Transfer Pricing: History, Lessons and Experiences as a Litigator

May 24, 2022

Porus Kaka
Senior Advocate and Former IFA President

1. Global history of transfer pricing

Transfer pricing came into the international tax lexicon in 1968 when the United States for the first time introduced it in federal tax legislation. This was followed by several European countries, including France (1973),[1] Germany (1983)[2] and the United Kingdom (1988).[3] Most of the developing world through the late 1980s and early 1990s had relatively closed economies, including especially China and India, hence the need to have such regimes was not felt as a necessity.

The international transfer pricing regime operates on the assumption that each associated enterprise ("AE"), including at time branches, etc. within the same enterprise, in a multinational group as a separate legal entity and is considered to ensure the AEs transact amongst themselves at arm's length. This assumption was accepted by the OECD in the 1979 Report on Transfer Pricing and Multinational Enterprises, its first significant contribution on the subject.[4] The report largely stemmed from the 1968 Regulations on transfer pricing issued by the US Internal Revenue Service. The OECD 1979 Report helped homogenize the law on transfer pricing globally. The emphasis of the 1979 OECD Report was on traditional methods such as comparable uncontrolled price ("CUP") method. In this method the price of the transaction is compared directly with that of a comparable transaction. The other traditional methods promoted by the 1979 Report were the resale price method and the cost-plus method. In the former, the resale margin between the transactions is compared, whereas in the latter, the mark-up over the cost between the transactions is compared; to determine whether the transaction is at "arms-length".[5]

1.1. 1995 OECD Transfer Pricing Guidelines

The difficulty in application of the CUP and other traditional methods created a rift due to the inability to find appropriate transactions and comparables. This led the United States in 1994 to introduce new transactional methods in its transfer pricing regulations. The OECD followed suit with the first Transfer Pricing Guidelines in 1995. The development of the transfer pricing regime has seen a visible shift to the transactional methods because of increased globalization and the resultant integration of multinational enterprises ("MNEs"). This integration has made MNEs and their supply chains ever more unique, straining the capacity of Revenue authorities to find applicable comparables to question the taxpayer's stance.

The 1995 OECD Transfer Pricing Guidelines accepted this difficulty. The Guidelines noted that the traditional methods may not be applicable to all scenarios and thus the use of transactional methods may, in rare cases, be required. The two transactional methods adopted were the net margin method and the profit split method. In the former, the net profit earned by the controlled enterprise to a base is compared relative to the same ratio achieved by the independent enterprise undertaking similar operations. In the profit-split method, the profit an independent enterprise would have expected to gain in a given set of transactions is identified and compared with the controlled enterprise. However, the use of transactional methods was greatly discouraged in the 1995 Guidelines.[6]

1.2. 2010 OECD Transfer Pricing Guidelines

With passing time, the limitations of the traditional methods became more apparent, and the transactional methods became popular among practitioners and the revenue alike. The 2010 OECD Transfer Pricing Guidelines recognized this limitation of traditional methods and approved the use of the transactional methods at parity. The 2010 Guidelines though tried to hold ground stating that the "traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length", the Guidelines could not deny that "there are situations where transactional profit methods are found to be more appropriate than traditional transaction methods".[7]

Further, in the transactional methods, the OECD Guidelines emphasize that individual transactions are compared, requiring that the methods be used to "examine the profits that arise from particular controlled transactions".[8] In practice, however, it is difficult, given the nature of the methods, to restrict the analysis to the particular transaction and so invariably the analysis spills over to the aggregate transactions of the enterprises. The 2010 Guidelines accept that the transactions may have to be evaluated on an aggregate basis, at least in some instances, instead of an evaluation at the transactional level.[9]

The 2010 OECD Guidelines also highlight the peculiarity of an MNE's structure which creates further issues for the transfer pricing regime. The common structure involves a centralized principal parent normally in a low-tax jurisdiction which is the primary risk-taker of the MNE group. Intellectual property ownership is also transferred to the central MNE parent.[10] This would also mean that the subsidiaries of the MNE in high-tax jurisdictions are converted into limited risk-takers.

