Following your valuable comments and feedback on the first four issues of Transfer Pricing 360°, we are delighted to introduce the second volume of our quarterly newsletter.

While India is presently aligning its transfer pricing regulations to global standards, there are some remarkable differences in the Indian regulations that are unique, such as the concept of ‘deeming fiction’. Deemed international transactions are those where certain local transactions would be treated as international transactions. In Focus Point, we discuss this development and highlight scenarios in which transactions, generally not attracting transfer pricing would now be subject to the regulations under ‘deemed international transactions’.

The last quarter reflected the commitment of the Indian government to reduce litigation in transfer pricing whereby the draft rules for the usage of multiple year data and the range of margins for the purpose of determining the arm’s length price were put up for public discussion. In addition, taxpayers have displayed their faith in the Advance Pricing Agreement programme, with over 500 applications filed since its launch in 2012. The India Updates section also covers a few other developments and commitments made by the Central Board of Direct Taxes that further strengthen the government’s vision of a non-adversarial tax regime. In Jury’s Word, we discuss some significant case laws in India.

In Global Developments, the OECD achieved substantial progress in its BEPS project with the release of the country-by-country reporting implementation package.

We hope you find this newsletter useful and look forward to your feedback. You can write to us at skp.tp360@skpgroup.com.

Warm regards,

The SKP Transfer Pricing team
Transfer pricing continues to make headlines and is still the key tax concern of enterprises operating globally. Given the nature and quantum of transfer pricing litigation in India, it is obvious that companies opt to structure their arrangements in a manner that would not trigger transfer pricing provisions. However, Indian regulations have always been a step ahead and in order to plug such planning tools, the concept of ‘deeming provisions’ has been introduced. In essence, the word ‘deemed’ under Indian tax law, includes ‘the obvious, the uncertain and the impossible’.

From a transfer pricing perspective, the two facets that trigger transfer pricing, a) associated enterprise (AE) and b) international transaction, are covered within the deeming fiction. There is a long list of situations where even though two enterprises are not related/group companies, they could be deemed associated enterprises. Similarly, even transactions with unrelated third parties can be considered deemed international transactions. This fiction has been extended by the last Budget to unrelated third parties in India – where, in essence, a local transaction would be regarded as an international transaction.

Once the transaction is considered an international transaction, whether deemed or otherwise, all the requirements under the Indian transfer pricing regulations must be complied with. This article focuses on the concept of deemed international transactions including the amendment which was made effective on 1 April 2014. In our article, we visualise business scenarios that may be captured under the definition of ‘deemed international transaction’.

**Definition: International Transaction**

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

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

Consider the following example, which is a common case: An Indian enterprise (ABC India) imports raw material from a non-resident unrelated party (XYZ China) under a global supply arrangement negotiated by an AE of ABC India outside India. This can be illustrated as in Figure 1.
In this scenario, the transaction between ABC India and XYZ China will be deemed an international transaction between the two AEs.

However, the provision concerning deemed international transactions, as worded before 1 April 2014, had led to doubt whether the unrelated person-enterprise must also be a non-resident for the transaction to be treated as a ‘deemed international transaction’. A number of tribunal rulings\(^1\) have concluded that the basic premise for invoking this deeming fiction does not arise when both of the parties to the transaction are residents or Indian enterprises. In order to clarify the ambiguities in the interpretation and scope of the provision on deemed international transactions, Finance (No. 2) Act 2014 amended the relevant provision.

After the amendment, a transaction between two Indian entities – an enterprise under consideration and an Indian third party – would also be deemed an ‘international transaction’ (provided either of the two conditions mentioned earlier are fulfilled).

This amendment was made effective on 1 April 2014 and thus applies to transactions entered into on or after 1 April 2014 (i.e. FY 2014-15). The effect of the amendment is illustrated in Figure 2.

**Figure 2**

- ABC USA (AE)
- Outside India
- Price is determined by ABC USA
- ABC India
  - WOS of ABC USA
- India
- XYZ India

1. Purchase of raw material from ABC USA
2. Sale of finished goods (manufactured out of raw material supplied by ABC USA)
3. Provided interest-free loan for manufacturing finished goods

For example, an Indian enterprise (ABC India) purchases finished goods from an Indian vendor (XYZ India) for which raw material is supplied by AE/parent of ABC India. Furthermore, the pricing or pricing formula with respect to goods supplied by XYZ India to ABC India is pre-determined by ABC USA and XYZ India in the form of a written agreement. ABC India obtains goods from XYZ India and distributes them in the Indian market. Moreover, ABC India has advanced an interest-free loan to XYZ India for manufacturing finished goods. In light of the above arrangement, the transactions of the supply of finished goods by XYZ India to ABC India would be considered a deemed international transaction subject to the determination of arm’s length price (ALP) and compliance with transfer pricing regulations by ABC India. Furthermore, advancement of an interest-free loan can also be covered by transfer pricing regulations if it stems from the same global agreement. However, if it can be demonstrated that it is a separate transaction governed by an independent agreement then it would be out of the purview of transfer pricing regulations.

Consider the following illustration, which highlights common business arrangements:

**Figure 3**

- ABC USA (AE)
- Outside India
- Price is determined by ABC USA
- ABC India
  - WOS of ABC USA
- India
- XYZ India

1. ABC USA acquired business of XYZ USA
2. As a global sale arrangement, ABC India acquired assets of XYZ India

\(^1\)CIT vs. Swarnandhra IJMII Integrated Township Development Co. Pvt Ltd (Hyderabad tribunal) and IJM (India) Infrastructure Ltd vs. Deputy CIT (Hyderabad tribunal)
Following the global sale arrangement, ABC USA (AE of ABC India) acquired XYZ USA's business in USA. Subsequent to this acquisition, ABC India acquired assets from XYZ India, the terms of which were derived from the global sale arrangement. In light of the amendment to the definition of ‘international transaction’, the transaction between ABC India and XYZ India would be considered a deemed international transaction subject to transfer pricing regulations.

