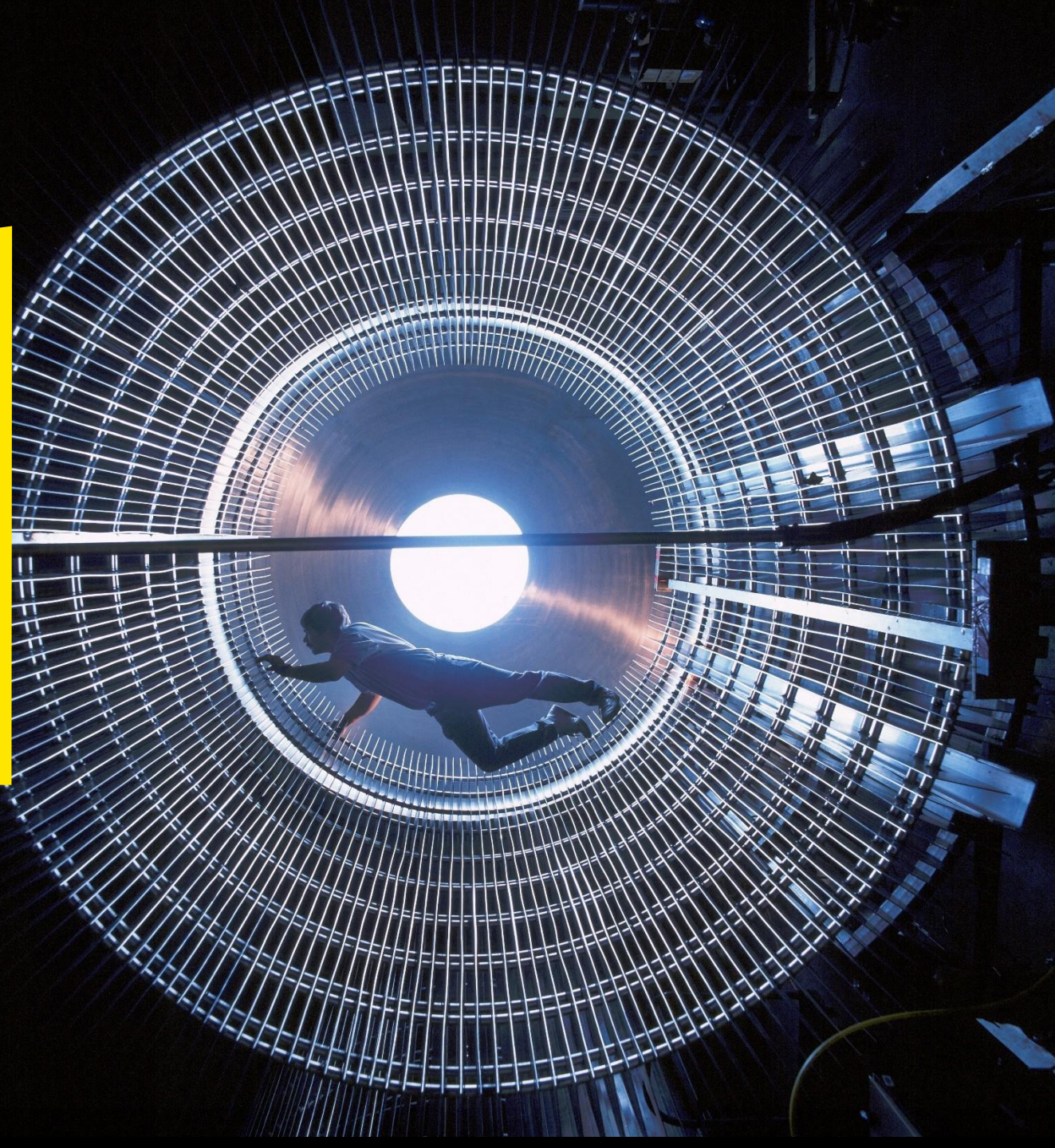


Interplay between Indirect tax and Transfer Pricing

CA Amit Dhadphale
CA Neeraj Menon

10 July 2020



What's latest in news?

Centre looking to merge CBDT, CBIC in austerity drive

Freezing hiring, curtailing allowances, and merging of job categories also on the cards

SHRIMI CHOUDHARY
New Delhi, 5 July

As part of the government's efforts to contain the costs of operations amid increasing revenue loss, the proposal to merge the direct and indirect tax boards is back on the table, with a massive downsizing of the cadre at all levels.