In summary, by 2015 the earlier acceptance and confidence on the arm's length price had given away to significant practical difficulties of finding appropriate comparables, allocating risk, nature of capital and valuation of intangibles. There were concerns also with the fundamental assumptions of the arm's length standard on dealing with group synergies. The difficulty in delineating and identifying the true FAR (functions, assets, and risk) of the transaction as presented by the taxpayer and its sequitur, the ability of the revenue to challenge the same brought about significant changes with the 2017 OECD Transfer Pricing Guidelines.

1.3. 2017 OECD Transfer Pricing Guidelines in a post-BEPS 1.0 world

Under the 2010 guidelines it was explicitly provided that the Government reserved the right to recharacterize or disregard transactions that lack economic substance[11] or that lack commercial rationality.

The BEPS Action Plans requires work on transfer pricing that would "develop rules to prevent BEPS by engaging in transactions which would not or would only very rarely, occur between a third party"[12] and also clarify the circumstances in which a transaction can be recharacterized.[13]

The 2017 guidelines therefore deal with this paradigm in the following manner:

Firstly, they require an "accurate delineation" of the transaction by giving particular emphasis to the conduct of the parties.[14] Secondly, the 2017 Guidelines remove the specific suggestion that transactions can be disregarded only when the economic substance differs from form. It adds a vague test that elaborates on the instances in which the transaction can be disregarded, giving primary impetus to the conduct of the parties, regardless of the content of the contracts.[15] Thirdly, the restrictions to disregard the transaction in paragraphs 1.64 and 1.65 under the 2010 Transfer Pricing Guidelines was removed and in place the test of "commercial rationality" was applied to disregard transactions.[16] The meaning of commercial rationality is also elaborated through examples. Finally, the most significant changes in the Guidelines appear in the delineation of the transaction. The 2017 Guidelines remove the regard that was earlier shown to the taxpayer's "structure and contracts".[17]

The emphasis therefore appears to be in finding "substance" through actual conduct, while at the same time not ignoring the form save and except when the transaction lacks commercial rationality.[18] Thus the emphasis is a subtle yet broader shift into finding the "elusive" substance, not by disregarding the transaction and/or recharacterizing the same, yet within the overall form, finding the true substance, through evaluation of the conduct rather than through the different terms of the conduct.

It is a moot point whether this is trying to fit a square peg in a round hole, since if the conduct and terms are significantly different, so as to require or necessitate the reworking of the FAR, effectively the form of the transaction is being ignored.

One fully agrees with the concerns that the terms of the contract at times cannot encompass the totality of the role which the parties to the contract will play; but to endorse and emphasize, *"conduct*" creates significant issues in subjectivity and evidentiary issues as to the manner of proof required both to prove and/or disprove conduct and consequentially the valuation issues on the same.

At times the vagueness in these guidelines could itself surmount to a significant problem in the courts. The Federal Court of Australia in *Commissioner of Taxation v Glencore Investment Pty Ltd* [2020] FCAFC 187 rejected the reliance of the Tax Officer on the OECD Guidelines by terming "the language deployed" as "very highly generalised and is frustratingly opaque".[19]

There were two other major changes brought forth through the 2017 Transfer Pricing Guidelines that merit a discussion.

1.3.1. Risk allocation

As alluded to above, with the BEPS reports and the resultant changes in the 2017 Transfer Pricing Guidelines, the emphasis changed from formal contracts between the AEs to the actual conduct of the AEs.

Corollary, the function undertaken, risks assumed, and the assets utilized by the enterprise in a particular jurisdiction is also scrutinized differently. In the pre-BEPS regime, a requirement that the enterprise only "bear" the risk was sufficient. However, post-BEPS and with the 2017 Guidelines, the requirement is that the enterprise not only "bear" the risk but also be "capable of assuming that risk". This is based on the assumption that entities transacting at arm's length would only assume such risks as its financial capacity permits it to assume.[20] In that light then the primary determination of the functional analysis in any transfer pricing case rests on the factual determination that the entity of the MNE group not only bears the risk, but also has the capacity to assume that risk. This is the integral element of the shift of the international transfer pricing regime from form to the substance of the transaction. The OECD argues that based on this functional analysis the transaction is more accurately delineated.

