



**WESTERN INDIA REGIONAL COUNCIL OF
THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF INDIA**

Transfer Pricing – Documentation

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Agenda

Transfer Pricing Landscape and Documentation - Importance

Transfer Pricing Documentation Requirements

Documentation Live Cases- Specific Transactions

- Royalty Payout
 - Management Fee Payout
 - Guarantee Transactions
 - Interest Transactions
 - Market Penetration
-

BEPS – Action Plan 13 TP Documentation

Q & A





Transfer Pricing Landscape and documentation - Importance

Evolving TP audit landscape

Global Trends

- TP foremost international tax challenge
- Focus on enforcement
 - “*Contemporaneous*” documentation
 - Collaborative approach with multiple years review at one-go
 - Emphasis on tax outcome while challenging TP policies
 - OECD / EUJTPF tackling TP issues
 - BEPS focusing on TP

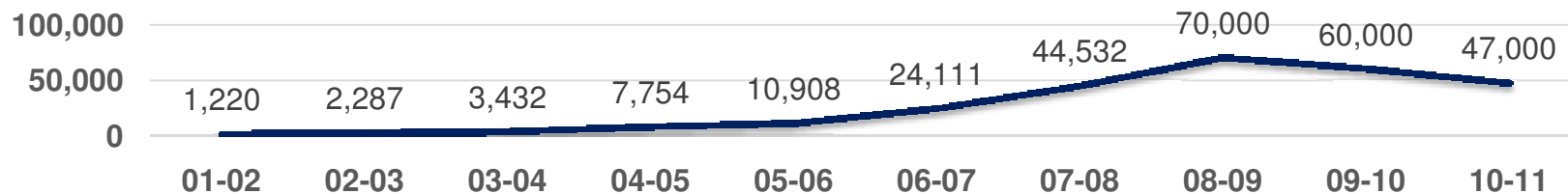
TP Week’s Top Ten **Toughest** Transfer Pricing Authorities