For example, XYZ Group is a global automobile company and has manufacturing locations in India and abroad. ABC Group is a global supplier of auto components and supplies these to XYZ Group globally. Since XYZ Group had a manufacturing facility in India, ABC Group also decided to set up operations in India (ABC India). ABC India would manufacture auto components that were sold to XYZ India according to the global price list. ABC India would procure certain critical materials from ABC Germany to manufacture these components.

The purchase of these raw materials would be regarded as an international transaction and would be subject to transfer pricing. But most importantly, now, following the amendment to the definition of ‘international transaction’, a transaction between ABC India and XYZ India would be considered as a deemed international transaction subject to transfer pricing regulations. Interestingly, the transactions to be reported for transfer pricing in case of ABC India would be both the purchase of raw materials and the sale of finished goods. In addition, the arm's length pricing needs to be demonstrated for both the transactions.

Consider another illustration:

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**Figure 4**

- **ABC Germany (AE)**
  - 1: ABC India imports raw materials from its AE i.e. ABC Germany
  - 2: ABC India sells auto components to XYZ India at a price predetermined between ABC Germany and XYZ Germany

**Figure 5**

- **ABC USA (Holding Company)**
  - 1: ABC Germany entered into an onshore and offshore service agreement with an Indian customer
  - 2: ABC Germany assigned the contract to ABC India
  - 3: ABC India provided services to an Indian customer under assignment of contract
In this illustration, ABC Germany (AE of ABC India) received an order from an Indian customer for a turnkey project and a master agreement was executed between ABC Germany and its Indian customer. For business convenience, the onshore part of the project was assigned to ABC India by ABC Germany which was governed by a separate agreement. However, the ultimate responsibility of the execution of the project and risk was borne by ABC Germany. After the amendment of the definition of ‘international transaction’, services rendered by ABC India to its Indian customer could be considered as a deemed international transaction between ABC India and ABC Germany. This would apply if there is a possibility of establishing a nexus between the two legs of the entire transaction. For example, it would apply if the terms of the agreement between ABC India and ABC Germany have any derivation from the master service arrangement with the customer.

Global/regional arrangements that would require special consideration while reviewing the applicability of transfer pricing provisions are as follows:

- Logistics arrangements
- Information technology – supply of computers/laptops, maintenance of IT infrastructure, software licenses, etc.
- Advertisement arrangements
- Professional services arrangements
- Transactions with Indian parties, which are negotiated at global levels

**Conclusion**

As mentioned, once a transaction is regarded as a deemed international transaction – whether it is with a resident or non-resident Indian enterprise, these would be covered under the purview of the Indian transfer pricing regulations and consequently, all the requirements relating to transfer pricing (determination of arm's length price, maintenance of detailed documentation, subject to the scrutiny by the tax authorities, etc.) will be applicable to such transactions.

Thus, it is critical to evaluate such transactions on a case-by-case basis, and there is no restrictive formula for the determination of deemed international transaction. The most critical factors to consider in this regard would be the overall independence and conduct of the transacting parties and the availability of the option to carve out a contractual arrangement, which is distinctly different from what had been pre-agreed upon at a global level (global agreement). Care should be taken to properly report and disclose deemed international transactions since the penalties are stringent.

The amendment would be applicable for transactions entered into from 1 April 2014 onwards. Therefore, it is advisable for taxpayers to undertake a deep dive analysis to ascertain the facts and ensure that such incidents where deeming fiction is triggered, comply with the transfer pricing regulations.
Arm’s length price computation – a new milestone with a few more boundaries

With the intention of aligning transfer pricing regulations in India with international practices and considerably reducing litigation on some repetitive issues, the Finance Minister of India, Arun Jaitley, in his budget speech in July 2014, had announced the introduction of the ‘range concept’ for determining the arm’s length price (ALP) and allowing the use of multiple year data for comparability analysis.

With this backdrop, on 21 May 2015, the Central Board of Direct Taxes (CBDT) released the long-awaited draft rules of the proposed application of range concept and use of multiple year data for the computation of ALP. The draft rules were made open for public comments and the final rules are presently awaited.

The proposed mechanism and conditions released by the CBDT, under which multiple year data and range computation would be used for the determination of ALP are:

**Multiple Year Data**

a. Multiple year data would be used only in cases where the method used for determining ALP is either the Transactional Net Margin Method (TNMM), Resale Price Method (RPM) or Cost Plus Method (CPM).

b. The multiple year data should comprise of three years including the current year i.e. (the year in which the transaction has been undertaken) and its use for the above-mentioned methods shall be mandatory.

c. In case data is not available for three years for any of the following reasons, data for two years may be used:
   - Data for the current year of the comparables may not be available on the databases at the time of filing of return of income by taxpayers;
   - A comparable may fail to clear a quantitative filter in any one of the three years;
   - A comparable may have commenced operations only in the last two years or may have closed down operations during the current year.

**Range Concept**

a. The ‘range concept’ shall be used only in cases where the method used for determining ALP is TNMM, RPM or CPM.

b. A minimum of nine entities are required to be selected as comparable entities for the tested party, based on the similarity of their functions, assets and risks (FAR) with that of the tested party.

c. Three-year data of these nine entities (or more) would be considered and the weighted average of such three-year data of each company would be used to construct the data set. In certain circumstances, data of two out of three years could also be used. Thus, the data set or series would have a minimum of nine data points.

d. For calculating the weighted average, the numerator and denominator of the chosen Profit Level Indicator (PLI) would be aggregated for all the years for every comparable entity and the margin would be computed thereafter.

e. The data points lying within the 40th to 60th percentile of the data series would constitute the range.

f. In case the transfer price of the tested party falls outside the range arrived at, the median of the range would be considered as the ALP.

g. There would not be a separate tolerance band once the range is allowed.

