Transfer Pricing Courtroom Around the World | 2019

Foreword

In 2019, many countries experienced a reduction in tax base and a decline in tax revenues due to economic developments. As a consequence, the pressure has never been higher on tax authorities to protect domestic tax revenues. It is not just a coincidence that the advent of 2020 being the year of the Rat, calls for new beginnings and brings with it a lot of expectations for prosperity and peace. Policymakers worldwide are refining local laws, and new fields of guidance aimed in that direction are underway.

There has been a surge of developments in the transfer pricing space - taxation of increasing digitalized businesses, clarity on financial transactions, etc. This transition of global business and constant transformation is now having a perceptible effect on the transfer pricing policy as well. While the international tax community observed an immense load of guidelines from OECD on the Tax front in recent times, on the other hand, the judiciary from around the world also provided beneficial guidance on critical matters surrounding this highly 'artistic' subject called 'Transfer Pricing.'

They say great learnings also come from the experiences of others.

With this backdrop, we at Nexdigm (SKP) have put together 10 important rulings of 2019, from the judiciary of different parts of the world, on various issues including – incidental benefits under intra-group arrangement, implementation of APA, economic characterization, valuation, treatment of ESOP expenses, and more. In this inaugural edition, we have attempted to analyze the key principles emanating out of these judgments which may be applied by the taxpayers while a) formulating transfer pricing policy, b) creating defense strategy during the audit stage.

We hope that this is an interesting read and would love to hear your take on these significant judgments that continue to shape the global transfer pricing landscape.

We look forward to hearing from you!

WORLD TP
HIGHLY REGARDED PRACTITIONER
2020

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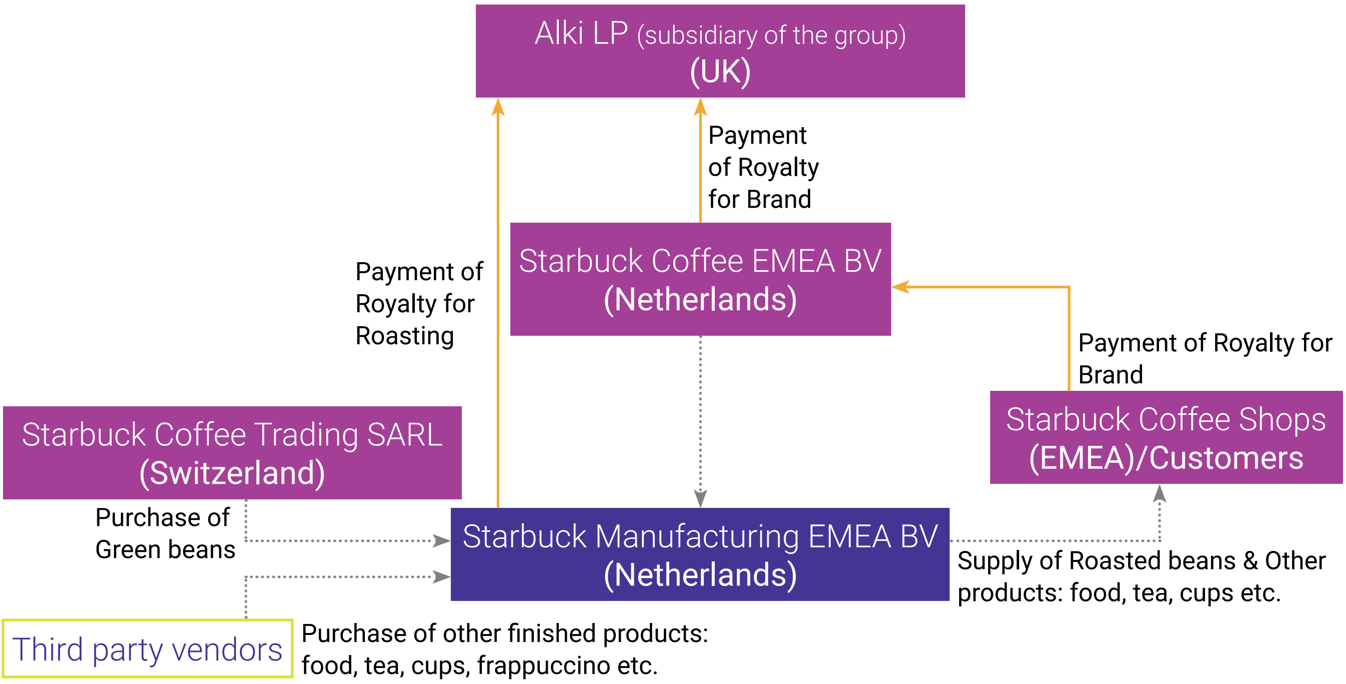
General Court of European Union holds that an undue advantage was offered to the taxpayer under the agreed Advance Pricing Agreement (APA)



Starbucks Manufacturing EMEA BV (SMBV), Netherlands, the taxpayer, is a subsidiary of the Starbucks group that has a 'roasting' agreement with another group company Alki, UK. Pursuant to the agreement, SMBV is to pay Alki a royalty fee for use of IP rights, roasting methods and know-how. SMBV concluded an APA with the Netherlands tax authorities for its production and distribution activities and the agreed outcome was that:

- SMBV to be remunerated on a cost-plus basis, wherein the cost did not include the cost of green coffee beans [purchased from Starbucks Coffee Trading SARL, Switzerland (SCTS)] and certain other third-party costs; and
- Royalty amount would be the difference between: (a) actual operating profit before royalty; and (b) SMBV's remuneration as per the APA.

Pursuant to the above, the European Commission (EC) initiated a formal investigation and found that the APA constituted state aid that was incompatible with the internal market.

Issue: Whether APA obtained by SMBV constituted state aid by The Netherlands Tax Administration to SMBV resulting in SMBV's profits in Netherlands lower than the arm's length standard.

Key contentions of the EC

- Regarding the Netherlands Tax Administration's argument that the EC could not examine the APA under an arm's length principle particular to EU law, the EC contended that its investigation did not aim at examining whether the APA observed an arm's length principle, but, it sought to determine whether the Netherlands Tax Administration had conferred 'selective advantage' on SMBV.
- SMBV did not receive any benefit (profit generation) from the use of Intellectual Property (IP) rights, therefore, the arm's length price (ALP) of Royalty should be Nil under CUP method.
- SCTS (supplier of green coffee beans) earned a significantly high gross margin during the APA period by significantly overpricing the green coffee beans to SMBV. The price premium lead to lowering the taxable base of SMBV, constituting a 'selective advantage.'

