TRANSFER PRICING AND PROFIT SHIFTING IN MULTI-NATIONAL COMPANIES

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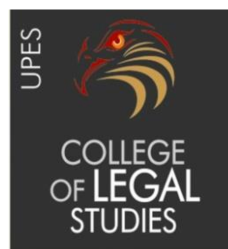
This dissertation is submitted in partial fulfillment of the degree of B.A., LL.B. (Hons.)



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CERTIFICATE

This is to certify that the research work entitled “Transfer Pricing and Profit Shifting in Multi-National Companies” is the work done by Miss Rajnandini Das 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 this dissertation entitled “Transfer Pricing and Profit Shifting in Multi-National Companies” is the outcome of my own work conducted under the supervision of Mr. Sujith P. 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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TABLE OF CONTENTS

CHAPTER I

1. Introduction 12

CHAPTER II 15

2. Tax Planning *versus* Tax Avoidance 15

2.1. Base Erosion and Profit Shifting 19

2.2. Transfer Pricing 21

2.2.1. Purpose of Transfer Pricing 24

2.2.2. Transfer Pricing Litigation in India 25

2.2.2.1. M/s. DIT (International Taxation), Mumbai v. M/s. Morgan Stanley & Co. Inc. 25

2.2.2.2. *Vodafone International Holdings BV v. Union of India & Anr.* 29

2.2.2.3. *Vodafone India Services Pvt. Ltd. v. Union of India & Ors.* 44

CHAPTER III

3. Arm's Length principle 55

3.1. Associated enterprises: An analysis of article 9 of the OECD Model Tax Convention 56

3.2. Application of Arm's Length Principle 59

3.2.1. Comparability Analysis 59

3.2.2. Functional Analysis 60

3.2.3. Contractual Terms 61

3.2.4. Economic Circumstances 62

3.2.5. Business Strategy 63

3.3. Methods of Transfer Pricing 63

3.3.1. Traditional transaction method 64

3.3.2. Transactional Profit Methods 66

CHAPTER IV

4. Conclusion 71

Bibliography 72

Annexure I 75
Annexure II 86
Annexure III 90
Annexure IV 95
Annexure V 97

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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EXECUTIVE SUMMARY

A multi-national corporation often places its affiliates at different jurisdictions, which differ in tax rates, so that it may easily shift its profit from a higher tax jurisdiction to a tax haven and, consequently, pay its corporate tax at a lower rate. This shifting of profit calls for a number of transactions among the transnational affiliates of the corporation, and the price agreed upon by the affiliates for these transactions is known as transfer price. However, usually this is not an unblemished accomplishment. When two affiliates of the same corporation transact with each other, due to common ownership and management, transactions between them are never fully subject to the market forces, which otherwise would have been had the transactions taken place between unrelated or independent parties. The affiliates of the same corporate group often attempt to artificially distort the price at which the transactions are recorded, commonly called transfer mispricing, and minimize the overall tax bill. The impulse of these transactions, therefore, poses quite a great challenge before the Revenue of different jurisdictions.

The affiliates resort to mispricing with an aim to maximize the present value of the group's overall profit and minimize the present and future risk of uncertainty regarding the value of profits. These ends are ordinarily attained by reducing customs duties on export and import, reducing tax liabilities by taking advantage of differences in national tax rates, engaging in exchange rate speculation in order to move profits from a devaluing currency to a stronger one, etc. This adversely affects the domestic economy of a country, because if transfer pricing fails to reflect the true profits earned in that country, the country is unfairly deprived of funds and opportunities for development, the cost of which is ultimately borne by the people of that country.

Valuing the transactions at arm's length has been the traditional international approach to deal with this issue of mispricing. That is to say, had the affiliates been unrelated, the transactions would have been modeled on the market price, therefore, the principle of arm's length pricing affirms that transfer price should be the same as if the affiliates involved were two unrelated parties negotiating in an ordinary market and do not form a part of the same corporate group. However, implementing the arm's length price is a

difficult task as they ordinarily take place in discretion that it often becomes difficult to locate the actual income accrued to bring it within the scope of the tax legislation of the jurisdiction.

This dissertation traces the evils bred by transfer pricing and examines the viability of various regulations and measures adopted by India and certain other jurisdictions to deal with the same.

CHAPTER I

1. INTRODUCTION

In the modern world, there is mutual interdependence of the various national economies.[1] The antecedent to the spread of international trade lies in one belief, i.e., no country is self-sufficient. Therefore, the practice of transnational exchange of goods, services, technologies, and other resources pro-generated the concept of international trade. The enhancement of the scope of trade across the world with an objective of moving towards the global economies, commonly known as globalization, has given rise to a plethora of issues from various standpoints, including commercial, business, and tax. Today, "international trade" is no longer confined to the mere exchange of surplus goods, nor is it confined to the dealings in spice, tea, or silk only. The practice has traversed much beyond the fundamental concept of "trade".

Globalization has, in many instances, proved to be a boon for domestic economies. The pace at which the national economies and markets have integrated with one another in the process of globalization has substantially increased in the recent years. The process involves free movement of labour and capital, gradual removal of trade barriers, shifting of manufacturing units from high-cost jurisdiction to low cost jurisdiction, etc. It yields growth, provides job opportunities, fosters innovation, and has helped fighting unemployment especially in developing countries.

The process of globalization has also had a far-reaching effect on the countries' corporate income tax regimes. The League of Nations was the first ever organization that recognized very rightly that the trade interaction between the different domestic tax systems had the intensity to breed "double taxation",[2] which consequently might affect the growth of the global economies and global prosperity. After much deliberation over this newly propounded menace of double taxation, the members of the League arrived at a consensus that double taxation had to be eliminated at all costs and in order to achieve

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[1] G. V. Vijayasri, *The Importance of International Trade in the World*, 2 INTERNATIONAL JOURNAL OF MARKETING, FINANCIAL SERVICES & MANAGEMENT RESEARCH 9 (2013)
[2] UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES (2001)

this objective, certain international rules and norms were to be framed which could be beneficial to the governments and the business organizations. Therefore, it is quite pertinent to note in this regard that international tax law is an important ingredient that facilitates the growth of global economy.

One of the quintessential features of globalization is the "integration" of the countries across the globe. This interaction among the countries further integrates corporations incorporated in different jurisdictions. Multi-national Enterprises (MNE), the common terminology oft used to refer to these corporations, today, represent a large fraction of the global Gross Domestic Product (GDP). The intra-firm or intra-company trade also represents a growing section of the overall trade. Globalization has resulted in a shift from country-specific operating models to global models based on matrix management organizations and integrated supply chains that centralize several functions at a regional or global level.[3] Moreover, the growing importance of the service component of the economy and of digital products that often can be delivered over the internet, has made it much easier for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers.[4] The inter-company transfer of goods and services between the parent company and its subsidiary, incorporated in a different jurisdiction, is often considered a technique for optimal allocation of costs and revenues among divisions, subsidiaries, and joint ventures within a group of related entities.[5] These accretions have been aggravated by the increasing sophistication of tax planners that have given the MNEs an unprecedented confidence to take aggressive tax positions. As a result of this practice, the MNEs have availed of every possible opportunity to minimize their tax burden to every possible extent. This practice of minimizing tax burden, commonly called base erosion and profit shifting (BEPS), has, consequently, given rise to new issues altogether, which are discussed as under:

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[3] OECD ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013)

[4] *Id.*

[5] PREM SIKKA AND HUGH WILLMOTT, THE DARK SIDE OF TRANSFER PRICING: ITS ROLE IN TAX AVOIDANCE AND WEALTH RETENTIVENESS- A CRITICAL PERSPECTIVE ON ACCOUNTING 21 (2010), http://scinet.dost.gov.ph/union/UploadFiles/download.php?b=sdarticle_008_177172.pdf&f=../Downloads/sdarticle_008_177172.pdf&t=application/pdf

- BEPS undermines the integrity of the domestic tax systems. The governments are often found under the obligation to shoulder the burden of coping with less revenue and a higher cost in order to conform to the domestic taxation norms. This especially affects the economy of the developing countries, where the minimal accumulation of revenue results in critical under-funding of public investment, which could otherwise have promoted economic growth in the country.
- Common citizens or individual taxpayers also fall prey to the menace of tax planning by MNEs. This is because, where taxation norms permit businesses to shift their income to a different jurisdiction, preferably to a tax haven so as to minimize their tax burden, the tax payers in that jurisdiction shoulder bulk of the burden.
- Fair competition is disrupted by the distortions facilitated by BEPS. Small scale corporations that operate in the domestic markets including family-owned businesses and sole proprietors often find it difficult to compete with the MNEs, which have an advantage of shifting their profits to other jurisdictions to avoid or reduce tax.

CHAPTER II

2. TAX PLANNING *VERSUS* TAX AVOIDANCE

> "*Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax*".[6]

When a business expands, it often does two things, namely: "first, it reconfigures itself into a corporate group by dividing itself into a multitude of commonly owned subsidiaries; second, it causes various entities in the said group to guarantee each other's debts".[7] A typical large business corporation consists of sub-incorporates. Such division is recognized in the eyes of law. The structure of the division is so that at the apex is the parent company, most commonly known as the holding company. It is the public face of the business. Below the parent company are its subsidiary companies, which hold operational assets of the business and which often have their own subordinate entities that can extend layers. If such large corporations are not divided into subsidiaries, creditors generally are expected to monitor the transactions and businesses of the enterprise in its entirety. But one advantage of incorporating subsidiary companies is that they reduce the amount of information that creditors otherwise need to gather. Subsidiaries also promote the benefits of specialization. But one of the most important reasons for incorporating subsidiaries particularly in a different jurisdiction is for tax avoidance or tax planning. The working framework between the holding company and its subsidiaries has been well portrayed by the Supreme Court of India as under:

> "*The subsidiaries at times come into existence from mergers and acquisitions. As group members, subsidiaries work together to make the same or complementary goods and services and hence they are subject to*

[6] *IRC v. Duke of Westminster,* [1936] AC 1
[7] *Vodafone International Holdings BV v. Union of India & Anr.*, Civil Appeal No. 733 of 2012

the same market supply and demand conditions. They are financially inter linked. One such linkage is the intra-group loans and guarantees. Parent entities own equity stakes in their subsidiaries. Consequently, on many occasions, the parent suffers a loss whenever the rest of the group experiences a downturn. Such grouping is based on the principle of internal correlation. Courts have evolved doctrines like piercing the corporate veil, substance over form etc. enabling taxation of underlying assets in cases of fraud, sham, tax avoidant, etc. However, genuine strategic tax planning is not ruled out".[8]

The legal position of a company incorporated in a different jurisdiction is that its powers, functions, and responsibilities are governed by the law of that jurisdiction under which the company has been incorporated, because no multinational company can operate in a foreign jurisdiction save by operating independently as a "good local citizen". A company is a separate legal entity and "the fact that all its shares are owned by one person or by the parent company has nothing to do with its separate legal existence. If the owned company is wound up, the liquidator, and not its parent company, would get hold of the assets of the subsidiary. In none of the authorities have the assets of the subsidiary been held to be those of the parent unless it is acting as an agent".[9]

Though it may be advantageous for parent and subsidiary companies to work as a group, each subsidiary will look to see whether there are separate commercial interests which should be guarded. When there is a parent company with subsidiaries, is it or is it not the law that the parent company has the "power" over the subsidiary. It depends on the facts of each case. For instance, take the case of a one-man company, where only one man is the shareholder perhaps holding 99% of the shares, his wife holding 1%. In those circumstances, his control over the company may be so complete that it is his alter ego. But, in case of multinationals it is important to realise that their subsidiaries have a great deal of autonomy in the country concerned except where subsidiaries are created or used as a sham. Of course, in many cases the courts do lift up a corner of the veil but that does

[8] *Vodafone International Holdings BV v. Union of India & Anr.*, Civil Appeal No. 733 of 2012
[9] *Id.*

not mean that they alter the legal position between the companies. The fact that the parent company exercises shareholder's influence on its subsidiaries cannot obliterate the decision-making power or authority of its (subsidiary's) directors. They cannot be reduced to be puppets.

In order to attain the objective of good governance, companies often seek to minimize their tax liability through tax planning. While tax planning is seen as complaint behaviour, tax avoidance is more of a grey issue.[10] The term "tax avoidance" is used to refer to legitimate but may be aggressive use of things such as financial instruments and other arrangements to obtain a tax result not intended, or anticipated by the government.[11] The use of overseas tax havens is one example. Most of the debate about tax avoidance has centered on the taxes businesses pay on their profits.

The interface between tax avoidance and tax planning has been a crucial matter of deliberation among taxpayers, revenue authorities, judicial authorities, and the legislative bodies. In the recent times, the revenue and the judicial authority across the globe have taken a stern approach towards transactions that aim at reducing taxes. Tax incidence is generally reduced by means of tax planning, tax evasion or tax avoidance.

Tax evasion is ordinarily an illegal practice to escape from the incidence of tax. The taxpayer conceals their taxable income, profits, et al., which is otherwise liable to be taxed, misrepresents the amount or source of income, or the factors that reduced the tax, like, deductions, exemptions, or deliberately overstates the credits. Tax evasion can occur as an isolated incident within activities that are, in other aspects, legal, or tax evasion occurs in the informal economy where the whole activity takes place in an informal manner, that is to say the business is not only evading tax payments, but is also not registered as formal enterprise at all.[12]

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[10] Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, 3 HANDBOOK OF PUBLIC ECONOMICS (2002)
[11] *Id*.
[12] THE GERMAN FEDERAL MINISTRY FOR ECONOMIC COOPERATION AND DEVELOPMENT, ADDRESSING TAX EVASION AND TAX AVOIDANCE IN DEVELOPING COUNTRIES (2010), http://www.taxcompact.net/documents/2010-12-22_GTZ_Addressing-tax-evasion-and-avoidance.pdf

Tax planning, on the other hand, is an arrangement by way of which the taxpayer takes full advantage of an eligible tax exemption, concession, deduction, rebate, or allowance sanctioned under the Income Tax Act, 1961 so that the tax liability on the taxpayer is minimized without contravening any legal provision. Such transactions are permissible legally if it deals solely with commercial substance and is not a colourable device. The Indian courts have over the years passed many decisions affirming the practice of tax planning. For instance, in *M/s. McDowell & Co. Ltd. v. Commercial Tax Officer*[13], the Supreme Court held as under:

> "*For tax planning to be legitimate it must be within the legal framework and colourable devices cannot be part of tax planning. In deciding whether a transaction is a genuine or colourable device, it is open for the tax authorities to go behind the transaction and examine the substance and not merely the form*".

Tax evasion is a method by means of which the taxpayer illegally through unaccepted means avoids to pay tax. The taxpayer in such an arrangement generally tries to reduce their tax liability by deliberately suppressing the income and by inflating the expenditure, recording fictitious transactions, and the like.[14]

The Direct Tax Code (DTC) provides for General Anti-Avoidance Rules (GAAR) to address the issues of tax avoidance. The provisions of GAAR could be invoked by the Commissioner of Income Tax (CIT), wherein a taxpayer has entered into an arrangement to obtain any kind of tax benefit and such arrangement satisfies any one of the following conditions:[15]

- The transaction is not according to the arm's length principle;
- The transaction represents misuse or abuse of the provisions of the DTC;
- The transaction lacks commercial substance;
- The transaction is not entered into for any bona fide business purpose.

