

**Intangibles –
Planning
Perspective
Seminar on
International Taxation
– WIRC**

**Mr. Vishal Gada
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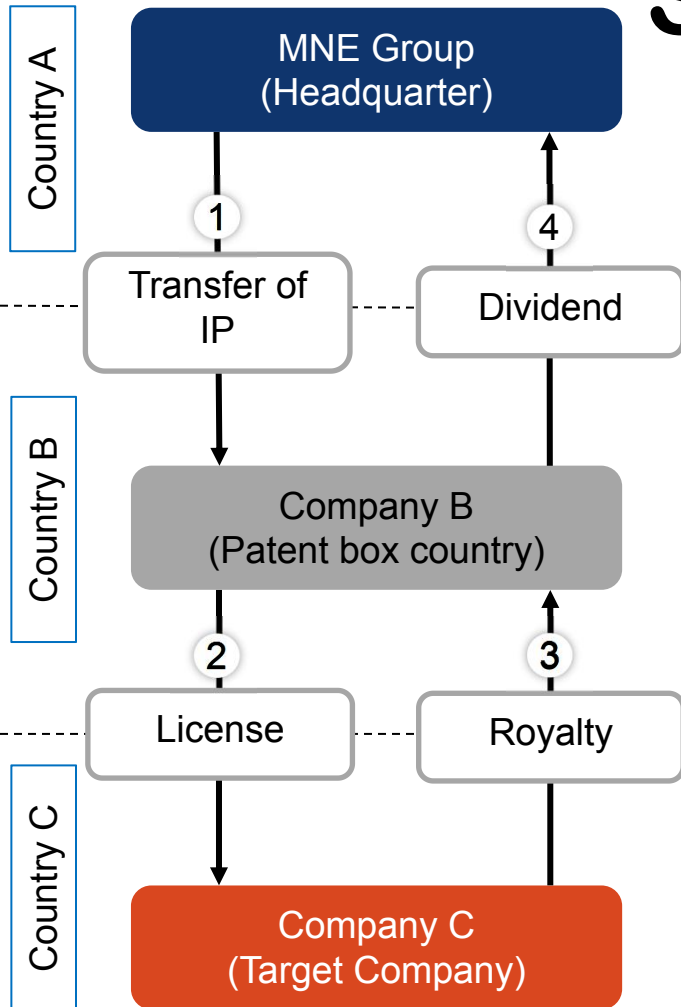
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**IP Structures
resulting in Base
Erosion & Profit
Shifting**

Tax planning using Patent Box

Steps



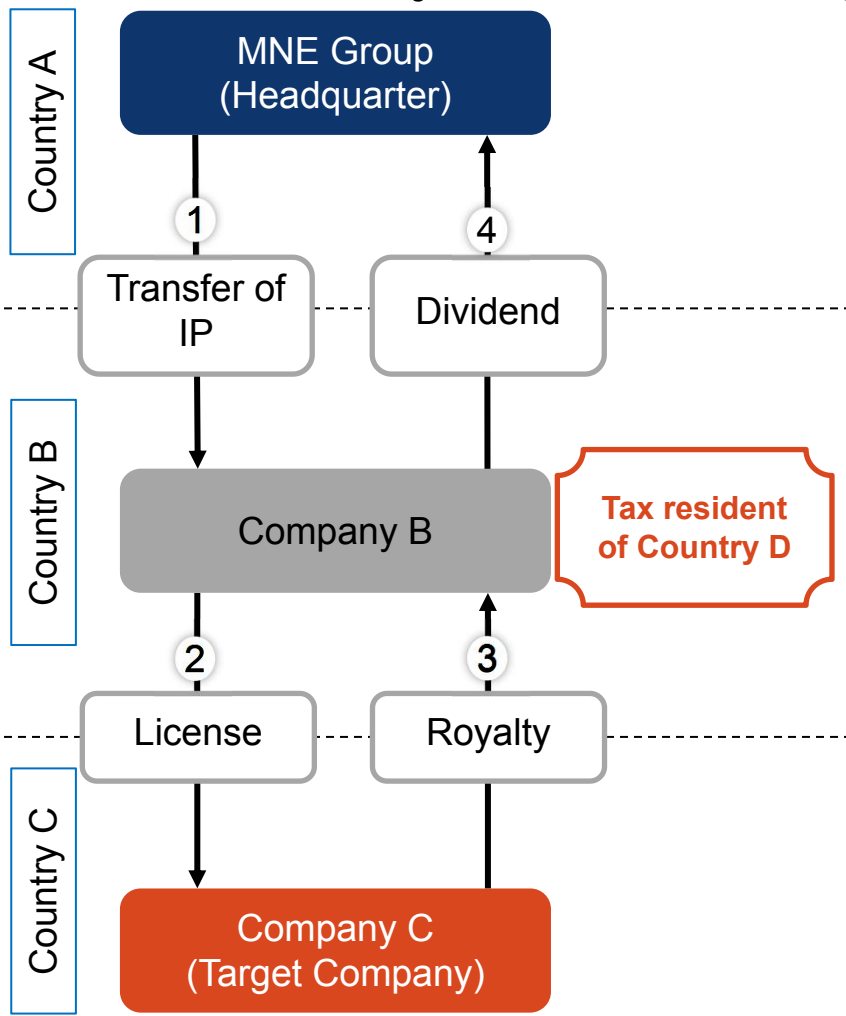
A. Mechanics:

- MNE group to have a subsidiary in a patent box country;
- Patents / intangible assets of the MNE group to be registered in a patent box country;
- Deduction for royalty paid by Target Company to result in low profits in Country C;
- Lower tax rates in patent box country (i.e. Country B) to result in lower tax burden on royalty income

B. Comments:

- **MNE group:** Overall effective tax rate of the MNE group to be lower than the statutory tax rate in the headquarter country;
- **Company B:** More patents / intangible assets with higher profitability and lower tax burden;
- **Company C:** Less profitability and less tax burden

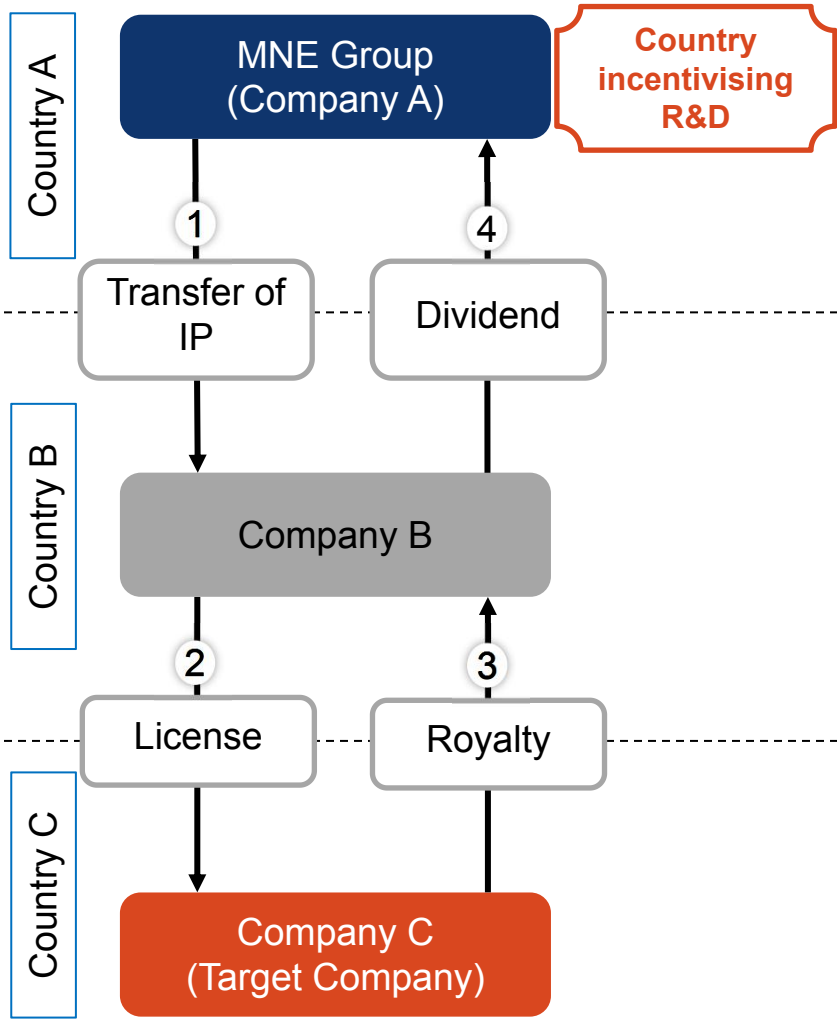
Tax planning using POEM



- A. Mechanics:**
- MNE group to have a subsidiary incorporated in Country B which is a tax resident of Country D;
 - Patents / intangible assets of the MNE group to be transferred to Company B which is tax resident of Country D;
 - Deduction for royalty paid by Target Company to result in low profits in Country C;
 - Royalty income to be exempt from tax for Company B

- B. Comments:**
- **MNE group:** Overall tax liability of the MNE group is lower than the statutory tax rate in the headquarter country;
 - **Company B:** More patents / intangible assets, higher profitability with no tax burden;
 - **Company C:** Less profitability and less tax burden

Double Tax Benefit



A. Mechanics:

1. MNE group:

- MNE group to set up R&D facilities in countries which provides tax incentives (for e.g. weighted deduction) for expenditure on R&D;

2. Company B:

- Royalty received by Company B from Company C to be exempt from tax in Country B;

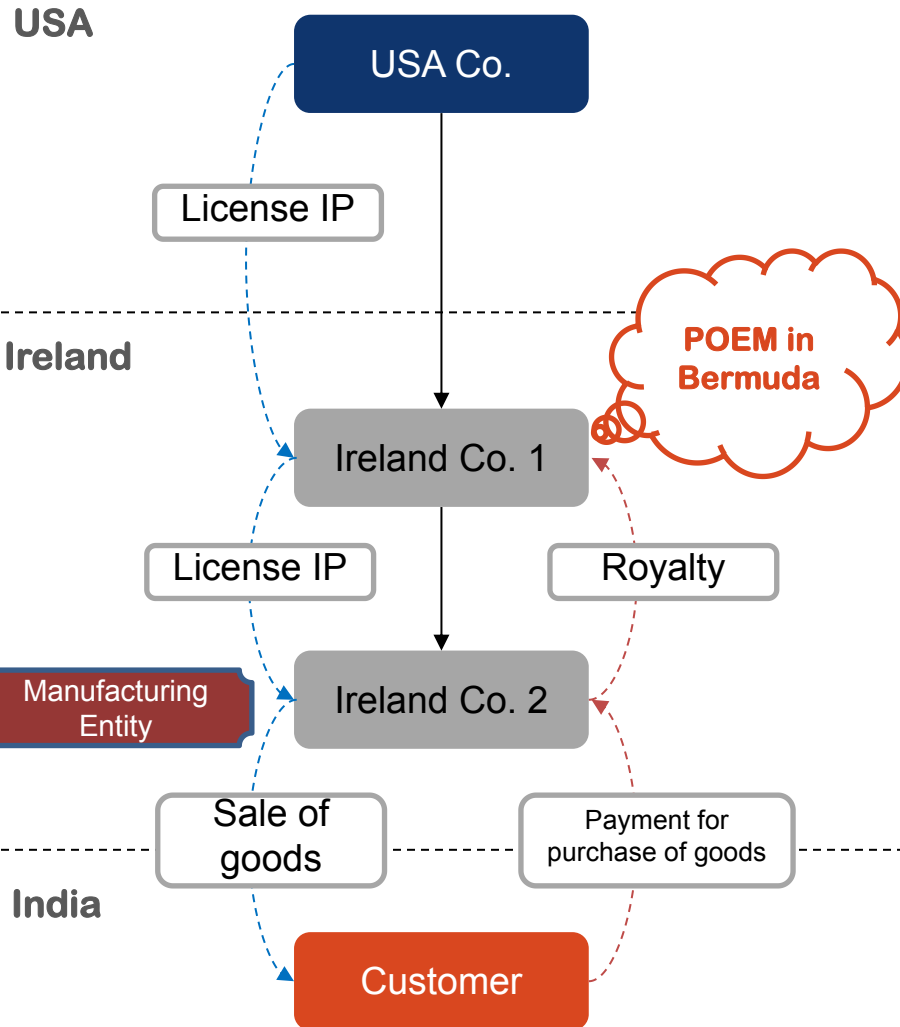
3. Company C:

