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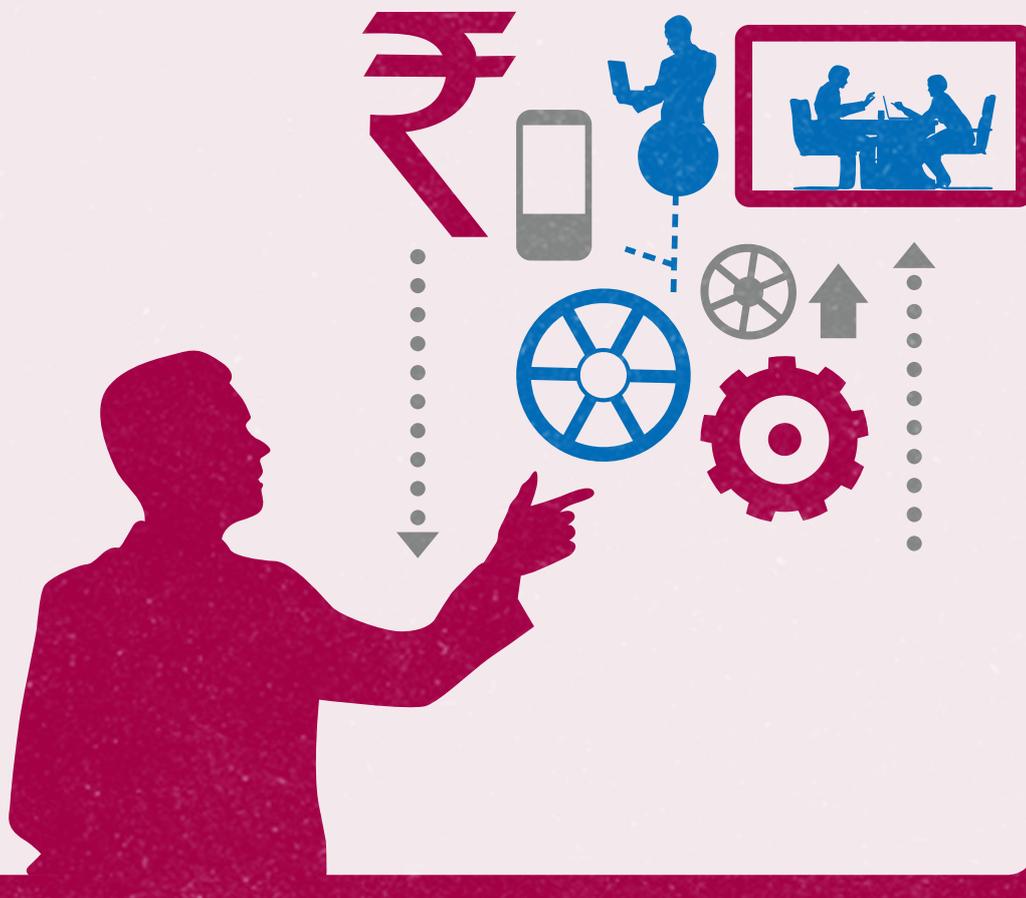
A spectrum of transfer pricing issues

Quarterly Edition: January-March 2017



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Foreword



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Dear Readers,

We are glad to present our quarterly newsletter TP Niche. The objective of this newsletter is not only to share our experience on emerging transfer pricing (TP) trends, but provide readers valuable insights on its evolving nature in India as well.

This issue of TP Niche covers a wide range of transfer pricing topics categorised under five sections: 'Perspective', 'Our experience', 'From the judiciary', 'Tracker' and 'Global corner'.

The Perspective section covers an analysis of the AMP expenses in the Indian landscape.

In 'Our Experience' section, we share our experience of complying with arm's length principle from a regulatory perspective, which includes Companies Act, 2013, SEBI (Listing Obligations and Disclosure Requirement).

With so many decisions being pronounced by the Tribunal and High Courts on transfer pricing issues on a regular basis, it is challenging to keep track of fundamental positions emerging from such decisions on peculiar issues. With this in mind, we have summarised the recent key rulings covering the IT/ITeS sectors from Tribunal and High Court in the section - 'From the judiciary'.

'Tracker' section lists key developments in the form of notifications, circulars and other publications touching different legislative and practical aspects of TP, which can work as a ready reckoner for our readers.

'Global Corner' is a section which is designed to highlight the key developments in the TP regimes of some key jurisdictions. In this edition, we have covered recent developments in the TP regime of Australia.

We hope that you will find this TP Niche edition engaging and informative. In case you have any comment or query, please reach out to us. Your feedback is valuable.



Perspective

This section emphasises on transfer pricing (TP) issues related to Advertising, Marketing & Promotional (AMP) expenses. It provides a viewpoint on the present Indian scenario in light of the recent judicial precedence.

A. Overview:

One of the most widely publicised and followed topics in TP is the characterisation of AMP expenses as an international transaction and benchmarking of the same. The ruling of the Hon'ble Delhi High Court (HC)¹ has given a different perspective to the issue by concluding that the Bright Line Test (BLT) has no statutory mandate and that the incidence of international transactions cannot be determined by application of quantitative methods. Further it held that if Transactional Net Margin Method (TNMM) is accepted as the most appropriate method, then it would be inappropriate for the revenue to treat a particular expenditure like AMP as a separate international transaction. However, the revenue authorities have taken up the matter before the Hon'ble Supreme Court (SC) of India, which is pending disposal. Considering the above, the revenue authorities during the primary assessment stage continue to treat the AMP expenses as an International transaction and are carrying out TP adjustments. Considering the same, the AMP expense issue is being litigated before the appellate authorities drawing the attention of the tax payers.

B. AMP Expenses:

AMP expenses form a critical component of the expenditure of any entity, as this provides the requisite visibility for the products dealt with by the entity in its territory of operation. It makes the products/services visible to the potential/targeted customers and in turn strengthens its market presence. Advertising/marketing / promotional activities are defined as follows: Identifying potential customers/vendors.

Advertising: Advertising is bringing a product (or service) to the attention of potential and current customers. Advertising is typically done with signs, brochures, commercials, direct mailers or e-mail messages, personal contact, etc.

Marketing Activities: Marketing is the wide range of activities involved in making sure that an entity continuing to meet the requirements of its customers and gets value in return. Marketing activities include "inbound marketing", such as market research to find out, for example, what groups of potential customers exist, what their requirements are, which of those requirements can be met, how it should be met, etc.

The activities discussed above relates to the AMP expenses and does not include selling expenses, like selling commission paid to distributors/dealers, marketing commission paid to sales agents, discount on goods, gifts to end customers, etc., as these expenses do not contribute to the development of/increase in the visibility of the brand of the products. The special bench of the Income-tax Appellate Tribunal (ITAT) in the case of LG Electronics India² had held that the expenses for promotion of sales and expenses in connection with the sales have to be kept in different compartments. While expenses for the promotion of sales directly lead to brand building, the expenses directly in connection with sales are only sales specific and hence do not correspond to brand building.

1. Hon'ble Delhi HC in the case of Sony Ericsson Mobile Communications India Private Ltd Vs CIT (374 ITR 118)

2. TS-11-ITAT-2013(DEL)-TP-LG_Electronics_Special_Bench.pdf



The AMP expenses incurred by the assessee would result in an allowable expenditure for the entity concerned, in case the following requirements are satisfied:

- AMP expenses are incurred on its own account by the Indian entity and is not based on the direction/guidance from its AEs to promote the AEs brand image
- There are no deliberate and concerted action on behalf of the Indian entity to promote the brand image/logo of its AEs
- The Indian entity is the economic owner of the brand in the region concerned, failing which at least the Indian entity should not be barred from claiming economic ownership of the brand in the region concerned
- AMP expenses should enable the entity to increase its market share for its products/services and in turn to strengthen the brand presence in the region concerned
- AMP expenses incurred is with regard to the products dealt with by the entity concerned
- AMP expenses are wholly and exclusively incurred for the purposes of the business of the entity concerned and if at all AEs derive any benefit, then it would be incidental in nature
- AMP expenses incurred by the Indian entity is revenue in nature and does not result in an enduring benefit
- Indian entity is not involved in brand building or brand promotion business

By demonstrating the above requirements, the entity incurring the AMP expenses would be better placed to claim the same as an allowable expenditure from an income-tax perspective. In addition, the entity concerned has to demonstrate that the said expenditure has been incurred by it on its own account, by capturing sufficient evidence in this regard. This would negate the proposition, if any, put forth by the revenue authorities that the AMP expenses are incurred by the entity concerned at the behest of the AE and with an intention to promote the brand of the AEs.

