TRANSFER PRICING LAW IN INDIA

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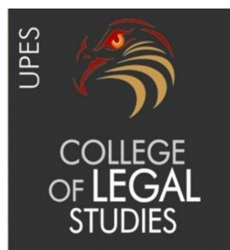
This dissertation is submitted in partial fulfilment of the degree of B.A., LL.B. (Hons.)



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CERTIFICATE

This is to certify that the research work entitled **“Transfer Pricing Law In India”** is the work done by Pratik Raoka under my guidance and supervision for the partial fulfillment of the requirement of B.A., LL.B. (Hons.) degree at College of Legal Studies, University of Petroleum and Energy Studies, Dehradun.

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DECLARATION

I declare that the dissertation entitled **"Transfer Pricing Law In India"** is the outcome of my own work conducted under the supervision of Prof. Sujith Surendran, at College of Legal Studies, University of Petroleum and Energy Studies, Dehradun.

I declare that the dissertation comprises only of my original work and due acknowledgement has been made in the text to all other material used.

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ABBREVIATIONS

AAR	:	Authority of Advance Rulings
AC	:	Appeal Cases
AE	:	Associated Enterprise
AIR	:	All India Reporter
ALP	:	Arm's Length Price
APA	:	Advance Pricing Agreement
BEPS	:	Base Erosion and Profit Shifting
CBDT	:	Central Board of Direct Taxes
CIT	:	Commissioner of Income Tax
CPM	:	Cost Plus Method
DTC	:	Direct Tax Coode
GAAR	:	General Anti-Avoidance Rules
GDP	:	Gross Domestic Product
IE	:	Independent Enterprise
ITAT	:	Income Tax Appellate Tribunal
ITR	:	Income Tax Reporter
MNE	:	Multi-National Enterprise
NAV	:	Net Asset Value
OECD	:	Organization for Economic Cooperation and Development
PE	:	Permanent Establishment
PSM	:	Profit Split Method
SCC	:	Supreme Court Cases
SEBI	:	Securities and Exchange Board of India
SPV	:	Special Purpose Vehicle
TNMM	:	Transactional Net Margin Method
TPO	:	Transfer Pricing Officer

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TABLE OF CONTENTS

1. Transfer Pricing In India 13

1. Introduction: 13

1.1. Transfer Pricing – Meaning and Effect 15

1.2. Transfer Pricing – Aims and Objectives 17

1.3. Salient features of the transfer pricing provisions: 20

2. Overview Of The New Provisions 22

2.1. International Transactions – Computation of Income 23

2.2. International Transaction – Report From An Accountant 23

2.3. Arm's Length Price – Computation 23

2.4. Assessment Procedure: 24

2.5. Computation of ALP by the Transfer Pricing Officer 25

2.6. Hearing By The TPO Is Mandatory: 26

2.7. Penalties An Relation To The Transfer Pricing Provisions 27

3. International Transaction 29

3.1. Introduction 29

3.2. International Transaction – Meaning 29

3.3. Restricted Meaning 30

3.3.1. Transaction – Meaning 30

3.3.2. Between Two Or More Associated Enterprises 32

3.3.3. Transaction in the Nature of 33

3.3.4. Not Between Associated Enterprises But Deemed 34

3.3.5. Other Transaction Than Specifically Mentioned Having Bearing On Profits 35

3.4. Extended Meaning 37

3.4.1. Mutual Agreement Or Arrangement 37

3.4.2. In Connection With 38

3.4.3. Benefit, Service Or Facility 38

4. Associated Enterprise 40

4.1. Enterprise 40

4.2. Associated Enterprise 42

4.2.1. Enterprises deemed associated even if they are not associated when transaction executed ... 44

4.2.2. Special Relationship Under Deeming Provision Of Section 92A (2) ... 44

5. Arm's Length Price ... 47

5.1. Introduction ... 47

5.2. Arm's Length Price – Old Provision ... 47

5.3. Arm's Length Price – New Provisions ... 49

5.4. Arm's Length Principle – Meaning ... 50

5.5. Arm's Length Principle – Application Requires Comparison Of Conditions And Transactions ... 52

5.6. Arm's Length Price – As Defined Under The Income Tax Act, 1961 ... 53

5.7. Arm's Length Transaction – Meaning ... 54

5.8. Income Splitting Or Tax Fragmentation ... 56

5.8.1. Income splitting – contract for work or supply of goods ... 56

5.8.2. Ramsay Principle ... 57

5.8.3. Meaning Of "Preordained Series Of Transaction": ... 58

5.9. Tax Avoidance ... 59

5.9.1. Circumstances Under Which Tax Avoidance Is Inferred: ... 60

5.9.2. Tax Avoidance Is Presumed If No Valid Business Purpose: ... 60

5.9.3. Test For Business Purpose – Limitations: ... 61

5.10. The Look Through Doctrine And Interpretation Of Section 9 Of The Act As Laid Down By The Vodafone Case ... 62

5.11. Computation Of Arm's Length Price ... 63

5.11.1. Methods ... 65

5.11.2. Comparable Uncontrolled Price Method ... 66

5.11.3. Profit Split Method ... 73

5.11.4. Cost Plus Method ... 75

5.11.5. Resale Price method ... 76

5.11.6. Transactional Net Marginal Method ... 77

6. Penalties ... 80

6.1. Introduction ... 80

6.1.1. Penalties – Meaning ... 81

6.2. Penalties - OECD Guidelines ... 81

6.3. Non-Compliance With Procedural Requirement ... 82

6.3.1. **Failure- Meaning** 84
6.4. **Failure- Every Failure Is Penalised** 84
6.5. **Failure- Furnish A Report From An Accountant** 85
6.6. **Penalty Even If Assessee Depends On Information And Documentation Not Contemporaneously Maintained** 86
6.6.1. **Any Person** 86
6.6.2. **Value Of International Transaction** 87
6.6.3. **Understatement Of Profits** 87
6.6.4. **Concealment Or Inaccurate Particulars Of Income** 88
6.7. **Good Faith And With Due Diligence** 90
7. **Interpretation Of Taxing Statutes** .... **Error! Bookmark not defined.**
7.1. **Cardinal Rules For Interpretation Of Taxing Statutes:** .... **Error! Bookmark not defined.**
7.1.1. **Literal Interpretation** .... **Error! Bookmark not defined.**
7.1.2. **Golden Rule** .... **Error! Bookmark not defined.**
7.1.3. **Rule Of Harmonious Construction** .... **Error! Bookmark not defined.**
7.1.4. **Doctrine Of "Reading Down"** .... **Error! Bookmark not defined.**
7.1.5. **Rule Of Beneficial Construction** .... **Error! Bookmark not defined.**
7.1.6. **Charging sections to be strictly construed** .... **Error! Bookmark not defined.**
7.1.7. **Mischief Rule** .... **Error! Bookmark not defined.**
7.1.8. **Construction Of Penal Provisions** .... **Error! Bookmark not defined.**
7.1.9. **Rule Of Ejusdem Generis Or Noscitur A Sociis** .... **Error! Bookmark not defined.**
7.1.10. **External Aids To Interpretation** .... **Error! Bookmark not defined.**
7.1.11. **Generalia Specialibus Non Derogant** .... **Error! Bookmark not defined.**
7.1.12. **Mimansa Rules Of Interpretation** .... **Error! Bookmark not defined.**
Bibliography 91

1. TRANSFER PRICING IN INDIA

1. INTRODUCTION:

In the year 1991, the Indian economy started opening up. Foreign investment started pouring in as a result of economic reform measures taken up by the Government. Industrial licensing policy has been considerably liberalised, that structure is simplified and made internationally compatible the economic climate in the country is conducive to investment; India a favourite destination in order to have a smooth flow of investment and trade India has entered into agreements with almost all the capital and technology exporting countries, to avoid double taxation of income arising in India by virtue of the business connection double taxation agreements are established we for the states to agree at international level for the resolution of the problems arising from the cross-border trading and investment. Prominent amongst them are taxation of income doubly, the vision and collection of taxes and discrimination between the resident and the non-resident and the national of the third state. The tax treaty facilitates investment and trade provide preventing discrimination between taxpayers, adds fiscal certainty to the cross-border operations, prevent evasion and avoidance of tax at international level, facilitates collection of taxes, and contributes attainment of national development goal. The major feature is that a treaty guarantees the stability of tax burden. So that its provisions may not be used by multinational enterprises by fixing prices, terms and conditions of transaction between their controlled enterprises located in different jurisdiction, the treaty requires that such transaction be dealt with as a between the unrelated parties, accounts read it and if it required, and real profits taxed which is sought to be manipulated. Article 9 of the treaty so provides but not the methodology of how to do. The law of transfer pricing as enacted in Section 92 to Section 92F of the Indian Income Tax Act, 1961 read with the Rules 10A to Rules 10E of the Indian Income Tax Rules, 1962 provides the methodology. It is better known the OECD guidelines, 1995. The law is enacted to prevent erosion of Indian tax base by the multinationals through the mechanism of what is known as "transfer pricing".

With the expansion of global operations of multinational companies well equipped in tax planning to minimise tax incidence of various countries in which they operate, there has

been a corresponding legislative activity to counter such measures. The application of the principle of transfer pricing is one such measure. The provision of transfer pricing were first introduced by substituting sections 92 to 92F for existing Section 92 by the Finance Act, 2001. The Act was brought into effect from April 1, 2002. The new provisions supported by the rules now provide detailed machinery for computation of the reasonable and equitable profits and tax in India in the case of multinational enterprises.[1]

The basic intention underlying transfer pricing regulation is to prevent the shifting of profits by manipulating prices charged or paid in international transaction thereby eroding the country's tax base. Before transfer pricing mechanism, international transactions were attacked only on the ground if they were sham, i.e. lacking economy substance by looking at the substance rather than form. That mechanism was inefficient capable of being manipulated with ease; multinational corporations providing economic substance sufficient to overcome the ground of attack. For example, in *El Du Pont de Nemours & Co. v. United States*[2], the court found that a wholly-owned Swiss subsidiary of the US parent company, which sold only its parent products to yield 75 percent of the total profits realised upon their sale, perform substantial commercial functions and could not be considered a sham operation, though the subsidiary internal memoranda were replete with references to transfer pricing benefits. Under the transfer pricing regime, an international transaction is not only modified and income relocated on the ground of improper accounting, fraudulent, colourful or sham dealings, but also incorrect reporting on the arm's length standard. The new provisions and the rules made their render outline the methods of determination of arm's length price, defining the keywords and expression used for the purpose, such as arm's length price, enterprise, associated enterprise, transaction, international transaction etc.

It has to be noted that sale of goods, transfer or licensing of technology and patent rights, and provision of services are the vehicles for transfer pricing abuses. Section 92 of the Income tax Act, 1961 which provided for preventing such abuses, was found to be insufficient for the purpose. It empowered the Assessing Officer to determine and then include in the taxable income of the resident assessee, the amount of profits which might reasonably be deemed to have been derived from such business transactions as has been arranged, because of the close connection between the resident and the non-resident, so as to yield no profit on less than the ordinary profit. That section has now been substituted by new sections ranging from section

[1] In Re: Instrumentarium vs Unknown on 25th November, 2004, (2005 272 ITR 299 AAR)
[2] 608 F 2d 44 (1979)

92 to 92F. The new provisions were operated with effect from 1 April 2002. Section 92 relates to computation of income from international transaction is having regard to arm's-length base. Section 92A defines the expression "associated enterprise" and Section 92B defines "international transaction". Section 92C prescribes the method for determination of the arm's-length price in relation to an international transaction. Section 92D deals with the maintenance, keeping of information and documents by persons entering into international transaction is, and, section 92E, with the requirement of obtaining by them a report from an accountant. Section 92F is a definition clause, defining various expressions used in the aforesaid sections. Penalties have been provided for failure to comply with the requirements of said new provisions. Section 271AA, 271BA and 271G have been newly inserted for the purpose. A new Explanation 7 has been inserted in subsection (1) of section 271, which deems assessee having concealed particulars of income or furnished in accurate particulars in respect of the amount added or disallowed on arm's-length price having been determined.

1.1. TRANSFER PRICING – MEANING AND EFFECT

Commercial transactions between different parts of multinational groups may not be subject to the same market forces shaping relations between two independent firms. Open market considerations not necessarily govern the transactions between two enterprises under the same of common control. The prices paid for a transaction between members of multinational enterprise in order to meet the convenience of the multinational enterprise or a group as a whole and done in a variety of ways. Such fixing would not have been possible if the parties to the transaction were independent acting at arm's length. In fixing the price the group convenience may be purely commercial or a matter of minimising total tax burden. One part transfers to another goods or services for a price. That price is known as "transfer price". This may be arbitrary and dictated, with no relation to the cost and added value, diverge from the market price. Transfer Price is, thus, a price which represents the value of goods and services between independently operating units of an organisation. But the expression "transfer pricing" generally refers to prices of transaction between associated enterprises which may take place under conditions differing from independent enterprises.

It is defined as the price paid for goods transferred from one economic unit to another, assuming that the two units involved are situated in different countries but belong to the same

multinational firm. Transfer price is a price charged in a transaction. The term "transfer price" is used to describe the actual price charged between the associated enterprises in an international transaction. Where the transfer price is different from the price which would have been charged if the enterprises were not associated and the difference gives rise to the tax advantage, the tax is thus calculated on the basis of arm's length price. The rules under which it is done are the transfer pricing rules as provided under the Income Tax Act and Rules. These Rules require that the actual results of the international transactions are adjusted to arm's length results for the purpose of re-computing taxable profits or losses. The essence of transfer price is that it is not set by an independent transferor and transferee in arm's length negotiations. It is within the discretion of the single enterprise. Transfer pricing is widely used in multinational organisations, which typically involves a parent company domiciled in one country and a number of subsidiary companies domiciled in other countries. When multinational firms, conduct business within their groups, the concept of market pricing or arm's length pricing has no relevance. Income or deduction is arbitrarily shifted.

Suppose a company "A" purchases goods for 100 rupees and sells it to its associated company B in another country for 200 rupees, who in turn sells in the open market for 400 rupees. Had A sold it direct, it would have made a profit of 300 rupees. But by routing it through B, it restricted it to 100 rupees, permitting B to appropriate the balance. The transaction between A and B is arranged and not governed by market forces. The profit of 200 rupees is, thereby, shifted to the country of B. The goods are transferred on a price (transfer price) which is arbitrary or dictated (200 hundred rupees), but not on the market price (400 rupees).

Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group which manufacture products in a high tax country may decide to sell them at a low profit to its affiliate sales company based in a tax haven country. That company would in turn sell the product at an

arm's length price and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves[3]

It has to be taken into consideration that Shifting of Profits is the essence of transfer pricing. But that shifting is not always inferred every time where the transaction is below the market price, especially when the price is controlled by Government Regulations and not by the dictate of an MNE. For Example, in *Texco vs CIR*[4], Saudi Arabian Government permitted a subsidiary of Taxco to purchase Saudi Arabian Crude Oil at a price below the market price with a prohibition not to resell at price higher than the officially established selling price which was again lower than the market price. Textrad sold the crude oil to the related and unrelated parties. The revenue enhanced the taxable income of Textrad on the belief that it has unduly shifted the profits. The court reversed; holding that the pricing was subject to restrictions imposed by Saudi Government and there was no shifting of profits.

1.2. TRANSFER PRICING – AIMS AND OBJECTIVES

Transfer price as aforesaid, refers to the value attached to transfer of goods, services and technology between related entities such as parent and subsidiary corporations and also between the parties which are controlled by a common entity, its essence being that the pricing is not set by an independent transferor and transferee in arm’s length transaction. Transaction between them is not governed by open market considerations the price is fixed, which is within the discretion of the single enterprise this is done in order to meet the convenience of the multinational enterprise or a group as a whole and may in consequence the fixed in a variety of ways which would not be possible if the parties to the transaction is but independent persons acting at arm’s length. The group’s convenience may, for example, be a matter for arranging the direction of cash flow or of minimising the total tax burden.

Whatever the reason for fixing a transfer price which is not at arm’s length, the result is the shift of profits. The effect is that the profit is appropriately attributable to one jurisdiction is shifted to another jurisdiction. The expression “transfer pricing” has of late acquired a

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[3] http://www.incometaxindia.gov.in/Pages/international-taxation/transfer-pricing.aspx , <last accessed on 31st March 2013>

[4] US Court of Appeal5th; Cir. No. 95-60696

pejorative meaning. It evokes the idea of systematic manipulation of prices in order to reduce profits artificially, causing losses; avoid taxes or duties in a specific country.

