An introduction to transfer pricing economics essay

Economics

ASSIGN BUSTER

1. 1 OverviewWith the rise in intra-group cross-border transaction in the present globalisation era, transfer pricing has emerged as one of the most considerable tax issues facing multinational enterprises (MNE's). The ability of MNEs to manipulating prices in related party transaction, thereby, allocating profits from jurisdiction with high tax to those with favourable jurisdictions or low tax jurisdiction[1], is a matter of serious consideration of tax authorities' worldwide. As the MNE tax department attempt to keep up to speed with rapid change in the companies they serve, it seems that the tax authorities in a number of countries around the world are deploying increasing resources and energies to resisting that change for investigating the tax implications of transfer prices in related party transaction. The environment in which MNEs find themselves is one of increased suspicion and scrutiny of the tax implications of business change. In some cases, governments have proposed draconian rules to charge MNEs tax when they relocate, close or change operations in their countries. The increased attention by tax authorities has resulted in MNEs being required to comply with stringent transfer pricing legislation in various counties to prevent possible double taxation and penalties. This chapter provides a general introduction to the current transfer pricing environment. 1. 2 Transfer Pricing and the Growth of World TradeThe world has experienced two globalization booms over the past two centuries, and one bust[2]. Global trade increased at a remarkable pace in the decades prior to World War I as well as in decades following World War II, while the years in between were ones of anti-global backlash. Economic globalisation has been one of the most dominant forces to have shaped the post-war world. In particular,

international trade in goods and services has become increasingly important over the last 50 years and international financial flows over the last 30 years. The fifteenth and sixteenth centuries are often cited by economic historians as the period of origin of MNEs. Colonisation facilitated the emergence of large companies undertaking trade of commodities in colonies of their home countries. Yet, it was only in the early twentieth century that companies began to engage in significant manufacturing activities outside their home territories. This increase in production activities accelerated significantly in the aftermath of the Second World War, as developed countries began to invest heavily in rebuilding their economies. In fact, many historians attributed the foundation of global economy to the period immediately following the Second World War. This era saw the MNE establish itself as a driver of global production and trade, with the most significant growth taking place over the last three decades. Over the last three decades, the volume of cross border economic transactions has grown rapidly, motivated in particular by developments in technology and communication, free trade agreements and liberalisation of national markets that have removed significant constraints on the operation of foreign companies and the ease of cross-border trade[3]. Also, the increasing growth in world trade is attributed to the desire of companies to expand global operations by taking advantage of cheaper labour and growing demand in developing countries. This has been one of the most significant global economic phenomenon of recent decades. As a consequence, the number of MNEs has also risen significantly. The enhancement of the scope of trade all around the world has resulted into increase in transfer of goods throughout the world. The economies tend to

integrate their operations globally, rather than restricting themselves to their own region. 1. 3 Transfer Pricing- Defining the issuePrice is the quantity of payment or compensation given by one party to another in return for goods or services[4]. When two unrelated companies trade with each other, the price at which they undertake their transactions is simple known as the ‘ price’. However, when supply of goods, sevices or finance is made to another related company, the negotiated price is called ‘ Transfer Pricing’. Transfer pricing is the internationally accepted term for determining and adjusting the price for a transaction that has taken place between two related parties, i. e. affiliated companies, situated in different countries. It generally refers to intercompany pricing arrangements for the transfer of goods, services and intangibles between associated persons. Black’s Law Dictionary defines the term ‘ Transfer price’ as‘ The price charged by one segment of an organization for a product or service supplied to another segment of the same organization; esp., the charge assigned to an exchange of goods or services between a corporation’s organizational units.’[5]Transfer pricing, the term generally used in income tax parlance, is one of the key factors of a management control system, which helps a company to achieve its goals, including profit maximization and tax minimization. By manipulating transfer prices, MNEs can reduce the global incidence of tax by transferring higher income to low tax jurisdictions or greater expenditure to those jurisdictions where the tax rate is very high. Royalties and service charges can also be arranged to ensure the best global tax advantages to MNEs. From the view of tax authorities, there is only a limited amount of global tax to be shared between all potential taxing states.

Hence, it would be rational behaviour for each taxing state to try to augment the size of its share. The logical outcome of this is the attempt by every tax authority to compel the MNE to recognise more profit, and thereby pay more tax in its jurisdiction. This dichotomy between companies and tax authorities is the cause of much of the conflict surrounding transfer pricing resulting to which many major industrial nations have introduced legislation to prevent the perceived erosion of their tax base. Transfer pricing was till recent years a subject of interest only for tax administrators and subject specialists. But recent economic developments in the world have ensured that a large spectrum of society " businessmen, multinational employees, banks and so on" have realised the importance of this subject in the era of globalisation and with it, the proliferation of multinational corporations over the globe. OECD Transfer Pricing Guidelines state, " Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions.[6]" Today, almost 70% of the cross-border trade is taking place within MNE’s[7], the importance of transfer pricing increases with tax authorities warming up to the phenomenon and rapidly taking steps to place their national revenue interests on the table. It can be said that the term " transfer pricing" refers to the valuation of sales and other transactions, loans, investments etc. which occur between different arms of the same corporation or business group. A transfer price is the price charged for intercompany transactions within the group. The concept relates not only to trade operations proper, but also to other intra-firm transactions, such as those relating to transfer of technology, dividend

