

# Beginners Study Course On Transfer Pricing



**New Areas: Transfer of Intangibles, Cost contribution, Management services, Cost Allocation, Advance Pricing Arrangements and MAP, etc.**

**Rajesh S. Athavale**

**26 June 2013**



# Roadmap for discussion

- Transfer of Intangibles
- Management Services
- Cost Contribution
- Advance Pricing Arrangement
- Mutual Agreement Procedure

# Transfer of Intangibles

# Definition of Intangible and its Specialised Subset

## Definition:

- “Not tangible, incapable of being touched; not cognizable by the sense of touch;

impalpable”

- The Shorter Oxford English Dictionary

## Specialized subset of intangible assets:

- Intangible assets create a competitive advantage
- Intellectual property creates a proprietary advantage

## Intangibles – Economic attributes

- Non-physical in nature
- Capable of producing future economic benefits
- Legally protected (brand name, patented formulae/processes etc.) OR De Facto rights (know-how)
- Limited relationship with cost
- Routine v. Non Routine Intangibles
  - Generally, enterprises possessing non-routine intangibles are expected to earn above-average profits over a period of time

# Intangible Assets – Broader Identification

- Marketing-related intangible assets

Trademarks, trade names, brand names, logos, service marks, internet domain names, non-competition agreements

- Customer-related intangible assets

Customer lists, order or production backlogs, customer contracts, franchise agreements, distribution networks and customer relationships

- Technology-based intangible assets

Laboratory Notebooks, Technical Know-How, Licensing and royalty agreements, service or supply agreements, employment contracts, Patents

- Artistic - related intangible assets

Explanation (ii) to Section 92B

# Intangible Assets – Broader Identification

- Data Processing - related intangible assets

Computer software copyrights, Automated Databases, Integrated Circuit Masks and Masters, Computer chip Masks Masters

- Engineering – related intangible assets

Industrial Designs, Trade Secrets, Product Patents  
Blueprints, Proprietary Documentation

Creative : Trademark,  
Copyright and Computer  
Software

- Contract - related intangible assets

Favourable Supplier, Contracts, Licence Agreements,  
Franchise Agreements, Non-Compete Agreements

Innovative : Patents,  
Industrial Designs, Trade  
Secrets

- Location – related intangible assets

Leasehold interest, mineral exploitation rights, air rights

# Valuing Intangibles

## Value factors

- Strength and enforceability of legal protection
- Risk of future litigation
- Specified legal life
- Life cycle
- Expected remaining useful life
- External commercialization opportunities



## Valuing Intangibles

- Value based on highest price obtainable
- OECD TP Guidelines :
  - consider usefulness of intangible property to AE
  - consider perspective of transferor and transferee
- Examine price at which comparable independent enterprise would be willing to transfer property
- From transferor's perspective – highest price
- From transferee's perspective, whether comparable independent enterprise would be prepared to pay such a price, depending on the value and usefulness of the intangible property to the transferee in its business

# Intangible Assets – Valuation techniques

- Market based approach

Value intangible assets by reference to transactions that occurred recently in similar markets, or benchmarks of comparable assets

It can provide the best evidence of fair values because it relies on evidence from actual market transactions, but can be difficult to apply in practice with lack of relevant information

- Income based approach

Value intangible assets on the basis of the future economic benefits derived from ownership of the asset i.e. identify and quantify, in present day terms, the future earnings attributable to the asset

- Cost based approach

Value intangible assets by assessing the development or replacement cost of the asset.

## Key Focus Areas – Royalty Payouts

- Royalty-compensation for use of manufacturing / trading intangible
- Benchmarking Issues:
  - Limits set by RBI / FEMA are not CUP
  - Aggregation approach (with manufacturing / trading results)– Challenged
  - lack of availability of comparables
  - Transaction specific approach adopted by revenue
  - Examine ‘cost /benefit’ analysis
  - Recent view of revenue – Profit Split approaches

In a Loss Situation – Difficult to demonstrate the ALP of Royalty

# Benchmarking - Royalty, Technical Know-how

- Maximum incremental TP adjustments in this area
- Taxpayers asked to demonstrate
  - Description of intangibles and the benefit it accrues
  - Whether royalty is embedded in import / sales price
  - Owner of intangibles (details of foreign enterprise)
  - Challenging the commercial need for the arrangement
- Appropriate ALP for intangible property
  - TNMM may be acceptable when there are no other international transactions reflected in the P&L
  - Alternative Methodologies:
    - CUP – In the absence of local agreements, search for agreements in international databases (Lexis-Nexis, Royalty stat etc)
    - Profit Split Method
    - Alternate valuation methodologies (DCF, P/E multiple, capitalized R&D, Other Prescribed Method can be used to determine ALP)

## Key Focus Areas – Royalty Payouts

- Documentary evidence / analysis to substantiate Royalty:
  - Copies of license agreement
  - Benefits received by tax payer
  - Quantification of the benefit
  - Rights of the taxpayer to receive upgrades
  - Comparative profits before/ after Royalty
  - Rates at which the royalty is paid for use of similar intangibles by any other concern / subsidiary of the AE / Group

# Relevant rulings for Royalty

- A legally binding agreement approved by regulatory agencies, can't be rejected merely on ground of no commercial need - commercial expediency is domain of taxpayer;
- Royalty payments should be based on production and sales
- No distinction be made between the sales made to AEs and Non-AEs (where taxpayer is not a contract manufacturer and the royalty payment is recovered as part of selling price);
- Taxpayer can pay for technical services of AE in addition to royalty (with evidences that such services rendered are not the responsibility of AE)