- Transactional Net Margin Method (TNMM) approach adopted by SMBV is erroneous, because:
  - SMBV, having regard to its operations (in comparison to Alki), cannot be regarded as simpler entity, thus tested party
  - SMBV is principally a reseller and therefore the Profit Linked Indicator (PLI) shall not be cost-based, but revenue-based

Key contentions of SMBV and The Netherlands Tax administration

- EC has erred in examining the arm's length principle, thereby, challenging the Member State's fiscal autonomy.
- Payment of Royalty is not covered transaction under the APA.
- The payment of Royalty does not impact the remuneration to SMBV, given the manner of computation (see above).
- There is no strict rule in the Netherlands tax laws that suggest the use of CUP method over TNMM. Also, merely alleging a methodological error does not equate to proof of 'State aid'.

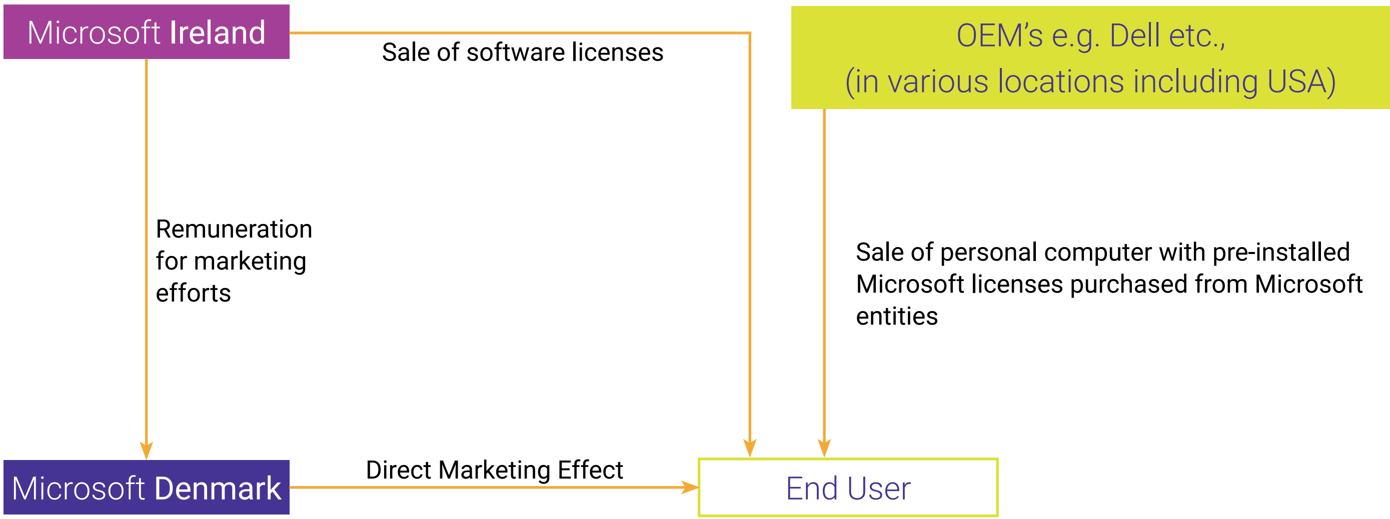
Judgment of the General Court (GC)

- The GC ruled that EC did not err in identifying ALP as a criterion for assessing existence of 'State aid.' The ALP is a tool that allows EC to check that the intra-group transactions meet the open market condition, that tool falls within EC's competence in State aid matters.
- The GC concluded that EC did not provide any backup to establish the difference in pricing determined as per the APA and market prices. Also, it failed to demonstrate that various errors identified under TNMM approach had the effect of reducing the taxable income.

Key takeaways

- EC can look at national tax arrangements and is entitled to identify an arm's length principle as a criterion for assessing the existence of State aid.
- EC lost the said case due to lack of proof on the state aid and unable to establish the 'advantage' provided by the APA. It can be expected that the European Commission, will argue such matters more constructively and conduct detailed analysis in future. Therefore, irrespective of a tax arrangement, the taxpayer should maintain substantive documentation to demonstrate the arm's length nature of its transactions.

Danish Supreme Court deletes transfer pricing adjustments on account of incidental benefits



Microsoft Ireland Operation Limited (Microsoft, Ireland) is engaged in sales, production, distribution and logistics in EMEA region. Microsoft Demark ApS (Microsoft Denmark/ Taxpayer) was appointed to provide marketing support services to Microsoft Ireland in Denmark. For the said marketing effort, the taxpayer was remunerated with certain Commission % on sales and a cost plus mark-up of 15%.

The group would supply the software licenses to broadly two category of customers
1) End users and 2) Original Equipment Manufacturers ("OEM").

Notably, software licenses sold to OEM's (e.g. Dell) would be used by these OEM's to pre-install it in personal computers, before these personal computers are sold by OEM's to end customers.

Based on the language of inter-co agreement (market development agreement/MDA) between Microsoft Ireland and Microsoft Denmark, the Danish tax authorities alleged that the taxpayer should be remunerated for its marketing efforts towards *all* sale, including, sale of the pre-installed software by certain category of OEM's in Denmark (refer to above).

Issue: Whether Microsoft Denmark was required to be compensated for the incidental benefits that arose to Microsoft Group?

Key contentions of Danish Tax Authorities

- Microsoft Denmark was contractually obliged to market all of the group's products.
- Microsoft Denmark's marketing effort to the sale of packages license also impacted demand of computers with pre-installed Microsoft programs, leading to an increase in demand for Original Equipment Manufacturer (OEMs) licenses in Denmark.
- Hence, Microsoft Denmark is required to be compensated for sale of OEM licenses by Microsoft US/Denmark.

Key contentions of Microsoft Denmark

- Microsoft Denmark was neither contractually obliged to perform marketing nor entitled for compensation towards the group's sale of OEM licenses to multinational computer manufacturers.

