

# Transfer Pricing

REPORT

Volume 14 Number 7  
Wednesday, August 3, 2005  
ISSN 1521-7760

Page 289

## Analysis

### INDIA

#### A Didactic Discourse on Transfer Pricing- Narratives in Law and Economics in India

By Aashish Kaul & Sanjiv Malhotra \*

*\* Aashish Kaul is an Advocate and Sanjiv Malhotra is a chartered accountant and a business economist in the New Delhi offices of BMR & Associates. The views expressed in this article are those of the authors and should not be attributed to BMR & Associates.*

Trade and finance is increasingly acquiring a global character. The integration of financial markets around the world and countries opening up their economies to allow free flow of goods and services are the two most convincing signals of this trend. The wave of liberalization-privatization-globalization is puncturing national boundaries and deeply impacting lives of millions around the world entrenching the belief that the 21st Century is the century of the internationalization of business.

This has led to a generous growth in the number of multinational enterprises (MNEs), having presence, through subsidiaries and group companies, in several jurisdictions around the world and involved in an intricate matrix of intra-group transactions. It is in this very milieu that transfer pricing finds its significant bearing in world commerce. Transfer pricing is being increasingly employed as an effective tool by MNEs to shift their income from a high tax country to a low tax country to accentuate the global tax savings of the group as a whole.

From the perspective of a taxing state, there is only a finite amount of global tax to be shared between all potential taxing states. Hence, it would be rational behavior for each taxing state to try to augment the size of its 'take.' The logical consequence of this is the attempt by every tax authority to force the MNE to recognize more profit and consequently pay more tax in its jurisdiction. This dichotomy between companies and tax authorities is the cause of much conflict and hence, many major industrial nations have introduced legislation to prevent the perceived erosion of their tax base.<sup>1</sup>

# Dialectics of Arm's-Length Principle

An arm's-length transaction is a straightforward transaction as if it were between independent and unrelated persons, involving no favoritism and without any consideration other than commercial.<sup>2</sup> The underlying economic concept behind the arm's-length theory is that transactions between related parties should be structured in the same manner as those taking place between two unrelated enterprises dealing in a free market whereby each party seeks to maximize its economic utility. In other words, the concept revolves around free pricing and profit maximization in an uncontrolled environment.

To determine the arm's-length price for any controlled transaction it is essential to dwell upon the functions of the activities performed, risks assumed, and the assets employed for rendering the services. Any price paid or received in course of a controlled-party transaction would be construed as the arm's-length price, if it can be justified on the basis of these three variables.

Further, the concept of comparability is central to the application of the arm's-length principle. Arm's-length methodologies are based on the concept of comparing the controlled-party transaction with that of the transactions between independent enterprises. This is done by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from the interaction of the forces of demand and supply in a comparable open market among comparable independent enterprises. This is achieved by using the data available in public domain of independent parties as a benchmark. This idea finds support in paragraph 1.7 of OECD guidelines which states:

There are several reasons why OECD Member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for MNEs and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.<sup>3</sup>

However, there are essentially two types of problems associated with the application of the arm's-length price, namely the conceptual and the process-related shortcomings. Conceptual shortcomings include the fact that segments of an MNE may behave differently from independent enterprises (e.g. different transactional structures, different products being exchanged, and different functions and risks being allocated) and that the arm's-length price is in many cases unable to account for integrated MNEs' network profit (i.e. the profit attributable to the existence of an MNE) usually represented by the economies of scale and other synergies realized.

Process-related shortcomings, on the other hand, refer to the fact that the effective application of the arm's-length price is often hampered by a number of factors that cumulatively amount to a significant trade barrier for MNEs. Among those factors are the diverging interpretation of the arm's-length price (possibly leading to economic double taxation), the yearly transactional analyses, the negotiations at the competent authority level, and the burdensome documentation requirements, all of which contribute to the development of a state of uncertainty for taxpayers engaged in controlled transactions.<sup>4</sup>

Another practical difficulty in applying the arm's-length principle is that associate enterprises may engage in transactions that independent enterprises would not undertake. Such transaction may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other members of an MNE group face different commercial circumstances than would independent enterprises.

# Indian Transfer Pricing Legislation

The Finance Act 2001 introduced the substantive provisions relating to transfer pricing in the Income Tax Act, 1961 (Act) viz. the new section 92 to 92F<sup>5</sup> incorporated under Chapter X of the Act. The legislature classified this body of law as special provisions to stop tax avoidance. These provisions are broadly based on the OECD guidelines and became operational for computing taxable income for assessment year 2002-03 onwards.

