WESTERN INDIA REGIONAL COUNCIL OF
THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF INDIA

# Transfer Pricing for Select Industries

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# Agenda

**Transfer Pricing - in the News**

**IT / ITES Industry**

**Financial Transactions - Guarantees and Loans**

**Manufacturing / Trading Industry**

**Other Industries - Specific Transactions**

- Royalty Payout
- Management Services

**Emerging issues and Recent updates**

**Q & A**

# Transfer Pricing Recent Controversies !!

**Vodafone**

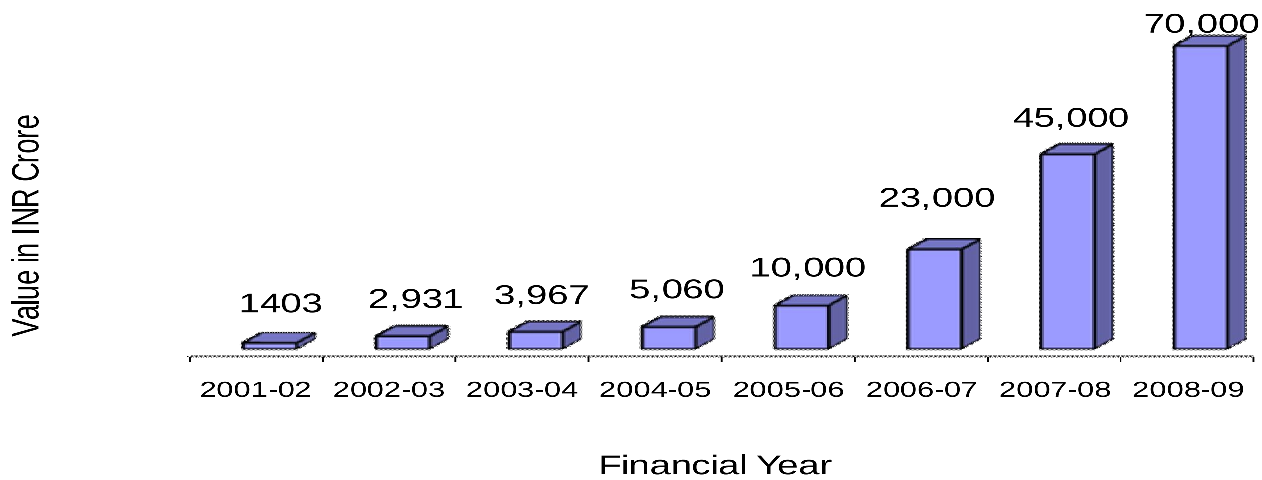
Rs 1,300 crore TP Addition - Economic Times, 7 February 2013

**Shell India**

**India accounts for about 70% of all Global TP disputes by volume – Financial Express, 1 September 2012**

# High Pitched Adjustments - Indian Revenue in Audits

**Total TP adjustments* made by Revenue upon audit**




**The above figures are approximate and based on informal feedback*

***TP adjustments of approx. INR 70,000 crores made on cross-border transactions in last concluded TP audit***

***On an average, TP adjustments are made on 50%* of the cases picked up for scrutiny***

***•Estimates based on various sources***

# Background

**Indian IT / ITES Industry can be broadly categorized into followings:**

- Software Development Services - IT Services
- Back Office Processing Services - ITES Services
- Knowledge process Outsourcing (KPO) Services
- Contract Research and Development Services

