

TRANSFER PRICING (DAY 1)

**PRESENTATION BY
ELVIANA RIYANTO/
SARAH CHEW**

1 - 2 AUGUST 2019



Introduction to Transfer Pricing Basic Concepts

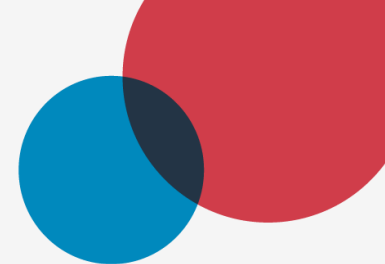
OBJECTIVES



What will you achieve through this course?

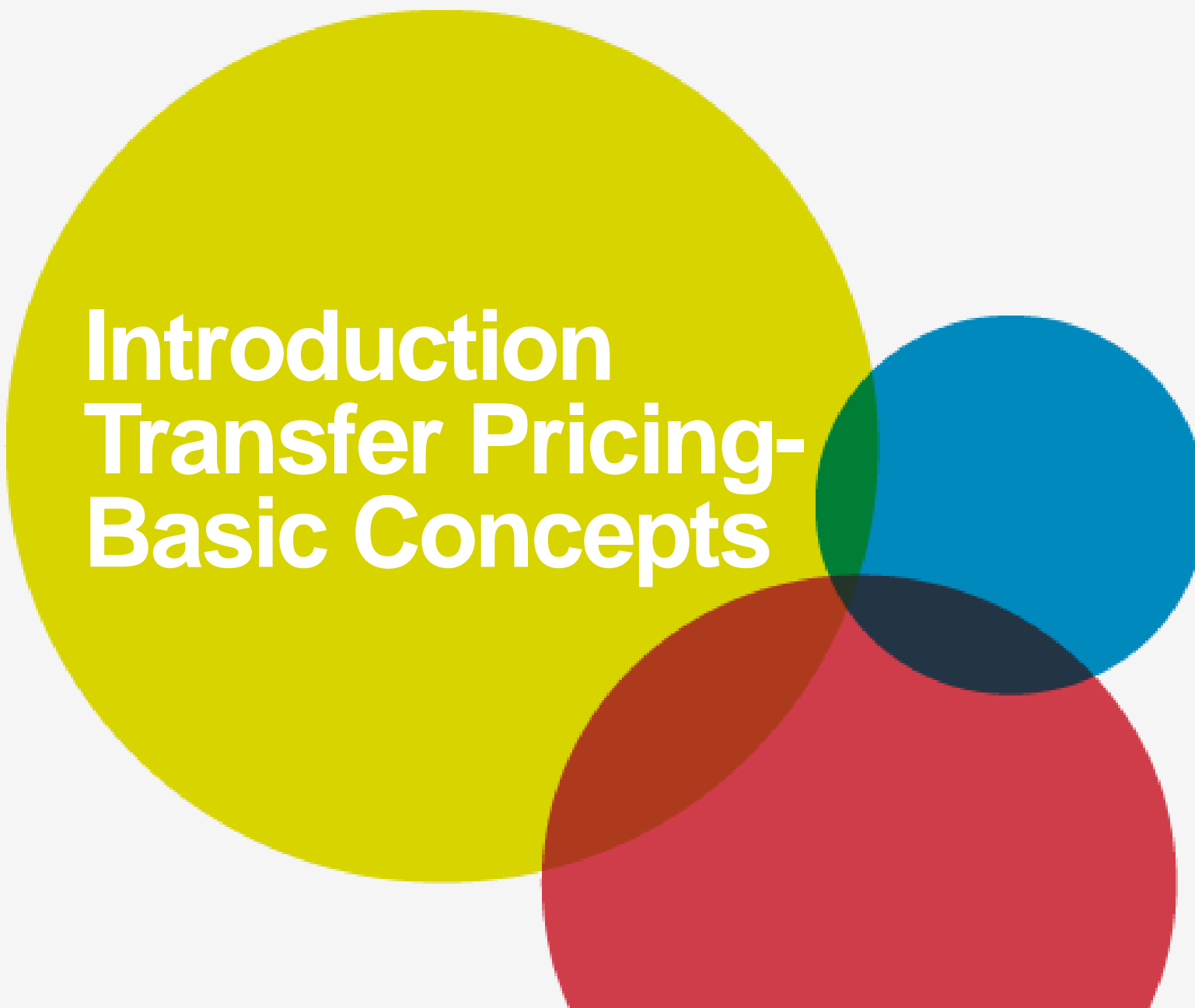
- ❖ Obtain a broad understanding of Transfer Pricing
- ❖ Understand Transfer Pricing methodologies and their applicability
- ❖ Understand documentation requirements
- ❖ Know practical aspects to undertaking a Transfer Pricing analysis
- ❖ Be aware of the Transfer Pricing framework most commonly followed across countries
- ❖ Be aware of global and regional Transfer Pricing developments
- ❖ Exploring marketing opportunities

Agenda



Today's agenda (Day 1)

- ❖ Introduction to Transfer Pricing: Basic concepts
- ❖ OECD Framework & Guidelines
 - Article 9 of the OECD Model Tax Convention
 - OECD Transfer Pricing Guidelines 2017
 - Base Erosion and Profit Shifting (BEPS) project
 - Transfer Pricing Methodologies
 - Comparability Analysis
- ❖ Understanding Different Business Models
- ❖ Transfer Pricing Documentation
- ❖ OECD Guidelines – Other Concepts
- ❖ Case Studies on TP Methodologies and Business Models



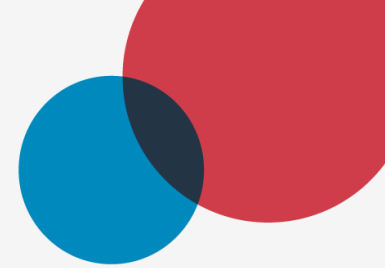
**Introduction
Transfer Pricing-
Basic Concepts**

WHAT IS TRANSFER PRICING?



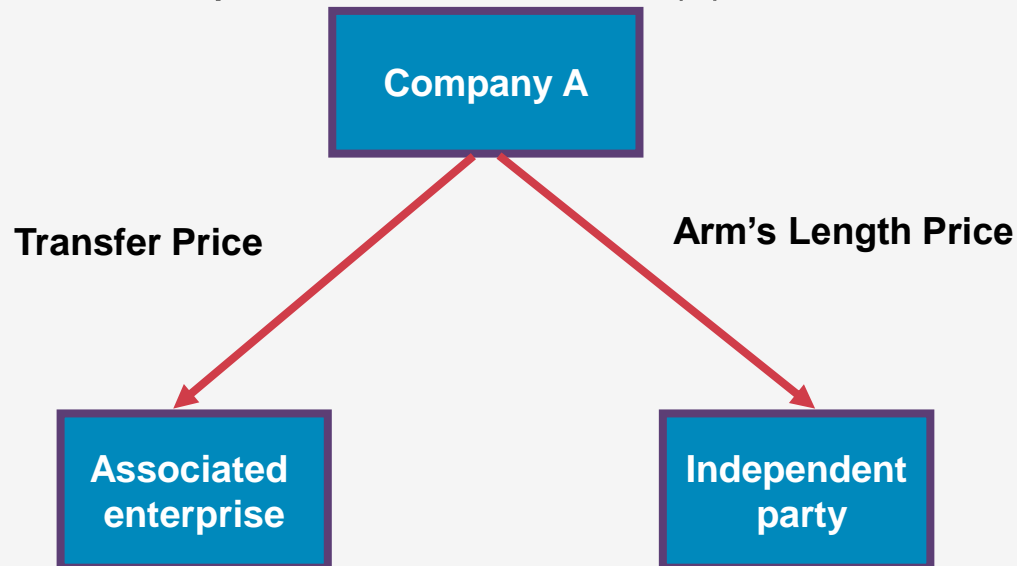
- ❖ Transfer pricing refers to the pricing of cross-border transactions between entities in a group of companies (**associated enterprises**)
- ❖ It applies to transactions between associated enterprises operating in different tax jurisdictions
- ❖ Cross border transactions between associated enterprises (**international transactions**) can be in the nature of transfer of goods, services & intangibles

WHAT IS TRANSFER PRICING?



❖ General definitions:

- **Transfer Price:** amount paid or received by a person in a transaction with associated enterprises for the use of property or as consideration for services
- **Arm's length price:** price at which independent enterprises enter into comparable transaction(s)

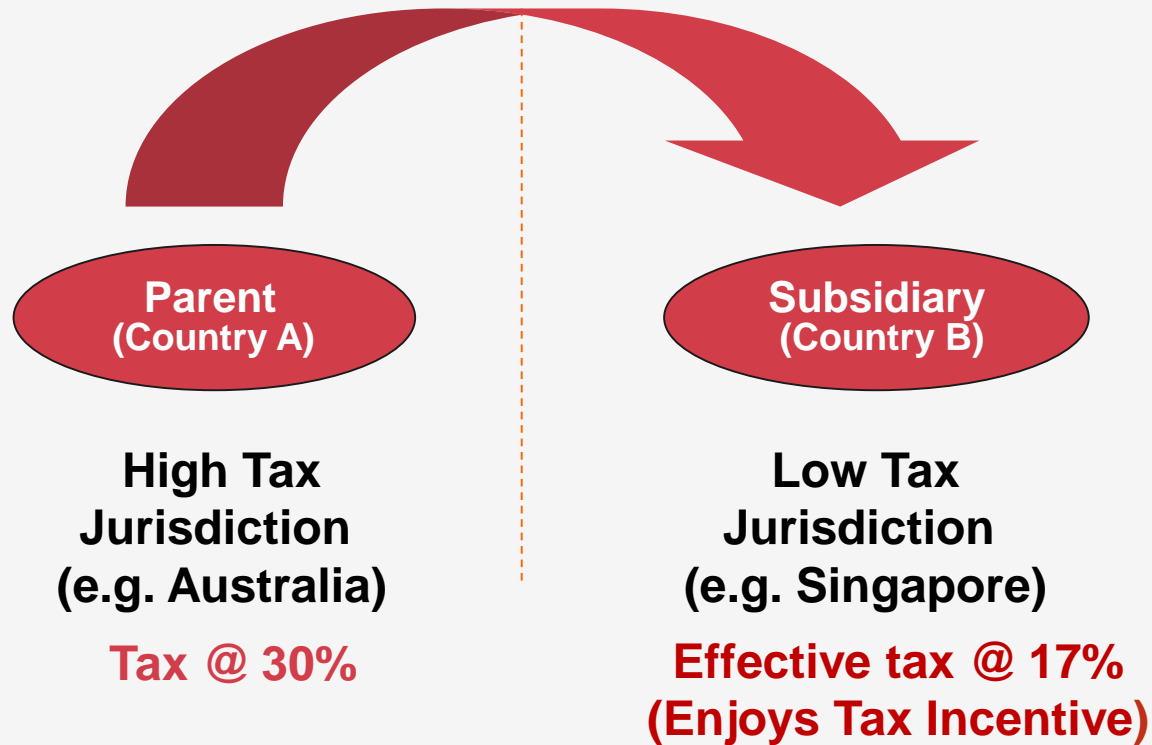


WHAT IS TRANSFER PRICING?

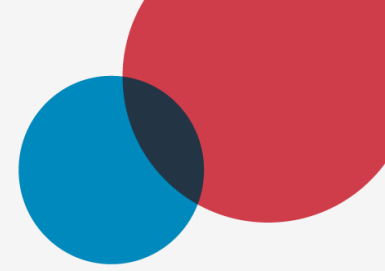


Taxpayer's perspective

Profit - Shifting

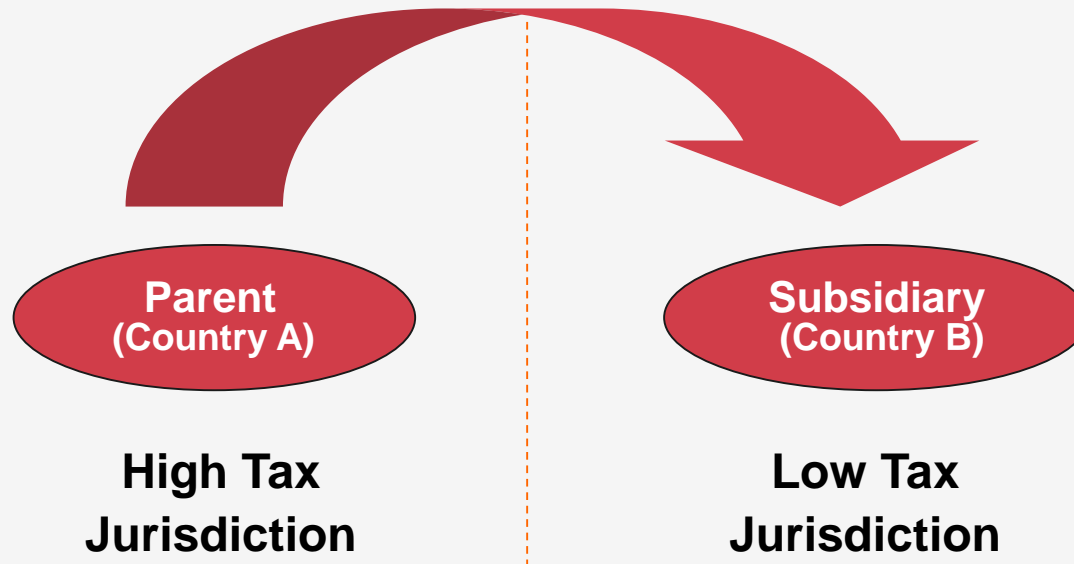


WHAT IS TRANSFER PRICING?



Revenue's perspective

Profit - Shifting



Revenue authorities in Country A (e.g. Australia) would question the rationale of profit shifting while in Country B (e.g. Singapore), there would be no adverse implication

WHAT IS TRANSFER PRICING?



Arm's Length Principle

The transfer price should not differ from the prevailing market price for a comparable transaction

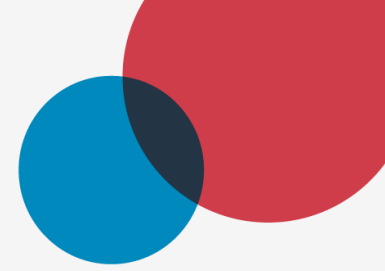
WHAT IS TRANSFER PRICING?



Arm's Length Principle

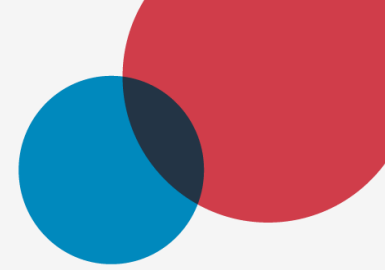
- ❖ International standard used to compute transfer prices for tax purposes
- ❖ Conditions of commercial and financial relations between AEs governed by varying market forces
- ❖ In case TP does not reflect market price / arm's length principle
 - Tax liabilities of AEs and tax revenues of host countries may be distorted – leading to adjustments
 - Conversely, factors other than tax considerations may distort conditions prevailing
(e.g. governmental pressures relating to customs valuation)

DETERMINING TP RISK – IDENTIFYING TP RISK



- ❖ Determine types of transactions with associated persons
 - ❖ Sale of goods
 - ❖ Purchase of inventory
 - ❖ Sale / purchase / lease of tangible assets
 - ❖ Provision of services
 - ❖ Transfer / purchase / use of intangible assets - royalties
 - ❖ Lending or borrowing of money – interest
 - ❖ Other transactions which affect the profit or loss of the company
- ❖ Source
 - ❖ Audited accounts – disclosure note on “Significant related party transactions”
 - ❖ Compliance information
 - ❖ Newspaper reports

DETERMINING TP RISK – IDENTIFYING TP RISK



- ❖ Indication of potential risk
 - ❖ Internal comparables i.e. purchase/sale from independent parties at different prices
 - ❖ Absence of TP documentation
 - ❖ Outdated TP documentation
 - ❖ Absence of supporting documentation to substantiate transactions with related parties

GROWING IMPORTANCE OF TRANSFER PRICING

Amazon challenged and won a US Tax Court case involving USD 2 billion IRS adjustment in connection with a qualified cost sharing arrangement. The Tax Court concluded that the IRS's recalculation of the buy-in payment (using the Discounted Cash Flow method) was arbitrary, capricious and unreasonable and rejected the calculation method based on that conclusion

Google realizes tax benefit of USD 90 million on account of APA with IRS

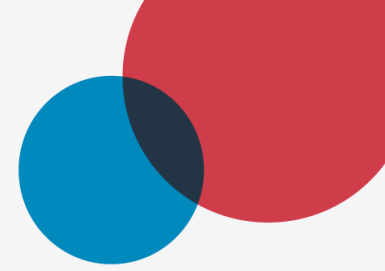
APAs are being increasingly used across many countries as a weapon against periodic adjustments

In the United States, the IRS revoked 2 unilateral APAs with Eaton Corporation, which led to the issuance of multi-year transfer pricing related tax deficiency notices. However, the Tax Court later held that the IRS had abused its discretion in cancelling the two unilateral APAs

Captive IT/ITeS units in India subjected to high TP adjustments – cost plus 22% to 25% determined as ALP

Chinese tax authorities have tightened TP regime via introduction of a three-layer documentation approach, including master, local and special issue files. The local file must now also include a value chain analysis and location-specific advantages. In addition, Annual Related Party Transactions Reporting Forms increased the total number of forms to 22 (and replacing previous 9 forms), thus requiring more detailed and transparent information disclosure

GROWING IMPORTANCE OF TRANSFER PRICING



In line with Hong Kong's commitment to implementing the BEPS package, TP legislation was gazetted on 13 July 2018. Mandatory TP documentation requirements was introduced into the Inland Revenue Ordinance (Cap. 112), and Hong Kong implemented the minimum standards released in the Consultation Report on Measures to Counter BEPS

The British government introduced 'Google Tax' to plug loophole on profits - Tech giants such as Google, Apple and Amazon will no longer be able to avoid paying tax in the United Kingdom by diverting profits overseas, the British Chancellor has announced

India introduced amendments relating to thin capitalization within its regulations in 2017 to restrict deductibility of interest for an Indian company (or PE of a foreign company in India) for debts issued/guaranteed (implicitly or explicitly) by a non-resident associated enterprise

In Indonesia, Minister of Finance published details on the three-tiered TP documentation requirements (CbC report, master and local file documentation) for related party transactions in accordance with BEPS Action 13 on 30 December 2016. Master and local file documentation must be provided no later than four months after the end of the tax year, whereas the CbC report is required to be submitted to the tax authorities no later than twelve months after the end of the tax year

GROWING IMPORTANCE OF TRANSFER PRICING

*In 2013, OECD released the BEPS action plan which targets base erosion and profit shifting through TP. OECD issued its final report on TP, under Actions 8-10 of the BEPS action plan, on 5 October 2015. **Changes were subsequently made to the OECD Guidelines in line with the BEPS action plan***

Thailand's TP Act came into effect for accounting years beginning on or after 1 January 2019, requiring taxpayers with related parties to prepare and submit a report providing descriptions of related party relationships and value of RPTs for each fiscal year to the tax authorities. This is irrespective of length of the relationship during an accounting period, or whether the taxpayer has RPTs in the first place

In response to continued public and media scrutiny, the tax authorities in New Zealand have introduced several measures in line with the OECD's BEPS action plan. These measures include the introduction of GST for overseas providers of online services to NZ consumers on 1 October 2016, and signing of the OECD's MCAA to facilitate information sharing of CbC Reports between tax authorities. In addition, the issuance of a briefing document which contained valuable information on the IRD's future directive towards BEPS indicates that the New Zealand tax authorities are looking at proposed changes to interest limitation rules

GROWING IMPORTANCE OF TRANSFER PRICING

Perceptions matter – the SAB Miller Story



actionaid
actionaid.org.uk/schtop

PREMIUM TASTE...
PREMIUM TAX DODGING.

TELL THEM TO



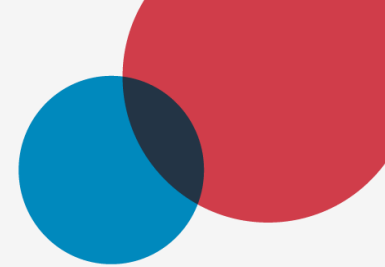
TAX DODGING

SABMiller, owner of Grolsch,
siphons millions into tax havens.

ActionAid is a registered charity, number 274467

GROWING IMPORTANCE OF TRANSFER PRICING

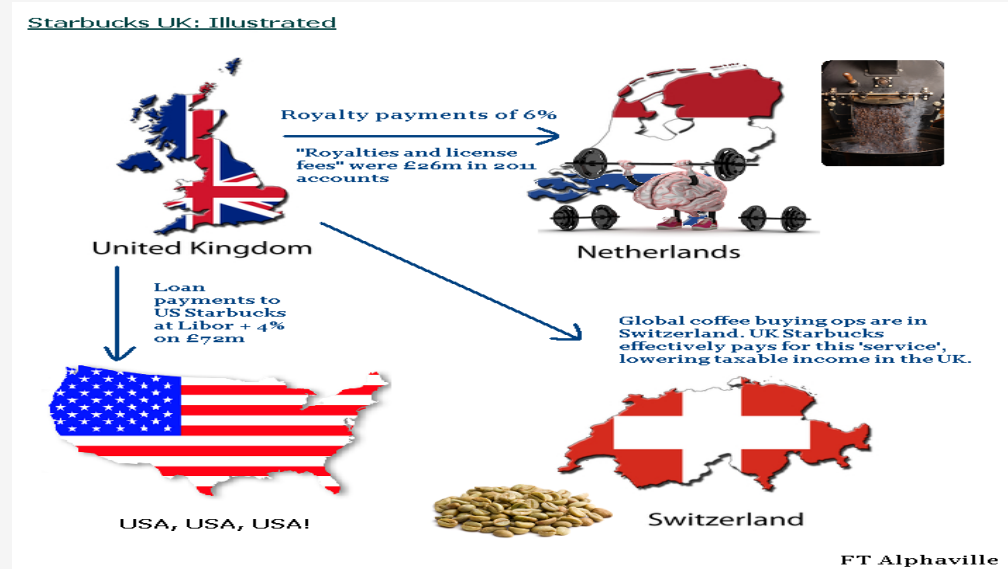
Perceptions matter – the Starbucks Story



STARBUCKS HAS PAID 0% TAX IN THE UK SINCE 2009.

STARBUCKS
Turnover: £1.2bn
Corporation tax: £0

Boycott tax evasion. #BoycottStarbucks.



BOYCOTT STARBUCKS

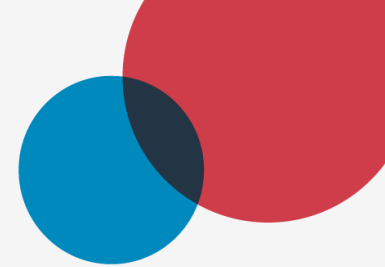
Support the British economy
Buy your hot drinks from your local independent cafe, because at least they pay their fair share of tax.

ANOTHER ANGRY VOICE



GROWING IMPORTANCE OF TRANSFER PRICING

Perceptions matter – the AppleStory



TELL CEO TIM COOK: DON'T BE A
#BADAPPLE

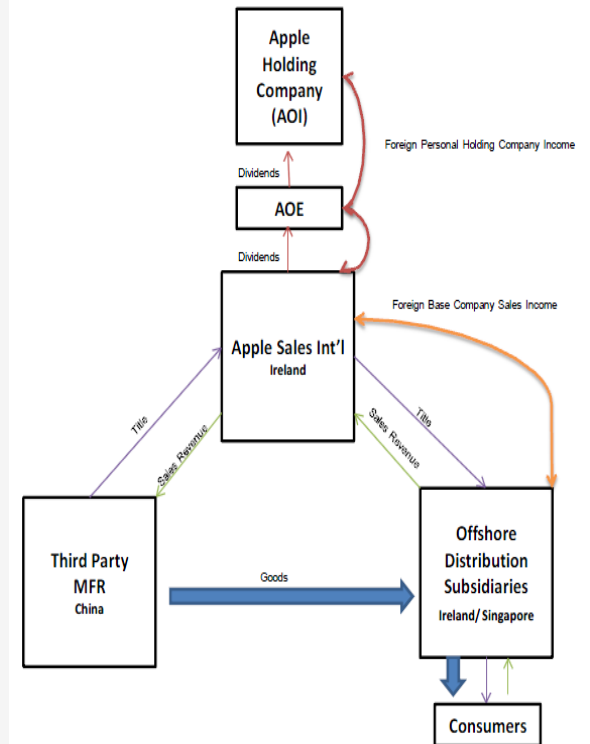



MAKE APPLE PAY
BILLIONS
IN DODGED TAXES

Americansfortaxfairness.org/badapple



Apple's Offshore Distribution Structure

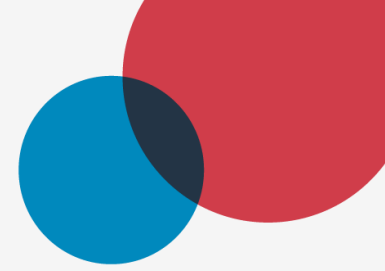





**OECD
Framework &
Guidelines**

CONTENTS

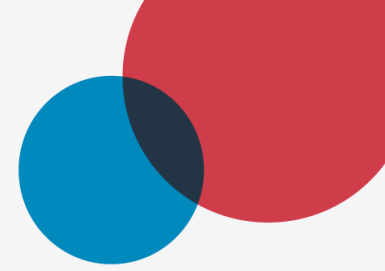
- ❖ Article 9 of OECD Model Tax Convention
- ❖ OECD Transfer Pricing Guidelines 2017
- ❖ Base Erosion and Profit Shifting (BEPS) Project
- ❖ Transfer Pricing Methodologies
- ❖ Comparability Analysis





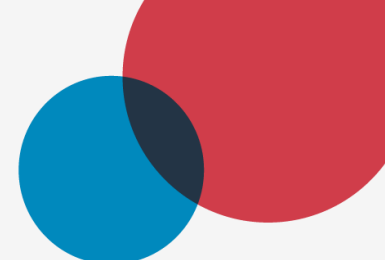
**Article 9: OECD
Model
Tax Convention**

ARTICLE 9



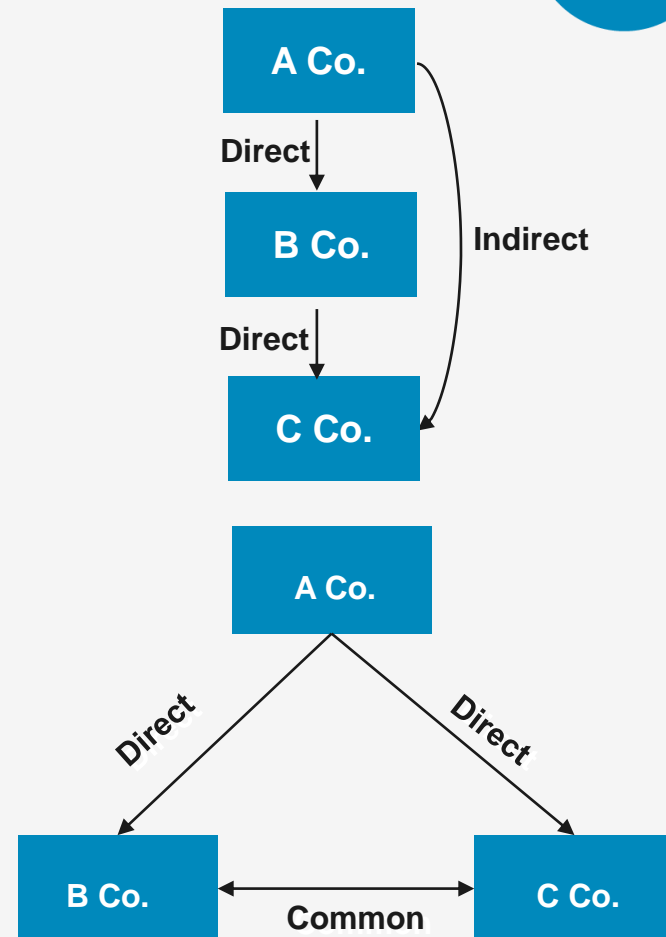
- ❖ Article 9 of Model Tax Convention deals with situations where the taxpayer does not adhere to the arm's length principle
- ❖ Article 9(1) [OECD / UN Model Convention]
 - Endorses the arm's length principle
 - Characterizes associated enterprises
 - Enables transfer pricing adjustment in a non-arm's length scenario
- ❖ Article 9(2) [OECD / UN Model Convention]
 - Enables corresponding adjustment to avoid economic double taxation
- ❖ Article 9(3) [UN Model Convention]
 - Provides situations where benefit of article 9(2) would not be available

ARTICLE 9(1) – ASSOCIATED ENTERPRISES

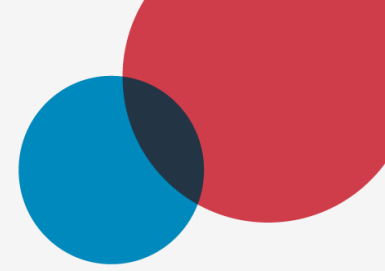


“An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State”

“The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State”



ARTICLE 9(1) – ASSOCIATED ENTERPRISES



- ❖ Broad definition of associated enterprises (AEs)
- ❖ Terms ‘control’, ‘management’, or ‘capital’ not defined
 - Control – De facto or de jure
 - Management – Board of directors
 - Capital – Equity share capital
- ❖ Degree of participation not mentioned
- ❖ Reliance placed on international commentaries subject to domestic law provisions
- ❖ Foundation for comparability analysis – introduces the need for comparison between conditions made / imposed between AEs and independent enterprises
- ❖ Two stage analysis:
 - Comparison of the conditions
 - Calculation of the transfer pricing adjustment

ARTICLE 9(1) – PRIMARY ADJUSTMENT



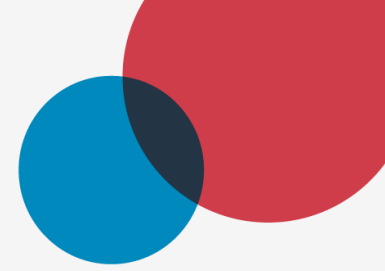
- ❖ Broad definition of associated enterprises (AEs)
- ❖ Article 9(1) enables a transfer pricing adjustment (primary adjustment) where the transfer price is not at arm's length
- ❖ OECD Guidelines defines a primary adjustment as:
 - “ *An adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an AE in a second tax jurisdiction*”
- ❖ Article 9 is not a legal basis to carry out TP adjustments
- ❖ Provisions of domestic law to be adhered to
- ❖ Mere existence of two AEs is not sufficient to justify a primary adjustment
- ❖ There must be a deviation from arm's length principle to warrant an adjustment

ARTICLE 9(2) – CORRESPONDING ADJUSTMENT



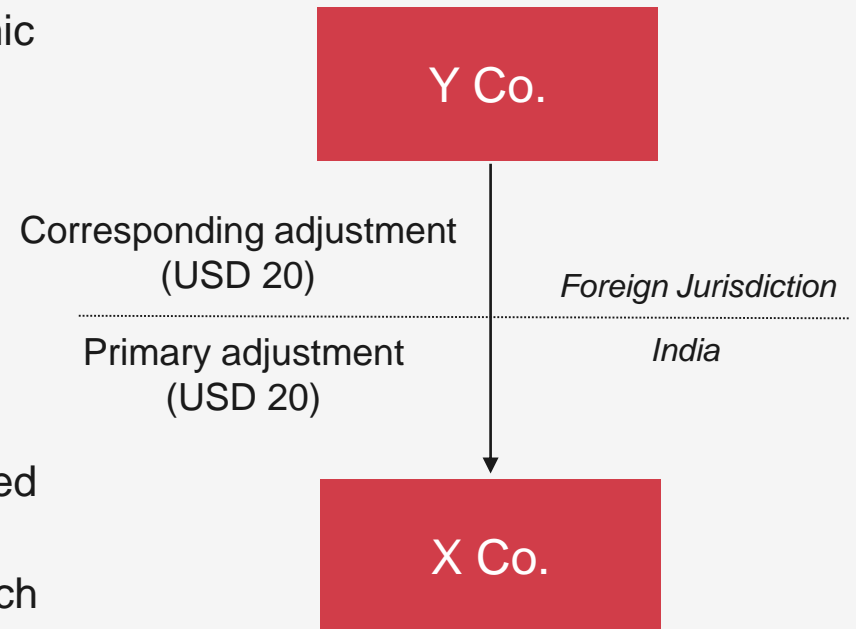
- ❖ Article 9(2) enables a transfer pricing adjustment to account for an adjustment vis-à-vis a given transaction in the AE's jurisdiction (corresponding adjustment)
- ❖ OECD Guidelines defines a corresponding adjustment as:
“An adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent.”
- ❖ To make a corresponding adjustment, the competent authorities of each jurisdiction may consult each other
- ❖ Due regard should be given to the domestic regulations in each jurisdiction

ECONOMIC DOUBLE TAXATION



❖ How does a TP adjustment leads to economic double taxation.

