# Transfer Pricing – Looking at it from Pre and Post Pandemic Lens

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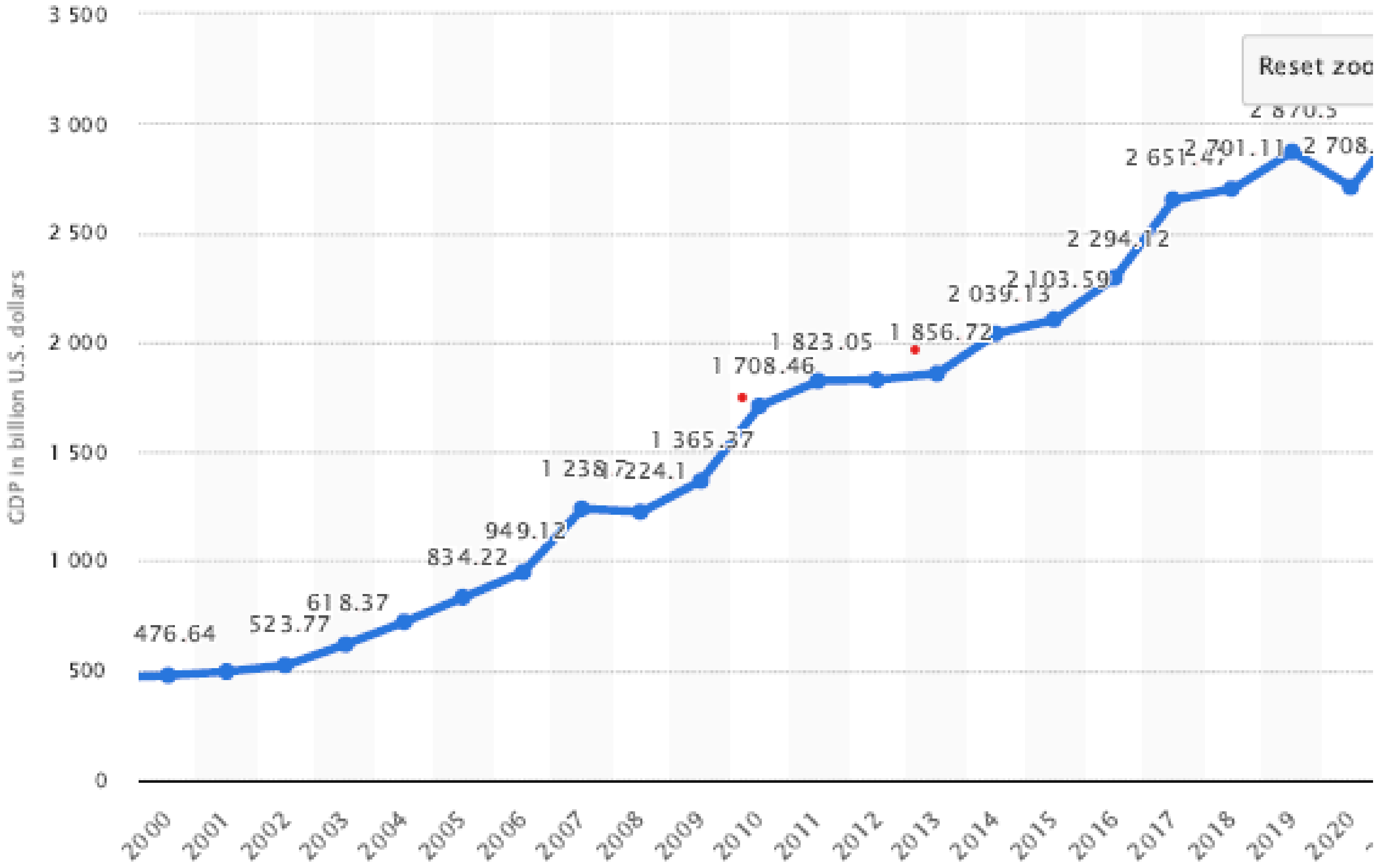
# An Incredible Growth Story

India's GDP (in current prices) since the introduction of Transfer Pricing Regulations in India (2001)




*Source: https://www.statista.com/statistics/263771/gross-domestic-product-gdp-in-india/*