The main object is to avoid tax as also to withdraw profits leaving very little for the global participation to share. Others are, avoidance of foreign exchange restrictions and the effect of political uncertainties how best and dexterously it could be done depends upon the track tax structure of a jurisdiction, it's exchange control regulations, its political and economic conditions, or its dependence on the foreign technology, know-how, skill, expertise etc. The incentives to engage in transfer pricing abuses are created in less developed than those in industrialised countries with the risk of detection being less.

Factors other than the tax considerations are outlined as:-

> *"1.4 Factors other than the tax considerations may distort the conditions of commercial and financial relations established between associated enterprises. For example, such enterprises may be subject to conflicting governmental pressures (in the domestic as well as foreign country) relating to customs valuations, anti-dumping duties, and exchange or price controls. In addition, transfer price distortions may be caused by the cash flow requirements of enterprises within the MNE group. An MNE group that is publicity held may feel pressure from shareholders to show high profitability at the parent company level, particularly if shareholder reporting is not undertaken on a consolidated basis. All of these factors may affect transfer prices and the amount of profits, accruing to associated enterprises within the MNE group."*[5]

The opportunities for international tax manipulations amongst the associated enterprises not only involve the use of arbitrary prices, but also involve the conversion of returns on equity investment to royalties and interest. Such a device is termed as "Thin Capitalisation".

Multinational Enterprises are not only the entities that engage the transfer pricing abuses. There are many instances in which the local individuals or companies use the device to shift artificially; profits so as to avoid or evade taxes, circumvent exchange control or reduce the economic exposure arising from political or economic uncertainties.

One has to clearly understand that the motive behind transfer pricing abuses is: tax avoidance, exchange control and foreign investment, withdrawal of profits in the form of royalties and due to political and economic uncertainties. But whatever the motive may be, the consequence is ***"Tax avoidance".***

[5] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration; OECD; 2009

The result for fixing a price which is not at arm's length price, whatever the motive, is the avoidance of profit from a country where it would have accrued had the transaction been at arm's length. To avoidance evasion of tax may not be the purpose or there could be honest difference of opinion about what should be the arm's-length price, the tax authorities are aware that tax is avoided. Therefore, the question of the tax treatment of the transfer pricing is always considered in association with avoidance evasion of tax the net effect of transfer pricing abuses is that profits properly attributable to one jurisdiction are shifted to another jurisdiction.

Every controlled transaction which is not at arm's length is covered. Shifting of profits and consequently avoidance of tax is presumed, whether done inadvertently or by design. Intent to avoid or evade or the impossibility of realisation of income is not the requirement for computing income on the arm's length standard. But under the transfer pricing rules income is not to be located to the taxpayer who could not legally receive it. Similarly, it would not be located if the underlying transaction is exempt under the relevant double taxation agreement. In *Venenburg Group B.V.,*[6] Authority for Advance Ruling held that the transfer by a non-resident company incorporated in the Netherlands of its entire shares in subsidiary company in India to its 100% subsidiary company incorporated in Netherlands, in the course of its corporate reorganisation, is not subject to capital gains tax in India in view of the DTAA between India and the Netherlands and also not subject to transfer pricing provisions.

The concept of transfer pricing was considered and explained by the Hon'ble Supreme Court in the case of *Mazagaon Dock Ltd. Vs. CIT*[7]

In this case, the appellant company which carried on business as marine engineers and ship repairers was resident and ordinarily resident for the purpose of Income Tax Act. To non-resident British companies engaged in the business of plying ships beneficially owned the entire share capital of the appellant company which repaired the ships of the non-resident companies at cost and charged no profits. The question before the Supreme Court was whether having regard to the course of dealings between the non-resident companies and the appellant-company it could be said of the former that they carried on business with the latter within the meaning of section 42(2). It was observed that section 42 spoke not of the non-residents carrying on business in the abstract but of their carrying on business with the

[6] (2007) 159 Taxmann 219
[7] (1958) 34 ITR 368

resident, and, in that context, it must include all activities between them having a relationship to their business. According to the court, the words where a person not resident in the taxable territories carries on business with a person resident' in section 42(2) aforesaid were held to mean that a non-resident should be held to carry on business with a resident if the dealings between them formed concerted and organized activities of a business character. Hence the apex court, rejecting contentions of the appellant company held that profits, if any foregone, must be taxed separately. The court expressed the view that the fact that the dealings were such as to yield no profit was immaterial.[8]

1.3. SALIENT FEATURES OF THE TRANSFER PRICING PROVISIONS:

The new legislation follows OECD Guidelines. The main points of OECD Guidelines are: adoption of the arm's length principle, setting up levels of comparability that emphasise functions performed, risk assumed and assets employed, introducing a strong preference for the use of traditional transaction-based methods, introducing a profit based method called transactional net marginal method and acknowledging the need for tax payer documentation of the arm's length character of its transfer pricing and role of played by penalties in encouraging compliance. Incorporating all above, the Indian law has the following important features:

1. It codifies the arm's length principle
2. The basic principle of the legislation is the arm's-length, as defined by the OECD guidelines using five permitted pricing methods that is comparable uncontrolled price, the sale price, cost plus, profit split and transactional net marginal method. Determination of arm's length price is not restricted to the above methods. It scope has been widened. Any other method which is not specified but may be prescribed by the board may be resorted to if it gives fair determination of arm's length price.
3. The arm's-length amount of consideration must be determined by applying the most appropriate method and with more than one prices data mining by the most appropriate method, the arm's-length price to be taken to be the arithmetical mean of such prices.
4. The arm's-length principle applies only so as to increase Indian tax base

[8] Transfer Pricing Concept & The Law in India by T. N. Pandey (http://taxguru.in/income-tax/transfer-pricing-concept-law-india.html) last accessed on 31st March 2015

5. The expression enterprise covers permanent establishment also, meaning that transaction between a non-resident entity and its permanent establishment or between a permanent establishments of a non-resident with other permanent establishment's outside India.
6. A widening scope of transfer pricing provisions through a broader concept of control between enterprises, that is direct or indirect, participating in the capital, management, or, supervision of another enterprise capable of influencing the price in respect of the transaction between them. It is the capacity to exercise control and not its extent or level which is relevant.
7. The concept of specific relations between entities is broadly defined, including situations ranging from statutory to economic dependency, and also certain family relations.
8. Extensive documentation requirement that requires the taxpayer to demonstrate the arm's length nature of the inter-company prices and how these prices have been arrived at, justifying transfer pricing arrangements;
9. Burden of proof as to the arm's length nature of consideration rests with the taxpayer.
10. Penalties for encouraging compliance.[9]

[9] Transfer Pricing: An Indian Perspective, Mukesh Bhutani, Lexis Nexis, 2007

2. Overview Of The New Provisions

The Finance Bill, 2001 reads as follows:

> *"New Legislation to curb tax avoidance by abuse of transfer pricing*
>
> *The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income-tax Act ………*"[10]

The scope and effect of the new set of provisions ranging from Sections 92 to 92F under Chapter X of the Indian Income Tax Act, 1961 was explained by the Central Board of Direct Taxes. The Board explained that the reason for inserting the provision was that increasing participation of multinational enterprise in the economic activities in the country; gave rise to "new" and "complex" issues whereby two or more enterprises of the same multi-national group would manipulate their prices in a manner which would lead to erosion of tax revenues of the home country. The reason for substituting the existing Section 92 of the Act is best explained in the Circulars provided and issued by the Central Board of Direct Taxes.

> *"With a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multi-national enterprises, the Act has substituted section 92 with a new section, and has introduced new Sections 92A to 92F in the Income Tax Act, relating to computation of income from an international transaction having regard to the arm's length price, meaning of associated enterprise, meaning of international transaction, computation of arm's length price, maintenance of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into international transactions and definitions of certain expressions occurring in the said sections…….."*[11]

[10] (2001) 248 ITR (St.) 181
[11] (2001) 252 ITR (st.) 65

2.1. International Transactions – Computation of Income

Section 92 provides that any income arising from an international transaction shall be computed having regards to the arm's length price. It further provides that the cost or expenses allocated or appropriated between the two or more associated enterprises shall be at arm's length. Section 92A defines the expression "associated enterprise", exhaustively. It consists of two parts. One defines it in terms of positive and the other, deeming tests. The concept of special relations between entities has been broadly defined, including situations ranging from statutory to economic dependency, and also certain family relations. Section 92B defines the expression "International Transaction" as meaning a transaction between two or more associated enterprises, either or both of who are non-resident. It also describes transaction with reference to which the income is to be computed under Section 92. The definition also applies in the case of "transactions" between a non-resident entity and its permanent establishment or between permanent establishments of a non-resident with other permanent establishments outside India.

2.2. International Transaction – Report From An Accountant

Section 92E seeks to provide that every person who has entered into an International Transaction during a previous year shall obtain a report from an accountant and furnish it on or before the specified date, in the prescribed form duly signed and verified in the prescribed manner by such accountant and setting forth such particulars as may be prescribed.

The legislation contains a set of methodology for evaluating transfer prices and the comparability factors that shall be taken into account while assessing their arm's length nature.

2.3. Arm's Length Price – Computation

Section 92C provides for computation of arm's length price which has to be done by (a) Comparable Uncontrolled Price Method; or (b) Resale Price Method; or (c) Cost Plus

Method; or (d) Profit Split Method; or (e) Transactional Net Marginal Method; or (f) any other method which may be prescribed by the Board. One of these may be the most appropriate. That method may be applied for computation of the arm's length price in the manner as may be prescribed by the Rules to be made by the Board in this behalf. In a case where more than one price can be determined by the most appropriate method, the arithmetical mean of such two determines the arm's length price. During the course of any proceeding for the assessment of Income the Assessing Officer may be of the opinion, formed on the basis of material or information or documents in his possession, that the price charged or paid has not been determined in the aforesaid manner; or the information and documents relating to the international transaction have not been kept and maintained as required under Section 92D(1) and (2), or furnished within the specified time as required under Section 92D(3); or information and data used in computation of arm's length price is unreliable or incorrect. In that case, the Assessing Officer may proceed to determine the arm's-length price in relation to the set transaction on the basis of material or information or documents available with him and compute the income accordingly, after giving an opportunity to the assessee of being heard. The legislation shifts the burden of proof from tax authorities to the assessee in showing that the transaction with the associated enterprise was at arm's length, on the basis of documents maintained and filed by it. The purpose of extensive documentation requirements is to enable the assessee to justify and document the transfer pricing arrangement.

2.4. ASSESSMENT PROCEDURE:

Under section 92C (1) of the Act the prerogative to choose the most appropriate method for determining the ALP as with the assessee. Acceptance of the ALP arrived at by the assessee as the rule and its rejection an exception. Section 92C (3) gives jurisdiction to the Assessing Officer to determine the ALP, if, in the course of the assessment proceedings he on the bass of material or information or document in his possession of the opinion that:

1. The price charged or pad in an international transaction has not been determined as per any of the specified methods or the assessee has not followed the most appropriate method in the manner prescribed by rule 10C; or

2. The assessee has not kept and maintained the information and documents relating to the international transaction in accordance with section 92D (1) of the Act and rule 10D of the Rules.
3. The information used in computing the ALP as not reliable or correct.
4. The assessee has failed to furnish within the specified time any information or document which he as required to furnish by a notice issued under section 92D (3).

The first proviso to sub-section (3) of section 92 clearly mandates that before the Assessing Officer proceeds to determine the ALP on the bass of the material or information or document available with him he shall gave an opportunity by serving upon the assessee a show cause notice fixing thereby a date and time for the sad purpose.

Under sub-section (4) of section 92C the Assessing Officer can proceed to compute the total income of the assessee only after the ALP has been determined by the Assessing Officer as per the provision of sub-section (3) of Section 92C.

2.5. COMPUTATION OF ALP BY THE TRANSFER PRICING OFFICER

Under Section 92CA, the Assessing Officer as empowered to refer the computation of ALP, in relation to, an "international transaction" under Section 92C to the TPO, if he considers it "necessary" or "expedient" to do so with the prior approval of the Commissioner. At as only after a reference as made under sub-section (1) of section 92CA that the TPO enters the picture and gets a mandate to approach upon the assessee by issuing him a notice calling upon him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the ALP.

At as interesting to note that the reference as in respect of each individual transaction and not of the assessee. The effect as that, if during the course of the proceedings, the transfer pricing officer becomes aware of certain other international transactions which have not been specifically referred to him for determination of ALP, then he cannot determine the ALP of

those transactions. Instead he would require a fresh reference in this regard from the Assessing Officer.[12]

Whenever the aggregate value of the international transaction exceeds rupees five crores, the case should be picked up for scrutiny and a mandatory reference be made to the transfer pricing officer for determination of ALP. Constitutional validity of this direction has been upheld by the Delhi High Court in the case of *Sony India Pt. Ltd. vs. CBDT*[13].

Sub-section (3) of Section 92CA provides that the TPO, by an order in writing, will determine the ALP in relation to an "international transaction" in accordance with subsection (3) of section 92C after hearing such evidence as the assessee may produce including any information or documents referred to in sub-section (3) of Section 92D and after considering such evidence as the TPO may require on any specified points, and after taking into account all relevant material which the TPO has gathered. The TPO as required to send a copy of the order, whereby a determination of ALP as made both to the Assessing Officer and the assessee. Sub-section (3A) of Section 92CA provides a time frame within which the TPO as required to pass an order under sub-section (3) of section 92CA.

2.6. HEARING BY THE TPO IS MANDATORY:

S. 92CA (3) imposes an obligation on the Transfer Pricing Officer to accord an oral hearing to the assessee. The fact that the assessee did not demand an oral hearing makes no difference. Further, the hearing has to be given before the order as passed. A *Moser Baer India Ltd vs. ACIT*[14] the Delhi High Court has mandated that the TPO should follow the procedure lad down:

(1) The show-cause notice issued by the TPO just prior to the determination of ALP should refer to the documents or material available with the AO in relation to the international transaction in issue. The show cause notice should also gave an option to the assessee:-

[12] Instruction 3 of 2003 dated 20-5-2003 issued by the CBDT.
[13] 288 ITR 52
[14] Judgment Pronounced on December 23, 2008 by Delhi High Court

(a) To inspect the material available with the AO as gave the leeway to file further material or evidence if he so desires, and
(b) To seek a personal hearing in the matter.

2.7. PENALTIES AN RELATION TO THE TRANSFER PRICING PROVISIONS

A necessary adjunct to chapter X of the Act, are certain provisions contained in Chapter XXI, which as, entitled “penalties imposable”. At as pertinent to note that with the insertion of chapter X in the Act, the legislature has also inserted the following provisions in Chapter XXI. Explanation 7 to Section 271 has been inserted which provides that any assessee who has entered into an international transaction as defined in section 92B, then, in the event of any amount being allowed or disallowed in the process of computation of total income of the assessee under sub-section (4) of section 92C, the amount, allowed or disallowed, will be deemed to represent the income, in respect of, which particulars have been concealed or inaccurate particulars have been furnished unless the assessee proves to the satisfaction of the Assessing Officer or the Commissioner(Appeals) or the Commissioner that the price charged or pad in such transaction was computed in accordance with the provisions contained in section 92C and the manner prescribed under that Section, in good faith and with due diligence. The sum and substance of the explanation as that it deems that any adjustment made in the ALP on account of transfer pricing provisions will be regarded as concealment of particulars of income or income or furnishing inaccurate particulars under Section 271(1)(c) unless the assessee as able to establish that the price charged or pad in respect of such an international transaction was not only in accordance with the provision of Section 92C and the manner prescribed in that Section, but also that, the assessee acted in good faith and with due diligence.

Apart from the above, penalties are also imposable under Section 271AA for failure to keep and maintain information and documents required under sub-section (1) or subsection (2) of Section 92D. The penalty prescribed as a sum equal to 2% of the value of each such international transaction entered into by such person.

Similarly, under Section 271BA, an Assessing Officer as entitled to impose a penalty equivalent to a sum of Rs. 1, 00,000 in the event of failure on the part of the assessee to

furnish an audit report in terms of section 92E. Lastly, under Section 271G, the Assessing Officer or the Commissioner of Appeals as entitled to impose penalty if the assessee fails to furnish any information or document as required in sub-section (3) of section 92D. Under this provision, the penalty imposable as a sum equal to 2% of the value of the international transaction for the each such failure.

3. INTERNATIONAL TRANSACTION

3.1. INTRODUCTION

Section 92B defines the nature of transaction as also the agreement or the arrangement between the associated enterprises as falling within the expression "international transaction" with reference to which the income distribution computed under Section 92.

3.2. INTERNATIONAL TRANSACTION – MEANING

Section 92B defines the expression "international transaction" by the use of expressions "means" and "shall include". The definition, therefore, consists of two parts – one, explanatory and other expandatory. The explanatory part is exhaustive. It defines it to mean a transaction between two or more associated enterprises, either or both of who are non-resident's, in the nature of purchase, sale or lease of tangible or intangible property; or the provision of services, or lending or borrowing money or any other transaction having bearing on the profits, income, losses or assets of such enterprises. It covers all commercial transactions between the associated enterprises which the legislature could think of from the very specific to the general.

