GUIDELINES

ON

TRANSFER PRICING

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

GUIDELINES

ON
TRANSFER PRICING

THE INSTITUTE OF COST AND WORKS ACCOUNTANTS OF INDIA

June 2002

Published by :

The Institute of Cost and Works Accountants of Inida

12, Suddr Street, Kolkata-700 016

Phone : 244-1031/1035

: 245-0302/245-0492

Fax : 91-33-2440993

: 91-33-2450026

E-mail : icwai@vsnl.com

Price : Rs. 150/- (One hundred and fifty only)

Foreword

Transfer Pricing has become very important issue in the economic activities in India because of increasing participation of multinational companies and the complexities emerging out of this. The Finance Minister expressed his concern on the same while introducing the Finance Bill, 2001. Accordingly, the Government has notified amendments in the Income-Tax Act, Central Excise Act with new provisions to take care the situation out of the changed environment. There have also been amendments in the Cost Accounting Record Rules for different industries under section 209(d)(1) and Cost Audit Report Rules for the purpose of Cost Audit under Section 233B of the Companies Act, 1956.

The Institute had already a book on Transfer Pricing and Measurement of Segmental Performance. All the recent changes have prompted the Institute of Cost and Works Accountants to come up with a fresh guidelines on Transfer Pricing. The present book covers the provisions of relevant acts relating to Transfer Pricing viz. Income-tax Act, Central Excise Act, Custom Valuation Rules with special emphasis on Cost Accounting Records Rules and Cost Audit Report Rules.

I am happy to note that the profession of Cost Accountants have taken up the new area with all seriousness. I would like to place on record, word of appreciation due to Shri Chandra Wadhwa, Central Council Member, Government Nominee, ICWAI for giving his sincere efforts in bringing out this booklet on "Guidelines on Transfer Pricing" for the benefit of the professionals.

The Institute will be greatly obliged if members and readers can send their suggestions for improvement in the book.

March 2002

V.V. Deodhar

President

Preface

Transfer Pricing issue has gained considerable momentum in International scenario and different countries are coming up with regulations on the same. India, being equally conscious about the situation has come out with new Regulations under different Acts. Recently, there have been amendments in Cost Accounting Record Rules for different industries under section 209(1) (d) and revised Cost Audit Report Rules, 2001 for the purpose of Cost Audit under Section 233B of the Companies Act, 1956. The Institute of Cost and Works Accountants thought it proper to come up with fresh and timely guidelines on Transfer Pricing. There are many methods for Transfer Pricing. At international level, application of transfer pricing based on cost is in high proportion which is quite natural. Thus, Transfer Pricing is expected to be new specialized area of service for the Cost Accountants in India. Under the situation, the book on Guidelines on Transfer Pricing will be helpful to the professional members of the Institute and the readers in different industries at large.

Further, the amendment in Income Tax Act in the Finance Act 2001 by incorporating section 92A to 92F in place of section 92 provides the frame work for transfer pricing relating to International transactions and the recent amendments in Central Excise Act with new provisions have the direction to take care of the situation due to the changed environment.

I take the opportunity to express my sincere thanks to Shri M L Mehta, FICWA, FCS, ICAS (Retd.), former Additional Chief Adviser (Cost), Ministry of Finance and a Practicing Member for his great contribution in the subject matter of the book. I also thank Shri A P Kar, Director (Technical) for his sincerity and dedication in the preparation of the book.

The Institute will appreciate the suggestions from readers for improvement.

March 2002

Chandra Wadhwa
Chairman, CASB

Contents

CHAPTERS

Page No.

Appendices

TRANSFER PRICING - MEANING AND SCOPE

1.1 Transfer price is the price charged by one unit/ segment to another unit/ segment of an organization in case of transactions between them. The term inter-unit transfer (intra-company transfer) is used to include any movement of products between divisions, plants or organizational units . The concept of transfer pricing is extended to inter company transfer when they are related in any way i.e. they are separately incorporated and are under the common control. The normal transaction between companies when they are not related in any way is termed as sale. But when they are related or under common control, these transactions are known as transfer in the accounting concept and the price so charged is termed as transfer price.

1.2 The term segment means unit, division, department, sales territory or branch. A segment is formed by grouping of activities on the basis of the functions, products, customers or geographical territories. Traditionally, inter segment transaction includes transfer of products and services within an entity. The transfer pricing policy has gained importance in the transaction of a business enterprise because of its requirement of reporting of financial information by segment and related party transactions as focused in the International Accounting Standard (IAS 14 & IAS 24) and Accounting Standard (AS 17 & AS 18). The Accounting Standards require inter alia disclosure of segment wise sales, other operating revenues, profit etc and basis for inter segment pricing. Thus, all the disclosures to be made under the above standards are to assist the transfer pricing analysis. In the era of open competition and liberalization, the focus has been on performance and revenue earning capabilities of individual segment and adoption of a rational basis of transfer pricing.

1.3 The term "related party" means a party that directly or indirectly through one or more intermediaries controls or is controlled by or is under common control with an enterprise. In other words, under three circumstances a company A is considered as an affiliate of another company B if

- A either directly or through intermediaries controls B
- B either directly or through intermediaries controls A
- Both A & B are under the control of another company C

The term 'control' is defined in IAS 24 "Related Party Disclosure " as –

- either enjoyment of more than one half of the voting power or substantial voting power directly or through subsidiaries indirectly.
- Power to direct the operating and financial policies of the management by statute or agreement

1.4 Transfer pricing under related party relationships is a normal feature of commerce and business. Many enterprises frequently carry on their activities through subsidiary or associated enterprises and acquire interest in other enterprises in investment or trading. The parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operating decisions. Related party transactions has special relevance in the era of globalization and due to increasing concentration of international economic activities in the hands of multi-national enterprises.

1.5 Report of UNCTAD on Transfer Pricing abuse

The report of UNCTAD released in 1978 indicated abuse of transfer price by Transnational Corporations (TNCs). The abuses as found were of the following nature :

- Exploitation of international market by monopoly control.
- Import controls were favourable means to consolidate the position of TNCs.
- Limitations on dividends and royalty payments forced the TNCs to find alternative ways of remitting profits and payments.
- The absence of concrete guidelines on Transfer Pricing opened up the opportunities for TNCs to use it as a mean of transfer of funds.

1.6 Change in the production process scenario

The globalisation of production has undergone a sea-change on account of producers effort to effectively use "value chain management". Producers are not only sourcing raw materials, machinery and capital from various parts of the globe but also managing the production at multi-locations, simultaneously. The concept of just-in-time delivery of input and state-of-the art communication facilities have helped the production process to be a multi-country affair. To avail the opportunities, the TNCs have augmented the transactions with their affiliates by multiple times.

1.7 International scenario on Transfer Pricing

Over the years, guidelines on transfer pricing are being issued in different countries. USA took the lead and subsequently many countries came up with the guidelines to be operative in their countries. The following table will give the progress in this regard :

Year	No	Name of the countries
1995	2	USA, Australia
1998	7	USA, Australia, France, Mexico, Brazil, Canada, Korea
2001	13	USA, Australia, France, Mexico, Brazil, Canada, Korea, U.K., Denmark, Germany. Poland, Belgium, India

Considering the importance of transfer pricing in international transaction, Organization for Economic and Co-operation Development (OECD) has brought out Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration to reinforce the commitment of arm's length principle throughout the wide range countries.

1.8 Transfer Pricing as a tool of fund transfer and avoiding of duties by the MNCs

Transfer pricing has become a convenient tool in the hands of MNCs in the matter of remittance of funds, taking advantage of corporate tax rate and possible manipulation for avoiding duties under different laws and acts. If a parent company wants to transfer funds to a subsidiary company it prefers a lower transfer pricing. To the contrary a parent company opts for higher transfer price when it desires to withdraw funds from its foreign subsidy. Another factor which guides the manipulation is the advantage of corporate tax rates in the two countries between which the transactions take place. When associated companies operate between two countries, their transfer pricing policy are sometimes made in a fashion to have maximum corporate tax advantage. Transfer Pricing for incoming goods is generally kept high and the same for outgoing goods are kept low in order to reduce profit in a country where tax rate is high.

A lower transfer pricing is opted to avoid exchange control imposed in the host country against import. This is also suitable for limited foreign exchange quota available with subsidiary in the host country. However, the Government of the host country may ignore such transfers in order to ensure flow of foreign direct investment. It is also possible to mix up transfer pricing of goods with royalty for technical know-how, brand, etc. By this, although the transfer of goods is priced low, the objective of funds transfer is achieved through higher royalty charged, share of holding companies R&D expenses and fees for services. Sometimes, the policy of transfer pricing between the related companies gives scope to shift the profits from one unit /region to another. The motivation behind the manipulation of prices is not only the setting of profit but also to avoid payment of duties, protection against exchange fluctuations and capitalization. The practices often resorted by TNCs are to show low profits / losses in the high tax rate countries which are offset by higher profits in low tax countries.

1.9 Indian Scenario on Transfer Pricing

Income Tax Act also deals with International transfer pricing. While introducing the Finance Bill 2001, the Finance Minister has explained the importance of transfer pricing as under :

" The increasing participation of multinational groups in economic activities has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by multinational group, by manipulating the prices charged and paid in such intra group transactions, thereby leading to erosion of tax revenue. With a view to provide statutory framework which can lead to computation of reasonable, fair and equitable profits tax in India in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act. "

The Government has thus notified "Transfer Pricing Guidelines" under section 92 of the Income-Tax Act vide notification dated 21st August,2001 which deals with various aspects of transfer price. The above rules have stressed the arm's length pricing under various situations. The concept of Arm's Length Pricing (ALP) has become a centre point for related party transaction. The department of Revenue has also notified the Central Excise Valuation (Determination of price of excisable goods) Rules 2000 vide GSR 575 (E) dated 30.06.2000. The rules are basically restricted to the valuation of goods and inter-alia deal with related party transactions.

Transfer pricing is also found relevant with respect to Anti–Dumping action and Custom duty evaluation under GATT, 1994. Transfer price used for export or import between related parties for the purpose of custom valuation is also guided by transaction value of identical or similar goods as given in Rule 2(2) of Custom Valuation (Determination of Price of Imported Goods) Rules, 1988 which is equivalent to comparable market price.

Cost Accounting Records Rules (as amended) for various industries notified under Section 209 (1)(d) of the Companies Act, 1956, require maintenance of records to determine reasonableness of transfer pricing policy adopted in case of related party transactions relating to supplies made or services rendered by a company to its holding company or subsidiary company and vice-a-versa, in respect of purchase and sale of raw materials, finished products, services etc. The above transactions are also covered under Cost Audit Report Rules, 2001 issued under Section 233B of the Companies Act, 1956. The above provisions are in addition to the provision under Manufacturing And Other Companies (Auditors Report) Order 1988 (MAOCARO) where a statutory auditor of the company is required to disclose transfer pricing policy adopted by the company in case of transactions of goods, materials and services made in pursuance of contacts or arrangement entered into in the register maintained under Section 301 of the Companies Act during a year are aggregated to Rs.50,000 or more in respect of each party.

The concept of transfer pricing surrounding the related party transactions has become a very sensible issue for the reasons indicated by the Finance Minister. There has been very similar approach adopted in different countries in the matter of assessing fair transfer price. Thus the introduction of transfer pricing regime in India presents unique challenges and opportunities that have to be accepted by proactively reviewing and analyzing the transfer policy of the corporates. The concept of cost accounting has become very pertinent in the application of various methods indicated under various rules. Different methods of costing may be applicable under different circumstances. Another guiding point is the market price of the similar product in identical or similar transaction. What is needed is to bring uniformity in the approach in a given situation in order to avoid conflict in the results so arrived under different Rules.

1.10 Survey of Transfer Pricing Methods

Two tables are given below from survey report showing transfer pricing methods adopted in case of domestic transaction and multinational transaction. The tables clearly show that cost based transfer pricing are used at a very high proportion except in U.K. where the cost based and market based pricing is used almost in the same proportion.

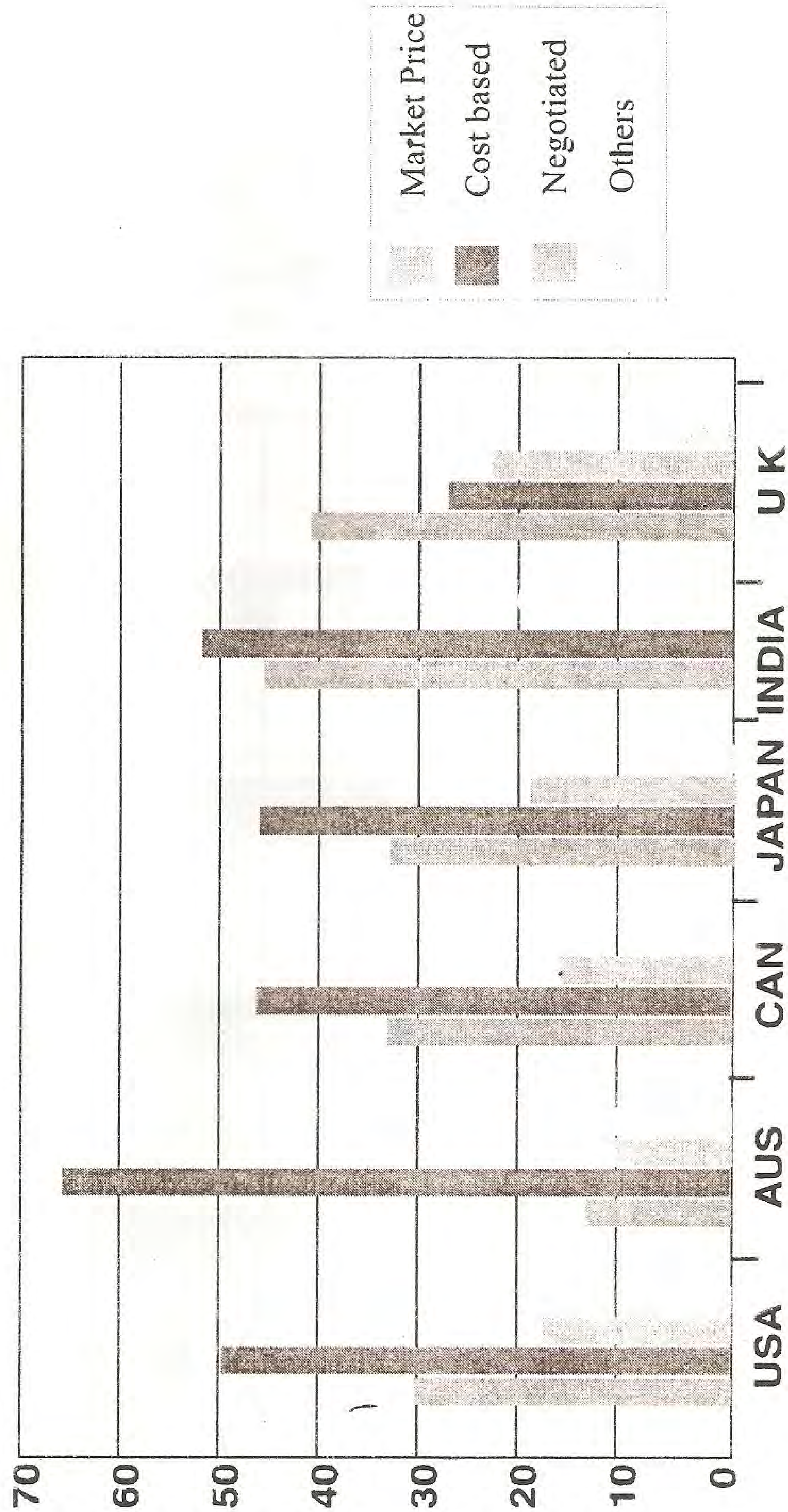
A. DOMESTIC TRANSFER-PRICING METHODS

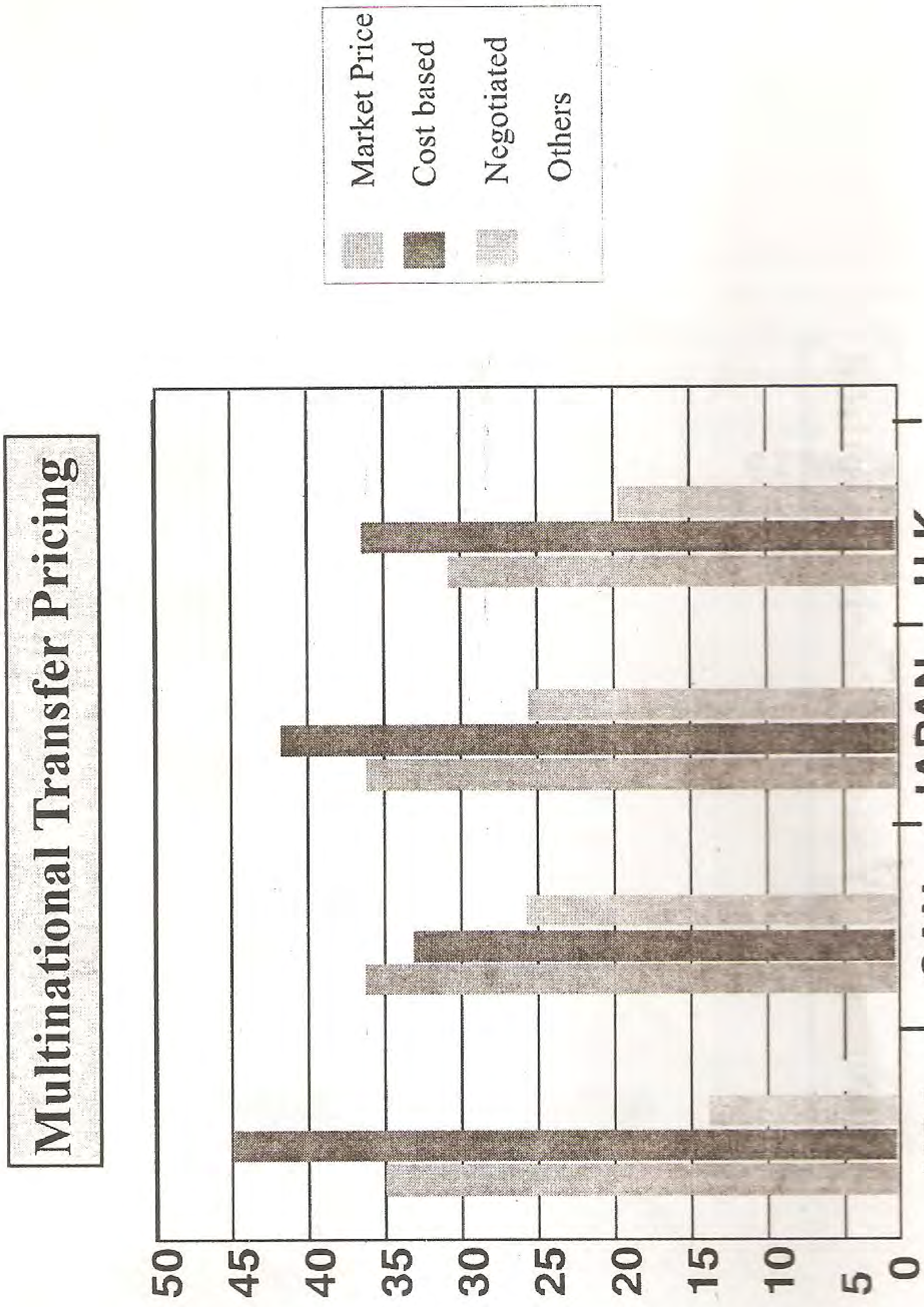
Methods	USA	Australia	Canada	Japan	India	U.K.
1. Market-price-based	30%	13%	34%	34%	47%	41%
2. **Cost-based:**						
Variable costs	4	N.D.	6	2	6	6
Absorption or full costs	45	N.D.	37	44	47	19
Other	1	N.D.	3	--	--	4
Total	50%	65%	46%	46%	53%	29%
3. Negotiated	18%	11%	18%	19%	--	24%
4. Other	2%	11%	2%	1%	--	6%
	100%	100%	100%	100%	100%	100%

B. MULTINATIONAL TRANSFER-PRICING METHODS

Methods	USA	Australia	Canada	Japan	India	U.K.
1. Market-price-based	35%	---	37%	37%	---	31%
2. **Cost-based:**		---				
Variable costs	2	---	5	3	---	5
Absorption or full costs	42	---	26	38	---	28
Other	2		2	--		5
Total	46%	---	33%	41%	--	38%
3. Negotiated	14%	---	26%	22%	--	20%
4. Other	5%		4%	1%		11%
	100%		100%	100%		100%

Domestic Transfer Pricing Method





Multinational Transfer Pricing
Market Price
Cost based
Negotiated
Others
50
45
40
35
30
25
20
15
10
5
0
USA
CAN
JAPAN
U K

1.11 Objective of Transfer Pricing Guidelines :

(a) To enable the pricing of related party transactions both in national or international trade to have a definite, uniform and consistent policy.

