A CONTINUUM OF TRANSFER PRICING METHODS

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Besides equality, administrability andefficiency, the fact of certainty is recognized as one of Adam Smith's four maxims of taxation.[1] The Organisation for Economic Co-operation and Development (OECD) Framework lists neutrality, efficiency, certainty, simplicity, effectiveness, fairness, and flexibility as the principles of international tax policy.[2] Commentators have categorically observed that "without a measure of uniformity and predictability in the tax treatment of international operations, such operations will fail to achieve their maximum potential, and to a parallel extent, the potential prosperity of nations will be tempered."[3]

Consequently, the tax framework of every country should endeavour to create, formulate and enact laws that lead to *certainty* and *predictability* for the corporate tax payer.

In this paper, the author seeks to comment on the case of *Sony India v. Central Board of Direct Taxes*[4] ("*Sony India*") and examine whether the existing law on transfer pricing in India conforms to the aforementioned tenets of tax laws. For the purpose of this paper, the case comment has been divided into the following parts:

(i) The first part introduces the legal framework as reflected in Indian tax legislations on transfer pricing and defines the concept of transfer pricing;

(ii) The second part analyses the case of *Sony India* which hints at the glaring loophole present in the existing framework on transfer pricing guidelines;

(iii) The third part gives a critique of the case and exposes the limitations of the judiciary in dealing with fiscal and economic policy matters;

(iv) The fourth part provides a discourse on the two methods of analyzing the transfer price which are recognized by the relevant rules; and

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1 Smith, Adam *An Inquiry into the Nature and Causes of the Wealth of Nations*, (R.H. Campbell & A.S. Skinner eds., Liberty Classics: 1981), 825.

2 OECD Committee on Fiscal Affairs, Electronic Commerce: Taxation Framework Conditions 4 (1998). In this report the OECD indicates that its members prefer the extension of international tax principles and concepts to electronic commerce as well.

3 Weiss, Arnold H. and Molnar, Ference E., *Tax Policy in the Twenty First Century,* (Herbert Stein Ed., 1988), 108.

4 [2007] 288 ITR 52 (Del).

(v) In the final part of the paper, the author has discussed an unconventional alternative to determine the transfer price so as to achieve predictability and certainty about the ensuing tax treatment for international transactions between the associated enterprises.

I. DEFINITIONAL AND LEGISLATIVE ASPECTS OF TRANSFER PRICING

1. Fundamentals of Transfer Pricing Laws

A transfer price is the price charged for a cross-border transfer of goods, assets, rights, money and services etc., between one part of an organization and another part of the same organization.[5] In other words, the price involved in a controlled international transaction is regarded as transfer pricing.

In an international transaction between two unrelated enterprises, the prices of the transaction get determined on the basis of market forces. Given that both enterprises work for the maximization of their respective interests, tax administrators treat such a transaction as the norm.[6]

However, a majority of international transactions happen between associated enterprises. As a synergistic measure, companies foray into outside markets by merging or acquiring entities, establishing wholly owned subsidiaries and by entering into joint ventures. A parent company having its units in one jurisdiction can transact in goods or services with its own branch or subsidiary placed in other parts of the world.

As tax treatments differ substantially from one jurisdiction to another, associated enterprises tend to price the transaction in a manner which results in a reduction of their tax liability. To maximize their collective interests, many associated enterprises often indulge in pricing transactions in such a way as to erode the tax revenues to the concerned countries which facilitates controlled international transactions. Clearly therefore, it is understandable that transfer pricing manipulation is one of the most common techniques of tax avoidance.[7] Consequently, one can conclude that the transfer

5 Neighbour, John Owens, Jeffrey "Transfer Pricing in the New Millennium: Will The Arm's Length Principle Survive?", (2002) 10 *Geo. Mason L. Rev.* 951; Kanga, Palkhivala, Vyas, *The Law and Practice of Income Tax,* (New Delhi: Lexis Nexis – Butterworths, 2004) 1532: Gopalakrishnan K.C., *Text Book on International Taxation,* (Mumbai: Snow White Publications, 2002), 115.