These could include a freeze on hiring for the Indian Revenue Service (IRS), changes in retirement rules, merging job categories, shifting revenue officers to other departments, and curtailing allowances of employees, said official sources. The austerity drive has begun amid the global pandemic, which has derailed the economy and widened the fiscal deficit.

"Both the tax boards, in concurrence with the finance ministry, are working on cost-cutting measures. Certain proposals have been discussed, such as a unified structure, which would help in creating synergies with a reduced workforce," said a person privy to the discussion.

As of now, the Central Board of Direct Taxes (CBDT) and Central Board of Indirect Taxes and Customs (CBIC) have independent financial powers to decide how much they would spend on tax generation.

The Tax Administration Reform Commission, under Parthasarathi Shome, the then advisor to the finance minister, had first suggested, in 2014, merging these two boards. The CBIC was then called the Central Board of Excise and Customs.

Since then the proposal has been taken up in various fora. Its 550-page report had said the two boards must embark on "selective convergences immediately to achieve better tax governance, and, in the next five years, move towards a unified management structure with a common board for both direct and indirect taxes".

Former CBDT member Akhilesh Ranjan said: "Theoretically this can be done. Several countries like the UK have a unified service. But considering the administrative formations that we have for income tax (I-T), Customs, and goods and services tax (GST) separately, it will mean a lot of upheaval without much benefit. Also, the GST set-up is distinct, with the GST Council setting policy."

At present, the two boards draft tax policies, and the Department of Revenue handles the budgets for carrying out their functions.

Besides, they share data, helping them in spotting income anomalies or mismatches between GST filings and I-T returns.

Further, creating posts will be reviewed. Apart from freezing new jobs, the two boards are looking at those created in the past two years. Those that lie vacant may not be filled.

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STRENGTH & FUNCTION

SANCTIONED STRENGTH IRS



CBDT

- Provides inputs for policy and planning of direct taxes in India, and is also responsible for administration of direct tax laws through the I-T department

CBIC

- Nodal national agency responsible for administering Customs, GST, central excise, service tax, and narcotics in India

IRS: Indian Revenue Service

I-T dept amends TDS form, makes it comprehensive

The income-tax (I-T) department has amended the tax deducted at source (TDS) form, making it more comprehensive and mandating deductors to state reasons for non-deduction of tax. According to the amended form, banks will also have to report TDS for cash withdrawals above ₹1 crore. Through a notification, the Central Board of Direct Taxes has amended the I-T rules to include TDS on e-commerce operators, dividend distributed by mutual funds and business trusts, cash withdrawals, professional fees, and interest.

News BusinessLine

'Centre mulling merger of CBDT, CBIC, downsizing'

Hemani Sheth | Mumbai | Updated on July 06, 2020 | Published on July 06, 2020



The proposal to merge the two tax wings is back on the table along with plans for a massive downsizing as per reports.

At present, the two boards operate independently, though, they request each for sharing of data.

The merger of the two boards and interchangeability of the officers from Income-tax to Indirect-taxes will achieve a classic interplay into picture!

Other relevant news (6 June, 2019)

Customs, I-T Depts Work Closer to Vet MNC Transfer Pricing

MNCs would file separate transfer pricing positions for taxation purpose and for international trade, thereby getting away with information arbitrage in some cases

Sachin.Dave
@timesgroup.com

Mumbai: The days of information arbitrage may just be over for many companies. The special valuation branch of the customs department is scrutinising transfer pricing methodologies of several multinationals with a view to reconcile their tax and import-export submissions.

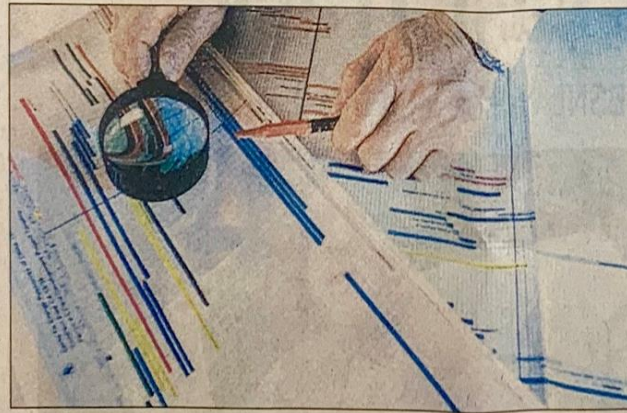
Until now, MNCs used to file separate transfer pricing positions to both departments, one for taxation purpose and the other for international trade. Since the two departments wouldn't share data with each other, companies could get away with the information arbitra-

ge in some cases, said people in the know of the matter.

