

Fundamentals/Principles of Transfer Pricing and substance in practice

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PART 1

01

Concept & Objectives

02

Evolution

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Indian TP Regulations – an overview

- Applicability
- Associated Enterprise
- International Transactions
- Specified Domestic Transaction

Objectives of Transfer Pricing

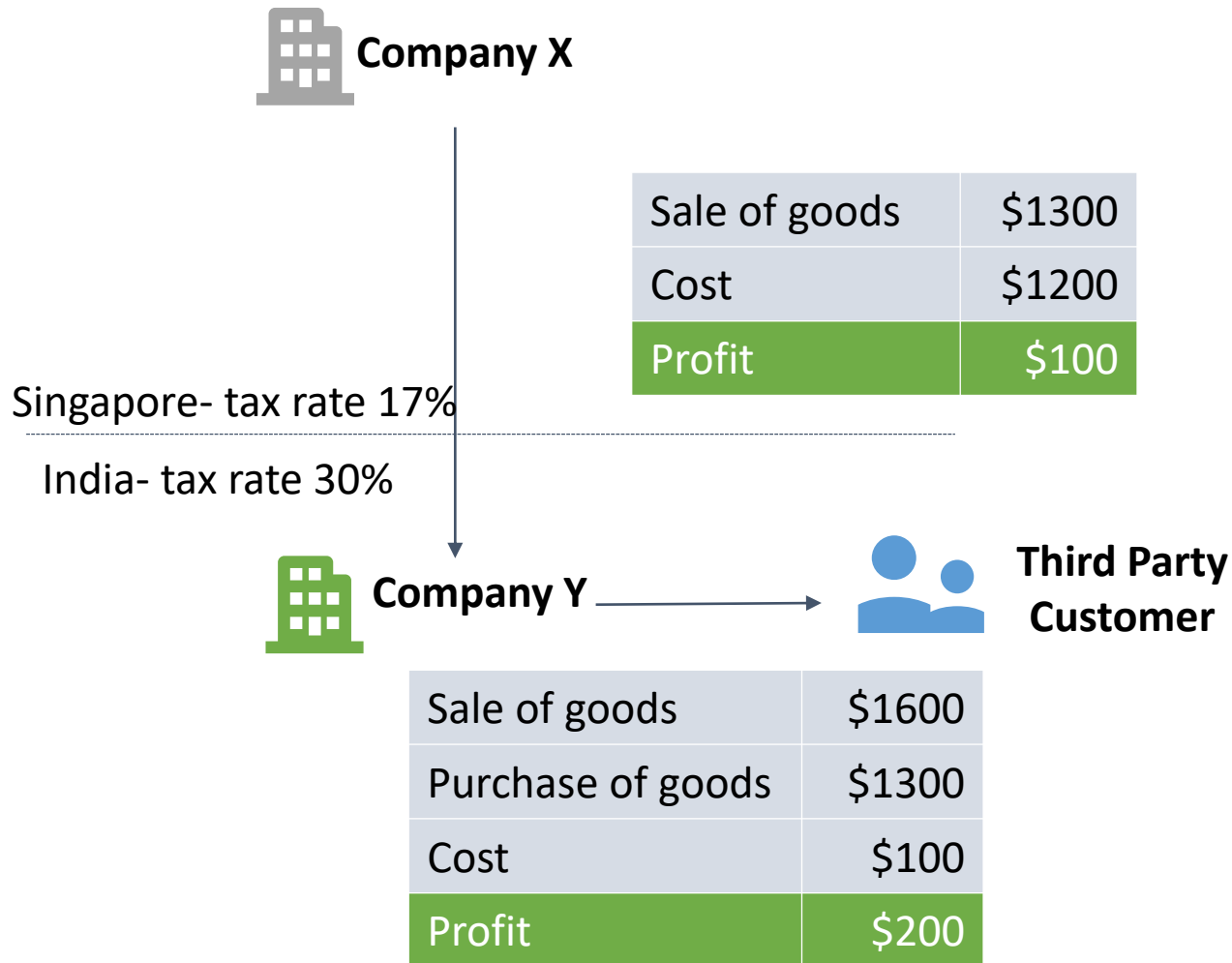
Protection of tax base

No Discrimination between MNE group and independent enterprises

Equitable sharing of tax revenues between the nations i.e. the residence and source countries

Check avoidance of taxes under opportunities of tax arbitrage for domestic transactions

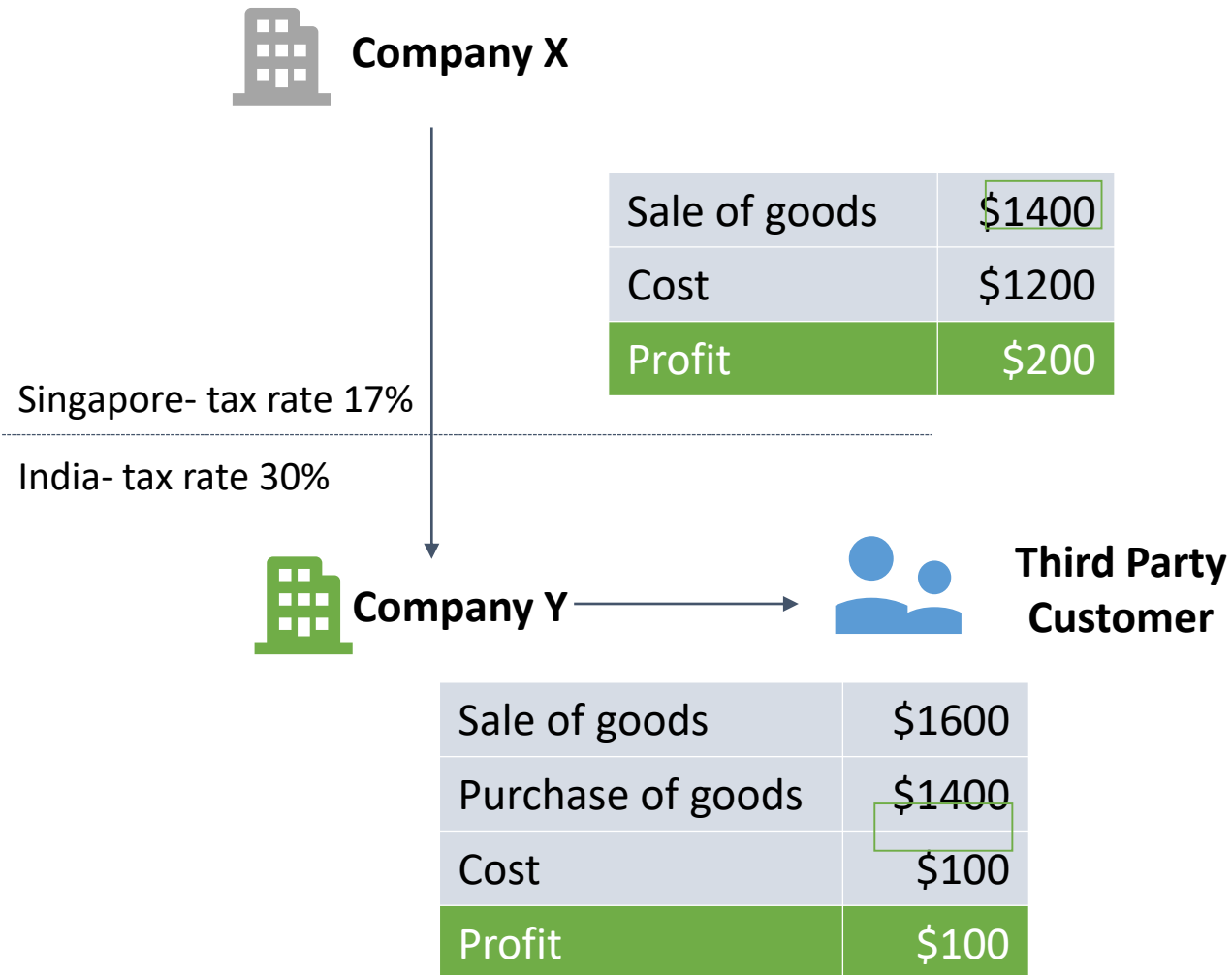
Let's understand: Scenario 1



Particulars	India
Selling Price to 3P customers in India	1,600
Selling cost of India	100
Cost of manufacture in Sgp	1,200
Total System Profits	300

Particulars	Singapore	India
Profit	100	200
Tax	17	60
Total tax	77	
Tax cost (%)	25.6%	

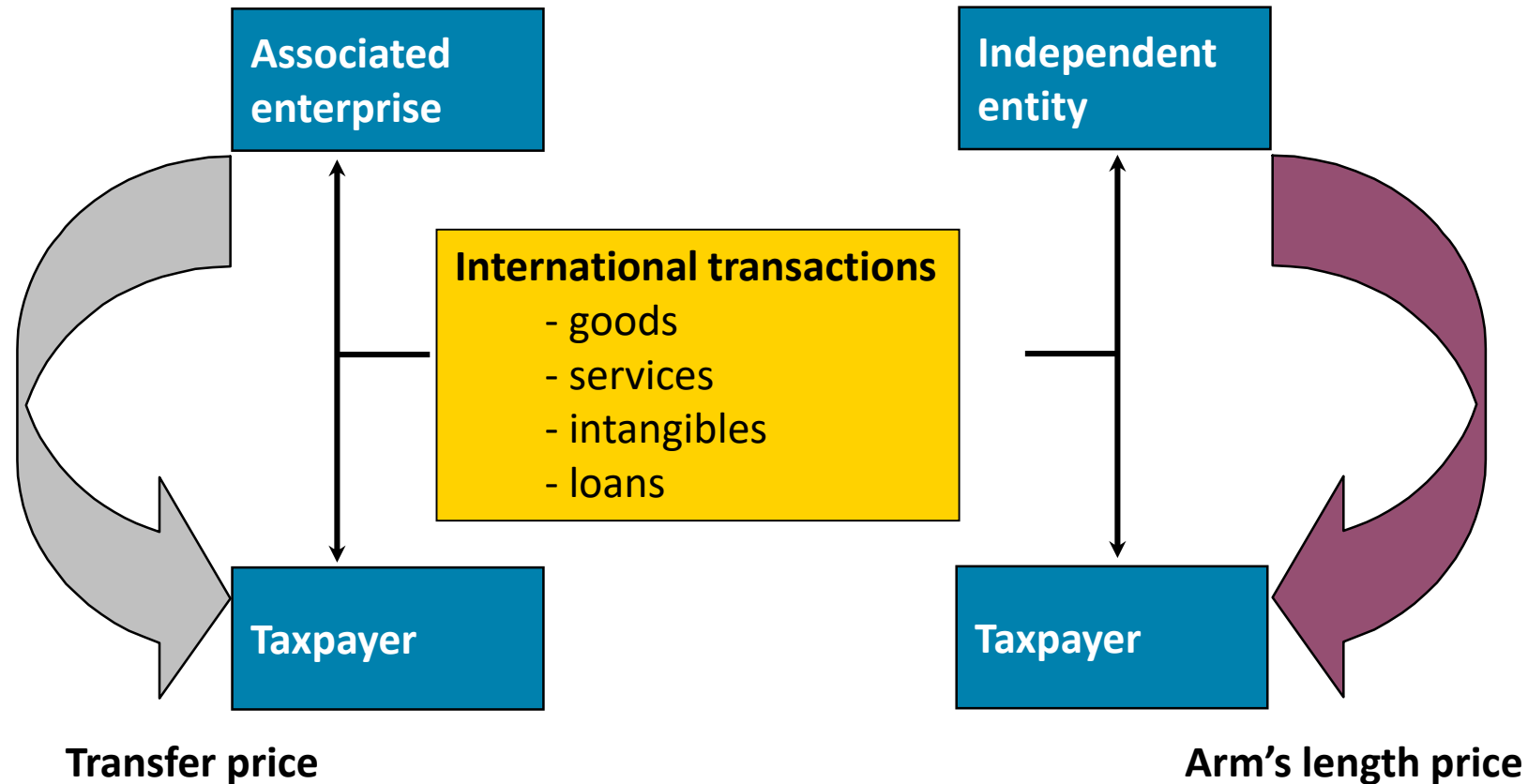
Let's understand: Scenario 2



Particulars	India
Selling Price to 3P customers in India	1,600
Selling cost of India	100
Cost of manufacture in Sgp	1,200
Total System Profits	300

Particulars	Singapore	India
Profit	200	100
Tax	34	30
Total tax	64	
Tax cost (%)	21.33%	

Concept of Transfer Pricing (TP)



1. "Arm's length price" means a **price** which is applied or proposed to be applied in a transaction between persons other than associated enterprises, **in uncontrolled conditions**
2. Transfer Price or Transfer Pricing is not defined

Post 2001 scenario of Transfer Pricing in India

Finance Act 2001 introduced TP Regulations

- The Memorandum stated that:
“The increasing participation of multinational groups in economic activities in the country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multinational group. The profits derived by such enterprises carrying on business in India can be controlled by the multinational group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues. With a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multinational enterprises, new provisions are proposed to be introduced in the Income Tax Act.”
 - Section 92 in the Act was substituted by eight sections in the Income Tax Act numbered 92, 92A, 92B, 92C, 92CA, 92D, 92E and 92F - to curb tax avoidance by abuse of transfer pricing.
 - Contents were explained in Explanatory Memorandum to the Finance Act, 2001
 - Circular 14, 2001 was issued to familiarize the taxpayers falling under the Transfer Pricing provisions apart from the Act and Rules
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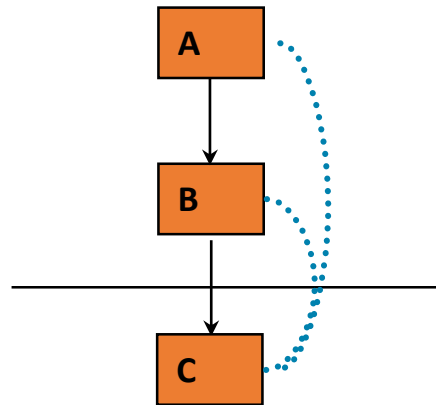
Indian Transfer Pricing Regulations

Sections	Provisions	Relevant Rules	
92	Computation of income having regard to ALP		
92A	Meaning of Associated Enterprise		
92B	Meaning of International transaction		
92BA	Meaning of specified domestic transactions		
92C	Computation of ALP	Rule 10AB, 10B , 10C, 10CA	Other method, Determination of ALP, MAM, Range working
92CA	Reference to Transfer Pricing Officer (TPO)		
92CB	Safe harbor rules	Rule 10TA, 10TB, 10TC, 10TD, 10TE, 10TF, 10TG, 10TH, 10THA, 10THB, 10THC, 10THD,	
92CC	Advance Pricing agreement	Rule 10F, 10G, 10H, 10I, 10J, 10K, 10L, 10M, 10MA, 10N, 10-O, 10P, 10Q,	
92CD	Effect of advance pricing agreement	10R,10RA, 10S, 10T	
92CE	Secondary Adjustment in certain cases	Rule 10CB	Computation of interest
92D	TP documentation & Master File	Rule 10D, 10DA	List of information for TPD and MF
92E	Accountant's Report in Form 3CEB	Rule 10E	
92F	Definitions	Rule 10A	Meaning of expressions for Rules 10AB to 10E
286	Country by Country reporting/ Intimations	Rule 10DB	