# Transfer Pricing Basics

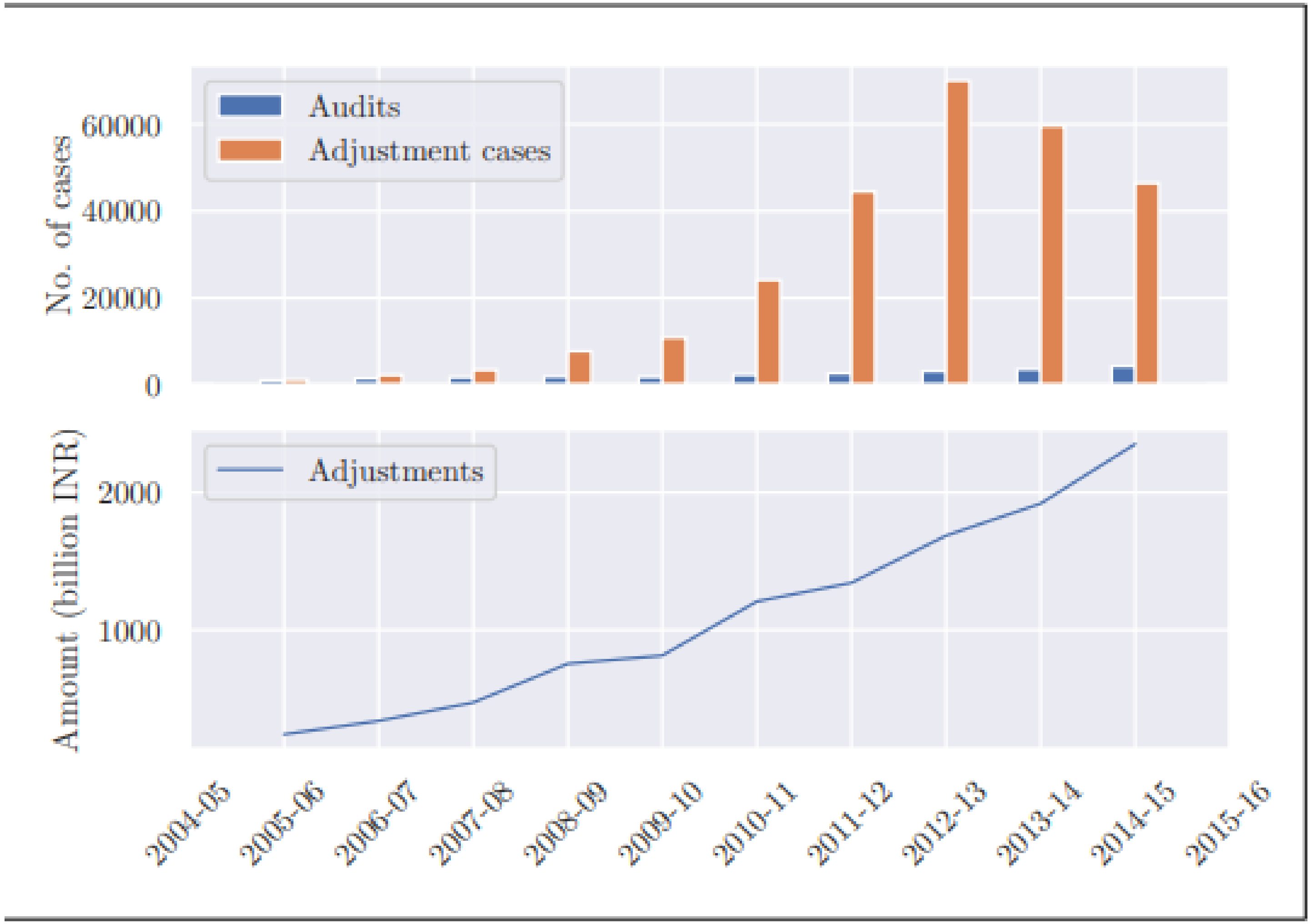
Chapter X [Section 92 – 92F]; Rule 10A – 10THD

- Scope – "Any income arising from an international transaction shall be computed having regard to the arm's length price" [Section 92]
- International transaction; Deemed international transaction [Section 92B] Specified Domestic Transaction [Section 92BA]
- ALP determination / Most appropriate Method [Section 92C and Rule 10B]
- Documentation (TP Report and Master File) [Section 92D; Rule 10D and Rule 10DA]
- Reporting Requirements [Section 92E – Form 3CEB]
- Reference to Transfer Pricing Officer [Section 92CA]
- Penalties [Section 271BA; Section 271AA; Section 271G; Section 270A]
- Advance Pricing Agreement [Section 92CC; Rule 10F to 10T and Rule 44GA]
- Safe Harbour Rules [Rule 10TA to Rule 10THD]
- CBDT Circulars and Instructions [Circular 6 of 2013 and Instruction 3 of 2016]

