

INTERNATIONAL TAXATION AND TRANSFER PRICING



**THE INSTITUTE OF
COST ACCOUNTANTS OF INDIA**

(Statutory Body under an Act of Parliament)

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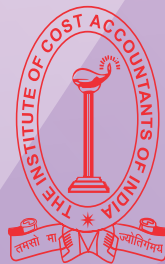
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1. Preparation of Suggestions and Analysis of various Tax matters for best Management Practices and for the professional development of the members of the Institute in the field of Taxation.
2. Conducting webinars, seminars and conferences etc. on various taxation related matters as per relevance to the profession and use by various stakeholders.
3. Submit representations to the Ministry from time to time for the betterment and financial inclusion of the Economy.
4. Evaluating opportunities for CMAs to make way for further development and sustenance of the opportunities.
5. Conducting and monitoring of Certificate Courses on Direct and Indirect Tax for members, practitioners and stakeholders.

International Taxation and Transfer Pricing



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President's Message

On behalf of the entire CMA fraternity, I would like to extend our appreciation to Team of Tax Research Department, especially CMA Niranjan Mishra, Chairman of Taxation Committee for the amazing work done by them in conceptualising the publication on 'International Taxation and Transfer Pricing'.

Inter-company transactions across borders are growing rapidly and becoming much more complex. Tax authorities are keeping a close eye on the growing number of cross-border, inter-company transactions, imposing stricter penalties and new documentation requirements. Complying with these requirements can be complicated and time-consuming. So every multinational company needs to have a coherent and defensible transfer pricing policy. By considering transfer pricing carefully, companies would be able to better manage risks, improve operational and financial performance and prepare for sustainable growth

Again these international operations bring in taxation hurdles like planning to expand into new jurisdictions, need of cash flow in overseas operations, managing treasury function globally, aligning tax function with the business plan and defending a tax authority challenge. These can be managed by providing advices in the field of foreign country taxation, tax efficient holding company locations, cross-border financing and treasury solutions, controlled foreign companies tax planning, income tax treaties, profit repatriation, loss utilisation, inbound and outbound structuring, managing intellectual property and intangible assets, tax efficient supply chain and shared services, regional tax issues, credit management and planning business models. I am sure this publication would be the initial step in this direction.

I congratulate CMA Niranjan Mishra, Chairman-Taxation Committee and his team, for their commitment and dedication. I acknowledge the efforts put in by the Tax Research Department to contribute positively in this field. I look forward to the department for continuing this important work towards fulfilling the vision of members and other stakeholders. I wish them all the Luck!!

With Warm Regards,

CMA Amit A. Apte

21st December, 2018



CHAIRMAN'S MESSAGE

In the process of Transfer pricing, dealing at arm's length is the basic principle; this means that the appropriate transfer price is the price, which an independent third-party would have also paid. For its member states, the OECD stipulates that any cross-border services and supplies must be acknowledged for tax purposes only if the conditions for these services and supplies correspond to the arm's length principle. If this condition is not fulfilled, the tax authorities are authorized to increase the profits at the expense of the taxpayer. This is applicable irrespective of the size of the company or the flows of goods or services within the group. In order to avoid drawbacks, all groups or companies with supplies and services between various units should take into account that all the supplies or services within the group are properly remunerated. For this purpose, the conditions of the parties involved should be negotiated at arm's length and put down in a written agreement.

To deal with the above issues expertise is required in International Taxation. Areas like, international tax planning, the preparation of transfer pricing policy documentation and supporting benchmarking studies, conducting risk reviews and resolving transfer pricing disputes are to be stressed upon. Knowledge on Cross border transactions, Inward and outward investment, Investment structures, Expansion of business activities into international arena, Thin capitalisation, Controlled foreign company structures, Withholding tax is absolutely necessary. We are optimistic that this handbook would provide guidance on these issues.

I congratulate Team – Tax Research, commendable job by the entire Team. I am happy and would like to congratulate other members of the Taxation Committee and knowledge contributors of the Institute for their efforts to bring out the "Handbook on International Taxation and Transfer Pricing". **CMA Mrityunjay Acharjee** deserves a special mention here for his untiring efforts in bringing out this publication. My best wishes to all for its all future endeavours. Keep up the good job.

A handwritten signature in black ink, appearing to read "Niranjan Mishra".

CMA Niranjan Mishra
21st December 2018

P R E F A C E

The main objective of transfer pricing law in international transactions is to ensure that transactions between associated enterprises take place at a price as if the transaction was taking place between unrelated parties.

An 'international transaction' in the context of transfer pricing law shall include a transaction between two or more associated enterprises, either or both of whom are non-residents wherein there is purchase, sale or lease of tangible or intangible property, or there is provision of services, or there is lending or borrowing of money.

It becomes important to note here that a transaction entered into by an enterprise with a person other than an associated enterprise shall be deemed to be an international transaction entered into between two associated enterprises, if: (i) there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or (ii) the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not.

There are many minute details in these aspects of the above which are needed to be handled carefully. Professionals dealing in this field would surely find this handbook an easy source of information to fall back up during their professional deliberations.

Here, we would also like to thank and acknowledge the immense contributions of **CMA Mrityunjay Acharjee** without whose hard work, toil and guidance the handbook could have never acquired its shape. The department is indebted to him for his contributions. CMA Nirranjan Mishra, Chairman – Taxation Committee has been our guiding star. Thank you Sir.

Tax Research Department

The Institute of Cost Accountants of India
21st December, 2018

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1

TRANSFER PRICING BACKGROUND

What is Transfer Pricing?

Transfer pricing, in simple terms, can be defined as the price charged by one unit of the enterprise from another unit of the same enterprise. For example, X Inc. has two units, Unit A and Unit B. Unit A of the X Inc. manufactures speedometers for automobiles and Unit B manufactures automobiles which include the speedometers produced by Unit A of the X Inc. Now, the price paid by Unit B for the speedometers produced by Unit A is the transfer pricing, and the method is known as Transfer Price.

While, this may not appear significant in small enterprise. It is of immense significance when the scale of an industry is raised. Another question can be that why would corporation employ transfer pricing, why not charge another unit the same price as they charge other companies, or why not give to their own unit for free?

It can be explained through and an example, let us assume that Unit A is in a **high tax** rate country, and Unit B is in a **low tax** rate country. Unit B can charge a rate, lower than the market rate for the speedometers produced by Unit A, which would give a loss to Unit A as far as the sale is concerned. But Unit B would make profits out of the sale. Since Unit A is in a high tax rate country, eventually, X Inc. will reduce the tax burden by making Unit B profitable and Unit A unprofitable as companies in loss are not taxed.

So, while this is profitable to the company it is the overall loss for the country where Unit A is located as they are not able to collect taxes while Unit A's parent company is reaping the profit. So, naturally, countries will have some regulations for transfer pricing.

The expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, Services and technology between related entities located at different territories. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity. Or in other words, profits accruing to the parent company can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction.

Transfer pricing can be defined as the value which is attached to the goods or services transferred between related parties. In other words, transfer pricing is the price which is paid for goods or services transferred from one unit of an organization to its other units situated in different countries.

In taxation and accounting, **transfer pricing** refers to the rules and methods for pricing transactions within and between enterprises under common ownership or control. Because of the potential for cross-border controlled transactions to distort taxable income, tax authorities in many countries can adjust intragroup



transfer prices that differ from what would have been charged by unrelated enterprises dealing at arm's length (the arm's-length principle). The OECD and World Bank recommend intragroup pricing rules based on the arm's-length principle, and 19 of the 20 members of the G20 have adopted similar measures through bilateral treaties and domestic legislation, regulations, or administrative practice. Countries with transfer pricing legislation generally follow the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* in most respects, although their rules can differ on some important details.

Where adopted, transfer pricing rules allow tax authorities to adjust prices for most cross-border intragroup transactions, including transfers of tangible or intangible property, services, and loans. For example, a tax authority may increase a company's taxable income by reducing the price of goods purchased from an affiliated foreign manufacturer or raising the royalty the company must charge its foreign subsidiaries for rights to use a proprietary technology or brand name. These adjustments are generally calculated using one or more of the transfer pricing methods specified in the OECD guidelines and are subject to judicial review or other dispute resolution mechanisms, although transfer pricing is sometimes inaccurately presented by commentators as a tax avoidance practice or technique, the term refers to a set of substantive and administrative regulatory requirements imposed by governments on certain taxpayers.

However, aggressive intragroup pricing – especially for debt and intangibles – has played a major role in corporate tax avoidance, and it was one of the issues identified when the OECD released its base erosion and profit shifting (BEPS) action plan in 2013. The OECD's 2015 final BEPS reports called for country-by-country reporting and stricter rules for transfers of risk and intangibles but recommended continued adherence to the arm's-length principle. These recommendations have been criticized by many taxpayers and professional service firms for departing from established principles and by some academics and advocacy groups for failing to make adequate changes.

Transfer pricing should not be conflated with fraudulent trade mis-invoicing, which is a technique for concealing illicit transfers by reporting falsified prices on invoices submitted to customs officials. "Because they often both involve mispricing, many aggressive tax avoidance schemes by multinational corporations can easily be confused with trade misinvoicing.

Over sixty governments have adopted transfer pricing rules, which in almost all cases (with the notable exceptions of Brazil and Kazakhstan) are based on the arm's-length principle. The rules of nearly all countries permit related parties to set prices in any manner, but permit the tax authorities to adjust those prices (for purposes of computing tax liability) where the prices charged are outside an arm's length range. Most, if not all, governments permit adjustments by the tax authority even where there is no intent to avoid or evade tax. The rules generally require that market level, functions, risks, and terms of sale of unrelated party transactions or activities be reasonably comparable to such items with respect to the related party transactions or profitability being tested.

Adjustment of prices is generally made by adjusting taxable income of all involved related parties within the jurisdiction, as well as adjusting any withholding or other taxes imposed on parties outside the jurisdiction. Such adjustments are generally made after filing of tax returns. For example, if Bigco US charges Bigco Germany for a machine, either the U.S. or German tax authorities may adjust the price upon examination of the respective tax return. Following an adjustment, the taxpayer generally is allowed (at least by the adjusting government) to make payments to reflect the adjusted prices.

Most systems allow use of transfer pricing multiple methods, where such methods are appropriate and are supported by reliable data, to test related party



prices. Among the commonly used methods are comparable uncontrolled prices, cost-plus, resale price or markup, and profitability based methods. Many systems differentiate methods of testing goods from those for services or use of property due to inherent differences in business aspects of such broad types of transactions. Some systems provide mechanisms for sharing or allocation of costs of acquiring assets (including intangible assets) among related parties in a manner designed to reduce tax controversy. Most governments have granted authorization to their tax authorities to adjust prices charged between related parties. Many such authorizations, including those of the United States, United Kingdom, Canada, and Germany, allow domestic as well as international adjustments. Some authorizations apply only internationally.

In addition, most systems recognize that an arm's length price may not be a particular price point but rather a range of prices. Some systems provide measures for evaluating whether a price within such range is considered arm's length, such as the *interquartile range* used in U.S. regulations. Significant deviation among points in the range may indicate lack of reliability of data. Reliability is generally considered to be improved by use of multiple year data.

Most rules require that the tax authorities consider actual transactions between parties, and permit adjustment only to actual transactions. Multiple transactions may be aggregated or tested separately, and testing may use multiple year data. In addition, transactions whose economic substance differs materially from their form may be recharacterized under the laws of many systems to follow the economic substance.

Transfer pricing adjustments have been a feature of many tax systems since the 1930s. The United States led the development of detailed, comprehensive transfer pricing guidelines with a White Paper in 1988 and proposals in 1990-1992, which ultimately became regulations in 1994. In 1995, the OECD issued its transfer pricing guidelines which it expanded in 1996 and 2010. The two sets of guidelines are broadly similar and contain certain principles followed by many countries. The OECD guidelines have been formally adopted by many European Union countries with little or no modification.

Comparability

Most rules provide standards for when unrelated party prices, transactions, profitability or other items are considered sufficiently comparable in testing related party items. Such standards typically require that data used in comparisons be reliable and that the means used to compare produce a reliable result. The U.S. and OECD rules require that reliable adjustments must be made for all differences (if any) between related party items and purported comparables that could materially affect the condition being examined. Where such reliable adjustments cannot be made, the reliability of the comparison is in doubt. Comparability of tested prices with uncontrolled prices is generally considered enhanced by use of multiple data. Transactions not undertaken in the ordinary course of business generally are not considered to be comparable to those taken in the ordinary course of business.

Among the factors that must be considered in determining comparability are:

- the nature of the property or services provided between the parties,
- functional analysis of the transactions and parties,
- comparison of contractual terms (whether written, verbal, or implied from conduct of the parties), and
- comparison of significant economic conditions that could affect prices, including the effects of different market levels and geographic markets.

Nature of property or services



Comparability is best achieved where identical items are compared. However, in some cases it is possible to make reliable adjustments for differences in the particular items, such as differences in features or quality. For example, gold prices might be adjusted based on the weight of the actual gold (one ounce of 10 carat gold would be half the price of one ounce of 20 carat gold).

Functions and risks

Buyers and sellers may perform different functions related to the exchange and undertake different risks. For example, a seller of a machine may or may not provide a warranty. The price a buyer would pay will be affected by this difference. Among the functions and risks that may impact prices are:

- Product development
- Manufacturing and assembly
- Marketing and advertising
- Transportation and warehousing
- Credit risk
- Product obsolescence risk
- Market and entrepreneurial risks
- Collection risk
- Financial and currency risks
- Company- or industry-specific items

Terms of sale

Manner and terms of sale may have a material impact on price. For example, buyers will pay more if they can defer payment and buy in smaller quantities. Terms that may impact price include payment timing, warranty, volume discounts, duration of rights to use of the product, form of consideration, etc.

Market level, economic conditions and geography

Goods, services, or property may be provided to different levels of buyers or users: producer to wholesaler, wholesaler to wholesaler, wholesaler to retailer, or for ultimate consumption. Market conditions, and thus prices, vary greatly at these levels. In addition, prices may vary greatly between different economies or geographies. For example, a head of cauliflower at a retail market will command a vastly different price in unelectrified rural India than in Tokyo. Buyers or sellers may have different market shares that allow them to achieve volume discounts or exert sufficient pressure on the other party to lower prices. Where prices are to be compared, the putative comparables must be at the same market level, within the same or similar economic and geographic environments, and under the same or similar conditions.

Testing of prices

Tax authorities generally examine prices actually charged between related parties to determine whether adjustments are appropriate. Such examination is by comparison (testing) of such prices to comparable prices charged among unrelated parties. Such testing may occur only on examination of tax returns by the tax authority, or taxpayers may be required to conduct such testing themselves in advance of filing tax returns. Such testing requires a determination of how the testing must be conducted, referred to as a transfer pricing method.

Best method rule

Some systems give preference to a specific method of testing prices. OECD and U.S. systems, however, provide that the method used to test the appropriateness of related party prices should be that method that produces the most reliable measure of arm's length results. This is often known as a "best method" rule.



Factors to be considered include comparability of tested and independent items, reliability of available data and assumptions under the method, and validation of the results of the method by other methods.

Comparable uncontrolled price (CUP) method

The comparable uncontrolled price (CUP) method is a transactional method that determines the arm's-length price using the prices charged in comparable transactions between unrelated parties. In principle, the OECD and most countries that follow the OECD guidelines consider the CUP method to be the most direct method, provided that any differences between the controlled and uncontrolled transactions have no material effect on price or their effects can be estimated and corresponding price adjustments can be made. Adjustments may be appropriate where the controlled and uncontrolled transactions differ only in volume or terms; for example, an interest adjustment could be applied where the only difference is time for payment (e.g., 30 days vs. 60 days). For undifferentiated products such as commodities, price data for arm's-length transactions ("external comparables") between two or more other unrelated parties may be available. For other transactions, it may be possible to use comparable transactions ("internal comparables") between the controlled party and unrelated parties.

The criteria for reliably applying the CUP method are often impossible to satisfy for licenses and other transactions involving unique intangible property, requiring use of valuation methods based on profit projections.

Other transactional methods

Among other methods relying on actual transactions (generally between one tested party and third parties) and not indices, aggregates, or market surveys are:

- ❑ Cost-plus (C+) method: goods or services provided to unrelated parties are consistently priced at actual cost plus a fixed markup. Testing is by comparison of the markup percentages.
- ❑ Resale price method (RPM): goods are regularly offered by a seller or purchased by a retailer to/from unrelated parties at a standard "list" price less a fixed discount. Testing is by comparison of the discount percentages.
- ❑ Gross margin method: similar to resale price method, recognised in a few systems.

Profit-Based methods

Some methods of testing prices do not rely on actual transactions. Use of these methods may be necessary due to the lack of reliable data for transactional methods. In some cases, non-transactional methods may be more reliable than transactional methods because market and economic adjustments to transactions may not be reliable. These methods may include:

- ❑ Comparable profits method (CPM): profit levels of similarly situated companies in similar industries may be compared to an appropriate tested party. See U.S. rules below.
- ❑ Transactional net margin method (TNMM): while called a transactional method, the testing is based on profitability of similar businesses. See OECD guidelines below.
- ❑ Profit split method: total enterprise profits are split in a formulaic manner based on econometric analyses.

CPM and TNMM have a practical advantage in ease of implementation. Both methods rely on microeconomic analysis of data rather than specific transactions. These methods are discussed further with respect to the U.S. and



OECD systems.

Two methods are often provided for splitting profits: comparable profit split and residual profit split. The former requires that profit split be derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are comparable to the transactions and activities being tested. The residual profit split method requires a two step process: first profits are allocated to routine operations, then the residual profit is allocated based on non-routine contributions of the parties. The residual allocation may be based on external market benchmarks or estimation based on capitalised costs.

Tested party and profit level indicator

Where testing of prices occurs on other than a purely transactional basis, such as CPM or TNMM, it may be necessary to determine which of the two related parties should be tested. Testing is to be done of that party testing of which will produce the most reliable results. Generally, this means that the tested party is that party with the most easily compared functions and risks. Comparing the tested party's results to those of comparable parties may require adjustments to results of the tested party or the comparables for such items as levels of inventory or receivables.

Testing requires determination of what indication of profitability should be used. This may be net profit on the transaction, return on assets employed, or some other measure. Reliability is generally improved for TNMM and CPM by using a range of results and multiple year data. This is based on circumstances of the relevant countries.

Intangible property issues

Valuable intangible property tends to be unique. Often there are no comparable items. The value added by use of intangibles may be represented in prices of goods or services, or by payment of fees (royalties) for use of the intangible property. Licensing of intangibles thus presents difficulties in identifying comparable items for testing. However, where the same property is licensed to independent parties, such license may provide comparable transactional prices. The profit split method specifically attempts to take value of intangibles into account.

Services

Enterprises may engage related or unrelated parties to provide services they need. Where the required services are available within a multinational group, there may be significant advantages to the enterprise as a whole for components of the group to perform those services. Two issues exist with respect to charges between related parties for services: whether services were actually performed which warrant payment, and the price charged for such services. Tax authorities in most major countries have, either formally or in practice, incorporated these queries into their examination of related party services transactions.

There may be tax advantages obtained for the group if one member charges another member for services, even where the member bearing the charge derives no benefit. To combat this, the rules of most systems allow the tax authorities to challenge whether the services allegedly performed actually benefit the member charged. The inquiry may focus on whether services were indeed performed as well as who benefited from the services. For this purpose, some rules differentiate stewardship services from other services. Stewardship services are generally those that an investor would incur for its own benefit in managing its investments. Charges to the investee for such services are generally inappropriate. Where services were not performed or where the related party bearing the charge derived no direct benefit, tax authorities may disallow the charge altogether.



Where the services were performed and provided benefit for the related party bearing a charge for such services, tax rules also permit adjustment to the price charged. Rules for testing prices of services may differ somewhat from rules for testing prices charged for goods due to the inherent differences between provision of services and sale of goods. The OECD Guidelines provide that the provisions relating to goods should be applied with minor modifications and additional considerations. In the U.S., a different set of price testing methods is provided for services. In both cases, standards of comparability and other matters apply to both goods and services.

It is common for enterprises to perform services for themselves (or for their components) that support their primary business. Examples include accounting, legal, and computer services for those enterprises not engaged in the business of providing such services. Transfer pricing rules recognize that it may be inappropriate for a component of an enterprise performing such services for another component to earn a profit on such services. Testing of prices charged in such case may be referred to a cost of services or services cost method. Application of this method may be limited under the rules of certain countries, and is required in some countries e.g. Canada.

Where services performed are of a nature performed by the enterprise (or the performing or receiving component) as a key aspect of its business, OECD and U.S. rules provide that some level of profit is appropriate to the service performing component. Canada's rules do not permit such profit. Testing of prices in such cases generally follows one of the methods described above for goods. The cost-plus method, in particular, may be favoured by tax authorities and taxpayers due to ease of administration.