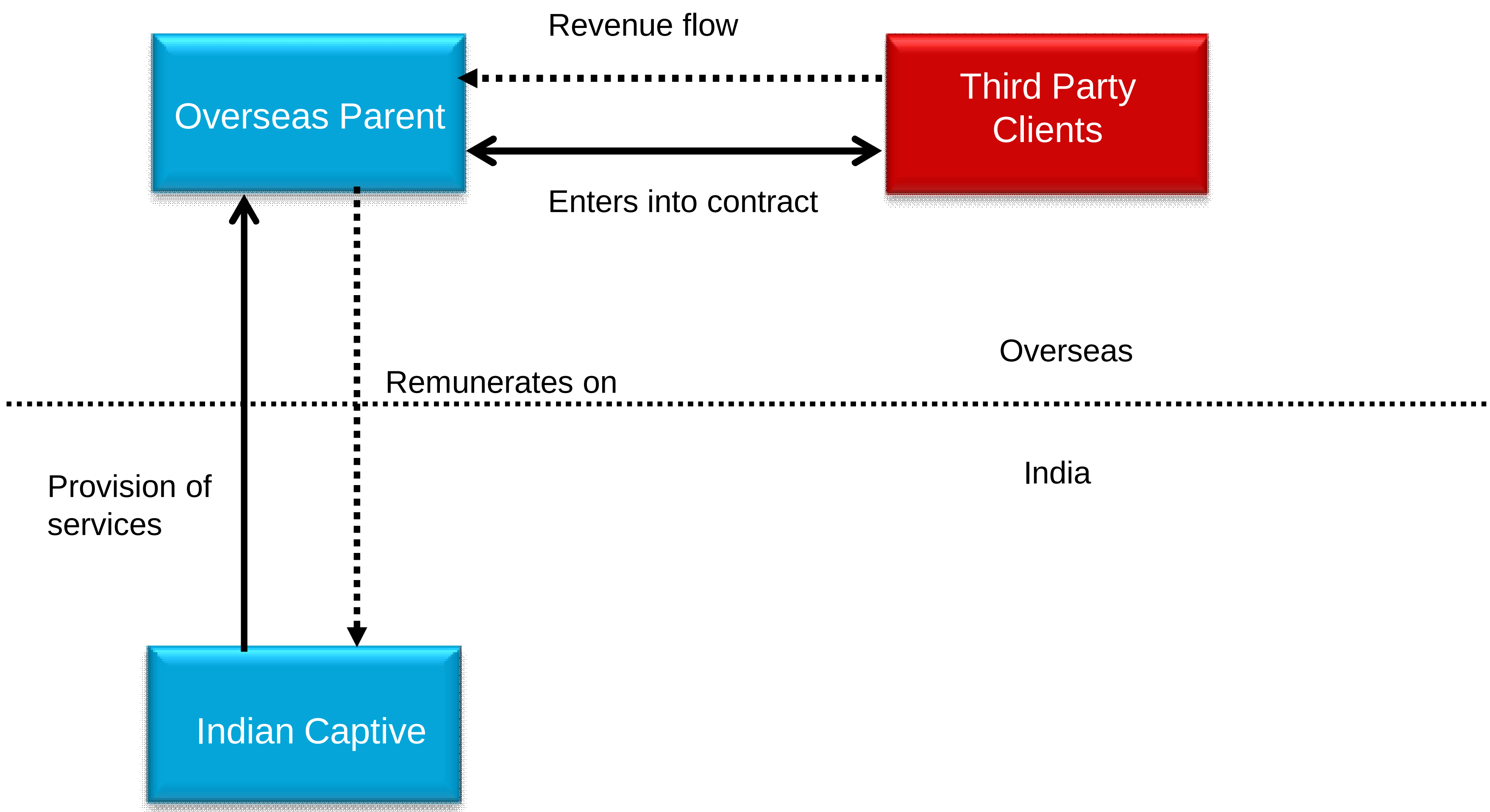
**Advantages:**

- Tax Incentives
- Easy availbility of ‘english speaking’/ talented personnel

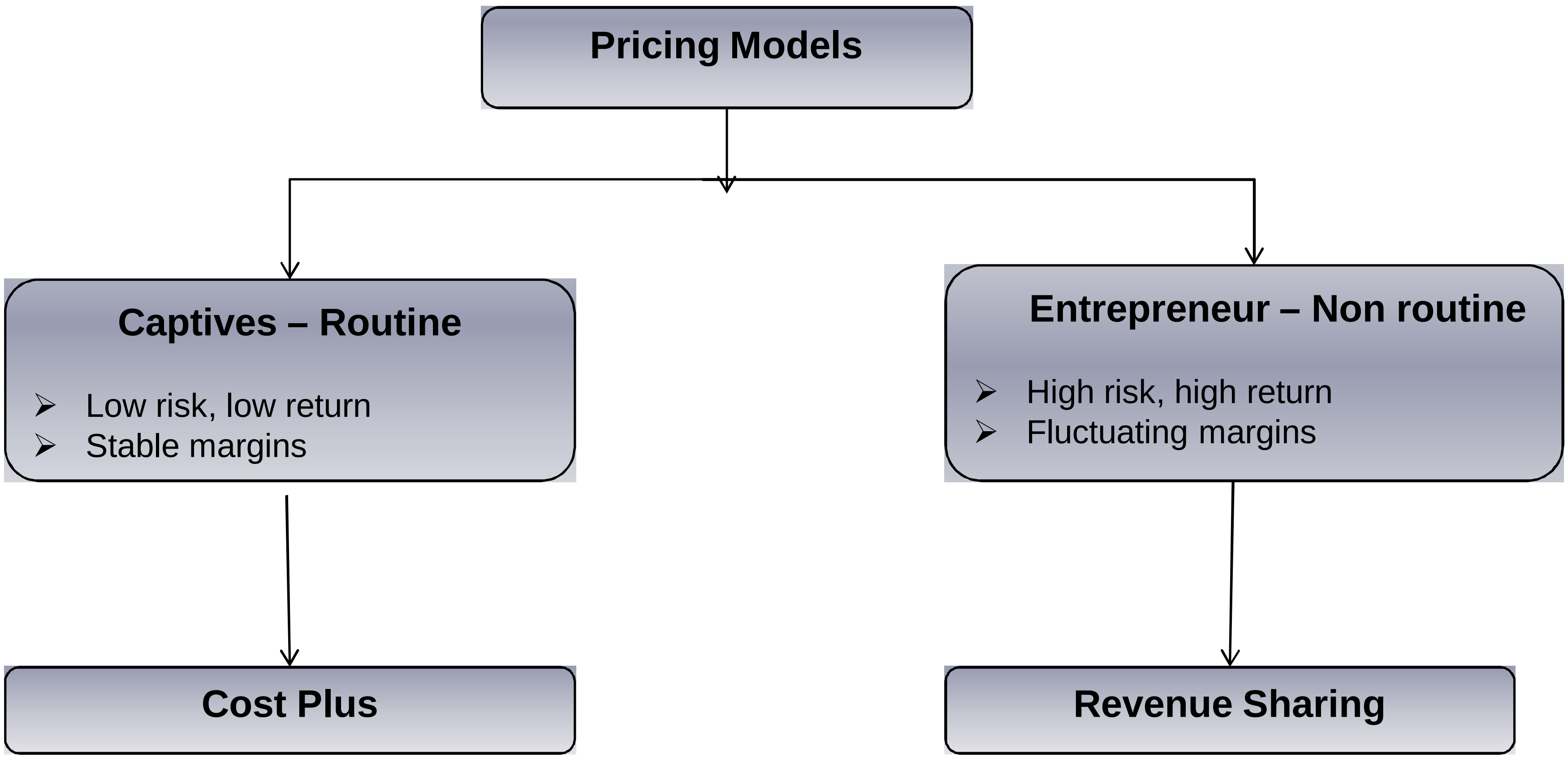
**Challenges:**

- Cascading transfer pricing disputes
- Diminishing cost arbitrage
- Competition from other developing countries

