Communiqué – Your TP Tabloid

Issue 2 | August 2018

Foreword

Dear Readers,

Hope you enjoyed our First Edition of Communiqué – Your TP Tabloid!

In this second edition for the month of August 2018, we again see Central Board of Direct Taxes (CBDT) continue with its efforts to amend domestic framework and marching ahead with its Advance Pricing Agreement program. Transfer Pricing (TP) enters the Tax Audit Report in Form 3CD for the first time to increase compliance requirements and the issue pertaining to Advertisement, Marketing and Promotion (AMP) transactions in the Indian Courts continue to oscillate. Separately, considering changes that are occurring on a number of fronts in India, it is only fair to pause to assess how India Inc. has fared so far and the areas where it needs to expend efforts in the future as it gears to fulfil obligation to file Master File (MF) and Country-by-Country Report (CbCR) in the second round.

In the global arena also, TP makes waves with positions pertaining to exclusion of Stock Based Compensation (SBC) in the cost sharing arrangements (CSA) of Companies being viewed differently across various forums in the United States (U.S.) and several other changes taking place in TP arena in other countries. Accordingly, towards our objective of being your value added partners, we discuss the above significant events/ happenings in this issue as tabulated below:

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We hope that our publications are beneficial and help you in understanding the potential impact of the changes with respect to your business in India. We look forward to receive your contributions/ suggestions at query@nangia.com, as through a mutually inclusive process we wish to make this series your sounding board for decision on TP going forward. 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. *Happy Reading!*

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TP Disclosures now part of Form 3CD (Tax Audit Report)

The new amendments to the Tax Audit Report, as set forth in notification 33/2018[1], effective from July 20, 2018 onwards, consist of a total of six amendments to the existing clauses and nine new clauses for disclosure purposes. The changes relate to several issues such as clauses on general anti-avoidance rule (GAAR), goods and services tax (GST)[2], deemed gains and allowances u/s 32AD of the Indian Income Tax Act, 1961 (the Act), etc. With respect to TP, the following new clauses have been introduced:

S.No. of Appendix II of Form 3CD	Disclosure Requirement (Section of the Act)	Analysis
Clause 30A	Disclosure regarding secondary adjustment *(Section 92CE)*	These disclosures were expected due to amendments introduced in the Indian legislation vide Finance Act 2017. The disclosed information will equip the tax authorities to carry out preliminary assessment on taxpayer's compliance with Indian tax provisions and accordingly, select cases for detailed risk-based assessments.
Clause 30B	Disclosure on limitation on interest deduction *(Section 94B(1))*	
Clause 43	Disclosure on furnishing of report in respect of international group *(Section 286(2))*	Again expected considering the changes in the Act vide Finance Act 2018, pertaining to increased scope of Constituent Entities (CE) in India to furnish CbCR. However, it is interesting to note here that new amendments for disclosure *only* pertains to CbCR furnished u/s 286(2) of Act and *does not* include those furnished u/s 286(4). This could be because the CBDT has yet not prescribed any due date for furnishing the latter. CE falling u/s 286(4) should therefore, expect another amendment in Form 3CD as soon as the dates are prescribed. Another important point to consider is that with such a clause added in the Tax Audit Report, MNEs will have to determine the name of the entity that will be filing the CbCR by the due date of Tax Audit Report[3].

Analysis

The tax audit report is a relatively important form as it compiles key information which impacts determination of taxable income of an assessee, ascertaining any penalties for non-compliance of any provisions, etc. Accordingly, the amendments are imperative as they will equip the tax department to analyse data filed by companies with different departments in a synchronized manner in order to detect discrepancies and leakages in the system, thereby, leading to detailed scrutiny. So, it is vital for taxpayers to take a comprehensive view while filing data with Indian Tax Authorities, especially in the amended tax audit form.

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[1] https://www.incometaxindia.gov.in/communications/notification/notification-33-2018.pdf

[2] The CBDT has put off the proposed GST and GAAR reporting under the amended tax audit form until March 31, 2019. This dispensation would be available for tax audit reports to be furnished on or after August 20 but before April 1, 2019.

