

Seminar on E-Commerce Industry

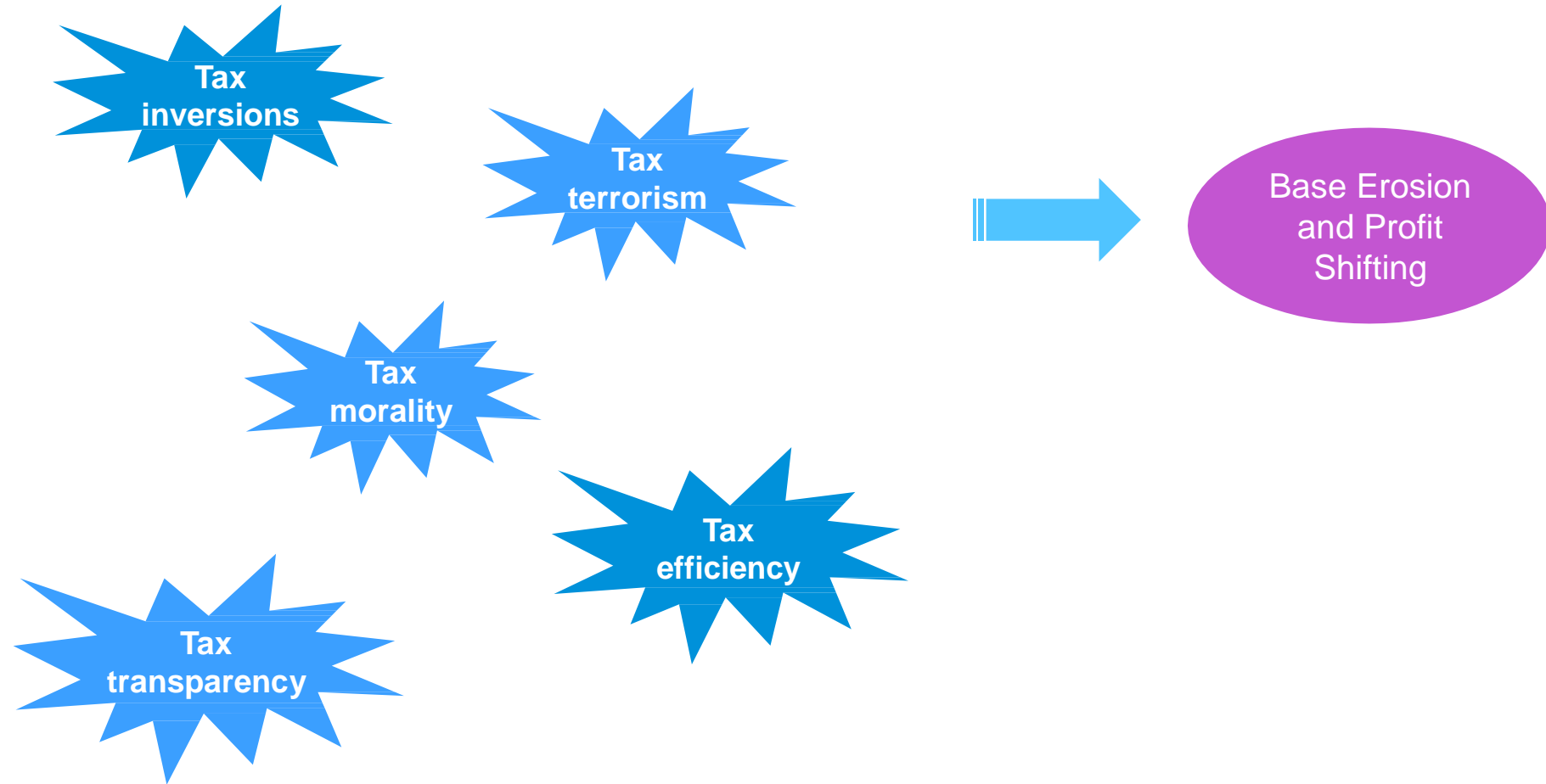
Transfer Pricing in India - Key aspects

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1 September 2018



Tax - A Boardroom Topic



Transfer Pricing – A proliferation in recent times





Tax Environment in India - Renewed Focus

Implementation of BEPS Package

- Preventing artificial avoidance of PE status
- India's acceptance to MLI
- CbC and Master File implemented from FY 2016-17



Uncertainty prevails in few areas

- AMP Issue – still needs finality
- Royalty payments & secondment arrangements – under critical examination

New Developments

- Increased PE exposure due to changes proposed by MLIs and BEPS Action Plan 7
- Exchange of CbCR to commence from September 2018
- Sharing of draft regulations for public consultation
- Shift in audit scrutiny criteria to risk-based approach

Key Considerations for the Taxpayers

Review of existing models/ transactions in the light of new developments/ BEPS

Mitigate possible risk by maintaining robust documentation and alternate analysis, where possible

Obtain certainty through alternate dispute resolution mechanism – APA/ MAP/ AAR

Alternate Dispute Resolution

- 20%+ APAs concluded – 10%+ bilateral APAs concluded
- 25%+ APA applications resolved in last 21 months
- APA conclusion timelines better than some developed countries
- 180+ MAP cases been resolved in last 3 years
- Faster disposal of cases by AAR

Transfer Pricing Litigation Position

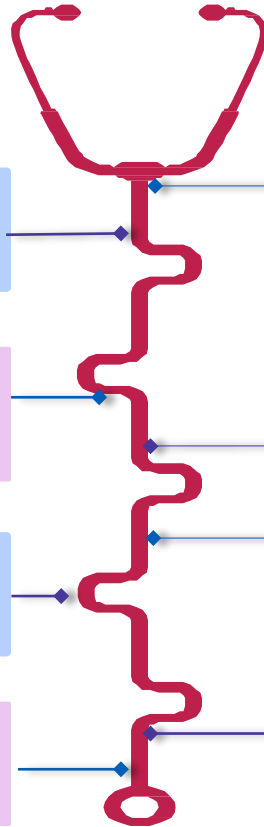


Shift in Audit approach - from “Monetary threshold” to “Risk based parameters”

Simplified transfer pricing administration (APA, MAP, Safe Harbour)

