The term 'arm's length' has been defined in the Kohler's Dictionary for the Accountants as something done ''on a commercial basis, dealing with or as though dealing with independent, unrelated persons; competitive; straightforward; involving no favouritism or irregularity; as, arm's length purchase''. It is also suggested in the said dictionary that transactions between affiliated companies are not ordinarily regarded as being at arm's length even though expressed in terms of market values. The point in particular is that, if two or three divisions or units / plants of a company enter into commercial transactions, say, intercompany transfer of goods and services, there will be no impact on the profit / loss of the entity even if one division charges another a price which is more or less than their commercial value. So for the entity, it remains a zero sum game. However, if the transaction is between two independent parties and the transaction is entered into for a price less than its commercial value, it impacts the ultimate profit or loss of the entities. It is this relative gain or loss of the business entities which makes arm's length pricing a very important aspect of the transfer pricing mechanism.

It is very common to find multi-divisional / multi-locational conglomerates which, by their inherent nature, have production and distribution facilities spread across different states and even countries with varied tax jurisdictions and implications. Decision to host a particular facility in a particular location or country is influenced by the strategic considerations. However, when the goods and services are exchanged between two or more divisions of the same enterprise, but located in different tax jurisdictions, the tax authorities will view the supplier of the goods and services as seller and the receiver as buyer, even though the transaction is essentially between two divisions or units of the same enterprise. This principle, known as the arm's length principle, is now part of the international consensus and also the cornerstone of the OECD principles of transfer pricing guidelines for the multinational enterprises around the world. Arm's length pricing would not only help the revenue authorities to get their reasonable share of tax revenues from the activities of the multinational entities in their territories, but would also lead to fair international allocation of income.

Although the logic of arm's length pricing appears to be straightforward, but in reality it requires robust economic analysis and a clear understanding of not only the functioning of the market, but also of the subtle factors like the economic divers and the mechanisms in the market. Behind the theory of arm's length pricing there is clearly an assumption that there is a free flow of information in the market and the parties involved—the multinational entities and the revenue authorities of the respective tax jurisdiction—are able to gather it whenever needed. Such an assumption, however, is not only naive, but it faces challenge from the theory of efficient market hypothesis, which comes in a strong, semi-strong and weak form. Indeed, the world we live in is better explained, not by such phenomena as perfect market or perfect information, but by the existence of imperfect market where information asymmetry prevails. Parties involved in such a situation can come up with differing interpretations for the same event and get muddled up in disputes. International transfer pricing is one such area, which upholds arm's length principle, but ends up in a maze of disputes while practically applying it. Perhaps, this explains why India is locked in tax disputes with several multinational entities involving thousands of crores in tax revenues.

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Considering the importance of the topic, the timing for deliberations on arm's length pricing in the pages of the Management Accountant could not be more perfect! I hope that our eminent contributors to this issue of the magazine will enlighten us on the various aspects of the problem and offer food for thoughts for our readers.