Chapter 2.

Literature Review
As discussed earlier, transfer pricing is not an old subject. Post World War II the multinational companies started expanding in Europe and other war affected countries and to controlling them was a big challenge for the managements. The resources of the enterprises were to be optimally utilized and that the profits pooled in the country of origin. Also the government regulation in the then war affected countries regarding movement of funds was very stringent. Hence transfer pricing was a very effective tool.

Origin of transfer pricing legislation is found in United Kingdom in the year 1915 followed by United States of America in 1917 (Wahi). Even India introduced transfer pricing legislation in 1922 under section 42(2) of the Income Tax Act which was further revamped in 2001 (Iyengar). Though the earlier legislations were not comprehensively dealing with the subject of transfer pricing, they did recognize it as an area of attention.

It is very obvious that there has been a lot of literature written in the area of transfer pricing. The literature survey is made with an objective to understand the work done till date in the field of international transfer pricing. It is also done with an objective to understand the various aspects in this field that have been studied and researched.

Literature survey was done on various aspects of transfer pricing, specifically for literature regarding, various uses of transfer pricing for MNC’s, including how it is used as a tax management tool, the legislature of transfer pricing and the areas of disputes between the tax payer and tax authorities, arising due to transfer pricing. The literature survey is divided into two parts for convenience of understanding:

A. ‘Various Definitions Used’
B. ‘Literature Survey’

The Part A contains various definitions used through the report and the Part B contains the gist of literature surveyed on the basis of the above aspects.
2.1 PART A: List of various definitions used

1. Arm’s Length Price:

As per Income Tax Act 1961:

“Arm’s length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.”

Researcher’s meaning:
The transfer price as determined using the Arm’s Length Principle, using various methods prescribed, is called the Arm’s Length Price.

2. Arm’s Length Principle:

As per OECD:
The arm’s length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. It says that;

“[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.”

3. Asset

Law Lexicon:
The property in hands of an heir, an executor, administrator, or trustee which is legally or equitably chargeable with the obligations which such heir, an executor, administrator, or trustee is, as such, required to discharge. Everything that can be made available for the payment of debts, whether belonging to the estate of a deceased person or not; property in general; all that
one owns considered as applicable to the payment of his debts; as his assets are much greater than his liabilities.
The word “asset” means, a man’s property, of whatever kind, which may be used to satisfy debts or demands existing against him.

*Income Tax Act 1961:*

Section 102 (2) defines “asset” includes property, or right, of any kind.

*English Dictionary:*

A thing of value, especially property, that a person or company owns, which can be used or sold to pay debts.

*Researcher’s meaning:*

Researcher has adopted the definition as given under Indian Income Tax Act 1961.

4. **Associated Enterprise:**

*As per OECD:*

It is an enterprise that satisfies the conditions set forth in Article 9, subparagraphs 1a) and 1b) of the OECD Model Tax Convention. Under these conditions, two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises (i.e. if both enterprises are under common control).

*As per Income Tax Act 1961:*

Section 92A.(1) For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "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.

(2) [For the purposes of sub-section (1), 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

(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.
5. Cannons of Taxation:
A set of criteria developed by Adam Smith that could be used to judge whether or not a tax was a 'good' tax. They were:

1. The cost of collection must be low relative to the yield
2. The timing and amount to be paid must be certain to the payer
3. The means and timing of payment must be convenient to the payer
4. Taxes should be levied according to ability to pay

6. Formula Apportionment:
A formulary apportionment method would allocate the profits of a business group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula.

7. Information Asymmetry:
Information asymmetry causes misinforming and is essential in every communication process.

8. Indian Legislation:

Researcher’s meaning:
Various enactments made by the legislator or legislative body in India.

It includes any Laws as prevailing in India along with the rules, guidelines and circulars as given under any of the law as prevailing in the country.

9. Origin-based tax:
(Bovenberg, 1994) Says that in origin based taxation the country of production collects the tax.

10. Profit Centre:
A profit center is a part of a corporation that directly adds to its profit.

11. Property:
As per Income Tax Act 1961 (Rule 10A):
“Includes goods, articles or things, and intangible property”.

12. Residence based tax system:
In a residence-based tax system, a country will include in its tax base all or part of the income, including income from sources outside that country, of any person (including juridical persons such as corporations) who is considered resident in that jurisdiction.

13. Safe harbour:

As per OECD guidelines:
“Formally, in the context of taxation, a safe harbour is a statutory provision that applies to a given category of taxpayers and that relieves eligible taxpayers from certain obligations otherwise imposed by the tax code by substituting exceptional, usually simpler obligations.”

As per Income Tax Act 1961:
“Means circumstances in which the income-tax authorities shall accept the transfer price declared by the assessee.”

14. Services:

As per Income Tax Act 1961 (Rule 10A):
“Include financial services”.

15. Source based tax system:
In a source-based tax system, a country will include in its tax base income arising within its tax jurisdiction, irrespective of the residence of the taxpayer.

16. Tax Avoidance:

*English Dictionary:*
Ways of paying only small amount of tax that you legally have to.

17. Tax Evasion:

*English Dictionary:*  
The crime of deliberately not paying all the taxes that you should pay.

18. Tax System:  
A legal system for assessing and collecting taxes.

19. Transaction:

*As per income Tax Act 1961 (Rule 10A):*  
“Includes a number of closely linked transactions”

20. Uncontrolled transaction:

*As per income Tax Act 1961 (Rule 10A):*  
“Means a transaction between enterprises other than associated enterprises, whether resident or non-resident”

2.2 PART B: Literature Survey

1961  
(Commissioner Of Income Tax vs. A.M.M. Mohammad Ibrahim Sahib, 1961), reported in 45 ITR 166, High Court of Madras held that the essential element is the intention to avoid tax liability. Avoidance of tax is inevitable in all cases of transfer of assets to non-resident and what is to be decided is whether the factual avoidance of tax was the result of design on the part of the assesseee and not merely an incident or effect of transaction entered into for other reasons. The case was relating to transfer of assets overseas to avoid tax, under section 44D(3)(a) of Income Tax Act 1922.

1965
(M.C.T.M. Chidambaram Chettiar & Ors. vs. Commissioner Of Income Tax, 1965), reported in 60 ITR 28, the Supreme Court of India held that the finding of the tribunal that the transfer was in fact for the avoidance of tax liability and that the assessee was not saved by section 44(3) of Income Tax Act 1922. It also held that the intention behind the transfer is important. It held that the transfer may not be necessarily by the tax payer but by virtue of the transfer the tax payer should have benefited.

1971

(Gurdial Singh Uppal vs. Commissioner Of Income Tax, 1971), reported in 85 ITR 238, the High Court of Punjab and Haryana, held that the transfer of shares by the managing director of the company days before the declaration of dividend was in fact to avoid tax and hence section 94(2)/94(3)(b) did apply. The transaction was held to be avoidance of tax.

1995

The Arm’s Length Pricing (ALP) of the intangible asset is the fair valuation of the intangible asset for transaction between associated enterprises. The OECD guidelines have classified intangible assets into two types, namely commercial intangibles and non-commercial intangibles. The noncommercial intangibles are not considered for the purpose of transfer pricing. The commercial intangibles are further classified as marketing intangibles and trade intangibles (OECD, 1995).

(Connolly, 1995), in his comment on new transfer pricing rules in US which are based on stringent norms against safe harbours (refer to part A of this chapter for meaning of safe harbour). However he suggests that the safe harbours should be positively looked as positive safe harbours where in the MNC’s get to use safe harbours for their benefits and the governments get their due revenue. He finds that the best method rule adopted is the interest of compliance and suggests further that the methodology for transfer pricing should be established more than the rules and regulations.

1996
(Mody & Patro, 1996), describe the importance of debt guarantee, and loan guarantee by the government to support the infrastructure projects or the corporations in financial distress. They state that the value of the guarantee increases with the risk of underlying asset or credit. This is mostly not accounted for. They also find that the rate of interest which is directly linked to the risk associated to the asset is dependent on the type of guarantee. They also give various methods of valuation of guarantee, which can be used for calculating contingent liability.

These valuation methods given can be used for valuation of corporate guarantee issued to the AE, to compute the benefit received by the AE due to the corporate guarantee, thus helping in setting the Alp for the corporate guarantee.

1998

(Kimberly, 1998), finds that there is a clear relationship between taxes and intra-firm trade flows. He finds that the trade between US affiliates in different foreign countries is influenced by tax considerations. The intrafirm trade balances have with low tax countries are less favorable and that the US exports to related parties in low tax countries are underpriced and that US imports from related parties from low tax countries are overpriced for minimizing total taxes globally. He also finds evidence showing clear relationship between taxes faced by affiliates abroad and their intra-firm trade transactions. Thus there is a tax minimizing behavior by the firms which may lead to intrafirm exports originating in country in higher marginal cost. When the magnitude of the tax differential and the trade balance between associates is considered it is found that 10% difference in the tax rate between the countries of the affiliates leads to lower relative intrafirm trade balance by 4.4%.

(Alles & Datar, 1998), focus on the use of cost for strategic purpose. In Oligopolistic firms generally the pricing decisions are based on the costs that are communicated to the marketing or selling departments. Thus the sales price determination gets the basis of communicated cost than actual cost. They find imperial evidence in the belief that there is a strategic component in cost system choice and transfer pricing and the fact that the firms may cross subsidize their products.
OECD Members have accepted this principle as international standard for determining transfer prices for tax purpose. The transfer prices are to be determined for tax purpose in case on international transactions in case the transactions are between two non-independent enterprises.

OECD Guidelines give the definition of associate enterprise as: 

"Two enterprises are associated enterprises with respect to each other if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise".

The Arm’s length Principle states that

"[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."

Simplifying the same it can be said that when the commercial or financial relations between two associated enterprises differ from that of an independent enterprise, the profits from such transactions should be equivalent to the profits, which would have accrued if the transaction would have been with an independent enterprise.

To implement this principle it is suggested to adopt comparability with uncontrolled transactions. It is accepted in the guidelines that the AE may involve into transactions which may not be in case of independent enterprises. In such comparability will be difficult, however it is suggested to use relevant adjustments to arrive at a reasonable comparable for the related transaction.

The guidelines have explained in detail five methods for determining the ALP for transfer pricing. It also gives the details as to what kind of adjustments are to be made
in case there is lack of availability of comparable. The guidelines however only indicate how the adjustments and its quantum are to be determined. The fact that transactions can be unique, standardizing the same will be very difficult and hence it is left to be determined on case to case basis, bringing subjectivity in the guidelines.