Moving towards transparent approaches - adoption of BEPS Action Plan 13

Reduction in the timelines for conducting audits



Continuing uncertainty - cases stuck at ITAT/ Courts

Remand back by Tribunal/ HC – unending cycle

Field office inclined to follow past precedents

Revenue cannot appeal against DRP





coeR Form case Study

Table 1 - Overview of allocation of income, taxes and business activities by tax jurisdiction

MNE Group - Jupiter Ltd. - India. Headquartered

| Country | Revenue | | | Profit (loss) tax before income tax | Income tax paid (on a cash basis) | Income accrued-current year | Stated capital | Accumulated earnings | Number of employees | Tangible assets other than cash and cash equivalents | Trigger (Profit per employee) | Functions |
|----------------|---------------|-----------------|---------|-------------------------------------|-----------------------------------|-----------------------------|----------------|----------------------|---------------------|--|-------------------------------|---------------|
| | Related party | Unrelated party | Total | | | | | | | | | |
| India | 3,000 | 6,000 | 100,000 | 20,000 | 4,000 | 6,000 | 50,000 | 24,000 | 500 | 76,000 | 40 | Fin / Mgmt. |
| United Kingdom | 2,000 | 8,000 | 10,000 | 1,200 | 240 | 336 | 5,000 | 30,000 | 75 | 7,500 | 16 | Log / Sales & |
| Mauritius | 90,000 | 10,000 | 100,000 | 40,000 | 4,000 | 6,000 | 4,000 | 500,000 | 10 | 10,000 | 4,000 | R&D / IP |

| Country | Company Name | Incorporation in | R&D | Country of organization or management | Sales or procurement | Manufacturing & production | Holding or subsidiary | PLJ or support services | Sales or services to unrelated parties | Provision of financial services | Admin, insurance, etc. | Intra. or other equity instruments | Activities | |
|-----------|-----------------|------------------|-----|---------------------------------------|----------------------|----------------------------|-----------------------|-------------------------|--|---------------------------------|------------------------|------------------------------------|------------|-------|
| | | | | | | | | | | | | | Other | Other |
| India | Jupiter Ltd. | India | | India | | | | | | | | | | |
| UK | Jupiter UK Ltd. | UK | | UK | | | | | | | | | | |
| Mauritius | Jupiter Ltd. | Mauritius | | Mauritius | | | | | | | | | | |

Value - Emphasis on where it is created



India specific requirements in the Master File

- ❖ Functions, assets and risk analysis of all the constituent entities of the MNE group that contribute at least 10 percent of revenues or assets or profits of the group
- ❖ Details of entities of the MNE group engaged in development of intangible property and in management of intangible property

“Actual conduct precedes over the contractual terms”

Certain rulings prescribe profit split method for functions having direct nexus with the core business activity of the Group

With the exchange and availability of CbC Reports, the tax authorities would now be in a better position to identify any mismatch in value creation and allocation of income/ profits

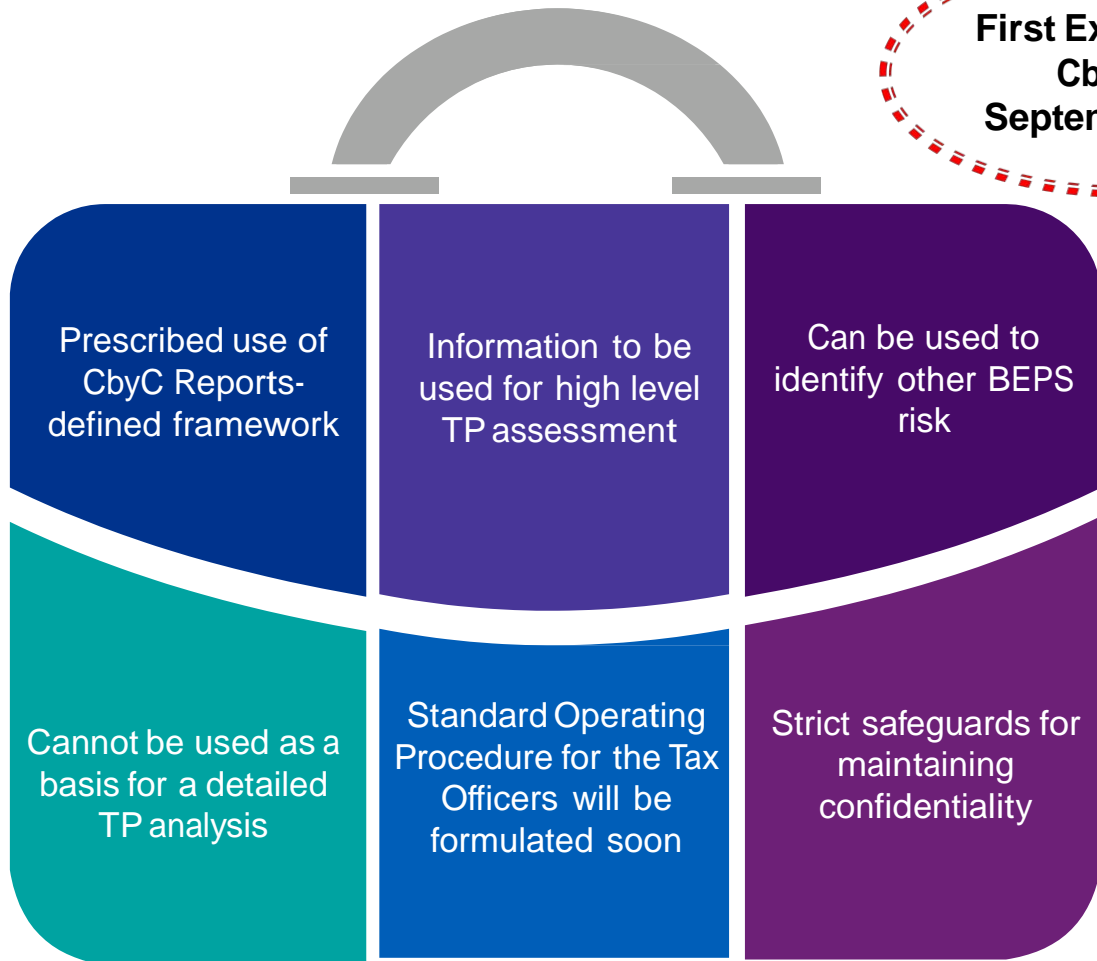
“Where is value created?”



