FICCI

International Conference on Tax Management and Emerging Fiscal Issues

Impact of Transfer Pricing Regulations on E-Commerce

Presented by Mr. Nishith M. Desai*

At Federation House, New Delhi

On November 8 & 9, 2001

Nishith Desai Associates**

Legal and Tax Counselling Worldwide

93-B MITTAL COURT, NARIMAN POINT
MUMBAI 400 021. INDIA
TEL: 91 (22) 282-0609
FAX: 91 (22) 287-5792

220 CALIFORNIA AVENUE., SUITE 201
PALO ALTO, CA 94306, USA
TEL: 1 (650) 325-7100
FAX: 1 (650) 325-7300

nda@nishithdesai.com
www.nishithdesai.com

* **Mr. Nishith Desai** is the founder of the firm Nishith Desai Associates, *Legal & Tax Counselling Worldwide*. He is an international lawyer, researcher, author and a lecturer. He has been on the advisory Board of the New York State Bar Association's International Law Review, chairperson of LawAsia Taxation Committee and a senior country correspondent for "Tax Notes International", US.

His practice areas include International Taxation and Transfer Pricing, Information Technology & e-commerce laws, Corporate Law, Mergers & Acquisition, Venture Capital, Media & Entertainment Laws, International Business Strategy and Employee Stock Option Plans.

Mr. Desai was on the Securities and Exchange Board of India (SEBI) Committee set up to evolve ESOP guidelines in India. He is also a member of the committee appointed by SEBI for synchronization / review of the various venture capital guidelines prevalent in the country. He has lectured extensively including on issues of e-commerce, privacy, ESOPs etc. at various national and international forum.

** **Nishith Desai Associates** (NDA), which is based in Mumbai and Silicon Valley, specializes in globalisation of Indian corporates, International Tax & Transfer Pricing, Offshore Funds, Corporate and Securities laws, ADRs, M&A, Information, Communication & Entertainment (ICE) laws, e-commerce laws, and Media & Entertainment laws. The firm has structured and acted for the largest number of private equity funds for India. NDA acted as underwriter's counsel in Infosys Technologies and Satyam Infoway's American Depository Receipt (ADR) offerings in the USA. It also represented Rediff.com, Silverline Technologies and Wipro in the ADR listings. NDA was involved in the first cross-border stock swap merger out of India, that is, BFL's acquisition of MphasiS, and was also involved in Silverline's acquisition of Seranova.

The firm is intensely research oriented and has undertaken studies in different areas of law and tax, some of which can be found on its website. The firm did an extensive research study for Global Information Infrastructure Commission (GIIC) on legal and tax issues relating to e-commerce. NDA was also involved in preparing a study for the European Commission on the Market Access Barriers in the Telecommunications Sector in India. The firm assisted the State Government of Andhra Pradesh in drafting the Andhra Pradesh Infrastructure Development Enabling Act (APIDEA). The firm also prepared a comprehensive report on the comparative business and legal practices in Hollywood and Bollywood, which is available on its website.

The presenter would like to acknowledge the contribution of Ms. Bijal Shah.

IMPACT OF TRANSFER PRICING REGULATIONS ON E-COMMERCE

-This paper must be read in conjunction with the Responsibility Statement.

CONTENTS

I. INTRODUCTION

With the advent of the new millennium, global trade has reached its zenith, and its role in the ever-increasing global economy is unparalleled. Fuelled by the significant developments in the field of telecommunications and the huge advances made in the field of information technology, the regional economies have transformed themselves and formed a part of the enlarging global economy, and have brought the world one step closer to the concept of '*One World-One Economy*'.

In less than a decade, the global information infrastructure has transformed the world, and the Internet has evolved as a fundamental medium in this regard. It has become a vehicle of the growing global digital economy, and has played an integral part in the growth and development of this kind of a booming economy.

Such a transformation of the world economy has given rise to a host of taxation issues, the concept of '*Transfer Pricing*' being one of the more important ones. However, with the emergence and growth of electronic commerce, the questions of transfer pricing have become more and more important and have raised certain difficulties relating to tax.

The ascertainment of the appropriate allocation and apportionment of income and expenses (for example, arising from the cross-border trading of financial products) is a matter of properly applying existing transfer pricing rules[1] and is a question of prime importance.

In this paper, we propose to examine the application of the transfer pricing principles to electronic commerce transactions and evaluate the application of the same.

II. BASIC CONCEPTS

A) E-Commerce

[1] Position paper on the taxation of electronic commerce- EU committee

As the world slowly progresses into the 21st century, the days of the telephone and telex have long been substituted by the 'World Wide Web' or as is commonly known the 'Internet'. As the name itself implies, the whole world has become a much smaller place and people are now at the 'click' of a button able to access information from any part of the world. As the Internet reaches new pinnacles of recognition, a new concept of 'trade and commerce' has also evolved.

Any person sitting at any remote area of the world can visit a particular site; click on a certain object, which he/she would desire to purchase and get it delivered to his/ her residence, even without having to shake a limb. This absolutely new concept of trade on the 'NET' has commonly been called 'Electronic Commerce' or 'E-Commerce'.

In order to explore and analyze the various aspects of taxation with regard to e-commerce, it is necessary for one to first understand the actual definition of E-Commerce.

Some of the definitions of e-commerce bring within its ambit all financial and commercial transactions that take place electronically, including electronic data interchange, electronic fund transfers and all credit/debit card activity; whereas, others limit e-commerce to retail sales to consumers for which the transaction and payment take place on open networks like the Internet[2].

Generally speaking, electronic commerce is defined as: *"the conduct of commerce in goods and services, with the assistance of telecommunications and telecommunication based tools."*[3]

The Organisation for Economic Cooperation and Development ("**OECD**") and the Government of Canada jointly organized a Ministerial Conference on Electronic Commerce in Ottawa from 7th to 9th October 1998 where the heads of major international organizations, industry leaders and representatives of consumer, labour and social interests came together to clarify respective roles, discuss priorities and develop plans to promote the development of global electronic commerce[4].

The OECD has defined e-commerce to be *'commercial transactions involving both organizations and individuals, that are based upon the processing and transmission*

[2] Defining and Measuring Electronic Commerce: OECD Workshop on 21st April 1999 http://www1.oecd.org/dsti/sti/ec/act/agenda_ECworkshop.htm (on 10/17/2001)

[3] Electronic Commerce Definitions, Roger Clarke: http:// www.ecominfocenter.com

