Current Controversial issues in Transfer Pricing
IFA AGM and Lecture Meeting

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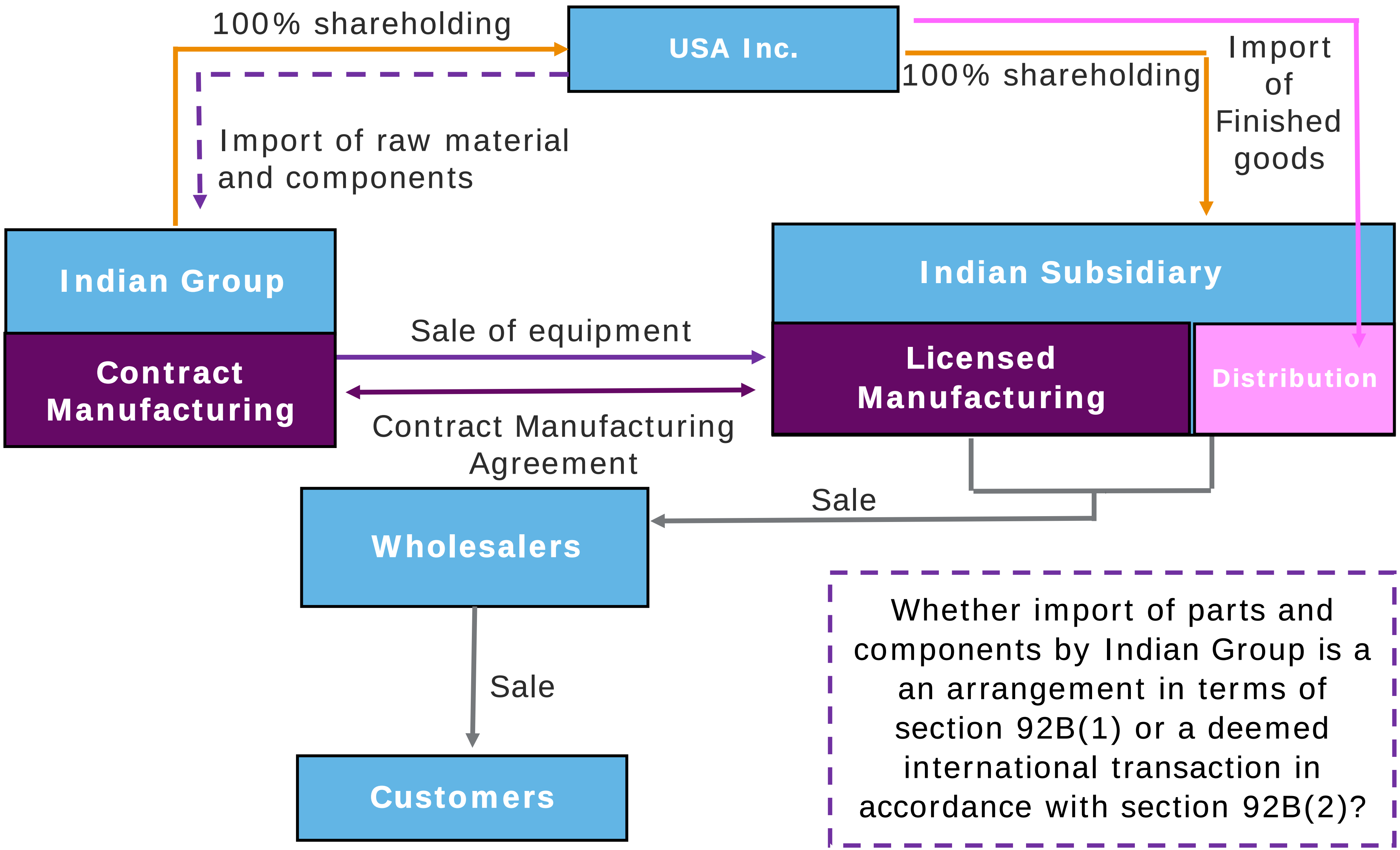
Agenda

1. Deemed International Transaction
2. Royalty
3. Segmentation
4. Intra Group Services
5. Distribution: What level of value addition tilts preference from RPM to TNMM
6. AMP Activity
7. Alternate Adjustment – Akin to protective assessment
8. Issue of shares
9. Non-binding Investment Advisory - Carried Interest
10. OECD Proposal for “Unified Approach” under Pillar One

1. Deemed International Transaction



Whether import of parts and components by Indian Group is a an arrangement in terms of section 92B(1) or a deemed international transaction in accordance with section 92B(2)?

