WIRC Study Course on International Tax

Basics of Transfer Pricing

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—

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Agenda

1	Introduction to transfer pricing
2	Methods and their application
3	Documentation
4	BEPS Documentation – Impact on Transfer Pricing in India
5	Transfer Pricing Audit and Litigation Process
6	APA, MAP and Safe Harbour
7	Secondary Adjustment and Limitation on Interest Deductibility
8	Case Studies
9	Emerging Areas and Key Takeaways

Introduction to Transfer Pricing

What is Transfer Pricing?

- A mechanism for pricing the transfer of goods and services between related entities:
  - Tangible Goods - Raw materials, Components, Spare-parts, Semi-finished/ Finished goods, Assets, etc.
  - Intangible Goods - trademarks, trade-names, patents, etc.
  - Services - IT/ IT Enabled, Management, , Marketing Support, Engineering, After Sales Services, etc.
- A mechanism which provides the conceptual framework for pricing intercompany transactions.

Why Transfer Pricing?

Situation I - Manipulated Price

Parent Co. India

Expenses		Income	
Cost	60	Sales	80
Profit	**20**		
Tax @ 30% = INR 6			

Sale to Sub Co. Dubai at INR80

Sub Co. Dubai

Expenses		Income	
Cost	80	Sales	140
Profit	**60**		
Tax @ NIL = NIL			

Sale by Sub Co. to customer INR140

3rd Party Customer

Overall tax burden of Group is INR 6

Situation II - Arm's Length Price ('ALP')

Parent Co. India

Expenses		Income	
Cost	60	Sales	120
Profit	**60**		
Tax @ 30% = INR 18			

Sale to Sub Co. @ ALP = INR120

Sub Co. Dubai

Expenses		Income	
Cost	120	Sales	140
Profit	**20**		
Tax @ NIL = NIL			

Sale by Sub Co. to customer INR140

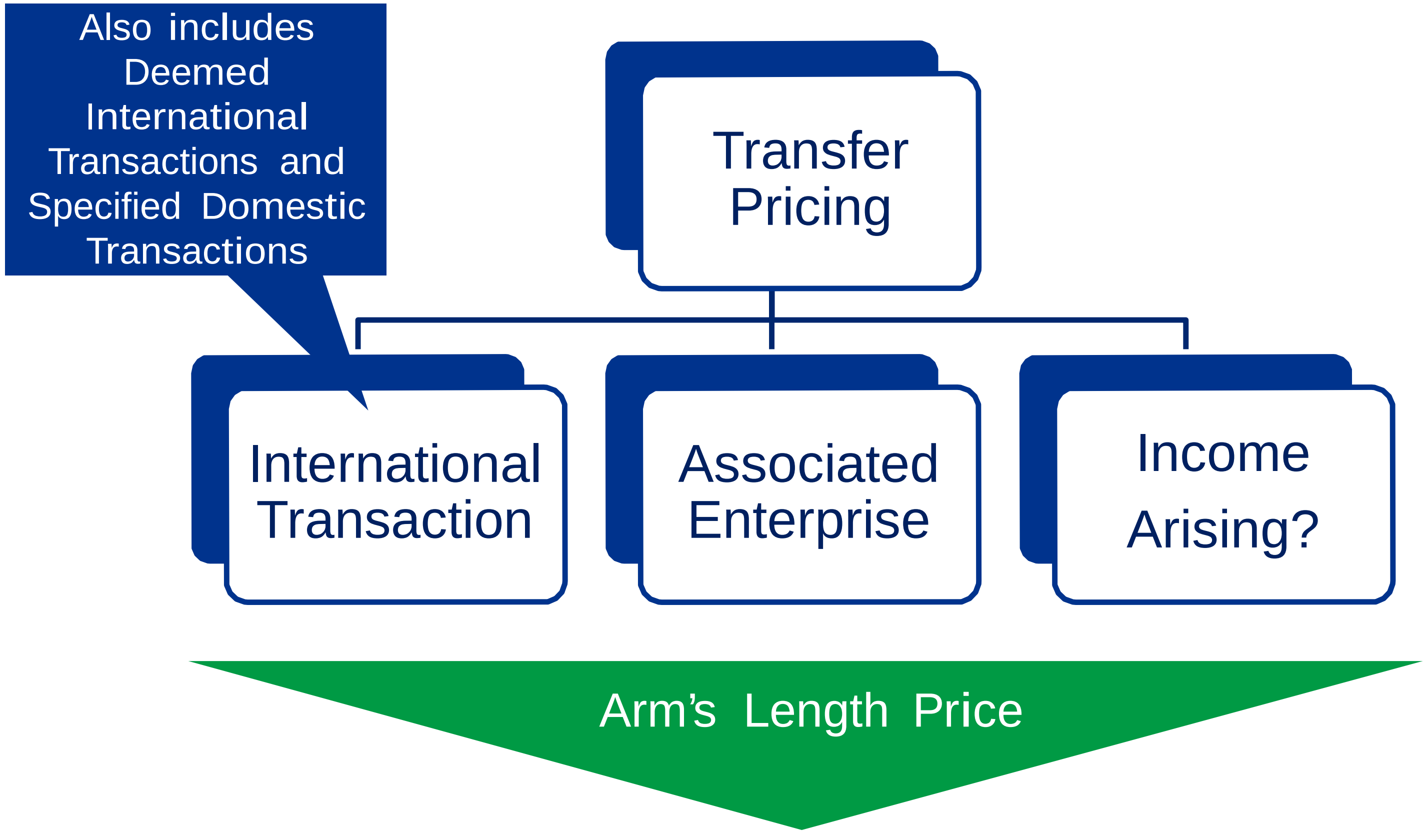
3rd Party Customer

Overall tax burden of Group is INR 18

To Prevent Shifting of profits by manipulating prices

Concepts of Transfer Pricing

- Any income arising from an international transaction with associated enterprises shall be computed having regard to the Arm's Length Price



Scheme of Transfer Pricing Regulations in India...

Relevant Provisions under **Section 92**
Computation of Income

International Transaction	Section 92B
Specified Domestic Transaction	Section 92BA
Associated Enterprises	Section 92A
Arm's Length Price	Section 92C + Rule 10B/ 10C
Documentation and Certificate	Section 92D and Section 92E

... Scheme of Transfer Pricing Regulations in India

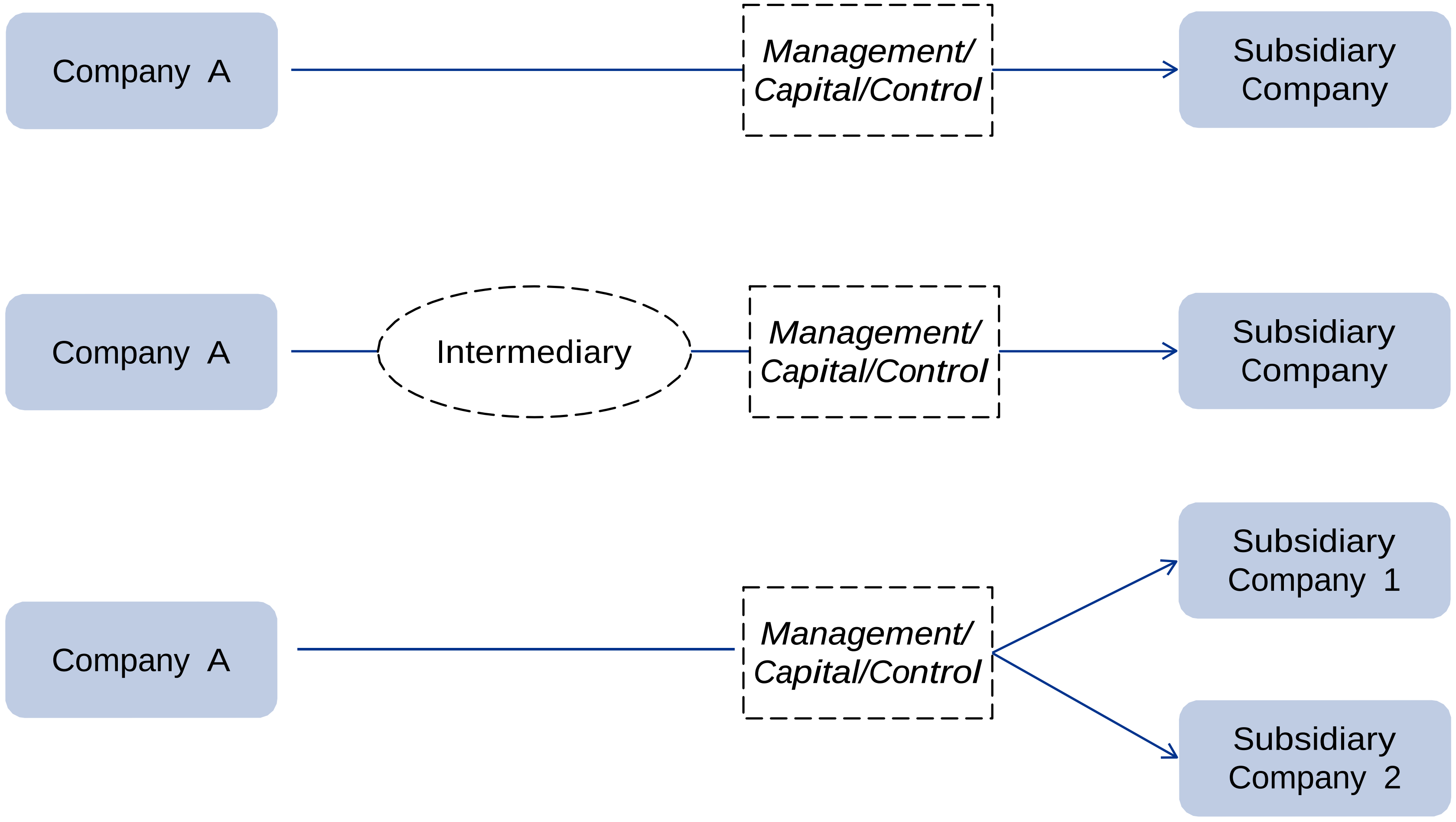
Scrutiny

Power of AO and TPO	Section 92CA
Dispute Resolution Panel	Section 144C
Penalties	Section 271 (1) (c), 271AA, 271BA, 271G

