Transfer Pricing - An Overview

BCAS Study Course
Hitesh D. Gajaria

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Transfer Pricing: An Introduction
Transfer Pricing - The impact of getting it wrong could be Fatal !!!

Canadian Revenue Agency’s denial of $136 million (CAD) in deductions for guarantee fees paid to US parent.....

Glaxo Smithkline landmark ruling – scope of TP Regulations broadened to be applied for domestic transactions as well

Belligerence shown by Indian tax authorities in TP, multinationals will have to be prepared for more TP challenges

Japan’s top pharmaceutical manufacture contests US$ 1.1 billion transfer pricing adjustment from its JV with Abott Laboratories...

Cumulative adjustments of approx. INR 25000 Crores in India

Maruti Suzuki’s landmark ruling on Marketing intangible – significance of bright line test and benefits and burdens test stressed....

AstraZeneca agrees to pay 505 million pounds to settle 15 year tax battle...

No guidance on the nature or type of adjustments or the manner in which those adjustments can be performed in the TP guidelines

Global Transfer Pricing – A Snapshot

- Around 60 countries with full fledged transfer pricing regimes
- Tax authorities in the ASPAC region are extremely active
- Tax authorities are developing more knowledge both of transfer pricing and of tax payer’s information.
- India, Australia, China, Korea and Japan have all seen an increase in audit activity; Singapore and other tax authorities have signaled intent to step up transfer pricing compliance and field audit work.
- Hong Kong, India, China, Korea and Japan significantly expanding. Adding key new requirements to their transfer pricing regimes.

Five ASPAC countries on TP Week’s Top Ten Toughest Tax Authorities for Transfer Pricing

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<th>Rank</th>
<th>Country</th>
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<td>1</td>
<td>Japan</td>
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<td>Korea</td>
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<td>United Kingdom</td>
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Asian Countries top aggressive tax authority poll – India ranks second following Japan and preceding China (source – TP Week)
Why Transfer Pricing?

Finance Minister’s speech on the rationale for introducing Transfer Pricing Regulations

“Presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November 1999 to examine the detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations.”

- Mr. Yashwant Sinha
Finance Minister, Government of India
February 28, 2001

What is Transfer Pricing?

- A mechanism for pricing the transfer of goods and services between related entities:
  - Tangible Goods
  - Intangible Goods ~ trademarks, trade-names, patents, etc
  - Services ~ management, engineering, after-sales services, etc

- A mechanism which provides the conceptual framework for pricing intercompany transactions

- Ensures an appropriate allocation of income between various tax jurisdictions in which a multinational company operates
Why Transfer Pricing?

(Contd.)

To ensure fair share of tax revenue to respective jurisdictions

Parent Co. Germany

Cost - INR 120

35% tax on INR 10

Sale to Sub Co. Dubai at INR 130

Sub Co. Dubai

Zero / Low Tax

Tax Savings on INR 40

Expenses

INR 130

Income

INR 170

Profit

INR 40

Sale to Sub Co. India at INR 170

Sub Co. India

Expenses

INR 170

Income

INR 190

34% tax on INR 20

To Prevent: Shifting of profits outside India by manipulating prices

How to do Transfer Pricing?

Relevant Provisions under Section 92

Computation of Income from International Transaction having regard to Arm’s Length Price

With

Associated Enterprises

Section 92A

International Transaction

Section 92B

Specified Domestic Transaction

Section 92B

Arm’s Length Price

Section 92C + Rules 10B / 10C

Documentation and Certificate

Sections 92D and 92E

Scrutiny

Power of AO and TPO

Section 92CA

Dispute Resolution Panel

Section 144C

Penalties

Section 271 (1) (c), 271AA, 271BA, 271G

Recent Amendments

- International transaction redefined
- Safe Harbor Introduced

Amendments by Finance Act 2012

- Powers of TPO expanded
- APAs introduced
Concepts of Transfer Pricing

Associated Enterprises: Primary Association

- Parent Company
- Intermediary
- Subsidiary Company
- Subsidiary Company 1
- Subsidiary Company 2
**Associated Enterprises: Secondary Association**

- Direct or indirect voting power of not less than 26%
- Loan advanced by one enterprise constituting not less than 51% or the book value of assets
- One enterprise provides guarantee of not less than 10% or more of the total borrowings
- More than half of the board of directors or members of the governing board, executive directors or members of the governing board are appointed by the same person
- Common parent appoints more than half of directors on board or one executive director in both
- Dependence on the knowhow, patents, copyrights, trade marks, licenses, franchises or any other business or commercial rights of similar nature of the other
- 90 percent of the raw materials consumed for the manufacture or processing of goods and articles carried out by one enterprise is supplied by the other enterprise
- Goods or articles manufactured by one enterprise are sold to other enterprise or parties specified by the other enterprise

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**International Transaction**

- Transaction between two or more associated enterprises, *either or both* of whom are *non-residents*
- In the nature of -
  - Purchase, sale or lease of tangible or intangible property, or
  - Provision of services, or
  - Lending or borrowing money, or
  - Any other transaction having a bearing on the profits, income, losses or assets of such enterprises,
  - Any mutual agreement or arrangement on allocation or apportionment or any contribution of cost or expenses
## International Transaction – Definition Expanded – Finance Act 2012

### Non reported transactions?
- Guarantee
- Excess credit period
- Advance for services

### Financing Transactions covered
- Capital financing

### Business restructuring / reorganization covered
- Covered transactions even if related profit / loss on future date
- Very wide coverage
- Exit Charge – a necessity now?

