

# EMERGING TRENDS IN TRANSFER PRICING

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# 1. RECENT TRANSFER PRICING AUDIT CONTROVERSIES

# SHARE-BASED PAYMENTS / COMPENSATION

# CASE STUDY

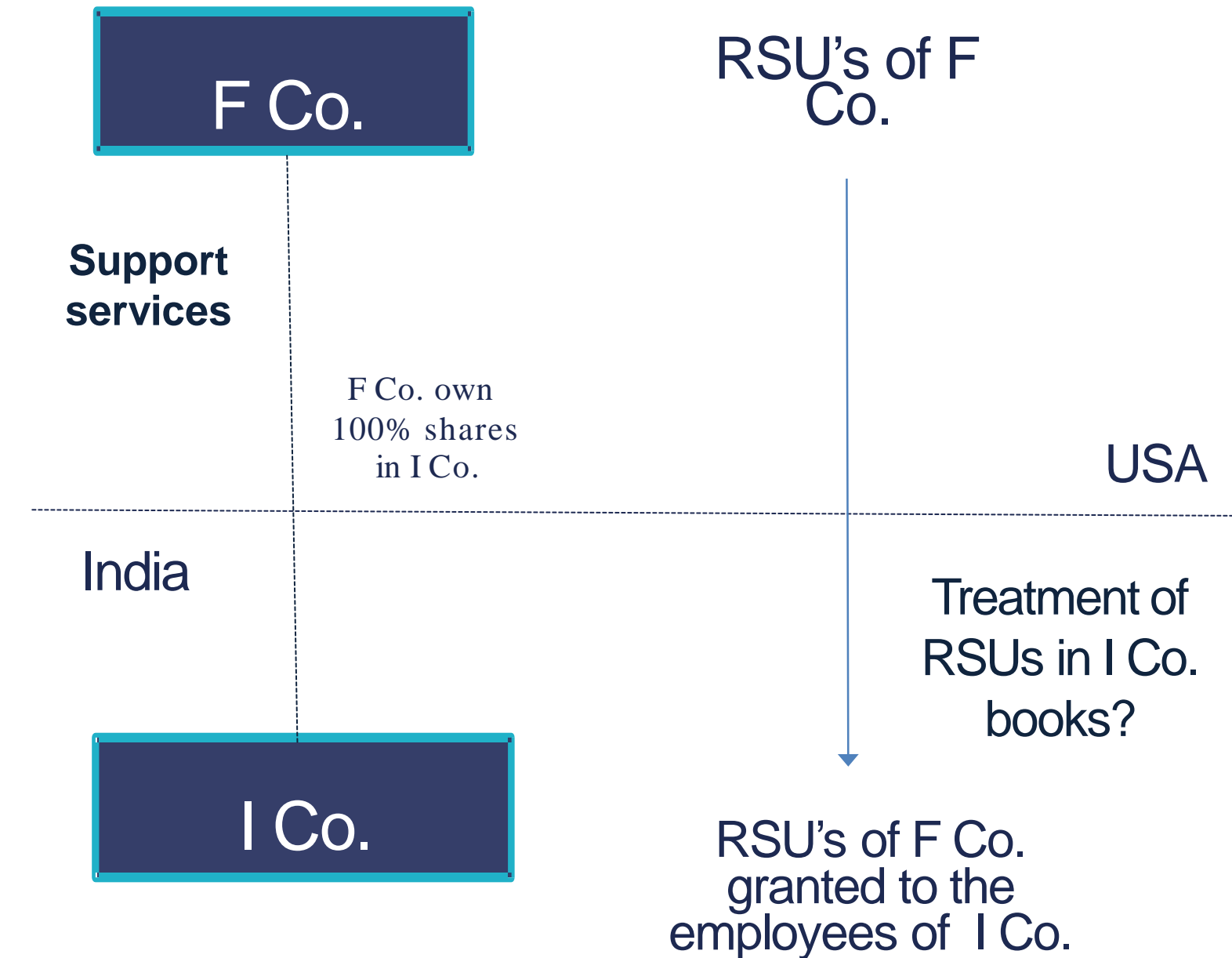
## Background

- F Co., a US listed company and the ultimate parent co. of the group offers share-based compensation plan, under which it offers Restricted Stock Units (RSUs) to the employees.
- The employees of I Co. (a subsidiary of F Co.), are eligible to participate in the share-based compensation plan offered by F Co. and receive the RSUs which is subject to certain vesting conditions.
- I Co. provides software development and other support services to F Co., for which it charges cost plus profit markup to F Co.

