Recent Developments in Income Tax Law in Transfer Pricing

National Tax Convention 2015

Western India Regional Council

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4 July 2015

Agenda

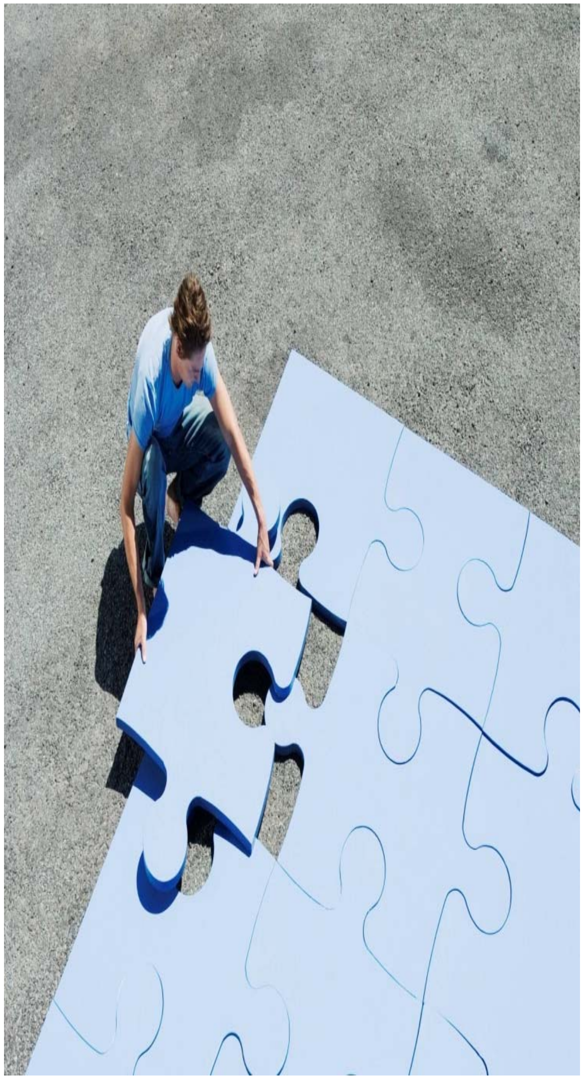
Transfer Pricing in the News

Key Issues in Recent TP Audits

Recent Amendments

Update on the APA Program

Discussion on OECD BEPS – Transfer Pricing Action Plans



Transfer Pricing – Rising Disputes !!

Source: Business Standard dated 3 January 2014


Business Standard beta

Tuesday, May 14, 2013 | 09:38 AM IST

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Dev Chatterjee & Viveat Susan Pinto | Mumbai February 25, 2013 Last Updated at 00:59 IST

LG India gets tax demand on high advertising spend

Tribunal ruling in I-T's favour may open floodgates to claims against other MNCs

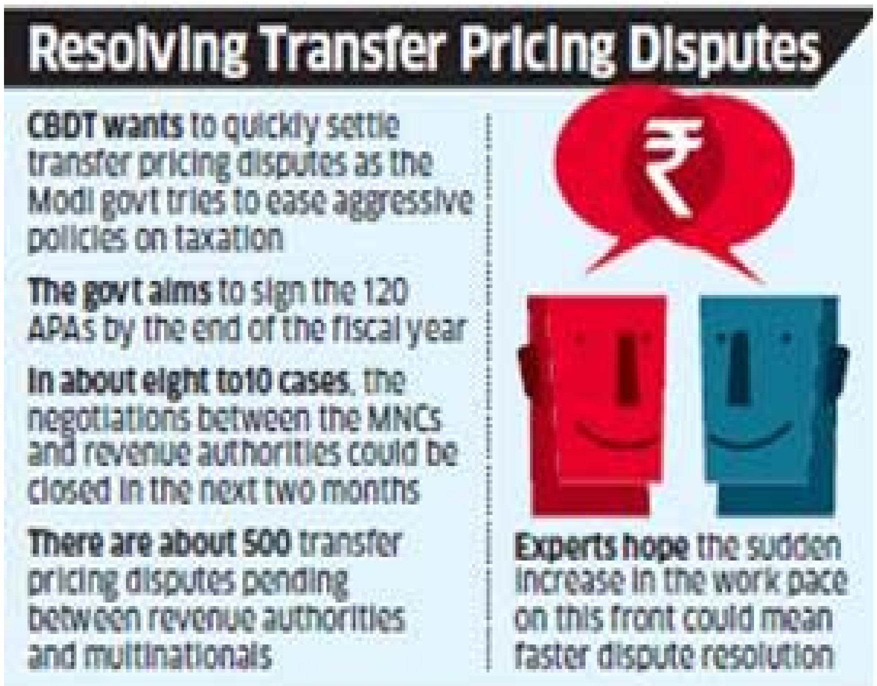
Need of the Hour - Certainty and reduction of the Protracted litigation

Transfer Pricing - Winds of change !!

