CHAPTER-VII

Problem of Transfer Pricing in practical application as enshrined in the Indian and international case laws, procedural Requirements, tax avoidance behavior of Multinational enterprises, comparability data vs. developing countries, and Arm’s Length principle vs. formulary Apportionment method and the concept of CCCTB – A critical study
CHAPTER VII

PROBLEMS OF TRANSFER PRICING IN PRACTICAL APPLICATION AS ENSHRINED IN THE INDIAN AND INTERNATIONAL CASE LAWS, PROCEDURAL REQUIREMENTS, TAX AVOIDANCE BEHAVIOUR OF MULTINATIONAL ENTERPRISES, COMPARABILITY DATA vs. DEVELOPING COUNTRIES, AND ARM’s LENGTH PRINCIPLE vs. FORMULARY APPORTIONMENT METHOD, AND THE CONCEPT OF CCCTB – A CRITICAL STUDY

7.01. INTRODUCTION

The subject of Transfer pricing is proving to be fertile ground for several controversies. The nascent stage of regulations and lack of clarity, prudence have often left the taxpayer and Revenue authorities in a fix. With the spread of global industrialization, tax authorities and MNEs have become increasingly concerned about the direction and complexity of international tax problem. The growth in world trade and the corresponding growth in MNEs have caused sovereign states to develop intricate laws for the taxation of international transactions. This leads to the taxation of cross-border intercompany transactions.

The international tax problem associated with cross-border intercompany trade is attributable to the structure of MNEs. MNEs conduct business in more than one country, by adopting legal structures to meet their business needs. These legal structures can be branches, subsidiaries, partnerships or even joint ventures. Despite the form, the operating units of MNEs are rarely independent. Often a dominant parent or partner in one country will control the operating units in foreign

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313 Thomas F Field, IFA congress participants Tackle International Tax issues, 77 TAX Notes 536 (Nov 3 1997) (relating the International fiscal association (IFA) congress held its 51st session in New Delhi, India in October 1997) Because of the complexity of international tax issues, and the evolving nature of world trade, the participants often found themselves disagreeing over such tax issues as investment funds, electronic commerce cross-border valuations and presumptive income taxation


316 Robert Turner, “Study of Transfer pricing” Technical Committee on Business Taxation, working paper 96-100) (this study recognizes that units of MNE are rarely self-sustaining or independent)(1996)p.5

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jurisdictions. As a result cross-border transactions often take place between the parent and the parent and the units and among the units collectively. The prices charged or paid for goods or services in these cross-border intra-group transactions may or may not reflect market forces and are the transfer price. \textit{Transfer pricing is therefore is the internal price at which intangible goods, intangible property, services, loans and leases are exchanged between constituent parts of MNEs}

\textit{Determining a transfer price is easy, when two independently self interested parties determine by negotiations fix the price of goods, because the income received is equal to the price paid. This type of exchange is referred to as an arm's length transaction and is reflective of the free market. Because the two parties to this transaction are acting out of their own self-interest.}

Indian transfer pricing regulations (Indian TP regulations) are exhaustive in many respects and broadly based on the OECD transfer pricing Guidelines for Multinational Enterprises and Tax administration (called OECD Guidelines) and prescribes methodologies to be followed, documentation to be maintained, and penalties to be levied, though in some respects they have their own peculiar flavor. In total the central theme of Indian TP regulations are similar to the most of the most regulations of the other countries.

\textbf{7.02. Documentation of Transfer pricing}

Documentation is an important aspect of transfer pricing as it forms the basis to establish arm’s length price of associated enterprise transactions. All MNEs consider Documentation is the key issue of transfer pricing of transactions entered into with affiliates or between entities within same group. The Documents and information kept by the assesses are used as evidence of the nature of transactions, arrangements between parties and pricing policy of the company. Most countries require taxpayers to prepare and maintain proper documentation and information to confirm that the amounts charged or paid in associated enterprises transactions are consistent with arm’s length principle. Some tax authorities require no documentation of transfer pricing practices and or no penalties for misstatements or noncompliance, while other require stringent contemporaneous documentation and impose severe penalties for noncooperation. TNC’s must be aware of and comply with each country’s specifics to avoid penalty assessment and to prepare the documentation.

\footnote{Ibid.}
appropriate to that country, rather than churning out generic documentation that might be too detailed for some tax authorities, but not detailed enough for others\textsuperscript{318}(also refer to the Appendix IV & V of this thesis)

7.02.1. Burden of proof

The burden of proof to show that the transaction with associated enterprise is at arm’s length lies on the assessee. The enterprise is required to provide data of comparable uncontrolled transactions; apply appropriate transfer pricing method and justify the method selected by producing relevant documents to revenue authorities. Since initial burden to prove the arm’s length nature of international transactions rests on the assessee, it can be effectively discharged through proper documentation. The OECD Guidelines 2010\textsuperscript{319} contain documentation rules and procedures that are recognized as model for various countries that do not have documentation rules in transfer pricing regulations. The guidelines are helpful to countries to frame their own rules on the subject. They also provide assistance to taxpayers in identifying documents and materials that may help in resolving transfer pricing disputes. The various principles enunciated in these guidelines are

a. The Taxpayer should determine arm’s length price of transactions considering information that is reasonably available at the time of price determination.

b. The Taxpayer should consider whether its transfer pricing is appropriate for tax purpose and whether appropriate comparable data is available\textsuperscript{320}

c. It also informs that the taxpayer when request for documents is made the tax administration should balance its need for documentation considering the cost and administrative burden of compliance on taxpayer particularly where this process suggests creation of documents. The Taxpayer should not be expected to incur disproportionately high costs and burden to obtain documents from foreign associated enterprises

d. The tax administration should not ask the information for the period which is beyond period of retention prescribed in domestic law\textsuperscript{321}.


\textsuperscript{319}Para 5.4 of OECD Guidelines 2010

\textsuperscript{320}ibid p 5.4

\textsuperscript{321}Para 5.8 of the OECD Guidelines 2010
e. The information that may be obtained from taxpayers to determine the arm’s length price is as follows:

- An outline of the business carried on by the concerned associated enterprise
- The structure of the organization and ownership linkages within the multinational enterprise group
- The sales and operating results for the last few years preceding the transactions
- The level of the transactions with foreign associated enterprise such as volume of sales of goods, the rendering of services, rent of tangible assets, transfer of intangible property and interest on loans
- Information on pricing policy, business strategies and special circumstances of the transactions at issue can be useful for determination of arm’s length price. The factors that might have influenced the setting of prices for taxpayer and whole group are relevant consideration.
- Special circumstances of the transactions showing functions performed, impact of risks, financial information, documents showing process of negotiation
- Appendix V of this thesis contains the detailed statute for burden of proof

7.02.2. PATA Documentation

Pacific Association of Tax Administrators (PATA) is an association of pacific countries of Australia Canada, Japan and USA. It lays down the principles as per which members can create uniform documentation package to comply documentation requirement in their country. PATA requires that taxpayer of the member country should prepare and maintain such documentation for transactions between itself and associated enterprise of another PATA jurisdiction that may demonstrate compliance of arm’s length rule. The documents so maintained for this purpose should be adequate to show that taxpayer had reasonably selected and applied particular transfer pricing method that produced an arm’s length result as per domestic rules of the country. The rules enshrined in the PATA for complying documentation and avoid penalties are as under:

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322 Wahi V.S “Transfer pricing Law procedure & Documentation” An Indian and Global analysis Snow white publication (2013) p. 283
1. Arm’s length principle: the taxpayer should make reasonable efforts to establish transfer prices in compliance with arm’s length principle and the efforts include analysis of controlled transactions search for comparable transactions and selection of appropriate transfer pricing method.

2. Contemporaneous documentation

3. Timely production of documentation

4. Nature of documentation

7.03. **Indian regulation on transfer pricing (documentation)**

Section 92D of the Income Tax Act 1961 and Rule 10D deals with documentation requirement that need to be complied by every enterprise entering into international transaction with associated enterprise. The regulations are exhaustive and provide documents, data record and information that may be considered necessary to establish arm’s length result of transactions. With amendment introduced by Finance Act 2012 the compliance to documentation requirement is necessary even for certain designated domestic transactions to which transfer pricing regulations have been extended. The Income Tax Rules 10D provides various type of information documents the general and specific information that may be necessary would depend upon the nature of transaction and data available in public domain, where transactions of similar nature are grouped together it may be sufficient compliance of the rules if common documentation is maintained especially when transactions are aggregated for comparability analysis. Appendix IV, Appendix IX of this thesis contains the details of comparative analysis of the documents required for the purpose of Transfer pricing. Apart from this the taxpayer has to maintain certain valid information from the angle of assessment in the Tax department like

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Section 92D “(1) every person who has entered into an international transaction shall keep and maintain such information and document in respect thereof, as may be prescribed

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

(3) the assessing officer of the Commissioner (Appeals) may, in the course of any proceeding under this Act, require any person who has entered into an international transaction to furnish any information or document in respect thereof, as may be prescribed under sub-section (1) within a period of 30 days from the date of receipt of notice issued in this regard:

Provided that the Assessing Officer or the Commissioner (Appeals) may on an application made by such person, extend the period of 30 days by a further period not exceeding thirty days

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Wahi V S *op cit.*, p. 287
a. Description of the business
b. Nature and terms of international transaction
c. FAR analysis
d. Economic and market analysis
e. Record of uncontrolled transaction
f. Comparability analysis
g. Transfer pricing method considered
h. Working of arm’s length price considered
i. Pricing policies and price negotiation
j. Details of adjustment
k. Any other information required

7.03.1. Accountant Report

(Section 92E of Indian Income Tax Act 1961\textsuperscript{325})

Section 92E of Income Tax Act 1961 obligates every taxpayer entering into international transaction to furnish a report from an accountant in the prescribed form 3CEB. These reports contain details of international transactions, associated enterprises particulars of tangible or intangible property or services provided or of any other transaction must be filed before specified date which is due date for filing return of income for relevant assessment year. The report from a chartered accountant or any other person qualified to be appointed as an auditor in the prescribed form 3CEB.

In the case of Development Consultant Pvt Ltd vs. TPO\textsuperscript{326}, the question of non-compliance of statutory requirement to furnish accountant’s report with return of income. The tribunal held every person entering into any international transaction with an AE should furnish accountant reporting prescribed form along with return of income and also maintain necessary documents, which must be filed with the department at the time of assessment. (please see Appendix XIII & XIV of this thesis gives the detailed description of the various sections of Indian Income Tax Act 1961 wherein the provisions of Reports and form were described)

\textsuperscript{325}. Section 92 E of Indian Income Tax Act 1961 states

“Every person who has entered into an international transaction during a previous year shall obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by such accountant setting forth such particulars as may be prescribed”

\textsuperscript{326}. (2008) 115 TTJ (Kol) 577
7.03.2. Documentation requirement in other countries (please see Appendix IV & Appendix IX of this Thesis for detailed picture of documents required in connection with Transfer pricing methodologies)

A. AUSTRALIA

The Taxpayer is required to maintain a record of the process of setting transfer prices and verification of those transactions against arm’s length principle. The Tax Ruling 98/11 issued by Australian Tax Office (ATO) deal with documentation requirements and practical issues relating setting and review of prices in international dealings. The guidelines provide that taxpayers should have flexibility in preparing contemporaneous documentation and maintain proper documents and records in respect of their transfer pricing arrangements before filing their tax returns. 327

B. USA

USA has elaborate requirements for documentation compliance. It contains information of organizational structures covering related parties and foreign affiliates and such other information and documents that are specifically prescribed in the regulations. In case of DHL Corporations and Subsidiaries v Commissioner, 328 the US court considered the effect of non-maintenance of necessary documentation. The court held that taxpayer was liable for transfer pricing penalty because requisite documentation was not prepared by the company but by a consultant who was doing work for DHL and was therefore not independent. It also held that other documents such as “memos to the file” should be very clear to establish the ownership of intellectual property.

C. United Kingdom

United kingdom rules are based on OECD guidelines though these are supplemented with instructions issued by the Government. The Tax payers are asked to prepare and retain such documentation as is reasonable and which identifies relevant commercial or financial relations falling within the scope of the legislation; the nature of the terms of relevant transactions, the methods used including study of comparables and any functional analysis undertaken. The documents maintained should indicate whether the method selected has resulted in arm’s length terms, and where it has not, the adjustment required and the basis of the calculation.

327 Wahi V S op.cit., p 311
328 TC Memo 1998-461
7.04. **Transfer pricing Audit Procedure**

Transfer pricing audit and scrutiny in Income Tax Department is handled by special units functioning under Directorate of International Taxation. These units are headed by the Director of Income Tax(Transfer Pricing) and function under the administrative control of Director General(International Tax). The special units set up in different cities handle references received from Assessing Officers for determination of arm’s length price of international transactions. The units are manned by competent officers who have requisite aptitude and expertise in handling these cases. Each unit is manned by several Transfer pricing Officers of the level of Additional commissioner, Joint Commissioner Deputy Commissioner, Assistant Commissioner supported by their staff. Many countries have special International audit staff to handle transfer pricing investigations. In UK the Investigation is conducted by a specialist though basic inquiries are imitated by the inspector handling the case at the district level.

7.04.1. **Selection Criteria for Scrutiny in transfer pricing**

The cases are selected for audit depending on value of International transactions. The CBDT fixed a threshold limit of Rs. 50 million international transactions for reference to TPO which in later years was increased to Rs. 150 million. The Board has not fixed any industry specific criteria, such as earnings below industry average, for selecting cases for scrutiny. However in some cases scrutiny is done on specific information.

7.04.2. **Reference to Transfer pricing officer**

Section 92 CA of the Income Tax Act 1961, provides that the assessing officer can make a reference to Transfer Pricing Officer, where he considers it necessary or expedient to do so, for determination of arm’s length price in a case involving international transaction. The reference can be made by the jurisdictional assessing Officer after taking prior approval from the concerned Commissioner of Income Tax. The proceedings for determination of arm’s length price of transactions commence after reference is received from the officer concerned. Thus the starting point for audit and scrutiny by the department is the reference made to TPO which is done on the basis of analysis of transactions reported in form 3CEB by the assessee and value of transactions. Section 92CA lays down the procedure for handling a case whenever
a reference is received from the Assessing Officer for determination of arm’s length price. The reference is necessary if assessee has entered into an international transaction in any previous year, and in opinion of the Assessing Officer it is necessary or expedite to make a reference for computation of arm’s length price of the international transactions.

### 7.04.3. Specified Domestic Transaction

The Finance Act 2012 by amendment in sub-section (1),(2), and (3) of section 92 CA has included the words ‘or specified domestic transaction” for the purpose of making a reference to Transfer pricing Officer to determine arm’s length price. The amendment has taken effect from 1.04.2013 and accordingly apply to assessment years 2013-14 onwards. The effect of the section is the scope of transfer pricing provisions has now been enlarged to specified domestic transactions as well. The term specified domestic transaction is defined by newly inserted section 92BA to include:

1. expenditure referred in section 40A(2)(b)of IT Act 1961
2. Any transaction referred to in section 80A
3. Transfer of goods or services referred to in section 80IA(8)
4. Business transacted between the assessee and other persons referred in Sn 80-IA (10)
5. Any transaction referred in ch-VIA or 10AA

The specified domestic transaction applies if the aggregate value of the such transaction exceed a sum of five crore rupees.\(^{329}\) (Please see Appendix XIII of this thesis for further detailed description)

### 7.04.4 Jurisdictional Issues

In India, transfer pricing is proving to be fertile ground for several controversies. The lack of clarity on various interpretational issues coupled with lack of judicial prudence has often left the taxpayer and Revenue authorities at odds. In Indian Income Tax Act 1961, the provision was created with insertion of Sn 92CA of the Income Tax Act 1961(Act) in financial year 2002-03 to provide the assessing

\(^{329}\) Wahi V S op.cit., pp375-376
officer expert inputs on the arm’s length nature of the transaction entered into by the taxpayer. Sn92CA(1) of the Income Tax Act 1961 provides that the assessing officer may make a reference to the Transfer pricing Officer if he considers it ‘necessary and expedient’ to do so. It has been held that the term the word ‘expedient’ means appropriate, advantageous and convenient as guided by self interest. The use of phrase ‘necessary and expedient’ in sn92CA (1) clearly implies vesting of discretion with the assessing officer in referring a case to Transfer Pricing Officer. The CBDT has issued instructions\(^{330}\) that all cases wherein the aggregate value of international transactions is above INR 50 million (INR 150 million from the financial year 2006-2007) should be referred to the Transfer pricing officer. Also it is unclear that whether the assessing officer is in fact duty bound to make a reference to the Transfer pricing officer in matters involving international transactions with an aggregate value of more than INR 50 million. Conversely it also not clear as to whether the assessing officer has the power to make a reference to the Transfer pricing officer in cases where the aggregate value of international transactions is less than INR 50 million. The legislation is silent on the above issues. Though CBDT has mandated a minimum value above which the assessing officer has to compulsorily make a reference, nothing precludes the assessing officer to make a reference in case the value is lower than the prescribed limit. Another issue is reference made to the Transfer pricing officer needs to be transaction specific and not taxpayer specific. Under the provisions of section 92CA, reference is in relation to the international transaction hence all transactions have to be explicitly mentioned in the notice for reference. In case assessee demand the TPO has to show that he has the power under section 92CA to determine the arm’s length price for a given international transaction. Under section 92CA(4) provides that on receipt of the order passed by the Transfer pricing Officer, the assessing officer shall proceed to re-compute the total income of the assessee ‘having regard to’ the arm’s length price determined by the Transfer pricing officer. Also the expression ‘having regard to’ in section 92CA implies that the order issued by the TPO is not ipso facto binding on the assessing officer, but is

\(^{330}\) CBDT New Delhi Ministry of Finance Govt of India vide Re Instruction No 3 of 2003 dated 20th may 2003 clarified that the Executive instructions, which are in the nature of subordinate or delegated legislation, are issued by the CBDT in exercise of its powers under 119 of the Act. Sn 119 of Income Tax Act 1961 reads as under “the Board may, from time to time, issue such orders, instructions and directions to other income-tax authorities as it may deem fit for the proper administration of this Act and such authorities and all other persons employed in the execution of this Act shall observe and follow such orders, instructions and directions of the Board.”
merely recommendatory in nature. The Honorable Supreme Court 331 observed “it is well settled that where such a phrase is unused, it means that the Assessing Officer has to take into consideration the relevant report, computation of factors and not that they are binding or decisive on the Assessing Officer…” In view of the above it is incumbent on the assessing officer to independently examine the TPO’s order, and not be bound by it. Though the order of the TPO is recommendatory in nature, one would find that in most cases the assessing officer takes the price determined by the Transfer pricing Officer as the arm’s length price.