remittances, royalties and technical fees payments. This has been understood rightly as a technique for optimal allocation of costs and revenue among divisions, subsidiaries and joint venture within a group of related entities. Transfer pricing is about shifting profits from one business to a related business by charging transfer prices, such as prices which do not conform to an arm's length standard. It operates by substituting arm's length terms in place of actual terms of transactions between connected parties. Normally, arm's length price is the price that would be charged in an uncontrollable transaction, for instance, when parties are unrelated. 1. 4 The Need for Transfer Pricing RegulationsTransfer pricing is a neutral concept which needs to be regulated to ensure that the parent country receives due revenue in the form of tax. To enable such a receipt, a country requires a flexible yet stringent transfer pricing regulation. The lack of such regulations leads to transfer pricing manipulation. On one hand, MNEs and their affiliated companies may bring economic benefits for both host and home countries. Benefits for the host country include the availability of scare factors of production, an increase in the government budget, and the building of economic infrastructure. The Home country may benefits through the availability of raw materials and employment generation. On the other hand, the MNE's also create cost for both host and home countries. For the home country, conflicts of interest could arise with the host country's government. The host country may experience unhealthy competition from foreign investors and competition from expatriate employment[8]. One of the most important benefits for the host country is growing government budget through income tax collection. In many developing countries, such as India,

tax revenue is a major contributor to the total national revenue. According to the World Bank Report published in 2012, the tax revenue of India is 9. 48 % of the total GDP for the year 2010[9]. However, the evolution of international trade has resulted into complexity in taxation matters, both for the tax administration and the companies as well[10]. The tax rates and tax systems differ from country to country which may lead to the misrepresentations in the pattern of production and trade. It may influence the countries in which goods or products are manufactured, and the countries from which saving are derived and in which investment takes place. The existing differences between effective taxation burdens in various countries give rise to great difficulties for the assessment officers in each country who tax MNE's. Moreover, these corporations themselves put considerable efforts into reducing overall tax burden by transferring capital and profits around the world. This is because most countries do not tax company groups as a single entity. Therefore transfer pricing becomes a problem for tax purposes due to the need to establish the amount of taxable profit for each taxable entity to reduce the tax burden of company groups as a whole. Furthermore, it is important when computing how much profit belongs to a part of a company which is located in another tax jurisdiction such as a permanent establishment. For the above reasons, most jurisdictions have legislation that aim to protect their tax base from manipulative transfer pricing practices by deeming that intra-group transactions must calculate taxable profits, for tax purposes, at market value using the ' arm's-length principle(ALP)'. Though, establishing market value is not that simple because it is difficult to determine what arm's length prices between connected parties should be

since information on comparable transactions in the open market is unavailable. Besides, governments are concerned to ensure that the profits reported by related companies reflect a fair commercial level of profit. However, they do not want to be so harsh that they fail to attract investment from multinational groups. This is a particular problem for DCs. 1. 5 The Arm’s Length StandardThe failure of governments across the globe in ensuring that their fiscal policies are keeping pace with the growing cross-border trade by MNE’s is a very important factor which has contributed in increased significance of transfer pricing. Taxation of profits emanating from global trade by MNEs is still determined by legal structure within national boundaries. Traditionally, most countries have had some form of transfer pricing legislations; however, lately many nations have formulated comprehensive rules in this regards. United States (’US’) and the OECD are founders and played a phenomenal role in evolution of transfer pricing practices across the world The Organization for Economic Cooperation and Development (OECD), one of the most influential bodies in setting international tax standards, made efforts to bring legislation and enforcement procedure.[11]In 1979, the OECD’s Committee on Fiscal Affairs released a report titled " Transfer Pricing and Multinational Enterprises[12]" encouraging its members to adopt the arm’s length principle as the standard in pricing inter-company transaction. The arm’s length principle is the TP principle determined, by the OECD MS, as the international TP standard for tax purposes. This principle is to be used both by tax administrations and by taxpayers within MNE groups[13]. This principle is be used for associated enterprises that performs a business restructuring and it is therefore of value

to firstly examine the meaning of the principle according to the OECD. The arm’s length principle is regulated in Article 9 paragraph 1 of the OECD model and states the following:"[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enter-prises, then any profits which would, but for those conditions, have accured to one of the enterprises, but, by reason of those conditions, have not so accured, may be included in the profits of that enter-prise and taxed accordingly."[14]The main purpose with the arm’s length principle is to find transactions between independent enterprises so called " comparable uncontrolled transactions"[15]and determining if they differ from the controlled transactions found between associated enterprises.[16]The different entities of MNE’s should not be regarded as inseparable parts of one single unified business; the MNE should instead be regarded as separate entities. With this approach, the focus becomes the transaction in itself and the nature of that transaction. This approach will then make it easier to determine whether a transaction, and its conditions, within an MNE differ from that of a comparable uncontrolled transaction. This type of an analysis is the core of the arm’s length principle and the OECD refers to is as a " comparability analysis"[17]. Article 9 of the OECD model hold the basis for an arm’s length principle and the comparability analysis by showing a need for two different aspects. The first being a comparison between the conditions laid down for associated enterprises and for independent enterprises. This comparison is done to assess whether the accounts, for tax liability, are to be re-calculated or if they are not in accordance with Article 9