In cases where the range concept does not apply, the arithmetic mean concept would continue to apply in the same manner as it applied before the amendment to the income tax law along with the benefit of the tolerance band, which should not
exceed 1% for wholesale traders and 3% in other cases. It is worthwhile to note that the use of range application and multiple year data for determining ALP is advocated by the OECD and is prevalent internationally. However, there is some divergence between the rules proposed by the CBDT and the practices in other developed and developing countries. There is no guideline that restricts the use of the range concept based on the number of comparables to be selected as comparable entities of the tested party. As for the requirement of a minimum of nine comparables, there are industries in India such as manufacturing, specific services, etc. for which it would be difficult for the Indian taxpayer to identify a good comparable set comprising of nine or more comparable companies. Therefore, these companies would be deprived from the benefit of applying the range concept while determining the ALP.

Furthermore, there is no specification in the OECD guidelines or in other country regulations for the use of multiple year data and range concepts, while applying specific benchmarking methods – TNMM, RPM or CPM. In the proposed CBDT rules, the range benefit is not applicable to cases where sufficient comparable transactions are available and related party transactions are benchmarked using the Comparable Uncontrolled Price (CUP) method.

The inter-quartile range prescribed in the draft rules released by the CBDT is between the 40th and 60th percentile of the data series. On the other hand, the inter-quartile range practised internationally is from the 25th to 75th percentile.

Overall, the application of the concepts of ‘arm’s length range’ and the ‘use of multiple year data’ will go a long way in reducing transfer pricing litigations surrounding these issues in India. It is expected that the CBDT may consider some of the aforementioned concern areas of the taxpayers while finalising the rules. **CBDT strongly criticises income tax officials on selection of cases for appeal**

The CBDT has asked the income tax (IT) department to take legal recourse only in ‘deserving’ cases. The CBDT also disapproved the casual attitude of the IT department in the selection of cases for appeal. Simultaneously, it has also questioned the concern of IT officials on these matters, citing four cases where IT officials received strong criticism from courts or the Income Tax Appellate Tribunal (ITAT).

“Needless to say the courts are taking a stern and inclement view as far as department’s actions in litigation matters is concerned. Further, besides financial costs, litigation also entails tarnishing the image of the department and straining its resources,” the CBDT said.

As the IT department is facing a shortage of officials at all levels, it is essential that all resources are optimally utilised to obtain the maximum benefit from litigation. The importance of filing an appeal and pursuing legal action only for deserving cases cannot be emphasised enough.

The CBDT, while issuing these instructions, said that the IT department has been pulled up by the Comptroller and Auditor General of India (CAG) and various courts for appealing against cases without considering their merits.

**India signs first bilateral APA with Japan**

After Prime Minister Narendra Modi’s visit to Japan earlier this year, the first bilateral Advance Pricing Agreement (APA) between the two countries was concluded, signed by one of Japan’s largest corporate trading houses.

The APA was finalised in about 1.5 years, which is shorter than the time normally taken in finalising APAs globally. The agreements were signed at three levels – the first agreement is between the competent authorities of India and Japan; the second is between the CBDT and the Japanese company in India; and the third is between the Japanese tax authority and the group company in Japan.

**Ministry of Finance publishes Annual Report for FY 2014-15**

India’s Ministry of Finance published key developmental statistics in its Annual Report 2014-15. Among other insights, the report shares statistics on transfer pricing matters, such as the number of cases selected for assessments and transfer pricing adjustments.

**Summary of statistics (cycle completed on 31 January 2015):**

<table>
<thead>
<tr>
<th>No. of transfer pricing assessment cases</th>
<th>No. of cases in which transfer pricing adjustments were made</th>
<th>Total amount of adjustments (INR million)</th>
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</thead>
<tbody>
<tr>
<td>4,290</td>
<td>2,353</td>
<td>464,655.8</td>
</tr>
</tbody>
</table>

**Transfer pricing assessment trends from 2002-03 to 2011-12:**

<table>
<thead>
<tr>
<th>Assessment year</th>
<th>Adjustment amount (INR million)</th>
<th>No. of cases selected for assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>15,000</td>
<td>1,081</td>
</tr>
<tr>
<td>2003-04</td>
<td>25,000</td>
<td>1,501</td>
</tr>
<tr>
<td>2004-05</td>
<td>35,000</td>
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<tr>
<td>2005-06</td>
<td>55,000</td>
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<td>100,000</td>
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<td>232,370</td>
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<td>442,310</td>
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<td>2009-10</td>
<td>700,160</td>
<td>3,171</td>
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<td>2010-11</td>
<td>596,020</td>
<td>3,671</td>
</tr>
<tr>
<td>2011-12</td>
<td>464,000</td>
<td>4,290</td>
</tr>
</tbody>
</table>

**Other highlights from the annual report:**

**India's active participation in OECD's Base Erosion and Profit Shifting (BEPS) Project**

After detailed negotiations in the G20 meeting, India became one of the eight non-OECD G20 countries in the Bureau Plus, a focused group to oversee the progress of the BEPS project and participate in the decision-making process. As BEPS were considered to be a global issue, the recommendations under the BEPS Project are now being developed on the basis of a consensus arrived at by...
the 34 OECD and eight non-OECD G20 countries. It is noteworthy that India, being an Associate in the BEPS Project, is an equal participant in developing the recommendations.

