CHAPTER-IV

The Concept of Arms Length Principle
Under International Transaction and Transfer Pricing
Chapter 4
ARM’S LENGTH PRINCIPLE AND TRANSFER PRICING

4.01. INTRODUCTION

Montesquieu observed that direct taxes on the individual are more natural to slavery, whereas indirect taxes on transactions are more natural to liberty\textsuperscript{127}. In the United States Income tax is perceived as an indirect tax, a tax on the receipt of income\textsuperscript{128} the relationship between liberty and income taxes may seem thin but the relationship between government revenue and income is not. A government’s income tax receipts are directly related to the amount of taxable income within its taxing jurisdiction. The amount of income is at the heart of transfer prices.

The amount of income received is equal to the price paid for goods or services less the cost. When the price of goods or services is determined by negotiations between independent self-interested enterprises, the price is said to be determined by market. The transaction is called arm’s length or uncontrolled because the enterprises are trying to maximize their respective interests. Not all prices are determined by the market. When the price of goods or services is set by negotiations between related enterprises, the price is the intercompany transfer price. The transfer price may be the market price or it may reflect other interest of the related group. The transaction is called controlled because enterprises have the opportunity to maximize the collective interests of the enterprise group, as well as their own. Tax avoidance is always one of those interests. Government has two choices for taxing controlled transactions. They can treat controlled transactions as if they were market transactions, or they can choose not to tax controlled transactions at all.\textsuperscript{129} If a government does not controlled the transactions, they usually treat controlled enterprise groups as a single business unit for tax purposes\textsuperscript{130} the first alternative is the arm’s length principle and the second is the unitary approach. The arm’s length principle imposes a comparable

\textsuperscript{128} \textit{Ibid.}, p. 313(In Canada United Kingdom and India income taxes are classified as direct taxes)
\textsuperscript{130} \textit{ILSA Journal of International & comparative Law} (1995) p. 286
market price on controlled transactions.\textsuperscript{131} Conversely the unitary approach does not try to achieve comparability among transactions. It uses a formula apportion income between controlled enterprises.\textsuperscript{132}

The rapid globalization of the Indian economy has seen the entry of the multinationals into India and with it increasingly complex international transactions being entered into by the entities. The multinational corporations may have business transactions with its associated enterprises situated in several other countries having similar or different tax systems. The \textit{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. This may adversely affect the tax base of a country having higher rate taxation to the advantage of another country having lower tax rates. In local group companies concern profit of a group can be shifted to a low tax rate or tax exempted associated companies.}

The regulations dealing with transfer pricing govern the parameters for determining transfer prices of tangible and intangible property transferred to associated enterprises and incorporate provisions for preventing revenue loss arising from shifting profits from one tax jurisdictions to another or among the group of companies. They deal with allocation of income earned within corporate groups of firms operating in different tax jurisdictions or group of companies in some jurisdictions where tax rates are not uniform. As a result many countries have been introducing anti-avoidance legislation to counteract tax avoidance by over or under pricing of goods and services.

The issue concerning transfer pricing are of importance to all countries, because of their impact on tax revenues and importance in the economic activities. When enterprises of a group have business activities 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 etc. They can also employ methods to minimize their tax liability, by shifting their profit base, from high to low tax


\textsuperscript{132} \textit{Ibid.}, p. 206
jurisdictions or associated company in the same jurisdiction which pays low tax rates or enjoying tax holidays or exemption. As these enterprises generate substantial taxable income outside their home county, they are concerned of prevailing transfer pricing regulations. Every country wants to preserve its rights to tax the profits that can reasonably be considered to arise within the territory. The transfer pricing legislation tries to address this issue and incorporates provisions which provide a fair basis of computing Arm’s length prices.

4.01.1 Definition, Concept and Meaning of Arm’s Length Principle

On the happening of events of backdropping of separate accounting (SA) which was accepted by the OECD as the method of allocating the profits to permanent establishments, there appears to be international consensus on using the Arm’s length principle (ALP) for allocation of income derived from such related-party (subsidiaries, branches etc) transactions. A simple scenario which arm’s length principle attempts to provide a solution as under133. For Example: a corporation manufactures products in country “A” and sells the finished products in country “B” (via its Subsidiary “S”) to unrelated parties (say, the public at large) in such a case “S”’s taxable profit is determined by the three factors:

a. Price at which it resells products to the unrelated parties;

b. Price at which the products were obtained from its parent corporation;

c. Its expenses other than cost of goods sold.

Now if country “A” where the products are manufactured has a tax rate much lower than “B”’s tax rate where the products are sold to unrelated parties, then the corporation would try to book as much profit as possible in country “A” and towards this show a very low sale value of products to country “B”. If the tax rate were higher in “A” than in “B” then the corporation would show a very high sale value and concentrate almost the entire profit in the hands of the manufacturer (country “A”).

The meaning of the same is when independent enterprises deal with each other, their financial relations are usually determined by market forces. When associated enterprises deal with each other, their financial relations may not be

directly affected by market forces but other considerations. Towards this the ALP seeks to determine whether the transactions between related taxpayers reflect their true tax liability by comparing them to similar transactions between unrelated taxpayers at arm’s length\(^{134}\).

The primary norm involving transfer pricing is arm’s length principle, which refers to that the transfer price should be based on the price that two unrelated parties negotiate for the identical or similar product traded on the active market\(^{135}\).

The term Arm’s length principle is generally based on the prices or margins obtained by arm’s length parties engaged in the same or similar transactions. In order for such price or margin comparisons to be useful, the economically relevant characteristics of the transactions being compared must be sufficiently similar so as to permit reasonably accurate adjustments to be made for any differences in such characteristics. In the international arena given that there are widely varying rate of taxation, this leads to tax avoidance practices and the ALP (via the transfer pricing methods) has been till date, the main weapon in the fight to prevent tax avoidance by MNEs\(^{136}\). Strictly speaking Arm’s length principle is accepted international transfer pricing standard by OECD member countries for taxation purposes of MNEs (Multinational Enterprises).

In general the term Transfer pricing has a common meaning “Keeping it at arm's length” or to stretch the arms to the length where it meets.

According to Black’s Law Dictionary arm’s length transaction means “a transaction negotiated by unrelated parties each acting in his or her own self-interest or a transaction in good faith in the ordinary course of business by parties with independent interests”. This concept is based on the tax principle that is recognized in most countries and applied to related party transactions. In other words ‘it is a transaction between persons or entities which are not influenced by any special relationship and are acting on terms and conditions as prevailing between independent parties\(^{137}\).