Judgement Supreme Court - Majority

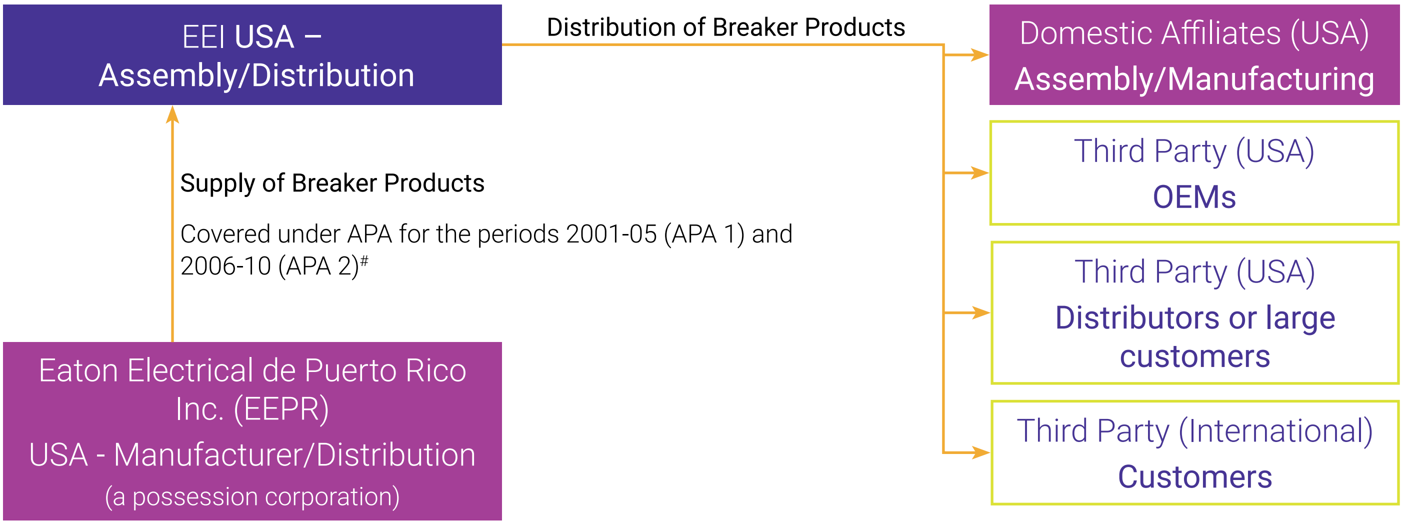
- Regarding the scope of marketing agreement, the Supreme Court opined that it only includes marketing efforts of Microsoft Denmark towards direct sale in Denmark. The indirect benefit of marketing effort of Microsoft Denmark (if at all) on sale of preinstalled software by OEM's was only incidental.
- The Supreme Court (majority) also opined that an independent party would not have been compensated towards sale of pre-installed software in similar situation.
- Lastly, it was held that the Tax authorities could not prove that the transaction was not meeting the arm's length standard therefore did not discharge the onus of proof.
- The Supreme court has clarified that the discretionary transfer pricing adjustments cannot be made unless the tax authorities prove that –
  1. The transfer pricing documentation is not submitted to the tax authorities by the date of the tax assessment; or,
  2. The transfer pricing documentation is so flawed that it cannot form an adequate basis for determining whether the arm's length principle has been complied with.
- Accordingly, the Supreme court ordered to delete the transfer pricing adjustments made by tax authorities in the instant case.

Key takeaways

- Judgment re-emphasizes the principle that - incidental benefits to one entity, do not led to compensation to other entity.
- It is important for taxpayers to take extra care while finalizing terms and conditions of written contractual agreement which may led to adverse impact on rights/ obligations to contracting entities.
- On a similar note, the robustness of transfer pricing documentation (especially keeping in mind defence strategy at the time of detailed audit by tax office) is very critical.

US tax court holds that cancelation of Advance Pricing Agreement (APA) was an abuse of discretion by the US Inland Revenue Services (IRS)

Eaton Corporation (the taxpayer or EEI), is a manufacturer of electrical and industrial products. It is a publicly held US parented corporation that had entered into two APAs. The operating structure of the group may be represented as follows:



Key terms of the APA:

- **TP Methodology:** Combination of Comparable Uncontrolled Price (CUP) and Cost Plus Method (CPM), wherein, income of EEI from the sale of goods to related parties shall be reconstructed with reference to selling price/mark-up for third party Original Equipment Manufacturers (OEM) customers.
- **Agreed TP in APA 1:** Taxpayer's Berry Ratio (Gross profit to Operating expense %) of 1.20 to 1.27, and, Selling, general, and administrative (SG&A) expenses to revenue within 13 to 20%.
- **Agreed TP in APA 2:** Taxpayer's Berry Ratio of 1.20 to 1.24.

Issue: The US Tax Court sought to determine whether the cancellation of the APA's was an abuse of the discretion available with the IRS.

Key contentions of the IRS

- The IRS canceled the APAs on the basis of numerous grounds, including the failure of a critical assumption, misrepresentation, and lack of good faith compliance with conditions of the APA.

Key contentions of EEI

- The taxpayer argued that it did not fail to comply with terms and conditions of APA but committed implementation and computational errors, not warranting cancellation of APA. The same could be corrected by way of adjustments.

- The US Tax Court analyzed nine areas of APA negotiation to conclude that the cancelation of APA was an abuse of discretion by the IRS. The nine areas included arguments of US IRS, such as –
  - EEI consistently incurred losses / marginal profits as per proposed TP methodology, whereas, 80% of the profits were allocated to the Island plants
  - EEI had material marketing intangible, therefore, cannot be regarded as simpler entity or Tested party for transfer pricing analysis.
  - The accounting records of EEI did not reflect the TP Methodology agreed in the APA etc.

Judgment of the US Tax Court (Key highlights)

- IRS's cancelation of the APAs was arbitrary and unreasonable. The US Tax Court found that the Taxpayer made immaterial and inadvertent errors that did not fit the revenue procedures' definition of 'material'. They viewed that as the IRS had entered into 2 APAs, and it ought to have a clear understanding of the taxpayer's transactions, based on its review of the facts after completing the second APA negotiations if there was concern that the taxpayer was omitting or misrepresenting information it should not have entered into a second APA. The US Tax Court also stated that an APA is a binding agreement and that it should be cancelled only according to the terms of the revenue procedures and the IRS should not use such errors as grounds for switching to a transfer pricing method that was contemplated during the negotiations for the APAs and would result in a significantly different profit split.
- Relevant inferences from the order are produced herein.
  - A taxpayer should not be expected to provide information that is not requested and that the taxpayer reasonably believes is unnecessary.
  - Misrepresentation must be false or misleading, usually with the intent to deceive, and relate to the terms of the APA. Difference in viewpoint is not same as a misrepresentation.
  - The immaterial/inadvertent errors made by the taxpayer did not justify appropriate grounds for switching TP methodology that was contemplated during the APAs.
  - Cancelation of an APA is a rare occurrence, should be done only when there are valid reasons (consistent with revenue procedures).