India’s expanding bilateral and multilateral treaty network

As on 31 December 2014, 92 bilateral tax treaties between India and other countries were in force. Since then there have been negotiations for an additional seven tax treaties.

India has also joined the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Multilateral Convention), which provides a wide range of administrative assistance in tax matters, exchange of information, assistance in collection of taxes, tax examination abroad, joint audit, etc. India has been actively pursuing other countries to join this convention. As on 31 December 2014, 84 countries/jurisdictions had signed the Multilateral Convention, which has been enforced in 46 countries/jurisdictions.

Thrust on automatic exchange of information

On the request of the G20, the OECD, together with India and the other non-OECD G20 countries, developed a single uniform standard, the Common Reporting Standards (CRS), for the automatic exchange of information. This new global standard was endorsed by the G20 nations. Prime Minister Narendra Modi in his intervention at the G20 Leaders' Summit in Brisbane strongly supported this new global standard, which would be instrumental in getting information about unaccounted money hoarded abroad and enable its eventual repatriation.
DCIT vs Innodata Isogen India Pvt Ltd\(^1\): Business risks and realities that cause decline in revenue and create idle capacity, warrant adjustments

The taxpayer is engaged in providing IT-enabled services (data conversion, composition and editorial services) to its parent company in USA and had declared a loss during the year. The Transfer Pricing Officer (TPO) determined the arm’s length price (ALP) of the international transaction using multiple year data and margins of comparables at 10.12%. The taxpayer appealed before the Commissioner of Income Tax (Appeals) (CIT(A)) citing reasons for the loss being on account of the fixed labour costs which created idle capacity. The CIT(A) allowed the idle capacity adjustment and deleted the addition as the margins were within a range of +/-5% after the capacity adjustment.

On account of these submissions, the ITAT, in agreement with the CIT(A), upheld the deletion of the adjustment proposed by the TPO.

ACIT vs Ray Keshavam Design Associates Pvt Ltd\(^2\): If documents submitted by the taxpayer prove the genuineness of the transaction, additional documents should not be called for

The taxpayer is engaged in the business of brand consulting and designing. Amongst other transactions, the taxpayer had made payments to its AEs in the nature of reimbursement of expenses. The taxpayer had submitted the nature of expenses, invoices, bills, receipts, etc. was being outsourced to the taxpayer; this was substantiated by quantitative facts. The TPO’s view that lower business was being outsourced to the taxpayer was thus, incorrect. The taxpayer had also stated that there was a global meltdown originating in USA, which had caused under-absorption of fixed costs, resulting in excess capacities and idle fixed costs, including manpower. Despite revenues being low, the taxpayer had to retain skilled technical manpower, and had also incurred fixed cost on rentals, electricity and depreciation on computers and infrastructure, which resulted in idle time costs.

On the department’s appeal, the Income Tax Appellate Tribunal (ITAT) viewed that the taxpayers and the Associated Enterprise (AE) were independent service providers exposed to the risk of business fluctuations. Furthermore, based on statistical data, the ITAT observed that while fixed personnel costs in absolute terms remained the same, they varied as a percentage of sales, which created idle capacity. The AE did not have as much operational capacity in USA so almost all of the AE’s work for the reimbursements. However, the TPO had called for details such as hourly payment rates, timesheets of the AE’s employees, cost-to-cost break-up of expenses, etc. As the taxpayer failed to provide the complete data expected, the arm’s length nature of the transaction was determined as nil.

The taxpayer further explained before the CIT(A) that the expenses were on account of travel costs incurred by the AE’s employees for rendering services to the taxpayer, which the taxpayer had recovered from its clients. In addition, it also showed healthy operating margins of 51.69%. Accordingly, the CIT(A) deleted the adjustment made by the TPO, which was also upheld by the ITAT. The ITAT also added that there was no motive to withhold information for the purpose of tax evasion by the taxpayer. The expectation of the Assessing Officer (AO)/TPO of details such as hourly payment rates, timesheets of AE’s employees, cost-to-cost break-up of expenses was unreasonable. The taxpayer had already submitted invoices, bills, receipts and the list of employees to whom the reimbursement of expenditure was made. Accordingly, the appeal of the Revenue was dismissed.

Everest Kanto Cylinders Ltd vs CIT\(^3\): Considerations for issuance of corporate guarantee are distinct and

\(^1\)ITA No. 5390/Del/2010 – AY 2003-04
\(^2\)ITA No. 383/Bang/2014 – AY 2009-10
\(^3\)High Court ITA No. 1165 of 2013 – Mumbai – AY 2007-08
The taxpayer had provided a corporate guarantee to ICICI Bank on behalf of its AE in Dubai. The taxpayer had charged 0.50% as guarantee commission. The TPO, considering the AE was newly formed and had a low credit rating, concluded that the AE would not have availed a loan without the taxpayer’s guarantee. Also, the taxpayer’s risk exposure was higher on account of this international transaction. The TPO had adopted a 3% guarantee commission rate as ALP by (i) comparing the difference in the bank rate and the prime lending rate (PLR) and (ii) external comparables. The CIT(A) upheld the TPO’s view.

However, the ITAT held that there was a fundamental difference between corporate and bank guarantees and they cannot be used interchangeably. In addition, the bank guarantee commission cannot be universally applied or used. Furthermore, as the AE’s assets were hypothecated against the loan, the guarantee could be invoked only after the charged assets were liquidated. Hence, there was no real financial burden on the taxpayer. Also, the rate at which the AE obtained the loan was in line with rates in the AE’s country.