- X Co. and Y Co. are AEs
- Y Co. sells goods to X Co. at USD 120
- ALP is USD 100
- X Co. faces TP adjustment of USD 20
- X Co. pays tax on its adjusted income
- Y Co. does not get deduction for adjusted amount
- Group X pays tax on an amount for which no corresponding deduction has taken place (Economic double taxation)



ARTICLE 9(3) UN MODEL DOUBLE TAXATION CONVENTION

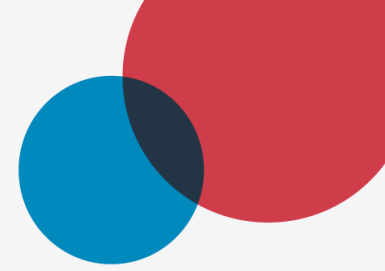


- ❖ Article 9(3) provides an exception to Article 9(2)
- ❖ Prohibits corresponding adjustments in cases of fraud, gross negligence, or willful default
- ❖ Rarely found in tax treaties



**OECD TP
Guidelines
2017**

OECD TP GUIDELINES 2017 – SALIENT FEATURES



- ❖ Most widely used international commentary on transfer pricing
- ❖ Adopts arm's length principle
- ❖ Prescribes five methods to compute arm's length price
- ❖ Comparability analysis
- ❖ Guidance on documentation to be maintained
- ❖ Approaches to avoid and resolve transfer pricing disputes
- ❖ Arm's length pricing of Intangible property, Cost Contribution Arrangements and Intra-group services
- ❖ Business restructurings

OECD TP GUIDELINES 2010 VS 2017 – KEY CHANGES

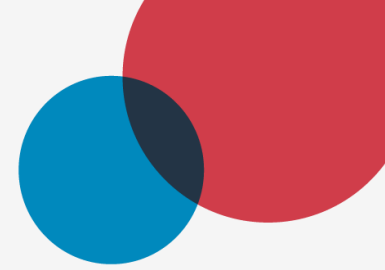


- ❖ Alignment with BEPS Actions 8 to 10 (Aligning Transfer Pricing Outcomes with Value Creation) and 13 (Transfer Pricing Documentation and Country-by-Country Reporting) – Changes were made to the following chapters:
 - I (The Arm's Length Principle)
 - II (Transfer Pricing Methods)
 - V (Documentation)
 - VI (Special Considerations for Intangibles)
 - VII (Special Considerations for Intra-Group Services)
 - VIII (Cost Contribution Agreements)
 - IX (Transfer Pricing Aspects of Business Restructurings)
- ❖ Incorporates the six-step process for identifying risk
- ❖ Provides revised guidance on safe harbours (i.e. 5% for low value-adding intra-group services)



**Base Erosion
and Profit
Shifting (BEPS)
Project**

BASE EROSION AND PROFIT SHIFTING (BEPS)



- ❖ BEPS occurs when MNEs structure their global operation in such a way that income is not being taxed anywhere or income tax paid is significantly reduced in the location where they operate
- ❖ In July 2012, the G20 world leaders called for action to reform the international tax system
- ❖ In addressing BEPS, the OECD/G20 members endorsed a 15-item Action Plan as published in July 2013.
- ❖ The task was referred to the Organisation for Economic Cooperation and Development (“OECD”), which set up a project on BEPS
- ❖ BEPS relate to tax planning strategies that:
 - exploit gaps and mismatches in tax rules to make profits ‘disappear’;
 - to shift profits to locations where there is little or no real activity resulting in little or no tax paid
- ❖ The above may arise from loop holes arising from a combination of various countries’ tax rules, the use of the digital economy, etc.

FIGHT AGAINST TAX AVOIDANCE SCHEMES

Oct 2014 - Irish Budget 2015 announced the “double-Irish” structure to be abolished, closed to new entrants from 2015 and phased out for existing taxpayers in 2020

Sept 2014 – Switzerland announced that certain beneficial tax models will be abolished to be in line with EU and OECD standards

Multinational companies have been exploiting differing national tax laws across the EU, considerably reducing their effective tax rates without even having to resort to tax havens

EU countries lose about € 1 trillion annually due to aggressive tax planning by large multinationals

June 2014 - Finance ministers in EU approved new legislation ensure that multinationals can no longer shift profits across the EU's borders

TRANSFER PRICING ASPECTS OF BEPS ACTION PLAN



- ❖ After a year's work, the OECD produced its Action Plan to address BEPS
- ❖ Transfer pricing elements contained in BEPS action plan involve:

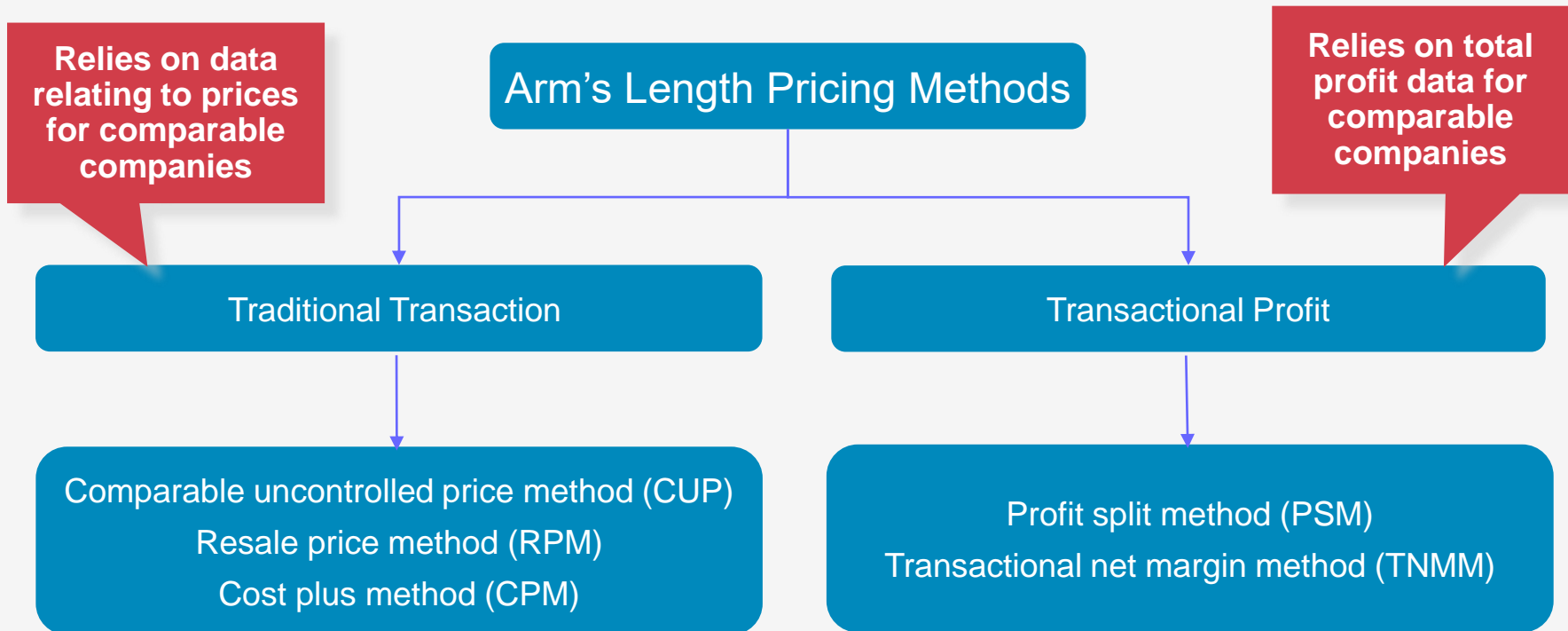
	Action Steps
Action 8	Develop rules to prevent BEPS by moving intangibles among group members
Action 9	Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members
Action 10	Develop rules to prevent BEPS by engaging in transactions which would not, or would very rarely, occur between third parties
Action 13	Develop rules regarding TP documentation (two tiered approach, country-by-country reporting)
Action 4	Develop TP guidance regarding pricing of related party financial transactions



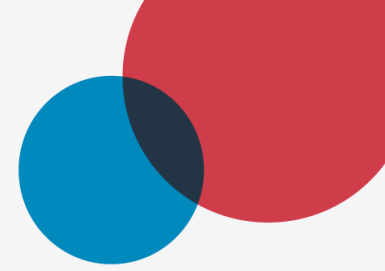
**Transfer Pricing
Methodologies**

METHODOLOGIES

- ❖ The following methodologies can be used in determining arm's length price:



METHODOLOGIES

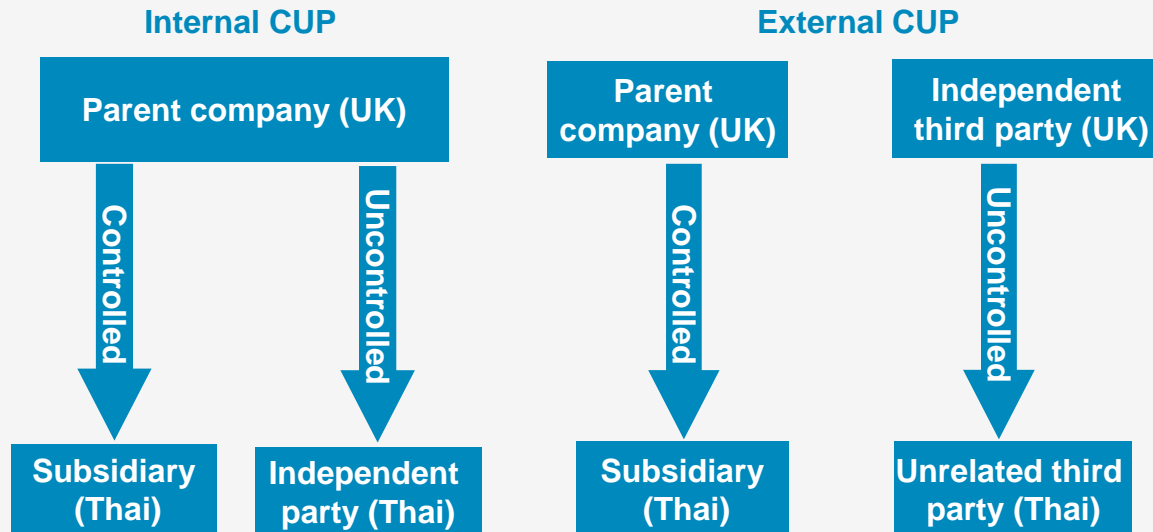


- ❖ The 2017 OECD TP Guidelines replaces the hierarchy of methods with the principle of the “most appropriate method to the circumstances of the case”
- ❖ Apart from the 5 prescribed methods, other methods may be used where none of the above are applicable
- ❖ The following should be taken into account in determining the most appropriate method to apply:
 - Strengths and weaknesses of the various methods;
 - Nature of the controlled transaction, determined through a functional analysis;
 - Availability of reliable information;
 - Degree of comparability;
 - Reliability of comparability adjustments; and
 - Nature, extent and reliability of assumptions for application of a method

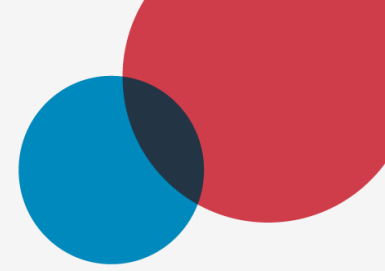
METHODOLOGIES – CUP



- ❖ Compares price charged for property / services transferred in a controlled transaction with that of a comparable uncontrolled transaction
- ❖ Generally produces the most reliable results – most direct method
- ❖ Preferred by OECD
- ❖ Types of CUP:



METHODOLOGIES – CUP



- ❖ While comparing controlled transaction with uncontrolled transaction, comparability based on the following should be established
 - Nature of goods/services transacted
 - Product characteristics
 - Functions performed, risks assumed
 - Economic circumstances
 - Business strategies
 - Contractual terms (e.g. volume, credit terms, warranties)
 - Ownership of intangibles e.g. branding of products
 - Date of transaction
 - Level of market
 - Geographic differences
- ❖ Where possible, adjustments should be made

METHODOLOGIES – CUP

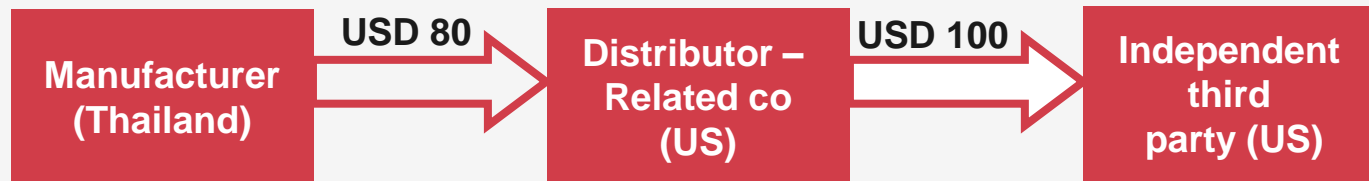


- ❖ More commonly used for transactions involving homogeneous products (e.g. traded commodities), interest rate charged on a loan, royalty payments, franchise fees or license fees

METHODOLOGIES – RPM



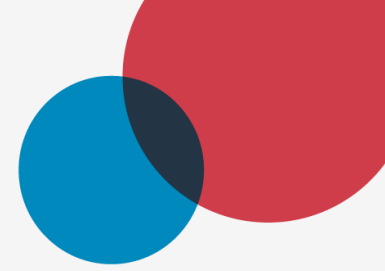
- ❖ Compares gross profit margin in a controlled transaction with that of an uncontrolled transaction
- ❖ Based on price of a product purchased from related party and resold to an independent party without any substantial value addition



USD 80 is arm's length price if 20% resale margin lies within arm's length range of margins earned by similar US distributors

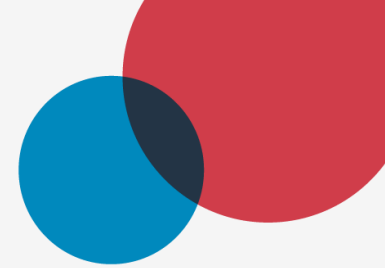
METHODOLOGIES – RPM

Practical Considerations



- ❖ Applicable to distributors i.e. when goods purchased from related parties and sold to independent parties
- ❖ In identifying comparable transactions, similarity of functions performed and risks undertaken is critical
- ❖ Gross margins are used for the purpose of comparison
- ❖ RPM cannot be applied in the absence of gross margin data
- ❖ RPM is appropriate where reseller adds little value
- ❖ RPM is not suitable where reseller contributes to creation or maintenance of intangible property (e.g. trademark) or provides high value add (e.g. assembly)

METHODOLOGIES – CPM



- ❖ Applicable to semi-finished goods sold between associated parties or where the manufacturer is a contract manufacturer or where the controlled transaction involves the provision of services
- ❖ Compares gross profit mark-up in a controlled transaction with that of an uncontrolled transaction
- ❖ Based on cost incurred by the supplier of property / service
- ❖ Cost base under CPM:
 - Direct cost e.g. cost of raw materials, etc.
 - Indirect cost e.g. depreciation, repair and maintenance, etc.
- ❖ Appropriate mark-up is added to the cost to make arm's length profit

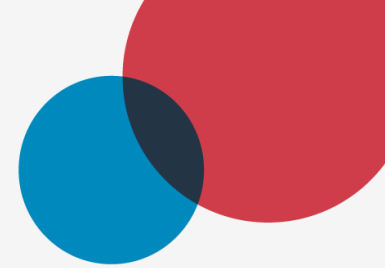
METHODOLOGIES – CPM

Practical Considerations



- ❖ Method used in cases involving manufacture, assembly or production of tangible products or services that are sold / provided to related parties
- ❖ In identifying comparable companies, less focus on product comparability more on functional comparability
- ❖ Gross margins can be used for the purpose of comparison
- ❖ Information on direct and indirect cost is not always available
- ❖ Comparable party may adopt a definition of cost base which is different from that of tested party

METHODOLOGIES – PSM

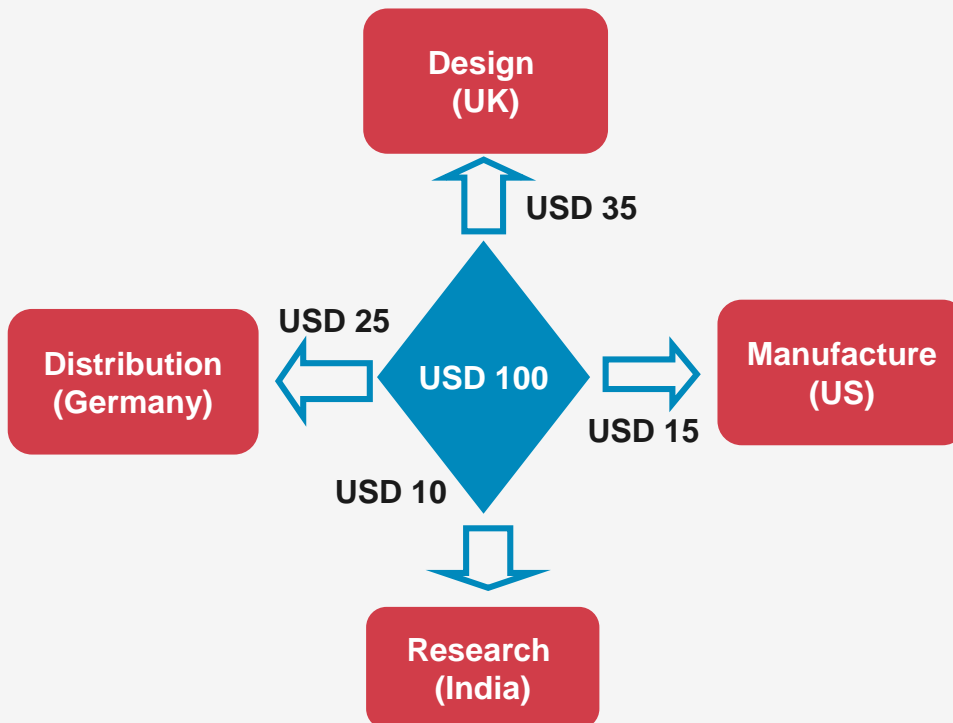


- ❖ The apportionment of profits may be determined under one of the following methods:
 - Residual profit split; or
 - Contribution analysis.
- ❖ In the Residual profit split, the profits are analysed using a two stage process:
 - Stage one - the combined profit is apportioned according to basic or routine returns assigned to each party to the transaction.
 - Stage two – the residual profit or loss is allocated to the parties based on facts and circumstances that indicate how the residual profit or loss would be divided between independent enterprises. Stage two focuses on intangible property contributed, relative bargaining positions, and reference is made to external market data.

METHODOLOGIES – PSM

Practical Considerations

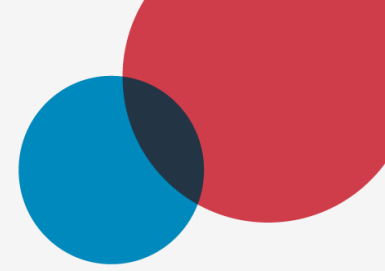
- ❖ In the Contribution analysis, profit from controlled transaction is split based on contribution of each related company in the group
- ❖ Each split has to be in agreement with that of an arm's length situation, with respect to specific function performed, assets utilized and risks undertaken



Residual profit of USD 15 is to be split according to allocation key

METHODOLOGIES – PSM

Practical Considerations

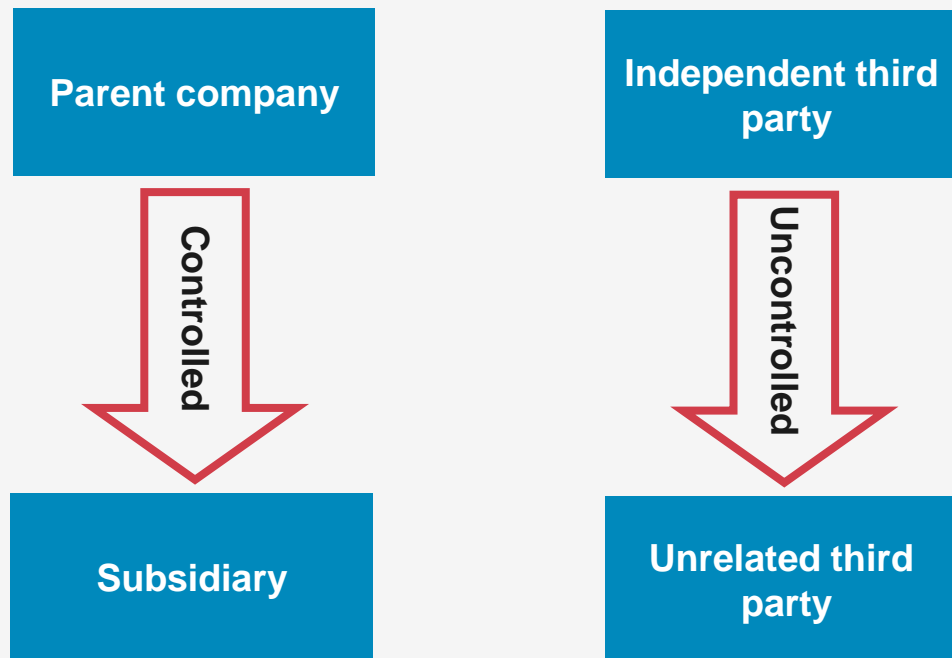


- ❖ PSM is appropriate where both parties to the transaction make unique and valuable contributions or where the transaction involves highly integrated operations for which a one sided approach would not be appropriate
- ❖ Reference to relative value of each controlled taxpayer's contribution (functions performed, risks assumed and resources employed)
- ❖ Complex method
- ❖ Sparingly used

METHODOLOGIES – TNMM



- ❖ Compares net operating profit margin relative to appropriate base (e.g. cost, sales) realized from a specific controlled transaction vis-à-vis similar uncontrolled transaction



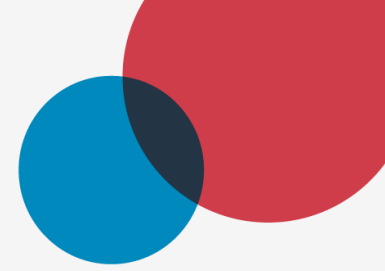
METHODOLOGIES – TNMM



- ❖ Net operating margin of company to be compared with net operating margin earned by similar enterprises in uncontrolled transactions
- ❖ Selection of Profit Level Indicator (e.g. return on sales, return on cost, etc)
- ❖ Broad similarity of resources employed, functions performed and risks assumed in identifying comparable companies
- ❖ Primary difference (compared to RPM and CPM) is that **TNMM focuses on net margins instead of gross margins**
- ❖ Most preferred and practical method
- ❖ Financial data readily available

METHODOLOGIES – TNMM

2017 OECD TP GUIDELINES



- ❖ Provides additional guidance on applying TNMM
- ❖ Determination of net profit:
 - Only include items which are directly and indirectly relate to the controlled transaction and are operating in nature
 - The following should generally be excluded:
 - Non-operating items such as interest income, interest expense and income taxes
 - Exceptional and extraordinary items of a non-recurring nature
 - Foreign exchange gains/loss (and any hedging of the forex exposure) which are non-trade in nature

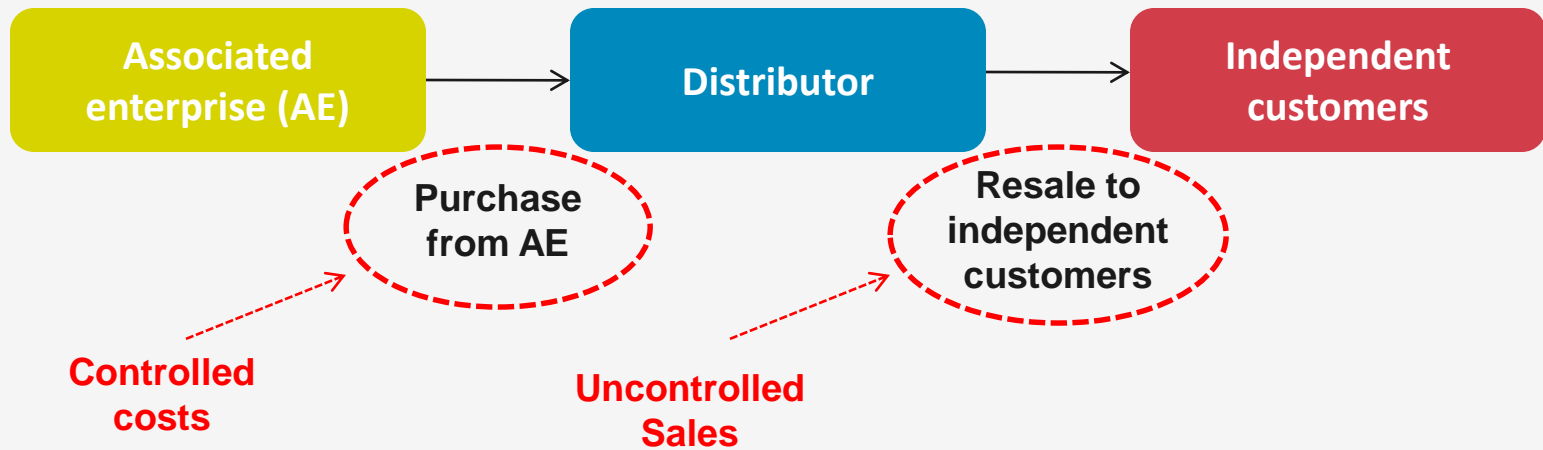
METHODOLOGIES – TNMM

2017 OECD TP GUIDELINES



$$\text{Profit Level Indicator} = \frac{\text{Net Profit}}{\text{Denominator ???}}$$

- ❖ Denominator:
 - Focused on the indicators of the value of functions performed and extent of risks assumed and assets employed, e.g. sales, expenses, assets, etc.
 - Should be independent from controlled transactions



What should be the profit level indicator for the distributor?

METHODOLOGIES – TNMM

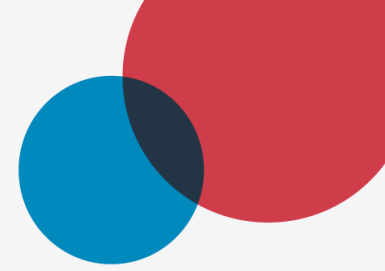
2017 OECD TP GUIDELINES



- ❖ *Net profit weighted to sales*
 - Frequently used for distributors which purchase from an associated enterprise for resale to independent customers
- ❖ *Net profit weighted to costs*
 - Should be used when costs are a relevant indicator of functions performed, risks assumed and assets employed
 - Costs = direct and indirect costs relating to the controlled transaction
 - Excluding “pass through” costs from the denominator:
 - Would independent parties also attribute no profit element to these costs?
 - Can these costs be clearly identified for the comparables as well?
 - Both actual and budgeted costs can be used as a base, depending on the circumstances of the case

METHODOLOGIES – TNMM

2017 OECD TP GUIDELINES



❖ *Net profit weighted to assets*

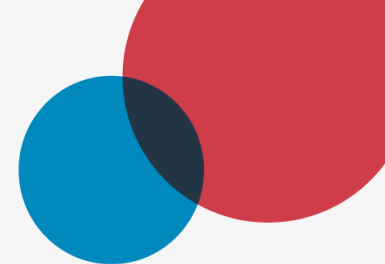
- Appropriate base in cases where assets are a better indicator of the value added by the tested party, e.g. certain manufacturing or asset-intensive activities
- Assets = operating assets, including:
 - Tangible operating assets – land and buildings, plant and equipment etc.
 - Intangible operating assets – patents, know how etc.
 - Working capital assets – trade receivables, inventory
 - **Exclude** cash and investments

SUMMARY OF METHODS

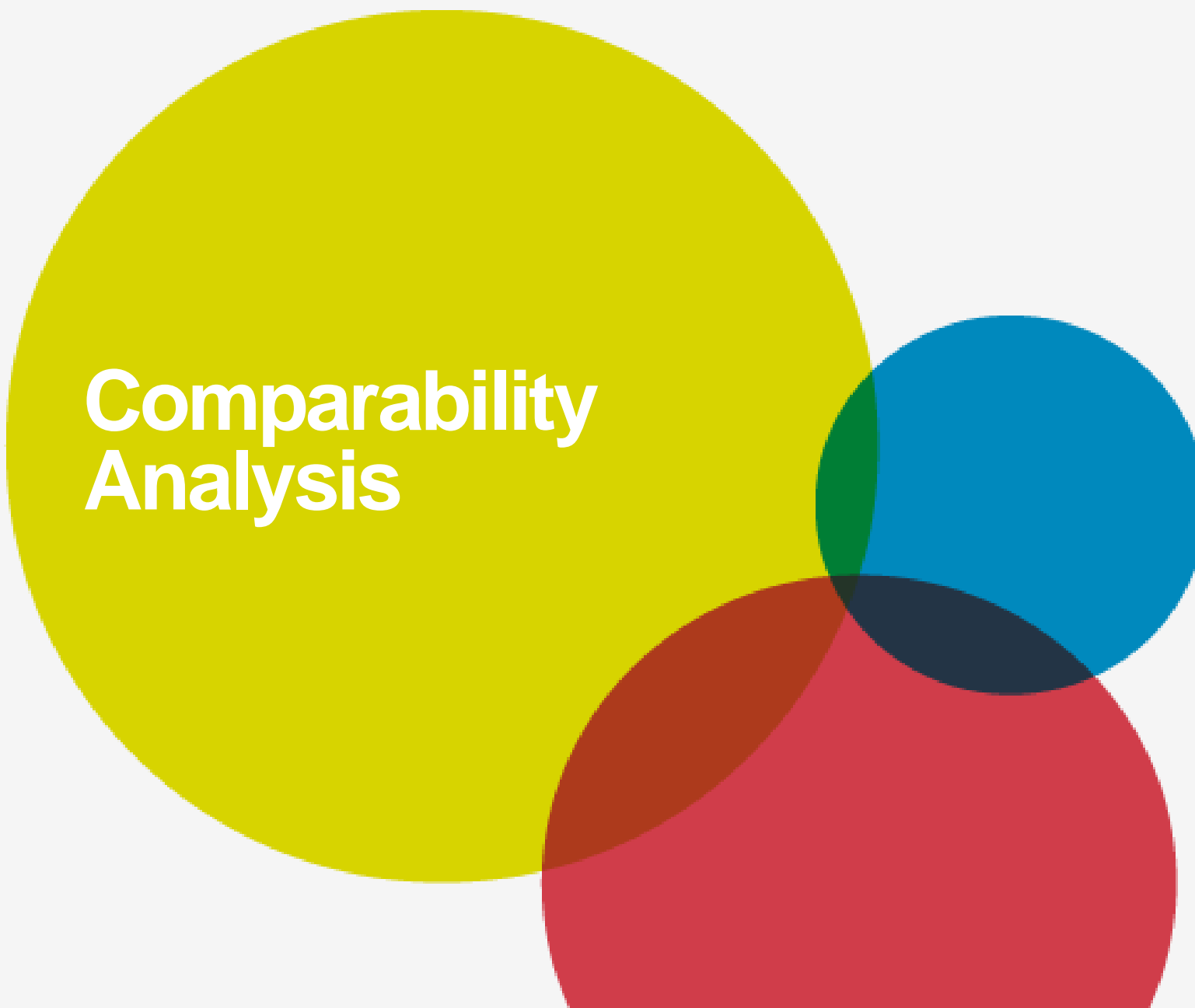


METHODS	COMPARABILITY REQUIREMENTS	APPROACH	APPLICABILITY
CUP	Very High	Prices are benchmarked	Every transaction including intangibles, transfer of commodities, loans, provision of financing
RPM	High	Gross Profit margins are benchmarked	Distribution of finished products
CPM	High	Gross Profit margins are benchmarked	Provision of services, transfer of semi finished goods, sale of finished goods
PSM	Medium	Individual transaction margins are benchmarked	A group of AE's involved in integrated transactions, usually involves intangibles
TNMM	Medium	Net Operating Profit margins are benchmarked	Provision of services, where other methods are inadequate