# Typical Transaction Flow

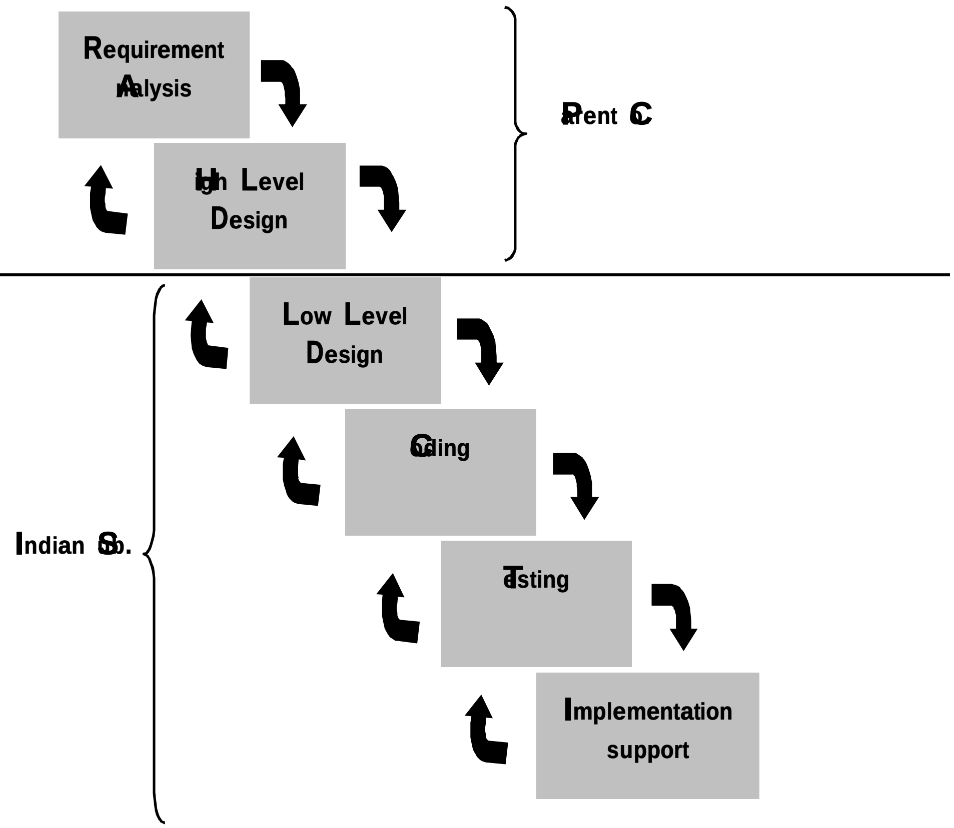


# Intercompany pricing models – IT / ITES Industry



# Software Development Services- IT Services

- **Software development / IT activities are of various categories –**
  - ➢ Coding
  - ➢ ERP customisation and implementation
  - ➢ Engineering services




## Functions

- ➢ Indian Entity only executes and performs part of software development activity
- ➢ Overseas Parent is into product development, conceptualization etc.

- **Mark-ups alleged by revenue authorities at first level ranges from 20% to 35%**

**Safe Harbour –**

- ➢ **22 %** mark-up for revenue more than INR 500 crores
- ➢ **20 %** mark-up for revenue less than INR 500 crores

# Back Office Processing Services - ITES Services

- **ITES activities are of various categories –**
  - ➢ Payroll processing
  - ➢ Back-office operations
  - ➢ Call centre

**Functions**

- ➢ Indian Entity only undertakes low end data feeding or processing tasks
- ➢ Overseas Parent undertakes marketing, customer relationship and bears risk

- **Mark-ups alleged by revenue authorities at first level ranges from 20% to 35%**

**Low Intelligence, Limited Customer Interaction**

- Data entry
- Call Centers
- Back office processing
- Medical transcription
- Insurance claims processing
- Payroll Processing
- Legal database
- Content development
- Customer service

**High Intelligence, High Customer Interaction**

**Safe Harbour –**

- ➢ **22 %** mark-up for revenue more than INR 500 crores
- ➢ **20 %** mark-up for revenue less than INR 500 crores

# Knowledge Processing Outsourcing (KPO) Services

**KPO services can be characterized as –**

- High end knowledge services
- Value added work
- People intensive efforts
- Judgment-driven rather than rule-driven processing
- Complex process

- **Mark-ups alleged by revenue authorities at first level ranges from 25% to 50%**

| Type of Activity | Examples |
|---|---|
| **Equity and Financial Research** | Investment research<br>Financial modeling<br>Company, Industry and Sector reports<br>Credit risk management<br>Valuation of companies |
| **Business and Marketing Research** | Market Analysis<br>Data mining<br>Report preparation<br>Customer Analytics |
| **Engineering and Design Services** | Very Large Scale Integration (VLSI) design<br>Simulations<br>Chip design<br>Prototype development |
| **Pharmaceutical research outsourcing** | Offshore drug discovery<br>Clinical research |

**Safe Harbour –**

- **25 %** mark-up without any threshold limit

# Contract R&D services

R&D activities in India

Conditions for characterisation

| | | |
|---|---|---|
| Functions | Economically "Significant" | Economically "Insignificant" |
| Funding/ Assets | Source of funds/ capital<br>Significant assets/ intangibles | No economically significant assets or intangibles |
| Supervision & Control | Strategic decisions for Core Functions & Monitoring | Operate under Guidance |
| Risk Profile | Significant Risks | No significant risks |
| Outcome of Research | Legal & economic owner of resultant IP | No ownership of resultant IP |

**Safe Harbour –**

- **30 %** mark-up for Contract R & D in Software development
- **20 %** mark-up for Contract R & D in Generic pharmaceutical drugs

# Tax Payer's Approach

- TNMM is most commonly used method and Indian entity selected as tested party
- Independent Indian companies engaged in the ITES / IT domain selected as comparables
- Categorization of various types of services not feasible within ITES / IT domain
- Single benchmarking analysis performed for ITES / IT services
- Operating margin on Operating cost is compared
- Following transactions integrated for comparability –
  - Reimbursement of expenses (on cost-to-cost basis)
  - Cost allocation, etc.

# Revenue's approach

- Extensive FAR analysis being done to re-characterize business / pricing model
  - Routine v/s. Value added services
- Cost base an issue – whether forex gain / loss, provision for doubtful debt, etc. to be included?
- Functions performed by BPO (low end activities), considered as KPO (high end activities)
- Use of secret comparables by exercise of powers u/s. 133(6) to gather information not publicly available
- Cherry-picking of favorable / high margin companies for benchmarking analysis
- Working Capital adjustment sometimes considered, Risk adjustment normally not considered

# Analysis of key Tribunal rulings – KPO v/s. BPO

| Tribunal | Mumbai | Mumbai | Delhi | Hyderabad | Hyderabad | Mumbai |
|---|---|---|---|---|---|---|
| Ruling / Contentions | Willis | Vodafone India Services | Actis Advisers | Capital IQ | Cognizant Technologies | Lloyds TSB |
| Whether companies providing KPO services are comparable to those providing low end BPO services? | Yes | Yes | Yes | No | No | No |
| Whether companies earning abnormally high profit margins should be excluded? | No | No | No | Yes | Yes | NA |

$\underbrace{\text{Willis, Vodafone India Services, Actis Advisers}}_{\text{Not Favourable}}$ $\underbrace{\text{Capital IQ, Cognizant Technologies, Lloyds TSB}}_{\text{Favourable}}$

