

Transfer Pricing

BEPS: Implementation of Transfer Pricing Changes (Part 2: India and Southeast Asia)

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Agenda

Domestic framework and impact of BEPS in India and South East Asia (SEA)

Transfer Pricing aspects of intangibles

Documentation and reporting

Low value-adding services

Risk and non-recognition

Questions & Answers

Domestic framework and impact of BEPS in India

India – domestic framework

Background

- The TP Regulations are contained in Chapter X, Section 92 of the Indian Income Tax Act, 1961 which deals with special provisions relating to avoidance of taxes
- Prescribes the information / documents to be maintained in the Transfer Pricing documentation
- Indian Government trying to reduce persistent and avoidable litigation, with focus on the APA route

BEPS update

- Implementation of the BEPS action plan would require substantive changes in the TP Regulation and treaty framework especially on the 3 tiered documentation requirement specified under Action 13 of the OECD Guidelines
- Indian Government examining all BEPS action plans for its implementation – Consultation with the industry and other stake holders is in progress
- Selection of Transfer Pricing cases for scrutiny now based on risk parameters – shift in emphasis on complexity of transaction

Domestic framework and impact of BEPS in SEA

BEPS in South East Asia

Country	Will the Tax Authorities adopt the BEPS guidance?	Has there been any regulatory changes locally in light of BEPS?	Have the BEPS principles been adopted in ongoing tax audits / litigation?	Likelihood of the positions to be sustained if the new BEPS guidance is not incorporated into the local regs?
Indonesia	No formal adoption announced yet but likely	No	Yes	General principles are likely to be adopted in practice but unlikely to be sustained without any regulations adopting the BEPS guidance
Singapore	No formal adoption announced yet	No	Not yet	Some of the general principles could be adopted in practice and those are likely to be sustained even without local regulations
Malaysia	No formal adoption announced yet	No	Not yet	Some of the general principles could be adopted in practice and those are likely to be sustained even without local regulations
Philippines	No formal adoption announced yet	No	Not yet	Uncertain at the moment, need more clarity
Vietnam	No formal adoption announced yet	No	Not yet	Uncertain at the moment, need more clarity
Thailand	No formal adoption announced yet	No	Not yet	Uncertain at the moment, need more clarity

South East Asia – domestic framework

Indonesia

Current framework

- The Directorate General of Taxation's (DGT) power to make transfer pricing adjustments is contained in Article 18 of the Income Tax Law
- This authority is implemented through three regulations issued by the DGT. These three regulations provide information and documents that must be contained in a Transfer Pricing Documentation
- In addition, since 2013, the DGT has also issued PER-22 and SE-50 that govern transfer pricing audits and have BEPS-like requirements

BEPS update

- As a member of the G20, Indonesia has indicated that some of these principles may be adopted in a Transfer Pricing regulation
- These changes will be contained in a superior regulation to be issued by the Ministry of Finance (MoF) in December 2015 or early next year
- CBCR is likely to be implemented as part of the new documentation rules. There are indications that additional information such as interest, service and royalty payments may be required to be disclosed

South East Asia – domestic framework

Singapore

- Singapore implemented contemporaneous TP documentation requirements in January 2015. Guidelines implicitly recognise master / local file through separation of documentation into group and local levels
- Adopting a “wait and see” attitude, though watching implementation details / developments at OECD very closely
- To-date, no major change to domestic framework proposed or implemented
- CBCR may be implemented, but no official indication or confirmation as yet
- Many of the BEPS recommendations / positions, if adopted in Singapore, would likely require formal amendments to existing tax laws

South East Asia – domestic framework

Malaysia

- The TP Rules and TP Guidelines require the preparation and maintenance of contemporaneous transfer pricing documentation
- Documentation should be prepared by the return filing due date
- Effective for year of assessment 2014, taxpayers must declare on the tax return whether they have prepared transfer pricing documentation for the period for which the return is made
- To date, no major change to domestic framework proposed or implemented for BEPS
- In November 2015 IRB issued press release:
 - IRB will update and revise the tax laws to align with international standards, where such standards are applicable and relevant locally
 - A BEPS Action Committee has been set up within the IRB to address implications for domestic law and provide recommendations to the government