REMARKS



METHODS	ADVANTAGES	DISADVANTAGES
CUP	Easy to use and most reliable, if available	Very difficult to apply as very high degree of comparability required
RPM	Few adjustments are needed to account for product differences	Reliability is affected if material differences in carrying out business activities exist
CPM	Few adjustments are needed to account for product differences	Gross margins are affected even with minor functional differences
PSM	Does not rely on closely comparable transactions	Complex method, sparingly used
TNMM	Most preferred and practically applicable method vis-à-vis taxpayer	Accurate and reliable determinations of arm's length net margins difficult



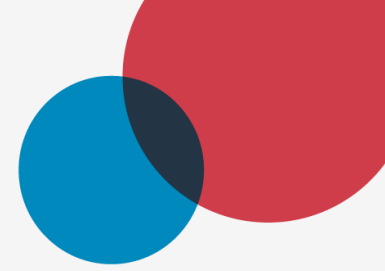
**Comparability
Analysis**

COMPARABILITY ANALYSIS



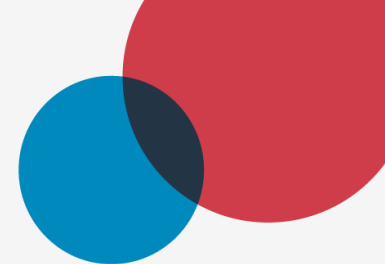
- ❖ Factors to be identified to determine commercial or financial relations between AEs include:
 - Contractual terms of the transaction
 - Functions performed, taking into account the assets employed and risks assumed
 - Characteristics of property or services
 - Economic circumstances of the parties
 - Business strategies pursued

COMPARABILITY ANALYSIS



- ❖ The “typical” (though not mandatory) nine-step process includes:
 - **Step 1:** Determination of years to be covered
 - **Step 2:** Broad-based analysis of the taxpayer’s circumstances
 - **Step 3:** Understanding the controlled transaction(s) under examination
 - **Step 4:** Review of existing internal comparables, if any
 - **Step 5:** Determination of available sources of information on external comparables, if needed
 - **Step 6:** Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator
 - **Step 7:** Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable
 - **Step 8:** Determination of and making comparability adjustments where appropriate
 - **Step 9:** Interpretation and use of data collected, determination of the arm’s length remuneration

COMPARABILITY ANALYSIS



Six- step framework for analyzing risk:

1 Identification of economically significant risks with specificity



2 Determine contractual assumption of the specific risk



3 Functional analysis in relation to risk



4 Interpreting steps 1–3



5 Allocation of risk



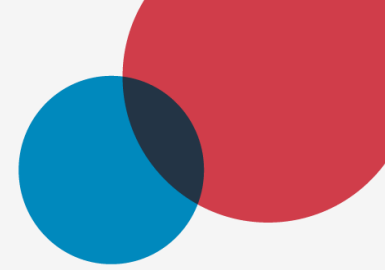
6 Pricing the transaction, taking into account the consequences of risk allocation



**Understanding
Different
Business Models**

MANUFACTURER'S BUSINESS MODELS

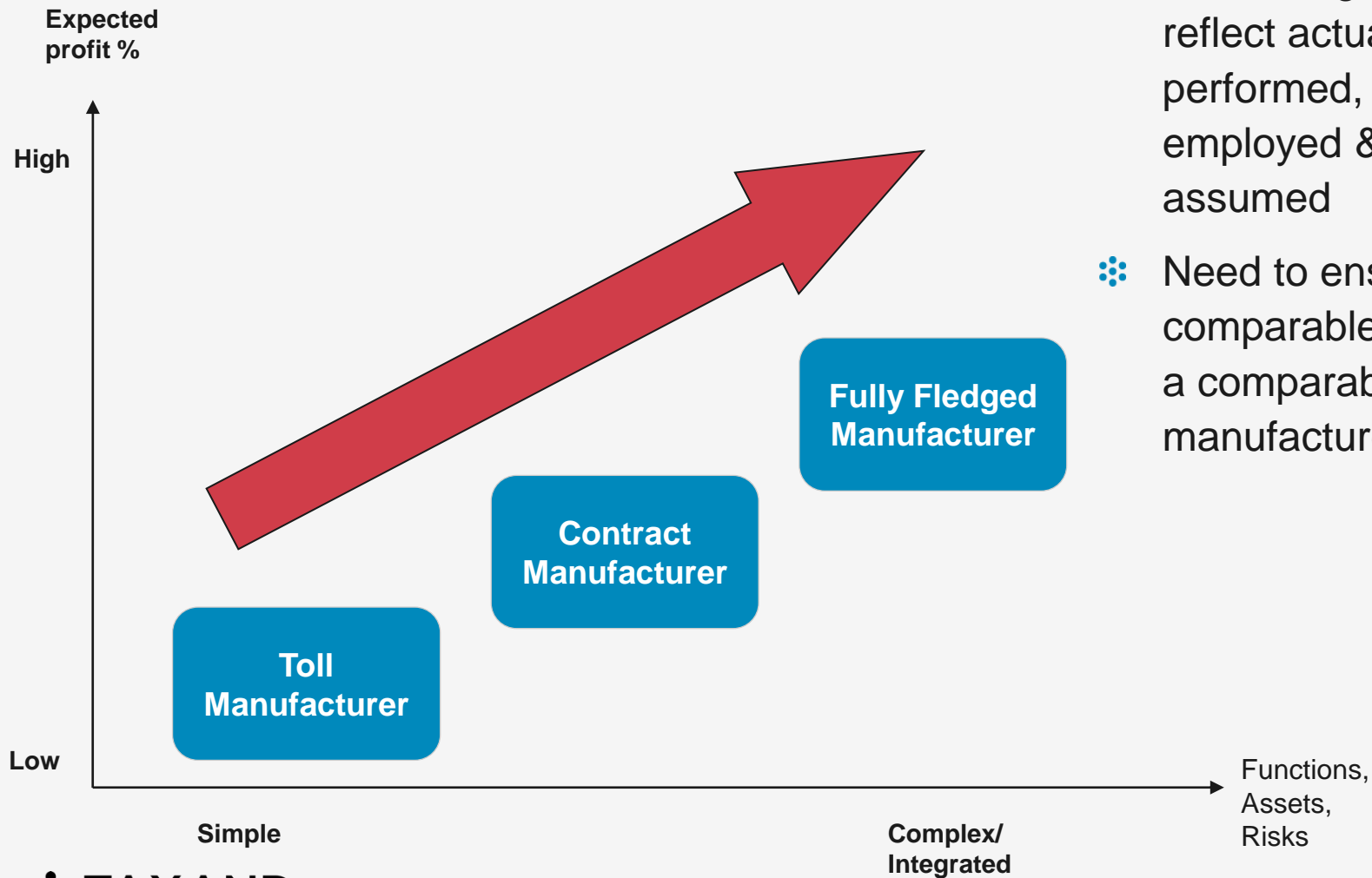
What type of manufacturer are you?



Functions	Fully fledged manufacturer	Contract manufacturer	Toll manufacturer
Sourcing of raw materials	X	X	
Consignment of raw materials			X
Manufacturing planning	X	X	X
Routine intangibles	X	X	X
Specific valuable manufacturing intangibles	X		
R&D	X		
Manufacturing	X	X	X
Title to goods	X	X	
Quality control	X	X	X
Assembling & packaging	X	X	X
Warehousing & logistics	X	X	(X)
Price setting	X		
Invoicing & collection	X	X	
Marketing & advertising	X		
Sales & distribution	X		
After sales support	X		
Warranty & repair	X		
General administrative functions	X	X	X

MANUFACTURER'S BUSINESS MODELS & EXPECTED RETURNS

What type of manufacturer are you?



- ❖ Arm's length price must reflect actual functions performed, assets employed & risks assumed
- ❖ Need to ensure comparable company is a comparable manufacturer

DISTRIBUTOR'S BUSINESS MODELS

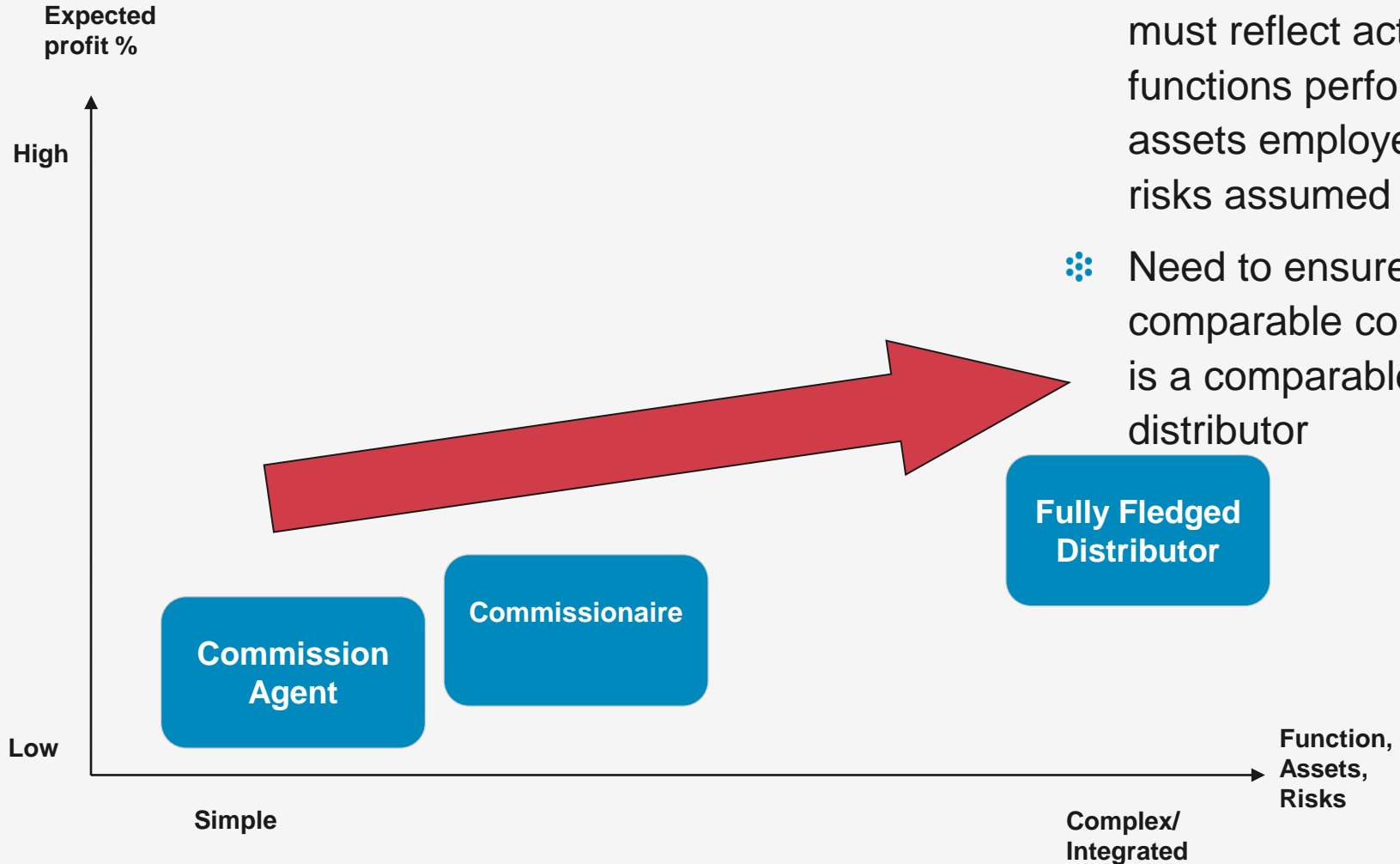
What type of distributor are you?



Functions	Fully fledged distributor	Classic buy-sell distributor	Commissionaire	Commission agent
Title to goods	X	X		
Warehousing & logistics	X	(X)		
Purchase planning	X	(X)		
Quality control	X			
Price setting	X			
Marketing & advertising	X	(X)	X	X
Sales & distribution	X	X	X	X
After sales support	X			
Warranty & repairs	X			
Invoicing & collection	X	X	X	
General administrative functions	X	X	X	X
Inventory risk	X	(X)		
Market risk	X	X	X	X
Forex risk	X	(X)		
Bad debt risk	X	X		
Product liability risk	X	X		

DISTRIBUTOR'S BUSINESS MODELS & EXPECTED RETURNS

What type of distributor are you?



- ❖ Arm's length price must reflect actual functions performed, assets employed & risks assumed
- ❖ Need to ensure comparable company is a comparable distributor

SERVICE PROVIDER'S BUSINESS MODELS

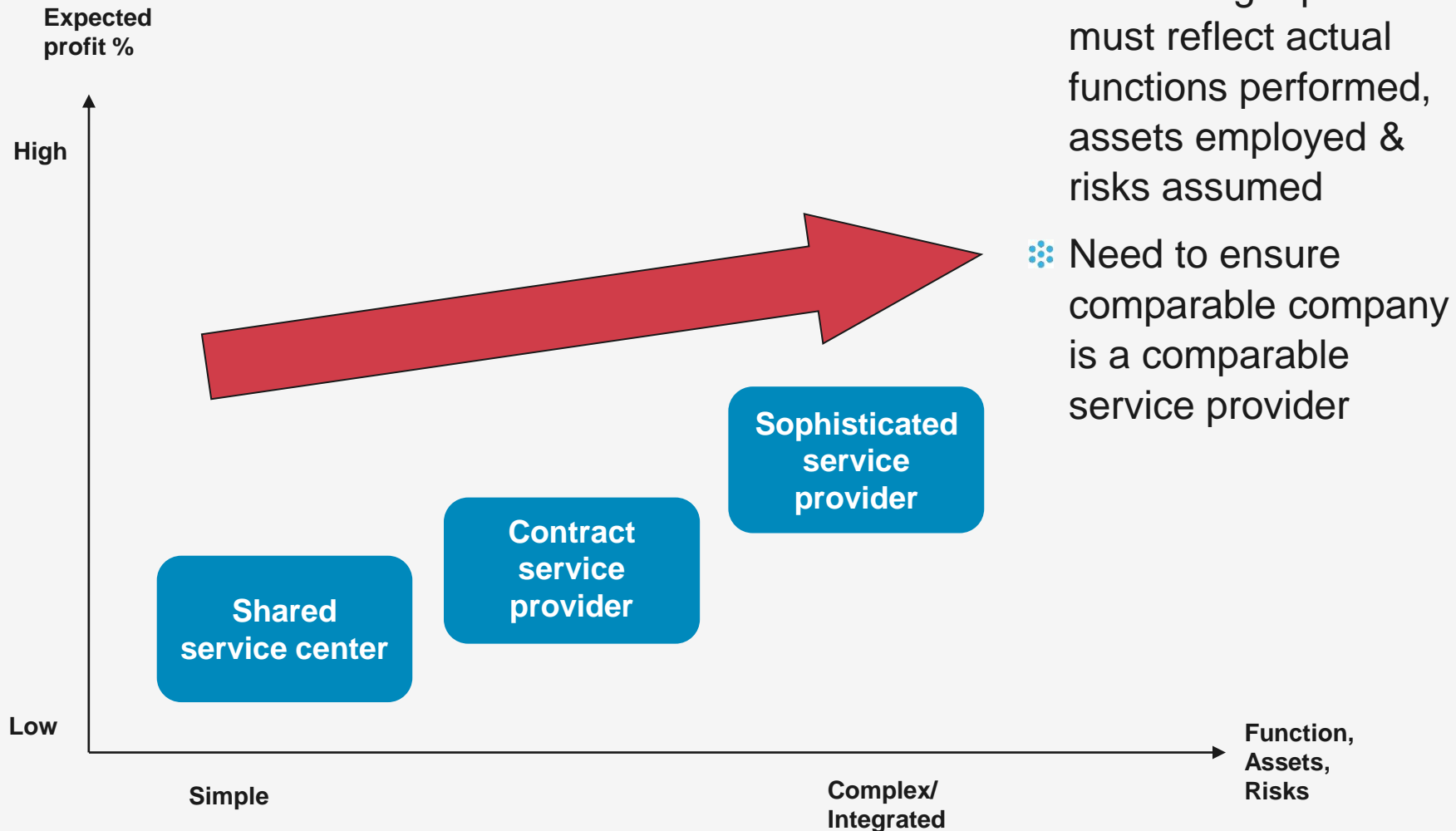


What type of service provider are you?

Functions	Sophisticated service provider	Contract service provider	Shared service center
Investments in assets used to render services	Typically high	Typically low	Can be low - high
Human resources	Higher compensation	Lower compensation	Depends on services rendered
Valuable intangibles	X		
Routine intangibles	X	X	X
Invoicing & collection	X	(X)	X
General administrative functions	X	X	X
Market risk	X		
Forex risk	X		
Bad debt risk	X		
Liability risk	X	(X)	(X)

SERVICE PROVIDER'S BUSINESS MODELS & EXPECTED RETURNS

What type of service provider are you?





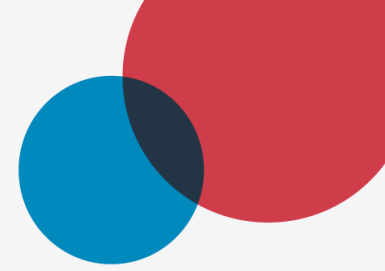
**Transfer Pricing
Documentation**

NEED FOR DOCUMENTATION



- ❖ **Chapter V - 2017 OECD TP Guidelines** provides basic guidance on Documentation
- ❖ Importance of documentation
 - Demonstrates arm's length nature of cross-border transactions
 - Mitigates risk of arbitrary adjustments
 - Substantiates the case before Revenue authorities
- ❖ Burden of proof:
 - In some jurisdictions, burden of proof rests with the taxpayer and thus maintenance of documentation is mandated by law – stringent penalties for non maintenance
 - In some others, burden of proof rests with tax administration
 - Burden shifts to taxpayer if tax administration proves an inconsistency with arm's length principle
 - Hence, taxpayer must maintain documentation, irrespective of where burden of proof lies
 - Documentation requirements should not disproportionately add to the burden of proof for taxpayer

TP DOCUMENTATION



Typical composition

Corporate Background

- ❖ Group and subsidiary operations
- ❖ Ownership structure
- ❖ Overview of the industry and market conditions

Functional Analysis

- ❖ Description and analysis of the functions performed by the taxpayer and associated enterprises
- ❖ Assumptions, strategies, policies

Assets & Risk Analysis

- ❖ Risks assumed by the taxpayer and associated enterprises
- ❖ Assets employed in the operations

Economic Analysis

- ❖ Determination of most appropriate method to arrive at arm's length
- ❖ Search for comparables and benchmarking
- ❖ Analysis of the results

TP DOCUMENTATION



Factual description

- ❖ Factual description includes:
 - Outline of the business and industry
 - ✓ Industry cycle and growth prospects
 - ✓ Competitor profiling
 - ✓ Factors influencing operations
 - Structure of the organization and ownership linkages within the group
 - Need / advantage of global operations and role of the entity
 - Details of transactions with associated enterprises
 - Information on pricing, including business strategies and special circumstances (such as set-off transactions)
 - Terms of transactions
 - Economic conditions at time of transaction

TP DOCUMENTATION

Functional analysis

- ❖ Returns earned by an entity governed by

Functions
performed

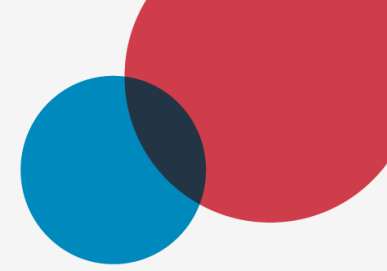
Assets
employed

Risks
assumed

- ❖ Comparison of functions performed necessary to evaluate controlled and uncontrolled transactions
- ❖ Includes :
 - Examination of nature and terms of transaction
 - Assessment of **economic significance of functions** in terms of frequency, nature and value
 - Review of structure and organisation of the controlled entity

FUNCTIONAL ANALYSIS

What should be documented?



Functions performed

- ❖ Details of transactions with associated enterprises
 - Elaborate nature of activities / type of services
 - Contractual terms
 - Role of both company and associated enterprises in the transaction
 - Business cycle (e.g. cyclical nature of industry, if relevant)
 - Geography served
 - Technology used
 - IP generation and ownership
 - Extraordinary events / items
- ❖ Business strategies and pricing
 - Start up phase
 - Market penetration

FUNCTIONAL ANALYSIS



What should be documented?

Risks assumed

- ❖ Adequately document risks assumed in the transaction by either party
- ❖ E.g. Market risk, credit risk, foreign exchange risk, contractual risk

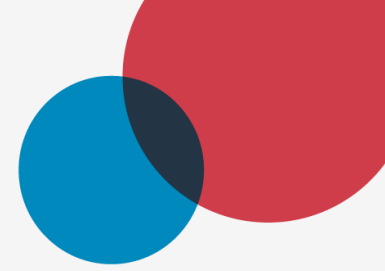
Assets employed

- ❖ Asset profile – nature and value of assets employed in operations
- ❖ Ownership of IPs – use of valuable intangibles

Methodology for collation of above information:

- ❖ Research in public domain
- ❖ Functional interviews
- ❖ Contract review

RESULT OF FAR ANALYSIS



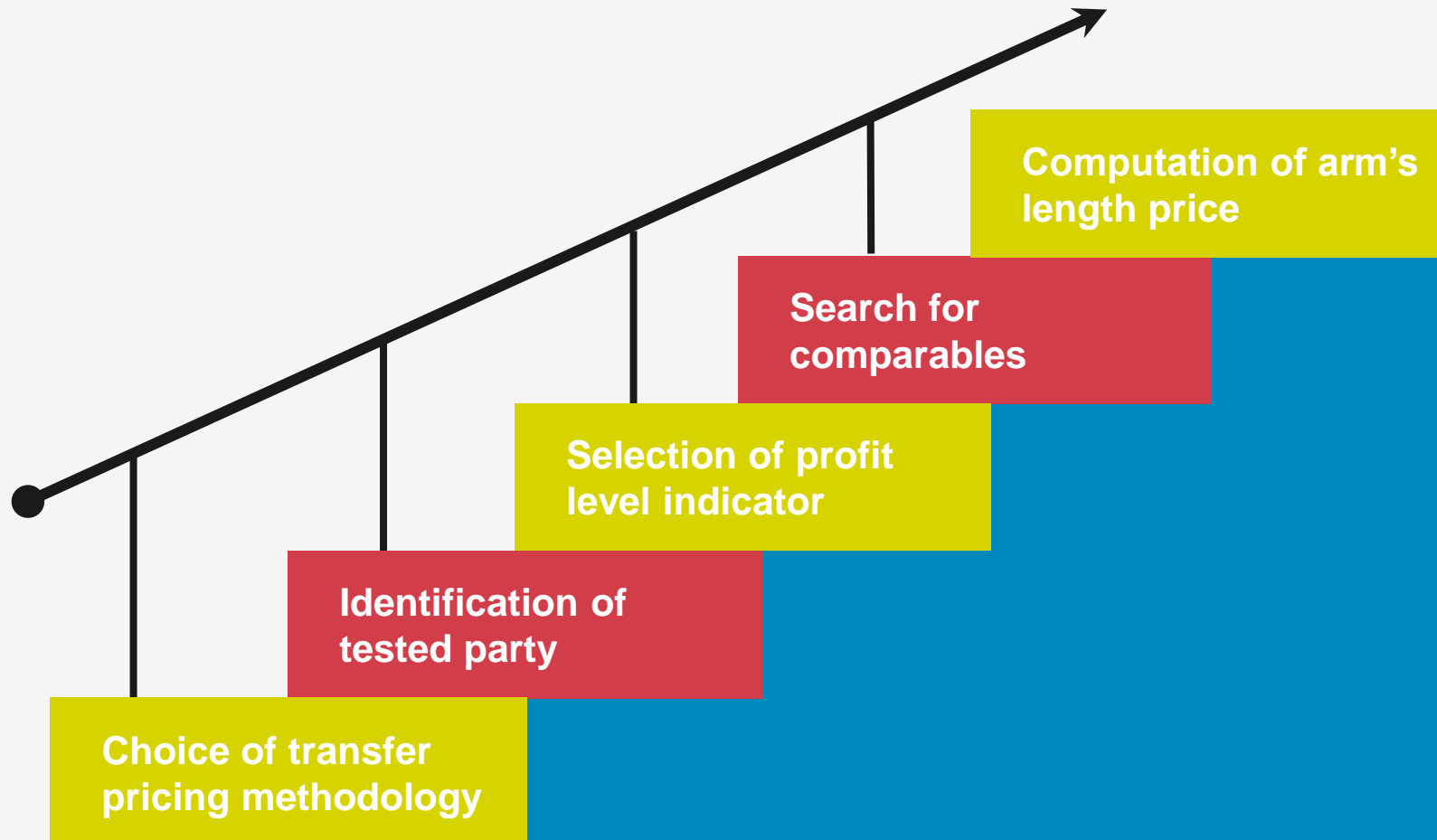
- ❖ Provides detailed understanding of the taxpayer
- ❖ Forms the basis for undertaking an economic analysis
- ❖ Demonstrates the transaction appropriately to the Revenue authorities

THE RESULT



ECONOMIC ANALYSIS

- ❖ Economic analysis aims at determination of arm's length price



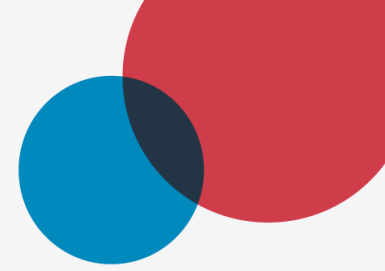
CHOICE OF TESTED PARTY



- ❖ Importance of optimal selection
 - Transaction is benchmarked from viewpoint of tested party
 - Independent enterprises comparable to tested party are selected for the benchmarking study

- ❖ Criteria for selection of tested party
 - Typically the least complex of the transacting parties - routine functions, simpler revenue generation, lower risk etc
 - Availability of most reliable data
 - Does not own valuable intangible or unique resource(s)
 - Requires fewest adjustments
 - Typically performs the functions in the transactions

CHOICE OF METHOD(S)



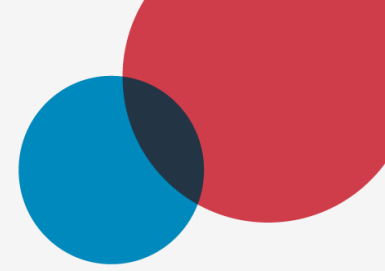
- ❖ 2017 OECD TP Guidelines stipulates the use of the ‘most appropriate’ method
- ❖ Different jurisdictions follow different approaches – most jurisdictions require use of most suitable method
- ❖ Factors to be considered for choice of methodology
 - ❖ Nature of international transactions – FAR of each entity
 - ❖ Availability of reliable data for application of method
 - ❖ Degree of comparability between international and uncontrolled transactions
 - ❖ Nature, extent and reliability of assumptions for application of a method

CHOICE OF PROFIT LEVEL INDICATOR



- ❖ Used for benchmarking returns
- ❖ Identifies best measure of comparison between two companies – not just best measure of profitability
- ❖ Typically an unbiased base serves as a good measure of comparison
- ❖ E.g:
 - Net operating profit based on **cost**
 - Gross operating profit based on **sales**

SEARCH FOR COMPARABLES

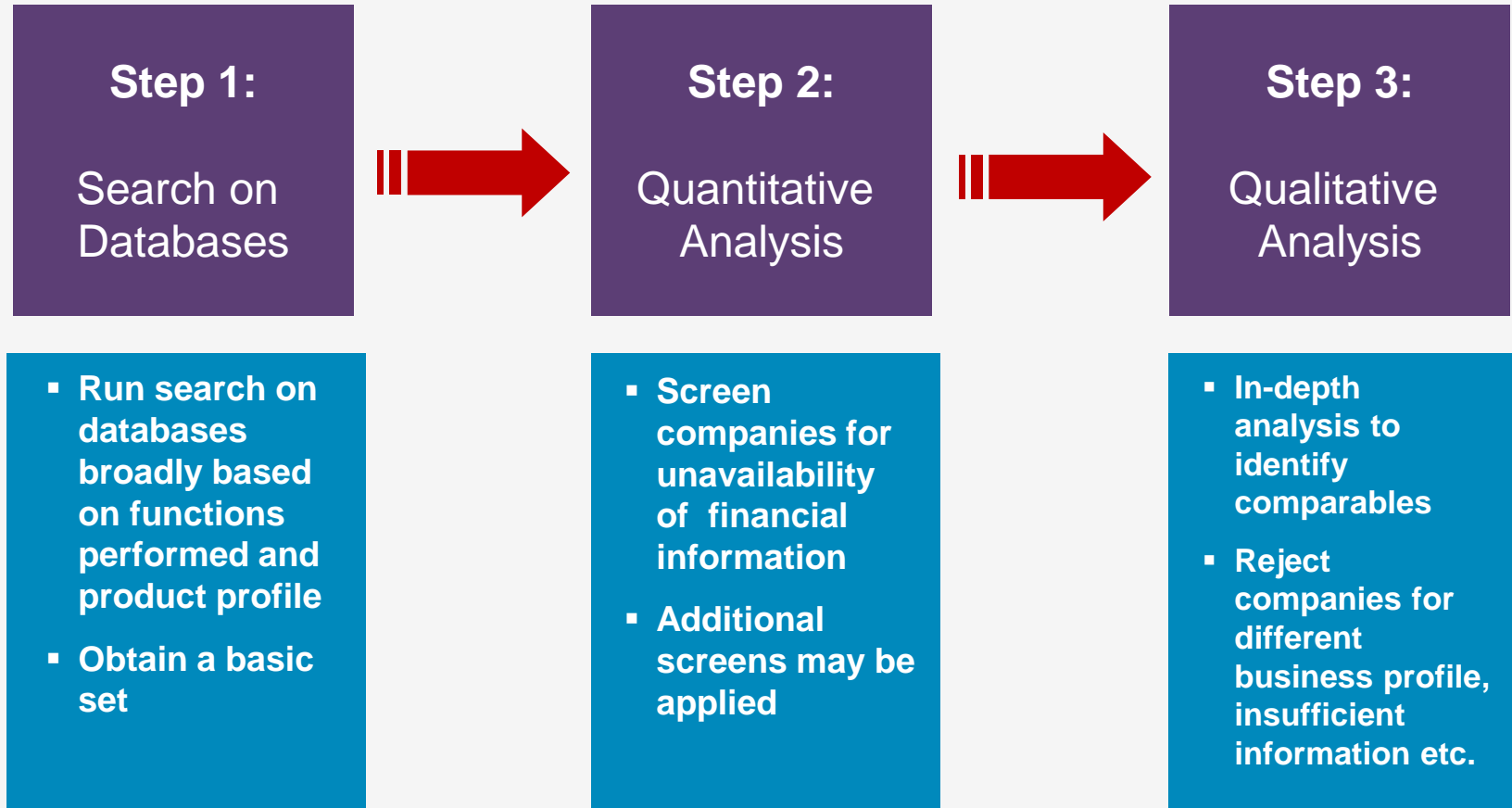


Comparable transactions/companies help determine the arm's length price

- ❖ Source of information
 - Independent transactions undertaken by the Group / company
 - Databases containing financial data and information for listed and unlisted companies – foreign and domestic
 - Third party transaction details available in public domain / with the company
- ❖ Basic requirement:
 - Authentic information
 - Valid for the relevant period of related party transaction – contemporaneous
 - Meets required comparability standards (method-specific)

SEARCH PROCESS

Steps involved in the search process



COMPUTATION OF ARM'S LENGTH PRICE



Determination of arm's length price and comparison with tested party

- ❖ Margins are computed for identified comparable companies, using the profit level indicator selected (not applicable for CUP method)
- ❖ Margin is also computed for the tested party using the same profit level indicator
- ❖ Comparison of the two margins above to conclude if a transaction is undertaken at arm's length price

ARM'S LENGTH RANGE - EXAMPLE

Set of comparables:

Name of the Company	Net Operating Margin
Company A	3.27%
Company B	4.75%
Company C	9.36%
Company D	9.61%
Company E	10.27%
Company F	11.83%
Company G	14.78%

Arm's length range:

Range	Net Operating Margin
Max Value	14.78%
Upper Quartile	11.05%
Median	9.61%
Lower Quartile	7.06%
Min Value	3.27%

Inter-quartile range

Note: Some jurisdictions accept the use of an “arm's length range” or “inter-quartile range” whilst others may use the “median”.