- Deduction for royalty paid by Target Company to result in low profits

B. Comments:

1. **MNE Group** - Reduction in overall tax burden of MNE group;
2. **Country A** - Higher deduction of R&D costs;
3. **Country B** - More patents / intangible assets, higher profitability with no tax burden;
4. **Country C** - Less profitability and less tax burden

Double Irish Structure (1/3)



Mechanics:

- Ireland Co.1 to be incorporated in Ireland but to be managed and controlled from Bermuda (low tax jurisdiction);
- Ireland Co. 2, wholly owned and managed by Ireland Co. 1, to be incorporated in Ireland;
- USA Co. to license rights to Ireland Co. 1 to develop and exploit IP outside the US;
- Ireland Co. 1 to sublicense the said rights to Ireland Co. 2;
- Ireland Co. 2 to use IP rights to manufacture and sell the products to customers outside the US;
- Ireland Co. 2 to file a check-the-box election in the US to be treated as a disregarded entity for the US tax purposes

Double Irish Structure (2/3)

Implications (1/2)

Ireland Co. 2

- Ireland Co. 2 to receive sale consideration from customers outside the US;
- Payment of royalty for IP rights by Ireland Co. 2 to Ireland Co. 1 to be deductible expense against its income;
- Balance income of Ireland Co. 2 to be taxed at 12.5% Irish Corporate tax rate applicable to active business income

Ireland Co. 1

- Since Ireland Co. 1 is incorporated outside the US, it is to be treated as a foreign corporation for the US tax purposes;
- Since Ireland Co. 1 is managed and controlled from Bermuda, it is to be treated as tax resident of Bermuda for tax purposes;
- Royalty income of Ireland Co. 1 not taxable in Bermuda since Bermuda does not generally impose income-tax

Double Irish Structure (3/3)

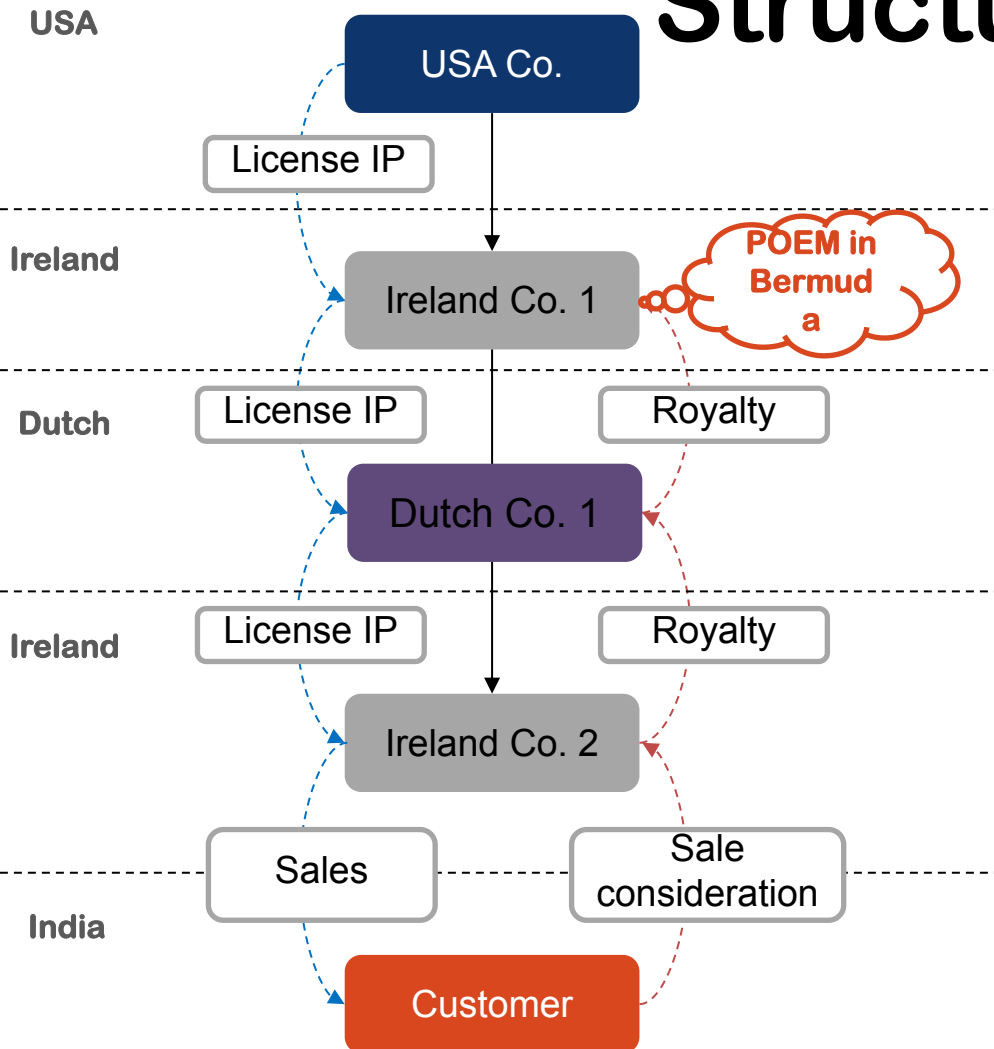
Implications (2/2)

MNE group

No adverse tax implications in the US from Controlled Foreign Corporation (CFC) perspective on account of the following;

- Ireland Co. 1 and Ireland Co. 2 to be treated as single Irish corporation (since Ireland Co. 2 is a disregarded entity for the US tax purpose);
- Transactions between Ireland Co. 1 and Ireland Co. 2 of licensing and royalty payments to be ignored since these transactions would be regarded as internal transactions;
- Royalty payments by Ireland Co. 2 to Ireland Co. 1 to be disregarded for USA tax purposes since both these companies are treated as single entity for USA tax purpose
- Since Ireland Co. 1 / Ireland Co. 2 have not purchased any property from a related person, the non-US sales of these companies not to be taxed in the US from CFC perspective

Double Irish Dutch Sandwich Structure



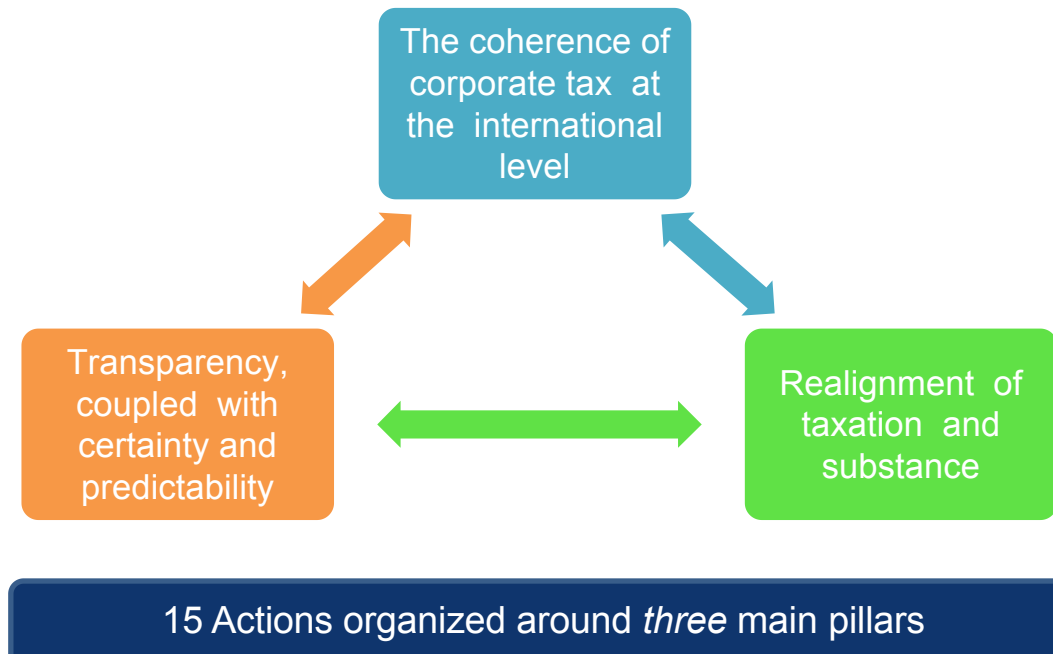
Mechanics:

- In Double Irish Structure, royalty payment by Ireland Co. 2 to Ireland Co. 1 may be subject to withholding taxes in Ireland;
- Therefore, a Dutch Co. 1 is generally created between Ireland Co. 1 and Ireland Co. 2 to avoid withholding tax implications;
- No withholding on payment of royalty between EU countries;
- Other implications as discussed in the earlier alternative would remain the same

**BEPS – Brief
Backdrop**

BEPS – Brief Backdrop

- On 19 July 2013 OECD released an Action Plan on Base Erosion and Profit Shifting (BEPS) which was presented to the meeting of G20 Finance Ministers in Moscow;
- **Purpose of BEPS** – “to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it.”
- “No or low taxation is not per se a cause for concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.”