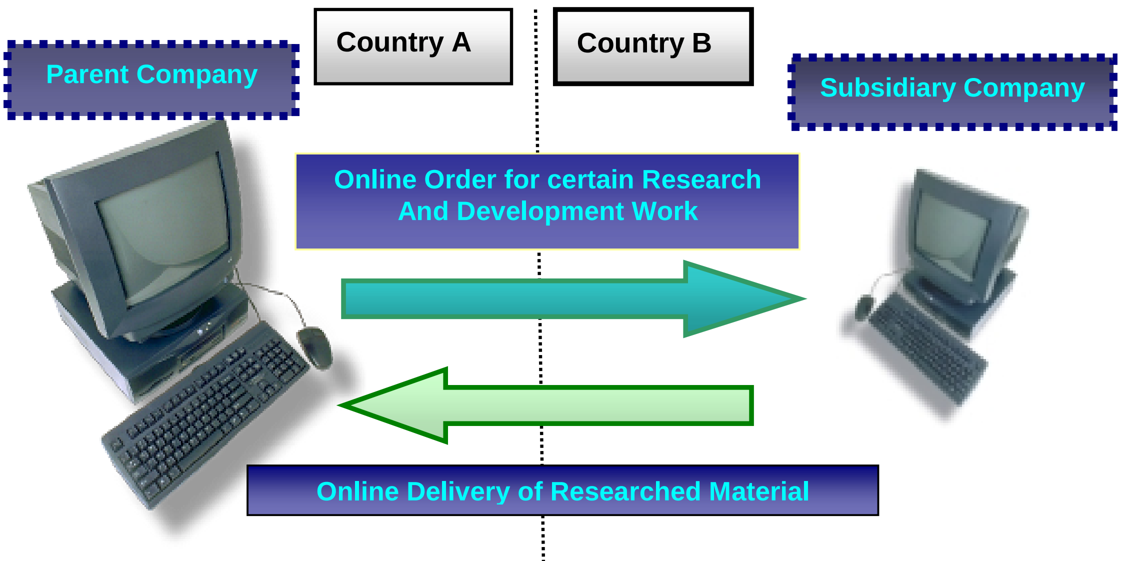
[4] http://www1.oecd.org/dsti/sti/it/ec/act/paris-ec_back.htm

of digitalized data, including text, sound and visual images that are carried out over open networks (like the Internet) or closed networks (like AOL or Minitel) that have a gateway onto an open network'. These include electronically marketed products from business-to-consumer, which are 'intangibles such as travel and ticketing services, software, entertainment, banking, insurance and brokerage services, information services, legal services, real estate services, and increasingly health care, education and government services[5].

The significant point to be noted is that according to the above-mentioned definition, e-commerce would include transactions involving delivery and payment in the traditional manner if offer and acceptance of the offer is through a 'network'.

It is pertinent to note here that; the High-Powered Committee on Taxation of Electronic Commerce in India did not find it necessary to introduce a definition of electronic commerce in the Indian tax laws.

A typical e-commerce transaction is depicted diagrammatically hereinbelow for the sake of clarity:



The Parent Company situated in Country A, sends out an order to its subsidiary company in Country B through an email. The Subsidiary Company researches on that order and sends the research and development analysis via email back to the

[5] The definition of e-commerce according to the OECD as provided in the Report of the High Powered Committee on "E-Commerce and Taxation" in India dated July 2001

Parent Company. This transaction is a typical e-commerce transaction where business transactions are concluded via the Net.

A potential taxation issue that could arise in such transactions on the transfer pricing front is that the subsidiary may undercharge the Parent company for the services that it renders due to the special relationship that it shares with the Parent company. However, the tax authorities would not favorably view such undercharging as it would result in the erosion of a tax base from the country of the subsidiary. There would be a transfer pricing issue involved in such a transaction, as the tax authorities would desire that the transfer price be at an arms length price, *i.e.* at a price which the subsidiary would have charged a company had it been offering its services to an unrelated independent company. We now go on to examine the concept of transfer pricing.

B) Transfer Pricing

After having discussed the evolving concept of 'e- commerce', it is very important for us to understand the several aspects of taxation, which arise therefrom.

In the present era, a humongous portion of world trade consists of the transfer of goods, intangibles and services within multinational enterprises through the Internet. Hence, the determination of their tax liabilities, in each jurisdiction is a matter of concern and prime importance.

The necessity to put the right price (i.e. the *arm's length price*) on these transactions has been realized and appreciated, so as to avoid double taxation or no taxation and hinder the growth of world trade. However, the near instantaneous methods of transmission of data through the Internet and the effective removal of all physical and territorial boundaries have become a significant impediment in the path of Transfer Pricing.

Commercial transactions between different parts of a multinational group may not be subject to the same market forces. Transfer prices basically deal with payments from one part of a multinational enterprise for goods or services provided by another, it might diverge from market prices for reasons of marketing or financial policy, or to minimize tax.

To ensure that, the tax base of a multinational enterprise is divided fairly, it is important that transfers within a group should approximate those which, would be negotiated between independent firms, hence necessitating the importance of the transfer being at arm's length price[6].

Hence, transfer pricing refers to the determination, for tax purposes, of prices charged or paid upon the transfer of physical goods and intangible property or the supply of services between associated enterprises in different tax jurisdictions[7].

- *Transfer Pricing Provisions in India*

The Union Budget of India for the financial year 2001–2002 introduced comprehensive transfer pricing regulations to the Indian legal and tax paradigm. The Finance Act 2001 has replaced the earlier Section 92 of the Indian Income-tax Act, 1961 (the "**Act**") which addressed transfer pricing in a very restricted manner.

The current provisions have been moulded to a large extent by the OECD guidelines, which were first published in 1979 and the Union Nations' Guidance Report. These provisions came into effect on April 1, 2001.

The Central Board of Direct Taxes ("**CBDT**") have recently announced the rules that list the various methods of transfer pricing and also describe the selection and application of such methods to the transaction in question.

The provisions recently introduced, like their global predecessors, are principally concerned with ascertaining the jurisdiction in which taxes are payable rather than the possibility of tax evasion. The thrust of the provisions is on the definition of an associated enterprise in the context of an international transaction. The provisions do not apply to purely domestic transactions entered into between two residents. One of the pre-requisites for any transaction to fall within the scope of the provisions is that at least one of the parties to the transaction should be a non-resident.

In order to understand and appreciate the scope of the aforementioned provisions it is necessary for one to deal at length with the following terms:

i. *Arm's Length Price*

Transfer pricing provisions primarily require any income arising from an international transaction to be computed 'having regard to the *arm's length price*'. All expenses/ interest incurred, as part of the transaction would also be subject to arm's length

[6] Tax and Multi Nationals: http://www1.oecd.org/daf/fa/tr_price/transfer.htm#tp_guide

[7] Department of Finance Canada: http://www.fin.gc.ca/news95/95-059_1e.html

pricing. The allocation or apportionment of any cost or expense incurred or any contribution made in connection with a benefit, service or facility provided by one enterprise to another would also be determined in a similar manner. Thus, cost sharing agreements or arrangements would also fall within the scope of the provisions.

The term '*arm's length price*' has been defined under Section 92F(ii) of the Act as, 'A *price, which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions*'.

As is apparent from the earlier definition, in order to understand the meaning of transfer pricing it is necessary for one to know what the meaning of 'enterprise' is. The term "enterprise" would include a permanent establishment of the enterprise[8]. Thus, transfer pricing provisions will apply to transactions between the head office and branch of the same entity. Therefore, the expenses and interest payable by / to a head office of an enterprise to / from its branch office would also fall within the purview of these provisions.

An area of concern, pertaining to cost sharing agreements or arrangements is that, till date there is no minimum threshold limit prescribed so far, for such agreements / arrangements. Further, there has also been no threshold limit specified for the value of the international transaction entered into, which would result in relatively insignificant transactions in terms of monetary value, falling within the purview of transfer pricing norms in India.

It is pertinent to mention here that, where the aggregate value of an international transaction does not exceed INR 100,00,000 (Rupees Ten Million), it is provided that, the transfer pricing norms concerning the maintenance of records and documents of such a transaction would not have to be complied with. However, the parties to the transaction must possess adequate documentation to demonstrate that *arm's length price* has, in fact, been applied.