The expandatory part extends the word "transaction" to cover mutual agreement or arrangement between the associated enterprises for the location or appropriation of any cost or expense contributed or incurred or to be incurred in connection with the benefit, service or facility provided or to be provided to anyone or more such enterprises.

Some transactions between the two associated enterprises have been specifically define to mean international transactions; some arrangements, two are not of the nature of transaction but are deemed so to the; while some others not between them but also so deemed. Subsection (2) deems the preordained arrangement between an enterprise and a person other than an associated enterprise as a transaction between that enterprise and associated enterprise. Thus, the term "transaction" is defined to cover arrangements, understanding and

mutual practices whether or not they are intended to be legally enforceable. It encompasses transactions for which no price has been set that would not have taken place between the third parties.

3.3. RESTRICTED MEANING

According to the first part of the definition, International Transaction is a:-

- Transaction,
- between two or more associated enterprises, either or both of whom are non-residents,
- in the nature of –
- purchase, sale or lease of tangible or intangible property, or
- provision of services, or
- lending or borrowing money, or
- any other transaction having a bearing on the profits, income, losses or assets of such enterprises.

International Transaction between two or more associated enterprises, either or both of them are non-resident has first to be a "transaction" of the nature as specified in Section 92B, is normally understood the ordinary, popular and natural since and also in the sense as inclusively defined in Section 92F(v). It therefore means any lease, sale, assignment, loan, advance, contribution, or any other transfer of interest in or a right to use any property or money or provision of services or any other transaction having bearing on the profits, income, losses or assets, as also an arrangement understanding, or action in concert, however such transaction is effected, and whether or not the terms of such transaction are formally documented or legally enforceable.

3.3.1. TRANSACTION – MEANING

A transaction is the transfer of goods and services, involving a physical product, or knowledge on a right to use or exploit an intangible asset. The word transaction has been defined in Section 92F(v) inclusively. It includes an arrangement, understanding, or action in

concert, irrespective whether it is formal or in writing, or whether it is intended to be in enforceable by legal proceedings. Action in concert may be a number of transactions, not necessarily in sequence, in respect of the same arrangement. Inclusive definition enlarges the meaning of the words or phrases as to take into the ordinary, popular and natural sense of the words and also the sense the statute wishes to attribute to them all to bring under one nomenclature or transactions possessing certain similar feature but going under differing needs and depending upon the context, in the process of enlarging, the definition may ever become exhaustive.[15] Any interpretation which extends the meaning of a word does not take away its ordinary and popular meaning.[16].

The word transaction as ordinarily understood means the management or settlement of benefit. Generally a transaction consists of an arrangement. In Webster's Third International Dictionary, the word "transaction" has been defined, *inter alia*, "as a business deal". The word "transact" in the same dictionary has been defined to mean "to prosecute negotiations: carry on business: to trade in or with".[17] The transaction relates to commercial or financial deal, embracing every phase of commercial and business activity and intercourse. Every transaction which turns out to be a source of the, profit, benefit or advantage to the parties, is covered. The term "transaction" has been given a wide meaning so as to cover all kinds of commercial and financial relationships. The relationships of commercial and financial nature include but are not limited to, exchange of goods or services, supply of information and technology, leasing, financing etc. the list is not exhaustive. Thus, the word "transaction" is to be construed broadly having regard to manifold activities which relate to trade, profit or commerce, having effect on profits, income, losses or assets of the parties to the transaction.

As ordinarily understood, transaction means an agreement. But the statutory definition covers what is not strictly speaking agreement. An agreement is an act in law whereby two or more parties declared their consent to any act or thing to be done. A document or instrument containing the terms of an enforceable obligation between the parties is called an agreement or a contract. It is a term which denotes the legal relations resulting from the acts of the parties. In the case of an agreement relating to business transaction, it follows almost as a matter of course that the parties intended legal consequences to follow. Any arrangement, understanding or action in concert, which lacks the above characteristics of an agreement

[15] Reserve Bank of India v. Peerless General Finance & Investment Co. , (1987) 61 Comp. Cas. 663 (SC)
[16] Jagatram Ahuja v. CGT, (2000) 246 ITR 609 (SC)
[17] Secured Investment Company v. Registrar, AIR 1984 All. 28

between the parties, is deemed so to be. Arrangement or understanding or action in concert but made or arrived at or done informally, which may not be in writing or intended to be enforceable, is also an agreement. An arrangement is a scheme of any kind whether or not it is intended to be legally enforceable.

3.3.2. BETWEEN TWO OR MORE ASSOCIATED ENTERPRISES

Transaction under the transfer pricing purposes is not restricted between two legal entities capable of entering into an agreement. Even transaction between two departments or branches of the same entity may be covered. The doctrine of mutuality that no person can make profit out of himself is not applicable. In *Mason v. Innes*[18], it was observed,

> *"I start with the elementary principle of IT law that a man can be taxed on profits that might have but has not been made."*

At first sight that elementary principle seems to cover the case. Mr. Hammond Innes did not receive anything from Doomed Oasis. But in the case of a trade, there is an exception to the principle. I take for simplicity the trade of a grocer. He makes out his accounts on an "earning basis". He brings in the value of stock in trade at the beginning and end of the year; he brings in his purchases and sales, debt owned by him and due to him, and so arrive at his profit or loss. If such a trader appropriates to himself part of his stock in trade, such as tins of beans and uses them for his own purpose he must bring them out in his accounts at market value. That is established by *Sharkey v. Wernher.*[19]

Now, suppose such a trader does no supply himself with such tins of beans but gives them away to his friend or relative. Again he has to bring them at the market value. This was established by *Petrotim Securities Ltd. V. Ayres*.[20]

The arm's length principle were held applicable in *Sharkey v. Wernher*[21] which was concerned with the determination as to the value at which horses should be transferred from a stud to a personal use as race horses, i.e., from trade to non-trade. The House of Lords held

[18] (1968) 70 ITR 491 (CA)
[19](1956) 29 ITR 962 (HL)
[20] (1964) 1 WLR 190 (CA)
[21] Supra 19

that the value of raced animals which being very much higher than the cost of breeding them be brought to the stud's farm accounts in respect of the transfer.

The principle that emerged is that if an asset is transferred between the trading and the non-trading activity of a person, it should be done at the market value and that the principle that a man cannot make a profit by trading with himself is not applicable especially if an enterprise deals with its establishments in another country. A transaction is some business or dealing which is carried on or transacted between the two or more persons.[22]

In *CIT v. Kaira District Co-operative Milk Producers Union Ltd.*[23], the Gujarat High Court said at page 322:

> *"Every transaction when analyzed has two aspects, an aspect of giving and an aspect of receiving"*

Transaction is, therefore, either bilateral or multilateral, but not unilateral. For it to be international it has to be between two or more associated enterprises, either or both of whom are non-residents. Parties to the transaction should not be non-other than the associated enterprises, at least one of them being a non-resident. If any of the two requirements is not satisfied, the transaction is not an international transaction.

3.3.3. TRANSACTION IN THE NATURE OF

The expression "in the nature of" means characteristically resembling or belonging to the same class. The transaction should not be of the type, and need no necessarily be, of the specified kind. The Legislature has used the expression "in the nature of purchase, sale…" in place of the "purchase, sale….''It is therefore much wider in its connotation, inasmuch as it would take within its scope not merely what may *stricto-sensu* be regarded purchase, sale etc., but also other transactions in nature partaking of some, if not all of their characteristics. It is a well-known principle of Interpretation that when construing a fiscal statute, the Court has to lean in its interpretation in favour of the subject matter.[24]

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[22] Chhanoo Matho v. Jang Bahadur, AIR 1957 Pat. 293
[23] (2001) 247 ITR 314
[24] Kr. Vishva Nath Singh v. The State, 1959 All L.J. 633

Generally a transaction is identifiable. In certain circumstances, however, a single transaction may consist of many identifiable components. For Example, in a case where selling price of a product includes amount for subsequent service, the transaction is to be identified as how much it relates to goods and how for the services. Sometimes the transactions are linked in such a way that the commercial effect cannot be understood without reference to a series of transaction as a whole, as in the case of a contract of turnkey project, or in case where an enterprise sells goods and at the same time enter into another agreement for the repurchase of goods at a later date. The substantive effect of such transaction cannot be understood without considering the transaction as a whole.

3.3.4. NOT BETWEEN ASSOCIATED ENTERPRISES BUT DEEMED

For a transaction to be an international transaction, it has to be between the associated enterprises. Even where it is between an enterprise and a person other than the associated enterprise, it is deemed to be between the associated enterprises 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.[25]

3.3.4.1. Prior Agreement between the Person and the Associated Enterprise

A transaction which is not between the associated enterprises but deemed to be between them, if there exists a prior agreement between the person to the agreement and the associated enterprises with regard to the transaction. Existence of a prior agreement is the requirement on which the legal fiction is to prevail. It is in effect echoes the principle as stated in *W.T. Ramsay v. IRC*[26] and *Furniss v. Dawson*[27]. When a transaction is entered into by an enterprise with the person other than an associated enterprise, that transaction has already been agreed by the enterprise to be a transaction between two associated enterprises, that person being

[25] Section 92B(2)
[26] (1982) AC 300
[27] (1984) AC 474

only an intermediary of the other enterprise. The said transaction is pre-arranged or pre-ordained to be between the associated enterprises. The scheme is preordained in the sense that all the transactions form part of the pre-planned tax avoidance scheme.

A series of transactions is considered to be a transaction, which are entered into in pursuance of, or in relation to, the same agreement or arrangement. This would mean that for example regular purchases made by a distributor under a distribution agreement would constitute a series of transaction. It is not necessary for all transactions in a series to take place between two or more associated enterprises or between the two related parties. It is also possible to have a situation where there are no transactions in the series to which both the parties are party.

3.3.4.2. Terms of the Transaction determined by the Associated Enterprise.

A transaction entered into by an enterprise with a person other than the associated enterprises is deemed to be an agreement between the associated enterprises, if it's terms are determined in substance by the associated enterprise. Thus, to the associated enterprise is not a party to the transaction, yet it has to be determined in its essential terms apart from that it is. The terms of the transaction, if fixed or dictated by the associated enterprise; that transaction cannot be said to have been entered into between the two independent parties associated enterprise may be taken to be a party to it. In that situation the transaction is deemed to be between two associated enterprises. In substance that transaction is an international transaction and Section 92B deems it so to be.

3.3.5. OTHER TRANSACTION THAN SPECIFICALLY MENTIONED HAVING BEARING ON PROFITS

The legislation covers transactions involving purchase, sale or lease of tangible or intangible property, or provision of services, lending or borrowing of money and other transactions. The legislation was deliberately left quite broad to give authority a greater degree of flexibility. All possible transactions having bearing on profits are specified, which the legislature could have thought of. There could still be possibility of other. The legislature did not leave it to

chance. Such possible transaction is covered by the residuary provision, "or any other transaction having a bearing on the profits, losses, income or assets of such enterprises." Other transaction means that transaction which is not the same as one or some already mentioned. The transaction need not be *ejusdem generis* with the transaction mentioned in the preceding clause, but it must be at least analogous. The word "transaction" must take colour from the preceding clause; it must be a transaction in the nature of transfer of goods or provision of services. It must have relation or relevance to profits, income, losses or assets of the associated enterprises. Thus, the transaction covers all business operations from the formation of contract and the acts done under the contract, from the initial and necessary stage of production or producing or purchasing the goods or things to the last of selling and realising the proceeds of the sale. The operations which collectively produce income are:-

- Pre-contract preparation and management;
- The making and performance of contract of purchase;
- The making and performance of contract for sale or lease;
- The making and performance of contract for borrowing or lending;
- The making and performance of contract for provision of services; and
- Post-contract performance and management.

Even benefit is also a kind of income. In economic sense the expression "income" includes not merely what is received or what comes in by exploiting the use of the property, but also what one saves. That which can be converted into income can reasonably regarded as giving rise to income.[28]

An activity is considered to provide benefit if it directly results in an increment of the economic and commercial value that enhances the recipient's commercial position which may give rise to the income, for which the recipient is willing to pay or perform itself. An activity for providing such benefit is therefore, covered under the expression "other transactions."

Assets means any owned physical object or the right having economic value of its owner. Any transaction affecting the economic value to the owner is covered within the meaning of international transaction. Profits from the asset could arise by operation of investment or by operation of sale. In the operation of investment, income is produced while the asset

[28] CIT v. Bhogilal Laherchand, (1954) 25 ITR 50 (SC); Bhagwan Das Jain v. UOI, (1981) 128 ITR 315 (SC)

continues to belong to the taxpayer. In the operation of sale, gain is produced, which is still income, but title to the asset is parted with. Although the processes involved in the two cases are different, the gain which has resulted to the owner of the asset in each case, is the gain which has arisen from the asset.[29]

The source is the property, the operations are different; operation of investment and operation of sale. The operation of sale could be further subdivided into two categories, depending on the nature of the property and the intention of the owner. If it is held as a capital asset and sold, capital gain arises; if held as a stock in trade, trading profits arise. It is profit or income in both the events. Income, therefore means "….. The gain derived from capital, from labour, or from both combine, provided it be understood to include profit gained through a sale or conversion of a capital asset"[30]. Any transaction having a bearing on any of the components would be covered within the meaning of international transaction.

3.4. Extended Meaning

According to the second part of the definition, international transaction includes:-

- a mutual agreement or arrangement between two or more associated enterprises for
- the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred
- in connection with
- a benefit, service or facility provided or to be provided to any one or more of such enterprises.

3.4.1. Mutual Agreement Or Arrangement

Mutual Agreement or Arrangement for the mutual benefit and allocation of cost, is also deemed transaction. The words "arrangement" and "agreement" are of wide import and their meaning is not limited to something analogous to transaction. Agreement or arrangement represents understandings, and not a transaction as ordinarily understood as being some business or dealing which is carried or transacted between two or more persons. It is reciprocal to contribute to the cost or incur expenditure to the mutual advantage or to share

[29] Sevantilal Maniklal Seth v. CIT, (1968) 68 ITR 503 (SC)
[30] Eisner v. Macomber, 252 US 189

according to the agreement or arrangement. Such agreement or arrangement is not in the nature of conveying any property or provision of services or lending or borrowing and is known as cost contribution arrangement. Mutual benefit is all pervasive. A participant has beneficial interest in the property or services that are the subject of cost contribution arrangement activity and therefore, reasonable expectation of being exploited or use and to obtain a benefit is always there. Reasonable, and not the realised, expectation of the benefit is the requirement. For legal purposes expectation cannot be same as anticipation. It is different from a desire or hope, nor can it amount to a claim. The benefit may not occur and expectation realised, immediately. Business strategies and losses are to be kept in mind if the benefits are not produced over a period in which normally they would have been expected to arise. Because the contribution is to be rewarded by a share in the expected benefits to be received from the cost contribution arrangement, there is immediately no recognition of income at the time when the contribution is made. The share of the benefit may not necessarily be in shape of the income generated directly by the cost contribution arrangement activity. It could be in form of share of cost savings.

3.4.2. IN CONNECTION WITH

The expression "in connection with" implies some Nexus between the two[31]. It includes matter occurring prior to as well as subsequent upon so long as they are related to the principal thing[32]

3.4.3. BENEFIT, SERVICE OR FACILITY

The expenditure or cost incurred or to be incurred should be in connection with benefit, service or facility provided or to be provided to anyone or more of the associated enterprises. There should be a nexus between the expenditure or the cost to such benefit or service or

[31] ITP (London) Ltd. V. Winstanley, (1947) 1 All ER 177
[32] V.A. Vasumathi v. CIT, (1980) 123 ITR 94 (Ker.)

facility. Benefit means any advantage, gain or improvement in condition[33]. It is a natural advantage or profit which includes a monetary advantage or monetary profit[34]

The expression “benefit” has been defined as follows:

> *“An activity is to be considered to provide a benefit to the recipient to the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer benefits if, taking into account the facts and circumstances, and uncontrolled taxpayer in circumstances comparable to those of the recipient for be willing to pay an uncontrolled party to perform the same or similar activity on either or a fixed or contingent payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. The benefit may result to the owner of intangible if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of the intangible.”*[35]

The expression “activity” has been defined to mean “an activity includes the performance of functions, assumptions of risk, or the use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and the ability to take advantage of particularly advantageous situation or circumstances. An activity also includes making available to the recipient any property or other resources of the renderer.” Service means assistance or benefit given. The Supreme Court held in *Lucknow Development Authority v. M.K. Gupta*[36] that the term “service” has a variety of meanings and that it may mean any benefit or any act resulting in promoting interest or happiness. The furnishing of water, heat, light and power etc., are considered service[37]. It may also mean providing management and administration or technical services. Facility means absence of difficulty i.e., making it easy to function. It is the building, equipment, services, opportunity or resources provided for doing something. Thus, the agreement is to develop, produce, or obtain any assets, services or rights for the mutual advantage. The common example is a cost contribution arrangement for the joint development of intangible property where each participant obtains a share of rights in the developed property.