## Issue

What will be the treatment of RSU's granted to I Co. employees in the books of I Co. books in the following situations:

- The cost of RSUs is cross-charged by F Co. to I Co.
- The cost of RSUs is not cross-charged by F Co. to I Co.



ECONOMIC CHARACTERISATION  
ISSUES / QUESTIONS AROUND  
FUNCTIONAL PROFILE

# CASE STUDY – ASSEMBLY VS MANUFACTURING

## **Background**

- A Co. (an Indian Company), undertakes basic customization of products purchased from its Associated Enterprise (AE) (for ex., assembly of multiple products ) per the customer specifications, and is primarily engaged in sale of such products to **third party customers** in India.
- A Co. had carried out aggregated benchmarking for its assembly and trading functions.

## **TPO's contention:**

- TPO in India disregarded the aggregated benchmarking for assembly and sales functions and carried out separate benchmarking by recharacterizing assembly functions as 'manufacturing function'.

## **Assessee's contention:**

- Since, both function of the assembly and trading functions were highly integrated, the benchmarking using TNMM aggregating both functions was correct approach.

# FINANCIAL TRANSACTIONS

# CASE STUDY

## Background

- A Co. (a US Co.) and B Co. (an Indian Co.) are AEs.
- B Co. availed loan from A Co.
  - Date of taking the loan: 01 January 2018
  - Purpose: Construction of an IT Park
  - Tenure: 8 years
  - Interest: LIBOR+3%
- B Co. also availed loan from nationalized Bank in India
  - Date of taking the loan: 01 September 2019
  - Purpose: Trading in securities
  - Tenure: 3 years
  - Interest: 16%

## Issue

- What would be the most appropriate method to benchmark the transactions, and how would you apply it ?

Whether LIBOR, SFOR or other Interbank reference rates are considered more appropriate?

## Considerations

- CUP – External comparability
- Determine credit rating of B Co. and undertake a search on databases to look for comparable transactions
- Factors to be considered:
  - Credit rating of the borrower;
  - Currency of the loan;
  - Lender and Borrower Country;
  - Tenure of the loan;
  - Base rate of the loan (LIBOR, EURIBOR, PLR, etc.);
  - Date of giving the loan; and
  - Secured or unsecured loan.
- Databases to benchmark foreign loan: Bloomberg, Loan Connector, etc.
- Databases to benchmark Indian loan: dealcurry.com



INTEREST DEDUCTION  
LIMITATION/ DISALLOWANCE  
OF INTEREST/ SECONDARY  
ADJUSTMENT?

# GLOBAL MOBILITY ISSUES

# Possible scenarios:

## **Movement of Key Personal to subsidiary/ another location**

- Part of DEMPE moved to new location
- Reallocation of functions/ attribution issues (PSM)
- POEM issues
- Exit taxes/ other potential issues

## **Mobile working policy**

- PE and TP attribution issues
- POEM issues

## **Possible risk mitigation strategies?**

# INTRA-GROUP SERVICES

- To determine whether the intra-group services are provided, various tests (**prominent one has been the need, benefit, and rendition test**) are carried out.
- Often the emphasis is placed on ensuring that such services entail commercial or economic benefit for the subsidiary for which the same is performed and whether an independent enterprise in comparable circumstances would be willing to pay for the services if performed for it by an independent enterprise or would it have performed the services in-house for itself.
- Further charges for intra group services could be direct charges or indirect charges. If a direct charge is not possible, MNEs must apply cost allocation or apportionment methods, which often require approximation or estimates to determine an arm's length price. Tax authorities often challenge the criteria for allocating the expenses incurred for intra-group services. Sometimes, it is preferred to use simpler criteria and more easily documentable keys just to reduce the challenges arising from the use of more sophisticated allocation keys. While sometimes (especially in the bundle of services), a single global allocation key (e.g., based on headcounts, sales and assets) is easier to apply.
- Further, in determining what constitutes an arm's length price for intra-group services is a matter of interpretation and analysis, raising documentation and compliance issues.