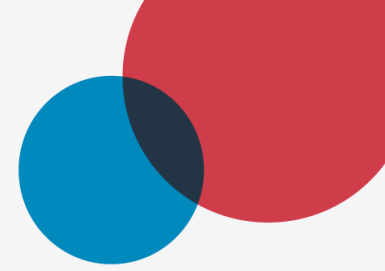
**Practical
Considerations**

ARM'S LENGTH RANGE



- ❖ Transfer pricing not an exact science – may produce multiple results
- ❖ Range of arm's length results may be obtained when:
 - Same transfer pricing method is applied to multiple comparable data
 - Different transfer pricing methods applied to test a single transaction
- ❖ Rare to find arm's length margins with equally reliable values
- ❖ Typical issues:
 - Wide variation in the margin of comparables – extremely high profits / losses in a comparable set
 - Use of loss making companies in a set of comparable companies
 - Difficulty in identifying suitable comparables in niche industries

ARM'S LENGTH RANGE



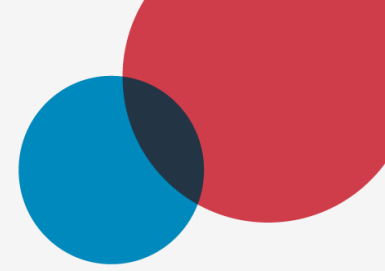
- ❖ Practically statistical tools used to determine appropriate range
 - **USA** - Inter-quartile range
 - **India** - Percentile range (35th-65th percentile) and median concept based on certain conditions and tolerance band of (+/-) 3 percent range from arithmetic mean of comparable prices in other cases
 - **Malaysia** - Reference (in practice) to median point in determining arm's length margin
 - **Indonesia** – Inter-quartile range, but if outside the range, it generally gets adjusted to median point

CONTEMPORANEOUS DATA



- ❖ Issues with respect to time of origin, collection and production of information
- ❖ Timing of collection and analysis of comparable data
 - Before entering into an international transaction
 - At the time of filing tax returns
 - At the time scrutiny by tax administration
- ❖ Time lag between completion of transfer pricing documentation and availability of contemporaneous data
 - Should comparable data pertain to the same year?
 - What data should be relied on if data pertaining to the same year is not available at the time of documentation (India recently issued a notification allowing the use of multiple year data subject to some conditions - Notification 83/2015)
 - What is defined as “latest available information” e.g. information available at the point of tax return filing?
- ❖ Information relied on by the tax administration
 - Should Revenue authorities rely on information submitted by taxpayer or additional information that may be available at the time of scrutiny?

MULTIPLE YEAR DATA



- ❖ Issues with respect to time of origin, collection and production of information
- ❖ What data should be used if data pertaining to year of transaction is not available during documentation?
- ❖ Is single year or multiple year data better?
 - Multiple year data may disclose facts that may have influenced transfer prices
 - If multiple year data is used, is the 3-year weighted average data the most appropriate set of data? Do tax authorities have differing views on how many years should be used in the case of multiple year data?
 - Single year data may not give accurate information
 - Appropriate to link the number of years (if multiple year data is used) to tested party's business cycle (if possible)
- ❖ How to eliminate effect of product / market cycles or ensure all comparable companies are at the same stage of the industrial cycle?

CONTEMPORANEOUS DATA



- ❖ Issues with respect to time of origin, collection and production of information
- ❖ Timing of collection and analysis of comparable data
 - Before entering into an international transaction
 - At the time of filing tax returns
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AGGREGATION OF TRANSACTIONS

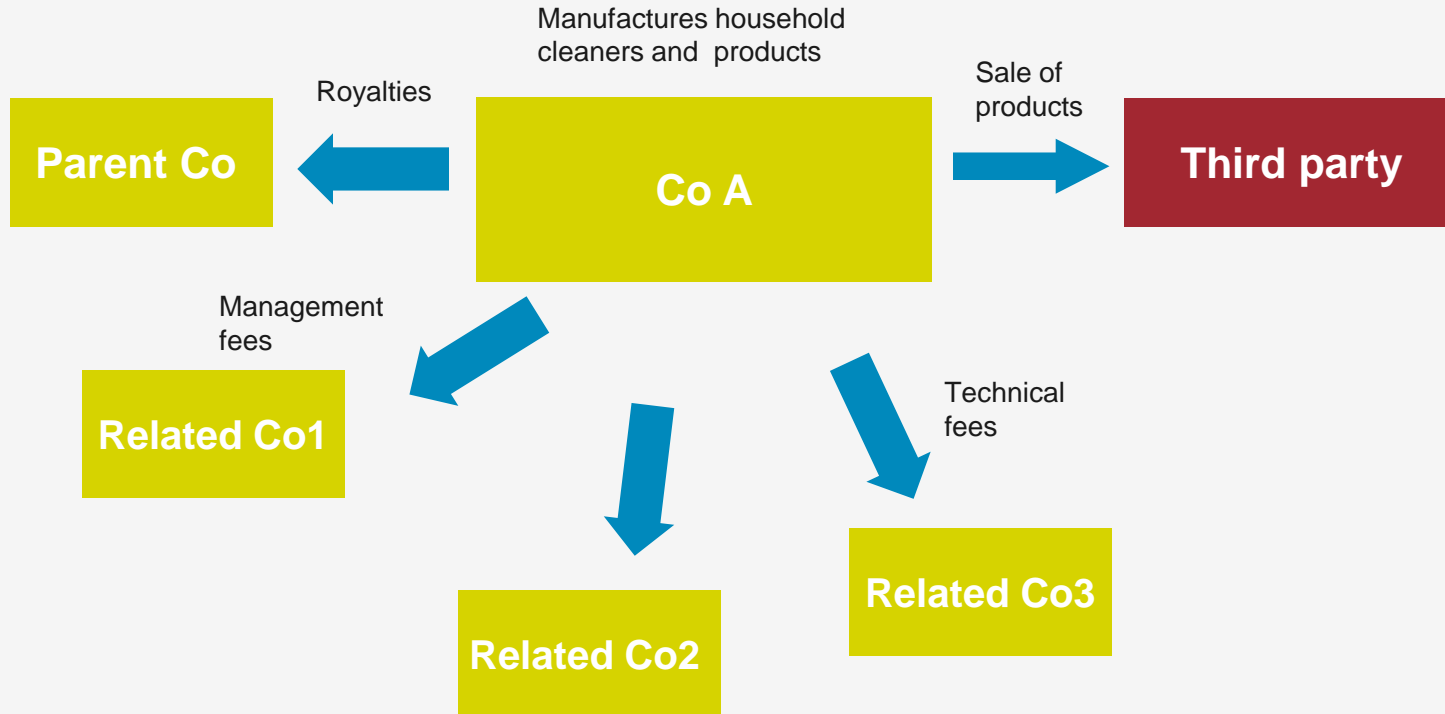
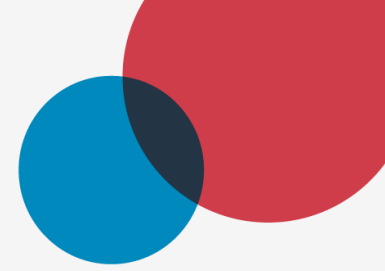


- ❖ Benchmark each transaction or the entity's margin

Practical aspects:

- ❖ Typically arm's length analysis is undertaken on a transaction by transaction basis
- ❖ Publicly available information generally limited to company wide financial data – prices or margins per product not disclosed by companies
- ❖ Reliance placed on segmental data or comparison of entity level information with a transaction
- ❖ Closely linked transactions can be aggregated due to paucity of comparable data
- ❖ Sometimes aggregation is a must
- ❖ Not suitable for CUPs

AGGREGATION OF TRANSACTIONS



What is the proposed TP approach?

1. By transaction?
2. By entity?

SECRET COMPARABLES



- ❖ Taxpayers have access only to internal and publicly available data regarding comparable transactions
- ❖ Revenue authorities generally have access to better comparable data through audits or filing procedures
- ❖ Revenue may use information obtained on other taxpayers – Secret comparables
- ❖ Secret comparables typically not shared with taxpayers
- ❖ Can secret comparables be used to legitimize a transfer pricing adjustment where the taxpayer is not in a position to agree or disagree on a secret comparable?
- ❖ Do revenue authorities in most countries typically use secret comparables in the cases of transfer pricing audits?

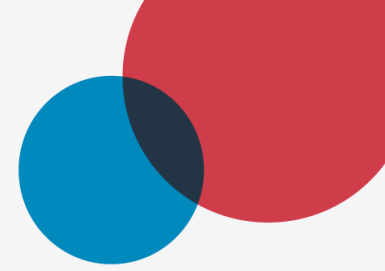
SECRET COMPARABLES



OECD view:

- ❖ Concerns with respect to fairness and transparency
- ❖ Less reliable since taxpayer (better informed about comparability than Revenue authorities) is deprived of any input
- ❖ Countries using secret comparables encouraged to develop appropriate safeguards in their domestic legislation or practices, to ensure reasonable fairness and reliability for taxpayers

COMPARABILITY ADJUSTMENTS




- ❖ Material differences between comparable companies can render analysis inaccurate
 - Whether functionally comparable companies which differ on account of other factors such as volume of operations, risk assumed should be accepted as comparables?
 - How to eliminate the impact of such differences?

COMPARABILITY ADJUSTMENTS



Practical aspects:

- ❖ Appropriate comparability adjustments should be carried out to enable comparison between related and uncontrolled transactions
 - Eliminate financial impact of differences in risk profile
 - Account for extraordinary factors that may influence profitability
 - Enhance comparability
- ❖ Examples of adjustments:
 - Accounting adjustments - Eliminate inconsistency in accounting standards
 - Capacity utilization adjustment
 - Working capital adjustment
 - Adjustment for abnormal expenses / income



**OECD
Guidelines –
Other Concepts**



Thin Capitalisation Rules

THIN CAPITALISATION RULES

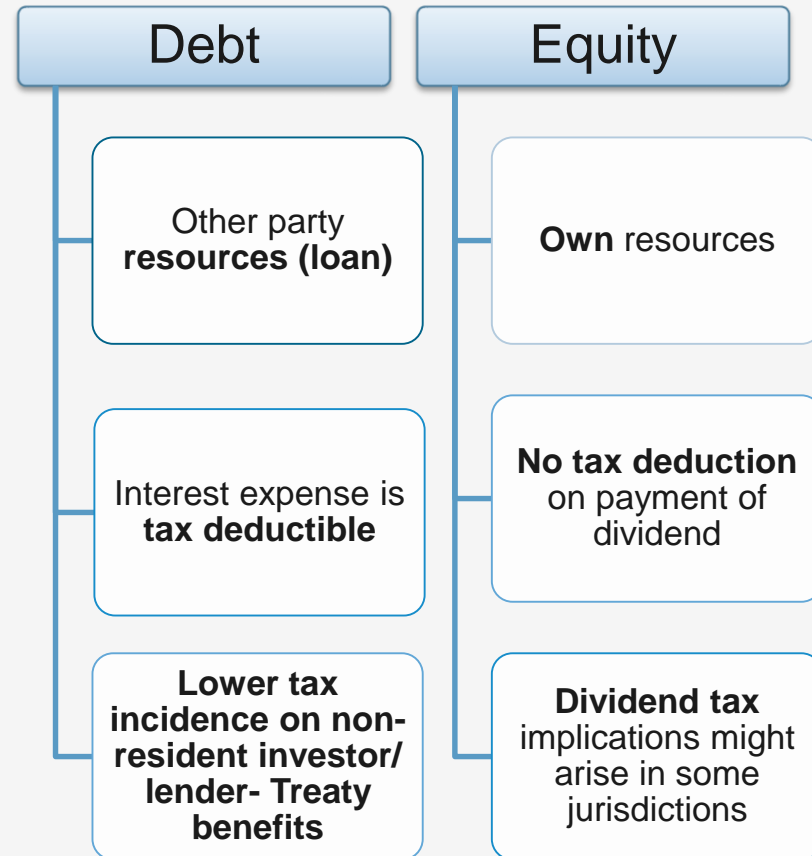
❖ What is Thin capitalisation:

It is a situation in which a company is financed through a relatively **high level of debt compared to equity**. Thinly capitalized companies are sometimes referred to as —highly leveraged or highly geared.

❖ Why is Thin capitalisation significant:

Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit. The **higher the level of debt** in a company, and thus amount of interest it pays, the **lower will be its taxable profit**.

❖ Aim of framing Thin capitalisation rules : To limit an entity's debt-to-equity ratio to control highly leveraged financing structures

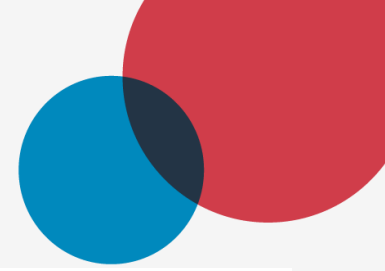


DIFFERENT APPROACHES TO THIN CAPITALISATION



Approaches	Method	Description
Excessive debt approach	Arm's length approach	<ul style="list-style-type: none"> • Maximum amount of “allowable” debt - Debt that an independent lender would be willing to lend to the entity i.e. the amount of debt that a borrower could borrow from an arm's length lender • Typically considers the specific attributes of the entity in determining its borrowing capacity (i.e. the amount of debt that entity would be able to obtain from independent lenders)
	Ratio approach	<ul style="list-style-type: none"> • Maximum amount of “allowable” debt – Debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity
Earnings stripping approach	Fixed ratio rule	<ul style="list-style-type: none"> • Limits entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA)
	Group ratio rule	<ul style="list-style-type: none"> • Allows an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group

APPROACHES DISCUSSED IN ACTION PLAN 4 (BEPS)



Fixed Ratio

- Limit net interest deduction to a fixed percentage of EBITDA
- The percentage to be somewhere between 10% to 30%

Group Ratio

- Group ratio is to supplement the fixed ratio rule
- Entity with net interest expense above the fixed ratio could be allowed to deduct such interest up to the interest/EBITDA ratio of the worldwide group to which it belongs
- The same can also be capped at additional 10% from the fixed ratio

Other recommendations

- Adopting an equity escape rule which allows interest expense so long as an entity's Debt : Equity ratio does not exceed that of the group
- Providing for carry forward and/or carry back of disallowed interest expense, within limits
- Providing exclusions for interest paid to third party lenders on loans used to fund public benefit projects

THIN CAPITALISATION IN DIFFERENT COUNTRIES



Jurisdiction	Approach/Method	Debt included	Additional information
Canada	Excessive debt	Related party debt	<ul style="list-style-type: none"> Permissible Debt : Equity ratio is 2:1
United States of America	Earning stripping and excessive debt	Both Internal and External debt	<ul style="list-style-type: none"> Interest paid to related parties, if the interest in the hands of the recipient is not taxed, is disallowed Applicable to corporations having Debt : Equity ratio exceeding 1.5:1 and when such corporation has excess interest expense
China	Ratio method	Related party debt	<ul style="list-style-type: none"> However, it provides flexibility of the ratio when the taxpayer is able to justify the high ratio
United Kingdom	Arms length method	Related party debts	<ul style="list-style-type: none"> Focuses on special relationship and whether the loan would have been accorded had there been no special relationship
Germany and Italy	Fixed ratio	All debts	<ul style="list-style-type: none"> Limits the deductibility to 30% of EBITDA
India	Fixed ratio	All debts	<ul style="list-style-type: none"> Limits the deductibility to 30% of EBITDA

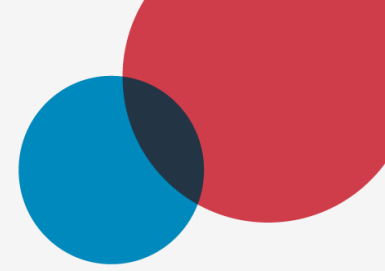
THIN CAPITALISATION IN DIFFERENT COUNTRIES

Jurisdiction	Approach/Method	Debt included	Additional information
Indonesia	Excessive Debt	All interest bearing debts and Interest bearing Trade Payables	<ul style="list-style-type: none">• Permissible Debt : Equity Ratio of 4:1
Malaysia	Fixed ratio	Related party debt	<ul style="list-style-type: none">• Limits the deductibility to 20% of EBITDA

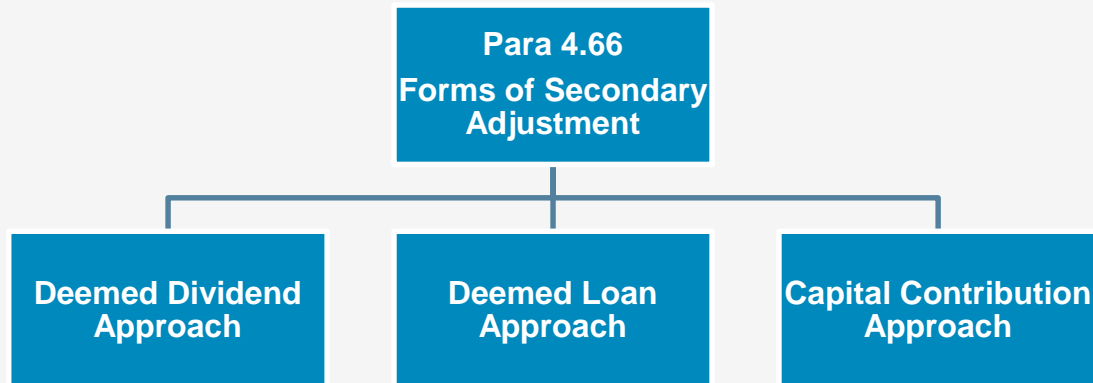


Secondary Adjustments

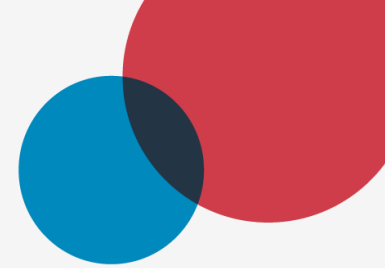
SECONDARY ADJUSTMENTS



- ❖ *Definition in OECD* - Secondary adjustment is as an adjustment that arises from imposing tax on a secondary transaction.
- ❖ *General meaning* – Secondary adjustment entails recharacterisation of primary adjustment amount.
- ❖ It implies the assertion of a constructive transaction (secondary transaction) that attempts to explain why the excess cash is sitting differently to what would have been, should the ALP had been applied by the related parties from the outset
- ❖ OECD TP guidelines (Chapter IV) recognizes the concept of secondary adjustment in the following forms:



SECONDARY ADJUSTMENTS



- ❖ Article 9 of Model Tax Convention does not deal with the issue of secondary adjustment and it is a matter of domestic law of contracting states.
- ❖ The following gives a brief of the treatment of secondary adjustment followed by various countries:
 - ❖ Deemed Dividend approach: Followed by France, USA, Canada, South Africa, Korea, Spain, Bulgaria, Luxembourg, Netherlands, Germany, and Austria
 - ❖ Deemed Loan Approach: South Africa^(Note 1), India and United Kingdom^(Note 2)
- ❖ Further, few of the countries listed above that follow deemed dividend approach also follow the capital contribution approach.

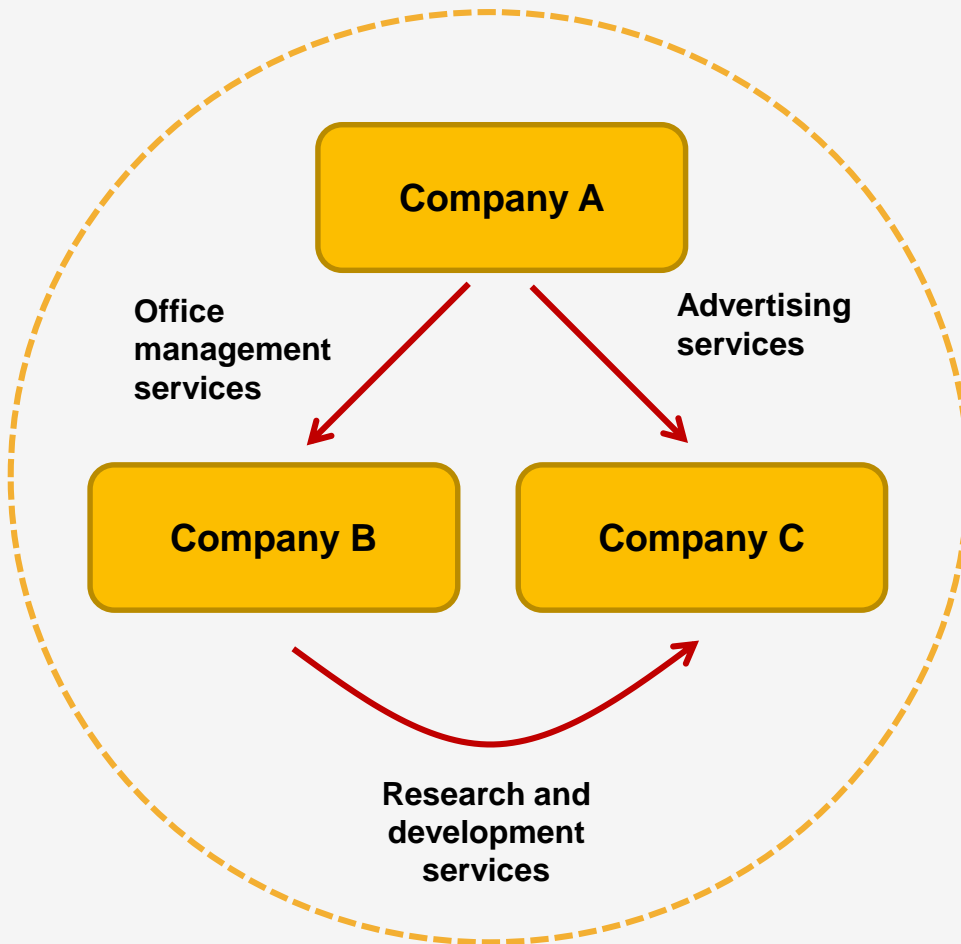
Note 1 - South Africa had earlier adopted the loan approach. However, due to practical difficulties, with effect from January 1, 2015, South Africa has also adopted deemed dividend approach

Note 2 - United Kingdom reflects the proposed Indian approach (although this was in consultation stage till August 2016 – no finality reached as yet)



**Intra-Group
Services**

INTRA-GROUP SERVICES



❖ Intra-group services:

- ❖ Provided by one member to other members belonging to the same group
- ❖ Wide scope of services (e.g. management, coordination, control functions for the whole group, R&D, technical know-how, etc.)

INTRA-GROUP SERVICES



- ❖ Intra-group services are **services provided by a member of a multinational group** for the **benefit of one or more specific members** of the same group
- ❖ Main issues to be addressed for intra-group services are:
 - Whether the intra-group services have in fact been provided
 - ✓ Recipient company should not be charged if no intra-group services have been rendered
 - Whether the activity provides any commercial or economic value or benefit to recipient
 - What are shareholder activities and duplicate activities (with examples)
 - Whether the charge is at arm's length (with regard to mark-up and the allocation keys used)
 - What are low-value adding intra-group services (*newly introduced*)

INTRA-GROUP SERVICES

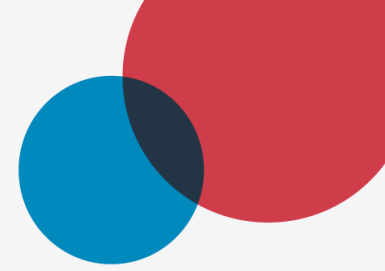
Chargeable Services

- ❖ Service must provide the recipient with economic or commercial value
- ❖ Concept of “benefit”
 - Would the service recipient be willing to pay an independent party to perform the same or similar activity; or
 - Otherwise perform the activity in-house for itself

Non-chargeable Services

- ❖ Shareholder activities i.e. activities performed by parent solely because of its ownership interest
 - E.g. shareholder meetings, issuing of shares, reporting requirements, raising funds for acquisition of its participants
- ❖ Duplicative activities
- ❖ Incidental benefits i.e. where services performed for one group member but incidentally provide benefits to other group members
- ❖ Passive association i.e. incidental benefits attributable solely due to group membership (e.g. higher credit rating due to affiliation)

INTRA-GROUP SERVICES



- ❖ Services should **not** be considered as intra-group services where:
 - ❖ Activities which merely duplicate a service that another group member is performing for itself or that is being performed for such other group member by a third party
 - ❖ Activities which are provided only to certain group members but incidentally benefiting other group members (e.g. study to acquire new business)
 - ❖ Activities giving rise to incidental benefits solely due to passive association
- ❖ OECD view on “on call services” – payment required if independent enterprises in comparable circumstances would pay for standby charges (e.g. IT trouble shooting, retainer fees for legal services)

If not considered as intra-group services → no charge to the recipient company

INTRA-GROUP SERVICES



- ❖ Intra-group services should be charged at a rate similar to that charged by an independent service provider
- ❖ Chapter VII of 2017 OECD TP Guidelines [Para 7.21 – 7.26] provides two methods for charging costs for intra-group services provided by one group company to its associated enterprise(s)

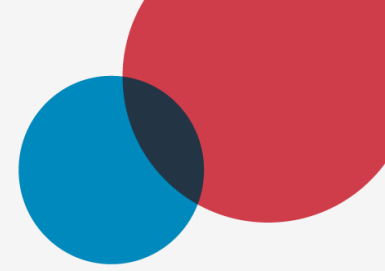
Direct Charge Method

- ✓ Associated enterprises are charged for specific services
- ✓ Services performed on the basis of payment are clearly identified
- ✓ Similar services may also be rendered to independent parties
- ✓ Difficult method to apply

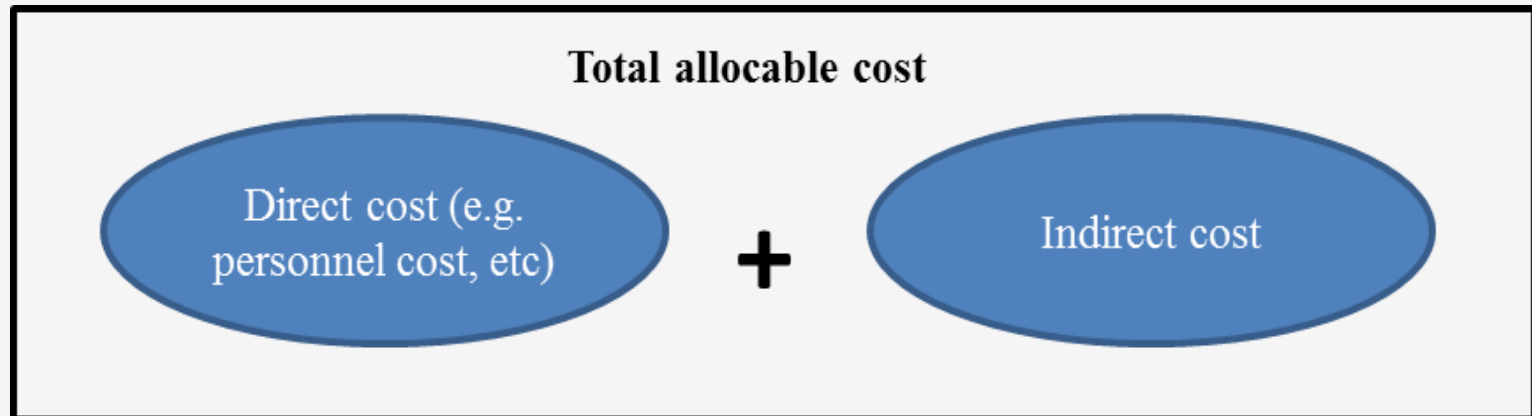
Indirect Charge Method (Cost Allocation and Apportionment)

- ✓ Charges are based on expected benefit
- ✓ Allocation is based on what comparable independent service providers would be prepared to accept
- ✓ Allocation based on turnover, staff employed, etc
- ✓ Method used more often

TOTAL COST BASE



- ❖ **Fully absorbed cost** comprise of all salaries (personnel directly and indirectly involved in provision of the services), direct costs and a share of common costs and overheads allocated to the functional departments, as illustrated in the following diagram:



TOTAL COST BASE

Flow-through Cost

- Where Service Provider arrange and pay for services acquired from 3rd parties on behalf of related parties (e.g. audit fees), it is possible to pass on cost to service recipients without mark-up

Non-allocable Cost

- Stewardship, duplicate services, providing incidental benefits or benefits by passive association
- Cost incurred for itself

Total Indirect Cost

- Overheads, depreciation, telecommunication, utilities
- Cost of internal facing depts

Total indirect cost allocated to each functional units based on head count

Total allocable cost by functional unit

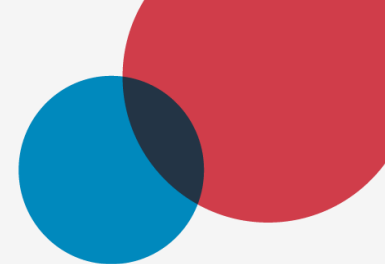
Direct Cost by Functional Unit
(e.g. manpower, materials consumed)



Indirect Cost by Functional Unit

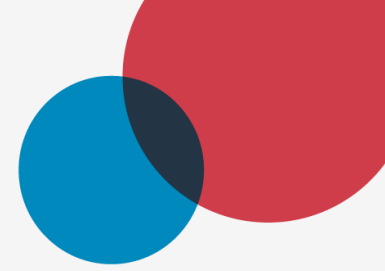
Apply Allocation Key

EXAMPLES OF ALLOCATION KEYS



Units / Divisions	Beneficiary	Allocation Key
Chairman's Office/ Board of Directors	Holding Co	Not applicable
Legal & Corporate Affairs	Holding Co and Subsidiary	Time spent
Internal Audit	Holding Co and Subsidiary	Time spent
Corporate Security	Holding Co and Subsidiary	Headcount
Functional Support Divisions		
Technical Services	Holding Co and Subsidiary	Headcount
Training	Holding Co and Subsidiary	Headcount
Group Treasury	Holding Co and Subsidiary	Value of funds managed
Group Account & Services	Holding Co and Subsidiary	No of transactions/turnover
Group Insurance	Holding Co and Subsidiary	Value of premium
Business Development	Holding Co and Subsidiary	Time spent
HR Administration	Holding Co and Subsidiary	Headcount
Corporate Information Technology	Holding Co and Subsidiary	Number of IT users

INTRA-GROUP SERVICES – ARM'S LENGTH CONSIDERATION



Should the intra-group service provider charge at COST or COST PLUS MARK-UP?