THE NEW INDIAN EXPRESS

Vodafone Wins Rs 3,200-cr Transfer Pricing Case in HC

By PTI | Published: 10th October 2014 07:18 PM Last Updated: 10th October 2014 07:18 PM



Source: Economic Times dated 21 May 2015

THE HINDU BusinessLine

Shell India wins 17,920-crore transfer pricing case

THE ECONOMIC TIMES

Government proposes separate unit for disposal of transfer pricing case

ET Bureau Dec 18, 2014, 04.00AM IST

Business Standard

India signs first bilateral APA with Japanese company

THE ECONOMIC TIMES

Obama in India: India, US finalise framework to resolve transfer pricing cases

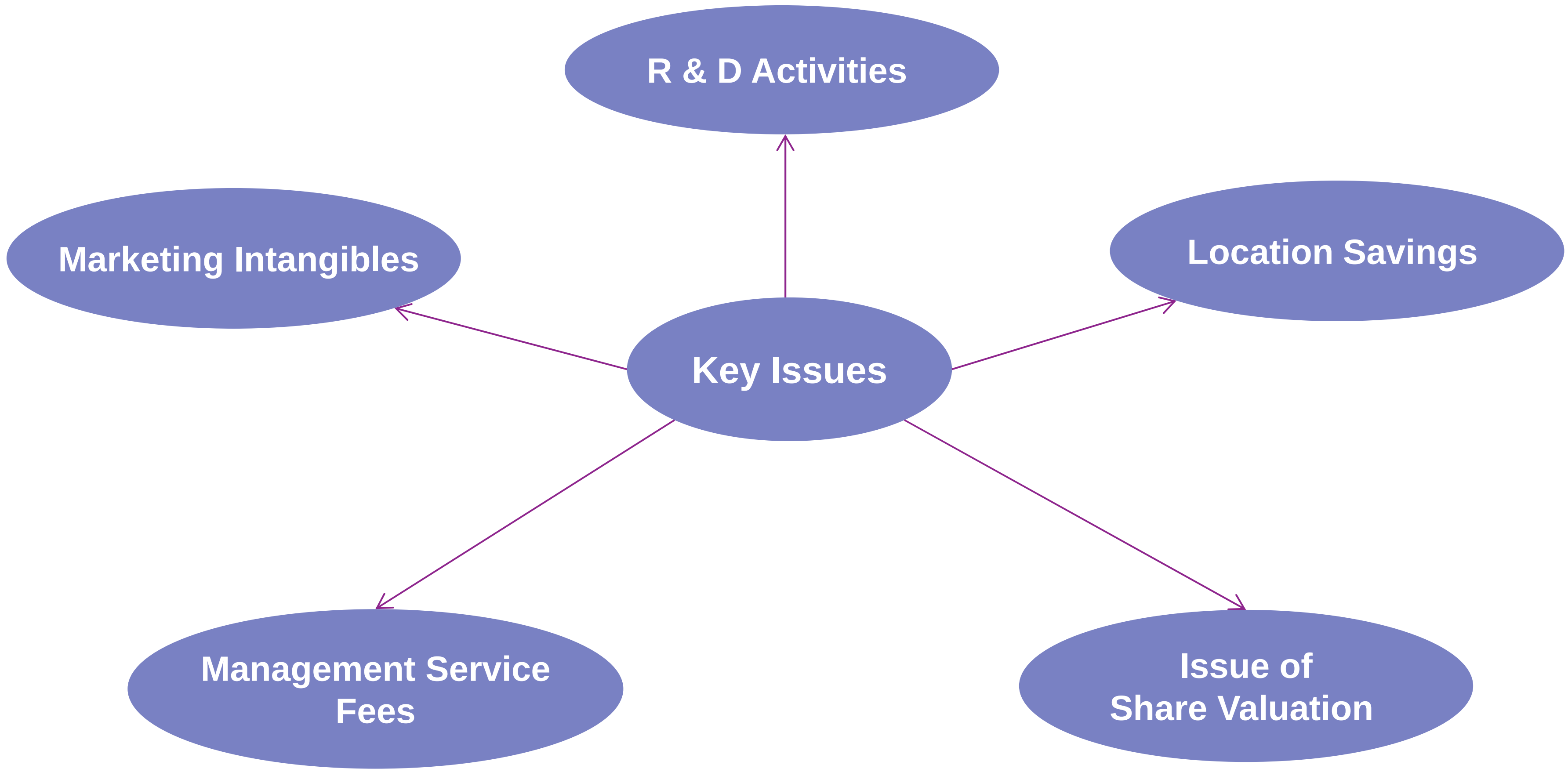
Transfer Pricing Litigation - Trend of Adjustments

India ranks among the top three most aggressive transfer pricing regimes, Canada and Denmark being the other two. Of the total global transfer pricing adjustments, India's share was 70 per cent by volume in 2012..

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
AY 2011-12				47,000

Source: http://www.financialexpress.com/article/fe-columnist/cleaning-up-the-transfer-pricing-mess/57164

Key Issues in Recent Transfer Pricing Audits



Marketing Intangibles: General Concept

AMP spend by Indian licensee

(-)

Arm's length licensee expenditure

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				
Application of 'Bright line' test Use of comparables selected under TNMM?	Treating excess as expense incurred for creation of intangible Application of CUP while determining the excess percentage	Deeming a service fee Adding a profit mark-up in addition	Royalty payment also challenged	Application of Profit Split Method Apportionment of global profits to India for brand /marketing intangible creation

Marketing Intangibles: contd.

