Communiqué – Your TP Tabloid

Issue 1 | July 2018

Foreword

The Tax authorities all over the world are working to protect their tax base and looking to amend their tax treaties to ring fence the issue of base erosion and profit shifting (BEPS) based on three core principles: greater coherence, rationalisation of substance and increased transparency. Consequently, Transfer Pricing (TP), which has been in the forefront since its introduction in 2001, has undergone a revolutionary change since 2015, resulting in more compliance for the businesses. This is coupled with stringent scrutiny by the Tax Authorities of business structures/ models and the way inter-company transactions are being priced to identify incidences of tax avoidance.

We, at Nangia Advisors, wish to be your value added business partners. Accordingly, we have endeavoured to provide insights into recent TP news, discuss topical events and provide key takeaways arising from various happenings in the arena of TP by way of this monthly series. This tabloid is envisaged to keep our readers informed of the important changes and help understand how these changes would impact doing business in India. In particular, current issue discusses:

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We look forward to your contributions or suggestions on this issue as through a mutually inclusive process we wish to make this series really your sounding board for decision on TP going forward. If there are any suggestions or feedback that you would like to share with us, please write me to at query@nangia.com.

Separately, if you would like to discuss any of the items in this issue in greater detail or general TP matters, please do let us know. Kindly note that information contained within this issue is of general nature and reliance on the same should not be placed without seeking professional advice.

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CBDT issues instruction on 'appropriate use' of CbCRs

On June 27, 2018, the CBDT issued instructions on appropriate use of CbCR which is one of the three pre-requisite conditions set out in BEPS Action Plan 13 which has to be included as a condition in the Multilateral Competent Authority Agreement for Automatic Exchange of Country-by-Country Reports (the CbC MCAA)/ Bilateral Competent Authority Agreements for Automatic Exchange of CbCR (CbC BCAA).

It is a proactive step by CBDT and ticks another box on global alignment.

Key Takeaways

The instructions cover the following areas:

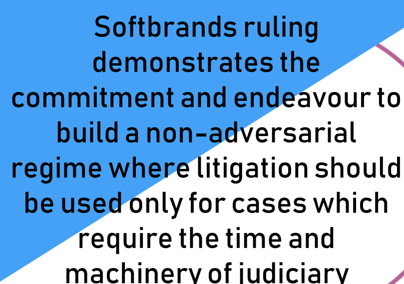
- Restriction on Access of CbCR limited to Designated personnel within CBDT:
  - Competent Authority of India (CA);
  - Director General of Income tax (Risk Assessment) (DGRA) for risk assessment; and
  - Jurisdictional Transfer Pricing Officer (TPO) for only those CEs that have been selected for audit in the initial risk assessment.
- Appropriate use of CbCR can primarily be for the purpose of:
  - High level Risk Assessment;
  - Assessment of other BEPS related risks; &
  - Economic & Statistical Analysis.

  It may also be used for planning a tax audit and as a basis for making further enquiries.
- Use of CbCR information shall be inappropriate if it is used as a substitute for detailed TP analysis and if it is used as the only material to propose TP adjustment.
- Regarding confidentiality, CBDT assures that all inbound or outbound CbCR filed with the DGRA either by a reporting/ alternate reporting entity will be subject to the requirements of confidentiality under the Treaties (guidelines provided in Chapter VII of Manual on Exchange of Information) and Act by all officers of Chief Commissioner of Income tax (CCIT) /Director General of Income Tax (DGIT).
- CBDT also states that adjustments made to income of taxpayer based on inappropriate use of CbCR will be promptly conceded by CA in Mutual Agreement Procedure (MAP) proceedings.
- Process for monitoring, control and review of appropriate use of information has been defined as follows:
  - Monitoring – Information used by TPO to be monitored by the Jurisdictional Commissioner of Income Tax (TP) [CIT(TP)] who would be responsible to bring any breach to the attention of CA, who shall intimate Coordinating Body Secretariat of OECD.
  - Review – A quarterly report of review of appropriate use of CbCR in the prescribed format shall be submitted within 30 days of quarter end by the Principal CCIT to the Board, who would get the review done through the CA.

