Indian Transfer Pricing

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Agenda

Part I : Introduction to Indian TP

Part II : Indian TP Legislation & Practice

Part III: Salient Features of Indian TP

Part IV: Current controversies in Indian TP with Recent Case Laws

Part V : Evolution of Indian TP

Part VI: Streamlining Indian TP Provisions

Part I

INTRODUCTION TO INDIAN TP

Indian TP provisions

- Indian TP provisions were introduced in the Indian Income Tax Act under a separate chapter:

“Chapter X : Special Provisions Relating to Avoidance of Tax”

  - **Chapter X, Section 92** of the Indian Income Tax Act and **Rule 10A-D** of the Income Tax Rules
  - Every year a Finance Act is passed called the “”Budget”” presented by the Finance Minister, in a widely televised and much anticipated event, which is used to makes amendments to the existing Income Tax Act and Rules
  - TP regime was introduced via the Finance Act 2001 w.e.f April 1st 2001.

- **Birds-eye, one-line overview of Indian TP**
  - **OECD-Lite provisions, UN-Lite implementation?!**

Indian TP Provisions – Chapter X, Section 92

Sections/Rules	Provisions
s 92	Computation of Income, expenses, CCA
s 92A	Associated Enterprises (“AE”)
s 92B	International Transactions
s 92C(1) (Rule 10B, 10C)	Computation of Arm’s Length Price (“ALP”)
s 92C/92CA	Powers of Assessing Officer (“AO”) and Transfer Pricing Officer(“TPO”)
s 92CB	Power of Board to make Safe Harbour Rules
s 92CC	Advance Pricing Agreement (APA)

Indian TP Provisions – Chapter X, Section 92 (continued…)

Sections/Rules	Provisions
s 92CD	Effect to Advance Pricing Arrangement (APA)
s 92D (Rule 10D)	Documentation requirements
s 92E (Rule 10E, Form 3CEB)	Accountant's report
s 92F (Rule 10A)	Definitions
s 93	Avoidance of income-tax by transactions resulting in transfer of income to non-residents
s 94A	Transactions in notified jurisdictional areas

Transfer Pricing Penal provisions

Reference under the Income-tax Act	Particulars	Penalty
271AA	Failure to maintain documentation	2% of the value of each international transaction
271G	Failure to furnish/submit any information / document to the transfer pricing officer	2% of the value of the international transaction for each such failure
271BA	Failure to furnish accountant's report	INR 100,000
271(1)(c)(iii) read with Explanation 7	Transfer pricing adjustment considered as concealed income	100-300% of amount of tax on adjustments

Indian TP vs. OECD Guidelines

Concepts	Indian regulations	OECD Guidelines
Associated Enterprises	Very wide definition	Restricted to controlled entities
Foreign comparables	Not permitted in practice	Permitted
Priority of methods	“Most appropriate method” rule – no preferred method	Originally, a preference for “traditional” methods
Use of unspecified method	A sixth method….allowing any other quantifiable method prescribed	Permitted
Intangibles	Definition added only in Finance Act 2012. **Lack of guidelines/discussion on Intangibles**	Definition, discussion, reports, guidance etc.

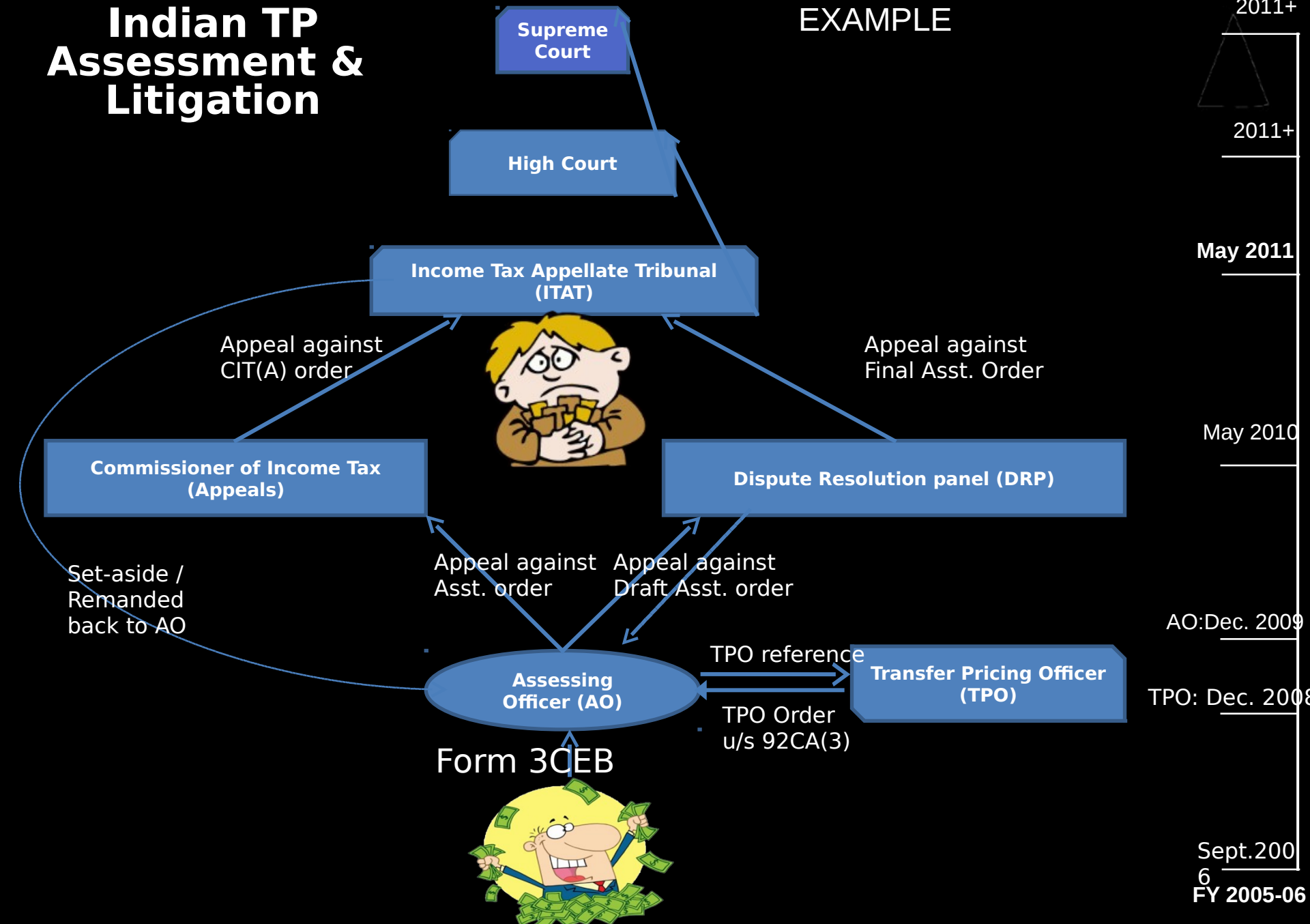
Indian TP vs. OECD Guidelines (continued…)

Concepts	Indian regulations	OECD Guidelines
Comparable range	• Arithmetic mean of comparable PLI with 5% range (was made 3% range in FY 2013) • Recent Notification 83 of 2015 finalized rules for use of percentiles in certain cases	Allows for range of comparable data
Multiple year data	• Earlier allowed only data for current year (previous 2 years only in special cases and rarely accepted) • Recent Notification 83 of 2015 permitted data of immediately previous year to be used, if current year data not available	Permitted
Documentation	• Stringent requirements; contemporaneous documentation required • Latest amendment in Finance Act 2016 adds Section 286 to provide for Country-by-Country Reporting regime as per Action Plan 13	Prudent business principles

Part II

INDIAN TP LEGISLATION & PRACTICE

Indian TP Assessment & Litigation



TP ASSESSMENT TIMELINE EXAMPLE

2011+

2011+

May 2011

May 2010

AO:Dec. 2009

TPO: Dec. 2008

Sept.2006

FY 2005-06

TP audits in India

Financial Year (FY)	Number of TP Audits Completed	Number of Adjustment Cases	% of Adjustment cases	Amount of Adjustment (in INR Crore)
2004-05	1,061	239	23	1220
2005-06	1,501	337	22	2287
2006-07	1,768	471	27	3,432
2007-08	219	84	39	1,614
2008-09	1,726	670	39	6,140
2009-10	1,830	813	44	10,908
2010-11	2,301	1,138	49	23,237
2011-12	2,638	1,343	52	44,531
2012-13	3,171	1,686	53	70,016
2013-14	3,617	1,920	53	59,602
2014-15	4,290	2,353	55	46,465

Source: Annual Report of Ministry of Finance, FY 2013-14 & 14-15

Part III

SALIENT FEATURES OF INDIAN TP (INCLUDING RECENT AMENDMENTS)

Salient Features of Indian TP

- Definition of “”Associated Enterprises”
- What is an “International Transaction”?
- Indian TP Methods
- Arm’s length range & Multiple year Data
- Documentation under Indian TP
- TP Assessment procedure
- APA in Indian TP
- Safe Harbour Rules

Salient Features of Indian TP

Associated Enterprise - AE

- Section 92A of the Indian Income Tax Act defines the term ‘associated enterprise’ in two parts
  - Enterprises which are regarded as AE’s (S.92A(1))
  - Enterprises which are *deemed* to be AE’s (S.92A(2))
- Furthermore, S.92F(iii) defines the word “enterprise” in a very broad manner
- Bottomline: Indian TP has a very broad view *(de jure & de facto)* of AE relationship

Salient Features of Indian TP – Associated Enterprise

Section 92A(1) – First Limb of AE definition

- (*a*) which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- (*b*) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

Section 92A(2) – "Deemed" AE provision

- Sec. 92A(2) ***deems*** two enterprise to be associated if there exists between them some kind of economic, executive, financial or business relationship or there is some kind of mutual interest.
- Relationship between two AEs is of dependency –
  - Direct control of the capital or voting rights, or
  - *De facto* control ie indirect control such as common management or commercial relationship.

Salient Features of Indian TP – Associated Enterprise

Section 92A(2) – "Deemed" AE

- Broad classification of **13 scenarios** u/s. 92A(2) for *deemed AE*
  - Controlling interest – clause (a), (b) and (l)
  - Financial transactions –clause (c) and (d)
  - Management and executive decisions – clause (e) and (f)
  - Operating transactions –clause (g), (h) and (i)
  - Family control –clause (j) and (k)

Salient Features of Indian TP - International Transaction

Section 92B of IT Act

- A very wide definition of international transaction is provided in Section 92B(1) and 92B(2)
- Wait, it gets worse!
  - There were differing interpretations (especially involving intangibles and financial transactions) and various pending disputes & litigation on the definition of international transaction
  - The Government thus introduced a wide-ranging Explanation clarifying scope of term "international transaction" vide *retrospective amendment* by Finance Act 2012 w.r.e.f 1-4-2002 !