- ❖ Chapter VII of 2017 OECD TP Guidelines [Para 7.34 – 7.37] recognise that there may be some circumstances where no mark-up is required:
 - Group enterprise acts as an **agent or intermediary** e.g. where a company incurs rental expenses on behalf of group members => apply a mark-up only to the costs incurred by the company in performing the agency function
 - Where the **market price is not greater than the costs** e.g. where the service is not an ordinary or recurrent activity of the service provider but is offered incidentally as a convenience to the group
 - **Unreasonable administrative burden** in calculating the charges

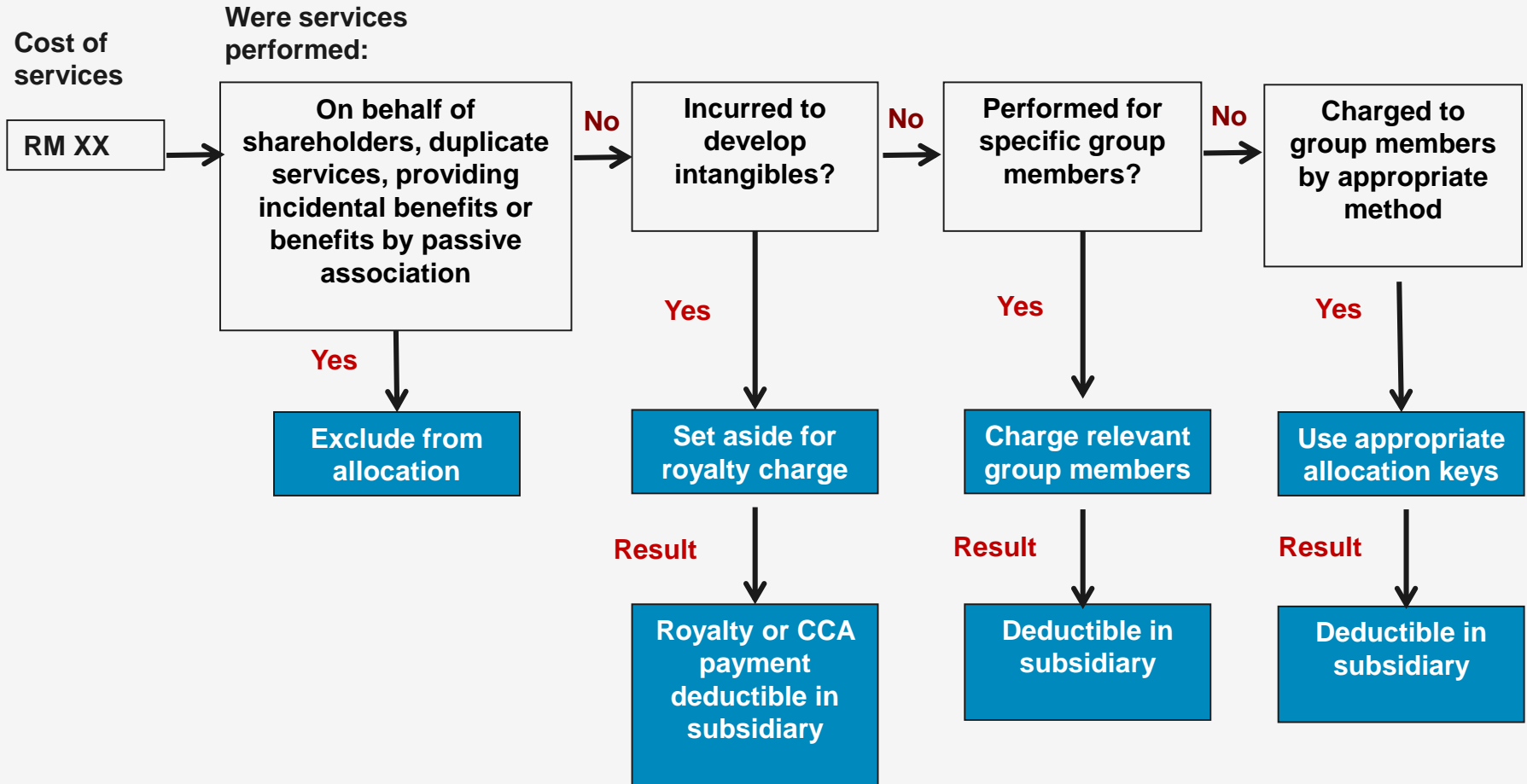
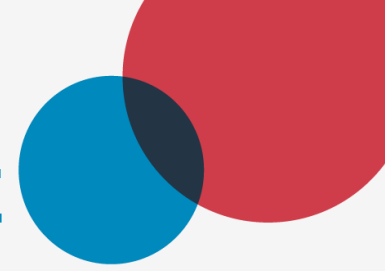
INTRA-GROUP SERVICES – ARM'S LENGTH CONSIDERATION



Should the intra-group service provider charge at COST or COST PLUS MARK-UP?

- ❖ A mark-up should be applied where the provision of the service is a **principal activity** of the service provider or where **direct charging** is possible as a basis from which to determine the arm's length price
- ❖ Different jurisdictions have different rules on whether intra-group services can be recovered at cost or at a cost plus a mark-up
- ❖ Safe harbours are provided in certain jurisdictions

INTRA-GROUP SERVICES – DECISION TREE



INTRA-GROUP SERVICES – PROVIDERS' PERSPECTIVE

Service Provider

- Transfer pricing documentation to document service provider's Functions, Assets and Risks undertaken to perform the services for its related companies
- Calculation of service provider's total cost base which is split into:
 - Identification of cost categories for inclusion
 - Allocation of cost to related companies
- Comparable study performed to ascertain the arm's length mark-up to be earned
- Differentiate services which recipients perform for themselves
- Maintain documentary evidence of services provided (e.g. emails, reports, memos, meeting minutes, etc.)

Robust TP documentation is critical

Determine what should be in the cost pool and allocation method

Is X% arm's length?

What is recipient already performing for itself? What is different with intra-group services provided?

How do you prove services have been rendered and benefited recipient?

INTRA-GROUP SERVICES – RECIPIENTS' PERSPECTIVE

Service Recipient

- Relies on service provider's transfer pricing documentation for intra-group services
- Ability to obtain total cost computation and allocation to satisfy local tax authority
- Whether a local comparable study is required
- Whether services are duplicative of functions which are already undertaken by recipient for itself
- Obtain documentary evidence of services provided (e.g. emails, reports, memos, meeting minutes, etc.) when requested by tax authority

Who is the tested party?

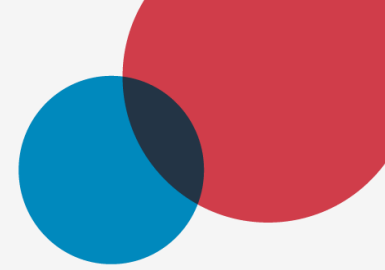
How to justify cost of services?

Are foreign comparables acceptable?

What is recipient already performing for itself? What is different with intra-group services provided?

How do you prove services have been rendered and that you benefited?

LOW VALUE ADDING INTRA-GROUP SERVICES



- ❖ **2017 OECD TP Guidelines [Para 7.43 – 7.65]** - Specific guidance has been given for specific management services, i.e. low value-adding intra group service (LVIGS)
- ❖ Therefore, a **new simplified approach** is introduced for LVIGS
- ❖ LVIGS are characterised as:

Services are Supportive in nature

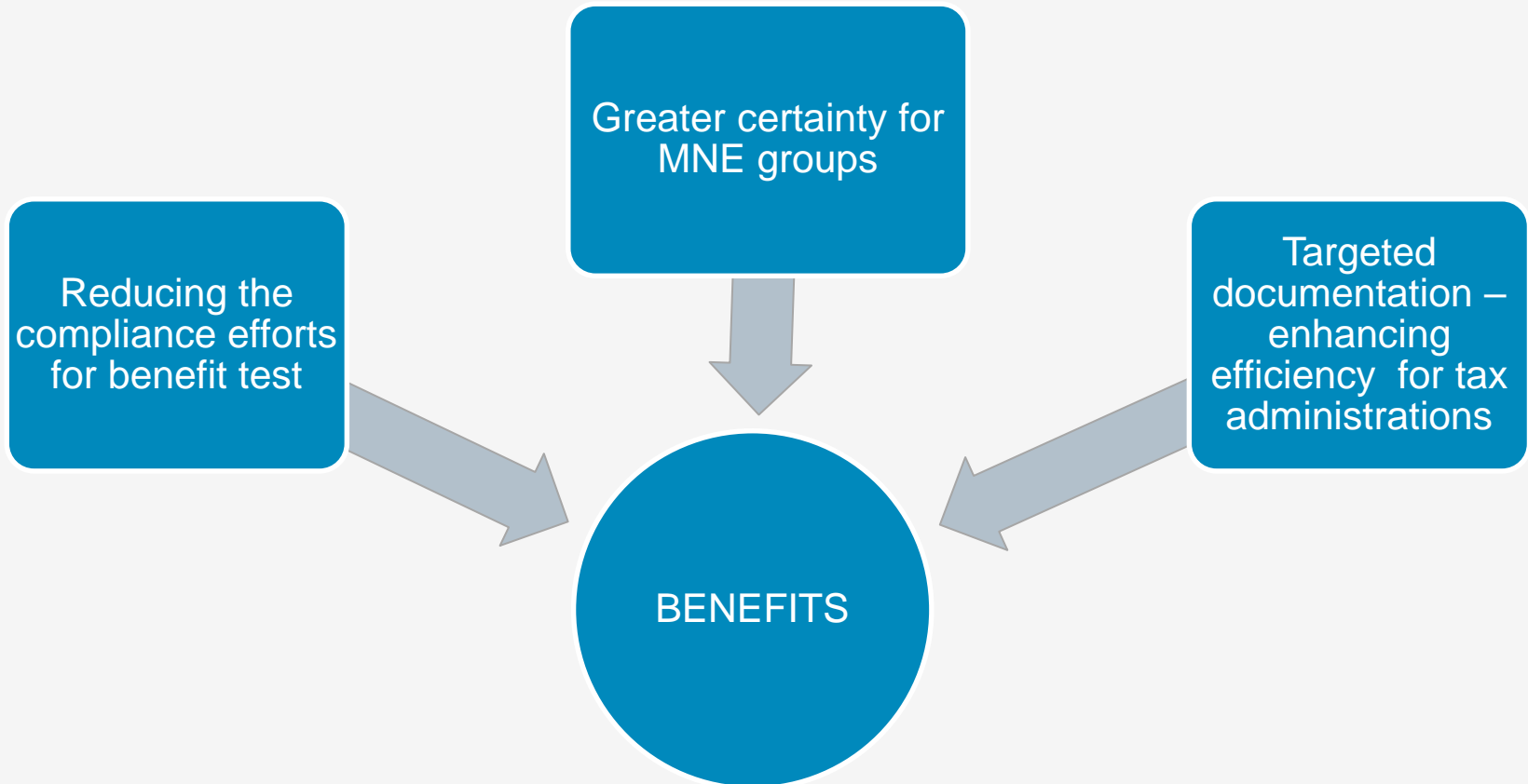
Services do not form part of core business of MNE group

Services do not lead to creation/usage of unique and valuable intangibles

Services do not lead to control or creation of significant risk

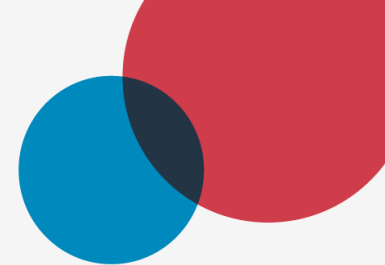
LOW VALUE ADDING INTRA-GROUP SERVICES

- ❖ New Simplified approach has various benefits for the taxpayers:



** Simplified approach is not applicable to LVIGS where internal comparables are available. Typically, such activities may tantamount to being the core part of business.

LOW VALUE ADDING INTRA-GROUP SERVICES



Inclusions/ Exclusions in LVIGS :

- ❖ Illustrative examples for **inclusion** and **exclusion** of services as LVIGS under SIMPLIFIED approach have been provided in Action Plan 10:

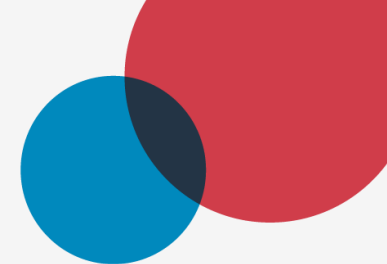


- ❖ Accounting and auditing
- ❖ Processing and management of account receivable/payable
- ❖ Human resource related activities
- ❖ Monitoring and compilation of data relating to health, safety, environment etc.
- ❖ Information technology related services
- ❖ Internal and external communication and public support
- ❖ Legal services / activities relating to tax obligations / general services of administrative or clerical nature



- ❖ Services relating to the core business of the Group
- ❖ R & D, manufacturing and production services
- ❖ Procurement related activities
- ❖ Sales, marketing and distribution activities
- ❖ Financial transactions
- ❖ Insurance and reinsurance
- ❖ Extraction, exploration or processing of natural resources
- ❖ Services of corporate senior management (Shareholder services)

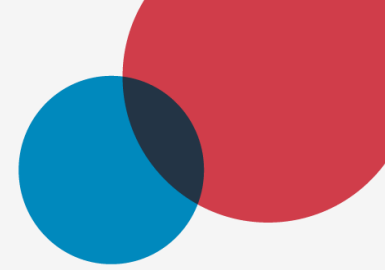
LOW VALUE ADDING INTRA-GROUP SERVICES



Conventional Intra group services vs LVIGS

Parameters	Conventional Intra Group Service	Contemporary LVIGS - Simplified Approach
Nature and Characterization of service	Administrative, technical, financial or commercial in nature, relate to management, coordination or control functions	Supportive in nature, part of non - core activity of MNE group, no use of unique intangibles, non assumption of significant risk
Benefit Test	Primary requirement for demonstrating the receipt of services	No specific need to prove benefit test and tax administrations are advised to refrain from challenging the same
Allocation	No clear methodology defined for pooling and cost and subsequent allocation	Process from identification of cost pool to charging of cost is explicitly stated
Documentation	No specific documentation requirement prescribed – separate benchmarking study required to be maintained.	Exhaustive list of documentation & reporting prescribed – No specific benchmarking study required.
Profit Mark-up	No explicit mark-up specified for such services	Safe harbour of 5 percent specified for LVIGS

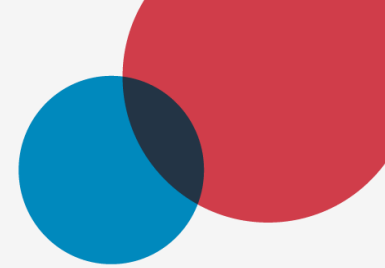
LOW VALUE ADDING INTRA-GROUP SERVICES



Determination of Cost pools and addition of mark-up

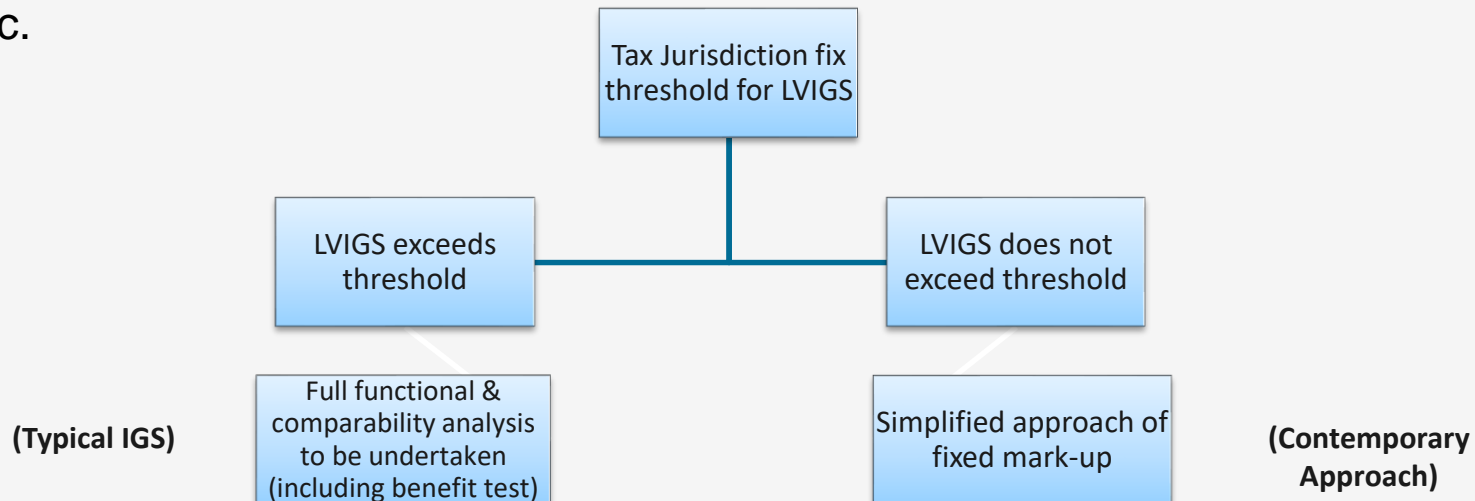
- ❖ BEPS Action Plan 10 has specifies following mechanism to identify cost pools for allocation of LVIGS:
 - ❖ Inclusive costs - All direct costs (eg. Payroll costs for HR services) and all indirect costs (eg. Rent of premises etc.)
 - ❖ Exclusive costs – Following costs should be excluded from cost pool:
 - Costs attributable to In-house activities benefitting service provider only
 - Shareholder activities related costs
 - Costs incurred on services performed solely for a particular group member
 - Pass through costs (in nature of reimbursements)
- ❖ Mark-up of 5 percent to be applied on all LVIGS (as against mark-up of 2% to 5% suggested in discussion draft)
- ❖ Key considerations for profit markup:
 - ❖ Similar mark-up to be applied to all LVIGS irrespective of service categories;
 - ❖ No mark-up to be applied on Pass-through costs

LOW VALUE ADDING INTRA-GROUP SERVICES

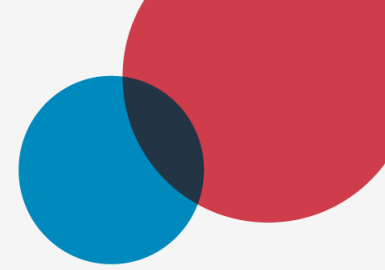


Determination of threshold for LVIGS

- ❖ BEPS Action Plan 10 does not provide for any specific threshold for application of LVIGS.
- ❖ It states that the tax jurisdiction in each country may determine a fixed threshold of LVIGS for application of simplified approach to a member of MNE group.
- ❖ Threshold may be determined based on fixed financial ratios, or group-wide ratio of management cost to turnover, costs, pre management charge profit, etc.



LOW VALUE ADDING INTRA-GROUP SERVICES



Documentation and reporting

- ❖ Description of category of service:
 - ❖ **Justification** for considering each category as LVIGS
 - ❖ **Rationale** for provision of services within the context of the business
 - ❖ Description of the **benefits** or expected benefits of each category of services
- ❖ Selection & Calculation of Allocation Keys:
 - ❖ Description of the selected allocation keys; reasons justifying that **allocation keys** produce outcomes reasonably reflecting benefits received
- ❖ **Written contracts** or agreements:
 - ❖ To maintain for the provision of services including nature, terms & conditions of services
- ❖ Cost Pools:
 - ❖ **Computation** of cost pool, confirmation of the **mark-up** applied and its calculation, and detailed list of all categories and amount of relevant costs.



Intangibles

INTRODUCTION

- ❖ Intangibles are increasingly being recognised as a valuable business asset
- ❖ Intangible property includes:
 - ❖ Patents, know-how, trade secret trademarks, trade names
 - ❖ Rights under contract or Government licences
 - ❖ Licenses, rights to use
 - ❖ Goodwill
- ❖ Increasing importance:
 - ❖ Shift towards business models with focus on ownership / location of intangibles and a core strategy for brand management
 - ❖ Outsourcing has released funds for value-adding activities such as research and development, brand development, core-marketing etc

INTRODUCTION

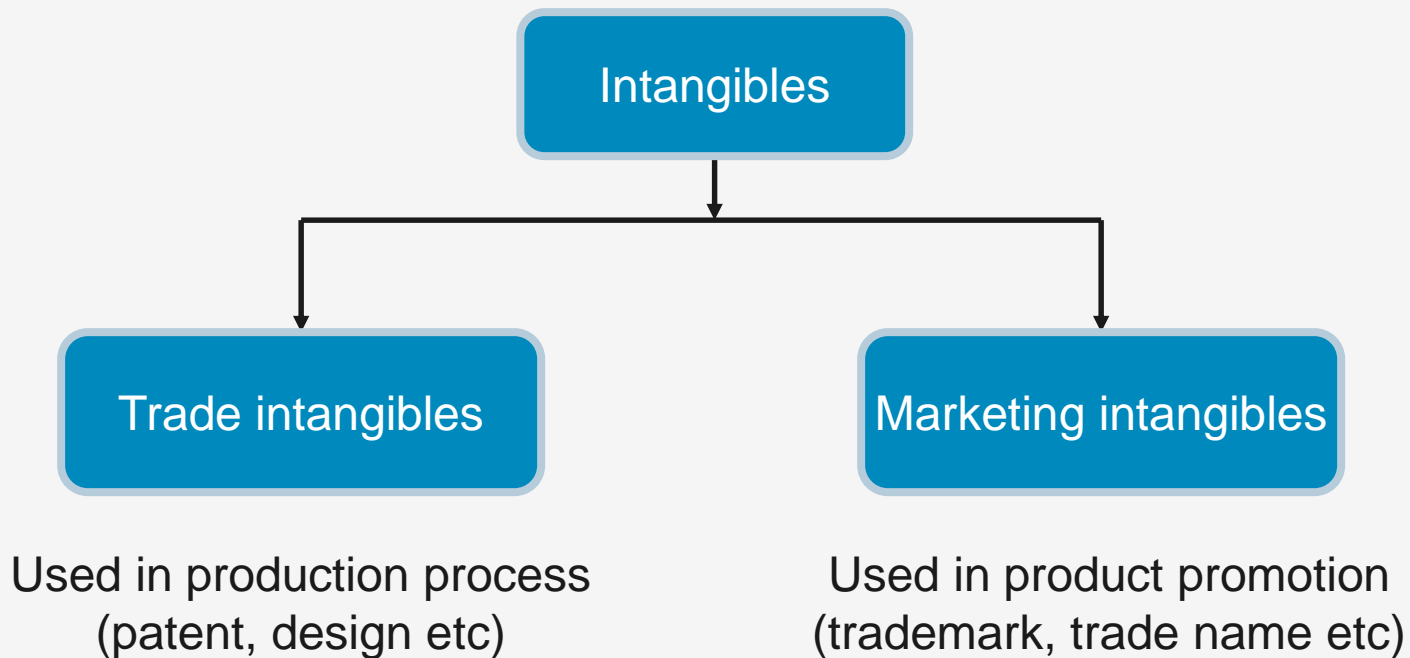
- ❖ BEPS Action Plan 8 has introduced New version of Chapter VI, building on September 2014 version
- ❖ Guidance on four aspects of intangibles:
 - ❖ Identifying intangibles for TP purposes
 - ❖ Identifying and characterising controlled transactions involving intangibles
 - ❖ Identifying types of transactions involving intangibles
 - ❖ Identifying arm's length conditions and pricing in cases involving intangibles

THE CONCEPT

- ❖ Defining features:
 - ❖ Unique to a company
 - ❖ Create entry barrier for competitors
 - ❖ Allow earning of super-normal profits
 - ❖ Originality
 - ❖ Exclusivity
- ❖ **Increased complexity in transfer pricing** due to:
 - ❖ Uniqueness
 - ❖ Lack of comparables
 - ❖ Intangibles are rarely licensed to third parties
 - ❖ Contribution from various Group member in DEMPE
 - ❖ Increased litigation on Marketing Intangibles issue (India specific)

TYPES OF INTANGIBLES

OECD distinguishes between “Trade Intangibles” and “Marketing Intangibles”



BENCHMARKING OF INTANGIBLES

- ❖ No exclusive method for valuation of intangibles
- ❖ Same five methods – CUP, RPM, CPM, TNMM and PSM to be applied to intangibles
- ❖ Comparability principles
 - ❖ Examine price from transferor and transferee's perspective
 - ❖ Price may not be based on the most productive use but the limited utility to transferee
 - ❖ All facts and circumstances to be considered

BENCHMARKING OF INTANGIBLES

- ❖ CUP is considered as the most appropriate method for benchmarking intangibles
 - ❖ Similar agreement by the Group for sharing of intangibles
 - ❖ Databases proving comparable third party agreements
- ❖ Other preferred methods of benchmarking
 - ❖ Profit Split method
 - ❖ Entity level TNMM where payment of royalty is also covered as an expenditure

WHO IS ENTITLED TO RETURN FROM INTANGIBLES (IMPORTANCE OF DEMPE)

- ❖ The entities within a multinational group which are entitled to share in returns derived by the group from exploiting intangibles are those entities making the following contributions:

Functions

- Entity(ies) controlling / performing development, enhancement, maintenance, protection and exploitation (DEMPE) functions in relation to the intangibles

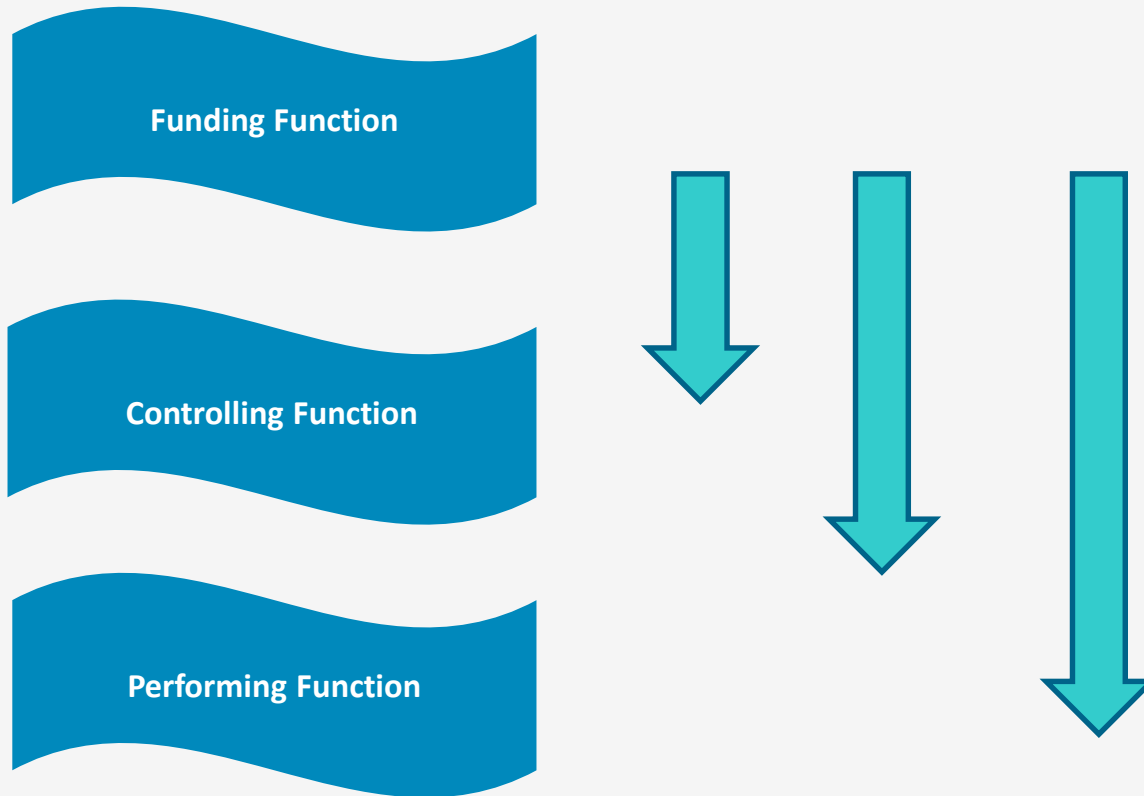
Risks

- Entity(ies) controlling risks and having the financial capacity to assume risks associated with the DEMPE of the intangibles

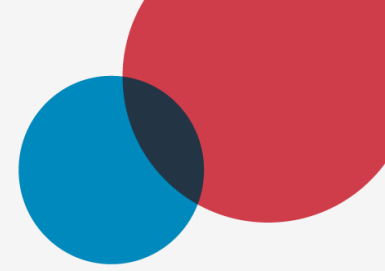
Assets

- Entity(ies) providing all assets, including funding necessary for DEMPE of intangibles

EXTENT OF INTANGIBLE RELATED RETURNS TO BE ATTRIBUTED



IDENTIFYING AND DEFINING IP



- ❖ The importance of intangibles for TP analysis may be different than for accounting purposes.
 - ❖ Costs associated with development and enhancement of intangibles are sometimes expensed and not reflected on balance sheet, creating problems of characterization of an item as an intangible.

Particulars	Schedule	Amount (Rs)
Income		
Sales and operating income	1	.....
Other income	2	.....
Total		.....
Expenditure		
Cost of goods sold	3	.....
Operating and other expenses	4	.....
Depreciation/Amortisation		.....
Interest		.....
Total		.....
Add/(Less): Exceptional items		.....
Profit/(Loss) before tax		.....
Less: Tax		.....
Profit/(Loss) after tax		.....



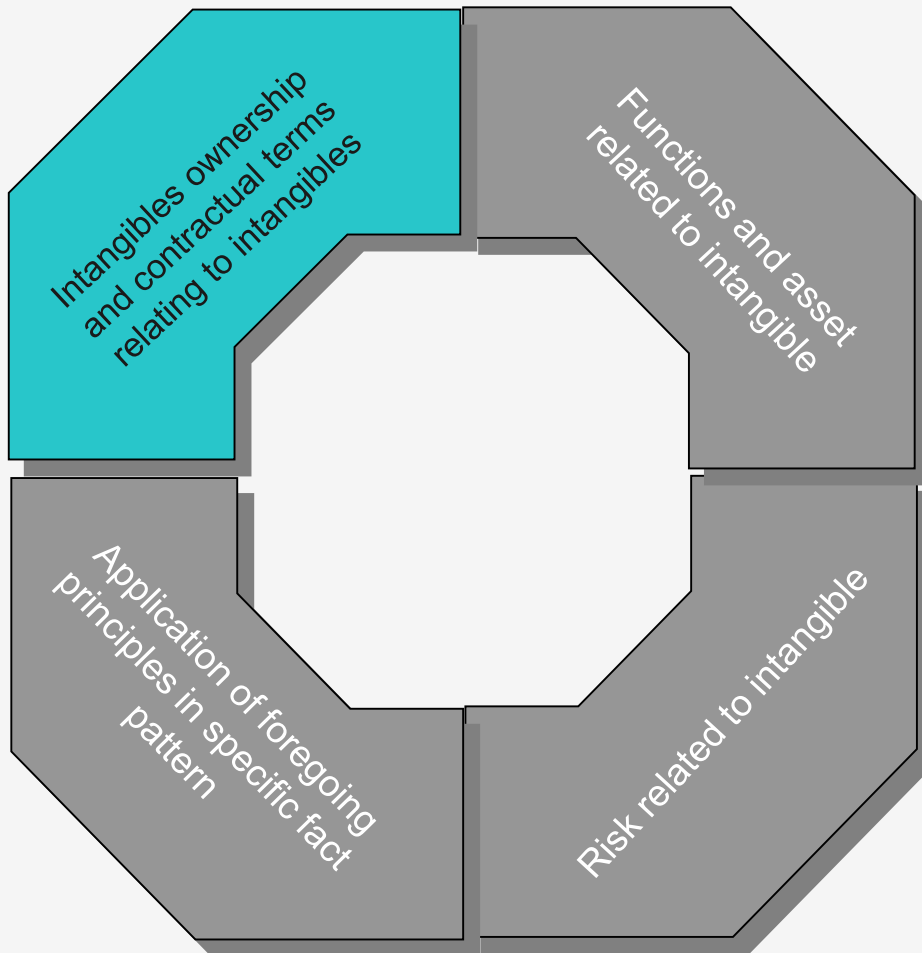
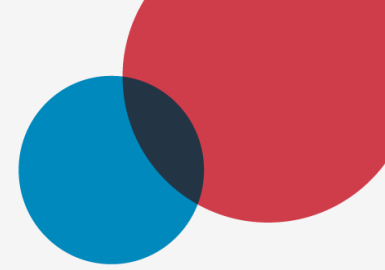
Particulars	₹	₹
Fixed Assets :		
Goodwill		xxx
Patents		xxx
Copy Rights		xxx
Trade Marks		xxx
Land & Buildings		xxx
Plant & Machinery		xxx
Furniture & Fittings		xxx
Current Assets :		
Stock	xxx	
Advance Payments	xxx	
Sundry Debtors	xxx	
Bills Receivable	xxx	
Cash at Bank	xxx	
Cash in Hand	xxx	xxx
Current Liabilities :		
Sundry Creditors	xxx	
Bills Payable	xxx	
Outstanding Expenses	xxx	
Income Received in Advance	xxx	xxx
Working Capital		
NET ASSETS EMPLOYED		—
Financed By :		
Long-terms Loans		xxx
Capital		xxx
<i>Add : Net Profit</i>		xxx

IDENTIFYING AND DEFINING IP



- ❖ Separate transferability is not a necessary condition for an item to be characterized as an intangible
- ❖ The identification of an intangible is separate from determining the price for use and transfer of the item
- ❖ All intangibles do not deserve a separate / additional compensation in all the circumstances, and not all intangibles give rise to premium returns
- ❖ An emphasis should be placed on whether and when an intangible exist, for example
- ❖ All research and development expenditure do not produce or enhance an intangible and all marketing activities does not result in the creation and enhancement of an intangible.
- ❖ A detailed functional analysis, including analysis of identified intangible in the MNE's global business should support the determination of arm's length conditions.

