

TRANSFER PRICING *communiqué*



Volume 1, Issue 1

Editorial

Welcome to our introductory Transfer Pricing Communiqué – the news update on significant developments.

Our communiqué is a means to foster discussion and generate meaningful debate on challenges faced by your enterprise. We shall feature updates from the vibrant Indian market and simultaneously keep an eye on significant global developments. We take this opportunity to introduce you to our team members engaged in meeting needs of our clients.

We value your patronage and continued support and look forward to receiving your feedback. Thank you for your time and we hope that you find the communiqué informative.

Regards,

Mukesh Butani

Focus

Transfer pricing takes center-stage in India - Morgan Stanley and Aztec rulings necessitate robust documentation for multinationals with cross-border transactions. Whereas, Morgan Stanley ruling clarifies attribution principle; Aztec becomes the first Tribunal ruling on transfer pricing matters...

Captive BPO / KPO businesses in India have become a soft target for the Revenue, particularly after the third round of transfer pricing audits. Revenue has worked out more or less uniform margins of 25 percent and 37 percent for captive IT and ITeS (IT enabled services) units, respectively. The margins are based on the income earned by independent BPO or software entrepreneurs that are full-fledged risk bearing entities – unlike captives that are low or risk-stripped service providers. However, Revenue continues to hold its stand on the issue of margins, despite representations made by industry bodies such as NASSCOM (National Association of Software Services Companies) and tax experts. Whereas the IT industry has been reeling under the impact of arbitrary adjustments, the added threat of profit attribution has been looming large. An Advance Ruling (AAR 661 of 2005), sought by Morgan Stanley (USA), clarified that no further profit could be attributed to the Indian subsidiary if it had been remunerated on arm's length basis.

Opinion had veered around the view that once arm's length reward is earned by an 'agent', no further profit attribution is required. However, in a recent Mumbai Tribunal decision in Sony's case, it was held that the tax liability of a foreign enterprise, in respect of its Dependent Agent Permanent Establishment (DAPE) is not extinguished by arm's length

Feedback

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consideration to the dependent agent. The Tribunal, in Sony's case, had made a fine distinction between the dependent agent and the dependent agent PE. The Tribunal decision sparked off a controversy and fears were expressed on possible over-taxation of BPO / KPO units. Interestingly, the Sony decision dates back to a time when India did not have transfer pricing legislation.

Captive units can now breathe a sigh of relief after the recent Supreme Court pronouncements. In Hyundai's case, the Supreme Court reaffirmed the view it adopted in Morgan Stanley Advance Ruling, though not in so many words. It did not categorically state that arm's length analysis was exhaustive of attribution of profits. Nonetheless, from the comments made in the decision, it appears that the apex court endorses the view adopted by the Authority for Advance Rulings.

The Supreme Court decision in Morgan Stanley's case has unequivocally affirmed the Morgan Stanley Advance Ruling and held that in cases where *"an associated enterprise (that also constitutes a PE) has been remunerated on arm's length basis, taking into account all risk-taking functions, nothing further would be left to be attributed to the PE."*

However, it needs to be borne in mind that the SET decision was delivered in the context of a DAPE whereas the Morgan Stanley Supreme Court decision is in relation to service PE.

From a tax planning and compliance perspective, it appears that Indian IT companies must get their transfer pricing analysis correct. Going by the Supreme Court Judgment, where an Indian subsidiary has been remunerated for all its functions (taking into account all assets employed and the risks assumed), no profits shall be attributed to the PE of the foreign enterprise.

Get BMR insights on three most relevant decisions:

[Sony](#) | [Morgan Stanley](#) | [Hyundai](#)

Tribunal ruling on Aztec Software

In a landmark Tribunal Ruling on transfer pricing matters, a special bench of Bangalore Income tax Appellate Tribunal has ruled on a number of controversial issues in the case of Aztec Software & Technology Services Limited.

