

# At arm's length in cyberspace

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Transfer pricing issues are a growing concern with increasing cross-border transactions between related parties. How do these principles apply in the case of e-commerce. Vishwanath Kane analyses

**T**HE INCREASE in the volume and complexity of e-commerce transactions causes tax authorities to question whether the existing tax principles on source, residence and permanent establishment will be adequate to protect their respective tax bases.

Generally speaking, e-commerce transactions cover the delivery of information, products, services, or payment by telephone, computer or other automated media. It includes ATMs, telephone, banking and stock market transactions, telephone sales, the extranet, the intranet, e-mail, faxes, credit and debit cards, and electronic data interchange.

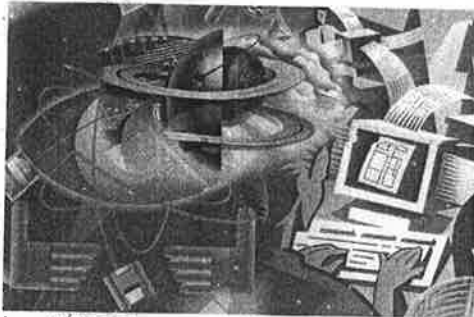
The OECD has issued draft guidelines for dealing with tax issues in the context of e-commerce transactions. Another issue of concern for tax authorities, the world over, is transfer pricing in the case of cross-border transactions between related parties.

In India, transfer pricing provisions are on the anvil. The expert group, constituted by the government of India to look into issues relating to transfer pricing has already submitted its report to the CBDT. When these provisions are made applicable in India and the guidelines on 'documentation' are implemented, the taxpayer will be required to possess a detailed documentation report at the time of furnishing the return of income or otherwise for the relevant assessment period, to indicate whether its transfer prices conform to the arm's length standard, that is, the prices transacted at should be the same if the parties were unrelated. This, coupled with issues like source rule, permanent establishment status in case of airline reservation systems, access to computer hub *et al* will lead to complex issues that require appropriate, practical and satisfying solutions.

Transfer pricing issues in controlled cross-border transactions in e-commerce are the application of arm's length principle, functional analysis, economic analysis and use of third party comparables. In the changed scenario as well, the requirements of having 'documentation' as regards the transfer prices will be the same as in the case of conventional cross-border transactions.

In the case of e-commerce transactions, just as in conventional ones, determining whether controlled and uncontrolled transactions or entities are comparable, requires a comparison of the functions performed, risks assumed, and resources employed by the taxpayers, involved in each transaction.

This is made possible by functional analysis. It is a general view that in e-commerce situations, the functional analysis poses problems. However, it should be noted that functional analysis helps put the controlled transaction in context



for the auditing tax authority. Functional analysis is a useful tool for the taxpayer in the conventional controlled transaction. The functional analysis helps identify and evaluate the role and contribution of each related party, including the economic risks assumed and the degree of responsibility for various organisational functions like engineering and production, continuing research, management and administration, marketing, and customer services.

OECD guidelines provide a list of the aspects of uncontrolled and controlled transactions or entities that should be documented for the tax authorities. It includes: the functions performed, risks assumed, assets employed and also the structure and organisation of the corporate group and the juridical capacity with which the taxpayer functions.



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It follows that if there is material difference in types of assets used, material risks assumed, and the functions performed by the related parties in the controlled transaction and the entities in the uncontrolled transactions, suitable adjustments need to be made.

Functional analysis is not a method of transfer pricing and does not, by itself, determine the arm's length result. However, it helps identify and assess the comparability of transactions or entities and indicates the distortions in the margins of related parties. Functional analysis facilitates the

determination of an 'appropriate' mark-up or a 'reasonable' profit contribution by providing the taxpayer a benchmark with which to identify and assess comparability of transactions or entities and help to identify severe distortions in the margins of related parties.

In the case of e-commerce, the preparation of functional analysis presents a big challenge as it is difficult to define the functions and risk of a virtual presence.

The next issue that requires attention is the review of the transfer pricing methods that can be applied in the circumstances. In conventional transactions, first, the applicability of each acceptable method is assessed and only then the most appropriate method is selected, that can derive an arm's length result in the circumstances. In e-commerce, this approach will not be altered. In this case also, the

attempt will have to be made to use comparable uncontrolled prices to determine an arm's length price for controlled transactions involving e-commerce.

However, the changed environment may pose some problems that may need to be addressed. For example, in a regular transaction, it may be possible to determine an arm's length price for the produce purchased by an offshore entity for resale in the importing country, based on the price previously paid by the independent distributors. However, if 'offshore entity' is substituted by 'virtual distribution operation' (that is, the server), the situation changes.

Given the low cost of operating such a virtual distribution operation, the availability of these controlled transactions may make it possible to shift significant profits to low-tax jurisdictions. It gives rise to the question whether a server, located anywhere in the world, retains the economic value of the real world entities it has replaced? Also, whether the same conventional, uncontrolled transactions that no longer exists, continues to be relied upon as a basis for determining transfer prices? Thus, though the basic requirement of transfer pricing documentation remains the same, the question whether the same kind of comparables that exists in conventional transactions can still be used in case of e-commerce transactions needs to be resolved. Generally, the comparison between controlled and uncontrolled transactions is done by having an acceptable profit level indicator, say gross margin and operating expense to sales ratio.

It is common knowledge that the cost of operating a virtual distribution operation is lower than in a traditional business. Hence, if the gross margin is accepted as a yardstick in case of comparables and the same is applied to the virtual distributor, it implies that a low level of profit may be attributed to the virtual distributor. Comparability in this case might be affected. The challenge faced in establishing an arm's length price intensifies when the e-commerce transactions involve a 'product' that was previously distributed as a tangible item but in the changed environment, is deliv-

ered electronically. For instance, a publisher in the US, that sold hard and soft cover books to Indian retailers, through a distribution subsidiary. In an e-commerce situation, those books may now be sold electronically to the Indian consumer, directly through a website that is connected to a server in a low-tax jurisdiction.

Since the new entity in the low-tax jurisdiction is operating as a virtual retailer, it may be possible to use the previous uncontrolled transactions between the old distribution subsidiary and the Indian retailers to establish a transfer price.

However, the use of such transactions implies that identical functionality would only be available in the near term and assumes that either the wholesale price of electronic books is comparable to the price of conventional books or that the margins realised by conventional and virtual retailers should be the same.

In the presence of uncontrolled transactions, taxpayers may be able to rely on transactional or profit-based variations of traditional transfer pricing methods to establish an arm's length price for controlled e-commerce transactions involving digital and tangible property.

However, in situations involving global collaboration within a multinational corporation via e-commerce, the conventional approach to establish transfer prices have their limitations. This may necessitate a taxpayer to rely on some form of profit-split method or resolve the issue through a pre-arranged cost sharing or contractual relationship.

An Advance Pricing Agreement (APA) may be effective and also provide the taxpayer an opportunity to apply unspecified transfer pricing methods. In a country like India the problem of lack of availability of information as regards the comparables will be further aggravated due to non-availability of comparables in a virtual economy. It will be a major hurdle in the implementation of transfer pricing regulations, particularly in case of e-commerce transactions.

Courtesy: Deloitte, Haskins and Sells