Salient Features of Indian TP

TP Methods

- **Five (now six!) methods prescribed**
  - CUP, Cost-Plus, RPM, TNMM and Profit-split are the FIVE *usual suspects*
  - Sixth "method" allowing "***any other quantifiable method "*** was notified a few years ago. Rule 10AB of the IT Rules was added for the same
  - **TNMM** (and CUP) rule the roost in practice
- Income Tax Rules (Rule 10B, Rule 10AB) prescribe the machinery of these methods
- **Prowess™ & CapitalLine™** company databases are used for TP reports by all parties
- **NO preferred method**

Salient Features of Indian TP
Arm's length range & Multiple year Data

- In Indian TP, the ALP has till recently been calculated only via **arithmetic mean** of comparable prices
  - **Band of 3%** (originally 5%) tolerance provided for ALP
  - Controversy over band vs. standard deduction resolved through multiple amendments over the years
- Furthermore, **till recently, provisions provided** Rule 10B(4) states *"The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into*
Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared."

Salient Features of Indian TP
Arm's length range & Multiple year data- Recent Changes

- Recently though, via **Notification No. 83/2015,** final rules for the use of Range and multiple year data have been brought into play by tax authorities!
- Amendment to Rule 10B – determining ALP based on Most Appropriate Method
- Amendment applicable to transactions entered into on or after 1 April 2014.
- Where RPM or Cost Plus Method or TNMM is used as MAM, comparability will be conducted based on
- data relating to the current year; or
- **if current year data is unavailable, data of immediate previous year**

Salient Features of Indian TP
Arm's length range & Multiple year data

- Arm's-length range: A minimum of six comparables required to apply Range.
- **Range from 35th to 65th percentile of ALP** determined will be considered
- Range NOT applicable where MAM is Profit Split Method or 'Other Method'.
- If Transfer Price is within the 35th & 65th percentile, transaction deemed to be at ALP
- **If not, the Median of the Range** i.e. 50th percentile will be adopted as the ALP
- If there are less than 6 comparables, or MAM is Profit Split Method or 'other method'

Salient Features of Indian TP Documentation under Indian TP – An Overview

- Maintenance of prescribed documentation to the extent contemporaneous (Section 92D r.w. Rule 10D)
- Obtaining and filing of Accountant's report (Form 3CEB) as prescribed under Section 92E read with Rule 10E is mandatory
- Stringent penal provisions in case of failure to maintain documentation

Salient Features of Indian TP - Documentation

Statutory Requirements

Particulars	Documents Required (Section 92D read with Rule 10D)
Organizational Structure	Profile of Group Shareholder details Legal status, residential status, ownership links, country of tax residence of each of the enterprises
Nature of business & Market Conditions	Broad description of business of the taxpayer Industry overview Business of the AE
Controlled Transactions	Nature & terms of international transactions Details of services provided and/or property transferred Value and quantum of international transactions
Background Documents	Economic & Market analysis Budgets, estimates, forecasts and any financial data
Comparability – FAR analysis	Record of uncontrolled transactions Evaluation of comparability of transactions Description of functions performed, risks assumed

Salient Features of Indian TP - Documentation

Statutory Requirements

Particulars	Documents Required (Section 92D r.w. Rule 10D)
Selection & Application of TP method	• Description of methods considered for determining ALP • Most Appropriate Method (MAM) selected along with reasons for selection • Actual working of ALP • Details of comparables and their PLI computation • Differences between comparable data & uncontrolled transactions • Method & mode of adjustments
Assumptions, strategies & Policies	Any assumptions or policies which have affected the determination of ALP
Supporting Information	• Publications, databases, annual reports, Governmental studies • Market research & technical publications • Correspondence of negotiation between

Salient Features of Indian TP - Documentation Relevant provisions & rules

- Threshold Limit:
  - If aggregate book value of international transaction < INR 10 million : NO need to maintain prescribed documentation
- Period of maintenance of documentation
  - Prescribed info & documentation should be contemporaneous and must be in existence by specified date (November 30th of following financial year)
  - Documentation to be retained for 9 years

Bottomline: The documentation requirements are onerous and burdensome for the Indian taxpayer

Salient Features of Indian TP - Documentation
Types of documents

ENTITY RELATED
TRANSACTION RELATED

PRICE RELATED

- **Profile of Group**
- **Profile of Indian entity**
- **Profile of AE's**
- **Profile of Industry**

- **Terms of Transactions**
- **F.A.R analysis *(functions, assets & risks)***
- **Economic analysis *(comparable benchmarking, method selection)***
- **Forecasts, budgets, estimates**

- **Agreements**
- **Bills, Invoices**
- **Correspondence related to pricing *(emails, documents, letters etc.*)**

Salient Features of Indian TP - Documentation Threshold parameters

- Threshold Limit:
  - If aggregate book value of international transaction < INR 10 million : NO need to maintain prescribed documentation
- Period of maintenance of documentation
  - Prescribed info & documentation should be contemporaneous and must be in existence by specified date (November 30th of following financial year)
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Bottomline: The documentation requirements are onerous and burdensome for the Indian taxpayer

Salient Features of Indian TP - Documentation
Recent changes – OECD BEPS ACTION PLAN 13

SECOND DOCUMENTATION REQUIREMENTS

- **India has woken up to CbCR requirements introducing amendments in Finance Act 2016 to implement OECD BEPS Action Plan 13!**
- Under Section 92D, a **further requirement** has been introduced for a constituent entity of an international group to keep and maintain such information and documents in respect of an international group as may be prescribed, and to furnish such information and documents, on or before the due date, as may be prescribed.
- Failure to furnish such information/documents would attract a penalty of INR 5,00,000 under section 271AA. (This is in *addition to* penalty of 2% leviable u/s 271G as discussed earlier)

Salient Features of Indian TP - Documentation Recent changes - Country by Country Reporting (CbCR)

- MNEs with consolidated revenue exceeding €750mn (approx. INR 5500 crore at current rates) in immediate preceding previous year have to file CbCR
- The CbCR, Master file and Local file to be submitted annually
- MNE to file CbCR with the tax authority of the ultimate parent – shared via treaty network; Concept of alternate reporting entity
- Master file and Local file to be filed directly with relevant tax jurisdictions
- First year will be April 2016 to March 2017

Salient Features of Indian TP - Documentation Recent changes – Country by Country Reporting (CbCR)

- **Section 286 inserted in Indian Income Tax Act to provide for CbCR regime as per Action Plan 13.**
- Every constituent entity in India of an international group where the parent entity is not resident in India, shall provide information regarding the country or territory of residence of the parent of the international group to which it belongs to the prescribed authority on or before the prescribed date.
- Overview of allocation of income, taxes and business activities by tax jurisdiction and details of all the constituent Entities of the MNE group included in each aggregation per tax jurisdiction need to be disclosed in the CbCR
- Graded structure of penalty prescribed ranging from INR 5,000 to 50,000 per day for non-furnishing, non-

Documentation under Indian TP CbCR - Challenges

- Countries like USA and Germany are yet to implement CbCR rules. How would their subsidiaries cope with the mandatory CbCR requirements? How would the penalty provisions apply in such situation?
- What about MNEs headquartered in ‘no tax’ jurisdictions e.g. Dubai or BVI?
- CbCR prepared in country with different Accounting Standards/ GAAP or different year endings?
- How does the Indian tax authority plan to use the CbCR information for risk assessment purposes?

Documentation under Indian TP CbCR - Challenges

- Are there any specific triggers identified by the tax authority?
- How will the documents filed under CbCR be disseminated to the Transfer Pricing Officer level?
- Will CbCR furnished by an entity have an impact on any previous assessment years? Can tax officers reopen assessments based on facts obtained from CbCR?
- Will CbCR lead to use of secret comparables?
- What risk do companies face regarding data misinterpretation under CbCR?
- How would the confidentiality of the CbCR information be maintained by the tax authorities?

Documentation under Indian TP CbCR – Possible Solutions

- ✓ **Introduce materiality threshold for inclusion of entities in CbCR**
- ✓ **Relax penalty provisions for the initial years**
- ✓ **Relax the timeline for the initial years**
- ✓ **Safeguards to prevent reopening of past years:** limitation on use of information beyond certain period
- ✓ **Provision to facilitate a corresponding adjustment to avoid double taxation**

