CHAPTER VI

Transfer Pricing Guidelines framed by the OECD Model Tax Convention/UN Model Convention for Multinational Enterprises and Tax Administrations and its implication on developed and developing countries - An analytical view on the methods/practices followed by the selected countries under reference to India
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6.01 Introduction to the Historical Background of OECD and its Developments

The organization for Economic Co-operation and Development (OECD) is a forum of member countries in which they discuss various issues concerning economic, tax and social policy. It gives advice and assists members in negotiation of agreements and the promotion of legal codes in certain sectors. It also promotes the expansion of the world trade on a multilateral, non-discriminatory basis in accordance with international obligations. The organization was set up in Paris on 14th December, 1960, for promoting policies relating to development of world economy. It has 29 member including Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, New Zealand, Norway, Korea, Spain, Sweden, Switzerland, United Kingdom, and United States. The member countries consult each other so that they can achieve the greatest possible economic growth and social well being for their population. The fiscal affairs committee of the organization has brought out several official reports on certain aspects of international taxation and also published a model double taxation convention known as the OECD Model Treaty. The League of Nations was, very likely, the first global body to deal with problems of international double taxation: the results of which are found in a series of bilateral conventions later on.

6.01.1. 1935 Model Convention

This 1935 Model Convention defined the term “business income” and was the first model treaty to contain specific provision on allocation of profit from one company to an associated company. Though the 1935 Convention was never formally adopted it was of great significance because of the issues it dealt with. 1935 draft adopted the principle of income attributable to a permanent establishment based on separate accounting, interestingly; it provided two more methods namely:

- Empirical method (percentage of turnover for example)
• Fractional apportionment under which net business income was determined by various factors.

The 1935 draft was mainly based on the “Carroll Report”\textsuperscript{249}. According to it three common methods of allocating profits to permanent establishments;

- Separate accounting which took the declaration of income buttressed by the accounts of the local branch as basis of assessment this followed by Japan, UK and USA\textsuperscript{250}.
- Empirical methods used by tax administrators when they believed income declared was insufficient or false and used in the UK, USA and continental Europe\textsuperscript{251}.
- Fractional apportionment determined the “income of one establishment of an enterprise by dividing total net income in the ratio of certain factors-for example assets turnover, pay-roll or a fixed percentage\textsuperscript{252}” this is used by the countries like Spain and Switzerland.

It is interesting to note that Carroll indicated a clear preference for separate-accounting method for allocating profits to permanent establishments and the “independent person” approach for allocating profits to associated enterprises, Caroll rejected apportionment method on multiple grounds\textsuperscript{253} stating that:

That states would likely choose formulas that allocate more income to their tax jurisdictions;
- Separate-accounting was “preferred by the great majority of Governments, and business enterprises presented in the international Chamber of Commerce, as well as by other authoritative groups”.

Caroll recommends the arms length approach. Stanley Langbein, the American legal scholar criticized the Carroll report for being in favor of arms-length and ignoring the fractional apportional methods in Spain, Switzerland and certain other states\textsuperscript{254}.

\textsuperscript{249} Mitchell B Caroll, “Methods of Allocating Taxable Income” League of Nations Taxation of Foreign and National Enterprises called as” Carroll Report” (1933)vol.4 p.83. This report is based on Carroll’s visit to 27 countries to extensively study their tax systems. Carroll described three common methods of allocating profits to permanent establishments:

\textsuperscript{250} \textit{Ibid} p. 84

\textsuperscript{251} \textit{Ibid} p. 84

\textsuperscript{252} Caroll Report Supra note 1 p.46

\textsuperscript{253} \textit{Ibid} p. 189

\textsuperscript{254} Stanley Langbein, “the unitary Method and the Myth of Arm’s length” Libra Publication(1986) p. 102
6.01.2. Mexico & London Model

The Mexico model of 1943 and London Models of 1946 were the next step in the evolution of model treaties; neither were formally fully and unanimously accepted. The Mexico Model reflected an insistence on taxation at source, with the apparent burden of tax relief shifted to the country of residence\textsuperscript{255} it called for the country of residence to retain the right to tax the entire income of the taxpayer but to provide deduction on taxes paid in source country to the extent they did not exceed the proportion of the tax effectively due in the residence country. Income allocation rules for permanent establishment and associated enterprises were included in this accord, the London Model also imposed the threshold of permanent establishment for business profits to be taxable in the source country.

The Organization for European Economic Co-operation (OEEC) which subsequently became the OECD, in 1956, set up on the task of working on a draft bilateral convention “that would effectively resolve the double taxation problems existing between OECD member countries and that would be acceptable to all Member countries”\textsuperscript{256}. The Fiscal Committee used the London model as its reference and revised it extensively taking into account practices embodied in tax treaties negotiated by member countries. The OECD model was published in draft form first in 1963 and then revised in 1977 and again in 1992. It has been hugely successful\textsuperscript{257}.

The OECD model has four parts. They are:

1. Provisions on scope, coverage and general definitions;
2. Assignment of tax jurisdiction for main categories of income;
3. Methods for elimination of double taxation;
4. Special provisions on cooperation;

Overall the OECD model favors capital-exporting countries over capital importing countries: the OECD model compared to the UN model favors residence taxation and in order to eliminate double taxation requires the source country to give up some or all of its taxation on certain categories of income. When the flow of trade

\textsuperscript{256} Organization for Economic Co-operation and Development Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital (Paris OECD) (“OECD Model”).
\textsuperscript{257} Jinyan Li op cit., p.46
and investments between two countries is unequal the capital importing country tends to loose source taxation under the OECD model\textsuperscript{258}.

Today OECD is associated with more than 100 countries, of which 30 are permanent members. India is an observer country in OECD. It is provider of comparative data, analysis and forecasts and is best known for its publication and statistics which cover economic and social issues from macroeconomics to trade, education, development and science and innovation. OECD has played a crucial role in modeling international tax systems in the 21\textsuperscript{st} century. As countries become aware of their responsibilities in the new global environment, geographical boundaries are becoming less significant, and countries are coming closer making inter-country relations more complex. In such a dynamic environment, respective governments are forced to contend with a host of social and economic issues. Policy makers are looking to tax systems for solutions. The OECD’s Centre for Tax policy and Administration is at the forefront of setting international tax standards, its two significant initiatives being OECD Model Tax Convention, and the Transfer Pricing Guidelines, which have undergone changes in the recent past. The OECD Model Tax convention forms the basis of an extensive network of mutual income tax treaties amongst OECD member countries and between OECD member and non-member countries. There are about 350 treaties entered between OECD member countries, and over 1500 worldwide treaties which are based on the Model Convention. The Committee on fiscal affairs (CFA) provides an international platform where senior officials from OECD member governments can come together to discuss and exchange views on tax policy and administrative issues. The CFA defines the OECD work programme in the tax area\textsuperscript{259}.

Taxation issues are especially problematic to deal with in the case of cross-border transactions for both MNEs and tax administrations. The former are faced with the challenging task of complying with different tax jurisdictions. In the case of tax administrations, international taxation necessitates extra caution to avoid double taxation, which can create barriers to cross-border trade. The international aspects of taxation are especially difficult to deal with because they involve more than one tax jurisdiction and therefore, any adjustment to the transfer price in one jurisdiction calls

\textsuperscript{258} Ibid., p. 46
for a corresponding adjustment in another jurisdiction. Sometimes both jurisdictions may not be in agreement to making the adjustment, and hence it is possible that the MNE group is taxed on the same income twice. The only way to minimize the risk of double taxation is to arrive at an international consensus on the establishment of transfer prices for cross-border transactions. And this is the aim of the OECD strive to achieve. In 1979, the CFA published ‘Transfer pricing and Multinational Enterprises’. These guidelines advocated a coherent stance by OECD members with regard to the risk of MNEs being able to shift profits to the lowest tax jurisdictions. By adhering to a set of common guidelines, tax authorities could hope to reduce any asymmetries in transfer pricing enforcement, and to decrease the risk of double taxation. The committee has published two reports since 1979 addressing transfer pricing issues with respect to specific topics. The topics are ‘Three Taxation issues’(1984) and ‘Thin Capitalization’(1987) apart from this the OECD published ‘Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations’ in 1995 a substantially revised and extended version of its earlier guidelines. The OECD guidelines adhere to the arm’s length standard and recommend the use of uncontrolled comparable transactions and specific transfer pricing methods to determine a range of arm’s length prices for a controlled cross-border transaction. The Guidelines acknowledge that taxpayers should base their controlled transfer prices on a sound analysis and should document the basis on which such prices are set, the amount of effort called for by the Guidelines is markedly less than what U.S. regulations would require to avoid a tax penalty on a large transfer pricing adjustment. 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. 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 Guidelines260.

6.02. 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

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several countries. The OECD has published several reports and guidelines on the subject. The main features of these guidelines are under\textsuperscript{261}:

1. The guidelines provide guidance in applying the general principles of transfer pricing to complex situations, such as permanent establishments. Financial services, global trading and thin capitalization.

2. They provide the mechanism for monitoring the implementation of the guidelines and guidance for amending and updating the regulations on the subject.

