# A STUDY ON DECISION MAKING MECHANISM OF TRANSFER PRICING

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**ABSTRACT** The Project is a Study based on Transfer Pricing, which has been one of the most discussed taxation issues in the current world. The methods of Calculating Arm's Length Price and the factors to be considered to select an appropriate method have been discussecd in the study.

Transfer pricing refers to arrangements and techniques for valuing transactions inside and between Related Party Enterprises. It is used as a technique of window dressing Financial Books. By adjusting or manipulating the multinational entities concerning their accounting to attenuate liabilities. Because of the capacity for internationally controlled transactions to twist measurable financial gain, tax authorities in many nations will change intra-group transfer prices that vary from what will be charged by unrelated parties dealing at arm's length.

The study also talks about the documentation requirements by the Taxpayer during the assesssment years and the penalty involved if there is failure of furnishing Documentation.

The BRICS and The OECD guidelines and the norms have been discussed in detail, The guidelines given by BRICS and OECD to the Indian Transfer Pricing Law has been Considered.

**Introduction** : The study focuses mainly on the international rules on transfer pricing and the initiatives taken by the government for non evasion of tax. The focus was mainly on the methods used to calculate and handle transfer pricing issues under BRICS and OECD countries.

### Literature Review:

**Rasmus Steiness, Cand.Merc** , in their study **Accounting, Strategy And Control** have stated that the appropriate pricing method would be the benchmarking method, however the method would still need to take the effect that the association amid the involved parties would have on the price, however there cannot be a standalone approach. Thus the study concludes, that assessing prices for transfer pricing purposes should take a more holistic approach and acknowledge the broader business dynamics and market realities, without disregarding the substance of the tested transaction.

**Ida Hjertberg & Sanna Pettersson** in their study stated that Transfer pricing is a complex issue and to fix the price various internal goals should be aligned with the external factors like duty tariffs, competition and legal compliances. The theory and the guidelines provide tools for enterprises to develop their transfer pricing strategy but they can rarely use the models and methods provided traight off. They conclude the study by stating that the method of setting up a strategy to fix the transfer price varies from one organisation to another depending on the individual's internal and external influences.

**Thassiane Ayres Gossler** in their paper have explained the variations and lack of coordination among the BRICS nations. The BRICS nations have adopted Arms length pricing method, but there also exists difficulties in finding comparables and in establishing transfer prices. Though India follows the OECD guidelines , India argues that the OECD transfer pricing approach does not effectively consider specific market circumstances of the country such as location savings realised in India or actual risk borne by the Indian subsidiaries.

## SCOPE OF THE STUDY

- The Income Tax Policies issued by the Central Board of Direct Tax in regard with Transfer Pricing.
- The BRICS & the OECD guidelines for Transfer Pricing.
- The Transfer Pricing policy followed by Indian companies referring to one of the Export Oriented Units located in India. (Name of which is undisclosed)

## OBJECTIVES OF THE STUDY

- To have a better understanding of the Transfer Pricing Policies in India.
- To study Transfer Pricing Mechanism in the OECD and BRICS countries.
- Responsibility of an Accountant when International transactions are involved.

## DATA

- Financial Statements and Form 3CEB of a 100% Export Oriented Unit located in India with its parent company in abroad, has been used for the study

## SOURCES OF DATA

### PRIMARY SOURCE

- The Primary Data has been taken directly in interaction with Senior manager - Finance & Taxation of the EOU.

### SECONDARY SOURCE

- The secondary data has been taken from books related to transfer pricing and also from few Indian and abroad thesis framed on Transfer Pricing.
- The Balance sheets , Profit or loss Account and other financial statements have been taken from the exporting subsidiary.

**LIMITATIONS OF THE STUDY**

- The Financial Data has been collected from an Export Oriented Unit, (Subsidiary) located in India and the Parent Company located Abroad.
- The name of which has not been disclosed to maintain confidentiality of the data.
- The Financial Records have been used only for the purpose of analysing the Impact of Transfer Prices on the Financial Positions of the company.
- The data considered is only 3 year Financial Statements of the Export Oriented Unit.
- The study only gives a Brief analysis of OECD guidelines and BRICS countries Transfer Pricing Norms, based on which further analysis can be carried out with specific reference to the laws of each nation.