\(^{134}\) Reuven S. Avi-Yonah, op.cit., p. 3


\(^{136}\) Ibid., p.3

The “arm’s-length principle” of transfer pricing states that the amount charged by one related party to another for a given product must be the same as if the parties were not related. An arm’s-length price for a transaction is therefore what the price of that transaction would be on the open market. For commodities, determining the arm’s length price can sometimes be as simple a matter as looming up comparable pricing from non-related party transactions, but when dealing with proprietary goods and services or intangibles, arriving at an arm’s length price can be a much more complicated matter.

As per OECD Guidelines\textsuperscript{138} “when the transfer pricing does not reflect market forces and the arm’s length principle, the tax liabilities of the associated enterprises and tax revenues of the host countries could be distorted. Therefore the OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that arm’s length principle is satisfied”. This principle is sound in theory since it provides the closest approximations to the workings of the open market in cases where property is transferred or services are rendered between associated enterprises. Arm’s length rule provides a parity of tax treatment for transactions between related parties\textit{inter se}, and transactions between unrelated parties, and puts them on an equal footing for tax purposes. The objective is to allow each tax jurisdictions to bring to tax the profit attributable to the business carried on in that country and prevent shifting of profits to favorable tax jurisdictions\textsuperscript{139}. In ReHaines Barnsdall vs. FCT\textsuperscript{140} the court observed that the term “at arm’s length” was developed in law with respect to transactions between persons, one of whom, such as a trustee or solicitor, is in a position of special influence with respect to the other, a beneficiary or client” Arm’s length standard implies that where the market prices are not reflected in prices set by related parties, the tax authorities should have the power to adjust profits so that they represent an arm’s length result.

\textsuperscript{138} Ibid., p. 77
\textsuperscript{139} Ibid., p. 78
\textsuperscript{140} (1988)19 ATR 1352
In Robson Leather Company Ltd v Minister for National Revenue\textsuperscript{141}, the Canadian Court held that parties will be regarded as not dealing at arm’s length if they are effectively controlled from the same source or the same person.

The Arm’s length principle has been found to work effectively in a majority of cases, but may occasionally be difficult and complicated to apply. OECD member countries regard the ‘separate entity’ approach as the most reasonable means for minimizing the risk of double taxation. This approach is a combination of two traditional tax systems the residence-based tax system, and the source-based tax system. In a source based tax system a country includes within its tax base all income arising within its tax jurisdiction, regardless of the residence of the taxpayer. In a residence based tax system, a country includes in its tax base, income which could include income from outside the resident’s country in that jurisdictions. As per the separate entity approach adopted by the OECD, each individual group member is subject to tax on the income arising to it on a residence or source basis\textsuperscript{142}. The following aspects need special consideration for application of arm’s length standard.

1. Characteristics of the property or service.
2. Functions performed and risks assumed by the parties.
3. Markets in which transactions take place and

The pricing methods are based on this principle compare the conditions determining transaction between associated enterprises with those determining the similar transactions between independent parties. To apply this rule it is necessary to identify comparable uncontrolled transactions under conditions similar to those determining the transactions under considerations. The OECD guidelines provide for applying the arm’s-length principle\textsuperscript{143}. These guidelines which we outline below provide a good understanding on how OECD expects the separate accounting principles are to be applied to arrive at an arm’s length price for cross-border transactions. The guidance for applying the arm’s length principle is as follows:

\textsuperscript{141} (1977) 77 DTC 5106
1. Principles of Comparability.
2. Functional analysis (functions assets and risks analysis-FAR)
3. Contractual terms
4. Economic circumstances
5. Business strategies
6. Recognition of actual transactions undertaken
7. Evaluation of separate and combined transactions
8. Use of arm’s length range
9. Use of multiple year data
10. Losses
11. Effect of government policies.
14. Use of Transfer pricing methods

4.01.2 Arm’s Length Standard

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result). However, because identical transactions can rarely be located, whether a transaction produces an arm’s length results generally will be determined by reference to the results of comparable transactions under comparable circumstances.

4.01.3 Principles of comparability

The first factors that determines the determination of Arms length price is principles of comparability. The same has been explained in details under the heading CUP methods is equally applicable for the traditional methods like Resale price method and Cost plus method and the same is useful in application of profit based methods. The detailed observations on the principles of comparability is made in the Chapter 5 and Chapter 6 of this thesis.
4.01.4 Reasons for examining comparability

Although the arm’s length principle is reasonably sound in theory it has certain practical limitation. Difficulties can arise particularly for transactions involving specialized goods and services or unique intangibles, or where associated enterprises enter into transactions which independent parties would not undertake.

The application of the arm’s length principle is generally based on a comparison of the conditions in controlled transactions with the conditions in transaction between independent enterprises. Where such transactions are not identical, similar transactions need to be considered. The usefulness of the comparison depends on the economically relevant characteristics of the situation being sufficiently comparable. This requires that none of the conditions between the situations being compared could materially affect the conditions being examined in methodology or that reasonably accurate adjustments can be made to accommodate such differences.

It is important to recognize that arm’s length principle is far from science and often a range of data will need to be used. OECD guidelines indicate that a number of general factors should be taken into account in analyzing each case.

4.01.5. Position in India

As per the Indian Income Tax Act, 1961 Transfer pricing rules laid down the following criteria to decide on the comparability of transactions.

1. Characteristics of the property transferred or services provided functions performed taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions.
2. Contractual terms.
3. Conditions prevailing in the market place.
4. Geographical location and size of the markets.
5. Laws and government orders in force.
6. Level of competition.
7. Nature of markets whether wholesale or retail.

144. Mukeshbutani op cit., p.254
4.01.6 **Characteristics of property transferred or services provided**

The comparison of these features is important to identify the comparables. It is important to identify the following characteristics in evaluating the comparables of product or services:

1. Transfer of Intangible property
2. Physical features of the property
3. Quality and reliability
4. Availability
5. Volume of supply
6. Form of transaction more for transfer of intangibles
7. Duration
8. Degree of protection
9. Nature of services (in case if it is provision of services)

4.01.7 **Definition Arm’s Length Price**

Arm’s length price means the price, which is paid by a willing buyer to a willing seller, if the transactions had taken place in open market conditions. The price is influenced by open market conditions and reflects the price that would be charged in uncontrolled transactions between parties.

The crucial test is that transfer price should not be influenced by special relationship between parties: and the price determined is the price which is applied or proposed to be applied in uncontrolled transactions in comparable circumstances. It is therefore the price charged between persons other than associated enterprises in uncontrolled conditions for same or similar transactions.

Section 92F (ii) of the Indian Income Tax Act, 1961 defines it as a “a price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions” .The transaction between associated enterprises is usually governed by arm’s length principle and therefore price determined under this principle is called arm’s length price. It is price which is

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ordinarily determined by market forces and would be charged in transactions between independent enterprises that deal with each other.