[33] CIT v. Kamalini Gautam Sarabhai, (1994) 208 ITR 139 (Guj.)
[34] Agra Chain Manufacturing Company v. CIT, (1978) 114 ITR 840 (All.)
[35] US State Treasury Regulation, Section 1-482-9(1)(3)(i)
[36] (1994) 80 Comp. Cas. 714
[37] Gir Prasad v. Government of UP, (1996) 87 Comp. Cas. 623

4. Associated Enterprise

Arm's length price determination is applicable to income arising from transaction between two or more associated enterprises within the meaning in Section 92A. The expression "associated enterprise" has been defined in Section 92A, as an enterprise in relation to another enterprise if any of the requisites as set out in that section is found to be existing. The expression "enterprise" has been defined in Section 92F(iii).

4.1. Enterprise

The definition of "enterprise" is very wide. It has been defined in Section 92F(iii) to mean any person who is, or has been, or is proposed to be engaged in the following activity or business which is carried on, irrespective of whether done directly or through one or more of its units or divisions or subsidiaries and irrespective of whether such units or division or subsidiary is located at the same or at the different place:-

1. Engaged in any activity relating to:-
    a. the production, storage, supply, distribution, acquisition or control of articles or goods, or
    b. know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or
    c. any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights, or
    d. the provision of services of any kind, or in carrying out any work in pursuance of a contract, or
2. Engaged in investment, or providing loan or
3. Engaged in the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate,

In common parlance the expression "enterprise" means an economic activity carried on by a person, capable of producing profits, an activity which is exercised in an independent manner, consisting of well-defined actions, and, having economic character.

It may also mean an organisation of capital and labour with a view to making profits by participating in the market activities. Thus, an enterprise may mean an activity for the exchange of goods or services and also an organisation of capital and labour with a view to making profits. It has the following features: –

- The activity must be exercised in an independent manner;
- It must consist of repetition of well-defined actions;
- It must have an economic character

The term "enterprise" includes any form of undertaking whether carried on by an individual, partnership, corporation or any other entity. It has no exact counterpart in the taxing code[38]. A transaction entered into for business or commercial purposes is an enterprise. Enterprise and business have identical meaning. Thus, an enterprise may mean an activity and also an organisation.

Section 92F(iii) defines "enterprise" as a person. It then defines "person" and he who is engaged in an activity or business, and then defines "activity" and "business". Activity relates to:

i. tangible goods
ii. business or commercial rights
iii. intangible goods
iv. provision of services
v. investment or providing loan

The "business" relates to the business of acquiring, holding, underwriting or dealing with shares, debentures or other securities of any other body corporate. The emphasis is on the person carrying on the said activity or business. It is irrespective of whether it is carried on: –

- directly, or
- to one or more of its units or divisions or subsidiaries, or

[38] Theil v. Commissioner of Taxation, (1990) 90 ATC 4717

- whether such unit or division or subsidiary is located at the same place where the enterprise is located or at a different place or places.

Under Section 92F(iii), “enterprise”, thus, means a “person who is engaged in” any activity “relating to” the defined activities.

4.2. ASSOCIATED ENTERPRISE

The term “associated enterprise” has been defined in the Income Tax Act 1961[39]. Associated enterprises are those which are owned or controlled by the same or common interest. It includes any kind of control, direct or indirect; exercised or exercisable. The associated enterprises form a group, the courts may refer to as “sufficient common connection” and “community of interest and other common links among the shareholders evidenced by voting trust, shareholder agreement, and, impliedly if not explicitly, by close family relationships.[40]”

The arm’s length principle deals with the enterprises which are factually separate but commonly managed or controlled or in some way related. The expression has been in Section 92A; with reference to when the enterprises are commonly managed or controlled and also with reference to when they are in some way associated. Sub-section (1) deals with the one and sub-section (2) deals with another. Sub-section (1) defines it restrictively. It has, first to be an enterprise in the sense already discussed above. In relation to another enterprise it is taken to be an associated enterprise when it itself participates, directly or indirectly in the management or control of capital of that other enterprise, or the person so participates in respect of the both the enterprises. It means that the enterprises are associated if they are owned or controlled by the same interest.

A party is related to an entity if the party controls, or is controlled by, the entity or both under the common control of a third party or has an interest that gives significant influence over the entity.” Control” means the power to govern financial and operating policies of an economic activity so as to obtain benefits out of it, and “significant influence” is the power to

[39] Section 92A

[40] Express Cable Television Ltd. V. MNR, 82 DTC 1431 (TRB)

participate in the financial and operating decisions of an entity, but not having control over those policies[41].

Control is acquired where and enterprise gains the ability to affect the strategy decisions of another. It shall be constituted by rights or contracts or any other means which confer decisive influence on decisions of the enterprise or the possibility of exercising this decisive influence by ownership or the rights to use all or part of assets of the enterprise. The one is controlled over the management. The other is control over assets. Economic dependence be some time lead to control on a *de-facto* basis there, for example, very long-term supply agreements or credits provided by supplier or customer, coupled with structural links, confer decisive influence. An example of a link of a structural nature is provided in Flat Glass case[42] as where two or more independent undertakings jointly have, through agreements or licences, a technological lead affording them the power to behave to an appreciable extent independently of their competitors, their consumers and ultimately of their customers. In that case it was also held that two or more independent economic entities from being, on a specific market, united by such economic links that, by virtue of that fact, together they hold a dominant position *vis-à-vis* the other operators on the same market, it is the link between the parties that facilitate collusion, tacit or explicit, between them. It does not matter whether the links are purely economic and provided by the market structures or structural provided by contracts or licences between the undertakings or by shareholdings which one of the undertaking has in the other.[43]

For enterprise to be said associated, some kind of special relationship must exist to associate one with the other. The concept of special relationship between the entities is broadly defined, including situations ranging from statutory to economic dependency, and also certain family relations. The first part of the definition speaks about the “control” as an “owner”, and the second part, about the “influence” because of the economic or family or other relationship. The “control” and the “influence” have impact on transfer pricing.

Section 92A consists of two subsections. Subsection (1) deals with the situation when one enterprise controls or is controlled by another, directly or indirectly; and subsection (2) when there is no much control by one over the other, but there is a relationship of indirect ownership or of mutual interest between the two. In the first case interest in the business of

[41] International Accounting Standard 31
[42] (1992) ECR II-1403, (1992) 5 CMLR 302
[43] Gencor Limited v. Commission, (1999) 4 CMLR 971

the other is reflected by the controlled as an owner, while the second, by relationship of mutual interest, other than ownership. One endures over a period of years, while the other fluctuates from year to year, depending on the existence or nonexistence of the circumstances mentioned therein.

Associated enterprises are thus those who are under the control of the same interest. Control for the purpose may be any kind, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. It is the reality of control that matters and not the form how it is exercised.

4.2.1. ENTERPRISES DEEMED ASSOCIATED EVEN IF THEY ARE NOT ASSOCIATED WHEN TRANSACTION EXECUTED

Enterprises are deemed to be associated if any of the circumstances provided under Section 92A suggests control obtained during the previous year. A question arises whether when a transaction is formulated during a previous year when such a circumstance exist but executed in another year when it no longer exists, enterprises could be treated associated. The answer is yes. The requisite control should be measured when the controlling entities are dealing with each other. All that is necessary is that the control exists when the parties irrevocably bind themselves to a transaction, even though the party's execution of the agreement terms may occur when control no longer exists.[44]

4.2.2. SPECIAL RELATIONSHIP UNDER DEEMING PROVISION OF SECTION 92A (2)

"Control" for the purpose of transfer pricing law is not confined to the situations where one party is the majority shareholder in the another. It would also mean where one party has the power to ensure that the affairs of another party are conducted in accordance with the first party wish. When one enterprise could, directly or indirectly, influence the conduct of affairs

[44] DHL Corporation v. Commissioner (T.C. Memo 1998-461)

of the other without any stock ownership, because of certain special specified relationship substituting between them, they are deemed to be associated.

Control may, therefore mean any kind of control, direct or indirect, exercised or exercisable. In determining whether entities are commonly controlled, the courts look to the "reality of control" rather than just to the actual control[45]. It is the reality of the control which is decisive, not its form or the mode of its exercise. Tax consequences must turn upon the economic substance of the transaction and not upon the time sequences or form of the transaction. Further when the interest controlling one entity and those controlling another have a common interest of shifting income from the former to the later, entities may be considered commonly controlled. This is especially true where one entity deals with another on the arm's-length basis.[46]

The existence of control as defined is a factual issue that depends on the circumstance of each individual, though even 49% ownership is not equal to control.[47]

Subsection (2) of Section 92A deems to enterprises to be associated if there exists between them some kind of economic, executive, financial or business relationship or there is some kind of mutual interest. By virtue of such relationship or interest, an enterprise has the ability to exercise significant influence over the other enterprise in its financial or operating decisions. The relationship between the associated enterprises is of "dependency" which can be either because of direct control of the capital or voting rights or *de-facto* control, i.e., indirect control such as to, management. De facto control results from commercial relationship. The special relationship of "dependency" may exist when the activities of one substantially depends on industrial or intellectual property rights or know-how owned or granted by the other; the source of raw materials or access of sales outlets for one substantially depends upon the other; substantial part of the activity of one can be performed with the other or depends on decisions taken by the other; prices are determined by the other; terms and conditions of commercial or juridicial relation have the effect that one can influence the management decision of the other. The 13 specified situations can broadly be grouped into –

[45] Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951)
[46] Supra 44
[47] R.T. French Co. v. Commissioner, (1973) 60 T.C. 836

1. **Controlling interest – Indirect ownership –** situation when one enterprise holds not less than 26% of the voting power in the other enterprise[48], or a third enterprise so holds in both the companies.[49]
2. **Management and Executive decisions – Influencing –** situation when one enterprise is able to influence the management and executive decisions of significance of the other enterprise –
    - When more than 50% of the directors of an enterprise are appointed by another enterprise[50] or of both enterprises by a common entity[51].
    - When not less than 10% of the interest in an enterprise which is a firm or association of persons or a body of individuals is held by another enterprise[52].
3. **Financial or operating transaction – significant influence –** situations which would enable to exercise significant influence in the financial or operating policy decisions of the other enterprise but not control of those policies, such as where –
    - A considerable proportion of an enterprise computing transactions is with other enterprise.[53]
    - A considerable proportion of the company's outstanding loans which are necessary for the enterprise operations have been borrowed from or guaranteed by the other enterprise.[54]
4. **Family control –** situations where one enterprise is controlled by an individual and the other by his relative.[55]
5. **Mutual interest –** relationship where there is a relationship of mutual interest other than mentioned above, as may be prescribed[56]

[48] Section 92A(2)(a)
[49] Section 92A(2)(b)
[50] Section 92A(2)(e)
[51] Section 92A(2)(f)
[52] Section 92A(2)(l)
[53] Section 92A(2)(g)(h)(i)
[54] Section 92A(2)(c)(d)
[55] Section 92A(2) (j)(k)
[56] Section 92A(2)(m)

5. ARM'S LENGTH PRICE

5.1. INTRODUCTION

The Indian transfer pricing rules, before the amendment of law with effect from 1 April 2002, were somewhat generalised inform and offered several loopholes for avoidance. Section 92 of the Income Tax Act, 1961, provided computation of income often assessee from transactions with non-residents, there are businesses carried out with him and non-resident and it appears to the Assessing Officer that, owing to the close connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profit which might be expected to arise in the business. This provision has now been substituted by the Finance Act, 2001, effective from 1st April, 2002. The new provisions provides for the computation from international transaction having regard to arm's-length price. The expression is associated enterprises, international transaction and's length price having separately defined in section 92A, 92B, 92F.

5.2. ARM'S LENGTH PRICE – OLD PROVISION

Section 92, before the amendment, provided that where the business is carried on between a resident and a non-resident and it appears to the Assessing Officer that owing to the close connection between the, the course of the business is so arranged that the business transacted between them produces to the resident either no profits or less than the ordinary profit which might be expected to arise in the business, the officer shall determine the amount of profits which might reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident.

That section consisted of two lives. The first, prescribed the condition on which the charge arises, viz, there should be a business as carried on between the resident and the non-resident, the course of which is so arranged so as to produce no profits or produce less than the expected profits. Such arrangement has been made possible because of the close connection

between them and this arrangement may be responsible for no profits or reduce profits in the opinion of the Assessing Officer. The second them imposing the charge, empowering the officer to determine and the amount of profits which might reasonably be deemed to have been derived therefrom and then include such amount in the total income of the resident assessee. The expression "profits" in the chat a part of the enactment is associated with the words "which may reasonably be deemed to have been derived and this association has its origin in the preceding clause "produces to the resident the profits or than the ordinary profit is which might be expected to arise in the business". The word "therefrom" has reference to the business and it is this business, therefore, that is subject to charge under the old section 92. It has no reference to the arrangement between the non-resident and the resident, as it is impossible to conceive how arrangement relating to the conduct of business can, as such, be the subject matter of income tax court from the business in which the profits and gains are made.[57] Two classes of are contemplated; one that the business of the resident produces no profits and the other parent produces less than the ordinary profit is. The charges imposed in both of these classes of cases. Both relate to the business of the resident.

The ingredients of the old section 92 are: –

If it appears to the Assessing Officer that:

- Where business is carried on between the resident and the non-resident and it is,
- Course is so arranged, owing to the close connection between them, that
- Business transacted between them,
- produces to the resident either
- No profit or
- Less than the ordinary profits, then

The Assessing Officer shall determine

- the amount of profits which might reasonably be deemed to have been derived therefrom and
- include such amount in the total income of the resident

[57] Mazgaon Dock Ltd. Vs. CIT (1958) 24 ITR 368 (SC)

The section, therefore, empower the tax authorities to ascertain whether the relationship between the two enterprises has diverted the course of carrying on the business or profession from the normal course as to prevent accruing at all of the ordinary profits.

5.3. ARM'S LENGTH PRICE – NEW PROVISIONS

The transfer pricing rules under the old section 92 but somewhat generalised and, therefore, vague and rarely applied. The new provision are comprehensive and provides for computation of income from international transactions having regards to the arm's length price and not confine to the business transactions. The word "business transacted between them produces to the resident either no profits or less than the ordinary profits" in that section can be taxed the resident must be carrying on business or profession the income of which is taxable in its hands, and the commercial transactions between the and the non-resident are controlled or managed in such a manner so as to cause variations in the profits of the resident which would not have been possible had these two being not thus associated. Commercial or financial relations between the two as such cannot be the subject matter of the income tax, apart from the business or profession in which the profits and gains in order to meet. Section 92 now covers commercial or financial transactions are transactions, or close which are in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing of money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises. Utility mat or an arrangement between two or more associated enterprises for the location or apportioned of any expense incurred is also covered.[58]

The new section provides that income arising from an international transaction shall be computed having regards the arm's length price. In doing so alone is foreign expense on interest shall also be determined on the same principle. That principle is also to be applied in allocating apportioning the cost or expenses incurred by two or more associated enterprises that have entered into a mutual agreement or arrangement for allocation or apportionment, in relation to the international transaction. The arm's-length principle pervades. The trading arrangement and pricing policies under which multinational enterprises operate can result in prices and terms considerably different from those would have been between the unrelated parties engaged in the same or similar transaction. The pricing terms between the unrelated

[58] Section 92B

parties is referred to as arm's length. The arm's-length principle is applied international transaction by placing the actual terms and prices under which a transaction was done with the arm's-length terms and prices and re-computing for tax purposes the profits accordingly. Thus the principle with regard to which the following determination is to be done is the principle of the arm's-length price: –

1. Computation of income arising from an international transaction;
2. Allowance for any expenditure on interest in the above computation;
3. Allocation or apportionment of any cost or expense incurred by two or more associated enterprises, in relation to the international transaction.