7.05. Tax avoidance behavior of the Multinational corporations can it be treated as a legitimate problem or not- A critical view

To answer this question first we have to identify the subject of Legitimacy theory. According to which the organization strive towards being perceived as legitimate by operating within the bounds and norms of the society. Bounds and norms of the society are changing overtime, thus organization have to “be responsive to ethical (or moral) environment in which they operate”332. Legitimacy theory treats legitimacy as a resource that is necessary for an organization’s survival. the organization will pursue the appropriate legitimating strategies for continued supply of such a necessary resource in order to gain, maintain or repair legitimacy333 the importance does not lies in what the organization actually does but rather in “what society collectively knows or perceives about the organizations conduct” Traditionally, the optimal corporate performance is considered to be profit maximization. However, as social expectations have evolved over time, the focus of society’s expectations has shifted towards some social issues such as environment, health and safety of consumers and employee334 legitimacy theory stresses that an organization should consider “the rights of the public at large, not merely those of its investors”335 organizations are not considered to an inherent right towards resources “ and they need to earn this right. “There is an imperfect correlation between law and social norms” 336 the concept of gaining maintaining or repairing legitimacy,

331 JuggilalKamalapat v WTO reported in ITR 145 (1983)(p 485 (SC)
333 Ibid., p. 234
334 Deegan, Craig & Unerman Jeffrey. P 325
335 Ibid p .325
336 Ibid p. 328
organizations will choose different legitimating tactics depending on their different needs to do with their current legitimacy “gaining legitimacy occurs when an organization moves into new area of operations in which it has no past reputation” strategies through using accounting reports, since annual reports is a way of public disclosure of information. In recent year gaining and maintaining legitimacy is more about building or maintaining an organization’s reputation. Reputation risk management is a notion created under such circumstances. It indicates the financial importance of legitimacy to organizations. A corporation’s reputation is considered to be “a resource of considerable (if normally unquantified) in generating future profits any damage to this reputation will have negative impacts on the corporation’s future profitability. Therefore, threats to corporate legitimacy can cause damage to the value of corporation’s reputation, which must be minimized through active management. Corporate tax avoidance is one of the main reasons, companies use tax havens. Such a behavior has a “a massive impact on developing and developed countries alike. Yet the developing countries suffered more from multinational corporation tax avoidance behavior, because such a behavior cuts off the only sustainable source of funding for (developing countries) governments to invest in reducing poverty and inequality the OECD estimates that developing countries lose almost three times more to tax havens than all the aid they receive each year.

According to Ernst & Young’s 2013 global transfer pricing survey which is based on interviews with professionals at 878 corporation in 66% of companies identified ‘risk management’ as their highest priority for transfer pricing. There is a “32% increase over surveys conducted in 2007 and 2010”. The results of survey also show that “28%of companies reported using the mutual agreement procedure: 26% of companies reported using the advance pricing agreement process (APA),

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337 Ibid p. 331
338 Ibid., P. 333
339 Ibid., p.333
341 Ibid p1
15% of companies reported having referred a case to litigation in the past years; 28% of companies report unresolved transfer pricing examinations.

The above statistics show that there is growing concern for transfer pricing issues, leads to increasing amount of work for supranational organizations. OECD has recently carried out a project on BEPS (Base Erosion and Profit Shifting) which is focusing on harmonizing tax authority’s approaches to eliminate inappropriate tax avoidance. In BEPS project report, some indicators show that “tax practices of some multinational companies have become more aggressive over time, raising serious compliance and fairness issues”\(^{343}\), the reports points that the Transfer pricing is “key pressure area” especially when it comes to “the shifting of intangibles, the artificial splitting and ownership of assets between entities within a group, and transactions between such entities that would rarely take place between independents.”\(^{344}\)

7.05.1. Tax Avoidance through transfer pricing manipulation - A study with illustrations with respect to facts and circumstances of the following instances reported by the NGOs/private Agencies like Action Aid\(2009\)/Oxfam n.d./Christian Aid/Bloomberg/Reituer etc.,

The following facts and illustrations are collected from the companies website and other various sources such Forbes, Bloomberg, the Guardian and Action Aid reports these are all facts and circumstances wherein neither of them has been decided by the court of law nor Income Tax Appellate Tribunals. These multinational corporations how mispriced the concept of Transfer price under the umbrella of Tax avoidance which neither falls under legality nor illegality which is grey area of law. Which falls under the fine line between Tax evasion and Tax avoidance. The following instances multinational corporations tax avoidance behavior via transfer pricing manipulations is harmful to the society because it causes loss of social welfare; it is against the moral ethics, since such a behavior is against the social norm of fairness, thereby breaches the social contract and its results evasion to corporate social responsibility.

\(^{343}\) Ernst & Young opcit., p 6
\(^{344}\) OECD 2013 p.6
I. Forest Laboratories Inc. Case- The Double Irish

Forest laboratories Inc., a pharmaceutical company, having its headquarters in New York city known for licensing European pharmaceuticals. The company used to sell the medicine by name Lexapro the medicine generated in 2002 is 13.8 billion revenue and in the year 2009 it generated 2.3 billion in revenue. But most if its profits are not taxed in the US and company pays little tax elsewhere the profit from Lexapro makes a journey across the Atlantic ocean to Dublin Ireland. The Irish subsidy controls the patents of Lexapro for the U.S market: while forest licenses the use of patent from a Danish pharmaceutical company. The Irish subsidiary sells Lexapro to the parent company in the U.S. The secondary processing, such as bottling and blister-packing, is carried out in the U.S. Each tablet the parent company buy helps shift profit to Ireland, where the corporate tax rate is between 0 percent and 12.5 percent. But the corporate rate of tax at U.S is 35 percent which is one of the world’s highest tax rates on corporate income.

In a fiscal year 2009 the Irish subsidy reported 2.5 billion in sales which accounted for 70% of parent company’s net sales. Its sales is 3.6 billion the profit from lexapro does not stay in Ireland. The law office established subsidiary in Ireland was to deal with manufacturing and sublicensing the rights to the patents. This arrangement helped the Irish subsidiary reduces its effective tax rate from 10.3 % to 2.4 % this type of structure has s special name called the Double Irish

The Irish-Dutch-Bermudan international operation doubled Forest’s income tax saving. In 2007 the company’s effective tax rate was reduced by 21.8 percent. By using transfer pricing manipulations Forest save more than one third the total sales of Forest during the four years from 2009 to 2012 ( 4% in 2009, 7% in 2010, 8% in 2011 and 4.3 % in 2012). In the year 2013 the corporation’s net sales decreased 33.9 percent with a significant decrease of 90.0 percent in net sales The 2013 annual report blames the sharp decline of the corporation’s net sales to a dramatic decrease in lexapro sales, which as per the 2013 annual report is the result of the “expiration of its market exclusivity in March 2012

346. Ibid., p. 12(Sources Forest Laboratories. Inc.(2013) 2013 Annual Report,p.12)
347. Drucker Ibid., p 42
2. **Apple Case** by using transfer pricing manipulation, Apple successfully cuts its U.S. corporate tax by an average of 10 billion yearly for four years. The apple minimizes the property income by charging little to its foreign affiliates for using intellectual property. This helps Apple shift the profit to its foreign subsidiaries by maximizing their profits. Apple has two firms in Ireland and they are the core of Apple’s tax arrangement. These two firms helped Apple funnel two-thirds of its pre-tax global income. Apple generated 34 billion pre-tax income in total, of which 22 billion was shifted to these two firms in Ireland. However, these income did not return to Apple. It disappeared into the deep blue. That is the “ocean income” as interpreted by the professor Steve Shay of Harvard University. According to the Australian Financial Review, Apple has moved 8.9 billion in profits from Australia to Ireland in the past 10 years. In 2013, Apple Sales International in Ireland was reported to help Apple shift 2 billion income from Australia to Ireland and Apple only reported 88.5 million in pre-tax earnings in Australia.

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<td>Domestic and International Net Sales</td>
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3. **Caterpillar Case**:

Caterpillar Inc. is one of the world’s largest manufacturing companies which designs, manufactures, markets and sells machinery and engines. It is reported that the company moved more than 8 billion in profits to Switzerland for the reason of tax avoidance. The majority of manufacturing, R&D and employment are in the U.S.

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349. Gleckman, Howard “The Real Story on Apple’s Tax avoidance: How Ordinary it is” Forbes accessed at [http://www.forbes.com/sites/beltway/2013/05/21/the-real-story-about-apples-tax-avoidance-how-ordinary-it-is-retrieved-on-03.03.2015-at-3.30-a.m.](http://www.forbes.com/sites/beltway/2013/05/21/the-real-story-about-apples-tax-avoidance-how-ordinary-it-is-retrieved-on-03.03.2015-at-3.30-a.m.)

350. Ibid., p.45


The company’s most profitable business is the international spare parts business. The Swiss subsidiary is established only for the tax avoidance purpose. It is reported that 85 percent of profit from the international spare parts business were routed through Caterpillar’s Swiss subsidiary. By making a deal with Swiss tax authorities, the company succeeded in avoiding paying more than 2.4 billion in U.S. tax, over a decade. And Caterpillar’s Geneva based subsidiary only paid 4% tax on the profits of international spare parts sales. Thereby the company utilized the concept of Tax avoidance by way of manipulation.

4. SABMiller Case:

It is one of the FTSE 100 corporations and it is world’s second biggest brewer and one of the world’s biggest bottlers of Coca-cola products. SABMiller has more than 200 beer brands and over 70,000 employees in 75 countries around the world. The headquarters of the company is situated in London, United Kingdom (SABMiller). SABMiller has involved in many tax affairs in the developing World. one example is the corporations’ tax dispute case in Delhi High court, India. SABMiller is accused of evading tax when buying intangible assets (Foser’s brand name and patent in the Indian branch) from Forster’s Australia, one of the SABMiller’s subsidiaries. In 2011 SABMiller was sentenced to pay tax on the deal of purchasing the Indian assets from Foster’s. Accra Brewery, SABMiller’s subsidiary in Ghana, Africa, is the second largest brewer in Ghana the company generated 29 million pound of beer yearly but it recorded a loss in the past two years. Moreover, company “paid corporation tax in only one of the four years from 2007-2010” A small retailer of SABMiller’s club beer in Ghana with pound 220 in profit monthly paid more income than it’s suppler. During the year 2009-2010 in principle the SABMiller shown the tax loss to the African countries also similarly in Netherland. The total estimated tax loss to African countries is 10 million pounds.

356. Ibid p.7
357. Ibid p 8
The analysis of above cases reveals the practice and means of existing Multinational Corporations/MNEs. Among the three forms of tax planning, 1. Tax evasion and 2. Tax fraud are fundamentally illegal, while 3. Tax avoidance lies in a grey area. It is a sort of legitimate form of tax planning which uses loopholes in laws and regulations for avoiding taxes. These tax avoidance behavior of Multinational and transfer pricing issues are like a two faces of the same coin. These multinational enterprises practices of tax avoidance automatically tend to shift the profit to low tax jurisdiction areas resulting manipulations.

But there is a fine line between tax avoidance and tax evasion. Governments of developed countries are losing billions of dollars annually in tax revenue because of Multinational Corporation’s tax avoidance behavior via transfer pricing manipulation. As per the OECD estimates “developing countries lose almost three times more to tax havens, than all the aid they receive each year” on observing the above cited case laws it is evident that developing countries suffered more, from multinational corporations tax avoidance behavior via shifting profit out of those developing countries. Even if tax avoidance is not illegal, it brings the same or even more severe negative impacts on the society. It leads to welfare loss to the society and it discourages other tax compliant firms and individuals. Also the behavior of the MNEs results suffocating the country’s economic development.

For the developing world multinational corporations profit shifting behavior through transfer pricing manipulation (e.g. in SABMiller case) has caused huge losses, which those poor countries government can hardly afford. Developing countries like Ghana in Africa are trying very hard in order to develop the national economy and improving their tax systems in order to generate additional revenue for the national development. The U.S Senator Carl Levin (2009) pointed out that “tax avoidance behavior, redistributes the tax burden because, the compliant taxpayer will eventually bear the whole tax burden”.

The survey of Multinational Enterprises reveals the fact, that there is lack of concern among the general public for tax planning. From 2009 to 2011 SABMiller had a tax dispute case in the Delhi High court, India, which is involving the

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transferring of intangible assets, such as Foster’s brand name and patent to SABMiller Company.

By and large the results reveals the manipulation of transfer pricing-profit maximization goal, corporations will continue to find loopholes in the laws and regulations related to transfer pricing and the legitimacy problem for corporations and legitimacy theory is not applicable for the issue of tax planning.

**Starbucks Corporation**

The Starbucks Coffee (Starbucks Corporation) is the premier roaster, marketer and retailer of specialty of coffee in the world. They are operating around 18000, retail stores in 60 countries. It was started from a roaster and retailer of whole bean and ground coffee, tea and spice with a single store in Seattle’s Pike Place Market in 1971. Starbucks was incorporated under the laws of the State of Washington, in the Olympia Washington, on Nov 4th 1985 and went public on 26th June 1992 at a price of $ 17 per share and closed trading first day at $21.50 per share. Starbucks Corporation’s common stock is listed on NASDAQ under the trading symbol ABUX. Subsequently Starbucks is accused of tax avoidance activities in the UK having paid just Pound 8.6 million in corporation tax over 15 years for their existence in UK. According to Reuters Investigation in October 2012 Starbucks has told investors that the UK business if profitable, while reporting losses to tax authorities. There is no suggestion that any laws have been broken, but campaigners suggest that this is a clear case of tax avoidance made possible due to current UK tax system rules. The research attributes that Starbuck like many other US Multinational companies is an enthusiastic stateless income tax planner. Starbucks had significant losses in some jurisdictions and higher profits in others. The remedy begins with transparency toward tax authorities and policymakers, through which those institutions have a clear and complete picture of the global tax planning, structures of multinational companies.

Multinational company uses Transfer pricing in the purpose of tax avoidance. Transfer pricing is not, in itself, illegal or necessarily abusive, there are several methods of Transfer pricing that accepted by the OECD and use the methods

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359. Ririn Susanti Hunar Nuraini Sari “ Analysis method of Transfer pricing used by multinational companies related to tax avoidance and its consistencies to the Arm’s length principle(case study: Starbucks corporation) accessed on [http://uk.reuters.com/article/2014/04/24/uk-starbuckstaxbritain-idUKBREA3N0X020140424](http://uk.reuters.com/article/2014/04/24/uk-starbuckstaxbritain-idUKBREA3N0X020140424) dated 09.03.2015 at 3 A. M
consistent with the arm’s length principles. The multinational company need to meet criteria and conditions required in the arm’s length principles that regulated by the OECD in selecting the appropriate transfer pricing method. Starbucks denies any wrongdoing in relation to tax avoidance. Only it has utilized the factor in reducing Starbucks taxable income in addition to the allocation of funds generated in the UK to other subsidiaries in its supply chain. On the happening of this event the OECD addressed the concern of BEPS (2013) (Base Erosion profit splitting) a number of 15 action plan to be done by September 2014 until December 2015. By the internal motives of manipulating transfer pricing-profit maximization goal, corporations will continue to find loopholes in the laws and regulations related to transfer pricing.

7.06. Transfer pricing Comparability Data and Developing Countries

The application of the arm’s length principle often requires that a comparison to be made between the prices charged in controlled transactions, or the financial results of such transactions, and the prices set in or the financial results of similar transactions between independent enterprises in similar circumstances. This comparison is used to determine whether a transfer pricing adjustment is needed when computing the taxable profits of one or more of the associated enterprises. Comparability is therefore, at the heart of transfer pricing. The OECD and non-OECD countries frequently express concerns about the availability and quality of financial data on transactions between unrelated parties, that can be used to make the relevant comparisons.