C. Indian TP audit landscape³

The tax authorities had analysed the AMP expenses incurred by Indian tax payers for its compliance from an arm's length perspective. In this regard, the revenue authorities during the course of the audit had concluded that the AMP expenses incurred by the tax payer to be an international transaction based on the following criteria:

- Ownership of the brand name/logo including its intangible rights in India
- Application of BLT by Indian revenue authorities for ascertaining:
 - The list of companies that are carrying on comparable activities was identified from the public domain
 - The AMP cost incurred by the identified comparable companies as a percentage of sale value were computed
 - The average percentage of AMP expenses incurred by the identified comparable companies were computed and it formed the Bright Line
 - The AMP expenses of the Indian entity is computed as a percentage of the sale value of the entity concerned
 - In case the AMP expenses (as a percentage of sales) of the Indian entity is more than the Bright Line as computed above, then:
 - The Indian revenue authorities concluded that the Indian entity has rendered services to its Associated Enterprises ("AE"), in improvising their brand value in India.
 - Consequently, it was concluded by the Indian revenue authorities that:
 - Indian entity had entered into an international transaction with its AEs
 - The arm's length nature of the said international transactions to be computed, by recommending a cost plus mark-up for the services rendered by the Indian entity.

3. Reliance placed on

- (i) Goodyear India Limited - TS-115-HC-2017(DEL)-TP
- (ii) Nippon Paint India Pvt Ltd - TS-102-ITAT-2017(CHNY)-TP
- (iii) Bacardi India Pvt Ltd - TS-1052-ITAT-2016(DEL)-TP
- (iv) Widex India Pvt Ltd - TS-60-ITAT-2017(CHANDI)-TP

On appeal by the tax payer, the Hon'ble Delhi HC⁴ had ruled in the following manner with regard to characterisation of the AMP expenses as international transactions and its benchmarking requirements:

iv. The incidence of international transactions:

- BLT has no statutory mandate
- The onus is on the revenue authorities to demonstrate the incidence of the international transactions with positive material that the Indian entity and its AEs have come together and there was a unison or agreement for acting together for some common purpose⁵.
- Whether there exists an arrangement between the Indian entity and its AE to promote the brand owned by its AEs? Arrangements can be in any form, either written agreements or oral or a mutual understanding or acting in concert, etc. This would put forth that there exist international transactions and subsequent to the same, the said international transaction has to be evaluated for its compliance with arm's length requirements.
- The revenue authorities cannot construct a 'transaction' or 'international transaction' on the basis of assumption or surmises.
- International transactions cannot be constructed by undertaking a mathematical analysis and thereby inferring, implying or presuming that the parties would have been acting in concert.

Appropriateness of Berry ratio in case of Sogo Shosha

The above ruling of the HC (on AMP expenses) has been contested upon by the revenue authorities before the Hon'ble SC of India and the appeal has been accepted for analysis and disposal. However, the appellate authorities have consistently held that AMP expenses do not constitute international transactions in the absence of any agreement or arrangement between the entities concerned. In this regard, the ITAT has placed reliance on the ruling of the HC. In another case,⁶ the Hon'ble Delhi HC had refused to revisit the principles laid down in the above ruling, thereby confirming the principles laid down therein.

Considering the fact that the revenue authorities have filed an appeal before the Hon. SC of India, the lower revenue authorities continue to characterise the AMP expenses incurred by the tax payers as an international transaction and have proposed TP adjustments by computing the arm's length price for the said transactions. With regard to the above, it is recommended that the entities concerned incurring substantial AMP expenses may consider evaluating the same and to document the facts involved.

D. Conclusion:

Entities incurring AMP expenses need to take sufficient care to ensure that:

- v. The facts involved are clearly captured in the TP analysis.
- vi. The AMP expenses vis-à-vis selling expenses incurred by the Indian entity is clearly segregated and it may be ensured that necessary disclosures are made, to avoid inclusion of selling expenses as part of AMP expenses by the revenue authorities while evaluating the arm's length compliance of the AMP expenses.
- vii. The tangible benefit, if any, enjoyed by the entity is clearly documented
- viii. To substantiate that the AMP expenses were incurred wholly and exclusively for its business.
- ix. The revenue nature of the AMP expenses should be demonstrated and in addition to demonstrating that there is no enduring benefit arising out of the said expenditure.

In case there exists an arrangement/agreement with AEs with regards to the promotion of the AE's brand in India, then:

- x. The same may be suitably considered in the TP document and necessary disclosures be made in the TP certificate
- xi. To conclude on the requirement of an arm's length compensation (cost plus mark-up) for the entity towards the services rendered.

In case there does not exist an arrangement/ agreement/ understanding, etc., then the basis and requirement of incurring the said AMP expenses and the benefit generated by incurring the AMP expenses may be clearly brought forward at the time of preparation of the TP document itself.

4. Hon'ble Delhi HC in the case of Sony Ericsson Mobile Communications India Private Ltd Vs CIT (374 ITR 118)

5. Moser Baer India Ltd 316 ITR 1

6. Goodyear India Limited [TS-115-HC-2017(DEL)-TP]



Our experience

This section focuses on Grant Thornton India LLP’s (Grant Thornton India/GTILLP) experience on evaluating the arm’s length pricing of related party transactions of a Listed Company from Companies Act 2013 perspective.

Introduction

This section focuses on Grant Thornton India LLP’s (“Grant Thornton India”/ “GTILLP”) experience on evaluating the arm’s length pricing of related party transactions of a Listed Company from Companies Act 2013, perspective. This section seeks to highlight the key differences between the “Regulatory Provisions” (i.e. The Companies Act, 2013, Clause 49 of the Listing Agreement and Ind AS 24) and the Indian TP Regulations in relation to the definition of the term Related Party and Related Party transactions. This will also bring out the interplay between the TP Regulations and the Regulatory Provisions in evaluating the arm’s length compliance of the related party transactions.

Related Parties

The Act 2013 was enacted on August 30, 2013. The Companies Act substantially widened the scope of the term “Related Party Transactions” by introducing two new Sections i.e. - Section 2(76) “Related Party” and Section 188

“Related Party Transactions”. These sections came into force from April 1, 2014.

