

**Report of the
Expert Group on Transfer Pricing Guidelines**

**Submitted to the
Government of India
Ministry of Finance and Company Affairs
Department of Company Affairs
August 2002**

Report of the Expert Group on Transfer Pricing Guidelines

1 Background and Terms of Reference

In April 2002, the Central Government constituted an Expert Group to recommend transfer pricing guidelines for companies for pricing their products in connection with the transactions with related parties and transactions between different segments of the same company. The composition of the Expert Group is given in Annexure 1.

The terms of reference of the Group were as follows:

“The Expert Group shall deliberate upon the scope and extent of the comprehensive transfer pricing guidelines under the provisions of Companies Act, 1956 in the context of related party transactions. The above guidelines shall also encompass segmental transfers within the same corporate entity. The Expert Group shall identify and develop the form of these guidelines and shall particularly consider:

- (a) whether the desired objective of laying down of comprehensive transfer pricing guidelines could be achieved within the framework of the existing provisions of the Companies Act, 1956; or
- (b) if (a) above is not considered feasible, suggest such legislative framework and contents thereof, as may be necessary to achieve the desired objective.

The Group may take into account similar guidelines relating to transfer pricing as enshrined in other tax statutes such as Income Tax Act, 1961, Central Excise Act, 1944 and Customs Act etc. The prevalent practices in this regard in the global scenario may also guide the Group in its endeavour in prescribing the most practical methodologies for pricing of such transfers.”

The Group held four meetings during the course of its deliberations. In addition, the members interacted extensively through the medium of email. Moreover, several subgroups had their own meetings and interactions while preparing the initial drafts that formed the basis for the Group's deliberations.

Dr. Ashok Haldia disagrees with several aspects of this report. His note of dissent is attached to and forms part of this report.

2 The Group's Approach and Procedure

2.1 Acknowledgements

The Group would like to acknowledge the valuable contribution of the Institute of Chartered Accountants of India, the Institute of Company Secretaries of India and the Institute of Cost and Works Accountants of India in providing valuable research support to the Group through their representatives on the Group. The Group would also like to thank the Institute of Company Secretaries of India and the Institute of Cost and Works Accountants of India for their hospitality when the meetings of the Group were held in their premises.

The Group would like to place on record its appreciation of the outstanding support provided by its member-secretary, Mr. I. P. Singh and his colleagues in the Department of Company Affairs. Mr. Singh displayed an extraordinarily high level of dedication and commitment.

The Group would also like to thank the various subgroups that helped the Group to complete its task.

2.2 Current Regulatory Regime in India and Globally

The Group began by studying the laws and practices relating to transfer pricing in India and abroad. Annexure 2 summarises the provisions relating to transfer pricing under the various Indian laws and regulations in the form of a comparative chart. Annexure 3 summarises the global legal regimes relating to transfer pricing.

The following conclusions can be drawn from these two annexures.

- (a) Indian and global tax authorities have armed themselves with substantial powers to plug the tax evasion that arises from creative transfer pricing.
- (b) Transactions between related parties come under the ambit of Accounting Standard AS 18 in India and IAS 24 internationally. These standards require disclosure of certain aspects of such transactions.
- (c) Neither in India nor elsewhere in the world have company law authorities prescribed transfer pricing methods or disclosures.
- (d) The methodologies for determining arm's length transfer prices (Comparable Uncontrolled Price, Resale Price Method etc.) are broadly the same in India and abroad.
- (e) There is a great deal of diversity in the definition of related party.

2.3 Current Corporate Practices in India

The Group also looked at current corporate practices related to transfer pricing in India. While some Indian companies have no doubt set high standards of corporate governance and fairness in this area, many Indian companies have more to do. Several members of the Group observed that in the course of their professional life, they had come across companies that have resorted to unhealthy practices in the area of transfer pricing. Considerable anecdotal evidence is also found in the financial press. Annexure 4 summarises some of the transfer pricing abuses that have given rise to concerns among shareholders, creditors and other stakeholders

about transfer pricing regulation.

2.4 Adequacy of Accounting Standard AS 18

It was pointed out in 2.2 above that as far as shareholders and creditors are concerned, the only protection against transfer pricing abuses is the accounting standard on related parties. It thus becomes necessary to evaluate whether Accounting Standard AS 18 on related party disclosures is adequate to deal with the problem of transfer pricing in India.

The Group recognises that the introduction of AS 18 last year has greatly enhanced the quality of disclosure about transfer pricing and thereby potentially limited the abuses in this area. The principal provision dealing with pricing in AS 18 is Paragraph 25:

“Paragraph 23 (v) requires disclosure of ‘any other elements of the related party transactions necessary for an understanding of the financial statements’. An example of such a disclosure would be an indication that the transfer of a major asset had taken place at an amount materially different from that obtainable on normal commercial terms.”

This is a major step forward in that it does require some gross transfer price abuses to be disclosed. However, the Group is of the view that it would be useful to impose a positive obligation on the part of the company to use an arm’s length transfer price. It would also be useful to have a more elaborate adequate mechanism to determine whether transfer prices are fair or not.

2.5 Global Best Practices and Beyond

This analysis suggests the need for a transfer price guideline under the Companies Act to ensure the fairness of transfer prices from a shareholder/creditor perspective. At the same time, the Group is well aware that the current regulatory regime in India is similar to that elsewhere in the world. In most jurisdictions in the world, the company law is yet to regulate transfer prices. All over the world, this appears to have been left to company management alone to determine in accordance with the business judgement rule.

In today’s environment where we are attempting to incorporate global best practices in all our laws and regulations, introducing a new regulation that is yet to be introduced anywhere else in the world is not something to be done lightly. The Group debated this issue at length. A number of factors swung the Group’s thinking in favour of such a guideline despite this concern:

1. There is global dissatisfaction with corporate governance and corporate disclosure practices in the wake of some well publicized corporate failures during 2001 and 2002 in the United States and elsewhere. Regulators in many jurisdictions are rethinking their approach towards regulation and contemplating measures to tighten the laws regarding corporate abuses. In this situation where global regulatory practices are evolving, there is scope for countries like India to innovate and set new standards of disclosure and transparency that leapfrog current global best practices.
2. There have been corporate governance abuses in India too. Many observers believe that violations of investor and creditor rights have damaged the financial system severely. On the one hand, the erosion of investor confidence has dealt a body blow to our capital markets. On the other hand, mounting corporate delinquencies have debilitated the banking system. In this situation, it could be argued that there is a case for a regulatory regime to check transfer-pricing abuses.

2.6 Transfer Pricing Guidelines under the Companies Act

After extensive discussion and deliberations, the Group came to the conclusion that transfer pricing guidelines should be framed under the Companies Act. The Group noted that the Companies Act (S 209 and S 211) requires that the books of account of the company as well as its Balance Sheet and Profit and Loss Account present a true and fair view of the affairs of the company. The Group believes that the “true and fair view” obligation requires substantial disclosures of transfer pricing policies. It also requires a mechanism to ensure that transfer prices approximate arm’s length prices.

The need for transfer pricing guidelines therefore arises for all users of the financial statements of the company who rely on these statements for a true and fair view:

- shareholders who wish to evaluate the performance of the company management and assess the future prospects of the company
- creditors who wish to ascertain the credit worthiness of the company and monitor compliance with debt covenants
- revenue authorities who may rely partly or wholly on the financial statements to determine tax liability
- other government authorities who may rely on the financial statements to monitor compliance with various laws and regulations (for example, exchange control) or for statistical purposes (for example, price indices or GDP statistics)
- other stakeholders (for example, employees, customers, suppliers) who may use the financial statements for various purposes

For some of these purposes the requirement of arms length transfer prices applies to inter-divisional transfers within the same legal entity. For example, shareholders need a true and fair view of segment revenues and profits as different valuation and performance benchmarks may apply to different segments. Revenue authorities may also require this when different tax rates apply to different segments.

The Group has attempted to keep the needs of all these users in mind while framing the transfer pricing guidelines.

3 Transfer Pricing Guidelines: Core Principles

The Group recommends that the proposed transfer pricing guidelines be guided by the following core principles:

3.1 Requirement of arm's length transfer prices

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 except as provided below.

Remarks: It must be emphasised that even a transfer price more favourable to the company than an arm's length price is problematic. This is so because (a) valuation is impacted by the possibility that the related party may demand an arm's length price in the future and (b) the threat to charge an arm's length price in future could become a form of poison-pill/blackmail.

3.2 Exceptions to arm's length transfer price

In exceptional cases, the company may decide to use a non-arm's length transfer price provided:

- ***the Board of Directors as well as the audit committee of the Board are satisfied for reasons to be recorded in writing that it is in the interest of the company to do so, and***
- ***the use of a non-arms length transfer price, the reasons therefor, and the profit impact thereof are disclosed in the annual report***

Remarks: Examples of such exceptional cases could be a company giving an interest free loan to a loss making subsidiary or a company accepting the offer of a controlling shareholder to work as the CEO on a nominal salary.

3.3 Transfer Price Policy Statement and Implementation Report

The company shall prepare a Statement on Transfer Price Policy (the “Policy Statement”) and a Report on Implementation of Transfer Price Policy (the “Implementation Report”).

- ***The Policy Statement would explain the specific transfer pricing methods used for different classes of transactions with different parties with special emphasis on those transactions where a Comparable Uncontrolled Price/Transaction (CUP/CUT) method could not be adopted.***
- ***The Implementation Report would document the compliance with the Policy Statement and would include the actual detailed computation of an arm's length price for every material transaction with a related party or internal business segment.***
- ***The Implementation Report would be audited by an independent Chartered Accountant or Cost Accountant.***
- ***The Policy Statement and the Implementation Report would be placed before the Audit Committee for approval***
- ***The Policy Statement would also be placed before the Board for approval***
- ***Related party transactions should be undertaken only after the Policy Statement relating to that party has been approved by the Audit Committee and the Board.***

Remarks: The Policy Statement is the primary responsibility of management. The Implementation Report is subject to audit.

