

# Recent Issues and Developments in Transfer Pricing

**CA Bhavesh Dedhia**  
**CA Jiger Nagda**

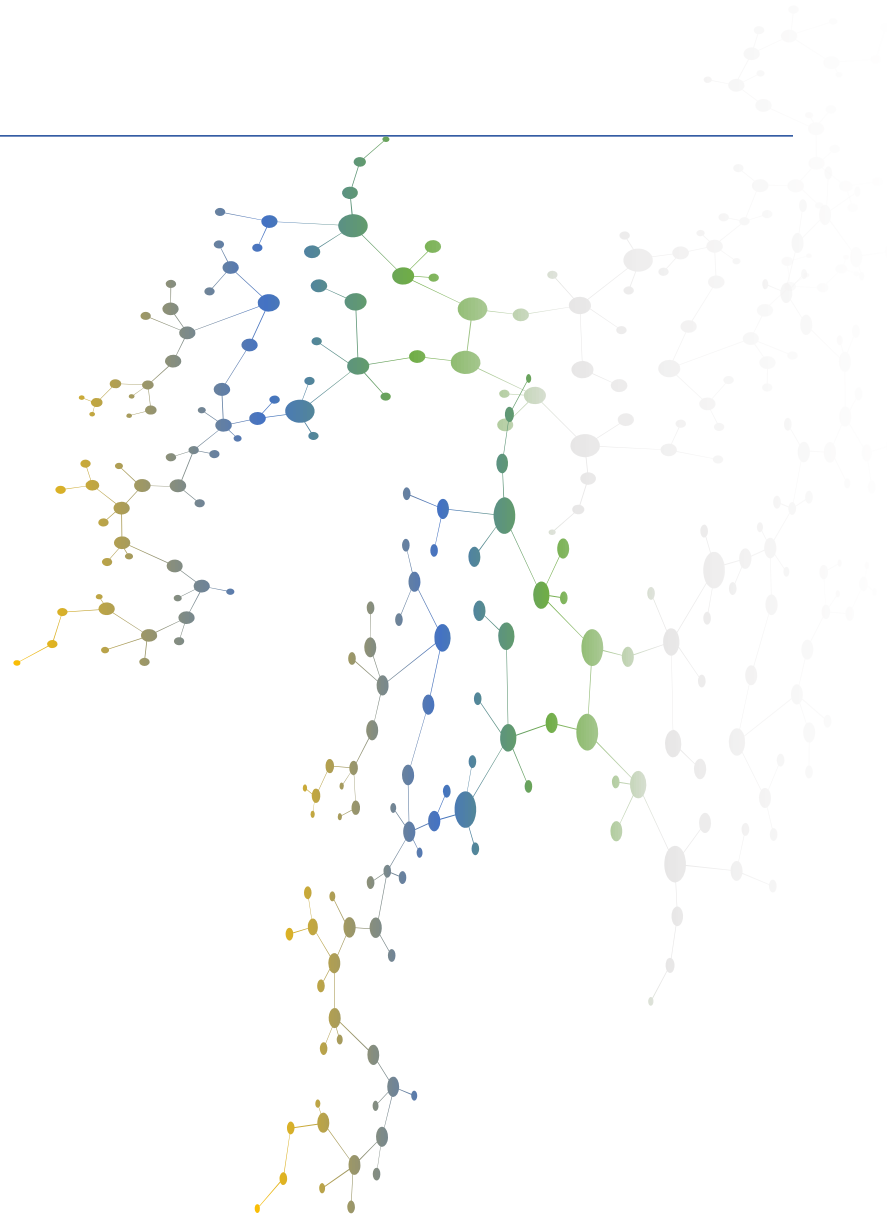
15 June 2022



# Agenda

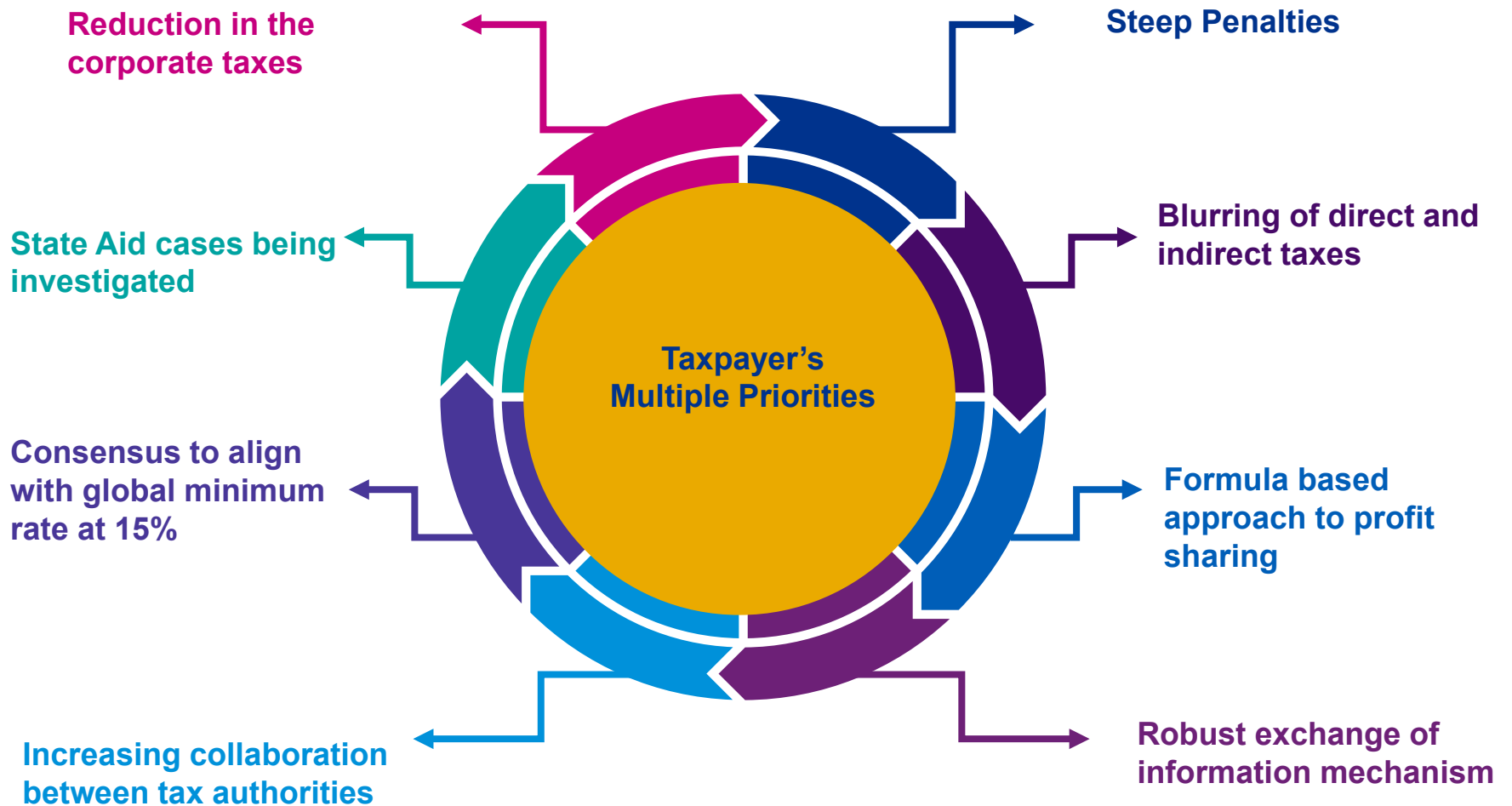
---

- **Key TP Issues**
  - Intra-group Services
  - Royalty Transaction
  - Overdue Receivable
  - Corporate Guarantee
- **Complex TP Issues**
  - Business restructuring
  - Intangibles
  - Deemed International Transaction
- **Interlinkages of TP with other regulations**
  - GAAR and TP
  - POEM and TP
  - Ind-AS and TP
- **Other Updates**
  - BEPS 2.0
  - Non-Resident - TP implications
  - Penalty provisions



# Global Trend

---



# Transfer Pricing – Board Room Topic!

---



- Transfer Pricing – A global concept wherein each country tries to tax as per their own regulations in order to get fair share of tax
- Organizations like OECD and United Nations are established to provide guidance to the developed and developing countries so that each country adopts consistent approach in the regulations (e.g., OECD Action Plans and Pillar 1 and Pillar 2)
- Tax is a board room topic for all companies wherein its has implications on the finances
- In view of the above, it is important to understand the unique practices and developments in the global scenario