Cost sharing

Multi-component enterprises may find significant business advantage to sharing the costs of developing or acquiring certain assets, particularly intangible assets. Detailed U.S. rules provide that members of a group may enter into a cost sharing agreement (CSA) with respect to costs and benefits from the development of intangible assets. OECD Guidelines provide more generalized suggestions to tax authorities for enforcement related to cost contribution agreements (CCAs) with respect to acquisition of various types of assets. Both sets of rules generally provide that costs should be allocated among members based on respective anticipated benefits. Inter-member charges should then be made so that each member bears only its share of such allocated costs. Since the allocations must inherently be made based on expectations of future events, the mechanism for allocation must provide for prospective adjustments where prior projections of events have proved incorrect. However, both sets of rules generally prohibit applying hindsight in making allocations.

A key requirement to limit adjustments related to costs of developing intangible assets is that there must be a written agreement in place among the members. Tax rules may impose additional contractual, documentation, accounting, and reporting requirements on participants of a CSA or CCA, which vary by country.

Generally, under a CSA or CCA, each participating member must be entitled to use of some portion rights developed pursuant to the agreement without further payments. Thus, a CCA participant should be entitled to use a process developed under the CCA without payment of royalties. Ownership of the rights need not be transferred to the participants. The division of rights is generally to be based on some observable measure, such as by geography.

Participants in CSAs and CCAs may contribute pre-existing assets or rights for use in the development of assets. Such contribution may be referred to as a platform contribution. Such contribution is generally considered a deemed payment by the contributing member, and is itself subject to transfer pricing



rules or special CSA rules.

A key consideration in a CSA or CCA is what costs development or acquisition costs should be subject to the agreement. This may be specified under the agreement, but is also subject to adjustment by tax authorities.

In determining reasonably anticipated benefits, participants are forced to make projections of future events. Such projections are inherently uncertain. Further, there may exist uncertainty as to how such benefits should be measured. One manner of determining such anticipated benefits is to project respective sales or gross margins of participants, measured in a common currency, or sales in units.

Both sets of rules recognize that participants may enter or leave a CSA or CCA. Upon such events, the rules require that members make buy-in or buy-out payments. Such payments may be required to represent the market value of the existing state of development, or may be computed under cost recovery or market capitalization models.

Penalties and documentation

Some jurisdictions impose significant penalties relating to transfer pricing adjustments by tax authorities. These penalties may have thresholds for the basic imposition of penalty, and the penalty may be increased at other thresholds. For example, U.S. rules impose a 20% penalty where the adjustment exceeds USD 5 million, increased to 40% of the additional tax where the adjustment exceeds USD 20 million.

The rules of many countries require taxpayers to document that prices charged are within the prices permitted under the transfer pricing rules. Where such documentation is not timely prepared, penalties may be imposed, as above. Documentation may be required to be in place prior to filing a tax return in order to avoid these penalties. Documentation by a taxpayer need not be relied upon by the tax authority in any jurisdiction permitting adjustment of prices. Some systems allow the tax authority to disregard information not timely provided by taxpayers, including such advance documentation. India requires that documentation not only be in place prior to filing a return, but also that the documentation be certified by the chartered accountant preparing a company return.



2

TRANSFER PRICING AS PART OF INTERNATIONAL TAXATION

Transfer pricing is one of the most important issues in international tax.

"Transfer pricing is the leading edge of what is wrong with international tax", Tax Analysts, August 2012. Transfer pricing happens whenever two companies that are part of the same multinational group trade with each other: when a US-based subsidiary of Coca-Cola, for example, buys something from a French-based subsidiary of Coca-Cola. When the parties establish a price for the transaction, this is transfer pricing.

Transfer pricing is not, in itself, illegal or necessarily abusive. What is illegal or abusive is transfer mispricing, also known as transfer pricing manipulation or abusive transfer pricing. (Transfer mispricing is a form of a more general phenomenon known as trade mispricing, which includes trade between unrelated or apparently unrelated parties – an example is re invoicing.

It is estimated that about 60 percent of international trade happens within, rather than between, multinationals: that is, across national boundaries but within the same corporate group. Suggestions have been made that this figure may be closer to 70 percent.

Estimates vary as to how much tax revenue is lost by governments due to transfer mispricing. Global Financial Integrity in Washington estimates the amount at several hundred billion dollars annually.

Transfer Pricing Related Rules in US and OECD Model U.S. specific tax rules

U.S. transfer pricing rules are lengthy. They incorporate all of the principles above, using CPM (see below) instead of TNMM. U.S. rules specifically provide that a taxpayer's intent to avoid or evade tax is not a prerequisite to adjustment by the Internal Revenue Service, nor are nonrecognition provisions. The U.S. rules give no priority to any particular method of testing prices, requiring instead explicit analysis to determine the best method. U.S. comparability standards limit use of adjustments for business strategies in testing prices to clearly defined market share strategies, but permit limited consideration of location savings.

Comparable profits method

The Comparable Profits method (CPM) was introduced in the 1992 proposed regulations and has been a prominent feature of IRS transfer pricing practice since. Under CPM, the tested party's overall results, rather than its transactions, are compared with the overall results of similarly situated enterprises for whom reliable data is available. Comparisons are made for the profit level indicator that most reliably represents profitability for the type of business. For example, a sales company's profitability may be most reliably measured as a return on sales (pre-tax profit as a percent of sales).

CPM inherently requires lower levels of comparability in the nature of the goods or services. Further, data used for CPM generally can be readily obtained in the U.S. and many countries through public filings of comparable enterprises.

Results of the tested party or comparable enterprises may require adjustment to achieve comparability. Such adjustments may include effective interest



adjustments for customer financing or debt levels, inventory adjustments, etc.

Cost plus and resale price issues

U.S. rules apply resale price method and cost-plus with respect to goods strictly on a transactional basis. Thus, comparable transactions must be found for all tested transactions in order to apply these methods. Industry **averages or statistical measures are** not permitted. Where a manufacturing entity provides contract manufacturing for both related and unrelated parties, it may readily have reliable data on comparable transactions. However, absent such in-house comparables, it is often difficult to obtain reliable data for applying cost-plus.

The rules on services expand cost-plus, providing an additional option to mitigate these data problems. Charges to related parties for services not in the primary business of either the tested party or the related party group are rebuttably presumed to be arm's length if priced at cost plus zero (the services cost method). Such services may include back-room operations (e.g., accounting and data processing services for groups not engaged in providing such services to clients), product testing, or a variety of such non-integral services. This method is not permitted for manufacturing, reselling, and certain other services that typically are integral to a business.

U.S. rules also specifically permit shared services agreements. Under such agreements, various group members may perform services which benefit more than one member. Prices charged are considered arm's length where the costs are allocated in a consistent manner among the members based on reasonably anticipated benefits. For instance, shared services costs may be allocated among members based on a formula involving expected or actual sales or a combination of factors.

Terms between parties

Under U.S. rules, actual conduct of the parties is more important than contractual terms. Where the conduct of the parties differs from terms of the contract, the IRS has authority to deem the actual terms to be those needed to permit the actual conduct.

Adjustments

U.S. rules require that the IRS may not adjust prices found to be within the arm's length range. Where prices charged are outside that range, prices may be adjusted by the IRS unilaterally to the midpoint of the range. The burden of proof that a transfer pricing adjustment by the IRS is incorrect is on the taxpayer unless the IRS adjustment is shown to be arbitrary and capricious. However, the courts have generally required that both taxpayers and the IRS to demonstrate their facts where agreement is not reached.

Documentation and penalties

If the IRS adjusts prices by more than \$5 million or 10 percent of the taxpayer's gross receipts, penalties apply. The penalty is 20% of the amount of the tax adjustment, increased to 40% at a higher threshold.

This penalty may be avoided only if the taxpayer maintains contemporaneous documentation meeting requirements in the regulations, and provides such documentation to the IRS within 30 days of IRS request. If documentation is not provided at all, the IRS may make adjustments based on any information it has available. Contemporaneous means the documentation existed with 30 days of filing the taxpayer's tax return. Documentation requirements are quite specific, and generally require a best method analysis and detailed support for the pricing and methodology used for testing such pricing. To qualify, the documentation must reasonably support the prices used in computing tax.

Commensurate with income standard

U.S. tax law requires that the foreign transferee/user of intangible property (patents, processes, trademarks, know-how, etc.) will be deemed to pay to a controlling transferor/developer a royalty commensurate with the income



derived from using the intangible property. This applies whether such royalty is actually paid or not. This requirement may result in withholding tax on deemed payments for use of intangible property in the U.S.

OECD specific tax rules

OECD guidelines are voluntary for member nations. Some nations have adopted the guidelines almost unchanged. Terminology may vary between adopting nations, and may vary from that used above.

OECD guidelines give priority to transactional methods, described as the "most direct way" to establish comparability. The Transactional Net Margin Method and Profit Split methods are used either as methods of last resort or where traditional transactional methods cannot be reliably applied. CUP is not given priority among transactional methods in OECD guidelines. The Guidelines state, "It may be difficult to find a transaction between independent enterprises that is similar enough to a controlled transaction such that no differences have a material effect on price." Thus, adjustments are often required to either tested prices or uncontrolled process.

Comparability standards

OECD rules permit consideration of business strategies in determining if results or transactions are comparable. Such strategies include market penetration, expansion of market share, cost or location savings, etc.

Transactional net margin method

The transactional net margin method (TNMM) compares the net profitability of a transaction, or group or aggregation of transactions, to that of another transaction, group or aggregation. Under TNMM, use of actual, verifiable transactions is given strong preference. However, in practice TNMM allows making computations for company-level aggregates of transactions. Thus, TNMM may in some circumstances function like U.S. CPM.

Terms

Contractual terms and transactions between parties are to be respected under OECD rules unless both the substance of the transactions differs materially from those terms and following such terms would impede tax administration.

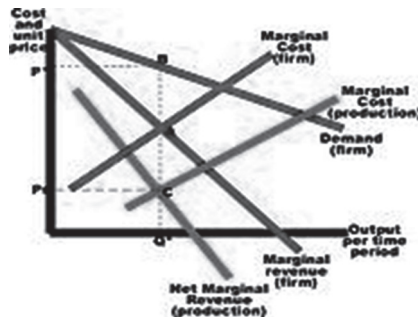
Adjustments

OECD rules generally do not permit tax authorities to make adjustments if prices charged between related parties are within the arm's length range. Where prices are outside such range, the prices may be adjusted to the most appropriate point. The burden of proof of the appropriateness of an adjustment is generally on the tax authority.

Documentation

OECD Guidelines do not provide specific rules on the nature of taxpayer documentation. Such matters are left to individual member nations.

Economic theory

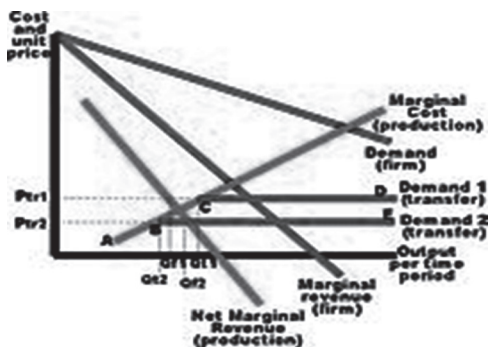


Transfer Pricing with No External Market

The discussion in this section explains an economic theory behind optimal transfer pricing with *optimal* defined as transfer pricing that maximizes overall firm profits in a non-realistic world with no taxes, no capital risk, no development risk, no externalities or any other frictions which exist in the real world. In practice a great many factors influence the transfer prices that are used by multinational corporations, including performance measurement, capabilities of accounting systems, import quotas, customs duties, VAT, taxes on profits, and (in many cases) simple lack of attention to the pricing.

From marginal price determination theory, the optimum level of output is that where marginal cost equals marginal revenue. That is to say, a firm should expand its output as long as the marginal revenue from additional sales is greater than their marginal costs. In the diagram that follows, this intersection is represented by point A, which will yield a price of P^* , given the demand at point B.

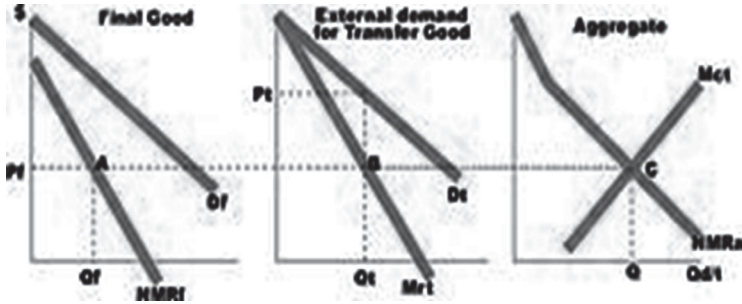
When a firm is selling some of its product to itself, and only to itself (i.e. there is no external market for that particular transfer good), then the picture gets more complicated, but the outcome remains the same. The demand curve remains the same. The optimum price and quantity remain the same. But marginal cost of production can be separated from the firm's total marginal costs. Likewise, the marginal revenue associated with the production division can be separated from the marginal revenue for the total firm. This is referred to as the Net Marginal Revenue in production (NMR) and is calculated as the marginal revenue from the firm minus the marginal costs of distribution.



Transfer Pricing with a Competitive External Market

It can be shown algebraically that the intersection of the firm's marginal cost curve and marginal revenue curve (point A) must occur at the same quantity as the intersection of the production division's marginal cost curve with the net marginal revenue from production (point C).

If the production division is able to sell the transfer good in a competitive market (as well as internally), then again both must operate where their marginal costs equal their marginal revenue, for profit maximization. Because the external market is competitive, the firm is a price taker and must accept the transfer price determined by market forces (their marginal revenue from transfer and demand for transfer products becomes the transfer price). If the market price is relatively high (as in $Ptr1$ in the next diagram), then the firm will experience an internal surplus (excess internal supply) equal to the amount $Qf1$ minus $Qf1$. The actual marginal cost curve is defined by points A,C,D.



Transfer Pricing with an Imperfect External Market

If the firm is able to sell its transfer goods in an imperfect market, then it need not be a price taker. There are two markets each with its own price (P_f and P_t in the next diagram). The aggregate market is constructed from the first two. That is, point C is a horizontal summation of points A and B (and likewise for all other points on the Net Marginal Revenue curves (NMRa)). The total optimum quantity (Q) is the sum of Q_f plus Q_t .

Alternative approaches to profit allocation

A frequently-propose alternative to arm's-length principle-based transfer pricing rules is formulary apportionment, under which corporate profits are allocated according to objective metrics of activity such as sales, employees, or fixed assets. Some countries (including Canada and the United States) allocate taxing rights among their political subdivisions in this way, and it has recommended by the European Commission for use within the European Union. According to the *amicus curiae* brief, filed by the attorneys general of Alaska, Montana, New Hampshire, and Oregon in support of the state of California in the U.S. Supreme Court case of *Barclays Bank PLC v. Franchise Tax Board*, the formulary apportionment method, which is also known as the unitary apportionment method, has at least three major advantages over the separate accounting system when applied to multi-jurisdictional businesses. First, the unitary method captures the added wealth and value resulting from economic interdependencies of multistate and multinational corporations through their functional integration,

Centralization of management, and economies of scale. A unitary business also benefits from more intangible values shared among its constituent parts, such as reputation, good will, customers and other business relationships.

Separate accounting, with its emphasis on carving out of the overall business only income from sources within a single state, ignores the value attributable to the integrated nature of the business. Yet, to a large degree, the wealth, power, and profits of the world's large multinational enterprises are attributable to the very fact that they are integrated, unitary businesses.

As one commentator has explained: To believe that multinational corporations do not maintain an advantage over independent corporations operating within a similar business sphere is to ignore the economic and political strength of the multinational giants. By attempting to treat those businesses which are in fact unitary as independent entities, separate accounting "operates in a universe of pretence; as in Alice in Wonderland, it turns reality into fancy and then pretends it is the real world"

Because countries impose different corporate tax rates, a corporation that has a goal of minimizing the overall taxes to be paid will set transfer prices to allocate



more of the worldwide profit to lower tax countries. Many countries attempt to impose penalties on corporations if the countries consider that they are being deprived of taxes on otherwise taxable profit. However, since the participating countries are sovereign entities, obtaining data and initiating meaningful actions to limit tax avoidance is hard. A publication of the Organisation for Economic Co-operation and Development (OECD) states, "Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions."



3

OECD MODEL ON TRANSFER PRICING

The Arm's Length principle

If two unrelated companies trade with each other, a market price for the transaction will generally result. This is known as "arms-length" trading, because it is the product of genuine negotiation in a market. This arm's length price is usually considered to be acceptable for tax purposes.

But when two *related* companies trade with each other, they may wish to artificially distort the price at which the trade is recorded, to minimise the overall tax bill. This might, for example, help it record as much of its profit as possible in a tax haven with low or zero taxes.

The example in the box illustrates how this is done. The "Arm's Length" principle is supposed to stop this by ensuring that the prices are recorded as if the trades were conducted at 'arm's length.' In practice, it is unworkable in many if not most situations: a lot of multinational corporate tax avoidance happens for this reason.

Consider what has happened in the example in the box with World Inc. These games have not resulted in more efficient or cost-effective production, transport, distribution or retail processes in the real world. The end result is, instead, that World Inc. has shifted its profits artificially out of both Africa and the United States, and into a tax haven. As a result, tax dollars have been shifted artificially away from both African and U.S. tax authorities, and have been converted into higher profits for the multinational. This is a core issue of tax justice – and unlike many issues which are considered to be either "developing country" issues or "developed country" issues – in this case the citizens of both rich and poor nations alike share a common set of concerns. Even so, developing countries are the most vulnerable to transfer mispricing by multinational corporations.

Transfer mispricing: traditional approaches

The conventional international approach to dealing with transfer mispricing is through the "arm's length" principle: that a transfer price should be the same as if the two companies involved were indeed two unrelated parties negotiating in a normal market, and not part of the same corporate structure. The OECD and the United Nations Tax Committee have both endorsed the "arm's length" principle, and it is widely used as the basis for bilateral treaties between governments.

Many companies strive to use the arm's length principle faithfully. Many companies strive to move in exactly the opposite direction. In truth, however, the arm's length principle is very hard to implement, even with the best intentions.

Imagine, for example, that two related parties are trading a tiny component for an aircraft engine, which is only made for that engine, and not made by anyone else. There are no market comparisons to be made, so the "arm's length" price is not obvious. Or consider the case of a company's brand. How much is the Shell Oil logo really worth? There is great scope for misunderstanding and for deliberate mispricing – providing much leeway for abuse, especially with regard to intellectual property such as patents, trademarks, and other proprietary information.



The resulting damage from the prevalent “arm’s length” approach has been, and is, substantial. Governments around the world are systematically hobbled in their ability to collect revenues from the corporate tax system. Billions of dollars are wasted annually around the world on governmental enforcement efforts that have little chance of success, and on meeting expensive compliance requirements.

Alternative approaches: unitary taxation with profit apportionment

While multinationals tend to favour the arm’s length principle as the basis for determining transfer pricing – it gives them tremendous leeway to minimise tax – academics, some public sector and private sector practitioners and, increasingly, non-governmental organisations, favour an alternative approach: combined reporting, with formulary apportionment and Unitary Taxation. This would prioritise the economic *substance* of a multinational and its transactions, instead of prioritising the legal *form* in which a multinational organises itself and its transactions.

These terms may seem complex and baffling, but the basic principles are quite straightforward, and the system is far simpler than the ineffective “arm’s length” method. While the arm’s length principle gives multinational companies leeway to decide for themselves where to shift their profits, the unitary taxation approach involves taxing the various parts of a multinational company based on what it is doing in the real world.

Unitary taxation originated in the United States over a century ago, as a response to the difficulties that U.S. states were having in taxing railroads. How would these multi-jurisdictional corporate entities be taxed by each state? Gross receipts within the state? Assets? How should they tax the railroad’s rolling stock? In the state of incorporation, or in the states in which it was used?

Transactions subject to Transfer pricing

The following are some of the typical international transactions which are governed by the transfer pricing rules:

- Sale of finished goods;
- Purchase of raw material;
- Purchase of fixed assets;
- Sale or purchase of machinery etc.
- Sale or purchase of Intangibles.
- Reimbursement of expenses paid/received;
- IT Enabled services;
- Support services;
- Software Development services;
- Technical Service fees;
- Management fees;
- Royalty fee;
- Corporate Guarantee fees;
- Loan received or paid.

Purposes of Transfer Pricing

The key objectives behind having transfer pricing are:

- Generating separate profit for each of the divisions and enabling performance evaluation of each division separately.
- Transfer prices would affect not just the reported profits of every centre, but



would also affect the allocation of a company's resources (Cost incurred by one centre will be considered as the resources utilized by them).

Why Organizations need to understand Transfer Pricing

For the purpose of management accounting and reporting, multinational companies (MNCs) have some amount of discretion while defining how to distribute the profits and expenses to the subsidiaries located in various countries. Sometimes a subsidiary of a company might be divided into segments or might be accounted for as a standalone business. In these cases, transfer pricing helps in allocating revenue and expenses to such subsidiaries in the right manner.

The profitability of a subsidiary depends on prices at which the inter-company transactions occur. These days the inter-company transactions are facing increased scrutiny by the governments. Here, when transfer pricing is applied, it could impact shareholders wealth as this influences company's taxable income and its after-tax, free cash flow.

