Revenue Recognition of a Related Party Company According to "Transfer Pricing"

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Introduction

XYZ Developers Group is a group which consists with three BOI registered companies. The businesses of the companies are purchasing lands, constructing apartment buildings and sell them to customers. As the companies are registered under BOI they are in a tax exempted period.

XYZ Developers Group

X Developers (Pvt) Ltd	Y Developers (Pvt) Ltd	Z Developers (Pvt) Ltd
BOI agreement has ended in 2014. There for the company is liable to pay income tax on the profit	BOI agreement will be end in 2017. Therefore the company is within the tax exempted period.	BOI agreement will be end in 2019. Therefore the company is within the tax exempted period.

Since the board of directors and the shareholders are same, these three companies are related parties and there are intercompany transactions within the companies. If there are intercompany transactions in between related parties they have to consider the "Transfer Pricing" concept. A transfer price is the price charged between related parties in an intercompany transaction. Although intercompany transactions are eliminated when consolidating the financial results, for tax purposes such entities are not consolidated, and the transactions are therefore not eliminated.

Discussion of the Issue

Inventory of these companies include bare lands. X Developers (Pvt) Ltd has a land at Temple Avenue, Kottawa which is purchased in 2008 at a cost of Rs.15 million. This land has been there without doing any construction until 2013. X Developers (Pvt) Ltd and Y Developers (Pvt) Ltd entered in to an agreement to transfer this land to Y Developers (Pvt) Ltd on rent to construct apartment buildings. Transfer of the land had occurred at cost. Once the Y Developers (Pvt) Ltd complete the construction, sold the building with the land and transferred the selling price of the land to X Developers (Pvt) Ltd at the cost. Since both the companies has signed the sales agreement there was no legal issue on sale.

Implication of the Issue

As there was no any other sales occurred during the year at the accounts of X Developers (Pvt) Ltd the statement of comprehensive income shows zero gross profit and the profit on sales of land has been recognized under the accounts of Y Developers (Pvt) Ltd.

X Developers (Pvt) Ltd
Statement of Comprehensive Income as at 31.03.2015

Revenue	15,000,000	
Cost of sales	(15,000,000)	
Gross profit		0.00

Since the X Developers (Pvt) Ltd are out of the BOI agreement, it should pay income tax on profit. Even though Y Developers (Pvt) Ltd earned profit, it is not liable to pay income tax based on profit since they are within the BOI agreement period. Because of this,

- Revenue of X Developers (Pvt) Ltd is understated.
- Revenue of Y Developers (Pvt) Ltd is overstated.

Conclusion and Recommendation

Transfer prices directly affect the allocation of group wide taxable income. Hence, a company's transfer-pricing policies can directly affect its after-tax income; both the companies should recognize their revenue according to the arm's length price, which is the fair value of the transaction.

According to the Extraordinary Gazette Notice No.1907/26 dated 25th March 2015 issued by the Inland Revenue Department (IRD), group of Companies which have entered into transactions with related parties, will need to include the following details in the Certificate of the Approved Account submitted under section 107(2) (a) of the Inland Revenue Act No.10 of 2006, along with the Income Tax return.

1. Name and business relationship with each related company
2. Brief description of the business carried out by related companies.
3. Description and details of the transaction, amounts received/paid and method(s) used to compute arm's length price for the following transaction categories,

(a) Purchase/sale of raw materials or any other supplies for assembling/ processing/ manufacturing of goods from or to related company
(b) Purchase/sale of traded/finished goods

(c) Purchase/sale/lease of any other moveable/immovable property

(d) Purchase/sale of intangible property (e.g.: royalty, know-how, patents, copyright, licenses etc.)

(e) For services such financial, administrative, technical, commercial services etc.

(f) Granting/receiving loans

(g) Mutual arrangement or arrangement for the allocation or apportionment of costs

(h) Any other transaction not referred to above.

Therefore the companies should consider transfer pricing when performing intercompany transactions with related companies. Afterwards they should identify the revenue and profit correctly to pay income tax based on the profit and for fair presentation of financial statements.