The last few weeks have seen some of the most important developments in the international taxation and transfer pricing domain. The Organisation for Economic Co-operation and Development (OECD) released their Base Erosion and Profit Shifting (BEPS) Project recommendations while India adopted the use of the range concept and multiple year data for the computation of arm’s length price.

With the objective of creating a level playing field for tax authorities and multinational enterprises (MNEs) operating across the globe and in order to curb the avoidance of legitimate taxation, the OECD launched the BEPS Project in 2013, which was supported by the G20 nations. Owing to the enormous underlying efforts, the OECD published far-reaching recommendations based on 15 Actions on various aspects of international taxation, including transfer pricing.

In India, the government recently released the final rules specifying the use of the range concept and multiple year data for computation of arm’s length price. Simultaneously, the Central Board of Direct Taxes (India’s apex tax-policy-making body) issued guidelines to the tax authorities on the selection of cases for detailed transfer pricing scrutiny based on risk parameters instead of the transaction-volume-based approach of selection.

With the constantly evolving transfer pricing environment, we are pleased to present the latest issue in our series of quarterly newsletters to update you on the various aspects of these developments.

The business models adopted by MNEs are changing along with the global business landscape. Companies are re-evaluating their operational arrangements and as a result, we have seen several cases of restructuring among MNEs. These arrangements attract tax as well as transfer pricing implications and it becomes imperative to analyse them before the actual arrangement takes place. In Focus Point, we discuss the transfer pricing issues that could arise from the different types of restructurings that MNEs may undertake.

The India Updates section covers important developments during the last quarter including India’s position on the quantum of tax litigation cases in the country and Mutual Agreement Procedures (MAP) with other nations. In Jury’s Word, we discuss the recent tax rulings in India, which throw light on the judiciary positions of contentious transfer pricing issues.

In Global Developments, we cover the early signs of wide acceptance of the OECD’s BEPS Project recommendations, especially regarding the enhanced level of transfer pricing documentation.

While businesses are gearing up for their annual transfer pricing compliances and assessments, 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
While business restructuring has various complexities, it has become quite common for multinational enterprises (MNEs) over the last few years. MNEs consider restructuring their operations in response to competitive pressures, opportunities presented by the digital economy, changing regulatory and operating environment, etc. For example, moving manufacturing operations closer to the target market with a view to reduce the carrying cost and lead time or consolidating common functions at a central location with a view to achieve economies of scale. Many MNEs have also used restructuring as a legitimate tool for tax planning by shifting profits in tax favorable jurisdictions and thereby reducing the effective corporate tax rate of the Group.

Cross-border redeployment of functions, assets and/or risks by MNEs is regarded as business restructuring and involves any of the following:

- Transfer of tangible and intangible assets such as creating intangible property holding companies;
- Termination or renegotiation of existing arrangements;
- Conversion of a full-fledged manufacturer into a contract manufacturer or toll manufacturer, or distributor to a limited risk distributor;
- Rationalisation/specialisation of operations (For example, creation of a centralised support centre or centralised research and development (R&D) unit).

Such restructuring activities have been subject to increasing scrutiny from the OECD and various tax authorities due to the potential impact on domestic tax bases when profit-making activities are shifted from one jurisdiction to another. The OECD Guidelines place importance on justifying the arm's length nature of such activities.

This article highlights the transfer pricing issues arising from the different types of restructurings that MNEs may undertake.

**Issues from a transfer pricing perspective**

Transfer pricing issues for tax authorities in relation to business restructuring are twofold. First, whether the restructuring and transfer of assets (tangible and intangible) and risk is at arm's length and, second, whether the post-restructuring transfer pricing arrangements are at arm's length. However, a more fundamental question is whether the restructuring is actually carried out in substance or merely in form. These issues are discussed below:

**Substance vs form**

The key transfer pricing issues relating to restructuring stem from whether the reduced or changed functionality reflects the economic reality of the underlying transactions. A shift of functions only in form and not in substance may lead tax authorities to disregard the contractual terms/arrangements/ transfers and re-evaluate the transactions in accordance with substance or economic realities. The OECD Guidelines highlight a few instances in which tax authorities could disregard such transactions/structure adopted by a taxpayer. The guidelines permit two exceptional scenarios in which the structure/characterisation could be disregarded by the tax authorities, where the economic substance does not coincide with the legal structure or where there is a set of transactions which, when viewed in totality do not represent a rationale behavior by independent parties.

For example, an MNE may decide to transfer its newly developed and yet to be commercialised/intellectual property (IP) from its home country to a low tax jurisdiction. Such centralisation of IP ownership to a newly created subsidiary presents

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1 In fact, “… nearly half of all CEOs launch a reorganization during their first two years on the job.” Marcia W. Blenko, Michael C. Mankins & Paul Rogers, The decision-Driven Organization, Harvard Business Review 56 (June 2010)
The group decided to restructure the chemicals manufactured by A. B is currently engaged in the business of distributor for parent Company A in Germany. For example, while restructuring the entity performing R&D activities for the IP holding company is compensated with an arm’s length mark-up for its work. Similarly, in the second example, the agent should be remunerated with arm’s length remuneration for its marketing functions.

Another issue that arises in restructuring is the termination of existing contractual agreements and indemnification or adequate compensation on account of termination of agreement. If the agreement is terminated in accordance with the contractual terms and the notice period has been observed then compensation is generally not required. Of course, this requires that the contractual terms in the first place are at arm’s length as if they were between independent parties. Alternatively, if the termination of the agreement is without adequate notice it would lead to an ‘exit charge’ based on indemnification of loss of profits that would have been generated.

