Transfer Pricing In India

A transfer price is what one part of a company charges another part of the same company for goods or services. It is a mechanism for distributing revenue between different divisions which jointly develop, manufacture and market products and services. Transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services or the use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing exists to communicate data which will lead to goal-achieving decisions and also to evaluate performance and motivate managers to make goal-achieving decisions. The objective of international transfer pricing focuses on minimizing taxes, duties, and foreign exchange risks, along with enhancing a company's competitive position and improving its relations with foreign governments.

Transfer pricing is a recent corporate tax happening in India. Prompted by the growing participation of multinationals in India, the government introduced “transfer pricing” regulations in the Finance Act of 2001 to ensure that Indian companies report “reasonable, fair and equitable” profits and taxes on transactions with “associated enterprises” such as a foreign parent company. When one subsidiary of a corporation in one country sells goods, services or know-how to another subsidiary in another country, the price charged for these goods or services is called the transfer price. All kinds of transactions within corporations are subject to transfer pricing, including those involving raw material, finished products and payments such as management fees, intellectual property royalties, loans, interest on loans, payments for technical assistance and know-how and other transactions. The rules on transfer pricing require MNCs to conduct business between their affiliates and subsidiaries on an ‘arm’s length’ basis, which means that any transaction between two entities of the same MNC should be priced as if the transaction was conducted between two unrelated parties.

Transfer pricing systems are made to achieve the following objectives:

• To provide each division with relevant information required to make the best possible decisions for the organisation as a whole;

• To promote goal correspondence: that is, actions by divisional managers to optimize divisional performance should automatically optimize the firm's performance;

• To facilitate measuring of divisional performances: It is useful for evaluating the economic performance of divisions and the managerial performance of division managers.

• To ensure that divisional autonomy is maintained: In principle, the top management of the company could simply issue precise instructions to divisions as to what goods to transfer to each other, in what quantities and at what prices. However, most of the organisations are unwilling to do this because of the enormous benefits of allowing divisional autonomy.

• To evaluate a division manager’s performance, based on the profits that he generates,

• To help coordinate the divisions' decisions to achieve the organisation's goals - i.e. to ensure goal consensus.

• To enable the divisions to take decisions such as the pricing of the final product,

• To preserve the divisions' autonomy.

There are three general methods for establishing transfer prices.

1. Market-based transfer price: In the presence of competitive and stable external markets for the transferred product, many firms use the external market price as the transfer price.

2. Cost-based transfer price: The transfer price is based on the production cost of the upstream division. A cost-based transfer price requires that the following criteria be specified:
a. Actual cost or budgeted (standard) cost.
b. Full cost or variable cost.
c. The amount of markup, if any, to allow the upstream division to earn a profit on the transferred product.

3. Negotiated transfer price: The senior management does not specify the transfer price. Instead, divisional managers negotiate a mutually-agreeable price.

Purposes of Transfer-Pricing
There are two main reasons for instituting a transfer-pricing scheme:
• It generates separate profit figures for each division and thereby evaluates the performance of each division separately.
• It helps coordinate the production, sales and pricing decisions of the different divisions (via an appropriate choice of transfer prices). Transfer prices make managers aware of the value that goods and services have for other segments of the firm.
• Transfer pricing allows the company to generate profit (or cost) figures for each division separately.
• The transfer price will affect not only the reported profit of each centre, but will also affect the allocation of an organisation's resources.

One general advantage that all companies involved in transfer pricing can look out for and try to manage on their own, would be to establish high transfer prices for their goods and services and transfer them to a unit that is located in a jurisdiction that has low tax rates. This will result in the company having more revenue in a jurisdiction that is subjected to a lower tax rate and less revenue in a jurisdiction that is subjected to a higher tax rate.

A very important element when working with transfer pricing is to maintain a buyer-seller relationship between the units of a single company. Sometimes companies face the problem of double taxation, as many companies that are involved in transfer-pricing operate under different taxation authorities or in different jurisdictions. Double taxation occurs when a company is forced to obey the taxation authorities of two jurisdictions, due to overlapping or conflicting tax laws and regulations. It is advisable for a company which is involved in transfer-pricing to have a knowledgeable understanding of the different ways they can increase their advantages and decrease their disadvantages. Transfer pricing is a mode by which Multinational Enterprises (MNEs) makes huge profits by increasing the price of products or services in low-tax jurisdictions and decreasing the price in high-tax jurisdictions, thereby shifting profits especially in a scenario in which more than 60 percent of the international trade is carried out intra-group. Transfer pricing thus results in a huge loss to the public department which is prevented from taxing a product or service or, on the other hand, is prevented from realising the actual tax at which a product would have been taxed in a country. The theory of Transfer Pricing is based on the concept of 'functions, risks and assets'.