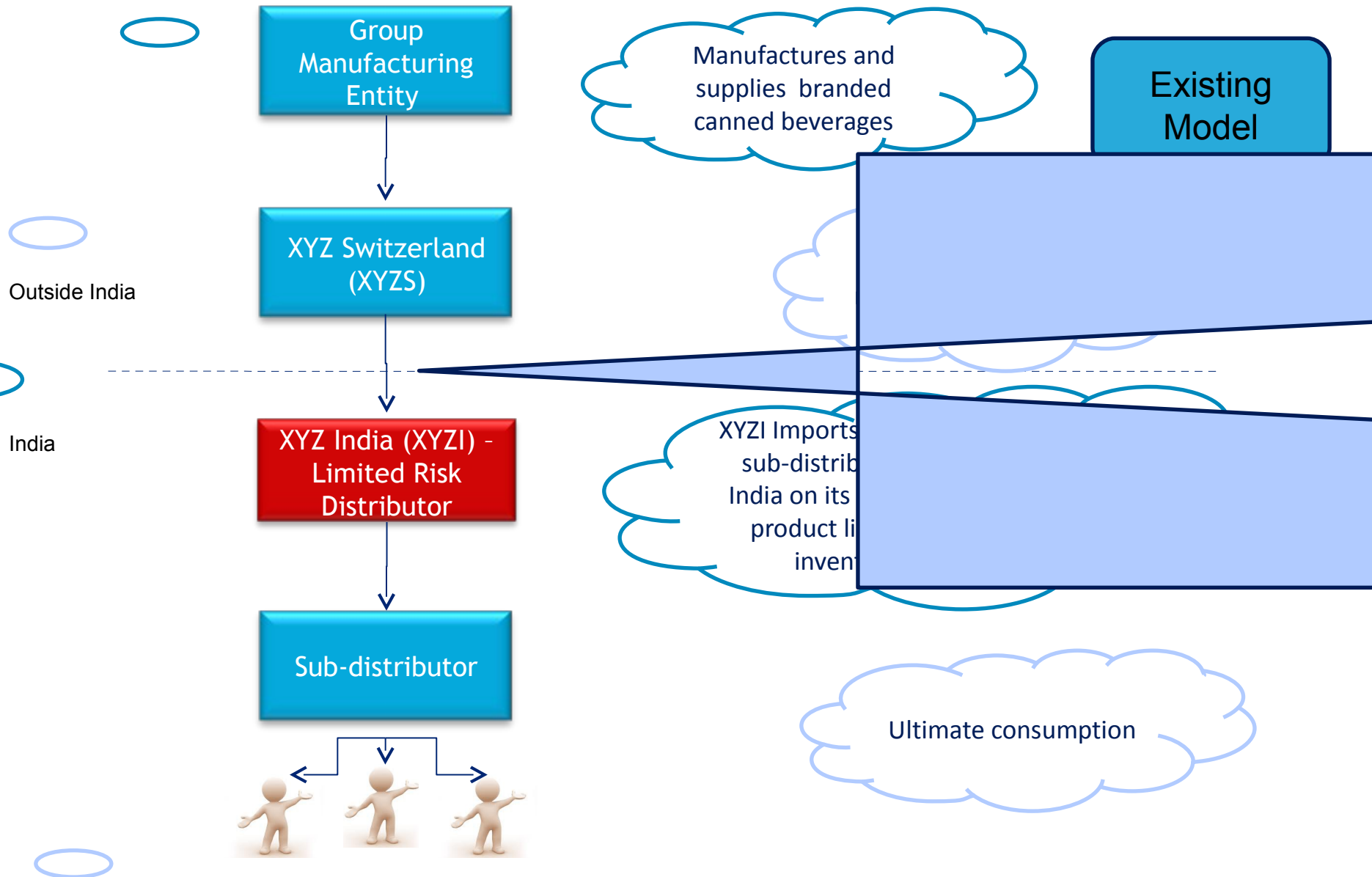
*(Abhishek Auto Industries Limited Vs DCIT, Sona Okegawa Precision Forging Ltd Vs ACIT)*

# Marketing Intangibles

- Marketing expenditure incurred by related party Distributor in India for distributing goods of a foreign trademark is questioned
  - To whom should the income attributable to the trademark be allocated?
  - “Legal owner” of the trademark (foreign supplier) or local “developer” of trademark (Indian Distributor)
  - Has the marketing expenditure enhanced economic value of the trademark in India?
- Can a distributor be regarded as the “economic owner” of the Intangible?
- Greater focus on local marketing expenses – is it more than other comparable companies?

The Indian TPO's may be indirectly raising the issue of a “payment” for selling into the vast Indian market

# Case Study – Marketing Intangible





## Case Study - FAR Analysis – Existing Model...

Sr No	Functions Performed	XYZI	AE	Explanation
1.	Market Survey and order processing	✓	-	XYZI liaises with Indian sub-distributors to anticipate demand and accordingly places orders on the AE for supply of goods
2.	Procurement and supply of beverages	-	✓	Based on the orders placed by XYZI, the Dubai AE procures goods (canned beverages) from a group manufacturing entity and supplies the same to XYZI
3.	Import of beverage into India	✓	-	XYZI arranges for import of goods in India
4.	Warehousing	✓	-	Before the goods are supplied to sub-distributors the same are warehoused in India by XYZI
5.	Distribution Co-ordination and Management	✓	-	XYZI manages and supports the distribution network in India
6.	Marketing and brand promotion in India (continuous process. Explained in detail in next slide)	✓	✓	XYZI undertakes all marketing and brand promotion activities in India. However, global brand promotion activities are managed by the overseas group entities

# Case Study - FAR Analysis – Existing Model...

Sr No	Functions Performed	XYZI	AE
<b>Marketing function</b>			
6a.	Decide global marketing strategy, develop marketing plans and guidelines	-	✓
6b.	Plan/develop advertising formats and targeted media in India based on global plan and approved by the Group	✓	✓
6c.	Plan trade convention / road shows in India	✓	-
6d.	Develop new markets in India	✓	-
6e.	Appoint media managers / agents	✓	-
6f.	Brand building	✓	-

