

TRANSFER PRICING: AN OVERVIEW

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With the looming financial depression across the globe, the sacred arena of tax administrators seems to have been invaded. Throngs of Economists, Politicians, NGOs and financial analyst have suddenly come to debate the one of the most sacred idiom of the Corporate Taxation world. "Transfer Pricing" has become the core contention and inseparable strategy of tax planning by the Corporate Giants. Till the 1990s Transfer Pricing was characterized by vague references in local tax law to the need for arm's length pricing. It was typically the indirect tax authorities who paid close attention to cross-border transactions for goods while withholding taxes were often used to "police" overseas royalty and service fees^{129*}. However with the integration of the global businesses, the size and volume of inter-company cross-border transactions have escalated geometrically. No government wants its tax base to suffer. Increased globalization and rise of multinationals have added to the woes of the policy makers. In 2007 GlaxoSmithKline, hit the international headlines when it agreed to pay the US government \$3.4 billion to settle a long-running dispute over its tax dealings between the UK parent company and its American subsidiary. The investigations carried out by the Internal Revenue Service revealed startling details. The American subsidiary of GlaxoSmithKline overpaid its UK parent company for drug supplies during 1989-2005 periods, mainly its blockbuster drug, Zantac. These overpayments were meant to reduce the company's profit in the US and thereby its tax bill. The IRS charged Europe's largest drugs company for engaging in manipulative "transfer pricing."¹³⁰ This was the largest settlement of tax dispute in United States.

With the tremendous growth of multinational corporations, transactions between related parties are not uncommon. With different Tax rates across the globe, there is a strong tendency to shift income to a country that has lower tax rate. Therefore the first consideration for the Revenue Authorities worldwide is the understanding of the concept of Transfer Pricing. United Kingdom and United States had developed the law decades ago but the awakening dawned in India only with the amendment of Finance

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129 Chris D Rolfe, 'Fact Development And The Policies Of Transfer Pricing Documentation', 2002 George Mason Law Review.

130 Kavaljit Singh, "Growing Abuse of Transfer Pricing by TNC". Available at <<http://www.countercurrents.org/kavaljitsingh280507.htm>>. (Last visited on 29.04.09)

Act 2001 that inserted a Chapter 10 w.e.f. April 2001. Transfer pricing is essentially the pricing of goods and services or intangibles when the same is transacted between related parties for use or sale. In large organizations, a central management cannot monitor and control all the parameters of every subunit. For this reason, large organizations are usually separated into divisions. Each division is an autonomous unit and its manager has the freedom to take necessary action. In order to evaluate the performance of each division, a method is needed for measuring the contribution of each division to the total profit of the organization. A common solution to this problem is to set prices for intermediate goods which are transferred from one division to another.¹³¹ Transfer prices are mainly used to¹³²

1. Evaluate division manager's performance
2. Help coordinate the division's decisions to achieve the organizations goals and ensure goal congruence
3. Enable divisions to take decisions like pricing of final product.
4. Preserve division's autonomy
5. Prevent illegal tax evasion by determination of appropriate prices.

In India the provisions laid down in section 92 to 92F provide the statutory framework to ensure that the profits chargeable to tax in India are not siphoned elsewhere. Prior to this Section 92 provided a very little scope that made provision for making adjustment to the income of a resident taxpayer from a transaction with a non-resident. The CBDT¹³³ Circular 14 of 2001 categorically clarified the intention of the legislature behind the provisions relating to Finance Act 2001. It stated that: "The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the Country's tax base."