The transfer pricing Guidelines for Multinational Enterprises and Tax Administration 2010 vide in paragraph 1.13 states that “Both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the arm’s length principle. Because the arm’s length principle usually requires taxpayers and tax administrations to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data. The information that is accessible may be incomplete and difficult to interpret; other information, if it exists, any it will be difficult to obtain for reasons of its geographical location or that of the parties from whom it may have to be acquired. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns. In other cases information about an independent
enterprise which could be of relevant may simply not exist, or there may be no comparable independent enterprises.”

The United Nations Practical Transfer Pricing Manual for Developing Countries (2012) describes specific challenges for developing countries as in paragraph 1.10.6 as “it is often in practice extremely difficult, especially in some developing countries, to obtain adequate information to apply the arm’s length principle for the following reasons:

a. In developing countries there tend to be fewer organized players in any given sector than in developed countries; finding proper comparable data can be very difficult;

b. In developing countries the availability of comparable information is also incomplete and in a form which it is difficult to analyze because the resources and processes are not available. The database relied on transfer pricing analysis tend to focus on developed country data may not be relevant to developing country markets because in a developed country data accessibility and resources are very costly and developing country may not be in a position to acquire it easily.

c. In many developing countries whose economies have just opened up or are in the process of opening up there are many hurdles and in particular sector it cannot be exploited at all. Also there are cases wherein there is lack of comparables.

In the absence of reliable comparables data, concerns may arise as to appropriate bases from which negotiations should start. It is also very important that these negotiators should have required skill, experience and governance framework to bring to a successful conclusion. In relation to this the developing countries expressed number of view on the quality and availability of the information on comparable transactions. the difficulties faced by the developing countries are listed under in which the improvements can be made by adopting the following effective measure like

362. OECD Task Force on Tax and Development report to the “Transparency in Financial Reporting” sub Group of the OECD omfpr.a; task force on tax and Development on Central registration and
a. More availability and expanding access to data sources for comparables.
b. More effective use of data sources for comparables
c. approaches to reducing reliance on direct comparables and
d. Advance pricing agreements and mutual agreements proceedings.

7.06.1. Expanding access to data sources for comparables

The practical problem for much developing country tax administration is whether paying for access to a commercial database is the best use of their limited resources. Some developing countries have considered regional initiatives to reduce individual countries’ cost and increase value for money. The OECD Tax and Development Programme is supporting ATAF’s (African Tax Administration Forum) work on providing support to its members in accessing database information. Costs remain a concern for developing countries and support could be provided by donors to fund access to such databases. The United Nations Practical Transfer Pricing Manual for Developing countries (2012) discusses the question of introducing an obligation to file statutory accounts and making them easily available to the public.

7.06.2. More effective use of data sources for comparables

The effective use of comparability data requires a degree of skill and experience. The skill required in evaluating search results in arriving at a set of appropriate comparables and transfer pricing range may also be an important concern.

Paragraph 3.38 of the OECD Guidelines 2010 notes that “independent transactions may be scarce in certain markets and industries. A pragmatic solution may need to be found, on a case-by-case basis” also the degree of compromise involved by the parties is also recognized by the Guidelines. The other option identified is broadening the search for comparables to uncontrolled transactions in the same industry but in different geographic markets. The selection of foreign comparable is very difficult task and involves complexity on the task of identifying appropriate comparables as part of a transfer pricing analysis. For example Newzealand economy is closely connected to the Australian economy, basically forming a single market. To find practical solution New Zealand has to look into the

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public availability of statutory accounts in developing countries, available on http://www.oecd.org/ctp/tax-global/2%20Final-report-to-Sub-Group.pdf retrieved on 5.03.2015at 3.A.M
Australian markets and also to beyond Australia to markets in Europe particularly in United Kingdom and North America, in such cases where reliable data may exist…?

Once appropriate foreign comparables have been identified the question arise is to whether comparability adjustments are required for use in domestic context and, if so how they should be made. To solve this the Practical Manual (United Nations Practical Transfer pricing Manual for Developing countries (2012) provides examples of countries that apply country adjustment in the country practices. Action 13 of the Action plan on Base Erosion and Profit Shifting 2013 (BEPS) seeks to “Develop rules regarding transfer pricing documentation to enhance transparency for tax administration.” In this concept review of country experience in evaluating transactions by testing the foreign counterparty may be useful to developing countries.  

7.06.3. Approaches to reduce reliance on direct comparables

There arises always a situation that both developed and developing countries may encounter the situation that no appropriate internal comparables or publicly available external comparables are identifiable. Nevertheless the transfer prices must still be set by taxpayer and audited by tax administrations. In such a situation consideration will be given to alternative approaches that do not directly rely on comparables. These alternate income allocation systems, including formula based systems, are sometimes suggested called Formulary apportionment, which would represent a replacement of the arm’s length principle, there is consensus among government that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioral changes companies might adopt in response to use of a formula would lead to investment decisions that are more efficient and tax neutral than under a separate entity approach”

Other alternative approaches to evaluating transactions that do not rely directly on comparables exist and may be required if no direct comparables are available, the question arises as to whether “other evidence” of an arm’s length outcome might be used. Other approaches include the use of the profit-split method, which is explicitly recognized in this context in paragraph 3.39 of the OECD Guidelines 2010, and the application of economic analysis or value-chain analysis is required. These value

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chain analyses include value added by business functions within a multinational enterprise group to allocate the value added to members of the group. The concept that reduces the need for comparables in specific cases is be found in the revised guidance on safe harbors provided by the OECD’s Revised Section E on Safe Harbors Transfer pricing Guidelines of 16th May 2013. The safeharbour that are negotiated on bilateral bases between country competent authorities can reduce the need to obtain comparables for specific transactions. The bilateral safe harbors negotiated between countries competent authorities are to be preferred, potential alternatives to bilateral safe harbors such as, regionally developed safe harbors for regions that share common characteristics, may also assist.

7.06.4. The concept of “Sixth method” and similar Methods used in Latin America and Africa

This is example of practice of different method prevailed in the Latin America and South Africa. According to which “the mandatory use of publicly quoted commodity prices for certain transactions involving commodity products”. The primary benefit of this approach is that a clear and certain benchmark for transactions between related parties in the specified commodities is in place. The primary concern relates to the divergence that may arise between the conditions under which the publicly quoted prices are quoted and the conditions of the actual transactions that may mean the publicly quoted price may not be the arm’s length price. For example the data used for transaction or place of delivery may differ. More fundamentally the stage of processing or nature of the commodity may differ. As a result the treatment of the transactions may diverge from the arm’s length principle, transactions may be over-or under taxed and double taxation or double non-taxation may occur. In certain cases the mandatory use of publicly quoted commodity prices for certain classes of commodities may be considered an appropriate anti-avoidance approach under certain circumstances.

7.06.5. Advance pricing agreement and mutual agreement proceedings

The concept of advance pricing agreement (APA) aimed at offering tax administrations and taxpayers certainty with respect to transfer pricing for a predetermined period. A developing country’s tax administration may be attracted to an

\[364\] United Nations Practical Transfer Pricing Manual for Developing Countries 2012
APA programme since it provides a less adversarial and more open environment for understanding and evaluating a multinational enterprise’s environment, operations and transfer pricing methodology, including basis for arriving at any comparables it considers appropriate. These APA programme requires access to skilled and experienced human resources.

Interaction may take place between taxpayers and the tax administration once the likelihood of a dispute has become apparent during an audit or when a dispute is in progress after the conclusion of an audit. The use of negotiation to resolve an impending actual dispute may be an attractive low cost option for a developing country but concern may arise to the skill, experience and governance framework required to bring such negotiation to a successful conclusion. The review of country approaches to negotiations with respect to resolving transfer pricing disputes and their governance frameworks may be useful to developing countries.

These transfer pricing adjustments by a developing country may involve transactions with low or no tax jurisdictions, so that question of double-taxation are minimized or do not arise, it is inevitable that at some stage double taxation will be an issue. If the tax treaty is in force, a mutual agreement procedure (MAP) as contemplated by Article 9(2) and 25 of Model Tax convention of OECD could come into play. Subsequently OECD has developed the newly established MAP Forum which is engaged in resource and empowerment challenges faced by competent authorities around the world that may be of relevance to developing countries. The Chapter VI of this thesis deals in detail the procedure of Advance pricing agreement and mutual agreement proceedings.

7.07. Arm’s length principle vs. a Formula apportionment (Formulary Apportionment): main differences

Both the system reveals good number of difference between themselves. In contrast to a tax system based on separate accounting and arm’s length pricing, under formulary apportionment, the companies do not attempt to calculate the income of the affiliated entities of the corporate group, instead, the corporate group first combines (or consolidates) the income of each of its operative into a single measure of taxable income. The group then uses a formula to apportion the income to the various locations, where the group conducts its business. This formula generally
share the income based on business activity in a location to the total business activity in all locations.

Arm’s length principle basically originated from the US system is deeply rooted in the European taxation by way of reasoning the case of intra group transactions on multiple levels, OECD’s level, UE’s level and purely domestic level. The ultimate goal is to achieve an attribution of fair shares of tax to different jurisdictions in cases where one part of an enterprise delivers goods, services or knowhow to another part of the same enterprise that is located in another country.

Formula apportionment pursues the determination of the geographic source of corporate taxable income based on a predetermined formula, rather than using separate accounting. Therefore by employing this formula, the tax liability does not concern the profits actually earned in a particular jurisdiction but the profits generated throughout the group of jurisdiction.

The Arm’s length Standard (ALS) is related to its international acceptance, it may even constitute an international custom by way of timely practice, and has become the source of international taxation law. It has attained the status of International law called peremptory norm (Jus cogens) but formula apportionment method is a huge obstacle which cannot be accepted as International law. Chapter VI of this thesis makes a study of the Formulary apportionment in comparison of the Arm’s length principle and the possible effect of the combination of the two has been studied. Now the detailed application process of Formulary apportionment with detailed comparison of Arm’s length principle is made in this chapter.

ALS work in majority of the cases effectively together with the possibility of making adjustments, which reveals great importance in what concerns the avoidance of double taxation. It is true that by using the formula apportionment, the interrelations occurred. In a business group is also considered, the FA also shares the predetermined formula, it does not share the same flexibility of the arm’s length principle. The FA is not interested in the precise determination of the origin of income, as the system is based on formula; the attribution of income is allocated among many jurisdictions. Due to which it triggers arbitrary and unreasonable results, reflecting a fundamental problem regarding the application of FA.
It is based on an implicit assumption that profitability compared with whatever factors appear in the apportionment formula, is uniform across related companies operating in different jurisdictions. Even if this assumption is politically accepted in the US it may not be accepted within the EU since this requires higher economic convergence. In addition under FA method, there is a distortion of the geographic attribution of income which normally occurs when income cannot be clearly being identified with a particular location.

Formula apportionment requires the achievement of agreements between the countries involved and tax administrations, concerning the factors to be taken into account. Thus this formula treats each dollar of payroll, property and sales as if they produce the same amount of income or an equal quantity of product. Each unit of particular apportionment factor, for example each unit of labor cost or of sale, of a given taxpayer is equally productive on income on average, whenever it is located and whatever the use made of that labor is capital. The fact is that the validity of this assumption cannot be taken as such namely in the case of the property factor and, especially in the case of payrolls and sales since, according to the economic theory, in a long term, international capital flows lead to the equalization of marginal returns to capital, but this does not imply either that average returns are equalized in the long run or that marginal return are equalized in the short run, if an uniform application of the formula to all industries simplified the process although, *it could create inequities and distortions.*

In so far specific industries demand a special formula and in that case the use of different formulas by components of a conglomerate company operating in industries, would imply the determination of the boundaries of the industries and even the application of the ALS, or some kind of a hybrid formula, in order to split the income among industries.

FA method requires much more comparable economic and taxing conditions than the arm 'length principle. The companies are asked to fulfill combined reports which create an administrative burden to the companies whenever there is a variation of the accounting principles and currency in the involved jurisdictions. This constitutes one of the main reasons why the formula apportionment method is, in the majority of the cases, used in areas where there is some homogeneity, such as in the federal states. The fundamental problem of FA is that “it is not based on theoretical
foundation and, therefore, it is inherently arbitrary”. Therefore while the ALS may trigger some conceptual and practical problems, The FA suffers from a lack of rational economic basis which interferes with the required political consensus, essential to the adoption of universal rules.

7.07.1. Formulary apportionment conceptual shift

The OECD regards the Arm’s length Principle as the most accurate method in the determination of the taxable income. In this background, the non arm’s length principle method, as the Formulary apportionment, is rejected by the OECD Guideline 2010. The OECD Transfer pricing Guidelines 2010 MN 1.19 categorically infers the reason for non acceptance of FA as an appropriate form of profit allocation based on the reason that this FA constitutes arbitrary nature of formula which does not take into consideration the market conditions. In a method like FA some basic issues like unitary business (which combination has to be employed) the choice of apportionment formula (with all the political implications) and how to measure the factors in general FA implemented on a firm by firm basis can trigger the same tax fraud opportunities on transfer prices as well as separate accounting, if there is wide variations in tax rates continue to occur, it would be inadvisable to adopt FA: it must require the combination of firms in the engagement in a unitary business, since the conceptual problems and the temptation for income shifting would be too great. In this sense, the formula should be uniform across

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365 OECD TPG 2010 MN 1.32
366 OECD TPG 2010 MN 1.25
367 OECD TPG 2010 MN 1.25
368 This reveals great importance related to the inclusion of crucial factors: it is not clear if ti must be included just one company or the tax base is also extensible to the subsidiaries and affiliates where some may be wholly owned and controlled as a part of a business rather than others which are independent, or if this covers all subsidiaries all over the world.
369 This constitutes one of the most difficult questions to solve, in first place, this would imply the achievement of agreement by all the member States concerning the definition of the unitary business. Even if there were reached a consensus concerning the non extensibility of the apportion able tax base to subsidiaries non resident in the Indian territory with no connection to the other countries. On the other hand in order to avoid maneuvering through transfer price, controlled and integrated subsidiaries and affiliates locate within the union territory of India. In USA according to the definition of Supreme Court it is related to the interdependence integration and interrelation that occur between the parts of the business group involved. However and as can be seen through the US example this concept of business unitary is not the some in every federal states since it differs from state to state. Similarly in India though the state is quasi federal and the common Income tax law is applicable the concept of unitary business is not clear whether it is applicable in the case of company of the tax base is extensible to the subsidiaries and affiliates, where some may be wholly owned and controlled as a part of a business rather than others which are independent, or if this covers all subsidiaries all over the world. Hence the application of FA is not suggested.
member States, which might require that tax competition among jurisdictions should be supervised in order to avoid “beggar thy neighbor” tax policies among Member States.\footnote{276}

7.07.2. Formulary apportionment as the alternative to the Arm’s length price – A critique

According to James H Hines Jr “Formulary methods are typically defended as pragmatic compromises, representing imperfect alternatives to the current, arguable flawed system of separate accounting”\footnote{371} in fact notwithstanding the referred advantages of the ALP system, many of them can be rebutted. A crucial point that cannot be overlooked is the ALP suffers from one of the fundamental problem: it only works under perfect conditions, which means that all the enterprises involved are forced to work together in good faith, furthermore it seems needless to refer that the real business world in no way reflect this premise of perfect conditions. This is due to the need for profit maximization which eventually leads to the aforementioned undesired profit shifting towards low-tax jurisdictions.\footnote{372} Thus the administrative burden on both sides, either to the business part as to the tax authority, has increased significantly. In fact the treatment that the ALP method gives to business transactions constitutes one particular disadvantage and works as an argument in favour of the application of the FA.

In fact the area where FA has an edge over ALP it is that place where the reducing compliance and administrative costs both for tax administrations and taxpayers, when applied to a group of companies.

Sometimes the application of FA may be better solution but it depends on the industry at stage. For instance, it may be suitable for industries in which market prices are readily available, where the interconnected relations between the enterprises are not a crucial factor or where a member of a group of companies generates taxable income and does not share these resources with the other group of companies.

\footnote{Mauricio, Maria Joao da Curz “Transfer pricing and the arm’s length principle in the European Union law and domestic law” Universidade do Minho p 51 accessed in the internet http://hdl.handle.net/1822/28395 on 18.02.2015 at 3.00AM}


\footnote{Mauricio, Maria Joao da Curz “Transfer pricing and the arm’s length principle in the European Union law and domestic law” op.cit., p. 53}
companies generate taxable income and does not share these resources with other group members that integrate it. In this light, it must be recognized the conceptual impossibility of applying the ALS when facing some economic interdependence or whenever the goods or services are not transferred in a market transaction. Whenever the economic interdependence is at stake, FA could resolve some difficulties related to transfer pricing that contaminate ALP.

Example in case of application to corporate groups, FA would turn “tax havens” ineffective. In fact the ALP is criticized due to its incapability of capturing the positive effect (meaning higher profits) due to the economies of scale and scope of large multinational enterprises. The larger the multinational enterprise is, the higher the probability of less accurate income allocation based on transfer pricing becomes.