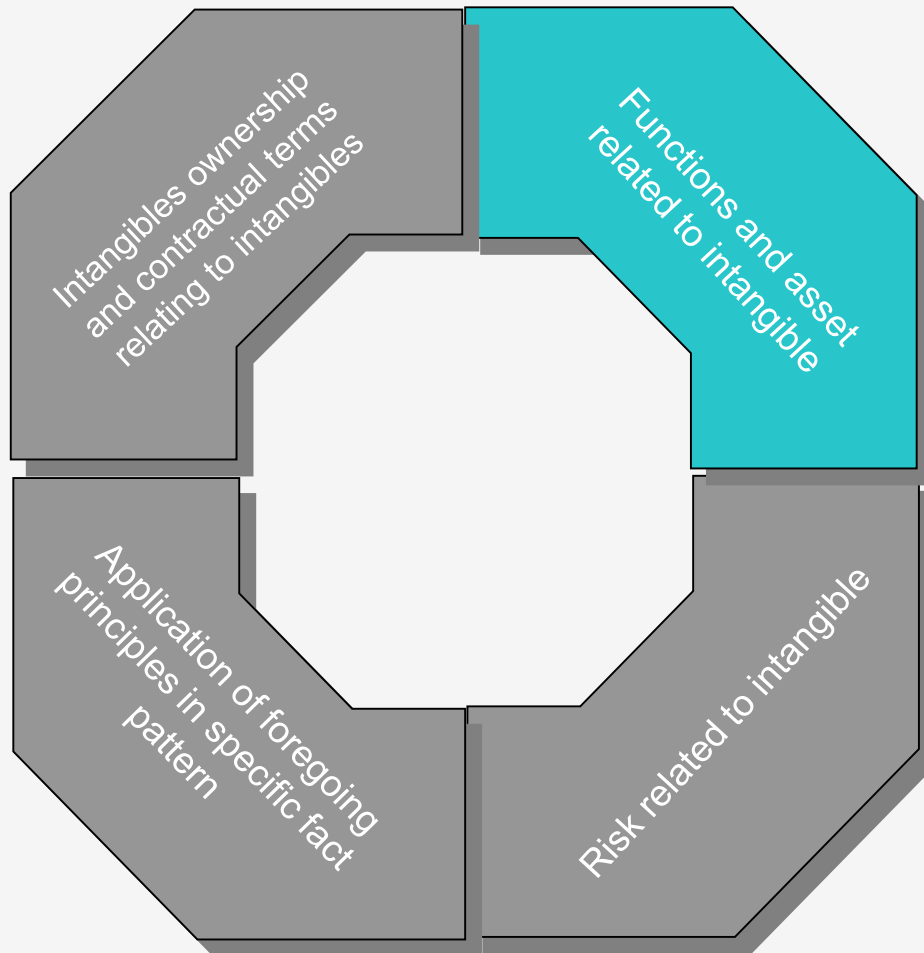
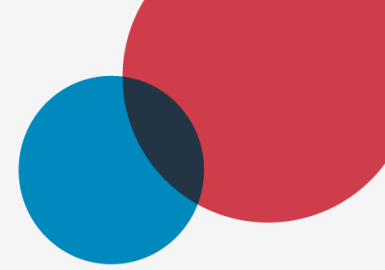
OWNERSHIP OF INTANGIBLES AND TRANSACTIONS INVOLVING DEMPE FUNCTIONS



Legal ownership and contractual relationships:

- ❖ Legal ownership of intangibles does not confer any right to retain returns derived by the MNE group from exploiting the intangible.
- ❖ Legal ownership and contractual relationships simply serve as reference points for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions.

OWNERSHIP OF INTANGIBLES AND TRANSACTIONS INVOLVING DEMPE FUNCTIONS



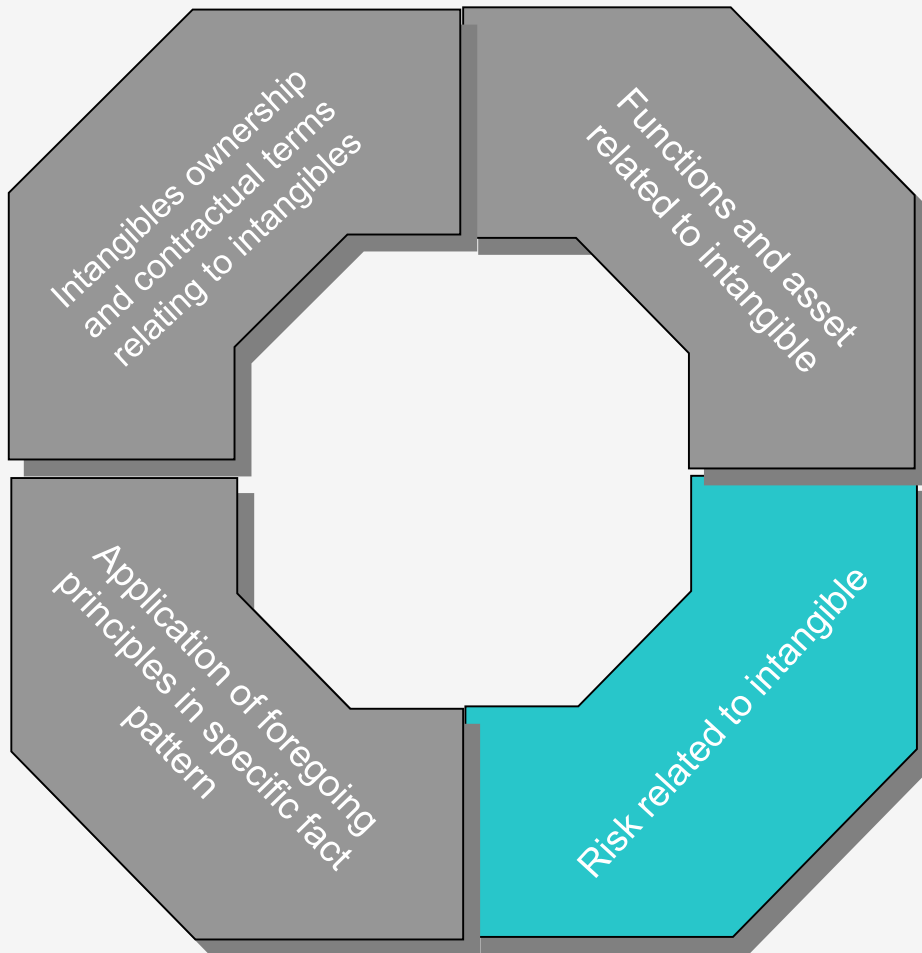
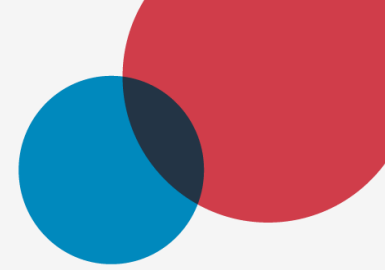
Performance and control of functions:

- ❖ In outsourcing transactions between independent enterprises, usually the entity performing functions on behalf of the legal owner of the intangible that relate to the DEMPE of intangible, operates under the control of such legal owner
- ❖ It may be necessary to utilise TP methods not directly based on comparables, including transactional PSM and ex ante valuation techniques, to appropriately reward the performance of those important functions.

Use of Assets

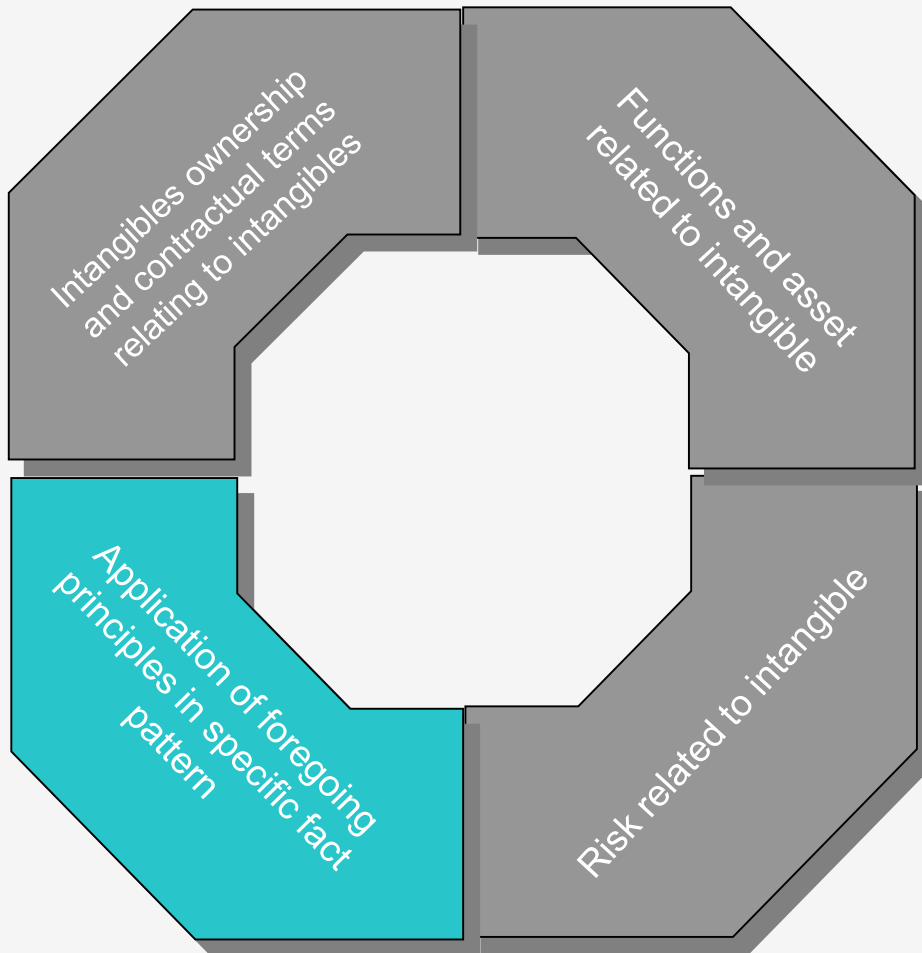
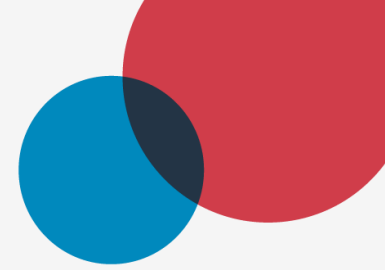
- ❖ Funding and risk-taking are integrally related in the sense that funding often coincides with the taking of certain risks

OWNERSHIP OF INTANGIBLES AND TRANSACTIONS INVOLVING DEMPE FUNCTIONS



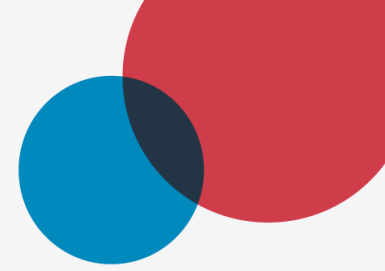
- ❖ Assumption of Risk:
 - ❖ Risks related to development of intangibles
 - ❖ Risk of product obsolescence
 - ❖ Infringement risk
 - ❖ Product liability
 - ❖ Exploitation risks
- ❖ Actual ex-post returns

OWNERSHIP OF INTANGIBLES AND TRANSACTIONS INVOLVING DEMPE FUNCTIONS



- ❖ Development and enhancement of marketing intangibles
- ❖ Research, development and process improvement arrangements
- ❖ Payments for use of the company name

VALUATION METHODS (ACTION PLAN 8)



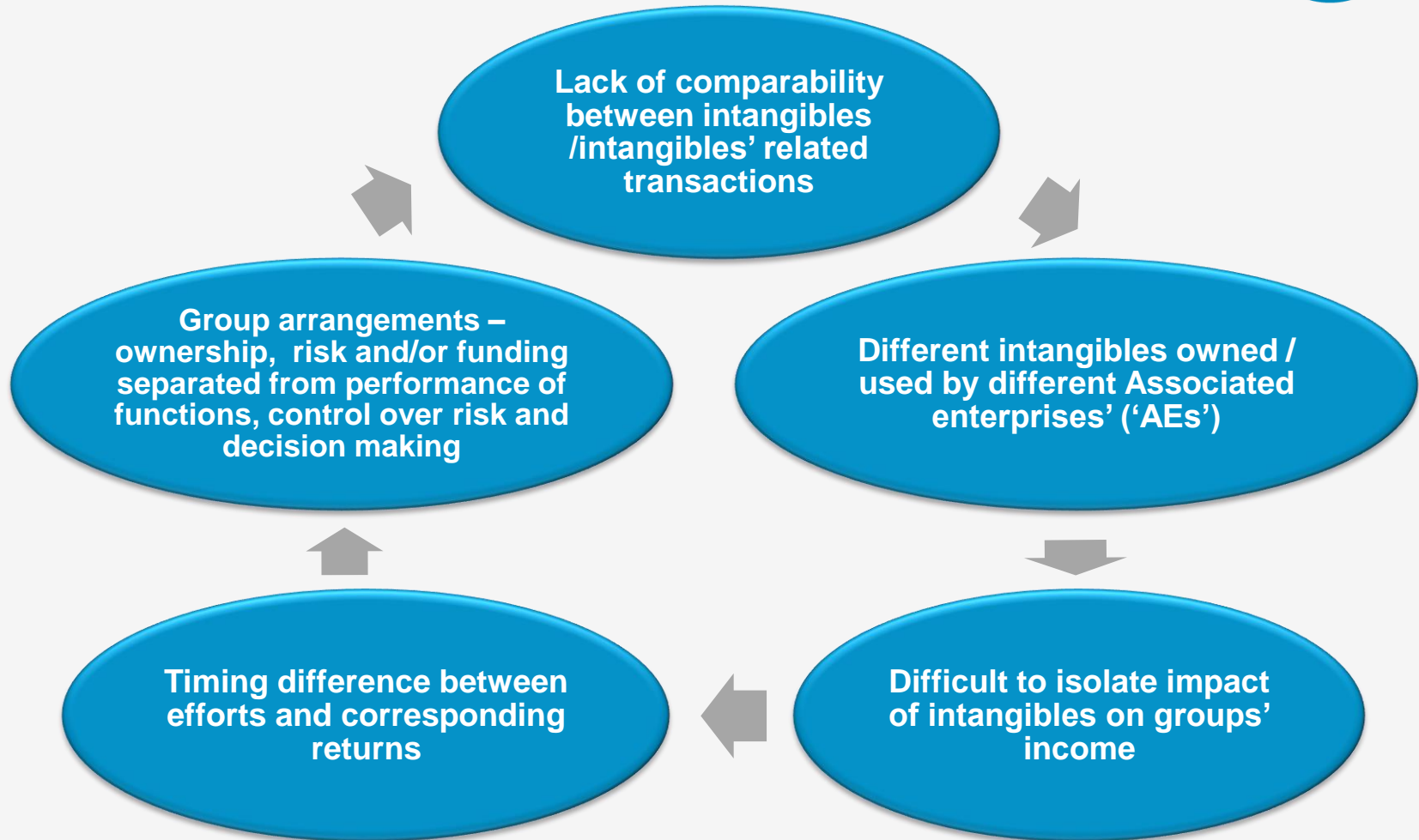
❖ Guidance on what to use:

- ❖ Consideration of options realistically available, looking from the point of view of both parties
- ❖ Methods most likely to prove useful are the CUP and the transactional profit split methods
- ❖ Valuation techniques may be used but with caution

❖ Guidance on what **not** to use:

- ❖ Methods based on cost of development are generally discouraged
- ❖ A rule of thumb cannot be used
- ❖ One-sided methods including the resale price method and TNMM are generally not reliable methods
- ❖ When using the CUP method, *“it should be recognised that the identification of comparables in many cases involving intangibles may be difficult or impossible”*

CHALLENGES FOR APPLICATION OF ARM'S LENGTH PRICE

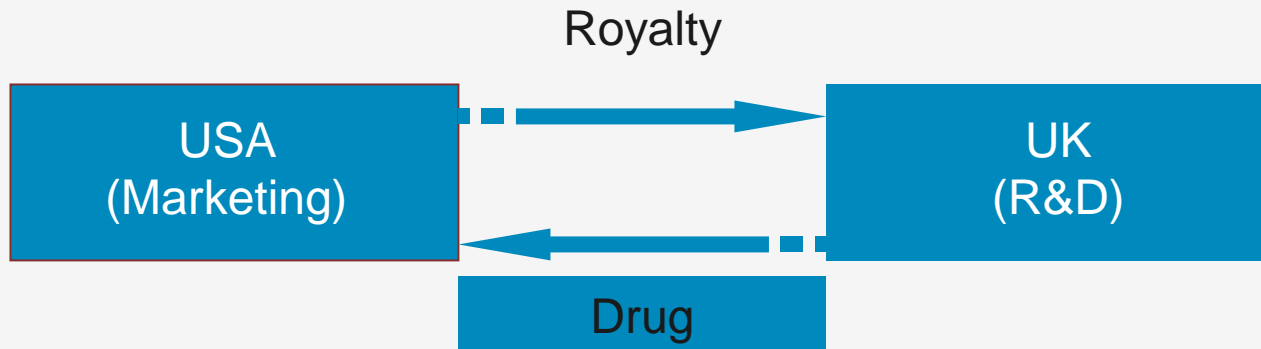


HARD-TO-VALUE INTANGIBLES

- ❖ Hard-to-value intangibles (HTVI) are defined as intangibles where:
 - ❖ No reliable comparables exist; and
 - ❖ At the time of the transactions, the projections of future cash flows or income expected to be derived or the assumptions are highly uncertain
- ❖ May exhibit one or more of the following:
 - ❖ Intangible is only partially developed at the time of transfer
 - ❖ Commercial exploitation is several years after the transaction
 - ❖ Intangible may not strictly be HTVI but is integral to HTVI development
 - ❖ Exploitation method is novel and projections highly uncertain
 - ❖ Intangible has been transferred for a lump-sum payment
 - ❖ Intangible has connection with cost sharing arrangements

“Address information asymmetry by reviewing ex-post results to evaluate reasonableness of ex-ante assumptions”

GSK SETTLEMENT



- ❖ GlaxoSmithKline (GSK) develops and sells a drug – ‘Zantac’
- ❖ UK – Research & Development
- ❖ US – Marketing
- ❖ Where does ‘Value’ lie?

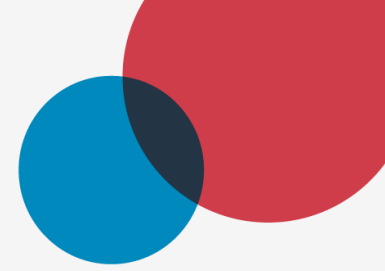
GSK SETTLEMENT



Revenue	Taxpayer
Value attributed to marketing efforts in US - drug is a marginal improvement over its predecessor	Value attributable to R&D undertaken in UK - pioneer drug with fewer side effects
Contractual terms guaranteed Glaxo UK a fixed rate of return	R&D by itself was a significant value add function
Increase in sales force	R&D requires relatively fewer specialists

Case settled for USD 3.4 billion

LATEST DEVELOPMENT



- ❖ Highlights of the new guidance on Intangibles (from BEPS Project) include:
 - ❖ Consensus was reached on treatment of corporate synergies, location savings, and definition of intangibles
 - ❖ Focused on ensuring that the profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation
 - ❖ Provides new approach to addressing transfers of HTVI



**Location
Savings**

LOCATION SAVINGS



- ❖ Concept
 - ❖ Cost savings realized by multinational company from relocation of processes to low cost jurisdiction
 - ❖ Savings relate to labour, rental, raw materials, property tax or training
- ❖ Computation of the amount of location savings is difficult
 - ❖ Adjustment for difference in labor productivity (keeping in view capital-labor ratio, skills etc)
 - ❖ Adjustment for difference in production volume (keeping in view workforce, availability of raw materials etc)

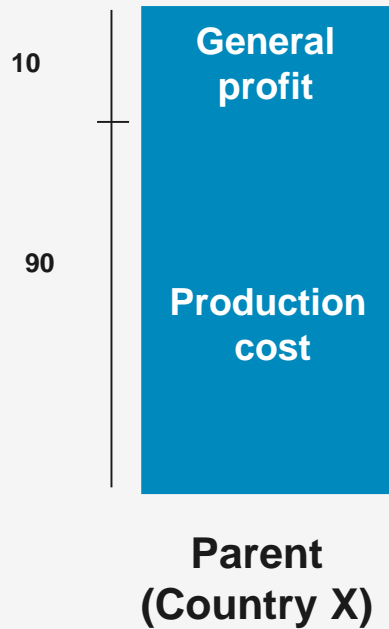
LOCATION SAVINGS

- ❖ Factors for determining how location savings are to be shared between associated enterprises:
 - ❖ whether location savings exist;
 - ❖ amount of any location savings;
 - ❖ extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and
 - ❖ where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

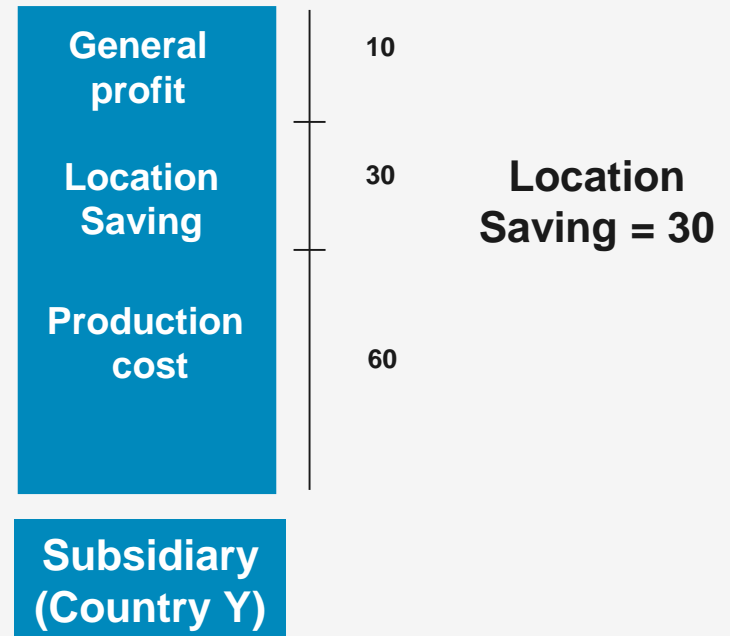
ATTRIBUTION OF LOCATION SAVINGS



Scenario I – Manufacturing in country X (by Parent)



Scenario II – Manufacturing in country Y (by subsidiary)



Who is entitled to Location Saving – Country X or Y?

ATTRIBUTION OF LOCATION SAVINGS

Arguments (Country X)

- ❖ Provision of know-how while setting up of plant in country Y
- ❖ Investment risk undertaken
- ❖ Provision of intangible assets

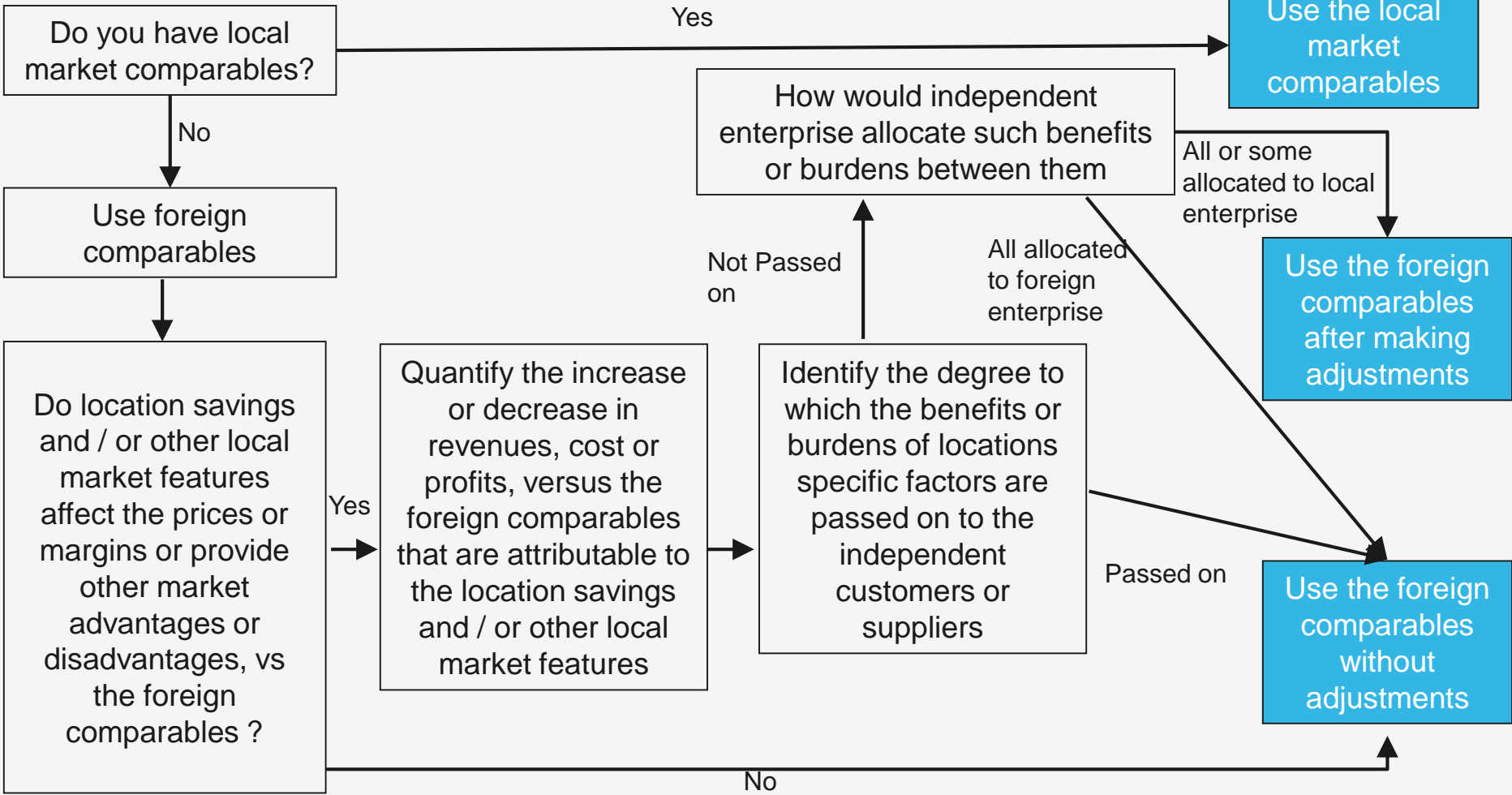
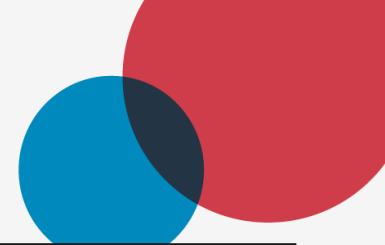
Counter - arguments (Country Y)

- ❖ Cost advantage – cheap labor and raw materials
- ❖ Infrastructure
- ❖ Knowledge of local operations

Some thoughts:

- ❖ Allocation of location savings is simple if CUP available
- ❖ Problem more complex in absence of CUP
- ❖ Allocation possible through arm's length analysis – return to be based on functions performed, assets employed and risks assumed by each entity

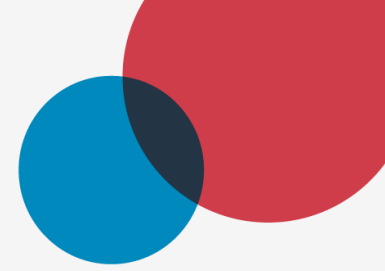
GUIDANCE ON LOCATION SAVINGS AS PER BEPS ACTION PLAN 8-10





Safe Harbour

OVERVIEW OF SAFE HARBOUR



- ❖ Safe Harbour Rules are the circumstances under which tax authorities automatically accept the transfer prices declared by the taxpayer;
- ❖ Provides certainty, compliance relief and administrative simplicity;
- ❖ Could be in the form margin threshold or exclusion of certain classes of transactions from TP regulations;
- ❖ Safe Harbour provisions are being practiced by several mature jurisdictions across the globe
 - ❖ in Australia and New Zealand, a 7.5 per cent markup on cost is generally accepted as an arm's length margin for the non-core services acquired
 - ❖ US has prescribed a Safe Harbour for low margin covered services. Here the services charged at cost (or markup up to 7 per cent) are considered to be at an arm's length
 - ❖ Brazil have introduced safe harbour provisions in respect of exports
 - ❖ Detailed safe harbour guidelines prescribed in India in 2013 for IT, ITES and other sectors with specified rates
 - ❖ The Singapore TP Guidelines provides for the application of a 5% cost mark-up for certain routine support services
- ❖ The OECD has issued a revised guidelines on Safe Harbour on May 16, 2013 which encourages the use of safe harbour on a bilateral basis



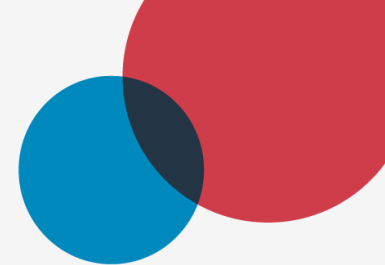
End of Day 1

TRANSFER PRICING (DAY 2)

PRESENTATION BY
ELVIANA RIYANTO/
SARAH CHEW

1 - 2 AUGUST 2019

Agenda



Today's agenda (Day 2)

- ❖ OECD Guidelines – Other Concepts (Cont'd)
 - Mutual Agreement Procedure
 - Advance Pricing Arrangements
- ❖ Country Presentation
- ❖ Latest Court Decisions on Transfer Pricing
- ❖ Case Study 3: Transfer Pricing Analysis
- ❖ Marketing Opportunities

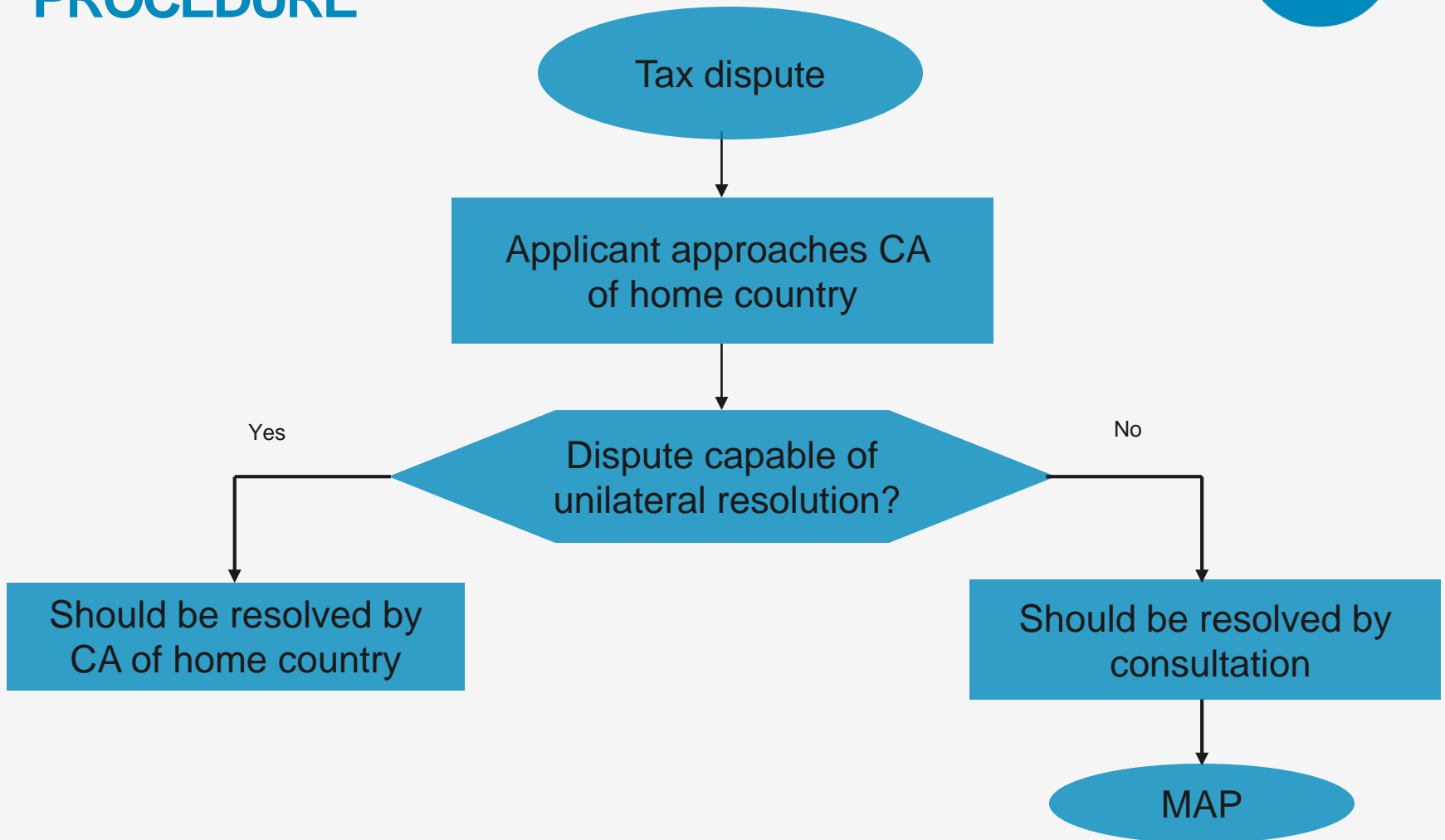


Mutual Agreement Procedure

INTRODUCTION

- ❖ Article 25 of the UN and OECD Model Tax Convention
- ❖ Alternative to administrative appeal process
- ❖ Dispute resolution through interaction between competent authorities
- ❖ Period of limitation – 3 years from first notification of action
- ❖ Applicable to cases where:
 - ❖ Taxation not in accordance with convention
 - ❖ Issues on interpretation or applicability of treaty
 - ❖ Consultation for elimination of double taxation

