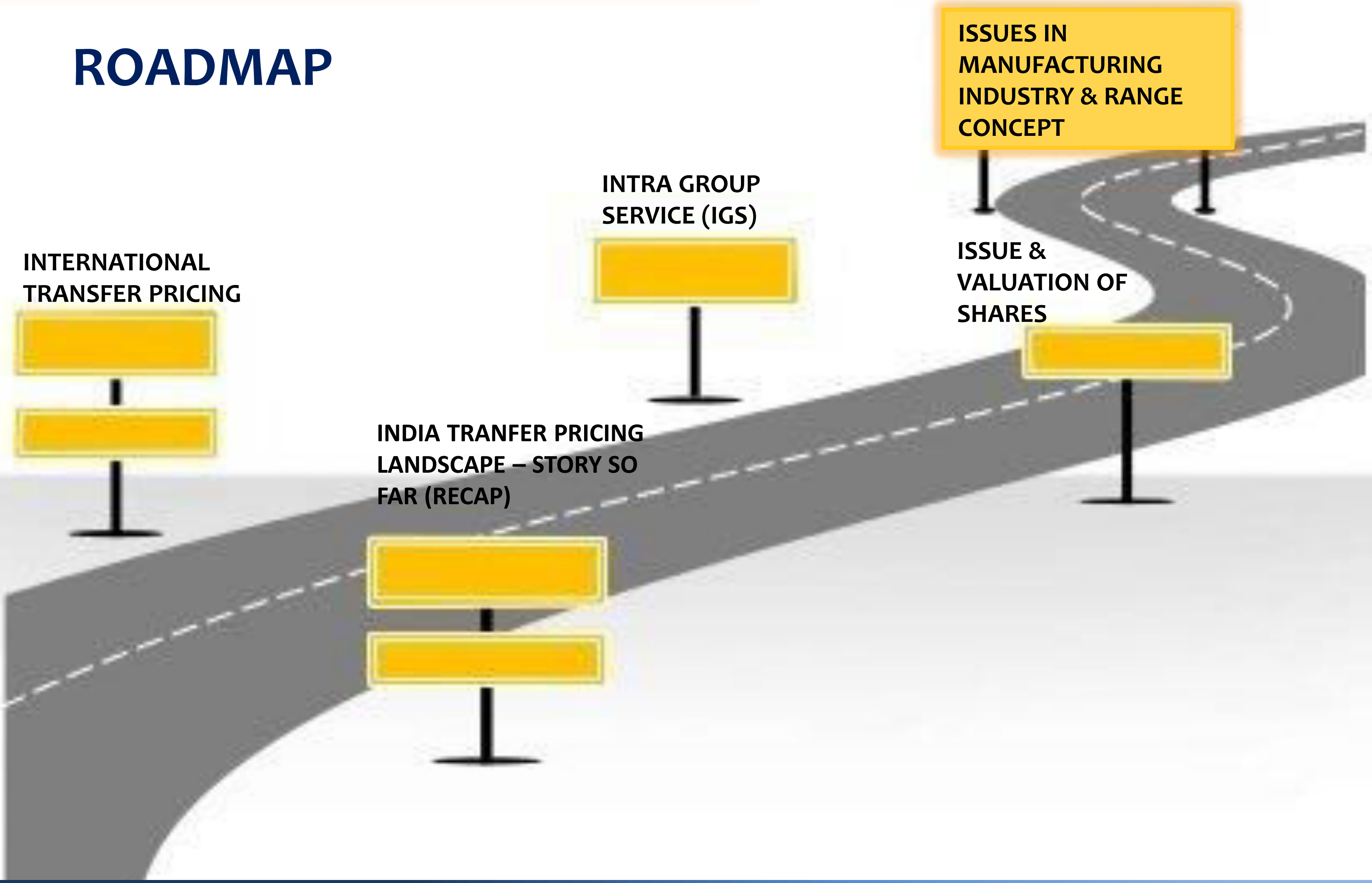
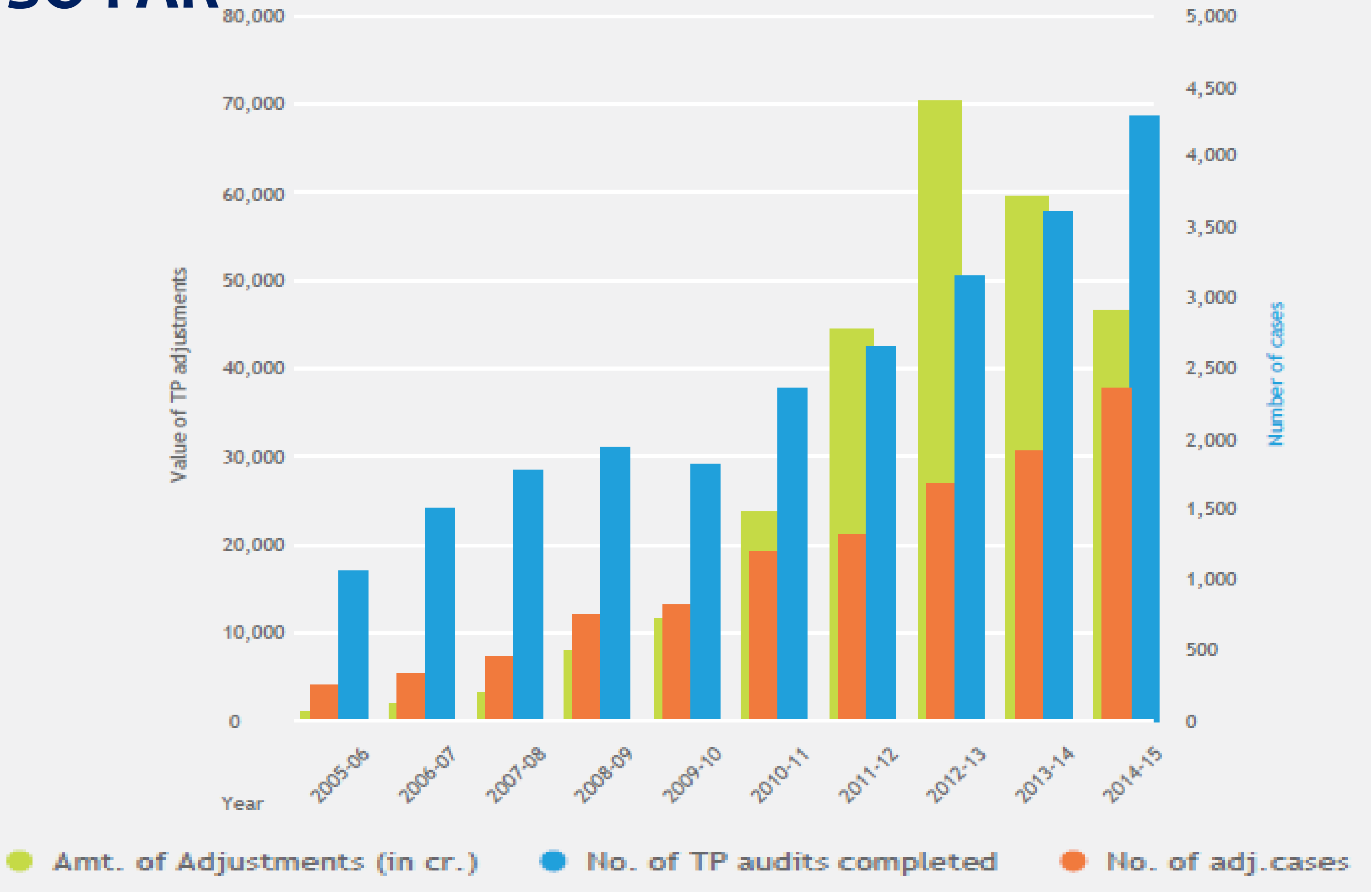
TRANSFER PRICING

ROADMAP


INTERNATIONAL TRANSFER PRICING
INDIA TRANFER PRICING LANDSCAPE – STORY SO FAR (RECAP)
INTRA GROUP SERVICE (IGS)
ISSUE & VALUATION OF SHARES
ISSUES IN MANUFACTURING INDUSTRY & RANGE CONCEPT

RECAP

INDIA TRANSFER PRICING LANDSCAPE – STORY SO FAR



RECAP

- Introduction of **Dispute Resolution Panels** – effective in limited sense, not achieved intended objectives
- Inordinately delayed resolution at ITAT level – Positive is that there has been a **significant disposal of cases** during FY 2015-16
- HC rulings on significant issues are in favour of taxpayers; Tribunal Rulings also, **substantially, in favour of taxpayers**; also remanded back in certain cases
- Issuance of **clarificatory circulars** on critical TP issues (e.g. Circular on R & D centers)
- Introduction of **Safe Harbour Rules**
- Introduction of **Range concept** and allowing use of **multiple years data**
- **Dedicated DRP** charge for commissioners
- **APA** (along with rollback provisions)