Delving a bit deeper, the 2017 Guidelines assume that in an arm's length setting, risk management of any entity would require it to have the "capability to decide" whether to "take on risk" or "how to respond to the risk, including by diversifying the risk and having the functional capabilities to mitigate the risk and generate a return from the opportunity".[21] That is, an entity assumes and bears the risk if it has the capacity to make and does in fact make informed commercial decisions regarding whether to take risk, lay-off risk or decline risk and at the same time have the "financial capacity" to do so.

The 2017 Guidelines define "financial capacity" as having access to funding to either take or lay-off risk or to bear the consequences in the event the risk materializes.[22] The entity is not required to have the funds ready in hand to bear the risk. It should rather have its independent borrowing capacity.

In summary, as a significant shift from the earlier versions of the Transfer Pricing Guidelines, the OECD recommends that the functional analysis of transfer pricing take into account the conduct of the parties. Thus, the conduct be examined to determine which party actually bears the consequences of the risk in the event of materialization and whether that same entity bearing the risk has the financial capacity to take that risk.

1.3.2. Intangibles

Another major contribution of the 2017 OECD Transfer Pricing Guidelines has been on the intangibles front. The taxation of intangibles has been a source of much debate and concern over the past decades. The issue partly stems from transfer of intellectual property to low-tax jurisdictions at a relatively early stage of their development. When the intangible is finally developed, its marketability warrants payment of, at times, heavy royalty. The BEPS Reports highlighted this, and the 2017 OECD Guidelines devoted a complete chapter on the special considerations for intangibles.

A peculiarity within the intangibles sphere is that they are hard to value. These intangibles are hard to value as they are partially developed at the time they are transferred offshore. No one, let alone the revenue authorities, are in a position to determine whether that intangible in the near or late future would significantly increase in value. The intangible's commercial worth is of relevance at the time of its transfer to determine the cost base. This creates a problem for the taxpayer, where in the event the intangible is commercially successful, the tax authorities may be inclined to "look back" and rely on post-transfer profitability to make an adjustment to the sale of the intangible. The temptation to consider hindsight in the valuation process has increasingly become a significant pressure, especially from the Revenue's side. While on one hand the OECD discouraged the use of hindsight, the pressure to look at the actuals was increasing exponentially.[23]

The OECD notes that there is an asymmetry of information between the taxpayer and the authorities on the commerciality of the intangible.[24] To alleviate some of these concerns, the OECD recommends that post-transfer results can be taken into account in certain situations and are presumed useful to determine whether there were uncertainties in the valuation at the time of the transfer. This is a rebuttable presumption. The taxpayer may argue that given the projections used and the manner in which the risks were understood at the time of the transfer, the valuation of the intangible was proper.[25] The taxpayer would have to further demonstrate that the difference between the valuation of the intangible at the date of transfer and post-transaction could be attributed to unforeseeable events that could not have been accounted for at the time.[26] The presumption could also be rebutted by the taxpayer if an advanced pricing agreement ("APA")was obtained or if the actual valuation of the intangible was within a 20% range of the projected valuation used at the time of the initial transfer.[27] In a different world, taking post-transaction information to determine the arm's length price would be greatly frowned upon, however, given the limitations with the current transfer pricing regime, the OECD argues that these are fully consistent and do not come with hindsight bias.

2. Lessons and experiences

The objective of transfer pricing was to check manipulation of prices and shifting of profits by related parties who have the power to set prices.[28] Hence, the objective being to reduce the power of global organizations to be able to shift income and prices into jurisdictions that had low taxes or tax advantages. When the developing world consisted of closed economies this did not present itself as a significant problem. As countries started to open their international trade policies, however, they rapidly developed transfer pricing regimes in an attempt to stem the possibility of MNEs to shift profits out of their respective jurisdictions. Accordingly, South Africa (1995), Brazil (1997), China (1998) and India (2002) introduced their transfer pricing regimes in the years respectively.

India as a strange quirk of faith using perhaps out of context a comment by the Honourable then Chief Justice Kapadia in Glaxo (in SLP (Civil) No. 18121 of 2007, dated 26.10.2010) introduced for a brief period of time transfer pricing to even cover domestic transfer pricing situations.