The Indian Transfer pricing provisions are broadly based on the guidelines issued by the OECD.¹³⁴ Many factors other than transfer pricing influence the profitability of multinationals, but transfer pricing is significant for both tax administrations and taxpayers because it affects the allocation of profits from intra-group transactions

131 Gavius, Arie, 'Transfer Pricing', Available at <<http://www.bgu.ac.il/~ariegh/tpintro.htm>>. (Last visted on 25.04.09)

132 *Ibid*

133 Central Board of Direct Taxes.

134 It may be noted that India is not a member of OECD.

between the different tax jurisdictions in which a multinational operates. The OECD transfer pricing guidelines were first issued in 1979 and have become internationally respected. They maintain the arm's length principle of treating related enterprises within a multinational group and affirm traditional transaction methods as the preferred way of implementing the principle. An extensive update was published in 1995 and revisions and additional material are published periodically.¹³⁵ As we know that the commercial transactions between related entities of multinational corporations ("MNC") increasingly dominate the sphere of world trade, a huge amount of transaction takes place between related entities. The pricing of these transactions between related parties, which is known as 'transfer pricing' may differ from those that take place between unrelated parties.¹³⁶ The income arising from international transaction¹³⁷ is computed as according to Arms Length price. Arms Length price as defined under section 92F(ii)¹³⁸ means *price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions*. Certain preconditions required for the application of arms length price are as follows.

That there has to be an 'international transaction' between 'two or more Associate Enterprises'¹³⁹.

An 'International Transaction' is defined by Section 92B¹⁴⁰. For the purposes of this

135 "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators", issued by OECD For details see http://www.oecd.org/document/34/0,3343,en_2649_33753_1915490_1_1_1_1,00.html. (Last visited on 30.05.09)

136 Archana Rajaram and Nishchal Joshipura 'Transfer Pricing in India'. Available at <http://www.nishithdesai.com/Research-Papers/Trf-Pricing-India-BNA.pdf>. (Last visited on 29.05.09)

137 International transaction is subjected to Arm's length price only if it is a case where the transaction is Between two associate enterprises or those who are deemed to be associate enterprises.

138 Income Tax Act 1961

139 Section 92F(iii)enterprise means a person (including a permanent establishment of such person) who is, or has been, or is proposed to be, engaged in any activity, relating to the production, storage, supply, distribution, acquisition or control of articles or goods, or know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or the provision of services of any kind, [or in carrying out any work in pursuance of a contract,] or in investment, or providing loan or in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate, whether such activity or business is carried on, directly or through one or more of its units or divisions or subsidiaries, or whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places

140 Of the Indian Income Tax Act 1961.

section and section 92,¹⁴¹ section 92C¹⁴², section 92D¹⁴³ and section 92E¹⁴⁴, International transaction means “a transaction between two or more associated enterprises, either or

141 Substitute by the finance Act of 2002. It States that 1). Any income arising from an international transaction shall be computed having regard to the arm’s length price.

Explanation.-For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm’s length price.

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

(3) The provisions of this section shall not apply in a case where the computation of income under sub-section (1) or the determination of the allowance for any expense or interest under that sub-section, or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2), has the effect of reducing the income chargeable to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction was entered into.

142 See www.incometaxindia.gov.in Section 92C deals with methods used to determine Arms Length Price.

“In accordance with internationally accepted principles, it has been provided that any income arising from an international transaction or an outgoing like expenses or interest from the international transaction between associated enterprises shall be computed having regard to the arm’s length price, which is the price that would be charged in the transaction if it had been entered into by unrelated parties in similar conditions.”

143 See www.incometaxindia.gov.in Section 92D provides that every person who has undertaken an international taxation shall keep and maintain such information and documents as specified by rules made by the Board. The Board has also been empowered to specify by rules the period for which the information and documents are required to be retained. The documentation has been prescribed under Rule 10D. Such documentation includes background information on the commercial environment in which the transaction has been entered into, and information regarding the international transaction entered into, the analysis carried out to select the most appropriate method and to identify comparable transactions, and the actual working out of the arm’s length price of the transaction. The documentation should be available with the assessee by the specified date defined in section 92F and should be retained for a period of 8 years. During the course of any proceedings under the Act, an AO or Commissioner (Appeals) may require any person who has undertaken an international transaction to furnish any of the information and documents specified under the rule within a period of thirty days from the date of receipt of notice issued in this regard, and such period may be extended by a further period not exceeding thirty days.