# Case Study - FAR Analysis – Existing Model...

Sr No	Risks Assumed	XYZI	AE	Explanation
1.	Product Quality Risk	✓✓	✓	Primary risk associated with the issues regarding the quality of the product is borne by XYZI. AE / Group may face only a cascading effect
2.	Market Risk	✓	✓	Relates to decline in sales, over-estimating market demand, change in food habits, etc.
3.	Price Risk	✓✓	✓	Primary risk relating to market's sensitivity to competitive pricing is borne by XYZI
4.	Inventory Risk	✓	-	XYZI, having complete stock ownership, is exposed to all risks associated with the warehousing of goods in India. E.g. damages, shelf life limitation, etc.
5.	Credit Risk	✓	-	XYZI faces all the risks relating to payment default by sub-distributors
6.	Government Policy Risk	✓✓	✓	Primarily borne by XYZI
7.	Foreign Exchange Risk	✓	-	XYZI's purchases from AE are in foreign currency and hence, the forex fluctuation risk is borne by XYZI

## Case Study - FAR Analysis – Existing Model...

Sr No	Assets Employed / Created	XYZI	AE	Explanation
1.	Marketing intangibles in India	✓✓	✓	XYZI incurs huge marketing spend on its own account to enhance its product's visibility in Indian market and hence, may be considered as an economic owner of the marketing intangible. Group's worldwide brand promotion activities also help XYZI in its marketing efforts
2.	Sales team	✓	-	XYZI has its own sales and marketing team for the distribution activities
3.	Fixed assets	✓	-	All fixed assets and resources such as premises, warehouses, vehicles, etc. are employed by XYZI

The FAR analysis portrays XYZI to be the one performing significant functions and assuming significant risks and hence, it may be characterised as a full-fledged distributor, who also carries out the function of creating marketing intangibles in India

# Case Study - Types of Distributors...

Expression	Full Fledged / Full Risk Bearing Distributor	Limited Risk Distributor	Commission Agent
<b>Functions</b>			
Purchase of goods on its own account	✓	✓	-
Sales solicitation activity	✓	✓	✓*
Marketing function carried out by & marketing expenditure borne by	✓	-**	-
Warehousing	✓	✓	-
Distribution	✓	✓	-
<i>Summary</i>	<i>Detailed functions</i>	<i>Limited functions</i>	<i>Limited functions</i>
<b>Creation of non-routine Assets</b>			
Marketing intangibles	✓	-	-

\* Solicits sales on behalf of its principal \*\* even if low risk distributor sometimes undertakes marketing , cost is borne by entrepreneur

# Case Study - Types of Distributors...

Expression	Full Fledged / Full Risk Bearing Distributor	Limited Risk Distributor	Commission Agent
<b>Risks</b>			
Product quality / liability risk	✓	**	-
Market risk	✓	-	-
Price risk	✓	-	-
Inventory risk	✓	✓	-
<i>Summary</i>	<i>High risk</i>	<i>Limited risk</i>	<i>Low / no risk</i>
<b>Profitability</b>			
Remuneration basis	Residual profits	Profits commensurate to functions and risks / Cost plus	Commission on sales made through such agent
<b>Profitability</b>	High / unlimited	Limited	Limited

\* Many times, primary risk is borne by a low risk distributor, however, the same is compensated by the risk bearing entity in a group

In case of Limited Risk Distributor the functions like marketing, after sales service are centralized, major risk are borne by the entrepreneur and brand is owned and developed by such entrepreneur

# Case Study - Implications of Suo Moto Adjustment

Particulars	FY 2012-13
Revenue	748,707,639
Cost of Goods Sold	
Purchase of Canned Beverage (A)	165,799,640
Tax and other Costs	165,799,640
<b>Gross Profit</b>	<b>417,108,360</b>
Selling & Distribution expenses	143,787,092
Brand promotion and Marketing expenses	184,031,142
Other Overheads	318,909,661
<b>Net Profit before Adjustment (B)</b>	<b>(229,619,534)</b>
Arm's Length Net Profit Margin (%) (Applied TNMM)	7.22
<b>Profit at arm's length margin (C)</b>	<b>54,056,692</b>
<b>Self Adjustment (D=C-B)</b>	<b>283,676,226</b>
<b><i>Suo moto</i> Adjustment / International transaction value (D/A)</b>	<b>171.10%</b>

# Case Study - Implications of Suo Moto Adjustment

- **Absurd situation:** Value of *suo moto* transfer pricing adjustment overshadows the value of international transaction (i.e. import of canned beverage)
- **Disconnect with the desired objective:** To achieve the desired objective of the Group, it is pertinent for XYZI to shed its '*full fledged distributor also creating marketing intangibles*' status and the conduct of business and economic profile of XYZI should portray that it is a 'limited risk distributor'
- **Challenges in remitting residual profits outside India:** The existing transfer pricing mechanism does not allow for tax effective remittance of residual profits from India to the parent entity
- **Possible challenges from the tax authorities in India:** Due to the disconnect between the purported and the perceived economic profile of XYZI, Indian revenue authorities may in-spite of the *Suo Moto* adjustment, consider market development activities as being carried out by XYZI and thus require to recover the same from the AE with a profit margin

Form V. Substance



## Marketing Intangibles – Points to ponder.....

- Ownership of intangibles – Legal v. economic
- Contractual terms - analysis of rights, terms of contract, responsibility split etc.
- Bifurcation of AMP expenditure between routine and non routine expenditure
- Compensation by brand owner to entity developing brand
- AMP spends - satisfy the 'bright line' test
- Quantification of returns attributable to the marketing intangible

# Relevant Ruling - Maruti Suzuki India vs. ACIT (Delhi High

Court) One of the first major Indian judicial precedents in case of marketing intangibles

- Facts

- Maruti India started using logo of Suzuki (owned by Suzuki Motor Corp, Japan) in 1993 replacing its own logo, paying royalty in consideration of the same;

- TP Authorities Contentions

- “Suzuki” trademark had piggybacked on the trademark “Maruti” without consideration;
- “**Maruti**” a “super” brand in India, while “**Suzuki**” a “weak” brand & hence co-branding led to the reinforcement of “Suzuki” at the cost of impairment of “Maruti”;
- Portion of royalty paid & non-routine advertising spends by Maruti India adjusted