In practice the determination of arm’s length price is not easy as it may require the identification of comparable transactions between unrelated entities and their application to transactions between associated enterprises.

**4.01.8 Determination of Arm’s Length Price**

The choice of a particular method for determining arm’s length price depends upon many factors like extent of comparability between controlled and uncontrolled transaction, quality reliability of data complexity of transaction number of adjustment and magnitude and accuracy of adjustment. Apart from this the following factors are generally taken into consideration for choosing a particular transfer pricing method.

1. The nature of the activities being examined
2. The availability coverage, and reliability of the data
3. The degree of comparability existing between the controlled and uncontrolled dealings and the nature and extent of any assumptions

**4.01.9 Article 9 of OECD Model Convention** (Appendix –I)

Article 9 of OECD model convention reads as under;

“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”

The use of words “but for” in Article 9 implies improper accrual of profits and existence of conditions other than that of independent enterprise in the economic and financial relations of associated enterprises. When transfer pricing does not reflect the arm’s length principle, there can be distortion in tax liabilities of the associated enterprises and tax revenues of the host countries.

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146. Wahi V S *op.cit.* pp. 81
4.01.10OECD Guidelines$^{147}$

The OECD member countries are of the view that for tax purposes the profits of associated enterprises can require some adjustment to correct any distortions and thereby ensure that the arm’s length principle is satisfied. The guidelines do not endorse alternative approach of unitary or global methods, for determination of arm’s length profits where no other satisfactory method of arriving arm’s length price can be found. Transfer pricing methods compare conditions determining transaction between associated enterprises with those determining the similar transaction between independent parties. The application of the arm’s length principle it is essential to identify comparable uncontrolled transaction under conditions similar to those determining the transactions under considerations. Multinational enterprises and their advisors cannot afford to ignore the OECD Transfer pricing Guidelines. Most OECD member countries, including major international traders such as the United Kingdom, have never issued detailed transfer pricing regulations. In those countries the Guidelines may serve as de factor local transfer pricing regulations. Even when a member country has issued detailed regulations, the Guidelines will serve as the common point of reference for negotiations with the competent authorities of tax treaty partners over the proper allocation of taxable income from cross border transactions. The impact of the OECD Guidelines is not limited to OECD member countries: the OECD has a program that encourages non member countries to adhere to the Guidelines$^{148}$. There are no binding force it is only a recommendatory body on the fiscal terms.

Most tax jurisdictions and international tax agreements adopt the arm’s length principle; a taxation concept referring to dealings between unrelated parties which are completely independent of one another$^{149}$. Tax authorities are often given the power of adjusting prices paid in respect of business transacted between affiliated parties to arm’s length prices, or prices that independent parties would have agreed upon in the same circumstances. The object of tax treaties had been to remove tax barriers in the international flow of trade, investments, or the transmission of technical knowledge.

147 Wahi V S Ibid., p. 82
149 Originally section 482 of the United States legislation e.i., Internal Revenue Code which established the foundation for the arm’s length principle as the touchstone for intercompany transfer pricing under the US tax rules. It was enacted in 1923 (as section 45 under the law then in effect)
However technical tax problems and the various mechanisms for avoiding double taxation were not the only important issues to be settled in treaty negotiations. They could not be considered an end in themselves but must be seen also as instrument for promoting the more rapid development of the economics of developing countries. This goal clearly was in the best interests of the industrial countries also. The history of tax treaties had shown that they were formulated in the light of various monetary, fiscal social and other policies important to the contracting countries. The observations of U.N. in its report on tax treaties between developed and developing countries (1969) it reveals the fact that there are no set rules and regulations in the Tax treaties between the two countries and some variations can be found on the issues like interpretation of treaties, classification and assignment rules like Business income, personal services income investment personal services income, Mutual agreement procedure exchange of information and tax sparings. In general each country is sovereign in fiscal matters the legislature in each country can revise its own view and amend the existing enactments. A double tax avoidance or relief treaty with other countries cannot afford protection against any subsequent change of law. There is no consensus on this legal issue. The principle of LexFori implies that each state qualifies the agreement terms according to the requirement of its own domestic law. In view of the above it is observed that there is no international uniformity in the interpretation of issues arising in the tax treaties. The Andhra Pradesh High court quoted the wordings of Lord Radcliffe in a case Ostinev Australian Mutual Provident Fund Society affirmed that the standard OECD and U N Models, which are being used in various countries there is need for developing ‘international tax language’ and international tax law and emphasized the maintenance of uniformity in the interpretation of a rule is as important the initial removal of divergences. Tax agreements between the countries are based on understanding and co-operation, there cannot be any precise definition, binding on the Nations. Normally tax treaty between two countries cover (a) persons (b) taxes (c) territory and (d) time. The treaty generally applies to residents of the contracting state. Each country retains the power to tax its citizens and residents on their world income (Status jurisdiction) taxes other (non citizens) (non-residents)only on their income in the country(Source Jurisdiction).

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151 Ibid., p. 49
152 Ibid., p. 49 - the case law is Commissioner of Income Tax v Vishakhapatnam Port Trust (1983) 144 ITR p .146
The treaty provisions protect the taxpayer from suffering double taxation on the same income. But the OECD has done extensive research on the issue of Transfer pricing for the benefit of the MNEs and the Governments. The arm’s length principle can find easier application in transactions involving real or tangible property for which precise or at least conventional valuations can be established. The factors important for comparison of controlled and uncontrolled transactions are:

(a) Nature of the property or services transferred: this is very important for purpose of determining the comparability of controlled and uncontrolled transactions. In transactions relating to supply of goods it is useful to consider the physical features of property, quality, reliability, quantity and volume of supply. In case of provision of services the nature and extent of services is important. In cases of intangible the form of transaction, type of property and anticipated benefits from the use of property is relevant criteria.

(b) Functions performed and risks assumed by the parties here the principal functions performed by each party are examined and adjustments are made for any material differences from the functions undertaken by independent enterprises with which the comparison is made. Analysis made here is not complete unless the material risks assumed by each party are also considered and taken into consideration for comparability of transactions.

(c) Contractual terms: this contractual terms and conditions can be referred from written contracts or correspondence between parties. When terms and conditions are not put in writing this can be deducted from conduct of the parties. Functional analysis is required if there is divergence in terms and conditions of contract between the independent enterprises and associated enterprise.

(d) Economic circumstances: Arm’s length prices can differ in transactions involving same property or services due to economic circumstances which include markets in which independent and associated enterprises operate. In case there are differences due to market conditions the adjustments for such differences may be necessary to determine arm’s length prices.