# Key TP Issues



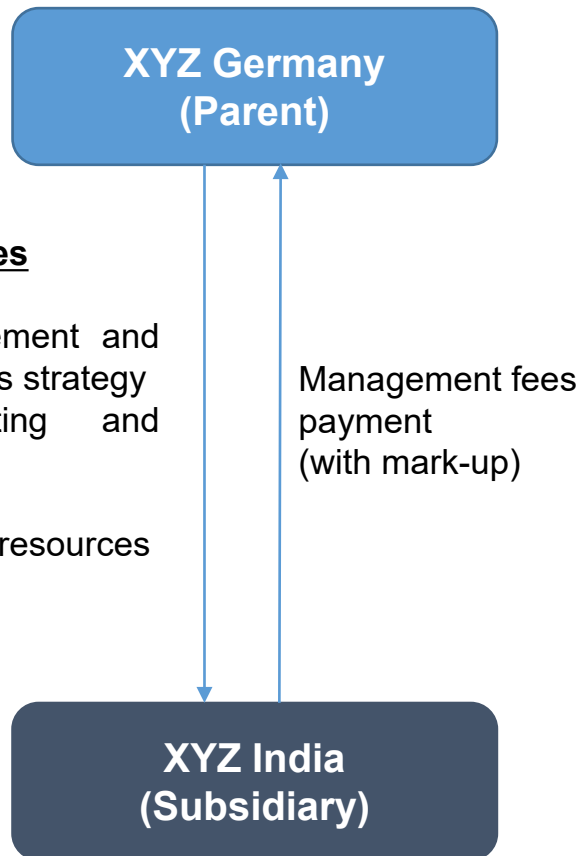
# Intra-group Services

# IGS – Background and Case Study

---

## IGS Services

- General management and business strategy
- Accounting and finance
- IT
- Human resources



## TPO's Observations:

1. The taxpayer has not shown whether such services are rendered except producing invoice copy and describing the nature of services
2. Unable to demonstrate the value by an independent entity dealing in similar circumstances
3. Failed to produce any evidence regarding the expenditure incurred by the AE on behalf of the taxpayer
4. Cost allocation details were not submitted
5. Administrative staff maintained by the taxpayer and hence IGS services not warranted
6. Increase in sales / profits are due to taxpayers' efforts and cannot be attributed to IGS
7. The services provided were in nature of shareholder services, and no separate payments are warranted

TPO determined ALP as Nil and the entire amount paid as management fee is treated as an adjustment

# Issues for Discussions

---

1. Documentations to justify:
  - Global practices with the group
  - Uniform and standardized infrastructure
  - Eliminating duplication of efforts and cost savings
2. Can the following cost details help the taxpayer?
  - Detailed break-up of cost pool
  - Third-party cost incurred at the global level
  - Report from a Certified Accountant certifying the cost allocation working
3. Whether third parties would be willing to pay for the same services?
4. Whether TPO applied any method / rejected any method before making an adjustment?
5. Issues while benchmarking the IGS transaction
  - CUP vs. TNMM
  - Standalone vs. aggregation principle
  - Foreign AE as tested party and challenges with the right set of comparable companies
6. Issues with the cost base:
  - No charge for the shareholder services
  - Mark-up on the IGS services
  - Free of cost services
  - Actual vs. Budgeted cost for true-up / true-down – Prior period vs. current year expenses
7. Treatment of IGS transaction in the hands of XYZ Germany i.e., flipside entity
8. Justifying the mark-up vs. cost-to-cost
  - Safe Harbour regulations for low value adding IGS
  - OECD regulations / BEPS Action Plan
9. Whether IGS transaction was covered in any APA/MAP with other countries, within the same Group?

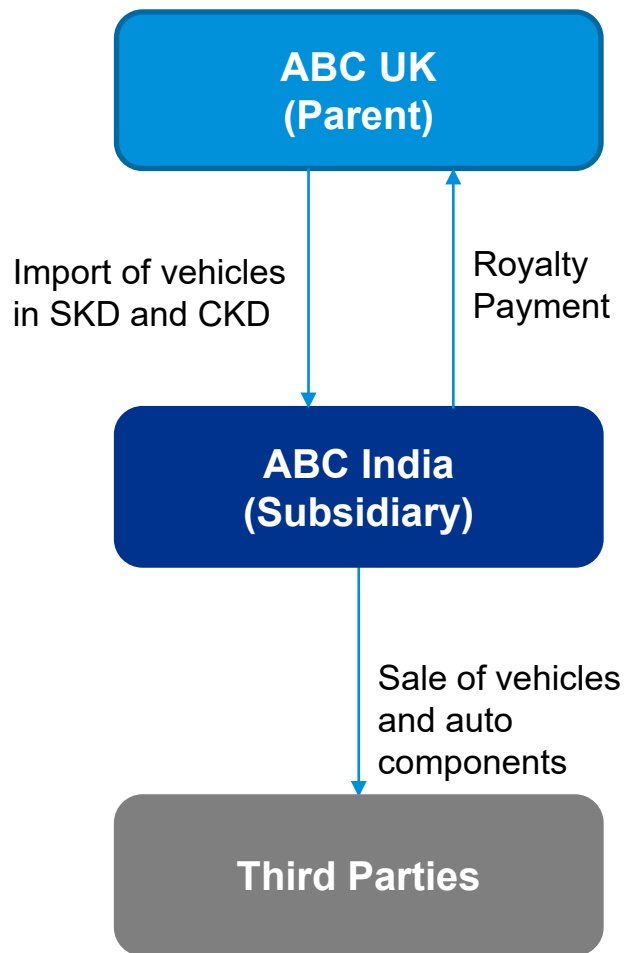


# Key judicial precedents

Case law	Rulings
<b>Cushman and Wakefield (India) P Ltd</b> Delhi HC	<ul style="list-style-type: none"> <li>The role of the TPO is to determine the arm's length nature of the transactions entered between the AEs by applying the provisions of the law. Whether it is commercially prudent or not to employ outsiders to conduct this activity is a matter that lies within the assessee's exclusive domain, and cannot be second-guessed by the Revenue</li> </ul>
<b>Goodyear South Asia Tyres Pvt Ltd</b> Pune ITAT	<ul style="list-style-type: none"> <li>If the TPO cannot benchmark IGS transaction, need to accept the assessee's benchmarking</li> <li>Rejects ALP at NIL</li> </ul>
<b>Dresser Rand India (P) Ltd.</b>  Mumbai ITAT	<ul style="list-style-type: none"> <li><b>Taxpayer's prerogative to decide how to conduct its business.</b> Taxpayer may have any number of qualified accountants and management experts on his rolls, and yet may decide to engage services of outside experts for auditing and management consultancy</li> <li>Whether a particular expenditure on services received actually benefits the taxpayer in monetary terms is not a consideration for it being allowed as a deduction and that cannot play any role in determining ALP of that service. What needs to be determined is whether the same price for the service would be paid by an independent enterprise</li> <li><b>Taxpayer had given sufficient evidence of the services having been actually rendered to the taxpayer.</b></li> </ul>
<b>Fosroc Chemicals India Pvt Ltd</b> Bangalore ITAT	<ul style="list-style-type: none"> <li>It is wholly irrelevant as to whether the assessee benefits from it or not; the real question is whether an independent enterprise would have paid for the similar services</li> <li>Where the expenses are reimbursed with no mark-up, the tax base erosion can happen only if the costs reimbursed are itself inflated. Filing of voluminous correspondence, reports etc., would not be a proper way of discharge of assessee's burden to establish the ALP of expenditure in question.</li> </ul>
<b>Gemplus India Private Limited</b>  Bangalore ITAT	<ul style="list-style-type: none"> <li>The charge for management services must be commensurate with the nature, volume and quality of services. <b>There were no evidence/details available on record to demonstrate the nature of services rendered.</b></li> <li><b>Taxpayer has not proved the commensurate benefits received for the service fees paid to the AE and hence TP adjustment upheld.</b></li> </ul>
<b>Quintiles Research (India) Private Ltd</b> Bangalore ITAT	<ul style="list-style-type: none"> <li>The invoices regarding nature of services rendered, however, are in the form of invoices supported by emails exchanged between the assessee and the AE. <b>These invoices per se, in our opinion, do not demonstrate the nature of services rendered.</b> The invoices have to be linked to the emails in support of the invoices.</li> </ul>

# Royalty Transaction

# Royalty – Background and Case Study



## TPO's Observations:

1. The taxpayer unable to substantiate the benefits accrued from such royalty payments
2. Company is operating since many years and have made its own name and goodwill
3. Royalty was not paid since inception of business but later years
4. No proof that the other group entities or 3P have also charged / paid identical royalty
5. The purchase price of material includes consideration for the technology
6. The RBI limit / permission was granted in the context of FEMA regulations
7. CUP benchmarking undertaken by the taxpayer are in respect of overseas jurisdictions
8. The AE have certain obligation as the shareholder
9. The taxpayer did not produce any study conducted on the future cash flow
10. No direct evidence has been furnished by the taxpayer to justify royalty payment

TPO determined ALP as Nil and the entire amount paid as royalty is treated as an adjustment

# Royalty – Issues for Discussions

---

1. Documentations maintained by the taxpayer?
  - Documents substantiating technical training provided by the AE (e.g., Sessions conducted, minutes, email, presentations, white paper, etc.)
  - Document / note on leadership / R&D brainstorming session
  - Design / blueprint, updates, etc. provided by the AE (*subject to confidentiality*)
  - Travel records of employees (passport copies, flight details, training details, etc.) provided by the AE for technology / training conducted
2. Details of new model / product launch
  - Any new launch during the year?
  - Email communication / note in relation with new technological updates (monthly / quarterly updates)
3. Regulatory filings:
  - Analyze the TCR certificate (old cases)
  - Royalty limit fixed by the regulatory authorities
4. Methods to benchmark the royalty transaction (CUP vs. TNMM vs Other Method)
5. Implications of not charging royalty charges i.e., free of cost to ABC India
6. Treatment of royalty transaction in the hands of ABC UK i.e., flipside entity
7. Tax authority questioning necessity of incurring royalty payments is outside the prerogative of the tax authorities?
8. Challenges in obtaining right set of comparable companies / agreements while benchmarking the transaction

**Overdue Receivable**

## TP Issues in relation with AE's outstanding receivable balance

---

- Finance Act 2012 inserted by way of a clarification under Sec. 92B of the Income Tax Act, retrospectively with effect from 1.4.2002 as follows:

*International transaction **shall include**: –*

*...(c) Capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments **or deferred payment or receivable or any other debt** arising during the course of business*

- Pursuant to the above amendment, tax authorities have held that outstanding balances as a separate international transaction and in various cases treated the same as loan transaction
- Following points are relevant to evaluate whether outstanding balances are to be treated as loan transaction with AE or not'
  - Credit period provided to AEs as per Agreement
  - Credit period provided to third parties
  - Interest rate charged by Assessee to third party
  - Currency of transaction, etc.

