

TRANSFER PRICING *communiqué*



Volume 2, Issue 1

Editorial

Dear Readers,

The transfer pricing landscape has witnessed significant developments since the last edition of TP communiqué. Lately, Indian Tax Tribunals have pronounced important decisions on complex transfer pricing issues. Taking cue from international jurisprudence and practice, the decisions lay down important principles supplementing the legislation.

On a closer look, it is possible to discern some trends in Tribunal decisions. There is increasing alignment with international principles and thankfully (for taxpayer!), roll back of adjustments in situations where Revenue has overstepped its mandate. The Indian competent authorities also formally commenced the process of TP related mutual agreement procedure over a week long meeting with the US counter parts last week of April. While the policy makers continue to debate the introduction of Advance Pricing Agreement (APA) regime, investors may feel a bit relieved from the practicality with which Tribunals have dealt with intricate transfer pricing issues.

We trust you enjoy this edition of Transfer Pricing Communiqué, summarizing recent rulings and developments together with other developments in the transfer pricing landscape.

Regards

Mukesh Butani

Focus

Recent rulings on the choice of tested party and aggregation principles

Recently, the Calcutta Tribunal pronounced its decision in the case of Development Consultants Pvt Ltd, which affirms established principles on

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Other Resources

the choice of tested party and aggregation principles. Earlier, both principles were established by the Delhi Tribunal in the case of Ranbaxy Laboratories Limited. In both cases, the Tax Tribunal has drawn support from US regulations and OECD Guidelines (transfer pricing), since guidance on such issues is absent or at best limited under the Indian regulations.

Choice of tested party

The decisions highlight that for determining choice of tested party, the following factors should be kept in mind:

- Complexity of the transacting entities (based on functions, assets and risks); and
- Availability of reliable data for comparability analysis

Where an overseas entity is chosen as the tested party, reliable data should either be in public domain or provided to the Revenue authorities by the taxpayer. Hence, merely choosing the least complex entity for benchmarking is not enough, if there is insufficiency of information.

Aggregation Principle

Endorsing the OECD Guidelines, the decisions emphasize that comparison for transfer pricing purposes should ideally be undertaken on transaction-by-transaction basis. Aggregation of transactions should be undertaken only where transactions are 'closely linked' and it is not possible to evaluate transactions on individual basis (Indian regulations define a transaction to include 'closely linked' transactions, whereas OECD Guidelines allow 'closely linked or continuous' transactions).

It is pertinent to note that none of the rulings provide guidance on circumstances in which transactions may be considered as 'closely linked'. Practically however, such situations may arise where pricing of different products is inter-related, for instance 'razor-blade pricing strategy', wherein blades may be sold at relatively higher price compared to razor.

The decision on aggregation principle is being dubbed as a strict interpretation of law. Hence, it is incumbent on part of tax payers to present a business case and commercial perspective for pricing of international transactions. To illustrate, if a tax payer resorts to 'razor blade pricing' strategy, principle for closely linked transaction and hence aggregation could be established. However, the eventual decision to follow the aggregation principle will depend equally upon the business strategies 'Commercial, rationale and availability of data'.

The decisions also provide guidance on other issues such as use of multiple year data and the application of arm's length range. In the case of Development Consultants, the Calcutta Tribunal has allowed use of multiple year data on the facts of the case. In the same case, the Tribunal has adopted an interpretation of the (+/-) 5 percent range, which is favourable to taxpayer. The Revenue department is likely to appeal against the liberal interpretation of (+/-) 5 percent safe harbour provisions.

Read BMR Insights on:
[Ranbaxy](#) | [Development Consultants](#)

Transfer Pricing:

<http://www.bmrtax.com/transferPricing.php>

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<http://www.bmrtax.com/industryGroups.php>

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Snippet

Introduction of APA

It is anticipated that it would take some time before APAs are introduced and implemented. However, on its part the Revenue Department has taken initiative to seek comments from large tax payers and TP advisors on the feasibility of introducing APA's in India. Recently, an interactive session was hosted by the Director General of International Tax to discuss the need and models for APAs in the Indian context.

Decision of Tax Tribunal on transfer pricing documentation and penalty

The Delhi Tax Tribunal in a landmark ruling in the case of Cargill India Pvt Ltd, has laid down important principles on transfer pricing documentation and penalties for non-compliance.

The Tribunal has held that the documentation requirements, are voluminous and the taxpayer is not required to maintain / furnish every information prescribed therein. It has to be determined based on the specific facts and circumstances of each case.