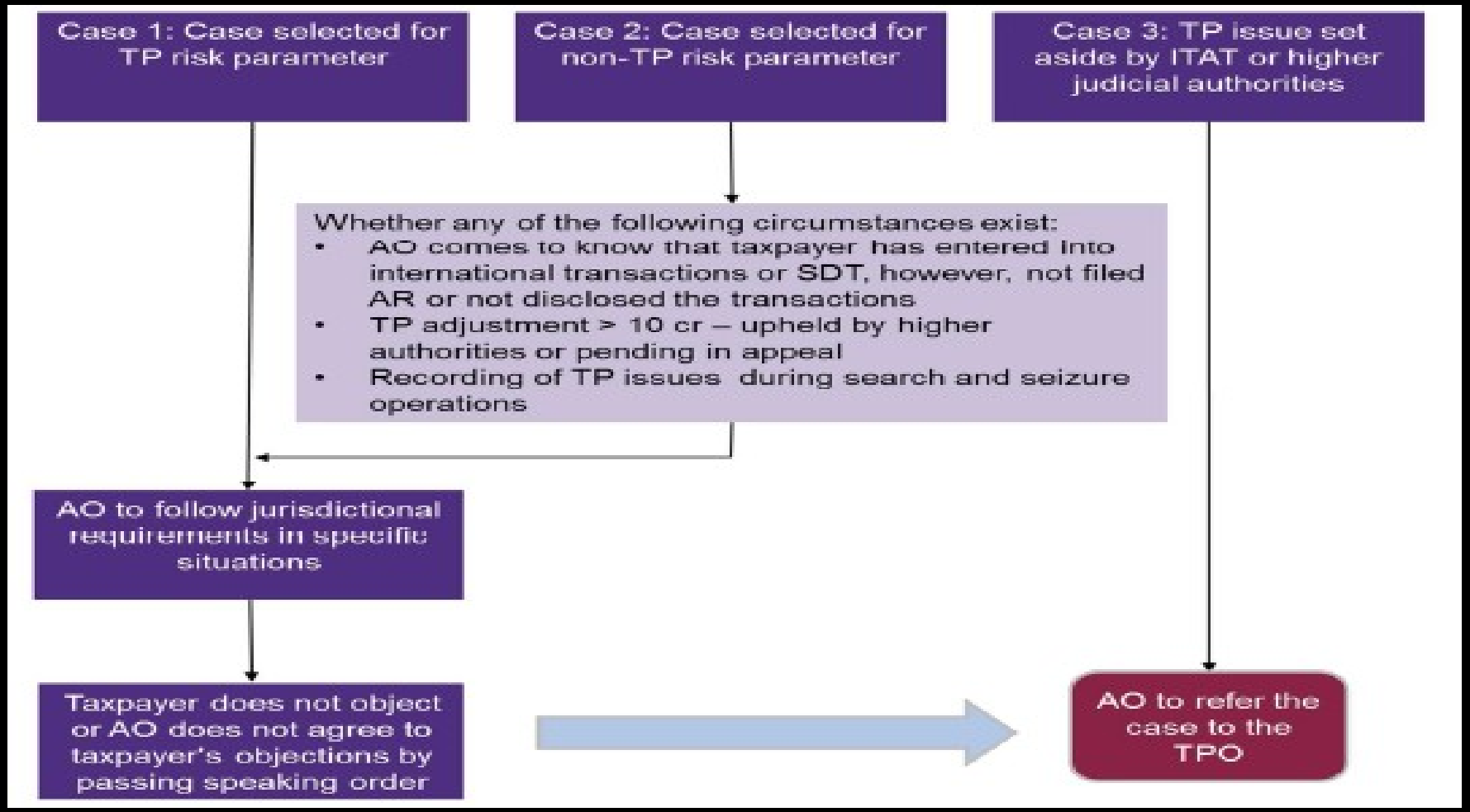
TP Assessment procedure Reference to TPO - Instruction No 3/2016

- Currently, the cases have been selected for TP assessment **based on the value of international transactions**
- After completion of almost ten audit cycles, CBDT issued Instruction no. 15/2015, (October 2015) in which **focus shifted to risk based TP assessments** with AO's continuing to being empowered to perform TP assessments , in certain situations**.**
- In 2016, CBDT come out with a new instruction clarifying that the AO is not empowered to conduct TP Assessments.

TP Assessment procedure Reference to TPO – Instruction No 3/2016

- TPO is empowered to determine ALP for ITs which comes to his notice during proceedings before him but only for SDT specifically referred to him by AO.
- TPO's order must contain details of data used, reasons for arriving at a certain price and applicability of method used. Further, such order is subject to judicial scrutiny.
- AO has to use the ALP determined by the TPO.
- If reference is made in certain cases, AO must record his satisfaction that there is (potential) income which is being affected by ALP determination and take approval of PCIT/ CIT:
  - Report u/s 92E not filed and AO discovers IT or SDT
  - IT or SDT not been disclosed in report u/s 92E & AO discovers the same
  - Transaction declared as not IT or SDT but it is
  - Transaction claimed not to affect income but it does

TP Assessment procedure Reference to TPO – Instruction No 3/2016



Salient Features of Indian TP
APA Provisions in Indian Income Tax Act

- APA introduced in Finance Bill 2012 (S.92CC & S.92CD)
- APA Scheme notified: (Income Tax Rules 10F-10T)
  - Tax payer approaches the Central Board of Direct Taxes (CBDT) for determination of ALP in relation to an international transaction that may be entered into by taxpayer
  - The ALP determined under the APA shall be deemed to be the ALP for the international transaction with respect to which the APA has been entered into
  - The APA shall be binding on the taxpayer and the revenue authorities as long as there are no changes in law or facts that served as the basis for the APA.

Introduction of APA in India

- Under India's APA program, an APA generally is valid for up to five years, and may be subject to renewal, revision or cancellation under certain circumstances.
- During the five-year period, the taxpayer must file an annual report to confirm its compliance with the terms of the APA (and the tax authorities are to conduct a limited audit to verify compliance).
- Rollback provisions for APA's were introduced in Finance Act 2014 and notified by CBDT in 2015. Under the rollback facility, the pricing agreed in an APA (advance pricing agreements) for future transactions (maximum for five years) may be applied to transactions for **previous** four years in specified circumstances.

Some Indian APA statistics.....

- 70+ Bilateral APA submissions made since March 2013
- Over 500+ unilateral APAs
- Over 710 applications have been filed as on 31 March 2016
- 98 APAs signed so far - 65 are unilateral APAs and 3 are bilateral APAs
- On 19 December 2014, Indian APA authorities signed its first bilateral APA with a Japanese company in a time frame shorter than the average time taken internationally, with 2 more signed with the UK in 2016
- Maximum number of APA applications filed in relation to the following :
  - Provision of software / IT enabled services
  - Payment of royalty
  - Issue of marketing intangibles in case of manufacturers / distributors
  - Corporate guarantee
  - Consulting and Investment Advisory services
  - Back-office services for financial institution
  - Trading support services (Sogo Shosha) (BAPA w/Japan)
  - Contract manufacturing (Pharma & apparel)

Salient Features of Indian TP

Sector-wide safe harbours under Indian TP

- Hue & cry from industry resulted in *"N.Rangachari Committee"* culminating in publication of Safe

S.No.	International transaction	Safe Harbour margin
1	Software development	20% or more on oper. expenses
2	BPO	20% or more on oper. expenses
3	KPO	30% or more on oper. expenses
4	Intra-group loan (< INR 500million)	State Bank rate + 150 basis pts
5	Intra-group loan (> INR 500million	State Bank rate + 300 basis pts
6	Corporate Guarantee to WOS	2% per annum on amount
7	Software contract R&D	30% or more on oper. expenses

Salient Features of Indian TP Domestic Transfer Pricing

- In the case of ***CIT Vs Glaxosmithkline Asia (P) Ltd. [(2010) 236 CTR (SC) 113],*** the Hon'ble Supreme Court made recommendations to extend the TP regulations to the domestic transactions covered under Section 40 A(2) and 80-IA(10) of the Indian Income Tax Act – **Indian Govt. promptly introduced Domestic TP in Finance Act, 2012**!
- "Specified domestic transactions" (SDT) was defined in S.92BA of the IT Act and made applicable to transactions involving:
  - **Expenditure incurred between related parties** (S.40A(2))
  - Inter-unit transfer of goods and services by undertaking to which profit-linked deductions apply (Sec.80-IA(8))
  - Transactions between undertakings to which profit-linked deductions apply having "close connections" (Sec.80-IA(10))

Part IV

CURRENT CONTROVERSIES IN INDIAN TP (WITH RECENT CASE LAWS)

CURRENT CONTROVERSIES IN INDIAN TP
WITH RECENT CASE LAWS

1. Marketing Intangibles
2. Royalty payments to AE
3. Corporate Guarantee
4. Interest-free loans from AE
5. Issue of shares and Indian TP provisions
6. Comparability Analysis
7. Location Savings in Indian TP

Part IV.1

MARKETING INTANGIBLES UNDER INDIAN TP

Marketing Intangibles

IS FOREIGN AE's BRAND ENHANCED BY INDIAN CO'S AMP SPEND?

- The current **hot-topic of TP discussion & litigation throughout India** is about accretion **to the "brand" (i.e so called marketing intangible) of the foreign AE due to advertising spend of its branded products by Indian co/subsidiary in India:**
  - VERY common scenario is Indian subsidiary is established by big foreign brand for entering India; Indian subsidiary spends a lot on **advertising , marketing & sales promotion (AMP)** expenditure in India....
- Questions being asked by the Revenue Department
  - **Does the foreign company's brand get enhanced by the advertising & marketing spend (AMP) of its Indian subsidiary?**
  - **Shouldn't the foreign AE therefore compensate its Indian subsidiary (with markup) the excess AMP spend**
- **What about other options such as reduce cost of products supplied to India or reduce Royalty rates instead?**

Current Controversies in Indian TP Marketing Intangibles : The Indian Govt's viewpoint

- Reply in **Chapter X to UN TP Manual** spells **Indian Govt's** current view clearly:
  - Position is that there should be *reimbursement by the foreign AE of* ***excess*** *Advertising & Marketing expenditure (AMP) with a markup*
  - Indian subsidiaries need to get additional returns in the form of reimbursement of AMP
  - "Bright-line test" for marketing intangibles may be used
  - Developer of marketing intangibles having economic ownership IS ENTITLED to ADDITIONAL RETURNS (i.e., the Indian company is entitled to additional returns!)

Current Controversies in Indian TP Marketing Intangibles : Reading between the lines...

- **The Indian Government rationale seems to be as follows:**
  - Indian subsidiaries sells millions of branded items but consistently shows losses in India. **Thus, no immediate benefit (i.e., taxes paid) to India**
  - **Even though Indian companies claim they are low-risk, they don't seem to get even fixed cost plus profits but make huge losses**
  - Main expenditure items for Indian subsidiary seems to be **advertising/marketing & sales promotion (AMP) spend**

Current Controversies in Indian TP

Intangibles: Reading between the lines…

- Indian Govt's stand (continued)…
  - Economic owner (Indian subsidiary) spends all the money creating marketing intangibles for the AE but does not get returns
  - Legal owner (foreign AE) gets benefit of AMP spend
  - However such benefit is not being shared with Indian subsidiaries by the foreign AE
  - Only available & immediately taxable indicator of value accretion to marketing intangible is AMP spend – **this AMP spend needs to be shared/reimbursed with Indian subsidiary by foreign AE**

Current Controversies in Indian TP
Marketing Intangibles: Indian Judiciary's tangible role

- The Government stand on brand reimbursement was initially supported by certain judgments but the tide has turned?
  - Marketing Intangibles has a checkered history in the India Tax Tribunals and Courts
  - Literally hundreds of brands such as *Maruti Suzuki, LG, Ford, Panasonic, Sony Ericsson, BMW, Diageo India, Glaxo Smithkline, Haier Appliance, RayBan, Reebok, Samsung, Sony* etc. have come under the tax radar on this issue
- **Thousands of millions of Rupees** tax demand for reimbursement by foreign AE on excess AMP spend to Indian subsidiaries currently being litigated!