of the OECD model. The second aspect aims towards the determination of the accured profits that would have occurred if the transaction were at arm's length. This part is important as to the determination of the amount of any re-calculation and re-writing of the tax accounts[18]. There is always a risk of distortion of competition between associated enterprises and independent enterprises if they are treated differently for tax purposes. The arm's length principle has shown to be a great toll to create equality between associated enterprises and independent enterprises when it comes to tax treatment. The principle creates a more equal playing field for tax purposes and therefore helps avoid emerging tax advantages or disadvantages that can hinder competition between different types of enterprises. This has be-come one of the main reasons for OECD MS to implement the arm's length principle[19]. When looking at business restructuring, the commercial and financial relation of that business transactions are normally determined by other similar transactions between independent enterprises. This is not the case between associated enterprises since the transactions that occur within associated enterprises may not have any external market force influencing them. The taxpayers within an associated enterprise may therefore have difficulties finding an independent transaction for comparison.[20]When this difficulty occurs and the price is no longer guaranteed to follow the arm's length principle, there is a risk of both tax liabilities and tax revenues being misrepresented[21]. This difficulty does not however by itself exclude a transaction from being at arm's length.[22]Even if there is a comparable transaction between associated enterprises and independent enterprises, the comparison can still create an unjustifiable burden for taxpayers and tax

administrations. It can become difficult to find the information needed for a comparison of uncontrolled transactions and the task of finding the information needed can in itself be regarded as a burden for both the taxpayers and the tax administrations. Reasons why the information may be hard to find are for an example, geographical reasons, lack of existing information or even confidentiality issues preventing an independent enterprise from sharing the information needed to find a comparable independent uncontrolled transaction. The OECD has made it clear that " TP is not an exact science" but is instead something that demands a great deal of knowledge, judgment and time from both the taxpayers and the tax authorities[23]. Even though taxpayers and tax authorities are faced with a heavy burden by using the arm’s length principle; it provides income levels that are adequate enough to satisfy tax administrations. The principle is also the closest to estimate a fair value of transactions that are transferred between associated enterprises as to uphold the open market. By not using the arm’s length principle, the risk of double taxations would increase and the OECD MS have therefore shown a continuing support of the principle. [24]1. 6 The Evolution of Global Transfer Pricing LegislationOne of the pioneers in application of the principles of transfer pricing is the Unites States of America. Transfer pricing transactions in the US are currently governed by section 482 of the Internal Revenue Code. This section authorizes the Internal Revenue Service to reallocate income and deductions among parties owned or controlled, either directly or indirectly, by the same interests, " in order to prevent evasion of taxes or clearly reflect the income of any organizations, trade, or businesses[25]. Thus, section 482 is generally

applied by the IRS in case of a transaction between a controlling and a controlled party to ensure that the dealings are done at an arm's length standard. However, it is noteworthy that it was not the provisions of section 482 which brought into existence the provisions on transfer pricing. The earliest statutory predecessor of section 482 can be found in section 262 of the 1921 Revenue Act, which permitted the Commissioner to prepare consolidated returns on behalf of controlled entities so as to enable them to reflect their true tax liability[26]. Further, under section 45 in the 1928 Revenue Act, the scope of the section 262 of the earlier act, was widened. This code is the direct predecessor of the current section 482. It gave the Commissioner the powers to see that there would be no evasion of tax by the related parties in transactions between themselves and that their tax returns reflected their actual incomes and deductions. Section 45 of the 1928 Act became section 482 in the IRC of 1954, which has since then continued as the relevant section for transfer pricing regulations. However, towards the turn of the second half of the 21st century companies started doing business globally. The revenue authorities decided that instead of introducing new regulations it would be easier to expand the scope of the sections on transfer pricing to provide more definitive guidance with respect to allocation of income and deductions. As a result in 1968, the Treasury Department issued the regulations as they stand (mostly) today under section 482. Following the Tax Reforms Act, 1986, a study of different issues of transfer pricing was undertaken and in January 1992, the proposed regulations were issued which brought forth two important features, earlier not touched upon. One, the parties to conduct business as uncontrolled

parties in establishing transfer pricing policies. Next, the regulations brought about three new methods for establishing the arms length price, for transactions of intangibles, namely the matching transaction method, the comparable adjustable transaction method and the comparable profit interval. In January 1993, the Treasury Department released the Temporary and Proposed Regulations with certain changes. Finally on July 1, 1994 the Temporary and Proposed Regulations were adopted and are effective from since then. Following the US, the Organisation for Economic Co-operation and Development, also initiated the formulation of the transfer pricing guidelines. The first guidelines were issued in 1979, which were substantially revised in 1995 to include more clearly the concept of comparability and also introduced the profit method for calculation of transfer pricing. Subsequently, in 1996 it added another chapter on intangibles and services, in 1997 on cost contribution arrangements, in 1998 on it published annexes containing the procedures on monitoring the implementation of guidelines and in 1998 OECD issued its guidelines on advance pricing arrangements under the mutual agreement procedures. In the United Kingdom, the earlier transfer pricing regulations were covered under sections 770 to 773 of the Income and Corporation Taxes Act, 1988. New transfer pricing regulations were introduced through the Finance Act, 1998 and can be found in sections 770A and Schedule 28AA of the ITCA, 1988. These new legislations are effective on and from July 1, 1999. These new regulations do not define the arms length standard, but clearly requires that the company make adjustments in the income, profits and losses in case there are any adjustments made in the transaction which would otherwise not have been