The Implementation Report could contain commercially confidential information that is not suitable for wider disclosure. The Policy Statement while not compromising commercially confidentiality would provide sufficient information for an evaluation of the adequacy and fairness of the transfer price policy in the company.

CUP/CUT is a reliable and objective method in those cases where it is applicable. Cases where no comparable uncontrolled price is available present a greater challenge for transfer pricing. Highlighting these cases and explaining the transfer pricing policy in these cases is important from a disclosure point of view.

3.4 Disclosures in Annual Report

- The Transfer Pricing Policy Statement would be annexed to and form part of the Directors’ Report.***
- The Directors’ Report would also certify that the Transfer Pricing Guidelines have been complied with and that transactions entered into are at arm’s length unless otherwise stated and are not prejudicial to the company.***
- The Directors’ Report would disclose any use of a non-arms length transfer price, the reasons therefor, and the profit impact thereof.***
- The Auditors would certify that they have examined the implementation of the transfer pricing policy and found it to be in conformity with the Transfer Pricing Guidelines and with the Policy Statement.***
- The Annual Report would contain the disclosures required under the Transfer Pricing Guidelines as well as the disclosures required in AS 18. These disclosures would appear together in the Annual Report in order to be more meaningful and to enhance ease of understanding.***

Remarks: Though the Implementation Report is not disclosed to the shareholders, the auditors' certification, which is based on their audit of the Implementation Report, provides substantial comfort to them.

The revenue authorities and other regulatory/governmental agencies could call for the audited Implementation Report where needed and might in most cases be able to rely on it without carrying out their own transfer pricing study.

The disclosures required under AS 18 include the following:

- Name of the related party and nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.
- If there have been transactions between related parties, during the existence of a related party relationship:
 - the name of the transacting related party;
 - a description of the relationship between the parties;
 - a description of the nature of transactions;
 - volume of the transactions either as an amount or as an appropriate proportion;
 - any other elements of the related party transactions necessary for an understanding of the financial statements;
 - the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
 - amounts written off or written back in the period in respect of debts due from or to related parties.

4 Legal Foundation for the Transfer Pricing Guidelines

After extensive deliberations, the Group is of the view that a new clause (e) should be inserted in section 209(1) of the Companies Act specifically empowering the Central Government to frame rules or guidelines on transfer pricing. Such a legislative measure would invest the Guidelines with unambiguous statutory force. The Group recommends the insertion of the following clause in the Companies Act:

“209(1)(e) Every company, which enters into any transaction either with related party or within its segments per se, shall maintain such books of account and other records as shall enable the ascertainment of arm's length price of such transaction. The arm's length price shall be determined based on such guidelines as may be issued by the Central Government from time to time.”

However, the Group recognizes that a legislative amendment is potentially time consuming and that it would be desirable to consider alternative mechanisms that could be put in place faster. The Group therefore recommends:

- Government may consider whether the Guidelines could be issued under the residuary powers vested in it under section 642(1)(b) of the Companies Act.
- Most of the Group's recommendations pertaining to additional disclosures could also be implemented by incorporating them in Schedule VI of the

Companies Act. This could be done by the Central Government in the exercise of the powers conferred on it under section 641(1) of the Companies Act.

If the legislative process of amending the Companies Act is likely to be time consuming, it would be desirable in the interim for the Government to implement the recommendations of the Group to the extent possible by resorting to its powers under section 641 and/or section 642.

5 Draft Guidelines

The Group recommends that the following draft guidelines be issued under the proposed Section 209(1)(e):

DRAFT TRANSFER PRICING GUIDELINES

In exercise of the powers conferred by sub-section (1) of section 642, read with clause (e) of sub-section (1) of section 209 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following guidelines, namely :-

1. Short title and Commencement.-

- (1) These guidelines may be called “Transfer Pricing Guidelines, 2002”.
- (2) These guidelines shall come into force on the date of their publication in the official gazette.

2. Application.-

These guidelines shall apply to such transactions, which a company may enter into with its related party or within its segments per se.

Provided that nothing contained herein shall apply to those transactions where the transaction price is fixed by any Government department or authority pursuant to any Law or Act of Parliament.

3. Definitions.-

In these guidelines, unless the context otherwise requires -

- (1) “**arm’s length price**” means the price, which is applied in a transaction between persons other than related party in uncontrolled conditions.
- (2) “**related party**”, in relation to a company, means an entity -
 - (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa; or
 - (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of such company or vice versa.

An entity shall be deemed to be a related party in relation to a company if, at any time during the previous year -

- (a) the entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in such company or vice versa; or
- (b) any person or entity holds, directly or indirectly, shares carrying not less than twenty-six percent of the voting power in each of the entities; or
- (c) a loan advanced by the entity to the company constitutes not less than fifty-one percent of the book value of the total assets of the company or vice versa; or
- (d) the entity guarantees not less than fifty-one percent of the total borrowings of the company or vice versa; or
- (e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of the entity, are appointed by the company or vice versa ; or
- (f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the entity and the company are appointed by the same person or persons; or
- (g) the manufacture or processing of goods or articles or business carried out by the entity is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, 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 company is the owner or in respect of which the company has exclusive rights or vice versa; or
- (h) ninety percent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the entity, are supplied by the company, or by persons specified by the company, and the prices and other conditions relating to the supply are influenced by such company or vice versa; or
 - (i) the goods or articles manufactured or processed by the entity, are sold/transferred to the company or to persons specified by the company, and the prices and other conditions relating thereto are influenced by such company or vice versa; or
 - (j) where the entity is controlled by an individual, the other company is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
 - (k) where an entity has the power to direct, by statute or agreement, the financial and operating policies of the company or vice versa;
 - (l) there exists between two entities, any relationship of mutual interest as may be prescribed provided one of them is a company.
- (3) **“entity”**.- the term “entity” means an individual or a Hindu undivided family or a partnership firm or an association of persons or a trust or a company.
- (4) **“relative”**.- A person shall be deemed to be a relative of another; if, and only if,-
- (a) they are members of a Hindu undivided family; or
 - (b) they are husband and wife; or
 - (c) the one is related to the other in the manner indicated in Schedule I A of the Companies Act, 1956.
- (5) **“segment”** means any business segment for which financial results are prepared either for the purpose of segmental reporting or for complying with or availing benefits under the provisions of any of the Acts or Laws.
- (6) **“transaction”** includes any sale, purchase, transfer, arrangement, understanding or action, whether formal or informal, whether oral or in writing, whether legally enforceable or not with respect to :
- (a) raw materials, process materials, utilities like water, steam, gas, air, power, effluent treatment facility, finished products and rejected goods including scraps, etc;
 - (b) utilisation of plant facilities and technical know-how;
 - (c) rendering or receiving of services including deputation of man power;
 - (d) administrative, technical, managerial or any other consultancy services;
 - (e) capital goods including plant and machinery;
 - (f) lease of tangible or intangible property;
 - (g) provision of finance (including loans, advances and equity or other contribution in cash or in kind);
 - (h) agency and distribution arrangements;
 - (i) leasing or hire purchase arrangements;
 - (j) transfer of or sharing of the benefits of research and development;
 - (k) licence or know-how agreements;
 - (l) guarantees and collaterals;
 - (m) management contracts;
 - (n) any work in pursuance to a contract;
 - (o) any other sharing or provision of resources or undertaking of obligations between or on behalf of related parties regardless of whether or not a price is charged.

4. Transactions to be at arm’s length price

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 determined in accordance with Clause 5.

Provided that in exceptional cases, the company may decide to use a non-arm’s length transfer price if the Board of Directors as well as the audit

committee of the Board are satisfied for reasons to be recorded in writing that it is in the interest of the company to do so. In all such cases, the use of a non-arms length transfer price, the reasons therefor, and the profit impact thereof shall be disclosed in the annual report.

5. Methods Of Computation Of Arm's Length Price

The arm's length price shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction, namely :-

- (1) Comparable Uncontrolled Price Method
- (2) Resale Price Method
- (3) Cost Plus Method
- (4) Profit Split Method
- (5) Transactional Net Margin Method
- (6) Any other basis approved by the Central Government, which has the effect of valuing such transaction at arm's length price.

(1) Comparable Uncontrolled Price (CUP) Method :

The price charged or paid in a comparable uncontrolled transaction or a number of such transactions shall be identified. Such price shall be adjusted to account for differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. The adjusted price shall be taken as arm's length price.

The uncontrolled transaction means a transaction between independent enterprises other than related parties and shall cover goods or services of a similar type, quality and quantity as those between the related parties and relate to transactions taking place at a similar time and stage in the production/ distribution chain with similar terms and conditions applying.

(2) Resale Price Method :

The price at which the goods purchased or services obtained from a related party is resold or is provided to an unrelated entity shall be identified. Such resale price shall be reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar goods or services in a comparable uncontrolled transaction or a number of such transactions. The price so arrived at shall be further reduced by the expenses incurred by the enterprise in connection with the purchase of goods or services. Such price shall be further adjusted to take into account the functional and other differences including differences in accounting practices, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market. The adjusted price shall be taken as arm's length price in respect of goods purchased or services obtained from the related party.

The resale price method would normally be adopted where the seller adds relatively little or no value to the product or where there is little or no value addition by the reseller prior to the resale of the finished products or other goods acquired from related parties. This method is often used when goods are transferred between related parties before sale to an independent party.

(3) Cost Plus Method :

The total cost of production incurred by the enterprise in respect of goods transferred or services provided to a related party shall be determined. The amount of a normal gross profit mark-up to such costs arising from the transfer of same or similar goods or services by the enterprise or by an unrelated enterprise in a comparable uncontrolled transaction or a number of such transactions, shall be determined. The amount of a normal gross profit mark-up shall be adjusted to take into account the functional and other differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market. The total cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price. It is also important here to ensure that the cost base to which mark-up is applied is comparable to the cost base of the third party transaction which serve as comparable. For example, it may be necessary to make an adjustment to cost where one person leases its business assets while other owns its business assets.

