TRANSFER PRICING communiqué

December 2009

Editorial

Dear Readers,

The last quarter of 2009 saw a number of Indian judicial developments providing guidance on principles relating to interplay of transfer pricing provisions and the domestic tax law, penalties, and insights on the application of CUPs. In this edition, we have analyzed these developments and attempted to outline the positions that are emerging on the above principles, which should be helpful for taxpayers in implementing effective transfer pricing policies and procedures. Readers would also find the analysis of international judicial developments relating to guarantee fees and cost sharing payments useful given that these are some of the newer areas which would attract the Indian revenue's attention.

2010 appears to a year of definitive changes to the Indian transfer pricing landscape. The alternate dispute resolution process and impending introduction of the safe harbor guidelines are changes which will impact the resolution of transfer pricing disputes and hopefully fast track them. We will keep you updated on these important developments.

Many thanks for your continuing support, which enabled us to bag the "Best Transfer Pricing Team" award for the third consecutive year at International Tax Review's Asia Awards 2009 in Singapore. Also, BMR was awarded "India Case of the Year" award for exceptional work on Sony India's case.

We trust you enjoy reading this and future editions of TP Communiqué.
Best wishes for a peaceful year ahead.
BMR Transfer Pricing team

Focus

Recent Rulings

This edition of TP Communiqué discusses the rulings of the Tax Tribunal in the case of Gharda Chemicals Ltd (Mumbai Bench), Oracle India Private Limited and Vertex Customer Services (India) Private Limited (Delhi Bench) and the ruling of the Authority for Advance Rulings ("AAR") in the case of Dana Corporation.

- In the case of Oracle India, the Tribunal held that transfer pricing

Feedback

Events

Upcoming Events

- Indian Corporate Taxation Course, March 18-19, 2010, Singapore

Recent Events

- Direct Tax Code – Deciphering the 'Code'
- International Taxation Conference – 2009, December 3-5, 2009, Mumbai, India

Awards & Recognitions

- BMR wins ITR's Asia Award for "Transfer Pricing Firm of the Year" for the third consecutive year
- BMR wins "India Case of the Year" award at ITR Asia Awards
- BMR named the leading Financial Advisor in the mid market segment in India and 10th in APAC
- BMR is Tier 1 Firm in India for second consecutive year
- BMR is top mid-market dealmaker

Contents

Editorial
Focus

provisions, being specific in nature, override the domestic tax avoidance provisions concerning related party transactions. Accordingly, if the Transfer Pricing Officer holds a transaction to be at arm's length, there can be no disallowance under the pretext of excessive payment to related party under the provisions of Section 40(A) of the Act. The recent ruling is also in line with the ruling of the AAR in *Canoro Resources*, where it was held that the Transfer Pricing provisions, being more specific override the general provisions. The AAR in that case, had held that the arm's length nature of transactions have to be established, even when the provisions under the domestic law provided for the book value to be taken as the sale price for computation of capital gains in certain cases. Reference in this regard may also be made to the view taken by the Special Bench of the Tribunal in the case of *Aztec Software*.

Read BMR's Tax Edge on **Oracle India (October 2009)** | **Aztec Software (July 2007)** | **Canoro resources (May 2009)**

- In a landmark ruling in the case of Vertex, the Tribunal has affirmed that where a taxpayer has computed the arm's length price as per law, in 'good faith' and with 'due diligence', penalty should not be levied. This comes as welcome relief to taxpayers subjected to arbitrary or procedural penalty on transfer pricing adjustments. In reaching its decision, the Tribunal considered the fact that the taxpayers engaged reputed consultant to conduct the transfer pricing analysis, disclosed all relevant facts to the Revenue and that the benchmarking methods or comparables chosen by the taxpayer were not contended by the Revenue. This ruling is significant as under the Indian tax laws, any transfer pricing adjustment made by the Revenue can be treated as concealment by the taxpayer, unless 'exercise of good faith' and 'due diligence' by the taxpayer is proven.

  Earlier, the Tribunal had favored the taxpayer in the case of *Cargill India*, where penalty was levied for 'non-maintenance of documentation'. In this case, the Tribunal had ruled that Revenue has to call only for specific and relevant information and not simply 'all information'. It further held that the penalty would not be justified if the Revenue does not point out any specific default in complying with the documentation requirements and does not consider any 'reasonable cause' that the taxpayer may have resulting in the default.