South East Asia – domestic framework

Thailand

- TP guidelines issued on 16 May 2002, follows OECD Guidelines. Not a law but an internal instruction to tax officers to request for TP documentation
- New transfer pricing laws have been approved in principal by the Thai Cabinet and are currently under review by the Council of State
- The new laws will require preparation of contemporaneous documentation with fine for failure to do so. Expected that the new laws will be issued in 2016
- Whilst the new laws would represent an opportunity to factor in BEPS, there does not appear to be any recognition at this stage

Polling question 1

In your transfer pricing examinations / reviews / audits, have the tax authorities asserted positions based on the principles of the BEPS transfer pricing deliverables?

- Yes
- No
- Not applicable as no TP review / audit has occurred recently

Intangibles

Action 8: TP aspects of intangibles

Determining intangibles-related return

Step 1: Identify the intangibles with specificity

Step 2: Identify the contractual arrangements

Step 3: Identify parties performing important functions

Step 4: Confirm conduct of the parties consistent with contracts

Step 5: Delineate the actual transactions

Step 6: Determine the arm's length price for the transactions

Action 8: TP aspects of intangibles

India overview

- Broad definition

“Something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”

- **Issues impacting India**

- **Research, development, and process improvement arrangements**
- **Development and enhancement of marketing intangibles**
- **Location specific advantages, local market features, workforce, etc. – not considered as intangibles but market features**

Role of conduct in transfer pricing of intangibles

Conduct is more important than the contract

Several aspects of the revised guidance are in line with view of the Indian tax authorities

BEPS

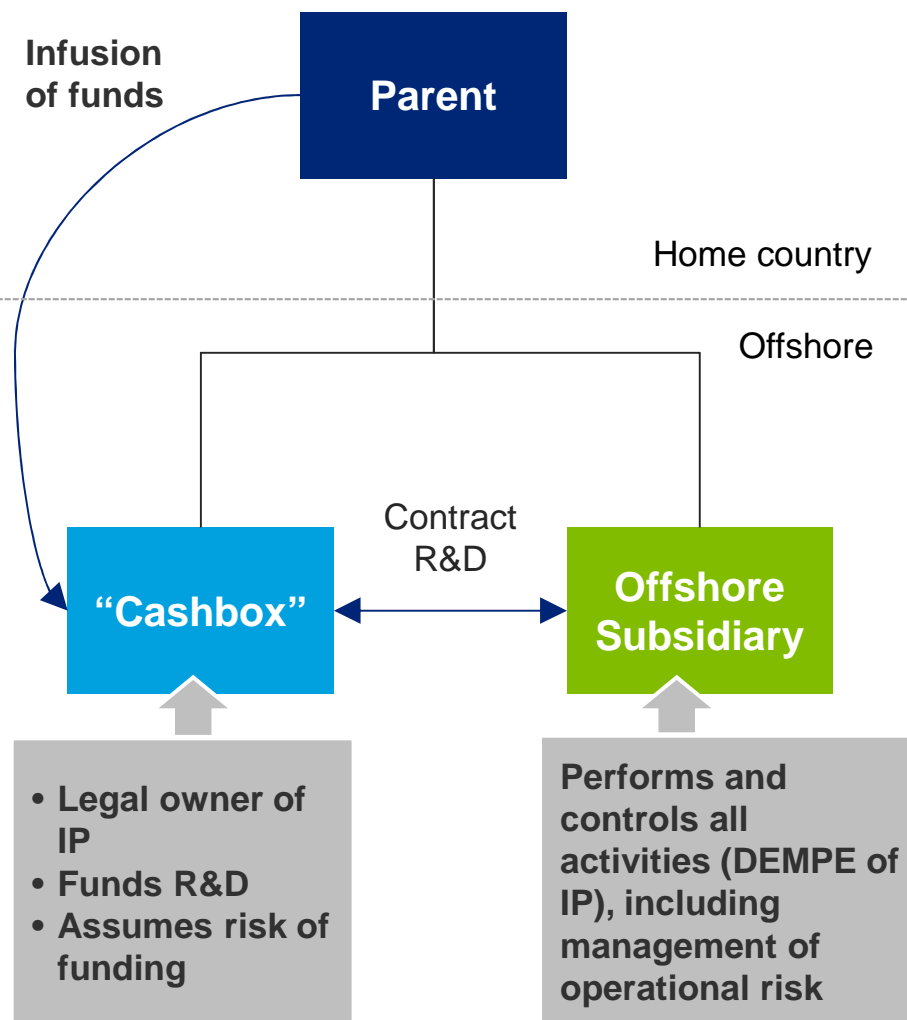
- Contracts are the starting point of the analysis, however, conduct of the parties are the ultimate determinants
- Focus on functions, risks and costs
- Fact specific analysis to be done while examining the DEMPE functions
- The alignment of functional contributions and financial investment with legal rights
- Direct exercise of all important functions and control over service providers performing outsourced activities