Applicability

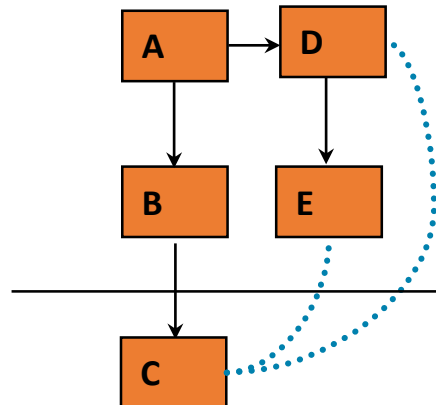
- The provisions of [Section 92 to 92F](#) of the Act are applicable only if:
 - There are two or more enterprises (defined in Sec 92F); and
 - The enterprises are [AEs](#) (defined in Sec 92A); and
 - The enterprises enter into a transaction (defined in Sec 92F); and
 - The transaction is an [International transaction](#) (defined in Sec 92B), includes deemed international transaction.
- Further w.e.f. 1 April 2012, TP provisions were extended to include specified domestic transactions (SDTs) also (defined in Sec 92BA).
- Consequences of these provisions:
 - Computation of [income/ allowance of expenses](#) having regard to the [Arm's length price](#) [Section 92C]
 - Maintenance of prescribed [Documentation](#) (Section 92D & Rule 10D)
 - Obtaining of [Accountant's report](#) (under Form 3CEB) (Section 92E) and filing the same within prescribed timeline
 - To ensure compliance with the arm's length principle, stiff [penalties](#) have been prescribed

Meaning of Associated Enterprises (Sec 92A)



Both A and B are associated enterprises of C

Direct or indirect participation (through one or more intermediaries) in **management or control or capital**



D and E are also associated enterprises of C since they have a common ultimate parent (A)

Deemed Associated enterprises (Sec 92A(2))

Holding	Management	Activities	Control
<p>1. $\geq 26\%$ direct / indirect holding by enterprise <u>OR</u></p> <p>2. By same person in each enterprise</p> <p>3. Loan $\geq 51\%$ of Total Assets</p> <p>4. Guarantees $\geq 10\%$ of debt</p> <p>5. $> 10\%$ interest in Firm / AOP / BOI</p>	<p>6. Appointment $> 50\%$ of Directors/one or more Executive Director by an enterprise <u>OR</u></p> <p>7. Appointment by same person in each enterprise</p>	<p>8. Wholly dependent on use of intangibles for manufacture / processing / business</p> <p>9. Direct / indirect supply of $\geq 90\%$ Raw Materials under influenced prices and conditions</p> <p>10. Sale under influenced prices and other conditions</p>	<p>11. One enterprise controlled by an individual and the other by himself or his relative or jointly</p> <p>12. One enterprise controlled by HUF and the other by</p> <ul style="list-style-type: none"> - a member of HUF - his relative or - Jointly by member and relative

13. Any relationship of mutual interest between two enterprises, as may be prescribed.

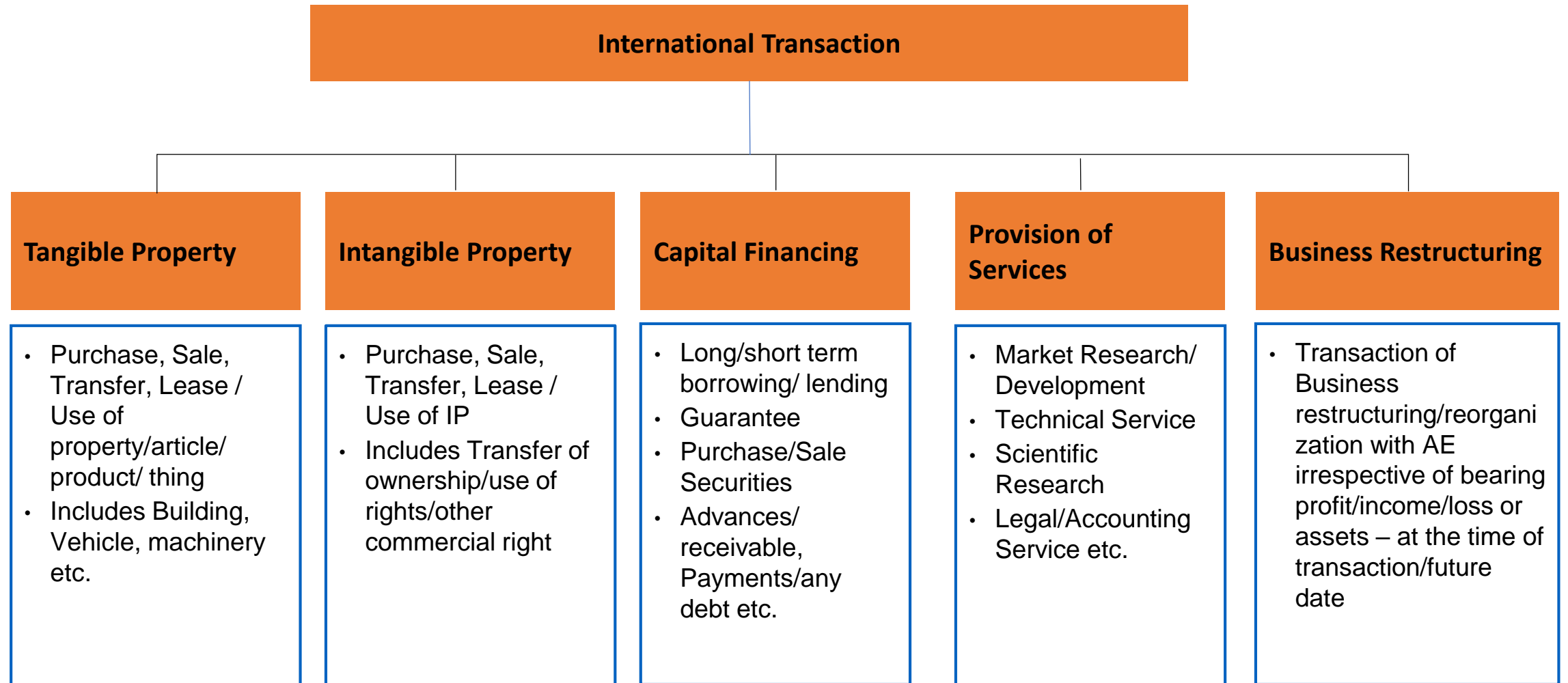
International transaction (Sec 92B)

- Transactions between two or more AEs, **either or both** of whom are non-residents
- Transaction relates to:
 - 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 the enterprises**; or
 - Mutual agreements or arrangements for allocation or apportionment of, or any contribution to, any cost or expense incurred

As per Section 92F(V):

- “transaction” includes an arrangement, understanding or action in concert –
 - (A) whether or not such arrangement, understanding or action is formal or in writing: or
 - (B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

Enhanced definition of International transaction (w.e.f. 1 April 2002)



CASE STUDY 1

Where an Indian company issues shares to its non-resident holding company at premium, will provisions of TP be applicable?

Is there are a requirement to disclose such transaction in Form 3CEB?

CASE STUDY 2

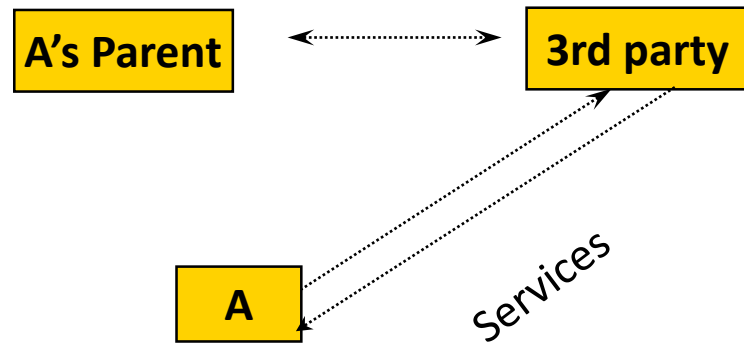
If a non-resident company holding shares of an Indian company sells the shares to its non-resident associated enterprise outside India, whether TP provisions would still apply?

Whether the price charged for such transfer would have to be justified using ALP?

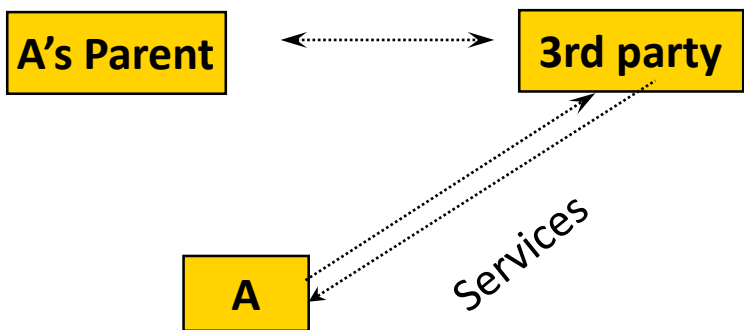
Whether both the companies would have to maintain documentation and also obtain an accountant's report?

Deemed international transaction- Sec 92B(2)

Prior agreement



Determination of terms



- For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase,.....
- 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 an international 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 **where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not.**

CASE STUDY 3

- F Co (non-resident) has two subsidiaries in India (I Co1 and I Co2). Accordingly, ICo1 and I Co2 are AEs.
- I Co1 propose to transfer one of its business undertakings to I Co2. There is an understanding or arrangement which I Co1 has with F Co regarding transfer of such business as well as the terms and conditions of transfer (including the sale consideration).
- Is TP applicable to this transaction?
- Whether Section 92B(2) is applicable to transaction between I CO1 and ICo2?

CASE STUDY 4

- I Co (resident of India) is a distributor of goods in India.
- I Co enters into an arrangement with a third party contract manufacturer in India for manufacture of goods and purchase.
- The terms and conditions of the agreement between I Co and third party contract manufacturers are determined in substance by F Co, a non-resident AE of I Co.
- Whether Section 92B(2) is applicable?

CASE STUDY 5

- F Co1 (non-resident) has a subsidiary I Co1 (resident) in India.
 - F Co2 (non-resident) has a subsidiary I Co2 (resident) in India.
 - F Co1 and F Co2 are different groups of MNCs and are not related.
 - Pursuant to agreement between F Co1 and F Co2, one of business divisions of F Co1 is agreed to be sold to F Co2 Group.
 - Consequently, it is agreed that the parallel division in I Co1 also would be sold to I Co2.
 - Is 92B(2) applicable?
-

Applicability of Section 92B(2)

Residential status of the Taxpayer	Residential status of the non AE with whom the transaction is being entered into	Residential status of the AE	Applicability of section 92B(2) to the transaction between the Taxpayer and the non AE which is being evaluated
Resident	Resident	Non-resident	?
Resident	Non-resident	Non-resident	?
Non-resident	Resident	Resident	?
Non-resident	Non-resident	Resident	?
Non-resident	Resident	Non-resident	?
Non-resident	Non-resident	Non-resident	?
Resident	Resident	Resident	?
Resident	Non-resident	Resident	?

Applicability of Section 92B(2)

Residential status of the Taxpayer	Residential status of the non AE with whom the transaction is being entered into	Residential status of the AE	Applicability of section 92B(2) to the transaction between the Taxpayer and the non AE which is being evaluated
Resident	Resident	Non-resident	YES
Resident	Non-resident	Non-resident	YES
Non-resident	Resident	Resident	YES
Non-resident	Non-resident	Resident	YES
Non-resident	Resident	Non-resident	YES
Non-resident	Non-resident	Non-resident	YES
Resident	Resident	Resident	NO
Resident	Non-resident	Resident	NO

Applicability (contd.)

- **Section 92(1)–**

Any income arising from an international transaction shall be computed having regard to the arm's length price.

Explanation - the allowance for any expense or interest arising from an international transaction shall also be determined having regard to the arm's length price

- **Section 92(3) –**

The provisions are not intended to be applied in case determination of arm's length price reduces the income chargeable to tax or increases the loss as the case may be

CASE STUDY 6

Where an Indian company issues shares to its non-resident holding company at premium, will provisions of TP be applicable?

CASE STUDY 7

If an Indian company purchases a capital asset from its non-resident associated enterprise, whether ALP will have to be justified for such transaction (since, in such case, no deduction for expenses is claimed by Indian company but only depreciation allowance would be claimed)?

CASE STUDY 8

US Co. provides some routine support services to I Co. US Co and I Co are Associated Enterprises.

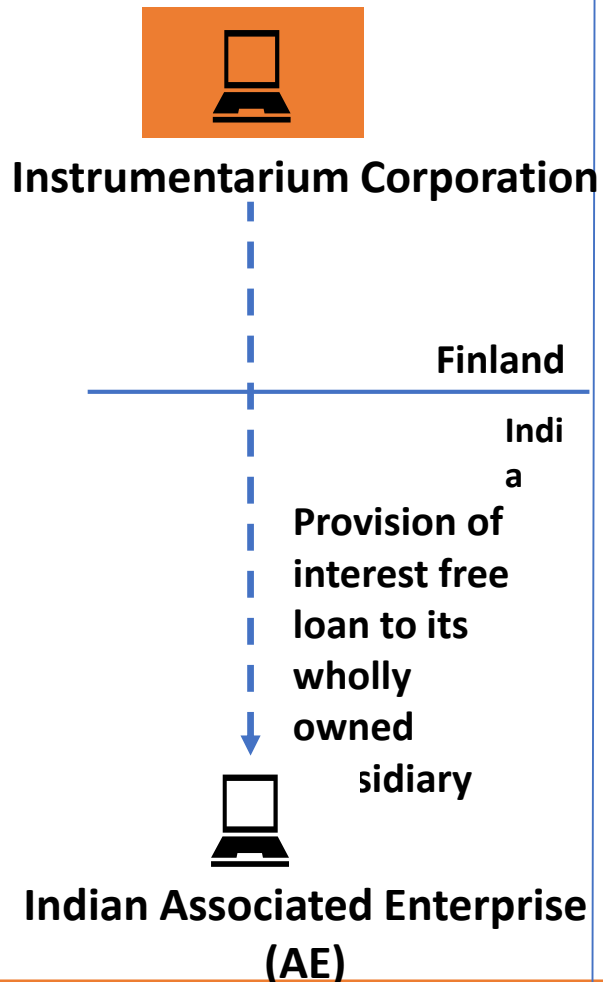
US Co. wants to know if the services should be charged to I Co. at cost or at ALP (i.e. Cost-plus mark-up in the hands of US Co.)?

CASE STUDY 9

F Co and I Co and Associated Enterprises. F Co licenses royalty free technology and manufacturing know-how to I Co. I Co commercially exploits the technology and know-how in the Indian market.

Please advice your client on the TP implications.