144 Section 92E provides 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 and form No. 3CEB have been notified in this regard. The accountants report only requires furnishing of factual information relating to the international transaction entered into, the arm’s length price determined by the assessee and the method applied in such determination. It also requires an opinion as to whether the prescribed documentation has been maintained

both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

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

An international transaction is essentially a cross border transaction between associated enterprises in any sort of property, whether tangible or intangible, or in the provision of services, lending of money etc. At least one of the parties to the transaction must be a non-resident. The definition also covers a transaction between two non-residents where for example, one of them has a permanent establishment whose income is taxable in India. Sub-section (2), of section 92B¹⁴⁵ extends the scope of the definition of international transaction by providing that a transaction entered into with an unrelated person shall be deemed to be a transaction with an associated enterprise, if there exists a prior agreement in relation to the transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined by the associated enterprise.¹⁴⁶

An illustration of such a transaction could be where the assessee, being an enterprise resident in India, exports goods to an unrelated person abroad, and there is a separate arrangement or agreement between the unrelated person and an associated enterprise which influences the price at which the goods are exported. In such a case the transaction with the unrelated enterprise will also be subject to transfer pricing regulations.¹⁴⁷

145 of the Indian Income Tax Act 1961

146 Excerpted from 'Transfer Pricing Law In India', Available at <http://www.incometaxindia.gov.in/archive/archive.asp>. (Last visited on 25.05.09)

147 *Ibid*

The term transaction defined under section 92F¹⁴⁸ means and includes an arrangement, understanding or action in concert both in writing or otherwise, which is intended to be enforced by a legal proceeding.

Therefore for a transaction to be categorized as an international transaction it should be between Associated Enterprises if (either or both are non residents) it is:

1. For purchase, sale or lease sale or lease of tangible or intangible property,
2. Provision of services, or lending or borrowing money,
3. Any other transaction having a bearing on the profits, income, losses or assets of such enterprises,
4. Provision of Service.

Or mutual agreement or arrangement between two or more associated enterprises for allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

Section 92(B) provides that transaction shall be deemed to be transaction entered into between two associated enterprises, if

1. There exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise; or
2. The terms of the relevant transaction are determined in substance between such other person and the associated enterprise.

The second criteria for the application of arm's length price is that the transaction should be between 'associate enterprises' or between enterprises that can be 'deemed to be associate enterprises'. This principle has been well complied with in the Indian scenario. The provisions of section 92 to 92F apply only if the concerned enterprises fall in the ambit of the definition of 'Associate Enterprises.' Associate Enterprises is defined under section 92A as:

148 Section 92F of the Income Tax Act 1961 states that "Transaction as it means and includes an arrangement, understanding or action in concert,

1. Whether or not such arrangement, understanding or action is formal or in writing; or
2. Whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

For the purposes of this section and sections 92¹⁴⁹, 92B¹⁵⁰, 92C¹⁵¹, 92D¹⁵², 92E¹⁵³ and 92F¹⁵⁴, associated enterprise, in relation to another enterprise, means an enterprise

- (a) Which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (b) In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

It may be noted that clause (a) of the section indicates that two entities shall be considered to be within the ambit of the definition of associated enterprises if its participation in the other entity can be established either directly or indirectly or via an intermediary. However clause (b) substantiates the aspect of a third party participating either directly or indirectly or via an intermediary in two entities. In the former cases the participating entity and the other entity are regarded as Associate Enterprises while in the later case the entities become associate enterprises by virtue them being controlled or managed by the same, "one or more person."