3. They examine various methods of dispute resolution like Advance pricing arrangement, Mutual agreement procedure and arbitration.

4. They encourage the non-member countries to follow guidelines in drafting transfer pricing regulations. This is undertaken by arranging multilateral seminars and appropriate regional partners.

5. They form the basis of the transfer pricing regulations of many countries including non-member countries.

\textit{6.02.1. The OECD Report 1979}

The OECD in its first report on "Transfer pricing and Multinational Enterprises" in 1979 reaffirmed and elaborated the arm’s length principle. The report outlined various principles, without laying down the precise rules for determining the transfer price for tax purpose. This report explored the use of classic methods and suggested an approach, which was found acceptable both to taxpayers and the tax administration.

\textit{6.02.2. The OECD Report 1984}

The organization brought out a second report in 1984 on “Transfer pricing and Multinational Enterprises”, “three taxation issues”. This report supplemented the recommendations made in earlier report and considered some other issues on transfer pricing. The other issues examined are:

- The tax treatment of interest payable or deemed to be payable on loans and deposits within multinational banking enterprise: The pricing of intra-group services, and

• The methods of resolving dispute tax authorities and taxpayers in regard to acceptable arm’s length price.

6.02.3. The OECD Report 1987

The organization published another report in 1987 on “International Tax Avoidance and Evasion-four related issues” in which an in-depth analysis was made of different aspects of the international tax evasion and tax avoidance. This report examined the use of low tax or tax haven countries and the ‘base company’ as a shelter. It analyzes the possible modes of “treaty shopping” and methods of countering them. Though transfer pricing is not explicitly considered as one of the four issues, it has been treated as relevant issue throughout this publication. The organization also published a study on thin capitalization. The thin capitalization is a phenomenon under which capital is provided in the form of debt rather than as equity. Equity capital is kept very thin whereas the debt proportion is kept very heavy. Also this report considered the various methods of designing domestic tax provisions by tax administrations to counter possible abuse in this area. The issues relating to thin capitalization have also been considered in its model tax convention published in 1992.

6.02.4. The OECD Report 1995

The guidelines issued by the OECD 1979 were substantially influenced by the US legislation which had set out in detail the approved methods for determining the arm’s length prices. Therefore, it was considered necessary to review the existing guidelines, because of transfer pricing provisions enacted in US code. Later in 1986 the provisions of US section 482 of IRS were amended to provide new rules for adjustment of transfer prices in respect of intangible property. In 1994, USA also brought new regulations dealing with determination of arm’s length price.

There were other developments in regard to use of transfer pricing methods. The traditional methods like comparable uncontrolled price, cost-plus or resale price were considered insufficient to handle all type of cases because they relied heavily on comparable transactions between independent parties. The profit-based methods were criticized, as they did not follow arm’s length principle. Besides the law in USA introduced the comparable profits method which was based on a comparison of net profit margin. All these developments formed the basis of reviewing the exiting
guidelines and bring a new report on the subject. Accordingly OECD in 1995 brought another report called “Transfer pricing Guidelines for Multinational Enterprises and Tax Administration”. This report dealt with all aspects of transfer pricing and focused on arm’s length principle. It reiterated the conclusions arrived at in 1979 report and recommended the use of three standard methods for arriving (CUP, RPM and CPM methods) at arm’s length prices and discouraged the use of comparable profits methods and profit split approaches. It suggested that profit methods should be used only as a last resort. The report also came down firmly against global or unitary approaches. It did not state any strict order of priority for the use of the various methods and advised against the use of hindsight towards making adjustments.

The guidelines and reports of 1995 provided a detailed and systematic guidance on various issues by way of specific recommendations and examples. It also considered a number of other topics which were merely touched upon, or were not considered in earlier reports like arm’s length range, multiple year data, burden of proof, penalties corresponding and compensatory adjustments, examination practices and advance pricing agreements. It also elaborated the brief comments of the earlier reports. However, special problems involved in the pricing of intra group services, intangibles and loans were not examined. These reports can be considered as important step towards the achievement of satisfactory international guidelines on transfer pricing.

6.02.5 Later Developments in OECD:

In 1996 new chapters were incorporated in the report concerning transfer of intangibles and provision of services. Later in August 1997 a chapter on ‘cost contribution arrangements’ was added. The chapter recognized the agreement of all member countries in regard to cost contribution arrangement for tax purpose and suggests uniform principles in dealing with these arrangements. The cost contribution arrangement can be used by business enterprises to share the costs and risks of developing, producing or obtaining any assets, services or rights it states that arm’s length principle would be satisfied provided that each participant’s share of the overall contributions to the subject activity is consistent with participant’s share of the overall benefits likely to be received. In 1998 the OECD again published a revised and updated version of the discussion draft regarding the taxation of global trading of financial instruments. This publication reviewed the background to global trading,
analyzed the challenges posed to traditional taxation methods and discussed a range of policy options. The publication although reviewed a specific sector, it raised many issues for further discussion. The high level of global integration of functions and intensive co-operation between different geographic locations may be relevant to other industries as well due to spread of globalization and electronic commerce. In 1999 the organization has published an update of 1995 report the summary of the report is as follows:

a. **The Arm’s length principle:** the guidelines recommend that arm’s length principle should be the guiding principle for determining transfer prices among associated enterprise. The principle provides broad parity of tax treatment for multinationals and independent enterprises. The 1979 reports suggest the examination by tax administration should be based on actual transaction undertaken by the associated enterprises using the methods applied by the taxpayer.

b. **The transfer pricing methods:** the guidelines incorporate the detailed discussion on traditional transaction methods and other methods used to apply the arm’s length principle. The relationship of this with Art 9 of OECD model convention was also examined.

(i) The first method is comparable uncontrolled price method. It compares the price charged for the property or services transferred in controlled transactions to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

(ii) The second method is resale price method it begins with the price at which a product purchased from an associated enterprise is resold to an independent enterprise. The resale price is then reduced by appropriate gross margin represents the amount in which reseller would seek to cover its selling and other operating expenses. If there is any material differences between controlled and uncontrolled the adjustments has to be made

(iii) The third method is cost plus method. It begins with cost incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to a related purchaser. A suitable cost plus mark up is then added to this cost, to make appropriate profit in the light of
functions performed and the market conditions. The price arrived after adding
the cost plus mark up is regarded as the arm’s length price of the controlled
transaction. It has to be compared with uncontrolled transaction

(iv) Other methods: the guidelines also recognize the other methods for
determinations of arm’s length price. The taxpayer may apply other methods
provided they satisfy the arm’s length principle. These methods are known as
transaction profit methods. They concern allocation of profits of transactions
entered between related parties. These methods may be accepted in exceptional
cases where the complexities of business put practical difficulties in application
of the traditional transaction methods. The profit split method is applied where
transactions are interrelated and cannot be evaluated on a separate basis. It
seeks to eliminate the effect of special conditions made in controlled transaction
on profits of the enterprise. This method first identifies the combined profits of
the associated enterprises and then splits those profits between the associated
enterprises on an economically valid basis. The transactional net margin
method examines the net profit margin from a controlled transaction to an
appropriate base like costs, sale and assets. It operates in a manner similar to
cost plus and resale methods. The main strength of this method is that net
margins are more tolerant to some functional differences between controlled and
uncontrolled transactions than gross profit margins. The weakness of this
method is that net margins can be influenced by some factor that has a lesser
effect on price or gross margins.

(v) Priority of methods: the guidelines provide that transaction methods should be
preferred over profit methods as a means of establishing arm’s length price.
There may be cases where transactional methods cannot be reliably applied
alone or cannot be applied at all. For example, where there is insufficient data
on uncontrolled transactions the transactional method cannot be used. In such
circumstances profits methods may be used as a last resort.

(vi) Practical limit to adjustments: the 1979 report provides that there are practical
limits to adjustments and these should not be made if transfer price can be
substantiated as arm’s length price. Also it says adjustments should not be
ordinarily be made if they result in minor or marginal difference to tax liability
of the taxpayer.
(vii) **Effect of government policies:** The report of 1979 examines the effect of governmental policies, such as price controls, interest rate controls and controls over payment for services. It is stated that these government interventions should be treated as conditions of the market in the particular country and should be considered in evaluating the taxpayer’s transfer price in that market.

(viii) **Set-offs:** The guidelines recognize that it would be consistent with the arm’s length principle to accept the set-off of advantageous and disadvantageous in transactions between a taxpayer and a related entity if unrelated parties would accept such an arrangement.

(ix) **Global formulary Apportionment:** The report examines global formulary apportionment approach, which is non-arm’s length approach to transfer pricing. As per this principle the global profits of a multinational group are determined on a consolidated basis and then allocated among the associated enterprises in different countries on the basis of a predetermined formula. The OECD members do not accept this approach and also do not find it a suitable alternative to the arm’s length principle.

(x) **Package Deals:** The 1979 report provides that undifferentiated single payments may be made for package deals. It is stated while in some situations it may be feasible to treat the single deal as one transaction, in many cases the various ingredients of the deal will need to be separately priced. The 1995 report of OECD explains the typical package deals and develops the arguments in detail.