### Intangible properties defined
- Marketing related intangible assets (customer list, customer contracts etc.)
- Human capital related intangible assets (organized and trained work force)
- Other property deriving value from intellectual content rather than physical attributes

## Deemed International Transaction: Section 92B(2) of the Act

Third Party transactions deemed to be international transaction - Section 92B(2)

### Prior agreement/ Determination of terms

Transaction between A and Third Party also subject to transfer pricing, if:
- a prior agreement exists between A’s parent and Third party; OR
- terms of transaction between A and 3rd Party are determined in substance by A’s parent and Third Party
**Scope of Domestic Transfer Pricing – w.e.f. F.Y. 2012-13**

**Expenditure - Payment to specified person - [section 40A(2)(b)]**
- Any expenditure in respect of which payment has been made or to be made to a specified person;

**Tax Payer enjoying tax holiday**
- Inter unit transfer of goods or services [80-IA (8)]
- Transaction between the taxpayer and other person having close connection [80-IA (10)]
- Inter unit or intra group transaction for taxpayer enjoying benefit of Chapter VI-A or section 10AA (SEZ units); or
- Profits and gains of undertaking / unit / eligible business is to be computed having regard to arm’s length price in case of inter unit transfer of goods or services by the taxpayer [section 80A].

**Applicability**
- Applicable where aggregate amount of exceeds INR 50 million (approximately US $ 1 million) in a year
- Applicable from Financial Year (FY) 2012-13 onwards

**Compliance Requirement**
- Preparation of Transfer Pricing Documentation (TP Report)
- Accountant's Report in Form 3CEB

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**Computation of Arm’s Length Price**

- Determination of ALP using one of the Prescribed methods -
  - Best suited to the facts and circumstances of each particular international transaction and
  - Provides the most reliable measure of an arm’s length price in relation to the international transaction – termed as the "Most Appropriate Method"
- Where more than one ALP is determined, the arithmetic mean of such prices is taken to be the ALP
- Industry specific variance to ALP is proposed to be implemented w.e.f Finance Act 2011

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**Prescribed Methods**

- Traditional Transaction Method
- Comparable Uncontrolled Price
- Resale Price
- Cost Plus
- Profit Split
- Net Margin

**Recent Amendments**
- Variance of 3 percent of international transaction
- Variance of 1 percent in case of wholesale trades
- Standard Deduction denied

**No hierarchy or preference of methods prescribed under the Act**
Factors considered for selection of the most appropriate method:

- Nature and class of international transaction
- Class of associated enterprise and functions performed
- Availability, coverage and reliability of data
- Degree of comparability between the International transaction
- Extent to which reliable and accurate adjustments can be made
- The nature, extent and reliability of assumptions for application of the method

Most Appropriate Method: Rule 10C of the Rules

Most Direct Method for testing ALP and the Prices are Benchmarked
- Requires strict comparability in products, contractual terms, economic terms, etc.
- Two types of CUPs available - Internal CUP & External CUP
- Calls for adjustments to be made for differences which could materially affect the price in the open market e.g.:
  - Difference in volume/quality of product
  - Difference in credit terms
  - Risks assumed
  - Geographic market
- OECD - Priority to Internal CUP over External CUP due to higher degree of comparability
Resale Price Method

- Compares the resale gross margin earned by associated enterprise with the resale gross margin earned by comparable independent distributors.
- Preferred method for a distributor buying finished goods from a related party for reselling to unrelated party (if no CUP available).
- Under this method comparability is less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed.

Price paid by Sub Co. to AE is at arm’s length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors.

Cost Plus Method

- Compares and identifies the mark up earned on direct and indirect costs incurred with that of comparable independent companies.
- Preferred method in case
  - Semi finished goods sold between related parties
  - Contract / toll manufacturing agreement
  - Long term buy / supply arrangements
- To be applied in cases involving manufacture, assembly or production of tangible products or services that are sold/provided to AEs.
- Comparability under this method is not as much dependent on close physical similarity between the products.
- Larger emphasis on functional comparability.