The concept arm's length principle as postulated in article 7 of the OECD model Convention as between permanent establishment and headquarters is contained in article 9 in relation to enterprises which are factually separate but in some way associated. Article 9 anticipates circumstances may, due to financial relationship between the enterprises in the two states may not take place on an arm's-length basis. Arm's length transaction is an open market transaction which means that transaction between the unrelated parties. The implication of that concept is that taxable profits in a jurisdiction may be adjusted to a level which reflects that which would have been the market price. The authoritative statement of the arm's-length principle is found in the OECD model tax Convention, which provides:

> *"when conditions are made or imposed between associated enterprises in the commercial or financial relations which differ from those which would make between independently enterprises, then profits which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so, meaning included in the profits of the enterprise and taxed accordingly."*[59]

5.4. ARM'S LENGTH PRINCIPLE – MEANING

The arm's-length principle may be that in the case of an enterprise which is an associated enterprise of another enterprise "conditions are made or imposed between them in their

[59] Para 1 Article 9 of OECD Model Tax Convention

commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which will, but for those conditions, have not approved, may be included in the profits of that enterprise and taxed accordingly". Associated enterprise in relation to another enterprise means an enterprise which participates directly or indirectly in the management, control of capital of the other enterprise, of the same persons so participate in respect of both. Thus, the associated enterprise are owned or controlled by the same of common interest which includes any kind of control, direct or indirect, exercised or exercisable. It is the reality of control which is decisive, not its form or the mode of its exercise. If income or deduction is arbitrarily shifted, the control is presumed. Parties are regarded not dealing at arm's length if they are effectively controlled from the same source or the same person.[60] The application of this principle to or transaction between the two enterprises, requires the following to be known,

- Whether one enterprise participates in the other on the same persons do in both, in the manner as indicated above which indirectly means whether both the enterprises are under common control, and if the answer is yes, then,
- Whether because of such relationship conditions and made or imposed between the two enterprises in their commercial or financial relations and, which differ from those which would be made between independent enterprises.

If the answer to the second question is also in affirmative, then,

- Any profits which would, but for those conditions, have not so who may be included in the profits of that enterprise; and
- Taxed accordingly

The arm's-length principle deals with the enterprises which are factually separate but commonly managed or controlled or in some way associated. It enables the Assessing Officer to rewrite the accounts of the assessee enterprises, as a result of the special relations between it and other enterprise; the accounts do not show the true taxable profits. In so doing, he can apply the principle of arm's length pricing. Thus, the arm's-length principle eliminates the effect on the profits, of the special conditions imposed by reason of the close relationship of the enterprise.

[60] Robson Leather Company Ltd. Vs. MNR 77 DTC 5106

5.5. ARM'S LENGTH PRINCIPLE – APPLICATION REQUIRES COMPARISON OF CONDITIONS AND TRANSACTIONS

The general theory of law of transfer pricing is to treat each of the individual members of a commonly controlled group as a separate entity, transaction between them are taxable events to be conformed to the economic realities that would obtain between independent economic entities conducting the identical transaction at arm's length.[61]

The arm's-length principle operates on a hypothesis that associated enterprises are independent of each other in their commercial and financial relations and their transactions between them are to be free from any conditions which could be imposed because of such relationship. Profits from transactions, if they are dictated, have to be worked out by reference the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances. Comparison of the conditions in a controlled transaction with the conditions in the uncontrolled transactions between independent enterprises is required to be made, to find out whether there is a difference. They relate to: –

1. The price of the goods are transferred or services provided; and
2. The conditions of the transfer or the provision.

If there is a difference with regards to any of the two and consequently in the price of the margin of profit, profits are to be adjusted.

Thus, the application of the principle of arm's length requires comparison of conditions in a controlled action with the conditions in an uncontrolled transaction for any defence between the two situations, and adjustment of profits to offset the effect of any such difference. To be comparable means –

- That none of the differences between the two situations could materially affect the conditions being examined in the methodology or
- That reasonable adjustment can be made to offset the effect of such differences, if any.

[61] Commissioner vs. First Sec. Bank [72.1 USTC 9292A, 405 US 394, 400(1972)]

Whether there is comparability between the two situations compared, one has to look for the differences. Comparability exists, if there is none, and achieved if eliminated by way of adjustment to offset the effect.

5.6. ARM'S LENGTH PRICE – AS DEFINED UNDER THE INCOME TAX ACT, 1961

An arm's length price is the price that and unrelated party would have paid under the same circumstances for the property or service involved in the control seen. Since unrelated parties normally sell products at a profit, and arm's-length price normally involves a profit to the seller. The expression "arm's length price" has been defined in section 92F to mean a price which is applied on proposed to be applied in a transaction between persons other than the associated enterprises, in uncontrolled condition. The expression "associated enterprise" has been separately defined in section 92A, exhaustively and also inclusively. Transactions between enterprises under the same of common control may not necessarily be governed by the open market considerations. Thus, the transactions between associated enterprises may take place under conditions differing from those taking place between independent enterprises and the prices of such transactions between associated enterprises should, nevertheless, for tax purposes, be in conformity with those which would be charged between independent enterprises usually referred to as arm's length pricing. The prices paid for the transactions between such enterprises, called transfer price, made us the fixed in order to meet the convenience of the multinational enterprise or a group as a whole and may in consequence be done in a variety of ways which would not be possible if the parties to the transaction is but independent persons acting at arm's length. The group convenience may be a matter of arranging the direction of cash flow or a matter of minimising total tax burden. Whatever the reason for fixing a transfer price which is not at arm's length price, the result is that the profit is, which would have accrued to a member of group would not accrue. The country where that member is located abroad, thereby, has a lower base for the taxation.

5.7. ARM'S LENGTH TRANSACTION – MEANING

Arm's length price is the price applies to a transaction between the persons other than the associated enterprises. Such transaction is called arm's length transaction. It means a transaction as though between independent and unrelated persons, complicated and straightforward, involving no favouritism or irregularity without any consideration other than commercial. A buyer or sellers free to act in seeking his own best economic interest and agreeing on a price, are said to have an arm's length relationship. Transactions between the affiliated companies are not ordinarily recorded as being arm's length even though expressed in terms of market value. Transactions between enterprises under the same common control may not be governed by open market considerations. A transfer price which is the prices paid for the transaction may be fixed. Its essence is that the pricing is not set by an independent transferor and transferee in an arm's length transaction. It is within the discretion of the single enterprise.

The test of arm's length transaction would now come to, whether uncontrolled taxpayer exercising sound business judgement would have agreed to the same terms given the actual circumstances under which controlled taxpayer is dealt. For example, the taxpayer would have to take into consideration such factors as whether an independent party would provide a discount because it hoped to establish a long-term relationship with a high-volume custom.

In *Sundstrand Corporation vs. Commissioner*,[62] the US Court considered a case where Sundstrand, a market leader in the US in the manufacture and sale of constant speed drive, selected Singapore in 1974 as a foreign location for the manufacture of CSD. Industrial property rights needed to manufacture CSD spare parts were licensed to a Singapore subsidiary called Sun Pac. Sun Pac was also given certain nonexclusive sales rights for the CSD spare parts manufactured under license. A 2% royalty based on net selling price was being able under the license. Later a technical assistance fee was added to the license. The parties also concluded a distribution agreement under which Sundstrand acted as a distributor of the spare parts manufactured by Sun Pac for a 15% discount of Sun Pac's catalogue price. Among the issues raised before the court was the contention of the IRS that Sun Pac should be treated as a "contract manufacturer" for Sundstrand and thereby entitled to a much reduced return similar to a subcontractor in the same industry. In rejecting the IRS contention, the

[62] 96 TC No. 12 (1991)

court found that Sun Pac had, at best certain expectations as to say is what you and prices not amounting to guarantee to insulate it from market risks. Accordingly, it was more than a mere subcontractor and was entitled to earn an entrepreneurial return for the functions performed and risks one, in assessing whether the 15% owned by Sundstrand made the arm's length standard, the court rejected several comparable given by both the parties and eventually decided on a 20% discount, effectively "splitting the difference" between the parties. In rejecting the IRS contention the court relied heavily on the decision in *Bausch & Lomb Inc. vs. Commissioner.*[63] In that case the court had rejected a similar contention because it required "a degree of economic sophistication which appears reasonable in theory, but which defies qualification in practice."

In *Indalex Ltd vs. the Queen*;[64] in case a taxpayer ordered aluminium from a Bermuda company. The company forwarded the information to a related company which supplied the product to the taxpayer directly. The company retained volume discounts available from falling the purchase of several groups and charged the Canadian company the undiscounted invoice price as on arm's-length price. It was held that the price charged to the plaintiff was not on arm's-length price and concluded that the Bermuda Company bought nothing for its own account, contributed nothing in the way of financial or administrative advantage and did not provide any value deserving compensation. Therefore the discount was not attributable to the company's activities and was relocated to Canada. The court reorganised and recognised that the Bermuda Company could not justify the income it on by the functions it performed or the capital it employed.

Transfer price is considered as a vehicle for the evasion or avoidance of tax. For that matter the concept is extended to income splitting, transaction splitting, inserting steps or transactions through the means of associated enterprises, with no economic and commercial purposes. The economic substance of transaction may differ from its form. Transactions may be concluded which are not normally done between unrelated parties. Contracts may be ordered, suspended or extended, sometimes even retroactively. In all these, underlying reality has to be determined in applying the arm's-length principle

[63] 92 TC No. 525 (1989)
[64] 88 DTC 6053

5.8. INCOME SPLITTING OR TAX FRAGMENTATION

Multinational Enterprises operate in a number of countries. So that the combined tax effect on their income should be minimal, they resort to devices known as income splitting or tax fragmentation.

Income Splitting consists of dividing one composite contract into number of separate contracts which may be spread over a number of countries in such a manner that the bulk of the profits arise in low-tax a rate country. This is usually practiced in a contracting business. The profit is assessable in the country where such contract is undertaken whilst the sale of equipment supplied as part of contract arises in another country. A contract for work may involve sale of goods if there is an independent term in the said contract for sale of any specific goods. This is possible where not only work is to be done, but the execution of work requires material to be used. Thus, the execution of work is performed in one country and the sale of goods require for such execution, in the other. The contract agreed upon is thus divisible. The composite contract by arrangement is split up into many constitutes mainly two, one for sale of goods and other for work and labour. The term income splitting is adopted to distinguish the practice from transfer pricing

5.8.1. INCOME SPLITTING – CONTRACT FOR WORK OR SUPPLY OF GOODS

Where not only work is to be done but the execution of such work requires material to be used, may take one of the three forms.

1. The contract may be for the work to be done for remuneration and for supply of material used in the execution of work for a price.
2. It may be contract for work in which the use of materials is accessory or incidental to the execution of work.
3. It may be a contract for supply of goods where some but is required to be done as incidental to sale.

A transaction may be split up into a series of such transactions so that each may be looked upon as an independent source of income; though the entire series is nothing but in substance constitutes one composite transaction. By fragmenting the transaction, income is also fragmented so as to appear arising in different jurisdictions. Till recently such arrangement would have been permissible, as a person is master of his own affairs who could arrange them in a manner most suitable and beneficial to him.

The doctrine that every man is entitled, if he can, to order his affairs so that the tax attracted under the appropriate Act is less than it would otherwise be, as pronounced by Lord Tomlin in IRC v. Duke of Westminster[65] and as followed in India in CIT v. A. Raman & Co.[66] and some other cases, has long back been given a befitting burial in W.T. Ramsay Ltd. vs. IRC[67], IRC v. Burmah Oil Co. Ltd.[68] and McDowell and Co. Ltd v. CTO[69]. In India Justice Desai of Gujarat High Court recorded a sign of departure from this principle, in Wood Polymer Ltd., In re[70] by refusing to accord sanction to the amalgamation of companies as that would lead to avoidance of tax. The departure was completed by the Supreme Court in the case of McDowell & Co. Ltd.[71]

5.8.2. RAMSAY PRINCIPLE

Tax fragmentation involves breaking one composite transaction into separate constituent parts or inserting self-cancelling transactions, spreading them and consequently incomes if arising in a number of countries, so that each constituent is subjected to different tax treatment. The sum total of all is considerably less than what would have been the tax consequence had the transaction been taken as composite one whole in one country. This is based on the principle as stated in W.T. Ramsay v. IRC[72], known as Ramsay Principle. The principle lays down that while the court is obliged to accept documents or transactions found to be genuine, as such, it does not compel the court to look at the document or transaction in blinkers, isolated from the context to which it properly belongs. If it can be seen that a

[65] (1936) AC 1
[66] (1968) 67 ITR 11 (SC)
[67] (1981) 1 All ER 865
[68] (1982) STC 30
[69] (1985) 154 ITR 148 (SC)
[70] (1977) 109 ITR 177 (Guj.)
[71] Supra
[72] (1982) AC 300

document or a transaction was intended to have effect as a part of the nexus or series of transactions, or as an ingredient of wider transaction intended as a whole, there is nothing in the Westminster Doctrine, to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or a combination of transactions, intended to operate as such, it is that series or combination which may be regarded as a whole.

Lord Brightman in Furniss v. Dawson[73] stated that the formulation of Lord Diplock in Burmah Oil Co. Ltd.[74] expresses the limitation of the Ramsay Principle. First, there must be pre-ordained series of transaction; or, if one likes one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. Secondly, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax, “no business effect”. If these two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court may then look at the end result. Precisely how the end result would be taxed will depend on the terms of the taxing statute sought to be applied. Thus for rejecting a device aimed at saving the tax, formulation of law veers around two concepts:

- First, there should be pre-ordained series of transaction i.e., one single composite transaction;
- Second, there must be inserted steps which have no commercial purpose apart from the avoidance of tax liability.

5.8.3. MEANING OF “PREORDAINED SERIES OF TRANSACTION”:

The expression “Pre-ordained Series of Transaction” has been subject-matter of discussion in three English Cases viz. Baylis v. Gregory[75], IRC v. Bowater Property Developments Ltd. and Craven v. White. Slade LJ said:-

“I conclude that two successive transactions, each of which have legal effects are not properly to be regarded as a pre-ordained series or a single composite transaction within the

[73] (1984) AC 474 (HL)
[74] Supra
[75] (1987) STC 297 (CA)

meaning of First Ramsay condition as stated by the House of Lords unless, at the time when the first transaction was effected, all essential features (not merely the general nature) of the second transaction had already been determined by a person or persons who had the firm intention and for practical purposes the liability to procure the implementation of second transaction."

Thus, the expression "preordained series of transactions" contemplates that the person has in contemplation the sequence of transactions when he takes the first steps, to follow that step with intention of saving tax. If there is no planning without the next step being arranged or the next step was expected but did not in fact materialize or the next step was one and probably more likely of the two possible outcomes that the subsequent steps cannot be said to be preordained series of transactions. What is required is to be proved that at the time of the First Transaction it was intended by the taxpayer that the first transaction is used as conveyancing machinery in order to achieve the final object of saving tax. One cannot have composite transactions unless the second part has been pre-arranged or pre-ordained at the time of the first. In Ramsay and Dawson the reasoning had been that there is no difference between series of steps which are followed through as part of an arrangement which falls short of a contract and a series which are carried out under a contract. By the same reasoning a quasi-contract in the absence of one of the parties being identified cannot be said to be an arrangement through a contract. If there is an uncertainty and difficulty in practice about the next step, it is very difficult to tax the income at first stage on the basis that second stage is bound to happen. The court of Appeal in the aforesaid decisions, therefore, pointed out that preordained series of transaction or a single composite transaction cannot be taken to be the one where the next step has not been arranged or has not in-fact materialized or the next step is one and probably the more likely of the two possible outcomes.

5.9. TAX AVOIDANCE

Tax avoidance occurs when the taxpayer takes advantage of a provision of law, the formulation of which is obscure or incomplete or very complex so that he can reduce or avoid his liability while remaining within the limits of law. If, however the taxpayer is acting against the will of legislature even if he remains within the literal interpretation of law, he can be said avoiding the tax. The revenue authorities cannot brush aside any and every attempt at

saving the tax if an attempt is sanctioned or hold the assessee guilty of avoidance when the saving is the result of series of steps which at the time of taking the first step could not be in contemplation of or devised by the assessee.

5.9.1. CIRCUMSTANCES UNDER WHICH TAX AVOIDANCE IS INFERRED:

- Only under the following circumstances tax avoidance can be inferred:-
- There is no economic or other significant reason which could justify the transaction;
- The existence of the intent to avoid tax can be clearly established;
- Acts leading to its occurrence are unusual or artificial and give rise to situation where the letter of the tax regulation does not apply but differs so little from a situation provided for under the regulations that the purpose and the spirit of the regulations would be frustrated if it were to be declared inapplicable.