(xi) **Documentation:** The report provides general guidance for tax authorities to take into account rules and procedures on documentation to be obtained from taxpayers in connection with a transfer pricing enquiry. The guidelines recommend that tax administration and taxpayers should commit themselves to a greater level of co-operation in addressing documentation issues. The authorities should try to avoid excessive documentation while at the same time incorporating rules to provide for adequate information to apply the arm’s length principle. It states that taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether the transfer pricing is appropriate for tax purpose in accordance with the arm’s length principle. The administration should have the right to obtain the documentation prepared or
referred to in this process as a means of verifying compliance with arm’s length principle.

(xii) Intangible property and Intra Group Services: The guideline also deals with intangible property and intragroup services. It discusses the application of appropriate methods under the arm’s length principle for establishing transfer pricing for transactions involving intangible property. As far as intra group services, two issues are relevant. The first issue is whether intra group services have in fact been provided. The other issue is whether charge for such services is in accordance with arm’s length principle.

(xiii) Cost contribution arrangement: the guidelines explains that the cost contribution arrangement is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets services, or rights, and to determine the nature of interests of each participant in those assets, services or rights. It also states each participant’s interest in the results of CCA activity should be established even where the interest is inter-linked with that of other participants. This is a contractual arrangement where each participant in the arrangement, in return for agreeing to make a specified contribution towards the activity performed under the arrangement acquires a specified interest in the results of that activity.

(xiv) Administrative approaches to resolve disputes: the 1995 reports examines various administrative procedures for setting transfer pricing disputes. It is possible that tax authorities may not agree with the determination of transfer pricing with taxpayers or there may be difficulties in interpreting and evaluating the circumstances of individual cases. It is stated that tax compliance should be developed and implemented in each member country according to its own domestic legislation and administrative procedures. The issues relating to examination practices, burden of proof and issue regarding penalties are discussed.

(xv) Safe harbours: under the safe harbor rules, certain transactions are excluded from the scope of transfer provisions. For example, the rules may provide for setting threshold limits or designating ranges within which the prices or profits may fall. OECD in a meeting with leading experts discussed the provisions of
Safe harbor means “provision in an agreement, law, or regulation that affords protection from liability or penalty under specified circumstances of if certain conditions are met”.

(xvi) Advanced pricing arrangement: these arrangements are intended to supplement the traditional mechanisms for resolving transfer pricing disputes. An advanced pricing arrangement may provide a system for determining in advance appropriate criteria for the determination of the transfer pricing.

(xvii) Penalties: the guidelines state that penalties should be fair and not unduly onerous for the taxpayer. It also dealt with corresponding and compensatory adjustments and a number of administrative matters, such as examination practices (including simultaneous auditing or examination of the accounts of a multinational by more than one country).

6.02.6. OECD Report updated 2008

OECD has been continuously developing, revising and updating practical guidance for the implementation of the arm’s length principle since the year 1979 via the OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations. The arm’s length principle dates all the way back to the first half of the century, when the League of Nations Model Tax Conventions formed the international consensus and in 1963 it was adopted by the United Nations Model Double Taxation Convention between Developed and Developing Countries. Today the arm’s length principle is used in bilateral income tax treaties between OECD member countries as well as between OECD member countries and non OECD economies. It is currently part of the transfer pricing rules in over a hundred countries domestic legislation. Due to increase in globalized economy which creates huge challenges and in the year 2010 the Guidelines were revised with a focus on comparability and profit methods. Among other things, this led to new guidance on transfer pricing aspects of business restructurings. During 2011 two new projects dealing with the transfer pricing of intangibles and the simplification of transfer pricing were launched by the OECD. They are:

- Intangibles in connection to transfer pricing related matters such as transfer pricing aspects of business restructuring were considered to be a key area of concern to governments and taxpayers, because there is a lack of sufficient
international guidance in particular on the definition identification and valuation of intangibles for transfer pricing purposes\textsuperscript{262}

- The project concerning transfer pricing simplification was considered to be a high priority project and was aimed streamlining the administration of the transfer pricing system in areas such as transfer pricing documentation and understandability of the guidelines themselves.\textsuperscript{263}

6.02.7. Attribution of Profits to Permanent Establishments

OECD Report update the permanent establishment of a foreign enterprise which should be considered similar to subsidiary companies as this approach is closer to the arm’s length principle. The underlying basis of attribution of profits is that profits of Permanent establishment would be profits which would have been realized considering the permanent establishment as a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions. The attribution of profit is essential to identify the business activities carried on by the enterprise through its permanent establishment in other country. Identification of business activities is done by carrying out functional analysis (functions, assets and risks) of the foreign associated enterprise engaged in business through a permanent establishment in another country. The update report recommend that for application of Article 7 of the treaty the OECD report should have same status as transfer pricing guidelines. The OECD 2008 had taken a project on treaty and transfer pricing aspects of business restructurings particularly relating to articles on permanent establishment, business profits and associated enterprises. The process of business restructuring issues can involve application of transfer pricing rules, attribution of profits to permanent establishment, recharacterisation of transactions and it also deals with issues relating to business risks; arm’s length compensation for restructuring itself: remuneration of post restructuring controlled transactions and recognition of actual transaction undertaken by the taxpayers.

6.02.8. OECD updated 2010

The part 1 of Chapter II of the 2010 Guidelines deals with selection of most appropriate transfer pricing method to the circumstances of the case whereas earlier

\textsuperscript{262} Ruiter 2012 p.2 reported by the agency for publication of new of OECD
\textsuperscript{263} Ibid., p.2
reports and guidelines gave preference to traditional transaction methods over transactional profit methods for selecting appropriate method to determine arm’s length price of transactions. The change in approach followed by the OECD is clear from the paragraph of OECD 2010\textsuperscript{264}. It is clear from the above that principle of most appropriate method is now firmly recognized in revised guidelines for determination of the arm’s length price. There can be situations where profit methods may be found to be more appropriate than traditional transaction methods and therefore in such cases it may be appropriate to apply the profit method. But at the same time it is not appropriate to apply a profit based method merely because the data of comparable uncontrolled transactions are difficult to obtain or incomplete in one or more respects. The criteria given in paragraph 2.2\textsuperscript{265} that none of the traditional transaction methods can reliably be applied under the circumstances must be taken into consideration before considering the application of profit methods. Moreover, profit methods can be accepted only if they are compatible to Article 9 of the OECD Model Tax Convention, especially with regard to comparability of transactions and applying of a particular profit method approximates the arm’s length pricing\textsuperscript{266}.

6.02.9. Dispute Resolution

The update of the Model Tax Convention issued in 2008 contained some changes in regard to functioning of the mutual agreement procedure (MAP) the

\textsuperscript{264}. OECD 2010 paragraph 2.2 regarding selection of transfer pricing method is “while selecting the method always aims at finding the most appropriate method for a particular case. For this purpose, the selection process should take account of the respective strengths and weaknesses of the OECD recognized methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis, the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods: and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material difference between them. No one method is suitable in every possible situation, not is it necessary to prove that a particular method is not suitable under the circumstances”

OECD 2010 paragraph 2.3 says “Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm’s length. This is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to commercial and financial relations made or imposed between the enterprises, and the arm’s length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction. As a result, where taking account of the criteria described in paragraph 2.2 a traditional transaction method and a transaction profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, where, taking account of the criteria described at paragraph 2.2, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred”.

\textsuperscript{265}. Ibid paragraph 2.2 of OECD 2010

\textsuperscript{266}. Paragraphs 2.4 to 2.6 of 2010 Guidelines
mechanism of mutual agreement procedure was used to resolve a number of disputes of double taxation. The OECD committee on fiscal affairs felt that there was a need to assess the functioning of MAP and suggests improvements. The Changes suggested in 2008 update relate to the conditions to have access to MAP; guidance on suspension of collection of tax; and suspension or remission of interest and penalties during MAP and comments on the relationship between domestic law and MAP agreements. In OECD 2008 a new paragraph 5 was added in Article 25 of the OECD which provides provision for compulsory and binding arbitration procedure. The important development of the this procedure is in case where competent authorities are unable to reach an agreement in MAP within two years, the unresolved issues should be solved through an arbitration process.

