CHAPTER-II

Origin and Development of Transfer Pricing
CHAPTER 2
ORIGIN AND DEVELOPMENT OF TRANSFER PRICING

2.01. INTRODUCTION

“Tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state”.

Tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return and not imposed as a penalty for any legal offence. The concept of Tax has been defined as “a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred”. This brings out that the tax is a compulsory payment for the common benefit of all and common benefit is the duty of the government. Hence, tax is a rightful need of the government to fulfill its duties.

Perhaps the greatest problem facing the international tax system is the taxation of transfer pricing within related groups of corporations. The price charged by one business entity to another for the provision of goods, services, or intangibles constitutes the easiest way for reallocating income and expenses between entities. One of the tax avoidance methods, frequently adopted by the Multinational corporations are manipulation of price in intra-firm exchange. The basic objective in this method is to maximize the company’s overall after-tax profit rather than the profit of individual subsidiaries. The prices charged by the subsidiary on sale to another located in different countries is popularly known as Transfer of pricing; prices are fixed not according to market principles i.e., interaction of demand and supply principles but artificially by the parent company with a view to desire maximum benefits, comparative labour cost and comparative tax advantages. Transfer pricing has gained much attention in recent years. the reasons are the tendency of business

51. Hugh Dalton “Principles of Public Finance” (Dalton 1922) reprinted by the Allied publishers Pvt ltd (2004) p. 23 Dalton proposes the principles of social advantage which the root of public finance. Thus the government has to raise funds for maximum social advantage. He states that every tax is evil and that every public expenditure is good. But for the good to happen there has to be an evil. This is for the fact that government has to have source of revenue to fund public expense and tax is one of the major source for public revenue.
53. Gopalakrishnan K C “Text Book on International Taxation” Snow White Publication (2002) p. 113
to install a base in both the countries and try to carry out its operations in a manner which would render most profitable activities in the country with low tax rate.

Each country would expect a fair share of taxes to be paid by companies operating in their territory as they exploit the resources made available to them by the country and thus they are entitled to collect taxes to reflect the cost of the resources being made available. Multinational enterprises and group of companies have been playing a dominant role in International and local trade and business. This multinational corporation may have business transactions with its associated enterprises situation in several other countries having similar or different tax systems. The enterprise may transfer goods to its associated enterprises at prices which are not market driven and not comparable with uncontrolled transaction entered between unrelated entities. Same thing happen in local group companies. The issues concerning transfer pricing are of importance to all countries, because of their impact on tax revenues and importance in the economic activities.

2.01.1. Definition, Concept and Nature of Transfer Pricing:

“"The shifting of profits from a higher tax jurisdictions to lower tax jurisdictions by related entities(or affiliate enterprises) by changing the pricing policy at which the transactions between these related entities take place is described as transfer pricing”

The definition of “transfer price” in business economics reads as “the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization”

If there is a competitive open market for the products or services transferred internally, the best solution from a business economics point of view is to use the market price as a transfer price. The market price may be derived from the published price lists for similar products and services, or it may be the price charged by a group entity to its customers.

The definition of price is “When two unrelated companies trade with each other, the price at which they undertake their transactions is simply known as the “price”. However, when the supply of goods, services or finance is made to another

related company, the negotiated price is called the ‘transfer price’. \(^{55}\) An efficient Transfer pricing system is the one that provides a reasonable method for allocating revenue to the concerned taxation jurisdictions apart from providing underlying the transfer pricing legislation should be internationally acceptable and the cost of administering the regulations should not be high. Besides, the compliance costs for the taxpayers should be reasonable.

“It is the term used to describe the prices that related parties set for goods, services, loans, intangibles, and property rentals when engaged in transactions among themselves. Because these prices are not negotiated in a free open market, it is possible that they may deviate from prices agreed upon by non-related parties in comparable transactions under the same or similar circumstances. In addition multinational enterprises sometimes attempt to use transfer prices to subject as much profit as possible to tax in low-tax jurisdictions.”\(^{56}\)

In a simple term the term Transfer pricing refers to the prices that related parties charge one another for goods and services passing between them. The most common application of the Transfer pricing rules is the determination of the correct price for sales between subsidiaries of a multinational corporation. These prices can be used to shift profits to tax-favored jurisdictions. If in a transaction between a subsidiary in a high-tax jurisdiction and another in a low-tax jurisdiction, the high-tax subsidiary charges a price below the “true” price, some of the group’s economic profit is shifted to the low-tax subsidiary. Obviously taxpayers would want to engage in this sort of behavior because it can significantly reduce their taxes. If there were no limitations on this behavior, the entire income of multinational corporations would be taxed at the lowest tax rate in the world to zero rate of taxation. Consequently most countries have some set of tax rules that regulate the prices that related persons can charge one another.

To solve this problem major countries of the world including USA set up a standard principle known as arm’s length principle according to which the prices


charge related parties to one another should be consistent with the price that would have been charged if both parties were unrelated and negotiated arm’s length\(^{57}\).

### 2.01.2. Growth of World Trade and Transfer Pricing Policy

*The growth of world trade*

The fifteenth and Sixteenth centuries are often cited by economic historians as period of origin of Multinational Enterprises (MNEs). Colonization facilitated the emergence of large companies undertaking trade of commodities in colonies of their home countries. But during early 20\(^{th}\) centuries the companies began to engage in significant manufacturing activities outside their home territories. This increase in production activities accelerated significantly in the aftermath of the Second World war, as developed countries began to invest heavily in rebuilding their economies. This period is the landmark for the MNE to establish itself as a driver of global production and trade, with the most significant growth taking place in the last decade. This increased the growth in world trade to the desire of companies to expand global operations by taking advantage of cheaper labour, growing demand in developing countries. The revolution in information technology has resulted in transactions being executed at lower marginal costs. This has resulted in profit opportunities in a wider variety of products and services and geographic areas than were formerly attainable. Multinational Corporations (MNCs) are of great importance in the global economy. According to the World Investment Report 2010\(^{58}\) there are 889,416 multinational corporations worldwide in 2009, among which 82,053 mother corporations each have almost 10 affiliates. Since 2009, the world has seen the great economic recession as a result of the global financial crisis. However, large multinational corporations are still playing the predominant role in international trade because trade between and within Multinational Corporations represents a large share of the global trade. World Investment Report 2013\(^{59}\) states that “Foreign Direct Investment (FDI) stocks rose by 9% in 2012, Foreign affiliate of TNCs(Transactional Corporations) generated sales worth $26 trillion, increasing 7.4 % from 2011. They contributed value added work $6.6 trillion, up 5.5 % which compares well with global GDP growth of 2.3 percent”. Furthermore, a large amount of international trade