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[13] AIR 1986 SC 649

[14] *Supra* n. 10

[15] Ministry of Finance, Department of Revenue, *Tax Evasion by Foreign Companies*, *available at* http://pib.nic.in/newsite/erelease.aspx?relid=99349

In order to avoid the application of GAAR on arbitrary grounds, the Central Board of Direct Taxes (CBDT) is expected to provide the threshold limit and the guidelines to specifically lay down the circumstances under which the GAAR provisions may be invoked.

2.1. BASE EROSION AND PROFIT SHIFTING

Taxation is a crucial aspect of a country's sovereignty, but the mechanism of tax planning and interactions of various tax systems across the globe in the recent times has given birth to a number of rifts and frictions at the international and domestic taxation regimes. When a State designs its taxation norms, it often does not sufficiently take into consideration the effect of taxation rules of the other sovereign States and this becomes the ground for giving rise to double taxation, tax avoidance, and the like.[16] It also calls for a situation where corporate income is not taxed at all by the country of source or by the country of residence, or may be taxed at a nominal rate.[17] The principle of "coherence" has different connotations in the domestic taxation regime and international plane. In the domestic system, tax is levied, unless exempted explicitly, when the income has accrued to the recipient, but contrarily, this is not the case in international taxation regime, wherein the taxpayer gets enough space for arbitrage.[18] Although the States have put in efforts to bring in coherence, but the attempt is restricted only to a narrow field, i.e., prevention of double taxation.

International taxation norms have sought to redress these gaps and frictions, trying best to not tamper with the sovereignty of the States, yet have failed considerably in their attempt. As mentioned before, it was the League of Nations, which first recognized the menace of the interactions between the different domestic tax regimes leading to double taxation, it was not before 1920 that such contemplation was given a thought to. Since then the countries across the world have worked out plans to eliminate double taxation so as to minimize trade impediments and distortions in order to boost an overall economic growth, assuring at the same times that the countries' individual sovereign rights with regard to their own taxation systems are not affected. However, the gaps and frictions

[16] *Supra* n. 10
[17] *Id.*
[18] OECD WHITE PAPER ON TRANSFER PRICING DOCUMENTATION (2013)

among these countries' tax systems have not been taken into account adequately while designing the international taxation norms. Unfortunately, they are also not looked into by the bilateral tax treaties. It is the need of the hour that the global economies collaborate and cooperate with each other on matters relating to taxation and tax planning, which may help them protect their tax sovereignty.

In the middle of all the discussions over double taxation, tax sovereignty, etc, in certain circumstances, the existing domestic tax systems and standards governing the taxation of transnational profits have yielded the desired results without letting BEPS. International cooperation has over the years brought into effect a number of bilateral tax treaties to prevent double taxation on profits earned from transnational activities. But the provisions of these treaties have also showed up faults and weaknesses that have created the opportunities for BEPS.[19] BEPS is an arrangement that shifts profit from one jurisdiction to another jurisdiction leading to no or low taxation in either of the jurisdictions.[20] This practice becomes a matter of concern when it is associated with the mechanisms that artificially segregate taxable income that the activities that generate such incomes.

The expansion of digital economy has recently started posing challenges for international taxation regimes. The digital economy is attributable to an undeniable reliance on intangible assets, which makes it difficult to determine the jurisdiction wherein the "creation" occurs.[21] This brings forth a fundamental questions, i.e., how could the enterprises in the digital economy add value and earn profits; how could the digital economy be attributed to the concepts of source or residence for the purpose of income tax.[22] It is also true at the same time that that a distribution of taxing rights which may result in relocation of business in a low tax jurisdiction is not always an indicator of the faults and gaps in the existing standards. The fundamental test is to examine the method adopted by the enterprises of the digital economy to add value and earn profits, based on which BEPS may be prevented.

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[19] *Supra* n. 16
[20] *Supra* n. 3
[21] Molly Saunders &Scott, *How Does Transfer-Pricing Enforcement Affect Reported Profits* (2013), http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/doctoral_meeting/2013/saunders-scott.pdf
[22] *Id.*

These faults and weaknesses as mentioned above makes the existing consensus-based standards vulnerable to risks and, therefore, a bold move by the policy makers becomes the need of the hour in order to prevent the problem from being exacerbated. However, on the contrary, if the governments show a lackadaisical approach towards this issue, they are bound to lose out on the corporate tax revenue; also, if the existing consensus-based standards are replaced by unilateral measures, it may result in global taxation chaos aggravating to the re-emergence of the menace of double taxation. It is, therefore, most pertinent that the governments achieve consensus on their decisions and take collective actions so as to deal with these gaps and frictions. It is worthy to mention in this respect one of the most appropriate factors pointed out by the G20 Leaders, "despite the challenges we all face domestically, we have agreed that multilateralism is of even greater importance in the current climate, and remains our best asset to resolve the global economy's difficulties".[23]

2.2. TRANSFER PRICING

Globalization has accelerated a rapid advance in technology, transportation, and communication. As a result of this advancement multinational enterprises (MNEs) have come up with a new practice of placing their enterprises and activities in different jurisdiction across the globe. As mentioned above in Chapter I, a significant volume of global trade, in the recent times, includes international transfers of goods and provisions of services, capital and intangible properties within an MNE group. These transfers are commonly known as "intra-group" transactions.[24] There is evidence that intra-group trade is growing steadily and arguably accounts for more than 30% of all international transactions.[25] Recent studies show that transactions involving mostly intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE's commercial transactions. This practice is also responsible for increasing the complexities associated with analyzing and understanding such transactions. The structure of such transactions within an MNE group, commonly called "associated enterprise", is determined by an

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[23] G20 LEADERS DECLARATION 2012, http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CTPA/CFA(2012)56&docLanguage=En

[24] UNTC AN INTRODUCTION TO TRANSFER PRICING

[25] *Id.*

array of the market forces and conditions, which are different in the transactions between the independent enterprises.[26] Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces, which are driven by the common interests of the entities of a group.[27] In such transactions involving the intra-group, transnational transfer of goods and services, intangibles, etc., one of the most important factors that needs to be sorted is determining the consideration for the transfer, i.e., the price at which the transfers are executed. This price is called "transfer price".

The Indian Income Tax Department defines "transfer pricing" in the following words:

> "*Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. One party 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 cost and added value, diverge from the market forces. Transfer price is, thus, a price which represents the value of good; or services between independently operating units of an organization. But, the expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity.*
>
> *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*

[26] UNTC AN INTRODUCTION TO TRANSFER PRICING
[27] *Id.*

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 is 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 countries 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".[28]

Transfer pricing, therefore, in a layman's term be understood as the pricing of transnational, intra-corporation transactions carried out between related parties to transfer property, goods, or provisions of services between the associated enterprises belonging to the same MNE group. These transactions are also called "controlled transactions", as distinct from "uncontrolled transactions" that takes place between companies which are not related to each other or are independent enterprises.[29]

Transfer pricing is a method of corporate tax planning, but it does not necessarily aims at indulging in tax avoidance, though in recent times, there have been a number of cases wherein companies have been found to have indulged in activities under the garb of transfer pricing in order to minimize of avoid payment of income tax. If the price of such transaction does not conform to the internationally accepted norms and standards or the

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[28] Ministry of Finance, Department of Revenue, *Transfer Pricing*, *available at* http://www.incometaxindia.gov.in/Pages/international-taxation/transfer-pricing.aspx

[29] *Supra* n. 24

domestic laws relating to transfer pricing, the menace is referred to as "mispricing", "unjustified pricing", or "incorrect pricing", etc. and in such circumstances the issues of tax avoidance or evasion arise.

The economic reason behind setting a transfer price between the associated enterprises for intra-corporation transactions must necessarily have the ability to measure the performance or the functional utility of the individual entities in the MNE group.[30] For the purpose of taxation, the individual enterprises are considered as separate profit earning units and transfer prices are required to determine the profitability of these individual enterprises. The transfer price determined between the associated enterprises must necessarily be at arm's length, i.e., the price which would have been paid ordinarily, governed by the market forces, had the transaction been executed between independent enterprises.

Although the entire transaction at a transfer price theoretically sounds innocuous, determining a proper and correct transfer price is quite a difficult task as it is often difficult to identify the intangibles or goods or services provided or transferred and the price at which these factors are to be valued. Therefore, though the practice helps the multinational corporations to plan their corporate tax, it is in itself quite a complex affair.

2.2.1. PURPOSE OF TRANSFER PRICING[31]

Transfer pricing is oft euphemized as a method of corporate tax avoidance scheme. The purpose this arrangement may be summed up as follows:

- To generate separate profit figures for every division and accordingly evaluate the performance of the individual divisions;
- To coordinate manufacture, production, pricing decisions, and sales of the different divisions of the corporations by applying the appropriate methods of transfer pricing;
- To allow the corporations to generate profit figures for every division individually.

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[30] Ernst & Young, *Transfer Pricing Global Reference Guide*, www.ey.com/Publication/Transfer_pricing_global_reference_guide_2013.pdf

[31] Heath, Hudart & Slotta, *Transfer Pricing*, INTERNATIONAL STRATEGY WBA 434 (2009)

2.2.2. TRANSFER PRICING LITIGATION IN INDIA

2.2.2.1.M/S. DIT (INTERNATIONAL TAXATION), MUMBAI V. M/S. MORGAN STANLEY & CO. INC.[32]

Morgan Stanley & Co. (hereinafter referred to as MS & Co.) is a company incorporated in the United States of America. It provides financial advisory services, corporate lending, and securities underwriting services. It has a number of group companies situated in various parts of the world. Morgan Stanley Advantage Services Pvt. Ltd. (hereinafter referred to as the MSAS) is an Indian company set up by the Morgan Stanley Group. MSAS has been incorporated with an objective to support the group members' front office and infrastructure unit functions in their global operations. The support services rendered by MSAS broadly cover functions such as information technology support, account reconciliation, research support, et al. MS & Co. outsourced some activities to MSAS, by way of a service agreement. MS & Co. proposed to send some personnel to India to undertake stewardship activities to enforce quality control standards and depute some personnel to MSAS who would work under the supervision and control of MSAS.

In the present case the Indian Income Tax Authorities raised the question as to whether or not MS & Co. has a PE in India, according to Article 5 of the India-US tax treaty, and if so, whether or not the payment of arm's length price by MS & Co. to MSAS extinguishes its tax liability in India.

With regard to the existence of a PE of MS & Co. in India by virtue of the performance of outsourced activities by MSAS, the Supreme Court observed that in order to decide whether or not a PE was constituted, the activities undertaken by the establishment must be analyzed, both functionally and factually. Under Article 5(1) of the treaty, a PE of a multinational enterprise would come into existence in India only if there is a fixed place in India through which the business of the multinational enterprise is wholly or partly carried out.

[32] Appeal (Civil) 2914 of 2007

The Supreme Court further noted that MSAS in India was engaged in supporting the front office functions of MS & Co. in fixed income and equity research and in providing IT-enabled services such as data-processing support, technical services, and reconciliation of accounts. Accordingly, it observed that Article 5(1) of the treaty would not apply, as MSAS was performing only back-office operations, which according to the Supreme Court could not be construed as the business of the multinational enterprise, thus failing to satisfy Article 5 (1) entirely. The Supreme Court also held that the services performed by MSAS, was more of back-office functions, falling under Article 5(3) (e) of the treaty, which expressly excludes activities of a preparatory or auxiliary character (even if it is performed out of a fixed place of business) from constituting a PE.

The Supreme Court, further, ruled that there is no agency PE, as MSAS in India had no express or implied authority to enter into or conclude contracts on behalf of MS & Co. In this regard, the Supreme Court also observed that while the contracts were entered and concluded in the United States, those contracts were only implemented in India, to the extent of back-office functions.

Further, with regard to the services rendered by the personnel of MS & Co. on deputation to MSAS, the Supreme Court held that the deputation constituted a PE within the terms of Article 5(2) (l) of the treaty. Under Article 5(2) (l) of the treaty, even a single day on which services are furnished by the employees of a non-resident enterprise to a related enterprise through a fixed place in India constitutes a PE. But an employee of MS & Co., when deputed to MSAS, does not become an employee of MSAS. The deputed employee has a lien on his employment with MS & Co. and as long as the lien continues to exist with MS & Co., the parent company may be considered to retain control over the deputed employee's terms of employment. Thus, the deputed person cannot be considered as an employee of MSAS. The Court then considered that when the activities of a multinational enterprise entail it being responsible for the work of deputed employees and the employees continue to be on the payroll of "the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise,'' a service PE can emerge. Further, the Court took into consideration that the request for the deputation of employees with specialized skills generally comes from MSAS. Furthermore, MS & Co.

retained a degree of supervision and control over the employees to the extent that they remain on the payroll of MS & Co. and any disciplinary action against them could not be taken by MSAS without consulting with MS & Co. The services are not for MS & Co., but they are rendered for and to MSAS. Therefore, because the deputed employee remained an employee of MS & Co. and is provided services to and for MSAS, a service PE was created under the terms of Article 5(2)(l) of the treaty. However, the personnel of MS & Co. engaged in stewardship activities for MSAS did not constitute a service PE of the parent company in India. The Supreme Court went on to observe that a service recipient such as MS & Co., which has worldwide operations, is entitled to insist on quality control and confidentiality from the service provider. Furthermore, a service provider may also be required to act according to the quality control specifications imposed by its customer. Thus, it held that because the object of the employees of MS & Co. sent as stewards was primarily to protect the interest of MS & Co., it cannot be said that MS & Co. had been rendering the services to MSAS. In the words of the Supreme Court, MS & Co. ‘‘is merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services.’’

The Supreme Court also observed that once the price of the transaction has been paid on the basis of arm’s length by a nonresident enterprise to its PE in India, nothing further can be attributed to the PE. Sections 92 to 92E of the Income Tax Act, 1961 impose an obligation of arm’s-length computation of income in international transactions among related parties. The Supreme Court noted that the transfer pricing provisions engrafted in the above mentioned sections were enacted to prevent the shifting of profits outside India. Further, the Supreme Court referred to Article 7 of the treaty, under which it is the income of the nonresident enterprise attributed to the PE that is taxable and held that the economic nexus is an important feature of any such profit attribution exercise. With regard to the attribution of further profits to the PE of MS & Co., the Supreme Court observed that once a proper transfer pricing analysis has been undertaken, a further need to attribute profits to the PE should not arise. In the context of the service PE, the Supreme Court held that the entire exercise aims at ascertaining ultimately whether or not the service charges payable or paid to the service provider fully represent the value of the profit attributed to the service. However, the Supreme Court noted that it is for the Indian

Income Tax Authorities to examine whether or not the PE has obtained services from the multinational enterprise at a price, which is lower than arm's length. Therefore, the Indian Income Tax Authorities had the obligation to determine income, expense, or cost allocations relating to the arm's length prices so as to decide the proper application of the transfer pricing regulations.

The Supreme Court noted that section 92C(1)[33] of the Income Tax Act, 1961, read with the rules framed there under provides with five methods for the computation of the arm's length price. They are namely, the comparable uncontrolled price method, the profit-split method, the resale price method, the cost-plus method, and the transactional net margin method. Modeled on these methods, the Supreme Court noted that the transfer pricing analysis to determine the arm's length price must sufficiently include the risks taken, and that the most appropriate method depends on the facts and circumstances of every case. The Supreme Court observed that the Indian income tax authorities had accepted the arm's length price established by MSAS by applying the transactional net margin method (hereinafter referred to as TNMM). The Supreme Court also independently approved the cost-plus margin, finding it appropriate in the case of a service PE. Since the TNMM method apportions the total operating profit arising from the transaction on the basis of sales, costs, assets, et al., regarding the attribution of profits to the PE it would be the correct method to arrive at a suitable arm's-length price that must be paid by MS & Co. to its PE. The Court found that a markup of 29% charged under TNMM by MSAS was correct.