#### **Points to consider:**

- **Whether intra-group services have actually been provided: Lack of sufficient document to justify this**
- **The level of benefits provided: Failure to demonstrate the entity genuinely benefited from the services**
- **What the arm's length charge for such services should be: Missing robust documentation justifying the allocation keys/ cost base, mark ups etc.**

# CASE STUDY

## **Background**

- A Co. (a US Co.) and B Co. (an Indian Co.) are AEs
- B Co. availed certain intragroup services (IGS) (for ex., management charges) from A Co.
- B Co. benchmarked the above IGS under TNMM with primary transactions

## **TPO's contention:**

The payment for management charges were disallowed by considering the same a separate transaction. It was further contended that:

- Services are not rendered by Company A; and
- There is no benefit arising for company B.

## **Current Scenario**

The issue is pending before the Indian Tax Tribunal / APA for multiple taxpayers in India.

## **Movement from FAR to FARM?**

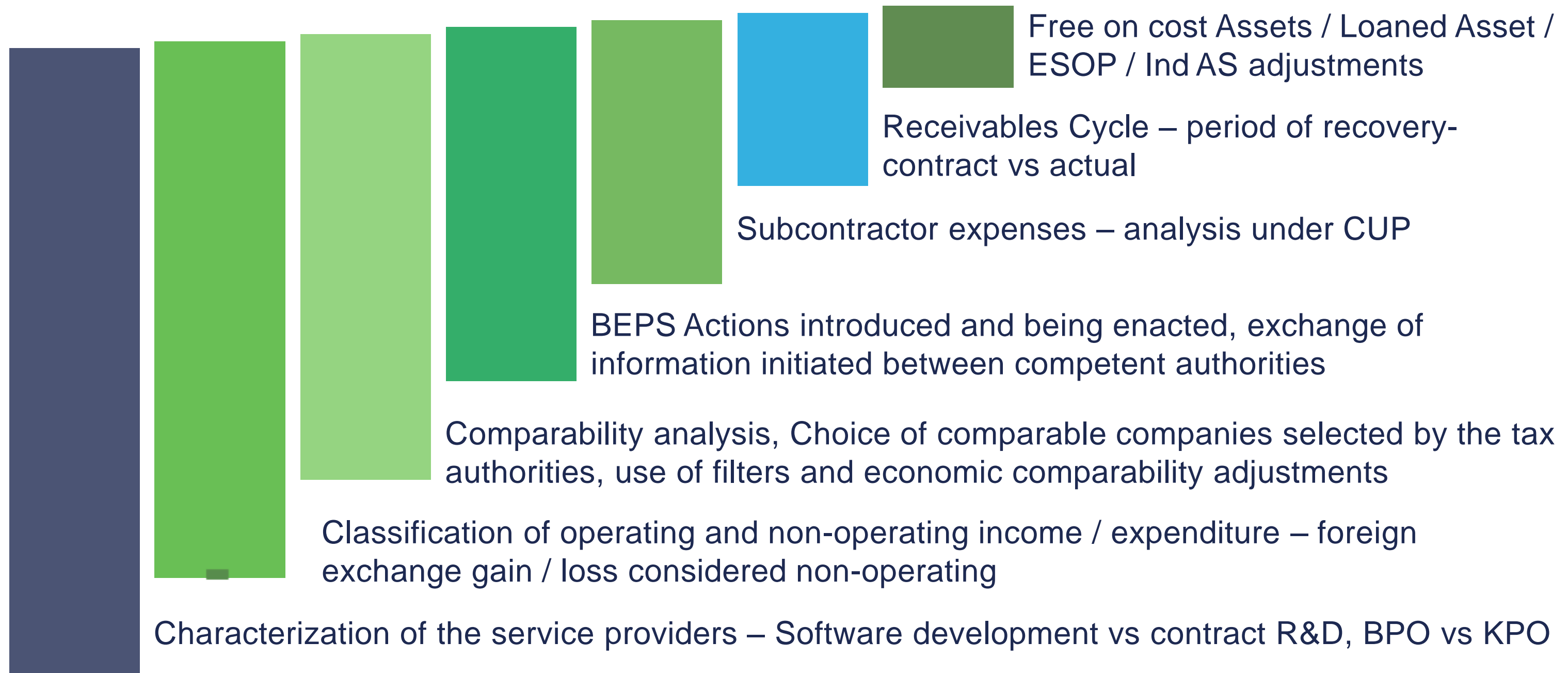
# LOW VALUE-ADDED SERVICES ? WHETHER THERE IS A UNIFORM DEFINITION ?