Section 92A (2) provides that two or more enterprises can also be deemed to be Associate Enterprise if they satisfy the conditions mentioned therein. Enumerating 13 categories it states that

Two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,

- (a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or
- (b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or
- (c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or

149 Supra note 136

150 Supra note 136

151 Supra note 137

152 Supra note 138

153 Supra note 139

154 Supra note 143

- (d) One enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or
- (e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or
- (f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or
- (g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licenses, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or
- (h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or
- (i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise; or
- (j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or
- (k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or
- (l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or
- (m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

Once it is established that the concerned entities are within the ambit of associate enterprises or can be deemed to be associate enterprises then the Arm's length price can be determined as accordingly.

According to section 92F, Arms Length price¹⁵⁵ is applied or proposed to be applied whenever there arise a transaction between persons who do not fall in the definition of Associate Enterprise in uncontrolled conditions. Section 92C lays down that:-

The Arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe¹⁵⁶, namely:

- (a) Comparable uncontrolled price method¹⁵⁷;
- (b) Resale price method¹⁵⁸;

155 Refer supra Note 134

156 See rule 10B of the Indian Income Tax Act

157 Rule 10B(1) enumerates that Comparable Uncontrolled Price Method, is applied when,—

1. the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
2. such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market; the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction;

158 Rule 10B lays down that Resale Price Method is the method in which

1. the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified;
2. such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions;
3. the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services;
4. the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market;
5. the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise;

- (c) Cost plus method¹⁵⁹
- (d) Profit split method¹⁶⁰;

159 In Cost plus Method

1. the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;
2. the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;
3. the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;
4. the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);
5. the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;

160 In Profit Split Method

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

1. the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;
2. the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which 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, as evaluated under sub-clause (ii);
3. the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction :

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

- (e) Transactional net margin method¹⁶¹
- (f) Such other method as may be prescribed¹⁶² by the Board.

(2) the most appropriate method referred to in sub-section (1) shall be applied, for determination of arms length price, in the manner as may be prescribed¹⁶³

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the

161 Transactional net margin method, in which,—

1. the net profit margin realized 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 by the enterprise or having regard to any other relevant base;
2. the net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;
3. the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
4. the net profit margin realized by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
5. The net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

162 Discussed on Page 13 of the Paper

163 Rule 10C (1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length price in relation to the international transaction.

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

- a. the nature and class of the international transaction;
- b. the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;
- c. The availability, coverage and reliability of data necessary for application of the method;
- d. The degree of comparability existing between the international transaction and the uncontrolled Transaction and between the enterprises entering into such transactions;
- e. The extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;
- f. The nature, extent and reliability of assumptions required to be made in application of a method.

option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.¹⁶⁴

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that:

- (a) the price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2); or
- (b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or
- (c) The information or data used in computation of the arms length price is not reliable or correct; or
- (d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,

The Assessing Officer may proceed to determine the arms length price in relation to the said international transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:

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

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

Provided that no deduction under section 10A or section 10AA¹⁶⁵ or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section :

¹⁶⁴ Substituted by The Finance Act 2002. w.e.f. 1.4.2002

¹⁶⁵ Inserted by the Finance Act 2006. w.e.f. 1.6.2007

Provided further that where the total income of an associated enterprise is computed under this sub-section on determination of the arms length price paid to another associated enterprise from which tax has been deducted or was deductible¹⁶⁶ under the provisions of Chapter XVIII B, the income of the other associated enterprise shall not be recomputed by reason of such determination of arms length price in the case of the first mentioned enterprise.

Rule 10B further lays down certain guidelines for the comparability of transaction that are as follows.

10B (2). For the purposes of sub-rule (1)¹⁶⁷, the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:—

- (a) The specific characteristics of the property transferred or services provided in either transaction;
 - (b) The functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
 - (c) The contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;
 - (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.
- (3) An uncontrolled transaction shall be comparable to an international transaction if—
- (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

166 Inserted by the Finance Act 2002 w.e.f. 1.4.2002

167 Refers to the rule 10B (1) of the Indian Income Tax Act.

- (ii) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.
- (4) The data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:

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

It is submitted that the process of computation of arm's length price is essentially a factual exercise.¹⁶⁸ Each case depends on its own peculiar facts and circumstances. In certain cases where identical or almost similar uncontrolled transaction is available for comparison; determination of Arm's length Price is an easy task.¹⁶⁹ However, it is not so in most of transactions and rarely one is able to locate an identical transaction. In such cases Arm's length Price is determined by taking results of a comparable transaction in comparable circumstances and makes suitable adjustments for the differences.¹⁷⁰ The Legislature in India, in order to take true income of taxpayer, has prescribed certain universally accepted methodologies to compute arm's length price under the IT Act read with the IT Rules.¹⁷¹ Thus whatever methodology is chosen for the purpose of determination of arm's length price under Section 92C, these criteria, as specified in the Act and the Rules have to form a basis of judging the comparability.¹⁷² Therefore there should be a proper analysis of such transactions with respect to, the functions performed, the assets employed and the risk assumed by the respective parties with reference to the transaction in question. This can be termed as functional, asset, risk analysis, i.e., FAR analysis. All the three ingredients of FAR have direct bearing on the pricing of products/services. The provision also provides scope for carrying out adjustments in cases where there are some differences or variations to make two transactions commercially comparable, for the purpose of benchmarking.¹⁷³ In other words, an uncontrolled transaction selected for benchmarking should be adjusted by

168 *Ajantha Industries v. CBDT*; 102 ITR 281

169 *CIT v. PVAL Kulandagan Chettiar*; [2004] 267 ITR 654

170 *CIT v. R.M. Muthaiah*; (1993) 202 ITR 508 (Karn)

171 *Aztec Software & Technology Services v. Assistant Commissioner of Income Tax*; (2007) 107 ITD 141 (Bang) SB

172 *CIT v. VVR NM Subbiah* (1947) 15 ITR 502 (Mad)

173 *CIT v. S.R.M. Firm & Others* [1994]208 ITR 400 (Mad)

employing certain techniques like FAR analysis, to be selected on its peculiar factual matrix, for the purpose of enabling comparison of the same with a controlled international transaction so that the differences or variations are ironed out or minimized. The underlying principle being that only likes can be compared with like.¹⁷⁴ The adjustments are suggested to achieve the object of testing and trying to see if both the parties or /and the transactions are similar or nearly similar. At times even after adjustments, the transaction/s or parties sought to be compared may not be identical or there might not be a possibility of adjustment. This is a very subjective exercise and fact based.¹⁷⁵

The selection of the most appropriate method (MAM) is based on the nature of transaction, the availability of relevant data and the possibility of making appropriate adjustments.¹⁷⁶

Comparability Process and Its Relevance for Transfer Pricing Provisions

We have already seen that the basic purpose of Transfer Pricing is to compare the price charged amongst unrelated companies under the free market condition and those fixed between the related entities or deemed to be related entities; in a cross border transaction. Arm's length is the most accepted methods available and is regarded as the fairest and consistent technique. It was chosen and suggested by the OECD as the most accurate means of establishing inter company prices¹⁷⁷. The economics of trade in a free market is driven by market forces. When two or more unrelated entities deal with each other, the prices or considerations are directed by the market forces however, this principle is a little short in case of deal between group companies. However the noteworthy aspect is that the OECD guidelines on Transfer Pricing¹⁷⁸ also stated that,

When independent entities deal with each other, the conditions of their commercial and financial relations (the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by the market forces. When associated enterprise deal with each other, their commercial and financial relations may not be directly affected by the market forces in the same way, although

174 *AEG Aktiengesellschaft v. IAC* ; (1994) 48 ITD 359 (Bang)

175 *CIT v. Nandlal Gandalal*; (1960) 40 ITR I (SC)

176 *CIT v. Shoorji Vallabhdas & Co*; [1962] 46 ITR 144(SC)

177 OECD, Transfer pricing Guidelines for Multinational Enterprises & Tax Administration, Paris:OECD.

178 Supra note 173

associated enterprise often seek to replicate the dynamics of market forces in their dealings with each other. Tax Administration should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining the market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustment to approximate arm's length dealings arise irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax. Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non tax purpose between the associated enterprises, and may be appropriate even where is no intent to minimize or avoid tax.

