CRITICAL EVALUATION OF TRANSFER PRICING IN INTERNATIONAL TAXATION

A DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT OF THE LL.M. DEGREE

Under the Guidance of

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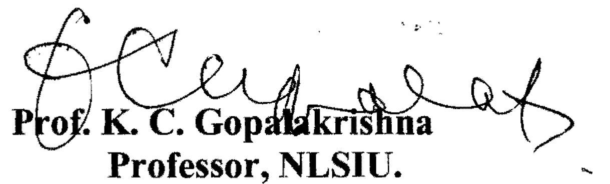
Certificate

I certify that this is a bonafide work of Mr. Manoneet Dalal under my guidance and is submitted in partial fulfillment of the requirement for the award of the degree of Masters of Law, National Law School of India University.

This work has not been presented or submitted in any other University or like institution.



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DECLARATION

I, Manoneet Dalal, hereby declare that this dissertation "Critical Evaluation of Transfer Pricing in International Taxation" is written by me in the partial fulfillment of my masters of law at the National Law School of India University. The work in this dissertation is original except for such help taken from such authorities as has been referred to at appropriate places. This work has not been submitted either in whole or in part in any degree at any university.

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List of Abbreviations

A L S ?

Alp	ALP — Arm's Length Price / Principle
ALI-ABA	American Law Institute - American Bar Association
Am. U. L. Rev.	American University Law Review
Ann. Surv. Int'l & Comp. L.	Annual Survey of International & Comparative Law
CA	Chartered Accountant
Cornell L. Rev	Cornell Law Review
Duke J. Comp. & Int'l L.	Duke Journal of Comparative & International Law
Fla. B.J.	Florida Bar Journal
Geo. Manson L. Rev.	George Manson Law Review
Geo. Wash. Int'l L. Rev.	George Washington International Law Review
ITPJ	International Transfer Pricing Journal
J. Bus. Valuation	Journal of Business Valuation
J. Int'l Tax.	The Journal of International Taxation
Law & Pol'y Int'l Bus.	Law and Policy in International Business
Loy. L.A. Int'l & Comp. L.J.	Loyola of Los Angeles International and Comparative Law Journal
Loy. L.A. L. Rev.	Loyola of Los Angeles Law Review
Minn. J. Global Trade	Minnesota Journal of Global
Nw. J. Int'l L. & Bus.	Northwestern Journal of International Law and Business
OECD	Organization for Economic Cooperation and Development
Pac. Rim L. & Pol'y J.	Pacific Rim Law and Policy Journal
Sw. L.J.	Southwestern Law Journal
T. Jefferson L. Rev.	Thomas Jefferson Law Review
Tax L. Rev.	Tax Law Review
Transnat'l Law.	Transnational Lawyer
U. Det. Mercy L. Rev.	University of Detroit Mercy Law Review
U. Miami L. Rev.	University of Miami Law Review
U. Pa. J. Int'l Bus. L.	University of Pennsylvania Journal of International Business Law

IRS ?

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19. Sunstrand Corporation and Subsidiaries V. Commissioner of Internal Revenue, 96 T.C. 226
20. United States Steel Corp. v. Commissioner, 617 F.2d 942
21. Watson Brothers v Hornby, 24 TC 506

Chapter 1

INTRODUCTION

Liberalization of the world economy in the last two decade has shown an unprecedented growth of the international trade. The free economic operations across the countries borders have been expedited by the revolution in information and technology. There are broadly two types of such economic operations, viz., one, the flow of goods and services from one country to another and two, the flow of capital from one country to another. A possible combination of these two types of activities could exemplify another type of economic operation i.e. the production of goods and services. But when the productions of goods and services take place in different jurisdictions with different tax rates, the flow of profits from the high tax jurisdiction to the low tax jurisdiction is obvious which poses great concerns in international taxations.

The key actors in the globalized economy and the primary beneficiaries of liberalized trade are Multinational Corporation (MNC)[1] These MNCs with wholly and partially owned subsidiaries in different parts of the world, carries on business at a gigantic scale. By definition[2], a MNC is a company with operations in two or more countries, generally allowing it to transfer funds and products according to price and demand conditions, subjects to risks such as changes in exchanges or political instability. Liberalisation has put MNCs at an advantageous position compared to domestic corporations by taking benefits of cost differentials for raising cheaper capital and maximizing profits.[3]

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1 Many words like Transnational Corporation, Multinational Enterprise or Transnational Enterprises are used to represent Multinational Corporation; the difference is only of the nomenclature attributed to them by different scholars according to their respective conveniences. It is submitted here that according to the researcher Multinational Corporation is best suited as it refers to a single Corporation rather than multiple Corporations making up a group, it does convey a sense of singularity and integrated control that typically characterizes such groups.
2 Black's Law Dictionary (7th ed., St. Paul: West Group, 1999).
3 S P Singh et al., "Transfer Pricing and Regulations for India: Approvals and Alternatives" (New Delhi: UBSPD, 2002) at 2 (Henceforth Singh)

The very nature of MNCs spread across boundaries and the enormous power associated with them has made them important actors at the international arena. The immense power of MNCs is indicated by a comparison between the economic wealth generated by corporations, measured by sales as compared with a country's gross GDP. Of the 100 largest economies in the world, 51 are corporations; only 49 are countries. Moreover the 999 sales of each of the top five corporations (General Motors, Wal-Mart, Exxon Mobil, Ford Motor, and DaimlerChrysler) are bigger than the GDPs of 182 countries.[4] Consequently, these actors are proving to be the biggest regulatory challenge for sovereign nation states.

With the emergence of the multinational corporation as a powerful form of business organisation, traditional notions of residence, the place of production, the source of income have attained new dimensions, and tax law of nations are now struggling to solve the complex taxation issue pertaining to transactions undertaken by MNCs operating simultaneously in several jurisdictions. One such prominent area of concern since the 1990s has been "Transfer Pricing".

Intra-group transfers[5] are inherent to the structure of the MNC which grows with the growth of MNCs. The intra-group trade during the last decade has reached around 60% of world trade[6] which was just around one-third of the world trade in 1993[7] and it would not be wrong to presume that it will further grows in times to come. The problem it poses is can be related to a situation when a transaction occurs between two subsidiaries of a common parent or the parent and its subsidiary which does not take place on the market principles of demand and supply. The two players in this transaction no longer seek to maximise their gains (as it is the gain of the overall organisation that is at stake) and

4 Sarah Anderson and John Cavanagh, "The Rise of Corporate Global Power" Institute for Policy Studies (December 4, 2000)at http://www.ips-dc.org/downloads/Top_200.pdf

5 Intra-group transfers, intra-corporate transfer, are transfer of goods and services between the subsidiaries of a same corporations.

6 John Neighbour and Jeffrey Owens, "Transfer Pricing in the New Millennium: Will the ALP Survive?" 10 Geo. Manson L. Rev. 951 (2002) at 952 (Henceforth Neighbour and Owens)

7 Singh, supra note 3 at 2

hence may set a price which would not have been arrived at in the open market. One of the common purposes of such a transaction is to avoid tax liability[8] of the company.[9]

TRACING THE ROOTS

Allocation of taxable income to establishments located in different countries but belonging to one "group" has been discussed internationally for over 70 years. A survey of the legislation and administrative practice of 35 countries was conducted by The Fiscal Committee of the League of Nations in 1930[10]. The subject of the study was allocation of income to local establishments of foreign enterprises and in 1933, a multilateral treaty was drafted on allocation of Business profits. For the first time term "dealing at Arm's Length" appeared in the draft Legislation. Art.3 provided for profit allocation on the basis of the "independent enterprise" principle, which apparently was a new term for separate accounting or separate entity approach. In March 1946, the Fiscal Committee drew up a new model treaty, which confirmed the pre-eminence of independent enterprise approach to profit allocation, referring to Arm's Length Principle (henceforth ALP).

Later we see the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD)[11] continued the Work of the Fiscal Committee of the League of Nations. In 1960, a report was published which contained a draft article on "profit attribution to permanent establishments and related companies". This was included as Art.7 in the OECD Model Convention of 1963 and Art.9 in the later version i.e 1977 OECD Model Tax Convention. Thus the provision relating to Associated Enterprises have been included in OECD Model Convention since 1963. Art 9 in context of Transfer

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8 Black's Law Dictionary defines Tax Avoidance as "the act of taking advantage of legally available tax – planning opportunities in order to minimize one's tax liability."

9 Robert G. Clark, "Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonised Income Allocation Measures from Multinational Cacophony" 42 Am. U. L. Rev. 1155 (1993). It is pertinent to note that what constitutes tax avoidance can be determined either according to the form of the transaction or the intention of the party. See Graeme S. Cooper, "International Experience with General Anti-avoidance Rules" 54 Sw. L.J. 83 (2001).

10 The survey was carried out by Mitchell B. Carroll, an advisor to the US Treasury and later the chairman of the Fiscal Committee. See manupatra's introduction to Transfer Pricing from www.manupatra.com at http://www.manupatra.com/nxt/gateway.dll/dtax/bandp4/directtax/transfer%20pricing/tranferpricing

11 OECD took over form the Organisation for European Economic Co-operation (OEEC), which had been established to administer American and Canadian aid to Europe in the aftermath of the Second World War. Initially for first four decades the focus of OECD has been to build strong economies in its member countries but its focus is changed in last two decades to encompass all countries in its member countries.

Pricing does not; on the face of it concerns it self with transfer pricing as such. It only provides that in certain circumstances, profits, which have not accrued to an enterprise, may be taxed as if they had so accrued. Profits have not accrued to the enterprises due to the conditions imposed or made in the commercial relations between the enterprise and an associated enterprise, which would be differ from the conditions which would exist between independent enterprises.

The OECD Committee on Fiscal Affairs (CFA) issued the first major landmark report in 1979 titled "Transfer Pricing and Multinational Enterprises'. This report defined the term 'Arm's length price' as the price 'which would be agreed between unrelated parties in the same or similar transactions under the same or similar conditions in the open market'. The 1979 OECD report did not cover the issue of corresponding adjustments arising on transfer pricing which was considered in the second report of the OECD on Transfer Pricing (1984 OECD report).). This report addressed three issues associated with transfer pricing:

- Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure
- The taxation of Multinational Banking Enterprises
- The Allocation of Central Management and Service Costs

The CFA in 1993 began to revise the landmark 1979 OECD report as supplemented by the 1984 OECD report. The CFA in 1995 issued guidelines titled 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration' which have been issued in loose format. The 1995 OECD report focuses on both transaction oriented & profit oriented approach for arriving at arm's length price.

In 1995 OECD published and updated guidelines on Transfer Pricing, these guidelines have been ratified by all the member states

WHAT IS TRANSFER PRICING?

Dictionary meaning of Transfer Price[12] is the charge assigned to an exchange of goods or services between a corporation's organizational units. Transfer pricing is a term used to describe all aspects of inter-company pricing arrangements between related business entities, and commonly applies to inter-company transfers of tangible and intangible property.[13] In short, Transfer Price is the internal price charged by one segment of a firm for a product or service supplied to another segment of the same firm. Some examples of transfer prices are:

- Internal charge paid by final assembly division for components produced by other divisions
- Service fees to operating departments for telecommunications, maintenance, and services by support services departments
- Cost allocations for central administrative services (general overhead allocation) Purchase of goods or services from a related party at little or no cost or at inflated prices to the entity.

In the common parlance, the working definition of the term transfer price can be been understood to mean a price charged for a cross-border transfer of goods, assets, rights, money and services etc., between one part of an organisation and another part of the same organisation[14].

There are numerals reasons for an MNC to indulge in Transfer Pricing such reasons can either be internally driven or externally driven.

Transfer pricing are internal driven when such pricing leads to optimal decision making for Subsidiary Corporation, promoting autonomy to the subsidiary, increasing share profits from joint ventures or evaluating the performance of Subsidiary.

12 Black's Law Dictionary (7th ed., St. Paul: West Group, 1999).
13http://www.pwcglobal.com/extweb/service.nsf/docid/8C5B7EE7E2A6913B852567AE00672AD2
14 See Neighbour and Owens, supra note 6.

External objectives such as minimizing taxes, better competitive positions, better relations with government, minimizing tariffs, minimizing exchanges risks etc. too can drive MNCs to adjust intra-group prices.[15]

So dealing with transfer pricing is particularly complex because different agencies of the host government approach the question with conflicting objectives. A mere listing of these objectives suggests the diversity:

(1) income tax authorities will seek higher prices assigned to exports and lower prices to imports;

(2) foreign exchange authorities will push in the same directions to minimize losses to hard currency reserves;

(3) customs and sales (or value added) tax authorities, however, will be interested in increasing the value assigned to imports;

(4) the agency charged with preventing "dumping" [16] will view the local price as artificially low;

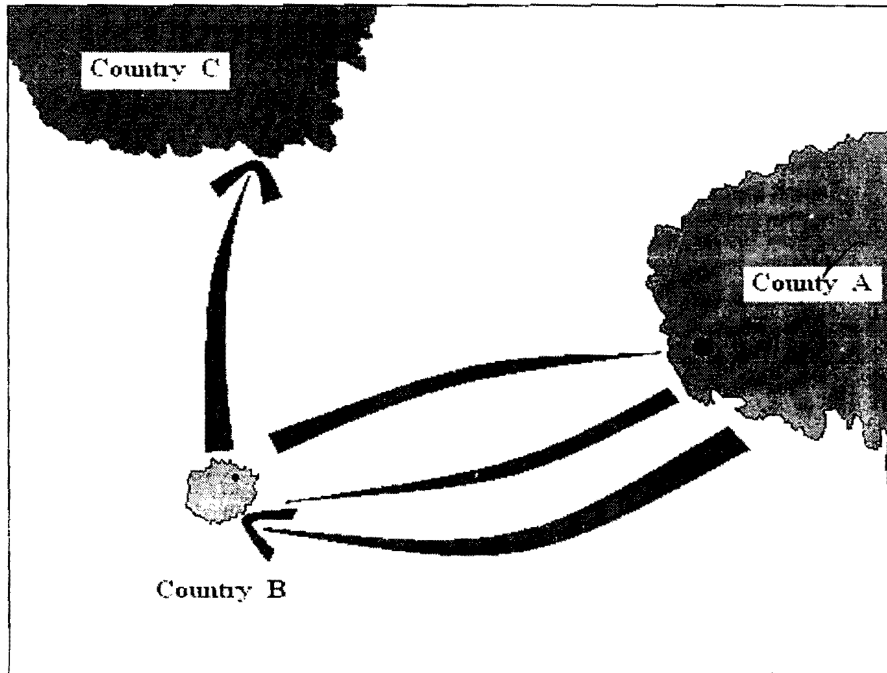
(5) the agency charged with administering the revenue from the country's natural resources will press upward on the export price which is the tax base.

MNCs approach in higher tax country will be to reduce taxable income in that country by charging high prices on imports and low prices on exports and in lower tax country, thereby increase taxable income in that country by charging low prices on imports and high prices on exports. In another case, if a parent company wishes to move funds out of one country, it can charge higher prices on goods sold to its affiliate located there. Similarly, if it wishes to finance an affiliate, it can lower the prices on goods sold to this unit. In short, transfer prices are **artificially high or artificially low prices** charged between **related parties (or associated parties)**.

15 Ranganathan Srivatsan, "Rationale and Some Issues on Transfer Pricing" April 2004 CA 1067 (2004) at 1067

16 In economic terms, dumping is selling abroad at discounts unjustified by cost differentials. Anthony, "The American Response to Dumping from Capitalist and Socialist Economies", 54 Cornell L. Rev. 159 (1969). As cited from Detlev F. Vagts, "The Multinational Enterprise: A New Challenge for Transnational Law" 83 Harv. L. Rev. 739 (1970) at 762

However, a ceremonial definition has been provided under article 9 of the OECD Model Tax Convention where the term Transfer Price has been defined as the 'price at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. [17] Consequently, the term 'transfer pricing' refers to the process of attaching value to transfer of goods, services and technology between related corporations. As discussed above, unlike prices set in transactions between independent enterprises, where only the market is the guiding factor, transfer prices are set between associated enterprises in a MNC group in accordance with the group's objectives. Tax avoidance may be only one such objective. Additional factors like the wish to reduce tariffs on components imported by subsidiary companies, expectations of movements of exchange rates on currency markets may also be important considerations in determining appropriate transfer prices.[18] This makes transfer pricing a complex exercise, different from price determination by an enterprise in its transaction with another independent enterprise under uncontrolled conditions. The present chart may further help in understanding and appreciating the concept of transfer pricing.



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17 Singh, *supra* note 3 at 3.
18 JDR Adams and J Whaley, "The International Taxation of Multinational Enterprises in Developing Countries" (Connecticut: Greenwood Press. 1977) at 164.

Corporation A is located in a Country A where it produces a given product. The Corporation could sell this product directly to Corporation C in Country C for Rs. 1000 and increase its total sales figure attributable to the business in the Country A and hence increase its tax liability in that state. Instead, it forms a subsidiary corporation in a tax haven in the Country B and sells the product to the latter for Rs. 500. The interposed corporation then resells the product in London for Rs 1000, thus making a tax-free profit of Rs 500 and depriving the entity in the Country A, corporation A, of that extra amount.

For another example, A Pharmaceutical Corporation got all patents registered for Corporation B a subsidiary of Corporation C which solely has all distributive rights. Similarly like above example the Products are manufactured in Country A, for Rs 500 who sells all products to Corporation B which resells all products to Corporation A at Rs 1000 and to Corporation C at Rs 1000 thereby depriving both country A and Country C of the real taxable profits.

In order to facilitate an in-depth understanding of the concept, let's assume a simple hypothetical example, which attempt to touch upon each of the essential issues in the pricing contexts:-

"TaielCo" is a MNC based in a developed country, which has a wholly-owned foreign subsidiary engaged in the crude oil exploration and production business in an operating area ("UttpadanCo"). UttPadan loads crude on vessels owned by another foreign subsidiary ("VaahanCo"), which transports the crude to a refinery owned by a third foreign subsidiary of TaielCo ("ChaanCo"), which, in turns, refines the crude and sells resultant products to foreign affiliates throughout its operating area.

This illustration[19] poses a broad range of pricing issues that may be important to the developed country (where TaielCo files a consolidated return), as well as in each country where a subsidiary is organized or conducts operations:

19 This illustration has been inspired from this article. See generally, George N. Carlson, Cym H. Lowell and Rom P. Watson, "Transfer Pricing For Goods, Services, And Intangibles", ALI-ABA Inbound Tax Conference June 13, 1991.

a. Sales of goods -- e.g., crude oil and refined products.

b. Provision of services -- e.g., shipping, technical, administrative or other.

c. Financial transfers -- e.g., loans, accounts receivable/payable, and others.

d. Use of intangible property -- e.g., exploration and development, shipping, refining, and marketing technology.

e. The same range of issues will arise with respect to non-controlled companies or joint ventures.

Because each country touched by the extended TaielCo operations may want to tax an appropriate portion of the profits of companies that are deemed to do business within its borders, the spectre of double taxation is inevitably present.

WHO CAN BE AFFECTED?

Transfer pricing issues impact as well as affect both the businesses that may have to pay the taxes and the tax collectors that expect to collect the taxes. The following parties are affected by a transfer pricing transaction:, assuming that one party is a Indian entity:

- The Indian entity engaged in the transaction
- The Income Tax Authorities
- The foreign counter-party to the Indian party
- The foreign taxing authorities

IS TRANSFER PRICING REALLY AN ISSUE?

To answer this question we need to explore reasons for the same. First, in practice, many companies give up the argument on transfer pricing, either during a tax audit or later, in order to avoid long and expensive disputes and uncertainties (or reach a reasonably cost-effective solution). Second, businesses spend considerable sums of money on constructing extensive documentation in support of their inter-company prices. Third, uncertainties about the treatment of transfer prices will hamper not only cross-border trade, but probably also investments, particularly in countries with a robust transfer

pricing system.[20] Thus we see that transfer pricing is really an issue.

TRANSFER PRICING: A CHALLENGE TO INTERNATIONAL TAXATION?

Transfer pricing should now more be seen as the administrative prices set by the management of MNCs. In a comprehensive study to identify the relative importance of various responsible for transfer pricing was undertaken by *Arpan* it was found that income tax has been considered as the most import factor by most of the MNCs.[21] Tax authorities fear that MNCs use transfer pricing as an instrument of global profit optimization.

Further, it is a well-known fact that the tax law of a country influences its trade and economic relations with other countries and therefore, plays an important role in international business relationship. With the integration of national economies into global economy, it is being realized that there should be some uniformity in the application of tax legislation on international aspects of business. Conflicting interests of nations have to be reconciled to arrive at a legislation whose fundamental concepts should be acceptable to all failing which would result in double taxation, which would be detrimental to international trade.[22]

Another aspect in international taxation, which is drawing attention of tax administration and policy makers, is the use of 'tax heaven' for parking profits. Transfer pricing misuse would be minimized if tax heaven issue can be addressed effectively.[23]

On the one hand, an MNC which like to pursue its profit maximization goal by reducing it's overall tax liability and on the other hand, the host country has genuine concerns for its fair share of revenue from the operations of such MNC in that country makes transfer pricing one of the hottest international tax issues for both taxpayers and tax authorities in the latter part of the 20th century.

20 J. Philip Van Hilten, "Transfer Pricing Policy in the International Tax System--Past and Present and a Quick Look in the Fiscal Crystal Ball" 10 Geo. Mason L. Rev. 709 (2002) at 711

21 R. Y. W. Tang "Multinational Transfer Pricing: Canadian and British Presepective" (Toronto: Butterworth 1981) as cited from Singh supra note at 7-8.

22 Singh supra note 3 at 10.

23 Id.

Moreover, in the last two decades the role of MNCs in the developing economies has resulted in the substantial improvement of such economies – both qualitative and quantitative. The developing countries no longer are seen as the source of raw material but also the markets for the products of the MNCs. To attract these MNCs developing countries are more liberal and pro-export policies. Thus the growing interest of the MNCs in the developing economies make tax authorities alert in these economies regarding transfer pricing. It was generally argued that transfer pricing abuses are peculiar to developed economies on the following reasons:[24]

- Developing Countries have softer tax regimes than developed countries
- In cases where the parent corporation is resident in a country with a foreign tax credit system, corporate taxes paid in a host country can be credited against the tax liability imposed by the home country on remitted profits.

However this assumption suffers from several flaws such as[25]

- The assumption that marginal corporate rates in developing countries are lower is not always true.
- Tax administration in developing countries are typically lax, which reduce the risk that such abuses in developing countries can be detected.
- Even where tax rates are low, tax havens provide incentives for shifting profits away from developing countries.

Tax administrations all over the world look at transfer pricing with suspicion. To deal with this problem without adversely affecting the international trade, comprehensive tax legislations are being introduced. Further, in developing countries, it is a greater challenge to create an environment conducive to international flow of investment, and cause no necessary loss of revenue.

The international tax community is aware that it is necessary to evolve a system, which secures appropriate revenues for host countries and avoids double taxation. The efforts

24 Ibid at 12
25 Ibid at 13

are directed at finding mutually acceptable solutions to tax problems arising out of the transfer pricing policy of MNCs. In this background that OECD also has "continuously worked to build consensuses on international taxation principles, thereby avoiding unilateral responses to multilateral problems."

RESEARCH METHODOLOGY

AIM:

The Aim of this paper has been to understand the phenomenon of transfer pricing and its abuse by MNCs and various laws relating to this transfer pricing. How developed and developing countries across the globe reacted to this problem and to analyze the OECD Guidelines in the light of the same.

RESEARCH QUESTIONS

- What is transfer pricing? How is it used by MNCs as a tax avoidance device?
- What are the methods of prevention of tax avoidance by MNCs through transfer pricing?
- What is Arm's Length Standard or the Arm's Length Principle?
- What is the Global Formulary Apportionment method? Is it an effective alternative to the ALS?
- What are the traditional methods used to determine the arm's length price?
- What are the requirements to implement these methods and tries to explore alternatives of these methods?
- What are the limitations in the application of the ALS to transactions involving services, intangible property and cost contribution arrangements?
- What are the theoretical and practical problems with the application of the ALS?
- How do the developed and developing nations of the world respond to the complex issue of Transfer Pricing?
- What are the inadequacies in the application of current methods?
- What are current issues which require OECD reflections?

SCOPE

This paper seeks to understand the concept of transfer pricing and its exploitation as a measure of tax avoidance. Thereafter, the paper examines as to how the arm's length principle is a method of preventing the abuses of transfer pricing. It then analyses the theoretical and practical problems with the application of the ALS and examines the Global Formulary Apportionment Method as an alternative to the ALS.

The paper thereafter examines the relative transfer pricing regulations in developed and developing countries. In this paper researcher limited the scope of developed nations only to United States and United Kingdom as both of these countries are forerunners regarding Transfer Pricing Regulations and their transfer pricing regulations are backed by long historical developments which has been briefly discussed in respective chapters.

As regards Developing Countries, the scope of the paper has been limited to three major BRIC (Brazil, Russia, India and China) countries. As Russia doesn't have sufficient laws relating to transfer pricing so to keep the coherency of paper it has been excluded. Moreover, in all the three countries, transfer pricing is a new subject and it is interesting to note developments in these countries.

Further, the scope of this paper is limited to the discussion of only transfer pricing as a tax avoidance device as opposed to other tax avoidance devices. This **limitation** has been necessitated due to the vast and complex nature of the subject under study in order to undertake a meaningful discussion of the issues identified. The paper therefore suffers from the limitation of not being a comprehensive study of all tax avoidance devices used by MNCs.

The law relating to transfer pricing has been largely a product of the efforts of the OECD since 1979 which has published various Reports and Guidelines that have been used by countries in devising their transfer pricing regimes. However, due to unavailability of these primary sources, this paper has accessed these Reports and Guidelines through secondary sources. Thus, this paper suffers from the inherent limitation of reliance upon secondary sources.

RESEARCH METHODS

Both descriptive and analytical methods have been used in the course of writing this paper. The paper is descriptive in as much as it seeks to understand the phenomenon of transfer pricing, its abuse by MNCs, methods of prevention of such abuse and the transfer pricing regimes in various countries. It is analytical in as much as it examines the merits and demerits of the ALS as well as the Global Formulary apportionment method as also when it undertakes a critical study of the practical difficulty in application of general principles of transfer pricing and the new emerging issues in OECD Guidelines.

SOURCES

Secondary sources of data like articles and books have been read to understanding about the subject and than the Primary sources of data like cases, reports, legal texts are used to reflect on the issues and outcomes emerging from the same.

MODE OF CITATION

A uniform mode of citation has been employed throughout the course of writing this paper.

PART – I

UNDERSTANDING TRANSFER PRICING

At the outset transfer pricing can be termed as a neutral concept since it refers to the price that one company charges to a related company for the transfer of goods or the provision of services so in any transaction between related companies there is a transfer price involved. Transfer pricing may be used as a tax planning tool whereby a group company conducting its business in more than one jurisdiction uses transfer pricing to shift income from a high tax jurisdiction to a low tax jurisdiction, thereby posing a challenge for tax authorities to adjust these prices and avoid a loss of revenue.[26] Tax authorities try to reduce transfer pricing manipulation by computation of income from international transactions with help of documentation.

This section analysis the various principles which have been put forward to curb the tax avoidance through the device of transfer pricing and discusses the methods of tax computation under it by looking at the practical difficulties and formalities posed by such methods. These will be discussed as follows:

1. A Jurisprudential Inquiry
2. Methods of Transfer Pricing.
3. Documentation

26 Omar Morales, "Transfer Pricing in Chile: A Comparison of the OECD Guidelines and U.S. Regulations" 79 U. Det. Mercy L. Rev. 415 (2002) at 415

Chapter 2

A Jurisprudential Inquiry

Introduction

The most significant issue regarding the income taxation of MNCs is how to allocate income among the various jurisdictions in which the MNCs operate.[27] Governments of late have recognized that transfer pricing is one of the easiest ways to manipulate income to defer taxation[28] and therefore adopts various transfer pricing methods while computing true income of a MNC subsidiary.

The extent of taxation in a country is dependent upon the principles of taxation adopted by that country. Reasonable claims to tax the business income of MNCs arise from both the source and residence jurisdictions[29] i.e. the source or *situs* principle and the residence or *fiscal domicile* principle.[30] Apart from these two there is citizenship principle.[31]

27 Ernst & Young, Transfer Pricing 1997 Global Survey, 15 Tax Notes Int'l 761 (1997) at 763; Ernst & Young, Transfer Pricing 1999 Global Survey: Practices, Perceptions, and Trends for 2000 and Beyond, 19 Tax Notes Int'l 1907 (1999) at 1908; Ernst & Young, Transfer Pricing 2001 Global Survey: Making Informed Decisions in Uncertain Times, 24 Tax Notes Int'l 1151 (2001) at 1151 as cited from Robert Ackerman and Elizabeth Chorvat, "Modern Financial Theory And Transfer Pricing" 10 Geo. Mason L. Rev. 637 (2002) at 640 (Henceforth Ackerman and Elizabeth)

28 Harlow N. Higinbotham et al., "Effective Application of the Section 482 Transfer Pricing Regulations", 42 Tax Law Rev. 295 (1987) at 300-02 as cited from id.

29 The source of income is where the activities that generate the income are conducted. The source country is the country that is the source of the income. The residence country of a corporation is the country in which the corporation is managed or where it is incorporated. Further complicating the issue of double taxation, the United States taxes the worldwide income of its residents while most of its important trading partners have adopted territorial systems. Under a territorial system, the resident country exempts foreign source income from taxation. This includes, for example, Canada, the Netherlands, France, and Germany, while Japan and the United Kingdom have worldwide credit systems. Hugh J. Ault, "Comparative Income Taxation: A Structural Analysis" (1997) as cited from. Id.

30 See Walter Hellerstein, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" 38 Ga. L. Rev. 1 (2003)

31 In this principle all the income of the citizen are taxed in that country irrespective of the source or location of the income. This principle is followed in the US and the Philipines. See Singh, supra note at 18-19.