Transfer price is basically a price charged by a subsidiary or a division of a company to another. Rules suggest that there has to be an 'arm's length' while fixing this price so that it's not too low or too high than the existing open market price. Tax officers can question and demand tax in case they suspect that companies are escaping taxes.

The customs department too has its own valuation mechanism whereby it checks the price of imports and exports to subsidiaries outside India.

"Collaboration between the customs and income tax department was initiated a few years ago; it's only recently that we have seen



that data and information provided by businesses to one is being used by the other more frequently," said Pratik Jain, partner and national leader, indirect taxation, at

PwC India. "While the objectives of the departments could be different, there could be disputes where multinationals may see their methodologies and positions challeng-

ed by either of the departments."

Tax experts said often the objective of the customs department was to challenge the arm's length pricing and check if companies were under-quoting prices. For the tax department, it is to see if the arm's length price quoted by a company was high and should be lower.

Arm's length pricing usually is an industry average price at which companies buy and sell goods. For the first time in 2016, the customs department sought details from MNCs about their transfer pricing positions with the tax department. While no notices have been issued so far, that could happen in some cases in the coming months, said industry trackers.

"Customs circulars (on valua-

tion) issued in early 2016 mandate submission of transfer pricing reports apart from other relevant valuation-related information.

For the first time, customs department is comparing figures with those of tax department

Given that the methodology under both laws for a given transaction could be different, this could be an area of disconnect from an SVB (special valuation branch) proceedings standpoint," said Suresh Nair, partner at EY India.

In some cases, according to MNC executives, the transfer pricing figures would be different for genuine reasons. "The transfer pricing for customs is a subjected matter of the

logistics department in a company. While the finance or the tax team looks at transfer pricing for taxation, often these two departments don't talk to each other in a company," said a senior financial executive at a multinational firm.

"It's important for companies to align their customs and transfer pricing strategies," said Jain. There seems to be a fundamental shift in tax administration, as one department is extensively using data provided to another, and it is here to stay, he added. People in the know said some companies would show lower margins for customs submissions and higher margins for taxation purposes for transfer pricing on the same transaction with subsidiaries outside India.

Going forward, it is more likely that both the tax wings may work in close co-ordination to tap the inconsistencies in terms of pricing positions adopted in direct taxes, (TP) vis-à-vis IDT

Indian Transfer pricing regulations overview



Litigation

- ▶ Transfer pricing audit would be conducted in case of:
 - ▶ Failure to file Form 3CEB
 - ▶ Risk profile/ parameters
 - ▶ TP adjustment \geq 10 Cr. in previous assessment year

General

- ▶ Transfer pricing is the setting of price for goods and services sold between controlled (or related) legal entities within an enterprise
- ▶ Transaction with a third party shall be deemed to be an international transaction with the AE if there exists a prior agreement or the terms of the transaction are determined in substance between the AE and the third party

Forms/ documents

- ▶ TP forms (Accountant's report) are required to be obtained from Independent CA
- ▶ Due date for furnishing form 3CEB is 30th November of every year
- ▶ Maintenance of TP documentation (in case value of international transactions during the year exceed INR 1 crore) as per Rule 10D(1)
- ▶ Recently provisions regarding CbC report and Master File introduced (covered in subsequent slides)

Indian Law

- ▶ Indian TP provisions require demonstration that "transfer price" is at "arm's length"

Effective date of transfer pricing rules in India

- International Transactions: 1 April 2001
- Domestic Transactions: 1 April 2012

Why Transfer Pricing

- ▶ Due to special relationship between related parties
- ▶ Used as a profit allocation method to countries where it does business

Applicability

- ▶ All enterprises that enter into an international transaction with related party
- ▶ Also applicable to specified domestic transactions