[8] Section 92F(iii) of the Act

ii. Associated Enterprise[9]

The definition of an 'associated enterprise' consists of two parts; the first part deals with the concept of an associated enterprise *per se,* whereas, the second part exhaustively lists down the circumstances in which two enterprises are *deemed* to be associated enterprises.

This definition contemplates a situation where, there is either a common person / groups of persons controlling the enterprise under scrutiny and the other enterprise with which it has transacted, or where one enterprise itself controls another enterprise with which it has transacted business. The concept of control in terms of the capital and management has been elaborated upon in the deeming provisions. These provisions envisage thirteen situations in which two enterprises are deemed to be associated for the purpose of transfer pricing, which principally relate to percentage of equity ownership or common equity holding in excess of the prescribed limits, the grant or guarantee of loans or borrowings by one enterprise for another enterprise in excess of the prescribed limits, business interdependence, and so on. These deeming provisions are unique to India, since existing transfer-pricing norms in other jurisdictions do not enumerate such detailed and explicit criteria.

This clause under the transfer pricing provisions spawns problems of unpredictability of the application of these provisions by the tax authorities.

iii. Methods of Transfer Pricing

Under the Act, *arm's length price* in relation to an international transaction between two or more associated enterprises may be determined by any one of the following methods:

(a) comparable uncontrolled price method;
(b) resale price method;
(c) cost plus method;

[9] As per section 92C of the Act, an associated enterprise means:

(a) an enterprise which participates – directly or indirectly – or through one or more intermediaries, in the management or control or capital of another enterprise; or

(b) an enterprise in respect of which one or more persons who participate – directly or indirectly – or through one or more intermediaries in the management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management, capital or control of the other enterprise.

(d) profit split method;
(e) transactional net margin method; or
(f) such other method as may be prescribed by the CBDT.

The taxpayer has an option to select the most appropriate method, which is applicable to his transaction. The rules for transfer pricing, announced by the CBDT, elaborate upon the manner in which such method is to be applied and consequently, how the appropriate price is to be arrived at. Under the OECD model, the first three methods are popularly understood to be transaction-based methods, whereas the methods mentioned in items (d) and (e) hereinabove fall under the category of transactional profit methods. The aforementioned rules of the CBDT favor the former category of methods, which is in accordance with the prioritization of methods under the OECD guidelines. However, where more than one price may be determined by the most appropriate method, the *arm's length price* is to be taken to be the arithmetic mean of such prices. This provision is peculiar to Indian legislation and has been the cause of much public outcry. The Indian tax regime has so far not provided for an advance pricing mechanism under the provisions, which would enable a party involved in an international transaction to ascertain whether or not his method of pricing would be acceptable to Indian tax authorities, and thereby minimize the risk of litigation in the future.

It is evident from a general analysis that, the "*most appropriate method*" under Indian transfer pricing provisions is rather similar to the "*best method rule*" under the US transfer pricing law. Further, it is also clear that the accuracy of an arm's length price is largely dependent on the availability of comparables.

The transfer pricing regime in India appears to cast the onus of proof on the tax officer. However, if the tax officer can *prima facie* show – that, the transfer pricing policy of a taxpayer is inconsistent with the arm's length principle, the burden of proof of delineating the correctness of the transfer pricing policy would shift to the taxpayer. Hence, the burden of proof on transfer pricing is proposed to be shared between the taxpayer and the income tax authorities.

The penalties for evasion of tax may range from 100 per cent to 300 per cent of the tax which was sought to be evaded. Furthermore, interest may also be levied for non-payment of advance tax on the adjusted profit - currently the rate, according to the Act is fixed at 15 per cent per annum.

Documentation for establishing arm's length price broadly consists of information about associated enterprises themselves; information derived from independent enterprises engaged in similar business and other such factors, which would have a bearing on the price.

Transfer pricing provisions in India are at a nascent stage at the moment, but would benefit greatly from relying on and learning from international experience in this regard.

III. EVOLUTION OF THE IMPACT OF TRANSFER PRICING ON E-COMMERCE

The impact of electronic commerce on transfer pricing received attention at the OECD Ottawa Conference on electronic commerce in 1998. Till date, electronic commerce has presented neither fundamentally new nor categorically different problems for transfer pricing[10]. However, it has the potential to make some of the more difficult transfer pricing problems more common. In addition, as a result of the nearly instantaneous transmission of information and the effect of the removal of physical boundaries, it may become significantly more difficult for tax administrations to identify, trace, quantify and verify cross-border transactions.

Specifically electronic commerce and the development of internal private networks within multinational groups may be seen as putting significant pressure on the traditional approach taken to deal with non-arm's length transfer pricing, even though the basic nature of the problem has not changed[11].

The difficulty lies in the application of internationally accepted methods to the special factual circumstances created by electronic commerce activities. These are, in particular, the increased possibility for specialisation, integration of common functions, and co-operation between different locations and legal entities within a multinational group.

IV. POTENTIAL DIFFICULTIES

[10] The Discussion document prepared by the Fiscal Affairs Committee (Electronic Commerce: A Discussion Paper on Taxation Issues (OECD 17 September 1998)).

[11] Paper by Jonathan S. Schwarz entitled "Transfer Pricing and Electronic Commerce"

The task of locating appropriate comparable transactions is perceived to be the most difficult transfer pricing challenge arising from new market transactions. This arises from the nature of the business models being adopted in the new economy. In general, the evolution of business models towards greater integration of transactions among related entities, and greater specialization of functions all could make identification of comparables more difficult.

For instance, a multinational enterprise may be established in different jurisdictions based on optimization of costs, regional headquarters, research and development facilities, administrative or back-office functions, customer support, manufacturing, local or regional sales and marketing, all of which network with each other, yet, ultimately are managed by a global corporate headquarters located in a third jurisdiction. These operations are tied together electronically through the global communications infrastructure, which allows the global enterprise to operate across borders efficiently and effectively in unique ways. This structure may contrast with more traditional organizations, which frequently concentrated the most important functions in a single jurisdiction, in order to facilitate management of all aspects of the enterprise. As decentralization of organizations takes place, the provincial locations may not necessarily support or report solely to the corporate headquarters in the home jurisdiction.

To the extent that a global enterprise distributes more functions across more jurisdictions than has been typical in the past, the mere multiplicity of locations has created related party transactions, which are being tested. The dramatic increase in the number of jurisdictions adopting transfer pricing documentation requirements, the compliance burdens on multinational enterprises can become quite substantial. It could be said without further thought that, the differences in national transfer pricing law in this new economy environment, would go on to provide another ground to raise controversies!

Very often, diffusion of activities is accompanied by an increase in focus and specialization performed by particular entities. For example, an entity performing manufacturing support for a region may perform only that function, while an R&D facility may be engaged solely in R&D without the need to support that activity with sales and marketing activities. Jurisdictions, which accept transfer pricing methods based on profit-based measures, would encounter that the task of identifying comparable entities performing such functions is by no means child play. Where services are transferred between the specialized entities via the internet/intranet there are possible transfer pricing issues that are involved.

A further difficulty that arises in identifying comparable transactions or comparable entities is when the electronic commerce entity is engaging in business activities that do not have an accurate economic parallel in traditional commerce. For example[12], two types of enterprises standing at the core of the electronic commerce infrastructure are the Internet Service Providers and Web Portal Companies. It may be relatively straightforward to identify comparable transactions for an Internet Service Provider, at least if the taxpayer is able to identify other transactions involving the provision of services utilizing sophisticated equipment which the provider must maintain. The business model of the web portal company, however, is completely novel, and valuing the various economic inputs to that business will provide transfer pricing challenges.