The High Court reiterated the ITAT’s view and rejected the TPO’s approach of using guarantee commission chargeable by commercial banks for bank guarantees as a comparable for the issuance of a corporate guarantee by the taxpayer. It held that a commercial bank’s bank guarantee can be easily encashed in the event of a default and a higher rate was justified in those cases. However, in this case, the taxpayer had issued a corporate guarantee, which is distinct and separate from a bank guarantee. Accordingly, the department’s appeal was dismissed.

**JCB India Ltd vs ACIT**: High unusual operating expenses in the first year of operation, without any substantiation, cannot be allowed as an adjustment to taxpayer

The taxpayer is engaged in the business of manufacturing machine components. The international transactions under contention were the import of raw materials and the export of finished goods. The taxpayer had jointly benchmarked the transactions using an entity-level Transactional Net Margin (TNM) method. However, the TPO rejected 2 of the 10 comparables selected by the taxpayer. Furthermore, the TPO observed that the taxpayer had adjusted its own Profit Level Indicator (PLI) from (-) 45.23% to 10.79% on account of it being the first year of operations. The taxpayer substituted the actual cost of Assessment Year (AY) 2006-07 with standard costs based on the subsequent year’s expenses, which reduced the expenses by almost 50%. These expenses in AY 2006-07 were on account of higher consumption of electricity, higher distribution and fixed costs, and lower productivity/volumes were due to it being the learning phase for the workmen. The TPO rejected the taxpayer’s adjusted PLI since the adjustment can be made only to the profit margin of the comparables and not to the profit margin of the taxpayer as per The Income Tax Rules, 1962 (the Rules) and proposed an addition to the income, which the Dispute Resolution Panel (DRP) confirmed.

The ITAT held that there is no provision that calls for adjusting the net profit margin realised by the taxpayer from its international transaction. The operating profit margin should be according to the books of accounts strictly in conformity with the business conditions as they exist without any variation. Furthermore, the ITAT also held that the first year of operation of a business is not an extraordinary event as such. It is only when the taxpayer proves the distinguishing factors on account of abnormal expenses, etc. that it becomes entitled to claim adjustment in profit margins of its comparables. The matter was remitted to the AO to determine the ALP after considering appropriate comparables and PLI computation.

**Novo Nordisk India Pvt Ltd vs DCIT**: Concerted arrangement between AE and Indian third party to attract transfer pricing provisions

The taxpayer is engaged in the trading of pharmaceutical products. Apart from other international transactions, the taxpayer had received a subvention fee to carry on its operations in India. The taxpayer had adopted the TNM method (distribution segment) to benchmark its transactions.

In the course of the assessment proceedings, the TPO noticed that the taxpayer’s AE had supplied raw materials to an unrelated domestic entity (TPL) at a rate pre-determined by the AE. These raw materials were used by the TPL for manufacturing finished goods that were then sold to the taxpayer for resale, which was also pre-determined by the AE. The TPO viewed the entire arrangement to be concerted and concluded that TPL merely acted as a contract manufacturer getting a fixed margin and the taxpayer was the risk-bearing manufacturer. The TPO held that provisions of section 92B(2) were attracted and the transaction between the taxpayer and TPL was deemed to be a transaction between AEs. The TPO treated the taxpayer as a manufacturer and arrived at a new set of comparables. The operating margin of the taxpayer was also revised considering operating revenues before subvention fee, on the contention that it was a self adjustment by the taxpayer and not a revenue stream. Furthermore, the TPO also noticed that the taxpayer had given an interest-free loan to TPL and further proposed to determine the arm’s length interest at 17.22%.

The DRP upheld the TPO’s view but proposed to determine the ALP using the Profit Split Method (PSM) and allocated profits between the taxpayer and AE in an ad-hoc ratio of 50:50.

The ITAT upheld the applicability of transfer pricing regulations in this case and also stated that tax erosion in India can happen only at the point of supply of goods from the AE. Both, TPL and the taxpayer are Indian companies and as such there is no tax erosion in India from the transaction of manufacture through TPL. For determining the ALP, the transactions
of (a) supply of raw material (through TPL) were identified as a part of manufacturing activity and (b) sale of imported products as a part of trading activity. The taxpayer was directed to provide the TPO with the study for each transaction separately. The ITAT suggested a reconsideration of the application of PSM as the most appropriate method (MAM). Further, it also noted that the sublicense fee was to be set off against any transfer pricing adjustment that might ultimately be made as it will not be subjected to an independent ALP test.

Lastly, the ITAT deleted the interest adjustment made by the TPO/DRP by stating that the transaction could not result in tax base erosion since both the assessee and TPL were subject to tax in India and concluded that it cannot be a matter of investigation.

Fosroc Chemicals India Pvt Ltd: Substantiating benefits derived out of intra-group services received for the taxpayer’s business is more important than submitting evidence such as emails and other documents

The taxpayer is a manufacturer of specialty construction chemicals and had entered into various international transactions including the payment for technical and management fees to its AEs. The taxpayer benchmarked all transactions using the TNM method on an aggregate basis. The TPO held that the payment of technical and management fees is an independent transaction and should be analysed separately using the Comparable Uncontrolled Price (CUP) method. Although the taxpayer produced sample invoice copies and email correspondence regarding the visit of personnel to India, the TPO stated that it did not show the requirement of the services for the taxpayer’s business. In the absence of quantification of services, whether they had been actually rendered, cost-benefit analysis, etc. the TPO determined the ALP of the payment to be nil.

The DRP upheld the view of the TPO and further stated that the services rendered by the AE were in the nature of shareholders’ activity and as the TPO could not find any comparable transactions, the services rendered were not warranted.