Accordingly, the US Tax Court concluded that it was 'an abuse of discretion' for the IRS to cancel the APAs.

Key takeaways

- Notably, in above referred case of EEI, the computational errors in implementation did not materially affect the transfer price agreed in the APA and that was a very important consideration for the court to reject the cancelation of the APAs proposed by US IRS. Therefore, Taxpayers are advised to have robust internal controls to ensure adequate implementation of the APA terms.
- Following may be relevant considerations with regard to the implementation:
  - The inter-co transactions are recorded appropriately (e.g. computation of transfer prices, date of invoice)
  - Relevant operational documents (e.g. inter-co agreements, detailed mechanism of deriving transfer prices) are reviewed and updated periodically to align with the APA terms
  - Internal control mechanism at the time of closure of accounts to assess assurance to requisite annual compliance requirements mandated by APA

Federal Court dismisses Australian Tax Office (ATO) transfer pricing adjustment citing OECD's other than exceptional circumstances as well as considering comparable independent dealings

Glencore International AG, Switzerland (GIAG)

Transfer Price = 'Price sharing agreement' at 23% of copper reference price on London Metal exchange

Selling 100% of production of copper concentrate

Cobar Management Pty Ltd, Australia

In the relevant years (i.e. 2007, 2008 and 2009), Glencore Investment Pty Ltd (Taxpayer) was assessed as the head of a multiple entry consolidated group for Australian tax purposes, of which Cobar Management Pty Ltd (Cobar management) is a member. In the relevant years, CMPL, which managed and operated the copper mine in Cobar, New South Wales, sold 100% of the copper concentrate produced at the mine to its Swiss parent, Glencore International AG (GIAG).

The 'price sharing agreement' referred to above entered during February 2007, had the feature of 'quotational period optionality with back pricing' . A deduction at 23% was then made from the copper reference price for treatment and copper refining charges (TCRCs)for the relevant years.

Prior to the 'price sharing agreement', series of life of mine offtake agreements had been entered into between the taxpayer and GIAG, in mid-1999, with each being structured as 'market-related' agreements. It may be noted that the 2007 'price sharing agreement' was a fundamentally different agreement than the former 'market-related' agreement.

Issue: Whether the 2007 'price sharing agreement favored GIAG to the taxpayer, thus not an arm's length dealing. Also, whether independent mine producer would have agreed to a price sharing arrangement with quotational period optionality with back pricing.

Key contentions of the ATO

- Independent mine operators would not have agreed for a price sharing agreement or quotational period with back pricing options
- Taxpayer should have sold its production under a life of mine agreement on market related terms and limited quotational period optionality with no back pricing
- None of the contracts put into evidence by Glencore were directly comparable; no evidence of price sharing especially for three year term

Key contentions of the taxpayer

- Terms governing the agreement existed in contracts for sale of copper concentrate between independent market participants and can be said to be terms that would exist in hypothetical agreement also
- 12 agreements with similar pricing arrangement submitted as evidence to justify that such pricing agreement existed in the market

1. Glencore International AG could elect to link the quotational period to either the month of shipment of the copper concentrate from the loading port of embarkation or the month of arrival of the copper concentrate at the port of disembarkation. Further, within each alternative, Glencore International AG had the option to elect one of quotational periods to be declared prior to each shipment from the loading port, at which time it would be aware of the average copper prices in (at least) one of the periods from which it was to make its selection (known in the copper concentrate industry as "quotational period optionality with back pricing").

Judgment of Full Federal Court 2019 (the Court)

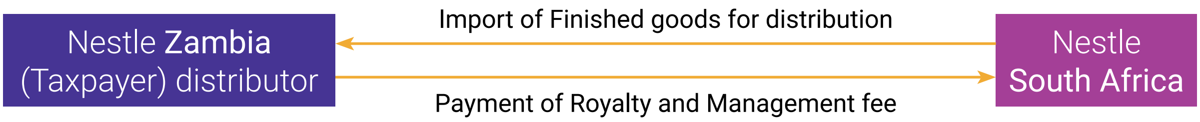
- The Court perused the facts of the case and placed reliance on the OECD guidelines that the transaction/ arrangement entered into between parties cannot be completely disregarded while testing the arm's length nature 'in other than exceptional circumstances.' Thus, the tax authority cannot disregard the existing legitimate business transaction which is outside the purview of 'exceptional circumstances.'
- Further the Court opined that 2007 price sharing agreement was also prevalent in the commercial market between independent parties and thus the arrangement was at arm's length.

Key takeaways

- This decision of the Federal Court throws light on the emphasis of OCED's framework of aligning substance and form while analysing related party dealings. It is important to note that Australian Taxation Office (ATO) over the past few years has provided numerous compliance Guidance to provide a framework around the key focus areas around related party transactions and the risk assessment criteria.
- This ruling stresses on the aspects of maintaining suitable evidence, conducting a thorough analysis of comparable transactions and producing evidences that the comparable transactions typically showcase the arrangements in independent dealings.
- This case re-emphasizes the need to have good comparables, use of experts in transfer pricing matters.

Nestle | Zambia | Limited skilled staff, significant oversee by parent entity is akin to characteristics of Limited Risk Distributor rather than Full Fledged distributor

The Tax Appeals Tribunal (TAT) citing FAR analysis, upheld the observations of ZAR to re-characterize taxpayer as a limited risk distributor (LRD)



The Zambia Revenue Authority (ZRA) conducted a transfer pricing audit with respect to taxpayers operations in Zambia and noted -

- the Taxpayer has been incurring operating losses for the last five years and
- is undertaking significant amount of related party transactions which are in the nature of management fee payments and royalty pay-outs for use of intellectual property.
- Taxpayer performs very limited functions and assumes insignificant risks akin to Limited Risk Distributor LRD)

In view of the above facts, ZRA re-classified the Taxpayer as a LRD, aggregated all the transactions and concluded that the taxpayer's related party transactions are not in compliance with the arm's length principle, thereby proposing a transfer pricing adjustment.