INTERNATIONAL TRANSFER PRICING

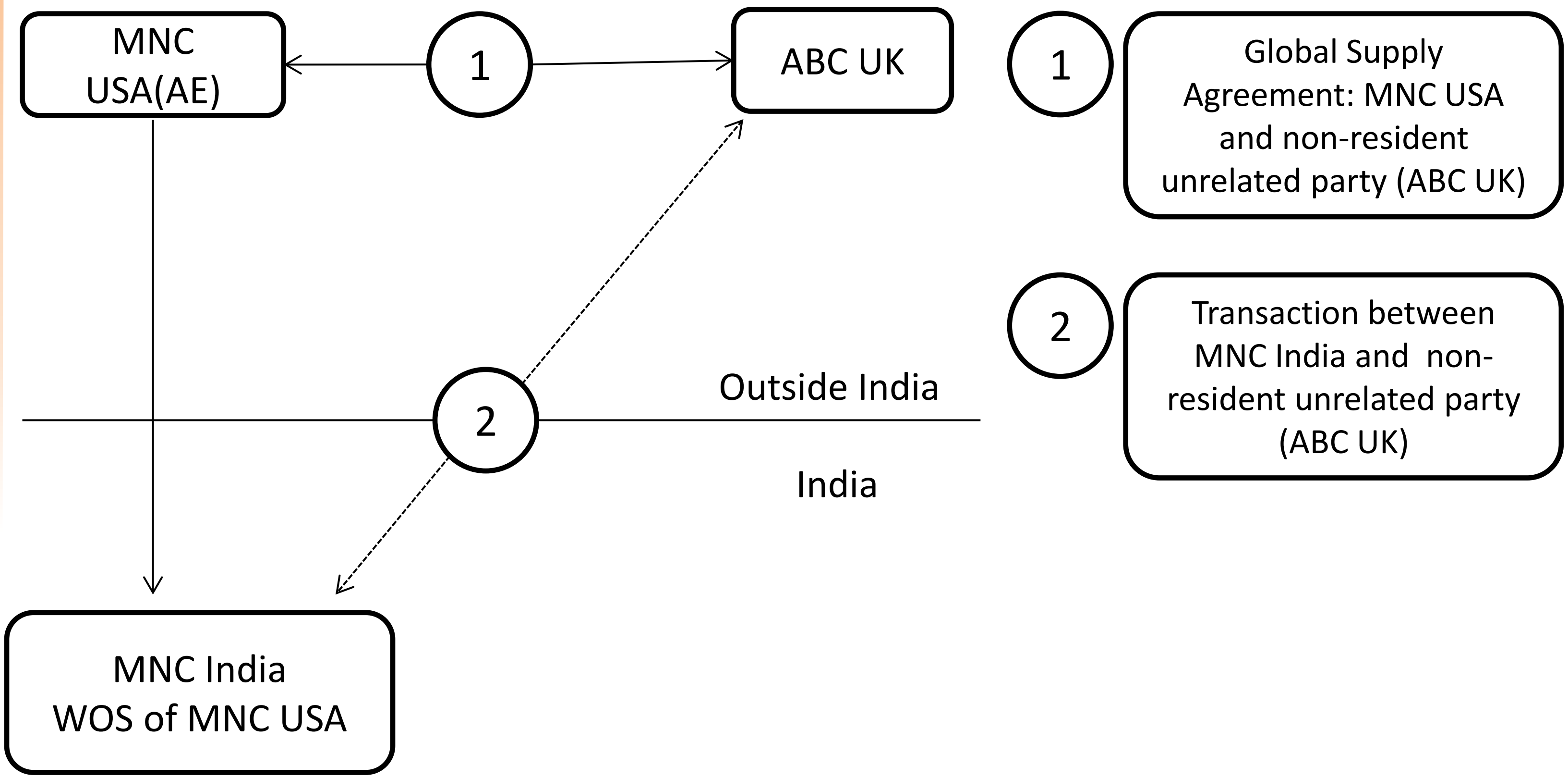
DEEMED INTERNATIONAL TRANSACTION – CASE STUDIES

DEFINITION – INTERNATIONAL TRANSACTION

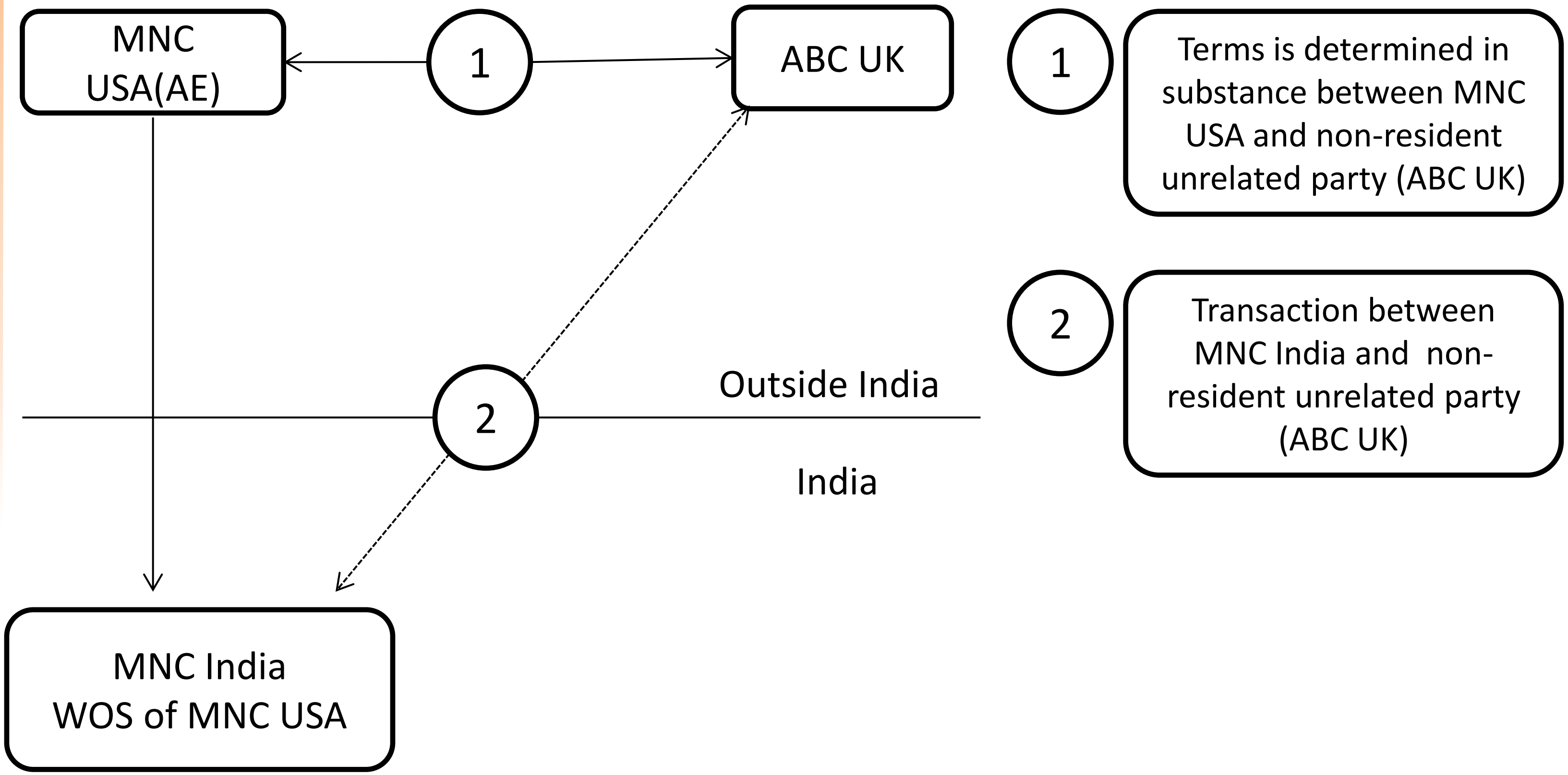
- The term international is exhaustively defined and covers all transaction between two or more AEs, either or both whom are non-residents .