The procedures for implementation of the different methods given under the guidelines are as follows: (relevant extracts are reproduced)

Quote “Comparable uncontrolled price method

2.6 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. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

2.7 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the CUP method if one of two conditions is met:

1. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or

2. reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP Method is preferable over all other methods.

2.8 It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price. For example, a minor
difference in the property transferred in the controlled and uncontrolled transactions could materially affect the price even though the nature of the business activities undertaken may be sufficiently similar to generate the same overall profit margin. When this is the case, some adjustments will be appropriate. As discussed below in paragraph 2.9, the extent and reliability of such adjustments will affect the relative reliability of the analysis under the CUP method.

2.9 In considering whether controlled and uncontrolled transactions are comparable, regard should be had to the effect on price of broader business functions other than just product comparability (i.e. factors relevant to determining comparability under Chapter I). Where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP Method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP Method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.

Resale price method

2.14 The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment
for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.

2.15 The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions. Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide. Where the reseller is carrying on a general brokerage business, the resale price margin may be related to a brokerage fee, which is usually calculated as a percentage of the sales price of the product sold. The determination of the resale price margin in such a case should take into account whether the broker is acting as an agent or a principal.

2.16 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the resale price method if one of two conditions is met: 1. 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 2. 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.

2.17 In a market economy, the compensation for performing similar functions would tend to be equalized across different activities. In contrast, prices for different products would tend to equalize only to the extent that those products were substitutes for one another. Because gross profit margins represent gross compensation, after the cost of sales for
specific functions performed (taking into account assets used and risks assumed), product differences are less significant. For example, the facts may indicate that a distribution company performs the same functions (taking into account assets used and risks assumed) selling toasters as it would selling blenders, and hence in a market economy there should be a similar level of compensation for the two activities. However, consumers would not consider toasters and blenders to be particularly close substitutes, and hence there would be no reason to expect their prices to be the same.

2.18 Although broader product differences can be allowed in the resale price method, the property transferred in the controlled transaction must still be compared to that being transferred in the uncontrolled transaction. Broader differences are more likely to be reflected in differences in functions performed between the parties to the controlled and uncontrolled transactions. While less product comparability may be required in using the resale price method, it remains the case that closer comparability of products will produce a better result. For example, where there is a high-value or relatively unique intangible involved in the transaction, product similarity may assume greater importance and particular attention should be paid to it to ensure that the comparison is valid.

2.19 It may be appropriate to give more weight to other attributes of comparability discussed in Chapter I (i.e. functions performed, economic circumstances, etc.) when the profit margin relates primarily to those other attributes and only secondarily to the particular product being transferred. This circumstance will usually exist where the profit margin is determined for an associated enterprise that has not used relatively unique assets (such as highly valuable intangibles) to add significant value to the product being transferred. Thus, where uncontrolled and controlled transactions are comparable in all characteristics other than the product itself, the resale price method might produce a more reliable measure of arm's length conditions than the CUP method, unless reasonably accurate
adjustments could be made to account for differences in the products transferred. The same point is true for the cost plus method, discussed below.

2.20 When the resale price margin used is that of an independent enterprise in a comparable transaction, the reliability of the resale price method may be affected if there are material differences in the ways the associated enterprises and independent enterprises carry out their businesses. Such differences could include those that affect the level of costs taken into account (e.g. the differences could include the effect of management efficiency on levels and ranges of inventory maintenance), which may well have an impact on the profitability of an enterprise but which may not necessarily affect the price at which it buys or sells its goods or services in the open market. These types of characteristics should be analyzed in determining whether an uncontrolled transaction is comparable for purposes of applying the resale price method.

2.21 The resale price method also depends on comparability of functions performed (taking into account assets used and risks assumed). It may become less reliable when there are differences between the controlled and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure arm's length conditions, in this case the resale price margin realized. Where there are material differences that affect the gross margins earned in the controlled and uncontrolled transactions (e.g. in the nature of the functions performed by the parties to the transactions), adjustments should be made to account for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the resale price method in any particular case.

2.22 An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm's length price where, before resale, the goods are further processed
or incorporated into a more complicated product so that their identity is lost or transformed (e.g. where components are joined together in finished or semi-finished goods). Another example where the resale price margin requires particular care is where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.

2.23 A resale price margin is more accurate where it is realized within a short time of the reseller's purchase of the goods. The more time that elapses between the original purchase and resale the more likely it is that other factors -- changes in the market, in rates of exchange, in costs, etc. -- will need to be taken into account in any comparison.

2.24 It should be expected that the amount of the resale price margin will be influenced by the level of activities performed by the reseller. This level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, and other connected services. If the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party, the resale price margin could, in light of the functions performed, be a small one. The resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product. However, the level of activity performed by the reseller, whether minimal or substantial, would need to be well supported by relevant evidence. This would include justification for marketing expenditures that might be considered unreasonably high; for example, when part or most of
the promotional expenditure was clearly incurred as a service performed in favour of the legal owner of the trademark. In such a case the cost plus method may well supplement the resale price method.

2.25 Where the reseller is clearly carrying on a substantial commercial activity in addition to the resale activity itself, then a reasonably substantial resale price margin might be expected. If the reseller in its activities employs reasonably valuable and possibly unique assets (e.g. intangible property of the reseller, such as its marketing organization), it may be inappropriate to evaluate the arm’s length conditions in the controlled transaction using an unadjusted resale price margin derived from uncontrolled transactions in which the uncontrolled reseller does not employ similar assets. If the reseller possesses valuable marketing intangibles, the resale price margin in the uncontrolled transaction may underestimate the profit to which the reseller in the controlled transaction is entitled, unless the comparable uncontrolled transaction involves the same reseller or a reseller with similarly valuable marketing intangibles.

2.26 In a case where there is a chain of distribution of goods through an intermediate company, it may be relevant for tax administrations to look not only at the resale price of goods that have been purchased from the intermediate company but also at the price that such company pays to its own supplier and the functions that the intermediate company undertakes. There could well be practical difficulties in obtaining this information and the true function of the intermediate company may be difficult to determine. If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group, because independent enterprises would not normally have allowed such a company to share in the profits of the transaction.
2.27 The resale price margin should also be expected to vary according to whether the reseller has the exclusive right to resell the goods. Arrangements of this kind are found in transactions between independent enterprises and may influence the margin. Thus, this type of exclusive right should be taken into account in any comparison. The value to be attributed to such an exclusive right will depend to some extent upon its geographical scope and the existence and relative competitiveness of possible substitute goods. The arrangement may be valuable to both the supplier and the reseller in an arm's length transaction. For instance, it may stimulate the reseller to greater efforts to sell the supplier's particular line of goods. On the other hand, such an arrangement may provide the reseller with a kind of monopoly with the result that the reseller possibly can realize a substantial turnover without great effort. Accordingly, the effect of this factor upon the appropriate resale price margin must be examined with care in each case.

2.28 Where the accounting practices differ from the controlled transaction to the uncontrolled transaction, appropriate adjustments should be made to the data used in calculating the resale price margin in order to ensure that the same types of costs are used in each case to arrive at the gross margin. For example, costs of R&D may be reflected in operating expenses or in costs of sales. The respective gross margins would not be comparable without appropriate adjustments.

Cost plus method

2.32 The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus markup is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus markup to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility
agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

2.33 The cost plus markup of the supplier in the controlled transaction should ideally be established by reference to the cost plus markup that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus markup that would have been earned in comparable transactions by an independent enterprise may serve as a guide.

2.34 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met:

1. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or
2. reasonably accurate adjustments can be made to eliminate the material effects of such differences.

In determining whether a transaction is a comparable uncontrolled transaction for the purposes of the cost plus method, the same principles apply as described in paragraphs 2.16-2.21 for the resale price method. Thus, fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP Method, and it may be appropriate to give more weight to other factors of comparability described in Chapter I, some of which may have a more significant effect on the cost plus markup than they do on price. As under the resale price method (see paragraph 2.21), where there are differences that materially affect the cost plus mark ups earned in the controlled and uncontrolled transactions (for example in the nature of the functions performed by the parties to the transactions), adjustments should be made to account for such differences. The extent and reliability of those adjustments will affect
the relative reliability of the analysis under the cost plus method in particular cases.

2.35 For example, assume that Company A sells toasters to a distributor that is an associated enterprise, that Company B sells irons to a distributor that is an independent enterprise, and that the profit margins on the manufacture of basic toasters and irons are generally the same in the small household appliance industry. (The use of the cost plus method here presumes that there are no highly similar toaster manufacturers). If the cost plus method were being applied, the profit margins being compared in the controlled and uncontrolled transactions would be the difference between the selling price by the manufacturer to the distributor and the costs of manufacturing the product. However, Company A may be much more efficient in its manufacturing processes than Company B thereby enabling it to have lower costs. As a result, even if Company A were making irons instead of toasters and charging the same price as Company B is charging for irons (i.e. no special condition were to exist), it would be appropriate for Company A’s profit margin to be higher than that of Company B. Thus, unless it is possible to adjust for the effect of this difference on the profit margin, the application of the cost plus method would not be wholly reliable in this context.

2.36 The cost plus method presents some difficulties in proper application, particularly in the determination of costs. Although it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be the determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where there is no discernible link between the level of costs incurred and a market price (e.g. where a valuable discovery has been made and the owner has incurred only small research costs in making it).
2.37 In addition, when applying the cost plus method one should pay attention to apply a comparable mark up to a comparable cost basis. For instance, if the supplier to which reference is made in applying the cost plus method in carrying out its activities employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. As with the resale price method, the cost plus method relies upon a comparison of the mark up on costs achieved by the controlled supplier of goods or services and the mark up achieved by one or more uncontrolled entities on their costs with respect to comparable transactions. Therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the markup must be analyzed to determine what adjustments should be made to the uncontrolled transactions' respective mark up.

2.38 For this purpose, it is particularly important to consider differences in the level and types of expenses -- operating expenses and non-operating expenses including financing expenditures -- associated with functions performed and risks assumed by the parties or transactions being compared. Consideration of these differences may indicate the following:

1. If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus markup may be required.

2. If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may for example amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's length arrangements may require separate adjustment.

3. If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally
be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin may be appropriate.

In any of the above circumstances it may be appropriate to supplement the cost plus and resale price methods by considering the results obtained from applying other methods (see paragraphs 1.69-1.70).