The cost plus method would normally be adopted if CUP method or resale price method cannot be applied to a specific transaction or where goods are sold between associates at such stage where uncontrolled price is not available or where there are long term buy and supply arrangements or in the case of provision of services or contract manufacturing.

(4) Profit Split Method :

The combined net profit of the related parties arising from a transaction in which they are engaged shall be determined. This combined net profit shall be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of transaction in which it is engaged with reference to market returns achieved for similar types transactions by independent enterprises. The residual net profit, thereafter, shall be split amongst the related parties in proportion to their relative contribution to the combined net profit. This relative contribution of the related parties shall be evaluated on the basis of the function performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. The combined net profit will then be split amongst the enterprises in proportion to their relative contributions. The profit so apportioned shall be taken into account to arrive at an arm's length price

This method would normally be adopted in those transactions where integrated services are provided by more than one enterprise or in the case multiple inter-related transactions which cannot be separately evaluated.

(5) Transactional Net Margin Method :

The net profit margin realised by the enterprise from a related party transaction shall be computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base. The net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions, shall also be computed having regard to the same base. This net profit margin shall be adjusted to take into account the differences, if any, between the related party transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect such net profit margin in the open market. The cost of production referred to above increased by the adjusted profit mark-up shall be taken as arm's length price. The adjusted net profit margin shall be taken as arm's length price.

This method would normally be adopted in the case of transfer of semi finished goods.; distribution of finished products where resale price method cannot be adequately applied; and transaction involving provision of services.

6. Authentication of the documents provided by the company

The information/documents provided by the company to the auditor for certification as provided in clause 7 hereof shall be signed on behalf of the Board by the Company Secretary and at least one Director of the company. In the absence of Company Secretary in the company, the same shall be signed by at least two Directors of the company on behalf of the Board.

7. Certification of Related Party Transactions

A report on the compliance of the transfer pricing guidelines **in respect of transactions with related parties** shall be obtained from an independent Chartered Accountant in whole-time practice or Cost Accountant in whole-time practice in the format prescribed hereunder. Such audit report shall be published in the annual report of the company in the event of any qualification or disagreement with the Board of Directors on any transaction.

- (i) I/We* have audited the accompanying Schedule A – Record of transactions entered into by the company with related parties. This schedule is the responsibility of the Company's management. My/Our* responsibility is to express an opinion on this schedule based on our audit.
- (ii) The Report on Implementation of Transfer Pricing prepared under clause 10 has been furnished by the company and has been examined and verified by me/us*.
- (iii) I/We* conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that I/we* plan and perform the audit to obtain reasonable assurance about whether the record of transactions entered into with related parties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of accounts receivable. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. I/We* believe that my/our* audit provides a reasonable basis for our opinion.
- (iv) In my/our* opinion, the record of transactions entered into with related parties referred to above presents fairly, in all material respects, the related party transactions of the company in conformity with accounting principles generally accepted in India.
- (v) The financial information given in the above statement is in agreement with the records and documents furnished to me/us*, and the same has been incorporated in the books of accounts maintained by the company.
- (vi) I/We* are not a related party of the company as defined in the Transfer Pricing Guidelines

Signature and Stamp/Seal of the
Chartered Accountant /Cost Accountant
Name of the Signatory, Membership No. and Full Address

Place :

Date :

*Delete whichever is not applicable.

9. Directors' Certificate on Transfer Pricing Guidelines

The Directors' Report shall contain a certificate in the following format:

To the Members

It is certified that the company has complied with the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956. The information pursuant to these Guidelines is given in Annexure 'A' to this Certificate. We believe that the record of transactions entered into with related parties during the period from _____ through _____ are at arm's length and not prejudicial to the interests of the company. These transactions are entered into on the basis of a transfer pricing policy adopted by the company. All transactions have been submitted to the independent auditors for audit. [No adverse remarks have been made in their report on the audit of such transactions]/[The auditors have qualified their report and the audit report is attached] *.

Date:

For and on behalf of

Place :

Board of Directors

*Delete whichever is not applicable.

9. Disclosures in the Directors' Report

The Directors' Report shall contain the following disclosures relating to transfer pricing:

- The record of transactions entered into with related parties in the format specified in Schedule A.
- Transfer Pricing Policy Statement describing the strategies and policies influencing the determination of transfer price in a format as close to Schedule B as may be practicable.
- Management perception of risk factors involved, if any.
- The amounts or appropriate proportions of outstanding items pertaining to related parties balances and provisions for doubtful debts due from such parties as on Balance sheet date.
- Any other material information pertaining to related party transactions that are necessary for understanding of the financial statements or are required to be disclosed under any other law or under any accounting standard. The disclosures required under these guidelines as well as the disclosures regarding related party transactions required under other laws or under accounting standards would appear together in the Annual Report in order to be more meaningful and to enhance ease of understanding.

10. Transfer Price Implementation Report

The company shall prepare a Report on Implementation of Transfer Pricing documenting the compliance with the Guidelines and the Transfer Price Policy Statement. This report shall be placed before the Audit Committee of the Board of Directors for approval. It shall also be submitted to the independent auditor appointed under clause 7. This report shall include the following information:

- List of related parties with whom the Company has entered into transactions with the following details :
 - (i) General information of related party such as name, trade name, address etc.
 - (ii) Nature of relationship with the related party.
 - (iii) Brief description of the business carried on by the related party.
 - (iv) If the related party is a foreign party, the name, trade name and address of their permanent establishments located abroad.
- Nature and Description of the transaction carried/undertaken by related party, specifying the category of transactions in terms of the list given in clause 3(6).

(This has to be given along with volume of the transaction. In case this is not possible, then, approximate value of the transaction should be given).

- Terms and conditions of the transaction undertaken by the company with the related parties and the quantity purchased/sold.
- Method adopted for determining transfer price. In case there is an established price for an unrelated party, then, how much is the difference, by adopting different method, for related party.
- Detailed assumptions and estimates underlying the transfer price and the details of the computation of the transfer price.
- The following additional information in respect of lending or borrowing:
 - (i) Nature of financing agreement.
 - (ii) Currency in which loan/advance granted/received.
 - (iii) Interest rate charged/paid in respect of each loan/advance.
- If the company has entered into any transaction with a related party by way of a mutual agreement or arrangement for the allocation of 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 entrepreneurs, description of such mutual agreement or arrangement.
- Any other material information pertaining to related party transactions necessary for understanding of the financial statements.

Schedule A – Record of transactions entered into with related parties

Name of related party	Nature of transaction	Amount (Rs.)	Transacted at arm's length basis (Yes/No)	Remarks* (in case of exceptions to arm's length basis of trading)

* If the company has not followed the method prescribed under the guidelines in pricing of the transaction with any related party, the impact thereof on the profits/losses of the company shall be indicated here.

Schedule B: Illustrative Statement on Transfer Pricing Policy

Objective

1. The primary objective of this Statement on Transfer Pricing Policy (the “Statement”) is to ensure that all transactions between the company and related parties or between two business segments of the company are ordinarily at arm's length transfer prices. The Board of Directors (“BOD”) believes that this process enhances the transparency, integrity and quality of financial reporting and would comply with regulatory requirements in this regard.

Scope

2. This Statement applies to all transactions where a related party relationship exists between the company and that other transacting party as also transactions between two business segments of the company.
3. This Statement will not be applied in respect of transactions between the company and its consolidated subsidiaries, in respect of consolidated financial statements, since such transactions will be eliminated during the consolidation process. Provided that if the subsidiary or subsidiaries

constitute a business segment, this Statement will apply to that subsidiary or those subsidiaries as it does to other business segments.

Definitions

4. For the purposes of this Statement, the terms “*transactions*”, “*arm’s length*”, “*related party*” and “*business segment*” have the meanings assigned to them under the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956.

Statement of Policy

5. All transactions between the company and its related parties or between any two or more business segments of the company shall normally be contracted on an arm’s length basis as required under the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956.

6. For each related party, a statement shall be recorded disclosing the basis/methodology for various transactions and shall form the basis on which transactions are entered into.

7. In respect of each such transaction with each related party, a record shall be maintained giving the following particulars:

- Name of the contracting party;
- Nature of the transaction;
- Terms and conditions of the transaction undertaken including the amount of consideration received or given up;
- Basis or methodology of determining such consideration;
- Detailed assumptions and estimates underlying the transfer price and the details of the computation of the transfer price.
- A statement whether, in management’s opinion, such consideration is at an arm’s length basis with specific reference to a comparable uncontrolled price or a comparable uncontrolled transaction. Such statement can be prepared and presented annually; and
- This record may also be maintained for a group of similar transactions

8. The policy on entering into a transaction with a related party shall be placed before the BOD/independent audit committee of the BOD for approval before any such transactions are entered into.

9. The records of all such transactions with each such related party shall be placed before the Board of Directors at each Board meeting for formal approval/ratification.

10. Where an officer of the company (as defined under the Companies Act, 1956) possesses knowledge that a transaction may not be consummated on an arm’s length basis due to certain specific circumstances, he/she shall inform the BOD within ____ business days, also giving reasons for deviation from an arm’s length basis of pricing.

11. The BOD has discretionary authority to formally approve such exceptional transactions. It should also place such transactions together with reasons for deviations from the policy before the independent audit committee for their ratification.

12. The records of all such related party transactions (including exceptional transactions) shall also be placed before the independent audit committee of the company at each meeting of the audit committee for their approval.

13. It should be appreciated that the record of related party transactions contains commercially confidential information that is not appropriate for wider disclosure.