1	Japan
2	India
3	China
4	Canada
5	United States
6	France
7	Germany
8	Australia
9	Korea
10	United Kingdom

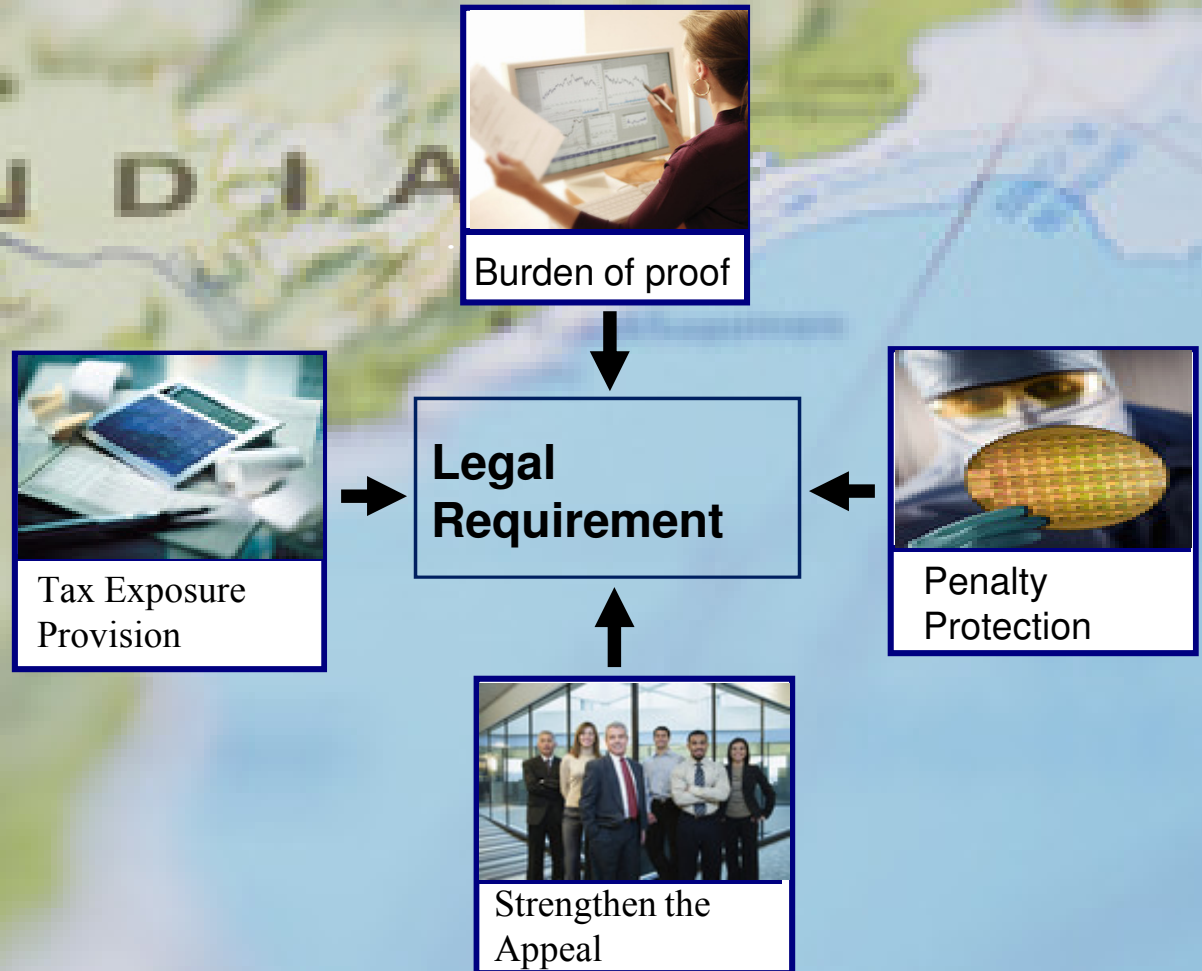
Indian Trends

- TP adjustments approx \$ 51 bn cumulatively
- Approx. \$7-10 bn in audits done for FY 2010-11
- TP Adjustments in 55% of cases scrutinized as against 25% globally

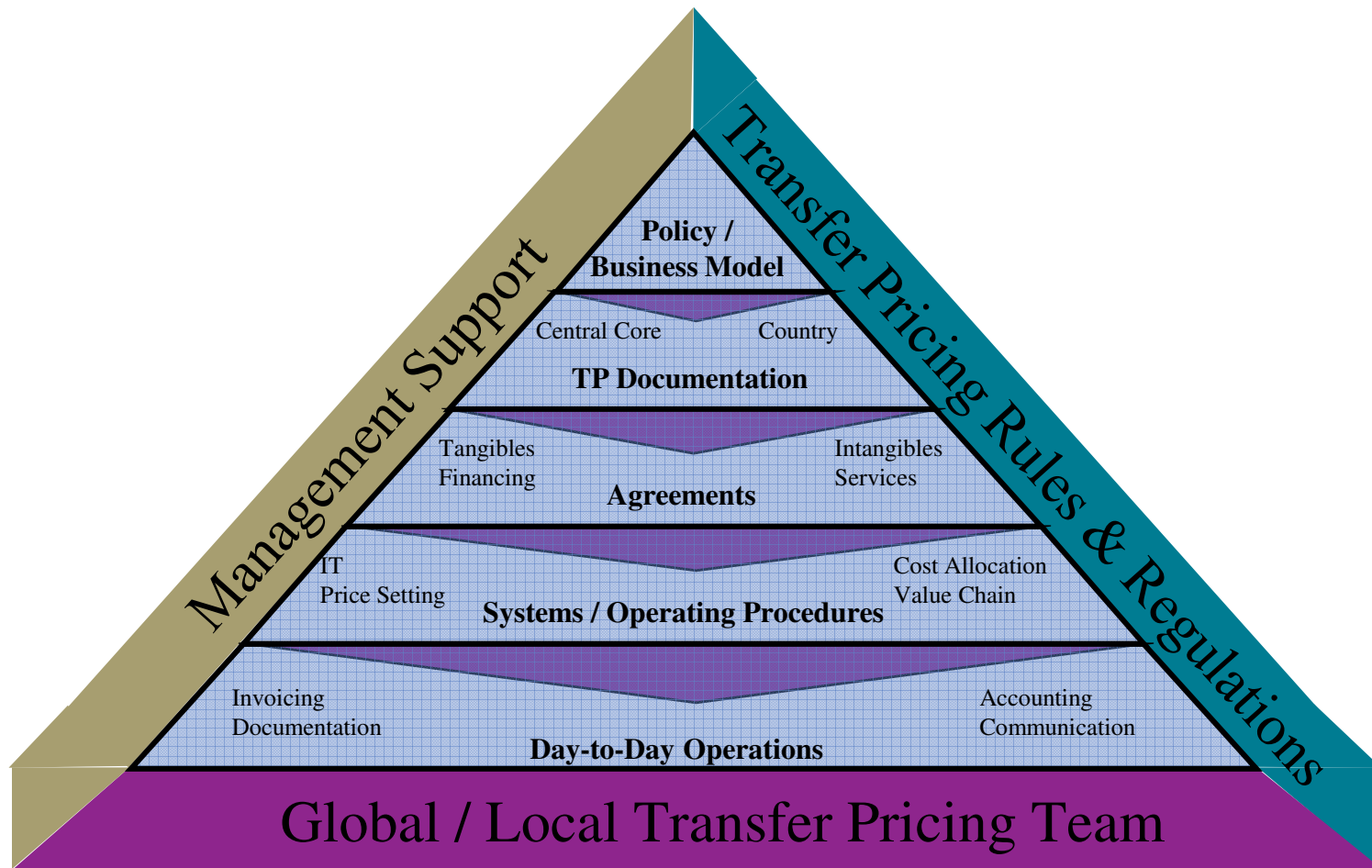
TP Adjustment (in INR crores)