Circular no. 6/ 2013

- ❖ Importance of people and economically significant functions
- ❖ Focus on key decision makers and their location
- ❖ Limits profit associated with contractual rights
- ❖ Considers actual conduct over contractual arrangements

Guidance on appropriate use of CbC Report



First Exchange of CbCR in September 2018

What to expect ?

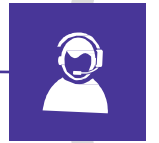


Cases having potential BEPS risk to be taken up for scrutiny

Guidelines on Risk Assessment parameters

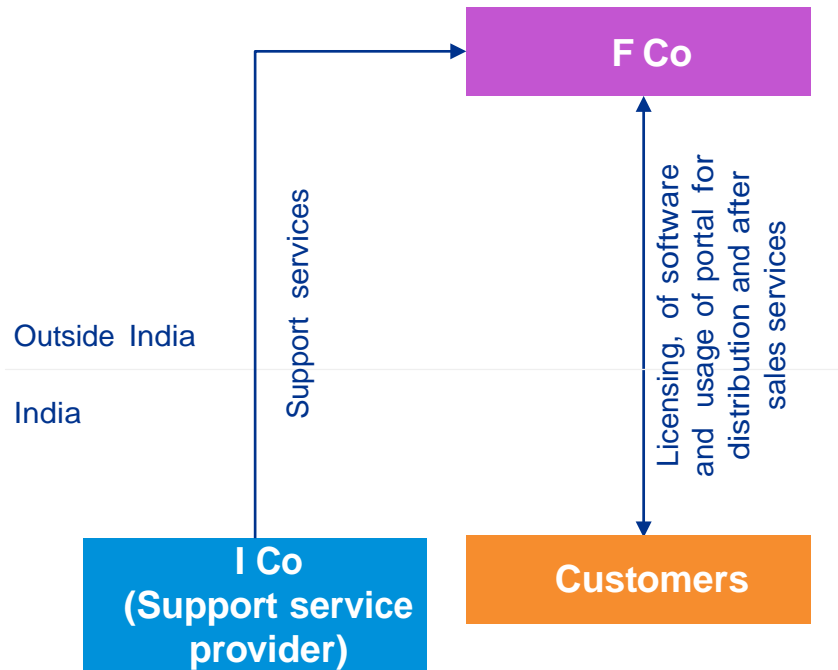
Thorough and robust assessment proceedings

Request for more diversified information about the International Group





Support Services Provider



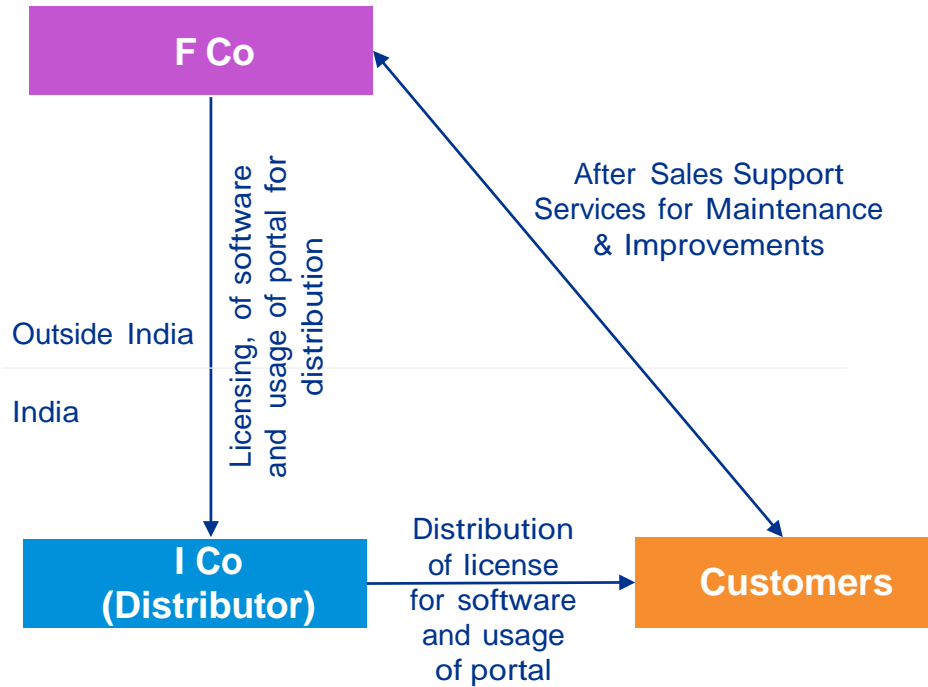
Remuneration model

| | |
|------|---|
| F Co | Profits / losses arising out of customer contracts |
| I Co | Cost plus, irrespective of profits / losses from customer contracts |

| Summary of FAR analysis | F Co | I Co |
|---|---------------|-----------------------------|
| Technology & Marketing intangibles | | |
| Creation and improvement | ✓✓ | x |
| Maintenance | ✓✓ | ✓ (execution) |
| Marketing & Business strategy | | |
| Strategy formulation | ✓✓ | ✓ (inputs) |
| Strategy execution | ✓✓ | ✓ |
| Operations | | |
| Contracting with customers | ✓✓ | x |
| Marketing | ✓✓ (strategy) | ✓ (execution) |
| Support and execution services | x | ✓✓ |
| Assets & Risks | | |
| Technology & Marketing intangibles and related risks | ✓✓ | x |
| Business related assets | ✓ | ✓ |
| Business related risks – employees turnover, business assets, etc | ✓ | ✓ (limited since cost plus) |