A) Difficulties identified by the OECD in the allocation of profits area

In the paper entitled "*A Discussion Paper on Taxation Issues (OECD 17 September 1998))*", the OECD identified five of the most significant potential difficulties in the mater of transfer pricing in e-commerce as:

i. applying the transactional approach;
ii. establishing comparability and carrying out a functional analysis;
iii. applying traditional transaction methods;
iv. the tax treatment of integrated businesses;
v. determining and complying with appropriate documentation and information reporting requirements.

Since, the concept of transfer pricing has evolved in most economies just recently, the experience amongst tax administrations in dealing with transfer pricing matters in the field of electronic commerce is fairly limited so far. The OECD has noted that it may be difficult for tax administrations to perform a detailed examination of the factual background at such an early stage in the development of the business of electronic commerce.

OECD Committee on Fiscal Affairs preliminary concluded that the existing guidance in the transfer pricing guidelines[13] is capable of being applied to the special factual circumstances of multinational groups conducting their business through electronic commerce. As a result, traditional transaction methods are still to be preferred as a means of establishing arm's length prices. However, the OECD accepts that where such methods cannot be applied reliably because there is insufficient data on

[12] Cahiers – International Fiscal Association, 2001 San Francisco Congress

[13] OECD: Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

uncontrolled transactions, or such data is considered unreliable, or because of the nature of the business situation, transactional profit methods could be used.

B) Intangible properties

The use of intangible properties in electronic commerce businesses could set hurdles in the process of identifying appropriate comparables especially in the case of transfer between related enterprises. The distinctions between product and marketable intangibles can get blurred in electronic commerce businesses, and comparables derived from traditional transactions thus are more difficult to apply. In some cases, enterprises may regard their intangible value as deriving from entirely different circumstances than those underlying traditional enterprises. The so-called "*first mover advantage*" which direct providers of goods and services to consumers, seek to establish by staking out their *forte* in the electronic commerce marketplace does not have an exact counterpart in traditional commerce. Goodwill perhaps is the closest parallel.

C) Applying the transactional approach

The OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrators ("**OECD Guidelines**") make it clear that adjustments of profits are by reference to conditions, which would have been obtained between independent enterprises in comparable transactions and comparable circumstances[14]. There can be no adjustment in the absence of a transaction. The main difficulty in the context of electronic commerce that appears to challenge the transactional approach is in identifying precisely what the transaction is.

The OECD Guidelines indicate that, ideally in order to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis[15]. However, it is noted in the OECD Guidelines that, at times separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. The OECD Guidelines suggest that some transactions need to be evaluated together as a package[16].

At this point of time, it would be of great help to look at how the United Kingdom has addressed this question of defining a "transaction" in its new transfer pricing

---

[14] Chapter 1 para. 1.6.

[15] Chapter 1 para. 1.42

[16] Chapter 1 para. 1.43

legislation. ICTA[17] 1988 Schedule 28AA Paragraph 1 requires that, a provision be made or imposed between affected persons by means of "a transaction or a series of transactions". The meaning of a series of transactions is expanded in Paragraph 3(2) of the aforesaid. This includes a number of transactions each entered into, whether or not one after the other in pursuance of or in relation to the same arrangement[18].

D) Difficulty in applying transaction based methods

It is sometimes argued that, electronic commerce does not lend itself to the application of traditional transaction methods. These are the comparable uncontrolled price method, the resale price method and the cost-plus method. Each of these methods must be examined having regard to its potential applicability to the industry sectors that are relevant to electronic commerce. Important questions as to the number of stages in the value chain involving connected parties need to be considered. This may be shortened in the context of electronic commerce.

One of the most interesting and common areas where the impacts of e-commerce on transfer pricing can be felt is, in the working of the multi national groups. Closer integration of the management of multinational groups and the sharing of services is likely to be enabled by information and communication technology developments, particularly of intranets.

One consequence of electronic commerce is in relation to business relocation. The Internet may offer certain businesses' opportunities to relocate non-physical activities to different jurisdictions, particularly resulting in shifting profits out of high tax jurisdictions to low tax or no tax jurisdictions. Another aspect of this, which, is perhaps more important, is the ability to shift physical activities to low cost jurisdictions. The ability to provide services at a place other than where the recipient is located is becoming of increasing importance. Thus, a variety of services can be provided to multinational companies from remote locations. The range of possibilities will increase, both where human intervention is required and those that are provided electronically, such as help pages on the Internet or Intranets. These might include administrative services such as planning, co-ordination, financial advice, accounting, auditing, legal, factoring, computer and financial services. Typically, such services are dealt with under cost-plus arrangements or under cost-sharing arrangements.

[17] Income and Corporation Taxes Act, 1988

[18] Paragraph 3(5)) of ICTA 1988 Schedule 28AA defines an arrangement is defined as any scheme or arrangement of any kind (whether or not it is or is intended to be legally enforceable)

Where cost-plus is appropriate for services of this kind and the activities are shifted to low cost jurisdictions, the profit allocation will be reduced proportionally.

The OECD Report on the Economic and Social Impact of Electronic Commerce[19] expects that, distribution costs will be cut by about 5 per cent. However, it notes that these savings will only lead to lower consumer prices if there is fiercer competition. This may mean a shift towards an increase in value of intangibles such as customer lists, which may be owned and developed relatively easily in low tax jurisdictions.

If the cost savings are passed on to end-users in some form, then the overall allocation of profits may not change. Where the profitability is retained, this may mean that profits are effectively allocated to other functions. In other words, efficiency gains may properly be allocated to intangibles or other value adding functions.

Some of the difficulties in applying transaction based methods to individual transactions may be alleviated by applying the existing guidance on evaluating combined rather than separate transactions. Further, in order to be able to identify, trace, quantify and verify transactions undertaken in the course of electronic commerce, it will still be necessary to follow the existing guidance concerning appropriate documentation.

E) Transactional profit methods

Many tax jurists world-wide are of the view that the use of profit-based transfer pricing methods may become more prevalent in the context of associated entities engaged in an electronic commerce business. In many jurisdictions, the profit-based methods are methods of last resort. Accordingly, methods such as the comparable uncontrolled price method, the resale price method and the cost-plus method would be preferred to methods such as, the transactional net margin method, or the profit-split method. For example, Japanese law allows the use of the profit-split method as a method of last resort when none of the comparable uncontrolled price, resale price or cost-plus methods is available.

The OECD Guidelines suggest that, transactional profit methods might be applied as a case of last resort where the traditional transaction methods cannot be reliably applied *alone* or cannot be applied at all. The guidelines state that, these cases arise only where there is insufficient data on uncontrolled transactions, or where the data

[19] http://www1.oecd.org/subject/e_commerce/summary.htm

exist but is considered unreliable, or due to the nature of the business situation. Tax administrations almost uniformly prefer comparables drawn from transactions involving local entities. If a global electronic commerce enterprise has established a business unit in the jurisdiction, which performs functions for which there are few (if any) publicly available comparables, taxpayers and tax administrators will have difficulty applying their traditional transaction methods. The OECD Guidelines recognize that, both the profit split method and the transactional net margin method, are somewhat more forgiving and flexible when unusual circumstances exist. Even though various members of the electronic commerce enterprise may make contributions of differing types (for example, services, R&D, manufacturing, and the like), the allocation should be based upon external market data and some economic assessment of the relative values of the contributions[21]. Given the need to assess market data even for profit-based transactions, therefore, it should not automatically be assumed that profit-based methods are to be applied whenever the application of traditional transaction based methods becomes difficult.