**Supreme Court Ruling - If two views are possible then one which is favourable to the assessee is to be adopted**

# Financial Transactions – Interest on Loans

- Foreign currency loan benchmarking requires foreign benchmarks
- Taxpayer uses LIBOR as benchmark whereas tax authorities consider PLR for benchmarking
- Interest on overdue balances - not recovered from the Parent
- Interest free loan given by Indian company to its subsidiary – Taxpayer's argument that loan is in effect quasi-equity or is advanced out of interest free funds, is not accepted by the tax authorities

# Financial Transactions - Corporate Guarantees

- Corporate Guarantee is a legally binding agreement under which the guarantor agrees to pay any or all of the amount due on a loan instrument in the event of non payment by the borrower
- No charge for guarantee fee on the ground that there is no cost of guarantee
- Comfort Letters are also viewed as an form of Guarantee
- Granting of interest free loans has historically led to tax controversies with the Revenue authorities

# Financial Transactions – Loans and Guarantees - Judicial precedents

| Cases | Tribunal Ruling |
|---|---|
| **Perot systems TSI**<br>**Delhi ITAT**<br><br>**VVF Limited-**<br>**Mumbai ITAT** | ▪ Interest –free loans by Indian Companies to foreign subsidiaries do not comply with arm's length standard<br>▪ Benefit of +/- 5% safe harbor is available only where more than one arm's length price is determined<br>▪ RBI's approval does not endorse the arm's length character of the international transaction |
| **Logix Micro Systems**<br>**Bangalore ITAT** | ▪ The Tribunal observed that funds parked with the AE do not partake the nature of a loan transaction and hence LIBOR / US Fed rate cannot be used to calculate the interest.<br>▪ Taxpayer losing an opportunity to pay off its working capital loans, if any and/or is also loosing an interest income had the funds been deployed in a considerable investment destination in India and there by fixed the rate at 5% based on short term deposit rates prevailing in India |
| **Nimbus Communication Limited**<br>**Mumbai ITAT** | ▪ Rate of interest charged on loan granted cannot be used as comparable for charging interest on outstanding trade receivables<br>▪ An outstanding debit balance on account of services rendered to the Group companies does not qualify as an international transaction since the same is not an independent transaction, but merely the result of a commercial transaction<br>▪ The charging of interest is applicable only with the lending or borrowing of funds and not in the case of commercial over dues |

# Financial Transactions – Loans and Guarantees - Judicial precedents

| Cases | Tribunal Ruling |
|---|---|
| **Siva Industries**<br>**Chennai ITAT** | ▪ Where the taxpayer has extended a loan to its Group companies in foreign currency, LIBOR must be considered for determining arm's length interest rate |
| **Tech Mahindra Limited**<br>**Mumbai ITAT** | ▪ The Tribunal held that the USD LIBOR, instead of the Euro should be used as a benchmark for the extended credit period granted to the Group company in USA. The rate of interest charged should match the currency in which the international transaction has taken place<br>▪ In the said decision, the Tribunal has categorically mentioned that it would refrain from making any observations on whether or not extended credit period should be compared with a loan |
| **Four Soft**<br>**Hyderabad ITAT** | ▪ Guarantee to an affiliate is not an international transaction |
| **GE Capital, Canada** | ▪ Savings to GE Canada implicit outcome of guarantee arrangement<br>▪ Yield approach (interest savings approach: 1.83% drop in coupon rate) upheld to be an appropriate method for benchmarking |

# Guarantee Fee - Benchmark and Documentation

- ✓ Credit rating of borrowing entity by an external reputed agency
- ✓ Benchmarking analysis, if any, conducted to determine the guarantee fee
- ✓ External Documents - Quotation from Bank
- ✓ Internal Documents- Details of guarantee fee, if any, paid / received in a comparable transaction
- ✓ Copy of transfer pricing policy, if any, followed by the Group
- ✓ A detailed note to demonstrate the need for funds on the part of the borrowing entity
- ✓ Documents evidencing cost saving, if any, anticipated by borrowing entity due to guarantee

**Safe Harbour –**

- ➢ Guarantee upto Rs.100 crores to WOS - 2 % p.a. or more
- ➢ Guarantee above Rs.100 crores to WOS – 1.75 % p.a. or more

# Interest on Loans - Benchmark and Documentation

- ✓ Copy of agreement and correspondences evidencing negotiation
- ✓ Copy of transfer pricing policy and benchmarking analysis, if any, conducted to determine the interest rate
- ✓ Quotation from Bank or interest rate published in the reputed databases (i.e. Bloomberg etc)
- ✓ Details of interest, if any, paid / received in a comparable transaction
- ✓ A detailed note to demonstrate the need for funds on the part of the borrowing entity
- ✓ Working of the interest amount along with following:
  - Details of opening balance, repayment and outstanding balances of loan; and
  - Abstract from the external website to demonstrate movement in underlying LIBOR rate

**Safe Harbour –**

- ➢ Loan upto Rs.50 crores to WOS abroad - SBI base rate plus 150 bps
- ➢ Loan above Rs.50 crores to WOS abroad - SBI base rate plus 300 bps

# Background

**Manufacturing activities can be broadly classified as :**

- Entrepreneur
- Licensed Manufacturer
- Contract Manufacturer
- Toll Manufacturer