14. At the end of every financial reporting period (quarterly, half-yearly or annual), an Implementation Report shall be prepared and presented before the Board of Directors for their approval. (This can form part of the Directors Responsibility Statement, signed by the Managing Director and Chairman and placed before the BOD together with the audit report referred to in paragraph 17 below)

15. The record of related party transactions shall be audited on a (quarterly/half yearly/annual) basis by an independent auditor as required under the Transfer Pricing Guidelines issued under Section 209(1)(e) of the Companies Act, 1956. The audit report shall be taken on record at the meeting of the Board of Directors. ***Such audit report shall be published in the annual report of the company in the event of any qualification or disagreement with the BOD on any transaction.***

16. Any amendments to this Statement shall be effective only if taken on record and approved by the independent audit committee and the Board of Directors of the company.

17. This Statement was taken on record and approved by the independent audit committee at their meeting held on _____, 20XX.

18. This Statement was taken on record and approved by the Board of Directors at their meeting held on _____, 20XX.



6 Review of This Report

The Group recognizes that transfer pricing regulation is a relatively new area worldwide and that it has been evolving continuously. It would therefore be desirable to review the recommendations of the Group after a period of three years with a view to improving them and updating them in line with emerging developments in India and elsewhere.

Jayanth R. Varma

T. V. Mohandas Pai

J. K. Puri

Suraj Bhan Nain

A. K. Prasad

K. Narasimha Murthy

Ashok Haldia

V. Kalyanaraman

S. P. Narang

D. K. Mittal

I. P. Singh

Annexure 1

Composition of the Expert Group on Transfer Pricing

S. No	Names	
1	Prof. J.R.Varma (IIM)	Chairman
2	Shri T.V.Mohandas Pai (Infosys)	Member
3	Shri J.K.Puri (Ministry of Finance)	Member
4	Shri Suraj Bhan Nain (CBDT)*	Member
5	Shri A.K.Prasad (CBEC)	Member
6	Shri K.Narasimha Murthy (IDBI)	Member
7	Shri Ashok Haldia (ICAI)	Member
8	Shri V.Kalyanaraman (ICWAI)	Member
9	Dr. S.P.Narang (ICSI)	Member
10	Shri D.K.Mittal (Tariff Commission)	Member
11	Shri I.P.Singh (Department of Company Affairs)	Member-Secretary

* Nominated in place of Shri A.J.Majumdar, Joint Secretary, Department of Revenue.

Annexure 2

Comparative Chart Showing Provisions Relating to Transfer Pricing under Different Laws and Regulations

INCOME TAX ACT, 1961	CUSTOMS ACT, 1962	CENTRAL EXCISE ACT, 1944	ACCOUNTING STANDARD-18
I Type of Transactions			

<p>This Act relates to International Transactions. These transactions has been defined under Section 92B of the Act.</p>	<p>This Act relates to transactions relating to exportation and importation in the course of International Trade. (However, the term International Trade has not been defined under the Act)</p>	<p>This Act relates to transactions relating to Captive consumption of goods and related party transactions.</p>	<p>This Standard covers related party transactions. These transactions involve transfer of resources or obligations between related parties, regardless of whether or not a price is charged. This Standard became effective in respect of accounting periods commencing on or after 1.4.2001. AS-18 is mandatory only in respect of following enterprises and not all enterprises as at present :</p> <ul style="list-style-type: none"> (i) Enterprises whose equity or debt securities are listed on a recognized stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the Board of directors' resolution in this regard. <p>All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs.50 crores.</p>
--	---	--	--

II. Associated enterprise/Associated persons/ Related party/Related person (see below for Companies Act and MRTTP Act definitions)

<p>The term "Associated enterprise has been defined under Section 92A of the Act. As per this Section-</p> <p>(1)"associated enterprise", in relation to another enterprise, means an enterprise -</p> <ul style="list-style-type: none"> (a) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or (b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise. <p>(2) Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year, -</p>	<p>This Act provides for the definition of the term Related person under Rule 2 (2) of the Customs Valuation (Determination of Price of Imported Goods) Rules, 1988. As per this rule -</p> <p>Persons shall be deemed to be "related" only if -</p> <ul style="list-style-type: none"> (i) they are officers or directors of one another's businesses; (ii) they are legally recognised 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 or 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 person; (vii) together they directly or indirectly control a third person; or (viii) they are members of the same family. <p>Explanation I to the Rule provides that the</p>	<p>The Act provides for the definition of the term related person under Section 4 (3)(b) which provides-</p> <p>Persons shall be deemed to be "related" if-</p> <ul style="list-style-type: none"> (i) they are inter-connected undertakings; (ii) they are relatives; (iii) amongst them the buyer is a relative and a distributor of the assessee, or a sub-distributor of such distributor; or (iv) they are so associated that they have interest, directly or indirectly, in the business of each other; <p>Explanation to the clause provides "inter-connected undertakings" shall have the same meaning as provided in section 2(g) of the MRTTP Act, 1969 and the term "relative" shall have the same meaning as provided in Section 2(41) of the Companies Act, 1956.</p>	<p>Accounting Standard-18 provides for the definition of the term 'related party' as per which parties are considered to be related if any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.</p> <p>The term control means :</p> <ul style="list-style-type: none"> (a) ownership, directly or indirectly, of more than one half of the voting power of an enterprise, or (b) control of the composition of the Board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise, or (c) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise. <p>An enterprise is considered to have a substantial interest in another enterprise if</p>
---	--	--	--

- (a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or
- (b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or
- (c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or
- (d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or
- (e) more than half of the Board of directors or members of the governing board, or one or more executive directors or executive members of the governing Board of one enterprise, are appointed by the other enterprise; or
- (f) more than half of the directors or members of the governing Board, or one or more of the executive directors or members of the governing Board, of each of the two enterprises are appointed by the same person or persons; or
- (g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of 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 other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- (h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or

term "person" also includes legal persons. Further it has been provided in Explanation II that 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.

that enterprise owns, directly or indirectly, 20 per cent or more interest in the voting power of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, 20 per cent or more interest in the voting power of the enterprise.

The term significant influence refers to participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies. Significant influence may be exercised in several ways, for example

- by representation on the Board of directors,
- participation in the policy making process,
- material inter-company transactions,
- interchange of managerial personnel, or
- dependence on technical information.

For the purposes of this standard an associate is an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

A joint venture is a contractual agreement whereby two or more parties undertake an economic activity which is subject to joint control. The term joint control refers to the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

This standard provides for the definition of the term relative as per which relative in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be

articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) 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; or

(j) 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 relative of such individual; or

(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family, or by a relative of a member of such Hindu undivided family, or jointly by such member and his relative; or

(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or

(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

influenced by, that individual in his/her dealings with the reporting enterprise.

III. Basis of Determination of Price

Computation of Income from International Transactions shall be done having regard to arm's length price as per section 92C where under six methods are prescribed namely :

- (a) comparable uncontrolled price method;
- (b) resale price method;
- (b) cost plus method;
- (c) profit split method;
- (d) transactional net margin method;
- (e) such other method as may be prescribed by the Board.

"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 14 of the Act provides for valuation of goods. Valuation of the such goods shall be deemed to be the price at which such goods 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 buyer have no interest in the business of each other and the price is the sole consideration for sale or offer for sale.

Rule 4(3) of Customs Valuation (Determination of Price of Imported Goods) Rules, 1988 provides that where the seller and buyer are related to each other, the value shall be accepted provided that the examination of the circumstances of the sale of the imported goods indicate that the relationship did not influence the price.

However, Where the buyer and seller are related, the transaction value shall be accepted provided that the examination of the circumstances of the sale of the imported goods indicate that the relationship did not influence the price.

In a sale between related persons, the transaction value shall be accepted, when-ever the importer demonstrates that the declared value of the goods being valued, closely approximates to one of the following values ascertained at or about the same time -

- (i) the transaction value of identical goods, or of similar goods, in sales to unrelated buyers in India;
- (ii) the deductive value for identical goods or similar goods;
- (iii) the computed value for identical goods or similar goods.

Provided that in applying the values used for comparison, due account shall be taken of demonstrated difference in commercial levels, quantity levels, adjustments in accordance with the provisions of Rule 9 of these rules and

Section 4 of the Act provides for valuation of excisable goods for purposes of charging of duty of excise where under, the duty of excise is chargeable on any excisable goods with reference to their value. On each removal of the goods, such value shall in a case where the goods are sold by the assessee for delivery at the time and place of removal, the assessee and the buyer of the goods are not related and the price is the sole consideration for the sale will be the transaction value.

In any other case, including the case where the goods are not sold, the value shall be determined in such manner as may be prescribed. However, this section is not applicable in respect of any excisable goods for which a tariff value has been fixed under Section 3(2) of the Act. Where the excisable goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles or where the assessee so arranges that the excisable goods are not sold by him except to or through a related person in such a situation the value shall be determined as per Rules 8, 9 and 10 of the Central Excise (Determination of Price of Excisable Goods) Rules, 2000. These Rules provide that—

Where the excisable goods are not sold by the assessee but are used for consumption by him or on his behalf in the production or manufacture of other articles, the value shall be one hundred and fifteen per cent of the cost of production or manufacture of such goods. (Rule 8)

When the assessee so arranges that the excisable goods are not sold by an assessee except to or through a person who is related in the manner specified in either of sub-clauses (ii), (iii) or (iv) of clause (b) of sub-section (3) of section 4 of the Act, the value of the goods shall be the normal transaction value at which these are sold by the related person at the time of removal, to buyers (not being related person); or where such goods are not sold to such buyers, to buyers (being related person), who sells such goods in retail : It is however provided that in a case where the related person does not sell the goods but uses or consumes such goods in the production or manufacture of articles, the value shall be determined in the manner specified in Rule 8. (Rule 9)

When the assessee so arranges that the excisable goods are not sold by him except to

It requires disclosure of information regarding related parties and transactions with related parties that are recognized in the financial statements of an enterprise.

This standard establishes the requirements for disclosure of :

- related party relationships; and
- transactions between a reporting enterprise and its related parties.

