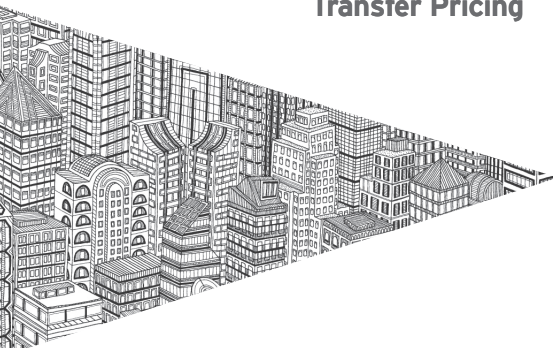


International Tax Alert

News and views from
Transfer Pricing



Recent developments on transfer pricing audits in India: increased focus on transfer pricing aspects of intangible property

Executive summary

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One of the most challenging issues in transfer pricing (TP) is the taxation of income from intangible property (IP). The issues may arise in several contexts, such as the appropriate royalty to be charged by a licensee of unique IP or the appropriate intercompany transfer price for goods manufactured and sold by a controlled distributor when the manufacturer owns the trademark for the finished goods. This Alert summarizes recent developments in transfer pricing enforcement and audits in India relating to IP transactions between related parties.

Recent TP audit experiences have shown an increased and intense focus by the Indian tax authority on IP aspects of TP. The approach of the tax authority has been to make a detailed inquiry into the nature of the arrangements entered into by the taxpayer relating to transfer / use of the IP, request the taxpayer to demonstrate the benefits received from use of the IP, and seek justification that the payment is arm's length in nature. The nature and extent of inquiry is likely to put an onerous burden on most taxpayers as documentation of these categories of transactions often lags behind documentation for tangible goods transactions. This is likely to result in making the already challenging Indian transfer pricing audit process even more difficult to manage. Absence of specific TP rules in India dealing with IP and the controversial nature of some of the issues are likely to result in complex and monetarily significant transfer pricing disputes and risks of double taxation.

In light of recent developments, taxpayers may need to consider developing or enhancing their existing documentation for these types of transactions, consider customizing their global TP platforms for IP transactions to meet local requirements, prepare for audits in advance by building a TP defense file based on the information/data requests made in recent audits and adopt a more proactive approach to TP dispute resolution and controversy management as early as possible in the audit life cycle.

Furthermore, as this is a continually evolving area, taxpayers are also advised to follow the progress of the OECD's recent initiative on TP aspects of IP to assess the likely impact of the developments on their pricing for IP transactions.

The tax authority's approach: recent developments

The Indian tax authority has become increasingly sophisticated in relation to its management of TP issues. An audit begins by reviewing the transfer pricing documentation prepared by the taxpayer. Transfer Pricing Officers (TPOs) scrutinize payment for the use of IP such as a trademarks, know-how and brand names by Indian taxpayers in great detail. Once in an audit phase, the TPO will gather information usually by the issue of notices or information requests. While payments for the use of IP have generally been a focus area during a TP audit, recent experiences seem to indicate a higher degree of scrutiny and inquiry. The

information/data request made by the TPOs are fairly comprehensive as well as quite specific. Some of the information/data that have been requested in recent audits are outlined below:

- ▶ A copy of the intercompany agreement for the use/transfer of the IP
- ▶ Information pertaining to the IP, including:
 - Description of the IP
 - Uniqueness of the IP
 - Details of process, product, components or devices covered by the IP
 - Details of improvements and whether the Indian affiliate has the right to receive upgraded versions or modifications to the technology
 - Information relating to the estimated useful life of the IP and development life cycle
 - Information relating to availability in the open market and potential substitutes for the IP
- ▶ Demonstration of the benefits
 - Details of the cost-benefit analysis undertaken at the time of entering into the intercompany agreement showing expected benefit from the use of technology vis-à-vis payment made for the technology
 - Evidence of the tangible and direct benefit derived from the use of the IP

- Quantification of the benefits derived
- Comparison of profits before and after the use of the IP
- ▶ Justification of arm's length price
 - Basis of determination of the rate of royalty
 - Details of royalties paid by other affiliates to the affiliate owning the IP
 - Whether the owner of the intangible is providing similar technology to an independent party and if yes, the rate of royalty thereof
 - Contemporaneous comparable uncontrolled data relating to royalty rates
 - Evidence that the royalty payment is not included in the price of goods purchased from an affiliate; in the absence of evidence, explanation as to why there should not be a presumption of its inclusion

From a review of the information/data requests, it appears the tax authority would expect a taxpayer to have the ability to demonstrate that the benefits it reasonably expects to secure from the use of the IP are satisfactory relative to other options realistically available and the relevant comparability factors. This test, known as the benefit test, is critical to determine whether a related party would pay for the use of the IP and, therefore, whether the licensor can justify a charge for the provision of the IP under arm's length conditions. Inherent in the information/data

request is the need for a taxpayer to consider special factors relevant to comparability of IP transactions, which include expected benefits from the IP, limitations on the geographic area in which rights may be exercised, exclusive or nonexclusive character of any rights transferred, capital investment and startup expenses and the development work required to exploit the IP, licensee's right to participate in the licensor's further developments of the property, etc.

What does this mean for taxpayers?

Taxpayers may experience more intense audit activity on related party IP transactions and more TP disputes. Further, as may be gleaned from the information/data requests, compiling the necessary information is likely to be an onerous and time consuming task for taxpayers, which may be further compounded by the short time frame within which the tax authority would typically expect the taxpayer to respond.

The general principles for determining the arm's length price contained in the Indian TP rules equally apply to IP transactions. These principles can, however, be difficult to apply to controlled transactions involving IP. First,

such property may have a special character that complicates the search for comparables and in some cases makes value difficult to determine at the time of the transaction. Further, associated enterprises might sometimes structure a transfer in a manner that independent enterprises would not contemplate because of legitimate business reasons that arise as a result of the relationship between them. Absence of specific TP rules in India dealing with IP and the controversial nature of some of the issues are likely to result in complex and monetarily significant transfer pricing disputes and risks of double taxation.

What should taxpayers do?

Taxpayers may need to consider the following for managing the likely challenge:

- ▶ Develop or enhance documentation for these types of transactions. As identified in Ernst & Young's 2010 Global Transfer Pricing Survey documentation of IP transactions (along with service and financing transactions) often lags behind documentation for tangible goods.
- ▶ Taxpayers may need to tailor their global TP platform for analysis of IP transactions to local

requirements in view of the higher risk of scrutiny. Taxpayers should look at developing an integrated global and local approach to documentation.

- ▶ Prepare for an intensive TP audit on these types of transactions in advance by building a TP defense file based on the information/documents that may be requested during an audit.
- ▶ Consider a more proactive approach to controversy management and dispute resolution early in the life cycle of an audit.

TP aspects of IP transactions have been identified by the OECD as a key area of concern for governments and taxpayers due to insufficient guidance in particular on the definition, identification and valuation of IP for TP purposes. Considering the importance, the OECD has recently launched a project on this issue that could result in a revision of the OECD TP Guidelines on IP. As this is a continually evolving area, taxpayers should follow the OECD developments closely to assess impact, if any, on their TP policy and practices for IP transactions.

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EYG no. CM2429

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