New economy enterprises will present situations to taxpayers and tax administrators where the application of any method would be difficult. While this particular market glitch may be sorted out over the next few years, the profit model of many emerging enterprises remains unclear. A profit-based method does not provide obvious conceptual advantages over a transaction-based method when, the profit forecasts of an enterprise are unreliable. The new economy includes various emerging enterprises or even entire market sectors; it is not clear what transactions truly are comparable to those engaged in by these emerging companies. Traditional companies investing in electronic commerce business models are substantially increasing their investments in technology to create business process efficiencies. It is debatable whether, this capital investment should be regarded as giving rise to the same returns as traditional investment in productive equipment or other assets.

Hence, what may result is that, the new economy itself may produce its own comparables. For example, the increase in outsourcing will produce third party hosting transactions of various sorts. Perhaps, presently we are in a transition period where the dearth of comparables will be remedied as the new business models become more established.

F) Global formulatory apportionment method

None of these issues, however, suggests that global formulary apportionment will provide a better answer. Even a multinational, functional analysis can assess the

[21] OECD Guidelines

activities performed and value-added by the business units in each location. The difficulties in achieving international consensus for global formulary apportionment would be no less in the electronic commerce environment than for traditional industries. It is not conceivable that, global formulary apportionment could be applied as the agreed transfer pricing methodology solely for the electronic commerce sector. A separation of the economy into electronic commerce and non-electronic commerce functions for purposes of applying different transfer pricing principles simply is not possible.

G) Comparability analysis

The arm's length principle is essentially based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the economically relevant characteristics of these situations must be sufficiently comparable in determining the degree of comparability. An understanding of how unrelated companies would evaluate the potential transaction is required. This may give rise to particular issues as more and more businesses migrate from traditional to electronic commerce.

i. Character of property/services

There would be obvious differences in property/services that form commercial activities in part for their value in the open market. Comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. Electronic commerce would definitely have a great impact on this. One of the most glaring being that of dematerialization[22].

Would it be possible to compare transactions involving the physical delivery of a CD or cassette with music recorded on it, which is enclosed in a plastic package with an attractive cover and delivery of the same music by downloading it from a website onto the acquirer's computer?

The conversion of tangible property to intangible property does give rise to a number of changes. Sturdiness is one factor. A CD may be used many times. Digitised products are subject to management by the supplier, for example in relation to duration. It is possible to supply music on demand for a single use. On the other hand, the ease with which digitised products may be copied, whether legally or not, may affect their value.

[22] Dematerialisation is the adaptation of information technology to convert products that were previously supplied in physical form into digital form. Current examples include music, films and packaged software.

ii. Functional analysis

In dealings between two independent enterprises, compensation will usually reflect the functions that each enterprise performs, taking into account assets used and risks performed. As a result, in determining whether controlled and uncontrolled transactions are comparable, a comparison of the functions taken on by the parties is necessary. The functions that need to be identified will include concept design, research and development, manufacturing, assembling, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. One party may provide a large number of functions relative to that of another in the transaction. It is the economic significance, however, of these functions in terms of their frequency, nature and value to the respective parties that is important.

Functional analysis in the context of electronic commerce requires a close understanding of particular business functions. The impact of electronic commerce in this area will be very much dependent as a result on the use to which electronic commerce is put. Thus, in the context of those using the internet to deliver content, the manner in which intangibles are delivered, whether they are subject to copyright or not, whether it is used only for advertising or for actual trading, whether it is used to provide services or to manage group facilities will be relevant.

iii. Disintermediation

An important emerging issue in the context of electronic commerce is disintermediation. This is the removal of intermediaries from a system of distributing goods or services, which traditionally relies on them for collecting information and reporting. The ability of original producers of goods or services to provide them directly to customers may diminish the role of wholesalers, brokers, agents and advisors from the system. The absence of such value added activities in the chain might result in less profit overall. Where it does not, it means that a higher value will be added to other functions.

A question that will be on the minds of taxpayers and tax authorities is where this value is added. A question that would cross the mind is that since electronic distribution diminishes certain forms of intermediary, will the value of the distribution function itself ought to be downgraded?

iv. *Infrastructure providers*

In the case of infrastructure providers, there may be considerable investment in tangible and intangible assets. If expensive infrastructure is relevant to the allocation of income on transactions, the extent to which there is flexibility as to where the assets are located will have a significant impact. On the other hand, rapid obsolescence and comparative vulnerability of intellectual property rights on the Internet may require a lower value to be placed on such assets.

It may also be relevant and helpful to consider risks assumed by the respective parties[23]. Assumption of increased risk should be compensated by an increase in the expected return. A question that would arise is that, are the risks in electronic commerce significantly different from those in the more traditional commerce? While traditional risks, such as market risks, cost and sales fluctuation, may continue; there may be particular risks associated with electronic commerce at the present time, which we have not been able to identify, due to the fact that this form of commerce is in the process of development. An example of such a risk could perhaps be that of viruses infecting a particular computer system. The OECD Guidelines, however, regard the conduct of the parties as the best evidence concerning true allocation of risk. In many cases, arm's length dealings are characterised by risk borne by the party, which has relatively more control over the particular risk factors.

v. Contractual terms

In arm's length dealings, the contractual terms of a transaction should define how the responsibilities, risks and benefits are divided between the parties[24]. This will continue to be the case in the context of electronic commerce, although evidence as to what the terms of a contract are, might be difficult to ascertain.. In addition, where the parties are associated, it is necessary to examine their conduct in order to determine whether they have followed the contractual terms or not. Lack of identification may be a relevant feature of electronic commerce. Since, Internet business leaves behind no paper trail, there arises a potent difficulty of identifying transactions and even the parties.

H) Integrated Businesses

The OECD has identified that electronic commerce may require special tax treatment because of the highly integrated nature of the activities. Difficulties in dealing with highly integrated businesses have already been considered by the OECD in their discussion paper on `The Global Trading of Financial Instruments' published in 1997. In that context, it was noted that trading, marketing, management and major

[23] OECD Guidelines, Chapter 1 para. 1.26

[24] OECD Guidelines, Chapter 1 para. 1.28

supporting activities should share profits to the extent that they are regarded as integral to the realisation of profits. Difficulties arise as to when an activity becomes so integral that, it should be rewarded by a share of global profits under a profit split method, rather than by a traditional method.

I) Attribution of profits to a permanent establishment

Another emerging transfer pricing issue that affects all companies which benefit from communications, distribution or other business efficiencies created by electronic commerce relates to, the allocation of profits arising from reduction in costs. The dot com e-tailers may be the biggest participants in the new economy, but the most significant investment in new economy business models will be made by multinational companies seeking to improve their business processes. By and large, no multinational company will invest in electronic commerce business systems such as automated sales systems, human resources systems or other business process systems unless the enterprise expected a significant return on that investment. The return on investment will be reflected as a decrease in costs. A cost decrease would translate into a corresponding increase in taxable profit. The profit that remains with the enterprise, must be allocated to some segment of the enterprise as a matter of income allocation, and practices will need to be developed to address that allocation.