# Transfer Pricing – An Easy Target?

- Transfer Pricing - a subjective area
- India – Amongst countries having largest no. of TP disputes
- Governments have always been vocal about stepping up TP audit resources and homing in on cross-border transactions
- Pandemic has disrupted and further complicated the never simple world of TP

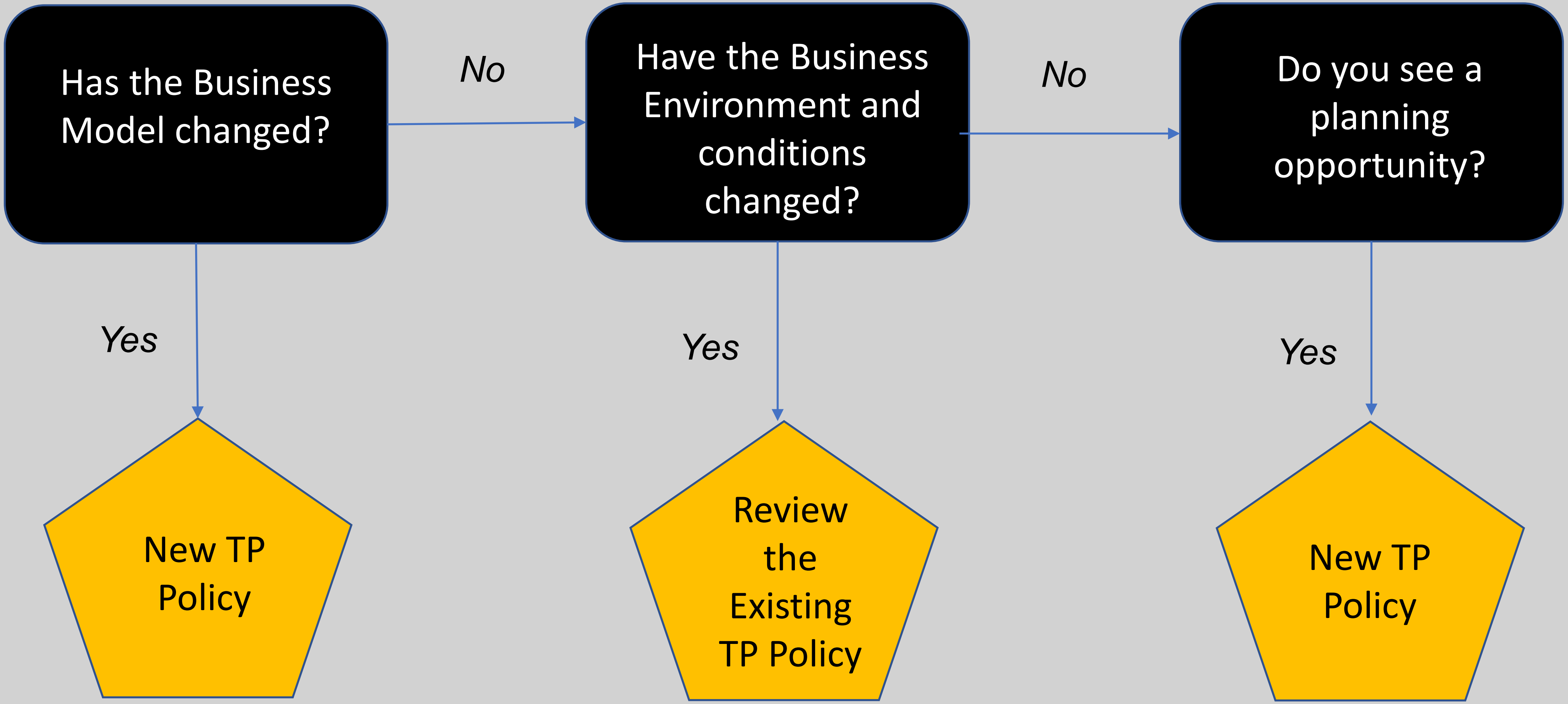
Figure 3: Audits and Adjustments




ource: Annual Reports of MoF, 2013-14 and 2014-15

# Impact of Pandemic on TP Analysis

# Changes Resulting from the Pandemic



# Guiding Principles for Reviewing / Changing the TP Policy

- TP policy (including selection of the most appropriate method and benchmarks) and intercompany contracts applied in an economic downturn "may" be different from those applied before the economic downturn

- Know your economic story – does it support the proposed review / change?

- Review existing intercompany arrangements and allocation of risks – do they support the change?