2.39 Another important aspect of comparability is accounting consistency. Where the accounting practices differ in the controlled transaction and the uncontrolled transaction, appropriate adjustments should be made to the data used to ensure that the same type of costs are used in each case to ensure consistency. The gross profit mark ups must be measured consistently between the associated enterprise and the independent enterprise. In addition, there may be differences across enterprises in the treatment of costs that affect gross profit mark ups that would need to be accounted for in order to achieve reliable comparability. In some cases it may be necessary to take into account certain operating expenses in order to achieve consistency and comparability; in these circumstances the cost plus method starts to approach a net rather than gross margin. To the extent that the analysis takes into account operating expenses, the reliability of the analysis may be adversely affected, for the reasons set forth in paragraphs 3.29-3.32. Thus, the safeguards described in paragraphs 3.34-3.40 may be relevant in assessing the reliability of such analyses.

2.40 While precise accounting standards and terms may vary, in general the costs and expenses of an enterprise are understood to be divisible into three broad categories. First, there are the direct costs of producing a product or service, such as the cost of raw materials. Second, there are indirect costs of production, which although closely related to the production process may be common to several products or services (e.g. the costs of a repair department that services equipment used to produce different products). Finally, there are the operating expenses of the
enterprise as a whole, such as supervisory, general, and administrative expenses.

2.41 The distinction between gross and net margin analyses may be understood in the following terms. In general, the cost plus method will use margins computed after direct and indirect costs of production, while a net margin method will use margins computed after operating expenses of the enterprise as well. It must be recognized that because of the variations in practice among countries, it is difficult to draw any precise lines between the three categories described above. Thus, for example, an application of the cost plus method may in a particular case include the consideration of some expenses that might be considered operating expenses, as discussed in paragraph 2.39. Nevertheless, the problems in delineating with mathematical precision the boundaries of the three categories described above do not alter the basic practical distinction between the gross and net margin approaches.

2.42 In principle historical costs should be attributed to individual units of production, although admittedly the cost plus method may over-emphasize historical costs. Some costs, for example costs of materials, labour, and transport will vary over a period and in such a case it may be appropriate to average the costs over the period. Averaging also may be appropriate across product groups or over a particular line of production. Further, averaging may be appropriate with respect to the costs of fixed assets where the production or processing of different products is carried on simultaneously and the volume of activity fluctuates. Costs such as replacement costs and marginal costs also may need to be considered where these can be measured and they result in a more accurate estimate of the appropriate profit margin.

2.43 The costs that may be considered in applying the cost plus method are limited to those of the supplier of goods or services. This limitation may raise a problem of how to allocate some costs between suppliers and purchasers. There is a possibility that some costs will be borne by the
purchaser in order to diminish the supplier's cost base on which the markup will be calculated. In practice, this may be achieved by not allocating to the supplier an appropriate share of overheads and other costs borne by the purchaser (often the parent company) for the benefit of the supplier (often a subsidiary). The allocation should be undertaken based on an analysis of functions performed (taking into account assets used and risks assumed) by the respective parties as provided in Chapter I. A related problem is how overhead costs should be apportioned, whether by reference to turnover, number or cost of employees, or some other criterion. The issue of cost allocation will also be discussed subsequently in a chapter on cost contribution arrangements.

2.44 In some cases, there may be a basis for using only variable or incremental (e.g. marginal) costs, because the transactions represent a disposal of marginal production. Such a claim could be justified if the goods could not be sold at a higher price in the relevant foreign market (see also the discussion of market penetration in Chapter I). Factors that could be taken into account in evaluating such a claim include information on whether the taxpayer has any other sales of the same or similar products in that particular foreign market, the percentage of the taxpayers' production (in both volume and value terms) that the claimed "marginal production" represents, the term of the arrangement, and details of the marketing analysis that was undertaken by the taxpayer or MNE group which led to the conclusion that the goods could not be sold at a higher price in that foreign market.

2.45 No general rule can be set out that deals with all cases. The various methods for determining costs should be consistent as between the controlled and uncontrolled transactions and consistent over time in relation to particular enterprises. For example, in determining the appropriate cost plus mark up, it may be necessary to take into account whether products can be supplied by various sources at widely differing costs. Related parties may choose to calculate their cost plus basis on a standardized basis. An unrelated party probably would not accept to pay a
higher price resulting from the inefficiency of the other party. On the other hand, if the other party is more efficient than can be expected under normal circumstances, this other party should benefit from that advantage. The associated enterprise may agree in advance which costs would be acceptable as a basis for the cost plus method.

**Profit split method**

a) **In general**

3.5 Where transactions are very interrelated it might be that they cannot be evaluated on a separate basis. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate under the principles of Chapter I) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The profit split method first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles. The contribution of each enterprise is based upon a functional analysis as described in Chapter I, and valued to the extent possible by any available reliable external market data. The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise. The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions.
Subsection c) of this Section provides guidance for applying the profit split method.

b) Strengths and weaknesses

3.6 One strength of the profit split method is that it generally does not rely directly on closely comparable transactions, and it can therefore be used in cases when no such transactions between independent enterprises can be identified. The allocation of profit is based on the division of functions between the associated enterprises themselves. External data from independent enterprises is relevant in the profit split analysis primarily to assess the value of the contributions that each associated enterprise makes to the transactions, and not to determine directly the division of profit. As a consequence, the profit split method offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances.

3.7 Another strength is that under the profit split method, it is less likely that either party to the controlled transaction will be left with an extreme and improbable profit result, since both parties to the transaction are evaluated. This aspect can be particularly important when analysing the contributions by the parties in respect of the intangible property employed in the controlled transactions. This two-sided approach may also be used to achieve a division of the profits from economies of scale or other joint efficiencies that satisfies both the taxpayer and tax administrations.

3.8 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.

3.9 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.

3.10 The foregoing considerations should be taken into account in determining whether any particular application of the profit split method is appropriate given the facts and circumstances. More importantly, because of the foregoing considerations, the application of the profit split method is subject to the conclusions and limitations on transactional profit methods set forth in Section iii).

c) Guidance for application

3.11 If the profit split method were to be used by associated enterprises to establish transfer pricing in controlled transactions, then each associated enterprise would seek to achieve the division of profits that independent enterprises would have expected to realize in a joint venture relationship. Generally, conditions established in this manner would have to be based
upon projected profits rather than actual profits, because it is not possible for the taxpayers to know what the profits of the business activity would be at the time the conditions are established.

3.12 When a tax administration examines the application of the method to evaluate whether the method has reliably approximated arm's length transfer pricing, it is critical for the tax administration to acknowledge that the taxpayer could not have known what the actual profit experience of the business activity would be at the time that the conditions of the controlled transaction were established. Without such an acknowledgement, the application of the profit split method could penalize or reward a taxpayer by focusing on circumstances that the taxpayer could not reasonably have foreseen. Such an application would be contrary to the arm's length principle, because independent enterprises in similar circumstances could only have relied upon projections and could not have known the actual profit experience.

3.13 In using the profit split method to establish the conditions of controlled transactions, the associated enterprises would seek to achieve the division of profit that independent enterprises would have realized. The evaluation of the conditions of the controlled transactions of associated enterprises using a profit split method will be easiest for a tax administration where the associated enterprises have originally determined such conditions on the same basis. The evaluation may then begin on the same basis to verify whether the division of actual profits is in accordance with the arm's length principle.

3.14 Where the associated enterprises have determined the conditions in their controlled transactions on a basis other than the profit split method (as will almost always be the case), the tax administration would evaluate such conditions on the basis of the actual profit experience of the enterprise. However, care would need to be exercised to ensure that the application of a profit split method is performed in a context that is similar to what the associated enterprises would have experienced, i.e. on
the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into, in order to avoid the use of hindsight.

3.15 There are a number of approaches for estimating the division of profits, based on either projected or actual profits, as may be appropriate, that independent enterprises would have expected, two of which are discussed in the following paragraphs. These approaches -- contribution analysis and residual analysis -- are not necessarily exhaustive or mutually exclusive.

3.16 Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated enterprises based upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances. In cases where the relative value of the contributions can be measured directly, it may not be necessary to estimate the actual market value of each participant’s contributions.

3.17 Generally, the profit to be combined and divided under the contribution analysis is operating profit. Applying the profit split in this manner ensures that both income and expenses of the MNE are attributed to the relevant associated enterprise on a consistent basis. However, occasionally, it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise (and excluding expenses taken into account in computing gross profits). In such cases, where different analyses are being applied to divide the gross income and the deductions of the MNE among associated enterprises, care must be taken to ensure that the expenses incurred in or attributable to each enterprise are consistent with the activities and risks undertaken there, and that the allocation of gross profits is likewise
consistent with the placement of activities and risks. For example, in the case of an MNE that engages in highly integrated worldwide trading operations, involving various types of property, it may be possible to determine the enterprises in which expenses are incurred (or attributed), but not to accurately determine the particular trading activities to which those expenses relate. In such a case, it may be appropriate to split the gross profits from each trading activity and then deduct from the resulting overall gross profits the expenses incurred in or attributable to each enterprise, bearing in mind the caution noted above.

3.18 It can be difficult to determine the relative value of the contribution that each of the related participants makes to the controlled transactions, and the approach will often depend on the facts and circumstances of each case. The determination might be made by comparing the nature and degree of each party’s contribution of differing types (for example, provision of services, development expenses incurred, capital invested) and assigning a percentage based upon the relative comparison and external market data.

3.19 A residual analysis divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent enterprises. Thus, the basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises. Indicators of the parties’ contributions of intangible property and relative bargaining positions could be particularly useful in this context.
3.20 The residual could derive from the application of other methods. For example, market data from traditional transaction methods could assist in the preliminary ascertainment of normal profits attributable to associated enterprises where one enterprise manufactures a unique product using proprietary processes and then transfers the product to another associated enterprise for further processing using other proprietary processes and for distribution.

3.21 One approach to a residual analysis would seek to replicate the outcome of bargaining between independent enterprises in the free market. In this context, the basic return provided to each participant would correspond to the lowest price an independent seller reasonably would accept in the circumstances and the highest price that the buyer would be reasonably willing to pay. Any discrepancy between these two figures could result in the residual profit over which independent enterprises would bargain. The residual analysis therefore could divide this pool of profit based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller's minimum price and the buyer's maximum price.

3.22 In some cases an analysis could be performed, perhaps as part of a residual profit split or as a method of splitting profits in its own right, by taking into account the discounted cash flow to the parties to the controlled transactions over the anticipated life of the business. This may be an effective method in the following circumstances: where a start-up is involved, cash flow projections were carried out as part of assessing the viability of the project, and capital investment and sales could be estimated with a reasonable degree of certainty. However, the reliability of such an approach will depend on the use of an appropriate discount rate, which should be based on market benchmarks. In this regard, it should be noted that industry-wide risk premiums used to calculate the discount do not distinguish between particular companies let alone segments of businesses, and estimates of the relative timing of receipts can
be problematic. Such an approach, therefore, would require considerable caution and should be supplemented where possible by information derived from other methods.