FA will be helpful among the members of the water-edge group using transfer prices. They cannot be manipulated in order to shift the income to low-tax jurisdictions, just one parenthesis: the limitation of the income to be apportioned by the formula would be that of a unitary group determined, through the application of SA/ALP to be earned within the US. The concept of water edge is defined in several ways and might include all affiliates of a unitary business that are resident in the EU or that are:

The water edge group generally exclude the income and operations of all affiliates that did not do business within the territory (EU)

There is also shortcoming concerning the intangible assets that does not occur if applied the FA. The ALP should help find fair transfer prices for intra-group or dealings. The fact is that, in what concerns the transactions of intangible assets, such dealings would not often occur with an independent enterprise at all. Many times these intra-group transactions are the reason for the existence of multinational enterprises and the way to develop unique intangible values in the first place.

373. Ibid., p.54 the term water edge means “a few US states have applied unitary combination on a worldwide basis which means that, in order to calculate profits subject to taxation by the State, they have combined the income and factors of foreign enterprises, such as parents, subsidiaries and sister corporations, with those of domestic entities with which they are deemed to be unitary. This is justified by necessity of determine accurately the income of the entity operating in the state, by including in the combined report of the in-state entity the activities of the in-state entity the activities of foreign affiliates that are part of the unitary business, event form those that do not carry any activity in the US. Wince world-wide unitary combinations is a controversial topic a water’s-edge limitation seems a more reasonable approach for the EU at this time, which is constitute by a more diverse group of countries than US, which already have substantial economic integration.
Therefore this means that especially regarding intangible assets it is very hard to
determine the arm’s length price or even impossible to do so for the reason of lack of
comparability between the transactions among independent enterprises.

Furthermore, the structural elements of multinational enterprise are most of
the times so closely linked turning impossible the attribution of individual profit
shares based on transfer prices.

It is observed that contrary to the SA/ALP the FA does not even try to
identify the real source of the income. In this light it is reasonable to accept the
arguments defending that this can trigger some inaccurateness, but on the opposite
side, it can be said that is FA method tries to establish a compromise between
theoretical accuracy and radical simplification and feasibility. The most reasonable
solution is to operate systems based on FA and SA accounting side by side (if a given
corporation is more active in more than one industry, its income shall be divided
among these activities) on the other hand, if formulas are applied to the income of
unitary businesses and a given corporation group is engaged in more than one unitary
business the separate accounting must be used in order to detriment the income of
each of the businesses.

The practical implication that the closer alignment with economic reality and
thus greatly improve its effectiveness and legitimacy. The main usage of the
Formulary approach is that for example if a income of a firm is earned by firm as a
whole, the unitary approach does not attempt to indentify or quantify how much it
could be earned by any of the component parts. Instead income is apportioned by a
formula using factors which quantify the actual geographical location of its activities
reflecting the real economic activities in each place where they occur.

Formula apportionment is great importance as it constitutes an alternative to
the arm’s length principle, although it cannot be assumed as the only choice for
Europe, but rather as one within an array of options. For example aiming at equal tax
rates in the EU may represent another device for the prevention of the manipulation of
transfer prices.

In case of the uniformity of the tax rates, the companies would not have any
interest in changing the source of income for tax purposes. Increasing integration
and uniformity as far as possible in order to achieve a fair and foreseeable taxation of
corporate income. In order to work efficiently, the integration of an economic area and great cooperation among States.

7.07.3. The New CCCTB proposed scheme - is it boon-an analysis

On a prima facie analysis this European apportionment mechanism is an ambitious project, by using a complex sharing formula yet flexible when it comes to its application. As discussed in chapter 5 of this thesis the concept of CCCTB is a flexible formula when compared to US Formulary apportionment system. As it is noticed the formulary apportionment suffers from different tax base definitions, differences in the scope of enterprises subject to formulary apportionment. These formulary apportionment enterprises subject to higher administrative and compliance costs proneness to tax avoidance, situations of double taxation or double non taxation and lead to an overall unnecessary complex system. Many of the experts feel uniformity of the apportionment formula has a greater priority than a sound economic justification.

As learnt the main priority purpose of the CCTB is the elimination of tax obstacles to corporate cross-border activity in a single market with a view of enhancing the effectiveness of the internal market. the proposal does not involve the harmonization of the tax rates since this matter continues to be a subject reserved to the tax sovereignty of the Member states and therefore under the competence of the national tax legislator. The proposal does not intend to interfere in the tax revenues of each member state and therefore, the impact on the distribution of the tax bases among EU member States has been assessed. The principle associated is “consolidated “ which is the heart of the project. This consolidation method represents the main advantage of the CCCTB scheme, benefit that is also recognized by the industry. As it was discussed earlier consolidated tax base is only shared when it is positive. The application of a uniform set of rules within the EU requires the existence of only one tax administration. Thus under the CCCTB, the one-stop-shop system will be implemented and according to it a company opting for the CCCTB application will not be subject to the national corporate tax arrangements concerning the tax matters regulated by the common rules. The concept of CCCTB is based on three key concept i.e., 1. one stop shop,2. Sharing mechanism and 3. Safeguard clause. This CCCTB is not about tax rates but rather the transformation, through apportionment, of the corporate income tax into direct tax under specific
factors. The concept of sharing mechanism is applicable to all the taxable income including passive income, such as interest royalties and dividends.

As discussed earlier in Chapter 5 of this Thesis much about the CCCTB proposal of EU it is noticed that the dissatisfaction with the arm’s length principle and separate accounting may increase both from an economic perspective as well as from a pure administrative perspective. A revealing example is a recent survey showing that in more than 20 percent of the cases, companies in Europe see transfer pricing as the biggest challenge, preceded only by keeping abreast of developments. At the European institutional level, several proposals are currently being discussed for the design of an efficient trans-border corporate tax system for the EU such as Common Consolidated Base Taxation (CCBT). The so called UDITPA which is in existence in USA is not a Federal Act but a model Act to be implemented by the states. The main object of the UDITPA is to provide a uniform approach to the division of a multi-state enterprise’s income: The arm’s length standard is enshrined in both the OECD and UN Model Tax Conventions as well as in thousands of bilateral double taxation treaties. Its global reach after its fully fledged extension to permanent establishment by the OECD under the functionally separate entity approach than ever before is under attack. It is argued by the both renewed tax law academics and practitioners that the existing system of transfer pricing control is completely dysfunctional and impossible to fix. The implementation of CCCTB proposed Directive can give rise to several controversial topics regarding litigation between taxpayer and tax authorities as well as among the authorities who adopt the CCCTB. The controversies about the CCCTB are as under:

1. Omission of intangible from the asset factor.
2. Consolidation of accounts that need to be filed
3. Fairness of the formula: meaning different states adopt different levels of advantages from CCCCTB depending on how the apportionment is constructed.
4. Difficulty in estimate of loss of revenue. i.e., transfer of losses among the companies of the same group

The advantages of CCCTB is the concept of double taxation due to conflicting qualifications would no longer arise for EU tax authorities. The current complexities of interpretation and application of the OECD guidelines on transfer pricing cease to
exist for EU activities. The consolidation of the tax base will allow the determination of the taxable income for the group of companies so the transactions’ price will have no influence on corporate income tax paid by companies.

7.07.4. Demerits of the Principle of proportionality and subsidiary

The proposal does not involve the harmonization of the tax rates since this matter continues to be a subject reserved to a tax sovereignty of the member states and it comes under the competence of the national tax legislator.

a. The proposal does not intend to interfere in the tax revenues of each member state and, therefore, the impact on the distribution of the tax bases among EU member States has been assessed.

b. Harmonization of the tax base will not interfere with financial accounts

c. Principle associated to this method is suggested by the word “consolidated” which is the heart of the project. The consolidation method represents the main advantage of the CCCTB scheme, benefit that is also recognized by the industry

d. The consolidated tax base is only shared when it is positive. A negative consolidated tax base would be carried forward at group level and be set off against future consolidated profits. Subsequently the tax base so attributed will be taxed in the Member states where the relevant subsidiaries (or permanent establishments) are resident (or located) at the domestic corporation tax rate.

e. On the basis of single tax return, the consolidated tax base of the entire consolidated group is determined. The consolidated tax base is subsequently

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374. Member States will continue to have their national rules on financial accounting and the CCCTB system will introduce autonomous rules specific for the determination of the tax base of the companies.

375. The explanation of the each of the individual item of CCCTB is that one single set of rules that could be applied across the EU: consolidated – the term consideration means adding up all the profits and losses of a company or group of companies from different member states to arrive at a net profit or loss for the whole of its activity in the EU. This would then be used to decide the final taxable base of the company or group. For example a CCCTB group consists of companies A, B, C, and D companies A and B have revenues equal to 10 million each company C has revenue equal to 15 million company D has a loss equal to 8 million. The consolidated tax base for this group is A+B+C-D +27 millions. Corporate and tax base the amount of a company’s profit that will be taxed. The tax base is calculated as the company’s revenues, minus the amount that can benefit fro tax exemptions and deductions such as wages and depreciation. Each member State has a different set of rules for calculating this tax base. Example Member State A may allow assets to be depreciated over 10 years while member State B might allow depreciation only over 5 years. Or Member State A might allow all entertaining expenses to be deducted from profits whereas member State B might not. A single EU tax base would mean that companies only need go do their calculations in line with one set of rules.
attributed to each of the respective entities (or permanent establishments) and not between member states, in each tax year, on the basis of a formula for apportionment that will make the object of the analysis.

f. As per CCCTB rules companies with permanent establishments in at least two member states would be able to gather their taxable income and only have to comply with one set of rules. They system of common rules for computing the tax base can also be applied by EU-located branches for third-country companies. In fact this method eradicated many of the existing intra community transfer price difficulties, permit cross border loss compensations and facilitate many operations that involve international restructuring and avoid double taxation.

7.07.5. Position of India if it adopts Formulary apportionment formula

FA system based on micro economic factors will probably witness enormous political difficulties in being agreed upon effectively implemented due to the different economic interest of the Member States. The reason a developing country like India wherein the socio economic principles prevails in various parts of the internal states, different manufacturing activities in some parts of the India, services industry in some parts. Labor oriented practices in some part etc. The MNEs in certain parts of the world purely interested in investing on research and development or in the exportation of intellectual property rather than others which are not importers of intellectual property. The fact these disparities cause non consensus in the determination of the apportionment factors that should be included in the formula. Apart from this the country like India wherein huge cultural, historical and linguistic differences is within the country that do not exist within the USA. In USA the application of FA is possible but the position in India is totally different when compared to USA, different. Similarly just like other countries the MNEs which are based in India and the individual who are opting for transfer pricing regulations may not feel the oneness among the country. That is citizen of the country do not recognize their own interests as the interest of the India this means to some extent brooding of protectionism of the MNEs and prevalence of self interest ideas which could be determinant in the choice of the factors by the Member States and the weight that is granted to these factors creates a large gap. Reaching agreement on the common factors would imply an equal interpretation by the member states of those provisions.
India is quasi federal and the basic principles of Indian economy are based on the agricultural history and the prevailing socio-economic condition, the adoption of fully Formulary apportionment concept will be a misnomer. Hence under this condition due to non-availability of exact comparables the principles of Arm’s length principle may suffer setback particularly in the intangible nature of property with respect of Formulary apportionment wherein the formula pre-determines the entire group income many not possible to the situation of India for the aforesaid reason. Apart from this the other factors like disparity and proportionality of income among the groups and social strata existed in the country may cause the negative factors for fullest extent of Formulary apportionment principle.

The other drawback of Formula apportionment method is it deals with a formula that is predetermined this means that, contrary to the arm’s length principle, it cannot take into consideration the particular circumstances and facts related to particular case. In addition it uses different factors, this might create double taxation situations, and thus, the agreements about corresponding adjustments, similar to those related to the arm’s length principle, are essential. Since US is federal country the concept of UDITPA called Uniform Division of Income for Tax Purposes is applicable and the relevance of the same does not arise in India.

In the matter of harmonizing the accounting standard, India has already accepted International standard of Accounting procedure which consonance with TP regulations. Basing on the facts and circumstances mentioned above the, the model of European called CCCTB wherein the application of both Formulary apportionment and experience of the nation in solving the problem like sharing of consolidated tax base only when it is positive. A negative consolidated tax base would be carried forward at group level and be set off against future consolidated profits. Subsequently the tax base so attributed will be taxed in the Member states where the relevant subsidiaries (or permanent establishments) are resident (or located) at the domestic corporation tax rate. negative consolidated tax base would be carried forward at group level and be set off against future consolidated profits. Subsequently the tax base so attributed will be taxed in the Member states where the relevant subsidiaries (or permanent establishments) are resident (or located) at the domestic corporation tax rate. In view of the above facts the factors chosen in the apportionment formula clubbed with common consolidated tax base across
jurisdiction, the phenomenon of apportionment formula which are of high importance for distribution of the tax base of the country. Based upon these circumstances the more labour intensive country like India it will receive a larger share of profits from the labour factor. By this the apportionment mechanism may be regarded as key factor highly influential to both states and multinationals.

Under this situation the principle of Golden rule of APA, the principle of ALS wherever there is availability of comparables and FA wherever the comparables are not available will be the solution in the present day world to solve the issue of Transfer pricing. Besides this Indian courts are not much followed the principles of Formulary apportionment except in the under mentioned case wherein the question of permanent Establishment was discussed in the case of Ericsson Radio System AB(Ericsson) Motorola Inc(Motorola) and Nokia Network OY (Nokia) the facts of the case is Ericsson neither had business connection nor permanent establishment(PE) within the meaning of Sweden –India DTAA and hence no income attributable to India. Motorola had a business connection though its activities fell within the meaning of USA-India DTAA hence no income attributable to tax in the case of Nokia Finland had business connection and PE in India within the meaning of Finland-India DTAA. The Income Appellate Tribunal while deciding on the extent of attribution to a PE, took into consideration the fact that economically significant functions such as R&D and manufacturing had not been performed by PE as these activities had taken place wholly outside India. In this issue The Tribunal did not apply transfer pricing methods for determination of arm’s length prices. But it adopted a formulary apportionment approach which is in practice in USA Canada Switzerland and other countries. Here is the first time the Indian Tribunal started the opening for applying the principle of Formulary apportionment method and started with worldwide net profit margin of the enterprise and applied the margin to the total revenues earned by the enterprise from India. The resultant figure was deemed to be the net profit arising from Indian activities.

Inference: though this approach has provided a practical solution to resolve difficult attribution issues yet was not consistent with arm’s length pricing methods. But the Tribunal has made it a point that in case of non existence of arm’s length principle the utilization of Formulary apportionment method can be adopted.

376. Motorola Inc vs. DCIT 96 TTJ1(2005)
7.08. Analysis of Case Laws

In the initial years of enactments of transfer pricing regulations, the courts and tribunals decided very few cases of transfer pricing as law was evolving in that period. Both revenue and taxpayers largely depended on OECD Guidelines and CBDT instructions and circulars; and issues were hardly agitated beyond first appellate level. Revenue approach in first few years was aggressive as transfer pricing cases contributed major part of tax collections. To remove ambiguity the courts in many cases have laid down important principles of law which have helped taxpayers and tax administrations in interpretation of the rules. Of the various methods, CUP method is most suitable method. CUP is reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. Some of the landmark transfer pricing cases decided by courts and tribunals on various disputed issues are as under:

7.08.1. Indian Case Law

The concept of applying the arm’s length method is hard stuff—difficult to apply certainly, but also difficult to comprehend when carefully appraised, the cases laws stated below makes an attempt to exact application of how the courts observed in certain cases. In the case of Rolls Royce Plc (RRP) vs. TPO wherein The Rolls Royce Plc supplied aeronautical engines and spare parts to certain establishments in India. It had wholly owned subsidiary in India by name of Rolls Royce India Ltd (RRIL). The court in this case found that the premises although in the name of RRIL, was being occupied by RRP for purposes of its business operations in India. Thus RRP had a PE in India within the meaning of Article 5(1) of the India-U.K tax treaty. The Income Tax authority allocated 50% of profits to manufacturing activity that could not be taxed in India and 15% of the profits to research and development activity conducted outside India. The balance 35% of the profits was attributable to the marketing activity that was carried out in India. Held: The Delhi Tribunal observed that for purpose of attribution of profits the economically significant activities and responsibilities undertaken through the PE (Permanent Establishment) should be identified based on a factual and functional analysis. The question of Permanent Establishment was discussed in the case of Ericsson Radio System.

377. Rolls Royce Plc (2008) 19 SOT 42 (Delhi)
the facts of the case is Ericsson neither had business connection nor permanent establishment (PE) within the meaning of Sweden–India DTAA and hence no income attributable to India. Motorola had a business connection though its activities fell within the meaning of USA–India DTAA hence no income attributable to tax in the case of Nokia Finland had business connection and PE in India within the meaning of Finland–India DTAA. The Income Appellate Tribunal while deciding on the extent of attribution to a PE, took into consideration the fact that economically significant functions such as R&D and manufacturing had not been performed by PE as these activities had taken place wholly outside India. In this issue The Tribunal did not apply transfer pricing methods for determination of arm’s length prices. But it adopted a formulary apportionment approach which is in practice in USA Canada Switzerland and other countries. Here is the first time the Indian Tribunal started the opening for applying the principle of Formulary apportionment method and started with worldwide net profit margin of the enterprise and applied the margin to the total revenues earned by the enterprise from India. The resultant figure was deemed to be the net profit arising from Indian activities.