- Court Rulings

- Indian entity can choose to use a foreign brand name by paying royalty, if primary benefits accrue to the Indian entity
- a foreign trademark, discretionarily used by assessee does not warrant any payment from foreign entity;
- however if it is mandatorily required to use the foreign trademark, appropriate payment is required from foreign entity, for benefit it derives in the form of marketing intangibles;
- foreign entity needs to suitably compensate domestic entity, if expenditure by domestic entity on advertising, promotion and marketing of its products using a foreign trademark exceeds expenditure by a comparable independent domestic entity

# Service Companies & Intangibles Development In India

- Tax authorities contend:
  - the Indian entity employs key personnel and conducts cutting edge research
  - India's role in the global value chain is important and this should translate to a higher bargaining power in a "arm's length" setting
  - The fact India is high up the value chain is reflected in the number of patents filed from India as well as the press releases
- The Indian entity accordingly needs to be compensated commensurate to the effort involved and responsibilities assumed towards development of the concerned intangible
  - Particularly relevant for companies whose global organization is into product development
  - Secondary analysis critical to mitigate aggressive approach of the tax authorities
- One approach to mitigate risks
  - Develop a detailed and well done functional analysis – make it different from a "run of the mill" approach
  - If the services are low key, state so and provide all documentary support for it
  - Back up the functional analysis with anecdotal evidence

## Points to ponder

- **Whether cost to develop brand by the AE will diminish the right of the taxpayer to receive the royalty?**
- **If yes, what would be threshold principle?**
- **Whether taxpayer was correct in not charging Royalty because that expenditure was incurred by AEs for promotion of brand owned by the Indian company?**
- **Whether TPO was correct in computing ALP of Royalty following the agreements which are still under operation?**

# Management Charges

# Management Charges

- Emerging dispute - intercompany allocation of HQ/ management services rendered by foreign parent to its Indian counterpart disallowed almost as a rule
  - Revenue authorities treat these costs as tribute payments to the parent
  - Allocation of management fees by AE
    - “Benefits Test” critical
    - Evidence of receipt of services
    - Determination of allocated amount
- Cost reimbursement (with no mark-up) defensible if benefit is established
- Minimum requirement for substantiating cost reimbursement
  - Cost allocation mechanism
  - Documentation substantiating actual receipt of services
  - Supporting intercompany agreements
  - Possible certification from AE’s Auditor

Any management fee should be corroborated at TNMM Level

# Cost Contribution

# What is Cost Contribution Arrangement / Cost Sharing Arrangement?

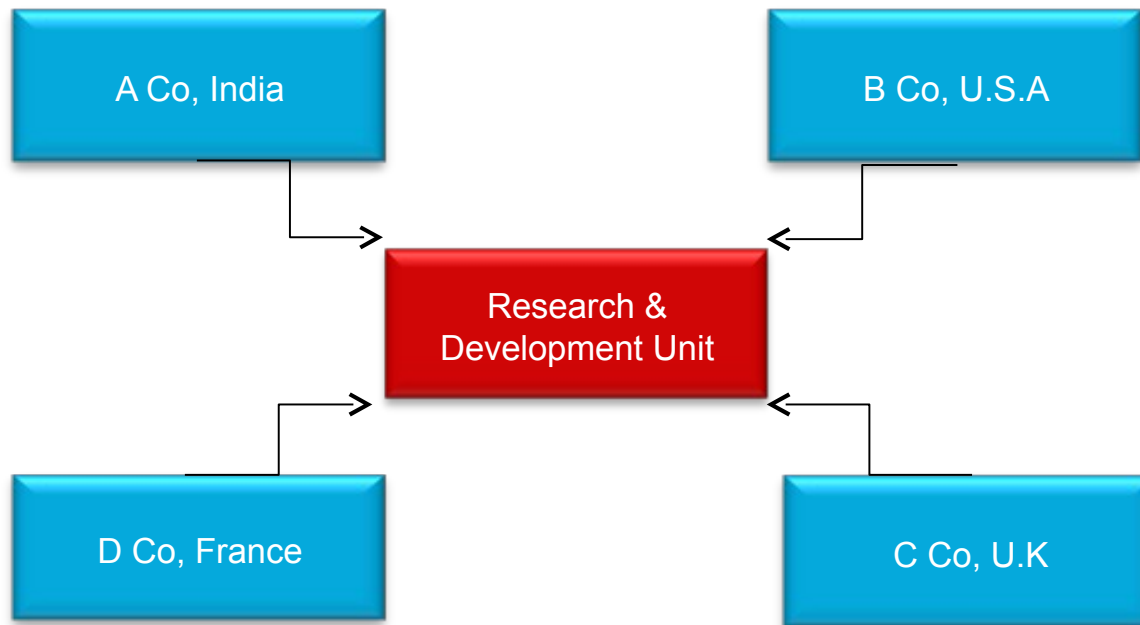
## Definition :

*“A CCA is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights.”*

*-OECD Transfer Pricing Guidelines (Para 8.3)*



# What is Cost Contribution Arrangement / Cost Sharing Arrangement?



- A Co, B Co, C Co and D Co are participants located at various geographical locations
- A Co, B Co, C Co and D Co bring in consideration in return for the Technical knowhow they get R&D Unit
- A Co, B Co, C Co and D Co will share the cost & risk of the R&D unit
- When they enter a contractual arrangement it becomes a CCA

# Overview of CCAs

- A Cost Contribution Agreement (CCA) is a framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights – OECD Transfer Pricing Guidelines
- Generally, such arrangements are found when a group of companies with a common need for particular activities decides to centralize or undertake jointly the activities in a way that minimises costs and risks to the benefit of each participant
- While commonly observed for joint development of intangibles, CCA's can also exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services
- In case of cost contribution agreements and cost allocations, it is felt that none of the five methods can be used. Even though the Indian regulations specifically bring in such transactions within the transfer pricing net, no specific guidelines are available to address the

