

Issues in Transfer Pricing



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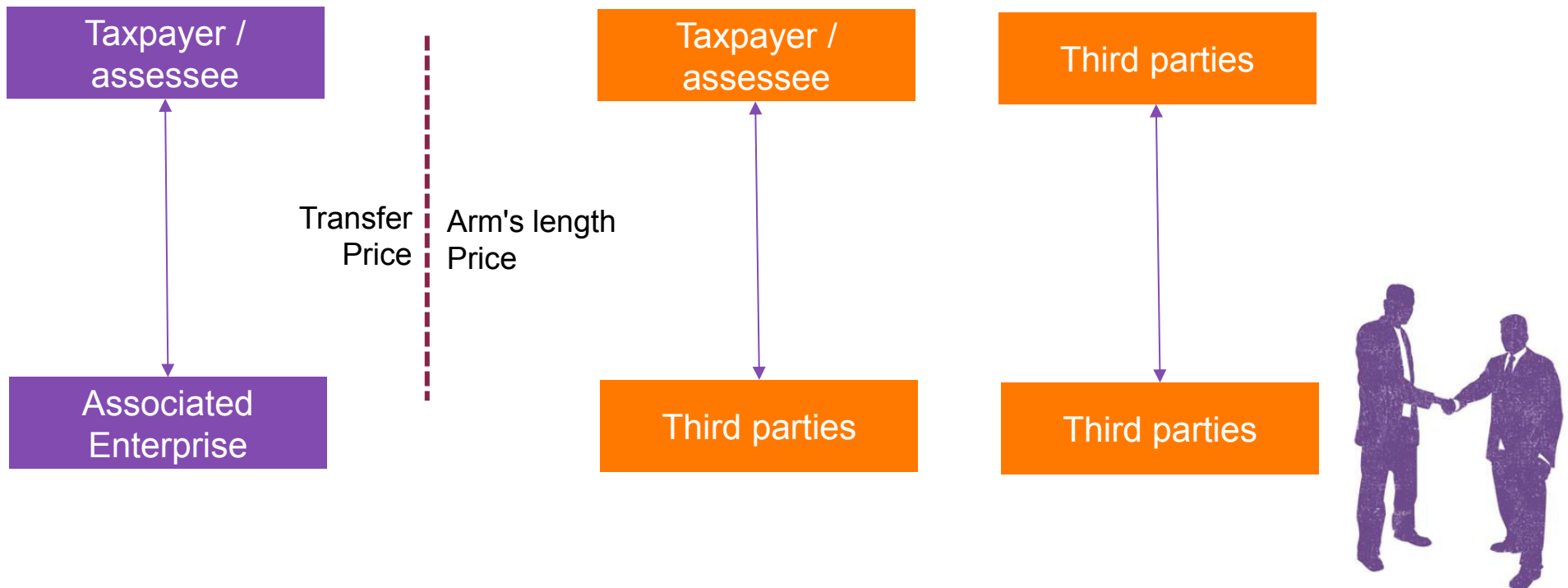
Transfer Pricing to Pharma Industry



Transfer Pricing - Basic

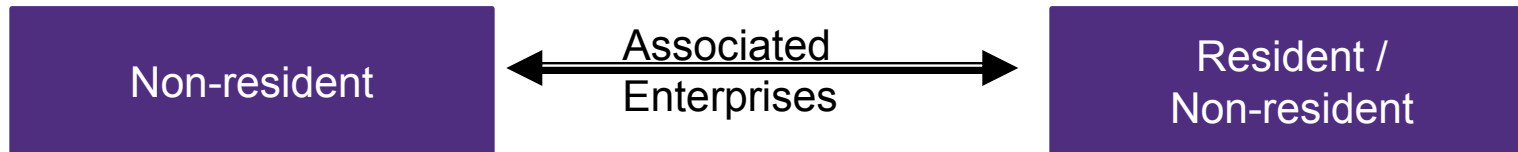
Transfer pricing – a quick background

- **Transfer Pricing** in India introduced with effect from April 1, 2001
- Any international transaction undertaken between associated enterprises would be subject to transfer pricing regulations
- The term “international transaction” is widely defined to cover almost all kinds of transactions
- Domestic TP applicable if aggregate value of specified domestic transactions (“SDT”) exceeds INR 20 crores from AY 2017-18



International Transaction

- The term “**international transaction**” is widely defined to cover almost all kinds of transactions



- Associated Enterprises**



- One enterprise participates **directly** or **indirectly** or through one or more intermediaries in the **management** or **control** or **capital** of the other enterprise;

OR

- Where **one or more persons (same person or persons)** participate directly or indirectly or through one or more intermediaries in the management or control or capital in both the enterprises

- The term “enterprise” is defined expansively in section 92F(iii) of the Act to mean a person (including a permanent establishment of such person)
- The term “person” is defined in section 2(31) of the Act

Compliance requirements



Transfer Pricing Documentation:-

- Under Section 92D of the Act every person entering into an international transaction and specified domestic transactions is required to maintain Transfer Pricing Documentation in support of their international transactions and specified domestic transactions
- Transfer Pricing Documentation is mandatory if the **aggregate value** of all international transactions exceeds **one crore rupees** and **domestic TP** exceeds **twenty crore rupees from FY 2016-17 onwards**