MECHANICS OF MUTUAL AGREEMENT PROCEDURE



MUTUAL AGREEMENT PROCEDURE



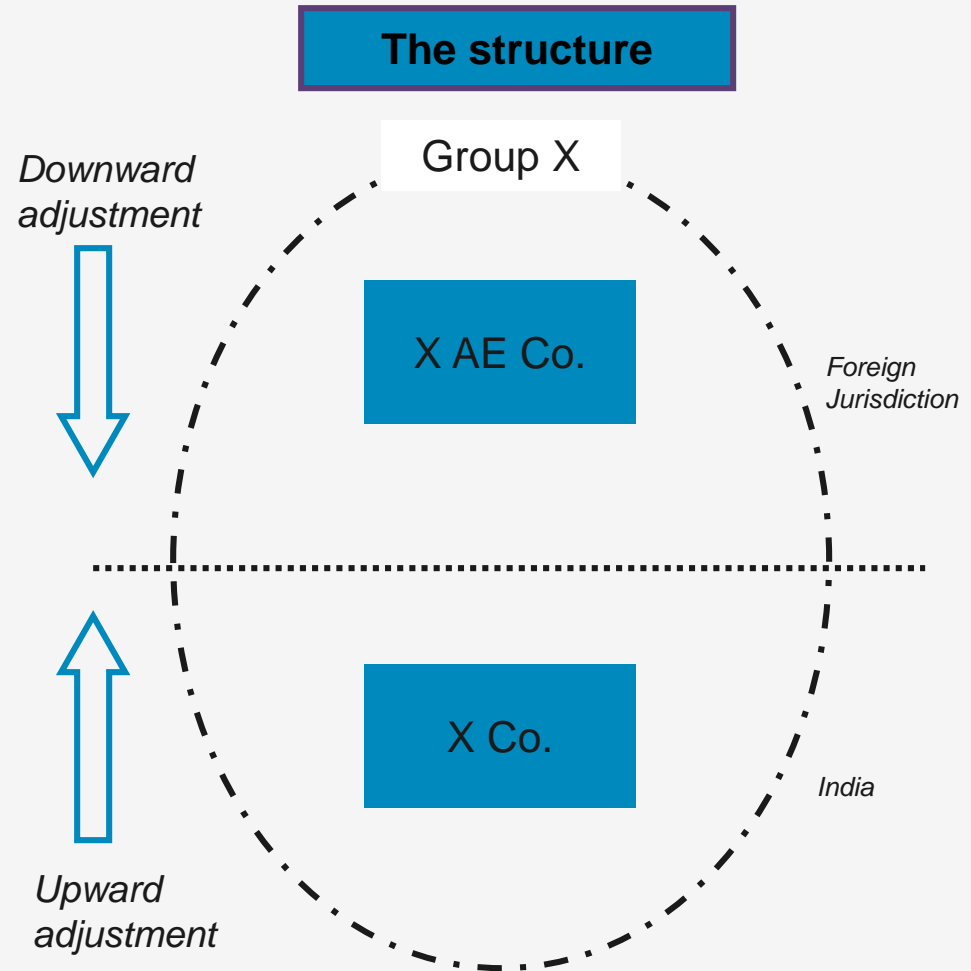
- ❖ Typical issues resolved under MAP
 - ❖ Determination of Permanent Establishment (PE) or residency
 - ❖ Attribution of income and administrative expenses of PE
 - ❖ Questions of interpretation or applicability of treaty provisions
 - ❖ Characterization of income
 - ❖ Applicability of thin capitalization rules
 - ❖ **Transfer Pricing situations (Article 9)**

RELEVANCE TO TRANSFER PRICING

- ❖ Avoidance of Economic Double Taxation
 - ❖ X Co. of Group X faces Transfer Pricing adjustment
 - ❖ X Co. pays tax on its adjusted income
 - ❖ X's AE Co. in foreign jurisdiction also pays tax on same income
 - ❖ Group X taxed twice on same income

Solution: downward adjustment in income of X AE Co. in foreign jurisdiction (Corresponding Adjustment) – enabled through MAP

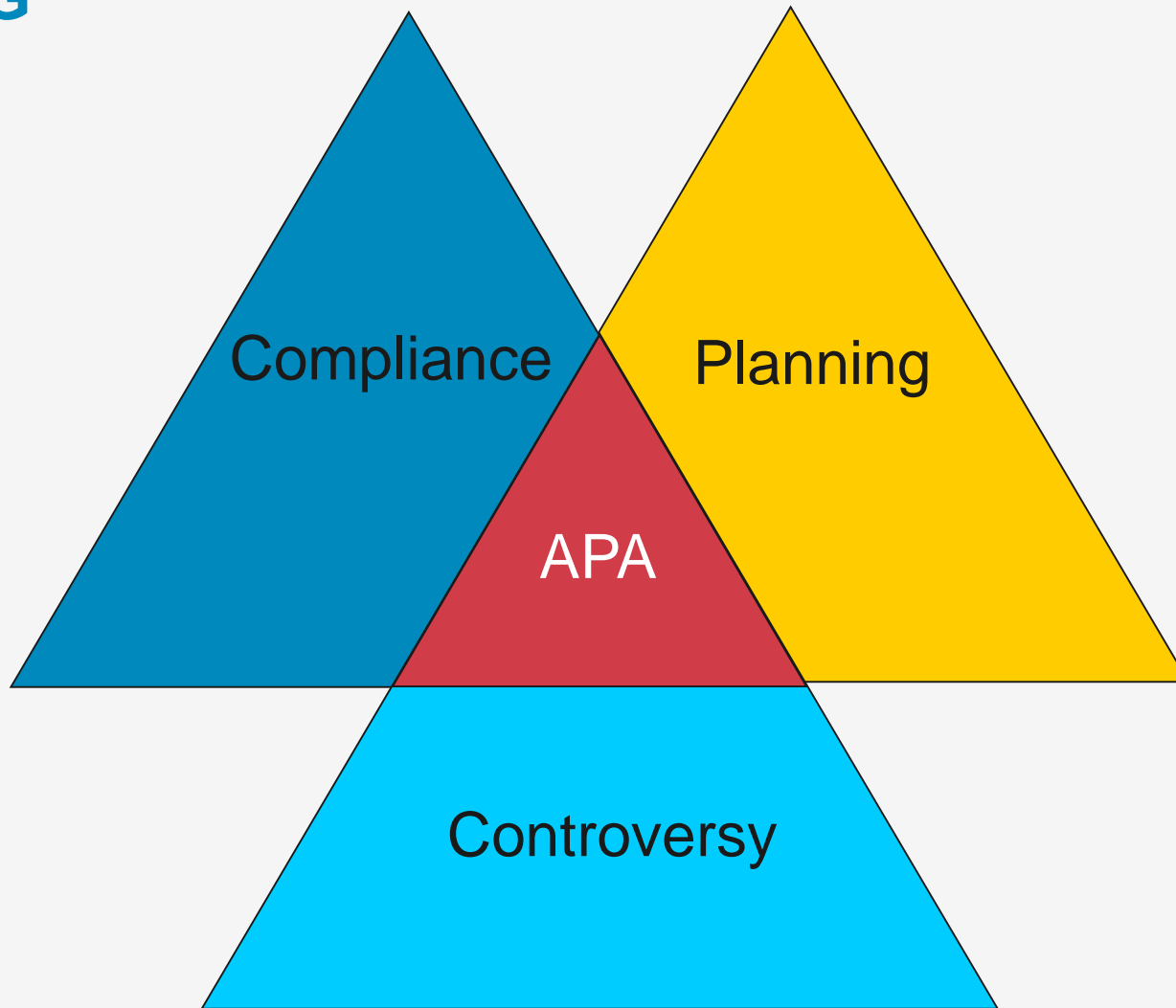
❖ TAXAND





Advance Pricing Arrangements

WORKING WITH THE REALITIES OF TRANSFER PRICING



THE CONCEPT

❖ OECD definition

“An advance pricing arrangement (“APA”) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.”

- ❖ Binding agreement between taxpayer and tax authority/(ies)
- ❖ Based on negotiation and requires consent of signing parties
- ❖ Based on a set of assumptions
 - ❖ Require verification before application
 - ❖ Continual monitoring to ensure validity
- ❖ Valid for a fixed term (3 to 5 years)
- ❖ May apply retroactively (rollback)

KINDS OF APAS

❖ Unilateral

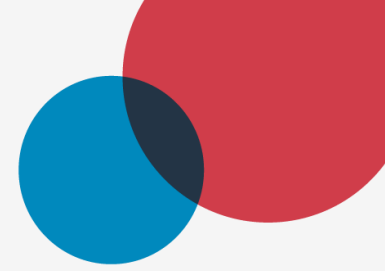
- ❖ Taxpayer and tax authority of a country are involved

❖ Bilateral

- ❖ Taxpayer and tax authorities of two countries are involved
- ❖ Under MAP article in relevant tax treaty

❖ Multilateral

- ❖ Taxpayer and tax authorities of multiple countries are involved
- ❖ Separate agreements between
 - Taxpayer and each tax authority
 - *Tax authority of country of residence and each other tax authority*



PROCEDURES FOR OBTAINING AN APA

- ❖ Prefiling meetings
- ❖ Formal acceptance letter and user charges
- ❖ APA submission
- ❖ Review and evaluation phase
- ❖ Finalization phase, including negotiations
- ❖ Compliance phase
- ❖ APA renewal



CRITICAL ASSUMPTIONS



- ❖ Refers to any assumed objective criterion that would significantly affect the terms of an APA if the underlying conditions are changed
- ❖ Tailored to taxpayer facts and circumstances
- ❖ Should be broad
- ❖ Typically covers the following:
 - ❖ Functions, assets and risks
 - ❖ Domestic law and treaty provisions
 - ❖ Exchange rates, interest rates, capital structure and credit rating
 - ❖ Tariffs, duties, import restrictions and government regulations
 - ❖ Economic conditions (market share, end – selling price etc)
 - ❖ Jurisdiction and form of enterprise
- ❖ Fundamental change in assumptions may lead to:
 - ❖ Revision
 - ❖ Cancellation

REALITIES OF AN APA

- ❖ Presentation of facts is as important as facts themselves – tax authority may not be familiar with business models
- ❖ All important information must be provided at the time of filing a submission (E.g. detailed TP Documentation, Group organisational and shareholding structure, etc)
- ❖ Be prepared to share additional supporting documents (E.g. Contracts, documentary evidence of specific transactions, etc)
- ❖ Tax authority may apply own principles/interpretations
- ❖ Preference for tax authority to agree on a point
- ❖ Demanding in terms of time and resources for tax administration and taxpayer (1 - 2 years for a unilateral APA)
- ❖ Requires flexibility and willingness to reach an outcome from taxpayer and tax authority
- ❖ If negotiations fail, may lead to an audit
- ❖ Unilateral APA poses risk of double taxation
- ❖ Risk of secondary adjustments (India specific)



BENEFITS OF AN APA

- ❖ Greater tax certainty
- ❖ Eliminates risk of audit of related party transactions over APA term
- ❖ Efficient resolution of recurring complex transfer pricing issues (less time and audit resources)
- ❖ Reduces compliance burden
- ❖ Mitigates exposure to penalty
- ❖ Prospective avoidance of double taxation (only bilateral or multilateral APAs)
- ❖ Potential application of findings to past years (rollback)
- ❖ Certainty in tax collections
- ❖ Long-term savings: renewals are usually less time consuming
- ❖ Alternative dispute resolution mechanism leading to reduced litigation

CAUTION POINTS

- ❖ Expensive for small tax payers
- ❖ Sensitive information may be potentially compromised
- ❖ May lead to audit of non-transfer pricing matters
- ❖ Demanding in terms of resources for tax administration
- ❖ Requires continuity of personnel
- ❖ Requires flexibility and willingness to reach an outcome from taxpayer and Revenue
- ❖ Unilateral APA poses risk of double taxation

INTERNATIONAL EXPERIENCE



- ❖ First APA signed between USA and Australia (1991)
- ❖ Overall results of cost benefit analysis have been positive
- ❖ Increasing documentation requirements coupled with draconian penalties resulting in more APAs
- ❖ US, UK, Canada, Australia and Mexico have continuously updated APA programs
 - ❖ US: 98 APA applications filed in 2016
 - ❖ US: 86 APAs executed in 2016 (21 unilateral; 65 bilateral)
 - ❖ At end of 2016 – 398 APA requests pending
- ❖ Asian countries active on APAs
 - ❖ Singapore concluded more than 70 APAs in 2017
 - ❖ Thailand concluded a number of APAs
 - ❖ Malaysia concluded several APAs to-date
 - ❖ India introduced APA mechanism in 2012 and has concluded 152 APAs as on March 31, 2017
 - ❖ Indonesia concluded more than 20 APAs from 2016 to 2018

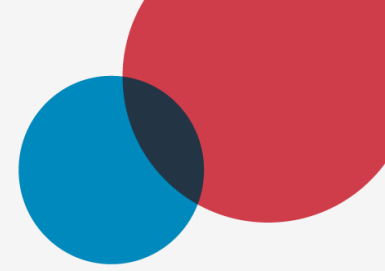


Country Presentation



Latest Court Decisions on Transfer Pricing

INSTRUMENTARIUM CORPORATION LIMITED (SPECIAL BENCH – KOLKATA) Recent Jurisprudence



FACTS

- ❖ Indian AE of Instrumentarium Finland suffered losses in relevant Assessment years.
- ❖ Tax officer issued notices for income escapement to Taxpayer – which were not complied.
- ❖ Tax officer alleged that non-resident appellant should have charged an arm's length interest from its Indian AE - made adjustment
- ❖ Taxpayer pleaded base erosion – i.e. overall tax reduction in India. Since resident AE of taxpayer was chargeable to tax at 36.75%, while taxpayer was taxed at treaty rate of 10% - therefore base erosion
- ❖ First level appellate authority (Commissioner Appeals) upheld tax officer's order

ISSUE

- ❖ Whether a non-resident has to comply with the Indian TP provisions (wherever income is taxable in India)?
- ❖ Whether the international transactions will be required to be justified at arm's length even in the case that it will lead to payment outflow from Indian AE?
- ❖ Whether the answer to questions above would depend upon the income/loss situation of resident AE?

INSTRUMENTARIUM CORPORATION LIMITED (SPECIAL BENCH – KOLKATA) Recent Jurisprudence



DECISION

- ❖ Section 92(3) of the Act Provides determining impact on profit/ loss only for the year under consideration, & not for considering the impact on subsequent years
- ❖ Also, Section 92(3) is applicable on the taxpayer & not the AEs
- ❖ There is no provision under Indian TP regulations to provide corresponding deduction/ adjustment
- ❖ Proviso to Section 92C(4) provides a bar against lowering income of the non-resident AE, as a result of lowering of deduction in hands of the Indian AE - & not vice-versa
- ❖ There is no need to go into the intent if literal interpretation is unambiguous
- ❖ No point of base erosion arises as Indian AE was incurring losses – *Obiter Dicta*
- ❖ Held against the Appellant – though the quantum of adjustment not deliberated by the Tribunal, while rejecting the contentions of the taxpayer

SHELL GLOBAL SOLUTIONS INTERNATIONAL B.V. – AHMEDABAD ITAT Recent Jurisprudence



FACTS

- ❖ Article 9(1) of the India-Netherlands tax treaty ('Treaty') authorizes re-computation of the taxable profits of a taxpayer in the source jurisdiction & Article 9(2) relieves the economic double taxation caused by adjustments – by providing corresponding adjustment .
- ❖ Taxpayer contended that where corresponding adjustment cannot be made under the Treaty – arm's length price adjustments cannot be made as India-Netherlands treaty does not provide relief from juridical double taxation
- ❖ Taxpayer also argued on the provision of Indian Income Tax Act wherein it is mentioned that Treaty overrides the Act, except when the provisions in Act are more beneficial to the taxpayer

ISSUE

- ❖ Whether absence of Article 9(1) restrict application of Article 9(2)?
- ❖ Whether arm's length adjustment can be made basis article 9(1)?

SHELL GLOBAL SOLUTIONS INTERNATIONAL B.V. – AHMEDABAD ITAT Recent Jurisprudence



DECISION

- ❖ Tribunal held against the taxpayer and upheld the TP adjustment made by tax officer by holding that:
 - ❖ **Article 9(1) permits ALP adjustment in all situations:** adjustments in cases wherein ALP require higher profits in hands of any one of the enterprises which have not so accrued to be included in the profits of that enterprise and taxed accordingly
 - ❖ **Article 9(2) does not restrict application of Article 9(1):** There is no reason to believe Article 9 is confined to enabling ALP adjustment in respect of only domestic entities – Further, Article 9(2) which provides relief in cases of economic double taxation - nowhere restricts the application of Article 9(1)
 - ❖ Article 9(1) is an enabling provision and the TP mechanism under the domestic law is machinery provision - rejected argument of appellant & upheld order of lower authorities

CHRYSCAPITAL INVESTMENT ADVISORS (INDIA) PRIVATE LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



FACTS

- ❖ Taxpayer was a private limited company, engaged in providing investment advisory services on a cost-plus mark-up basis to its associated enterprise.
- ❖ It used Transactional Net Margin Method (TNMM) as the most appropriate method for determining the ALP of the said international transaction.
- ❖ Taxpayer selected four companies as comparables and computed the operating margin of these comparables using multiple year data.
- ❖ During assessment proceedings, Tax officer made adjustment to taxpayer's income by adding two new companies with abnormal profits to comparable set and re-computing arm's length margin by using single year data for all companies.
- ❖ Dispute resolution panel & Appellate Tribunal both confirmed approach of Tax officer.

ISSUE

- ❖ Whether factors like differential functional and risk profile coupled with high degree of volatility in operating profit margins was sufficient ground to reject the comparables for TP analysis?
- ❖ Whether multiple year data could be used by the taxpayers to compute ALP of the transaction?

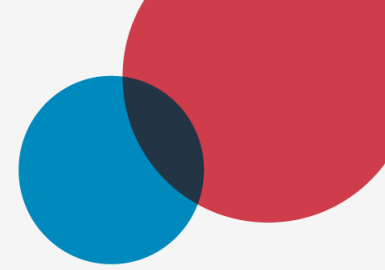
CHRYSCAPITAL INVESTMENT ADVISORS (INDIA) PRIVATE LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



DECISION

- ❖ High Court emphasized functional analysis as the key comparability criterion, and inter alia held that:
 - ❖ mere earning of high profits/ losses could not be a reason to exclude a company as a comparable; and
 - ❖ for the purpose of comparability analysis, data of multiple years could be used only when such data had an influence on the transfer price of the transaction under consideration.

SONY ERICSSON MOBILE COMMUNICATIONS INDIA PRIVATE LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



FACTS

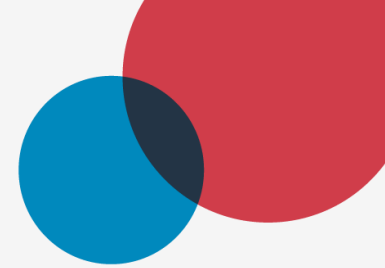
- ❖ Indian subsidiaries of foreign associated enterprises (AEs) engaged in distribution, selling and marketing of imported, branded products of AEs
- ❖ Intangible rights in the brand-name/ trademark/ trade-name – owned by foreign AE
- ❖ Taxpayers benchmarked their primary international transactions of import of goods for resale using TNMM or RPM
- ❖ Transfer Pricing Officer made additions on account of abnormal Advertisement, Marketing and Promotion ('AMP') expenditure – using 'Bright Line Test'

ISSUE

- ❖ AMP not an international transaction – Expenditure incurred in India towards independent third parties
- ❖ Bright line test is not a method recognized in the Indian Transfer Pricing provisions
- ❖ AMP expenditure incurred by Taxpayers to enhance its own sales and the Taxpayers are not in the business of providing brand building services to AEs

❖ TAXAND

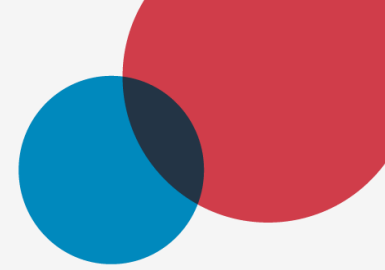
SONY ERICSSON MOBILE COMMUNICATIONS INDIA PRIVATE LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



DECISION

- ❖ AMP is an international transaction under section 92B of the Act
- ❖ Rejected Revenue's contention with regard to bright line approach to determine the quantum of non-routine AMP spend
- ❖ Universal application of bright line test to segregate AMP into routine and non-routine AMP is unwarranted
- ❖ 'Bright Line Test' not mandated under the Act
 - Using it would be adding and writing words in the statute and the Rules;
 - No provision under the Act or Rules to hold that it is obligatory that AMP expenses must be subjected to 'bright line test'
- ❖ Possible to build a brand name without incurring substantial AMP expenses
 - There may be extensive and large scale advertisements but brand values had not been created
 - Erroneous and fallacious to treat brand building as counterpart or to commensurate brand with advertisement expenses
 - 'Routine or day-to-day marketing or sale promotion expenses' even when excessive would not amount to brand-building expenses
 - High Court appreciated that reputed brands incur AMP expenses to increase sale of products, and not necessarily to increase the brand value

SONY ERICSSON MOBILE COMMUNICATIONS INDIA PRIVATE LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



DECISION

- ❖ Marketing and distribution function can be bundled as one transaction for the purpose of benchmarking
- ❖ Price of international transaction declared in the Form 3CEB includes an element of AMP expenses – adjudged to be duly compensated based on the margins of the Indian affiliate
- ❖ Specific purchase price adjustment / set off required if AMP expenses are segregated and considered as an independent international transaction
 - Reliance placed on UN TP manual for developing countries (India chapter) – taxpayer should be adequately compensated for the functions performed by it including AMP expenses
 - Such compensation may be in any of the forms: lower purchase price; non or reduced payment of royalty; or by way of direct payment to ensure adequate profits
- ❖ Once TPO accepts and adopts TNMM, no requirement to treat AMP expenditure as a separate international transaction
- ❖ Once suitable adjustments have been made, all line item expenses (including AMP expenses) are taken into account
- ❖ RPM: External comparables – not being the legal owner of the brand name, trade mark etc. but performing similar functions including AMP

MARUTI SUZUKI INDIA LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



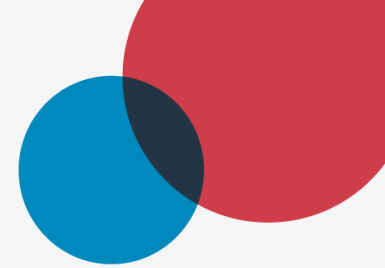
FACTS

- ❖ Taxpayer was a manufacturer of passenger cars in India, and operated as a subsidiary of a Japanese corporation which owns majority stake of Taxpayer and also owns the brand 'Suzuki'.
- ❖ Taxpayer entered into license agreement with the holding company for use of co-branded trademark 'Maruti-Suzuki' on its products.
- ❖ In the relevant year, it incurred AMP expenses of 1.87% on sales as against 0.620% incurred by the comparable companies.
- ❖ Thus, the Tax Officer concluded that the excess AMP expenses must be regarded as having been incurred for promotion of brand 'Suzuki'.
- ❖ Consequently, TP adjustment was made in relation to excess AMP expenses, along with mark-up.
- ❖ Appellate Tribunal following ruling in Sony's case – partially sustained adjustment.

ISSUE

- ❖ Whether the transaction of AMP spends constituted an international transaction
- ❖ Was the Revenue's application of Bright Line Test ('BLT') after being rejected in Sony Ericsson case valid?

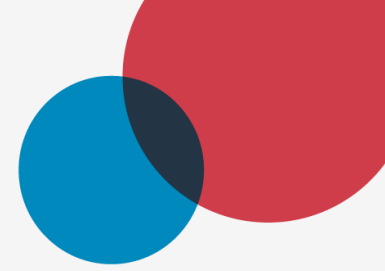
MARUTI SUZUKI INDIA LIMITED (HIGH COURT of DELHI) Recent Jurisprudence



DECISION

- ❖ Explaining the scope of international transaction, the HC noted that incurring AMP expenditure does not qualify as “deemed international transaction” under the provisions of section 92B(1) read with section 92(1) of the Act
- ❖ The burden to show existence of an 'understanding' or an 'arrangement' or 'action in concert' regarding AMP spend for brand promotion is on the Revenue
- ❖ Unless Revenue shows that the taxpayer was obliged to incur AMP expenses of certain level for promoting its AEs brand, an international transaction cannot be inferred
- ❖ Since use of BLT itself has been negated in Sony’s case - which was the basis of examining existence of an international transaction as well as for determination of the arm’s length price - there can be no basis to allege existence of an international transaction.
- ❖ It is incumbent on the Revenue to first show existence of an international transaction. And then, to ascertain the disclosed 'price' of such transaction and thereafter ask whether it is at ALP.

VODAFONE INDIA SERVICES PRIVATE LIMITED (HIGH COURT of MUMBAI) Recent Jurisprudence



FACTS

- ❖ Vodafone India Services Pvt Ltd (VISPL) was a wholly owned subsidiary of Vodafone Tele Services (India) Holdings Ltd (VTSIHL), a Mauritian company
- ❖ It issued equity shares at a premium to VTSIHL based on valuation as per Controller of Capital Issues (“CCI”) guidelines
- ❖ Share issue declared to be an international transaction in Form 3CEB as an abundant caution, however, in the note appended thereto, the same was claimed to be outside the ambit of TP provisions.

ISSUE

- ❖ Whether the transaction of issuance of fresh shares by an Indian company to its overseas associated enterprise (“AE”) is an ‘international transaction’?
- ❖ What would be the valuation of shares issued by the Indian company to its AE?

VODAFONE INDIA SERVICES PRIVATE LIMITED (HIGH COURT of MUMBAI) Recent Jurisprudence



DECISION

- ❖ Capital receipts are not taxable unless expressly provided for – Issue of shares not taxable under the Act in the absence of express provisions/legal fiction.

MAERSK GLOBAL CENTRES (INDIA) PRIVATE LIMITED (TRIBUNAL SPECIAL BENCH)

Recent Jurisprudence



FACTS

- ❖ Maersk Global Centres (India) Private Limited (“Maersk India”) among others was engaged in the supply of provision of IT enabled services like transaction processing, data entry, accounting and logistic support services to its U.S. parent
- ❖ The taxpayer substantiated the arm’s length nature of its international transactions for ITeS applying TNMM considering predominantly BPO companies as its comparables
- ❖ The Revenue authorities recomputed the arm’s length price of the taxpayer for the ITES segment by considering certain KPO companies also as comparable under the ITES umbrella, which included certain high profit margin companies

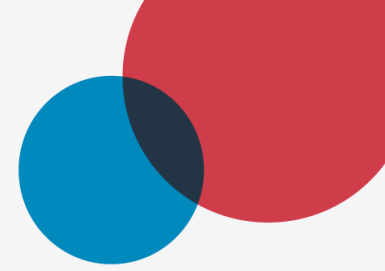
ISSUE

- ❖ Whether BPO activities of a taxpayer can be compared with companies performing KPO activities for computing ALP, even though BPO and KPO would both fit within the ITES umbrella
- ❖ Whether a comparable earning abnormally high margins should be included in the list of comparable cases

❖ TAXAND

MAERSK GLOBAL CENTRES (INDIA) PRIVATE LIMITED (TRIBUNAL SPECIAL BENCH)

Recent Jurisprudence



DECISION

- ❖ IT enabled services cannot be further dissected into BPO and KPO services for the purposes of comparability analysis in view of the following
 - ❖ Significant overlap between BPO and KPO services, no strict line of distinction can be drawn
 - ❖ Most comparable companies (including the taxpayer) render both BPO and KPO companies, the artificial segregation is not practicable
- ❖ A two step approach suggested:
 - ❖ Step 1: Select all potentially comparable ITeS companies;
 - ❖ Step 2: Eliminate comparable with lesser degree of comparability in step 1
- ❖ However, the Tribunal has mentioned that it is not the intention to dilute the standards of comparability just because the TNMM was being used.
- ❖ Comparable cannot be excluded merely on account of super profits, however this should trigger further investigation to find out if there is any abnormal conditions during the year for that comparable

CUSHMAN AND WAKEFIELD (INDIA) PVT. LTD. (HIGH COURT of NEW DELHI) Recent Jurisprudence



FACTS

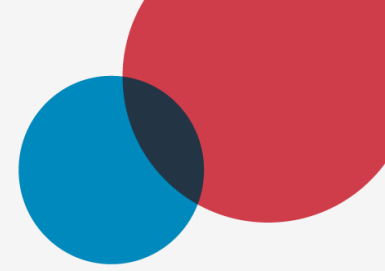
- ❖ Cushman and Wakefield (India) Private Limited (“CW India”) is engaged in the provision of services in the real estate sector such as advisory and research, project management, etc.
- ❖ CW India had reimbursed certain expenses to its AE, Cushman and Wakefield, Singapore (“CWS”) for providing liaison and co-ordination services to CW India’s client, IBM. This was based on an agreement entered into between related parties stipulating that CW India would reimburse CWS for costs (including salary and other attributable costs for concerned employees), taking into account the activities actually performed by CWS and the benefits derived by CW India.
- ❖ In another transaction, CW India also made payments to Cushman and Wakefield, Hong Kong (“CWHK”) for marketing support services provided to it. The payment was stipulated under an agreement based on similar lines as entered between CW India and CWS.

ISSUE

- ❖ Whether the ALP of intra-group charges is nil?
- ❖ What should be the ideal way to determine the ALP of intra-group charges?

❖ TAXAND

CUSHMAN AND WAKEFIELD (INDIA) PVT. LTD. (HIGH COURT of NEW DELHI) Recent Jurisprudence



DECISION

- ❖ The Transfer Pricing Officer and the Tax Tribunal had placed reliance on OECD Transfer Pricing Guidelines (Para 7.4 to 7.6), which deal with intra-group services. Without out rightly rejecting OECD Guidelines, the HC observed that these guidelines are not binding and further, that para 7.4 of the OECD Guidelines itself recognizes that each case would depend upon facts and circumstances.
- ❖ It is necessary to relate cost of specific activities conducted to the benefit received by CW India, rather than allocating cost from common pool or basket of revenue through unexplained percentage of revenue generated. Ultimate analysis has to disclose whether the service rendered has a value and if so, the value needs to be determined.
- ❖ The TPO lacked authority to disallow the expenditure stating that CW India did not benefit from the same since its powers are limited to determination of arm's length price. The TPO may however determine the arm's length price as 'nil' in situations where an independent entity in a comparable transaction would not pay any amount.
- ❖ Commercial wisdom of the taxpayer cannot be challenged by the Revenue Authorities.