(b) To enable the correct assessment of assets, investments and profitability of the units or affiliates of an organization.

(c) To restrict the scope of manipulation in transfer pricing to ensure fair picture of performance of each individual entity in a group organization towards better strategic decision making

(d) To establish better understanding and confidence between the industry and the financial institution by checking the manipulation in periodic statements of the company

(e) To protect the interest of Indian industry to ensure fair competition and stable growth

(f) To check the evasion of taxes, duties and tariffs to promote revenue generation in Government exchequer.

(g) To protect consumers from undue higher price of product

1.12 Transfer Pricing and Corporate Governance

Establishment of fair transfer pricing policy in relation to related party transactions will reduce the scope of manipulation in the financial results and will play a big role in projecting true and fair picture of affairs of business activities in different units in an organization. This will promote the cause of corporate governance to a great extent in the following way :

(g) To prc'ect consumers from undue higher price of product

(a) Better transparency in the business activities by disclosure of true and fair picture of each separate entity in the organization for correct reporting to the share-holders.

(b) To ensure better strategic decision based on performance of individual units towards optimum profitability.

(c) To protect the interest of the investors from illegal transfer of fund and manipulation of financial results.

(d) To bring confidence of the shareholders and investors by displaying the correct status of each individual units of the company in terms of assets and profitability.

(e) To Check the manipulation in presentation of financial performance of subsidiary corporate entity under the control of a bigger holding company.

COST ACCOUNTING RECORD RULES – AND TRANSFER PRICING.

2.1 The Cost Accounting Records Rules have been notified for various industries under Section 209-(1)(d) Companies Act, 1956 by the Government from time to time. These rules inter alia contained provision relating to "Inter Company Transactions". The above provision has recently been amended vide notification dated 28 September, 2001. The Appendix 1 gives the detail list of industries amended under Cost Accounting Records Rules and the provision of "Inter Company Transfer" in the Rules is presented in Appendix 2.

Exhibit below gives a comparative details of inter related party transactions under the earlier provision and the amended provision.

Provision prior to 28.9.2001	Provision as per amendment dated 28.9.01
Title Inter-company Transactions	Inter-company Transfer
Related Party Transactions covered under the rules are supplies made or services rendered in respect of: a. purchase and sale of raw materials and process materials and by products; b. utilization of plant facilities; c. supply of utilities; d. administrative, technical, managerial and any other consultancy services; and e. sale of finished products.	Related Party Transactions covered under the rules are supplies made or services rendered in respect of: a. purchase and sale of raw materials, finished products, process materials, chemicals and rejected goods including scraps, etc; b. utilization of plant facilities and technical know-how; c. supply of utilities and any other services; d. administrative, technical, managerial or any other consultancy services; e. purchase and sale of capital goods including plant and machinery; f. any other payment related to production, processing or manufacturing of products under reference.

The above exhibit indicates that from item (a) of earlier provision word " by-products" had been deleted under the amended provision. Item (e) of earlier provision " sale of finished product" has been clubbed with (a) of the amended provision with the addition of further words such as " process materials, chemicals, and rejected goods including scrap etc." Against item (b) " technical know how has been covered under the amended provision. Against item (c) , besides utilities, " other services" have also been brought under the purview of amended provision. Two new items (e) and (f) relating to "purchase and sale of capital goods including plant and machinery." and " any other payment related to production, processing or manufacturing of products under reference has been covered under the amended provision.

Thus with the amendment dated 28 September, 2001 the coverage of related company transfer has been widened.

2.2 Definition of transactions

The definition of transaction includes, contracts entered into, agreements or understanding reached in respect of items indicated in the exhibit above. As per explanation given to these rules, related party transaction means the transfer of resources or obligation between related parties whether or not a price is charged.

2.3 Related Party Relationship

In the earlier provisions related party transaction was defined with reference to section 370(1) B of the Companies Act viz holding company or a subsidiary company or a company in the same management.

Amended provision now defines the related party relationship as per sub-rule 2 (2)of the Cost Accounting Record Rules. It has described "Related party relationship" under five categories as under:

(1) Related party relationship means parties who are considered to be related if at 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 decision;

Control means

(i) ownership, directly or indirectly, of more than one half of the voting power of an enterprise; or

(ii) 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

(iii) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise;

Thus, enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries) are related parties.

Section 4 of the Companies Act, 1956 defines the holding company and subsidiary company. In terms of section 4(4), a company shall be deemed to be the holding company of another if, but only if, that is its subsidiary.

A subsidiary company as per Section 4(1), a company shall be deemed to be a subsidiary of another, if, but only if:-

(a) that other controls the composition of its Board of Directors; or

(b) that other –

  (i) where the first mentioned company exercises or controls more than half of the equity share capital of the other in terms of nominal value (in case holders of preference share of the company enjoy same voting rights as the equity share holders, holding should be more than half of the total voting rights).

  (ii) where the first mentioned company is any other company holding more than half in nominal value of its equity share capital; or

(c) the first mentioned company is a subsidiary of any company which is that others subsidiary.

Illustration

If company A controls more than half of the total voting power of the B Company, Company B is a subsidiary of company A. If Company C is a subsidiary of company B, Company C is also a subsidiary of company A by virtue of clause (c) above. In brief the company which controls the composition of the Board of Directors of the other company is called the holding company and the other is called the Subsidiary Company. Holding company can appoint all or majority of directors of subsidiary company by fulfilling any one of the following conditions:

(a) that the appointment cannot be made without the consent or concurrence of holding company; or

(b) that appointment follows necessarily from his appointment as Director or Manager or because of the appointee holds any other kind of office or employment in holding company; or

(c) that the Directorship is held by an individual nominated by holding company or its subsidiary company.

For determining whether a company is a subsidiary of another the shares held in fiduciary capacity shall not be taken into account. Further, the shares held or power exercisable by a subsidiary shall be treated as held or exercisable by the holding company. For example, in case B and C the subsidiary companies of company A hold together more than half of equity share capital of company D, then D shall be deemed to be a subsidiary of A although it has not made any direct investment nor B and C singly hold more than fifty percent share in the company D.

(2) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

"Associate" means an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party.

"Significance influence" means participation in the financial or operating policy decisions of an enterprise, but not control of those policies;

"Joint Venture" means a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(3) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individuals;

(4) key management personnel and relatives of such personnel;

"Key management personnel" means those persons who have the authority and responsibility for planning directing and controlling the activities of the reporting enterprises.

"Relative" means the spouse, son, daughter, brother, sister, father and mother who may be connected by blood relationship.

(5) enterprises over which any person described in (3) or (4) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

However, the following 3 exceptions have been described which shall not be deemed as "related party relationship"

(a) two companies simply because they have a Director in common, notwithstanding paragraph (4) or (5) above (unless the Director is able to affect the policies of both companies in their mutual dealings);

(b) a single customer, supplier, franchiser, distribution, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealing with an enterprise by 'virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process);

(i) providers of finance;

(ii) trade unions;

(iii) public utilities;

(iv) government departments and government agencies including government sponsored bodies-

Note: Provider of finance has not been defined. It is to be clarified by the Department whether besides banks transaction of finance with a NFBC of the group will be deemed as a related party relationship or not.

2.4 To sum up the related party concept now covers the enterprises under (i) common management; (ii) associates and joint ventures; (iii) persons having control or significant influence over the enterprise and their relatives; (iv) key management personnel and their close relatives; and (v) enterprises in which persons stated in (iii) and/or (iv) are interested and includes enterprises owned by Directors or major shareholders of the reporting enterprise (excluding the exceptions stated above).

Related party transaction under Accounting Standard and Cost Accounting Records Rules

2.5 Related party relationship as mentioned above is the same as those prescribed under Accounting Standard AS-18 and the same has become mandatory w.e.f. 1.4.2001. Exhibit below gives a comparative position of the transactions covered under Cost Accounting Records Rules and AS-18.

Cost Accounting Records Rules Provision as per amendment dated 28.9.01	**Accounting Standard** AS-18 - Related Party Disclosure
Inter-company Transfer	
Related Party Transactions covered under the rules are supplies made or services rendered in respect of: (a) purchase and sale of raw materials, finished products, process materials, chemicals and rejected goods including scraps, etc; (b) utilization of plant facilities and technical know-how; (c) supply of utilities and any other services; (d) administrative, technical, managerial or any other consultancy services; (e) purchase and sale of capital goods including plant and machinery; (f) any other payment related to production, processing or manufacturing of products under reference.	Example of Related party transaction as per para 24 & 25; a) purchases or sales of goods (finished or unfinished); b) licence agreements; c) rendering or receiving of services; d) management contracts including for deputation of employees; e) purchases or sales of fixed assets; f) agency arrangement; g) leasing or hire purchase arrangements; h) transfer of Research & Development i) guarantees and collaterals. j) finance (including loans and equity contribution in cash or kind) k) any other elements of the related party transactions necessary for an understanding of the financial statement.

Broadly, transactions under CARR and AS-18 are identical, except for financial transactions.

Both Cost Accounting Record Rules and AS-18 have not covered transaction involving labour. However, the clause (f) of Cost Accounting record covers transactions involving any payment relating to production or processing.

Keeping the broad objectives of studying and analyzing the inter-company transactions, impact of another type of transactions involving intangible assets in the form of 'brand name' which are widely used by associated companies are not included in Cost Accounting Record Rules nor in Accounting Standard AS 18. The establishing transfer price for intangible assets has been a significant problem because of the inherent difficulty of valuing intangibles. Thus, the same is kept is out of the ambit of the present exercise.

Explanation for various key terms used in the Cost Accounting Records Rules as amended is given in Appendix 2.

A related party transactions may have an effect on the financial position and operating results of the reporting enterprise. The operating results and financial position of an enterprise may be affected by the related party relationship even if the related party transactions do not occur. The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relationship with a trading partner on acquisition by the parent of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of sufficient influence of another. For example, a subsidiary may be instructed by its parent not to engage in research and development.

The term significant influence is considered authority to participate in framing operating and financial policies. Participation is possible through representation in the Board of Directors. It is also possible in many other ways like interchange of managerial personnel and material, inter-company transactions, dependence for technical knowledge, etc. Thus Company A may become related party of Company B in two ways, namely, by participation in framing operating and financial policies and directing thereof. Policy direction is possible by enjoyment of more than one half of the voting power or substantial voting power directly in Company B by Company A or through its subsidiaries.

Both the Cost Accounting Record Rules and the Accounting Standard AS-18 have the primary focus on disclosure of essential information relating to related party transactions. The basic aim of the disclosure is to study the rationality in the pricing of the transactions listed above between the related parties and prescribes the basic records in order to display the transparency in transaction, their cost (indicating various elements of cost), basis of allocation of overheads and transfer price adopted.

2.8 Determination of reasonableness of rates charged/paid :

The proviso of amended sub-rule 2(1) (f) provides :

" These records shall also indicate the basis followed for arriving at the rates charged/ paid for such products or services so as to enable determination of the **reasonableness of such rates** in so far as they are in any way related to product under reference."

The rules provide for maintenance of records for inter company transfer to determine the reasonableness of rate charged or paid in inter-company transfer. As the rates applicable vary widely in different situations, the rule has not been rigid in defining the reasonableness.

The normal practice in the industry, set rules of cost accounting procedures and particular nature of transaction will form the basis of reasonableness in determining the transfer price. The objective of the rule is that one party does not get undue benefit at the cost of other and transactions take place as should have been done in normal course of business had the parties been unrelated.

2.9 Arm's Length Price

Accounting recognition of a transfer of resources is normally based on the price agreed between the parties. Between the unrelated parties the price is an arm's length price. The principle of arm's length price has become widely accepted through out the globe. The basic principle of arm's length price do prescribe a methodology based on the concept of comparing the transactions of associate enterprises with that of the transactions of independent enterprises. The guidelines on Arm's length principle suggest that arm's consideration between the associated enterprises be established on the following basis:

- The prices paid, profit earned, income splits agreed
- Consideration under comparable circumstances
- Nature of bargaining that took place between the parties
- The economic performance of the transaction

2.10 Difficulties in applying arm's length approach

i) The Monopoly Situation : If the market is controlled by some monopoly firms, the existence of normal price is not expected and the "above normal profits" cannot be ruled out.

ii) The Valuation of Intangibles : The transfer of resources involves in many cases, some factors of production which are intangible in nature. It is difficult to go for straight forward measurement of value of these items. In some cases a good amount of judgement has to be forced into and in some cases they are not practical.

iii) Co-existence of vertically or horizontally multinational corporations: In these cases the technology available only in related party dealings may be dominant. Third party prices is a difficult preposition.

The Applicability of Arm's Length Price

The arm length pricing policy is a very flexible approach for adoption. The provision of estimation for the difference is allowed for adjustment. Thus, it has a very scientific approach in terms of its applicability. The relevant exercise to be undertaken cover a broad area like production technology, economic performance of the transaction and the type of transaction in question.

2.11 Indian Rules

The Income-tax Rule, 1992 has given sufficient stress on Arm's Length Price (ALP). Different methods like Comparable Uncontrolled Price (CUP), Resale Price Method etc. is centered around determining the arm's length price. The factors which consider to be relevant and given due importance are:

- Principle of comparability
- Nature of market
- Fair degree of competition
- Geographical location and size of the market

The valuation of goods under Customs Act also accepts the role of arm's length pricing. With regard to remittances on royalty and technical service fee, the principle of arm's length price has been duly recognized by the Ministry of Finance.

The valuation under Customs Regulation will have significant influence on determination of ALP. Although the custom officials and tax administrations may have a similar purpose in examining the report and values of cross-boarder control transactions, there is a need of co-operation between the two authorities to arrive at a common price acceptable to both the purposes in order to reduce the conflict.

Transfer Pricing in Related Party Transactions

2.12 Various types of transfer pricing methods for domestic transactions are:

(a) Full product cost

(b) Marginal Cost or Variable cost

(c) Cost plus

(d) Market Price

(e) Negotiated price.

2.13 Full Product Cost: Full product cost means total cost inclusive of prime cost, depreciation, share of manufacturing and administrative overhead, share of R&D overhead, selling & distribution overhead and interest on working capital. Full product costs include both unit fixed cost and unit variable costs in the cost base. Full cost gives an idea about the chargeable cost for the product or service. Transfer at full product cost does not provide for an element of profit for the transferor and as such transferee is benefited to the extent of difference between transaction price and market price. The above method is applied for intra company transaction. In a company where concept of profit center has been evolved, supply division will be reluctant to provide goods for other divisions at full cost.

Application of full cost method

The aggregation of direct cost and indirect cost is known as absorption costing. The term absorption costing represents a method by which all direct manufacturing costs and all manufacturing overhead costs (both fixed and variable) are considered. The advantages cited for including unit fixed costs for pricing decisions (including that in the long run) are relevant costs because if a company charges prices that cannot generate sufficient revenues to meet all of its costs, then it causes loss to the company. All costs-whether fixed cost or variable costs are relevant. The disadvantages of full cost method are :

- The common cost including unavoidable cost gets allocated and hence the pricing strategy becomes inefficient.
- The allocation of common cost may sometimes become arbitrary.
- The identification of common cost will be a difficult exercise and hence the concept of relevance costing which is important in pricing the product loses its importance.

2.14 Marginal Cost or Variable Cost : It is the lowest price charged for any particular transfer. This is applicable only when the transferee is weak and is not in a position to take the burden of fixed overhead expenses of the transferor. In true sense, the profitability/ performance of transferor is under stated.

Application of Marginal Costing method

- This approach is adopted only to support the transferee to face the competition in the market in difficult phase of business.
- Marginal costing is also used by companies and multinational enterprises for internal management control purposes.
- It is also applied in a situation when the aim of business is to obtain a price that will contribute the greatest amount to its net profits.