\(^{59}\) UNCTAD *ibid* p. XV
involves foreign affiliates of multinational corporations. According to the OECD (Organization of Economic Cooperation and Development) around 60% of world trade actually takes place within multinational enterprises. Trade within a multinational corporation refers to intra-firm trade and the price related to intra-firm trade is transfer price. Multinational corporations can set price for intra-firm trade, i.e. transfer price. Transfer price is the process of establishing price for a transaction of goods or services between two parties within one organization. Multinational enterprises (MNEs) earn their income globally, but countries tax it locally by imposing techniques of geographical division or allocation. The analytical framework related to transfer price is represented as under in the chart:

### Growth of Transfer Pricing Policy

As noted the Transfer pricing legislation was first introduced in UK in 1915 which was followed by the United States in 1917. The provisions were introduced to discourage companies from shifting profit to overseas associates through under or overpricing of cross-border transactions. The legislation though was not very effective in curbing shifting of profit due to price manipulations, yet it reduced the incidence to a large extent. Prior to 1960 transfer pricing was not considered important as there was no significant international trade during this period. The legal approaches in this period had taken variety of forms and developed at different pace.

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in different countries. The period after sixties witnessed a substantial growth in the business of multinational corporations. Thereby several group enterprises tried to shift profits by artificial transfer prices. The countries started laying emphasis on rules, to devise means of countering such profit shifting. Besides there was also considerable expansion of treaty network between various countries, which adopted the provision, relating to associate enterprises on the lines of Article 9(1) of the OECD draft\textsuperscript{62}. These provisions allowed the tax administrations to adjust profits and ensure that multinationals pay their proper share of tax on their profits.

Globalization makes it possible for resources to move freely across borders. Organizations can establish affiliates, subsidiaries, joint ventures, etc without territorial limitations. Globalization creates new complexities for transfer pricing policy making, because multinational corporations can take advantage of low taxes in different geographical locations\textsuperscript{63} the International Monetary Fund (IMF) proclaims that globalization causes taxation problems related to “potential use and abuse of transfer prices” by multinational corporations\textsuperscript{64}

In mid 1970s many developed countries, had a problem in preserving their tax base. The tax authorities therefore started developing expertise in transfer pricing matters and applied prevailing law to deal with transactions routed through tax heaven when simpler or provisions that are more straightforward could not apply. In 1979, the Organization for Economic Cooperation and development (OECD) undertook an in-depth analysis of transfer pricing provisions and published a report on “Transfer pricing and Multinational Enterprises”. This report reaffirmed the arm’s length principle, not only in the context of treaties but also as a general rule. It described the three standard methods of computing the Arm’s length price i.e., they are as under;

\textsuperscript{62} Article 9 of the OECD Model Tax convention reads as “ where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of Contracting State and an enterprise of the other contracting state,

And in either case 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.


\textsuperscript{64} Tanzi V (2000) Globalization, technological developments, and the work of fiscal termites (WP/00/181) Washington DC IMF
a. comparable un-controlled price method
b. resale price method
c. cost plus method

and mentioned the danger of using other bases for estimating the profits to achieve arm's length standard. It did not suggest any strict order of priority for application of the suggested methods and indicated that it might be suitable to use more than one method. In 1984 OECD published another report entitled “Transfer Pricing and Multinational Enterprises Three Taxations Issues”. This report incorporated the discussions of transfer prices for intra group services and dealt with the treatment of intra-bank interest and other issues, which could not be resolved under the tax treaties. In 1984 the United Kingdom (UK) introduced a new anti-avoidance legislation called the “The Controlled Foreign Corporation (CFC) rules. The aim of this legislation was to check the aggressive use of tax heavens by domestic corporations. The law provided that profits accumulated in offshore subsidiaries should be attributed back to the parent company. Subsequently OECD published further reports in 1987, 1988 and 1994 which considered the problems relating to thin capitalization, the tax consequences of foreign exchange gains and losses, and attribution of income to permanent establishments. During this regime USA introduced several new provisions relating to widening of existing provisions, compliance requirements, penalties and interest deductions to the aforesaid development made OECD to review its guidelines and published another report in 1995 dealing with transfer pricing issues. The report reaffirmed the conclusions of the 1979 report and upheld arm’s length principle and the three standard methods of arriving at arm’s length prices. In 1996 another report brought from OECD and 1997 report on cost contribution arrangements was brought. In 1999 the guidelines for conducting advance-pricing arrangements were also issued. During this period the role of multinational corporations in the world trade had substantially increased. As such a number of countries including USA Canada, UK France, West Germany, Australia, South Korea and China started paying more attention to transfer pricing issues and introduced the comprehensive legislation in the field of Transfer pricing.

66. Ibid., p. 296
2.01.3 Rationale of Regulations

Transfer pricing has an inherent problem, which is the difficulty for setting a fair price in absence of two unrelated parties in a transaction. Price of goods and services in transactions between unrelated parties is usually affected by certain market factors, for example, supply and demand, tariffs or political conditions, while intra-firm trade often ignores these market factors. Looking from a global view, transfer pricing between affiliates across borders brings about further complications related to tax planning. Different regulations and taxation systems in different countries make it possible for multinational corporations to exploit the differences in tax rates and to maximize their profits via manipulating transfer pricing. A great many cases of tax planning related to transfer pricing manipulation are reported.

The enterprises of a group have business in different countries, they can determine the level of taxation in a particular country by adjusting the price mechanism. They can combine the available resources and save on interest, other costs and research and development expenses. They can also employ methods to minimize their tax liability: by shifting their profit base, from high to low tax jurisdictions. The focus of regulations and taxation laws are on aggressive or abusive transfer pricing manipulation which most probably leads to tax evasion or tax fraud. Tax planning involving tax avoidance is considered to be legal, or more exactly, not illegal. Multinational corporations’ tax avoidance behavior is morally acceptable to government and tax authorities, at least based on the interpretation of current regulations and taxation laws.

2.01.4 Problems of transfer pricing Manipulation

Resource allocation is another issue related to transfer pricing. Researchers discovered long time ago that transfer pricing manipulation can result in resources misallocation. In a global context, besides loss of income tax and custom duties, transfer pricing manipulations can have other potential negative impacts for the host country, such as “depletion of natural resources, environmental damage health hazards, increased national debt and poverty, psychological feelings of betrayal and loss of trust inMNEs and economic colonialism.” Some researchers state that transfer pricing is a tool for capital flight. It 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”\(^{70}\). Capital shifting and tax avoidance raise questions about the quality of national economic statistics because most governments steer the economy based on the “data of imports, exports, national income, corporate profitability, balance of payments and terms of trade” which is problematized by multinational corporations’ transfer pricing policies\(^{71}\).