India - CBDT Circular No. 6/ 2013 (Circular)

- Circular Classifies R&D centres of overseas MNEs into three broad categories based on functions, assets and risk assumed by the centre established in India
- Guidelines laid down to identify the R&D centres as a contract R&D service provider assuming insignificant risk
- Emphasis on the functions / conduct of parties rather than the contractual arrangement
- Emphasis on nature and quantum of risk borne by R&D centres
- Alignment of functional contributions and financial investment with legal rights recommended by circular as well

Funding and intangibles

Cashbox – India impact



Final BEPS recommendations

- Affirmation that capital-rich entities without relevant economic activities (“cash boxes”) will not be entitled to any excess profits
- Three scenarios possible:
 - No management of funding risk: entitlement to no more than risk-free return
 - Management of funding risk: entitlement to risk adjusted return
 - Management of funding risk and operational risk: not a cash box!

India Impact

- Investments in India through “cash boxes” may trigger non cost-plus outcomes
 - Indian offshore subsidiary performs and controls all DEMPE functions including risk management
 - From the routine return currently received by Indian subsidiary, they would now be entitled to a significant allocation of profits
- Guidance akin to Circular No. 6/2013 issued to classify the contract Research and Development (R&D) centers of overseas multinational enterprises (MNEs) as R&D centers bearing insignificant risk

Marketing intangibles

Divergent view – India perspective

OECD guidance – focuses on the functional profile / rights of the distributor to evaluate payment required, if any

Also provides that such remuneration could take different forms (such as decrease in the purchase price of the product, a reduction in royalty rate, etc.)

India perspective: Indian company with high AMP spend, even if not the “legal owner”, held to be local “developer” of trade name / trademarks

Brightline test applied by the tax authorities to determine the “routine” marketing spend of the Indian company

Any excess spend expected to be reimbursed by the overseas company to Indian company in form of service fee irrespective of the functional profile

Recent High Court Ruling resonates the principles laid down by OECD while setting the jurisprudence of the country

Location savings

Divergent view – India perspective

OECD guidance – comparables provide the best evidence of location saving

India perspective: mere comparability may not consider the benefit of location savings. Need to take into account the cost difference in the low cost country and in the high cost country from where the business activity was relocated

- Workforce in place

OECD guidance – not an intangible since work force cannot be owned or controlled by a single enterprise