The applicability and definition of the term related party as per the Companies Act, 2013, Clause 49 of the Listing Agreement and Ind AS 24 is summarised in table below:

Particulars	Companies Act, 2013	Ind AS 24	Clause 49 of the Listing Agreement
Applicability	All companies incorporated under the Act or any other previous company law	All companies having net-worth equal to or more than INR 500 crore from FY 2016-17	All Listed Companies
Key criteria defining related party relationship	<p>“Related party”, with reference to a company, means:</p> <ul style="list-style-type: none"> • Directors • Manager • Key managerial personnel (“KMP”) • KMP of the holding company or her/his relatives • Directors, other than independent directors, of the holding company • Holding company, Subsidiary Company or Associate Company (only for Public companies) 	<p>As per Ind AS 24, related party includes</p> <ul style="list-style-type: none"> • Fellow subsidiaries • Associates of the entity and other members of the group • Joint ventures of the entity and other members of the group • Members of key management personnel of the entity or of a • parent of the entity including close members of their families • Persons with control, joint control or significant influence • over the entity including close members of their families • Post-employment benefit plans • Entities or any of their group members providing key management personnel services to the entity or its parent 	<p>Related Party means:-</p> <ul style="list-style-type: none"> • related party as defined under Section 2(76) of the Companies Act, 2013; or • related party as per applicable accounting standards

A comparative analysis of the term “Related Party” as per the Transfer Pricing Regulations and as per the Regulatory Provisions are provided in table below:

Particulars	Transfer Pricing Regulations	Regulatory Provisions
Governing provision	<ul style="list-style-type: none"> International Transactions -Section 92A Domestic Related Parties- Section 40A(2)(b) 	<ul style="list-style-type: none"> The Companies Act, 2013 - Section 2(76) Clause 49 of the Listing Agreement Ind-AS 24
Related Parties – Key definitions	<p>Associated Enterprises:</p> <ul style="list-style-type: none"> The key criteria's specified defining two entities to be AEs are as under: <ul style="list-style-type: none"> one enterprise holds directly or indirectly shares carrying not less than 26 per cent of the voting power in the other enterprise; a where a person/enterprise holds shares carrying not less than 26 per cent of the voting power in each such enterprises, the two enterprises shall be regarded AEs. 	<p>Related parties as per the Regulatory provisions include:</p> <ul style="list-style-type: none"> Associate Company defined to be a company in which another Company has significant influence and includes a joint venture. Significant influence is defined as one enterprise holding 20 per cent or more shareholding in the other enterprise Director/relatives of Directors, KMP/relatives of KMP Substantial interest criteria not required to be satisfied to be treated as related parties. E.g. Mere common directorship in two companies will result in those two companies being treated as related parties from the Companies Act, 2013 perspective.
	<p>Domestic Related Parties</p> <p>Entities/Units enjoying full/partial tax holiday exemption</p>	

Thus the Regulatory Provisions are much wider and would cover a greater list of related parties as compared to the definition of related party under the **Companies Act** as the threshold is only 20 per cent as against 26 per cent in the Act and in addition the definition as per the Ind AS further expands the scope of the term.

Related Party Transactions

A comparative analysis of the term “Related Party Transactions” as per the Transfer Pricing Regulations and as per the Regulatory Provisions are as under:

Particulars	Transfer Pricing Regulations	Regulatory Provisions
Governing Provisions	<ul style="list-style-type: none"> International Transaction- Section 92B Specified Domestic Transactions(“SDT”)- Section 92BA 	<ul style="list-style-type: none"> The Companies Act, 2013- Section 188 read with Companies (Meetings of Board and its Powers) Rules, 2014 Clause 49 of the Listing Agreement Ind AS 24
Related Party Transactions covered	<p>International Transactions</p> <ul style="list-style-type: none"> Purchase, sale, transfer, lease or use of tangible or intangible property Capital financing Provision of services Transaction of business restructuring or reorganisation <p>SDT: It is defined as Transaction entered into by an entity with:</p> <ul style="list-style-type: none"> Tax holiday units <ul style="list-style-type: none"> All transactions (both income and expenditure transactions) undertaken by tax holiday unit with domestic related parties Inter Unit transfers also covered 	<p>Covered Transactions as per Regulatory Provisions, as per all the three governing regulations</p> <ul style="list-style-type: none"> sale, purchase or supply of any goods or materials; selling or otherwise disposing of, or buying, property of any kind; leasing of property of any kind; availing or rendering of any services; appointment of any agent for purchase or sale of goods, materials, services or property; such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and underwriting the subscription of any securities or derivatives thereof, of the company. <p>Other points for consideration under Regulatory provisions (all the three regulations)</p> <ul style="list-style-type: none"> Financial /Guarantee Transactions are not covered by virtue of Section 186 of the Companies Act, 2013. Inter Unit transfers within tax holiday entity not covered. Transactions in the nature of pure reimbursements whether to be considered as covered transaction or not, is subject to interpretations, even though it might not have any implications as it does not involve any markup.



The table on the previous page shows that a larger set of transactions would be covered within the definition as provided in the Income-tax Act, 1961 and other relevant regulations as compared to the Act.

In addition, the definition of related party transaction as per the regulatory provisions are more stringent as compared to The Income-tax Act, 1961 as the transactions with related parties u/s. 40A(2)(b) have been excluded from the applicability of the transfer pricing provisions as per Income-tax Act, 1961 (hereinafter referred as TP provisions).

Analysis of Related Party Transactions

Section 188 of the Companies Act provides that transactions with related parties that:-

- i. are not entered in the ordinary course of business; or
- ii. are not at arm's length require prior approval of the Board and where the transaction exceeds the specified threshold, mandates a prior approval from the shareholders.

Further in respect of a Listed Company, all related party transactions are required to be approved by the audit committee as per Section 177 of the Companies Act, 2013.

In this context, reference may be drawn to Clause 49 of the Listing Agreement which provides that following conditions be fulfilled by a listed company in respect of transactions entered with related parties:

- Listed companies shall obtain approval of shareholders through special resolution in respect of all material related party transactions.
- In respect of related party transactions not exceeding Rs.1 crore, the audit committee of listed company is authorised to grant an omnibus approval, subject to compliance with the following conditions:
 - Omnibus approval is granted only in respect of transactions which are repetitive in nature, and only if the audit committee is satisfied for the need of such approval in the interest of the company;
 - Such approval is granted in compliance with a detailed guidelines/criteria laid down by the audit committee.

On a combined reading of the above provisions, it is clear that the requirement for a related party transaction to comply with arm's length pricing from a Companies Act perspective is more to ensure that:

- i. there are no conflicts of interest arising from entering into such related party transactions and to protect the interest of the shareholders; and
- ii. prior approval from the board and shareholders (if applicable) is obtained where such related party transactions are not in the ordinary course of business or not at arm's length, in addition to obtaining approval from audit committee.

Any such contract or arrangement which has been entered without obtaining the consent of the board/shareholders has to be ratified by the board/shareholders as the case may be within three months from the date on which such contract or arrangement has been entered.

What is Ordinary Course of Business?

The Companies Act, 2013 does not define the term "Ordinary Course of Business". In the absence of an authoritative guidance, the term should be interpreted to mean transactions that are directly or indirectly connected to or necessary for the conduct of its business.

Determining whether a particular related party transaction is entered in the ordinary course of business or not would require an in depth understanding of the business of the assessee and would pose many practical difficulties in the absence of guidelines. Consider the following example:

Scenario

A Company which is engaged in the manufacturing of automobiles is also providing IT support services to its group companies. The IT support cost incurred by the said company is recovered on cost to cost basis by using appropriate allocation keys. Whether such IT support services offered by the company qualify as rendered in the ordinary course of business?

For a transaction to be regarded as in the ordinary course of business, it is not essential that the transaction should form part of the core activity undertaken by the Company. Thus all transactions that are ancillary to the core activity or transactions that facilitate/support the routine operations of a company will still constitute as transactions entered into in the ordinary course of business.

Thus in the given scenario the company had extended IT support services to its group companies to ensure that their IT infrastructure and support system necessary for carrying the routine activities are intact. As the company had additional capacity from its existing resources and had extended the resources to its related party with an intention to optimally utilise the available resources, the rendering of IT support services could be considered to have been entered in the ordinary course of business.

Arm's Length analysis of related party transactions

The term Arm's length transaction has been defined in Section 188 of the Companies Act, 2013 to mean transactions between two related parties that are conducted as if they were unrelated so that there is no conflict of interest. However there is no guidance in the Companies Act, 2013 on application of the arm's length principle. Since specific guidance under the Companies Act, 2013 is not available, reliance can be placed on the Indian Income-tax Act, 1961, Organisation for Economic Cooperation and Development (OECD) guidelines and United Nations (UN) TP manual for the purposes of determining arm's length nature of transactions.