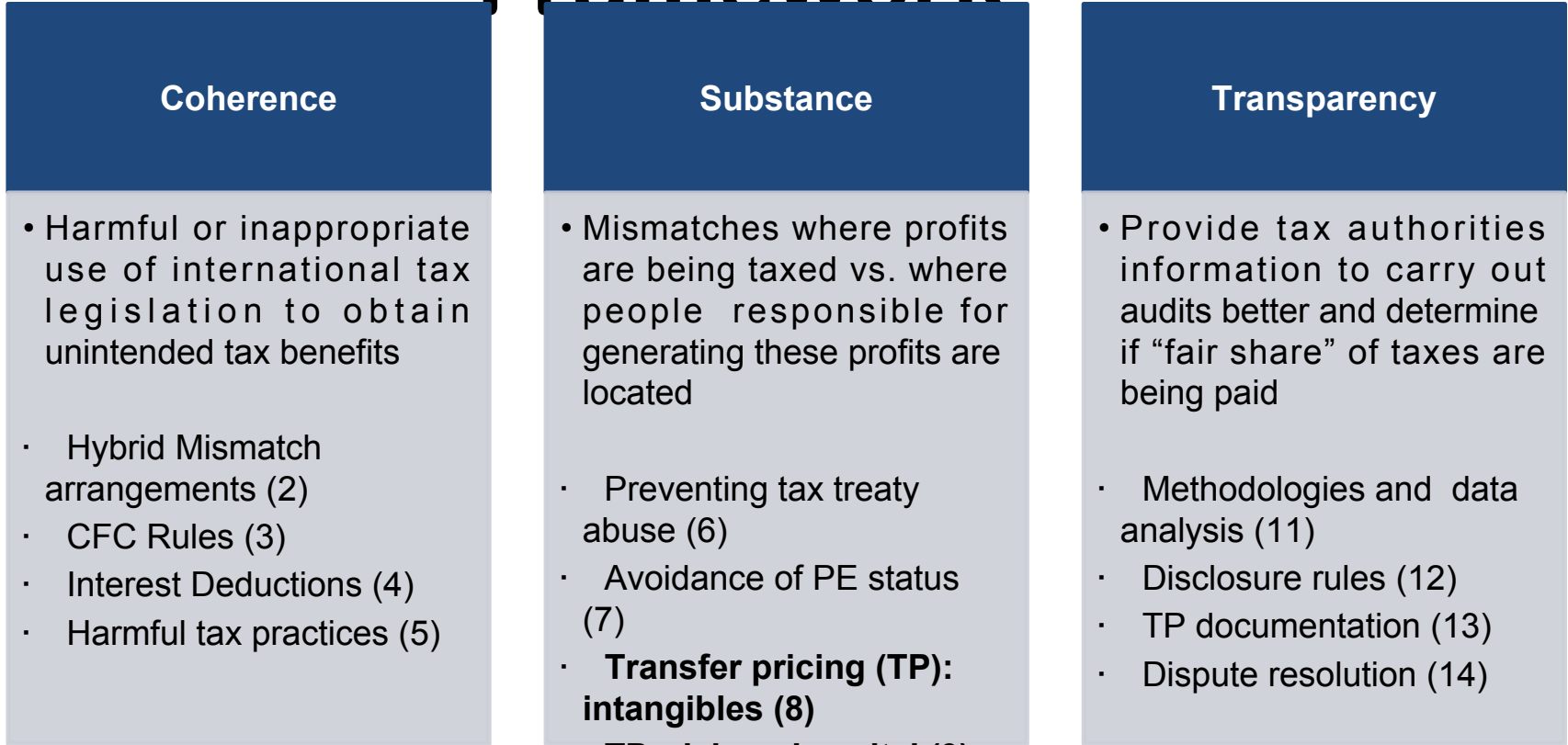
BEPS – Action Plan (1/2)

Sr. No.	Action Name	Action Objective
1	Digital economy	Rework existing tax rules to deal with digital economy. May involve introduction of VAT on digital goods, virtual PE rules, WHT, etc.
2	Hybrid mismatch arrangements	<ul style="list-style-type: none"> To curb abuse of hybrid instruments / entities; May involve ordering rules to specify primary and defensive rules with respect to the deduction and the exemption
3	CFC rules	<ul style="list-style-type: none"> Curb tax deferral through parking of profits to low / new tax jurisdictions; May involve identification of best practices and likely a proposal for some form of minimum standard for CFC rules
4	Limit base erosion via interest deductions	Address thin capitalization issues. Group wide approach and fixed ratio approach being evaluated
5	Counter harmful tax practices	Curb tax competition among countries to attract investments e.g., UK Patent Box, Dutch Innovation Box, low / reduced CTX rates
6	Prevent treaty abuse	Objective of treaty is not to create double non-taxation. May involve introduction of US style LOB or UK style GAAR (principle purpose test) rules
7	Prevent artificial avoidance of PE	Amending PE article in tax treaties to remove exemptions to PE clause and address artificial avoidance arrangements

BEPS – Action Plan (2/2)

Sr. No.	Action Name	Action Objective
8	TP aspects of Intangibles	Ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in line with value creation
9	Risks and capital	Substance over form w.r.t. capital contribution or allocation of risks
10	Other high risk transactions	Develop rules to prevent BEPS involving transactions which would not (or would only very rarely) occur between third parties. e.g., intra group services, management fees, etc.
11	Analyse data on BEPS	Analyzing economic impact of actions taken to address BEPS on ongoing basis (taxpayer confidentiality, compliance costs and burdens on taxpayers and tax administrations)
12	Disclosure of aggressive tax planning	Develop mandatory disclosure rules for aggressive or abusive transactions, arrangements or structures
13	Re-examine TP documentation	Introducing three tiered documentation consisting of Master file, Local file and CbC reporting template
14	Dispute resolution	Improving effectiveness of MAP and arbitration provisions
15	Multilateral instrument	Develop multilateral instruments which would be signed by all countries to agree upon common treaty arrangements

BEPS – Three Pillars of OECD Framework



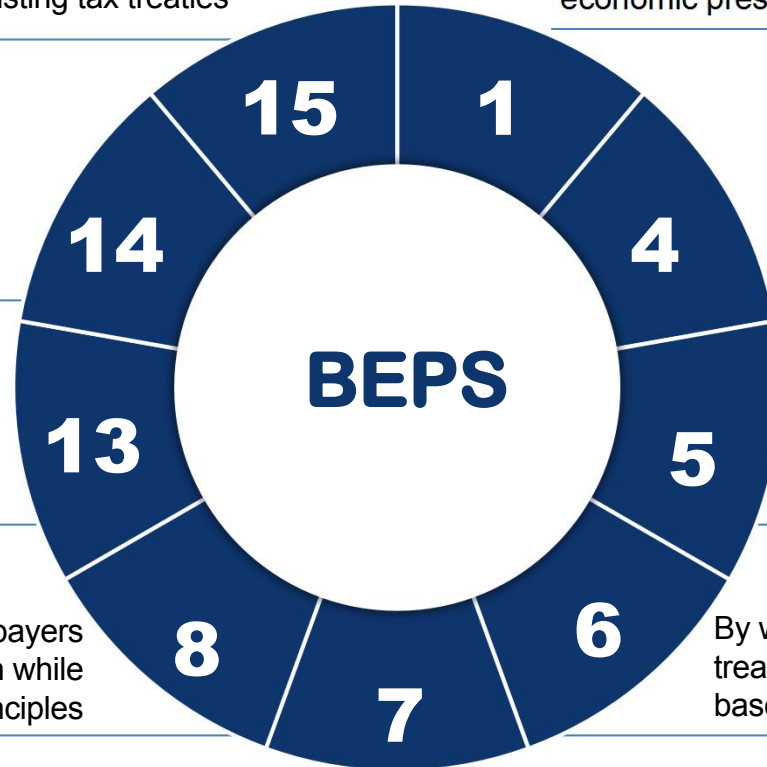
Digital Economy (1) Multilateral Instrument (15)

Place of value creation most important

BEPS – Implementation in India

On 7 June 2017, India along with 67 other countries signed the MLI to modify existing tax treaties

- Introduction of Equalization Levy in 2016 Union Budget
- Introduced concept of significant economic presence in 2017 Union budget



Acceptance of MAP / BAPA regardless of Article 9(2), amendment of treaties through MLI

Introduction of the interest deduction limitation rule in the 2017 Union Budget

Introduction of CbCR and Master File TP documentation in the 2016 Union Budget

Introduction of patent box regime in Union Budget 2016

Tax administration and taxpayers expected to give consideration while applying arm's length principles

By way of MLI, renegotiation of tax treaties to ensure greater source-based taxation / prevent treaty abuse

- Budget 2017 amended business connection definition in line with new Agency PE definition
- Amending tax treaties by way of MLI or re-negotiation

BEPS Action 8 - 10

Action 8 – 10: Mandate by G20

Action 8

Intangibles

- Develop rules to prevent BEPS by moving intangibles among group members
- This will involve: (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements

Action 9

Risk & Capital

- Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members
- This will involve adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation
- This work will be coordinated with the work on interest expense deductions and other financial payments

Action 10

Other high-risks transactions

- Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties
- This will involve adopting transfer pricing rules or special measures to : (i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses

Assure that TP outcomes are in line with Value Creation

Action 8 – 10: Outcome from OECD

BEPS Action 8, 9 and 10

Assure that transfer pricing outcomes are in line with value creation

Action 8: Intangibles

- Wider and clearer definition of “intangibles”
- Introduction of a six step framework
- Legal ownership alone does not generate a right to the return generated by the exploitation of an intangible
- Focus on Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions

Action 9: Risk and Capital

- Focus on conduct of parties and their capability and functionality to manage risks
- Assumption of risk without ‘control’ over that risk is likely to be problematic
- Separate consideration regarding an appropriate return to any cash investment
- Introduction of a six step framework