Need For Transfer Pricing Documentation



Systematically Meeting Transfer Pricing Challenge ...



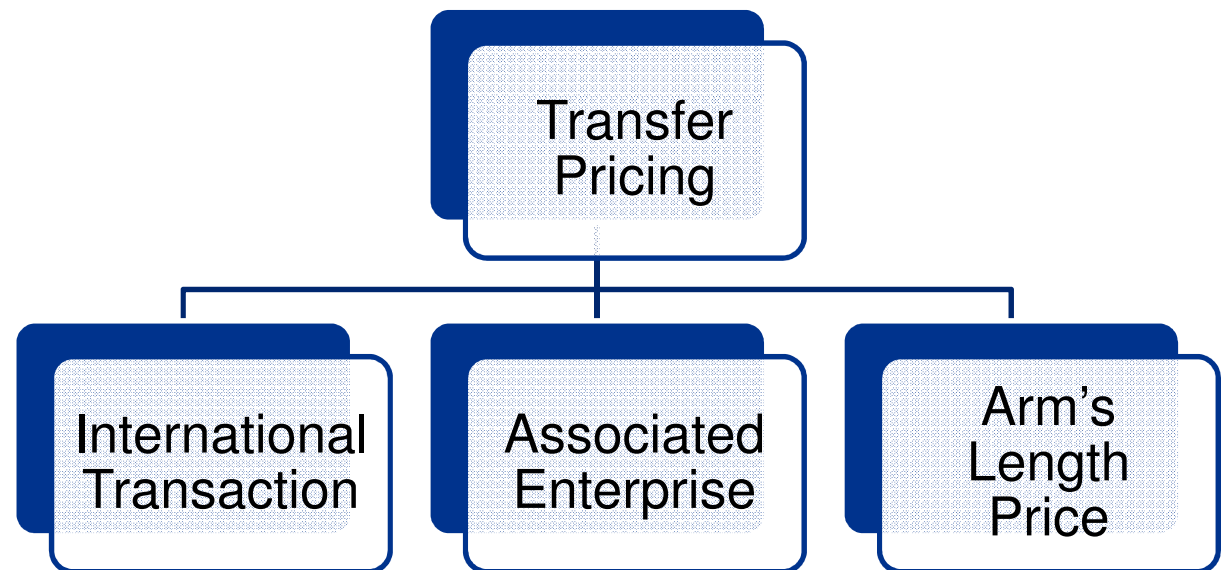
A photograph of a modern office interior. In the foreground, three business professionals are gathered around a dark, reflective conference table. A man in a white suit is seated on the left, looking at a laptop. A woman in a white top and dark vest stands on the right, leaning over the table. Another person is partially visible behind them. The background features large windows with a view of a city skyline under a clear blue sky. The overall lighting is bright and professional.