### 2.01.5 The relevance of tax treaties

Tax treaties are relevant in transfer pricing cases that involve cross border transactions between entities of two countries which have entered into treaty. The following Articles of DTA agreement are relevant in this regard:

1. Article 5- Permanent establishment.
2. Article 7- Business profits and provisions of attribution of Profit
3. Article 9- Associated enterprise transactions;
4. Article 11(6) and Article 12(4) of DTA (Double Taxation Agreement) provide for limited relief from Tax on income from interest and royalties where special relationship exists between the pay and recipient
5. Article 23- Elimination of double taxation
6. Article 26 -Exchange of information

The associated enterprise transactions are dealt in Article 9 which is based on OECD Model Tax Convention. This Article permits tax authorities to restate the accounts of the enterprise if it does not reflect true profits accruing from transactions with associated enterprises. The increased focus on transfer pricing issues has brought another aspect into prominence that is Cooperation between tax authorities of different countries. That is the Article dealing with “exchange of information” deals with aspects of regular exchange on matters relating cross border transactions and avoidance of tax. These exchanges of information cause certain limits in respect of trade, business industrial or professional secrets or trade process. Though tax authorities have access to confidential information, which may be of interest to a taxpayer’s commercial rivals, yet the authorities cannot part with such information.

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\(^{70}\) SikkaPrem&Willmott, Hugh op.cit p. 30

\(^{71}\) Ibid., pp 13-16
The other treaty clauses which are of relevance are:

1. Elimination of double taxation and mutual agreement procedure.

2. Transfer pricing adjustment disputes can be taken with concerned competent authorities.

2.02. Role of Developing Countries

a) Over the years the role of developing country’s economies have witnessed substantial changes as they are moving towards era of globalization of business. They are no longer the supplier of raw materials to enterprise of developed countries. On the contrary they attract substantial foreign direct investments due to lower costs of labour, raw materials and friendly tax regimes.

b) The abusive of transfer pricing practices impact on the tax revenues of a country in different ways. Whereas these practices can affect tax revenue of a developing country in a big way their impact may not be significant to developed countries. Transfer pricing regulations helps the taxpayers to abide law by delineating the limits within they can practice transfer pricing.

c) The developing countries can face the impacts of transfer pricing effectively only if they have efficient and good transfer pricing regime. These countries while formulating the rules on transfer pricing system they have to not only safeguard their revenue but also keep in mind the abusive practices can affect them adversely.

d) Multinational enterprises presence is most important to developing countries as they need them for foreign investment, technological growth and employment opportunities. When developing countries have rigorous transfer pricing rules, multinational enterprises may shift their investments to countries that have soft laws and liberal policies.

e) India realized the need for comprehensive transfer pricing regulations after it initiated the process of economic reforms following the policy of liberalization and removal of controls. (the development of Transfer pricing regime in India mentioned separately in Chapter III of this thesis work)
2.03. Evolution of Global Transfer Pricing Legislation.

2.03.1 History of legislations and Development of Transfer pricing in USA

The United States (US) is the world’s largest economy. It has an extensive and well developed transfer pricing regulations. The US congress amended section 482 in 1986 to include income standard for transfer of intangible property. Between 1988 and 1992 the Congress again amended some provisions to impose on taxpayers new information and documentation requirements. The regulations are contained in Section 482 of Internal Revenue Code 1986 (“IRC”) which authorizes (Internal Revenue service of US) IRS to distribute apportion or allocate gross income, deductions or credits or allowance among the two or more organizations trade or business that are owned or controlled by related parties. The IRS issued a study of intercompany pricing under Section 482 called “White paper on Section 482 of US regulations”. The detailed Treasury Regulations issued under section 482 are the main basis to apply arm’s length standard. The important information is as under72;

1. Access to information: IRS under section 482 will have access to relevant information to make pricing determinations. In the initial stages the examiners has faced lot of problem for the reason they are unable to obtain data.

2. Necessity of maintaining good relationship with the taxpayer.

3. Intangible transfers generally are the most problematic adjustments due to the inherent difficulty of valuing intangibles under the existing regulations.

4. Sometimes the taxpayers tried to shift large amount of income to tax haven subsidiaries by loaning a few key employees.

Here, the transfer pricing regulations apply to all transactions including purchase/sale of goods, provision of services, lease hire purchase, financing etc., between controlled taxpayers (taxpayers who are connected to each other) Section 482 of provision clearly enshrines the principle that the subsidiaries of the foreign companies should disclose all their monitory and non monitory transactions with related parties in the specified form.

72. “A study of Inter-company pricing, Discussion Draft” US Department of the Treasury and Internal Revenue.(1986)
USA follows the internationally accepted arm’s length principle. According to arms lengths principles rules *a controlled transaction meets the arm’s length standard if the result of the transaction are consistent with the result that would have been realized if the uncontrolled taxpayers had engaged in the same transaction under the same circumstances.*

The important achievement of Section 482 provision of IRS is “where controlled transactions affects determination of taxpayer’s income from US sources or the income effectively connected with the conduct of a trade or business within the United States. Subsidiaries of foreign companies are required to disclose all transactions with related parties in the specified form. The principle in case of related party transactions is that U.S. taxpayer taxable income must reflect arm’s length transfer prices. The Country’s Snapshot of Transfer pricing policy is shown in the Table-1 as under