6 Lester, Eugene E, "International Transfer Pricing Rules: Unconventional Wisdom", (1995) 2 *ILSA J. Int'l & Comp. L.* 283, 285.

7 DiMattero, Larry A., *The Law of International Business Transactions,* (London: Thomson

pricing problem is one of the major international tax policy challenges.

2. Law of Transfer Pricing in India

It was only in 2001, that the Indian government realized the need for regulating international transactions between associated enterprises.[8] Thus, in 2002 certain amendments were introduced to Section 92 of the Income Tax Act (the "Act"). Owing its allegiance to the OECD Guidelines,[9] Section 92 was modified to categorically state that *any income* arising from an international transaction *shall be computed* having regard to the *arm's length price.*[10] Section 92 F of the Act stipulates that arm's length price means that price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in *uncontrolled conditions.*

Section 92 C of the Act stipulates Comparable Uncontrolled Price, Resale Price Method, Cost Plus Method, Profit Split Method and Transactional Net Margin Method as different ways through which the transfer price of a controlled international transaction

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Publishers, 2003), 363: Avi-Yonah, Reuven S., "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", (1995) 15 *Va. Tax Rev.* 89, 90.

8 In his speech for the budget year 2001 the Finance Minister observed as under: *"The presence of Multi National Enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern."*

9 The OECD took the initiative to contain the possible tax avoidance involved in controlled international transactions. In 1979, the OECD Committee on Fiscal Affairs formulated its first report on Transfer Pricing and Multinational Enterprise (the "Report"). This Report generally described agreed practices in determining transfer prices for tax purposes. The Report stated that, as a matter of general principle, transfer prices established for fiscal purposes should accord with those which would have been paid between independent enterprises *acting at arm's length.* Finally, in 1995, the OECD announced new transfer pricing guidelines (the "New Guidelines"). The New Guidelines indicate expressly, for the first time, that Article 9, Paragraph 1 of the OECD Model Tax Convention is the "authoritative statement of the arm's length principle". See Horner, Frances M., "International Cooperation and Understanding what's New about the OECD'S Transfer Pricing Guidelines", (1996) 50 *U. Miami L. Rev.* 577, 578.

10 Section 92 of the Income Tax Act, 1961. It is necessary to observe that the rules as specified in the 1995 and 1999 guidelines (collectively, the "OECD Guidelines") have been the source upon which countries have developed domestic tax law jurisprudence and bilateral treaties to regulate and compute the transfer price of controlled international transactions. See Lepard, Brian D., "Is The United States Obligated To Drive On The Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Length Standard As A Case Study", (1999) 10 *Duke J. Comp. & Int'l L.* 43, 83.

has to be determined.[11] Consequently, for the purpose of Section 92 (1) the arm's length price will be determined in one of the methods as mentioned above. Rule 10 B of the Income Tax Rules, 1962, lays down the procedure in which each such method of calculation can be utilized to compute and determine the arm's length price of controlled international transactions.

II. CASE ANALYSIS

1. Contentions Raised by the Petitioner

Sony India (P) Limited (the "petitioner") is a wholly owned subsidiary of Sony Corporation of Japan. The petitioner imported high end products from its associated enterprises. For the assessment year 2002-03, the petitioner had filed its annual return declaring an income of Rs. 8,67,46,730. Following the mandate under the Instruction, the Assessing Officer (the "AO") referred the international transactions of the petitioner to the Transfer Pricing Officer (the "TPO"). The TPO recommended that the total income should be enhanced to Rs. 42,41,40,934. Subsequent to this finding, the AO issued the assessment order assessing the income of the petitioner at Rs. 59,92,40,000.