(e) Business strategies: Business strategies such as development of new product, degree of diversification, risk aversion etc has bearing on conduct of the business and affect the comparability of transactions. These strategies also include market
penetration schemes where lower price may be charged as a strategy to capture a share of market. For comparing the controlled and uncontrolled consideration regard must be given to the strategies adopted by different parties.

(f) Government policies: The government interventions such as price control subsidies, antidumping duties and exchange controls may have bearing on the price attached to an uncontrolled transaction and should be taken into considerations.

4.01.11. Differences between Arm’s length principle and Arm’s length price

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<th>Arm’s length price</th>
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<td>Under Section 92A of Income Tax Act, 1961 Arm’s length price is defined to mean a price which is applied in a transaction between persons other than associated enterprises in uncontrolled conditions. Arm’s length price under the Indian regulations seeks to determine the price in uncontrolled conditions. under the Indian regulations</td>
<td>Article 9 of the OECD Model Tax Convention defines Arm’s length principle as “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 not so accrued may be included in the profits of that enterprise and taxed accordingly” The OECD guidelines seeks to determine the Arm’s Length principle based on the facts whether the conditions made between the parties would have been made if the parties are independent and not related parties. The OECD guidelines do not merely stop with the determination of price but also seeks to examine whether the conditions made between the parties would have made if the parties are not independent.</td>
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4.01.12 Procedure for Computing Arm’s Length Price

Section 92C of Income tax Act 1961 of India deals with the procedure for computing arm’s length price in relation to an international transaction or specified domestic transaction. The selection of most appropriate method should be made having regard to the nature of transaction or class of transaction or class of associated enterprise of functions performed by the enterprise or other relevant factors. The choice of specific method in practice depends upon various factors such as extent of comparability between controlled and uncontrolled transaction etc.,
Section 92C(1)(f) of Income Tax Act 1961: The Arm’s length price in relation to an international transaction for specified domestic 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;

1. Comparable uncontrolled price method;
2. Resale price method;
3. Cost plus method;
4. Profit split method;
5. Transactional net margin method;
6. Such other method as may be prescribed by the Board

The most appropriate method referred to in sub section (1) 92 (c) of Income Tax Act, 1961, 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.\footnote{Substituted by the Indian Finance (no2) Act, 2009}

Section 92C (1) of Income Tax Act 1961 provides different methods for computation of arm’s length price. The assessee may select any one of the prescribed methods for determining arm’s length price of international transaction or specified domestic transaction. The law does not lay down any order of priority for selection of transfer pricing method and hence depending upon the nature or class of transaction or class of associated persons or functions performed the assessee can select any one of the prescribed methods as most appropriate method. The Board (Central Board of Direct Taxes) is vested with power that allows taxpayers to prescribe any other method if considered necessary.

Many countries have provision that allows taxpayers to adopt the ‘residuary method’ where it is not feasible to apply any one of the specified method because
transaction is of unique nature or for other reasons. In India the Board has not prescribed the sixth method even though the provision existed on the statute. The taxpayer also had been demanding for the choice of the other method particularly for transaction where traditional transaction methods or profit methods failed to apply. Considering the difficulty of taxpayers the Board vide notification issued on 23.05.2012 has allowed the use of the ‘other method’ for determining the arm’s length price subject to prescribed conditions

India follows principle of most appropriate method for determination of arm’s length price.

4.01.13 most appropriate method for determination of arm’s length price:

India follows principle of most appropriate method for determination of arm’s length price. As per Rule 10C the most appropriate method is the method, which is best, suited to the facts and circumstances of each particular international transaction, which provides the most reliable measure of an arm’s length price in relation to the

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154. Wahi V S op cit., p. 97—Section 92C(1) of Income Tax Act, 1961 provides different methods for computation of arm’s length price. The assessee may select any one of the prescribed methods for determining arm’s length price of international transaction or specified domestic transaction. The law does not lay down any order of priority for selection of transfer pricing method and hence depending upon the nature or class off transaction or class of associated persons or functions performed the assessee can select any one of the prescribed methods as most appropriate method. The methods prescribed for the purpose are comparable uncontroll ed price(CUP); resale price (RPM); Cost plus method(CPM) profit split method(PSM); and Transactional net margin method. The Board is vested with power that allows taxpayers to prescribe any other method if considered necessary. Board of Direct Taxes by way of notification dated 23.05.2012 has now prescribed a new rule 10AB in Income Tax Rules, 1962” whereby the taxpayer has the option to choose any other method as the most appropriate method for determining arm’s length price. The rules prescribes “the other method for determination of arm’s 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 uncontroll ed transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.

155. Income Tax Rules 1962 as amended in 2011 & 2012 Directorate of Income Tax (PR PP & OL) New Delhi p 1.107-1.109-- as per which Rule 10C the taxpayer has the option to choose any other method as the most appropriate method for determining arm’s length price. The rules prescribes “the other method for determination of arm’s 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 uncontroll ed transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. While selecting the most appropriate method as per sub rule (1) the following factors shall be taken into account namely;(a) the nature and class of international transactions(b) the class or classes of associated enterprises entering into transaction and the function performed by them taking into account assets employed risks assumed (c) the availability, coverage reliability of data necessary for application of method (d) the degree of comparability existing between the international transaction and the uncontrolled transaction (e) the extent to which reliable and accurate adjustment can be made to account for difference (f) the nature, extent and reliability of assumptions required to be made in application of a method.
international transaction. The word ‘best suited’ and most reliable measure indicate that the method should be selected after thorough appraisal of all facts and circumstances of the international transaction. Although Rule 10 A (d) refers to particular transaction; the most appropriate method can be selected for group of closely interlinked transactions. Selection of particular method as most appropriate method depends upon nature and class of transaction and availability of data of comparable transactions. The choice of most appropriate method as in the case of *UCB India Pvt Ltd v Assistant Commissioner of Income Tax* 156 here the assessee has demonstrated his selection with supporting records and data. The tax authority at the same time has to consider the specific characteristics of the transactions, functions performed and assets used for examining the choice of the method made by the assessee. In this case the assessee has selected Comparable Uncontrolled Price (CUP) method taking into consideration all the relevant factors relating to quality, contractual terms, level of market etc., the burden was on Revenue to demonstrate why in that case CUP could not be considered as most appropriate method.

4.01.14  **Best method rule of USA**

USA follows the Best method rule for determining the arm’s length price compared to most appropriate method rule accepted in India. Best method rule helps taxpayer and the IRS to choose from various methods the one which provides the most accurate measure of an arm’s length result. This best method rules tries to avoid rigid approach of the priority of methods and suggests the method which is considered best in the facts of a case for an arm’s length result. Once a taxpayer has selected the best method, the IRS can review the selection and can ask the taxpayer to substantiate the selection. Taxpayer is then required to compute the price under each method and choose one method that may provide the most reliable measure of arm’s length result. The factors that required are the degree of comparability between the controlled and uncontrolled transaction; data quality and assumptions made157.

