to the other enterprise constitutes at least fifty-one percent (51%) of the book value of the total assets of the other enterprise;
- (iv) one enterprise guarantees at least ten percent (10%) of the total borrowings of the other enterprise;
- (v) more than half of the board of directors or members of the governing board, or one or more of the executive directors or members of the governing board, of both the enterprises are appointed by the same person(s);
- (vi) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent upon the use of know-how, patents, copyrights, trade marks, licenses, franchises, or any other data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or has exclusive rights;
- (vii) one enterprise or persons specified by it, supply and influence the prices and other conditions relating to ninety percent (90%) or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the other enterprise;

- (viii) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise;
- (ix) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and the relative of such individual; or
- (x) there exists between the two enterprises, any relationship or mutual interests, as may be prescribed (*the Government has not as yet elaborated on mutual interests*).

Further, an international transaction means a transaction, whether an oral or written arrangement, between two or more associated enterprises, either or both of whom are non-residents, in the nature of:

- (i) purchase, sale or lease of tangible or intangible property,
- (ii) provision of services,
- (iii) lending or borrowing money, or
- (iv) any other transaction having a bearing on profits, income, losses or assets of such enterprises–

and includes a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. (Section 92B(1) of the IT Act)

The income arising from an international transaction is required to be computed having regard to arm's length price. Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. (Section 92F(ii) of the IT Act)

Any one of the following methods prescribed must be used to calculate arm's length price:

- (i) comparable uncontrolled price method,
- (ii) resale price method,
- (iii) cost plus method,
- (iv) profit split method,
- (v) transactional net margin method, or
- (vi) such other method as may be prescribed.

Thus far, Indian software development companies have been using the cost plus method. In this method, Indian subsidiaries invoice their parent companies in an amount equivalent to the actual time cost of the software programmers, other costs (rent, etc.), and approximately seven percent (7%) thereon. However, the income tax authorities are of the view that this method is not the appropriate method for calculating arm's length prices in respect of software development by Indian subsidiary and other companies. They propose to adopt the comparable uncontrolled price method, i.e., the price that would be charged by a third party for the same project in an uncontrolled situation. Moreover an accountant has to be certified in a report to be filed along with the return of income that the transfer pricing laws have been followed in computing arm's length price.

Thus it is clear that cost controlling or reduced price strategies being adopted by companies in India will not work in the days ahead.