Valuation for related party transactions under Customs

1

▶ When buyers and sellers are related

2

▶ Price is sole consideration for sale - transaction value to be accepted

3

▶ Reasons to doubt the transaction value not being at arm's length

4

▶ Related party transactions are referred to Special Valuation Branch (SVB) by default for determining whether there has been an undervaluation

5

▶ Value to be determined in accordance with the Customs Valuation Rules

Customs authorities seek to allege under valuation and TP authorities seek to allege over valuation of the goods

Valuation for related party transactions under GST

Value of supply to be determined in following order:

- 1 ▶ Open Market Value*
- 2 ▶ Value of supply of like kind and quality
- 3 ▶ 110% of the cost of production or acquisition
- 4 ▶ Any other reasonable basis consistent with the legislation

*If the recipient is eligible for full input tax credit, the value declared in the invoice shall be deemed to be the open market value

Methods of valuation under Customs vis-à-vis ALP determination methods under TP regulations

Customs

Transaction value of identical goods - adjustments for difference in commercial level and/ or quantity allowed

Transaction value of similar goods - above adjustments allowed here as well

Deductive value - value of similar/ identical goods sold to unrelated buyers in India as is or after further processing subject to deduction of usual costs, transportation, profit, etc

Computed value - cost of materials, processing, general expenses and profit of the overseas exporter while producing the imported goods

Residual method - in case price not determinable as per above, price to be determined using reasonable means consistent with the principles of valuation rules and data available in India

TP

Comparable Uncontrolled Price - Compare transaction price; Most direct method; Can be used in all cases where comparable prices available

Resale Price Method - Comparison of gross margins; Mostly used in case of distributors without significant value add.

Cost Plus Method - Comparison of cost (direct and indirect) plus margins; Mostly used in case of service providers or semi-finished goods.

Profit Split Method - Can be residual or contribution based profit split; Used in cases involving creation of intangibles and complex inter-linked transactions.

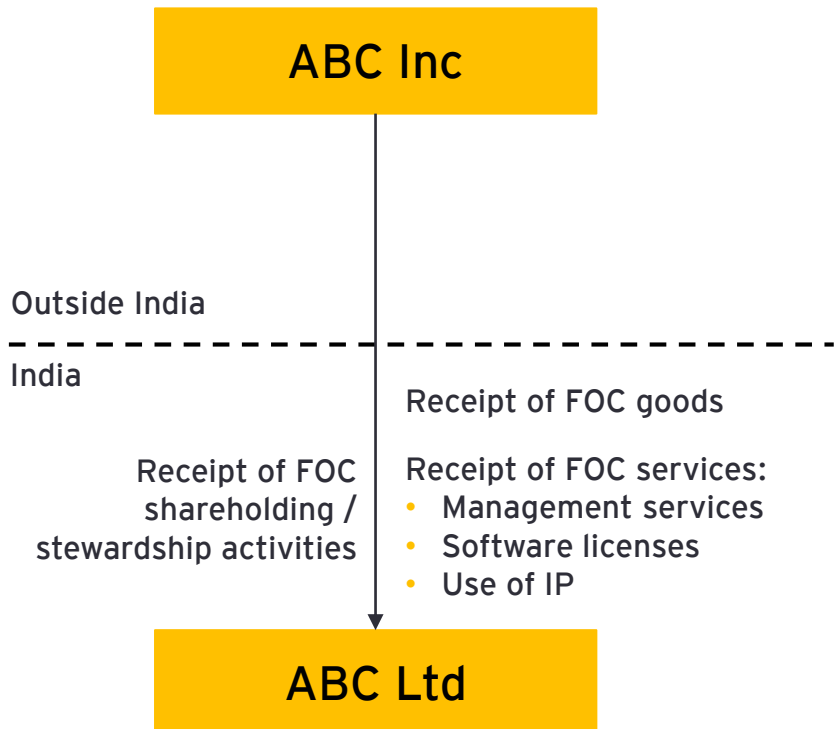
Transactional Net Margin Method - Comparison of net profit margins; Most widely used; Can make use of different profit level indicators (PLI) like, OP on OC/ (OI), ROA, ROVAC, etc

Other Method - Can use price which has been or would have been charged or paid; Eg: Revenue split, valuation certificates, quotations, etc