Price charged by Sub co to AE is at arm’s length if the 25% mark up on cost is more than that of similar Indian assemblers.
**Profit Split Method**

- To be applied in cases involving transfer of unique intangibles or in multiple international transactions that cannot be evaluated separately
- Calculates the combined operating profit resulting from an inter-company transaction based on the relative value of each AEs contribution to the operating profit
- Evaluates allocation of combined profit/loss in controlled integrated transactions
- The contribution made by each party is based upon a functional analysis and valued, if possible, using external comparable data
- The two methods discussed by OECD Guidelines:
  - Contribution PSM Analysis
  - Residual PSM Analysis

**Transactional Net Margin Method**

- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc) in respect of similar parties
- Ideally, operating margin should be compared to operating margin earned by same enterprise on uncontrolled transaction – Internal TNMM
- Most frequently used method in India, due to lack of availability of comparable uncontrolled prices and gross margin data required for application of the comparable uncontrolled price method / cost plus method / resale price method
- Broad level of product comparability and high level of functional comparability
- Applicable for any type of transaction and often used to supplement analysis under other methods
- The application of the TNMM to a specific tested party breaks down when factors other than transfer prices have a material impact upon profits
**Transactional Net Margin Method (Contd.)**

- Grouping of transaction - Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- **Selection of tested party - Least complex entity**
- Selection of Profit Level Indicator such as Operating Margin, Return on Value added expenses, Return on assets – Unaffected by transfer price
- **Benchmarking exercise (on Databases)**
  - Entity with similar industry classification to the tested party – through search in Prowess and Capitaline plus databases
  - Screen entities by applying appropriate quantitative filters, such as mfg sales <75%, R&D exp >5%, Advertisement exp >5%.
  - Review financial and textual information available in the public database of the selected entities – for qualitative filters
  - Computation of ALP

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**“Other Method” - Sixth method notified by CBDT**

- CBDT has notified the “other method” vide a Notification and Rule 10AB has now been inserted in the Income-tax Rules, 1962 (the Rules). Applicable from FY 2011-12.

- Rule 10AB describes the other method as “any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts.”

- “other method” refers to “price which has been charged or paid, or would have been charged or paid”. Effectively, this implies that under this “other method” “quotations” rather than prices “actually” charged or paid can also be used by the taxpayers.

- Could be applied in case of revenue split / allocation in case of investment banking, logistics and other similar complex uncontrolled transactions wherein it is difficult to use the other five prescribed methods.

- Could also cover new instances of ALP computation which would now arise due to the various amendments introduced in the Finance Act 2012 like expansion / clarification of the definition of “international transaction” and introduction of domestic transfer pricing. (e.g., intangibles, exit charge)

- Proper documentation specifying the rejection reasons for non-application of the other five prescribed methods and the appropriateness of the “other method” based on the facts and circumstances of the case would have to be maintained by the taxpayer.
Transfer Pricing Documentation: Section 92D / Rule 10D

- **Entity related**
  - Profile of industry
  - Profile of group
  - Profile of Indian entity
  - Profile of associated enterprises

- **Price related**
  - Transaction terms
  - Functional analysis (functions, assets and risks)
  - Economic analysis (method selection, comparable benchmarking)
  - Forecasts, budgets, estimates

- **Transaction related**
  - Agreements
  - Invoices
  - Pricing related correspondence (letters, emails etc)

- Contemporaneous documentation requirement – Rule 10D
- Documentation to be retained for 9 years
- No specific documentation requirement if the value of international transactions is less than one crore rupees.
Transfer Pricing Process

Stage 1: Pre-project planning
- Preparation of project plan

Stage 2: Functional analysis
- Interviews
- Questionnaires
- Discussions with Management
- Characterization of each entity
- Agreement reviews

Stage 3: Economic Analysis
- Search strategy
- Access to local & global database
- Analysis of internal comparables
- Judicious identification of arm’s length range

Stage 4: Additional Analysis
- Understand existing costing mechanism
- Determination of billing methodology

Stage 5: Issuance of Documentation
- Consultation with management
- Finalization of Transfer Pricing Documentation

Accruals Report: Section 92E / Rule 10E

- Obtained by every person entering into an international transaction
- To be filed by the due date for filing return of income (no e-filing)
- Opinion whether prescribed documents have been maintained the particulars in the report are “true and correct”
- Review is limited to international transactions undertaken by the assessee
- Relevant annexures and appendices are attached
- Inputs:
  - Related party ledgers extracts
  - Related party Schedule under AS-18
  - Sample Invoices/ Vouchers / DN / CN
  - Relevant intra-group agreements
  - CUP/ Internal comparison info

Form No. 3CEB
[See rule 10E]
Report from an accountant to be furnished under section 92E relating to international transaction(s)

1. We have examined the accounts and records of ENTITY NAME AND POSTAL ADDRESS - PAN No. relating to the international transactions entered into by the assessee during the previous year ending on 31st March 2012.
2. In our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction(s) entered into so far as appears from our examination of the records of the assessee.
3. The particulars required to be furnished under section 92E are given in the Annexure to this Form. In our opinion and to the best of our information and according to the explanations given to us, the particulars given in the Annexure are true and correct.

