

Foreword

Tax and finance have been very much in the news lately. In July, the Finance Bill 2019 was presented by Modi Government 2.0, and now the new Direct Tax Code is under review. Discussions around economic growth, automobile industry downturn, fiscal deficit, bank credits, etc. are common.

As regards the Indian transfer pricing (TP) regulations, the Finance Bill 2019 (FB 2019) included amendments to rationalise and clarify the existing TP provisions. The Central Board of Direct Taxes (CBDT) has proposed changes in the draft policy for profit attribution to Permanent Establishment (PE). The litigation matters continued in the same vein and has resulted in some significant judgements. In the Global arena, United Nations has issued its draft report on Financial Transactions (FT); China has published its 10th Advance Pricing Arrangement (APA) Annual Report (AR); Singapore has published TP guidelines on commodity marketing and trading activities apart from regulatory updates in other countries around the world; to name a few. Accordingly, towards our objective of being your value-added partners, we discuss the above significant events/ happenings in this quarterly issue as tabulated below:

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We hope that our publications are beneficial and help you in understanding the potential impact (if any) of the changes with respect to your business in India. We look forward to your suggestions or feedback that you would like to share with us, at query@nangia.com. 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, especially on litigation matters.

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Budget 2019 - TP - Inching Closer to Global Standards?

The FB 2019 under Modi Government 2.0 was presented under the overhanging challenges of slower economic growth, declining tax collections, ways to attract more investments into the country, giving a boost to industries, etc. to fuel the growth. Batting on a sticky wicket, the Finance Minister (FM), in her maiden budget, has craftily articulated various measures in the FB to revive the confidence of manufacturing sectors, financial institutions and investors, focus on Start-up India, MSME & Digital India, Electric Vehicles, etc.

Amidst all the amendments in the FB, there have been some welcome clarifications/ amendment on the TPR. This budget is another example of the keenness of this Modi Government on not to lose momentum and staying close of the realities on the ground.

The FB has received Presidential assent on August 1, 2019. To read more about the TP centric aspects of the FB that have now been enacted, kindly refer to our article dated July 8, 2019 published on the Taxsutra website. The link for the same is provided below:

<https://tp.taxsutra.com/experts/column?sid=504>

CBDT Invites Public Comments on the Proposal for Amendment of Rules for Profit Attribution to PE

Attribution of profit for taxing the income of a foreign enterprise as attributable to its PE in India has always been complex in absence of specific rules or formula.

The methodology specified in the Rule 10 is very wide and incorporates methods which involves a lot of discretion. Thus, there arises lack of uniformity in the approach of the tax officers and appellate authorities in different cases. Considering the significance of the issue in respect of profit attribution, a committee was formed to examine the existing scheme of profit

attribution to PE under Article 7 of the DTAA and recommend changes in Rule 10 to achieve greater clarity and predictability in this regard.

On 18 April 2019, the committee submitted its report seeking public comments on the recommendations made by it. To read the discussions and recommendations of the committee in detail, kindly refer our News Flash at link below:

<https://www.nangia.com/wp-content/uploads/2019/04/NEWSFLASH - Volume-115.pdf>

TP Implications of Transition from LIBOR to New World Order - An Analysis

On 27 July 2017, Andrew Bailey, the chief executive of the UK's Financial Conduct Authority (FCA) had announced that market participants should not rely on London Interbank Offered Rate (LIBOR) being available after 2021 as FCA will not persuade LIBOR panel banks to continue to submit quotes after 2021. Accordingly, FCA gave a clear global direction for adoption of Alternative Reference Rates (ARRs).

Though India witnessed spate of rulings wherein LIBOR had been considered for benchmarking of many such transactions to reach to an arm's length consideration, this certainty is short-lived with the impending discontinuation of LIBOR. In the new world order, organisations will need to identify the affected contracts and renegotiate the terms with their counterparties to transition the base rate from LIBOR to an ARR. Moreover, certain Indian TP provisions such as Safe Harbour Rules & Secondary Adjustment would need to be amended with reference to LIBOR.