The Taxpayer challenged to above actions of ZRA before the Tax Appeals Tribunal ('TAT') on several legal and factual grounds. The key issue of re-characterizing Taxpayers business profile as LRD is summarized below

Issue: Whether re-characterization of the Taxpayer is valid and whether royalty/ management fee can be disregarded to be at arm's length for a loss making company

Key contentions of the ZRA

- Losses were due to high related party payments like royalties, management fee, purchases
- With regards to reclassification into LRD, arguments put forth are:
  - Staff of Zimbabwe entity oversaw operations of Taxpayer in Zambia
  - Investment level in Taxpayer entity was low
  - Taxpayer had very limited staff capable of performing marketing and accounting related functions
  - Customers facilitated their own logistics

Key contentions of the taxpayer

- The taxpayer performs all significant functions as that of full-fledged distributor and has financial capacity to assume risk associated with distribution activity.
- The taxpayer assumes credit risk associated with the failure of customers to honor payments.
- Taxpayer bears the full risk associated with the inventory
- Taxpayer performs marketing functions; although with guidance from head office
- Taxpayer also absorbs risks associated with fluctuations in foreign exchange rate

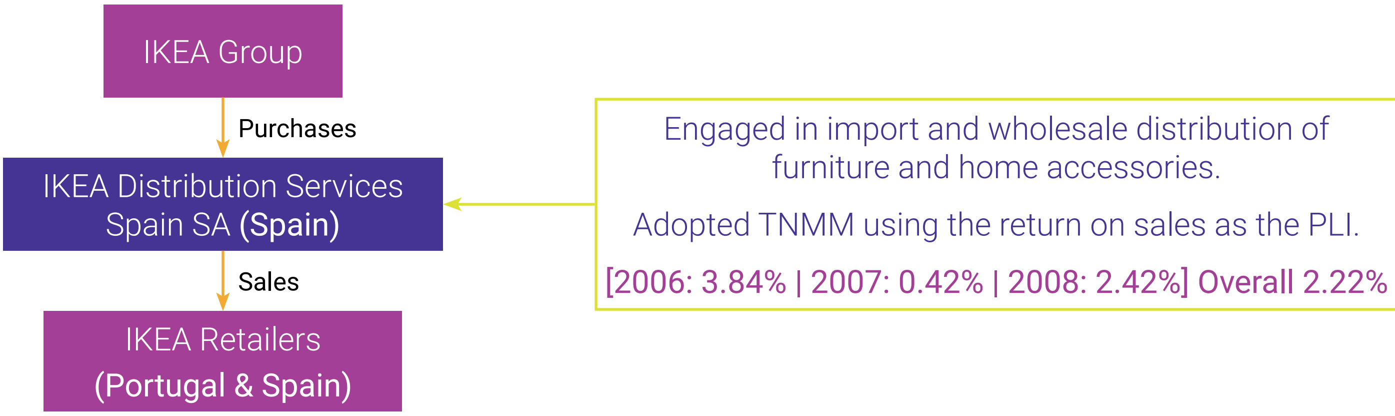
Judgment

- The Tribunal observed that ZRA's approach of aggregating the transactions for analysis is unwarranted as the transactions were unrelated and not closely linked.
- Regarding re-characterization of taxpayer as LRD, the Tribunal ruled in favour of the ZRA, citing reasons that there was significant control being exercised by the Zimbabwe (parent) entity and the risks in relation to ownership of know-how, marketing, distribution lay with the parent company and not the taxpayer.
- Accordingly the appeal was partly ruled in favour of the taxpayer and partly in favour of ZRA.

Key takeaways

- Royalty and Management fee payments in the context of transfer pricing has always been very litigious, universally. Moreover, the loss making operations of taxpayer makes it even more challenging to justify need and benefit of Royalty and management fee to associated entities.
- In the instant case, the approach of the tax authorities appears to be somewhat interesting. Typically, it is observed that the tax authorities would re-characterise LRD's in to full-fledged distributors, in as much as, LRD's are expected to earn very low level of profits (lower base for taxation) when compared to full-fledged distributors. In the given case, the ZRA emphasized on re-characterizing taxpayer as LRD to take support in former's argument that related party payments such as Royalty and management fees are not required in the instant case.
- The taxpayers, while preparing transfer pricing documentation, need to analyze and document all critical business functions, viz pricing, inventory management, customer interaction, forecast of purchases etc which could help in a justifiable classification (economic characterization).
- The approach of scrutinizing loss-making taxpayers having significant related party payments could now be a trigger point for African tax authorities in selecting cases for carrying out assessments.

IKEA | Spain | Arm's Length Nature to be established for each tested year rather than taking a composite of a bunch of years



The sales prices were accepted based on comparable unit price method. However, in relation to the purchases prices, based on a benchmarking analysis conducted the arm's length range of operating margins of comparable companies for the years 2003 to 2005 resulted in an inter-quartile range as follows:

Arm's Length Range	Return on Sales [2003-2005]
Lower Quartile	2.1%
Median	4.1%
Upper Quartile	7.6%
Average	6.1%

In 2007 taxable profits had been below the interquartile range and in 2008 and 2009 taxable profits had been within the interquartile range but below the median.

Issue: Tax Administration had issued an adjustment for the years 2007, 2008, and 2009 as the transfer price was not considered to be in accordance with the arm's length principle. In all years taxable profits had been adjusted to the median found in the benchmark study.

Key contentions of the Tax Administration

- The arm's length price (ALP) of the purchase of goods for wholesale resale should be such that the net margin on sales of the entity is 4.1%. In 2007, as the net margins was only 0.42% adjustment was warranted that amounted to 37 Million Euros.
- Placing reliance on the OECD guidelines on adoption of the appropriateness of analysing tax years on a single-year basis. The use of multiple years should apply only to the interquartile range construction from the comparability analysis. There was no justification by the Taxpayer for use of behind the selection of the number of years (i.e. three years) for the calculation of the average and its comparison with the interquartile range.
- For 2008 also they adjusted the taxpayers return on sale to the median since the margin (i.e. 2.42%) was situated below the median.

Key contentions of the taxpayer

- The taxpayer argued that volatility caused by market risks and reductions in raw material prices over the period warranted the consideration of multiple years. The market range of the return on sales for comparable companies engaged in wholesale was 2.1% and 7.6% (for 2003 -2005 period).

