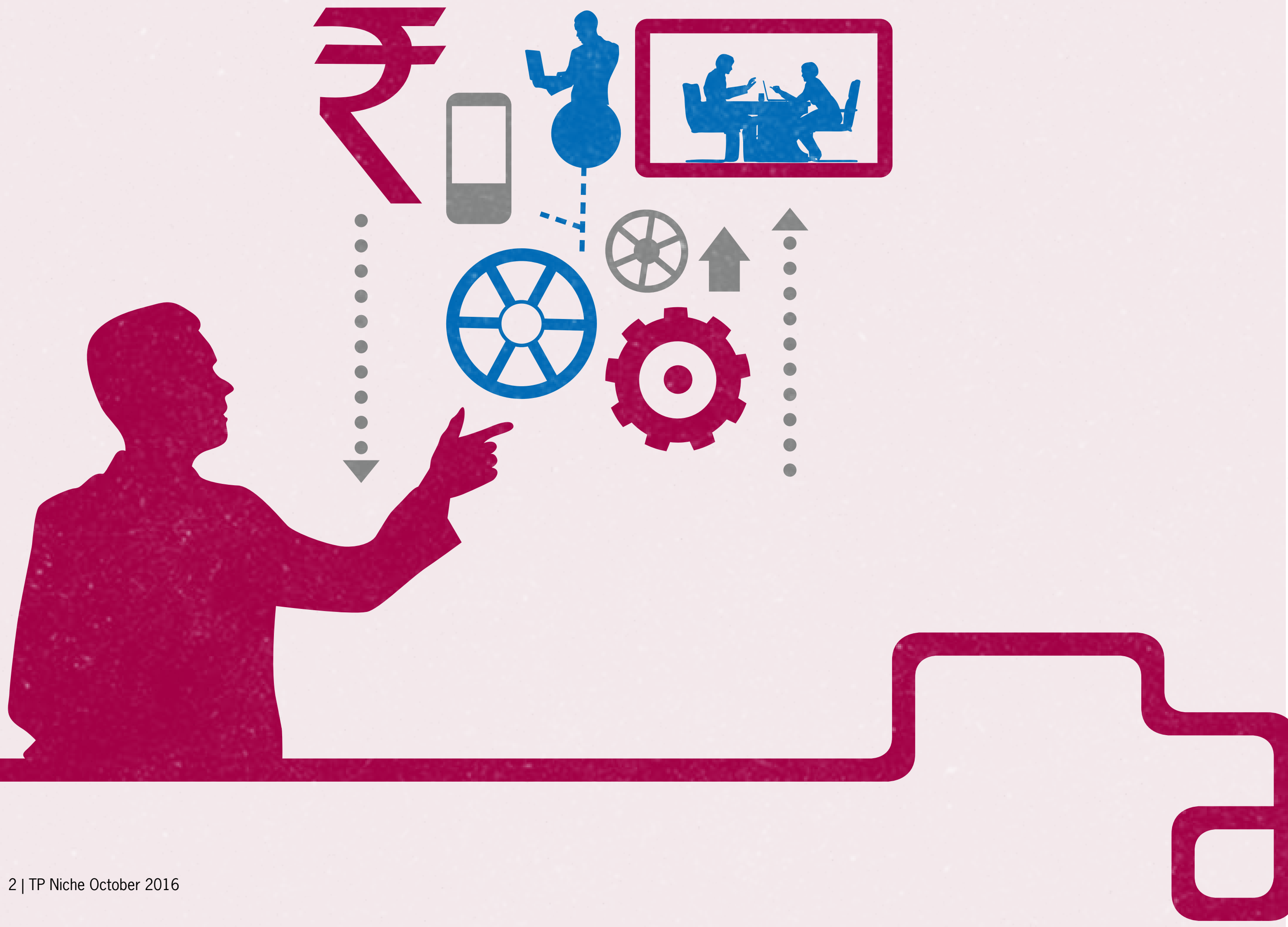
Grant Thornton
An instinct for growth™

TP Niche

A spectrum of transfer pricing issues

Quarterly Edition: July-September 2016

Contents



Foreword

Arun Chhabra
Director
Grant Thornton Advisory Pvt. Ltd.

We are glad to present our quarterly newsletter- TP Niche. Through this newsletter our endeavour is to share our experience on emerging transfer pricing trends and provide our readers valuable insights on the evolving transfer pricing landscape in India.

This issue of TP Niche covers a wide range of transfer pricing topics categorised under five sections viz. 'Perspective', 'Our experience', 'From the judiciary', 'Tracker' and 'Global corner'. The Perspective section covers analysis of key transfer pricing issues. In this edition, we have covered two interesting issues: The first issue relates to 'India TP landscape for intangibles' and the second pertaining to the relatively macro topic of 'Changing TP landscape for intangibles under the action plans formulated under the Base Erosion and Profit Shifting project'.

In 'Our Experience' section, we share our relevant litigation experience and provide some practical insights pertaining to the emerging focus areas for Indian TP authorities.

With so many decisions being pronounced by the Tribunal and High Courts on Transfer Pricing issues on regular basis, it is challenging to keep track of fundamental positions emerging from such decisions on peculiar issues. With this in mind, we have captured some key rulings reported in the last quarter in the section - 'From the judiciary', to give our readers a snapshot of important judicial pronouncements.

'Tracker' section lists key developments in the form of notifications, circulars and other publications touching different legislative and practical aspects of transfer pricing, which the readers may want to have it for their easy reference.

'Global Corner' is a section which is designed to highlight the key developments in the TP regimes of some key jurisdictions. In this edition, readers get to know of recent development in the U.S. TP regime.

We hope that you will find the TP Niche edition engaging and informative. In case you have any comment or query, please reach out to us. Your feedback is important to us. We look forward to receiving it.

Perspective

This section emphasises on transfer pricing ("TP") issues relating to intangibles. It provides a viewpoint on benchmarking of transactions involving intangibles and highlights the need for re-alignment of existing arrangements involving intangibles in light of the new framework provided by Base erosion and profit shifting ('BEPS') actions plans.

Overview

Globally, the transactions involving intangibles have always been on the radar of many tax authorities during their reviews and audits. In recent years, the Indian tax authorities have been scrutinising transactions related to intangibles. Further, the transfer pricing legislation explicitly defines the term 'intangibles' and steps have been taken for implementation of 'country-by-country reporting' standards to have access to relevant information pertaining to various key business aspects including intangibles. However, undoubtedly there is a long way to go for having an effective TP framework for transactions involving intangibles.

Many multi-national corporations have been inclined to migrate their intangibles to reduce group tax liabilities despite the efforts of tax authorities to limit their ability to do so. Nevertheless, since the last decade, the restructuring of intangible ownership is taking place in connection with other corporate initiatives, such as acquisitions, dispositions, strategic expansions, or efficiency and cost-cutting efforts rather than the sole purpose of reducing tax liabilities.

BEPS initiated by the G20[1] economies and now endorsed internationally aims to close tax loop holes and ensure income is taxed where there is value creation. Transactions involving intangibles are at the forefront of this tax battle.

Recently, organisation for economic co-operation and development ("OECD") also introduced the BEPS Actions 8-10 "aligning transfer pricing outcomes with value creation".

Before delving into the relevant guidance of Action 8 of BEPS Action plan, it is important to understand the nuances of TP audit landscape for intangibles in India so as to enable one to harmoniously evaluate such nuances in the light of the guidance of internationally recognised BEPS Action 8.

A. India TP audit landscape for transactions involving intangibles

Typically, royalty transactions are designed to remunerate intangibles. What does royalty mean?

Royalties are amounts received as consideration by the owner of an intangible property towards use or right to use such intangible property. Some of the intangibles are patent, copyright, design or model, secret formula or process, trademark, trade name or for information concerning industrial, commercial or scientific experience.

What are the common issues faced by taxpayers for intangible transactions involving royalty payments?

1. Commercial expediency and benefit test aspects

In many cases, the tax authorities have been disallowing royalty payments in entirety or in part, on the ground that the taxpayer has failed to convincingly demonstrate –

- the commercial rationale/need for availing the intellectual property ("IP");
- the nature of IP and how commensurate economic and commercial benefit accrues from the receipt of IP,
- whether royalty is bundled with other transactions or is on standalone basis,
- evidentiary documents to support the proprietary nature of IP,
- receipts of relevant updates pertaining to IP in situations where IP is fairly absorbed etc.