In this regard, we have discussed the key TP implications triggered by this change and the allied next steps like identification and renegotiations of contracts maturing beyond 2021 etc. in an article published on May 14, 2019 on Taxsutra website. To read the full article, follow the link:

<https://tp.taxsutra.com/experts/column?sid=493>

Applicability of TPR to Special Tax Provisions

- ***ACIT vs. Max New York Life Insurance Company Ltd - ITA No.1768/Del/2011***

Delhi Income Tax Appellate Tribunal (ITAT) ruled that TPR are applicable to the income computation of insurance business based on special provisions contained in Section 44 of Income Tax Act, 1961 (the Act) read with First Schedule. Referring to the non-obstante clause in Section 44 of the Act, ITAT stated that Section 44 of the Act supersedes only certain specified provisions and not Section 92 of the Act and thereby concluded that TPR under Section 92 of the Act not being specifically excluded from the purview of Section 44 of the Act would apply additionally in cases where the special computational provisions of Section 44 of the Act are applicable.

- ***Van Oord India Private Limited vs ACIT - ITA No. 7228/Mum/2012***

Mumbai ITAT opines that Tonnage Taxation Scheme (TTS) under Chapter XII-G of the Act is a separate code by itself comprising a self-contained charging provision and specific method of computation of income as well. Moreover, the income of a tonnage tax company is computed disregarding the actual revenue realizations and the expenditure incurred and the computation is based on the tonnage capacity of the qualifying ships and the number of days for which it has been held. Thus, ITAT held that TPR do not apply where the income is taxed under TTS.

Nangia's Take

In light of above discussion, the ITAT finding helps to draw following fundamentals for consideration on the applicability of TPR in case special tax provisions apply on a taxpayer:

- The overriding coverage of the non-obstante clause of the particular presumptive tax-

based Section under consideration (as explained above); and

- Whether the income computation using the prescribed presumptive taxation method of an international transaction is impacted by the actual transaction value. For example, Section 44B of the Act presumes a 7.5% profit on the gross receipts of freight for carriage of goods. In this case, TPR would be applicable only if the 'receipts' side of the entity can be recognized as an international transaction. The 'expenses' side, not having any bearing on profits in this case would not be covered by the provisions of Section 92 of the Act.

Having said the above, if Section 92 of the Act does not specifically exclude, then filing of the Form 3CEB and maintaining of TP Report for such transaction remains mandatory as per the Act.

Whether cash profit can be adopted as PLI under TNMM ?

- ***INA Bearings India Private Limited vs ITAT- ITA No.148/PUN/2017***

Pune ITAT rejects the Assessee's claim for adoption of PBDIT/ Sales as its PLI under the TNMM method and upholds PBIT as numerator in the PLI. Referring to the judgement of DIT (IT) Vs. Morgan Stanley & Company). The ITAT opines that one cannot fetch sales revenue or run business operations without the usage of assets, the wear and tear of which results in depreciation, this makes depreciation an inevitable part of the operating profits. It further held that the depreciation adjustment is considered only when there is a difference on account of different rates of depreciation and not different quantum of depreciation. Basis this, it was concluded that cash profits could not be considered as PLI.

- ***Snecma HAL Aerospace Pvt Ltd vs ITAT-IT(TP)A No.432/Bang/2015***

Bangalore ITAT held that in case of substantial variation in the manner of charging depreciation by the Assessee and the comparable companies, the cash profits may be considered for PLI computation. However, ITAT also emphasised that the onus is with Assessee to furnish the details to prove that there is substantial variation.

Nangia's Take

Prima facie, the above judgements seems to be very fair specific and taken basis the circumstantial evidence and comparables available for analysis. The first case revolves around adoption of cash PLI due to significant difference in quantum of depreciation (where cash PLI is rejected by ITAT) whilst the other seeks cash PLI due to substantial variation in the methodology of charging depreciation (where cash PLI is accepted by ITAT). Accordingly, the essence is that for allowance of any claim for adjustment, it is imperative that the claim by a taxpayer is duly substantiated by the underlying facts and demonstrated through sufficient documentary evidence. An in-depth analysis of the comparables is also a must before an approach can be adopted.

Other Significant Rulings in India

Key findings of certain rulings during this quarter are summarized as below:

Specified Domestic Transaction (SDT) of inter-unit transfers to be compared at entity level under TNMM (Sheela Foams Ltd vs. ACIT - ITA No.8155/Del/2018)

Delhi ITAT inter alia rules on comparability at entity level vs unit level for TP adjustments on SDT of inter-unit transfer of raw materials by Assessee [eligible for deduction under Section u/s. 80IC of the Act on one of its units]. The assessee pleaded to consider margin of only eligible units of comparable companies (instead of margins of the comparable entity as a whole) with the margin of the eligible unit of the Assessee. ITAT rejected the plea as opined that such

a comparison will not be an independent uncontrolled transaction and being related party transactions, they cannot be considered for comparison with the SDT carried out by the Assessee.