Transfer Pricing Documentation Requirement

Applicability of Transfer Pricing Regulations

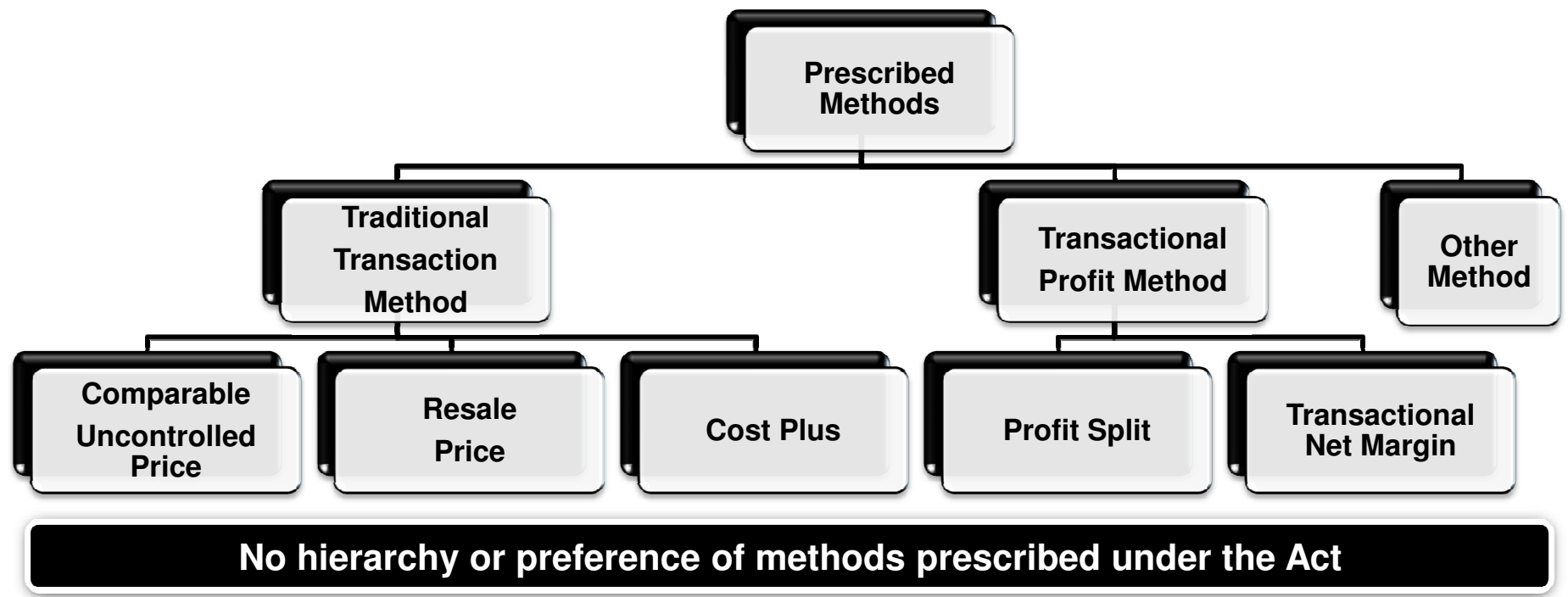


- Any income arising to associated enterprises from an international transaction shall be computed having regard to the arm's length price



Computation of Arm's Length Price

- Determination of ALP using one of the Prescribed methods -
 - Best suited to the facts and circumstances of each particular international transaction and
 - Provides the most reliable measure of an arm's length price in relation to the international transaction ~ termed as the “**Most Appropriate Method**”
- Where more than one ALP is determined, the arithmetic mean of such prices is taken to be the ALP



Transfer Pricing Documentation: Section 92D / Rule 10D

Entity related

- Profile of industry
- Profile of group
- Profile of Indian entity
- Profile of associated enterprises

Price related

- Transaction terms
- Functional analysis (functions, assets and risks)
- Economic analysis (method selection, comparable benchmarking)
- Forecasts, budgets, estimates

Transaction related

- Agreements
- Invoices
- Pricing related correspondence (letters, emails etc)

- Contemporaneous documentation requirement – Rule 10D
- Documentation to be retained for 9 years
- No specific documentation requirement if the value of international transactions **is less than one crore rupees.**

Transfer Pricing Process

Stage 1

Pre-project planning

- Preparation of project plan

Stage 2

Functional analysis

- Interviews
- Questionnaires
- Discussions with Management
- Characterization of each entity
- Agreement reviews

Stage 3

Economic Analysis

- Search strategy
- Access to local & global database
- Analysis of internal comparables
- Judicious identification of arm's length range