Simplified approach to determining the arm's length charges provided for low-value-adding intra-group services.

As per OECD guidelines, these are services performed by one member or more than one member of an MNE group on behalf of one or more other group members, which:

- ✓ are of a supportive nature,
  - ✓ are not part of the core business of the MNE group (i.e., not creating profit-earning activities or contributing to economically significant activities of the MNE group),
  - ✓ do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles, and
  - ✓ do not involve the assumption or control of substantial or significant risk by the service provider and do not create significant risk for the service provider.
- The OECD Guidelines allow for a simplified approach to determine the arm's length charges. Namely, a mark-up on all related costs except pass-through costs should equal 5% and does not have to be justified by a benchmarking study;
  - OECD Guidelines specify what activities would not qualify as low-value adding intra-group services (e.g., R&D, manufacturing, purchasing of raw materials, sales and marketing, financial transactions, extraction and exploration, insurance and reinsurance, and services of corporate senior management);
  - Further, examples of certain typical intra-group services meeting the low value-adding services criteria is also provided (e.g., accounting and auditing, HR activities, regulatory data processing, IT services, communications and PR, legal services, tax support and general administrative and clerical support).

# TP AUDIT – SOME OTHER ISSUES



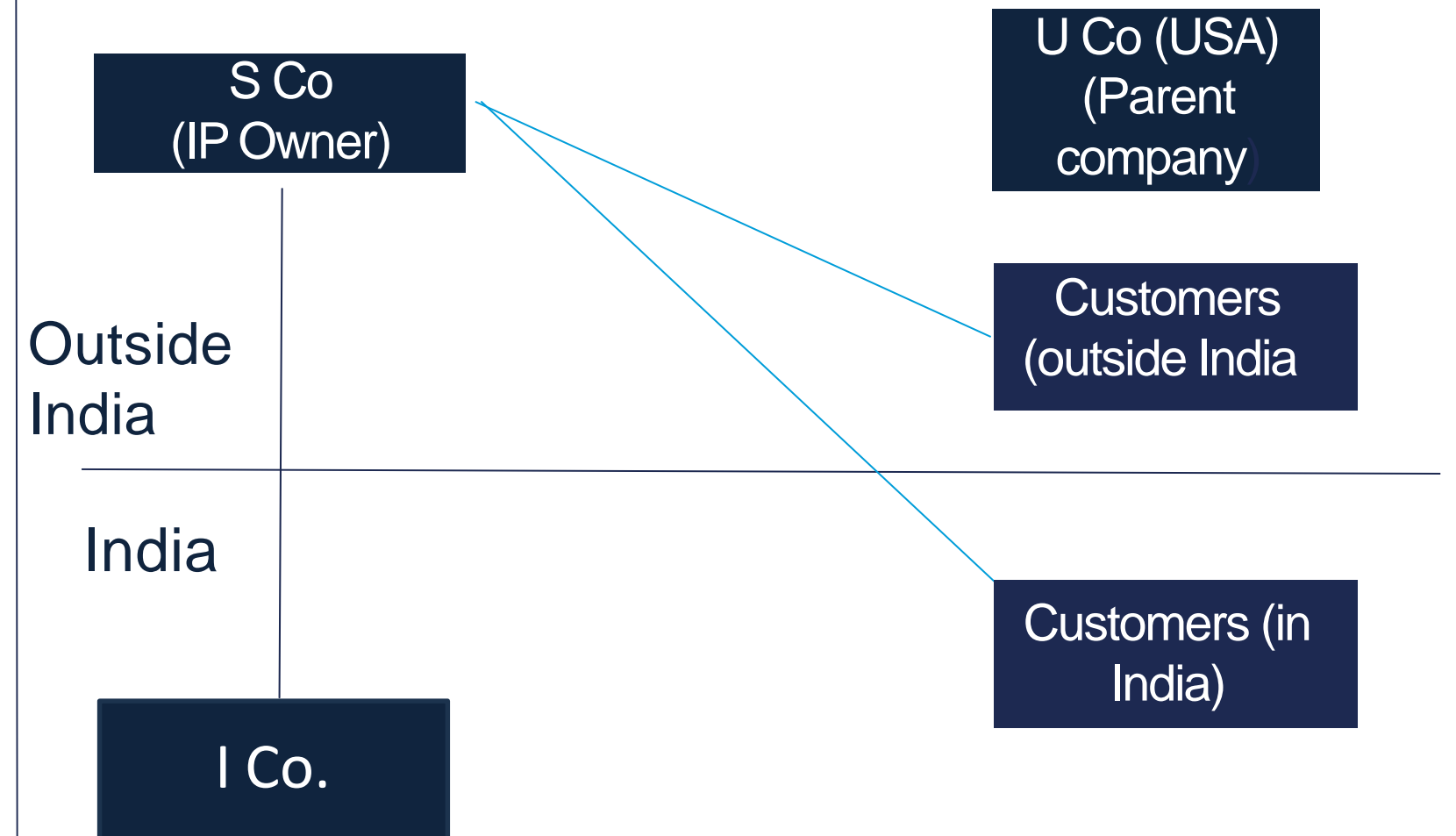
Issue of comparables and the PLI?