Only in a few countries of the world, taxation is based on only one of the three principles of jurisdiction to tax. Most countries adopt a combination of two or all the three principles. This results in economic or jurisdictional double taxation. The former occurs when the same income is taxed twice, once on residence principle and than on source principle. On the other hand, jurisdictional double taxation occurs when a person's income is taxed in two countries when a person is covered by domicile and/or citizenship in two countries. The other fallout of overlapping of taxation jurisdiction is that any upward adjustment by tax authorities to transfer prices shown by a taxpayer would result in double taxation unless the authorities in the other country make corresponding compensating adjustment.[32]

THEORETICAL FOUNDATIONS

Transfer Pricing rules are not imposed as economic penalties upon the MNCs who conduct business among related parties instead of unrelated parties. The principle of transfer pricing for international taxation is that there should be economic neutrality between domestic and multinational Corporations for the purposes of taxation, and the mere fact that MNCs operate in different tax jurisdictions should not take advantage of the same.[33] While appropriating income to MNCs entities for taxation two major theories has been are applied and on the basis of these the income allocation is consummated on which principles of taxing controlled transactions are based. The two basic and polar alternatives-- the separate entity theory and the unitary entity theory[34]-- in separate entity theory each associate within the MNC group is treated as a separate legal entity for the taxation purposes and in unitary entity theory MNC group is treated as a single indivisible economic unit and tax is applied to all units as they are part of one group.

The decision as to which of these theories should be adopted for income allocation for transfer pricing should usually be dependent upon the structure of MNC and how that

32 Singh, supra note 3 at 19.
33 See generally Sandra Reid Robertson, "Transfer Pricing Solutions in the Global Economy" 3 Ann. Surv. Int'l & Comp. L. 177 (1996) and id.
34 "Multinational Corporations and Income Allocation under Section 482 of the Internal Revenue Code" 89 Harv. L. Rev. 1202 (1976) at 1205

MNC produce its income which should than will largely dictate the broad outlines of the system to be constructed.

'ENTITY' OR 'SEPARATE LEGAL PERSONALITY' THEORY

In *'Entity' or 'Separate Legal Personality' theory* each associate entity within the MNC group is treated as a separate legal entity for the purposes of taxation.[35] They can treat controlled transactions as if they were market transactions. In a separate entity it is presumed that each entity maintains its accounting records as if it were independent from its affiliates so that all inter-firm transfers be recorded and accounted for Intercompany transactions, like transactions with unrelated parties, are treated as taxable events. Since each commonly- controlled entity is viewed as separate and independent, the government will calculate its true taxable income by adjusting intercompany transactions to conform to the results of bargains which would have been negotiated between unrelated parties dealing at arm's length in similar goods or services in similar circumstances.[36] This alternative known as the ***Arm's Length Principle*** imposes a comparable market price on controlled transactions.

The Arm's Length Principle (ALP)

The ALP is the principle by which transfer prices between members of a commonly controlled organisation (controlled transactions) are evaluated. The principle requires that, for tax purposes, each related entity or subsidiary of MNC group should be treated as independent legal entity and the transfer prices of controlled transactions should be similar to those of comparable transactions between independents in comparable circumstances (uncontrolled transactions). The theory is that uncontrolled transactions are subject to the full play of market forces and so these are, by definition, arm's length. They provide a benchmark against which the controlled transaction can be evaluated[37].

35 Ludwig, General Report, 58a Cahiers De Droit Fiscal International I/64 (1973). As cited from id.
36 Ludwig, General Report, 58a Cahiers De Droit Fiscal International I/64 (1973), at I/64; Surrey & Tillinghast, General Report, 56b Cahiers De Droit Fiscal International I/2-I/4 (1971)., at I/13, I/25. as cited from id.
37 Neighbour and Owens, supra note 6 at 952

The ALP, which is the cornerstone of the OECD transfer pricing guidelines, is found in paragraph 1 of ***Article 9*** of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD Member countries and an increasing number of non-Member countries, which describes ***ALP*** in the following terms-:

"When conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Further, the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (henceforth OECD Guidelines) provide considerable information on how this benchmark can be applied in practice. For example, it is essential when comparing controlled and uncontrolled transactions to compare like with like to compare apples with apples and not apples with pears. However, the transactions do not have to be identical to be comparable, provided any differences are either not material or can be adjusted for on a reasonably accurate basis. To continue the fruit metaphor, green apples may still be comparable with red apples provided you can adjust for any differences in market prices due to differences in colour or taste.

However the authorized basis for the application of the arm's length standard has been formalized in Para 1 of Article 7 of the OECD Model Tax Convention, which provides

"The profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. In such a case, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to the permanent establishment."[38]

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38 Singh, supra note 3, at 20.

Arm's Length Price means the price, which is applied in a transaction between persons other than related party in uncontrolled conditions.[39] According to this principle the two tests came into limelight, the test are thus

a. First the said transaction should be between **related parties**, and
b. Second, transaction should be in **controlled conditions** but generally while applying ALP it is the first principle that guides the other.

If the transaction is between the related parties, controlled conditions are presumed and than the arm's length methods are applied to find out prices of the uncontrolled transactions. Therefore, the arm's length standard requires that prices charged among related parties must be adjusted to reflect prices that unrelated parties would charge each other in the market. Further for successful application of the ALP depends upon the selection of comparable uncontrolled transaction between independent enterprises under conditions similar to those determining the transaction between associated enterprises. This makes the process of comparison of conditions determining the comparable transaction very important. While determining an ALP, the following factors should be kept in mind[40]-:

a) Characteristics of property or services.
b) Functions performed and risks assumed.
c) Markets in which the transaction takes place.
d) Business strategies followed by the enterprises involved in the transaction.

The internationally accepted methodologies for the purpose of determining transfer prices in accordance with the ALP can be divided into two groups[41] –

(a) *Traditional transaction methods* – these methods are based on the premise that the most direct way to establish whether a transaction between related parties is at arm's

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39 "Draft Transfer Pricing Guidelines" from Ministry of Finance and Company Affairs, "Report of the Expert Group on Transfer Pricing Guidelines" August 2002
40 See Chapter 10 Transfer Pricing: Practical Considerations
41 Marc M. Levey and Lawrence W. Shapiro, "OECD Transfer Pricing Avoids Overpapering the Best Method" 6 J. Int'l Tax. 52 (1995).

length is to compare the prices charged in controlled transactions with prices charged in comparable uncontrolled transactions;

(b) *Transaction profit methods* – these examine the profits that arise from controlled transactions of one or more parties participating in these transactions. The level of profits may be a relevant indicator of whether the transactions giving rise to those profits have been affected by conditions that differ from those in comparable uncontrolled circumstances.

The traditional transaction methods are the Comparable Uncontrolled Price (CUP) Method, Resale Price Method (RPM) and the Cost Plus Method (CPM), while the transaction profit methods are the Profit Split Method (PSM) and the Transactional Net Margin Method (TNMM).[42] In short, ALP can be understood as try to allocate market prices to a transaction between related parties.

Advantages of ALP.

a. It has been accepted that the market forces of supply and demand are the best ways to allocate resources and to reward effort.[43]
b. Ensures that each State gets its share of revenue.
c. Creates a broad equality of tax treatment between MNCs and independent enterprises where by it avoids the creation of tax advantage that would otherwise distort the relative competitive position of either type of entity.
d. The ALP has been found to work effectively in the was majority of cases and supports growth of International trade and investment

Criticism of Separate Personality Theory

The theoretical premise of ALP--that MNC parents and affiliates are properly viewed as separate entities--is subject to serious criticism.[44] In economic theory, affiliates of a MNC

42 These methods have been dealt at length in forthcoming chapter.
43 Diane Hay, Frances Horner and Jeffery Owens, "Past and Present Works in the OECD on Transfer Pricing and Selected Issues. Bulletin 48 (10) International Bureau of Fiscal Documentation (1994) Netherlands as cited from Singh supra note 3 at 39.

would not necessarily be expected to treat other affiliates as wholly separate corporations or to choose arm's length prices for their transfers, since affiliation may give rise to a variety of synergistic effects which alter the costs and benefits of transacting intercompany business.[45]

Whenever commonly-controlled entities who directly contribute, either horizontally or vertically, to a single production-distribution process, there opportunities for cost savings through economies of scale and reduced transaction costs may result.[46] Even if no direct transfers are made, centralized managerial control over a group of affiliates may produce efficiencies in management, in raising capital, in obtaining quantity discounts, and in advertising.[47] In addition, diversification of risk creates potential savings where there are few similarities between affiliates.[48] Finally, political and economic power, which may be used to increase long-run profits of the whole MNC, may stem from large size alone regardless of the degree of compatibility between the affiliates.[49] As a result of all of these considerations, transfer prices may vary from arm's length to reflect the increased profitability of intercompany transactions.

Moreover, related parties know that they will realize the benefits of synergy only on intercompany transactions and that any one party, if it chooses to deal with outsiders, will deprive other affiliates of these extra profits. Accordingly, it will be in the interest of each party to induce the others to engage in transactions within the firm; such inducement will take the form of sharing the decreased costs or increased profits by adjusting transfer prices.[50] Since the benefits of synergy result from the cooperation of numerous affiliates, the true income of each should include a share of the increased profits. This will not be the case under the separate entity-arm's length standard which does not recognize the

44 Supra note 34 at 1214
45 F. Scherer, "Industrial Market Structure and Economic Performance" (1970).at 72-103 as cited from ibid at 1215
46 Scherer at 72-74, 86-87, 470-71 as cited from id.
47 Keesling & Warren, The Unitary Concept in the Allocation of Income, 12 HASTINGS L.J. 42, (1960) at 51-52, F. Scherer, "Industrial Market Structure and Economic Performance" (1970).at 64, P. Steiner, "Mergers: Motives, Effects, Policies" (1975) at 60-69 as cited form id.
48 Steiner at 66 as cited from id.
49 Steiner at 69-74, 310-11 as cited from id.
50 Id.

differences between intercompany dealings with integrated affiliates and open-market transactions with strangers.[51]

Further, the separate entity approach has the virtue of geographic neutrality which does not give any special advantages to, or place any special burdens upon, income earned abroad, other than the threat of double taxation.[52]

Difficulties associated with the ALP

- ALP has been accused of creating a climate of uncertainty and an immense administrative burden for the taxpayers, the taxing authority and the courts, and provides ample opportunity for abuse. This is largely due to the sheer volume of information required for applying the appropriate arm's length price to determine the true value of the transaction. There are reports of auditors confronting significant problems and delays in securing information from taxpayers on which to base pricing adjustments. Indeed, those information-gathering problems are compounded when auditors must search out comparable price information from third parties not involved in the audits at hand.[53] This burden largely arises from the need to apply the arm's length standard on a factual, case-by-case basis, without any general rules in the majority of cases in which there are no comparables.[54]
- Another foremost criticism of the ALP is that it ignores the economic reality by treating associated enterprises as separate entities and factors such as economies of scale and synergistic operations that are the motivating factor behind the MNC structure.[55]
- The practical use of the arm's length standard even in USA has been accompanied by serious problems which most clearly evidenced by the suprisingly frequent reliance of revenue agents and courts on ad-hoc fourth method approaches, based not on the

51 Ibid at 1216
52 ibid at 1215
53 Dan R Bucks, "Will the Emperor Discover he has no clothes before the Empire is Sold? The Problem of Transfer Pricing for State and Federal Governments" 44 (3) National Tax Journal 311 (1999) at 312.
54 Reuven S Avi Yonah, "The Rise and Fall of Arm's Length: A Case Study in the Evolution of US International Taxation" 15 Va. Tax Rev. 89 (1995) at 150.
55 Eugene E Lester, "Note And Comment: International Transfer Pricing Rules: Unconventional Wisdom" 2 ILSA J Int'l & Comp L 283 (1995) at 295.

theory of the regulation, but on the unitary entity theory.[56]

- The pervasive application of the ALP may also hamper legitimate business transactions. For instance, an MNC might opt for flexible pricing for a perfectly valid business reason such as temporarily subsidising a distributor in order to establish or expand its client base. This approach is prohibited by tax considerations that require the transaction to take place at an estimated arm's length, fair market price. Since the current system may frustrate legitimate business decisions, the result may be that the entity is less efficient and produces less net income.[57]
- Also, determining a transfer price is a subjective factual judgement and involves the exercise of business discretion and judgement. Hence, the taxpayer can never be too sure that he has arrived at the correct price by applying the ALP and will not be liable for stating an incorrect price. Moreover, because the ALP requires a transaction-by-transaction analysis of the arms length price, it acts as a handicap in the fast moving world of global trading.[58]

- Intangible property poses unique problems for the application of the ALP. This is because of the very nature of unique, high value intangibles for which third-party comparable uncontrolled transactions were unlikely to be available to use as arm's length comparables.[59]In the absence of available comparables, the traditional transaction methods would be impossible to apply and the taxpayer may have to resort to the transactional profit methods.[60] The complexity in pricing intangibles arises because the value of intangibles such as patent assignments, licensing

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56 Supra note 34 at 1238

57 Brian D. Lepard, Is the United States Obligated to Drive on the Right? A Multidisciplinary Enquiry into the Normative Authority of Contemporary International Law Using the Arms Length Standard as a Case Study 10 Duke J. Comp. & Int'l L.43 (1999).

58 Kevin K. Leung, "Taxing Global Trading: An Appropriate Testing Ground for Formula Apportionment?" 1 Minn. J. Global Trade 201 (1992).

59 Robert J. Cunningham, "The Future of International Transfer Pricing: Practical and Policy Opportunities Unique to Intellectual Property Foreign Transfer Pricing Audits of Intangibles" 10 Geo. Manson L. Rev. 697 (2002); James R. Mogle, The Future of International Transfer Pricing: Practical and Policy Opportunities Unique to Intellectual Property, Economic Substance, and Entrepreneurial Risk in the Allocation of Intangible Income 10 Geo. Manson L. Rev. 925 (2002).

60 Terry Thompson, "Canada's Transfer Pricing Laws: Keeping Pace with an International Trend" 11 Transnat'l Law. 311 (1998) at 352.

agreements, or sales of intangibles, may be measured only after the transferee has derived income from them.[61]

- Another major economic drawback is area which involves the cost-saving technique known as marginal pricing: the practice of selling surplus production in foreign markets at prices lower than those prevailing in the manufacturer's primary market which may not allow recovery of the full costs of production.[62]

UNITARY ENTITY THEORY

In *Unitary Entity theory* view a group of affiliates from an economic angle and view each of the affiliates as a single business which is divided into separate legal subsidiaries purely for the sake of legal and business conveniences. This theory reflects the belief that MNC parents will tend to exercise strong centralized control over all parts of the enterprise and treat each subsidiary as an interdependent part of a larger system.[63] As all MNC subsidiaries are considered to be parts of the same unitary business, so intercompany transactions cannot produce a real economic profit or loss and must therefore be eliminated from tax consideration.[64] Under this approach the tax authorities treat controlled enterprise groups as a 'single economic unit' for tax purposes. As opposed to the arm's length method, the unitary approach does not try to achieve comparability among transactions but in fact uses a formula to apportion income between controlled enterprises and it approach is called ***formulary apportionment***.

61 See Clark, supra note 9 at 1178-1179.
62 Scherer at 258-59 as cited from supra note 34 at 1218
63 It is doubtlessly true that if there were typically few or no significant financial interrelationships or interdependencies between MNC components, there would be much less need for centralized control by MNC parents, especially given the perceived advantages of decentralized management systems. See generally M. Brooke & H. Remmers, "The Strategy of Multinational Enterprise: Organization and Finance" (1970) 68-124 as cited from ibid at 1206
64 Ludwig, General Report, 58a Cahiers de Droit Fiscal International I/64 (1973) at I/68. Under a unitary entity view, no individual component of a MNC may have a true profit if other parts of the MNC have overall losses exceeding the amount of the profit. As cited from id.

GLOBAL FORMULATORY APPORTIONMENT METHOD (GFA)

As we see there are several difficulties associated with the ALP, so several scholars recommend the adoption of the Global Formulatory Apportionment Approach (GFA).[65] This method is based on the 'unitary theory", and hence also called unitary approach. This approach involves taxing MNCs on their worldwide income, without separating the earnings and profits of affiliated corporations. The tax base is divided between countries through a source-oriented formula, which would consider, for example, the amount of assets, sales, and payroll that a given enterprise had in each country.[66]

Unitary business is not simply based on ownership but "it is the synergy or integration between or among the parts of the commonly owned business that is fundamental to the unitary business principle."[67] The unitary business concept has developed through a patchwork of statutory definitions and judicial common law. Current unitary business tests include the "three unities" test,[68] the "contribution or dependency" test,[69] the "modern" test,[70] and the "basic operations interdependence" test.[71] Hence, the definition of unitary business varies among the states, which has led to much litigation.[72]

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65 See supra note 34, 53, 59 and also see Steve Christensen, "Formulatory Apportionment: More Simple – On Balance Better?" 28 Law & Pol'y Int'l Bus 1133 (1997).

66 Asim Bhansali, "Globalising Consolidated Taxation of Unite States Multinationals" 74 Tax L. Rev. 1401 (1996) at 1408. Formula based apportionment methods are used in the United States for determining the state income tax liability of multinational and multistate enterprises. In Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983), the United States Supreme Court upheld the constitutionality of California's apportionment method as a basis for taxation of worldwide income a U.S. based MNC. In Barclays Bank v. Franchise Tax Board, 114 S. Ct. 2268, the Court has extended this holding to the taxation, by states, of the U.S. subsidiaries of foreign-based multinational enterprises. However, the method has been unequivocally rejected by the international community. See Prabhat Agarwal, Transfer Pricing – An Overview 41 Sebi & Corporate Laws 33 (2003).

67 Eric J. Coffill & Prentiss Willson Jr., "Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?", 59 Tax Notes 1103, 1114 (1993) as cited from Christensen, supra note 65 at 1144

68 Edison Cal. Stores v. McColgan, 183 P.2d 16, 21 (Cal. 1947). The contribution or dependency test finds unitary business where out-of-state activities contribute to or depend upon in-state activities. As cited form id.

69 Edison Cal. Stores v. McColgan, 183 P.2d 16, 21 (Cal. 1947). The contribution or dependency test finds unitary business where out-of-state activities contribute to or depend upon in-state activities. As cited form id.

70 Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 178-79 (1983); Allied-Signal, Inc. ex rel Bendix Corp. v. Director, Div. of Taxation, 504 U.S. 768 (1992). The modern test looks to three factors to determine unitary business: functional integration, centralization of management, and economies of scale as cited from id.

It has been in practice in many US states, Uniform Division of Income for Tax Purposes Act (UDITPA) has UDITPA Factors adopted an equally weighted, three factor apportionment scheme and all three equally have been weighted.

UDITPA: Three Factor Apportionment[73]

In-State Property of All Unitary Corporations Operating in State	In-State Payroll of All Unitary Corporations Operating in State	In-State Sales of All Unitary Corporations Operating in State
Everywhere Property of Unitary Group	Everywhere Payroll of Unitary Group	Everywhere Sales of Unitary Group

Averaged by Dividing these Factors by 3

Turning to the merits of the three UDITPA factors, the first factor is the payroll factor.

a) **Payroll Factor** is the fraction of in-state compensation divided by the compensation paid in total.[74] The payroll factor has the distinction of being the least controversial and easiest factor to administer.[75]

The payroll factor has two issues which are makes it difficult to apply. First what constitutes compensation and second, problem with the payroll factor is the old "employee versus independent contractor" issue.

b) **Property Factor** is the fraction of the historic cost of assets located and used within

71 Commonwealth v. ACF Indus., Inc., 441 Pa. 129, 271 A.2d 273 (1970) as cited from id.
72 Allied-Signal, 504 U.S. at 768; Asarco Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) as cited from id.
73 Ibid at 1147
74 UDITPA § 13. Ibid at 1148.
75Eric J. Coffill and Prentiss Willson Jr., "Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?", 59 Tax Notes 1103 (1993) at , 1114. As cited form id.

the taxing jurisdiction to the historical costs of all property owned by the entity.[76]

It also suffers from two major drawbacks, first valuation problem, e.g. newly purchased assets will have a historic cost equal to or nearly equal to their fair market value (FMV), and historic assets will have historic costs that do not reflect their FMV. Secondly, Intangible Problem, UDITPA completely excludes intangibles from the property factor.[77]

c) **Sales Factor** is defined as the sales made within the state divided by the sales made by the entire unitary business.[78]

Advantages of Global Formulary Apportionment

The unitary entity theory has certain clear advantages over the separate entity, Principal among these is its theoretical superiority as a means for ascertaining true income of various MNC components. Treatment of the MNC as a unitary entity reflects the fact that strong interdependence from common control may exist which renders unrealistic any analogy to a collection of unrelated, competitive companies.[79] Furthermore, the unitary entity theory does not create taxable income on the basis of inter-company transfers, since such transfers do not make the MNC as a whole better off until income is realized from ultimate sales to unrelated parties.[80] Finally, a unitary formula provides management with the flexibility necessary to make efficient use of transfer pricing for internal and external non-income tax purposes, thus avoiding the frustration of legitimate business behavior which may accompany application of the separate entity theory.[81]

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76 UDITPA § 10. id.
77 UDITPA § 10 ibid at 1151
78 UDITPA § 15. id.
79 New York State Bar Ass'n Tax Section, "Comm. on Deductions from Foreign Income, Proposals for Improvement of Rules for Allocation of Deductions between Foreign and U.S.-Source Income" (1974), reprinted in 29 Tax L. Rev. 597 (1974) 1215 as cited from supra note 34 at 1228
80 Id
81 id

Difficulties with the Application of the GFA

The **first** is deciding to which taxpayers it should apply. On the state level, in order to apply formulary apportionment to affiliated corporations, the corporations must be deemed part of a 'unitary business' based on the degree to which their activities are interdependent. The need to define a unitary business has however been a source of great controversy. An answer to this problem has been proposed that if two corporations are under common control and have substantial inter-company transactions, they will be presumed to be unitary.[82] Current unitary business tests include the 'three unities' test, the 'contribution or dependency' test, the 'modern test', and the 'basic operations interdependence' test. The different standards would cause a lot of confusion and lead to a tremendous amount of litigation, rendering the application of the impossible.

Second, the formulary apportionment methodology is based on the present relationships between the factors of production such as property, payroll and sales and doesn't take into consideration which might significantly alter the relationship between the assets such as market conditions, risks to which the assets are subject and the degree of economic integration of the enterprise[83]..

Third, formulary apportionment requires that the various factors and allocable income tax be converted into a single currency.[84]

The **Fourth** criticism of the GFA model is that it would impose an enormous administrative burden on multinationals, which will have to compile worldwide income and sales data using the accountancy procedures of every individual country in the absence of an international agreement on the use of the GFA model. But in a world of just-in-time inventory and activity-based cost accounting, it seems unreasonable to assume that the international manager does not have ready access to volumes of needed

82 Avi-Yonah, supra note 34 at 154.
83 Ackerman and Chorvat, supra note 27 at 655
84 Benjamin Miller feels that foreign currency translation does not present a serious problem given the existence of many developed methods to account for currency fluctuations. Benjamin F. Miller, A Reply to 'From the Frying Pan to the Fire', 61 Tax Notes 241 (1993) at 243 as cited from Christensen, supra note 65 at 1156

information.[85] This internal information is exactly what an international tax auditor would be looking for in a **formulary apportionment** world. Hence it is advocated that its generation would not be expected to place a heavy or undue burden on an MNE.

Last, the problem relates to the factors to be employed for apportionment of income. If different countries choose to employ different factors for the apportionment of the income, this might lead to a situation of double taxation.[86] The solution to this has been proposed in the form of **Advance Pricing Agreements (APA)** which are currently being resorted to even in the application of the ALP for purposes of ensuring greater certainty and reducing litigation. Under this procedure, the taxpayer can suggest a transfer pricing method in advance, and if the taxing authority agrees, the method can be applied by the taxpayer with no fear of an adjustment in accordance with the arm's length price.

Conclusion

The concept that each country should get its share of taxes is an economic proposition in relation to their economic realities can be realized when the related parties in an international transaction deal at arm's length so that there is no deeming of tax arbitrage being put into use by-any of them.[87] At international level, the tax policy goals of economic neutrality and ownership structure neutrality support the continued application of the ALP inspite of its practical limitations in allocating synergistic profits.[88]

The Formulary Apportionment methods are not consistent with the fundamental of economics of an enterprise and will yield odd results as they don't consider market, risks and degree of economic integration of the enterprise.[89] But this is not the case with arm's

85 For the view that technological advances and non-tax related reporting requirements have made record gathering and maintenance a non-issue, see Hellerstein, Federal Income Taxation of Multinationals, Jerome R. Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment", 60 Tax Notes 1131, (1993) at 1142 as cited from id
86 Christensen, supra note 65 at 1162. ALP also faces the similar criticism. This has advanced arm's length to adopt APA approach of Formulary Apportionment.
87 Srivatsan, supra note 15 at 1068
88 Ackerman and Chorvat, supra note 27 at 655.
89 id

length standard, as fact specific compensation of related – party activities inherent in the ALP.[90]

Another important aspect is from the arm's length standard implicitly accounts for debt versus equity decisions which is line with the Modigliani-Miller theorem[91], because transfer pricing based on ALP allocates both income and expense and, as such, is neutral to the debt versus equity decision. Formulary apportionment, by contrast, allocates profits based on the placement of the entire capital of the enterprise. Formulary apportionment allocates profits as opposed to revenues and, as a result, will allocate returns to equity that will differ depending on the debt-equity ratio in a particular country. An allocation that is susceptible of manipulation depending on relative proportions of debt and equity cannot lead to a principled result.[92]

Practical application of ALP is not an easy task as there is evidence to suggest a massive hemorrhaging of tax revenues because of transfer pricing abuses and because of the flawed arm's-length pricing method employed by the IRS in US. The General Accounting Office (GAO) has reported that more than 73 percent of the foreign firms doing business in U.S. pay no U.S. taxes, despite generating hundreds of billions of dollars in revenues every year.[93]

90 id

91 A cornerstone of modern financial theory, the Modigliani-Miller indifference proposition, supports the concept of fact-specific compensation. The key idea of the Modigliani-Miller theorem is that (but for tax and bankruptcy laws) the debt versus equity decision should not affect how the enterprise conducts its business. In other words, the total value of the corporation is not affected by the firm's capital structure. The choice by suppliers of capital with respect to capital structure and how they choose to allocate profits should not affect the maximization of profits. It follows that capital structure should not affect transfer pricing. Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment: Reply, 49 Am. Econ. Rev. 655 (1959), Peter H. Huang & Michael S. Knoll, Articles and Essays: Corporate Finance, Corporate Law and Finance Theory, 74 S. Cal. L. Rev. 175 (2000). As cited form ibid at 655 – 656.

92 id

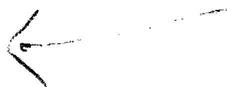
93 Mr. Dorgan "There are also several independent studies of the problem that estimate U.S. revenue losses ranging from $2 billion to $40 billion a year. I happen to think that this country is losing between $10 and $15 billion in revenues from foreign-based firms alone. But I recognize that there hasn't been a comprehensive and official government study that attempts to pinpoint the true size of the U.S. tax gap caused by transfer pricing abuses and to map out the best approach to plug the gap." He is one of the biggest advocate of the Global Formulary Apportionment method in US. Mr. Dorgan, "Income Tax Treaties" U.S. Congressional Record – Senate, Proceedings and Debates of the 104th Congress, First Session, 141 Cong. Rec. S12200-03 (August 10, 1995) at S12200

For taxing authorities Formulary Apportionment fulfills the cannons of administrative convenience and is collects more revenue but if the GFA model is accepted in theory by all countries across the world, achieving consensus on methods of implementation of the GFA model including determining the taxpayers covered by the model, the formula of apportionment that must be applied, the factors to be taken into consideration while applying such a formula, the accountancy procedures to be used would require a very high level of international cooperation which is unrealistic to expect in the field of international taxation.[94]

Therefore, it is submitted that the researcher although agrees that the ALP will survive as the principle on which the necessary international consensus is based, this does not mean it is perfect in every aspect. ALP presently seems to be the best approach as it is flexible to meet the present requirements and future challenges.[95]

Moreover, separate entity theory is perfectly in line with the states sovereign authority of taxation and it's ALP provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises, which is the basis of globalized economy and it's flexibility to adopt to the changing needs leaves no ambiguity of arm's length standard as a success.

94 Supra note 3, at 78.
95 With strong international consensus since the League of Nations, ALP has seen number of developments from comparability to the its various methods and further it's flexibility in adopting the formulary apportionment's APA to resolve transfer pricing disputes heralded for the growth of ALP..



Chapter 3

METHODS OF TRANSFER PRICING

As we have seen that inspite of its various shortcomings, the arm's length method is the one most popular method to arrive at the correct price of a transaction between two related enterprises. Arriving at a correct price can be done through several methods. The choice of the method depends upon the availability of evidence for comparable transactions in an uncontrolled environment, which again depends upon the particular transaction that has been entered into.

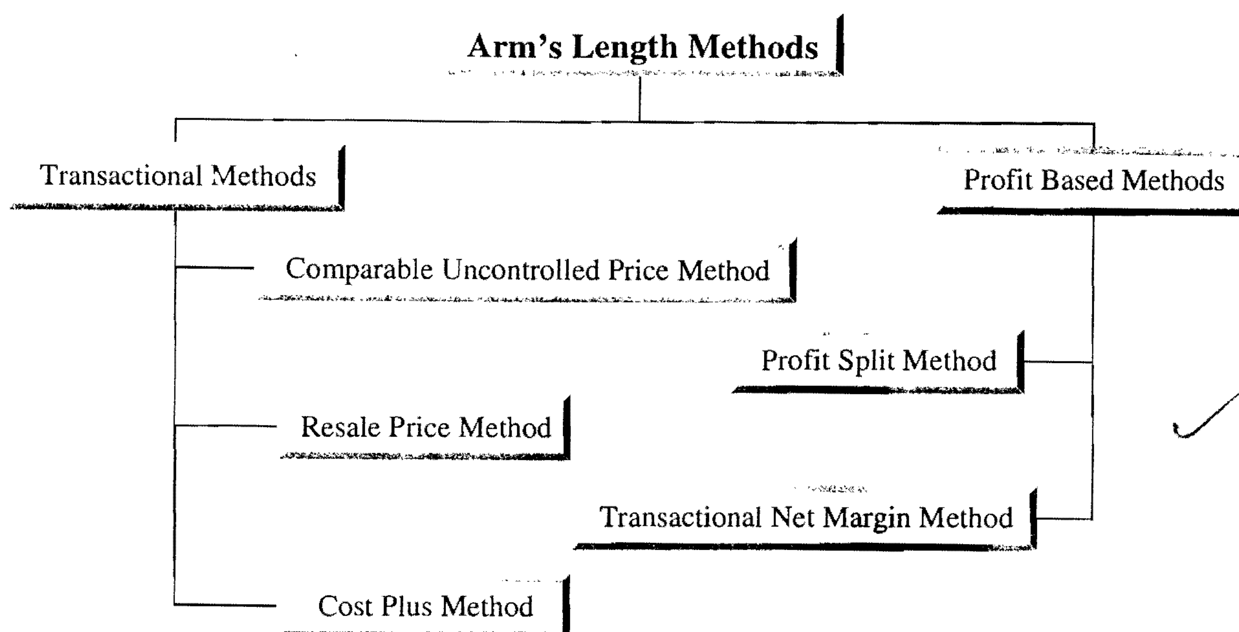
OECD Guidelines has prescribed two sets of methods for determining arm's length price for controlled transactions. These methods are:-

- **Traditional Transaction Methods**
- **Transactional Profit Methods,**

The traditional transaction methods rely on data relating to the prices of comparable transactions between companies operating on an arm's length basis, whereas the transactional profit methods rely on data of companies involved in comparable arm's length transactions or on total profit data for these enterprises to be apportioned appropriately between those companies.

