

Contemporary issues on Transfer Pricing



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Overview



Transfer Pricing – The story so far

1991

- India welcomed foreign investments and opened up gates for globalisation

2001

- Transfer Pricing provisions introduced in India.
- Section 92A to 92F and Rules 10A to 10E were introduced w.e.f 1st April 2002

2009

- Dispute resolution mechanism introduced to expeditiously resolve TP disputes.
- Dispute Resolution Panel was set up.
- Concept of 'Safe Harbour' Rules was introduced

2012

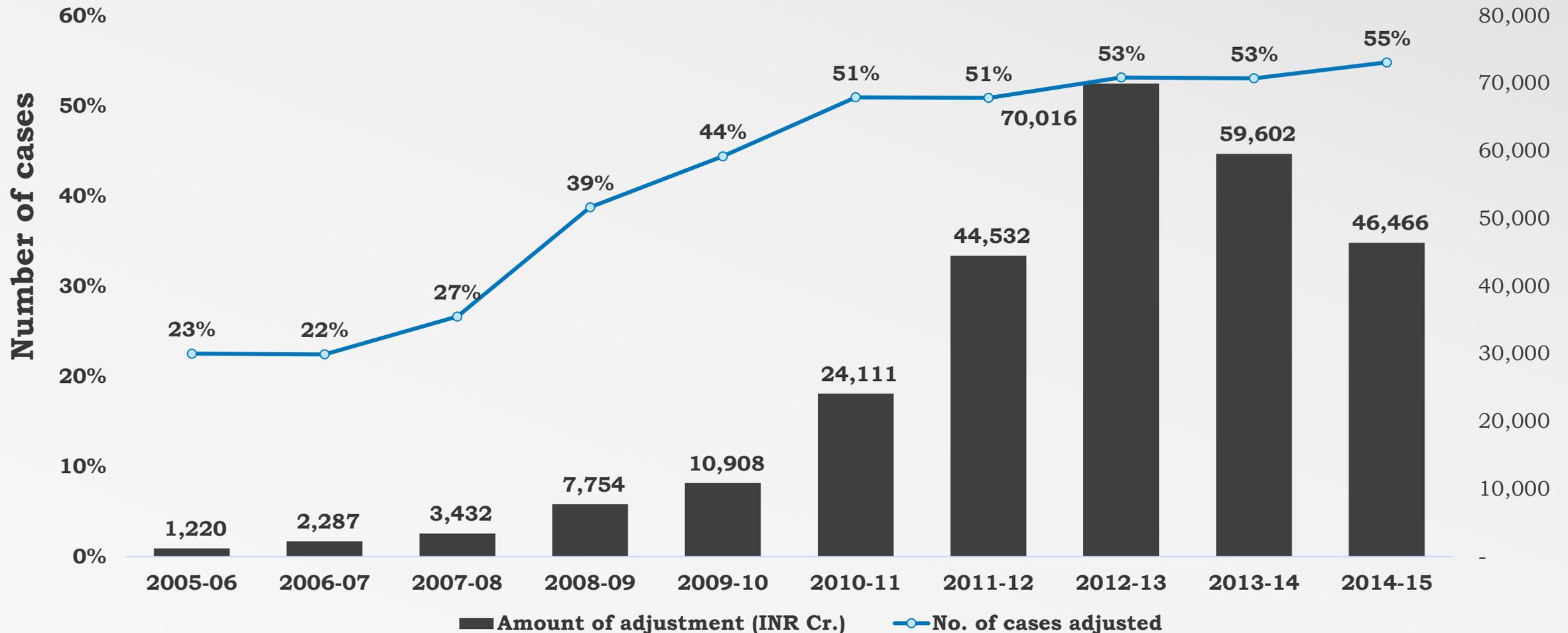
- Transfer pricing provisions extended to 'Specified Domestic Transaction'
- Advance Pricing Arrangement introduced
- Scope of international transaction amended with retrospective effect from FY 2001-02

2015

- Safe Harbour Rules were notified w.e.f 4th February 2015



Transfer Pricing – Taxed over the years



Source: Transfer Pricing Disputes Trend, 2015 by Tax Sutra and Deloitte. This data is based on statistics appearing in Annual Reports 2013-14 and 2014-15 published by Ministry of Finance



Transfer Pricing – Contemporary Issues

Marketing
Intangible

Royalty

Guarantee
Fee

Notional
Interest

Foreign
Exchange
Fluctuation

Marketing Intangible



Marketing Intangible - Overview

- **OECD BEPS Project – Aligning Transfer Pricing Outcomes with Value Creation**

Marketing Intangible has been defined in OECD TP Guidelines, “An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and / or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.”