## 2 . CONSIDERATIONS FOR STRUCTURING CASES

# CASE STUDY ON DEMPE

- The principal operations of the group encompass the design, manufacture, and distribution of information technology-related products.
- U Co. is the parent entity of the group and takes all key strategic decisions of the group.
- U Co. conducts significant research and development activities and incurs the associated expenditure, that leads to product innovations and improvements as well as new product development.
- S Co. owns the intellectual property (IP) of the products and is also engaged in selling the products to third-party customers.
- I Co. is a subsidiary of S Co and conducts contract research and development.



# KEY FUNCTIONS AND DISCUSSION POINTS

## **Discussion points**

- Who owns the intangibles from a DEMPE perspective?
- How to determine the role of each entity from a DEMPE perspective?
- What would be the ideal remuneration model for U Co, S Co, and I Co?
- If I Co had conducted significant research and development activities instead of contract research and development, what would be the ideal remuneration model for each entity?

# OFFSHORING OF IP

<i>Marketing related intangibles</i>	Marketing intangibles relate to <b>marketing activities which aid in the commercial exploitation of a product or service and/or have an important promotional value for the product concerned.</b> (per the OECD Glossary in Transfer pricing guidelines)	Trademarks, trade names, customer lists, customer relationships, brand names, logos, domain name etc.
<i>Trade intangibles</i>	Trade intangibles are referred to as intangibles other than marketing intangibles. (per the OECD Glossary in Transfer pricing guidelines)	<ul style="list-style-type: none"> <li>• Technology related intangibles like process patents, technical know-how, in-process R&amp;D, computer software</li> <li>• Data processing related intangibles like algorithms, automated databases</li> <li>• Engineering related intangibles like trade secrets, product patents</li> </ul>
<i>Customer-related intangible assets</i>	Mainly includes intangibles created in the due course of establishing relationships with the customer in the due course of business.	Some examples could be customer contracts, contractual and non-contractual relationships, customer lists etc.
<i>Hard to value intangibles (HTVI)</i>	HTVIs are those intangibles in respect of which (i) no reliable comparables exist, and (ii) the projections or assumptions used for the valuation of the intangible are highly uncertain, impeding the prediction of the level of success of the intangible at the time of the transfer' (per the OECD transfer pricing guidelines)	

# OFFSHORING OF IP

- **Centralized model for ownership and development**
- **Centralized legal owner with decentralized development**
- **Decentralized ownership and development**

## **Considerations in case of offshoring the IP to new jurisdiction:**

- Appropriate documents to justify that IP owning entity is performing the strategic functions and controlling IP related financial risks.
- Business rationale, commercial expediency, need and benefit test in relation to the IP licensed from the new IP entity for payments of royalty to the new IP entity.
- In situations where R&D is moved to captive entity, the captive entity should be responsible for the operational risks independently.
- Analysis of key/ significant people that needs to be moved to IP entity (legal and economic ownership) to ensure that major part of the DEMPE is carried out by that entity.
- Also, all individuals undertaking operation decisions in relation to IP should be on payroll of IP entity to ensure that DEMPE is performed by that entity.
- All decision and contracts relating to the IP should be signed in the IP entity.
- Appropriate license fees benchmarking.
- Valuation of IP issues?