2.15 Cost plus method: Under this method the total cost of production plus a percentage of profit is added to reach a mark up price for the transfer. The percentage of profit is determined based on convenience or the understanding between the transferor and the transferee or normal profit as could have been there in case of similar transactions between unrelated parties in the trade or business. The only deficiency in this method is that the inefficiency or high cost due to low capacity utilization by the transferor are passed on to the transferee. In such a situation question of capacity adjustment arises. If the overhead be charged fully when the capacity utilization is very low, it may result in high price. On the other hand if overhead is not recovered, the transferor may suffer loss or earn low profit. A reasonable approach is that if capacity is reserved for the contract, overhead should be charged to that extent even actual utilization is lower than the capacity booked. For some products no outside market exists and there is no way to approximate a reliable competitive price. In such a situation to strike a balance between a fair return to the supplying unit and encouragement to inter firm transaction cost plus method is adopted.

Application of Cost plus method

- This method is applied for products where no outside market exists and there is no way to approximate a reliable competitive price
- Cost plus method may generally be applicable where there is value addition in the goods, property or services by the transferor involved in the related party transactions by way of manufacturing process or other services.

The steps in the method are –

Step 1 : The direct and indirect costs incurred by the transferor for making the goods, property or services effective for transaction are determined

Step 2 : The amount of a normal gross profit mark-up to such costs arising from the transaction of similar material, goods or services by the party or by an unrelated party, in a comparable uncontrolled transaction, or a number of such transactions, is determined

Step 3 : The normal gross profit mark-up referred to in step 2 is adjusted to take into account the functional and other differences, if any, between the transaction in question and the comparable uncontrolled transactions, or between the parties entering into such transactions, which could materially affect such profit mark-up in the open market

Step 4 : The sum of the cost as referred in step 1 and adjusted profit mark-up arrived at under step 3 is taken to be an arm's length price in relation to the transaction between related parties.

Thus, issues involved in Cost Plus Method are :

1. Computation of Cost . The critical factors are :

   i) Allocation of overhead: The problem arises in case of allocation of fixed overhead. Normal capacity should be the base for allocation. Capacity variance or efficiency variance may be adjusted in determining the price.

   ii) Administrative overhead: Administrative overhead may cover number of product or services in the organization. The question of transfer of product or services may be limited to a few. Apportionment of overhead on the basis of volume of business may seem to be a rational one

iii) Factors like business risk and efficiency/inefficiency in different products are ignored which may lead to difference in price fixing.

2. Identification of the Comparables
3. Identification of appropriate margin
4. Comparing the mark up with an independent transaction.

Example 1 : Cost Based Transfer Pricing

Cost Based Transfer Pricing

Sl No	Particulars				
			Per unit	(Hr)	
		Total	based on Actual production	based on normal capacity	
			A	B	
1	Normal Capacity - units	60,000			
2	Normal Capacity Hour	48,000		0.80	
3	Actual units manufactured (Units)	50,000			
4	Actual hours worked (Hrs)	44,000	0.88		
		Rs in lakhs	Rs	Rs	
5	Raw Material	45.00	90.00	90.00	
6	Direct wages	20.00	40.00	40.00	
7	Variable Factory Overhead	3.50	7.00	7.00	
8	Marginal Cost (b)	68.50	137.00	137.00	
9	Fixed Factory Overhead	12.90			
10	Administration Overhead	8.50			
11	Selling and Distribution Overhead	10.10			
12	Total Fixed Overhead (9)+(10)+(11)	31.50	63.00	52.50	
13	Total Cost (8) + (12)	100.00	200.00	189.50	
14	Profit @ 10% on total cost (13)		20.00	18.95	
15	Transfer Price (Cost Plus)		220.00	208.45	
	Variance Analysis				
16	Fixed overhead standard rate				
	per at normal capacity (12)/ (1)			52.50	
17	Actual Fixed Overhead			63.00	
18	Capacity variance (Row 13) A – B			10.50	(A)
19	Profit Margin Variance (Row 14) A – B			1.05	(A)
20	Total Variance (Row 15) A – B			11.55	(A)

Note : (A) = Adverse Variance.

2.16 Market Price: Market price is based on principle of opportunity cost. The transferee receives the product at a price which it would have been paid if purchased from outside. The transferor gets the fair reward and incentive for efficient production. The efficiency or inefficiency of the transferor does not pass on to the transferee.

Application of market Price

The market based transfer price is widely used. For its use a well developed outside markets should exist i.e. price charged is usually identical with one charged to outside customer. But the serious drawback to this method is the requirement for the existence of a well-developed outside competitive market. Market prices are not always readily available. In some cases no outside market exists for the intermediate product.

Finer aspect of Market Price Method

i) Market price for a product or service is strictly comparable only when credit term, grade / quality, delivery terms, and auxiliary considerations are precisely the same.

ii) Market price is not always determinable specially for intermediate product and in imperfect competition.

iii) It includes many elements like selling and distribution expenses, commission, discount etc which are not of much relevance in case of related party transaction.

2.17 Negotiated price: Negotiated transfer pricing is arrived at after negotiation between the transferor and the transferee when the two are in a position to make the best of the bargain. The transferee obtains quotation from transferor as well as from external suppliers. Information about cost and market may be used in these negotiations.

Application of negotiated Price

The negotiated transfer price is generally used if a competitive outside market exists. This method is time consuming one and may require frequent re-examination and revision of prices. The decision is taken whether to purchase from outside or obtain internally on the basis of quality and reliability of supply.

B. Transfer pricing for international transactions

2.18 Comparable uncontrolled price (CUP) method : This is a price determined with the price of comparable goods sold in economically comparable market to a buyer unrelated to the seller. Price so arrived is taken to be arm's length price. The comparable uncontrolled price (CUP) focuses directly on the price of the property or services transferred between parties to a transaction. The price charged between independent parties forms the basis for determining the arm's length price under the CUP method. Similarity of products is the pre-condition of applying CUP. As the product difference increases the reliability of CUP decreases. Moreover, many intermediate products are not traded in the open market, thereby restricting its application.

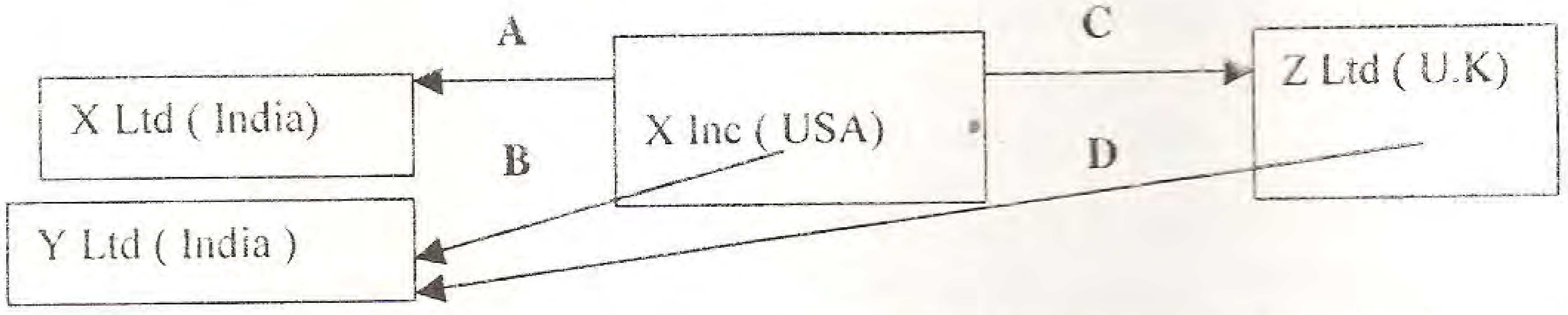
The comparable uncontrolled price method (CUP) shall be determined in the following manner:

Step 1 : The price charged or paid in a comparable uncontrolled transaction is identified;

Step 2 : The price is reduced by the amount of normal profit margin accruing to the transferor or to an unrelated enterprise from the purchase and resale of the same or similar property, in the comparable uncontrolled transaction.

Step 3 : The price so arrived at is adjusted to take into account the differences, if any, in the transactions being compared and between the enterprises entering into such transactions, which could materially affect such expense or profit margin in the open market; and

Step 4 : The price thus arrived at is taken to be the arm's length price in respect of the purchase of the goods, articles or things by the assessee from the associated enterprise.



Trasaction	From	To	Type of Transaction
A	X Inc (USA)	X Ltd (India)	Internal CUP
B	X Inc (USA)	Y Ltd (India)	Internal CUP
C	X Inc (USA)	Z Ltd (U.K)	External CUP
D	Z ltd (U K)	Y Ltd (India)	Internal CUP

Based on the above, the steps involved in applying the CUP method are:

1. Identification of Comparable uncontrolled transaction
2. Identification of price charged in Comparable uncontrolled transaction
3. Identification of differences between controlled and uncontrolled transaction
4. Adjustment of price to account for the differences

CUP may be applicable for the following situation :

- No difference between controlled and uncontrolled transaction
- There is minor difference for which adjustment is possible in the price determination

Some finer aspects in the application of CUP

In the application of CUP the following points are to be given due importance in assessing the value of similar/identical price of comparable goods/services :

- Similar characteristics
- Quality
- Reputation

Similar goods are the goods which although not alike in all respects have:

- Like characteristics
- Like component materials
- Commercially interchangeable

In assessing the quality the following are to be considered:

- Design of the product
- Product engineering
- Product features
- Functions to be performed
- Durability and service etc.

Reputation means

- Brand value
- Goodwill
- Maintainability and after sale service quality etc.

2.19 Resale Price method : Resale price method may generally be applied in case of resale of goods or property or services without any value addition by the transferee in the related party transaction to an un-related party. The steps in the method are :-

Step 1 : The price at which transaction between the related parties is identified

Step 2 : In case of re-sale of the same goods or property or services by the transferee in the related party transaction to an un-related party, the resale price is identified

Step 3 : Resale price arrived at step 2 is reduced by the amount of a normal gross profit margin accruing to the party or to an unrelated party from the purchase and resale of the same or similar material, goods or services in a comparable uncontrolled transaction, or a number of such transactions

Step 4 : The price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the transaction in question and the comparable uncontrolled transactions, or between the parties entering into such transactions, which could materially affect the amount of gross profit margin in the open market

Step 5 : The adjusted re-sale price is further reduced by the expenses incurred by the party in connection with the purchase of material or goods or services. The adjusted price so arrived is taken to be an arm's length price in respect of the transaction.

Applicability of Resale Price Method (RPM)

The resale price is generally applied in the case where the reseller does not add any substantial value to the tangible property and no physical alteration in product is done.

The RPM cannot be applied in the following cases:

- Where reseller alters the physical alteration of the product causing value addition
- Where reseller enhances the value of the product by adding intangible property.

Example 2 :

X Ltd. receives refrigerator from its parent company Y in USA @ Rs.15000 per unit and sells the same @ Rs.20000/-. X Ltd. also receives deep freezer from 'Z' company (which is not a related company) @ Rs.12000. X sells the same @ Rs.15000/- per unit. Operating and selling & distribution expenses per unit is Rs 1500/-. Both the products are sold in the same market under the same condition.

Since second transaction is with unrelated party, the same can be taken as basis.

Margin earned in case of uncontrolled transaction and by X Co. with Z Co.

1.	Deep freezer – sale value	Rs.15000
2.	Cost of goods sold	12000
3.	Gross Profit	3000
4.	Less operating expenses	1500
5.	Gross Margin	1500
6.	Gross Margin (5 as % of 1)	10%

Margin to be applied in case of controlled transaction of X Company with Y Company

1.	Cost of goods sold	15000
2.	Operating Expenses	1500
3.	Total (1+2)	16500
4.	Gross Margin (10% on sale)	2000
5.	Transfer Price	18,500

2.20 Cost plus method : This has been dealt earlier under domestic transactions.

2.21 Profit split method: This method is applied in cases of multiple transactions amongst associated enterprises and the transactions are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any single transaction. First, combined profits of all associated enterprises from all such inter-related parties are determined. The relative contribution made by each such associated enterprise are evaluated on the basis of the functions performed, assets used and risk assumed. The combined profits are then split amongst the enterprises in proportion to their relative contribution. The profit thus apportioned gives the arm's length price in relation to each transaction.

Steps in application of Profit Split Method (PSM)

Under the profit split method:

Step 1 : To **determine the total profit** earned by the parties from a controlled transaction. The profit split method allocates the total integrated profits related to a controlled transaction, not the total profits of the group as a whole. The profit to be split is generally the operating profit, before the deduction of interest and taxes. In some cases, it may be appropriate to split the gross profit.

Step 2 : To **split the profit between the parties** based on the relative value of their contributions to the non-arm's length transactions, considering the functions performed, the assets used, and the risks assumed by each non-arm's length party, in relation to what arm's length parties would have received.

Step 3 : To take account of the profit thus apportioned to arrive at an arm's length price in relation to the transaction between the related parties.

Consideration for profit split method

- The relative contribution among the associated of enterprises must be computed on the basis of the external market data.
- The consistent approach in apportionment of contribution.
- Risk involved in the business

Example 3

A and B are related companies. A Ltd sells goods to B Ltd for further sales in the market.

	A Ltd Rs. In lakhs	B Ltd Rs In Lakhs	Consolidated Rs. In Lakhs
1. Sales	100	150	150
2. Cost of Goods sold	80	100	80
3. Gross Profit (1 – 2)	20	50	70
4. Operating expenses (including selling & distribution)	10	30	40
5. Operating Profit (3 – 4)	10	20	30

If total cost is recomputed taking into account return on capital employed, the revised transfer paid will be as under:

6. Capital employed (CE)	100	50	
7. Return on capital employed @15%	15	7.50	
8. Total cost including return (2+4+7) For B (4+7)	105	37.50	142.50
9. Apportionment of operating profit 30 (in the ratio of total cost including return)	22.00	8.00	30
10. Transfer Price (1 – 5 + 9)	112.00		

Transfer price under profit split method will work out Rs.112.00 lakhs against Rs.100 lakhs.

2.22 Transactional Net Margin Method (TNM Method)

Transactional net margin method may generally be applicable where the goods, property or service involved in the transaction is of special characteristics or specification or quality standard that the market price of the same is not readily available but the normal net profit margin in similar transaction is available. The steps in the method are –

Step 1 : The net profit margin realized by the party from a transaction with a related party is computed in relation to costs incurred or assets employed or to be employed by the party or having regard to any other relevant base

Step 2 : The net profit margin realized by the party or by an unrelated party from a comparable uncontrolled transaction or a number of such transactions is computed

Step 3 : The net profit margin referred to in step 2 arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the transaction in question and the comparable uncontrolled transactions, or between the parties entering into such transactions, which could materially affect the amount of net profit margin in the open market

Step 4 : The net profit margin realized by the party as referred to in step 1 is established to be the same as the net profit margin referred to in step 3 .

Step 5 : The net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the transaction.

Application of TNM Method

Net margin can also be computed by the use of various ratios such as :

(i) net profit before tax

(ii) net profit before interest and tax

(iii) gross profit as percentage of operating expenses.

Example 4

Two members of a multinational have the following profit and loss statement.

Company A (Manufacturing Co.)	(Rs.)
Sales to distribution Company B	20,000
Less Manufacturing costs	10,000
Gross Profit	10,000
Operating expenses	6,000
Net Profit	4,000

Company B(Distributor Co.)	
Sales to third parties	40,000
Less purchase from Company A	20,000
Gross Profit	20,000
Operating expenses	8,000
Net Profit	12,000

Thus in the example the issue to be determined is whether the transfer price method between Company A and Company B (Rs.20,000/- Sales) is consistent with the price adopted by independent firms for a comparable product in comparable circumstances.

The resale price method focuses on the gross margin obtained by the Company B (Distributor). The margin represents the amount from which a reseller would seek to cover its selling and other operating expenses and make an appropriate profit in relation to the margin obtained by independent distributors performing similar functions, bearing similar risks and contributing similar assets used as the basis for determining the appropriate margin for the member of the multinational.

In the example the gross profit margin obtained by the Distributor is 50% (20000/40000). The issue to be determined is whether this margin is consistent with the gross margin earned by independent distributors performing comparable functions bearing similar risks and employing similar assets to those of multinational.

The cost plus method focuses on the gross mark up obtained by the manufacturer. The arm's length price is determined by adding a mark-up to the cost incurred by the member of the multinational to determine an appropriate profit in relation to the functions performed, assets used and risks assumed. Thus mark up is determined by reference to the mark-up earned by comparable independent manufacturers performing comparable functions.

In the example, the gross mark-up obtained by Company A(manufacturer) is 100% [(20000-10000)/10000]. The issue to be determined is whether this mark-up is consistent with the gross mark up earned by independent manufacturers performing comparable functions, bearing similar risks and employing similar assets to those of the multinational.

The profit split method starts by identifying the combined profit to be split between the related parties in a controlled transactions in general, combined operating profit is used although gross profits may be appropriated in some circumstances. That profit is then split between the parties based upon an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

In the given example the combined operating profit of Company A (manufacturer) and Company B (Distrobutor) is Rs.16000/- as under:

Sales	40,000
Less Manufacturing cost	10,000
Operating expenses	14,000
Operating Profit	16,000

One way that profit could be split might be on the basis of the relative contribution of each member to that profit.

The comparable profit methods are a range of methods that examine the net profit margin realized by a taxpayer from a controlled transaction relative to an appropriate base. Possible bases include the return on assets, operating income to sales, and other suitable financial ratios. The methods are globally referred to by the OECD as the "Transactional Net Margin Method (TNMM)".

In the example the Company B (Distributor) may apply the ratio of net profit to sales giving a net margin of 30% (12000/40000). The issue to be then determined is whether this net margin is consistent with the net margin earned by independent distributors performing comparable functions the those of the multinational.

The traditional transactional methods (CUP, resale price and cost plus methods) form the starting point for considering the theory under pinning the arm's length principle. From an economic approach the CUP method effectively combines both the resale price and the cost plus methods into a single price. If a standardized market price exists for sales from the manufacturer to the retailer (which will be the arm's length price under the CUP method), the resale price and cost plus method will point to that price as the arm's length price. The resale price method will identify the arm's length margin based on the standardized resale price. Economically speaking therefore the CUP method consider the price from the perspective of both the manufacturer and the retailer, but it does this by direct reference to the market price adopted. For this reason the CUP method, when it can be applied reliably is considered to provide the most accurate measure of arm's length price.