Marketing Intangibles in Indian Judiciary
"Let's start at the very beginning….." – Maruti Suzuki case
Round #1 (Delhi Tribunal, High Court)

- Maruti-Suzuki issue was whether Suzuki™ derives benefit from advertising expenditure incurred by Indian company while promoting the co-branded Maruti-Suzuki car in India
  - Court supported the **"Bright-line test"** of the US judiciary
  - Made a distinction between *mandatory* and *discretionary* use of brand name to decide whether AMP expenditure of Indian AE increased brand value of foreign AE
  - Gave due recognition to OECD principles relating to intangibles
  - As usual with TP, no specifics and only general guiding principles outlined and case sent back to lower authorities
- On Appeal, the Supreme Court however set-aside the Maruti-Suzuki judgment by sending it back to the TPO to decide afresh to law!!

Marketing Intangibles in Indian Judiciary
"Bright Line" is the Right Line! - *L.G. Special Bench* decision

- In the meanwhile, an elaborate judgment analyzing the concept of foreign AE returns on its "brand" being promoted in India was passed by the Income Tax Appellate Tribunal's (ITAT) Special Bench
- Underlying theme is that the foreign brand gets exposed to, developed and enhanced in India and hence this accretion of *marketing intangible* created in India ought to be reimbursed by the foreign AE
- Assessee's prima facie contention that local advertising expenditure did not amount to an international transaction – Rejected outright

Marketing Intangibles in Indian judiciary *L.G. Special Bench* (contd..)

- Enumerated 14 questions/principles to determine the nature of the relationship between the AE's and their use and cost/value of the intangibles shared
- Held that:
  - Position taken by assessee that economic ownership (based on *developer-assistor rule*) by the Indian subsidiary leads to it becoming the "owner" of brand is *flawed* AND
  - Position that the underlying intangible legal owner (foreign AE) does *not* obtain returns on its "brand" is unacceptable
- Direct selling expenditure may be excluded in calculation of reasonable AMP!
  - What constitutes direct selling as opposed to brand promotion?

Marketing Intangibles in Indian Judiciary "Advantage Assessee!"– Sony Ericsson, Maruti Suzuki et al

- Post the *LG Special Bench* decision, a number of tax demands was raised across the country on many international brands' distributors in India as well as local licensed manufacturers
- Batches of these cases were taken up over period of months recently by the Delhi High Court
- The Delhi HC in a series of judgments has come strongly pro-taxpayer and against the Revenue's approach of adjustment for "excess AMP" with markup and shot down the BLT test in toto!

Case Name	Summary of Decision
Sony Ericsson Mobile Communications Pvt. Ltd. & Ors	<u>Jurisdiction of TPO:</u> ▪Reference made by AO to TPO without prior approval of Commissioner – not justified by virtue of subsection (2B) to Sec 92CA inserted vide Finance Act, 2012 w.e.f. **01.06.2002** ▪HC observed that "*Section 92CA has to be interpreted pragmatically. Therefore, once reference of composite/bundled or packaged international transaction is made, it will be difficult for the assessee to contest applicability of sub-section (1) in cases of segregation or when the TPO invokes sub-section (2B) to Section 92CA of the Act. This flaw as it existed stands corrected with insertion of Sub-Section (2B) to Section 92CA with retrospective effect. It clarifies and cures the deficiency and shortcoming of the earlier provision.*"
	<u>Difference between Sec 37(1) and Chapter X</u> ▪Confirmed that AMP expenditure is an International Transaction ▪Chpt. X concerned with ALP determination, not expense disallowance ▪Impact of Chapter X cannot be controlled or curtailed by allowability u/s 37(1). Adjustment to expense exceeding ALP can be made under Chapter X to expense claimed u/s

Case Name	Summary of Decision
Sony Ericsson Mobile Communications Pvt. Ltd. & Ors	<u>Sec 92(3) and Bundled / Inter-Connected Transactions</u> ▪The use of expression “class of transaction”, “functions performed by the parties” in Section 92C(1) illustrates to the contrary, that the word “transaction” can never include and would exclude bundle or group of connected transactions. ▪It would be inappropriate to proceed with the ALP computation methods, with pre-conceived suppositions on singularity as a statutory mandate. ▪Clubbing of closely linked, which would include continuous transactions, may be permissible and not ostracized. ▪Taxpayer can aggregate the controlled transactions if the transactions meet the specified common portfolio or package parameters.
	▪ TPO can overrule assessee and select MAM after giving reasons & justifications for the same. Once TPO adopts TNMM, AMP expenses cannot be treated as a separate international transaction. ▪ This would lead to unusual and incongruous results since AMP are costs or expense and are factored in the net profit of the inter-linked transaction.
	▪ The TPO can for good & sufficient reasons un-bundle

Case Name	Summary of Decision
Sony Ericsson Mobile Communications Pvt. Ltd. & Ors	<u>Brand & Brand Building</u> ▪To assert & profess that brand building as equivalent or substantial attribute of advertisement/ sales promotion would be largely incorrect. ▪Fallacious to treat brand building or brand as counterpart or commensurate with advertising expenses ▪Application of Bright Line Test to Indian Cos would lead to difficulty, unforeseen tax implications and complications. ▪If BLT is applied and AMP expenses are bifurcated/ segregated towards brand building and creation, the results would be '**startling and unacceptable**" ▪Applying BLT to AMP expense by assessee who does not have any right in the intangible brand value would be "**unrealistic and impracticable, if not delusive and misleading.**"
	▪ Broad-brush universal approach of treating AMP in excess of ALP under the BLT as a separate transaction of brand building is unwarranted and would amount to judicial legislation ▪ Applying BLT would mean adding and writing words to the statute & Rules and introducing a concept not recognized or accepted by any international commentaries or principles of International Taxation.

Case Name	Summary of Decision
Sony Ericsson Mobile Communications Pvt. Ltd. & Ors	<u>Whether section 92(3) prohibits segregation</u> ▪If nature of transactions taken as a whole is so inter-related that it will be more reliable means of determining ALP – segregation is not merely permissible, but desirable ▪If bifurcation is legitimate and mandated, apportionment should proceed accurate and punctilious manner which is fair & reasonable ▪Approach cannot be universal
	Reliance on OECD/ UN Guidelines ▪If the Act/ Rules do not enact contrary provision, OECD/ UN guidelines should not be discarded or ignored without adequate justification ▪Doing so would amount to treating the dexterous and deliberated elucidations made under the guidelines as redundant and superfluous
	▪ Re-categorization of transaction would result in re-categorization of the functions and therefore the comparables ▪ Aggregation or segregation accepts that transactions per se do not require re-categorization ▪ Re-categorization may require subsequent aggregation or segregation

Case Name	Summary of Decision
Sony Ericsson Mobile Communications Pvt. Ltd. & Ors	Inclusion or exclusion of a cost while computing ALP under Cost Plus method may result in different Gross Profit, and therefore higher or lower ALP. The same is different from subjecting the same transaction to different methods as permitted by first Proviso to sec 92C.
	Applying CP method by factoring and treating AMP and trade discounts as independent transactions, while continuing to treat expenses as a component of a packaged transaction which is separately benchmarked would lead to inaccurate and unreliable results
Maruti Suzuki India Ltd. (ROUND #2!)	▪ AMP expenses incurred by assessee are not an international transaction u/s 92B ▪ Sony Ericsson ruling was delivered in context of taxpayers who were distributors' of products manufactured by foreign AE and not 'manufactures' themselves (like assessee) ▪ Decision in Sony Ericsson expressly negatived use of BLT both to form base and determine if there is an international transaction and secondly to determine ALP ▪ 'Step wise analysis of statutory provisions' of Sect 92B to 92F, concludes that, in absence of BLT, there is no machinery provision to discern existence of international transaction on account of AMP expenditure, nor there is a

Case Name	Summary of Decision
Bausch & Lomb Eyecare India Pvt. Ltd.	▪ Revenue unable to demonstrate with tangible material the existence of international transaction involving AMP expenses between assessee and foreign AE, thus the question of determining ALP does not arise; ▪ Relies on coordinate bench ruling in Maruti Suzuki to hold that assessees' cases were not covered by Sony Ericsson case, since the assessees in that case were distributors not manufacturers ▪ As regards the question on existence of international transaction of AMP expenses, although, u/s 92B read with Sec 92F(v), an international transaction could include an arrangement, understanding or action in concert, this cannot be a matter of inference – there has to be a tangible evidence on record to show that two parties 'acted in concert'
Goodyear India Ltd [TS-226-ITAT-2016(DEL)-TP]	▪ TP-adjustment on trademark fee paid by Goodyear India to foreign AE deleted by rejecting TPO's approach of considering this transaction in isolation in view of direct nexus between assessee's earning of revenue and payment for using 'Goodyear' brand name; ▪ Fact that no such payment was made by another AE was irrelevant considering business dynamics and commercial realities in both the companies. Transaction between

Case Name	Summary of Decision
BMW India Pvt. Ltd. [TS-230-ITAT-2013(DEL)-TP]	▪ No separate compensation needed for excessive AMP Exp, when distributor receives sufficient profits/ rewards as part of pricing; ▪ BMW India not a licensed manufacturer, but a distributor with greater intensity of functions; ▪ Assessee performed advertisement function as part of its activities as distributor, which contributed to the brand building for its AE but the Assessee's gross & net margin substantially higher than that of comparables; Such higher margin sufficient to cover assessee's higher AMP expenditure in comparison with that of other entities; ▪ Revenue cannot insist that mode of compensation by foreign AE to assessee necessarily be direct compensation and not pricing adjustment, absent specific provision to that effect in IT Act ; ▪ Rejects assessee's argument that incurring AMP expenses as a function of distributor, not an international transaction, relying on LG ruling; ▪ No bar on referring to OECD Guidelines & International Tax Jurisprudence, to the extent, they don't run foul of IT Act & Rules

Case Name	Summary of Decision
Mondelez India Foods Private Limited [TS-256-ITAT-2016(Mum)-TP]	▪ AMP expenditure incurred by Cadbury India (now Mondelez) does not constitute an international transaction. No specific agreement with AE to share AMP expenses, assessee made advertisement payments mainly to unrelated parties and TPO did not prove that expenses were not for assessee's India business; ▪ ITAT accepts that assessee's 'KUCH MEETHA HO JAYE' campaign proves local marketing strategy and that assessee had incurred AMP expenditure for creating product awareness for local market and to recall the value of existing products, also observes that assessee's commercial wisdom would compel it to be innovative and spend reasonable expenditure for maintaining its market position; ▪ Perceived/notional indirect benefit to the AE due to incurring of certain expenditure by assessee in India, is not covered by the TP provisions"; ▪ Notes fundamental distinction between Sec 37 (which is expense oriented) & Sec 92 (which is pricing oriented) ▪ By questioning 'higher expenditure' and 'justification' of AMP expenditure, CIT(A) had attempted to incorporate the ingredients of Sec 37 while dealing with TP adjustments, which was incorrect and against the basic philosophy of TP provisions;