Penalty for non-disclosure of outstanding balances?

## Key judicial precedents – Outstanding receivables

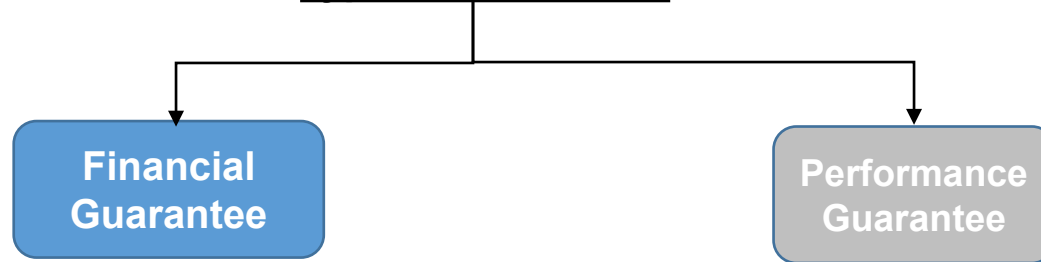
Case law	Tribunal's Ruling
Indo American Jewellery Ltd (Mumbai HC) Avery Dennison (India) P Ltd (Delhi ITAT)	<ul style="list-style-type: none"> <li>• Credit period provided to AE as well as Non-AE</li> <li>• Interest on overdue debtors not charged from AEs and non-AE</li> <li>• No TP adjustments for outstanding receivables from AEs</li> </ul>
Kusum Healthcare (Delhi HC) Parveen Industries P Ltd (Delhi ITAT)	<ul style="list-style-type: none"> <li>• Working capital adjusted margin of assessee is more than such margins of comparable companies</li> <li>• Interest on overdue receivables stands subsumed under working capital adjustment</li> <li>• Deletes TP-adjustment in respect of AE-receivables</li> </ul>
Doosan Power Systems India Pvt Ltd (Chennai ITAT)	<ul style="list-style-type: none"> <li>• Delay in realization of receivables from AE beyond normal credit period constitutes a separate international transaction as the same would tantamount to indirect funding to AE;</li> <li>• Directs application of appropriate rate for imputing interest on overdue receivable</li> </ul>
Adama India Pvt Ltd (Hyderabad ITAT)	<ul style="list-style-type: none"> <li>• No MAM adopted by the TPO</li> <li>• TPO adopted SBI PLR rate to compute interest</li> <li>• ITAT disregarded adoption of SBI PLR rate of 14.5% without following any MAM</li> <li>• The entire TP adjustment was deleted.</li> </ul>

# Corporate Guarantee



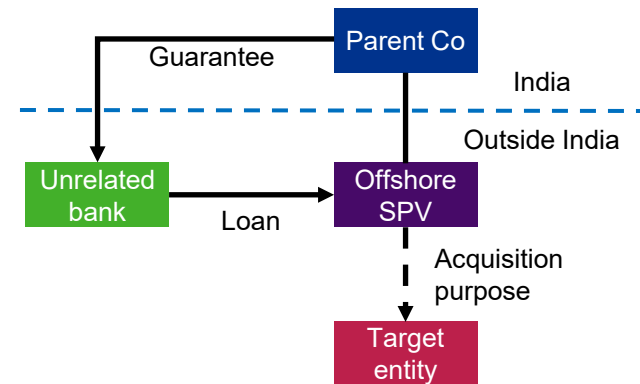
# Corporate Guarantee – Case Study

## Types of Guarantee



### Financing for the acquisition of a target

- An Indian Parent Co proposes to acquire a target company through a special purpose vehicle ('SPV') incorporated overseas
- Parent Co needs to fund its acquisition using external financing by way of a loan.
- SPV obtains loan from an international bank
- SPV does not have any independent credit history and also does not have any assets, save the capital injected by Parent Co
- This loan is therefore guaranteed by Parent Co on behalf of the SPV



# Experience from TP Assessments

---

## TPO's Observations

- TPO disregards the benchmarking analysis and implicit support
- TPO reliance's on Safe Harbour Rules
- TPO make an ad hoc additions of 25-100 bps on account of difference between the AE's credit rating and comparable's rating

## Issue Identified

- Identify if there is an implicit support
- What factors to be considered?
- Is there any guidance / mechanism to determine the quantum of implicit support?
- Credit rating of borrower entity should factor the implicit support?

# Complex TP issues



# Business Restructuring

# Business Restructuring - Definition

---

## Income Tax Provision

Explanation (i)(e) to 92B(1)...

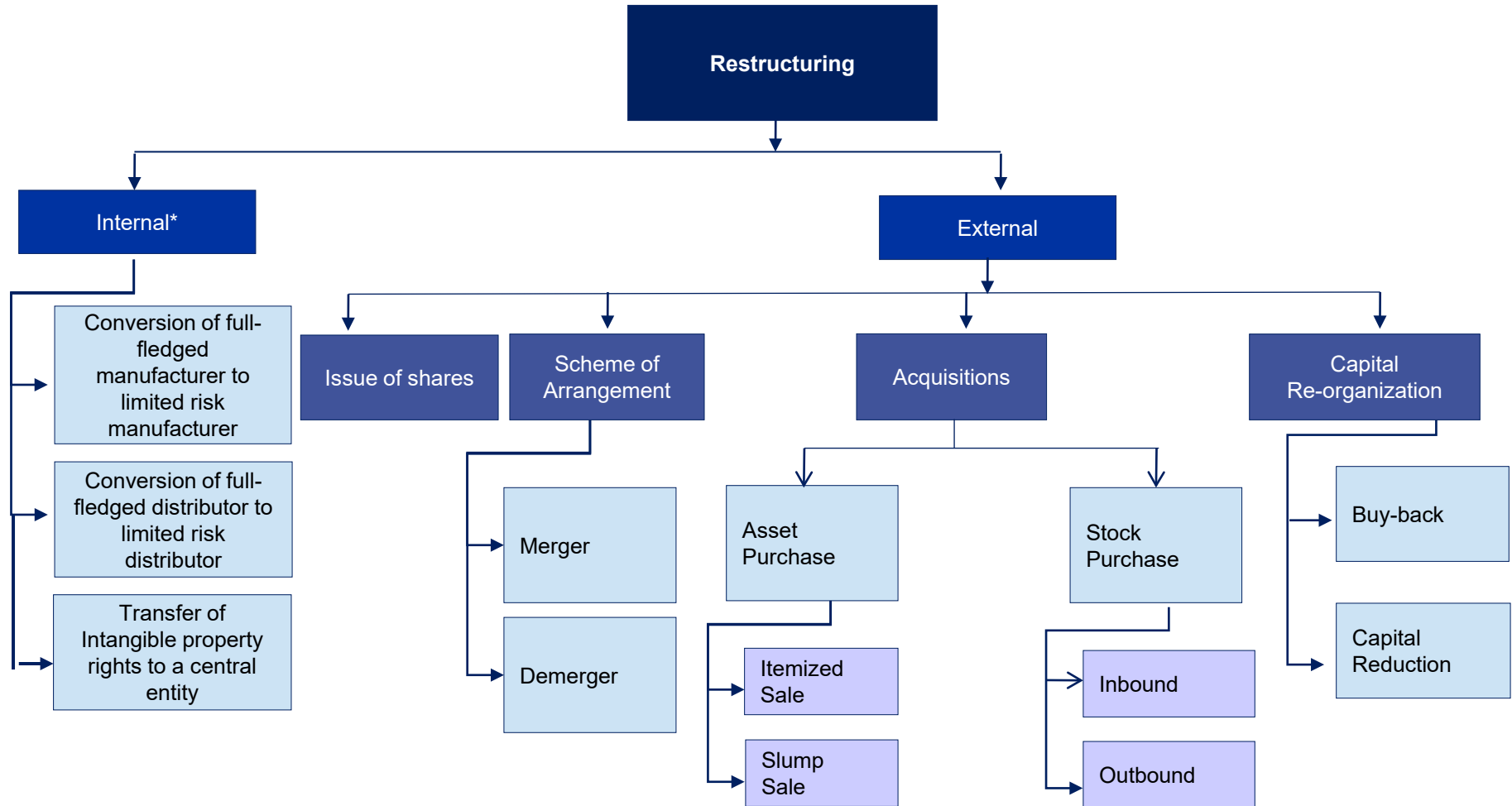
*“(e) a transaction of **business restructuring or reorganisation**, entered into by an enterprise with an associated enterprise, **irrespective of the fact that it has bearing on the profit, income, losses or assets of such enterprises at the time of the transaction or at any future date**”*