Place :
Date :
For Shamitabh & Co.
Chartered Accountants
Penalties: Section 271A / Sec 271AA

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<th>Penalty</th>
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<td>In case of a post-inquiry adjustment, there is deemed to be a concealment of income</td>
<td>100-300 percent of tax on the adjusted amount</td>
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<tr>
<td>Failure to maintain documents</td>
<td>2 percent of the value of international transaction</td>
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<tr>
<td>Failure to furnish documents</td>
<td>2 percent of the value of international transaction</td>
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<tr>
<td>Failure to furnish accountant’s report</td>
<td>INR 100,000</td>
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Maintenance of contemporaneous and robust documentation is the key to avoid penalties

Amendments by Finance Act 2012
- Failure to report any international transaction ~ 2 percent of the value of international transaction

Budget Updates 2014
APA Roll-back Provisions

- TP assessment complete, however appeal pending before relevant appellate forums
- TP assessment pending or appeal filed before relevant appellate forums
- Applicable for transactions from FY 2015-16 onwards for continuing transactions

APA filed in FY 2014-15

Possible of getting covered by a Settlement Commission

Prospective period of 5 years from FY 2015-16

Applicable for transactions from FY 2014-15

Prior period of 4 years from years covered under the APA

Transactions up to FY 2011-12 covered under roll-back

APA valid up to FY 2019-20

APA roll-back provisions

- APA roll-back provisions announced for up to 4 years preceding the years covered by the APA in line with international best practices.
- Detailed rules in this regard awaited.
- In the budget speech, the FM has also proposed to enlarge the scope of Settlement Commission for disputes. It is expected that the scope would be enlarged to cover matters under appeal / litigation.

In the budget speech the FM has highlighted the government’s resolve to reduce TP litigation

APA Process - Timeline

- Certainty for 5 years with simpler compliances after the APA has been entered into
- Reduces documentation burden
- Time and cost saving
- Mandatory pre-filing consultation helps in taking a decision for entering into an APA
- Possible persuasive value in litigation and open audit years.

- Methodology / Arms’s length price
- Unlock the tax locked up as part of transfer pricing disputes
- Can help avoid initiating litigation for 4 years
- Potential to use APA for persuasive value incase of litigation for years preceding period covered by roll-back

Roll back of APA provisions in line with international practices
Range Concept and Multiple year data – Key considerations

Range Concept
• Concept of price / margin range for determination of ALP
• Clarified that the existing concept of arithmetic mean would continue to apply where number of available comparables is inadequate.
• Appropriate rules will be prescribed in this regards.

Multiple Year data
• Regulations to be amended to allow use of multiple year data for comparability analysis.
• No amendments currently proposed in the Finance Bill.
• Necessary legislative amendments are expected subsequently in this regard.
• Earlier regulations and judicial precedents gave preference to single year data for arriving at an ALP.

Deemed International Transactions - Pre-budget scenario

- Pre-budget provision
  • A Inc. based in USA has a global software procurement contract with C Inc. which is an independent third party and which is also based in USA.
  • Pursuant to the said contract, B Ltd which is the assessee and subsidiary of A Inc. procures the software from C Inc.
  • Since the price at which B Ltd purchases from C Inc. is influenced by the agreement between A Inc. and C Inc, the above transaction between B Ltd and C Inc. is deemed to be an international transaction as per Sec. 92B(2)
Deemed International Transactions - Post-budget Scenario

- **Post-budget provisions**
  - Assuming in the above illustration C Ltd which is an independent third party and with whom A Inc. has a global procurement contract is based in India.
  - Under the existing scenario, various ITAT judgments have held that such arrangements would not qualify as a deemed international transaction since both the transacting parties are resident entities.
  - The said position has been amended to provide that henceforth, the current arrangement would be construed as a deemed international transaction, even when both the parties are resident in India.

Deemed International Transactions – Points for Consideration

- **Points for consideration**
  - A Inc. has entered into an agreement with C Inc. to sell its medical equipments division globally.
  - Pursuant to the said agreement, B Ltd which is a subsidiary of A Inc. sells the same to D Ltd which is a subsidiary of C Inc.
  - Although the transaction between B Ltd and D Ltd is pursuant to a global agreement between the parent companies, there is no independent contract between A Inc. i.e. the AE and D Ltd which is the third party.