It is pertinent to note here that the key difference between the TP provisions and the Companies Act, 2013 with regard to arm's length pricing is that the Companies Act focuses more on commercial rationale and business necessities and the manner in which the prices have been determined considering the prevailing market conditions and prudent business practices and does not provide for any specific method for determination of the arm's length price unlike TP regulations which has laid down various methods for determining the arm's length price. Further under the Companies Act, 2013 approval is required to be sought for every transaction while the TP Provisions allows aggregation of transactions for the purposes of determining arm's length pricing.

The determination of arm's length price from a Companies Act, 2013 perspective is forward-looking requiring analysis of the contracts/ documents and other supporting documents/ information based on which the transaction pricing has been determined.

Arm's Length analysis - Practical Scenarios

Scenario 1:

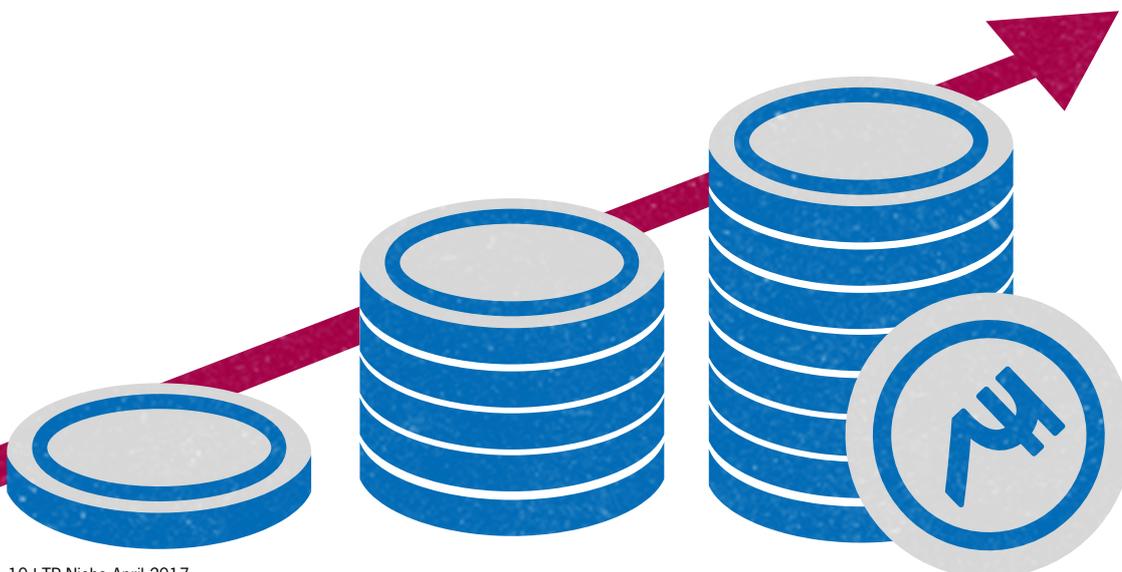
A company engaged in manufacturing operations proposes to enter into a transaction with a related party for sale of scrap wherein the transaction has been finalised based on e-auction. Whether it can be considered to be satisfying the arm's length requirement?

In an E-Auction process, the specification of the item to be sold along with the price is posted on the e-auction database by the seller. All the potential bidders (buyers), including the related party, would submit its quote and the transactions is finalised based on the best competitive terms. Accordingly in the above scenario, it can be inferred that the transaction has been concluded with the related party on the basis of competitive quote submitted in the e-auction process and hence it satisfies the arm's length requirement. The same can be considered by the approving authority to grant approval.

Scenario 2:

A company engaged in the manufacturing operations proposes to sell its used assets to its related party. The selling price is determined on the basis of quotes received from third parties. Whether the said transaction can be concluded to be satisfying the arm's length requirement?

The above transaction can be concluded to be in the ordinary course of business since it is a common practice across the industry to sell the used assets that are no longer required in the manufacturing process. Further, since the selling price is proposed to be determined on the basis of a quote received from an unrelated third party, the basis of determination of the price can be concluded to be at arm's length. The company is required to maintain adequate documentation to support the basis on which the selling price is determined.





Scenario 3:

The prices of product is determined on the basis of internal cost sheet that captures the cost of manufacturing the product. The final selling price is determined by considering the average margin as laid down by the management. Whether the said transaction can be concluded to be satisfying the arm's length requirement?

Even though the company sells the product at comparable margins (profit/cost%) to related as well as to unrelated entities, it would be advisable to maintain detailed documentation to demonstrate the characteristics and similarity of the products being compared to ensure that the profit % being compared is of same/similar products. This would be a key requirement to conclude on the arm's length nature of the transactions.

Scenario 4:

The price at which the product is proposed to be purchased from related party is higher than the quote received from unrelated third party for similar products. Can this transaction be concluded to satisfy the arm's length requirement?

Commercial rationale, business decisions and market strategies play a key role in determining whether a transaction is concluded at arm's length, from a Companies Act, 2013 perspective.

Accordingly, in the above scenario the transaction should be analysed from a business perspective considering the following factors:-

- quality of the product sold by related party vis-à-vis unrelated third party
- customer satisfaction survey reports on quality of the products sold by related party vis-à-vis unrelated third party
- ability of the supplier to promptly meet the delivery schedule provided by the company
- ability of the supplier to meet the demand requirements of the company
- other similar business considerations that are having a direct impact on the pricing of the product

Considering all the above factors, the said transaction can be considered to be satisfying the arm's length requirement from Companies Act, 2013 perspective. However given the nature of transaction, the onus lies on the Company to maintain robust documentation while entering into the transaction and to ensure that the criteria laid down at the time of approval by the Audit Committee is supported by facts of the transaction.

Scenario 5

Adjustment to the prices - Market penetration

Company, as part of its market penetration strategy, proposes to sell its products to related party dealers at highly competitive prices. Whether the said transaction can be considered to be at arm's length?

The company, while entering into the above transaction should maintain a robust documentation quantifying the amount of adjustment to the prices proposed to be made on account of its business strategy and quantify the expected future benefits/earnings from such strategy. This will ensure that criteria laid down at the time of approval by the Audit Committee is supported by facts of the transaction. Similarly even in scenarios where a company proposes to offer volume discounts as part of its strategy to boost its sales, it is essential to maintain sufficient documentation as evidence that volume discounts offered are in line with the industry practices.

Conclusion

The review of related party transactions from a Companies Act, 2013 perspective focuses more on the commercial rationale and current business requirements as it is based on past experience. Guidance provided at the time of approval has to be strictly complied with and should be backed by documentary evidences.

From the judiciary

This section focuses on the particulars of the comparable companies discussed/analysed in the recent judicial pronouncement by various benches of the Income Tax Appellate Tribunal during the last quarter i.e. January-March 2017

A: ANALYSIS OF COMPARABLES

COMPANIES ENGAGED IN SOFTWARE DEVELOPMENT

S. no.	Comparable name	Case law	AY	Accepted / Rejected by ITAT	Remarks	Threshold for applying filters
1	Sankhya Infotech Ltd.	Thomson Reuters India Services Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Engaged in development of software products	-
		CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Absence of segmental details	-
2	Visual Soft Technologies Ltd.	Thomson Reuters India Services Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Engaged in substantial R&D activities and not comparable with routine software development service provider	-
3	Melstar Information Technologies Ltd.	Thomson Reuters India Services Pvt. Ltd.	2005-06	Accepted	Functionally similar to the taxpayer - Clears all the filters applied by Transfer Pricing Officer (TPO)	-
4	Acropetal Technologies Limited	TIBCO Software India Pvt. Ltd.	2010-11	Rejected	Functionally dissimilar - Engaged in rendering engineering design services	-
5	R Systems International Limited	Polaris Consulting & Services Ltd.	2008-09	Rejected	Functionally dissimilar - Engaged in development of software products	-
6	Wipro Limited	Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at 1-200 crore