The stakes involved in transfer pricing litigation rose rapidly in various countries, alluding to the complexity of the transfer pricing regime. To take India as an example the stakes involved were reported in the Annual Report of the Ministry of Finance as under:[29]

[INR figures in crore]

– FY 2001-02 – 1,220

– FY 2002-03 – 2,287

– FY 2003-04 – 3,432

– FY 2004-05 – 7,754

– FY 2005-06 – 10,908

– FY 2006-07 – 24,111

– FY 2007-08 – 44,531

– FY 2009-10 – 70,016

– FY 2010-11 – 59,602

Transfer pricing litigation has in a very short period of time become a major component of international tax disputes. Speaking of myself personally it has come to occupy nearly 60% to 70% of my litigation and advisory practice in the last decade. The principal seat of the Income Tax Appellate Tribunal in India (Mumbai) has now not one, but two Benches exclusively set up to hear transfer pricing litigation, which has exploded.

Transfer pricing in my professional experience and judgement is not a science nor an art, it's touchstone is an attempt to establish conduct of business in a fair and reasonable manner. Speaking as an individual, it perhaps frightens me at times to consider the basis of transfer pricing as a determination of income/profits, dependent on what a third party earns.

The two globally divergent methods currently existing are the widely accepted arm's length principle used by most countries such as the OECD countries and others including India, China, and South Africa; and formulary apportionment used primarily by Brazil but might rapidly come into the international tax world when we embark on the Pillar One for taxing the digital economy.[30]

The greatest drivers of the litigation in transfer pricing revolve around the following areas:

– meaning of associated enterprise;

– definition of international transaction;

– analysis of most appropriate method;

– comparability analysis, including the functions, assets, and risks analysis;

– availability of uncontrolled comparable transaction;

– availability of proper comparable; and

– valuation of intangibles and what is an intangible.

2.1. Litigation journey

India has had a unique litigation journey in the judicial analysis of the transfer pricing principles. This journey consisting of four players, namely the corporate tax assessees, advocates and chartered accountants, the Revenue Department and judiciary, were thrown in without any floats, into the deep end of the swimming pool being the "World of Transfer Pricing" at a notice of 1 year in 2002. In little under two decades since then, the country has developed judicial experience few others can rival, its Revenue Officers and its judiciary have tested perhaps every transfer pricing position and situation. The Revenue's ability to "think out of the box" has resulted in judicial decisions on many new transfer pricing areas and aspects. The efforts to consider for example the market as an intangible and bring up concepts such as location savings, are just one example.[31] Credit to some of the positions, which might have sounded outlandish to begin with, for example, the relevance of the "market" as a factor for consideration is now being seriously considered in the digital tax proposals.

In transfer pricing litigation while it may be tempting to win as a litigator on technical issues such as jurisdiction, procedural matters, and compliances, etc., it has been my experience that these at many times, provide only temporary relief to the taxpayer. For the assessees, far greater precedential value is there, when a court adjudicates and accepts its transfer pricing stand and methodology, and that endeavour in litigation is always preferable in the long run.

In preparing for a hearing especially on merits of the transfer pricing position, it is critical that the evidence before the courts is sufficient to satisfy the court of the reasonableness of the positions, whether of the Revenue or the taxpayers. Attempts to justify extreme positions in my opinion are inadvisable. In many cases I have found that the evidence is incomplete and insufficient and requires to be buttressed, before one can be comfortable or confident of a particular position. It is critical to keep this in mind before the litigation reaches a certain stage, wherein fresh evidence cannot be introduced, before you step out to defend your client.

A major transfer pricing litigation in India involved testing a proposition on the relevance of a mutual agreement settlement (MAP) with a particular jurisdiction and its transfer pricing relevance when considering countries outside the settlement.[32] At first flush, this proposition seemed difficult and contrary to the methodology laid down under the law. However, as many litigations experience bear out, what seems to be difficult at the outset only means it requires further work and research. The rationale of the argument was, however, based on equity and reasonableness, which as I said earlier is the touchstone of the arm's length principle.