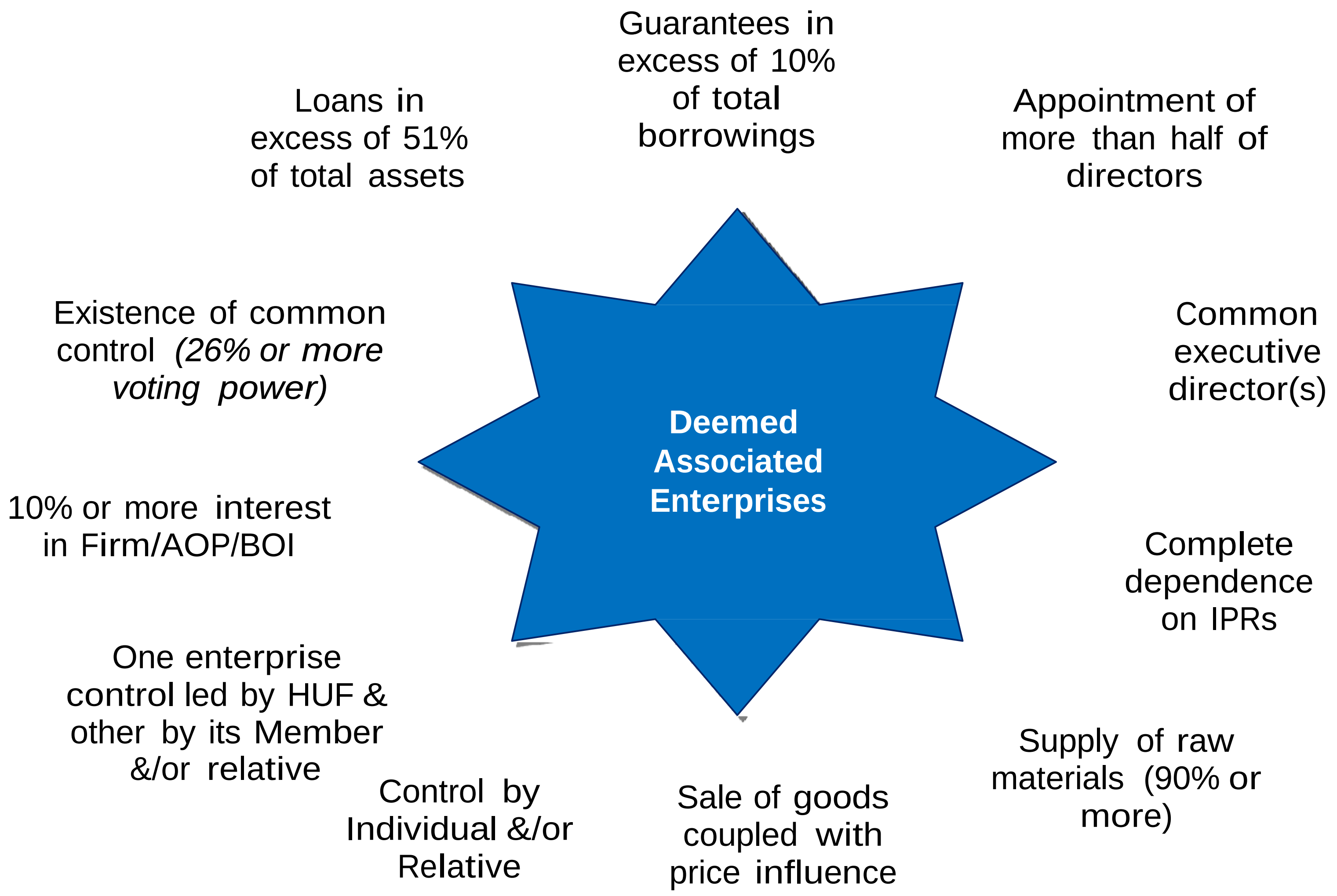
Other relevant provisions

Advance Pricing Agreements	Section 92CC and 92CD+ Rules 10F to 10T
Safe Harbour	Section 92CB + Rules 10TA to 10TG
Secondary Adjustment	Section 92CE + Rule 10CB
CbCr	Section 286

Associated Enterprise – Section 92A(1)

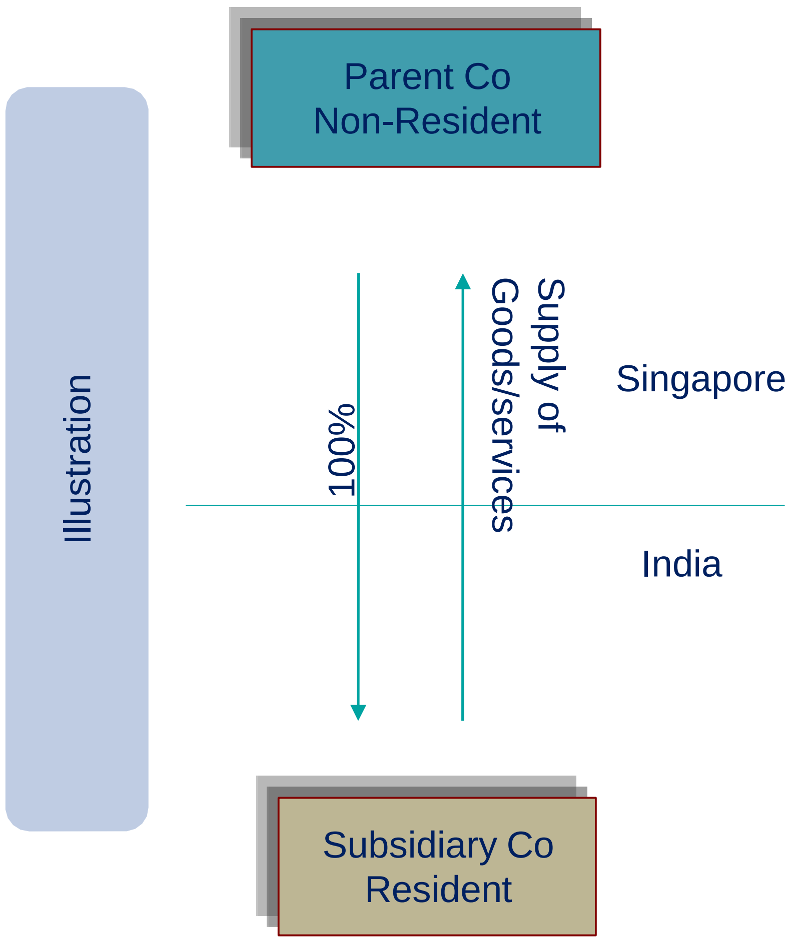


Deemed Associated Enterprises – Section 92A(2)

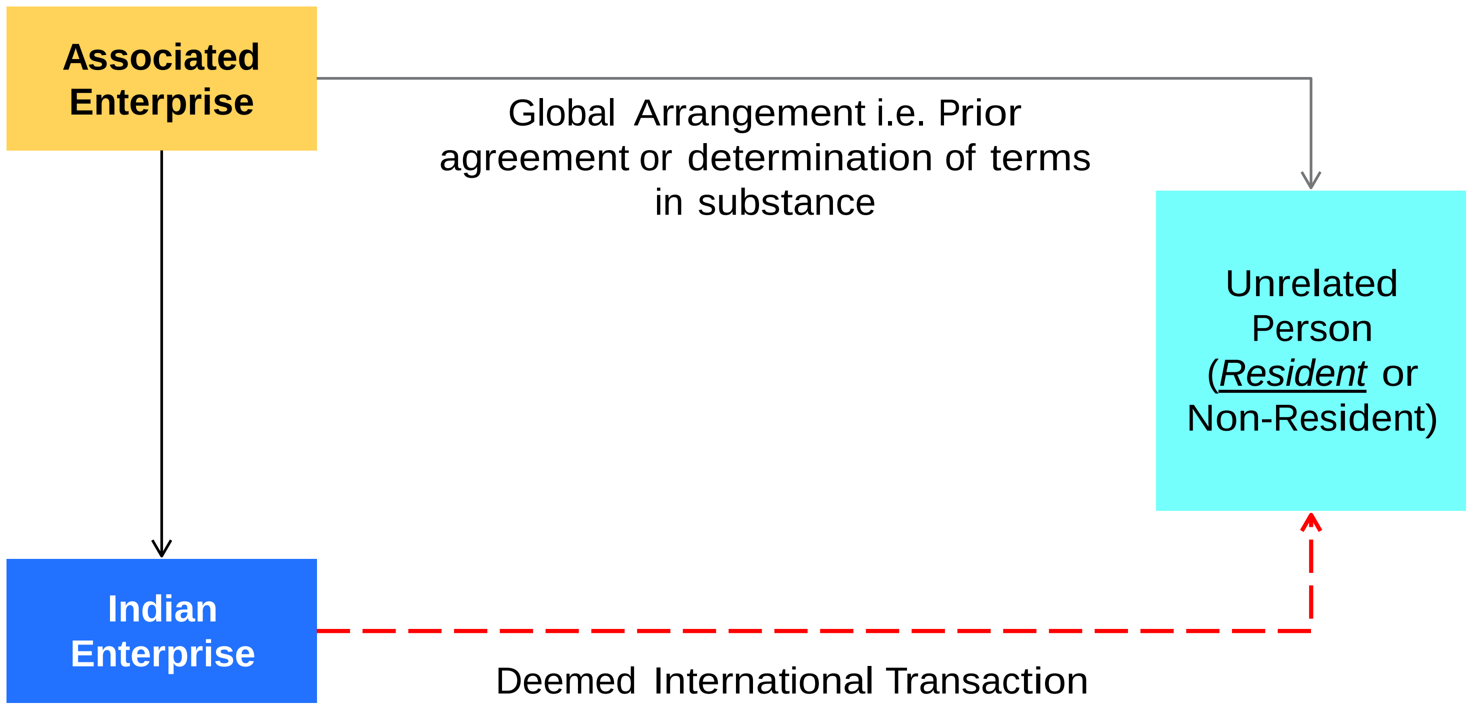


International Transaction – Section 92B(1)

- Transaction between two or more associated enterprises, **either** or **both** of whom are non-residents
- In the nature of –
  - 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 such enterprises,
  - Any mutual agreement or arrangement on allocation or apportionment or any contribution of cost or expenses
- Coverage expanded by inserting an explanation to include– Tangible property, Intangible property, Capital financing, Services and Business restructuring



Deemed International Transaction – Section 92B(2)



Transactions with unrelated parties whether resident or non-resident to be reported as Deemed International Transactions under Section 92B(2) of the Act

Specified Domestic Transactions – Section 92BA

Tax Holiday Unit (“THU”)

Transactions of Tax Holiday Unit:

- Inter-unit transfer of goods or services
- Business transacted between the THU and closely connected person

Other Transactions

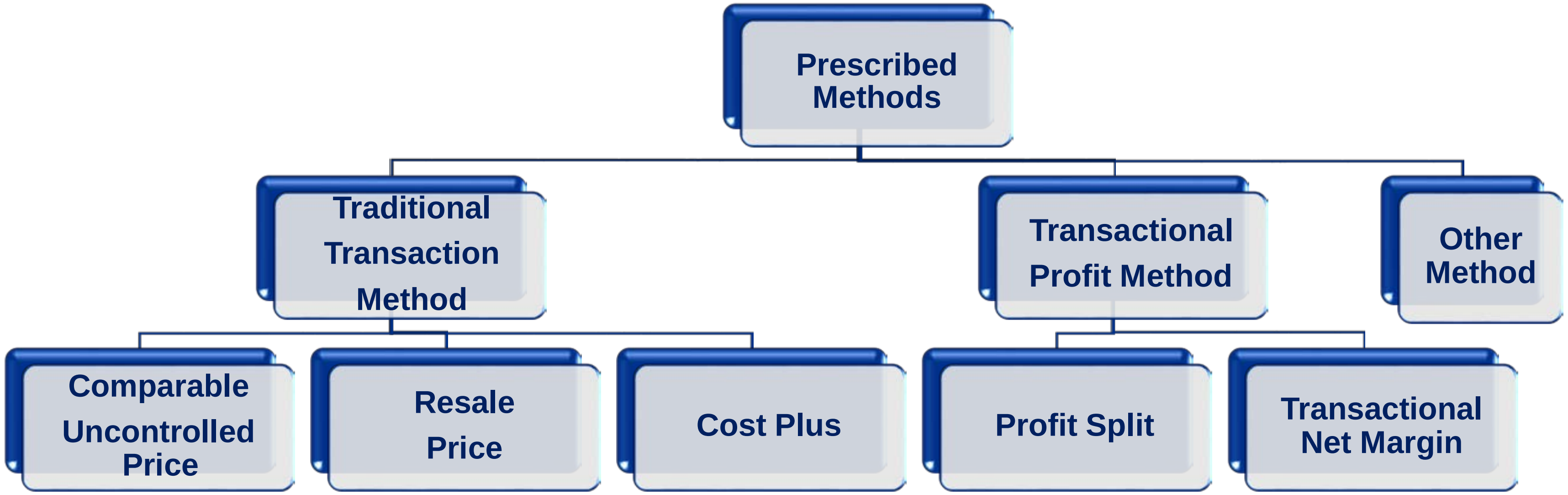
Any other transactions as may be prescribed. Till date CBDT has not prescribed any transaction