**TABLE-1**

<table>
<thead>
<tr>
<th>PARTICULARS</th>
<th>DETAILS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Authority</td>
<td>Internal Revenue Service (IRS)</td>
</tr>
<tr>
<td>Relevant TP Regulations</td>
<td>Section 482 of the IRC</td>
</tr>
<tr>
<td>Acceptable methods</td>
<td>CUP, Resale Price, Cost Plus, Comparable profit split, Residual Profit Split, TNMM and CPM</td>
</tr>
<tr>
<td>Priority of methods</td>
<td>Best method rule applies</td>
</tr>
<tr>
<td>Documentation requirements</td>
<td>Contemporaneous documentation is required</td>
</tr>
<tr>
<td>Penalty of TP adjustments</td>
<td>Transfer pricing penalty up to 20 or 40 percent of additional tax for adjustments exceeding specified thresholds</td>
</tr>
<tr>
<td>Provision for reduction of penalties</td>
<td>No penalty if best method reasonably selected, applied and documented and if the contemporaneous obligation is met</td>
</tr>
<tr>
<td>Timelines for preparation/submission of TP Documents</td>
<td>To be prepared by filing date of annual income tax return</td>
</tr>
<tr>
<td>APA’s</td>
<td>Unilateral and bilateral APAs both are available under Rev procedure</td>
</tr>
<tr>
<td>Self initiated adjustments</td>
<td>Permits a adjustment on amended return as long as adjustment does not decrease income</td>
</tr>
<tr>
<td>Cost sharing agreements</td>
<td>Cost sharing payments are deductible under section 1482-7(h) Internal revenue services Code of U.S. Cost sharing payments are not subject to withholding tax under s 1482-7(h) U.S.</td>
</tr>
<tr>
<td>-------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Time for limitation for TP audits</td>
<td>Three years from the original due date of return, whichever is later. For substantial omissions of income, period is extended to 6 years. In case of non-filing or fraud, period is unlimited. Limitation period can be extended if company is in a Net operating Loss position</td>
</tr>
<tr>
<td>Secret comparables</td>
<td>No secret comparables</td>
</tr>
<tr>
<td>Foreign comparables</td>
<td>Foreign comparables are acceptable depending upon the facts and circumstances</td>
</tr>
<tr>
<td>Key definitions of Section 482</td>
<td>Meaning</td>
</tr>
<tr>
<td>Organization</td>
<td>It includes an organization of any kind, whether a sole proprietorship, a partnership, a trust an estate, an association or a corporation irrespective of place of organization operation or conduct of the trade or business and regardless of whether it is a domestic or foreign organizations under Regulation Section. 1482-1(i)(1) IRS code of U.S.</td>
</tr>
<tr>
<td>Transaction</td>
<td>Means any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented.</td>
</tr>
<tr>
<td>Controlled</td>
<td>Includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.</td>
</tr>
<tr>
<td>Controlled Taxpayer</td>
<td>Means any one of two or more taxpayers owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers</td>
</tr>
<tr>
<td>Uncontrolled Taxpayer</td>
<td>Means any one of two or more taxpayers not owned or controlled directly or indirectly by the same interests Regulations Sn 1-482-1(i)(5)</td>
</tr>
<tr>
<td>Group/controlled group/group of controlled taxpayers</td>
<td>Means the taxpayers owned or controlled directly or indirectly by the same interest Sn 1.482-1(b)(1)</td>
</tr>
</tbody>
</table>
US Regulations follow the internationally accepted arm’s length principle. A controlled transaction is considered to meet arm’s length standard if the results of transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under same circumstances. Since in practice it is difficult to identify identical or similar transactions entered into between independent parties the controlled transactions can be evaluated with comparable transactions, which are not necessarily identical. Allocation of income or expenses of controlled transactions is made by using any one of the methods prescribed namely, CUP, RPM, CPM PSM and other unspecified methods. Generally in the case of transfer of intangibles the methods used are comparable uncontrolled transactions (CUT) method, comparable profits method, profit split method and any unspecified method.

2.03.2. History of Legislation and Development of Transfer Pricing in United Kingdom

The Transfer pricing provisions are contained in section 108 and schedule 16 of Finance Act, 1998, which are incorporated as section 770A and Schedule 28AA of Income and Corporation Taxes Act, (ICTA) 1988 of (U.K). The legislation of U.K applies between the persons who have carried out transactions between person of U.K and person of outside the U.K. One of the persons of the contract must directly or indirectly participate in the management, control, or capital of each of the Transaction. U.K law permits the following methods for determining arm’s length price in regard to related party transactions.

a. Comparable uncontrolled price method
b. Resale price method
c. Cost-plus method
d. Profit split method
e. Transactional net margin method
f. Other methods

The legislation contained in Section 770 to 773 ICTA 1988 was replaced by the Income and Corporation taxes Act 1988 U K Act. The new legislation (Schedule 28AA referred) was brought into effect that had far-reaching implications for all UK taxpayers that dealt with related parties. Under Schedule 28AA companies are required to complete their tax returns on the basis that all relevant dealings are at arm’s length. The transfer pricing legislation is now compulsory rather than imposed at the direction of the tax authorities.

The basic pricing rule is included in Schedule 28AA Para 1 of Income and Corporation Taxes Act, 1988(ICTA). The rule refers to ‘provision’ made or imposed between two persons by means of a transaction or series of transactions. It requires the adjustment of income, profits or losses, where that provision departs from the arm’s length standard and has created a potential advantage for purposes of UK taxation. It is also important that schedule 28AA states that transfer pricing rules relating to arm’s length pricing should be construed in a manner consistent with the OECD transfer pricing guidelines. The basic rule in Schedule 28AA is intended to reproduce in UK law is to follow the effect of article 9(1) of the OECD Model Tax Convention. It is intended that the legislation will be construed in accordance with the OECD language, irrespective of whether there is a double taxation agreement in force between the UK and the country of residence of one of the parties to the provision. It is pertinent to note that the transfer pricing rules in Schedule 28AA do not apply to oil exploration and production companies under certain conditions.

In U K, the International Division of Board of Inland Revenue is the central monitoring authority. During the course of enquiry, there are number of meetings between the Inland Revenue and the taxpayer and his advisers. Though in the initial the law does not provide for any specific documentation requirements, revised guidelines published by the inland Revenue in October 1998 which states that “tax payers will be required to self assess accurately, and may be called on by the inland Revenue to justify their prices and the quantum of income, profits or losses returned

74. Article 9 of OECD model tax convention supra note 12
75. ICTA Schedule 28AA para 9-11 contains special rules dealing with oil sales and companies which carry on oil extraction activities in the UK or the UK continental shelf
for tax purposes”. The Snap shot of UK Transfer pricing is shown in the Table-2 as under:

**TABLE-2**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Authority</td>
<td>Her Majesty’s Revenue and Customs (HMRC)</td>
</tr>
<tr>
<td>OECD Member</td>
<td>Yes</td>
</tr>
<tr>
<td>Acceptable Methods</td>
<td>Methods set out in the OECD Transfer Pricing Guidelines including: Traditional methods-CUP,RPM,CPM Transactional methods-PSM and TNMM</td>
</tr>
<tr>
<td>Priority of methods</td>
<td>In accordance with OECD Transfer Pricing Guidelines, one method selected that is clever of having tendency to provide the best indication of an arm’s length price given the specific circumstances</td>
</tr>
<tr>
<td>Documentation required</td>
<td>Yes</td>
</tr>
<tr>
<td>Frequency of TP Audits</td>
<td>No set pattern, HMRC conduct a risk assessment before initiating a transfer pricing enquiry.</td>
</tr>
<tr>
<td>Penalty for TP adjustments</td>
<td>Yes-maximum of 100% of the underpaid taxation</td>
</tr>
<tr>
<td>Provision for reduction of penalties</td>
<td>Yes</td>
</tr>
<tr>
<td>Timeline for preparation of TP Documents</td>
<td>Date of preparation of accounts and filing of annual corporation tax return.</td>
</tr>
<tr>
<td>Timeline for submission of TP documents</td>
<td>Within 60 days of request although extensions may be available.</td>
</tr>
<tr>
<td>Advance Pricing Agreements(APA)</td>
<td>Yes where there is sufficient difficulty or doubt with respect to arm’s length pricing</td>
</tr>
<tr>
<td>Self initiated adjustments</td>
<td>Upward adjustments to arm’s length price accepted for cross-border transactions</td>
</tr>
<tr>
<td>Cost sharing agreements(deductibility)</td>
<td>Generally deductible if priced at arm’s length</td>
</tr>
<tr>
<td>Cost of sharing(withholding tax)</td>
<td>Withholding tax in the UK applies only to interest, royalties and dividends although the UK’s extensive</td>
</tr>
</tbody>
</table>

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network of tax treaties may provide mitigation possibilities.

Limitation period for TP audits
6 years after the end of the accounting period may be extended to 21 years in case of negligent or fraudulent misstatement

Secret comparables
No

Foreign Comparables
HMRC have advised that if there are no UK comparables, or the UK comparable companies put forward are flawed in some way, then it may be necessary to consider using comparables in other countries.

2.03.3. History of Legislation and Development of Transfer Pricing in Australia

The Government of Australia was one of the first governments among industrialized nations to modernize its Transfer pricing legislation. Earlier the Commissioner of Taxation in Australia has made announcements to the press that transfer pricing is their number one concern regarding MNEs operating within Australia. The Australian rules are based on the OECD Guidelines, but are more extensive.

Transfer pricing regulations in Australia are incorporated in Division 13 of Part III of the Income Tax Assessment Act, 1936 and in relevant provisions of Double Tax Treaties and Taxation Rulings issued from time to time. The provisions of Division 13 dealing with transfer pricing do not apply automatically. The Commissioner may in his discretion invoke the provisions where a transaction has resulted in a profit shift from Australia, regardless of the motive or purpose of the agreement. Section 136 of the provisions would apply if following conditions were satisfied.

1. The Taxpayer has acquired or supplied property or services under an international agreement.

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77. Division 13, comprising SS 136AA-136AG of the 1936 Act, replaced Section 136 in 1982. Section 136 is a restricted provision, applying only to business carried on in Australia, controlled principally by non-residents or companies with a majority of foreign shareholders. Division 13 contains no such ownership, and control limitations and has wide-ranging application to all cross-border transactions. The business profit article of all Australian treaties differs from the OECD Model Tax Convention in that it applies to international dealings with the permanent establishment or with other enterprises with which it deals.
2. The Commissioner is of the opinion that the parties to the agreement were not dealing at arm’s length with each other.

3. The consideration received for supply of the property of services is less than the arm’s length consideration or consideration paid for acquisition of property or services is greater than the arm’s length consideration.

4. The Commissioner is of the view that provisions of Division 13 need to be invoked.

A case of profit shifting may arise as a result of allocation of excessive part of the expenses to the conduct of the income earning activities in Australia by a non-resident carrying on business in Australia through a branch. It may also arise where a resident taxpayer carries on business in foreign country through a permanent establishment. This transfer pricing regulations in Australia provides for allocation of the appropriate amount of the actual income and expenses of a multinational enterprise between its Australian and International operations. There are internal shifting rules as well external shifting rules. The same item of income or expenditure cannot be subject to reallocation under both sets of rules.

*The Snapshot of Transfer Pricing of Australia is shown in the Table-3 as under:*

**TABLE-3**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Authority</td>
<td>Australian Taxation Office</td>
</tr>
<tr>
<td>Acceptable methods</td>
<td>CUP, RPM, CPM, PSM and TNMM.</td>
</tr>
<tr>
<td>Priority of methods</td>
<td>Traditional methods over profit based methods as per the OECD Guidelines.</td>
</tr>
<tr>
<td>Documentation requirements</td>
<td>Contemporaneous documentation detailing process of setting transfer prices and verifying arm’s length</td>
</tr>
<tr>
<td>Frequency of TP audits</td>
<td>No Statutory regulations.</td>
</tr>
<tr>
<td>Penalty of TP adjustments</td>
<td>Up to 50% of additional tax payable.</td>
</tr>
</tbody>
</table>
2.04. Role of OECD in Development of Transfer Pricing

*History, background of OECD and role concerning transfer pricing issues*

With the growth of cross border transactions among multinational enterprises and globalization of world economies transfer pricing assumed importance among several countries. The OECD first published its report in 1979 called “Transfer pricing and Multinational Enterprises” wherein it reaffirmed and elaborated the arm’s length principle. The 2nd report in 1984 on “Transfer pricing and Multinational enterprises Three Taxation issues” wherein it supplemented the recommendation made in the earlier report like

1. Tax treatment of interest payable
2. The price of intra-group services
3. The method of resolving disputes between tax authorities and taxpayer in regard to acceptable arm’s length price

OECD in 1987 published another report on “International Tax Avoidance and Evasion-Four related issues” wherein depth analysis was made on different aspects of international tax evasion and tax avoidance. This report mainly concerns on the issues of low tax or tax haven countries and the base company as a shelter. In 1995 the OECD has published “Transfer pricing Guidelines for Multinational Enterprises and Tax administration”. This report dealt all aspects of transfer pricing focused on
Arm’s length principle. It recommended the use of three standard methods for arriving arm’s length prices and discouraged the use of comparable profits method and suggested that profit methods as a last resort. In 1997 new chapter were incorporated in the report concerning transfer of intangibles and provision of services. In 1999 the organization published an update report of 1995. It viewed in detail various aspects of Transfer pricing like Transfer pricing methods, priority of methods, practical limits to adjustments, effect of government policies, set offs, Global formulary Apportionment, documentation, Cost contribution arrangements, safe harbor penalties and Advance pricing arrangements etc., The major development of the OECD and its role in formulating the Transfer pricing guidelines are dealt in chapter VI of this thesis

2.04.1 OECD Report of 2008&2010

The OECD report 2008 updates the concept of permanent establishment of a foreign enterprise should be considered similar to subsidiary companies as this approach is closer to the arm’s length principle. It updated the process of Business restructurings means reorganizing of the business activities of the enterprises in different jurisdictions in a manner that may result in shifting profits from one jurisdiction to another. These business restructuring issues can involve application of transfer pricing rules, attribution of profits to permanent Establishments. The OECD 2010 released revised transfer pricing guidelines for multinational corporations and tax administrations. The new guidelines take into consideration the recommendations made in earlier guidelines and reports with suitable modifications. The features of the guidelines are as under:

1. Chapter 1 of the revised guidelines reaffirms the arm’s length principles as international standard for determining price of related party transactions. Since the arm’s length principle is the core principle followed to determine transfer prices of transactions between associated enterprises.