made in case of transactions at arm's length. These legislations very clearly exclude all transactions between associated enterprises within UK, except where one of the associated UK taxpayers carries on business abroad and claims double taxation relief. Following the global movement in transfer pricing, the Government of India, introduced through the Finance Act, 2001 the transfer pricing regulations replacing the existing section 92 of the Indian Income-tax Act, 1961. Transfer pricing regulations find forbearance in the earlier Income Tax Act of 1922, under section 42 of the said act. The earlier regulations were enforced when there were business transactions between Indian residents and a person not resident or not ordinarily resident and there existed a close relation between them. These regulations concentrated more on the profits that would have been made had the resident done business on ordinary commercial terms[27]. Thus, it can be seen that transfer pricing has far and wide reaching impact in the business world. 1. 7 Transfer Pricing Regime in IndiaIndia, with a nominal gross domestic product of 4. 06 trillion U. S. Dollars is the fourth largest economy in the world[28]. The number of foreign companies in India has shot up from 489 in 1991[29]to 3, 178 in 2011[30]. This has led to an increase in the economic activity with respect to India and the international markets. As the Indian economy has become more and more incorporated with the world's, the valuation of buying and selling prices vis-a-vis taxation of returns assumes larger significance and governments across the globe have become alert to the so-called " loss of revenues" due to the effect of pricing methodologies adopted by corporations in their dealings with related entities. Transfer pricing as a concept in direct taxation did not receive much attention until

the mid-1990s when following the liberalization of the Indian economy, cross-border flows of capital and investments and increasing setting up of subsidiaries of multinational companies in India made it necessary to examine the tax implications of related-party transactions. The new Indian economy has seen the purchasing power of its population go up substantially, and this has manifested itself in increasing demands for FMCGs, vehicles, and electronics. This has encouraged multinationals to set up units in Indian to supply these items and there are transactions between themselves which affect the incomes of the respective bodies. This market is variously described to hold a potential of over 400 million customers. Prior to introduction of detailed transfer pricing regulations, the Income Tax Act 1961 contained key provisions to deal with transfer pricing and tax avoidance in relation thereto. Though there were no detailed transfer pricing law until the Finance Act 2001 was introduced; basic principles and provisions did exist in the income tax legislations, the customs legislations and the excise legislation. The current transfer pricing regulations were introduced in the year 2001. Since then the Income Tax Department has generated revenue worth thousands of crores in transfer pricing adjustment, which would have otherwise escaped from purview. As per a recent report, in the guise of transfer pricing, MNCs in India have under-reported revenues by 22, 800 crore rupees in 2010-11[31]. Such additional revenue trapped by the provisions of the regulation could enable the Government to spend more in public welfare and lighten the tax liability on the common man. Another adverse effect of transfer pricing manipulation is the loss of precious foreign exchange leading to a negative result in the Balance of Payments[32]. An

effective transfer pricing regulation will curb all these ill-effects. The former section 92 provided that if tax authorities believed that a transaction between a resident and a non resident[33]resulted in less than ‘ ordinary profits’ for the resident owing to a ‘ close connection’ between the two, they could re-compute the income of the resident. Section 9(1)(i) of the Act, provides that where a business connection exists in India, the income that is reasonably attributed to the business operation carried out in India shall be taxed in India. Further rule 10 of the Income tax Rules 1962 (Rules) [34]provides guidance upon how income of a non-resident tax payer may be apportioned to the business operations carried out in India, in the event it cannot be definitely ascertained. Section 40A(2) of the Act empowers the Revenue to disallow a taxpayer’s claim for deduction of a sum paid to a related party, to the extend such sum is consideration excessive or unreasonable. Section 93 addressed the practice of avoiding tax liability by transferring assets to non-residents while still enjoying the income from such assets. Certain provisions exist in the act (such as section 10A, 80IA etc) whereby the Revenue authorities are given powers to adjust profits arising to a unit eligible for a tax holiday, where they believe profits have been shifted to such eligible units due to a ‘ close connection’ between tax payers. Article 9 of the tax treaties entered into by India enables re-computation of the profits of an associated enterprise in accordance with the arm’s length principle. Besides specific statutory provisions there are general tax principles, laid down by courts, such as principle apportionment, reliance on comparables for determining the rate return and the doctrine of substance over form that can be invoked by the Revenue authority to prevent shifting