S. no.	Comparable name	Case law	AY	Accepted / Rejected by ITAT	Remarks	Threshold for applying filters
7	Infosys Technologies Limited	Ut Starcom Inc (India Branch)	2007-08	Rejected	Functionally dissimilar - High turnover, risk-taking company; owns huge significant intangibles	-
		Arowana Consulting Pvt. Ltd.	2011-12	Rejected	Fails upper turnover filter; Functionally dissimilar - substantial brand value	Threshold for applying sales turnover filter is determined at 1/10th or 10 times of turnover
		Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1- 200 crore
8	KALS Information System Limited	Ut Starcom Inc (India Branch)	2007-08	Rejected	Functionally dissimilar - Engaged in executing end to end project through the entire value chain of software development life cycle	
		TIBCO Software India Pvt Ltd.	2010-11	Rejected	Functionally dissimilar - Engaged in development of software products	
		NovellSoftware Development (Ind.) Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar	
		Polaris Consulting & Services Ltd.	2008-09	Rejected	Functionally dissimilar - Engaged in development of software products	
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar - Derives revenue from software services and software products; segmental information unavailable	
9	Tata Elxsi Limited	Ut Starcom Inc (India Branch)	2007-08	Rejected	Functionally dissimilar - Renders integrated hardware and package software solution	-
		NovellSoftware Development (Ind.) Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar	-
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar; segmental information unavailable	
		Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1-200 crore
10	Avani Cimcon Technologies Ltd	Polaris Consulting & Services Ltd.	2008-09	Rejected	Functionally dissimilar - Engaged in software product development and segment details were unavailable	-
11	Accel Transmatic Ltd	Polaris Consulting & Services Ltd.	2008-09	Rejected	Functionally dissimilar - Software development service company	-
		NovellSoftware Development (Ind.) Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar	-
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar	-

S. no.	Comparable name	Case law	AY	Accepted / Rejected by ITAT	Remarks	Threshold for applying filters
12	Celestial Ltd	Polaris Consulting & Services Ltd	2008-09	Rejected	Functionally dissimilar - Engaged in clinical research and manufacture of bio products	-
13	E-Zest Solutions Ltd	Polaris Consulting & Services Ltd.	2008-09	Rejected	Functionally dissimilar - Renders product development services and high-end technical services which come under the category of Knowledge Process Outsourcing(KPO) services	-
		TIBCO Software India Pvt. Ltd.	2010-11	Accepted	Functionally similar	-
14	Ishir Infotech Ltd.	Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails employee cost filter	Threshold for Employee cost filter determined at 25% on turnover
15	Lucid Software Ltd.	Polaris Consulting & Services Ltd	2008-09	Rejected	Functionally dissimilar - Engaged in development of software products	-
		NovellSoftware Development (Ind.) Pvt Ltd	2006-07	Rejected	Functionally dissimilar	-
16	Megasoft Ltd.	NovellSoftware Development (Ind.) Pvt. Ltd	2006-07	Rejected	Functionally dissimilar	-
17	Thirdware Solutions Ltd.	Polaris Consulting & Services Ltd	2008-09	Rejected	Functionally dissimilar - Engaged in development of software products	-
		TIBCO Software India Pvt Ltd	2010-11	Rejected	Functionally dissimilar - Development of software product, trading of software licences and training implementation activities	-
		CA India Technologies Pvt Ltd	2005-06	Rejected	Functionally dissimilar - Engaged in trading and development of software products; segmental information not available	-
18	Infosys Ltd.	TIBCO Software India Pvt Ltd	2010-11	Rejected	Functionally dissimilar - Engaged in development of software products	-
		NovellSoftware Development (Ind.) Pvt.Ltd	2006-07	Rejected	Functionally dissimilar	-
		CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar	-
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Fails turnover filter	Threshold for applying sales turnover filter is determined at 1/10th or 10 times of turnover
19	FCS Software Ltd.	TIBCO Software India Pvt. Ltd.	2010-11	Rejected	Functionally dissimilar - Engaged in development of software products	-
20	Evoke Technologies Ltd.	TIBCO Software India Pvt. Ltd.	2010-11	Accepted	Functionally similar	-
21	E-Infochips Ltd.	TIBCO Software India Pvt. Ltd.	2010-11	Accepted	Functionally similar	-



S. no.	Comparable name	Case law	AY	Accepted / Rejected by ITAT	Remarks	Threshold for applying filters
22	Persistent Systems Limited	NovellSoftware Development (Ind.) Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar	-
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar - Engaged in development of software products	-
		Polaris Consulting & Services Ltd	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1 - 200 crores
23	Aztec Software Ltd.	NovellSoftware Development (Ind.) Pvt. Ltd	2006-07	Rejected	Functionally dissimilar	-
		Valtech India Systems Pvt Ltd	2006-07	Rejected	Fails RPT filter	Threshold for RPT filter determined at 15% of turnover
24	Geometric Software Ltd.	NovellSoftware Development (Ind.) Pvt. Ltd	2006-07	Rejected	Functionally dissimilar	-
		CA India Technologies Pvt Ltd	2005-06	Rejected	Functionally dissimilar; Segmental details not available	-
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Fails RPT filter	Threshold for RPT filter determined at 15% of turnover
25	Flextronics Software Ltd.	NovellSoftware Development (Ind.) Pvt. Ltd.	2006-07	Rejected	Functionally dissimilar - Product company	-
		CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - End to end provider of communication products, services and solutions to network equipment providers	-
		Valtech India Systems Pvt Ltd	2006-07	Rejected	Fails turnover filter	Threshold for applying sales turnover filter is determined at 1/10th or 10 times of turnover
		Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1-200 crore
27	Tanla Solutions	PTC Software India Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Engaged in development of software products Extraordinary event - Acquisition	-
28	Geodesic Information Systems Ltd.	PTC Software India Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Engaged in development of software products; segmental information not available	-
29	Trident Infotech Corporation Ltd.	PTC Software India Pvt. Ltd.	2005-06	Rejected	Fails RPT filter	Threshold for RPT filter has not been specified
30	Exensys Software Solutions Ltd. (ESSL)	CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - High brand value; extraordinary event	-

S. no.	Comparable name	Case law	AY	Accepted / Rejected by ITAT	Remarks	Threshold for applying filters
31	Foursoft	CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Engaged in development of software products	-
32	Compulink	CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar - Engaged in rendering software development services, project management training and consultancy services; segmental details not available	-
33	Satyam Computer Services Ltd.	CA India Technologies Pvt. Ltd.	2005-06	Rejected	Functionally dissimilar	-
34	L&T Infotech Ltd.	Arowana Consulting Pvt. Ltd.	2011-12	Rejected	Functionally dissimilar; fails upper turnover filter	Threshold for applying sales turnover filter is determined at 1/10th or 10 times of turnover
35	Akshay Software Technologies Ltd.	Arowana Consulting Pvt. Ltd.	2011-12	Accepted	Functionally similar - No specific reason provided by the TPO for rejection	-
36	Bodhtree Consulting Ltd.	Narus Networks Private Ltd.	2009-10	Accepted	Functionally similar; not disputed in previous years	
		Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Abnormal variation in profit margins	-
37	Lanco Global Solutions Ltd.	Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Fails RPT filter	Threshold for RPT filter determined at 15% of turnover
38	IGate Global Solutions Ltd.	Valtech India Systems Pvt Ltd	2006-07	Rejected	Fails turnover filter	Threshold for applying sales turnover filter is determined at 1/10th or 10 times of turnover
		Polaris Consulting & Services Ltd	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1-200 crore
39	Mindtree Ltd.	Valtech India Systems Pvt. Ltd.	2006-07	Rejected	Fails turnover filter	Threshold for applying sales turnover filter is determined at 1/10th or 10 times of turnover
		Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1-200 crore
40	Sasken Communication Technologies Ltd.	Polaris Consulting & Services Ltd.	2008-09	Rejected	Fails turnover filter	Threshold for sales turnover filter determined at Rs. 1-200 crore