- In addition, a transaction entered into by an enterprise with an independent third party can also be deemed to be an international transaction entered into between two AEs if either of the following condition are satisfied : a)There is a prior agreement in relation to the relevant transaction between such independent third party and the AE of that enterprises; or b) The term of the relevant transaction are determined in substance between such independent third party and the AE of that enterprise

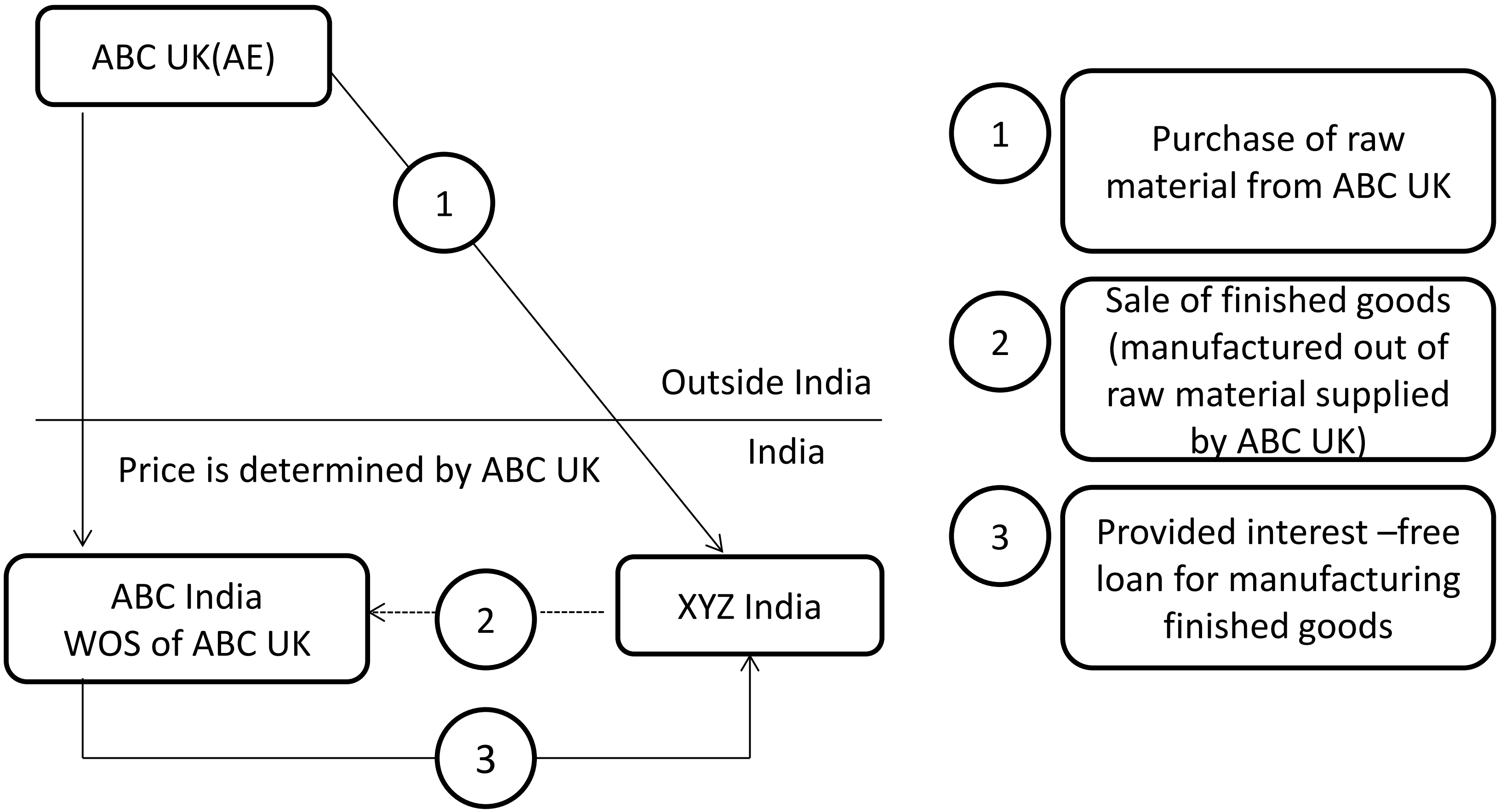
CASE STUDY – 1 (Prior agreement is available)



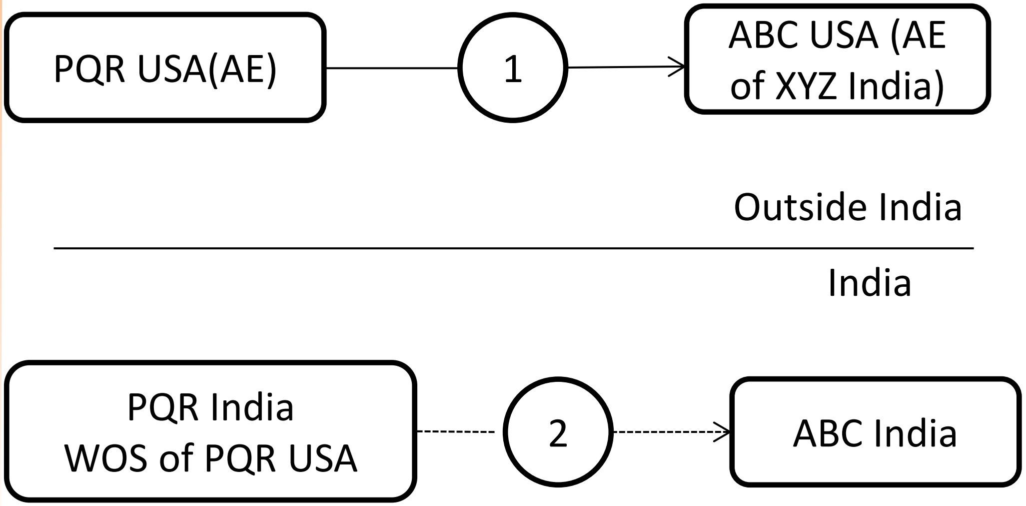
CASE STUDY – 1.1 (No prior agreement is available but terms of the transaction is determined in substance)



CASE STUDY - 2


ABC UK(AE)
1
Outside India
India
Price is determined by ABC UK
ABC India
WOS of ABC UK
2
XYZ India
3
1
Purchase of raw material from ABC UK
2
Sale of finished goods (manufactured out of raw material supplied by ABC UK)
3
Provided interest –free loan for manufacturing finished goods