[3] As per the Act, this is required to be filed by the parent entity or alternate reporting entity - 12 months from the end of reporting accounting year in respect of which the financial and operational results are required to be reflected in the report. For example, for FY 2017-18, if the reporting accounting year of the parent entity/ alternate reporting entity resident in India is 31 March 2018, then in an ideal situation, the due date for filing of CbCR u/s 286(2) of the Act is 31 March 2019. However, with the amendments in Form 3CD, the due date for disclosure of information on CbCR u/s 286(2) in Form 3CD for FY 2017-18 would get preponed to 30 November 2018.

INDIA

CBDT signs first Bilateral-APA with Switzerland

On August 3, 2018, CBDT has officialised its first bilateral APA with Switzerland. Another reason this is important is because the two nations signed a consensus APA on the royalty model for trademarks, technology and strategic functions by application of Residual Profit Split Method. Thus, this bilateral APA showcases that India has a matured APA program which can handle and resolve complex issues in its negotiations such as determination of royalty income involving numerous intangibles, which otherwise have always been a matter of protracted litigation with the Tax authorities in India.

According to the press release by CBDT on August 1, 2018, the total number of APAs signed stand at the count of 232, which includes 20 bilateral APAs.

CbCR's: The development so far…

The compliance requirement mandated by the global Base Erosion and Profit Shifting (BEPS) project of the OECD enters into its second year of filing for international businesses in India. This compliance requires businesses to provide MF and CbCR that breaks down key elements of their financial statements by jurisdiction other than local files. So, recently, Nitin Narang, Partner, International Tax and TP in an interview with ETCFO, discussed the progress so far on this front, challenges ahead for the MNEs as they gear up for filings and how it is important that companies look at control frameworks in connection to data sources, formats and content that is delivered digitally to various government agencies world over. *Click here to read full article.*

ITAT ruling on AMP – Another twist in the tale!

In a recent ruling, Delhi ITAT deleted AMP adjustment in the case of Sony Mobile Communications Vs CIT[4]. The case was restored by the Hon'ble High Court (HC), which laid down some landmark guidelines on following issues:

- **Brand Building Vs Brand Maintenance:** The ITAT opined that incurring expenditure in the domestic market could not have added any value to the brand name of the associated enterprise (AE), who was in fact undertaking global sales and distribution of the product. Further, aggressive advertising was necessitated, being the first year of business for the Assessee. The expenditure incurred was therefore, considered to be for *brand maintenance* rather than *brand building*.

- **Service Fee Vs Return:** For the determination of compensation on AMP expenses, the ITAT relied upon the Organisation of Economic Cooperation and Development (OECD) Guidelines, Para 6.37, which suggested that a service fee is sufficient to compensate the distributor appropriately for its agency activities and not provide it with a return on marketing intangibles. However, if the distributor (who is not the legal owner) bears the cost of marketing activities, the arm's length returns to share the potential benefits of such activities will depend on the "substance of the rights of that party". In light of this principle and facts of the case, the ITAT, concluded that *"it is merely a presumption that the assessee has incurred some extra-ordinary expense in excess of the normal routine expenses and should have been compensated by the AE."*

- **Benefit Test:** Based on the functional analysis con ducted and the OECD Guidelines, the ITAT concluded that the expenditure incurred was not for the benefit of the AE but for the Assessee's business itself.

- **Benchmarking approach to determine compensation:** The ITAT has stated that even if AMP expenses result in a separate international transaction and evaluated under the segregated approach, the *"excessive profit derived by benchmarking of distribution segment should be adjusted with alleged excessive AMP expenditure thereby*

[4] ITA No. 6410/DEL/2012

providing benefit of set off." However, in the present case, the ITAT did not delve into the question of bundled approach vs segregated approach. It held the segregated approach to be incorrect as the Transfer Pricing Officer (TPO) had already accepted the comparable under bundled approach to evaluate the AMP expenses related transaction:

Analysis

Issue of AMP resulting in creation of marketing intangibles is a highly litigated one in India. So, far there has not been any consensus adjudication on any single approach. The above ITAT decision is a welcoming decision for the taxpayers as it elucidates the approach of the tax authorities to focus more on ascertaining the ***real nature of the relationship*** between the Indian subsidiary and its AE. Overall, it needs to be appreciated that this issue is highly fact-sensitive and accordingly, it would not be feasible for the courts to be able to enunciate any straight-jacket formula with mathematical precision to determine the arm's length price (ALP) relating to AMP expenses. The tug of war thus continues.