Case Name	Summary of Decision
Nikon India Pvt Ltd [TS-469-ITAT-2016(DEL)-TP]	▪ Upholds TPO's jurisdiction to determine ALP of alleged international transaction relating to AMP expenses not reported in Form 3CEB ▪ Rejects assessee's reliance on Instruction 3/ 2016 to argue that AO must have first provided an opportunity of being heard to before recording a satisfaction in respect of AMP-transaction ▪ Though the original jurisdiction of the TPO is confined to the international transactions referred to him by the AO for determination of the ALP, but, such jurisdiction is extendable to other international transactions which come to his notice during the course of proceedings before him"; ▪ Rejects assessee's contention that Instruction 3/ 2016 should have retrospective effect ▪ Stating that Instructions to Board Officers setting up a procedure for implementation of certain provisions cannot assume the character of a legislative provision so as to toy with the possibility of applying the same retrospectively ▪ Holds that assessee's reliance on SC ruling in Vatika Township is completely out of context and relies on jurisdictional HC ruling in Ericsson A.B. to uphold prospective nature of the Instruction; ▪ However, ITAT remits ALP determination of AMP-transaction following several Tribunal orders post Sony

Case Name	Summary of Decision
Whirlpool of India Ltd [TS-622-HC-2015(DEL)-TP]	▪ Allows appeal against ITAT order, holds the Revenue is unable to demonstrate with tangible material that there is an international transaction involving AMP expenses between Whirlpool India and Whirlpool USA, thus the question of determining ALP does not arise; ▪ Observes that "the provisions under Chapter X do envisage a 'separate entity concept'…. merely because Whirlpool USA has a financial interest, it cannot be presumed that AMP expense incurred by the WOIL are at the instance or on behalf of Whirlpool USA"; ▪ As per Sec. 92C(1), TP adjustment is made by substituting ALP for transaction price and therefore, there has to be an international transaction with certain disclosed price for applying TP provisions; ▪ HC holds that clauses of trademark and trade name license agreement (TLA) do not indicate that assessee was under any obligation to incur an extent of AMP expense for building the brand of Whirlpool USA, Revenue could not explain why there should be a presumption that as a result of the TLA, there must have been an understanding between assessee and its AE, that assessee will spend 'excessively' on AMP in order to promote the 'Whirlpool' brand in India; ▪ Existence of Int. transaction will have to be established de

Case Name	Summary of Decision
Thomas Cook (India) Limited [TS-307-ITAT-2016(Mum)-TP]	▪ Deletes TP-adjustment on AMP expenses incurred by assessee (tour operator/travel agent/foreign exchange dealer) ▪ Legal position now crystal clear, considering Delhi HC's conclusion that AMP expenditure cannot be IT based on probable incidental benefit to AE and absent agreement for sharing AMP expenses; ▪ Factors like payment under AMP head to independent third parties and promotion of own business interest, "take away the alleged ‘internationality’ of the transaction"; ▪ Further, refuses to remit issue to the file of AO / TPO as no reasonable cause shown to justify the same, expresses that litigation must be put to an end at some stage, and the recourse of remanding matters to AO should be resorted to rarely and selectively; ▪ Deleted TP adjustment on travel related segment, holding that TPO had wrongly rejected 3 out of 4 comparables selected by assessee, stresses on 'functional comparability' over 'product comparability' under TNMM; ▪ Principles of res-judicata inapplicable to IT proceedings, however, rule of consistency applicable, chides TPO/ DRP for rejecting comparables which were found valid in previous years and holds, “the stand taken in the earlier years should not be disturbed in the subsequent years

Marketing Intangibles in Indian Judiciary
Judiciary: The assessee's "white knight"?

- For **normal distributors as well as licensed manufacturers**, Bright-Line Test (BLT) seems to have been discredited and hence the entire TPO exercise of arriving at "excess" AMP has been discarded
- For **licensed manufacturers**, the Courts seem to have gone one step further and held that *prima facie* there is no international transaction and BLT cannot be used to justify that there is one, so the TP machinery itself fails given no international transaction!
- If TNMM is used, separate benchmarking of AMP is now frowned upon
- So, has BLT been buried for good? Have "excess" AMP assessments by Revenue authorities on international brands in India run their course? Have the landmark *Maruti Suzuki* and *Sony Ericsson* judgments restored normalcy to the "brand" related high-pitched tax assessments?
  - Revenue will appeal these High Court judgments…wait and watch!

Current Controversies in Indian TP

Marketing Intangibles - Points to ponder....

- Isn’t there a difference between brand exploitation to establish in the local market and brand building for the foreign AE? (**Product promotion vs. Brand Promotion**!)
- How can the valuation of accretion of brand of foreign AE (ie the “marketing intangible” created) be tied directly and exclusively only to excess of AMP spend?
  - Methods **for valuation of intangibles** such as *Income-Based methods, Super-profit, Replacement-cost, Binomial/non-traditional methods* not being used at all.
- Exception also needs to be given for initial years extraordinary advertising and marketing (“startup effect”)

Part IV.2

ROYALTY PAYMENTS TO AE – TREATMENT UNDER INDIAN TP

Royalty Payments to AE

- **Typical scenario**: Indian Co pays Foreign Co “royalties” for technical knowhow, trademark usage etc based on agreements
  - Usually, say, a % (maybe 3-5%) of export sales in the year
- Tax authorities have in recent years initiated numerous demands:
  - Asked taxpayer to demonstrate the benefit that accrues due to these payments (“benefit test”)
  - Challenged the commercial need for such an arrangement
  - Have separated out Royalty transactions and applied CUP on it (or) in many cases set the ALP as NIL meaning no Royalty was required to be paid!
- Bottomline:
  - Taxpayers say the tax authorities (TPO) cannot look into business expediency and apply “benefit test”.
  - Tax authorities say high quantum of Royalty payments continuing over many years being used as a tool to shift money out of India

Royalty Payments to AE
CIT vs. EKL Appliances Ltd. (ITA No.1068, 1070/2011, Delhi HC)

- Landmark decision of **EKL Appliances** in the Delhi High Court after a number of decisions pro and against the taxpayer. **Facts of the case are**:
- Taxpayer in the business of manufacturing and trading of refrigerators, washing machines, compressors etc. For Financial Years (FYs) 2001-02 & 2002-03, TPO accepted all international transactions of taxpayer as at ALP but disallowed payment of royalty by the taxpayer to its AE. The CIT(A) and Tribunal both ruled in favour of taxpayer, and tax department lodged an appeal before the High Court.
- **Tax department's contention**
  - Taxpayer has been incurring huge losses year after year. Royalty payments did not enable taxpayer to achieve profits from operations
  - The continuous losses incurred by the taxpayer showed that the taxpayer did not benefit in any way from the royalty payment. **Thus payment of royalty to the AE is not justified.**
- **Taxpayer's contentions**
  - The allowance of royalty depends on the utility of the brand name and technical knowhow and does not depend on profitability of the taxpayer

Royalty Payments to AE
EKL Appliances case – High Court observations

- The Delhi High Court held that:
  - Assessee need NOT show that legitimate expenditure incurred by him was also out of necessity
  - Not necessary to show that the expenditure incurred in course of business actually resulted in profit or income in same/subsequent yrs
  - Tax Department cannot “dictate” the taxpayer whether or not to incur expenditure
  - Relied on the OECD Guidelines to the effect that the tax administrations should not disregard and restructure transactions 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.

Part IV.3

CORPORATE GUARANTEE TRANSACTIONS IN INDIAN TP

CORPORATE GUARANTEE
Bharti Airtel Ltd. vs ACIT (43 taxmann.com 150 ITAT Delhi)

- **Facts:** The taxpayer issued a corporate guarantee to a bank on behalf of its AE, for which it did not incur any costs.
- In its TP study, taxpayer determined 0.65% p.a. to be an arm's length commission for issuing the guarantee, which the TPO rejected and instead determined the arm's length commission to be 4.68% p.a.. which was upheld by the Dispute Resolution Panel (DRP) on which taxpayer appealed to the Tribunal
- This issue had been litigated for and against the taxpayers in various judicial forums. The Indian Govt. keeping in mind favourable decisions introduced a ***retrospective amendment*** in 2012 augmenting decision of S.92B ie "international transaction"
- **After considering the retrospective amendment**, the Tribunal in this landmark decision of *Bharti Airtel* held corporate guarantee transaction was not an international transaction under Sec.92B and hence no TP adjustment possible on the

CORPORATE GUARANTEE
Bharti Airtel Ltd. case – Section 92B

92B. *(1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, 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,*** *and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.*

CORPORATE GUARANTEE
Bharti Airtel Ltd. case – Explanation to Section 92B

Explanation.—For the removal of doubts, it is hereby clarified that—

(i) the expression "international transaction" shall include—

(a) the purchase, sale, transfer, lease or use of tangible property including building, transportation vehicle, machinery, equipment, tools, plant, furniture, commodity or any other article, product or thing;

(b) the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership or the provision of use of rights regarding land use, copyrights, patents, trademarks, licences, franchises, customer list, marketing channel, brand, commercial secret, know-how, industrial property right, exterior design or practical and new design or any other business or commercial rights of similar nature;

(c) ***capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;***

(d) provision of services, including provision of market research, market development, marketing management, administration, technical service, repairs, design, consultation, agency, scientific research, legal or accounting service;

(e) a transaction of business restructuring or reorga-nisation, entered into by an enterprise with an associated enterprise, irrespective of the fact that it has

CORPORATE GUARANTEE
Bharti Airtel case verdict

- In order to attract TP adjustment, a transaction had to be an ‘international transaction’ under Sec.92B of the Income-tax Act
- Explanation to section 92B, inserted with retrospective effect from April 1, 2002, was clarificatory in nature and hence did not alter the basic character of ‘international transaction’ under S.92B.
- The international transactions in clauses (a), (b) and (d) of the Explanation were already explicitly covered in section 92B(1). It was only the clauses (c) and (e) of the Explanation that were not explicitly covered, and thus fell under the residuary clause that covered “any other transaction having a bearing on profits, incomes, losses, or assets of such enterprises”.
  - Therefore, if a transaction had to be covered by clauses (c) and (e), the transactions had to be such as to have a bearing on profits, incomes, losses or assets of such enterprise.