5.9.2. TAX AVOIDANCE IS PRESUMED IF NO VALID BUSINESS PURPOSE:

Tax avoidance is presumed to be intended if there is no valid business purpose. For example in National Securities Corp. v. Commissioner[76], transaction was disregarded (non-recognition transaction) which involved transfer of stock from parent to subsidiary followed by the subsidiary's sale of stock and realization of a loss that had substantially more favorable tax consequence for the subsidiary than for the parent. In Northwestern National Bank v. United States[77], transfer of appreciated property was followed by donation to charity under preconceived plan to make the contribution through the parent for tax reason, was not recognized. In another case transaction involving distribution of Treasury Bonds as dividends to parents in effort to obtain more favorable tax treatment or gain was not recognized.[78] Any presumption that the transfer was designed merely to obtain more favorable tax treatment of a planned disposal of the assets by the controlled group can be eliminated if the transferred assets is used rather than disposed of.[79] The US Tax Court in Eli Lilly rejected the

[76] 137 F.2d 600 (3rd Cir.) (1943)
[77] 556 F.2d 889 (8th Cir.) (1977)
[78] Southern Bancorporation v. Commissioner; 67 T. C. 1022 (1977)
[79] See Bank of America v. United States; 79-1 U.S. TC (CCH) 9170 (N.D. Cal. 1979; Eli Lilly & Co. v. Commissioner 84 T.C. 996 at 1123-24 (1985)

Commissioner's view that exchange of manufacturing intangibles by the parent to the subsidiary for stock was entirely voidable and that the subsidiary ownership of the intangibles should be disregarded for purposes of allocating income under Section 482.

5.9.3. TEST FOR BUSINESS PURPOSE – LIMITATIONS:

The proposition cannot be accepted in its entirety that transaction may be disregarded for tax purposes solely on the basis that it was entered into without any bonafide business purposes. A strict business purpose test in certain circumstances would run counter to the apparent legislative intent which in the modern taxing statutes may have dual aspect. Income-tax legislation is no longer a devise to raise revenue to meet the cost of governing community. It is also employed to attain economic policies. The economic policy element of the Act sometimes takes the form of an inducement to a taxpayer to undertake by or redirect a specific activity. Without the inducement, the activity may not be undertaken by the taxpayer for whom the induced action would be otherwise having no bonafide business purpose. Thus, by imposing a positive requirement that there be such a bonafide business purpose, the taxpayer might be barred from undertaking the very activity Legislative wishes to encourage. At minimum, a business purpose requirement might inhibit the taxpayer from undertaking a specific activity which the Parliament has invited in order to attain economic and social policy goals. Indeed where the Parliament is successful and the taxpayer is induced to act in a certain manner by virtue of the incentives prescribed by the legislation, it is at least arguable that the taxpayer was attracted to this incentive for business purpose of reducing his cash outlay for taxes to conserve his resources for other business activity. The tax authorities may presume that tax avoidance was intended if the taxpayer chooses to carry out the transaction which may be regarded an unusual.

5.10. THE LOOK THROUGH DOCTRINE AND INTERPRETATION OF SECTION 9 OF THE ACT AS LAID DOWN BY THE VODAFONE CASE

The Hon'ble Court while interpreting the section 9 of the Income Tax Act, 1961 mentioned that it was not a "look through" provision so as to cover the indirect transfers of the capital assets situated in India.

The crux of the issue was whether the deeming provisions of section 9(1)(*i*) triggering capital gains taxation for non-residents is a 'look through' provision, so as to cover indirect transfer of capital assets situated in India.

The Judgment held that the essential condition for triggering capital gains taxation under the source rules is that the capital asset must be situated in India. Accordingly, the charge of capital gains requires the existence of all the three essential elements, (*i*) transfer, (*ii*) existence of a capital asset, and (iii) situation of such asset in India. If the term 'indirect' is also read into the provision, it would render the above requirement nugatory. The judgment further held that the word 'directly or indirectly' would go only with the term 'income' and not with the term 'transfer of capital asset'. Further, it has also been observed that as the proposed Direct Taxes Code 2009 and 2010 expressly provided for taxation of indirect transfers, the existing provisions in the Act does not cover such situations. It was, accordingly, held that the question of providing a 'look through' or 'limitation of benefits' provision in the Act or in the tax treaty, is a matter of policy, and needs to be expressly provided by way of a specific legislation.

The judgment in this manner lays down various cardinal principles of interpretations of taxing statutes that might impact the tax jurisprudence of the nation deeply. Perhaps most importantly, the judgment lays down the cardinal rule on how to interpret transactions for tax purposes, *i.e.* , one has to "look at" a transaction, rather than "look through" it. A balance, however, appears to have been struck, with the Court observing that the tax authorities could invoke the "substance over form" principle or pierce the corporate veil, but only if they were able to establish that the transaction was a sham or a tax avoidant. This test will undoubtedly have far reaching ramifications and may apply to several other controversies. The Court has unanimously rejected the contention of the tax authorities that section 9(1) (*i*) must be given a purposive interpretation so as to include within its ambit indirect transfers of assets in India.

This is a very positive finding and will have a significant impact on several other similar cases that are currently at various levels of litigation.

On one hand the judgment is brought under questions for giving restrictive interpretation by excluding the 'indirect transfers, it is also appreciated to facilitate the certainty in law especially regarding the scope of taxing statutes. In its judgment, the Court specifically talked about the importance of certainty in tax policy from an investor's point of view and observed that it was for the Government to incorporate doctrines like "limitation of benefits" and "look through" by appropriate legislative action to avoid disputes. This is similar to the approach adopted by other countries.

Similar transactions have been sought to be taxed in other countries, though by legislative diktat, rather than judicial process. China, Indonesia, Peru, Australia are among the countries who have specifically made changes in law to deal with such issues. Interestingly, while India too has proposed a legislative change under the Direct Taxes Code to bring similar transactions to tax in India, the Indian approach is significantly wider in scope than those followed in other countries, who have sought to limit the applicability of such provisions to cases of tax avoidance, or transfer of real property interests. The phrase "directly or indirectly" used in section 9(1)(*i*) is associated with or qualifies the word "income" which may accrue or arise in India, or which may be deemed to have accrued or arisen in India and not with the word "transfer". Therefore, even if there may be an indirect transfer of capital assets in India, capital gains therefrom cannot be taxed in India.

5.11. COMPUTATION OF ARM'S LENGTH PRICE

The arm's length price shall be determined by any of the method specified in Section 92C, being the most appropriate method. Where an assessee has entered into various types of International Transactions with associated enterprises, arm's length price should be determined on a transaction-by-transaction basis and not an aggregate basis.[80]

Arm's length price can be computed by the following methods:

a) Comparable Uncontrolled Price Method

[80] Development Consultants (P.) Ltd. Vs CIT (2008) 23 SOT 455 (Kol.)

b) Resale Price method
c) Cost Plus Method
d) Transactional Net Margin Method
e) Such other Method as may be prescribed by the Board.

Section 92C of the income tax act empowers the revenue authorities to substitute arm's length price for the one actually used and, as a result, to amend the profit be able tax. Arm's length price is the price that and unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Section 92C prescribes and rule 10B of the income tax rules describes methods that may be used to determine an arm's length price: the comparable uncontrolled price method, the resale price method and the cost plus method, profit split method, transactional net marginal method. The standard for applying is that often assessee dealing at arm's length with an uncontrolled taxpayer, that is, what the later would have realised if he were engaged in the same transaction under the same circumstances. Since absolute identity between the transactions is unlikely, the arm's-length result is obtained if they are sufficiently similar. To obtain that similarity, the material differences between the compared and comparable transactions are adjusted, which have effect on the prices of the profits. Rule 10B prescribes the methodology for the purpose of comparability.

Taxpayer's income is adjusted if –

- the parties involved in the transaction unrelated;
- there is income production compared to what the situation had been had the parties not been related;
- the income reduction has occurred as a consequence of the relationship between the parties

Section 92C has set of the methods in respect of different kinds of transaction, to determine compatibility and, in order to enhance it, to make adjustments for the material differences so that the compared transactions become comparable. All factors that could affect prices or profits are taken into consideration by evaluating the comparability of transactions and comparability of circumstances. Some factors are, however more relevant to a particular method.

5.11.1. METHODS

The application of the arm's-length principle is based on a comparison of the conditions in a controlled transaction with the conditions in transaction between independent enterprises, to determine the market price or such margin. Such determination should be the purpose of methodology. Subsection (1) of section 92C provides that the arm's length price in relation to an international transaction shall be determined by any of the following methods: –

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Profit split method
- Transactional net marginal method
- Such other method as may be prescribed by the board

The general theory is to treat each of the individual members of a commonly controlled group as a separate entity, transactions between which are taxable events to be conformed to the economic realities that would be obtained between independent economic entities conducting the identical transaction at arm's length[81].

The above methods could be broadly divided into four different categories –

1. First, the method which focuses directly on the price of products sold or transferred requiring both functional and product comparability. In this category falls the uncontrolled price method
2. Second, the method which operates on the Cross profit margin level, requiring functional rather than the product comparability. In this category falls the resale price method and the cost plus method. Resale price method is usually applicable to marketing and selling operations and the cost plus method to manufacturing operations.
3. Third, the method which operates on the operating profit margin level used for highly complex and integrated enterprises. In this category falls to profit split method and the transactional net margin method. The profit split method is applied all the parties in the transaction by the transactional net margin method applies to only one party. The

[81] Commissioner vs. first Sec., bank of Utah, 405 US 394 (1972)

transactional net marginal method is not usually applied in cases involving unique intangibles.

4. Residual method, as may be prescribed by the board

The first two methods collectively are known as traditional methods or that the pricing methods; and the third as transactional profit method.

The traditional methods relate to arriving at the arm's-length price. The transactional profit method relate to arriving at the arm's-length profit and not the price the board be prescribed any method other than these. It has not so far been done. Since no method has been prescribed any other than any of the specified in the above, maybe followed if it gives reliable comparable data. Thus if none of the specified is appropriate, then by using whatever method is appropriate arm's length price is determined.

It is clear from the residual method that if no method is prescribed, there is no manner available as such to be followed. Any other method than those specified in the above may be followed which gives a reliable measure of arm's length.

5.11.2. COMPARABLE UNCONTROLLED PRICE METHOD

The comparable uncontrolled price method is primarily used where an enterprise transacts the same goods or services under similar circumstances and conditions with both the associated enterprises and the unrelated party. Comparable uncontrolled price method could be defined as a transfer pricing method that compares the price of the property or service transfer in a controlled transaction to the price charged for the property or service is transferred in a comparable uncontrolled transaction and comparable circumstances. The difference between the two prices indicates the conditions and the commercial and financial relations of the associated enterprises are not at arm's length and the price in the uncontrolled transaction is to be substituted for the controlled price. The market price of the same or similar goods has to be found out in the open uncontrolled market. It is done by reference to the prices charged on comparable arm's length transaction, that is, the price at which the same kind of inventory is sold/purchased by unaffiliated parties under the same and similar circumstances.

The CUP method relies upon the price prevailing in comparable sales between entities that are not members of the same controlled group. The arm's-length price of a controlled sale is equal to the price paid in comparable uncontrolled sales including necessary adjustments.

Comparable sales for that purpose include –

- Sales by a member of the controlled group to and unrelated party;
- Sales made to a member of the controlled group by and unrelated party, and
- Sales made between parties which are not related to each other.

"Uncontrolled sales" are sales in which the seller and the buyer are not members of the same controlled group. These include sales between a member of the controlled group and unrelated party, as well as unrelated sales in which none of the parties are members of the controlled group uncontrolled sales are considered comparable to the controlled sales –

- If the physical property and circumstances involved in the uncontrolled sales identical to the physical property and circumstances involved are so nearly identical that differences either have no effect on the price or such differences can be reflected by a reasonable number of adjustments to the price of the uncontrolled sales;
- Adjustments can be made only where such differences have a definite and reasonably assert enable effect on the price;
- Some of the differences affecting prices are differences in quality, terms of sale, intangible property associated with the sale, level of the market, and geographic market in which the sale takes place;
- Whether differences render sales non-comparable depends upon the particular circumstances and property involved;
- The differences may be examined to determine whether and to what extent differences in the various properties and circumstances affect price. Minor physical differences in the property generally have a definite and reasonably assert enable effect on the prices. Such differences do not normally render the uncontrolled sales non-comparable to the controlled sales.[82]

[82] Compaq computer Corporation v. CIR (T.C. Memo. 1999-220)

Uncontrolled sales do not include sales that unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify an on arm's-length price on a large volume of controlled sales[83]. Purchases should be in the regular course of business and substantial in both frequency and amount. CUP method comprising of a single transaction is rejected.[84] Using comparable transactions from years prior to the taxable years is common and held to be valid.[85]

The Salient features of the comparable uncontrolled price method are –

- Used when there is a transfer of product or services;
- Comparability of the price in comparable circumstances of the controlled and the uncontrolled transaction;
- Comparability of the product and also business functions;
- Adjustments of differences in the contractual terms, economic conditions and circumstances surrounding controlled and the uncontrolled transaction, to eliminate the effect on price comparability.

The exact method explaining as to how the comparable uncontrolled price method has to be applied to arrive at an arm's length price has been explained in the income tax rules as follows[86] –

1) Under this method the price charged or paid for any item under any comparable uncontrolled transaction or transactions should be identified.

2) Adjustment to the account for differences between the international transaction and comparable uncontrolled transactions between the enterprises entering into such transactions which could materially affect the price in the open market can be made.

[83] Bausch & Lomb v. Commissioner (92 T.C. 525, 592
[84] Seagate Technology Inc. & Consol. Subs. V. Commissioner (102 T.C. 149, 188 (1994))
[85] Sundstrand Corporation & Subs. V. Commissioner (92 T.C. 525); Ciba-Geigy Corporation v. Commissioner (85 T.C. 172 (1985))
[86] Rule 10B(1)(a) of Income Tax Rules, 1962

3) The adjusted price as worked out under the previous statement will be considered as on arm's-length price for the item.

The method consists in first identifying the prices charged in a comparable uncontrolled transaction and then adjusting to account for the material differences between the controlled and the uncontrolled transaction. For example, a company A sells its product to an associated company B and also to an unrelated company C. The products sold to company B and C are identical in all respects and there is no material differences between the related and the unrelated transaction that could materially affect the price. The price at which the product is sold to company C is reliable measure of arm’s length price.

A taxpayer must be is prices in transactions between commonly controlled entities on “comparable uncontrolled prices”, prices in sales between unrelated parties that involve identical or nearly identical products and conditions. Differences as regards product and conditions, if quantifiable, quantified and adjusted thus –

- This method looks to the price paid in comparable uncontrolled sales, where the products and the conditions are substantially similar.
- Any difference is adjusted their differences have a definite and reasonably assert enable effect on the price.
- Those differences ignored which has no or very minor effect on the price.
- Quantifiable adjustment could be made for differences in product quality, terms of sale, use of intangible property, time of sale, geographic market, market share and level of sale.

This method is more appropriately applied where an enterprise sells the products to both the controlled and uncontrolled entities. The difficulty in making reasonably accurate adjustments should not be considered an impediment in the application of this method. The OECD transfer pricing guidelines provides: –

> *“Where differences exist between the controlled and uncontrolled transactions, it may be difficult to determine and reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in*

attempting to make reasonably accurate adjustments should not be preclude the possible application of the comparable uncontrolled price method. Practical considerations dictate a more flexible approach to enable comparable uncontrolled price method to be used and to be supplemented as necessary by other appropriate method is, all of which should be evaluated according to the relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in the CUP method. As for any method, the relative reliability of the CUP method affected by the degree of accuracy with which adjustments can be made to achieve comparability."

The CUP method is applied in relation to the transaction the subject matter of which is the product. Comparable sales between a member of the controlled group to an unrelated party or vice versa or between the parties which are not related to each other may provide enough data for the purpose of comparable uncontrolled price method. In order to secure comparability between the transaction under consideration and the transaction with which compared, if the conditions surrounding them are not identical, some adjustments be made to reconcile the variations. For example, if the related party is given a credit of say 60 days as against 30 for unrelated, the difference in payment terms should be taken into account, before the arm's-length price is determined. The unrelated party price is to be adjusted by the difference of the credit terms, which is calculated on the basis of prevailing interest rate. The related price should reflect the unrelated price plus the interest for difference of the period of credit terms.
The comparable uncontrolled price method evaluates whether the amount charged as an arm's length by reference to the amount charged in comparable uncontrolled transaction comparability under this method primary depends on the close similarity of the products. However, contractual terms or economic conditions if material having effect on price, should also be similar. Thus, if a uncontrolled transaction is similar to the controlled transaction as regards to the quality of the, as also as regards to minor and ascertainable contractual terms and economic conditions having effect on price, that transaction provides a measure of arm's length price of the controlled transaction.

Compaq Computer Corporation v. CIR (T.C. Memo 1999-220)

The issue before the court was whether the transfer prices for the printed circuit assemblies that were charged between Compaq US and Compaq Asia made the arm's length standard the

petitioner had earlier responded to response information request during audit, by describing its transfer pricing formula as "a cost plus formula inclusive of location savings" and stated the CUP method was not applicable. Respondent adopted the modified cost plus or profit based method. Prior to trial, the petitioner abandoned cost plus method and I trial defended the Internet company prices pursuant to the comparable uncontrolled price method based on Compaq US regular and substantial purchases of identical or nearly identical printed circuit assemblies from uncontrolled subcontractors.