Over time the Transfer Pricing Assessments resulted in various MNCs having to pay taxes on advertising, marketing & promotion (AMP) expenses incurred over / above the industry average…

Subsequently the Delhi High Court in the Sony Ericsson Mobile Communication India Pvt. Ltd and several other connected matters ITA No. 16/2014 has upheld:

- Characterizing AMP expenses as an international transaction subject to transfer pricing
- Distribution and marketing are intertwined functions and can be analysed together as a bundled transaction
- Segregation of non-routine AMP expenditure using the bright line approach inappropriate
- Separate remuneration for the AMP activities may not be required if such compensation is already provided by way of lower purchase price or reduced payment of royalty

Introduction of R&D Circular no. 06/2013 – New Administrative Guidance

Circular 6 recognizes that the R&D Centres set up by foreign companies in India can be classified into three broad categories based on functions, assets and risk assumed by them

Contract R&D	Cost Sharing R&D	Entrepreneurial R&D
TNMM Cost + X%	Most Appropriate Method (As suitable based on facts)	Most Appropriate Method (As suitable based on facts)

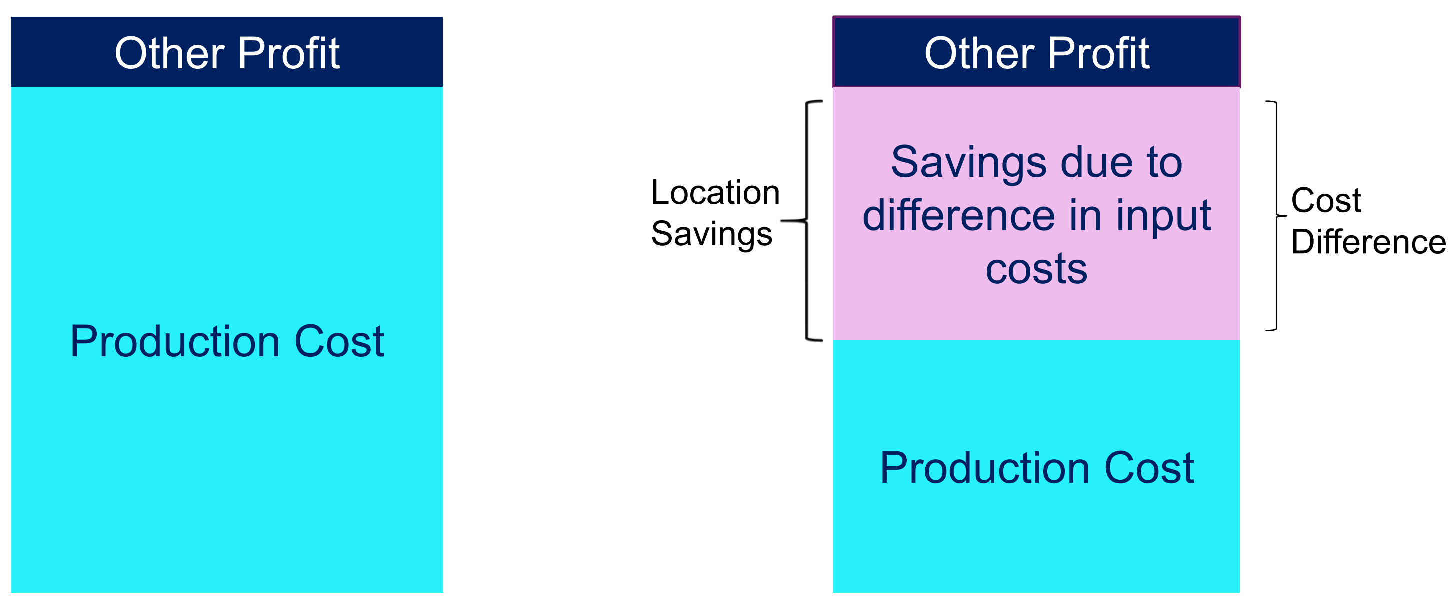
Parameters	Outside India	In India
Functions	Economically “Significant” such as conceptualization and design; providing strategic direction	Economically “Insignificant”
Funding/ Assets	Source of funds / capital , significant assets/ intangibles	No economically significant assets or intangibles
Supervision & Control	Actual control /supervision; Strategic decisions for core functions and monitoring	Operate under guidance of foreign principal
Risk Profile	Significant risks	No significant risks
Outcome of Research	Legal & economic owner of resultant IP	No ownership of resultant IP

Inference point for distinguishing R&D centers as ‘Contract R&D’ or ‘Entrepreneurial R&D’

Location Savings – the Concept

- Net ‘<u>Cost savings</u>’ realized by an MNC as a result of relocating manufacturing functions / production / operation sites from a ‘high cost’ to ‘<u>low cost</u>’ jurisdiction to obtain competitive advantage
- Typical cost savings includes labour costs, raw material costs, rent and property taxes, training costs, Infrastructure costs and Incentives including tax exemptions

Location savings = Input cost in a high cost region – Input cost in a low cost region



Who is entitled to such benefits: Parent or Subsidiary?