Analysis

The recent instructions is a welcome step as it is focused on putting in place stringent control measures within the legal framework to prevent abuse of information received from CbCR as well as leakage of confidential data, which were the major areas of concern for the International Community. It also helps to bring about uniformity in the way the recent changes in the local TP rules/ regulations will be administered in India with those done globally by other tax jurisdictions as the instruction is quite aligned with the OECD's Guidance on the appropriate use of information contained in CbCR. Further, its issuance would go a long way to curb any unjust enquires and litigation.

For more detailed information, refer to our article on Taxsutra http://tp.taxsutra.com/experts/column?sid=452



CBDT signs 3 more unilateral APAs with taxpayers

On July 4, 2018, the CBDT has signed three more unilateral APAs. As of now the total number of APAs entered into by the CBDT is 223, which inter-alia includes 20 bilateral APAs covering the consumer industry, automobile, precious stones and metal industry. The APAs have been signed for international transactions of provision of corporate guarantee, purchase of brand, availing of grading services, availing of management services and payment of royalty.

Analysis

India has fared much better than other jurisdiction on the APA front. With the progress so far, the Government has been able to foster its objective of showcasing India as an efficient tax regime. However, now it needs to be seen how soon can we see consensus on complex tax issues, transactions and business models such that APA becomes a meaningful dispute resolution solution.

Karnataka HC Ruling in Softbrands

June 25, 2018 marked yet another historical date for the Indian tax legal system as the Karnataka High Court in the case of Softbrands India Private Limited[1] (Softbrands).

Facts and key takeaways from the HC Ruling

The present appeal was filed by the Revenue under Section 260A of the Indian Income-tax Act, 1961 (the Act) for two issues: 1) Rejection of specific comparable companies, and, 2) Justification of related party threshold at 15%. However, the HC instead of addressing these issues, delved on the aspect of whether the grounds of appeal really qualify as 'Substantial Question of Law' or not. Significant jurisprudence laid down by the HC is as below:

- TP is a matter of estimate of broad/ fair guess-work of the Authorities based on relevant material before the Authorities;
- HC again concluded that ITAT attains primacy as the highest and last fact finding body and the orders passed by ITAT are binding on the lower Tax Authorities as well as the HC; and
- HC will not interfere against an ITAT ruling *"unless the finding of the Tribunal is found ex-facie perverse".*

Analysis

Indian Courts have time and again adjudicated on concept of substantial question of law, however, so far no ruling had discussed this in the context of TP. The present HC ruling indeed fills the void.

Such rulings are like double edged swords since it could lead to various questions also, such as, does this give unprecedented power to ITAT, will HC not consider any appeals which are related to comparable companies, what if the issues involve both Question of Law and Fact, what about complex cases which can have mass implications, etc. The answer to these may lie in each case separately but it does give an argument to the other party in the appeal to make the case look like having only Question of Fact and thus render it inadmissible. Though, the HC did state that it will only consider cases of ex-facie perversity of the findings of the ITAT,

[1] ITA No. 536/ 2015 and ITA No. 537/ 2015

and unless it is so, even inconsistent view adopted by ITAT in different cases based on relevant facts cannot automatically lead to formation of Substantial Question of Law.

This also bring us to another important aspect that the ruling makes it incumbent on the Appellant to establish the perversity of facts as technically the onus is not upon the HC to perform any fact finding exercise. As a matter of fact, within three weeks of the ratio being laid down in 87 cases appeal were dismissed by HC. In some of these cases, the HC also urged the Applicants to adopt the alternative modes such as Miscellaneous Application with ITAT rather than blindly filing appeal before HC.