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156  *UCB India P Ltd v Ass CIT (2009) 317 ITR(AT) 292 Mumbai*
157  Wahi V *op.cit.*, p.104
### 4.01.15 Difference between Best Method Rule and Most Appropriate Method

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<th>BEST METHOD RULE (USA)</th>
<th>MOST APPROPRIATE METHOD (INDIA)</th>
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<tr>
<td>It is more rigid</td>
<td>It is less rigid</td>
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<td>Here, the taxpayer has to compute the arm’s length price under each method and then show that method selected by it is the best method for determination of arm’s length price</td>
<td>Here, the taxpayer has choice to select any one of the specified method which in its view provides most reliable measure of an arm’s length price. Here, the emphasis is on reliability of measure of arm’s length price and not on establishing that it is the best method out of various methods prescribed.</td>
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<tr>
<td>In transfer pricing study report the asseesee has to give reasons for choosing a particular method and rejecting other methods prescribed.</td>
<td>In India taxpayer is required to demonstrate that in the facts of the case the method selected is most appropriate method even though it is not the best method.</td>
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<td>The Revised OECD Guidelines, 2010 also recommend the concept of most appropriate method to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm’s length principle.</td>
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### 4.01.16 Shortcoming of Arm’s length principle

The basic shortcomings of applying the arm’s length principle are as under:

1. The principle is inherently weak as it follows separate entity approach and fails to consider special conditions that may exist in contracts between associated enterprises.

2. The practical difficulties in applying this principle are when associated enterprise undertakes transactions which normally are not carried out by independent enterprises. The motive of entering into related party transactions may not always be tax avoidance; but it can be to provide a service or product which is not easily available in open market conditions.

3. This principle may fail to apply to transactions of intangible property because these may not be acceptable to independent enterprises due to fear of degradation.

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158 Paragraph of 2.1 of OECD 2010 Guidelines

of technology that can affect its value. In respect of intangible asset it is also difficult to obtain information of similar comparable transactions due to lack of data or confidentiality factor.\textsuperscript{160}

4. In practicable sense it is not so easy to find instances of comparable uncontrolled transactions because of special conditions that may be imposed. Identification of comparable transaction can also increase the compliance costs for taxpayers.

5. It is very difficult to apply this principle to transactions involving specialized goods and services.

6. This principle cannot be applied to transactions involving sale of unique goods or intangible property such as patents and provision of technical services.

7. The Arm’s length principle as per section 92(3) of IT Act, 1961 is not applicable where computation of income or determination of allowances for expenses or interest has the effect of reducing the income or increasing the loss of the assessee.

\textbf{4.01.17. Arithmetic Mean}

The concept of arithmetic mean is unique to Indian transfer pricing regulations as it averages comparable prices and gives single price under a particular method. The averaging is not followed when different prices are obtained under various methods. As against this the rules do not provide for the concept of arm’s length range, though CBDT circular clarifies that no adjustment would be called for when the variation in arm’s length price is around 5\% the first proviso to \textbf{section 92C(2) of Income Tax Act 1961} provides that where more than one price is determined by most appropriate method the arithmetic mean of such prices shall be the arm’s length price. The arithmetic mean can be applied only for specific method selected by assessee and not as mean of prices under various methods considered for analysis. Where it is difficult to find exact comparable of price or margins of transactions appropriate adjustments may be considered necessary to establish that price is within permissible range. This arithmetic mean was criticized on various angles like Transfer pricing is not a science but an art that has to be applied considering various factors. The concept of Arithmetic mean is influenced by extreme figures which may be very high or low and therefore not a good statistical tool. The audit of Transfer price shows that Revenue

\textsuperscript{160} Wahi V S \textit{op.cit.,} pp. 83-84
in most cases tries to rely on comparables which usually are on the higher side and thus adversely influence determination of arm’s length price the Finance Act 2012 has been amended (Indian Income Tax Act 1961)

The second proviso to section 92C(2) of Income Tax Act, 1961 confers power on the Central Government to notify limit of percentage as not exceeding three percent of the latter in case of variation between the arm’s length price so determined and the price at which the international transaction has actually been undertaken. This amendment would come into effect from 1.4.2013. The tolerance band of five percent for determination of arm’s length price shall not be available as a standard deduction. Accordingly, the newly inserted clause (2A) the benefit of standard deduction of five percent of arithmetic mean cannot be claimed at the option of the assessee in a case where first proviso is applicable.

4.01.18. Arm’s length Range

Many countries follow the concept of ‘arm’s length range’. If it is not possible to apply the arm’ length principle to arrive at a single figure. There can be situations when application of most appropriate method produces a range of figures all of which are equally reliable. Differences in figures that comprise the range may be caused by the fact that in general the application of the arm’s length principle only produces an approximation of conditions that would have been established between independent enterprises. Therefore, transfer-pricing rules of many countries provide for use of arm’s length range and do not permit adjustment of income if differences in prices are within range. OECD guidelines recommends that if the relevant conditions of the controlled transaction fall outside the range, the tax payer should be allowed the opportunity to present his case and satisfy the authorities that conditions of the transactions are in accordance with the arm’s length principle.

Indian Regulations follow the concept of arithmetic mean to account for differences in prices rather than arm’s length range. The CBDT realizing some difficulties in application of the rules in initial years of enactment permitted some variance or range in a limited manner. The CBDT vide in its circular No 12 of 2001 provides that the Assessing Officer shall not make any adjustment to the transfer price of international transaction if the price fixed was within tolerance range of 5% of the arm’s length price determined by the Assessing Officer. The Union Budget for 2014-
15 proposed the introduction of the “Range concept” for the determination of the Arm’s length price (ALP). To be in line with the best global practices, the ‘range concept’ for determination of ALP and arithmetic mean concept will continue to apply as per the Union Budget 2014-15

4.01.19. SafeHarbours

It means tax authorities have agreed to surrender a portion of their discretionary power in favor of automatic rules. The rules provide a hedge to taxpayers from penal actions if the claims fall within safe harbor. The objective is to provide administrative convenience to the taxpayers as well as to tax administrations in complying with tax laws. These rules prescribe the circumstances in which the tax authorities would have to accept transfer prices if they fall in prescribed range and fulfill the conditions specified. Under safe harbor the rule the assessee may not be required to follow a specific pricing method, or even have a pricing method for tax purposes.