It is important that a business having cross-border intercompany transactions should understand transfer pricing concept, particularly for the compliance requirements as per law and to eliminate the risks of non-compliance.

Provisions in the Income Tax Statute

To restrict these kinds of the activities, finance Act, 1994 has introduced section 92A to 92F under the Income Tax Act, 1994 which is also known as "transfer pricing". A separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 (the Act) covers intra-group cross-border transactions which is applicable from 1 April 2001 and specified domestic transactions which is applicable from 1 April 2012. Since the introduction of the code, transfer pricing has become the most important international tax issue affecting multinational enterprises operating in India. The regulations are broadly based on the Organisation for Economic Co-operation and Development (OECD) Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements, and contain harsh penal provisions for noncompliance.

The Indian Transfer Pricing Code prescribes that income arising from international transactions or specified domestic transactions between associated enterprises should be computed having regard to the arm's-length price. It has been clarified that any allowance for an expenditure or interest or allocation of any cost or expense arising from an international transaction or specified domestic transaction also shall be determined having regard to the arm's-length price. The Act defines the terms 'international transactions', 'specified domestic transactions', 'associated enterprises' and 'arm's-length price'.

Transfer Pricing Methodologies

The OECD (The Organisation for Economic Co-operation and Development) Guidelines discusses the transfer pricing methods which could be used for examining the arms-length price of the controlled transactions. Here, arms-length price refers to the price which is applied or proposed or charged when unrelated parties enter into similar transactions in an uncontrolled condition.

The following are three of the most commonly used transfer pricing methodologies:

For the purpose of understanding, associated enterprises refer to an enterprise which directly or indirectly participates in the management or capital or control of another enterprise.

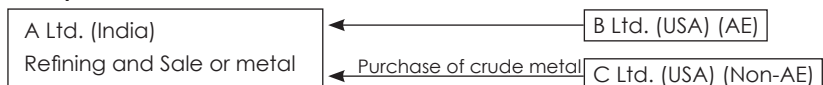
Comparable Uncontrolled Price (CUP) Method

Under CUP method, a price which is charged in an uncontrolled transaction between the comparable firms is recognized and evaluated with a verified



entity price for determining the Arm's Length Price.

Example:



A Ltd. purchases 10,000 MT metal from B Ltd. its subsidiary @ INR 30,000 /MT. Also purchase from C Ltd. 2,500 MT @ INR 40,000/MT. A Ltd. received discount of INR 500 /MT as quantity discount from B Ltd. B Ltd. allows credit of one month at 1.25% pm. The transaction with B Ltd. is at FOB (Free on board) whereas with C Ltd. is at CIF (Cost, Insurance, and Freight). The cost of freight and Insurance is INR 1,000. Here, the terms of transactions are not same and hence, it has affected the cost of the crude metal. Hence, adjustments are needed.

Adjustments required for differences in:

1. Quantity discount: In case similar discount is offered by C Ltd., the price that was charged by C Ltd. would have been lower by INR 500/MT.
2. Freight & Insurance (FOB Vs CIF): In case the purchase from C Ltd. was also on FOB, then price charged by C Ltd. would have been lesser. Hence, the cost of freight & insurance must be reduced from purchase price.
3. Credit period: In case the similar credit was offered by C Ltd., then price charged by them would have been more after factoring such cost. Hence, 1.25% pm must be added to the purchase price.

Computation of Arm's length price:

<u>Particulars</u>	<u>Price per MT</u>
	INR 40,000
Price/MT	
Adjustments:	
Less: Quantity discount	(500)
Less: Freight & Insurance Cost	(1000)
Add: Interest for credit	500 (40,000 *1.25%)
Arm's length price/MT	INR 39,000

This method is most reliable and is considered as a direct way of applying arms-length principle and for determining the prices for related party transactions. However, while considering whether the controlled and uncontrolled transactions are comparable, high care has to be taken. Hence, this way of arriving at transfer price isn't applied unless products or services meet the stringent requirements of the high comparability.

Resale Price Method or Resale Minus Method

In this method, it takes the prices at which the associated enterprise sells its product to the third party. This price is referred to as the resale price. The gross margin which is determined by comparing the gross margins in a comparable uncontrolled transaction is then reduced from this resale price. After this, costs which are associated with the purchase of such product such as the customs duty are deducted. What remains is considered as arm's length price for a controlled transaction between the associated enterprises.

Example:

A Ltd is a deal in IT products. A Ltd had purchased desktops from a related party, B Ltd and also from a non-related party C Ltd.



Particulars	B Ltd. (AE)	C Ltd. (Non-AE)
Purchase price of A Ltd.	INR 30,0000	INR 44,000
Sales Price of A Ltd.	INR 36,000	INR 52,000
Other Expenses incurred by A Ltd	INR 500	INR 800
Gross Margin	18.33%	13.85%

Calculation of Arm's length price

Particulars	Amount	
Sale Price in India	36,000	
Less: Expenses related to B Ltd.	INR 500	
Less: Resale Margin @ 13.85%	INR 4986	
Arm's length price	INR 30,514	➤ Price which should have been paid
Price paid to B Ltd.	INR 30,000	➤ Price which is actually paid

Cost Plus Method

With Cost Plus Method, you emphasize on costs of the supplier of goods or services in the controlled transaction. Once you're aware of the costs, you need to add a mark-up. This mark-up must reflect the profit for the associated enterprise on basis of risks and functions performed. The result is the arm's length price. Generally, the mark-up in the cost plus method would be calculated after the direct and indirect cost related to production or supply is considered. But, operating expenses of an enterprise (like overhead expenses) aren't part of this mark-up.

Example

Associated Enterprise-A, a computer manufacturer in Thailand, manufactures under a contract for Associated Enterprise B. Associated Enterprise B would instruct Associated Enterprise-A about quantity and quality of computers to be manufactured. The Associated Enterprise-A would be guaranteed of its sales to Associated Enterprise B and would have little or no risk.

Let's assume that Cost of goods sold is INR 50,000. Also, assume that the arm's length mark-up which Associated Enterprise-A should earn is 40%. The resulting arm's length price between Associated Enterprise-A and Associated Enterprise B is INR 70,000 (i.e. INR 50,000 x (1 + 0.40)).

Domestic Transactions

Until financial year (FY) 2011-12, transfer pricing regulations were not applicable to domestic transactions. However, The Finance Act 2012 has extended the application of transfer pricing regulations to 'specified domestic transactions', being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds INR 5 crore:

Transactions which are covered under the Specified Domestic Transactions include:

Expenditures in which payment has been made or would be made to:

- a. A director
- b. A relative of the director
- c. An entity where a director or the company has the voting interest exceeding 20%
- ☐ Transactions which relates to transfer of goods or services provided in Section 80-IA (8) & (10) (i.e. deductions which are related to profits and gains from enterprises engaged in infrastructure development or industrial undertakings, producers and distributors of power or Telecommunication Service Providers). SDT is also applicable to the transactions between the entity located in a tax holiday area, and the one which is situated in a



non-tax holiday area in case both are under same management structure.

- For undertakings which are established in SEZs (special economic zones), free trade zone or EOUs (export-oriented units) involving transfer of goods and services to another unit under same management at the non-market prices.

The above transactions would be treated as Specified Domestic Transactions only if the aggregate value of such transactions exceeds INR 5 crore.

Any expenditure with respect to which deduction is claimed while computing profits and gains of business or profession.

Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (Section 80-IA) and SEZ units (section 10AA).

Any other transactions as may be specified.

This amendment is applicable from FY 2012-13.

Definition of Associated enterprises

The relationship of associated enterprises (AEs) is defined by Section 92A of the Act to cover direct/Indirect participation in the management, Control or capital of an enterprise by another enterprise. It also covers situations in which the same person (directly or indirectly) participates in the management, control or capital of both the enterprises. For the purposes of the above definition, certain specific parameters have been laid down based on which two enterprises would be deemed as AEs.

These parameters include:

Direct/Indirect holding of 26% or more voting power in an enterprise by the other enterprise or in both the enterprises by the same person.

Advancement of a loan, by an enterprise, that constitutes 51% or more of the total book value of the assets of the borrowing enterprise.

Guarantee by an enterprise for 10% or more of total borrowings of the other enterprise.

Appointment by an enterprise of more than 50% of the board of directors or one or more executive directors of the other enterprise or the appointment of specified directorships of both enterprises by the same person.

Complete dependence of an enterprise (in carrying on its business) on the intellectual property licensed to it by the other enterprise.

Substantial purchase of raw material/sale of manufactured goods by an enterprise from/to the other enterprise at prices and conditions influenced by the latter.

The existence of any prescribed relationship of mutual interest.

Furthermore, in certain cases, a transaction between an enterprise and a third party may be deemed to be a transaction between AEs if there exists a prior agreement in relation to such transaction between the third party and an AE or if the terms of such transaction are determined in substance between the third party and an AE. Accordingly, this rule aims to counter any move by taxpayers to avoid the transfer pricing regulations by interposing third parties between group entities.

The arm's-length principle and pricing methodologies

The term 'arm's-length price' is defined by Section 92F of the Act to mean a price that is applied or is proposed to be applied to transactions between persons other than AEs in uncontrolled conditions. The following methods have been prescribed by Section 92C of the Act for the determination of the arm's-length price:



Comparable uncontrolled price (CUP) method.

- Resale price method (RPM).
- Cost plus method (CPM).
- Profit split method (PSM).
- Transactional net margin method (TNMM).
- Such other methods as may be prescribed.

In this regard, The Central Board of Direct Taxes has notified that the 'other method' for determination of the arm's-length price in relation to an international transaction shall be any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts. The 'other method' shall apply to FY 2011-12 and subsequent years. However, For domestic transaction there is no "other method" as been prescribed by CBDT so far which has resulted in difficulty in determination of Arm Length Price in various cases. No particular method has been accorded a greater or lesser priority. The most appropriate method for a particular transaction would need to be determined having regard to the nature of the transaction, Class of transaction or associated persons and functions performed by such persons, as well as other relevant factors.

The regulations require a taxpayer to determine an arm's-length price for international transactions or specified domestic transactions. It further provides that where more than one arm's-length price is determined by applying the most appropriate transfer pricing method, the arithmetic mean (average) of such prices shall be the arm's-length price of the international transaction or specified domestic transactions. Accordingly, The Indian regulations do not recognise the concept of arm's-length range but requires the determination of a single arm's-length price.

However, some flexibility has been extended to taxpayers by allowing a range benefit which may be extended up to maximum 5%. Accordingly, if the variation between the arm's-length price and the price at which the transaction has actually been undertaken does not exceed the specified range of the latter, the price at which the transaction has actually been undertaken shall be deemed to be the arm's-length price. Therefore, the benefit of the range would be available only if the arm's-length price falls within the specified range of the transfer price. This, In turn, would have the effect of disallowing the benefit to a taxpayer where variation between the arm's-length price and transfer price of the taxpayer exceeds the specified range, leading to a transfer pricing adjustment even though the transfer price is only marginally outside the range benefit.

The transfer pricing provisions will not apply if the arm's-length price would result in a downward revision in the income chargeable to tax in India.

Documentation requirements

Taxpayers are required to maintain, on an annual basis, A set of extensive information and documents relating to international transactions undertaken with AEs or specified domestic transactions. Rule 10D of the Income Tax Rules, 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer. Such requirements can broadly be divided into two parts.

The first part of the rule lists mandatory documents/Information that a taxpayer must maintain likewise, the second part of the rule requires that adequate documentation be maintained that substantiates the information/analysis/



studies documented under the first part of the rule. The second part also contains a recommended list of such supporting documents, including government publications, reports, studies, technical publications/market research studies undertaken by reputable institutions, Price publications, Relevant agreements, contracts and correspondence.

Taxpayers having aggregate international transactions below the prescribed threshold of INR 10 million and specified domestic transactions below the threshold of INR 50 million are relieved from maintaining the prescribed documentation. However, even in these cases, It is imperative that the documentation maintained should be adequate to substantiate the arm's-length price of the international transactions or specified domestic transactions.

All prescribed documents and information have to be contemporaneously maintained (to the extent possible) and must be in place by the due date of the tax return filing. Companies to whom transfer pricing regulations are applicable are currently required to file their tax returns on or before 30 November following the close of the relevant tax year. The prescribed documents must be maintained for a period of nine years from the end of the relevant tax year and must be updated annually on an ongoing basis. The documentation requirements are also applicable to foreign companies deriving income liable to Indian withholding tax.

Accountant's report

It is mandatory for all taxpayers, without exception, to obtain an independent accountant's report in respect of all international transactions between associated enterprises or specified domestic transactions. The report has to be furnished by the due date of the tax return filing (i.e. on or before 30 November). The form of the report has been prescribed. The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer. Furthermore, the accountant is required to certify the correctness of an extensive list of prescribed particulars.

In this context, it is important to note that entities enjoying a tax holiday in India still need to comply with transfer pricing provisions and would need to demonstrate that their international transactions have been carried out at arm's length. In addition, such entities would not be entitled to a tax holiday on any upward adjustment made to their transfer prices in the course of an audit.



4

TRANSFER PRICING METHODS

There are several methods that multinational enterprises (MNEs) and tax administrations can use to determine accurate arm's length transfer pricing for transactions between associated enterprises. The Organisation for Economic Co-operation and Development (OECD) outlines five main transfer pricing methods that MNEs and tax administrations can use. We explore the five methods, giving examples for each, to help organizations decide which is most appropriate for their needs. Royalty Range's premier-quality databases enable organizations to access the latest comparable agreements and other comparables data so that they can apply transfer methods accurately and efficiently.

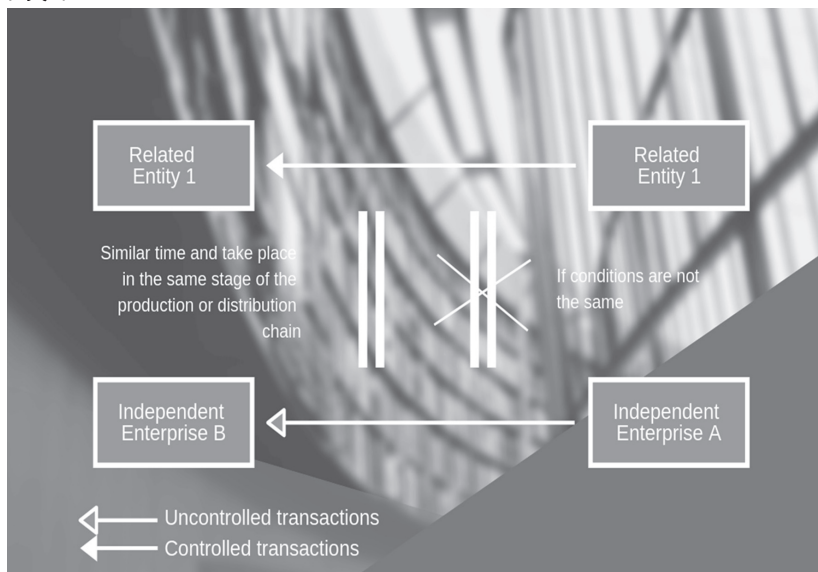
1. Comparable uncontrolled price (CUP) method

The CUP method is grouped by the OECD as a traditional transaction method (as opposed to a transactional profit method). It compares the price of goods or services and conditions of a controlled transaction (between related entities) with those of an uncontrolled transaction (between unrelated entities). To do so, the CUP method requires comparables data from commercial databases.

If the two transactions result in different prices, then this suggests that the arm's length principle may not be implemented in the commercial and financial conditions of the associated enterprises. In such circumstances, the OECD says the price in the transaction between unrelated parties may need to be substituted for the price in the controlled transaction. The CUP method is the OECD's preferred method in situations where comparables data is available.

Example of CUP

An example of when the CUP method works well is when a product is sold between two associated enterprises and the same product is also sold by an independent enterprise. The OECD gives the example of coffee beans. The two transactions can be seen as comparable if the conditions are the same, they happen at a similar time and take place in the same stage of the production or distribution chain. If there are differences in the product sold in each of the transactions (e.g. the uncontrolled transaction used coffee beans from another source) then the associated enterprises would need to determine whether this affected the price. If so, it would need to make adjustments to the cost to ensure it was priced at arm's length.



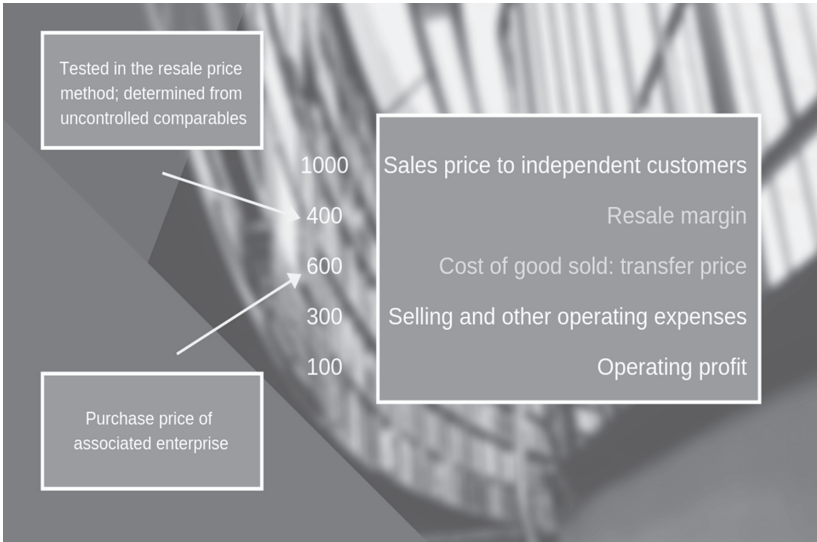
2. Resale price method

Another traditional transaction method for determining transfer pricing is the resale price method. This method starts by looking at the resale price of a product that has been bought from an associated enterprise and then sold onto an independent party. The price of the transaction where the item is resold to the independent enterprise is called the resale price. The method then requires the resale price margin to be identified, which is the amount of money the party reselling the product would require to cover the costs of the associated selling and operating expenses.

The resale price margin also includes the amount the reseller would need to make a fair profit, taking into account the functions it performed (including assets used and risks assumed). This gross resale price margin is deducted from the resale price.

The amount that remains after the margin has been subtracted and fair adjustments have been made (e.g. expenses like customs duty have been taken into account) is the arm's length price for the original transaction between related entities.

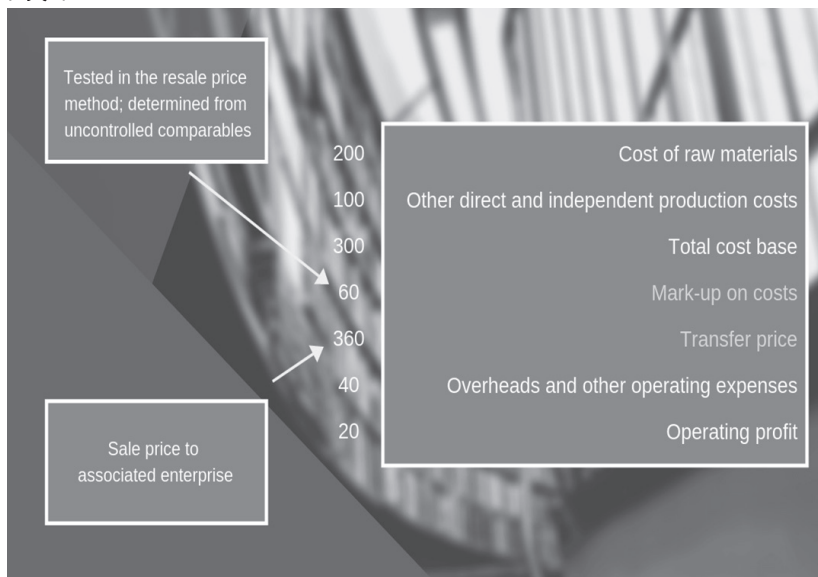
The resale price method requires resale price margins to be comparable in order for an arm's length price to be identified. This means that factors such as whether a warranty is offered (and how it is applied) must be taken into account. If a distributor offers a warranty and sells the product at a higher price to account for that warranty, then they will make a higher gross profit margin than a distributor that does not offer a warranty and sells the product at a lower price. For the two transactions to be comparable, the taxpayer must make accurate adjustments to the transaction cost to account for the margin discrepancy.



3. Cost plus method

The cost plus method is a traditional transaction method that analyzes a controlled transaction between an associated supplier and purchaser. It is often used when semi-finished goods are transacted between associated parties or when related entities have long-term arrangements for 'buy and supply'. The supplier's costs are added to a mark-up for the product or service so that the supplier makes an appropriate profit that takes into account the functions they performed and the current conditions of the market. The combined price is the arm's length price for the transaction.

For example, Party A manufactures zips for business bags and briefcases to be sold by companies around the world. Party A sells the product to Party B, which is an associated company in another country. From this transaction with Party B, Party A earns a gross profit mark-up. Party A does not include operating expenses in the cost of the product. Party C and Party D are independent enterprises that manufacture zip mechanisms for coats. They sell their products to independent clothing brands and also earn a gross profit mark-up for the transaction. Party C and Party D include operating expenses in the cost of their products. So, the gross profit mark-ups of Party C and Party D need to be adjusted to be comparable with Party A's.