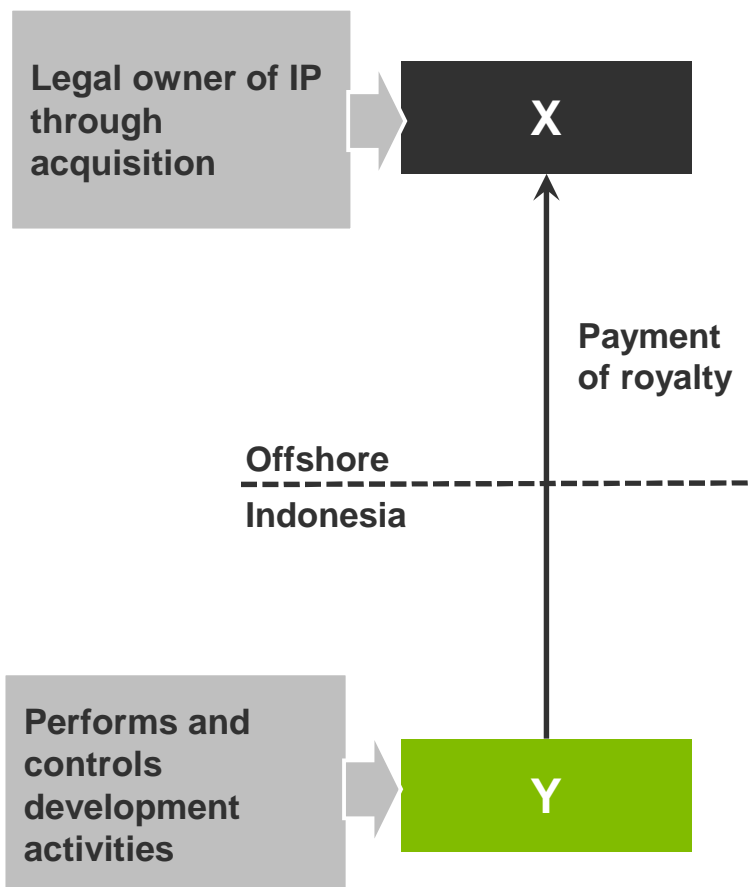
India perspective: trained and organized work force is an intangible. Also included in the definition of intangible

Intangibles – South East Asia

Indonesia

- Started adopting the concept of “economic ownership” in contrast with “legal ownership”. During audits, DGT has started to seek information on the performance of DEMPE functions in intangibles related transactions
- As early as 2013, PER-22 & SE-50 required taxpayers to prove any contribution to the IP made by the taxpayer and the licensor. If the local taxpayer is found to contribute in the development, enhancement etc., an adjustment is made to the royalty rate or is completely disallowed
- Additional Guidance on funding and other aspects likely to be brought into the local regulations soon

Intangibles – South East Asia (cont'd)



Background

- X is the legal owner of the IP which is licensed to the Indonesian sub (Y)
- Y manufactures products using X's IP
- The IP was originally developed in Indonesia by a local third party company and subsequently acquired and transferred to X by its affiliate
- Y determines the marketing budget and strategy in Indonesia and its marketing costs are higher than comparable companies in Indonesia

DGT's approach

- Payment of royalty was disallowed as Y is construed to be the economic owner performing all the significant functions in relation to DEMPE, bore the risk as well as the cost associated with the development of the IP
- Marketing cost incurred by Y was regarded as cost related to the development of the IP
- Case is to be submitted to the Supreme Court

Intangibles – South East Asia (cont'd)

- Malaysia TP rules include specific guidance on intangibles, including consideration of marketing intangibles
- Currently, little formal guidance on intangibles in other countries
- Main focus in some countries has been ensuring that IP is actually provided and provides a benefit to the local subsidiary (i.e., benefit test)
- Whilst some challenges on existence of marketing intangibles and location savings, no clear focus
- Unclear at this moment whether other countries will follow the entire new OECD chapter on intangibles
- However, it is envisaged that the general principles particularly regarding the identification of the true owner, and determination of arm's length pricing will apply in practice

Documentation and reporting

Documentation – India

Rule 10 (d) vs. OECD documentation requirements

- Changes to Indian TP regulations and treaty framework required to implement Action 13 guidance in India
- Majority of local file requirements are met by the existing Indian documentation requirements.
- Rules need to be introduced for the maintenance of CbCR and master file – likely before April 2016
- India may seek additional information/ document relating to related party interest payments, royalty payments and payment for services
- Impact approximately 150+ Indian MNEs
- Only material transactions need to be disclosed. However, the definition of materiality is not provided

Documentation – India

Rule 10 (d) vs. OECD documentation requirements

Rule 10 (D) Details regarding:	OECD documentation requirements
Ownership structure	Requirements of Master File
Profile of MNE group	Requirements of Master File
Description of business and industry	Requirements of Master File
Details of international transaction	Requirements of Local File
FAR analysis	Requirements of Local File
Financial estimates	Requirements of Local File
Uncontrolled transactions	Requirements of Local File
Comparability of uncontrolled transactions with relevant transaction	Requirements of Local File
Requirements of Local File	Requirements of Local File
Arms length price	Requirements of Local File