Disclosures under this standard is a means of conveying to the users that certain related party relationship exists or related party transactions have taken place and that the results of these transactions have been incorporated in the financial statements. These disclosures will make financial statements more transparent and users of financial statements can make informed decisions based on it.

cost incurred by the seller in sales in which he and the buyer are not related; Substituted values shall not be established under the above provisions.

or through an inter-connected undertaking, the value of goods shall be determined in the following manner, namely :-
 (a) If the under-takings are so connected that they are also related in terms of sub-clause (ii) or (iii) or (iv) of clause (b) of sub-section (3) of Section 4 of the Act or the buyer is a holding company or subsidiary company of the assessee, then the value shall be determined in the manner prescribed in rule 9.
 (b) In any other case, the value shall be determined as if they are not related persons for that purposes of Section 4(1). (Rule 10) .

Definition of Associated enterprise/Associated persons/ Related party/Related person under Companies Act and MRTP Act

COMPANIES ACT, 1956

There is only one provision under section 370(1B) of the Act which provides for the instances when two body corporates shall be deemed to be under the same management. It provides, two bodies corporate shall be deemed to be under the same management—

(i) if the managing agent, secretaries and treasurers, managing director or manager of the one body, or where such managing agent or secretaries and treasurers are a firm, any partner in the firm, or where such managing agent or secretaries and treasurers are a private company, any director of such company, is—

(a) the managing agent, secretaries and treasurers, managing director or manager of other body; or

(b) a partner in the firm acting as managing agent or secretaries and treasurers of the other body; or

(c) a director of a private company acting as management agent, or secretaries and treasurers of the other body;

(ii) if a majority of the directors of the one body constitute, or at any time within the six months immediately preceding constituted, a majority of the directors of the other body or,

(iii) if not less than one-third of the total voting power with respect to any matter relating to each of the two bodies corporate is exercised or controlled by the same individual or body corporate, or

(iv) if the holding company of the one body corporate is under the same management as the other body corporate within the meaning of clause (i), clause (ii) or clause (iii), or

if one or more directors of the one body corporate while holding, whether by themselves or together with their relatives, the majority of shares in that body corporate also hold, whether by themselves or together with their relatives, the majority of shares in the other body corporate.

MRTP ACT, 1969

The term "Inter-connected undertaking" as defined under Section 2(g) of this Act means two or more undertakings which are inter-connected with each other in any of the following manner, namely :-

(i) if one owns or controls the other.

(ii) where the undertakings are owned by firms, if such firms have one or more common partners.

(iii) where the undertakings are owned by bodies corporate, -

(a) if one body corporate manages the other body corporate, or

(b) if one body corporate is a subsidiary of the other body corporate, or

(c) if the bodies corporate are under the same management, or

(d) if one body corporate exercises control over the other body corporate in any other manner;

(iv) where one undertaking is owned by a body corporate and the other is owned by a firm, if one or more partners of the firm, -

(a) hold, directly or indirectly, not less than fifty per cent of the shares, whether preference or equity, of the body corporate, or

(b) exercise control, directly or indirectly, whether as director or otherwise, over the body corporate,

(v) if one is owned by a body corporate and the other is owned by a firm having bodies corporate as its partners, if such bodies corporate are under the same management ,

(vi) if the undertakings are owned or controlled by the same person or by the same group,

(vii) if one is connected with the other either directly or through any number of undertakings which are inter-connected undertakings within the meaning of one or more of the foregoing sub-clauses.

Explanation 1 to the Clause provides that two bodies corporate, shall be deemed to be under the same management, -

(i) if one such body corporate exercises control over the other or both are under the control of the same group or any of the constituents of the same group; or

(ii) if the managing director or manager of one such body corporate is the managing director or manager of the other; or

(iii) if one such body corporate holds not less than one-fourth of the equity shares in the other or controls the composition of not less than one-fourth of the total membership of the board of directors of the other; or

(iv) if one or more directors of one such body corporate constitute, or at any time within a period of six

months immediately preceding the day when the question arises as to whether such bodies corporate are under the same management, constituted (whether independently or together with relatives of such directors or the employees of the first mentioned body corporate) one-fourth of the directors of the other; or

(v) if the same individual or individuals belonging to a group, while holding (whether by themselves or together with their relatives) not less than one-fourth of the equity shares in one such body corporate also hold (whether by themselves or together with their relatives) not less than one-fourth of the equity shares in the other; or

(vi) if the same body corporate or bodies corporate belonging to a group, holding, whether independently or along with its or their subsidiary or subsidiaries, not less than one-fourth of the equity shares in one body corporate, also hold not less than one-fourth of the equity shares in the other; or

(vii) if not less than one-fourth of the total voting power in relation to each of the two bodies corporate is exercised or controlled by the same individual (whether independently or together with his relatives) or the same body corporate (whether independently or together with its subsidiaries); or

(viii) if not less than one-fourth of the total voting power in relation to each of the two bodies corporate is exercised or controlled by the same individuals belonging to a group or by the same bodies corporate belonging to a group, or jointly by such individual or individuals and one or more of such bodies corporate; or

if the directors of the one such body corporate are accustomed to act in accordance with the directions or instructions of one or more of the directors of the other, or if the directors of both the bodies corporate are accustomed to act in accordance with the directions or instructions of an individual, whether belonging to a group or not.

Explanation II provides that if a group exercises control over a body corporate, that body corporate and every other body corporate, which is a constituent of or controlled by, the group shall be deemed to be under the same management.

Explanation III to clause provides that if two or more bodies corporate under the same management hold, in the aggregate, not less than one-fourth equity share capital in any other body corporate, such other body corporate shall be deemed to be under the same management as the first mentioned bodies corporate.

It is further provided in Explanation IV that in determining whether or not two or more bodies corporate are under the same management, the shares held by financial institutions in such bodies corporate shall not be taken into account.

The Act defines the term Group under section 2(e) as per which 'group' means a group of – (i) two or more individuals, associations of individuals, firms, trusts, trustees or bodies corporate (excluding financial institutions) or any combination thereof, which exercises, or is established to be in a position to exercise, control, directly or indirectly, over any body corporate, firm or trust; or

(ii) associated persons.

Explanation : For the purposes of this clause—

(I) a group of persons who are able, directly or indirectly, to control the policy of a body corporate, firm or trust, without having a controlling interest in that body corporate, firm or trust, shall also be deemed to be in a position to exercise control over it;

(II) "Associated persons" -

(a) in relation to a director of a body corporate, means -

(i) a relative of such director, and includes a firm in which such director or his relative is a partner;
 (ii) any trust of which any such director or his relative is a trustee;
 (iii) any company of which such director, whether independently or together with his relatives, constitutes one-fourth of its board of directors;
 (iv) any other body corporate, at any general meeting of which not less than one-fourth of the total number of directors of such other body corporate are appointed or controlled by the director of the first mentioned body corporate or his relative, whether acting singly or jointly;
 (b) in relation to the partner of a firm, means a relative of such partner and includes any other partner of such firm; and
 (c) in relation to the trustee of a trust, means any other trustee of such trust;
 (III) where any person is an associated person in relation to another, the latter shall also be deemed to be an associated person in relation to the former;

Annexure 3

Summary Of Global Practice Relating To Transfer Pricing

FEATURES	DETAILS
Argentina	
Legal Position	Income Tax Act (ITA) as amended by Act No. 25063 and Act No. 25239. Argentine Revenue Service(ARS) Regulation No. 1122 (dt. 31.10.2001 but applicable for financial years beginning on or after 31.12.99). Previously ARS Regulation No. 702 amended by 1007/01 was in force.
Parties & Transaction	Parties are related when one entity directly or indirectly controls another party with which it engages in transactions, or when the entities that engage in the transactions are under common control of a third entity Tested party must be a local party, i.e. entity domiciled in Argentina Following transactions are subject to transfer pricing scrutiny : Transactions carried out by Argentine entities with - - Foreign related parties - Foreign parties that must be 'acting in concert' standard - Parties located in low or zero tax jurisdictions - Their permanent establishments located abroad and - Unrelated parties that import and export tangible goods with no available data to validate wholesale prices

Pricing Methods Allowed	For transactions of tangible goods between independent parties : Wholesale Price, Comparable Uncontrolled Price (CUP), Resale Price, Cost Plus, Profit Split and Transactional Net Margin Method (TNMM) Transactions between related parties :- CUP, Resale Price, Cost Plus, Profit Split and TNMM Argentine statute requires a taxpayer to use the 'best method' with reference to regular market practices and economy
Documentation/ Returns	The documentation should be contemporaneous with the tax returns. Key elements of transfer pricing study include comparison of all the methods and explanations for seeking the identified method as the best one, functional analysis, risk analysis, a description of capital structure and an organisational chart of the multinational group. This study is included in Semi-Annual/Annual Transfer Pricing Returns. Form 741, Form 742 and Form 743 which are to be completed with ARS Special Software, are to be submitted. With Annual Transfer Pricing Return (Form 743), a special report signed by the assessee and certified by an independent CPA, must be filed with the ARS.
Penalty	General Penalty applied for transfer pricing transaction Interest - 3% on monthly basis (upon filing of law suit interest is increased to 4%) Fines - 50% to 100% of unpaid taxes depending upon the case For fraud, fine is from 2 to 10 times of the unpaid taxes
Canada	
Legal Position	Section 247 of the Canadian Income Tax Act requires non-arm's length parties to conduct their transactions using arm's length terms and conditions. Further as per Section 251(10) of that Act related parties not to deal in arm's length, the issue is whether non-related parties are dealing at arm's length price or not. Interpretation of the Transfer Pricing requirements are set out in Canada Customs and Revenue Agency (CCRA) Information Circular 87-2R.
Pricing Methods Allowed	Only non-related parties should deal in arm's length price. Acts and Regulations do not provide any instruction on the application of the arm's length principle including the meaning of 'arm's length terms and conditions'. Though CCRA Information Circular 87-2R clarified some of the interpretations, since that is an information circular, it does not have legal binding. As per CCRA, Transfer pricing methods will be examined in the following hierarchical order :- CUP, Resale Price, Cost Plus, Profit Split and TNMM. The method which provides highest degree of comparability between transactions, is the most appropriate method.