✓✓ Significant ✓ Routine x None

Low-risk distributor



Remuneration model

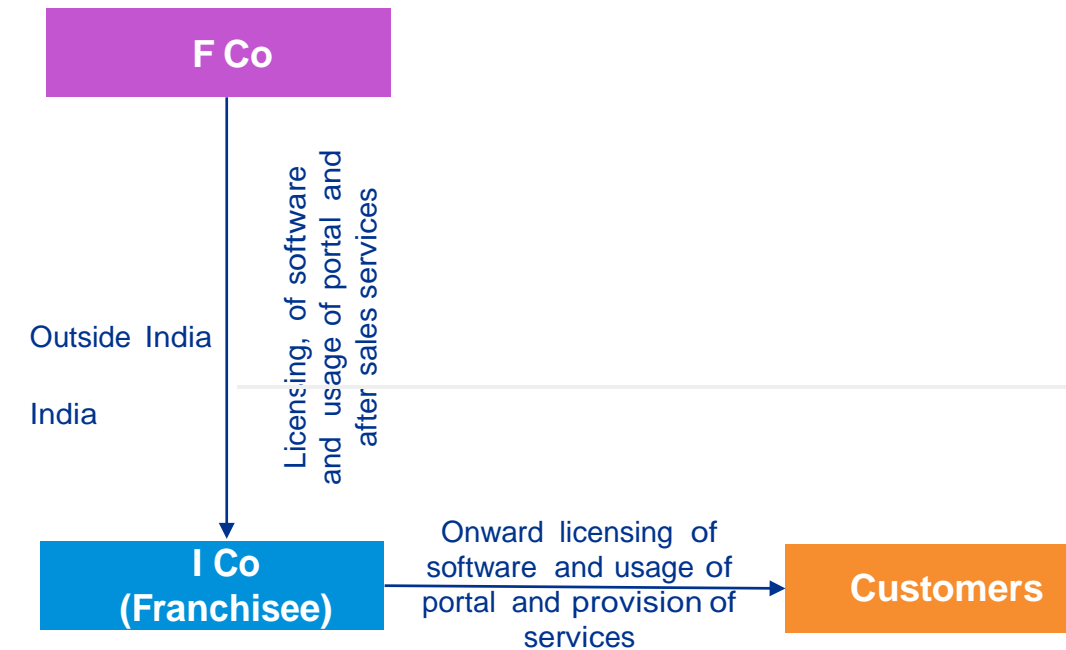
F Co % of Sales of I Co for use of license

I Co Routine returns, as % of sales (with minimum assured net margin)

| Summary of FAR analysis | F Co | I Co |
|---|---------------|---------------|
| Technology & Marketing intangibles | | |
| Creation and improvement | ✓✓ | x |
| Maintenance | ✓✓ | ✓ (execution) |
| Marketing & Business strategy | | |
| Strategy formulation | ✓✓ | ✓ (inputs) |
| Strategy execution | ✓ (limited) | ✓✓ |
| Operations | | |
| Contracting with customers | x | ✓✓ |
| Marketing | ✓✓ (strategy) | ✓ (execution) |
| Support and execution services | x | ✓✓ |
| Assets & Risks | | |
| Technology & Marketing intangibles and related risks | ✓✓ | ✓ |
| Business related assets | ✓ | ✓ |
| Business related risks – employees turnover, business assets, etc | ✓ | ✓✓ |

✓✓ Significant ✓ Routine x None

Franchisee



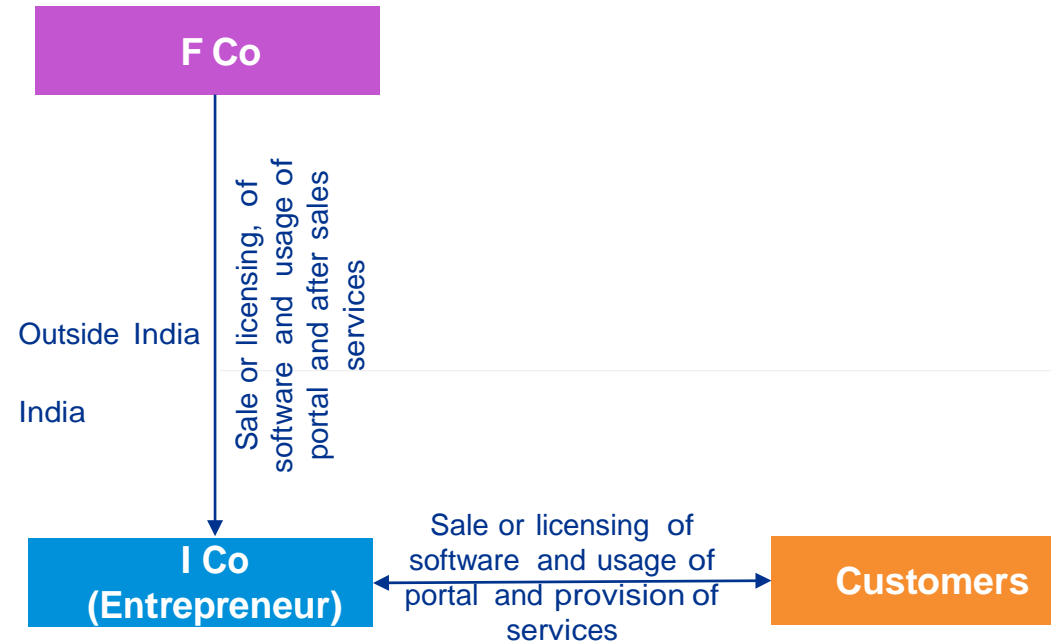
Remuneration model

| | |
|------|---|
| F Co | Royalty for technology and brand plus a share in non-routine profits / losses |
| I Co | Routine profits plus a share in non-routine profits / losses |

| Summary of FAR analysis | F Co | I Co |
|---|-----------------------------|------|
| Technology & Marketing intangibles | | |
| Creation and improvement | ✓✓ | ✓ |
| Maintenance | ✓✓ | ✓✓ |
| Marketing & Business strategy | | |
| Strategy formulation | ✓✓ | ✓✓ |
| Strategy execution | ✓ (limited) | ✓✓ |
| Operations | | |
| Contracting with customers | x | ✓✓ |
| Marketing | x / ✓ (strategic inputs) | ✓✓ |
| Support and execution services | x | ✓✓ |
| Assets & Risks | | |
| Technology & Marketing intangibles and related risks | ✓✓ | ✓ |
| Business related assets | ✓ | ✓✓ |
| Business related risks – employees turnover, business assets, etc | ✓ | ✓✓ |