Dispute Resolution Panel's ("DRP's") jurisdiction to direct the Assessing Officer ("AO")/ TP Officer ("TPO") to make further enquiries and decide the matter (India Trimmings Pvt Ltd vs DCIT - Tax Case No. No. 118/2018)

Madras HC adjudicates on DRP's jurisdiction and sets aside ITAT order holding that DRP had no power/ authority under Section 144C of the Act to direct TPO to decide the percentage of risk adjustment to be calculated. Further, HC points out that Revenue did not argue DRP's jurisdiction and plead against the final assessment order passed u/s 144C(13) of the Act r.w.s. 143(3) of the Act. HC notes that DRP via its directions reduced the variation proposed in draft assessment order and accordingly, HC concludes that "Tribunal was required to consider on merits whether the said assessment order was justified or not...rather than allowing the appeal filed by the Revenue in its entirety".

Memorandum entries for charter-hire reimbursement to comprise an 'international transaction' (Synefra Engineering & Construction Ltd (now known as Aspen Infrastructures Limited) vs. ACIT - ITA No. 1368/Ahd/2013)

Ahmedabad ITAT holds that the memorandum entries for reimbursement of charter hire, bunker charges by Assessee to AE comprise an 'international transaction'. The ITAT opines that when an Assessee enters into a time charter contract, and instead of using the vessel on his own, allows an AE to use the vessel on the same terms (including the price) on which the Assessee has contracted, generally such an arrangement has an impact on profit and losses of the Assessee. The order further elucidates that actual earning of profits or incurring of losses in a transaction is not a sine qua non for transaction being treated as 'international transaction', "having the bearing" profit and losses is sufficient for the transaction being treated as international transaction. However, it pointed that ALP adjustment could at best be for the functions performed i.e. negotiation of contract and therefore it would be wholly unreasonable to assign 7.5% profit for a small function while entire estimate profit of operation of ships by the foreign companies is 7.5% under the

presumptive taxation scheme under Section 172 of the Act.

Application of international borrowing rate over AE loan rate for working capital adjustment (“WCA”) computation (DCIT vs Emami Limited - ITA No. 873/Kol/2017)

Kolkata ITAT upholds CIT(A)’s order in favour of the Assessee. ITAT notes that postulating the extended blockage of working capital funds of the Assessee due to significantly excess credit period allowed to the AEs in comparison to non-AEs, TPO made the WCA. ITAT observed that the exports made to the AEs & non-AEs were denominated in foreign currency and hence, opined that it would only be appropriate to work out the WCA against the relevant currency denominated LIBOR rate as opposed to the interest rate charged on the loans advanced to the AEs. Further, ITAT upheld that the base for WCA has to be the same as the base of the PLI.

‘Nature of services’ overrides ‘nomenclature’ to decide upon comparability, ITAT rejects Profit Split Method (PSM) in absence of unique intangibles/interrelated transactions; (Synergy Maritime Pvt. Ltd vs. DCIT – ITA No. 2825/CHNY/ 2017)

Chennai ITAT accepts internal Comparable Uncontrolled Price Method (CUP Method) applied by Assessee for determination of ALP of provision of vessel management services to its AEs; Regardless of agreement’s reference to Assessee as an ‘Agent’, ITAT approves third party rendering similar services to AE in the capacity of ‘Manager’ as internal comparable basis the similarity in the underlying nature of services.

Noting that TPO had split the revenue between Assessee and AE based on Section 44C of the Act where TPO classified AE’s functions to be head-quarter functions, ITAT observes that AE’s activity of procuring orders by liaising with ship owners is a core and crucial activity and not a mere executive or general administrative activity to be categorized as head office function covered u/s 44C of the Act. Further states that application of PSM can be done only using the prescribed method under Rule 10B(1)(d) of the Act. Also throws light of Circular No. 2/2013 which states that where information for

application of PSM was not available, TPO could consider TNMM or CUP Method as Most Appropriate Method (“MAM”). Further, states that in the absence of unique intangibles or finding on multiple interrelated international transactions between the Assessee and AE, there was no scope for adopting PSM as the MAM for arriving at ALP.