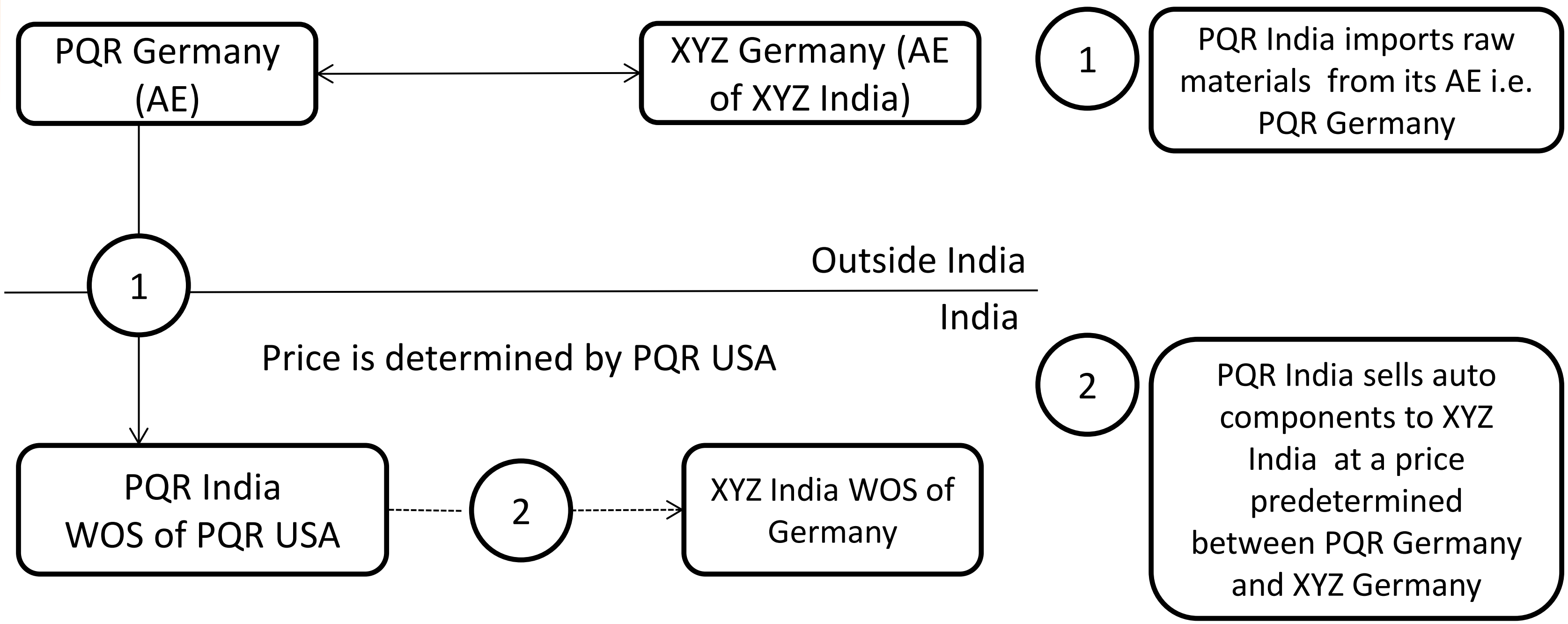
CASE STUDY - 3



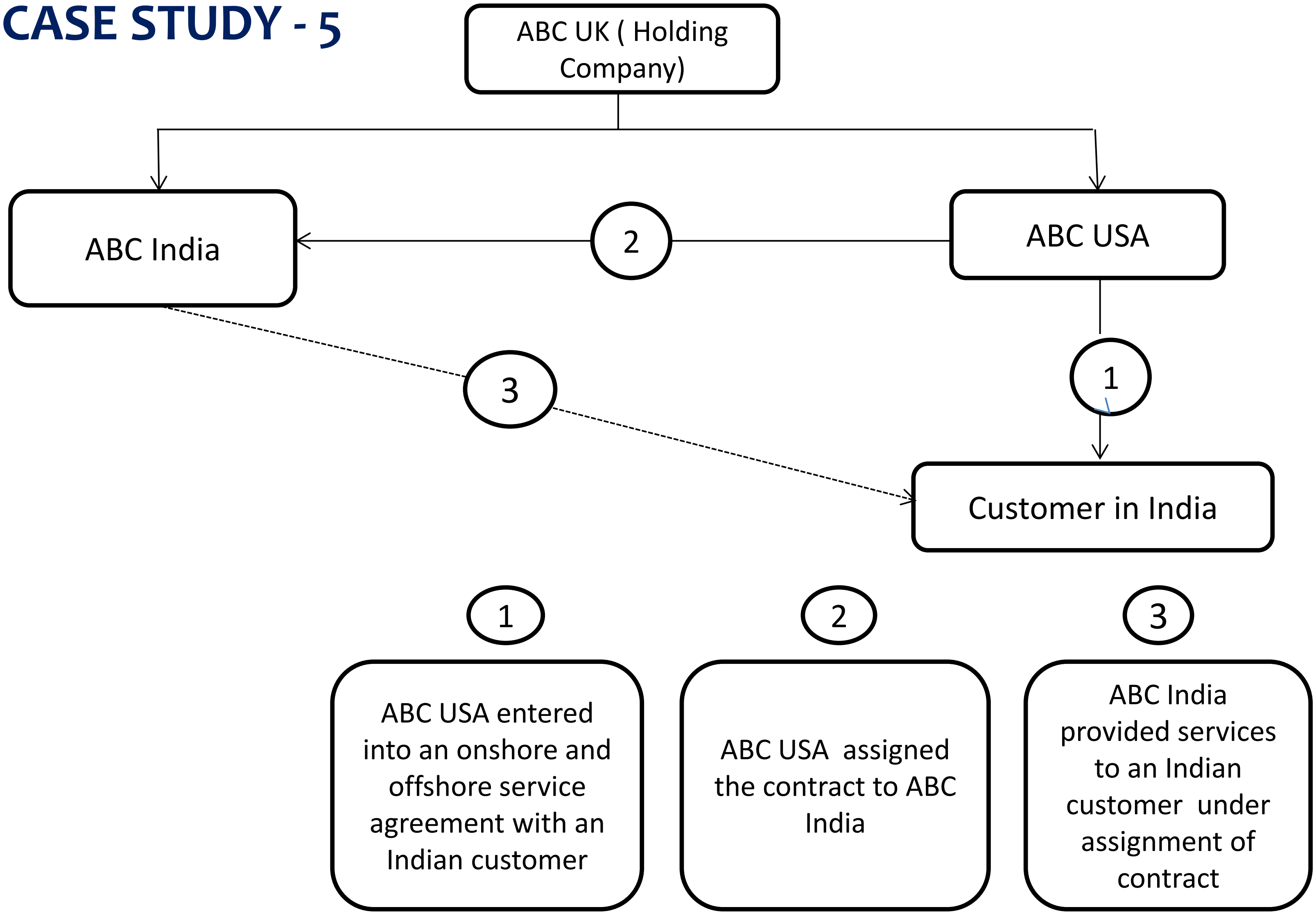
1 — PQR USA acquired business of ABC USA

2 — As a global sale arrangement, PQR India acquired assets of ABC India

CASE STUDY - 4


PQR Germany (AE)
XYZ Germany (AE of XYZ India)
1
PQR India imports raw materials from its AE i.e. PQR Germany
1
Outside India
India
Price is determined by PQR USA
2
PQR India sells auto components to XYZ India at a price predetermined between PQR Germany and XYZ Germany
PQR India WOS of PQR USA
2
XYZ India WOS of Germany

CASE STUDY - 5

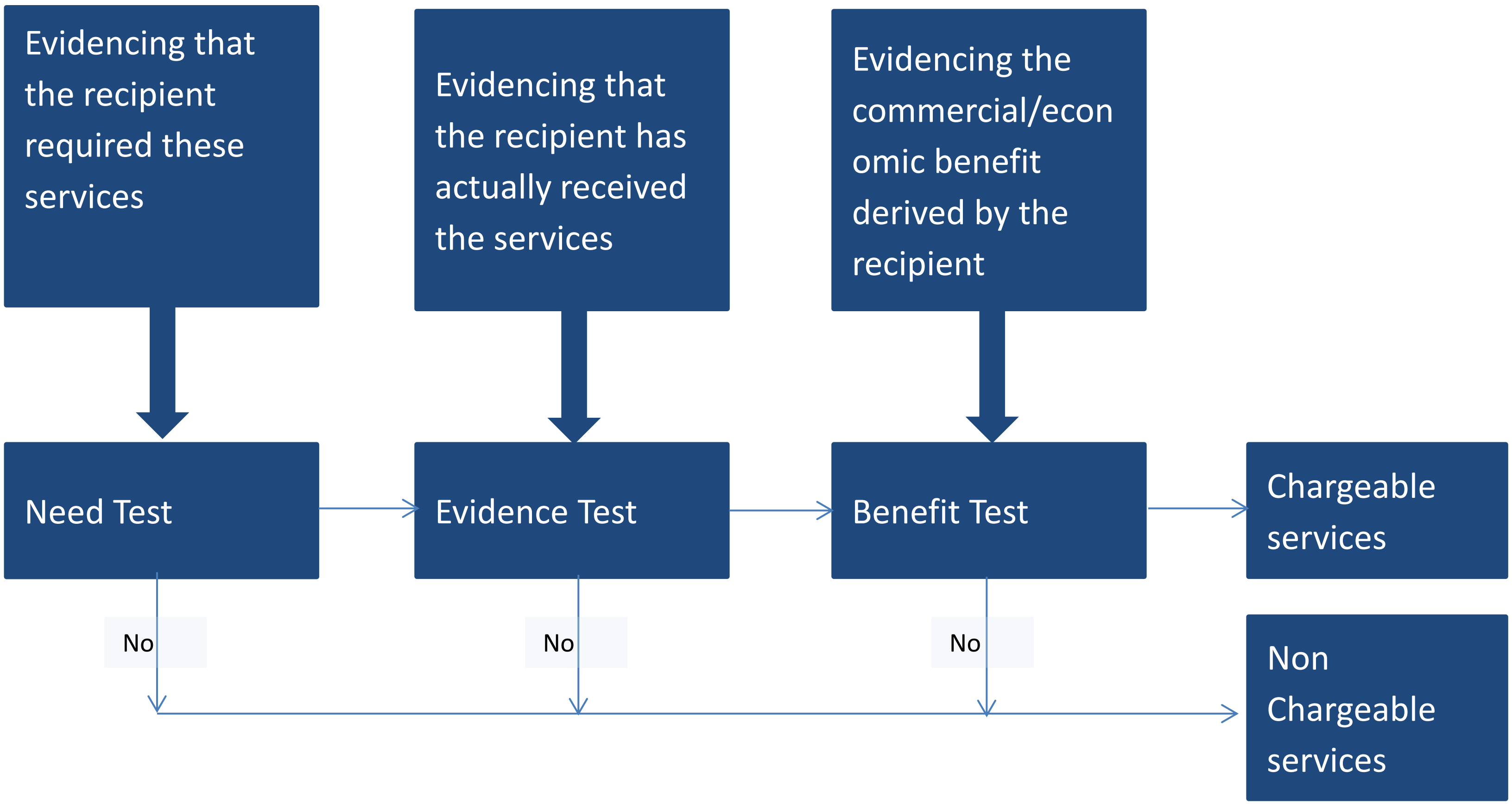

ABC UK (Holding Company)
ABC India
2
ABC USA
3
1
Customer in India
1
2
3
ABC USA entered into an onshore and offshore service agreement with an Indian customer
ABC USA assigned the contract to ABC India
ABC India provided services to an Indian customer under assignment of contract