TRANSFER PRICING METHODS

OECD Guidelines makes a fundamental distinction between two sets of transfer pricing methods for determing arm's length prices between related parties as thus:



- **"transaction methods"** which rely, directly or indirectly, on information on the prices at which comparable transactions are entered into by parties operating at arm's length; the transaction methods comprise the following methods:

  - comparable uncontrolled price method (CUP);
  - resale price method (RPM); and
  - cost plus method (C+).

- **"other methods" or "transactional profit methods"**, which rely on information either on the level of profits made by one party to a comparable arm's length transaction or on how the overall profits made by both parties to such a transaction would be divided between them; the transactional profit methods comprise the following methods:

  - profit split method; and
  - transactional net margin method.

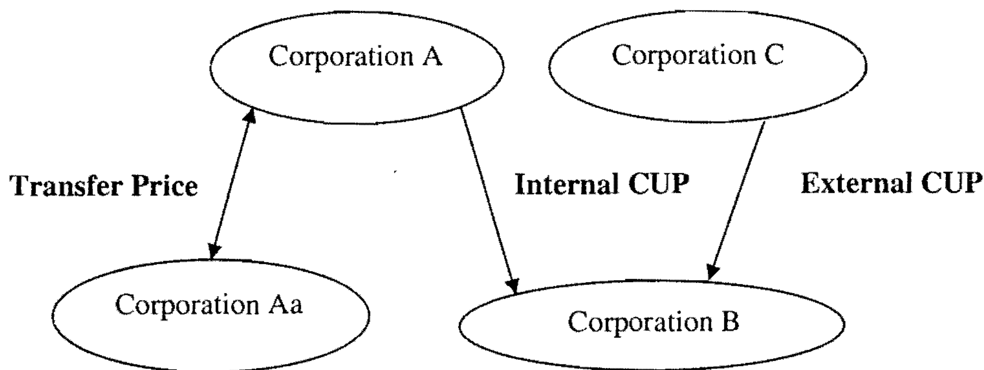
The OECD Guidelines express a strong preference for CUP over other transactions methods and for transactions methods over other methods. The transaction profit methods are methods of the last resort. The "last resort" status means that transactional profit methods cannot be used when traditional transaction methods can be reliably applied.

THE COMPARABLE UNCONTROLLED PRICE METHOD (CUP)

The OECD guidelines define the CUP method as a "transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances".[96] Thus in a CUP a Controlled Price is compared with the Uncontrolled Price i.e. transaction between

Under CUP method, prices can between controlled and uncontrolled transactions can be compared in any of the following two ways:

1. If the enterprise sells or buys the same product under same circumstances to or from an unrelated third party, that price can be used as a CUP, it is called internal CUP.
2. If a transaction is undertaken either by the company with a third party or by two unrelated parties and there are some differences in the product traded, or in the circumstances of the transaction, and adjustments can be made to the price to take account of these differences, then the adjusted price can be used as a CUP, known as External CUP.



This can easily be understood with the chart below, price that Company A will charge to its subsidiary Aa is Transfer Price. In an internal CUP the Transfer price between Company A and Company Aa will be compared with price between Company A and Company B and in external CUP it will be compared with the price between Company C and Company B.

Internal CUP is more accurate and preferable as it doesn't results into any entity and functional differences between the controlled and uncontrolled transactions[97].

96 OECD Guidelines, para 2.6
97 Mukesh Butani, "Transfer Pricing An Indian Prespective" (New Delhi: LexisNexis 2003) at 71 (Henceforth Butani).

The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

Comparability of transactions depends upon many factors; similarity of products has the greatest effect on comparability under this method. If differences exist between the controlled and uncontrolled transactions that would affect price, adjustments has to be made to the price of the uncontrolled transaction in order to make the same comparable to the controlled transaction. Comparability under this method depends upon the following factors:

- (i) quality and quantity of the product;
- (ii) terms of the contract (eg scope and terms of warranties provided, purchase volume, credit terms, transport terms);
- (iii) Kind of market (i.e wholesale, retail, etc);
- (iv) geographic market in which the transaction takes place;
- (v) date of the transaction;
- (vi) intangible property associated with the sale;
- (vii) foreign currency risks; and
- (viii) alternatives available to the buyer and seller.

Let us consider an example of how to determine the CUP:

1. Suppose UniLever, sells fast moving consumer goods (FMCG) to its Indian subsidiary, HLL @ Rs 4,000/- per FMCG. It also supplies the same FMCG at identical terms to independent firms @ Rs 2,500/- per FMCG. The CUP would be Rs 2,500/-.
2. In the above example, UniLever handles the warranty of FMCG's sold to independent firm for 1 year valued at Rs 500/- per FMCG, but HLL has to cover its own warranty. In such a case, the arm's length price would be:

Third party sale price	Rs 2,500/-
Less value of warranty	Rs 500/-
CUP	Rs 2,000/-

However, it is clear from the above 2 conditions that CUP method can be used only if[98]:

1. None of the differences between the transactions being compared or between the enterprises undertaking those transactions **could materially affect the price** in the open market, and
2. Reasonably **accurate adjustments can be made to eliminate the material effects** of such differences.

The CUP method is the most pure theoretical application of the ALP, but is frought with difficulties as outlined above. It is well known that prices change considerably with factors such as the market, risks, availability of credit, volume of transaction, insurance etc and therefore any accurate determination is practically impossible. It is the preferred method used only when such factors are absent.

THE RESALE PRICE METHOD (RPM)

The OECD guidelines define the RPM as a "transfer pricing method based on the price at which a product that has been purchases from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left can be regarded, after adjustment for other costs associated with the purchase of the product, as an arm's length price of the original transfer of property between the associated enterprises"[99].

The RPM compares the gross profit margin in a controlled transaction with gross profit margin in an uncontrolled transaction.[100] It is worthwhile to remember that the resale price margin may be determined either by reference to the resale price margin that the same reseller or an independent third party earns on items purchased and sold in comparable uncontrolled transactions as none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or reasonably accurate adjustments can be made to eliminate the material effects of such differences. In making comparisons for purposes of the resale price method, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price.[101]

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98 Art 2.7 of the OECD guidelines.
99 OECD Guidelines, para 2.14
100 Butani supra note 97 at 76.
101 OECD Guideline, para 2.16

As CUP Method, the RPM method also be applied by way of an internal RPM or an External RPM[102]

- An internal RPM can be used by benchmarking the resale price margin that the same reseller earns on items purchased and sold in uncontrolled transactions, as against earned in a controlled transactions.
- An External RPM can be used by benchmarking resale price margins earned by an independent enterprise in comparable uncontrolled transactions against the margins earned by the tested party from a controlled transaction.

While applying the RPM, the material differences between the controlled and uncontrolled transactions that affect the gross profit margin, should be adjusted to the gross profit margin earned in the comparable uncontrolled transactions. Various factors may effect the gross profit such as cost structures, differences in the age of plant and equipment, business experience etc.

Adjustments may be required to be made for application of the RPM for the following :

(i) Inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;

(ii) Contractual terms, eg scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms;

(iii) sales, marketing, advertising programs and services including promotional programs, rebates and co-operative advertising;

(iv) The level of the market, for example wholesale, retail, etc; and

(v) Foreign currency risks.

Compared to the CUP method, fewer adjustments are required to account for product differences under the RPM, since many of the differences are already reflected in the resale price. However, other comparability attributes such, as the functionality of the reseller and contractual terms have a similar effect on the resale price margin as they have on the price under the CUP method.

An example of the RPM

Suppose in the above example, UniLever has sold the FMCG's to HLL and the final retail price to the customers is Rs 5,000/-. If unrelated parties have a margin of Rs 500/-, then the RPM would

102 Butani, supra note 97 at 77.

arrive at the arm's length price by reducing Rs 500/- from Rs 5,000/- to get Rs 4,500/-.

The resale price method is ordinarily used when the reseller has not added substantial value by either physically altering the property or using its intangible value before resale. This is generally used in cases where one of the related enterprises is importing the product as a retailer of its group enterprise and acts merely as a middle man. So it is difficult to use when, before resale, the goods are further processed so that their identity is transformed, or when there is a considerable time lag between the purchase and resale of the goods. Moreover, if the reseller has a monopoly on the resale, the margin can be influenced by the size of the market, competitiveness of substitute goods etc.[103]

THE COST PLUS METHOD (CPM)

The OECD guidelines define CPM as a "transfer pricing method using the costs incurred by the supplier of property or services in a controlled transaction. An appropriate cost plus mark up is added to this cost to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after this addition may be regarded as an arm's length price of the original controlled transaction."[104] The cost plus mark up is defined as "a mark up that is measured by reference to margins computed after the direct and indirect costs incurred by a supplier of property or services in a transaction."[105]

CPM is a functional approach. It compares the functions performed such as risks assumed and assets employed by an entity in a controlled transaction with an uncontrolled transaction. Although broader product differences can be allowed in the application of CPM, the products transferred in the uncontrolled transaction must still be comparable.[106] It should be noted that the conditions that apply when applying the CUP method also apply during the CPM and if any of them are not complied with, this process cannot be used. It is also to be taken into consideration that the cost plus mark should ideally be established with reference to the cost plus mark that the same supplier earns in comparable uncontrolled transactions and such cost plus mark of an independent supplier in similar circumstances may be taken only as a guide.

In Cost Plus Method, first the cost incurred by the supplier of property (mainly service) is determined. An appropriate cost plus mark-up is then added to the cost, to arrive at an appropriate

103 Singh, supra note 3 at 50
104 OECD Guidelines, para 2.32
105 OECD Guidelines, glossary.
106 Butani, supra note 97 at 81 – 82

profit in the light of the functions performed and market conditions. The resultant figure is the arm's length price. So essentially, CPM involves comparability of gross margins earned by suppliers in uncontrolled transactions.This method is useful for sale of semi-finished goods, rendering of services, etc.

While applying the CPM, if material differences between the controlled and uncontrolled transactions exist, that affect the gross profit margin, adjustments will have to be made to the gross profit margin earned in comparable uncontrolled transactions.

Some of the factors in respect of which **adjustments** may be required to be made for application of the CPM are:

(i) Complexity of manufacturing or assembling;
(ii) Manufacturing, production, and process engineering;
(iii) Procurement, purchasing, and inventory control activities;
(iv) Testing functions;
(v) Selling, general and administrative expenses;
(vi) Foreign currency risks; and
(vii) Contractual terms for example scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms.

Example of CPM

Suppose HLL is selling to UniLever certain FMCG's @ Rs 10,000/- per FMCG. The cost per FMCG is Rs 5,000/-. Other enterprises in the FMCG sector in India earn about 50% as margin on their costs. The cost plus mark .up for HLL therefore would be 50% of Rs 5,000/- which comes to Rs 2,5000/-. Therefore, the arm's length price would be

Rs 5,000/- + Rs 2,500/- = Rs 7,500/-.

The problems associated with the application of the CPM are that it may be difficult to determine the relevant costs in the first place, as cost accounting concepts vary between jurisdictions and businesses. There can also be problems with respect to the allocation of costs between vendors and purchasers, and of exceptionally heavy costs such as expenditure on R & D, capital equipment

etc.[107] Also, since the method is mainly applicable in the case of transfer of semi-finished goods, a limitation in its applicability is that comparables need to be present at each stage of the value chain of the company[108]

The problem with the traditional transactional methods is that in practice, it is extremely difficult, if not impossible to identify uncontrolled transactions that are similar enough to the controlled transaction under scrutiny in order to make the comparison between the two transactions meaningful.[109] Even otherwise, the information needed to fulfil the requirements of these methods of price determination is either not routinely collected by the MNCs, or is extremely difficult to obtain. They must look to outside information relating to other transactions by other corporations to determine the appropriate transfer price.[110] In order to address these problems, the transaction profit methods have been introduced.

THE PROFIT SPLIT METHOD (PSM)

The OECD guidelines define the PSM as a "transactional profit method that identifies the combined profit to be split for the associated enterprises from a controlled transaction and then splits those profits between the associated enterprises based upon an economically valid basis that approximates the division of profit that would have been anticipated and reflected in an agreement made at arm's length"

This method is applicable where transactions are so inter-related that they cannot be evaluated separately for the purpose of determining arm's length price of any one transaction. The profit-split method first identifies the profit to be split for the associated enterprises. Then the profit so determined is split between the associated enterprises on the basis of functions performed, assets employed or to be employed and risks assumed by each enterprise. Such contribution is valued to the extent possible by any available reliable external data. It is generally employed 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. In this method, the combined net profit of

107 Singh, supra note 3 at 53-54.
108 Niraj Jain & Harvinder Jaspal, "The New Transfer Pricing Regime: Issues and Implications" 122 Taxman 149 (2002).
109 See Thompson, supra note 60.
110 See Christensen, supra note 65.

the associated enterprises arising from the international transaction in which they are engaged, is determined. Then the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is evaluated on the basis of the functions performed, assets employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances. The combined net profit is then split amongst the enterprises in proportion to their relative contributions and this profit is taken into account to arrive at an arm's length price in relation to the international transaction.

Profit Split Method is mainly applicable in international transactions involving transfer of unique intangibles or where multiple interrelated international transactions are involved. This method is particularly useful where transactions consist of a number of interrelated functions, which cannot be evaluated on separate basis. Profits amongst the group enterprises should be divided in manner in which independent enterprises would do, under circumstances comparable to the transaction under review.

Profit allocation between the parties to a controlled transaction should reflect, as far as possible, the actual profits that would be achieved by independent enterprises participating in a comparable transaction. This is done in the following manner:

- Firstly minimum profit is established, for which an independent party would undertake to perform the function, which has been performed by the parties to the controlled transaction.
- Residual profit or loss, then will be allocated by considering various factors such as bargaining power of each entity and any intangible property contributed.

An example of the PSM

A is a company in the United States that provides patents to a related manufacturing company B in India. B sells its entire production to a related marketing company C.

Methodology: In order to determine the arm's length price for the **royalty** to be paid by B in respect of the patents provided by A, the following needs to be done:

1. A set of companies comparable to B are to be found.
2. On the basis of profits of such companies, the optimum profits of B are determined.
3. A set of marketing companies comparable to C are to be found.

4. On the basis of profits of such companies, the optimum profits of C are determined.
5. The entire actual profits of the group, that is A, B and C are then aggregated.
6. From such aggregate profits, the optimum profits of B and C are deducted.
7. The balance profits give the value of intangibles held by A and would indicate the optimum level or royalty to be paid by B.

There are also a number of weaknesses to the profit split method. One such weakness is that the external market data considered in valuing the contribution each associated enterprise makes to the controlled transactions will be less closely connected to those transactions than is the case with the other available methods. The more tenuous the nature of the external market data used when applying the profit split method, the more subjective will be the resulting allocation of profits.[111]

A second weakness relates to difficulties in applying the profit split method. On first review, the profit split method may appear readily accessible to both taxpayers and tax administrations because it tends to rely less on information about independent enterprises. However, associated enterprises and tax administrations alike may have difficulty accessing information from foreign affiliates. Moreover, independent enterprises do not ordinarily use the profit split method to determine their transfer pricing (except perhaps in joint ventures). In addition, it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions, which would require stating books and records on a common basis and making adjustments in accounting practices and currencies. Further, when the profit split method is applied to operating profit, it may be difficult to identify the appropriate operating expenses associated with the transactions and to allocate costs between the transactions and the associated enterprises' other activities.[112]

As Profit split method does not follow comparability standards as stringently as traditional transaction methods, thus it can be used in circumstances when other methods prove inappropriate. However, according to OECD guidelines PSM is less reliable than the traditional transactional methods because transfer price tends to be derived through less direct methods of comparison.

TRANSACTIONAL NET MARGIN METHOD (TNMM)

The OECD guidelines define TNMM as a "transactional profit method that examines the net profit

111 OECD Guidelines, para 3.8
112 OECD Guidelines, para 3.9

margin relative to an appropriate base (eg costs, sales, assets) that a taxpayer realises from a controlled transaction (or transactions that it is appropriate to aggregate)"[113]. The net margin shall preferably be that of the same enterprise in a comparable uncontrolled transaction but if that is not available, then the net margin of an independent enterprise in the same conditions can also be taken. It should be remembered that a functional analysis of the associated enterprise and, in the latter case, the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.

In case of this method, the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed in the enterprise or having regard to any other relevant base. Such net margin then, may be compared with comparable uncontrolled transaction, which the tax-payer has entered into with unrelated enterprise (internal comparison). If this is not possible, net margin that would have been earned in comparable transactions by an independent enterprise may be compared (external comparison). Thus, TNMM operates in a manner similar to cost plus and resale price methods.

Good thing in TNMM 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.[114]

Another practical strength is that it is not necessary to determine the functions performed and responsibilities assumed by more than one of the associated enterprises. Similarly, it is often not necessary to state the books and records of all participants in the business activity on a common basis or to allocate costs for all participants. This can be practically advantageous when one of the parties to the transaction is complex and has many interrelated activities or when it is difficult to obtain reliable information about one of the parties.[115]

Application

113 OECD Guidelines, para 3.26
114 OECD Guidelines, para 3.27.
115 OECD Guidelines, para 3.28

It is inappropriate to apply the TNMM on a companywide basis, if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise.

The associated enterprise to which the TNMM is applied, should be the enterprise for which reliable data on the most closely comparable transactions can be identified. This will often entail selecting the associated enterprise that is the least complex of the enterprises involved in the controlled transaction and that does not own valuable intangible property or unique assets.

There are also a number of weaknesses to the transactional net margin method. Perhaps the greatest weakness is that the net margin of a taxpayer can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect, on price or gross margins. These aspects make accurate and reliable determinations of arm's length net margins difficult.[116]

Application of any arm's length method requires information on uncontrolled transactions that may not be available at the time of the controlled transactions. This may make it particularly difficult for taxpayers that attempt to apply the transactional net margin method at the time of the controlled transactions. In addition, taxpayers may not have access to enough specific information on the profits attributable to uncontrolled transactions to make a valid application of the method. It also may be difficult to ascertain revenue and operating expenses related to the controlled transactions to establish the financial return used as the profit measure for the transactions. Tax administrators may have more information available to them from examinations of other taxpayers. However, as with any other method, it would be unfair to apply the transactional net margin method on the basis of such data unless the data can be disclosed (within the limits of the confidentiality requirements of tax laws) to the taxpayer so that there is an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.[117]

One other issue that arises for the transactional net margin method is that the method is typically applied to only one of the associated enterprises. This one-sided aspect does not distinguish the method from most other methods, given that the resale price and cost plus methods also have this feature. However, the fact that many factors unrelated to transfer prices can affect net margins and can render the transactional net margin method less reliable heightens the concerns over a one-sided analysis. A one- sided analysis may not take into account the overall profitability of the MNE group

116 OECD Guidelines, para 3.29
117 OECD Guidelines, para 3.30

from the controlled transactions for purposes of comparability. A one- sided analysis potentially can attribute to one member of MNCgroup a level of profit that implicitly leaves other members of the group with implausibly low or high profit levels. While the impact on the profits of the other parties to a transaction is not always a conclusive factor in determining the pricing of a transaction, it may act as a counter-check of the conclusions reached.[118]

The problem with the profit methods is that they reach an arm's length result "only on a case-by-case basis".[119] Particularly, with respect to the TNMM, since it is applied to only one associated enterprise, it can produce absurd results. Many factors unrelated to transfer prices can affect net margins, for instance, market share has a tremendous influence on a company's net profit margin. With respect to its competitive position in the market, all of the differences are likely to have a material effect on the profitability of the compared transactions.[120]

COST CONTRIBUTION ARRANGEMENTS

Cost contribution arrangements have been defined by the OECD to refer to a framework agreed to among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights.[121] This is normally done when the cost of developing an asset is too high for one enterprise to bear as in the case of costly intangibles.

For the application of the ALP to such transactions, first, the expectation of benefits by each party should be determined. This should be followed by a determination of the contribution by each participant. Then, it should be seen whether the contribution by the taxpayer is proportional to the expected benefit. In case of a difference observed in the previous step, corresponding adjustments should be made. [122]

For the determination of expected benefits from the transaction, the additional income generated or costs saved by each participant as a result of the arrangement must be estimated. Then by using

118 OECD Guidelines, para 3.31
119 Lester, supra note 55 at 292.
120 Thompson, supra note 60 at 337.
121 Ibid. at 73.
122"OECD: Cost Contribution Arrangements" 5(2) International Transfer Pricing Journal (The Netherlands, International Bureau of Fiscal Documentation, 1998), (hereinafter 1998 OECD Report), cited from supra note 3, at 74.

allocation keys like sales, units used, produced or sold, gross or operating profits, the number of employees, capital employed and so forth, the total benefit may be divided amongst the participants[123].

THE BEST METHOD RULE

This rule states that the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of the arm's length result. Two primary factors must be analyzed to determine what method yields the best result:

(1) the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables; and
(2) The quality of the data and assumptions used in the analysis. [124]

Various problems have been identified with the 'best method' rule.

First, in many cases where it is not clear *ex ante* which method is best, a MNC will have to perform several separate arms' length evaluations in order to determine the best method. Because of the expense and time involved with such an evaluation, MNEs will be subject to a much greater administrative burden.[125]

Secondly, the best method rule could cause problems for MNCs that are subject to the transfer pricing rules of other countries. The 1979 OECD Report clearly established a preference for use of the CUP method, and many countries have adopted this preference. A MNC based in one of these countries may need to apply the CUP method, even if it would not qualify as the 'best method' under the law.[126] Thus, MNCs subject to the transfer pricing rules of other countries may have to use two different methods, further increasing administrative costs and burdens.

An alternative to the best method rule has been proposed in the form of the Reasonable Method Rule.[127] This method envisages that the arm's length method with respect to a particular MNC is determined in consultation with the other countries in which the enterprises of the MNC are located. Application of such a rule will allow the MNC to establish transfer prices more efficiently without

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123Id.
124 Charles F Connolly, "Comment: The New Transfer Pricing And Penalty Regulations: Increased Compliance, Increased Burdens, And The Search For A Safe Harbor" 16 U Pa J Int'l Bus L 339 (1995) at 354.
125 Ibid. at 355.
126 Ibid. at 356.
127 Ibid. at 357.

fear of double taxation. This increased cooperation would not only ease the administrative burden on MNCs, but would pave the way for international agreement on proper transfer pricing methodologies.

Chapter 4

DOCUMENTATION

To have an effective Transfer Pricing regulations it is required that these regulations should be accompanied by extensive documentation requirements and stiff penalty regimes. The methods developed to determine the arm's length price will be of no use unless these are supported by the documentation requirements. Documentation of characterization, methodology, conditions, assumptions, etc which determine the arm's length nature of the transactions among associated corporation is essential for transfer pricing regulations. Although ALP is a recognized principle around the globe but different documentation requirements in different jurisdictions makes the applications of transfer price regulations uneven and harder at global level.

Documentation--the Fundamental Objective

The fundamental objective of documentation is that "Each taxpayer should endeavour to determine transfer pricing for tax purposes in accordance with the ALP, based upon information reasonably available at the time of the determination. Thus, a taxpayer ordinarily should give consideration to whether its transfer pricing is appropriate for tax purposes before the pricing is established. For example, it would be reasonable for a taxpayer to have made a determination regarding whether comparable data from uncontrolled transactions are available."[128] Put simply, transfer pricing documentation must satisfy the reader that the tested party's transactions with its affiliates are set as if the parties were dealing at arm's length. The point to make here is that if the documentation leaves a logical audit trail that starts with an analysis of the transaction, identifies an arm's length price range and shows that the transaction is acceptable given that benchmark, then taxpayers should surely be entitled to consider their compliance

128 OECD Guidelines, para 5.3

obligation fulfilled from any reasonable perspective.[129]

The taxpayer needs to be especially careful about what constitutes the 'transaction' here. All too frequently, taxpayers and revenue authorities alike consider the 'price' of the transaction in isolation. In most commercial relationships, the terms of any transaction are much more complex than mere price, and address other aspects of the arrangement such as the ordering process, inventory and delivery liability, payment terms and after sales service. Documenting these aspects makes for a complete functional analysis that will enable these transactions to be benchmarked against comparable data in a more robust manner.[130]

Another key feature of the transformation in transfer pricing compliance has been a shift in the burden of proof for validating inter-company pricing policies from revenue authorities to the taxpayer. The need to document the policy is implicit in any situation where the burden of proof lies with the taxpayer. Legislation may often be rather more prescriptive as to what forms of documentation are expected, as can be seen in various specific country rules.[131]

Even in territories where the burden of proof remains with the revenue authority, it can still be advisable for taxpayers in that territory to maintain a minimum level of transfer pricing documentation. The OECD Guidelines explain that "without adequate information, the tax administration would not be able to examine the case properly."[132] Add to this the fact that documenting a global transfer pricing policy can often identify tax planning opportunities for the taxpayer, the conclusion in terms of best practice is clear. In this way, documentation should not be viewed as an administrative burden to be avoided by the multinational wherever possible, but as a best practice tool that is fundamental to global tax planning activities while also helping to satisfy statutory reporting requirements. However, the diversity and resulting complexity of global documentation requirements means that, typically, the multinational is forced to view

129 Chris D Rolfe, "Fact Development and the Policies of Transfer Pricing Documentation", 10 Geo. Mason L. Rev. 959 (2002) at 961
130 Rolfe, supra note 129 at 961
131 Ibid at 961 – 962.
132 OECD Guidelines, para 5.2

documentation as a compliance burden rather than an opportunity.[133]

Documentation - The Standard Elements

Chapter V of the OECD Guidelines gives much more substance in respect to the model documentation set. A good documentation is a requirement both for taxpayers and tax administrators. Information/documentation requirements can be put under two categories[134]:

1. Information required to be submitted by taxpayers along with their returns of income, and
2. Documents that should be kept and maintained and which would be requested by tax authorities during audit.

As the information is concerned, it is for the taxpayers to see whether a particular case needs to be taken up for examination from transfer pricing perspective or not and as for documentation requirements, it should be much elaborate and includes information, documents and books of accounts relevant for transfer pricing.[135]

Briefly, a typical documentation set can be broken down into four main categories:[136]

Characterisation of the Business sets the context for the analysis. It will provide an overview of the multinational's business and the main economic and commercial drivers such as the nature of its markets, its competitive position, reliance on suppliers, use of intangibles, etc. Next, a more detailed functional analysis of the tested party is necessary, highlighting the exact activities it performs within the group, the tangible and intangible assets it uses and giving a profile of its suppliers and customers, both third party and related. Broadly known as functional analysis, the goal of this aspect of documentation is to provide a view on the various functions, risks and tangible and intangible assets used

133 Rolfe, supra note 129 at 962
134 Singh, supra note 3 at 83
135 id
136 Rolfe, supra note 129 at 961 -963.

by the group as a whole and the tested party in particular.[137]

Characterization of the inter-company transactions then addresses individual transactions or, more likely, categories of transactions. Vital to this is some analysis of the statutory accounts that enables the reader to identify these categories. Typical analyses will show financials by product or business line. In addition, this analysis and supporting information must identify clearly how the inter-company prices impact the financials. Transactions not covered by the transfer pricing laws should be separately identified at this stage. Once the financial effects of the related party transactions are isolated, their qualitative aspects should be documented, including the names of the related counter-parties, the terms of the transactions and their size and volume. Any contracts or other agreements that can support this disclosure should be included as back up to the core documentation.[138]

Selection and application of methodology comprises two main steps. First, the appropriate **pricing methodology** must be selected. This will then help to identify the types of comparables that can be used for benchmarking. The **selection rationale** must be documented fully, along with any subsequent adjustments and statistical analyses that are required to arrive at a satisfactory arm's length benchmark, typically a range.[139]

One crucial point should be made here. It is usually preferable to analyze the simpler counter-party to the transaction, regardless of the entity for which documentation is being prepared. This is especially true in cases where actual transfer prices are set by reference to an analysis of profit margin rather than CUP-based data. This requires a minimum level of co-operation between the related parties, including perhaps some level of information exchange. In cases where there is a mismatch in priorities for the relevant personnel or compliance burdens for the corporate entities, the documentation process can become slow and burdensome.[140]

The final step, validation of arm's length pricing, pulls all the elements together. What is

137 Ibid at 962
138 Ibid at 963
139 id
140 id

required here is a **logical explanation of** how the forgoing **information** demonstrates that the transactions being scrutinised satisfy the ALP. Typically, this will involve applying the results of the comparable work to the tested party's financial data after making and clearly explaining any necessary adjustments.[141]

Taxpayers must recognize that adequate record keeping practice and voluntary production of documents can improve the persuasiveness of its approach to transfer pricing. Tax administrators are also required not to be overenthuasitc in demanding documentation during examination of transfer pricing cases.

- The requirement of documentation should be reasonable. Care should be taken to balance the need for documentation against the cost and administrative burden to taxpayer of creating or obtaining the required documents.
- Taxpayers should not be asked to produce documents that are not in the actual possession or control of the taxpayer or otherwise not reasonably available.
- Only those documents should be called for which contain information relevant for determining transfer prices.
- It should be ensured that there is no public disclosure of trade secrets, scientific secrets, or other confidential data.
- The amount of information that is reqested at the stage of filing the tax return should be limited. This should be limited to information sufficient to allow the tax administration to determine approximately which taxpayers need further examination.

SUMMARY OF OECD GUIDELINES ON DOCUMENTATION

The OECD guidelines do not specify any particular document to be maintained by the taxpayer. However, taxpayers should make reasonable efforts at the time when transfer pricing is established, to determine whether the transfer price is in accordance with the ALP, and to document the same.

