Determination of Arm’s Length of Price. 
Income Tax vs Customs

Suhas Kulkarni¹ and Prof. Dr. H. G. Abhyankar²

Research Scholar,
¹Bharti Vidyapeeth Deemed University,
Institute of Management and Entrepreneurship Development
²Gokhale Institute of Politics and Economics, Pune

Abstract:
Transfer pricing analysis, always revolves around the issue of determination of Arms Length Price. Determination of arm’s length price ensures that there is no tax evasion by the domestic company by artificially fixing the price, which is more suitable to its counterparts situated in lower tax jurisdiction.

In the present research paper, the researcher has tried to identify the issues of determination of Arm’s Length Price keeping in view of two revenue departments of the government, viz., Income tax department as well as customs department. The research is done against the backdrop of OECD guidelines in this regards and attempts to justify that the government should regulate both of its wings in appropriate manner and it is the need of the time that statutes should be amended in such a way that once valuation arrived by one of the authority, it should be binding on the other authority.

Key Words: Transfer Pricing, OECD Guidelines, Income tax Act, Customs Duty, Direct and Indirect Tax

Background of Study:
Whenever there is a cross border transaction relating to transfer of goods between the two units of same multinational group, takes place, value of such transaction plays a crucial role between the multi-national corporations as well as for the two wings of the government, viz., Income Tax and Customs Authorities. Both these revenue authorities are greatly concerned about valuation of such transactions as it has direct bearing on both the direct and indirect taxes.

Identification of the problem:
Value or the price of the transaction in a cross-border transaction is important from the point of assessing Customs duty on the transactions. The same is also important for arriving the profits of the entity under the income tax assessments. Both these statutes mandate that the transactions between related parties or Associate Enterprises should be priced as per the market forces prevalent for similar transaction between independent parties in order to prevent shifting of tax from high taxed country to low taxed country. Therefore, Customs authorities always would like to see as to whether the transaction has been underpriced to reduce the customs duty, while The Income Tax authorities always would like to see as to whether the transaction has been overpriced so as to reduce the profit, ultimately leading to lower profit and lower income tax.

Therefore, Customs authority while assessing the transaction value, always inclined to determine the price higher than the stated price so as to prevent Customs duty leakages. On the other hand, Income Tax authority while assessing the transaction value, always inclined to determine the price lowers than the stated price so as to prevent Income tax leakages.

Thus, there lies an inherent conflict of interests between Customs and Income Tax Authorities, two wings of the same government. This is mainly because assessment carried out by both the departments is based on different principles while viewing the valuation of imported goods.

Analysis of the problem with reference to statutory provisions:
Customs Valuation as well as Transfer Pricing rules under Income Tax act, both are based on fair value of the transactions. However, the international rules and guidelines are different in Customs and Income Tax domains. Assessment under Customs is guided through provisions on related party transactions, based on the World Trade Organization (WTO) Agreement on Customs Valuation. Income Tax authorities are guided by the ‘arm’s length principle’ published in the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines.

Under the Customs Rules, the ‘Assessable Value’ is the invoice value (i.e. ‘Transaction Value’). If the custom authority does not accept the ‘Transaction Value’ as the ‘Assessable Value’, then the case is referred to the Special Valuation Branch.
(SVB), for determination of the ‘Assessable Value’.

**Valuation under Customs Act:**
Different methods for valuation of imported goods are prescribed under Rule 4 to Rule 9 of the Customs Valuation Rules viz:
(i) Transaction Value (Rule 4);
(ii) Transaction Value of identical goods (Rule 5);
(iii) Transaction Value of similar goods (Rule 6);
(iv) Deductive Value (Rule 7);
(v) Computed Value (Rule 8); and
(vi) Residual method (Rule 9).

As per the rule 4, except in specified circumstances the ‘Transaction Value’ of the goods should be considered for determining duty on imported goods. If any of the conditions specified in Rule 4 are not met with, application of Rules 5 to Rule 9 is considered.

Methods prescribed under Rules 5 to 9 are independent of each other. They are to be applied sequentially. i.e If conditions prescribed under rule 5 is not met, then the one has to go rule 6 and so on. Use of residual Method directly for the valuation is not allowed under the Customs Act.

Vide Notification No.41/2001-NT dated 26th June 2001, two important amendments has been made by the government to the Valuation Rules

Firstly, the invoice value of imported goods shall be considered the ‘Transaction Value’, unless the customs officer has a reason to believe that the taxpayer has not declared the true value of the transaction.

Secondly, Rule 4(2) suggests four conditions to be verified before not considering the ‘Transaction Value’ as ‘Assessable Value’.

**Special Valuation Branch (‘SVB’) of Customs**
The SVB is a separate wing for determining the value of transactions involving special relationships which has a direct bearing on the value of import goods

**Transfer Pricing Under Income Tax Act:**
As per the income tax provisions, any income arising from an international transaction between associated enterprises it should be computed on the basis of arm’s length price (ALP). The concept of ‘Associated enterprises’ and ‘arms length principle’ has been defined in detail.

