



India, at Arm's Length

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Dear readers,

We are delighted to present the sixth edition of India, at Arm's Length, our quarterly publication covering transfer pricing developments in India and a round-up on key international developments on transfer pricing (TP).

In recent years, the appropriate treatment for provision of intra-group services has become a critical TP issue in India. These types of transactions are more susceptible to audit by tax authorities. Recent TP audit experiences have shown an increased and intense focus by the Indian tax authority on TP aspects of intra group services. The "Viewpoint" section of this edition covers some key TP aspects of intra-group services.

In our "Insights" section we provide information on current trends and experiences in transfer pricing controversy and dispute resolution.

"By order!" covers transfer decisions in India that could have an impact on your business, while the "Around the world" section covers a round-up of key TP developments from around the world.

We hope you find this a useful publication and look forward to your feedback and suggestions to improve it further.

Best regards,

Ernst & Young Transfer Pricing team

Viewpoint

Transfer pricing aspects of intra-group services

In recent years, the appropriate treatment of provision of intra-group services has become a critical transfer pricing (TP) issue in India. These types of transactions are more susceptible to audit by tax authorities. If it is determined for TP purposes that services have been provided by one member of a group to other members of that group, arm's length pricing for these intra group services needs to be established. The issues that arise in this context include justifying that a benefit is anticipated to be or has been obtained from the performance of services and determining that the amount of charge is at arm's length.

OECD TP guidelines

In multinational groups, it is common to arrange for a wide scope of services to be made available to its members, particularly administrative, technical, financial, and commercial services. Such services may include management, coordination, and control functions for the whole group.

Essential guidance on the treatment of intra-group services can be found in Chapter VII of the OECD Guidelines and the 1984 OECD Report 1984 on the Allocation of Central Costs. The Guidelines qualify an activity by a group member as a (chargeable) service if the activity provides another group member with "economic or commercial value to enhance its commercial position". This benefit test is coupled with an arm's length test: will an independent party in comparable circumstances be willing to pay for the activity concerned (or have performed the activity in-house for itself)? As for the benefit test, the Guidelines seem to focus on the receiver of a service, requiring a specific benefit for which an unrelated party will be willing to pay. Such requirements may not always be feasible; however, as is the common practice in MNEs where different types of activities are carried out for the benefit of the group as a whole, and a specific actual benefit for individual group members may be difficult to determine.

The Guidelines discuss categories of activities and benefits for which no charges should be made: shareholder activities, duplicative services, incidental benefits and affiliation benefits. The Guidelines qualify these categories as generally not resulting in a benefit for the other party.

Shareholder activities: The scope of shareholder activities is often a point of discussion between taxpayers and tax administrations. These are activities that a group company (parent company or regional holding company) performs solely because of its ownership interest in one or more of the group members, i.e., in its capacity as shareholder even though these members do not need the activity and will not be willing to pay for it. The Guidelines explain that the term "stewardship activity" is to be distinguished from

shareholder activity. The Guidelines quote the following examples of shareholder activities from the 1984 Report: (a) costs of activities relating to juridical structure of the parent itself, such as meetings of its shareholders, issuing of shares in the parent and costs of the supervisory board; (b) costs relating to reporting requirements of the parent, including consolidation of reports; and (c) costs of raising funds for the acquisition of participations.

Duplicative activities: No charge should be made in cases where an activity of a group member merely duplicates a service that another group member is performing for itself or which is rendered by a third party for it. A seemingly duplicative activity may, however, be useful for the party aimed at, according to the Guidelines, e.g., in the case of a second legal opinion. In cases of reorganization, duplication of activities may arise, justifying a temporary exception to the principle of not charging. In practice, it may often happen that tax authorities do not accept a charge pointing to the duplicative character of an activity using the argument that an independent party would not have ordered or carried out the same activity twice. Counterarguments could be risk reduction in complicated matters and the benefit of intra-group capabilities at relatively low cost. It may be useful to note that § 1.482-9(i)(3)(iii) of the US TP Regulations makes an exception where the duplicative activity itself provides an additional benefit to the recipient. Example 6 in the paragraph mentioned illustrates the situation: company X has expert in-house legal staff. (Group) company Y negotiates a complicated joint venture with a third party, for which it obtains outside legal advice. Before the deal is made the legal department of X reviews the documents and concurs with the external counsel's opinion. Although the activities are duplicative there is an additional benefit for Y in that its commercial risk is reduced because of the check by the internal legal department.

Incidental benefit: Incidental benefits arise from activities meant for other group members. As an independent enterprise will not be willing to pay for such benefits no charges should be made, according to the Guidelines. The Guidelines focus on the recipient stating that a recipient will not be prepared to pay an uncontrolled party to perform an activity yielding an indirect or remote benefit only.