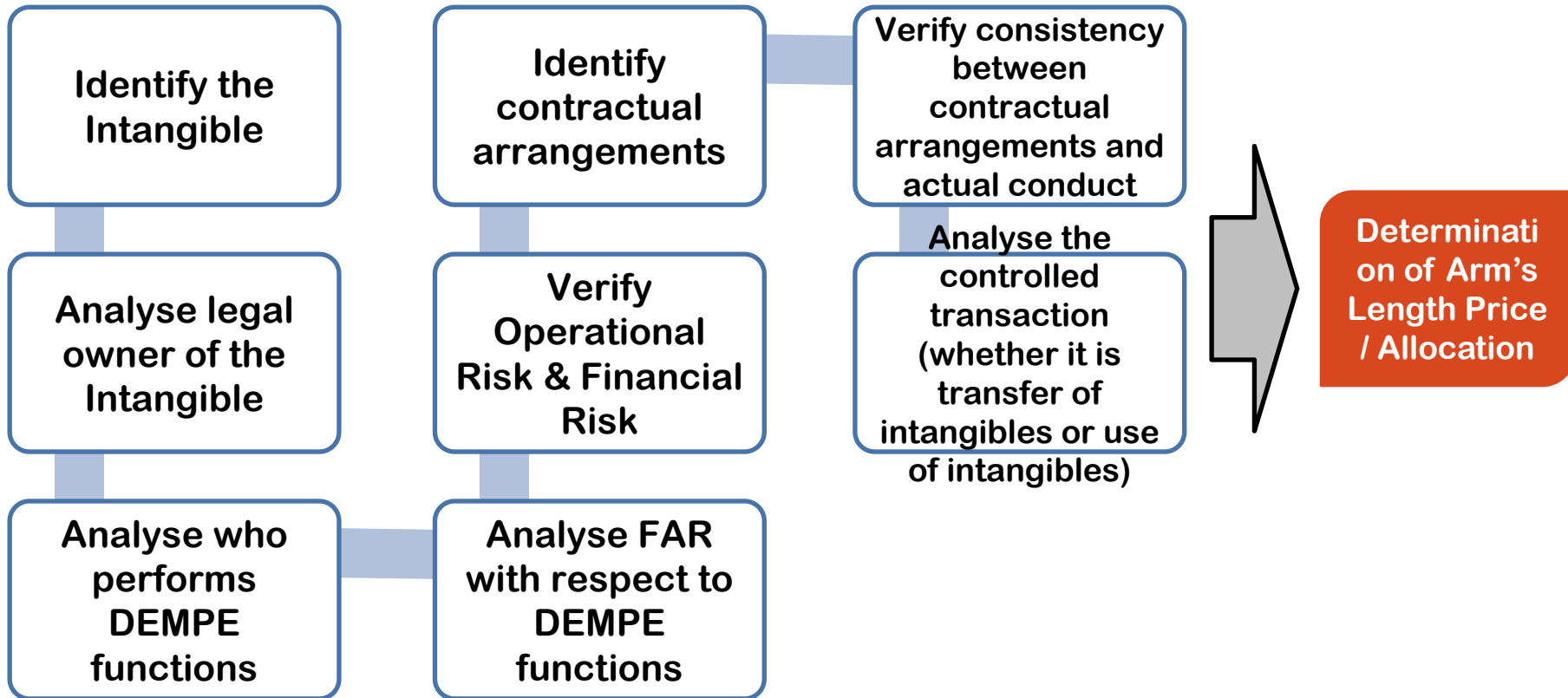
Action 10: Other high risk transactions

- Intra-group services / low value-add services
- Profit Splits
- Recognition of transactions
- Commodity transactions

BEPS triggers a shift from “arm’s length pricing” to “arm’s length profit allocation”

Risks should be allocated to enterprise that exercises control and has financial capacity to assume the risk

Action 8 – 10: General Rules



More credence to economic substance rather than legal form

Action Plan 8 – Intangibles

Intangibles - What is the concern?

Intangible assets are transferred to related parties for less than full value and Intangibles are not taxed consistently with the value creation underpinning them

Intangibles initiative & BEPS

Intangibles Initiative

- June 2012 – initial draft issued
- November 2012 – public consultation
- 30 July 2013 – revised draft
- 1 October 2013 – final date for comments
- November 2013 – further consultation meeting
- September 2014 – Guidance issued
- **October 2015 – Final Report by OECD**

BEPS

Transfer of intangibles to low tax countries seen as a source of BEPS and the **Action Plan 8 - 10** provide for:

- Broad definition of intangibles;
- Profits from intangibles to be allocated in line with value creation;
- Development of valuation rules;
- Updated guidance on cost contribution agreements (CCAs)

Intangibles: Definition

OECD Para 6.6

“Something which is **not a physical asset** or a financial asset, which is **capable of being owned or controlled for use in commercial activities**, and whose **use or transfer would be compensated** had it occurred in a transaction between independent parties in comparable circumstances.”

Key highlights

- Not a tangible asset or a financial asset (including shares);
- Capable of being used in commercial activities;
- Capable of being owned or controlled;
- Does not include local market conditions such as the high purchasing power, low labour cost, etc.
- Does not include MNE group synergies
- Use or transfer would be compensated in transactions between independent parties

Following are not required

- Need not be an intangible for accounting purposes;
- Need not be an intangible for general tax or treaty withholding tax purposes – Article 12 (Royalty) Model Tax Convention;
- Need not be an intangible for customs purposes;
- Need not be legally protected;
- Need not be separately transferable

Intangibles: Classification

The OECD guidance broadly discusses following intangibles:

Marketing intangible:

“An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, **aids in the commercial exploitation of a product or service, and / or has an important promotional value for the product concerned.** Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers”

Trade intangible:

“An intangible other than a marketing intangible.”

- Dealership network
- Brand name
- Goodwill
- Customer relationship
- Trademarks

- Know how
- Trade secrets
- Rights
- Licenses

OECD does not provide comprehensive list of items that may constitute Intangibles – It provides illustrations of items that are considered as Intangibles

Items not included in the list of illustrations may be intangibles for transfer pricing purposes

Intangibles: Exclusion

Location Savings

- Represents net cost saving as a result of shifting operations to a low cost location;
- Sources of cost saving include Labour, Raw material, Transportation, Rent, Capital etc.;
- Important to evaluate the extent to which location savings are retained or passed on to customers or suppliers;
- Where location savings are retained in the MNE group and where local market comparables are available, such comparables will provide the most reliable indication on how location savings should be allocated
- Where local market comparables are not available, allocation of

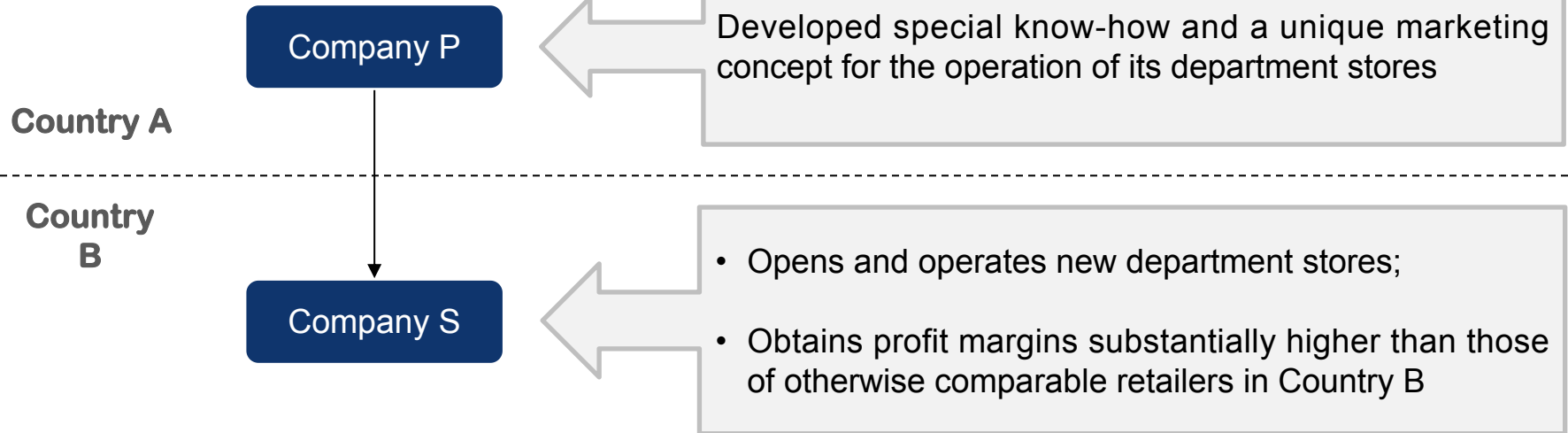
Assembled work force

- Some MNE's use uniquely qualified or experienced cadre of employees in catering group entities,
- Efficiency of such employee group affects the transfer price of a product or service: A measure of arm's length could be the payment of compensation to such employees
- Analyze whether such arrangement warrants separate compensation
- Indian TP regulations: Workforce intangibles

MNE Group Synergies

- MNE groups may benefit from interactions or synergies among group members;
- It should be analyzed whether group synergies arise due to deliberate action – e.g. setting up centralized purchasing to avail volume discounts;
- Synergistic benefits / burdens purely from MNE group membership without deliberate concerted action by group members need not be separately compensated;
- Benefits of synergies should be shared in proportion to group members' contribution

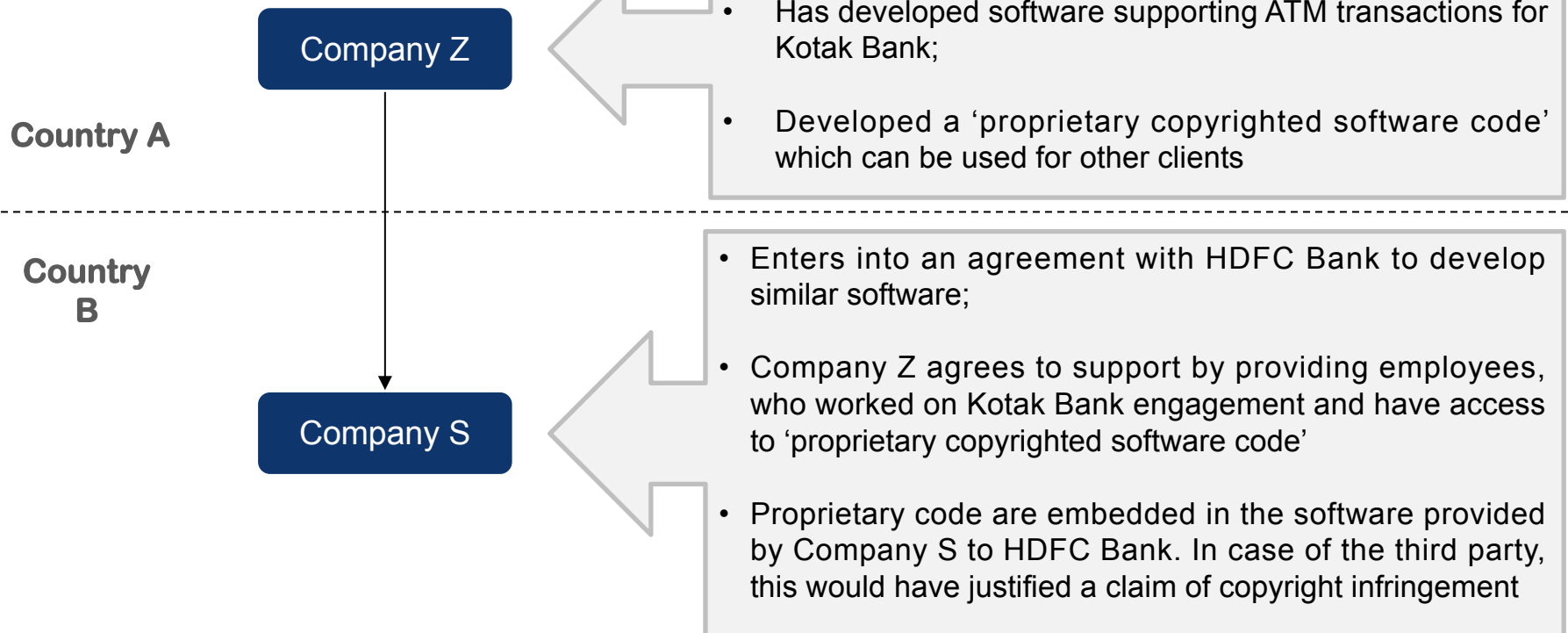
Example 19 – OECD TP Guidelines 2017



FAR analysis:

- On detailed analysis, it is revealed that Company S uses in its operations the same know-how and unique marketing concept as the ones used by Company P;
- Conduct of the parties reveals that a transaction has taken place consisting in the transfer from Company P to Company S of the right to use the know-how and unique marketing concept;
- Independent parties would have concluded a license agreement for royalty payment