B: ITAT RULINGS

I. Sandvik Information Technology AB vs DDIT - AY 2005-06

Facts of the case

- The taxpayer, a non-resident company in Sweden had received fees towards rendering IT support services to the Indian entity. The taxpayer filed its return of income declaring NIL income and filed Form 3CEB in respect of the international transactions entered into with the Indian entity.
- The initial assessment proceedings were closed by the Assessing Officer (AO) without referring the international transaction to the TPO for arm's length determination.
- The AO later reopened the assessment proceedings on the ground that one of the group companies of the assessee, had in its Form 3CEB disclosed a payment of Rs. 2.38 crore made to the assessee for availing IT support services, which constituted a tangible material in the hands of the AO to believe that income chargeable to tax for AY 2005-06 had escaped assessment.
- The taxpayer argued that the information based on which the assessment was reopened was already available with AO and that there was no fresh material or reason to believe that income of the taxpayer has escaped assessment and preferred an appeal before the Dispute Resolution Panel (DRP).
- The DRP held that the reopening of assessment was invalid and ruled in favour of the taxpayer.

ITAT Ruling

- ITAT held that the AO did not have any new information or tangible material on record to believe that income has escaped assessment. It was also held that mere ignorance on part of the AO does not constitute a valid ground for reopening the assessment.
- ITAT also ruled that the DRP has powers to adjudicate jurisdictional issues and set aside variations proposed by the TPO.

II. Valtech India Systems Pvt. Ltd. vs ACIT - AY 2006-07

Facts of the case

- The taxpayer is a software development service provider and had identified nine comparable companies while determining the arm's length price of the transactions entered into with its AEs.
- The TPO rejected the TP study of the taxpayer and proposed an upward adjustment by carrying out a fresh search.
- The taxpayer had argued on the application of related party filter, sales turnover filter and treatment of extraordinary expenses as non-operating. The summary of the TPO's argument, taxpayer's contention and the ITAT Ruling is as under:



Issue	TPO's argument	Taxpayer's contention	ITAT Ruling
Determining the threshold for RPT filter	Threshold for applying RPT filter should be determined at 25%	Threshold for applying RPT filter should be determined at 15%	<ul style="list-style-type: none"> Threshold limit should be determined based on the number of comparables available If the comparables are adequate the threshold can be determined at 15% and if the comparables are scarce, threshold should be determined at 25% Since good number of comparables are available in the taxpayer's case, threshold should be determined at 15% of turnover
Determining threshold for sales turnover	Threshold for applying sales turnover filter should be determined at Rs.1-100 crore	Threshold for applying sales turnover filter should be determined at 1/10th and 10 times of the taxpayer's revenue	<ul style="list-style-type: none"> Turnover filter should not be applied based on fixed slabs 1/10th and 10 times of the taxpayer should be considered as the basis for applying sale turnover filter
Extraordinary expenditure should be considered as non-operating	Extraordinary expenditure should be considered as non-operating for the purpose of determining taxpayer's margin	Expenditure incurred were in the normal course of business and should not be considered non-operating	<ul style="list-style-type: none"> Extraordinary expense incurred by the taxpayer, which otherwise would not have been incurred in the ordinary course of business alone should be considered as non-operating.

III. Axa Business Services Private Limited vs DCIT

Facts of the case

- The taxpayer is an IT-enabled service provider operating on a fixed cost plus model.
- The taxpayer had incurred certain expenditure on behalf of their AEs and later recovered it at cost without charging any mark-up.
- Since these expenditure were not routed through the profit and loss account and were incidental in nature, the taxpayer argued that such expenditure should not form part of the cost base for the purpose of determining mark-up.
- However, the TPO determined the arm's length price by proposing a mark-up on such expenditure incurred by the taxpayer on behalf of the AEs and proposed an upward adjustment.

ITAT Ruling

- ITAT observed that the expenditure incurred by the taxpayer on behalf of the AEs comprised of staff welfare expense, software expense, recruitment & training expense, travelling & conveyance expense etc. ITAT held that since the expenditure incurred by the taxpayer were for the purpose of rendering services to the AEs, an arm's length mark-up should be charged on such expenses.

IV. Carraro India Pvt. Ltd. vs ACIT – AY 2008-09

Facts of the case

- The taxpayer is engaged in providing design engineering and IT-enabled services (ITES) to its AEs.
- The revenue appealed against the order of CIT (A) in directing the AO to include export incentives as operating income for computation of operating margins of both comparable companies and of taxpayer.
- The taxpayer had contended that export benefit was to be included as a part of the operating profit, and had relied upon ITAT and HC rulings in case of Welspun Zucchi Textiles Ltd. Vs. ACIT in this regard. Taxpayer had also contended that working capital adjustment was to be allowed.

ITAT Ruling

- ITAT dismissed revenue's appeal against CIT(A) order. It held that export incentives should be considered as operating income for computation of operating margins of taxpayer as well as comparable companies; by relying on ITAT and HC rulings in case of Welspun Zucchi Textiles Ltd. vs. ACIT.
- With regard to working capital adjustment, ITAT held since taxpayer's transaction price falls within 5 per cent range of ALP determined by TPO, no adjustment was required to be made and hence dismissed the taxpayer's claim for working capital adjustment holding it to be academic in nature.



Tracker

A. Notifications/Press Releases

- **The Platform for Collaboration on Tax issued a draft toolkit to help developing countries address the lack of comparables for TP analysis**

The toolkit addresses the ways developing countries can overcome a lack of data on comparables, or the market prices for goods and services transferred between members of multinational corporations.

- **CBDT clarifies on rollback availability for bilateral APA under revised India-Korea DTAA**

The rollback provision would be available for bilateral APA application filed by taxpayers for APA period beginning FY 2017-18. Inclusion of rollback in such bilateral APAs would be subject to regulations of Korea.

- **CBDT's APA Programme crosses the 150 Milestone**

The total number of APAs entered by the CBDT has reached 152. This includes 11 bilateral and 141 unilateral APAs. More than 800 applications have been filed in the last five years.

B. Budget 2017

- **Secondary Adjustment**

Sec 92CE has been introduced to provide for secondary adjustment, recording the primary transfer pricing adjustment in the books of account and to repatriate the funds to India.

- **SDT**

Scope of domestic TP provisions has been limited to transactions between domestic related parties, where one of the parties is eligible for claiming profit-linked deduction.

- **Interest deduction rules.**

The budget introduced limitations on interest deductions to 30 per cent of cash profit in the hands of an Indian taxpayer on borrowings obtained from foreign AE or even from third parties and guaranteed by AEs.

C. Articles published

- **For ease of doing business, MNCs need simple rules, not high pitched safe harbour rules**

The article analyses the present safe harbour rules and talks about the changes that are being looked at to ensure ease of doing business in India.

- **Secondary adjustments – A paradigm shift towards arduous TP Regime**

The article sets out in detail the secondary adjustment provision proposed in the Union Budget 2017-18.

- **Evolving Transfer Pricing Regulations: Are we in sync globally?**

The article talks about alignment of Indian TP regulations with global best practices.



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 Australia, focusing on the guidelines issued by the Australian Tax Office (ATO) outlining the approach to transfer pricing issues related to offshore marketing hubs

A. ATO Guidance on off-shore marketing hubs

On 16 January 2017, the Australian Taxation Office (ATO) released Practical Compliance Guideline 2017/1 (PCG), that lays down the compliance approach to TP issues related to centralised operating models (hubs) covering procurement, marketing, sales and distribution functions. The PCG has been released as part of Australia's efforts to implement the Base Erosion and Profit Sharing (BEPS) action plans. Australia has taken a proactive approach in implementing the BEPS action plans, having already introduced others such as Country-by Country reporting.