In February 2001, the OECD released a discussion paper addressing the issue of how income, expenses or profit may be allocable to a permanent establishment[25].

It seems to be an international consensus that, income allocation methodologies could perhaps be applied under current law to electronic commerce transactions. The OECD would be like a pioneer in developing principles that would perhaps be followed by most countries in the world. In the context of transactions between related entities, of course, the internationally prevailing standard is that of arm's length dealing. The traditional transaction-based methods, broadly speaking, are accepted in most jurisdictions. Unfortunately, there is considerably less international consensus on the rules concerning allocation of income within a single legal entity to a permanent establishment in another jurisdiction. It can be anticipated that an application of the existing domestic law principles would give disastrous results.

In India, it seems to be the general consensus amongst eminent jurists that, the existing principles for allocating income of various units of a globally integrated business could perhaps be applied to electronic commerce. As per domestic Indian

[25] Discussion draft on the attribution of profits to PEs, issued in February 2001 by the Committee on Fiscal Affairs

law, only income attributable to operations carried on in India can be taxed in India. The Indian law provides a choice of allocation methods to be applied at the discretion of the income tax officer. If the officer disagrees with the accounts maintained by the taxpayer, the tax officer may adopt any of the following three allocation methods:

- a percentage to the turnover;
- a global profit split (including allocating global profits to India based on relative turnover realized in India); or
- any other manner that the tax officer considers suitable.

It may be interesting to note that, Russian law includes a provision similar to Indian law where the attribution may be performed based on other objective parameters, for instance a reasonable portion of global revenues.

In Chinese Taipei, there are no established rules or practices regarding the attribution or allocation of income derived from traditional means, leave aside income derived from electronic commerce.

Other issues arise in some jurisdictions, which impose limits on deductible payments. For example, in Brazil, a Brazilian corporate payer may be subject to deductibility limitations on the amount of royalties, technical services and technical or administrative assistance service fees paid abroad. Brazilian transfer pricing rules provide that taxable income may be imputed and deductible expenses disregarded in case they exceed preset limits.

As can be seen by the scarcity of existing applications of income allocation rules or transfer pricing principles to electronic commerce transactions, there is much unexplored terrain lying ahead of taxpayers and tax administrators.

J) *Documentation*

The subject of documentation, is itself problematic even in the traditional areas of commerce, leave aside e-commerce. There are many unresolved issues. In the context of electronic commerce, the nature of documentation and test of relevance will take on a new perspective. The recommendation of the Committee on Fiscal Affairs is that revenue authorities should monitor developments in electronic commerce to see whether additional guidance on the application of the guidelines is necessary. They raise specifically, the question whether existing guidance on documentation requirements, need to be revised for businesses engaged in electronic commerce in order to ensure the necessary availability of verifiable information on transactional data.

The manner in which, such systems are designed and operated are likely to come under scrutiny. The necessity of producing software programs and material relating to their development as a central part of relevant documentation may demand greater importance. As the tax authorities develop their own technology to interrogate computer systems directly, the battle lines and parameters are likely to be drawn quite differently from those who view documentation in a more traditional framework.

V. EHICAL ISSUES

The maze of transfer pricing is a classic empire of smoke and mirrors. It is obvious that there is 'no right answer'. In the context of a specific situation, ethical issues arise easily and professionals (internal and external to a multinational taxpayer) play a significant role. For instance the association governing a professional (say of an accountant or an attorney) would prescribe as an obligation for that professional to zealously represent the interests of its client. Very often, the professional defending the position of the taxpayer would take inconsistent interpretations of the same economics and legal agreements. In context to transfer pricing, professionals require to give appropriate presentation of financial results of one or more controlled parties of multinational transactions.

Thus as can be seen a number of ethical considerations arise in the context of transfer pricing cases which would more so be widened in the e-commerce environment.

VI. LANDMARK CASES

Comparatively[26] speaking, the United States has a large volume of case law in the transfer pricing arena. Perhaps the two most important of the recent cases involve *DHL Corporation, DHL Corporation and Subsidiaries v. Commissioner*[27]*, and Compaq Computer, Compaq Computer Corporation v. Commissioner*[28].

[26] This section has been written from an article entitled "Transfer Pricing in the United States: Recent Events and Expectations for the Future" written by Dr. Deloris R. Wright
[27] T.C. Memo. 1998-461, December 30, 1998
[28] Dec, 53,443 (M), 78 T.C.M, 20: T.C. Memo, 1999-220.

These two cases are discussed here partly because they are among the most recent cases and partly because of their importance to ongoing transfer pricing planning and audit defense. Since transfer pricing is very fact-intensive, these transfer-pricing cases do not generally establish precedents, but they nevertheless provide some valuable guidance. DHL establishes that the Tax Court will impose transfer-pricing penalties in situations where the Court deems it appropriate. DHL is also a case study in managing both IRS audits and outside experts. Compaq, where the taxpayer won, substantially eases the requirements for a valid comparable uncontrolled price.

A) Compaq

The Tax Court seems to have a strong preference for transaction-based approaches to transfer pricing determination (as opposed to profit-based approaches). This preference was demonstrated, once again, in a case involving Compaq Computer. Although this case was decided under the 1968 regulations[29], it is interesting to note that the court used the language from the 1994 regulations in its application of the comparable uncontrolled price (CUP) method.

In *Compaq,* the U.S. parent contracted with a subsidiary in Singapore (Compaq-Singapore) whereby Compaq-Singapore produced and sold printed circuit boards to the U.S. parent. At the trial, Compaq presented a CUP involving contract manufacture relationships within the United States between Compaq and unrelated companies. Three significant differences existed between the intercompany transactions involving Compaq-Singapore and the CUP transactions. First, the products were not identical. Second, there were important functional differences involving the purchase/consignment of raw material and, third, there were geographic market differences.

The 1968 regulations require that, for a transaction to qualify as a CUP, the products must be identical, or nearly identical, to the products involved in the intercompany transaction. Ordinarily, it has been assumed that these adjustments must be few in number and result in only minor adjustments to the price. The 1994 regulations, in contrast require only that products be only “substantially similar” to qualify as CUPs. In *Compaq,* the Tax Court used the “substantially similar” language to evaluate Compaq’s CUP, even though the years at the issue involved pre-1994 years. This factor is widely interpreted to mean that the Court prefers to use a CUP, even if it requires significant adjustments to do so.

[29] I.R.C. Code 482 issued in 1968

In *Compaq,* the products were not identical. While both the intercompany and the CUP transactions involved printed circuit boards, the boards were of different sizes, contained different components and were used in different end-products. Compaq made adjustments for these differences, and the Tax Court accepted the adjustments without modification.

The second issue, the functional differences, is even more significant. Compaq consigned the key raw materials (boards and components) to the unrelated parties, while Compaq-Singapore purchased raw materials used in it. Compaq made adjustments to the third party transactions for this functional difference and as would be expected, the adjustments were quite large. The Tax Court accepted these adjustments.

The geographic market difference was the third issue of importance in Compaq. The unrelated contract manufactures provided their manufacturing services in the United States, while Compaq-Singapore operated in much lower cost environment in Singapore. The Tax Court did not make any adjustments for difference, which means that, in effect, the labor savings inherent in the Singapore location benefited Compaq-Singapore. Before the Compaq decision, most economist would have argued that, in arm's length relationships between unrelated parties, Compaq (the U.S. parent) would have negotiated in such a way as to obtain those labor savings for itself.