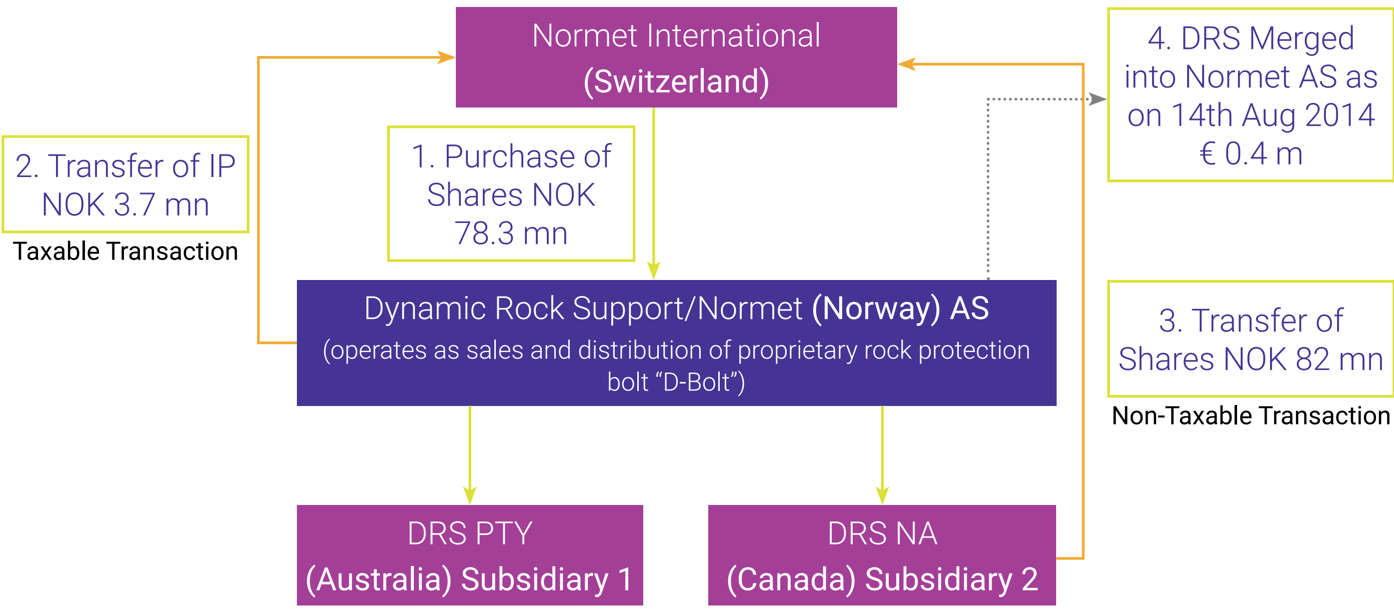
Decision of Court of Appeal (the Court)

- Regarding the taxpayers argument on using multiple-year data of its own profitability, the court concluded that while the comparable data points can be computed on multiple year basis, the taxpayer must compare the financial position within the individual year viz the taxpayer can not use three year average of its own profit to justify arm's length nature.
- With respect to 2007 where the profit had been outside the interquartile range, the Court held that profits should be adjusted to the lower quartile instead of the median, as argued by the Tax Administration.
- The Tax Administration had not demonstrated comparability defect in the comparability study provided by the taxpayer that justified using the median in the assessment of the arm's length profit.
- For 2008 and 2009 where the taxable profit had been within the interquartile range – but below the median – the court held that an adjustment was not appropriate.

Key takeaways

- The court significantly relied on the OECD guidelines in reaching its conclusion, which appears to be rationale and consistent with the approach followed in other cases on similar matters.
- This judgment re-emphasizes the importance of conducting transfer pricing analysis and documentation in a compliant manner, following the guidelines (OECD in the instant case).
- Notably, this judgment provides much needed certainty to Spanish Taxpayers regarding –
    - Use of Multi Year data
    - Selection of point in ALP range

Normet | Norway | Valuation Methods should be aligned with transfer pricing principles



- Normet International Ltd, a swiss company, acquired Dynamic Rock Support ("DRS") as on 30 January 2013 and subsequently purchased its:
  - Intellectual property (IP's) rights on 1 February 2013 at valuation of NOK 3.7 Mn. The value of such IP was estimated by Taxpayer based on the "relief from royalty valuation method" i.e. determining the present value of the future cash flow (i.e. Royalty) that can be generated by allowing the patent to be utilized by a third party.
  - Shares in subsidiaries in Australia and Canada on 30 October 2013 at valuation of NOK 82 Mn

Issue: Valuation of IP rights and shares were incorrectly distributed which led to reduction in the taxable income of the taxpayer

Key contentions of the Tax Authorities

- Tax authorities challenged the valuation determined by DRS and argued that Valuation of IP (Taxable transaction) was undervalued, whereas, valuation of transfer of shares of subsidiaries (non-Taxable transaction) was overvalued.
- Further, as regards the valuation of subsidiaries, the tax officer observed that subsidiaries are limited risk distributor with limited assets and strained finances, having only two employees each. Therefore, the valuation of subsidiaries at NOK 80 million was too high and an independent buyer would not pay such high prices.
- In view of the above, Tax Authorities re-determined the valuation of IP, using adjusted comparable price (as given in table below)

Key contentions of the taxpayer

- The relief method adopted, is a recognized method and is also recommended in OECD guidelines. Further, the valuation has been accepted by Norwegian, Swiss and Finnish auditors. Also, the valuation was assessed by Swiss tax authorities.
- The taxpayer contended that adjusted comparable price determined by the Tax Authorities cannot be adopted as the transaction covered far more than the IP that was transferred in the subsequent transaction.