1. Deemed International Transaction

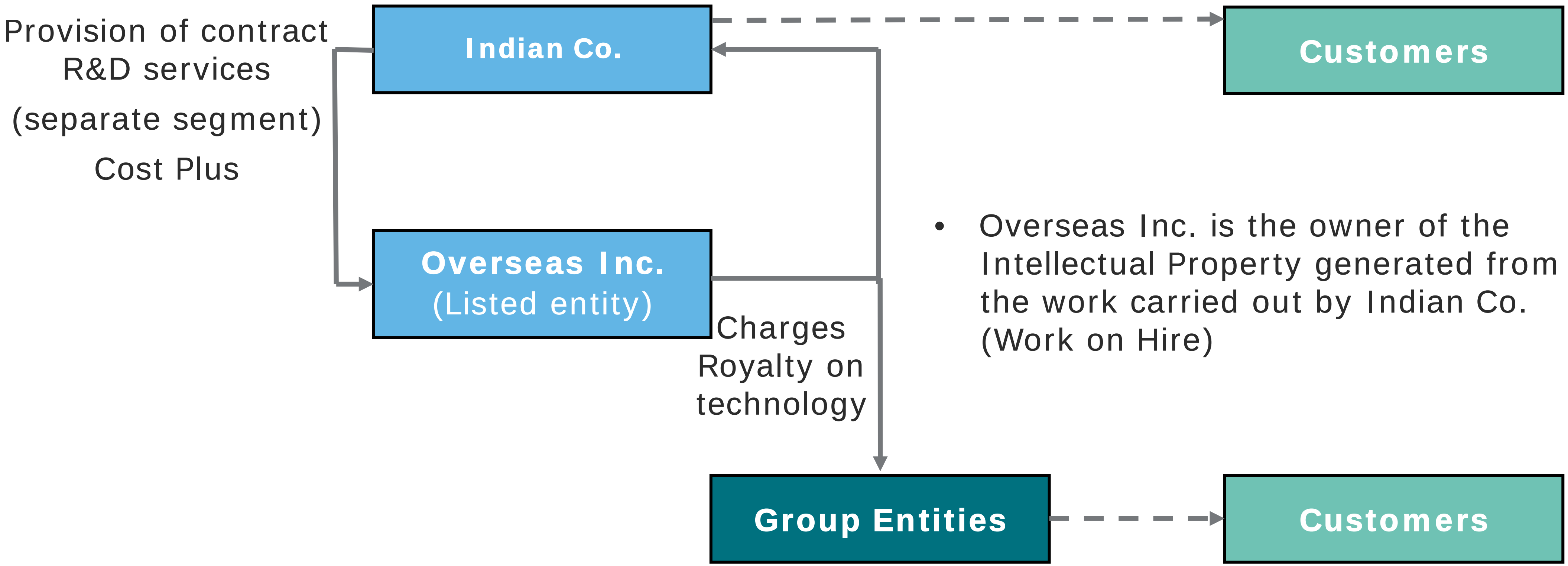
- **Section 92B(1) reads as under:**

"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**."

- **Section 92B(2) reads as under:**

"A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be an international transaction entered into between two associated enterprises, **if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents** irrespective of whether such other person is a non-resident or not."

2. Royalty



- Overseas Inc. is the owner of the Intellectual Property generated from the work carried out by Indian Co. (Work on Hire)

- The TPO is challenging mark-up on contract R&D
- The TPO, in addition, is also allocating a portion of the global royalty earned by the Overseas Inc. as income of the Indian Co. in ratio of head count

3. Segmentation

- When different activities are being carried out, TP requires, segmentation (e.g. functions)
- Such segmentation is not required to be audited
- However, has to be appropriately worked out
- Expenses. other than actuals, need to be allocated on appropriate allocation keys

Example of Allocation Keys
Revenue
Production Quantity
Gross Margin / Contribution
Head Count
Man Hours
No. of Computers
No. of Licenses

- TPOs are scrutinizing the manner in which segmentation is worked out
- Thus, changing the entire segment profitability, which vitiates the taxpayers benchmarking exercise
- For example, if Revenue is used as an allocation key – It is rejected as it does not reflect the actual utilization
- Production Quantity – It is rejected unless it is proved that all products manufactured are identical
- Head Count – It is rejected on the ground that mere head does not capture purchase price parity
- Product wise profitability being demanded (costing records)
- Notional segment created using TP Policy stated (like in cost plus cases)