3.23 This Report does not seek to provide an exhaustive catalogue of ways in which the profit split method may be applied. Application of the method will depend on the circumstances of the case and the information available, but the overriding objective should be to approximate as closely as possible the split of profits that would have been realised had the parties been independent enterprises operating at arm's length.

3.24 One possible approach not discussed above is to split the combined profit so that each of the associated enterprises participating in the controlled transactions earns the same rate of return on the capital it employs in that transaction. This method assumes that each participant's capital investment in the transaction is subject to a similar level of risk, so that one might expect the participants to earn similar rates of return if they were operating in the open market. However, this assumption may not be realistic. For example, it would not account for conditions in capital markets and could ignore other relevant aspects that would be revealed by a functional analysis and that should be taken into account in a profit split.

Therefore, this method should be used with great care and, in any event, other profit split methods should be considered before electing its use.

3.25 Another possibility is to determine the profit split based on the division of profits that actually results from comparable transactions among independent enterprises. In most cases where traditional transaction methods would not be used, it will be difficult to find independent enterprises engaged in transactions that are sufficiently comparable to use this approach as the primary method. Even where such transactions exist, adequate information on the independent enterprises might not be available to taxpayers and tax administrations. However, co-
operative arrangements are not confined to associated enterprises, but also sometimes occur between independent enterprises. Independent enterprises may set up joint-venture-like arrangements because they want to carry out, for example, a specific research project. In such a situation, independent enterprises might come to an arrangement in which prices are corrected afterwards, for instance because the profitability is unpredictable and because they want to share the risks or the costs involved. Independent enterprises might choose to set up a real joint venture, and in such a case probably would agree to some form of profit split.

**Transactional net margin method**

a) In general

3.26 The transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. 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. Further, the other
requirements for comparability, and in particular those of paragraphs 3.34-3.40, must be applied.

b) Strengths and weaknesses

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

3.28 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.

3.29 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. Thus, it is important to provide some detailed guidance on establishing comparability for the transactional net margin method, as set forth in subsection c)(1) below.
3.30 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 (although use of multiple year averages as discussed in paragraphs 1.49 through 1.51 may mitigate this concern). 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.

3.31 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 from the controlled transactions for purposes of comparability. A one-sided analysis potentially can attribute to one member of an MNE group 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.
3.32 There may also be serious difficulties in determining an appropriate corresponding adjustment when applying the transactional net margin method, particularly where it is not possible to work back to a transfer price. This could be the case, for example, where the taxpayer deals with associated enterprises on both the buying and the selling sides of the controlled transaction. In such a case, if the transactional net margin method indicates that the taxpayer's profit should be adjusted upwards, there may be some uncertainty about which of the associated enterprises' profits should be reduced.

3.33 The foregoing considerations should be taken into account in determining whether any particular application of the transactional net margin method is appropriate given the facts and circumstances of a case. More importantly, because of the foregoing considerations, the application of the transactional net margin method is subject to the conclusions and limitations on transactional profit methods set forth in Section iii).

c) Guidance for application

1. The comparability standard to be applied to the transactional net margin method

3.34 Prices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but operating profits are less adversely affected by such differences. As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons. Assuming similar functions can be isolated from among the wide range of functions that enterprises may exercise, in order to apply the method, the profit margins related to such functions may still not be automatically comparable where, for instance, the enterprises concerned carry on those
functions in different economic sectors or markets with different levels of profitability. When the comparable uncontrolled transactions being used are those of an independent enterprise, a high degree of similarity is required in a number of aspects of the associated enterprise and the independent enterprise involved in the transactions in order for the controlled transactions to be comparable; there are various factors other than products and functions that can significantly influence net margins.

3.35 The use of net margins can potentially introduce a greater element of volatility into the determination of transfer prices for two reasons. First, net margins can be influenced by some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variation of operating expenses across enterprises. Second, net margins can be influenced by some of the same factors, such as competitive position, that can influence price and gross margins, but the effect of these factors may not be as readily eliminated. In the traditional transaction methods, the effect of these factors may be eliminated as a natural consequence of insisting upon greater product and function similarity.

3.36 Net margins may be directly affected by such forces operating in the industry as follows: threat of new entrants, competitive position, management efficiency and individual strategies, threat of substitute products, varying cost structures (as reflected, for example, in the age of plant and equipment), differences in the cost of capital (e.g. self financing versus borrowing), and the degree of business experience (e.g. whether the business is in a start-up phase or is mature). Each of these factors in turn can be influenced by numerous other elements. For example, the level of the threat of new entrants will be determined by such elements as product differentiation, capital requirements, and government subsidies and regulations. Some of these elements also may impact the application of the traditional transaction methods.
3.37 Assume, for example, that a taxpayer sells top quality video cassette recorders to an associated enterprise, and the only profit information available on comparable business activities is on generic medium quality VCR sales. Assume that the top quality VCR market is growing in its sales, has a high entry barrier, has a small number of competitors, and is with wide possibilities for product differentiation. All of the differences are likely to have material effect on the profitability of the examined activities and compared activities, and in such a case would require adjustment. As with other methods, the reliability of the necessary adjustments will affect the reliability of the analysis. It should be noted that even if two enterprises are in exactly the same industry, the profitability may differ depending on their market shares, competitive positions, etc.

3.38 It might be argued that the potential inaccuracies resulting from the above factors can be reflected in the size of the arm’s length range. The use of a range may to some extent mitigate the level of inaccuracy, but may not account for situations where a taxpayer's profits are reduced by a factor unique to that taxpayer. In such a case, the range may not include points representing the profits of independent enterprises that are affected in a similar manner by a unique factor. The use of a range, therefore, may not always solve the difficulties discussed above.

3.39 The transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for differences of the type referred to above. The transactional net margin method should not be used unless the net margins are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable uncontrolled transactions are those of an independent enterprise, the differences between the associated enterprises and the independent enterprises that have a material effect on the net margin being used are adequately taken into account. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin
method. Thus where differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the transactional net margin method.

3.40 Another important aspect of comparability is measurement consistency. The net margins must be measured consistently between the associated enterprise and the independent enterprise. In addition, there may be differences in the treatment across enterprises of operating expenses and non-operating expenses affecting the net margins such as depreciation and reserves or provisions that would need to be accounted for in order to achieve reliable comparability.

2. Other guidance

3.41 In applying the transactional net margin method, various considerations should influence the choice of margin used. For example, these considerations would include how well the value of assets employed in the calculations is measured (e.g. to what extent there is intangible property the value of which is not captured on the books of the enterprise), and the factors affecting whether specific costs should be passed through, marked up, or excluded entirely from the calculation.

3.42 An analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide 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. Similarly, when analysing the transactions between the independent enterprises to the extent they are needed, profits attributable to transactions that are not similar to the controlled
transactions under examination should be excluded from the comparison. Finally, when profit margins of an independent enterprise are used, the profits attributable to the transactions of the independent enterprise must not be distorted by controlled transactions of that enterprise.

3.43 The associated enterprise to which the transactional net margin method 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. However, the choice may be restricted by limited data availability regarding the transactions undertaken by enterprises located in a foreign tax jurisdiction.

3.44 Multiple year data should be considered in the transactional net margin method for both the enterprise under examination and independent enterprises to the extent their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions. For example, multiple year data could show whether the independent enterprises that engaged in comparable uncontrolled transactions had suffered from the effects of market conditions in the same way and over a similar period as the associated enterprise under examination. Such data could also show whether similar business patterns over a similar length of time affected the profits of comparable independent enterprises in the same way as the enterprise under examination.

3.45 It also is important to take into account a range of results when using the transactional net margin method. The use of the range in this context could help reduce the effects of differences in the business characteristics of associated enterprises and any independent enterprises engaged in comparable uncontrolled transactions, because the range would permit results that would occur under a variety of commercial and financial conditions.
4.11 Like examination practices, the burden of proof rules for tax cases also differ among OECD Member countries. In most jurisdictions, the tax administration bears the burden of proof both in its own internal dealings with the taxpayer (e.g. assessment and appeals) and in litigation. In some of these countries, the burden of proof can be reversed, allowing the tax administration to estimate taxable income, if the taxpayer is found not to have acted in good faith, for example, by not cooperating or complying with reasonable documentation requests or by filing false or misleading returns. In other countries, the burden of proof is on the taxpayer. In this respect, however, the conclusions of paragraphs 4.16 and 4.17 should be noted.

4.12 The implication for the behaviour of the tax administration and the taxpayer of the rules governing burden of proof should be taken into account. For example, where as a matter of domestic law the burden of proof is on the tax administration, the taxpayer may not have any legal obligation to prove the correctness of its transfer pricing unless the tax administration makes a prima facie showing that the pricing is inconsistent with the arm's length principle. Even in such a case, of course, the tax administration might still reasonably oblige the taxpayer to produce its records that would enable the tax administration to undertake its examination. In some countries, taxpayers have a duty to cooperate with the tax administration imposed on them by law. In the event that a taxpayer fails to cooperate, the tax administration may be given the authority to estimate the taxpayer's income and to assume relevant facts based on experience. In these cases, tax administrations should not seek to impose such a high level of cooperation that would make it too difficult for reasonable taxpayers to comply.

4.13 In jurisdictions where the burden of proof is on the taxpayer, tax administrations are generally not at liberty to raise assessments against
taxpayers which are not soundly based in law. A tax administration in an OECD Member country, for example, could not raise an assessment based on a taxable income calculated as a fixed percentage of turnover and simply ignore the arm's length principle. In the context of litigation in countries where the burden of proof is on the taxpayer, the burden of proof is often seen as a shifting burden. Where the taxpayer presents to a court a reasonable argument and evidence to suggest that its transfer pricing was arm's length, the burden of proof may legally or de facto shift to the tax administration to counter the taxpayer's position and to present argument and evidence as to why the taxpayer's transfer pricing was not arm's length and why the assessment is correct. On the other hand, where a taxpayer makes little effort to show that its transfer pricing was arm's length, the burden imposed on the taxpayer would not be satisfied where a tax administration raised an assessment which was soundly based in law.