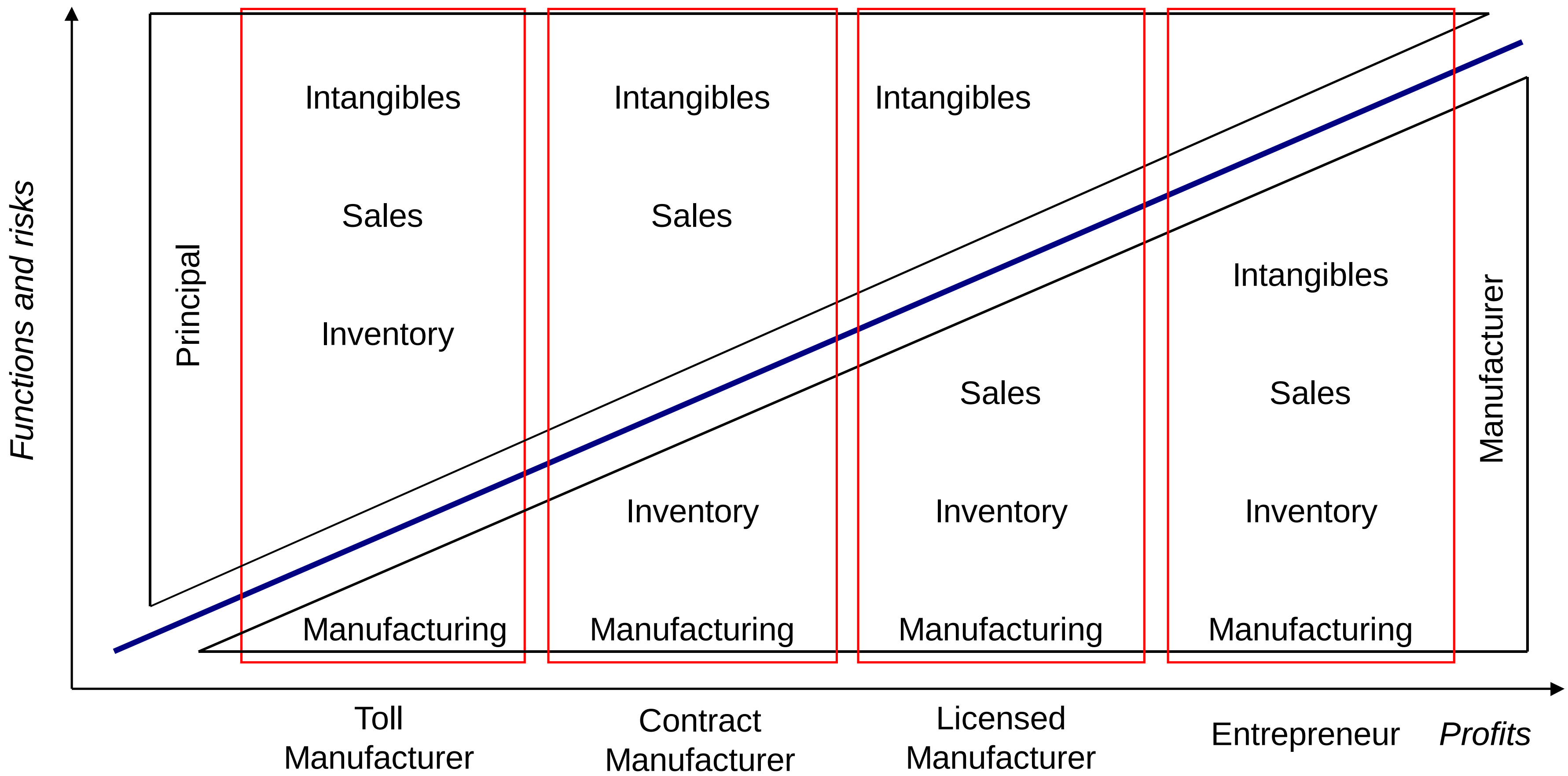
**Distribution activities can be broadly classified as :**

- Full-Fledged Distributor
- Low Risk Distributor
- Commissionaire
- Commission Agent

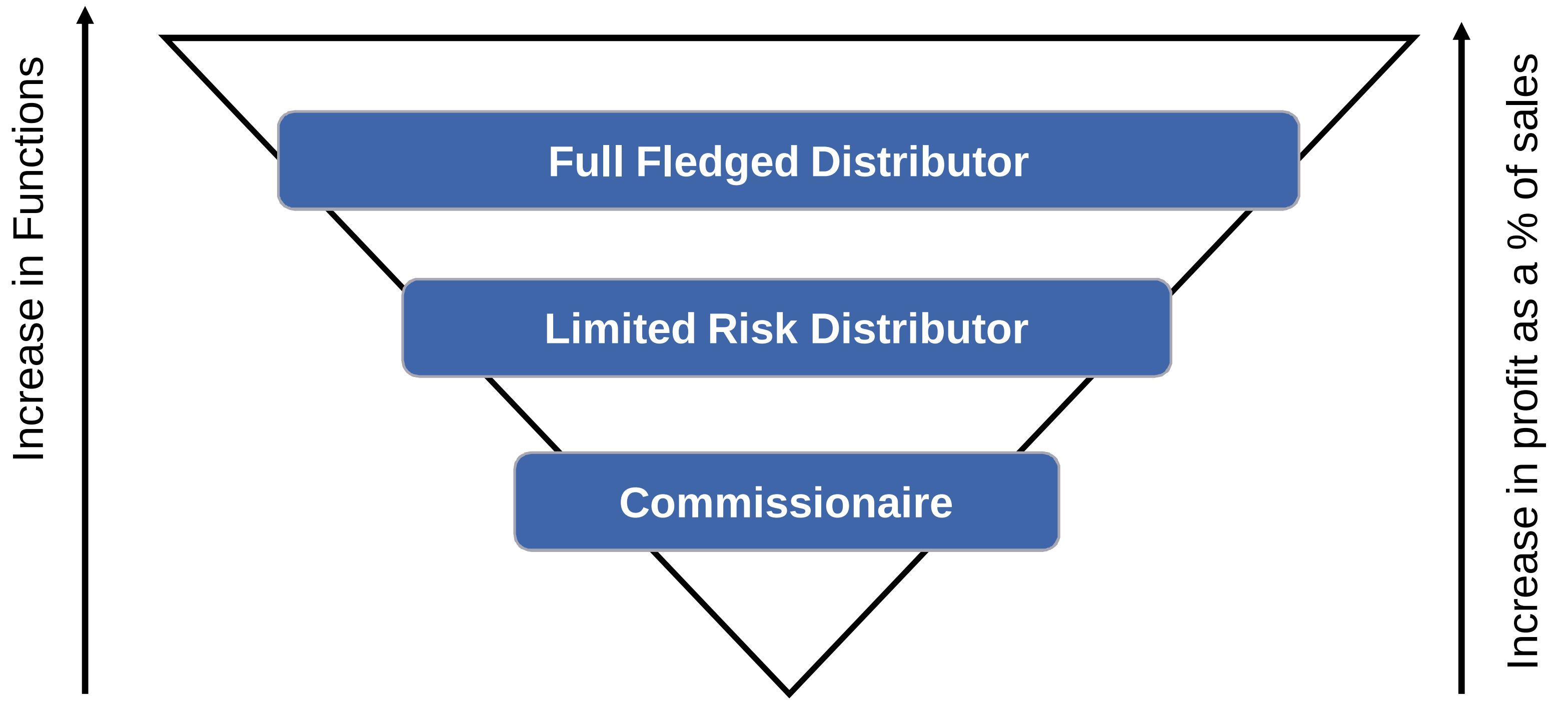
**TNMM is the most commonly used method**