4. Intra-group services

Issues

- Rendition of Services
- Need
- Benefit
- Whether shareholder services
- Documentary evidence
- Separate benchmarking
- Impact of BEPS
- Ad-hoc disallowances making it Nil

Judicial Precedence

- Tax payer needs to demonstrate a proper pricing policy which is in line with the Group TP policy
- The need to avail services/IP is a business decision
- TNMM analysis at entity level along with documentary evidence accepted in some decisions
- TPO's act of merely disallowing entire amount on ad-hoc basis not as per the rules, bad in law
- Remand in such case not appropriate (Kodak Bom HC)

APA Outcome

- No need to submit voluminous documentation
- Service Received and Benefit test can be demonstrated by site visit
- Allows overseas entity as the tested party with an overall cap
- No need to make profit – management fees allowed even if entity is making loss.
- Imposes an overall cap based on revenue (3 – 5%)

4. Intra-group services - Case study

Retainer Agreement	General Agreement	No specific agreement
Fixed Monthly payments A bouquet of services Only 2-3 services actually requested and availed	Cost plus mechanism of remuneration On-call services Onus may be cast to demonstrate request of services, as one may technically interpret 'cost' as relating to only those where actual services are availed	General intra-group services being availed No specific documentation maintained Good margins enjoyed
This is better resolved through the litigation route as favorable precedents available	**High documentation requirement – depending on availability dispute resolution route can be chosen**	**APA authorities may be able to close this despite negligible documentation. Services received and implicit benefit test can be evaluated during site visit**

5. Distribution: What level of value addition tilts preference from RPM to TNMM

- Distribution is a simple activity where goods are imported and resold without any value addition
- Under, such circumstances there is no dispute that RPM is the preferred method
- However, even distribution may entail carrying out limited functions:
  - Re-labelling
  - Re-packaging
  - Quality Checks
  - Warehousing
  - Marketing
- Further, in the normal course of distribution, these risks are borne:
  - Inventory
  - Credit
  - Government regulations etc.

- TPOs generally do not agree with adopting RPM as the most appropriate method
- This is because generally there is sufficient profitability at the gross level, but may not be at the net level
- For example, if there is a net loss, as the Indian entity is incurring huge marketing expenses, the TPO prefers TNMM
- RPM is also rejected if the Indian entity carries out activities like re-labelling, re-packaging, quality checks, warehousing etc.
- RPM is also rejected on the grounds that the Indian entity bears inventory risk, credit risk, government regulation risks etc.
- However, there are various judicial precedents available to navigate through these hurdles

5. Distribution: What level of value addition tilts preference from RPM to TNMM

- **L'Oreal India P. Ltd. [TS-376-HC-2014(BOM)-TP]**

  "The Tribunal has noted in para 19 of the order under challenge that this method is one of the standard method and the OECD (Organization of Economic Commercial Development) guidelines also state in case of distribution or marketing activities when the goods are purchased from associated entities and there are sales effected to unrelated parties without any further processing, then, this method can be adopted."

- **Luxottica India Eyewear P Ltd [TS-532-HC-2015(DEL)-TP]**

  "This Court finds that once the ITAT, on considering the relevant facts as well as the order of the TPO, had concluded that the business of the assessee was merely that of a pure trader, and there was no value addition made before re-selling the particular products (i.e. the SIM cards), its consequent finding that RPM is the Most Appropriate Method, is irreproachable."

- **Videojet Technologies (I) Pvt Limited [TS-497-ITAT-2019(Mum)-TP]**

  "a normal distributor will undertake all such functions which are related to sales of a product viz. market research, sales and marketing, warehousing, inventory control, quality control etc., and would also bear risks viz. market risk, inventory risk, credit risk etc. As a matter of fact, the TPO/DRP had not placed on record instances of any such comparable which is engaged in the business of a distributor and is not performing the aforementioned functions."

6. AMP Activity

TP Dispute

Arguments of lower tax authorities

TP adjustment

- Indian entity builds or enhances the value of the brand
- This brand promotion activity is an international transaction
- Use of Bright Line Method
- Excess AMP needs to be recovered by the Indian entity from the foreign AE along with mark-up
- Concept of economic ownership ignored

- Adjustment for recovery of excess AMP along with mark up as service income.
- Resort to AMP intensity adjustment to compare the net margin earned by taxpayer vis-à-vis comparable companies for all companies irrespective of their characterization
- Resort to profit split method in some cases

The above views are currently subjudice in the Supreme Court

6. AMP Activity

- **Important contentions to take**
  - Facts on AMP for product sale
  - AMP ratio (comparable companies to be really comparable)
  - Rationale of aggregation
  - Review distribution agreement, documents, board meeting minutes

AMP issues Pending at SC

Maruti Suzuki India Ltd.