Other Case Laws

Case Law	Summary
ITAT deletes secondary adjustment for Prudential Process Management Services India Private Limited[5]	The matter pertains to deletion of adjustment for AY 2011-12 & AY 2012-13 made by the TPO on account of interest relating to sale of business by the Assessee by stating *"that the concept of secondary expenditure is not expressly provided in the Chapter X of the Act."* It further opined that the *"mandate of the chapter in the Act requires the TPO to compute the ALP of the international transaction. There is nothing further provided to impute any secondary adjustment."*
Constitutional Validity Challenged before Madras High court (HC) of the proviso u/s 94B (Interest Deduction Limitation)	Siemens Gamesa Renewable Power Pvt. Ltd. (Petitioner) has filed a writ petition[6] before the HC contending that the proviso[7] of the Section 94B(1) of the Act be struck down as no BEPS is being created in such cases. It has raised objections on the following grounds: • True intention of the provision is to reduce thin capitalization and not to penalise companies from merely being associated with another enterprise; • Citing Article 14 and 19 of the Constitution[8], it contends that that a similarly placed company with more loans than that of a company falling within the challenged proviso would enjoy a lesser tax burden comparatively; • Banks usually prefer guarantees from AEs to hedge their exposure to risk of default; • CBDT has not clarified whether the word lender means non-resident or resident lender; and • CBDT should specify the computational basis of arriving at EBITDA. ***A notice has been issued to the Revenue for which a response is awaited on the matter.***
ITAT Rejects Resale Price Method (RPM), Upholds Transactional Net Margin Method (TNMM) as the Most Appropriate	The ITAT upheld the TPO's TNMM as the MAM and rejected RPM for benchmarking the international transactions relating to distribution of books, software, electronic products, as well as reprinting of books and publication on the basis that *"reprinting of books needs deployment of assets,*

[5] I.T.A. No. 5526/Mum/2015 *[The ITAT in its ruling implicitly followed the second proviso of Section 92CE of the Act the Act introduced vide Finance Act 2017, which make secondary adjustment applicable for AY 2016-17 or later]*

[6] Writ Misc. Petition 22874 of 2018

[7] **94B.** *(1) Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, incurs any expenditure by way of interest or of similar nature exceeding one crore rupees which is deductible in computing income chargeable under the head "Profits and gains of business or profession" in respect of any debt issued by a non-resident, being an associated enterprise of such borrower, the interest shall not be deductible in computation of income under the said head to the extent that it arises from excess interest, as specified in sub-section (2) :*
Provided *that where the debt is issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, such debt shall be deemed to have been issued by an associated enterprise.*

[8] Providing for equality of the law for all and freedom of speech and expression, respectively

Case Law	Summary
Method (MAM) for books reprinting & distribution[9]	*employment of employees and risk involved in publishing and selling and therefore, the parameters as required for resale method are not applicable as other value addition and application of technology and assets were made by the assessee for the purpose of reprinting, publishing etc."*
Mumbai ITAT rejects the Revenue's plea for a higher arm's length margin as agreed under the APA for AY 2010-11 to AY under consideration (i.e., AY 2009-10) [10]	Relying upon the provisions under Rule 10MA(iv)(2) of the Income Tax Rules, 1962, the Mumbai ITAT rejected the plea of the Revenue to consider a higher margin which was agreed under an APA by the Assessee for AY 2010-11. The Assessee did not request for a roll-back during the APA proceedings. The ITAT held this to be a necessary requirement for the APA agreed margin to apply in a roll-back year during APA proceeding but not for cases under normal litigation.

Ninth Circuit Withdraws Altera Opinion; Case to be Reassessed

On August 7, 2018, the Ninth Circuit Court of Appeals (Ninth Circuit) withdrew its unanimous 2-1 decision reached on July 24, 2018[11] in the case of *Altera v. Commissioner* due to passing away of one of the judges shortly after reaching the decision, expediting a de-novo review of the case. The original decision overturned the Tax Court's decision regarding the exclusion of Stock Based Compensation (SBC) in their cost sharing arrangements (CSA) with AEs.