This issue has been adjudicated by various high courts ('HC') and Income Tax Appellate tribunals ("ITAT").

In the following case laws it has been held that if royalty expenditure is incurred wholly and exclusively for business purposes, then the taxpayer need not demonstrate that the expenditure actually resulted in income or profits either in the same or subsequent years.

1. G20 is an international forum for the governments and central bank governors from 20 major economies. The members include 19 individual countries—Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States—along with the European Union

Case laws for
EKL Appliances Ltd[2]
Daksh Business Process Services Pvt Ltd[3]
LG Polymers India Pvt. Ltd.[4]
Lumax Industries Ltd. (AY 2007-08)[5]
SC Enviro Agro India Pvt. Ltd.[6]
Toyota Kirloskar Auto Parts Pvt. Ltd.[7]

In the below-mentioned cases, ITAT considered the arguments of the taxpayer that the royalty payment have resulted in tangible benefits, and rejected the adhoc application of benefit test by the transfer pricing officer ("TPO") for reducing the royalty payment.

Case laws for
RAK Ceramics India Pvt Ltd[8]
Reebok[9]

Based on the above mentioned rulings, there seems to be a clear position that the tax authorities cannot determine the commercial expediency of royalty payment by merely applying the benefit test or through quantification of benefits. In spite of this, it is recommended that the taxpayers maintain the relevant evidences for demonstrating the business necessity/rationale along with the advantages associated with the use of such intangible assets i.e. increase in sales/profits, reduction in costs or any other relevant parameters. This documentation would assist the taxpayers to strengthen their case at the initial level of scrutiny.

2. Methodology for determining and benchmarking the royalty rates/arrangements

Determination of arm's length royalty for use of intangible property can be a challenging exercise. The two most common approaches for determination of royalty rate are the transactional approach and the income based approach.

a. Transactional approach

For applying the transactional approach, the taxpayers may apply comparable uncontrolled price ("CUP") method by relying on independent comparable arrangement(s). As a start point, one can look for an internal CUP i.e. whether any similar transaction of licensing of IP has been entered into by the Group entity with other independent third party(ies). Practically, in most of cases, internal CUP is not available and thus, eventually the taxpayers have to fall back on external CUP. For application of external CUP, generally, a comparable agreement search is performed on global databases (such as RoyaltyStat, ktMINE etc.).

The extent of publicly available IP related data on these databases would differ by industry and category of IP, depending on the prevalence of licensing and need for disclosure.

There are several factors one needs to take into account for analysing comparable licence transactions such as duration of licence, impact of difference in terms and conditions, methodology for calculating royalty (on gross/net sales or profits) etc.

There are various case laws where different principles have been emanated for benchmarking the royalty transaction on transactional basis:

2. ITA. Nos.1068/2011 & ITA. Nos.1070/2011
3. ITA No.-2666/Del/2014
4. ITA No.524/Vizag/2010
5. ITA No.5252/Del/2011
6. ITA No. 704/Mum/2012
7. IT(TP)A No1642/Bang/2012
8. ITA No. 1492/Hyd/2014
9. ITA. No. 5857/Del/2012

Case law	Benchmarking on transactional level
SKOL Breweries Ltd.[10]	ITAT directed to use CUP method for benchmarking royalty transaction, after considering the fact that royalty payment constituted only 3.93% of the total operating cost. Consequently held that applicability of transactional net margin method ("TNMM") at entity level for testing the arm's length nature of royalty transaction is in contravention of the provisions of the TP regulations.
Syngenta India Limited[11]	TPO directed to decide arm's length price ("ALP") of royalty using CUP method since royalty paid by other comparable companies were available.
JCB India Ltd.[12]	As "payment of royalty" transaction is independent of the other international transactions TNMM on an entity level basis cannot be applied and thus a transaction by transaction approach (CUP method) should be used.
A W Faber Castell (India) Pvt Ltd.[13]	Tribunal held that royalty payment was a separate transaction, rejected clubbing of royalty transaction with the transactions of purchase and sale of goods and material with the AE.
LG Electronics India Pvt. Ltd.[14]	Tribunal rejected taxpayer's combined benchmarking approach under TNMM and held that transactions of payment of royalty and export commission were not closely linked to other transactions.

On the global front, in the recent case of **Medtronic Inc's,** the US Tax Court has upheld the principle of benchmarking the royalty payment on transactional basis. The US Tax court rejected Revenue's aggregation of transactions involving intangibles, tangible goods, and provision of services, stating that such aggregation did not result in a reasonable determination of true taxable income.

Based on the above rulings, it can be observed that the transactional approach is the preferred approach for benchmarking the royalty transaction. At a superficial level, this transactional approach seems straight forward, provided that relevant information from comparable license agreements is available. Nevertheless, the distinctive characteristics of IP and the nuances of license agreements can complicate matters.

b. Income based approach

When the transactional approach cannot be applied, the taxpayer can rely on profit methods. The TNMM is the most common method applied in such situation. In case of unique/high value intangibles, profit split method ('PSM') can be applied.

In the case of **Toyota Kirloskar Auto Parts Pvt. Ltd**[15], the ITAT held that, "where comparable uncontrolled transactions are not available, establishing arm's length price or royalty rate may not be a straight forward exercise and may require a flexible approach that need not be strictly based on specified TP methods". Accordingly, the ITAT suggested that, "in such a situation, the perfect approach for indirectly benchmarking royalty payments is to benchmark the profit margin left in the tested party, after payment of lump sum fee or royalty with the profit margins of comparable uncontrolled companies".

However, it is important to note that in the **Bausch and Lomb's ("B&L") case,** the U.S. tax court observed that as sufficiently similar transaction involving third party comparable were not available, "there must be an attempt to 'construct' an arm's-length royalty". In this regard, the tax court devised a methodology factoring the profits that an independent entrepreneur would anticipate from the use of technology (involved in the instant case) and the capital investment required to generate those profits. In the Indian context, B&L case is particularly relevant in situations where the transactional data for similar transactions is not available. Also, the TNMM does not provide convincing results, and the principles laid down with respect to the approach of 'constructing' an arm's length royalty could be effectively implemented under the "other method" introduced by the Indian tax authorities. Although one can argue that a PSM could also be applied for such a methodology applied by the U.S. court, as ultimately the profits generated by use of the intangible under consideration is split among the related parties under arm's length conditions.

10. ITA No. 6175/Mum/2011
11. ITA No.2977/Mum/2006
12. ITA No.1075/Del/2016
13. ITA No.577(Mum.) 2015
14. ITA No.5140/Del/2011
15. IT(TP)A No.1356/Bang/2011

3. Approval by regulatory authorities, for payments involving intangibles, could be considered as benchmark

In the case of **Owens Corning Industries (India) (P.) Ltd.**[16], the Tribunal held that once the Reserve Bank of India's ("RBI") approval of the royalty was obtained, the payment was considered to be held at arm's length. However, there have been contrary views by other Tribunals on this issue. Such as, in the case of **SKOL Breweries Ltd**[17]., the Mumbai ITAT held that the automatic approval permitting certain percentage of payment of royalty cannot substitute as ALP to be determined under the provisions of the Indian Income-Tax Act,1961 ("the Act") and Income Tax Rules, 1962 ("the Rules"). Also, when a proper mechanism is provided under the provisions of the Act and the Rules for determination of the ALP, then the approval by 'other than the tax authorities', for the purpose of remittance of the foreign exchange, does not ispo facto, partake the character of ALP, which has to be determined as per TP regulations. Similar views have been taken by some other ITATs as well.

In some cases, it has been held that the approval provided by RBI/Industrial Board cannot be considered as a conclusive proof. However, the TPO cannot disregard these transactions as sham in light of the approvals by these regulatory agencies.

Case law	Adoption of CUP along with approval of regulatory authorities
Reebok India Co.[18]	Tribunal held that approval provided by the Ministry of Government of India should be given due consideration for determination of ALP, though not a conclusive evidence.
Abhishek Auto Industries[19]	Agreement under which royalty was paid to taxpayer for technical know-how, not to be disregarded without cogent reasons, especially when it was approved by RBI and other regulatory agencies.