The judgment has added a positive niche to the plethora of international tax decisions pronounced by the Indian courts over the past few years. It has significantly recognized that the mere presence of a fixed place of business is not enough and that it is important to examine whose business is being carried out through such a fixed place. The question attributed to it is whether the business carried out is of the resident enterprise or of the non-resident enterprise, which alone may constitute a PE under Article 5(1). This judgment has brought the much required respite to the Indian outsourcing industry, which has been bogged down by the Indian Income Tax Authorities' unrelenting stance that

[33] Provided in Annexure II

outsourcing is really the conducting of the activities of the non-resident enterprise itself. The Supreme Court has reiterated the principle that the fact that two enterprises are related should not, in itself, lead to an inference that a PE exists. The Supreme Court also observed that the definition of a PE under Article 5 of the treaty is exhaustive in nature. The Court has brought out the fine distinction in the tax treatment of stewardship and deputation. The fundamental difference, as per this judgment, is the degree of control exercised by the employer. This aspect of intercompany assignments is expected to be scrutinized rigorously for the future endeavours as multinational enterprises will have to structure such transfers of human resources among group entities with careful consideration to avoid a service PE exposure in India.

The Supreme Court has clearly endorsed in this judgment the single-entity approach towards the attribution of profits to a PE. The broad acceptance by the Supreme Court of the principle that once transfer pricing adequately takes into account functions and risks, no further profits are attributable is a positive step. Interestingly, the Supreme Court has unequivocally indicated the importance of the principle of economic nexus in determining profits attributable to a nonresident enterprise through its PE in India. This principle has been emphasized upon in a number of decisions passed subsequent to this judgment.

Although the AAR did not rule on the questions relating to transfer pricing, the Supreme Court pronounced on the appropriateness of both the method and the markup arrived at by MSAS in *M/s. DIT (International Taxation), Mumbai v. M/s. Morgan Stanley & Co. Inc*.[34] Mechanisms such as advance pricing agreements do not exist in India, and it seems the AAR should now be able to rule on questions pertaining to transfer pricing, thus providing certainty to multinational enterprises seeking to do business in India.

2.2.2.2.*VODAFONE INTERNATIONAL HOLDINGS BV V. UNION OF INDIA & ANR.*[35]

This is a tax dispute between the Vodafone Group and the Indian Income Tax Authorities with regard to acquisition by Vodafone International Holdings BV, a company incorporated in Netherlands, of the entire share capital of CGP Investments (Holdings)

[34] AIR 1986 SC 649
[35] Civil Appeal No. 733 of 2012

Ltd., a company incorporated in Cayman Islands. According to the Indian Income Tax Authorities, the stated aim of the appellants, Vodafone International Holdings BV, was to acquire 67% controlling interest in Hutchison Essar Ltd., a company incorporated in India. This was disputed by the appellants contending that they had agreed to acquire companies that in turn controlled a 67% interest, but not controlling interest, in Hutchison Essar Ltd. According to the appellants, CGP Investment (Holdings) Ltd. indirectly, through other companies, held 52% shareholding interest in Hutchison Essar Ltd. and options to acquire further a 15% shareholding in Hutchison Essar Ltd. In short, in this case, the Indian Income Tax Authorities sought to levy tax on the capital gains that they claimed to have arisen from the sale of the share capital of CGP Investment (Holdings) Ltd. on the basis that this company, not being a tax resident in India, held the underlying Indian assets.

The Supreme Court of India, ruling in favour of the appellants observed that:

> "*Tax planning may be legitimate provided it is within the framework of law…colourable device cannot be a part of tax planning and it is wrong to encourage the belief that it is honourable to avoid payment of tax by resorting to dubious methods*".[36]

The decision of the Supreme Court on different aspects of the transaction is as follows:

International Tax Aspects of Holding Structures

Pope Innocent IV, in the 13th century, espoused the theory of "legal fiction" stating thereby that "corporate bodies could not be ex-communicated because they only exist in abstract". This helped in laying down the foundation of the principle of 'separate legal entity of a company". The approach of corporate law and taxation law in India and in other jurisdictions generally revolves around the concept of the principle of separate legal entity, whereby a company is treated and considered as a separate person in the eyes of law.

[36] *McDowell & Co. Ltd. v. Commercial Tax Officer*, AIR 1986 SC 649

Under the Indian Income Tax Act, 1961, companies and entities are considered to be economic entities with legal independence, i.e., companies are independent of their shareholders or participants. The law further clarifies that a holding and a subsidiary company are also completely distinct from each other when it comes to paying taxes. As a result of this consideration, the entities subject to income tax are taxed on profits derived by them totally on standalone basis, irrespective of their actual degree of economic independence and whether or not the profits earned by them are reserved or distributed to its shareholders of participants as the case may be. Further, shareholders or participants are ordinarily taxed on the profits they derive in consideration of their shareholding or participation as the case may be, like capital gain. It is a well settled principle in law that for the purpose of taxation treaties, a subsidiary company is considered to be totally separate and distinct from its parent company.

A parent company of a group is generally involved in giving principal guidance, like policy guidelines t its subsidiaries in the group. That a parent company exercises shareholder's influence over its subsidiary companies does not necessarily imply that the subsidiary companies are to be deemed as residents of the State where the parent company is incorporated, in other words, the subsidiary companies are not supposed to be deemed to have the same tax residency as that of their parent company.

Further, a parent company's executive director(s) generally lead the group of companies and the parent company's shareholder's influence is generally employed to that end. This indicates a restriction on the autonomy of the director(s) of the subsidiary companies. Such restrictions are reasonably accepted in both corporate law and tax law across the globe. If, however, the competences of the executive director(s) of the subsidiary companies are transferred to certain other persons or bodies, or if the decision making power of the executive director(s) of the subsidiary companies become subordinate to that of the holding company, consequently making the executive director(s) of the subsidiary companies "puppets", then the turning point with regard to the place of residence of the subsidiary company comes about. Likewise, if a controlling nonresident enterprise indirectly transfers through "abuse of organization form or legal form and without reasonable business purpose", resulting into tax avoidance or avoidance of

withholding tax, then the Indian Income Tax Authorities may disregard the form or scheme of the arrangement or the impugned action through use of nonresident holding company, re-characterize the equity transfer according to its economic substance and impose the tax on the controlling nonresident enterprise. Thus, whether or not a transaction is modeled ideally as a colourable device for the distribution of earnings, profits, and gains, is determined by reviewing all the facts and circumstances revolving around the transaction.

The common law countries invariably impose tax on corporations based on the fundamental principle that the corporation is a person separate from its members. Back in 1897, in the case of *Salomon v. Salomon & Co. Ltd.*[37], the House of Lords propounded the principle of separate legal entity, thereby opening the door for the formation of corporate groups. If a one-man company could be incorporated, it would be implicit that one company may be a subsidiary of another. This, further, lays down the platform for "holding structures". It is quite a common practice at the international plane that foreign companies or investors invest in Indian companies through an interposed foreign holding or operating company. As a result of this practice, foreign investors are often able to avoid the otherwise prolific processes of approval and registration required for direct transfers, i.e., without a foreign holding or operating entity, of equity interest in a foreign invested Indian company. Taxing the holding entities gives rise to various other issues, like double taxation, tax avoidance, tax deferrals, etc. The concept of General Anti-Avoidance Rules (GAAR) has been dealt with in this case. The concept is not new in the Indian taxation regime, as India has already enforced a judicial anti-avoidance rule, like many other jurisdictions. Lack of clarity and absence of appropriate provisions in the statute and in the treaty relating to the circumstances wherein judicial anti-avoidance rules would be applicable has triggered assiduous litigation in India. The Special Purpose Vehicle (SPV) and the holding corporation have their spaces in the Indian legal structure, be it in company law, under the SEBI takeover code, or income tax law. When it comes to taxing a holding entity, the burden is generally on the Indian Income Tax Authorities to allege and establish abuse, in terms of avoiding the tax incidence by creating such

[37] (1897) AC 22

structures. While applying the judicial anti-avoidance rule, the Indian Income Tax Authorities may invoke the principle of "substance over from" or the test of "piercing the corporate veil" once they can establish that the transaction in question aims at avoiding tax incidence or is a mere sham. For example, "if a structure is used for circular trading or round tripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity". Likewise, if the Indian Income Tax Authorities identify that in a holding structure an entity has been interposed, which has barely or no business or commercial substance, in order to avoid tax, then in such instances by the application of the test of fiscal nullity, it would be open to the Indian Income Tax Authorities to disregard and discard the interposition o the entity so executed. But this must necessarily be done at the threshold. In this connection, the Supreme Court turned to the "look at" principle propounded in the *WT Ramsay Ltd. v. Inland Revenue Commissioners*,[38] wherein it was observed that:

> "*The Revenue or the Court must look at a document or a transaction in a context to which it properly belongs to. It is the task of the Revenue or the Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment or saving device, but that it should apply the 'look at' test to ascertain its true legal nature*".

By applying the abovementioned tests, the Supreme Court observed that:

> "*Every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue or the Courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the Holding Structure exists; the period of business operations in India. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device*".

[38] (1981) All ER 865

Whether or not Section 9 of the Income Tax Act, 1961 is a "look through" provision?

The Indian Income Tax Authorities contended that the income that was earned by selling the shares of CGP Investment (Holdings) Ltd. falls under Section 9 of the Income Tax Act, 1961 as the said provision provides for the "look through" principle. They further contended that the word "through" in this provision means *inter alia* "in consequence of". Against this background, the Indian Income Tax Authorities claimed that if transfer of a capital asset situated in India happens "in consequence of" anything that has taken place overseas, which may include the transfer of capital assets, then all income earned even indirectly from such a transfer, even though abroad, is liable to be taxed in India.

However, the Supreme Court rejecting the submission, perused the relevant provisions of the Income Tax Act, 1961 as follows:

> "***Scope of total income.***
>
> ***Section 5.***
>
> *(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—*
>
> *(a) is received or is deemed to be received in India in such year by or on behalf of such person; or*
>
> *(b) accrues or arises or is deemed to accrue or arise to him in India during such year.*
>
> *Explanation 1.—Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.*
>
> *Explanation 2.—For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the*

basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India".

*"**Income deemed to accrue or arise in India.***

Section 9.

(1) The following incomes shall be deemed to accrue or arise in India:—

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

Explanation 1.—For the purposes of this clause—

(a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India;

(b) in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export;

(c) in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India;

(d) in the case of a non-resident, being—

(1) an individual who is not a citizen of India; or

(2) a firm which does not have any partner who is a citizen of India or who is resident in India; or

(3) a company which does not have any shareholder who is a citizen of India or who is resident in India, no income shall be deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India.

Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business:

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on

behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

Explanation 3.—Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

Explanation 4.—For the removal of doubts, it is hereby clarified that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

Explanation 5.—For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India".

Section 9 of the Act deals with different heads of income and income earned under each of the sub-clauses is deemed to accrue or arise in India. There are mainly four heads of income and the income dealt with under each sub-clause is distinct and independent of one another and the requirements to bring income within each head are separately noted. It is not necessary that income falling under one head must also satisfy the requirements of other heads in order to bring it within the scope of "income deemed to accrue or arise in India" in Section 9. A charge on capital gains arises on transferring capital asset situated in India during the "previous year". In Section 9(1)(i), three elements are to be satisfied so as to invoke the provision, they are: transfer; existence of a capital asset; and the situation of that capital asset in India. If such a transfer does not take place in the

previous year, no charge over the capital asset in question can be attracted. Further, Section 45[39] states that "such income shall be deemed to be the income of the previous year in which transfer took place". Therefore, evidently, there is no scope for doubt that such transfer must exist during the previous year so as to attract the abovementioned provision. The "fiction" created by Section 9(1)(i) is applicable on the assessment of income of nonresidents. Whereas if residents are involved, it is immaterial whether the place where the income arises is within or without India, because in either case, the resident will be liable to pay the tax. But the situation is different in the case of a nonresident, i.e., unless the income earned by the nonresident accrues or arises in India, he cannot be held liable to pay any tax. To put it in other words, if any income accrues or arises to a nonresident, directly or indirectly, outside India is "fictionally deemed to accrue or arise in India" if the income in question accrues or arises to him as a result of transferring capital asset situated in India. Once this is established by the Indian Income Tax Authorities, the income so arose or accrued to the nonresident from such transfer is made liable to be taxed under Section 5(2)(b) of the Act. Further, this fiction can only be enforced only when the income is not taxed on the basis of "receipt" in India, because in India receipt of income is anyway liable to be taxed irrespective of whether the recipient is a resident or a nonresident.

The legislature inducted this fiction or deeming provision into the Act with an objective of quashing any possible contention by a nonresident vendor that the profit arose or accrued to him outside India under any contract of sale executed outside India. Therefore, the law is quite well settled that income arising or accruing to any nonresident outside India on transferring capital asset situated in India is "fictionally deemed" to have arisen or accrued in India and is further liable to be charged to by means of Section 5(2)(b) of the Income Tax Act, 1961. This is the main objective behind the provision engrafted in Section 9(1)(i) of the Act. The Supreme Court went on to stating further that a legal fiction has a very limited scope; it cannot be expanded by purposive interpretations especially when the interpretation may likely transform the concept chargeability.

[39] Provided in Annexure III

The Supreme Court clarified further that in the contention of the Indian Income Tax Authorities, they meant that under Section 9(1)(i), they can "look through" the transfer of shares of a foreign company which is holding shares in an Indian company and, therefore, treat that transfer of shares of the foreign company as equivalent to the transfer of shares of the Indian company income on the ground that Section 9(1)(i) covers "direct and indirect transfers" of capital assets situated in India. But Section 9(1)(i), as observed by the Supreme Court, cannot by means of interpretation be extended to bring within its ambit "indirect transfers" of any property or capital asset situated in India, because if that is done, the content and the ambit of Section 9(1)(i) will be changed. Also, if "indirect transfer" be read into Section 9(1)(i), it would make the fourth sub-clause under the same provision nugatory, because this provision can be applied only when capital assets situated in India are transferred. Similarly, the term "underlying asset" does not find any place in the said provision. It is, further, to be noted that the transfer must necessarily be of an asset with regard to which it should be possible to compute the capital gain according to the provisions of the Act. Even Section 163(1)(c)[40] has a wide connotation which covers income earned directly or indirectly. Therefore, the words "directly" or "indirectly" in Section 9(1)(i) must necessarily go with the income and not with the transfer of a property or capital asset.

The Supreme Court most pertinently mentioned in this respect that:

> "*The Direct Tax Code Bill, 2010 proposes to tax income from transfer of shares of a foreign company by a nonresident, where at any time during 12 months preceding the transfer, the fair market value of the assets in India, owned directly or indirectly, by the company, represents at least 50% of the fair market value of all assets owned by the company*".

Therefore, by way of proposing to tax offshore share transactions, it is clear that indirect transfers are not covered by the existing Section 9(1)(i) of the Income Tax Act, 1961. The Bill of 2010 expressly states that income accruing even from indirect transfer of capital asset situated in India is to be deemed to have accrued in India. This proposal clarifies the

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[40] Provided in Annexure IV

stand that “indirect transfer” cannot be read into Section 9(1)(i) for the purpose of construction. It is a matter of policy to provide “look through” in a statute or a treaty and it is to be expressly provided for in the statute or the treaty in question. Due to the same reason, the principle of “limitation of benefits” must also be expressly mentioned in the treaty. Such clauses cannot be read into the provisions of law only for the purpose of interpretation. Therefore, the Supreme Court concluded that for the reasons mentioned above, Section 9 is not a “look through” provision.