4.14 When transfer pricing issues are present, the divergent rules on burden of proof among OECD Member countries will present serious problems if the strict legal rights implied by those rules are used as a guide for appropriate behaviour. For example, consider the case where the controlled transaction under examination involves one jurisdiction in which the burden of proof is on the taxpayer and a second jurisdiction in which the burden of proof is on the tax administration. If the burden of proof is guiding behaviour, the tax administration in the first jurisdiction might make an unsubstantiated assertion about the transfer pricing, which the taxpayer might accept, and the tax administration in the second jurisdiction would have the burden of disproving the pricing. It could be that neither the taxpayer in the second jurisdiction nor the tax administration in the first jurisdiction would be making efforts to establish an acceptable arm's length price. This type of behaviour would set the stage for significant conflict as well as double taxation.

4.15 Consider the same facts as in the example in the preceding paragraph. If the burden of proof is again guiding behaviour, a taxpayer in the first jurisdiction being a subsidiary of a taxpayer in the second
jurisdiction (notwithstanding the burden of proof and these Guidelines),
may be unable or unwilling to show that its transfer prices are arm's length. The tax administration in the first jurisdiction after examination makes an adjustment in good faith based on the information available to it. The parent company in the second jurisdiction is not obliged to provide to its tax administration any information to show that the transfer pricing was arm's length as the burden of proof rests with the tax administration. This will make it difficult for the two tax administrations to reach agreement in competent authority proceedings.

4.16 In practice, neither countries nor taxpayers should misuse the burden of proof in the manner described above. Because of the difficulties with transfer pricing analyses, it would be appropriate for both taxpayers and tax administrations to take special care and to use restraint in relying on the burden of proof in the course of the examination of a transfer pricing case. More particularly, as a matter of good practice, the burden of proof should not be misused by tax administrations or taxpayers as a justification for making groundless or unverifiable assertions about transfer pricing. A tax administration should be prepared to make a good faith showing that its determination of transfer pricing is consistent with the arm's length principle even where the burden of proof is on the taxpayer, and taxpayers similarly should be prepared to make a good faith showing that their transfer pricing is consistent with the arm's length principle regardless of where the burden of proof lies.

4.17 The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State "considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length". This means that in competent authority proceedings the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment "is justified both in principle and as regards the
Both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases." Unquote.

The guidelines also mention that there are bound to be disputes and hence mutual agreement is required for the procedures for administration of the ALP. Procedures for the same are detailed in the guidelines. A further solution to reducing the disputes is given in the form of option for Advancing Pricing Arrangements, where in the taxpayer and the tax authorities agree to an ALP method or an ALP itself for duration of time and the same will be reviewed for any significant change after the stipulated time. This brings in certainty towards tax liability. However to arrive at the advance Pricing Agreement, the comparability and methods for determination of ALP as mentioned earlier is to be followed.

OECD has also given a non-arm's-length approach: Global Formulary Apportionment. Under this approach the global earnings of the MNC are to be determined and a global profit decided. The global profit is to be divided amongst the subsidiary and related concerns on the basis of their contribution to the global profits. These respective profits are then to be subjected to tax as per the local rates.

In regards to the Companies Act 1956, the related party disclosures are mandatory. The details of the disclosure are given under the Accounting Standard 18, issued by the Institute of Chartered Accounts of India. The accounting standard does not prescribe to disclose the ALP of the transaction. However the quantum of related party transaction is to be disclosed. The standard has come into effect since April 1st 2001 (ICAI, 2000).

(Mehafdi, 2000), find that international transfer pricing is used as a legitimate tool to misrepresent financial success of the operations and evade taxation. This in turn effects in more draconian measures to protect the national financial interests by the government agencies. It is also found that the international transfer price has ethical issues as well to address. The unethical transfer pricing behavior consumes scares resources, causes cost but does not create value in the country.
(Nielsen, Raimondos-MYller, & Schjelderup, 2001), find that contrary to the belief of policy makers and economist the formula apportion method does not eliminate the profit shifting incentives under oligopolistic competition. The MNC’s use transfer pricing as a device to win local market share especially if quantity is the strategic variable. The strategic benefits although depend upon the relative tax rates in the countries in which the MNC operates. The drawbacks of the separate accounting system are not eliminated in the formula apportionment method.

(Eden, 2001) They have made the study to find if related party transfer prices distort the international price index of the US. It is found that the various methods for ALP do not give a clear picture and that the valuation on basis of customs laws for the purpose of index. This is because the related party transactions are high and will distort the index if transfer price is not at arm’s length price, which is very difficult to trace.

2002

The intangible assets can be classified based upon its method of acquisition. The types of intangible assets upon this classification are as follows: (ICAI, 2002)

1. Acquisition by purchase
2. Acquisition as part of amalgamation
3. Acquisition as part of Government Grant
4. Acquisition by exchange of assets
5. Internally generated goodwill
6. Internally generated intangible assets

Valuation of the intangible assets for accounting purpose and taxation purpose cannot be compared. For accounting purpose the accounting standard AS 26 in India is the one that takes care of the price and the methodology of accounting of intangibles. The accounting standard also gives details about the when to recognize the expenditure or in revenue for recording the transaction. The standard gives details on all the six types of intangible assets based on how the asset is acquired.
(Gans, Williams, & David, 2002), find that there is a very little chance of creating monopolies with acquisition of intellectual rights. In their view the monopoly enjoyed by the intellectual property owner does not mean that there will not be a similar product which is equally good can be stopped from entering the market by the intellectual property holder. If the product is a tube emitting light, there can be someone who will stand up and come out with a bulb emitting similar light. This does not mean that the patent holder will be able to stop the bulb manufacturer from selling his product since he has patent rights for the tube.

2003

(Bradford, 2003), explores possible special rules for trans-border transactions between related parties in an origin-based system (refer to part A of this chapter for details of origin based tax system) to eliminate the transfer-pricing problem. He finds a solution in cash-flow based taxation system for international transactions should replace the existing origin based system to eliminate issues of transfer pricing which are basically accounting based issues. He accepts the complexity in the proposed system but says that if achieved the system will give advantages of origin based approach without its disadvantages.

2004

(Korn & Lengsfeld, 2004), find that numerous (high-tax) countries presume that multinational firms use their transfer-pricing policies to shift profits into countries with lower tax rates. The transfer pricing strategic disorders are based on, competition, tax and punishment effect for the non-arm’s length pricing. Tax enforcement goal of the governments directly influences the competition.

It is found that the tighter transfer pricing rules may help firms to mitigate competition and to increase their profits and that noncompliance to the arm's-length principle is part of their equilibrium strategy of the MNC’s.

(Choe & Hyde, 2004), finds that increasing multinationals are using different transfer prices for internal transfer purpose and for tax purpose, for the fact that the marginal
cost rule for transfer pricing does not give work in purchase decision making for multinationals in the different tax environment. It is found that the optimum incentive transfer price is shown by the weighted average transfer price plus adjustment by a faction of marginal penalty for non-ALP for which the relevant affiliate is held responsible. As long as the tax rates are different in different jurisdictions the firm optimally trades off the benefit of tax arbitrage against the penalty of non-ALP.

(Sakurai, 2004), in working paper finds that unlike Japanese MNC’s the British and American MNC’s are proactive in their policy formulation towards transfer pricing and their global tax planning. However the differences are slowly reducing with time and pressure on margins. The non-confrontational regulatory approach of the Japanese is less transparent but the US adversarial approach has a risk of creating creative compliance which escapes the intended impact of law. Transparency and accountability is the key to success due to the subjective nature of the legislature, however cooperative and consultative regulatory approach is also key to the implementation, for which multilateral discussions and adaptation is required to rationalize the tax management styles towards transfer pricing so as to increase cooperation and reduce conflict amongst tax administrators and tax managers.

The research of Sakurai indicates that there is a requirement of creating a relationship of mutual trust between the MNC’s and the tax administrators, which is a very difficult job. An environment has to be created where in the tax managers feel that the law is to be respected not to be worked upon.

(Sandmo, 2004), in their discussion paper find that the decision of tax evasion by the tax payer depends upon their perception of behavior of others. For this purpose tax evasion should be controlled by the authorities so that it does not become a social phenomenon. Tax avoidance is a legally designed mechanism for encouragement for certain acts. However the thin line between tax evasion and tax avoidance is should be drawn and strictly followed is order to help avoid large scale evasion of tax.

2006
Cannons or Maxims of Taxation (refer to Part A of this chapter for explanation of this term) were given by Adam Smith and further addition to the four given by him, Bastable added further five. All of them have been well accepted in the theory of public finance, and has been well explained by (Mithani, 2006). They are as follows:

1. Cannon of equality:
   The cannon of equality, implies that the burden of taxation must be distributed equally or equitably in relation to the ability of the tax payers. This means that the rich people should bear more burden of tax than the poor.

2. Cannon of certainty:
   The cannon of certainty says that “the tax which the taxpayer is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the amount to be paid ought to be clear and plan to the contributor and to every other person”. This means that there has to certainty in taxation about: Incidence of tax, revenue to the government and certainty of tax liability to the tax payer for a particular period of time and the exchequer should be known unambiguously. The provisions of the legislation are currently not giving this precise certainty. The subjectivity about the method to be used and the adjustments to be made to the comparable is immense. The tax authorities not the tax payer is in a position to estimate fairly precisely as to who much tax liability to expect in a particular case.

3. Cannon of economy:
   It suggests that the cost of collecting the tax should not be exorbitant, but minimum. High cost of collection can be on account of complicated taxes, heavy taxes, etc. causing further economic damage.

4. Cannon of convenience:
   This cannon state that the tax should be collected at a time and in a manner that is convenient to the contributor. For example taxes on land be collected after harvest, which becomes easy for the tax payer to pay from the yield.

5. Cannon of elasticity:
This cannon suggests that the tax collection should be flexible so that he revenue collected varies according to the prosperity of the country. Meaning it is in line with the movement in national income of the country.

6. Cannon of productivity:
There are two parts to this cannon, firstly the tax collected should be sizable and should be productive. Secondly it should stimulate communal productive efforts, and should not obstruct or discourage production.

7. Cannon of simplicity:
The cannon of simplicity signify that the levy and structure of tax should be simple and intelligible to the common man. That means that any tax system should not be complex or complicated. Any common man should be able to understand the tax system. The legislation of direct tax regarding the international transactions between related parties is in no way uncomplicated. It has options that can be challenged by the tax exchequer as well as the tax payer on case to case basis.

8. Cannon of diversity:
Diversity cannon imply that there should be multiple tax system of diverse nature rather than single tax system.

9. Cannon of expediency:
This suggests that the tax should be determined on the ground of its economic, social and political advisability. Consensus of all three is required so as to have a stable tax system.

Out of the above cannons, the cannon of certainty and the cannon of simplicity have special reference in the context of transfer pricing legislature.