2.23 Summary of Transfer Pricing Methods

Domestic Transactions

Method	Applicability	Brief Description of method	Issues involved
Full Cost	Intra Company or inter company transaction	Absorption Costing - Both Variable costs and Fixed costs are absorbed.	Fixed cost to be charged on the basis of normal capacity
Marginal Cost	Intra Company or inter company transaction	Marginal Costing Technique- Only variable costs are included.	No fixed cost component is included. Transferor is unduly gainer.
Cost Plus	Value Addition Manufacturing	Total Cost plus appropriate margin.	Allocation of overhead on the basis of normal capacity. Identification of comparables and comparing the mark up.
Market Price	Where market price of similar price is available	Market price of similar product	Market price includes selling/ distribution, sales promotion expenses, commission etc.
Negotiated Price	Where the competitive market for the product is absent.	Negotiated price between transferor and transferee.	

Domestic Transactions

Method	Applicability	Brief Description of method	Issues involved
CUP	In case transaction by market driven strategy.	Comparable uncontrolled transaction is identified and adjustment for material difference, if any.	Information required for comparables includes market condition, geographical condition, level of competition etc. Accuracy in adjustment in material difference is important.
RPM	In case of distributor where there is no value addition	Adjustment to resale price to third party by reasonable expenses and normal profit	Comparability with an uncontrolled transaction. Characteristics of goods.
Cost Plus	Value Addition manufacturing	Total Cost plus appropriate margin.	Allocation of overhead on the basis of normal capacity. Identification of comparables and comparing the mark up.
Profit Split	In case of multiple transactions among the related parties.	Total profit of multiple transactions are determined which is apportioned on the basis of value relative contribution.	For assessment of relative contribution, asset employed, risk involved or other bases are to be considered.
Transactional Net Margin	When market price of the product is not available but normal net profit margin for similar transaction is available	Net profit margin realized by the party and from a comparable uncontrolled transaction are determined to make necessary adjustment.	Adjustment by comparison with comparable uncontrolled transaction to take care material difference.

Maintenance of Records

2.24 Cost Accounting Record Rules requires that records be maintained showing the details of related party transactions and the basis for adoption of transfer prices. If the transactions involve different products, the basis of apportionment of cost to different product under reference should be indicated. The broad guidelines for maintaining records are indicated below in relation to the specific type of transaction. However, if some other documents beyond the ones specified below which formed the basis for pricing the transactions between related parties, the same may be preserved for the purpose of the cost audit or any other type of audit relating to the product under reference.

a. Contracts entered into; and

b. Agreements or understanding reached in respect of related party transfer indicating the basis followed for arriving at the rates charged for the above related party transactions recorded in the registers required to be kept under Section 301 of the Companies Act.

c. Record relating to purchase of raw material, finished products, process material, chemicals from related parties

- Quotations from other suppliers
- Quality specifications
- Purchase order
- Invoice giving details of price, discount, commission and freight
- Duties and other taxes paid
- Other conditions of supply such as credit term, voluntary clause after sales service etc.

In case of procurement from parties outside India, the other documents required are

- Letter of credit
- Bill of lading (value assessed by custom authorities)
- Letter of origin
- Import incentive, if any

d. record relating to sale of raw material, finished products, process material, chemicals to related parties

- Prime cost components
- Method of costing – Absorption costing or Marginal costing
- Allocation and absorption of overheads and their basis
- Price with details of discount, commission and freight
- Price charged to other parties, if any
- Duties and taxes

In case of procurement from parties outside India, the other documents required are

- Duty draw back
- Export incentives, if any

e. In case of sale or purchase of rejected goods including scraps

- Cost details
- Nature of rejected goods with speficications
- Terms of delivery – Ex Godown, FOR etc.
- System of charging price
- Comparative price in the market
- Freight
- Other conditions (for scrap as type and material contents) etc.

f. records for utilization of plant facilities and technical know how

- details of usage of different plant facilities by outside parties including related parties in term of time of use

- specific plant/machine used and its capital cost
- manpower used
- power cost
- Basis adopted for charges etc.

g. record of use of technical know how in terms of technology or expertise with details of usage and normal rate of royalty or any other method of charging. To determine whether it has economic affect on the transaction

- Agreement of technical know-how
- Terms and validity period
- Any provision for updation of technology
- Results in higher productivity, better quality and reduction in maintenance cost
- Whether a package deal on transfer of brand, technical know-how, sale of goods, marketing support, export conditions, etc.

In case of transfer of intangibles (Technical know-how) it is not possible to identify the comparable as the nature of such intangible will be unique to the market position and has various risks attached to the value. A board principle for such transaction to assess comparability is to determine by calculating the Net Present Value (NPV) of the expected benefits to be realized (potential profits or cost saving) through the use of intangible property. The other method is to match it with industry standard.

h. records of supply of utility and any other service by outside party including related party

- cost of utility or services
- standard method of charging fees etc

i. records of administrative , technical, managerial or any other consultancy services

- time duration
- standard rate etc

j. records of purchase and sale of capital goods including plant and machinery

(i) purchase of capital goods from related party **within** the country

if new

- details of items (including any service spares), date of procurement, expected life of plant, capacity
- specification, quality inspection record
- price paid

- installation cost
- Duties and taxes etc

if used one(s)

- details of items (including any service spares), date of procurement, life of plant already used in terms of time or other mode of usage
- depreciation at the time of procurement as per the books of transferor
- price
- Installation cost etc

(ii) purchase of capital goods from related party **outside** the country

If new

- details of items (including any service spares), date of procurement, expected life of plant, capacity
- Purchase order
- Letter of credit
- Quotation
- Duties and taxes
- Exemption on import, if any etc

If used one

- details of items (including any service spares), date of procurement, life of plant already used in terms of time or other mode of usage
- depreciation at the time of procurement as per the books of transferor
- price and nstallation cost
- other conditions, etc.

Sale of capital goods to related party within the country

if new

- cost
- price and comparative price of similar products
- discount, commission and freight
- duties & taxes

if used

- Cost details
- System of charging price
- Comparative price in the market
- Freight etc.

k. Sale of capital goods to related party outside the country

if new

- cost
- price and comparative price of similar products
- discount, commission and freight
- duties & taxes

if used

- Cost details
- System of charging price
- Comparative price in the market
- Freight etc.

l. records of any other payment related to production, processing or manufacturing of products under reference.

- miscellaneous transactions involving payments between the related parties
- If the payment is for multiple products, the basis of apportionment for the product under reference

CHAPTER 3

COST AUDITOR'S RESPONSIBILITY

3.1 Para 27 of Annexure to Cost Audit Report Rules, 2001 requires details to be furnished for related part transactions. The details to be furnished include:

(i) name of the related party;

(ii) product / activity;

(iii) Contract / agreement / correspondence ;

(iv) Period of Agreement

(v) Date of transaction;

(vi) Volume of transaction

(vii) Rate;

(viii) Amount

(ix) Normal price etc.

3.2 The cost auditor should examine the related party transaction as under:

(1) In case of related party transactions, auditor responsibilities are mainly directed towards ascertaining the fairness in pricing the transactions and check the consistency in the system. Thus, the procedure involves the following steps :

i) To see the relationship of the parties involved in the transaction and the relevant documents with reference to ownership structure, share holding, profile of the group, operation of the company, segment operation data, comparable companies data;

ii) To examine the method of pricing and the functions performed by each related party in terms of product strategy design, purchasing, production, marketing and distribution etc;

iii) To see the documents and records for the purpose of computation of cost and price;

iv) To judge the suitability of the application of the method adopted in the transaction;

v) To check the method and correctness in computation with reference to transfer price documents, tax returns, agreements, market plans and other literature;

vi) To see the consistency in the method adopted.

(2) If there is change in the system which may be primarily due to change in circumstances or business situation, the same may be reported with his opinion/ observations.

(3) If the transactions cover various types of products or processes under reference, the cost auditor has to undertake the separate exercise for each of them and report accordingly.

(4) comparability of an international transaction with an uncontrolled transaction must be judged in relation to:

(a) the specific characteristics of property transferred or services provided in either transactions;

(b) the functions performed having regard to the assets employed or to be employed and the risks assumed by the respective parties to the transaction;

(c) conditions prevailing in the market in which respective parties to the transactions operate including geographical location

(d) size of the market

(e) overall economic development

(f) level of competition

(g) government rules and orders

(h) terms of trade

(5) The computation of the transfer price applicable for the products or process must be on the basis of the data available in the sets of relevant records. The following information are to be considered to check the calculation of transfer price :

(a) Physical features of the goods

(b) Volume of supply

(c) Terms of delivery and payment

(d) Quality & reliability

(6) Special care has to be taken for apportionment of overhead expenses and the basis applied has be checked in case of individual items with regards to their justification. The basis for apportionment, once adopted should be followed consistently unless there is a pressing requirement for a change. In such case, the impact in the cost vis-à-vis pricing be indicated separately.

(7) He should also take care of the following at the time of computation of price :

(a) In case company is adopting standard costing, all variances viz, material usage variance, price variance, labour efficiency variance, overhead variances have been properly accounted for.

(b) Capacity utilization factor has to be examined in order to adjust the price variance due to underutilization of capacity, whether for internal factors or external factors.

(c) If there is any abnormal cost due to situations beyond control, such as lock out, strike, accident etc, the same should be excluded from the cost.

(8) He should assess the impact of each transaction on the business in terms of :

(a) Volume of transaction

(b) Contribution of the transaction

(c) Type of transaction – normal or special in relation to usual business practice

(d) Any other features of the transaction worth to be disclosed

TRANSFER PRICING IN INCOME TAX ACT

4.1 Transfer pricing concept has also relevance under the various provisions of the Income-tax Act as detailed in this section. Further, the increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. Existing section 92 did not explain the methodology to be followed in determining of ordinary profit. To overcome the problem and to broaden the existing statutory framework existing section 92 has been substituted and further new sections 92A to 92F have been inserted in the Income-Tax Act, by the Finance Act, 2001.These provisions relate to computation of income from international transactions having regard to arm's length price, meaning of associated enterprise, meaning of international transaction, determining of arm's length price, keeping and maintaining of information and documents, furnishing a report from an accountant etc.These are dealt with in subsequent paragraphs.

1.2 Existing and New Provisions

Section 40A(2) and Section 92 of the Income-tax Act, 1961 deal with transaction with related parties. Section 40A(2) covers transactions with all parties residents as well as non residents. It defines the term persons "person having substantial interest" as to one who basically holds 20% or more share holding. Its emphasis is on fair market value of goods or services purchased by the assessee for the legitimate needs of the business or profession of the assessee. This section authorizes the assessing officer to disallow any business expenses representing payment made to the connected persons which are **excessive** and **unreasonable** having regard to the fair market value of the goods, services or facilities. In the absence of market value or commercial character for the goods, services or facilities the provisions of section 40A (2) cannot be attracted [TT (P) Limited Vs. ITO [121 ITR 551 (KAR)].The emphasis of this section is about disallowing any excessive or unreasonable expenses. If no expenditure has been incurred but discount has been allowed to related party in respect of goods sold the discount allowed cannot be considered as "expenditure" and provision of section 40A (2) will not be attracted. The connected parties are identified in clause (b) of sub-section (2) of section 40A (2). Fair market value mentioned in this should imply comparable market price.

Other various existing provisions which have relevance in regard to transfer pricing concept are as under:

Valuation of export sales and total sales under section 10A & 10B:

One of the pre-conditions for availing of tax holiday under section 10A by an industrial undertaking established in free trade zones is that an undertaking which commenced business on or after 1.4.1995 should have export sale of not less than seventy five per cent of the total sales during the previous year [Section 10A (ia)]. Similarly a hundred per cent export oriented undertaking established on or after 1.4.1994 should export not less than seventy per cent of its sales during the previous year to avail of the tax holiday under Section 10B [Section 10B (ia)]. These pre-conditions require proper valuation of domestic sales and export sales. Comparable market price should be adopted as fair price to avoid any possible over-valuation of exports and under-valuation of domestic sales. Comparable market price means average market price of a comparable item during a given time. Monthly or quarterly average may be taken for determining average market price. It may also mean average price charged for a particular item by an entity to different customers during the given time.

Valuation of Plant and Machinery (Second hand) for the purpose of Section 10A, 10B.

Section 10A(1) (iii), requires that industrial undertaking established in free trade zones should not be formed by transfer of old machinery or plant previously used for any purpose that exceeds twenty per cent of total value of plant and machinery;

Section 10B (1) (iii) requires that hundred per cent export oriented undertaking should not be formed by transfer of old machinery or plant previously used for any purpose that exceeds twenty per cent of total value of plant and machinery;

Section 80HH requires that newly established industrial undertaking or hotels in backward areas should not be formed by transfer of old machinery or plant previously used for any purpose that exceeds twenty per cent of total value of plant and machinery;

Section 80HHA requires that newly established small scale industrial undertakings should not be formed by transfer of old machinery or plant previously used for any purpose that exceeds twenty per cent of total value of plant and machinery;

Section 80I and 80A requires that specified newly business should not be formed by transfer of old machinery or plant previously used for any purpose that exceeds twenty per cent of total value of plant and machinery. Transfer price of second hand machinery should be arrived at current market value, which should be derived pursuing comparable market price approach.

Besides the above section 92 deals with the situation of transactions of non-resident parties. Section 92 has been substituted by finance Act 2001, and sections 92A to 92F have been added. Thus with this amendment the section 40A will henceforth get confined to domestic transactions only and for international transactions section 92 to 92F will be relevant. These provisions are :

Section	Provision of section
92	Income from international transaction
92A	Definition of Associated enterprise
92B	Definition of International Transaction
92C	Computation of Income Tax under Arm's Length Method
92D	Maintenance of Information and Document by the company
92E	Furnishing Report by a Chartered Accountant
92F	Definition of Transaction, Arm's length price etc

The aforesaid provisions have been enacted with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profit for tax in India so that chargeable tax in India do not get diverted elsewhere by altering the prices charged and paid, intra-group transactions leading to erosion of tax revenues. The Income-tax Rules, 1962 have been amended vide SO 808(E) dated 21st August, 2001. Five new rules have been inserted after Rule 10 as under:

Rule	
10A	Meaning of expressions used in computation of arm's length
10B	Determination of arm's length price under section 92C
10C	Arm's Length price under section 92C.
10D	Information and documents to be kept and maintained under section 92D
10E	Report from an accountant to be furnished under section 92E.

4.3 Section 92 – Definition Arm's Length Price:

Section 92 (as substituted) is quite elaborate and provides that any income arising from an international transaction shall be computed having regard to the arm's length price. Arm's length price is defined to mean a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions. It further provides that the cost or expenses incurred or to be incurred, or allocated, or apportioned to, or as the case may be, shall be at arm's length price between two or more associated enterprises. Rule 10A also defines the following terms used in the computation of arm's length price.

(a) Uncontrolled transactions means a transaction between enterprises other than associated enterprises whether resident or non-resident;

(b) Property includes goods, articles or things and intangible property;

(c) Services include financial services;

(d) Transaction include a number of closely linked transactions.

4.4 Definition of Associated Enterprise under section 92A

Section 92A(1) defines associated enterprise as an enterprise :

- Which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of other enterprise; or

- In respect of one or more persons who participate, directly or indirectly, through one or more intermediaries, in the 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 other enterprise.

Here the term 'participation in management' means taking part in decision making in the business affairs and term 'control' means the power of directing, restraining and holding in check.

4.5 Definition of International Transaction under section 92B

For the purpose of this section and the sections 92C, 92D and 92E, the international transaction means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale, or lease of tangible or intangible property, or provision of services, or lending or borrowing money or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement between two associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service, facility provided or to be provided to any one or more such enterprises . [Section 92B(1)].

Thus, the definition of international transaction under section 92B has been made very wide. It includes almost all types of transactions a resident can undertake. It also includes:

(a) Transaction between two non-residents

(b) Transactions relating to purchase, sale, lease of tangible property / intangible property

(c) Provision of services

(d) Lending or borrowing of money

(e) Any arrangement or agreement on sharing cost

(f) Any transaction having bearing on the profits, losses or assets of an associated enterprise

Here, the term "agreement" means a contract i.e. a legally binding arrangement between two or more persons, by which right are acquired by one or more acts of forbearance on the part of the other or others.

4.6 Deemed International Transaction

Section 92B(2) provides that a transaction entered into by an enterprise with a person other than the associated enterprise, will be deemed a transaction with an associated if any of the following conditions are satisfied :

- There exists a prior arrangement in relation to the relevant transaction between such other person and the associated entries;
- The terms of the relevant transaction are determined in substance between such other person and the associated enterprise

4.7 Determination of Arm's Length Price

According to section 92C, the arm's length price in relation to international transaction shall be determined by any of the following methods (being the most appropriate method ha ing regard to the nature of transaction or clause of transaction / clause of associated persons or functions performance:

1. Comparable Uncontrolled Price Method (CUP)
2. Resale Price Method (RPM)
3. Cost Plus Method
4. Profit Split Method
5. Transactional Net Margin Method (TNM)

Section 92C (2) provides that where more than one price may be determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical means of such prices.

Rule 10B prescribes the basis for determination of arm's length price under section 92C as detailed in the following paras:

Rule	
!9B(1) (a)	Comparable uncontrolled price method
10B(1) (b)	Resale Price Method
10B(1) (c)	Cost Plus Method
10B(1) (d)	Profit Split Method
10B(1) (e)	Transactional Net Margin Method

Details of above methods are described in chapter 3 (Cost Accounting Record Rules – Transfer Pricing). Details of Rules are given in Appendix 4.

4.8 Other Issues :

Transfer price system can range from the very simple to the extremely complex depending on the nature of the business. When viewed strictly from a business perspective, another factor greatly influencing pricing decision is the market environment. It is also effected by the following two classes of considerations:

(a) Multinational Enterprise viewpoint

- Environmental issues
- Behavioral context
- Responsibility accounting

(b) Tax administrator' view point.