Of late, it seemed such a ruling was coming anytime, since it was time to check the spate of avoidable litigation. Intent of the Legislators is also not far behind in this cause, as a subsequent press release from the CBDT on July 11, 2018 to substantially enhance the monetary thresholds for appeals before ITAT and Courts (refer below table) to reduce the plethora of long-pending litigations in various courts.

Appeals in Income-tax matters	Monetary Limit (Before) (INR)	Monetary Limit (Now) (INR)
ITAT	10,00,000	20,00,000
High Court	20,00,000	50,00,000
Supreme Court	25,00,000	1 crore

In fact, the benefits of Softbrands ruling are clearly visible in the short term itself with jurisdictional HCs rejecting admission of various appeals that do not pass the "litmus test" laid down by ruling of Softbrands. In the aftermath, around 87 cases have been dismissed. But, the last word on this in the area of TP is still not out as the HC has stated that questions on interpretation of domestic law or tax treaties, share transfers, and BEPS, etc. that have an inter-play of TP would be considered as 'Substantial Questions of Law'.

OECD's discussion draft on Financial Transactions

The OECD on July 3, 2018 released the long-awaited discussion draft on financial transactions (Draft) under BEPS Action Plan 8-10[2] of 2015, which mandated follow-up work in this area. It is a guidance on the application of principles incorporated in 2017 edition of the OECD TP Guidelines to financial transactions. This is not a consensus document and accordingly, the OECD has invited comments to specific questions by September 7, 2018.

Key takeaways from the Draft

General

- Delineation of financial transactions should precede ascertaining of arm's length pricing.
- The transactions should be assessed beyond the contractual terms, with due consideration to be given to the full set of circumstances and the options realistically available to both the transacting parties.
- Does not prevent countries from implementing approaches to address capital structure and interest deductibility under their domestic legislation.
- It clarifies that, usually, treasury function constitutes a support service to the main value adding operations of a business.

Specific Transactions

- **Intra-group loans:** Need to consider a dual perspective (i.e. both lenders and borrowers) while undertaking an analysis of the arm's length interest rate. Further, the Draft analysis discusses three key factors that need to be evaluated for these transactions: 1) Credit Rating, which is one of the most important tool to evaluate options to ward-off high-risk borrowers. Such analysis should adjust for differences including the presence of inter-co transactions; 2) Effect of group membership - evaluates that being a member of an MNE group, the presence of the implicit group support is incidental. Therefore, it invites commentators to provide a definition of the standalone credit rating of an MNE and

[2] Aligning Transfer Pricing (TP) Outcomes with Value Creation

how to measure the impact of implicit support; and 3) Covenants, Guarantees, Loan Fees/ Charges related to the loan.

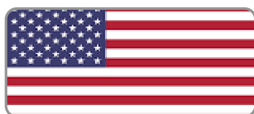
As per the Draft, the comparable uncontrolled price (CUP) method has been identified as the preferred method for determining the arm's length interest rate for such transactions. In addition to the above approach, the Draft is flexible to evaluate other methods such as return of realistic alternative transactions like bond issues and cost of funds incurred by lender in raising funds to lend. However, applicability of informal letters or rather 'bank opinions' obtained from external banks is not considered appropriate.