Aggregate value exceeds INR 20 crore

Computation of Arm's Length Price

Provisions of Section 92C read with Rules 10B and 10C

- Determination of ALP using one of the Prescribed methods -
  - Best suited to the facts and circumstances of each particular international transaction/specified domestic transaction
  - Provides the most reliable measure of an arm's length price in relation to the international transaction ~ termed as the "**Most Appropriate Method**"
- Where more than one ALP is determined, the arithmetic mean of such prices is taken to be the ALP *(w.e.f 1 April 2014, concept of range or arithmetic mean based on the rules shall apply)*



Methods and their Application

Most Appropriate Method: Rule 10C

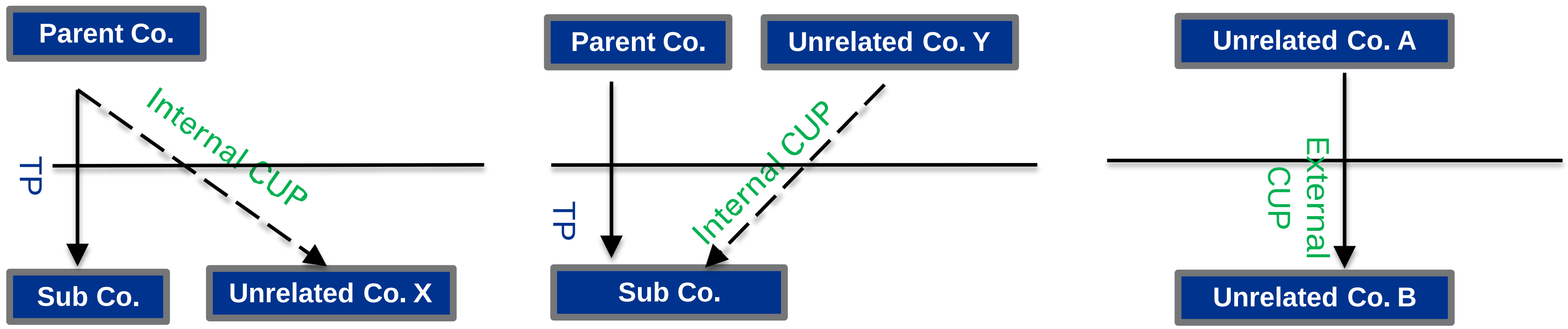
Factors considered for selection of the most appropriate method:

- Nature and class of international transaction or specified domestic transaction
- Class of associated enterprise and functions performed
- Availability, coverage and reliability of data
- Degree of comparability between the International transaction or specified domestic transaction
- Extent to which reliable and accurate adjustments can be made
- The nature, extent and reliability of assumptions for application of the method

No hierarchy or preference of methods prescribed under the Act

Comparable Uncontrolled Price ('CUP') Method

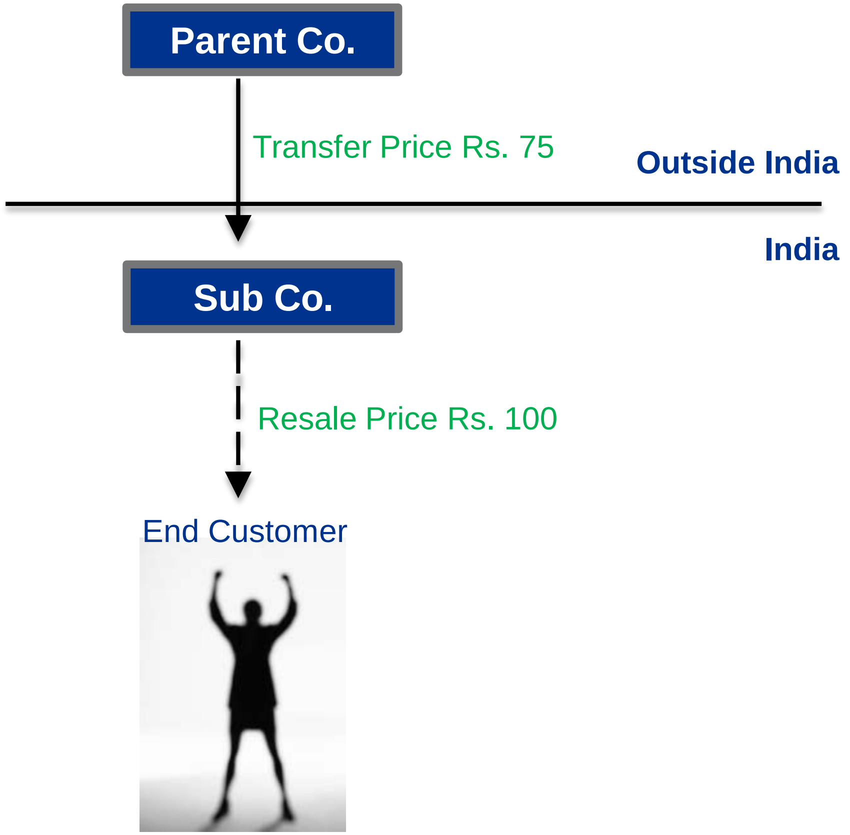
- Most Direct Method
- Prices are benchmarked without any reference to the profits
- Requires strict comparability in products, contractual terms, economic terms, etc.
  - Volume/ quantity of product, Credit terms, Geographic market, Other terms of contract
- Internal CUP / External CUP



Internal CUP preferrable over External CUP due to higher degree of comparability

Resale Price Method ('RPM')

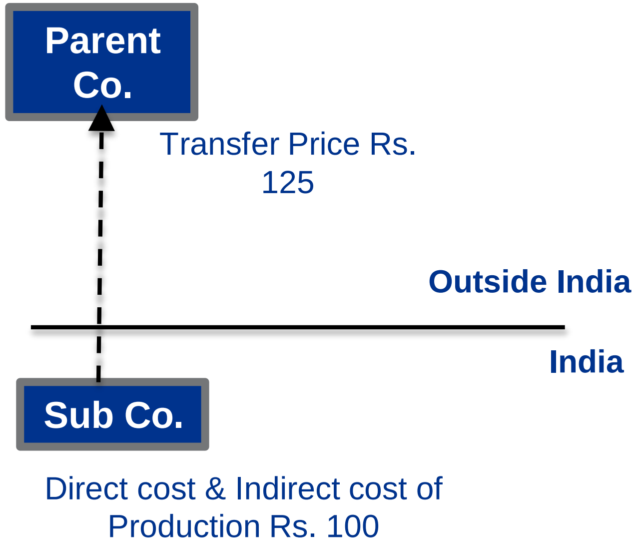
- Compares resale Gross Margin
- Preferred method for a distributor - buying purely finished goods from a group company
- Comparability is relatively less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed
- Used when reseller does not add substantial value to the goods and does not apply intangible assets to add value
- Difficult to apply where goods are further processed before resale



Price paid by Sub Co. to AE is at arm's length if the 25% resale margin earned by Sub Co. is more than margins earned by similar Indian distributors

Cost Plus Method ('CPM')

- Compares and identifies mark-up earned on direct and indirect costs of production incurred with that of comparable independent companies
- Preferred method in case-
  - Semi-finished goods sold between related parties
  - Contract manufacturing agreement
  - Provision of services
- To be applied in cases involving manufacture, assembly or production of tangible products or services that are sold/ provided to AEs
- Comparability is relatively less dependent on strict product comparability and additional emphasis is on similarity of functions performed & risks assumed



Price charged by Sub Co. to AE is at arm's length if the 25% mark-up on cost is more than that of similar Indian assemblers

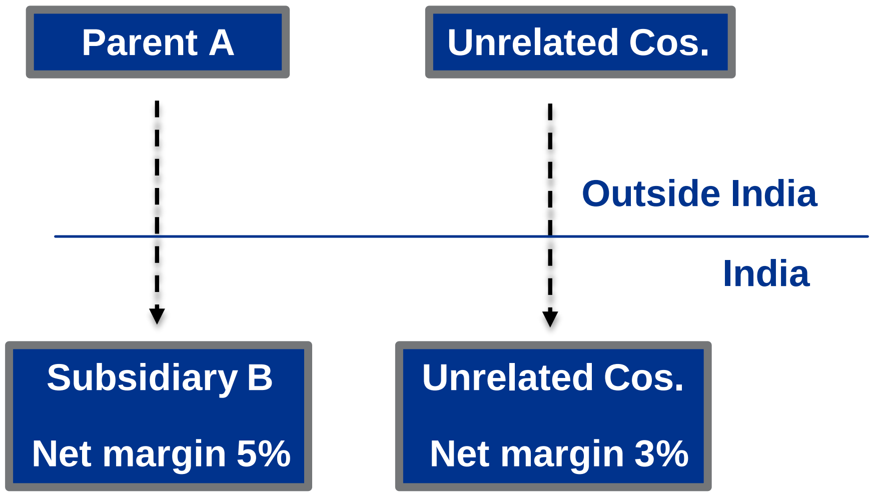
Profit Spilt Method ('PSM')

- PSM is applied in cases:
  - involving transfer of unique intangibles or
  - multiple international transactions that cannot be evaluated separately
- PSM can be (a) Total Profit Split or (b) Residual Profit Split.
- PSM requires selection and application of appropriate allocation keys for splitting profits amongst the members of the MNE group contributing to generation of combined profits.
- Strengths and weakness of PSM:

Strengths	Weakness
• Offers solutions for integrated operations not offered by one-sided methods • Helps share profits for unique intangibles contributed • Less dependant on comparables • Less likely to leave any party to the transaction with extreme profitability as both parties are evaluated	• Difficulty in application • Necessitating application of similar accounting policies and standards • Selection of allocation keys • Reluctance of tax authorities to accept

Transactional Net Margin Method ('TNMM')...

- Most frequently used method, due to lack of availability of data for application of other methods
- Examines net operating profit from transactions as a percentage of a certain base (can use different bases i.e. costs, turnover, etc)
- Both internal TNMM and external TNMM are possible
- Broad level of product comparability and high level of functional comparability
- Applicable for most categories of transaction and often used to supplement analysis under other methods



Transactional Net Margin Method (Contd.)

- Grouping of transaction - Relevant controlled transactions require to be aggregated to test whether the controlled transaction earn a reasonable margin as compared to uncontrolled transaction
- **Selection of tested party - Least complex entity**
- Selection of Profit Level Indicator such as Operating Margin, Return on Value added expenses, Return on assets – Unaffected by transfer price
- Benchmarking exercise (**on Databases**)
  - Entity with similar industry classification to the tested party – through search in Prowess and Capitaline plus databases
  - Screen entities by applying appropriate quantitative filters, such as mfg sales <75%, R&D exp >5%, Advertisement exp >5%.
  - Review financial and textual information available in the public database of the selected entities – for qualitative filters
  - Computation of ALP

Usually regarded as an indirect and one-sided method, but is most widely adopted

"Other Method" - Sixth method notified by CBDT

- CBDT had notified the "Other method" vide Notification No. 18/2012 dated 23.05.2012
- Applicable from FY 2011-12

Rule 10AB - "any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts."