141 id

The OECD recommends that tax administrations should have the right to obtain the documentation prepared or referred to determining the arm's length price, as a means of verifying compliance with the ALP.

However, the OECD guidelines suggests that the extensiveness of this process should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance. The need for the documents should be balanced by the costs and administrative burdens, particularly where this process suggests the creation of documents that would not otherwise be prepared or referred to in the absence of tax considerations.

As per the OECD guidelines, documentation requirements should not impose on taxpayers, costs and burdens disproportionate to the circumstances. Taxpayers should nonetheless recognize that adequate record-keeping practices and voluntary production of documents facilitate examinations and the resolution of transfer pricing issues that arise.

Examination Practices

Valuation is a art and not a science is equally true for transfer pricing. Transfer pricing is dependent not only on the nature of the relationship among the group but also on the market factors. Consequently in examination of transfer pricing differs considerably from the examination of prices charged or paid to independent enterprises. Transfer pricing examination is very much dependent on finding right comparables.[142]

Taxpayers faces great problem when the methodology used by the tax administrators differs from what is being followed by tax administrators in the host or home country which causes additional burden to taxpayers. However this can be avoided if all countries follow an internationally acceptable examination practice with the following features:

- The methodology used by tax examiners should be umambigious, and unless there are strong reasons the methodology used by the taxpayers should not be rejected.

142 Comparability has been dealt at length in chapter Transfer Pricing: Practical Considerations.

- Tax examiners should be flexible in their approach and not demand from taxpayers in their transfer pricing a precision that is unrealistic under the given facts and circumstances.
- The transfer pricing analysis should be based on commercial realities and the method used by the taxpayers should not be rejected without valid reasons.

ALTERNATIVE DISPUTE RESOLUTION MEASURES

Any adjustments to transfer prices made by tax administration, which is not agreed by taxpayers, results in litigation. Maintaining legal disputes is not only expensive but also time consuming for both taxpayers and tax administrations. Hence for the growth of international trade, alternative dispute resolution system needs to be developed that should be less expensive and expeditious.

SAFE HARBOURS

Safe harbours are the rules that define circumstances in which transfer prices shown by taxpayers would be automatically accepted by tax administrations. In specific instances of transfer pricing, the administrative requirement of safe harbour may vary from a total relief from the obligation to conform to a country's transfer pricing legislation and regulations to obligation to comply with various procedural rules in a simplified manner. These rules could, for example require taxpayers to establish transfer prices by a specified method and to maintain documents of controlled transactions in a particular manner. The safe harbour rules need to be revised and published periodically by tax authorities.

Safe harbours are advantageous to both taxpayers as they provide certainty and to tax administrations as they are free from the task of further examination and audit of taxpayers eligible for the benefit under safe harbour rules, who can therefore allocate resources for the examination of other transactions and taxpayers.

Safe harbour has certain limitations which hinders its universal application[143].

- The implementation of a safe harbour in a given country would not only affect tax calculations within that jurisdiction, but would also impinge on the tax calculations of associated enterprises in other jurisdictions.
- It is difficult to esatablish satisfactory criteria for defining safe harbour which can potentially produce prices or results that may not be consistent with the ALP.
- Under safe harbour rules transfer prices are predominately established by references to a standard target as opposed to the individual facts and circumstances of the transaction as under the ALP. Consequently, the application of safe harbour rules sacrifices accuracy.
- Safe harbours are likely to be arbitrary since they rarely fit into the varying facts and circumstances even of enterprises in the same business.
- Taxpayers may be induced to modify the prices in order to increase the profits to meet the targets and thereby avoid transfer pricing scrutiny or audit.
- Safe harbour would also provide taxpayers with tax planning opportunities and may also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbour provisions.

ADVANCED PRICING AGREEMENTS (APAs)

APAs have been advocated as a solution to the problem of double taxation as well as a method of reducing the problems associated with complying with transfer pricing regulations. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a period of time. APAs are agreements that for a fixed term, the assessing authority will accept an agreed transfer pricing method used by the assessee. Such agreements are formal in nature with fixed terms and limits; they are obtained through a process of formal inquiry and negotiation and based on statute.[144]APAs lend

143 Singh, supra note 3 at 92-94

144 Pamela L. Kayfetz & Leo B. Helzel, "Transfer Pricing: Achieving Fair National Taxation of International Transactions" 3 Ann. Surv. Int'l & Comp. L. 193 (1996). In the United States, Rev.Proc.91-92

certainty to tax treatment of transfer pricing situations, limit the cost and time spent in examination and reduce the possibility of litigation. However, they require disclosure of sensitive information by the MNC to the tax authority and a huge amount of time and money is required for their preparation. Moreover, they might not be able to eliminate the risk of double taxation, without being able to provide bilateral or even multilateral authority.[145]

Advantages of APAs

The APA process is developed as possible alternative to prolonged expensive litigation as the primary method for resolving transfer pricing disputes. Hence both tax payers and tax administration share information and expertise for arriving at a mutually acceptable price of intra-group transactions. The biggest advantage of an APA is that it creates a non-adversarial environment in which transfer pricing issues are discussed in a professional setting.

- It eliminates uncertainty by enhancing the predictability of tax treatment in international transaction.
- It prevents costly and time consuming examinations and litigation. Once an APA has been agreed to, fewer resources may needed for subsequent examination of the taxpayer's return, because more information is known about the taxpayers.
- Bilateral and multilateral APAs substantially reduce or eliminate the possibility of juridical or economic double taxation since all the relevant countries participate.
- It may assist tax administration in gaining insight into complex international transactions undertaken by MNCs

But the **APA procedure** has its own limitations. *First*, it is extremely complicated and costly in practice for it requires extensive submissions and documentation and if the parties fail to agree, litigation is still possible.

1991-1 CB 534 provides for APAs with the IRS and the agreement is binding between the IRS and the taxpayer see K.C. Gopalakrishnan, Text Book on International Taxation 119 (2002).

145 Andrew M. Snyder, "Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology" 48 Tax Lawyer 1057 (1995).

Secondly, APAs are not published and in the absence of comparables, are not subject to any standards. This leads to the impression that the taxing authority is in effect cutting deals with well-off corporate taxpayers, which remain secret and are not subject to any general standard of law or to any review.

Thirdly, it provides no solution in case of smaller taxpayers who may not wish to engage in the prolonged effort to develop an APA. [146]

Fourthly, although this practice protects the taxpayer from exposure of an audit and the subsequent penalties that can arise, many companies may be hesitant to release the requisite detailed financial information. By entering into an APA, the taxpayer will be revealing information that will assist the IRS in understanding the intercompany pricing arrangement, but it could also alert the IRS to inconsistencies that may never have surfaced in the course of the regular audit process. However, this should be balanced against the risks that come from potential penalty assessments for those who choose to wait until they are audited.[147]

146 Avi-Yonah, supra note 54 at 155-156.
147 Roland Ryan Davis, "The New Transfer Pricing Tax Regulations: Now That They're Here What Should You Do?" 10 Computer & High Tech L J 195 (1994) at 199.

Part II

Developed and Developing Countries Perspectives.

Developing countries have always looked at globalization with a suspicious eye. For developing countries the allocation of profits to the Parent Corporation by Subsidiary Corporation has always posed challenged especially when new business models results from technological advancements. These profit transfers are huge and it deprives a developing country from its legitimate taxation than the expressed concerns are genuine

Tax policies of nations are, to a great extent, influenced by that country's stage of economic development.[148] In order to appreciate the concerns of developing nations, it is necessary to obtain a general overview of their economies and related characteristics.

Developing countries exhibit a number of characteristics that define their economy and impact tax policies. First, most developing countries are net importers of technology, goods, and services, and accordingly aim to maximize source-rule taxation in order to collect their fair share of taxes.[149]

Second, rapid increases in e-commerce transactions have had a distinct impact. E-commerce transactions in India are expected to grow from US$ 27.87 million in 1998-99 to between US$ 5.70 billion and US$ 13.40 billion in the year 2008.[150]

Tax contributions by MNCs executing cross-border transactions contribute significantly to the total tax collections of developing countries. Accordingly, such countries are

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148 J. Bethélemey & A. Varoudakis," Policies for Economic Take-off" (OECD Development Centre, Policy Paper No. 12), available at http:// www.oecd.org/pdf/M00008000/M00008088.pdf. as cited from Shyamal Mukherjee, "Attribution of Profits to Permanent Establishments: A Developing Country's Perspective" 10 Geo. Mason L. Rev. 785 (2002) at 789

149 Ibid at 790

150 Among the Asian nations, the Compounded Annual Growth Rate of e-commerce between 1997 and 2003 is expected to be as follows: India 246% China 243%, South Korea 145%, Hong Kong 110% India Ministry of Finance, Central Board of Direct Taxes Committee on Electronic Commerce and Taxation Report ¶ 2.2, at 6, available at http:// finmin.nic.in/cbdt/executive.pdf. as cited from id

especially concerned that new economy business models will erode their tax base.[151]

Fourth, almost all developing countries have some kind of exchange control regulations in place. Accordingly, the application of the arm's- length test in a developing country is to a certain extent subordinate to the broader government objective of preserving valuable foreign exchange.[152]

Finally, revenue authorities in developing countries have limited resources to focus on niche issues like transfer pricing. Accordingly, such jurisdictions generally have stricter penal provisions in their transfer pricing laws to encourage voluntary compliance than developed countries as the latter have considerable experience in addressing such issues and the resource allocation for empirical research, and staff training.[153]

A related aspect of this approach is that developing countries place the burden of compliance on the taxpayer. Unlike the criminal justice system where there is no presumption of guilt, developing countries almost always shift the bulk of the compliance burden to the taxpayer. A clear example of this is India, where the transfer pricing law places such a burden on the taxpayer.[154] Developing countries recognize that transfer pricing cases can present a special challenge from an audit or examination viewpoint.[155]

151 id
152 M. Amarasuriya, Comparative Study of Financial & Investment Regulatory Framework of Singapore, Hong Kong, U.A.E., Mauitius, & Sri Lanka (Sri Lanka Deregulation Conference, Feb. 2002), available at http:// www.gov.lk/imst/activities/deregu/Current/dg-paperderegctee_Final.doc. as cited from id.
153 id
154 See Indian Income Tax Act (1961), ch. 10, § 92D and 92E.
155 See Mukherjee, supra note 148 at 790, See Chapter 7 Transfer Pricing in Brazil and Chapter 9 Transfer Pricing in India.

Chapter 5

Transfer Pricing in United States of America

The United States has been a leader in formulating legislation and guidelines in respect of transfer pricing. It started with the legislature responded to potential pricing abuses in the War Revenue Act of 1917 by requiring every corporation to supply the Commissioner of the Internal Revenue Service with information describing its relations with other affiliated corporations.[156] The Commissioner required corporations to file consolidated tax returns to properly "determine"' income.[157] The Revenue Act of 1921 vested the Commissioner with the direct power to prepare consolidated tax returns in order to reflect the taxpayer's "accurate"' income.[158] Seven years later Congress enacted the Revenue Act of 1928, which included section 45, labeled "Allocation of Income and Deductions."'[159] With section 45 Congress went beyond the narrow scope of the consolidated return provisions of prior revenue acts into the broader area of allocation of income and deductions.[160] The legislative history provided the Commissioner with authority to make allocations necessary in order to prevent tax evasion and to reflect clearly the "true"' tax liability of commonly controlled businesses.[161]

156 Regulation 41, articles 77-78, War Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917). Code sections 1501 through 1505 currently deal with consolidated return filing. I.R.C. § § 1501-1505 (1986). Companies that file consolidated tax returns benefit when the affiliated corporations' respective strengths and weaknesses offset each other. As cited from Josh O. Ungerman, "The White Paper: The Stealth Bomber of the Section 482 Arsenal" 42 Sw. L.J. 1107 (1989) at 1109

157 Regulation 41, art. 78, War Revenue Act of 1917. as cited from ibid at 1110

158 Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260 (1921). As cited from id

159 Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806 (1928). As cited from id.

160 While § 240(d) of the Revenue Act of 1921 stated that "the Commissioner may consolidate the accounts of . . . related trades and businesses,"' § 45 of the 1928 Act provided that "the Commissioner is authorized to . . . allocate gross income . . . among such trades or businesses . . . . " id.

161 The report from the House Ways and Means Committee on the Revenue Bill of 1928 stated that "the Commissioner may . . . apportion, allocate or distribute the income or deductions . . . in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods adopted for the purpose of "milking"'), and in order clearly to reflect . . . true tax liability."' H.R. REP. NO. 2, 70th Cong., 1st Sess. 16-17 (1928) as cited from id.

The early regulations and case law arising under section 45 of the Revenue Act of 1928 established the statutory underpinnings of section 482. [162] Treasury regulations issued in 1935 provided another cornerstone in the development of section 482 with the mandated use of an arm's length standard.[163] The regulations required that taxpayers treat their transactions, in all cases, as if the negotiations involved uncontrolled taxpayers dealing at arm's length. The 1935 regulations did not define the term "uncontrolled taxpayers," but implied that it meant two or more organizations, trades, or businesses with no common interests.[164]

It was only in 1962 when the Treasury released a short set of regulations that described the scope and application of section 482 which lead the House and Senate to debate the issue of amending the Code section itself. The Senate eventually convinced the House that the allocation objective could best be accomplished through additional regulations promulgated by the Treasury.[165]

The Treasury acted on Congress's recommendations and ultimately issued additional section 482 regulations in 1968. While the earlier regulations established the basic ideas of the section's application to international transactions and the concept of measuring all transactions on an arm's length basis, the 1968 regulations expanded these key ideas and

162 The following statutes reflect almost identical terminology: Section 45 of the Code states:
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
I.R.C. § 45 (1939). Section 482 of the Code states:
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
I.R.C. § 482 (1954). See id.
163 Treas. Regs. 86, § 45-1(b) (1935). "'The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." As cited id.
164 Ibid at 1111.
165 id

laid down the framework for dealing with specific types of transactions.[166]

The 1968 regulations, most of which remain in effect and unchanged since issuance, provide guidance on the transfer or sale of services, tangible property, and intangible property. The regulations mandate allocations in the event that the amount charged for a service differs from an arm's length charge. An arm's length charge for services theoretically equals the amount independently charged for the same or similar services among unrelated parties in similar circumstances. The regulations state, however, that generally the arm's length charge is deemed to be equal to the costs or deductions incurred by the members with respect to the services.[167]

The regulations guiding the determination of an arm's length price for the sale of tangible property between commonly controlled companies provide a complex hierarchy of methods. To convert a "controlled sale"' price to an arm's length price, the regulations offer four methods: (1) the Comparable Uncontrolled Price Method, (2) the Resale Price Method, (3) the Cost Plus Method, and (4) an unspecified "fourth method."' The regulations require the taxpayer to attempt to apply the methods in sequence beginning with the Comparable Uncontrolled Price Method. If the factors necessary to apply a particular method are unavailable or undeterminable, the taxpayer tries the next method. As a last resort, the regulations permit the use of a "fourth method,"' which amounts to any alternative method that satisfies the basic objectives of the regulations.[168]

In determining what constitutes "arm's length consideration"' for the transfer or use of intangibles, the Service applies the standard test: the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. In the absence of comparative unrelated party transactions, the regulations provide twelve factors designed to assist in arriving at an arm's length price. Thus while the Service applies a cost-oriented "methods"' approach to the sale of tangibles, the government simply stipulates relevant "factors"' when focusing on the arm's length price of

166 ibid at 1112.
167 id
168 ibid at 1113.

intangibles.[169]

Following the Tax Reforms Act, 1986, a study of different issues of transfer pricing was undertaken and in January 1992, the proposed regulations were issued which brought forth two important features, earlier not touched upon. One, the parties to conduct business as uncontrolled parties in establishing transfer pricing policies. Next, the regulations brought about three new methods for establishing the arms length price, for transactions of intangibles, namely the matching transaction method, the comparable adjustable transaction method and the comparable profit interval. In January 1993, the Treasury Department released the Temporary and Proposed Regulations with certain changes. Finally on July 1, 1994 the Temporary and Proposed Regulations were adopted and are effective from since then.

Important US Case Laws

In **Compaq Computer Corporation v. Commissioner,**[170] Compaq US were able to prove that their transaction is at arm's length price. Compaq Computer Corporation ("Compaq - US") is a company incorporated in the state of Delaware, USA, and having its principal place of business in Houston, Texas. Compaq - US along with its subsidiaries Singapore ("Compaq –Singapore") and the United Kingdom manufactured Printed Circuit Assemblies ("PCAs") which are an essential component for the manufacture of the CPU. Compaq - US, in addition to manufacturing the PCAs itself, could source these from Compaq - Singapore or various other unrelated subcontractors located mainly in the US. Compaq – US contracted with Compaq-Singapore whereby Compaq-Singapore produced and sold PCAs to its U.S. parent. Compaq-US used many advanced procedures in the manufacture of the PCAs. Compaq-Singapore was set up on lines similar to the already existing structure of Compaq-US. As result of this Compaq-Singapore was more advanced than other Singapore PCAs manufactures and hence did not compete with them. Both, Compaq-US and Compaq-Singapore used standard costs

169 Ibid at 1113-1114
170 T.C. Memo, 1999-220. July 2, 1999

system as a method of tracking their manufacturing costs. They assigned specific costs to arrive at a material standard, a labour standard and an overhead standard. These standards were based on forecasted production facility in their respective locations. A point to be noted here is that the cost of production in Singapore was much lower than that in US.

On an enquiry, Compaq presented a comparable uncontrolled price (CUP) involving contract manufacture relationships and unrelated companies. Three significant differences existed between the intercompany transactions involving Compaq-Singapore and the CUP transactions. First, the products were not identical. Second, there were important functional differences involving the purchase/consignment of raw material and, third, there were geographic market differences. It was as a result of these differences that an adjustment was required in the prices of the transactions with unrelated sub-contractors, to arrive at an appropriate CUP. The petitioner (Compaq-US) in the case had used the CUP method in its dealings with the Compaq-Singapore to arrive at an arm's length price. The CUP was arrived at by considering transactions that Compaq-US had with unrelated subcontractors. The respondent was of the opinion that the petitioner had used cost plus method in arriving at the return position and had used the CUP method only at the trial. The petitioner had the burden of proving that the respondent's claim of tax deficiency was arbitrary, unacceptable and capricious. The Court held that the petitioner had satisfied its burden of proving that the transactions were conducted at arms length and that the use of CUP was warranted. The Tax Court saw no problems with Compaq's application of the CUP method and allowed its use without further adjustment.

DHL Corporation and Subsidiaries v. Commissioner[171] DHL is a worldwide overnight package delivery company that was formed in the United States in 1969 who in 1972 formed a Hong Kong subsidiary, DHLI, that conducted DHLs international operations with Middletown NV (MNV), a Netherlands Antilles company. DHLI managed the international operations, while DHL operated in the US market. The international operations were conducted through DHLI, its affiliates and a series of independent agents that agreed to do business within the DHL network, who were all required to use the DHL trademark. In the late 1970s, DHLI has formulated a logo for

171 T.C. Memo. 1998-461, December 30, 1998

itself and from 1983, DHLI began process of registering the DHL name in countries outside the United States. The name was registered in the name of DHLI without reference to the fact that DHLI was a licensee of DHL. DHLI incurred the cost of trademark registration, protected the trademark against infringement outside the United States, and handled disputes with terminated agents related to trademark usage. Finally, DHLI bore the cost of advertising the DHL network outside the United States. In December 1990, a group of investors including Japan Air Lines company (JAL), Nissho Iwai Corp. (Nissho Iwai) and Deutshce Lufthansa Aktiengesellschaft (Lufthansa), have acquired a partial interest in DHLs international operations (DHLI and MNV). The foreign investors also obtained an option to purchase controlling interest in DHLs international operations. On August 18, 1992, they exercised their stock purchase option and became majority owners of DHLI and MNV. Pursuant to these purchases, the parties agreed on a price for the entire transaction.

During the due diligence activity that accompanied these transactions, concern was expressed that the IRS might seek to impute a royalty for DHLI's use of the DHL trademark. At the same time, DHL's continuing cash flow problems threatened the worldwide DHL network. For these reasons, the parties agreed that DHLI should purchase the DHL trademark as a vehicle for capitalizing DHL and to eliminate potential IRS audit exposure. Several advisers valued the DHL name at the values ranging from USD 20 million to USD 200 million. Ultimately, a USD 20 million valuation was used, and the sale was consummated in 1992, one month after the foreign investors exercised their rights to purchase a controlling interest in DHLI. It is important to note that the total value of the transactions was not affected by the varying values for the trademark. After the USD 20 million value was placed on the trademark, Bain was asked to prepare a valuation of the DHL trademark. Two days after being hired, Bain presented a draft letter stating that the value of the DHL trademark was USD 20 million. It appears that Bain confused both the date of valuation and whether it was to value the worldwide rights or just the US rights. DHLs legal advisers worked with Bain to clarify these matters, but the USD 20 million did not change. A central issue in DHL, was the ownership of the DHL trademark. The ownership of the US rights to the trademark was not at issue- both sides

agreed that DHL (the US company) owned those rights. Because, DHL was, at the outset, solely a US company, it is clear that the non-US rights to the DHL trademark were initially US property. From this point, the documentation is unclear, at best. A 1974 memorandum of understanding appointed DHLI as a foreign pickup and delivery agent for DHL, and DHL licensed the use of the DHL name to DHLI for no compensation. The memorandum of understanding was amended on six occasions, but the arrangement never included a royalty for use of the DHL name. There appear to be no other arrangements that address the intangible ownership issue.

The Tax Court rejected both DHL's and the IRS determination of the value of the DHL name of USD 600 million. The Court decided that the value of the worldwide rights was USD 150 million, which it reduced to USD 100 million because of imperfections in DHL's ownership of the non-U.S. rights. In addition, the Court imposed a transfer pricing penalty because DHL's documentation was prepared by a consultant (Bain) who was doing work for DHL and was therefore, not independent. The Court stated:

"........ it was not reasonable for [DHL] to rely on (or more properly hide behind) the Bain appraisal or comfort letter. If the parties to the transaction had given the valuation to an independent valuation entity before any values being placed on the trademark by the parties and/or not advised the evaluator of a value, it might have been reasonable for petitioners to rely on such an appraisal. As this trail has again demonstrated, parties can find experts who will advance and support values that favor the position of the person or entity that hired them."

The Tax Court's decision contained various references to the uncooperative and contentious behaviour of the parties. It seems reasonable to conclude that DHL's recalcitrance worked against the interests in the Court's holdings. On the issues of interest here, the Court held that DHL owned the worldwide rights to the DHL name, although the quality and value of those rights were lessened by the imprecision of the legal agreements and by DHLI's registration of name in various countries.

In Texaco, Inc. And Subsidiaries v. Commissioner of Internal Revenue[172] the Commissioner of Internal Revenue challenges the Tax Court's legal conclusion before the Appellate Court. Texaco, Inc. is the parent corporation of a group of entities engaged in the production, refining, transportation, and marketing of crude oil and refined products in the United States and abroad. Texaco has a number of subsidiary/affiliate corporations under its umbrella. One of those affiliates is Texaco International Trader, Inc. ("Textrad"), which acted as the international trading company for the worldwide Texaco refining and marketing system during the period in question. As the trading company, Textrad purchased Saudi crude oil from the Saudi government by way of the Arabian American Oil Company ("Aramco") and resold that crude to both affiliates and unrelated customers.

From early 1979 through late 1981, Saudi Arabia permitted Texaco and the other Aramco participants to buy Saudi Arabian crude oil at below market prices. The Saudi government also established the official selling price ("OSP") for Saudi Arabian crude below the market price. The Saudi government took these actions in response to requests by the United States and other consuming countries to moderate the price of crude oil. To ensure its price regulation had its intended effect, the Saudi government prohibited Texaco and other participants in Aramco from re-selling Saudi crude at prices higher than the OSP vide Letter 103/z. The restrictions in Letter 103/z, however, applied only to Saudi crude, not to the sale of products refined from Saudi crude. As a result, the companies that bought Saudi crude from Textrad at the below market OSP, including Texaco's refining affiliates, earned large profits from the sale of refined products. Unlike its domestic affiliates, Texaco's foreign refining affiliates reported no taxable income in the United States.

During the period in question, Textrad sold approximately 34 percent of its Saudi crude to its refining affiliates. Textrad also sold 15-20 percent of its Saudi oil at the below market OSP to customers that were completely unrelated to Texaco. This was consistent with the pattern and volume of Textrad's sales to unrelated customers in earlier years.

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172 U.S. Court of Appeals for the Fifth Circuit's Decision (No. 95-60696, Filed 10/17/96).

The Commissioner contended that Textrad unduly shifted profits to its foreign affiliates. The appellate court agreed that Letter 103/z had the effect of a legal restriction in Saudi Arabia. These restrictions applied to all sales of Saudi crude by the Aramco participants and others. The restrictions were in effect during the period at issue and were followed by Texaco. The appellate court fully supported the findings of the Tax Court's and supported its conclusion that Letter 103/z should be given the effect of law for purposes of § 482 and 61 of the IRS.

The Court supported this conclusion with a number of factual findings, including the following:

1. The Saudi government, with the approval of the King, issued Letter 103/z prohibiting the resale of Saudi crude at amounts exceeding the OSP.
2. Texaco was subject to that restriction and faced severe economic repercussions, including loss of its supply of Saudi crude and confiscation of its assets, if it violated Letter 103/z.
3. This mandatory price restriction applied to all sales of Saudi crude, including sales to affiliated entities.
4. Neither Texaco nor any other Aramco participant had any power to negotiate or alter the terms of this restriction.

Exxon Corporation and Affiliated Companies, et al V. Commissioner.[173] Exxon Corporation (Exxon) is a company having its principal place of business in New York engaged in the business of producing, refining and marketing of crude oil and petroleum products in US and other countries over the world. In 1979 Mediterranean Standard Oil Co., Inc (MEDSTAN) a wholly owned subsidiary ("WOS") of Exxon was incorporated in the United States to purchase oil from Saudi Arabia via Arabian American Oil Company (Aramco). In the next year Exxon International Trading Co., Inc (EITCO) another WOS of Exxon was incorporated in US to carry the functions of MEDSTAN. Later, in 1981 Exxon International Saudi Arabia ("EISAI") was incorporated in the US to perform similar function of purchasing oil from Saudi Arabia. This company made these

173 T.C.Memo. 1993-616, December 22, 1993

purchases pursuant to an oil incentive agreement which entitled Exxon to purchase additional oil from Saudi Arabia. Saudi Arabian Government ("SAG") set prices for sale of the crude oil purchased from Saudi, which was lower than the market price of the crude oil. SAG had placed a restriction on the selling price on the oil purchased from Saudi. In light of the same Exxon Corporation and its affiliates sold oil at the restricted price as set by the SAG. Exxon sold crude oil it purchased from Saudi Arabia to third parties and affiliates at a price which was lower than the market price. The Commissioner was of the opinion that Exxon be charged on extra profits it earned on dealings with its affiliates involving sale of crude oil and therefore be assessed under section 482. Thus, the issue evolved, whether Exxon was liable since it complied with restrictive regulations laid down by SAG.

The contention of the Commissioner was found to unacceptable and hence was precluded from attributing such profits presumably earned by Exxon in its dealings with its refining subsidiaries. SAG had in its letter 1031Z clearly prohibited the sale of Saudi crude oil at prices higher than official selling price as laid down by it. It had also, clearly stated that this restriction applied equally to transactions with affiliated and unaffiliated entities. Also, these restrictions were mandatory in nature. There was evidence that non-adherence to these restrictions would culminate potentially serious consequences for the defaulters. Thus, in selling at a price lesser than the current market prices, Exxon had only followed the restrictions by which it was bound.

In **Central De Gas De Chihuahua, S.A., V. Commissioner of Internal Revenue,**[174] Central De Gas De Chihuahua, S.A., (the "CG") rented equipment to Company X ("X"), where both CG and X were under the common control of Company Y ("Y"). X did not pay any rent for the use of the equipment to CG. CG did not file a federal income tax return for the year 1990. Commissioner of Internal Revenue ("CIR") acting under 482 allocated to CG the fair rental value of the equipment for 1990 and further determined that CG was liable for the 30% tax, as per section 881, on the fair rental value of the equipment. The issue was whether the applicability of section 881 was restricted to actual payment or whether it would also apply in cases of deemed payment. The contention of

174 Docket No. 18370-91, April 4, 1994.

CG was that in order for section 881 to apply, there must be an actual payment by X of the fair rental values of the equipment. However, CIR asserted that there is no requirement of actual payment under section 881 and that the allocation of rent to CG under section 482 provides a sufficient basis for imposing the 30% tax. CG further contended that the allocated fair rental value would amount to constructive dividend to Y and a non taxable contribution of capital to CG. Therefore, the issue as it stood before the authorities was, whether or not CG was liable to pay tax on the income which it did not receive. It was held that the Section 881 was applicable in cases of deemed payment and the actual payment was not required for its application. It was held that the word "received" in section 881 included the fair rental value of the equipment even though the amount thereof was not actually received by CG from X. It was also held that the allocation of fair rental value would not amount to constructive dividend to Y and a non taxable contribution of capital to CG, thereby making CG liable to pay tax on fair rental values of the equipment.

In **Sunstrand Corporation and Subsidiaries V. Commissioner of Internal Revenue**[175] Sunstrand Corporation ("Sunstrand Corp") is a company incorporated in the State of Delaware in the United States having its principal place of business in Rockford, Illinois, having a public holding. Sunstrand Corp was engaged in the business of designing, manufacturing and selling of a variety of products for diversified aerospace products and industrial markets. Sunstrand Corp had a wholly owned subsidiary Sunstrand Pacific (PTE) Ltd. ("SunPac") incorporated in Singapore and was engaged in the business of manufacture and sale of parts required in aircraft transmission. The items were sold at 15 percent discount form Sustrands spare parts list. The 15 percent discount was intended to cover Sustrand's costs and a distribution profit. The I.R.S. argued that some of Sunpac's profits should be attributed to Sunstrand as it was unable to find a CUPs for the particular parts sold by Sunpac or make use of the cost plus or resale price methods, the court looked at discount prices enjoyed by other distributors of aerospace parts in general, finding that a discount of catalogue prices of atleast 2 percent was prevalent by imposing

175 96 T.C. 226

a 20 percent discount rate, the court lowered sunstrand's cost of goods sold thereby raising its taxable income.