Example 24 – OECD TP Guidelines 2017



FAR analysis:

Company S received two benefits from Company Z which requires compensation for (1) services of employees and (2) rights in proprietary software

Six step analytical framework for transactions

1

•Identify the intangibles and economically significant risks with specificity

2

Analyze contractual arrangement to determine legal ownership, rights and obligations of entities in relation to intangibles

3

Undertake functional analysis (performance of important functions / assumptions of risks related to DEMPE) to determine actual conduct of parties

4

Confirm consistency between contractual arrangement and conduct on ground

5

Delineate the controlled transaction based on conduct of parties

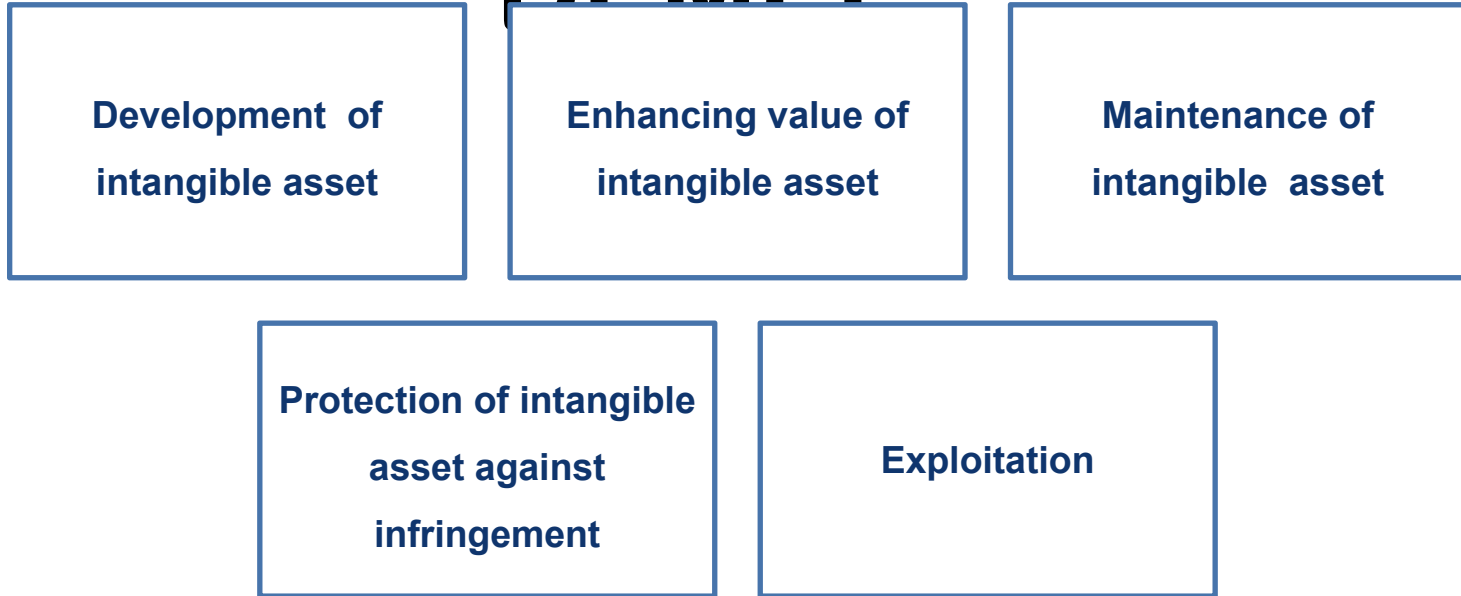
6

Determination of arm's length price based on FAR of each entity

Focus on performance of “DEMPE” Functions, Control over risks and Financial Capacity to assume risks

Functions: Strong focus on

DEMPE



- **Key factor:** The enterprise to directly perform DEMPE functions or control the performance of DEMPE functions and related risks;
- **Return to be retained by an entity depends on the contributions it makes through DEMPE functions to the anticipated value of intangible relative to contributions made by other group members**

Focuses on 'Actual Conduct' as against mere 'Contractual Obligations'

Six step analytical framework for analyzing risks

• Identify
Determine
economically
how the
y significant
associate
risks with
specificity
Enterprise
Determine
s operate
contractu
in relation
a risk
Interpret
allocation
the
assumptio
outcome
it and
of step 1, 2
Management
and
can be
determining
whether
particular
the or
not control
contractu
functions
does not
the
assumptio
transactio
can be
consistent
acceptably
with them
determined
should be
conduct
priced,
specific
appropriate
guidance
on
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risk

Risk: Control Over Risk and Financial Capacity

An associated enterprise assuming risk in relation to the development, enhancement maintenance, protection and exploitation of the intangibles must exercise control over the risks and have the financial capacity to assume the risks and control

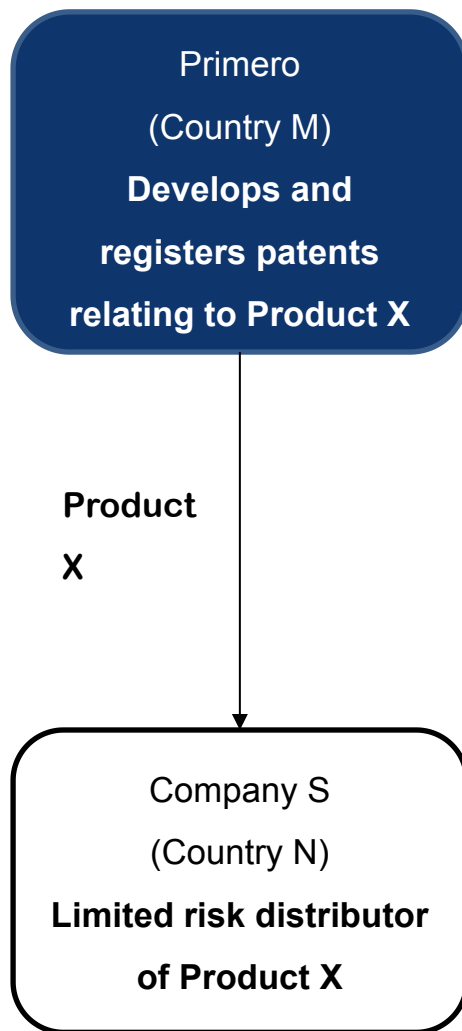
Control over risk

- i. the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; and
- ii. the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision making function

Financial capacity

Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes

Example 7 – OECD TP Guidelines 2017 ^(1/2)



- Primero, engaged in the pharmaceutical business, develops patents and other intangibles relating to Product X - registers those patents in countries around the world;
- Company S, wholly owned subsidiary distributes product X in specified countries on a limited risk basis. Distribution agreement provides that Primero is to bear product recall and product liability risk;
- Primero will be entitled to all profit or loss from sales of Product X after providing Company S with routine returns consistent with its limited risk characterization;
- After 3 years, Product X causes significant side effects and becomes necessary to recall the product and remove it from market. Company S incurs substantial costs in connection with the recall, however Primero does not reimburse Company S for these recall related costs or liability claim

Example 7 – OECD TP Guidelines 2017 (2/2)

FAR analysis:

- There is an inconsistency between Primero's asserted entitlement to returns and its failure to bear the costs associated with the risks supporting that assertion;
- A transfer pricing adjustment would be appropriate to remedy the inconsistency either in the form of an allocation of the recall / product liability related costs from Company S to Primero or if the facts suggest that Company S exercises control over product liability and recall risk, then an increase in the distribution margins for all years might be made to reflect the true risk allocation between the parties.

Guidance on comparability and other aspects while determining

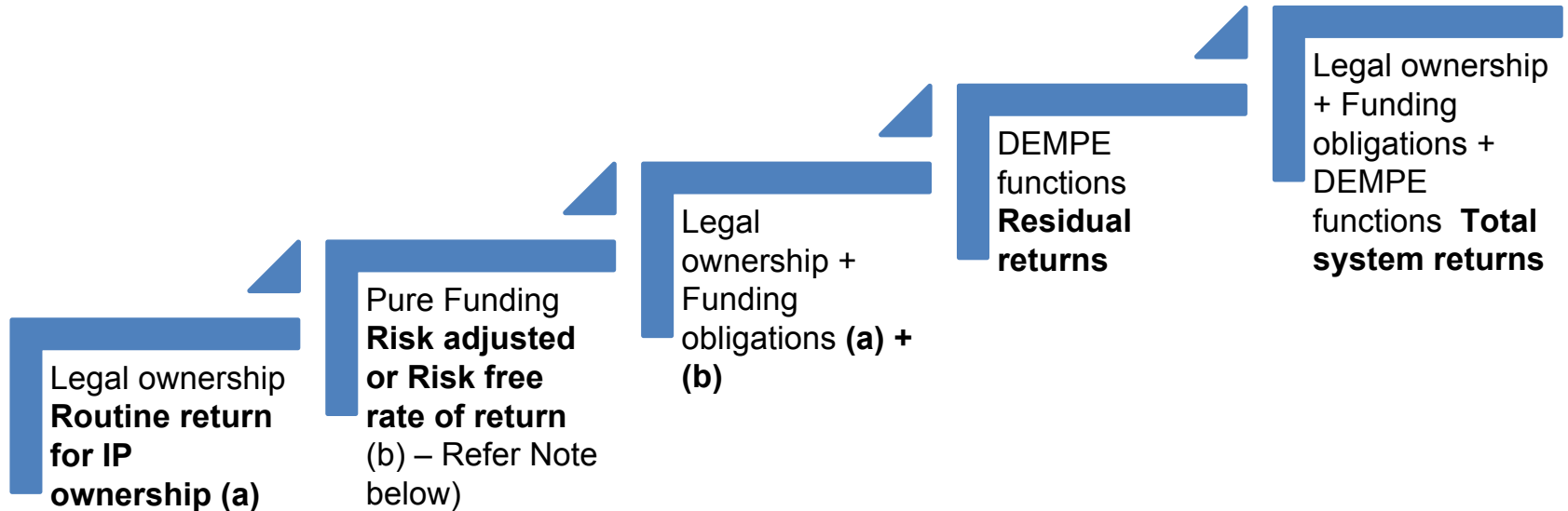
- Guidelines provide an inclusive list of unique features of Intangibles which may prove crucial in comparability analysis: **ALP**
 - Extent and duration of legal protection;
 - Geographic scope;
 - Useful life;
 - Stage of development;
 - Expectation of future benefits
- **Application of CUP method considering the above comparability factors – third party transactions data from databases is unlikely to have these details**
- One sided analysis or methods such as TNMM or RPM may not provide sufficient basis to evaluate the transaction
- Consider options realistically available to both the parties:
 - Though the financial outcome of one party alone should not influence the arm's length principle
- Rules of thumb cannot be used to evidence that a price or an apportionment of income is at arm's length, including in particular an apportionment of income between a licensor and a licensee of intangibles

Increased application of profit split method / valuation techniques may be observed in relation to transactions involving intangibles