Affiliation benefit: No intra-group service can be recognized in the event of merely being a member of a larger concern, without any specific activity being performed for that member. The Guidelines give the example of a higher credit rating than when being unaffiliated. Only when this is due to a guarantee given by another group member or as a result of a group's reputation deriving from public relations campaigns, the benefit is more than incidental.

Whether any activity falls within the definition of "non-beneficial" activities should be determined based on all surrounding facts and circumstances. The underlying test in all cases should be whether



an independent enterprise in comparable circumstances will be willing to pay for it or perform it in-house. Once this is determined, inclusion or exclusion as a service rendered is determined.

Once it is determined that an intra-group service has been rendered, it is necessary to determine whether the amount of the charge, if any, is in accordance with the arm's length principle. This means that the charge for intra-group services should be one which would have been made and accepted between independent enterprises in comparable circumstances¹.

The OECD Guidelines distinguish between direct charging and indirect charging as systems for the allocation of central activities and remuneration for services rendered to other group members.

Direct charging, which means charging for specific services rendered to other group members, has traditionally been favored by tax authorities, as it allows a relatively easy check on the arm's length character. The Guidelines state that MNEs should be able to adopt direct charging arrangements where similar services are also rendered to unrelated parties. It is not phrased, however, as being mandatory, as the Guidelines use the term "encouraged". Only where the services concerned form a main business activity of the enterprise concerned and are also rendered to third parties, indirect charging will not be permitted.

Where similar services are rendered to unrelated parties as well, the third-party charge may be - or may become after necessary modifications - an internal CUP. The Guidelines also point to comparable services, such as accounting, legal and IT, available in the open market, which may provide external CUPs.

In the absence of (internal) CUP, the cost-plus method is the most appropriate method under the Guidelines and the transfer pricing regulations of almost all countries and also the most common method in practice. Under the cost-plus method an arm's length markup must be established.

According to the Guidelines, indirect charging methods are allowed if sufficient regard is given to the value of the services to the recipient and to the extent to which comparable services are provided between independent enterprises. An exception is made for services rendered also to unrelated parties, which form a main business activity of the renderer. Indirect charging is unavoidable in two cases, according to the Guidelines: (1) where the value of the services to the related entities cannot be quantified except on an estimated basis (e.g. in cases of central sales promotion); and (2) where recording and analysis of service activities for each recipient will involve a disproportionate administrative burden. An allocation method must be applied, which makes sense for the activity concerned. The allocation method used must lead to a result that

¹ Para 7.24 of the OECD TP Guidelines

is consistent with what comparable independent enterprises would have been prepared to accept. This test seems rather theoretical as information on acceptability by independent enterprises in such cases is probably very difficult to obtain (except where non-related parties participate in the activity and the allocation system concerned on the same conditions).

The Guidelines discuss the cost base of the cost-plus method from the perspective of comparison of transactions, referring to the necessity of adjusting the cost base of a controlled transaction if the proportion of overhead costs to direct costs is higher than in the transaction it is compared with. It may be useful to note that the US TP Regulations [§ 1.482-9(j)] indicate which costs must be included: "total service costs", meaning all costs in cash or in kind (including stock-based compensation) that are directly identified with, or reasonably allocated to, the services concerned. For a reasonable allocation of indirect costs, such as overhead expenses, costs of supporting departments and other general or administrative costs, consideration must be given to all bases and factors, e.g., assets, sales, compensation, space utilized and time spent [§ 1.482-9(k)].

If in the absence of a CUP, a cost-based method has to be applied, the question arises whether a markup should be added. The 1984 OECD Report states that normally an appropriate profit element should be included except where the service is usually performed between unrelated parties on a cost price base. In particular where the provision of the services concerned is a major activity of the enterprise, or the enterprise is particularly capable of providing valuable services to related recipients, a profit element will be mandatory. The 1984 Report, however, makes an exception to this rule. It states that where a group service center renders services to group members only, the function of such a center may, in essence, be to reduce the costs of the group rather than make a profit for itself. In such a case direct or indirect charging of costs only should be acceptable.