Eli Lilly & Co. v. Commissioner[176] represents the type of situation over which the IRS felt dissatisfied. Lilly developed and patented two manufacturing intangibles, Darvon and Darvon-N. Lilly subsequentl Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806 (1928).y deducted research and development costs in accordance with the appropriate Code sections. Next, Lilly made a section 351 tax-free transfer of the patents and manufacturing know-how to its subsidiary, a Puerto Rican possession corporation. The subsidiary manufactured Darvon and Darvon-N in Puerto Rico and sold the drugs to Lilly for resale to wholesalers in the United States. Lilly had effectively shifted the income associated with the intangibles outside of the United States tax base, to which the IRS protested. Lilly enjoyed the benefits of massive research and development deductions without experiencing the burden of a tax on the intangible's profit. The Service argued for the allocation to Lilly of the profits derived from the intangibles, regardless of the tax-free transfer to Lilly's possession subsidiary. The Service further contended that no comparable transactions existed. The Tax Court accepted only parts of the government's argument. Upon finding no comparable transaction under the three methods explicitly stated in the section 482 regulation, the court applied a profit-split approach. The profit split resulted in the allocation of 45 of the intangible income to Lilly as a marketing profit and 55 of the intangible income to Lilly's possession subsidiary as a manufacturing profit. The Tax Court simply stated that with regard to the 45-55 profit split, the court had used its best judgment and that the taxpayer's failure to support the transfer prices under the arm's length standard was to its own detriment.[177]

On appeal, the Seventh Circuit affirmed the Tax Court's profit split, but refused to enforce the court's allocation of some of Eli Lilly's general research and development expenses to its subsidiary. The appeals court thus affirmed the Tax Court's decision to reject Lilly's allocation method, but reversed in part with regard to how the Tax Court had applied its alternative method. Since the Tax Court did not specify the amount of this

176 84 T.C. 996

177 Ungerman, infra note 179 at 1115 - 1116

particular allocation, the appeals court remanded the case. Regardless of the 45-55 profit split, Lilly still managed to reduce its tax liability significantly by transferring the manufacturing intangibles to its Puerto Rican subsidiary.[178]

In **G.O. Searle & Co. v. Commissioner** the taxpayer transferred the patents or licenses related to five out of the company's seven major product lines to its subsidiary, Searle & Co. (hereinafter SCO), which was operating as a possession corporation in Puerto Rico. Searle subsequently marketed the products in the United States acting as an agent of its subsidiary, SCO. The intangible accounted for close to 80 of Searle's profits. The Service argued for a section 482 reallocation of the profits from the intangibles. The Tax Court found previous licenses held by Searle to be noncomparable and refused to use them as a safe harbor when resolving the case. The Tax Court mandated a profit split of 25, which the Treasury felt allocated too small a percentage of profits from the possession corporation, SCO, to the parent corporation, G.D. Searle & Company.[179]

Like Searle, the court in **Hospital Corporation of America v. Commissioner**[180] applied a profit-split approach in a situation classified as not technically appropriate for the use of a fourth method. The court allocated 75 of the profit to Hospital Corporation of America for the transfer of its extremely profitable and noncomparable intangibles. The Treasury once again felt that the reallocation resulted in too little profit allocated to the parent corporation.[181]

The consecutive three cases described above dealt with the situation in which no adequate comparables existed. In **United States Steel Corp. v. Commissioner**[182] the parent company, U.S. Steel, accounted for approximately 75 of the business transacted by its subsidiary, Navios. Navios and U.S. Steel's shipping contracts covered substantially longer periods of time than Navios's other shipping contracts. Navios, however, charged U.S. Steel the same rates that it charged unrelated parties. The Service contended that the

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178 id
179 Josh O. Ungerman, "The White Paper: The Stealth Bomber of the Section 482 Arsenal" 42 Sw. L.J. 1107 (1989) at 1115 - 1116
180 81 T.C. 520
181 Ungerman, supra note 179 at 1117
182 617 F.2d 942

rate Navios charged for shipping ore from Venezuela to the United States exceeded an arm's length rate. The Service introduced figures indicating that U.S. Steel could have shipped the same amount of ore for considerably less money. U.S. Steel argued that a perfect comparable existed because Navios charged U.S. Steel and unrelated parties the same shipping rates, and the comparable adequately represented an arm's length price.[183]

Hearing the case on appeal, the Second Circuit found the unrelated party transactions constituted appropriate comparables. The court held that when an appropriate comparable existed to justify the price charged, an allocation under section 482 would not apply even if the upholding of the comparable potentially results in the shifting of tax liability between related parties. In holding that the shipping services were adequately similar, the court found the term "comparable"' not synonymous with the term "'identical."'[184]

In an earlier case in the transfer pricing area, **R.T. French & Co. v. Commissioner**[185], the Tax Court addressed the controversial issue of using hindsight to evaluate intercompany royalty agreements. R.T. French involved a twenty-year license between a British corporation and its U.S. affiliate R.T. French. The license allowed the U.S. company to manufacture instant mashed potatoes following a patented process. The Service alleged that the U.S. licensee received very little benefit for the royalty payments in the final two years of the twenty-year license. By 1963 the patented process for making instant mashed potatoes was no longer unique and the food industry commonly understood the process. The Tax Court ruled in favor of the taxpayer, upholding the royalty payments. The court stated that if a licensing agreement contained reasonable payments in accordance with ALP at its creation, then the IRS could not subsequently reallocate under section 482 purely on hindsight. Regardless of the judiciary's view on the use of hindsight, the IRS supported its hindsight approach in a 1973 Technical Advice Memorandum. The memorandum advocated yearly review of long-term agreements to

183 Ungerman, supra note 179 at 1116
184 ibid at 1117.
185 60 T.C. 836

determine whether unrelated parties in the same circumstances would modify the agreement.[186]

Comments:

What do you make out of the above decisions rendered in the context of US law? What would be the impact of the ratio therein to the Indian scenario post 2001? Can an improvement or modification of the current Indian model in the IT Act, 1961 be effect based on the US experiences gained in litigation? A short conclusive para would be advisable.

186 Ungerman, supra note 179 at 1117

Chapter 6

TRANSFER PRICING IN UNITED KINGDOM

Legislation to deal with transfer pricing was first introduced in the United Kingdom in 1952,[187] and the basic rules have remained largely unaltered since that date.[188] As in many other countries, however, the policy of the United Kingdom's tax agency, Inland Revenue, on transfer pricing has developed rapidly[189], and in recent years there has been a marked increase in the number of taxpayers targeted for investigation.

The Inland Revenue's determination to stamp out what it views as an abuse of the transfer pricing rules is based on the significant amount of revenue which it estimated to be lost by the United Kingdom.[190] Its ability to deal more effectively with the perceived abuse results not from any change in the rules, which have remained largely unaltered since 1952, but rather in the ever-increasing sophistication of Inland Revenue investigative techniques and from the ever-increasing cooperation between revenue authorities around the world.[191]

Legislation in the United Kingdom

Legislation governing transfer pricing in the United Kingdom is contained in sections 770 through 774 of the Income and Corporation Taxes Act of 1988,[192] with the principal

187 See Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, ch. 10, § 469 as cited from Paul D. Hunston and Michael W. Turner "International Taxation and the Great Transfer Pricing Debate: The Position adopted on the other side of the Atlantic" 24 Loy. L.A. L. Rev. 691 (1991) at 692

188 The legislation is now consolidated in the Income and Corporation Taxes Act, 1988, ch. 1, § 770. ibid at 692

189 See "The Transfer Pricing of Multinational Enterprises: Notes by the U.K. Inland Revenue", 5 Simon's Tax Intelligence 42 (1981) (henceforth U.K. Inland Revenue), as cited from id.

190 See U.K. Inland Revenue at 43, ibid at 693

191 See U.K. Inland Revenue, at 44 id.

192 Income and Corporation Taxes Act, 1988, ch. 1, § § 770-774 (formerly incorporated in Income and Corporation Taxes Act, 1970, ch. 4, § 485 and Income Taxes Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, ch. 10, § 469). Id

charging provisions contained in section 770.

Section 770 provides that the Inland Revenue may substitute, for tax purposes, a notional price equal to the price which the goods or services would have fetched in an open market transaction for the active price paid if both of the following are satisfied: (1) property, including goods, services and other business facilities, is sold under circumstances where the buyer controls the seller, or vice versa, or where both are under common control, and the property is sold at a price which is either:

(i) less than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's- length (the arm's-length price), or (ii) greater than the arm's-length price;

and (2) the buyer resides and carries on a trade in the United Kingdom, and the price paid by the buyer for the property is taken into account as a deduction in computing the profits or losses of that trade for United Kingdom tax purposes, or (where the actual price paid is greater than the arm's-length price) the seller resides and carries on a trade in the United Kingdom, and the price paid for the property is not to be taken into account as a trading receipt in the United Kingdom in the hands of the seller.

Section 770 only applies to transactions between parties one of which controls the other or both of which are under common control. There are a number of different definitions of "control" for various purposes contained in United Kingdom tax legislation. For transfer pricing purposes, a person--an individual, a company or a partnership--has control of a company if that person has the power either to secure that the affairs of the company in question are conducted in accordance with that person's wishes by virtue of holding shares or possessing voting power, or by virtue of any powers conferred by the articles of association of the company or any other document. A person has control of a partnership if that person has the right to more than half of that partnership's income or assets. In determining whether any person has control of a company or a partnership, it should always be borne in mind that that person will have attributed to him or her all of the rights and powers of his nominees and of persons who are connected with him,

which would include his or her spouse, brothers, sisters, ancestors, lineal descendants, partners and the spouses and nominees of such connected persons.[193]

Section 770 also applies to sales of goods and services between connected persons. It is extended, with necessary adaptations, to "letting and hiring of property, grants and transfers of rights, interests or licenses and the giving of business facilities of whatever kind," to loan interest, patent royalties, management fees and payment for services. In addition, section 770 applies to contributions by a subsidiary towards costs incurred by its parent company.

In view of tremendous developments in the global ecomony, international trading, and world wide practice, it was old legislation of transfer pricing was inadequate, so in 1997, a plan to modernize the transfer pricing legislation was announced by the Inland Revenue. In the consultative document Modernisation of the Transfer Pricing Legislation the important reason for introducing new set of rules on transfer pricing was the introduction of self-assessment in the United States. The Self-assessment scheme was applicable from june 30 1999.Under this Scheme, companies will be required to include their own assessment of their corporation tax liabilities as part of their tax return. This contrasts with the earlier situation where taxpayers sent a return of their profits to the Inland Revenue which then calculated and assessed their tax.[194]

Accordingly, the 1998 Finance Act introduced a comprehensive modernization of the UK's transfer pricing legislation. Section 770-773 of the Income and Corporation Taxes Act (ICTA) 1988 are replaced by section 108-111 and schedule 16 FA 98, with full text of the basic rules appearing at Schedule 28AA ICTA 1988. As mentioned earlier, the changes bring the legislation on transfer pricing within the new Self Assessment framework.[195]

193 ibid at 694 – 695.
194 Singh, supra note 3 at 110.
195 See Annexure for present laws.

Important Case Laws

Watson Brothers v Hornby[196]

It is interesting to note that on the domestic front the Courts had no problem embracing the main tenet of any transfer pricing code, namely the ALP.

The first modern instance was the 1942 case of Watson Brothers v Hornby. The brothers were poultry farmers and under the then rules were taxed on their farming profits under Schedule B, which only charged a portion of the annual value of the land. They also, however, ran a hatchery, which was a trade within Case I Schedule D because the activities were outside the definition of' 'husbandry'. The brothers used the hatchery as their source of hens for the poultry business, so that it became necessary to consider at what value the chicks should be transferred from the Schedule D trade to the Schedule B farming business.

Relying on the mutuality principle, the Revenue contended that a man cannot make a profit by trading with himself and therefore that the chicks should be transferred at the cost of rearing them. Market conditions, however, dictated that the chicks could have been sold only for something less than cost: some of the chicks sold at auction had fetched four pence each whereas the cost of rearing had been seven pence each. The Watson Brothers wrote off the difference between cost and market price and claimed it as a Schedule D loss.

The Courts upheld the claim that the ALP should apply and allowed the market value, in this case lower than cost, as the transfer price.

Rochester (UK) Limited and Another v Pickin[197]

Rochester UK consists of Mr. York ("Mr. Y") holding 40% and the Canadian parent Rochester Canada holding the balance 60%. Mr. Salisbury ("Mr. S") was the majority shareholder of Rochester Canada. Mr. S was a director of Rochester Canada and

196 24 TC 506
197 [1998] STC (SCD) 138.

chairman and director of Rochester UK. Mr. Y was the managing director of Rochester UK. Rochester UK purchased oil seeds from a Dutch supplier, Glederland BV (the "Dutch Company"), for the purpose of extracting oil. After a couple of years the Dutch

Company agreed to supply the seeds to a newly incorporated Swiss company, Appenzell AG (the "Swiss Company"). The Swiss company made arrangements for the extraction of the oil, which it in turn supplied, to the UK and Canadian companies. The revenue contended that the profits earned by the Swiss company had been applied for the benefit of Mr. Y and Mr. S, by purchasing sterling certificate deposits, which were further deposited with the banks as a security for the loans taken by Mr. Y and Mr. S. the loans taken were used to purchase shares of Rochester Canada.

The Inland Revenue of UK considered that arrangements had been fraudulently made for the Swiss company to be inserted in the chain as a device to enable the UK company to pay excessive prices for the oil supplied by the Swiss company, thereby evading UK tax on the UK company's profits. They also argued that certain payments made by the UK Company to the Swiss company relating to medical research were for no consideration. The UK company was assessed on the basis of the part of the price paid to the Swiss company which exceeded a reasonable price for the oil and for the payments relating to medical research on the basis that they were not incurred wholly and exclusively for the purpose of the UK company's trade within Corporation Taxes Act, 1988, s74 (1)(a). They were therefore not deductible and remained profits of the UK Company. The assessments were made for the years from 1985 to 1991.

It was held that much of the case considered assessments out-of-time and the Special Commissioners concluded that the Revenue had failed to discharge the burden of proving fraudulent or negligent conduct in relation to the out-of-time assessments. In relation to the in-time assessments, the Special Commissioners found that the payments had been made as part of a commercial arrangement and that they had been made wholly and exclusively for the purposes of the trade of the UK company. Also there was no evidence that the profits earned by the Swiss company were used to fund the loans taken by Mr. Y for the purchase of shares of Rochester Canada.

Glaxo v CIR[198]

In August 1995 three Glaxo companies issued an originating summons to the High Court. Their principal contention was that where a direction had been given under Section 485(3) ICTA 1970 (subsequently ICTA88/S770(2)(d), effect can only be given to the direction by the making of a new assessment, and not by amendment of an open assessment which pre-dates the direction. Such a new assessment must be made within six years of the end of the accounting period to which the direction relates (TMA70/S34).

The Revenue argued that where an assessment for the relevant accounting period remains open, effect can be given to the direction by an adjustment made to that assessment either by the Commissioners or by an agreement reached under TMA70/S54. The Revenue agreed that where there is no open assessment for the period, then a new assessment is required and must be made within the six-year time limit of Section 34.

The parties had been in discussion over Glaxo's transfer prices for many years and in relation to a considerable number of accounting periods. The practical effect of a finding in Glaxo's favour would be that the Revenue could no longer pursue transfer pricing adjustments for most of those accounting periods.

In October 1995 the High Court found for the Revenue. And in December 1995 the Court of Appeal unanimously upheld the High Court's decision. Leave to go to the House of Lords was refused.

In the Court of Appeal Millett LJ noted that increasing an open assessment might result in interest on unpaid tax being charged from a date before the giving of the relevant direction. He decided that this was 'not obviously unfair', since interest would not become payable unless the assessment incorporating the transfer pricing adjustment was upheld. The Judge's comments here are very useful as it is sometimes contended that interest under TMA70/S86 cannot run from a date earlier than the date on which the

198 68 TC 166

relevant direction was given. Inspectors should resist pressure from taxpayers to compromise on this question.

Newidgets Manufacturing Ltd v Jones.[199]

The point at issue in this 1999 case was whether the Revenue was precluded from issuing discovery assessments by virtue of having agreed the taxpayer company's calculations (and having formally determined appeals). The subject of the further assessments in question was the transfer pricing of a licensing arrangement. They were issued following directions under ICTA88/S770(2)(d).

The Revenue contended that, at the time of making the original agreements with the taxpayer, the Inspector had not been required to consider whether the licensing arrangement had been made on arm's length terms. And consequently the agreements did not preclude the making of further assessments following the issue of directions under ICTA88/S770(2)(d).

However the Commissioners determined that the facts indicated that the Inspector had directed his mind to the licensing arrangement, possessed sufficient information to form a proper view, and had intended to grant finality. So, having taken the view that the transfer pricing matter had been fully disclosed, discussed and agreed, the Commissioners found in favour of the company.

The decision is silent about the relationship between the assessing machinery and the transfer pricing rules.

Petrotim Securities Ltd v Ayres[200] The principle which emerged from Watson Brothers v Hornby and Sharkey v Wernher established what value should be given to an asset transferred between a trading and a non-trading activity. In the 1963 case of Petrotim Securities Ltd v Ayres the principle was developed further to encompass the treatment of a transaction not with oneself but with an associated company.

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199 SpC197
200 41 TC 389

In this case, the company, which was a dealer in stocks and shares, sold part of its trading stock to an associated company at a gross under-value. The Court took the view that the transaction was entirely outside the scope of the company's ordinary trading activities so that, on the principle established by the earlier cases, the shares should be treated as having been sold at their market value. The case thereby determined how the profits of a trader within the scope of Case I Schedule D should be adjusted in transactions with a connected person who was not within its scope.

Ridge Securities Ltd v CIR[201]

In a dividend-stripping operation, a share-dealing company purchased War Loan from an associated company for £10,000 and sold it shortly afterwards in the open market for £104,918. The purchase of the War Loan was the issue considered in the case of Petrotim Securities Ltd v Ayres.

The purchasing company claimed that as the result of this transaction it had made a profit out of which it could declare a dividend. The Special Commissioners rejected this contention and the Chancery Division dismissed the company's appeal. Applying Petrotim Securities Ltd v Ayres and the principle laid down in Sharkey v Wernher, it was held that the acquisition value of the War Loan brought into the computation should be its market value (with the consequence that there was no profit).

Note: My comments at the end of the US chapter would apply mutatis-mutandis to the UK chapter and Brazil chapter which you have attempted.

201 44 TC 373

Chapter 7

TRANSFER PRICING IN BRAZIL

Brazil legal system is based on civil law. It does not recognize the principle of stare decisis, and its judicial decisions are of limited value. Thus, unlike the Anglo-American system in which case law is essential in order to understand the system and to fill in gaps in legislation, an examination of Brazilian tax rules is only a statutory endeavor.

Until very recently there was no statute governing transfer pricing in Brazil. Situations in which prices were transferred with a tax avoidance purpose could be dealt with only as a disguised distribution of profits.[202] The principle underlying the income taxation in Brazil was mainly territorial, and transactions between Brazilian residents and non-residents could easily avoid taxation.

However, with the enactment of Law 9430/96,[203] effective January 1, 1997, the worldwide income principle[204] was adopted, and transfer pricing dispositions were for the first time expressly introduced in Brazilian tax legislation. In fact, with MERCOSUR[205] Brazil had to create mechanisms to prevent tax avoidance, and Law 9430/96 became a tool to restrict transfer pricing as much as possible. Perhaps because this law was the first attempt to deal with transfer pricing, it takes a rather defensive

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202 Articles 432- 438 of the Regulamento do Imposto de Renda approved by the Decree No. 1.041 of January 11, 1994, D.O.U. of January 12, 1994. The Regulamento do Imposto de Renda corresponds to the Internal Revenue Code in the United States. It is a federal law. As cited from Alexandre Tadeu Seguim, "New Transfer Pricing Rules in Brazil" 19 Nw. J. Int'l L. & Bus. 394 (1999) at 395

203 Law No. 9.430/96 of December 27, 1996, D.O.U. of December 28, 1996. As a federal law, it is considered an ordinary law, and corresponds in terms of enforceability to the Internal Revenue Code in the United States. Id.

204 The worldwide income principle developed in opposition with the territoriality principle. According to the former, only income derived within the boundaries of a country would be taxable by this country. The worldwide income principle reaches beyond the territory of a country, and it includes all income derived by the resident of its country, regardless of its origin. Id.

205 The MERCOSUR is a common market among Argentina, Brazil, Paraguay and Uruguay that was formed in 1992 through the "Ouro Preto Protocol." The MERCOSUR comprises not only a free trade area, with the elimination of all tariffs and equivalent measures among its members, but also the coordination and integration of the members political economics. Ibid at 396.

approach to it, as this study will demonstrate. This defensiveness exhibits a clear misreading of the concept as described above.[206] It must be mentioned that the Brazilian Internal Revenue Service has already enacted a Normative Instruction, which is similar in its effect to the Treasury Regulations enacted by the IRS in the United States, regulating the application of Law 9430/96.[207]

It is also important to note that the federal corporate income tax in Brazil has been going through substantial changes since 1995; these revisions attempt to adapt the tax legislation to a more complex and international economic reality wherein globalization directs the flow of wealth. Some key provisions include the exemption of income tax for distribution of profits or dividends introduced by the Laws 9249/95[208] and 9250/95,[209] both effective January 1, 1996, in an attempt to abolish the double taxation regime for corporations. Other innovations include the taxation of profits and gains from foreign sources by including them in the worldwide income of the taxpayer and the reduction of the bracket of the tax on repatriation of income.[210]

Law 9430/96 continued this modernization process by allowing the consolidation of the results from financial transactions made abroad with the ones made in Brazil with a tax credit allowance (another move towards the implementation of a worldwide income tax regime instead of a territorial system). Finally, transfer pricing provisions were enacted for the first time.[211]

In order to fully understand the scope of the transfer pricing legislation in Brazil it is essential to define what is considered a transaction between related parties, because this is the main aspect in determining whether the transaction complies with the tax provisions.

206 For instance, the following statement highlights that idea: "Because of the position taken by the Brazilian rules, one may end up with the conclusion that the concept of transfer pricing is actually attached to a deliberate shifting of profits.", Alejandro E. Messineo, "Transfer Pricing in Latin America: New Rules in Mexico and Brazil" 42, ITPJ, vol. 4, No. 2, (March/April 1997). id

207 Normative Instruction No. 38 of April 30, 1997 of the Internal Revenue Department, D.O.U. of May 1997. id

208 Law No. 9.249/95 of December 1994, D.O.U. of December 1994. id

209 Law No. 9.250/95 of December 1994, D.O.U. of December 1994.. id

210 id.

211 see Mary Elbe Gomes, Queiros Maia, Tributacao Das Pessoas Juridicas 1-10 (1997). Ibid at 397

Article 23 of Law 9430/96 enumerates ten situations in which a legal entity will be deemed a related party for the purposes of the application of the transfer pricing rules. [212]

Of particular importance is sub-item V of Article 23, which states that a legal entity domiciled abroad will be considered a related party when it and the company domiciled in Brazil are under common corporate or administrative control or when at least ten percent of the capital of each of them is owned by the same individual or legal entity. Paragraph 1 of Article 2 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department interprets sub-item V of Article 23 of Law 9430/96 in a very broad sense.

Common corporate control will be deemed to exist whenever the same individual or legal entity, regardless of the location of residence or domicile, is the holder of a shareholder's right in each one of the assumed related parties which assures on a permanent basis preponderance in the corporate deliberations of these companies and the power to elect the majority of its management.[213] Common administrative control will exist when: a) the administrative council president or the director-president of both companies is the same person; or b) the administrative council president of one and the director-president of the

212 Article 23 of Law No. 9.430/96 of December 27, 1996, D.O.U. of December 28, 1996: "Related party-concept. Article 23- For the purposes of Articles 18 through 22, the following are considered as related to a legal entity domiciled in Brazil: I- its head office, when domiciled abroad; II- its affiliate or branch, domiciled abroad; III- an individual or legal entity, resident or domiciled abroad, whose holding in its capital characterizes it as its parent or associated company, in the manner defined in paragraphs 1 and 2 of art. 243 of Law 6.404 of December 15, 1976; IV- a legal entity domiciled abroad which would be characterized as its subsidiary or associated company, in the manner defined in paragraphs 1 and 2 of art. 243 of Law 6.404 of December 15, 1976; V- a legal entity domiciled abroad, when it and the company domiciled in Brazil are under common corporate or administrative control or when at least ten percent of the capital of each of them is owned by the same individual or legal entity; VI- an individual or legal entity, resident or domiciled abroad, who, together with a legal entity domiciled in Brazil, has a holding in the capital of a third legal entity, the sum of which characterizes them as parent or associated companies in the manner defined in paragraphs 1 and 2 of art. 243 of Law 6.404 of December 15, 1976; VII- an individual or legal entity, resident or domiciled abroad, which is its associate in a consortium or condominium, when defined as such in Brazilian legislation, in any venture; VIII- an individual resident abroad who is a relative or kin up to the third level, spouse or companion of any of its directors or of its controlling partner or shareholder in a direct or indirect participation; IX- an individual or legal entity, resident or domiciled abroad, who is its exclusive agent, distributor or dealer for the purchase and sale of goods, services or rights; X- an individual or legal entity, resident or domiciled abroad, in relation to which the legal entity domiciled in Brazil is its exclusive agent, distributor or dealer for the purchase and sale of goods, services or rights." As cited from ibid at 397.

213 Article 2, paragraph 1, sub-item I of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department, D.O.U. of May 1, 1997. ibid at 398

other is the same person; or c) the same person is a director, with decision powers, of both companies.[214]

When a transaction falls within Article 23, transfer pricing provisions will apply whether an arm's length transaction has taken place or not. The approach adopted in Law 9430/96 demonstrates that the **Brazilian Congress views transfer pricing as a mechanism created by organizations to inherently avoid taxation, instead of applying the OECD's approach which assumes transfer pricing as an economic reality derived** from the operations of MNEs. There is a substantial likelihood that the Brazilian approach will conflict with other transfer pricing systems, such as those of the United States which adopt the ALP where the ALP relies in the concept of equal treatment or the neutrality principle. As we seen in an earlier chapter, in the United States there is no explicit reference to the ALP in the IRC.[215]

Law 9430/96 guarantees a minimum revenue insurance for the Brazilian government, and the **transfer pricing provisions aim to limit this practice by establishing a ceiling for deductible expenses on imports, a minimum gross income for exports and a safe harbor for interest payment to related parties** whenever the loan contract is registered with the Brazilian Central Bank, otherwise a limitation on the deduction of interest becomes applicable.[216]

A. Transfer Pricing On Imports Of Goods And Services

Article 18 of Law 9430/96 limits deductions of expenses and charges relating to goods, services and rights stated on import or acquisition documents up to an amount not exceeding the price determined by one the methods established in the statute. There are three methods to calculate this deduction:

(a) the **Comparable Independent Price Method** (PIC), which defines the transfer price

214 Article 2, paragraph 1, sub-item II of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department, D.O.U. of May, 1997 id.
215 Countries that specifically refers to the ALP in their income tax legislation are Australia, Argentina, Austria, Canada, Denmark, Italy, Japan, Spain and the United Kingdom. German, Netherlands and Switzerland developed the principle with reference to transfer pricing.. id.
216 Ibid at 399.

as the arithmetic average of the sales prices for the same or similar goods, services or rights prevailing between unrelated prices. Under this method, the price to be taken into account is the contract price, regardless of the economic circumstances, such as geographical location, market size, governmental regulation, and others described by the OECD in its Guidelines for Transfer Pricing;

(b) the **Resale Price Less Profit Margin Method** (PRL), which defines the transfer price as the arithmetic average of resale prices of good or rights reduced by discounts, taxes and commissions and a 20% profit margin. Obviously, services transfer prices cannot be calculated under this method;

(c) production **Cost Plus Profit Margin Method** (CPL), which includes the average cost of production of similar goods, services or rights in the country where they were originally produced, increased by export-related taxes and a 20% profit margin.[217]

Because there is no "best method rule" under Law 9430/96, the taxpayer may choose any of the methods, and may deduct from the method with the highest transfer price.[218]

B. Transfer Pricing On Exports Of Goods And Services[219]

When revenue arises from exports transactions between related parties, Article 19 of Law 9430/96 establishes that the transfer price provisions will apply whenever the price charged is less than 90% of the average price practiced on the sale of the same goods, services or rights in the Brazilian market during the same period and under the same payment conditions.[220] **If the price is less than 90%, then a new price is arbitrated according to any available method.** The average price used as a parameter must be made without regard to any tax discounts eventually granted and after the deduction of

217 Article 19, paragraphs 1 and 2 of Law No. 9.430/96 of December 26, 1996, D.O.U of December 1996. ibid 399
218 ibid at 400
219 id
220 Article 19 of Law No. 9.430, of December 26, 1996, D.O.U. of December, 1996. id

the freight and insurance charges borne by the exporter.[221]

Similar to the import pricing method, export transfer pricing is done under one the following four methods:

(a) **Export Sales Price** (PVEx), defined as the arithmetic average of sales prices on exports made by the company itself to other customers or by any other local exporter of identical or similar goods, services or rights during the same period for which income tax is calculated;

(b) **Wholesale Price in the country of destination, Less Profit Margin** (PVA), in which the transfer price is determined as the arithmetic average of the wholesale prices in the destination country in unrelated transactions of the same or similar goods, services or rights under similar payment conditions less taxes included in that price and reduced by a profit margin equal to 15% of the wholesale price;

(c) **Retail Price in the country of destination, Less Profit Margin** (PVV), the same as the PVA, except that the retail price and not the wholesale price is used in the determination of the arithmetic average, and instead of a 15% reduction in the profit margin, PVV reduces the margin by 30% of the retail price;

(d) **Purchase or production cost plus taxes and profit margin** (CAP), in which the transfer price is defined as the average acquisition or production cost of the exported goods, services or rights plus any Brazilian related taxes or contributions increased by a mark-up equal to 15% of such cost.