✓✓ Significant ✓ Routine x None

Entrepreneur



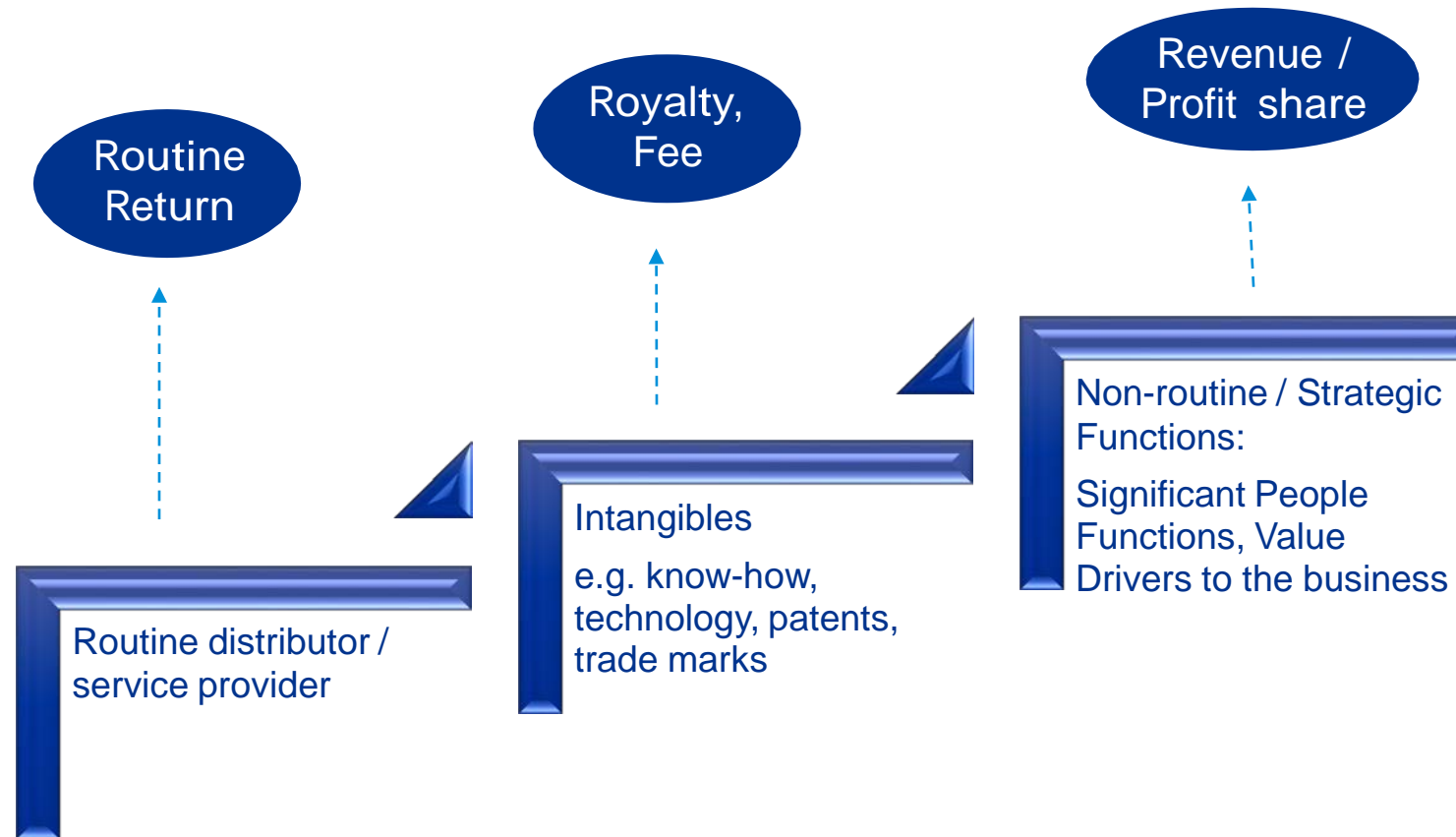
Remuneration model

| | |
|------|--|
| F Co | One-time consideration for the purchase of technology license and portal and / or ongoing royalty for improvements |
| I Co | Entrepreneurial profits or losses |

| Summary of FAR analysis | F Co | I Co |
|---|------|------|
| Technology & Marketing intangibles | | |
| Creation and improvement | ✓ | ✓✓ |
| Maintenance | ✓ | ✓✓ |
| Marketing & Business strategy | | |
| Strategy formulation | x | ✓✓ |
| Strategy execution | x | ✓✓ |
| Operations | | |
| Contracting with customers | x | ✓✓ |
| Marketing | x | ✓✓ |
| Support and execution services | x | ✓✓ |
| Assets & Risks | | |
| Technology & Marketing intangibles and related risks | ✓ | ✓✓ |
| Business related assets | ✓ | ✓✓ |
| Business related risks – employees turnover, business assets, etc | ✓ | ✓✓ |

✓✓ Significant ✓ Routine x None

Value chain - Key Contributors





DEMPE: Key Questions Expected

What is
DEMPE?