6.02.10. Draft note on Comparability

The term Arm’s length principle is reasonably sound in theory. It has certain practical limitations. Difficulties can arise, particularly for transactions involving specialized goods and services or unique intangible, 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 condition in a controlled transaction with the conditions in transactions between independent enterprises, where such transactions are not identical, similar transactions need to be considered. The usefulness of the comparisons 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 the methodology (for example, price or margin) or that reasonably accurate adjustments can be made to accommodate such differences. Thus it is important to recognize that the arm’s length principle is far from an exact science, and often a range of data will need to be used. Further, judgmental call is required to establish where within this range the circumstances of the respective transaction are best reflected. OECD considers number of general factors for consideration into account in analyzing each case. The factors are^267

^267. MukeshButani “*op.cit.*, pp 254-256
1. **Characteristics of properties and Services:** this will matter most in comparing prices of controlled and uncontrolled transactions and less when comparing profit margins. Example; Quality, durability and reliability of the goods or services;

2. **Functional Analysis:** this will identify and compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. The functions carried out would determine to some extent the allocation of risks between the parties, and thus the conditions each party would consider in arm’s length dealings. The risks to be considered while performing the functional analysis include market risks, risks associated with the investment in and use of property plant and equipment, research and development risks, financial risks such as exchange and interest rate variability, credit risk etc.;

3. **Contractual Terms:** the arm’s length dealings the division of responsibilities, risks and benefits between the concerned parties is determined through the contractual terms of transaction. Differences in the contractual terms of the controlled transaction relative to the uncontrolled transaction may significantly affect comparability. Examples are credit and payment terms;

4. **Economic Circumstances:** factors like competition in the markets availability of substitutes, and overall levels of demand the supply need to be factored;

5. **Business strategies:** while determining comparability, it is important to take into account factors such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws and other factors that have a bearing on the daily conduct of the business. A taxpayer seeking to implement a market penetration scheme or to increase its market share may temporarily charge a price for its product that is lower than the price charged for comparability products in the same market. Such taxpayer may incur higher costs in the initial years (due to start-up costs or increased marketing and advertisement spends) and hence achieve lower profit levels than comparable organizations other taxpayers operating the same market;

6. **Losses:** an independent enterprise would ordinarily avoid prolonged losses. An associated enterprise consistently making losses, particularly where the group as a whole is making profit will often find its transfer pricing policy under scrutiny by the tax administrators;
7. **Transaction Structure:** A transaction should be construed to reflect the economic reality of the circumstances. Ordinarily a tax administrator’s examination would be based on the transaction actually undertaken. In two situations the tax administrators disregard the structure adopted by a taxpayer in entering into controlled transactions. One is the economic substance of a transaction differs from its form example thinly capitalized company may borrow from its associated enterprise. In order to do this the tax administrator may need to restructure the transaction such that the debt of the borrowing company is reclassified as equity thereby reflecting the true economic position of the borrower. The second situation is form and substance of the transaction are the same, the arrangements made in relation to the transaction viewed in their totality, differ from those which would have been adopted by the independent enterprise behaving in commercially rational manner\(^\text{268}\). The comparability analysis has an important role in implementation of transfer pricing policy. The application of the arm’s length principle is based on a comparison of the conditions in a transaction with associated enterprise with conditions in transactions between independent parties. In order that a case is considered comparable, none of the differences between the situations being compared should materially affect the condition being examined in respect of pricing method, or there should be possibility of making reasonable accurate adjustments for the differences\(^\text{269}\). The independent enterprises tend to consider all options available to them and they will only enter into the transaction if they see no alternative that is more attractive. For example, independent enterprise before opting to purchase a product would consider whether the same product could be purchased at a lower rate from another party. Therefore in applying the arm’s length principle it must be examined whether any options are available to independent enterprises and if there are differences between the options whether it would significantly affect their value. Therefore comparison of their features can help in determining the comparability of controlled and independent transactions\(^\text{270}\).

\(^\text{268}\) OECD Guidelines Paragraph 1.37
\(^\text{270}\) Wahi V S ibid., p. 175
OECD held its first annual meeting in March 2012. The meeting was about transfer pricing under the auspices of global forum on treaties and transfer pricing. This enabled government officials from 90 countries to discuss transfer pricing issues. OECDs Task Force on Tax and Development identified transfer pricing as one of its high-priority areas and aims to help developing countries introduce and implement transfer pricing rules by providing support on policies issues for administrative structures, regulations and guidance and building practical auditing skills. Other aspects that will be looked over are availability of comparable data and access to financial data that is sometimes needed in order to apply transfer pricing rules.

OECD, the European Commission and World Bank formed an international partnership in order to provide support. During May 2012 the Task Force on Tax and Development launched “Tax Inspectors without Borders” which is an initiative to help developing countries make their tax systems fairer and more effective. plans were made by the OECD to establish an independent foundation to provide international auditing expertise and advice to help developing countries combat tax base erosion such as tax evasion as well as avoidance.

During 2013 new guidelines were introduced concerning safe harbors in order to relieve some of the compliance burdens as well as to provide a greater certainty when involving smaller taxpayers and less complicated transactions, making developing countries able to make optimal use of the, limited resources available. Some of the old guidelines concerning safe harbors were revised to better reflect the practices of OECD member countries, as the way they are viewed have somewhat changed to a more positive view. Among the some of the changes are bilateral agreements leading to safe harbors, A proposed draft recognizes that properly designed safe harbors can help relieve compliance burdens and provide taxpayers with greater certainty. OECD historically has placed a lot of focus on eliminating double taxation. The Model Tax Convention serves as a basis for over 3000 bilateral tax treaties. The director of OECD, Pascal Saint-Amans, OECD Centre for Tax policy and Administration has stated during a 23rd January 2014 that “OECD might have been so effective in eliminating double taxation that they may have facilitated double non taxation”. This recognition of double non taxation practices such as tax

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271 OECD 2014 visited at www.oecd.org accessed on 22.02.2015 at 4 A.M.
272 Pascal Saint-Amans a French National took on his duties as Director of the Centre for tax policy and Administration at the OECD on 1st February 2012.
avoidance has led to OECD focusing on Base Erosion and Profit Shifting (BEPS) and publishing two reports they are

1. “Addressing Base Erosion and Profit Shifting” in Feb 2013

Now OECD is working together with G20 countries on the BEPS project in order to develop rules to rehabilitate global taxation system. The OECD has timelines for the implementation of the BEPS project. A major purpose of transfer pricing rules, the arm’s length principle in particular, is to allocate multinational corporations profits in order to make them taxed in the countries where corporations conduct their business. In many cases transfer pricing rules based on the arm’s length principle are able to achieve this aim effectively and efficiently. In other instances however, this might not always be case. Multinational corporations are able to manipulate the rules to separate the income from the economic activities which generate the income, by moving the income to low-tax jurisdictions such as tax havens. The OECD has recognized that the current regulatory systems need to be changed. However, due to the practical difficulties regarding the implementation and the importance of concerned action, the best course of action is directly address the flaws regarding returns related to intangible assets, risk and over-capitalizations in the current transfer pricing system rather than replacing it with an entirely new system. To this end special measures either within or beyond the arm’s length principle may be required. Intangible develop rules to prevent.

The Action Plan on Base Erosion and Profit Shifting (BEPS) by moving intangibles among group members. This will involve:

- adopting a broad and clearly delineated definition of intangibles;
- ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance (rather than divorced from) value creation;
- Developing transfer pricing rules or special measures for transfers of hard-to-value intangibles: and

Saint Amans the Director of OECD 2013 reported in 2013 OECD Reports (2013) pp 17-24, OECD 2013 op cit., p. 13 BEPS project is a plan for the actions that OECD wants to take in order to restrain base erosion and profit shifting. It also sets timelines for the implementation of the BEPS project.
• Updating the guidance on cost contribution arrangements.

Base Erosion and Profit Shifting state which involves various action projects by OECD. They are Risk and capital develops rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. The other important Action plan of the OECD in connection is High risk transactions develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to:

• Clarify the circumstances in which transactions can be re-characterized;
• Clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains;
• Provide protection against common types of base eroding payments such as management fees and head office expenses.

The starting point for the BEPS project is that OECD’s work needs to be inclusive and effective, which means that OECD’s work should “take into account perspective of developing countries and benefits from input of business and the civil society at large” in the light of the strong interest and support expressed by the G20 governments, even non OECD member countries of the G20 are invited to be part of the BEPS project as associates. Moreover, they will be on equal footing with OECD member countries and thereby they ‘will expected to associate themselves with the outcome of the BEPS Project’.275

6.03. OECD Transfer pricing Guidelines, Transfer pricing developments in selected countries with established transfer pricing regimes and Indian developments:

Many developing countries lack effective transfer pricing regimes, lacking appropriate transfer pricing legislation, sufficient administrative capacity to effectively implement the legislation, or both. As a result, many countries may be losing significant tax revenues as a result of both intentional and unintentional transfer mispricing276. Statistics reported by the tax administrations of countries with recently

275 OECD 2013, p.25
276 Working draft “International Transfer pricing and developing Economies: from implementation to application” A toolkit for policy makers and Practitioners published by UNCTAD Statistics dated 19th February 2013 wherein the concept of Transfer mispricing arises as a result of abusive or inappropriate transfer pricing practices. Abusive practices includes situations in which transfer
established transfer pricing regimes also provide insight into the vast sums potentially involved

“In 2010, China’s tax authority, the State Administration of Taxation is reported to have collected an additional ¥10.272 billion (about $1.5 billion) as a result of its approach toward transfer pricing issues (PwC 2011). In Hungary, the National Tax and Customs Administration has reported that an additional 370m of tax difference was revealed due to transfer pricing audits during 2006-10 (in the figure shown below) in India, reports indicate that India about $15.42 billion of transfer pricing adjustments were made during the period 2008-2012. In the United Kingdom, HMRC reports transfer pricing yields of £519 million in 2007/08; £1,595 million in 2008/09; £1,039 million in 2009/10; and, £436 million in 2010/11, with fluctuations in annual yields principally reflecting the small number of very large cases (HMRC 2011)”.