The taxpayer can use more than one method, but the **lowest transfer price** obtained from the application of one these methods will prevail. Finally, Article 20 of Law 9430/96 gives authority to the Minister of Finance also to change the percentages concerning exports.[222] A company may also apply to a particular treatment due to the economic

221 Article 19, paragraphs 1 and 2 of Law No. 9.430/96 of December 26, 1996, D.O.U of December 1996. id
222 Article 20 of Law No 9.430 of December 26, 1996. ibid at 401

peculiarities of the industry.[223] Ordinance 95 of April 30, 1997 of the Minister of Finance establishes the procedures and cases in which profit margins may be lowered for transfer pricing purposes.[224] Also, Article 30 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department states that the percentages used in the transfer pricing methods, namely PRL, CPL, PVA, PVV, CAP and the 90% ceiling on exports prices may be modified by the Minister of Finance.[225]

D. Special Provisions[226]

There are some special provisions of the Brazilian transfer pricing provisions that warrant consideration. First, the **similarity concept** for the purposes of comparison set in Article 26 of Normative Instruction 38 states that whenever two or more goods (it mentions neither services nor rights) have the same nature and function, and they can be mutually interchanged for the function they are intended, they will be considered similar.[227] Why services and rights were excluded from the similarity concept is unclear and may create confusion when applying one of the transfer pricing methods to services or rights.

Another special provision is Article 24 of Law 9430/96,[228] by which the transfer pricing provisions will apply to operations carried out by individuals or legal entities resident or domiciled in Brazil, with any individual or legal entity, even if not related, resident or domiciled in a country which does not tax income or which taxes it at a maximum rate of less than twenty percent.[229] Congress intended to avoid any transaction between a Brazilian company and an entity or individual domiciled in a tax haven. It is important to emphasize that **transfer pricing provisions will apply even** when the transaction occurs

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223 Article 1 of Ordinance 95 of April 30, 1997 of the Minister of Revenue, D.O.U. of May 1997. id
224 Article 1 of Ordinance 95 of April 30, 1997 of the Minister of Revenue states: "The changes in percentages referred to in art. 18, II and III, and art. 19, caption, and sub-items II, III and IV of paragraph 3, all of Law 9.430/96, will be made on a general, sectorial or specific basis via an official notice or in reply to requests of class entities representing an economic sector, as regards transactions involving goods, services or rights of the represented companies, or, in reply to the request of an interested company itself." Id.
225 Article 30 of Normative Instruction of April 30, 1997 of the Internal Revenue Department. Id.
226 Article 24 of Law No. 9.430/96 of December 26, 1996. ibid at 402.
227 Article 26 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department. Id.
228 Article 37 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department also address this issue. Id.
229 Article 24 of Law No. 9.430/96 of December 26, 1996. id.

between unrelated parties.

Finally, Article 28 of Normative Instruction 38 is worth noticing. This provision is a **safe harbor provision for prices transferred in export operations** aiming to enter new markets.[230] In this case, if a Brazilian company is trying to enter new markets, it may price its goods, services or production rights at less than the 90% of average prices practiced in Brazil. The rationale for such a provision is to encourage Brazilian exports to new markets, by considering the costs incurred by businesses to make their products known in a new market.

As described earlier, the concept of transfer pricing has an economic basis and refers essentially to transactions between related parties. Brazilian approach to extend transfer pricing provisions to transactions between unrelated parties denotes a gross misreading of the concept, and will certainly create problems. For instance, it is difficult to determine whether the price allegedly transferred would be different in other transactions between other unrelated parties. What about the circumstances underlying each transaction? How to presume that a transaction with a company domiciled in a tax haven has an inherent tax avoidance purpose? It can be concluded that Brazil depicts a right picture of a developing countries suspicion towards MNCs for them these economic powers will not use transfer pricing for economic necessity but for tax avoidance purposes.

230 Article 28 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department. Id.

Chapter 8

TRANSFER PRICING IN CHINA

People's Republic of China ("PRC") legal system is based on civil law. It does not recognize the principle of stare decisis, and its judicial decisions are of limited value. Thus, unlike the Anglo-American system in which case law is essential in order to understand the system and to fill in gaps in legislation, an examination of PRC tax rules is only a statutory endeavor. [231]

The comparison of China's tax laws with those of the United States and United Kingdom is driven by economic reality. A primary concern is to look at it from the perspective of developing nations. Before that a brief background of Chinese taxability. Generally speaking there are two ways to become liable to a tax regime: either one has a sufficient presence in or physical nexus with the country concerned to be taxed on a net income basis as a resident ("physical presence taxation"), or one derives income from a taxable source within the country without having a taxable presence in the country, thereby incurring a withholding tax ("source-based taxation"). Although it is unique in many other ways, the PRC tax system uses both of these methods of tax liability.[232]

Transfer Pricing is one major tax collection issue addressed by the Tax Administration Law between affiliated business enterprises,[233] including foreign enterprises doing

231 William A. Thomson, "Liability to Tax and Transfer Pricing in the People's RepubliC of China: A Comparative Analysis" 4 Pac. Rim L. & Pol'y J. 327 (1995) 328
232 Ibid at 330
233 Detailed Rules for the Implementation of the Law of the People's Republic of China to Administer the Levying and Collection of Taxes (Aug.4, 1993), translated in [Taxation & Customs] China Laws for Foreign Business (CCH) PP39-622 art. 36 (qualifying the term "affiliated enterprises"). As cited from Kara L. Phillips and Amy L. Sommers, "Assessing the Tax Administration Law of the People's Republic of China" 18 Loy. L.A. Int'l & Comp. L.J. 339 (1996) at 357

business in China.[234] With the advent of economic reform in the early 1980s, foreign enterprises increasingly began to invest in China. They often transferred profits so as to avoid showing a profit in the Chinese entity.[235] Enterprises also used subsidiaries to conceal profits. These phenomena led to the passage of the PRC's Foreign Enterprises Income Tax Law, which, for the first time, addressed the problem of abuses in transfer pricing. Article 24 of the Tax Administration Law addresses these problems. It permits tax authorities to make adjustments to reflect the actual amount of tax due if payments between enterprises do not comply with substantive provisions relating to business transactions between independent enterprises.[236]

Prior to the enactment of the FEIT in 1991, there were two separate tax laws for foreign-related business in the PRC, the Income Tax Law of the PRC Concerning Joint Ventures (Joint Venture Income Tax Law, or "JVITL") and the Income Tax Law for Foreign Enterprises (Foreign Enterprise Income Tax, or "FEIT"), the latter prescribing source-based taxation within the PRC. The FEIT generally provided that certain PRC sourced income would be taxed by a 20% withholding at source in the PRC. The PRC authorities have carried over this approach into the new Income Tax Law of the PRC for Enterprises with Foreign Investment and Foreign Enterprises (Unified Income Tax Law, or "UTL")[237]. UTL, which provides that where a foreign enterprise has no establishment or

234 Detailed Rules for the Implementation of the Law of the People's Republic of China to Administer the Levying and Collection of Taxes (Aug.4, 1993), translated in [Taxation & Customs] China Laws for Foreign Business (CCH) PP39-622 art. 24 (qualifying the term "affiliated enterprises"). As cited from id.

235 Zeng Zhi, "Zhonghua Renmin Gongheguo Shuishou Zhengshou Guanli Fa" Shiyi, Disan Zhang, Shuikuan Zhengshou, [An Explanation of the "Law of the People's Republic of China to Administer the Levying and Collection of Taxes," Part Three, Tax Revenue Collection], Zhongguo Shuiwu [China Taxation] July 1993, at27, 28. id

236 The phrase "business transactions between independent enterprises" refers to business dealing between unrelated enterprises that are conducted using fair prices and in line with common business practices. Implementing Regulations, supra note 9, art. 37; Tax Administration Law, supra note 8, art. 24. See generally Zeng Zhi, supra note107 (comparing the situation in China to that faced by other developing countries, where international tax avoidance is rampant). That article draws a parallel to Section 482 of the United States Internal Revenue Code, which deals with businesses under common control and which requires that such businesses allocate their income and losses as if they were independent entities. Id. Adjustments in purchase and sales transactions between affiliated enterprises will be made according to Implementing Regulations, supra note 9, art. 38. See also Implementing Regulations, supra note 9, arts. 39-41 (dealing with payments of other kinds between affiliated enterprises, such as interest, or wages or use fees). id

237 Zhonghua renmin gonghe guo waishang touzi qiye he waiguo qiye suode shuifa (Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises), National

place in the PRC, income that it derives from sources within the PRC, including interest, rental, royalty, profit and other income, is taxed at the rate of 20% of the gross payment.[238] This enactment is itself relatively brief, consisting of only thirty articles, but is supplemented by Detailed Rules for the Implementation of the Income Tax Law of the PRC for Foreign Investment Enterprises and Foreign Enterprises ("UTL Regulations").[239] Also of importance in this area is the Law of the PRC to Administer the Levying and Collection of Taxes ("ATC").[240]

TRANSFER PRICING

In contrast with many other areas of its law which are characterized by generality and brevity, the PRC has adopted detailed transfer pricing rules. Under the UTL, the general rule is that the payment or receipt of charges or fees between "associated" foreign investment enterprises, or their establishments or places set up in the PRC, must be made in the same manner as the payment or receipt of those charges in transactions between independent enterprises. Where the payment or receipt of charges or fees is not made in the same manner as in business transactions between independent enterprises and results in a reduction of taxable income, the UTL empowers the tax authorities to make reasonable adjustments.[241]

The UTL includes detailed regulations to fill out the coverage of the general transfer pricing rule. Thus, the term "associated" is defined in terms of one of three alternative relationships: (1) direct/indirect ownership or control of one party by the other; (2) a third party directly/indirectly owns or controls the two enterprises; or (3) another mutually beneficial association exists. In terms of ownership and control, these tests are met if there is a direct/indirect ownership of 25% or more of the total share capital of the

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People's Congress (Apr. 9, 1991) [hereinafter UTL], translated in CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-505 (CCH Int'l 1993). As cited from Thompson, supra note 60 at 328.

238 Thomson, supra note 231 at 331

239 Zhonghua renmin gongheguo waishang touzi qiye he waiguo qiye suode shuifa shishi xize (Detailed Rules for the Implementation of the Income Tax Law of the People's Republic of China for Foreign Investment Enterprises and Foreign Enterprises), State Council (June 30, 1991) [hereinafter UTL Regs.], translated in CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 32-507 (CCH Int'l 1993). See Thompson, supra note 231 at 549

240 Zhonghua renmin gongheguo shuishou zhengshou guanlifa (Law of the People's Republic of China to Administer the Levying and Collection of Taxes), National People's Congress (Sept. 4, 1992) [hereinafter ATC], translated in CHINA LAWS FOR FOREIGN BUSINESS: TAXATION ¶ 39-620 (CCH Int'l 1993). Id.

241 Phillips and Sommers, supra note 233 at 350

associated enterprise, or the direct/indirect ownership of 25% or more of the total share capital of both the transferee and transferor entities by a third entity. Other relationships which will create associated enterprises within the meaning of the law include where an entity provides 50% or more of the total loan capital of another, or where 10% or more of one entity's loan capital is guaranteed by another entity. In addition, the following mutually beneficial associations will constitute associated enterprises: (1) where one enterprise's production and business operations are dependent on the other for the provision of industrial property or intellectual property; (2) where one enterprise controls the prices and terms upon which the other can purchase its inputs; (3) where one enterprise controls the sales of the other's outputs; or (4) where an enterprise has effective control over the business operations of another, or other relationships (including family and relatives) exist.[242]

There are several uncertainties regarding the application of the PRC transfer pricing rule. Particularly troubling is the broad definition of mutually beneficial associations. Licensors, suppliers and distributors which lack ownership or family relationships with a PRC business partner could nevertheless be found to have a mutually beneficial association with that PRC business partner. If so, this relationship would be sufficient to taint the foreign party as an associated party for the purposes of the PRC transfer pricing law. Also, the concept of control is not adequately defined in the rules. For example, it is unclear whether the power to veto, or negative control, is sufficient to constitute control in this context. Finally, the nature of the family relationship necessary to constitute control is not adequately defined.[243]

A transfer pricing rule very similar to that in the UTL is contained the ATC. However, one striking difference is that the ATC states that the PRC tax authorities may apply the transfer pricing rule not only if an enterprise reduces its taxable income, but also if it reduces its earnings. [244] Therefore the ATC is slightly broader in scope. For example, if a foreign-invested enterprise ("FIE") sells its product at an artificially low level to a related

242 Ibid at 350 -351
243 Ibid at 351
244 id

non-resident, under the UTL it would only violate the transfer pricing rule if, on re-adjustment of that price to a price that would obtain between independent enterprises, the extra profit would cause the FIE to earn taxable income. If the FIE had sufficient other expenses (or losses carried forward) such that an upward adjustment of the transfer price to a price that would obtain between independent enterprises would still not put the FIE in a taxable position, then article 13 of the UTL would not apply. This defect has been remedied by the ATC, which would allow the PRC tax authorities to re-adjust the price to reduce the loss. Where the transfer price was not one which would obtain between independent enterprises, article 24 of the ATC could be applied to reduce the losses of the FIE. The ability to reallocate prices regardless of the tax position of the parties involved is a significant advantage of the ATC.[245]

Another uncertainty under the transfer pricing rules is determining which actors are affected. The UTL transfer pricing rules do not relate solely to companies, but also to enterprises and other economic organizations. They do not, however, extend to PRC individuals. The ATC transfer pricing rules apply to enterprises or foreign enterprises with establishments in the PRC, and their affiliated enterprises. Presumably PRC individuals are given a free hand when setting transfer prices with related enterprises. [246]

Rules governing transfer prices have arisen in large part to prevent revenue leakage to other states. Many jurisdictions have framed their transfer pricing rules such that they apply to transactions between residents and non- residents. Neither the UTL, nor the ATC, nor regulations made pursuant to these laws makes specific reference to cross-border situations, which leads to the conclusion that the UTL and the ATC are not limited by geography in their application. It seems that both sets of transfer pricing rules could be used in purely domestic situations. Two such situations come to mind: (1) an arrangement whereby profits are unjustifiably transferred from a profitable to a loss-making company; or (2) an arrangement whereby profits are unjustifiably transferred from an enterprise paying the standard rate of tax to an enterprise located in a Special Economic Zone ("SEZ") paying little or no tax. Unfortunately, the PRC tax authorities have not yet

245 Ibid at 352
246 Ibid at 352

indicated whether they will apply these transfer pricing rules in domestic situations.[247]

1. Another uncertainty under the transfer pricing rules is just how an appropriate transfer price is to be determined in a particular case. The UTL requires that business transactions between associated enterprises be carried on in the same manner as those between independent enterprises. "Business transactions between independent enterprises" is defined to mean business dealings between unassociated enterprises at fair transaction prices conducted in accordance with common business practices. The PRC tax authorities are given broad power to adjust prices when this rule has been violated. In that event, the adjusted prices are to be determined in accordance with one of four alternative methods:
   (1) comparable price for the same or similar transaction between unassociated enterprises;
   (2) according to the profit margin normally obtainable in transactions with unassociated enterprises;
   (3) the cost of the transaction, plus a reasonable profit margin; or
   (4) any other appropriate method. As the UTL regulations do not specify a hierarchy for the application of these tests, there is plenty of room for argument between the State Tax Bureau and the taxpayer about which test should be applied in any particular situation.

The ATC Regulations have overcome this difficulty by specifying a hierarchy for the substantially similar tests. The taxation authorities are to apply the methods in the order in which they appear (i.e., from (1) to (4) immediately above). No further guidance is given in the ATC Regulations.[248]

In a departure from the standard practice of determining the appropriate arm's length price, there is an indication that, at least in Shenzhen, other methods may apply. One writer has indicated that the tax authorities may use a comparable profit standard whereby the taxpayer's competitors' profitability is used as a yardstick and then the

247 Ibid at 353
248 id

taxpayer's transfer prices are adjusted accordingly to achieve a comparable profitability. This is a draconian measure and the writer has not learned of other instances of the use of this method in the PRC.[249]

Other questions remain about the PRC's disclosure requirements. The taxpayer is specifically obliged to disclose details of prices, fee standards and other relevant information in relation to its business. This is usually very confidential information, and foreign business persons doing business in the PRC would want the confidentiality of this information protected. Although there is provision for maintaining information in relation to a tax investigation confidential, there are no penalty provisions should the information be disclosed. There does not appear to be a blanket requirement that tax officials maintain confidentiality of the information that comes into their hands.[250]

The PRC transfer pricing laws are monitored and administered in at least two ways. Foreign enterprises must complete and submit to the tax authorities an annual information return concerning transactions with associated enterprises along with their annual tax return. In addition, in 1993 the State Tax Bureau established an anti-tax avoidance group of experienced tax officers who are charged with monitoring and dealing with transfer pricing issues in the PRC.[251]

In addition to these general transfer pricing provisions, the PRC has enacted specific transfer pricing provisions to counter inaccurate transfer pricing in the form of loan interest, through the pricing of labor services, through the assignment of assets or the provision of property rights, and through purchasing and marketing.[252]

In June 1998, the State Administration of Tax issued a comprehensive circular on transfer pricing for internal use by SAT examiners and multinational companies superseding all earlier circulars. This requires maintenance of proper documentation in respect of transfer pricing. This circular, also, widens the scope of application by adopting additional transfer pricing methods accepted in the United States and other jurisdictions. For

249 Ibid at 354
250 Id.
251 Id
252 Id

example, the comparable profits method and the profit – split method are now acceptable, although these methods are not defined. However, the circular is not very clear about the methodology to be followed in cases of newly accepted methods. It is likely that the same may be clarified by the tax administration soon.[253]

Another important development has been the adoption of APAs as alternative dispute resolution route.[254]

253 Singh, supra note 3 at 117 – 118.
254 See annexure for details.

Chapter 9

TRANSFER PRICING IN INDIA

Like other developing economies the growing pace of intra-group transactions in globalization has placed transfer pricing among the most challenging issues on the schedule of the Indian companies. The Finance Minister in his Budget Speech 2001 noted that *"the profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues"* and further explained that *"With a view to provide a statutory framework, which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income-tax Act"*. The Finance Act 2001 was introduced with various provisions to effectively curb the abuse of transfer pricing measures by MNCs. These are effective from 1 April 2001, and will be applicable to all international transactions entered into by associated enterprises in India after that date.

THE EARLIER REGIME

The important sections relating to transfer pricing in the Income Tax Act 1961, before the new transfer pricing regulations were introduced were S. 40A(2)[255], S. 80 IA(9), S. 80 IA (10)[256] and section 92[257].

255 This enables tax authorities to disallow any expenditure made to a related party which they feel is excessive.
256 Certain tax benefits are available under section 80 IA such as a tax holiday for a certain number of years. If transfer pricing is suspected then the tax authorities can deny such tax holidays.
257 Section 92 provided that, if owing to a close connection between an Indian entity and a foreign party, the Indian tax authorities felt that the prices charged in a transaction were not at an arm's length they could adjust the taxable income of the Indian party. In other words, taxable income could be enhanced if the transaction has led to lower profits for the Indian party.

Out of these provisions, S. 92 is of particular importance because this was the only provision in the Act which enabled an Assessing Officer to interfere with the prices agreed to between a resident taxpayer and an associated entity. It empowered the Assessing Officer to make suitable adjustments to the income of a resident taxpayer from a transaction with a non resident if he was of the view that the income from such a transaction was understated in the hands of the resident due to the close connection between the two.[258] Rules 10 and 11 of the Income Tax Rules, 1962 provided that assessing officer could determine the amount of income between associated parties[259].

However, S. 92 had various limitations and was unsuitable to deal with the whole gamut of transfer pricing abuses by MNCs in the Indian jurisdiction in post liberalization era which can be characterized as follows-:

- The scope of the section was considerably reduced by the use of the term 'resident' rendering the same inapplicable in case of transactions entered into between two non-residents. In other words, this section would be inapplicable in case of transactions between the 'permanent establishment' of a non-resident and the non-resident itself or in the case of transactions between the Home Office and Branch office of an entity.
- The section was also not broad enough to cover transactions in intangible goods and services.
- The emphasis of the section is on the term 'profit' but the term 'profit' had not been defined in the Act. The complexities involved in using the 'profit split' method have already been discussed which is perhaps the reason why most countries apply the ALP with respect to price rather than profit.
- The section also left important terms like 'close connection' undefined thereby making the determination or assessment under the section subjective. Further, use of

258 This concept has always been a part of the Income Tax law in India. Earlier, it was incorporated in S. 42(2) of the 1922 Act. S. 92 as introduced in the 1969 Act is almost a mirror image of the provision in the 1922 Act.

259 Rule 10 and 11 provide that amount determine could be 1) Such percentage of the turnover so accruing or arising as the Assessing Officer may consider to be reasonable. 2) The amount which bears some proportion to the total profits and gains from business of such person computed in accordance with the provisions of the Act. 3) The amount determined by the Assessing Officer in any manner deemed suitable.

the word 'reasonable' puts an obligation on the Assessing Officer to base his judgment on some grounds that are not arbitrary.

No specific rules or obligations about maintenance of documents about such transactions existed under the old Section 92. The only documentation requirements were those that were imposed generally under S. 44A of the Act.[260] These documentation requirements were grossly inadequate to deal with transfer pricing transactions owing to the special relationship between the parties. These transactions necessarily require contemporaneous documentation because in these cases, the factors responsible for determining prices are within the knowledge of the parties. As a consequence of the above shortcomings, while S. 92 remained in the statute for a number of years, it was rarely invoked in practice.

THE PRESENT REGIME AND REGULATIONS ON TRANSFER PRICING

With a view to provide a statutory framework which would lead to computation of reasonable, fair and equitable profits and tax in India, transfer pricing legislations were introduced in India in line with the prevailing international norms. The methods and principles set forth in the OECD Guidelines form the basis for detailed regulations issued in India.

The *Finance Act, 2001* introduced Transfer Pricing Regulations in India with effect from 1st April 2001. The sections and rules under the *Income Tax Act, 1961* which deal with TPR are Sections 92 to 92F and rules 10A to 10E and Sections 271(1)(c), 271AA, 271BA and 271G. The provisions are:

- **Section 92** seeks to provide that income arising from international transactions (between associated enterprises) shall be computed having regard to the arm's length price.

260 This section provides for compulsory maintenance of accounts by certain categories of taxpayers as provided in clause (1) and for other taxpayers if their income exceeded certain specified limits so as to enable the Assessing Officer to determine the total income of the taxpayer in accordance with the provisions of the Act.

➢ **Section 92A** and **Section 92B** provide the meaning of the expressions "associated enterprises" and "international transaction" with respect to which the income is to be computed under the new Sec 92.

➢ **Rule 10A** provide for the basic and the additional criteria to determine associated enterprises.

➢ **Section 92C** provides for the computation of arm's length price. The section prescribes the following methods as being the most appropriate in determining the arm's length price:

- comparable uncontrolled price method; or
- resale price method; or
- cost plus method; or
- profit split method; or
- transactional net margin method; or
- any other method which may be prescribed by the Board.

In a case where more than one price can be determined by the most appropriate method, the arm's length price shall be the arithmetical mean of such two or more prices.

➢ **Rule 10B** explains in detail methods prescribed above.

The Rule also provides that the comparability of one transaction with another shall be judged with reference to the following, namely:-

a) the specific characteristics of the property or services transferred in either transaction;
b) the functions performed taking into account assets employed or to be employed and the risks assumed by respective parties of 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, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

➢ **Rule 10C** provides the criteria's which will facilitate the selection of the most appropriate method. Further, based on the material and information available, the Assessing Officer, in the course of the assessment proceedings, can determine the arm's length price where price is not in accordance with the proposed provisions or prescribed information is not maintained/furnished or data used for computing such price is not reliable or correct. The tax authorities shall not make any adjustments to the arm's length price adopted by the taxpayer if such price is up to 5% less or 5% more than such price determined by the Assessing Officer.

➢ **Section 92D** seeks to provide that every person who has undertaken an international transaction shall keep, maintain and retain such information and documents as may be specified by the Central Board of Direct Taxes (CBDT). Documentation requirements shall not be applicable in cases where the aggregate value of international transactions entered into during a year is up to Rs10 million.

➢ **Rule 10D** provide for the documents required to be kept and maintained by persons falling in Category 1 (those persons who have entered into international transactions the total value of which exceeds Rs. 1 crore) and Category 2 (those persons who have entered into international transactions the total value of which does not exceeds Rs. 1 crore).

➢ **Section 92E** seeks to provide that 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 and manner.

➢ **Rule 10E** prescribes the Form No. 3CEB for the audit report.

➢ **Section 92F** defines the expressions "accountant", "arm's length price", "enterprise", "specified date" and "transaction".

With a view to ensure that multinational enterprises comply with the requirements of the new sections, **amendment** was made in Section 271 and new **Sections 271(1)(c), 271AA, 271BA and 271G** were inserted in the Income Tax Act, so as to provide for penalty to be levied in cases of non-compliance with the procedural requirements, and in cases of understatement of profits through fraud or willful negligence.

Considering the complex issues involved in transfer pricing, and with a view to avoid hardship to the taxpayers in the initial stages of implementation of the new regulations, the Central Board of Direct Taxes (CBDT) has from time-to-time issued clarifications through notifications and circulars.

The Finance Act 2002

Certain amendments were made in the Transfer Pricing Regulations through the Finance Act 2002. The amendments are effective from 1st April 2003 corresponding to the Assessment Year 2003-04. The exercise of amendment is carried out to remove inconsistencies, administrative problems and inconveniences besides widening the tax base.

- **Section 92** is amended to clarify that provision of transfer pricing shall not apply where it has the effect of reducing income chargeable to tax or increasing the loss computed on the basis of entries made in the books of account.
- **Section 92A** is amended to clear the confusion on the meaning of 'associated enterprises'. The definition of 'associated enterprises' included situations in which an enterprise was regarded as a 'deemed associate enterprise' and these conditions were very wide. It has now been clarified that if only one of the conditions in the definition of a 'deemed associate enterprise' is met, will an enterprise be regarded as an associate enterprise.
- **Proviso to Section 92C** is amended to provide that the taxpayer shall have an option in case where more than one price is determined by the most appropriate method, to opt for the arithmetical mean or price which may vary from the arithmetical mean by an amount not exceeding 5 percent of such arithmetical mean.

➢ A new **Section 92CA** has been inserted w.e.f. 1.6.2002. This section provides for a procedure for reference to a Transfer Pricing Officer (T.P.O.) of any issue relating to the computation of arm's length price in an international transaction. The T.P.O. has been given all the powers of an A.O. for such computation.

➢ Definition under **Section 92F** of 'enterprise' is widened to include person or permanent establishment engaged in carrying out any work in pursuance of contracts.

➢ Definition of 'permanent establishment' ("PE") is inserted and shall mean to include a fixed place of business through which the business of the enterprise is wholly or partly carried on.

Applicability-:

S. 92 of the Act stipulates that any income arising from an international transaction shall be computed using the ALP. [261] It is further provided that the allowance for any expense or interest arising from an international transaction shall also be determined with regard to the arm's length price.[262] Some doubts had been expressed in relation to the fact that the use of the word 'shall' implied that the determination of the income in accordance with the ALP was also required to be done in a case where the income reported is higher than the arm's length price.[263] This has now been clarified by the insertion of clause (3) to S. 92 by the Finance Act, 2002. It is now specifically provided that the section shall not apply in case where the computation of income under clause (1), or the determination of any cost or expense allocated or apportioned, as the case may be, under clause (2) has the effect of reducing the income chargeable to tax or increasing the loss as the case may be.

There are certain preconditions that have been put for the applicability of the transfer pricing provisions. The conditions are:

- there are ***two or more enterprises***, as defined in Section 92F(iii);
- the enterprises are ***associated enterprises***, as defined in Section 92A;
- the associated enterprises enter into a ***transaction***, as defined in section 92F(v);

261 S. 92(1).
262 Explanation to S. 92(1).
263 Sachin Vasudeva, "Transfer Pricing" 34 SEBI & Corporate Laws 67 (2001) at 68.

- the transaction is an ***international transaction*** as defined in section 92B.

However, if the aforesaid preconditions are fulfilled, then following are the consequences that result due to the application of the *Transfer Pricing* Provisions:

- the income arising from an international transaction shall be computed having regard to the arm's length price, as defined in section 92F(ii) and explained in section 92 C;
- the Assessing Officer may determine the arm's length price in certain situations;
- the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined;
- every person entering into an international transaction shall maintain documents and information as may be specified by the CBDT;
- every person entering into an international transaction shall obtain and furnish a report from an accountant.

The central feature of the law of transfer pricing is its insistence on the income arising from the transaction being computed according to the Arms Length Principle (ALP). Therefore, an analysis of this principle is central to the determination of the efficiency with which the IT Act and Rules prevent the avoidance of tax through the instrument of transfer pricing.

Documentation Requirements

Section 92D of the Act provides the legal framework for maintenance of information and documentation by a taxpayer requiring every person who enters into an international transaction with an associated enterprise to provide information and maintain documents prescribed under Rule 10D of the Income tax Rules. These include the following types of documents-:

(A) Enterprise wise documents-:

These include documents giving description of the ownership structure of the enterprise; profile of the multinational group of which the taxpayer is a part and a broad description of the business of the taxpayer and the industry in which it operates and the business of the associated enterprises.

(B) Transaction specific documents-:

These include documents providing a description of the nature, terms and prices of international transactions entered into with each associated enterprise; a description of the functions performed, risks assumed and assets employed by the taxpayer and by the associated enterprise involved in the international transaction; and a record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the taxpayer for its business as a whole or separately for each division or product which may have a bearing on the international transaction entered into by the taxpayer.

(C) Computation related documents-:

These include documents containing

- A record of uncontrolled transactions taken into account for analysing their comparability with the international transaction entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be relevant to the pricing of the internationals transactions;
- A record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction; a description of the pricing methods used, the most appropriate method and the reasons for considering it the same, and how such method was applied in each case;
- A record of the actual working carried out for determining the arm's length price, including details of the comparable data and financiai information used in applying the most appropriate method.
- The assumptions, policies and price negotiations if any which have critically affected the determination of the arm's length price ;

- Details of the adjustments, if any made to the transfer price to align it with arm's length price determined under these rules and consequent adjustment made to the total income for tax purposes;

Two criticisms have been made with respect to the elaborate documentation requirements-:

First, the costs involved in maintaining such elaborate documentation are restrictive.

Secondly, there are no commitments to the secrecy of the documents and information provided by the group and this serves as a disincentive to comply with these requirements. This can serve as an impediment to the goal of attracting increasing amounts of FDI to the country.[264]

The answer to the first criticism is that though the law provides for such detailed documentation requirements, this would not impose any additional onerous obligation upon the MNCs for they would generally maintain atleast the enterprise related and transaction related information anyways and the requirement to maintain the computation related information arises from the fact that this is the only way to determine that the assessee has in fact determined the appropriate arm's length price.