- During an economic downturn / conditions beyond control, "**Bargaining Theory**" is a more prevalent expression of the arm's length principle

- International Guidance – OECD / Guidance issued by various countries – Australia, Singapore, Malaysia, New Zealand and few others

# Possibilities while conducting TP Analysis

**<u>Possibility 1 - Most Appropriate Method remains unchanged</u>**

- Conduct a detailed Industry overview / industry impact analysis
- Revisit tested transaction / tested party’s underlying data - Do they include extraordinary / exceptional items?
- Revisit comparables search, quantitative and qualitative filters

# Possibilities while conducting TP Analysis

**Possibility 1 - Most Appropriate Method remains unchanged**

- Reconsider tested segment
  - Can tested party results be further segmented?
  - Should multiple transactions be bundled together or aggregated?
- Reconsider tested party
- Reconsider testing period – possibility of breaking down the testing period?
- Evaluate the need and possibility to adopt single year data within the most appropriate method

# Possibilities while conducting TP Analysis

**Possibility 2 - Most Appropriate Method is changed**

- Document the need for change in most appropriate method - **Consistency and good justification for switch is critical**
  - Unavailability / limited availability of comparable data
  - Survivor Bias resulting in higher arms length range
  - Change in FAR resulting from the impact of pandemic

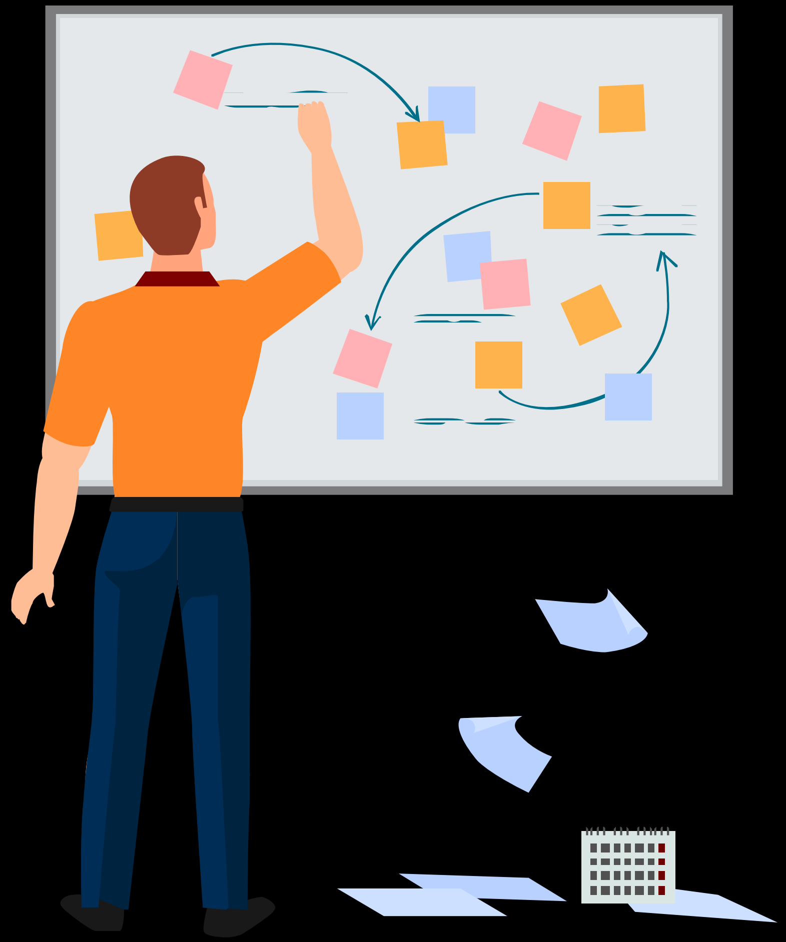
- Need to select a valid, appropriate transfer pricing method regardless of economic conditions

# Possibilities while conducting TP Analysis

**Possibility 2 - Most Appropriate Method is changed**

- Policies that provide low profits in strong economic environment and loss sharing in economic downturns may be challenged
  - Inconsistent without convincing logic behind the change
  - could be viewed as transfer pricing manipulation
- What happens to the method when the economy recovers – is it still the best method or would it merit changing again?
- Views of profit/loss split could vary across different taxing authorities