The bar chart shown under in Table -1 reveals the facts that due to lack of effective transfer pricing regimes, lacking appropriate transfer pricing legislation, sufficient administrative capacity to effectively implement the legislation, or both. As a result many countries may be losing significant tax revenues as a result of both intentional and unintentional transfer mispricing.

Table-1

<table>
<thead>
<tr>
<th>SI No</th>
<th>Description of trade/goods/period</th>
<th>European Union</th>
<th>United States</th>
<th>If taxed the Revenue collection (additional Tax Revenue)</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Capital flow 2005-2007</td>
<td>$1 trillion</td>
<td>$1 trillion</td>
<td>$121.8 billion</td>
<td>Christian Aid^278</td>
</tr>
<tr>
<td>2</td>
<td>Shifting of corporate profits out of developing countries resulted a revenue loss of $50 billion a year -source (Oxfam 2000)^279</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

prices are intentionally manipulated to achieve certain outcomes, and inappropriate practices include situation in which the parties unintentionally use transfer prices that external stakeholder find unacceptable because, for example, they are inconsistent with applicable laws, regulations, standards, or relevant commercial practices.

^277 Ibid p 11
The bar chart in Table 2 shows the statistics reported by the tax administrations of countries with recently established transfer pricing regimes also provide insight into the vast sums potentially involved. The Table 2 shows the Tax difference revealed due to transfer pricing audits for the period 2006-2010 of the country of Hungary the bar charts shows the revenue loss in millions of Euros.

Table-2
Tax difference revealed due to Transfer pricing Audit (2006-2010)

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Number of TP Audits Completed</th>
<th>Number of Adjustment cases</th>
<th>% of Adjustment Cases</th>
<th>Amount of Adjustment (in Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004-05</td>
<td>1,061</td>
<td>239</td>
<td>23</td>
<td>1,220</td>
</tr>
<tr>
<td>2005-06</td>
<td>1,501</td>
<td>337</td>
<td>22</td>
<td>2,287</td>
</tr>
<tr>
<td>2006-07</td>
<td>1,768</td>
<td>471</td>
<td>27</td>
<td>3,432</td>
</tr>
<tr>
<td>2007-08</td>
<td>219</td>
<td>84</td>
<td>39</td>
<td>1,614</td>
</tr>
<tr>
<td>2008-09</td>
<td>1,726</td>
<td>670</td>
<td>39</td>
<td>1,614</td>
</tr>
<tr>
<td>2009-10</td>
<td>1,830</td>
<td>813</td>
<td>44</td>
<td>10,908</td>
</tr>
<tr>
<td>2010-11</td>
<td>2,368</td>
<td>1,138</td>
<td>49</td>
<td>23,237</td>
</tr>
<tr>
<td>2011-12</td>
<td>2,368</td>
<td>1,343</td>
<td>52</td>
<td>44,531</td>
</tr>
</tbody>
</table>

(Source : CBDT New Delhi

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280 White Paper on Black Money 2012 CBDT Ministry of Finance New Delhi
The Directorate of Transfer Pricing has detected mispricing Rs. 67,768 crore in the last two financial years (the above table shows) Rs. 44,531 crore in the current financial year. This has effectively stopped transfer of equivalent amount of profits out of the country. For better understanding the figures are shown in the Bar chart as well as pie chart as under in Table-4

**Table-4**

![Bar chart showing amount of adjustment](image1)

![Pie chart showing No. of TP Audits](image2)

By and large after establishment of Directorate of Transfer pricing the country is 2004-05 to 2011-12. Able to check the erosion of the revenue as seen for the period
Also the statistics as per the Global Tax Alert Transfer pricing reported on March 2015 the number of TP audits completed during the FY 2013-2014 were 3,617 out of which 1920 (around 53%) resulted an adjustment grossing INR 596 billion. The annual data relating to the number of cases adjusted and amount of adjustment is as under in the Table-5.


dataframe

<table>
<thead>
<tr>
<th>Sl No</th>
<th>TP audit year</th>
<th>No of TP audits completed</th>
<th>No of adjusted cases</th>
<th>% of adjusted cases (rounded)</th>
<th>Amount of adjustment (in INR billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2012-2013</td>
<td>3,171</td>
<td>1,686</td>
<td>53</td>
<td>700.16</td>
</tr>
<tr>
<td>2</td>
<td>2013-2014</td>
<td>3,617</td>
<td>1,920</td>
<td>53</td>
<td>596.02</td>
</tr>
</tbody>
</table>

dataframe

This trend continues, with many countries, developed and developing, introducing new transfer pricing legislation, amending existing legislation, investing in tax administration resources and introducing or updating their compliance requirements. A number of countries with established transfer pricing regimes are undertaking reviews of their transfer pricing regimes in order to align them with international developments and address emerging areas of concern. The brief details of transfer pricing regimes are as under. (Please refer the chart under Appendix-XII-5 of this thesis for detailed comparative table of OECD guidelines and Indian Regulations)

6.03.1 Australia transfer pricing Regime

On November 1, 2011, the Treasury released a consultation paper on proposed changes to Australia’s transfer pricing rules intended to bring them in line with Australian and international developments (Australian Treasury 2011). The paper outlines the history of transfer pricing rules and proposes a number of areas for change. Suggested changes include the introduction of an arm’s length standard that reflects international norms, interpretation of new rules in a manner that best secures consistency with guidance from the Organisation for Economic Co-operation and Development (OECD) and application of the new rules on a self-assessment basis. On 22 November 2012 an expose draft was released that included draft legislation and explanatory memorandum (Australian Treasury 2012).
6.03.2. United Kingdom transfer pricing Regime

In June 2008, Her Majesty’s Revenue & Customs (HMRC) issued its “Guidelines for the Conduct of Transfer Pricing Enquiries,” which included the creation of a specialized transfer pricing group, a transfer pricing review board, and a risk-based approach to transfer pricing enquiries. In late 2010, HMRC also issued guidance to its field teams on more extensive use of penalties in transfer pricing cases (Ernst & Young 2011).

6.03.3 United States Transfer pricing Regime

The Internal Revenue Service (IRS) added 1,200 employees in 2009 to deal with international issues, with another 800 added through the end of 2010. The IRS has established a goal of achieving a staff of 120 transfer pricing economists, the largest number in its history. As part of its transfer pricing focus, in December 2009 the IRS announced a number of important changes, including creation of a transfer pricing practice, establishment of a transfer pricing council to coordinate transfer pricing reviews, and establishment of a tiered approach to targeting intercompany transactions based on their potential for abuse (Ernst & Young 2011).

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. Unlike international practice, the Indian legislation does not allow an option to select a method other than the prescribed five methods, even if it is most appropriate to the business of the taxpayer. A forum was constituted over 40 commissioners or Heads of Taxation of OECD and non-OECD economies make up OECDs Forum on Tax Administration. The aim of this form is to produce outputs of significant relevance to developing countries and in 2012 the forum published the report “Dealing Effectively with the Challenges of Transfer Pricing” which focused on practical administration of transfer pricing programs. During 2012 at the conference more than 100 private sector representatives participated and discussion were relating to Intangibles, Safe Harbors and Timing Issues. There was a discussion about how to improve the transfer pricing
compliance and enforcement and the implementation of targeted safe harbor provisions.

The details of OECD guidelines are as under:

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

b. The OECD guidelines prescribe two broad sets of methodology viz., traditional transaction methods and transactional profit methods giving preference to the traditional methods. Indian provisions prescribe broadly, the same methods as the OECD but there is no preference to particular method but most appropriate method is considered;

c. The 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. But the Indian legislation does not provide guidance on the actual determination of the arm’s length price;

d. The OECD (guidelines) suggests that penalties should be fair and not unreasonably burdensome for taxpayers. The Indian provisions prescribe separate adjustment related and documentation related penalties. (please see Appendix XII-5 for comparative analysis of India and OECD)

6.04. Tax Planning and Tax Haven

Tax planning industry is thriving and many international tax accountants and lawyers are helping various multinational corporations to minimize their global tax burden281. Shifting profit to tax haven through transfer pricing manipulations is one of the golden tools for helping tax planning, which includes three forms: tax avoidance, tax evasion and tax fraud. Tax planning is perceived as compliant behavior when it is not concerned with the aggressive tax avoidance behavior that usually leads to tax evasion and tax fraud. Tax evasion refers to “the situation where a company tries to

reduce tax liability by falsely suppressing income or inflating expenditure recording fictitious transactions, etc.”

Tax fraud is tax evasion by hiding relevant facts, creating nonexistent facts, or which is “covered by a criminal provision in national tax law.” Tax haven is a growing economic phenomenon and its growth rate is enormous. However, there are various definitions for tax haven. “The term tax haven “is not always easy to interpret, mainly because it has taken on so many different connotations.” In broadly the term Tax haven as defined by Colin Power in her book “Tax haven and their uses” reads as “what identifies an area as a tax haven is the existence of a composite tax structure established deliberately to take advantage of, and exploit, a worldwide demand for opportunities to engage in tax avoidance.”