  Read BMR's Tax Edge on **Vertex (October 2009)** | **Cargill (February 2008)**

- The AAR in the case of Dana Corporation ruled that when the transfer of shares was exempt under the domestic tax law provisions, Transfer Pricing provisions could not be applied. The AAR applied its earlier ruling in the case of *Vanenbury Group BV* and held that Transfer Pricing provisions did not intend to bring in a new head of income or to charge the tax on income which was not otherwise chargeable under the Act.

  Read BMR's Tax Edge on **Dana Corporation (January 2010)**

- The Gharda Chemical ruling provides an unprecedented view point of the Tribunal in relation to application of CUP. Even as the Tribunal recognised that Internal CUP is preferable to external comparables, it ruled that comparability has to be established in terms of market

Snippet

- Chile becomes the member of OECD
- Australian government has released for public consultation draft legislation on proposed changes to the country's thin capitalization rules

Global window

For more information, contact:

Mukesh Butani, New Delhi
Phone: +91 11 3081 5010
Email ID:
mukesh.butani@bmradvisors.com

Darpan Mehta, Mumbai
Phone: +91 22 3021 7135
Email ID:
darpan.mehta@bmradvisors.com

Abhishek Goenka, Bangalore
Phone: +91 80 4032 0100
Email ID:
abhishek.goenka@bmradvisors.com

Sriram Seshadri, Chennai
Phone: +91 44 4298 7000
Email ID:
sriram.seshadri@bmradvisors.com

Gagan Malik, Singapore
Phone: +65 6408 8004
Email ID:
gagan.malik@bmradvisors.com

Contributors to this edition:

Manish Khurana
Sahiba Tandon
Deepanjan Mitra

Other Resources

Transfer Pricing

Industry Groups

conditions and similarity of circumstances, before the internal transaction can be accepted as a comparable. Specific to the facts, it held that export by taxpayer to associated enterprise in the USA on wholesale basis is not comparable to retail exports to third parties in several other countries. It further ruled that a report of an external expert listing transaction prices cannot be sole basis for application of external CUP especially when the expert does not represent any Government agency.

Earlier, in the case of *UCB India*, the Tribunal had held generic pharma ingredients are not comparable under CUP method, to products of patented original research and observed that FAR analysis of the generic suppliers is also necessary before accepting the products as comparable. Recently, the Delhi High Court in the case of *Denso Haryana*, held prices pertaining to subsequent periods cannot be accepted as CUP.

Read BMR's Tax Edge on **Gharda (January 2010)** | **UCB (March 2009)** | **Denso (January 2010)**

Indian regulatory changes

Dispute Resolution Panel Rules

The Central Board of Direct Taxes recently announced the Income tax (Dispute Resolution Panel) Rules, 2009 to regulate the scheme of Dispute Resolution Panel ('DRP') introduced in Union Budget 2009. The DRP scheme requires the revenue authorities to issue draft assessment orders in case of eligible taxpayers, pursuant to which the DRP can be approached. The DRP shall then pass a final assessment order within nine months that can be challenged in the Income Tax Appellate Tribunal by the taxpayer (and not by the revenue authorities). The rules provide for the detailed forms and the procedural aspects.

While the DRP does offer the advantage of delaying collection of demands till the Panel passes a final order and expediting the passage to the Appellate Tribunal, some of the aspects that need more clarity are:

- It is not entirely clear whether a eligible taxpayer (ie a non-resident or a resident, in whose case an transfer pricing order has been passed) who has received a draft order, can opt for the traditional route of approaching the Commissioner (Appeals) or whether he is required to approach the Panel
- What course of action should a eligible taxpayer adopt where the revenue authorities fail to issue a draft assessment order in his case and instead erroneously, issue a final assessment order
- Are the Panel's power of enhancements restricted to the issues raised in the draft assessment order

Read BMR's Tax Edge Special on the **DRP rules**

Royalty and lump sum fees cap rules

The Government of India has removed the cap on payment of royalties, lump sum fee for transfer of technology and payments for use of trademark/brand name under the automatic approval route. Earlier, for instance, royalty for

Competencies

Publications

Key Personnel

Snippet

Chile

Chile is all set to become the 31st member of the Organization of Economic Co-operation and Development or the OECD. The country, which otherwise has a very vague transfer pricing norm, is expected to undertake major reforms in its transfer pricing regime primarily in line with the OECD guidelines. By becoming a member of the OECD, Chile will have to comply with the organization's standards for transfer pricing and establishing arm's-length prices.