## ICAI Guidance Note

*“4.3.2 ... guidance may be drawn from the OECD guidelines, which defines business restructuring as cross border **re-organisation of the commercial or financial relations** between AEs including the termination or substantial renegotiation of existing arrangements. Relationships with third parties (e.g. suppliers, sub-contractors, customers) may be a reason for the restructuring or be affected by it.*

*4.3.3 Restructuring could be in the form of **operational change (in functional, asset and risk profile of the entity) or organizational change (in ownership structure/management of the entity)**. It could include a change in the nature or scope of transactions among controlled entities, a shift in the allocation of risks, a change in responsibility for specific functions or commencement or termination of a relationship, etc.*

# Types of Restructuring



\* Internal restructuring primarily consist of internal re-allocation of functions, assets and risks within a multinational enterprise

# Business Restructuring - TP implications

---

## **Reallocation of profit potential**

- Compensation payment to the entity giving up functions and/or risks
- Converting from fully-fledged to limited risk
- Analysing the DEMPE functions

## **Transfer of “something of value” (assets)**

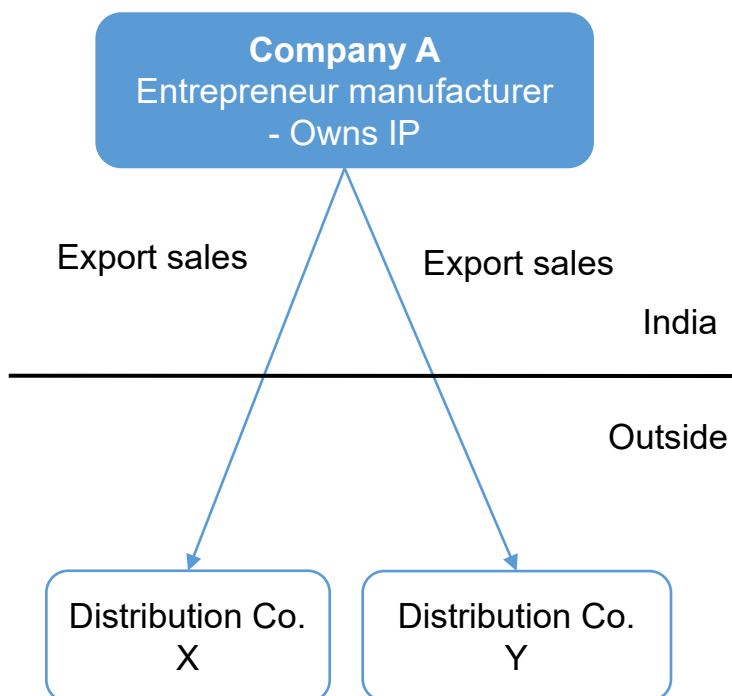
- Transfer of tangible assets (inventory) to determine the manufacturer’s risk profile
- Transfer of Intangible assets (Rights or IP) to determine the inherent profit potential

## **Termination of existing agreements**

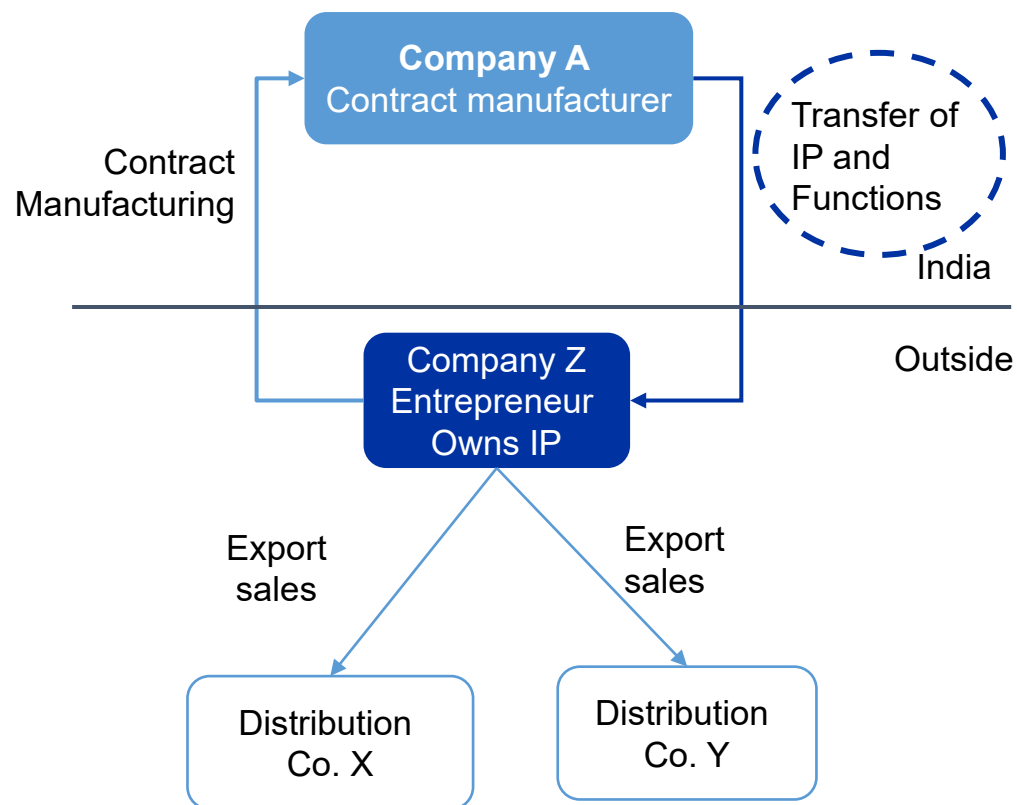
- Agreements are terminated or renegotiated
- Assess whether an indemnification needs to be paid to ensure arm’s length conditions
- Termination or renegotiation of agreements might inherently lead to a reallocation of profit potential or transfer of value (assets)

# Case study - 1

## Pre restructuring



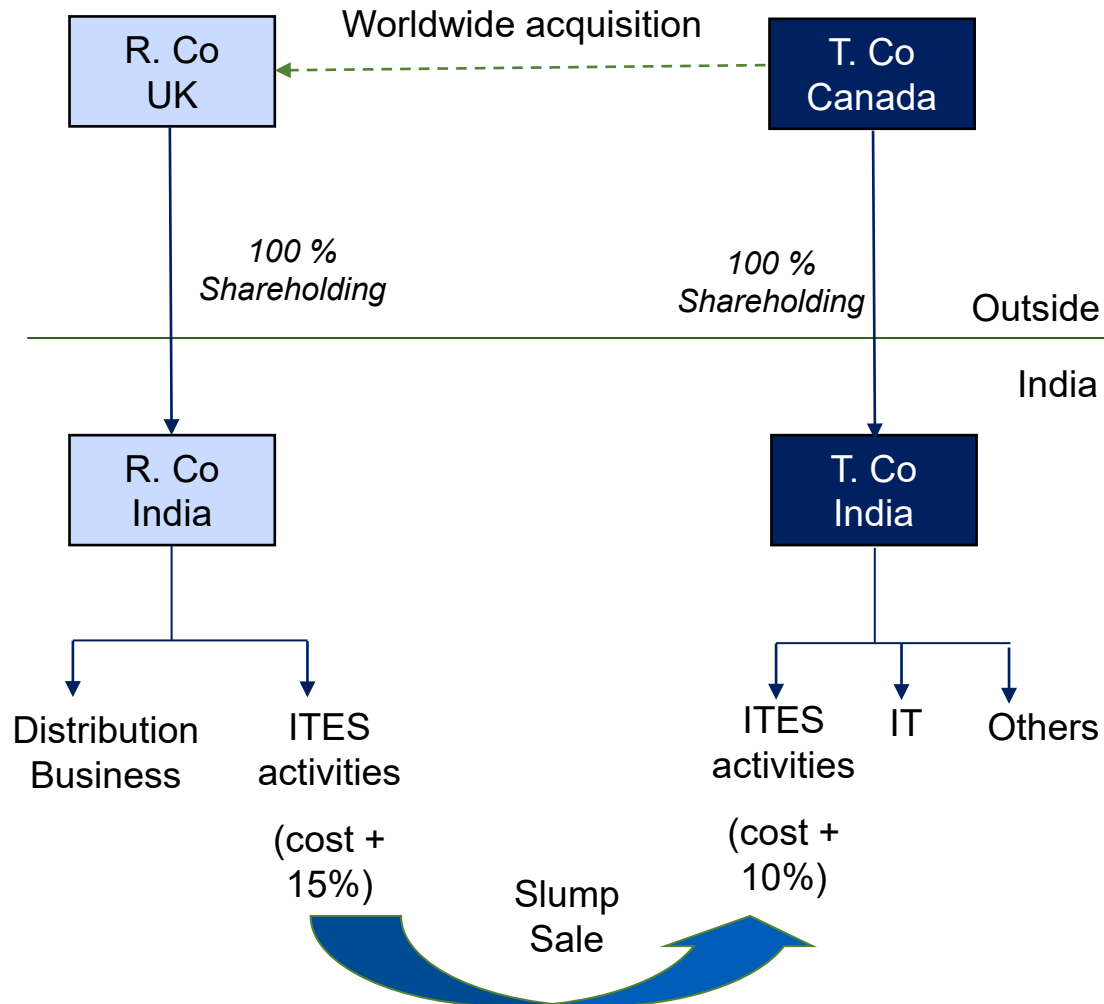
## Post restructuring



Need to evaluate FAR, economic substance and business reasons !