# CCAs – How Beneficial?

Advantageous to MNCs carrying out business globally

- For example:
  - Consider large MNC group with manufacturing sites around the world
  - Having ownership of intangible assets vested in a number of different entities may be complex
  - It would necessitate complex system of cross charges such as royalties and also bring in complexities involved in the withholding taxes
  - Determination of royalty rates is a most difficult part in such scenario
  - In such case, cost sharing arrangement can be utilised by the MNC in two unrelated but different ways:
    - ›Intangible under development
    - ›Pre-existing intangible

# Applying Arm's Length Principle

To apply the arm's length principle to a CCA, it is necessary to determine -

- All the parties to the arrangement have the expectation of benefits
- To calculate each participant's relative contribution to the joint activity (whether in cash or in kind)
- Determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) is proper

For the conditions of a CCA to satisfy the arm's length principle -

- The contribution made must be consistent with what an independent party would have agreed to contribute
- What an independent party would agree to contribute would depend on what that independent party expected to be his benefit

# Documentation Requirements

**Controlled participants must timely update and provide information sufficient to:**

- Identify cost shared intangibles
- Establish that each controlled participant anticipates it will benefit from exploiting cost shared intangibles
- Establish the amount of each controlled participant's Intangible Development Costs for each year
- Describe method used to estimate each controlled participant's share of Reasonably Anticipated Benefits for each year
- Describe external contributions, explain method used to determine payment for each contributed intangible
- Describe economic analysis, data, and projections relied upon in developing and selecting the method used to determine the PCT payment
- Explanation of alternatives considered and why not selected
- Choice of discount rate and explanation of why reasonable
- All information to be updated in timely manner

# Cost Sharing - Issues

## What should be included in “costs”?

- Costs incurred related to the intangible development area ordinarily include expenses associated with advertising, promotion, sales, marketing, warehousing, distribution and general administration, but excluding depreciation or amortization expense, plus the charge for the use of any tangible property made available to the qualified cost sharing arrangement
- All stock-based compensation that is granted to the employees during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost

## How do you measure “expected benefits”?

- **Direct Method**
  - Estimated additional income to be generated or costs to be saved by the use of covered intangibles
- **Indirect Method**
  - Sales
  - Operating Profits
  - Gross Profits
  - Employees

# Case Study 1 - Documentation in Cost Sharing Agreement

1/3

## Gemplus India (P) Ltd. Vs ACIT

### Facts:

- The assessee is an Indian subsidiary of Gemplus SA, France, a multi national engaged in providing smart card solution for telecommunication industry, financial services and other e business segments and functions under the regional headquarters of Gemplus Singapore
- During the year, the assessee had international transactions with its Singapore associate Gemplus Singapore in respect of:
  - Import of SIM Card – Rs. 21,67,98,272
  - Payment of management fees – Rs. 1,44,98,000
  - Reimbursement of expenses – Rs. 6,76,906
- The transaction of payment of management fees of Rs.1, 44, 98,000/- was questioned
- The transfer pricing officer ('TPO') observed that cost has been apportioned by Gemplus Singapore for different country centers on a mutually agreed basis and not on the basis of actual services rendered

# Case Study 1 - Documentation in Cost Sharing Agreement

2/3

- The TPO concluded that the assessee has not derived any specific benefit from the management services allegedly advanced by Gemplus Singapore and this was more so because the assessee in India has already incurred separate head-wise expenses for professional and consultancy services. In the circumstances, the TPO held that the payment of management service fee was not justified. The CIT (A) also dismissed assessee's appeal

## **Assessee's contention:**

- In further appeal before the Tribunal, the assessee company argued that they had achieved a commendable amount of sales turnover for the previous year which would not have been possible but for the various services rendered by Gemplus Singapore on the basis of the services agreement
- It was explained that that the Profit level indicator opted by the assessee company was justified in the nature of business carried on by it and that the TPO had gone wrong in holding that the payment of service charges to Gemplus Singapore has impaired the acceptability of the PLI



# Case Study 1 - Documentation in Cost Sharing Agreement

3/3

## Revenue's contention:

- The Department argued that the assessee has not proved anything in black and white to establish that the so called services were rendered by Gemplus Singapore to the assessee company in India
- The assessee company has qualified personnel and has already incurred expenditure for similar services. In such circumstances, there was no justification for making out a case for further services to be rendered by a foreign associate; that there is no comparison between the volume and quality and services and the amounts paid by the assessee company

## Ruling:

- The Tribunal held that the TPO is justified in making a pertinent observation that the expenses are apportioned by Singapore affiliate among different country centers on the basis of their own agreements and not on the basis of the actual services rendered to the individual units
- The TPO has made a clear finding that there are no details available on record in respect of the nature of services rendered by Singapore affiliate to the assessee company. Therefore, the TPO is justified in making the adjustment of Arms length price under Section 92CA of the Income-tax Act 1961

# Takeaways

Sufficient and appropriate documentation will be required to prove the following conditions:

- The need for services or intangibles is established
- The services or intangibles have actually been received
- The benefit from services or intangibles is commensurate with the charge

The onus to satisfy the above conditions and to build necessary documentation lies with the assessee

The assessees with similar transactions should review their existing intra-group agreements, policies and other relevant documentation to evaluate the need to either prepare or improve and strengthen the same

# Case Study 2 – R&D cost sharing

1/4

## AAR:

### Facts:

- The Applicant, ABB Limited (“ABB India”) is a company incorporated in India. As per ABB Group’s Research & Development (“R&D”) policy, all basic R&D activities were coordinated and directed through ABB Research Limited, Zurich (“ABB Zurich”)
- The group entities could avail the benefit of the R&D activities by entering into a CCA with ABB Zurich, whereby the participating entities (“ABB entities”) agree to contribute towards the R&D expenses incurred by ABB Zurich based on an allocation
- ABB entities are allowed a royalty-free unlimited access to the results of the research undertaken including any Intellectual Property Rights (‘IPRs’) generated from the R&D
- The IPRs generated are legally owned by ABB Zurich. A fee is paid by ABB entities to ABB Zurich for acting as a coordinating agency under the CCA

# Case Study 2 – R&D cost sharing

2/4

## Main issue before the AAR:

- Whether the Applicant's contribution to the R&D expenses incurred by ABB Zurich would constitute income under the provisions of the Income-tax Act, 1961 ("Act")?
- In absence of any permanent establishment ('PE') of ABB Zurich in India, whether the proposed cost contribution could be taxable in India?