Post-restructuring considerations

As a general proposition, the application of the transfer pricing rules to the post-restructure transactions, should follow the same arm’s length principle. In the examples above, it is critical that after restructuring the entity performing R&D activities for the IP holding company is compensated with an arm’s length mark-up for its work. Similarly, in the second example, the agent should be remunerated with arm’s length remuneration for its marketing functions.

Another important aspect is that the MNE must not lose sight of a wide range of other direct and indirect tax consequences arising out of the restructuring. For example, while restructuring the functions of a distributor to a commissionaire agent, it may trigger permanent establishment (PE) exposure for the MNE. Similarly, while transferring IPs or any other asset there could be a potential VAT or capital duty consideration.
implication. An MNE must review its withholding tax, VAT and sales tax positions post restructuring in the new scheme of things. Allocation of expenses relating to restructuring and its deductibility also pose an important issue in most cases.

Documentation
As is the case with any transfer pricing arrangement, documentation plays a pivotal role in audit defence which holds true even in the case of business restructuring. An MNE must prepare and maintain contemporaneous and robust documentation. It is important to clearly document the functions, assets and risks of the entities involved in a business restructuring. The identification of key value drivers that result in the profit-earning capability of such businesses also needs to be documented. It is necessary to ensure that legal contracts, both pre and post restructuring are aligned with business and commercial realities and backed by economic substance. The commercial justification, cost-benefit analysis and business reasons for undertaking the restructuring exercise would have the last and final word in the entire exercise.

Conclusion
Most restructuring activities are not limited to the movement of assets, etc. but involve fundamental changes in an organisation's decision-making and in the way it functions. While more often than not the restructuring exercise is a result of commercial objectives and intent to create, it does attract scrutiny from tax authorities.

With the final guidelines on the Action Plan under the BEPS Project being released by the OECD, a paradigm shift is expected in the way corporate structures are built and in the tax authorities' approach towards them. It would be essential to revisit the existing structures with a view to align them with these new guidelines. Lastly, BEPS will not have a mere tax impact, but is expected to change the way an MNE carries out its business.
Advance Pricing Agreement (APA) information covered under Right to Information Act, 2005

Right to information (RTI) is a fundamental right given to every citizen of India to obtain information from public authorities. Citizens can get such information by filing applications under the Right to Information Act, 2005.

Recently, while pronouncing an order for an appeal filed by an RTI applicant, the Central Information Commissioner (CIC) held that the information about APAs are legitimately covered under the Right to Information Act, 2005 unless it is specifically excluded. The CIC further directed CBDT to disclose certain APA details to the applicant, especially estimated amount of transactions, detail of currency involved and approximation of the amount of revenue expected to be earned by tax authorities, thereof.

While the above steps may bring in transparency to the APA proceedings, it is imperative that the CBDT maintains the desired level of confidentiality about information pertaining to the companies involved in such APAs.

Huge quantum of income-tax cases pending in appeals at various levels

The Indian Finance Minister has recently mentioned that a significant number of cases are pending at various levels of the appellate authorities in India as on March, 2015.

<table>
<thead>
<tr>
<th>Appellate authority</th>
<th>Number of pending cases</th>
<th>Quantum of amount disputed (INR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income-tax Appellate Tribunal</td>
<td>37,506</td>
<td>1,450 billion</td>
</tr>
<tr>
<td>High Court</td>
<td>34,281</td>
<td>376.84 billion</td>
</tr>
<tr>
<td>Supreme Court</td>
<td>5,661</td>
<td>46.54 billion</td>
</tr>
</tbody>
</table>

In order to moderate the large number of pending cases, the Indian government has taken various initiatives such as increasing the threshold limit for handling a case by the single bench of the ITAT, issuing directions to the tax officers outlining the manner in which the standing counsels should be assisted to bring a speedy redressal of the pending cases, increasing the scope of settlement commission, extending availability of advance ruling to domestic companies with certain criteria, strengthening the advance pricing mechanism for transfer pricing matters, etc.

CBDT directs tax officers to file appeal on merit basis

Recently, the CBDT has reportedly asked senior tax officers to make ‘merit’ the essential criteria for moving forward in appeal proceedings. The CBDT warned officers against the laxity followed while filing appeals. On quoting recent judgments by the Tribunals/Higher Courts and adverse remarks by bodies like CAG, the CBDT mentioned that such an approach not only requires financial costs but also tarnishes the image of the department and strains its resources.

Tax officers have been directed to ensure that appeals are filed on the merits thereof and not merely on the tax amounts involved.

MAP Framework Agreement with USA to resolve bilateral tax disputes

Mutual Agreement Procedure (MAP) serves two nations to prevent taxation which is not in accordance with the Double Taxation Avoidance Agreement (DTAA).

As a major development in this regard, India and USA have signed a ‘Framework Agreement’ under the MAP provisions of India-USA Double Taxation Avoidance Convention. Around 35 disputes have been resolved under MAP recently; with an...
ambitious objective of resolving 200 disputed cases during the current year, large portion of which consist of companies in the IT and ITeS sectors.

India not in favour of the Mandatory Arbitration clause under MAP

OECD’s Base Erosion and Profit Shifting (BEPS) Project proposes to include a mandatory and binding arbitration clause in MAP of tax treaties.

The arbitration contract helps the parties to resolve their disputes outside the court. However, in case of mandatory and binding arbitration contracts, parties are required to waive their right to file a suit or appeal in court even if any of the parties disagree with the arbitrator’s judgment.

Such contracts can reduce the burden of resolving disputes on traditional court systems. However, the introduction of such a clause in MAPs may intrude the sovereign rights of a nation in taxation and limit the ability to apply its domestic laws for taxing non-residents and foreign companies.