Inference: though this approach has provided a practical solution to resolve difficult attribution issues yet was not consistent with arm’s length pricing methods. But the Tribunal has made it a point that in case of non existence of arm’s length principle the utilization of Formulary apportionment method can be adopted.

The fundamental issue of whether attribution of profits to permanent Establishment was reasonable and proper came up before the Supreme Court of India. In the case of Director of Income Tax (International Taxation) vs Morgan Stanley and Co Ltd. (2007) the facts of the case is Morgan Stanely& Co USA was engaged in business of Investment banking and its operations included financial advisory services, corporate lending and securities under-writing. Another company Morgan Stanley Advantage Services Pvt Ltd (MSAS) was formed in India to support front office and infrastructure functions of group companies in respect of their global operations. MSAS was wholly owned subsidiary of Morgan Stanley International Holding Inc., USA, in which 80% shares are held by Morgan Stanley, USA and 20%
by another US company. On December 2003 US company entered into agreement for outsources their business support services, viz., information technology, account reconciliation research and such other services to MSAS the Indian company. MSAS did not undertake any important revenue generating functions and was also not bearing any market risk with respect to its functions. The client’s interaction was done entirely by the staff of the parent company. The parent company agreed to send its staff to India for stewardship activities and other similar activities to ensure that the high standards of quality are met by the company. As per agreement between parties the MSAS was to be paid for cost of services plus a mark-up of a certain percentage of the cost. The company selected TNM method for computing arm’s length price of services provided by MSAS with operating profit over cost as profit level indicator. The assessee filed an application to AAR seeking advance ruling on the questions whether Morgan Stanley & Co Inc., USA had a permanent establishment in India under article 5 of DTA agreement and whether any further income can be attributed to PE even though MSAS is considered a PE so long MSAS is remunerated for its services as per arm’s length principle. After considering the facts of the case held that Morgan Stanely USA could not be said to have permanent establishment in India as there was nothing to show that business of the US company was carried through fixed place of business of MSAS. Since the basic condition of carrying business through fixed place was not satisfied the Article 5(1) of DTAA was not attracted. Further it has not satisfied the Article 5(1) of DTAA was not attracted. There was no material to show that MSAS constituted agency PE of the US company AAR held that since employees of US company had been deputed to office of MSAS for stewardship activities or on deputation for more than 90 days there was service PE AAR further held portion of Morgan Stanley’s global profit would not be taxable in India as long as it pays arm’s length price, no decision was given as AAR was precluded from giving judgment on an issue which involved determination of the market price. Aggrieved by this decision a special leave petition was filed to the Supreme Court. Supreme Court Held: Profit attributable to PE must be determined on arm’s length principle. Once PE was remunerated on arm’s length basis, no further attribution was possible. The facts can be illustrated by the diagram as in the table shown below.
The diagrammatic representation can be made as under:

1st Instance:

![Diagram 1st Instance](image1)

2nd Instance

![Diagram 2nd Instance](image2)

Intermediary

[Description of the diagram]

As can be seen from the diagram, in the first instance, A is holding directly more than 26% in B Ltd and, accordingly A Ltd and B Ltd are associated enterprises. However in the second instance since A ltd is holding 40% in B Ltd (intermediary) which in turns holds 50% in C Ltd. As such arithmetically though A ltd is holding in effect only 20% in C Ltd. But indirectly through the intermediary it own more than 26% in C Ltd. In such a situation A Ltd and C Ltd are termed as associated enterprises.]

The issue of selling of cross-border trade mark and intellectual property rights by the Indian subsidiary came before the AAR at India in the case of Fosters Australian Limited an Australian company (Foster Group Australia) to a U. K based company would be taxable in India. In this case as an agreement had been entered between the Australian Company into a brand license with India in return of a royalty amount received from Foster India. The AAR ruling has laid down that income attributable to such IP could not be taxed in India. It was held that the Independent Valuation Report be relied upon the quantification of true and correct value of taxable items.

In a number of decisions the tax authority has highlighted that benchmarking method as proposed by Company in preference over transactional profit method without any cogent reason, a preference of traditional benchmarking method (CUP, CPM and RPM) over profit based method (TNMM, PSM) and decided that determination of arm’s length price is essential. It also held that the data of current year and operating items of the income statement are to be considered for analyzing

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380 Fosters Australian Ltd A.A.R. No 736 of 2006
the comparability under transfer pricing regulation. As discussed earlier it is evident in the case of Morgan Stanley and Co Ltd (2007) in its judgment, the Supreme Court prevented the abuse of transfer pricing as it was noted that provision of back office and other outsourced services by Inc (Morgan Stanley Advantage Services Pvt Ltd) MSAS a captive service provider would not constitute a Permanent Establishment of MSCO (Morgan Stanley and Co) in India, however be regarded as a Service PE in India under Article 5(2)(1) of India-US Tax Treaty. With regards to attribution of profits to the PE of MSCO. Profits of foreign enterprise which have economic nexus with PE in India would be taxable. No further profits would be required to be attributed to the foreign enterprise where an associated enterprise that did constitute a PE is remunerated on the arm’s length basis. It also observed a robust transfer pricing analysis should adequately reflect the functions performed and risk assumed by enterprise. In VVF Limited Vs DCIT381 it was held by the ITAT that the transaction of lending money by the assessee by way of interest free foreign currency loan to its foreign subsidiaries, should be compared with a company lending in foreign currency to unrelated party. It was observed that the ICICI Bank had advanced foreign currency loan to the assessee at LIBOR plus 3%. This can be taken as an “internal CUP” as the credit rating of subsidiary merger with the credit rating of the Parent. The comparison of interest should not be benchmarked with the Cash Credit @ 14% given to the Assessee. In another case, DCIT vs. M/s 3 Global Services Private Limited382 the ITAT held that per hour billing rate published by the NASSCOM for a specific business segments an “external CUP” in determining the arm’s length price. In this the assessee operates in the voice-based customer care sub-segment of IT-enabled services industry. The assessee rendered services to its associated enterprise and the selected CUP method as the Most Appropriate Method to justify the arm’s length price of its international transactions. Theassessee applied the CUP method, relying on the hourly rate of the “customer care” published by the NASSCOM and a report prepared by the Batliwala&Karani Securities (India) Pvt Ltd, an equity research company. Here the Transfer pricing officer rejected the CUP method selected by the Assessee and chose Transaction Net Margin Method (TNMM) as the Most Appropriate Method selecting five companies operating in various segments such as KPO, Content Development, Data Conversion, Software the like. These segments are

381 ITA No. 673/MUMBAI 2008
382 ITA No 1812/MUM/2009
totally different from the Voice Based Customer Support Services performed by the Assessee. On appeal, the CIT(Appeals) agreed to Assessee’s contention and rejected the TNM M method proposed by the TPO stating that the comparables selected do not belong to the Voice Based BPO services. The Revenue went on appeal to the ITAT. The ITAT categorically state that per hour rate of a specific sub-segment of the ITES industry can be considered as the CUP provided the assessee applying such rate belongs to such sub-segment. Further, companies operating in different segment of the industry cannot be selected as comparable for applying the TNMM. In a case by name Ranbaxy Laboratories Limited the case came before the Commissioner of Income Tax wherein the taxpayer exported goods and services to its associated enterprise (AE). The prices were determined at arm’s length price using the TNMM with profit level indicator (PLI) of operating Margin on Sales. The dispute arose on the ground that the determination of ALP was not referred by the Assessing Officer to the Transfer pricing officer as was instructed under CBDT (Central Board of Direct Taxes). The Tribunal upheld the decision and contended that no transfer pricing adjustment if the parties earn gross margin within arm’s length level as determined through the foreign benchmarking exercise after a flexible allowance of 5% from arithmetic allowance was provided.

Inference: it was held that the Transfer pricing assessment made by the AO can be revised the Commissioner of Income Tax if the AO had failed to consider the relevant facts in determining the arm’s length price.

In the case of Skoda Auto India Pvt Ltd (2009)384. The facts of the case are as under: Skoda Auto India (P) Ltd, an Indian company was engaged in business of manufacturing and selling passenger cars. The company started commercial production of cars in November 2001. During the 1st year of business operations, the company entered into international transactions, aggregating to Rs. 269.98 crores, with two associated enterprises the Skoda Auto Czechoslovakia, and Volkswagen AG, Germany, the details of the international transaction are as under: 1. Purchases of raw material Rs. 224.33 crores 2. Royalty and technical knowhow fees payment Rs. 44.57 crores. The assessee company first examined application of comparable uncontrolled price (CUP) and transactional net margin methods to substantiate arm’s length price of international transactions.

383 Ranbaxy Laboratories Ltd vs. CIT (2008)114 TTJ (Del) 110: ITD 428
384 Skoda Auto India Pvt Ltd vs. DIT (2009) 30 SOT 319
However it finally adopted TNMM as most appropriate method to substantiate arm’s length nature of import of raw materials, spares and accessories and also for payments of royalty and fees for technical knowhow. During the scrutiny the assessees filed details of data relied by it using CUP and TNMM method. It stated that the transfer prices of material purchase was justified as subject products, being outcome of extensive research carried by the associated enterprises over the years, are unique and distinct and therefore, price of purchases of material from the Skoda could be considered at arm’s length. As far TNMM it filed updated chart of net margin of comparable companies, in the course of proceedings before TPO. The TPO was of the view that out of six comparables relied by the assessees one of the comparables was to be rejected for want of relevant year data and another comparable also because that company incurred sustained losses which indicated abnormality of circumstances of that particular company. The assessees used two years data for the Year ending March 2001 and March 2002 TPO did not accept the use of two year data stating that in the captioned case meaningful comparison can be made only on the basis of three year data as permitted under the transfer pricing legislation, under proviso to Rule 10(B)(4) of Indian Income Tax Act 1961. TPO did not recommend any separate adjustment for royalties and fees for technical know-how, he recommended an overall addition of Rs. 23.59 crores for various adjustments. Assessees went on appeal.. CIT appeal did not accept the contention of the assessees against the proposed adjustments. Assessees went for Tribunal. The Tribunal basing on the facts of the case application of TNMM was justified as in the instant case the comparable transactions related to controlled transactions which was irrelevant for CUP analysis. The use of TNMM was therefore upheld. In the case of Sony India Pvt Ltd the validity of the CBDT instruction was tested. The facts of the case are Sony India (P) Ltd, a wholly owned subsidiary of Sony Corporation of Japan, was engaged in business of assembling, manufacturing and distribution of electronic goods including colour televisions and audio products. During assessment year 2002-03 the company imported certain high end products like DVDs, handy cams, play stations and projectors from associated enterprises. the company filed return of income for the AY 2002-03 on 31.10.2002 for income of Rs. 8.71 crore which later on revised to 8.67 crore. The CBDT on instruction no 3 of 2003 provided that in all cases where aggregate value of

385. Sony India(P)Ltd vs. TPO (2008) 114 ITD 448 (Del)
international transaction exceeds Rs 5 crores the assessing officers should select the case for scrutiny and make reference to transfer pricing officer for determination of arm’s length price. The assessee filed a writ petition under Article 226 of the Constitution challenging the validity of the Board instruction No 3 of 2003 and urged that assessment order passed on 21st March 2005 be quashed. The assessee raised various questions in writs like whether classification of international transactions in two categories, i.e., those exceeding Rs. 5 crores a which reference has to compulsorily made to the TPO by the assessing officer was based on intelligible differentia and has no nexus with the object sought to be achieved and whether such classification is violative of Art 14 of the Constitution and whether CBDT has the power to introduce such classification in exercise of its power under section 119 of the Act. On hearing the representation from the learned counsel for the petitioner the High court held that the impugned instruction is not ultra vires of the Act because the classification of International transactions brought out in the instruction is not contained in the act. Also the classification made is not inconsistent with or contrary to the objective sought to be achieved by the provisions of Chapter X of the Act. The CBDT instruction is helpful in ensuring that the discretion of the Assessing officer will not be abused. In these circumstances instruction no 3 dated 20.05.2003 is neither arbitrary nor unreasonable and not also ultra virus of the Act.

Inference: ITAT made clear that India’s transfer pricing regulations include a safe harbor, although the regulations do not specifically refer to one. Any taxpayer may choose the option of determining the appropriate transfer price by making adjustments within a 5% range of uncontrolled price.

In the case of SGS India Pvt. Ltd vs. ACIT\textsuperscript{386} the company SGS India, incorporated in India was engaged in carrying on the business of providing verification, inspection and certification of services in India. For the Assessment Year 2001-2002 the Assessing Officer passed an order under section 143(3) of I.T Act 1961 and disallowed part of the payment relating to technical know-how team. However, AO allowed the deduction claimed in respect of research and development fees. On the basis of the TPO order for the AY 2002-03 as per which the assessment was reopened under section 147 of the Act stating that the assessee had wrongly claimed expenses and suppressed its income and the issue was payments for R&D

\textsuperscript{386} SGS India Pvt Ltd vs. ACIT 292 ITR 93(2003)
expenditure to SGS Switzerland was not considered at arm’s length for the asst year 2001-02. The reason is the assessee had wrongly claimed these expenses and suppressed its income. The assessee objected to reopening of assessment made on the basis of assessment order for A.Y 2002-03. The assessee filed writ petition challenging the notice dated 25th May 2005 and the order dated 21st Nov 2006 for rejecting its objection by the A.O. the assessee argued that the special provisions relating the transfer pricing came into force with effect from 1st April 2002 and therefore the same applicable to Asst. year 2002-03. The principle laid down in these cannot be applied to AY 2001-02. The Revenue justified reopening of Assessment on the ground that it was not based on the law which came into force w.e.f 1st April 2002 but was based on the material gathered from the assessment order for A.Y 2002-03. Hence valid. The High court quashed the notice issued for the reassessment and held that reopening of assessment for AY 2001-02 based on order for AY 2002-3 was not sustainable. The contention of the AO that international transactions were not at arm’s length in accordance with provisions as applicable to AY 2002-03. In present case contravention of any provisions applicable to AY 2001-02 had not been established. Hence reopening of assessment was bad in law. While it is observed that whether the fundamental cardinal principle of natural hearing has been followed while deciding the issues of Transfer pricing was a question raised in many of the cases. In the case of Moser Baer India Ltd vs. Addl. CIT387 the issue was the order of the Transfer pricing officer on the ground that TPO did not grant any oral hearing to the assessee before determining the arm’s length price was raised. Moser Baer India Ltd., is company incorporated in India. The company by filing a writ in High court challenged the order passed by Transfer Pricing Officer on the ground that TPO did not grant any oral hearing to the assessee before determining the arm’s length price and failed to consider documents and information filed by the assessee. The challenge was also made to non-disclosure to the assessee of information and document obtained by the TPO which were used for determining the arm’s length price. The assessee submitted that the TPO while determining the arm’s length price of international transactions undertaken by the assessee had failed to follow a fair procedure. The determination of ALP was a complex process which not only required the TPO to take into consideration the information provided by the assessee by way of

387 Moser Baer India Ltd vs. Addl CIT (2009) 176 Taxman 473 (Delhi) also (2009)316 ITR 1 Delhi
audit report in the form 3CEB, but also as per principle of natural justice required to confront the assessee with material or information which could form the basis of determination of ALP. There is lack of fairness in procedure adopted by the TPO was evident from the fact after issue of notice to the petitioner in May 2007. The Revenue argued that there is no violation of principle of natural justice. The department have no objection to grant oral hearing if the matter was remanded to TPO for redetermination of arm’s length price as giving hearing on the basis of material already on record would be illusory and impede the correct determination of ALP. High court on hearing both side held: the order passed by the TPO is in violation of principles of natural justice and it is nullity in law. Oral hearing is a must in law. The show case notice issued by the assessing officer just prior to determination of ALP under section 92CA(3) should refer to the documents or material available with assessing officer in relation to the international transaction in issue.

Inference: court determined that TPO can adjust related party prices for tax purposes only after giving the taxpayer a hearing, considering the documents filed by the taxpayer and revealing to the taxpayer the information relied on to support the TPO’s findings. Examiner error the case throws fresh insights and guidelines on the manner in which Transfer pricing proceedings are required to be undertaken.

The issue relating to the use of the trademark in valuation of the Arm’s length price was considered in the case of Maruthi Suzuki India Ltd vs Addl.CIT/Transfer pricing Officer388 here the petitioner MaruthiUdyog Ltd was engaged in the business of manufacture and sale of automobiles, besides trading in spares and components of automotive vehicles. The company was registered owner of trademark/logo “M” and used this logo to represent its brand nameMaruthi prior to 1993, the Maruti Company was using logo ‘M’ on the front of the Cars manufactured by it. But from the year 1993 it started using the logo “S” which is the logo of Suzuke, in the front of new models of the cars manufactured and sold by it, though it continued to use the trademark ‘Maruti’ along with the word “Suzuki” on the rear side of the Vehicles manufactured and sold by it. The assessee agreed to pay Suzuki a lump sum amount of the hundred million Japanese Yen in three installments. It also agreed to pay royalty of 2.5 % of FOB price to SUZUKI in respect of deleted portion of CKD

components and further royalty of 2% on aggregate sum of ex-factory prices of ‘Maruti’ parts shipped by company during royalty calculation period. The Assessing officer made reference to TPO to determine the arm’s length price of international transaction undertaken by Maruthi Company with its associated enterprise Suzuki Corporation in the F.Y 2004-05. During the course of proceedings the TPO noticed that whereas Maruti was paying substantial amount of royalty of Rs. 198.6 crores by way of royalty to Suzuki corporation, it was not receiving reimbursement for any part of the enormous advertisement and marketing expenditure incurred by the company in promoting the Suzuki brand. The TPO issued show cause notice proposing the adjustment of 50:50 on the expenditure made by the company. The company filed writ petition against the show cause notice and objected for proposed adjustment. the matter came before the Hon’ble High court. The High court after considering the rival submission and facts of the case was of the view that taking into consideration the civil consequences and observed that there was no justification for the TPO insisting upon payment by Suzuki to Maruti, merely on account of use of the name and logo of Suzuki on the products and parts manufactured and sold by Maruti, created the necessity of using the Suzuki brand name and logo. It is Maruthi which felt the necessity of use of Suzuki’s brand name and logo and that necessity was recognized by the Government of India, by approving the agreement between Maruti and Suzuki. The court did not agree with the content of the TPO that Maruti had become a super brand and petitioner should not use Suzuki brand. It held that the onus to prove the transaction at arm’s length was on the assessee but where the price was computed by the assessee it cannot be rejected only because the assessee has not discharged the onus or where the data used justify the price is considered unreliable, incorrect or improper.