The characteristics of good tax system also given by (Mithani, 2006), say that “the taxes are to be universally applicable, that is the person with the same ability to pay are treated in the same way without discrimination”. In the current legislation there is a possibility that the similar cases can be treated by different methods prescribed in
the legislation and still be legally correct. These provisions violate the above mentioned requirements of a good tax system.

The objective of public finance is to raise funds for the government expenditure to fulfill the wants of its citizens (Mithani, 2006). The public economics aims at maximizing equality of distribution of income and social welfare. In doing this the tax system has to be so designed that there is no excess burden to any one and it facilitates equal distribution of income by taking more tax from the higher income group of the society and lesser from the lower income group. The government cannot carry out its welfare responsibilities if the citizens do not pay taxes.

Thus the government can have right over the rightful tax that the person is required to pay as per principles of the taxation and the legislation designed accordingly.

(Sikdar, 2006) explains how MNC’s are born for which one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi-national enterprise, in which the control of the owners is delegated through the board of directors and the group of enterprises work together towards achievement of their common business objective. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labor, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises.

In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that happen between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations
were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues.

2007

(Martini, Niemann, & Simons, 2007), find that, apart from co-ordination function, transfer pricing is also used for tax purposes. Legally independent MNC group members realize intra-group sales and contribute to a single product. Taxable group profits are often allocated among the participating companies by means of transfer prices. In this case, from the group’s perspective, transfer pricing is a device of international tax planning. National tax authorities are aware of this. The tax revenue in Europe of the high-tax legislations eroded due to tax differentials. One of the solutions put forth is formula apportionment.

A prominent result of the analysis was that Formula Apportionment offsets the advantages of decision decentralization as it reverses the separation of responsibility areas. No clarity was found on, whether Formula Apportionment is desirable from a fiscal or an entrepreneurial perspective. The effects of Formula Apportionment compared to transfer pricing depend strongly on the parameter setting under consideration, which is one of the most important determinants is the internal decision procedure within the multi-national group.

2008

(Urquidi, 2008), finds in his Case study based article that the corporate seek to solve the transfer pricing problem for three reasons, namely:

1. Satisfies the needs of the business with respect to strategy and internal incentives
2. Results in an efficient use of resources
3. Provides the “right” transfer pricing answer from a tax perspective

He finds that this is a daunting task for the corporate especially in the financial services sector which does not have any specific transfer pricing regulations. He
further finds that the macro economic factors play a vital role in transfer pricing and the firms will have to rely on upon the economic factors to help them navigate the problem of transfer pricing process.

The author is indicating towards continuous review on transfer pricing policies based on macro-economic factors so as to satisfy the three reasons cited creating problems of transfer pricing.

(OECD, 2008), The Forum on Tax Administration in its Seoul declaration identified transfer pricing as one of the significant concerns for tax jurisdictions. The different corporate tax rate is one of the considerations when it comes to the locational determination by the MNC’s. This gives rise to the arbitrage opportunities for the MNC’s and loss to local governments. The prices of the international transactions are no more entirely driven by the market forces. The fact is that they try to satisfy several interests which in some cases may be mutually conflicting, making the system for determining the intra-group transactions very complicated. They plan the prices so as to minimize the profits at the high tax locations. This concern has given rise to the modern transfer pricing legislations throughout the world.

The OECD guidelines for transfer pricing give the principle of Arm’s Length. The Principle is laid down in the OECD Model Tax Convention which goes as under (OECD, 2008):

"conditions are made or imposed between the two 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".

The Arm’s Length Price is the price determination done by the market forces of demand and supply. It is also governed by the need and necessity of the buyer and the seller to buy and sell respectively. This is true in case the parties to the transactions are independent and have no interest in each other than the business under consideration. That means the parties to the transactions are not associated or related parties.
In case of a multinational enterprise this independent relationship is possible in transactions which are not done with sister concerns or subsidiary. Such independent transactions can be called as uncontrolled transactions. The transactions in which the parties to the transactions are related to each other or are associated to each other the transactions are may be controlled transactions.

In case the international transactions are controlled transactions the revenue authorities stand a chance to lose their tax revenue. The transaction thus has to be subjected to the market forces for determining the fair value of the transaction. This fair value determined by the market forces can be called as the Arm’s Length Price. The OECD Model Tax Convention in Article 9 gives two conditions under which the associated enterprises are defined as the enterprises in which the persons controlling the management or the majority capital are the same in the two contracting states. It also states that the due adjustments can made by the states if there is no Arm’s Length Price followed subject to there being no double taxation (OECD, 2008).

Germany does not agree to use arm’s length profit and the United States of America observes that there may be ways of solving the thin capitalization problem in different way, like; differing on deductions by the taxing state for interest paid. Countries like Germany, Australia, Italy and Czech Republic have reserved rights to the extent of the agreements.

(Dube, 2008) Says that there must be a balance between the competition policy and the intellectual property rights. There can be a case of reduction in the competition due to intellectual property rights acquisition not only for the purpose of protecting the innovation but also for use of innovation for monopoly creation.

(Cools M., 2008), carried out an in-depth case study based study. MNC compliance with transfer pricing regulations is not generally seen as an easy task. The arm’s length principle is so fluid that national tax authorities interpret and implement it in different ways, reflecting long-established domestic tax practices. The consequential divergence in approach among tax administrations is a growing concern to MNCs. The pressure to comply with the documentation requirements is high. Support is
found in the notion of recognizing fiscal regulation as a contingent variable to examine MNC internal processes in future studies.

(Shor & Chen, 2008), they find that the firms can use TP strategically as a collusive device. Firms are individually better off in a centralized organizational format. Collusion on prices is sustainable whereas on numbers is not as well the price collusion may also escape legal scrutiny. Cost-shifting between regulated monopolists and their corporate affiliates is regarded as a major concern for regulators and researchers.

(Ackerman, 2008) Article gives detailed discussion on planning for transfer of intangible assets to minimize tax risk. It is found that such transactions have increased and the tax authorities are targeting the same for valuation. The article highlights the requirement of data collection and analysis as to the clear and comprehensive description of the rights to be transferred, exact scope of transaction. Data regarding similar transaction that may have occurred before and its detailed analysis should be documented. Traditional approach, if supportable, should be preferred for valuation is better to be followed as the tax authorities generally prefer the same. Proper documentation and record maintenance is required to be maintained regarding the choice of method and valuation results. The above steps can help reduce uncertainties with thoughtful tax and economic analysis.

(Az’emar, Corcos, & Delios, 2008) The research gives a model for international capital allocation for the firms, whose ability to manipulate transfer prices is heterogeneous. It finds that the ability to shift profits makes the parent companies investment decisions more tax rate sensitive. This is based on the assumption that the investors expect the price profit decision methods used by the fiscal authorities. It is found that there is greater semi-elasticity of investments in relation to statutory tax rates where in the parent company is wholly owned or is R & D intensive. Though expected there is no evidence found in correlation between abusive transfer pricing and standard profit-to asset ratio to minimize risk of detection and punishment. However it is found that characteristics of parents and affiliates and the ability to shift income are correlated. Negative relationship is found between statutory taxes and
Japanese capital invested in wholly-owned affiliates and high R&D affiliates, relative to joint-ventures and low R&D affiliates.

This paper is included as a reference for its relevance with the subject. However there are doubts about the quality of work. Considering this observation and reservations about the same, the work is included in this chapter.

2009

The studies show that the intra group trade has grown to the extent that it now accounts for more than sixty percent of the international trade (Deloitte, 2009)

The result of the above developments is that the prices of the international transactions are no more entirely driven by the market forces. This is for the fact that the MNC’s try to satisfy several interests which in some cases may be mutually conflicting, making the system for determining the intra-group transactions very complicated. The OECD’s Forum on Tax Administration in its Seoul declaration identified transfer pricing as one of the significant concerns for tax jurisdictions. The different corporate tax rate is one of the considerations when it comes to the locational determination by the MNC’s. This gives rise to the arbitrage opportunities for the MNC’s and loss to local governments. The MNC’s plan the prices so as to minimize the profits at the high tax locations. This concern has given rise to the modern transfer pricing legislations throughout the world.

The Arm’s Length Price under Indian legislations other than Income Tax Act 1961 is as given by (Deloitte, 2009) are as follows:

Excise Law:
The indirect taxation is governed through the Central Excise Act 1944. The rate at which the excise duty is collected is stipulated under Central “Excise Tariff Act 1985. The Excise Act has under gone revision and as per the revised Central Excise Act 1994 the duty is payable on the assessable value of the goods. For this purpose detailed rules are provided. The Act deals with the related party transaction with provision that the value of sale for excise duty purpose is to be taken as the invoice...
price of subsequent sale to unrelated buyers. The clubbing of value applies if the entity has common management or common control or common manufacturing facilities. The related party is exhaustively defined under the regulations along with details of interconnected undertakings through direct or indirect control.

*Customs Law:*

The Customs Act follows the principles laid down by General Agreement on Tariffs and Trade (GATT) for determining the assessable value of the goods. The price at which the goods are ordinarily transacted between unrelated parties is accepted. The price of similar or identical goods is also accepted. The assessable value of import transactions between related parties is determined by the Special Valuation branch of the Customs Dept.

*Service Tax:*

There is no specific provision under the Service Tax Act for valuation of services between related parties. There is a small difference that relates to payment of tax and not valuation of assessable value.

*Companies Act 1956:*

The provisions relating to the transfer pricing are limited under the Companies Act 1956 to deal with the effect of transfer pricing on the profitability of the company. The Act provides the definition of the associated persons, related persons and related party. The Act also puts obligation upon the companies to disclose the Directors or persons who may be substantially interested in the transaction. The Act requires the statutory auditors to comment on the related party transactions.

*Monopolies and Restrictive Trade Practices Act, 1969:*

Monopolies and restrictive trade practices act provides the method for determining prices for transaction between related person. It gives comprehensive definition of related person.

*(Income Tax Act 1961, As ammended by Finance Act 2009):*

Under the Income Tax Act the associated enterprise is defined under section 92A. It is as follows:
(1) “For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, “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.

(2) [For the purposes of sub-section (1), 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

(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.

Section 92B has given elaboration on what is an international transaction, and section 92C has given methods to determine ALP. The implementation of the given methods is detailed in rule 10B. Further the Act states that the AO finds that the transfer pricing is not at ALP then he may decide the same as per the provisions of the Act and
the rules there in. This gives the AO / TPO discretion right to audit the determination of ALP based on the available information with him.

The procedure of computation of ALP as given under the Act is: (relevant extract of the provisions are reproduced)

Quote “*Computation of income from international transaction having regard to arm’s length price.*

**Section 92.**

(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.