# Practical Considerations



# Case 1

# Case 1 – Distribution of Profits between Manufacturer and Limited Risk Distributor (LRD)

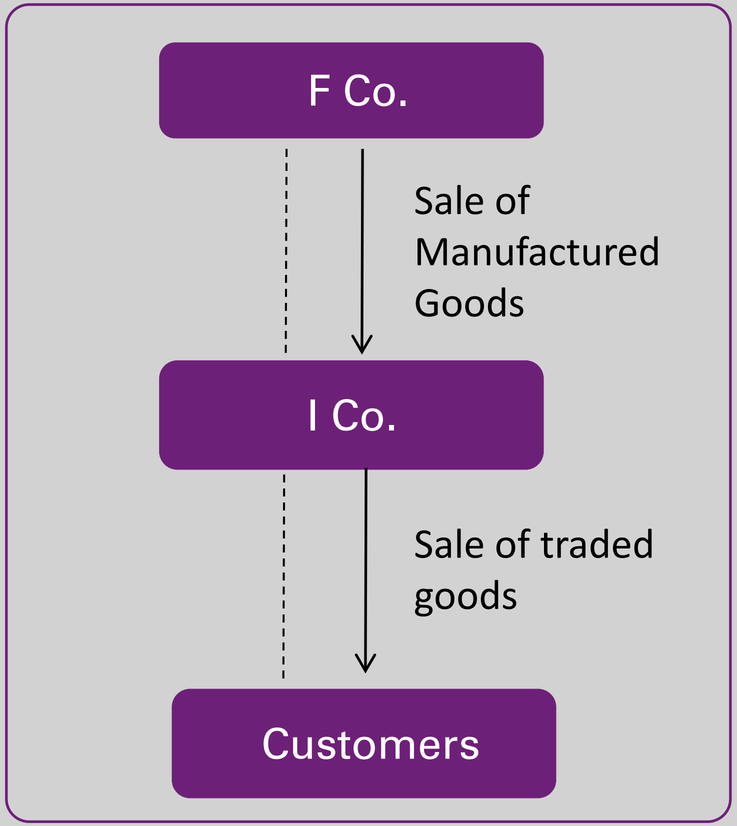
**Facts of the Case**

- F Co - Manufacturer in Country A
- I Co - Limited Risk Distributor in Country B

- Historical TP policy: LRD targets 2 percent Operating Margin

- During the Pandemic, there is a significant decline in sales and several exceptional costs incurred both by the Manufacturer (F Co.) and the LRD (I Co.) but manufacturer still compensates LRD in line with the historical TP Policy.

- Thus, while the group is loss making, the LRD continues to make profit and the group has a tax pay out.



# Case 1 – Distribution of Profits between Manufacturer and Limited Risk Distributor (LRD)

| | Combined Group | Manufacturer | LRD |
|---|---|---|---|
| Sales | 1000 | 580 | 1000 |
| COGS | (560) | (560) | (580) |
| SG&A costs | (480) | (80) | (400) |
| Profit/(Loss) | (40) | (60) | 20 |
| Tax at 30% | 6 | 0 | 6 |

# Case 1 – Distribution of Profits between Manufacturer and Limited Risk Distributor (LRD)

- Due to historical TP policies (aiming to reward limited risk operations with positive routine returns), some MNEs may incur losses at group level and yet have tax outflows

- Questions to be answered
  1. Can a historical TP policy be now modified with no change in FAR?
  2. Do the returns for routine functions and risks need always to be positive?
  3. What if the risk profile of the limited risk operator has changed in the current economic climate?

# Case 1 – Distribution of Profits between Manufacturer and Limited Risk Distributor (LRD)

**Solution #1: Modify TP policy to reduce LRD's target OM in line with benchmark range**

- Action: Perform an adjusted benchmarking analysis for routine distribution operations
- Impact: Reducing LRD's OM to say 1percent (a value within the benchmarking range) gives immediate cash savings

| Profit / (Loss) | Combined Group | Manufacturer | LRD |
|---|---|---|---|
| Under Historic TP Policy | (40) | (60) | 20 |
| Under Revised TP Policy | (40) | (50) | 10 |
| Tax at 30% | 3 | 0 | 3 |

# Case 1 – Distribution of Profits between Manufacturer and Limited Risk Distributor (LRD)

**Solution #2: Build a case for a breakeven or loss-making position for LRD**

- Feasible provided that the intercompany transaction reflects commercial (third-party) reality
- Easier to justify if LRD shares reduced/increased profitability *symmetrically* in economic downturns and upturns (Intercompany agreements would need to provide for adjusted returns in downturns and upturns)

| Profit / (Loss) | Combined Group | Manufacturer | LRD |
|---|---|---|---|
| Under Historic TP Policy | (40) | (60) | 20 |
| Under Revised TP Policy | (40) | (40) | 0 |
| Tax at 30% | 0 | 0 | 0 |