Guidance on use of Valuation techniques

- Valuation techniques are considered relevant in cases where reliable comparables cannot be identified;
- The OECD Guidelines do not provide a comprehensive summary of valuation techniques available nor does it endorse or reject any valuation standards utilized by valuation professionals;
- Provides caution to consider the valuation undertaken for
 - Accounting purpose (since the same may reflect conservative assumptions)
 - Purchase Price Allocation purposes
- Valuation based on the cost of development discouraged;
- Reference made to Discounted Cash Flow Method and its variations, though areas of concern highlighted such as:
 - Accuracy of financial projections;
 - Assumption regarding growth rates;
 - Discount rates;
 - Useful life of intangibles;
 - Assumption regarding taxes

Return entitlement



Note

- Funder that takes certain financial risks and exercises control is entitled to Risk Adjusted Rate of Return
- Funder that does not control financial risk should be entitled to no more than a risk-free financial return

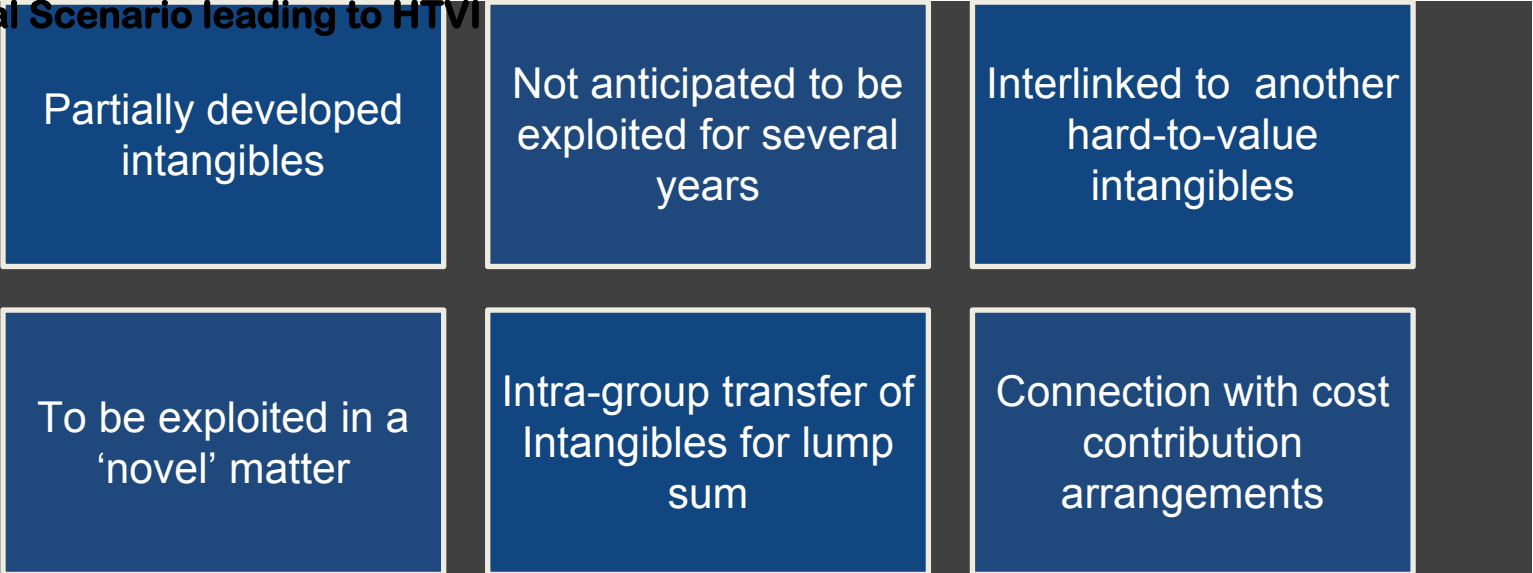
Hard to value intangibles: Concept

What are Hard to Value Intangibles (HTVI)?

Intangibles or rights in intangibles for which at the time of transfer between associate enterprises:

- (i) No reliable comparables exist; and
- (ii) Projections for future cash flow / income or assumptions used in valuation are highly uncertain

Typical Scenario leading to HTVI



Hard to value intangibles: Key Considerations

In case of HTVI, tax administration can consider 'ex-post' (actual) outcome as presumptive evidence about appropriateness of the 'ex-ante' (anticipated) pricing agreements

Information symmetry



Tax authorities have lesser insight than businesses, may use ex-post outcomes in later years to impose price adjustments

Exemptions



Reliable evidence on ex-ante calculations, including how risks were accounted for in calculations & appropriateness of consideration of foreseeable events



Bilateral or multilateral advanced pricing agreements

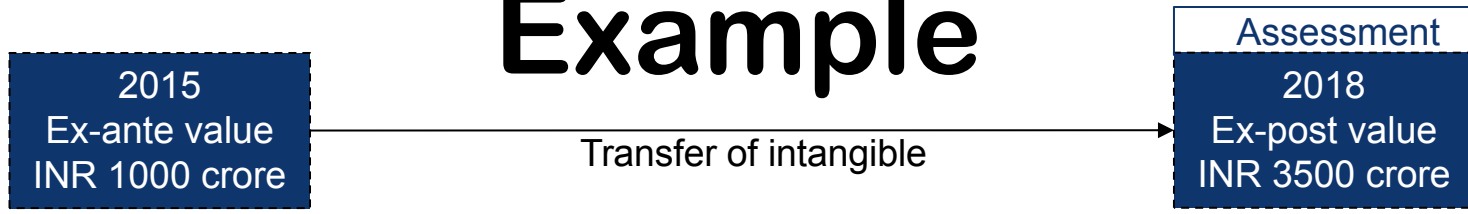


Ex-post outcome of compensation within 20% plus / minus of ex-ante calculations



5 year look-back period, with variation in actuals and projections not greater than 20% of projections

Hard to value intangibles: Example



Difference of valuation due to **anticipated** reasons?

No

Yes

No adjustment to be made

Adjustment can be made

Substantiate following:

- Provide full details of ex-ante projections
- Provide satisfactory evidence that significant difference are due to unforeseeable or extraordinary developments or subsequent events

Key application areas:

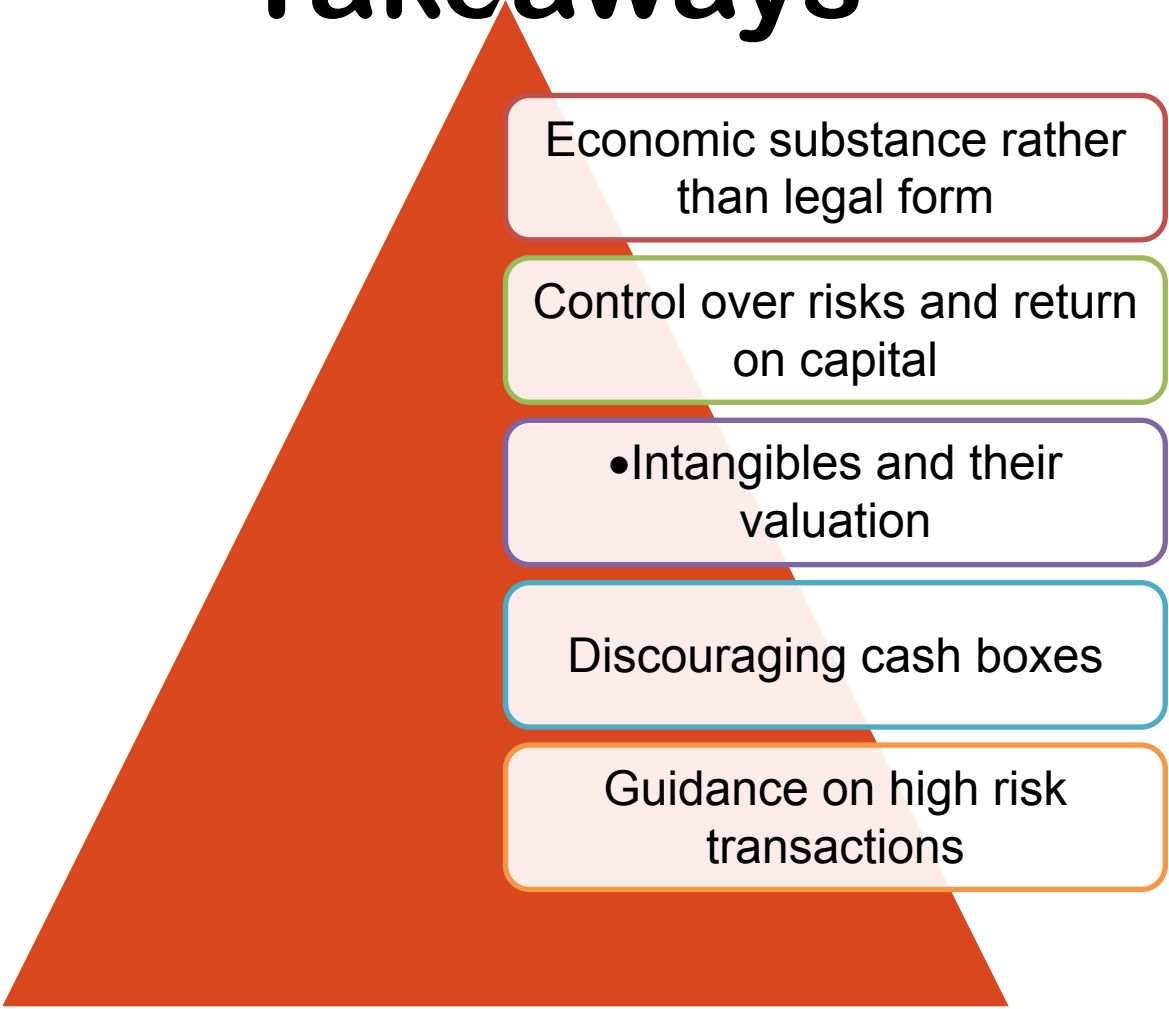
- Pharma drugs / chemical compounds under development
- Oil and Gas exploration
- Novel products / applications such as E-wallets, learning applications etc.
- Price adjustments also observed in third party scenario

FAR vs Actual data: Role of CbCR Data

Tax Jurisdiction	Name (Main Business)	Revenue	PBT	Head count
India	HQ Co.	100,000	15,000	2,000
India	R&D Co.	6,000	2,000	500
India	Trading Co.	50,000	5,000	2
USA	Manufacture Co.	40,000	(1,000)	1,000
Netherlands	Finance Co.	26,000	18,000	6
Bermuda	IP Owner Co.	28,000	20,000	1
UAE	Trading Co.	38,000	23,000	2
	Consolidated		82,000	

More data available in the hands of tax office to validate FAR!