Development

Enhancement

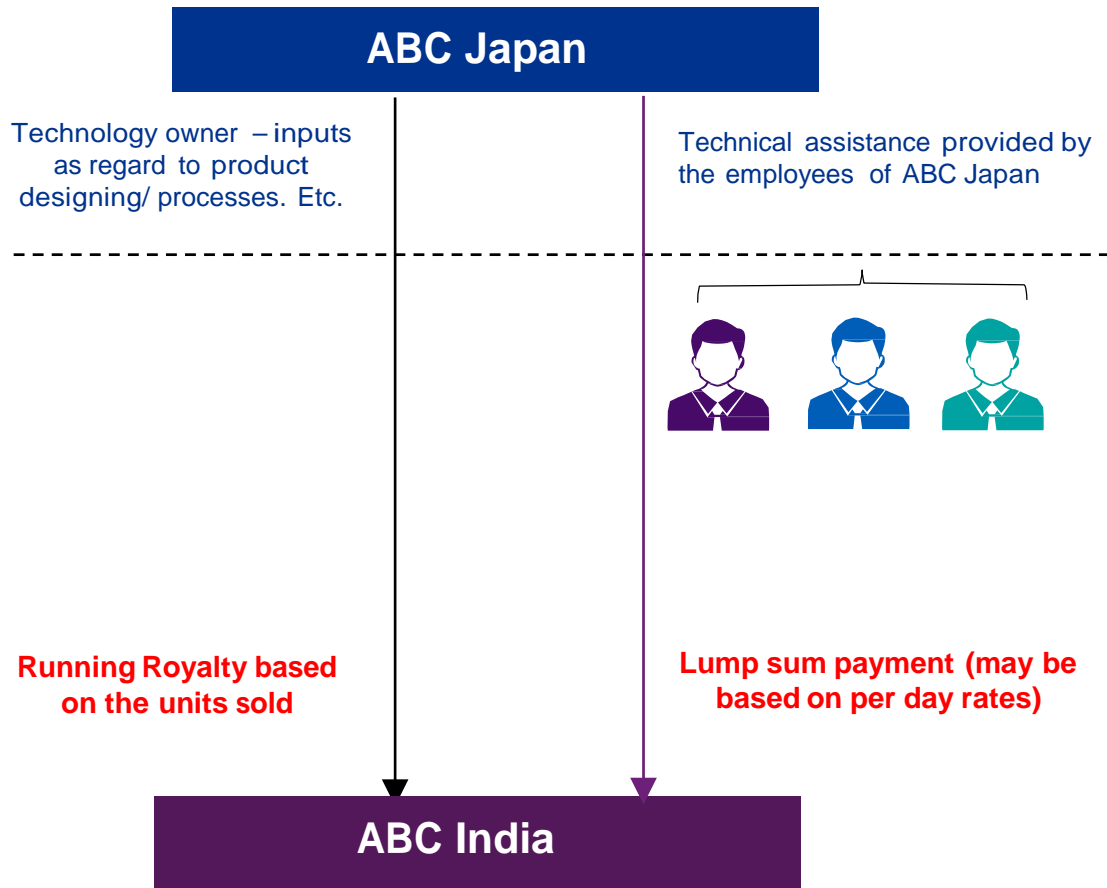
Maintenance

Protection

Exploitation

| Lookout for who performs DEMPE functions – key areas |
|---|
| Brand strategy and policy setting |
| Brand management and protection |
| Strategies/ budgets for local marketing |
| Supervision of the Development, approval with respect to the design and budgets |
| Funding for development, enhancement, maintenance, protection of IP |
| Risk of unsuccessful developments/ protection |

Royalty for Technology and Brand



- Purpose and need for which royalties are paid
- Whether duplication of services?
- Running royalty sufficient to cover ongoing support?
- Royalty pay outs in the years of losses / low profitability
 - Business reasons to be substantiated
 - Future projections / budgets to be maintained
- Continued royalty pay outs for longer duration

improvements to be received

Robust documentation is the key to mitigate litigation

AMP issue in India

Foreign Company
(Brand Owner)

Allows use of
"Brand Name"

Indian Company

AMP Expenditure in India to
enhance sales



Allegations of Tax Authorities in India



Expenditure incurred in India results in creation of local marketable intangibles



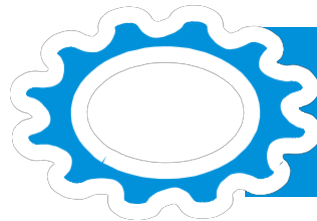
Use of various methodologies to determine ALP (Bright Line, Intensity approach, Profit Split)



Even Selling and Distribution expenses considered as a part of AMP

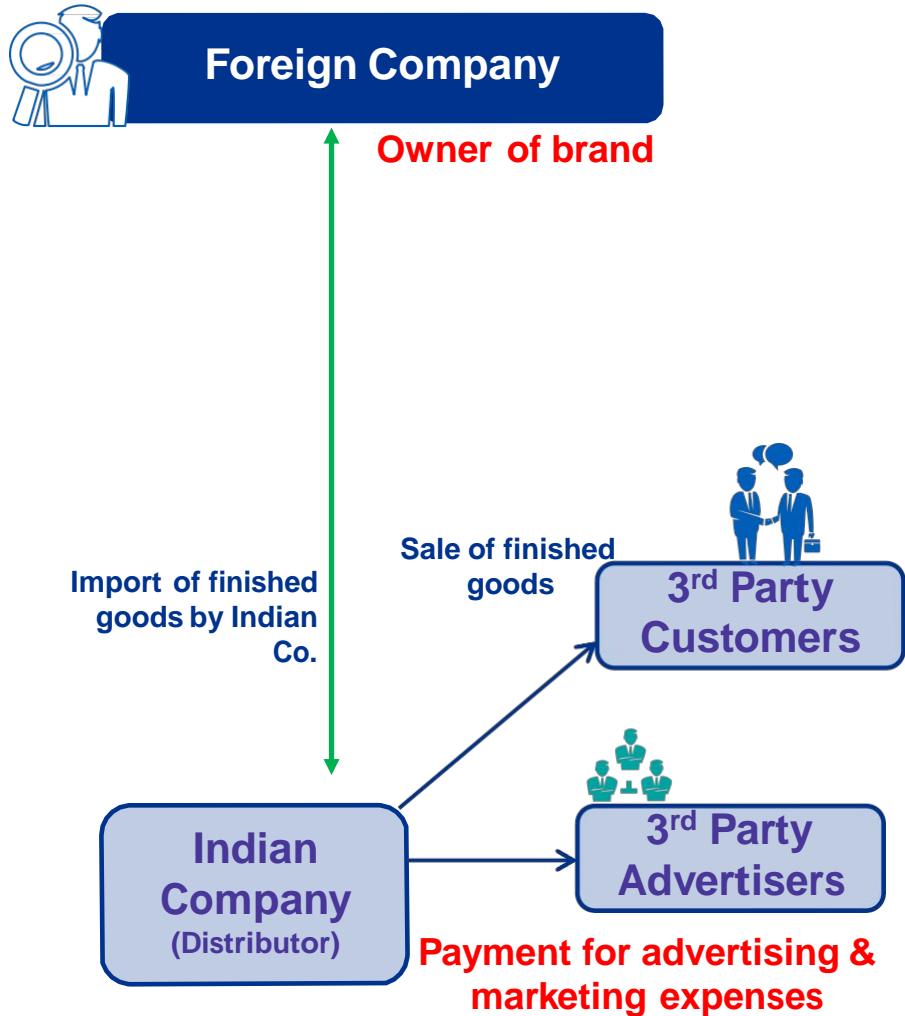


More challenges in case of royalty payment/ recovery of partial AMP spent



Diverse findings of Delhi High Court, in the cases of Distributor (Sony and others) and Manufacturer (Maruti)
Both pending at SC