## Applicant's contentions:

- The payment under the CCA was merely reimbursement of R&D cost and cannot be treated as income of ABB Zurich
- Even if the payment was regarded as income of ABB Zurich, it is not liable to tax in India in absence of PE for ABB Zurich in India

## Revenue's contentions:

- The payment should be regarded as 'fees for technical service' in the hands of ABB Zurich and should be liable to tax in India

# Case Study 2 – R&D cost sharing

3/4

## Rulings of the AAR:

- The payment cannot be regarded as fees for technical services. Sharing the results of the R&D activities with ABB entities cannot be regarded as managerial, technical or consultancy services
- ABB Zurich did not have any right to withhold the research information or results from the ABB entities. The CCA did not even contemplate granting of license by ABB Zurich to the ABB entities, which were entitled to avail the fruits of research without any restriction
- While legal ownership of IPRs generated through the R&D activities rests with ABB Zurich, the ABB entities were the beneficial owners thereof. The contribution under the CCA cannot be regarded as consideration for transferring or conferring any rights or benefits of R&D activities
- The R&D Board of ABB group and ABB Zurich devised cost allocation keys. Further, the CCA provided that the income derived from the commercial exploitation of IPRs would be reduced from the R&D expenses. These clauses in the CCA indicated that it was merely a joint group initiative to derive the benefits of R&D activities
- Thus, ABB Zurich did not transfer any rights in the nature of intellectual property to the ABB entities which could be covered within the definition of royalty either under India Switzerland Tax Treaty or section 9(1)(vi) of the Act

## Case Study 2 – R&D cost sharing

4/4

- Further, the cost reimbursement, even if regarded as business income, will not be liable to tax in India In absence of PE for ABB Zurich in India and the Applicant was not obliged to withhold tax from the reimbursement of R&D expenses

## Case Study 2 – R&D cost sharing

4/4

- Further, the cost reimbursement, even if regarded as business income, will not be liable to tax in India In absence of PE for ABB Zurich in India and the Applicant was not obliged to withhold tax from the reimbursement of R&D expenses

# **Normal Dispute Resolution Mechanisms**



# Normal Dispute Resolution Mechanisms

- Most tax disputes are dealt under traditional dispute resolution avenues
- Each level of hierarchy involves substantial period of time
- At times, cases at lower levels are passed in favor of revenue

**Biggest disadvantage — It could take several years to achieve certainty in tax position!!**

# Normal Dispute Resolution Mechanisms - Challenges

- Tax uncertainty coupled with substantial period in litigation process
- Huge number of pending cases before the various dispute resolution fora
- Aggressive approach in tax collections and tedious tax refund process dents taxpayers confidence
- Conflicting decisions at various levels of dispute resolution fora adds to the complexity of the Indian tax laws
- Possibility of further litigation

**Need for other options for resolution of disputes**

# Advanced Pricing Agreement

# APA – An Overview

- The OECD transfer pricing guidelines Chapter IV, Section F define Advance Pricing Arrangement ('APA') as:
  - *“An arrangement that determines, in advance (emphasis added) of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events, etc.) for the determination of the arm’s length price for those transactions over an agreed period of time.”*
- APA provides win-win situation for all the parties involved
- APA's are of 3 types
  - Unilateral APA – APA between taxpayer and tax authority of domestic country
  - Bilateral APA – APA between taxpayer and two tax authorities
  - Multilateral APA – APA between taxpayer and multiple tax authorities

**Although simpler to implement than a bilateral/multilateral APA, a unilateral APA is not recognized by the foreign tax authority**

# Features of an APA

- Initiated before actual transaction takes place
- Can be applied for variety of transactions such as sale/purchase of goods, provision/receipt of services, intangibles, cost sharing, etc.
- Aims at solving potential taxation dispute in a co-operative manner
- Certainty of tax treatment; reduced cost of compliance, risk of audit/ litigation and penalty; simpler and efficient for the taxpayers to conclude APAs
- Undertaken in a co-operative manner, allows flexibility and efficiency in arriving at appropriate set of criteria for the computation of the transfer price (including TP method to be applied, critical assumptions, etc.)
- Assist tax authority in gaining insight into complex international transactions

# Scope of APA

- Voluntary process — Taxpayer decides what transactions to address
- No requirement that all related entities or all transactions or product lines among related parties be covered
- Specify the time period to which they apply
  - Proposed term is generally 3 to 5 years, unless there is a specific reason for shorter term
- In certain countries, rollbacks prior to open tax years are allowed

No Roll Back Provision in Indian APA

# APA Process

## APA – Global scenario

- US, Canada, France, UK, Australia, Japan, China, Korea etc., have successfully implemented APA mechanism
- Most of the countries prefer bilateral or multilateral APAs (Australia and China have had larger number of unilateral APAs)
- Few jurisdictions like US, UK etc., provide rollback application of APAs
- Certain jurisdictions have a concept of filing of annual reports by taxpayers



# Indian APA

Characteristics	Ramarks
Types of APA	<ul style="list-style-type: none"><li>· Unilateral or Bilateral / Multilateral</li></ul>
Eligibility	<ul style="list-style-type: none"><li>· Made available to all taxpayers having international transactions</li></ul>
Resources	<ul style="list-style-type: none"><li>· Dedicated APA team, separate from field TPOs</li><li>• Employ the right resources i.e. industry experts, economists</li><li>• Adequate training to be provided</li></ul>
Confidentiality	<ul style="list-style-type: none"><li>· Confidentiality of information in an APA</li></ul>
Withdrawal from the APA	<ul style="list-style-type: none"><li>· Permissible - Withdrawal of APA application at any stage of the process</li></ul>
Statute of Limitation	<ul style="list-style-type: none"><li>· Where the APA application is pending, normal assessment will be reopened to give effect to APA</li></ul>