2. Article 9 of the OECD Model Tax Convention contains an authoritative statement of the arm’s length principle. Wherein it treats the members of the multinational group as operating as separate entities rather than as inseparable parts of a single unified system.
3. Paragraph 1.11 of 2010 Guidelines affirms that a transaction may not be found between independent enterprises does not itself mean that transaction is not at arm’s length. The arm’s length principle usually requires that both taxpayers and tax administrations should evaluate uncontrolled transactions and business activities of the independent enterprises and compare them with transactions and activities of associated enterprises.

4. It also provides guidelines for applying the arm’s length principle. The principal of comparability analysis. The arm’s length principle is based on the comparison of conditions in a controlled transaction with the conditions of transactions between independent enterprises.

2.04.2 Comparison of OECD and UN Guidelines on the Issue of Non-Discrimination on Transfer Pricing

Most of the agreements include non-discrimination clause on the lines of article 24 of the UN model. On observing the commentary of the UN it may be seen that the intention of the who prepared the draft for both the OECD and UN models which has been adopted verbatim in all these agreements. The object of introducing of non-discrimination clause in a DTAA is really to maintain revenue neutrality between nationals of different countries who have any source of income in India. It is doubtful whether there can be any objection to differential treatment of residents and non-residents who have no permanent establishments in India. The offer of non tax inducement to a resident is unobjectionable; restriction of tax subsidy to a section of the taxpayers cannot be seriously resisted. The fact that all resident tax-payers may not qualify for a particular relief also serves to show that there is no element of discrimination in designing any subsidy. Discrimination is unequal treatment in identical situation different treatment by itself, does not constitute discrimination unless it is arbitrary. Article 24 is a special rule providing for avoidance of discrimination against nationals or residents of another contracting state. However not all differences in tax treatment, either between nationals of two States or between residents of two states, are violations of the prohibition against discrimination. The

79. Ibid., p. 1113
non-discrimination obligation of Art 24 apply only if the nationals or residents of the two States are comparably situated\textsuperscript{81} the comparison should be at the level of the taxpayer and not at the level of the class to which the taxpayer belongs\textsuperscript{82}

While the discrimination clause in the tax treaties seeks to safeguard the interest of non-residents and or of their home countries, there seems to be non bar to any preferential treatment of any section of the non-residents vis-a-vis other non residents. Non-resident Indian are entitled to several tax privileges in India. It would appear that the discrimination clause does no hit these privileges. In effect, the non-resident Indians pay less tax than ordinary residents in India and also enjoy all the benefits conferred by India’s tax treaties with countries where they are resident.\textsuperscript{83} Model Commentaries\textsuperscript{84} provide that Art 24 has to be read in the context of other Articles of the Convention: hence, discriminative measures which are permitted by other Articles of the Convention do not violate Art 24. Article 24 of UN Model convention has various paragraphs which deal with different types of discrimination that are quite distinct in character and in scope\textsuperscript{85}

**Text of Article (OECD and UN Treaty Nearly Identical Except for Paragraph 4)**

*The details are in the Table-4 as under\textsuperscript{86}*

<table>
<thead>
<tr>
<th>TABLE-4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paragraph 1 Article 24(1) of UN model is identical to Art 24(1) of the OECD model</td>
</tr>
</tbody>
</table>

\textsuperscript{81}\textit{Ibid}., p. 212
\textsuperscript{82} OECD Report 2008 on “Application and Interpretation of Article 24(Non- discrimination) para 24,25
\textsuperscript{83} K Srinivasan “Guide to Double Taxation avoidance agreements” Vidhi publishing (p) Ltd,(1988)\textsuperscript{4th} Ed p. 1.122
\textsuperscript{84} UN Commentary (2011) para 1,2,3: OECD commentary (2010)para 4, 34,79
\textsuperscript{85} Nilesh Mode “the law and practice of Tax Treaties an Indian perspectives op.cit., p.1114
\textsuperscript{86} C S Mathur Dr. Maximilian Gorl Karl Sonntag “Principles of Model Tax Conventions and International taxation” Lexis Nexis, (2013) p. 230
\textsuperscript{87} The Text of the Article 1 defines that “this convention shall apply to persons who are residents of one or both of the contracting States”.

58
<table>
<thead>
<tr>
<th>Paragraph 2 Art 24(2) of UN Model</th>
<th>Stateless persons(^{88}) who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence are or may be subjected.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paragraph 3 Art 24(3) of UN Model</td>
<td>The taxation on a permanent establishment(^{89}) which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.</td>
</tr>
<tr>
<td>Paragraph 4 Art 24(4) of UN Model</td>
<td>Except where the provision of paragraph 1 of Art 9 Paragraph 6 of Art. 11 or Paragraph 4(6 UN) of Art. 12 apply interest, royalties and other disbursements paid by an enterprise of Contracting State to a resident of the other Contracting State Shall for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to resident of the 1st mentioned State. Similarly any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first mentioned States.(^{90})</td>
</tr>
</tbody>
</table>

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88 S.K. Kapoor “International Law” op.cit p. 306 “A person who does not possess the nationality of any nation cannot exercise the rights conferred upon him by international law” Stateless persons are not only without the diplomatic protection of any State, they are also refused enjoyment of right dependent on reciprocity. Nationality is important to the individual not only with regard to political rights and privileges but also because his civil status and economic capacity may be dependent upon it.” Model commentaries (UN commentary(2011) para 2: OECD commentary (2010) para 32) provide that a “stateless person” is a person who is not considered as a “national” by any State under the operation of its law.

89 Wahi V S “Transfer pricing Law procedure and Documentation” op.cit., p. 1182 the term permanent establishment means a fixed place of business with a specific sites through which the business of the enterprise is wholly or partly carried on. Fixed place of business includes any premises, facilities or installations used for carrying on the business of the enterprise. The presence of permanent establishment implies that the foreign company has a business presence in another country where permanent establishment is located.