Based on the above rulings, in our opinion, if the approvals (except automatic approvals) have been provided by the regulatory agencies, one can demonstrate that the transaction of royalty payment is bona-fide in nature. Nonetheless, the benchmarking exercise for determination of ALP for royalty payment has to be conducted separately.

Accordingly, with conflicting views been taken by various ITATs, the onus lies on the tax payers to maintain appropriate documentation (including thorough benchmarking exercise) demonstrating the evidence, need for technical assistance and benefit derived by paying the royalty which would serve as a tangible basis for considering the royalty payments to be held at arm's length.

In case where one single method does not provide compelling results, it is strongly recommended that a "triangulation" technique be adopted which would facilitate validation through cross verification by use of two or more methods i.e. transactional, income based, or any other globally recognised method for determination of royalty rate.

At this juncture, it is very essential to note that increasingly there has been revelation (by tax authorities globally) of aggressive tax planning by multi-national corporations, pertaining to transactions involving intangibles, which is being primarily driven by the objective of tax avoidance. Such environment has compelled Indian tax authorities to conduct detailed scrutiny of economic analysis for testing the arm's length nature of the transactions involving intangibles. However, with limited knowledge about the transactions involving intangibles, coupled with the challenges in obtaining reliable comparable data, the Indian tax authorities are resorting to some unreasonable positions to protect its tax base and ignore the compelling reasons (faced by the taxpayer) to enter into transactions involving intangibles. Moreover, with no proper information sharing platform being available amongst tax authorities, it would not be incorrect to mention that the tax authorities were favouring extreme positions to protect their respective tax bases without giving any importance to the function, assets and risk ("FAR") analysis documented by the taxpayers.

With evolution of BEPS Actions, the taxpayers as well as the tax administrations have been appropriately guided to formulate robust documentation approach and ensure alignment of TP outcomes with value creation.

16. IT APPEAL NOS. 549 & 595 (HYD.) OF 2014
17. ITA No. 6175/Mum/2011
18. I.T.A. No. 5857/Del/2012
19. I.T.A.No.1433/Del/2009

B. Changing TP landscape for intangibles under BEPS

Historically, wherever commercial and legal opportunities existed, many multinational groups have often designed their structures to centralise or migrate the global or regional ownership of intangibles by adopting TP strategies that allocated significant profits to favourable tax jurisdiction. However, in some of these cases, no or low functionality (i.e. no employee were transferred with the IP) are resulting to cash box companies.

Globally, such structures have been under careful scrutiny of many tax authorities. Nonetheless, it has been very challenging for the tax authorities (including the Indian tax authorities) to crackdown these structures either due to the inadequacy of information available of these multinational companies at a global level or due to the limitations emanating from legal regulations. Such challenging conditions compelled the tax authorities (of various countries) to vehemently challenge the transactions involving intangibles and ignore the business/practical realities.

Therefore, in order to recognise and address the impact of these structures, OECD as part of the BEPS project introduced Actions 8-10 and Action 13 which deal with specific TP concerns.

Further, OECD as part of Action 5 provided substantive guidance for structures that separate R&D activity from IP ownership in order to restrict the tax incentives provided by countries which have a preferential IP regime.

We have focussed on the key implications of Action 8 concerning TP issues related to transactions involving intangibles in the following sections.

Principles outlined by Action 8 of BEPS Action plan

As per the guidance provided in Action 8 of BEPS Action plan, members of the MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection, and exploitation ("DEMPE") of intangibles. The guidance indicates that legal ownership and the funding of the development of an intangible without performing and controlling all of the functions would not establish entitlement to the returns derived from the exploitation of those intangibles.

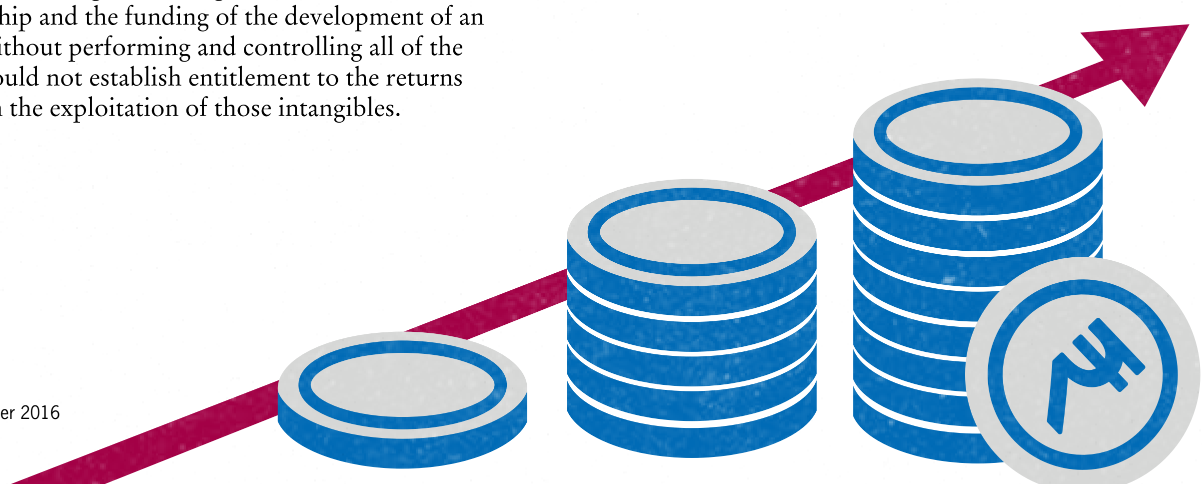
The focus on the performing and controlling elements in these DEMPE functions to identify ownership is one of the key differences between the previous iteration of the OECD TP guidelines and the new guidance.

This action 8 of BEPS Action plan has developed the following rules:

1. adopting a broad and clearly delineated definition of intangibles;
2. appropriate allocation of profits associated with transfer and use of intangibles according to value creations;
3. developing TP rules or special measures for transfer of hard-to-value intangibles.

Following steps are provided for analysing the transactions involving intangibles between AEs:

- **Identify the intangibles** used or transferred with economically significant risks associated with the DEMPE functions;
- **Identification of contractual arrangements** by determining the legal ownership, contractual rights and obligations of intangibles including the risks assumed;
- **Identification of parties performing functions, using assets and assuming risks ('FAR')** relating to DEMPE functions, and any specific outsourced functions and risks controlled by any of the parties.
- Confirm the **consistency between the terms of contractual agreements and conduct of the parties also whether the parties** assuming economically significant risks under step 3, controls and has the financial capacity to assume the risks relating to DEMPE functions of intangibles;
- **Delineation of the actual controlled transactions** related to DEMPE of intangibles in the light of legal ownership, contractual relations, conduct of parties including contributions of FAR considering framework for analysing and allocation of risk
- Where possible, **determine ALP** for these transactions consistent with each party's contribution of FAR.



Action 8 emphasises on performing and controlling DEMPE functions to identify economic ownership. Hence, a shift has occurred from routine functions to DEMPE in identifying the economic ownership of intangibles whereas contributions in the form of some important functions are relevant. Important functions may include:

- design and control of research and marketing programmes;
- direction of and establishing priorities for creative undertakings including determining the course of "blue-sky" research;
- control over strategic decisions regarding intangible development programmes, and management and control of budgets;
- defence and protection of intangibles; and
- on-going quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

Given the OECD's increased focus on "substance" when undertaking a TP analysis of intangibles, all multinational enterprises will have to review their ownership structures to determine whether there is adequate capability and authority at the legal owner level (or the controller of DEMPE functions) for the intangibles, and whether all contributions by other entities are sufficiently remunerated.

In a post BEPS world additional precautions and care would be required while planning transactions involving intangibles. Whilst there are multiple challenges during planning stage, at the same time there are many opportunities for multi-national corporations to streamline their value chain. An increasing number of multi-national corporations have started looking into these challenges / issues and may evaluate possible options which could be considered:

- Migration of IP from the legal owner of IP to the entity that is principally responsible for the DEMPE of the intangibles. Valuation of IP will be at the forefront of such migration analysis.
- Retain the IP offshore and retain legal ownerships structure. This would involve conceptualisation of appropriate arrangement in attributing the economic returns of the IP to the economic owner(s) and may involve formulation of sub-licensing arrangements as well.