The petitioner asserted that the respondents notice determination is but unacceptable and that the comparable transactions unrelated parties proved that the transfer prices satisfy the arm's length standard, and argued that, under the comparable uncontrolled price method, petitioner's proof must prevail. Respondent asserted that petitioner has not presented comparable uncontrolled prices to 2 that its transfer pricing system should be upheld and thus amounts of data mining under the notice of deficiency should be sustained or, in the alternative recommendations of the respondents experts be adopted. The court found:

> *"Petitioner has presented substantial evidence of uncontrolled transaction with unrelated subcontractors. Petitioner's comparable uncontrolled price analysis is predicated on Compaq US purchases of 3.6 million printed circuit assemblies from unrelated subcontractors between 1990 to 1993. The aggregate purchase price of these printed circuit assemblies totalled $ 597 million. On a turnkey equivalent basis and was 93.1 of the Compaq US standard cost. In addition, the purchases occurred in the regular course of business and were substantial in both the Quincy and the amount. Although these transactions were not identical to the controlled transaction is involving Compaq Asia, we conclude that they are sufficiently similar to provide a reliable measure of an arm's-length result. Thus, the purchases from unrelated subcontractors identified by petitioner qualify as comparable uncontrolled sales for purposes of the application of the comparable uncontrolled price method."*

The court concluded that the overwhelming evidence establish that the printed circuit assemblies in the control and uncontrolled transactions were substantially similar or nearly identical and deferred in only two respects:

i. the cost of the specific components and material used on each printed circuit assemblies and

ii. the amount of time required to process each printed circuit the same, and that adjustment could and had been made to make the transactions comparable and that "accordingly, transactions with unrelated subcontractors warranted application of the comparable uncontrolled price method"

Non-application if the price is reasonable:

If comparison of the prices charged for goods and services transfer in a controlled transaction with the price charged in a comparable transaction radiation which could be justified on the grounds of reasonableness, there would be no scope of disturbing the transfer price. In Spur Oil Ltd. V. The Queen[87], Spur purchased oil for its refining business from a related US company for a set price. In 1970, it began to sources oil from a related Bermuda company at a higher price. The increase was alleged due to the shipping cost. The additional charge was denied by the authority holding the transaction to be artificial unduly reducing Spur's income. The Federal Court of Appeal held that the ultimate price paid to Bermuda company was approximately equal to the fair market value of the oil and the relevant time and therefore it could not be said that the payments to the related Bermuda company resulted in an Undue Reduction in Income.

In another case, Irving Oil Ltd. V. The Queen [88], the Federal Court of Appeal held that the price at which the sale to Canada took place was similar to that which would have been paid to acquire the product from any other source, the transaction was not sham or artificial. The Court followed the Spur's decision in concluding that an amount did not artificially reduce income when the transaction price did not exceeded what was reasonable in the circumstances.

[87] (81 DTC 5168)
[88] (91 DTC 5106)

5.11.3. PROFIT SPLIT METHOD

The Profit Split Method is applied where –

- The operations of the related parties are highly integrated making evaluation on individual basis difficult; and
- both parties own valuable non-routine intangible asset for which no comparable data could be available and thereby make it impossible to apply resale or cost plus method which is based on establishing high degree of comparability with uncontrolled comparables.

The method is applicable in cases involving multiple transactions amongst the associated groups which are so interrelated and closely linked or continuous that they cannot be evaluated on separate basis for the purpose of data mining the arm's-length price of any transaction. Continuity as well as close linkage amongst transactions are common in global trading. The profit split method is often suggested as the most suggesting and fitting solution to deal with complex cases where global trading activities are highly integrated amongst the business functions and locations. Other methods could not be appropriately applied because of the impossibility of identifying sufficiently reliable uncontrolled comparables.

The OECD report on "E-commerce: implementation of the Ottawa Taxation Framework Conditions" states as follows:-

> *"The aggregation rules in chapter 1 of the guidelines permit such aggregation where the transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis"*[89]

A reading of the Income Tax Rules[90] along with the US regulations and the OECD guidelines would indicate the general rule that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer and that for such determination there must be an assessment of the functions performed, economic costs incurred and risk assumed by each so that the income could be assigned commensurate with the relative economic contribution and relative risk taker.

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[89] Para 38 of OECD: Ottawa Taxation Framework Conditions
[90] Rule 10B(1)(d)

The method consists in first identifying the combined net profit, then splitting that profit between the related parties in proportion to the relative contribution as evaluated on the basis of functions performed and on the basis of reliable external market criteria which may include profit Split's percentage returns observed amongst independent enterprises with comparable functions. The functional analysis will identify and evaluate the contribution of and the economic risk assumed by each party to the transaction including the economic risk assumed. The object of detailed functional analysis is to assess relative contribution of and risks taken by each party and to assign income accordingly. The combined net profit is divided as follows –

a) first, allocating to each enterprise to provide with the basic return appropriate for the type of international transaction with reference to the market returns achieved with similar types of transactions by independent enterprises, and then
b) dividing whatever remains thereafter in proportion to the relative contribution in the manner as mentioned above.

The total of the above two represents the net profit each enterprise would gain from the international transaction.

The Salient features of Profit Split Method are:-

- Used where facts surrounding the taxpayer's transaction made it impossible to identify sufficiently reliable uncontrolled comparables under some other methods;
- Used where in international transactions involve transfer of unique intangibles or which are multiple and so interrelated and interdependent that it is not possible to identify closely comparable transaction and thus cannot be evaluated separately, as it does not rely on closely comparable transaction;
- Allocation of the combined net profits of the parties involved based on the value of the relative contribution of each;
- Relative contribution evaluated on the basis how the unrelated parties performing comparable functions would evaluate.

5.11.4. COST PLUS METHOD

Cost Plus Method involves determination of the cost to the associated enterprise and gross profit, which could be reasonably expected to be earned by the provider of the goods or service. This means that there should be adequate information as to the cost.

Cost can be both direct and indirect. Determination of the cost for a particular product involves allocation of common cost, an exercise which may not be too difficult under any costing system worth its name. Information relevant should be available. While direct cost can be more readily ascertainable, indirect cost may involve allocation of common cost. Cost of production involving materials and labour to convert such materials into saleable product could be direct cost, while indirect cost would involve allocation of cost or other costs including marketing. The rules do not spell out the manner in which this exercise has to be undertaken, except broadly stating that direct and indirect cost of production for the goods or services would have to be determined at the first stage in clause (1).

To this aggregate of direct or indirect cost of goods or services, addition has to be made for normal gross profit. Normal gross profit is one which is expected to be earned in a comparable uncontrolled transaction or a number of transactions. This is one factor which is less certain for ascertainment, compared to direct and indirect cost. Adjustments may be required to be made as to what is the normal gross profit. Normal gross profit in an uncertain market would require being higher than, where the market is stable. Uniform gross profit may not be considered reasonable with reference to sale in different geographic locations. A potential expansion of the market may find a lower margin. Adjustments may have to be made for the same. The aggregate cost so arrived at, along with the gross profit, which should take into consideration the possible variations, should be taken at arm’s length.

While resale price method starts with sale price of goods purchased from associated concern, cost plus method adopts price of goods purchased. Cost plus method ultimately requires a fair mark-up on the basis of normal gross profit for determination of arm’s length price. Comparison with competitors’ facts is, therefore, unavoidable even in this method.

In *Altair Engineering India P Ltd v DCIT*[91], it was held, that cost plus method is acceptable only if the basis of mark-up is clearly demonstrated as justified failing which the Transfer Pricing Officer will resort to TNMM Method.

In a U.S. case, the parent company made available research and development services on a cost plus designated mark-up on a sliding scale dependent on the quantum of cost. Revenue argued that CUP method should be preferred on the basis of information related to 15 other companies. Expert witness of IRS besides its functional and risk analysis in support of CUP Method was not found acceptable. [92]

5.11.5. RESALE PRICE METHOD

Resale Price Method is relatively a simple one. While the transaction between associated concerns may be susceptible of variation because of the significant influence or control exercised by one over the other, the ultimate sale price in the open market cannot be questioned. It is this price, which is known as resale price. If the price paid for the purchases or services is commensurate with the value addition made before resale, there is no reason, why it should not be accepted as arm's length price.

Clause (i) of sub-clause (b) would require that where this method is adopted, resale price is the price in the open market to an unrelated enterprise and not to another associate enterprise. This is an obvious requirement. Where the sale is uncontrolled, it offers a basis for which the transaction price could be worked out. Once the resultant price is identified adjustments are required to be made. Clause (ii) provides for such adjustments and the first step is reduction of the same by normal gross profit margin. It is recognized that resale price cannot be adopted as arm's length price because of the distribution cost and the distributor's margin. It is for this purpose normal gross profit margin is reduced from the sale price. If there is any value addition made, such value addition would also require to be adjusted and such amount as further reduced will be an amount, which should be treated as the arm's length price.

Rule 10B (1) (b)(iii) further provides reduction by way of expenses incurred by the party is connection with purchase of the property or obtaining the services. In other words sub-clause

[91] ITA No. 1184 of 2010, dated 14.3.2011 (Bang.-ITAT)
[92] *Westreco Inc. v Commissioner T.C. Memo* 1992-561 (1992)

(ii) and (iii) together require deduction of profit margin and expenses at both ends, so that it would mean that value additions made at the sale point will be reduced from the resale price. But such amount as reduced by these items may not automatically mean that the net resale price is the arm's length price.

There may be various factors, which are functional or otherwise, which may lead to a further difference in price. Accounting practice or other factors may clearly affect gross profit margin in the open market. Mere reduction of resale price by gross profit and the cost does not necessarily give arm's length price. Further adjustments would be required to make them comparable or, in other words, one may look for an explanation, wherever the transaction price is different from the price calculated with reference to the resale price. Gross profit margin in the open market may not be a correct cure, because the actual gross profit could be influenced by parties. Subject to these, resale price may be the most appropriate method. One advantage of this method is the fact that information for arriving at this price is more readily available.

The resale method offers good evidence and it is more suitable method in some circumstances. In *E I Du Pont de Nemours*[93], the inference of U.S. authorities that the commission by the U.S. Company to its Swiss distributor was under-charged as is evident from the abnormal profits of its Swiss subsidiary, bringing to tax the difference by adoption of normal commission.

Resale price method was found appropriate in view of the comparability of gross margins with a foreign tested party rendering services in construction and engineering for core duties in high technology projects in respect of its transaction with the associated enterprises in Bahamas and USA. The comparability was in respect of foreign information data base as decided in *Development Consultants Pvt Ltd*. [94]

5.11.6. TRANSACTIONAL NET MARGINAL METHOD

Transactional net margin method is not essentially different from what Assessing Officer are prone to resort to, when they find that no accounts or accounts produced are reliable. The

[93] (1979) 608 F2d, 445
[94] 2008-ITOL-150-ITAT-Kol.

normal margin of profit that is expected in the line of trade forms the basis of turnover of either purchases or sales, whichever is considered more reliable. The following steps are contemplated:

i. The net profit margin of the associated enterprise is computed with reference to the sales, or the costs, or assets employed or any other relevant base.
ii. Net profit margin that would have been realized, if the transactions were between unrelated enterprises under uncontrolled conditions on the same basis is computed.
iii. The net profit margin as ascertained in Item 2 is adjusted for factors relevant for international transactions and materially affecting the profit as it would have otherwise been made in uncontrolled conditions as between independent persons.

Net profit margin is worked out after adjustments in 3 above will be treated as the actual margin of profit made by associated enterprise. Such margin will be added to the cost of the associated enterprise to arrive at the arm's length price.
The task in computing the profit of the associated enterprise is not avoided, but such task is limited to the ascertainment of the profit of the associated enterprise situated in the country, where arm's length price is required to be determined, while in the case of profit split method, such ascertainment would have to be determined with reference to the data available in both the countries to arrive at combined profits with the result that this method is easier in some respects. The net profit spelt out in Rule 10B(1)(e) would have to be computed with reference to the cost incurred or sales effected or assets employed or required to be employed by the enterprise or having regard to any other relevant base indicating that determination of the net profit is not a matter which can be done on an *ad hoc* basis. Though there are as many as five steps indicated in the sub-rule, it may not be necessary to go through all the five steps. Even the first step may not be necessary if the objective of the tax collector is ascertainment of profit. The net profit margin for uncontrolled transactions can be arrived at and it is such profit which will be treated as earned by the non-resident subject to variations in other participating State for purposes of Section 9(1)(i) and the profit attributable to permanent establishment under double tax avoidance agreement.

The presumptive rate of profit can be said to be based upon expected margin in each line of business. Income-tax law already has a presumptive rate stipulated in the statute. Section 44B would adopt 7.5% for profits of shipping business, section 44B, a rate of 10% for computing

profits in the business of exploration, etc. of mineral oil, and section 44BBB a rate if 10% with business of civil construction etc. in turnkey projects. Operation of aircraft, however, is presumed to earn 5% net profit as prescribed under section 44BBA. Royalty and technical fees are taxed at 20% now reduced to 10%, which is a rate lower than the ruling rate justified with reference to the lower net income therefrom, since the rate is on gross income. Double tax avoidance agreements may prescribe even a lower rate as a matter of mutual agreement for certain categories of income as it does for interest and dividend incomes.

Concessional rates of tax are prescribed for returns on capital not always with reference to principle of fair revenue-sharing, but as a matter concessions intended to encourage inflow of foreign capital. Hence, it would appear that fundamentally the presumptive rate, which could be treated as a method of arriving at the net profit margin. It can be no less reliable than any other method. In fact, such presumptive rate would lead to a certainty, which is considered necessary in tax matters. It is considered more preferable than what is considered to be fair in academic sense. Revenue sharing on presumptive basis may not be as fair as the most appropriate method. It is possible the rate may be oppressive, where it is not possible to earn matching profit as prescribed in the statute. But then, the rates that are fixed are not permanent, since it is possible for alteration either way.

Transactional Net Margin Method (TNMM) was founded by Supreme Court to be more suitable in *DIT (International Taxation) v Morgan Stanley and Co. Inc*[95]. **However, the special bench**

Transactional Net Margin Method (TNMM) was found by the Supreme Court to be more suitable in *DIT (International Taxation) v Morgan Stanley and Co Inc*[96].

[95] (2007) 292 ITR 416 (SC).
[96] (2007) 292 ITR 416 (SC).

6. PENALTIES

6.1. INTRODUCTION

Section 92 is a new legislation to curb tax avoidance by abuse of transfer pricing. The memorandum explaining the provisions of the Bill 2001, states in respect to that section,

> *"the increasing participation of multinational groups in economic activities in the country has given rise and complex issues emerging from transactions entered into between two or more groups or enterprises belonging to the same multinational groups. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid such intragroup transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of the reasonable, fair and equitable profits and tax in India in the case of multinational enterprises, new provisions are proposed to be introduced in the income tax act."*

The provisions, therefore, cast some obligations upon the person undertaking international transactions. Non-compliance is proposed to be penalised. For that purpose section 271 has been amended, and new sections 271AA, 271BA and 271G, have been inserted. A new Explanation 7 has also been inserted in subsection (1) of section 271 extending the scope of concealment with the device of transfer pricing and under statements of profits.

Since the principal focus of the transfer pricing law is to avoid penalty, the taxpayer should maintain documentation to defend his selection and application of pricing method provided a reliable arm's-length result, given the available data the objective of penalty regime under the Indian income tax Act is to encourage the taxpayer to make a reasonable effort as regards determination of arm's length character of an international transaction, maintenance of information and documentation, and cooperation in the proceedings for the determination and computation of the arm's-length price.

6.1.1. PENALTIES – MEANING

For infraction of law, there are three sanctions: interest, penalty, and prosecution. Interest is compensation, as a commercial equivalent of the deprivation of the use of money. It is the compensation allowed by law or fixed by the parties for the use or forbearance for detention of money. It may be regarded as the presenting the profit that the correct person might have made if he had used the amount of money or conversely the loss he suffered because he has not been provided the promised amount of the general idea is that he is entitled to compensation for the deprivation[97]. Penalties are a loss, disability or a disadvantage of some kind – fixed by law for contravention. It is a suffering and next by law to some illegal act. It is not an exaggeration and not compensatory in nature, as the interest is. It is a civil liability remedial". It is merely a method for enforcing compliance with the provisions of law. It is different from the penalty for applying a fine for forfeiture provided as punishment for the violation of criminal or penal laws. Thus, every wrong is not a plan. Some ROMs are of similar nature; while some more great, criminal. Every wrong has to be punished or penal provision consists of two parts; first, a statement of the prohibited at, or mission or other course of conduct, and, second, a provision for sanction which is applicable in case breach of the provision. The provision alone is ineffective. For it is but lost labour to say: "do this, and avoid that", unless we also declare: "this shall be consequence of your non-compliance."