## Case study – 2 (Aligning TP Policies)



- R. Co and T. Co are independent MNCs having operations in India through their respective subsidiaries
- Both have outsourced ITES to their respective Indian subsidiaries. R. Co is remunerated @ cost + 15% and T. Co @ cost + 10%
- R. Co gets acquired by T. Co overseas
- As a result of the global acquisition, to consolidate operations, ITES activity of R. Co is transferred to T. Co by way of a slump sale
- **Aligning TP policies post acquisition – to integrate with business changes**



**Intangibles**

# What is an intangible from TP perspective

---

## Section 92B – Explanation (ii)

### **Expression “intangible property” shall include:**

- Marketing related
- Technology related
- Artistic related
- Data processing related
- Engineering related
- Customer related
- Contract related
- Human capital related
- Location related
- Goodwill related
- Methods, programs, systems, procedures etc.

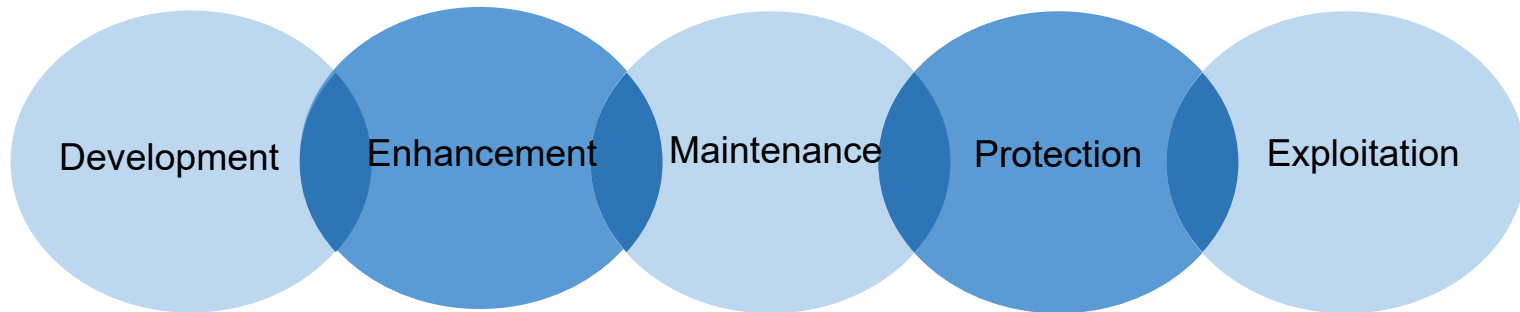
## Examples of Intangibles

- Patents
- Know-how and trade secrets
- Trademarks, trade names, and brands
- Rights under contracts
- Licenses and similar limited rights in intangibles
- Goodwill, etc.

# Intangibles - DEMPE functions

---

- Action 8 focus is on DEMPE functions relating to intangible assets

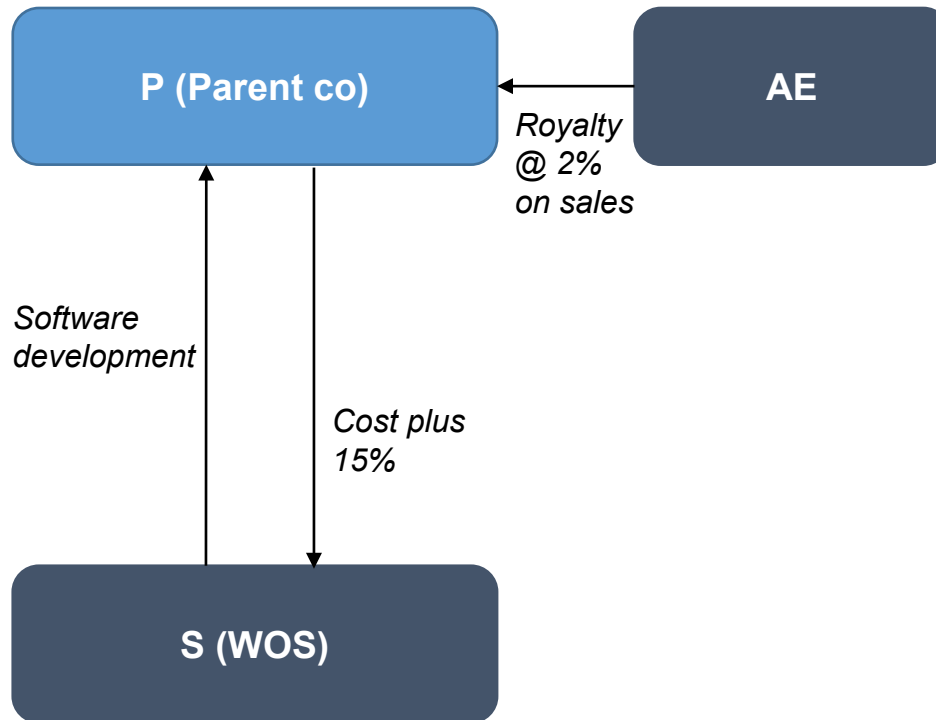


- There is no automatic return on account of mere legal ownership of intangible
- Requirement to directly perform or to control the performance of DEMPE functions and related risks
- Return retained by an entity in group depends on the contributions it makes through DEMPE functions to the anticipated value of intangible relative to contributions made by other group members
- Not all intangibles deserve separate compensation in all circumstances

The OECD guidance focuses on '**substance**' for conducting TP analysis of intangibles

# Case Study – Pre BEPS

---



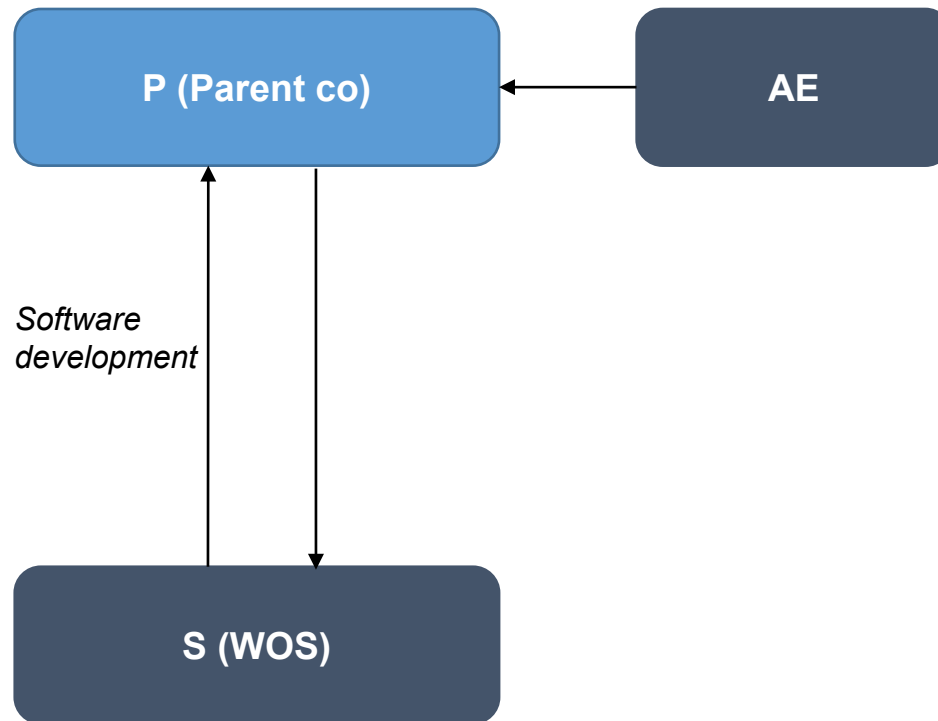
## Key Facts:

- P is the legal owner / licensor of a software application.
- S has software development team
- S is compensated at Cost+15%
- AE sells the software application in its jurisdiction and pays royalty @2% to P
- Transfer Pricing was driven mainly by looking at the legal form rather than the actual functions and risks assumed by the parties.

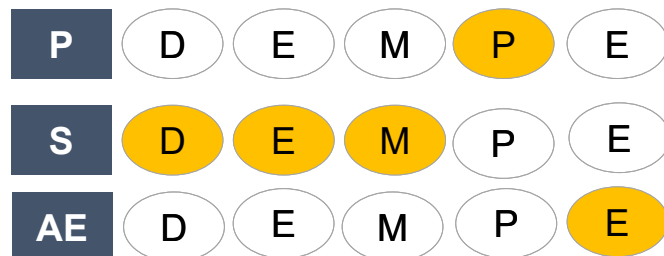
## Focus so far:

- Mark-up
- Cost base (FoC, ESOP, etc.)