Points to ponder

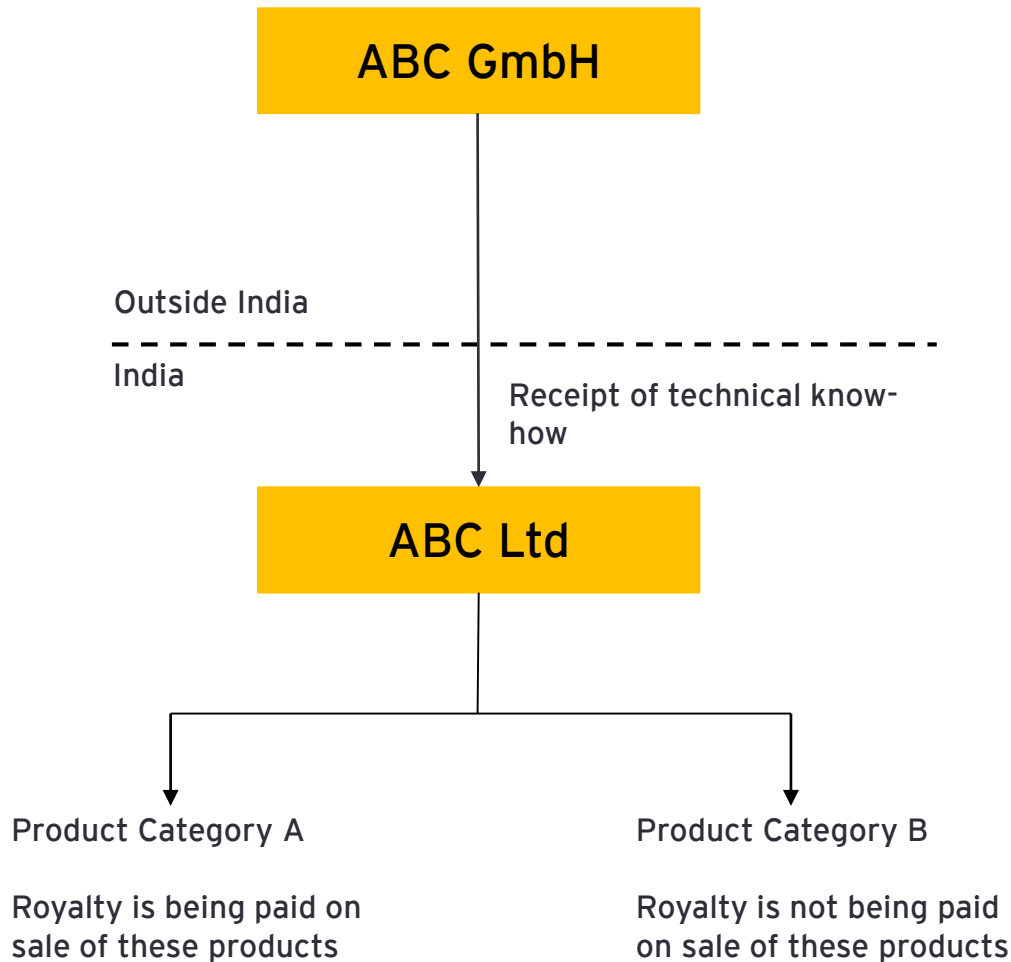
1. Moulds are manufactured by the Indian subsidiary, using the designs provided by the overseas Parent and the ownership in moulds is transferred by Indian subsidiary to the overseas Parent. These moulds would be used for manufacturing components to be supplied to the overseas Parent.
 - a) Would GST be required to be paid on the designs, even if no separate consideration is paid for the same?
 - b) Can the consideration received by the Indian subsidiary for the moulds to the overseas Parent be considered as export?
 - c) Would Income-tax TP apply?
 - d) If the consideration for the moulds is not charged separately, but included in the value of components exported, would GST still trigger on open market value of the moulds?
 - e) What would be TP considerations on either of the above arrangements?