‘TP comparability issues’ – Substantial Question of Law or mere facts? (Pyramid IT Consulting P Ltd vs Addl. CIT – W.P.(C) 5198/2019/ ITA 1289/2018)

Delhi HC acknowledges Assessee’s writ petition opposed to ITAT order retaining HCCA business services as comparable in its staffing segment. It abandons revenue’s stand that mere exclusion or inclusion of a comparable for the purposes of TP adjustment does not give rise to any substantial question of law¹. In the present scenario, HC found perversity in the order of ITAT that upheld inclusion of HCCA on ground of ownership of intangibles as ITAT failed to justify its earlier decision (LG Chemical India Pvt. Ltd vs. ACIT - ITA No.1819/Del/2015) wherein HCCA was excluded on the basis that a company owning intangibles cannot be compared with one which does not. Further, HC stated that ITAT seems to have neglected Assessee’s objection regarding inclusion of HCCA on ground of functional dissimilarity. Accordingly, HC admitted the issue as question of law and remanded the entire issue of determining the TP adjustment to the TPO for a fresh determination.

GLOBAL UPDATES

Singapore publishes TP guidelines on commodity marketing and trading activities

On 24 May 2019, Inland Revenue Authority of Singapore (IRAS) published TP guidelines for taxpayers dealing in commodity marketing or trading activities. The new e-tax guide analyses the economic value of taxpayers’ commodity marketing and trading activities in Singapore and assists taxpayers in complying with the arm’s length principle and TP documentation requirement in case of activities carried out with

¹ Principles on similar issues were laid down by Karnataka HC in case of Pr.CIT vs. Softbrands India P. Ltd (ITA No. 536/2015) [Kindly refer page 3 of our TP Communique for

July 2018 to read the facts and findings of Softbrands ruling in detail - https://www.nangia.com/wp-content/uploads/2018/08/NA_-_TP-Comminque_-_Issue-1.pdf

related parties. The guide states that commodity marketing/ trading entities undertake a wide spectrum of activities with different levels of intensity involving complex value chain, covering origination, sourcing, refining, processing, storage, shipping, etc. They may carry different levels of assets, such as inventory, working capital and intangibles (e.g., customer relationships and deep market knowledge). They may bear varying types and extent of risks. Their level of functions, assets and risks would depend on the commodity that they deal in and the specific market characteristics for that commodity; this would define the entities' value contribution and the corresponding remuneration.

The guidelines are an extension to the Singapore TP Guidelines OECD TP Pricing Guidelines for Multinational Enterprises and Tax Administrations which aims to align Singapore regulations with OECD TP Guidelines for Multinational Enterprises and Tax Administrations. It also emphasizes to avoid/ resolve double taxation TP disputes through MAP or APA (for future years). The illustrations on economic value of commodity marketing or trading activities can be accessed in e-tax guide at the link below:

https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/eTax_Guides/etaxguide_CIT_Commodity%20activities.pdf

UN issued Discussion Draft on FT

The UN issued discussion draft on FT supplementing last year's OECD draft proposals on FTs with minor differences and similarities sharing the similar goal of tackling tax issues.

The draft discusses the importance of intra-group FTs within multinational groups and how these transactions may lead to base erosion. The draft focuses primarily on intra-group loans and guarantees for non-financial companies.

Broadly, it deals with the following:

- Common types of intragroup FTs, contractual terms of agreements, functional profile of

the parties and characteristics of financial products;

- The process of actual delineation and relevant characteristics of FTs by recharacterisation of intra group loans to tackle base erosion through excessive debt;
- The process and system of credit rating;
- Potential TP methods, including the use of simplification measures/ safe harbors; and
- Different types of intra-group loans as well as guarantees and determining their arms' length nature by following four step analysis.

A detailed insight on the UN draft guidance on FTs can be accessed at the below link:

<https://www.nangia.com/un-draft-guidance-on-financial-transactions-a-welcome-move-nitin-narang/>

China APA Update

China has published its 10th APA AR 2018 covering period from 1 January 2005 to 31 December 2018 with total count of 156 APAs (89 unilateral and 67 bilateral) signed during this 14 year period. The addition in the APA count vis-à-vis ninth APA AR with cumulative total of 147 APAs, still pertains to the manufacturing industry, with ~84% of the total signed APAs involving manufacturing industry. During 2018, 2 unilateral APAs and 7 bilateral APAs (out of which 5 were with Asian countries) were signed. According to 2018 AR, *'APA request will arise against the backdrop of concern about uncertainty drawn out by the universal implementation of Base Erosion and Profit Shifting (BEPS) projects and the increased TP scrutiny by tax administrations'*. This coupled with Chinese authorities' increased efforts on MAP meetings shows its commitment on resolving double taxation issues. The detailed APA AR 2018 can be accessed at link below:

<http://www.chinatax.gov.cn/n810214/n810606/c4244610/part/4246243.pdf>

Rulings across the globe

Spanish Appeals Court Rules on IKEA TP adjustment

The Spanish Court of Appeal (the Court) passed final ruling on March 6, 2019 involving TP adjustment of € 37 million in case IKEA's Spanish subsidiary (engaged in wholesale distribution of furniture and household appliances to related party retail companies, wherein TNMM was applied for testing); considering that the taxable profit in years 2007, 2008, and 2009 were not determined in accordance with the arm's length principle.

Key Highlights

- With respect to 2007 where the margins deviated from the interquartile range, the Court held that profits should be adjusted to the lower quartile instead of the median, as argued by lower tax administration.
- With respect to the years 2008 and 2009, wherein the taxable profits were within the interquartile range but below the median, the Court upheld in favour of taxpayer and deleted the TP adjustment. The Court upheld that an adjustment to the median should be made in case there exists any comparability defects.
- The Court in line with OECD's TP Guidelines relied upon the appropriate use of multiyear (i.e. 3 year) analysis for purposes of determining the arm's length range of profitability while applying TNMM. ○

For more details refer the below link:

<https://mnetax.com/spanish-appeals-court-rules-on-ikea-subsidiarys-approach-to-transfer-pricing-comparability-arms-length-range-34481>

Other News – Around The Globe!



Australia

- The Australian Taxation Office (ATO) issued draft ruling for the application of arm's length debt test (ALDT) in the thin capitalisation rules on retrospective basis, to bring consistency in the way rules are applied in practice. The ATO has invited public comments on draft ruling till 2 August 2019.



Poland

- Poland proposes draft "simplified APA" (apart from standard APA) procedures on unilateral basis for low value-added services or fees for right to use trademark or technical know-how transactions. 'Simplified APA' would be completed within three months of the applications, with applicability for maximum period of 3 years and renewal for next 3 years (provided no change in the functional profile of the taxpayer).



New Zealand

- On 29 April 2019, the lawmakers published TP guidance to align with the OECD BEPS. The guidance covers special TP interest limits for controlled inbound financing; various amendments to the TP provisions; administrative measures (i.e. enhanced powers to collect information and tax from large MNEs with global consolidated annual revenues exceeding EUR 750 million); and collection of taxes owed by a nonresident member of a large MNE from another New Zealand resident wholly-owned group entity.



Argentina

- Argentina passed resolution dated 27 May 2019 for single due data for various TP forms and TP documentation i.e. first week of the eighth month following the close of the tax year. No changes for deadlines concerning CbCR compliances.



Belgium

- Belgium reduced the compliance burden for entities required to file CbCR notification form. The said form is only required to be filed in subsequent period in case there is any change in the information filed for the previous reporting year.



Peru

- Peru issued TP guidance on undervalued transfer of Peruvian entity shares to foreign related parties. The guidance states that in case of undervalued transfer, the cost of acquirer's shares will have acquisition price and TP adjustment, if any, which would also affect the income tax of the issuer.



Belarus

- Belarus has introduced new TP measures effective beginning 2019 with changes made to definition/ determination of related parties, transaction thresholds, requirement to submit TP documentation, APA options for “major transactions”, etc. The new rules have revoked the 20% acceptable deviation from fair market prices that were applicable in earlier TP rules since 2016.



Cyprus

- Cyprus has drafted a bill to address TP issue involving high prices charged for intra group transaction by exploiting low tax rate applicable in transacting country. The bill aims to align the country’s TP legislation with the OECD Guidelines.



Panama

- On 27 May 2019, Panama issued legislative requirement for CbCR in Panama in line with BEPS Action Plan 13 requirements i.e. applicable for consolidated group revenue of MNE greater than €750 million in previous financial year. The rules state that the information contained in CbCR shall only be used for TP risk assessment and not for TP adjustments.



OECD (general)

- On 18 June 2019, the OECD released new TP country profiles for Chile, Finland and Italy, taking the total number of countries covered to 55. These country profiles reflect the current state of legislation and practice in each country regarding the application of the arm’s length principle and other key TP aspects including to what extent the specific national rules follow the OECD TP Guidelines.



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