Accountant's Report in Form 3CEB

- Every person who enters into any **international transaction** (irrespective of value of international transactions) and **Domestic TP** (if exceeds Rs. 20 crore) has to maintain **Form 3CEB** which has to be certified by Chartered Accountant

Country-by-Country Reporting and Master File

- The new law passed on Finance Act 2016 aligns domestic legislation with BEPS Action 13 by way of introducing **Country-by-Country (CBC) Reporting** and **Master File**



Recent Developments in Transfer Pricing

Recent developments – Country-by-Country Reporting

- The Organisation for Economic Co-operation and Development (**OECD**) had launched an initiative in July 2013 to address Base Erosion and Profit Shifting ('BEPS'), which was endorsed by G20 countries
- It included 15 key areas for identifying and curbing aggressive tax planning and practices and modernizing the international tax system
- Pursuant to such initiative, on 5 October 2015, the OECD issued a final package of reports to address BEPS, as well as a plan for follow-up work and a timetable for implementation thereof
- BEPS Action 13 sets out a **three-tiered standardised** approach to TP documentation which consists of the following:-
 1. Country-by-Country Reporting ("CbCR");
 2. Master File ("MF"); and
 3. Local File
- Many countries have already adopted or are poised to adopt changes to their international tax systems based on OECD recommendation

Country-by-Country Reporting

- In India, the Finance Act 2016 introduced provisions with respect to CbCR and MF
- The Central Board of Direct Taxes (CBDT) released draft rules providing guidelines regarding CbCR and MF and timeline for furnishing the relevant information
- On 31 October 2017, the **CBDT** introduced much awaited **final rules governing furnishing of CbCR, MF** and timelines
- The Indian CbCR rules are largely in line with OECD's Action 13 whereas customised rules placed for MF
 - Rule 10DA for MF: Laid down the thresholds for applicability, timelines, requirements and procedures of MF
 - Rule 10DB for CbCR: Laid down the thresholds for applicability, timelines, requirements and procedures of CbCR

Country-by-Country Reporting

- The threshold limit for CbCR & MF:-

Master File	Country by Country Report
<p>The <u>consolidated group revenue</u> of the international group for the immediately preceding previous year <u>exceeds INR 500 crores</u>; and</p> <p>I. The <u>aggregate value of the international transactions</u> exceeds <u>INR 50 crores</u>; or</p> <p>II. The <u>aggregate value of international transactions</u> involving <u>intangible goods</u> exceeds <u>INR 10 crores</u></p>	<p><u>Consolidated group revenue</u> exceeds <u>INR 5,500 crores</u> in the <u>immediately preceding previous year</u></p>

- The rate of exchange for conversion shall be the telegraphic transfer buying rate of such currency which is rate adopted by State Bank of India (SBI) for buying currency

Contents of MF

Master File

Part A

Basic Details of (CE)

To be filed by all CEs of International Group, resident in India (even if Rule 10DA(1) not satisfied)

Part B

Exhaustive Details of International Group

- Organization structure
- Description of MNE's business
- MNE's Intangibles
- MNE's intercompany financial activities
- MNE's financial and tax positions

To be prepared by entities which meet the thresholds as per Rule 10DA(1)

Contents of CbCR

PART A: OVERVIEW OF ALLOCATION OF INCOME, TAXES AND BUSINESS ACTIVITIES BY TAX JURISDICTION

<i>Name of the Multinational Enterprise group:</i>										
<i>Reportable accounting year:</i>										
<i>Currency used:</i>										
<i>Tax Jurisdiction</i>	<i>Revenues</i>			<i>Profit(Loss) before Income Tax</i>	<i>Income Tax Paid (on Cash Basis)</i>	<i>Income Tax Accrued – Reportable Accounting Year</i>	<i>Stated Capital</i>	<i>Accumulated Earnings</i>	<i>Number of Employees</i>	<i>Tangible Assets other than Cash and Cash Equivalents</i>
	<i>Unrelated Party</i>	<i>Related Party</i>	<i>Total</i>							

PART B: LIST OF ALL THE CONSTITUENT ENTITIES OF THE MULTINATIONAL ENTERPRISES GROUP INCLUDED IN EACH AGGREGATION PER TAX JURISDICTION

<i>Name of the Multinational Enterprise group:</i>															
<i>Fiscal year concerned:</i>															
<i>Tax Jurisdiction</i>	<i>Constituent entities Resident in the Tax Jurisdiction</i>	<i>Tax Jurisdiction of Organisation or Incorporation if Different from Tax Jurisdiction of Residence</i>	<i>Main Business Activity (ies)</i>												
			<i>Research and Development</i>	<i>Holding or Managing Intellectual Property</i>	<i>Purchasing or Procurement</i>	<i>Manufacturing or Production</i>	<i>Sales, Marketing or Distribution</i>	<i>Administrative, Management and Support Services</i>	<i>Provision of Services to Unrelated Parties</i>	<i>Internal Group Finance</i>	<i>Regulated Financial Services</i>	<i>Insurance</i>	<i>Holding Shares or other Equity instruments</i>	<i>Dormant</i>	<i>Other</i>