Location Savings … Judicial Precedents

GAP International Sourcing (India) Private Limited – Delhi ITAT: Key findings

- ✓ Location Savings arise to the industry as a whole and there is nothing to prove that the taxpayer was sole beneficiary
- ✓ The objective of sourcing from low cost countries is to survive in stiff competition by providing a lower cost to its end-customers
- ✓ The advantage of Location Savings is passed onto the end-customer via a competitive sales strategy. Thus, no separate / additional allocation is called for on account of Location Savings

Mumbai Tribunal in the case of Watson Pharma Private Limited (ITA No. 1423/ Mum/2014) held that no adjustment on account of location savings is required when arm's length price is determined on the basis of appropriate comparables

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.

Share Valuation … Judicial Precedents

Vodafone India Services Pvt. Ltd. – Bombay High Court Writ Petition No .871 of 2014 (October 2014)

- Bombay High Court rules in favour of Vodafone India in share valuation case;
  - Absent income, there is no 'international transaction'
  - Share issue at premium does not give rise to 'income' to trigger TP provisions;
  - Rejects Revenue's contention that income must be given a broader meaning to include notional income

Union Cabinet accepts the Bombay High Court order

The Union Cabinet, decided to accept the order of the High Court of Bombay in the case of Vodafone India Services Pvt. Ltd. and not to challenge it before the Supreme Court of India

Ruling: The High Court quashed the order of previous authorities by ruling that no jurisdiction of Chapter X applies for issue of shares at a premium as it does not give rise to any income from an admitted international transaction

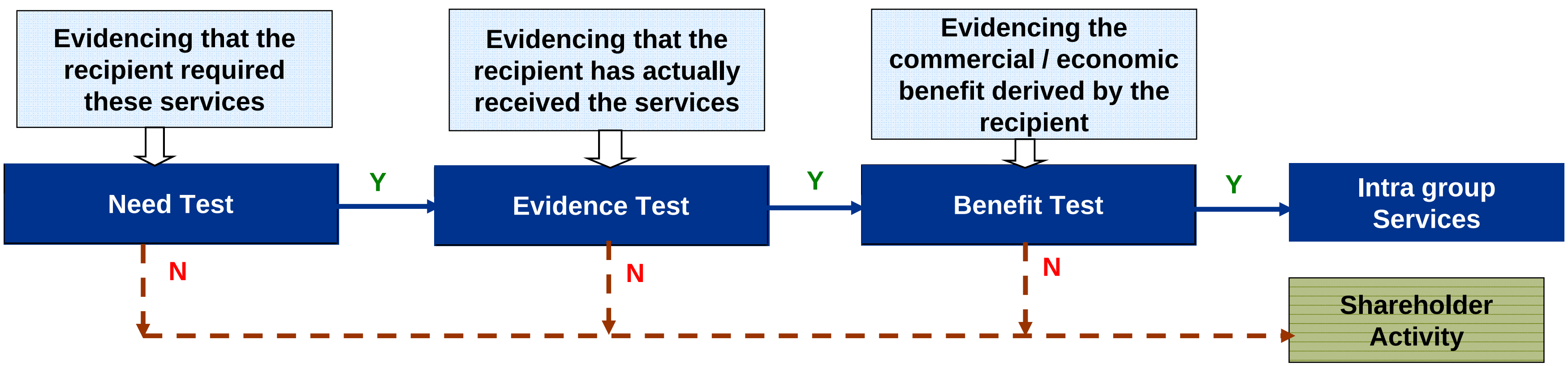
Management service fees

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

- ✓ 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.

Tests



Management Service Fees – Judicial Precedents

McCann Erickson India Private Limited – Delhi ITAT Key findings

- Considering the business environment of the taxpayer, it would be difficult to operate successfully without receipt of services which carry huge intrinsic and creative value.
- Legitimate business needs of the taxpayer must be judged from the perspective of the taxpayer. It is not for the AO to dictate what the business needs of the taxpayer should be
- The term “benefit” to a taxpayer in relation to its business has a very wide connotation and is difficult to accurately measure
- Taxpayer needs to establish that payments made for the services are commensurate to the volume and quality of services

Dresser Rand India Private Limited – Mumbai ITAT Key findings

- When computing the ALP, the TPO / AO cannot question the commercial wisdom of the taxpayer. It is the taxpayer’s prerogative to decide how to conduct its business
- If services availed by the taxpayer is legitimate furtherance of its business interests and are wholly exclusively for the purposes of business, such costs should be treated to have been computed in a fair and transparent manner.