Whether possible to argue that transaction between B Ltd and D Ltd is not a deemed international transaction?
### Transfer Pricing Litigation

**File tax return & Accountant’s Report**
(30th November)

Reference to be made to TPO by the AO
Compulsory Reference to be made by AO if international transactions exceed Rs 15 Crores

**Options of Filing an appeal**

Notice to be issued by the TPO – TPO calls for supporting documents & evidence

Rectification application can be made against the order of TPO for apparent mistakes
[Section 92CA (5)]

**TP Audit**

Based on results of above mentioned procedure assessing officer passes the order

**Appeal Procedure**

1. TPO issues a preliminary questionnaire
2. We file all the relevant documents with the TPO’s office (TP Report, AR, Agreements, etc.)
   adjourned sine die;
3. TPO’s send a fresh notice for hearing ask for updated margins, RPT details, eliminating loss-making companies;
4. We file 2nd Submission which includes updated margins, etc;
5. TPO may ask for further queries, if required pertaining to business profile of assessee and comparables, specific details economic analysis;
6. We file 3rd Submission, if required;
7. TPO issues a show-cause notice (SCN) which includes the reasons as to why the TPO believe that an adjustment should be made;
8. We file a reply to the SCN – research, detailed response filed;
9. TPO passes the order and sends a copy to the AO;
10. AO passes a draft order u/s 144C.
**Audit Process for AY 2011-12**

- **TPO proposes a TP Adjustment**
- **AO forwards “draft” assessment order**
- **Assessee files an objection**
- **DRP issues direction***
  - 9 Months (approx.)
- **AO passes the final Order**
- **Issue of demand notice**
- **CIT (A) Route**

**Right to Mutual Agreement Procedure (MAP) not forfeited**

**Particulars** | **No. of cases selected for scrutiny** | **No of cases adjusted** | **% of cases adjusted** | **Adjustments (in INR Cr)**
--- | --- | --- | --- | ---
AY 2002-03 | 1081 | 236 | 22 | 1,403
AY 2003-04 | 1501 | 345 | 23 | 2,631
AY 2004-05 | 1768 | 477 | 27 | 3,947
AY 2005-06 | 1479 | 370 | 25 | 5,060
AY 2006-07 | 1600 | 800 | 50 | 10,000
AY 2007-08 | 2301 | 1138 | 49 | 23,237
AY 2008-09 | 2589 | 1338 | 52 | 44,531
AY 2009-10 | Not Available | | | 70,016
AY 2010-11 | | | | 60,000

**INR 60,000 crores of TP adjustment in concluded audit cycle for AY 2010-11**
Key Triggers and Contributors for Transfer Pricing Litigation

**Key Triggers for Aggressive Audits**
- Consistent losses / low margins of the assessee attributable to inter-company transactions
- Significant changes in profitability of the assessee and its AEs
- High Royalty / Technical fee payouts, Cost charges, Management Fees, Cost allocations
- Net losses incurred by routine distributors
- Low mark-ups for services
- Application of Ratio's such as ROCE / Berry ratio / cash profit instead of net margins
- Significant advertisement and marketing spends by manufacturing / distribution companies
- Use of foreign comparables

**Contributors to Aggressive Audits:**
- Mounting fiscal demand on Government
- Need to Preserve tax base
- Constant competitive pressure to restructure business operations efficiently
- Unprecedented sharing of information between revenue authorities

Substantial increase in transfer pricing audits and disputes across the Globe, India is no exception....

Emerging Transfer Pricing Issues
## Key Issues in Recent Transfer Pricing Audits

- **R & D Activities**
- **Marketing Intangibles**
- **Location Savings**
- **Issue of Share Valuation**
- **Management Service Fees**

### Marketing Intangibles: General Concept

**AMP spend by Indian licensee**

\[ (-) \]

**Arm’s length licensee expenditure**

\[ \text{Excess} \]

**Assumed to be incurred for strengthening of brand name of the AE**

**Indian licensee:** Must be reimbursed along with a suitable mark up.

**AMP: Advertisement, marketing, promotion**

**Bright line**

### Revenue’s Approach

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<tr>
<th>Use of comparables selected under TNMM?</th>
<th>Application of ‘Bright line’ test</th>
<th>Treating excess as expense incurred for creation of intangible</th>
<th>Deeming a service fee</th>
<th>Adding a profit mark-up in addition</th>
<th>Royalty payment also challenged</th>
<th>Apportionment of global profits to India for brand/marketing intangible creation</th>
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<td>Application of CUP while determining the excess percentage</td>
<td>Treat excess as expense incurred for creation of intangible</td>
<td>Deeming a service fee</td>
<td>Adding a profit mark-up in addition</td>
<td>Royalty payment also challenged</td>
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Marketing Intangibles