# Indian APA

Characteristics	Remarks
Information requirements	<ul style="list-style-type: none"><li>· Prescribed the list of documents to be file along with the APA application;</li><li>· Flexible and discuss during pre-filing stage</li></ul>
Roll-back of APA	<ul style="list-style-type: none"><li>· No Roll-back provisions</li></ul>
Time frame of APA	<ul style="list-style-type: none"><li>· Tax authorities should typically agree a proposed timetable at the time of pre-lodgement</li></ul>
Public Reporting	<ul style="list-style-type: none"><li>· Issuance of annual report by the tax authorities – to include details on APA i.e. number of APA application filed, number of APA's taken into the scheme, types of APA's, methodologies used, etc.</li></ul>

# Advance Pricing Arrangement (APA)

## Types of APAs

### Unilateral APA

- Arrangement between a taxpayer and the tax authority of the country in which the taxpayer is situated
- This does not involve or require agreement with a foreign tax authority
- Generally concluded in a shorter time frame
- One-sided tools addressing a bilateral issue
- Useful in certain circumstances, covering issues or transactions where no applicable tax convention exists.

### Bilateral APA

Arrangement between a taxpayer, the tax authority of the country in which the taxpayer is situated and the tax authority of the foreign country where the related party of the taxpayer, with which the covered transaction is sought to be entered into, is situated

Tax authorities of the two countries negotiate with each other in order to reach an agreed position

Bilateral/ multilateral APAs, which could, as per international experience, typically take anywhere between 1 to 4 years.

# Advance Pricing Arrangement (APA)

## Types of APAs

### Unilateral APA

- However, do not provide the tax certainty of a bilateral/ multilateral APA and do not ensure elimination of economic double taxation
- Tax authority provides a written confirmation of the agreement to the taxpayer.

More and More multilateral and/ or bilateral APAs,  
More Chances of reduction in the number of MAP cases

### Bilateral APA

Arrangement between related parties covers more than two entities and tax jurisdictions and therefore, tax authority of the country in which the taxpayer is situated, negotiates with the taxpayer and the tax authorities of more than one foreign country

Preferential by both the taxpayer as well as the tax authorities over unilateral APAs, as they proactively prevent disputes and are more cost effective in the long term

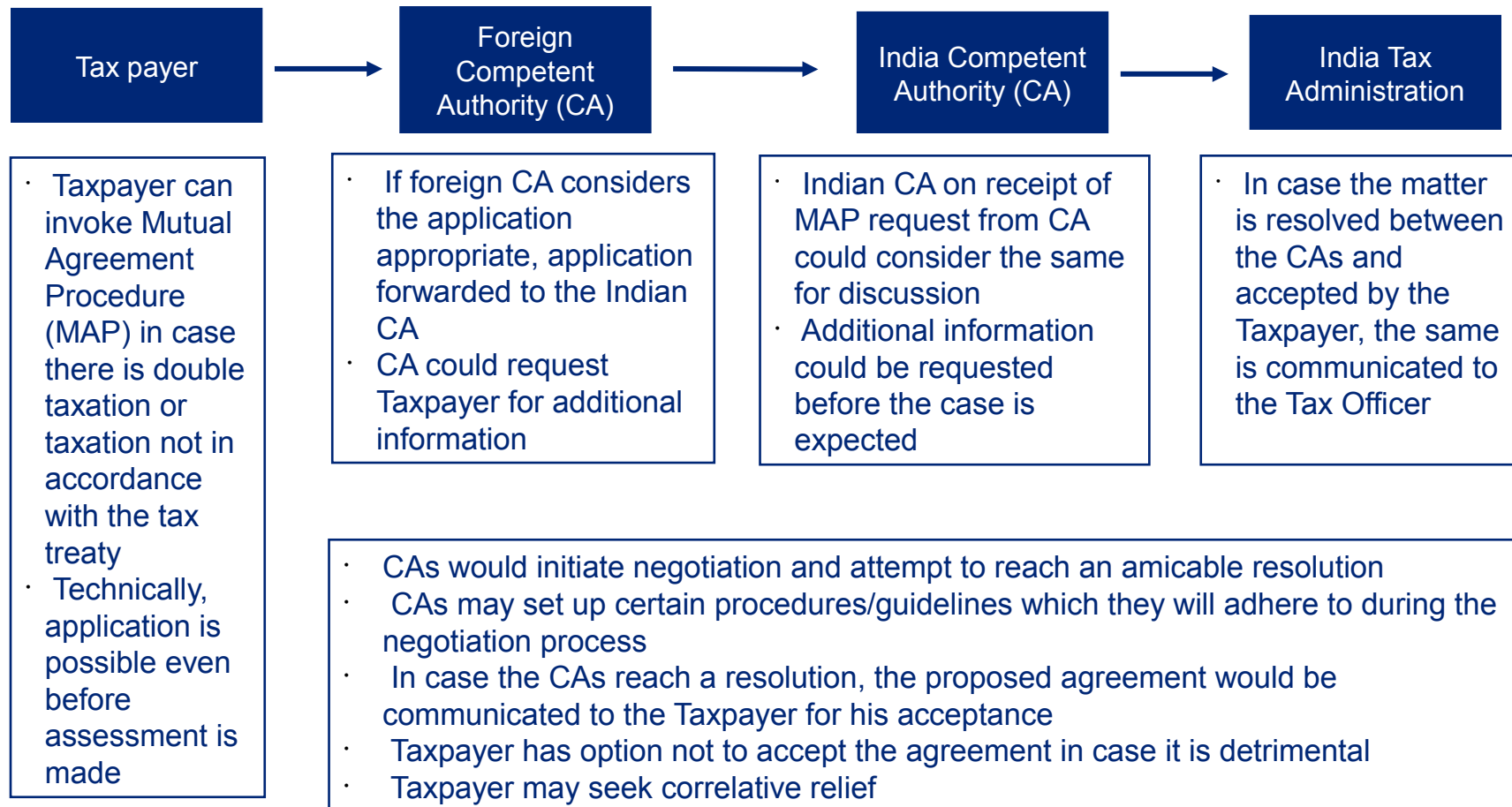
Administrations exchange position papers outlining the acceptability of the proposed TPM and taxpayer receives a written confirmation of concluded agreement