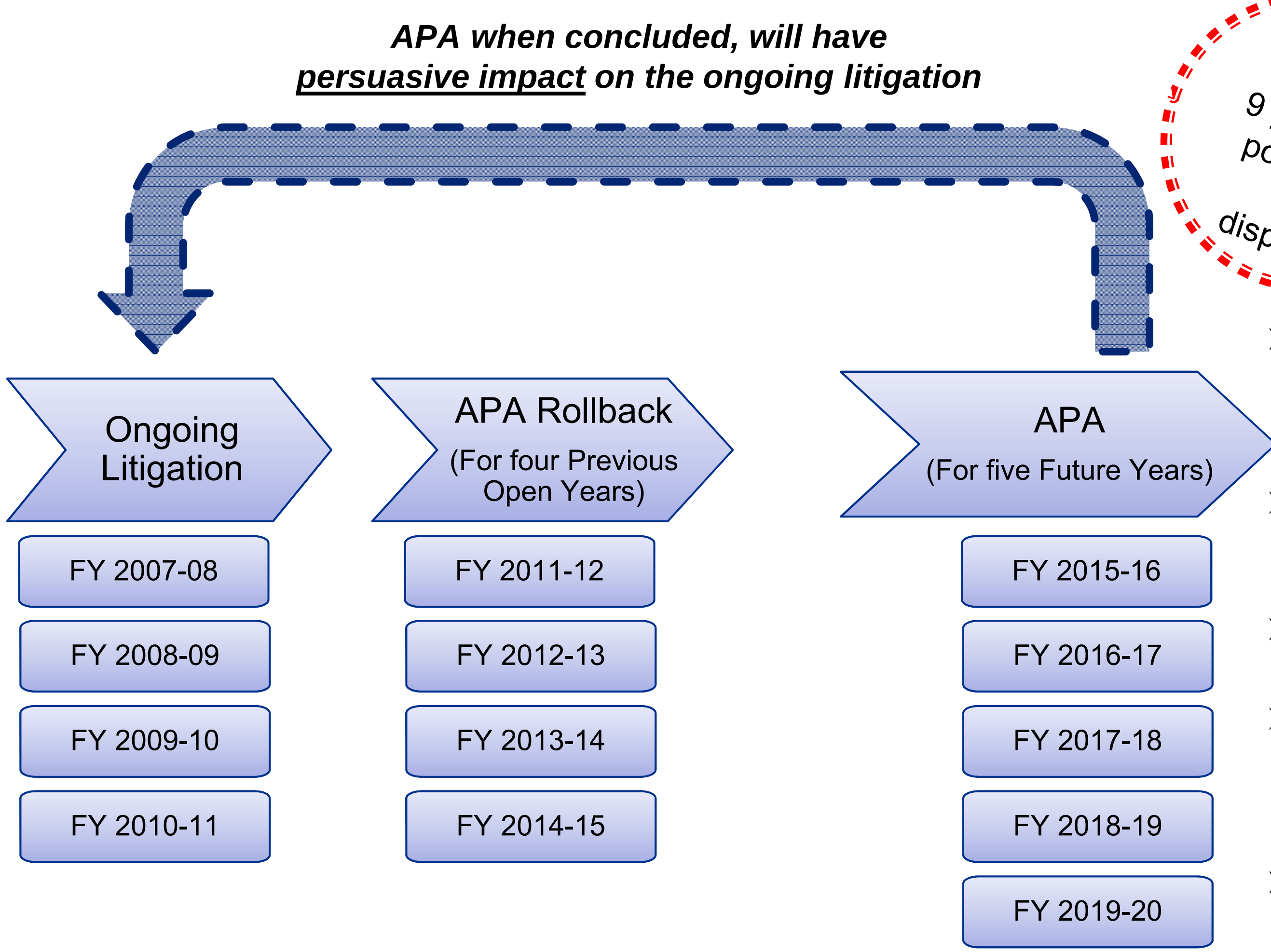
Recent Tax Amendments

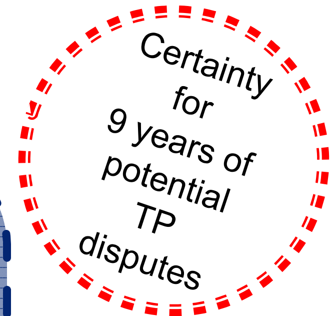
Recent Amendments

Roll back provisions	• Roll back provisions notified in March 2015 – to enable applicability of APA provisions for the preceding 4 years
Deemed International Transaction	• Deemed international transactions now fall within the gamut of TP
Range concept	• In line with international practice – to provide flexibility and spread in complying with Arm's Length Price
Multiple year data	• Aligned with global practices, avoids sway of extreme results of single year – rational manner to arrive at ALP
Speedy disposal of APAs	• Augmenting Tax administration for APAs – to help speedy disposal of APA applications – further boost to Indian APA program

Finance Minister endorsed Government's commitment to non-aggressive tax regime to improve investment climate – ET Global Business Summit 2015

APA – Introduction of ‘Rollback provisions’





- APA ‘Rollback provisions’ introduced for maximum four previous years w.e.f. October 1, 2014
- **Conditions**, **procedure** and manner of rollback **to be prescribed**
- **Persuasive value** for prior years in litigation
- **Augmentation of** Tax Administration for APAs – *to help **speedy disposal** of APA Applications*
- **Further boost** to Indian APA Program