- Manufacturing Companies
- Revenue challenged HC decision that it is not an international transaction

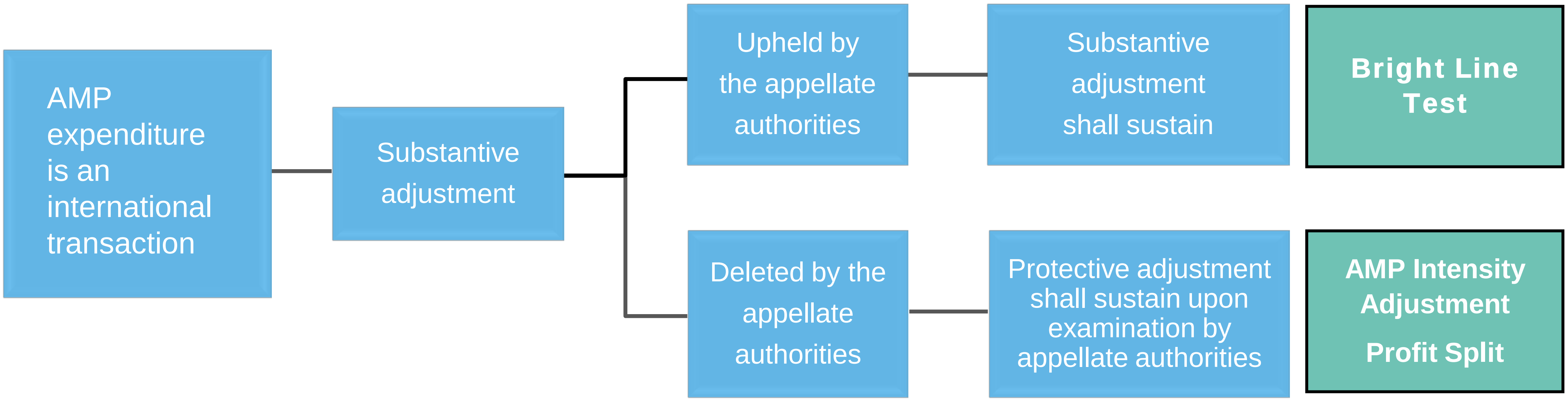
Sony Ericsson Mobile Communications India (P.) Ltd.

- Distribution Companies
- The Appellant has filed SLP against HCs decision

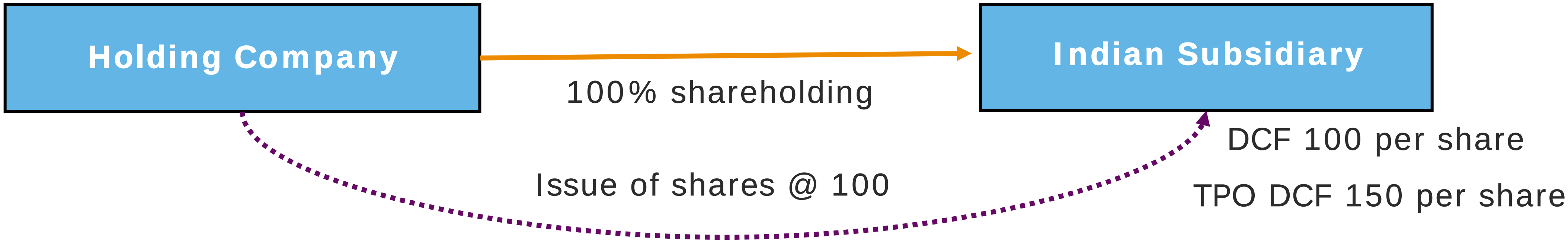
7. Alternate Adjustments (akin to protective assessments)

- **Substantive Basis:** Primary adjustment
- **Protective Basis:** Fall back adjustment, if primary adjustment is deleted by the judicial authorities

For example the Revenue is consistent in making adjustments relating to AMP expenditure, both a Substantive and Protective basis