Documentation/ Returns	A tax-payer is required to make contemporaneous documentation. Documentation must include complete and accurate information on the following items : <ul style="list-style-type: none"> - Transaction related property or service -Terms and conditions of the transaction -Identity of the participants of the transaction and their inter-relationship - Risk Factor -Methods considered for determining transfer price and -Assumption, strategies and policies influencing the determination of Transfer price Form T106 is to be submitted to CCRA giving details of transfer pricing.
Penalty	10% penalty on total adjustment to transaction plus non-deductible interest, on both transaction on income account and on capital account.
Mexico	
Legal Position	Transfer pricing in Mexico is regulated by Ministry of Finance and Public Credit, Tax Administration Service (SAT) as per Article 86 of the Mexican Income Tax Law.
Applicability	The following parties are subject to Transfer Pricing <ul style="list-style-type: none"> -parent, subsidiary or affiliated companies outside Mexico -companies outside Mexico, related or unrelated, located in a tax haven country as designated by the SAT. -The members of a joint venture -The Head office of a permanent establishment in Mexico, or other permanent establishments of the Head office The law applies to any inter-company transactions. The broad categories are <ul style="list-style-type: none"> - loans and advances - services -sale of tangible properties or goods -lease of tangible properties Inter-company, inter-Mexico transaction, though require to be conducted on arm's length basis, no documentation is required for the same.
Pricing Methods Allowed	CUP, Uncontrolled Price, Resale Price, Cost Plus, Profit Split, Residual Profit Split and TNMM
Documentation/ Returns	Following information related to intercompany transactions carried out with related parties must be compiled : <ol style="list-style-type: none"> 1. Name, Trade Name, domicile and tax residence of the related persons and documents showing the direct and indirect participation between the related parties. 2. Information regarding functions or activities, assets used and risks assumed by the tax payer. 3. Information and documentation on the main transactions with related parties and the amount thereof 4. Method applied 5. Form 2002 onwards, the tax payers must indentify foreign related party transactions clearly on their financial accounts books. In March, companies have to file an information return with respect to their transactions with the related parties abroad that includes general information of the related parties,

	classification, amount, method applied and profit/loss
Penalty	If paid before being notified of a deficiency :-50% of unpaid tax If paid after being notified of a deficiency :- 70% to 100% of unpaid tax For overstatement of loss :-30% to 40% of the overstated amount of loss However, if documentation is in place, penalties are reduced as below :- If paid before notified of a deficiency :-25% of the unpaid tax If paid after notified of a deficiency :-35% to 50% of unpaid tax For over statement of loss :-15% to 20% of the overstated loss
USA	
Legal Position	Internal Revenue Services, Internal Revenue Code 482, 6038A, 6038C, 6062(e)-(n)
Pricing Method Allowed	Best Method among CUP, Resale Price, Cost Plus, CPM, Profit Split
Documentation/ Return	A tax payer is required to maintain extensive contemporaneous documentation. Returns in Forms 5471 and 5472 have to be filed.
Penalty	20% and 40% penalty for underpayment of tax is levied.
France	
Legal Position	Transfer pricing in France is administered by French Tax Administration on the basis of general Tax Code Article 57 and Tax procedure Book Article L13B and L188A. Administrative Doctrine has also been released on Article 57 and Article L13B
Pricing Method Allowed	CUP, Resale Price, Cost Plus, Profit Split, TNMM. Priority is given to transaction-based method.
Documentation/ Return	Effective documentation is required for audit purposes. Annual Report is required to be filed if a company is filing an APA. Otherwise, no specific disclosure is required
Penalty	Late payment interest is levied on assessment. Further, failure to produce requested documents attracts penalty. There are two types of penalties: 40% for bad faith 80% for fraud
Germany	
Legal Position	Federal Ministry of Finance controls Transfer Pricing in Germany. Section 8 of the Corporate Income Tax Act, Section 4 of the Income Tax Directive and Section 1 of the Foreign Transaction Tax Act regulates it. Apart from this, from time to time, administrative Principles are released by the Federal Ministry of Finance on various matters relating to Transfer Pricing

Pricing Method Allowed	Transaction based method of determining Transfer Pricing is given preference to Profit based approach. Among various methods applied, CUP, Resale Price, Cost Plus are more prominent. Sometimes, Modified Resale Price Method is also done. As the last resort Profit Split method is used.
Documentation/ Return	There is no specific provision for maintaining transfer pricing documentation. The Tax-payer is required to provide existing documents. No specific disclosure is required. Information on cross border transactions are required to be provided at the time of Tax Audit. Some documentation is required to be prepared ex ante before the transaction takes place.
Penalty	There is no penalty
Russia	
Legal Position	Article 20 & Article 40 of Part 1 of the Russian Tax Code. Sales below cost rules has been abolished from 1st January 1999.
Applicability	The Tax Authorities can check validity of pricing of any transaction (not restricted to Cross border or related party transaction) where one or more of the following conditions exist: i) The parties are mutually dependent ii) The transaction is a barter or exchange iii) The transaction is cross-border or iv) The price differs by more than 20% from the price applied to homogeneous goods works or service, within a short period.
Pricing Method Allowed	Emphasis is given on CUP method of pricing. However, in its absence Subsequent Realisation Price (SRP) Method or Expense Method may be applied.
Documentation/ Return	No specific documentation or disclosure is required under the law.
Penalty	There is no specific Transfer Pricing Penalty. However, penalty may be levied for general underpayment of tax.
United Kingdom	
Legal Position	Schedule 28AA of the Income and Corporation Taxes Act, 1988 and Section 12B of the Taxes Management Act 1970 guide transfer pricing in UK. The affairs are controlled by Inland Revenue Department. Guidance Notes in Inland Revenue Tax Bulletin 37 & 38 have also been published.
Applicability	It relates to transactions actually made between a UK body corporate and another body corporate, partnership or unit trust under common control, in a transaction or a series of transactions. Where the parties are not under common control, Schedule 28AA may still apply as between a Joint Stock Company and one or both of two 40 per cent shareholders.

Pricing Method Allowed	Most reasonable method among CUP, Resale Price, Cost Plus, Profit Split, TNMM is used. Preference is given to Transaction based method over profit-based method.
Documentation/Return	Contemporaneous documentation is needed. The tax payer should keep all such records as may be required for the purpose of enabling him to make and deliver a correct and complete tax return. The absence of it is tantamount to negligence, exposing the tax payer to heavy panalties. Apart from Annual Return showing compliance with any APA, no other return is required to be submitted.
Penalty	Upto 100% of any additional tax due as a result of transfer pricing adjustment where the tax payer is negligent.

Australia

Legal Position	Australia's Transfer Pricing rules contain in Division 13 of Part III of the Income Tax Assessment Act, 1936. Australian Taxation Office has come up with series of draft Taxation Rulings (TR) which are the guidelines of Transfer Pricing. Latest TRs are, TR2000/D15, TR2001/D6, TR2001/11 and TR2002/2 etc.
Applicability	Australia's transfer pricing rules apply to the allocation of profits to a Permanent Establishment (PE). Tax treatment to PEs is single entity approach i.e., a PE is not a separate legal entity. The arm's length standard is notionally applied to a transaction between an entity and its PE. That is why separate treaty provision and domestic provision have been made.
Pricing Method Allowed	Most reasonable method among CUP, Resale Price, Cost Plus, Profit Split, TNMM is used.
Documentation/Return	Extensive documentation, preferably contemporaneous documentation is preferred. Disclosures relating to Transaction types, amounts, countries, documentation maintained and methodologies used are required under schedule 25A
Penalty	Under TR98/16, provision for penalty is there.

China

Legal Position	Transfer Pricing was introduced in the Income Tax Law of the PRC for Enterprises with Foreign Investment and Foreign Enterprises, Article13 and the Detailed Implementing Rules and Regulations framed in 1991. The Chinese State Administration of Taxation (SAT) issued Gou Shui Fa No. 59 in 1998 under the title Tax Administration Rules and Procedures for Transaction between related parties.
----------------	---

Applicability	Transfer pricing arises on a transaction taken place between two companies both of whom are members of the same multinational group. In such cases the transfer prices must meet the arm's length prices. The following types of transactions are subject to transfer pricing: Purchase of products, Sale of products, payment of royalties, payment of service fees, payment of interest.
Pricing Method Allowed	CUP, Resale Price, Cost Plus are the main methods- the most reasonable one is to be followed.
Documentation/ Return	There is no statutory requirement of documentation. However, contemporaneous documentation, which includes a report containing a functional and benchmarking analysis and designed to demonstrate that the tax payer's current transfer pricing policies are at arm's length, is preferred. Annual Return in Form A or in Form B disclosing transactions with related enterprises has to be filed within four months from the year end.
Penalty	Penalty for late filing of related party transactions declaration Form: 2000 to 10000 Chinese Yuan. If the tax payer fails to pay the tax resulting from Transfer Pricing adjustment, in time, a surcharge of 0.05% per day, subject to maximum of 5 times of the amount is levied. The amount of adjusted profit is considered a deemed dividend to the foreign investor and subject to a penalty withholding tax of 20% or 10%, unless the profits are other wise returned to the FIE
India	
Legal Position	The Finance Act 2001 introduced with effect from Assessment Year 2002-2003, detailed Transfer Pricing regulations vide Section 92 to 92F of the Income Tax Act , 1961. The Central Board of Direct Taxes (CBDT) has come out with Transfer Pricing Rules - Rule 10A to Rule 10E.
Applicability	Transfer Pricing provisions are applicable based on some criteria: Firstly, There must be an international transaction, Secondly, such international transaction must be between two or more associated enterprises, either or both of whom are non-resident/s.
Pricing Method Allowed	Arm's Length Price is to be determined by adopting any one of the following methods, : being the most appropriate method: CUP method, Resale Price Method, CPM, Profit Split Method, TNMM, or Any other method prescribed by the CBDT.