Circular No. 12 of 2001 issued by the Central Board of Direct Taxes (CBDT) elucidates the purpose behind their enactment:

The aforesaid provisions have been enacted with a view to provide a statutory framework which can lead to *computation of reasonable, fair and equitable profit and tax in India* so that the profits chargeable to tax in India *do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions* leading to erosion of our tax revenues.

(emphasis added)

The transfer pricing provisions under the Act entail that any international transaction with a related party should be computed having regard to the arm's-length price.<sup>6</sup> Arm's-length price is a price applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.<sup>7</sup> Two enterprises are considered associated enterprises for the purposes of these provisions if one enterprise participates, directly or indirectly, in the management or control or capital of the other enterprise; or where common persons participate, directly or indirectly, in the management, control, or capital of the two enterprises.<sup>8</sup> The definition in essence, therefore, is one that is based on the three concepts of *management, control, and capital*. It is noteworthy that this definition traces its origin to Article 9 of the OECD model convention.<sup>9</sup>

The definition of associated enterprise is further augmented by the deeming provisions of sub-section (2) of section 92A of the Act which provide a host of circumstances where two enterprises shall be construed to be associated enterprises. These include:

- holding of more than 26% equity;
- loans in excess of 51% of total assets;
- power to appoint executive directors;
- guarantees in excess of 10%;
- supply of raw materials (90% or more);
- complete dependence on IPRs; or
- relationship of mutual interest as may be prescribed by CBDT.

The intent of the legislature is to make the definition all encompassing, whereby any relationship which may have an influence on the arm's-length character of the transaction can be brought with the purview of the transfer pricing provisions.

An "international transaction" under these provisions is yet again liberally worded for it includes any transaction that two associated enterprises undertake between themselves, either or both of whom are non-residents, for:

- purchase, sale or lease of tangible or intangible property;
- provisions of services;
- lending or borrowing of money;
- cost sharing/allocation arrangement or agreement; or
- any other transaction having a bearing on the profits, income, losses or assets.

Further, any transaction entered into by an enterprise with a person other than an associated enterprise shall also be deemed to be an international transaction, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise; or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise.<sup>10</sup>

## Five Methods

Section 92(2) of the Act stipulates that the price charged/received in an international transaction between two associated enterprises should be at arm's-length prices. Section 92C prescribes five methods for the computation of the arm's-length price. The legislation warrants that the most appropriate method be selected having regard to the nature or class of transaction and the functions performed in course of such transaction in order to compute the arm's-length price. The following methods are prescribed under the provisions:

- a) Comparable Uncontrolled Price (CUP) Method;
- b) Resale Price Method (RPM);
- c) Cost Plus Method (CPM);
- d) Profit Split Method (PSM); and
- e) Transactional Net Margin Method (TNMM).

The CUP method seeks to determine the arm's-length price by comparing the *price* paid/received in a controlled transaction with the *price* paid/received in an uncontrolled transaction. This method can be used only when there is a *high degree of similarity of products or services*. It is a direct method and generally produces reliable results. However, this method is sparingly used due to unavailability of data. For instance, a manufacturer based in India engages in manufacturing ball bearings sold to both an associated enterprise and a third party in China. The price charged from the unrelated customer can be construed as the arm's-length price for benchmarking the controlled party transaction of sale to the associated enterprise in China.

RPM begins with the price at which a product that has been purchased from an associated enterprise is *resold* to an independent enterprise. This price (the resale price) is then reduced by an appropriate *gross margin* (the resale price margin) representing the amount the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded as an arm's-length price for the original transfer of property between the associated enterprises. This method is usually applied to distributor transactions.

CPM begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate *mark-up* is then added to this cost to earn an appropriate profit in light of the functions performed and risks assumed. The arm's-length price under this method is computed by adding this mark-up to the cost incurred by the supplier in the original controlled transaction. This method is usually employed where *semi-finished goods* are sold between related parties or when related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction relates to provision of services.

