

Analysis of EXPORT FILTER used in Transfer Pricing

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Abstract: *In* determination of ALP the main issue is to find the suitable comparables or closer comparables. The issue becomes more complex, when OECD and income tax guidelines do not indicate requirement of parameter, if any, to be applied to eliminate companies not having comparable business. The current research paper identifies certain parameters as filters and explores its efficacies in determining comparable companies to arrive at ALP. The research is done against the backdrop of OECD guidelines in this regards and attempts to justify that more than 50% than sales turnover can be considered as a filter required to effectively measure the comparability.

Keywords

1. Transfer Pricing
2. Export Filter
3. OECD Guidelines
4. Income tax ACT

Background of Study

Transfer pricing regulations in India requires that an international transaction between two associated enterprises (AEs) should be at an Arm's Length Price (ALP). This process of determination of Arm's Length Price mainly consists of three steps

1. To carry out the analysis of functions performed, assets employed and risks assumed by the company.
2. To find out the similar companies that with the assessee company
3. To make any adjustment in price on account of difference in (ii)

The determination of arm's length price therefore depends upon the quality of analysis so carried. The present research aims to address various issues arising in finding the closer comparable companies in transfer pricing analysis.

The Organization of the Research Paper is as under

1. Concept of transfer pricing
2. Identification of the problem
3. Analysis of the statutory provisions under the income tax act
4. Conclusion and recommendations.

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Concept of Transfer Pricing

Transfer pricing refers to the price charged by one entity during the transaction enters with the other entity of the same group. The transaction may be related to sale/purchase of the product or sale/purchase of services or may be even related to cost sharing arrangement. Since the transaction takes place within two entities of the same group which are controlled by the same management, it is also referred as controlled transaction. Transfer pricing study examines the pricing of such controlled transaction with the uncontrolled transactions (i.e. transaction between unrelated parties).

Description of the Analysis

Determination of Arm's Length Price in transfer pricing revolves around issue of finding suitable comparables from publically available data. To find out such comparables is not an easy task, mainly because in reality, none of the two companies operate in same business with almost identical terms & conditions. Therefore the in transfer pricing analysis efforts are made to find the closer comparables. To find out such comparables elimination process is used. Once the data base of the company is procured, certain filters are applied. The companies that crosses these filters is considered as a closer comparable for transfer pricing analysis. Selection of such filters also creates some kind of disputes in determination of arms length price.

Interestingly, none of these filters have been prescribed by any authority including OECD Guidelines and Income tax Act.

Various steps that are used in comparable analysis:

The prominent filters used in the comparability analysis are:

- (i) Insufficient financial data;
(Companies that do not have sufficient financial data available in public domain are eliminated)
- (ii) No operations/ Sick companies/ persistent loss makers
(Companies that do not have any operations during the relevant year/ or companies which are Sick / companies with persistent loss are eliminated)
- (iii) Functionally different;
(Companies that do not have functional similarity are eliminated)
- (iv) Companies having significant related party transactions (Companies that are having significant related party transactions are eliminated)
- (v) Companies with exceptional year(s) of operations
(Companies that are having exceptional year of operation are eliminated)
- (vi) Turnover
(This filter is selected on the basis of the turnover of Indian company. Accordingly the company having too low turnover or huge turnover are eliminated)
- (vii) Export percentage (This filter is selected on the basis percentage of export earnings of the comparable companies. Companies having export turnover below certain percentage are eliminated)

The present study revolves around the export filter selected in comparability analysis Identification of the problem:

In transfer pricing analysis of functions, risk and assets of the companies plays an important role. The issue arises as to whether companies which are having similar functions, risk and assets are

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also required to pass through export filter? With this background, issue requires to be addressed are-

1. Whether Company which is 100% exporter be compared with the company having domestic business?
2. In transfer pricing analysis when, Functional analysis, assets employed and risk borne by the entities are having prime importance then can company be considered not comparable only based on the location of the customer?
3. Even it is admitted that prices does get affected due to location of the customer, does it necessarily affect the net margins of the company, which are dependent on the expenses incurred for earning the income?
4. If the export filter is applied what should be the limit for such export filter?

Analysis of the problem with reference to statutory provisions

Provisions of the Income Tax Act and Rules

Rule 10A(ab) ¹

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

The rule does not put any bar in selecting the comparable company.

Thus as per rule 10A (ab), there is no specific requirement of export filter.

Source: Income tax Rules 1962

TNMM Method

As per the ratio laid down in the case of e-gain communications in the case of Pune ITAT (2008 23 SOT 385 (Pune)) ²

One strength of the transactional net margin method is that net margins (e.g. return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP Method. The net margins also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits.

As per the ratio laid down, it is equally true that in TNMM, broad functionality is required to consider. There is no specific requirement of locations of the enterprise.

Thus as per strengths of TNMM, again there is no specific requirement of export filter.

Rule 10B (2)(d) ³

For the purposes of sub-rule (1), the comparability of an international transaction [or a specified domestic 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;
 - 1. Source: 2008 23 SOT 385 (Pune))
 - 2. Source: Income tax Rules 1962
- 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.

This rule though does not lay down express requirement of export filter. However it mandates that the comparability of an international transaction should be judged with reference to market conditions, geographical location, Size of the market, Costs of labour, Overall economic development and Level of competition etc.

Therefore, though rule 10A(ab) and TNMM does not specify requirement of export filter, 10B(2)(d) mandates to consider the markets condition, the geographical location, the size of the market, costs of labor, overall economic development and level of competition,

Thus this rule highlights the importance and necessity of turnover filter

Now next issue is to whether export filter of 75% should be applied or can be it lowered down below:

Reference can be drawn from *OECD guidelines reproduced below*⁴

“Arm’s length prices may vary across different markets even for transactions involving the same property or services; therefore to achieve comparability requires that the markets in which the independent and associated enterprises operate are comparable, and that differences do not have a material effect on price or that appropriate adjustments can be made.

The levels of supply and demand in the market as a whole and in particular regions, if relevant, consumer purchasing power, the nature and extent of government regulations of the market, costs of production, including the costs of land, labour and capital, transport costs, the level of market (wholesale or retail).....”

Source: TRANSFER PRICING GUIDELINES published by OECD in July 2010

Conclusion

Thus facts emerge from OECD Guidelines and income tax are

- 1. The operating markets should be same or similar in the case of taxpayer and the comparable.
- 2. Differences in overall economic development, purchase power parity, business model, cost arbitrage and also level of competition need to be considered.

Recommendations

Thus it is very much clear that comparable company should have substantial export activity. As per the dictionary meaning of substantial, it means “considerable, real, material, weighty, solid,

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sizeable, meaningful, significant, important, notable, major, marked, valuable, useful, worthwhile etc.

This definition supports the view that export filter should not be kept at lower level. Companies need to be selected having substantial export. The word substantial indicates that the major portion of the earnings of the company from export market. This could lead to inference that the companies having export higher than 50% of the sales should be selected as comparables. Companies having export less than 50% may not be fit into the rules of comparability.

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