Documentation/ Return	<p>13 Different types of documents are required to be maintained. These are-</p> <p>(1) Enterprise-wise documents- Description of the enterprise, Relationship with other associated enterprises, Nature of business carried out.</p> <p>(2) Transaction-specific documents_ Information regarding each transaction, Description of the functions performed, Assets employed and risks assumed by each party to the transaction, Economic & Market Analysis etc.</p> <p>(3) Computation related documents- Describe in details the method considered, Actual working assumptions, policies etc., Adjustment made to transfer price, Any other relevant information, data, documents relied for determination of arm's Length price etc.</p> <p>A report from a Chartered Accountant in the prescribed form giving details of transactions is required to be submitted within a specific time limit.</p>
Penalty	<p>Penalty for concealment of income or furnishing inaccurate particulars thereof- 100% to 300% of the tax sought to be evaded.</p> <p>Penalty for failure to keep and maintain information and documents in respect of International transaction- 2% of the value of each international transaction</p> <p>Penalty for failure to furnish report under Section 92E- Rs. 100000/-</p>
Indonesia	
Legal Position	<p>Indonesian Income Tax Law, Article 18 has been implemented w.e.f. 1.1.2001. However, no implementing regulation has been issued so far.</p>
Applicability	<p>Indonesian transfer pricing rules are applicable not only to international transactions, but also to domestic transactions between parties having a special relationship, since in Indonesia there is no grouping of tax losses.</p>
Pricing Method Allowed	<p>Generally profit based methods including CUP, Cost Plus Method, Sales minus resale price method etc. are accepted.</p>
Documentation/ Return	<p>No formal documentation and disclosure of related party transaction is required as yet. However, invoices and agreements are required to be produced before the tax Authority.</p>
Penalty	<p>There is a penalty of 2% per month up to a maximum of 48% of any tax underpayment discovered.</p>
Japan	

Legal Position	Transfer pricing in japan is governed by National Tax Administration (NTA) Special Taxation Measures Law(STML) Article 66-4. Asministrative guidelines have been issued on 1.6.02.
Pricing Method Allowed	Here transaction based method is preferred to profit based approach. Main methods followed are CUP, Resale Price, Cost Plus, Profit Split method etc.
Documentation/ Return	Though there is no statutory obligation of documentation, a list of documents have been suggested in the administrative guidelines. These may be examined during transfer pricing audit.Return in the Schedule 16-4 relating to Detailed statement Concerning Foreign Affiliated Persons and Related Party Transactions is to be filed.
Penalty	Though there is no transfer pricing penalty is involved, general tax penalty provisions apply.

*Annexure 4***Undesirable Corporate Practices Related to Transfer Pricing**

Some of the related party transactions, which are usually resorted to for diversion of funds are detailed below.

- (a) Purchase of goods or services from a related party at little or no cost or at inflated prices to the entity.
- (b) Payments for services never rendered or at inflated prices.
- (c) Sales at below market rates to an unnecessary “middle man” related party, who in turn sells to the ultimate customer at a higher price with the related party (and ultimately its principals) retaining the difference.
- (d) Purchases of assets at prices in excess of fair market value.
- (e) Use of trade names or patent rights at exorbitant rates even after their expiry or at a price much higher than the price, which can not be described as reasonable.
- (f) Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- (g) Exchanging property for similar property in a non monetary transaction.
- (h) Selling real estate at a price that differs significantly from its appraised value.
- (i) Accruing interest at above market rates on loans.

Some examples of such abuses are given below:

Case 1 on evasion of customs duty and taxes thereon

The parent unit is supplying raw materials to its 100% EOU subsidiary located separately at an estimated cost which covers raw material costs and variable conversion charges. The EOU unit reckons this cost as its purchase cost of raw materials and adds value to the raw material to produce the final product which is exported from this unit. Since the 100% EOU is exempt from customs duty and excise duty on finished product there is no payment of duty on this account by the 100% EOU. The transfer of raw materials from the parent unit being below the full cost of the product there is an inbuilt mechanism to divert profits from the main company to the 100% EOU unit which enjoys exemption from various duties and taxes.

The FOB value of exports being approximately Rs100 crores in a given year the impact of taxes can be worked out.

Case 2 on investment in a subsidiary

The parent company is giving loans to its subsidiary companies on an interest free basis which remains unpaid for more than 5 years now. The amount of interest free loans given to its subsidiaries totals Rs1500 crores. The parent company is a flag ship company and has a wide range of products in manufacturing and trading. Some of the subsidiary companies have not taken off at all and some of them have become defunct and there is no action for recovery by the parent. The annual loss on interest to the parent company on a notional basis at 15% p.a. is estimated at Rs220 cr. This is a clear suppression of profits arising from evasion of legitimate income resulting from the diversion of borrowed funds by pledging of assets by the parent company. Since the company is making profits, no queries are raised by outside agencies as they get regular interest payments and repayment of loans without a default. This is a case where diversion of funds and transfer of funds at below cost is resorted to in order to avoid a legitimate return to the shareholders.

Case 3 Mismanagement by holding company of companies under the same management

Many of the companies resort to formation of 100% holding companies to control totally the management which is the company providing funds to various companies in the same management. Many of them do not go for public finances as the holding company takes care of the entire financial structuring for these related companies. These companies mostly do not trade in the open market by listing, as the shares are closely held by the parent company. The surpluses of the subsidiary go back to the parent company in the form of high rates of dividends. The investment of funds gets a good return to the parent company which has several baskets of companies to set off profits against losses and minimize the payment of taxes to the authorities. This is a very clear case of legitimate tax avoidance beyond the legal net. This type of promoter controlled business is widely resorted to as a corporate strategy to avoid taxes by the holding company and this is well within the laws of land. The question before the public is how is the profit suppression by business conglomerates to be addressed. As more and more MNCs are stepping into our country the flight of foreign exchange by diversion of funds is a serious concern to the country. The disclosures will not serve any purpose as there is no violation of the accepted form of investment. What is required is to consider payment of dividends to holding companies as a related party transaction and to regulate such payments which may be beyond the prescribed investment norms.

Case 4 Siphoning of funds by formation of Joint ventures

In forming a JV Company 'A', a foreign company supplies plant and machinery and technology to Company 'B' located in India. Mostly the plant and machinery is old but categorised as refurbished to avail of the benefits of depreciation and other allowances.

For technology transfer the Company 'A' is paid a hefty amount as technical fees by Company 'B' based on volume of sales. The Company 'A' treats the supply of plant and machinery as their share of the JV investments. Company 'B' pays dividends treating the value of plant and machinery as equity participation apart from paying royalty and technical knowhow fees for technology transfer.

The issue before the public is denying genuine Indian investors of the advantage of equity participation by company 'A' getting additional rights issue and bonus issues for no consideration and beyond the value of plant and machinery supplied. Over the years it could be found that Company A's share of equity and royalty payments far exceed the value of the assets invested by the company. There is flight of capital as dividends paid for expanded capital not to forget payments as technology transfer which is difficult to measure.

Case 5 – Indian MNC covering all aspects

The company was established over 50 years ago and is listed on the BSE. The sector in which the company operated was reserved for the small scale industry. In order to maintain its market leadership, the company had to find new methods of holding on to its manufacturing base and expanding it to keep pace with market demand.

The company continued to invest heavily in R&D and Plant and Machinery. It floated joint ventures and/or companies where the major shareholder was its distributor in each region. It transferred its old plant and machinery to the new companies at a price just below the Rs. 20 lakh ceiling then in force for a company to qualify as an SSI unit. The management and operational control of each of these smaller manufacturing entities rested entirely with the MNC.

The MNC operated each of these smaller companies through 2 modes.

1. In the first mode, all Raw Material and Packing Material was supplied by the parent company to each manufacturing facility. The finished product was shipped to company warehouses and distributor godowns for onward movement in the company's supply chain.
2. In the second mode of operation, each smaller company was allowed to negotiate and source raw and packing material (primary items only from approved suppliers) and do its own manufacturing. The manufacturing unit was run under a very stringent Standard costing system where standard cost of procurement and standard selling prices (TP) were fixed in March of each year. The TP was fixed with a small profit margin based on the tight standard costs of material. The finished product was sold to the MNC at the TP (based on Standard Cost+Margin). The MNC would then sell the FG at its normal price after markup.

The units operating under the second method were found to have vastly superior manufacturing efficiencies.

This TP mechanism was designed to meet 4 objectives

1. Overcome the constraints imposed by government policy (reservation).
2. Take advantage of the lower excise duty for SSIs.
3. Drive towards greater manufacturing and operational efficiencies.
4. Continue to take advantage of utilizing almost fully depreciated assets while keeping up new investment levels in the parent company.

Over the next 30 years the company continued to maintain its leadership position in the market and its share continues to remain one of the most valuable shares in the Indian stock market. The recent deregulation of the sector in which the company operates may see a marked change in manufacturing strategy.

Case 6: Cement Industry:

A major plant, with a capacity of more than 0.60 Million TPA used to sell surplus Clinker to Grinding units. Generally, every Cement plant keeps higher capacity upto clinker stage, in order to ensure continuous supply of Cement in the market even during Kiln shut down for periodical maintenance. The surplus clinker is sold to various other small grinding units. In the instant case the close relatives of Promoters got other Small / Mini Cement Plants to which the clinker is sold @ Rs.250/- to Rs.300/- per ton where as they use to sell @ Rs. 950/- to Rs.1000/- in the market, the cost of production works out to more than Rs. 800/- per ton. This practice is prevalent in many Cement units. In the instant case, the Cement unit became Sick and FIs & Banks have to forge substantial amounts

Coal and Cement transport are generally done by outside transport contractors for a Cement unit. Many of the Promoters also promote transport companies under benami names or through relatives who are given contract for transport of Coal, Cement or other Raw materials. Rates of the transport very substantially from period

to period, on questioned for such variations they are explained as market exigencies are the reasons for higher payments during some periods. Some times even the lean season rates are unjustifiably & very higher- nothing but diversion of funds.