Recent Tribunal rulings

The Bangalore Income Tax Appellate Tribunal (Tribunal), in a ruling in the case of M/s Gemplus India Pvt. Ltd.² (Gemplus India), ruled on the TP aspects of management services fees paid by Gemplus India to its regional headquarter company (HQ). In this case,

Gemplus India has entered a Management Services Agreement (MSA) with its regional headquarters and AE in Singapore according to the terms of which the AE will provide need-based services with respect to marketing and sales support, customer service support, finance, accounting and administration support and legal support. The charges for the services rendered by the AE were billed on the basis of the time spent for the services rendered to the taxpayer with an overall cap of US\$300,000 per annum. During the audit proceedings, the Transfer Pricing Officer (TPO) held that the Taxpayer had not derived any specific benefit from the management services and that the payment toward management services was not justified. The Tribunal upheld the adjustment made by the TPO and held that Gemplus India has not proved the commensurate benefits received for the service fees paid to the HQ and, hence, ruled that the payment of the management services was not justified under arm's length principles. The Tribunal, in this case, had relied on the underlying documentation of Gemplus India before concluding that there were no details available on record with respect to the nature of services rendered by the HQ to Gemplus India.

In another ruling, in the case of M/s Dresser-Rand India Pvt. Ltd. (Dresser India)³, the Mumbai Tribunal has ruled on the TP aspects of payments made under a cost contribution arrangement (CCA) for intra group services availed by the taxpayer from its parent company or AE. In this case, Dresser India has entered into a CCA with its AE for provision of various services by its AE. According to the terms of the CCA, the Taxpayer was to compensate the AE on an equitable basis for the expenses incurred and the allocation of the cost contribution to various affiliates of the Group (including the Taxpayer) was on the basis of headcount and sales. During the audit proceedings, the TPO proposed an adjustment to these payments on the basis that these services were duplicative in nature and that the Taxpayer had not derived any benefit from these services. The Tribunal held that the TPO cannot question the commercial wisdom or reasoning to provide the services and should restrict itself to determining whether the price paid by the Taxpayer was comparable to the price paid by an independent enterprise for the same transaction. The Tribunal held that documentary evidence submitted by the Taxpayer is sufficient proof of services rendered and the tax authorities should have provided reasons for not considering the evidence as satisfactory rather than summarily concluding that no service has been rendered.

² 2010-TII-55-ITAT-BANG-TP

³ ITA No. 8753/Mum/2010; as reported in <http://www.taxsutra.com>

⁴ ITA No. 5156/Del/2010; as reported in <http://www.taxsutra.com>

The Delhi Tribunal, in a ruling⁴ in the case of Li & Fung (India) Private Limited (Li Fung India), has ruled on the TP aspects of intra-group procurement services. In this case, the taxpayer - Li Fung India is engaged in providing buying/sourcing services to its AE. The AE received remuneration from uncontrolled customers at 5% of the "FOB value" of exports of the sourced products. For the provision of procurement services, Li Fung India was remunerated on an operating cost plus 5%. In this case, The Tribunal held that as the taxpayer has performed all the critical functions pertaining to sourcing of finished products sold by the AE, has developed intangibles over a period of time and has a location advantage, remuneration based on a cost plus mark up is not appropriate.

The Tribunal upheld the approach adopted by the Transfer Pricing Officer (TPO) and confirmed that with regard to the facts of the case, the taxpayer should earn a remuneration based on a percentage of FOB value of exports to end customers. The Tribunal accordingly ruled that 80% of the 5% commission on FOB value of goods earned by the taxpayer's Associated Enterprise (AE) from uncontrolled customers should be allocated to the taxpayer.

The ruling reinforces that a careful review of these factors is necessary to determine an appropriate transfer pricing model. The ruling, however, does not provide clear guidance on what kind of functions, risks and unique intangibles related to sourcing functions may give rise to non-routine procurement benefits. The ruling also raises the question on the relevance of location savings/ location-specific advantages in TP even though it does not lay down an analytical framework to evaluate the existence of location savings and other location-specific advantages, quantify them and to whom they should be attributed under arm's length conditions.

The above rulings highlight the importance of maintaining documentary evidence in order to demonstrate the nature of services rendered and the extent benefit is derived. Factors such as use of intangibles to provide services and location advantages enjoyed by the service provider to determine the appropriate TP are also emerging as relevant issues. While the Dresser Rand ruling suggests that the tax authority may not question the commercial wisdom of a taxpayer entering an international transaction, it does suggest that determining whether a service provides commercial or economic value may still be relevant in evaluating whether a taxpayer has received a benefit from a service, which, consequently, must be compensated at arm's length.

Some practical challenges

While it is relatively easy to identify the various categories of expenses, problems exist in determining within which class certain expenses should be placed, whether the benefits are direct or indirect and whether the benefits are proximate or remote. Challenges can also arise in identifying good quality comparables.