Whether a company’s property right is transferred by extinguishment?

The Supreme Court drew a conceptual difference between “preordained transaction”, which is mostly created for the purposes of tax avoidance, and a transaction, which establishes “investment to participate” in India and went on to observe that:

> “*In order to find out whether a given transaction evidences a preordained transaction or investment to participate, one has to take into account the factors enumerated hereinabove, namely, duration of time during which the holding structure existed; the period of business operations in India; generation of taxable revenue in India during the period of business operations in India; the timing of the exit; the continuity of business on such exit; etc*”.

Therefore, the Supreme Court refused to accept that the structure in the present case was created or used for avoiding tax or as a sham, and that neither HTIL nor VIH was a “fly by night” operator, i.e., a short time investor. If the “look at” test be applied then extinguishment clearly seems to have taken place due to the transfer of the shares of CGP Investment (Holdings) Ltd. and not means of various clauses of the Sale and Purchase Agreement (SPA).

Impugned approach of the High Court

The High Court of Bombay applied the “nature and character of the transaction” test, as per which it was concluded that the transfer of the shares of CGP Investment (Holdings) Ltd. was inadequate to attain the objective of consummating the transaction between Hutchison Telecommunication International Limited and Vodafone International

Holdings BV. The purpose of the transaction was the transfer of other "rights and entitlements", which constituted "capital assets" within the meaning of Section 2(14)[41] of the Income Tax Act, 1961. As per the High Court's observation, Vodafone International Holdings BV acquired the shares of CGP Investment (Holding) Ltd. with other rights and entitlements. But this approach was corrected by the Supreme Court holding that whatever the appellant acquired was through the shares of CGP Investment (Holding) Ltd.

The Supreme Court went on to hold that the subject matter of the transaction must essentially be viewed from a realistic and commercial standpoint. The case in hand deals in offshore transaction involving a structured investment. It concerns a "share sale" and not an "asset sale". A "sale" takes various forms and accordingly their tax consequences also vary. Therefore, the tax consequence of an asset sale will be different from that of a share sale. The Supreme Court went to further clarify that:

> "*Control" is a mixed question of law and fact. Ownership of shares may, in certain situations, result in the assumption of an interest which has the character of a controlling interest in the management of the company. A controlling interest is an incident of ownership of shares in a company, something which flows out of the holding of shares. A controlling interest is, therefore, not an identifiable or distinct capital asset independent of the holding of shares. The control of a company resides in the voting power of its shareholders and shares represent an interest of a shareholder which is made up of various rights contained in the contract embedded in the Articles of Association. The right of a shareholder may assume the character of a controlling interest where the extent of the shareholding enables the shareholder to control the management. Shares, and the rights which emanate from them, flow together and cannot be dissected*".

The Supreme Court relied on *IRC v. Crossman*[42], which throws light on the "congeries of rights and liabilities" created by the laws relating to company and the Memorandum and

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[41] Provided in Annexure V
[42] [1936] 1 All ER 762

Articles of Association of the company and held that control and management is nothing but a facet of shareholding. Applying this test, the Supreme Court concluded that the transaction in the present case is that of a share sale, wherein Vodafone International Holdings BV acquired upstream shares with an objective that the congeries of rights flowing from CGP Investment (Holding) Ltd. would give the former an indirect control over the three genres o companies.

Scope and applicability of Sections 195 and 163[43] of the Income Tax Act, 1961

Section 195 of the Income Tax Act, 1961 confers an obligation on the taxpayer to deduct tax at source from the payments made to nonresidents, which are otherwise chargeable to tax. Such payments must necessarily have an element of income embedded in it, which is chargeable to tax in India. If the sum paid or credited by the taxpayer is not chargeable to tax in India then there arises no obligation to deduct the tax. The shareholding in companies incorporated outside India, CGP Investment (Holding) Ltd. in this case, is a property situated outside India. If these shares become the subject matter of offshore transfer or transaction between two nonresidents, then there arises no liability for capital gains tax. Also, in such a circumstance, the question of deducting tax at source does not arise. If under any provision of law the responsibility of paying is on the nonresident, the fact that the payment has already been made, under the nonresident's instructions, to its nominee or agent in India or its permanent establishment or branch office will not absolve the taxpayer of his liability to deduct tax at source under Section 195. Section 195(1)[44] confers a duty on the taxpayer of any income specified therein to a nonresident to deduct there from the tax at source unless such taxpayer is liable to pay tax thereon as an agent of the taxpayer. Under Section 201, if such a taxpayer fails to deduct that tax at source, he is deemed to be an assessee-in-default with regard to the amount of tax so deductable. The Supreme Court clearly differentiated "assessment" from "liability to deduct tax". The person who is under the obligation to deduct tax at source may not be the person who has earned that income. The assessment of the income has to be done

[43] *Supra* n. 54
[44] *Supra* n. 40

once the liability to deduct tax at source has arisen. The objective of Section 195 is to ensure that the tax due from a nonresident is secured at its earliest point in time so that subsequent difficulties in collecting the tax at the time of irregular assessment do not arise. In this case, there is a transaction of "outright sale" of capital assets outside India between two nonresidents. This transaction was entered upon on a principal to principal basis. Therefore, the liability to pay tax at source did not arise.

Further, where there is a transfer of structure in its entirety, the "single consolidated bargain", which took place between the foreign companies outside India, has to be looked into holistically. Under the transaction, the payment was not split up by the companies. It was the Indian Income Tax Authorities that split the consolidated payment and wanted to assign a value to the rights to control the premium, rights to consultancy support, rights to non-compete, et al. The Indian Income Tax Authorities did not assign any price for each right, which was considered by them as "capital asset" in the transaction. In the absence of a permanent establishment, profits were not attributed to the Indian companies. Income can be levied on any factor of the transaction provided the factor is subjected to tax under the Income Tax Act, 1961 and is not an unrelated matter. Further, "the investment made by Vodafone Group companies in Bharti did not make all entities of that Group subject to the Indian Income Tax Act, 1961 and the jurisdiction of the tax authorities. Tax presence must be construed in the context, and in a manner that brings the nonresident assessee under the jurisdiction of the Indian tax authorities".

Observation

Finally, the Supreme Court concluded that:

> "*FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works. Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner. Legal doctrines like 'Limitation of Benefits' and 'look through' are matters of policy. It is for the Government of the day to have them incorporated in the Treaties and in the laws so as to*

avoid conflicting views. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws."

2.2.2.3.*VODAFONE INDIA SERVICES PVT. LTD. V. UNION OF INDIA & ORS.*[45]

Vodafone India Services Pvt. Ltd. (hereinafter referred to as "the petitioner") is a company incorporated in India and is a wholly owned subsidiary of a non-resident company, namely the Vodafone Tele-Services (India) Holding Ltd. (hereinafter referred to as "the holding company"). The petitioner issued 2,89,224 equity shares of a face value of Rs. 10/- each at the premium of Rs. 8,519/- per share to its holding company. As a result of this transaction, the petitioner received a total consideration of Rs. 246.38 crores from its holding company in lieu of issuing the shares. The fair market value of the equity shares so issued was determined as per the methodology prescribed in the Capital Issues (Control) Act, 1947. The petitioner filed its return of income for the Assessment Year (AY) 2009-10 with the Revenue. The petitioner also filed Form 3-CEB as per Section 92E[46] of the Income Tax Act, 1961, wherein the petitioner declared that the transaction of issuing the equity shares to its holding company for a consideration was an international transaction and the Arm's Length Price of the shares so issued were determined as per the most appropriate method. The petitioner also clarified at this point that the transaction so mentioned in Form 3-CEB did not affect its income. The information was provided only as an abundant caution.

In December 2012, the respondent Transfer Pricing Officer (TPO) issued a show cause notice to the petitioner calling them upon to show cause why:

"*i. The issue price (including the premium) of the equity shares to its holding company as declared by the petitioner;*

[45] Writ Petition No. 871 of 2014

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

ii. The issue price (including the premium) of the equity shares to its holding company as declared by the petitioner should be accepted for the purposes of computing ALP under the Act; and

iii. The ALP of the shares issued by the petitioner to its holding company be not determined on the basis of its Net Asset Value (in short "NAV"), after taking into account the transfer pricing adjustment for the Assessment Years 2007-08 and 2008-09."

The petitioner duly filed its response to the show cause notice, thereby contending that Chapter X of the Act of 1961 containing the provisions relating to transfer pricing does not apply on issue of equity shares and, therefore, on this ground, the TPO was without jurisdiction to issue the notice. Against this contention, the TPO passed the following order:

"*i. The issue of equity shares is an international transaction governed by Chapter X of the Act as is evident from Form 3 CEB dated 28 September 2009 filed by the petitioner;*

ii. The transaction was an international transaction as is evident from the Explanation (i)- (c)[47] and (e)[48] to Section 92- B of the Act, which provides that capital financing and restructuring of business would be so;

iii. The issue whether any Income has arisen and/or affected by the international transaction for purposes of Chapter X of the Act would be determined by the AO. The jurisdiction exercised by TPO is only to determine the ALP of international transactions and not compute and/or assess the income arising out of such international transactions;

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[47] The expression "international transaction" shall include—capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business.

[48] The expression "international transaction" shall include—a transaction of business restructuring or reorganization, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date.

iv. The consequence of issue of shares by the petitioner to its holding company at a lower premium resulted in the petitioner subsidizing the price payable by the holding company. This deficit would be a loan extended by the petitioner to its holding company and such loan would have bearing on the profit of the assessee in terms of interest;

v. The ALP of the issue of equity shares by the petitioner to its holding company as determined by the Accountant under Section 92E of the Act was rejected. This on the ground that methodology of valuation adopted is not suitable to derive the ALP;

vi. The transfer pricing adjustment for the A.Y.s 2007-08 and 2008-09 have to be taken into account to determine the fair value of the petitioner's business".

As the matter came up for hearing before the High Court of Bombay, the petitioner contended the following:

Chapter X of the Income Tax Act, 1961 has been incorporated in the Act as a special provision relating to issues of tax avoidance. Under Section 92(1),[49] income arising from international transaction is computed based on the arm's length principle. Therefore, one of the key essentials to invoke this provision of law is that the income must arise from an "international transaction". However, in the transaction in question, no income has arisen from issuing the equity share by the petitioner to its holding company.

The word "income" has not been separately defined in Chapter X. Therefore, the for the purpose of the international transaction in question, for interpreting the word "income", the definition given in Section 2(24)[50] of the Act has to be relied upon. The Indian Income Tax Authorities cannot be given the privilege of interpreting a fiscal statute as per its whims and fancies, because it is a well principle of law that "*a fiscal statute has to be*

[49] Any income arising from an international transaction shall be computed having regard to the arm's length price. *Explanation.*—For the removal of doubts, it is hereby clarified that the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price.

[50] *Supra* n. 41

strictly interpreted upon its own terms and the meaning of ordinary words cannot be expanded to give purposeful interpretation".

Further, Chapter X of the Income Tax Act, 1961 does not aim at levying tax on all sums involved in a transaction, which would otherwise not come within the ambit of tax incidence under the Act. "The purpose and objective is not to tax difference between the ALP and the contracted or book value of said transaction but to reach the fair price or consideration". Therefore, for a transaction to be charged to tax under the Act, it is essential that a "taxable income" arises. However, the Indian Income Tax Authorities, in the transaction in question, aimed at levying income tax on all amounts involved, which is equivalent to imposing penalty for entering upon a transfer pricing transaction, which does not give rise to any taxable income to either party, at a value determined by the Indian Income Tax Authorities based on ALP.

The share premium on the issue of shares cannot be taxed. But the Indian Income Tax Authorities in this transaction aimed at bringing to tax the amount of share premium as they had deemed that the amount was not as per ALP.

Shares come to existence only when they are allotted, i.e., when they are allotted for the first time, they become of movable property for the first time. This is conceptually different from transfer of shares, in the case of which an already existing movable property is passed on. Issuing shares is a process by which shares are created and it should not be mistaken for transfer of shares. Since there is no transfer of shares in the present transaction, there arises no requirement to apply Section 45[51] of the Act.

In the present transaction, the petitioner issued shares to its holding company and the receipt of consideration of the same is a capital receipt under the Income Tax Act, 1961. As per the Act, capital receipts cannot be taxed unless expressly or specifically charged to tax under the Act. It is a well settled principle in law that "capital receipt" does not come within the bounds of the definition of "income" under Section 2(24)[52]. It only makes capital gain chargeable to tax under Section 45.

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[51] *Supra* n. 52

[52] *Supra* n. 64

Under Section 2(24)(xvi) of the Income Tax Act, 1961, “income” includes within its ambit the amount received that has accrued or arisen under Section 56(2)(vii)(b). But it applies only when the shares are issued to a resident and additionally it seeks to levy tax on the consideration received in excess of the fair market value of the shares and not the shortfall in the issue price of the equity shares. This clearly indicates that the Act does not intend to tax the issue of shares below fair market value.

The Indian Income Tax Authorities has proceeded on a conjecture with the believe that the amount of share premium foregone received by the petitioner would have been invested by them giving rise to an income. It is a well settled principle in law that tax cannot be charged on a mere presumption unless there is full proof evidence that an income has arisen as a result of any transaction.

The Indian Income Tax Authorities relied on the meaning of “international transaction” as provided in Explanation (i)- (c) and (e) to Section 92B of the Income Tax Act, 1961 so as to conclude that an income has arisen. However, it is to be taken into account that Explanation (i)-(c) to Section 92B only states that a capital financing transaction such as borrowing or lending money to an associated enterprise is an international transaction. What has been charged to tax in the present case is not the quantum of amount lent or borrowed but the impact on income as a result of such lending and borrowing. The impact has been found in either under reporting or over reporting the interest paid or received. Likewise, Explanation (i)-(e) to Section 92B covers within its ambit business restructuring and the provision will be applicable only is such a restructuring has an impact on the income. If such restructuring impact the income be it in present or future, then that income would be charged to tax. However, in this case, such a contingency has not arisen, as there has been no impact on the income, therefore, the share premium foregone received due to issue of shares cannot be brought to be taxed under the Income Tax Act, 1961.

The Bombay High Court ruled in favor of the petitioner and held and observed as under:

As per the submission of the Indian Income Tax Authorities, Section 91(1) requires to be read with Section 92(2)[53] *of the Income Tax Act, 1961, and this conjoint reading indicates that the cost incurred to pass on the benefit to the holding company has been sought to be taxed and it is not the share premium that is foregone which has been aimed to be taxed. The difference between the price charged for issuing the shares and ALP is the benefit earned by the holding company. This passage of benefit to the holding company is a cost to the petitioner, which the Indian Income Tax Authorities aimed to tax. Considering this argument, the High Court perused Section 92 in the following manner (The dotted words are omitted for the purpose of interpretation/construction):*

*"**Computation of income from international transaction having regard to arm's length price.***

Section 92.

(2) Where in an international transaction…two or more associated enterprises enter into a mutual…arrangement for…any contribution to, any cost…incurred…in connection with a benefit…provided…to any one or more of such enterprises, the cost…contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit…"[54]

The High Court was of the view that a provision has to be read in its entirety. By rejecting or ignoring certain words to make the provision unworkable to the situation in hand is not a permissible mode of interpretation. Section 92(2) deals with the scheme of arrangement in which two associated enterprises receive a benefit, facility, or provision of service and where the allocation, contribution, and apportionment towards the cost and

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[53] *Infra* n.68

[54] §92(2) Where in an international transaction or specified domestic transaction, two or more associated enterprises enter into a mutual agreement or arrangement 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, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

expenditure is determined based on ALP. The High Court elaborated this with the help of the following example:

> *"Thus, to illustrate, the cost of research carried on by an AE for the benefit of three AE's, then the cost will be distributed i.e. allocated, apportioned or contributed depending upon the ALP of such benefit to be received by the assessed AE. It would have no application in the cases like the present one, where there is no occasion to allocate, apportion or contribute any cost and/or expenses between the Petitioner and the holding company*".