SB decision in the case of Instrumentarium Corporation Limited



- Instrumentarium Corporation Limited (Instrumentarium or the taxpayer), a company incorporated in Finland had advanced an interest free loan to its wholly owned subsidiary in India (Indian AE).
- The tax authorities made TP adjustment by determining arm's length interest on the loan.
- The taxpayer's argument
 - Relied on base erosion principles - section 92(3) of the Income Tax Act, 1961 (the Act); Circular Nos. 12 and 14 of 2001 issued by the Central Board of Direct Taxes (CBDT),
 - Arm's length interest charge would lead to erosion of tax base in India (tax benefit of 34% on interest expense deduction for the Indian AE *vis-à-vis* 10% taxation on interest income for tax payer)
 - Advancing interest free loan is shareholder's activity
 - TP provisions should not apply in the absence of income arising in the first place
- ITAT Special Bench ruled against the tax payer

Key observations of the SB

- Rejected taxpayer's reliance on **base erosion principles**:
 - As per section 92(3), the impact of profits or losses needs to be seen for the year under consideration and qua the taxpayer only.
 - In the absence of correlative relief, addition made to income of the non-resident taxpayer would not be available as a deduction to its Indian AE
 - “Base erosion theory” cannot be applied by merely comparing the nominal tax rates at which the income recipient and payer of the income are taxed.
 - Cannot overlook the “tax shield” which is available to the taxpayer (in the facts of the case the Indian AE had carry-over losses;).
 - Role of ‘intent of legislature’ comes into play only when there is any ambiguity in the words of the statute. Since, there was no ambiguity in the provisions of section 92(3), the intent of introducing transfer pricing provisions was not relevant.
 - Argument of shareholder's was not upheld as in the facts of the case, the tax payer had been paying interest during earlier years when profitable
 - Zero interest is not “no income” – there is a charge applicable and hence, section 92(1) being computational provisions shall be applicable.
-

Specified Domestic Transaction – Sec 92BA

- Scope of TP provisions expanded w.e.f AY 2013-14 by including “SDT” if aggregate value of such transaction exceeds INR 50 Million (5 Crores) – Finance Act 2012; Threshold increased to INR 20 crores w.e.f AY 2016-17 – Finance Act 2015
- Applicability of TP regulations (including procedural and penalty provisions) to specified transactions between domestic related parties and payments made to related parties.
- All provisions applicable for determination of ALP for international transactions would apply in case of SDT also. Also penal provisions applicable to international transactions would apply to SDT

Specified Domestic Transaction – Sec 92BA

- “**Specified Domestic Transactions** “ in case of an assessee means any of the following transactions , **not being an international transaction** , namely -
 - Any expenditure in respect of which payment is made or to be made to a person u/s 40A(2)(b) ;
 - Any transaction referred u/s 80A ;
 - Any transfer of goods/services u/s 80-IA (8);
 - Any business transaction u/s 80-IA(10) ;
 - Any transaction under Chapter VI-A or u/s 10AA – to which provisions of Sec 80-IA (8) or (10) applies ;
 - Any business transaction between the persons referred to in sub-section (6) of section 115BAB* ;
 - Any other transaction as may be prescribed.
- Omission of applicability of SDT to persons referred to in section 40A(2) w.e.f. AY 2017-18 – Finance Act 2017
 - Had the impact of coverage of remuneration to Key Managerial Personnel !!!

* *Section 115BAB(6) – New manufacturing domestic company and any other person*

PART 2

Transfer Pricing Documentation

Accountants Report

Master File and CbC Reporting

Domestic Litigation

Safe Harbour

Advance Pricing Mechanism

Mutual Agreement Procedure

Secondary adjustments

Limitation on interest deduction

Penalties

Transfer Pricing Documentation

- Detailed documentation not required in case aggregate transaction value is less than Rs. 1 Crore
- Detailed documentation is required to be maintained in case the aggregate value of specified domestic transactions exceeds INR 20 crores
- Contemporaneous data requirements
- Documentation to be maintained as of the specified date – One month prior to the due date for furnishing the return of income under sub-section (1) of section 139 for the relevant assessment year

Transfer Pricing Documentation

A detailed list of mandatory documents are given in Rule 10D(1) of the Rules.

- Ownership Structure
 - Profile of multinational group
 - Business description/ Profile of industry
 - Nature and terms (including price) of international transactions
 - Description of functions performed, risk assumed and assets employed(functional analysis)
 - Records of economic and market analysis (economic analysis)
 - Record of budgets, forecasts, financial estimates
 - Any other record of analysis (if, any) to evaluate comparability of international transaction with uncontrolled transaction(s)
 - Description of method considered with reasons of rejection of other methods
 - Details of transfer pricing adjustment(s) made (if any)
 - Any other information e.g. data, documents like invoices, agreements, price related correspondence etc.
-
- The diagram shows three categories of documentation on the right, each in a colored box with a bracket pointing to the corresponding items in the list:
- Entity Related** (Dark Blue box): Includes Ownership Structure, Profile of multinational group, and Business description/ Profile of industry.
 - Price Related** (Red box): Includes Nature and terms (including price) of international transactions, Description of functions performed, risk assumed and assets employed(functional analysis), Records of economic and market analysis (economic analysis), Record of budgets, forecasts, financial estimates, Any other record of analysis (if, any) to evaluate comparability of international transaction with uncontrolled transaction(s), and Description of method considered with reasons of rejection of other methods.
 - Transaction Related** (Green box): Includes Details of transfer pricing adjustment(s) made (if any) and Any other information e.g. data, documents like invoices, agreements, price related correspondence etc.

Accountant's report (Form 3CEB) - Rule 10E

- Obtained by every tax payer filing a return in India and having international transaction or SDT
- To be filed by due date for filing return of income
- Essentially comments on the following:
 - whether the tax payer has maintained the **transfer pricing documentation** as required by the legislation,
 - whether as per the transfer pricing documentation the prices of international transactions are **at arm's length**, and
 - certifies the value of the international transactions as per the books of account and as per the transfer pricing documentation are **"true and correct"**

TP documentation framework in India

CBC REPORT

- Who has to file CbC report in India? Parent entity resident in India
 - Alternate reporting entity (ARE) if it is resident in India
 - Indian affiliate of an MNC group, in certain exceptional cases
 - Indian affiliate to notify tax authority on parent entity/ARE that would be filing the CbC report on behalf of the Group

MASTER FILE

- Indian affiliates of an international group to maintain prescribed information if specified threshold is exceeded
- Rules introduced to prescribe additional information/ documents in line with Action 13

LOCAL FILE

- Current Indian TP rules prescribe maintenance of contemporaneous TP documentation
 - Includes information about the local business, including details on intercompany transactions
-

TP Documentation: Section 92D(1)(i)/Rule 10D

Enterprise Centric documents	Transaction Specific Documents	Computation and connected Documents
Ownership details [10D(1)(a)]	Terms of International Transaction [10D(1)(d)]	Analysis of methods used for determining ALP [10D(1)(i)]
Profile of the multinational group [10D(1)(b)]	FAR Analysis (Functions, Assets and Risks Analysis) [10D(1)(e)]	Workings for determining ALP [10D(1)(j)]
Business profile of taxpayer and AE [10D(1)(c)]	Economic and Market Analysis [10D(1)(f)]	Assumptions, policies and Price Negotiations [10D(1)(k)]
	Record of Uncontrolled Transactions [10D(1)(g)]	Adjustment details [10D(1)(l)]
	Evaluation of comparability [10D(1)(h)]	Any other information [10D(1)(m)]

- Contemporaneous documentation requirement – Rule 10D
- Documentation to be kept and maintained for 8 years from the end of the relevant assessment year.
- No specific documentation requirement if the value of the international transaction is less than **one crore rupees**.

LOCAL FILE

BEPS ACTION 13 vs. INDIA Rule 10D DOCUMENTATION

RULE 10D DOCUMENTS

- Group overview and Ownership structure
- Business and industry overview
- Selection of most appropriate TP method
- Description of controlled transactions
- Functional analysis
- Comparable transactions or companies
- Economic analysis
- Supporting documents

LOCAL FILE

- Organizational structure
 - Detailed business strategy
 - Competitors
 - Controlled transactions
 - Intercompany payments and receipts
 - Associated enterprises
 - Intercompany agreements
 - Detailed comparability and functional analysis
 - TP method selected
 - Tested party
 - Assumptions applying TP method
 - Explanation of multiyear analysis
 - Comparable transactions or companies search and financials
 - Comparability adjustments
 - Conclusions
 - TP method financial information
 - Copy of APAs and tax rulings
-

Master File Requirements: Section 92D(1)(ii)/Rule 10DA

Entity responsible	Filing obligation	Threshold for applicability	Due date
Constituent entity (CE)	Master file to be filed in Form 3CEAA	Part A of Form 3CEAA — General information for all constituent entities	<u>Form 3CEAA</u> Filing of the return of income as per section 139 (1) of the Act.
Designated CE	Notification report to be filed to designate a CE in Form 3CEAB and Master file to be filed in Form 3CEAA	Part B of Form 3CEAA — Consolidated group revenue of INR 500 crore and (i) Aggregate value of international transaction exceeds <u>INR 50 crore</u> or (ii) Value of purchase, sale, transfer etc. of intangible property exceeds <u>INR 10 crore</u>	<u>Form 3CEAB</u> 30 days before the due date for filing Form 3CEAA

Contents Of Master File

Organization structure	Business description	Intangibles	Intercompany financial activities	Financial and tax positions
<p>Structure chart:</p> <ul style="list-style-type: none">• List of all the operating entities along with their addresses• Legal status and ownership	<ul style="list-style-type: none">• Nature of business• Important drivers of business profit• Supply chain of:<ul style="list-style-type: none">• Five largest products/services by turnover• Products/services generating more than 5% of group sales• Main geographic markets for the products/services• Description of important service arrangements along with their capabilities• Functional analysis of the entities that contribute at least 10% of the revenue, asset and profit of the MNE group• TP policy for service cost allocation and pricing intra-group services• Business restructuring/acquisitions/divestments during the financial year	<ul style="list-style-type: none">• Overall strategy description• List of entities (with address) engaged in development and management of intangibles• List of important intangibles and legal owners• List of important intangible/cost contribution/research /license agreements• TP policy for R&D and intangible• Details of important transfers	<ul style="list-style-type: none">• Financing arrangements of the group, including names and address of top 10 unrelated lenders• List of entities providing central financing functions with address of operation and effective management• Details of financial TP policies <p>Note: Departure/ additional information <i>vis-à-vis</i> BEPS Action 13 requirement</p>	<ul style="list-style-type: none">• Annual consolidated financial statements• List and description of existing unilateral advance pricing agreements (APAs) and other tax rulings

Master File information and risk assessment

- A master file provides the tax administrations with high-level information on the global business operations and TP policies of an MNE.
 - The master file differs from typical current documentation standards as it has a global scope and should provide an overview of the global value chain.
 - Possible use of master file information during audits by tax authorities
 - Supply chain: Re-invoicing companies
 - Service arrangements: Place of effective management (PoEM)
 - Geographic markets: Main markets and General Anti-Avoidance Rules (GAAR) type legislation
 - Business restructuring: Exit tax
 - FAR analysis: Action 9 and contractual allocation of risk
 - List of entities engaged in development and management of intangibles: Return based on function
 - List of agreement on intangibles: Cost contribution arrangements (CCA)/Royalty payment
 - TP policy on intangibles: R&D policy and R&D credits
 - Intercompany financial arrangement and treasury function: Profits belong to entity undertaking decisions
-

Section 286 – CbC Reporting and applicability

- Who has to file CbC report in India?
 - Parent entity resident in India
 - Alternate reporting entity (ARE) if it is resident in India
 - Indian affiliate of an MNC group, in certain exceptional cases
 - Indian affiliate to notify tax authority on parent entity/ARE that would be filing the CbC report on behalf of the Group
 - Applicability - Total consolidated group revenue as reflected in the consolidated financial statements for the preceding accounting year exceeds INR 5,500 crores.
 - Where the consolidated revenue is reflected in foreign currency, the exchange rate shall be the TT buying rate of such currency on the last day of the preceding the accounting year.
 - Information in the CbC Report shall include:
 - Amount of revenue, profit or loss before income-tax, income-tax paid, income-tax accrued, stated capital, accumulated earnings, number of employees and tangible assets (other than cash or cash equivalents), for each country or territory
 - Details of each constituent entity
 - Nature and details of the main business activity or activities of each constituent entity; and
 - any other information as may be prescribed
-

SECTION 286 – CbC Reporting and applicability

- Exceptional cases requiring CbC filing by CE [**Section 286(4)**]
 - Parent entity not obliged to file the Cbc report; or
 - India does not have an agreement providing for exchange of the report; or
 - There is a systemic failure and the said failure has been intimated by the prescribed authority to such CE.
 - Exceptional cases requiring CE filing (above) does not apply if ARE has furnished the CbC report and the following conditions are satisfied, namely:—
 - the report is required to be furnished under the law for the time being in force in the said country or territory;
 - the said country or territory has entered into an agreement with India providing for exchange of the said report;
 - the prescribed authority has not conveyed any systemic failure in respect of the said country or territory to any constituent entity of the group that is resident in India;
 - the said country or territory has been informed in writing by the CE that it is the alternate reporting entity on behalf of the international group; and
 - Appropriate intimations made to the Indian prescribed authority.
 - Following terms defined – (i) Accounting year; (ii) Agreement; (iii) Alternate Reporting Entity; (iv) Constituent Entity; (v) Group; (vi) Consolidated Financial Statements; (vii) International Group; (viii) Parent Entity; (ix) Permanent Establishment; (x) Reporting Accounting Year; (xi) Reporting Entity; (xii) Systemic failure
-

CBC Reporting/ Compliance Obligations

S.No	Filing obligation	Contents of the Form	Accounting period	Due date (As per current Rules)
1.	Form 3CEAC	Intimate (i) it is ARE; or (ii) details of Parent or ARE	Applicable accounting year for financial statements	2 months prior to due date for filing Form 3CEAD
2.	Form 3CEAD	CbC Reporting	Applicable accounting year for financial statements	12 months from the end of the relevant reporting accounting year*
3.	Form 3CEAE	Notify details of designated entity in India	NA	No due date specified

FORM 3CEAC - Intimation

- CE, being resident in India, designated as the ARE
- CE, being resident in India, Parent is not resident in India
 - S-286(4) conditions not triggered
 - S-286(4) conditions triggered but Group has designated another ARE [which satisfies S-286(5)]

FORM 3CEAD – CbC report

- Ultimate Parent Company, being resident in India
- CE, being resident in India, designated as the ARE
- Conditions in S-286(4) triggered and no ARE is designated.