- Ownership of intangibles – Legal vs. Economic
- Excess Advertisement Marketing and Promotion (AMP) expenses incurred by a brand licensee is an international transaction – Delhi ITAT Special Bench ruling – LG Electronics India Pvt. Ltd.
- AMP spends to satisfy the ‘bright line’ test - Identification of expenses “in connection with sales” as against “for promotion of sales”
- Revenue expects Mark-up on AMP expenses in excess of bright line – in some cases have also considered global profit split
- India’s position in the UN TP manual – Primarily based on AMP expense by no risk or limited risk distributors working on cost plus model – they should incur only routine AMP expenses
- Recent Delhi Tribunal ruling in the case of BMW India Private Limited drew a distinction in the facts from that of LG India’s case and held that premium profits earned by distributor are adequate compensation for excessive AMP, and deletes adjustment

R&D Activities – new administrative guidance

**Circular No. 2 / 3 (dt. 26/3/2013)**
Application of Profit Split Method (‘PSM’)
Conditions relevant to identify Contract R&D with insignificant risk

**Circular No. 6 (dt. 29/6/2013)**
Circular No. 2 on PSM rescinded
Circular No. 3 on contract R&D amended and reissued

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<th>In India</th>
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<td>Functions</td>
<td>Economically “Significant”</td>
<td>Economically “Insignificant”</td>
</tr>
<tr>
<td>Funding/ Assets</td>
<td>Source of funds/capital&lt;br&gt;Significant assets/intangibles</td>
<td>No economically significant assets or intangibles</td>
</tr>
<tr>
<td>Supervision &amp; Control</td>
<td>Strategic decisions for Core&lt;br&gt;Functions &amp; Monitoring</td>
<td>Operate under Guidance</td>
</tr>
<tr>
<td>Risk Profile</td>
<td>Significant Risks</td>
<td>No significant risks</td>
</tr>
<tr>
<td>Outcome of Research</td>
<td>Legal &amp; economic owner of resultant IP</td>
<td>No ownership of resultant IP</td>
</tr>
</tbody>
</table>

Primary Coverage - Indian Captives engaged in Research and Development Activities
Location Savings

- Refers to Cost Savings due to relocation of business from 'high cost' location to 'low cost' location and 'Location Specific Advantages' (e.g. skilled manpower, large customer base, superior network etc) enjoyed by growing economies like India
- Quantification and allocation of Location Savings is subject matter of controversy
  - UN and OECD Manual: Depends on functional analysis and bargaining power of the parties
- Indian Revenue authorities believe Profit Split Method ('PSM') may be used to allocate Location Savings
- Location Savings considered through applications of higher mark-up in low cost countries
- GAP Ruling- geographical comparability considers Location Savings
- No Location Savings where location’s benefits are actually shifted to customers

Share Valuation

**General contentions of the Taxpayers**

- Issue of equity share capital does not constitute ‘income’ hence not covered by section 92(1) of the Income Tax Act and therefore there is no requirement to satisfy the arm’s length test laid down by the Act.
- The valuation report ought to be accepted by the Revenue unless it is proved to be vitiated by fraud, bias or a patent mistake.
- The shortfall in the value of equity shares cannot be considered as a deemed loan, as no actual loan has been given by the taxpayer and hence there is no question of Transaction as defined under section 92F of the Act.
- The action proposed by the revenue in considering the shortfall as a deemed loan would tantamount to consider every transfer pricing adjustment as a notional loan/receivable.
- It is not open to the department to prescribe or dictate to the assessee as to how it should have conducted the business or earned income on its funds.

**General contentions of the Revenue**

- All type of transactions being in nature of Capital Financing under clause (v) of explanation to section 92F of the Act have been included in the definition of international transactions from retrospective effect from 1st April 2002.
- Issue of equity shares is in nature of Capital Financing and hence is an international transaction which is required to be at arm’s length under the Indian Transfer Pricing regulations.
Management service fees

- Payment towards management fees is generally towards services such as Planning & Coordination, Budgetary Control, Financial advice, Accounting, Auditing, Legal services, Computer services, Financial services, Management and administrative services, Purchasing, marketing and distribution, Human resource services etc.

- Management fee charged by AEs are investigated in great detail by the Revenue department

- Robust / exhaustive documentation requirement demanded to substantiate the total receipt of services and benefits received. In absence of substantial documentation demonstrating the services received such allocations are disallowed completely or determined at a substantially lower amount

- Revenue also enquire into whether a similar charge is levied on other group entities and rates thereof are also called for and examined

- Typical mindset of the Revenue is that management charge are used for profit repatriation.