CORPORATE GUARANTEE
Bharti Airtel case verdict

- When Indian taxpayer extends assistance to AE, which did not cost it anything, and for which the taxpayer could not have realised money by giving it to someone else, such an assistance did NOT have any bearing on its profits, income, losses or assets, and, therefore, was outside the ambit of 'international transaction'
- Onus on Revenue authorities to demonstrate that the transaction had a ***"bearing on profits, income, losses or assets"***
- The impact on profits, incomes, losses or assets **cannot be on contingent or hypothetical basis but on a real one**. In the context of guarantee, a liability could arise for the guarantor if a default took place – however, this was a hypothetical situation and, based on this hypothesis, the guarantee could not be said to be an international transaction.

Part IV.4

INTEREST-FREE LOANS IN INDIAN TP

Interest free loan from non-resident co to Indian subsidiary

Instrumentarium Corporation Limited [TS-467-ITAT-2016(Kol)-TP]

ITAT: SB explains base erosion - transfer pricing relationship; Adjustment mandatory for inbound interest-free loan

- Revenue is entitled to make TP adjustment in respect of interest-free loan advanced by an assessee (a non-resident) to its Indian subsidiary;
- Rejects stand that case is covered by exclusion u/s 92(3) (TP-adjustment shall not apply if income reduced or loss increased)
- As per Sec 92(3) income to be computed based on entries in books and "there is thus no scope at all for taking into account the impact on taxes for the subsequent year";
- Rejects argument that "if an altogether new income is brought to tax in the hands of the assessee, as a result of

Interest free loan from non-resident co to Indian subsidiary

Instrumentarium Corporation Limited [TS-467-ITAT-2016(Kol)-TP]

- Nothing in the Act to allow Indian co to re-compute income and claim the loss on account of higher interest expense or set off against the profits of the future year
- “Tax administration cannot be expected to have clairvoyance of whether or not Indian AE will actually make sufficient profits in the next eight assessment years which will subsume the losses incurred by the assessee by the AE";
- Rejects assessee’s reliance on Australian law to support base erosion argument
- Rejects reliance on SC's Morgan Stanley ruling to buttress claim that adequate profits taxed in India
- Further rejects 'business expediency' and 'shareholder service' argument of assessee, concludes that "commercial

Part IV.5

ISSUE OF SHARES AND TP

Issues of Shares and TP
Vodafone India Services vs. UOI (WP 871 of 2014, Mumbai HC)

- **Facts:** The issue before the HC was **whether the Indian transfer pricing (TP) provisions are applicable to the Taxpayer's issue of shares to its associated enterprise (AE)** and **whether the Indian Tax Authorities have jurisdiction under the Indian Tax Laws (ITL) to tax a short-fall between the alleged fair market value (FMV) of the shares and the issue price of the equity shares.**
- In this case, during financial year (FY) 2008-09 the Taxpayer issued 289,224 equity shares of face value of INR 10 each at a premium of INR 8,519 (approx. US$ 142) per share to its AE in accordance with methodology prescribed for capital issues by Indian Govt. under exchange control regulations.
- However, during course of audit, the Tax Authorities proceeded to compute the arm's length price (ALP) of the equity shares and enhanced the value of each share to INR 53,775 (approx. US$ 896).
- The Tax Authorities treated the difference in the value of shares as income of the Taxpayer and also, made a "secondary adjustment" by treating the short receipt of consideration for issue of shares as a deemed loan by the Taxpayer to its AE and charged a notional interest on the same. Accordingly, a TP adjustment of INR 13.97 billion (approx. US$ 232.88 million) was determined.

Issues of Shares and TP
Vodafone India Services case

- The HC in this case, examined nature of share issue transactions holding that ”income” arising from an international transaction is a condition precedent for applying TP provisions.
- The transaction on capital account or on account of restructuring would become taxable to the extent it impacts income i.e., under reporting of interest received or over reporting of interest paid or claiming of depreciation.
- **The HC found substance in the Taxpayer’s case that neither its capital receipts on issue of equity shares to its AE nor the alleged short-fall between the FMV of its equity shares and the issue price of the equity shares can be considered as ‘income**’ within meaning of the expression as defined in the Act and hence not subject to TP provisions in India.
- Further, the Court held that the entire exercise of taxing the short receipt of consideration for issue of shares fails as the consideration for issue of shares itself is not taxable
- **Ruling in favor of the Taxpayer**, the HC concluded that in the present facts, issue of shares at a premium by the Taxpayer to its nonresident AE does not give rise to any income from the reported international transaction and thus, Indian TP provisions are not applicable in such a case

Issues of Shares and TP

Shell India Markets vs ACIT (51 taxmann.com 519 Mumbai HC)

- **Facts:** Shell India Markets Private Limited (the taxpayer) had issued equity shares to its non-resident associated enterprises (AEs) at face value.
- The Transfer Pricing Officer (TPO) alleged short receipt of consideration for issue of shares and made an adjustment for the difference between the arm's length price (ALP) consideration (as computed by the TPO) and the consideration based on face value (as had been received by the taxpayer).
- The TPO also added an interest amount on the short receipt.
- Aggrieved, the taxpayer filed a writ petition before the High Court of Bombay (HC) on the issue of jurisdiction, i.e., the jurisdiction of Revenue to bring to tax amount received on capital account, viz., issue of equity shares to its AEs under Chapter X of the Indian Income-tax Act, 1961 (the Act).

Issues of Shares and TP *Shell India Markets* case

- **The HC held in favour of the taxpayer and observed that the jurisdiction to apply Chapter X (TP provisions) of the Act would occasion only when income arises out of an international transaction and such income is chargeable to tax under the Act.**
- Further, the HC held that the fact that the taxpayer chose not to declare issue of shares to its AEs in Form 3CEB as in its understanding it fell outside the scope of Chapter X of the Act, now stands vindicated by the decision of the HC in the case of Vodafone India Services Private Limited.
- Moreover, the HC clarified that mere non filing of Form 3CEB on the part of the taxpayer would not give jurisdiction to the Revenue to tax an amount which it does not have jurisdiction to tax.
- In this decision the High Court followed the coordinate Bench judgment of the Mumbai HC in the ***Vodafone India Services*** case

Part IV.5

COMPARABILITY ANALYSIS

Issue #1
Comparables: *Whither art thou?*

- There is a lack of comparables in many segments
  - Problem especially acute in developing countries where there are a number of ‘sunrise’ or emerging industries
- Result of this data paucity is not merely a lack of comparables but the **serious consequence of using incorrect comparables** in the TP assessment
  - International comparables data is nearly impossible to gather and many times are rejected by Revenue or by Courts
  - It often becomes a case of non-technical people trying to do technical work *(classic example - choosing KPO software companies for comparison with BPO assessee, choosing comparables across different software verticals etc.)*

Bottomline: The whole comparability analysis exercise may at times become unsound and indefensible

Issue #2
Adjustments to comparables

- **TP provisions are vague!**

"(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is ***adjusted to take into account the differences****, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions,* ***which could materially affect the amount of net profit margin*** *in the open market"* **Rule 10B(e)(iii) on TNMM**

Issue #2
Adjustments to comparables

- TP adjustments in practice is not the same as theory. **In India following are observed:**
  - Foreign AE's are typically not accepted as tested party
  - Foreign comparables are almost always not accepted due to data paucity on adjustments
- What are the adjustments which will be accepted?
  - No specific guidance or certainty on this
  - From practice, adjustments typically disputed by Revenue are: *Idle capacity, depreciation, risk, differences in accounting policy etc..*
- How to quantify any of these TP adjustments?
  - Quantification of adjustments are usually ad-hoc or supported using suitably tweaked formulae.
  - Department and taxpayer spar regularly on this issue in Courts

Bottomline: Fundamental lack of clarity & guidance with respect to Transfer Pricing Adjustments

Issue #2
Adjustments to comparables (contd.)

- Comparables are rejected using “filters” . Some popular filters used are:
    - Employee cost filter (> 25% employee cost over sales)
    - Different year ending filter
    - Diminishing revenue filter
    - Related party filter
    - On-site revenue filter
    - Turnover filters
    - Super-profit (& loss-making) filters
    - Functional difference filters
- **These filters are neither prescribed in any provision or Rule nor is guidance provided for them.** Rather a number of landmark judicial decisions have helped shape comparability analysis!

Functional Comparability under TNMM
Rampgreen Solutions Private Limited vs CIT (ITA 102/2015)

- **Facts:** Taxpayer is a call-center (low-end BPO) providing offshore call support center for foreign AE.
- Indian tech companies classified as IT and ITeS. IT is for software development companies, ITeS is technology enabled services and support companies. Taxpayer falls in the latter.
- Taxpayer chose other ITeS companies performing similar low-end (BPO) services for its TP study; TPO disagreed and expanded the search to include other ITeS companies performing high-end (knowledge processing) services, such as medical transcription
- Assessee aggrieved approached Tribunal who held in favour of Revenue and so assessee went before High Court.
- Hundreds of cases in comparability analysis of ITeS are pending on similar issue before Courts
  - Functional comparability under TNMM is one of the most pressing practical problems with TP implementation

Functional Comparability under TNMM ***Rampgreen Solutions* case** verdict

- The Delhi High Court, overruling the observations of the *Maersk Special Bench case*, in its landmark judgment held that entities performing voice call center services (BPO) and KPO services may be employing different IT systems, services, functions, quality of manpower and undertaking different risks. Thus, **comparing high-end KPO service providers with low end BPO centers would be unreliable and possibly flawed**
- Tribunal view that there can be no sub-classification of services falling under ITeS is difficult to be accepted and is contrary to the fundamental rationale of ALP
- Functional comparability is the key criteria for the selection of comparable companies
  - Broad functionality test is inappropriate as not being in accordance with transfer pricing principles.
  - Functionally dissimilar companies cannot be considered as comparable taking recourse to TNMM, which is less sensitive to functional differences

Comparability Analysis under TNMM Applicability of Turnover filter – ***Agnity India*** case

- **Can high turnover companies be considered as comparables? What is the turnover criteria for rejection of a comparable?** This problem has hounded the taxpayer and Department for the past few years
  - Tribunals and Courts have issued differing judgments on "turnover" criteria for selecting comparables
- Three possible outcomes have emerged from the mists of confusion!
  - Turnover filter not to be applied (*Capgemini India Private Limited vs. ACIT [TS-45-ITAT-2013(Mum)-TP)]*)
  - Turnover filter fixed in the range of 1-200 crore to be applied (*ACI Worldwide Solutions [TS-494-ITAT-2015(Bang)-TP]*)
  - Turnover filter of 10x taxpayers upper limit and 1/10th lower limit (*ACIT vs. Mcafee Software India P Ltd. ITA (TP) No 1388/Bang/2011*)
- Landmark judgment in Delhi HC in the case of ***CIT vs. Agnity India Technologies (ITA 1204/2011)*** held that software "giants" such as Infosys should be excluded on basis of turnover and brand/IP