FORM 3CEAE - Designation

- Conditions in S-286(4) triggered; no ARE is designated and there are more than one CE in India

- * In case of systemic failure, shall be reduced by 6 months from the end of the month in which said systemic failure has been intimated

Form 3CEAD – Country-by-Country Report

Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organization or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)													
			Research & Development	Holding or managing IP	Purchasing or Procurement	Mfg or production	Sales, marketing or distri.	Admin., Mgmt or support services	Provision of services to unrelated parties	Internal group finance	Regulated financial services	Insurance	Holding shares or other equity instruments	Dormant	Other	

- Specify nature of the activity in the 'Additional Information' section, if 'Other' is chosen
- **Table 3 (Additional Information)** requires to include any further information or explanation that is considered necessary or that would facilitate the understanding of the compulsory information provided in the CBCR

Use of CbC - CBDT Instructions

- On 27th June, 2018 vide Instruction No.2/2018, CBDT provided guidance on appropriate use of CbC Reports
 - **Access to CBC Reports:**
 - All CbC Reports shall be primarily accessed by Competent Authority of India and DGRA.
 - In case where any CE is selected for scrutiny, the jurisdictional TPO will have access .
 - To safeguard use of information, standard operating procedure will be formulated by CRAU of DGRA.
 - **Appropriate Use of the CbC Reports:**
 - TPO can use the CbC Reports information primarily for the following three purposes:
 - High Level TP risks assessment – In case CbC Report indicates any potential risks on TP arrangement, the reports may be used for planning a tax audit of Indian taxpayer for relevant assessment year.
 - Assessment of other BEPS related risks – Detailed enquiry to be conducted during assessment to examine possible tax risks unrelated to TP .
 - Economic and Statistical Analysis – CbC reports may be used for economic and statistical Analysis, in terms of understanding its use, identifying features , use and risk of the report and tax system , in consistency with provisions of tax treaties.
-

Use of CbC - CBDT Instructions

- **Inappropriate Use of CbC Reports** – Use of CbC Report will be considered inappropriate in following two situations:
 - If information is used as a substitute for a detailed TP analysis of international transactions and determination of arm's length price based on a detailed functional and comparability analysis; and
 - If the information is used as the only evidence to propose a TP adjustment
 - **Confidentiality of the CbC Reports** –
 - Any report received through exchange of information or under Section 286(2) or 286(4) are subject to requirement of tax treaties.
 - Hence, all the officers who handle the reports are directed to strictly follow the detailed guidelines on maintaining confidentiality in Chapter VII of Manual on Exchange of Information.
 - **Monitoring, control and review**
 - Use of CbC Report information by the TPO shall be monitored by jurisdictional CIT(TP) and breach be informed to Competent Authority.
 - Any concern raised by taxpayer on inappropriate use of information, shall be reported by TPO to jurisdictional CIT(TP).
 - Adjustment made based on inappropriate use to be conceded by Competent Authority of India.
 - Use of information shall be regularly reviewed by CBDT through Competent Authority of India.
-

BEPS Action 13 in Indian context

- Finance Act, 2016 amended the Income-tax Act, 1961 ('the Act') to introduce provisions for additional TP documentation and CbC reporting. To be applicable w.e.f. 1 April 2017.
- **Section 92D** amended to provide for :
 - the keeping and maintaining of the master file by every constituent entity ('CE') of an international group
 - CE to furnish the above information and documents to the prescribed authority (under new section 286) in the prescribed forms; Amendment vide Finance Act 2019.
- New Section 286 introduced to cast CbC reporting and furnishing requirements on Parent entity/ Alternate Reporting Entity/ Constituent Entity (CE)
- **CBDT notified the final Rules for CbC report and master file on 31 October 2017**
- These are largely in line with the OECD's final report on Action 13, with minor deviations

BEPS Action 13 – An overview

- Action 13 is designed to increase transparency by providing tax authorities with sufficient information to allow them to conduct transfer pricing risk assessments and consider whether groups have engaged in BEPS-type activities.
- It requires companies to use a consistent three-tier framework for providing information on global allocation of income, economic activity and intercompany pricing across all of a company's global operations.
- CbC reporting applies to multinational enterprises.

Master file

High-level information about the MNE's business, transfer pricing policies and agreements with tax authorities in a single document available to all tax authorities where the MNE has operations

Local file

Detailed information about the local business, including related-party payments and receipts for products, services, royalties, interest, etc.

CbC report

High-level information about the jurisdictional allocation of profits, revenues, employees and assets

Litigation process – an overview



*If the case is remanded, then the over-all time limit may increase accordingly



Alternate Dispute Resolution Mechanism – (i) Safe Harbour; (ii) Advance Pricing Agreement, (iii) Mutual Agreement Procedure

Indian Safe Harbor Rules

- Safe Harbour – Defined as circumstances in which Tax Authorities shall accept the transfer price or income deemed to accrue or arise u/s 9(1)(i), as the case may be, declared by the Taxpayer
- Safe harbour applicable to international transactions at the option of the Taxpayer or income referred to in section 9(1)(i), i.e., through or from any business connection in India, property in India, asset or source of income in India or through the transfer of a capital asset situated in India.
- Ineligible taxpayers - International transaction with AE located in;
 - Country or territory notified under section 94A or
 - No tax or low tax country or territory i.e. income tax rate less than 15%

Indian Safe Harbor Rules

- Taxpayers can opt to apply safe harbour rules *inter-alia* for the following international transactions:
 - a) Provision of software development services / ITeS / Knowledge Process Outsourcing (KPO) services **with insignificant risk**
 - b) Provision of contract R&D services relating to IT / generic pharmaceutical drugs **with insignificant risk**
 - c) Intra group loan **to non-resident wholly owned subsidiaries**
 - d) Provision of explicit corporate guarantee **to loans taken by non-resident wholly owned subsidiaries**
 - e) Manufacture and export of core and non-core auto components where at least 90% of sale is to OEM
 - f) Receipt of intra-group **low value added services**
- First set of Rules applied to AY 2013-14 and four AYs immediately following it
- Amended Rules applicable from AY 2017-18 and two AYs immediately following it.
- Also applicable to certain specified domestic transactions
- **Budget Amendment: the Provisions of Safe Harbor Rules and Advance Pricing Agreement shall now apply also for determination of income attributable to the operations carried out in India by a non-resident.**

Advance Pricing Agreement (APA)

- CBDT empowered, with effect from 1.07.2012 to enter into APA with any person in relation to an international transaction for determining ALP or specifying the manner of determining income referred to in section 9(1)(i)
 - As per method referred in S. 92C or the method provided by rules made under this Act
 - With such adjustments or variations as may be necessary/expedient
 - The agreement shall be valid for period not exceeding five consecutive previous years; Roll back permissible for 4 prior years.
 - APA is binding on the concerned person and the tax authorities provided there is no change in law or no change in facts
 - With approval of Central Government, APA can be regarded as void ab initio (as if the agreement was never entered into) if obtained by fraud or misrepresentation of facts
 - CBDT given the powers to prescribe a scheme specifying the manner, form, procedure and any other matters in respect of APA [Rule 10F to Rule 10T]
 - Taxpayer to furnish modified return, limited to the impact of APA, within 3 months of date of APA, including for years for which assessments have been completed.
 - Taxpayer may be disentitled to claim the impact of APA in the event of delay in submission of modified return
-

Mutual Agreement Procedure - An Overview

- MAP is an alternate mechanism incorporated into tax treaties for the resolution of international tax disputes
 - MAP and domestic tax law appeals are mutually exclusive. MAP is therefore an alternative to or in addition to the domestic tax law appeal process
 - Scope limited to issues pertaining to tax treaties (including TP) and does not extend to domestic tax laws
- Resolution of disputes through intervention of Competent Authorities (CAs) of each state who evolve a mutually acceptable solution
 - Possibility of dispute resolution through a negotiated settlement
- Relief through MAP possible regardless of remedies available under domestic tax laws
- Issues which can be resolved through MAP
 - Disputes where taxpayer contends that he is being taxed in a manner not in accordance with the tax treaty
 - Issues relating to interpretation of terms appearing in the tax treaty
 - Elimination of double taxation in cases not covered by tax treaties

Mutual Agreement Procedure - An Overview

- Article 9(2) of the OECD Model Tax Convention prescribes corresponding adjustment for transfer disputes and use of MAP process for the same.
- The Indian Government had previously denied access to MAPs for TP disputes and bilateral APAs(BAPAs) in the absence of Article 9(2) in the tax treaty, resulting in no access to MAPs for TP disputes and BAPAs to taxpayers located in some of India's larger trading partner companies, such as France, Germany and Italy.
- A press release was issued on 27 November 2017 by the Indian Government, allowing, for the first time, MAPs for TP disputes and bilateral APAs with Germany, France and Italy, among other countries.
- Multilateral Instrument (MLI) clarifies this position as minimum standard in tax treaties

SECONDARY ADJUSTMENTS w.e.f 1 April 2018 [FA 2017]

Secondary Adjustments

- Adjustment in the books of accounts of the Assessee and its AE:
 - to reflect that actual allocation of profits between the Assessee and its AE are consistent with the transfer price determined as a result of primary adjustment
- thereby removing the imbalance between cash account and actual profit of the Assessee

Scenarios

- Where a primary adjustment in TP is made in excess of INR 1 crore in the hands of an Indian taxpayer, in any of the following situations:
 - suo-moto by the taxpayer in the return of income
 - by the AO in assessment and accepted by the taxpayer
 - APA
 - Safe Harbor Rules
 - MAP settlement.
- Under any of the above situations, the excess money available with the AE would need to be repatriated to India by the AE within a time limit to be duly prescribed
- Not applicable to Primary adjustment made in respect of AY 2016-17 or before

Consequences of non-repatriation of funds by AE

- Such funds would be deemed to be an advance made by the taxpayer to such foreign AE
- The interest thereon shall be computed in a manner to prescribed [Rule 10CB]
- Such interest will be taxed in the hands of the taxpayer
- FA 2019 Amendments:
 - Excess money may be repatriated by any AE
 - Where excess money not repatriated, additional income tax at 18% may be paid

THIN CAPITALISATION

Applicability

- An Indian company or a PE of a foreign company being the borrower who pays interest exceeding INR 1 crore in respect of any debt issued or guaranteed by a non-resident AE
- Also covers
 - Implicit/explicit guarantee provided by AE in relation to third party loans; or
 - AE depositing a corresponding and matching amount of funds with the third party lender
- Not Applicable for Assessee engaged in banking/insurance business

Allowability

- Interest expenses to be allowed as deduction, shall be lower of the following:
 - 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA); or
 - interest paid/ payable to AE
- Allows for carry forward of disallowed interest for a period of 8 AYs immediately succeeding relevant AY

Budget Amendment – Sub-section (1A) u/s 94B inserted so as to provide that provisions of interest limitations would not apply to interest paid in respect of debt issued by a lender which is a PE in India of a non-resident engaged in the business of banking. [Effective from April 1, 2021]

TP Penalties-Section 271

Default	Penalty
Furnishing of incorrect information in any report or certificate furnished by an accountant or a merchant banker or a registered valuer → u/s 271J	Rs. 10,000 for each report or certificate to be paid by the issuer of certificate
Post-inquiry adjustment (deemed concealment of income) → u/s 270A*	<ul style="list-style-type: none">▶ No penalty, where transfer pricing documentation maintained, transaction declared and material facts disclosed▶ Penalty at 50% of tax on transfer pricing adjustment, where transfer pricing documentation not maintained▶ Penalty at 200% of tax on transfer pricing adjustment, where the TP adjustment is in consequence of not reporting an international transaction.

*Amended as notified by Finance Act 2016, w.e.f from 1 April, 2017

TP Penalties-Section 271

Default	Penalty
Failure to maintain information or documents / Fails to report transactions / Maintains or furnishes an incorrect information or documents → u/s 271AA	2% of the transaction value
Failure to furnish information or documents → u/s 271G	2% of the transaction value
Failure to furnish accountants report → u/s 271BA	Rs 100,000

Consequences of non-compliance

Particulars	Penalties
Not maintaining and filing the required information in the master file within the due date	INR500,000
Non-filing of CbC report by Indian resident parent company/ARE	<ul style="list-style-type: none">• INR5,000 per day up to one month• INR15,000 per day beyond one month• INR50,000 per day for continuing default after service of notice
Not furnishing the information called for by the tax authority within the given time limit	<ul style="list-style-type: none">• INR5,000 for every day up to the service of the penalty order• INR50,000 per day for the default beyond the date of service of the penalty order
Furnishing inaccurate particulars/not filing the corrected CbC report within 15 days	INR500,000



PART 3- Function, Asset and Risk Analysis

Relevant provisions /guidance on FAR analysis



Income-tax Act, 1961

- Section 92C(1) of the Income Tax Act, 1961 read with Rule 10B(2) and Rule 10C(2) of the Income Tax Rules, 1962, requires comparability of FAR analysis to determine ALP.
- Rule 10D(1)(e) requires FAR analysis to be a part of statutory TP documentation



OECD TP Guidelines

- Para D.1.2 provides for the TP documentation to be based on a detailed functional analysis



UN Practical Manual on TP for Developing Countries

- Para B.2.3.1 - Understanding the Economically Significant Characteristics of the Industry, Business and Controlled Transactions provides for a detailed discussion on the FAR analysis, including a detailed FAR checklist [Part 3 of Appendix 1 to the UN TP Manual]



ICAI Guidance Note on TP report u/s. 92E

- Para 7.33 of the Guidance Note describes the FAR analysis stipulated under Rule 10D(1)(e) as part of TP documentation.

Rule 10B

(2) For the purposes of sub-rule (1), the comparability of an international transaction [or a specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following, namely:—

- (a) the specific characteristics of the property transferred or services provided in either transaction;*
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;*
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;*
- (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.*

(3) An uncontrolled transaction shall be comparable to an international transaction [or a specified domestic transaction] if—

- (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or*
 - (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.*
-

Determination of ALP – Rule 10B(4) & Rule 10B(5)

Data to be used for undertaking comparability analysis

1. If MAM is RPM, CPM or TNMM
 - the data relating to the current year; or
 - If the data relating to the current year is not available; then use the data relating to FY immediately preceding the current FY

Data relating to the current year subsequently available during the course of any assessment proceeding shall be used irrespective of the fact that the data was not available at the time of preparation of TP documentation

2. If MAM is CUP, PSM or Other method
 - Use only data relating to current year
-

Rule 10C

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:—

- (a) the nature and class of the international transaction [or the specified domestic transaction];*
- (b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;*
- (c) the availability, coverage and reliability of data necessary for application of the method;*
- (d) the degree of comparability existing between the international transaction [or the specified domestic transaction] and the uncontrolled transaction and between the enterprises entering into such transactions;*
- (e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transaction or between the enterprises entering into such transactions;*
- (f) the nature, extent and reliability of assumptions required to be made in application of a method.*

Computation of ALP – Rule 10CA

Concept of range

1. If MAM is CUP, RPM, CPM or TNMM **and** there are at least 6 comparables
 - Prepare a dataset in ascending order
 - Arm's length range would be data points lying between the **35th and 65th percentile** of the data set.
 - If the transaction price falls within the range, then the same shall be deemed to be the ALP.
 - If the transaction price falls outside the range, the ALP shall be taken to be the Median of the data set.
 2. In all other cases, arithmetic mean shall be applied. Tolerance range of 1% or 3% (as the case maybe) be applied from transfer price.
 3. Where multiple year comparable data is available, weighted average of such data shall be taken based on prescribed weights.
-

Key aspects in TP analysis

Broad based Analysis

- Review of Controlled transaction
- Company Overview
- Group Overview
- Industry Overview

Principles in Comparability

- FAR Analysis
- Characterization
- Tested Party
- Transfer Pricing Methods
- Profit Level Indicators
- Contemporaneous Data

Comparability - Approach

- Identification of databases
- Selection of potential comparables
- Comparability Adjustments
- Price setting vs. Price testing

Most appropriate method – An overview

Appropriateness of the method considered based on functional analysis

Availability of reliable information

Degree of comparability between controlled and uncontrolled transaction

Reliability of comparability adjustments, if any

“No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.”