Stage 4

Additional Analysis

- Understand existing costing mechanism
- Determination of billing methodology

Stage 5

Issuance of Documentation

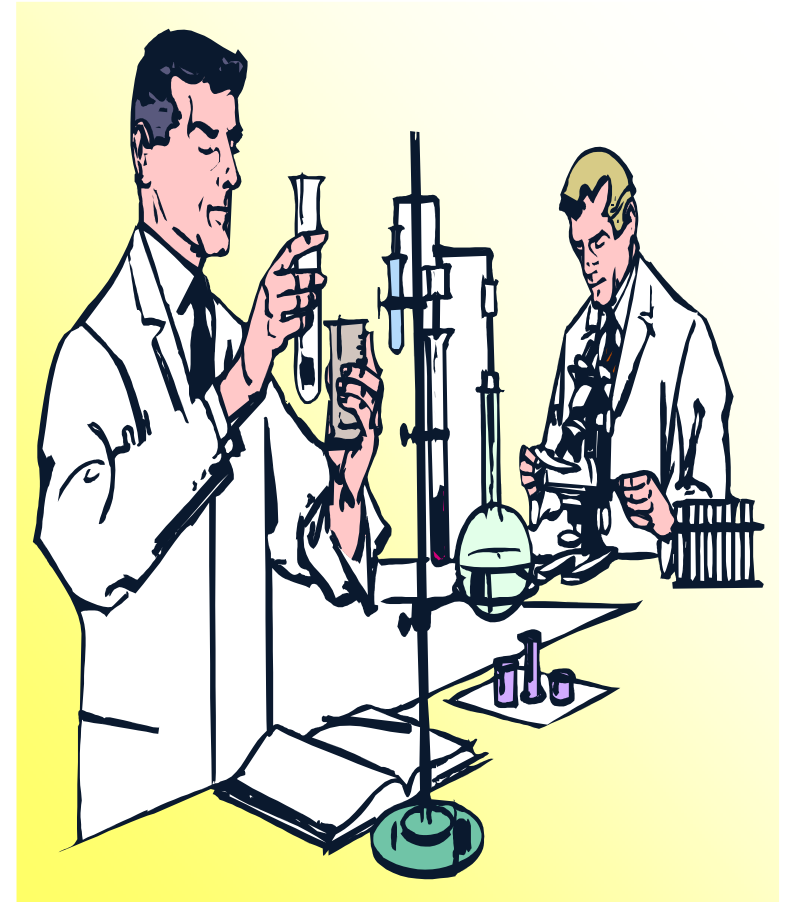
- Consultation with management
- Finalization of Transfer Pricing Documentation



Documentation Live Cases - Specific Transactions

Royalty Payouts

- Royalty widely adopted mechanism to compensate for use of manufacturing intangible
- Extremely controversy prone in recent times
- Transfer pricing adjustments common in this area
- Recently, the regulatory caps were removed – paving way for higher royalty payment



Is Royalty Payment justified in case of loss situation?

Recent Judicial Rulings - EKL Appliances Ltd.

Delhi High Court's Ruling – Payment of Royalty to AE

- It is not for the Revenue authorities to dictate to the taxpayer how he or she should conduct his business and what expenditure should be incurred.
- It is not necessary for the taxpayer to show that any legitimate expenditure incurred by him or her
 - was also incurred out of necessity or
 - that the expenditure incurred by him or her for the purpose of business has actually resulted in profit or income.
- The taxpayer only needs to show that the expenditure should have been incurred “wholly and exclusively” for the purpose of business.
- The amount of expenditure can be examined by the TPO but he or she has no authority to disallow the expenditure on the basis that the taxpayer has suffered continuous losses.
- The High Court also relied on the OECD Guidelines: Tax administrations should not disregard and restructure the transactions as actually undertaken by the taxpayer except
 - where the economic substance of a transaction differs from its form; and
 - where the form and substance of the transaction are the same but arrangements made in relation to the transaction differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.



Royalty Payouts - Judicial precedents

Cases	Tribunal Ruling
<p>Honda Motorcycle and Scooter India Private Limited vs ACIT Delhi ITAT</p>	<ul style="list-style-type: none"> ▪ ITAT Allows royalty payment on AE-sales ▪ Rejects TPO's stand of disallowing royalty on AE sales (by Honda Japan's Indian subsidiary) on technology-transfer. ▪ TPO's finding that assessee was a contract manufacturer, was without any basis and contrary to facts on record, ▪ Financial results indicate that Indian subsidiary (assessee) had independent sales in domestic and export segments & AE sales were made on Principal to Principal basis; Pricing details also indicate that assessee earned premium which would not be possible in case of a contract manufacturer
<p>Johnson & Johnson vs. ACIT</p>	<ul style="list-style-type: none"> ▪ The ITAT allows the benchmarking based on TNMM in respect of Royalty transaction ▪ TPO not justified in disallowing taxes & R&D cess borne by assessee; ▪ TPO cannot question commercial arrangement while calculating ALP; ▪ Reverses CIT(A) order disallowing royalty for period prior to entering into agreement; ▪ Assessee entitled to incur expenditure, even though it is not originated in contractual obligation; ▪ Not necessary that formal must precede incurring of expenditure
<p>LG Electronics India Pvt. Ltd. vs. ACIT Delhi ITAT</p>	<ul style="list-style-type: none"> ▪ ITAT dismisses assessee's combined benchmarking approach under TNMM ▪ Applying entity-level TNMM defeats mandate of various provisions, <i>"When we consider more than one separate transaction under combined umbrella of TNMM on an entity level, it is quite possible that a probable addition on account of TP adjustment arising from one international transaction may be usurped by income from other international transaction giving higher income on transacted value"</i>; ▪ RBI approval for royalty rate not binding on AO, RBI permission is not sacrosanct for purposes of IT Act & is merely persuasive & not conclusive,