The profit split method is usually applied where an international transaction involves transfer of *unique intangibles* or when there are *multiple transactions* that are so interrelated that they cannot be evaluated individually for the purpose of computation of arm's-length price. This method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction(s) by determining the division of profits that independent enterprises would have expected to realize from engaging in such transactions. The profit split method first identifies the profit to be split among the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits these profits among associated enterprises on an economically valid basis that approximates the division of profit that would have been anticipated and reflected in an agreement made at arm's length. This method is sparingly used as it involves measurement of combined revenue and cost of the associated enterprises, stating the accounts and books on common basis and obtaining the relevant data from the foreign affiliates.

TNMM examines the *net profit margins* in relation to an appropriate base (for e.g., costs, sales, or assets) that an enterprise yields from a controlled transaction. This margin is compared with the margins earned by companies undertaking similar functions in an uncontrolled environment in order to determine the arm's-length nature of the controlled party transaction. This method is adopted most frequently as it compares the net margins which are *less affected by transactional differences*.

## Traditional vs. Non-Traditional Methods

It is noteworthy that CUP, RPM, and CPM are characterized as *traditional methods* whereas the profit split and TNMM are characterized as *transactional methods*. Indian legislation does not provide for any hierarchy in which the methods are to be applied as opposed to the OECD guidelines, which clearly favor the use of traditional methods over the transactional ones.<sup>11</sup> The manner in which these methods are to be applied are illustrated in the corresponding Income Tax Rules, 1962 (Rules).<sup>12</sup> CBDT, in Circular No. 14 dated Nov. 20, 2001, paragraph 55.11, suggested that the primary onus of selecting the most appropriate method should rest with the taxpayer.<sup>13</sup>

The process of selecting the most appropriate method and computing the arm's-length price based on such a method needs to be documented along with other statutory information as mandated by these provisions.<sup>14</sup>

The documentation must include:

- descriptions of functions performed, risks assumed, and assets utilized;
- record of transactions considered for determining price of international transactions;
- analysis performed to evaluate comparability;
- description of all methods considered and reasons for selection of the most appropriate method;
- record of actual working for determining arm's- length price; and
- details of comparable data used in applying most appropriate method.

Further, an accountant's certificate in the prescribed form 3CEB needs to be furnished along with the income tax return by any enterprise which has entered into an international transaction during the previous year.

## **Administrative Framework, Controversies**

The Act empowers the Assessing Officer to compute the arm's- length price for a given international transaction (by employing any one of the aforesaid five methods being the most appropriate method) only when of the opinion that:

- the price charged or paid in an international transaction has not been determined according to the most appropriate method;
- the information and documents on an international transaction have not been kept and maintained by the taxpayer in accordance with the relevant provisions of the Act and the corresponding rules;
- the information or data used in computation of the arm's-length price is not reliable or correct;  
or
- the taxpayer has failed to furnish the requisite information/documentation within the time specified.

[15](#)

Such a computation of the arm's-length price shall be based on the materials and documents placed on record and other information available to the Assessing Officer. The proviso to the sub-section mandates that the Assessing Officer serve a show cause notice upon the taxpayer before making a transfer pricing adjustment to the company's detriment.

Alternatively, the Act endows the Assessing Officer with the option of making a reference to the Transfer Pricing Officer<sup>16</sup> (with the prior approval of the Commissioner, Income tax) if, he considers it *necessary or expedient to do so*.<sup>17</sup> The words *necessary or expedient to do so* entail that the Assessing Officer applies his mind to clearly ascertain the need for such a reference to the Transfer Pricing Officer and should not make a reference in a routine and mechanical style. This is in keeping with the mandate of law, which provides that administrative authorities invested with quasi-judicial powers must reach a just and fair conclusion after due deliberation and consideration of all issues involved, and thereby fulfilling the requirements of equity and natural justice.

## **CBDT Instruction No. 3/2003 Mandate**

Although the provisions of the Act bestow the primary option of computing the arm's-length price for a given international transaction upon the Assessing Officer, CBDT Instruction no. 3/2003, dated Aug. 11, 2003, made it obligatory upon the Assessing Officer to make a reference to the Transfer Pricing Officer wherever the aggregate value of an international transaction exceeds rupees 5 crores (approximately US\$1 million). The relevant part of the circular states: In the initial years of implementation of these provisions and pending development of adequate data base, it would be appropriate if a small number of cases are selected for scrutiny of transfer price and these are dealt with effectively. The Central Board of Direct Taxes, therefore, have decided that *wherever the aggregate value of international transaction exceeds Rs. 5 crores, the case should be pricked up for scrutiny and reference under section 92CA be made to the TPO*. If there are more than one transaction with an associated enterprise or there are transactions with more than one associated enterprises the aggregate value of which exceeds Rs. 5 crores, the transactions should be referred to the TPO... The threshold limit of Rs. 5 crores will be reviewed depending upon the workload of the TPOs.