Key Points for success in Transfer Pricing audits in India

- Detailed Functions-Assets-Risks analysis
- Proactive Planning
- Agreements / contracts should exist for transactions between Associated Enterprises
- Price setting mechanisms to be documented
- Localization of Global Transfer Pricing policies
- Documentation should completely describe search methodology, basis for inclusion / exclusion of comparables, etc.
- Substantiate business, economic and commercial rationale
- Maintain detailed cost-benefit analysis with respect to cross charges (intra-group services)
- Strategizing and providing appropriate information during the audit
### Dispute Resolution Mechanisms

#### Dispute Resolution Panel (DRP)
- Alternate dispute resolution mechanism to 1st level appellate proceeding before the CIT (A)
- Specialist 3 member collegium for settling disputes on a fast track basis
- No demand till Assessing Officer issues final order after directions of DRP

#### Mutual Agreement Procedure (MAP) – To avoid double taxation and provide relief
- MAP is an alternate mechanism incorporated into tax treaties for the resolution of international tax disputes
- Resolution of disputes through the intervention of competent authorities of each State who evolve a mutually acceptable solution
- Indo-US Competent Authorities arrived at a mutual agreement in respect of US captive providing software/IT enabled services for FY 2004-05

- Would be limited to a maximum term of five consecutive financial years
- The ALP shall be determined on the basis of prescribed methods or any other method
- Rules governing the APA regime notified by CBDT

#### Safe Harbor – Proposed to reduce transfer pricing disputes
- Final Safe Harbor rules notified
- Seeks to reduce the impact of judgmental errors in transfer pricing
- Stipulation of margins-specified industries (Priority - IT/ITeS, KPO, contract R&D, etc.)
- Safe Harbour regime would be valid for 5 years starting with AY 13-14

#### Evolving Dispute Resolution Mechanism
DRP and MAP

**DRP – In practice yet to yield desired result to the taxpayers**

- Alternate dispute resolution mechanism to 1st level appellate proceeding before the CIT (A)
- Specialist 3 member collegium for settling disputes on a fast track basis
- Time bound 9 months
- No demand till Assessing Officer issues final order after directions of DRP
- DRP directions appealable by Revenue

**MAP – To avoid double taxation and provide relief**

- MAP is an alternate mechanism incorporated into tax treaties for the resolution of international tax disputes
- Resolution of disputes through the intervention of competent authorities of each country who evolve a mutually acceptable solution
- Relief through MAP possible irrespective of remedies available under domestic tax laws
- Two Competent authorities appointed based on region

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### Safe Harbour Rules

<table>
<thead>
<tr>
<th>Intercompany Transaction</th>
<th>Value of Intercompany Transaction</th>
<th>Safe Harbour</th>
</tr>
</thead>
</table>
| **Software Development or Back-office support Services** | • Upto $80 million  
• Exceeds $80 million | • 20% or higher  
• 22% or higher |
| **ITES being knowledge processes outsourcing services** | • No monetary limit | • 25% or higher |
| **Contract R&D services**                         | • No monetary limit  | • 30% or higher |
| **Intra-group loan to wholly owned subsidiary**   | • Upto $8 million  
• Exceeds $8 million | • SBI base rate plus 150 bps  
• SBI base rate plus 300 bps |
| **Corporate guarantee**                           | • Does not exceed $16 million  
• Exceeds $16 million and the credit rating of the AE is of the adequate to highest safety | • Commission rate not less than 2% p.a. on the amount guaranteed  
• Commission rate not less than 1.75% p.a. on the amount guaranteed |
Safe Harbour Rules contd.

- Safe Harbours are said to be convenience prices which are higher than the Arm’s Length Price.
- The option of being governed by Safe Harbour Rules shall be valid for a period of five years starting with AY 2013-14 or for a lesser period at the option of the taxpayer.
- No economic or other adjustments allowed to taxpayers opting for Safe Harbour.
- Range of +/-3% not allowed.
- No respite is provided from maintenance of mandatory documentation.
- A taxpayer opting for Safe Harbour rules will not be able to avoid possibility of economic double taxation.
- Introduced new concept of Knowledge Process Outsourcing (KPO) services with high markups
- Companies opting for safe harbour not allowed to opt for MAP /CA proceedings
- Due to apprehension in various industry sectors - Government has issued instructions that Safe harbour margins not to be followed for general Audit or APA purposes.
- Tepid response to safe harbour option due to very high markups

APAs: Backdrop

- APA provisions introduced with effect from 1 July 2012
- ALP shall be determined on the basis of prescribed methods or any other method
- APA can be entered into for either determining the ALP or specifying the manner in which the ALP is to be determined
- Valid for a maximum of five consecutive years
- In the case an APA covering a particular year is obtained after filing the return of income, a modified return to be filed based on the APA and assessment or reassessment to be completed based on such modified return
- Rules governing the APA regime now notified by the CBDT
APA Rules

- To cover Unilateral as well as Bilateral / Multilateral APAs
- Will cover existing (by March 31) as well as new international transactions (any time during the previous year)
- Specified format for APA application - withdrawal/renewal of APA application possible
- Pre-filing consultation (also anonymous)
- Schedule of APA Fees