Section 92 CA (4) of the Act stipulates that the AO, where he, "considers it necessary or expedient so to do", *may* refer the computation of the arm's length price of any international transaction[12] between associated enterprises to the TPO. In 2003, the Central Board of Direct Taxes (the "CBDT") issued Instruction No. 3 (the "Instruction") stipulating that, wherever the aggregate value of international transaction exceeds Rs. 5 crore, such transactions *should* be referred to the TPO. On the basis that, the Instruction fettered with the discretion of the AO, it was challenged in a writ petition before the Delhi High Court (the "High Court") in the case of *Sony India.*

Before the High Court, the petitioner argued, *inter alia*, that:

(i) The classification of international transactions in to two categories, i.e., those of the value exceeding Rs. 5 cores and those of a lesser value is not based on an intelligible differentia and has no nexus with the object sought to be achieved. Hence, the Instruction is violative of Article 14 of the Constitution of India; and

(ii) The petitioner also contended that the discretion of the AO under Section 92 CA of the Act has been taken away by the Instruction. Consequently, the impugned Instruction is illegal and *ultra vires* the Act.

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11 Moghul, S.I., "How to Comply with India's Transfer Pricing Rules", (2002) 12 *Int'l Tax Rev* 43, 44.

12 Section 92 B of the Act provides the meaning of 'international transaction' in the context of transfer pricing.

2. Judgment of the Court

The High Court stated that the classification stipulated in the Instruction is based on a straightforward recognizable basis. The Court rightly observed that the objective of introducing transfer pricing provisions was to curb tax avoidance by determining the arm's length price. Efficient examination of such intricate commercial transaction may not be possible at the level of the AO. Thus, in the opinion of the High Court, the Instruction endeavours to achieve the objective of curbing tax avoidance, as there will be a specialized determination by the TPO. Consequently, the classification bears a nexus with the said objective, and hence the Court rejected the petitioner's objection on the basis of violation of constitutional principles.

Moreover, the High Court pointed out that the Instruction was only a guideline to the AO.[13] Further, it was observed that that the TPO's order would help the AO exercise his discretionary power in a knowledgeable and intelligible way.

III. QUEST FOR CERTAINTY: JUDICIARY'S LIMITATION IN POLICY CHANGE

The rationale behind the Instruction can be said to be two fold:

(i) Firstly, it is a means to considerably reduce the revenue loss arising from evasion since as per the Instruction all transactions above Rs. 5 crores shall be scrutinized by the TPO, an authority which is specially equipped with the relevant technical knowledge for computation; and

(ii) Secondly, it also has the effect of ensuring some amount of certainty as the threshold limit for reference to scrutiny is laid out in clear terms.

By upholding the Instruction, which stipulates that any controlled international transaction worth of Rs. 5 crore will be referred to the TPO, the Court has therefore, at one level assisted in ensuring certainty. In that, if there were to be a controlled international transaction worth Rs. 5 crore or more, then the tax payer is certain that their transactions get referred to the TPO and would take measures accordingly.

However, from the tax payer's standpoint it would be ideal if certainty is realised in a

13 In *Sony India* the High Court had also declared that the opinion of the TPO is not binding on the AO. According to the Finance ministry, the TPO is an expert in matters concerning the determination of the arm's length price. Consequently, it observed that the opinion given by the TPO should be binding on the AO. To this effect, the Finance Act, 2007 amended Section 92 CA (4) of the Act. Hereafter, the AO would have no discretion to apply his mind to the report of the TPO. To this extent, the legislative change has annulled the decision in *Sony India's* case.

fuller measure at other levels as well. As shall be subsequently explained, the existing law which governs the transfer pricing methods, especially the arm's length principle, suffers from an inherent loophole which leads to uncertainty in ensuing tax treatment and this aspect goes beyond what came up in question in *Sony India.*

The Court, in *Sony India*, limited its examination to the relevant constitutional and administrative law principles. There is, however, one facet of this case that has been overlooked. According to the petitioner it had an income of Rs. 8,67,46,730. Subsequent to computation by the TPO the total income of the assessee stood at Rs. 59,92,40,000. One notices that there is a whopping difference of more than Rs. 50 crores. Though the case of *Sony India* does not specifically examine the soundness of the method that is followed, it is clear that, Section 92 of the Act, which provides for the arm's length principle to compute the transfer price, may not lead to certainty and predictability for all controlled international transactions.