The Tax Authorities re-determined the Valuation of IP as follows:

Tax Authorities Approach [Comparable Uncontrolled Price (CUP) Method]		
Acquisition price of DRS shares (considered as CUP, subject to below economic adjustments)	A	NOK 78.3 mn
Less: Book value of DRS	B	(NOK 16.2 mn)
Market value of IP and Subsidiaries	C=A-B	NOK 62.10 mn
Less: Market value of Subsidiaries (revalued by Tax authorities*)	D	(NOK 3.90 mn)
Adjusted Comparable price for IP as per Tax authorities	**E=C-D**	**NOK 58.20 mn**
Transfer Price determined by Taxpayer	**F**	**NOK 3.70 mn**
Transfer pricing adjustment	**G=E-F**	**NOK 54.50 mn**

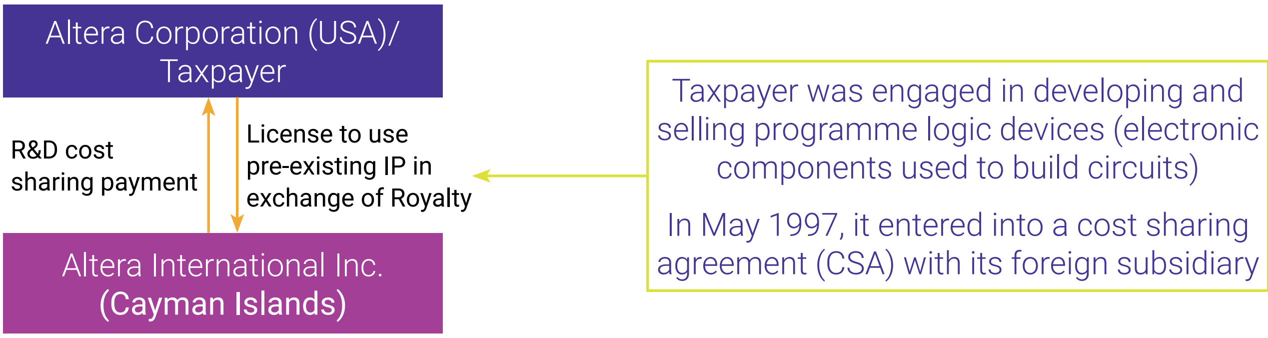
Decision of Court of Appeal (the Court)

- Considering the above facts, the Court agreed with the Tax Authorities that the relief from royalty method was not an appropriate method in determining the market price since it does not evaluate the entire transfer of commercial value that DRS technology contributes to its patents.
- No evidence was found that indicates that the value of subsidiaries changed significantly from the acquisition in January 2013 until the sale of shares in October 2013.
- Reliance was placed on OECD guidelines which states that there are situations wherein separate transactions are closely linked and cannot be separately evaluated. Accordingly, the Tax Authorities was correct in using CUP method to analyse the transfer of shares and intangibles.
- In light of the above, the Court majority ruled in favor of Tax Authorities.

Key takeaways

- While the transfer pricing rules allows adoption of various valuation methods and techniques for determining the arm's length price, however it of utmost importance that any method adopted to determine such arm's length price should be in lines with that of OECD guidelines.
- Further, the said ruling emphasis on the fact that if the transfer of property or any intangibles is undertaken within the group then one should not only value the intangibles by a general valuation method but should also be in lines with the arm's length principle.
- Taxpayers should evaluate the assets being transferred very closely to ensure that all possible intangibles are identified and accounted for in their consideration or valuation exercise.

Altera | United States of America | Inclusion of stock-based compensation cost in cost base for cost sharing agreement



In prior years, the taxpayer had included Stock Based Compensation (SBC) for the purpose of allocations under CSA in accordance with the terms of Advance Pricing Agreement, however, pursuant to amendment in the relevant regulations and also a Court ruling[2] based thereon, the taxpayer discontinued the practice of allocating SBC costs under CSA.

Issue: Whether the cost allocated by Taxpayer under CSA should include the costs incurred towards Employees SBC?

Key contentions of the tax department

- Taxpayer violated relevant regulations which mandates “all costs” shall be considered for allocation under CSA
- The regulations were specifically amended in the Year 2003 to suggest that SBC’s shall be considered for allocation under CSA

Key contentions of the taxpayer

- SBC costs cannot be allocated in a case where comparable third-party instances for sharing similar SBC costs do not exist/are not available
- The amendment introduced in the year 2003 is valid under the administrative procedure act, which required application of Arm’s length standard using comparability analysis. Therefore, in the absence of any comparable transaction, the SBC can not be included in cost base for allocation

Judgment of Ninth Circuit Court in 2019

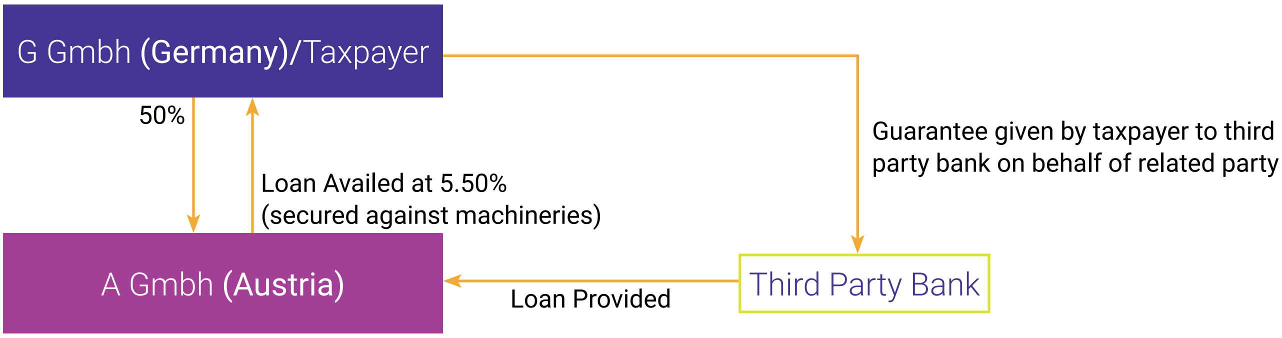
- Any method to determine arm’s length price can be adopted as long as it is based on economic activity approach. Other flexible approach (other than strict comparability) may be adopted.
- SBC is in the nature of accounting costs and hence required to be shared for the purpose of cost-sharing arrangements.
- Judicial precedents relied by taxpayer are invalid, since the same pertained to pre-amendment to SBC regulations.

Key takeaways

- The said ruling given by the Ninth Circuit Court will have a far-reaching impact on taxpayers who have taken similar positions, and they shall have to revalidate their position in light of the development in Altera USA’s case.
- Under the US laws, the taxpayer can not take full deduction of SBC from the taxable income, implying that the taxpayer will end up paying higher taxes.

2. Xilinx, Inc. v. Comm’r, 598 F.3d 1191, 1193–94 (9th Cir. 2010).

G Gmbh | Germany | Shareholders activity not sufficient to justify arm's length standard



Issue: Whether writing down of loans provided to related party and provisions towards guarantee provided on behalf of related party in books of accounts be treated as deduction from taxable income?