Marketing activities

Commercial exploitation

Promotional Value

- **Income-tax Act, 1961 (‘the Act’)**

Explanation (i) to Section 92B provides that provision of services, including provision of market research, market development, marketing management....

Explanation (ii) to Section 92B provides that intangible shall include marketing related intangible assets, such as, trademarks, trade names, brand names, logos



Marketing Intangible – Issue in consideration

Whether an international transaction?

Whether marketer should be compensated as a service provider?

How the return attributable to the marketing intangibles can be identified?

Bright Line Test (‘BLT’)



Marketing Intangible – Judicial Views

Maruti Suzuki India Ltd [DEL HC - 2010 – 328 ITR 210]

- AMP incurred by domestic entity are more than what similarly situated and comparable independent domestic entity would have incurred.
- To be compensated in the form of marketing intangible development.

L.G. Electronics India Pvt. Ltd. [SB DEL ITAT - 2013 – 140 ITD 41]

- Economic ownership exists only in commercial sense.
- Provided broad guidance on various factors that needs to be considered for determination of value of international transaction of brand promotion.
- Selling & Distribution expenses do not form part of AMP.

BMW India Pvt. Ltd. [DEL ITAT - 2014 – 146 ITD 165]

- AMP is an international transaction and BLT can be applied.
- No separate compensation required for excessive AMP as the same has been received by way of premium profits.
- Compensation need not be direct and Revenue cannot insist on mechanism.

Sony Ericsson Mobile Communications India Pvt. Ltd. [DEL HC - 2015 – 374 ITR 118]

- AMP can be categorised as an international transaction. However, ignored BLT.
- When transaction are so interlinked, aggregation may be the way out. AMP will be aggregated with other transactions.
- Else, segregate AMP along with appropriate revenue and benchmark



Marketing Intangible – Judicial Views

Maruti Suzuki India Ltd [*DEL HC - 2015 – 381 ITR 117*]

- Incurring AMP expenditure does not qualify as “international transaction” under the provisions of section 92B(1) read with section 92(1) of the Act.
- Section 92F(v) of the Act - Defines 'transaction' to include 'arrangement', 'understanding' or 'action in concert', 'whether formal or in writing. Revenue should show the existence of an ‘arrangement’, ‘understanding’ or ‘action in concert’.
- The Indian transfer pricing law does not contain provisions to determine what should be the fair 'compensation'. Therefore, the same cannot be permitted in relation to AMP expenses.

Royalty



Royalty - Overview

- **OECD BEPS Project – Aligning Transfer Pricing Outcomes with Value Creation**

“The word “intangible” is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”



- **Income-tax Act, 1961 (‘the Act’)**

Explanation (i) to Section 92B provides that the purchase, sale, transfer, lease or use of intangible property, including the transfer of ownership...

Explanation (ii) to Section 92B provides that intangible shall include activities related to marketing, technology, artistic, data processing, engineering, customer, contract, human capital, location, goodwill...



Royalty – Issue in consideration

Benefit test

Embedded in pricing

Most Appropriate Method

Royalty on processes where there is no technological improvement

RBI's cap on royalty payments



Royalty – Judicial Views

EKL Appliances Ltd [DEL HC - 2012 - 345 ITR 241]

- No authority to disallow expenditure on the ground that it has suffered continuous losses
- Quantum of expenditure can in no doubt be examined
- All that matters is that the expenditure incurred must be ‘wholly and exclusively’ for business

SC Enviro Agro India Pvt. Ltd. [Mum ITAT - 2013 - 59 SOT 109]

- The TPO has to examine whether the price paid or amount paid was at arms length or not under the provisions of Transfer Pricing and its rules.
- The rule does not authorize the TPO to disallow any expenditure on the ground that it was not necessary or prudent for assessee to have incurred the same.

Samsung India Electronics Pvt. Ltd. [DEL ITAT - 2013 - 59 SOT 261]

- Parent Company cannot be deprived of its right to earn an arm’s length return on the sales made to other AEs
- To be termed as a ‘Contract Manufacturer’, extensive instruction should exist as regards nature, quantity & quality and an assurance should exist that the entire production will be purchased.
- Royalty is a return on R&D investments it has made over the years

LG Electronics India Pvt. Ltd. [DEL ITAT - 2011 - 153 ITD 591]

- Royalty not closely linked with other international transactions and cannot be aggregated
- Rate of royalty approved by RBI cannot be binding as it has a persuasive value and not conclusive
- Adjustments were brought to adjust fixed term agreement royalty rates against perpetual agreement entered into by LG. 10% was adjusted to bring in fixed term in line with perpetual agreement.