- **Cash Pooling:** Arrangements need to define clear synergies and the savings must be spread across all MNE's participants. It also discusses three mechanisms for sharing of cash pool synergies.
- **Hedging:** Contemplates that a centralised hedging function usually improve efficiency and effectiveness as individual entities risks are hedged at a Group level even though it may not be possible to obtain it individually. Therefore, OECD seeks specific comments from the stakeholders on dealing with such cases. It also indicates that such a centralised hedging function would be characterised as a provision of service for which an arm's length remuneration is waraanted.
- **Guarantees:** Details different types of guarantees namely, explicit, implicit and cross-border guarantees and their features. It indicates that no guarantee fee should be due in cases where there is an implicit element in an explicit guarantee as a result of financial interdependency of the MNE group resulting in no added benefit beyond the level of credit enhancement. But it does not give any solution on how to measure the impact of implicit element on the explicit guarantee such that no guarantee is due.
  Further, it suggests that CUP method is the most reliable for determining the arm's-length guarantee fee and outlines four other approaches (of yield approach, cost approach, valuation of expected loss approach and capital support method) that may be considered.
- **Captive Insurance:** As per the Draft, the first step is to determine that the transaction is genuinely one of insurance for which it has laid out indicators that are typically expected in an independent insurer. It also provides suggestions on pricing the intra-group insurance transactions while recognizing that there may be differences in capital discipline of independent insurers and captives, and this may require appropriate adjustments. In particular, it has discussed fronting arrangement and two specific scenarios of group synergy and agency sales.

Analysis

Financial transactions and issues surrounding them can be very complicated especially in a complex matrix management/ organizational structure of a MNE groups. In light of this, the Draft is a welcome relief for both the tax administrations and the tax payers since it analyses different situations and provides valuable guidance on the implication. Once finalized it would be the most comprehensive guide on this subject as it lays out OECD's perspective on dealing with the complexities and challenges linked to such transactions. Although, a number of critical areas remain open as of now but, this Draft serves as a pre-cursor to winds of change expected to blow in the future. Groups should now closely monitor developments as well as carefully understand diversity of application and interpretation by tax authorities in this area.

Other news – around the globe!

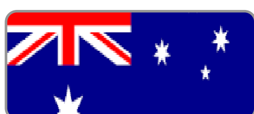


USA

- Introduced a new tax called BEAT Tax - short for the Base Erosion and Anti-Abuse Tax. Companies making cross-border payments to AEs exceeding 3% of total tax-deductible costs will have to recalculate their taxes.
- Ninth Circuit reverses Tax Court, upholds cost-sharing regulations. These regulations require related entities to share the cost of employee stock compensation in order for their cost-sharing arrangements to be classified as "qualified cost-sharing arrangements" and to avoid an IRS adjustment.
- Release on CbCR issued by IRS that covers updated jurisdiction status table showing recently signed arrangements for the exchange of CbCRs, etc.

Canada

- Releases statistics from 2017 APA program. Highlights closure of record number of cases but, increase in time for case completion.



Australia

- An exposure draft for consultation has been released by Treasury that will extend the Significant Global Entity definition, align Australia's CbCR framework with the OECD model requirements, etc.

France

- A decree (n°2018-554) issued that clarifies requirements for the content of and the format for presenting TP documentation.

Belgium

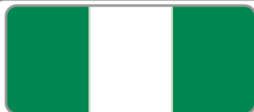
- Civil penalties to be imposed for failures to comply with the TP documentation requirements ranging from €1,250 to €25,000 established by a Royal Decree.

Poland

- Published draft legislation that would provide a new, separate chapter dedicated to TP in both the corporate income tax and individual income tax laws. Proposed to be effective from 1 January 2019.

Germany

- Releases a circular that adopts the arm's length standard for the examination of cost contribution arrangements and incorporates by reference to principles of Chapter VII of OECD's TP Guidelines.



Nigeria

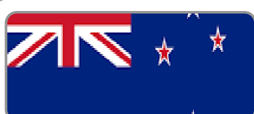
- Guidelines with respect to CbCR issued by the Federal IRS.

Curacao

- Legislative measures have been approved for purposes of implementing parts of the BEPS recommendations or actions, including TP reporting requirements.

Hong Kong

- TP legislation - in the form of Inland Revenue (Amendment) (No. 6) Bill 2017 has been passed. Most of the provisions within the Bill will have retrospective effect from year of assessment 2018/19.



New Zealand

- New tax law - Taxation (Neutralising BEPS) Act has been enacted. Among others, it covers TP aspects such as new interest rate rules for inbound related-party debt require rates generally to be based on the group credit rating, etc.

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