Having done much spade work in showing an initially hostile court similarity between the transactions by the taxpayers in the MAP jurisdiction and other jurisdictions but going further to establish its identical nature and acceptance by the government of its identical nature, finally helped the Hon'ble High Court to accept the position that there is some relevance to MAP settlements, in transfer pricing disputes outside the MAP jurisdictions.

When one looks back at 20 years of litigation and sees many of the Commentaries in the OECD Transfer Pricing Guidelines become more subjective and in favour of the Revenue, concerns about that is an area of litigation which is not going to go away in a hurry.

The Indian Revenue has received its share of brick bats for its positions which at times are termed as "ingenuity". However, in my experience it would be difficult not to credit them with developing and testing new ideas albeit with a resource generation motive. Many of ideas which at times initially seem surprising, for example the market is intangible and/or relevant factor for transfer pricing, is now in the realm of acceptance in the digital taxable proposal.

The judiciary equally have excelled themselves when being thrown into the deep side of the pool and one can find in India's judicial orders, perhaps at least one judgment on every troublesome issue under the sun, or as one may better call it, under the arm's length principle!

3. 2019 and beyond

The 2017 OECD Transfer Pricing Guidelines recognize that the arm's length standard may not be best suited as MNEs operate in an integrated manner instead of its constituent AEs acting and transacting independently.[33] Moreover, asymmetry of information and lack of a robust database of comparables makes it difficult for the Revenue to adequately find comparables to make the appropriate transfer pricing adjustment.

In recognition of these concerns, the OECD published its Public Consultation Document (Secretariat's Proposal) under Pillar One and Pillar Two in late 2019 ("2019 Pillar Reports") and its Report on the challenges to Pillar One and Two stemming from digitalisation in October 2020 ("2020 Reports"). The 2019 and 2020 Reports recognize that the market jurisdictions have a right in the global profits of an MNE group (Pillar One) and focuses on the need for a global minimum tax (Pillar Two).

4. Moving away from Arm's Length Price

The OECD on 8 October 2021 issued a statement discussed in the OECD/G20 Inclusive Framework on BEPS on Pillar One and Pillar Two.

Pillar 1 seeks to remunerate the market jurisdictions through the following:

Amount A (new taxing right): As per the statement, a share of residual profit allocated to market countries using a 'formulaic approach'. It applies to multinational enterprises (MNEs) with global turnover above 20 billion euros and profitability above 10% calculated using an averaging mechanism.[34]

Regulated financial services are kept out of scope. Under the Framework, "*for in-scope MNEs, 25% of residual profit defined as profit in excess of 10% of revenue will be allocated to market jurisdictions with nexus using a revenue-based allocation key*".[35]

Amount B (fixed "baseline" return): arm's length principle would still be applicable for 'baseline' transactions with related parties in the nature of marketing and distribution functions.[36]

Amount C (dispute): A binding dispute resolution process is envisaged dealing with all aspects of allocation under Pillar 1.[37]

Pertinently, Pillar 2 deals with Global Anti-Base Erosion Model Rules. Under the Pillar 2, a minimum effective tax rate of 15%. As the OECD acknowledges:

"*Countries that choose to introduce the Global Anti-Base Erosion (GloBE) rules have agreed to do so in a consistent and co-ordinated way. The inter-locking nature of the GloBE rules means that their adoption by a critical mass of jurisdictions will be sufficient to ensure that MNEs are required to pay the minimum level of tax on their profits arising in each jurisdiction where they operate.*

…

The GloBE rules acknowledge the calls from developing countries for more transparent, mechanical, predictable rules to level the playing field and reduce the incentive for MNEs to shift profits out of developing countries. The GloBE rules are expected to reduce pressure on governments to offer wasteful tax incentives and tax holidays, while still providing a carve-out for certain income that arises from real substance."

This is a clear move away from the long-standing and established arm's length principle to a formulary apportionment method by the OECD. It creates an entirely new taxing right for states. Additionally, it also mandates (if the states so chose to accept the GloBE Rules) a minimum tax be levied on enterprises. This is an unprecedented shift in the international tax regime which previously has limited itself to transfer pricing principles, taxation and determination of profits being solely based on the arm's length principle.