Taxpayers may experience more intense audit activity on intra group services and more TP disputes. In the absence of adequate underlying documentation, the tax authorities may contend that the services rendered by the foreign affiliate are either "shareholder activities" or do not provide a specific benefit to the Indian affiliate, and therefore, under arm's length conditions do not justify a charge. Further, 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 typically expect the taxpayer to respond.

Absence of specific TP rules in India to deal with intra group services and the controversial nature of some of the issues are likely to result in complex and monetarily significant transfer pricing disputes and to risks of double taxation.

Future outlook

Taxpayers may need to consider the following to manage the likely challenge:

- ▶ Taxpayers can develop or enhance documentation for these types of transactions.
- ▶ Taxpayers may need to tailor their global TP platform for analysis of intra group service transactions to local requirements in view of the increased risk of scrutiny. They should look at developing an integrated global and local approach to documentation.
- ▶ Taxpayers should 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.
- ▶ They should consider a more proactive approach to controversy management and dispute resolution early in the life cycle of an audit.

Insights

Dispute resolution panel news

Introduced in July 2009, the intent of the dispute resolution panel (DRP) was to provide an alternative mechanism to resolve disputes. The DRP was to replace the first-level appellate authority under the current hierarchy of appeals under the Indian Tax Law (ITL). The first cycle of the DRP (pertaining to AY2006-07) saw the panel reluctant to disturb any substantive or legal issues of dispute. Further, in a number of instances, the DRP had not passed speaking orders. The Delhi High Court and numerous Tribunals had remitted the files of the DRP for reconsideration to pass a speaking order.

The second cycle of the DRP (pertaining to AY2007-08) is currently in progress. Like last year, this year too, the Panel was reluctant to disturb any substantive or legal issues of dispute. While some locations such as Delhi and Hyderabad have seen relief being granted to taxpayers on certain factual positions, some locations such as Bangalore have provided very limited or no relief to the taxpayers even on factual matters.

Further, in light of the rulings stated above, the DRP has passed a speaking order in most cases.

Taxpayers may need to consider evaluating alternative approaches to controversy management in case of adverse orders from the Panel at an early stage.

Assessment news

The Central Board of Direct Taxes (CBDT) recently completed a reshuffle of its officers. The transfers have been across locations. The TP audits for FY07-08 are currently in progress. Most Transfer Pricing Officers (TPOs) took charge only by end of August 2011. Given the paucity of time in completing the audits for FY07-08, the initial notices and adjustments proposed indicate that the trend of prior years is likely to continue. There is continued focus on transactions such as sales and marketing support services, allocation for management services and use of intangibles.

There is also an increased focus on transactions such as procurement services rendered by Indian affiliates. Tax authorities will typically review the level of activities undertaken by the Indian affiliate to assess if the same is routine or whether the activities provide unique non-routine benefits to the Group.

These trends indicate that transfer pricing will continue to be a contentious issues for taxpayers. Taxpayers will need to consider developing an approach to dispute resolution and risk management at the time of setting their transfer pricing policies for India.

In the absence of a mechanism for advanced pricing agreements in the law for achieving upfront tax certainty on these issues, taxpayers may need to consider resolution of the dispute either by way of litigation or by way of mutual agreement procedure (MAP). Litigation can be a costly and time consuming procedure and if a comprehensive win is not achieved, economic double taxation cannot be avoided. Therefore, resolution through the MAP should be given due consideration.



By Order!

Delhi Tribunal

Treatment of extraordinary expenses considered by the Tribunal
S 92CA; A/Y 2004-05 and 2006-07; in favor of Revenue

The Taxpayer, an Indian company, was engaged in providing call center services only to its parent company. During the year under consideration (previous year 2003-04), the parent company was to get new business from a client. It was decided that a part of the business will be allocated to the Taxpayer. In order to carry out this work, the Taxpayer was required to increase its capacity. Therefore, new premises were hired and prepared for the work. However, the order was cancelled by the client and a winding up agreement was signed for payment of compensation for direct set up expenses. The Taxpayer was reimbursed all the initial set up costs but the rent and electricity charges for the premises were not reimbursed. The lease for the new premises had a lock in period of three years due to which the Taxpayer had to pay rent for three years whether the agreement was terminated or not. The Taxpayer adopted TNMM to determine the ALP of its transactions and considered the rent and electricity expenses as extraordinary expenses while computing the profit level indicator (PLI).

During the audit proceedings, the TPO questioned the treatment of the rent and electricity expenses as "extraordinary items". The Taxpayer argued that it had been making efforts independently to develop its customer base so as to utilize the new premises. However, it had not resulted in any contract. It was argued that the expenditure had no nexus with its international transactions. The TPO disregarded the contentions and held that the extraordinary expenses were that of the parent company and not of the Taxpayer. He also rejected various comparables selected by the Taxpayer on various grounds such as differences in market in which service is provided, low turnover and insufficient public information. He also undertook a fresh search considered new comparables to determine the ALP.