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Fees</th>
</tr>
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<tbody>
<tr>
<td>RPTs value up to INR 1 billion</td>
<td>INR 1 million (approx USD 20,000)</td>
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<tr>
<td>(approx USD 20 million)</td>
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</tr>
<tr>
<td>RPTs value up to INR 2 billion</td>
<td>INR 1.5 million (approx USD 30,000)</td>
</tr>
<tr>
<td>(approx USD 40 million)</td>
<td></td>
</tr>
<tr>
<td>RPTs value above INR 2 billion</td>
<td>INR 2 million (approx USD 40,000)</td>
</tr>
<tr>
<td>(approx USD 40 million)</td>
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</table>

- APA Directorate includes panel of experts such as Economists, Statisticians, etc.
- Annual compliance report / audit

Indian APA Program – Key Features

Indian APA Program announced in August 2012

- Provides certainty for 5 tax years
- Bilateral option would mitigate double tax
- Anonymous filing option
- More cooperative approach, as compared to desk audit
- Significant cost saving (internal and external resources)
- Roll-back Provisions for 4 years preceding the year covered by APA
Indian APA Program – Advantages

Primary Advantages

- **Certainty**
  - No transfer pricing audits and adjustments for five years.

- **Anonymous**
  - Pre-filing application and meeting can be anonymous.

- **Non-committal**
  - LinkedIn can decide not to pursue an APA if it does not like the results.

- **No Filing Fee**
  - Taxpayer does not have to pay any filing fee for pre-filing application.

Secondary Advantages

- **Simple**
  - Pre-filing application is simple - does not require significant time commitment from LinkedIn’s team.

- **Cost Efficient**
  - LinkedIn may spend only a small portion of total APA budget for pre-filing.

- **Open Feedback**
  - The APA Team provides open and honest feedback based on facts presented during pre-filing meeting.

- **Evaluate APA Approach**
  - LinkedIn can evaluate the APA environment without significant investment of time and money.

Indian APA Program – Experience so far

- Discussions on the various APA cases happening in Bangalore, Delhi and Mumbai.

- Some cases are discussed at specific locations based on specific activities. For e.g. the IT/ITES activities will be primarily done by APA team in Bangalore.

- The initial focus is on the Functions Assets and Risks (FAR) analysis to which the APA team is paying attention in great details.

- Site visits by the APA teams in progress. To date the visits have been scheduled in consultation with the taxpayers and have been conducted in a cordial and un-intrusive manner.

- Based on the FAR analysis, the economic analysis will be done followed by rounds of discussions and negotiations.

*Sector-wise APAs filed*

- Estimates based on various sources.
Indian APA Program – Statistics to date

- Indian taxpayers filed 146 APA applications in the first year and 232 APA applications in the second year.
- 5 Unilateral APAs and 1 Bilateral APA concluded as on date – commendable and rare accomplishment considering international norms.
- Companies whose APAs have been concluded are engaged in different industrial sectors including pharmaceuticals, telecom, exploration and financial services.
- About 50 Bilateral APA applications have been discussed, remaining were unilateral applications.
- Primary focus of APA teams is to reach consensus on Function Asset Risk (FAR) analysis for which site visits are planned.

Abbreviations and Acronyms

<table>
<thead>
<tr>
<th>Abbreviations and Acronyms</th>
<th>Full Name</th>
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<tbody>
<tr>
<td>AEs</td>
<td>Associated Enterprises</td>
</tr>
<tr>
<td>APA</td>
<td>Advance Pricing Arrangements</td>
</tr>
<tr>
<td>AO</td>
<td>Assessing Officer</td>
</tr>
<tr>
<td>CIT(A)</td>
<td>Commissioner Income Tax Appeals</td>
</tr>
<tr>
<td>CPLM</td>
<td>Cost Plus Method</td>
</tr>
<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price Method</td>
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<tr>
<td>DRP</td>
<td>Dispute Resolution Method</td>
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<tr>
<td>ITAT</td>
<td>Income Tax Appellate Tribunal</td>
</tr>
<tr>
<td>NCP</td>
<td>Net Cost Plus Margins</td>
</tr>
<tr>
<td>NPM</td>
<td>Net Profit Margins</td>
</tr>
<tr>
<td>PLI</td>
<td>Profit Level Indicator</td>
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<tr>
<td>PSM</td>
<td>Profit Split Method</td>
</tr>
<tr>
<td>RPM</td>
<td>Resale Price Method</td>
</tr>
<tr>
<td>The Act</td>
<td>Income Tax Act, 1961</td>
</tr>
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</table>
### Abbreviations and Acronyms

<table>
<thead>
<tr>
<th>Abbreviations and Acronyms</th>
<th>Full Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>TPO</td>
<td>Transfer Pricing Officer</td>
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<tr>
<td>TNMM</td>
<td>Transactional Net Margin Method</td>
</tr>
</tbody>
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### Thank You

Hitesh Gajaria  
Partner  
T: +91 22 3090 2110  
Mob: + 91 9892333375  
Email: hgajaria@bsraffiliates.com