* Addition of new business activity from earlier draft rules

Advance Pricing Agreement

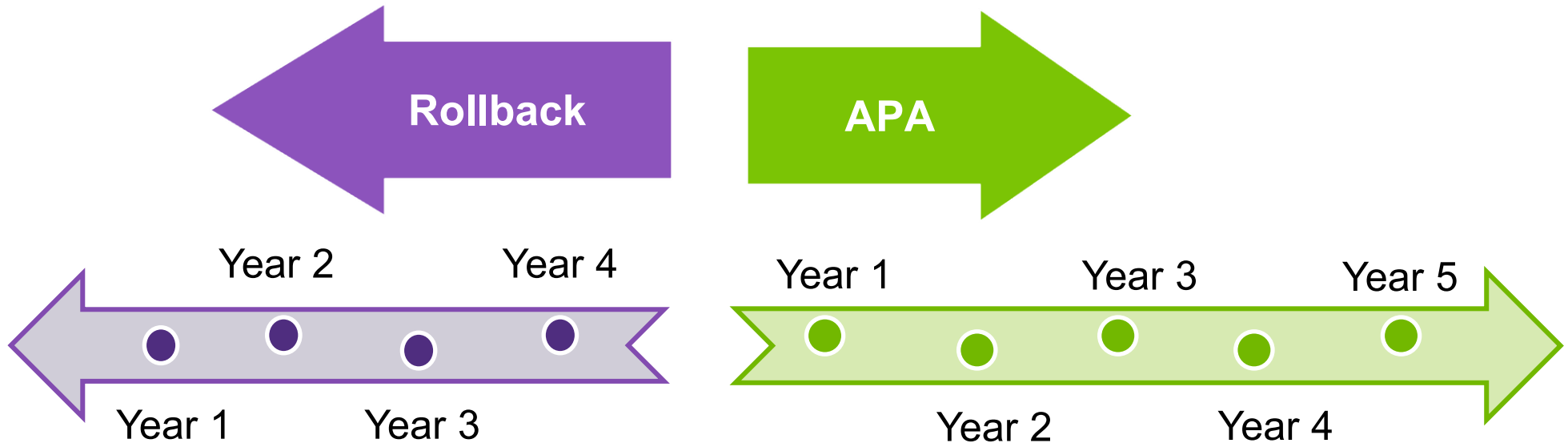
- APA is an arrangement between the taxpayer and the revenue authorities in respect of determination of pricing or determination of methodology to ascertain the pricing of international transaction/s with an aim to mitigate potential transfer pricing disputes.
- APA provisions were introduced in India w.e.f. from 1 July 2012.

Advance	sets transfer pricing (TP) in advance
Pricing	establishes arm's length transfer pricing policy for a specified period of time
Agreement	between the taxpayer and one/more national tax authority agree