income from India. The concept of transfer pricing is also very much in vogue in indirect taxes in India. The provisions in the customs, excise law and service tax in respect of transactions with related parties (associated enterprise). Under Central Excise Act 1944, the transaction is between ‘ related persons’, the excise duty levied is the amount payable on the transaction value at which a related person sells good to an unrelated party. The rates are to be stipulated in the Central Excise Tariff Act, 1985. Excise duty is payable in the assessable value for which detailed valuation rules are provided If goods are sold to related party , the invoice price would be the price at which the goods are subsequently sold to unrelated party. Under Customs Act, the transfer pricing are dealt within valuation rules. General Agreement on Tariff and Trade (GATT) valuation principle are followed for determining the assessable value, the price at which the goods are ordinarily sold between unrelated parties is accepted. The Special Value Branch of the Customs Department determines the assessable values of the imported goods in respect of transaction between related parties. The Finance Act 1994 (Service Tax Act) does not contain any specific provisions relating to valuation of taxable services in case of transaction between related parties entities. The term ‘ associated enterprise’ has been defined as explained under Transfer Pricing Regulation under the Act; the service tax is to be deposited only upon the receipt of payment. But in case of transactions between associated enterprises, service tax is required to be paid immediately on accounting the transaction except in case of advance wherein the payment would to be made. Corporate and other laws: Under the Companies Act 1956, the effect of transfer pricing on the profitability of

the company is dealt in Section 211 wherein financial statements of the concerned financial year should give a true and fair view of the state affairs. The law puts an obligation on companies to make certain disclosure of transactions in which directors or persons having substantial interest. A detailed definition of associated persons, related party and related person is also provided. Mandatory disclosure of related party transactions is also provided in accounting standard 18 issued by Institute of Chartered Accountants of India (ICAI). Monopolies and Restrictive Trade Practices Act, 1969(MRTP): The MRTP Act provides the method to determine the price as well as detailed definition of a related person. The comparative definitions of associated enterprises, associated persons, related parties under the Companies Act 1956 and the MRTP Act 1969 are given.

CHAPTER 2: TRANSFER PRICING METHODS

2. 1 IntroductionThis Chapter discusses about the various transfer pricing methodologies that can be used for determining the arm’s length price and also explains how these methods can be applied in practice. For determining the arm’s length price there are majorly five methods that broadly falls into two categories namely the traditional transaction methods and transactional profit methods, which both are approved and recommended by the OECD. The OECD Guidelines however establish a hierarchy of methods which can be used in the examination of transfer prices. The OECD advocates the use of traditional transaction methods before using profit methods. In the hierarchy of the methods, the traditional transaction methods are at the top of this hierarchy. They include the comparable uncontrolled price method, which is preferred over the cost plus and resale price methods. " The most direct way

to establish whether the conditions made or imposed between associated enterprises are arm's length is to compare the prices charged in controlled transactions undertaken between those enterprises with prices charged in comparable transactions undertaken between independent enterprises. […] However, there will not always be comparable transactions available to allow reliance on this direct approach alone, and so it may be necessary to compare other less direct indicia, such as gross margins, from controlled and controlled transactions.[35]" The transaction profit methods follow in the hierarchy. Transaction profit methods are " other approaches that might be used to approximate arm's length conditions when traditional methods cannot be reliably applied alone or exceptionally cannot be applied at all[36]". Transactional profit methods shall only be used when the traditional transaction methods are found to be inappropriate, not sufficiently reliable or cannot be used due to the lack of comparable transactions[37]. The transactional profit methods are regarded as " last resort" method the application of which should be limited to those exceptional circumstances where there is no information available or where the available information is not of a sufficient quality to rely completely or even partially on the traditional transaction methods. The setting of prices and the strategies for setting of prices varies with different corporations and also largely depend on the type of business which is why there is no universal transfer pricing method that can be incorporated by all the corporations. The non-arm's-length based approach, known as a global formulary apportionment, is rejected by the OECD member states because they support the arm's length principle. This method has sometimes been suggested as an alternative to

the arm’s length principle, however, it has only been an attempted by some local taxing jurisdictions, but not applied between the countries[38]. The OECD Guidelines express a clear preference for the traditional transactional methods over the traditional profit methods. However, there is no such preference under the Indian Transfer Pricing regulations which mandates the use of the " most appropriate method (MAM)". The appropriate application of arm’s length principle and determination of the transfer price hinges on the choice of transfer pricing methods. The nature or class of transactions, class of associated persons, functions performed by such persons, and other such relevant factors are to be kept for consideration while determining the most appropriate method of pricing. 2. 2 Traditional transaction methods2. 2. 1 IntroductionThe traditional transaction method of transfer pricing is the most direct means of establishing whether the conditions of transactions between associated corporations are set according to the arm’s length principle. This is also the reason why these methods are the preferable ones. The drawback to these methods is that in cases where there no information is available or the available information is insufficient then this method is difficult to apply. Under the Traditional transaction method the following methods are prescribed for the computation of the arm’s length price: Comparable Uncontrolled Price (CUP) Method; Resale Price Method (RPM); andCost Plus Method (CPM)2. 2. 2 Comparable Uncontrolled Price MethodComparable Uncontrolled Price method is the first traditional transaction method which is based on the market price on comparable goods. Market based prices can include both internal and external comparison transactions to ensure that the arm’s length principle is set according to the CUP. A comparison can be