The ITAT stated that the mere description of services and filing of voluminous emails would not suffice as evidence to establish the ALP. Rather, the utilisation of services and their usefulness in the business, and the benefits derived by the taxpayer’s business segments must be demonstrated. With respect to selecting the MAM, the ITAT stated that an expense transaction should be preferably benchmarked using the CUP method and not a profit-based method. Furthermore, the taxpayer would need to showcase the interrelation of the transactions to adopt the TNM method. The ITAT fundamentally stated that the determination of ALP for intra-group service transactions involves:

- Identification and basis of allocation of cost incurred by AE;
- Determination of requirement of reimbursement of such costs along with mark-up (if charged) and the ALP of the mark-up;
- Determination of whether services are duplicated.

Thus, the matter was finally remanded to the TPO for fresh consideration.

Honda Motorcycle and Scooter India Pvt Ltd: TPO to determine only the ALP and not whether any service was actually rendered

The taxpayer is engaged in the manufacture, sale and service of two wheelers, parts and accessories. The TPO allowed royalty payment made to the AE for domestic and export sales to a non-AE. However, the TPO disallowed royalty paid to its AEs for sales made to the AE considering the taxpayer as a contract manufacturer to the AE. Further, the TPO disallowed the payment made by the taxpayer to the AE for export commission by determining ALP as nil. The DRP upheld the TPO’s contentions.

The taxpayer contended before the ITAT with respect to royalty payments, that it was an independent, full-risk-bearing manufacturing entity and not a contract manufacturer and submitted a chart justifying that the price of the exports to AEs was much higher than that of non-AEs. The ITAT thus observed that the TPO’s finding that the taxpayer was a contract manufacturer was baseless, since it was evident from the taxpayer’s financial results that it had independent sales – both domestic as well as exports. Furthermore, in the case of the taxpayer’s sister concern, Hero MotoCorp Ltd vs ACIT6, the ITAT held identical payment of royalty as allowable. Accordingly, the ITAT deleted the addition made by the TPO.

With regards to disallowance of export commission by the TPO, the ITAT held that the TPO’s authority is only to conduct a transfer pricing analysis to determine the ALP and not to determine whether there is a service from which the taxpayer benefits; that aspect of the exercise is left to the AO. What falls within the TPO’s jurisdiction is to determine what an independent entity would have paid for those services and not whether any service has actually been received by the taxpayer. Accordingly, the matter was restored to the TPO for fresh consideration.

Sumitomo Corporation India Pvt Ltd: Commission earned under indenting business cannot be compared with the income from trading business

The taxpayer is a subsidiary of a Japanese sogo shosha trading company and has two distinct business segments i.e. commission business (indenting) and trading activities. The taxpayer had clubbed both segments and determined the ALP using the TNM method. The TPO rejected the TNM method based upon the previous year’s orders in which the ‘Berry Ratio’ was used to

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6SP 107/Bang/2014 & IT(TP)A No.148/Bang/2014
7ITA No.132/Del./2013
8ITA No.5130/Del./2010 order dated 23.11.2012
9ITA No.328/Del/2014 & ITA 83/2015
determine ALP and made an adjustment in respect of income from the AE in the commission segment by adopting the margin from trading activities with non-AEs.

The taxpayer approached the ITAT contending that the TPO's stand disturbed the consistent approach allowed by the ITAT in the past two years with respect to benchmarking using the TNM method. The ITAT ruled in the taxpayer's favour. Furthermore, it stated that the TPO was incorrect in comparing the margin of one segment with another, where functions, risk and capital employed differed considerably. The ITAT held that comparisons of margins for commission income from an AE ought to be made with margins of the same income from non-AEs and not with the margin of income from other business segments. The ITAT remitted the matter back to the AO in order to find the rate of commission income from non-AEs and apply it to the transaction with the AE.

**Cargill Foods India Ltd**\(^{10}\): **Commodity exchange quotes to be accepted as external CUP method**

The taxpayer imported soyabean oil and sunflower oil from its AEs as well as third parties in India and overseas. The CUP method was used to benchmark its purchase transaction. The taxpayer emphasised the use of broker quotes, which the TPO rejected stating that broker quotes, did not reflect 'price charged or paid' as it is not an actual transaction. Therefore, the TPO rejected the CUP method and adopted the TNM method for determining the ALP. For benchmarking the transaction using the CUP method, the taxpayer made the following submissions:

- Broker price notes issued by a certain reputed broker that gave details of market prices on the dates when the taxpayer had purchased from the AE;
- Sample quotes from another brokerage house and prices from an independent publication whose reliability was upheld in the benchmark case decided by the Gujarat High Court (CIT vs Adani Wilmar Limited)\(^{11}\);
- Comparative analysis of internal uncontrolled transactions with third parties vis-à-vis transactions with AEs for import of oil was also submitted to the TPO.

The DRP upheld the TPO's contentsions.

The Revenue before the ITAT emphasised that broker notes, other quotes and publications were not the 'price charged or paid' and cannot take the characteristics of comparable uncontrolled transaction referring to the Rules. The taxpayer argued that the rates at which comparable imports were made from unrelated third parties were higher than the per unit price paid for an import from AEs. The taxpayer also contended that in the subsequent year, the taxpayer's similar comparative analysis by using internal and external CUP was accepted by the TPO, and hence by rejecting it in the current year, the principle of consistency was defeated by the TPO. The ITAT held that when it is possible to identify and locate a comparable transaction, the CUP method would be a preferable method to benchmark the transaction and that the quotations appearing on recognised commodity exchanges would reflect the price at which commodities are traded at in the market place. The ITAT further referred to Rule 10D of the Rules, which mentions that price publications of stock exchange and commodity market quotations are documents to be maintained with respect to international transactions and also relied on the ruling in the case of Adani (mentioned earlier) in which prices of the same publications were held authentic and reliable. The ITAT ruled in favour of the taxpayer with respect to the ground of consistency. Accordingly, the AO was asked to delete the addition.