- Effectively this implies that "quotations" rather than "actual prices" charged or paid can also be used
- Could also cover new instances of ALP computation which would now arise due to the various amendments introduced in the Finance Act 2012 – Expansion of definition of "international transaction" and introduction of domestic transfer pricing
- To maintain proper documentation specifying the rejection reasons for non-application of other five methods and appropriateness of the "other method"

Transfer Pricing Method and Comparability

Methods	Comparability Requirements	Approach	Practical Applicability
CUP	Very High	Prices are benchmarked	Low
RPM	High	Gross margins are benchmarked	Low
CPM	High	Gross margins are benchmarked	Low
PSM	Medium to High	Profit margins are benchmarked	Low
TNMM	Medium	Net Profit margins are benchmarked	High

Rules for use of Range Concept and Multiple Year Data

Following are some of key features of the Final Rules:

- A minimum of six comparables required in the dataset for applying range
- In absence of six or more comparables, the arm's length price shall be the arithmetical mean
- Range = starting from 35th percentile and ending on the 65th percentile (Dataset to be arranged in ascending order)
- The arm's length price = the weighted average of the prices/data points for;
  - the Current Year and preceding two financial years; or
  - two financial years immediately preceding the Current Year (but not including the Current Year as the same may not have been available)
- Comparability factors need to be analyzed for current year. If a company is not comparable for current year, it would be rejected from the dataset.
- If during the assessment, based on current year data (which may be then available – even if not available at the time of benchmarking), any company is considered as not comparable then that company will be removed from the dataset, irrespective of the fact that such company was comparable in the immediately preceding years
- Likewise new comparables can be added during the assessment based on the data available at that point of time
- As a result of the last 2 points, ambiguity / uncertainty with regard to arm's length margin will continue to exist in transfer pricing assessments

Rules for use of Range Concept and Multiple Year Data

Methods	Multiple year data	Range Concept
CUP	✗	✓
RPM	✓	✓
CPM	✓	✓
PSM	✗	✗
TNMM	✓	✓
Other Method	✗	✗

Rules for use of Range Concept and Multiple Year Data

As per TP Study at the time of filing Return of income

Step 1: Computation of weighted average

SL	Name	Year1		Year2		Year3 [Current Year]		Aggregation		Weighted Average (OP/OC %)
		Operating Cost	Operating Profit	Operating Cost	Operating Profit	Operating Cost	Operating Profit	Operating Cost	Operating Profit	
1	A	100	12	150	10	225	35	475	57	12.00%
2	B	80	10	125	5			205	15	7.32%
3	C	250	22	230	26	250	18	730	66	9.04%
4	D			220	22			220	22	10.00%
5	E					100	-5	100	-5	-5.00%
6	F	160	21	120	14	140	15	420	50	11.90%
7	G	150	21	130	12	155	13	435	46	10.57%

Step 2: Arrange the data in ascending order

Observation No.	1	2	3	4	5	6	7
Name	E	B	C	D	G	F	A
Weighted Average	-5.00%	7.32%	9.04%	10.00%	10.57%	11.90%	12.00%

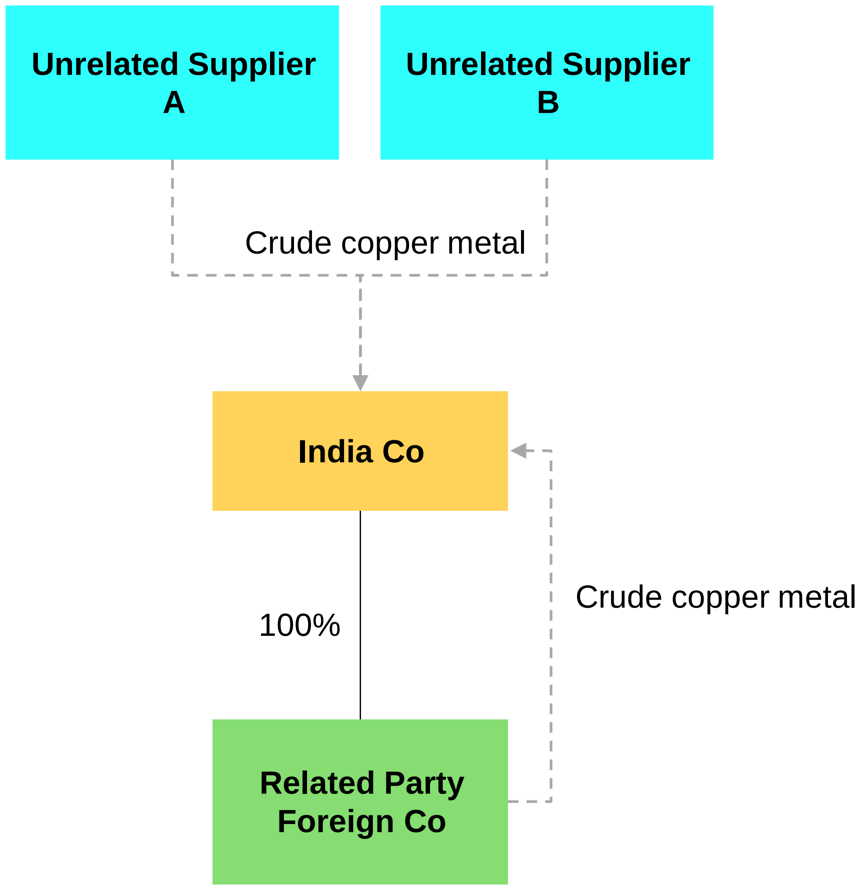
Observations	7	Statistical position		
Data place of the thirty-fifth percentile	7*0.35	2.45	3rd	==>> C
Data place of the sixty-fifth percentile	7*.65	4.55	5th	==>> G
Range	**9.04% to 10.57%**			
	7*0.5	3.5	4th	==>> D

Rules for use of Range Concept and Multiple Year Data

CUP Method - Case Study 1

refining and sale of copper metal.

- India Co purchases crude metal from both related and unrelated parties.
- Critical factors that affect the crude copper price are:
  - Volume
  - Tenure of supply contract (long terms, short term)
  - Product mix (with or without small quantities of other metal alloys like gold and silver)
  - Other terms of contracts (FOB vs CIF, port of shipment etc)



CUP Method - Case Study 1

Criteria	Related Party Foreign Co Controlled	Unrelated Party A Uncontrolled	Unrelated Party B Uncontrolled
Tenure of Contract	Long Term (10 yrs)	Long Term (8 yrs)	Short Term (2 yrs)
Volume during year under consideration	2200 MT	3000 MT	9000 MT
Alloy Mix	0.5% Gold, 1% silver	1% Gold, 1% silver	None
Port of shipment	Australia	Japan	Russia
Price (per MT)	INR 29,500 (applicable for entire year)	INR 32,000 (applicable for entire year)	INR 28,500 (applicable for entire year)
Other Terms	FOB basis	CIF basis	FOB basis

CUP Method - Case Study 1

Comparability analysis – Unrelated Party A

- The controlled and uncontrolled arrangements are comparable except in following areas
  - **Tenure of contracts:** Both Long Term (2 year difference)
  - **Volume:** Insignificant variance of 800 MT
  - **Alloy mix**: Supplier A's crude copper contains a higher mix of gold, making the product more expensive
  - **Terms of supply**: Supplier A sells on CIF basis, whereas Foreign Co sells on FOB basis.

Comparability analysis – Unrelated Party B

- The controlled and uncontrolled arrangements have following differences
  - **Tenure of Contract:** Short Term Vs Long term (8 year difference)
  - **Volume:** the difference in volume purchased from Foreign Co and from Supplier B is significant (2200 MT and 9000 MT)
  - **Alloy mix:** Supplier B's copper crude does not contain any gold or silver
  - **Terms of supply**: Similarity in terms as both are on FOB basis.

Based on the above analysis, which CUP is more appropriate?
Are any adjustments required?

CUP Method - Case Study 2

Functions rendered	EO services (I Co.)	FB services (I Co.)	EO services (Third party providers)
Marketing			
• Identification of potential customers	×	✓	✓
• Business development meetings	×	✓	✓
• Idea generation	×	✓	×
• Follow-up with clients	×	✓	×
• Arranging meeting with management	×	✓	×
Research inputs	×	✓	×
Order origination	✓	✓	✓
Order execution and settlement	✓	✓	✓

To benchmark the transactions between I Co and A Co, what would be the relevant CUP?

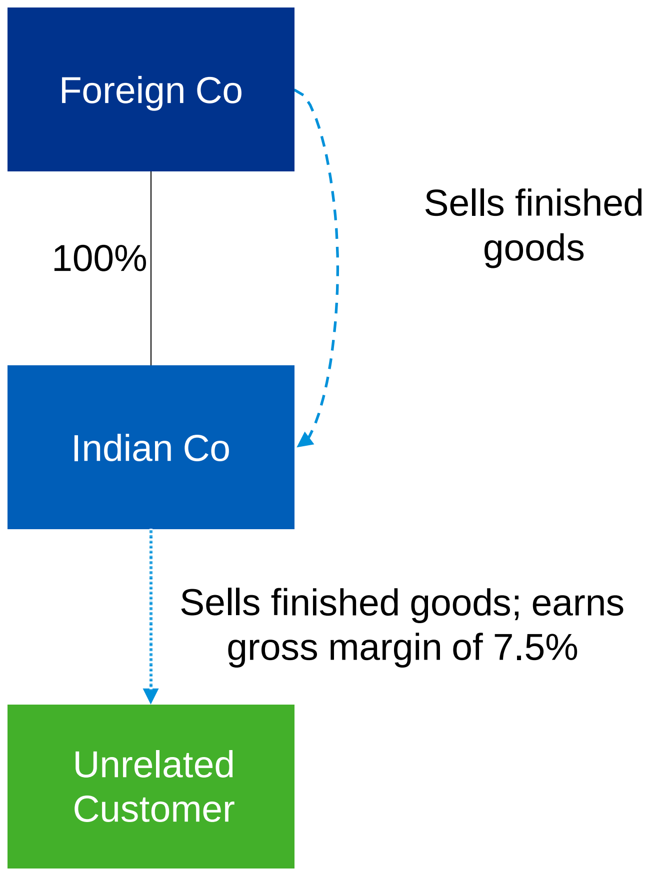
1) Services provided by I Co. to third party customers outside India **OR**
2) Services availed by A Co from third party service providers in India **OR**
3) Both

RPM - Case Study

- F Co. is a manufacturer and sells finished goods to I Co.
- I Co. onwards sells the finished goods to unrelated customers
- I Co makes a gross margin of 7.5% on sales
- The gross margins of various Unrelated Suppliers on sales of similar goods in the Indian market are as under:

Unrelated Supplier	COGS (INR)	Final Sales Value (INR)	Gross Profit (INR)	Gross Margin(%)
1	500	520	20	3.8%
2	700	750	50	7.1%
3	370	400	30	7.5%
4	780	850	70	8.9%
5	450	500	50	10%
6	600	670	70	10.44%

Minimum	3.8%
30th Percentile	7.1%
Median	3%
60th Percentile	8.9%
Maximum	10.44%



TNMM - Case Study 1

Facts:

- A Ltd, an Indian Company is engaged in the manufacture and sale of garments in India as well as in the export market.
- For the purpose of manufacturing, it imports certain raw materials from its AE in Germany.
- A Ltd. also exports garments to third party customers in the Asia-Pacific region. For this purpose, it avails marketing support services from its AE located in Singapore.
- A Ltd. also provides contract R&D services to its AEs with respect to certain design trends.
- Based on the above fact pattern, the international transactions of A Ltd. can be classified as under:

Transaction	Tested Party	PLI	Comparables
Import of raw materials – Manufacturing function	A Ltd.	OP / Sales	Indian companies engaged in manufacturing garments
Rendering contract R&D services	A Ltd.	OP / Total Cost	Indian contract R&D service providers
Availing marketing support services	AE	OP / Total Cost	Companies engaged in providing marketing support services in Singapore (or Asia Pacific region)

TNMM - Case Study 1

Particulars	Books of A Ltd. Import of Raw-Material	Books of A Ltd Contract R&D Service	Books of AE Marketing Services
Sales	720,000	280,000	475,000
Cost of purchases	370,000	-	-
Operating cost	250,000	250,000	453,000
Total Expenses	620,000	250,000	453,000
Total Profit	100,000	30,000	22,000
NPM(%) / NCP(%) of Tested Party	13.89%	12.00%	4.85%
IQR of comparable companies	8% to 13.5%	14% to 20%	5% to 7%

Whether following transactions are at arm's length? And How?