Section 92B – Deemed International Transaction

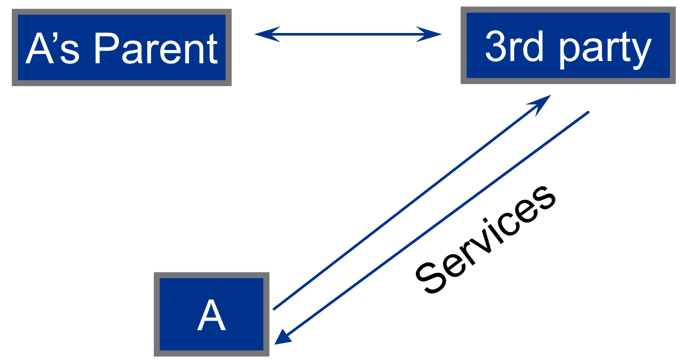
A transaction entered into by an enterprise with a person **other than** an associated enterprise shall, for the purposes of **sub-section (1)**, be deemed to be a transaction entered into between two associated enterprises, if

- there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or
- the terms of the relevant transaction are determined in substance between such other person and the associated enterprise

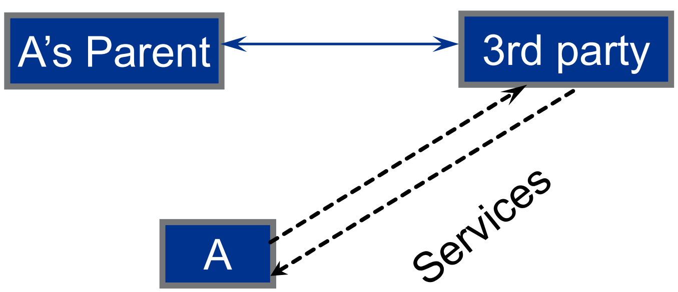
Section 92B – Deemed International Transaction … contd.

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

Prior agreement



Determination of terms

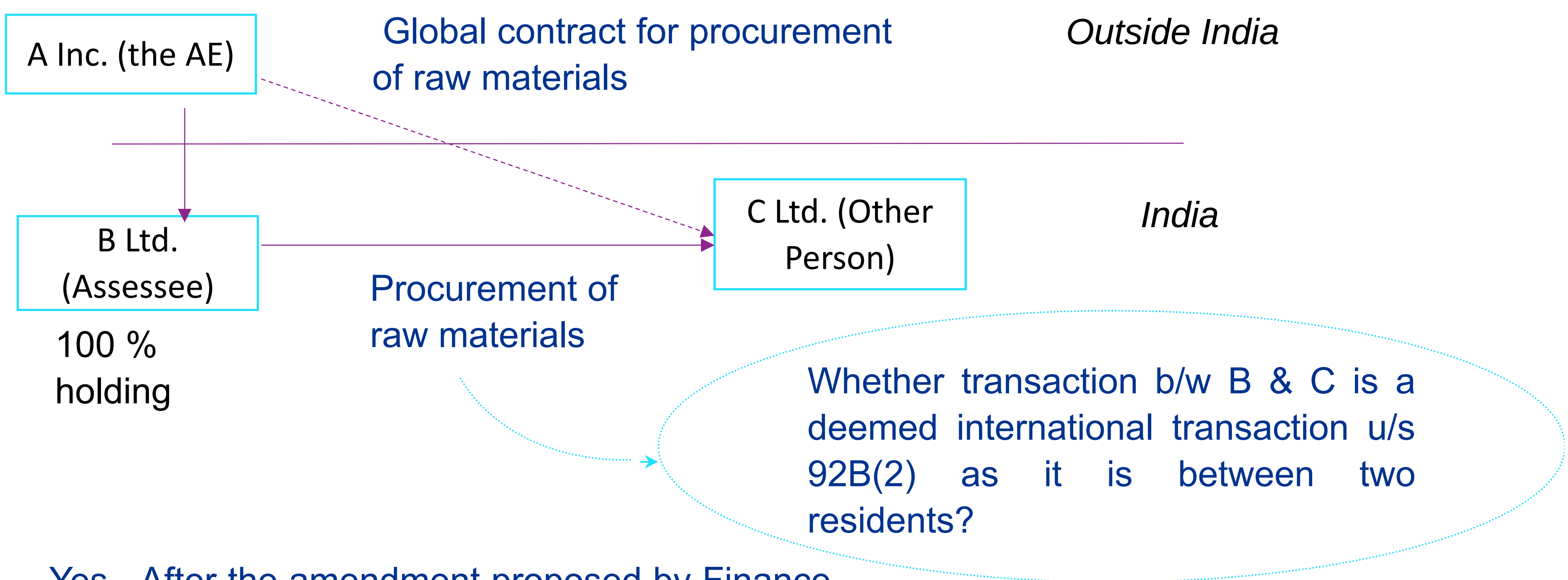


Transaction between A and Third party also subject to transfer pricing norms, if:

- a prior agreement exists between A's parent and Third party; or
- terms of transaction are determined in substance by A's parent and Third party

Section 92B – Deemed International Transaction … contd.