# DISPUTE MITIGATION STRATEGIES ?

- Documentation around conduct/ contracts/ decision responsibility/ accountability/ proposals/ business case/ policies & manuals/ meeting agendas & minutes/ agreements etc.
- Co-ordination between different departments: Many a time legal teams and board would be unaware of possible tax risks. This may impact public domain sentiments/ reputational risks when culminated/ material tax issues should reach to boardroom discussion - tax Risk Register/ dashboards etc.
- Document reflecting alignment with Value Chain Analysis (VCA facilitates in detailed FAR, alignment with the operating, strategic and governance models of an MNE).
- Possibility of adoption technology solutions.

# 3 . INCENTIVES (LIKE SUBSIDIES ) AND TP CONSIDERATIONS

# PRODUCTION LINKED INCENTIVES – OPERATING vs. NON-OPERATING

## **Operating:**

- Any income that is relating to normal operations of the Assessee is operating revenue;
- Incentives are not exceptional in nature and available to the industry as a whole;
- The quantum of incentives impacts the pricing of the product as well as services; and
- Difference in Accounting treatment.

## **Non-Operating:**

- Timing difference in recognition of incentive; and
- Capital Grants.



# INCENTIVES AND TP CONSIDERATIONS

## Introduction

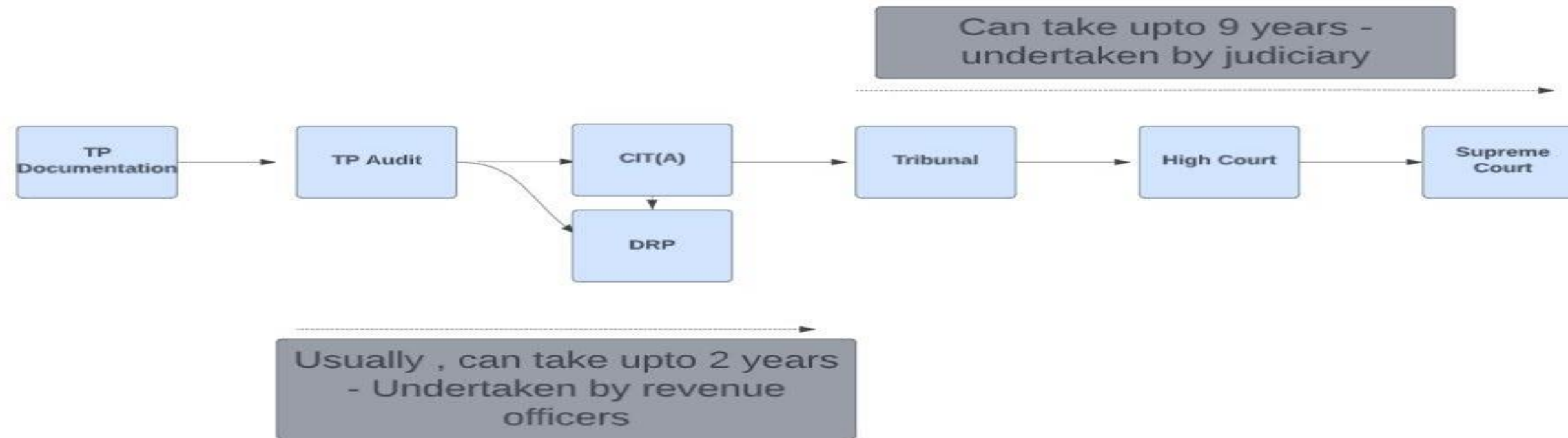
- A subsidy or government incentive is a form of financial aid or support extended to an economic sector generally with the aim of promoting economic and social policy.
- Incentives include direct government expenditures, tax incentives (such as tax credits or reduced tax rates), equity infusions, soft loans, government provision of goods and services and procurement on favorable terms, and price supports.