Reportedly, many OECD members seriously contemplated for a mandatory and binding arbitration clause in model MAPs. However, India along with few other countries, have insisted to make it optional.

India gearing up for implementing OECD’s BEPS recommendations

The Joint Secretary and Competent Authority of India, Akhilesh Ranjan, has shared his views on BEPS during an interview held at 69th IFA Congress in Basel.

With regards to implementation of BEPS in India, he said that the Indian government is already in the process of holding seminars and training programmes and courses for familiarising the audience with BEPS. However, as far as implementation is concerned, India will wait for all the reports to be submitted to the G20. Further, he confirmed that implementation will be in line with the outcomes of the BEPS Project. Mr Ranjan indicated that multinationals will have to face additional compliance requirements and correspondingly reorient their strategies.
JURY’S WORD

HCL Technologies BPO Services Ltd vs ACIT: Adjustment cannot exceed the amount received by AE from customers. Abnormal costs on account of start-ups should be excluded when calculating operating cost.

The taxpayer is engaged in providing IT Enabled Services to its AE and benchmarked the transactions using the Transactional Net Margin Method (TNMM) using multiple year data. The TPO reluctantly accepted the comparable companies’ chosen by the taxpayer but rejected the use of multiple year data and proposed a transfer pricing adjustment of approximately INR 170 million on the transaction value of approximately INR 130 million. Aggrieved before the Commissioner of Income Tax (Appeals) (CIT(A)), the taxpayer contended that the transfer pricing adjustment should be restricted to the amount which is actually retained by the AE on the sale to the third party (being approximately INR 10 million). This was accepted by CIT(A) and partial relief to the taxpayer was provided.

The ITAT relied on the Kolkata Tribunal case of Global Vantedge Pvt Ltd where it was held that adjustment on account of arm’s length price cannot exceed the amount received by the AE from the customer and the actual value of the international transactions. The department's appeal against this ITAT order was dismissed by HC and Supreme Court (SC). Thus, the ITAT upheld the order passed by CIT(A). Furthermore, the taxpayer wanted to make adjustments for its one-time start-up costs that had lead to the losses and accordingly adjust the operating profit of taxpayer comparable companies. Being the first year of the taxpayer's operation, the ITAT accepted the taxpayer’s plea and directed the TPO/AO to re-determine the operating margins and consequent adjustment (if any).

Technimont ICB House vs DCIT: Notional interest on overdue receivable only till the end of the financial year and due consideration to be given if the sales price is fixed considering the delay in recovery of price.

The taxpayer is engaged in the business of execution of turnkey projects, design, supervision and other services. The taxpayer had entered into various international transactions with its AE which was benchmarked using TNMM and was also accepted by the TPO to be at ALP. However, the TPO charged notional interest on the delayed recovery of export receivables and delayed recovery of expenses. The TPO considered 60 days as the normal credit period and calculated interest at the rate of 12.25% (SBI PLR) for the period beyond 60 days till the date of the TPO order. This was upheld by the DRP.

Before the ITAT, the taxpayer contended that no interest was charged for the delay in the case of its AE and non-AE and transfer pricing regulations prevailing at that point of time did not include transactions pertaining to interest on outstanding receivables. Also, since the margin earned by the taxpayer was higher as compared to the comparable companies, the element of interest for delayed payment was subsumed in the higher mark-up charged. The ITAT held that, due to the retrospective amendment, interest on outstanding receivables shall attract transfer pricing regulations. However, the ITAT directed AO for charging of interest only till the end of the financial year under consideration. With respect to the taxpayer's contention that sales price was fixed considering the delay in recovery of price, the ITAT relying on the case of Goldstar Jewellery Ltd, directed the AO to check if the price charged had considered the delay. Lastly, the ITAT upheld the notional

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3 ITA No. 487/Mum/2014 – AY 2009-10
4 ITA No. 6570/Mum/2012 – AY 2008-09
interest calculated on the delayed recovery of reimbursement of expenses, however, they directed the AO to use the Libor rate for interest calculation.

DCIT vs Class India Pvt Ltd\(^5\): Capacity utilisation to be made in the margins of comparable companies; proportionate adjustments should be made for the same in the fixed costs.

The taxpayer is engaged in the manufacture of harvester combines and engine related products, licensed by the Class Group. The taxpayer benchmarked its various international transactions of purchase, sale, payment/receipt for support services by applying TNMM. The taxpayer had claimed that its adjusted operating profit on total cost margin was at arm's length when compared with three comparable companies. The TPO rejected two out of the three companies selected by the taxpayer and added an additional company of its own. The company added by the TPO was not challenged by the taxpayer. The CIT(A) has rejected the TPO's rejection of the two companies. However, the ITAT held that the exclusion and inclusion of comparables should be driven by the functional similarity or dissimilarity. The scale of similarity can be compromised to a certain extent in TNMM but not to the extent of changing the entire product line. Accordingly, the ITAT rejected the two companies, being tractor manufacturing companies, from the set of comparables.

Additionally, the taxpayer had claimed to have worked at 29% capacity whereas the comparable worked at 44% capacity, based on which, it had carried out capacity utilisation adjustment. The TPO, in principle, had accepted the argument of the taxpayer but modified its application in light of the final list of comparable companies. The TPO had also restricted the adjustment to only a few costs. This was also upheld by the CIT(A) who extended the capacity adjustment to advertisement, marketing and employee cost as well.