Actions 8 - 10: Key Takeaways



Economic substance rather than legal form

Control over risks and return on capital

- Intangibles and their valuation

Discouraging cash boxes

Guidance on high risk transactions

Success of BEPS

G20 Finance Ministers have welcomed BEPS recommendations

Ultimate success dependent on implementation by each country

Success of BEPS

Each country's tax rules need to change to align with BEPS recommendations

Political considerations of each country will play a significant role

India Perspective

India perspective (1/2)

A. Income-tax Act, 1961:

- No specific amendments in Transfer Pricing provisions under the Income-tax Act, 1961 post recommendations in Action Plan 8 of BEPS

B. Circulars:

- Pursuant to Circular No. 06 / 2013 dated 29 June 2013, CBDT has directed the revenue authorities to examine functional and risk characterization of Contract R&D centres based on the conduct of the parties;
- Guidance provided by CBDT is largely in line with recommendations in Action Plan 8 of BEPS

C. Judicial precedents:

- In the past, the recommendations given in Action Plans of BEPS project of OECD have been considered in the following rulings by Indian courts:
 - ITAT, Delhi Bench, in case of Deputy Commissioner of Income-tax, Circle-13(1), New Delhi v. Noble Resources & Trading India (P.) Ltd. [2016] 70 taxmann.com 300

India perspective (2/2)

- ITAT, Mumbai Bench, in case of Syngenta India Ltd. v. Deputy Commissioner of Income-tax- 1 (3), Mumbai [2017] 77 taxmann.com 220

D. Areas for consideration:

- Action Plan 8 – 10 will have persuasive value but it will be interesting to see how Indian tax authorities and Indian courts take into consideration the guidelines provided under Action Plan 8 – 10;
- Interplay between GAAR and transfer pricing (being a SAAR) remains to be seen

Marketing Intangible / AMP - Concept

Advertisement

Marketing

**Sales
Promotion**

- In case of MNCs, brand is owned by one entity but is exploited across the group;
- Group entities incur AMP expenses in their jurisdiction which results into two-fold benefits:
 - Direct Benefit – Increase in sales of such entities;
 - Indirect Benefit – Enhances value of the brand

Whether AMP activities by Group entities amount to Brand Building and be considered as contribution to DEMPE?

Guidance on Marketing Intangible

- **OECD TP Guidelines:**
 - Recognizes such indirect brand building;
 - Entities performing functions of ‘Development, Enhancement, Maintenance, Protection & Exploitation’ of intangible (“DEMPE”) should be compensated;
 - Provides framework for identifying DEMPE (Para 6.34)
- **UN TP Manual:**
 - Recognises marketing intangibles;
 - Such local marketing activities may result into ‘unique and valuable intangible’ distinct from foreign owned brand;
 - Provides for significance of DAEMPE and its FAR analysis
 - ‘A’ stands for acquisition of intangible

Marketing intangible – India

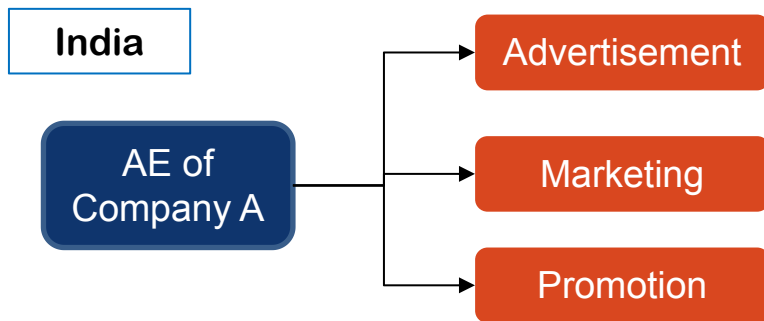
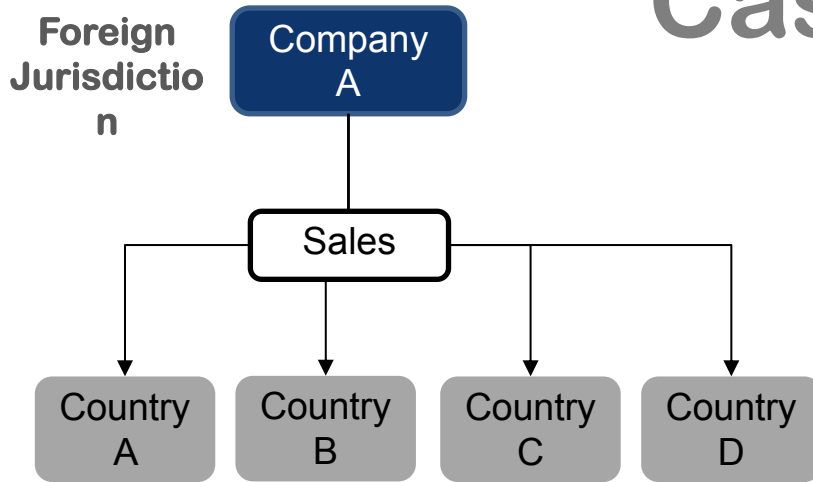
perspective

- AMP expenses incurred by Indian entity considered as ‘international transaction’ – Transaction in the nature of ‘provision of service’ under section 92B of the Income-tax Act, 1961
- Tax department take view that AMP expenses incurred by Indian entity leads to creation of marketing intangible for foreign entity owning the brand name, use ‘Bright-line test’ as yardstick
- **Main issue on compensation model for marketing activity** - compensated as a service provider (i.e. for providing promotional services) or whether share of return attributable to the marketing Intangible Property (IP) - **DEMPE?**
- Adopting the ‘significant people functions’ approach in determining the economic owner of intangibles
- Instances of compensation sought with a mark-up on entire AMP expenses.

Tax department is likely to draw inference and support from OECD guidelines in determining the return from intangibles

Marketing Intangible

Case Study



Facts:

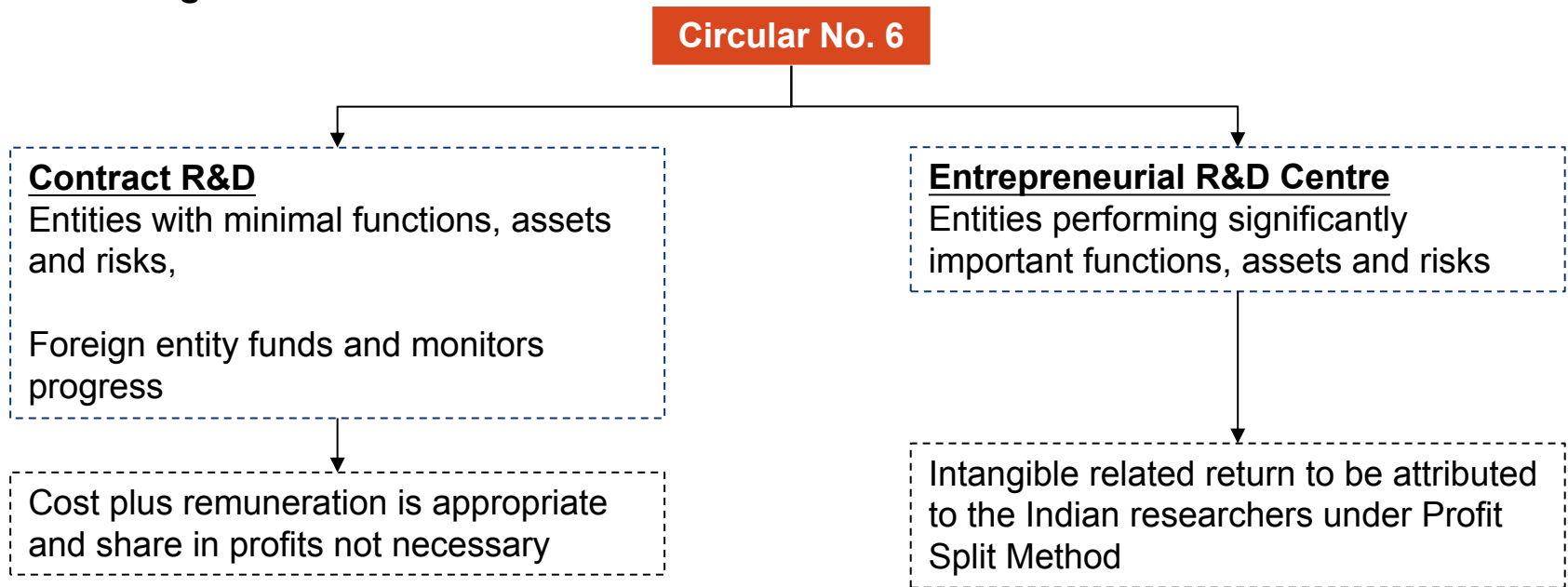
- Company A (registered owner of the brand) sells its products in several countries including India;
- The brand is well known in all countries except India;
- To create brand awareness in India, Indian entity (distributor) incurs substantial advertisement, marketing and promotion (AMP) expenditure which is higher than what a similarly placed distributor is expected to incur;
- Indian entity may be regarded as having economic ownership in brand in relation to Indian market based on DEMPE functions undertaken by it;
- After few years, Company A decides to sell the brand to a third party

Whether any portion of sale consideration from sale of brand by Company A should be apportioned to AE of Company A in India?

R&D arrangements

R&D arrangements

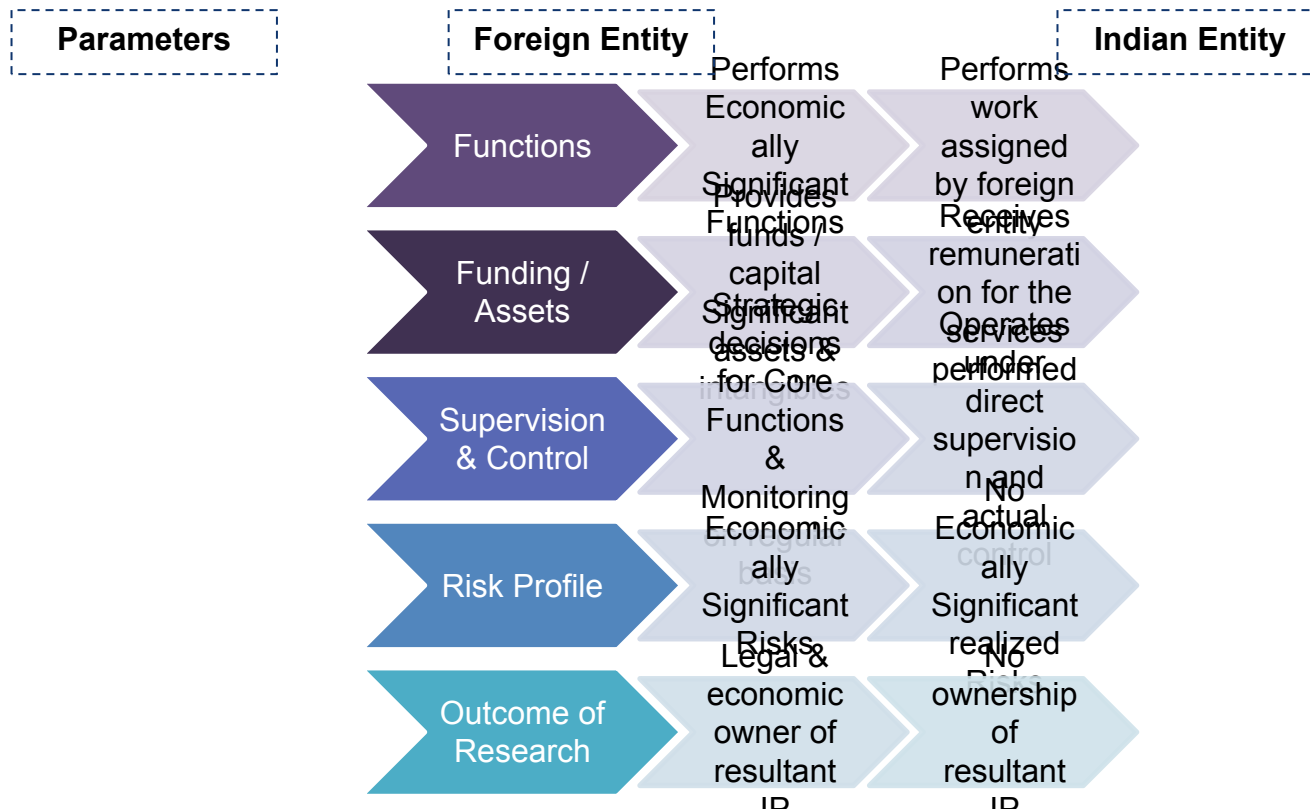
- Even before the introduction of the BEPS action plan, the Indian Revenue authorities issued Circular no. 6 which discusses circumstances in which profit split method will apply for determination of compensation in case of R&D centers developing intangibles