4. Transactional net margin method (TNMM)

The TNMM is one of two transactional profit methods outlined by the OECD for determining transfer pricing. These types of methods assess the profits from particular controlled transactions. The TNMM involves assessing net profit against an “appropriate base”, such as sales or assets, those results from a controlled transaction. The OECD states that, in order to be accurate, the taxpayer should use the same net profit indicator that they would apply in comparable uncontrolled transactions. Taxpayer can use comparables data to find the net margin that would have been earned by independent enterprises in comparable transactions. The taxpayer also needs to carry out a functional analysis of the transactions to assess their comparability.

If an adjustment is needed for a gross profit mark-up to be comparable, but the information on the relevant costs is not available, then taxpayers can use the net profit method and indicators to assess the transaction. This approach can be taken when the functions performed by comparable entities are slightly different. For example, an independent enterprise offers technical support for the sale of a piece of IT equipment.

The cost of the support is included in the price of the product but cannot be easily separated from it. An associated enterprise sells the same product but doesn't offer this support. So, the gross margins of the transactions are not comparable. By examining net margins, associated enterprises can more easily identify the difference in transfer pricing in relation to the functions performed.

5. Transactional profit split method

The second transactional profit method outlined by the OECD is the transactional profit split method. It focuses on highlighting how profits (and indeed losses) would have been divided within independent enterprises in comparable transactions. By doing so, it removes any influence from “special conditions made or imposed in a controlled transaction”. It starts by determining the profits from the controlled transactions that are to be split. The profits are then split between the associated enterprises according to how they would have

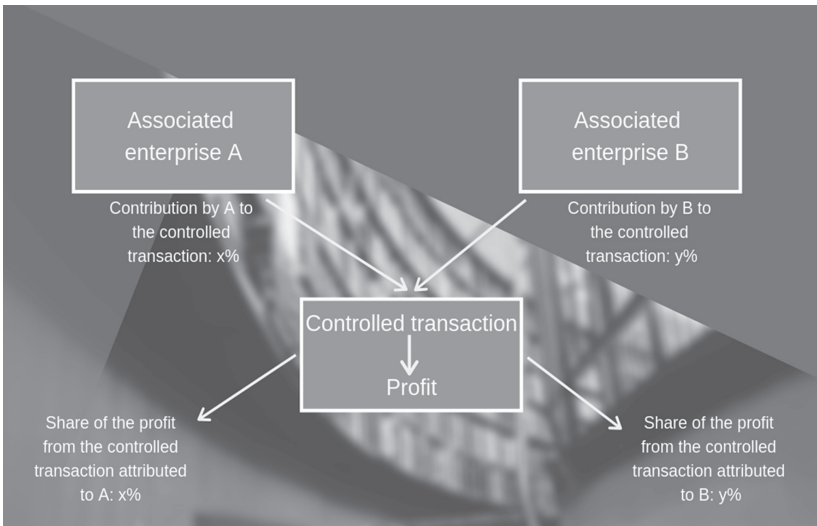


been divided between independent enterprises in a comparable uncontrolled transaction. This method results in an appropriate arm's length price of controlled transactions.

There are two main approaches that can be taken for splitting profits. These are:

Contribution analysis: The combined profits are divided based on the relative value of the functions performed by each of the related entities within the controlled transaction (considering assets used and risks assumed).

Residual analysis: The combined profits are divided in two stages. First, each entity is allocated arm's length compensation for its functions and contribution to the controlled transaction. Second, any remaining profit or loss after the first stage is divided based on analysis of the facts and circumstances of the transaction.



Accessing data for transfer pricing analyses

These are the five transfer pricing methods, and the ones favoured by the OECD. The option that an organization chooses to use depends on the particular situation. It should take into account the amount of relevant comparable data that is available, the level of comparability of the uncontrolled and controlled transactions in question, and whether a method is appropriate for the nature of a particular transaction (determined through a functional analysis). The OECD states that it is not necessary to use more than one transfer pricing method when determining the arm's length price for a particular transaction.

Problems associated with Transfer Pricing

There are quite a few problems associated with the transfer prices. Some of these issues include:

- ❑ There could be differences in opinions among organizational divisional managers with respect to how transfer price needs to be set.
- ❑ Additional time, costs and manpower would be required for executing the transfer prices and designing the accounting system to match the requirements of transfer pricing rules.
- ❑ Arm's length prices might cause dysfunctional behaviour among the



managers of organizational units.

- For some of the divisions or departments, for instance, a service department, arm's-length prices don't work equally well as such departments don't offer measurable benefits.
- The transfer pricing issue in a multinational setup is very complicated.

Burden of proof

The burden of proving the arm's-length nature of a transaction primarily lies with the taxpayer. If the tax authorities, during audit proceedings on the basis of material, information or documents in their possession, are of the opinion that the arm's-length price was not applied to the transaction or that the taxpayer did not maintain/Produce adequate and correct documents/Information/Data, The total taxable income of the taxpayer may be recomputed after a hearing opportunity is granted to the taxpayer.

When does the Transfer Pricing Rule Apply?

Transfer pricing rules apply only to '**Associated Enterprises**' involved in trading with each other. So, in order to determine whether an enterprise is an "Associated Enterprise" or not depends on the relationship between the enterprises. The relationship between the enterprises is determined by the participation in management, control of one enterprise by another enterprise, etc. One important thing that is to be noted here is that the association can be direct or indirect or through one or more intermediaries. For example, enterprise A owns or controls enterprise B either directly or through an intermediary, then enterprise A and B are Associated Enterprises and transfer pricing rule applies to them. And if Mr. X is controlling both Enterprise A and Enterprise B then enterprises A and B are Associated Enterprises.

In case of cross-border transactions, the transfer pricing rules apply, where at least one of the associated enterprises to the transaction is a non-resident enterprise. For example, Enterprise A is located in India and its associated enterprise, B is located in South Africa. The transfer pricing rules will apply to the transaction between Enterprise A and Enterprise B. But Suppose, Enterprise A is the resident enterprise which imports goods from an unassociated foreign enterprise B. But they have an agreement which states that the import prices would be fixed by an associated enterprise of A say C. Now the transfer pricing rules will apply to this transaction with the unassociated foreign enterprise B also. The transfer pricing rules also apply to specified domestic transactions (which are not international transactions) if the aggregate value exceeds 'Rs.5 crore'.

How Should the Income be calculated?

The income arising out of the international transactions between the associated enterprises should be determined by using the **Arm's Length Price (ALP)**. Arm's Length Price is a price that is fixed by the associated enterprises as if they had fixed the price between unassociated enterprises entering into the transaction. There are prescribed methods for determining the Arm's Length Price. They are: Transactional Net Margin Method, Profit Split Method, Comparable Uncontrolled Price Method, Cost plus method and Resale Price Method. The taxpayers should use the most appropriate method.

Importance of Documentation

If the aggregate value of the international transaction is above INR 10 million, then all the information regarding the international transaction should be documented. An analysis of the most appropriate method used should also be documented. An accountant should also certify that the method used to determine the ALP was in accordance with the transfer pricing rules. And this documentation is a mandatory annual requirement, and it should be maintained for a minimum period of 8 years. If the value is less than INR 10 million then the



analysis on the determination of ALP would be sufficient. The documentation should be submitted within 30 days of request. The documentation is important because the burden of proof is always on the taxpayers and they have to prove their claim that the method used was in accordance with the rules.

Adjustments to Reported Income

The taxpayer might have followed all the procedures in accordance with the rules, but sometimes there may be a difference between transfer prices as per the financial statement and the arm's length price. In such cases, the Transfer Pricing Officer can propose an amount that can be adjusted to the reported income of the taxpayers. The additional assessment amount should be paid within 30 days of notice.



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TRANSFER PRICING REGULATION IN INDIA

Transfer Pricing In India

In India, TP Regulations were first introduced in 2001, as a measure against tax avoidance. The Indian TP Regulations are largely influenced by the said OECD TP Guidelines, but they are modified to specifically meet the needs of the Indian tax regime.

Similar to the OECD Guidelines and TP Regulations of several other countries, Indian TP Regulations prescribe methods to compute 'Arm's Length Price' for an 'International Transaction' or a 'Specified Domestic Transaction' entered into by a taxpayer with its 'Associated Enterprise'.

Section 92 of the Income tax Act, 1961 provides for the authority to an assessing officer to determine the profit which may be reasonably be deemed to have been derived from a transaction. This would be applicable where controlled Companies (associated enterprises) arrange the business between them in a way that either no profit is earned from such transaction or profit earned is lower than what would be expected in a transaction between uncontrolled Companies (un related entities).

A transfer price is what one part of a company charges another part of the same company for goods or services. It is a mechanism for distributing revenue between different divisions which jointly develop, manufacture and market products and services. Transfer pricing refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services or the use of property (including intangible property). Transfer prices among components of an enterprise may be used to reflect allocation of resources among such components, or for other purposes. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing exists to communicate data which will lead to goal-achieving decisions and also to evaluate performance and motivate managers to make goal-achieving decisions. The objective of international transfer pricing focuses on minimizing taxes, duties, and foreign exchange risks, along with enhancing a company's competitive position and improving its relations with foreign governments. Transfer pricing is a recent corporate tax happening in India. Prompted by the growing participation of multinationals in India, the government introduced "transfer pricing" regulations in the Finance Act of 2001 to ensure that Indian companies report "reasonable, fair and equitable" profits and taxes on transactions with "associated enterprises" such as a foreign parent company. When one subsidiary of a corporation in one country sells goods, services or know-how to another subsidiary in another country, the price charged for these goods or services is called the transfer price. All kinds of transactions within corporations are subject to transfer pricing, including those involving raw material, finished products and payments such as management fees, intellectual property royalties, loans, interest on loans, payments for technical assistance and know-how and other transactions. The rules on transfer pricing



require MNCs to conduct business between their affiliates and subsidiaries on an 'arm's length' basis, which means that any transaction between two entities of the same MNC should be priced as if the transaction was conducted between two unrelated parties.

Transfer pricing systems are made to achieve **the following objectives:**

- To provide each division with relevant information required to make the best possible decisions for the organisation as a whole;
- To promote goal correspondence: that is, actions by divisional managers to optimize divisional performance should automatically optimize the firm's performance;
- To facilitate measuring of divisional performances: It is useful for evaluating the economic performance of divisions and the managerial performance of division managers.
- To ensure that divisional autonomy is maintained: In principle, the top management of the company could simply issue precise instructions to divisions as to what goods to transfer to each other, in what quantities and at what prices. However, most of the organisations are unwilling to do this because of the enormous benefits of allowing divisional autonomy.
- To evaluate a division manager's performance, based on the profits that he generates,
- To help coordinate the divisions' decisions to achieve the organisation's goals - i.e. to ensure goal consensus.
- To enable the divisions to take decisions such as the pricing of the final product,
- To preserve the divisions' autonomy.

There are three general methods for establishing transfer prices.

1. **Market-based transfer price:** In the presence of competitive and stable external markets for the transferred product, many firms use the external market price as the transfer price.
2. **Cost-based transfer price:** The transfer price is based on the production cost of the upstream division.
A cost-based transfer price requires that the following criteria be specified:
 - a. Actual cost or budgeted (standard) cost.
 - b. Full cost or variable cost.
 - c. The amount of mark-up, if any, to allow the upstream division to earn a profit on the transferred product.
3. **Negotiated transfer price:** The senior management does not specify the transfer price. Instead, divisional managers negotiate a mutually-agreeable price.

Purposes of Transfer-Pricing

There are below main reasons for instituting a transfer-pricing scheme:

- It generates separate profit figures for each division and thereby evaluates the performance of each division separately.
- It helps coordinate the production, sales and pricing decisions of the different divisions (via an appropriate choice of transfer prices). Transfer prices make managers aware of the value that goods and services have for other segments of the firm.
- Transfer pricing allows the company to generate profit (or cost) figures for each division separately.
- The transfer price will affect not only the reported profit of each centre, but



will also affect the allocation of an organisation's resources.

One general advantage that all companies involved in transfer pricing can look out for and try to manage on their own, would be to establish high transfer prices for their goods and services and transfer them to a unit that is located in a jurisdiction that has low tax rates.

This will result in the company having more revenue in a jurisdiction that is subjected to a lower tax rate and less revenue in a jurisdiction that is subjected to a higher tax rate.

A very important element when working with transfer pricing is to maintain a buyer-seller relationship between the units of a single company. Sometimes companies face the problem of double taxation, as many companies that are involved in transfer-pricing operate under different taxation authorities or in different jurisdictions.

Double taxation occurs when a company is forced to obey the taxation authorities of two jurisdictions, due to overlapping or conflicting tax laws and regulations. It is advisable for a company which is involved in transfer-pricing to have a knowledgeable understanding of the different ways they can increase their advantages and decrease their disadvantages.

Transfer pricing is a mode by which Multinational Enterprises (MNEs) makes huge profits by increasing the price of products or services in low-tax jurisdictions and decreasing the price in high-tax jurisdictions, thereby shifting profits especially in a scenario in which more than 60 percent of the international trade is carried out intra-group. Transfer pricing thus results in a huge loss to the public department which is prevented from taxing a product or service or, on the other hand, is prevented from realising the actual tax at which a product would have been taxed in a country. The theory of Transfer Pricing is based on the concept of 'functions, risks and assets'.



6

STATUTORY RULES AND REGULATIONS UNDER INCOME TAX ACT

A separate code on transfer pricing under Sections 92 to 92F of the Indian Income Tax Act, 1961 ("the Act") covers intra-group cross-border transactions and specified domestic transactions. Since the introduction of the code, transfer pricing has become the most important international tax issue affecting multinational enterprises operating in India. The regulations are broadly based on the Organisation for Economic Co-operation and Development ("OECD") Guidelines and describe the various transfer pricing methods, impose extensive annual transfer pricing documentation requirements and contain harsh penal provisions for noncompliance.

The Indian Transfer Pricing Code prescribes that income arising from international transactions or specified domestic transactions between associated enterprises should be computed having regard to the arm's length price. It has been clarified that any allowance for an expenditure or interest or allocation of any cost or expense arising from an international transaction or specified domestic transaction also shall be determined having regard to the arm's-length price. The Act defines the terms international transactions, specified domestic transactions, associated enterprises and arm's length price.

Type of transactions covered

The Indian transfer pricing regulations are applicable to an international transaction as well as to specified domestic transactions entered into two (or more) associated enterprises. Section 92B of the Act defines the term "international transaction" to mean a transaction between two (or more) associated enterprises involving the sale, purchase or lease of tangible or intangible property; provision of services; cost-sharing arrangements; lending/borrowing of money; or any other transaction having a bearing on the profits, income, losses or assets of such enterprises.

Further, the Finance Act 2012 extended the application of transfer pricing regulations to "specified domestic transactions", being the following transactions with certain related domestic parties, if the aggregate value of such transactions exceeds INR 5 crore:

- Any transaction related to businesses eligible for profit-linked tax incentives, for example, infrastructure facilities (Section 80-IA) and SEZ units (section 10AA); and
- Any other transactions as may be specified.

Associated enterprises ("AEs")

The relationship of associated enterprises is defined by Section 92A of the Act to cover direct/ indirect participation in the management, control or capital of an enterprise by another enterprise. It also covers situations in which the same person (directly or indirectly) participates in the management, control or capital of both the enterprises. For the purposes of the above definition, Section 92A of the Act specifies certain parameters have been laid down based on which two enterprises would be deemed as AEs.



Arm's length principle and pricing methodologies

The term 'arm's length price' is defined by Section 92F of the Act to mean a price that is applied or is proposed to be applied to transactions between persons other than AEs in uncontrolled conditions. The following methods have been prescribed by Section 92C of the Act for the determination of the arm's-length price:

- Comparable uncontrolled price (CUP) method
- Resale price method (RPM)
- Cost plus method (CPM)
- Profit split method (PSM)
- Transactional net margin method (TNMM)
- Such other methods as may be prescribed

These regulations require a taxpayer to determine an arm's-length price for international transactions or specified domestic transactions. However, transfer pricing provisions will not apply if the arm's-length price would result in a downward revision in the income chargeable to tax in India.

Documentation requirements

Taxpayers are required to maintain, on an annual basis, a set of extensive information and documents relating to international transactions undertaken with AEs or specified domestic transactions. Rule 10D of the Income Tax Rules, 1962 prescribes detailed information and documentation that has to be maintained by the taxpayer.

Further, it is mandatory for all taxpayers, without exception, to obtain an independent accountant's report in respect of all international transactions between associated enterprises or specified domestic transactions. The report has to be furnished by the due date of the tax return filing (i.e. on or before 30 November) to avoid stringent penalties prescribed for noncompliance with the provisions of the transfer pricing code.

Associated Enterprises

Section 92A of the Income Tax Act, 1961 defines associated enterprise as, an enterprise which:

- Participates directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management, control, or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

The Regulations further provide specific conditions and circumstances under which two entities are deemed to be Associated Enterprises.

Computation of ALP

The Indian TP Regulations require computation of ALP based on the prescribed TP methods. The Regulations have prescribed the following five methods for determination of ALP —

Price Based Methods

1. Comparable Uncontrolled Price Method (CUP):
 - Compare the prices charged for property or services for controlled transactions vs. uncontrolled transactions.
 - The basic tenet is to compare close similarity in products, property or



services that are involved

- Timing of the transactions are relevant where prices of the product fluctuate regularly
- 2. Cost Plus Method (CPM)
 - CPM determines ALP by adding Gross Profit Margin (mark-up) earned in comparable transaction(s) / by comparable companies to the cost incurred by Tested Party under controlled transaction
- 3. Resale Price Method (RPM)
 - RPM computes purchase price paid to related party based on its resale price to unrelated party
 - RPM is typically useful to determine ALP of purchases made by the distributor (trader) from related party

Profit Based Methods

- 1. Profit Split Method (PSM):
 - PSM determines arm's length profit based on combined profits derived by related parties
- 2. Transactional Net Margin Method (TNMM).
 - TNMM tests the net margins of the tested party as oppose to gross margins in case of RPM or CPM

The TP Regulations also provide for use of any other method, which takes into consideration a price charged in a similar transaction between unrelated parties in uncontrolled circumstances.

In cases where there is more than one price determined using the most appropriate from the above methods, ALP shall be taken to be at arithmetic mean of such prices. Where the transfer price differs from ALP, no TP adjustment is made where the arithmetic mean falls within the tolerance range of transfer price. Currently, the tolerance range available for wholesale traders is 1%, while that for other taxpayers is 3% of the value of International Transaction/ Specified Domestic Transaction.

Use of Range Concept

The Central Board of Direct Taxes (CBDT), the regulatory body responsible for tax administration in India, has also notified the concept of 'arm's length range' for computation of ALP for transactions after April 1, 2014. Under this concept, data points lying within the 35th and the 65th percentile of a data set constructed using comparable data would constitute the arm's length range. Accordingly, transfer price falling within the arm's length range would be considered to be at arm's length.

A minimum of six comparable entities are required for application of the range concept. In cases where the number of comparables in a data set is less than six, the arithmetic mean would continue to be considered as the ALP. Where the arithmetic mean is considered as the ALP, the benefit of a tolerance range continues to be available.

Use of Multiple Year Data

Originally, the TP Regulations did not provide for using data of years other than the year in which transactions were undertaken (except in certain specific cases). The CBDT has amended the Rules and now permitted use of 'multiple year data' while performing a benchmarking analysis. If certain conditions are satisfied, the taxpayer shall be permitted to use comparable data of 2 years preceding the relevant fiscal year along with that of the relevant fiscal "current" year.



Reporting needs

Taxpayers in India by law have an obligation to report compliance to the requirements under the act of entering into any international or specified domestic transaction. This is done by obtaining a certificate from an accountant that needs to be furnished before the due date of filing of income tax return.

The accountant is required to certify on two key points:

- The ALP computed by the tax payer is correct and in line with the regulations; and
- Appropriate documentation has been maintained by the tax payer, as per the regulatory requirements

This is reported along with specific details of the international / specified domestic transaction, how ALP has been determined, the value of the transaction etc.

Three tiered Documentation

Documentation is known to be one of the foremost requirements. The OECD has come up with a recommendation under Base Erosion and profit shifting (BEPS) action plan, which prescribes a three-tiered approach to maintenance of documentation. This requires the taxpayer to maintain:

1. A master file
2. A local file
3. A country by country report

The union budget of India for 2016 provided for a similar convergence with the OECD recommendation, and it is therefore now a mandate for Companies in India to align their documentation in line with the OECD recommendations, as listed above.

1. **The master file** is required to include global information about the multinational corporation group, including information on intangibles and financial activities, to be made available to the local regulations.
2. **The local file** must contain all relevant information for material intercompany transactions of the group entity, in each separate Country
3. **Country-by-country report (CbCR)** must contain details on income, earnings, taxes paid and measures of economic activities.

This is a game-changing move that increased the burden of compliance for MNEs, as they will now need to provide a lot more granular level information to the tax authorities, as compared to the past.