**Quality Engineering and Software Technologies Pvt Ltd**\(^{12}\): **Internal CUP method held over external TNM method since transaction-by-transaction comparison is more reliable**

The taxpayer, a subsidiary of Quest, USA, is engaged in the business of developing and providing software and specialised services in the area of Computer Aided Design (CAD) and Computer Aided Engineering (CAE) to Quest USA and third parties. The taxpayer was charging its AE on agreed rates according to the Memorandum of Understanding and had adopted the TNM method to benchmark its international transactions. The TPO contended that out of the total value of international transactions, transactions amounting to more than 40% were similar to services provided to non-AEs. Accordingly, an internal CUP method was considered to be a more appropriate benchmarking method. The TPO determined the ALP rate and adjusted the rates using a simple average of hourly rates, disregarding different rates for different skill sets. Furthermore, the TPO also found some unnumbered invoices and made an addition on account of suppressed income.

With respect to the MAM and use of internal CUP, the CIT(A) upheld the action of the TPO. Furthermore, with respect to the issue pertaining to unnumbered invoices, the CIT(A) remanded the matter back to the AO where it was proved that the unnumbered invoices were a compilation of data from various invoices actually raised and that these were workings meant for internal purposes. Accordingly, the CIT(A) deleted the addition on account of suppressed income.

With respect to the MAM, the ITAT upheld the action of the TPO since the internal CUP method was readily available. The ITAT held that when details of each person who had provided services to the AE and a comparable party were available, either direct comparison of rates for different skill sets used for providing services should be used or a weighted average rate should be computed and applied instead of a simple average. On the issue of the deletion of the adjustment by CIT(A) with regards to suppressed income, the ITAT held in conformity with CIT(A) and the Revenue's appeal was dismissed.

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10ITA No.1460/PN/2010
Following the recommendations for three-tiered transfer pricing documentation under Action Plan 13 of the Organisation for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) project (see Transfer Pricing 360° Volume 1 Issue 4 (January – March 2015) for details; the OECD has recently released a CbC reporting implementation package consisting of:

- Model legislations that can be used by countries to facilitate filing the CbC report; and
- Three types of competent authority agreements that could facilitate the exchange of CbC reports amongst jurisdictions, based on:
  a. The Multilateral Convention on Administrative Assistance in Tax Matters
  b. Bilateral tax conventions
  c. Tax Information Exchange Agreements.

**Highlights of the model legislation**

- It does not take into account the constitutional law, legal system or wording of tax legislation of any particular jurisdiction as countries would be expected to adapt the model legislation to their own legal systems based on their requirements.
- The CbC report may be filed by the Ultimate Parent Entity or a Surrogate Parent Entity (defined as an entity that may be appointed by the multinational enterprise (MNE) Group to file the CbC report on satisfaction of certain conditions including the backup filing.)
- A CbC report for an MNE Group would contain the following:
  a. Aggregate information in relation to revenue, profit/loss before tax, income tax paid and accrued, stated capital, accumulated earnings, number of employees and tangible assets for each jurisdiction in which the MNE Group operates.
  b. The identification of each Constituent Entity including jurisdiction of tax residence, nature of business activity of each Constituent Entity, etc.
- The primary use of the CbC report is to help tax authorities assess high-level transfer pricing and other BEPS-related risks. However, transfer pricing adjustments will not be based on the CbC report.
- The model legislation has not provided any penalty provisions for non-compliance with the reporting requirements. It has kept this area open for the tax authorities of the adopting country to draft it in line with their existing transfer pricing documentation penalty regime.
- The effective date proposed for an MNE Group’s reporting is the fiscal year beginning on or after 1 January 2016.
- An MNE Group with annual consolidated group revenue of less than EUR 750 million (or equivalent amount in local currency) during the fiscal year immediately preceding the reporting fiscal year, as reflected in its consolidated financial statements for such preceding fiscal year, may be excluded from the CbC reporting requirement.

Apart from the model legislation, the implementation package also consists of three model competent authority agreements to enable the exchange of CbC reports amongst jurisdictions. The jurisdictions are expected to have in place appropriate safeguards to ensure that the information received, pursuant to the agreement, remains confidential and is used only for specified purposes.
With the advent of this model legislation, it is imperative that countries modify their legal and tax legislation as well as provide clarity to taxpayers regarding disclosure requirements as outlined in the OECD recommendations. The proposed scheme of automatic exchange of information between countries further emphasises the need for MNEs to review global transfer pricing policies and take appropriate steps in a timely manner.

Global Happenings

Australia: Federal Budget 2015-16 – Strong measures announced

During the release of the Australian government’s 2015-16 Federal Budget, Treasurer, Joe Hockey, in his speech to the Australian parliament on 12 May 2015, announced key measures targeted at multinationals:

- A commitment to implement the new OECD transfer pricing documentation requirements, including CbC reporting, from 1 January 2016;
- Higher penalties for companies that enter into tax avoidance or profit shifting schemes;
- Measures designed to create a level playing field for goods and services tax (GST) for offshore and local digital content providers (draft law released)

Australia: Transfer pricing documentation requirements

With effect from 1 January 2016, all multinational corporations (MNCs) with an Australian presence and global revenue of AUD 1 billion or more are required to prepare and maintain transfer pricing documents as per the proposed OECD standards. This will include the OECD CbC report; the master file containing an overview of their global business, organisational structure and transfer pricing policies; and the local file containing details of local taxpayer businesses, inter-company transactions and supporting transfer pricing analysis. By adopting these key action points from the BEPS Action Plan, being developed under Australia’s G20 presidency, Australia continues to demonstrate its strong focus on the OECD’s BEPS proceedings.