## TP Considerations

- The question that arises is how one should treat these export incentives in performing TP analysis.
- The tax authorities and APA authorities have invariably treated incentives as non-operating income of the taxpayer. This denies the benefit of incentives in the computation of PLI.
- Indian jurisprudence has presented a diverse range of perspectives, with certain cases considering incentives as operating, while others consider them as non-operating.

# 4. DISPUTE PREVENTION/ RESOLUTION MECHANISMS

# LITIGATION ROUTE



## Timelines

AY	TP Order	AO Order
2020-21	31 July 2023	30 September 2023
2021-22	31 October 2023	31 December 2023
2022-23	29 January 2025	31 March 2025

PCIT v. Soft brands India (P) Limited [2018] 406 ITR 513 (Karnataka) case: Perversity demonstrated in order of Tribunal / Substantial question of law

# APA / SHR / LITIGATION

Criteria	Advance Pricing Agreements (APAs)	Safe Harbor Rules (SHR) (discussed in detail in next section)	Litigation
Timelines	Unilateral APA usually takes 1.5 to 2.5 years	Usually takes 6 to 8 months from filing of the application	Could take between 7 to 13 years
Threshold for application	No threshold specified	Threshold specified	No threshold specified
Definition	Flexible	Restricted	No restriction, general classification
Binding nature	Binding in nature post finalization and signing of the agreement	Binding in nature post finalization and signing of the order by the AO	Binding, but sequential appeals can be made to higher judicial authorities – Year on year litigation of the international transactions of the taxpayer
Past years	Applicable for four years in rollback option	Year on year application	Scrutiny is undertaken on a year-on-year basis by the tax authorities
Applicability	Applicable for all existing as well as proposed transactions of the taxpayer	Applicable only for certain eligible transactions as defined in the Safe Harbor Rules	Applicable for all the international transactions
Taxpayer involvement	Considerable involvement	Moderate involvement limited to establishing the eligibility	Significant involvement
Double taxation	Bi-lateral APA protects from double taxation	No protection	No protection

# MAP

- Mutual Agreement Procedure ('MAP') is an alternate mechanism for the resolution of international tax disputes incorporated in the double tax avoidance agreement (DTAA) of many countries.
- It is a mechanism for dispute resolution through a negotiated settlement.
- Relief under MAP is in addition to the dispute resolution mechanisms available under domestic tax laws
- It can be pursued in parallel through litigation, parking the case in CIT(A) / Tribunal.
- MAP settlement could have persuasive value for the open years under consideration.

## Suspension of collection of taxes

The Indian Government has entered into a Memorandum of Understanding (MOU) with some countries regarding suspension of collection of outstanding taxes during the pendency of MAP.

## Update from Recent APA annual report 2023 on MAP

- India has an inventory of almost 700 MAP cases pending to be negotiated with other treaty partners.
- In last four years, up to December 2022, India has resolved total 635 cases.

ICAPs as a dispute prevention mechanism ?

# 5. SAFE HARBOUR RULES

# SHR - BASICS

Particulars	Remarks
Introduction	13 September 2013
Validity	First time: 5 years AY 2013-14 to AY 2017-18 Revision: 3 years AY 2017-18 to AY 2019-20* *Extended to AY 2020-21 to AY 2023-24
Objective	Avoidance of litigation
Safe Harbour Rules has over riding effect on Section 92C and 92CA of the Act	
Safe Harbour Application can be made by an Eligible Assessee for an Eligible international transaction as defined under Rule 10TB and Rule 10TC of the Rules	

# SHR – ELIGIBLE INTERNATIONAL TRANSACTIONS

- Software Development services
- Information Technology enabled Services
- Provision of Knowledge Process Outsourcing
- Advance of intra-group loans
- Provision of Corporate guarantee
- Manufacture and export of non-core auto components
- Provision of Contract Research and Development services relating to generic pharm-aceutical drug
- Provision of Contract Research and Development services wholly or partly relating to software development services
- Manufacture and export of core auto components
- Receipt of low value adding intra group services