Adjustment to the Reported Income

The tax officer is bound to adjust the reported income of the taxpayer with the amount of adjustment proposed by the TPO. This would have an effect of increasing the assessed income or alternatively decreasing the assessed loss. Furthermore, the eligible deductions available to the taxpayer under section 80 could not be availed on the enhanced income. However, those taxpayers who are eligible for deductions under section 10A and 10B remain unaffected as these deductions remain available on the enhanced income.

Conclusion

With the speed at which globalization is affecting the business world and the way countries are competing with one another for foreign direct investments, it may be safe to conclude that the world of transfer pricing is only going to get more interesting by the day. It is quite apparent that the views of the regulators are also evolving, as there is a clear demonstration of intent to simplify the processes. However, only time will tell if they are able to keep pace with the dynamic changes in the business models and structures being formed with



the advent of technology, free market economy and aggressive investment vehicles coming into

Implications of Transfer Pricing in India

Transfer Pricing is not an exact science, evaluation of transactions through which the process of determination is carried is an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out, yet it has to be shown that analysis was 'judicial' and was done after taking into account all the relevant facts and circumstances .

Transfer Pricing denotes the price which is fixed for intra-group transactions. In simple words it is the price in which a product or service is transferred between related entities.

For e.g. a company in United States having an Indian subsidiary transfers a product or service to its subsidiary for a fixed price determined by the parent U.S Company for sale in the open market in India. This is normally less than the actual market price at which the product or service is actually sold in the market. The Implications of Transfer pricing comes to light when such a pricing of products or services are done to evade tax. Transfer pricing has huge implications on the tax jurisdictions of various states especially when Double Taxation Avoidance Agreements (DTAA) are entered into by the states (such as Indo-Mauritius Free Trade Agreement).

Transfer Pricing is a mode by which Multinational Enterprises (MNE's) makes huge profits by increasing the price of products or services in low tax jurisdictions and decreasing the price in high tax jurisdictions thereby shifting profits especially in a scenario wherein more than 60 percent of international trade is done intra-group (E&Y Survey). Transfer Pricing thus provides for huge loss to the public exchequer as they are prevented from taxing a product or service or on the other hand are prevented from realizing the real tax at which a product was to be taxed in a country. The theory of Transfer Pricing is based on the concept of 'functions, risks and assets'.

It is at this juncture that we need a strict Transfer Pricing Regulation to prevent the Multinational Enterprises from evading tax and reaping huge profits left unaccounted. The Morgan Stanley Case (AAR No 61 of 2005) made huge waves in the economic and legal sector and brought out the concept of implications of Transfer Pricing in the forefront, though indirectly. The case assumed significance for it raised significant issues in the emerging BPO sector in India and the manner in which Transfer Pricing provisions were applicable. One of the groups of companies of Morgan Stanley & Co (MSCo), Morgan Stanley Advantage Services Private Limited (MSAS) incorporated in India provided certain support services to MSCo. MSCo provided personnel to MSAS for stewardship activities and persons on deputation. The question arose was whether MSAS was a Permanent Establishment (PE) for tax purposes and whether profits attributed to the PE was within the purview of Transfer Pricing provisions.

The AAR in the said ruling held unequivocally that as long as the PE deals on an Arms length basis with its associated enterprises, there cannot be any further attribution. It is in this context that the impact on IT Enabled services becomes a matter of concern. For the purpose of determining ALP, the Revenue authorities have to determine the price of services rendered by the PE to its head office or vice versa. Bringing BPO's under the transfer pricing regime will have a considerable effect on the booming industry especially in the light of rupee appreciation, US Sub-prime crisis and changing political scenario.

Similarly, the Mentor Graphics Pvt Ltd (2007) 165 Taxman 28, also brought about the need of having a strict transfer pricing regime in India especially in era of booming of IT and ITeS. It was seen as victory for the corporate taxpayers as the



Income Tax Appellate Tribunal (ITAT) rejected the tax authorities' adjustments to the transfer pricing bill of mentor graphics. The recent decision of the Authority for Advanced Ruling (AAR) in *In re Mustaq Ahmed* ([2007] 293 ITR 0530) wherein the issue was relating to taxing of a non-resident in a case of tax avoidance and in another case of *Vanenburg Group B.V In re* ([2007] 289 ITR 0464), it was a question of determining whether transfer pricing provisions would be applicable to a Foreign Company holding 100 percent shares in Indian company in the transfer of shares to its foreign subsidiary abroad.

The ruling went in favour of the assessee, throws light on the implication of Transfer Pricing in the present economic and legal scenario.

The Indian Transfer Pricing Regulation owes its existence to the Finance Act, 2001 which amended Section 92 of the Income Tax Act by bringing in sections 92A to F. It came into existence from the methods and principles set forth in the Organization for Economic Co-operation and Development's Report on Transfer Pricing and Multinational Enterprises (OECD TP Report). Section 92 A of the Income Tax Act, 1962 (as Amended in 2001) provided for clarity in terms like International Transactions, Enterprise, Associated Enterprises etc which are essential for clothing various Multinational Enterprises(MNE) within the gamut of direct taxation. The amended Act also provided for the methods by which the 'Arms Length Price' (ALP) or the Price in which a related party has to transact has to be measured.

ALP proposes that in an International Transaction the price at which unrelated or independent parties transact should be the price at which related entities transact. For e.g. where an American Company transacts with its Indian subsidiary, the price at which they shall transact would be the price at which a third party transacts with the Indian subsidiary in a similar transaction. It should be understood that there are 5 methods by which the ALP is determined, The Comparable Uncontrolled Method (CUP), Resale Price Method (RPM), Cost Plus Method (CPM), Profit Split Method (PSM) and the Transactional Net Margin Method (TNMM) (S.92C). The Act provides for the determination of ALP by Assessing Officer or Transfer Pricing Officer (TPO) in case of trade of value INR 150 Million or more.

The various areas wherein the concept of Transfer Pricing is seen reflected are the Central Excise Act, 1944 which speaks of Levying of excise duty for transactions between 'related persons' determined by value at which it sells a good to an unrelated party (Section 4 (3)(b)). The valuation rules under the Customs Act, 1962 recognizes the principle of ALP in dealing with Transfer Pricing. Under the Customs Rules, unless an exception applies, the 'Assessable Value' is the invoice value (i.e. 'Transaction Value' under Rule 4(2)). Transfer Pricing is Customs valuation under S.14 of the Act read with S.2(2) Customs Valuation (Determination of Prices of Imported Goods), Rules, 1988. While provisions in the Companies Act, 1956 such as S.211 which deals with the form and content of Balance sheet and the profit and loss account requires the financial statements to provide the true and fair picture of the state of affairs of the company. Similar provisions relating to disclosure requirements and financial statements have indirect implication on Transfer Pricing. The Accounting Standards (AS-18) framed by the Institute of Chartered Accountants in India (ICAI) deals with transactions between a reporting enterprise and its related parties. S.8 of Foreign Exchange Management Act (FEMA) provides for provisions relating ALP. Computation of transfer pricing using ALP has been done on related entities using these provisions.

The various provisions under Income Tax Act, 1961 (as amended by Finance Act, 2001) and Rules 10 A to 10 E effectively deals with Transfer Pricing in India. S.92 (1) provides that 'any income arising from an international transaction shall be



computed having regard to the Arm's length price. An Associated Enterprise as per the Income Tax Act has to comply with a) Maintaining a prescribed Documentation and b) Obtain an Accountant's Certificate. While the MNE is free to determine the Transfer Price, it is the duty of the Authorities to see that it is in Arm's Length Price. Thus where the market prices are not reflected in prices set by related parties, the Tax authorities will have the power to adjust profits so that they represent an Arm's length result. It is here where the issue of strict compliance comes into the picture.

The Transfer Pricing Officer (TPO) appointed under the Act should find the 'most appropriate method' (Rule 10 C(2) of Income Tax Rules, 1962) in determining ALP when none of the aforementioned methods does not apply, which is subject to the discretion of the Assessing or TP Officer as the case maybe. This proves to be negative as the TPO may not be efficient enough to determine the price in certain cases. In the recent case of Sony Pvt Ltd v. Central Board of Direct Taxes ([2007] 288 ITR 0052), evolved the question of reference in determining ALP to TPO. The best way to comply with the TP Regulations would be to have a TP Study and determine the ALP thereby saving the procedural difficulties.

But without adequate procedural requirements, such a study may not be fruitful in most cases. In addition to this the Indian tax regime has the shortcoming of realizing the importance of an Advance Pricing Agreement (APA) which would enable the taxpayer (MNE's) and the tax authorities to save time and money. In the case of APA's, the Taxpayer which in most cases would be the MNE's and the Tax Authority would reach an Agreement with respect to the price at which a product or service shall be traded. In most cases it would the price in a uncontrolled transaction vis-à-vis a Controlled transaction (Associated entities).

The present Indian Tax regime suffers the lacunae of having provisions relating to safe harbours which are a simple set of rules which if satisfied by the tax payer would enable it to be relieved from certain regulatory obligations otherwise imposed by tax legislation. Similarly lack of comparables needed to determine ALP is another issue and can be redeemed with a reliable database (like Prowess and Capitaline). But all these changes can be made only by a strict compliance of Transfer Pricing Regulation with regular updating of the technology in tune with the changing needs with a more reliable assessment of Transfer Pricing. In a country where there is a steep increase in financial transactions with large number of Merger & Acquisition's (M&A's) happening, there is a need to post an efficient, reliable and transparent Transfer Pricing with regards to the implications it can have on the International Trade.

Though we can be proud of having a more reliable Transfer Pricing Provisions compared to other countries, the need to emerge as a stronghold of the International Trade, India has to reinvigorate its taxing procedures.

To end one should understand the concept of Transfer Pricing as held by the Commissioner of Income Tax (Appellate) in Aztech Computer case (Aztech Software & Technology Services Ltd. v. ACIT 249 ITR (AT) 32) that "Transfer Pricing is not an exact science, evaluation of transactions through which the process of determination is carried is an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out, yet it has to be shown that analysis was 'judicial' and was done after taking into account all the relevant facts and circumstances of the case."



7

BASE EROSION & PROFIT SHIFTING [BEPS]

India Focus on BEPS – Base Erosion & Profit Shifting

The view of governments across the world is that the current international tax standards have not kept pace with the changes in global business practices. Many countries have perceived the relevance of adopting BEPS as these reports include recommendations for significant changes in key elements of the international tax architecture.

India is actively following the BEPS recommendations and has been bringing amendments in the domestic law to be in line with BEPS regulations. A number of proposals in Indian Finance Act, 2016, are influenced from the recommendations emanating from the final reports of the OECD under its Action Plan on BEPS. These include implementation of Master File and Country-by-Country (CbC) Reporting (in compliance with Action 13), introduction of equalization levy which requires withholding on gross basis for all payments in relation to certain specified digital services (Action 1) and a "Patent Box" tax regime for royalty income (Action 5).

Response to BEPS will have to be managed in a phased manner and will require proactive and timely planning. Companies will have to build consideration of potential BEPS impact into current tax planning and prepare different scenarios for its application.

India is committed to the BEPS outcome

For past few years, the Organisation for Economic Co-operation and Development [OECD] and G20 countries have actively worked on base erosion and profit shifting [BEPS] project. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profit 'disappear' for tax purpose or to shift profits to locations where there is little or no real activity but taxes are low, resulting in little or no overall corporate tax being paid.

The OECD and G20 has released their recommendations on BEPS action plans (15 action plans) on 5 October 2015. The BEPS action plans are structured around three fundamental pillars:

Introducing coherence in domestic rules that affect cross-border activities:

These actions include aspects relating to limitations on interest deductions,

Countering tax avoidance using hybrid mismatches, challenging harmful tax Practices, etc.

Reinforcing substance requirements in international standards to ensure

alignment of taxation with the location of economic activity and value creation:

There are aspects to prevent tax treaty abuse (i.e. treaty shopping), strengthen rules relating to creation of a permanent establishment for taxation in the source country, ensuring transfer pricing outcomes are in line with value creation in relation to intangibles, etc.

Improving transparency, as well as certainty for businesses and governments: The key action relates to transfer pricing documentation, which will provide significant information to the revenue authorities in relation to global operations



and financial information of companies. The BEPS action plans also deal with the digital economy across all the three areas discussed above.

As a member of G20 and an active participant of the BEPS project, India is committed to the BEPS outcome. To implement the BEPS actions, India has been amending its domestic tax law as well as tax treaties. This publication analyses key issues around BEPS as well as outlines the Indian perspective in relation to these issues.

Preventing treaty abuse and counter harmful tax practices

Tax treaty abuse and in particular, treaty shopping is the most significant source of BEPS concerns as governments are probing ways to tackle this issue. Treaty shopping can be defined as the use of the tax treaty by a person who is not the resident of either of the treaty countries, usually through the use of a conduit entity resident in one of the countries.

The major concern for the developing and emerging economies like India is that they face no taxation or lower taxation where a person takes advantage of the treaty in an unintended manner. BEPS Action 6 targets tax treaty shopping by multinational enterprises that establish 'letterbox', 'shell' or 'conduit' companies in countries with favourable tax treaties - although such companies exist on paper, they may have no (or very little) substance in reality and may exist only to take advantage of tax treaty benefits.

Action 6 of BEPS was conceptualised to cater to the three broad objectives of treaty abuse and treaty shopping.

01. To clarify that tax treaties are not intended to be used to generate double non-taxation.
02. To identify the tax policy considerations that, in general, countries should Consider before deciding to enter into a tax treaty with another country.
03. To develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in Inappropriate circumstances.

The OECD, on 5 October 2015, has released its final report on this action, recommending measures to combat treaty shopping and treaty abuse through agreed minimum standards, with some flexibility in the implementation of these standards, in order to allow adaptation of each country's specific circumstances and negotiated bilateral tax treaties. The final version of the report supersedes the interim version issued in September 2014 with number of changes to the rules proposed in the September 2014 report.

The concept is divided into 3 sections:

Section A

Provides for the inclusion of anti-abuse provisions in the tax treaties including a minimum standard to counter treaty shopping. This section discusses a limitation on benefits [LOB] Rule and a principal purposes test [PPT] rule. An LOB rule is typically included in the tax treaties of the US, including some treaties concluded by Japan and India – the LOB rule essentially limits the availability of tax treaty benefits that meet certain conditions (based on legal nature, ownership and general activities of the entity) and is objective in nature. On the other hand, the PPT rule seeks to deny tax treaty benefits if one of the principal purposes of the transaction or arrangement was to obtain treaty benefits –

This is more subjective in nature. For this purpose, countries would implement in their tax treaties

01. The combined approach of an LOB and PPT rule;
02. The PPT rule alone; or



03. The LOB plus a mechanism to deal with conduit financing arrangements.

In addition to the above, there are targeted rules to address other forms of treaty abuse:

01. Dividend transfer transaction that artificially lower withholding tax on dividends;
02. Transaction that circumvent the rule that prevents source taxation of sale of shares deriving value primarily from immovable property;
03. Dual residency of entities;
04. Transfer of property and assets to a permanent establishment. A new rule is proposed to provide that tax treaties do not generally restrict the taxability in the State of residence.

It is also proposed to clarify that departure or exit taxes and not in conflict with tax treaties.

Section B

Provides for the reformulation of the title and preamble of the Model tax convention which would clearly state that the intention of the parties to the tax treaty is to eliminate double taxation without creating opportunities for tax evasion and avoidance, in particular through treaty shopping arrangements. This is also a minimum standard that has been laid down.

Section C

Provides for identifying the tax policy considerations relevant for deciding whether they should enter into a tax treaty and also whether they should modify (or ultimately terminate) a treaty in the event of change of circumstances.

India perspective Historically, the Indian jurisprudence has respected the form of the transaction, unless the form itself is sham, and thus, have rejected the approach of the tax authorities to deny treaty benefits on the ground of treaty shopping.

The Supreme Court in the landmark judgement of Azadi Bachao Andolan, has held that in absence of LOB clause in the tax treaty, treaty benefit would prevail. This principle has been reiterated in the Vodafone case as well. The Court held that in the absence of LOB rules in a tax treaty, the tax treaty benefit cannot be denied unless the tax authorities establish on facts that the company has been interposed (as the owner of shares in India) at the time of disposal of shares to a third party solely with a view to avoid tax and without any commercial substance.

Coming to treaty negotiations, India has been asserting upon inclusion of a clause in the tax treaties to combat treaty shopping where multinational enterprises take benefits of a favourable tax jurisdiction. An example is the clause introduced in the India-Singapore tax treaty for determining the eligibility to claim exemption from capital gains tax. The India-Singapore tax treaty also provides for an expenditure test i.e.

India has also initiated the process of renegotiating some of its existing bilateral tax treaties, to combat treaty shopping by inserting anti-abuse rules. Recently India's tax treaties with Mauritius, Singapore and Cyprus have been amended to provide anti-abuse rules on taxation of capital gains. On the legislative front, the Indian Government has recognised that treaty shopping results in tax leakages.

Therefore, over the past few years, the Indian government has been working to tighten the rules in the Indian tax law for granting tax treaty benefits. India has Included various clauses in its domestic law, some of which are as under:

Mandating requirement to furnish a tax residency certificate along with a self-declaration confirming certain basic information, as a minimum threshold to



claim tax treaty benefits;

The PPT rule as recommended under Action 6 of BEPS is akin to the main purpose test as proposed under the Indian GAAR. The Indian GAAR would empower the revenue authorities to go deeper into the transactions and/or arrangements (e.g. looking at ownership structures, beneficial ownership, voting rights, etc.) and would enable them to draw inference, whether a particular entity is a conduit entity without any real economic substance/activity with the main purpose being obtaining a preferential tax benefit. The Indian GAAR also overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules – this is specifically included in various bilateral treaties that India has entered into e.g. the India-Luxembourg, India-Malaysia and other tax treaties signed by India with Singapore, Israel, Indonesia, Korea, Macedonia and Thailand.

The proposed Indian GAAR also overrides tax treaties, which is consistent with the OECD commentary on anti-avoidance rules

The provision of levying higher withholding tax in the absence of Indian PAN/ specified documents;

- Reporting and taxing of indirect transfers materially modifying the ownership Structure or control of an Indian entity;
- Adoption of place of effective management as a threshold for determining residency; and
- limiting interest deduction on borrowings from non-resident associated enterprises.

Additionally, in 2012, the Indian Government codified the general anti-avoidance rule [GAAR], though the implementation has been made effective from 1 April 2017. Interestingly, the implementation of GAAR was deferred in 2015, to be aligned with the BEPS actions.

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To conclude, the GAAR and LOB/PPT rule may impact intermediate holding companies for investing into India, which lacks substance and have been interposed only to avail tax treaty benefits. Foreign investors that have made investments or are doing business in India need to review their existing operational structure, arrangements, agreements and investment modes to consider whether they are sufficiently robust to withstand a potential challenge under the LOB/PPT rule and anti-avoidance rules.

The latest update on this is the signing of the Multilateral Instrument ('MLI') under BEPS Action 15. India has signed on the minimum standard for tax treaty abuse applicable to all Indian tax treaties by adopting the PPT and simplified LOB. Moreover, it has introduced express statement in the preamble of the treaties that common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or



avoidance, including through treaty shopping arrangements.

Counter harmful tax practices Action 5 of BEPS aims to identify and counter harmful tax practices, taking into account transparency and substance. The Action looks at developing recommendations on the definition of harmful tax practices, and developing a strategy to expand to non-OECD members. The final report released on 5 October 2015 establishes minimum standards with regard to both determining whether preferential regimes take sufficient account of the need to reward only substantial activities, and ensuring that there is transparency in relation to rulings. It also sets out minimum standards for domestic law provisions in respect of intellectual property [IP] regimes, such as patent box regimes.

Several approaches have been considered to determine a lack of otherwise of substantial activity. The OECD has achieved consensus on the 'nexus approach'. The nexus approach uses expenditure as a proxy for activity, and this principle can be applied to all types of preferential regimes. In the context of IP regimes, a relevant connection (i.e. a nexus) is to be established between firstly, taxpayer's performance of R&D which resulted in development of the IP asset, and secondly, taxpayer's income from the IP asset.

The IP regimes have been considered as inconsistent, either in whole or in part, with the nexus approach as described in the BEPS report. Hence, countries with such regimes will now proceed with a review of possible amendments of the relevant features of their regime. The report also analyses non-IP regimes as existing in different countries. As regards Indian non-IP regimes, it has been concluded in the report that the following regimes are not considered as harmful from the BEPS perspective, subject to analysing these regimes in the context of the 'substantial activities' test:

- Deductions in respect of certain incomes of offshore banking units and international financial services centre
 - Special provisions in respect of newly established units in special economic Zones
 - Special provisions relating to income of shipping companies – tonnage tax Scheme
 - Taxation of profits and gains of life insurance business
- Improving transparency effectively would mean a framework for the compulsory spontaneous exchange of information, between tax authorities, on taxpayer-specific rulings.

Thus, BEPS proposes to revamp the work on harmful tax practices requiring substantial activity for preferential regime.

India perspective India has always been an advocator of the substantial activity test and does not have a harmful IP or other regime. A framework for mandatory spontaneous exchange of certain preferential rulings will further strengthen the automatic exchange of information, to which India has consented to be a part of.