# Case 1 – Distribution of Profits between Manufacturer and Limited Risk Distributor (LRD)

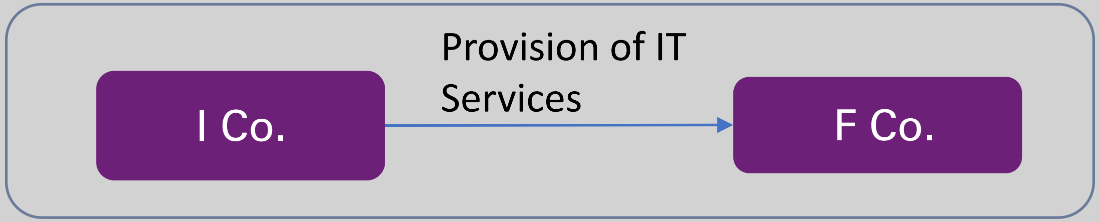
**Solution #3: Recharacterize the LRD as an "entrepreneur"**

- Feasible if supported by fact pattern
  - Distributor developing marketing intangibles
  - Distributor bearing market risk / having control over managing such risk

| Profit / (Loss) | Combined Group | Manufacturer | LRD |
|---|---|---|---|
| Under Historic TP Policy | (40) | (60) | 20 |
| Under Revised TP Policy | (40) | (30) | (10) |
| Tax at 30% | 0 | 0 | 0 |

# Case 2

# Case 2 – IT / ITeS and other Captive Services




**Facts of the Case**

- I Co is Limited risk captive entity engaged in providing IT / ITeS services on a cost-plus basis
- Pandemic has adversely impacted F Co. which has resulted in significant drop in revenues and lower economic activity
- Volume of work outsourced to I Co. has dropped and the ability of F Co. to pay has significantly reduced
- Meanwhile, I Co. has made investments to facilitate remote working of employees.

# Case 2 – IT / ITeS and other Captive Services

The various challenges faced by I Co. in this scenario are:

- Underutilization of resources
- Revision of mark-up?
- Comparability issues
- Treatment of incremental / exceptional costs and economic adjustments
- Delayed collections