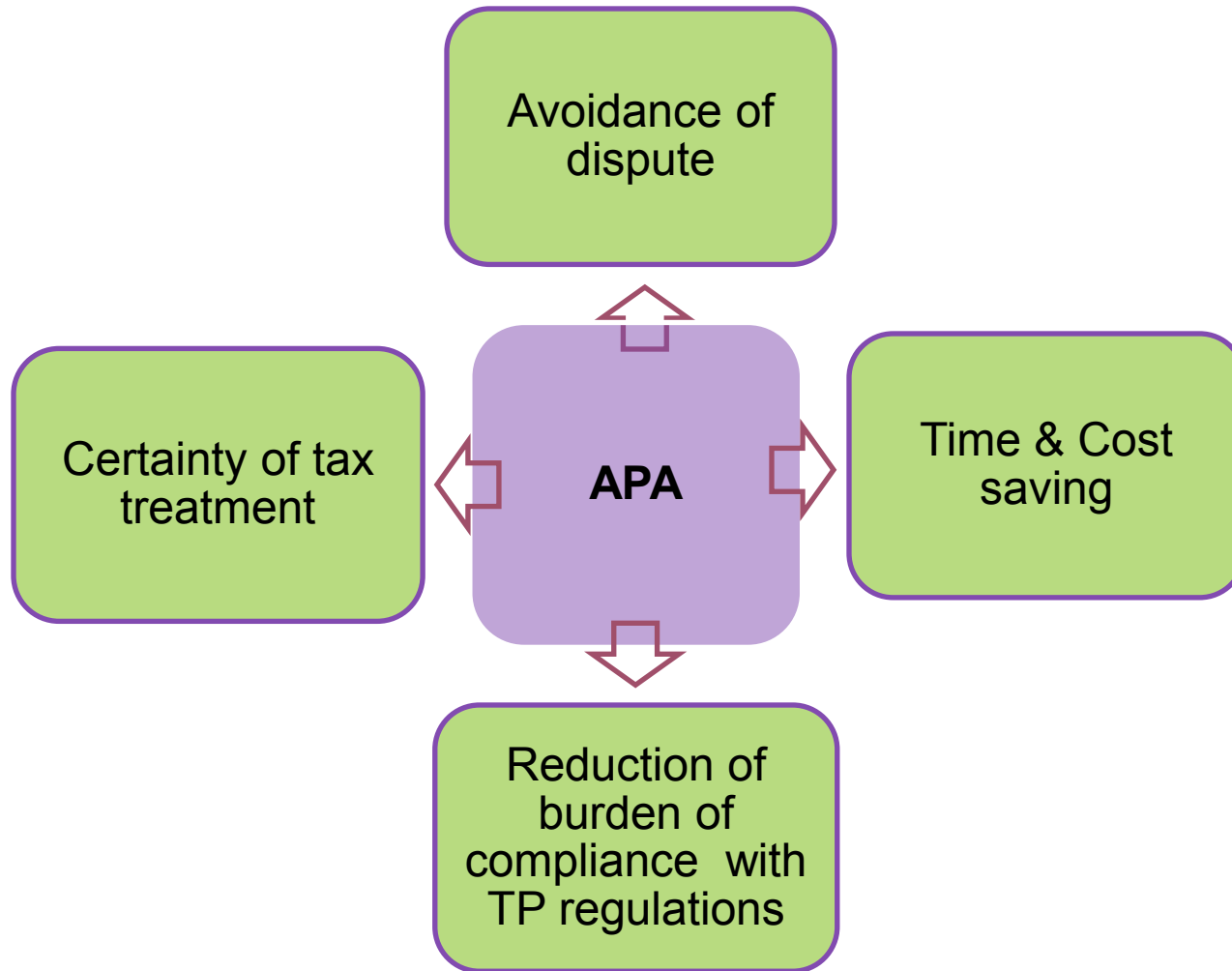


Advance Pricing Agreement

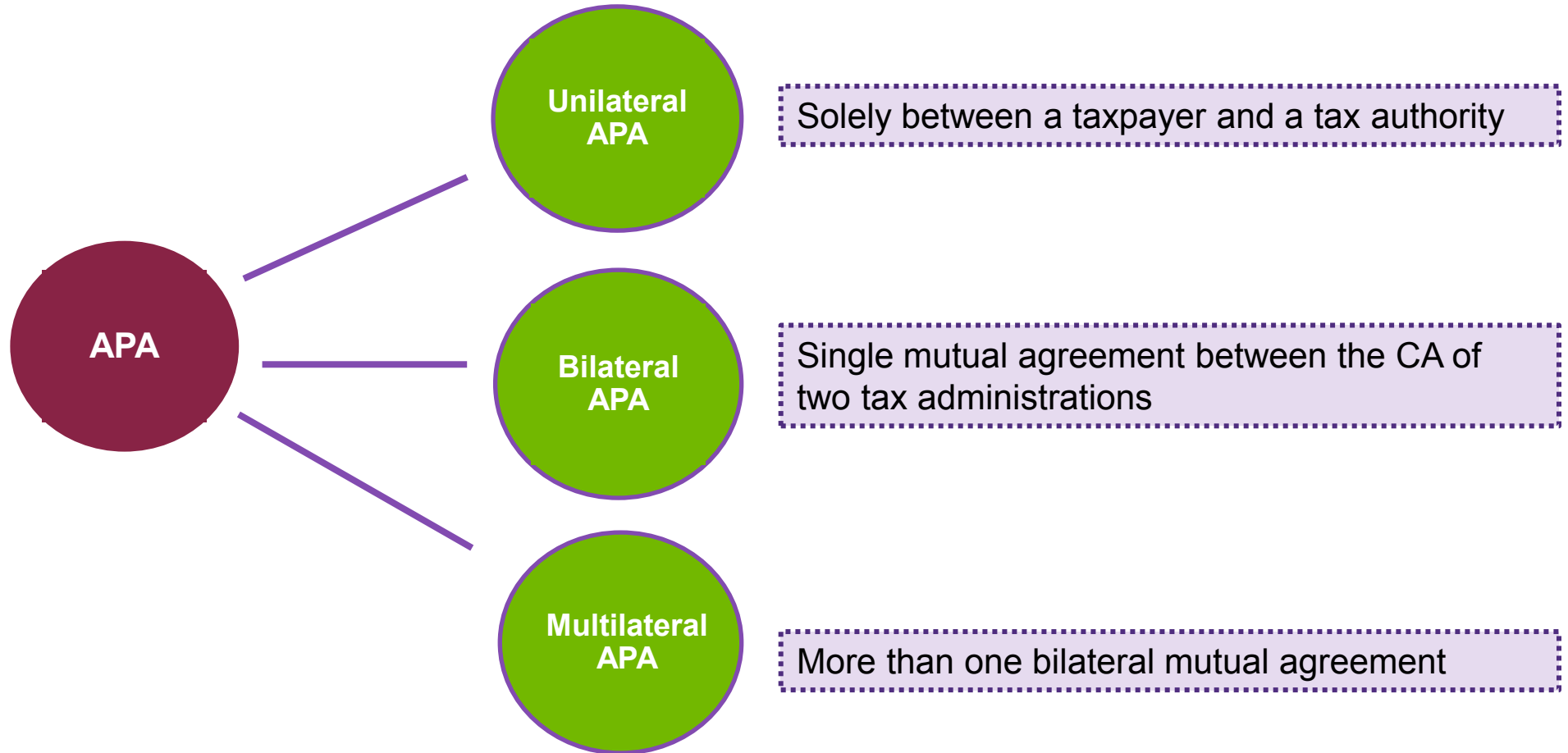
- Rollback provisions were introduced in year 2014 to provide certainty on the pricing of international transactions of 4 preceding years