In this regard several crucial questions emerge. What are the inherent problems of the arm's length principle that does not lead to certainty and predictability? Other questions also need to be surfaced - for example, what are the alternative methods of computing transfer price apart from arm's length principle and which method of computation leads to more certainty and predictability?

Even if the Court had an occasion to examine these questions, it is very likely that the same would have been summarily brushed aside following the ratio in *Azadi Bachao Andolan-*[14] that policy matters are beyond the competence of the Courts. In view of the inherent complexity of these fiscal adjustments, the Courts have given greater discretion to the Legislature and Executive in the matter of its preferences of economic and social policies to effectuate the chosen system in all possible and reasonable ways. So, it can be inferred that there are limitations in the extent to which the Courts can contribute to certainty in the matter of transfer pricing involved in a controlled international transaction. Clearly therefore, the required changes in transfer pricing policy framework will have to be effected through other means whether legislative or executive.

IV. CRITICAL ANALYSIS OF THE TWO METHODS

On a general note, the transfer pricing rules recognize two methods of taxing controlled international transactions. One is the Arm's Length Price method (the "ALP method") and other one is Global Formulary Apportionment method (the "GFA method"). The OECD Guidelines endorse the usage of ALP methods to compute the transfer price in

14 *Union of India v. Azadi Bachao Andolan*, (2004) 10 SCC 1: MANU/SC/0784/2003.

controlled international transactions. Similarly, Section 92 (1) of the Act reflects this position and stipulates that income arising from an international transaction shall be computed having regard to the *arm's length price.*

It is submitted that, consideration of other methods are required to ensure greater degree of certainty while computing true transfer price of controlled international transactions.

1. Critique of the Alp Method

A price at which independent enterprises deal with each other should be reckoned as the arm's length price.[15] A bare perusal of the New OECD Guidelines reveals that the ALP method follows the approach of treating the members of a Multi-National Corporation group ("MNC group") as operating as separate entities rather than as inseparable parts of a single unified business. The OECD Guidelines state that by incorporating the separate entity concept, the ALP method places related and unrelated enterprises on an equal footing for tax purposes. This avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity.[16]

According to the OECD, this principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises. Therefore, advocates of this method argue that the ALP method reaches a comparable uncontrolled market price that is reasonably reliable for standard transactions where the price range is narrow and the market price is certain.

It is submitted that notwithstanding all this, the ALP method has an inherent loophole which adversely affects the computation of transfer price for controlled international transactions, thereby making the tax treatment of associated enterprises uncertain and unpredictable. The OECD itself acknowledges that the ALP method is "inherently flawed" since it does not account for the economic realities created by associated enterprises in their respective international transactions.[17] Similarly, the OECD also concedes that following the ALP method may result in an administrative burden for both the tax payer and the tax administration of evaluating significant numbers and types of cross-border transactions. Additionally, if one were to follow the ALP method,

15 Lal, B.B., Vashisht, N, *Direct Taxes – Income Tax, Wealth Tax and Tax Planning,* (Delhi: Pearson Education, 2006), 770.

16 Para 1.7 of the New OECD Guidelines, 1995.

17 At para 1.9, of the New OECD Guidelines, 1995.

the uncertainty prevailing over the possible tax liability actually affects the competitive position of the associated enterprises.

Furthermore, if one were to analyze the true character of many international transactions between associated enterprises, we can observe that enterprises structure transactions in such a manner that there can be no comparisons. Consequently, the ALP method which is based on the premise of comparable uncontrolled transactions becomes inapplicable for such transactions. For instance, the applicability of the ALP method becomes impractical in transactions which involve the integration of highly specialized goods, unique intangibles or specialized services, new technology and business structures.

Therefore, adopting the ALP method to compute the transfer price of complex commercial controlled transactions might become difficult, if not impossible. Such difficulties in determining the true price will always impact the predictability and certainty about the possible tax liability.