4.9 Section 92D-Records to be maintained- General Information on the business

The following records are to be maintained in relation to inter-company transfer :

(a) records relating to ownership structure of the company with details of shares or other ownership interest held by other enterprise;

(b) names and addresses of all associated enterprises within the meaning of sub-section (2) of section 92A of Income Tax Act with details of the relationship with each such enterprise;

(c) the nature and terms (including prices) of transactions entered into with each associated enterprise, and the quantum and the value of each such transaction;

(d) an overview of the business of the company and a description of the business of the associated enterprises with whom the company has transacted;

(e) all commercial agreements setting forth the terms and conditions of transactions with associated enterprises as well as with third parties;

(f) record of any forecasts, budgets or any other financial estimates prepared by the company for the business as a whole and for each division or product separately;

(g) detail of the property or services to which the transactions relate;

(h) description of the functions performed, risks assumed and assets utilized by the company and by the associated enterprises involved in the international transaction;

TRANSFER PRICING CONCEPT - THE CENTRAL EXCISE ACT 1944

5.1 Transfer Pricing concept is applicable in assessment of valuation of Excisable goods. Excise Audit under section 14A of the Central Excise Act, 1944 basically involves the application of system of valuation of excisable goods. The Transfer Pricing concept will be the key tools in the hands of the auditors in the process of performance of their job. There were many grey areas in the system of valuation. To overcome the situation the Government have issued Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000 vide GSR575(E) dated 30.6.2000. The section 4 of the Central Excise Act, 1944 has been substituted which came into force from 1st July, 2000. By a recent order F No 354/81/2000 –TRU dated 30.06.2000 issued by the Department of Revenue, Ministry of Finance have clarified the various issues in regard to valuation of excisable goods. Earlier, normal price was the basis for assessment of excise chargeable on the value of excisable goods. Now, the concept of "normal price" has been replaced by a new Section as "transaction value" for assessment which are described below. In other words, this section basically permits levy of excise duty at transaction value except in case of related persons. Transaction value in simple language refers to "commercial price for arm's length transaction".

5.2 Under Section 4(1)(a) of the Act, the excise duty is chargeable on any excisable goods with reference to their transaction value and following requirements has to be satisfied:

(i) The goods are sold by an assessee for delivery at the time and place of removal.

(ii) the assessee and the buyer of the goods are not related; and

(ii) and the price is the sole consideration.

In case where tariff value has been fixed for any goods in term of section 3 (2) value under section 4 is not determinable and the tariff value will be assessable value.

5.3 The new section 4 accepts different transaction value which may be charged to different customers for assessment purposes so long as these are based upon purely commercial consideration where buyer and seller have no relationship and the price is the sole consideration for sale. Thus it enables valuation of goods for excise purposes on value charged as per commercial practice rather than looking for a notionally determined value.

5.4 Transaction Value – Definition :

Section 4(3)(d) defines transaction value as under :

"**Transaction value** means the price actually paid or payable for the goods, when sold, and includes in addition to the amount charged as price, any amount that the buyer is liable to pay to on behalf of the assessee by reason of, or in connection with the sale, whether payable at the time of the sale, or at any other time, including, but not limited to, any amount charged for, or to make provision for, advertising or publicity, marketing & selling organization expenses, storage, outward handling, servicing, warranty, commission or any other matter, but does not include the amount of duty of excise, sales tax, other taxes, if any actually paid or actually payable on such goods."

5.5 Transaction Value – Inclusion of various items

The transaction value includes in addition to the price charged all other amount which the buyer is liable to pay:

i. By reason of the sale;

ii. In connection with the sale;

iii. The above amounts may be payable at the time of sale or at a later time.

Thus, under the new system, erection and commissioning charges, warranty charges, after sales service charges, will be includable provided the conditions mentioned in section 4(3)(d) are satisfied.

Permissible Deductions

(i) Freight: As per Rule 5, equalized freight is not deductible. Freight will be allowed only if the amount is actually mentioned in the invoice and charged to the buyer,

(ii) Trade Discount: Under the new scheme, trade discount is allowable deduction and would have already been reduced to determine transaction value. In case where discounts are based on turnover or granted at the end of the year, assessment can be made on provisional basis and deduction allowed;

(iii) Indirect Taxes: Excise duty, sales tax and other taxes actually paid or payable are eligible for deductions. If any excise duty or tax is paid at concessional rate for a particular transaction, deduction will be allowed for the tax actually paid and assessee cannot claim tax deduction at normal rate;

(iv) Packing charges: Under the old scheme durable and returnable packing charges were deductible from assessable value. But now it is not available as deduction and will be added to the assessable value.

For the purpose of Central Excise valuation, the study of the following terms is of relevance:

The term **'place of removal'** has been defined to mean –

(i) a factory or any other place or premises of production or manufacture of the excisable goods;

(ii) a warehouse or any other place or premises wherein the excisable goods have been permitted to be deposited without payment of duty, from where such goods are removed.

"Assessee" means a person who is liable to pay the duty of excise under this Act and includes his agent.

"Related party" means persons, if

(i) they are inter-connected undertaking;

(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.

"Relative" has the same meaning as in the clause 41 of section 2 of the Companies Act, 1956.

"Inter-connected undertakings" means two or more undertakings which are inter-connected with each other in any of the following manner, namely:-

(ii) if one owns or controls the other,

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

(iv) 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;

(v) Where one undertaking is owned by a body corporate and the other is owned by a firm, 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,

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

(vii) If the undertakings are owned or controlled by the same person (by the same group),

(viii) 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 foregoing sub-classes.

Explanation I.- For the purpose of this Act, (two bodies corporate), shall be deemed to be under the same management, -

(i) if one such body corporate exercise 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) 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);

(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

(ix) 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 directors or instructions of an individual, whether belonging to a group or not.

Explanation II.- If a group exercise 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.- If two or more bodies corporate under the same management hold, in the aggregate, not less than (one-fourth) equity share in any other body corporate, such other body corporate shall be deemed to be under the same management as the first mentioned bodies corporate.

Explanation IV.- 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.

Illustration

Undertakings N is inter-connected with undertaking A and undertaking C is inter-connected with undertaking B. Undertaking C is inter-connected with undertaking A; if undertaking D is inter-connected with undertaking C, undertaking D will be inter-connected with undertaking B and consequently with undertaking A; and so on.

Thus, the term inter-connected undertakings covers large categories of legal entities/ undertakings to whom goods are sold by the assesses which may be held as "related person" under the new definition. It may be noted that under the erstwhile provisions under section 4, except for the specifically named categories, namely, holding company, subsidiary company, a relative and a distributor of the assessee and any sub-distributor of such distributor, buyer was held to be related to selling assessee only if they were so associated that they have interest directly or indirectly in the business of each other. In contrast no such general condition/restriction applies for inter-connected undertakings to be "related" under new section 4. 5However, a provision has been made in the new valuation rules that even if the assessee and the buyer are inter-connected undertakings, the transaction value will be "rejected" only when they are "related" in the same sense of any of clauses (ii), (iii) or (iv) of sub-section 4(3)(b) or the buyer is a holding company or a subsidiary company of the assessee. In other words, while dealing with transactions between inter-connected undertakings, if the relationship as described in clauses(ii), (iii) or (iv) does not exist and the buyer is also not a holding company or a subsidiary company, then for assessment purposes, they will not be considered related. "Transaction value" could then form the basis of valuation provided other two conditions, namely, price is for delivery at the time and place of removal and the price is the sole consideration for sale are satisfied. If any of the two aforesaid conditions are not satisfied then, quite obviously, value in such cases will be determined under the relevant rule.

The test of related person is that they are either so associated that they have interest, directly or indirectly in the business of each other or have holding / subsidiary relationship. Several judicial pronouncements have held that having interest in the business of each other clearly requires mutuality of interest. Merely having interest of one in the other is not sufficient. It should have interest in each other's business. If on the other hand, if there exist holding subsidiary relationship this is a sufficient condition to conclude that the assessee and buyer are related person.

5.6 Valuation Rules

Following are points to be considered at the time of valuation of transaction :

1. **Price** : Any amount paid or payable to the assessee as the consideration of the goods sold. The full value of the goods, whether paid in full or paid partly at time of the transaction or to be paid subsequently will be accounted for.

2. **Packaging Charges** : Packaging charges will be included, even if it is charged separately.

3. **Warranty charges** : Warranty charges will also be included, even if the warranty is not recovered at the time of sale but the warranty is mandatory and the same will have to be paid subsequently. If the warranty is optional and the same is not recovered in the transaction, the question of inclusion does not arise.

4. **Interest** : Interest charged for delayed payment beyond the normal credit period of the industry concerned will not form a part of valuation.

5. **Discount** : As the advantage of discount is passed on to the buyer by the assessee for the sake the business promotion or marketing strategy, the same will not form part of transaction value. Even in case where the discount are based on turn over

or granted at the end of the year, assessment can be made on provisional basis and deduction allowed.

6. **Advertisement charges or Publicity Charges :** If an assessee recovers Advertisement charges or Publicity Charges from the buyer, the same will be included in the value.

7. **Additional Consideration (Rule 6):** Any direct or indirect additional consideration will be added to the assessable value. This will include the value of:-

   (i) materials, components, parts and similar items relatable to such goods;

   (ii) value of tools, dies, moulds drawings, blue prints, technical maps and charts and similar items used in production of such goods;

   (iii) value of engineering, development, art work design work and plans and sketches undertaken elsewhere than in the factory of production and necessary for the production of such goods.

8. **Freight (Rule 5):** Equalised freight is not deductible. Freight will be allowed as deduction only if the amount is actually mentioned in the invoice and charged to buyer.

9. **Depot Sales (Rule 7) :** Where goods are sold at factory gate, transaction value at the depot will have to be adopted. There will be deductions in freight charges as mentioned in Rule 5.

10. **Excise, Sales Tax or other taxes :** Any excise duty or other taxes actually paid or payable relating to the goods involved in the transaction, are eligible for deduction from the price of the goods to the extent of duty or taxed actually paid, irrespective of the "normal rate" in the case of the type of transaction.

A. In case the parties in transaction are not related :

i) As per Rule 5 if the goods are sold at place other than the factory gate or warehouse, then assessable value will not include the cost of transportation from factory/ warehouse upto the place of delivery. However, the exclusion of cost of transportation will be allowed only if the assessee has shown them separately in the invoice and the exclusion is permissible only for the actual cost so charged to the buyer. If the assessee has a system of pricing the sale at uniform rate inclusive of equated freight for delivery at factory gate or elsewhere, no deduction for freight element will be permissible.

ii) If the goods are not sold at the factory gate or at the warehouse but they are transferred by the assessee to his depots or consignment agents or any other place for sale, then assessable value in such case for the goods cleared from factory/warehouse shall be the normal transaction value at the depot, etc. at or about the same time on which the goods are being valued are removed from the factory or warehouse.

Illustration : If an assessee transfers a consignment of a chemical from factory at Gurgaon to Depot at Faridabad on 06.09.2001 and if the normal price of the same quality of chemical at Faridabad on 06.09.2001 is Rs 30,000 per tonne for transaction between unrelated parties, then the price for calculation the assessable value of the consignment transfer will be Rs 30,000 per tonne. If there is no transaction of same quality of chemical on 06.09.2001 at Faridabad, the price of transaction at the nearest date of 06.09.2001 at Faridabad will be the basis for calculation.

iii) For captive consumption: In terms of Rule 8, the assessable value will be based on cost of production of the goods or comparable goods manufactured and sold by the assessee. Assessable value will be taken as 115% of the cost of production, 15% being considered as appropriate rate of margin for the purpose of excise valuation.

B. In case the parties in transaction are related :

5.7 **Comparable Uncontrolled Price (CUP)** : If the comparable price of similar quality of product is available for the similar type of market i.e. wholesale market in case of transaction is of nature of wholesale or retail market in case the transaction is of retail in nature, will be considered for assessment.

5.8 Cost Plus method : In case of transaction is not for sale but for captive consumption by the buyer, the Cost plus method should be applied.

(1) Sale to related person (Rule 9) if the entire output is sold to related person, the price of related person will be adopted. If part of the goods are sold to a related person, than transaction value of such goods sold to independent buyer will have to be adopted as per Rule 4. If related person captively consumed the goods, the value will be cost plus 15% as per Rule 8.

(2) Sales to Inter Connected Undertaking (ICU) (Rule 10):- The same principle as per Rule 9, if the buyer is holding/subsidiary company or is a relative/distributor or there is mutual interest, if it is an ICU but not holding/subsidiary the transaction value has to be adopted. The net result is that as long as inter-connected undertaking is not a subsidiary the transaction will be adopted.

(3) Residual Method (Rule 11) : This is similar to the best judgement method whereby the value can be determined by "reasonable means" consistent with the provisions of Section 4 and Rule 11.

TRANSFER PRICING CONCEPT IN THE CUSTOMS VALUATION (DETERMINATION OF PRICE OF IMPORTED GOODS) RULES, 1988.

6.1 Section 14(1) and 14(1A) of the Custom Act, 1942 lays down the basic principle of valuation of goods for assessment purpose and empowers the Government to make rules thereof. In exercise of the above powers the Government notified custom valuation (Determination of Price of Imported Goods) Rules 1988. The concept of arm's length pricing (ALP) is applicable. These rules are based on 1979 GATT Agreement on Customs Valuation (ACV). These rules stipulate the following six valuation methods for the value of imported goods:

Transactional value of imported goods

Following basis to determine transaction value have been laid under the rules:

i. Transactional value of imported goods

ii. Transactional value of **identical goods** sold for export to India and imported at or about the same time.

iii. Transactional value of **similar goods** sold for export to India and imported at or about the same time.

iv. Deductive value based on the price at which imported goods or identical or similar imported goods are sold in India.

v. Computed value based on Cost Plus Profit; and

vi. Residual method i.e. any other reasonable means.

In terms of Rule 5 of the Customs Value Rules, the value of the imported goods shall be transactional value of:-

(i) Identical goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued.

(ii) Where no sale above referred is found, the transaction value of identical goods sold at a different commercial level adjusted to take account of different attributable to both quantity and commercial level.

(iii) If more than one transaction value of identical goods is found the lowest of such value shall be used to determine the value of imported goods.

In determining the value, the transactions value of identical or similar goods shall be used as a basis.

In terms of Rule 4(1) the "transaction value" as defined in Rule 2(1)(f) shall be the price actually paid or payable when sold for export to India, adjusted in accordance with Rule

9, the transaction value [in terms of Rule 4(2)] shall be accepted subject to certain conditions one of which inter alia is that buyer and seller are not related, the transaction value is acceptable under Rule 4(3). Rule 4(3) provides that where the buyer and seller are related, the transaction value shall be accepted provided that the examination of circumstances of the sale of the imported goods indicates that the relationship did not influence the price.

In sale between related persons the transaction value shall be accepted whenever the importer demonstrates that the declared value of the goods closely approximates to the transactions value of identical or similar goods after making necessary adjustments under Rule 9. Thrust of the Rule 4 is that the prices actually paid or payable should not be influenced by relation if any, between the buyer and seller if there exists such relationship. If there is no relationship the transactions value would be actual price paid or payable of goods imported.

Thus important pre conditions for using transaction value of imported goods are :

i. the buyer and seller should have no interest in each other business.

ii. the price is the only consideration for sale; and

iii. the buyer and seller are not related persons.

Transaction value of imported goods can be used even for transaction between related persons in case the relationship has not affected the price and the price is comparable to identical or similar goods.

6.2 Deductive Value Method

Rule 7 provides:-

(1) Subject to provisions of rule 3 of these rules, if the goods being valued are identical or similar imported goods are sold in India, in the condition as imported at or about the time at which the declaration for determination of value is presented, the value of imported goods shall be based on the unit price at which the imported goods or identical or similar imported goods are sold in the greatest aggregate quantity to persons who are not related to the sellers in India, subject to the following deductions:

(i) either the commission usually paid or agreed to be paid or the additions usually made for profits and general expenses in connection with sales in India of imported goods of the same class or kind;

(ii) the usual costs of transport and insurance and associated costs incurred within India;

(iii) customs duties and other taxes payable in India by reason of importation or sale of the goods.

(2) If neither the imported goods nor similar imported goods are sold at or about the same time of importation of the goods being valued, the value of imported goods shall, subject otherwise to the provisions of sub-rule (1) of this rule, be based on the unit price at which the imported goods or identical or similar imported goods are sold in India, at the earliest date after importation, but before the expiry of ninety days after such importation.

(3) (a) If neither the imported goods nor identical nor similar imported goods are sold in India in the condition as imported, then the value shall be based on the unit price at which the imported goods, after further processing, are sold in the greatest aggregate quantity who are not related to the seller in India.

(b) In such determination, the due allowance shall be made for the value added by processing and the deductions provided for in items (i) to (iii) of sub-rule (1) of this rule.

In other words this method basically applies the price of similar or identical goods sold in domestic market. The deductions in the price relates to the following cost components in the transaction:

- Commission paid or agreed to be paid
- Cost of transport and insurance
- Custom duty or other taxes payable for the import
- Normal profit in the similar type of transaction

If the price of similar or identical goods are not available in the domestic market on the date of transaction concerned, the price of similar goods at the earliest date after importation will be applicable, subject to the restriction of applicability within ninety days of such transaction.

If the goods are not identical nor similar and the parties involved in the transaction are not related, then the unit price of the imported goods aggregated with processing charge, if any.

In case the buyer and the seller are related, this method is not applicable.

6.3 Computed Value Method

The computed value is taken as sum of :

(i) cost of raw materials,fabrication and other processing cost;

(ii) general overheads and reasonable profit as per the standard of country of export; and

(iii) other expenses like transport, insurance, loading, unloading and handling expenses.

(iv) normal profit: this method is in fact cost plus method. In custom valuation computed value based on cost plus profit approach requires cost data for determining of custom tariff to be imposed on imported goods in the importing country. Under this approach an exporter is required to furnish cost data. Inclusion of internal profit while determining cost of final product would affect the export competitiveness of a product. However, generally, custom valuation is made on the basis of comparable market price.

Difficulties in the application of computed value method are:

- Non-availability of correct data related to cost of material
- In case the buyer and the seller are related, this method is not applicable
- There may be dispute in determining the normal profit rate.

6.3 Residual Method

Residual method involves the application of fair reasons to derive the value. This is applicable also in case of related party transaction. There is no specific steps set for the method. When the above methods as described above fail, this approach is adopted to find a fair value of the transaction taking the concept and logic of all the above methods to the extent permissible so that the value is free from bias and practical in its application.