- Import of raw materials
- Rendering of contract R&D services
- Availing marketing support services

Documentation

Accountant's Report: Section 92E r.w. Rule 10E

- Obtained by every person entering into an international transaction and specified domestic transactions
- To be filed by the due date for filing return of income (**e-filing mandatory**)
- Opinion whether prescribed documents have been maintained the particulars in the report are "true and correct"
- Inputs:
  - Related party ledgers extracts
  - Related party Schedule under AS-18
  - Sample Invoices/ Vouchers / DN / CN
  - Relevant intra-group agreements
  - CUP/ Internal comparison info

Form No. 3CEB

[See rule 10E]

Report from an accountant to be furnished under section 92E relating to international transaction(s)

1. We have examined the accounts and records of ENTITY NAME AND POSTAL ADDRESS - PAN No. that have been made available to us relating to the international transactions and specified domestic transactions entered into by the assessee during the previous year ending on 31st March 2014.
2. In our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction (s) and specified domestic transaction (s) entered into so far as appears from our examination of the records of the assessee.
3. The particulars required to be furnished under section 92E are given in the Annexure to this Form. In our opinion and to the best of our information and according to the explanations given to us, the particulars given in the Annexure are true and correct.

Place :

Date : For

Chartered Accountants

Transfer Pricing Documentation: Section 92D r.w. Rule 10D

Entity related

- Profile of industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

Price related

- Transaction terms
- Functional analysis (functions, assets and risks)
- Economic analysis (method selection, comparable benchmarking)
- Forecasts, budgets, estimates

Transaction related

- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc)

- Contemporaneous documentation requirement – Rule 10D
- Documentation to be retained for 8 years from the end of relevant assessment year.

Transfer Pricing Process

Stage 1

Functional analysis

- Detailed analysis of functions assets and risks
- Characterization of each entity
- Agreement reviews

Stage 2

Economic Analysis

- Search strategy
- Access to local & global database
- Analysis of internal comparables
- Judicious identification of arm's length range

Stage 3

Additional Analysis

- Understand existing costing mechanism
- Determination of billing methodology

Stage 4

Finalization of Documentation

- Finalization of Transfer Pricing Documentation

Penalties

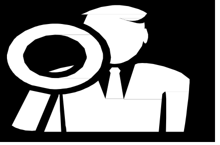
Default	Penalty
In case of a post-inquiry adjustment, there is deemed to be a concealment of income / inaccurate (Section 271(1)(c) of the Act)	100-300% of tax on the adjusted amount
Penalty for underreporting and misreporting of Income (Section 270A shall replace Section 271(1)(c) wef 1 April 2017)	- 50% of tax payable on under reported transactions - 200% of the tax payable on misreporting of transaction
Failure to maintain documents (Section 271AA of the Act)	2% of the value of transaction
Failure to report a transaction in accountant's report (Section 271AA of the Act)	2% of the value of transaction
Maintaining or furnishing incorrect information or documents (Section 271AA of the Act)	2% of the value of transaction
Failure to furnish accountant's report (Section 271BA of the Act)	Rs. 100,000
Failure to furnish documents (Section 271G of the Act)	2% of the value of transaction

BEPS Documentation

Impact on Transfer Pricing in India

OECD BEPS Action 13—Requirements and Indian Provisions

Objectives



Aid tax authorities perform a transfer pricing risk assessment.

Ensure taxpayers give appropriate consideration to setting prices consistent with the arm's- length principle.

Provide information needed for tax authority audit.

Reports to be prepared

Country by Country Report (CbyC)

Master File (MF)

Local File (LF)

These three documents together are a taxpayer's key tools for managing transfer pricing risk. They must be consistent.

Indian Forms

Form No. 3CEAD – CbyC

Form No. 3CEAC – Intimation by Indian CE of foreign parented entity

Form No. 3CEAE – Intimation by Indian reporting CE filing under certain circumstances

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Form No. 3CEAA – Part A – applicable to all CEs in India, irrespective of threshold

Form No. 3CEAA – Part B – applicable if threshold is met

FORM 3CEAB – Intimation to be filed by designated entity

Form No. 3CEB – reporting Intl. and domestic transactions

TP documentation – as per Rule 10D of the Rules No additional requirement in India

Indian Government introduced BEPS Action 13 related provisions through Finance Act 2016 to align with OECD Guidelines. Final Rules for Master File and CbyC were released in October 2017

CbyC Filing – Applicability in India

Applicability

Particulars	Value during the accounting year
Consolidated group revenue for the accounting year <u>preceding</u> the reporting year exceeds	INR 5,500 Crore (in line with Action 13 threshold of EURO 750 million)

Time Lines

FY 2017-18 and onwards	Within a period of 12 months from the end of reporting accounting year (i.e. for FY 2017-18, the deadline is 31st March 2019)
Notification by Constituent entities (CE) of foreign inbound MNEs	2 months prior to deadline for filing CbyC

coyc reoorting temo ate

CbyC Template-Page 1*

Country	Revenue			Profit(loss) before income tax	Income tax paid (on a cash basis)	Income tax accrued-current year	Stated capital and accumulated earnings	Number of employees	Tangible assets other than cash and cash equivalents
	Related party	Unrelated party	Total						
Country A	X	X	X	X	X	X	X	X	X
Country B	X	X	X	X	X	X	X	X	X

CbyC Template-Page 2* (onwar-ds)

Country	Constituent entities resident in country	Country of organisation or incorporation in different from country of residence	Activities
Country A	Entity A	Country B	.,/ .,/
	Entity B		.,/ .,/

*Information obtained from annexure III to chapter V of OECD/620 base erosion and profit shifting Project: Guidance on transfer pricing documentation and Country-by-Country reporting

Master file – Applicability in India

Applicability

Particulars	Value during the accounting year
Consolidated group revenue for the reporting accounting year exceeds	INR 500 Crore (USD 75 million)
And	
Aggregate value of international transactions: a. overall as per books exceeds OR b. of intangible transactions as per books exceeds	INR 50 Crore (USD 7.5 million) INR10 Crore (USD 1.5 million)

Time Lines

Financial Year (FY)	Time Line
FY 2017-18 and onwards	30 Nov following fiscal year end in March

All documents to be filed with the Director General of Income-tax (Risk Assessment)

Penalties

Penalty for CbCR : (Section 271GB)	Delay upto one month	Delay beyond one month	Delay in payment of penalty - after receipt of penalty order
Failure to furnish CbCR by the due date of filing of return of income	INR 5,000 per day	INR 15,000 per day	INR 50,000 per day
Failure to furnish additional information and documents sought by the Revenue authorities	INR 5,000 per day from the day on which the period for furnishing the information and document expires		INR 50,000 per day
Inaccurate information filed under the CbCR (Penalty to be levied based on certain conditions)	INR 500,000		

Failure to furnish information and documentation (Master File) as may be prescribed in rules by the due date will attract penalty of be INR 500,000 – Section 271AA(2)

Case Study - Master File requirements

Threshold	Accounting year ending	Form No.	Requirement	Due Date	Applicability
Consolidated group revenue for the reporting accounting year > INR 500 crore **<u>AND</u>** **i) Aggregate value of international transactions as per books > INR 50 crore** **<u>OR</u>** **ii) Aggregate value of intangible related international transactions as per books > INR 10 crore**	31-Mar-19 [Of the designated constituent entity ('CE') in India	3CEAA – Part A i.e. Basic information of MF	Every Indian CE of an international group requires to undertake filing, irrespective of satisfaction of threshold	30-Nov-19	Yes
		3CEAA – Part B i.e. Detailed MF	MF related information to be filed, if the threshold is satisfied		Yes – to be evaluated subject to thresholds
		3CEAB – MF intimation	In case of one or more than one resident CE in India, the Group shall designate one CE to undertake aforesaid compliance	31-Oct-19	Yes

Case Study - Country-by-Country requirements

Threshold	Accounting year ending	Form No.	Requirement	Due Date	Applicability
Consolidated group revenue for the accounting year preceding the reporting year > INR 5,500 crore	31-Dec-18 [Of the parent entity – outside India]	3CEAC – CbCR intimation	Every Indian CE of an international group requires to undertake filing on satisfaction of threshold	31-Oct-19	Yes
		3CEAD – Filing of CbCR	CBDT, vide press release dated 23 March 2018, has announced that it is yet to prescribe the time for furnishing CbCR report in cases where: (a) the parent entity is not obliged to file the report, or, (b) the parent entity is headquartered outside India and Multilateral Competent Authority Agreement ('MCAA') on the Exchange of Country-by-Country Reports is not signed between India and the country of the parent entity, or, (c) MCAA is signed and there has been a systematic failure by parent entity to exchange the CbCR with Indian government and the same is intimated by the prescribed authority to such CE	Not yet prescribed	Not Applicable

Guidance on appropriate use of CbC Report

First Exchange of CbCR in September 2018

Prescribed use of CbyC Reports- defined framework

Information to be used for high level TP assessment

Can be used to identify other BEPS risk

Cannot be used as a basis for a detailed TP analysis

Standard Operating Procedure for the Tax Officers will be formulated soon

Strict safeguards for maintaining confidentiality

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

Transfer Pricing Audit Process and Litigation

Audit Process

1. File tax return & Accountant's Report **(30th November)**

2. Reference to be made to TPO by the AO based on **risk based assessment approach**.

3. Notice to be issued by the TPO ~ TPO calls for supporting documents & evidence

4. **TP Audit**

5. Based on results of above mentioned procedure assessing officer passes the order

6. Rectification application can be made against the order of TPO for apparent mistakes [Section 92CA (5)]

7. Options of Filing an appeal
   - CIT (Appeals)
   - Dispute Resolution Panel

4 Stages in TP Audit

1. TPO issues a preliminary questionnaire;
2. FIle all the relevant documents with the TPO's office (TP Report, AR, Agreements, etc) ;
3. TPO's send a fresh notice for hearing ~ ask for updated margins, RPT details, eliminating loss-making companies;
4. File 2nd Submission which includes updated margins, etc;
5. TPO may ask for further queries, if required ~ pertaining to business profile of assessee and comparables, specific details on economic analysis;
6. File 3rd Submission, if required;
7. TPO issues a show-cause notice (SCN) which includes the reasons as to why the TPO believe that an adjustment should be made;
8. We file a reply to the SCN ~ research, detailed response filed;
9. TPO passes the order and sends a copy to the AO;
10. AO passes a draft order u/s 144C.