Relying on the decision of *Mazagaon Dock Ltd. v. CIT*,[55] the Indian Income Tax Authorities contended that the issue is no longer res intergra. Section 42(2) of the Income Tax Act of 1922 dealt with transfer pricing. In this case it was observed that:

> "*The tax is charged on the resident in respect of profits which he would have normally made but not made, because of a business association with a nonresident*".

In the abovementioned case, the resident was subjected to tax on notional profits relating to its business dealings with a nonresident. For better understanding of this contention, the High Court perused Section 42(2) of the Income Tax Act, 1922, which reads as under:

> ***"Non-residents.***
>
> ***Section 42.***
>
> *(2) Where a person not resident or not ordinarily resident in the taxable territories carries an business with a person resident in the taxable territories, and it appears to the Income Tax Officer that owing to the close connection between such persons, the course of business is so arranged that the business done by the resident person with the person not resident or not ordinarily resident produces to the resident either no*

[55] (1958) 38 ITR 368

profits or less than the ordinary profits which might be expected to arise in that business, the profits derived therefrom, or which may reasonably be deemed to have been derived therefrom, shall be chargeable to income tax in the name of the resident person who shall be deemed to be, for all the purpose of this Act, the assessee in respect of such income tax."

If the above provision is compared with Chapter X of the Income Tax Act, 1961, particularly with Section 92, the words "shall be chargeable to income tax" found in Section 42(2) of the erstwhile Act are absent in Chapter X of the Act of 1961. Therefore, it seems very clear that the deemed income or the notional income dealt under the erstwhile Act has been done away with under the Act of 1961. Evidently, the charge of income has to be found in under Section 4 of the Income Tax Act, 1961. This made the High Court peruse the definition of "income" given in Section 2(24)[56] of the Income Tax Act, 1961. The amount received on issuing the shares is a capital account transaction, which is not separately brought within the definition of "income", except for in those cases that are expressly covered under Section 56(2)(vii)(b) of the Act of 1961. "Thus such capital account transaction not falling within a statutory exception cannot be brought to tax".

The following factors are the most essential ingredients to a taxing statute:

- Subject of tax;
- Person liable to pay the tax;
- The rate at which the tax is to be paid;
- The measure or the value on which the rate is to be applied.

These factors clearly establish that there is a difference between "charge to tax" and "measure of tax". This distinction was brought out by the Supreme Court in the case of *Bombay Tyres India Ltd. v. Union of India*[57] wherein it was observed that:

"*The charge of excise duty is on manufacture while the measure of the tax is the selling price of the manufactured goods*".

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[56] *Supra* n.64
[57] 1984 (1) SCC 467

In the present case, the charge is on income and if the income arises from an international transaction, then the measure is to be found by applying ALP as far as Chapter X is concerned. However, on computing the value of the transaction on the basis of ALP, does not convert a non-income into income. Tax can be levied only on the income, and if no income arises, i.e., if factor (a) is not satisfied, then the question of applying the measure of ALP to the value or consideration of the transaction does not arise.

The Indian Income Tax Authorities contended that keeping Chapter X of the Income Tax Act, 1961 in view, the notional or the deemed income must be brought to tax and the real income will have no place. The very exercise to determine ALP aims at arriving at the real income earned by the associated enterprises, i.e., the correct price of the transaction. Here, the Indian Income Tax Authorities have mistaken by calling the measure a deemed or notional income. The High Court has also given due consideration to the contention of the petitioner in this regard. The definition of "income" given in Section 2(24)(xvi) includes the scope of Section 56(2)(vii)(b) of the Income Tax Act, 1961. On perusing these provisions, the High Court observed that:

> "*This indicates the intent of the Parliament to tax issue of shares to a resident, when the issue price is above its fair market value. In the instant case, the Revenue's case is that the issue price of equity share is below the fair market value of the shares issued to a non-resident. Thus, Parliament has consciously not brought to tax amounts received from a non-resident for issue of shares, as it would discourage capital inflow from abroad. The revenue has not been able to meet the above submission but have in their written submission only submitted that the above provisions would have no application to the present facts*".

Before Section 56(1) can be applied, it must essentially be established that an income has arisen. Section 56 does not allow income of every kind, which is not excluded from the total income, to be charged to tax under the head "income from other sources". Here the issue of the shares at premium is on capital account as mentioned above and this does not give rise to any income.

The High Court further observes that ALP aims at determining the actual or the real value of the transaction between the associated enterprises. It is an exercise of re-computation o income, like interest received or paid, loans given or taken, depreciation taken on machinery, etc., carried out only when income arises from an international transaction between the associated enterprises. And the entire exercise is a capital account transaction. This does not warrant the re-computation of a consideration given or received from a capital account. To put it in other words:

> "*Although Section 56(1) of the Act would permit including within its head, all income not otherwise excluded, it does not provide for a charge to tax on Capital Account Transaction of issue of shares, as is specifically provided for in Section 45 or Section 56(2)(vii)(b) of the Act and included within the definition of income in Section 2(24) of the Act*".

The Indian Income Tax Authorities further contended that income becomes taxable as soon as it arises or accrues or when it is deemed to arise or accrue and not only when it is received. Though the petitioner did not receive the consideration for issuing its shares to its holding company, i.e., the ALP value, the difference between the contract price and the ALP is the income, which even if is not received but arises must be brought to be taxed under the Act. Against this contention, the High Court held that:

> "*There can be no dispute with the proposition that income under the Act is taxable when it accrues or arises or is received or when it is deemed to accrue, arise or received. The charge-ability to tax is when right to charge-ability to tax is when right to receive an income becomes vested in the assessee. However, the issue under consideration is different viz: whether the amount said to accrue, arise or receive is at all income. The issue of shares to the holding company is a capital account transaction, therefore, has nothing to do with income*".

The Indian Income Tax Authorities contended that Chapter X is not merely an instrument to compute ALP. "It is a hidden benefit of the transaction which is being charged to tax and the charging Section is inherent in Chapter X of the Act. It is well settled position in

law that a charge to tax must be found specifically mentioned in the Act. In the absence of there being a charging Section in Chapter X of the Act, it is not possible to read a charging provision into Chapter X of the Act". The High Court observed in this regard that Chapter X of the Income Tax Act, 1961 is nothing but an instrument by which ALP is determined in the transaction between associated enterprises. The substantive charging provisions in the Act are mainly Sections 4, 5, 15, 22, 28, 45, and 56. It is essential that an income arising from an international transaction between the associated enterprises satisfies the test of income under the several heads mentioned above. It is only after such satisfaction can the tax be levied upon. However, the High Court noted that the Indian Income Tax Authorities have not been able to show that such conditions have been fulfilled.

The Indian Income Tax Authorities further contended that the instrumental section of the Act, i.e., Chapter X cannot be read de hors charging sections mentioned above.
For the reasons furnished above, the High Court took the view that:

> "*The issue of shares at a premium by the petitioner company to its holding company does not give rise to any income from an admitted international transaction*".

CHAPTER III

3. ARM'S LENGTH PRINCIPLE

A transaction between independent enterprises and the financial and commercial relations, i.e., the conditions of transfer, the price at which services are provided or goods are transferred, etc., arising between the parties as a result of such transaction are ordinarily determined by market forces.[58] However, a transaction between associated enterprises and the financial and commercial relation between the parties arising as a result of this transaction may not always be directly affected by the external market forces. But this must not necessarily induce the tax authorities assume that the associated enterprises resorted to manipulate their profits, because determining an accurate market price may be difficult in the absence of market forces or when a particular commercial strategy is adopted. It is pertinent to note at this point that the need to make adjustments to any arm's length transaction crops up notwithstanding any contractual obligation undertaken by the parties for paying a certain price or of any intention of the parties to minimize tax liability.[59] Therefore, any adjustment of tax under the arm's length principle ideally does not affect the contractual obligations for non-tax purpose between the associated enterprises and it may be appropriate even if there is no intention to minimize or avoid tax liability.[60] Further, the consideration for transfer pricing should not be mistaken for tax avoidance, even though the policies relating to transfer pricing may be used for such purpose.

If it may so arise that transfer pricing fails to reflect the market forces and the arm's length principle, it will distort the tax liabilities of the associated enterprises parties to the transaction and the tax revenues of the host countries.[61] In order to avoid such a fiasco, the member countries of the Organization of Economic Cooperation and Development have arrived at a consensus that for the purpose of taxation, the profits of the associated enterprises must necessarily be adjusted to the distortions so as to ensure that the arm's

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[58] UNTC TRANSFER PRICING METHODS
[59] *Id*.
[60] PWC, *International Transfer Pricing* 2013/14, www.pwc.com/International-transfer-pricing/assets/itp-2013-final.pdf
[61] *Supra* n. 18

length principle is satisfied. The member countries further consider that an appropriate adjustment can most definitely be achieved between the associated enterprises by establishing the conditions of the financial and commercial relations that they would otherwise expect to find had the transaction been between independent enterprises in comparable transactions. It should not be taken for granted that the conditions of financial and commercial relations between associated enterprises will deviate invariable from what the market would otherwise demand. Associated enterprises in MNEs sometimes have a considerable amount of autonomy and can often bargain with each other as though they were independent enterprises.[62] Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises.[63] Therefore, a proof of only hard bargaining does not suffice alone to establish that the transaction as per arm's length principle.

3.1. ASSOCIATED ENTERPRISES: AN ANALYSIS OF ARTICLE 9 OF THE OECD MODEL TAX CONVENTION

The concept of arm's length principle finds its authoritative statement in Article 9 of the OECD Model Tax Convention, which serves as the backbone of the bilateral tax treaties between the member countries of the OECD and the non-member countries. Article 9 states as under:

> "***ASSOCIATED ENTERPRISES***
>
> ***Article 9.***
>
> *1. Where*
>
> *a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their*

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[62] OECD DISCUSSION DRAFT ON TRANSFER PRICING DOCUMENTATION AND CBC REPORTING (2014)
[63] *Id*.

commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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

The arm's length principle follows stand of treating the affiliates of an MNE group as separate entities instead of indivisible parts of a single unified business. To this end, the principle seeks to adjust the profits by referring to the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances, i.e., comparable uncontrolled transactions. The rationale behind following the approach of treating the affiliates of MNE as separate entities is that emphasis will likely be laid upon the nature of the transactions between the members so as to determine the extent to which the conditions differ from the conditions that would be obtained in comparable uncontrolled transactions.[64] Therefore, it is to be taken into account in this respect that an analysis of uncontrolled and controlled transactions, often called the "comparability analysis" is the sole factor to determine the arm's length price. Article 9 of the OECD Model Tax Convention, thus, lays the foundation for comparability analysis as it brings to light the need for the following:

[64] OECD TRANSFER PRICING COMPARABILITY DATA AND DEVELOPING COUNTRIES (2014)

- A comparison between the conditions of financial and commercial relations of associated enterprises and that of independent enterprises to determine whether a re-writing of accounts for the purposes of calculating tax liabilities of associated enterprises is authorized under Article 9 of the OECD Model Tax Convention; and
- A determination of profits that would have accrued at arm's length to determine the quantum of any re-writing of accounts.[65]

The rationale behind adopting arm's length principle by the member countries of the OECD is that ALP facilitates a wide parity of tax treatment for the members of the MNE groups and the independent enterprises. This is because ALP puts associated and independent enterprises on an equal footing for the purpose of taxation. It averts the possibilities of tax advantages and disadvantages which otherwise have the capability of distorting the relative competition positions of either type of entity. By setting aside the tax considerations from economic decisions, ALP promotes the expansion of international trade and helps in bringing in more investments from all across the world.

Notwithstanding the advantages of implementing ALP, the mechanism has also been viewed as inherently flawed as critiques are of opinion that the separate entity approach in many circumstances may not account for the economies of scale and interrelation of diverse activities created by integrated business.[66] Moreover, there are some practical difficulties in applying ALP, for instance, associated enterprises may often undertake certain transactions, which the independent enterprises may not indulge in. Such transactions between the associated enterprises may not essentially be motivated by tax avoidance but may often be encouraged because while transacting with each other, the affiliates of the MNE group may face different commercial and financial circumstances than would independent enterprises. Also, independent enterprises seldom transact the kinds of business undertaken by the associated enterprises in their ordinary course; in such a circumstance, it is difficult to apply ALP as there is barely any evidence of the kind of conditions that would have been established by the independent enterprises.

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[65] OECD TRANSFER PRICING COMPARABILITY DATA AND DEVELOPING COUNTRIES (2014)
[66] *Id*.

Further, ALP may prove to be an administrative burden of evaluating the numbers and types of the transnational transactions for the taxpayer as well as for the tax authorities. Although associated enterprises ordinarily establish the financial and commercial conditions for a transaction, at times they are also required to corroborate that these conditions are consistent with ALP. The tax authority is often required to verify the process of the transaction. The verification mechanism involves reviewing the documents prepared by the taxpayer to show that the transaction in question conforms to ALP, gathering information regarding comparable uncontrolled transactions, verifying the market condition that prevailed at the time of the transaction, etc.

The tax authority as well as the taxpayer often find it difficult to obtain adequate information for applying ALP. Substantial data is required to be obtained as the application of ALP ordinarily requires taxpayers and tax authorities to evaluate uncontrolled transactions and the business carried out by independent enterprises and compare them with the transactions and business activities carried out by the associated enterprises. The information available for this purpose may be incomplete or ambiguous making it difficult to interpret and other information may be difficult to access due to their geographical location or the parties from whom they are to be obtained.

3.2. APPLICATION OF ARM'S LENGTH PRINCIPLE[67]

3.2.1. COMPARABILITY ANALYSIS

The application of ALP is generally dependent on a comparison of the financial and commercial conditions in a controlled transaction with such conditions in a transaction between independent enterprises. In order to have the comparison worked, the economically relevant attributes of the situations being compared must essentially be "comparable", that is to say, the differences between the situations being compared must not affect the conditions that are being examined in the methodology or reasonably accurate adjustments must be made to minimize the effect of such differences.[68]

[67] *Supra* n. 18
[68] UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (2013)

When the independent enterprises evaluate the terms and conditions of any potential transaction, they tend to compare the transaction to the other options accessible to them and they enter into such transaction only when they exhaust all other plausible alternatives. Therefore, when the comparisons are being entailed by applying ALP, the tax authorities must take into account the differences to establish the comparability between the situations being compared and make the necessary adjustments to achieve the comparability.[69]

Therefore, when making the comparisons entailed by application of the arm's length principle, tax administrations should also take these differences into account when establishing whether there is comparability between the situations being compared and what adjustments may be necessary to achieve comparability.

3.2.2. FUNCTIONAL ANALYSIS

The functional analysis aims at identifying and comparing the economically significant responsibilities and activities undertaken, risks assumed, and assets used by the parties to the transaction. To this end, it becomes indispensible to understand the structure of the MNE group and how they influence the operations of the taxpayer.

It is pertinent to identify and compare the functions of the taxpayer and the tax authority emphasizing on the research and development, manufacturing, servicing, advertising, transportation, distribution, marketing, financing, management, et al. It is the principal function performed by the party in the transaction that needs to be identified. Necessary adjustments may be made for any material differences from the functions performed by the independent enterprises with which that party is being compared.