**Local comparables are acceptable to the tax office where tested party is in India**

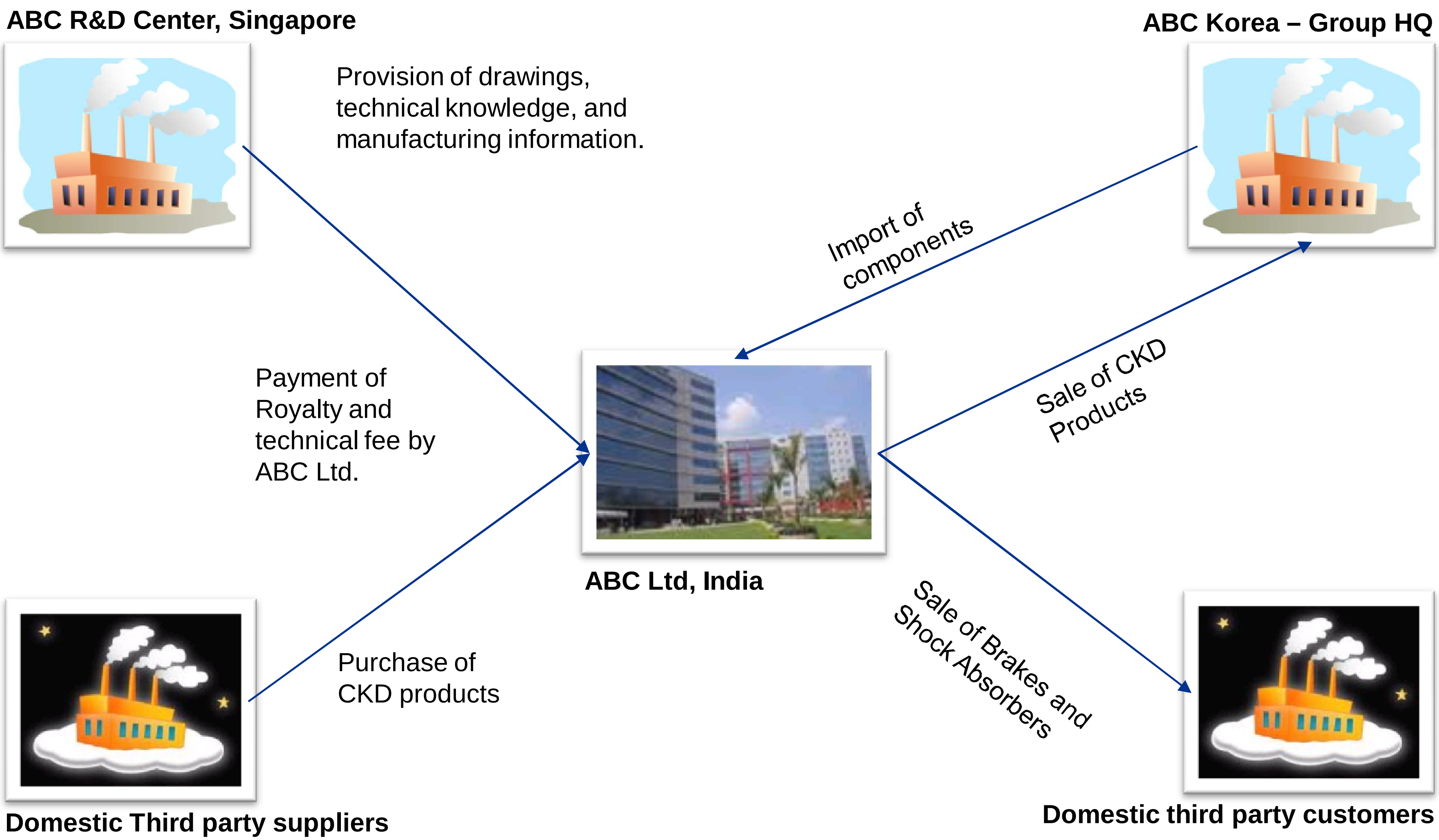
# Risk and Rewards: Manufacturing Activities



# Risk and Rewards: Distribution Activities



# Case Study - Group Process flow



# Case Study - Benchmarking

ABC Korea

100% Subsidiary

Engaged in the manufacture and distribution of brakes and shock absorbers
**Characterized as Entrepreneur**

ABC India

Engaged in the manufacture of brakes and shock absorbers and distribution of CKD Products
**Characterized as Licensed Manufacturer**

Inputs → Processing → Output

| Inputs Received from | Output Delivered to |
|---|---|
| **Domestic Parties** | **Domestic Parties** |
| • Purchase of CKD products | • Sale of Brakes and Shock Absorbers |
| | |
| **Related Parties** | **Related Parties** |
| • Import of components<br>• Provision of drawings, technical knowledge, and manufacturing information **(R& D Center)** | • Sale of CKD Products |

# Case Study - Snapshot of International Transactions

| Particulars | Amount |
|---|---|
| Import of Components | 15,000 |
| Payment towards Royalty | 5,000 |
| Payment towards Technical fees | 5,000 |
| Sale of CKD Products | 150,000 |
| Reimbursement | 15,000 |

The following international transactions are inextricably linked with the manufacturing function of ABC India and hence have been aggregated:

- Import of components; and
- Payment towards royalty and technical fees

# Case Study - Segmented P&L

| Particulars | Manufacturing | Trading | Total |
|---|---|---|---|
| Sales | 200,000 | 300,000 | 500,000 |
| Manufacturing expenses / cost of purchases | 90,000 | 210,000 | 300,000 |
| Royalty and technical fees | 10,000 | - | 10,000 |
| Employee cost | 30,000 | 24,000 | 54,000 |
| Administrative expenses | 24,000 | 15,000 | 39,000 |
| Selling and distribution cost | 16,000 | 24,000 | 40,000 |
| Depreciation | 16,000 | 12,000 | 28,000 |
| Total Expenses | 186,000 | 285,000 | 471,000 |
| Total Profit | 14,000 | 15,000 | 29,000 |
| **Net cost plus Margins (NCP)** | | **5%** | |
| **Net Profit Margins (NPM)** | **7%** | | |