**TOOLS USED FOR ANALYSIS**

- ANOVA
- Correlation

**HYPOTHESIS**

H0 : The Export Oriented Unit is in line with Arm's Length Standards.

H1 : The Export Oriented Unit is yet to follow the Arm's Length Standards.

**ANALYSIS**

**QUALITATIVE ANALYSIS**

The analysis was made on the OECD guidelines and the rules prescribed by the Indian legislation. Though India has adopted the OECD norms there are certain differences in the Indian Legislation and these variations have been analysed. India is one among the BRICS nations, but it does not mean that all the BRICS nations are in line with the traditional and dominant international tax governance. Though the BRICS are non member countries of the OECD, they exercise sufficient power to influence the OECD decisions.

The challenges in India's Transfer Pricing Policies have also been analysed. The necessity of comparables in framing the arm's length price have been a basic issue, because finding proper comparables, especially in regard with the intangibles has been a tedious task. The analysis also includes a brief study on the Location Specific Advantages (LSA) and the Base Erosion and Profit Shifting (BEPS) Action plans.
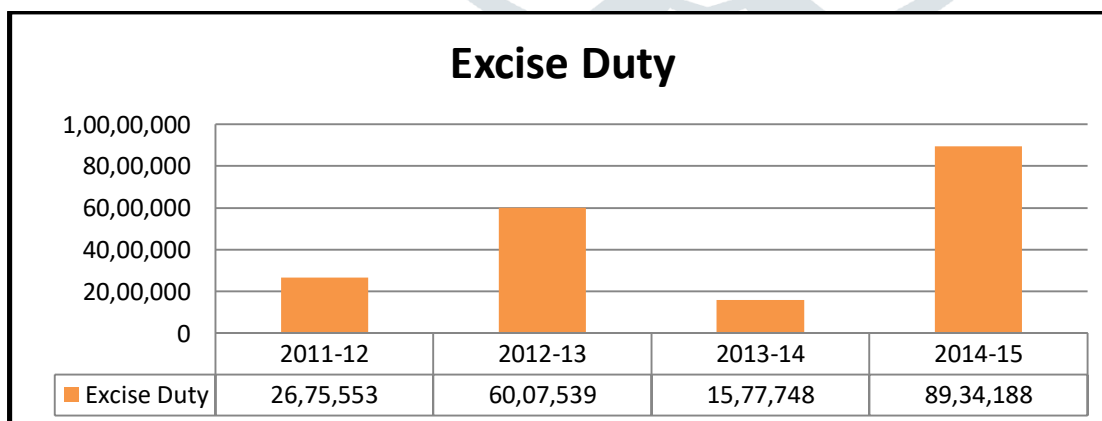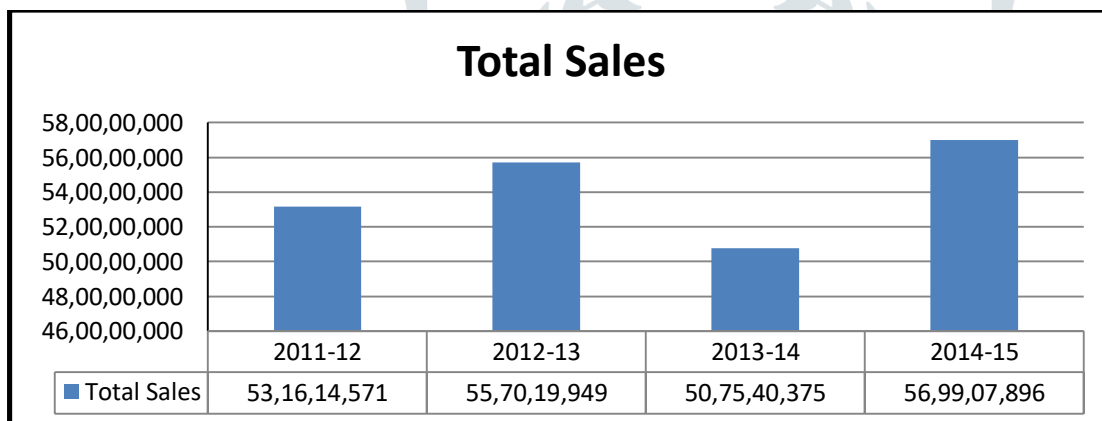
**QUANTITATIVE ANALYSIS**

The data used for the quantitative study have been taken from a 100% Export Oriented Unit, located in India. The quantitative Analysis includes an analysis done on the degree to which the data of the Export Oriented Unit are in line with the Transfer Pricing rules of India. Statistical tools like ANOVA and Correlation have been used to analyse the Quantitative aspect of the study.