Relevant developments in Indian scenario

Being part of G20, India has been an active participant in the BEPS project. Thus, it is anticipated that India would adopt most or almost all the BEPS recommendations. Below are some of the steps taken by the Indian government, reinforcing the fact that there is an increasing focus on transactions involving intangibles.

1. **Country-by-Country reporting (Action 13) -** Action 13 has already been implemented by India. One of the requirements of Action 13 is to maintain a master file. As part of the master file, the multinational companies are required to provide details on the overall strategy for intangibles, important intangibles (including owner name), intra-group agreements on intangibles, group's TP policies on intangibles and R&D, and any transfers of intangibles made during the year. The detailed guidance in this respect is yet to be prescribed by the government.
2. **General anti-avoidance rule ("GAAR") –** GAAR provisions are applicable from FY 2017-18 and it empowers the revenue authorities to question transactions and arrangements and disregard their form to deny tax benefit. It would be interesting to note whether the Indian Government adopts the Action 8-10 of BEPS Action plan by revising the GAAR provisions or issue different set of regulations or both.
3. **Patent box regime –** India recently introduced the patent box regime vide Finance Act, 2016 where under this new regime the income earned by a qualifying taxpayer from the exploitation of a patent would be taxed at a preferential rate of 10 per cent. This regime does appear to satisfy the nexus approach recommended by Action 5 of BEPS Action plan, by linking the reduced rate of IP income to the expenditure incurred on development. However, there are some clarifications required for its application in specific cases (such as acquisition of "in process IP" and its further development).

Ironically, in a recent landmark decision in the case of **CUB Pty Ltd. v. Union of India,**[20] the Delhi HC has held that income accruing from the transfer of intangible assets licensed for use in India was not taxable in India because the situs of ownership was elsewhere.

20. TS-401-HC-2016(DEL)

HC upheld internationally accepted principle of 'mobilia sequuntur personam', and observes that "The situs of the owner of an intangible asset would be the closest approximation of the situs of an intangible asset". Since, the principle was not altered in Indian context, it was concluded that situs of intangible assets was not located in India since the owner (i.e. Fosters Australia) was not located in India at the time of the transaction and "income accruing to the petitioner from the transfer of its right, title or interest in and to the trademarks in Foster's brand intellectual property is not taxable in India under the Income Tax Act, 1961".

This issue dealt by the Delhi HC incidentally attaches relevance to the discussions on the concept of economic ownership, which has been litigated at length in the Indian TP arena on marketing intangibles. Also, it is in one way or another linked with the recommendations contained in Actions 8-10 of the BEPS project of "Aligning TP Outcomes with Value Creation". Thus, it would be quiet interesting to see that how the Indian Government would incorporate the concept of economic ownership in light of the recent Delhi HC decision (underlining on legal ownership) and the recommendation of Actions 8-10 (emphasising on economic substance and control).

Concluding remarks

For all multinational corporations, the reformed tax environment creates the need to assess their strategy for the creation, protection and exploitation of intangibles.

The collective effect of Action 5 and 8 to 10 of BEPS Action plan on IP structures is that multinational groups that wish to attribute significant profits to an IP owner and obtain the benefits of a preferential IP taxation regime, will need to confirm that the IP owner carries out not only the funding of the IP development but also the decision-making and control over development, enhancement, maintenance, protection and exploitation of the IP, as well as a substantial proportion of the execution of the R&D activity. Further, Action 13 of BEPS Action plan would enable the tax authorities to obtain relevant information about the transactions involving intangibles which will go a long way in conducting meaningful comparability analysis resulting into reasonable positions being taken by tax authorities.

The fresh guidance provided by OECD with respect to intangibles certainly moves away from placing substantial emphasis on legal ownership towards economic substance and control. Once this guidance is incorporated in the Indian tax legislation, it would definitely provide more tools to the Indian tax authorities to elevate and support the TP adjustments. Corporations with IP at an offshore entity with limited economic substance should re-examine their arrangements and consider necessary changes or support that may be required to its existing arrangement. Accordingly, the taxpayers must be aware and take due consideration of the new guidance before structuring and planning any IP related arrangement.

Our experience

This section focusses on Grant Thornton litigation experience. It concentrates on key TP audit issues faced by the taxpayers and emerging focus areas for Indian TP authorities across the country.

A. Recent trends/approaches followed by TP authorities across India

1. Outstanding receivables

Increasingly, the TP authorities are scrutinising the outstanding receivables with associated enterprise ("AE"), and evaluate whether any TP adjustments could be proposed on the basis of delay in actual realisation period vis-à-vis the normal collection period. Also, it is important to note that the TP authorities are reluctant to propose such TP adjustments in case there is similar delay in realisation with third party transactions. Such outstanding receivable transactions are not tested to be at arm's length, based on aggregation approach by conducting working capital adjustments, but on the contrary are attempted to be tested on standalone basis.

State Bank of India (SBI") prime lending rate ("PLR") rate has been typically used by the TP authorities for making TP adjustments on the outstanding receivables with AEs.

2. Foreign exchange gain/loss

The TPO's in some parts of India, particularly south, have treated gain/loss arising from foreign exchange fluctuation ('Foreign exchange gain/loss') as an operating income/ expense, while computing the profit level indicator ("PLI") of the tested party as well as that of the comparable companies. However, a majority of TPO's in other parts of India are taking a contrary view and treating the foreign exchange gain/loss as a non-operating item by relying on either the operating margin computation methodology provided in the safe harbour rules or certain judicial precedents.

It is very essential that consistent positions are adopted by the TP authorities across India on the basis of some guidelines, which could be issued by the income-tax authorities on the treatment of foreign exchange gain/loss, to mitigate unwanted TP litigations.

3. Loss or abnormal profit earning comparable company

It is more or less settled that comparable companies cannot be rejected solely on the ground of being a loss or abnormal profit company, unless they involve a duly justified abnormal business condition attached to such loss or abnormal profit.

In some cases the ITAT seems to be advocating rejection of the loss making comparable companies, in situations where the taxpayer is a captive entity and operates on a cost plus basis.

However, in such cases, there is no clarity whether high profit making companies would also be rejected on similar logical reasoning i.e. captives bearing low risks and operating on a cost plus basis cannot be earning abnormally high profit.

4. Management fee payments

Service payments could be considered to be at the epicentre of the transfer pricing litigation. Based on our recent experience, the TP authorities are conducting detailed scrutiny on the management fee, cost sharing, technical service fee payments etc. Some of the key questions from the TP authorities, which are featuring in the standard questionnaires issued by the TPO's across India, are as follows:

- Explanation for commercial need for the services
- Provision of documentary evidences proving receipt of services
- Service requisition mode/medium followed by the taxpayers for availing services from the AEs
- Pricing for such services and documentary evidences in this regard
- Benefits derived by the taxpayers from the receipt of services. Quantification of the benefits
- Ascertaining whether any duplication of services which were received from the AE
- Provision of allocation keys and relevant workings for the cost sharing arrangement

The taxpayer is dependent on its AE for procuring this information and this may, at times, create difficulty for the taxpayer.

Real-time compilation of relevant information by the taxpayers, keeping in mind the above mentioned logical requirements, would go a long way in appropriately managing the transfer pricing audits of service payments to AEs.

5. Issuance of shares/corporate guarantee transaction

Based on our recent experience, for issuance of shares, the Vodafone judgement[21] is relied upon by the TP Authorities and valuation reports are being accepted by the TPOs.

6. Internal TNMM vs. External TNMM

By and large the TPO's position of disregarding the use of an internal TNMM analysis (involving comparison of profitability of the taxpayers AE business segment with that of the non-AE business segment) has remained the same as it was in the previous year.

7. Selection of foreign tested party

There has been a mixed response from the TP authorities while dealing on the selection of foreign tested party during the assessment proceedings.

Only few TPO's from some selected pockets on India have demonstrated their openness to selection of foreign entities as tested parties, wherever such selection is on the basis of a robust FAR analysis, strongly depicting foreign entities as less complex entity and on the basis of availability of financial data of foreign comparable companies.