(emphasis added)

This instruction has introduced a fair amount of ambiguity both for the Revenue as well as the taxpayers inasmuch as it may be interpreted as depriving the Assessing Officer of the option to exercise his discretion for making a reference to the Transfer Pricing Officer as provided under the Act for international transactions that transcend the five crore threshold limit.

A writ petition to annul this instruction has been filed before the Hon'ble Delhi High Court and is pending. The next hearing for the writ is scheduled for Sept. 16 when the Revenue is expected to put forward its case. The first hearing took place May 27.

One part of the Act--section 119--provides for the proper administration of the Act, making it mandatory that India's tax authorities observe and follow the CBDT's orders, instructions, and directions. It is the author's view that although the instant instruction appears ostensibly to deviate from the Act's provisions, it has been issued to facilitate the assessment of transfer pricing transactions under the Act and buttresses the procedure of assessment inasmuch as the Transfer Pricing Officer is a specialized authority established to have the background to best compute the arm's-length price. This is in light of the fact that such computation necessarily involves an elaborate economic and functional analysis of comparable unrelated companies and, in the absence of comprehensive indigenous guidelines to this effect, it becomes vital, almost in all cases, to refer to several specialized databases, international commentaries, and sourcebooks to properly compute the price. The instant instruction is a delegated legislation and needs to be read harmoniously with the provisions of the Act to fulfill the true intent and spirit of the transfer pricing legislation. Therefore, although at a textual level the instruction may seem to conflict with the Act, the underlying purpose unmistakably irons out such ambiguity.

Assuming that the Court holds the instruction is in conformity with the Act's provisions, it will still need to be seen whether the Assessing Officer will be justified in computing the arm's-length price for an international transaction that exceeds the five crore threshold limit. By doing so he would plainly disregard the instruction issued under section 119 of the Act that makes it mandatory on him to observe and follow the instructions issued by CBDT.

It is the view of the authors that if a conflict would arise between sections 92CA(1) and 119 of the Act and that there would be a need to interpret the provisions of those sections in a manner that vests a certain degree of discretion with the Assessing Officer as stipulated under section 92CA(1) of the Act, and at the same time, places due regard upon the CBDT's instructions. This would be possible when the Assessing Officer would in the normal course refer all the international transactions aggregating to more than five crores to the Transfer Pricing Officer and when no referral is made, the Assessing Officer records adequate reasons to substantiate why he did not refer the case to the Transfer Pricing Officer.

Once a case is referred to the Transfer Pricing Officer by the Assessing Officer for the computation of the arm's-length price, the Transfer Pricing Officer shall issue a notice to the taxpayer calling forth the material on which the taxpayer may rely in support of its computation of the arm's-length price. Subsequent to hearing the taxpayer's submissions regarding such computation, the Transfer Pricing Officer, by an order in writing, will determine the arm's-length price for the taxpayer's international transaction according to the provisions of the Act. The Transfer Pricing Officer then will forward a copy of the order to the Assessing Officer and the taxpayer.

On receipt of the Transfer Pricing Officer's order, the Assessing Officer shall proceed to compute the total income of the taxpayer having regard to the arm's-length price determined by the Transfer Pricing Officer. However, the Act stipulates that the Assessing Officer provide the taxpayer with an opportunity of being heard before computing any adjustment to income.

This opportunity must necessarily fulfill the mandate of equity and natural justice, and a mere formality to show cause provided by the Assessing Officer would not meet the terms of natural justice. Denying this opportunity to a taxpayer would render the order bad in law and liable to be annulled for violation of the principles of natural justice. This would be a procedural infirmity that cannot be set right at a later date. The Apex Court in its landmark judgment in *BALCO Employees' Union v. Union of India* (2002), 2 SCC 333, held that *any wrong order may adversely affect a person and it is essentially for this reason that a reasonable opportunity may have to be granted before passing an administrative order*. In view of the authors, the Assessing Officer is not obliged to follow the arm's-length price computed by the Transfer Pricing Officer, for the Act only entails him to *have regard to*<sup>18</sup> such arm's-length price while computing the income of the taxpayer.