From an Indian perspective, this action is likely to impact Indian multinational enterprises that have opted for some of the 'harmful' IP regimes in overseas jurisdictions. India has introduced a special regime for taxation of income from patents taking a cue from Action 5 of BEPS. This regime is applicable from financial year 2016-17 and covers existing and new patents. The royalty income from patents developed and registered in India is taxable at 10 percent (plus surcharge and education cess) on the gross amount of royalty. No expenditure or allowance is allowable in such cases.



The benefits of this regime is available to a person resident in India, who is the true and first inventor of the invention and whose name is entered on the patent register as the patentee in accordance with Patents Act, 1971.

The arm's length principle has been the cornerstone of transfer pricing rules. It is embedded in treaties and appears as Article 9(1) of the OECD and UN Model Tax Conventions. The existing international rules for transfer pricing have been found to be misapplied or considered insufficient to the extent that the allocation of profits is not aligned with the economic activity that results in profits. The OECD in the BEPS action plan has tried to correct that imbalance through Action 8, as it brings out how misallocation of the profits generated by valuable intangibles has contributed to base erosion and profit shifting. The OECD report, to achieve that, introduced guidance to ensure that the transfer pricing rules secure Outcomes that see operational profits allocated to the economic **activities which Generate them**. The report also provides additional guidance on aspects of location saving, local market features, assembled workforce and passive association ('guidance on comparability factors').

Definition of intangibles the guidance also provides a broad definition of intangibles.

The new guidance defines an intangible as something i) that is not a physical asset or a financial asset, ii) that is capable of being owned or controlled for use in commercial activities; and iii) whose use of transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. This definition of intangible acknowledges the existence of intangibles, irrespective of accounting for / reporting of intangibles in financials by the MNE. The new guidance notes that a transfer pricing analysis should carefully consider whether an intangible exists and whether an intangible has been used or transferred.

The guidance also clarifies that legal ownership alone does not necessarily generate a right to all of the return that is generated by the exploitation of the intangible.

Entitlement to return from intangibles the report emphasises that the group companies performing important functions, controlling economically significant risks and contributing assets in development, enhancement, maintenance, protection and exploitation [DEMPE] of the intangible, as determined through the accurate delineation of the actual transaction, shall also be entitled to an appropriate return reflecting the value of their contributions. The deliverable leverages on the framework for analysing risk provided in Chapter I (exercising control over functions and having financial capacity to assume the risk) to determine which parties assumed risk in relation to intangibles, and for assessing which member of the MNE group controlled the performance of DEMPE functions in relation to intangibles (and consequent entitlement to profit or loss relating to differences between actual and expected profits).

According to the new guidance, to be termed and priced as an "outsourced service", the control over such services (considered as ability to understand and evaluate the performance of functions, and taking the final decisions regarding important aspects) needs to be exercised by the enterprise claiming entitlement of intangibles related return. Accordingly, an enterprise neither performing nor controlling the important functions and not assuming relevant risks, would not be entitled to intangible related returns.

The guidance also elucidates in clear terms that the legal ownership/ funding of the intangible does not determine entitlement, as already stated, to intangible related returns. The guidance provides that mere funding of the DEMPE of an intangible by an entity, without performing any of the important functions in



relation to the intangible, and without exercising control over the financial risk, will entitle the entity only to a risk-free return.

Addressing information asymmetries the guidance also seeks to ensure that this analysis will not be weakened by information asymmetries between the tax administration and the taxpayer.

Comparability and options realistically available Supplemental guidance regarding transfers of intangibles or rights in intangibles, including comparability, has also been provided in the guidelines. The guidelines provide for several factors for comparability of intangibles or rights in intangibles, though one may feel that the guidance raises the comparability bar too high to be complied with, given the lack of available data in the public domain with respect to transactions involving intangibles/rights in intangibles.

Also, in performing the comparability analysis and determining the arm's length compensation for an intangible transaction, the guidance provides for evaluating the options realistically available to the parties and cautions that one-sided comparability analysis would be insufficient. The guidance further provides that specific circumstances of one of the parties should not be used to support an outcome which is contrary to the realistically available options of the other party.

Also, given the unique nature of the intangible transaction, the guidance observes that the CUP method, transactional profit split and discounted cash flow techniques could be highly useful. However, any selected method and the comparability adjustment, if any, should take into account all the relevant factors that materially contribute to the creation of value and not just the intangible or routine functions. It is also interesting to refer to Action 5 where FHTP has evaluated three different approaches to requiring substantial activities in an IP regime in order for the MNE group to avail associated tax benefits.

Out of the three approaches, namely 'Value creation approach', 'Transfer Pricing approach' and 'Nexus approach', the Nexus approach (which is developed in the context of IP Regimes and allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying R&D expenditures that gave rise to the IP income) was agreed upon by FHTP under Action 5 for evaluating eligible activities in IP regimes. But, in Action 8, the thrust is on functions performed, assets used and risk assumed in relation to DEMPE of the intangible, and not on the level/amount of expenditure incurred by entities.

The taxpayers would need to keep in view the above while evaluating their IP structures. India perspective some of the important guidance by OECD and its relevance in the Indian context has been discussed below. R&D activities and resulting intangibles with the establishment of numerous research and development [R&D] centres in India, abundant availability of talent pool, discussions on transfer pricing aspects of intangibles have dominated the Indian TP landscape in the past few years. In respect of such R&D centres, there has been debate over the entitlement of both parties over the intangibles related return.

The guidance by OECD on intangible provides clarity on the approach to be followed for identification of the intangible, ownership (legal or economic), approach for the comparability and selection of transfer pricing method for determination of the arm's length price. In this respect, several aspects of the guidance are in line with the practices followed by the Indian tax authorities. The guidance, for instance, emphasises supplementing (or replacing, where appropriate) the contractual arrangement through examination of the actual conduct of the parties based on the functions performed, assets used, and risks assumed, including control of important functions and economically significant risks. This approach finds support in the Indian context as the CBDT Circular No.



6/ 2013 issued to classify the contract R&D centres of overseas MNEs as R&D centres bearing insignificant risk, does emphasise on the conduct of the parties rather than the contractual arrangement.

The alignment of functional contributions and financial investment with legal rights the problem of information asymmetry, the guidance provide a new tool to tax administrations, which is based on evaluation of ex-post outcomes vis-à-vis ex-ante expenditure/spend to price hard-to-value intangibles [HTVI]. The revised guidance also provides safeguards to taxpayers by providing certain exemptions where such an approach will not apply to transactions involving the transfer or use of HTVI. In several cases the tax authorities, during TP Audit, may have considered the actual results in place of the projected results at the time of transactions for making any TP adjustments—the above guidance would support the said position.

Therefore, businesses could expect more audits and adjustments in relation to the pricing of HTVI and would be required to prepare a robust documentation considering all assumptions used for preparation of projections and valuation of the HTVI. The discussion draft also provides that MAP will apply to disputes in respect of HTVI as it applies to other treaty-related transactions – this will assist businesses in resolving complex disputes relating to pricing of HTVI through MAPs.

It is seen in the circular as well. The exercise of important functions by the foreign principal and control over service providers are factors that are in line with the OECD Guidelines and accordingly, on this aspect the view of Indian tax authorities appears to be aligned to the OECD. Also, the jurisprudence in India, with respect to intangible transactions, emphasises on the detailed analysis of the functions, assets and risks profile of the parties to the transaction and the contractual arrangements and their comparability with the selected comparables.

Therefore, as BEPS guidance is more and more internalised by TP authorities as well as practitioners, it is likely that TP audits would have a greater focus on functional characterisation. Marketing intangibles determination of the arm's length price of intangibles/rights in intangibles, as well as bearing cost associated with development/maintenance of intangibles, has been one of the most significant TP litigation in India, with amount under litigation exceeding thousands of crores. The guidelines discuss the application of the principles in respect of development and enhancement of marketing intangibles.

It is pertinent to note that the guidance, as in the original draft guidance, discusses the concept of marketing intangible in case of a distributor and not for manufacturers. However, the Indian revenue authorities have applied the concept of marketing intangible irrespective of the functionality (distributor/ manufacturer) and characterisation (limited risk / entrepreneur) of the Indian entity.

The guidance observes that under long-term contract of sole distributor rights of the trademarked product, the efforts of the distributor may enhance the value of its own intangible viz its distribution rights. A similar line of contention has been adopted by numerous Indian taxpayers where the expenditure incurred by them is for exploiting the intangible in their prescribed territory, thereby increasing the value of 'their intangible' and not that of the legal owner of the intangible and therefore, separate remuneration from overseas entity for such activities is not warranted. Also, the guidelines opine that the remuneration for such functions can come in several forms such as separate compensation, reduction in price of goods, reduction in royalty rates, etc., which is similar to the view taken by the Delhi High Court in case of Sony Ericsson and others

The taxpayers can draw support from the guidance on such aspects (e.g., long-term contract by virtue of conduct, exclusive rights to do business in specified



territory, performance and control of functions, etc.) while putting forth the contentions. However, it remains to be seen if and how the BEPS Guidance impacts the view of Indian revenue authorities.

It is important to note that several court rulings have emphasized that tax authorities need to demonstrate existence of an "arrangement" between Indian entity and the overseas entity for the marketing spend before raising concern over compensation payable to Indian entity for developing marketing intangible. Considering the same, the guidance on intangible in BEPS and increased focus on the granular functional analysis, it is likely that TP audits would have a much greater focus on arrangement between Indian taxpayer and overseas group entities for the marketing and advertisement in India (including factors such as global marketing strategy, communication between Indian entity and overseas entity regarding marketing/advertisement in India, role of overseas entities in finalisation of Indian marketing content, Indian marketing budgets, modes of advertisement etc).

Location savings/location specific advantages The OECD guidance states that no separate compensation is required for location savings / location-specific advantages, if there exist local comparable uncontrolled transactions. But, the Indian tax authorities believe that there is benefit from location savings which can be computed by taking into account the difference between costs across countries. In this respect, it is pertinent to note that the jurisprudence in India (decision in case of Watson Pharma) and the views expressed in Rangachary Committee report on Safe Harbour Rules are in line with the view presented in the guidelines (i.e., where local comparables are considered for determining the arm's length price of transactions, no separate compensation is required for location saving/local market features).

The guidance also puts notable emphasis on whether the location saving is retained by a member or members of the MNE group or are passed on to independent customers or suppliers. Accordingly, in cases where the location saving is completely passed on to the customer or supplier (demonstrating a perfectly competitive business scenario wherein the cost reduction due to location saving is vital to compete in the market), the return for location saving is not relevant. A similar view was taken by the Hon'ble Delhi High Court in case of Li & Fung wherein the adjustment to income was deleted on the ground that the Indian tax administration failed to demonstrate the extent to which the overseas related party benefitted from locational advantages before rejecting the taxpayer's economic analysis. The taxpayers, in addition to the available judicial precedence, can rely upon the guidelines to support their argument. Way forward overall, the guidelines on intangibles support the remuneration linked to value creation with formidable emphasis on performance of important value-creating functions/assumption of risks related to the DEMPE of the intangibles.

The guidelines is a step forward in ensuring that the intangible related returns are not being retained based only on the contractual framework but is appropriately supplemented by a comprehensive functional analysis in respect of intangibles.

From an Indian perspective, the courts in India have often acknowledged the role of OECD TP Guidelines while applying the TP principles. The tax authorities are also likely to leverage upon the TP Guidelines particularly for identifying the detailed demarcated roles and responsibilities of the Indian taxpayer and overseas entity, determining the "existence of transactions" and contribution of each side to value creation. Therefore, the guidance on the intangibles, and the guidance on comparability factors, is likely to impact both the tax authorities and taxpayers, warranting a review of the existing practices and arrangements.



Permanent Establishment

Most countries, including India, tax their residents on their global income under residence based taxation, and tax non-residents by applying source based taxation. The permanent establishment [PE] concept is used to analyse the taxation of non-residents in the source country. The concept finds its mention under tax treaties, and is broadly similar to the 'business connection' test as prescribed under the Indian domestic tax law. In the context of business profits, typically, a tax treaty would allocate taxing rights to the source country only if the foreign enterprise carries on its business in the source country through a PE situated therein, and only to the extent that profits are attributable to such a PE.

The Indian appellate authorities and Courts have, time and again, evaluated the issue of a PE and have laid down certain principles, such as 'close nexus', 'inextricable links' 'enduring and permanent presence' etc. in deciding the issue.

One may refer to the landmark judgment in the case of Vishakhapatnam Port Trust which held that a PE postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another, which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country onto the soil of another country.

Historically, the concept of PE developed in the late 19th century in the era of the second industrial revolution. The prevalent business operations and models laid emphasis on elements such as geographical location, physical presence, business nexus, place of business, permanency, etc. However, with the evolution of business models such as franchise, outsourcing, and especially cyberspace (digital economy), a non-resident could be significantly involved in the economic life of another country, and earn substantial profits, without having a taxable presence or a PE. The governments felt that the traditional approaches to a PE was leading to tax base erosion and therefore there was a need to align international tax laws with contemporary business models.

In the aforesaid context, the OECD and the G20 nations agreed to strengthen the existing international standards, including avoiding the artificial avoidance of PE status (Action 7).

The final report builds on proposals put forward in the G20/OECD's discussion drafts of October 2014 and May 2015, and seeks to update the definition of PE in Article 5 of the OECD's model tax treaty, and also provides detailed explanation in the associated Commentary. The changes suggested in the final report seek to ensure that where the activities of an intermediary in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise will be considered to have a taxable presence in that country, unless the intermediary is performing the activities in the course of its independent business.

The changes will restrict the application of a number of exceptions to the definition of PE to activities that are preparatory or auxiliary nature, and will ensure that it is not possible to take advantage of these exceptions by the fragmentation of a cohesive operating business into several small operations. Also, the report proposes to address situations where the minimum threshold (number of days) applicable to construction sites is circumvented through the splitting-up contracts between closely related enterprises of a multinational group.

Part A: Artificial avoidance of PE through commissionaire arrangements and similar arrangements (Article 12 of MLI) many multinational enterprises adopt Intermediary models/marketing agency/commissionaire arrangements to



operate in another country without setting up a legal entity in the other country. A commissionaire/intermediary arrangement is one which enables the intermediary enterprise to sell products of the owner of the product; the intermediary enterprise is entitled to compensation/commission.

The proposals in the report target to uncover any undisclosed agency or commissionaire agreements as well as other agency agreements as under:

01. Tightening the agency PE rules to include not only contracts in the name of the non-resident entity, but also contracts for the transfer of, or the granting of the right to use, property, or the provision of services by the non-resident where the intermediary habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.
02. Modification and narrowing the requirements for an agent to be considered 'independent', such that this will not be the case where the agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related.

Article 12 of MLI seeks to amend Article 5 of the tax treaties, which defines the term PE, on the following aspects:

- Scope of agency PE to counter the commissionaire arrangement entered into by foreign enterprise in order to avoid PE in the source state;
- Creation of agency PE when the agent habitually plays principle role leading to conclusion of contracts with routine approval of the principal;
- Agent will not be considered to be an independent agent if he acts exclusively or almost exclusively on behalf of a closely related enterprise. As per the provisional notifications, India would adopt this Article in its tax treaties.

However, certain countries (Canada, Cyprus, Luxembourg, Singapore, UK, etc.), have opted not to adopt this Article, while certain countries (e.g. France, Japan, Netherlands) would adopt the Article. This Article can get adopted in Indian treaties, subject to matching.

India perspective India, being a common law country, may not be much impacted by commissionaire arrangements as such structures are not permissible under the provisions of the Indian Contract Act.

The changes could however impact foreign companies having subsidiaries in India which undertakes marketing and sales support activities. Where such subsidiaries habitually play the principal role leading to the conclusion of contracts that are routinely concluded by the foreign principal without material modification, it could create a PE of the foreign principal in India. The terms 'principal role', 'routinely concluded' and 'material modification' have not been defined and could, therefore, lead to different tests being applied by different taxing authorities. The mischief sought to be avoided seems to be where all essential activities in relation to the conclusion of sale is performed by the agent in the source country, but the final contract or order is 'rubber stamped' by the foreign principal outside the source country .

The proposed expansion of the definition of agency PE in the context of conclusion of contracts, and the inability of the Indian subsidiary to be regarded as an 'independent agent', could expose a part of the overseas group entity's profit on sale of products to be taxed in India, depending on the facts of the case.

Hence, maintaining robust documentation on the roles and responsibilities, and Detailed mapping of the activities of the agent and the principal in relation to the generation of Indian sales of the foreign principal would be of critical



importance.

Approach 1

Changes to the model treaty will mean that exceptions from creating a fixed place PE for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) will only apply where the activity or activities in question is only preparatory or auxiliary in relation to the business as a whole. This is to reflect modern ways of doing business, where such activities may represent a key part of a business' value chain (particularly relevant for supply chains involving digital sales).

A number of helpful examples are included in the revised Commentary, together with limited guidance on the meaning of 'preparatory or auxiliary'. For example, storing and delivering goods to fulfil online sales may not be considered as preparatory or auxiliary in character if such activities are an essential part of the company's sales or distribution business, whereas storing of goods in a bonded warehouse during the custom clearance process would be considered as preparatory and auxiliary.

Approach 2

The Commentary includes an alternative for countries who consider that the specific activities referred to are intrinsically preparatory or auxiliary and prefer the certainty of retaining their blanket exception status. Such countries' consider that BEPS concerns will be sufficiently addressed by the anti-fragmentation rule.

The rule aims to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operations into several small operations in order to argue that each is merely engaged in 'preparatory or auxiliary' services. Examination would not happen in isolation, and only genuine preparatory and auxiliary activities would be accepted as exceptions to PE.

The primary objective of Article 13 of MLI is to ensure that the benefit of Article 5(4) [i.e. certain activities do not result in PE even when carried out through fixed place] is allowed only when the activities, carried on either individually or collectively, are preparatory or auxiliary in nature. It also contains an anti-fragmentation provision to prevent breaking of activities in order to benefit from the preparatory or auxiliary exemption. As per the provisional notifications, while India would adopt this provision (Approach 1), certain countries (e.g. Canada, Cyprus, France, Luxembourg, Singapore, etc.), have opted not to adopt this provision in the tax treaties. This Article can get adopted in Indian treaties, subject to matching. India perspective Indian Courts have dealt with the term 'preparatory or auxiliary' and are generally of a similar view as expressed in the BEPS report on Action 7. However, what constitutes 'preparatory or auxiliary' activities has always been a contentious issue with revenue authorities around the world. The challenge faced by the revenue authorities around the world was to examine a stand-alone activity in a scenario where a multinational enterprise was carrying out procurement, sales and marketing functions in India through different group companies around the world.

- Liaison offices: A significant number of foreign companies have set up liaison offices in India – the argument taken in such cases is that the activities of the liaison office are preparatory or auxiliary in nature, and accordingly, no PE is created. With the proposed tightening of the conditions relating to preparatory or auxiliary activities, coupled with the anti-fragmentation rule for specific activity exemptions, the Revenue authorities are likely to look at such functioning of liaison offices in greater detail.
- Spurt of e-commerce in India: With the tremendous growth of e-commerce business in India, functions such as warehousing, display,



delivery, and supply chain model may not be considered as 'preparatory or auxiliary' activity. Depending on the facts and circumstances of digital businesses, the narrowing of the specific activity exemptions (say, proposal that delivery of goods needs to be a preparatory or auxiliary activity to qualify for the exemption) and proposed widening of the agency PE rule, could lead to creation of a PE of such digital businesses in India.

Part C: Splitting up of contracts

(Article 14 of MLI)

The report addresses the splitting up of contracts between group companies with An objective to circumvent the specific 12-month time period for establishing a PE for a building site, construction or installation project. The key changes are as follows:

- ❑ Adding an example to illustrate the application of the principal purposes test for the prevention of treaty abuse (Action 6 of the BEPS Action Plan) to deal with splitting up of contracts.
- ❑ Suggesting an alternative provision (for treaties that do not include the principal purposes test) to add connected activities (exceeding 30 days' duration) carried on by closely related enterprises to the period of time on site for the purposes of determining the 12-month period.
- ❑ Article 14 of MLI addresses avoidance of PE by splitting the contracts between Related enterprises to circumvent the threshold of creation of PE. As per the provisional statement, India has not made any reservation against adoption of this Article, while certain countries (e.g. Canada, Cyprus, Japan, Luxembourg, Singapore, UK, etc.) have opted not to adopt this provision in the tax treaties. This Article can get adopted in Indian treaties, subject to matching.
- ❑ India perspective India has a significant number of turnkey or EPC contracts being executed by multinational enterprises, especially in the infrastructure sector. In many cases, business considerations may drive the requirement of various group entities executing different parts of the project, thereby necessitating the need to enter into respective contracts with the end customer. It will be interesting to see the approach of the Indian tax authorities towards such projects and contracts.