INTRA GROUP SERVICE

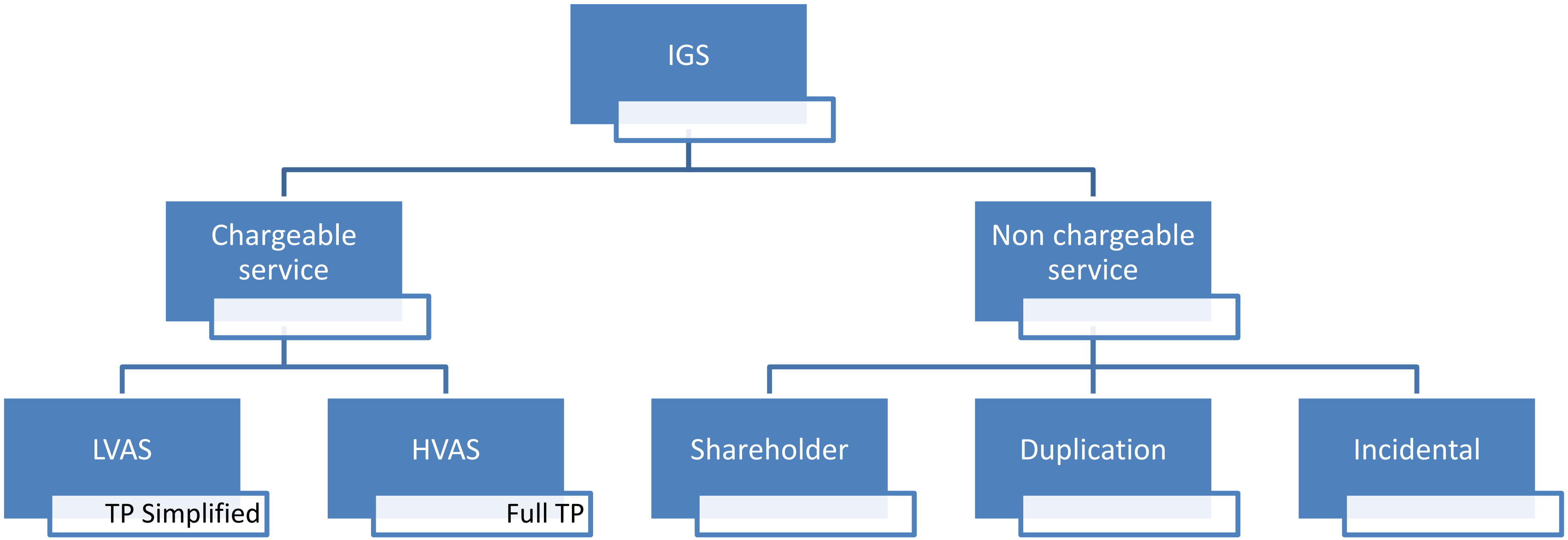
INTRODUCTION

- MNE group may obtain services directly or indirectly from independent companies, or from companies of same MNE group (i.e. intra-group)
- **Benefits** of intra group services
  - Economies of scale, synergy, efficient use of resources & high degree of specialization
  - Developing own expertise, coordination & control and avoiding duplication of work
- Intra Group Service ("IGS") **includes**
  - Services by One member to other member or members of MNE
  - Services provided by group of members for the benefit of overall group
  - Service by Parent company to member & group of members
  - Service from third party on behalf of member or members

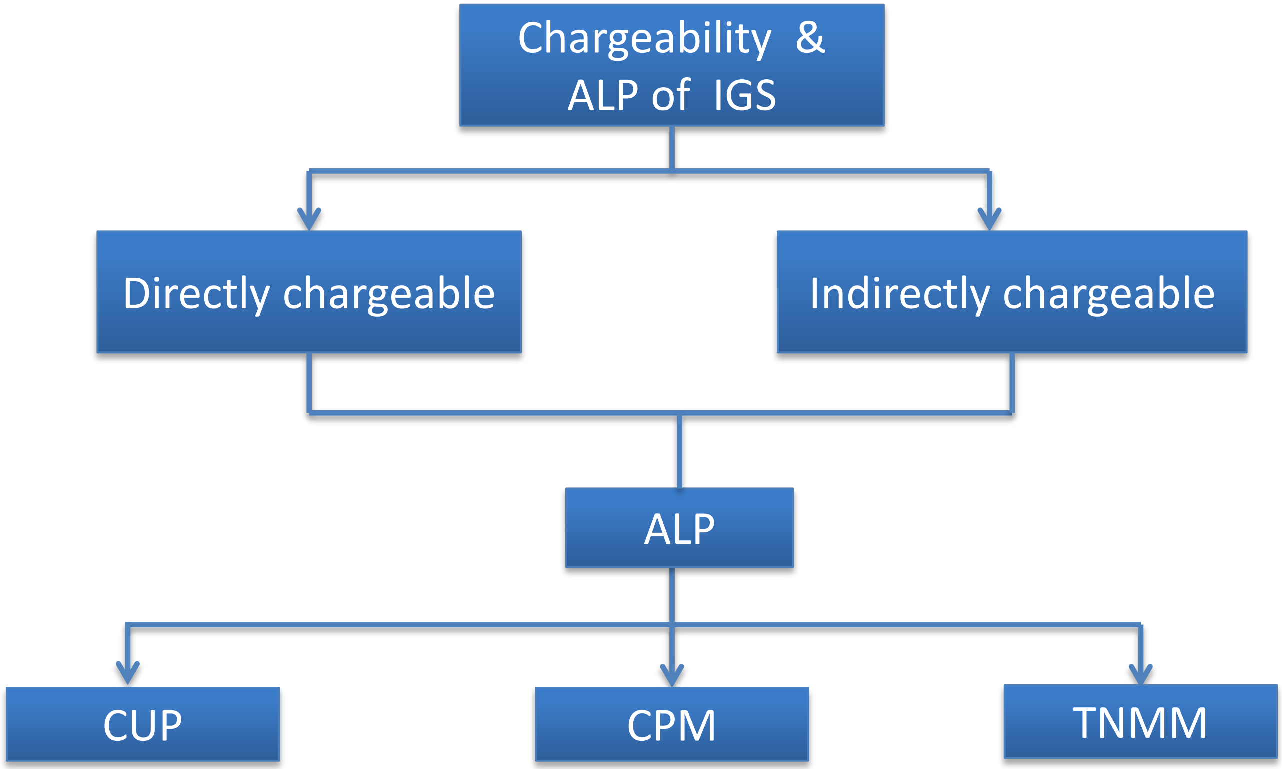
CHALLENGES


Evidencing that the recipient required these services
Evidencing that the recipient has actually received the services
Evidencing the commercial/economic benefit derived by the recipient
Need Test
Evidence Test
Benefit Test
Chargeable services
No
No
No
Non Chargeable services

INTRAGROUP SERVICES



Chargeability and ALP of IGS



Illustrations

- Whether guarantee given by group member increasing credit rating is IGS?
- appointment and remuneration of parent company directors
- Where the enterprise benefitted from global marketing and public relations campaigns done by Group Company ?
- activity of parent company's in preparation and filing of consolidated financial reports
- Service undertaken to reduce risk of a wrong business decision (e.g. by getting a second legal opinion on a subject)
- activities of parent company for raising funds used to acquire share capital in subsidiary companies;

Illustrations

- Whether AE received enhance credit rating by reason of its affiliation with larger group; is IGS ?
- activities of the parent company to protect its capital investment in subsidiary companies.
- Resource sharing service
- Whether supplier giving additional credit based on guarantee given by IGS?
- Accounting & Auditing service
- meetings of the parent company's board of directors and shareholder

WAY TO ALP

- Chargeable services
  - Benefit Test
    - Economic Benefit
      - Received
      - Anticipated
    - Independent party
- ALP
  - Charging
    - Direct
    - Indirect
  - Calculation
    - Cup
    - Cost plus
    - TNMM

IGS – A DOUBLE EDGED SWORD

Service Provider

- How much does the service cost?