Guarantee Fees



Guarantee Fee - Overview

- **Guarantee**

Guarantee is an 'Intra Group services' covered in 'Action Plan 8 - 10' of OECD – BEPS Report

- **Income-tax Act, 1961 ('the Act')**

Explanation (i) to Section 92B provides that capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business

- **General understanding**

The parent entity provides guarantee / comfort letter for supporting its subsidiary to borrow loan from a third party lender.

The parent entity may use this as a funding mechanism

By doing so, the subsidiary shall have increased working capital or reduced interest rates or indemnify on loan default

Guarantee could be implicit or explicit

Explicit guarantee may be in the nature of financial guarantee or performance guarantee



Guarantee Fee – Issue in consideration

Whether an international transaction?

Value of guarantee

Most Appropriate Method



Guarantee Fee – Judicial Views

Bharti Airtel Ltd [*DEL ITAT - 2014 - 63 SOT 113*]

- Clarificatory amendment does not alter the basic character of 'International Transaction'.
- Any transaction including guarantees can be regarded as an 'international transaction' only if such transaction has a bearing on the profits, income, losses or assets of an enterprise (either immediately or in future but certain).
- Guarantees issued by the taxpayer to the bank on behalf of its AE did not have any implication on the profits, income, losses or assets of the taxpayer.

Reddington India Ltd. [*MDS ITAT - 2014 - 59 SOT 261*]

- Guarantee extended was for the over all interest of the business and hence a shareholder activity
- Providing corporate guarantee does not involve any cost and hence not an 'international transaction'

Everest Kanto Cylinders Ltd. [*Mum HC - 2015 - 378 ITR 57*]

- Corporate guarantee is distinct and separate from bank guarantee and cannot be compared.
- Common rate of 3% charged by banks were ignored and 0.50% which was currently being charged by the assessee was upheld.

Notional Interest



Notional Interest - Overview

- Excessive credit period allowed to AEs and delay in realization of sales proceeds from AEs as compared to non AEs
- Adjustment made in respect of excess credit allowed to AE Debtors by charging notional interest

Notional Interest – Issue under consideration

Whether an international transaction?

Most Appropriate Method



Notional Interest – Judicial Views

TALLY Solutions Pvt. Ltd. [*Bang ITAT - 1364/Bang/2011*]

- The transaction is otherwise capable of generating income and its just that the AE's decided not to charge / pay each other
- Extending credit period is a closely linked transaction therefore cannot be treated as independent transaction for benchmarking.

Indo American Jewellery Ltd. [*Mum HC - 2014 – 223 Taxman 8*]

- Notional interest doesn't arise when there was complete uniformity in act of assessee in not charging interest from both AE and non-AE debtors for delay in realization of export proceeds

Micro Ink Ltd. [*Ahd ITAT - 2013 - 144 ITD 261*]

- Credit period for finished goods cannot be compared with credit period for unfinished goods and raw materials, and in any case, when products are not the same.

Kusum Healthcare Pvt. Ltd. [*DEL ITAT - 6814/Del/2014*]

- The underlying transaction of sales to AE has been held to be at arm's length based on the working capital adjusted arm's length margin under TNMM, no further TP adjustment for interest on outstanding receivables is warranted.
- The specified credit period was a part of the sales contract and the cost of funds blocked in the credit period were inbuilt in the price.

Foreign Exchange Fluctuation



Foreign Exchange Fluctuation - Overview

- Foreign exchange fluctuation is accounted as income or gain in the financial statements
- Foreign exchange gain is part of the net profit that would be used to compute operating margins in TNMM
- Foreign exchange could be realised or unrealised in nature

Foreign Exchange Fluctuation – Issue under consideration

Operating / Non-operating

Who bears the forex risk?



Foreign Exchange Fluctuation – Judicial Views

Honda Trading Corp. [*Del ITAT - 2011 – 5297/Del/2011*]

- Abnormal and unanticipated adverse fluctuation of the currency will materially affect the profit margin and has to be eliminated

D.A. Jhaveri [*Mum ITAT - 2012 - 54 SOT 219*]

- Exchange difference was required to be accounted under the head ‘non-operating’ expenses.

DHL Express (India) Pvt. Ltd. [*Mum ITAT - 2009 - 124 TTJ 108*]

- Interest income, rent receipts, dividend receipts, penalty collected, rent deposits returned back, foreign exchange fluctuation and profit on sale of assets do not form part of operational income.

Way Forward



Documentation

Function, Asset and Risk Analysis

Characterisation of the entity

Detailed documentation



Governments Effort

Safe Harbour Rules

Advance Pricing Arrangement

Multiple Year Data

Range Concept



Questions?



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Thank you for your time

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