4.01.20. Current year Data

It means the data relating to the financial year in which the international transaction has been entered into. According to Rule 10B(4) of Income Tax Rules 1962 for analyzing comparability of an uncontrolled transaction with an international transaction the data of current year is relevant. An assessee entering into an international transaction is required to maintain and keep documentation before the due date of filing return of income. It is obligatory for taxpayer to take into account data of relevant previous year for comparison of controlled transaction with uncontrolled transaction. The main idea of using the current year data is such data rules out the effect of any difference in economic and market conditions prevailing at different time period held in *M/s Symantec Software Solutions Pvt Ltd v. ACIT*\(^{161}\) . When the current year data was not available to the assessee at the time of transfer pricing study report; even though such data existed in public domain, the assessee cannot insist using multiyear data.

\(^{161}\) ITA No. 7894/MUM/2010 cited by Wahi V.S *op.cit.*, p.112.
4.01.21. Multiple year data

Indian regulations do not permit the assessee to use multiple year data except in circumstances provided in proviso to rule 10B (4) of Income Tax Rules 1962. The proviso to rule 10B (4) of IT Rules 1962 (as amended in year 2012) read as under:

“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 influence on determination of transfer prices in relation to the transactions being compared”

According to sub-rule 4 of rule 10B multiple year data of not more than two years, can be used only in limited cases, if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared. General rule of comparability is that only relevant financial year data which is contemporaneous data can be used. The proviso carves out an exception to general rule that applies only in specified conditions. Thus multiple year data is permitted when prescribed conditions to use data of more than one year are fulfilled. In the case of Aztec Software & Technology Services Ltd v. ACIT it was held that “where the assessee does not bring any material on record to suggest that there were circumstances to apply multiple year data, the assessee cannot use the data of previous two years. In the case of Skoda Auto India (p)Ltd v. m it was ACIT, the issue where the assessee pressed upon the necessity to use three year data for the purpose of making meaningful comparison so as to neutralize the impact of cyclic fluctuations of different product cycles. Tribunal while remitting the matter to the Transfer pricing officer, observed that relevance of multiple year data hinges on relevance of product cycle theory advanced by the assessee as having considerable impact on operating profit margins and that one year results being viewed in isolation would lead to absurd results. Indian Union Budget for 2014-2015 proposed the introduction of multiple year data for comparability analysis by taxpayers. As comparable information is a crucial element for defending transfer price in India.

162 (2007) 294 ITR 32 Bang
163 (2009) 30 SOT 319; 122 TTJ (Pune)699
4.02  Application of arm’s length principle and its valuation in USA

USA has extensive and well-defined transfer pricing regulations. The focus on transfer pricing issues increased after 1986 when a comprehensive study of intercompany transfer pricing policies was undertaken by the internal Revenue Service to consider whether the regulations needed modifications. 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 results that would have been realized if uncontrolled taxpayer 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.

4.02.1 Arm’s length Range in USA

The law accepts the principle of arm’s length range as per which no adjustment will be made to transfer pricing results obtained by taxpayer if these are within arm’s length range derived from two or more comparable transactions entered into with uncontrolled taxpayers. Where each comparable transaction meets high degree of comparability the range will be based on all the comparables. On the other hand if the comparables used are not exact the range will be based on the comparables falling between the 25th and 75th percentile. When the results are outside arm’s length range the adjustment required would be to any point in that range which is median of range.

4.02.2 Criteria for Arm’s length Transaction in USA

Revenue authorities in USA determine whether arm’s length price was reasonable or not from all the facts and circumstances of a case. For this purpose it may take into consideration the degree of comparability between the controlled and uncontrolled transaction, data quality, critical assumptions and number and accuracy of the adjustment required under each method. These comparability includes analysis of functions performed risks assumed, contractual terms, and characteristics of the property transferred or the services provided. The rules contain guidance for evaluating the comparability of uncontrolled to controlled transactions. Degree of similarity and adjustments that may be required for a transaction to be considered
comparable is prescribed. Reasonably accurate adjustments are made to the uncontrolled comparable, to take into account material differences between the controlled and uncontrolled transactions provided such adjustments will improve the reliability of the results under a particular method. The tax authority would consider whether the taxpayer reasonably relied on an analysis performed by a professional who is qualified to conduct such an analysis. Also transfer pricing regulations provide rules relating to issue of set-offs for non-arm’s length transaction within the controlled group. Sn 1.482-2 through 1.482-6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm’s length standard, and if they do not, to determine the arm’s length result. The methods listed in Section 1.482-2 apply to different types of transactions, such as transfers of property, services, loans or advances, and rentals. Accordingly the method or methods most appropriate to the calculation of arm’s length results for controlled transactions must be selected, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm’s length result. But section 1.482-1(f)(2)(i) deals with aggregation of transactions

4.03. Application of arm’s length principle and its valuation in UK

Transfer pricing rules in UK form part of schedule 28AA and Section 770A of the Corporation Taxes Act, 1988. After enactments of the Finance Act, 1988 and amendment of income-tax statute several changes had been made in the rules. The current rules effective from 1st April 2010. In UK after introduction of self assessment procedure the taxpayers are required to self assess their transfer pricing compliance with filing of tax return. Taxpayers must identify their transactions with related parties and if required make pricing adjustment at the time of submitting tax returns. Adjustments to price or income are needed if they result in increased taxable profits in UK though in reverse situation it is not permitted. The new rules provide

164. Greenback Allan London published in the Daily NNA UK March 2008 the web: [www.greenback.alan.cl.uk](http://www.greenback.alan.cl.uk) accessed on 09.02.2015 at 3.00AM - according to which from 1st April 2004 the UK’s transfer pricing legislation also applies to transactions between commonly controlled UK entities. The legislation was framed in a way that explicitly identified it with Article 9 of the OECD model treaty and the OECD Transfer pricing Guidelines—the legislation, framed in accordance with the OECD Guidelines, adopts the arm’s length standard, the internationally
self assessment procedures to comply transfer pricing rules. Taxpayers are required to assess themselves their compliance with arm’s length principle at the time of filing tax return. Onus of compliance having shifted on taxpayers; the companies are forced to pay more attention to transfer pricing methods and documentation. The earlier law provided exemption from transfer pricing rules for UK to UK transactions subject to certain restrictions were withdrawn from 1rst April 2004 and implemented new legislation. Now, in UK transaction the disadvantaged person can get transfer pricing adjustments by way of compensating adjustment provision.

In UK the transfer pricing guidelines are in consonance with the OECD transfer pricing Guidelines. Prior to introduction of new legislation taxpayers are under no obligation to apply the arms length standard in income-tax returns. This places UK tax at risk and it is unfair to majority of the taxpayers who take care to apply the arms length principle in setting prices and returning profits. this result a lot of inconvenience to the taxpayers resulted the change in transfer pricing legislation. The key reasons for change in the Transfer pricing legislation is as under165;

1. Increased globalization of international trade and commerce and increasing concentration of international economic activity.