done either with the price used for a similar or the same product that is transferred between two completely independent corporations, an external comparison. Or the price for the same or similar product that is transferred between one of the dependent corporations and one independent corporation can be used, an internal comparison. To get a meaningful comparison the economically significant features has to be sufficiently comparable to one another. Some examples of these features are terms of the contract, differences in quality and quantity and terms of payment. However, the differences in price can be a symptom of the market situation that prevailed when the agreements were entered into. The Income Tax Rules 1962 (Rules) describes CUP under r 10B(1)(a) as: the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified; such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market; the adjusted price arrived at is taken to be an arm’s length price in respect of the property transferred or services provided in the international transaction. The Advantages and Disadvantages of the CUP MethodA CUP is one of the most direct ways of ascertaining an arm’s-length price of a controlled transaction because it is the 'open market' price of the tested transaction between related parties. Consequently, where a CUP meets the stringent comparability criteria then it should used. The Guidelines state: ‘ Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply

the arm's-length principle. Consequently, in such cases the CUP method is preferable over all other methods'.[39]When reliable comparables are available, the results derived by use of CUP method would be most accurate. However, in practice, many potential CUPs are rejected because they cannot match one or more of the comparability criteria, such as similar markets, volumes and position in the supply chain. In many industries, even a small difference between the circumstances of two transactions could impact the price. For example, two transactions in Product A, being exactly the same in all regards with the exception that in one transaction the vendor has monopoly power in the market and in the other the purchaser has monopoly power is likely to result in two very different prices for what at first blush is the same transaction. The importance of relative bargaining power in transfer pricing is addressed, for example in DSG Retail Ltd and others v HMRC[40]. As a consequence, true CUPs are most commonly available for transactions in products that are traded on commodity-type markets. The homogenous nature of the product and the availability of pricing information to both buyers and sellers means that prices are driven by equilibrium between supply and demand and it is possible to be sure that the tested transaction and the uncontrolled transaction occur in comparable circumstances. Furthermore, whilst adjustments to CUPs are permitted, many practitioners prefer to use an alternative method rather than apply somewhat arbitrary adjustments to a CUP, arguing that every ' adjustment' distances the CUP from what was actually agreed in the open market. Common errors are for taxpayers to seek to apply a ' CUP' that is derived from one or two ' distress purchases' or transactions outside their normal

markets, or conversely to ignore apparent CUPs without explaining why they should be distinguished. 2. 2. 3 Resale Price MethodDetermining a market based price accordingly to the RPM is an indirect way of determining a TP. This method evaluates the transfer price by comparing gross profit margin in a controlled transaction with the gross profit margin in one or more independent transactions. It is then probable to see if the set transfer price is in conflict with the arm`s length principle. When a product that is acquired from an associated corporation is sold on to an independent buyer, the resale price used to sell the product to that independent buyer is the base for this method. To get a TP by using this method that can be considered to be a price set accordingly to the arm’s length principle; the resale price given to the independent buyer has to be reduced with a suitable before-tax profit. This suitable before-tax profit is equal to the amount of which the corporation needs to cover their costs, including a profit markup. In other words, taking the resale price and decrease this with the before-tax profit is considered to be an appropriate price for the original transaction performed within the corporate group. Rule 10B(1)(b) of the Rules describes RPM as: the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified; such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions; the price so arrived at is further reduced by the expenses incurred by the enterprise in

connection with the purchase of property or obtaining of services; the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market; the adjusted price arrived at is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise; Like CUP method, RPM may also be applied by way of an internal RPM or an external RPM. An internal RPM can be used by benchmarking the resale price margin that the same reseller earns on items purchased and sold in uncontrolled transactions, as against margin earned in a controlled transaction. An external RPM can be used by benchmarking resale price margins earned by an independent enterprise in comparable uncontrolled transactions against margins earned by the tested party from a controlled transaction. RPM is most useful where applied to marketing operations. It is generally used to test transaction involving distribution function, i. e., when the tested party purchases products/acquires services from a related part, and resells the same to independent parties. The use of RPM is appropriate where the reseller does not add substantially to the value of the product/service. In contrary, it is more difficult to use RPM to arrive at an arm's length price where before resale, the goods are further processed or incorporated into a complex product such that their identity is lost or transformed, e. g. where components are joined together in finished or semi finished goods[41]. The

Advantages and disadvantages of the RPMOne of the disadvantages of the RPM is that it is very difficult to identify whether the comparable businesses do or do not employ valuable marketing intangibles in their business. Arguably the presence of such intangibles may allow the comparable entity to enjoy a higher level of profitability compared with those marketing/selling companies without such an intangible. Without the ability to undertake a functional analysis of the comparables the practitioner is always uncertain on this point. Furthermore, small product differences can make a large difference to the gross margin that a company earns. For example, some products ‘ sell themselves’, whilst for others the marketing company has to make significant efforts to make even a low level of sales. In the latter case one might expect that the distributor should receive a higher gross margin to cover its additional selling costs. To calculate or estimate a correct gross profit margin (before-tax profit) is the difficult part with this type of method. The longer the time goes between the two involved transactions, the less useful this method becomes. This is so since then the corporations need to consider other factors when making the comparison, such as exchange rates, costs etc. Another downside to the method is that if the resale price margin of an independent corporation is used, it can be affected if there are material differences in the way in which the dependent and independent corporations carry out their businesses (OECD TP guidelines, 1995). 2. 2. 4 Cost plus methodThe cost plus method is the method that builds on the cost of the product or service. On top of that cost of manufacturing or acquiring, a market based cost plus mark-up is added. Like the RPM the cost plus method is also an indirect method for setting a TP accordingly to the arm’s length