90 C S Mathur Dr. Maximilian Gorl Karl Sonntag “Principles of Model Tax Conventions and International taxation” op.cit p.230-231 … paragraph 1 of Article 9 of Model Tax Convention states “(a)Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b)the same persons participate directly or indirectly in the management, control or capital of enterprise of
Paragraph 5 Art 24(5) of UN Model is identical to Art 24(5) of the OECD Model

Enterprises of Contracting State, the capita of which is wholly or partly owned or controlled, directly or indirectly by one or more residents of the other Contracting State, shall not be subjected in the first mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected.

Paragraph 6 Art 24(6) of UN Model is identical to Art 24(6) of the OECD Model

The provisions of this Article shall, notwithstanding the provisions of Art.2 apply to taxes of every kind and description.

Except for the non-substantial difference in paragraph 4 above, the UN has adopted the entire wording of Art. 24 (Non-discrimination) in the Model Convention. Consequently, all of OECD’s commentaries are reflected in the UN MTCC 2011. Article 24(1) prohibits discrimination on the basis of nationality. the purpose of 24(1) is to ensure that national of State N (national of a contracting State who may not be resident of State N)and State S(resident of contracting State S) are not treated differently by the same State (State S) there is no discrimination when an income is taxed in one State whereas the same income is exempt from tax in another State Article 24(1) prohibits discriminatory taxation on the grounds of nationality alone; it

Contracting State and an enterprise of the other Contracting State, and in either case 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.”

Paragraph 6 of Article 11 states “Where by reason of special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention”.

Paragraph 4 of Article 12 states “Where by reason of special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention”.

91 Nilesh Mode “the law and practice of Tax Treaties an Indian perspectives op.cit., p.1115
92 Ibid., p. 1115
93 Ibid., p .1115
does not prohibit discrimination against non-residents when differential tax treatments are given to taxpayers on the basis of criterion connected with requirements regarding residence of the taxpayer, Article 24(1) does not provide any relief. Thus Art 24(1) cannot be applied when the differentiation in tax rates or discrimination in payment of interest on tax refunds is based on residence of taxpayer and not on their nationality.

As per the Indian income-tax residency rules, it is possible that, depending upon the satisfaction of the prescribed tests, a foreign national (individual) may be treated as a resident of India, while on Indian national (individual) may be treated as a non-resident thus there could be a situations where foreign nationals as well Indian nationals could be non-residents. In general Indian Income-tax law provides for different treatment for residents and non-residents, but does not make distinction between the nationalities of taxpayers.

2.04.3. Equal Treatment of foreign Taxpayer

Like other many agreements concluded by States, the parties to a tax treaty undertake to accord nationals of the other State Equality of treatment with its own nationals. The residence in one of the Contracting States is not a condition for the application of Art. 24 (Non-discrimination).

2.04.4. Restriction on equal treatment

This does not necessarily mean that nationals of a Contracting State have a right to be treated tax wise in other State in absolutely in same way as nationals of the later state, because only foreign nationals living “in the same circumstances” are entitled to equal treatment. The clause “in particular with respect to residence” makes clear that residence is a decisive factor in determining whether taxpayers are placed in the same circumstances. As a result, specific tax provisions which under domestic law are applied to the States own residents need, in the context of non-discrimination rules, not necessarily be granted to non-residents, irrespective of whether they are nationals of the other Contracting State or not.

95. Ibid., p. 1117 (reported in the case of Transworld Garnet Company Ltd, In re 2011-TII-02-ARA-INTL)
96. Ibid., p. 1117
2.04.5. Extent of Equal Treatment

Para 1 of the Article 24 United Nations Model Tax Convention (UNMTC) cited above in the column box state that “taxation or any requirement connected therewith which is other or more burdensome” than to which nationals of the other State are subjected, it is clear that taxation must be in the same form as regards the tax basis and tax rate, as well as the method of assessment and connected formalities, makes that they live in same circumstances.

2.04.6. The Situation of Companies

Article 3 Sub Para (g) OECD MTC98 the term ‘National’ includes any legal person, partnership or association deriving its legal status from the laws of its country of incorporation. Thus the restriction on equal treatment as described in paragraph 3 also applies to companies.

2.04.7. Treatment of Stateless persons99

The intention of paragraph 2 of the model conventions is to grant to stateless persons (persons not considered as a national by any state) who reside in one of the Contracting States, the same shelter against discrimination as is given to national of two States as mentioned in the paragraph 1 of the convention.

2.04.8. Permanent Establishment100

The paragraph applies without exceptions, to all persons resident in a Contracting State who maintain a permanent establishment in the other State. Hence, it is not based on nationality, nor does it prevent different taxation procedures, as long as the profits tax burden of the Permanent Establishment of a foreign resident is comparable to that of a similar domestic company.

The substance of the principle of equal treatment has never been adequately defined, and this has resulted in wide differences of opinion with regard to its manifold implications. The main reason for these difficulties lies in the fact that a permanent establishment is a dependent part of an enterprise that has its head office in another country. To compare such a unit with a complete company of the PE country will always be problematic and leaves room for discretion ary treatment.

98. Ibid., p. 230
100. Wahi V S “Transfer pricing Law procedure and Documentation” op.cit., p. 119
2.04.9. Treatment of foreign owned enterprises

The paragraph relates to companies resident in a Contracting State, the capital of which is owned or controlled by residents of the other State, and stipulates that such companies must be treated, tax wise, in the same way as resident companies owned or controlled by residents of the first mentioned State. Transfer pricing issues are not affected by this provision. For example, additional requirements on transfer prices which are more stringent, or even a reversal of the burden of proof are not regarded as being discriminatory under Art 24 of UNMTC. This article 24 deals with elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay. The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions.

2.04.10. INDIA’s Role and OECD

Indian Transfer pricing regulations in many respects follow the best international tax practices and the OECD guidelines. Some provisions are unique to Indian situations and differ significantly from transfer pricing provisions in other countries. India is not the OECD member and its guidelines are therefore, not binding on tax authorities. Since Transfer pricing regime in India was first introduced by the Finance Act 2001, the law on the subject is still evolving. The decisions of foreign courts and tribunals are therefore, relevant to both taxpayer and tax authorities to deal with complex transfer pricing issues particularly relating to application of transfer pricing methods, documentation requirements and determination of arm’s length prices. The Indian legislation has been drafted based on the recommendations of an expert committee instituted for this purpose and is broadly in line with the OECD Guidelines. To some extent, the Indian legislation has relied on definitions from China, Korea Germany, Italy, and Brazil. The regulations of UK and USA have also been considered in certain areas. The primary suggestion of the OECD was that difference in the arm’s length price estimated by the tax authorities and taxpayer should be acceptable if the difference falls within a range of 10-15 percent.