Inference: here we can find that no objection to the business decision taken by the Maruthi in this regard. It would be noteworthy here that it was not obligatory for Maruti to use the logo of Suzuki on the products manufactured and sold by it in India, though Maruti in its discretion could use that logo, on those products as well.

In one of the case the issue came up the Tribunal is whether Tribunal was justified in holding that no further income was attributable to the assessee as the transactions was at arm’s length basis- and whether the ratio in the case of Morgan Stanely could be applied when mandatory FAR analysis whether ratio in the case of
Morgan Stanley could apply when mandatory FAR analysis was not conducted for any assessment year. In the case of *Director of Income Tax vs. BBC Worldwide Ltd*[^389^], it was held that BBC worldwide Ltd is a non-resident company incorporated under the laws of England and Wales as part of BBC Group. The BBC had an Indian company M/s BBC Worldwide India Pvt Ltd (BWPL) which in the year under consideration, operated as an international consumer media company in the field of television publishing and programme channel operated through a separate division, BBC World Division. BBC worldwide company appointed BWIPL as its agent in India for selling advertising airtime on the channel at the rates and terms and conditions provided by UK group company. The payment made by the Indian advertisers for airtime and sponsorship was recovered directly by the assessee through EEFC account or RBI permission. Later the BBC Worldwide filed Nil return of Income for the Year under consideration, claiming it was not taxable on its airtime sale income being business profits, in the absence of permanent establishment in India. However the revised return of the company shown the royalty income which was inadvertently not shown in the original return. The AO held that the income was taxable in India under section 9(1) read with Article 5(4)(a) and Article 5(4)(c) of the DTAA between India and UK and accordingly estimated 20% of the total advertisement revenues attributed to India operations. The tribunal held that the TPO himself accepted that commission of 15% paid to BWIPL is fair transfer price and on the basis of this opinion the income declared by BWIPL was accepted by the department and also CUP method selected by the BWIPL for determination of Arm’s length price was acceptable. The Revenue contended the Tribunal was not justified in relying upon the order of the TPO in case of BWIPL when no FAR analysis was done in case of assessee which was mandatory under the provisions of Art 7 DTAA with U.K. Tribunal cannot do FAR analysis of the permanent establishment when it has not been done by the AO or TPO as the assessee has not maintaining any country wise accounts.

High court held that as the transfer pricing was introduced from the assessment year 2002-03 no FAR analysis was needed in respect of the asst year 2000-01 and 2001-02. The Asst Year 2002-03 FAR analysis was prepared and submitted by the assessee’s agent BWIPL once commission at 15% on gross sales was

[^389^]: Director of Income Tax vs. BBC world wide Ltd. 203 Taxman 554 Delhi HC (2006)
held as reasonable commission on arm’s length basis by TPO, a different view cannot be taken in the hands of the assessee who paid the same commission to its agent. Therefore there was no merit in the contention of the department that FAR analysis by the TPO in case of BWIPL was not relevant. Here the court has taken into consideration the decision in the case of Morgan Stanley and held that no further attribution was possible when the payment was made on arm’s length basis. The matter decided in favour of the assessee. In the case of Aztec Software and Technology Service Ltd vs. ACIT

Aztech Software & Technology Service Ltd an Indian company engaged in the business of development and export of software. It has a wholly owned subsidiary in the United States of America (USA) it appointed marketing agent in USA for services of products sold by assessee. Aztech issued work orders to US Company for every client’s projects on the basis of specifications given therein and professionals employed by US company performed the stipulated tasks. Designing and development of software (offshore services) was undertaken in India by the assessee. In consideration of such services, USA company received remuneration based on a cost plus mark-up basis from Aztec-India. During the F Y 2001-02 the assessee Aztec –India received onsite revenue and offsite revenue of Rs. 25.69 and 44.58 crores respectively. It also paid Rs. 28.32 crores for on site services and Rs. 9.32 crores as sales commission to its US associated enterprise. AztechIndia claimed the deduction under section 10A in respects of profits and gains derived from export of software. In the Transfer pricing study. It undertook a combined transaction analysis for the marketing and onsite services rendered by Aztec-USA. Transactional net margin method (TNMM) was applied by aggregating the marketing and onsite services to demonstrate that the services were rendered at arm’s length price. The TPO rejected the Transfer pricing analysis undertaken by Aztec India, based on TNMM and recomputed the arm’s length price. A separate analysis was made with respect to onsite services and marketing services. As far onsite software services TPO computed the arm’s length price (ALP) by applying comparable Uncontrolled price (CUP) method for which he used industry average data provided by NASSCOM and made adjustment to transfer price between the entities. With regard to marketing

services an adjustment was also made to the transfer price between the entities by applying the TNMM. The additions were disputed in appeal as under:

1. Whether legal requirement under the provisions of ch-X of Indian Income Tax Act 1961 would prima facie demonstrate that there is tax avoidance?

2. Whether the AO is satisfied under sub-section 3 of section 92c of the said Act before his case is referred to the TPO? And whether before making a reference to the TPO it is condition precedent the assessing officer shall provide opportunity to the assessee?

3. Whether the order of the TPO is binding on the AO

Tribunal on perusal of the facts of the case observed that legal requirement of reaching prima facie satisfaction through the mechanism of section 92C(3) of IT Act was not met as observed the addition based on the determination of arm’s length price on the basis of TPO could not be justified. The AO is not bound to refer the case of the assessee to the TPO and he may refer the case of assessee to TPO if he considers it necessary or expedient to do so. Tribunal held the law discretion is given to the Assessing Officer to refer question of computation of ALP to TPO if he consider that it is suitable appropriate, profitable or convenient to the Revenue. Also the assessemnt under the Income Tax act is quasi-judicial and principle of natural justice are applicable, but it cannot follow that every step taken by the AO must satisfy principles of natural justice or must be judicial in character. The AO has to play dual role of that of an adjudicator and the assessor while remaining a quasi-judicial authority. AO is obliged to collect the material from various sources but that does not mean that assessee should be associated with such collection of material. A mere reference does not lead to violation of any civil rights of the assessee it would not tantamount to any adverse assessment or use of adverse material. Finally on various factors the CIT(A) has set aside the matter to the file of the AO. There are other cases wherein the question of comparability analysis and functionality test were conducted to approve the methods followed in applying the principles of Arm’s length principle. In the case Mentor Graphics (Noida) Pvt Ltd wherein Mentor Graphics an Indian company, was captive service provider rendering software development support and marketing service to its parent company in USA. The Indian company being a contract service provider undertook limited functions and risks. The business
risks were mostly borne by the parent company and intangible property including
discoveries inventions and trade secrets was held exclusive by that company.
Software developed by the Indian company under instructions of parent company
was in house integrated with other components developed by the parent company.
During F.Y 2001-02 the Indian company entered into several international
transactions with its parent company viz., export of software development and
marketing support services. It selected transactional net margin method(TNMM) to
determine arm’s length price of the services with net margin based on costs as the
profit level indicator (PLI) in the present case there were no instances available of
internal comparable transactions. Similarly instances of external CUP were not
available due to difference in billing rates from technology to technology, one domain
to another hierarchy levels: contractual terms: market and geographical conditions.
The TPO proposed the adjustments in respect of income received from software
development services, while provision of marketing systems services was held to be
at arm’s length. The addition/adjustment proposed by TPO was upheld by the
CIT(A). Aggrieved by this order of CIT(A) the assessee filed 2nd Appeal before
Tribunal. The Tribunal based facts and circumstances of the case adjustments
proposed by the TPO cannot be sustained, the reason is TPO himself used the data
pertains to F.Y 2001-02 and did not permit the taxpayer to use data for any year other
than F.Y 2001-02 TPO failed to apply FAR test(Functions, Assets and Risks) since
Transfer price is not exact science the approximation could not be ruled out. It has to
shows that analysis was judicial and done after taking into accounted all the relevant
facts and circumstances of the case. Tribunal held considering the OECD Guidelines
and Indian regulations, even where TNM method is applied to determine arm’s length
price, functional profits, assets and risks assumed in controlled and uncontrolled
transaction need to be considered. Besides while applying TNMM the TPO cannot
refuse to consider specific characteristics of transaction, functions performed and
assets employed. Arms length price can be computed by Revenue and the taxpayer
using different methods.

Tribunal held the TPO neither followed mandatory provisions of Rule 10 B of
income Tax Act nor guidelines of OECD and the assessee screening of
comparables companies carrying software business in India and exporting services
and goods abroad was upheld by the Tribunal

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Inferences of the case:  this case related to the Transfer pricing of captive software development services rendered by an Indian entity to its overseas parent. The primary issue in this case was the methodology of selection of appropriate comparables for benchmarking the profits of the Indian taxpayer, in order to evaluate the adequacy of the Transfer prices between the Indian entity and its overseas parent.

Applications of the case: the landmark ruling by the Tribunal is a step in the right direction as it focuses on economic issues and recognizes commercial realities of businesses, which are the key in any Transfer pricing analysis. The emphasis laid on functions, assets and risk analysis, as well as recognition of the no risk captive contract software development .it provides some assurances that taxpayers undertaking due diligence and detailed robust analysis are better placed to face intense TP audits in India.

Supreme court of India No 2914of 2997 held whether US investment bank Morgan Stanley & co had a PE under the US India income tax treaty because of the functions performed by the personnel seconded to the Indian affiliate from the United states. The SCI ruled in favour of government when it determined the taxpayer was a services PE but attributed no further profit to the PE because the transactions at issue were at arm's length prices. In the case M/s Essar Shipping Limited vs DCIT the issue was whether data available in publications or industry indices can be used as reliable CUPs. The facts of the case is the assesseeEssar Shipping Company Ltd had wholly owned subsidiary company Essar International Ltd. The subsidiary company was engaged in business of shipping. The Essar shipping ltd entered into agreement with EIL for chartering its ship for a period of one year. As per Clarkson Report the avg one year time charter rate for similar vessel was Rs. 12582 US dollars per day. The assessee paid charter hire charges at US dollars94,550 per month. It had computed the charter hire at the rate of around 25 % of rate prescribed in Clarkson report which worked out at US 94550 per month on the ground that ship hired by it 22 years old. The assessee computed arm’s length price applying CUP method. It also submitted alternative working of ALP on the cost plus method. TPO accepted the working of the charter rate provided by the assessee as per cost plus method. The CIT (A) held inclusion of dividend by the assessee in hire charges was erroneous. The Tribunal held on the issue of comparable uncontrolled transaction

391. Essar Shipping Limited vs. DCIT ITA No. 4624/ MUM/(2006)
odds cannot be compared with the events and vice versa. There should be real comparison and cited comparable case which fall in near vicinity of the case to be compared with. The assessee had computed charter hire payment made to EIL at the rate of around 25% of the rate as prescribed in Clarkson Report. With respect to cost plus method it was noticed that from the direct and indirect costs what was to be included is the amount of normal gross profit. Tribunal held that in the facts of the case gross profit margin of 10% could be considered as reasonable for the inclusion in the direct and indirect costs for determining the arm’s length price.

Inference: this case often a debate on whether data available in publications or industry indices can be used as reliable CUPs. The Tribunal has not drawn any adverse reference insofar as the use of Clarkson report. The Tribunal laid down important principles regarding the application of Transfer pricing methods. The Tribunal had commented on the comparability requirements as required under CUP also in relation to application of CPM the correct manner in which the method should be applied has been provided for. The Tribunal held without any Transfer Pricing analysis is contrary to the principle of determination of arm’s length price on basis of detailed benchmarking analysis. In the case of Deputy Commissioner of Income Tax vs Deloitte consulting India (p) Ltd. The assessee Deloitte Consulting India Pvt Ltd derived income from international transaction relating software development and IT enabled services rendered to associated enterprises for the Asst. Year 2004-05. The international transactions comprised back office services and SAP project work. The assessee selected TNMM as most appropriate method for back office services and software development services. It arrived at arithmetic mean of 13 comparable companies at 8.69% as against 7% declared by the assessee. Since net margin of the assessee was within 5% range of average cost plus mark-up of comparable companies, the company in transfer pricing study reported that the transactions were at arm’s length. In the captioned AO made reference under sn92CA(1) of the Act to Addl CIT for determination of the ALP. The TPO passed the order under section 92CA (3) adopting transaction net margin method as the most appropriate method and determined ALP for IT enabled services, after making adjustment of Rs.4.70 crores. As for as software development services arm’s length price was determined after

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making addition of ₹.49 crore. Aggrieved by the order of the AO, the assessee preferred appeal before CIT (A) confirmed the action of TPO in not considering few companies as comparable in respect of back office segment. Aggrieved by the order assessee preferred appeal before Tribunal. The argument of the assessee before the tribunal is the assessee has used multiple year data for determination of ALP as current year data was not available at the time of filing return of income. The arithmetic mean of comparable prices would have been reduced by 5% as permitted by proviso to section 92 C(2) of the Act. The departmental representative on the contrary submitted no standard deduction has been provided to the assessee and therefore benefit of variation of standard deduction could not be allowed as claimed.

_Tribunal held: for the purpose of determination of Arm’s length price the transaction entered into with AEs are to be compared with uncontrolled transactions carried on by an entity during the same period as that of Assessee company. TPO is right in considering the issue of assessee contention of non availability of data and accordingly directed the assesee to search for the comparables. The other issues of the assessee like non resident risk free environment are considered by the assessee._

7.08.2. INTERNATIONAL CASES

1. **AUSTRALIA**

Arm’s length principle is the basic rule applied to transactions between related parties. This principle applies to all transactions made in respect of supply or acquisition of property or services under an international agreement between separate legal entities. Australian Transfer pricing provisions are contained in the Income Tax Assessment Act, 1981. These regulations are part of Division 13 of Part III of the tax statute. Transfer pricing regulations are anti-avoidance rules that are enacted to counteract global profit shifting from Australia to other countries. Division 13 does not permit downward adjustment of income. Therefore where the amount received by an Australian taxpayer for outbound transaction is excessive or amount paid in respect of inbound transaction is less than arm’s length the law does not allow the adjustment for decrease of income of the taxpayer. The application of CUP method involves direct comparison of the compensation for the product or service in a controlled transaction with the consideration in comparable uncontrolled transactions was examined on various issues. The Application of CUP methods where exact
comparables are not available in such cases use of inexact comparables in the circumstances were tested. In a case *SNF (Australia) Pvt Ltd vs. Commissioner of Taxation*\(^{393}\) wherein SNF (Australia) was a wholly owned subsidiary of a multinational chemical manufacturing company SNF (France). The SNF (Australia) was engaged in the business of manufacture and distribution of chemical products namely flocculent and coagulants which were sold to mining, paper and sewage treatment industries in Australia. During the audit period 1998 to 2004 the SNF (Australia) did not report any profit though SNF group was profitable and sales were growing. As a matter of fact for eleven years the SNF (Australia) experienced trading losses and had paid no income tax. The commissioner contended that continued losses of the Australian Company showed that motive of the taxpayer was to make losses in Australia and shifts profits to France by transfer pricing. The flocculants and coagulants were purchased by SNF from related parties in China, France and the US and then resold in the market. It was alleged that inventory price of the products was not based on the transfer pricing study but on educated guess of the prevailing prices. The commissioner contended that prices paid by SNF (Australia) to related party suppliers were too high and therefore not at arm’s length. It was stated that losses incurred by Australian company did not make sense if the inter-company prices were at market prices. The government accordingly made an adjustment of Aus 13 million supported by the TNMM analysis. At the Federal court the company tried to justify transfer prices by constructing three comparable uncontrolled prices (CUPs) based on internal comparables. 1st CUP 2\(^{nd}\) CUP and 3\(^{rd}\) CUP taxpayers referred different comparables he made to arrive decisions. The Federal court of Appeals on the first CUP upheld the taxpayer’s arguments and turned down the request of the commissioner for further adjustments. The 2\(^{nd}\) CUP court did not disregard the Commissioner’s expert. Dr Becker’s objection and held that the trial court should not have relied on the second set of comparables even in limited way he did. Finally the it held that the transactions were held at arm’s length and earlier decision of a single judge of the same court was upheld. For the reason tax payer was able to demonstrate that the actual prices paid by the taxpayer were lower than the prices paid by unrelated parties. In a case of *Daihatsu Australia pvt. Ltd vs. Federal Commissioner*
Daihatsu Australia Pty Limited (DAPL) an Australian company carried on business of import and wholesale distribution of motor vehicles and spare parts manufactured by DMC(Japan) a company incorporated in Japan DMC was a majority share holder in DAPL. In June 2000 the commissioner of taxes issued a notice to DAPL of amended assessment for the year ending 30th June 1992 for the year ending 1993 to 1996. The notices for each year were accompanied by documents entitled “income Tax adjustment sheets” indicating the adjustments that had been made to previously assessed income. For the relevant years of income the commissioner carried out the audit of DAPL with a particular focus on the amounts paid for import of vehicles from 1992 to 1997. The commissioner was of the view that the amount paid for vehicle purchases for these years required to be adjusted; and accordingly he made determinations pursuant to Division 13 of the ITAA 1936 and in terms of Para 3 of the Protocol. It was noted that for each year of income the deductions for purchases were reduced by different amounts in accordance with determination made by the tax office. The division 13 determinations were issued to taxpayer on 19th June 2000. The Assistant commissioner of the Australian Tax office has made the findings that during the year DAPL had paid more than arm’s length consideration in relation to the acquisitions of goods. Section 136 Ad(3) provision applied to DAPL in relation to acquisition of the property during the relevant period. Under section 136 AD(4) the consideration paid or payable for acquisition of the property was determined in excess of the arm’s length considerations by specified amounts for each year. Therefore the excess amount was liable to be included in the income for each tax year. The ATO adopted TNM method for determining the arm’s length price in support of this method Mr Coakley noted that although ideally arm’s length principle should be applied on a transaction by transaction basis but he agreed with OECD guidelines that there could be circumstances in which it would be appropriate to aggregate transactions; and this was a case where separate transaction were so closely linked that they could not be evaluated adequately on a separate basis. Federal court accepted the evidence of Mr. Coakley who had recommended the application of TNMM for determination of arm’s length price in view of the reasons given by him. The comparables selected had been determined after much consideration and weighing up of factors by the ATO economists and that aggregating