Advance Pricing Agreement - Advantages



Advance Pricing Agreement - Types

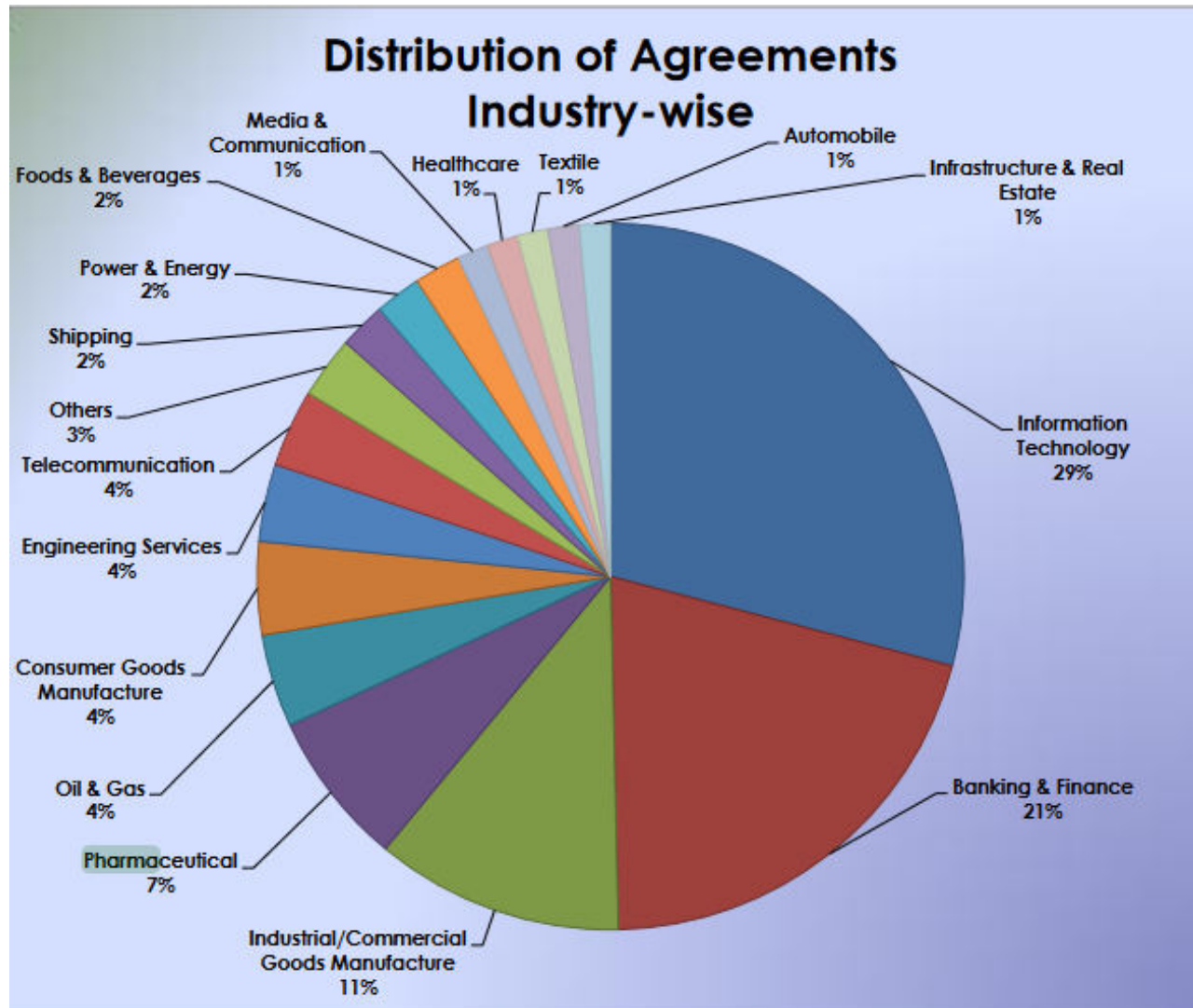


Advance Pricing Agreement – Distribution of Agreement

Economic Activity	Number of agreement signed	
	UAPA	BAPA
Service	102	4
Manufacturing	34	2
Trading	1	5
Diversified	4	1
Total	141	11

Source: <https://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/161/Advance-Pricing-Agreement-01-05-2017.pdf>

Advance Pricing Agreement – Detailed industry



Source: <https://www.incometaxindia.gov.in/Lists/Latest%20News/Attachments/161/Advance-Pricing-Agreement-01-05-2017.pdf>