# Case 2 – IT / ITeS and other Captive Services

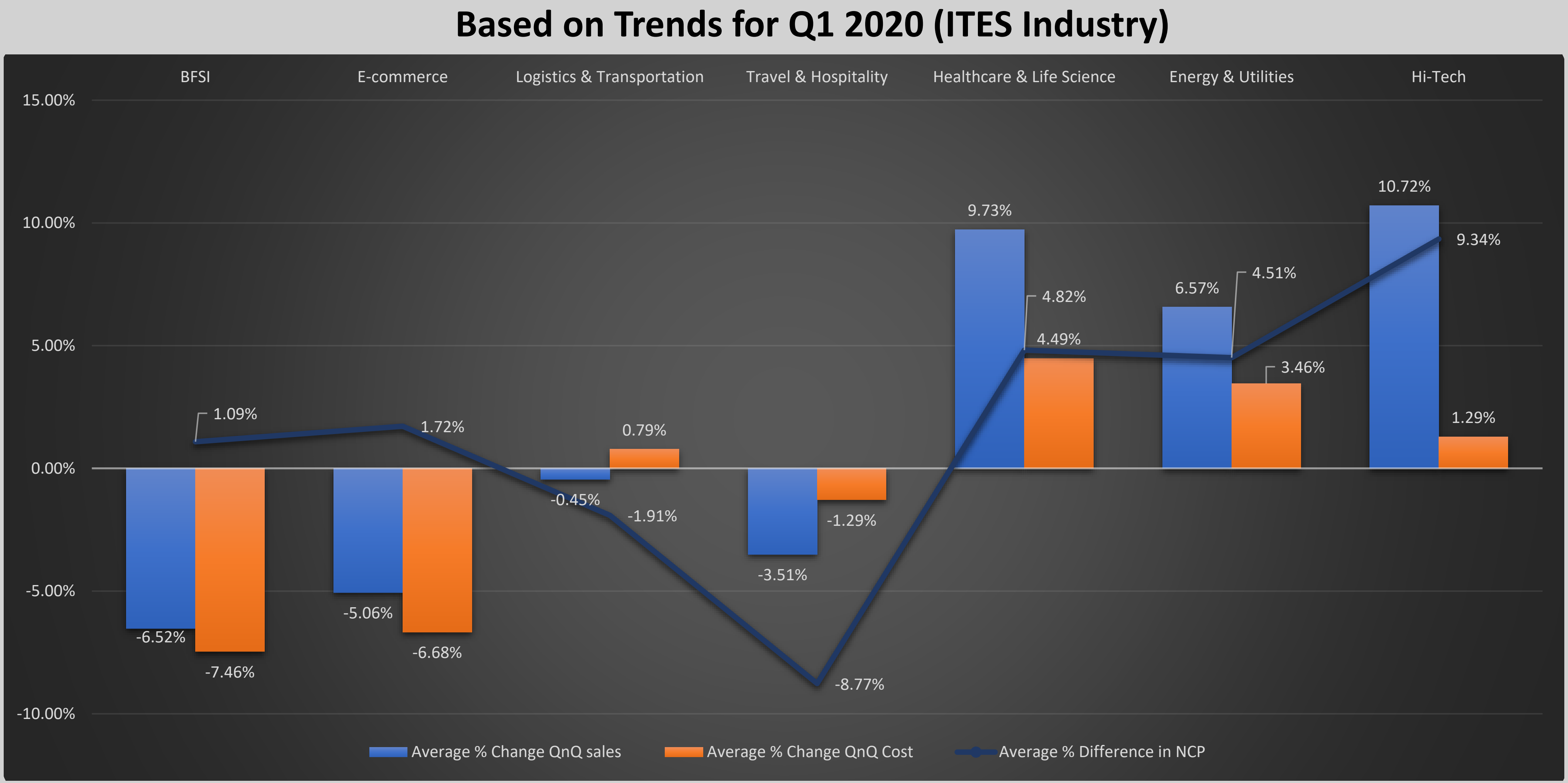
## Key Considerations

- Characterisation' considerations:
  - New risk assumed owing to the pandemic?
  - Characterisation in the pre- and post-pandemic periods
  - Change of mark-up without change in risk profile?
- Increased audit risk at HQ level in case of non-reduction?

## Preferred Approach

- Change in mark-up without altering risk profile, to be based on similar third-party behavior – for a short term
- Challenges in benchmarking with external data:
  - Contemporaneous data, multiple year vs single year data
  - Alternate data points - For example, industry trends, sectoral analysis, quarterly margin analysis, etc.
  - Should search become domain specific as different domains could be impacted differently?

# Case 2 – IT / ITeS and other Captive Services



# Case 2 – IT / ITeS and other Captive Services

**Key Considerations**

- Idle capacity risk
  - Who bears - Pricing policy - Cost plus versus hourly rate
  - Calculation based on tested party historic data / budgeted costs
- Determination if the costs are exceptional in nature
- No compensation versus cost-to-cost reimbursement.

**Preferred Approach**

- Identification should be for the period of impact of the pandemic
- Factoring the potential cost savings – Whether the benefit of savings need to be passed on?
- Possibility of adjustment to third party data.