Snippet

Australia

The Australian government has released for public consultation draft legislation on proposed changes to the country's thin capitalization rules. The changes will clarify how treasury shares, the business insurance assets and capitalized software costs will be treated under the thin capitalization provisions.

technology transfer was capped at five percent of domestic sales or eight percent of export sales. Similarly, the caps for royalty towards trademarks or brands were one and two percent respectively. While, this is a move to ease exchange control restrictions, it has an unintended effect on Transfer Pricing compliance for royalty transactions. Earlier, in the absence of comparables, taxpayers have referred to the exchange control ceilings to argue that the royalty payments should be accepted to be at arms length when they are within the limits prescribed by the Reserve Bank of India ("RBI"). However, this argument was not accepted by the Punjab and Haryana High Court in the case of *Coca-Cola India,* wherein the court held that exchange control provisions control the provisions of the Income-tax Act and reiterated need for applying the arm's length price in international transactions with related parties. Nevertheless, the removal of exchange control caps necessitates the need for a robust study of comparable transactions entered into by third parties to justify the royalty charged or paid to associated enterprises.

Read BMR's Tax Edge Special on **Press note 8 (2009)** for more analysis on the changes

---

Global window

Recent Global Decisions

In this section we have covered the rulings pronounced in the case of General Electric Capital Canada Inc. v. The Queen (Tax Court of Canada) and VERITAS Software Corporation & Subsidiaries vs Commissioner (United States Tax Court).

- In a long awaited judgment, the Tax Court of Canada has allowed the payment of 1% annual guarantee fees by GE Canada to its immediate holding company GE US, setting aside the Canadian Revenue Agency's contention of disallowing the fees.

  GEC Canada raised capital through the issuance of commercial paper and unsecured debentures to third parties, which was guaranteed by GEC US since 1988. GE US started charging a fee for this guarantee in 1995. The Revenue argued that there was no specific reason for charging the fees as GE Canada and GE US were closely knit organizations and GE US would never allow GE Canada to default in payments. Accordingly, there was no requirement of any additional guarantee for raising the required capital. The court, however, relied on the taxpayer's argument which suggested that the arm's length standard precludes taking the relationship between the two parties into consideration and hence guarantee fees should be paid to GE US as on a standalone basis (ie without GE US's guarantee) GE Canada's credit ratings were not healthy enough to raise the capital required.

  Related-party guarantee arrangements are always a matter of contention between the taxpayer and the tax administration, as it is very difficult to separate the implicit and explicit parental financial support of a subsidiary. This decision provides a greater importance to the explicit relationship that existed between the guarantor and the guarantee as

compared to the implicit relationship of parent and subsidiary, while determining the justification of the payment of guarantee fees.

- In the case of VERITAS Software Corp vs Commissioner, the US Tax Court has set aside a billion dollar adjustment of the cost-sharing buy-in payment received by VERITAS Software Corp. (the Taxpayer) from its Irish affiliate. The court has further held that the Taxpayer's comparable uncontrolled transactions (CUT) method, with adjustments determined by the court, was the best method to calculate the buy-in payment.

In this case, the US parent company entered into a cost sharing agreement and a technology licensing agreement with its non-resident Irish subsidiary under which the subsidiary was granted rights to develop and manufacture storage management software products and was provided the rights to use certain pre-existing intangibles (i.e. the "buy-in" transaction) respectively.

The taxpayer priced the buy-in transaction using a Comparable Uncontrolled Transaction Method ('CUT'), which featured a royalty that declined over time. This method was rejected by the IRS, which referred to the 2007 Coordinated Issue Paper on Cost Sharing Agreement Buy-In adjustments, and determined the income method as the method for determining the arm's length price for such buy-in transactions, even for transactions that occurred prior to the issuance of the temporary cost sharing regulations. Based on this, the IRS went ahead with an adjustment. Once approached, the Tax Court found that the IRS' findings were arbitrary, capricious, and unreasonable. It also found that the taxpayer's CUT method, after the Court made certain adjustments, was the best method to determine the required buy-in payment.