Para 2.2 OECD TP Guidelines for Multinational Enterprises and Tax Administrations

Transfer Pricing Methods

01

Comparable
Uncontrolled Price
Method (CUP)

02

Resale Price Method
(RPM)

03

Cost Plus Method
(CPM)

04

Profit Split Method
(PSM)

05

Transactional Net Margin
Method (TNMM)

06

Any Other Method



Transfer Pricing Methods.. A comparison

Method	Measurement focus	Comparability Requirements	Indicative difference requiring adjustments
CUP	Price	<ul style="list-style-type: none">• Similar products• Similar conditions	<ul style="list-style-type: none">• Product quality• Contractual terms• Level of market• Intangible property• Transaction date• Foreign exchange
RPM	Gross Income	<ul style="list-style-type: none">• Similar functions• Risk• Contractual terms• Similar product group	<ul style="list-style-type: none">• Inventory levels• Turnover rates• Operating expenses• Foreign currency risks• Accounting differences

Transfer Pricing Methods.. A comparison

Method	Measurement focus	Comparability Requirements	Indicative difference requiring adjustments
CPM	Gross Income	<ul style="list-style-type: none"> • Similar functions • Risk • Contractual terms • Similar product group 	<ul style="list-style-type: none"> • Operating complexity • Operating expenses • Foreign currency risks • Accounting differences
TNMM	Net Operating Income	<ul style="list-style-type: none"> • Functions • Assets • Risks 	<ul style="list-style-type: none"> • Economic risk adjustment • Foreign currency risks • Accounting differences
PSM	Profit	<ul style="list-style-type: none"> • Functions performed – routine and non-routine • Value drivers • Industry value indicators • Multiple transactions 	

Typical Business Models

Manufacturer

- Toll Manufacturer
- Contract Manufacturer
- Licensed Manufacturer
- Full fledged Manufacturer

Distributor

- Low Risk Distributor
- Normal Distributor

Service Provider

- Captive Service Provider
- Limited Risk Service Provider
- Entrepreneur Service Provider

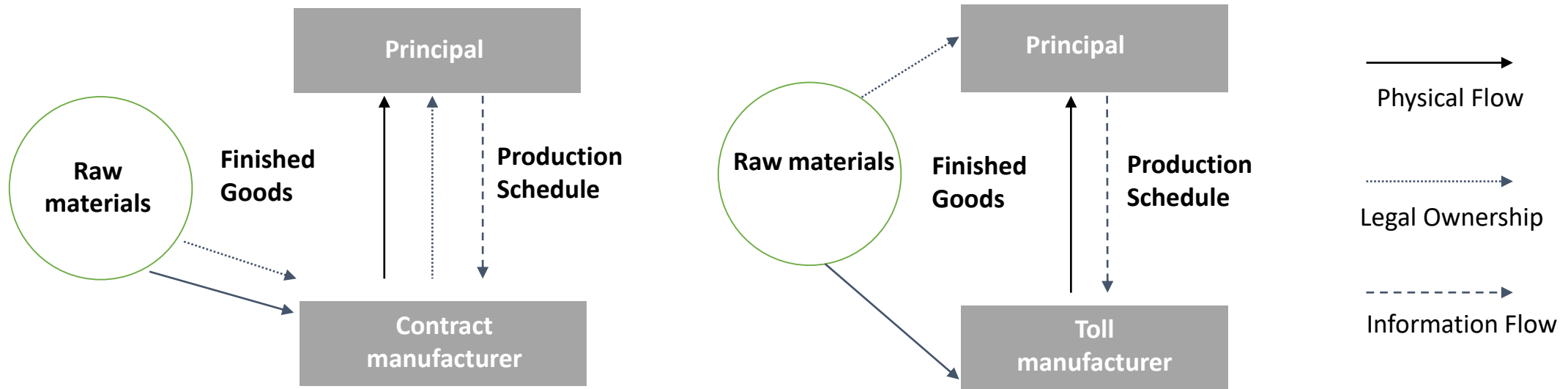


The image features a white background with several abstract geometric elements. On the left, there are two vertical yellow dashed lines, a green square outline, and a blue circle. In the top right, there is a yellow circle and a green L-shaped line. A large orange semi-circle occupies the right side of the frame. The word 'MANUFACTURERS' is written in white, uppercase, sans-serif font across the center of the orange semi-circle. At the bottom right, the number '74' is displayed in a small, grey font.

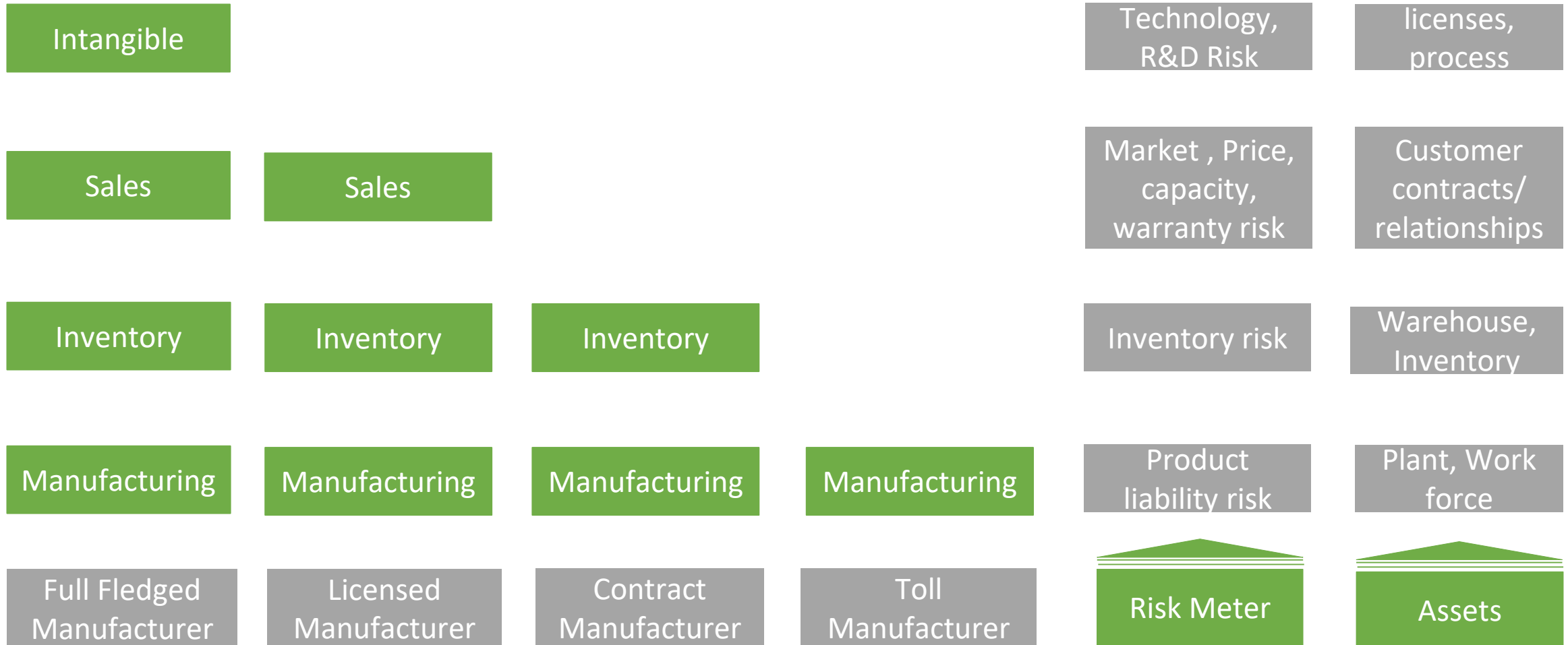
MANUFACTURERS

Typical manufacturing models

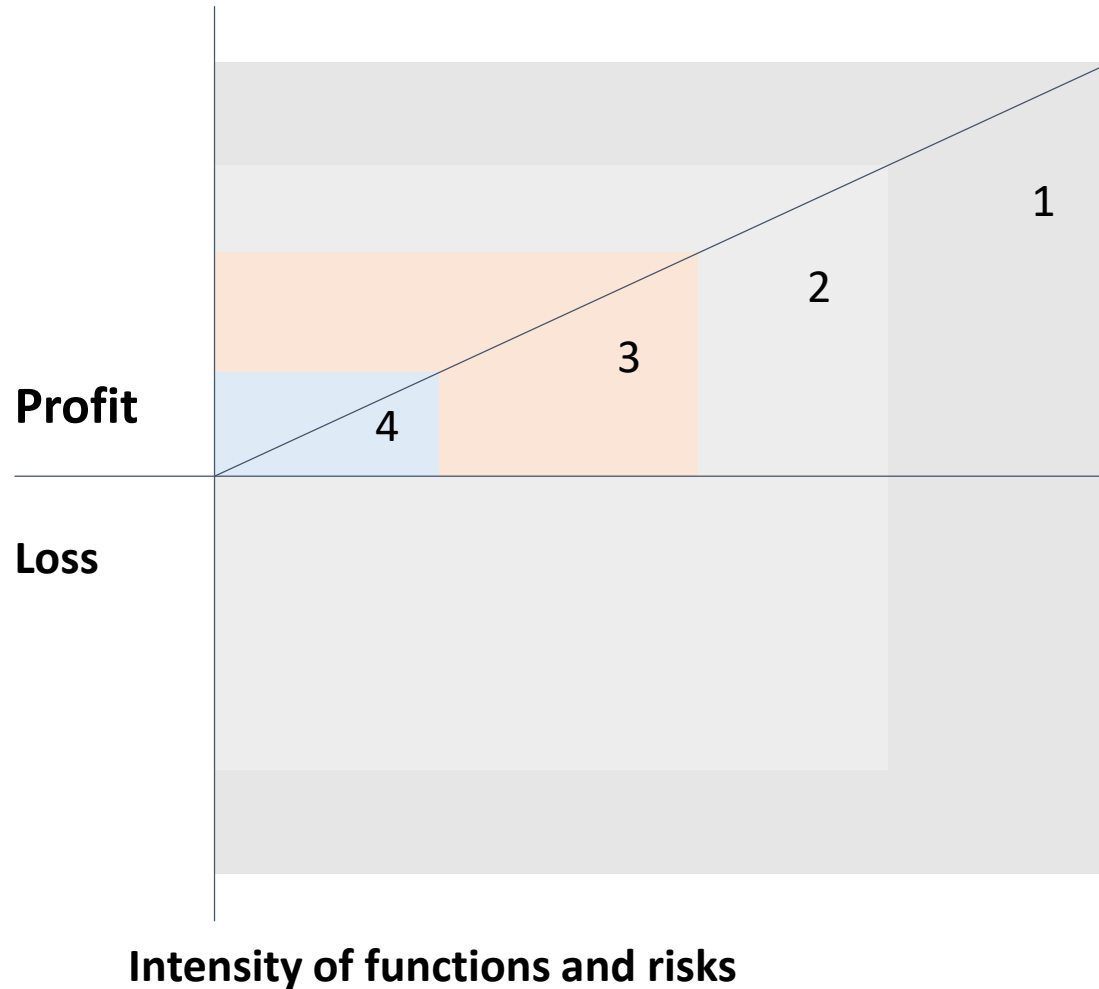
Parameters	Full Fledge Manufacturer	Licensed Manufacturer	Contract Manufacturer	Toll Manufacturer
Produces on	Own behalf	Own behalf	Principal	Principal
Intellectual Property	Owns the IP	Licensed IP	Does not own	Does not own
Materials	Owns	Owns	Owns	Does not own