Royalty payouts

- Copies of license agreement
- Benefits received / receivable by the tax payer and quantification of the benefit
- Unique nature of the intangible, market where it is used and strategic advantage achieved
- Rights of the taxpayer to receive upgrades .
- Comparative profits before and after the use of intangible.
- Whether there are any geographic restrictions such as to export based on the licensed technology
- Details of patents / intangibles registered by taxpayer in India
- Quote of a comparable independent technology recipient for the intangible.
- Rates at which the royalty is paid for use of similar intangibles by any other concern / subsidiary of the AE / Group.



Management Services

- Payment justified for services not in the nature of:
 - ✓ shareholding services;
 - ✓ duplicative services:
 - ✓ passive association benefits
- Another area prone to litigation in India
- Stringent “benefits test”



Recent Judicial Rulings - McCann Erickson India Pvt. Ltd.

Delhi Tribunal's Ruling – Management services received from AE

- The taxpayer had placed substantial evidence in respect of the management service charges and client coordination fee on record and had been able to establish the nature and benefits of services provided by the Associated Enterprise (AE). The tax department had not brought out anything to negate such evidence.
- The taxpayer is engaged in only one class of business. There are no segments which can be said to be independent of each other. Entity level benchmarking using the Transactional Net Margin Method (TNMM) shall be most appropriate .
- Considering the business environment of the taxpayer, it would be difficult to operate successfully without receipt of services which carry huge intrinsic and creative value. Only a business expert can evaluate the true intrinsic and creative value of such services.
- The Tribunal relied on the High Court judgment in the case of **Hive Communication Pvt. Ltd.** wherein it was held that the legitimate business needs of the company must be judged from the perspective of the company. It is not for the AO to dictate what the business needs of the company should be.
- The term “benefit” to a company in relation to its business has a very wide connotation. It is difficult to accurately measure these benefits in terms of money value separately.



Management services – Judicial precedents

Judicial Precedents	Tribunal Ruling
<p>Gemplus India Private Limited</p> <p>Bangalore ITAT</p>	<ul style="list-style-type: none"> ▪ The charge for management services must be commensurate with the nature, volume and quality of services. ▪ There were no evidence/details available on record to demonstrate the nature of services rendered ▪ The Tribunal held that the expenses incurred should ideally be apportioned on the basis of actual services rendered to the individual units
<p>Dresser Rand</p> <p>Mumbai ITAT</p>	<ul style="list-style-type: none"> ▪ Taxpayer's prerogative to decide how to conduct its business. Taxpayer may have any number of qualified accountants and management experts on his rolls, and yet may decide to engage services of outside experts for auditing and management consultancy ▪ Whether a particular expenditure on services received actually benefits the taxpayer in monetary terms is not a consideration for it being allowed as a deduction and that cannot play any role in determining ALP of that service. What needs to be determined is whether the same price for the service would be paid by an independent enterprise ▪ Taxpayer had given sufficient evidence of the services having been actually rendered to the taxpayer ▪ Payment was made without involving any mark-up and the costs involved are not in dispute, hence it cannot be said that the amount paid is excessive or unreasonable ▪ Payments were wholly and exclusively for the purpose of the taxpayer's business. No disallowance under Section 37(1) and Section 40A(2)(b) is warranted ▪ There is no objective way in which use of services can be measured and as is the commercial practice even in market factors driven situation, the costs are shared in accordance with some objective criterion, including sales revenues and number of employees