Held, the Taxpayer had no responsibility to market for the business of the group. This is also documented in the TP report of the Taxpayer. Further a perusal of the profit and loss account for the years under consideration reflects that there is no separate head of expenses relating to advertisement, sales promotion etc. and hence, it will be difficult to come to a conclusion that the Taxpayer has been marketing its business independently. The conclusion to be drawn on the basis of the facts on record is that the expenditure has been incurred by the Taxpayer at the behest of the parent company. Therefore, the expenditure should have been borne by the parent company in the same manner as other costs were borne as a consequence of the winding up. Further, held that suitable adjustments have to be made to the PLI in respect of the idle capacity of the Taxpayer. The Tribunal further held that companies, which

are functionally different, companies with persistent operating losses, companies with significant related party transactions and companies operating in different geographic locations, ought to be rejected while undertaking a comparability analysis.

Matter remitted back to the AO/TPO to determine the ALP in accordance with the above.

ITO vs. CRM Services India (P) Ltd., Bangalore [2011-TII-86-ITAT-DEL-TP]

Hyderabad Tribunal

The tolerance band (+/-5% range) provided under the Act is not to be taken as a standard deduction.

The Taxpayer is responsible for the quality of the work it performs for its AEs and hence, it cannot be said that the Taxpayer operates in a risk-free environment to warrant a risk adjustment.

S 92A(2Xi), 92C(2), 92CA A/Y 2004-05; in favor of Revenue

The Taxpayer, a resident in India, provided IT-enabled (BPO) and software development services to its overseas AEs and was compensated on a cost plus 7% mark up basis by its AEs. The Taxpayer adopted TNMM to determine the ALP and conducted a search to identify potentially comparable companies. For the software development segment, the Taxpayer identified 13 comparable companies with an arithmetic mean of 8.69% as against the 7% declared by the Taxpayer. For the BPO segment, the Taxpayer identified six comparable companies with an arithmetic mean of 9.29% as against 7% declared by the Taxpayer. Since the net margin of the Taxpayer was within the 5% range of the arithmetic mean of the comparable companies under both the segments, it was concluded that the international transactions are at arm's length. Further, in the absence of financial data for FY03-04, data for FY01-02 and FY02-03 were also used.

During the audit proceedings, the TPO rejected nine companies out of the 13 companies in the software segment and arrived at a net profit margin of 16.78%. For the BPO segment, the TPO rejected 5 out of 6 companies identified as comparables and also conducted a fresh comparability analysis to arrive at net profit margin of 35.60% as the arm's length margin. The TPO also rejected the claim of the Taxpayer for a risk adjustment and also did not allow the benefit of 5% range.

Held, the tolerance band of the +/-5% range provided under the Act is not to be taken as a standard deduction. It is only when the arithmetic mean falls within the tolerance band there should not be any adjustment to the transfer price. If it exceeds the said tolerance band, then an adjustment to the TP is required without giving deduction of 5%. On the availability of the risk adjustment, the

Tribunal, after a perusal of the agreement between the Taxpayer and its AE held that the Taxpayer had warranted delivering its work free from any errors. It was carrying several risks while undertaking various services for its AEs and hence, it cannot be said that the Taxpayer was operating in a risk-free environment. Held, that the Taxpayer is not entitled to any risk adjustment. The Tribunal also dealt with the acceptance and/or rejection of various companies by the TPO.

The matter was remitted back to the AO/TPO to determine the ALP in accordance with the above.

M/s Deloitte Consulting India Pvt. Ltd. vs. DCIT, Hyderabad [2011-TII-88-ITAT-HYD-TP]

Chennai Tribunal

Customs valuations can act as a CUP

S 92CA(3), 92CA A/Y 2006-07; in favor of Revenue

During the year under consideration, the Taxpayer imported coal from its AE to supply the same to various consumers in India. During the audit proceedings, the TPO obtained data from the customs authorities and determined an instance of import made by the Taxpayer for a price higher than the price quoted by another importer for the same day. The TPO observed that the Taxpayer had imported 1,000 MT of coal at US\$46.51 per MT while another party had imported 1,440 MT at US\$43 per MT. The TPO held that since the difference between the consignment of the Taxpayer and that of the third party crossed the tolerance limit of +/-5%, an adjustment to the purchase price of the Taxpayer is warranted.