Comparability Analysis under TNMM Rejection of Super-profit companies – ***ChrysCapital*** case

- **Can comparable companies earning super-profits be rejected outright as comparables?** The taxpayers say yes, Department says no!
  - One of the vexing practical problems in Indian TP today
- Various Tribunals have held differing views over the years. Recent landmark judgment in the Delhi High Court in ***ChrysCapital Investment Advisors (India) P Ltd vs DCIT (ITA 417 of 2014)*** held that if any entity has high profits/losses , it does not ipso facto lead to its exclusion. A more detailed FAR analysis should be carried out to determine the comparability.
- The Court said the OECD Guidelines in this regard was not binding on Indian tax authorities

Comparability Analysis under TNMM Applicability of Related Party Transactions (RPT) filter

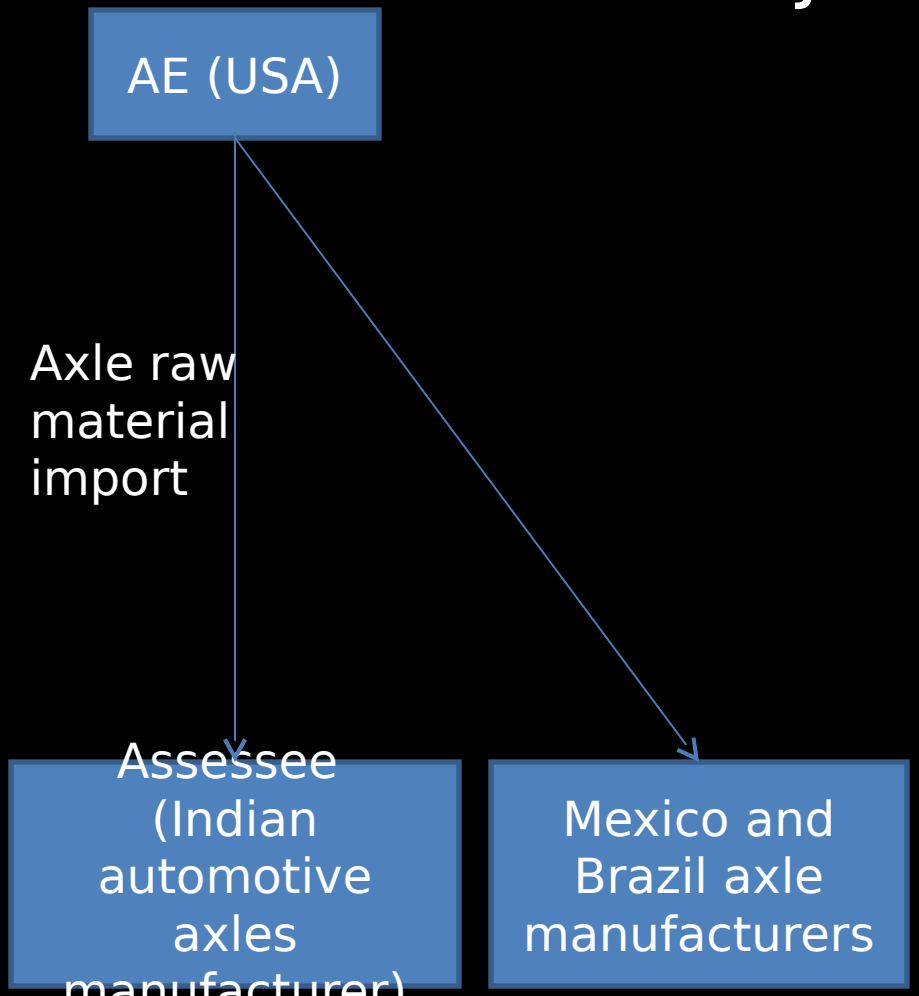
- Department and assessee's have applied filter where comparables with related party transactions beyond a certain threshold % were rejected
- Initially this threshold % was 25% based on a number of Tribunal judgments
- Subsequently, couple of decisions of the Tribunal in ***Sony India P. Ltd. (2009-TII-09-ITAT-DEL-TP) and Philips Software Services Ltd. (2008-TII-09-ITAT-BANG-TP)*** held that even 1 Rupee of related party transaction (ie RPT 0%) would render the comparable unfit!
- Thankfully, the impractical nature of such a decision was recognized by Tribunals in subsequent decisions and the **current jurisprudence is threshold of 15% of RPT is allowable for a comparable** ((*ACIT vs. Mcafee Software India P Ltd. ITA (TP) No 1388/Bang/2011*))

Bottomline: No clarity as per TP provisions!

Comparability Analysis under TNMM Use of different year-ending comparables

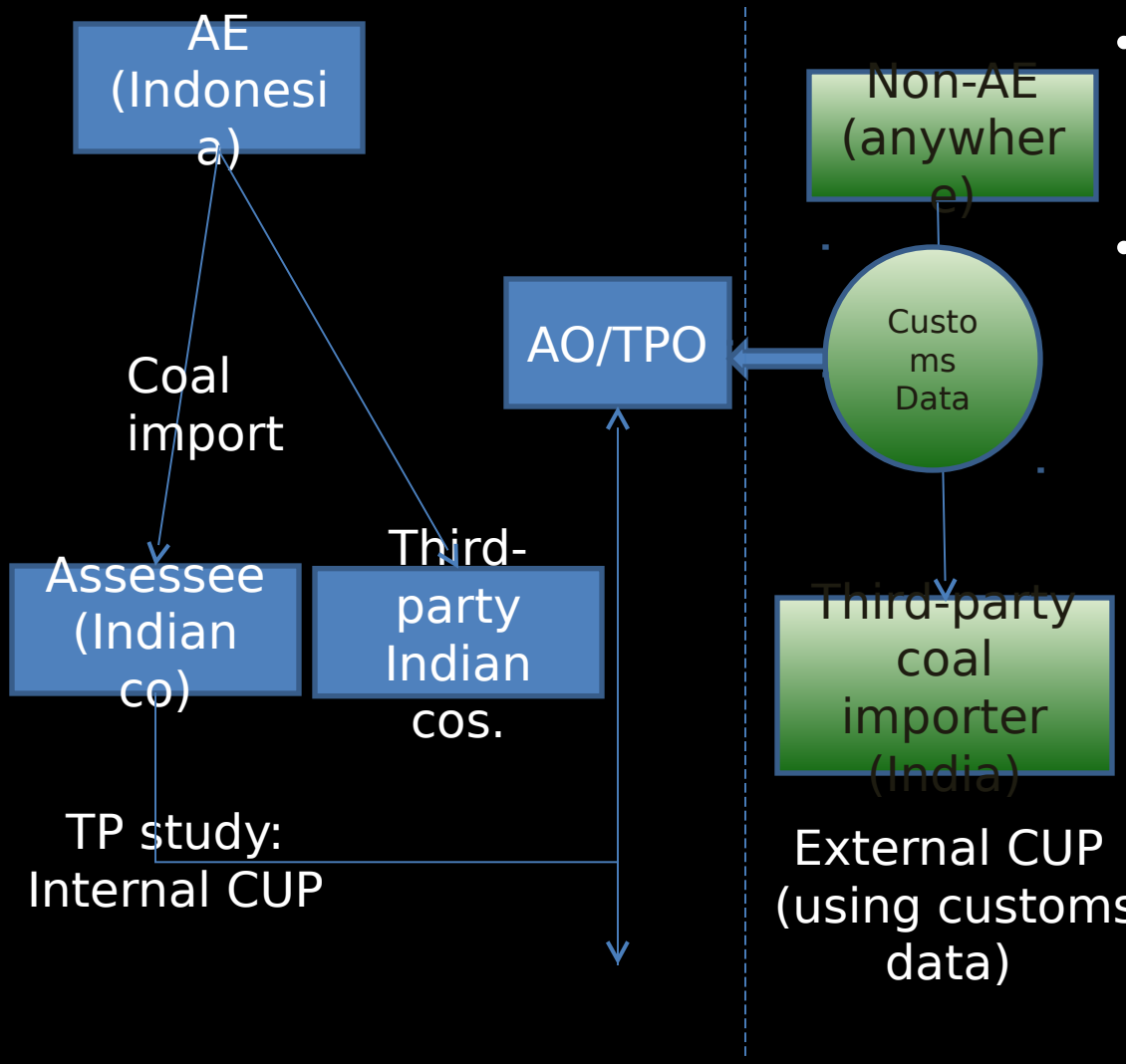
- Over the years, the Department has rejected comparables which have a different financial year (say, following calendar year) instead of April 1-March 31st Indian fiscal year
- However, recent judgments of the Tribunals such as ***TechBooks International Pvt. Ltd. Vs. DCIT (ITA No 240/Del/2015)*** have allowed the use of such comparables holding that as long as *"relevant data for the concerned financial year can be deduced from the information available from their annual reports, then, there can be no objection to the inclusion of these companies in the list of comparables with the adjusted data for the relevant financial year itself."*

Adjustments to comparables Foreign tested party, Geographical adjustments



- Internal CUP with company AE as tested party rejected by TPO
  - Typically foreign companies are not allowed as tested parties.
  - No good answers for India vs. Brazil, India vs. Mexico geographical market adjustments
- TNMM chosen with “Auto ancillaries”
  - Only one proper comparable but no segmental data available
  - Other comparables are in “shock-absorbers”, “battery companies”
- Moving from one incomplete puzzle (CUP) to an incorrect result (TNMM) is better?