Documentation – India

Rule 10 (d) vs. OECD documentation requirements

- Rule 10 (d) does not include the following elements of the OECD documentation requirements
- Master file: Global organization structure, key profit drivers, description of main geographic markets, global supply chain, business changes, intangibles strategy, listing of intangibles, TP policy regarding intangibles, group financing policies and TP relating to the same, unilateral APAs and tax rulings
- Local file: Management structure and reporting lines, detailed business strategy, competitors, APAs and tax rulings
- Country-by-country Report
- The local file contains much of the same information found traditionally included in TP documentation reports

Documentation – SEA

- Most Southeast Asian countries have transfer pricing regulations that require the preparation of transfer pricing documentations
- Most of the local requirements are covered by the information to be disclosed in the master file and local reports
- Indonesia will issue a new Ministry of Finance regulations that will contain CbC reporting and new guidance on transfer pricing documentations. Details are however not yet available
- Singapore's new TP rules effective 1 January 2015, whilst not explicitly adopting master file, do separate documentation between group and entity level
- In the rest of the countries, it is still unclear if CbC reporting will be required

Polling question 2

What best describes your company's approach for responding to BEPS' transfer pricing implications?

- Primarily focusing on documentation
- Performing a risk assessment of existing transactions in light of the changes
- Waiting to see how and when the domestic authorities will change rules

Low value-adding services

Low value-adding services - India

- BEPS definition of low value-add services quite broad

What are “low value-adding”	What are not “low value-adding”
Accounting and auditing, accounts receivable / payable, human resources, legal, tax	R&D, manufacturing, sales, marketing, distribution, corporate senior management

- Two significant changes from draft
 - **Inclusion of software development which is not part of core business**
 - **Management supervision also included unless it is corporate senior management**
- BEPS definition may cover within its scope, most of services provided by Indian subsidiaries or shared service centres
- New guidance prescribes mark-up of 5% for such services
 - **Not in line with comparable reality**
 - **Higher than Safe Harbour Rules**
- Unlikely that Indian Revenue Authorities would adopt the simplified approach for low value-add services in its current form
- Location savings?

South East Asia implications

Indonesia

- PER-22 prescribes a cost-plus remuneration for services. Hence, service fees calculated as a percentage of taxpayer's sales are disallowed
- Generally, service fees for providing back-office support services to an Indonesian entity are charged at a cost plus 5%. Since most of these service fees are charged by a Singapore entity, the DGT appears to generally accept a cost plus 5% fee

South East Asia implications (cont'd)

- Singapore's safe-harbor rules for services closely follow the OECD approach on low-value services
 - Similar definition of routine / low value services and same acceptable mark-up
- Remains to be seen whether approach is adopted by other countries which have RHQ regimes (e.g., Malaysia, Thailand)
- For services received, common focus of tax authorities has been challenging whether benefit test satisfied. Remains to be seen whether qualifying low-value services would be deemed to satisfy benefit test

Risk and non-recognition

Risk – India

- Indian Authorities believe that risk cannot be controlled remotely by the parent
 - Indian subsidiaries of overseas MNE perform core / important functions and take strategic decisions, therefore a cost + mechanism of remuneration is not acceptable
 - Historically resorted to non- recognition / re-characterisation of the transaction for lack of substance in cases like
 - Domestic marketing and advertising spend re-characterised as provision of brand building services
 - Shortfall in prices of shares issued to overseas group entity or delayed payments as loan extended
- The BEPS focus on commercial rationality vis-à-vis substance is inline with the manner in which Indian authorities deal with such transactions

Risk – South East Asia

Indonesia

- Indonesia principally follows OECD guidance and some of the principles on risk and non-recognition may be incorporated into the new regulation
- In PER-22, the DGT has required taxpayers to present job descriptions and CVs of the personnel alleged to be performing the function to determine the risk and functional profile of the entities
- The DGT has re-characterized transactions based on actual conduct of parties. Thus, in some tax audits, the tax authorities are contending for a higher remuneration for local LRDs undertaking marketing functions and bearing the respective risk

Rest of SEA

- No formal acceptance of the OECD principles in most of the other SEA countries
- However, it is envisaged that these principles will be at least persuasive for their TP purposes
- Adoption of such principles into practice is not likely to require major, formal changes to tax / TP legislation

Questions & Answers



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