AMP in case of Distributor



Revenue's Approach

- Indian Co. spent significantly higher (say 8%) on AMP compared to 3rd Party Distributors (say 2%). The difference of 6% of Sales used to make adjustment along with mark-up (Brightline test)
- Reimbursement of partial AMP proved that international transaction exists
- Inter company agreement had language to suggest that marketing strategy inputs were provided by the Foreign Company
- Routine Selling and Distribution expense were included as part of AMP

Learning points/ Key considerations

- Delhi HC in Sony Ericsson held that there is an international transaction
- BLT was rejected by HC and India agreed to consider it in UN Manual on TP, however, the approach continues in modified format
- Currently, adjustments are being made using intensity approach – resulting in higher adjustment, where losses at net level
- Careful review of TP documentation & inter-company agreement required to establish who is performing DEMPE functions

Contract R&D

Indian captive R&D service centres of MNEs typically remunerated on – Cost+ X%, or Hourly/ Man-day basis

Revenue's Allegations

Valuable & Unique IP generating work undertaken in India

India R&D Centre becomes Economic Owner of IP

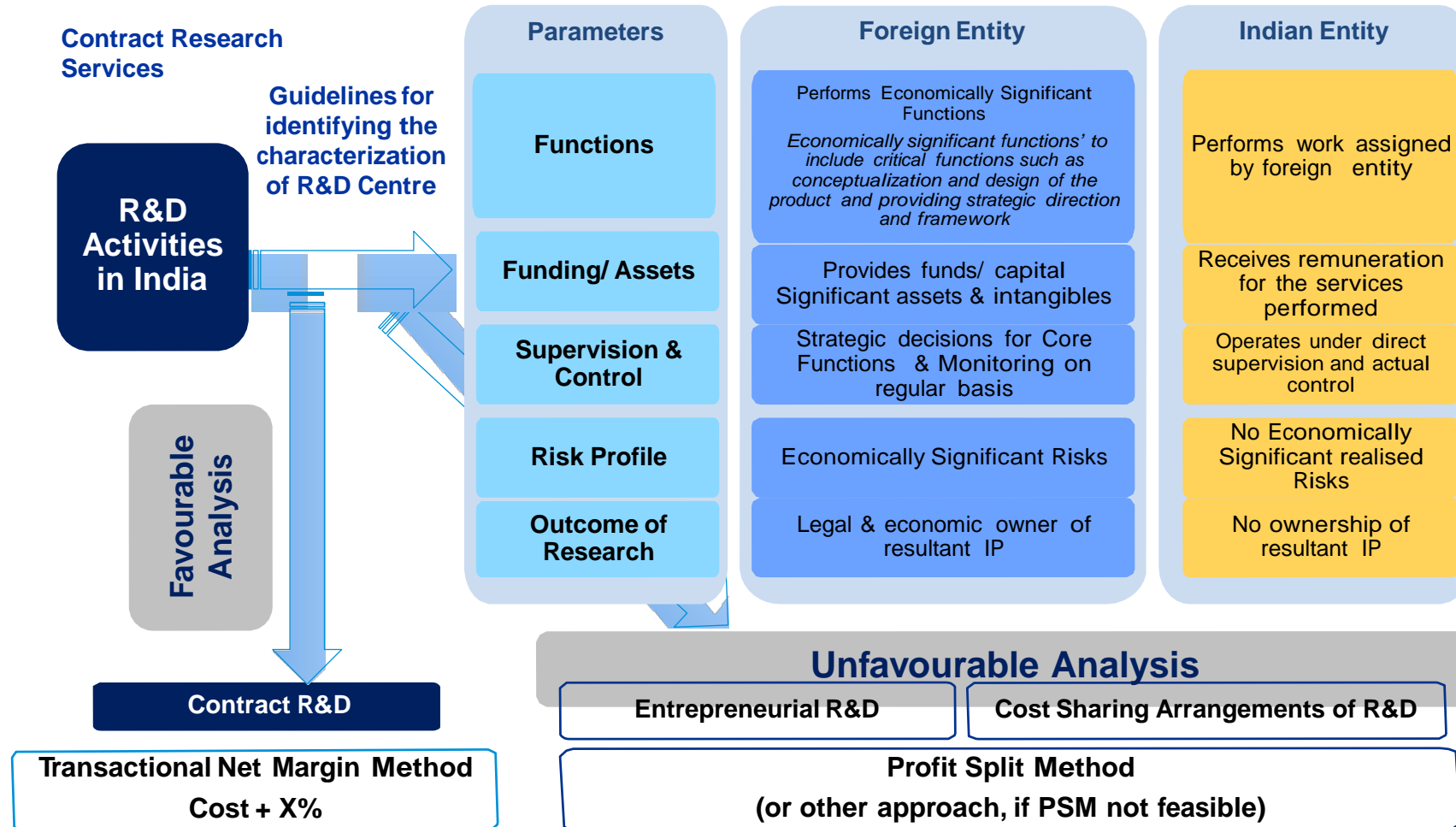
IP transferred without adequate compensation

Global Profits of MNE allocated to India on ratios such as R&D Head Count, etc.

