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India Alert on BEPS
Incisive Insights

What's new in transfer pricing?

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Latest update

The Organization for Economic Cooperation and Development (OECD) on October 5 released the final reports under the base erosion and profit shifting (BEPS) project it started two years ago to address perceived gaps in international tax rules. The final reports including three transfer pricing actions has been submitted to the G-20 finance ministers at their meeting in Lima, Peru, on October 8.

Key transfer pricing aspects

The 186-page final transfer pricing report and the 70-page documentation and country-by-country reporting report provide guidance on a multitude of transfer pricing topics. Some of the salient features and its significance in Indian scenario include the following:

Global transfer pricing documentation and country-by-country reporting

As expected, the OECD did not introduce any new guidance in the global documentation and Country-by-Country (CbC) final report, which is simply a compilation of previously released deliverables.

From an India perspective, rules may need to be framed to provide for maintenance of information contained in the master file and CbC template as the Indian transfer pricing regulations presently do not require maintenance of such information. While the timelines of this guidance to be implemented in India is still awaited, considering the OECD proposed timelines on CbC reporting, companies would need to take this on priority. Further, India together with few countries from emerging markets have requested for additional transactional data (beyond that required in the master file and local file) regarding related party interest payments, royalty payments and especially related party service fees, which the MNEs having Indian operations need to bear in mind.

Role of contracts

The contractual arrangements between parties is the starting place for proper understanding (delineation) of a transaction. However, written contracts are unlikely to provide all the information necessary to perform a transfer pricing analysis. Therefore, actual conduct of the parties should be considered to clarify or supplement the terms of the contract, or replace the contract if the contract is not supported by the conduct of the parties. This view is largely aligned with the Indian view particularly in the area of intangible related research and development. Further, this view will have an important bearing on engineering and procurement contracts within the context of an international transaction.

Risk

To contractually assume risk, a party must exercise control over the risk and have the financial capacity to assume the risk. Although there is no bright line test to determine control over risk, the factors considered include: (1) performance of the decision to take risks; (2) the act of responding to risks associated with the business opportunity; and (3) performance of risk mitigation activities. The guidance permits day-to-day risk mitigation activity to be outsourced as long as the party outsourcing the risk mitigation activity exercises control over the party doing the day-to-day risk mitigating activity. The guidance provides a six-step process to determine the entity incurring risk.

With increased emphasis on actual conduct, the taxpayers would need to ensure that the contractual arrangement is in line with underlying substance and actual conduct of the transacting parties. In the context of marketing intangibles in India, it will be important to consider the implication of this in line with recent judicial precedents.

Intangibles

The final report retains the 2014 guidance on categories of intangibles, transfer pricing methods, and important functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles (the DEMPE functions). To be entitled to intangible returns associated with the DEMPE functions, the final report incorporates the control and funding requirements from the risk action, discussed above. The guidance states that the entity entitled to the differential profit or loss between projected and actual outcomes, will be the entity exercising the control functions over the risks that caused the difference.

It is pertinent to note that the Indian view on marketing intangibles has largely developed on the basis of judicial precedents and numerous MNEs are facing the litigation in India on this aspect. Reviewing and aligning with BEPS guidance may pose challenges. Further, while India is largely aligned with the BEPS view on DEMPE, the treatment of intangible related transactions are guided by Circular 6 (issued in June 2013). An alignment of both may be necessary in dealing with this issue from an Indian perspective.

Funding and cash boxes

An entity that does not control the financial risks associated with its funding will be entitled only to a risk-free return. An entity that does control the financial risks associated with the DEMPE functions will be entitled to a risk-adjusted return.

The Guidance would impact the arrangements wherein the group companies have limited/NIL functionality and therefore, the outbound Indian corporates would need to relook at their IP structures and the charge for use and exploitation of Intangibles. Importantly, for inbound companies, the OECD view on cash boxes largely align with India’s position which is guided by Circular 6.