A liability in law arises out of an act of commission or an act of omission. When a person does an act which law prohibits him from doing and attaches a penalty, he is stated to have committed an act of omission which amounts to around in the eye of law similarly, when he commits doing an act which is required by law to be performed and attaches a penalty he is said to have committed an act of omission which is also wrong in the eye of law.

6.2. PENALTIES - OECD GUIDELINES

According to OECD transfer pricing guidelines, penalties are generally designed to make tax underpayments and other types of non-compliance more costly than compliance. Their

[97] Westminister bank Ltd vs Riches (1947) 28 TC 159

objective is to promote compliance. Penalties can involve either civil or criminal sanctions-criminal penalties are virtually reserved for cases of very significant fraud, and they usually carry a high burden of proof for the tax administration. Criminal penalties are not the principal means to promote compliance. Civil penalties involve a monetary sanction. They are generally directed towards procedural compliance, such as timely filing of returns and information reporting. The amount of such penalties is often small and based on a fixed amount that may be assessed for each day in which the failure continues. The more significant civil penalties are those directed at an understatement of tax liability[98]. Civil monetary penalties for tax understatement are frequently triggered by one or more of the following:-

- an understatement of tax liability is exceeding the threshold amount,
- negligence of the tax payer, or
- wilful attempt to evade tax

According to OECD, the penalties should be fair and commensurate with the offence. The guidelines provides:-

> *"Improved compliance in the transfer pricing area is of some concern to OECD member countries and appropriate use of penalties may play a role in addressing this concern. However, owing to the nature of transfer pricing problems, clear should be taken to ensure that the administration of a penalty system as applied in such cases is fair and not unduly onerous for taxpayers."*[99]

6.3. NON-COMPLIANCE WITH PROCEDURAL REQUIREMENT

Penalties under the Indian income tax are directed towards procedural compliance and also directed at understatement of tax liability.

The assessee who has entered into an international transaction is four important transfer-pricing obligations:

[98] Para 4.21 of the OECD Guidelines
[99] Paragraph 4.25 of the OECD Guidelines

1. To sell-assess his compliance with arm's length principle in making tax returns;
2. To maintain information and documents as prescribed;
3. To furnish particulars relating to international transaction and a report from an accountant; and
4. To co-operate in the investigation and furnish any information and document, if requested by the Assessing officer.

Failure in regard to any of the above would lead the taxing authority to make his own assessment of the transfer price as provided in section 92C(3) and section 92 CA is also in appropriate cases impose penalty as provided in sections 271(1)(c), 271 AA, 271 BA, 271G. Failure in regard to obligation to return income on the basis of arm's length principle is viewed seriously and treated at par with intention to concealing income. Other failures relate to procedural and punished by way of penalty.

Penalty for procedural compliance relates to the person who has entered into international transaction and failing to:-

1. keep and maintain information and documents as required under section 90D(1), for the period as may be prescribed under section 92D(2);
2. furnished in the course of any proceeding under the act when required to be done under section 92D(3), of any information or document in respect of the international transaction within 30 days of the receipt of the notice which could be extended for another 30 days;
3. Furnish a report after having obtained from an accountant, on or before the specified date in the prescribed form duly signed and verified in the prescribed manner by a chartered accountant as required under section 92E.

For 1 and 2 above, the amount of penalty will be equal to 2% of the value of international transaction and for 3, Rs. 100,000. The Assessing Officer or the Commissioner (Appeals), as the case may be, may direct that the defaulting person shall pay the sum, by way of penalty. The above penalty cannot be imposed if the assessee proves that there was reasonable cause for such failures[100].

Penalty is imposed for:-

[100] Section 273B

- Failure of
- Any person per non-compliance as mentioned above.

6.3.1. FAILURE- MEANING

Failure connotes that there is an obligation which has not been carried out and if there is no obligations upon the person to do some act, then it would not be failure on his part to carry that obligation[101]. Omission is not failure as there is no obligation. Penalty is imposable if the failure is lacking bone fide. Unintentional or in advertent failure is not to be punished. It is punished when it is deliberate, where the mind has been brought into play and man has, after taking facts into consideration, refused to do an act which he is statutorily bound to do.

Failure should be deliberate

The liability to pay does not arise merely of the proof of default. An order imposing penalty for failure to carry out statutory obligation is the result of quasi-criminal proceedings. It will not ordinarily be imposed unless the party obliged, either acted deliberately in defiance of law or was guilty of conduct, contumacious or dishonest, or acted in conscious disregard of its obligation. Penalty is also not to be imposed merely because it is lawful to do so. We are a penalty should be imposed for failure to perform a statutory obligation is a matter for this discretion to be exercised judicially and on consideration of all relevant circumstances. Even if minimum penalty is prescribed, the authority competent to impose the penalty will be justified in refusing to impose the penalty, then there is a technical or venial breach of the provisions of the act or where the breach flows from the bone fide belief that the offender is not liable to act in the manner prescribed by the statute.[102]

6.4. FAILURE- EVERY FAILURE IS PENALISED

Under section 271G each failure is penalised with penalty of a sum equal to 2% of the value of the transaction. Failure to furnish information or document when required to be done under a notice from the assessing officer or the Commissioner (appeals), as the case may be, is the offence. Having once been penalised, a person cannot claim immunity from not being

[101] Clixby vs. Pountney (Inspector of taxes), 1969] 72 ITR 340 (Ch.D)
[102] Hindustan steel Ltd v State of Orissa, (1972) 83 ITR 26 (SC)

penalised again for subsequent similar failure. Each failure is an independent offence and is not exonerated by reasons of earlier failure having been penalised.

6.5. FAILURE- FURNISH A REPORT FROM AN ACCOUNTANT

Separate penalty has been provided for failure (1) keep and maintain information and documents, under section 271 AA, (2) to furnish them, under section 271G, and, (3) to furnish a report from an accountant under section 271 BA. If an assessee has not kept and maintained information and documents he may be penalised under section 271 AA, but not under section 271G for failing to produce a non-existing thing or under section 371 BA for failing to furnish a report in respect of non-existing documents in a similar manner when assessee having failed to furnish income tax return cannot be penalised for concealing income[103]. That Allahabad High Court in *CIT v Bisauli Tractors*[104] held:

> *"Separate penalty has been provided for non-maintenance of accounts, that is, under section 271 A of the income tax act, 1961, and for not getting the accounts audited and not furnishing the audit report, that is, under section 271 B. If a person has not maintained account books or any accounts the question of audit does not arise. In such an event the imposition of penalty under the provision contained in section 271 A for alleged non-compliance with 44 AA may arise but the provisions of section 44 AB does not get violated in a case where accounts have not been maintained at all and therefore the penal provision of section 271B of the act would not apply"*

Under section 271BA failure to furnish a report from an accountant as required by section 92E is penalised. The obligation under section 92E is two-fold. One is to obtain a report from the accountant in the prescribed form duly signed and verified in the prescribed manner by such accountant; and the second, to furnish such report on or before the specified date. A cursory reading of section 271 BA suggests that only the second obligation is penalised, and not the first. But the second obligation arises only if the first has been complied. A person may escape penalty if he has not obtained the said report, by alleging that he cannot be required to furnish which he has not got. He therefore, may not obtain the report as to secure

[103] Thoppil Kutti Eroor v CIT, (1958) 34 ITR 850 (Ker.)., S.Santhosa Nadar v First Addl. ITO, (1962) 46 ITR 411 (Mad.)., CWT v. Yadu Raj Narain Singh, (2006) 286 ITR 564 (All.).
[103] CWT v. Yadu Raj Narain Singh [2006] 286 ITR 564 (All.).
[104] (2008) 299 ITR 219

for himself the escape route. A close reading however, does not so suggest. Furnishing of the report is the; it may be for reason of not obtaining or after having obtained not furnishing. Whatever the reason, if the report is not furnished as required by section 92E, the person is liable to be penalised.

6.6. PENALTY EVEN IF ASSESSEE DEPENDS ON INFORMATION AND DOCUMENTATION NOT CONTEMPORANEOUSLY MAINTAINED

Penalty under section 271 AA is imposed for failure to keep and maintain information and documentation contemporaneously. Even though the assessee has maintained and kept such information and documentation, penalty is still leviable if he in his defence does not rely upon them but on different method or comparable. An assessee is free to defend his transfer price determination against the adjustment made by the assessing officer, including on the basis of transfer pricing method or exact or inexact comparable that he did not rely upon contemporaneously while entering into a controlled transaction[105], provided that method meets arm's length standard. In such method is based on information or documentation which were not in existence when the return was filed, penalty is imposable to the extent a subsequently adopted method fails to fully support the assesse's determination as arm's length.

6.6.1. ANY PERSON

Any person who has entered into an international transaction, is liable to be penalised who has failed to do what he was required to be done. Any person means all and everyone. The word "any" excludes limitation or qualification. Therefore, every person whether natural or artificial is liable. The word "person" defined in Section 2(31) of the income tax act includes an individual and Hindu undivided family, a local authority and, every artificial judicial person. The words "any person" means everyone, not one, but all. The only qualification is that the person must have entered into an international transaction. The expression "international transaction" has been defined in section 92B as meaning, inter alia, (either or

[105] Compaq Computer Corporation v Commissioner, (T.C. Memo 1999-220)

both of whom are non-resident) or transaction which may not be between the associated enterprises but also a transaction entered into by an enterprise if that transaction by virtue of pre-arrangement is in effect a transaction between the associated enterprises. Thus an enterprise which is not associated enterprise is also liable, if it has entered into a transaction in the circumstances as mentioned in section 92B (2).

6.6.2. VALUE OF INTERNATIONAL TRANSACTION

The amount of penalty is based on the value of international transaction. The term “value” has only subjective significance and is not to be confused with, even though often identified with and measured by cost. The term may also be closely related to the concept of price. It may be identified with cost or the price depending upon the context. Price charged or paid in the international transaction if, in the opinion of the assessing officer, falls short of the arm’s-length price is the starting point for initiating proceedings. The expression “price charged” or “price paid” is used with reference to a party when it is a seller or when a purchaser. In one case it represents the price and in the other, cost of the transaction. If the defaulting person is the seller, value of the informational transaction may mean what it has charged; and if it is the purchaser, it may mean what it has paid.

6.6.3. UNDERSTATEMENT OF PROFITS

The assessee who has entered into an international transaction would be deemed to have concealed particulars of his income or furnished in accurate particulars of such income in respect of the amount added or disallowed in computing his total income under section 92C(4), unless he proves to the satisfaction of the assessing officer or the Commissioner (Appeals), as the case may be, that the price charged or paid in such transaction was computed in accordance with the provisions contained in section 92C and in the manner prescribed under that section, in good faith and with due diligence. An explanation 7 in section 271(1) has been inserted in this regard.

The assessing officer or the Commissioner (Appeals), as the case may be, may direct that the defaulting person shall pay by way of penalty in addition to any tax payable by him, a sum

which shall not be less than, but which shall not exceed three times, the amount of tax sought to have been evaded by reason of the concealment of particulars of his income or the furnishing of in accurate particulars of such income.

6.6.4. CONCEALMENT OR INACCURATE PARTICULARS OF INCOME

For initiating penalty proceedings, the assessing officer or the Commissioner (Appeals) has to be satisfied during the course of any proceedings that the person has understated the profits and thus has conceal the particulars of his income or furnished in accurate particulars in respect thereof. The amount added or disallowed in computing the total income under section 92C (4) assumes a deemed character of concealment by reason of Explanation 7 to section 271 of the income tax act, unless the assessee proves to the satisfaction of the officer (or Commissioner) that the price charged or paid was computed in good faith and with due diligence in accordance with the provisions of section 92C and in the manner prescribed under that section. There are two types of satisfaction. One is to be regarded at the time of initiating the proceedings and the second, to be arrived at the time of imposing the penalty. The one is to enable the officer to initiate the proceedings. That satisfaction is not enough for imposition of the penalty. Such satisfaction has to be derived separately during the penalty proceedings, on consideration of the explanation, if offered, and evidence furnished by the assessee.

Assessment and penalty are different and distinct concepts. Penalty proceedings have distinct features. The assessee is heard separately. Separate evidence is taken. A separate time-limit is fixed for their completion. An order imposing penalty proceedings is the result of the quasi-judicial proceedings. The findings in the assessment proceedings are not conclusive so far as penalty proceedings are concerned. They cannot be automatically adopted as findings to that effect in the penalty proceedings. They may be relevant evidence to support the allegation of concealment but cannot be the foundation for holding the assessee guilty of concealment. It is not open to the assessing officer to raise presumption about any specific sums added or deductions disallowed, to consider income in respect of which particulars of income having been concealed merely on the ground of such addition or disallowance of deduction. The addition or disallowance could arise on account of non-satisfactoriness of the explanation, and not of falsity or lacking bona fide. Non-satisfactory nature is different from falsity or

lacking bona fide. The former is sufficient to include the disputed sum in the computation of income as falsity of the explanation and intentional act. In a penalty proceeding the concerned authority has to consider the matter afresh on the matter available before it, and necessary conclusion attracting penalty has to be drawn and specific finding has to be given[106]. The very fact that penalty proceedings are separately taken an opportunity given to the assessee to show cause and produced evidence etc. shows that before inflicting penalty it could be examined whether there is a deliberate violation of the Act.[107]

The amount added or disallowed in computing the total income under section 92C (4) in respect of an international transaction is deemed to represent concealment by reason of Explanation 7 to section 271 unless the assessee proves to the satisfaction of the officer that the price charged or paid in such transaction was computed in accordance with the provisions of section 92C and in the manner prescribed under that section, in good faith with due diligence. There could be two situations:

1. When the assessee offers no explanation, or
2. When the explanation offered is such as to satisfy the assessing officer or Commissioner (Appeals) that computation was done by him in good faith with the due diligence

In the case of 1, concealment is deemed. In case of 2, failing to prove bona fides and due diligence, income is also deemed to have been concealed. The onus is on the assessee to prove bona fide and due diligence. Thus, there is explanation and the material and evidence in support thereof, the officer has to consider them with regard to the bona fide of, and due diligence involved in, the computation made by the assessee for the price charged or paid in respect of the international transaction. The officers should feel satisfied honestly on the prima facie reasonable grounds of the assessee bona fide and due diligence. To be satisfied in the state of thing means to be honestly satisfied in one’s own mind. The satisfaction must be based on objective facts. There must be evidence and material to arrive at the conclusion and satisfaction. The onus of the assessee is limited to showing the computation having been done in good faith and due diligence.

[106] CGT v Late H.H. Maharaja Bhagwat Singh, (1997) 226 ITR 91 (Raj.)
[107] CIT v K.S.D. pandurangan [1996] 218 ITR 8 (Mad.).

6.7. GOOD FAITH AND WITH DUE DILIGENCE

A thing can be said to have been done in good faith when it is done honestly, whether it is done negligently or not[108]. The Indian penal code defines the expression "good faith" as nothing is said to be done are believed in good faith which is done or believed without due care or attention. That definition is more close to the expression "in good faith and due diligence."

If the assessee could demonstrate that he did what a reasonable man would have done to ensure that the return was made in accordance the arm's-length principle, penalty would not be leviable. For example, he could demonstrate that he made an honest and reasonable attempt to comply with arm's length standard by showing maintenance of good quality documentation, by using his commercial knowledge and judgement in making arrangements and setting prices, seeking professional help in case needed.

Negligence would, thus, mean failure to make a reasonable attempt to comply with the provisions of section 92C. A taxpayer cannot be said failing, if he relies on an expert opinion. No negligence could be inferred when he does on an appraisal that is at least "reasonably debatable".[109] Expert valuation precludes negligence penalty if bad faith is absent. Court may be reluctant to find negligence that transactions are complex and no clear authority exists[110]. But the expert's opinion will not help, if it lacks reasonableness and substantial well-recognised basis but given only to pander the interest of the party who has engaged the expert. The US Tax Court observed in DHL Corporation v. Commissioner[111]:

> *"Considering all of the above, the whole that it was not reasonable for the petitioners to rely on the Bain appraisal or comfort letter. If the parties to the transaction had given the valuation to an independent valuation entity before any values being placed on the trademark by the parties and/or not advised the evaluator of the value, it might have been reasonable for petitioners to rely on such an appraisal. As this trial has again demonstrated, parties can find exports who will advance and support values that favoured the position of the person or entity that hired them."*

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[108] Section 3(22) of General Clauses Act
[109] Sammons v. Commissioner, 838 F.2d 330 (9th Cir. 1988)
[110] Foster v. Commissioner, 756 F.2d 1430 (9th Cir. 1985)
[111] T.C. Memo 1998-461

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