Arms Length Price is required to be determined by using any one method from the prescribed methods. Six different methods as prescribed by the Income Tax act are (i) Comparable Uncontrolled Price method (CUP), (ii) Resale Price method (RPM), (iii) Cost plus method (CPM), (iv) Transactional Net Margin method(TNMM), (v) Profit Split method (PSM) and (vi) A residual method known as “any other method”. Regulations do not provide any hierarchy of the methods. It only specifies the concept of “most appropriate method” under the facts and circumstances of the case.

The essential distinctions between the scope and purpose of the Customs Valuation regulations and the Transfer pricing guidelines are:

<table>
<thead>
<tr>
<th>Transfer pricing Under Income Tax Act</th>
<th>Customs Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>It not only deals with the transaction related to goods, services and intangibles but also deals with the transactions such as lending or borrowing of money.</td>
<td>It deals only with the transaction related to import of transfer of goods.</td>
</tr>
<tr>
<td><strong>Higher the value of imported goods, lower is the profitability resulting to lower tax effect.</strong></td>
<td><strong>Lower is the import value of goods. Lower is the customs duty.</strong></td>
</tr>
<tr>
<td>Assessment of the transaction is at the end of the financial year.</td>
<td>Assessment of Customs duty is per transaction.</td>
</tr>
<tr>
<td>Rules are applicable only to international transactions between associated related parties.</td>
<td>Rules are applicable to transactions between unrelated parties also.</td>
</tr>
<tr>
<td>No hierarchy of methods is required to be followed.</td>
<td>The hierarchy of methods has to be followed.</td>
</tr>
<tr>
<td>Deviation up to the extent of 5% from the ALP is allowed.</td>
<td>No such deviation.</td>
</tr>
<tr>
<td>Extensive documentation requirements are prescribed in the Income Tax Act.</td>
<td>No such specific documentation requirement.</td>
</tr>
</tbody>
</table>

A summary of the transfer pricing methodology adopted in the Indian context and the approximately comparable methodology under the Indian Customs Valuation Rules is tabulated hereunder:
<table>
<thead>
<tr>
<th>Transfer pricing</th>
<th>Customs Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Comparable uncontrolled price</td>
<td>(i) Transaction value should be identical to the value</td>
</tr>
<tr>
<td>method ('CUP') - This method compares the price charged in a controlled transaction (i.e transaction with related parties) to the price charged in comparable uncontrolled transaction in comparable circumstances. (i.e transaction with non-related parties)</td>
<td></td>
</tr>
<tr>
<td>(ii) Resale price method ('RPM') - It is normally preferred for reseller or the companies engaged in distribution activities.</td>
<td>(ii) Deductive value - From the resale price of the goods imported, the commission paid/profit and general expenses such as costs of transportation, insurance, associated costs, custom and other taxes etc. are deducted</td>
</tr>
<tr>
<td>(iii) Cost plus method ('CPM') - It is normally preferred for contract manufacturer or for manufacturers with low risk.</td>
<td>(iii) Computed value - This is similar to Cost Plus Method.</td>
</tr>
<tr>
<td>(iv) Profit split method ('PSM') - In this method profit is allocated amongst various units on the basis of work carried out.</td>
<td>(iv) Residual method - The value is determined by applying principles and general provisions of the Valuation Rules.</td>
</tr>
<tr>
<td>(v) Transactional net margin method ('TNMM') - It is generally method of last resort and requires comparison at Net profit level.</td>
<td></td>
</tr>
<tr>
<td>(vi) Any other method as prescribed by CBDT</td>
<td></td>
</tr>
</tbody>
</table>

**Efforts at International level to minimize the conflict:**

Considering the importance of the issues all over the world, the World Customs Organization (WCO) and the OECD hosted two international conferences on Transfer Pricing and Customs Valuation, in May 2006 and in May 2007. Both the meetings resulted without any headway to resolve the conflict.

**Conclusion:**

Income tax and Customs though, both are the revenue departments of the government, both are having diametrically opposite views on determination of arms length price.

**Recommendations:**

India is fast emerging as a business hub because of its geographic location as well intelligence. More and more capital centric industries are expected to start their business in India. To provide them ease of business, the government should regulate both of its wings in appropriate manner and it is the need of the time that statutes should be amended in such a way that once valuation arrived by one of the authority, it should be binding on the other authority.

**Reference:**

S Dutt Majumder, Convergence of Transfer Pricing and Customs Valuation - Is it a myth? Search at www.taxindiaonline.com

Hemal Zobalia, Transfer pricing v/s. Other Statutes search at www.transferpricer.com

KARTHIK SUNDARAM, Convergence between Transfer Pricing and Customs Valuation in the Indian context search at 18 taxmann.com 256