However, the ITAT, giving reference to Rule 10B, stated that in case of differences between taxpayer and comparables, an adjustment should be made to the margins of the comparables and not the taxpayer. Furthermore, the ITAT laid down computational principles to be followed and stated that variable and semi-variable costs remain unchanged due to the capacity utilisation and hence, no adjustment should be made to these costs. However, fixed costs have to be adjusted as per capacity utilised and this can be done by scaling up or down the fixed costs of the comparables as per those incurred by the taxpayer. Accordingly, the ITAT directed the TPO/AO to recompute the amount of capacity utilisation in light of the above principles.

DCIT vs Casio India Company Pvt Ltd\(^6\): Ruling on AMP expenses relying on Delhi HC ruling of Sony Ericsson

The taxpayer is engaged in distribution of watches and other related products of Casio Japan in India. The international transactions reported by the taxpayer were held to be at ALP by the TPO. However, the TPO proposed a transfer pricing adjustment on account of excessive AMP expenditure incurred by the taxpayer. The TPO was of the opinion that the excessive AMP led to the creation of marketing intangibles. The TPO relied on Special Bench's ruling in the case of LG Electronics\(^2\) and used the bright line test for identifying non-routine AMP expenses and applied Cost Plus Method (CPM) for making an adjustment. The adjustment was confirmed by the DRP.

However, in light of the HC case of Sony Ericsson Mobile Communications India Pvt Ltd\(^3\), The ITAT remanded the matter for recomputation according to the observations of the HC.

- The use of the bright line test was rejected and the ALP was to be determined preferably in a bundled manner with the distribution activity where suitable comparables (undertaking similar distribution activities and also incurring AMP expenses), should be chosen.
- If no suitable comparables are found then a suitable adjustment should be made to bring international transactions and comparable transactions at par.
- If an adjustment is not possible or a comparable is not available, then, the entity level TNMM should not be applied.
- In the above eventuality, international transactions of AMP should be viewed in a de-bundled manner or separately. In separately determining the ALP of AMP expenses, the TPO is free to choose any other suitable method including CPM.
- With respect to the computation of the base of AMP expenses, it was held that the subsidy received does not reduce the AMP for determining ALP. It has to be reduced from the amount of adjustment, if any, after determining the ALP.

Payne (India) Pvt Ltd vs DCIT\(^4\): ITAT upheld the payment of intra-group transactions at arm's length to the extent of cost

The taxpayer had made payments towards intra-group services at cost plus 5.8% to its AE and it was benchmarked using TNMM. The TPO determined ALP in respect to group services at nil by holding that the intra-group services did not result increase the profit margin. Aggrieved by this, the taxpayer filed an appeal with CIT (A). CIT(A) allowed payment towards intra-group services to the extent of cost restricted and the transfer pricing adjustment only to the extent of mark up. Aggrieved by this, revenue filed an appeal with ITAT.

The ITAT held that computation of ALP by the TPO at nil is contrary to transfer pricing provisions. The ITAT also observed that the TPO in subsequent assessment years had restricted transfer pricing adjustments only to the extent of mark-up charged.
by the AE. Accordingly, the ITAT partly ruled in the favour of the taxpayer and an adjustment to the extent of the mark-up was sustained.

**DCIT vs UPS Jetair Express Pvt Ltd**: Subvention income allowed as a deduction from transfer pricing adjustment amount, not considered in the operating margins of the taxpayer

The taxpayer is engaged in integrated transportation services. The taxpayer had incurred exceptional losses on account of adverse business and economic conditions. As compensation, the taxpayer received subvention income from its AE and offered the same to tax. Furthermore, the taxpayer used TNMM for benchmarking and considered the amount as operating income while working out operating margins. The TPO excluded the subvention income from the operating profit margin calculation and accordingly worked out a transfer pricing adjustment. The taxpayer filed its objection before the DRP.

The DRP while accepting that subvention income is not a part of operating income, held that the said amount should be allowed as a deduction from the transfer pricing adjustment value since tax is already paid by the taxpayer. The ITAT agreed with the views of the DRP and held that subvention income is as much as it was offered to tax, cannot be taxed twice and accordingly, should be reduced from the amount of adjustment. At the same time, the ITAT observed that since subvention income received is not derived from operating activities, it cannot be regarded as operating income for Profit Level Indicator (PLI) calculation.

**Reliable Cashew Co Pvt Ltd**: ITAT upheld the use of Comparable Uncontrolled Price (CUP) method using trade journal data and allows adjustment for extra credit period granted to the taxpayer

The taxpayer had entered into an international transaction with its AE for the purchase of raw cashews. The taxpayer had benchmarked the above transaction by comparing its average monthly import price with the average monthly price published by the cashew bulletin of the Cashew Export Promotion Council. Furthermore, the AE did not grant any credit period to third parties but the taxpayer was extended a credit period of 150 days. Accordingly, the taxpayer’s purchase price was higher since it included interest at the rate of 12% for an average credit period granted over 30 days. The TPO ignored the interest adjustment claimed by the taxpayer in the purchase price and compared each purchase price (including interest) with average prices published by the cashew bulletin. CIT(A) upheld the adjustments made by the TPO.

The ITAT directed the TPO to compare the average monthly price published in the cashew bulletin with the average price charged by the taxpayer. Additionally, the ITAT considered the taxpayer’s plea as industrial norms suggest the import of cashew was carried out on immediate payment terms and since it had availed credit for payment, payment of interest was viable. The purchase price was a little higher than the external prices relied by the revenue and the difference was acceptable on account of interest. The ITAT accordingly deleted the adjustment.

**Aquila Software Services Pvt Ltd** vs DCIT: ITAT upheld that for invoking provision with respect to more than ordinary profits under section 80-IA(10), it is essential to prove business arrangements are tainted.