Case 7 - Paper Industry

Paper is sold through a large dealer network. Most of the dealers are either relatives or relatives of relatives under benami Partnerships. Paper is sold to the related parties at a much discounted / lower rates.

Similarly the transport of various Materials & Paper is also done through related party transport companies. Major chemicals for e.g. Lime (high purity) is also purchased from related party companies having Lime Kilns

Case 8 - Pharmaceutical Industry:

Third party Loan Licensing for manufacturing and system of distribution / selling agencies for Sales are very common. The final rates for various conversion jobs are fixed as a part of profit planning exercise. It is also observed that substantial year-end journal vouchers are passed giving rebates / discounts / reimbursement of special expenses etc., for Selling Agencies / Distributors in related party accounts.

Case 9 - Multinational Companies

Various multinational brands have certain ingredients which give the flavour / fragrance / taste, to their brand patents. The cost of purchase of such items changes from period to period, even some times quarter to quarter. The invoices and other documentations are built up and journal vouchers are passed at the period end against advanced payments made from time to time. Such entries are made even for Technical Services rendered on adhoc basis in the name of a Technical Up-gradation, Consultancy Fees etc., in addition to huge Royalty and Sales commission.

Dissent Views of Mr. Amarjit Chopra and Dr. Ashok Haldia – Members of the Expert Group constituted by DCA for Suggesting Transfer Pricing Guidelines.

There is no denying to the fact that the transfer pricing practices adopted by the companies could be a possible tool for corporate abuse. A probe into transfer pricing cases, causing transfer of economic resources to the related party at less than arm's length price is necessitated for host of reasons ranging from evasion/avoidance of tax liability to siphon-off the resources. Transfer of resources to and from the related party should be at arm's length and at arm's length price. Any exception to this should be a subject matter of close scrutiny, proper disclosure and effective accountability.

2. Transactions with the related parties are currently subject to the requirements of the accounting standards, and financial as well as cost audit. In addition, various tax laws seek to regulate, and check the possible abuse for taxation purposes. The Companies Act, 1956 does provide for a frame work for transactions in which directors etc. are interested with a view to avoid situation of conflict of interest.
3. The requirements of transfer pricing transactions, at present, are to be addressed through Accounting Standards, (AS) – 18. The AS-18 came in the effect for the accounting periods commencing on or after 1st April, 2001. The Standard provides for disclosure of related party relationships, and certain particulars of transactions with the related parties, in case of listed companies, and companies whose turnover exceeds Rs. 50 crores. The application of Accounting Standard would involve the following stages/processes:

- i) Identification of related parties, and, then, transactions with those parties.
- ii) Maintenance of proper records and documentation for the transactions entered into with the related parties, and the method/basis adopted for pricing such transactions.
- iii) Ascertainment as to whether the arm's length has been maintained and whether arm's length price has been charged.
- iv) Disclosure of particulars in regard to related party relationships and related party transactions as integral part of the financial statements. The AS also requires disclosure of particulars in respect of certain types of related parties which might have controlling interest even though no transaction might have had taken place during the course of the year.
- v) Proper disclosures in case of non-compliance to the requirement, the fact of non-maintenance of arm's-length or absence of arm's-length price alongwith relevant details.

4. Section 217(2AA) casts responsibility on the Board of Directors for (i) preparation of annual accounts in accordance with the applicable accounting standards alongwith proper explanation related to material departure, (ii) selection and applicability of accounting polices and exercise of judgement so as to give true and fair view. The Directors responsibility as aforesaid would also extend to and cover the related party transactions.

5. The Board of Directors has to ensure compliance with the Accounting Standards and statutory auditor is required to verify the related partly relationship, and, the related party transactions. On that basis he is expected to express his opinion on the adequacy or otherwise of the disclosures made, and on reasonableness of the consideration/price charged in those transactions. If not satisfied, he is required to qualify his report bringing out the facts and the exact impact on the true and fair view of the financial statements.

6. The Cost Accounting Records Rules provide for proper maintenance of records in respect of transactions with the related parties including to indicate the basis followed to arriving at the rates charged or paid for such activities or services so as to enable determination of the reasonableness of such rates. The cost auditor is required to specifically give his observations, in his report, on cases, where price charged for related party transactions is different from the normal price and impact of such lower/higher price.

7. The segment-wise reporting has been exhaustively dealt with by the AS-17. The segment-wise costing has been exhaustively dealt with by the relevant Cost Accounting (Records) Rules and audit requirement in regard thereto. Under the Relevant rules, cost statement of each service (segment-wise and elements of cost) is Required to be given. The cost statement is also required to be submitted to the Audit Committee wherever set up under Section 292A of the Companies Act, 1956.

8. In the background of the above, the recommendations of the Export Group provides for :

- i) Preparation by a company of a policy statement on transfer pricing.
- ii) Preparation by a company the implementation report to document compliance with the policy and detailed computation on transfer pricing for every transaction with related party or in regard to the internal business segment.
- iii) Separate audit of record of transactions (related party) and expression of opinion thereon. The record of transactions in the prescribed format to form part of the audit report.
- iv) Verification of the report on implementation on transfer pricing, by the separate auditor.

v) Disclosure in Directors' Report/Annual Report:

§ Record of Transactions as per Schedule A.

§ Transfer Policy Statement (a comprehensive and detailed one).

§ The aforesaid disclosure are to be given in the Director's Report alongwith those required under Accounting Standard –18 (disclosures as per AS –18 form part of accounts and, therefore, would require to be re-disclosed in the Directors' Report.)

§ Director's certificate of compliance on Transfer Pricing.

§ Separate Auditors report alongwith the Record of Transactions.

9. The requirements under AS 18 are based on principles based definition of the term related party, disclosures by exception, and, additionally provide for disclosure of critical relationships (even without any transactions). The due diligence process to be adopted for the framework suggested by the Group would essentially be the same as listed out at para 3 above. The requirements of separate audit suggested by the group is in fact re-audit or repeat of the work which a statutory auditor would do in any case, and is therefore wholly unnecessary. Rule-based definition of related party within the ambit of broad principles as suggested by the Group would only encourage non-compliance while remaining within the confines of the legal framework. The group has adopted the definition of 'related party' given under Income Tax Laws for the purpose of bringing in to focus international transactions with the related parties. Such a definition would fall short of requirements from corporate governance perspective. The definition of related party under AS-18 is wholesome and principle based. It is compatible with the definition of the term given in the relevant International Accounting Standard.

10. Financial and or non-financial disclosures should be relevant and meaningful for the users' need. Detailed disclosures generally run the risk of addition to the size of the Annual Report without corresponding value addition. The users interest is well served if they are informed whether or not good practices have been followed, and, if not, what has been the impact on the true and fair view of the financial statements or on the quality of the governance. Leaving the small investors as they are in India, to the complexities of the details would cause more harm than good. On these parameters the nature and the level of disclosures suggested by the Expert Group may not be worthwhile proposition. The same information, for example, record of transactions is required to be disclosed at three places with minor variations/additions, as per the guidelines suggested by the Expert Group.

11. In our view the requirement under AS-18 meets the intended purpose. The Standard has come into effect only very recently and the financial statements based on the applicability of the Standard would be available only by the end of September, 2002. At best the disclosure requirement as per AS-18 could be re-looked into to provide explicitly additional disclosure in respect of each of the transactions where arm's length has not been maintained and the arm's length price has not been charged (including impact thereof individually as well as in aggregate on the true and fair view of the financial statements). It should be re-emphasized that such a requirement is implicit under the current Standard. The applicability of AS-18 could be extended to include all the corporate entities. As stated there is no case for re-audit more so when the Directors' policy statement seeks to provide for approval of the policy and methods of pricing in each case by the Board of Directors through the Audit Committee. In terms of Section 292A areas of disagreement between the Board and the Audit Committee would require to be brought to the information of shareholders.

12. While there could be a case for the Board of Directors adopting a Statement of Policy on Transfer Pricing, there is no need for disclosure of such a detailed statement in the Annual Report. Ground rules for adoption in the policy could be prescribed. These would then in the normal course be

looked into by the auditors for compliance and wherever required for reporting. Needless to add that Audit Committee/Board are also expected, in the normal course, to monitor/ensure compliance.

Reply to the Dissent Note of Mr. Amarjit Chopra and Dr. Ashok Haldia – Members of the Expert Group on Transfer Pricing Guidelines.

The Committee has already considered the views/points as raised by the representatives of ICAI in their dissent note. The Committee was of the view that the existing requirements of AS-18 do not adequately provide for checking and reporting on the misuse of the medium of related party transactions, which are resorted to, to the detriment of various stakeholders of the company. Under the AS-18, there is no obligation on the part of the company to use an arm's length price nor is there an adequate mechanism to determine whether transfer prices are fair or not. Also AS-18 does not cover inter-divisional transfer between the various segments of a company. The proposed Transfer Pricing Guidelines seek to complement accounting standard in this regard. Implementation of these guidelines will in no way affect the disclosure under AS-18.

In the Transfer Pricing Guidelines suggested by the Committee, efforts have been made to harmonize the relevant provisions contained in the various tax laws and AS-18. These guidelines cover not only domestic and international transactions but also inter-divisional transfers. The definition of "related party" under the guidelines is broad enough to cover all these transactions.

Moreover, unlike the provisions of Income Tax Act, Central Excise Act, Customs Act, AS-18 and Cost Accounting Records Rules, these guidelines would be obligatory and apply uniformly to all the companies covered under Companies Act, 1956. These guidelines do not compel a company to appoint a separate auditor for this purpose. The statutory auditor can also verify/sign the compliance certificate prescribed under these guidelines.