**Meaning of international transaction:**
**Section 92B.**

(1) For the purposes of this section and sections 92, 92C, 92D and 92E, “international transaction” means a transaction between two or more associated enterprises, either or 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.

**Computation of arm’s length price.**

**Section 92C.**

(1) 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 prescribe, namely :

   (g) comparable uncontrolled price method;
   
   (h) resale price method;
   
   (i) cost plus method;
   
   (j) profit split method;
(k) transactional net margin method;

(l) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm’s length price, in the manner as may be prescribed:

[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:

Provided further that if the variation between the arm’s length price so determined and price at which the international transaction has actually been undertaken does not exceed five per cent of the latter, the price at which the international transaction has actually been undertaken shall be deemed to be the arm’s length price.]

(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 arm’s 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 arm’s 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 arm’s 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 arm’s 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 arm’s length price so determined:

Provided that no deduction under section 10A [or section 10AA] 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:

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

Reference to Transfer Pricing Officer:

Section 92CA.

(1) Where any person, being the assessee, has entered into an international transaction in any previous year, and the Assessing Officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm’s length price in relation to the said international transaction under section 92C to the Transfer Pricing Officer.

(2) Where a reference is made under sub-section (1), the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or
cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm’s length price in relation to the international transaction referred to in sub-section (1).

(3) On the date specified in the notice under sub-section (2), or as soon thereafter as may be, after hearing such evidence as the assessee may produce, including any information or documents referred to in sub-section (3) of section 92D and after considering such evidence as the Transfer Pricing Officer may require on any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm’s length price in relation to the international transaction in accordance with sub-section (3) of section 92C and send a copy of his order to the Assessing Officer and to the assessee.

[(3A) Where a reference was made under sub-section (1) before the 1st day of June, 2007 but the order under sub-section (3) has not been made by the Transfer Pricing Officer before the said date, or a reference under sub-section (1) is made on or after the 1st day of June, 2007, an order under sub-section (3) may be made at any time before sixty days prior to the date on which the period of limitation referred to in section 153, or as the case may be, in section 153B for making the order of assessment or reassessment or recomputation or fresh assessment, as the case may be, expires.]

[(4) On receipt of the order under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C in conformity with the arm’s length price as so determined by the Transfer Pricing Officer.]

(5) With a view to rectifying any mistake apparent from the record, the Transfer Pricing Officer may amend any order passed by him under sub-section (3), and the provisions of section 154 shall, so far as may be, apply accordingly.
(6) Where any amendment is made by the Transfer Pricing Officer under sub-section (5), he shall send a copy of his order to the Assessing Officer who shall thereafter proceed to amend the order of assessment in conformity with such order of the Transfer Pricing Officer.

(7) The Transfer Pricing Officer may, for the purposes of determining the arm’s length price under this section, exercise all or any of the powers specified in clauses (a) to (d) of sub-section (1) of section 131 or sub-section (6) of section 133.

Explanation.—For the purposes of this section, “Transfer Pricing Officer” means a Joint Commissioner or Deputy Commissioner or Assistant Commissioner authorised by the Board to perform all or any of the functions of an Assessing Officer specified in sections 92C and 92D in respect of any person or class of persons.

**Maintenance and keeping of information and document by persons entering into an international transaction:**

**Section 92D.**

(1) Every person who has entered into an international transaction shall keep and maintain such information and document in respect thereof, as may be prescribed.

(2) Without prejudice to the provisions contained in sub-section (1), the Board may prescribe the period for which the information and document shall be kept and maintained under that sub-section.

(3) The Assessing Officer or the Commissioner (Appeals) may, in the course of any proceeding under this Act, require any person who has entered into an international transaction to furnish any information or document in respect thereof, as may be prescribed under sub-section (1),
within a period of thirty days from the date of receipt of a notice issued in this regard:

Provided that the Assessing Officer or the Commissioner (Appeals) may, on an application made by such person, extend the period of thirty days by a further period not exceeding thirty days.

Determination of arm's length price under section 92C.

Rule 10B.

(1) For the purposes of sub-section (2) of section 92C, 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, in the following manner, namely:—

(a) comparable uncontrolled price method, by which,—

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

(ii) 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;

(iii) 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;

(b) resale price method, by which,—

(i) 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;

(ii) 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;
(iii) 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;
(iv) 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;
(v) 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 method, by which,—
(i) 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;
(ii) 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;
(iii) 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;
(iv) the costs referred to in sub-clause (i) are increased by the adjusted
profit mark-up arrived at under sub-clause (iii);
(v) 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;
(d) 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—

(i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined;

(ii) 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;

(iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);

(iv) 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 method, by which,—

(i) 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 by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised 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;

(iii) 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;

(iv) the net profit margin realised 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);

(v) 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.

[(f) Any other method as provided in rule 10AB.]

(2) For the purposes of sub-rule (1), 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

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) The data to be used in analysing 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.

Other method of determination of arm's length price.

Rule 10AB.
For the purposes of clause (f) of sub-section (1) of section 92C, the other method for determination of the arms' length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

Most appropriate method.
**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.

**Information and documents to be kept and maintained under section 92D.**

**Rule 10D.**

(1) Every person who has entered into an international transaction shall keep and maintain the following information and documents, namely:—
(a) a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises;

(b) a profile of the multinational group of which the assessee enterprise is a part along with the name, address, legal status and country of tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them;

(c) a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted;

(d) the nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction;

(e) a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction;

(f) a record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee;

(g) a record of uncontrolled transactions taken into account for analysing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions;

(h) a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction;

(i) a description of the methods considered for determining the arm’s length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method
along with explanations as to why such method was so selected, and how such method was applied in each case;

(j) a record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions;

(k) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;

(l) details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these rules and consequent adjustment made to the total income for tax purposes;

(m) any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

(2) Nothing contained in sub-rule (1) shall apply in a case where the aggregate value, as recorded in the books of account, of international transactions entered into by the assessee does not exceed one crore rupees:

Provided that the assessee shall be required to substantiate, on the basis of material available with him, that income arising from international transactions entered into by him has been computed in accordance with section 92.

(3) The information specified in sub-rule (1) shall be supported by authentic documents, which may include the following:

(a) official publications, reports, studies and data bases from the Government of the country of residence of the associated enterprise, or of any other country;
(b) reports of market research studies carried out and technical publications brought out by institutions of national or international repute;

(c) price publications including stock exchange and commodity market quotations;

(d) published accounts and financial statements relating to the business affairs of the associated enterprises;

(e) agreements and contracts entered into with associated enterprises or with unrelated enterprises in respect of transactions similar to the international transactions;

(f) letters and other correspondence documenting any terms negotiated between the assessee and the associated enterprise;

(g) documents normally issued in connection with various transactions under the accounting practices followed.

(4) The information and documents specified under sub-rules (1) and (2), should, as far as possible, be contemporaneous and should exist latest by the specified date referred to in clause (iv) of section 92F: Provided that where an international transaction continues to have effect over more than one previous year, fresh documentation need not be maintained separately in respect of each previous year, unless there is any significant change in the nature or terms of the international transaction, in the assumptions made, or in any other factor which could influence the transfer price, and in the case of such significant change, fresh documentation as may be necessary under sub-rules (1) and (2) shall be maintained bringing out the impact of the change on the pricing of the international transaction.

(5) The information and documents specified in sub-rules (1) and (2) shall be kept and maintained for a period of eight years from the end of the relevant assessment year. “Unquote.
The tax considerations are one of the considerations for financing decisions of the foreign operations (Choi & Meek, 2009). The valuation of capital can be divided into categories:

a. Equity capital
b. Debt capital

The tax management through debt creation recently by the corporate through ECB, FCCB and other ways and means to fund the acquisition, running, equity infusion into the foreign subsidiary is the one that requires careful examination. Financing is a service provided by the parent company to its subsidiary or vice-versa. There are various reasons for which the associate enterprises provide financing to each other can be said to be as follows:

a. Capital infusion for business setup
b. Capital infusion for business expansion
c. Capital infusion for betterment of financial health
d. Debt
   i. Debt when fund raising is difficult due to financial situation of the subsidiary
   ii. Debt when the funds are available to the parent company at cheaper rates that that available to the subsidiary.
   iii. Debt when funds are more easily available to the parent company.
   iv. Guarantee for debt servicing

Using this logic to the guarantee for the loan provided by the parent company to the subsidiary company is a service and valuation of the service as per the principle of Arm’s Length Price is to be made and the same value is to be added to the income of the parent company for taxation purpose. The view has been supported by Deloitte wherein they have identified that the law is not clear on this point and the clarity is required (Deloitte, 2009).

(Autrey & Bova, 2009), follow the work of Hirshleifer, who finds that the optimum transfer price is a function of the nature of downstream competition, whereas Autrey and Bova find that if there is a product leak to upstream market the function is reversed and becomes on the nature of the upstream market. They find that is a partial equilibrium the transfer prices are so set that the gray market costs are increased so as to reduce the competitive advantage in the domestic market for the gray market
products. In cases where in the reverse flow of the products of the MNC’s creates competition even through the gray market, it is beneficial to the domestic economy and hence giving incentive for lack of tax enforcement of transfer pricing. This is a case where in non-arm’s length pricing is accepted by tax authorities for the purpose of domestic welfare, on the other hand intra-company discounts to foreign subsidiaries is function of domestic competition and homogeneity of companies domestic and foreign product. In either case the lax attitude of the tax authorities is on account on welfare of the domestic markets. Thus transfer pricing can be used by the tax authorities as domestic welfare control strategy.

(Cools & Slagmulder, 2009) Study the effect of international transfer prices within management control systems. The study is limited to firms using single transfer price for management control system and that of tax purpose. In this situation the TP negotiations are eliminated giving rise to economically harmful decisions. Administrative mechanism for profit determination can lead to suboptimal decisions and lastly revenue or cost centers are designated as profit centers for tax compliance. TP and tax compliance is related to profit centers. In the case study undertaken it was found that the management found utility in treating the associate as profit center than revenue or cost center.

(Behrens, Peralta, & Picard, 2009) The firms that the tax authorities are unable to audit, the CUP or CP methods given by OECD distort the firm’s output and pricing decisions. ALP between the exporters and distribution setup serves as a benchmark and the CUP or CP rules detrimental to consumers in the low tax country, yet benefits consumers in the high tax country. They find that the choice of transfer pricing rules directly affects the firm’s decision on how to serve the foreign market. Restrictive transfer price may entice excessive number of firms to operate as exporters harming the consumers. They advise that the consumer welfare should be considered when evaluating the desirability of the given transfer pricing policy.