The taxpayer is engaged in the business of providing IT enabled BPO services to its AEs.

The taxpayer had, during the year, sold equity shares of Aegis BPO Services (Gurgoan) Ltd to Essar Services Holding Ltd, Mauritius, at a valuation of INR 12.72 per share. The taxpayer used Discounted Cash Flow (DCF) approach and determined the value of shares to be nil and accordingly justified that the transaction is at ALP. The TPO rejected the valuation and computed the value of the share using DCF technique at INR 133 per share. Furthermore, the DRP reduced the value of each equity share to INR 104 and accordingly made the adjustment. The ITAT observed that the taxpayer had pointed out several defects in the TPO’s methodology and thus directed the AO to verify the working given by the taxpayer as per the DCF technique and determine the correct value of shares accordingly.
and make suitable adjustments if required.

With respect to the transaction of providing guarantee on loans to the AE, the taxpayer had entered into guarantee agreements with third party banks. The taxpayer relied on the case of Bharti Airtel\(^{13}\) and did not disclose the transaction in the Form 3CEB. Furthermore, the taxpayer in AY 2012-13 had charged guarantee commission at the rate of 1% to its AE retrospectively from AY 2008-09. The TPO contended that guarantee commission should have been charged at the rate of 5% from the AE and made the adjustment accordingly. However, the DRP was of the opinion that since Indian banks charge 3% as guarantee commission, it was appropriate to use 3% as a benchmark. The ITAT also stated that, since in many cases, tribunals have accepted 0.5% to 1% rate as guarantee commission, 1% should be considered as an appropriate benchmark.

With respect to the transaction of subscription and redemption of preference shares, the taxpayer had, during the year, subscribed and redeemed preference shares at par. The TPO observed that these shares were non-cumulative and redeemable at par without any dividend. Accordingly, the TPO re-characterised the above transaction as an interest free loan advanced to the AE and determined the rate of interest at 15.41% and accordingly made an adjustment. The DRP upheld the action of the TPO and determined the interest rate at 15.43%. The ITAT held that the transaction was clearly a case of investment in shares and cannot be treated differently so as to expand the scope of transfer pricing by re-characterising it as an interest free loan. The ITAT also held that the TPO cannot question the commercial expediency of the transaction entered into by the taxpayer unless there is evidence and circumstances to doubt.

With respect to the transaction of advances given to the AE, the taxpayer had given an advance to the AE to engage a consultant overseas. The taxpayer had erroneously disclosed the transaction as advance when it had made actual payments in the subsequent year, against the invoices. However, the TPO characterised it as an interest-free loan and computed interest at 15.41% and made an adjustment accordingly which was confirmed by the DRP. The ITAT held that since such expenditure has been booked in the succeeding year, it cannot be characterised as an advance. It is purely for business and commercial consideration and hence, no interest can be charged on such an advance/expense.

**Marubeni Itochu Steel India Pvt Ltd vs DCIT: ITAT upheld the use of berry ratio and deleted adjustments for location savings and intangibles\(^{14}\)**

The taxpayer is engaged in the business of trading of steel items and provides support services to its AE. The inter-company transactions and its benchmarking are explained below:

a) Trading segment, where the taxpayer does back-to-back trading transactions on the basis of confirmed orders. TNMM was used as the benchmarking method where the taxpayer’s PLI of operating profit on sales was 7.91% as compared to 7.52% of its comparables.

b) Support service segment, where the taxpayer acts as a communication channel between the AE and end customer. TNMM was used as the benchmarking method where the taxpayer’s PLI of operating profit on value added expenses was 0.8% as compared to 0.61% of its comparables.

The TPO re-characterised the indenting transaction as a trading transaction and compared the margins with other comparable companies engaged in trading activities. The TPO lowered the taxpayer's margin by adding the value of goods in the cost base and used operating profit on operating cost as the PLI. Furthermore, the TPO also regarded the taxpayer as the owner of the supply chain management and human intangibles and contended that the compensation model of the taxpayer did not consider profits attributable to location savings.

The DRP directed the TPO to reduce the value of the goods added to the cost base and rejected all other objections of the taxpayer. The taxpayer preferred an appeal before ITAT.

ITAT noted that the fact that the taxpayer was a part of the leading ‘Sogo Shosha’ i.e. general trading establishment in Japan. The ITAT, while ruling in the favour of the taxpayer, held as under:

- Placing reliance on Mitsubishi Corporation India Pvt Ltd’s\(^{15}\) case, the ITAT upheld the taxpayer’s contention that berry ratio was correctly applied. The ITAT also stated that it is no longer open to the revenue authorities to reconstruct the financial statements and derive hypothetical trading profits for determining the arm’s length price.

- Use of intangibles cannot be inferred and needs to be demonstrated on the basis of cogent material by the TPO.

- The ITAT placed reliance on the case of Mitsubishi Corporation India Pvt Ltd which held that where the taxpayer is a facilitator, its activities may not result in location savings to the group.

Thus, the ITAT deleted adjustments and remitted the matter back to the TPO for factual corrections.

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13 ITA No. 5816/Del/2012 - AY 2008-09
14 ITA No. 761/Del /2015 - AY 2010-11
15 ITA No. 761/Del /2015 - AY 2010-11
In what is widely considered to be one of the most fundamental changes in the international tax framework of this century, on 5 October 2015, the Organisation for Economic Co-operation and Development (OECD), presented a set of final reports on 15 action points aimed at curbing Base Erosion and Profit Shifting (BEPS) practices perceived to be undertaken by multinational corporations/enterprises.