If a situation so arises where one party performs bulk of the functions as compared to the other party to the transaction, the economic significance of such functions in terms of their nature, frequency, and value to the respective parties to the transaction needs to be seen to.

Further, the functional analysis is to take into account the type and nature of the assets used such as plant and equipment, financial assets, market value, protections available,

[69] UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (2013)

property rights, location, etc. the functional analysis will not be complete if the material risks assumed by the parties to the transaction have not been considered, because it is the allocation and assumption of risks that influence the financial and commercial conditions of the transactions between the associated enterprises.

Generally, in the open market, the assumption of increased risk is compensated by an increase in the expected return, even if the actual return does not increase, depending on the degree to which the risks are actually realized.[70] “Risks” as mentioned above include market risks, i.e., input cost and output price fluctuations; risks of loss related to the investment over any property, plant, and equipment; risks of the success or failure of such investment in research and development; risks cause by currency exchange rate and interest rate variability; credit risks; etc.

The functions so performed by the parties to the transaction will determine the allocation of risks and accordingly the financial and commercial conditions each party is to expect in arm’s length transaction.

3.2.3. CONTRACTUAL TERMS

The contractual terms of a transaction lay down the responsibilities, duties and obligations, risks and benefits to be shouldered by the parties to the transaction. The terms of the transaction are generally found in written form. However, if no written contract exists, the contractual relationship between the parties is to be gathered from their business conduct and the economic forces that in the ordinary parlance govern the relationship between the independent enterprises. In a case of a transaction between independent enterprises, there generally exists a divergence of interests which prompts the parties to adhere to the terms of the contract and the contractual terms and conditions may be amended and altered as per the conveniences of the parties provided both the parties assent to the same. But the same divergent interests may not exist between the associated enterprise when they transact, and it is therefore indispensible to assess whether or not the conduct of the parties conforms to the terms and conditions of the contract or whether or not the conduct of the parties contravene the contractual

[70] UNITED NATIONS PRACTICAL MANUAL ON TRANSFER PRICING FOR DEVELOPING COUNTRIES (2013)

obligations. In these cases, a detailed analysis is required to determine the true terms of the transaction

The information relating to the contractual terms and conditions of a comparable uncontrolled transaction, in practice, may be limited or even unavailable, especially when the external comparables provide the basis for the analysis. The effect of unavailability of information to establish comparability differs depending on the nature of the transaction in question and the transfer pricing method so applied.

3.2.4. ECONOMIC CIRCUMSTANCES

ALP varies across the globe due to the different market conditions in different jurisdictions, therefore, in order to attain the "comparability", it is necessary that the markets in which the associated and the independent enterprises operate do not have difference that would otherwise affect the price or make it difficult to induct the appropriate adjustments.

As a matter of fact, it is pertinent to identify the relevant market considering the availability of substitute goods and services. Economic circumstances, which are relevant to determine the market comparability, include within its ambit the size of the market; the geographic location; factors of competition; the position of the buyer and seller; supply, demand, and availability of goods and provisions of service; purchasing power of the consumer; government's control over the market and the market related government regulations; time of the transaction; etc. Whether or not the economic circumstances affect the price and the subsequent adjustments differ from one case to another depending on the particular facts pertaining to the transaction.

The economic-business-product cycle is an economic circumstance that affects comparability. Further, the geographic location of the market is another economic circumstance which affects the factor of comparability. The identification of the relevant market condition is a question of fact.

Where the MNE group carries out similar controlled transactions in different jurisdictions, and if the economic circumstances in these jurisdictions are approximately homogenous, the MNE group often relies on a "multiple-country comparability analysis"

in order to support its transfer pricing policy towards the jurisdictions in question. Contrarily it may also happen that an MNE group offers significantly different ranges of goods and services or undertakes to perform different sets of functions in different jurisdictions, using different assets and assuming different risks, following different business strategies. In such a situation, resorting to a multiple-country approach may have the ability to reduce the reliability.

3.2.5. BUSINESS STRATEGY

A business strategy takes into consideration many aspects of the enterprise, for instance product development, risk aversion, degree of diversification, dynamics of the political affairs, labour related issues, etc. that affect the day to day conduct of the business. Sometimes business strategies also include schemes of market penetration wherein a taxpayer may penetrate the market or lower the price of any product to increase its market share, the taxpayer's share in the market may also incur higher costs and, consequently, attain relatively lower profit level as compared to taxpayers operating in the same market.

In order to evaluate whether or not the taxpayer has been following a business strategy that temporarily decreased profits in lieu of higher-long run profits, certain factors are to be taken into account. The tax authority is required to examine the parties' conduct in order to determine if it is consistent with the purported business strategy.

3.3. METHODS OF TRANSFER PRICING

In order to calculate or test the arm's length nature of prices or profits, use is made of transfer pricing methods or methodologies. Transfer pricing methods are ways of calculating the profit margin of transactions or an entire enterprise or of calculating a transfer price that qualifies as being at arm's length.[71] The application of transfer pricing methods is required to assure that transactions between associated enterprises conform to the arm's length standard. It is also pertinent to note in this respect that although the term "profit margin" is used, companies may also have legitimate reasons to report losses at arm's length. Furthermore, transfer pricing methods are not determinative in and of

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[71] *Supra* n. 72

themselves. If an associated enterprise reports an arm's length amount of income, without the explicit use of one of the transfer pricing methods recognized in the OECD Transfer Pricing Guidelines, this does not mean that its pricing is automatically not at arm's length and there may be no reason to impose adjustments.[72]

OECD introduced the transfer pricing guidelines for multinational enterprises and tax administrations in 1995. OECD guidelines are appreciated globally. In the transfer pricing system, the transfer pricing has to be resolute on the basis of the arm's length principle so price determined is the Arm's Length Price (ALP). There are two[73] type of transfer pricing method:

1. Traditional Transaction Method;
2. Transactional profit method or Non Transactional Method.

3.3.1. TRADITIONAL TRANSACTION METHOD

3.3.1.1. COMPARABLE UNCONTROLLED PRICE

The Comparable Uncontrolled Price (CUP) method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.[74] The method is also used in transactions involving payment of royalties. It is generally applied in controlled transactions that deal in properties and provisions of services. The application of this method is mainly based on the internal comparables wherein a detailed transactional comparison is involved and the controlled and uncontrolled transactions are compared as per the five factors of comparability mentioned above. It is pertinent to note in this respect that the details of all these factors are necessary to analyze the comparison.

Where there is a comparable uncontrolled transaction, the CUP method is used to determine the arm's length price as per the financial and commercial relations between the associated enterprises. This indicates that when a transfer pricing issue is to be analyzed, first all the possible external and internal comparables are required to be

[72] *Supra* n.72
[73] *Id.*
[74] *Id.*

pointed out. If in case internal comparables cannot be found, reliance has to be placed on external comparables. However, in the case of external comparables, it is difficult to access the data involved therein. Research shows that the CUP method is beneficial in the following circumstances:[75]

- "*When one of the parties, i.e., one of the associated enterprises to the transfer pricing transaction is engaged in comparable uncontrolled transactions with an independent enterprise. In such a case, all the relevant information of the uncontrolled transaction required are available and this gives ut a possibility that all the material differences between controlled and uncontrolled transactions will easily be identified.*
- *When the transaction deals in commodity type products in which product differences are negligible.*
- *When interest rates are charged for an inter-company loan*".

3.3.1.2. RESALE PRICE METHOD

The resale price method is used when the companies perform the functions of marketing and selling, i.e., in other words, when the companies undertake to purchase and resale tangible properties. In such a case, the reseller may not add any substantial value to the properties in question by means of modifying them before reselling or they may substantially add on to the creation or the maintenance of the tangible product.[76] If the transaction between companies involves a manufacturer who owns intangible properties including patents and the affiliated sales companies purchase and resell the products to any unrelated customer, the resale price method is used. Further, if there is a commissionaire or commission agent structure involved in the transaction, the resale price method is used to determine the arm's length commission that the commissionaires or the commission agents are to earn.

3.3.1.3. COST PLUS METHOD

The Cost Plus Method (CPM) is generally used in a controlled transaction that involves dealing in tangible products and rendering provision of services. This method analyzes

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[75] *Supra* n. 78
[76] *Supra* n.21

the cost incurred by the party that supplies the properties or services as the case may be to a related purchaser in a controlled transaction. Once the cost is analyzed, an appropriate cost plus mark up is added on to the cost incurred so as to arrive at an appropriate profit keeping in view the functions performed, assets used, market conditions involved, risks assumed, etc. CPM evaluates ALP of the transaction between the associated enterprises by referring to the gross profit mark up based on the cost involved by the supplier company, also called the tested party. It compares the gross profit mark up earned by the tested party to the gross profit mark up earned by the comparable companies involved in the transaction.

CPM is ideally used in those transactions that involve a low risk assembler, or a contract manufacturer, or a toll manufacturer that does not own the intangibles per se and incurs little loss. The manufacturer or supplier, as the case may be, performs limited functions. The customer engaged in the controlled transaction is generally considered to be more complex than a contract manufacturer when it comes to evaluate and analyze the functions performed, like, coordinating production, marketing, selling, giving instructions about the quality and the quantity of production, purchasing raw materials, etc; risks assumed, like inventory risk, credit risk, market risk, etc.; and assets owned, i.e., the intangibles.[77] Therefore, involving a contract manufacture as a tested party is a lesser hassle while analyzing the transfer pricing transaction.

However, CPM may not prove to be the appropriate method to use in transactions that involve a fully-fledged manufacturer who owns the intangibles, because it is generally next to impossible to point out the independent manufacturers who own the comparable product intangibles.[78] In case of such manufacturers, it is also difficult to establish the profit mark-up that is required to remunerate them for owning the intangible properties.

3.3.2. TRANSACTIONAL PROFIT METHODS

The transactional profit method analyzes the profits earned from a controlled transaction so as to determine whether or not the transfer price was at arm's length. This method is,

[77] *Supra* n.78
[78] *Id.*

further, categorized into transactional net margin method (TNMM) and transactional profit split method (PSM).

These methods are generally applied when the associated enterprises use intangible assets with other associated enterprises and the appropriate return for the use of these intangible assets in question is required to be determined.[79] Therefore, these methods are different from the traditional methods in the sense that the analysis is not dependent on the particular comparable uncontrolled transaction. That is to say, the analysis is dependent on the return realized by the associated enterprises engaged in the business, more appropriately the functions so performed.

3.3.2.1. TRANSACTIONAL NET MARGIN METHOD

The TNMM examines the net profit margin relative to an appropriate base that a taxpayer realizes from a controlled transaction. The appropriate base includes the assets, costs, sales, etc. This method mainly compares the net profit margin earned by a tested party in any controlled transactions to the net profit margins earned by the tested party in any comparable uncontrolled transactions, or to any independent comparable companies.

It is quite an indirect method if compared to CPM, or resale price, or even CUP method as discussed above, since this method uses the net profit margins to arrive at the ALP. This method is used when the associated enterprises parties to the transaction deal in intangible assets, but cannot determine the appropriate return directly. In such cases, the compensation based on ALP is determined by arriving at the margin otherwise would be realized by the enterprises engaged in similar functions with independent enterprises or unrelated parties. The remaining return, commonly placed in the "residual category", is resultantly left to the associated enterprises that are controlling the intangible properties as a return left over after the other functions have been appropriately compensated employing ALP. This indicates that this method is applied to the least complex of the related parties engaged in the controlled transaction. It is also to be kept in view while

[79] *Supra* n. 21

applying this method that is the tested party is not supposed to own the intangible asset involved in the transaction. [80]

This method is quite similar to the methods of CPM and resale price, but the only difference is that TNMM employs net profit margins to determine ALP. This method proves to be advantageous over other methods in the sense that this method has the ability to use the profit level indicator to compare the functions instead of the transactions kept in discreet by the parties involved.

When two associated parties enter into a continuing series of transactions and one of these associated enterprises controls the intangible assets involved in the transaction, but the parties cannot arrive at the arm's length return, TNMM is generally used to sort this issue out. This method allows the parties to receive the appropriate return because the method applies to the parties performing routine manufacturing and distribution or other functions that do not involve control over the intangible assets in question.

TNMM may also be appropriate for use in certain situations in which data limitations on uncontrolled transactions make it more reliable than traditional methods:[81]

- "*If the data on gross margins are less reliable due to accounting differences (i.e. differences in the treatment of certain costs as cost of goods sold or operating expenses) between the tested party and the comparable companies for which no adjustments can be made as it is impossible to identify the specific costs for which adjustments are needed. In such a case, it may be more appropriate to analyse net margins, a more consistent measured profit level indicator than gross margins in case of accounting differences;*
- *Where the available comparables differ significantly with respect to products and functions in order to reliably apply the cost plus or resale price method, it may be more appropriate to apply the TNMM, because net margins are less affected by such differences. For example, in performing a benchmarking analysis for the purposes of the resale price or cost plus method, it appears*

[80] *Supra* n. 72
[81] *Id.*

that exact product and functional comparables cannot be found. In fact, the comparables differ substantially regarding product and functional comparability. In such a case, the TNMM might be more appropriate using the same comparables than the resale price or cost plus method;

- *Where the data is simply not available to perform a gross margin method of analysis. For example, the gross profits of comparable companies are not published and only their operating profits are known. The cost of goods sold by companies may also not be available, therefore only a net margin method of analysis can be applied using return on total costs as the profit level indicator*".

Besides the three situations mentioned above, TNMM is also used by the tax authorities to identify companies for an audit by analyzing the net profit margins of companies.

3.3.2.2. PROFIT SPLIT METHOD

The profit split method (PSM) is typically applied when both sides of the controlled transaction own significant intangible properties. The profit is to be divided such as is expected in a joint venture relationship. The profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions that are appropriate to aggregate) by determining the division of profits that independent enterprises would have expected to realize from engaging in the transaction or transactions. The profit split starts with identifying the profits to be divided between the associated enterprises from the controlled transactions. Subsequently, these profits are divided between the associated enterprises based on the relative value of each enterprise's contribution, which should reflect the functions performed, risks incurred and assets used by each enterprise in the controlled transactions. External market data (e.g., profit split percentages among independent enterprises performing comparable functions) should be used to value each enterprise's contribution, if possible, so that the division of combined profits between the associated enterprises is in accordance with that between independent enterprises performing functions comparable to the functions performed by the associated enterprises. The profit split method might be used in cases involving highly interrelated transactions that cannot be analyzed on a separate basis. This means

that the profit split method can be applied in cases where the associated enterprises engages in several transactions that are interdependent in such a way that they cannot be evaluated on a separate basis using a traditional transaction method. The transactions are thus so interrelated that it is impossible to identify comparable transactions. In this respect, the profit split method is applicable in complex industries, such as, for example, the global financial services business.

The (residual) profit split method is typically used in complex cases where both sides to the controlled transaction own valuable intangible properties (e.g., patents, trademarks, and trade names). If only one of the associated enterprises own valuable intangible property, the other associated enterprise would have been the tested party in the analysis using the cost plus, resale price or transactional net margin methods. However, if both sides own valuable intangible properties for which it is impossible to find comparables, then the profit split method might be the most reliable method.