Recharacterization

If a transaction lacks the commercial rationality of an arrangement that would have been agreed between unrelated parties, the guidance permits the non-recognition of the transaction. The fact that a transaction is not observed between unrelated parties is not sufficient grounds for not recognizing the transaction.

The guidance stresses upon actual transaction possessing the commercial rationality of arrangements. The risk/re-characterization has been a matter of dispute in India in the pre BEPS period as well (such as re-characterizing the domestic advertisement and marketing expenses as provision of brand building services, re-characterizing the outstanding receivables /shortfall in price of shares issued to overseas group company as loan extended etc.) and the MNEs need to factor in and evaluate the impact of the above guidance on their ongoing litigation.

Hard-to-value intangibles

If the taxpayer cannot demonstrate that its pricing is based on a thorough analysis, the ex post outcome will be used as a presumptive evidence of the appropriateness of ex ante pricing arrangements. The OECD includes several exemptions to this rule based on unforeseeable events and adopts a five-year look-back rule with a 20 per cent tolerance. They also allow taxpayers to bypass the provisions of this section by disclosing the underlying ex ante and ex post data and explaining why the variance was not anticipated.

The Indian tax administration have in past questioned the statistical tools used and projections made based on realistic assumptions; it would be difficult to use the new guidelines from an India perspective. Also inherent restrictions in the transfer pricing legislation on the use of past year data could create more litigation for the taxpayers.

Cost contribution arrangements

The final report updates the CCA guidance to conform to the changes on contracts, risk, and intangibles discussed above. The guidance retains the requirement that ongoing contributions be valued at value rather than cost unless the parties value the opportunity cost of the upfront commitment to contribute resources to the CCA.

In the Indian context, determination of the arm’s length nature of the CCA based on the anticipated future benefits may find difficulty in acceptance by the Indian tax administration. Also the concept of economic ownership is not well recognized by the Indian Courts.

Low value-adding intragroup services

To qualify for the Safe Harbor on low-value-adding intragroup services, taxpayers must document the cost pool and choose appropriate allocation keys. If the level of low-value-adding intragroup service fees exceeds a threshold determined by an individual country, tax administrations are able to require a full functional and comparability analysis including the application of the benefits test to specific service charges.

The proposed simplified approach to low value-adding services will be helpful for several MNE groups facing the litigation on account of disallowance of service charge. However, keeping in view the perspective of the developing countries, the deliverable now includes the guidance on setting of a threshold by the tax authorities for application of these principles.

Moreover, the proposed mark-up of 5% for low value-adding intra-group services is significantly lower than the Safe Harbor rates prescribed by the Indian tax authorities as well as the margins determined by them during audits. It would be interesting to observe how and to what extent the said guidance would be implemented by Indian tax authorities.

Dispute resolution

Twenty nations—Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the U.K. and the U.S.—have committed to provide for mandatory binding MAP arbitration in their bilateral tax treaties as a mechanism to guarantee that treaty-related disputes will be resolved within a specified time frame. Other countries have agreed to minimum standards and a peer review monitoring system.

In the Indian scenario comprising of widespread litigations, many MNEs operating in India have resorted to dispute resolution through MAP. However, the position of Indian tax authorities in not accepting MAP filings where DTAA lacks Article 9(2) and the time taken in resolution of MAP have resulted in concerns. The OECD proposal to resolve disputes in a timely manner is an encouraging move though India believes that mandatory and binding arbitration in tax disputes is not acceptable and should remain as an option.

Profit splits

Final guidance on profit splits has been postponed until 2016 and 2017.

Way forward

The Indian Revenue officials have mentioned in public forums that India would adhere with the OECD/G-20 consensus on BEPS while drafting domestic laws and that India will start firming up its legislation in 2016 post winding up of the BEPS work. Apart from impact assessments, taxpayers need to be aware of and monitor the changes that India intends to bring about in its domestic law and tax treaties.

Upcoming Dbriefs on BEPS

BEPS: The Final Reports

Part 1: Transfer Pricing	Part 2: Non-Transfer Pricing
28 October, 8:30 AM IST	4 November, 11:30 AM IST
Click here to register	**Click here** to register

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