This PCG is the first of a series of guidance from the ATO and focuses on marketing hubs. The PCG arose from the ATO's long-standing concerns about offshore entities operating as marketing hubs in supply chain, especially in Singapore and Hong Kong. This leads to shifting of profits which impacts Australia's tax base.

The principles arising from this PCG are not limited to marketing hubs. It is expected that the ATO would release further schedules detailing guidance for other types of hubs.

The PCG is broken down into three key parts:

Part A: Lays down the general indicators and principles of the hub framework which apply to all types of offshore hubs for both inbound and outbound activities.

Part B: Provides guidance to assist taxpayers when preparing their TP analysis if their hub operations fall outside the low-risk benchmark.

Schedules: The schedule attached to this guideline sets out the specific indicators relevant to marketing hubs.

The ATO recommends that taxpayers perform a self-assessment of the TP risk of any offshore hub that they deal with. It is key to note that the ATO prefers to take preventive over correction approach on compliance and are willing to work with taxpayers to mitigate their TP risk.

The PCG is effective from 1 January 2017 and will apply to both new and existing hubs.

Part A – The hub risk framework

What is a hub?

The definition of “hub” as per the PCG is very broad. For an entity to be considered as hub, the following conditions should be met:

- The entity is a related offshore entity or a permanent establishment of a related Australian entity or related foreign entity;
- The entity acts as agent or principal of the taxpayer in relation to the procurement or sale of goods or commodities; and
- The entity sells the goods/commodities or provides a service on behalf of the taxpayer without substantial alteration.

The PCG is based on the premise that the hubs have commercial and economic substance. Some examples of establishing the commercial rationale for hubs include:

- Efficiencies and synergies for the global group through centralisation of activities;
- An ability for the taxpayer to access economies of scale in the procurement of third party goods/services; and
- Benefits associated with key staff being located close to major markets.



Risk assessment framework

If a taxpayer has a hub, they are able to use the principles in the PCG to self-assess their compliance risk. To facilitate this, the ATO has developed the hub compliance risk framework:

- White zone – self-assessment of risk rating unnecessary
- Green zone – low-risk
- Blue zone – low to moderate risk
- Yellow zone – moderate to high-risk
- Amber zone – high-risk, and
- Red zone – very high-risk.

A taxpayer can work out the risk rating for its hub having regard to a number of factors including possible tax at risk, pricing indicators, and the quality of their TP documentation.

It is not necessary for the taxpayers to self-assess the risk rating (white zone) of their hub if the arrangement is covered by:

- Advanced Pricing Arrangement
- Settlement agreement with the ATO
- Court decision within the last two years on TP outcomes of the hub
- Low-risk rating from an ATO review

For a taxpayer to assess whether it falls in the green zone, there is a need to test arrangements using the methodology in the schedule and compare it to the outcomes against the ATO low-risk benchmarks present the schedule. It is important to note that the methodologies outlined in the schedules to test pricing outcomes do not indicate the ATO is advocating the use of that particular method as a preferred price-setting TP method. Rather, the methodologies are used as a method for the Commissioner to cross-check the reliability of other methods and the reasonableness of the outcomes of the taxpayer's price-setting method.

Importantly, the PCG stresses that the green zone is not a safe harbour, and taxpayers in this zone must still meet their obligation to meet arm's length pricing requirements.

For the ATO to effectively allocate its resources to cases which exhibit greater risk, cases outside the green zone are separated. Further categorisation is determined considering the tax impact of a taxpayer's hub arrangements for a relevant year and whether the taxpayer has TP documentation which meets the requirements of Division 284-E of Schedule 1 to the Taxation Administration Act 1953.

For example, based on the guidance provided for marketing hubs in the schedule, if the tax impact is below \$5 million per annum and the taxpayer has prepared documentation in accordance with Division 284-E of Schedule 1 to the Taxation Administration Act 1953, it would come in the blue zone. If any of these conditions are not met, the taxpayer would either move to the yellow or the amber zone, depending on the tax impact.

For taxpayers that are outside the green zone can decrease their risk rating by engaging cooperatively with the ATO after applying for an APA or by having an internal team work to achieve a low-risk rating. By cooperating with the ATO, a taxpayer may be able to move to either the green zone or, if the criteria for the white zone is met, to the white zone.

The Commissioner recognises that the publication of the PCG may cause taxpayers to review their hubs with the effect that some taxpayers may adjust their pricing policies to move into the green zone in future. If a taxpayer does intend to adjust its pricing going forward, the Commissioner is willing to cooperate to resolve cases of previous years. If a taxpayer takes no action regarding back years, it will be subject to the compliance approach for hubs outside the green zone in those years.

Part B – Guidance for preparing a TP analysis

Part B of the PCG provides guidance to assist taxpayers with their TP analysis should they fall outside the green zone. There is no presumption that if taxpayers fall outside the green zone, their TP outcomes are incorrect. Rather, it means the ATO considers they are at risk of obtaining a TP benefit. In general, the higher a taxpayer's risk rating, the more detailed and comprehensive the ATO would expect its TP and supporting documentation to be.

The PCG sets out framing questions which the ATO will consider when reviewing a hub, which should be considered when undertaking a TP analysis. These questions fall into the following categories:

Commerciality of the hub: In considering the commerciality of a hub, the key considerations include determining the economic substance and commercial purpose of a separate or centralised hub and what are the arm's length commercial and financial relations with respect to the hub arrangement. In addition to these factors, it is also important to consider whether there is evidence that the activities of the hub are adding value to the global value chain and whether there is evidence of market conduct that resembles the structure of the associated entities.

Functions of the hub: In considering the functions of the hub, it is important to look at the evidence available to substantiate that key decision-making is happening in the hub. In considering this evidence, it must also be examined whether there is evidence that if these key functions have been moved offshore, Australia is no longer physically performing these functions.

Evidence regarding the risks assumed by the hub: It is important to consider the nature of the risk borne in substance by the hub. In doing so, there needs to be evidence that supports which risks are economically significant to the value chain and that the hub has the financial capacity and the ability to control and bear the risks involved. In addition, it must be considered whether there is specific documentation which supports the commercial conduct of the effective risk transfer to the hub.

Commerciality/arm's length nature of the pricing arrangements: In assessing this factor, it is important to look at whether the profit accruing in the hub reflects the true economic contribution made by the hub and whether they can be reconciled with reference to profit outcomes observed in other similar independent entities. In addition, in assessing the arm's length nature of pricing arrangements there needs to be a consideration of evidence that demonstrates regular review of price setting.

As far as possible, taxpayers should support evidence in the form of primary documents, not narratives. These primary documents include financial statements, legal agreements, key performance indicators which are considered favourable as compared to a narrative description of these documents.

Schedule 1 - Application to marketing hubs

An offshore related party would be treated as an "offshore marketing hub", if:

- an Australian resident sells goods or commodities via, or supported by, this offshore related party(s) having commercial and economic substance; and
- it acts as an agent or principal in relation to the marketing and sale of goods or commodities sourced (directly or indirectly) from Australia, without substantial alteration.

An offshore marketing hub will be assessed as being in the green zone if it satisfies the low-risk benchmark. The low-risk benchmark is based on the cost plus indicator where the hub profit is less than or equal to 100 per cent markup of hub costs.

For a taxpayer to assess risk, taxpayers having an offshore marketing hub arrangement will need to:

- Apply the cost plus methodology to the actual accounting results of an offshore marketing hub at the end of the income year, and
- Compare the results to the cost plus indicator.

When calculating their cost base, a taxpayer should include operating costs related to the marketing and sales activities of the hub. However, the following should be excluded from the cost base:

- The cost of the commodity itself in instances where the tested hub has taken title to the goods or commodities before they are on-sold
- pass through costs, and
- costs related to generating revenue separate from the sales and marketing function.