The use of the profit split method will be limited in most countries because it is relatively difficult to apply in comparison with the other methods. The profit split method involves the determination of the factors that bring about the combined profit, setting a relative weight to each factor, and calculating the allocation of profits between the associated enterprises.[82] The contribution analysis is difficult to apply, because external market data that reflect how independent enterprises would allocate the profits in similar circumstances is usually not available. The first step of the residual analysis often involves the use of the TNMM to calculate a return and is not, in itself, more complicated than the typical application of TNMM. The second step is, however, an additional step and often raises difficult additional issues related to the valuation of intangibles.

[82] *Supra* n.72

CHAPTER IV

4. CONCLUSION

One of the most prominent issues being faced by the MNEs and the governments of almost all the jurisdictions across the globe, relating to international transaction, is transfer pricing. It is quite a vital factor that affects the commercial activities of developed and developing countries alike and neither the MNEs nor the governments can afford to overlook this aspect. The issue deals with various aspects of a commercial transaction, including human resources, the compliance costs, etc. The issue is ever evolving, it is often difficult to find even the comparables, also in those situations where adjustment has been required to apply the methods of transfer pricing.

Transfer pricing is often a resource intensive affair and, since, developing countries often do not have easy access to resources, their governments find it difficult to effectively administer the regulations relating to transfer pricing. Manipulation of transfer price by the MNEs reduces the potential of the governments to earn their entitled revenue. As a result of this practice of mispricing, not only do the governments lose out on their earnings, but such losses are often imposed on the common citizens to bear.

Simplifying the structure and the system of international taxation, including transfer pricing, keeping it judiciously viable and equitable for the players is a difficult task. A practical approach by the governments of various jurisdictions across the globe will help them focus on the key to the problems that transfer pricing breeds. This approach will further help the developing countries to address the issues of transfer pricing that is fair and robust for all stakeholders, being internationally coherent, and reduce the costs of compliance and the incidence of unrelieved double taxation.

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ANNEXURE I

Legal Framework for Transfer Pricing in India and Other Jurisdictions:

A Comparative Analysis

The amount locked up in litigation in direct tax cases in India on September 30, 2012, was INR 1.002 trillion (about $15.4 billion).[83] The transfer pricing adjustments made in 2012-2013 alone were INR 700 billion (about $10.8 billion).[84] In the recent past, a large majority of direct tax disputes have been decided initially in favor of the tax authorities but later in favor of the taxpayer at appellate levels in tribunals and courts.[85]

The following table captures some of the important provisions of the transfer pricing regulations (along with comparison of the position in other countries whenever possible), the analysis of which is vital to understanding whether the Indian transfer pricing provisions are fair, just, and reasonable:[86]

Background	Position in India	Contrasting Position in Other Prominent Jurisdictions
Burden of Proof		
Many countries have made it mandatory in their transfer pricing regulations for associated enterprises to prepare and submit documentation on	The concerned tax official merely has to form an opinion that the ALP determined by the taxpayer is not in accordance with statutory provisions, or that	**U.K.** — If the taxpayer's transfer pricing position is reasonable and well documented, the tax authorities will have to demonstrate that it is

[83] Subhomoy Bhattacharjee & Anil Sasi, *Enough: Govt. May Choose to Draw the Line on Tax Litigation With Firms*, The INDIAN EXPRESS, April 25th, 2013

[84] Ministry of Finance, Department of Revenue, *Tax Evasion by Foreign Companies*, *available at* http://pib.nic.in/newsite/erelease.aspx?relid=99349

[85] As per the Report of the Standing Committee on Finance on Demand for Grants 2013-14 of the Ministry of Finance, Department of Revenue, published on April 16th, 2013, in2011-12, in appeals cases filed by the tax payer at the tribunal, High Court, and Supreme Court, 36%, 38%, and 33% respectively have been decided wholly in favour of the tax payer, compared to 35%, 36%, and 14% respectively (that is, slightly less), decided wholly in favour of the tax authorities. For the same period, in case of appeals filed by the tax authorities, only 19%, 20%, and 10% respectively, were decided wholly in favour of the tax authorities, compared to 52%, 62%, and 39% respectively, decided wholly in favour of the tax payer.

[86] Mihir Naniwadekar & T P Janani, *Tripping over Transfer Pricing Regulations in India*, 71 TAX NOTES INTERNATIONAL 1127 (2013)

the determination of ALP in various transactions they enter into among each other. Leaving apart such documentation, countries differ with respect to whether they impose the burden of proof on the taxpayer or the tax officials so as to arrive at an ALP which is different from the one reflected in the documentation submitted by the taxpayer.	the information used for computation thereof is not reliable/correct (*instead of having to substantiate the same*). It is the taxpayer who has to show why the ALP suggested by the tax official is not correct. While it has been judicially interpreted[87] that once a taxpayer presents a reasonable argument and evidence to suggest that its transfer pricing was at arm's length, the burden of proof shifts to the tax officials to establish why the taxpayer's transfer pricing was not at arm's length, the tax officials, particularly lower level officials, reject the taxpayer's determination of ALP as a matter of routine without assigning reasons and shift the burden of proof to the taxpayer by asking the taxpayer to show cause as to why the determination made by the tax officials should not be adopted. The	wrong before an adjustment can be imposed. **Australia** — If the tax office's view of the relevant ALP is materially different to that adopted by the taxpayer, a position paper is issued by the Australian Taxation Office (ATO) *setting out the basis for the ATO's determination*. The taxpayer has an opportunity to respond to the position paper before the ATO makes a final decision. **Japan** — The *tax authorities bear the burden of proof* for the allegation that the transfer pricing method applied by the tax authorities accords with one of the methods provided for under Japanese tax law. **U.S.** — While the taxpayer has to bear the burden of

[87] *Deputy Commissioner of Income Tax v. Indo American Jewellery Ltd.*, [2010] 41 SOT 1 (Mum), *Aztec Software & Technology Services Ltd. v. Assistant Commissioner of Income Tax*, [2007] 107 ITD41 (Bang)

	harshness of the imposition of such burden of proof on the taxpayer becomes more prominent when seen in light of: (i) judicial interpretation[88] that absence of motive to avoid tax or to shift profits outside India is not a defense against applicability of the transfer pricing provisions; and (ii) *the difficulty in treating transfer pricing regulations as charging provisions*[89] (compared with mere rules of evidence, for the application of which requires some real evidence of tax evasion).	proof in showing both that the tax authorities' determination of ALP is arbitrary, capricious, and unreasonable, and that the ALP determined by it is accurate, the tax authorities are required to provide the taxpayer with an explanation as to how their adjustment was determined.
Reciprocity- Whether both upward and downward adjustments are made?		

[88] *Coca Cola India Inc. v. Assistant Commissioner of Income Tax*, 309 ITR 194 (P&H), *Aztec Software and Technology Service Ltd. v. Assistant Commissioner of Income Tax*, [2007] 294 ITR 32 (Bang), *Assistant Commissioner of Income Tax v. MSS India*, ITA No. 393/PN/07

[89] Under the Income Tax Act, 1961, tax is only chargeable on income that is either accrued/received in India or deemed to have been accrued or received in India (as against income that ought to have accrued in India).

Where tax officials determine the ALP with respect to a transaction (different from the one determined by the taxpayer) and make an adjustment with respect to the income of one of the associated enterprises to the transaction, there could be double taxation of such additional income if a corresponding adjustment (or downward adjustment) is not made with respect to the income of the other associated enterprise(s).	In cases where tax is required be deducted at source according to the Indian Income Tax Act, 1961, by way of a withholding/similar procedure and an upward adjustment is made in case of the payer, *downward adjustment is not permissible* in case of the payee.	**U.S. and U.K.** — When an ALP adjustment is made, the corresponding downward adjustment is also *allowed*. **South Africa** — When an ALP adjustment is made, the corresponding downward adjustment is also *allowed, if the enterprise in question is resident in a jurisdiction with which South Africa has a tax treaty*. **Canada** — The tax officials allow corresponding adjustments *in accordance with the provisions of the relevant tax treaty*, subject to the tax officials being satisfied that the primary adjustment made by the treaty partner's tax officials is in order.
Quantum of Penalty		
It is a widely accepted principle that determination of ALP is not an exact science, is	If ALP determined by the taxpayer differs from the one determined by the tax officials by a margin of more	**U.S.**—In case of transfer pricing, the maximum penalty that could be imposed is 40 percent.

undertaken by way of a subjective analysis, and is largely dependent on data integrity, which is difficult (if not impossible) to determine. It is merely the determination of an estimate. Penalty imposed by transfer pricing regulations, though treated as a civil penalty, is nothing but punishment for wrongdoing and thereby has an element of criminal penalty. Therefore, the extent to which wrongdoing can be attributed with respect to a calculation, for an undertaking for which there is no objective/ scientific method, is something that needs to be handled very carefully.	than 3 percent, *interest is levied at 12 percent per annum and penalty can be imposed up to 300 percent* of the additional income tax liability. There are no binding guidelines to determine the different factors that aggravate or reduce the quantum of penalty within the 300 percent limit. Moreover, in practice penalties are levied, particularly by lower level tax authorities, as a matter of routine whenever an additional tax liability is ascertained by the tax authorities and the burden of proof is on the taxpayer to show good and sufficient reasons for default and to prove non concealment of income and particulars thereof.	There are clear rules prescribed regarding the quantum of penalty that could be imposed.[90] **U.K.**—*Maximum penalty imposed is 60 percent* of the additional tax liability, except in cases involving deliberate and/or unconcealed action. **Australia**—The tax officials may impose interest as well as penalties. Penalty could *range from 10 to 50 percent* of the additional tax liability. **Japan**—The penalty for understatement *range from 10 to 15 percent* of the corporation tax additionally imposed. The delinquency tax (equivalent to interest) is currently 4.3 percent per annum (four percentage points above the Central Bank's interest rate of 0.3

[90] For example, a penalty of up to 20 percent and 40 percent could be imposed only if the ALP determined by the tax authorities is more than twofold and fourfold or less than one-half and one-quarter, respectively, of the determination by the taxpayer. Further, the total adjustment must also be beyond certain absolute and relative thresholds.

		percent per annum). **Canada**—*Maximum penalty up to 10 percent* of the additional tax liability is levied. **South Africa**—Differing quantum of penalty has been prescribed depending on the levels of culpability involved and on whether there is voluntary disclosure post audit. The *maximum understatement penalty (except in case of repeat offense) is 75 percent* of the additional tax imposed. **Brazil**—In the absence of fraud and/or non adherence with notifications issued during investigation by the tax officials, *penalty up to 75 percent* of the additional tax liability could be levied.
Advance Pricing Agreement		
A lot of uncertainty arises in relation to compliance with transfer pricing provisions by virtue of the fact that	The APA was introduced in India in 2012. The following are some of its important characteristics: • valid for a maximum period	**U.S., Canada, U.K., and Japan** — The transfer pricing method agreed upon for the term of the APA can be sought by the

determination of the ALP is an exercise involving subjective analysis and is not an exact science. Therefore, to reduce uncertainty and avoidable litigation, many countries have introduced advance pricing arrangements, whereby the taxpayers can enter into an agreement with the tax officials in advance (that is, prior to a dispute arising) on the determination of ALP. Such agreements can be classified into unilateral, bilateral, and multilateral, depending on the number of countries whose tax officials are involved. Agreement involving tax officials from two or more countries is sought by a taxpayer where there is a possibility of double or higher taxation arising from different ALP determination by tax officials in different	of five years; • contract binding on the taxpayer and the relevant tax officials; • would cease to be binding if there is a change in law; • *no relief from compliance with mandatory Documentation* requirements for determination of ALP; • pending APA, *no relief from regular proceeding* for ALP determination; • in bilateral and multilateral APAs, *neither is an applicant permitted to be part of the discussions between the tax officials nor are the tax officials bound to communicate with or consult the applicant* on APA negotiations; and • for an applicant to be able to enter into an APA with the tax officials, the agreement as approved by the tax officials is also required to be approved by the central	taxpayer to be extended for a period immediately prior to the commencement of such term (the *rollback period*), unless the functions performed, risks undertaken, and assets used by the applicant are significantly different from those during the term of the APA. **Japan** — While an APA is in progress, *no tax examination of transfer pricing issues will be conducted for the years to be covered* by the APA application (including rollback years). **Australia** — While the taxpayer is not entitled to be directly involved in the APA process in the case of bilateral and multilateral APAs, the *taxpayer could seek to be kept informed of the progress of the negotiations and the issues that emerge.* **Japan** — Although a MAP is a government-level

countries with respect to the same transaction. This is generally carried out in accordance with the mutual agreement procedure (MAP) prescribed in the bilateral tax treaties between such countries. A large majority of APA proceedings that have taken place in the world are bilateral.	government, thereby *necessitating approval by multiple authorities*.	negotiation procedure, taxpayers that file APA requests are *permitted to participate in some sessions to provide factual information*. **Australia** — The APA process is managed by the tax officials without the involvement of any other government agencies in Australia.
Miscellaneous		
i. Expanding the scope of the Nature of Transactions Covered Retrospectively		
Certainty (including coherence with established principles) is key to bringing about taxpayer compliance, and is more so relevant in subjective fields like transfer pricing.	In 2012 the definition of the term ‘‘international transaction’’ was introduced in the Income Tax Act, 1961, with *retrospective effect* from 2001, to enumerate the types of transactions that are covered within the ambit of the transfer pricing regulations. The definition overrules judicial interpretation rendered with respect to the applicability of the term in specific circumstances like extension	

	of credit/existence of a continuing debit balance,[91] group restructuring activities,[92] and so forth. The definition also includes within the scope of its provisions transactions which are simple capital receipts,[93] with *no element of income or gain* (a basic requirement for taxability under the Income Tax Act, 1961).	
ii. Applicability of Transfer Pricing Provisions in case of tax exempt transactions		
Applicability of transfer pricing regulations to tax-exempt transactions is a futile exercise where the exemption is based on the nature of the transaction and does not vary with the value/price of the transaction.	The transfer pricing regulations do not expressly exclude tax-exempt transactions from the applicability of transfer pricing provisions. It has been judicially interpreted[94] that transfer pricing regulations (including maintenance of documentation) would apply	

[91] *Patni Computer Systems v. Deputy Commissioner of Income Tax*, [2011] 16 ITR 533 (Pune), *Nimbus Communications Limited v. Assistant Commissioner of Income Tax*, ITA No. 6597/Mum/09
[92] *Dana Corporation v. Director of Income Tax*, [2010] 321 ITR 178 (AAR)
[93] An instance of application of this provision is the recent issue of a draft assessment order to *Shell India Markets Private Limited* adding INR 150 billion to the taxable income of the company by alleging under-pricing in relation to issue of shares to an overseas group entity.
[94] *In re Castleton Investment Limited*, [2012] 348 ITR 537 (AAR)

	to such transactions, *though on a final analysis there would be no tax payable*.	
iii. Choosing a Method for ALP determination		
There are various methods prescribed in various countries for determination of ALP (such as the comparable uncontrolled price method, resale price method, cost plus method, profit-split method, transaction net margin method, and so forth).	With respect to a transaction, India requires the *most appropriate method* to be followed, which is to be determined having regard to the nature of transaction, class of transaction, class of associated persons, functions performed, and so forth.	**Brazil** — The transfer pricing law allows the taxpayer to rely on *whichever method results in the smallest adjustment* (instead of a best-method approach).
iv. Alternate Dispute Resolution		
	Leaving apart the existence of a settlement commission (which is more relevant with respect to making disclosures and avoiding penalty for undisclosed income), in transfer pricing matters, there is *no alternative dispute resolution mechanism*.	**South Africa** — The tax officials can enter into settlements using alternative dispute resolution procedure. To date, no transfer pricing case has been taken to court, and all disputes have been settled by negotiation.
v. Taxpayer's rights		
	The Department nor the Union Legislature There is no clear-cut/comprehensive	**Australia** — It has a *taxpayers' charter*, which is a policy guide to provide

	recognition of taxpayer rights.	information to taxpayers on their legal rights.[95] Although the charter is not legally binding, taxpayers have a legitimate expectation that it will be followed.