Whether transaction between 2 Residents a Deemed International transaction if 1 of them and a Non-Resident AE of the other have a prior Agreement?



Yes. After the amendment proposed by Finance Bill 2014 worded as "irrespective of whether such other person is a Non-resident or not", TP provisions apply even if it's a Resident third party.

Introduction of Range and Multiple Year Data

Range Concept

- Price / Margin range for determination of ALP to be introduced in the ITR
- Existing Arithmetic Mean would continue if number of comparables are “**inadequate**”
- Notification is pending

Allowability of multiple year data

- TPO’s approach to consider single year data highly debated in appellate authorities
- Alignment with International practices
- Legislative amendments expected

Update on the APA Program

- 378 applications filed in two years - 146 in the 1st year (117 Unilateral and 29 Bilateral) and 232 in the 2nd year (206 Unilateral and 32 Bilateral) – includes large MNCs and Fortune 100 companies; in the 3rd year the APA program has received a positive response with number of applications being filed;
- Companies whose APAs have been concluded are engaged in different industrial sectors including pharmaceuticals, telecom, exploration and financial services, contract manufacturing, professional and support services and IT/ITES services
- Discussions in the conferences comparable with international standards
- The APA team has been paying strong emphasis on first establishing and mutually agreeing on detailed FAR – logical and sensible approach
- Primary focus of APA teams is to reach consensus on Function Asset Risk (FAR) analysis for which site visits are planned
- Optional and 'Anonymous Pre-filing' – no downside
- Approach of the APA team thus far has been rational and pragmatic
- Roll back provisions to provide further impetus to the APA program since applicability to extend to the earlier four years.

9 Unilateral and 1 Bilateral APAs signed in record time as compared to international standards since the introduction of the Indian APA program…this reiterates the commitment of the Revenue authorities in making India a stable tax regime

Organization for Economic Co-operation and Development (OECD)

BEPS – Transfer Pricing Action Plans

Action 8

Transfer Pricing Aspects of intangibles

Transfer Pricing Aspects of Intangibles

- **Objective**
- Prevent BEPS that may result from abuse of TP rules related to cross-border relocation of intangibles and other transactions involving use of intangibles
- Ensure that transfer pricing outcomes are in line with 'Value Creation”

To be finalised in 2015 along with other BEPS action points that are closely related (risks and capital, high-risk transactions and hard to value intangibles)

Key areas covered in the Guidance

- Detailed guidance on location savings, assembled workforce and MNE group synergies as part of Chapter I of OECD guidelines
- Broader definition of intangible property (six specific categories of intangibles discussed)
- Ownership of intangibles and entitlement to returns – who is entitled to returns from intangibles
- Relevant considerations for various transactions involving intangibles
- Supplementary guidance around determining arm’s length conditions involving intangibles – considers unique features of intangible transactions

India Perspective

- **Location savings** – Even where local comparable are available, specific adjustment on account of location savings are required – view of Indian Revenue Authorities (IRA)
- **Marketing intangibles** – Marketer / distributor should be compensated for enhancing the value of trademarks and other marketing intangibles
- **R&D arrangements** – appropriate compensation for research services will depend on all the facts and circumstances (whether research team possesses unique skills and experience, bears risks, uses its own intangibles etc.)

Various issues included in the Guidance are contemporary, highly debated, and frequently litigated TP issues in India - Indian tax authorities are likely to draw inference and support from OECD guidelines in determining the return from intangibles

Delhi High Court decision to consider AMP expense as an international transaction. But AMP activity being closely linked to overall marketing and distribution, can be benchmarked on an aggregate basis.

Even before the introduction of the BEPS action plan the IRA authorities issued Circular no. 6 which discusses circumstances in which PSM will apply for determination of compensation in case of R&D centers developing intangibles.

India also adopts the 'Significant Peoples Function' as a criteria in allocation of profits relating to intangibles which is in line with OECDs guidance

What needs to be done : Companies operating in India need to analyze

- **Legal ownership** and **contractual arrangements** vis-à-vis intangibles to begin with
- As **next steps** more importantly focus has to be on **thorough analysis of FAR** and actual conduct of the various entities

Action 10

Intra-group services – Discussion Draft

Intra-group services – Discussion Draft

Objective

- Focus on developing rules to prevent BEPS through the use of transactions (management fees, head office expenses etc) which would not, or would only very rarely, occur between independent parties
- Revision of chapter VII of the OECD guidelines related to Intra-Group Services (IGS)
- Simplified approach suggested to deal with "low value-adding intra-group services (LVIGS)" – New section D proposed to be added to chapter VII

Key areas covered in the Draft guidance

- Determining whether intra-group services have been actually rendered. Focus areas – Benefit Test, Shareholder activities, Duplicative services and Agency services
- Determination of arm's length price – Direct charge methods vs. Indirect charge methods
- What constitutes LVIGS
- Clarifying the meaning of shareholder activities and duplicative costs in context of LVIGS
- Guidance on mark-ups, appropriate cost allocation methodologies, benefit tests and required documentation in context of LVIGS

Low value-adding Intra-group services – LVIGS

Definition

- Services of supportive nature and **not a part of core business of the Group***
- Do not require the **use of** or **lead to the creation of** valuable and unique intangibles
- No assumption, control or creation of substantial or significant risk
- It is pertinent to understand the nature of the services in order to classify them as LVIGS. The LVIGS should be supportive in nature and should not form part of the core business of the MNE group.