394. (2001)FCA 588 Federal Court of Australia
transactions resulted in a consideration that was conservative and in the tax payer’s favour. Accordingly the court approved the determination of ATO transfer pricing methodology and dismissed the application of the taxpayer. Tax payer generally rely on profit based methods as detailed information in respect of comparable transactions or potential comparable enterprises is not easily available there are limited financial disclosure requirements for Australia companies. Certain few cases where transfer pricing assessment procedure has been challenged are San Remo Marcone Pty Ltd (1999); Daihatsu Australia Pty Ltd (2001) and WR Carpenter holdings Pty Ltd &Anor, (2006) but most of the cases are decided in favour of the Revenue. The Australian Appellate Tribunal in landmark case of Roche products Pty Ltd (2008) held that DTAs do not give the ability to impose tax. Therefore Division 13 should form the base that supports transfer pricing assessment. The arm’s length prices should be determined for each separate year under consideration, rather than a multiple year average. Though there was difficulty in finding available comparable data, preference needs to be given to transactional methods over profit methods, such as net profit margin method.

2. United Kingdom

In UK under old rules UK taxpayer was required to adopt arm’s length price when HMRC issued a direction to that effect. But after introduction of self-assessment procedure the taxpayers are required to self assess their transfer pricing compliance with filing of tax return. In UK control is important aspect of transactions governed by transfer pricing rules. The regulations are applicable where one party controls the other or both parties are under common control. In UK law provides limited exemption from application of transfer pricing rules in case of small and medium sized enterprise. The responsibility to make adjustment to price or income lies on taxpayer. Adjustments are not allowed where non-arm’s length transaction does not result in tax advantage in UK. The Law states that any dealings between the permanent establishment and the non-resident company should be as per arm’s length principle. With introduction of self-assessment procedure the tax payers are required to accurately self-assess and justify their prices, income, profits, or losses returned for tax purposes. The issue regarding whether transfer pricing adjustments could be given effect in respect of assessments lying open without making further assessment. In the case of Glaxo Group vs Inland Revenue Commissioner United Kingdom
Glaxo welcome Plc a company belonging to Glaxo Group had three wholly owned subsidiaries; Glaxo Group limited, Glaxopharmaceuticals UK Ltd and Glaxo operations UK ltd located in UK and Singapore. The tax assessments of Glaxo Welcome Plc were lying open for number of years under an agreement between Glaxo Plc., UK and its Singapore subsidiary, the parent company transferred technology to Singapore Company. The Revenue believed that since transaction of technology transfer was not at arm’s length price, adjustment was required to be made for the differences caused due to transfer pricing. It noted that the assessments for number of years were lying open and there was a subsequent direction under Section 485(3) of the Income and Corporation Taxes Act, 1970. However the adjustment was not possible as assessments in relation to accounts of many of the years under dispute were out of time and the prescribed period for making adjustment was six years from the end of the chargeable period to which the assessment related. Tax payer contended that Revenue should have made further assessments before giving effect to adjustments arising from transfer pricing which was not possible at that time since these were time barred. Revenue position was that it was possible to give effect to transfer pricing adjustments in respect of assessments that were already open. Tax court under Section 485(3) held it was mandatory to make all adjustments that were necessary in income, profits or losses of the taxpayer.

**Inference:** The commissioner had the power under section 50(7) of the act to increase an open assessment while hearing of an appeal. He also had power to accept evidence which may result in increase in the assessment. But the taxpayer cannot withdraw his appeal without the consent of the inspector. The court of appeal held that commissioner had power to make adjustments and enhance the assessment.

The issue relating to associated enterprises was a device to enable UK company to pay excessive price for the Oil supplied by the Swiss company. Whether the facts and documentation it can be said that transactions was fraudulent and profit earned were used to fund the loans taken by the shareholder for purchase of share of Rochester Canada. The issue came up before the country. In the case of *Rochester(UK)limited and Another v Pickin*\(^{396}\) Rochester (UK) limited is a company incorporated in UK in which 60% shares are held by its parent Rochester Canada and

\(^{395}\) Glaxo Group Limited vs. Inland Revenue Commissioner (1996) STC 191 68 Tax Case 166

\(^{396}\) Rochester (UK)limited and Another vs. Pickin (1998)STC (SCD) 138
40% by one Mr. York ("Y") Dr Salisbury (S) had the majority shareholding of Rochester Canada and was a Director of Rochester Canada and the Chairman and Director of Rochester UK. Mr. Y was the Managing Director of the UK company Rochester UK limited. During the year under consideration Rochester UK purchased oilseeds from a Dutch company, Glederland BV, for the purpose of extracting Oil. After a couple of years, the Dutch company agreed to supply the oil seeds to a newlyincorporated Swiss company, Appenzell AG the ("Swill Company") the Swiss company made arrangements for extracting oil from the oil seeds purchased by it from Dutch Company. The Swiss company in turn supplied extracted oil to the UK and Canadian companies. According to the Revenue the profits earned by the Swiss company had been applied for benefit of Y and S by purchasing sterling certificate deposits, which were further deposited with the banks as a security for the loans taken by Mr. Y and Mr. “S” the loan amounts were then used to purchase shares of the Rochester Canada. According to the UK Revenue authorities the arrangements were fraudulently made and the Swiss company was inserted in the case only as a device to enable that UK company to pay excessive prices for the oil supplied by the Swiss company. In this way UK tax was evaded on the UK Company’ profits. The Tax authorities contended that payments by the UK company to the Swiss company in respect of medical research were for no consideration and therefore could not be deducted. The UK company which was considered to have been paid in excess of the reasonable price for the supply of oil. The assessments were completed after making appropriate adjustments in the case of UK company.

Decision: Special commissioners held that in instant case the Revenue had failed to discharge the burden of proving fraudulent or negligent conduct in relation to the out of time assessments. As far assessments relating to years which were within the special commissioners found that the payments had been made as part of commercial arrangement and that they have made wholly and exclusively for the purposes of the trade of the UK Company. It has been ascertained that these business arrangements were made with Swiss company was fraudulently inserted in the chain as a device for tax evasion of UK company profits. the issue relating to applicability of CUP method like inexact CUP, middleman acting on behalf of the re-insurer-Arm’s length consideration that should be paid for the provision were discussed in the DSG Retail
This group is the largest retailer of electrical goods in the UK comprising the Dixons, Curry’s and PC World retail chains. The DSG Retail ltd was engaged in retail business and had a subsidiary CIS. The subsidiary company CIS acted as a agent for Cornhill Insurance Plc that offered DSG customers extended warranties on electrical goods. Cornhill paid CIS a sales commission in 1986 and 1997 the cornhill company acted as insurer of DSG customers. This company retained only 5% of the risk with itself and reinsured 95% to a subsidiary of DSG that was incorporated in isle of Man DISL there was no direct contractual relationship between DSG and DISL the arrangements between the parties were extended in 1993 for a period of five years and terms of profit commission were altered so that CIS receives higher commission. To avoid payment of higher tax on insurance premium, the DSG restructured the arrangement to service contract with ASL an isle of Man company. The fees charged for repair contract did not attract insurance premium tax because it was a service contract and not an insurance transaction. HMRC invoked the transfer pricing rules and contended that the arrangements were not as per the arm’s length principle. DSG argued for the use of comparable uncontrolled price(CUP) method and put forward a number of comparables in support of its arguments. For this purpose it relied on a number of reports of accounting firms. The comparable s selected by the taxpayer were not accepted by HMRC for the reason first and second comparables were different. Since HMRC did not accept the comparables identified by DSG its expert witness applied profit split approach, whereby DISL profits would be computed based on notional rate of return on investor’s capital following capital asset pricing model.

Decision: according to the special commissioner the arrangements between parties were not as arm’s length and price set by DSG confers a potential advantage in relation to UK Tax. This is because DSG profits did not include income it would have received for its provisions of the business facility, if the parties were dealing at arm’s length. It was held that profits should be adjusted to that of arm’s length arrangements applying the profit split method. Inference of the courts decision: whenever there is a case of CUP courts are generally strict when a CUP is proposed

397. DSG Retail Ltd vs. Commissioners for Her Majesty’s Revenue and Customs (2009) UKFTT 31 (TC)
particularly if it involves use of inexact CUP. The case emphasizes the need for a bargaining power in matters of adjustments.

3. **United States of America:**

   The USA has extensive and well-defined transfer pricing regulations.

   Of the various methods CUP method is most suitable method. CUP is reliable method where an independent enterprise sells the same product as is sold between two associated enterprises In the case of “*Eli Lilly and Company vs Commissioner*” court held that onus is on a prove the satisfaction of arm’s length principle in addition to proving that deficiencies set forth in the notice are arbitrary capricious, or unreasonable.

Facts of the case: Eli Lilly is a company incorporated in USA that transferred patent of a drug known as” Darvon” to its subsidiary company Puerto Rico. The subsidiary company carried on the business of manufacturing drugs in Puerto Rico; that were would after manufacturing to the US parent Company. US parent then marketed and supplied the drugs to third parties within United States. The company adopted formula for inter-company transfer as per which combined profits from sale of Darvon were derived between Eli Lilly and its Puerto Rican Subsidiary. The issue is what would be the best transfer pricing method in the facts of case to determine arm’s length pricing method in the facts of the case to determine arm’s length price. The Revenue contention was that Cost-plus method should be applied as that would allow the subsidiary company to recover its manufacturing and other costs taking into account the locational savings.

   Held the CUP method was rejected because the adjustment could not be made on account of differences arising due to credit terms supply, of raw material, packaging product quality and patent. court rejected any of the traditional transaction method including RPM. In the instant case Cost plus method cannot be regarded as best method relying on the evidence furnished by the IRS experts of the America.

Inference: US Regulations 1.482-3(b)(5) provides that when the CUP method is to be applied on the basis of the public data, it should be a widely and routinely used data. The data should have been used for setting up prices for controlled transactions

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398. 84 TC 996(1985)
in the same way, as it is being used for uncontrolled. Hence, CUP method is not applicable.

In the case of *Compaq Computer Corporation vs. Commissioner*\(^{399}\)-the issue discussed was CUP- adjustment. The facts of the case is as under: Compaq Computer Corporation ("Compaq US") is a US company incorporated in State of Delaware. The principal place of business of the company is situated in Houston, Texas and its main business consists of manufacture of central processing units (CPU) for computers. The US company has several subsidiaries located in Singapore, UK and other countries. The company assembles the printed circuit assemblies (PCA) a component of central processing unit using advanced manufacturing procedures. The company mainly purchased the PCAs from Compaq Singapore ((the subsidiary company) and some US sub-contractors. The Singapore subsidiary was carrying on the business on similar lines as Compaq-US existing structure. Compaq-Singapore had more advanced systems than other Singapore manufactures of PCA and therefore, the company had no competition with them. The Compaq US and its Singapore subsidiary were using standard costs system to track their manufacturing costs. They assigned specific costs to arrive at a material standard, a labor standard and overhead standard. The cost of production in Singapore was much lower than that in USA. The Compaq US used comparable uncontrolled price (CUP) method for transactions entered into with Compaq Singapore to determine arm’s length price. The difference between Compaq-Singapore transactions and that of unrelated parties related to product similarity, functional differences and conditions of geographic markets. Due to these differences transfer pricing adjustments was required for transactions entered into with sub-contractors which were not related to Singapore Company. The IRS investigation discovered that the purchases from Singapore and other unrelated subsidiaries were almost identical except for some difference in the transactions. The Comparable transactions used by Compaq U.S did not satisfy as arm’s length comparables for the purchases of PCA’s form Compaq Singapore. It was determined that the transfer price used was not at arm’s length and the IRS increased Compaq U.S taxable income in 1991 by $124.4 million and $ 90.4 million in 1992\(^{400}\) the Compaq US compared its pricing decisions with its standard costs on the turnkey

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\(^{399}\) *Compaq Computer Corporation vs. Commissioner* 78TCM 20, Memo (1999)

\(^{400}\) *Ibid*
basis. Under the turnkey transactions with unrelated subcontractors, Compaq U.S bought 3.6 million PCA’s worth $597 million dollars in 1991&1992 compaq US argues that the transactions with unrelated subcontractors are consignment purchases and cannot be used as comparables. As a result the transactions cannot accurately be converted to comparable prices and thus CUP comparison cannot be used.

Held: Since the petitioner had satisfied its burden of proof that transactions between related parties were conducted at arm’s length and use of CUP method was justified. There was no problem with Compaq using CUP method and apply it without adjustment. Revenue contended that CUP method required that products would be identical or almost identical for determining arm’s length price. The second issue is identification of transfer pricing adjustments due to functional differences between controlled and uncontrolled transactions. Due to difference in functions performed adjustments were made by Compaq-US which was accepted by Court. Quality of goods was another area which could impact the purchase price of PCA Compaq US considered this factor and reworked the price of defective PCA’s received from Compaq-Singapore and subcontractors. Compaq Singapore worked in low cost environment and therefore, had benefit of labor cost savings. Court upheld use of CUP method on the facts of the case.

**Inference:** In order to satisfy CUP method the comparable transactions must be identical and yield a similar net profit margin in order to be at arm’s length. Here CUP method is acceptable.

To find out the Transfer price charged by the subsidiaries would satisfy the Arm’s length price or not was discussed in one of the case law called *National Semiconductor vs. Commissioner*401 here the corporation was engaged in the business of manufacturing semi-conductors. The company had certain Asian subsidiaries which were carrying on semi-conductor packaging and associated activities and it got the advantage of lower labour costs and overheads. It also received tax incentives allowed by local government because of moving operations in Southeast Asia. The Asian subsidiaries purchased from NSC dies and other materials, including lead frames, headers, packages and circuit boards, from Dyna-Craft plants from Japan. NSC subsidiaries sold packaged semi-conductors devices, primarily to the parent on a

cost-plus basis and also to foreign affiliates and third parties. The issue came up before the court was whether transfer prices charged by NSC and its Asian subsidiaries satisfied arm’s length principle of section 482 of the code. US court opined that NSC presented a number of comparable transactions between unrelated parties to show that its transfer prices satisfied the arm’s length test. US court observed that both parties did not provide price to support CUP method analysis. There was no basis to translate a given price for the device for a particular year into proper allocation of income among petitioners and Asian subsidiaries. US court depended on expert opinion who in turn presented two analysis one is on price to price analysis and other is cost-plus analysis. Court considered the related to charge of R&D expenses by the parent company to the subsidiary.

Held: The evidence produced by both parties showed that reallocations of income between parent company and Asian subsidiaries were arbitrary, capricious and UN reasonable. The court believed that due to the interdependent nature of their relationship, petitioner should not have sustained losses over the years in issue, while the overseas Asian subsidiaries maintained high profits. Here the income should be reallocated from the subsidiaries to the parent company. Based on the relationship between NSC and its Asian subsidiaries it is unrealistic that the transfer prices used would result in operating losses for the parent company while the subsidiaries incur high profit. The court made appropriate adjustments to bring the pricing closer to reasonable arm’s length standards. The court adjusted to produce a fair adjustment and increased NSC’s taxable income.