However, most of the TPOs in other regions of India seem to be rejecting the selection of foreign entities as the tested party on the premise that Indian taxpayers are always the tested parties or by citing unavailability of reliable information as the reason for rejecting foreign tested parties. This has been generally done on the premise that the annual reports of the foreign comparable companies are not available and thus, they cannot verify the business overview and the financial data of such comparable companies.

8. Information technology ("IT")/ IT enabled services ("ITES") Industry

It seems that the aggression of the TP authorities towards the IT and ITES industry may have been diluted in the current Indian TP landscape with the evolution of APA programme and the implementation of safe harbours.

We are experiencing meagre resistance from some TPOs for cases wherein the taxpayer (being captive IT/ITES service provider providing routine IT/ITES service) has reported an operating margin between 17 to 20 per cent of total cost. This indicates a matured approach by some TPO's as they have aligned their position (on arm's length margin for IT/ITES service providers) with the margins having higher chances of acceptability at the APA level, margins advocated under the safe harbour and the mutual agreement procedures ('MAP') governed by double tax avoidance agreements ('DTAA').

Such TPO's are proceeding with selecting appropriate comparable companies for the purpose of comparison with low risk bearing taxpayers (being captive service providers), by not selecting heavyweights operating in IT/ITES industry and companies which are functionally not comparable.

Nevertheless, it should be noted that the IT/ITES industry would need to wait for some more time (and spend some more effort) to expect consistent matured positions from all TPOs in India.

21. Vodafone India Services Private Limited Vs. UOI (Writ petition 871 of 2014 (Bom))

9. Penalty

In cases, where the TP adjustment has been sustained at the Commissioner of Income Tax (Appeals) ("CIT (A)") or the Dispute Resolution Panel ("DRP") level, the AO's have been levying penalty in a routine manner without considering the quantum issue under question.

However, in the event where the taxpayer has demonstrated that the TP adjustment is because of the difference in opinion (pertaining to selection of comparable companies) and there is no malafide intentions, the CIT(A) has deleted the penalty issued by the TPOs /AOs.

B. Audit experience at various litigation levels

1. Assessment experience

The situation at the TPO level has not changed significantly, as the TPOs at ground level continue to adopt aggressive positions. However, it has to be admitted that for certain transactions (primarily IT / ITES service income on cost plus basis), the TPOs are following a matured approach which is governed by the evolution of such transactions over a period of time providing plethora of judicial precedents. Nevertheless, the aggression of the TPOs for the service payment transactions cost sharing payment transactions, reimbursement expense and income transactions etc. has been on the rise. Though, the TPOs while scrutinising such transactions collate detailed information/documents but are not having adequate knowledge/ experience to analyse the same either from transfer pricing perspectives or from taxpayers business strategy perspectives.

2. DRP experience

The experiences with some of our DRP cases have been positive. The panel has been consistent in following the precedents laid by the HC particularly in relation to the following:

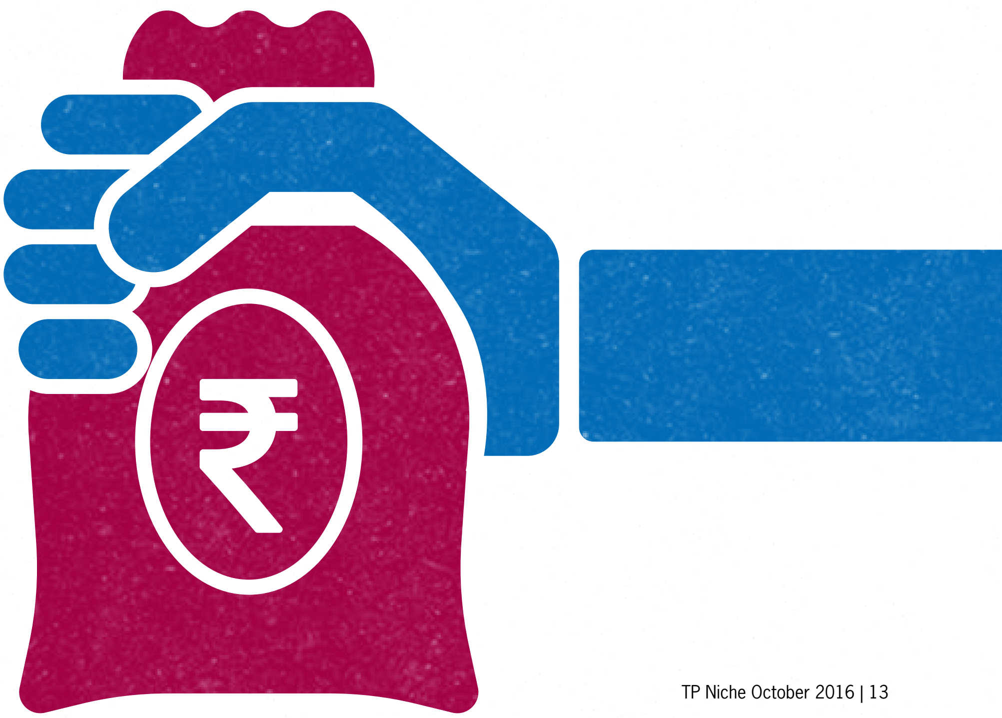
- Rejection of companies like Infosys and TCS E-Serve Limited as comparable to captive IT/ITES service providers on the ground that such companies are not comparable to captive service providers in terms of their size
- Rejection of companies like E-Clerx Services Limited on the ground that such companies are engaged in providing high end services
- Use of LIBOR based rates for determining the arm's length nature of transactions in the nature of outstanding receivables and loan denominated in foreign currency

3. ITAT experience

The experience at the ITAT level has been largely positive, as the ITAT is able to appreciate TP fundamentals and also accept judicial precedents. This provides the much needed respite to taxpayers.

4. Advance pricing agreement ("APA") experience

There is better synergy and transparency in the negotiation process adopted by the APA teams especially in the IT-ITES sector. We hope that the Indian government allocate adequate skilled manpower to this proactive TP dispute resolution mechanism to take the success of this initiative to newer heights. This will help boost India's position on the ease of doing business parameters.



From the judiciary

A. Sumitomo Corporation India Pvt. Ltd. Vs CIT[22]

AY 2007-08, 2008-09, 2009-10 and 2010-11

Facts of the case

- The taxpayer, a subsidiary of Sumitomo Corporation Japan had earned commission in respect of indenting transactions (i.e., rendered assistance by following up with the customers) with its AE on principal to principal basis. It had adopted TNMM as MAM with Berry Ratio as PLI.
- The TPO classified the taxpayer's sales into "indent sales" and "proper sales" and held that:
  - the indenting transactions should be compared to the trading transactions entered into by taxpayer with Non AE's;
  - the use of Berry Ratio, as the PLI, is to be rejected as such ratio is not permitted under Rule10B(1)(e) of the Rules.
  - the taxpayer had substantial intangibles in the form of human resource intangible and supply chain intangibles, thus Berry ratio was not appropriate.
- Taxpayer appealed before the DRP, which was ruled against the taxpayer

ITAT ruling

- ITAT held that trading transactions involved certain risks and finances, whereas in respect of indenting transactions, the taxpayer did not incur any financial obligation or carry any significant risks. However, ITAT accepted that it would be appropriate to compare commission earned by the taxpayer in respect of transactions with AEs with the similar transactions with non-AEs.
- ITAT directed that the commission be computed at the rate of 2.26 percent (i.e. the rate of commission in respect of transactions with non-AEs), not allowing any adjustment for differences in turnover

HC ruling/observations

- HC confirmed that the taxpayer was engaged in facilitation of trade and its financial commitment and risk were inconsiderable.
- Net profit margin can be calculated using "any relevant base", thus Berry ratio can be taken as PLI without any difficulty. Berry ratio would not be appropriate where the taxpayer owns unique intangibles or has fixed assets, the value of which cannot be captured in berry ratio.
- The taxpayer had business in two segments and is earning different profit margins in each segment. Berry ratio would give unreliable results if the product mix of the comparable companies is different from the product mix of the taxpayer.
- The matter was remanded back to the ITAT to decide it afresh.

Our view

- The High Court has analysed various facets relating to the application of berry ratio for determining the arm's length price under Transactional Net Margin Method. This ruling provides with circumstances under which the taxpayers can apply berry ratio for their transactions.