Among the various far-reaching recommendations, Action 13 (Transfer Pricing Documentation and Country-by-Country (CbC) reporting) is already having an impact across the globe with different countries preparing to revise their transfer pricing documentation requirements.

The BEPS report on Action 13 recommends a three-tiered documentation approach that consists of:

1) A master file containing standardised information relevant for all group members of MNE;
2) A local file referring specifically to material transactions of the local taxpayer; and
3) A country-by-country (CbC) report containing certain economic information within the MNE group

Moreover, the OECD has also released the Implementation Package for CbC reporting on 8 June 2015 which contains model legislation that countries could use to implement CbC reporting conventions along with model Competent Authority Agreements that countries could use to facilitate cross-border exchange of information between tax authorities. Further, the OECD has recommended the implementation of the CbC reporting be effective from fiscal years starting on or after 1 January 2016.

The three-tiered documentation approach proposed by the OECD has received a positive response from countries around the world. The tax authorities are not only enacting new laws to revise documentation requirements in line with OECD’s action plan but also intensifying penal provisions to ensure improved compliances.

Recent country-wise updates in this regard are as follows:

**Spain**

On 10 July 2015, the Spanish Ministry of Finance published the Royal Decree 634/2015 approving Corporate Income Tax Regulations. The decree mandates a new transfer pricing documentation requirement which incorporates the need for a CbC Report in addition to the master file and local file.

The new reporting will be required for tax periods starting on or after 1 January 2016 following which the Spanish parent company of an MNE group will be subject to CbC reporting if the consolidated turnover of the MNE exceeds EUR 750 million.

Furthermore, the CbC report will have to include the following country-wise information on a comprehensive basis and it must be denominated in Euros.

- Group’s revenue, differentiating between revenue derived from related and unrelated parties
- Income tax paid (on cash basis), including withholdings incurred
- Share capital and equity at the end of the fiscal year
- Average number of employees
- Tangible assets and real estate investments, different from cash and cash equivalents
- Other relevant information

The group documentation rules specifically highlight two particularly contentious areas such as intangible assets and financial activity both of
which are subject to analysis by the OECD in the context of the BEPS Project.

**Korea**

On 6 August 2015, Korea’s Ministry of Strategy and Finance announced its 2015 tax reform proposals, which require taxpayers to maintain comprehensive transfer pricing reports in line with the master file and local file requirements suggested by the OECD. The comprehensive reports must be filed before the due date for filing Korean corporate tax returns. Furthermore, failure to comply with reporting requirements will attract penalties as high as KRW 10 million.

However, CbC reporting has not been included in current proposals.

**Germany**

The German government announced plans to incorporate CbC reporting requirements in its domestic tax laws. Proposed laws are being drafted by the German tax authorities and are expected to be finalised before the end of 2015.

**Australia**

On 6 August 2015, the Australian Treasury released an exposure draft with a clear intent to curb tax avoidance practices undertaken by some multinationals.

The new draft law requires Australian residents or foreign residents with an Australian permanent establishment (PE) that have an annual global revenue of AUD 1 billion or more to provide a statement to the Commissioner before the end of the next income year. This statement would include the CbC report, master file and local file.

Eligible entities must provide the statement to the Commissioner in the ‘approved form’. However, if multiple entities from the same group are resident in Australia, the Commissioner could specify that only one of those entities must provide the master file in its statement.

Moreover, the new draft law proposes to double the maximum penalty applicable to 120% of the amount of tax avoided, under the profit shifting/tax avoidance schemes as against 60% in the old scheme.

**Mexico**

On 8 September 2015, the Mexican government while releasing the Federal Budget for the year 2016 proposed to revise transfer pricing documentation requirements. Companies in Mexico with taxable revenue above MXN 644.59 million and such other specified companies will be required to annually file master file and local file information returns with the Mexican tax authorities. Furthermore, the threshold limit set is proposed to be revised on an annual basis to bring it at par with the limit in Euros specified in the BEPS Action 13 outcome.

Moreover, companies which are holding companies of any multinational with a consolidated global revenue above MXN 12 billion or companies that may be designated by the parent as responsible in this regard, will be additionally required to file a CbC information return annually.

These regulations are proposed to be implemented from 1 January 2016.

**Poland**

Recently, Poland’s Ministry of Finance released a CbC declaration template which contains two tables providing a summary of income allocation, taxes, business activity, etc. which must be prepared by taxpayers that have a consolidated revenue over EUR 750 million.

In addition, the amendments provide for a range of information which the taxpayer needs to add in the documentation such as financial data, related parties, transaction details, etc. The deadline to submit this documentation has been set at 30 days from the date of the delivery of the tax notice.

**Netherlands**

On 15 September 2015, the Dutch Ministry of Finance while presenting its National Budget for 2016 has proposed to introduce contemporaneous documentation requirements and to enact additional transfer pricing regulations that are proposed to be made applicable effective from 1 January 2016.

Under the new transfer pricing requirements, all Netherlands-based multinational companies having consolidated revenue above EUR 50 million in the preceding year will have to maintain contemporaneous documentation consisting of a master file and a local file.

Furthermore, multinationals that have the ultimate parent in the Netherlands will be additionally required to maintain a comprehensive CbC report if their consolidated revenue exceeds EUR 750 million. In addition, the CbC report needs to be filed annually with the tax authorities.

**China**

On 17 September 2015, China’s State Administration of Taxation (SAT) issued the discussion draft of ‘Special Tax Adjustment Implementation Measures’ covering a range of source materials including: (1) existing transfer pricing guidance; and (2) items emerging from proposals in the OECD’s BEPS Project. This draft proposes the adoption of a three-tiered documentation approach as per BEPS Action 13 and would comprehensively revise the current transfer pricing framework.