The answer to the second criticism is that under S. 138 of the Act, the Board or any other income tax authority has the power to demand any such information from the assessee as may be necessary to perform either its functions or the functions of any other government authority.

Burden of proof-:

The information and documentation requirements referred to above are linked to the burden of proof laid on the taxpayer to prove that the transfer price adopted is in

264 Niraj Jain and Harvinder Jaspal, "The New Transfer Pricing Regime: Issues and Implications"122 Taxmann 47 (2002) at 57.

accordance with the ALP. One of the conditions to be fulfilled for discharging this burden by the taxpayer is maintenance of prescribed information and documents in respect of an international transaction entered into with an associated enterprise. Default in maintaining information and documents in accordance with the rules is one of the conditions which may trigger a transfer pricing audit under Section 92C(3). While there is no requirement for their submission along with the report, Rule 10D requires that the information and documents maintained should be contemporaneous as far as possible and should exist latest by the specified date for filing the report under section 92E. Section 92D also provides that information and documentation may be requisitioned by the Assessing Officer or the Appellate Commissioner on a notice of thirty days which period may be extended by another period of 30 days.

Determination of the arm's length price by the Assessing Officer in case the assessee's computation is unacceptable

If the Assessing Officer in the course of an assessment proceeding is on the basis of material or information or documents in his possession of the opinion that

- The price charged or paid in an international transaction has not been calculated in accordance with the arm's length price.
- Any information or document relating to an international transaction have not been kept or maintained by the assessee in accordance with the prescribed rules or that the information or data used in computation of the arm's length price is not reliable or correct or
- Upon the failure of the assessee to furnish any document within the specified time which he was required to furnish by a notice issued under S. 92D(3),

He will proceed to determine the arm's length price in relation to the said international transaction in accordance with the provisions and the rules stipulated on the basis of the information or documents available to him. This may be used by the Assessing Officer to compute the total income of the assessee. As per Circular No. 12/2001, dated 23-8-2001, it has been made clear that in case of an international transaction, the Assessing Officer

can have recourse to sub-section (3) of section 92C only under the circumstances enumerated in clauses (a) to (d) of that sub-section and in the event of material information or document in his possession on the basis of which an opinion can be formed that any such circumstance exists. In all other cases, the value of the international transaction should be accepted without further scrutiny.

One criticism of the transfer pricing provisions is that under the proviso to S. 92C(4), no deduction shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after the computation of the total income under the section. In other words, the Assessing Officer is given the power to enhance the income of the non-resident attributable to the transactions he had with the resident in India but this in turn would not entitle the resident in India to a corresponding deduction for export of goods and services and exemption in respect of the income under sections 10A and 10B and Chapter VIA of the Act in his hands.[265] However, this provision can be justified on the ground that a tax deduction for expenditure or a subsidy is allowed only in respect of a disclosed income. But the same should obviously not be available to those who come before the Revenue with unclean hands.[266]

Penalties

The general penalty for concealment of income or furnishing inaccurate particulars thereof amounting to 100% to 300% of the tax sought to be evaded is applicable to international transactions. Apart from that, various stringent penalty provisions have been introduced by the Finance Act, 2001 in order to supplement the existing provisions to check income tax abuses. These include-:

- The failure to keep and maintain information and documents in respect of international transaction as required under S. 92D (1) and (2) shall attract a penalty amounting to 2% of the value of each international transaction.[267]

265 R Santhanam, "Double Standards in Transfer Pricing by Enhancement and Penalties" 172 Current Tax Reporter 1(2002) at 3.
266 K Srinivasan, "Draft Transfer Pricing Rules- A Review" 43 Corporate Law Advisor 1 (2001) at 4.
267 S. 271AA.

- The failure to furnish report by the accountant under Section 92E shall attract a penalty amounting to Rs. 1,00,000.[268]
- The failure to furnish any information or document required under S.92D (3), shall attract the imposition of penalty amounting to 2% of the value of each international transaction by either the Assessing Officer or the Director of Appeals as the case may be.[269]

However, no penalty shall be imposed for the abovementioned violations if the assessee can show reasonable cause for his failure to comply with the law.[270]

A lacuna in the law is that no specific provision for appeal against the penalties imposed has been provided.

Some Issues

Arithmetical Mean vs. Range of Prices

As per Indian transfer pricing regulations, in case more than one price is determined as arm's length price under the most appropriate method, the arithmetical mean of such prices should be considered the arm's length price.

However, since transfer pricing is not an exact science and it may be practically impossible that two comparable uncontrolled transactions take place at two difference prices, such rigid requirement for a particular price may not be fair on the taxpayers.

Further, OECD supports the concept of an arm's length range of prices for the purpose of transfer pricing. The OECD has even suggested to India to allow differences in the prices estimated by the tax authorities and the taxpayer, if they fall within the range of 10 percent to 15 percent. Such differences may be caused by the fact that the application of the ALP may produce only an approximation of conditions established between independent enterprises.

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268 S. 271BA.
269 S. 271G.
270 S. 273B.

Multiple year data – no provision

The newly introduced transfer pricing regulations do not provide for reliance on multiple year data for determining the arm's length price. It may happen that an enterprise has entered into a comparable uncontrolled transaction in the preceding year but not in the year under review. In such case, making use of data pertaining to such comparable transaction could be of immense help. It would also help in determining whether the independent enterprises engaged in comparable transactions were affected by comparable economic conditions.

No correlative adjustment contemplated – double jeopardy

It has been provided in the transfer pricing regulations that any adjustment (by the Tax Officer) to the income or expense of the taxpayer would not result in a corresponding adjustment to the expense or income of the associated enterprise of the taxpayer.

Confidentiality

Confidential data like trade secrets, pricing policies, etc. that is submitted to tax authorities must be kept confidential. The law as it currently stands does not provide for regulations to ensure that such information is not disclosed to third parties in general and competitors in particular.

Ensure Effectiveness

Training should be imparted to the income-tax personnel in investigation techniques in the context of growing international trade. Also, the Income Tax Officers should be held accountable so that they do not harass the MNC's to part with documents that are not part of the assessment. [271] Also, effective administrative machinery should be established for monitoring cross border dealings, FICCI said adding that in the context of growing e-commerce and m-commerce transactions, special rules be framed for checking misuse of

271 http://www.economictimes.com/200101/20econ04.htm

transfer pricing in an effective manner. [272]

Advance Administrative Rulings

Though the Act does not provide for Advance Pricing Agreements that may be concluded by the tax administration with MNCs, Chapter XIXB of the Act has been rationalised by the Finance Act, 2000 to enable a resident to apply to the Authority for Advance Rulings under S. 245Q read with Rule 44E, on *inter alia,* the pricing of goods that it proposes to apply or the services that it proposes to render to an associated enterprise outside India.

The important features of Advance Rulings which are designed specially to meet the needs of foreigners are-:

- The ruling obtained would be binding on both the taxpayer and the administration not merely for that year but also in the future unless the facts or the law.[273] This is an important measure aimed at reducing uncertainty amongst taxpayers regarding the application of various pricing methods in accordance with the arm's length standard for the taxpayer will know his liability towards income tax even before making his investment in India.
- The Authority[274] constituted will be competent to deal with complex issues relating to taxation including those related to DTAAs which may arise due to differences of opinion between the taxpayer and the administration.
- The Authority is required to pronounce the ruling within six months of the receipt of the application.
- The statute does not preclude the authority, if the circumstances so warrant from reframing or modifying the questions, agreements or projects till the date of hearing.
- Under the rules, the confidentiality of the proceedings before the authority is maintained.

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272 http://www.hindubusinessline.com/2000/12/27/stories/012720re.htm
273 S. 245S.
274 Under S. 245O(2), the authority shall include a person who is a retired judge of the Supreme Court, an officer of the Indian Revenue Service qualified to be a member of the CBDT, a member of the Indian Legal Service qualified to be an Additional Secretary to the Government of India.

- Where there is no complicated question of fact or law and the point of view put forth by the applicant is acceptable, a ruling will be pronounced by the authority even without personal hearing. This greatly works to the convenience of the non-resident.[275]

It is submitted that apart from the changes suggested in this section, the transfer pricing regime in India is largely in accordance with that followed in the rest of the world and is neither draconian nor arbitrary in its operation as has been the criticism from some quarters.

Comments:-

— Why have you not discussed transfer pricing under Customs Act, 1962 and the Valuation Rules, 1988 framed thereunder ???

— Indirect taxes in the form of Customs levies contributed 19.1% of the tax revenue to the Govt as per the Economic Survey of 2004. Corporate Income Tax contributed 25%. Therefore customs transfer pricing regulations are extremely important. With liberalized EXIM Policy and low rates of import duty the tendency to resort to transfer pricing models deleterious to economic interests of India, by vested interests having FDI in India, would be a factor to reckon with.

- Discuss after study of Art VII of GATT 1994 and Havana Charter of Geneva - 1948, the transfer pricing models for legislation by the signatory countries.

Pl. see my notes on the previous page with case-law references.

275 Supra note 3, at 157-158.

Part III

PRACTICING TRANSFER PRICING

Comparables play a central role in transfer pricing; both in defining and implementing arm's length transfer pricing policies and in documenting the application and results of those policies in a particular period.

It is rarely if ever possible to identify comparables which meet and can be shown to meet the rightly exacting standards. Internal comparables are often not available and, where they are, rarely capable of adjustment to the standards necessary to rely on them as a principal method or benchmark. As regards external comparables, there is only very limited information available to apply the transactional methods and TNMM as defined in the Guidelines.

The barriers to the effective application are well-known to practitioners but are so fundamental that they deserve to be confirmed as a point of departure which run the central theme of this part.

Chapter 10

TRANSFER PRICING:

PRACTICAL CONSIDERATIONS

Any transfer pricing valuation has been impacted heavily by the treatment of transaction that a subsidiary company engages in with its parent. The pricing of such transactions, whether in respect of the sale of tangible product, use of intangibles such as trademark or patents or the provision of services, will have a material impact on earnings and therefore value.[276]

Tax authorities focus exclusively on related-party transactions, which are termed "controlled transactions." Transfer pricing, for tax purposes, has no direct impact on independent-party transactions, which are termed "uncontrolled transactions."[277] The practice of transfer pricing poses many challenges as:

- The majority of corporations establish transfer prices based on some type of market price.
- Most do not use formal contracts. Companies generally have guidelines for the resolution of conflicts and an appeals process for disputes between affiliates about transfer prices.
- Explicit compliance with the regulations may not coincide with the objectives of MNCs that want to take advantage of market imperfections.

276 Andrew McCrodan, "Transfer Pricing from a Valuator's Perspective" 1999 J. Bus. Valuation 55 (1999) at 55

277 "Transactions," in this context, are determined broadly, and such transactions include sales, licensing, leasing, services, and financial loans. Robert Feinschreiber "Practical Aspects of Transfer Pricing" 70-MAR Fla. B.J. 41 (March 1996) at 41.

- MNCs have a strong incentive to manipulate the market forces that give rise to the "arm's length" price as a basis for assessing the degree to which transfer prices comply with applicable regulations.

The purpose of transfer pricing regulations are to encourage the taxpayer to implement transfer pricing that is based on the comparison of transactions, and discourage the division of income among related parties.

Relationship of the Parties

The relationship between parties to a transaction may affect the way in which transfer pricing is determined. The transfer pricing regulations recognize three relationships:

1) Both parties to the transaction are controlled; an example is a sale between a parent company and its subsidiary.

2) One party to the transaction is controlled, and the other party is not controlled. An example would be a sale between a subsidiary of the parent company to an unaffiliated company.

3) Neither party is controlled, and the transaction is wholly independent from the taxpayer's activities.[278]

The transfer pricing regulations generally do not favor wholly independent transactions as a basis for comparison. The primary thrust of the transfer pricing regulations is to compare wholly controlled transactions with transactions between a controlled party and uncontrolled parties, which are often referred to as in- house comparables.

278 Robert Feinschreiber "Practical Aspects of Transfer Pricing" 70-MAR Fla. B.J. 41 (March 1996) at 41

It is remarkable however that in the past decade, while all attention has been directed towards the tax dimension of transfer pricing, there has been considerable development of economic insights, specifically in fields directly relevant to understanding how companies behave, both internally and between them, and how markets work.[279]

In summary, a realistic and equitable application of the ALP (in the absence of relevant transactional comparables) requires an adequate identification of the circumstances under which parties operate ("their commercial and financial relations"), as "similarity" of those circumstances is a necessary starting point for comparing the pricing practices of related parties with those of unrelated parties. In this regard, one should concentrate on the relationship between parties concerned as a whole, rather than per transaction. Terms and conditions (price) per transaction will follow from applying the agreements which were made in view of the total set of roles and responsibilities of the individual parties to the transaction, and those terms and conditions are precisely what one would want to compare with how third parties would behave in such a relationship.[280]

OPERATING METHODS

Moreover, transfer pricing highlights opportunities to introduce new operating methods that optimally allocate functions, risks, and returns among the companies. As a general principle, the allocation of profit among an international group will depend upon the functions undertaken by each party, the risks taken and the intangibles owned. High profits are the reward for complex activities, high risk (such as investment in research and development) and valuable intangibles (such as patents, know how or brands). Low profits are justified by routine low risk activities.[281] So while accessing the arm's length nature of a transaction it is difficult to answer "what would unrelated parties agree to in the same circumstances". For example, a party taking high risk to develop a valuable

279 Pim Fris, "Dealing with Arm's Length and Comparability in the Years 2000" ITPJ (2003) 195
280 Ibid at 196
281 See Chapter 8 "The role of Transfer Pricing in Tax Planning" Butani supra 94 note at 191. Also see Andrew McCrodan, "Transfer Pricing from a Valuator's Perspective" 1999 J. Bus. Valuation 55 (1999) at 60.

proprietary drug would seek to retain as much of the ultimate profit as possible when negotiating with a distributor to sell the drug. If the distributor's selling activities are routine (i.e., many alternative distributors are available to perform that service), the profit earned by the distributor will be relatively low and all residual profit should reasonably be retained by the developer of the drug. The transfer price to a controlled distributor should reflect the risk and functions allocated to it.[282]

Comparability

When comparing companies and situations, one must do this on the basis of a number of factors mentioned in the OECD Guidelines e.g. quality and quantity of product, kind of market, geographic market, foreign currency risks etc. Unfortunately, the scope of interpretation and weighting of these factors, as well as their important aspects and elements, varies from country to country. This makes it not only difficult for businesses to determine an acceptable comparable price for certain transactions, but also hinders the actual documenting of these transactions.[283] Characteristics of the property or services transferred will be more important in case of comparison of prices (under transactions based methods) as compared to comparison of profits (under profits based methods). In order to ensure a meaningful comparison, the following factors should be considered.

Functional Analysis

Proper understanding of how independent parties evaluate and negotiate a potential business transaction is must. Functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken or to be undertaken in the independent and associated enterprises. In other words the functions performed and risk assumed by each party in transaction. In arm's length dealings, it generally makes sense for parties to allocate a greater share of risk to those items over which they have relatively more control. Analysis is required to determine to what extent each party bears risk in practice.

282 McCrodan ibid at 60

283 J. Philip Van Hilten, "Transfer Pricing Policy in the International Tax System--Past and Present and a Quick Look in the Fiscal Crystal Ball" 10 Geo. Mason L. Rev. 709 (2002) at 717

Contractual terms

The contractual terms of a transaction generally defines explicitly or implicitly how responsibilities, risks and benefits are to be divided between the parties e.g. the scope and terms of warranties, credit terms etc. Such analysis will form part of the functional analysis. If no contract exists, such relationship must be deduced from conduct of the parties and the economic principles that govern the relationship. Correspondence between the parties also may be useful to determine the contractual relationship.

Economic circumstances

Arm's length price may vary if the markets in which the independent and associate enterprises are operating are not comparable. It may call for appropriate adjustments. This will depend on various factors such as geographic location, size of the market, extent of competition, etc.

Business Strategies

Business strategies followed by similar organizations. Strategy as regards new product launch, research and development market penetration etc.[284] Business strategies would take into account many aspects of the enterprise, such as innovation, risk aversion, political changes, existing labour laws, etc.

Other factors to like prices, data should be compared for more than one year. This can eliminate the effect of cyclical nature of the business or a particular product life. There may be certain benefits or services provided to an enterprise which is set off or balanced by different benefits received from that enterprise. Both the enterprises perceive that the values of the respective benefits more or less same and hence claimed set off. Such intentional set off should be taken cognizance of while comparing prices charged for a transaction.[285]

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284 Rajiv Shah "Cost Contribution Arrangment Principles of Transfer Pricing" January 2000 CA 29 (2000) at 21.
285 Id.

However, if a transfer pricing issue arises long after an event, then one should be mindful of the fact that comparisons should only be made with successful independents. In other words, there is a risk that business failures may not be considered properly when the factors determining comparability are considered, often years later.

APPLICATION OF THE ALP TO SERVICES.

Transactions of services between associated enterprises are of a varied nature-administrative, technical, financial and commercial. Such services are for the management, control and coordination of the whole group. While some of the services are provided on a continuous basis (for example, technical assistance); while others are for specific services, for example, troubleshooting services. The cost for providing such services may be borne initially by the parent, or by a specially designated group member.[286]

At times, services accompany transfer of goods or intangible properties between associated enterprises. Whether a service can be considered as an intra group service would depend upon the actual facts and circumstances of the case, and it is not possible to establish any general criteria to identify such a service. For the purpose of determining the price of such service in accordance with the ALP, the first thing that should be ascertained is whether it has economic or commercial value, i.e. whether it enhances the commercial vale of other members of the group. If the activity is not one, which an independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the ALP. Moreover, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed.[287] For instance, no services would be received where an associated enterprise by reason of its affiliation alone has a higher credit rating than that which it would have, if it were unaffiliated. However, an intra group service would generally exist where the higher credit rating were due to a

286 OECD Task Force Report, Transfer Pricing Supplement No 19 (Netherlands, International Bureau of Fiscal Documentation, 1996), (hereinafter 1996 OECD Report), supra note 3, at 69.
287 Ibid. at 70.

guarantee by another group member, or where the enterprise benefitted from the group's reputation deriving from the global marketing and public relations campaign.[288]

There are two main arrangements for charging supply of Intra group services[289]-:

(a) **Direct Charging Methods-:** In this method, the associated enterprises are charged for specific services. This method is of great practical convenience to tax administrations because it allows the service performed and the basis of payment to be clearly identified. This method is applied in cases where the services rendered to associated enterprises are similar to those rendered to independent enterprises. At the same time, it becomes difficult to apply this method if the services to third parties are merely occasional or marginal.

(b) **Indirect Charging Methods-:** Where the above methods are inapplicable, MNCs apply indirect methods like cost allocation or apportionment. These should be allowed provided sufficient regard has been given to the value of the services to the recipients.

The relevant considerations for determining the arm's length price in relation to intra group services include the value of the service to the recipient and how much a comparable independent enterprise would be willing to pay in similar circumstances as well as the costs to the service provider. The economic alternatives available to the recipient of the service also need to be taken into account while determining the arm's length price.[290]

The CUP or Cost Plus methods are normally preferred for pricing intra group services. The CUP method shall be applied in cases where there a comparable service being is being provided by the associated enterprise to an independent enterprise or in the absence of that between independent enterprises in the market in similar circumstances. The CP method shall be used in cases of centralised service arrangements. Like in the case of

288 In other words, passive association should be distinguished from active promotion of the MNC's group attributes that positively enhance the profit making potential of a particular member of the group.
289 Ibid. at 71.
290 Ibid. at 72.

transactions involving goods, where none of the traditional transaction methods may be used, the transactional profit methods may have to be used.[291]

It may be noted here that it is not necessary that the intra-group service be such that it results in a profit for the service provider. As per the OECD Guidelines, though it is normally to be expected that in an arm's length transaction, an enterprise would normally seek to charge for its services in a manner as to derive profit, there may be circumstances in which an independent enterprise may not realise a profit from the performance of the service but may still provide the service in order to increase its profitability, perhaps by complementing its range of activities.[292]

THE PROBLEM OF INTANGIBLES STILL UNRESOLVED

While applying the ALP to trade in intangibles, the following factors have to be kept in mind:

- Limitations on the geographical area in which the rights may be exercised;
- Export restrictions on goods produced by virtue of the rights concerned;
- Exclusive or non-exclusive character of any rights transferred;
- Capital investment in terms of new plant or machinery;
- Start up expenses or development work required in the market;
- The possibility of sub-licensing, the licensee's distribution network; and
- Whether the licensee has the right to participate in further development of property by the licensor.[293]

Therefore, it is submitted that in these cases an apportionment method on the lines discussed in the next section would perhaps be better capable of dealing with the unique nature of transactions involving intangibles. In the absence of data conclusively establishing which method is more effective in transactions involving intangibles, the

291 Id.
292 Id.
293 Ibid. at 66-67.

researcher expresses herself as incompetent of venturing any conclusion in regard to this matter.

Chapter – 10

OECD GUIDELINES AND ISSUES AHEAD

International aspects of taxation are difficult to deal as they involve more than one jurisdiction and any adjustment to the transfer price in one jurisdiction calls for a corresponding adjustment in another jurisdiction. Sometimes both jurisdictions may not be agreeable to making the adjustments, and hence it is possible that the MNC is taxed on the same income twice. To minimize such risk of double taxation, international consensus on the establishment of transfer prices for cross – border transactions is required that is what OECD Strive to achieve.

The OECD has published extensive guidelines addressing transfer pricing. These guidelines published by the OECD feature in the domestic legislation of a number of countries as providing the definitive standard by which companies should benchmark their intercompany prices.

OECD Transfer Pricing Guidelines essentially aims at the following[294] :

- Providing guidance on how to apply the general principles of the guidelines to complex situations, such as permanent establishments, financial services, global trading and thin capitalization.
- Monitoring the practical implementation of the Guidelines and amending and updating the existing guidance given in the light of this monitoring like the development of further practical examples to illustrate the application of the ALP.
- Improvement of administrative procedures by using various methods of dispute resolution such as advance pricing arrangements (APAs), mutual agreement procedure and arbitration etc.

294 http://www.oecd.org/daf/fa/tr_price/transfer.htm

- Encouraging countries outside the OECD to associate themselves with the Guidelines.

The OECD guidelines have been heralded as a new international consensus, and an important achievement both for the twenty-five member countries and for the international business community.[295]

OECD Guidelines: A Giant Leap

The 1979 OECD report[296] did not cover the issue of corresponding adjustments arising on transfer pricing which was considered in the second report of the OECD on Transfer Pricing (1984 OECD report). This report addressed three issues associated with transfer pricing:

- Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure
- The taxation of Multinational Banking Enterprises
- The Allocation of Central Management and Service Costs

The CFA in 1993 began to revise the landmark 1979 OECD report as supplemented by the 1984 OECD report. The CFA in 1995 issued guidelines titled 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration' which have been issued in loose format. The 1995 OECD report focuses on both transaction oriented & profit oriented approach for arriving at arm's length price.[297]

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295 Frances M. Horner, "International Cooperation and Understanding: What's new about the OECD'S Transfer Pricing Guidelines" 50 U. Miami L. Rev. 577 (1996) at 577.
296 The OECD set up the OECD Committee on Fiscal Affairs (CFA) to study issues arising due to transfer pricing between related parties as early as in 1970's. The CFA issued the first major landmark report in 1979 titled "Transfer Pricing and Multinational Enterprises'. This report defined the term 'Arm's length price' as the price 'which would be agreed between unrelated parties in the same or similar transactions under the same or similar conditions in the open market'. It listed Comparable uncontrolled price method; resale price method; cost plus method; and Other methods for arriving at the arms-length price. This report stated that it is not possible to arrive at arm's length price very precisely and therefore reasonable approximation price would be acceptable. See Chapter 3 for methods and introduction foı OECD history "Tracing the roots"
297 See Chapter 3 for Methods

The 1995 OECD guidelines endorse, elaborate and extend the principles and concepts of 1979 OECD reports. Perhaps the most distinguishing part of the 1995 guidelines is the third chapter, which addresses "Other Methods," including profit methods that might be used to approximate arms length conditions.[298]

The language of Article 9, Paragraph 1 makes clear that an adjustment satisfies the ALP when the adjustment includes in an associated enterprise's profit any profits that would have accrued to that enterprise "but for" conditions made or imposed between associated enterprises in their financial relations that differ from the conditions that would be made between independent enterprises.[299]

This statement has both positive and negative implications for profit methods. The positive implication is that Article 9, Paragraph 1 does not *per se* preclude adjustments that arise from profits accruing to an associated enterprise. This should hardly be surprising, given that two of the traditional methods the 1979 report endorsed, resale price and cost plus, examine profit margins. The negative implication is more sobering. Article 9, Paragraph 1 requires a "but for" connection between the improper accrual of profits and the existence of improprieties in the economic and financial relations between the associated enterprises. This requirement, once taken seriously, presents an insurmountable obstacle to the regular use of profit methods on an overall company-wide basis (or to the use of any method in such a way). Many factors can affect the overall accrual of profits by an independent enterprise, some of which may be wholly unrelated to the controlled transaction for which transfer pricing is in question. When a transfer pricing inquiry extends beyond profits of the controlled transaction, it examines conditions unrelated to those between the associated enterprises involved in the transaction, thereby risking a violation of the ALP. This analysis ultimately led the OECD to articulate for the first time the concept of a "transactional profit method," and to reject any profit-based analysis inconsistent with that concept.[300]

Comparability Analysis and Business Strategies: the 1995 guidelines provide much

298 Horner, supra note 295 at 578.
299 OECD Guidelines, para 1.6.
300 Horner, supra note 295 at 579.

more detail about the relevant factors, including a discussion of functional analysis applicable to all transfer pricing methods.[301] In addition to the expanded comparability discussion, it is also important to note a significant development regarding business strategies. In contrast, the 1995 guidelines recognize a whole list of business strategies that could influence price,[302] and that list is not even meant to be exhaustive.

Recognition of the Actual Transactions: the 1995 guidelines provide instruction on when a tax administration may disregard the structure the taxpayer adopts in entering into a controlled transaction. The 1995 guidelines limit the possibility of such an interpretation. First, they expressly state that "[i]n other than exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for them."[303] The guidelines recognize only two circumstances when restructuring may be appropriate and legitimate.[304] The first is "where the economic substance of a transaction differs from its form,"[305] such as where an investment in an associated enterprise is structured as debt in economic circumstances where the substance is a subscription of capital.[306] The second circumstance is where the "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price."[307]

This rule is far more restrictive than the 1979 rule that allowed restructuring whenever the parties arranged their affairs differently than independent enterprises. The new rule sets up two additional hurdles. First, independent enterprises must not have considered the arrangements "commercially rational" under the circumstances. Second, the tax administration must effectively have no other recourse for fixing arm's length pricing. Both of these conditions must be met for restructuring to occur where the form and

301 OECD Guidelines, para 1.19-1.35
302 OECD Guidelines, para 1.31-1.35
303 OECD Guidelines, para 1.36. Horner, supra note 295 at 581
304 OECD Guidelines, para 1.37. id
305 id
306 id
307 ibid at 582.

substance of a transaction are the same.

Evaluation of Separate and Combined Transactions: In keeping with the Article 9 articulation of the ALP, the 1995 guidelines provide that ideally the principle "should be applied on a transaction-by-transaction basis."[308] At the same time, the guidelines recognize that there are circumstances in which it would be appropriate to aggregate transactions. The guidelines articulate a specific standard for when this may occur: "where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis." They cite a number of examples, such as long-term contracts for the supply of commodities or services, rights to use intangible property, and pricing a range of closely linked products when determining the price for each product or transaction is "impractical."

The 1995 guidelines provide a standard for determining whether aggregation of controlled transactions is appropriate. This standard is important for both taxpayers and tax administrations. From the taxpayer's perspective, the standard will protect against the global application of pricing methods by tax administrations. The ALP will require a transaction-by- transaction analysis, except where transactions are "so closely linked or continuous"[309] that a separate analysis will not work. The standard will help tax administrations protect against the combination of transactions in a way that impedes a proper arm's length analysis. Thus, the 1995 guidelines recognize that in some cases, package transactions may need to be evaluated separately. However, after such an analysis the tax administration should still consider "whether in total the transfer pricing for the entire package is arm's length."[310] This latter qualification should prevent tax examiners from inappropriately selecting for adjustment ("cherry-picking") the part of the package that is not arm's length without considering whether offsets exist in other parts of the package.

In short, both taxpayers and tax administrations now have flexible rule allowing separate transactions to be combined to permit a practical analysis, in keeping with

308 OECD Guidelines, para 1.42
309 OECD Guidelines, para 1.42.
310 OECD Guidelines, para 1.43

business realities. At the same time, the 1995 guidelines have attempted to articulate a standard to prevent aggregation from being abused.

Use of an Arm's Length Range: Using an arm's length range of transfer pricing is perhaps one of the most important additions that the 1995 guidelines make. These guidelines also state that "[t]ax administrators should hesitate from making minor or marginal adjustments."[311] However, the guidelines go further, specifically endorsing an arm's length range in many situations: "However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable."[312] Set-offs intentional set-offs should be allowed. An intentional set-off is one where the associated enterprises knowingly include a balancing of benefits in their arrangements with each other.[313] Under the 1995 guidelines, intentional set-offs may occur only between two associated enterprises. The guidelines give no explicit indication whether set-offs involving more than two parties (i.e., a triangular arrangement) should be recognized.

Selection of Transfer Pricing Methods: The 1995 guidelines similarly favor the CUP method: "Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the ALP. Consequently, in such cases the CUP Method is preferable over all other methods."[314] The 1995 guidelines also prefer the traditional transaction methods (such as CUP, cost plus and resale price) over transactional profit methods (such as transactional net margin method and profit split).[315] These latter methods are considered appropriate only in cases of last resort. Thus, all the methods do not have equal standing.