7 Appeal Procedure

Appeal to CIT (Appeals)/ DRP

↓

Passes an order/ issues direction

↓

Income Tax Appellate Tribunal

↓

High Court – relating to question of law

↓

Supreme Court

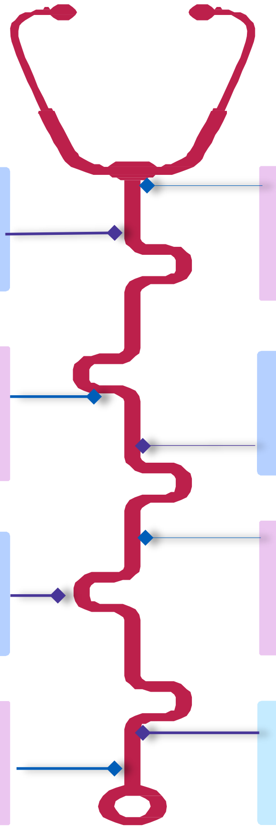
Transfer Pricing Litigation Position

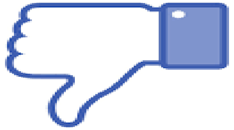
Shift in Audit approach - from “Monetary threshold” to “Risk based parameters”

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

Audit Process – Risk based assessment approach

- Cases selected for Scrutiny under CASS (Computed Assisted Scrutiny Selection) – based on TP Risk parameters – Mandatory Reference to the TPO
- Cases selected for Scrutiny under CASS (Computed Assisted Scrutiny Selection) – based on Non TP Risk parameters – Refer to TPO only under 3 circumstances –
  - Accountant’s Report in Form No. 3CEB not filed
  - TP Adjustment INR 10 Crores or more in previous year
  - Under Search and seizure : Findings on TP issues have been recorded

Audit Process – Risk based assessment approach

Key Triggers for Aggressive Audits

- Consistent losses / low margins of the assessee attributable to inter-company transactions
- Significant changes in profitability of the assessee and its AEs
- High Royalty / Technical fee payouts, Cost recharges, Management Fees, Cost allocations
- Net losses incurred by routine distributors
- Low mark-ups for services
- Application of Ratio's such as ROCE / Berry ratio / cash profit instead of net margins
- Significant Advertisement and marketing spends by manufacturing / distribution companies

Contributors to Aggressive Audits:

- Mounting fiscal demand on Government
- Need to Preserve tax base
- Constant competitive pressure to restructure business operations efficiently
- Unprecedented sharing of information between revenue authorities

**Substantial increase in transfer pricing audits and disputes across the Globe ,
India is no exception….**

Evolving Dispute Resolution Mechanism

Dispute Resolution Panel (DRP)

- Alternate dispute resolution mechanism to 1st level appellate proceeding before the CIT (A)
- Specialist 3 member collegium for settling disputes on a fast track basis
- No demand till Assessing Officer issues final order after directions of DRP
- Faster route to ITAT

Advance Pricing Agreement (APA) – Introduced in 2012

- Would be limited to a maximum term of 5 consecutive financial years
- The ALP shall be determined on the basis of prescribed methods or any other method
- Rules governing the APA regime notified by CBDT
- 4 Roll back years covered

Safe Harbour – introduced in 2013

- Seeks to reduce the impact of judgmental errors in transfer pricing
- Stipulation of margins-specified industries (Priority - IT/ITeS) / Class of transactions / threshold limits
- Safe Harbour regime would be optional and could be exercised on a year to year basis

Mutual Agreement Procedure (MAP) – To avoid double taxation

- MAP is an alternate mechanism incorporated into tax treaties for the resolution of international tax disputes
- Resolution of disputes through the intervention of competent authorities of each State who evolve a mutually acceptable solution

DRP – Key Aspects

- Introduced by Finance (No.2) Act, 2009 w.e.f 1 April 2009 . Alternative dispute resolution mechanism for "Eligible Assessee":
  - **Foreign company** - Transfer pricing adjustment not necessary
  - **Any other person** – If variation in pursuance to order issued by transfer pricing officer
- Objections to be filed against entire Draft Order issued by the AO – both transfer pricing as well as non transfer pricing (i.e. general tax issues) – within 30 days of receipt of draft order
- No payment of tax till AO issues the Final Order in pursuance of DRP directions

Taxpayer can appeal to ITAT against the order pursuant to DRP Directions
However, the department cannot appeal against the order

DRP vs CIT(A) - A Comparison

Key	DRP	CIT(A)
Constitution	Collegium of three officers of the CIT rank	Only one CIT
Application Process	If the taxpayer chooses this route, he is required to file objections within 30 days from receipt of Draft Order	Should file Appeal within 30 days from the receipt of Final AO Order
Time limit	Panel to issue directions within 9 months from end of the month in which order forwarded to the Assessee	No time limit
Pros	Fast track route to the ITAT	Detailed hearings may be granted to the Assessee to represent their case
Form	Form 35A – specific format to be followed for submission	Form 35

APA, MAP and Safe Harbour

APA Landscape in India

Validity
{Up to 5 years (renewal up to additional 5 years); Rollback option available for prior 4 years}

Optional Pre-filing consultation
{Anonymous filing possible to gauge views of APA authorities}

Types
{Unilateral and Bilateral. Option to get Unilateral APA converted to Bilateral}

No TP audits:
{Post APA no regular audits. Simple annual compliance and annual compliance audit}

Option to withdraw
{taxpayer can withdraw/ renew the APA application}

240+
(220 unilateral and 22 bilateral signed)

120+
Unilateral APAs signed with US
Average processing time – 29 months

13
Bilateral APAs signed with UK & Japan
Average processing time – 39 months

APA as an option

APA Rollback (For 4 previous fiscal years)

- FY2014-15
- FY2015-16
- FY2016-17
- FY2017-18

APA (For 5 future fiscal years)

- FY2018-19
- FY2019-20
- FY2020-21
- FY2021-22
- FY2022-23

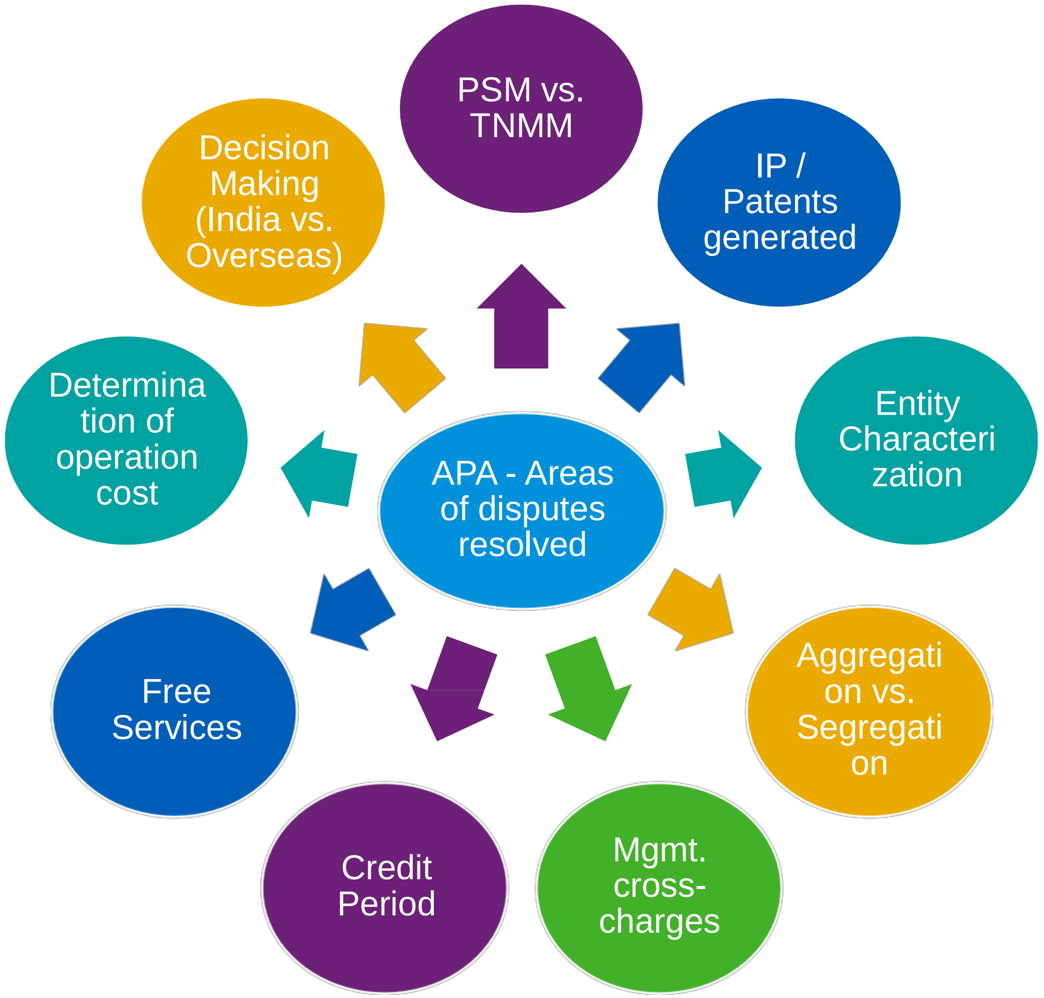
Renewal of APA (For 5 future years)

- In February 2016, the USA started accepting bilateral APAs with India, almost within a year from the broad Framework agreement between them in January 2015
  - Several bilateral APAs signed with the USA
- India has started to accept bilateral APA and MAP even in the absence of Article 9(2) in tax treaties*
- India-Singapore and India-Korea tax treaties recently revised ➔ bilateral APA and MAP opens up in similar countries
- With India signing the MLI, bilateral APA and MAP possible with all large trade partners of India

Conclusion reached in APA has persuasive value in past litigation

* *CBDT press release dated 27 November 2017*

APA - Issues raised & addressed



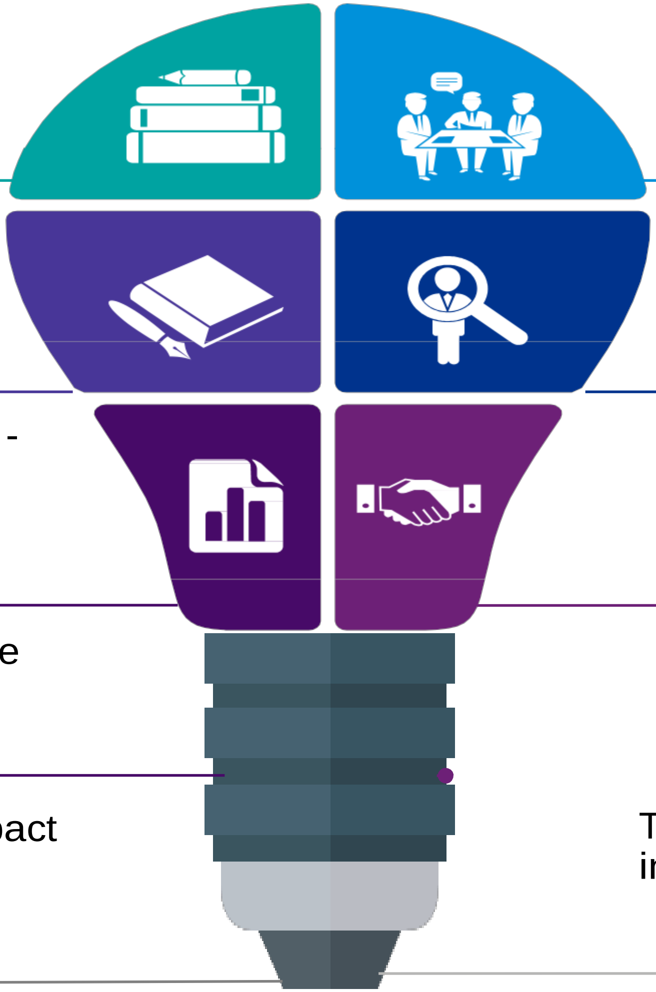
MAP- An overview

An additional remedy under Indian tax laws

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

Resolution of disputes through the invention of Competent Authorities

Transfer Pricing or Profit Attribution cases generally given priority



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

Several years can be aggregated together

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

Positive bilateral relationship should prove beneficial

Possibility of avoiding double tax impact through correlative relief

Treaties typically incorporate a time limit for initiation of MAP procedure

Approach to Dispute Resolution – Combination of APA & MAP

Financial Years under Scrutiny

2012-13
2011-12
2013-14*

Mutual Agreement Procedure (MAP)