6.4 Definition of "Related Persons and Mutuality"

Rule 2(2) defines that persons shall be deemed to be related only if they are officers or directors of one another's businesses;

(i) they are legally recognized partners in business;

(ii) they are employer and employee;

(iii) any person directly or indirectly owns, controls or holds five percent/or more of the outstanding voting stock or shares of both of them;

(iv) one of them directly or indirectly controls the other;

(v) both of them are directly or indirectly controlled by a third person;

(vi) together they directly or indirectly control a third person; or

(vii) they are members of the same family

As per explanations the term 'person' also includes legal person.

6.5 Mutuality of interest and judicial Rulings :

Section 14(1) states that it is only in cases where there is mutuality of interest between the buyer and seller that a relationship can be presumed and not otherwise. Mutuality of interest between the buyer and seller would be the first acid test to apply in regard to related party transaction. In UOI Vs. Atic Industries Ltd. 1984 (17) ELT 323 (SC) in the context of Section 4(4)(c) of the Central Excise Act, Supreme Court affirmed the view of High Court as to absence of mutuality of interest and thereby quashed the demands. The Supreme Court observed as under;-

"For treating the customer as a related person, the firs part of the definition of "related person" as given in Section 4(4)(c) requires that the person who is sought to be branded as a related person must be a person who is so associated with the assessee that they have a interest directly or indirectly in the business of each other. Thus it is not enough that the assessee has an interest directly or indirectly in the business of the person alleged to be related person nor is it enough that the person alleged to be a related person has any interest directly or indirectly in the business of the assessee. It is essential to attract the applicability of the first part of the definition that the assessee and the person alleged to be related person must have interest directly or indirectly in the business of each other. The equality and degree of interest which each has in the business of the other may be different; the interest of the one in the business of the other may be direct while the interest of the latter in the former may be indirect, but that would not make any difference so long as each has got some interest direct or indirect in the business of each other, the customer company holding shares in the manufacturing company cannot be treated to be a related person"

In Collector of Customs Vs. Maruti Udyog Ltd. 1989 (24) ECC 349 (SC), Supreme Court followed the rationale of the discussion in Atic Industries case while confirming the decision of the Tribunal as reported in 1987(28) ELT 390(T). In this case the Tribunal had held that although Suzuki of Japan held 26%of the shares in Maruti, and had a proportioned representation on the board of Maruti, the opposite was not true sense. Maruti had neither shareholding nor a representative in Suzuki. The Tribunal held that there was no mutuality of interest and on the basis of the decision of the Supreme Court in Atic Industries case, held that provision of Section 14 of the Act were similar to Section 4 of the Excise Act and therefore the negotiated price between the buyer and seller was to be accepted since it was based on transaction at arm's length and loading resorted to by the Department to the extent of royalty payment was unjustified. The Supreme Court confirmed the decision of the Tribunal and dismissed the appeals of the Collector."

The following are some of the important decisions rendered by the Tribunal (CEGAT) in the context of mutuality interest and its relevance to treat person as related persons:

1) Cadbury Fry (India) Pvt. Ltd. Vs. UOI 1990(40) ELT7(Bom.).
2) Kalyani Brakes Ltd. Vs. Collector 1997 (89) ELT 489(T).
3) Collector of Customs Vs. Hero Honda Motors Ltd. 1995(80) ELT 712 (T)

In the above case the Tribunal observed that to rule out valuation u/s 14(1)(A) of the Custom Acts 1962 mutuality of interest between parties has to be established and the seller and buyer must have interest in the business of each other. It was held that one sided interest was not enough to conclude the existence of mutuality.

INTER-SEGMENT TRANSACTION

7.1 The term segment means distinguishable component of enterprise engaged in providing individual product or service or a group of related product of services. They may be in different geographical areas. Traditionally the inter segment transaction means transfer of product or services within an entity. However, with the increased international transaction among various MNCs and related companies, there is a need to have a definite guideline in pricing the inter-segment transfers. The inter-segment transfers are also the mean for rendering services through supply chain within an entity. The transfer of product or service from one segment of an organization to another in which the latter adds value is termed as "inter-segment transfer for captive consumption".

Transfer pricing is being used as a tool to manipulate the profitability of different segments to derive maximum possible benefit for the organization as a whole in terms of reducing tax burden or transfer of fund from geographical region to the other. There must be check in this practice in order to plug the possible loop holes to augment the revenue generation of the Government, support the growth of the economy and encourage healthy competition within the organization.

Accounting Standard 17 issued by Institute of Chartered Accountant establishes the principle for financial reporting for different segments. The segmental reporting as in AS-17 mandates the financial reporting on the profitability of various segments in order to help the users of the financial statement to understand the performance of each segment, individual risk and return and future opportunities for growth and prospect. To serve the above objective in its true sense pricing the transfers among the segments should be on a rationale basis so that the profitability of each is preserved as would have been in the normal operation of the business. The measurement of performance of each segment is possible only through a well-designed system of valuation of inter-segment transfers.

In a decentralized organization managers of independent segment enjoy motivation to perform better as their compensation is linked to performance. In a competitive environment a company can grow only by emphasizing the area of core competency i.e. areas which can add maximum value. A rational transfer pricing policy facilitates identifying the core competency area.

Segment pricing will depend on the following information:

i. Total carrying amount of assets by each segment
ii. The total cost incurred to acquire segment asset during a particular period
iii. Total operational cost

iv. Sales to external customers and revenue generated out of it

v. Inter-segment transfers

vi. Composition of transfer

7.2 Approach to transfer Pricing

The concept of arm's length pricing will be applicable in order to make rational functional analysis of different segments. The cost based pricing are the full cost method, marginal cost, and cost plus which are dealt in details in Section 2 in setting the transfer pricing policy in case of related party transaction. Other methods like CUP, Resale Price Method and Profit Split methods are also discussed there in details.

1. In case inter-segment transfer pricing, normally cost forms the basis. The Cost Plus approach is adopted widely. Unless the overhead, particularly fixed overhead, allocation is done properly, the cost of product may be distorting one. Normal Capacity may be taken as a base for overhead allocation. The difficulty in the method the passing of burden of in-efficiency of the transferor segment to transferee.

2. The Market Price of the similar or identical product sounds more rational. The problem lies here in the non-availability of market price of similar product. To form the right kind of supply chain relation, the segments sometimes adhere the specific need of the transferee to satisfy the requirement in production or process in the trade or business. When the market for the product or services of the segment is predominant in nature, the transfer pricing is adopted on market price basis. Market price involves many components of cost which are actually not involved in case of inter-segment transfer. Apart from it, in case of unstable market price situation, the performance measurement gets affected.

3. The comparable uncontrolled price (CUP) becomes the third option. It is often applicable in case of international transaction among segments located at different geographical areas. In case of transfer of product or services over different regions, exact price of similar or identical product in the local market may be available and the price of is not readily available and hence comparable price is resorted to.

4. Resale Price Method is more suitable in case resale of product or service by the transferee segment to a third party without any value addition in the product or service. Here also, the question of identification of gross profit in comparable uncontrolled transaction is there to make adjustment in the price both in terms of gross profit as well as due to difference in the functional and other characteristics of the product or service.

5. Profit Split Method will be applicable in case multi-segments and cross-segments transfers and the segments are fulfilling complementary functions of others to a great extent to create a market of brand of products which involves different type of supplies and processing at different points under different segments.

Transfer pricing in inter-segment transaction has certain limitations in regard to following aspects:

i) Arbitrary allocation of joint costs: Many of the costs incurred for various segments are joint cost by nature. When transfer prices are based on cost consideration appropriate basis of allocation of joint cost will have a significant impact on the transfer price.

ii) Interchangeable assets: Similarly, certain assets are utilized for more than one segments it is difficult to earmark assets employed for a particular segment and therefore no relevant ratio of return on segment assets can be computed for evaluating comparative performance of various segments.

iii) Influence of transfer pricing: Segments results may be influenced by selecting appropriate transfer pricing formula thus profit of an efficient segment can be distributed among inter connected segments.

7.3 Transfer Pricing Policies

The objectives of Transfer Pricing are to assess the value of inter-segment or inter-unit transactions. The issue becomes critical when the parties involved are related by some means and the measurement of segmental performance is essential both in terms of having the fair picture of individual segment performance and the group performance. Keeping the above in view, the Transfer Pricing policy is determined on the basis of the cost center approach. Here the cost center may be the revenue center, profit center, or investor center. Transfer pricing policy is dependent primarily on following factors -

i. cost of product;

ii. market price of the product

iii. relationship between the transferor and the transferee;

iv. approach towards assessment of segmental performance.

The choice of Transfer pricing is guided by two broad objectives, namely,

i. Measurement of segmental performance in terms of cost, revenue and sales.

ii. Goal congruence – It implies that no decision of segment to maximize segmental performance should lead to sub-optimal corporate performance.

This happens when decision to out sourcing supply or transfer for earning better segmental profit affect the performance of the other segment resulting under performance of the corporate as a whole. This means gains of out sourcing is not sufficient to outlays opportunity laws arising out of internal transfers at of market price.

The essentials of a good transfer pricing system includes:

- Decentralized organization structure with fair degree of decisional autonomy;
- Choice of controlling focus in measurement divisional performance;
- Installation of a proper costing system;
- Rational overhead allocation system wherein service divisions are not recognized as profit center or investment center;
- Installation of a system of collection and compilation of comparable market price and other non-accounting product information;
- Establishment of an arbitration committee to settle inter-divisional dispute arising out of negotiation of transfer pricing;
- Policy Statement regarding divisional autonomy in outsourcing vis-à-vis and use of internal supplies.

7.4 The Cost based Transfer Pricing Policy

This is most suitable for service cost centers like stores, purchasing, repairs, maintenance, and administration etc. When a company follows a deliberate strategy of vertical integration, sourcing of raw materials of a division to another is normal in its operation. In such case it is desirable to consider each division lying in the vertical chain as cost center. The cost based price is most appropriate if there is no market for intermediate goods or services. In case market or intermediate goods is imperfect an internal division may be imposed to predatory pricing by the competitors. To avoid such situation it becomes essential to follow cost based pricing focusing cost efficiency rather than market efficiency. Cost based transfer Pricing are applicable in the situations described below.

7.5 Incremental cost based pricing

Incremental cost means cost of producing additional output. It includes both additional fixed cost and variable cost. Incremental cost approach can be used when a division sells its output to external customers and is working above the break-even point. Its surplus capacity is required to be utilized for inter-segmental transfer (see Example 5).

Example 5 : Incremental cost based transfer pricing

Division 1	Units	Per unit(Rs.)	Rs. In lacs
Full capacity (A)	1,00,000		
Outside sales (B)	80,000	5,000	4000
Variable cost (C)		2,000	1600
Contribution (D) = (B) – (C)			2400
Fixed cost (E)			1500
Break-even point (F) = (E) / (D)	50,000		
Inter-segment transfers to Division 2 (G) = (A) – (B)		20,000	
Incremental cost			
Variable cost (H)		2,000	400
Fixed cost (I)			500
Total incremental cost (J) = (H) + (I)			900

Since the division has achieved break-even point and it is unable to utilize its 20 per cent surplus capacity, inter-segment transfers may be arranged in order to utilize such surplus capacity. Accordingly, incremental cost based transfer pricing is used as a preferred approach. So Division 1 may transfer 20000 units to Division 2 at Rs.900 lacs.

Depreciation - For cost based transfer pricing depreciation should be charged on the basis of expected product life cycle wherein it is lower than useful life of the fixed assets. In case minimum depreciation as mandated in the company law should be used for costing purpose.

Cost of brand development – Although a product is manufactured in different divisions, brand is developed on unified basis. Cost of developing brand image is common cost of all the production divisions. Brand development cost should be charged at ratio of cost incurred in various production divisions.

Interest on working capital – Working capital is identifiable investment that is directly related to cost of production. Financing cost of working capital should also form part of transferable cost. However, it may be agreed to ignore finance charge from transferable cost in case financing decision is centrally controlled or a major portion of working capital is equity financed.

Research and development cost - In full cost transfer pricing of R & D cost is added to cost of production. Any R & D cost incurred specifically for a division is directly chargeable to that division. Amortisation period is dependent on the useful life of physical asset, product life cycle, usefulness of technical know-how, patent right or copy right, etc. However, if R & D cost represents any common physical asset or intangibles, amortizable cost per period is further apportioned to various divisions on the basis of total cost of each production division.

Royalty, service charge - It is normal practice to charge royalty per unit or service charge per unit in case of imported technology. This concept has been extended to charge royalty per unit for using brand name of the Group Resource Company. Royalty or service charge is computed on total cost or market price of the final product. It is necessary to apportion the per unit royalty or service charge in the ratio of per unit cost of final product. Cost apportionment technique has been illustrated in Example 6. While apportioning royalty, service charge etc., it is not fair to include internal profit to divisional cost.

Example 6 : Apportionment of royalty and service charge

	P1	P2	Total
Divisional cost (Rs.) (A)	11,00,000	13,00,000	24,00,000
Units produced (B)		10,000	8,000
Final output (C)			8,000
Cost per unit (Rs.) (D) = (A) / (C)			300
Royalty per unit @10% (E) = 10% of (D)			30
Royalty chargeable to Division 1 = Rs.30 * (11 / 24) (F)	13.75		
Royalty chargeable to Division 1 = Rs.30 * (13 / 24) (G)		16.25	

Inventory valuation – Any method of cost based pricing should specify the method followed for valuation of inventories. It is necessary to observe a suitable inventory valuation approach consistent with the entity's financial accounting policies to avoid accounting duplication. International Accounting Standard –2 does not recommend use of LIFO method. Accordingly, this method should be avoided. FIFO or weighted average method should be the ideal choice to establish a coordinated approach with financial accounting policies.

Accounting Standard-2 issued by the ICAI suggests adoption of normal capacity as base for overhead allocation, which provides an appropriate guideline to avoid the problem of under-utilisation of capacity in the transferor division. This also helps the transferor division in case of capacity over-utilisation-the cost advantage is not passed to the transferee division.

7.6 Cost plus pricing - Under this approach transfer price is set at full cost of the transferor and an agreed return on investment. Full cost should be determined after elimination of controllable price variance and efficiency variance of the transferor, capacity cost of transferor including cumulative capacity cost carried forward from the division of origin from which the transferred-in goods originated. Agreed return on investment is another point of arbitrary profit of addition. Any idle investment of the division would inflate profit charge. So only value of effective investments should utilized for the purpose of deriving cost plus value.

This method does not generate any competitive spirit among the decentralized divisions. Because a division is sure to get assured return on its cost incidence at a rate linked to investments. This may lead to increase in the value of investments. This does not reflect real value added by a division since no reference is made to comparable market price.

Deficiency of cost based transfer pricing - In a system of cost based transfer pricing market efficiency of a particular division cannot be assessed. A division that can be eliminated from the supply chain without affecting operations of the other divisions cannot be identified in cost based transfer pricing system. Controlling focus in cost based transfer pricing is achieving target quality product/service at the lowest possible cost. However, this does not necessarily maximize profit of the company and ensure proper resource allocation. The question of passing cost inefficiency of one division to another can be avoided by applying standard cost approach as elaborated above.

7.7 **Market** price based transfer pricing - It is the best form of transfer price if readily identifiable market exists for the products or services transferred. This approach is consistent with the philosophy of decentralization. Managers of a decentralized division, recognized as profit center or investment center, is free to choose buying and selling price. This facilitates performance evaluation of the divisional managers as well as contribution made by each division in the overall corporate profit pool. Use of market price base transfer pricing formula helps to create a competitive environment which allows various divisions to operate independently like separate entity.

However, all transfers may not have comparable market price. Accordingly, market price based transfer pricing has certain limiting conditions:

- Some intermediate products are not marketable, for example, hot liquid metal in a steel plant although an independent process division produce the same;
- Some intermediate products although marketable there is no reliable domestic market;
- Information about comparable market price may be imperfect in many occasions;
- Differences in product quality, features, credit terms, delivery schedules, service or replacement warranty, etc. makes comparison of market price difficult;
- Sometimes market price may reflect distress selling by domestic competitors, dumping by exporter or predatory pricing as market entry strategy. Adoption of such a price as basis for transfer pricing may weaken the competitive edge of the company as whole.

Despite of the limiting conditions, market price based transfer pricing is best choice for a decentralized division preferred to run as profit center or investment center. Certain steps may be taken to adopt market price based transfer pricing:

- It is necessary to establish a cell to monitor market prices of the comparable products or services. This cell, in fact, the research wing of the company to implement a decentralization successfully.
- The cell should derive the market price of the transferable products or services from the market price eliminating difference in quality, features, and other non-comparable characteristics.
- An arbitration cell should be established to settle the difference arises between buying and selling division.
- Buying segment should be free to buy from outside in case it make better profit in the long run. If a buying segment is asked buy internally, transfer should be made at comparable price, and any resultant loss of the selling segment should be reflected.
- Similarly, a selling segment should be free to sell to outside buyers in case it make better profit in the long run. If a selling segment is asked sell internally, transfer should be made at comparable price, and any resultant loss of the buying segment should be reflected.

Market price based transfer pricing may create a dysfunctional decision situation. By adopting market price based transfer pricing one division may refuse to buy from other division. Division 1 produces and sells to Division 2; alternatively, Division 2 can outsource if it is available at cheaper rate. By this although the selling division may earn better profitability, the company as a whole may not be benefited because of lower profit earned by the buying division (Example 7). In Exhibit 7 it has been illustrated that if Division 2 may be able to procure intermediate goods at Rs.312, at which Division 1 suffers loss. It cannot bargain for its cost inefficiency. In an ideal situation, it may be presumed that Division 1 may also be able. However, in competitive market Division 1 has to incur further expenditure on marketing that would increase its loss. Even in an excess supply situation, although Division 2 is buying at Rs.312, Division 1 may not get a market to sell at Rs.312. In case it has to sell eventually below Rs.312, that would further affect the overall corporate result. Alternatively, once Division 1 stopped production, Division 2 may not be able to outsource at the same rate. To avoid dysfunctional decision situation, it is possible to frame some general guidelines.