Documentation: 1995 Guidelines articulates a new standard for determining the appropriate level of documentation from a taxpayer.[316] It indicates that "[t]axpayers

311 OECD Guidelines, para 1.68
312 OECD Guidelines, para 1.45
313 OECD Guidelines, para 1.60
314 OECD Guidelines, para 2.7
315 OECD Guidelines, para 2.49
316 OECD Guidelines, para 5.1

should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purposes in accordance with the ALP."[317] In determining what constitutes reasonable efforts, the chapter provides that "[t]he taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance."[318]

The Chapter on documentation further makes clear that documents that "would not have been prepared or obtained other than for tax purposes"[319] should be expected "only if they are indispensable for a reasonable assessment of whether the transfer pricing satisfies the ALP and can be obtained or prepared by the taxpayer without a disproportionately high cost being incurred." This standard envisions tax administrators conducting a type of cost-benefit analysis before asking for documents other than those kept in the ordinary course of business. Finally, the chapter provides nonprescriptive detail about the type of information that may be relevant to a transfer pricing inquiry.[320]

ISSUES AHEAD

Issue: 1 – Requirement to perform an analysis of *transactions* vs. an analysis of third party information gathered at company level

All the OECD transfer pricing methods, whether traditional or profit based methods, are transactional methods. In practice, third party information is not often available at transactional level. So can third party data at company level meet the arm's length standard and if so under what conditions and to what extent?

Given that by nature a controlled transaction often exists to the exclusion of other transactions with uncontrolled parties, it is a significant issue. In practice, taxpayers are

317 OECD Guidelines, para 5.3
318 OECD Guidelines, para 5.4
319 OECD Guidelines, para 5.7
320 OECD Guidelines, para 5.16 – 5.27

required to attempt to apply the arm's length standard using third-party company data in circumstances where no internal comparable transactions exist. Since it is difficult to acquire third party comparable information at the transactional level in the absence of internal third party transactions, company level information is frequently used in practice.[321]

In practice, third party data at company level are generally used to evaluate or establish arm's length transfer prices; this data is, of necessity, very high level and aggregates a large number of individual transactions. Furthermore, such data is often consolidated and may reflect a diversity of business and economic circumstances.[322]

Para 1.42 of the Guidelines recognises that certain transactions may be aggregated, but only where they are "so closely linked or continuous that they cannot be evaluated adequately on a separate basis". This is slightly more restrictive that the IRS Regulations, which provide that transactions may be aggregated if they are "so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration"1. The level of information disclosed in the US is more detailed than is generally the case elsewhere, which may allow for a better evaluation of whether a third party's overall aggregated functions are suitably comparable to those of the taxpayer, and also allows for a review of the third party's activities on a segmented basis.[323]

As a practical matter, it is therefore necessary to rely on information reflecting aggregated third party transactions; and it would be helpful if the Guidelines were to recognise this. Therefore, the Guidelines should expand upon the comparability factors that it considers relevant to this approach.[324]

[321] Contribution Received from Grant Thornton. This and following comments can be visited http://www.oecd.org/document/47/0,2340,en_2649_33753_2508655_1_1_1_37427,00.html

[322] Contribution Received from Ernst and Young

[323] Contribution Received from Grant Thornton

[324] Contribution Received from Ernst and Young

Issue: 2 – Need to rely on transactions that took place between independent enterprises

Whether the information on third party enterprises that are part of another MNC group and as such engaged in controlled transactions with associated enterprises be systematically rejected, or should such information be regarded as providing useful information

It is a question of fact whether the third parties have complied with the arm's length standard in their intercompany transactions. The scarcity of information on uncontrolled transactions between unrelated parties suggests that no source of information should be rejected categorically. The challenge is to identify the best possible sources of information and evaluate them rigorously. However, it is rarely the case that information derived from related party transactions is likely to be acceptable as a sole benchmark.[325]

Again, there is a risk that acceptance of related party comparables will lead to the adoption of "secret comparables" by tax authorities. The use of private information derived from the related party transactions of one taxpayer in a controversy with another is wholly unacceptable.[326]

The existing guidance need not be amended, since paragraph 1.70 provides sufficient scope for transactions between multinational enterprises to be considered in "understanding the transaction or as a pointer to further investigation". This guidance could be extended to include a reference to the usual comparability tests.[327]

Issue: 3 – Need to obtain third party information relevant to the review of the five comparability factors

Details of the functions and risks, contractual terms and business strategies of third parties may not be available from public third party information. Moreover in particular, there is inherent difficulty in obtaining information on strategies and contractual terms

[325] id
[326] id
[327] Contribution Received from Grant Thornton

and conditions (matters of very major influence on pricing and other commercial terms at arm's length) simply because of the commercial sensitivity of this type of information. [328]

According to Ernst and Young the cost of a full documentation study for a taxpayer with transactions involving a number of jurisdictions will be measured in units of Euro hundred thousand. A transfer pricing design study involving complex transactions, which necessarily must address other important tax issues, may cost several Euro million.[329] Therefore an attempt to obtain information on comparability factor will be burdensome both for taxpayers and tax administrators.

Issue: 4 – Need to ensure objectivity of the list of external comparables

The selection of comparables is a matter of art as well as science. Therefore is necessary to obtain a balance between ensuring that all potential relevant external comparables are considered and having a set of potential companies that is manageable for research.[330]

It is essential to avoid too strict a comparability standard (which may eliminate good comparable companies). Experience shows that it is frequently not possible to obtain perfectly comparable information, and it is therefore necessary to use broad search criteria when identifying third party comparables. Similarly, "cherry-picking" can distort the results of a range of third party comparable companies. "Cherrypicking" by both taxpayers and tax authorities should be explicitly discouraged.[331]

Issue: 5 – Determination of the years to be covered and use of multiple year data

In practice that taxpayers rely on previous year data to determine future transfer pricing, because third party information is only published after the year end, therefore the use of multiple year data should be the standard, rather than an exception.[332]

[328] Contribution Received from Ernst and Young
[329] id
[330] id
[331] Contribution Received from Grant Thornton
[332] Contribution Received from IFA Korea

Taxpayers must use the data available at the time transfer prices are set for a fiscal year. Where the comparable uncontrolled price method cannot be applied, there is usually no public information available and previous years are therefore considered. Often it is the only information available, though taxpayers and tax authorities should take into account the prevailing and past industry conditions when determining the length of the averaging period, and any changes in accounting procedures that may cause a shift in mean profitability over time. The use of multiple years (rather than one prior year) in setting the transfer price helps to smooth out the effect of the product/business cycle and may provide a more robust range of arm's length prices.It may be useful for the Guidelines to provide some guidance as to the number of years that should be considered in reviewing multiple year data.[333]

Issue: 6 – Choice of relevant sources of information, including but not limited to commercial database

A commercial database is one of the key sources that support the application of transfer pricing rules.[334]

The primary advantages in the use of commercially-available databases relate to the efficiency/speed and cost-effectiveness of their use, in particular the ability to[335]

1. Access large/centralised volumes of data in electronic format;
2. Use the built-in search and interrogation capabilities because

    a. the data has been classified and summarised (eg, trade descriptions);
    b. inconsistencies in the financial reporting formats have been ironed out by reclassifying the financial information to a consistent format
    c. the built-in software/search engine allows Boolean logic to be used in developing a comprehensive search strategy

[333] Contribution Received from Grant Thornton
[334] Contribution Received from IFA Korea
[335] Contribution Received from Ernst and Young

d. the results can be displayed relatively quickly and the information exported to other document formats for further investigation / manipulation

The main disadvantages of commercially available databases relate to[336]

1. Inaccuracies in the classification of companies
2. Changes in the use of classification structures, and changes in the classification of individual companies, which means that there can be significant differences in each monthly edition of the database, and limits the ability to compare results over time
3. Loss of detail in financial statements due to the need to conform to a consistent standard.

As a practical matter, commercial electronic databases are therefore very widely used and this is one of the most important reasons for the almost pervasive adoption of TNMM or CPM.[337]

Issue: 7 – Definition of comparability adjustments where they are appropriate

As a matter of principle a vast range of adjustments may be appropriate, including:[338]

1. National economic factors such as demand and exchange rate shocks;
2. Differences in strategy, eg niche market vs cost leadership, which could influence margins;
3. Differences in the assignment of key business risks, eg volume risk for manufacturers in cyclical industries;

This diversity means that, in our view, it is not possible to develop useful guidance on when adjustment should be made and the nature of any such adjustments.

However, it would be helpful to establish a clearly stated principle that a taxpayer should take reasonable efforts to adjust for comparability differences in the light of the

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[336] id
[337] id
[338] id

information available. This could be supplemented by discussion of why adjustments are important in the application of the ALP.[339]

Issue: 8 – Interpretation and use of data collected

Diverging practices exist on the definition of the arm's length range and use of statistical tools. The interpretation and use of data is dependent on the quality of the comparables selected based on information. From the database, extreme cases should be able to be discarded from a group of selected comparables. It should be decided depending on the quality of data used. Loss-making comparables should be further examined depending on circumstance involved. Some reasonable adjustments to loss-making comparables may give rise to reasonable outcome.[340]

Issue: 9 – Specific comparability issues when applying transactional profit methods

Transactional Net Margin Method, it is often argued that a net margin approach is less sensitive to some of the discrepancies that may exist between the controlled transaction and the third party transactions being compared – for instance net margin indicators are less sensitive to differences in accounting standards as well as to some differences in products or functions. This problem exists in practice, and in many cases net margin analyses are a good solution. These tend to ensure that like is compared with like for the purpose of the economic analysis. If there are doubts as to the items included on a line by line basis in the company accounts (as is often the case when using third party databases) the use of this method will ensure the comparability of figures used for the calculation of the profit level indicators. The transactional net margin method is frequently used in practice because of difficulties in obtaining suitable third party information on gross margins.[341]

[339] id
[340] Contribution Received from IFA Korea
[341] Contribution Received from Grant Thornton

In the vast majority cases, the only OECD methods that can be applied are the TNM and transactional profit split methods. This applies to price setting as well as to documentation exercises focusing on the evaluation of the results of applying a policy.[342]

At present, the guidance on the application of methods departs considerably from what we understand to be general practice. The extent of that evidence suggests that TNMM should not be treated as a method of last resort. It would also be helpful to have more guidance on the practical application of these methods, including the level of effort that taxpayers are expected to apply in particular in terms of documentation. As regards the profit split method it would be helpful from a practical perspective if the Guidelines provided more guidance in terms of conducting a value chain analysis. It has turned out in practice that since more and more MNCs have run through business reengineering exercises in the recent past, traditional functional analysis approaches are not applicable anymore or only restrictively applicable.[343]

Read about: -
- factors to identify tax havens
- Harmful preferential tax regimes
- Tax-treaty network access
- Financial innovation and transfer pricing models.

[342] Contribution Received from Ernst and Young
[343] id

CONCLUSION

In the foregoing, we have seen that over the years that the role of MNCs in international trace has greatly increased resulting in integration of national economies into global market. At the same time, the increased importance of MNCs has thrown several issues including very pertinent tax issues. Among them, transfer pricing and the allocation of an economic unit's profit among its various functions is an issue of fundamental and increasing significance as more income is earned cross border. In a multi-jurisdictional world where tax rules differ, taxpayers have an incentive to structure their related party transactions to locate the entire group's profit or loss in the most desirable taxing jurisdiction. When a taxpayer engages in cross border transactions with related parties, the opportunities to limit or avoid income tax dramatically increase. However, because the parties are essentially a single economic unit, the price paid between the two merely splits the income between the two entities, but does not affect the wealth of the unit (tax effects aside). Thus, the two parties can price the transaction (e.g., the sale of goods, services, intellectual property) in a way that puts more income in the entity operating in a lower tax jurisdiction - a strategy of transfer pricing. This objective can be accomplished by pricing the transactions below or above market price.

Keeping this in mind, the international community has decided that each associate of an MNC should be taxed as "separate entity" for the income earned by it through a particular tax jurisdiction. The international consensus is that for tax purposes, transaction amongst associates of an MNC should be treated as if these transactions were at arm's length.

It is easier said than done and with the revolutions in technology, determining Arm's length price is going to become an even more difficult task. In order to allow international trade to proceed smoothly, it is necessary to find mutually acceptable solutions arising out of transfer pricing decisions. To deal with this problem, the OECD

presented a report in 1995, commonly called transfer pricing guidelines. These guidelines deal with the entire problem of transfer pricing, and also suggest the most appropriate method to deal with the problem. It reaffirms the ALP for determining the proper cost of the transaction, in as much as it is the price that would attach to a similar transaction between two independent enterprises in comparable circumstances. The methods for applying the principle are either based on the prices in the comparable uncontrolled conditions or on the profits in such situations. These arm's length methods are applicable not only in cases of transactions but also while dealing with intangibles and apportionment of costs when entities of a group combine to create asset jointly. However widely these method may be used, it suffers from some shortcomings like the absence of data on similar transactions between two independent enterprises, the impossibility of finding out comparable circumstances and the uniqueness of each transaction as influenced by some peculiar factors like market, risk etc.

So that arrived prices of intra-group transactions through arm's length are acceptable to tax administration, the taxpayer must maintain proper contemporary documentation. The rules should also be explicit in this respect. The enforcement of the rule has to be strengthened by appropriate and reasonable penalty provisions. These should be accompanied by development of an alternate dispute resolution system which should be both cost and resource efficient. It is in this context that APAs are being favored all over the world.

Countries either developed of developing are responding to this development by enacting comprehensive legislation supported by detailed regulations. These facilitate taxpayers and tax administrations in dealing with transfer pricing cases. The most noteable development as discussed earlier are in three areas – documentation, penalties and APAs. The APAs are advantageous both for taxpayers and tax administration as these are cost effective and efficient alternative dispute resolution procedures. The leader in all these aspects is the United States. Among the developing countries China and Brazil has taken the lead.

In India, the Indian Income Tax Act, 1961 has incorporated these principles in Sec 92 to

92F and attempts to regulate these transactions by adopting these methods. It thus tries to minimize the efforts to evade taxes by MNC's through the use of their subsidiaries. However, as pointed earlier that despite the broad and expansive definition of associated enterprises that is provided under the Income Tax Act, it fails to effectively plug all the loopholes that the business community may exploit. It fails to encompass domestic transactions between two associated enterprises and also overlooks the thin capitalization route adopted by MNÇ's to evade taxes. Regarding India researcher will like to observe that the three areas: rules regarding maintaining the confidentiality of the information obtained, setting up a standard for the use of multiple year data and use of range or prices instead of arithmetical means should be adopted.

Another common point where Brazil and India stands together, is the implementation of heavy penalty. This can be justified on the account of lack of staff and implementation measures in developing countries. So a deterrent move is required to see that the tax laws voluntarily followed.

Reaching at arm's length price is not so easy even in market conditions where all factors present so to arrive at that price in the absence of same is more difficult. As we have seen in the foregoing chapter, external comparables, adjustments, requirements of specific information, interpretation of data has posed several challenges to the OECD guidelines. Reaching at an arm's length price is an art and not science so no exact objective standards can be set for the same.

Tax administrations should also recognize that transfer pricing is mostly an issue of double taxation--not one of tax avoidance. If there is a desire to prevent double taxation and the related costs, then the swift resolution of disputes must be ensured[344] especially with help of APAs.

Finally, it is necessary to look at an issue connected closely with the past, present, and future of this issue. This is the change by a business from one transfer pricing system to another. In many cases, a business is prepared, or even eager, to change its transfer

344 J. Philip Van Hilten, "Transfer Pricing Policy in the International Tax System--Past and Present and a Quick Look in the Fiscal Crystal Ball" 10 Geo. Mason L. Rev. 709 (2002) at 723.

pricing policies. There, however, the question arises whether it can be inferred from the introduction of new transfer prices that the previous policies and prices were incorrect. Such an implied acknowledgement often prevents management from introducing a new method of setting inter-company prices. This aspect should also be covered--possibly through grandfathering--when tax administrations, together with businesses, reach agreement on a new transfer pricing method for the future.[345]

Comments

- Substantial effort has been made but your presentation needs to be bettered.
- Construction of sentences is to be improved.
- Copious references to foreign sources from the Net could be substituted by reading treatises of eminent authors on international taxation.
- Discuss the issues with the leading tax lawyers/C.As.

Overall performance - slightly above average.

345 id

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ANNEXURE

Brazil

Taxing Authority and Tax Law	Secreteria da Receita Federal (SRF); Ordinary Federal Law of December 27, 1996 (Law 9430/96), Articles 18 to 24 and 28
Regulations and Rulings	Normative Instruction (NI) SRF No. 243 of November 11, 2002 (NI 243/02).
Priorities/Pricing Methods	Method that yields lowest taxable income. CUP, Resale Price (20% or 60% statutory margin on imports, 15% or 30% on exports), Cost plus (20% statutory margins on imports, 15% on exports).
Transfer Pricing Penalties	Yes, for underpayment of tax and interest.
Reduction in Penalties	There are no specific reductions in penalties for documentation.
Documentation Requirements	Contemporaneous documentation required as part of annual tax return (DIPJ).

Categories of Documentation Required	In DIPJ: Form 31 A Summary of Operations with Foreign Related Parties Form 32 Export Transactions Form 33 Export Transactions–Foreign Related Persons Form 34 Import Transactions Form 35 Import Transactions–Foreign Related Parties
Deadline to Prepare Documentation	As part of annual tax return.
Deadline to Submit Documentation	As part of annual tax return.
Statute of Limitations on Transfer Pricing Assessments	5 years
Return Disclosure-Related Party Disclosure	Parties and transactions involved. Information regarding the products, transfer prices, and related parties is required in specific schedules that make part of the annual Income Tax Return.
Audit Risk/Transfer Pricing Scrutiny	Moderate. High for industries considered strategic (e.g. pharmaceuticals, agro-chemicals).
APA	Unilateral APA available. Bilateral APA unavailable. Unilateral APA procedures available under Federal Revenue Service's 1997NI 243/02.

China (PRC)

Taxing Authority and Tax Law	State Administration of Taxation; PRC Income Tax Law for Foreign-Invested Enterprises and Foreign Enterprises, Article 13; and its Detailed Rules for Implementation, Articles 52-58.
Regulations and Rulings	Taxation Administration Rules for Business Transactions Between Associated Enterprises (Guo Shui Fa No. 59 (1998)).
Priorities/Pricing Methods	Reasonable method. CUP, Resale Price, Cost Plus; other methods also considered.
Transfer Pricing Penalties	No specific transfer pricing penalties except for penalty for late filing of related party transactions declaration form: 2,000 to 10,000 Chinese yuan. For any tax payable resulting from a transfer pricing investigation, the taxpayer must settle the payment within the time limit prescribed by the tax authorities. If the taxpayer fails to pay the tax within the time limit, a surcharge of 0.05% per day and, for serious violation, up to 5 times that amount, may be imposed on any delinquent tax payment.
Reduction in Penalties	N/A
Documentation Requirements	No statutory requirement; contemporaneous documentation preferred.
Categories of Documentation Required	N/A
Deadline to Prepare Documentation	N/A
Deadline to Submit Documentation	N/A
Statute of Limitations on Transfer Pricing Assessments	Three to ten years depending on the facts and circumstances of the intercompany transactions.
Return Disclosure-Related Party Disclosure	Form A or Form B: annual declaration disclosing transaction with related enterprises.
Audit Risk/Transfer Pricing Scrutiny	Medium. The Chinese authorities currently mainly focus on tangible transactions, including but not limited to contract or toll manufacturing and trading. In the future, the tax authorities will pay more attention to other intercompany transactions, such as transfer of intangible assets, management service charges and intercompany financing.
APA	Draft APA rules are released for public comment in June 2003. Final APA rules could be available within 2003.

India

Taxing Authority and Tax Law	Section 40A(2), Sections 92-92F, Section 93, Section 271, 271AA, 271BA, and 271G of the Income Tax Act
Regulations and Rulings	Rule 10 to 10E of the Income Tax Rules.
Priorities/Pricing Methods	Prescribed Methods: CUP, Resale Price, Cost Plus, Profit Split, TNMM. No hierarchy of methods. Most appropriate method to be applied.
Transfer Pricing Penalties	2% of value of international transaction for inadequate documentation; 2% of transaction value for not furnishing information/documents required by tax officer; 100 to 300% of incremental tax on transfer pricing adjustment made by tax officer if no due diligence effort by the taxpayer to determine arm's length price; US $2000 for not furnishing Accountant's Certificate along with return.
Reduction in Penalties	Penalty can be avoided if due diligent effort is made to determine the arm's length price and the same is demonstrated through proper documentation as prescribed and provided to the tax authorities during assessment proceedings.
Documentation Requirements	Detailed list of "mandatory" documents prescribed in Rule10D. Some of the documents are: Description of the group (ownership structure and description of business and industry etc.); description of the international transactions; transfer pricing study, including functional analysis, assessment of comparables, and selection and application of methods; business plans, sales plans, forecasts, budgets, etc. List of "optional" documents is also provided in Rule 10D(3). Taxpayer is required to obtain and furnish a certificate of an Accountant's Certificate regarding adequacy of documentation maintained.
Categories of Documentation Required	■ Ownership structure; ■ Profile of the multinational group; ■ Business description; ■ The nature and terms (including prices) of international transactions; ■ Description of functions performed, risks assumed and assets employed;

Categories of Documentation Required (continued)	■ Record of any financial estimates; ■ Record of uncontrolled transaction with third parties and comparability evaluation; ■ Description of methods considered; ■ Reasons for rejection of alternative methods; ■ Details of transfer pricing adjustments; and ■ Any other information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.
Deadline to Prepare Documentation	The information and documentation should, as far as possible, be contemporaneous and should exist by the specified date of filing the income tax return, i.e., October 31 following the end of the fiscal year.
Deadline to Submit Documentation	An Accountant's Report is submitted along with the tax return. The taxpayer is not required to furnish the transfer pricing documentation with the Accountant's Report at the time of filing the tax return. TP documentation to be submitted to the assessing officer within 30 days of the notice, during assessment proceedings.
Statute of Limitations on Transfer Pricing Assessments	All tax assessments are to be completed within 3 years from the end of the financial year (April 1 to March 31). If the tax officer is of the opinion that income has escaped assessment, an assessment may be reopened within 7 years from the end of the fiscal year.
Return Disclosure-Related Party Disclosure	Under Section 92E, an Accountant's Report is required to be provided along with the tax return. The accountant certifies whether proper documentation is maintained by the taxpayer. As per Accounting Standard—18, the company is required to disclose related party transactions in its Financial Statements.
Audit Risk/Transfer Pricing Scrutiny	Two years of transfer pricing compliance has been completed. Companies with related party transactions in excess of US $1,000,000 for the financial year ended March 31, 2002, are likely to be scrutinized.
APA	Not available yet, but may become available as India increases its third-party comparables data bank and gains more experience in cross-border transfer pricing issues.

United Kingdom

Taxing Authority and Tax Law	Schedule 28AA, Income and Corporation Taxes Act of 1988; Section 12B Taxes Management Act of 1970; Section 108-111 and Schedule 16 Finance Act of 1988 (full text of the basic rule now appears in Schedule 28 AA ICTA 1988). Proposals in Consultative Document (August 2003) along with draft legislation published December 2003 to introduce provisions (UK/UK provisions) to regulate transactions within the UK (*i.e.*, between entities in the UK under common control). Transfer pricing laws will not be restricted to cross border transactions only. This is so to ensure that UK rules are not discriminatory within the EU and is a defense against recent European Court of Justice decisions. New legislation likely to be included in Finance Act 2004. Proposals include exemptions, which will exempt many transactions of small and medium sized enterprises, including cross border as well as domestic transactions.
Regulations and Rulings	No specific regulations exist but there are "Guidance Notes" in Inland Revenue Tax Bulletins 37 (new transfer pricing legislation including documentation requirements) and 38 (penalties and the new transfer pricing legislation). Other Bulletins include :Mutual Agreement Procedures (MAPs); Arbitration Convention; and Handling of Audits. Further Guidance on Documentation also promised. This is likely to also address UK/UK position.
Priorities/Pricing Methods	The OECD Transfer Pricing Guidelines are effectively imported into UK tax legislation. As such, the most appropriate method of pricing is effectively required by the UK legislation. Transaction methods are preferred over transactional profit methods, although there is a recent move by the Inland Revenue towards testing results against systems profits.
Transfer Pricing Penalties	Two possible penalty regimes are currently applicable, although report published Dec 2003 proposes that penalties will not be exigible in the two years beginning Janurary 1, 2004 due to failure to prepare and maintain adequate transfer pricing documentation. The regimes as they currently stand are that tax-geared penalty of up to 100% applies on the filing of an incorrect return due to fraudulent or negligent conduct–under Section 95/96 of Taxes Management Act of 1970 and Paragraph 20 Schedule 18 Finance Act of 1988. Failure to have a policy documented as "arm's length" may be seen as negligent. Under the Dec 2003 proposals, this penalty will not
Transfer Pricing Penalties (continued)	apply if only evidence of neglect is failure to maintain adequate documentation. A flat penalty of £3,000 applies for failure to keep proper records–under Paragraph 23 Schedule 18 Finance Act of 1988 for failure to keep proper records Proposals published in Dec 2003 provide for abolition of penalties for failure to prepare and maintain documentation for the two-year period beginning January 1, 2004.
Reduction in Penalties	Even with the proposed abolition of penalties through failure to prepare and maintain documentation, "neglect" penalties of up to 100% of the tax lost will still be available to the IR. The best protection against neglect penalties is a transfer pricing policy fully documented evidencing due consideration to the "arm's length" principle. Mitigation of tax-geared penalties will generally be made in relation to: a) Size and gravity; b) Disclosure; and c) Co-operation.
Documentation Requirements	The Inland Revenue have long struggled with guidance in this area. Tax Bulletin 37 originally set out the Inland Revenue's expectations. However this guidance is probably now superseded by the guidance published with the pre-Budget report December 2003. In this it is acknowledged that the extent and depth of documentation should be informed by a risk analysis (ie the extent of tax at stake). Documentation is important to audit defense and refutation of neglect arguments. Further guidance awaited.
Categories of Documentation Required	While Tax Bulletin 37, which published Guidance on the Inland Revenue's view of appropriate documentation is still current, it is likely to be superseded by the draft guidance published with the pre-Budget report 2003. This divides documentation into Primary Accounting Records, Tax Adjustment Records and Evidence. Documentation relating to Evidence of compliance with the arm's length principle is to follow OECD Guidance and the Revenue set out some suggestions on what this may include.

United Kingdom continued

Deadline to Prepare Documentation	Under the proposals now published the first two categories of documentation should be in existence when the accounts are prepared and the return submitted. In relation to "evidence" of arm's length pricing, this need not exist in a form that could be made available to the Inland Revenue until a request for such has been made. The previous guidance published by the Inland Revenue confirmed that all documentation should be in existence at the time the return is submitted. The changes in this regard are therefore fairly fundamental.
Deadline to Submit Documentation	Transfer pricing documentation should be retained and submitted at the request of the Tax Inspector, who has the power to request information within 60 days notice (though will usually give longer). Transfer pricing documentation should be preserved until the later of: Six years from the end of the accounting period; or the date on which inquiries to which documents are relevant are complete.
Statute of Limitations on Transfer Pricing Assessments	Discovery assessments: Six years after the company's accounting period ends but extended to twenty-one years where the misstatement is due to fraudulent or negligent conduct by the taxpayer. Determinations: Five years from the date of filing (i.e., six years from the company's accounting period end).
Return Disclosure-Related Party Disclosure	No return disclosures except that required in statutory accounts and that annual reports are to be filed in in compliance with any current APAs. Absence of disclosure requirements will typically leave years open to "discovery" assessments (see statute of limitations).
Audit Risk/Transfer Pricing Scrutiny	Inland Revenue now conducts a risk assessment before enquiry (Details contained in Tax Bulletin 60) and confirmed at the time of the pre-Budget report. Inland Revenue has also highlighted areas of concern that are likely to lead to enquires (i.e., changed business structures and characterizations, etc.). Additionally there is pressure on the department to maximize taxes and transfer pricing is known to be
Audit Risk/Transfer Pricing Scrutiny (continued)	top of the hit list. Noted recent increase in aggressiveness of audits by Inland Revenue. Uncertainty of application of UK rules to Intra-EU transactions awaiting clarification by Inland Revenue or testing through litigation. Consultative Document (August 2003) has merely added to doubt about the validity of current rules. Inclusion of UK/UK is likely fix from 2004.
APA	Section 85-87 of the Finance Act of 1999 introduced new enabling legislation on APAs. A Statement of Practice published in September 1999 supplements this legislation. Bilateral APAs are preferred, but unilateral also possible.

United States

Taxing Authority and Tax Law	Internal Revenue Service; Internal Revenue Code §482, §6038A, §6038C, §6662 (e)-(h).
Regulations and Rulings	§1.482, §1.6662, §1.6038A; §1.6038C; Rev. Proc. 96-53; and Rev. Proc. 99-32. Final regulations (T.D. 9088) on compensatory stock options under section 482 released on August 25, 2003, maintaining that stock-based compensation must be taken into account in determining operating expenses for qualified cost sharing arrangements ("QCSAs") under Treas. Reg. Section 1.482-7. Proposed regulations (REG-146893-02 and REG-115037-00) on controlled services transactions and allocation of income from intangibles, released on Sept. 5, 2003. Global dealing regulations are also expected in 2003.
Priorities/Pricing Methods	Best method. CUP, Resale Price, Cost Plus, CPM, Profit Split, or other unspecified method.
Transfer Pricing Penalties	20% and 40% penalty for underpayment of tax.
Reduction in Penalties	Penalty for disregarding rules or regulations and for a substantial understatement of income tax may be avoided by adequately disclosing certain information. Penalties for negligence and for substantial valuation misstatement may not be avoided by disclosure. No penalties, however, if there was reasonable cause and the taxpayer acted in good faith with respect to such transaction.
Documentation Requirements	Extensive contemporaneous documentation required.

Categories of Documentation Required	Business Overview; Organization Structure; Method Selected; Alternative Method Rejected; Analysis of Controlled Transactions; Identification of Comparables; Economic Analysis; Relevant Data Obtained After Year-End; Index; and other documentation may be requested.
Deadline to Prepare Documentation	By the filing date of the income tax return.
Deadline to Submit Documentation	Within 30 days upon examiner's request. Large and Mid-Size Business Division issued a directive on January 22, 2003 stating that it will more actively enforce the 30-day period for turning over transfer pricing contemporaneous documentation and violations will result in §6662(e) penalties.
Statute of Limitations on Transfer Pricing Assessments	General statute of limitations applies, which is 3 years from the later of: (1) the tax return due date, or (2) the date the return was actually filed. For substantial understatements of income, statute is extended to 6 years. For fraud, there is no statute of limitations.
Return Disclosure-Related Party Disclosure	Forms 5471 and 5472.

United States continued

Audit Risk/Transfer Pricing Scrutiny	High. Transfer pricing is extensively regulated and the recent directive on enforcing contemporaneous documentation violations indicates scrutiny will increase.
APA	APA Program responding to Congressional inquiry on various aspects of the program due January 26th.