The definition of tax haven “a country or territory where a wealthy individual either physically (having a local presence) or indirectly (meaning that he oversees operations from his resident country) may establish a legal tax shelter with advantages that extend further than those offered in his originating country. This individual may benefit by reducing his tax burden to benefit from a less tax-abrasive society by either self managing an account or by forming a trust”

The OECD in the year 1988 defines tax haven as follows:

- No or only nominal taxation combined with the fact that a country offers itself as a place, or is perceived to be a place, to be used by non-residents to escape tax in their country of residence may be sufficient to classify that jurisdiction as a tax haven.”
- No or only nominal taxation combined with various limitations on the ability of other countries to obtain information from that country for tax purposes would typically identify a tax haven


Eden Lorrain & Smith L Murphy op.cit., p. 16


Ibid., p2 (They quoted Colin Power’s quote that description about tax haven in her book Tax Haven and Their Uses: )

Assogbavi & Azondekon op.cit., p.2


In general tax haven is perceived to be a jurisdiction that creates attractive tax rules, systems of regulation and veils of secrecy in order to benefit non-resident individuals and companies. Similar to concept of Tax haven, there is not any unified list of tax haven.

6.05. **OECD and arm’s length principle**

The OECD Transfer Pricing Guidelines made it clear that the concept of transfer pricing should not be confused with a tax fraud or tax avoidance even though transfer pricing transactions may be used for these purposes. Since transfer pricing may also have other purposes than tax avoidance, fiscal authorities should not automatically determine that companies with cross border activity are trying to manipulate profits. Especially, because it is not easy to establish the price market in precise way. In this context, the Fiscal Affairs Committee of the OECD created a set of rules in order to reduce the risk of misunderstanding or abuse concerning the taxation of some operations in groups of companies, by adopting the so called arm’s length principle enshrined in Article 9 of the OECD Model Double Tax Convention. The arm’s length principle, established in article 9 of the OECD Model Tax Convention is framed in this way: “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”.

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292. Art 9 of OECD Transfer pricing Guideline is important to highlight that this article 9 is the base for the most bilateral tax treaties involving the OECD member countries and for an increasing number of non-members when dealing with transfer pricing.

293. Mauricio, Maria Joao da Cruz “Transfer pricing and the arm’s length principle in the European Union law and domestic law” Universidade do minho p.15 (retrieved on [http://hdl.handle.net/1822/28395](http://hdl.handle.net/1822/28395) on 22.02.2015 at 4 A.M)
mitigating or eliminating double taxation. A transfer pricing adjustment can be
defined as the recognition, for tax purposes, of the actual transaction and the
assignment of income among associated enterprises. In term the transfer price of the
transaction is the adjusted price, which includes the profits of one redistribution of
profits among taxpayers, namely, the increase in the profits of one taxpayer is
balanced by the decrease in the profits of the other. In this context, OECD member
states have concluding some agreements to consent adjustments for tax purposes
whenever the correction of distortion is needed and, thereby, guarantee the
effectiveness of the arm’s length principle. The wording of the article 9(1) of the
OECD Model and the Commentary do not disclose their main purpose, although, this
analysis of paragraph 11 of the commentary of article 25 of the OECD Model
indicates that the reason for inserting the provisions like article 9(1) in a treaty is to
cover, within its scope, economic double taxation. The same is suggested by its
relationship with article 7(1) of the OECD Model tax convention and article 8 of the
OECD Model and its strategic location among these distributive articles. In
addition to this main purpose the article 8 of OECD Model tax convention aims the
prevention of tax evasion and tax avoidance as well as an equitable inter-nation
allocation of taxing rights.

In relation to the domestic law the fact is that contracting states may rely on
domestic law as the authority to levy taxes since, generally tax treaties do not broaden
taxing rights-these rules are normally known as the “golden rule”. Therefore, the
right to make adjustments granted to the Contracting States must rely on the authority
provided by domestic law. In this sense tax treaties normally function by restricting

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294. Ibid p 15
295. Ibid p. 15 The term economic double taxation caused by transfer pricing adjustments (in the
absence of taxpayer identity). The basis of such double taxation may be legal or factual nature:
legally caused economic taxation may be due to the application of different allocation norms in
domestic tax laws of the contracting states; factually caused economic double taxation may arise
due to the disagreement of the contracting states in relation to the facts applicable to specific
allocation norm applied by both states and it may be resolved by the mutual agreement procedure in
article 25 differently article 7 of the OECD Model governs the international juridical double
taxation of business profits
296. Ibid p . 15 article 9(1) governs the taxation of item of income between two taxpayers whereas article
7(1) governs the taxation of an item of income of one taxpayer.
297. Ibid p 15 Article 9(1) provides for a quantification of income between associated enterprises to
which the contracting states are ascribed taxing rights according to the genuine distributive articles
determines the amount of business profits from transactions between associated enterprises
298. OECD Transfer Pricing Guidelines paragraph 7 of 2010
the taxing rights under domestic tax law. By accepting this reasoning i.e., that the arm’s length principle has restrictive nature, we are forced to conclude that the arm’s length principle is a treaty obligation by this way the concept of Arm’s length principle has attained the status of peremptory norm of International Taxation law. The basic question to be answered here is why the OECD member countries favored the arm’s length principle rather than other methods. The answer is “similar tax treatment for multinational enterprises, together with the efficiency that this standard is supposed to work in the great majority of the cases. In fact the recognition of this principle as a high value in itself is also reflected in the OECD 2010 updated Guidelines where worldwide acceptance of this principle was proudly showed. This can be easily demonstrated by the reformulation of the wording of its article 7 of the Model Tax Convention where the expression “separate and independent” rather than “distant and separate” can be now found reinforcing the idea of full competition principle. Further, it was removed from the text of Article 7 of OECD the possibility of opting for another approach, once allowed in paragraph number 4 of the OECD Report 2010 wherein the report and the Commentary to the current article 7 are explicit in what concerns its exceptionally and inadequacy.

According to the OECD the ALP(Arm’s length principle) expresses an international consensus-it must be face as the most effective way to combat transfer pricing. In recent years many developing countries have introduced or strengthened arrangements for combating tax avoidance, including abusive transfer pricing. However, the fact is that the great majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD approach. In view of this problem the countries like China, Brazil, India, and South Africa had serious difficulties in applying the ALP with regard to suitable comparables. This is a time consuming for both tax administrations and taxpayers. The OECD also conscious about the shortcomings of this principle they are insufficiency related to the separate entity approach which

299. Mauricio, Maria Joao da Cruz. “Transfer pricing and the arm’s length principle in the European Union law and domestic law” op.cit p 16 --Article 9 paragraph 4 of the commentary of OECD highlights the fundamental question whether article 9(1) is of a restrictive or an illustrative nature is not consensual among the OECD countries.

300. Ibid., p. 16

301. The OECD Transfer pricing Guidelines for Multinational Enterprises and Tax Administrators, reported in July 1995 with supplementary chapter 1.7 et seq.

302. Article 7 OECD.
may not always be suitable to the economies of scale and the interrelation of the
diverse activities carried on by integrated businesses. The main disadvantages
derived from the type of transactions are concerned, some related enterprises might
undertake what independent enterprises would not the para reads as “in case of
impossibility to estimate the profit potential of an intangible, it may sure that the
independent enterprise does not want to sell it. On the contrary, in a transaction of
this kind is undertaken by a multinational enterprise group, thereshould not the same
risk since the profit stays within the overall group’s profit.303 This creates the
difficulty in the application of the arm’s length principle in some cases due to the lack
of insufficient evidence of the conditions that would be established among
independent enterprises. it is noted that “taxpayers, their advisers and tax authorities
are left trying to reconstruct, from largely dissimilar transactions or entities, what
arm’s length parties have done in similar circumstances”304. By this the conclusion it
is true that the Transactional methodologies seems to be the most direct way to
determine transfer pricing. The only difficulty is to find identical transactions which
can be compared to the one in question. This is more in intangible item as there is no
comparison. In view of this “the taxpayer need, by definition to be able to determine
the tax payable in order to pay that tax, in the same way, tax authorities need to be
able to determine the tax payable in order to properly administer the tax system. The
needs of both parties are thus convergent. But the standard set by the arm’s length
principle that creates a systematic impreciseness in its application305.