Key highlights of the draft:

- If the taxpayer engages in intra-group service transactions, the company would have to maintain a special file, containing copies of the relevant inter-company agreements, documentation of service cost identification and allocation keys and the benefits received by the Chinese service recipient.
- The definition of intangibles has been expanded to include goodwill and going concern value (which is in line with the amendments in the guidelines on intangibles recommended in the BEPS Project)
- During the course of a special tax investigation, the Chinese tax authorities would have the power
to request the investigated enterprise to provide a CbC report.

- Transactions like equity transfers, transfers of financial assets, cash pooling arrangements, pre-payments and delayed payments, which should have been subject to interest, are now explicitly being addressed by the transfer pricing rules.

- Taxpayers would need to monitor transfer pricing policy implementation and profit levels along with the compliance of contemporaneous documentation and related party disclosure requirements.

- The discussion draft describes two types of ‘other methods’ that can be applied: the value contribution allocation method - applicable where comparables are difficult to find but an allocation formula can be reliably determined - and asset valuation method.

The SAT is seeking public comments on the draft by 16 October 2015.

Developments in Advance Pricing Agreement procedures

An Advance Pricing Agreement (APA) is an effective tool for signifying transfer pricing compliance. It offers cost-benefits in terms of time and resources for both multinationals and tax authorities.

Various jurisdictions are now taking appropriate steps by enacting new APA procedures, simplifying the existing ones and concluding the APA applications so as to provide a platform to multinationals for gaining transfer pricing certainty and avoiding litigations thereafter.

Recent developments in APA procedures are as follows:

Australia

On releasing the new Practice Statement Law Administration (PSLA) 2015/4, the Australian Tax Office (ATO) updated the old procedure for APAs, reducing the number of stages of APAs from five to three. These revised stages are:

1. Early engagement
2. APA application
3. Monitoring compliance

ATO has further introduced significant changes in the early engagement stage. In this stage, companies are profiled before proceedings of a formal APA application. ATO also declared that an APA management unit will manage the APA application centrally. ATO has set a time frame of maximum 6 months for the first stage. In the second stage, the ATO formally invites applicants to lodge applications. The maximum time frame for completion of the second stage is 18 months. The final stage is monitoring compliances which is an annual requirement after entering into the APA.

The new PSLA statement is comparatively easier to follow and provides a clear roadmap for taxpayers wishing to pursue an APA.

As on 30 June 2015, the number of completed APA applications had reached 129 while only nine applications were in process.

Ukraine

On 25 July 2015, the cabinet ministry of Ukraine introduced new APA procedures which override the earlier procedures issued in December 2014. The legislations also try to be mainly in line with the transfer pricing regulations as suggested in the OECD guidelines. The new procedures also highlight various upcoming developments in bilateral and multilateral APAs.

The preliminary stage of an APA allows authorities to examine the feasibility of the taxpayer to enter into an APA. This stage involves disclosure of limited information by taxpayers to the authorities. Authorities may also request for more information based on the facts and circumstances that may differ from case to case. Taxpayers can expect the results of preliminary feasibility assessments within 60 days.

Canada

On 17 August 2015, the APA Program Report for the fiscal year ending on 31 March 2015 was issued by the Canadian Revenue Authority (CRA). The report reflected important statistical analysis with respect to the implementation of the APA programme in Canada along with an operational review.

The key findings of the report are:

- In FY 2014-15, 38 APAs were filed, out of which 31 APAs were completed. Six were withdrawn and one was unresolved. Out of the 31 APAs, two were unilateral while the remaining were bilateral.

- The CRA divided the APA programme into three stages, namely the due diligence stage, negotiation stage and completion of agreement drafting and signing.

- In FY 2014-15, the CRA took an average of 31.5 months for the due diligence stage as compared to 30 months in FY 2013-14. The negotiation stage took an average of 5.8 months in FY 2014-15 as compared to 4.9 months in FY 2013-14. After the completion of negotiation stage, the CRA took an average 11.1 months to complete the final stage.

- With regard to the progress of APAs, Transactional Net Margin Method (TNMM) was used in 62% cases. The remaining cases included other methodologies such as Profit Split (13%), Comparable Uncontrolled Price/ Transaction (12%), Cost Plus (11%) and Resale Price (3%).

The authority is also engaged in bilateral and multilateral APA negotiations with many countries across the globe.

New Zealand

New Zealand updated guidance on the APA application process.

The APA process had not been explicitly defined in New Zealand. However, New Zealand's tax authority recently published a list of steps aiming to standardise the process where possible. Agreements can be
sought from Inland Revenue (IR) alone (unilateral) or between IR and another tax authority/ies (bilateral/multilateral). IR aims to complete all unilateral APAs and bilateral APAs with Australia within six months of acceptance of a formal application.

No timeframe has been specified for APAs involving tax authorities other than Australia.

India

The Indian government recently signed a unilateral APA with a multinational company in the information technology sector. Based on the details available, this is the third APA concluded with IT/ITeS companies, out of the total 20 unilateral (approximately) and one bilateral APA concluded by India till date.

India has also signed two unilateral APAs with roll-back provisions, the first is with a US-headquartered company for a nine-year period– including the previous four years and for the next five years.

Other Global Happenings

European Union (EU): Set-up of the work programme 2015-2019

On 17 June 2015, the European Commission communicated its Action Plan for a fairer corporate tax system in the European Union (28 member countries). Furthermore, EU’s Joint Transfer Pricing Forum (JTPF) agreed on the Work Programme for 2015-2019 for developing a framework so that the OECD’s BEPS Project outcomes can be applied consistently by all 28 member countries of the EU.