The data considers the amount of International Transactions and the Excise duty paid against it and also considers the profits before taxes and the taxes paid against it. The book value of the purchases and sales against the Arm's length prices have also been compared to find the degree of conformity with the rules.
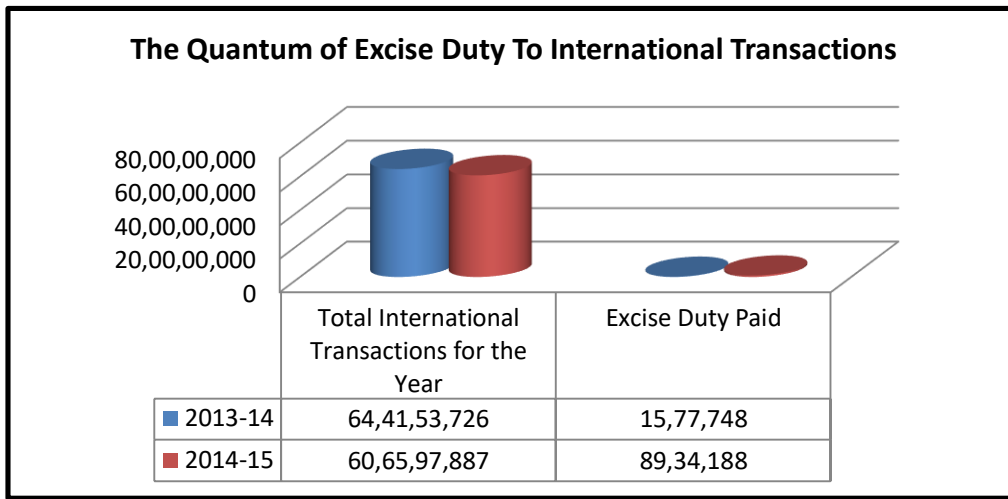
**GRAPHS DEPICTING THE ANALYSIS OF QUANTITATIVE DATA**

The graphs are related to the data collected from  the Export Oriented Unit Considered for study.

The Below graph indicates the changes in the excise duty as and when there is a change in the sales done during respective years. The change is proportional which shows that the percentage of excise duty has been promptly paid.

**Total Sales**

| | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---|---|---|---|---|
| ■ Total Sales | 53,16,14,571 | 55,70,19,949 | 50,75,40,375 | 56,99,07,896 |

**Excise Duty**

| | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---|---|---|---|---|
| ■ Excise Duty | 26,75,553 | 60,07,539 | 15,77,748 | 89,34,188 |

The graph below represents the amount of Excise Duty paid for the International Transactions in two different years.

**The Quantum of Excise Duty To International Transactions**



| | Total International Transactions for the Year | Excise Duty Paid |
|---|---|---|
| 2013-14 | 64,41,53,726 | 15,77,748 |
| 2014-15 | 60,65,97,887 | 89,34,188 |

**ANALYSIS ON EXCISE DUTY PAID AND SALES**

**Descriptive Statistics**

| | Mean | Std. Deviation | N |
|---|---|---|---|
| EXCISE DUTY PAID | 4798757.0000 | 3338953.81235 | 4 |
| TOTAL SALES | 541520697.7500 | 27681844.20143 | 4 |

From the descriptive statistics the average Excise duty paid and total sales are 4798757 and 541520697.

**Correlations**

| | | EXCISE DUTY PAID | TOTAL SALES |
|---|---|---|---|
| **Pearson Correlation** | EXCISE DUTY PAID | 1.000 | .962 |
| | TOTAL SALES | .962 | 1.000 |
| **Sig. (1-tailed)** | EXCISE DUTY PAID | . | .019 |
| | TOTAL SALES | .019 | . |
| **N** | EXCISE DUTY PAID | 4 | 4 |
| | TOTAL SALES | 4 | 4 |

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .962[a] | .924 | .887 | 1123651.59604 |

a. Predictors: (Constant), TOTAL SALES

From the model summary table it is evident from table that R=0.962 which indicates a very high positive correlation between excise duty and sales. The $R^2$ value indicates how much of the total variation in the dependent variable, EXCISE DUTY can be explained by the independent variable, SALES. In this case, 92.4 % can be explained, which forms major portion