Indian regulations prescribe the concept of an ‘arm’s length price’ which is contrary to the OECD practice of an ‘arm’s length range’. Where two or more prices
are computed by the most appropriate method, the legislation requires an arithmetic mean of the prices so computed to be adopted. In certain cases where there is variation caused by extremities in the data used, to overcome the CBDT (Central Board of Direct Taxes) introduced a tolerance zone of +/-5% around the arm’s length price. As per administrative circular, the tax authorities shall not make an adjustment to the arm’s length price adopted by the taxpayer if such price is within a +/-5 percent margin of such price determined by the assessing officer, in such cases, the price declared by the taxpayer would be accepted. The Finance Bill 2002 provides for a greater degree of flexibility in adopting an arm’s length price. It proposes that where the most appropriate method results in more than one price, a price which differs from the arithmetic mean by an amount not exceeding +/-5% of such mean, may be taken to be the arm’s length price. The OECD recommended that a provision be included in the Indian transfer pricing regulations to allow the taxpayer to base the determination of arm’s length price on data pertaining to the year under examination and prior years. This would help in complete understanding of the facts and circumstances surrounding the controlled transaction. The OECD suggested that the transfer pricing regulations should allow the taxpayer to use methods not specified in the transfer pricing rules, so long as such methods satisfy the arm’s length principle in accordance with guidelines. In conformity with the OECD approach, the Indian legislation prescribes five methods to compute the arm’s length price for transfer pricing purposes. The Indian Transfer pricing norms hinge on the arms length principle. Indian Tax laws do not use Global Formulary Approach and even if it is most appropriate to the business of the taxpayer. (pl. refer to Appendix XII-F for comparability chart of OECD & India)

The details of OECD guidelines are as follows:

a. OECD guidelines are clear in their intent that transfer pricing provisions should be fair and not unreasonably onerous for taxpayers. For Example guidelines prescribe that documentation requirements should not impose on taxpayers, costs and burdens disproportionate to the circumstances.

b. OECD prescribes two broad sets of methodology viz., traditional transaction methods and transactional profit methods giving preference to the traditional

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101 Central Board of Direct Taxes circular dated 23rd August 2000
102 Section 92C(2)of Income Tax Act, 1961
methods. Indian Income Tax Act 1961 provisions prescribe broadly, the same methods as the OECD but there is no preference of order to particular method but most appropriate method is considered depending upon the facts of the cases.

c. OECD guidelines provide specific guidance for determination of the arm’s length price in case of intra-group services, especially with respect to when services are said to be rendered, and when it is reasonable that mark-up be earned on services.

d. The OECD suggests that penalties should be fair and not unreasonably burdensome for taxpayers. The Indian provisions prescribe separate adjustment related and documentation related penalties.

2.05. Conclusions

The preceding discussion on series of approaches to the term of Transfer price its role in the modern world particularly Multinationals who are pondering over the issues of transfer price in order to protect their chunk of revenue and also the various issues of transfer pricing compliance and enforcement difficulties that each stage, a broadly drawn statute like Section 482 of USA statute of UK and Australia are all outcome of the struggle of Transfer pricing.

The focus on arm’s length dealings may be conceptually sound, but in the context in which transfer pricing occurs in a developing country like India it is very difficult to reap the benefits of transfer pricing. The government should also create an environment that curbs the abusive transfer pricing activities. The OECD has been involved in the issue of taxation and reconciling tax issues between states. The dedicated services of the OECD cannot be underestimated and it is difficult to over-emphasize the importance of these guidelines. And it was described as “consensus interpretation of the arm’s length standard” Experts in the area of taxation and transfer pricing agree that there will be a greater role of organization like the organization for economic cooperation and development than organization based in one country such as the Internal Revenue Code in USA. The U.K transfer pricing regulations primarily follow the OECD transfer pricing guidance. The UK regulations require the taxpayer to prepare documentation as to why a particular method is chosen. The taxpayer should file the relevant information with the authorities detailing business agreements and the transactions and the method chosen.
The article 24(1) prohibits discriminatory taxation on the grounds of nationality alone, it does not prohibit discrimination against non-residents\textsuperscript{103} when differential tax treatments are being given to taxpayers on the basis of criterion connected with requirements regarding residence of taxpayer, Article 24(1) does not provide any relief\textsuperscript{104} thus article 24(1) cannot be applied when the differentiation in tax rates or discrimination in payment of interest on tax refunds is based on residence of taxpayers and not on their nationality. By this Indian Income Tax Act which gives deductions only to resident individuals, do not discriminate on the basis of nationality of taxpayer; hence Art 24(1) cannot be invoked to apply these provisions to foreign nationals\textsuperscript{105}. Thus it is understood the cross-border transactions between Indian nationals one or both of whom are non-resident and who are associated enterprises, will also attract transfer pricing provisions, as they would apply to identically situated foreign nationals.

Internationally accepted standards for transfer pricing will definitely promote the efficiency and effectiveness of transfer pricing regulations and negotiations by and between states. The OECD is expected to continue to provide its expertise in assisting the Indian revenue in building a sound framework for transfer pricing legislation.

The methodology and the procedure adopted by the United States Regulations on Transfer pricing is a landmark and very important from the angle of following the transfer pricing regulations in other countries like India. US regulations has clearly explained the problem of asseessee in deciding the transfer pricing issues, also benchmarking the transactions with comparables and issues involved in intangible transactions in the White paper. Hence, it is important to note that in India, the examination of assessee under transfer pricing regulations should be done on a select cases after completing a preliminary analysis. Also comparable data which is available may not represent a quality comparable and hence imposition any adjustment under transfer pricing regulations should be done only it is absolutely correct and cannot be for any arbitrary reason.

\textsuperscript{103} Standard Chartered Bank vs IAC (1991) 39ITD 57 (Mum) also In re (1998) 234 ITR 371 (AAR)
\textsuperscript{104} IBFD case No 92/13/0307(Supreme Administrative Court of Austria) Credit Llyonnais vs DCIT (2005) 94ITD 401 (Mum)
\textsuperscript{105} Credit Llyonnais vs DCIT (2005) 94ITD 401 (Mum)