High mark up comparables selected by TPO without carrying out appropriate FAR as to whether Indian service provider does actual R&D activities leading to development of unique IP or only acts as routine service provider

Prone to high litigation due to lack of clarity / subjective interpretation

CBDT Circular – Administrative Guidance

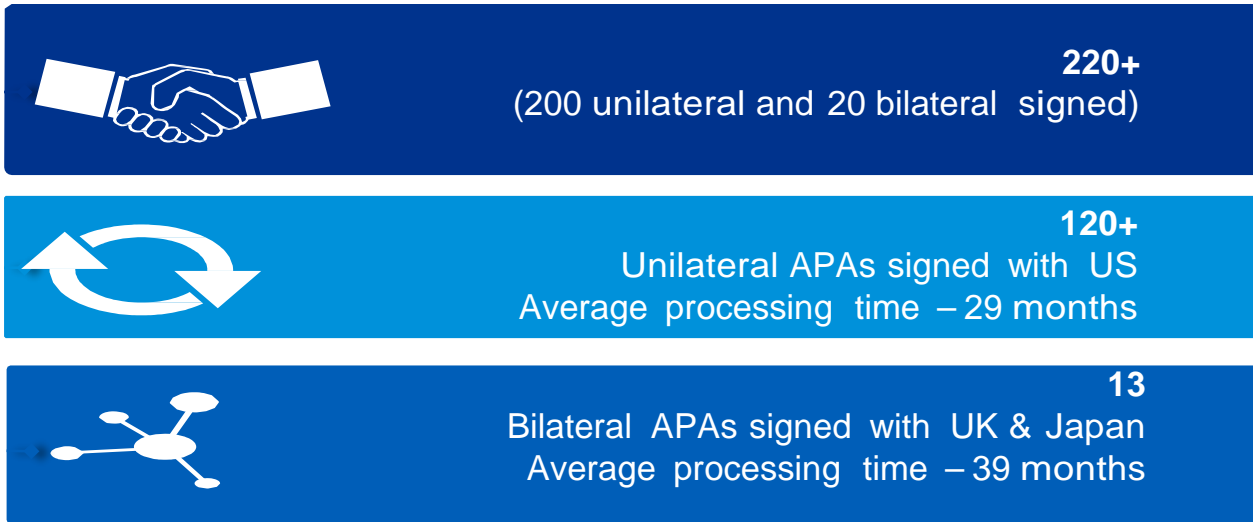
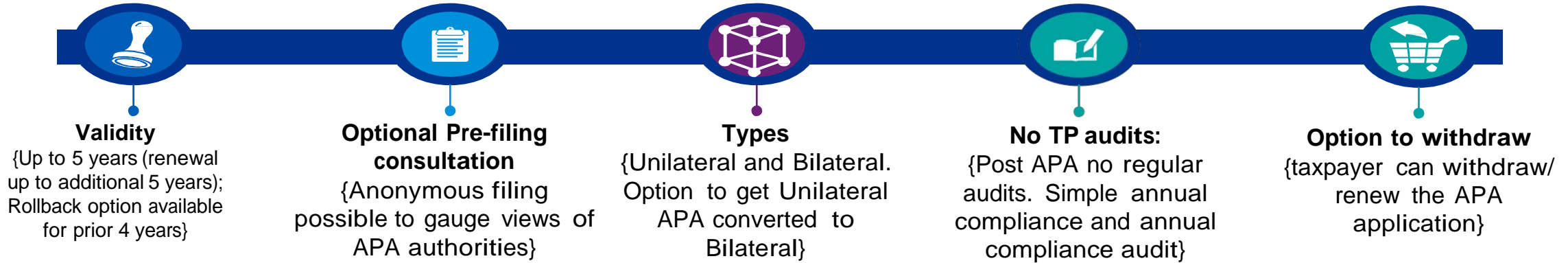


Other key issues

- **Value creation**
 - Actual conduct over documentation
 - Focus on Significant People Functions over Risk taking capabilities and Funding capabilities
 - Allegation of intangible creation and thereby, remuneration linked to exploitation of technology / Intellectual Property
- **Evolving business environment** – changing TP models as per business needs
 - Need for robust TP policy and documentation
- **Changes in models** – allegation of business restructuring / exit charges
- **Management cross-charges**
 - Focus on need, benefit tests
 - Robust documentation is a must



APA Landscape in India



MAP- An overview

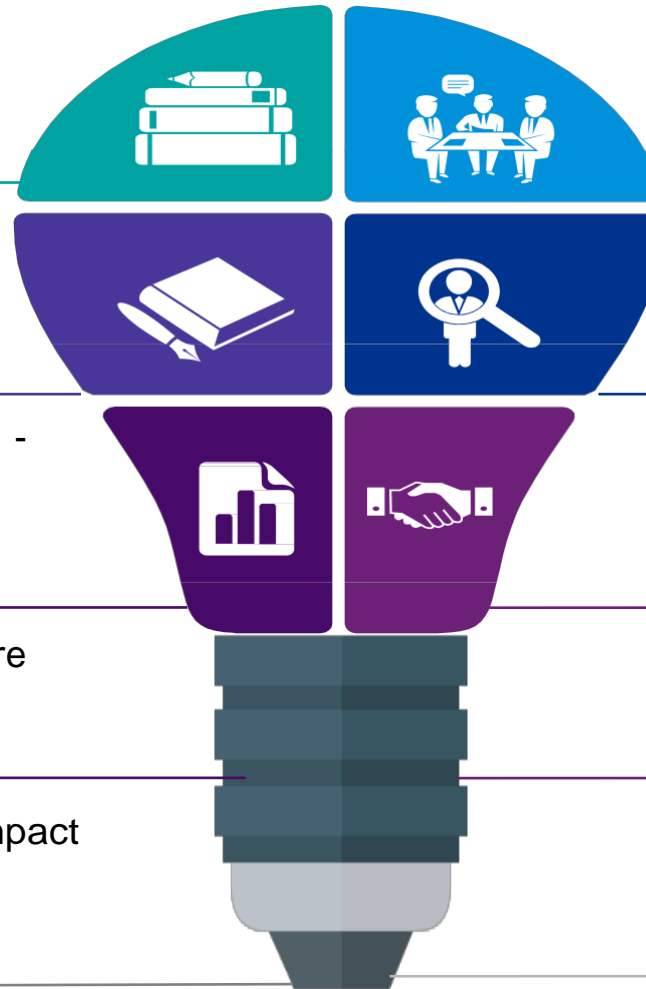
An additional remedy under Indian tax laws

Resolution of disputes through the invention of Competent Authorities

Can be pursued before or after appeals - Tax Officer not privy to MAP proceedings

Applicant can opt-out at anytime before the conclusion of MAP

Possibility of avoiding double tax impact through correlative relief



Resolution limited to principle issue determination – leaves income computation to tax officers

Transfer Pricing or Profit Attribution cases generally given priority

Several years can be aggregated together

Positive bilateral relationship should prove beneficial

Treaties typically incorporate a time limit for initiation of MAP procedure

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