The main focus of this programme is improving the framework to ensure that taxation of intra-group profits is more fairly linked to the actual place of activity.

EU has set up the following order of priority items to deal with transfer pricing items:

1) Provide guidance on practical issues arising on CbC reporting and multi-tier transfer pricing documentation so that companies and tax administrations can adopt OECD recommendations as early as possible.

2) Study ways where internal comparables can be excessively used and how external comparables can be used at a regional level, what kind of comparability adjustments can be made and the manner in which adjustments can be performed.

3) Provide guidance on economic valuation methods for inter-company transactions arising out of newly developing business models.

4) Review multi-country controls on transfer pricing matters.

5) Study and provide recommendations on the use of profit split methods as suggested by OECD in the BEPS Project.

6) Study and suggest measures to strengthen APA and dispute resolution mechanism.

The measures to be followed are aligned with the OECD’s BEPS reforms but are shaped to meet the EU’s own particular challenges and needs.

BRICS Nations: Strong support to OECD

During the Shanghai Cooperation Organization (SCO) and BRICS summit at Ufa, Russia in July 2015, the BRICS leaders declared the need to implement through the G20, global financial regulation reform and adaptation to new rules introduced by the Action Plan on OECD’s BEPS Project and the Common Reporting Standard for Automatic Exchange of Tax Information.

South Korea: Amendments to the Enforcement Decree of the Adjustment of International Taxes Act (AITA)

Modification to the submission of Arm’s Length Price Computation Method (Article 7 of the Enforcement Decree)

<table>
<thead>
<tr>
<th>Current Scenario</th>
<th>Changes</th>
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<tr>
<td>Transaction of goods:</td>
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<tr>
<td>Total amount: Less than KRW 5 billion</td>
<td>Amount of transactions of services: Less than KRW 1 billion</td>
</tr>
<tr>
<td>Amount of transactions of services: Less than KRW 500 million</td>
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<tr>
<td>Total amount of transactions of goods for each foreign related party</td>
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<tr>
<td>Total amount: Less than KRW 1 billion</td>
<td>Amount of transactions of services: Less than KRW 200 million</td>
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<tr>
<td>Amount of transactions of services: Less than KRW 100 million</td>
<td></td>
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</tbody>
</table>

With a view to reduce taxpayers’ compliance burden, the South Korean government has increased the criteria of exemption for submission of Arm’s Length Computation Method\(^1\) which will be made applicable from tax years starting 1 January 2015.

\(^1\) Arm’s Length Computation Method: Under South Korean transfer pricing disclosure requirements, a taxpayer is required to submit, with the annual tax return, the transfer pricing method selected and description of the reasons for the selection.
Base Erosion and Profit Shifting (BEPS) refers to the complex structuring done by multinational businesses to artificially shift profits to low-tax countries and pay little or no corporate tax. The OECD estimates that USD 100 to 240 billion in tax revenue is lost every year due to such tax avoidance – that’s 4-10% of global corporate income tax revenues. And so, in 2013 the OECD issued 15 BEPS action points and earlier this year, after several rounds of consultation, it issued final BEPS standards.

Maulik Doshi, Partner, International Tax and Transfer Pricing was interviewed by CNBC-TV18’s Executive Editor, Menaka Doshi, for The Firm — a show that covers corporate law, M&A, financial regulation, tax and audit matters in India. Here are key highlights of his interview on the impact of the BEPS standards on Indian companies and Indian multinationals.

**Top Impact Areas**

**Disclosures**
- *Transparency is a key pillar*  
- *Mandatory disclosure regime*  
- *Transfer pricing documentation*  
- *Country-by-country reporting*

**Maulik Doshi (MD):** “Essentially, the BEPS Action 13 requires three-tiered documentation. So, they are going to revise the transfer pricing documentation guidelines to provide for three-tiered documentation, which includes the preparation of a master file by the multinational enterprise, preparation of a local country filing in each of the countries where the MNC is operating and a country-by-country report. If a multinational is operating in India, the tax authority, at one go, is able to see what kind of profits it derives in Singapore, whether the profit derivation in Singapore is linked to value creation or if it is just a shell entity and the profit is just lying as is.

These concepts were already used by the Indian tax administration. Now with the OECD’s stamp of approval and being regarded as important competitive factors, it would just put more force on the Indian tax authorities in terms of using this.”

**Will the Mauritius route fade?**

**MD:** “The India–Mauritius treaty is already under renegotiation. A significant portion of the renegotiation has already taken place: it is just not in the public domain. The OECD BEPS plan would give more political advantage/bargaining power to India to negotiate with Mauritius and put the effective limitation of benefit clause, ensure that Mauritius does not allow treaty shopping.

...we will see more and more disclosures to be made in respect of the investment holding companies, etc.”

**Finance Minister Arun Jaitley in a Press Note**

“In international taxation matters, Finance Minister Arun Jaitley welcomed the efforts of OECD in areas of BEPS Project and automatic exchange of information which have important implications for Commonwealth countries. He emphasised the need to ensure that the Common Reporting Standards on Automatic Exchange of Information are implemented globally on a fully reciprocal basis as this would be a key to prevent international tax evasion and avoidance. He noted that India has been the beneficiary of these systems by getting vital information on tax evasion and emphasised the need for genuine and equitable multilateralism in deciding global norms and standards on taxation.”

You can view the full interview on CNBC-TV18’s YouTube channel or by clicking [here](#).
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