B. CIT vs. Mckinsey Knowledge Centre India Pvt. Ltd[23]

AY: 2006-07

Facts of the case

- Mckinsey Knowledge Centre India Pvt. Ltd ("Mckinsey India") is a wholly owned subsidiary of Mckinsey Holding Inc.
- The Company provides various support services in the area of export computer software, ITeS and research analysis & information to various McKinsey entities/ holdings across the globe.
- McKinsey India selected 11 comparables and determined TNMM as the MAM for determination of ALP
- TPO rejected 4 comparable out of 11 selected by McKinsey India. Following tabulates the reasons of rejection of the respective comparable.

22. TS-493-HC-2016(DEL)-TP
23. TS-672-HC-2015(DEL)-TP

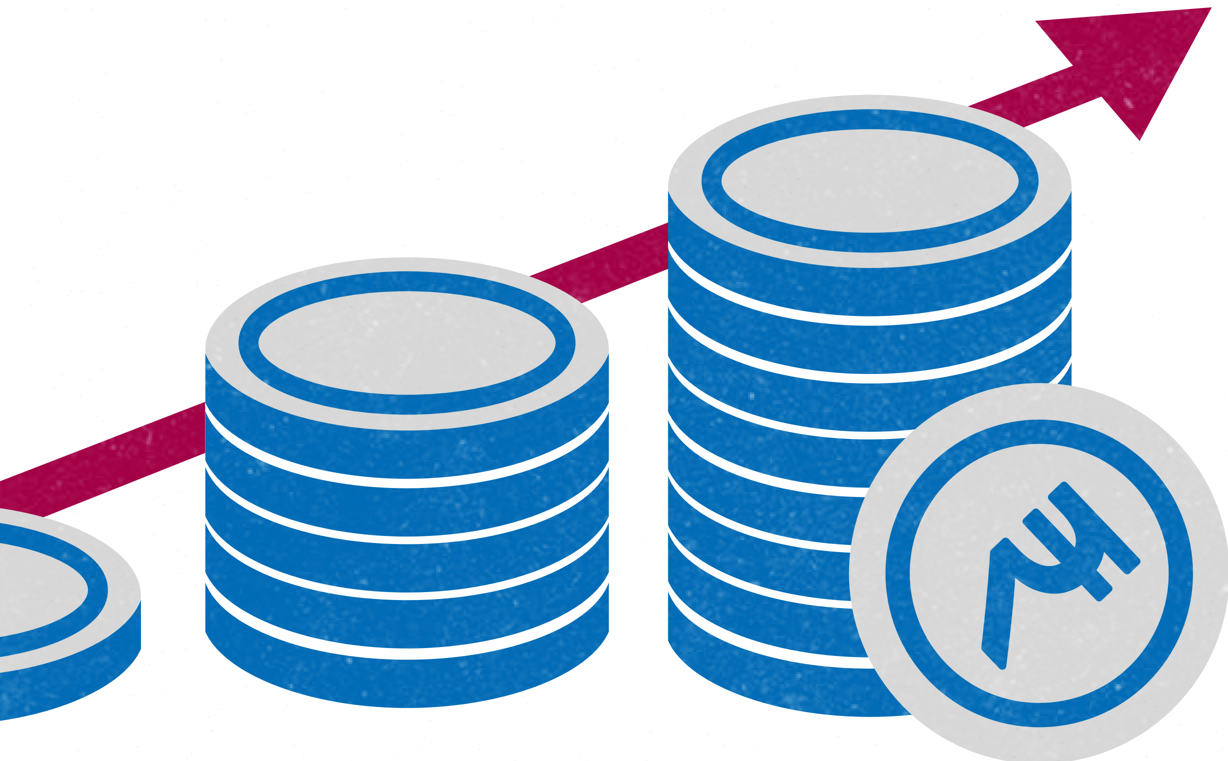
Comparables	Reasons of rejection by TPO
Fortune Infotech Ltd	the company had different financial year ending on December, 2006, whereas taxpayers FY ended on March, 2006
Kirloskar Computer Services Ltd	turnover of less than INR1 Crore
Mercury Outsourcing Management Ltd	turnover of less than INR1 Crore
Genesis International Corporation Ltd	a negative growth graph

ITAT ruling

- The ITAT ruled in favour of the taxpayer and held that all of the companies selected as comparable by the taxpayer were functionally similar and only varied in terms of certain common parameters considered for the assessment.
- The Revenue then further appealed before the HC against ITAT's order

HC ruling/observations

Company	HC observation	Ruling
Fortune Infotech Ltd.	If from the available data on record, the results for FY can reasonably be extrapolated then the comparable cannot be excluded solely on the ground that the comparables have different FY endings.	Rejection of functionally similar comparable company, merely on the ground that data for entire FY is not available, is not acceptable.
Kirloskar Computer Services Ltd and Mercury Outsourcing Management Ltd.	If the turnover filter of less than 1 Crore is applied then, the companies with a higher turnover also should have been rejected which was not the case in the said TP adjustments. The HC making a reference to Rule 10B (2) and to (4) of the Rules ruled in favour of the taxpayer and stated that where functional similarity of the comparable entity is emphasised, every effort must be made in the ALP determination to ensure that the "material effects of differences" between the tested party and the comparable must be eliminated.	It was held that the companies could not be rejected on the basis of turnover threshold limit. Therefore, emphasis is on demonstrating how the increase in turnover is an outcome of functions / assets / risks which are different between the tested parties and companies evaluated during the comparability analysis.
Genesis International Corporation	The HC, on perusal of the 2006 annual report, found that the company exhibited a considerable rise in the income over the past year.	This company has been wrongly rejected by the TPO on the grounds that it was in a negative growth phase



Tracker

A. Notifications/circulars/press release

- **CBDT Notification No. 57/2016 dt. 14 July 2016**

The CBDT has notified that where variation between ALP determined u/s 92C does not exceed 1 percent of the wholesale price (3 percent otherwise) of international or specified domestic transactions, then actual transaction price shall be taken as ALP for AY 2016-17, i.e. tolerance limits of price variation for TP purposes. Same tolerance limits were applicable for the immediately preceding year as well.

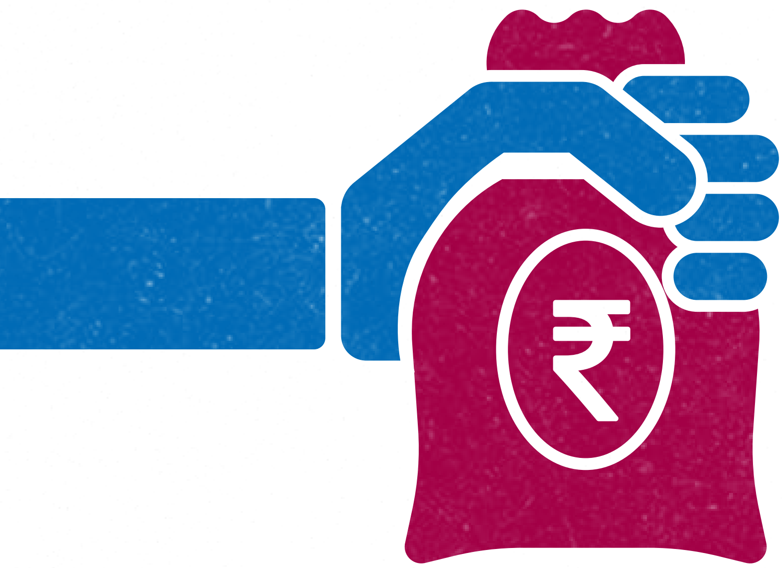
- **25 more APA signings take tally across the century mark**

CBDT has signed 25 more unilateral APAs, taking the total tally of APAs signed to 103. Out of the APAs signed, 2 include profit split methodology and 2 cases of big Indian MNCs. More than 700 applications have been filed out of which 103 agreements (99 unilateral, four bilateral) have been signed.

B. Grant Thornton thought leadership

- **BEPS goes global and local**

The article provides an interesting insight into the BEPS project and how and to what extent countries, including India, are implementing the action points. It also highlights challenges which MNCs might face along with guiding points on how one can proceed to manage these developments.