**ANOVA[a]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 30920651864418.630 | 1 | 30920651864418.630 | 24.490 | .038[b] |
| | Residual | 2525185818563.372 | 2 | 1262592909281.686 | | |
| | Total | 33445837682982.000 | 3 | | | |

a. Dependent Variable: EXCISE DUTY PAID

b. Predictors: (Constant), TOTAL SALES

From the ANOVA Table it is evident that the regression model statistically predicts the outcome variable that is Excise duty as P value is less than 0.05.Therefore we can conclude that the relationship between SALES and EXCISE DUTY is significant

**ANALYSIS ON TAX PAID AND PROFIT BEFORE SALES**

**Descriptive Statistics**

| | Mean | Std. Deviation | N |
|---|---|---|---|
| TAX PAID | 27163621.0000 | 13880308.33788 | 4 |
| PROFIT BEFORE TAX | 77638088.5000 | 25355469.71609 | 4 |

From the descriptive statistics the average tax paid and profit before tax is 27163621 and 77638088.

**Correlations**

| | | TAX PAID | PROFIT BEFORE TAX |
|---|---|---|---|
| Pearson Correlation | TAX PAID | 1.000 | .880 |
| | PROFIT BEFORE TAX | .880 | 1.000 |
| Sig. (1-tailed) | TAX PAID | . | .060 |
| | PROFIT BEFORE TAX | .060 | . |
| N | TAX PAID | 4 | 4 |
| | PROFIT BEFORE TAX | 4 | 4 |

**Model Summary**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .880[a] | .775 | .663 | 8062683.22667 |

a. Predictors: (Constant), PROFIT BEFORE TAX

From the model summary table it is evident from table that R=0.880 which indicates a very high positive correlation between profit before tax and tax paid. The $R^2$ value indicates how much of the total variation in the dependent variable, TAX PAID can be explained by the independent variable, PROFIT BEFORE TAX. In this case, 77.5 % can be explained, which forms major portion.

**ANOVA[a]**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | 447975157037053.440 | 1 | 447975157037053.440 | 6.891 | .120[b] |
| | Residual | 130013721627140.700 | 2 | 65006860813570.350 | | |
| | Total | 577988878664194.100 | 3 | | | |

a. Dependent Variable: TAX PAID

b. Predictors: (Constant), PROFIT BEFORE TAX

From the ANOVA Table it is evident that the regression model statistically predicts the outcome variable that is Excise duty as P value is greater than 0.05.Therefore we can conclude that the relationship between PROFIT BEFORE TAX and TAX PAID is not significant.

**FINDINGS AND CONCLUSION**

The ANOVA and Correlation analysis show that the Export Oriented Unit is in line with the Transfer Pricing laws issued by the CBDT and the Arm's Length price of the EOU has been calculated using Transactional Net Margin Method.

In India the multiple methods can be used to calculate the Arm's Length Price. "The Most Appropriate Method" can be selected based on the available data and the availability of the similar type / class of product.

The Indian legislation considers the average of the two prices calculated by using the best possible method. These methods are chosen based on the situation of the Individual Company and the extent of data available.

The OECD does not impose any minimum threshold value for international transactions to come under transfer pricing, However the Indian legislation suggests computation of arm's length prices irrespective of the value, but gives a token relief to applicability of documents. For collective transaction value of less than INR ten million, exhaustive documentation need not be maintained, and the taxpayer may maintain only reasonable documentation to substantiate that he is transacting at arm's length.

The Accountant is liable to submit Form 3 CEB before the due date and also maintain all the other documents, failing which the Entity will be liable to penalty.

There are a few challenges faced by the Indian Multinational Companies in calculating the Arm's Length Price as availability of comparables is a major hindrance.

OECD Guidelines provide specific guidance for determination of the arm's length price in case of intra-group services, especially with respect to when services are said to be rendered, and when it is reasonable that a mark-up be earned on services. The Indian legislation recognises the applicability of transfer pricing provisions to intra group services, but does not provide guidance on the actual determination of the arm's length price in such cases.

OECD the major committee framing the transfer pricing policy has been showing support to the Indian Tax Authorities in Framing the Transfer Pricing Laws and also organise seminars and training programs for the Revenue Department.

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