The following activities are likely to meet the definition of LVIGS	The following activities would not be considered LVIGS
Accounting and auditing	Services relating to the core business of the Group
Processing and management of account receivable and account payable	R & D , manufacturing and production services
Human resource related activities	Sales, marketing and distribution activities
Monitoring and compilation of data relating to – health, safety, environment etc	Financial transactions
Information technology services	Insurance and reinsurance
Internal and external communication and public support services	Extraction, exploration or processing of natural resources
Legal services / activities relating to tax obligations / general services of administrative or clerical nature	Services of corporate senior management

India Perspective

- The draft guidelines will enable the taxpayers and tax administrations to *focus their resources on high risk transactions* while they can adopt a standard norm for routine LVIGS .
- For a Captive Shared Service center, certain points such as nature of services outlined as ‘low value-adding’, manner of classifying core and non-core business activities, and proposed mark-up in the range in 2 per cent to 5 per cent etc. may be challenged by IRA
- MNCs need to take cognizance while planning the cross charge for services which might be routine i.e. low-value adding or high end.
- The adoption of *simplified approach* for LVIGS may be advantageous for both the taxpayers and tax administrations, as it not only reduces the compliance burden of the taxpayers but also reduces disputes between taxpayers and tax administration.

For Inbound IGS, it would be interesting to see how India adopts above Guidance, in light of the fact that IRA has been adopting aggressive approach in proposing adjustments and seeking voluminous documentation for such services

For Outbound IGS, it remains to be seen how India will adopt the above Guidance, once implemented given the fact that IRA has been claiming much higher markups compared to the recommended range of 2 to 5 percent for certain low end services

Action 13

Transfer Pricing Documentation and Country-by-Country (CbyC) reporting

TP documentation and CbyC report

Three-tier documentation structure proposed for all countries

Master file

- To provide the MNE's blueprint
  - The group's organisational structure
  - A description of the group's business, intangibles, intercompany financial activities, and financial and tax positions.

Local file

- To provide material transfer pricing positions of the local entity/taxpayer with its foreign affiliates
  - Demonstrates arm's length nature of transactions
  - Contains the comparable analysis.

Country by Country ('CbyC') Report

- To provide jurisdiction-wise information on global allocation of income, taxes paid/accrued, the stated capital, accumulated earnings, number of employees and tangible assets
- Entity-wise details of main business activities which will portray the value chain of inter-company transactions.

Implementation Guidelines on CbyC Template

On February 6, 2015, the OECD published guidance on the implementation of CbyC reporting.

Which MNEs are required to file a CbyC report	● MNEs with consolidated group revenue in the preceding fiscal year of 750 million Euros (INR 5250 crore) or more
Timing of CbyC report	● File for the fiscal years beginning on or after January 1, 2016 ● MNEs will be allowed one year from the fiscal year end to file the CbyC report
Where filed and mechanisms for exchange	● File CbyC report in the country of the ultimate parent of the MNE ● That country will exchange this information on an automatic basis with jurisdictions in which the MNE operates and that meet the necessary conditions described in guidance.
Necessary Conditions for Obtaining and Using CbyC Report	● Confidentiality, Consistency and Appropriate Use
Government-to-Government Mechanisms for Exchange of CbyC report	● Primary mechanism – automatic exchange from MNE parent country ● Secondary mechanism – MNE file the CbyC report locally or with next tier parent country that would automatically exchange
Implementation Package announced in June 2015	● Key elements of statutory legislation ● Agreements based on existing international agreements for the automatic exchange of the CbyC reports between jurisdictions (both bilateral and multilateral)

India Perspective

What needs to be done

- Companies operating in India especially Indian headquartered companies need to tie up the functional analysis of Indian operations vis-à-vis global operations
- Have Management discussions to re-align functions and pricing to ensure that profits/income are allocated in accordance with value creation in each jurisdiction
- Should analyse their internal accounting systems and MIS data, and upgrade the same to enable gathering of information required in Master File and CbyC report

Key Considerations:

- Mechanism for sharing information with tax administrations through Automatic Exchange of Information under tax treaties
- Taxpayers concerns about sharing business sensitive data and increasing compliance cost and burden
- CbyC report ought not be used by tax administrations to propose TP adjustments based on a global formulary apportionment of income
- However CbyC report would entitle the tax authorities to make further inquiries into the MNEs cross-border transactions

- **Indian Competent Authority commented* –** Indian Government expects that companies should provide information relating to CbyC reporting starting from FY 2016-2017

*** Minutes of Tax officers offsite organized by Ministry of Finance and CII's presentation at the meeting on 25 November 2014**

Necessary to highlight / action to be taken by the Company management / Audit Committee - implications and meeting the objective of Transparency of BEPS Project very important

Thank you

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