C. Articles published

- **Tested party: Concept vs. Reality**

The article is about selection of 'tested party' as one of the most basic steps in robust TP analysis, wherein it talks about the challenges in selection of a foreign AE as a tested party in absence of specific reference of tested party concept in the Indian TP regulation.

- **An examination of India's CUB (Foster's) Case**

The article covers the recent landmark judgement relating to transfer of intangibles in which the HC held that the income accruing from the transfer of intangible assets licensed for use in India was not taxable in India because the situs of ownership was elsewhere.

- **Tracing evolution of 'associated enterprises' definition under section 92A of the Act**

The article is about interpretation of sub sections (1) & (2) of section 92A of the Act which triggers the provisions of Chapter X of the Act.

D. Media

- **Indian revenue signs one more unilateral APA: GT India press release**

Grant Thornton India has successfully assisted one of its clients in the IT sector in inking their first unilateral Advanced Pricing Agreement ("APA") with the Indian Revenue within two years of filing the application in 2014.

The above news was also covered in the following:

Taxmann

Taxsguru

Global corner

This section highlights the TP environment worldwide to give a wider perspective on what is happening around the world. For this issue we have selected the U.S., wherein our counterparts in US have summarised the impact of actions under BEPS Action plan on their existing provisions.

A. Key developments in the US on country – by-country reporting

1. IRS issues final regulations on BEPS country-by-country reporting

The IRS issued final regulations on June 29 2016 that will require U. S. multinationals with more than US$ 850 mn in revenue, to report specific information on a country-by-country basis for the first time.

The regulations were drafted to comply with new country-by-country reporting ("CbCR") standards created by the BEPS project of the OECD.

The new reporting will require information, on a jurisdictional basis, information on a U.S. MNE group's revenues, taxes paid, number of employees, functions performed and certain other indicators of profit allocation within the group.

The final regulation largely adopts the proposed regulations, but with important changes to address a number of technical issues and clarify the rules. Many of these changes to the proposed regulations were made in order to be consistent with OECD minimum standards. The final regulations are generally effective starting with the tax year of the MNE's ultimate U.S. parent that begins on or after June 30, 2016. Treasury is working on a voluntary reporting option for tax years beginning prior to 30 June 2016, and on or after 1 January 2016, but such procedures will be provided in the forthcoming guidance.

2. CbCR at a glance

1. The reporting is required of the ultimate parent entity ("UPE") of a U.S. MNE meeting the US$ 850 mn threshold. The rules also apply if the U.S. business entity is required to consolidate the accounts, or its accounts would be consolidated, if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange.
2. If a UPE of a U.S. MNE is required to comply with CbCR, it must file Form 8975 by the extended due date of its U.S. federal income tax return.
3. Accordingly, Form 8975 will likely have three sections including the following:
   - Constituent entity information
   - Financial and employee information aggregated by tax jurisdiction
   - A space to provide additional information
4. The final regulations generally apply beginning with the UPE tax year that begins on or after 30 June 2016.

Definitions

1. UPE: A U.S. business entity that meets both of the following conditions:
   - Owns directly or indirectly a sufficient interest in one or more non-U.S. business entities such that it is required to consolidate the accounts of the other business entities with its own accounts under U.S. GAAP
   - Is not owned directly or indirectly by another business entity that consolidates the accounts of the U.S. business entity with its own accounts under U.S. GAAP
2. U.S. business entity: A business entity that is organised or has its tax jurisdiction of residence in the United States.
3. Business entity: It includes partnerships, permanent establishments ("PE") and disregarded entities ("DREs").

3. Final regulations

The final regulations amend the proposed regulations to address a number of technical issues and associated divergence from the BEPS standards. Some of the most important changes are discussed below.

U.S. territories and fiscal autonomy

The proposed regulations defined "tax jurisdiction" as a country or a jurisdiction that is not a country but that has "fiscal autonomy." The final regulations clarify that a U.S. territory or possession of the United States-defined as American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands--is considered to have fiscal autonomy for purposes of CbCR.

Surrogate parent entity filings

The preamble to the final regulations states that the IRS will not permit surrogate parent entity filing in the United States by foreign corporations because of resource constraints.

However, the final regulations say that a U.S. territory UPE may designate a U.S. business entity that it controls to file form on behalf of the U.S. territory UPE.

Business entities

The final regulations modify the term "business entity" in several key ways.

The first modification is to the reference to a PE in the definition of business entity. The final regulations provide that the term "PE" includes any of the following:

- A branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a permanent establishment under an income tax convention to which that tax jurisdiction is a party
- A branch or business establishment of a constituent entity that is liable to tax in the tax jurisdiction in which the branch or business establishment is located pursuant to the domestic law of such tax jurisdiction
- A branch or business establishment of a constituent entity that is treated in the same manner for tax purposes as an entity separate from its owner by the owner's tax jurisdiction of residence

The term "business entity" was also modified to exclude decedents' estates, individuals' bankruptcy estates and grantor trusts, the owners of which are individuals.

The final regulations do not redefine constituent entity reaffirming that reporting isn't required for foreign corporations or foreign partnerships for which the ultimate parent entity isn't required to furnish information

Stateless income

The proposed regulations were unclear regarding whether a country with a purely territorial tax regime--for example, Hong Kong--could be a tax jurisdiction of residence. Such ambiguity left uncertainty over whether the rules should be interpreted to treat all entities in tax jurisdictions with territorial tax regimes as stateless entities. Treasury stated in the preamble to the final regulations that the language in question was intended to indicate that a business entity will not have a tax jurisdiction of residence in a jurisdiction solely by being liable to tax in the jurisdiction on fixed, determinable, annual or periodical income from sources or capital situated in the jurisdiction. Accordingly, the final regulations were updated to unambiguously include purely territorial tax regimes as tax jurisdictions of residences.

4. Effective date and gap year

The final regulations generally apply beginning with the UPE tax year that begins on or after 30 June 2016. Accordingly, calendar year taxpayers are not required to comply until the 2017 calendar tax year.

This raised concerns for many taxpayers, because the OECD set standards recommending that jurisdictions implement requirements starting in 2016, and for most taxpayers the final regulations would not be effective until 2017. Because legislation in many of these jurisdictions includes secondary mechanisms (that require local reporting if the parent entity's jurisdiction doesn't require CbCR), this created what's been referred to as the "gap year." Without a voluntary submission alternative, many U.S. multinationals would be forced to comply with country-by-country requirements at various local levels during this so-called gap year.

The final regulations did not provide the "gap year" relief many taxpayers had hoped for, but the IRS stated in the preamble that it intends to allow U.S. MNEs to voluntarily file Form 8975 for reporting periods that begin on or after 1 January 2016, but before the applicability date of the final regulations. The preamble to the final regulations states that the treasury is working to ensure that foreign jurisdictions implementing CbCR requirements won't require foreign subsidiaries of U.S. MNEs to comply with foreign jurisdictions' secondary mechanisms if the U.S. MNE voluntary files Form 8975 with the IRS. The final regulations note that the procedures for this voluntary filing are to be provided in separate, forthcoming guidance.

5. Next steps

Taxpayers should carefully review the final regulations and consider whether they will be subject to the CbCR requirements. Failure to comply could result in civil and criminal penalties and an extended statute of limitation period for the income tax return filed by the UPE and for all related returns. In addition to the U.S. consequences, failure to comply could result in various reporting requirements under secondary mechanisms enforced by foreign jurisdictions that may also carry penalties and other consequences.

Complying with the final regulations may be a significant burden. Preparation could include changes or upgrades to ERP systems, identifying data sources, capturing data by permanent establishments as well as legal entity and analysis to determine entities included in the U.S. MNE group and respective jurisdictions in which such entities are subject to income tax. Overlaying the complexities of stateless income, partnership aggregation and other requirements under the final regulations could prove to be a daunting task for many U.S. MNEs.