Functional Analysis - Functions and risks

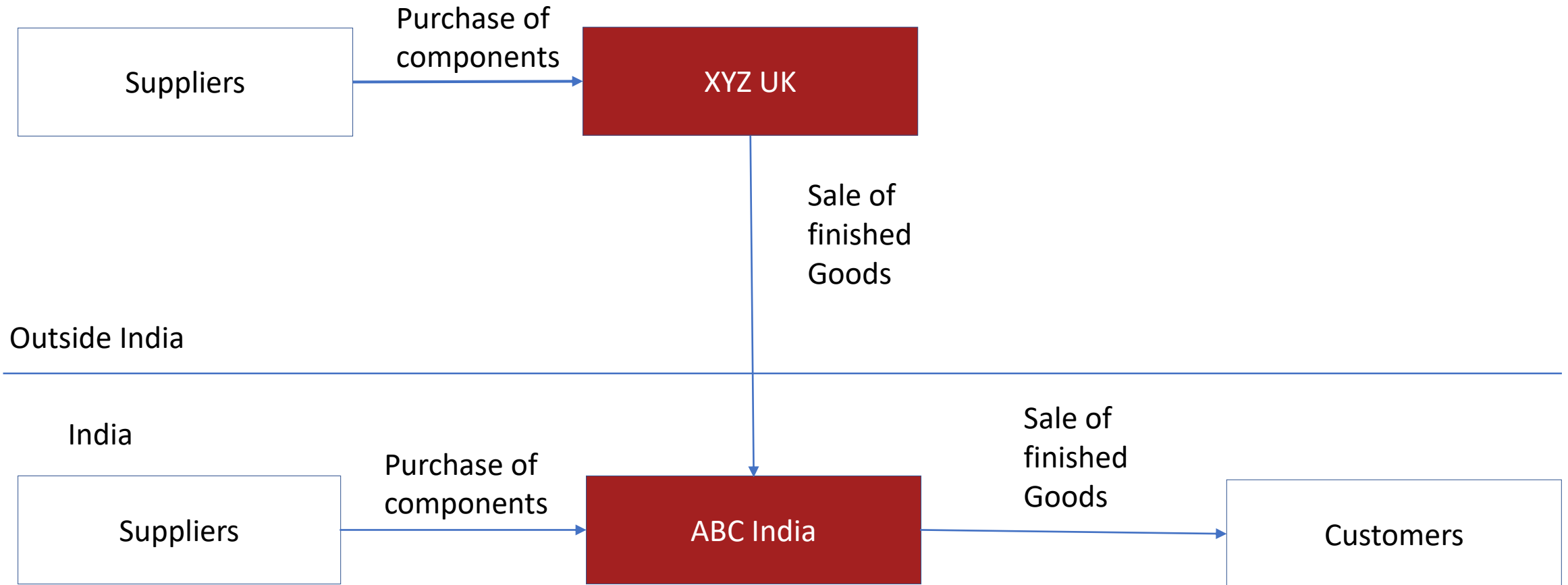


Functional Analysis - Characterisation



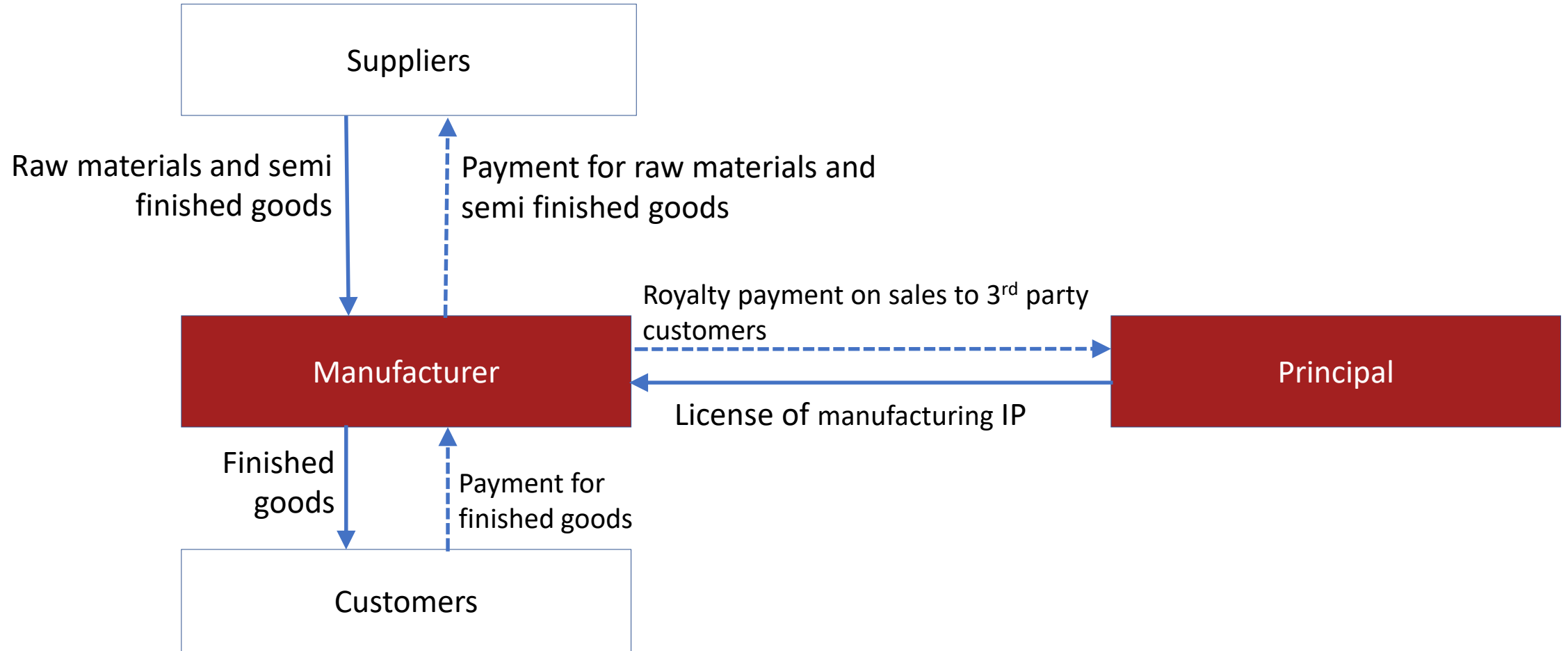
1. Full fledged manufacturer
2. Licensed Manufacturer
3. Limited risk contract manufacturer
4. Toll Manufacturer

CASE STUDY 10



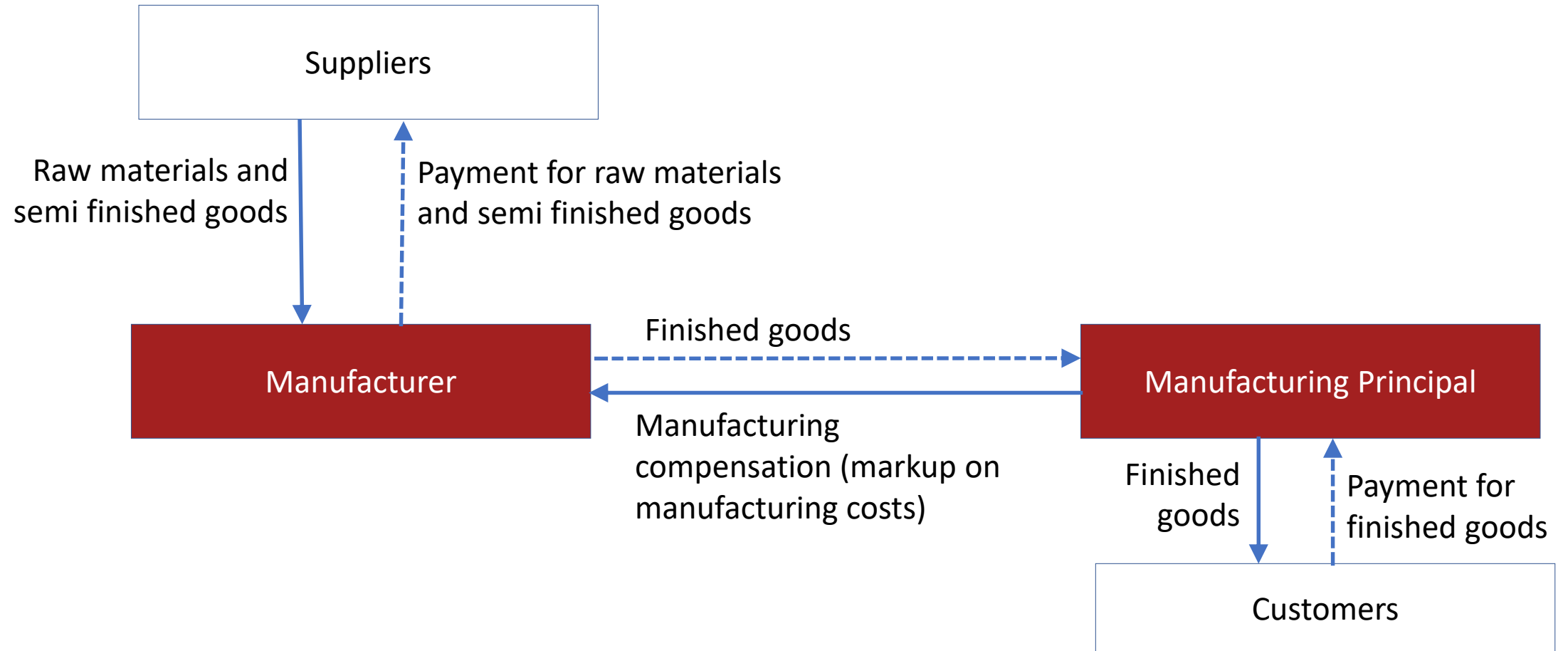
What is the characterisation of XYZ UK and ABC India?

CASE STUDY 11



What is the characterisation of the manufacturer?

CASE STUDY 12



What is the characterisation of the manufacturer?



DISTRIBUTORS

Selling and marketing – Business Models



Limited Risk Distributor ('LRD')

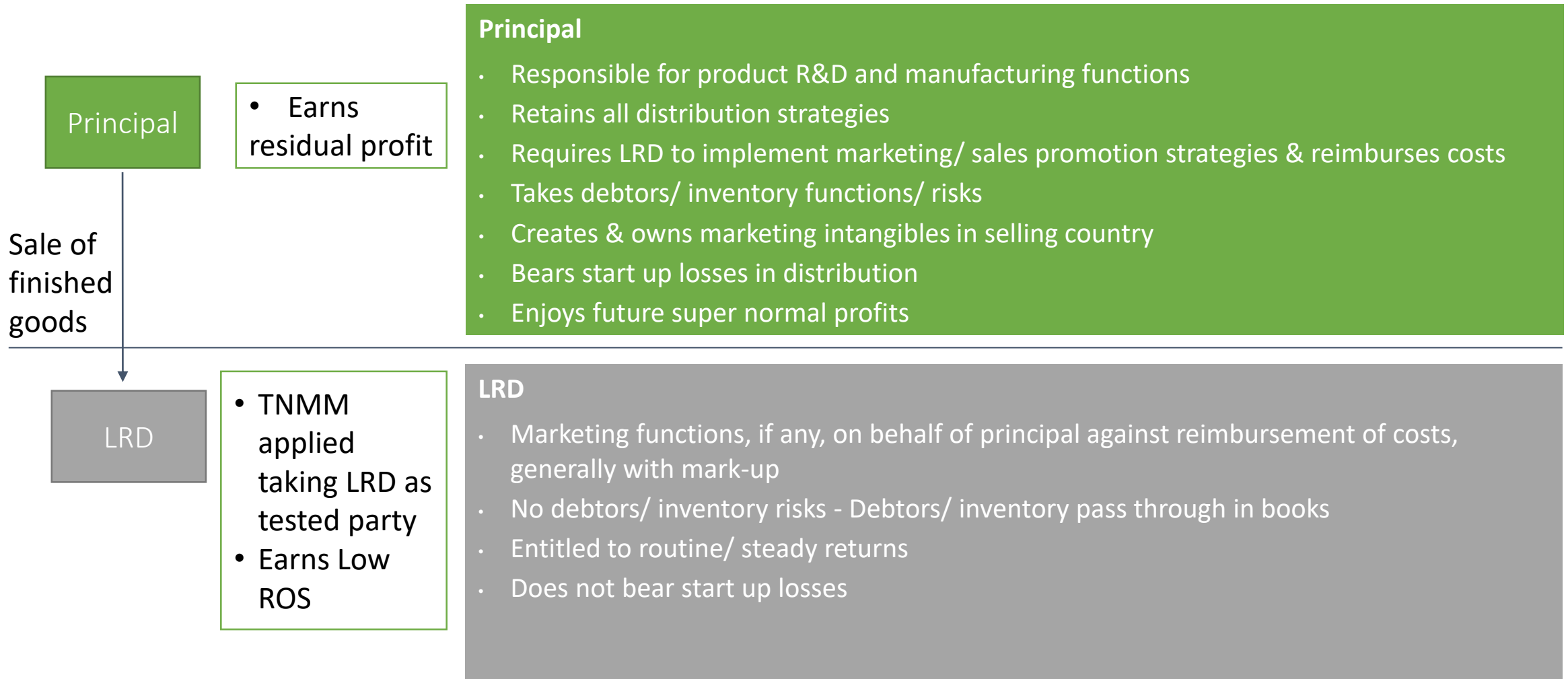
FAR Profile

- Limited marketing functions undertaken on behalf of principal
- A&M expenses incurred on account of principal
- A&M spend not significant
- Limited debtors/inventory functions/risks
- Does not bear start up losses
- Entitled to stable returns

Approach

- Key people functions performed by principal
- Distributor merely executes strategy formulated by principal
- Arm's length ROS ensures A&M expenses incurred by distributor are "picked up" by principal
- TNMM applied with distributor as tested party

Limited Risk Distributor ('LRD')



Normal Distributor ('ND')

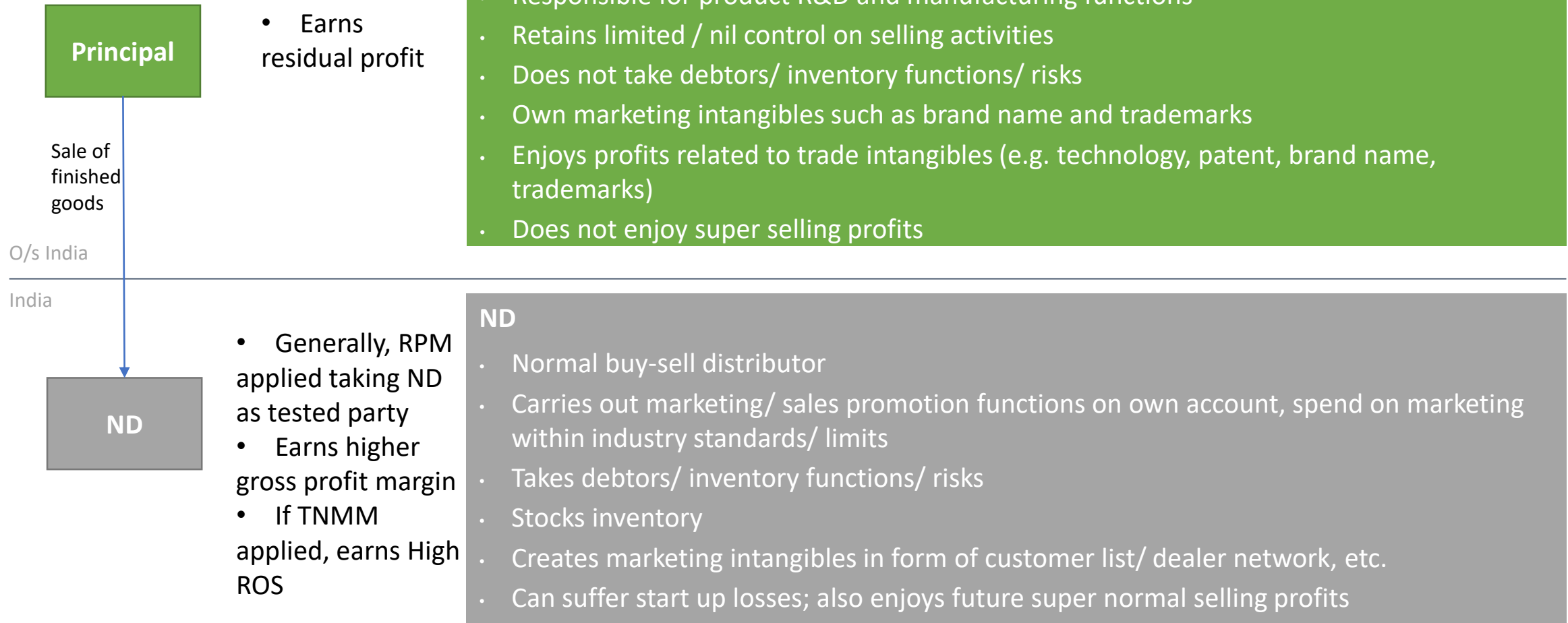
FAR Profile

- Performs normal marketing functions
- A&M expenses within industry limits
- Undertakes debtors/inventory functions/risks
- Creates marketing intangibles e.g. customers list, dealer network etc.
- Gets assured gross margin
- Can suffer start up losses, entitled to future higher profits