Management services – Illustrative model documentation

Documentation requirement specific to certain services

Strategic Planning	Information Technology Support
<ul style="list-style-type: none">• Business Reports / Plans• Trainings• E-mails• Telecon-notes• Corporate Governance initiatives	<ul style="list-style-type: none">• IT Security Policy and Manual;• Details of trainings received;• E-mail system• Intranet• Servers including Remote Servers
Accounting and Finance	Human Resources
<ul style="list-style-type: none">• Accounting system• Accounting manual• Business Reporting system• Trainings	<ul style="list-style-type: none">• HR Manuals• Appraisal and Evaluation• Welfare Schemes• Trainings
Sales and Marketing	Supply chain Management ('SCM')
<ul style="list-style-type: none">• Details of any marketing strategic inputs• Details of sales converted due to marketing assistance• Brand and Sales Promotion Material• Trainings	<ul style="list-style-type: none">• SCM Manual and Policies• Write-up on inventory management• Daily distribution plan• Demand forecasting and production scheduling

Corporate Guarantees and Interest on Loans

- Corporate Guarantee is a legally binding agreement under which the guarantor agrees to pay any or all of the amount due on a loan instrument in the event of non payment by the borrower.
- No charge for guarantee fee on the ground that there is no cost of guarantee
- Comfort Letters are also viewed as an form of Guarantee
- Granting of interest free loans has historically led to tax controversies with the Revenue authorities.



Financial Transactions – Loans - Judicial precedents

Cases	Tribunal Ruling
<p>CIT vs. Tata Autocomp Systems Ltd</p> <p>Mumbai High Court</p>	<ul style="list-style-type: none"> ■ The High Court upholds ITAT order applying EURIBOR as arm's length interest rate for advances to German AE; ■ Notes ITAT had followed decisions of Bombay Bench of Tribunal in the cases of VVF and Tech Mahindra, against which no appeal filed by Revenue; Infers that “The Revenue not having filed any appeal, has in fact accepted the decision of the Tribunal in “VVF Ltd. Vs. DCIT” and “DCIT Vs. Tech Mahindra Ltd.”; ■ Opines no reason to entertain appeal when Revenue had accepted view of Tribunal in similar matters, relied upon in present appeal
<p>CIT vs. Cotton Naturals (I) Pvt Ltd</p> <p>Delhi High Court</p>	<ul style="list-style-type: none"> ■ The High Court upholds ITAT order, rules that 4% interest rate charged by assessee for AY 2007-08 on loan given to US subsidiary AE is at arm's length and sets aside TPO's determination of 12.20% as arm's length interest rate
<p>Hinduja Global Solutions Ltd. vs. DCIT</p> <p>Mumbai ITAT</p>	<ul style="list-style-type: none"> ■ The ITAT Upholds LIBOR (without mark-up) as arm's length rate for lending to subsidiary in US Dollars; ■ Domestic PLR not relevant for benchmarking interest on foreign currency loans; ■ Assessee charged interest @ 6%, as against LIBOR of 2.49%; TP addition deleted

Financial Transactions – Loans and Guarantee- Judicial precedents

Cases	Tribunal Ruling
Siva Industries Chennai ITAT	<ul style="list-style-type: none"> Where the taxpayer has extended a loan to its Group companies in foreign currency, LIBOR must be considered for determining arm's length interest rate
Tech Mahindra Limited Mumbai ITAT	<ul style="list-style-type: none"> The Tribunal held that the USD LIBOR, instead of the Euro should be used as a benchmark for the extended credit period granted to the Group company in USA. The rate of interest charged should match the currency in which the international transaction has taken place In the said decision, the Tribunal has categorically mentioned that it would refrain from making any observations on whether or not extended credit period should be compared with a loan

Cases	Ruling
Four Soft Hyderabad ITAT	<ul style="list-style-type: none"> Guarantee to an affiliate is not an international transaction
GE Capital, Canada	<ul style="list-style-type: none"> Savings to GE Canada implicit outcome of guarantee arrangement Yield approach (interest savings approach: 1.83% drop in coupon rate) upheld to be an appropriate method for benchmarking

Interest on Loans- Documentation

- a) Copy of agreement and correspondences evidencing negotiation
- b) Benchmarking analysis, if any, conducted to determine the interest rate.
- c) Quotation from Bank or interest rate published in the reputed databases (i.e. Bloomberg etc).
- d) Details of interest, if any, paid / received in a comparable transaction
- e) Copy of transfer pricing policy.
- f) A detailed note to demonstrate the need for funds on the part of the borrowing entity.
- g) Documents evidencing cost saving, if any, anticipated by borrowing entity.
- i) Working of the interest amount along with following:
 - Details of opening balance, repayment and outstanding balances of loan; and
 - Abstract from the external website to demonstrate movement in underlying LIBOR rate;



Guarantee Fee - Documentation

- a) Credit rating of borrowing entity by an external reputed agency.
- b) Benchmarking analysis, if any, conducted to determine the guarantee fee.
- c) External Documents - Quotation from Bank.
- d) Internal Documents- Details of guarantee fee, if any, paid / received in a comparable transaction.
- e) Copy of transfer pricing policy, if any, followed by the Group.
- f) A detailed note to demonstrate the need for funds on the part of the borrowing entity.
- g) Documents evidencing cost saving, if any, anticipated by borrowing entity due to guarantee.