# Case Study – Post BEPS



## Summary of functions:



## Key Facts

- Situation 1 – Pre BEPS facts remaining the same
- Focus shifted to substance rather than the legal form of the contract

## Functions of P

- Legal owner and responsible for protection of software application
- No ideation / technical team

## Functions of S

- Performs ideation, development services including coding, customer feedback, bug fixing, etc.
- Controls all R&D functions

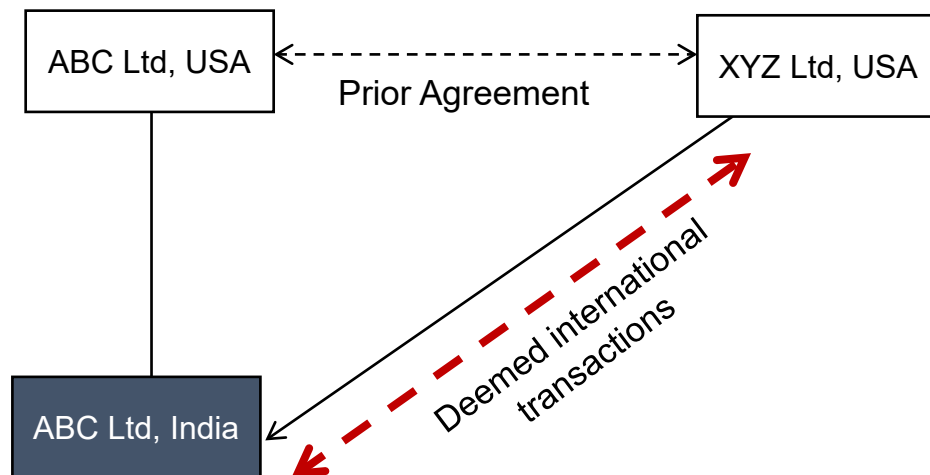
## Functions of AE

- Sale of software

Who undertakes DEMPE?

# Deemed International Transactions

## Section 92B(2) - Deemed International Transactions

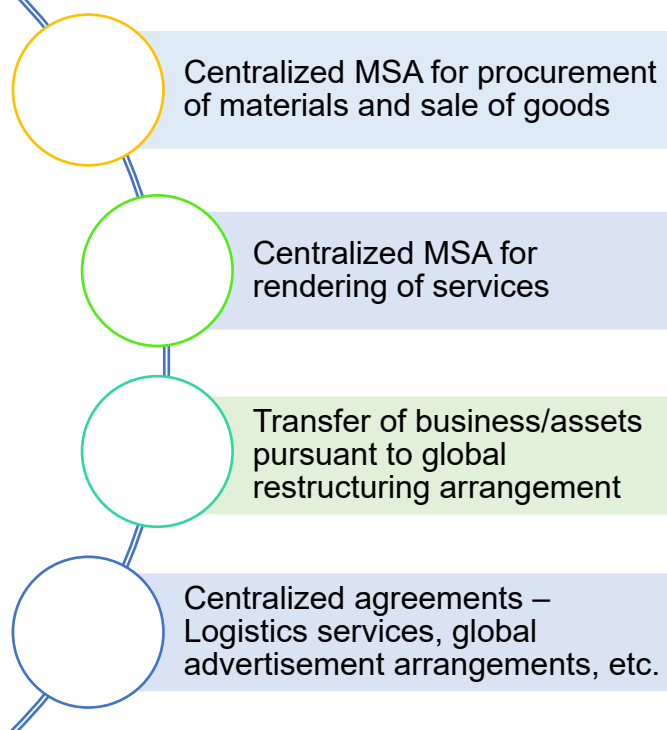


### Section 92B(2) – Deemed International Transaction

Section 92B(2) creates a deeming fiction, which extends the scope of an international transaction defined in section 92B(1). This fiction brings certain transactions between two non-AEs (i.e. two unrelated parties) within the purview of international transactions if the following conditions exist:

- a) There exists a prior agreement in relation to the relevant transaction(s) between such other person and the AE of the taxpayer, or
- b) The terms of the relevant transaction(s) are determined in substance between such other person and the AE of the taxpayer.

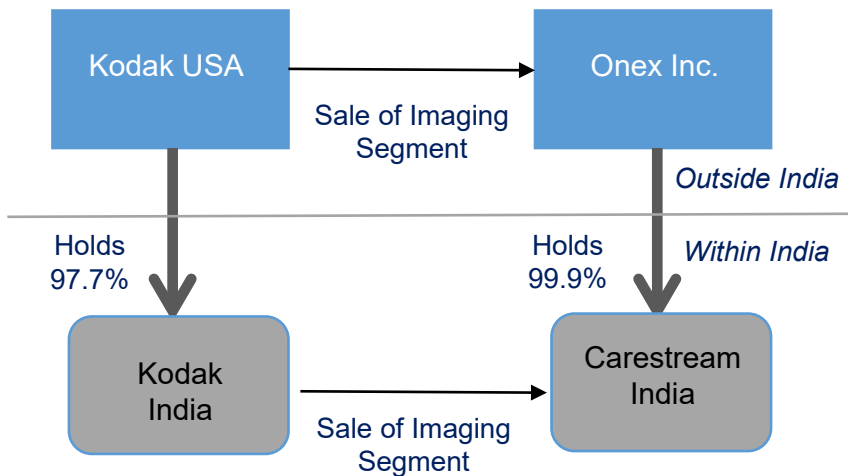
### Illustrative Cases of DIT





# Deemed International Transaction – Case Study

---



- **Kodak India Pvt Ltd – Mumbai HC**

- Transaction was negotiated and occurred between two Indian enterprises
- Terms not influenced by the AE / Group
- The transaction was held to be a purely domestic transaction
- Outside the scope of deemed international transaction

- **Prudential Process Management Services India Private Limited – Mumbai ITAT**

- Transaction entered into by the Indian enterprises to give effect to the global outsourcing agreement
- Without global agreement, transactions between the two Indian entities cannot materialized
- Qualifies as a deemed international transaction