2. Respond to the general modernization of transfer pricing legislation throughout the developed world.

3. Reinforce UK commitment to the arm’s length principle on which there is international consensus as expressed in the Article 9 and the OECD guidelines.

4. Encourage voluntary compliance by enabling taxpayers to self assess their profits taking transfer price rules into account.

accepted standard for setting transfer prices. This standard states that related entities should set prices on transfers to be the equivalent to that which would be charged if they were independent, i.e., not connected parties dealing with one another on an arm’s length basis. The UK’s tax legislation therefore imposes arm’s length transfer pricing on transactions with connected overseas entities. Similar transfer pricing regulations also operate in most countries to protect each jurisdictions tax base. Since 1rst April 2004 most small and medium sized entities no longer have to apply UK transfer pricing principles in dealings with connected overseas entities located in tax treaty countries. (prior to 1rst April 2004 transactions between connected UK entities were not subject to the arm’s length transfer pricing regulations, unless one of the entities carried on their trade using an overseas branch)

5. Ensure fairness between the taxpayer the requirement to apply the arm’s length principle

This resulted introduction of new Transfer pricing regulations and the main aim is to encourage voluntary compliance by the taxpayer and also to protect the UK tax base in an international context. While formulating the approach the UK Government is committed to the arm’s length principle expressed in OECD guidelines under Article 9(1). The new legislation Para 2 to Schedule 28AA clearly provides that to determine arm’s length price the OECD transfer pricing guidelines are required to be followed. The legislation does not consider various methods to be followed like legislation in other countries. The definition of Transfer pricing guidelines refers to all the documents published by the OECD after 1st May 1988.

4.04. Application of arm’s length principle and its valuation in Australia

The Fundamental approach of Australia to Transfer pricing regulations is based on the principle of “Arms length”. Australia’s Transfer pricing rules do not prescribe any particular methodology or preference for the order in which methodologies might be applied to arrive at an arm’s length outcome. While applying the transfer pricing regulations, the Australian authorities follow as closely as practicable the OECD guidelines on Transfer pricing. Australian Transfer pricing rules considers the Arm’s length Principle as the statutory test in the application of Transfer pricing regulations. Division 13 of the Income Tax Assessment Act incorporates the arms length principle in paragraph 136AA (3) (c) (d) and subsection 136 AD (1) to (4) of the Act166.

In Australia, the arms length principle requires a calculation of the taxable income that is expected if the parties were dealing at arm’s length with one another. It does this by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from the interaction of the forces of supply and demand in a comparable open market or from negotiating among comparable independent settings. Australian Tax office (ATO) guidelines use the three views to determine the arms length principle167.

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1. **External view:** the basis for external view found in the requirement to compare the economic conditions and financial relations between the associated enterprises. These conditions might be compared with the conditions that might be prevalent in transactions with independent parties.

2. **Process view:** the basis for process view is to compare the transactions of associated enterprises and that of the independent parties and trying to find out what the independent parties would have done.

3. **Performance view:** the basis for performance view is to ascertain what the independent parties dealing independently would have done and the profit accrued to them if the conditions are similar.

The Guidance on the Arms length principle suggests that the arms length consideration between the associated enterprises be established on the following basis;

1. Prices paid, margins achieved, income splits agreed to;
2. Consideration under the comparable circumstances;
3. Nature of bargaining that took place between the parties;

In the Australian taxation the concept of Arm’s length consideration means the consideration that might reasonably be expected to have been received in respect of supply, if the property has been supplied under an agreement between independent parties. Where no consideration is received or receivable and revenue is of the view that provision of **Section 136 AD (2) of Australian Taxation** is applicable then deeming provision would apply the taxpayer is deemed to have received the arm’s length consideration for supply of goods or services.

In determining the arm’s length consideration the tax office takes in to account the surrounding circumstances. For example, if a company breaks into market by under-cutting its competitors or has surplus stocks which it wants to dispose of by selling them at below market price these factors are important to determine arm’s length price. The arm’s length consideration may not always be the current market price. Sometime fixed price may be accepted as arm’s length price. However transfer
price adjustment can be made in case of long term supply contract, if price fixed is contrived as on arm’s length basis.

4.05 Application of arm’s length principle and its valuation in India

Arm’s length principle is governing principle to determine arm’s length nature of transactions. The principle follows the approach of using prices of uncontrolled transactions under normal market conditions for computing appropriate transfer price for transactions between related parties. The principle applies to cross border transactions between related parties where an attempt is made to determine a price that would be obtainable had the transaction taken place between independent parties in uncontrolled conditions. It is based on the premise that market forces are the best way to allocate profits. The general approach is to treat associated enterprise as independent enterprise rather than a single entity. Multinational enterprises in this way are able to allocate their income to group entities which reflect economic realities of controlled transactions.

According to the OECD guidelines “when transfer pricing does not reflect market forces and the arm’s length principle, the tax liabilities of the associated enterprises and tax revenues of the host countries could be distorted. Therefore OECD member countries have agreed that for tax purposes the profits of associated enterprises may be adjusted as necessary to correct any such distortions and thereby ensure that arm’s length principle is satisfied.\textsuperscript{168}

This principle is sound in theory since it provides the closest approximations to the workings of the open market in cases where property is transferred or services are rendered between associated enterprises.

Section 92F(ii) of the Indian Income Tax Act, 1961 defines the arm’s length price as a price which is applied or proposed to be applied in transaction between persons other than associated enterprises, in uncontrolled conditions. The steps involved in determination of arm’s length price can be summarized as follows:

1. Identification of the “International transaction”
2. Identification of an “uncontrolled transaction”—Rule 10A (a) IT Rules 1962 (as amended in 2012)

\textsuperscript{168}. Paragraph 1.14 of the OECD Guidelines 2010
3. Identification and comparison of specific characteristics embodied in international transaction and uncontrolled transactions—Rule 10B(2)IT Rules 1962 (as amended in year 2012)

4. Finding out whether uncontrolled and international transactions can be compared by reconciling/resolving differences, if any—Rule 10B(3)IT Rules 1962 (as amended in year 2012)

5. Ascertaining the most appropriate method by applying the tests laid down—Rule 10C of IT Rules 1962 (as amended in year 2012)

6. Determination of the arm’s length price by applying the method chosen Rule 10B(1) of IT Rules 1962 (as amended in year 2012)

7. Section 92C (1) of IT Act 1961 stipulates that the arm’s length price is to be determined by adopting any one method.

8. Rule 10C (1) of IT Rules 1962 lays down the general guidelines in the selection of the most appropriate method. The Rule states that the method to be selected shall be the one best suited to the facts and circumstances of each international transaction and that provides the most reliable measure of the arm’s length price.