Analysis and India perspective Action 1 of BEPS deals with addressing tax challenges of the digital economy. To study the tax issues raised by the digital economy and also to address them, a special body called the Task Force on the Digital Economy [TFDE] was setup in September 2013. The TFDE, after many rounds of consultation, published an interim report in September 2014 and the final report in October 2015. The Action 1 outlines conclusions regarding the digital economy, the BEPS issues, the resultant tax challenges and the recommended next steps.

With the evolution of businesses and also increasing use of digital platform to conduct business, both taxpayers and tax authorities have noticed complexities involved in determining the tax implications of a transaction as well as determining the jurisdiction in which the tax implications arise.

This report observes that the digital economy is increasingly becoming the economy itself and it would be difficult to ring fence the digital economy from the rest of the economy for tax purposes. In other words, it would be hard to frame a separate set of tax rules independently for digital transactions. This report aims to tackle the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these rules. This is the only report that takes a holistic approach and discusses indirect taxes as well.



A key observation in the report is that while the digital economy and its business models do not generate unique BEPS issues, the key features exacerbate BEPS risks. From a direct tax perspective, the report by itself does not suggest any recommendations – it however indicates that the work on certain other actions are expected to tackle issues faced in the digital economy as discussed below.

Modification of the exceptions to permanent establishment [PE]

Action 7 deals with preventing the artificial avoidance of PE status. This Action suggests that the PE exceptions will be modified to ensure that all activities that qualify for exemption are purely in the nature of preparatory and auxiliary activities. Another related rule is the anti-fragmentation rule that prevents activities being split up within group entities to avoid having a PE in any State.

In the context of the digital economy, an example is of an online seller of goods that maintains a large warehouse with significant number of personnel, which is essential for proximity to customers and quick delivery. Under current circumstances, it may be possible for an online seller to fall under an exception to PE in the State of sale despite housing a warehouse. Pursuant to modifications to the exception to PE, the online seller may have a PE in the country where the warehouse is located depending on the business model.

Tightening of the agency PE rule Action 7 of BEPS also deals with tightening the agency PE rules to include contracts for the transfer of, or the granting of the right to use, property, or the provision of services by the non-resident, where the intermediary habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the foreign enterprise.

Contracts, risks and recognition

On 5 October 2015, the OECD released the 15 final action plans in connection with BEPS. Amongst the action plans, Action 9 and 10 inter-alia deal with identification and allocation of risks for comparability analysis taking into account the contractual arrangement between the parties and their conduct, provide guidance on the recognition of the transaction by the tax authorities.

The guidance goes to the root of the transfer pricing analysis and reinforces the 'substance over form' principle which is consistently upheld by the Indian Tax Tribunals and emphasised by the tax authorities and tax experts. The guidance replaces Section D of Chapter I of the OECD Transfer Pricing Guidelines.

In brief, the guidance focuses on the importance of delineating the transaction between related parties with utmost specificity, having regard to the economically relevant characteristics of the transactions and how the functions performed by the parties relate to the generation of economic value by the multinational enterprises [MNEs]. Also, the guidance emphasises on the need for considering the options realistically available to the parties to the transaction in determining the arm's length nature of such a transaction. Per the guidance, in delineating a controlled transaction, understanding the contractual arrangement between the parties in relation to such transaction is considered as a first step, though the primary importance is placed on the conduct of the parties. The conduct of the parties is recognised through a detailed analysis of functions performed, assets employed and risks borne by the parties with respect to the transaction.

The guidance places significant importance on the risks borne by the parties since the assumption of risks would influence the prices and other economic conditions of the transaction. The framework for analysing risks include, identifying significant risks in connection with the transaction, determining who contractually assumes the risks, who manages and controls the risks including who performs risk mitigation functions, consistency between contractual



assumption of risks with the conduct of the parties, identifying whether the entity bearing the risks has the financial capacity to bear the risks.

Per the guidance, assumption of risks by an entity should be compensated with an appropriate return. Any risk mitigation activities, which can generally be delegated to other parties by the party controlling the risks, should be appropriately remunerated at arm's length. Therefore, a party performing only financing activities in relation to a transaction without exercising any control over the risks, is entitled to only a risk adjusted return for its financing activities.

Contracts, risks and recognition for the recognition of the transaction between the associated enterprises by the tax authorities, importance is placed on the commercial rationale or the business reasons of the transaction.

The guidance provides that the actual transactions between the associated enterprises maybe disregarded by the tax authorities for transfer pricing purposes, if the arrangement between the associated enterprises, viewed in its totality, differs from what would have been entered into between two unrelated parties behaving in a commercially rational manner. In recognising the transaction, the tax authorities should also consider the alternatives that are realistically available to the parties. An analysis of whether the MNE group would be worse off on a pre-tax basis due to the transaction / arrangement can be used as an indicator that the transaction viewed in its entirety lacks the commercial rationality.

However, the guidance cautions tax authorities on the re-characterisation / replacement of the transactions, as it can be a source of double taxation and dispute.

It is recommended in the guidance that 'every effort' should be made to determine the actual nature of the transaction (taking into account contractual arrangements and the conduct) and apply arm's length pricing to it. Absence of a similar transaction between unrelated parties should not lead to a conclusion of a commercially rational transaction between associated enterprises as not being carried out at arm's length.

India perspective the guidance echoes the sentiment of the developing nations including India on the identification and allocation of risks based on the conduct of the parties and attributing appropriate return for such allocation / assumption of risks. In fact, specifically for the Information Technology sector, the Central Board of Direct Taxes, which is the premiere governing body for corporate taxes, through Circular No. 6/2013 dated 29 June 2013, had set out a framework for identifying Research and Development [R&D] entities that can be considered as bearing insignificant risks in connection with rendering R&D services to the group companies. The Circular was issued to clarify the circumstance in which Transactional Net Margin Method can be applied as the most appropriate method to justify the R&D services rendered by a taxpayer.

The framework in the Circular resonates the principles provided in the guidance for accurately delineating the controlled transaction by considering the conduct of the parties and the risks assumed. In the referred Circular, importance is given to; identifying the party performing the economically significant functions, identifying the party providing economically significant assets including funding of the activities, party exercising control over the functions performed by the other party and finally identification of assumption of risks by the parties through a detailed analysis of conduct of the parties and not based on the contractual arrangement between the parties alone.

In this context, as highlighted by India in the UN Transfer Pricing Manual, core functions, key responsibilities, key decision making and levels of individual responsibility for the key decisions, gain importance in identifying the party



which has control over the risks.

In the event a taxpayer could not demonstrate that insignificant risks are borne in performing services, the tax authorities may consider disregarding the Transactional Net Margin Method as the most appropriate method in determining the arm's length price of the transaction. Instead, the tax authorities can consider applying Transactional Profit Split method, or demand a higher mark-up on the costs for the performance of economically significant functions and bearing critical risks by the taxpayer in the transaction.

Therefore, it is important on the part of the taxpayers to clearly document and detail the activities performed and risks borne in transactions and how these activities contribute to the economic value creation by the MNE group.

Following the recommendation in Action 13 of OECD BEPS action plan, India introduced the CbC reporting requirement from financial year 2016-17. Therefore, it is expected that with the increased availability of substantial information relating to the controlled transactions, the taxpayers may not have significant challenge in demonstrating before the tax authorities, the specific activity carried and risks borne in the context of the overall operations of the MNE group.

Although, in the light of the guidance and introduction of CbC requirements in India, the taxpayers may want to revisit and ensure that the transfer price followed in respect of the controlled transactions are in conformity with the level of risks borne and activities performed to avoid any dispute in the scrutiny proceedings by the tax authorities.

As mentioned earlier, the guidance cautions the tax authorities on disregarding the actual transactions entered into between associated enterprises or substituting the transaction with other transactions as it may create double tax incidence on the taxpayer. Importance in this regard is placed on the commercial rationality in entering into the transaction by the parties after considering the options that are realistically available to them.

The Indian Transfer Pricing Regulations provide that the income arising from Transactions between associated enterprises should be computed having regard to the arm's length price. The word 'having regard to' is not specifically defined in the Income-Tax Act, 1961. However, the judicial precedence available in this regard, provides that the term 'having regard to' include 'commercial rationale' or 'business reasons'. Therefore, the Indian Transfer Pricing Regulations require the tax payers and the tax authorities to determine the arm's length nature of a transaction by duly considering, inter-alia the 'business reasons' or 'commercial rationale' behind the transactions.

However, in practice, it has been our experience, that the taxpayers have generally given less weightage to document and detail the commercial rationale behind entering into a transaction especially when transactions involve intangibles or centralised services for which a perfect comparable transaction is generally not found in the open market. Further, the tax authorities, in performing a transfer pricing scrutiny, had lack of appreciation for the commercial rationale behind a taxpayer entering into a transaction with group companies, possibly due to lack of relevant industry expertise to appreciate the commercial reasons, leading to arbitrary transfer pricing adjustments and prolonged disputes. Also, the term 'options realistically available to the parties' is interpreted to have a wider connotation by the tax authorities in determining the commercial rationale behind the transactions.

For example: Obtaining centralised services by a taxpayer from a group company is disregarded by the tax authorities on the premise that similar services can be obtained by the tax payer domestically by incurring a lower



cost or the taxpayer has people providing similar services in-house therefore, the services received are duplicative in nature.

However, the Indian Tax Courts have largely ruled on this issue in favour of the taxpayers in few cases, wherein it is observed that the tax authorities should respect the commercial wisdom of the taxpayer and determine the arm's length nature of the transaction having regard to the relevant facts and circumstances of the case.

Conclusion

Most of the guidance on the importance of conduct of the parties over the contractual arrangements and identification and allocation of risks with appropriate compensation for assumption of risks have been followed by the developing nations including India even before the introduction of BEPS action plans. However, in view of the guidance, it is important on the part of the taxpayers to document the commercial rationality behind entering into the transactions with associated enterprises especially in respect of transactions that have no comparable transactions in the open market. Also, the tax authorities should appreciate the concepts like 'commercial rationality' in recognising the transactions between the associated enterprises and adopt a broader view in scrutiny of the transactions.



TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORT

Global Transfer Pricing Documentation will never be the same again, after the release of the final report on Action 13 in relation to transfer pricing documentation and country-by-country reporting. The G20/OECD have agreed on very significant changes to the compliance and reporting of global information, for risk assessment and transfer pricing purposes. The OECD has adopted a three-tiered approach to documentation, which includes:

Local file It provides an entity and transaction level transfer pricing analysis for each jurisdiction.

Master file

A high level overview of the MNE's global operations along with an overview of the group's transfer pricing policies Country-by-Country report A global financial snapshot of an MNE . From an applicability perspective, a 'Group' is defined as a collection of enterprises related through ownership or control such that it is either required to prepare consolidated financial reporting statements, or would be so required if 'equity interests in any of the enterprises' were publically traded on a stock exchange.

Constituent Entity' being defined as any separate business unit of the group, including companies together with permanent establishments that prepare a separate financial statement for any purpose (including management control and tax compliance CbC report is a 'minimum standard' requirement – it's not an option – countries participating in the BEPS project are expected to commit to and adopt this measure

The G20/OECD having agreed on very significant changes to compliance and reporting requirements, global transfer pricing documentation will never be the same again Transfer pricing local file The local file is required to provide information and support for intercompany transactions that the local company engages in with related parties. It needs to contain most of the information traditionally included in domestic transfer pricing documentation, though specific additional requirements have been introduced. The local file requirements include:

- ❑ Local management structure and an organisation chart, and disclosure of local management reporting line. Details of intercompany transactions and financial information
- ❑ Detailed functional and economic analysis for the intercompany transactions:
 - With preference for local comparables
 - With search for comparable companies once every three years for same functional profile and annual data update
- ❑ Details of bilateral and unilateral APAs, and other rulings 'related to' the transactions of the entity.



The local file is to be filed locally and it is recommended that it be finalised by the filing date for the local tax return.

Transfer pricing master file the report requires businesses to prepare a transfer pricing master file providing a high-level overview of the MNE's global operations along with an overview of the group's transfer pricing policies. The master file requirements including geographies Description of the business, including drivers of profit, supply chain for large products/services, important service arrangements including locations, capabilities, cost allocations and pricing Details of unilateral advance pricing agreements [APAs] and other tax rulings relating to allocation Description of overall strategy for development, ownership and exploitation of intangibles, including of principal R&D facilities and R&D management and details of intangibles related intra-group agreements (including related transfer pricing policies) Financing arrangements with third parties, group financials financing arrangements with third parties, group financing companies and their location (including related transfer pricing. Details of unilateral advance pricing agreements [APAs] and other tax rulings relating to allocation of income among countries.

Country-by-country [CbC]

Country-by-country [CbC] report The CbC report requires each MNE to provide key financial information on an aggregate country basis with an activity code for each member of the MNE. CbC report is a new concept for the international tax world and represents the biggest change to the existing guidelines on documentation. The provision of the CbC report to the tax authorities is a 'minimum standard' requirement, and the report makes clear that countries participating in the BEPS project are expected to commit to and adopt this measure. It will provide tax authorities with global information for the purposes of risk assessment. Multinational groups with consolidated revenue of more than €750 million (or equivalent in local currency) in the previous fiscal year will have to file a CbC report.

The filing requirement is effective for fiscal years beginning on or after 1 January 2016. The 'Reporting Entity' of the group will be required to file the CbC report, which will usually be the 'Ultimate Parent Entity', the company that prepares consolidated financial statements for the group. Alternatively, the group can nominate a 'Surrogate Parent Entity' that will be responsible for filing the CbC.

The CbC report should set out the specified financial data (diagrammatically represented) of the Group by tax jurisdiction, in a prescribed template together with a list of constituent entities by country of residence and indication of their activities.

The report provides for flexibility of data sources for preparation of the CbC report. Each MNE may choose to use data from its consolidated reporting packages, separate entity statutory financial statements, or internal management accounts. Each MNE is required to provide a short description of the sources of data used in CbC reporting and should use the same data source year on year (any changes in source data need to be explained). Additionally, no accounting adjustments or reconciliations are required.

CbC report is a 'minimum standard' requirement – it's not an option – countries participating in the BEPS project are expected to commit to and adopt this measure.

Submission, exchange and use The CbC is to be filed in the tax jurisdiction of the ultimate parent entity (or nominated surrogate parent entity) and will be exchanged widely by governments, including with many developing countries, via various sharing mechanisms. Where the ultimate parent company jurisdiction will not be able to implement the CbC reporting requirement with



respect to fiscal period beginning or after 1 January 2016, they may be able to accommodate voluntary filing for the ultimate parent entities resident in their jurisdiction for the fiscal period beginning of or after 1 January 2016 (referred as "parent surrogate filing"). If the CbC report is not shared by the tax jurisdiction of the ultimate parent company (or the nominated surrogate), constituent entities of such MNE may be required to file the CbC report locally in their respective jurisdictions.

The model agreements provide that information shared as a result of these agreements must be kept confidential and used appropriately. It is pertinent to note that the agreements emphasise that the CbC information should not be used as a substitute for detailed transfer pricing analysis of individual transactions, and that transfer pricing adjustments should not be made on the basis of CbC reporting alone.

Timelines CbC report is required to be filed annually by the MNE within 12 months of the end of its financial reporting year (for years beginning on or after 1 January 2016). In addition, each constituent entity will need to notify their local tax authority by the last day of the financial reporting year either (i) that it will be filing the CbC report for the year, or (ii) the name and tax residence of the company that will file the report for that fiscal year.

Tax authorities will be required to share the CbC report with other relevant tax authorities within 18 months of the end of the financial reporting year for the first year (thereafter within 15 months of the financial reporting year of the MNE). Therefore, the first CbC report would be required to be filed by 31 December 2017, which then would be shared with other relevant tax authorities by 30 June 2018. Thus, the CbC report may be one of the first initiatives to be implemented under the BEPS Action Plan.

The G20/OECD have developed an XML Schema and a related User Guide to allow for electronic tagging of data in the CbC reports to facilitate their exchange electronically. Countries will be monitored on their implementation of the CbC reporting requirements and associated exchange of information. The G20/ OECD governments have agreed to review the standards to ensure they are working effectively by 2020. Global adoption of the OECD documentation requirements It remains to be seen how coordinated will be the approach and the extent to which the various jurisdictions around the world dopt the OECD documentation requirements. Since the release of the Action Plan Final report in October 2015, there has been a constant increase in the number of countries that have implemented the CbC reporting requirement in their local legislation.

India perspective In order to implement the international consensus on Action 13 of the BEPS project, the Finance Act 2016 introduced the Country by Country (CbC) reporting requirement and the concept of master file in the Indian Income Tax Act, 1961. The CbC reporting requirement is introduced with effect from Assessment Year 2017-18 (financial year 2016-17), requiring Indian headquartered Multi-national Enterprises ("MNEs") and certain other Indian entities of global MNEs to file the CbC report with the Indian Authority.

India will adhere to the OECD prescribed group revenue threshold of Euro 750 million (INR equivalent) for the applicability of the CbC requirement. The CbC report is required to be filed on or before the due date for filing the return of income in India (typically on 30 November following the end of the Indian financial year in March). The core provisions are included in the Act and the balance detailed provisions in the Income Tax Rules. Stringent penalty provisions have also been prescribed for non-furnishing and/or furnishing inaccurate particulars.

In the present environment, it remains to be seen how tax authorities will use the information provided in the CbC report. Even though the OECD has emphasized



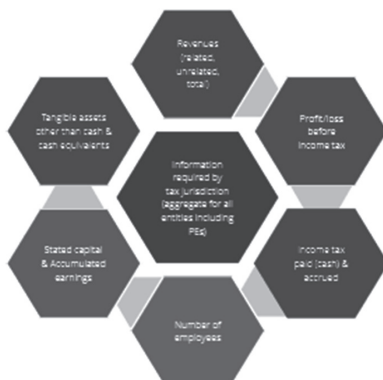
that the CbC report is only meant for high level risk assessment purposes, there is a risk that Indian authorities may apply formulary apportionment.

The impact of OECD's reporting requirement is that it raises the benchmark for the quality of information reported to Indian authorities even if it is not explicitly adopted in the Indian rules. Taxpayers will need to be more meticulous in preparing documentation as the Indian authorities may demand information and documentation of the MNE group (such as the master file and the CbC report maintained by the ultimate parent entity).

Indian authorities in trying to protect their revenue base may take a greater interest in the MNE's global value chain to ensure that the allocation of profit is consistent with the value creation in India. Given the emphasis in examining the actual conduct of parties rather than the contractual form, MNE's will be required to substantiate that they have delineated the transaction accurately as reflected in the documentation. Way forward the new guidance will provide tax authorities with substantial information and transparency regarding the financial results of a taxpayer's global transfer pricing policies. This increase in global transparency is likely to mean that deviations from a company's transfer pricing policy or the implementation of that policy will become more apparent to tax authorities around the world. Therefore, MNEs that currently do not establish and monitor transfer pricing policies on a global basis may find a need to do so now.

Businesses are likely to find it necessary to prepare or coordinate their transfer pricing documentation centrally to ensure that the CbC report, master file and local files provide consistent information about global and local operations and transfer pricing policies.

Tax authorities are likely to compile ratios to examine tax structures that do not align with value creation. Taxpayers should prepare by compiling ratios based on the parameters in the CbC report to pre-empt questions about certain constituent entities (which for example have low number of employees vis-à-vis total revenue). Tax authorities around the world could potentially compare the mark-ups on costs given by the MNE to different administrations and demand a more consistent approach world-wide. Proactive approaches to manage the uncertainty could include considering the APA/MAP route. In this environment, it is important for MNEs to undertake a risk assessment exercise to evaluate how the new documentation guidance will impact their current transfer pricing policies and their process for implementing, monitoring, and defending those policies as well as prepare for greater level of scrutiny by the tax authorities global.





A. Controlled foreign company rules Controlled foreign company [CFC] rules attempt to tackle the issue of a taxpayer shifting income from the State of residence to a State where the tax rates are low. A CFC is a company situated, typically, in a low tax jurisdiction and controlled by an entity situated in a higher tax jurisdiction.

While the rules applicable to CFCs and the attributes of a CFC differ from country to country, the hallmark of CFC regimes in general is that they eliminate the non-taxation or deferral of income earned by a CFC and tax residents upfront on their proportionate share of a CFC's income. Among the countries participating in OECD/G20 BEPS project, 30 countries have CFC rules and many others are interested in implementing them. However, considering the current CFC rules have not kept pace with the developments in the international business environment, there was a need to firm up a design for CFC rules.

Unlike many of the other BEPS reports, where countries agree on minimum standards that they wish to adopt, this report seeks to lay down 'building blocks'. These building blocks are a set of recommendations that countries who choose to implement effective CFC rules could adopt and some of these are discussed below.

❑ Definition of CFC:

In defining a CFC, there are two broad principles a jurisdiction should look into: (a) the entity; and (b) control over the entity. While CFC has largely been applied to corporate, it has been recommended that CFCs also include trusts, partnerships, permanent establishments to the extent that such entities raise BEPS concerns. As regards control, the recommendations seek to lay down how to determine when shareholders have sufficient control over a foreign company for that company to be a CFC.