Example 7 : Dysfunctional decision situation

	Division 1	Division 2
Situation 1 (Cost based analysis)		
Cost of intermediate goods transferred from Division 1 to Division 2 (Rs. In lacs)	324	324
Cost of Division 2 (Rs. In lacs)		112
Cost of final product (Rs. In lacs)		436
Market value of final product (Rs. In lacs)		472
Corporate Profit (Rs. In lacs)		36
Situation 2		
Cost of intermediate goods produced by Division 1 (Rs. In lacs)	324	
Cost of goods purchased by Division 2 from outside (Rs. In lacs)		312
Cost of Division 2 (Rs. In lacs)		112
Total cost Division 2 (Rs. In lacs)		424
Marketing expenses	10	
Market value (Rs. In lacs)	312	472
Divisional Profit / Loss (Rs. In lacs)	(22)	48
Corporate Profit (Rs. In lacs)		26

- The buying division should purchase internally so long as the selling division meets all conditions attached to fair market price offered by external seller;
- The selling division should sell internally so long as the buying division offers a comparable price;
- All rejections of internal transfers should be passed through independent arbitration cell;
- In the short run internal transfers may be allowed at less than market price to subsidise any division lying in the vertical chain of production. The resultant loss arising out of such transfers may be charged to the Division getting benefit out of lower transfer price.

Internal transfers can be carried out through arbitration cell. Although the company cannot make any additional profit in this process, it is benefited through understanding of the competitive strength of various divisions. In the long run, this helps in business restructuring.

7.8 Negotiated transfer price - It means price agreed upon by the transferor and transferee division for inter-segment transfer with reverence to cost of production, investment, market price, terms of supplies and market related profit. Negotiated price is a preferred approach in case no comparable market price of inter-segment transfer is possible to establish. In case the inter-segment transfer relates to a product for which market is imperfect, delivery terms offered by the external supplies is not matching with the requirement of the buying division, market price is highly volatile, after sale service is not standardized, then selling division any buying division may adopt a negotiated market price approach.

In Example 8 negotiated price approach has been explained.

Example 8 : Negotiated transfer pricing

Market price of comparable imported product (per unit)	$ 1000-$1400
Delivery schedule	2 months
Production cost of selling division (per unit)	Rs.48,000
Delivery Schedule	As per buyer's Specification
Identifiable investments of selling division	Rs.1000 lacs
Minimum Target return on investments (%)	20
Selling & Distribution expenses for outside sales (per unit)	3000
Share of corporate expenses	Rs.80 lacs
Normal production (Units)	2000
Expected market price of selling division	Rs. In lacs
Production cost	800
Share of corporate expenses	80
Total cost	880
Plus return on investments	200
Expected total transfer price on inter-segment transfer	1080
Minimum transfer price (per unit)	0.54

Based on the production cost, share of corporate overheads and minimum target return, the selling division could offer a minimum quote of Rs.54,000 per unit. In case it gets a better buying quote from outside, say Rs.60,000, it may consider for a maximum quote of Rs.57,000 per unit net of selling and distribution overhead per unit, which would be negotiated for bulk inter-segment order for a longer term. On the other hand, the buying department may consider a minimum buying quote of Rs.48,000 (assuming conversion rate of $1 = Rs.48), however, it would be willing to pay more considering volatility of import price, volatility in exchange rate, longer delivery schedule etc. So the spread of negotiation is Rs.48,000 – Rs.57,000.

The pre-conditions using negotiated price are-

- Freedom of the buying and selling division to enter into buying and selling deals in case negotiated fails;
- Exchange of information between buying and selling division;
- Active arbitration cell.

Negotiated price is as a surrogate to market price. The buying and selling division enjoy the freedom to settle the deals as if they are operating in a competitive market. At the same time price differential with the prevailing market price is agreed upon rationally to avoid dysfunctional decision.

Appendix 1

List of Cost Accounting Record Rules (CARR) amended vide GRS indicated against each CARR to cover "Inter Company Transfer".

Industry	Amended by GRS No.	Dated
Cost Accounting Records (Bulk Drugs) Rules	707 (E)	28.09.2001
Cost Accounting Records (Cement) Rules, 1997	708 (E)	28.09.2001
Cost Accounting Records (Cycle) Rules, 1997	709 (E)	28.09.2001
Cost Accounting Records (Tyres & Tubes) Rules, 1967	710 (E)	28.09.2001
Cost Accounting Records (Caustic Soda) Rules, 1967	711 (E)	28.09.2001
Cost Accounting Records (Room Air Conditioners) Rules, 1967	712 (E)	28.09.2001
Cost Accounting Records (Refrigerators) Rules, 1967	713 (E)	28.09.2001
Cost Accounting Records (Batteries other than Dry Cell Batteries) Rules, 1967	714 (E)	28.09.2001
Cost Accounting Records (Electric Lamps) Rules, 1967	715 (E)	28.09.2001
Cost Accounting Records (Electric Fans) Rules, 1969	716 (E)	28.09.2001
Cost Accounting Records (Electric Motors) Rules, 1969	717 (E)	28.09.2001
Cost Accounting Records (Motor Vehicles) Rules, 1997	718 (E)	28.09.2001
Cost Accounting Records (Sugar) Rules, 1997	719 (E)	28.09.2001
Cost Accounting Records (Industrial Alcohol) Rules, 1997	720 (E)	28.09.2001
Cost Accounting Records (Jute Goods) Rules, 1975	721 (E)	28.09.2001
Cost Accounting Records (Paper) Rules, 1975	722 (E)	28.09.2001
Cost Accounting Records (Rayon) Rules, 1976	723 (E)	28.09.2001
Cost Accounting Records (Dyes) Rules, 1976	724 (E)	28.09.2001
Cost Accounting Records (Soda Ash) Rules, 1976	725 (E)	28.09.2001
Cost Accounting Records (Nylon) Rules, 1977	726 (E)	28.09.2001
Cost Accounting Records (Polyester) Rules, 1977	727 (E)	28.09.2001
Cost Accounting Records (Textiles) Rules, 1977	728 (E)	28.09.2001
Cost Accounting Records (Dry Cell Batteries) Rules, 1979	729 (E)	28.09.2001
Cost Accounting Records (Sulphuric Acid) Rules, 1980	730 (E)	28.09.2001
Cost Accounting Records (Engineering Industries) Rules, 1984	731 (E)	28.09.2001
Cost Accounting Records (Steel Tubes and Pipes) Rules, 1984	732 (E)	28.09.2001
Cost Accounting Records (Electric Cables and Conductors) Rules, 1984	733 (E)	28.09.2001
Cost Accounting Records (Bearings) Rules, 1985	734 (E)	28.09.2001
Cost Accounting Records (Chemical Industries) Rules, 1987	735 (E)	28.09.2001
Cost Accounting Records (Steel Plant) Rules, 1990	736 (E)	28.09.2001
Cost Accounting Records (Insecticides) Rules, 1993	737 (E)	28.09.2001
Cost Accounting Records (Fertilizers) Rules, 1993	738 (E)	28.09.2001
Cost Accounting Records (Soaps and Detergents) Rules, 1993	739 (E)	28.09.2001
Cost Accounting Records (Cosmetics and Toiletries) Rules, 1993	740 (E)	28.09.2001
Cost Accounting Records (Footwear) Rules, 1996	741 (E)	28.09.2001
Cost Accounting Records (Shaving Systems) Rules, 1996	742 (E)	28.09.2001
Cost Accounting Records (Industrial Gases) Rules, 1996	743 (E)	28.09.2001
Cost Accounting Records (Mining and Metallurgy) Rules, 2001	744 (E)	28.09.2001
Cost Accounting Records (Electronic Products) Rules, 2001	745 (E)	28.09.2001
Cost Accounting Records (Aluminium) Rules,	746 (E)	28.09.2001
Cost Accounting Records (Vanaspati) Rules,	747 (E)	28.09.2001
Cost Accounting Records (Milk Food) Rules,	749 (E)	28.09.2001
Cost Accounting Records (Formulations) Rules,	750 (E)	28.09.2001
Cost Accounting Records (Milk Food) Rules,	749 (E)	28.09.2001
Cost Accounting Records (Formulations) Rules,	750 (E)	28.09.2001
Cost Accounting Records (Electricity Industry) Rules 2001	913 (E)	21.12.2001

NOTIFICATION

New Delhi, the 28th September, 2001

Cost Accounting Records *(—) Amendment Rules, 2001.

INTER COMPANY TRANSFER

1 (1) These rules may be called the Cost Accounting Records *(——) Amendment Rules, 2001.

(2) They shall come into force on the date of their publication in the Official Gazette.

2. In the Cost Accounting Records *(———) Rules, 2001:- in schedule I, and item 24 and the entries relating thereto, the following shall be inserted namely:-

* For industry see Appendix 1.

Inter-Company Transfer:

(1) In respect of related party transactions or supplies made or services rendered by a company to its holding company or subsidiary or a company termed "related party relationship" as defined below and vice-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of:

(a) purchase and sale of raw materials, finished products, process materials, chemicals and rejected goods including scraps, etc;

(b) utilization of plant facilities and technical know-how;

(c) supply of utilities and any other services;

(d) administrative, technical, managerial or any other consultancy services;

(e) purchase and sale of capital goods including plant and machinery;

(f) any other payment related to production, processing or manufacturing of products under reference.

These records shall also indicate the basis followed for arriving at the rates charged or paid for such products or services so as to enable determination of the reasonableness of such rates in so far as they are in any way related to product under reference.

(2) The transactions by the following "related party relationship" shall be covered under sub-rule (1):-

(a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);

(b) associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;

(c) individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individuals;

(d) key management personnel and relatives of such personnel; and

(e) enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a number of key management in common with the reporting enterprise.

However, the following shall not be deemed as "related party relationships":-

(a) two companies simply because they have a Director in common, notwithstanding paragraph (d) or (e) above (unless the Director is able to affect the policies of both companies in their mutual dealings);

(b) a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence; and

(c) the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process);

   (i) providers of finance;

   (ii) trade unions;

   (iii) public utilities;

   (iv) government departments and government agencies including government sponsored bodies.

Explanation: For the purpose of these Rules:-

(a) "Related party relationships" means parties who are considered to be related if at 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 decision;

(b) **"Related party transaction"** means a transfer of resources or obligations between related parties, whether or not a price is charged;

(c) **"Control"** means

(i) ownership, directly or indirectly, or more than one half of the voting power of an enterprise; or

(ii) 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

(iii) a substantial interest in voting power and the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

(d) **"Significant influence"** means participation in the financial or operating policy decisions of an enterprise, but not control of those policies;

(e) **"Associate"** means an enterprise in which an investing reporting has significant influence and which is neither a subsidiary nor a joint venture of that party;

(f) **"Joint venture"** means a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control;

(g) **"Joint control"** means the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it;

(h) **"Key management personnel"** means those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise;

(i) **"Relative"** in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be connected by blood relationship;

(j) **"Holding company"** means a holding company within the meaning of Section 4 of the Companies Act, 1956 (1 of 1956);

(k) **"Subsidiary"** means a subsidiary company within the meaning of Section 4 of the Companies Act, 1956 (1 of 1956);

(l) **"Fellow subsidiary"** means a company is said to be a fellow subsidiary of another company if both are subsidiaries of the same holding company;

(m) **"State-controlled enterprise"** means an enterprise which is under the control of the Central Government or a State Government."

[F.No.52/01/CAB-2001]

A. RAMASWAMY, Joint
Secretary

SPECIAL PROVISIONS RELATING TO AVOIDANCE OF TAX

Extract from Income-Tax Act, 1961 the following sections 92 to 92F has been substituted for the existing section 92 by the Finance Act, 2001, w.e.f. 1.4.2002.

Computation of income from international transaction having regard to arm's length price.

92. (1) Any income arising from an international transaction shall be computed having regard to the arm's length price.

(2) In computing income under sub-section (1), the allowance for any expense or interest shall also be determined having regard to the arm's length price.

(3) Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to anyone or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

Meaning of associated enterprise.

92A. (1) For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise -

(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.

(2) Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year:-

(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, 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 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 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 person or body of individual, the other enterprise holds not less than ten per cent interest in such firm, association of person or body of individuals; or

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

Meaning of international transaction

92B. (1) For the purpose of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

Computation of arm's length price.

92C. (1) The arm's length price in relation to an international transaction 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 or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribed, namely:-

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

(b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,the Assesing Officer may proceed to determine the arm's length price in relation to the said international transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:

Provided that an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.

(4) Where an arm's length is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined:

Provided that no deduction under section 10A or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section:

Provided further that where the total income of an associated enterprise is computed under this sub-section or determination of the arm's length price paid to another associated enterprise from which tax has been deducted under the provisions of Chapter XVIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise.

Maintenance, and keeping of information and document by persons entering into international transaction.

92D. (1) Every person who has entered into an international transaction shall keep and maintain such information and document in respect thereof, as may be prescribed.

(2) Without prejudice to the provisions contained in sub-section (1), the Board may prescribe the period for which the information and document shall be kept and maintained under that sub-section.

(3) The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceeding under this Act, require any person who has entered into an international transaction to furnish any information or document in respect thereof, as may be prescribed under sub-section (1), within a period of thirty days from the date of receipt of a notice issued in this regard.

Provided that the Assessing Officer or the Commissioner (Appeals) may, on an application made by such person, extend the period of thirty days by a further period not exceeding thirty days.

Report from an accountant to be furnished by persons entering into international transaction.

92E. Every person who has entered into an international transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed.

Definitions of certain terms relevant to computation of arm's length price, etc.

92F. In sections 92, 92A, 92B, 92C, 92D and 92E, unless the context otherwise requires:-

(i) "accountant" shall have the same meaning as in the Explanation below sub-section (2) of section 288;

(ii) "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;

(iii) "enterprise" means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or 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 other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places;

(iv) "specified date" means,-

(a) where the assessee is a company, the 31st day of October of the relevant assessment year;

(b) in any other case, the 31st day of July of the relevant assessment year;

(v) "transaction" includes an arrangement, understanding or action in concert:-

(A) whether or not such arrangement, understanding or action is formal or in writing; or

(B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

Transfer Pricing Guidelines Income-Tax (21st Amendment) Rules, 2001

[Issued by the Ministry of Finance (Department of Revenue) (Central Board of Director Taxes) vide F.No.142/41/2001-TPL; Published in the Gazette of India Extraordinary in Part-II, Section 3, Sub-section (ii) dated 21-8-2001]

Notification

S.O.808(E) – In exercise of powers conferred by section 295, read with section 92C, 92D and 92E of the Income-tax Act, 1961 (43 of 1961), the Central Government hereby makes the following rules further to amend the Income-tax Rules, 1962, namely:-

1. (i) These rules may be called the Income-tax (21st Amendment) Rules, 2001

   (ii) They shall come into force on the date of their publication in the Official Gazette.

2. In the Income-tax Rules, 1962,-

   (i) after rule 10, the following rules shall be inserted, namely:-

"10A. Meaning of expressions used in computation of arm's length price

For the purpose of this rule and rules 10B to 10E,-

(a) 'uncontrolled transaction' means a transaction between enterprises other than associated enterprises, whether resident or non-resident;

(b) 'property' includes goods, articles or things, and intangible property;

(c) 'services' include financial services;

(d) 'transaction' includes a number of closely linked transactions.

10B. Determination of arm's length price under section 92C

(1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely:-

(a) comparable uncontrolled price method, by which,-

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

(ii) such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transaction, which could materially affect the price in the open market;

(iii) the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction;

(b) resale price method, by which,-

(i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;

(ii) such resale price is 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 property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;

(iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;

(iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international 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;

(v) the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise.

(c) cost plus method, by which,-

(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;

(ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;

(iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprise entering into such transactions, which could materially affect such profit mark-up in the open market;

(iv) the costs referred to in sub-clause(i) are increased by the adjusted profit mark-up arrived at under sub-clause(iii);

(v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise.

(d) profit split method, which may be applicable mainly in international transactions involving transfer of unique intangibles or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which-

(i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;

(ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicate how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;

(iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause(ii);

(iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction:

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction;

(e) transactional net margin method, by which,-

(i) the net profit margin realized by the enterprise from an international transactional transaction entered into with an associated enterprise is 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;

(ii) the net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause(ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realized by the enterprise and referred to in sub-clause(i) is established to be the same as the net profit margin referred to in sub-clause(iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

(2) For the purposes of sub-rule(1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following namely:-

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction if-

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in , or the profit arising from, such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) The data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

10C. Most appropriate method

(1) For the purposes of sub-section(1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.

(2) In selecting the most appropriate method as specified in sub-rule(1), the following factors shall be taken into account, namely:-

(a) the nature and class of the international transaction;

(b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

(c) the availability, coverage and reliability of data necessary for application of the method;

(d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions;

(e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(f) the nature, extent and reliability of assumptions required to be made in application of a method.

10D. Information and documents to be kept and maintained under section

92D

(1) Every person who has entered into an international transaction shall

keep and maintain the following information and documents, namely:-

(a) a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises;

(b) a profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them;

(c) a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted;

(d) the nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;

(e) a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction;

(f) a record of the economic and market analysis, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee;

(g) a record of uncontrolled transactions taken into account for analyzing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;

(h) a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

(i) a description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case;

(j) a record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;

(k) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;

(l) details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes;

(m) any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

(2) Nothing contained in sub-rule (1) shall apply in a case where the aggregate value, as recorded in the books of account, of international transactions entered into by the assessee does not exceed one crore rupees :

Provided that the assessee shall be required to substantiate, on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with section 92.

(3) The information specified in sub-rule(1) shall be supported by authentic documents, which may include the following:

(a) official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;

(b) reports of market reach studies carried out and technical publications brought out by institutions of national or international repute;

(c) price publications including stock exchange and commodity market quotations;

(d) published accounts and financial statements relating to the business affairs of the associated enterprises;

(e) agreement and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;

(f) letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

(g) documents normally issued in connection with various transactions under the accounting practices followed.

(4) The information and documents specified under sub-rules (1) and (2), should, as far as possible, be contemporaneous and should exist latest by the specified date referred to

in clause (iv) of section 92F:

Provided that where an international transaction continues to have effect over more than one previous years, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature or terms of the international transaction, in the assumptions made, or in any other factor which could influence the transfer price, and in case of such significance change, fresh documentation as may be necessary under sub-rules (1) and (2) shall be maintained bringing out the impact of the change on the pricing of the international transaction.

(5) The information and documents specified in sub-rules (1) and (2) shall be kept and maintained for a period of eight years from the end of the relevant assessment year.