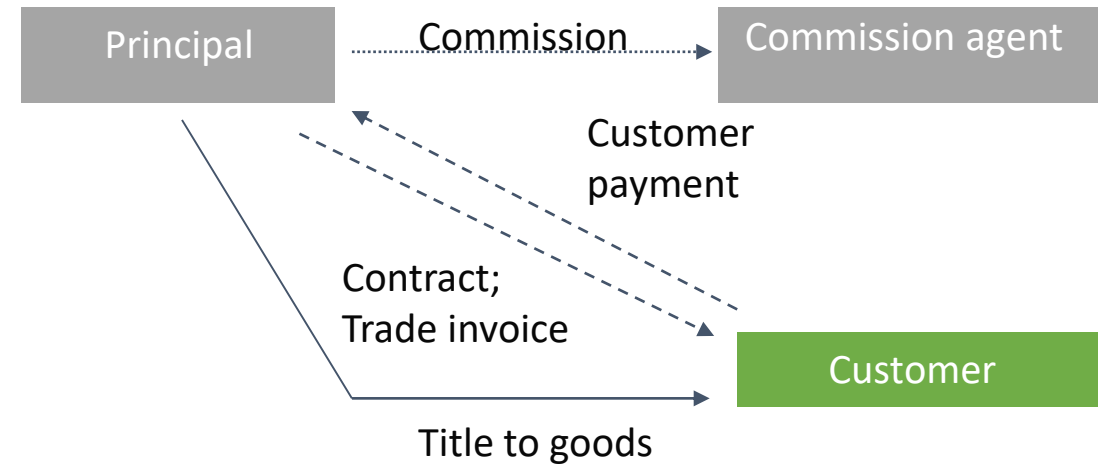
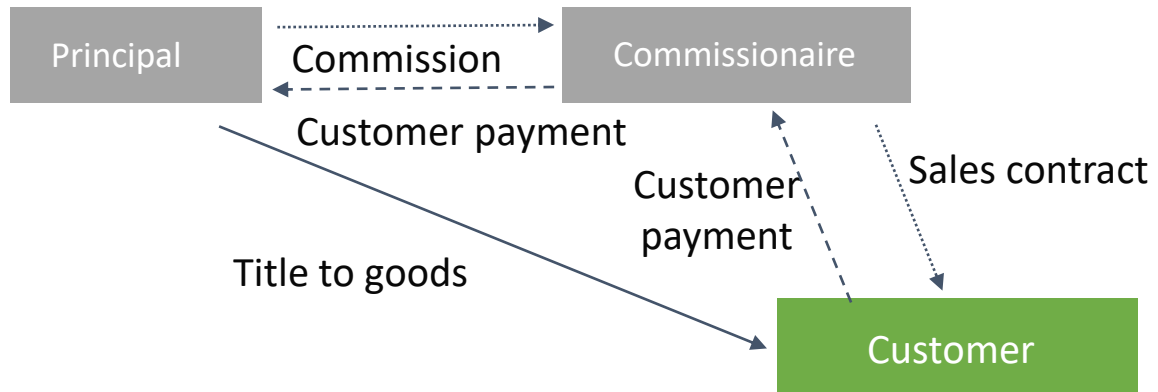
Approach

- Distributor's gross margin to be benchmarked using Resale Price Method (RPM)
- Intensity of functions critical while selecting comparables
 - Return on VAE

Normal Distributor ('ND')



Commission agent and Commissionaire



Relationship between Principal and Commissionaire

- Customer does not need to know who “product” supplier is
- Commissionaire contracts in own name, but on behalf of the Principal and does not bind the Principal
- Invoice to customer in commissionaire’s name
- Commissionaire does not take title to inventory
- Commissionaire does not need to refer back to the Principal for acceptance within pricing and T&C parameters
- Commissionaire receives payment for goods and earns commission from Principal

Relationship between Principal and Commission Agent

- Commission agent identifies potential customers for the Principal, earning an arm’s length commission
- Customer knows who “product” supplier is
- Customer contracts with Principal
- Commission agent typically has no powers to conclude contracts on behalf of the Principal

CASE STUDY 13

Q: ABC is soliciting customers on behalf of its AE. It is remunerated on a commission basis by its AE. The commission paid to ABC is certain percentage of the sale price of the machine sold by AE to third party in India. The AE raises the invoice.

What is the characterisation of ABC India??

- A) Commissionaire
- B) Commission Agent
- C) None of the above



CASE STUDY 14

XYZ India Pvt Ltd ('XYZ India') and PQR India Ltd ('PQR India') are group companies.

XYZ India have marketing expertise in cancer products where as PQR India has marketing expertise in eye care products.

Case I

- XYZ India owns IP for eye care product say 'Fresh Drops'
- XYZ India avails services from PQR India for marketing and promoting product 'Fresh Drops' in India
- PQR India is responsible for developing marketing strategy, budgets, promotion material, on behalf of XYZ India

Characterization of PQR India??

Case II

- PQR India owns IP for cancer product say 'Kill Cancer'
- PQR India avails services from XYZ India for marketing and selling product 'Kill Cancer' in India
- PQR India develops strategy for penetrating in the market. Therefore, it would be responsible for strategic decision making for its product
- XYZ India executes strategy for marketing & selling the product 'Kill Cancer'

Characterization of XYZ India??





SERVICE PROVIDERS

Captive service provider

FAR Profile

- Provides services under the directions and specifications of the Principal
- Responsible for quality to a limited extent
- Responsible for manpower employed
- Does not undertake key decision making activities
- Does not undertake any marketing function
- Does not assume any service liability, bad debts, foreign exchange or capacity utilization risks

Approach

- TNMM to be considered as the most appropriate method
- Remunerated on a total cost plus an arm's length return

Example – BPO/ KPO set up by an overseas Multinational for carrying out certain outsourced activities.

Entrepreneur service provider

FAR Profile

- Performs services on its own account
- Performs significant people functions – i.e. responsible for all strategies and decision marking
- Responsible for the overall quality of service rendered
- Performs the marketing functions
- Assumes bad debts, service liability , foreign exchange and credit risks

Approach

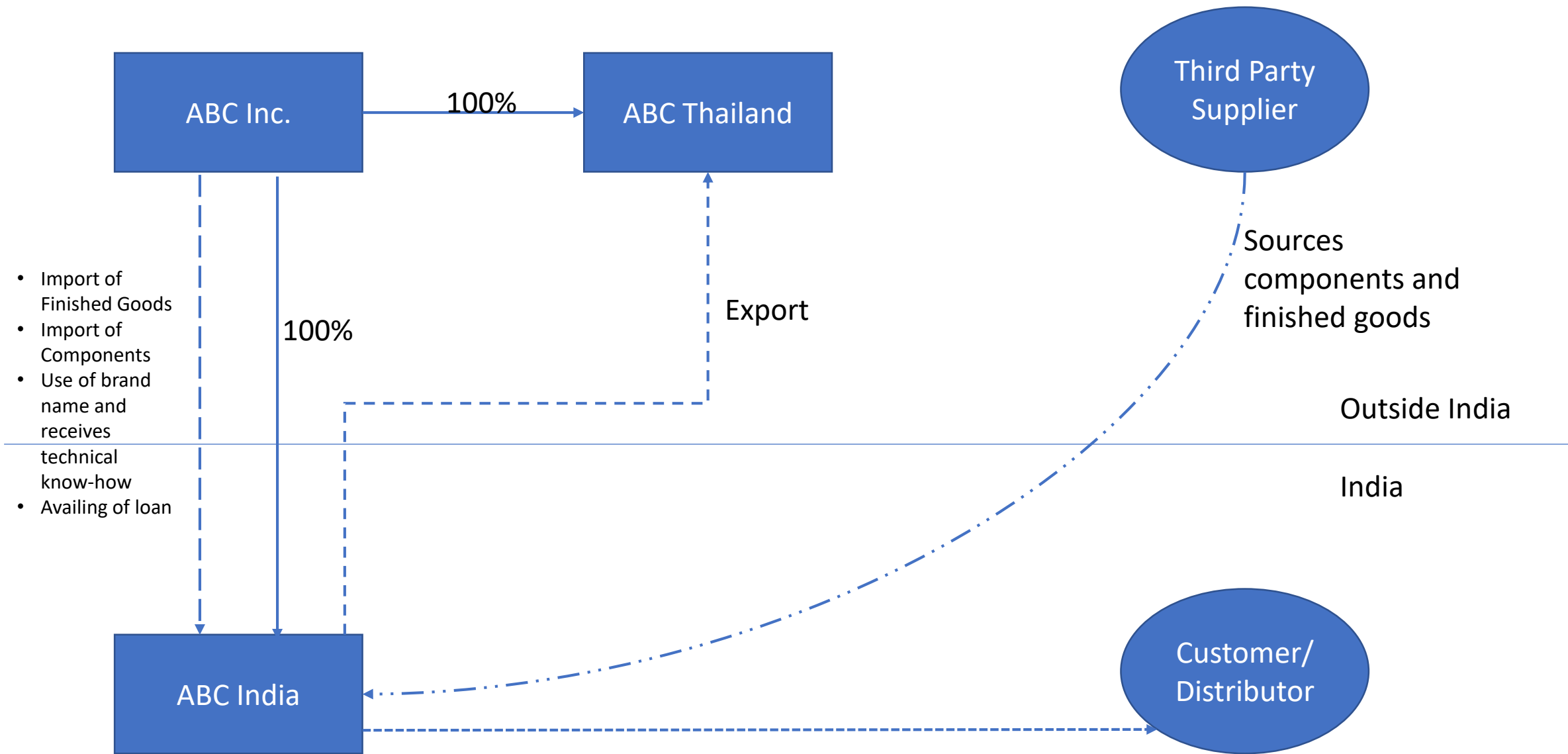
- Being the most complex entity in value chain, it is entitled to residual returns
- Test the least complex entity and remunerate it basis the functions performed

Example – An Engineering company providing services to Indian customer. May avail certain design and engineering services from an overseas AE.

CASE STUDY 15

- ABC Inc is an electronic component manufacturer based in Sweden and has a subsidiary in India, ABC India
- ABC India as a manufacturer has the following transactions with its parent company:
 - It sources components from ABC Inc to use in manufacture of CD players
 - It imports CD players from ABC Inc for resale
 - It receives technical know-how from ABC Inc and also uses the ABC brand name owned and developed by ABC Inc
 - It avails foreign currency loan from ABC Inc
- ABC India also sources components for its manufacturing function from unrelated entities
- ABC India purchases CD players from unrelated entities for resale purposes
- ABC India sells CD players to its group company in Thailand and also to unrelated entities

Evaluate and discuss the approach to TP analysis for ABC Group.



- Import of Finished Goods
- Import of Components
- Use of brand name and receives technical know-how
- Availing of loan