9. According to the proviso to sub-section (2) of section 92C IT Act 1961 where more than one price may be determined by the most appropriate method. The arm’s length price shall be taken to be the arithmetical mean of such price. Finance Bill, 2002 proposes to provide in such cases an option to the assessee to adopt a price which may vary from the arithmetical mean by an amount not exceeding 5% of such arithmetical mean.

10. Rule 10B (4) of IT Act 1962 provides that the data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into. It also prescribes the data relating to a period of not more than 2 years preceding such financial year may also be considered, if such data reveals facts which could have an influence on the determination of the price in an international transaction. (Pl refer Appendix XV for details)

Section 92 of the Income Tax Act 1961 (ITA) incorporates the arm’s length principle and provides that any income arising from an international transaction shall be computed having regard to arm’s length price. Income arising from the international transactions between associated enterprises must be determined “having regard to” has been explained in cases. The expression means that any process of
decision-making involved must take into consideration all relevant factors. The following cases make a bird’s eye view of the concept of Arm’s length principle in Indian Taxation

1. **Rajesh Kumar and Others vs Deputy Commissioner of Income Tax and others**\(^{169}\): in the said case the Hon’ble Supreme court has taken the note of the word having regard to arm’s length price. As per the section Any income arising from international transactions between associated enterprises must be determined “having regard to” has been explained in several cases the expression means that any process of decision-making involved must take into consideration all relevant factors. The Hon’ble Supreme Court has observed that expression 'having regard to' assumes significance and means that an opinion must be formed strictly in terms of factors enumerated in the provision together with all factors relevant for exercise of that power. The observation of the case implies the importance of the arm’s length price which is essential for determination of the Transfer price factors.

2. **India Cement Ltd vs Union of India**:\(^{170}\) in this case it has been noted that the words “having regard to” Used in a provision do not restrict the consideration only to two matters indicated in the section as it is impossible to arrive at a conclusion as to reasonableness by considering only to two matters mentioned isolated from other factors. It was observed in this the income arising from international transactions governed by transfer pricing rules is required to be computed in accordance with arm’s rule. Because comparable transactions takes into account the conditions of commercial and financial relations independent enterprises which are ordinarily determined by market forces. From the above the deductive method of arriving of logic is the controlled transactions are regarded at arm’s length if prices are determined taking into consideration arm’s length price of such transactions. The transfer price is regarded at arm’s

\(^{169}\) ITR 91 vol.2 (2006)

\(^{170}\) Reported in journal Supreme court cases (1990) 4 SCC p 356 wherein a reference was made with respect to Delhi Farming and Construction Pvt Ltd. Vs CIT (2003) 260 ITR p. 561 it is stated that arm’s length principle also is to be satisfied when determination of income involves allowance for any expense or payment of interest in respect of an international transaction. In other words while computing income from international transaction the principle of arm’s length price is applicable not only to items of income but also to claim for expenses as well as interest deduction. Thus if deduction claimed for expense or interest is more than the arm’s length price of the said item the excess claim will not be allowed.
length if it is computed taking into consideration prices of comparable uncontrolled transactions. The words “having regard to” means irrespective of the contractual terms and conditions prevailing in controlled transactions the price can be ‘arm’s length price’ if it is determined having regard to price of uncontrolled transactions made in similar circumstances.

The word having regard can be understood with the help of the following example;

**Example** When Indian company purchases goods from its overseas parent company the arm’s length price would be the price at which parent company sells similar product to non-associated enterprises or the Indian company purchases similar product from unrelated party. The purchase price will be the Arm’s length price.

**As per sub-section (2) of section 92 of Income Tax Act 1961,** the scope of arm’s length principle is further extended to international transactions where two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or contribution to any cost or expense incurred in connection with a benefit, service or facility provided to one or more of such enterprise. The Income Tax Act, 1961 was further amended by the Finance Act, 2012 the arm’s length principle of section 92 has been extended also to specified domestic transactions defined in the regulations. In certain cases the Government approved prices like Customs department authorities, may be valid prices but the important factor is that price itself is not an evidence for establishment of arm’s length price Section 92(1) of income Tax Act, 1961 provides scope that government always intended that income from international transactions should be computed having regard to arm’s length price both in case of income and allowance for any expense or interest payment. The questions was raised in various issues like when goods and services supplied free of cost whether arm’s length price should be determined even if the buyer did not incur any expenditure for goods or services supplied by the associated enterprise and consideration payable is in nature of deemed payments. In such case it is clear in Section 92 to 92F of the Act arm’s length price involves determination of fair market rate of interest; the courts have consistently taken the view that transactions involving free supply of goods or services are subject to transfer pricing regulations and tax authorities are justified to make adjustments for deemed payments based on market value of the property transferred.
4.06. Conclusions

The concept of Arm’s length principle is a guiding principle for determining transfer prices among the associated enterprises. The principle provides broad parity of tax treatment for multinationals and independent enterprises. It avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. United Nations Model Convention Article 9(1) provides that Arm’s length Principle is the accepted guiding principle in establishing an acceptable transfer price between Associated Enterprises. It is observed that the Arm’s Length Principle by itself is not new: it has its origins in contract law to arrange an equitable agreement that will stand up to legal scrutiny, even though the parties involved may have shared interests. The guidelines do not endorse the unitary or global methods approach though it may be legitimate to have some regard to the total profits of the multinational enterprise where no other satisfactory method of arriving arm’s length price be found. As with matter of application is concerned the principles and guidelines contain discussion on comparability analysis. The reason for examining comparability and factors determining comparability are examined at length. The Arm’s length principle is geographically neutral, as it treats profits from investments in different place in a similar manner. However this claim of neutrality is conditional on consistent rules and administration of the arm’s length principle throughout the jurisdictions in which an international enterprise operates. In the absence of consistent rules and administration, international enterprises may have an incentive to avoid taxation through transfer pricing manipulation. The tax authorities conducting transfer pricing examinations must be acutely aware of the fact that there can be many factors effecting the arm’s length price. These range from government policy and regulations to cash-flows of the entities in the MNE group. In many cases MNEs themselves may have an incentive to set an arm’s length price for their intra-group transaction so as to judge the true performance of their underlying entities.

By and large the concept and understanding of arm’s length principle is the attempt to place transactions, both uncontrolled and controlled on equal terms with respect to the tax advantages (or disadvantages) that they create. The arm’s length principle has been widely accepted and has found its way into most transfer pricing legislation across the world