Focus of Circular 6 and Action Plan 8 on same aspects: “Performance of critical / important functions” and “Control over Risks”

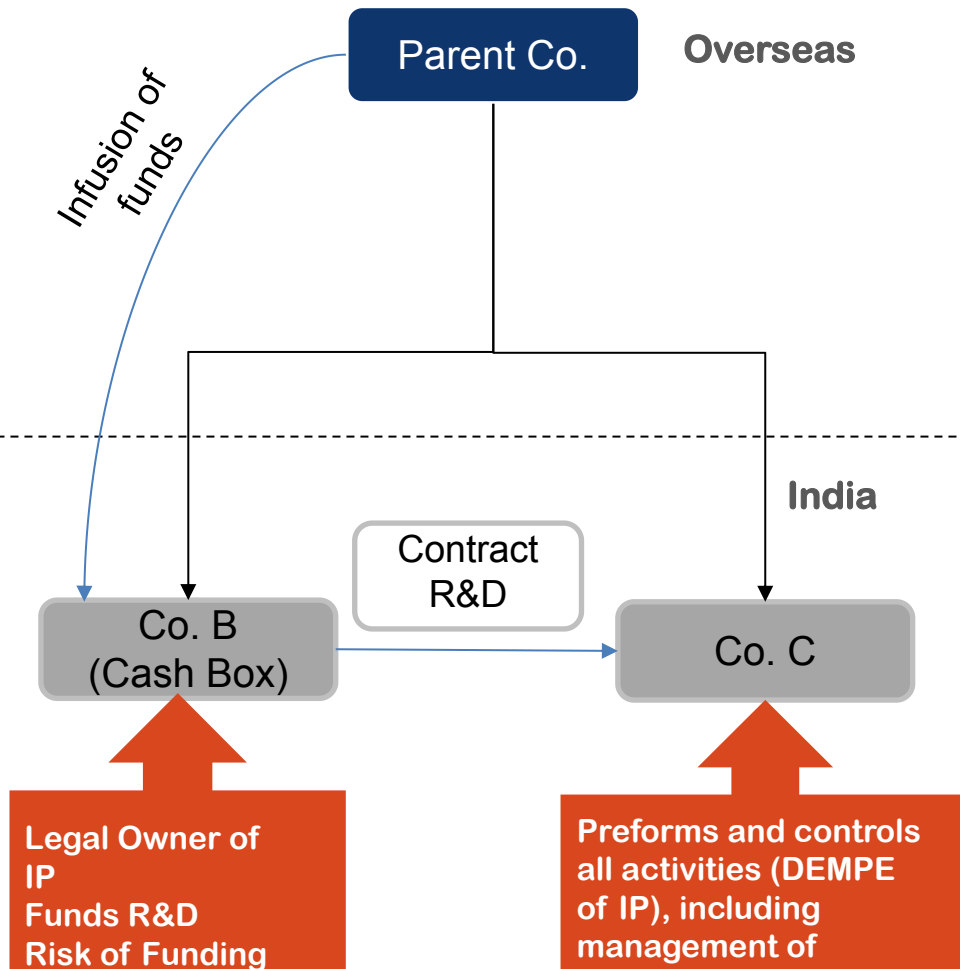
Circular 6: Contract R&D

Conditions to be met by Indian development center to be considered as contract R&D service provider with insignificant risk:



In the case of a foreign principal being located in a country / territory widely perceived as a low or no tax jurisdiction, it will be presumed that the foreign principal is not controlling the risk. However, the Indian Development Centre may rebut this presumption to the satisfaction of the revenue authorities.

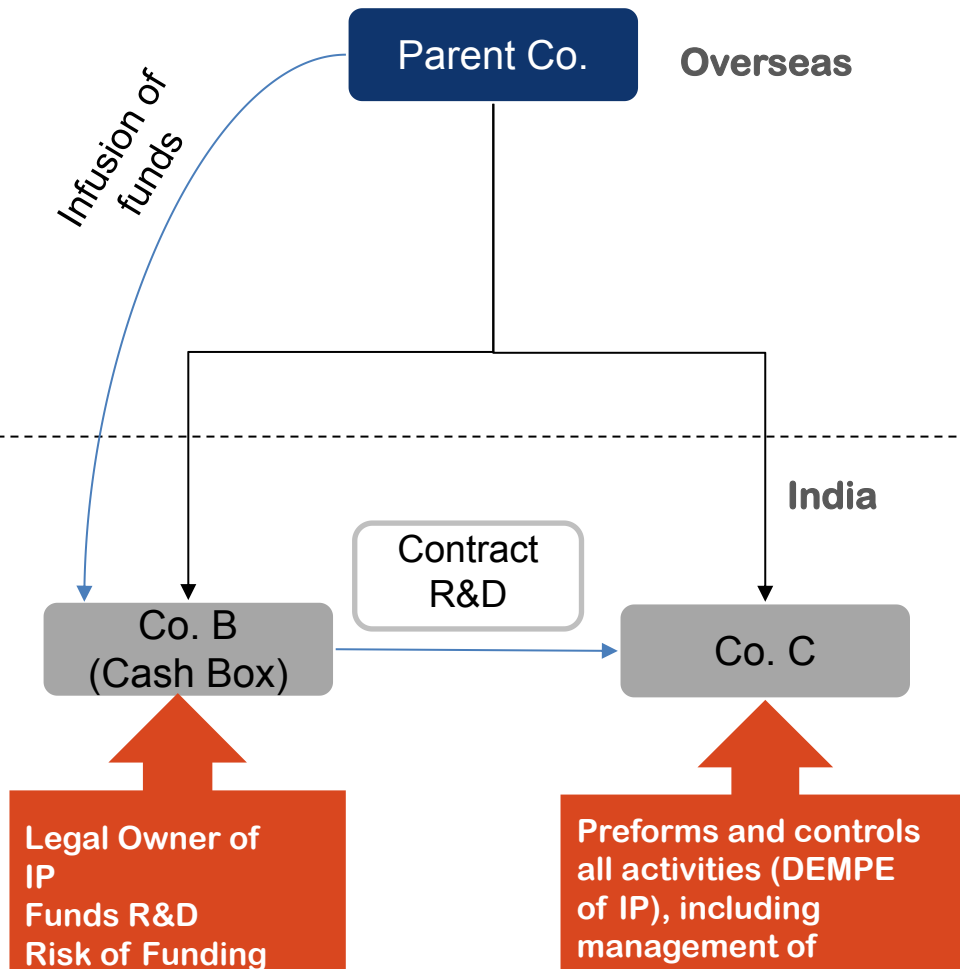
Cash Box – India Impact (1/2)



BEPS

- BEPS affirms that capital rich entities without relevant economic activities (“**cash-boxes**”) will not be entitled to any excess profits
- Three scenarios possible:
 - No management of funding risk – Entitlement to no more than risk free return
 - Management of funding risk – Entitlement to risk adjusted return
 - Management of funding and operational risk – Not a cash box and hence Intangible related return

Cash Box – India Impact (2/2)



India Impact

- Investment in India through “cash-boxes” may trigger non cost-plus outcomes;
- Indian subsidiary performs and controls all DEMPE functions including risk management;
- From the routine return currently received by Indian Subsidiary, they would now be entitled to a significant allocation of profits;
- Guidance in BEPS akin to Circular No. 6/2013 issued to classify the Contract R&D centres of overseas MNEs and R&D centres bearing insignificant risks

Way Forward

Questions we should be thinking about...

Illustrative questions:

- Does your definition of intangibles extend beyond legal or accounting definitions?
- Do you plan the transfer of any (further) intangibles?
- Can you demonstrate that key value drivers are controlled by the Principal and its IP licensor?
- Do you have entities performing high-value functions being remunerated as service providers to IP owners?
- Do you derive key benefits from an operating structure that relies on group synergies – e.g. centralized purchasing?
- Do you have inter-company transactions where one or both parties uses intangibles in connection with the sale of goods or provision of services?

Way Forward

More emphasis on substance and functions rather than contractual allocation of risks and rewards

Review existing structure and transfer pricing policies

Map the FAR of entities in terms of the overall value chain

Undertake robust documentation to demonstrate substance

Glossary (1/2)

Sr. No.	Abbreviation	Full Name
1	AE	Associated Enterprise
2	AMP	Advertisement, Marketing and Promotion
3	BAPA	Bilateral Advance Pricing Agreement
4	BEPS	Base Erosion and Profit Shifting
5	CbCr	Country-by-country reporting
6	CBDT	Central Board of Direct Taxes
7	CCA	Cost and Contribution Agreement
8	CFC	Controlled Foreign Corporation
9	CUP	Comparable Uncontrolled Price
10	DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
11	EU	European Union
12	FAR	Functions, Assets and Risk
13	GAAR	General Anti-Avoidance Rule
14	HTVI	Hard-to-value Intangibles
15	IP	Intangible Property

Glossary (2/2)

Sr. No.	Abbreviation	Full Name
16	ITAT	Income-tax Appellate Tribunal
17	LOB	Limitation of Benefit
18	MAP	Mutual Agreement Procedure
19	MLI	Multilateral Instrument
20	MNE	Multinational Enterprise
21	OECD	Organization for Economic Cooperation and Development
22	PE	Permanent Establishment
23	POEM	Place of Effective Management
24	R&D	Research and Development
25	RPM	Resale Price Method
26	SAAR	Specific Anti-Avoidance Rule
27	TNMM	Transactional Net Margin Method
28	TP	Transfer Pricing
29	UN	United Nations
30	VAT	Value Added Tax
31	WHT	Withholding tax

Thank you



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