Open Financial Years subject to Scrutiny

2014-15
2015-16
2016-17
2017-18
2018-19

In-between Financial Years
(Audit yet not completed by Indian Revenue)

Future Financial Years

2019-20
2020-21
2021-22
2022-23
2023-24

Advance Pricing Agreement (APA)

MAP and/ or APA when concluded, to have a persuasive impact

Mutual Agreement Procedure (MAP)

- Initiated after audit/ assessment has been completed
- Can be pursued parallel with the Appellate proceedings
- Eliminates double taxation
- Finalization/ clarity on the dispute with the Indian and the foreign jurisdiction Tax Authorities
- Possibility of partial payment of demand till MAP is concluded
- More than one assessment year could be clubbed in a MAP application
- MAP decision would provide finality to the issue as it would override the decision of the CIT(A)/ Tribunal, at the option of the taxpayer
- Taxpayer could choose whether to follow the MAP decision or not

Documentation Strategy and synchronized approach must be in place

- Review of existing documentation and strategizing the requirement of additional documentation and arguments to be filed before CIT(A)/ TPO
- From the experience of years under scrutiny, suggesting modifications to the existing documentation for open years
- Strategizing an approach which takes into account the issues for past years as well as ABC Ltd' proposition for future years

* *Assessment order for FY 2013-14 would have been passed by 31 Dec 2017*

MAP Process – Broad Steps and Potential Coverage Areas

Filing Application with CA of Home Country

CA has discretion to admit application

Making representation to CA of home country

CA of home country & host country to consult

Making representation to CA of host country

MAP resolution issued by CA of home & host country

Implementation of Solution

Indicative timelines of 30 to 36 months for resolution

Issues which can be tackled through MAP	Primary areas of dispute under MAP
Taxpayer contends ➔ he is being taxed in a manner not in accordance with tax treaty	Adjustments under TP
Issues relating to interpretation of terms appearing in the tax treaty	Determination of PE and profit attribution
Elimination of double taxation in cases not covered by tax treaties	Characterization / classification of income
	Witholding tax levied beyond the allowance limit within an applicable tax convention
	Taxpayer is considered to be resident of two countries

MAP – Indicative process

1. Assessment order received from the tax authorities making adjustment leading to double taxation
2. AE to file MAP application with the foreign tax CA
3. India to file a copy of same MAP application with Indian CA
4. Furnishing of BG equivalent to the amount of tax demand and int. proposed by the Indian tax authorities
5. Demand kept in abeyance by the AO until settlement of MAP process
6. CA of both countries will review the case, negotiate and agree to a resolution after mutual consultation
7. The resolution arrived at shall be communicated to DGIT or the CCIT in writing
8. The intimation regarding the resolution agreed by the two CA's is intimated to the AO.
9. AO sends intimation of resolution to the Indian taxpayer
10. If the resolution is accepted by the taxpayer, the final demand is raised by the AO as per the MAP resolution
11. The taxpayer withdraws the appeal against such dispute pending before any appellate authority
12. If MAP withdrawn, recourse to normal appellate provisions. No relief for double taxation

AO to give effect to the resolution within 90 days of receipt of the resolution by the CCIT or DGIT

Suspension of collection of taxes during MAP

Indian govt. has entered into a Memorandum of Understanding (MOU) with countries like US, UK, Denmark and Korea for suspension of tax collection during pendency of MAP

Once the MAP is invoked by AE in other country and is accepted by the Indian CA, the taxpayer in India is required to furnish a bank guarantee (BG), equal to the disputed tax and interest

On receipt of BG, the AO suspends the demand till MAP is resolved

MAP – Effects of MLI and India's position on MLI

Key changes proposed by MLI and India's position to key clauses

- **Presentation of case to competent authority:**
  - Expresses reservation on presentation of case to either of the competent authorities ☐ tobe presented by the taxpayer only in the country of its residence
- **Time limit for presenting the case for MAP:**
  - Agrees with the model time limit of three years
  - Extends time limit under Tax Treaties with shorter time limit e.g. Canada
- **Adoption of Article 9(2) of OECD model convention:**
  - Agrees to accept bilateral APA and MAP applications sans Article 9(2)
  - Key countries aligned –France, Belgium, Swiss Confederation; key countries unaligned – Germany, China
- **Mandatory binding arbitration:**
  - Article 19 of MLI provides for mandatory binding arbitration when CAs are unable to reach a decision under MAP within 2 years → India has not accepted such provision taking a position that such binding arbitration would adversely impact its sovereignty

Safe Harbour Rules

- "Safe harbour" - Circumstances in which the income-tax authorities shall accept the transfer price declared by the Assesse
- Introduced in India by inserting new Section 92CB
- Sector-wise/transaction-wise Safe Harbour for
  - IT Services
  - ITES Services
  - Financial Transactions-Outbound loans
  - Financial Transactions-Corporate Guarantees
  - Auto Ancillaries-Original Equipment Manufacturers, etc

Secondary Adjustments and Limitation on Interest Deductibility

Secondary Adjustments

- **Section 92CE** introduced to provide for secondary adjustment applicable on primary TP adjustments made for FY 2016-17; and future years
- Secondary adjustment on **primary TP adjustment in excess of INR 10 million** under following scenarios :
  - **suo-moto stand taken by the taxpayer in tax return;**
  - **made by Revenue Officer in TP audit, which is accepted by taxpayer;**
  - **determined in an APA;**
  - **made as per safe harbour rules;**
  - **MAP settlement**

The excess money available with the AE would be required to be repatriated to India by the AE.

- Non - repatriation of funds by AE within the prescribed time limit would result in the following consequences:

  - such funds would be deemed to be an advance made by the taxpayer to such foreign AE;

  - the notional interest thereon shall be computed in a manner to be prescribed; and

  - such interest will be taxed in the hands of the Indian taxpayer

Limitation on Interest Deductibility

International backdrop:

OECD BEPS project, in Action Plan 4, has proposed to limit deduction from interest expenditure, in the following manner:

- **Fixed Ratio Rule** – limit net interest expenses up to a benchmark rate of Earnings before Interest, Tax, Depreciation and Amortisation (‘EBITDA’)
- **Group Ratio Rule** – limit net interest expenses up to a group-level ratio of interest / EBITDA-based limitation
- Carry forward / carry back of unused / disallowed interest expenses
- Minimum threshold for removing low-risk entities

Indian context:

- The Finance Act, 2017 introduced **Section 94B** to **limit the interest which can be allowed as an expense** under the Act, applicable from FY 2017-18; following an offshoot of fixed ratio rule
- Deduction for interest expense is restricted ini following cases:
  - Interest expense is incurred by a company on **debt from an AE;** and / or
  - Interest expenses on **debt from an unrelated party** which is **based on guarantee or funds provided by an AE**
- Total amount of **interest paid over and above 30% of the EBITDA**; or the **actual amount of interest paid** to the Associated Enterprise; **whichever is lower, is disallowed**
- **Interest in excess of INR 10 million** in the particular FY
- Carry forward of unutilized amounts allowed for **8 assessment years**
- Banking and Insurance companies not covered

Case Studies

Distribution Business – Typical Operating Models

Assured routine return

Marketing support service provider

- Routine marketing / liaison support
- Limited risk borne by service provider

Return based on cost or sales

Indenting / commission agent

- Principal – agent relationship
- Limited risks borne by agent

Targeted / minimum assured return

Low / limited risk distributor

- Distributor undertakes routine functions
- Low risks borne by distributor

Entrepreneurial return

Full fledged distributor

- Independent, full-fledged operations undertaking major functions
- Full-to-major risks borne by distributor

Case study – Distributor

A Inc, USA

XYZ India Commission business

XYZ India Distribution business

Commission Agent activities remunerated by way of sales commission

Distribution example

- Entrepreneur – engaged in business of medical equipments worldwide
- Manufactures equipments (contract / toll basis) and sells worldwide through own subsidiaries or third party distributors or direct sales through agents / commissionaire models

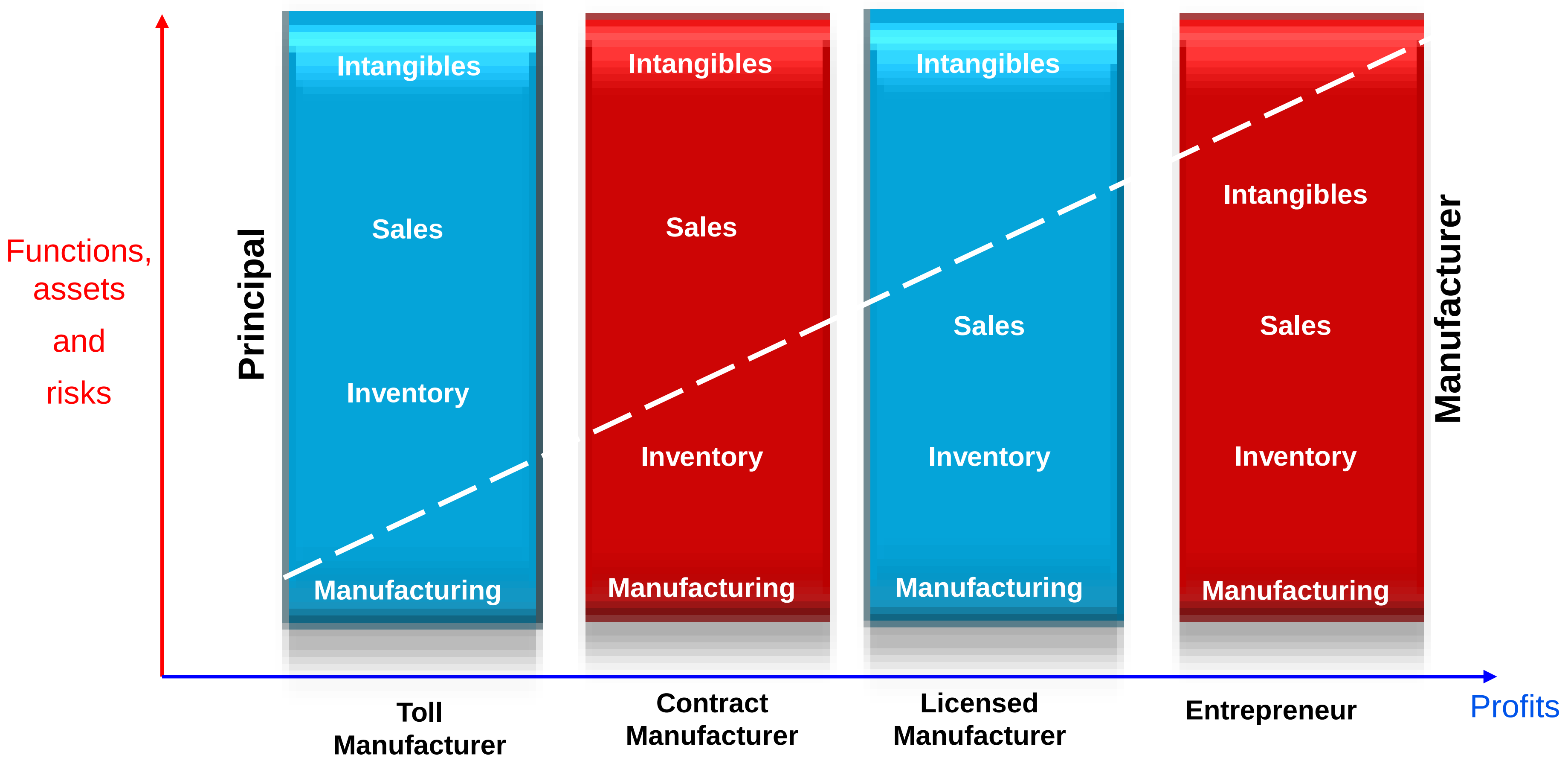
Distributor and after sales services

Operating models:

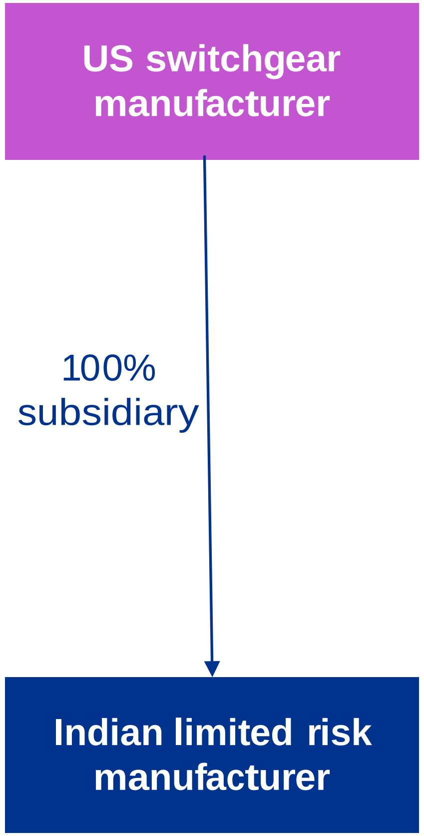
- Large equipments – back-to-back orders
- Medium-to-small equipments – stock and re-sell
- Lease business (with consumables)

Remunerated on a target resale minus margin

Manufacturing Business – Typical Operating Models



Case study – Manufacturing

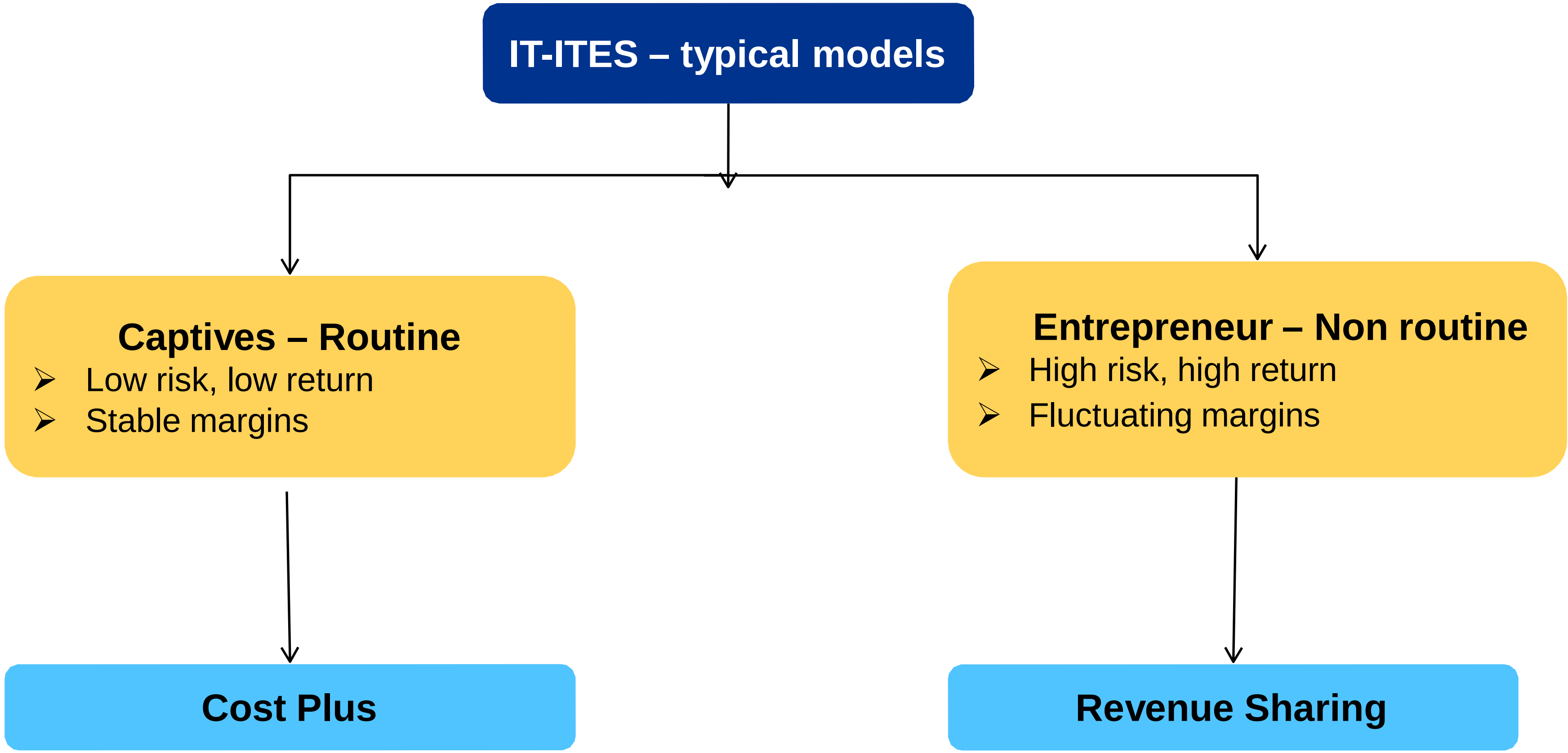


- US based switchgear manufacturer entering into following transactions:
  - Sale of raw materials and components
  - Trademark / process technology
  - Intra-group services
  - Letter of support for funding
  - Expenses reimbursement for administrative convenience

- Indian entity has manufacturing facilities in India, and supplies switchgears largely to Indian market and some exports to group entities and third parties in South East Asia
- Being limited risk entity, the transactions are arranged in a manner to provide an arm's length return commensurate with its functions, assets and risks
- Indian entity has achieved a margin of 1.5% vs average margin of local comparables of 6%

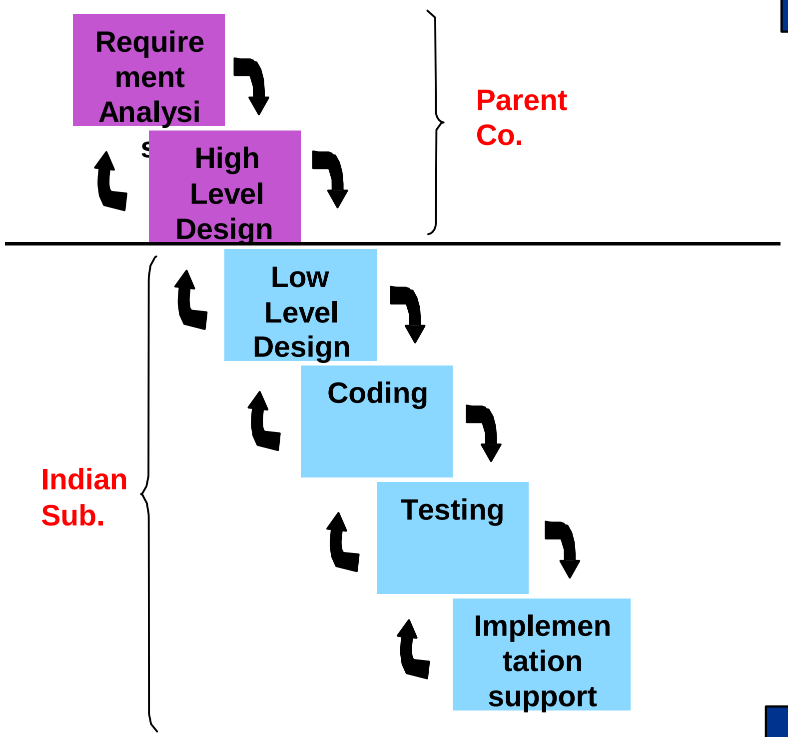
Microsoft Excel Worksheet

IT / ITES Business – Typical Operating Models

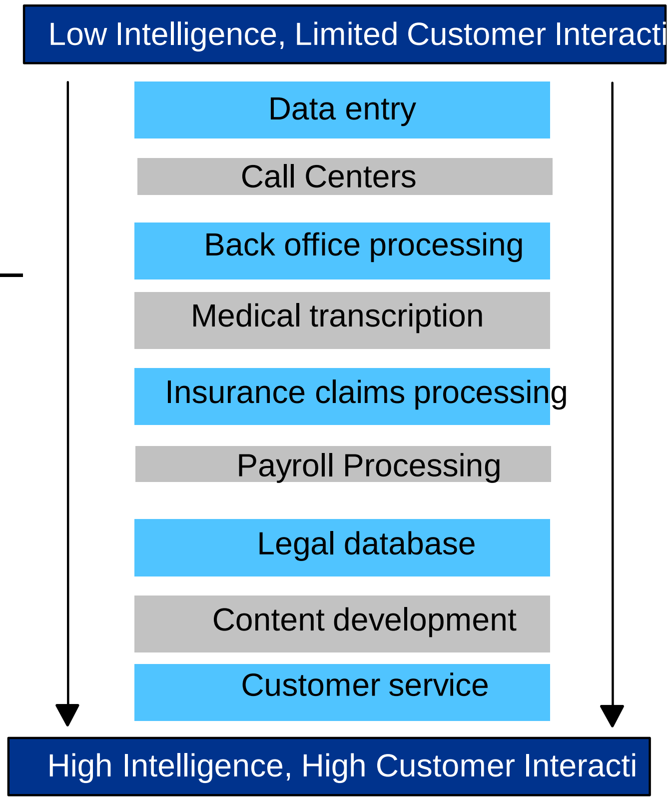


IT / ITES Business – Typical Operating Models

Software development activities



Back office activities



KPO activities

Type of Activity	Examples
Equity and Financial Research	➢ Investment research ➢ Financial modeling ➢ Company / Industry / Sector reports ➢ Credit risk management ➢ Valuation of companies
Business and Marketing Research	➢ Market Analysis ➢ Data mining ➢ Report preparation ➢ Customer Analytics
Engineering & Design Services	➢ Very Large Scale Integration ➢ Design ➢ Simulations ➢ Prototype development
Pharmaceutical research outsourcing	➢ Offshore drug discovery ➢ Clinical research

Emerging Areas and Key Takeaways

Emerging Areas - Meriting Attention

- Attribution of Profits to PE
- Intangibles
- Deemed International Transaction – Sec. 92B(2)
- Secondary Adjustment – 92CE
- Thin Capitalization – Sec. 94B
- CbyC / MF
- Interplay with GAAR, IND-AS & GST

Key Takeaways

- Detailed Functions-Assets-Risks analysis
- Proactive Planning
- Agreements / contracts should exist for transactions between Associated Enterprises
- Price setting mechanisms to be documented
- Localization of Global Transfer Pricing policies
- Documentation should completely describe search methodology, basis for inclusion / exclusion of comparables, etc.
- Substantiate business, economic and commercial rationale
- Maintain detailed cost-benefit analysis with respect to cross charges (intra-group services)
- Strategizing and providing appropriate information during the audit

Questions

&

Answers

CA Anjul Mota

CA Saurabh Damani