Safe harbour provisions

- Law introduced in India in Finance (No.2) Act, 2009
- The Finance (No. 2) Act, 2009 introduced the provisions in the Income Tax Law that empowered the Central Board of Direct Taxes (CBDT) to issue transfer pricing Safe Harbour Rules.
- In August 2013, the CBDT released draft safe harbor rules for public comment
- On 18 September 2013, the CBDT issued the final Safe Harbour Rules
- A “safe harbor” is defined as circumstances in which the tax authorities shall accept the transfer price declared by the taxpayer
- CBDT on 7 June 2017 revised the Safe Harbour Rules by relaxing the rates and making few other prominent changes
- The revised safe harbour provisions are applicable for 3 years starting from AY 2017-18
- For the first year AY 2017-18, an eligible taxpayer has been granted an option to opt for safe harbor parameters whichever is more beneficial

Safe harbour - Rates

Eligible International Transaction	Revised Safe Harbour Rules From FY 2016-17 to FY 2018-19	
	Threshold (INR)	Mark-up / Rates
Provision of contract R&D services relating to generic pharma drugs	< 200 Crores	not less than 24 % of operating expense
Providing corporate guarantee	NA	not less than 1% p.a.
Receipt of low value adding intra group services	Upto INR 10 Crore including mark-up	<ul style="list-style-type: none"> • 5% mark-up; and • Cost pooling method, exclusion of shareholders cost, duplicate costs and reasonableness of allocation keys is certified by an accountant.

Safe harbour - Rates

Eligible International Transaction	Revised Safe Harbour Rules From FY 2016-17 to FY 2018-19	
	Threshold	Rates
Advancing of intra-group loans (INR)	One year marginal cost of funds lending rate of SBI as on 1st April of relevant previous year plus:	
	CRISIL rating between AAA to A or its equivalent	175 basis points
	CRISIL rating of BBB-, BBB, BBB+ or its equivalent	325 basis points
	CRISIL rating of BB to B or its equivalent	475 basis points
	CRISIL rating between C & D or its equivalent	625 basis points
	<ul style="list-style-type: none"> • Credit rating is not available, and • Amount of loan does not exceed INR100 crores as on 31 March of relevant previous year 	425 basis pints
Advancing of intra-group loans (Forex)	6 month LIBOR interest rate as on 30th September of relevant previous year plus:	
	CRISIL rating between AAA to A	150 basis points
	CRISIL rating of BBB-, BBB, BBB+	300 basis points
	CRISIL rating of BB to B	450 basis points
	CRISIL rating between C & D	600 basis points
	<ul style="list-style-type: none"> • Credit rating is not available, and • Amount of loan does not exceed equivalent of INR100 crores as on 31st March of relevant previous year 	400 basis points

Safe harbour provisions

- Benefits of safe harbour rules:-
 - Certainty in tax position
 - Advance information or knowledge about the range of profits or prices to qualify for the safe harbour
 - Elimination of the possibility of litigation between the taxpayers and the revenue authorities
 - Ease in compliance
 - Reduction in compliance cost
- Challenges in safe harbour rules:-
 - Defining the eligibility
 - Computation of operating profits
 - Compliance burden
 - Risk of double taxation
 - Excludes taxpayers transacting with low tax or no tax countries
 - Approval process and subjectivity in approvals