Administrative guidance and means to share the gathered information with other revenue authorities are expected to follow.

Japan: Increased focus on resolving India-Japan transfer pricing disputes

Tax officials from India and Japan are expected to meet to resolve about 15 transfer pricing disputes of 30 litigated cases, by signing Mutual Agreement Procedures (MAPs). The MAP cases between India and Japan would be discussed in light of the restrictive industrial relations between India and Japan.

Reportedly, the resolution of MAP cases would help the automobile and auto ancillary sector as well as large trading houses. The aforementioned 15 cases involve a tax liability close to INR 100 billion (JPY 193 billion). The litigated issues include royalty, tax dues, profitability of trading houses, commission payments, etc.

Recently, India signed a bilateral Advance Pricing Agreement (APA) with a Japanese conglomerate. A bilateral APA involves two governments and the concerned company.

Korea: Simplified APA programme

Korea’s National Tax Service (NTS) introduced a simplified APA programme to reduce the time and complexities involved in filing an APA. This action has been taken after considering the APA statistics which reveal that the benefit of the previous APA programme was not availed by small and mid-sized foreign companies in Korea. According to NTS statistics, under the existing programme, the average time taken for APAs concluded by 2013 was 1 year and 8 months for unilateral APAs and 2 years and 5 months for bilateral APAs, whereas the simplified APA would reduce time substantially, bringing it to about a year.

The key features of the simplified APA programme are as follows:

- At the outset, the simplified APA programme is limited to small and mid-sized foreign companies.
- This will be based on the annual turnover of approximately KRW 50 billion (USD 45 million) or less.
- Currently, specified activities can be covered for simplified APAs, namely wholesale/retail, services or manufacturing-based corporations.
- The simplified APA programme is restricted to unilateral APAs. It will be carried out without the involvement of foreign tax administrations.
New Zealand: Increased focus on transfer pricing

New Zealand's (NZ) Inland Revenue Department (IRD) released its transfer pricing focus areas for 2015 and 2016 in light of the diminishing tax revenues, which demonstrate the intention of increasingly scrutinising related party transactions. The focus points include:

- Unexplained tax losses borne by foreign-owned groups;
- Loans in excess of NZD 10 million;
- Unsustainable levels of royalties and/or service charges such as management fees/guarantee fees;
- Material associated party transactions with no or low tax jurisdictions;
- Supply chain restructuring involving the shifting of any major functions, assets or risks away from NZ and thereby shifting profits outside NZ;
- Any unusual arrangements or outcomes that may be identified in controlled foreign company (CFC) disclosures.

The IRD plans to focus on the Significant Enterprises Segment, which comprises 560 taxpayer groups reporting a turnover over NZD 80 million. About half of these are foreign owned, and 25% have international transactions through CFCs. Accounting for over 50% of the country's corporate tax base and 10% of overall tax revenue, these groups have the highest risk of profit shifting due to their international transactions.

The IRD will continue to monitor the profitability of foreign-owned wholesale distributors, the most common form of multinational businesses in NZ. As a relief for small wholesale distributors (under NZD 30 million in annual turnover), the IRD will seek explanations for any performance resulting in a weighted average profit-before-tax ratio of less than 3%.

They will continue to refine risk assessments of all significant enterprises through analysis of financial statements, tax reconciliations and corporate structures supported by adequate transfer pricing questionnaires.

Poland: New transfer pricing documentation requirements

Recent amendments in Poland's Corporate Income Tax (CIT) Act published by the Polish government seek to introduce various new transfer pricing documentation requirements. These changes will have a significant impact on MNCs operating in Poland and undertaking related party transactions.

The proposed transfer pricing documentation requirements are mostly in line with the OECD BEPS Action Plan 13 and the European Union Directive on the prevention of aggressive tax planning.

The salient features are:

- Certain Polish MNEs (with consolidated income exceeding EUR 750 million) to prepare CbC reports.
- Taxpayers to prepare a 'Master File' (for MNEs with consolidated income exceeding EUR 20 million) and a 'Local File'.
- More extensive transfer pricing documentation, which will include mandatory local benchmarking analysis.
- The deadline for preparation of transfer pricing documentation will be brought in line with the annual tax return deadline.
- Transfer pricing documentation will also include a description of 'other events' between related parties which influence the taxpayer's taxable income/loss such as cash pooling, cost contribution arrangements, etc.
- Modification in the definition of related parties to increase the capital holding threshold from 5% to 20%.
- Exemption from transfer pricing documentation for micro taxpayers (income/expense less than EUR 2 million).

Thailand: Draft Act introducing contemporaneous transfer pricing documentation provisions

Thailand first introduced guidelines with respect to transfer pricing methods and documentation in 2002. However, these were issued as an instruction to revenue officers.

Thailand recently announced that it is planning to introduce new transfer pricing laws in the near future, wherein taxpayers will need to prepare and maintain contemporaneous transfer pricing documentation. At present, companies in Thailand have to comply with the market rate standards when transacting with related parties.

Key provisions of the new laws are:

- Transfer pricing documentation should be prepared within 150 days from the year-end closing date i.e. the same deadline as corporate income tax returns.
- Two or more entities are regarded as 'related' if they have share ownership in one another, or have a common management, or have common control, directly or indirectly.
- Failure to comply, or submitting incorrect information, would be subject to a penalty up to THB 400,000.
- It is also possible for large multinationals with significant related party transactions to consider applying for bilateral APAs. The new transfer pricing regulations will provide specific rules for APAs.

Thailand is expecting the new transfer pricing rules to become part of the law by the end of 2015, which is likely to be effective immediately after.
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