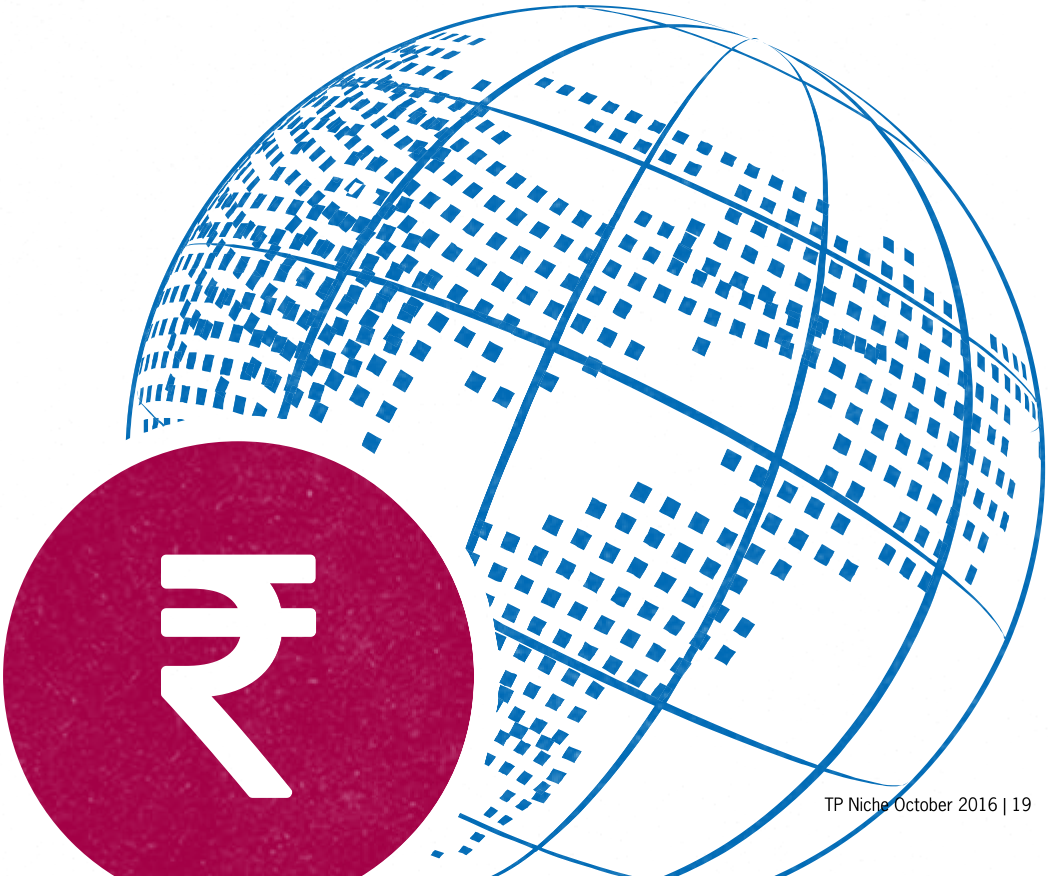
Complying with CbCR may also spotlight other pre-existing issues. The reporting could expose inadequate TP policies. On the other hand, collecting this data may greatly expand a U.S. MNE's ability to perform analytics, reduce risk and drive value from within the tax function.

B. CBDT : Signs first Bilateral-APA having "rollback" provision with Japanese company's Indian subsidiary

CBDT enters into bilateral APA with Indian subsidiary of a Japanese trading company on 2 August 2016, taking the overall Bilateral APA tally to 4.

C. OECD issues discussion drafts on PE-profit attribution and revised guidance on profit-splits

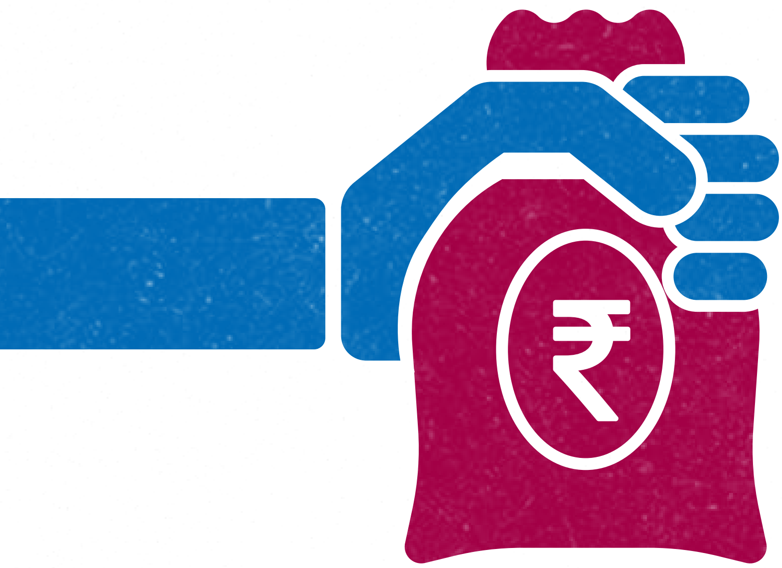
The guidelines aim at clarifying and strengthening the guidance on the transactional PSM in the context of global value chains.



Glossary

Abbreviations	Full name
AE	Associated enterprises
ALP	Arm's length price
APA	Advance price agreement
AO	Assessing officer
AY	Assessment year
BEPS	Base erosion and profit shifting
CBDT	Central Board of Direct Taxes
CbC	Country by country
CIT(A)	Commissioner of Income Tax (Appeals)
CPM	Cost plus method
CUP	Comparable uncontrolled price
DEMPE	Development, enhancement, maintainence, protection and exploitation
DRP	Dispute resolution panel
FAR	Functions, assets and risks
FY	Financial year
HC	High Court
ITAT	Income Tax Appellate Tribunal

Abbreviations	Full name
IT	Information technology
ITES	Information technology enabled services
IP	Intellectual property
KPO	Knowledge process outsourcing
LIBOR	London interbank offered rate
OECD	Organisation for Economic Cooperation and Development
PLI	Profit level indicator
PLR	Prime lending rate
PSM	Profit split method
RBI	Reserve bank of India
RPM	Resale price method
SBI	State bank of India
The Act	Indian Income-tax Act, 1961
The Rules	Indian Income-tax Rules, 1962
TNMM	Transactional net margin method
TP	Transfer pricing
TPO	Transfer pricing officer



Contact us

To know more, please visit **www.grantthornton.in** or contact any of our offices as mentioned below:

NEW DELHI
National Office
Outer Circle
L 41 Connaught Circus
New Delhi 110001
T +91 11 4278 7070

AHMEDABAD
BSQUARE Managed Offices
7th Floor, Shree Krishna
Centre
Nr. Mithakali Six Roads
Navrangpura
Ahmedabad 380009
T +91 76000 01620

BENGALURU
5th Floor, 65/2, Block A,
Bagmane Tridib, Bagmane
Tech Park,
C V Raman Nagar,
Bengaluru - 560093
T +91 80 4243 0700

CHANDIGARH
B-406A, 4th Floor
L&T Elante Office Building
Industrial Area Phase I
Chandigarh 160002
T +91 172 4338 000

CHENNAI
Arihant Nitco Park,
6th Floor, No. 90,
Dr. Radhakrishnan Salai
Mylapore
Chennai 600004
T +91 44 4294 0000

GURGAON
21st Floor, DLF Square
Jacaranda Marg
DLF Phase II
Gurgaon 122002
T +91 124 462 8000

HYDERABAD
7th Floor, Block III
White House
Kundan Bagh, Begumpet
Hyderabad 500016
T +91 40 6630 8200

KOCHI
7th Floor, Modayil Centre
point
Warriam road junction
M. G. Road
Kochi 682016
T +91 484 406 4541

KOLKATA
10C Hungerford Street
5th Floor
Kolkata 700017
T +91 33 4050 8000

MUMBAI
16th Floor, Tower II
Indiabulls Finance Centre
SB Marg, Elphinstone (W)
Mumbai 400013
T +91 22 6626 2600

MUMBAI
9th Floor, Classic Pentagon
Nr Bisleri factory, Western
Express Highway
Andheri (E)
Mumbai 400099
T +91 22 6176 7800

NOIDA
Plot No. 19A, 7th Floor
Sector – 16A
Noida 201301
T +91 120 7109 001

PUNE
401 Century Arcade
Narangi Baug Road
Off Boat Club Road
Pune 411001
T +91 20 4105 7000

For more information or for any queries, write to us at **contact@in.gt.com**

Follow us **@GrantThorntonIN**

Grant Thornton
An instinct for growth™