# Challenges of APA

- Tax authority gets more information than generally acquired during audit
- Confidentiality of trade secrets and other sensitive information are a matter of big concern
- If rollback is not allowed, information gained during APA may be used by tax authorities in assessment for open years
- Could take multiple years to finalize
- Reliance on predictions of future events – assumptions initially made may not adequately reflect changing market conditions
- High cost of filing



# Tax Treaty Resolution – Mutual Agreement Procedure



# Benefits of Tax Treaty Resolution

- Generally takes 2 to 3 years, which is significantly lesser as compared to Domestic Law Appeals
- More scope for negotiation/ compromise than Domestic Law Appeals
- Possibility of avoiding double tax impact through correlative relief
- Possibility of the Competent Authorities agreeing on suspension of collection
- Greater chance of reaching finality as decision of Competent Authority binding on Tax Officer (possibly for all disputed years)

The future of dispute resolution lies in Advanced Pricing Agreements (“APA”) and Safe Harbours!



# Mutual Agreement Procedure (MAP)

## Introduction

MAP is a mechanism under Double Taxation Avoidance Agreements (DTAA) for resolving disputes by the Competent Authorities

## Competent Authority (CA)

- India: Officer authorized by Central Government – Rule 44G / 44H
  - Other Countries: Ministry of Finance or Apex tax authority or Tax Commissioners or Directors as their representatives
- 
- Mostly a process of consultation, not litigation
  - Section 90 allows the Government to enter into an Mutual agreement with another country
  - CBDT vide Section 295 has notified new rules and forms with respect to MAP

# Mutual Agreement Procedure (MAP)

## Indian Scenario

### Rule 44G – for residents

- Residents aggrieved by action of any Foreign Country resulting in taxation not in accordance with tax convention to apply to CA in Form No. 34F

### Rule 44H – for non-residents

- CA in India to examine reference received from CA outside India
- CA in India to endeavor for resolution and communicate to CCIT or DGIT
- AO to give effect to MAP within 90 days of receipt of the same by CCIT or DGIT, subject to conditions fulfilled
- Tax, interest or penalty to be adjusted as per MAP in accordance with the provision of the Income tax Act 1961 irrespective of time barring of proceedings

# Mutual Agreement Procedure (MAP)

## India-USA DTAA ...

- Permits the taxpayer to seek MAP where the actions of one or both the contracting states result in taxation not in accordance with the DTAA
- Application to the CA of the contracting state of residence or nationality
- Stipulates a time limit of three years for all references
- CA shall endeavor to resolve the dispute itself. If not able to resolve itself, the CA may endeavour to resolve the dispute by mutual agreement with the CA of the other state
- Any agreement reached shall be implemented notwithstanding any time limits or procedural limitations in the domestic law
- CAs of the contracting states to resolve difficulties or doubts arising as to the interpretation or application of the DTAA and also provides for consultation for elimination of double taxation in cases not provided for in DTAA
- CAs may communicate directly without any diplomatic channels
- The CA's to develop appropriate bilateral/ unilateral procedures, methods and techniques for implementation of MAP

# Mutual Agreement Procedure (MAP)

## India-USA DTAA

Scenario I CASES RESULTING IN TAXATION NOT IN ACCORDANCE WITH THE DTAA	Scenario II Difficulties or doubts relating to interpretation or application of DTAA	Scenario III Cases not provided for in the DTAA
Determination of Permanent Establishment (PE) or Residency	Settle issues arising from changes in Domestic Tax Laws	Resident of a third country having a PE in both India and US
Article 9 (Associated Enterprises-Relationship) and Article 12 (Royalties / FTS)	Clarify vague / ambiguous definitions	Triangular cases
Attribution of income and administrative expenses to PE	Co-relative adjustment under Transfer Pricing under Article 9 (Associated Enterprises)	
E-commerce transactions (VISA / Mastercard)	APA etc.....	

# Mutual Agreement Procedure (MAP)

## Non Applicability of MAP

CA may refuse to apply MAP on the following grounds:

- Taxpayer has not provided sufficient information;
- Proposed interpretation contradicts that of the national revenue authorities;
- Case concerns only contravention of domestic law;
- Time limits lapsed;
- Taxpayer has failed to lodge the necessary appeals; and
- Tax taxpayer is guilty of tax evasion or tax fraud

# Mutual Agreement Procedure (MAP)

## India-US tax authorities reach settlement on TP issue

- Recent press report indicates that the US and Indian CAs have reached a negotiated settlement on transfer pricing dispute in respect of certain captive software development units for the financial year 2004-05
- The settlement has been reached through the MAP mechanism provided in the India-USA DTAA
- Indian tax authorities had assessed the transfer price of contract software service providers, which have been compensated at full cost plus mark up, at a markup of 25%-28% on costs for the financial year 2004-05
- A full cost mark-up of 17.5% for the financial year 2004-05 has been agreed

Though the settlement is binding only for the financial year under dispute and would not apply for either the past or future years, it would certainly have a persuasive value in other cases

# Learning Lessons



**The Revenue will never  
understand the business  
as well as you do**

**BUT**

**if you fail to explain your business  
and pricing in easy “language”,  
you will encounter ongoing expensive difficulties.**

# Learning Lessons

“Begin with the end in mind and don’t reinvent the wheel”





**Thank YOU**



**CA Rajesh S. Athavale**