# SHR – ELIGIBLE ASSESSEE

Engaged in provision of Eligible transaction and receipt of intra group services

Foreign principal performing most of the economically significant activities

Foreign principal providing capital and funds and other economically significant activities (including intangibles)

Work is performed under the direct supervision of foreign principal

Assessee has no legal or economic ownership rights on any intangible generated during the course of provision of services

Assessee does not assume or has no economically significant activities

# SHR – CERTAIN ISSUES

- Can the AO refer the years covered under Safe Harbour to the TPO if the same was not referred at the time of filing of the application?
- The Assessee has revenue from SWD and ITeS services and the value of international transactions are more than INR 200 crores. However, for both the services individually revenue is less than INR 200 crores. Whether the Assessee can opt for Safe Harbour Rules?
- Can the TPO make an interest adjustment on delayed receivables arising out of SWD and ITeS services?
- Software Development Services vs Contract R&D Services and ITeS services vs KPO services

## 6 . P I L L A R O N E A N D P I L L A R T W O

# PILLAR ONE AND PILLAR TWO

- Pillar One gives taxing rights to market jurisdictions on part of residual profits earned by MNE groups;
- Eligibility - Annual global turnover exceeding EUR 20bn and 10% profitability.

- Pillar Two mandates a jurisdiction by jurisdiction global minimum tax of 15% for MNE groups;
- Eligibility - Annual global turnover exceeding EUR 750mn.

# PILLAR ONE – KEY ELEMENTS

Amount A

New taxing right  
– A share of residual profit allocated to market countries using a formulaic approach

**Largest and most profitable businesses**

Amount B

Fixed "baseline" return  
– For marketing and distribution functions based on the arm's length principle

**All businesses**

Tax certainty

Tax certainty  
– Through effective dispute prevention and resolution mechanisms

**All businesses**

# BASELINE MARKETING AND DISTRIBUTION ACTIVITIES

## Amount B

- Transfer pricing disputes are common with respect to distribution arrangements between related parties.
- Many of those disputes arise in relation to the accurate delineation of the arrangement and often focus on whether the arrangement involves “baseline” distribution or whether it involves the performance of more complex activities, for instance, when the distributor assumes economically significant risks related to the distribution of the products.
- Disputes are also common with respect to the pricing considerations of marketing and distribution arrangements, commonly focusing on areas such as the selection of the transfer pricing method, the appropriateness of the benchmarking analysis or the identification of comparable companies with respect to certain geographical markets or, where necessary, how to make appropriate comparability adjustments.

Simplify transfer pricing of in-country baseline marketing and distribution activities

**Focus on needs of low-capacity countries**  
**Consultation document released in December 2022**

**Amount B will apply to all multinational businesses that undertake “routine” distribution activities, and, unlike Amount A, is not limited to the world’s largest multinationals.**

# PILLAR TWO - TRANSFER PRICING RULES

## **Arm's length requirement for intra-group transactions**

- Transactions between Group Entities to be priced consistently with the Arm's Length Principle and recorded at the same price for GLoBE purposes for all Constituent Entities that are parties to the transaction.
- Requires an adjustment to the Financial Accounting Net Income or Loss to avoid double taxation or double non-taxation under the GLoBE Rules where the taxable income of one or more Constituent Entities that are parties to a controlled transaction(counterparties) is determined using a transfer price different from the one used in the financial accounts (e.g., Unilateral APA, TP audit etc.) .

## **Arm's length requirement for same-country transactions**

- No adjustments required for transactions between Constituent Entities located in the same jurisdiction, as it will be taken care of due to jurisdictional blending and elimination on consolidation.
- Adjustments required for transactions if the sale or other transfer of an asset produces a loss, and that loss is considered in the computation of GLoBE Income or Loss; not applicable in case of consolidation accounting in the jurisdiction.

## **Election to consolidate transaction in same jurisdiction**

- Adjustment required to align with consolidated accounting treatment in case the election is made
- Adjustment to Financial Accounting Net Income or Loss that is required to align with consolidated accounting treatment for income, expenses, gains and losses from transactions between Constituent Entities that are in a tax consolidation group

**For further questions, reach us at:**

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