Service Recipient

- How much is the service worth?
- How much would a comparable independent enterprise be prepared to pay for that service in comparable circumstances?
- How much would it cost to provide the service in-house?
- How much would an external service provider charge?

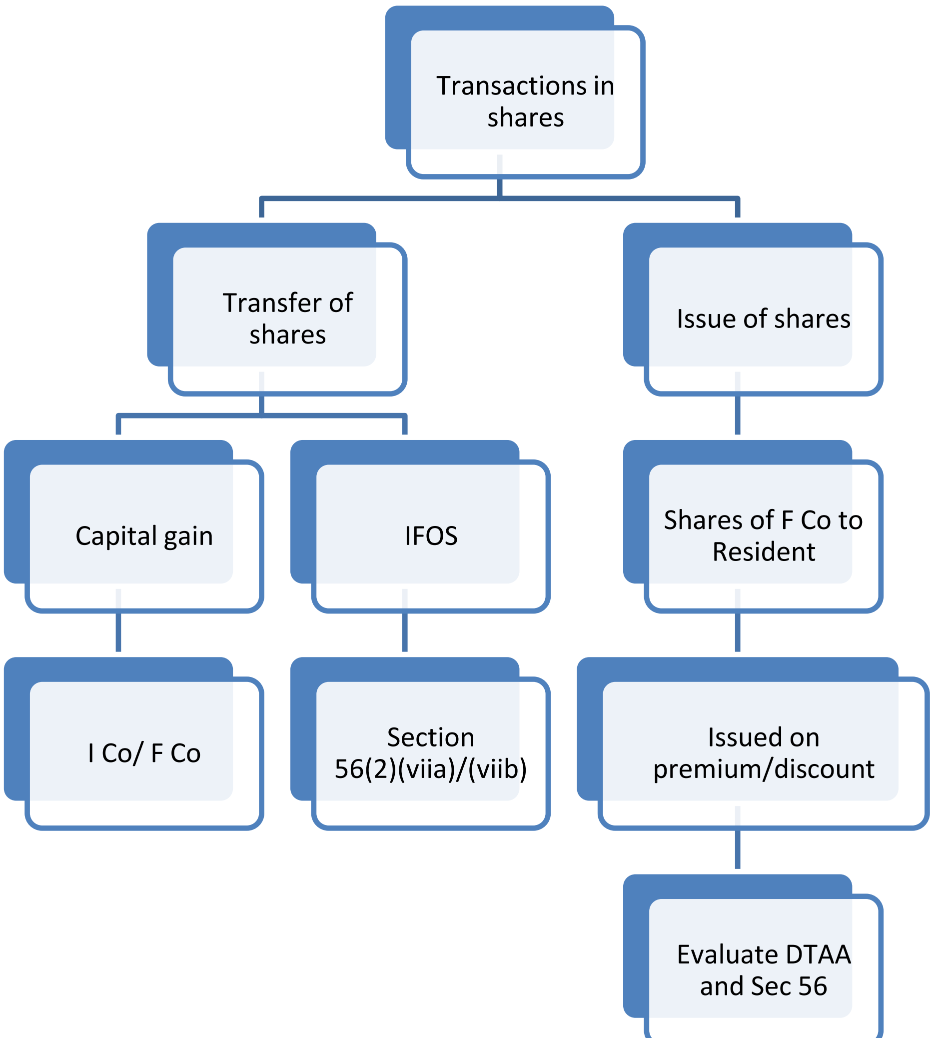
Determination of ALP

CHECKLIST OF DOCUMENTS

Sr No	Particulars	Docs to be collected	
		Local entity	Parent entity
1.	Intercompany service agreement	✓	
2.	Evidence demonstrating *receipt of service*	✓	
3.	Copy of emails, correspondence etc demonstrating scope of work and *negotiation of price* between group companies	✓	
4.	Copy of invoices raised – **recommended by BEPS for LVAS**	✓	
5.	Details of *cost incurred by group company* for providing such services		✓
6.	Documents demonstrating the *charge made on other group entities*		✓
7.	In case of *allocation of cost, certificate* from an independent auditor certifying the basis of allocation key used and calculation of charges		✓
8.	Benchmarking study done/ Transfer pricing report		✓
9.	Detail write up should be maintained to demonstrate following points: o Difference between regular service received by local entity v/s headquarter service received so as to prove that there is *no duplication of service* o Reasons for availing such service o Documents to substantiate that the services were actually received and were consistently received	✓	

ISSUES & VALUATION OF SHARES

SUMMARY


Transactions in shares
Transfer of shares
Issue of shares
Capital gain
IFOS
Shares of F Co to Resident
I Co/ F Co
Section 56(2)(viia)/(viib)
Issued on premium/discount
Evaluate DTAA and Sec 56

VODAFONE IV – BOMBAY HC

Issue	**Observation**
Whether issue of shares is a capital account transaction or revenue transaction?	The transaction is a capital account transaction, it is found based on an interpretation of section 2(24) of the Act "income will not in its normal meaning include capital receipts unless it is so specified, as in Section 2(23)(vi) of the Act." Since an issue of shares is a transaction on the capital account, the premium cannot be treated as income
Whether provisions of section 56(2)(viib) would apply for issuance of shares below fair market value?	• Section 56(2)(viib) of the Act where a capital transaction is deemed by legal fiction to amount to income. However, that provision applies only to premium received from a resident and that too where that premium is in excess of the FMV of the shares. The Vodafone case was far from that scenario because the premium was less than the alleged fair value of the shares, and that too received from a NR • Section 56(2)(viib) there is an actual receipt of the excess of amount, where as in this case there is only an imputed amount of the difference without any actual receipt
Does any income arise on the transaction of issue of shares?	The court unequivocally concluded that neither the capital receipts in the form of the issue price (par value plus premium) nor the imputed difference with the FMV could be considered income for the purpose of the Act.

VODAFONE IV – BOMBAY HC

Issue	Observation
Does chapter X apply to the transaction of issuance of shares?	Given the absence of "Income", which is a re-requisite for applicability of Section 92, the court concluded on the inapplicability of chapter X of the Act relating to transfer pricing and arm's length determination of income from international transaction.

To compute any income having regards to the ALP, the following two conditions should be satisfied:

- There should be an international transaction; and
- Such international transaction should result into income chargeable to tax.

VALUATION OF SHARES

ALP vs. FMV

- One of the six specified methods shall be applied for computation of ALP however in some cases TPO have adopted **multiple methods** which are at variance of prescribed methods

- **No prescribed methods** are followed as there is no method of valuation provided under the provisions to value equity shares because it is not considered as an international transaction

- Following are the illustrative list of the methods followed :

➢ Book value
➢ Discounted free cash flow
➢ Average of NAV (RBI Rules)
➢ Profit earning capacity Value (RBI Rules)
➢ CCI Guidelines (FEMA)

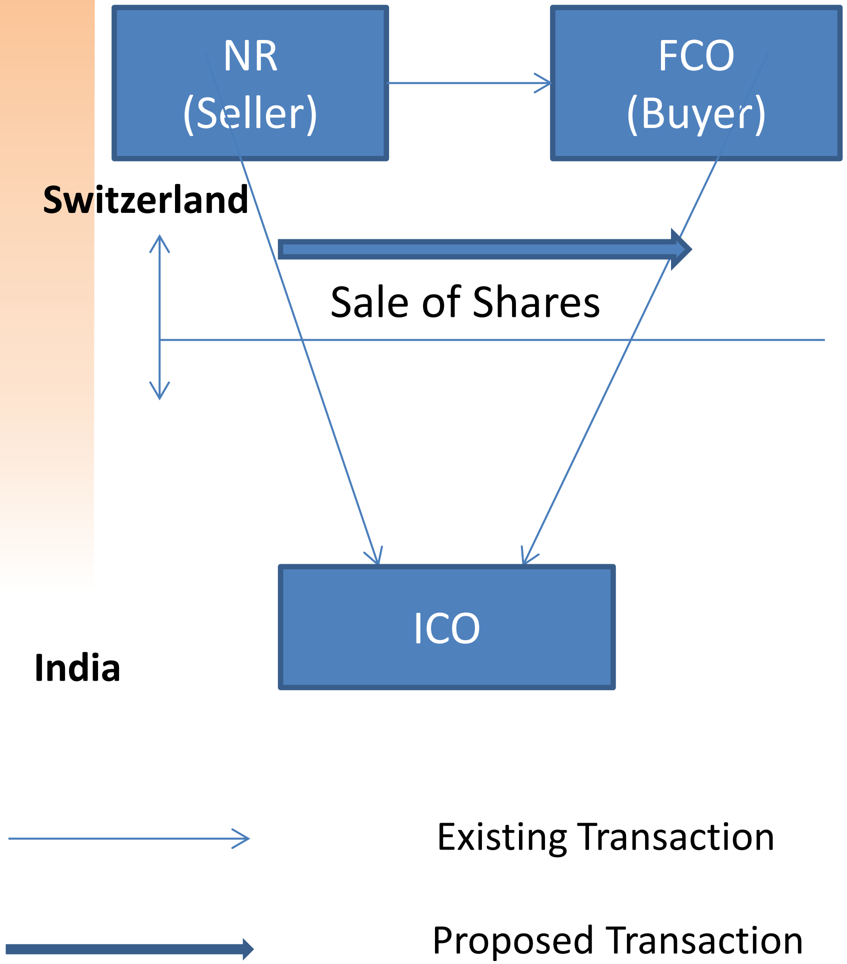
ISSUES IN VALUATION OF SHARES

- Projection for future cash flows
- Calculation of WACC
- Assumption of growth rate
- Reduction of incremental capex and working capital
- Terminal value of cash flows
- Reduction of debt from enterprise value
- Liquidity discount etc.