Key contentions of the tax department

- A third party as a lender/guarantor would not grant loans/ guarantee with insufficient collateral/without securing recourse claim, thus Taxpayer's recourse to corporate backing is invalid.
- A term pertaining to collateral would form part of an agreement in an ordinary course of business.
- Taxpayer not having a majority stake in related party questions existence of a group relationship.

Key contentions of the taxpayer

- Such risk was borne assuming shareholder's functions, hence full deduction of losses be allowed.

Judgment of Court of Justice of the European Union (CJEU)

- Inadequate collateralization of a loan or a right of recourse arising from use of a guarantee are against the principles of arm's length standard
- Any contractual relationship between taxpayer and its related party must be in a way as they would have arisen under the conditions agreed between independent third parties
- Matter remitted to lower tax authorities to determine arm's length price based on external comparability

Key takeaways

- Transfer pricing analysis of financial transaction has gained prominence in most jurisdictions, given the complexity involved. Whether it is determining the credit worthiness of the borrower or identifying comparable loan arrangements, all encompass a great practical challenge. Perhaps due to this very reason that the OECD as well as the United Nations have recently come out with a detailed guidance on transfer pricing analysis of financial transaction such as Loans, guarantees, etc.
- Needless to say that it is hard to find 'a like to like' situation, especially for a transaction such as corporate guarantee. However, a covenant such as collateral in the event of default typical exists in the third party situations, especially when third party bankers are sanctioning any funds to the businesses.
- While drafting the intra-group agreement/arrangement for financial transactions, various covenants (financial and non-financial) shall be benchmarked with covenants in third party/independent situations of similar nature.

Supreme Court[3] rejected the taxpayers Special Leave Petition against the High Court's treatment of the taxpayer as a Knowledge Process Outsourcing (KPO)

McKinsey Knowledge Centre India Pvt. Ltd. (India)

Engaged in providing information technology enabled services as well as acting as a support center for providing research, analysis and information to various McKinsey group entities globally.

The taxpayer benchmarked its related party transactions of (a) research and information services 7 (b) IT Support services using the Transactional Net Margin Method using the OP/OC as the PLI to test its cost plus 15% policy. The taxpayer had adopted two different sets of comparables for both the segments and basis, a benchmarking study for each segment, it held that the transactions were at ALP.

During the first level tax assessment before the Transfer Pricing Officer (TPO), the authorities observed for the research segment that the taxpayer had foreign companies rather than Indian companies and accordingly rejected foreign entities as comparable and selected additional Indian comparables thereby arriving at a tax adjustment. The TPO had accepted the benchmarking analysis for the IT support segment.

Issue: Whether the research and information services can be characterized as KPO services as against taxpayer's claim of BPO services for benchmarking purposes?

Key contentions of the ITAT

- Placing reliance to the ITAT order of the same taxpayer for a prior year, it held that the taxpayer's research and information services involved huge expertise and skills which requires not only analysis of specialized data but also involves analysis, processing, customization, interpretation of data and creation of knowledge bank. Accordingly, characterizing the taxpayer as a KPO center.
- As the lower level officer did not have knowledge of this characterization change the taxpayer sought to send the matter back to the desk of the TPO for a re-examination of the comparability.

Key contentions of the taxpayer (before the ITAT)

- The research and information services were for assistance in the group companies' projects and included accessing information across internet-based database like Bloomberg, Reuters, OneSource, Dow Jones, dialogue, and DataStream, etc. which had sub-divisions of knowledge on-call group, practice research group, and analytics group along with the employee work profile and functional analysis to conclude that the activities should be under the ambit of 'IT enabled services under BPO.'
- In light of this, the taxpayer had sought exclusion of few comparable companies that were included by the TPO on functional dissimilarity.

Pursuant to the above, an appeal was filed with the High Court.

3. Special Leave Petition before the Supreme Court of India No. 1786/2019 r.w. Income Tax Appeal No. 6648/Del-2016 before the Income Tax Appellate Tribunal & Income Tax Appeal No. 461/2017 before the High Court.

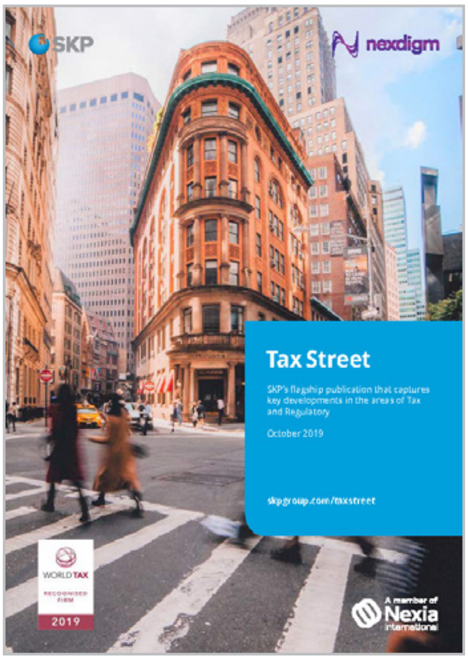
Judgment of the Delhi High Court (HC)

- The services rendered by the taxpayer are specialized and require specific skill-based analysis and research that is beyond the mere rudimentary nature of services rendered by a BPO. Therefore, the services provided by the taxpayer are more akin to a KPO and accordingly the mark-up earned by them should be compared to other KPO companies rather than BPO. The Supreme Court by dismissing the appeal sought to uphold this characterization by HC.

Key takeaways

- While both BPO and KPO services fall within the broad ambit of ITes services, the crux of the issue lies in Indian tax authorities' contention that the BPO and KPO activities are different and require different benchmarking and mark-up percentages.
- Even the Safe Harbour Rules in India (applicable to cases with value of transactions below specified thresholds) provides for 17-18% operating margin from a BPO as compared to 18-24% from a KPO.
- Now with the SC ruling affirming the HC characterization of Mckinsey India as KPO services rather than BPO, it is of utmost importance for every entity engaged in ITes activities to appropriately classify its activities as BPO or KPO and dig deep into the functional similarity of the potentially comparable companies with the taxpayer to determine whether a particular company can be selected as comparable to the taxpayer or otherwise.
- From a practical standpoint, tax authorities need to have an open approach to accept comparables which, though, do not have similar service profile but have similar functional profile as a BPO/KPO. Ultimately, fact of the matter is – deeper the need of subject specific expertise, higher the rewards expected.

Tax **Street**



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