Free of cost transactions for goods and services



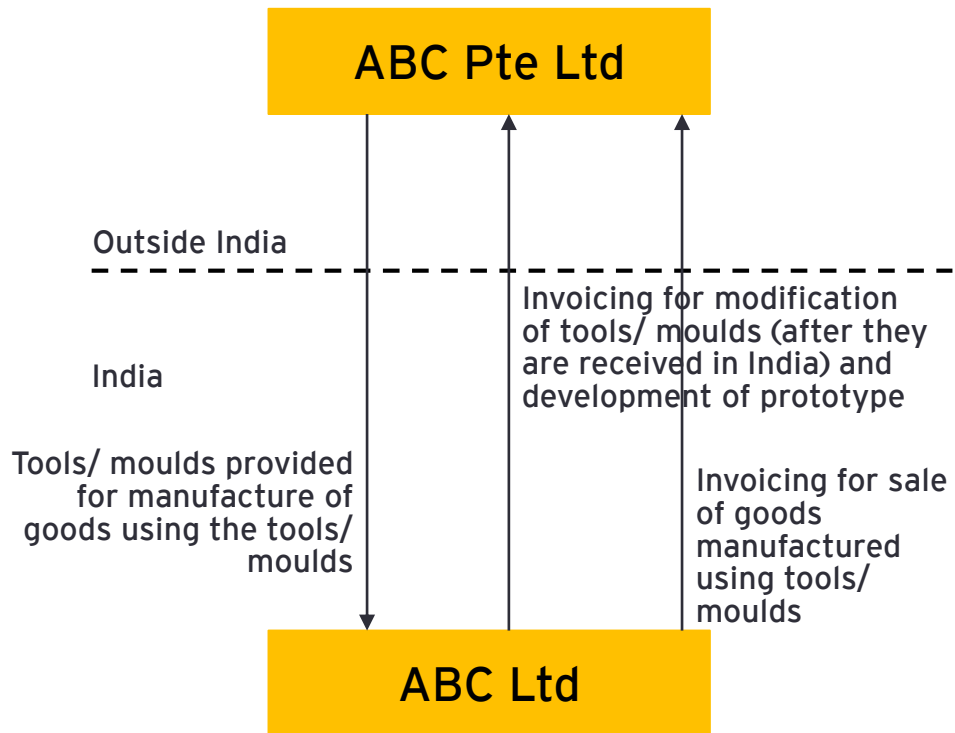
- ▶ What would be the indirect tax and TP implications for following FOC activities
 - ▶ Goods received
 - ▶ Under management services:
 - ▶ Overall management support
 - ▶ Shareholder / stewardship activities
 - ▶ Centralized functions such as procurement, IT support etc.
 - ▶ Centralized procurement of software licenses used by India
- ▶ What would be the indirect tax and TP implications for following categories of IP
 - ▶ Technical know-how
 - ▶ Royalty for tradename / brand name
- ▶ What if the inter company agreement provides for a moratorium of say, 2 years OR from the year in which ABC Ltd becomes profitable, for not charging fees for use of IP?

Free of cost transactions for goods and services



- ▶ ABC GmbH is a German Headquartered MNE Group and it has a wholly owned subsidiary in India
- ▶ ABC Ltd receives technical know-how from ABC GmbH and undertakes manufacturing activity in India based on the technical know-how provided by ABC GmbH
- ▶ Products manufactured by ABC Ltd are predominantly sold to unrelated customers in domestic and export market
- ▶ ABC Ltd has been paying royalty to ABC GmbH only on sale of certain category of products - Category A
- ▶ Now, ABC Ltd wants to increase the existing royalty rate and also wants to introduce royalty payment on sale of Category B products
- ▶ What would be the indirect tax and TP implications in such a scenario where there is no change in the technical know-how received from ABC GmbH and the royalty rate is to be increased as well as royalty is to be introduced?

Modification of tools and manufacture of goods using tools



- ▶ ABC Pte Ltd provides certain tools and moulds to ABC Ltd free of cost. These tools/ moulds have to be used by ABC Ltd in India for manufacture of goods in new facility set up as a global manufacturing hub in India
- ▶ On receiving the tools/ moulds, certain modifications are to be carried out on these and ABC Ltd raises a service invoice for carrying out such modifications.
- ▶ Also, the expenses incurred until the development of prototype before the start of regular manufacturing are to be recharged to ABC Pte Ltd
- ▶ What would be the Indirect tax and TP implications on the following:
 - ▶ Free of cost import of tools and moulds;
 - ▶ Invoicing for modification of tools and moulds;
 - ▶ Whether mark up would need to be charged on the recharge for the prototyping related expenses;
 - ▶ Whether the invoicing for the above services qualify as export under GST regulations;
 - ▶ Can the expenses (for modification and prototyping) be capitalised and recovered in the form of increased price of the components to be manufactured using these tools and moulds

Thank You