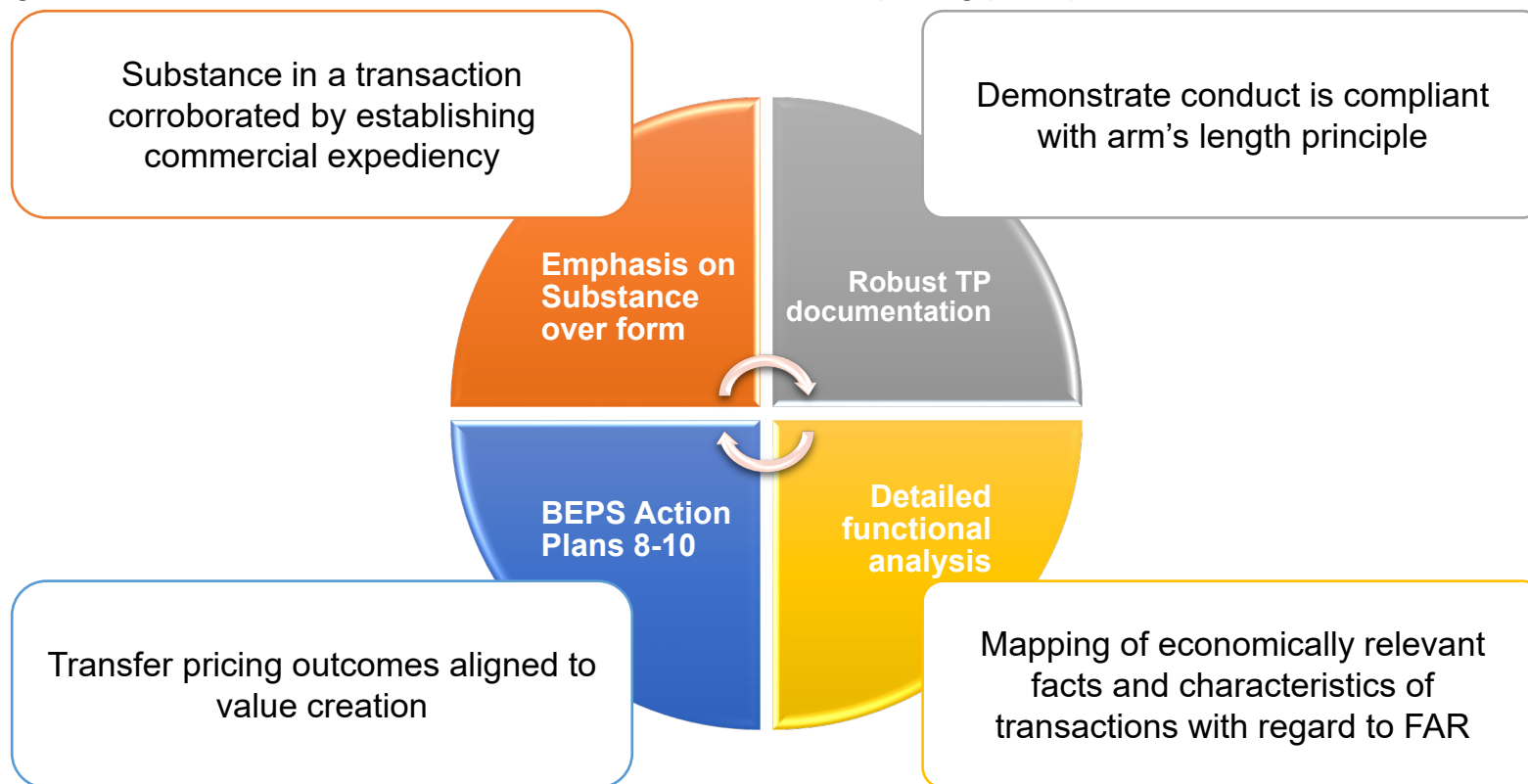


# Interlinkages of TP with other regulations

# GAAR and TP interlinkage

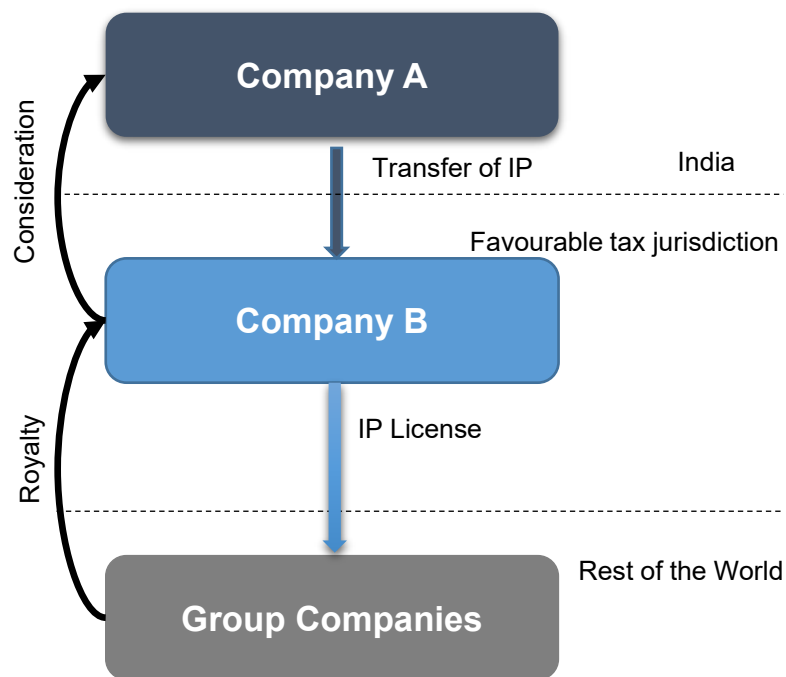
# Interplay between GAAR and Transfer pricing

By introduction of GAAR, apprehensions have been raised that there is no distinction between tax mitigation and tax avoidance. In such a situation the transfer pricing principles could be used



TP being Specific Anti- Avoidance Rule ('SAAR'), as per circular 7 of 2017 CBDT has clarified that GAAR and SAAR can co-exists as SAAR may be inadequate to address all instances of tax abuse

# Illustration



## Facts

- A is engaged in manufacturing of Pharma products
- B is resident in a favourable tax jurisdiction (e.g., Mauritius)
- A transfer the IP to Company B for a consideration
- B do not have substance
- B licenses the IP to the other group companies and earns royalty income
- A continues to be engaged in manufacturing and R&D operations

## Issue:

- Can GAAR be invoked?

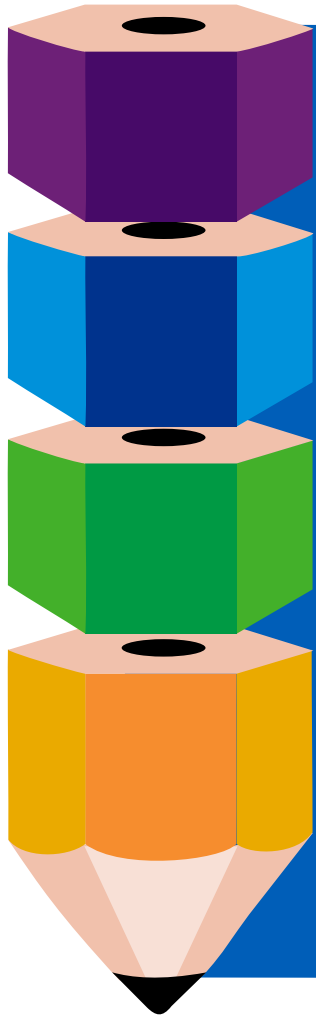
## Implications of invoking GAAR

1. Disregarding / re-characterising entire or part of an arrangement
2. Re-allocation of income, expenses
3. Disregarding of corporate structure
4. Denial of treaty benefits
5. Re-characterisation of equity-debt

# **Place of Effective Management ('POEM') and TP interlinkage**

# Place of Effective Management - In brief

---



- POEM is an anti-abuse provision introduced from 1st April 2016 (w.e.f. 1st April 2017)
- Prior to the amendment, residency of Foreign Company was depending on whether the control and management of its affairs are situated wholly in India.
- POEM refers to a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made.
- CBDT has clarified that if the BoD of foreign company are standing aside and powers of management are exercised either by holding company or regional HQ or any other person(s) resident in India then the POEM shall be in India.

# POEM - TP Interlinkage

- POEM – Control and Management
- Place of management and commercial decisions making
- Directors Residency
- Substance –
  - People
  - Funding
  - Actual Risk taking capability



- Shareholder / stewardship
  - Governance and compliance,
  - Group audits,
  - Group level acquisitions,
  - Public listing of a key / central group entity etc.
- Economic Substance
- Agreement vs. Conduct
- Funding
- IP
- People Function



# POEM – TP Jurisprudence

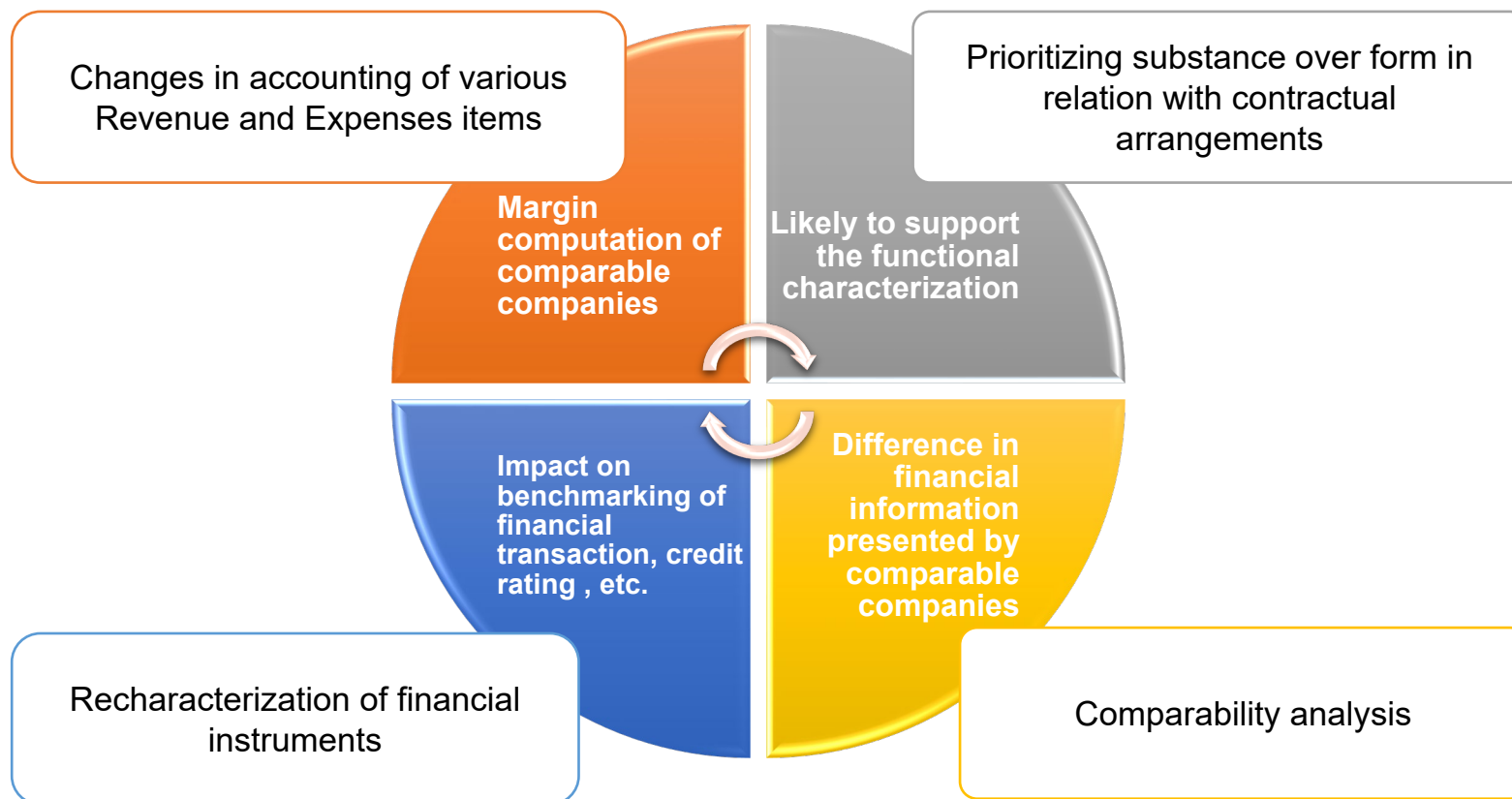
1 Facts of the Case	TPO's adjustment and DRP's confirmation	2
<ul style="list-style-type: none"> <li>■ Taxpayer engaged in trading, export of pharma products. Assessee had set up subsidiaries in Mauritius and UAE.</li> <li>■ TPO held that Management and control of global business was situated in India., Assessee performed critical functions e.g. procurement, client interactions, order management , etc. AE in Mauritius and UAE were sham</li> <li>■ Further TPO also held that Entire global purchases were routed through Mauritius and UAE, who had earned significant income.</li> </ul>	<ul style="list-style-type: none"> <li>■ TPO rejected TNMM and applied PSM method and appropriated 97 percent of global profits in the hands of Assessee</li> <li>■ Further the DRP confirmed the approach of the TPO however revised the allocation to 70%</li> </ul>	
<ul style="list-style-type: none"> <li>■ Held that issue of deciding the control and management of affairs and status of residence of overseas entities is not within the realm of determining ALP of international transactions.</li> <li>■ It was the duty of the AO to examine POEM related aspects. Hence, there is no merit in the exercise carried out by the TPO and the order of the TPO was quashed.</li> </ul>	<p>Ruling provide critical guidance as to</p> <ul style="list-style-type: none"> <li>■ Only AO is empowered to evaluate POEM</li> <li>■ Overlapping of POEM with TP Principles, requiring careful consideration</li> <li>■ E.g. The Indian HQ, upon receiving POEM enquiries would need to independently justify their overseas subsidiaries are not controlled and managed from India.</li> </ul>	
3 ITAT's observation	Key Takeaways	4