Comparability is fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the premise that it is possible to compare the prices charged between connected persons to those achieved by independent persons in similar dealings. In order for such comparisons to be meaningful, the economically relevant characteristics of the situations being compared must be highly correlative. The practice note recognizes that the assessment of comparability can be affected, *inter alia*, the characteristics of the goods and services; the relative importance of the functions performed (functional comparability); the terms and conditions of relevant agreements; the relative risks assumed by the parties; economic and market conditions; and business strategies. As far as the evaluation of functional comparability is concerned, the practice note endorses the preparation of a functional analysis. Functional analysis is a method utilized to find and organize facts about an enterprise in terms of its functions, assets and risks and is therefore recognized as a tool for assisting in the selection of an appropriate transfer pricing method and arm's length price.¹⁷⁹

Comparability between two transactions or companies is usually established by analyzing five main factors.¹⁸⁰

Characteristics of property and services: - Similarity in the characteristics of the property or service transferred matters most while accounting for the purpose of comparison of price. The relevant characteristics as included by the Transfer pricing guidelines for

179 Excerpted from Integritax Newsletter, International Tax 763, February 2000. Available at <https://www.saica.co.za/integritax/index.htm#763_Transfer_pricing.htm>. (Last visited on 27.04.09)

180 Siciliano Berger, Alexandre, 'Comparability In The Pharamaceutical Industry For Transfer Pricing Purpose' August 2002, Leiden University: School of Law, Working paper. Available at <SSRN:<http://ssrn.com/abstract=40028>>

Multinational Enterprises and Tax are

1. In case of transfer of tangible of property are the physical features of property, its quality and reliability, availability of volume of supply
2. In case of service is the nature and extent of service
3. In case of intangible property is the form of property (eg licensing, sale) or type (patent, trademark etc)

Functional Analysis: - In dealings between two entities compensation generally reflects the functions that each enterprise performs. Therefore while comparing the controlled and the uncontrolled transactions undertaken by the entities, comparison of functions undertaken by the entities is important. This includes identification and analysis of the significant activities and responsibilities undertaken by the entities.¹⁸¹

Contractual Terms:- Contractual terms generally define implicitly or explicitly how the responsibilities, risks and benefits are divided between the parties. This aspect is generally examined as a part of Functional Analysis.¹⁸²

Economic Circumstances: - Arms Length price may also vary across different markets even for transactions involving same property or same service. Therefore to achieve comparability, it requires that the markets where the independent or associated entities operate are also comparable and their difference does not have any affect on the price of the transaction.¹⁸³

Business strategies: - Business strategies may also be examined to for the purpose of comparability for determination of Transfer pricing. Business strategies take into account may aspects of an enterprise like innovation and new product, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labor laws; etc. it will be relevant to consider whether the said business strategy has been adopted by the MNE group or a member of the group acting separately. It is also seen as a scheme for market penetration.¹⁸⁴

181 "Transfer Pricing Guidelines For Multinational Enterprises And Tax Administrations" issued by Organisation for Economic Co-Operation and Development.

182 *Ibid*

183 *Ibid*

184 *Ibid*

Conclusion: - The global economy has integrated into an extended tiara of commercial relationship between nations. The lessening of rules and freedom of MNEs is transgressing into the hearts of countries. This might give a tough time to nations for protection of revenue base. The 20th century witnessed the expansion of MNEs across globe and with it developed the long chain of intra group transaction. Plethora of business strategies like M&As, Takeovers and strategic alliance have proved to be the final nail in the coffin. Governments are desperately trying to strike a balance between the regimes of liberalization and regulation. However, the biggest aspect of speculation of this century shall be perhaps the numerous ways that will be effectuated to counter the erosion of tax bases.