6.06 Summary of OECD methods

The table-6 mentioned under summarizes the OECD methods and typical
circumstances in which they are most appropriate.( For comparative charts of India
and OECD please see the Appendix XII-F)

303 Mauricio, Maria Joao da Cruz op cit., p. 17
304 Francois Vincent “Transfer pricing and Attribution of Income to Permanent Establishments: the Case for Systemic Global profit Split (just Don’t say Formulary Apportionment” Canadian Tax Journal 2005 p. 53
305 Mauricio, Maria Joao da Cruz op cit., p. 18
Table-6

<table>
<thead>
<tr>
<th>Transfer pricing methods</th>
<th>Typical circumstances where applicable</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP method</td>
<td>1. Intangibles</td>
</tr>
<tr>
<td></td>
<td>2. Transfer of commodities</td>
</tr>
<tr>
<td></td>
<td>3. Loans, provision of financing</td>
</tr>
<tr>
<td>CPM</td>
<td>1. Provision of services</td>
</tr>
<tr>
<td></td>
<td>2. Transfer of semi-finished goods</td>
</tr>
<tr>
<td></td>
<td>3. Long-term: buy and sell arrangements</td>
</tr>
<tr>
<td>RPM</td>
<td>1. Distribution of finished products</td>
</tr>
<tr>
<td>PSM</td>
<td>1. Transactions involving integrated services provided by more than one enterprise</td>
</tr>
<tr>
<td>TNMM</td>
<td>1. Provision of services</td>
</tr>
<tr>
<td></td>
<td>2. Distribution of finished products where the RPM cannot be adequately applied</td>
</tr>
<tr>
<td></td>
<td>3. Transfer of semi-finished goods.</td>
</tr>
</tbody>
</table>

6.07. **Advance pricing agreements/arrangement**

An Advance pricing Agreement/Arrangement (the specific terminology varies by country) or APA, is an agreement between the taxpayer and the competent taxation authorities that a future transaction will be conducted at the agreed-upon price, which is recognized as the arm’s length price for the period designated. Although retroactive APA’s can be used to reduce tax exposure in past years, APAs are primarily used to avoid the risk of future income assessment adjustments which, as in the case of GlaxoSmithKline could lead to hefty payments in the future.

There are two types of APAs: unilateral and bilateral/multilateral APAs. A unilateral APA is, as the name suggests, an agreement between a corporation and the authority of the country where it is subject to taxation. Although simpler to implement than a bilateral/multilateral APA, a unilateral APA will not be recognized by a foreign tax authority, meaning that a U.S. company securing a unilateral APA for trade with its British subsidiary would still run the risk of being assessed should the foreign tax authorities not agree with the method of calculating the arm’s length price, resulting in doubt taxation.
Bilateral-multilateral APAs however, do provide such coverage, although their implementation requires a more lengthy application process, including consultation between and the agreement of all competent authorities involved. Advance pricing agreements provide a means for business entities to reach a formal agreement with the competent authorities of the states having potential tax jurisdiction over a given set of transactions. According to revenue authorities from countries having some form of APA process, potential benefits to Multinational Corporation include bringing more certainty and predictability to tax treatment of transfer pricing situations, limiting costs and time spent in examination and reducing the possibility of litigation\textsuperscript{306}. Benefits of APAs to the authorities according to them included; a better understanding of a multinational corporation’s business, increased certainty that the correct amount of tax is paid, and a better working relationship between tax authorities of different nations\textsuperscript{307}. (please see Appendix IX-9)

The OECD\textsuperscript{308} defines APA as “an arrangement that determines in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time” APAs are entered into between taxpayer and tax authority to resolve transfer pricing issues as supplement to traditional dispute resolution mechanisms. The mechanism is useful when traditional mechanisms either fail or difficult to apply. The agreement helps to avoid a transfer pricing dispute as taxpayer and tax administration reach an agreement in respect of appropriate transfer pricing method, comparables and appropriate adjustments thereto, by negotiating an acceptable result. The APAs not only provide certainty for taxpayers and reduce tax audit time but it also reduces the reference to competent authorities to negotiate adjustments under the mutual agreement procedure lay down in tax treaties. APAs as a mechanism to resolve disputes is accepted by many countries including Australia, Canada, Japan, UK, USA, France, Netherlands, Germany, New Zealand, and Mexico etc., India also accepted the APA programme, when provisions in this regard were introduced in tax statute by the Finance Act, 2012. These APAs are having advantages and disadvantages as under shown in the Table-7.

\textsuperscript{306} Ernest & Young Transfer pricing “Transfer pricing Risk Reduction and Advance pricing Agreements” (Earnest & Young International Ltd 1995) journal 11 TAX Notes International Tax journal p. 293 (July 31 1995)
\textsuperscript{307} ibid., p. 295
\textsuperscript{308} Para 4.123 of OECD Guidelines 2010
### Table-7

<table>
<thead>
<tr>
<th>SL. No</th>
<th>Advantages of APA</th>
<th>Disadvantages of APA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>APA can assist taxpayers by enhancing certainty in tax treatment of International transactions.</td>
<td>The agreement reached may not always be consistent with the arm’s length principle, and therefore on this basis the competent authority of other country may refuse to allow corresponding adjustment.</td>
</tr>
<tr>
<td>2</td>
<td>Tax payers can plan their pricing strategies including choice of most appropriate method for the transactions.</td>
<td>There is a possibility that Revenue may concentrate efforts on cases of large taxpayers having huge revenue potential and thus ignore the claim of other taxpayer.</td>
</tr>
<tr>
<td>3</td>
<td>The mechanism provides opportunity to tax administration and taxpayer to consult each other and resolve issues in non-adversarial environment for coming to correct and predictable workable result.</td>
<td>Under bilateral APAs there is tendency to harmonize the basis for concluding APAs in a similar manner to those concluded earlier.</td>
</tr>
<tr>
<td>4</td>
<td>It prevents costly and time consuming litigation in respect of major transfer pricing issues. Once APA is agreed the subsequent examination of the case is easy because all possible data and information is available.</td>
<td>APA system can sometime leads to shortage of trained staff as experienced persons are diverted to units dealing with APA workload.</td>
</tr>
</tbody>
</table>

### 6.07.1. Advance pricing Agreement Mechanism in India

Advance pricing arrangement as a proactive dispute resolution mechanism wherein an advance agreement is reached between the authorities and taxpayers was not accepted in transfer pricing regulations as introduced in domestic law by the Finance Act, 2001. The Direct Tax Code Bill 2010 which has not come into force till contains the clause 118 of Direct Taxes Code (DTC) which provides that “with the approval of the Central Government, may enter into the APA with any person specifying the manner in which arm’s length price is to be determined in relation to international transaction to be entered into by that person”. The agreement so entered would be in respect of transfer pricing methodology for determination of arm’s length price out of various methods to be prescribed. The sub clause (3) of DTC stipulates
that the transfer price examination of international transactions for which advance pricing agreement has been concluded would be binding on the taxpayer and the Commissioner and his subordinate authorities and shall applicable for maximum of five years.

The APA procedure as a mechanism for resolving transfer pricing disputes was required in law for early resolution of complex pricing disputes, which created uncertainty in the mind of taxpayers entering into international transaction in respect of their tax liability. This has adversely affected the revenue collections and compliance to the provisions. Tax authorities approach in dealing with cases is also responsible for increase in transfer pricing adjustments as transfer pricing is regarded by authorities as major source of revenue for the country. Many a time for the taxpayer selection of most appropriate method is itself problem due to non-availability of comparables data in public domain. Appeal procedure for resolving disputes is time consuming and does not help in early settling of disputes. In these situations the option available to assessee is contest transfer pricing adjustment is restricted to either filing appeal against assessment or taking up matter under mutual agreement procedure provided in treaty. But this does not help much because of risk of possible double taxation as authorities in other country are not willing to allow corresponding adjustments to the associated enterprise. Many a time the mutual agreement procedure remedy howsoever onerous, is not available to taxpayer if transaction relates to the entity in a country with which India has no tax treaty. Multinational enterprises also sometime face problems to satisfy authorities that their transactions with associated enterprises are at arm’s length because of non-uniform approach followed by authorities in dealing with transfer pricing cases. This advance pricing agreement procedure introduced by the Finance Act, 2012 is almost welcomed by the most of the Taxpayers.

6.08 OECD Model Tax Convention/Treaty—An analysis

Article 9 of OECD Model Tax Convention deals with profits from transactions between associated enterprises covered by OECD treaty. The article 9 of Model Tax Convention deals with profits from transactions entered into between associated

\[309\] Article 9 of the OECD Model Tax Convention reads as 1. “where (a) an enterprise of Contracting State participates, directly or indirectly, in the management, control or capital of an enterprise of the other Contracting State, or
enterprises and provides for adjustment to profits for tax purposes, when two related
entities like parent and subsidiary company enter into transactions other than arm’s
length basis. The tax authorities after examining the conditions of this article have
power to determine tax liabilities of the associated enterprise and recalculate the
profits if the accounts do no show the true taxable income as per arm’s length
principle. Enterprises are regarded associated in any of the following situations:

1. If one of the enterprises participates, directly or indirectly, in the
management control or capital of other or;

2. If the same persons participate, directly or indirectly, in the management control
or capital of both enterprises.

The test to determine whether two or more enterprises are associated is
common management control, or capital. When one enterprise participates in the
management, control or capital of the enterprise of another Contracting State or same
persons participates in the management, control or capital of another Contracting
State the enterprises would be considered to be associated irrespective of the fact
whether the participation is there directly or indirectly. Whether or not the two
enterprises have common management or control or capital has to be decided as per
the regulations in domestic law of the country of which the enterprise is resident.