❑ CFC exemptions and threshold requirements:

In many countries, the CFC may be availing of a tax exemption that results in a lower effective tax rate. Under the current CFC laws, the foreign enterprise may regard the income earned by the CFC as a CFC income. However, it has been recommended that CFC rules should be applied only in cases where the company is subject to an effective tax rate which is meaningfully lower than the rate at the parent jurisdiction.

❑ Definition, computation and attribution of income:

The recommendation here is that the income items should be comprehensively defined. Further, CFC rules use the rules of the parent jurisdiction to compute CFC income. The attribution of income should be guided by the control threshold/proportionate ownership or influence.

❑ Prevention and elimination of double taxation:

It is essential that when a country designs an effective CFC rule, it does not lead to double taxation. Further, if where there is a double taxation involved, then CFC rules should grant a credit for the taxes paid. Considering CFC rules are governed by domestic laws, this Action recommends that if these rules are designed in the manner laid down, it will address BEPS concerns.

India perspective India currently does not have CFC rules under its domestic tax law. However, there was a proposal to introduce CFC regulations under the Direct Taxes Code [DTC]. The introduction of DTC to replace the current tax law is presently under cold storage. The Government of India has however introduced the concept of Place of effective management ('PoEM') for determining the residential status of the company in order to ensure that companies incorporated outside India but controlled from India do not escape taxation in India.



The intent of PoEM provisions is to target shell / conduit companies which are created to retain income outside India and not Indian MNC's engaged in the active business outside India.

Though the concept of PoEM, per se is not an anti-abuse tool but guidelines for determining PoEM, especially taxing the company on the basis of active and passive income, takes the colour of an anti-abuse measure which typically is a characteristic of CFC rules.

It is anticipated that in this year Budget, The Government is likely to introduce the concept of 'Controlled Foreign Corporation' (CFC) regulations replacing the concept of taxing a foreign company if its 'place of effective management' (PoEM) is in India. CFC rules are generally meant to counter tendency on the part of MNCs to defer taxes through parking of passive incomes (e.g. royalties, fees, interests, capital gains, profits made from buying and selling products from and to related parties, etc.) at the level of foreign subsidiaries, instead of repatriating the same back as dividends .

Assuming that the passive incomes in question pass the necessary tests of legitimacy, or else, such incomes would anyway would be taxed in India under specific or general anti avoidance rules, it is doubtful whether Indian MNCs would prefer to park these incomes abroad, purely to avoid taxes in India, since India currently encourages Indian companies to bring back foreign sourced income as dividends, by granting a lower base tax rate of 15% for such income, when compared to the base corporate tax rate of 30%. CFC regulations could also help in avoiding the subjective nature of applying PoEM criteria for Outbound Indian Companies as CFC will tax only the passive income of certain foreign entities located in low-tax jurisdiction and being controlled from India, as against the potential risk of global income being exposed for Taxation in India under PoEM Though designing effective CFC rules is one of the mandates of BEPS Action Plans, yet, one would need to evaluate and see how the CFC regulations would be introduced in the Indian domestic tax law

B. Dispute Resolution and Implementation (Multilateral Instrument) Countries participating in BEPS agree that the introduction of the measures developed to address BEPS should not lead to uncertainty for taxpayers and unintended double taxation. Therefore, refining dispute resolution mechanism is a vital and integral component of the work on BEPS issues.

With the above in view, the guidance in Action 14 of the BEPS Action provides for implementing "minimum standards" and "best practices" to enhance the effectiveness/ efficiency of the Mutual Agreement Procedure [MAP] process.

The minimum standards require countries to ensure that:

- treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner
- implementation of administrative processes that promote the prevention
- and timely resolution of treaty-related disputes and
- taxpayers can access the MAP when eligible. As part of minimum standard, important aspects include seeking to resolve MAP cases within an average time frame of 24 months and guidance that countries should not use performance indicators for the competent authorities which are based on amount of adjustment sustained and observes that number of MAPs resolved/ time taken in resolving MAPs may be more appropriate indicators. For easy access to MAPs, the guidance also suggests permitting a request to either competent authority, implementation of a bilateral notification system, publishing of MAP guidance etc.



In addition to above minimum standards, a set of best practices have been provided for. Such best practices includes implementation of bilateral advanced pricing arrangements, suspension of collection during pendency of MAP cases, training for tax examiners, access to MAPs for taxpayer-initiated adjustments etc.

The countries are also devoted to effective implementation of the above guidance through the establishment of a robust peer-based monitoring mechanism. Further, with a view to ensure timely resolution of treaty related disputes, several countries have also declared their commitment to provide for mandatory binding MAP arbitration in their bilateral tax treaties. The countries committing to mandatory binding MAPs were

involved in more than 90 percent of outstanding MAP cases at the end of 2013, as reported to the OECD.

In line with BEPS Action 14, the multilateral instrument includes chapter V on "Improving Dispute Resolution", which includes a specific Article on MAP. It inter alia provides for inclusion of Articles 25(1) to 25(3) of the OECD Model Convention on MAP in all tax treaties. If a tax treaty-related case qualifies to be considered under the MAP the taxpayer can approach the competent authority of either of the contracting jurisdiction. The multilateral instrument also includes a separate chapter VI on "Arbitration".

India perspective Several multinational companies operating in India have protracted litigations, in particular for transfer pricing matters. The double taxation arising from such litigation couple with extensive time taken in concluding the MAPs has been a major area of concern for the multinational companies.

The Indian revenue authority s, at several forums, have also expressed their reluctance to include arbitration within the Double Taxation Avoidance Agreement, which does not provide requisite level of comfort to the global investors. Moreover, Indian revenue authorities believe that absence of Article 9(2) in the tax treaty precludes MAPs in respect of economic double taxation (transfer pricing) and therefore, the multinational companies from several large jurisdictions have not been able to access MAP/ bilateral advance pricing arrangements. Considering the above, the guidance provided under Action 14 would be of significant interest/ relevance to such multinational companies particularly aspects such as resolution of MAP cases in two years.

As per the provisional list of reservation to the multilateral instrument, India has opted not to adopt a provision according to which the tax payer can approach the competent authority of either of the contracting jurisdiction. However, as this is a minimum standard, India has opted for bilateral notification or consultation process. India has not opted for chapter VI of the multilateral instrument dealing with mandatory arbitration.



9

AUDIT FORM

FORM NO. 3CEB

[See rule 10E]

Report from an accountant to be furnished under section 92E relating to international transaction(s) and specified domestic transaction(s)

1. *I/We have examined the accounts and records of _____ (name and address of the assessee with PAN) relating to the international transaction (s) and the specified domestic transaction(s) entered into by the assessee during the previous year ending on 31st March, _____
2. In*my/our opinion proper information and documents as are prescribed have been kept by the assessee in respect of the international transaction(s) and the specified domestic transactions entered into so far as appears from *my/our examination of the records of the assessee.
3. The particulars required to be furnished under section 92E are given in the Annexure to this Form. In*my/our opinion and to the best of my/our information and according to the explanations given to *me/us, the particulars given in the Annexure are true and correct.

**Signed

Name

Address : Membership No. :

Place :

Date :

Notes :

1. *Delete whichever is not applicable.
2. **This report has to be signed by—
 - (i) a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949); or
 - (ii) any person who, in relation to any State, is, by virtue of the provisions in sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), entitled to be appointed to act as an auditor of companies registered in that State.

ANNEXURE TO FORM NO. 3CEB

Particulars relating to international transactions and specified domestic transactions required to be furnished under section 92E of the Income-tax Act, 1961

PART A

1. Name of the assessee _____
2. Address _____
3. Permanent account number _____
4. Nature of business or activities of the assessee* _____
5. Status _____
6. Previous year ended _____
7. Assessment year _____
8. Aggregate value of international transactions as per books of accounts _____



9. Aggregate value of specified domestic transactions as per books of accounts _____

* Code for nature of business to be filled in as per instructions for filling Form ITR 6

**PART B
(International Transactions)**

10.	<p><i>List of associated enterprises with whom the assessee has entered into international transactions, with the following details :</i></p> <p>(a) Name of the associated enterprise.</p> <p>(b) Nature of the relationship with the associated enterprise as referred to in section 92A(2).</p> <p>(c) Brief description of the business carried on by the associated enterprise</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
11.	<p>Particulars in respect of transactions in tangible property.</p> <p>A. Has the assessee entered into any international transaction(s) in respect of purchase/sale of raw material, consumables or any other supplies for assembling or processing/manufacturing of goods or articles from/to associated enterprises?</p> <p>If 'yes', provide the following details in respect of each associated enterprise and each transaction or class of transaction :</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Description of transaction and quantity purchased/sold.</p> <p>(c) Total amount paid/received or payable/receivable in the transaction—</p> <p style="padding-left: 20px;">(i) as per books of account;</p> <p style="padding-left: 20px;">(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(d) Method used for determining the arm's length price [See section 92C(1)]</p> <p>B. Has the assessee entered into any international transaction(s) in respect of purchase/sale of traded/finished goods?</p> <p>If 'yes' provide the following details in respect of each associated enterprise and each transaction or class of transaction :</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Description of transaction and quantity</p>	<p>Yes/No <input type="checkbox"/></p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>Yes/No <input type="checkbox"/></p> <p>_____</p> <p>_____</p>



	<p>purchased/sold.</p> <p>(c) Total amount paid/ received or payable/receivable in the transaction</p> <p>(i) as per books of accounts;</p> <p>(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(d) Method used for determining the arm's length price [See section 92C(1)]</p> <p>C. Has the assessee entered into any international transaction(s) in respect of purchase, sale, transfer, lease or use of any other tangible property including transactions specified in Explanation (i)(a) below section 92B(2)?</p> <p>If 'yes' provide the following details in respect of each associated enterprise and each transaction or class of transaction:</p> <p>(a) Name and address of the associate enterprise with whom the international transaction has been entered into.</p> <p>(b) Description of the property and nature of transaction.</p> <p>(c) Number of units of each category of tangible property involved in the transaction.</p> <p>(d) Amount paid/received or payable/receivable in each transaction of purchase/sale/transfer /use, or lease rent paid/received or payable/receivable in respect of each lease provided/entered into —</p> <p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(e) Method used for determining the arm's length price [See section 92C(1)]</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>Yes/No _____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
12.	<p>Particulars in respect of transactions in intangible property :</p> <p>Has the assessee entered into any international transaction(s) in respect of purchase, sale, transfer, lease or use of intangible property including transactions specified in Explanation (i)(b) below section 92B(2)?</p> <p>If 'yes' provide the following details in respect of each associated enterprise and each category of intangible property :</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Description of intangible property and nature of</p>	<p>_____</p> <p>Yes/No _____</p> <p>_____</p> <p>_____</p>



	<p>transaction.</p> <p>(c) Amount paid/received or payable/receivable for purchase/sale/transfer/lease/use of each category of intangible property—</p> <p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm’s length price.</p> <p>(d) Method used for determining the arm’s length price [See section 92C(1)]</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
<p>13.</p>	<p>Particulars in respect of providing of services :</p> <p>Has the assessee entered into any international transaction(s) in respect of Services including transactions as specified in Explanation (i)(d) below section 92B(2)?</p> <p>If ‘yes’ provide the following details in respect of each associated enterprise and each category of service :</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Description of services provided/availed to/from the associated enterprise.</p> <p>(c) Amount paid/received or payable/receivable for the services provided/taken—</p> <p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm’s length price.</p> <p>(d) Method used for determining the arm’s length price [See section 92C(1)]</p>	<p>Yes/No <input type="checkbox"/></p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
<p>14.</p>	<p>Particulars in respect of lending or borrowing of money :</p> <p>Has the assessee entered into any international transaction(s) in respect of lending or borrowing of money including any type of advance, payments, deferred payments, receivable, non-convertible preference shares/debentures or any other debt arising during the course of business as specified in Explanation (i)(c) below section 92B (2)?</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Nature of financing agreement.</p> <p>(c) Currency in which transaction has taken place</p> <p>(d) Interest rate charged/paid in respect of each lending/borrowing.</p> <p>(e) Amount paid/received or payable/receivable in the transaction—</p>	<p>Yes/No <input type="checkbox"/></p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>



	<p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(f) Method used for determining the arm's length price [See section 92C(1)]</p>	<p>_____</p> <p>_____</p> <p>_____</p>
15.	<p>Particulars in respect of transactions in the nature of guarantee:</p> <p>Has the assessee entered into any international transaction(s) in the nature of guarantee?</p> <p>If yes, provide the following details:</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Nature of guarantee agreement</p> <p>(c) Currency in which the guarantee transaction was undertaken</p> <p>(d) Compensation/ fees charged/ paid in respect of the transaction</p> <p>(e) Method used for determining the arm's length price [See section 92C(1)]</p>	<p>Yes/No _____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
16.	<p>Particulars in respect of international transactions of purchase or sale of marketable securities, issue and buyback of equity shares, optionally convertible/ partially convertible/ compulsorily convertible debentures/ preference shares:</p> <p>Has the assessee entered into any international transaction(s) in respect of purchase or sale of marketable securities or issue of equity shares including transactions specified in Explanation (i)(c) below section 92B (2)?</p> <p>If yes, provide the following details:</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Nature of transaction</p> <p>(c) Currency in which the transaction was undertaken</p> <p>(d) Consideration charged/ paid in respect of the transaction.</p> <p>(e) Method used for determining the arm's length price [See section 92C(1)]</p>	<p>Yes/No _____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
17.	<p>Particulars in respect of mutual agreement or arrangement :</p> <p>Has the assessee entered into any international transaction with an associated enterprise or enterprises by way of a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or</p>	<p>Yes/No _____</p>



	<p>expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises? If 'yes' provide the following details in respect of each agreement/arrangement:</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Description of such mutual agreement or arrangement.</p> <p>(c) Amount paid/received or payable/receivable in each such transaction—</p> <p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(d) Method used for determining the arm's length price [See section 92C(1)].</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
<p>18.</p>	<p>Particulars in respect of international transactions arising out/ being part of business restructuring or reorganizations: Has the assessee entered into any international transaction(s) arising out/being part of any business restructuring or reorganization entered into by it with the associated enterprise or enterprises as specified in Explanation (i) (e) below section 92B (2) and which has not been specifically referred to above? If 'yes', provide the following details:</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered into.</p> <p>(b) Nature of transaction</p> <p>(c) Agreement in relation to such business restructuring/reorganization.</p> <p>(d) Terms of business restructuring/ reorganization.</p> <p>(e) Method used for determining the arm's length price [See section 92C(1)].</p>	<p>Yes/No <input type="checkbox"/></p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
<p>19.</p>	<p>Particulars in respect of any other transaction including the transaction having a bearing on the profits, income, losses or assets of the assessee: Has the assessee entered into any other international transaction(s) including a transaction having a bearing on the profits, income, losses or asset , but not specifically referred to above, with associated enterprise? If 'yes' provide the following details in respect of each associated enterprise and each transaction :</p> <p>(a) Name and address of the associated enterprise with whom the international transaction has been entered</p>	<p>Yes/No <input type="checkbox"/></p>



	<p>into.</p> <p>(b) Description of the transaction.</p> <p>(c) Amount paid/received or payable/receivable in the transaction—</p> <p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(d) Method used for determining the arm's length price [See section 92C(1)].</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
20.	<p>Particulars of deemed international transactions:</p> <p>Has the assessee entered into any transaction with a person other than an AE in pursuance of a prior agreement in relation to the relevant transaction between such other person and the associated enterprise?</p> <p>If yes, provide the following details in respect of each of such agreement</p> <p>(a) Name and address of the person other than the associated enterprise with whom the deemed international transaction has been entered into.</p> <p>(b) Description of the transaction.</p> <p>(c) Amount paid/received or payable/receivable in the transaction—</p> <p>(i) as per books of account;</p> <p>(ii) as computed by the assessee having regard to the arm's length price.</p> <p>(d) Method used for determining the arm's length price [See section 92C(1)].</p>	<p>Yes/No <input type="checkbox"/></p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
	PART C (Specified domestic transaction)	
21.	<p>List of associated enterprises with whom the assessee has entered into specified domestic transactions, with the following details:</p> <p>(a) Name, address and PAN of the associated enterprise.</p> <p>(b) Nature of the relationship with the associated enterprise</p> <p>(c) Brief description of the business carried on by the said associated enterprise.</p>	<p>_____</p> <p>_____</p> <p>_____</p>
22.	<p>Particulars in respect of transactions in the nature of any expenditure:</p> <p>Has the assessee entered into any specified domestic transaction (s) being any expenditure in respect of which payment has been made or is to be made to any person referred to in section 40A(2)(b)?</p> <p>If "yes", provide the following details in respect of each of</p>	<p>Yes/No <input type="checkbox"/></p>



	such person and each transaction or class of transaction: (a) Name of person with whom the specified domestic transaction has been entered into. (b) Description of transaction along with quantitative details, if any (c) Total amount paid or payable in the transaction— (i) as per books of account; (ii) as computed by the assessee having regard to the arm's length price. (d) Method used for determining the arm's length price [See section 92C(1)]	_____ _____ _____ _____ _____
23.	Particulars in respect of transactions in the nature of transfer or acquisition of any goods or services: A. Has any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA)]transferred any goods or services to any other business carried on by the assessee? If yes, provide the following details in respect of each unit or enterprise or eligible business: (a) Name and details of business to which goods or services have been transferred (b) Description of goods or services transferred (c) Amount received/receivable for transferring of such goods or services – (i) as per the books of account; (ii) as computed by the assessee having regard to the arm's length price. (d) Method used for determining the arm's length price [See section 92C(1)]. B. Has any undertaking or unit or enterprise or eligible business of the assessee [as referred to in section 80A(6), 80IA(8) or section 10AA] acquired any goods or services from another business of the assessee? If yes, provide the following details in respect of each unit or enterprise or eligible business: (a) Name and details of business from which goods or services have been acquired (b) Description of goods or services acquired (c) Amount paid/payable for acquiring of such goods or services– (i) as per the books of account; (ii) as computed by the assessee having regard to	Yes/No _____ _____ _____ _____ _____ _____ _____ _____ _____ _____ _____ _____ Yes/No _____ _____ _____ _____ _____ _____ _____



	<p style="text-align: center;">the arm’s length price</p> <p>(d) Method used for determining the arm’s length price [See section 92C(1)].</p>	
24.	<p>Particulars in respect of specified domestic transaction in the nature of any business transacted:</p> <p>Has the assessee entered into any specified domestic transaction(s) with any associated enterprise which has resulted in more than ordinary profits to an eligible business to which section 80IA(10) or section 10AA applies?</p> <p>If “yes”, provide the following details:</p> <p>(a) Name of the person with whom the specified domestic transaction has been entered into</p> <p>(b) Description of the transaction including quantitative details, if any.</p> <p>(c) Total amount received/receivable or paid/ payable in the transaction -</p> <p style="padding-left: 20px;">(i) as per books of account;</p> <p style="padding-left: 20px;">(ii) as computed by the assessee having regard to the arm’s length price.</p> <p>(d) Method used for determining the arm’s length price [See section 92C(1)].</p>	<p>Yes/No <input type="checkbox"/></p>
25.	<p>Particulars in respect of any other transactions :</p> <p>Has the assessee entered into any other specified domestic transaction(s) not specifically referred to above, with an associated enterprise ?</p> <p>If ‘yes’ provide the following details in respect of each associated enterprise and each transaction :</p> <p>(a) Name of the associated enterprise with whom the specified domestic transaction has been entered into.</p> <p>(b) Description of the transaction.</p> <p>(c) Amount paid/received or payable/receivable in the transaction—</p> <p style="padding-left: 20px;">(i) as per books of account;</p> <p style="padding-left: 20px;">(ii) as computed by the assessee having regard to the arm’s length price.</p> <p>(d) Method used for determining the arm’s length price [See section 92C(1)].</p>	<p>Yes/No <input type="checkbox"/></p>

**Signed _____
Name : _____
Address : _____

Place : _____

Date : _____

Notes :**This annexure has to be signed by -

(i) a chartered accountant within the meaning of the Chartered Accountants Act, 1949 (38 of 1949); or

(ii) any person who, in relation to any State, is, by virtue of the provisions in sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), entitled to be appointed to act as”.

NOTE

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Action Plan:

1. Successful conduct of Certificate Course on GST.
2. Publication and Circulation of Tax bulletin (both in electronic and printed formats) for the awareness and knowledge updation of stakeholders, members, traders, Chambers of Commerce, Universities.
3. Publication of Handbooks on Taxation related topics helping stakeholders in their job deliberations.
4. Carry out webinars for the Capacity building of Members - Trainers in the locality to facilitate the traders/ registered dealers.
5. Conducting Seminars and workshops on industry specific issues, in association with the Trade associations/ Traders/ Chamber of commerce in different location on practical issues/aspects associated with GST.
6. Tendering representation to the Government on practical difficulties faced by the stakeholders in Taxation related matters.
7. Updating Government about the steps taken by the Institute in removing the practical difficulties in implementing various Tax Laws including GST.
8. Facilitating general public other than members through GST Help-Desk opened at Head quarter of the Institute and other places of country.
9. Introducing advance level courses for the professionals on GST and Income Tax.
10. Extending Crash Courses on Taxation to Corporates, Universities, Trade Associations etc.

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