## Sava Healthcare Ltd (Pune ITAT)

**Ind AS and TP**

# Interplay between Ind-AS and Transfer pricing

There are various changes in preparation and presentation of books of accounts which may impact the TP analysis to be conducted by the Company. A gist of the impact of Ind AS on TP is presented as follows:



# Ind-AS and TP – Reclassification of Revenue and expenses

---

Below are some of the examples of how certain reclassification of Revenue and expenses items will have an impact on the TP analysis.



Extended credit period on sales



Extended warranty on sales



Excise duty payment



Discounts, Volume, rebates, etc.



Government grants



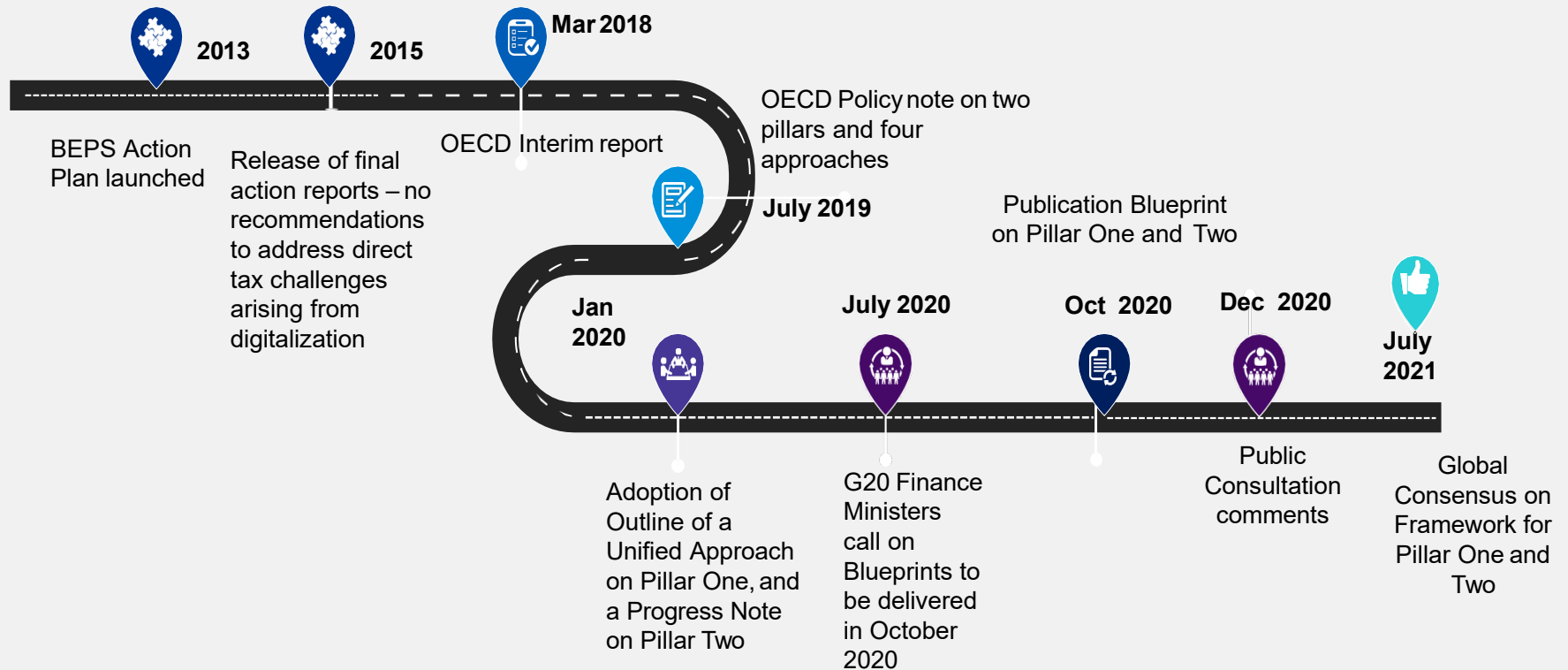
Share based payments (ESOPs)



# Other Updates

**BEPS 2.0**

# BEPS 2.0

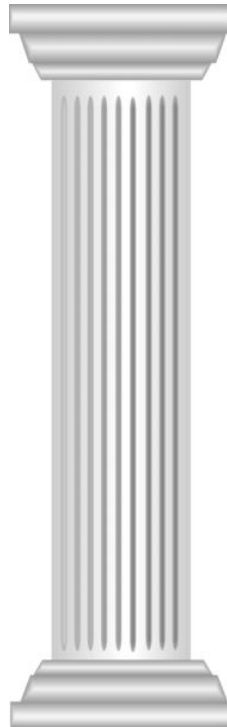


# BEPS 2.0 - Pillar One and Pillar Two

---

## Pillar 1

- Moves away from the idea that taxation largely requires physical presence in a country
- Focuses on the allocation of taxing rights between jurisdictions, new profit allocation and nexus rules
- Approach will look to accommodate new business models and expand taxing rights of market jurisdictions (e.g. location of users)



## Pillar 2

- Includes the Global Anti-Base Erosion (“GloBE”) proposal and seeks to address remaining BEPS issues
- Co-ordinated set of rules to address profit shifting and tax competition by providing jurisdictions with right to “tax back” where other jurisdictions have not exercised their primary taxing rights or where income is subject to low tax rate
- Proposed as a “top-up” tax to a minimum effective tax rate (“ETR”) to provide a level playing field



# **Non-Resident Assessee**

## **- TP implications**

# Non-Resident Assessee - TP Aspects

---

- Rules prescribed for filing of return of Income for Non-Residents
- No clear guidance on requirement of filing form 3CEB where ROI is not filed

- Reliance on TP Documentation of AE is not sufficient.
- Tax authorities evaluate the transactions independently

**Filtrex Technologies Pvt. Ltd, (Bangalore ITAT)**  
Transactions treated at ALP in hands of Indian AE, no disallowance can be made in hands of flipside entity

- Rely on the TP documentation of Indian AE
- Reporting of taxable or all transactions?

## **Convergys Customer Management Group Inc. (Delhi Tribunal):**

- Mandatory to report all the transaction i.e., taxable and non-taxable transaction.
- Mandatory to maintain separate TP documentation

# Penalty provisions

## Penalty provisions

Particulars	Section	Penalty
Penalty for under reporting and misreporting of income	Section 270A	50% to 200% of tax
Penalty for concealment of income or furnishing inaccurate particulars of income	Section 271(1)(c)	100% to 300% of tax
<ul style="list-style-type: none"> <li>Non-maintenance of information and documentation</li> <li>Failure to report such transaction</li> <li>Maintaining or furnishing incorrect information or document</li> </ul>	Section 271AA (1)	2% of value of international transaction or specified domestic transaction
Failure to furnish information and document required under section 92D(4) – Master File	Section 271AA (2)	INR 5,00,000
Non-furnishing of documentation	Section 271G	2% of value of international transaction or SDT for each failure
Penalty for failure to furnish report Section 286 (2)	Section 271GB	Graded penalty structure from INR 5,000 to INR 50,000 per day;
Non-furnishing of Accountant's Report	Section 271BA	INR 1,00,000
Penalty on Accountants for furnishing incorrect information in reports and certificates	Section 271J	INR 10,000
Penalty not to be imposed in certain cases	Section 273B	Not applicable

# Thank you

Contact:

**Bhavesh Dedhia** [bdedhia@bsraffiliates.com](mailto:bdedhia@bsraffiliates.com)

**Jiger Nagda** [jigernagda@bsraffiliates.com](mailto:jigernagda@bsraffiliates.com)