Inferences: the national Semiconductor Corporation case involved determining if the comparable transactions used by NSC were at arm’s length. The IRS argued they were not because the transactions were different for a variety of reasons. The court ruled they were not, because NSC was recording a loss when its subsidiaries were boasting profits. For the reason the evidences produced by the both parties showed the allocations of income between the parent company and Asian subsidiaries which were of interdependent and the losses sustained by the petitioner for which some adjustment were to be made.

While determining the concept of the Arm’s length principle it is came into the light that whether the price of competing products could influence the determination of arm’s length price of transactions between associated enterprises. If it so what kind of
evidence is sufficient to challenge successfully the issue came into light in the case of United States Steel vs Commissioner\textsuperscript{402} where Westreco Inc, a US corporation was engaged in providing research and development services to its Swiss parent Nestec. Both westreco and Nestec were subsidiary companies of Nestle, S A Switzerland. As per contract the fees payable by Nestec to Westreco was based on cost-formula. According to commissioner of Income Tax the fees paid to the company was inadequate and therefore he determined deficiency in tax as per section 482 of the code. During the appeal court considered among other things the risks associated with services for evaluating comparability of prices. IRS contended that adjustment was justified on the basis of a transaction based salary multiplier method, which was used by engineering consultants.

**Decision:** Court held adjustments were required to be made for any differences in non-bailable costs such as lack of down time, differences in administrative costs and other overhead costs. The commissioner in its view had abused discretion under Section 482 by allocating additional fee income to the petitioner company because the fees charged by Westreco from Nestec clearly reflected income within meaning of section of 482 of the IRC.

The issues of application of Resale price method for grant of right to use under license agreement was came up in a case by name Sundstrand Corporation and Subsidiaries vs. Commissioner\textsuperscript{403} Sundstrand Corporation a US based company carried out business of design, manufacture and sale of diversified products for aerospace and industrial markets. The company had a wholly owned subsidiary in Singapore called Sun Pac, which was engaged in business of manufacture and sale of parts required in aircraft transmission. In 1974 US company expanded its business and granted rights to its Singapore subsidiary under a license agreement for 1 exclusive right to use industrial property rights for manufacture of spare parts of CSD in Singapore:2. non exclusive right to sell its spare parts anywhere in the world 3. Right to use trademarks owned by the parent company. For this Sunpac agreed to pay the Sundstrand US royalty at 2% of net selling price of spare parts manufactured and sold by Sun pac. US parent company agreed to purchase all goods manufactured by subsidiary company at the Sundstrand catalogue price less a 15 % discount.

\textsuperscript{402} 617 F 2d 942 (2nd Cir. 1980)
\textsuperscript{403} Sundstrand Corporation and Subsidiaries vs Commissioner 96 TC 226 (1991)
**Decision:** the Court held that resale price method was most appropriate method to decide arm’s length price. However it did not agree with 15% discount offered and reconstructed discount at 20% relying on certain sales and distribution agreements between Sundstrand and unrelated parties. Here the court noticed that history of parent company granting discounts for its distribution agreements varied between 5% and 20%. In the circumstances of the case the court held that discount rate of 20% was appropriate to satisfy arm’s length test.

An issue came up before the court regarding the Transfer pricing audit, wherein the non cooperation and refusal of importance of clear and well written documentation was discussed. *DHL Corporation and Subsidiaries vs. Commissioner*. DHL was a worldwide US Courier company incorporated in 1969. The company established HongKong subsidiary DHLI in 1972 to carry on courier business outside USA. The international operations of the company were carried out by DHLI, its affiliates and series of independent agents that agreed to do business within the DHL network. All group companies were obliged to use the DHL trademark for their business. During seventies the HongKong subsidiary (DHLI) recognized the necessity to have a standard trademark or logo, which was used by the worldwide network. From 1983 DHLI started the process of registering the DHL name in countries outside United states. The name was registered as of DHLI without reference to the fact that DHLI was a licencee of DHL. DHLI incurred the cost of trademark registration, protected the trademark against infringement outside the United states, and handled disputes with agents related to trademark usage. Finally DHLI bore the cost of advertising the DHL network outside the United States. Later in mid eighties DHL experienced a serious cash problems and hired Bain and company to assist the company to achieve profitability. In order to prevent the cash flow problem of the DHL’s the DHLI should purchase the DHL trademark as a vehicle for capitalizing DHL and to eliminate potential IRS audit exposure. Several advisors valued the DHL name in range of USD 20 million to USD 200 million. Ultimately the company adopted value of USD 20 million for the sale completed in 1992.

**Decision:** The case is an approach to transfer pricing audits which relates to non-cooperation and refusal to provide the information needed to properly evaluate the

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404. DHL Corporation and subsidiaries vs. commissioner (TC memo 1998-461)
transfer pricing issues. In the captioned case no royalty was made payable for the use of DHL name. Later DHLI recognized the importance to have a need of a standard trademark therefore had the name registered in its name and had been licensed on a royalty-free basis. However later at the time of sale of trademark, DHL argued that DHL and DHLI were not related parties. The Court went into the merits of the case and imposed a fine of 20% as penalty on the failure by DHL to charge a royalty for the use of trademark while it was owned by it.

Inference: the court emphasized importance of maintaining clear and well-written transfer pricing documentation and at the same time have independent advisors to prepare transfer pricing documentations. The court imposed the transfer pricing penalty because DHL’s documentation was prepared by a consultant who was doing work for DHL and was therefore not independent. The court confirms the non-arm’s length pricing and upholds the $100 million price for the transaction here the payment was determined not at arm’s length because DHL’s trademark was sold at an undervalued price.

The issue of whether asset given to related entity without charging rent would attract transfer pricing regulations for deemed rent payment. The issue came up before court in the case of Central De Gas De Chihuahua S.A vs. Commissioner of Internal Revenue here the CG had given on hire certain equipment to its associated enterprise without charging hire charges for use of equipment from related party. CG argued that Section 881 provision was not applicable to the facts of case. It stated that allocation of fair rental value to the equipment amounts to payment of constructive dividend and a non taxable contribution of capital to CG. On the contrary revenue contended that there was no requirement of actual payment under section 881 of the Code and therefore, the allocation of rent to CG provided sufficient basis for imposing the 30% tax. It was held in this case that the present case involves the fair rental value of the equipment. Court held that the allocation of fair rental value of equipment could not be treated as payment of constructive dividend to the other company.

The question of application of Arm’s length Principle came up before the court in many cases. Its failure was discussed by the US courts for the reason it is

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405. DHL Corporation vs. Commissioner United states court of Appeals for the ninth circuit. Opcit., p 20
based on legal fiction that complicates and obfuscates instead of clarifying and simplifying which compare another legal fiction in tax law, the US depreciation rules provide for fictional, scheduled depreciation deductions for enumerated asset classes. The illustration of multifaceted dysfunction of ALS in practice was reflected in the famous transfer pricing case of *Bausch & Lomb Inc. vs. Commissioner* in this a manufacturer of contact lenses developed and patented the spin cast method for manufacturing soft contact lenses, which enabled production costs of approximately $1.50 per lens, while alternative methods used by competitors cost at least $3.00 per lens. Bausch & Lomb (B&L) subsequently licensed the technology to wholly owned Irish Subsidiary B&L Ireland. B&L Ireland manufactured the lenses at a cost of approximately $1.50 per lens and then sold them to B&L for $7.50 per lens. The IRS in challenging the transfer price as artificially high argued that B&L Ireland was analogous to contact manufacturer because of sale of its total production was assured. Because it did not bear the risks of an independent manufacture B&L Ireland entitled to cost plus a comparable contract manufacturer markup. B&L argued for application of the comparable uncontrolled price method, presenting evidence that the $7.50 per lens price was at or below the price which would have been charged by comparable uncontrolled manufacturers for similar lenses. The court found that comparable uncontrolled price was the appropriate method, with $7.50 a reasonable per unit price, in part because B&L Ireland was not contractually bound to sell the lenses it produced to B&L. This case illustrates several troubling aspects of administering ALS in practice. First the treatment of the parent and subsidiary as separate entities is particularly absurd in this case. It is clear that transaction in question would not have occurred but for the relatedness of the parties in the case of *Xilinx Inc. and Subsidiaries vs Commissioner of Internal Revenue United States Tax court* the question under consideration is the allocation made by the IRS’s allocation was contrary to the arm’s length standard mandated by sec 1.482-1(b), Income Tax Regulations. The facts of the case is The Xilinx Inc and Xilinx Ireland entered into a Cost and Risk Sharing Agreement, which provided rights, title and interests in new technology developed by either Xilinx or Xilinx Ireland would be jointly owned under this agreement costs directly related to research and development, indirect

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408 *Xilinx Inc. and subsidiaries vs. Commissioner of Internal Revenue United States Tax Court 125 TC 37: 2005 U.S TAX Ct LEXIS 24: T.C No 4 August 30 m2005 41452-01, 702-03
costs, and any other costs related to the development of intangible property, were to be shared during the year 1997, 1998, 1999. Xilinx wrote off $41 million, $40 million, and $96 million respectively. The deductions were recorded as business expenses based on employees exercises of non-statutory stock options disqualifying dispositions of incentive stock options and employee stock purchase plans. The IRS issued a notice of deficiency for Xilinx tax years of 1997, 1998, 1999. The notice challenged that the employee stock compensations issued to the employees working in research and development, should be shared between Xilinx and its subsidiary if shared the XilinxIncome deductions would decrease and taxable income would increase. The tax court issued the opinion that with respect to employee stock options, two unrelated parties would not share the costs at arm’s length. Under the code of Federal Regulations title 26 Internal Revenue, cost sharing agreements between two related parties are to reflect how two unrelated parties share costs with respect to arm’s length pricing. The court concluded that the IRS claims were arbitrary and capricious. The court determined that the employee stock options exercised in this case, are costs related to intangible property developments and must be shared between the two parties. The court’s opinion was as per section 1.482-7 (d)(1) which states the arm’s length standard should apply in every case was incompatible with 1.482-7(d)(1) which states all costs are to be shared in a cost sharing agreement.

On January 2010 the U.S Court of Appeals for Ninth Circuit, withdrew the previous decision and issued a new opinion on March 22 that the Court’s new opinion holds that the Stock-based compensation does not need to be included in the research and development costs in the a cost sharing agreement between two related parties\(^\text{409}\).

**Inference:** the regulations are hopelessly ambiguous and concluded that the ambiguity should be resolved in favor of what appears to be the commonly held understanding of the meaning and purpose of the arm’s length standard prior to this litigation\(^\text{410}\). Fisher argues that the Commissioner (IRS) attempts to square the all costs regulations with arm’s length standard have only universally understood by both

\(^{409}\) Kitgaard, Mark, Morrison, Phillip and Shapiro, in a paper accessed on http://scholarship.claremont.edu/cmc-theses/87 retrieved on 10.03.2015 at 3.A.M

taxpayers and the IRS. The current regulations are not clear to taxpayers on how transfer pricing decisions affect their firms.\textsuperscript{411}

\textbf{Outcome of the case:} The appeal court was confused between whether the arm’s length standard should apply in all cases or if all costs should be shared in a cost sharing agreement in the Xilinx case. The two regulations conflict because two unrelated parties will never share stock option costs but the costs pertained to research and development.

\textbf{7.09. Conclusions}

After detailed study of the various case laws of Indian context and US, U.K, Australia it is learnt that the intention of the Multinational Corporations to have a single international standard in order to reduce the incidence of double taxation. The application of arms-length principle has been debated since the first half of the century at the League of Nations Model Tax Convention. The reason for longevity of the principle is that although the principle has remained the same, the ways of applying the principle in practice has continually been evolved to take into account, the changing business or economic circumstances. Right from the beginning continues debates have been taken place in 1979 OECD Report on Transfer Pricing as to whether arm, s length principle be replaced by formulary apportionment, the issue gained limelight in 1995 IEC Model. The issue of comparability standards has been interpreted strictly. A thorough discussion has been made for comparative analysis of Arm’s length principle and the other method Formulary apportionment discussion

The main purpose of the arm’s length standard is to ensure related party transactions are transferred at prices competitive to the open market and to prevent tax evasion.\textsuperscript{412} In all the cases examined about either in the Australia, UK, USA, and India it is noticed that the Revenue of the concerned states sent a notice of deficiency due to disagreements over arm’s length pricing. Corporations who are issued a notice of deficiency must prove the related party transaction comply with arm’s length standard, under the various transfer pricing methods, a comparable unrelated party

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{411} Kitgaard Mark, Morrison, Phillip and Shapiro, Alan op cit p. 15
\item \textsuperscript{412} Parker Ken.“Arm’s Length Principal” October 15\textsuperscript{th} 2010 accessed on http://www.ustransferpricing.com/arms-length-principle.html, retrieved on 10.03.2015 at 3 A.M.
\end{itemize}
\end{footnotesize}
transactions is always needed to determine the arm’s length price. The corporation studied have been challenged as to whether the comparable transactions used as proof, abide with the arm’s length standard. Each corporation’s unique operation and transactions have been tested the courts /Tax court’s interpretation of arm’s length regulations.

It appears much time that the comparable transactions element in arm’s length standards is flawed and ambiguous because large multinational companies survive on unique related business transactions that have no comparables. A determinable arm’s length standard transfer price, when no unrelated comparable transaction is presented in impossible. Because of this imperfection, uncertainly surrounds the arm’s length standard. In the most of the cases arm’s length standard was the main disagreement in all of the courts, decisions. Basing upon the facts and circumstances and issues prevailing the concept of Formulary apportionment has been a solution suggested to dethrone the arm’s length standard. Currently all the United states based multinational corporations are required to declare profits in each separate international tax jurisdictions in which a subsidiary is present. With a formulary apportionment a formula would allocate a firm’s total income by determining the percentage of economic activity each subsidiary and parent contributes to the corporation and pay taxes accordingly perhaps if adopted multinational corporations could no longer manipulate transfer prices for financial benefits this may be the solution for the end of dichotomy of the arm’s length standard.

Even this FA approach as we have studied suffers from some form of lacuna. This FA requires substantial international coordination and consensus. It is felt that even if the some countries were willing to accept global formulary apportionment there would be disagreements because each country may want to emphasize or include different factors in the formula based on the activates of factors that predominate in its jurisdictions. The economists feel that FA is based on more sound and intuitive economic principles than the current regime. The current system finds

413. “Transfer pricing methods” accessed on http://www.itinet.org/transferpricing/methods.htm retrieved on 10.03.2015 at 3 A.M.
415. Ibid p. 31
disfavor with economists’ who feel that OECD recommended transfer pricing methods lack a sound economic base. The fact is that some of large developed economies of the world start using FA there will be huge incentive for the developing countries to use it too.

In this context the fast growing economies of the world like developing countries like China and India having global income can utilize the opportunities of implementing the system of Formulary apportionment principle.

The main arguments in favor of formulary taxation are that the system does a better job of addressing the economic reality of multinational firm behavior. The main deficiency in the transactional arm’s length principle is that the system artificially attempts to draw lines between related aspect of firm where no line truly exists. In particular multinational firms are becoming more highly integrated with each other’s operations located in different regions. It is often not possible to find comparable transactions with unrelated parties. Formulary taxation on the other hand accepts the reality of firm integration and tries to come up with a workable solution that matches each jurisdiction with tax revenues related to value adding economic activity that takes place within the jurisdiction. Formulary taxation are conceptually pure than the current arm’s length system, which is supported by international consensus among national tax authorities. Certain commentators points that the formulary apportionment is not the panacea for the reason in the case of intangibles will not fall within any formula to determine which jurisdiction should enjoy the right to tax. This problem alone might deal a death blow to formulary taxation for electronic commerce purposes because so many of these transactions involve intangible digital goods and services. Some critics point out that formulary taxation may in fact lead to more abusive tax planning as firms devise strategies, for instance, to hire independent contractors in the jurisdiction so that formula that included salaried employees would not count the independent contractor salaries. Canadian government report rejects formulary taxation for electronic commerce purposes because among other things, “it would not eliminate the risk of double taxation and it is doubtful whether it would be easier to administer than the current arm’s length principle”\(^{416}\) it is recognized that the distinction between formulary taxation and the

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arm’s length principle is not “pure black or white” and that the better way to view transfer pricing methodologies is that they are all part of the same continuum\textsuperscript{417}

Basing on the facts and circumstances prevailed in the Indian situation mentioned above the , the model of European called CCCTB (as detailed discussion was made in Chapter V of this thesis) wherein the application of both Formulary apportionment and experience of the nation in solving the problem like sharing of consolidated tax base only when it is positive. A negative consolidated tax base would be carried forward at group level and be set off against future consolidated profits. Subsequently the tax base so attributed will be taxed in the Member states where the relevant subsidiaries (or permanent establishments) are resident (or located) at the domestic corporation tax rate. Negative consolidated tax base would be carried forward at group level and be set off against future consolidated profits. Subsequently the tax base so attributed will be taxed in the Member states where the relevant subsidiaries (or permanent establishments) are resident (or located) at the domestic corporation tax rate. In view of the above facts the factors chosen in the apportionment formula clubbed with common consolidated tax base across jurisdiction, the phenomena of apportionment formula which are of high importance for distribution of the tax base of the country. Based upon these circumstances the more labour intensive country like India it will receive a larger share of profits from the labor factor. By this the apportionment mechanism may be regarded as key factor highly influential to both states and multinationals.