## Conclusion

India is fiercely competing with other developing economies to emerge as a favorable destination for foreign investment opportunities and, therefore, any law which may have a bearing on the activities of foreign investors needs to be very thoughtfully drafted.

In general, tax rules should distort business decisions as little as possible because rules that minimize such distortion will lead to the greatest possible production efficiency. Transfer pricing rules will allow the most efficient production technology to come to the fore if, holding the cost function constant, they result in the same tax burdens whether or not the parties are related. In other words, if unrelated parties somehow had access to the technology available to related parties, their operations should not result in more or less total taxes than would be paid by a multinational using this technology.<sup>19</sup>

Given the nascent stage of Indian transfer pricing legislation and the experience of the first year of transfer pricing assessments, an endeavor should be made by Revenue, industry, and practitioners alike to iron out the creases and to provide answers to the emanating controversies.

---

<sup>1</sup> Butani, Mukesh, *Transfer Pricing--An Indian Perspective*, p. 1, 1st Edition, Butterworths (2002).

<sup>2</sup> Mittal, D.P., *Indian Double Taxation Agreements and Tax Laws*, p. 1.352, Vol. 1, 4th ed., Taxmann (2004).

<sup>3</sup> *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995*, issued by Organization for Economic Co-operation and Development.

<sup>4</sup> Francescucci, David L.P., *The Arm's Length Principle and Group Dynamics - Part I: The conceptual shortcomings*, International Bureau of Fiscal Documentation, p. 55, March/April 2004.

<sup>5</sup> Subsequently amended by Finance Act 2002

<sup>6</sup> Section 92(1) of the Act.

<sup>7</sup> Section 92F(ii) of the Act.

<sup>8</sup> Section 92A(1) of the Act.

<sup>9</sup> The OECD's *Model Tax Convention on Income and on Capital, 2003*.

<sup>10</sup> Section 92B.

<sup>11</sup> Vogel, Klaus, *Double Taxation Conventions*, p. 532, 3rd Edition, Kluwer Law International (1997). A strict order of precedence of the three methods mentioned cannot be established because their utility tends to vary according to which of the different types of goods, services, etc., are involved... Provided the necessary data is capable of being ascertained, the comparable uncontrolled price method should invariably be given precedence over the other two and any further methods, as the former method is exclusively based on prices which the goods, services, etc., fetch, or could fetch in the market. In contrast, the resale price method involves the calculation in retrospect of margins, based on elements of costs, and of costing, that are not readily ascertainable. The last method to be resorted should usually be the cost plus method, because it is based on cost accounting where attribution is often extremely difficult. When applying the cost plus method or the resale price method, another point to be observed in each case is the *economic function* which the dependant enterprise has in relation to the controlling one.

<sup>12</sup> Rule 10B and 10C.

<sup>13</sup> Under the new provisions the primary onus is on the taxpayer to determine an arm's-length price in accordance with the rules, and to substantiate the same with the prescribed documentation. Where such onus is discharged by the assessee and the data used for determining the arm's-length price is reliable and correct, there can be no intervention by the Assessing Officer.


<sup>14</sup> Section 92D.

<sup>15</sup> Section 92C(3).

<sup>16</sup> Transfer Pricing Officer is a Joint Commissioner or Deputy Commissioner or Assistant Commissioner, authorized by CBDT to perform all or any of the functions of an Assessing Officer specified in sections 92C and 92D of the Act.

<sup>17</sup> Section 92CA(1).

<sup>18</sup> Section 92CA(4)-On receipt of the order under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C having regard to the arm's length price determined under sub-section (3) by the Transfer Pricing Officer.

<sup>19</sup> U.S. Treasury White Paper (10/19/88) Chapter 10, section B. 

---

Contact customer relations at: [customercare@bna.com](mailto:customercare@bna.com) or 1-800-372-1033  
ISSN 1521-7760

[Copyright](#) © 2005, The Bureau of National Affairs, Inc.  
[Copyright FAQs](#) | [Internet Privacy Policy](#) | [BNA Accessibility Statement](#) | [License](#)

Reproduction or redistribution, in whole or in part, and in any form,  
without express written permission, is prohibited except as permitted by the BNA Copyright Policy,  
<http://www.bna.com/corp/index.html#V>