Background

Altera Corporation & Subsidiaries (Altera) was under a CSA with its subsidiary in Cayman Islands to share research & development costs. The issue pertained to whether the SBC costs should be included in the calculation of costs paid to Altera by the subsidiary, as argued by the IRS, relying upon the 2003 cost sharing regulations that requires SBC to be included in the allocation of costs in a qualified CSA. Against this approach, Altera argued that the 2003 regulations were invalid, as IRS did not follow the procedural requirements of the Administrative Procedure Act (APA) when the law was promulgated. Further, Altera argued that in a traditional analysis under arm's length standard (ALS), unrelated parties would not usually share the cost of employee stock options.

The Tax Court held that the 2003 regulations were *'arbitrary'* and *'capricious'* for failing to meet the standards established by APA. It further opined that unrelated parties would never share the cost of SBC with each other, based on the evidence presented before it, thus, rendering the contention of the treasury invalid.

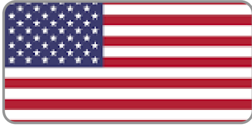
The case then moved to the Ninth Circuit for adjudication which in a majority decision reversed the Tax Court Order. The Ninth circuit held the 2003 regulations to be valid and binding post a detailed APA review. On the second matter related to analysis under ALS, the court relied on the 1986 amendment to Section 482 opining that the intention of the amendment was to ensure that income follows economic activity and as long as cost and income are allocated proportionately with the economic activity of the related parties, dispensation from comparability analysis was appropriate.

Analysis

The Tax Court's original decision stands upheld until a new decision is issued by Ninth Court. If the Ninth Circuit reiterates its withdrawn decision, it will impact how the Tax Court deals with future rulemaking challenges where APA standards are not followed by the IRS. Further, it will directly impact any service transaction where compensation is on a cost-plus markup basis. Hence, the taxpayers will have to re-assess their financial reporting position if the withdrawn decision is upheld post a de-novo review. Nevertheless, the decision gives enough impetus to Tax Authorities around the world to approach such issues and rigorously review cost base of companies.

[9] ITA No. 5926/DEL/2010 & ITA No. 1843/DEL/2010
[10] I.T.A. No. 1682/Mum/2014 & I.T.A. No. 1738/Mum/2014 (Assessment Year 2009-10)
[11] http://cdn.ca9.uscourts.gov/datastore/opinions/2018/07/24/16-70496.pdf

Other news – around the globe!



USA

- US IRS publishes new guide on TP examinations. This is a guide to best practices and processes to assist with the planning, execution and resolution of transfer pricing examinations.
- The Court of Appeals for the Eighth Circuit on August 16, 2018 remanded the Medtronic case back to the U.S. Tax Court as facts did not substantiate the TP method for intercompany license royalties. This can have significant consequences for companies like Facebook and Coke currently in appeal on similar issue for years.

Russia

- Russia amends TP rules to provide dispensation to a significant number of domestic transactions from the TP rules. Under the amendment, only transactions between domestic Russian companies that apply different tax rates on profits or special tax regimes will be subject to the rules, subject to the income from those transactions exceeds 1 billion Rubles per year.

Hong Kong

- The Hong Kong government passed the legislation to implement a BEPS and TP tax regulatory regime, mandating the use of the ALP in the pricing of intra-group cross-border transactions including adopting the OECD's CbCR, Master File and Local file documentation requirements.

Mexico

- The Mexican tax authorities issued a second resolution of modifications supplementing the 2018 Miscellaneous Tax Resolution (MTR) wherein rules regarding TP adjustments were amended and additional provisions were introduced.

Australia

- The Australian Tax Authority (ATO) has recently issued a Draft Schedule 2 to Practical Compliance Guideline (PCG) 2017/1 - **'ATO compliance approach to TP issues related to centralized operating models involving procurement, marketing, sales and distribution functions.'**; helping taxpayers in self-assessing their TP risks associated with certain purchases, financial arrangements.

Thailand

- The Thai government submitted a draft of law amending the Revenue Code on TP to the National Legislative Assembly for consideration which would become effective for the accounting periods starting 1 January 2019 mandating taxpayers breaching a certain income threshold to disclose relationships with all related parties including related party transactions.

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