The Tribunal has been mindful of draconian penalties (2% of value of the transaction!) prescribed under the regulations. While levying penalty for non-compliance, the Revenue has to be specific about the default committed by the taxpayer. The Revenue must not only specify the information that the taxpayer failed to furnish, but also the transaction and the statutory rule in respect of which the default has been committed.

Read BMR Insights on: [Cargill](#)

Global window

OECD discussion draft on transactional profit methods

In January, 2008, the OECD released a discussion draft on transactional profit methods (discussion draft) for public comments. The recently introduced discussion draft focuses on transactional profit methods and the intricacies surrounding its application.

The 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations', released by OECD in 1995, recognize five basic methods for benchmarking an international transaction. These are broadly classified as traditional and transactional profit methods. Traditional methods concentrate on transaction prices, while transactional profit methods [transactional net margin method (TNMM) and profit split method (PSM)] focus on determining and comparing the profitability of business operations as a whole.

PSM and TNMM have been regarded by the 1995 Guidelines as methods of last resort – to be used only in exceptional circumstances. However, a large number of cases have reported use of transactional profit methods (particularly TNMM) for determining arm's length price. Realizing the practical constraints in applying traditional methods, the discussion draft proposes to dilute the hierarchy in the choice of methods and move closer to the 'most appropriate method' rule. Incidentally, the most appropriate method rule is also enshrined in Indian regulations.

The discussion draft supports use of supplementary method in certain cases. For example, a secondary method may be used where the reliability of data used for applying the primary method is doubtful.

The discussion draft provides guidance on application of TNMM and PSM, particularly as applied to transactions involving intangibles. TNMM

Snippet

Australia: Roche Transfer Pricing Ruling

The Administrative Appeals Tribunal, Australia (AAT) recently adjudicated a transfer pricing case (Roche Products Pty Limited) that provides guidance on substantive transfer pricing issues.

The transfer pricing analysis undertaken by Australian Tax Office (ATO) was based on a comparison of net profit margin of taxpayer with similar companies. The AAT held that the approach of using net profit method, without taking into account the surrounding circumstances, was unconvincing and accordingly ruled the adjustment to be excessive.

The Australian Tax Office has used net profit outcome to assess transfer pricing risk. In this background, the Roche case assumes importance, as it highlights the fundamental problem with profit based methods that attribute all losses to transfer pricing without examining other factors.

Snippet

IRS releases report on APA

The Internal Revenue Service (IRS) released its ninth annual Advance Pricing Agreement (APA) report in March, 2008. The report captures a summary of developments in the APA programme and a statistical snapshot of the APA programme's activities during 2007. While the number of APAs executed is consistent with prior years, the figures reflect a significant improvement in the processing time. Inbound cases continue to account for the majority of the APA programme's caseload.

It is noticeable that the IRS has used various valuation methods based on

is appropriate where all unique contributions are made by one party. In such cases, the simpler of the two transacting entities may be chosen as the tested party. Similarly, the discussion draft mentions the choice of profit level indicator, allocation key and other technical nuances associated with the use of TNMM and PSM.

The discussion draft is a significant step towards clarifying issues on application of transactional profit methods.

Valuing Cost Sharing Buy-In Payments

Valuation of buy-in-payments for cost sharing arrangement has recently become a controversial issue. Though the Income Method published in the recently proposed cost sharing regulations is being purported by the Internal Revenue Services (“IRS”), the same is not very popular with the taxpayers.

The Income Method determines the total buy-in payment of a cost sharing arrangement by calculating the present value of the stream of projected operating profits from the intellectual property, less the cost sharing payments of the projected research and development expenses. However valuation of future intangibles based on projected financials poses enough practical hindrances. The future research and development costs typically would be difficult to anticipate.

The taxpayers are more bent on using the Residual Profit Split Method, which is based on actual profits. This view is contrary to that of the IRS, which states that an up-front valuation is crucial and cannot be achieved using the Residual Profit Split Method. However, due to lack of guidance from the IRS, there still has been no resolution to concerns of the taxpayers’ vis-à-vis the practical difficulties faced at undertaking valuations using projections. For the time being, the taxpayers may just have to resort to the unpreferred option of the Income Method.

US Tax Court rules on deductibility of intra-bank payments

A recent US Court of Appeals’ decision, in the case of National Westminster Bank (NatWest), has applied the separate entity principle for treatment of intra-bank transactions. Although, the Internal Revenue Services (IRS) disallowed deduction by way of intra-bank interest payments based on domestic law provisions, the Court held that this was inconsistent with Article 7 of the US-UK tax treaty. It was held that the treaty provisions were to prevail over domestic laws and intra-bank interest payments were fully deductible.