Market Penetration

- New Product Launch
- Expansion of Market Share
- Huge marketing spend, discounts etc
- Cross subsidization



Market penetration – Suggested Documentation

- An outline of the strategy & its aim.
- Identification & quantification of the anticipated costs.
- Reasons for variances where actual sales & costs deviate from plan.
- Increase in sale of other products due to cross subsidization
- Specifications of the benefit sought to be obtained by the parties to the strategy.
- Identification of anticipated time it will take to realise the benefits or profits for the respective parties to the strategy.
- Provision of a cost/benefit analysis and cash flow projection.





BEPS - Action 13

Transfer Pricing Documentation and Country-by-Country (CbyC) reporting

TP documentation and CbyC report

Three-tier documentation structure proposed for all countries

Master file

- To provide the MNE's blueprint
 - The group's organisational structure
 - A description of the group's business, intangibles, intercompany financial activities, and financial and tax positions.

Local file

- To provide material transfer pricing positions of the local entity/taxpayer with its foreign affiliates
 - Demonstrates arm's length nature of transactions
 - Contains the comparable analysis.

Country by country ('by') report

- To provide jurisdiction-wise information on global allocation of income, taxes paid/accrued, the stated capital, accumulated earnings, number of employees and tangible assets
- Entity-wise details of main business activities which will portray the value chain of inter-company transactions.

Country-by-Country reporting template

CbyC Template –Page 1*

Country	Revenue			Profit(loss) before income tax	Income tax paid (on a cash basis)	Income tax accrued – current year	Stated capital and accumulat ed earnings	Number of employee	Tangible assets other than cash and cash equivalent s
	Related party	Unrelated party	Total						
Country A	X	X	X	X	X	X	X	X	X
Country B	X	X	X	X	X	X	X	X	X

CbyC Template –Page 2* (onwards)

Country	Constituent entities resident in country	Country of organisation or incorporation in different from country of residence	Activities											
			R&D	Purchasing & procurement	Manufacturing & production	Sales, marketing & distribution	Administrative, management & support	External service	Regulated financial services	Insurance	Holding company	Dormant	Other	
Country A	Entity A	Country B	✓			✓								
	Entity B			✓	✓				✓					

Implementation Guidelines on CbyC Template

- On February 6, 2015, the OECD published guidance on the implementation of CbyC reporting. Some key elements are:

Which MNEs are required to file a CbyC report	<ul style="list-style-type: none">• MNEs with consolidated group revenue in the preceding fiscal year of 750 million Euros (INR 5250 crore) or more
Timing of CbyC report	<ul style="list-style-type: none">• File for the fiscal years beginning on or after January 1, 2016• MNEs will be allowed one year from the fiscal year end to file the CbyC report
Where filed and mechanisms for exchange	<ul style="list-style-type: none">• File CbyC report in the country of the ultimate parent of the MNE• That country will exchange this information on an automatic basis with jurisdictions in which the MNE operates and that meet the necessary conditions described in guidance.
Necessary Conditions for Obtaining and Using CbyC Report	<ul style="list-style-type: none">• Confidentiality, Consistency and Appropriate Use
Government-to-Government Mechanisms for Exchange of CbyC report	<ul style="list-style-type: none">• Primary mechanism – automatic exchange from MNE parent country• Secondary mechanism – MNE file the CbyC report locally or with next tier parent country that would automatically exchange
Implementation Package	<ul style="list-style-type: none">• Key elements of statutory legislation• Agreements based on existing international agreements for the automatic exchange of the CbyC reports between jurisdictions (both bilateral and multilateral)

Key Points for success

- Proactive TP analysis
- Detailed FAR analysis
 - Assessee
 - Associated Enterprises
 - Comparables
- Evaluating potential risk adjustments
- Determination of income attributable to a Permanent Establishment in India
- Strong and robust Transfer pricing documentation
- Global TP Policy – Need for localization and regular review
- Proactively determining the audit strategy
- Leveraging on the favorable evolving TP judicial decisions
- Strategically, ensuring the furnishing of adequate evidence / supporting documentation to effectively stake claims during initial TP audits



Questions & Answers



Questions

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Answers



Thank You

Bhavesh Dedhia