In appeal before the Tribunal, the Taxpayer contended that the valuation of the customs authorities need not necessarily be realistic as the customs department is more interested in collecting import duties. It was also argued that one of the reasons for the difference in the price could be the difference in the quality or the calorific value on the basis of which price of coal is determined in the international market.

Held, the valuation made by customs authorities is based on scientifically formulated methods, which depends upon large volume of international data classified according to internationally accepted protocol. Therefore, it is not possible to say that the credibility of the price rate furnished by the customs authorities needs to be discounted. In the present case, the Taxpayer has not submitted any information on the calorific value of the coal nor has

the Taxpayer produced any acceptable material to establish its case for a different price other than the customs price. The CUP method has to be applied in the present case.

M/s Coastal Energy Pvt. Ltd. vs. ACIT, Chennai [2011-TII-78-ITAT-MAD-TP]

Bangalore Tribunal

There is no restriction on the TPO to make an enquiry by issuing notices u/s 133(6) after the specified date to determine the ALP. The principle of natural justice requires that when any information is sought to be used against the Taxpayer, the Taxpayer shall be given a fair opportunity of hearing on that material.

S 92B, 92C, 92CA, 92D, 133(6) A/Y 2006-07; partly in favor of Taxpayer

The Taxpayer, a resident of India, provided IT-enabled (BPO) and software development services to its overseas AEs and was compensated on a cost plus 7% mark up basis by its AEs. The Taxpayer also rendered services to domestic clients. The Taxpayer adopted TNMM to determine the ALP and conducted a search to identify potentially comparable companies in both the segments. During the audit proceedings, the TPO rejected a few comparables determined by the company on various grounds. The TPO undertook a fresh comparability analysis and identified additional comparables after issuing notices under section 133(6) to companies where complete information was not available in databases. The TPO determined the average profit margin and made adjustments to the transfer price of the Taxpayer.

In appeal before the Tribunal the Taxpayer submitted that transfer pricing adjustments should be restricted to AE transactions only and hence operating cost of the software segment referable to AE transactions only should be taken into consideration. The Taxpayer also contended that the power of the TPO could not be used to cover information that came into the public domain after the specified date as this is not only against the principles of natural justice but is also likely to result in the ALP being fluid and would lead to an ever changing ALP.



Held, transfer pricing adjustments should be restricted to international transactions between AEs only. When companies, which are loss making are excluded by the TPO, then the super profit making companies should also be excluded. Turnover filter is very important since big companies are likely to be in a position to bargain the price and also attract more customers. It is also likely to have a broad base of skilled employees who are able to give better output. Hence, application of the turnover filter by the Taxpayer is justified.

Further, held that according to the law, the Taxpayer is under an obligation to maintain the information and documents as may be necessary to establish arm's length nature of the international transactions by the specified date. Hence there is no restriction on the TPO to make enquiries thereafter for determining the correct ALP. Thus, the TPO need not inform the Taxpayer about the process used by him for issuing the notices u/s 133(6) nor is he under an obligation to furnish the entire information to the Taxpayer. The principles of natural justice requires that when any information is sought to be used against the Taxpayer, the Taxpayer shall be given a fair opportunity of hearing on that material. If any information is sought to be used against the taxpayer, the same has to be furnished to the taxpayer and after taking into consideration the taxpayer's objections, the TPO should proceed to take a decision. If the Taxpayer seeks an opportunity to cross examine the party, the Taxpayer shall be provided such an opportunity.

Matter remanded back to the file of the AO/TPO to determine the ALP in accordance with the above.

M/s Genisys Integrating Systems (India) Pvt. Ltd. vs. DCIT [2011-TII-96-ITAT_BANG-TP]

Mumbai Tribunal

Lack of good faith and due diligence cannot be inferred when the ground on which ALP determined by the taxpayer has been rejected are reasonably debatable.

S 92C,27(1)(c),A/Y 2004-05; in favor of Taxpayer

The Taxpayer, an Indian company, provided stock broking services to its AEs and adopted TNMM to compute the ALP. During the audit proceedings, the Taxpayer contended that prices charged to AEs could not be compared with prices charged to non-AEs (i.e., internal CUP could not be applied), as no marketing effort was required and no credit risks were involved in doing business with AEs. However, the TPO rejected the application of TNMM and adopted the CUP method, holding that it was not possible that no marketing and sales efforts were required in the case of AEs. Based on the TPO's order, AO made an adjustment to Taxpayer's income and also levied penalty u/s 271(1)(c) on the ground that the Taxpayer had furnished inaccurate particulars of income.

The CIT(A), the first appellate authority, deleted the penalty, holding that transfer pricing was based on estimation and it was possible to draw different conclusions from the same facts. The Tribunal upheld the order of the CIT(A).