***Results*** *: The NCP and NPM earned by ABC in the trading and manufacturing segments are 5% and 7% respectively. The weighted average arithmetic mean margins of comparable companies engaged in similar trading and manufacturing business are 4.44% and 6.20% respectively.*

# Case Study - Analysis of Comparable companies

| Name of comparable companies | Weighted Avg NPM |
|---|---|
| A N G Industries Ltd | 16.21 |
| Bosch Chassis Systems India Ltd. | 6.95 |
| Brakes India Ltd | 9.52 |
| C M Smith & Sons Ltd | 3.46 |
| Hindustan Composites Ltd | 1.59 |
| Rambal Ltd | 12.83 |
| Rane Brake Lining Ltd | 6.57 |
| Renowned Auto Products Mfrs. Ltd | -7.54 |
| **Arithmetical Mean** | **6.20** |

Companies engaged in similar manufacturing or assembly activities

Companies engaged in similar trading activities

| Name of comparable companies | Weighted Avg NCP |
|---|---|
| George Oakes Ltd | 4.02 |
| Jullundur Motor Agency (Delhi) Ltd | 4.78 |
| Speed – A – Way Pvt Ltd | 6.22 |
| Sri Aruna Auto Service Ltd | 1.73 |
| PAE Ltd | 5.44 |
| **Arithmetical Mean** | **4.44** |

**Safe Harbour –**

- Manufacture and export of **core** auto components - **12 %** mark-up on cost
- Manufacture and export of **Non core** auto components – **8.5 %** mark-up on cost

# Manufacturing / Trading Industry - Audit Experience

**Triggers for Detailed Scrutiny**

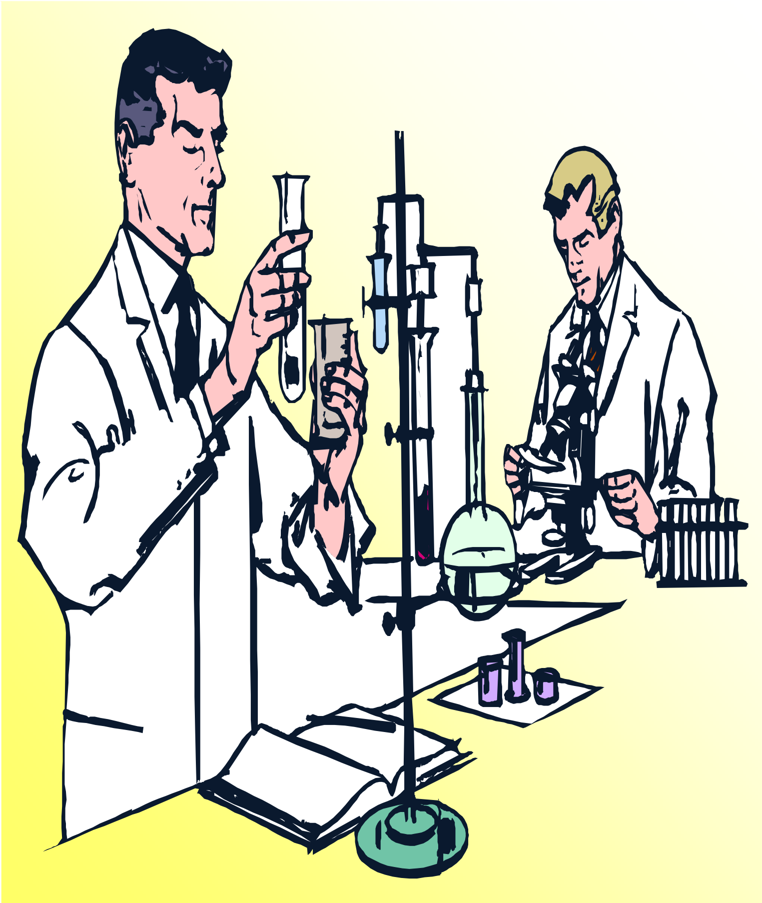
- Consistent losses / low margins
- Significant changes in profitability of the taxpayer
- High value intra-group services such as royalty / technical payouts, cost allocations, etc.
- Payment of ‘management charges’ and ‘royalty’ not passing the ‘benefit test’
- Net losses incurred by routine distributors
- Low mark-ups for services
- Significant marketing expenses by manufacturing / distribution companies

# Manufacturing / Trading Industry –Issues & Possible Remedies

| | |
|---|---|
| Low Gross Profit | Reimbursement of Custom Duty/ Reimbursement of discounts to retailers |
| | + |
| Low Volumes | Volume Guarantee |
| | + |
| Significant Marketing Expenses | Reimbursement of Marketing Expenses |

# Royalty Payouts

- Royalty widely adopted mechanism to compensate for use of manufacturing intangible
- Extremely controversy prone in recent times
- Transfer pricing adjustments common in this area
- Recently, the regulatory caps were removed – paving way for higher royalty payment
- Currently transfer pricing is the only obstacle in paying royalties at desired levels to related parties



**Is Royalty Payment justified in case of loss situation?**

# Royalty Payouts - Revenue's Approach / Issues

**Taxpayers asked to demonstrate**

- Description of intangibles and the benefit it accrues
- Whether royalty is embedded in price paid
- Owner of intangibles (details of foreign enterprise)

**Appropriate Arms Length Principle ("ALP") for intangible property**

- TNMM may be acceptable when there are no other international transactions reflected in the P&L
- Methodologies like DCF and Excess Earnings Method being increasingly used by Indian tax authorities
- Alternative methodologies
- CUT – in the absence of local agreements, search for agreements in international databases (Lexis-Nexis, Royalty Stat, etc.)
- Profit Split Method

**Benchmarking Issues**

- Limits specified by RBI and FEMA not considered as external CUP
- Aggregation approach under TNMM challenged and general lack of availability of comparables
- Transaction specific approach has been adopted by revenue – examine the 'cost –benefit' analysis
- The RBI ceiling of brand royalty at 1% on domestic and 2% on export sales and technical fee royalty at 5% on domestic and 8% on export sales have recently been removed. Therefore increased challenge in determining royalty payouts

# Recent Judicial Rulings - EKL Appliances Ltd.

**<u>Delhi High Court's Ruling – Payment of Royalty to AE</u>**

- It is not for the Revenue authorities to dictate to the taxpayer how he or she should conduct his business and what expenditure should be incurred.
- It is not necessary for the taxpayer to show that any legitimate expenditure incurred by him or her
  - was also incurred out of necessity or
  - that the expenditure incurred by him or her for the purpose of business has actually resulted in profit or income.
- The taxpayer only needs to show that the expenditure should have been incurred "wholly and exclusively" for the purpose of business.
- The amount of expenditure can be examined by the TPO but he or she has no authority to disallow the expenditure on the basis that the taxpayer has suffered continuous losses.
- The High Court also relied on the OECD Guidelines: Tax administrations should not disregard and restructure the transactions as actually undertaken by the taxpayer except
  - where the economic substance of a transaction differs from its form; and
  - where the form and substance of the transaction are the same but arrangements made in relation to the transaction differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.