Global Developments

Brazil

The Ministry of Finance in Brazil has been empowered to establish different profit margins based on business sector for transfer pricing purposes. *This is similar to the change proposed in India as per the Finance Act, 2009* empowering *the CBDT to* prescribe *safe harbor rules. While the CBDT has not yet spelled out as to what the rules could be, it is expected that similar to the Brazilian development, the CBDT would also prescribe industry wise profit margins acceptable from a Transfer Pricing administration perspective.*

In another important development, Brazil has introduced thin-capitalization rules effective from January 1, 2010. Under these rules, interest paid by Brazilian entity to related party is allowable subject to the following conditions:

- Ratio of related party debt to the equity of the Brazilian entity not to exceed 2:1
- Where the related party is in a low tax country or tax haven, the interest paid would be deductible only if the debt from such related party does not exceed 30 percent of the equity of the Brazilian entity. Further, the taxpayers have to establish that the interest expense was necessary for their activities.

Japan

Transfer pricing changes proposed in draft tax legislation

Japan has released a report on a draft tax legislation, which calls for more specific documentation requirements for foreign related-party transactions and the manner in which the intercompany pricing for those transactions is determined. However, it is not mandatory for the taxpayers to have the documentation in place at the time of furnishing the tax return. However, they have to be in a position to furnish the information and documentation, without delay, when requested by the tax authorities, failing which the authorities would be in a position to use secret comparables to determine arm's-length prices. The report does not provide for any form or the content for the maintenance of the documentation.

Under the current transfer pricing rules, the ownership of 50 percent of more of the stock of a foreign entity creates a related-party relationship as a result of which Japan's Transfer Pricing regulations become applicable. However, this resulted in the Transfer Pricing regulations being applied even when the shareholder did not exercise effective control over the subsidiary. Heeding to taxpayers' concerns on this, the report calls for the promulgation of rules to determine whether a taxpayer exercises effective control over a foreign entity.

Hong Kong

Towards the end of the year 2009, the Hong Kong Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Note No 46 (DIPN 46) which articulates IRD's view and provides specific guidelines in relation to transfer pricing matters. DIPN 46 broadly covers the following aspects of transfer pricing:

- The methods adopted by DIPN are in coherence with the OECD transfer pricing methods - the comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method and profit split method.
- Contrary to the State Administration of Taxation guidelines followed in mainland China, DIPN 46 stresses on the use of ranges for the determination of arm's length price.
- DIPN requires the use of multiple year data, both for tested party and the comparable companies under TNMM for substantiating the arm's length principle.
- DIPN does not provide for any hierarchy of methods but states that when both a transaction-based method and a profit-based method can be applied in an equally reliable manner, the transaction-based method is preferred. It also allows usage of other methods to justify the arm's length principle in case the prescribed methods do not yield fruitful results.
- DIPN also provides for "True-up adjustments" ie a review process to ensure adjustment for material changes to reach target levels of profitability established in benchmarking studies.
- Treatment of intra-group services has been dealt in great detail in the DIPN 46. On an overall basis the handling is similar to the OECD guidelines, except that mark-ups should be charged if the entity is in the principal business of rendering services. However, no markup would be required when an enterprise renders services merely as part of its general management and is not its primary business activity.
- DIPN 46 reiterates the fact that Transfer Pricing documentation is not mandatory under the Regulations, but indicates that the IRD may call

upon enterprises to justify their transfer pricing in an enquiry, audit, or investigation.

Disclaimer:

This newsletter has been prepared for clients and Firm personnel only. It provides general information and guidance as on date of preparation and does not express views or expert opinions of BMR Advisors. The newsletter is meant for general guidance and no responsibility for loss arising to any person acting or refraining from acting as a result of any material contained in this newsletter will be accepted by BMR Advisors. It is recommended that professional advice be sought based on the specific facts and circumstances. This newsletter does not substitute the need to refer to the original pronouncements.

About BMR | Contact Us | Archives