Transfer Pricing to Pharma Industry

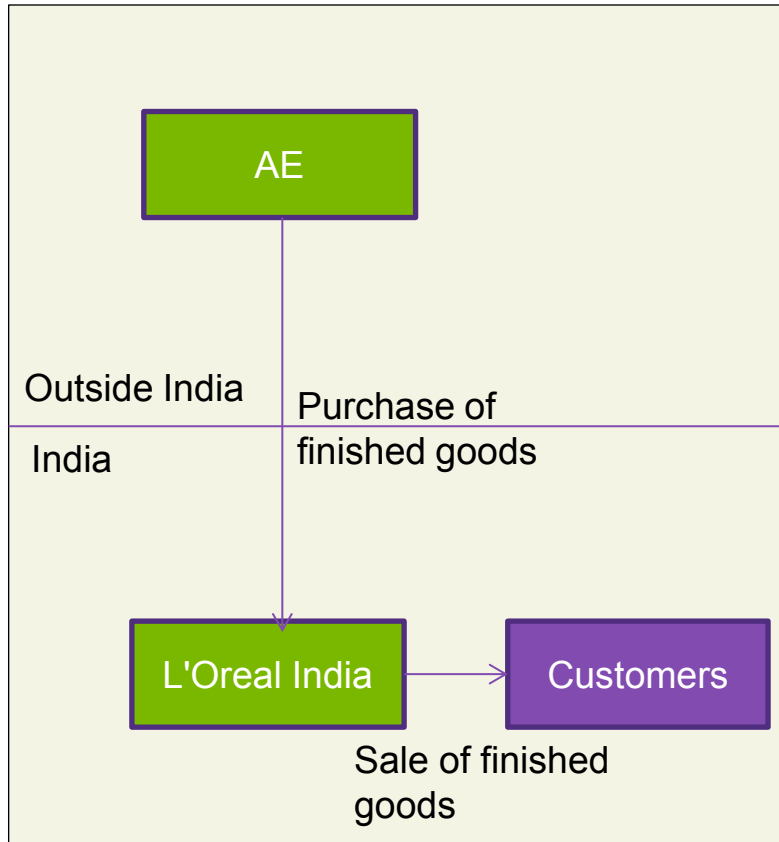
Typical FAR of Pharma Industry



Functions	Assets	Risks
<ul style="list-style-type: none"> – Research & Development – Procurement – Manufacturing – Primary & Secondary – Inventory Management – Quality control – Advertising / Marketing – Sales – Ordering and distribution – Invoicing and collection – Administrative, Financial and Legal Matters 	<ul style="list-style-type: none"> - Tangible Assets (e.g Building, Plant & Machinery, etc.) - Intangible Assets : Technical (Know-how) : Marketing (Brand name) 	<ul style="list-style-type: none"> – Market risk – Product liability risk – Inventory risk – Technology risk – Research and development risk – Credit risk – Foreign exchange risk – Manpower risk – General business risk

Judicial Precedent – L`Oreal India Pvt. Ltd

ITO vs. L`Oreal India P. Ltd



Facts of the case

- L'Oreal India is engaged in the business of manufacture and distribution of cosmetics and beauty products.
- L'Oreal India had two business (i) manufacture and (ii) ***distribution***.
- L'Oreal India adopted RPM to benchmark its international transaction pertaining to purchase of finished goods for distribution in India.



TPO's Contention

- The TPO rejected the RPM adopted by L'Oreal India, on the grounds that L'Oreal India's pricing policy is not at arm's length since it is consistently incurring losses.
- He proposed an adjustment by applying TNMM
- The TPO also observed that the comparable's gross margins cannot be relied upon because of product differences, and that the FAR comparison of L'Oreal India vis-à-vis comparable companies is sufficient only for application of TNMM and not RPM.

CIT's Contentions

- The CIT(A) deleted the entire addition made by the TPO and considered taxpayer's contentions
- Reliance was placed on the OECD guidelines and guidance note issued by ICAI.

ITAT Judgment

- The Tribunal agreed with the CIT(A) that there is no order of priority of methods to determine ALP.
- The Tribunal observed that RPM, being one of the standard methods, is the most appropriate method for distributing and marketing activities when the goods are purchased from AEs and resold to unrelated parties.
- The Tribunal also noted that this view was supported by OECD guidelines.

Judicial Precedent



The main grounds before the High Court and its verdict are as under:

Whether the Tribunal erred in holding that RPM was the most appropriate method for determining ALP in respect of imports of finished goods

There no distinguishing features were noted, the Tribunal did not err in holding that RPM was the most appropriate method for determining ALP in respect of imports of finished goods.

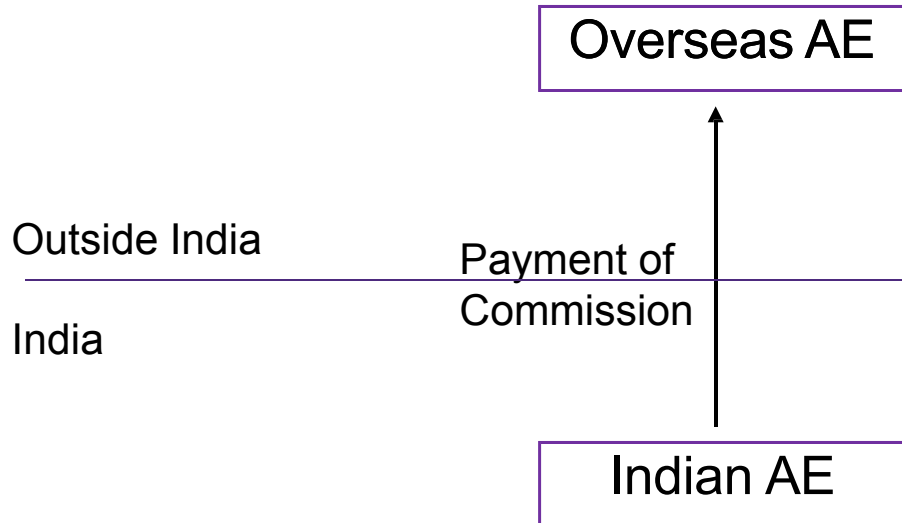
Whether the Tribunal erred in not appreciating that the substantial value addition made to the goods has changed the degree of similarity in the functions performed thereby making RPM non applicable in the instant case

The High Court observed that the Tribunal, in its order, has noted that RPM can be adopted 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. The same view is also supported by OECD guidelines and accordingly, the Tribunal did not err in holding that RPM is the most appropriate method for the international transactions in respect of import of finished goods.