# Royalty payouts - Benchmark and Documentation

- Copies of license agreement
- Benefits received / receivable by the tax payer and quantification of the benefit
- Unique nature of the intangible, market where it is used and strategic advantage achieved
- Rights of the taxpayer to receive upgrades .
- Comparative profits before and after the use of intangible.
- Whether there are any geographic restrictions such as to export based on the licensed technology
- Details of patents / intangibles registered by taxpayer in India
- Quote of a comparable independent technology recipient for the intangible.
- Rates at which the royalty is paid for use of similar intangibles by any other concern / subsidiary of the AE / Group.

# Headquarter and Management Services

- Payment justified for services not in the nature of:
  - ✓shareholding services
  - ✓ duplicative services
  - ✓passive association benefits
- Another area prone to litigation in India
- Stringent “benefits test”

# Headquarter and Management services

**Indian TP regulations silent on the subject. Reference has to be made to guidance given in the OECD Guidelines**

**Taxpayer's Approach**

- The allocation charge of total costs made by the Headquarter to subsidiaries around the globe by using certain allocation keys like headcount, turnover, computer expense, etc. is accepted by the Indian AE.
- The cost base of the Headquarter may or may not be authenticated. The details of the cost base may not be communicated by the Headquarter.
- There is not much focus on the "Need" for the service and the "Benefit" from the service.

**Revenue's Approach : Revenue requires the following parameters to be satisfied:**

- "Need" for services and documentary evidence that such services were indeed received
- Quantification of "Benefits" received to prove parity with the charge
- Services should not be duplicative in nature and should not include shareholder services
- Authenticity of allocation keys and cost base of the parent
- Comparison of intra-group fees with local market price of similar services (if applicable)

Revenue conclusion in most cases - "Need test" or "Benefit test" is not passed; "Evidences" are not conclusive or demonstrative of value received; and hence arm's length price is determined at NIL

# Recent Judicial Rulings - McCann Erickson India Pvt. Ltd.

**Delhi Tribunal's Ruling – Management services received from AE**

- The taxpayer had placed substantial evidence in respect of the management service charges and client coordination fee on record and had been able to establish the nature and benefits of services provided by the Associated Enterprise (AE). The tax department had not brought out anything to negate such evidence.
- The taxpayer is engaged in only one class of business. There are no segments which can be said to be independent of each other. Entity level benchmarking using the Transactional Net Margin Method (TNMM) shall be most appropriate .
- Considering the business environment of the taxpayer, it would be difficult to operate successfully without receipt of services which carry huge intrinsic and creative value. Only a business expert can evaluate the true intrinsic and creative value of such services.
- The Tribunal relied on the High Court judgment in the case of ***Hive Communication Pvt. Ltd.*** wherein it was held that the legitimate business needs of the company must be judged from the perspective of the company. It is not for the AO to dictate what the business needs of the company should be.
- The term "benefit" to a company in relation to its business has a very wide connotation. It is difficult to accurately measure these benefits in terms of money value separately.

# Management services – Illustrative model documentation

**Documentation requirement specific to certain services**

### Strategic Planning

- Business Reports / Plans
- Trainings
- E-mails
- Telecon-notes
- Corporate Governance initiatives

### Information Technology Support

- IT Security Policy and Manual;
- Details of trainings received;
- E-mail system
- Intranet
- Servers including Remote Servers

### Accounting and Finance

- Accounting system
- Accounting manual
- Business Reporting system
- Trainings

### Human Resources

- HR Manuals
- Appraisal and Evaluation
- Welfare Schemes
- Trainings

### Sales and Marketing

- Details of any marketing strategic inputs
- Details of sales converted due to marketing assistance
- Brand and Sales Promotion Material
- Trainings

### Supply chain Management ('SCM')

- SCM Manual and Policies
- Write-up on inventory management
- Daily distribution plan
- Demand forecasting and production scheduling


# Emerging issues

**Capital financing**

- Valuation is the key element

**Business restructuring**

- Involves wide gamut of transactions

**Intangibles**

- New definition widens scope `

**Contract R & D services**

- Circular 3 – stringent tests

**Compliance for non-resident entities**

- Stringent penal provisions for violations

# Recent updates

- Transfer Pricing provisions made applicable to transactions between domestic related parties for FY 12-13 onwards:
  - Expenses or payments made to domestic related parties as specified in Section 40(A)(2)(b)
  - Transactions with tax holiday units housed under such related parties
  - Value of transactions in aggregate exceeds INR 5 crore annually
- Advance Pricing Agreement ('APA') regime for  international transactions introduced
- "Other Method" for determining Arm's Length Price introduced
- Safe Harbour Rules notified
- Tolerance band for FY 13-14 notified – 1% for wholesale traders and 3% for all other cases
- Coverage and quantum of penalties for non-compliance expanded

# Key Points for success

- Proactive TP analysis
- Detailed FAR analysis
  - Assessee
  - Associated Enterprises
  - Comparables
- Evaluating potential risk adjustments
- Determination of income attributable to a PE in India
- Strong and robust Transfer pricing documentation
- Global TP Policy – Need for localization and regular review
- Proactively determining the audit strategy
- Leveraging on the favorable evolving TP judicial decisions
- Strategically, ensuring the furnishing of adequate evidence / supporting documentation to effectively stake claims during initial TP audits

# Questions & Answers

Questions

&

Answers

# Thank You

**Bhavesh Dedhia**

**Chartered Accountant**