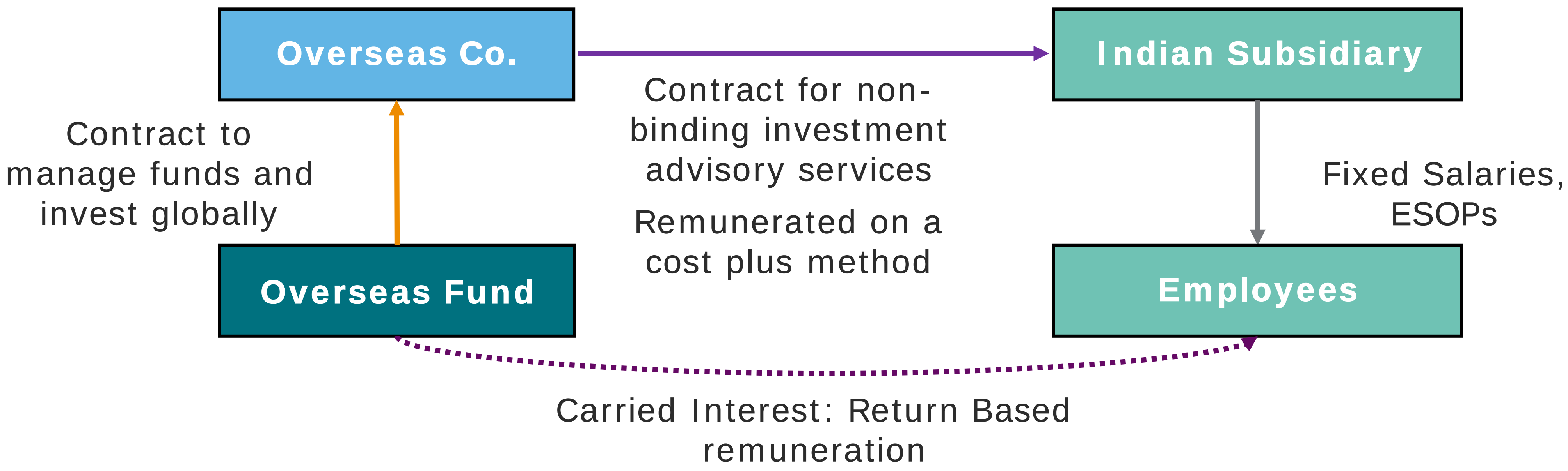
8. Issue of shares



- FEMA requires issue of shares to be at a value certified by an expert based on DCF approach
- However, in recent TP assessments it is observed that not only are the TPOs investigating the valuation approach but also suggesting additions
- TPO is requesting the AO to treat the difference of 50 as dividend distribution activity u/s 2(22)(a) and to levy dividend distribution tax u/s 115O
- Second, the Holding company's AO is directed to treat the difference of 50 as income taxable u/s 56(2)(viia)
- Separately, penalty proceedings are being initiated under section 271AA for not reporting dividend as an international transaction and also concealment under section 271(1)(c) / 270A

- Questions that beg answer:
  - Can the department resurrect a dead issue, especially when Vodafone's decision is accepted by the CBDT
  - Whether dividend is an "international transaction"
  - Whether the TPO has such wide spread powers to re-characterize transactions
  - Whether the TPO can go beyond his scope of determining ALP to recommend levy of taxes and determining chargeability of income
  - Can a Writ be considered in the High Court on this issue

9. Non-binding Investment Advisory - Carried Interest



- Department has started to apply mind to the carried interest aspect of remuneration.
- Whether the cost base of the Indian subsidiary should include only fixed salaries or also Carried Interest?
- Answer depends on the manner in remuneration models are set, the language of the contract and the basis of which such remuneration is earned by the employee
- Some questions that need to be analysed are:
  - Whether it is a case of dual employment?
  - Whether it is a case of return on the employees investment?

10. OECD Proposal for "Unified Approach" under Pillar One

New Nexus Rule to allocate more profits to market jurisdictions

Determining Non-routine return (over and above ALP)

01

Amount A

- Use a formulaic approach to allocate to market jurisdictions a share of a multinational business' non-routine return attributable to market intangibles
- Approach allows jurisdictions to maintain taxing rights over income generated through routine activities
- Determination of both routine return and non-routine return attributable to marketing would be determined by agreed formulas

Determining routine return (ALP)

02

Amount B

- Provide a fixed return for baseline marketing and distribution functions
- This return is based on the arm's length principle, but fixed amounts of return will be explored to minimize disputes

Attributing additional return (for additional functions)

03

Amount C

- Tax an additional return in accordance with existing transfer pricing rules when a market jurisdiction can successfully establish –that there are more functions than have been accounted for and included in Amount B

Question and Answer