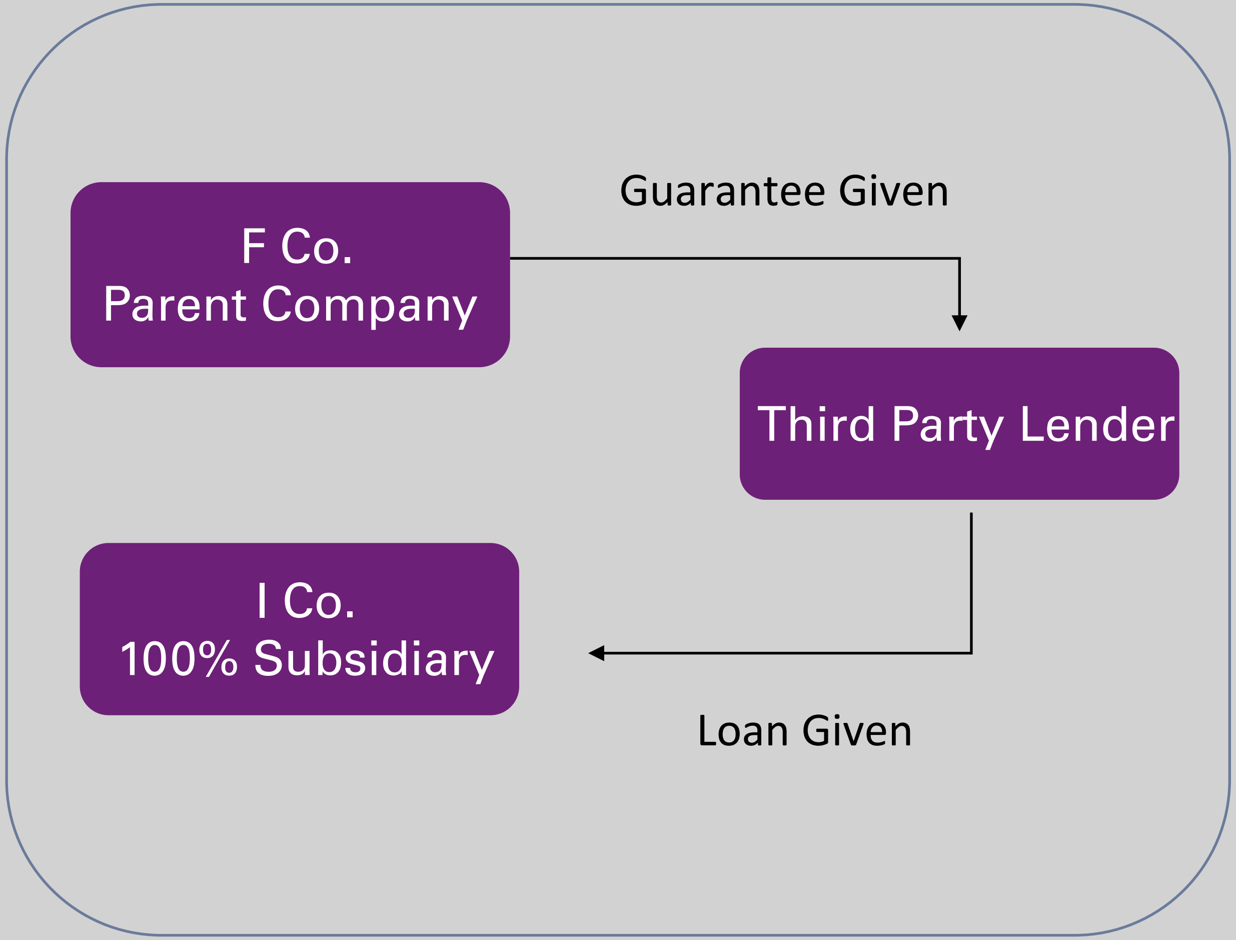
# Case 3

# Case 3 – Financial Transactions

**Facts of the Case**

Guarantee given by Parent Company to third party lender:

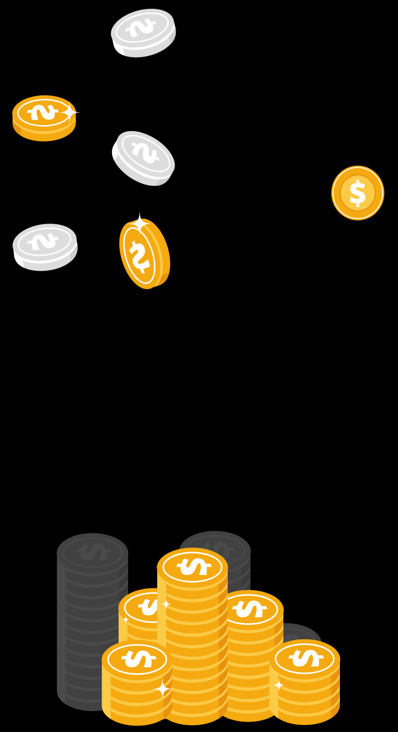
- to increase borrowing capacity of Subsidiary I Co (from USD50mn to USD70mn)
- to enhance subsidiary's credit rating



# Case 3 – Financial Transactions

**Issues / Challenges Faced**

- Will the loan be respected as a loan?
- Accurate delineation and benchmarking approach
- Whether Subsidiary I Co.  should pay Guarantee Fees on entire USD70mn (or USD 20mn, being increase in borrowing capacity) ?
- Section 94B implication
- Deemed international transaction



# Key Action Points

# Some Action Points for Pandemic Impacted Years

**Document your economic story - Maintain extensive evidence of impact of pandemic (Self and industry)**

- Identify extraordinary costs
- Treatment of extraordinary costs or losses in PLI computation to be in line with risks assumed / materialized
- But for COVID Analysis

**Alternate benchmarking approaches**

- Apply more than one TP method
- Use negotiations with third party vendors / customers as proxy
- Make suitable adjustments
- Use Q1, Q2, Q3, half-year results of comparables.

Any analysis to not dilute the Characterisation

**Consider renegotiating, modifying, or terminating contracts and APA**

- Considering realistic options available
- Evaluate impact in the long run
- Assess impact on past positions.

# Going beyond the Pandemic

# Going beyond the Pandemic Years

- **Changes in Business / Operating Models -** Businesses not likely to return to pre-pandemic normal; but will evolve and adapt to the New Normal
  - Role of Technology
  - Home working arrangement written into employment contracts, Virtual Board Meetings and Shareholder Meetings – Associated PE issues
  - Changes in reporting structures
  - Business restructuring and exit charge

- **Changes in Approach to Tax Scrutiny - Data Analytics – Exchange of Information**

- **Increased use of MAPs and Bilateral APAs -** As companies seek to resolve and avoid TP disputes in the years impacted by the Pandemic

# Q And A