10E. Report from an accountant to be furnished under section 92E

The report from an accountant required to be furnished under section 92E by every person who has entered into an international transaction during a previous year shall be in Form No. 3CEB and be verified in the manner indicated therein:-

(ii) Rule 11 shall be omitted;

(iii) in the appendix, after For No.3CEA, the following form shall be inserted.

CENTRAL EXCISE VALUATION (DETERMINATION OF PRICE OF EXCISABLE GOODS) RULES, 2000

[Issued by the Ministry of Finance (Department of Revenue) vide F.No.354/81/2000-TRU; Published in the Gazette of India Extraordinary Part II, Section 3, Sub-section (i) dated 30.6.2000].

NOTIFICATION [No. 45/2000-Central Excise (N.T.)]

G.S.R.575(E):- In exercise of the powers conferred by section 37 of the Central Excise Act, 1944 (1 of 1944), and in supersession of the Central Excise (Valuation) Rules, 1975 except as respect things done or omitted to be done before such supersession, the Central Government hereby makes the following rules, namely:-

1. (1) These rules may be called the Central Excise Valuation (Determination of Price of Excisable Goods) Rules, 2000.

   (2) They shall come into force on and from the 1st day of July, 2000.

CHAPTER I

PRELIMINARY

2. In these rules, unless the context otherwise requires:-

   (a) "Act" means the Central Excise Act, 1944 (1 of 1944)

   (b) "normal transaction value" means the transaction value at which the greatest aggregate quantity of goods are sold;

   (c) "value" means the value referred to in section 4 of the Act;

   (d) words and expressions used in these rules and not defined but defined in the Act shall have the meanings respectively assigned to them in the Act.

CHAPTER II

DETERMINATION OF VALUE

3. The value of any excisable goods shall, for the purposes of clause (b) of sub-section (1) of section 4 of the Act, be determined in accordance with these rules.

4. The value of the excisable goods shall be based on the value of such goods sold by the assessee for delivery at any other time nearest to the time of the removal of goods under assessment, subject, if necessary, to such adjustment on account of the difference

in the dates of delivery of such goods and of the excisable goods under assessment, as may appear reasonable.

5. Where any excisable goods are sold in the circumstances specified in clause (a) of sub-section (1) of section 4 of the Act except the circumstance in which excisable goods are sold for delivery at a place other than the place of removal, then the value of such excisable goods shall be deemed to be the transaction value, excluding the actual cost of transportation from the place of removal upto the place of delivery of such excisable goods provided the cost of transportation is charged to the buyer in addition to the price for the goods and shown separately in the invoice for such excisable goods.

6. Where the excisable goods are sold in the circumstances specified in clause (a) of sub section (1) of section 4 of the Act except the circumstance where the price is not the sole consideration for sale, the value of such goods shall be deemed to be the aggregate of such transaction value and the amount of money value of any additional consideration flowing directly or indirectly from the buyer to the assessee.

Explanation:- For removal of doubts, it is hereby clarified that the value, apportioned as appropriate, of the following goods and services, whether supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale of such goods, to the extent that such value has not been included in the price actually paid or payable, shall be treated to be the amount of money value of additional consideration flowing directly or indirectly from the buyer to the assessee in relation to sale of the goods being valued and aggregated accordingly, namely:-

(i) value of materials, components, parts and similar items relatable to such goods;

(ii) value of tools, dies, moulds, drawings, blue prints, technical maps and charts and similar items used in the production of such goods;

(iii) value of materials consumed, including packaging materials, in the production of such goods;

(iv) value of engineering, development, art work, design work and plans and sketches undertaken elsewhere than in the factory of production and necessary for the production of such goods.

7. Where the excisable goods are not sold by the assessee at the time and place of removal but are transferred to a depot, premises of a consignment agent or any other place or premises (hereinafter referred to as "such other place") from where the excisable goods are to be sold after their clearance from the place of removal and where the assessee and the buyer of the said goods are not related and the price is the sole consideration for the sale, the value shall be the normal transaction value of such goods

sold from such other place at or about the same time and, where such goods are not sold at or about the same time, at the time nearest to the time of removal of goods under assessment.

8. 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.

9. 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 buyer (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:

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.

10. When the assessee so arranges that the excisable goods are not sold by him except to or through an inter-connected undertaking, the value of goods shall be determined in the following manner, namely:-

(a) If the undertakings 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.

Explanation:- In this clause "holding company" and "subsidiary company" shall have the same meanings as in the Companies Act, 1956 (1 of 1956).

(b) in any other case, the value shall be determined as if they are not related persons for the purpose of sub-section (1) of section 4.

11. If the value of any excisable goods cannot be determined under the foregoing rules, the value shall be determined using reasonable means consistent with the principles and general provisions of these rules and sub-section (1) of section 4 of the Act.

T.R. RUSTAGI
Joint Secretary to the Govt. of India

Extract from Custom Valuation (Determination of Price of Imported Goods) Rules, 1988

Rules:

3. Determination of the method of valuation – For the purpose of these rules:-

(i) the value of imported goods shall be the transaction value;

(ii) if the value cannot be determined under the provisions of clause (i) above, the value shall be determined by proceeding sequentially through Rules 5 to 8 of these rules.

4. Transaction value:-

(1) The transaction value of imported goods shall be the price actually paid or payable for the goods when sold for export to India, adjusted in accordance with the provisions of Rule 9 of these rules.

(2) The transaction value of imported goods under sub-rule (1) above shall be accepted:

Provided that:-

(a) there are no restrictions as to the disposition or use of the goods by the buyer other than restrictions which –

(i) are imposed or required by law or by the public authorities in India; or

(ii) limit the geographical area in which the goods may be resold; or

(iii) do not substantially affect the value of the goods;

(b) the sale or price is not subject to same condition or consideration for which a value cannot be determined in respect of the goods being valued;

(c) no part of the proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue directly or indirectly to the seller, unless an appropriate adjustment can be made in accordance with the provisions of Rule 9 of these rules; and

(d) the buyer and seller are not related, or where the buyer and seller are related, that transaction value is acceptable for customs purposes under the provisions of sub-rule (3) below.

(3) (a) 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.

(b) In a sale between related persons, the transaction value shall be accepted, whenever 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;

[1][(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 cost incurred by the seller in sales in which he and the buyer are not related;

(c) substitute values shall not be established under the provisions of clause (b) of this sub-rule.

5. Transaction value of identical goods:-

(1)(a) Subject to the provisions of Rule 3 of these rules, the value of imported goods shall be the transaction value of identical goods sold for export to India and imported at or about the same time as the goods being valued.

(a) In applying this rule, the transaction value of identical goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued shall be used to determine the value of imported goods.

(b) Where no sale referred to in clause (b) of sub-rule (1) of this rule, is found, the transaction value of identical goods sold at a different commercial level or in different quantities or both, adjusted to take account of the difference attributable to commercial level or to the quantity or both, shall be used, provided that such adjustments shall be made on the basis of demonstrated evidence which clearly establishes the reasonableness and accuracy of the adjustments, whether such adjustment leads to an increase or decrease in the value.

(2) Where the costs and charges referred to in sub-rule (2) of Rule 9 of these rules are included in the transaction value of identical goods, an adjustment shall be made, if there are significant

differences in such costs and charges between the goods being valued and the identical goods in question arising from differences in distances and means of transport.

1. Inserted by M.F.(D.R.) Notification 26/95-Cus. (N.T.), dated 24.4.1995.

(3) In applying this rule, if more than one transaction value of identical goods is found; the lowest such value shall be used to determined the value of imported goods.

6. Transaction value of similar goods:-

(1) Subject to the provisions of Rule 3 of these rules, the value of imported goods shall be the transaction value of similar goods sold for export to India and imported at or about the same time as the goods being valued.

(2) The provisions of clauses (b) and (c) of sub-rule (1), sub-rule (2) and sub-rule (3), of Rule 5 of these rules shall, mutates mutandis, also apply in respect of similar goods.

[1][**6A. Determination of value when transaction value is not available.**

If the value of imported goods cannot be determined under the provisions of rules 4, 5 and 6, the value shall be determined under the provisions of rule 7 or, when the value cannot be determined under that rule, under rule 7A: Provided that at the request of the importer, and with the approval of the proper officer, the order of application of rules 7 and 7A shall be reversed.]

7. Deductive value:-

(1) Subject to the provisions of Rule 3 of these rules, if the goods being valued or identical or similar imported goods are sold in India, in the condition as imported at or about the time at which the declaration for determination of value is presented, the value of imported goods shall be based on the unit price at which the imported goods or identical or similar imported goods are sold in the greatest aggregate quantity to persons who are not related to the sellers in India, subject to the following deductions:-

(i) either the commission usually paid or agreed to be paid or the additions usually made for profits and general expenses in connection with sales of India of imported goods of the same class or kind;

(ii) the usual costs of transport and insurance and associated costs incurred within India;
(iii) the customs duties and other taxes payable in India by reason of importation or sale of the goods.
(2) If neither the imported goods nor identical nor similar imported goods are sold at or about the same time of importation of the goods being valued, the value of imported goods shall, subject otherwise to the provisions of sub-rule (1) of this rule, be based on the unit price at which the imported goods or identical or similar imported goods are sold in India, at the earliest date after importation but before the expiry of ninety days after such importation.

1. Inserted by M.F.(D.R.)Notification No. 26/95-Cus.(N.T.), dated 24.4.1995.

(3) (a) If neither the imported goods nor identical nor similar imported goods are sold in India in the condition as imported, then, the value shall be based on the unit price at which the imported goods, after further processing, are sold in the greatest aggregate quantity to person who are not related to the seller in India.

(b) In such determination, due allowance shall be made for the value added by processing and the deductions provided for in items (i) to (iii) of sub-rule (1) of this rule.

[1][**7A. Computed value:-** Subject to the provisions of rule 3, the value of imported goods shall be based on a computed value, which shall consist of the sum of:-

(a) the cost or value of materials and fabrication or other processing employed in producing the imported goods;

(b) an amount for profit and general expenses equal to that usually reflected in sales of goods of the same class or kind as the goods being valued which are made by producers in the country of exportation for export to India;

(c) the cost or value of all other expenses under sub-rule (2) of rule 9 of these rules.]

8. Residual method:-

(1) Subject to the provisions of Rule 3 of these rules, where the value of imported goods cannot be determined under the provisions of any of the preceding rules, the value shall be determined using reasonable means consistent which the principles and general provisions of these rules and sub-section (1) of Section 14 of the Customs Act, 1962 (52 of 1962) and on the basis of data available in India.

(2) No value shall be determined under the provisions of [2][this rule] on the basis of :-

(i) the selling price in India of the goods produced in India;

(ii) a system which provides for the acceptance for customs purposes of the highest of the two alternative values;

(iii) the price of the goods on the domestic market of the country of exportation;

[1][(iiia) the cost of production other than computed values which have been determined for identical or similar goods in accordance with the provisions of rule 7A.]

(iv) the price of the goods for the export to a country other than India;

(v) minimum customs values; or

(vi) arbitrary or fictitious values.

1. Inserted by M.F.(D.R.) Notification No.26/95-Cus.(N.T.), dated 24.4.1995.
2. Substituted by M.F.(D.R.) F. No.528/167/88-Cus.(TV)/ICD, dated 6.9.1988.

9. Cost and services:-

(1) In determining the transaction value, there shall be added to the price actually paid or payable for the imported goods:-

(a) the following cost and services, to the extent they are incurred by the buyer but are not included in the price actually paid or payable for the imported goods, namely:-

(i) commissions and brokerage, except buying commissions;

(ii) the cost of containers which are treated as being one for customs purposes with the goods in question;

(iii) the cost of packing whether for labour or materials;

(b) the value, apportioned as appropriate, of the following goods and services where supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale for export of imported goods, to the extent that such value has not been included in the price actually paid or payable, namely:-

(i) materials, components, parts and similar items incorporated in the imported goods;

(ii) tools, dies, moulds and similar items used in the production of the imported goods;

(iii) materials consumed in the production of the imported goods;

(iv) engineering, development, at work, design work, and plans and sketches undertaken elsewhere than in India and necessary for the production of the imported goods;

1. Inserted by M.F.(D.R.) Notification No.26/95-Cus.(N.T.), dated 24.4.1995.

(c) royalties and licence fees related to the imported goods that the buyer is required to pay, directly or indirectly, as a condition of the sale of the goods being valued, to the extent that such royalties and fees are not included in the price actually paid or payable;

(d) the value of any part of the proceeds of any subsequent resale, disposal or use of the imported goods that accrues, directly or indirectly, to the seller;

(e) all other payments actually made or to be made as a condition of sale of the imported goods, by the buyer to the seller, or by the buyer to a third party to satisfy an obligation of the seller to the extent that such payments are not included in the price actually paid or payable.

(2) For the purpose of sub-section (1) and sub-section (1A) of Section 14 of the Customs Act, 1962 (52 of 1962) and these rules, the value of the imported goods shall be the value of such goods, for delivery at the time and place of importation and shall include:-

(a) the cost of transport of the imported goods to the place of importation;

(b) loading, unloading and handling charges associated with the delivery of the imported goods at the place of importation; and

(c) the cost of insurance:

1[Provided that –

(i) where the cost of transport referring to in clause (a) is not ascertainable, such cost shall be twenty per cent of the free on board value of the goods;

(ii) the charges referred to in clause (b) shall be one per cent of the free on board value of the goods plus the cost of transport referred to in clause (a) plus the cost of insurance referred to in clause (c);

(iii) where the cost referred to in clause to in clause (c) is not ascertainable, such cost shall be 1.125% of free on board value of the goods;

Provided further that in the case of goods imported by air, where the cost referred to in clause (a) is ascertainable, such cost shall not exceed twenty per cent of free on board value of the goods:

Provided also that where the free on board value of the goods is not ascertainable, the costs referred to in clause (a) shall be twenty per cent of the free on board value of the goods plus cost of insurance for clause (i) above and the cost referred to in clause (c) shall be 1.125% of the free on board value of the goods plus cost of transport for clause (iii) above].

(3) Additions to the price actually paid or payable shall be made under this rule on the basis of objective and quantifiable data.

(4) No addition shall be made to the price actually paid or payable in determining the value of the imported goods except as provided for in this rule.

INSTITUTE PUBLICATIONS

A. GUIDELINES

	Rs.
Financial Service and WTO	100
Antidumping, Countervaling and Safeguard Duties Under WTO - Relevance for & Management Accountants	200
Managing The Bottom Line - A Guide to Management Accounting for Small Business	120
Guidelines of Transfer Pricing	150
Intellectual Property Rights- Relevance to the Accounting Profession (Ed. 98)	100
Handbook on Activity Based Costing (Ed. 98)	150
Handbook on Total Cost Management in the Manufacturing Industries (Ed. 98)	150
Introduction & Implementation of Cost & Management Accounting Systems (Ed 98)	80
Developing Cost Records - A Practical Approach (Ed. 98)	60
Guidelines of Central Excise -MODVAT Audit (Ed. 98)	50
Fields for Practising Cost Accountants (Abridged) (Revised 98)	20
Guidelines on Capacity Determination (Second Revised Edition, 97)	20
Guidance Notes on Valuation Audit under Central Excise Law (Third Revised Edition, 99)	80
Guidelines on Cost Audit (4th Revised edition, 98)	100
Cost Audit Social Objectives	5
Environment Audit and Role of Cost Accountants	60
Guidelines in Certification of Cash Compensatory Support	20
Compendium-Fields for Practising Cost Accountants (Revised Ed., 1998)	200
A source book for Tax Audit	100
Service Tax and Cost Accountants	125
Basics of Foreign Exchange for Management Accountants	200
Costing in Leather Goods (Shoes/Garments) (Edition, 2001)	80
Costing in Leather Processing Industry (Edition, 2001)	80
CAS-1 on "Classification of Cost"	30

B. RESEARCH PUBLICATIONS

	Rs.
Modvat Audit : A Practice Manual	75
Financing Asset Replacement	10
Inflation Accounting as a Tool to Fight Inflation	35
Corporate Governance and Management Audit	250
An Analysis of The Cost Behaviour with respect to Indian Industry	150
Glossary of Management Accounting Terms (Revised Ed. 98)	100
Corporate Capital Structure and Cost of Capital	50
Management Information Report for Operating Managers	150
Farm Management Accounting and Control	70
Management Accountant and the Computer	50
Management and Accounting for Research and Development- The Indian Praxis	125
Research Bulleting (Biannual each issue) Vol.- V to XVII	100
Vol.- XVIII to XIX	120
Profit Planning	60
Mutual Funds in India	200
Human Resource Accounting	150
Target Costing	150

C. INDUSTRY-WISE PUBLICATIONS

Cost Accounting Records Rules and Cost Audit (Report) Rules :

	Rs.
Cycle Industry (Revised Ed. 1999)	100
*Cement Industry	50
Automobile Battery Industry	50
Tyre and Tube Industry	50
Tractor Industry	50
Motor Vehicles Industry (Revised Ed., 1999)	100
Room Air-Conditioners Industry	50
Refrigerator Industry	50
Electric Fan industry	50
Aluminium Industry	50
Vanaspati Industry	50
Industrial Alcohol (Revised Ed., 1999)	100
Sugar Industry (Revised Ed., 1999)	100
*Paper Industry	50
Textile Industry (Revised Ed.,2001)	150
Soda Ash Industry	50
Jute Industry	50
Rayon Industry (Revised Ed.,2001)	150
Dry Cell Battery Industry	50
Power Driven Pump Industry	50
Electric Cables and Conductors Industry	50
Sulphuric Acid Industry	50
Steel Tubes & Pipes Industry	50
Formulation Industry	50
Mini Steel Plant Industry	50
Fertilizer Industry	50
Electric Lamp Industry	50
Electric Motor Industry	50
Insecticides (Tech. Grade) Industry	50
Nylon Industry (Revised Ed.,2001)	150
Infant Milk Food Industry	50
Caustic Soda	50
*Dyes	50
*Bulk Drugs Industry (Revised Ed., 1998)	125
Costmetics & Toiletries Industry(Ed.2001)	150
Shaving Systems Industry (Ed.2001)	150
Polyster Industry (Ed. 2001)	150
Footwear (Ed. 2002)	150
Soaps & Detergent Industry (Ed.2002)	150
Industrial Gases Industry (Ed.2002)	150

***Out of stock.**