To assess base rating, taxpayers need to calculate the tax impact of their offshore hubs. Broadly the tax impact is the difference between the actual hub profit and profit outcome that arises when applying the cost plus indicator. The following formula can be used to calculate the tax impact;

$$\text{Tax impact} = [\text{Hub profit less 100\% markup above costs}] \times \text{non-attributed income ratio} \times \text{Australian company tax rate.}$$

Note that the non-attributed income ratio is that part of hub profit that is not attributed back to and taxed in Australia under Australia's CFC provisions.

If hub profit is higher than the cost plus indicator a taxpayer may still qualify to be in the green zone if it can apply the Australian CFC rules. Further, if a taxpayer's offshore marketing hub has made a loss for the income year, there will be no need to apply the cost plus indicator. Provided the taxpayer calculates revenues and costs in accordance with the PCG, the offshore marketing hub will enter the green zone.

Australian multinationals with routine offshore distributors may inadvertently find they have an offshore marketing hub, and while it would be expected that such distributors would fall within the low-risk zone, there may be disclosure requirements associated with such arrangements.

The influence of these factors in assessing an appropriate zone for a marketing hub is demonstrated in the below table.



Zone	Description
Green Zone	<ul style="list-style-type: none"> • A taxpayer is in the green zone if it meets one of the following: <ul style="list-style-type: none"> - Hub profits are less than or equal to 100% markup of hub costs, or - Full attribution of hub profit through the Australia CFC rules. • Will be eligible to access the simplified record-keeping option
Blue Zone	<ul style="list-style-type: none"> • Tax impact is below \$5 million per annum • A taxpayer will remain in the blue zone if: <ul style="list-style-type: none"> - It has TP documentation, and - Its documentation meets the requirements explained in Taxation Ruling 2014/8 – Transfer pricing documentation and Subdivision 284-E (“TR 2014/8”) <p>If a taxpayer does not meet the criteria, its risk rating will be increased and it will be pushed into the yellow zone.</p>
Yellow Zone	<ul style="list-style-type: none"> • Tax impact is between \$5 million and \$50 million per annum • A taxpayer will remain in the yellow zone if: <ul style="list-style-type: none"> - It has TP documentation, and - The documentation meets the requirements defined in TR 2014/8. <p>If a taxpayer does not meet this criteria, its risk rating will be increased and it will be moved into the red zone.</p>
Amber Zone	<ul style="list-style-type: none"> • Tax impact is above \$50 million per annum • A taxpayer will remain in the amber zone if: <ul style="list-style-type: none"> - It has TP documentation, and - Documentation meets the requirements defined in TR 2014/8. <p>If a taxpayer does not meet the criteria, its risk rating will be increased and it will be pushed into the red zone.</p>
Red Zone	<ul style="list-style-type: none"> • The taxpayer will be in the red zone if it is unable or choose not to apply risk methodology or calculate tax impact • A taxpayer will move to the amber zone if: <ul style="list-style-type: none"> - It have TP documentation that meets the requirements defined in TR 2014/8, and - It has provided a copy of TP documentation (including details of global value chain) to the ATO on or before return is lodged, and - It has provided all other information requested by the ATO

B. OECD peer review for BEPS minimum standards

OECD released key documents forming the basis on which peer review of Action 13 and Action 5 will be carried out. The peer review documents, approved by the Inclusive Framework on BEPS, provide the terms of reference and the methodology that will be followed by the jurisdictions to complete the review. All members of the Inclusive Framework on BEPS are committed to implement the minimum standards and participate in the peer review.

C. US tax court rules in favour of Amazon in \$1.5 billion tax dispute

The US Tax Court has ruled in favour of Amazon in respect to TP adjustments, relating to a cost-sharing agreement for transfer of intangibles that would have increased the taxable income of Amazon by \$1.5 billion. The Court rejected the DCF approach followed by the IRS for recalculation of buy-in payment for Amazon’s transfer.

Citations

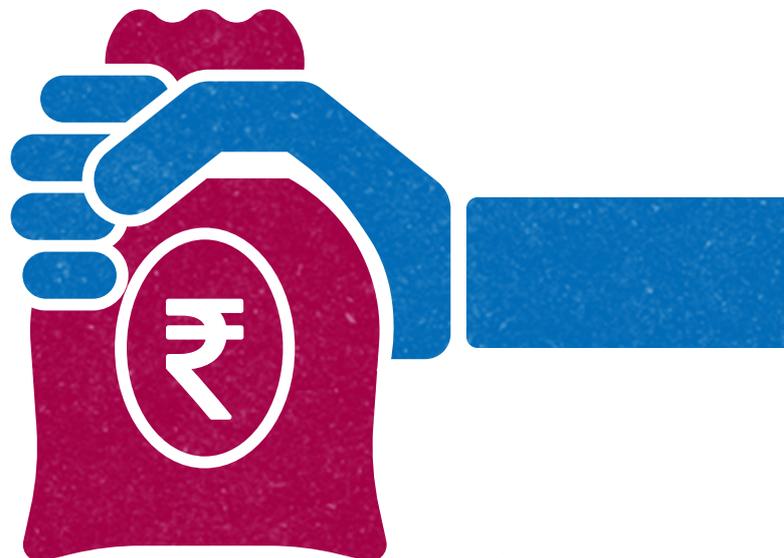
Case Laws	ITA Citation
Sandvik Information Technology AB vs DDIT	TS-1055-ITAT-2016(PUN)-TP
Valtech India Systems Pvt. Ltd. vs ACIT	TS-70-ITAT-2017(Bang)-TP
Axa Business Services Private Ltd. vs DCIT	¹ TS-1032-ITAT-2016(Bang)-TP
Carraro India Pvt Ltd vs ACIT	TS-26-ITAT-2017(PUN)-TP
Arowana Consulting Pvt. Ltd.	TS-47-ITAT-2017(Bang)-TP
CA India Technologies Pvt. Ltd.	TS-39-ITAT-2017(Mum)-TP
Narus Networks Private Limited	TS-55-ITAT-2017(Bang)-TP
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TIBCO Software India Pvt. Ltd.	TS-49-ITAT-2017(PUN)-TP
Ut Starcom Inc (India Branch)	TS-1063-ITAT-2016(DEL)-TP
Valtech India Systems Pvt. Ltd.	TS-70-ITAT-2017(Bang)-TP



Glossary

Abbreviations	Full name
	Accountant's Report
AE	Associated enterprises
ALP	Arm's length price
AMP	Advertising, marketing and promotions
AO	Assessing officer
APA	Advance price agreement
ATO	Australian Taxation Office
AY	Assessment year
BEPS	Base erosion and profit shifting
BLt	Bright Line Test
CBDT	Central Board of Direct Taxes
CPM	Cost plus method
CUP	Comparable uncontrolled price
DRP	Dispute resolution panel
FAR	Functions, assets and risks
FY	Financial year
GP	Gross profit
Grant Thornton/GTILLP	Grant Thornton India LLP
HC	High court
IRS	Internal Revenue Service
IT	Information technology
ITAT	Income Tax Appellate Tribunal

Abbreviations	Full name
ITeS	Information technology enabled services
KMP	Key Managerial Personnel
KPO	Knowledge Process Outsourcing
MAP	Mutual agreement procedure
MNE	Multinational Enterprise
OE	Operating expenses
OECD	Organisation for Economic Cooperation and Development
OP	Operating profit
PCG	Practical Compliance Guidance 2017
PE	Permanent establishment
PLI	Profit level indicator
RPT	Related party transaction
SC	Supreme Court
SDT	Specified domestic transactions
The Act	Indian Income-tax Act, 1961
The Form	Form 3CEB
The Rules	Indian Income-tax Rules, 1962
TNMM	Transactional net margin method
TP	Transfer pricing
TPO	Transfer pricing officer



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