principle. As mentioned, when using this method to set an arm’s length price between a seller and an associated buyer, the price is based on the seller’s cost of producing or acquiring a product or service with addition of the costs for every link in the MNE, plus a cost plus mark-up that is market based. The seller’s original cost for the product or service include both the costs for acquiring the semi-finished products or the raw material, and also the production costs for completion of the finished product or service, plus a mark-up for a reasonable profit. To the added cost for every party in the line of production a market based profit margin is added, which is calculated by comparisons from independent corporations. Rule 10B (1)(c) of the Rules describes CPM as: the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined; the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined; the normal gross profit mark-up is to be adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market; the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii); the sum so arrived at is taken to be an arm’s length price in relation to the supply of the property or provision of services by the enterprise; CPM can be

applied by way of an internal CPM and an external CPM. An internal CPM would be available where the tested party, has entered into a similar transaction with an uncontrolled party. For example, the cost plus mark-up earned by an Indian company from rendering software development services to independent parties could serve as a benchmark to determine the arm's length price in respect of similar services rendered by the Indian company to its foreign parent. An external CPM could be available in the form of margins earned by external companies from uncontrolled transaction For example, the cost plus mark-up earned by an independent Indian company from rendering software development services to independent parties could serve as a benchmark to determine the arm's length price in respect of similar services rendered by an Indian subsidiary to its foreign parent. The Advantages and Disadvantages of the RPMTwo situations where the cost plus method is most useful are when semi-finished goods are sold between associated corporations and when the controlled transaction is concerning the provision of services[42]. One downside to the method is that regulations and ways of account for costs vary between countries, which can cause severity on determining a relevant data of costs[43]. One important thing to keep in mind when determining this data is to also include indirect costs and not only the direct costs. However, when using the cost plus method it can be necessary to use cost calculations based on averages. A limitation to the method is that it is only the costs of the supplier of the goods that are being considered, and this can raise allocation problems of some of the costs between suppliers and purchasers. Since there are no single solution to deal with all these minor issues, the associated corporations can, in advance,

agree on what costs that will be an acceptable basis for the cost plus method[44]. 2. 3 Transactional profit methods2. 3. 1 IntroductionBesides the traditional transaction methods, OECD has also elaborated a set of transactional profit methods, the PSM and the TNMM. PSM means, in short, that each separate businesses in a corporate group gets their share of that corporate group's profit that is derived from a inter-group transaction. TNMM on the other hand is based on the net profit margin that a corporation, which is a part of a MNE, gets in an inter-group transaction. These transactional profit methods are the methods used when the traditional transaction methods either cannot be applied at all or cannot be applied on their own. These are methods that examine the profits that arise from particular transactions that are performed between associated corporations. There are some concerns from many countries regarding the use of this type of methods; one is that it might be applied without adequately taking relevant differences between the corporations, both dependent and independent, that are being compared. Another concern is that such safeguards that have been established for the traditional transaction methods might be overlooked. These methods are however not recognized to use when setting TP, instead it is most often used when considering if the price is set on an arm's length distance. Just as with the traditional profit methods, it is also here important to bear in mind that it is important that it is possible to calculate for appropriate adjustments.[45]2. 3. 2 Profit split methodSince very few countries have much experience when it comes to apply the TNMM, and since it is therefore considered to be experimental, most countries prefer to use the PSM as a last resort method. However, the PSM has not

either been frequently used, and when used it has mostly been in situations where the risk of unrelieved double taxation is minimal[46]. The allocation of internal profit, within a corporate group, when using the PSM needs to be performed in an economically well-grounded way[47]. There are though two conditions that needs to be fulfilled in order to be able to use the PSM, the first one is that a proper analysis of functions has to be done, and the second one is that it requires information from the involved foreign corporations within the corporate group[48]. When applying this method, the first thing that must be done is to determine a profit which will be generated by a transaction where two or more associated corporations co-operate. Examples of such transactions can be manufacturing or selling of products. Each MNEs contribution is evaluated on the basis of the function analysis, which is an analysis of the functions performed by each corporation. The second step in setting a TP accordingly to the PSM is to divide the aggregated transaction profits, in a way similar to that if the situation is such that the corporations were not associated to each other[49]. To divide the profit there are two different ways to go about, one is the contribution analysis and one is the residual analysis[50]. However, these two ways are not the only way to apply the PSM, as long as the arm's length principle is considered, nor are they mutually exclusive. When using the contribution analysis each corporation that is part of the transaction gets their share, which is equal to the comparative value of their function in the line of the transaction, of the total transactions profit. If the residual analysis is used for a specific transaction, then each corporation, which is a part of that specific transaction, gets a part of that transaction's total profit which is equal to a normal rate of return.