Section 92 A of the Income Tax Act, 1961, that defines ‘associated enterprise’ for
the purposes of transfer pricing provisions, contains in sub-section(2)several deeming
situations when two or more enterprises can be said to have common management,
control or capital, like holding shares carrying voting power exceeding 26% in
another enterprise; advancing loan of not less than 51% of book value; power to
appoint more than half of board of directors; providing guarantees of at least 10% of

(b) the same persons participate directly or indirectly in the management, control or capital of an
enterprise of a 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 not so accrued, may be included in the
profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly-
profits on which on enterprise of the other Contracting State has been charged to tax in that other
State and profits so included are profits which would have accrued to the enterprise of the first
mentioned State if the conditions made between the two enterprises had been those which would
have been made between independent enterprises, then that other State shall make an appropriate
adjustment to the amount of tax charged therein on those profits. In determining such adjustment,
due regard shall be had to the other provisions of the Convention and the competent authorities of
the Contracting States shall, if necessary, consult each other".
total borrowing of another enterprise; dependency on intangibles owned by another enterprise and substantial purchase of raw material from another enterprise.

Under US Tax Code the term ‘controlled’ means and include any kind of control, direct or indirect, whether legally enforceable or not, and however, exercisable or exercised. Section 90 of Income Tax Act, 1961, confers power on the Central Government to enter into an agreement with the Government of any country outside India for the avoidance of double taxation of income and prevention of fiscal evasion of taxes. This power is derived from entries 10 and 14 of List I of the Seventh Schedule of Constitution of India. Double Taxation Avoidance Agreements (DTAA) are concomitants of international trade and commerce and entered between two sovereign countries as per authority conferred by domestic law. These agreements being part of delegated legislation are negotiated by Governmental authorities and then ratified by the Government. The objective of DTAA is to provide a rational and equitable allocation of income between two countries over which both have tax jurisdiction and provide relief from double taxation of the same income taxed in two countries. Article 9 of DTA Agreement deals with associated enterprises transactions and taxation of profits of such entities. The article commands or orders on tax authority of a Contracting State power to restate the accounts of the enterprise if they do not show true taxable profits arising in the State due to special relations existing between the enterprises. in such cases as per OECD ‘the re-writing of transactions between associated enterprises in the situation may give rise to economic double taxation (taxation of the same income in the hands of different persons) in so far as an enterprise of State ‘A’ whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State ‘B’ the work of State ‘B’ is to make or adjust profits correctly as if the transaction had been at arm’s length. Sub-clause (2) of Article 9 of the OECD Convention makes a provision that the tax administrations can consider requests for corresponding adjustments to eliminate double taxation in transfer pricing cases. A corresponding adjustment can mitigate or eliminate double taxation in a case

310. Section 90(3) of the Income Tax Act, 1961(43 of 1961) deals with “The Central Government hereby notifies that were an agreement entered into by central government with the Government of any country outside India for granting relief of tax or as the case may be, avoidance of double taxation provides that any income of the resident of India ‘may be taxed’ in other country, such income shall be included in his total income chargeable to tax in India in accordance with the provisions of income tax Act 1961, and relief shall be granted in accordance with the method for elimination or avoidance of double taxation provided in such agreement”.

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where tax administration of one country increases taxable profits of company by applying arm’s length principle to transactions entered into between associated enterprises. The corresponding adjustment may be a downward adjustment of tax liability or decrease in the quantum of primary adjustment\textsuperscript{311}. 

OECD Model Tax Convention has set of rules and forms the basis for the other model conventions as well. Further more, the recommendations and interpretations are permanently reviewed and updated in order to take account of new findings resulting from scientific research and practical experience. In the OECD Fiscal committee which is in charge of continual process, only the tax administrations of the members countries are represented. Model conventions are not enforceable they lay down the guiding principles for the interpretation of tax treaties. OECD has formally recommended to its members to confirm with the OECD MTC when negotiating bilateral conventions.

6.09.\textit{UN MODEL TAX TREATY- an analysis}

The United Nations Model Double Taxation Convention between Developed and Developing countries (the UN MTC) is of similar importance as the OECD MTC. This model was first published in 1980 by the “United Nations Economic and Social Council” (ECOSOC) after twelve years of preparation. The Secretary General of the United Nations had in 1968, commissioned a international group of experts to perform preparatory work for such a model convention, because it had become evident that the provisions of the OECD MTC when included in a bilateral convention between a developing and a developed country, in many cases resulted in an unacceptable flow of funds from the former to the latter. The reason for this is that the OECD MTC is mainly governed by the principle of residence which is appropriate if the exchange of goods and services between the contracting states is more or less balanced. However, where the follow of goods, services, capital and know-how is mainly in one direction as it is often the case in the economic relations between developing and developed countries, it will be inequitable to allocate the right to tax income predominately to the country of residence. Consequently, the UN MTC puts a much stronger accent on taxation at source than the OECD MTC does. The UN group of experts, when elaborating the guidelines of the UN MTC decided to use the OECD

\textsuperscript{311} Wahi V S. “\textit{Transfer pricing Law procedure and documentation” an Indian and Global analysis”} Snow White Publication (2013)5\textsuperscript{th} Ed p. 409
MTC as its main reference text in order to take advantage of the accumulated technical expertise embodied in it, and in the commentaries thereon. As a result, the structure of both models is very similar; however, there are divergences in various respects, the most important of which relate to:

1. The period of time for the creation of a permanent establishment (PE) triggered by construction or installation work;
2. The creation of a PE by furnishing services;
3. The scope of profits attributable to a PE;
4. The taxation of dividends, interest and royalties.

Meanwhile, the UN MTC and MTCC have been reviewed and updated. ECOSOC have approved new version in 2000 & 2011. Most of the amendments to the OECD MTC are now reflected in the UN MTC. In brief as there is no much difference between the OECD MTC and UN MTCC the contents are as seen in model are as in the Table-8

### Table-8

<table>
<thead>
<tr>
<th>Sl No</th>
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<tr>
<td>1</td>
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<td>Chapter-I- Scope of the Convention</td>
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<td>Art.1- persons covered</td>
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<td>Art.2 Taxes covered</td>
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<td>Chapter-II Definitions</td>
<td>Chapter-II Definitions</td>
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<td></td>
<td>Art.3 General definitions</td>
<td>Art.3 General definitions</td>
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<tr>
<td></td>
<td>Art. 4 Resident</td>
<td>Art. 4 Resident</td>
</tr>
<tr>
<td></td>
<td>Art. 5 Permanent establishment</td>
<td>Art. 5 Permanent establishment</td>
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<tr>
<td>3</td>
<td>Chapter-III Taxation of Income</td>
<td>Chapter-III Taxation of Income</td>
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<tr>
<td></td>
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<td></td>
<td>Art. 7 Business profits</td>
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<tr>
<td></td>
<td>Art. 8 Shipping, inland waterways transport and air transport</td>
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<tr>
<td></td>
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<td>Art. 9 Associated enterprises</td>
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<tr>
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312 C S Mathur, Dr Maximillian Gorl, Karl Sonntag “Principles of Model Tax Conventions and International taxation” Lexis Nexis (2013) 1st Ed, vol.1, p. 6-7
6.10. **Conclusions**

Transfer pricing issues were not given due importance in developing countries. But in view of growing involvement of multinational enterprises in the economies of these countries, it was necessary that they formulate rules and regulations concerning transfer pricing. Moreover, the countries which are new to the international transfer pricing arena are increasingly at risk until they adopt regulations that concern pricing of transactions of goods and services transferred between related parties. It is very much necessary for the developing countries to make development in view of growing transfer pricing regime. The developing countries have to adopt the regulations that concern pricing of transactions of goods and services transferred between related parties. The motivation for transfer pricing manipulation, as some MNEs engage in
practices that seek to reduce their overall tax bills. This may involve profit shifting through non arm’s length transfer pricing in order to reduce the aggregate tax burden of the MNE. However, while reduction of taxes may be a motive influencing the MNE in setting transfer prices for intro-group transactions, it is not the only factor that determines the transfer pricing policies and practices. A comprehensive survey of all transfer pricing cases dealt with over the past decade by the courts in Australia, United States, United Kingdom shows that the application of the arm’s length principle still appears to be difficult. It is always a tug of war for taxpayer and tax administration to be of different opinion with respect to this application in a given situation. More successful instruments appear to be advance pricing agreements and mutual agreements procedures. Additionally high number of double taxation issues are resolved annually under the mutual agreement procedures. It is not known externally to what extent these proceedings indeed result in resolving the underlying transfer pricing disputes, the reported figures at EU level make it clear that dispute resolution on the basis of the EU Arbitration convention has proved to be a real success story.

Upon going through the practices of the above subject it is evident that an alternative to the arm’s length principle might be a Global Formulary Apportionment Method which would allocate the global profits of the MNE group amongst the associated enterprises on the basis of a multi-factor weighted formula (using factors such as property, payroll and sales for example, or such other factors as may be defined when adopting the formula). A formulary apportionment approach is currently used by some states of the USA, Cantons of Switzerland and provinces of Canada. Also, the Brazilian transfer pricing rules set out a maximum ceiling on the expenses that may be deducted for tax purposes in respect of imports and lay down a minimum level for the gross income in relation to exports, effectively using a set formula to allocate income to Brazil. The European Union is also considering a formulary approach, at the option of taxpayers, to harmonise its corporate taxes under the Common Consolidated corporate Tax Base (CCCTB) initiative.