[95] Taxpayers' rights include the right to be treated fairly and reasonably by the tax officials; to be presumed to be telling the truth unless their actions indicate otherwise; to have their privacy respected and the confidentiality of documentation maintained; and to obtain professional advice and representation.

ANNEXURE II

Computation of arm's length price.

92C. (1) The arm's length price in relation to an international transaction or specified domestic transaction] shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely :—

(*a*) comparable uncontrolled price method;

(*b*) resale price method;

(*c*) cost plus method;

(*d*) profit split method;

(*e*) transactional net margin method;

(*f*) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed :

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction] has actually been undertaken does not exceed such percentage not exceeding three per cent] of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price.

The following third proviso shall be inserted after the second proviso to sub-section (2) of section 92C by the Finance (No. 2) Act, 2014, w.e.f. 1-4-2015 :

Provided also *that where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply*.

Explanation.—For the removal of doubts, it is hereby clarified that the provisions of the second proviso shall also be applicable to all assessment or reassessment proceedings pending before an Assessing Officer as on the 1st day of October, 2009.

(2A) Where the first proviso to sub-section (2) as it stood before its amendment by the Finance (No. 2) Act, 2009 (33 of 2009), is applicable in respect of an international transaction for an assessment year and the variation between the arithmetical mean referred to in the said proviso and the price at which such transaction has actually been undertaken exceeds five per cent of the arithmetical mean, then, the assessee shall not be entitled to exercise the option as referred to in the said proviso.

(2B) Nothing contained in sub-section (2A) shall empower the Assessing Officer either to assess or reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154 for any assessment year the proceedings of which have been completed before the 1st day of October, 2009.

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that—

(*a*) the price charged or paid in an international transaction or specified domestic transaction has not been determined in accordance with sub-sections (1) and (2); or

(*b*) any information and document relating to an international transaction or specified domestic transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,

the Assessing Officer may proceed to determine the arm's length price in relation to the said international transaction or specified domestic transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:

Provided that an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.

(4) Where an arm's length price is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arm's length price so determined :

Provided that no deduction under section 10A or section 10AA or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section :

Provided further that where the total income of an associated enterprise is computed under this sub-section on determination of the arm's length price paid to another associated enterprise from which tax has been deducted or was deductible] under the

provisions of Chapter XVIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise.

ANNEXURE III

Capital gains.

45. (1) Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, save as otherwise provided in sections 54, 54B, 54D, 54E, 54EA, 54EB, 54F, 54G and 54H, be chargeable to income-tax under the head "Capital gains", and shall be deemed to be the income of the previous year in which the transfer took place.

(1A) Notwithstanding anything contained in sub-section (1), where any person receives at any time during any previous year any money or other assets under an insurance from an insurer on account of damage to, or destruction of, any capital asset, as a result of—

(*i*) flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature; or

(*ii*) riot or civil disturbance; or

(*iii*) accidental fire or explosion; or

(*iv*) action by an enemy or action taken in combating an enemy (whether with or without a declaration of war),

then, any profits or gains arising from receipt of such money or other assets shall be chargeable to income-tax under the head "Capital gains" and shall be deemed to be the income of such person of the previous year in which such money or other asset was received and for the purposes of section 48, value of any money or the fair market value of other assets on the date of such receipt shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of such capital asset.

Explanation.—For the purposes of this sub-section, the expression "insurer" shall have the meaning assigned to it in clause (*9*) of section 2 of the Insurance Act, 1938 (4 of 1938).

(2) Notwithstanding anything contained in sub-section (1), the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him as stock-in-trade of a business carried on by him shall be chargeable to income-tax as his income of the previous year in which such stock-in-trade is sold or otherwise transferred by him and, for the purposes of section 48, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

(2A) Where any person has had at any time during previous year any beneficial interest in any securities, then, any profits or gains arising from transfer made by the depository or participant of such beneficial interest in respect of securities shall be chargeable to income-tax as the income of the beneficial owner of the previous year in which such transfer took place and shall not be regarded as income of the depository who is deemed to be the registered owner of securities by virtue of sub-section (1) of section 10 of the Depositories Act, 1996, and for the purposes of—

(*i*) section 48; and

(*ii*) proviso to clause (*42A*) of section 2,

the cost of acquisition and the period of holding of any securities shall be determined on the basis of the first-in-first-out method.

Explanation.—For the purposes of this sub-section, the expressions "beneficial owner", "depository" and "security" shall have the meanings respectively assigned to them in clauses (*a*), (*e*) and (*l*) of sub-section (1) of section 2 of the Depositories Act, 1996.

(3) The profits or gains arising from the transfer of a capital asset by a person to a firm or other association of persons or body of individuals (not being a company or a co-operative society) in which he is or becomes a partner or member, by way of capital contribution or otherwise, shall be chargeable to tax as his income of the previous year in which such transfer takes place and, for the purposes of section 48, the amount recorded in the books of account of the firm, association or body as the value of the capital asset

shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

(4) The profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals (not being a company or a co-operative society) or otherwise, shall be chargeable to tax as the income of the firm, association or body, of the previous year in which the said transfer takes place and, for the purposes of section 48, the fair market value of the asset on the date of such transfer shall be deemed to be the full value of the consideration received or accruing as a result of the transfer.

(5) Notwithstanding anything contained in sub-section (1), where the capital gain arises from the transfer of a capital asset, being a transfer by way of compulsory acquisition under any law, or a transfer the consideration for which was determined or approved by the Central Government or the Reserve Bank of India, and the compensation or the consideration for such transfer is enhanced or further enhanced by any court, Tribunal or other authority, the capital gain shall be dealt with in the following manner, namely :—

(*a*) the capital gain computed with reference to the compensation awarded in the first instance or, as the case may be, the consideration determined or approved in the first instance by the Central Government or the Reserve Bank of India shall be chargeable as income under the head "Capital gains" of the previous year in which such compensation or part thereof, or such consideration or part thereof, was first received; and

(*b*) the amount by which the compensation or consideration is enhanced or further enhanced by the court, Tribunal or other authority shall be deemed to be income chargeable under the head "Capital gains" of the previous year in which such amount is received by the assessee;

The following proviso shall be inserted after clause (*b*) of sub-section (5) of section 45 by the Finance (No. 2) Act, 2014, w.e.f. 1-4-2015 :

Provided *that any amount of compensation received in pursuance of an interim order of a court, Tribunal or other authority shall be deemed to be income chargeable under the head "Capital gains" of the previous year in which the final order of such court, Tribunal or other authority is made;*

(*c*) where in the assessment for any year, the capital gain arising from the transfer of a capital asset is computed by taking the compensation or consideration referred to in clause (*a*) or, as the case may be, enhanced compensation or consideration referred to in clause (*b*), and subsequently such compensation or consideration is reduced by any court, Tribunal or other authority, such assessed capital gain of that year shall be recomputed by taking the compensation or consi-deration as so reduced by such court, Tribunal or other authority to be the full value of the consideration.

Explanation.—For the purposes of this sub-section,—

(*i*) in relation to the amount referred to in clause (*b*), the cost of acquisition and the cost of improvement shall be taken to be *nil*;

(*ii*) the provisions of this sub-section shall apply also in a case where the transfer took place prior to the 1st day of April, 1988;

(*iii*) where by reason of the death of the person who made the transfer, or for any other reason, the enhanced compensation or consideration is received by any other person, the amount referred to in clause (*b*) shall be deemed to be the income, chargeable to tax under the head "Capital gains", of such other person.]

(6) Notwithstanding anything contained in sub-section (1), the difference between the repurchase price of the units referred to in sub-section (2) of section 80CCB and the capital value of such units shall be deemed to be the capital gains arising to the assessee in the previous year in which such repurchase takes place or the plan referred to in that section is terminated and shall be taxed accordingly.

Explanation.—For the purposes of this sub-section, "capital value of such units" means any amount invested by the assessee in the units referred to in sub-section (2) of section 80CCB.

ANNEXURE IV

Who may be regarded as agent.

163. (1) For the purposes of this Act, "agent", in relation to a non-resident, includes any person in India—

(*a*) who is employed by or on behalf of the non-resident; or

(*b*) who has any business connection with the non-resident; or

(*c*) from or through whom the non-resident is in receipt of any income, whether directly or indirectly; or

(*d*) who is the trustee of the non-resident;

and includes also any other person who, whether a resident or non-resident, has acquired by means of a transfer, a capital asset in India :

Provided that a broker in India who, in respect of any transactions, does not deal directly with or on behalf of a non-resident principal but deals with or through a non-resident broker shall not be deemed to be an agent under this section in respect of such transactions, if the following conditions are fulfilled, namely:—

(*i*) the transactions are carried on in the ordinary course of business through the first-mentioned broker; and

(*ii*) the non-resident broker is carrying on such transactions in the ordinary course of his business and not as a principal.

Explanation.—For the purposes of this sub-section, the expression "business connection" shall have the meaning assigned to it in Explanation 2 to clause (i) of sub-section (1) of section 9 of this Act.

(2) No person shall be treated as the agent of a non-resident unless he has had an opportunity of being heard by the Assessing Officer as to his liability to be treated as such.

ANNEXURE V

Definitions.

2. (14) *"capital asset" means property of any kind held by an assessee, whether or not connected with his business or profession, but does not include—*

(*i) any stock-in-trade*, consumable stores or raw materials held for the purposes of his business or profession ;

(*ii*) personal effects, that is to say, movable property (including wearing apparel and furniture) held for personal use by the assessee or any member of his family dependent on him, but excludes—

(*a*) jewellery;

(*b*) archaeological collections;

(*c*) drawings;

(*d*) paintings;

(*e*) sculptures; or

(*f*) any work of art.

Explanation.—For the purposes of this sub-clause, "jewellery" includes—

(*a*) ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stone, and whether or not worked or sewn into any wearing apparel;

(*b*) precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel;

The following *Explanation* 2 shall be inserted after the renumbered *Explanation* 1 by the Finance (No. 2) Act, 2014, w.e.f. 1-4-2015 :

Explanation 2.—*For the purposes of this clause—*

(a) the expression "Foreign Institutional Investor" shall have the meaning assigned to it in clause (a) of the Explanation *to section* 115*AD;*

(b) the expression "securities" shall have the meaning assigned to it in clause (*h*) of section 2 *of the Securities Contracts (Regulation) Act,* 1956 (42 *of* 1956)*;*

(*iii*) agricultural land in India, not being land situate—

(*a*) in any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee, or by any other name) or a cantonment board and which has a population of not less than ten thousand; or

(*b*) in any area within the distance, measured aerially,—

(I) not being more than two kilometres, from the local limits of any municipality or cantonment board referred to in item (*a*) and which has a population of more than ten thousand but not exceeding one lakh; or

(II) not being more than six kilometres, from the local limits of any municipality or cantonment board referred to in item (*a*) and which has a population of more than one lakh but not exceeding ten lakh; or

(III) not being more than eight kilometres, from the local limits of any municipality or cantonment board referred to in item (*a*) and which has a population of more than ten lakh.

Explanation.—For the purposes of this sub-clause, "population" means the population according to the last preceding census of which the relevant figures have been published before the first day of the previous year;

(*iv*) 6 per cent Gold Bonds, 1977, or 7 per cent Gold Bonds, 1980,or National Defence Gold Bonds, 1980,] issued by the Central Government ;

(*v*) Special Bearer Bonds, 1991, issued by the Central Government ;

(*vi*) Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

Explanation.—For the removal of doubts, it is hereby clarified that "property" includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever.

2. (24) "income" includes—

(*i*) profits and gains;

(*ii*) dividend ;

(*iia*) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes or by an association or institution referred to in clause (21) or clause (23), or by a fund or trust or institution referred to in sub-clause (*iv*) or sub-clause (*v*) or by any university or other educational institution referred to in sub-clause (*iiiad*) or sub-clause (*vi*) or by any hospital or other institution referred to in sub-clause (*iiiae*) or sub-clause (*via*) of clause (23*C*) of section 10 or by an electoral trust.

Explanation.—For the purposes of this sub-clause, "trust" includes any other legal obligation ;

(*iii*) the value of any perquisite or profit in lieu of salary taxable under clauses (2) and (3) of section 17;

(*iiia*) any special allowance or benefit, other than perquisite included under sub-clause (*iii*), specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit ;

(*iiib*) any allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living;

(*iv*) the value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company, or by a relative of the director or such person, and any sum paid by any such company in respect of any obligation which, but for such payment, would have been payable by the director or other person aforesaid ;

(*iva*) the value of any benefit or perquisite, whether convertible into money or not, obtained by any representative assessee mentioned in clause (*iii*) or clause (*iv*) of sub-section (1) of section 160 or by any person on whose behalf or for whose benefit any income is receivable by the representative assessee (such person being hereafter in this sub-clause referred to as the "beneficiary") and any sum paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary;

(*v*) any sum chargeable to income-tax under clauses (*ii*) and (*iii*) of section 28 or section 41 or section 59;

(*va*) any sum chargeable to income-tax under clause (*iiia*) of section 28;

(*vb*) any sum chargeable to income-tax under clause (*iiib*) of section 28;

(*vc*) any sum chargeable to income-tax under clause (*iiic*) of section 28;

(*vd*) the value of any benefit or perquisite taxable under clause (*iv*) of section 28;

(*ve*) any sum chargeable to income-tax under clause (*v*) of section 28;

(*vi*) any capital gains chargeable under section 45;

(*vii*) the profits and gains of any business of insurance carried on by a mutual insurance company or by a co-operative society, computed in accordance with section 44 or any surplus taken to be such profits and gains by virtue of provisions contained in the First Schedule;

(*viia*) the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members;

(*viii*) *Omitted by the Finance Act,* 1988, w.e.f. 1-4-1988. Original sub-clause (viii) was inserted by the Finance Act, 1964, w.e.f. 1-4-1964*;*

(*ix*) any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever.

Explanation.—For the purposes of this sub-clause,—

(*i*) "lottery" includes winnings from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever, under any scheme or arrangement by whatever name called;

(*ii*) "card game and other game of any sort" includes any game show, an entertainment programme on television or electronic mode, in which people compete to win prizes or any other similar game ;

(*x*) any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or any fund set up under the provisions of the Employees' State Insurance Act, 1948 (34 of 1948), or any other fund for the welfare of such employees;

(*xi*) any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.

Explanation.—For the purposes of this clause, the expression "Keyman insurance policy" shall have the meaning assigned to it in the *Explanation* to clause (10*D*) of section 10;

(*xii*) any sum referred to in clause (*va*) of section 28;

(*xiii*) any sum referred to in clause (*v*) of sub-section (2) of section 56;

(*xiv*) any sum referred to in clause (*vi*) of sub-section (2) of section 56;

(*xv*) any sum of money or value of property referred to in clause (*vii*) or clause (*viia*) of sub-section (2) of section 56;

(*xvi*) any consideration received for issue of shares as exceeds the fair market value of the shares referred to in clause (*viib*) of sub-section (2) of section 56;

The following sub-clause (*xvii*) shall be inserted after sub-clause (*xvi*) of clause (24) of section 2 by the Finance (No. 2) Act, 2014, w.e.f. 1-4-2015 :

(xvii) any sum of money referred to in clause (*ix*) of sub-section (2) of section 56.