SALIENT FEATURES – SALE OF SHARES

- Transfer of existing shares on profits or loss are within the scope of TP
- Price charged as per SEBI Regulations cant be deemed to be at ALP
- TPO can adopt 6th method for valuation
- DCF is preferable over CCI guidelines

CASE STUDY



NR and FCO are Ae's

Assume that under FEMA the transaction is permitted

ICO shares – Alt. I	
Book Value	900
Sale Price(Premium 200)	1100
Face Value	1000

ICO shares – Alt. II	
Book Value	900
Sale Price(Discount 100)	800
Face Value	1000

TAX AND TP IMPLICATION

- **Alt. I- FCO (Buyer)**
  - No specific tax implication.
  - Should the transaction be reported although there is no tax implication ?
  - Any implication of buying shares at a high value?

- **Alt. II- NR(Seller)**
  - Normal capital gain
  - File TP report

TAX AND TP IMPLICATION

- **Alt. I- FCO (Buyer)**
- ➢ Difference between Book Value and Sale price - is taxable u/s. 56(2)(viia)
- ➢ Should ALP be computed and reported ?

- **Alt. II- NR(Seller)**
- Apply TP, compute ALP and pay tax
- This leads to **double tax to** the extent of 100 . Is this all right ?

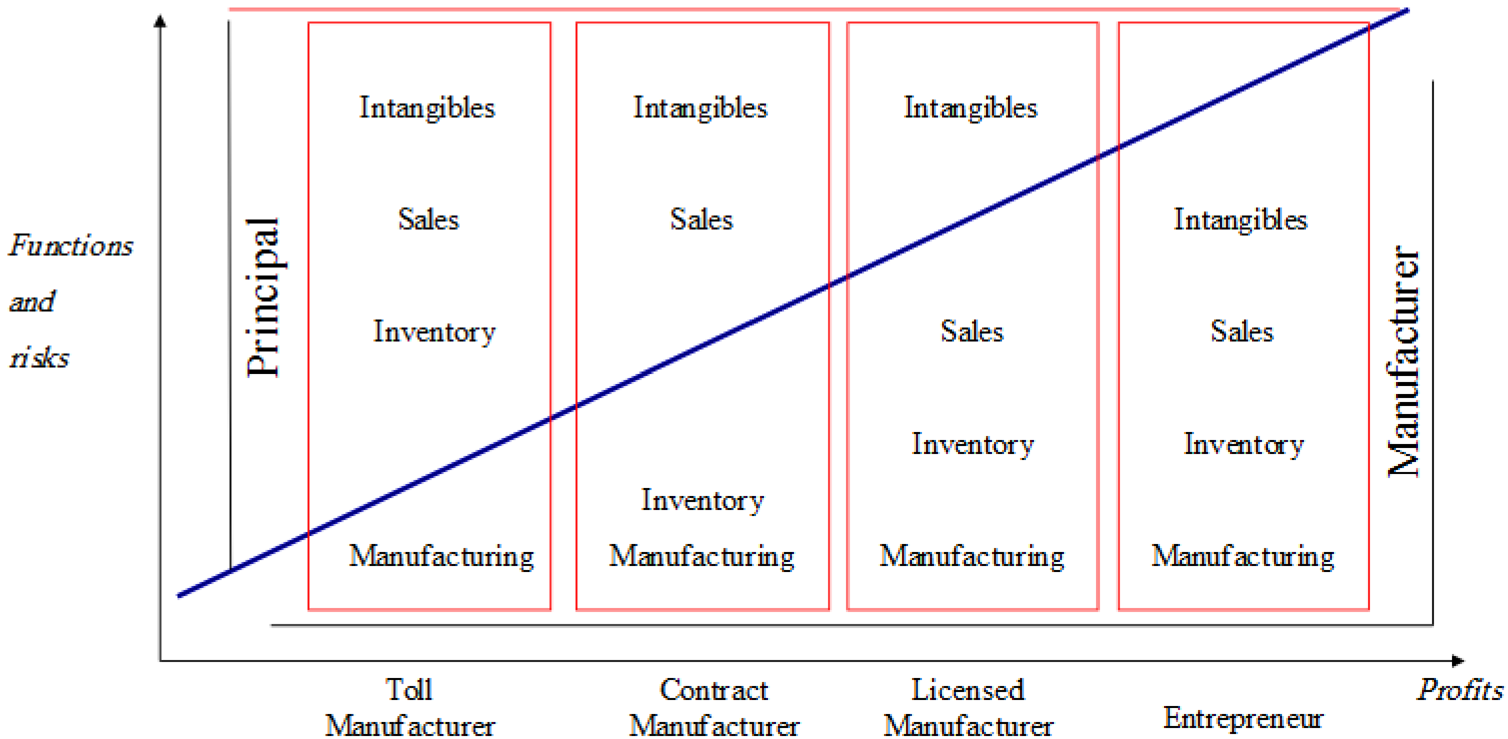
SUMMARY OF ISSUES IN MANUFACTURING SECTOR

FAR ANALYSIS

TYPICAL MANUFACTURING MODELS

Parameters	*Full Fledge Manufacturer*	*Licensed Manufacturer*	*Contract Manufacturer*	*Toll Manufacturer*
Produces on	Own behalf	Own behalf	Principal	Principal
Intellectual Property	Owns the IP	Licenses the IP	Does not own	Does not own
Materials	Owns	Owns	Owns	Does not own

CHART


Functions
and
risks
Principal
Intangibles
Sales
Inventory
Manufacturing
Intangibles
Sales
Inventory
Manufacturing
Intangibles
Sales
Inventory
Manufacturing
Intangibles
Sales
Inventory
Manufacturing
Manufacturer
Toll Manufacturer
Contract Manufacturer
Licensed Manufacturer
Entrepreneur
Profits

FUNCTIONS, ASSETS AND RISK ANALYSIS

FAR	Manufacturer			
	Full fledge	License	Contract	Toll
Functions				
Owns non-routine technology i.e. IP (Research & Development)	Y	N	N	N
Owns Material	Y	Y	Y	N
Manufactures for himself	Y	Y		
Manufactures on behalf of others			Y	Y
Marketing	Y	Y	N	N
Sales & Distribution	Y	Y	N	N

FUNCTIONS, ASSETS AND RISK ANALYSIS

Risks	Manufacturer			
	Normal	Less than normal	Limited	Minimal
Market risk	Y	Y	N (Minimal)	N (Minimal)
Price risk	Y	Y	N	N
Inventory risk	Y	Y	Y	N
Capacity risk	Y	Y	Limited	N
Product liability risk	Y	Y	N	N
Warranty risk	Y	Y	Limited to re-work	
Technology R & D risk	Y	N	N	N