2. Constructive Alternative - Global Formulary Apportionment Method

The New OECD Guidelines have also provided an erudite discourse on another method which can be followed to identify the transfer price of controlled international transactions. The OECD has reserved a part in Chapter III of the New OECD Guidelines to discuss and discard the GFA method. Under this method, first, the associated enterprises involved in an international transaction, are treated as a *single business unit*. Subsequently, on the basis of a predetermined formula, which is based on the relative proportions of property, payroll and sales,[18] the global profits of such associated enterprises are allocated.

The GFA method recognizes the actual contribution of the units of associated enterprises which are involved in the international transactions. It allocates or apportions the computed profit depending upon the identifiable involvement of the concerned units of the MNC group. The GFA method, unlike the ALP method, acknowledges the synergies which exist between the controlled entities. For international transactions which involve trading in intangibles, specialized technology and specialized services, the GFA method enables the assessee as well as the tax administrators to compute the actual and true transfer price. As the computation takes place prior to the finalization

18 McDaniel, Paul R., "Formulary Taxation in the North American Free Trade Zone", (1994) 49 *Tax L. Rev.* 691.

of the transaction, the units of associated enterprises can predict the tax treatment and accordingly structure the transactions.

The major difference between the ALP method and the GFA method is that the former starts with treating each entity in an affiliated group as a separate taxpayer, i.e. hypothetically considering a transaction between related enterprises in the group at arm's length. Conversely, the GFA method starts with the entire affiliated group as one unitary enterprise.[19]

It is submitted that the GFA method is not merely a theoretical construct. States in the USA have to follow the GFA method under the Uniform Division of Income for Tax Purposes Act (the "UDIPTA").[20] It is believed by the advocates of GFA method that this method reduces compliance costs for taxpayers since in principle only one set of accounts would be prepared for the group for domestic tax purposes. There are also commentators who argue that in order to implement the GFA method, it is essential to create an international organization which would fulfill, in the taxation field - a role equivalent to that of the World Trade Organization in international trade.[21]

V. CONCLUSION

An analysis of the foregoing leads to the conclusion that both the ALP method and GFA method fail to provide steps for identifying the true transfer price for all kinds of controlled international transactions. The ALP method conveniently ignores the aspect of economies of scale and synergistic operations which are inherent part of any given transaction. Conversely the GFA method is plagued with its own loopholes, in the sense that it does not take into account the market conditions involved, fluctuation of foreign currency rates etc.

Further, as detailed above, by upholding the Instruction the Court in *Sony India* has therefore, at one level assisted in ensuring certainty, in that, if there were to be a controlled international transaction worth Rs. 5 crore or more, then the tax payer is certain that their transactions get referred to the TPO and take measures accordingly.

19 Avi-Yonah, Reuven S., "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation", (1995) 15 *Va. Tax Rev.* 89, 93.

20 UDIPTA was formulated by the National Conference of Commissioners on Uniform State Laws in 1957.

21 Celestin, Lindsay C., "The Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative", Submitted to University of Sydney, October 2000. Available at <http://ses.library.usyd.edu.au/handle/2123/846?mode=_full&submit simple=Show+full+item+record > last visited on 03-07-2007

Keeping in mind the nuances involved in a transaction between the associated enterprises, acknowledging the judiciary's limitation in effectuating policy changes and recognizing the inherent loophole in endorsing only one method to ascertain the transfer price involved in controlled international transactions, the law makers can consider following unconventional alternatives to provide certainty in a fuller measure for the stake holders involved in the international controlled transactions:

(i) The Indian transfer pricing law can be revaluated to change its position of endorsing only the ALP method as the mechanism to identify the transfer price; and

(ii) Section 92 (1) of the Act, which stipulates that income arising from an international transaction shall be computed having regard to arm's length price, can be suitably amended to accommodate the GFA method of computation.

In the opinion of the author, such an integrated and intermediate approach is the most productive, appropriate and constructive alternative to determine the true transfer price. Such a holistic approach, providing fuller measure of *certainty*, will ensure that the tax payers are given an alternative to opt for the best method to determine their transfer price and true revenues can be realized by the tax administrators.

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