(Stuart, 2009) In the article references are made to the US MNC’s being exposed due to rigorous enforcement of business tax issues including TP. The author also refers to perfect documentation being challenged due to subjectivity in the legislation. Specific references are made to India & China for strict enforcement of legislation.
(Drtina & Reimers, 2009), in their article acknowledge that transferring profits is a motto of MNC’s and transfer pricing is used to gain benefit from differential tax rates. They also find that there are comparability issues using the current methods for determination of ALP. They also identify that the transfer pricing of intangible assets possess a special and different kind of problem. Comparable transactions are practically not possible and hence risk of dispute amongst the tax payer and tax authority arises, where in the cost on account of penalties is very high.

2010

Use of transfer pricing in modern management finds its roots in the management control systems in large organizations where in the concept of profit center is given high importance to enable the top management to exercise better control over the affairs of the enterprise. At the same time the profit center manager enjoys the autonomy which helps in better decision making and performance. This is better suited for multi-location and diversified enterprises. (Anthony & Govindarajan, 2010).

(Sikka & Willmott, 2010) highlight on the scattered evidence to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life.

(Jelena & Danijel, 2010), find that the transfer pricing affects the divisional revenues, expenditures and results. This creates competition amongst the divisions for increasing their performances. The method used for transfer pricing is thus plays an important role and is of most interest to the managers. They also find that the more successful divisions get more share in the allocation of resources.

In MNC’s where the transfer pricing is not used as a strategy for tax planning, there is a very strong case that the tradeoff is made by the managers of the divisions between benefits of tax management and higher share in resources from the management. Also there will be considerations given to the performance based bargaining capacity of the
division manager which can have impact on the transfer pricing method as well as price.

(Becker, 2010) In a study of two companies from different countries competing in third country, Becker finds that the tax credit system is the optimum policy choice for target country as well as the parent country if the tax rates are almost same and the transfer prices are higher than the variable cost of the home country. However he finds that if the transfer prices are close to the variable cost and the third country tax rates are lower than the parent country, the countries prefer tax exemption system over tax credit system. He uses Brander & Spencer (1985) model with change being that he assumes that the two companies have manufacturing facilities in third country. It reveals that if the countries are allowed to adjust the tax rates the countries will choose a tax rate in which both countries choose the exemption system. Transfer pricing may have a substantial effect on competition and should be treated accordingly by supranational competition institutions.

(Jost, Pfaffermaryr, & Winner, 2010), acknowledge the fact that the tax differential offer incentives to MNC have to transfer profits to low tax economies. However they find that there are inevitable tax compliance issues associated with transfer pricing activities of MNC’s. They find that the complex and variable nature of the transfer pricing regulations there is a compliance risk and hence risk of additions to the tax liability along with penalty. In an attempt to find the risk sensitivity of the MNC’s towards transfer pricing risk, they find that the intercompany arrangements for transfer pricing are dependent upon earlier experience of transfer pricing audit and that the statutory tax rate are not the prime reason for the risk perception but the procedural risk for tax compliance is a bigger perceived risk. These results were found by using data collected by E&Y by interviews of finance heads of MNC’s.

Undated

(Dawson & Miller), in their undated work find the roots of evolution of transfer pricing. They say one has to look at the organizational expansion and evolutionary stages in which the sole proprietor business has grown to a multi- national enterprise, in which the control of the owners is delegated through the board of directors and the
group of enterprises work together towards achievement of their common business objective. In this case the evaluation of fairness of the price applied in a transaction with related person arises only where the interested party is adversely affected, that is the transaction generally fetches lower than normal collections to the revenue authorities. Thus the transactions that are between related persons located in different states are subjected to transfer pricing. Transfer pricing can thus, be said to be as old as international transactions or inter-state transactions. Initially when the organizations were small the international transactions were generally trade of finished goods or raw material between unrelated parties, from place of production to place of consumption. This did not involve much of transfer pricing issues. With the industrial revolution the organizations started to grow in size and with revolutions in transportation and communication, movement of funds, labour, and ideas across geographies and political boundaries became effective, efficient and easy. The locational advantage started to be appreciated for its cost efficiency and administrative effectiveness. The companies expanded to different locations which gave them business advantages by way of having branches, affiliates and subsidiaries. This geographic expansion by the companies through branches, affiliates and subsidiaries gave birth to multi-national enterprises. The parent company continued to be in one country and the branches, affiliates and subsidiaries were at other locations. The various techniques and strategies adopted by the MNC’s for increased cost efficiency ensured that the volume of transactions between the multinational enterprise group increased many fold. These transactions are also called as intra group transactions or related party transactions. The structure and pricing of transactions within the MNC group is governed by the combination of market and group driven forces with a common objective that is to maximize the group profits and wealth.

The current legislation gives the detailed explanation for ALP determination under the Income Tax Act 1961. However before the transfer pricing legislature was included, The Act did include the principle which said that the profits of business have to be computed under fair market conditions. This legislation for transfer pricing first introduced in UK in 1915 followed by US in 1917 (Wahi). In India the Transfer pricing legislation was first introduced in 1922 through section 42(2) which was also included in Income Tax Act 1961 with slight modifications. The entire provisions were revamped by Finance Act 2001 with effect from April 1st, 2002, by introducing
provisions by section 92 to section 92(f). The provisions now enforced provide extensively determination of arm’s length price, including the rules there under (Iyengar).

(Shunko, Debo, & Gavimeni), in undated working paper find that the use transfer pricing to take advantage of tax differentials can help in profit improvement by as large as 30%. They find that the tradeoff curve between cost and tax advantage drives global firm’s choice for sourcing strategy. The curve demonstrates that the off-shoring option with a significant tax advantage should be considered even if it does not have a cost advantage.

(Boldrin & Levine) Say that in case of acquisition of an intangible asset, the valuation is to be based on the basis of the value that the acquiring company will generate as a result of acquisition of the intangible asset. It can be said that the value of the intangible asset to the acquiring company is based on the basis of the utility that the asset is going to give to the acquirer. The utility can be in form of increase in business or reduction in competition. This can be called as negative use of an acquired intangible asset. This is also called as defensive patent. The defensive patent is the one which does not have a business but protects the business from unwarranted intellectual disputes. It also helps the enterprise keep the competition away from taking away the technological idea and keeping the enterprise starved of the technology

In case of positive use of the asset the valuation of asset can be based on the expected revenues that may be generated from the business.

All said and done the ALP determination in case on intangible assets is subjected to a number of uncertainties and uncontrollable variables. These create a lot of dispute and uncertainty for determining the fair Transfer Price of the asset.

(Amershi & Cheng), develop a mechanism of intra firm resource allocation under information asymmetry. Using Myerson’s dominant strategy truth revealing equilibrium, they derive exact close form compensation functions. These compensation schemes are found to be cost plus transfer pricing mechanism, consists
of revenue sharing, cost refund and sharing, taxes and subsidies. This is indication to
the fact that the transfer pricing is looked at as a way to maximize the global wealth of
the enterprise by sharing the benefits of the subsidiary without letting the profit center
head to know what the exact goal is behind the pricing mechanism. Such a strategy
helps in secrecy about the transfer pricing strategy.

2.3 Conclusion from Literature
It is very evident from the above literature that international transfer price is no doubt
used for strategic purpose. It is used by the MNC’s as a tool for managing their tax
liabilities and for their fund management. It is used to acquire market share by
predictive pricing and justify the pricing by cross subsidization of the products. It is
also a very important tool for managing the local risk by moving funds out of the
country and hence managing risk. Transfer pricing is also used as a tool for
transferring funds when such a movement is restricted by law. Thus making it a vital
part of the business strategy. However it is also suggested through the literature that
transfer pricing is also used for efficient resource allocation at global level, and hence
forms very important part of the strategy of MNC’s.

Transfer pricing is also used as a tool for management control. Divisionalisation and
creating profit center helps in better autonomy and hence control. In turn transfer
pricing is used for better utilization of group resources and can be also used for tax
avoidance to maximize profits.

A lot of literature conforms that international transfer pricing is used by the MNC’s
for the purpose of tax management, and that the trade is designed in such a way that
the tax liability is reduced. Macro-economic factors also play a vital role in this
situation which affects the strategy of the MNC’s. That MNC’s try to create
equilibrium at international level and that non-compliance to ALP is a part of creating
equilibrium, along with taking advantage of tax arbitrage that is possible due to
difference in corporate tax rates in two countries where in the MNC operates. All this
makes international trade to be driven by forces other than that of the market forces,
and that subjectivity in the legislature helps in MNC’s to take advantage.
It is also found that the tax compliance is a big risk perceived by the MNC’s and that is one of the reasons that they resort to use of transfer pricing to reduce tax liability to mitigate the risk of difference in interpretation by the tax authorities for ALP and hence the arising penalties.

Literature also highlights subjectivity in the legislation and the guidelines are causing disputes between the tax payer and the tax authorities. This is especially true in case of intellectual properties and intangible assets which are unique and no comparable are possible to be used for determining the ALP. Thus the current legislation is not in a position to take care of this aspect. Alternative methods available under the accounting standards are not always used by the tax authorities and hence adding to the disputes. Debt guarantee and benefit arising out of it is also a part of dispute given by the literature.

There are landmark cases decided by the honorable Supreme Court of India and other High Courts in the country which talk about the intention behind international transactions. The courts have laid down that if the intention of the tax payer behind the transfer between related parties across the international boundaries should not be that of tax avoidance, however if the tax avoidance is incidental to other intention and objectives, and this creates reduction in the tax liability then the tax payer is not to be held liable for tax evasion.

Literature above emphasized the need for evaluations into the intentions of the tax payer behind international transfer pricing. There are a few reasons and one of the prominent out of the same is reducing the global tax liability. On the other hand the tax authorities require collection of revenue for the purpose of governance and hence maximizing the tax collection is the apparent intention. This brings contradiction in the intentions of the two, which becomes one of the reasons for disputes. There is however very less or no literature available which talk about the basis of disputes and areas of disputes that is prevailing amongst the tax payer and the tax authorities. It is found that there is a requirement for in-depth analysis of the reasons of dispute amongst the tax payer and that of the tax authorities. Also the areas of dispute have to be identified and then analyzed. Hence a critical analysis of controversies in this area is warranted and attempted in this research work.
2.4 Works Cited


2. M.CT.M. Chidambaram Chettiar & Ors. vs. Commissioner Of Income Tax, Civil Appeals Nos. 477 to 488 of 1964 (Supreme Court Of India November 29, 1965).