The Tribunal held that merely by finding (technical) faults with the transfer price determined by the Revenue, transfer pricing adjustments cannot be deleted. Unless the arm's length price, furnished by the taxpayer, is specifically accepted, the appellate authority has to determine the arm's length price itself or direct a lower authority to do the same. The Tribunal rejected the use of industry average as the Comparable Uncontrolled Price, since such an approach overlooked the factors relevant for examining comparability (such as quality, market conditions etc).

It is heartening to note that the Tribunal has made suitable references to OECD guidelines and US regulations. This will help in establishing parity between transfer pricing determination in India and internationally accepted principles. A damper for IT services, however, is the Tribunal's ruling that transfer pricing adjustments would still apply, despite a tax holiday for taxpayers in India. Thus, captive units, availing tax holidays in India, cannot ignore obligations under transfer pricing regulations; this was anticipated though. However, a disappointment for Revenue and practitioners, alike, has been the Tribunal's silence on the issue of computation of arm's length price.

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India snippet

New appellate body for TP disputes proposed

The Finance Ministry is planning to set up an appellate body that shall deal exclusively with transfer pricing matters. The appellate body is likely to be modelled on the lines of the existing Authority for Advance Rulings (AAR).

While the terms of reference and the consequent legislations are still to be finalized; it is likely that the appellate body would address cases related to prospective transactions by non-residents only.

India snippet

OECD calls for APAs in India

In order to reduce the number of disputes arising out of intra-group transactions, the Organisation for Economic Cooperation and Development (OECD) has asked India to

Instead, the case was remanded back to Revenue for determination of arm's length price. Thus, whereas a number of procedural issues have been reaffirmed, the Ruling has added to uncertainty on valuation front; which certainly does not gain much by the absence of an advance pricing mechanism in India.

Global window

Thailand introduces TP rules

Thailand's Revenue department has launched a crackdown on companies, which transfer profits to offshore tax havens using artificial pricing. Before the new guidelines were introduced last year, the Thai transfer pricing rules were fairly primitive. The new guidelines include three permitted valuation methods: Comparable Uncontrolled Price, Resale Price and Cost Plus, which will allow the Thai Revenue department to judge whether the parties involved in a transaction are related parties. Accordingly, the Revenue department will use the permitted valuation methods to establish arm's length price.

However, there is limited information available on how the Revenue will apply the rules in practice, or on what negotiating mechanisms will be available in disputed cases.

Source: IBFD

China: New Corporate Income Tax law focuses on TP

The new Chinese Corporate Income Tax (CIT) law devotes an entire chapter to Special Tax Adjustment (STA). The objective of these adjustments is to enable the STA to tax a wide range of activities that are regarded as transferring income outside of China. The primary focus will be on transfer pricing. The STA has begun issuing notices to local tax bureaus in order to strengthen their ability to analyze transfer pricing issues. The new STA rules expand its anti-tax-evasion authority to include comprehensive enforcement of transfer pricing, capital impairment and tax haven abuse restrictions.

Source: Industry Week

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introduce Advance Pricing Agreements (APAs) between tax authorities and MNCs. According to OECD, APAs will help MNCs as well as tax authorities to ascertain tax liability on intra-group transactions in advance, thereby reducing instances of transfer pricing disputes.

Although the Central Board of Excise and Customs (CBEC) has acknowledged the need for APAs, but it hoped that India's future OECD membership would help in fostering greater co-operation between customs authorities in different countries, which in turn will mitigate issues on prices.

India snippet

Joint Working Group formed

A Joint Working Group, comprising senior officers from Income Tax and Customs departments, was set up recently with an aim of promoting greater coordination between the Income Tax and Customs departments from a transfer pricing perspective.

The recommendations of the Group are preliminary in nature and will impact the Customs and Income Tax departments at the administrative level. However, no change with respect to documentation requirements, under the respective regulations, has been envisaged. Thus, the documentation burden still does not get reduced for the taxpayer.



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