The ‘separate entity’ principle postulates that for determining income of the branch, it should be hypothesized as an entity, which is separate and distinct from its head office. Accordingly, while interest payments made by the branch to the head office should be recognized as deductible expenses, interest received from head office should be considered as branch’s taxable income.

In the Indian context, conflicting judgments of the Calcutta and the

discounted cash flows and other analyses for cost sharing and / or buy-in APAs. This is a digression from the five methods generally used for benchmarking purposes.

Interestingly, in 2007 the APA economists received training on a new spreadsheet model that performs calculations in a comparable profits method (CPM) analysis. The model was built by APA economists and is routinely used by the APA office when performing CPM analyses

Source: Internal revenue Bulletin, April 14, 2008
[Click to access IRS site](#)

Mumbai benches of the tax Tribunal in the case of ABN Amro and Dresdner banks, respectively, have resulted in ambiguity in the minds of taxpayers. While the Calcutta Tribunal disallowed interest payments made by the branch to the overseas head office, based on the 'no profit from self' doctrine; the Mumbai Tribunal concluded that any interest received from overseas head office was taxable as income of the branch. The Calcutta Tribunal decision is currently pending for adjudication before the High Court.

Read Business Standard Column of Feb 11, 2008: [Be fair to foreign banks in India](#)

Events

Conference & Interactive Workshop on “Successful EPC Contracting - Fiscal and Legal Challenges

BMR, in collaboration with InfralineEnergy Research Services, hosted the 3rd Annual Conference & Interactive Workshop on “Successful EPC Contracting - Fiscal and Legal Challenges” at The Imperial Hotel, New Delhi, from April 17-19, 2008. The workshop facilitated EPC contractors and Project Owners to update and gain a deeper and concise knowledge of the current and evolving tax and legal issues surrounding it. This workshop provided an update and enriched the knowledge base of Financial, Legal and Commercial teams of Contractors and Project Owners. The workshop also captured all important announcements and developments of India Budget 2008.

For more details, please [click here](#).

International Tax Review to organise annual Asia Tax Forum 2008, in Singapore on June 5-6, 2008

International Tax Review, a Euromoney Legal Media Group publication, will host its third annual Asia Tax Forum on June 5-6, 2008, in Singapore. Leading Asian Tax and member Firms, BMR Advisors, India; KhattarWong, Singapore; and Kojima Law from Japan are supporting the annual event.

The annual Tax forum attracts participants comprising heads and regional heads of tax of leading companies in Singapore, Japan, North America and Europe. This event also brings together tax executives, officials and advisers from the Asian continent to discuss and debate the latest developments and issues in tax, including transfer pricing, financing structures and cross border tax structuring.

For more details, please click [here](#).

BMR Advisors expands partnership

Three tax professionals joined the partnership at BMR Advisors on April 1. Malini Mallikarjun specialises in a range of indirect taxes including

service tax, value added tax, sales tax and customs regulations. Russell Gaitonde is a specialist in direct tax in the financial services industry. Amod Khare's practice focuses on direct, corporate and international tax.

For more details, please click [here](#).

Awards

BMR is Transfer Pricing Firm of the Year - Asia Awards 2007

BMR & Associates received the "Transfer Pricing Firm of the Year" award for best advice on public and cross-border work at International Tax Review's (ITR) Asia Awards 2007 in Hong Kong. At the annual function, awards were presented to the leading tax firm, transfer pricing firm and tax controversy firm in 11 jurisdictions: Australia, China, Hong Kong, India, Japan, Malaysia, New Zealand, Singapore, South Korea, Taiwan and Thailand.

Four regional awards – tax firm of the year, transfer pricing firm of the year, tax controversy firm of the year in Asia and the Editors' Choice Award were also given out.

At the ITR Asia 2006 awards, BMR was adjudged the best firm in India and Asia to manage tax controversies for India.

For more details, please click [here](#).

Know our team



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Amod is a Partner at BMR, India's leading independent firm of tax advisors and is based in Mumbai, India. Amod has over 10 years of professional experience. Prior to joining BMR, Amod was a partner at Ernst & Young, where he was the Tax service line leader for the Media & Entertainment practice. Amod worked with Andersen for seven years until Andersen combined with Ernst & Young in 2002.

Amod has significant experience in advising clients in the Media & Entertainment Industry on tax and regulatory issues. Amod has also worked closely with major telecom operators in India. He has advised domestic and international clients on tax and regulatory issues arising from acquisitions in India, on structuring of transactions and tax optimization, as well as on cross border income tax issues.

Amod has a Bachelor's degree in Commerce from Bombay University and qualified as a Chartered Accountant in 1997.

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