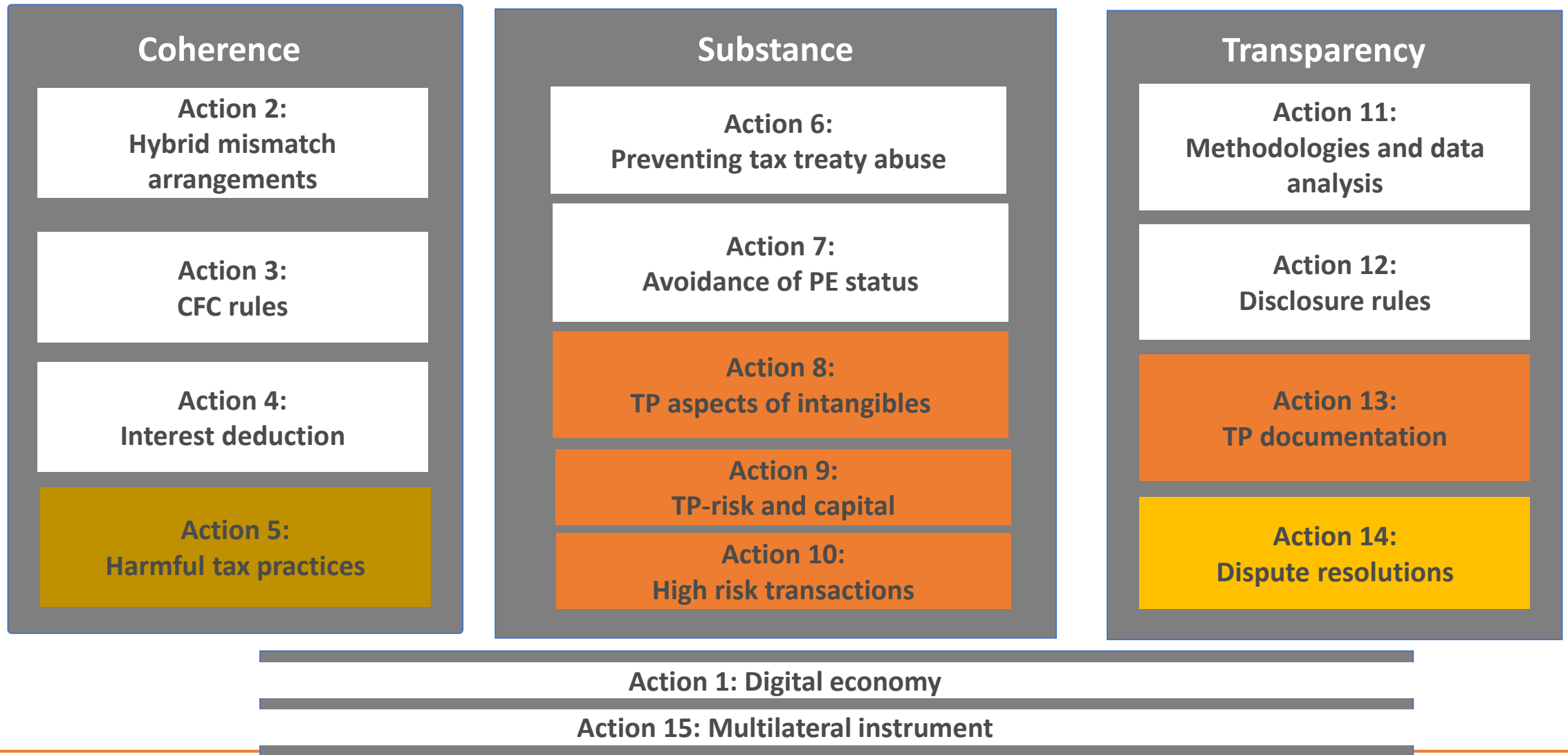
PART 4

BEPS

**Case
Study**

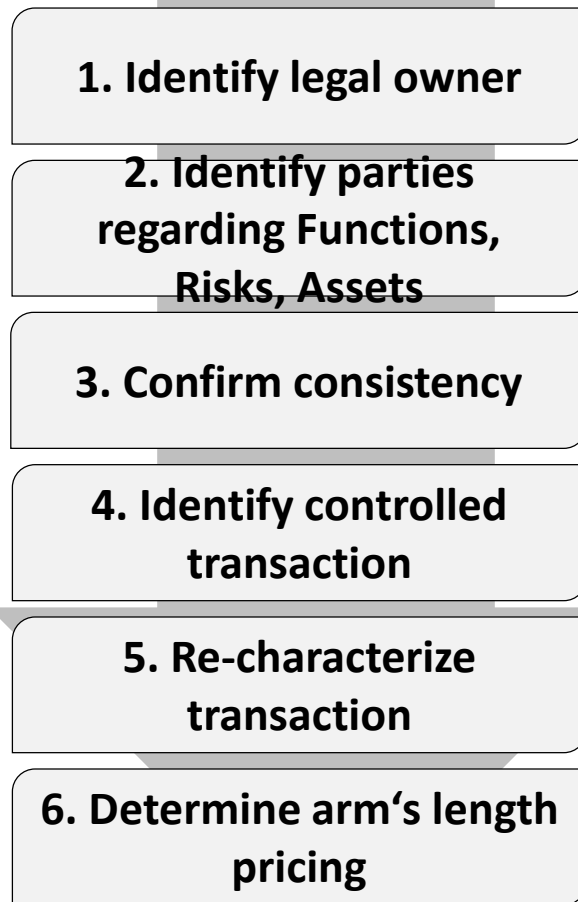
OECD BEPS action items

Overview



Analytical framework for intangibles

Steps in determining returns



Key functions

Development

Enhancement

Maintenance

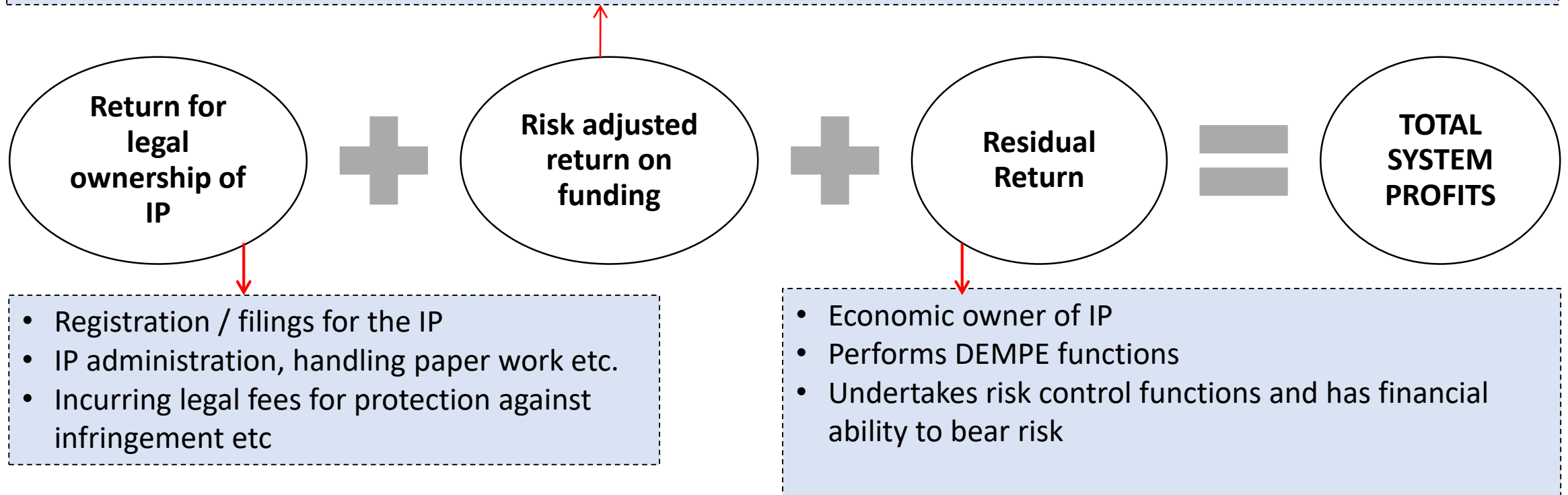
Protection

Exploitation

- **Identify the legal owner:** Based on the terms and conditions of legal arrangements, relevant registrations, license agreements, other relevant contracts.
- **Identify the parties performing functions:** Assets used, and Risks Assumed relating to DEMPE Functions of the intangibles
- **Confirm consistency** between conduct of the parties and terms of the relevant legal arrangements through a functional analysis.
- **Identify the controlled transactions** related to the DEMPE of intangibles in light of the legal ownership of the intangibles and the conduct of the parties and **verifying creation of value.**
- **Re-characterize/ Delineate transactions** as necessary to reflect arm's length conditions
- **Determine arm's length prices** for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed.

Entitlement of returns from exploitation of IP

- Access to capital markets/ financial institutions
- Providing funding for the R&D activity
- Perform strategic and risk control functions relating to funding*
- Has financial ability to bear risk related to funding



* Funder that does not control financial risk should be entitled to no more than a risk-free financial return

Risk analysis

Identify economically significant risks with specificity



Determine contractual risk allocation



Evaluate conduct of parties (control functions and financial capacity to assume the risk)



Determine whether the contractual assumption of risk is consistent with actual conduct



If there is disparity, specific guidance to be applied on risk allocation



Accurately delineated transaction should be compensated at ALP; appropriate pricing for risk management functions

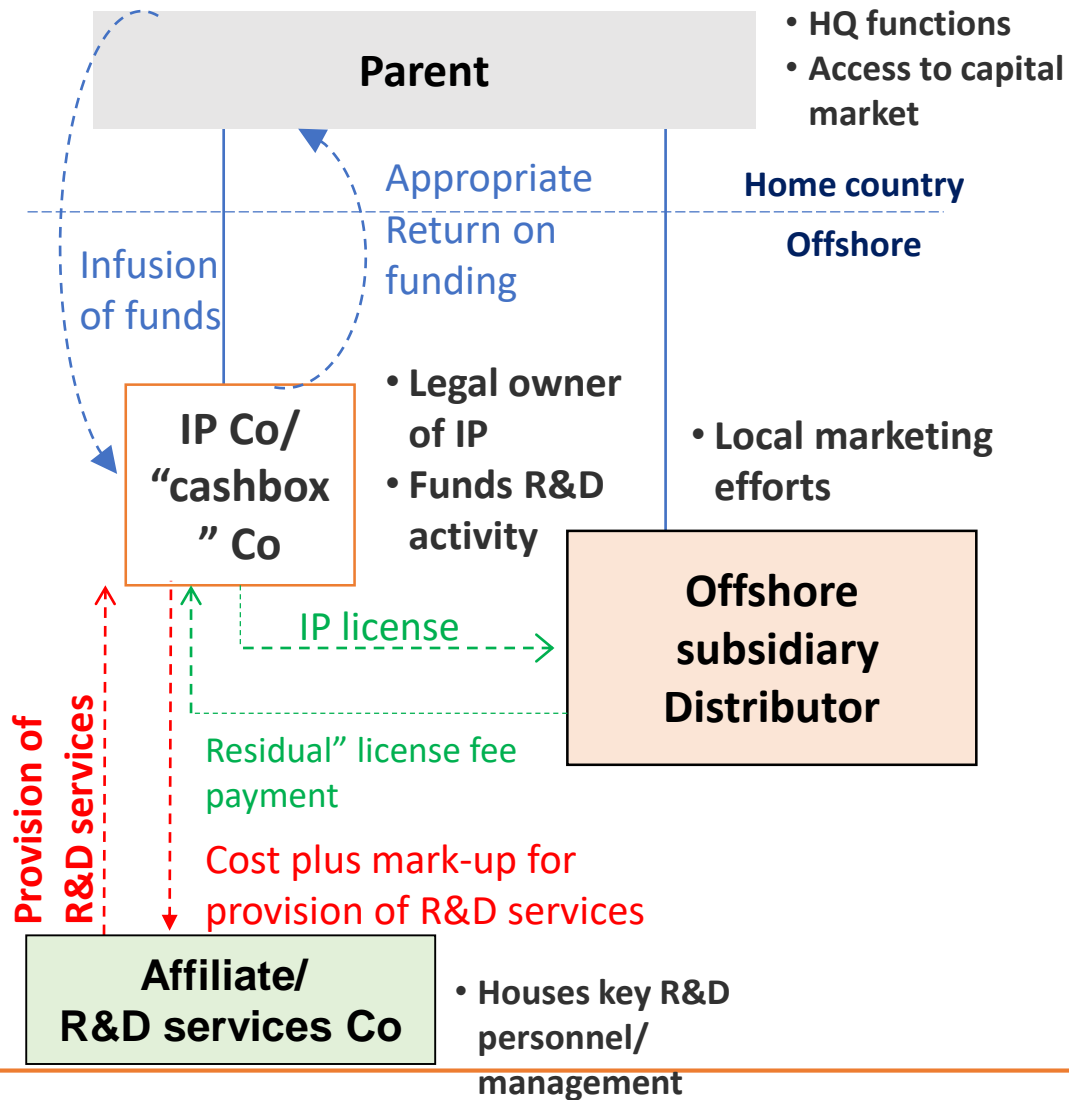
Circular 6 of 2013

~~The CBDT has carefully considered the matter and lays down the following guidelines for identifying the Development Centre as a contract R&D service provider with insignificant risk.~~

- 1. Foreign principal performs most of the economically significant functions involved in research or product development cycle either through its own employees or through its associated enterprises while the Indian Development Centre carries out the work assigned to it by the foreign principal. Economically significant functions would include critical functions such as conceptualization and design of the product and providing the strategic direction and framework;*
- 2. The foreign principal or its associated enterprise(s) provides funds/capital and other economically significant assets including intangibles for research or product development. The foreign principal or its associated enterprise(s) also provides a remuneration to the Indian Development Centre for the work carried out by the latter;*
- 3. The Indian Development Centre works under the direct supervision of the foreign principal or its associated enterprise which has not only the capability to control or supervise but also actually controls or supervises research or product development through its strategic decisions to perform core functions as well as monitor activities on regular basis;*
- 4. The Indian Development Centre does not assume or has no economically significant realized risks. If a contract shows that the foreign principal is obligated to control the risk but the conduct shows that the Indian Development Centre is doing so, then the contractual terms are not the final determinant of actual activities;*
- 5. In the case of a foreign principal being located in a country/territory widely perceived as a low or no tax jurisdiction, it will be presumed that the foreign principal is not controlling the risk. However, the Indian Development Centre may rebut this presumption to the satisfaction of the revenue authorities. Low tax jurisdiction shall mean any country or territory notified in this behalf under section 94A of the Act or any other country or territory that may be notified for the purpose of Chapter X of the Act;*
- 6. Indian Development Centre has no ownership right (legal or economic) on the outcome of the research which vests with the foreign principal and that this is evident from the contract as well as from the conduct of the parties.*

CASE STUDY – 16 (Typical supply
chain for R&D COMPANY)
pre & Post BEPS implications

Typical supply chain (Pre-BEPS arrangement)



IP owner and parent company relationship

- IP owner has an exclusive right over the IP rights outside of parent company's jurisdiction.
- The entrepreneurial profit associated with the IP rights accrues to the IP owner.
- While there is some substance in the IP owner, strategic decision making with regards to the worldwide rights remains in the parent company.

IP owner and local / off-shore distributor relationship

- IP owner licenses IP to a local distributor who makes sales to third parties in the local jurisdiction (earns return on sales and pays residual return to IP owner)

IP owner and affiliates relationship

- IP owner enters into agreements with affiliates to provide R&D and other services applicable to the IP. (possibly for a remuneration of cost plus mark-up basis)

Illustrative working

Particulars	Pre BEPS	Under BEPS
Total revenue from earned from distributor company	1,000	
Third party costs incurred by distributors	100	
License fee paid to/ received by IP Co	850 (bal.fig)	
Arm's length Profit/ loss of Distributor Company	50 [1000*5%]	
Arm's length remuneration paid by IP Co to R&D Co for services provided	230 [cost plus 15%]	
Third party costs incurred by R&D Services Co.	200	
Arm's length Profit/ loss of R&D services Co.	30	
Amount paid by IP Co to HQ for capital and other management services	0	
Third party cost incurred by IP Co	80	
Arm's length profit of IP Co	540 [850-230-80]	

Post BEPS implications

Parent Co.

- Function of funding and assuming and controlling related financial risks - shall be entitled to a risk-adjusted return on its funding. Also entitled to a return for the HQ and management functions.

IP Co

- Legal ownership of intangibles - May be entitled to routine return for IP ownership (administrative return).

R&D Service Company

- Houses R&D personnel and potentially performs “DEMPE” functions
- AE assuming risks must exercise functional control over the risks and have the financial capacity to assume the risks. In this case, IP Co does not have relevant people function.
- May be entitled for a more than routine return of cost plus “mark-up”. Potentially, entitled to residual return (by using profit split) depending on extent of contribution.

Distributor company

- Whether it performs any activities towards enhancement of marketing intangible (over and above promotion and distribution activities)?
- Depending on the facts, profit split method may be considered to better reflect value contribution rather than TNMM or the resale minus method

Illustrative working

Particulars	Pre BEPS	Under BEPS
Total revenue from earned from distributor company	1,000	1,000
Third party costs incurred by distributors	100	100
License fee paid to/ received by IP Co	850 (bal.fig)	800 (bal.fig)
Arm's length Profit/ loss of Distributor Company	50 [1000*5%]	100 [1000*10%]*
Arm's length remuneration paid by IP Co to R&D Co for services provided	230 [cost plus 15%]	400 [Profit share]**
Third party costs incurred by R&D Services Co.	200	200
Arm's length Profit/ loss of R&D services Co.	30	200
Amount paid by IP Co to HQ for capital and other management services	0	310 [800-400-80-10] [Residual return for HQ func/ risk]
Third party cost incurred by IP Co	80	80
Arm's length profit of IP Co	540 [850-230-80]	10 (cost plus ~10%)

* Higher compensation considering that Distributor company contributes towards enhancement of marketing intangible

** Simplified working

COVID-19 Impact

Australian Taxation Office ('ATO') issues Guidance addressing COVID-19 economic impacts on TP arrangements, aims to “assist those economically affected by COVID-19 when preparing documentation to support the arm’s length nature of their transfer pricing arrangements”

1. Some businesses will be negatively affected by COVID-19, which may lead to a reduction in revenues, increased expenses, and changes to profit outcomes
 2. Understand the facts and the individual circumstances by assessing:
 - a) the FAR profile of the Australian entity before and after COVID-19
 - b) economic circumstances, where the actual economic impacts of COVID-19 on the Australian operations should be outlined and evidenced – this may include a broader analysis of how the relevant industry has been affected
 - c) the contractual arrangements between the Australian entity and its related parties, and if any obligations or material terms and conditions have been varied, amended or terminated
 - d) evidence of the impact (if any) of COVID-19 on the specific product and service offerings of the Australian entity and how this has affected the financial results
 - e) evidence of changes in business strategies as a result of COVID-19, including decisions made, outcomes sort and actions taken to give effect to those strategies this was not a case where the assessee could be said to have deliberately avoided making payment of tax so as to attract penalty u/s 271C
-

COVID-19 Impact

Australian Taxation Office ('ATO') issues Guidance addressing COVID-19 economic impacts on TP arrangements, aims to “assist those economically affected by COVID-19 when preparing documentation to support the arm’s length nature of their transfer pricing arrangements”

Understand the financial outcomes you would have achieved ‘but for’ the impact of COVID-19. This analysis may include:

- a) a detailed profit and loss analysis showing changes in revenue and expenses, with an explanation for variances resulting from COVID-19 – this may include a variance analysis of budgeted (pre-COVID) versus actual results
- b) details of profitability adjusted to where your outcome would have been if COVID-19 had not occurred – this should consider all factors that have a positive or negative impact on your profits and should be supported by evidence
- c) the rationale and evidence for any increased allocation of costs or a reduction of sales (and subsequent changes in operating margins) to the Australian entity, taking into consideration its function, asset and risk profile
- d) evidence of any government assistance provided or affecting the Australian operations.

Transfer Pricing impact areas on account of Covid-19 disruption

- “Cash is king” – Likely spike in intra-group financing transactions to overcome liquidity constraints
 - Principles laid down in OECD Transfer Pricing Guidance issued in February 2020 on financial transactions
 - Evaluate over-hauling/ restructuring overall TP model in light of the “new normal”
 - Revise inter-company agreement to factor and address the challenges arising from the Pandemic
 - Potential approach to economic analysis
 - Stricter industry and comparability analysis to factor the sensitivity
 - Identify and segregate extraordinary cost/ idle capacity cost/ additional cost due to supply chain restrictions/ extraordinary forex fluctuation etc.
 - Use of internal comparable
 - Consider entering into APA or renegotiate existing APA
 - Limited use of traditional methods that use historical data
 - Taxpayers should evaluate use of Profit Split Method – move away from one-sided method
 - Guidance or clarification from CBDT would be welcome
 - Potential use of most recent quarterly/ half year results?
 - Rationalise safe harbour rules with reduced margins
 - Guidance on identification of extraordinary/ Covid19 related costs
-

Questions and Answers

Thank you!