Whatever is left after this is divided amongst the concerned corporations in an equal matter as if they would have been independent corporations. One caution that is brought up in the OECD TP guidelines is that the normal rate of return is calculated based on budgeted numbers and values, and is not based on numbers available after the transaction is performed[51]. As per the Rule 10B(1)(d) of the Rules PMS is applicable primarily for international transactions involving a transfer of unique intangibles, or in multiple international transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arms length price of anyone transaction. the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined; the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances; the combined net profit is then split amongst the enterprises in proportion to their relative contributions; the profit thus apportioned to the assessee is taken into account to arrive at an arm’s length price in relation to the international transaction. The proviso to r 10B(1)(d) provides that the combined net profit may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent

enterprises. Thereafter, the residual net profit remaining after such allocation may be split amongst the enterprises in proportion to their relative contribution. Thus, the profit split method may be applied in two ways. Traditional Profit Split MethodThe total integrated profit earned in a controlled transaction is split between the associated enterprises based on the relative value of their contribution to the transaction with respect to functions performed, assets utilised and risk assumed. Residual Profit Split Method[52]According to this method, the return allocable to each enterprise for the easily identifiable functions are determined based on an arm's length analysis established from data using one of the other methods. The profit is so determined will normally exclude any return attributable to valuable or unique intangible property. The residual profit (or loss) is then allocated to the related parties based on the relative contribution of the parties to the development and use of the intangible property. The Advantages and Disadvantages of PSMAs with the traditional transaction based methods, there are also downsides and advantages with this method. The downside with the PSM is that the method is based on some external market data which might have less connection to the joint transactions than other methods does. The external market data is used to estimate the contributions that each respective corporation within the MNE have done to the total transaction profit. However, an advantage is that since both parties which are involved in the transaction are being evaluated, there is a lesser risk that either of them will be left with and extreme and improbable profit result. Another advantage with this method is that it does not really require any comparable transactions. This is so since the dividing of the profit, to a

high degree, is based on the assets and functions that each respective corporation contributes with[53]. 5. 3. 3 Transactional net margin methodThe final of the five OECD methods of setting a TP accordingly to the arm's length principle is the TNMM. When using this method, a corporations operating profit is related to a suitable base consisting of, for example assets, costs or turnover. The operating profit used is the one arising from a transaction made with an associated corporation. TNMM consists of comparing an operating margin, or another suitable profit level indicator, with an equivalent margin. What margin that is used for comparison is influenced by how well the value of the assets, employed in the calculations, are measured and the factors affecting if specific costs shall be marked up, passed through or entirely excluded from the calculation[54]. This last mentioned margin, shall be equal to one that the concerned corporation obtained with, for example an independent corporation. If this situation is not possible to obtain, then the operating margin can be collected from a comparable transaction performed by an independent and comparable corporation. Such an operating margin can however be in need of adjustments; the reason for this is that the margin needs to be adapted to the differences between the chosen comparable transaction and the transaction that is " under investigation"[55]. Rule 10B (1)(e) of the Rules describes TNMM as: the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base; the net profit margin realised by the enterprise or by an unrelated

enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base; the net profit margin arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market; the net profit margin realised by the enterprise thus established is then taken into account to arrive at an arm's length price in relation to the international transactions. TNMM can be applied by way of an internal TNMM or an external TNMM. An internal TNMM, in the case of tax payer would involve the determination of operating margins from an international transaction with reference to operating margins earned in comparable uncontrolled transactions. Where an internal TNMM cannot be applied, an external TNMM can be used for determination of operating margins earned by a tax payer from an international transaction by referring to operating margins earned from comparable transactions between independent entities. The Advantages and Disadvantages of TNMMIf there are differences in the features of the transactions that are being compared, then this method can still be used. This since the operating margin does not become affected to such differences in the same degree as the price does, and this is an advantage with the TNMM[56]. Another advantage with this method is that it is only necessary to analyze one party. This data might not be available at the time of the controlled transaction, which makes the method hard to apply at the time when the transaction is performed. 2. 4 The Most Appropriate MethodSection 92C of the Act states

that the arm’s length price in relation to an international transaction shall be determined by the ‘ most appropriate method’ having regards to various factors set out in r 10C(2)[57]. Rule 10C (1) of the Rules defines the most appropriate method as the method which is: best suited to the facts and circumstances of each particular international transaction; andwhich provided the most reliable measure of an arm’s length price in relation to the international transaction. Comparison with " Best Method Rule" The US transfer pricing regulations refer to the ‘ best method rule’ for computation of arm’s length price. The ‘ best method rule’ does not prescribe any particular method as the best method to be applied depends on a given facts and situation. The " best method rule" of transfer pricing requires that the methodology used to determine the transfer price be the one that offers the greatest précising in matching the price of an arm's-length transaction between unrelated parties. Some countries leave the decision as to which method is most appropriate for a given transaction up to the taxpayer, while others require that a particular methodology be employed. IRS regulations specify the best method for a given type of transaction. It can be said that other than the nomenclatural difference, there is no other material difference between the best method rule, and the requirement to use the most appropriate method under Indian transfer pricing regulations. Use of Multiple Methods for Computation of Arm’s Length PriceThe OECD specifically states that the use of more than one method for a given transaction is not ‘ required’ and is usually not necessary, recognising that this could create an additional burden on taxpayers[58]. However, in complex cases the use of

more than one method, or the use of a corroborative method, can be helpful[59].