COMPARABILITY ANALYSIS

COMPARABILITY ANALYSIS

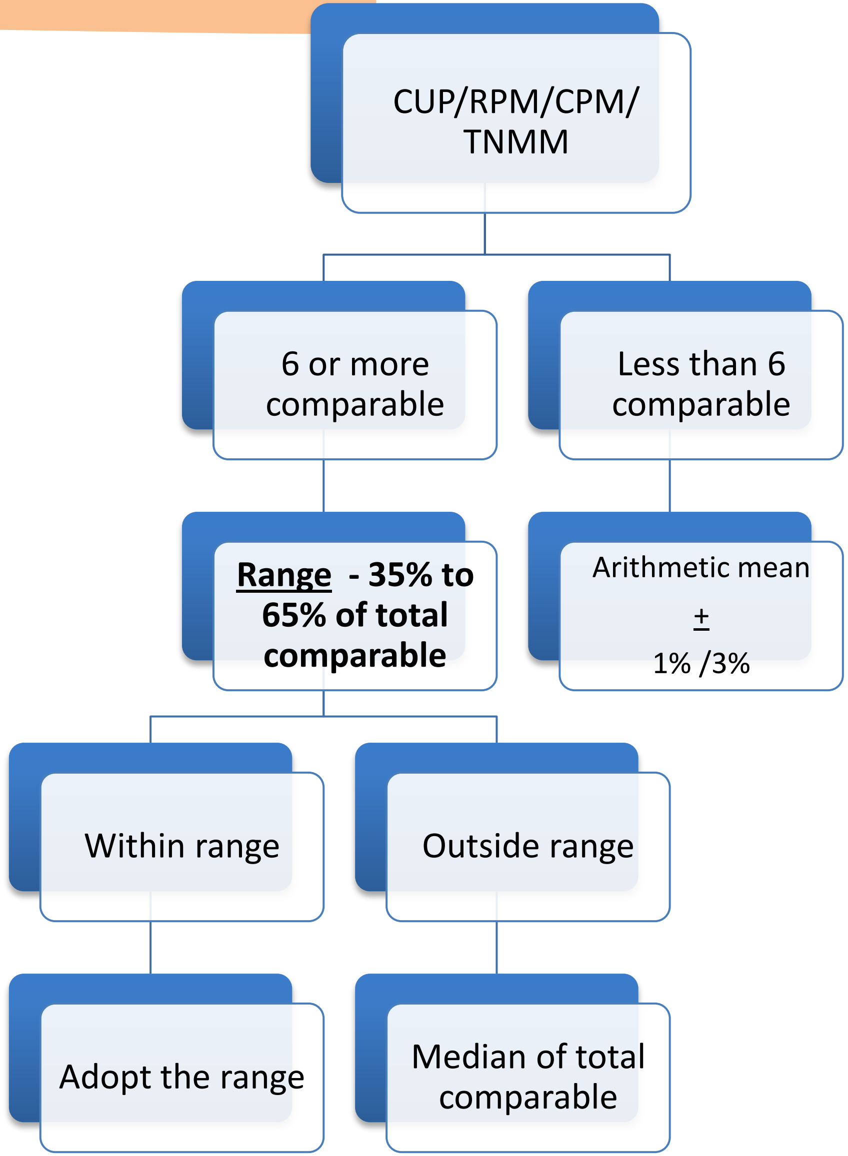
Approach	*Full Fledged*	*Licensed*	*Contract*	*Toll*
Comparable Set	*Manufacturing Set*			*Services Set*
Parameters for selection of comparable companies	Broad product comparability		Keywords such as contract, custom, job work, processing, as per specifications / requirements, on behalf of	
			Absence of distribution facilities, sales personnel, marketing of products	No raw material content, only consumables (Notes to Accounts is key)
Ratios to be analysed	Manuf. / Sales	Manuf. / Sales R&D / Sales	R&D / Sales, Adv & Marketing / Sales, Royalty expense	RM / TC

Adjustment for differences in risks between comparables and tested party necessary to be included in the TP Study Report

IMPORTANCE OF FAR ANALYSIS

- KPO v/s BPO
- Investment banking v/s merchant banking
- Software licensing v/s software development
- Outsourcing co. v/s Intangible equipment co.
- Different business strategy
- Marketing support services v/s engineering & consultancy services
- Marketing support services v/s advertisement & subscription services

RANGE CONCEPT


CUP/RPM/CPM/ TNMM
6 or more comparable
Less than 6 comparable
Range - 35% to 65% of total comparable
Arithmetic mean ± 1% /3%
Within range
Outside range
Adopt the range
Median of total comparable

CASE STUDY – CALCULATION OF RANGE IN CASE OF MULTIPLE YEAR DATA

- "Company A" is having 7 comparable companies and it's PLI is 24.81% Following is the data of comparable companies :

Particulars	Yr 1	Yr 2	Yr 3	Weighted Avg	Ascending order
A					
Operating income	0	15.5	10.38	25.88	
Total Expenditure	0	294.27	280.6	574.87	
% OP/TE	0.00%	5.27%	3.70%	4.50%	2
B					
Operating income	38.28	34.33	32.1	104.71	
Total Expenditure	334.14	309.67	269.22	913.03	
% OP/TE	11.46%	11.09%	11.92%	11.47%	4
C					
Operating income	13.26	22.49	21.71	57.46	
Total Expenditure	154.12	152.97	119.53	426.62	
% OP/TE	8.60%	14.70%	18.16%	13.47%	5
D					
Operating income	0	17.05	14.17	31.22	
Total Expenditure	0	251.37	204.84	456.21	
% OP/TE	0.00%	6.78%	6.92%	6.84%	3
E					
Operating income	6.79	6.43	6.14	19.36	
Total Expenditure	32.11	28.92	27.53	88.56	
% OP/TE	21.15%	22.23%	22.30%	21.86%	7
F					
Operating income	-2.88	-14.16	-8.6	-25.64	
Total Expenditure	18.27	40.91	50.88	110.06	
% OP/TE	-15.76%	-34.61%	-16.90%	-23.30%	1
G					
Operating income	45.85	39.09	33.65	118.59	
Total Expenditure	228.78	187.18	177	592.96	
% OP/TE	20.04%	20.88%	19.01%	20.00%	6

CALCULATION OF RANGE

			Range
35% of 7	2.45	3rd place	6.84%
65% of 7	4.55	5th place	13.47%
50% of 7	3.5	4th place	11.47%

Accordingly, the International transactions stated above could be said to be at arm's length from an Indian transfer pricing perspective as the companies PLI is 24.81% and the range is 6.84% to 13.47%

NUANCES IN MULTIPLE YEAR DATA

- *Method Applicable* –
- Transactional Net Margin Method (TNMM)
- Resale Price Method (RPM)
- Cost Plus Method (CPM)
- *Year from which effective* – 1st April 2014
- *If comparable has been identified on the basis of data relating to :*
- *Current Year,*
- then the data for the immediately preceding two financial years can be considered, provided the comparable has undertaken the same or similar comparable uncontrolled transaction in those preceding two years.
- *Financial year immediately preceding the current year,*

then the data for the immediately preceding two years can be considered provided the comparable has undertaken the same or similar comparable uncontrollable transaction in that preceding year.

✓ Enterprises may not be considered as comparable, if they have not undertaken comparable uncontrolled transaction in the current year. An enterprises shall be rejected from the comparable data set even if, such an enterprise had undertaken comparable uncontrolled transactions in either or both of the financial years immediately preceding the current year.

EXAMPLE ON WORKING CAPITAL ADJUSTMENT

CASE STUDY

Working Capital Adjustment	Year 1	Year 2	Year 3	Year 4	Year 5
TestCo's (R + I – P) / Sales	25.6%	25.8%	24.1%	26.7%	29.3%
CompCo's (R + I – P) / Sales	19.9%	20.6%	28.7%	24.5%	24.6%
Difference (D)	5.7%	5.1%	-4.7%	2.1%	4.7%
Interest Rate (i)	4.8%	5.4%	5.0%	5.5%	4.5%
Adjustment (D*i)	**0.27%**	**0.28%**	**-0.23%**	**0.12%**	**0.21%**
CompCo's EBIT/Sales (%)	1.32%	2.96%	2.59%	3.31%	4.95%
Working Capital Adjusted EBIT / Sales for CompCo	**1.59%**	**3.24%**	**2.35%**	**3.43%**	**5.16%**

REFERENCE TO TPO

REFERENCE TO TPO

Case selected for scrutiny on TP risk parameter	Case selected for scrutiny on non-TP risk parameter
If TP risk pertains to only IT, then only IT to be referred to TPO	Where the taxpayer has not filed Form No. 3CEB at all or has not disclosed IT or SDT which comes to the notice of the AO which has not been disclosed in the Form No. 3CEB
If TP risk pertains to only SDT, then only SDT to be referred to TPO	Where there has been a TP adjustment of INR 10 crores or more in an earlier assessment year and such adjustment has been upheld by the judicial authorities or is pending in the appeal
If TP risk pertains to IT and SDT, then both shall be referred together to TPO	Where search and seizure or survey operations have been carried out and findings regarding transfer pricing issues in respect of IT or SDT or both have been recorded by the Investigation Wing or the AO


QUESTIONS?
COMMENTS?
CONCERNS?

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