In short, before the Compaq decision, most transfer pricing experts would have said that the differences between the related and third-party transactions in Compaq were too great to allow the application of the CUP method. The Tax Court, however, saw no problems with Compaq's application of the CUP method and allowed its use without further adjustment. This is extremely goods news for multi-national companies. The CUP method is now significantly easier to apply than had previously been thought. It is worthwhile for companies to search their third party relationships for CUPs that in the past, would have been acceptable. In addition, geographic market differences and significantly different cost bases should no be major concerns an they present a significant planning opportunity to multinationals.

The message to multinationals operating in the United States is that the transaction based methods are alive and well, although it is probably wise to use a comparable profits methods, or some other profit based method, as a 'sanity check' on the results produced by the transaction based methods[30]. Further, it is important for a

[30] It is generally believed that sanity checks on CUPs are unnecessary, but sanity checks on other transaction based methods (resale price and cost plus) are wise.

multinational to have a consistent worldwide approach to transfer pricing determination and documentation. With the US tax court indicating a preference for transaction based methods, it is relatively easy for a multinational to satisfy the requirements of virtually all the taxing jurisdictions in which it operates.

B) DHL

The US Tax Court handed down its opinion in DHL on December 30, 1998. This case is important for several reasons. First, it addresses the wisdom of the "scorched earth" approach to transfer pricing audits. Second, it demonstrates that the Tax Court is willing to support the transfer pricing penalty legislation. Third, it illustrates the importance of clear and well -written transfer pricing documentation and, fourth, it demonstrates the care that needs to be used in managing outside advisors who prepare transfer-pricing documentation. The facts are presented very briefly, and each of these issues is then discussed.[31]

DHL is a worldwide overnight package delivery company that was formed in the United States in 1969. In 1972, DHL formed a Hong Kong subsidiary, DHLI. Together with Middletown NV (MNV), a Netherlands Antilles company formed in 1979, DHLI managed the international operations, while DHL operated in the US market.[32] The international operations were conducted through DHLI, its affiliates and a series of independent agents that agreed to do business within the DHL network. By 1988, the DHL network was the third largest air courier company in the world and, by 1992, DHL operated in nearly 195 countries.

A central issue in DHL, was the ownership of the DHL trademark. The ownership of the US rights to the trademark was not at issue- both sides agreed that DHL (the US company) owned those rights. Because, DHL was, at the outset, solely a US company, it is clear that the non-US rights to the DHL trademark were initially US property. From this point, the documentation is unclear, at best. A 1974 memorandum of understanding appointed DHLI as a foreign pickup and delivery agent for DHL, and DHL licensed the use of the DHL name to DHLI for no compensation. The memorandum of understanding was amended on six occasions, but the arrangement never included a royalty for use of the DHL name. There appear to be no other arrangements that address the intangible ownership issue.

---

[31] For more information about this case, see Wright. Deloris R. et al., "the DHL Case: What lessons can be learned?", 6 International Transfer Pricing Journal 3 (May/June 1999).

[32] Another international affiliate, DHL Operations BV, a Netherlands company formed in 1979, participated in the business but is not mentioned in this article in order to simplify the exposition.

In the late 1970s, DHLI recognized the need to have a standard trademark or logo, and it commissioned and paid for the design of the first standardized DHL Logo, which was used by the worldwide network. In addition, beginning 1983, DHLI began process of registering the DHL name in countries outside the United States. The name was registered in the name of DHLI without reference to the fact that DHLI was a licensee of DHL. DHLI incurred the cost of trademark registration, protected the trademark against infringement outside the United States, and handled disputes with terminated agents related to trademark usage. Finally, DHLI bore the cost of advertising the DHL network outside the United States.

By the mid-1980s, DHL was experiencing serious cash problems, and it hired Bain and Company (Bain) to assist in returning the company to profitability. Bain recommended that DHL find a merging partner; therefore, from late 1986 through early 1988, DHL and DHLI, attempted unsuccessfully, to do that. In December 1988, a group of investors including Japan Air Lines company (JAL), Nissho Iwai Corp. (Nissho Iwai) and Deutshce Lufthansa Aktiengesellschaft (Lufthansa), began negotiating to buy a controlling interest in DHLI. On December 7, 1990, these foreign investors acquired a partial interest in DHLs international operations (DHLI and MNV). The foreign investors also obtained an option to purchase controlling interest in DHLs international operations. On August 18, 1992, they exercised their stock purchase option and became majority owners of DHLI and MNV. Pursuant to these purchases, the parties agreed on a price for the entire transaction.

During the due diligence activity that accompanied these transactions, concern was expressed that the IRS might seek to impute a royalty for DHLI’s use of the DHL trademark. At the same time, DHL’s continuing cash flow problems threatened the worldwide DHL network. For these reasons, the parties agreed that DHLI should purchase the DHL trademark as a vehicle for capitalizing DHL and to eliminate potential IRS audit exposure.

Several advisers valued the DHL name at the values ranging from USD 20 million to USD 200 million. Ultimately, a USD 20 million valuation was used, and the sale was consummated in 1992, one month after the foreign investors exercised their rights to purchase a controlling interest in DHLI. It is important to note that the total value of the transactions was not affected by the varying values for the trademark.

After the USD 20 million value was placed on the trademark, Bain was asked to prepare a valuation of the DHL trademark. Two days after being hired, Bain presented a draft letter stating that the value of the DHL trademark was USD 20 million. It appears that Bain confused both the date of valuation and whether it was to value the worldwide rights or just the US rights. DHLs legal advisers worked with Bain to clarify these matters, but the USD 20 million did not change.

DHL's tax years from 1990 to 1992 were audited in what appears to be a confrontational and acrimonious audit, involving both third party summonses DHLs refusal to extend the statute of limitations. In addition, the Tax Court noted that the pretrial and trial dialogue was equally contentious. During the audit, IRS argued that a royalty should have been paid to DHL for the international rights to the DHL name. The IRS also challenged the USD 20 million valuation of the trademark. The IRS auditor argued that the trademark's value was more than USD 600 million. At the trial, the IRS valuation fell to USD 300 million. DHL on the other hand argued that the USD 20 million value was an arm's length value because DHL did not own the international rights, in part DHLI had incurred the advertising costs outside the United States and had registered the name outside the United States.

The Tax Court's decision contained various references to the uncooperative and contentious behaviour of the parties. It seems reasonable to conclude that DHL's recalcitrance worked against the interests in the Court's holdings. On the issues of interest here, the Court held that DHL owned the worldwide rights to the DHL name, although the quality and value of those rights were lessened by the imprecision of the legal agreements and by DHLI's registration of name in various countries.

The Tax Court rejected both DHL's and the IRS determination of the value of the DHL name. The Court decided that the value of the worldwide rights was USD 150 million, which it reduced to USD 100 million because of imperfections in DHL's ownership of the non-U.S. rights. In addition, the Court imposed a transfer pricing penalty because DHL's documentation was prepared by a consultant (Bain) who was doing work for DHL and was therefore, not independent. The Court stated:

"…….. it was not reasonable for [DHL] to rely on (or more properly hide behind) the Bain appraisal or comfort letter. If the parties to the transaction had given the valuation to an independent valuation entity before any values being placed on the trademark by the parties and/or not advised the evaluator of a value, it might have been reasonable for petitioners to rely on such an appraisal. At this trail has again demonstrated, parties can find experts who will advance and support values that favor the position of the person or entity that hired them."