Payment of Commission



Entities Involved



Functions

- Marketing outside India of products manufactured by Indian AE - canvasser
- Manufacturing of formulations
- Distribution of products in and outside India directly to the customer

Payment of Commission

Issue

- Evaluation of commission transaction separately required as the same is not closely connected to other transactions;
- If no direct documentary evidence to demonstrate services rendered could be disallowed;
- Commission percentage more than 3-5% scrutinized;

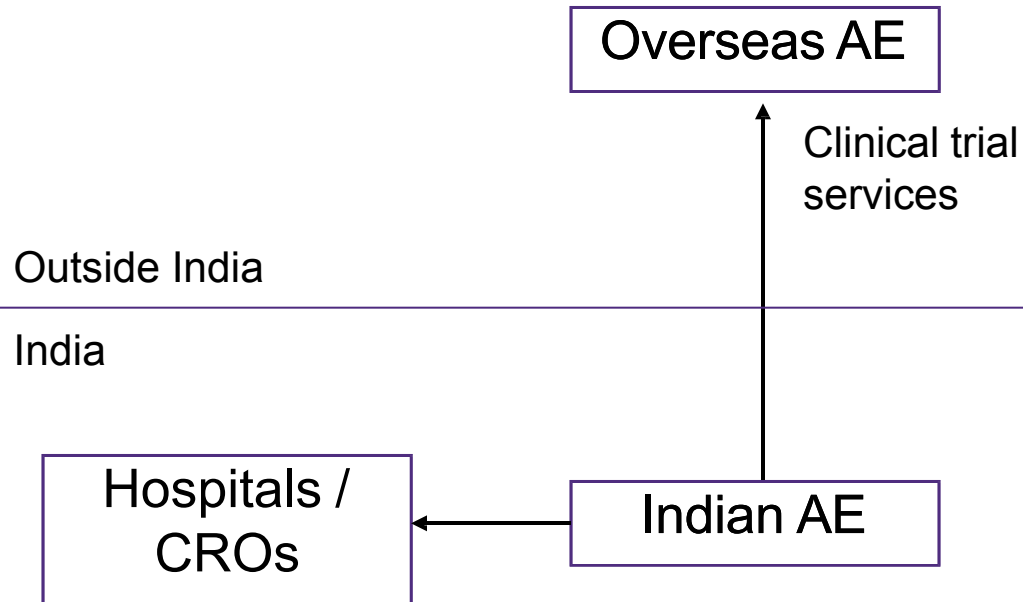
Documentary Suggestions

- Documentary evidences like copy of agreement, marketing material, letters from overseas AE, CA Certificate / Bank Realization Certificates, etc. should be maintained;
- Demonstrate tangible benefits;
- Demonstrate that marketing in India is routine and not non-routine

Documentary evidence very crucial

Clinical Trial Support services

Entities Involved



Functions / Risks

- Manufacturing
 - Marketing
 - Primary R&D including clinical
-
- Co-ordinates with hospital and CROs
 - payment to hospitals / CROs

Issue

- High mark up comparables selected by TPO without carrying out appropriate FAR as to whether Indian AE does actual clinical trials or only acts as coordinator;
- Difficulties arise in identifying appropriate comparable companies
- Charges mark-up even on pass through cost

Documentary Suggestions

- Role may vary from mere facilitation/co-ordination v/s responsibility for the completion of the trials;
- Risk associated with failure of product development primarily assumed by AE;
- Service being procured from a third party – pass through cost;
- Demonstrate pass through cost is pure reimbursement

Demonstrate the functional dissimilarity of comparables

Contract R&D and Contract Manufacturing Services



- Contract research vs. co-developing drugs with foreign partners based on revenue sharing models
- Relatively high mark-ups insisted by the revenue – with adjustment for location savings
- Difficulty in identifying appropriate comparable companies;
- Publicly available information databases do not provide results of companies purely engaged in contract research activities
- Difficult to ascertain whether potential comparables are engaged in contract research, or are co-developing drugs with foreign partners based on revenue sharing models

Other Issues



- Product Analysis vis-à-vis basket of products approach
- Drugs Prices Control Order (DPCO)
 - Price control under the DPCO may cause product margins of pharmaceutical companies to come under pressure
 - Where the pricing of raw material inputs procured from associated enterprises is sought to be reviewed by the application of profit based transfer pricing methods, the identification of comparable companies entails challenges
- Distribution
 - Start-up losses
 - Use of profit level indicator (Gross margin vs net margin)

Key Takeaways



- Need for proactive and robust CUP analysis. Mere reliance on the reason of difference in quality not sufficient for rejection of CUP
- Commercial justification to be built on to source APIs from AEs vis- à-vis third parties
- Need to have a detailed licensing agreement where trademark/brand is involved taking care of possible imputation of royalty
- FAR very crucial to defend the transaction and determination value and non-value additions
- Strong and robust economic analysis with supporting documentation along with business rationale
- Cost-benefit analysis vital
- Internal CUPs preferred over external CUPs

Way forward

- Be Proactive - not reactive - consider APA?
- Adopt Coordinated and centralized approach.
- Involve operational teams in tax and TP planning and documentation process
- Holistic solutions – not fragmented responses
- Global awareness and vision – not myopic
- Harmonize TP documentation with other regulatory requirements





Questions