Held that when TNMM is rejected by the revenue authorities, without finding any specific reasons for its inapplicability, and simply on the ground that a direct method is more appropriate to the particular fact or situation, it cannot be a fit case for imposition of penalty. Explanation 7 to Sec 271(1)(c) is a special provision confined to transfer pricing and will apply for levy of penalty for transfer pricing addition as against general provision embodied in Explanation 1 to Sec 271(1)(c) as adopted by the AO. Lack of good faith and due diligence cannot be inferred when the ground on which ALP determined by the taxpayer has been rejected are reasonably debatable, even if correct. The Taxpayer had obtained a transfer pricing study from an outside expert, the objectivity of which is not called into question. In such a situation, it cannot be said that the Taxpayer has not determined the ALP in accordance with the scheme of section 92C in good faith and with due diligence.

DCIT vs. RBS Equities India Ltd. [ITA No 2570/Mum/2010]



Around the world

Canada

The MAP program report reflects increased TP audit activity

On 29 July 2011, the Canada Revenue Agency (CRA) released its Mutual Agreement Procedure (MAP) Program Report for the fiscal year ending 31 March 2011 (covering the period from 1 April 2010 to 31 March 2011). The MAP is a process by which the competent authorities of two countries interact in an effort to eliminate taxation that is not in accordance with the provisions of a tax treaty between the two countries. The Canadian Competent Authority responsible for this process resides in the CRA's International and Large Business Directorate. The report provides an overview of the operations of the MAP program, including statistical analyses of MAP cases completed and in progress. The CRA releases a separate annual report on the Advance Pricing Arrangement (APA) Program.

The following are highlights from the MAP report:

- ▶ The percentage of cases initiated by Canadians rose to 88% of completed cases in 2010-11. This is the highest level ever observed and a significant increase over the 80% observed in 2009-10, and 83% in 2008-09.
- ▶ The time required to complete these Canadian-initiated cases has increased significantly, to an average of 32.16 months, (22.73 months in the prior fiscal year) as compared to the Canadian Competent Authority's targeted timeline of 24 months.
- ▶ Of the 95 cases negotiated with other jurisdictions, 13 (14%) did not obtain complete relief from double taxation. This is higher than usual rates, as rates below 10% have historically prevailed. In 2009-10, only three such cases were reported.
- ▶ The report indicates that the Canadian Competent Authority resolved 649 non-negotiable MAP cases compared to 333 such cases in 2009-10. Non-negotiable cases are those that do not require the Canadian Competent Authority to negotiate with another jurisdiction, and usually pertain to excess withholding tax.
- ▶ Transfer pricing cases represented 78% of the 95 completed negotiable cases. Among completed transfer pricing MAP cases, the transactional net margin method (TNMM) was applied in 51% of cases (38 out of 74).

The results in the MAP report sound a cautionary note. The report states that the Canadian Competent Authority expects increased audit activity and will result in more taxpayers seeking assistance through the MAP process. At the same time, the 2010-11 results reflect a program whose performance appears to be struggling to meet existing demand in an environment of government restraint

and tight resources. The report does not provide any insights or indications on how the Canadian Competent Authority plans to cope with the expected increase in the number of MAP cases. Despite these impending challenges, the MAP generally remains an effective tool to resolve taxation not in accordance with a treaty.

Russia

Russia enacts new transfer pricing law

On 8 July 2011, the lower chamber of the Russian parliament (Duma) approved the new TP law. The new TP rules will be in force from 1 January 2012.

The key provisions of the TP law adopted are :

▶ Controlled transactions

In relation to cross-border transactions, all related party transactions without any threshold have been brought within the ambit of the TP law. Further certain third party transactions (involving specified goods traded on global commodity exchanges or where the counterparty is located in a blacklisted jurisdiction) exceeding RUB60 million (approx US\$2.2 million) will also be subject to TP control.

In the domestic context, only related party transactions can be subject to TP control.

▶ Related parties

The definition of related parties is broadened and the TP law includes a list of criteria defining how companies and individuals might be declared as related parties, the main criterion being if one party directly or indirectly controls more than 25% of another party.

▶ TP methods

The TP law includes five methods similar to those used in the international TP practice. The Comparable Uncontrolled Price (CUP) method will have first priority, whereas the Profit Split method will serve as a method of last resort.

It is possible to establish the transaction price/value by use of an independent appraisal, in the case of one-off transactions when none of the above TP methods can be applied.

▶ New market price (profitability) range

The law abolishes the existing permissible 20% fluctuations from market price and introduces the market price range instead that will serve as a safe harbor. The market price range will be established by using an inter-quartile range computed in the same manner as other OECD countries.