Data sources – Using *customs* data
Coastal Energy P Ltd. Vs. ACIT (TS-356-ITAT-2011-CHNY)



- **Taxpayer:** Internal CUP with Indonesian AE as the tested party was submitted
- **TPO:**
  - **Rejects Internal CUP** and uses External CUP
  - Uses ***customs data*** of third-party transactions not in public domain
  - **Cherry-picks** data and chooses transactions without reference to gross-calorific value (quality) of coal, quantity etc.
  - Assessee requests competitors and obtains few invoices used by TPO which show **even CIF vs. FOB difference**

Part IV.6

LOCATION SAVING IN INDIAN TP

Location Savings in Indian TP
Watson Pharma Pvt. Ltd. Case (ITA 1423/Mum/2014, Mumbai ITAT)

- **Facts:** The taxpayer is a wholly owned subsidiary of Watson Labs, USA having facility for research and development in India and also manufactures raw materials & API. (**Contract Manufacturing & Contract R&D by Indian taxpayer to foreign AE**)
- **TPO made an adjustment on account of location savings:**
  - Location saving (LS) arises as manufacturing activity transferred from US/Europe (high cost) to India (low cost jurisdiction)
  - Watson India ought to receive extra compensation on account of LS over and above the margins earned by the comparables
  - LS - computed based on articles appearing in journal and websites – Ad-hoc allocation of LS equally between both the entities
- **Taxpayer contended that:**
  - Watson India and Watson US - Do not operate in a monopoly market - Any LS that arise would be passed on to the ultimate customers
  - LS (if any) is factored in the profit margin of local market comparables. Thus, specific adjustment for location savings is not required.
  - Watson US has bargaining power because of alternatives to procure products, thus LS should not be allocated to Watson India

Location Savings in Indian TP
Watson Pharma Pvt. Ltd. case verdict

ITAT concluded in favour of taxpayer that:

- Since the taxpayer operated in perfectly **competitive market** and did not have exclusive access to the factors that may result in specific location advantages , there was no super profit arising in the entire supply chain and there was no unique advantage over competitors
- India being a part of G20 countries, ITAT held that all G20 countries have concurred to the position *"where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required"*
- **Reliance on UN TP Manual was held to be incorrect since it was the view of the Indian tax authorities and was not binding on the appellate authorities**
- **"No adjustment on account of Location Savings is required when arm's length price is determined on the basis of appropriate comparables"**

Part IV.7

INDIAN JUDICIARY'S ROLE IN SHAPING INDIAN TP

Indian Judiciary – Active role

- Indian judiciary has played a very active role in interpreting Indian TP provisions
- Thousands of transfer pricing cases pending at various levels of quasi-judicial and judicial forums
- Number of disputes have more than doubled since last year
- Transfer pricing adjustments in excess of Rs.45,000 crores (US$7.5 billion) in disputes
- Daily new judgments are being passed which mould the Indian TP provisions

Assessee / Taxpayer	Judicial forum	Short point of ruling
DIT vs. Morgan Stanley	Supreme Court	Once TP analysis is undertaken, no further need to attribute profits to a PE
E-Gain Commn. P. Ltd	ITAT Pune	TNMM may afford a practical solution to otherwise insoluble transfer pricing problems if used sensibly and with appropriate adjustments
TNT India	ITAT Bangalore	For arriving at the net margin of operating income, only op. income & expenses for relevant business activity of assessee to be taken into consideration
Aztec Software & Technology	Bangalore ITAT SB	All characteristics of controlled transaction which are likely to affects its open market value must be taken into account
Mentor Graphics Ltd.	ITAT Delhi	If one point in arm's length range is satisfied, onus shifted to Dept. ALP not mean max. price or profit in range
UCB India (P) Ltd.	ITAT Pune	Method adopted by assessee is rejected, Revenue duty bound to compute ALP and substantiate and justify use of its method

Assessee / Taxpayer	Judicial forum	Short point of ruling
Schefenacker Motherson Ltd.	ITAT Delhi	Depreciation cost may be adjusted to eliminate material differences in 'asset' profile
ACIT vs. Wockhardt Ltd.	ITAT Mumbai	TNMM refers only to net margin realized by enterprise from international transactions but not operational margins of enterprise as a whole
Il Jin Electronics (India) Pvt. Ltd.	ITAT Delhi	Proportionate adjustment under TNMM on the ratio of international transactions with AEs to transactions with non-AEs
ACIT vs. Frost & Sullivan Pvt. Ltd.	ITAT Mumbai	No basis for excluding only loss making comparables and not excluding high profit marging comparables or companies which are not at all comparable based on size, turnover and other factors
Global Vantedge Pvt. Ltd.	ITAT Delhi	Total amount of adjustment made, along with ALP already reported, cannot exceed total revenues earned by the taxpayer and its AE from dealing with third party clients
Genisys Integrating Systems	ITAT Bangalore	TP adjustment restricted to AE segment, exclusion of super-profit making companies, application of upper turnover

Assessee / Taxpayer	Judicial forum	Short point of ruling
Philips Software vs. ACIT	ITAT Bangalore	Rule 10A(a) means co. having even single rupee of related party txn. not comparable
Sony India	ITAT Delhi	Contractual terms agreement to be looked into, consider cos. with less related party txns & losses too
Demag Cranes & Components	ITAT Pune	Duty of AO/TPO/DRP to minimize/eliminate difference which is likely to materially affect the price
Vertex Customer Services	ITAT Delhi	No penalty under S.271(1)(c) for bonafide TP adjustments
Honeywell Automation India Ltd.	ITAT Pune	Under Indian TP, consideration of subsequent year or average profits not permitted
In Re Dana Corporation	AAR	No capital gains in a business reorg. if consideration not determinate. TP law does not apply if there is no income
SSL-TTK Ltd.	ITAT Chennai	Penalty under 271G not to be levied for benign reasons in nature of procedural issues
Delphi TVS	ITAT Chennai	Re-visit by TPO for correctly assessing the prices under CUP for comparison after adj.
Ranbaxy Labs & Devel. Consultants	ITAT Delhi	Selection of overseas comparable maybe allowed provided such data is available in

Assessee / Taxpayer	Judicial forum	Short point of ruling
EKL Appliances (345 ITR 241)	Delhi HC	TPO cannot sit on judgment of business & commercial expediency of assessee's Royalty payments
Sony India	ITAT Delhi	Contractual terms agreement to be looked into, consider cos. with less related party txns & losses too
Lumax Industries	ITAT Delhi	TNMM approved as correct method for evaluating Royalty payment
Cadbury India	ITAT Mumbai	ALP of royalty for trademark usage can be determined as per TNMM. Approval of RBI means payment is at ALP
Sona Okagawa Precision Forging Ltd.	ITAT Delhi	Under Indian TP, consideration of subsequent year or average profits not permitted though OECD prescribes the same
Air Liquide Engineering	ITAT Hyderabad	TPO cannot sit on judgment about commercial expediency. RBI approval means it is at ALP
Panasonic AVC Networks India Co. Ltd.	ITAT Delhi	Adjustment for "capacity underutilization" can be made. Cherry-picking of comparables to be avoided
Tilda Riceland Pvt. Ltd.	ITAT Delhi	No bar on reliance on private database

Assessee / Taxpayer	Judicial forum	Short point of ruling
Glenmark Laboratories (following *Everest Kanto, Asian Paints*)	ITAT Mumbai	Guarantees are international transactions; distinguished bank & corporate guarantees; held that assessee rates (0.47-0.53%) were valid
Bharti Airtel Ltd.	ITAT Delhi	Corporate guarantee not an international transaction
L.G. Electronics Pvt. Ltd.	ITAT Delhi (Special Bench)	Wide-ranging discussion on marketing intangibles – held AMP expenditure reimbursable to Indian subsidiary
Glaxo Smithkline Consumer Healthcare	ITAT Chandigarh	Followed LG Special Bench and sent back matter to the TPO
Canon India Pvt. Ltd.	ITAT Delhi	Followed LG Special Bench while holding expenses on Commission, Cash Discount, Volume Rebate, Trade Discount etc. should be excluded
Ray Ban Optics India, Sony India Pvt. Ltd., Reebok Co., BMW India	ITAT Delhi	Followed LG Special Bench - upheld use of *Bright-Line-Test*

Part V

EVOLUTION OF INDIAN TP

Evolution of Indian TP

- **INITIAL YEARS (2001-2005)**
  - First TP assessments made –lot of ambiguity as it was a new area
  - ALP concept was being understood and put to practice
- **DISPUTE RESOLUTION PANEL (DRP)** initiated to handle TP cases
  - TP fundamentals tested and explained by many judgments by DRP and various Tribunals.
  - Controversies on fundamental issues relating to Arm's-length range, international transactions etc.
  - Comparability analysis (FAR) was deep-dived into
- **CATCHING UP WITH THE WORLD…..**
  - GAAR provisions, APA , Safe Harbour Rules ….
- **DOMESTIC TRANSFER PRICING INTRODUCED**

Evolution of Indian TP

- **“ERA OF INTANGIBLES”: CURRENT PHASE OF EVOLUTION VIA COURTS AND LEGISLATION**
  - **Financial txns:** Corporate Guarantee / Interest-free loans to foreign AE
  - **BRAND ACCRETION (Marketing Intangibles)**: reimbursement with markup from AE
  - **Royalty:** Payments made by Indian companies as royalty to foreign AE’s being questioned
- **Worrying storm clouds in Indian TP!**
  - **Equalization Levy :** A new path to tax outside clutch of treaties and existing provisions. Is this *modus operandi* moving forward?
  - **Indian GAAR** implementation from 2017 - **Damocles Sword** hanging over the taxpayers
  - **OECD BEPS Action Plan impacts** will surely be felt especially relating to Intangibles and Value Creation
    - Indian Revenue position on these issues spelled out in UN TP manual.
    - CbCR, Equalization Levy implemented. What next?

Bottomline: We are witnessing the arrival of Indian TP 2.0!

Part VI

STREAMLINING INDIAN TP

POINTS TO PONDER

Streamlining current Indian TP provisions
Points to Ponder...

- Formulary apportionment approach maybe promising in certain areas?
  - Attacks the crux of the TP problem that at end of the day it is a *tax-sharing formula* with all govts. wanting their piece of the pie
  - Correct approach of using math to solve an economics problem. Run predictive models, tweak formula, try again....
- Allow foreign comparables, allow foreign AE as tested party
- Provide clear guidance on adjustments specifically filters, risk, idle capacity, depreciation and working capital
- Prescribe clear turnover range filters for comparables
- Do not reject loss-making comparables outright
- **Allow technical expert reference for selecting functionally similar comparables**

Streamlining current TP provisions
More points to ponder...

- Ameliorate the data gathering system by the TPO and mandatorily involve the assessee at every step
- Use Advance Pricing Agreements (APAs) as much as possible
- MAP process should be pursued more and made time-bound and effective
- Clear guidance on Intangibles and their valuation methods.
  - **Need of the hour is more public discussion, analysis, feedback loop, technical reports and step-by-step evolution of Indian TP**
- TP assessments should NOT result in a pyrrhic exercise

Bottomline: Currently, TP is neither art nor science....its magic!

Thanks!

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