AMAZON.COM INC. & SUBSIDIARIES (US TAX COURT)

Recent Jurisprudence



FACTS

- ❖ In 2005, Amazon US entered into a cost sharing arrangement (“CSA”) with Amazon Luxembourg (“Amazon Lux”), granting Amazon Lux the right to use certain pre-existing intangible property (IP) in Europe to operate a website business.
- ❖ Amazon Lux had to make an upfront “buy-in payment” for the pre-existing intangible property and then annual payments to fund ongoing intangible development costs (“IDCs”).
- ❖ In filing its tax return, Amazon US used an unspecified income-based method to determine that Amazon Lux was required to make a \$2254.5 million buy-in payment over seven years.
- ❖ Upon audit, the Internal Revenue Service (“IRS”) determined that Amazon US’s method was inappropriate and applied the discounted cash flow (“DCF”) method. Under the DCF method, the IRS determined that the buy-in-payment should be \$3.4 billion.
- ❖ The IRS further asserted that 100% of technology and content costs constituted IDCs for cost-sharing purposes.
- ❖ Amazon US disagreed and petitioned the Tax Court, arguing that the IRS’s determination was contrary to *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009)#

A case in which the Tax Court rejected a method similar to the DCF method for determining buy-in payments.

AMAZON.COM INC. & SUBSIDIARIES (US TAX COURT)

Recent Jurisprudence



ISSUE

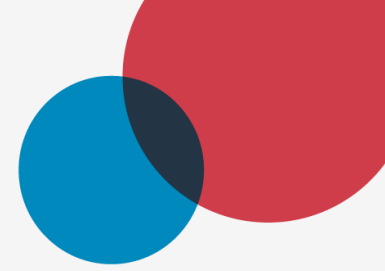
- ❖ Was the US Tax Court right in applying Veritas decision directly to Amazon's case?
- ❖ How should a taxpayer impute useful life of intangibles?
- ❖ Should Comparable uncontrolled transaction ("CUT") method be preferred over other methods?

DECISION

- ❖ The Tax Court held that IRS approach to valuing intangible transfers was arbitrary, capricious and unreasonable. Affirming its decision on Veritas – Tax Court rejected IRS attempts to distinguish or overrule Veritas and held:
 - ❖ The intangibles at issue did not have a perpetual useful life;
 - ❖ The buy-in payment was not akin to a 'sale';
 - ❖ The workforce in place, goodwill and going concern value should be excluded when determining buy-in payment;
 - ❖ Intangibles in at issue should not be valued in aggregate; and
 - ❖ Transferred website technology decayed in value over its useful life.

AMAZON.COM INC. & SUBSIDIARIES (US TAX COURT)

Recent Jurisprudence



DECISION

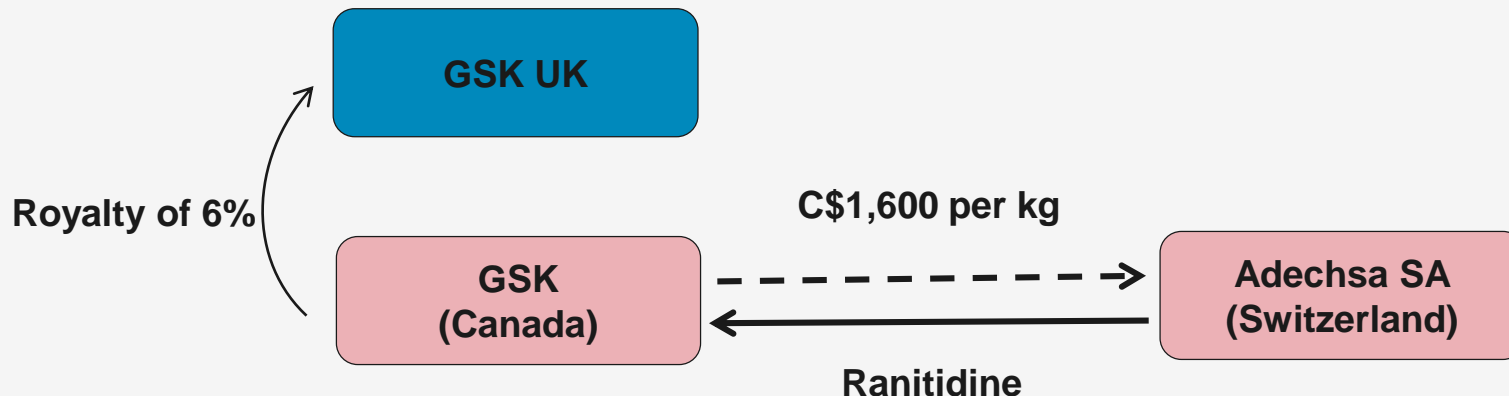
- ❖ Tax Court rejected IRS's attempt to value transferred intangibles in aggregate, since such an analysis would have effectively combined preexisting intangibles and subsequently developed intangibles.
- ❖ It could also combine the compensable intangibles and non-compensable residual business assets (goodwill, going concern value, etc.).
- ❖ Tax Court also rejected IRS contention that "realistic alternatives" principle supported IRS's application of DCF method.
- ❖ Also supported the use of CUT method over other methods.
- ❖ The use of perpetual life by taxpayer was also rejected by Tax Court since the same would include subsequently developed intangibles and preexisting intangibles.
- ❖ Ruled in favour of Amazon US

GLAXOSMITHKLINE V THE QUEEN



FACTS

- ❖ GSK is a Canadian company and the distributor in Canada for Adechsa SA, a related Swiss company
- ❖ Price that GSK paid to Adechsa for Ranitidine, an active ingredient found in Zantac (a drug marketed by GSK in Canada) was the focus of dispute
- ❖ The Minister of National Revenue believed that GSK had paid an excessive amount for Ranitidine (C\$1,600 per kg)
- ❖ Generic drug companies were paying third party manufacturers C\$200 to C\$300 per kg for the same ingredient
- ❖ GSK had a separate license agreement with GSK UK for the rights to certain intangibles (trade marks, marketing support, technical assistance, etc) on which a royalty of 6% was paid
- ❖ The Minister argued that the royalty agreement should be looked at separately
- ❖ The Minister increased GSK's income for the years in question by approximately C\$51 million



GLAXOSMITHKLINE V THE QUEEN

ISSUE

- ❖ Whether the price paid by GSK to Adechsa was at arm's length
- ❖ CUP analysis: CUP based on generic companies' purchases of Ranitidine OR CUP based on independent third party licensees in Europe which purchased Ranitidine under similar business circumstances as GSK
- ❖ Whether total cost of Ranitidine to GSK (including royalties) should be considered OR just purchase amount

DECISION – TAX COURT

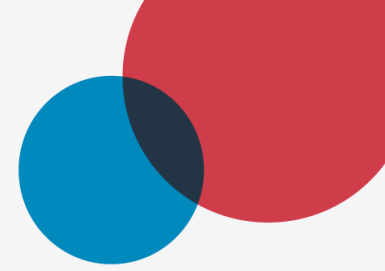
- ❖ Tax Court held that CUP method was the preferred method
- ❖ Transactions involving generic companies held as appropriate comparables
- ❖ Tax Court endorsed the OECD Guidelines and hierarchy of methods
- ❖ Considered applicability of some methods such as resale minus and cost plus but ignored TNMM
- ❖ GSK appealed to the Federal Court of Appeal

DECISION – FEDERAL COURT

- ❖ Reversed lower court ruling – request that lower court revisit decision
- ❖ The existence of patent, trademark, premium for brand name and taxpayer's license agreement with affiliate were business realities and should be considered in the benchmarking exercise

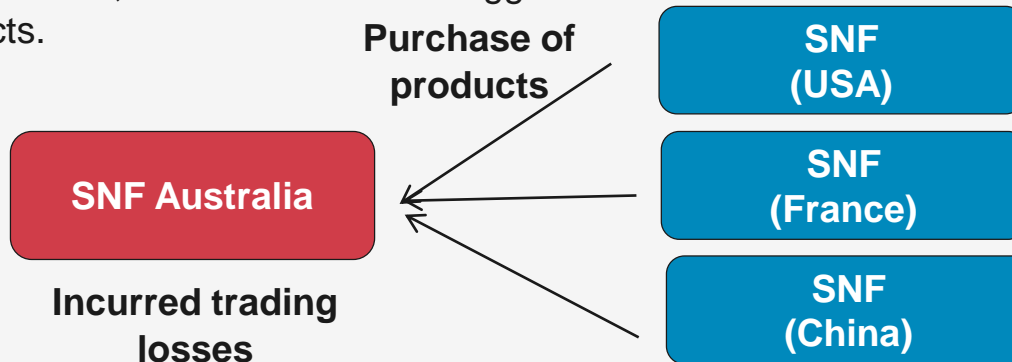
SNF AUSTRALIA V FCT

Recent Jurisprudence



FACTS

- ❖ SNF Australia, a wholly owned subsidiary of SNF France, carried on the business of manufacturing and selling polyacrylamide products to end users in the mining, paper and sewage treatment industries.
- ❖ During the 1998 to 2004 income years, SNF Australia purchased the products from various manufacturing subsidiaries of SNF France and incurred trading losses.
- ❖ SNF Australia attributed the trading losses to commercial reasons, including intense competition, poor management, defalcations by an employee, excessive stock levels, a series of bad debts etc.
- ❖ SNF Australia contended that it did not pay inflated prices for its purchases by presenting a Comparable Uncontrolled Price (“CUP”) analysis, comparing prices of transactions between suppliers and their arm’s length customers
- ❖ The ATO sought to adjust SNF Australia’s taxable income on the basis that they were loss making and submitted that SNF Australia did not address the question of “what an independent purchase in the position of the taxpayer would have agreed to pay”.
- ❖ Using the TNMM method, the Commissioner suggested that SNF Australia should have paid \$12.3million less for the products.



SNF AUSTRALIA V FCT

Recent Jurisprudence



ISSUE

- ❖ Whether prices paid by SNF Australia for the acquisition of the products from its related companies are at arm's length

DECISION

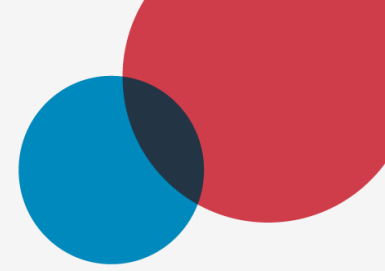
- ❖ The Federal Court of Australia rejected the use of TNMM, which focused on a purported need to make a net profit margin instead of focusing on the pricing of products
- ❖ Accepted the taxpayer's CUP analysis – the task is to price the acquisition and not determine what would an independent party “in the position of the taxpayer” would pay
- ❖ Agreed that the losses were attributable to commercial issues (e.g. poor management, defalcation of employees, etc.)
- ❖ Held that it could not be concluded that the prices were artificially inflated

CONCLUSION

- ❖ Apparent reluctance on the part of the Courts to accept TNMM analysis where internal comparables are available
- ❖ Rejected the Commissioner's inference that trading losses incurred over a period must be due to transfer pricing practices

DSG RETAIL LIMITED v HRMC

Recent Jurisprudence



FACTS

- ❖ DSG Retail Ltd (“DSG”) is a subsidiary of DSG International plc. The DSG Group is the largest retailer of electrical goods in the UK.
- ❖ When customers purchased electrical goods from DSG, they would be given a standard 12 month warranty. DSG would also offer customers an extended warranty for a certain period for a fixed premium.
- ❖ The Group’s offshore insurance subsidiary, DISL was not licensed to carry on an insurance business in the UK and hence warranties were issued by a 3rd party, Cornhill Insurance (Cornhill”).
- ❖ Warranties were sold by CIS (a DSG Group company) for Cornhill for which CIS received a commission.
- ❖ Cornhill was not prepared to accept more than 5% risk in respect of the warranties and hence 95% of the premium income was ceded to DISL. DISL paid Cornhill a ceding commission of 1.5%.
- ❖ MSDL carried out repairs and kept product data for which Cornhill paid an administrative fee.

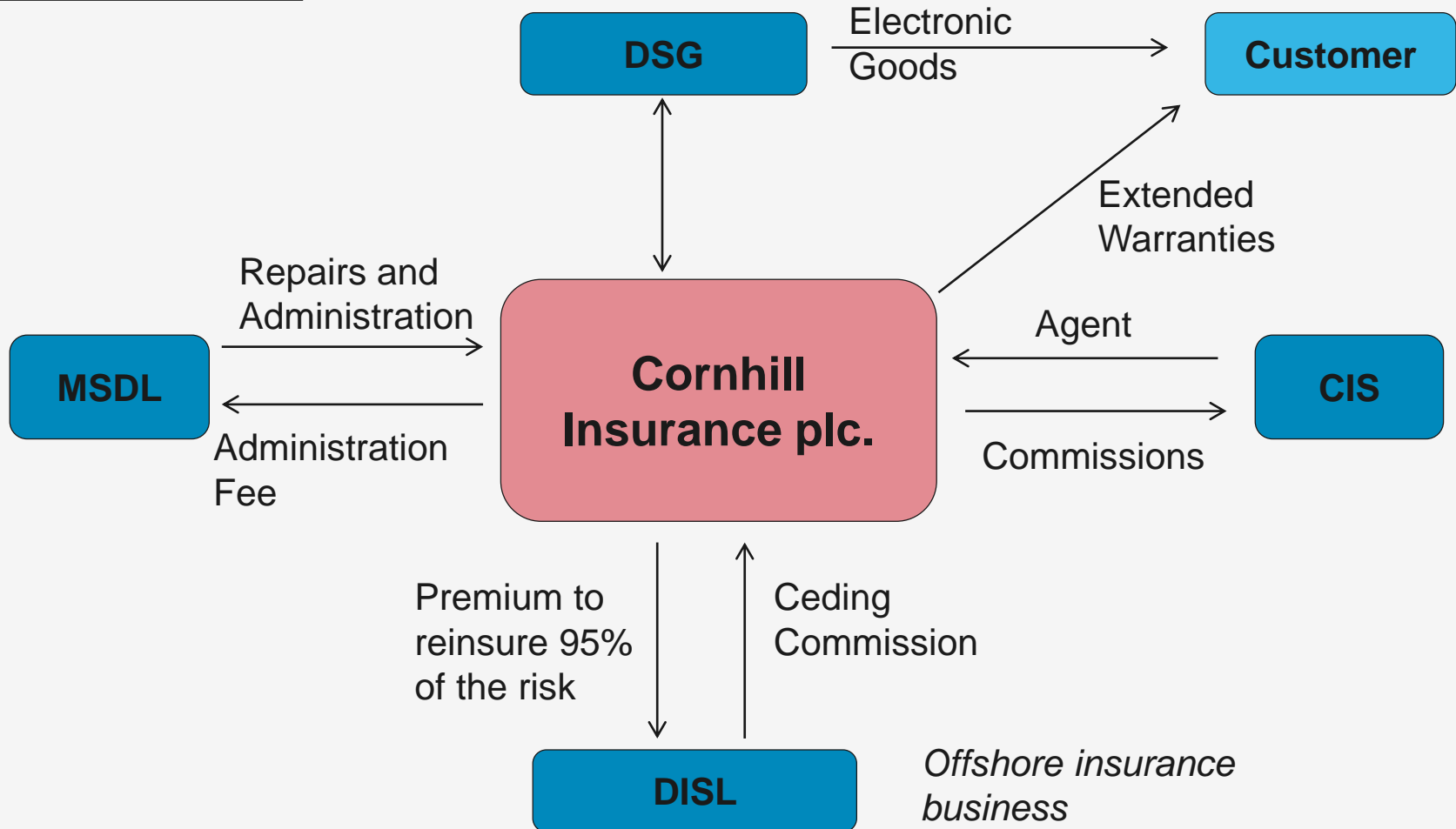
❖ TAXAND

DSG RETAIL LIMITED v HRMC

Recent Jurisprudence



FACTS



DSG RETAIL LIMITED v HRMC

Recent Jurisprudence



ISSUE

- ❖ Whether DSG had conferred a benefit on DISL by entering into the insurance/service contracts with Cornhill.

DECISION

- ❖ Although DSG had no direct contract with DISL, HMRC successfully argued that DSG had contracted with Cornhill only on the mutual understanding that the Cornhill would be reinsured by DISL.
- ❖ As such, DSG should have been paid by DISL for the benefit that it conferred on DISL (which would have brought a substantial portion of DISL's profit back to the UK)

CONCLUSION

- ❖ Revenue looks at the commercial and economic substance in the operational structure

CHEVRON AUSTRALIA HOLDINGS PTY LTD (FEDERAL COURT of AUSTRALIA) Recent Jurisprudence



FACTS

- ❖ Chevron Texaco Funding Corporation (“CFC”) was a wholly owned subsidiary of Chevron Australia Holdings Pty Ltd (“Chevron Australia”). CFC is a resident of the United States and not a resident of Australia.
- ❖ CFC borrowed an amount of USD2.5 billion from the commercial paper market at rates of interest at or below USD LIBOR (approximately **1.2%**).
- ❖ CFC provided an intercompany loan to Chevron Australia for the AUD equivalent of USD2.45 billion, under the Credit Facility agreement.
- ❖ The interest rate under the Credit Facility agreement was AUD LIBOR plus 4.14% (approximately equivalent to **9%**).
- ❖ CFC obtained a **guarantee** from Chevron Inc, the ultimate parent of the group for the Fund raised in US bond market by CFC.
- ❖ However, no security was provided by Chevron Australia and the advance to Chevron Australia was not guaranteed by Chevron Inc.

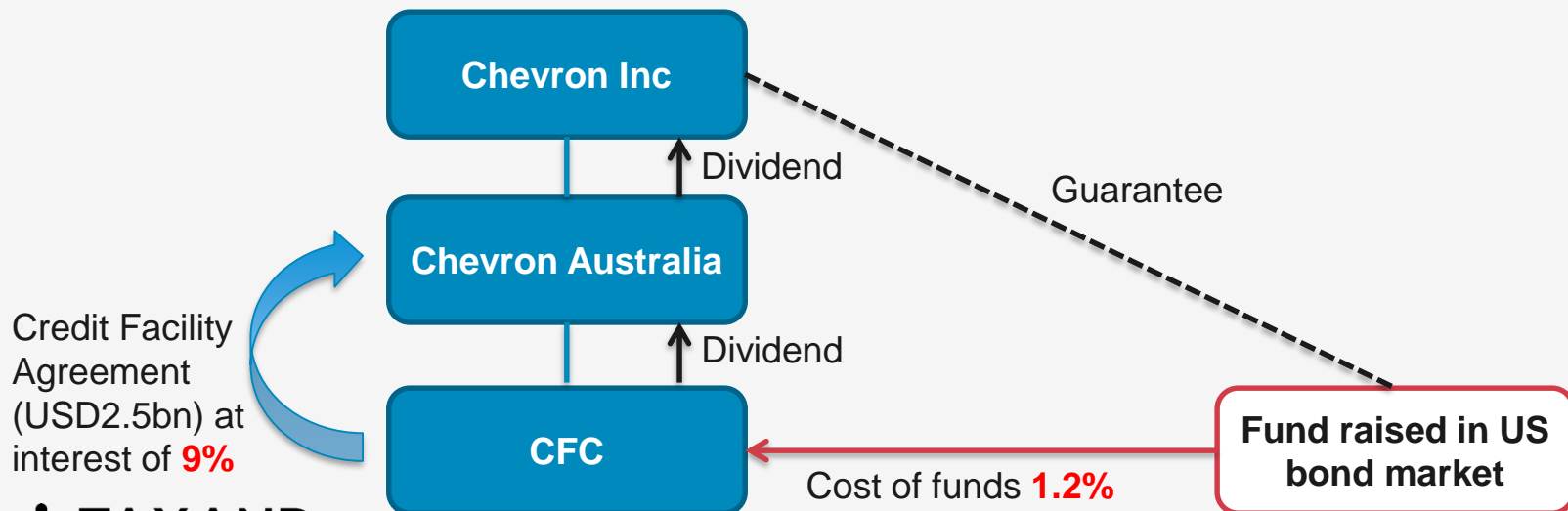
❖ TAXAND

CHEVRON AUSTRALIA HOLDINGS PTY LTD (FEDERAL COURT of AUSTRALIA) Recent Jurisprudence



FACTS

- ❖ Chevron Australia claimed a deduction on interest expense.
- ❖ CFC was not taxable in the US on the interest income.
- ❖ As a result of the **interest differential**, CFC generated profits and it paid dividends to Chevron Australia, which were exempt from tax in Australia.
- ❖ Chevron Australia in turn paid dividends to its shareholder.
- ❖ Commissioner of Taxation raised assessments in respect of 2004 – 2008 tax years of approximately AUD340m.



CHEVRON AUSTRALIA HOLDINGS PTY LTD (FEDERAL COURT of AUSTRALIA) Recent Jurisprudence



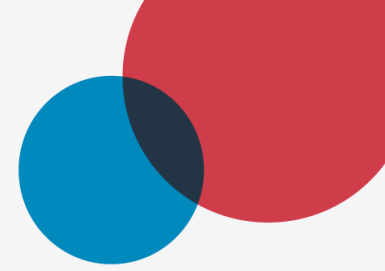
ISSUE

- ❖ Whether the interest paid by Chevron Australia to CFC exceeded the arm's length interest rate

DECISION

- ❖ Chevron Australia was unsuccessful before the Federal Court and appealed to the Full Federal Court.
- ❖ The Full Federal Court dismissed the appeal.
- ❖ The main thrust of the decision is that it **was necessary to construct a comparable arrangement** in respect of the borrowings that would have been entered into by independent parties dealing at arm's length.
- ❖ The Court held that such a comparable arrangement **would have included security and/or a parent company guarantee** in respect of external borrowings which would in turn have a bearing on the interest rate.

CHEVRON AUSTRALIA HOLDINGS PTY LTD (FEDERAL COURT of AUSTRALIA) Recent Jurisprudence



DECISION

- ❖ The Court contended that a secured and/or guaranteed loan would have been subject to a **lower interest rate** than that incurred by Chevron Australia.
- ❖ The Court effectively concluded that the a taxpayer **cannot write the terms of its loan** arrangements with related parties (e.g. to exclude security or a guarantee) and then determine the arm's length price according to those terms.
- ❖ The Court also rejected Chevron's "orphan theory" which puts forth the argument that Chevron Australia should be assessed as a stand-alone entity, shorn of all affiliation to its parent.
- ❖ Chevron Australia lodged an application for special leave for the matter to be heard by the High Court (Australia's superior court). However, Chevron Australia subsequently reached a *confidential settlement* with the Commissioner.

MM SDN BHD v KETUA PENGARAH LEMBAGA HASIL DALAM NEGERI

Recent Jurisprudence

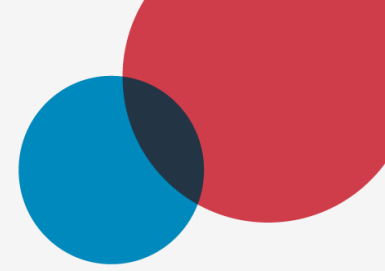


FACTS

- ❖ MM Sdn Bhd operates as a shipping and logistics operator.
- ❖ It received commission from its related parties.
- ❖ Business Process Improvement services and Regional Services were provided to MM Sdn Bhd by its related party in Singapore, for which it paid Business Process Improvements Services & Regional Services Charges.

MM SDN BHD v KETUA PENGARAH LEMBAGA HASIL DALAM NEGERI

Recent Jurisprudence

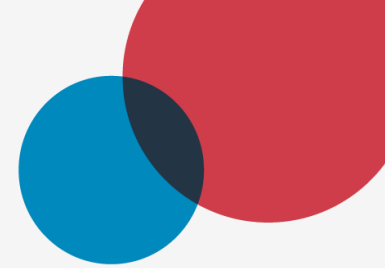


ISSUE

- ❖ The IRB carried out a transfer pricing audit on the company and raised the following issues:
 - Adjustment of the commission rate received by the taxpayer in the years of assessment 2002 to 2005, by increasing the commission rate by 0.25%.
 - Contended that the taxpayer did not receive Business Process Improvement services and Regional Services and disregarded the Business Process Improvements Services & Regional Services Charges paid by the taxpayer to M Singapore Pte Ltd in the years of assessment 1998, 1999, 2000(CYB), 2001, 2002, 2003, 2004 and 2005.
 - Notwithstanding the above, whether penalty under Section 113(2) of ITA should have been imposed on the taxpayer for the additional assessments which were made for the years of assessment 1998 to 2005.

MM SDN BHD v KETUA PENGARAH LEMBAGA HASIL DALAM NEGERI

Recent Jurisprudence



DECISION

- ❖ Special Commissioners of Income Tax (SCIT) decided that the taxpayer's transfer pricing documentation and benchmarking evidence were reliable in establishing that the taxpayer's pricing methodology was acceptable.
- ❖ SCIT also ruled that the transfer pricing adjustment made by the IRB was to be set aside, the IRB's Transfer Pricing Guidelines have no force of law; the failure to comply with Section 140(1) and Section 140(5) of the ITA rendered the assessments null and void and that transfer pricing was not an exact science.

CONCLUSION

- ❖ Decision served to highlight the importance of the preparation and maintenance of transfer pricing documentation on a contemporaneous basis in Malaysia.
- ❖ Taxpayer's comparable reports and the expert evidence led by the taxpayer were found to be reliable in establishing that the taxpayer's pricing methodology was acceptable.
- ❖ This further strengthens the need for taxpayers to ensure full compliance to local transfer pricing requirements in their respective jurisdictions.
- ❖ The transfer pricing documentation has proven to be a key instrument in demonstrating the application of the arm's length principle in relation to the transfer pricing policies adopted by the taxpayer.

ABC SDN BHD v SPECIAL COMMISSIONERS OF INCOME TAX

Recent Jurisprudence



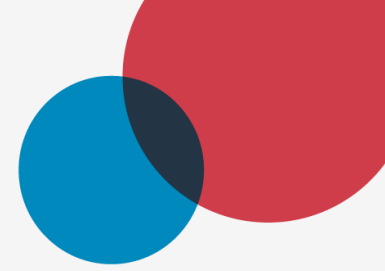
FACTS

Source: Baker McKenzie website

- ❖ Taxpayer is a Malaysian subsidiary of a MNC dealing in FMCG and was appointed to act as a LR distributor for a related party (overseeing the distribution of its products in Malaysia).
- ❖ It was agreed between the parties that the related party sets the prices of the goods sold to the taxpayer in a manner which guarantees an arm's length margin based on results of comparable third party distributors.
- ❖ Following a TP audit, the IRB decided to invoke its powers under the Income Tax Act 1967 to adjust the transactions between the taxpayer and related party, contrary to a detailed TP analysis prepared by the taxpayer and represented in the TP report.
- ❖ The IRB concluded that the taxpayer had mischaracterised itself in the functional analysis, was not a LR distributor and should therefore be entitled to a higher compensation.
- ❖ The IRB also selected five of its own comparable companies, after rejecting those put forward by the taxpayer, and insisted that TP adjustments at the median point of the comparable companies' results, instead of assessing whether the actual results of the tested party were within any point of the arm's length or the interquartile range.

ABC SDN BHD v SPECIAL COMMISSIONERS OF INCOME TAX

Recent Jurisprudence



ISSUES

- ❖ Use of IQR (vs. median point) as the correct approach
- ❖ Recharacterisation based on FAR Analysis and adjustments
- ❖ Selection of comparables (including usage of secret comparable data)
- ❖ Deductibility of transfer pricing (i.e. true-up/true-down) adjustments

DECISION

- ❖ On 25 January 2019, the SCIT rendered its decision, stating that it agreed with the Taxpayer's arguments and allowed the appeal in full

CONCLUSION

- ❖ The SCIT's decision is important as it successfully challenged some long standing IRB practices which have long troubled taxpayers, namely the inordinate focus on functions in the FAR analysis, insistence on adjusting to the median and frequent IRB failure to undertake proper TP analysis on taxpayers before raising TP adjustments.
- ❖ The decision also provided clarity and affirmation of commonly understood TP principles and acts as a timely reminder on the importance of preparing defensible and robust TP documentation.

PT L'OREAL INDONESIA v DIRECTORATE GENERAL OF TAXES (DGT)

Recent Jurisprudence



FACTS

- ❖ PT L'Oreal Indonesia (PTLI) is the sole license holder in Indonesia to use L'Oreal brands based on License agreement with L'Oreal SA France
- ❖ L'Oreal SA France grants an exclusive rights to PTLI to use the technology, to use the licensed trademark and to distribute and sell the licensed products
- ❖ PTLI states that it sub-contracts PT Yasulor Indonesia (PTYI) to manufacture the products based on order and formula specification from PTLI and PTLI is the party to receive rights to use the technology of L'Oreal SA France. In this case PTYI produces goods based on order from L'Oreal Group and is unable to sell to third party outside Group
- ❖ The Group's policy is that royalty is charged on the Distributor Level
- ❖ Thus, PTLI received benefit by being able to manufacture the products (sub-contract PTYI) and sell the products in Indonesia

PT L'OREAL INDONESIA v DIRECTORATE GENERAL OF TAXES (DGT)

Recent Jurisprudence

ISSUES

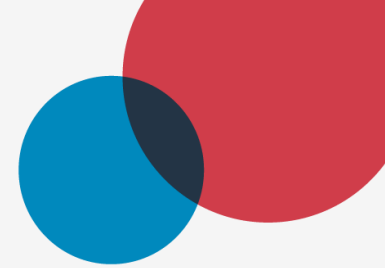
- ❖ DGT denied the deductibility of royalty payment related to the use of technology and trademark from PT L'Oreal Indonesia (PTLI) to L'Oreal SA France as no benefit is deemed to be received by PTLI. PTLI, as a distributor, does not use the technology to manufacture the products but instead has PTYI manufacture the products. Thus, DGT deems that no benefit is received by paying royalty.

DECISION

- ❖ In July 2010, Tax Court ruled in favor of DGT, stating that it agreed with the DGT's arguments. PTLI appealed to Supreme Court and received its decision in 2013 stating that it agreed with Tax Court's decision

CONCLUSION

- ❖ The Decision is used by DGT as a reference to make TP adjustment of Royalty expenses when Distributor pays royalty related to license of Technology, whereby it has third party to manufacture the products. This scenario is common in business, thus, advice should be given to clients that high risks of TP adjustment when paying royalty for use of technology when the taxpayers only engages in distributing and selling products. However, in Indonesia, the previous tax court decision is not legally binding for other taxpayers in similar situations.





**Marketing
Opportunities**

GROWING A TP PRACTICE



❖ Resources

❖ Taxand resources

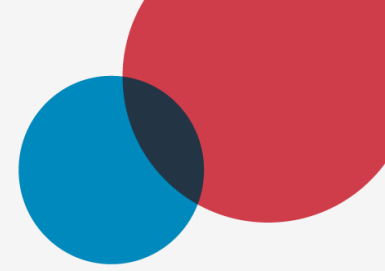
- Taxand TP Team: www.taxand.com
- Don't forget: Various Taxand member firms in all areas have the capacity to perform economic analysis and comparable searches

❖ External database subscription

- Under negotiation: Global preferable arrangements with Taxand for countries willing to access database
- E.g. OneSource, Oriana Database

❖ Sell and cross-sell

MARKETING DEVELOPMENTS – TAXAND BUSINESS DEVELOPMENTS



- ❖ More cross border / Global engagements / cooperations involving numerous countries
- ❖ Monitor global and regional TP developments to assess impact on taxpayers
- ❖ To develop marketing efforts on each marketplace and on a **regional** basis
 - ❖ Marketing tools (APA & IBFD Guides)
 - ❖ Implementing a **reporting tool** including success stories and client oriented information
 - ❖ Developing visibility towards regulators
 - Participation to OECD business advisory groups
 - Global response to calls for comments e.g. business restructuring
 - ❖ Assisting practices in the process of **hiring TP dedicated teams**
 - ❖ Developing, in connection with Taxand global KM, **knowledge sharing tools**: training, intranet
 - ❖ Implementing a regular review of **client portfolios** and creating a **TP clients database**
 - ❖ Participating actively in **events and initiatives with a global impact**, as far as possible with international presence of Taxand member firms



THANK YOU

ABOUT TAXAND

Taxand is the world's largest independent tax organisation with more than 400 tax partners and over 2,000 tax advisors in over 40 countries. Taxand focuses on delivering high quality, integrated tax advice, free from conflict creating audit work. Taxand advisors work together to deliver global tax services for clients.

www.taxand.com

Taxand is a global organisation of tax advisory firms. Each firm in each country is a separate and independent legal entity responsible for delivering client services.

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Registered office: 1B Heienhaff, L-1736 Senningerberg –
RCS Luxembourg C68