5. Conclusion

It would be improper not to mention the complexity of the current transfer pricing regime that will result from the move towards subjectivity and the shift to finding that elusive "substance over form" requirements. Determination will need to be made, for example, at each stage whether the conduct of the AEs in the risk analysis corresponds to their contractual relationship or whether the conduct equals the form. Apart from this, the additional methods and allocation rules under the new Pillar One and Two will bring their own share of complexities. This I'm afraid does not bode well for reduction in the litigation going forward.

---

* Porus F. Kaka graduated from Harvard Law School in 1991 earning an LLM and is a Senior Advocate (India) and Barrister (England & Wales). I also extend gratitude to Aditya Vora, without whose help this article, prepared in a relatively short time, could not have seen the light of day.

The article was first published as 'Transfer Pricing: History, Lessons and Experiences as a Litigator', published in Thinker, Teacher, Traveler: Reimagining International Tax. Essays in Honor of H. David Rosenbloom (2021, IBFD Books), available here: https://www.ibfd.org/shop/Thinker-Teacher-Traveler-Reimagining-International-Tax

[1]. PwC, International Transfer Pricing – France, available at pwc.com/gx/en/international-transfer-pricing/assets/france.pdf (accessed March 20, 2022).

[2]. PwC, International Transfer Pricing – Germany, available at pwc.com/gx/en/international-transfer-pricing/assets/germany.pdf (accessed March 20, 2022).

[3]. PwC, International Transfer Pricing – United Kingdom, available at pwc.com/gx/en/international-transfer-pricing/assets/ united-kingdom.pdf (accessed March 20, 2022).

[4]. OECD – Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises 1979, Annex, paras. 1-2, Primary Sources IBFD.

[5]. Id., at paras. 56 and 63.

[6]. Id., at paras. 3.2, 3.5 and 3.49-3.57.

[7]. OECD - Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – 22 July 2010, paras. 2.3 and 2.4, Primary Sources IBFD.

[8]. Id., at para. 2.57.

[9]. Id., at para. 9.94.

[10]. Id., at para. 9.1.

[11]. Id., at paras. 1.64-1.65.

[12]. OECD, Action Plan on Base Erosion and Profit Shifting, p. 20, Primary Sources IBFD.

[13]. Id.

[14]. OECD - Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017), paras. 1.33-1.50, Primary Sources IBFD.

[15]. R. Collier & J. Andrus, Transfer Pricing and the Arm's Length Principle After BEPS p. 199 (Oxford University Press 2017).

[16]. OECD Guidelines, supra n. 14, at para. 1.122.

[17] Id., at, para. 1.43; Collier & Andrus, supra n. 15, at p. 200.

[18]. OECD Guidelines, supra n. 14, at para. 1.122.

[19]. AU: FCAFC, 6 Nov. 2020, Commissioner of Taxation v Glencore Investment Pty Ltd, [2020] FCAFC 187, para. 153.

[20]. OECD Guidelines, supra n. 14, at para. 1.60 and sec. D.1.2.1.3.

[21]. Id., at para. 1.79.

[22]. Id., at para. 1.64.

[23]. OECD Guidelines, supra n. 7, at para. 3.74.

[24]. OECD Guidelines, supra n. 14, at para. 6.191.

[25]. Id., at para. 6.192.

[26]. Id., at para. 6.193 (i).

[27]. Id., at para. 6.193 (ii) and 6.193 (iii).

[28]. OECD Guidelines, supra n. 4.

[29]. Ministry of Finance Annual Report 2013-14, available at

https://dea.gov.in/sites/default/files/AnnualReport 2013-14.pdf (accessed March 20, 2022).

[30]. 2019 OECD Secretariat Proposal for a “Unified Approach” under Pillar One.

[31]. United Nations 2017 Manual on Transfer Pricing, para. D.3.7.

[32]. IN: Bom. HC, 25 Mar. 2019, Income Tax Appeal 170 of 2017, Principal Commissioner of Income Tax v. J. P. Morgan Services India Pvt. Ltd.

[33]. OECD Guidelines, supra n. 14, at para. 1.10.

[34] Statement issued by Inclusive Framework on 8 October 2021.

[35] Statement issued by Inclusive Framework on 8 October 2021.

[36] Id.

[37] Public consultation document: Secretariat Proposal for a “Unified Approach” under Pillar One