This case is important to multinationals for at least three reasons. First, the strategy for handling IRS audit has changed. Before the transfer pricing penalty legislation, a "scorched earth" approach to audits was fairly common. Briefly, this approach appeared to be non-cooperative, refusing to provide the information needed to properly evaluate the transfer pricing issues in the case. Now, the burden of explaining why a transfer pricing system is appropriate is the responsibility of the tax payer if the tax payer wants to avoid transfer pricing penalties. Today, the "scorched earth" policy is less effective than it was before the penalty legislation, and DHL clearly indicates that the Tax Court is willing to impose penalties when it deems them appropriate. The Court's comments about DHL's behaviour suggest that a cooperative approach to an IRS audit may be more productive than the approach taken by DHL.

Second, documentation is very important. DHL demonstrates the importance of clear and well reasoned inter-company legal agreements. Other documents, such as "memos to the file", should also be very clear to establish the ownership of intellectual property as well as the functions and risks of each legal entity in the multinational group. Had DHL's documentation been less confusing, the outcome of this case might have been quite different.

Third, it is important that the outside advisers to be independent. DHL selected Bain to prepare the valuation of the trademark, even though Bain was significant other work for DHL. The Tax Court had serious concerns about whether Bain was independent under these circumstances. In addition, the timing of Bain's engagement led the court to question the validity of Bain's opinion, i.e. Bain was asked to value the trademark only after the value had been determined. Many times, companies hire transfer pricing experts after the end of the year to prepare documentation for the preceding year. Obviously, the prices have been determined at that point, and the advisor can only support what was actually done.[33] The Court seemed to suggest that advisers should be hired before the prices are determined or should not be told what number to support so that their independence is protected.

VII. CASE STUDIES

A) Case Study 1: Accounting Software Supplier

<u>Facts:</u>

[33] This is too simple a statement in that such advisers may advise significant changes in the subsequent years to correct "errors" in the year in question. In addition, the advisor may support only a portion of what was done.

Clouds Inc. is a supplier of accounting software. The core software was developed by Clouds in Country A where it is incorporated and has its head office to develop its global marketing strategy including its valuable branding.

Clouds Regional Inc. is a subsidiary of Clouds Inc. and is incorporated in Country B. It localizes Clouds accounting software for individual markets within its region and develops a regional marketing strategy. It maintains a help desk for customers based in the region including country C. It pays Clouds Inc. a royalty for the use of the core software. It manufactures shrink-wrapped boxes containing CDs with the accounting software loaded on them.

Clouds Local Inc. is a subsidiary of Clouds Inc. incorporated in country C which sells Clouds software to customers in C. Clouds Local Inc. purchases the shrink wrapped boxes from Clouds Regional Inc.

Clouds Regional Inc. builds and hosts a website in country B permitting customers in Country C to purchases Clouds software direct from it by electronic downloading. Regional marketing refers to this website. Because of the distribution savings digitally delivered Clouds software is 20% cheaper to customers in country C which still allows Clouds Regional Inc. to make additional 15% margin compared with the shrink wrapped boxed software it supplies.

There are no readily identifiable comparable uncontrolled prices (CUPs).

<u>Queries:</u>

Clouds Regional Inc. retains all of the distribution savings on digitally delivered sales to customers in country C. Is this an appropriate result of should Clouds Inc. or Clouds Local Inc. also have some of the incremental group profits attributed to them?

If Clouds Regional Inc establishes a subsidiary, Clouds Website Inc. in country D which owns and operates the server and website used to make digitally delivered sales in country C under a license granted by Clouds Regional Inc. Can Clouds Website Inc. earn a significant profit? Will these profits be significantly greater if Clouds Website Inc. incurs significant risks such as marketing risks? Are comparables likely to be helpful? Is a royalty an appropriate return for Clouds Regional Inc?

What documentation requirements should the Clouds companies be subject to?

B) Case Study 2: Jupiter

Facts:

- Jupiter is a multinational group consisting of:

Name	Function	Country location
Jupiter Corp.	Headquarters and Marketing	A
R&D Corp.	R&D company	ALH
MFG Corp.	Manufacturing company	AL
SSD Corp.	Sales, Services & Distribution	ALH
Finance Corp.	Financing company	ALH
Dot.com	Web servers & sales force	AL

Country A is the home country. Country L represents several countries, which are *low cost jurisdictions*. Country H represents many countries, which are *high cost jurisdictions*.

- Products consist of both complex (high cost) and simple (low cost) "information technology solutions". A "solution" normally includes hardware, software, services and financing. Hardware and software are usually imported by SSD Corp. in each country and sold in the local market.

- Marketing, on a strategic level is performed in country A, while local marketing is performed in countries L and H.

- Direct sales and distribution are conducted by potentially 3 different channels. Because sales of high cost solutions are complex, the 3 channels are frequently involved in various aspects of the sale.

  1. bIn house "face to face" sales force in each subsidiary in countries ALH
  2. Unrelated vendors located in countries ALH
  3. The Dot.com company located in country A and L

- The direct "sales process" consists of the following activities:
  1. Demand generation
  2. Presales activities (validating the match between customer need and vendor product)
  3. Sales closure
     - Solution design
     - Drafting proposal
     - Cross selling

- Price negotiation
- Closing deal

4. Fulfillment and Distribution
5. Support

- Contribution of the local "face to face" sales force/unrelated vendor versus the Dot.com in the "sales process" is as follows:

  1.High –cost IT solutions: Local sales force/unrelated vendor spends 300% more time than Dot.com.
  2. Low-cost IT solutions: Dot.com spends 300% more time than local sales force/unrelated vendor.
  3.Time spent jointly by both local sales force/ unrelated vendor and Dot.com on solutions is 20%.

Queries:

Transfer pricing:

1. Traditional Methods (CUP)
   A. Is a commission structure appropriate?
   B. What are the possible comparables?
   C. What about non-web distributors of comparable products?
   D. Is there value to the branded website?
   E. Is it possible to build a commission that reflects integration of Dot.com functions (e.g., may contain functions appropriate to both cost- plus and resale – minus methodologies?)

2. Profit Split

   A. What intangibles are created in connection with Dot.com?
   B. Is there a separate brand?
   C. What are the marketing intangibles and which company is entitled to the profit they generate?
   D. What is the value of the technology web-based software?

3. Who is entitled to the benefits of lower expense to revenue ratios in the Dot.com channel and who benefits from these cost-savings in the cost-sharing context?

Does transfer pricing for Dot.com differ from that of the "traditional channel".

VIII. CONCLUSION

After having discussed the various issues with respect to the impact of transfer pricing regulations on e-commerce, it is pertinent to mention that, this new evolving concept of business on the Net has made our policy makers aware of the problems arising herefrom.

How policymakers approach the Internet environment is crucial to determine whether citizens and businesses will be able to participate in and benefit fully from this new global environment. Policymakers can use their power of innovation to introduce taxation principles that are indelible to this evolving form of business. Policymakers should keep in mind, the ever-changing business environment of the world and work towards the realization of the concept, "*One World – One Economy*".