A taxpayer may make a voluntary adjustment of its tax liability, if it was incorrect, as a result of its TP arrangements. However, the law does not allow a taxpayer to make any adjustments of transfer prices themselves, or of margins, if, as a result of transfer pricing, the amount of actual profit reported by the taxpayer was outside the market profitability range.

► **Sources of information**

Only publicly available sources of information may be used by both the taxpayers and the tax authorities to determine the market price/profitability range.

It will be forbidden to use any information that could be qualified as a tax secret or when access to such information is restricted by the Russian legislation (with the exception of information about the taxpayer being audited by the tax authority).

► **Reporting and TP documentation requirements**

Taxpayers will be obliged to present information on

transactions where the annual aggregate revenue of all controlled transactions between the same related parties, exceeds a threshold of RUB100 million (approximately US\$3.6 million).

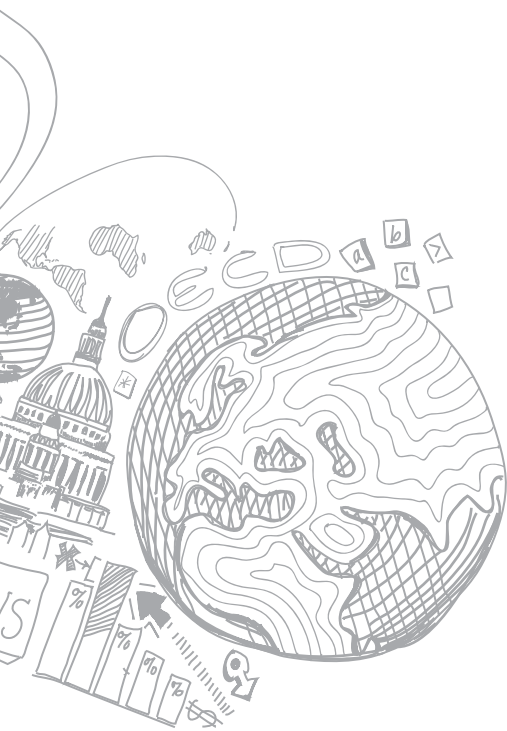
The information should include references to the subject of the transaction, the parties to the transaction and the amount of income received or expenses incurred as a result of the controlled transaction.

► **TP documentation requirements**

The law envisages that taxpayers must prepare and keep a certain set of documents as well as present information on transactions where the annual aggregate revenue of all controlled transactions between the same related parties exceeds the threshold of RUB100 million (approximately US\$3.6 million).

► **Advance pricing agreements**

Starting 1 January 2012, "large" taxpayers may apply for an advance pricing agreement (APA) on prices to be used or on the methods to determine those prices.



Israel

New legislation in Israel excludes certain related party financing transactions from application of transfer pricing rules

As a short background, Israel enacted transfer pricing rules in 2006 that applied substantially to all types of cross-border related party transactions (including all types of financial transactions).

As a result, certain interest free loans (commonly known as capital notes), that, prior to the transfer pricing legislation, were not subject to imputation of arm's length interest, fell within the scope of the transfer pricing rules. Nevertheless, due to the acknowledgement of the tax authorities regarding the importance and common use of such instruments, the tax authorities issued several circulars that: (a) allow capital notes that were issued no later than 5 March 2008, to be excluded from the application of the transfer pricing rules; and (b) reflect their intention to initiate legislation that will exclude certain interest-free shareholder loans that meet certain conditions as would be determined in the legislation, from the application of transfer pricing rules. As a result, the status of capital notes issued after 5 March 2008 became unclear.

On 3 August 2011, the Israeli Parliament enacted amendment 185 (the Amendment), which refers to such capital notes issued after 5 March 2008 until the end of 2010, and provides that in years 2008-2010, such capital notes shall be excluded from the application of the transfer pricing rules that meet all the following conditions:

- ▶ The loan is made to a company by its controlling shareholder. For this purpose, control means direct or indirect holdings of 50% or more in the company's means of control.
- ▶ The loan is not linked to any index and does not carry any interest. For this purpose, foreign currency fluctuation shall not be viewed as an index provided that the loan has been denominated in the currency of the borrower, US dollars or Euros.
- ▶ The loan cannot be repaid prior to five years from the date of its issuance.
- ▶ The loan is subordinated to all other liabilities and shall have priority only in respect to distribution of assets under liquidation.

The Amendment also refers to capital notes issued prior to 5 March 2008, and provides that such capital notes shall be excluded from the application of the transfer pricing rules that meet the above conditions.

The Amendment provides that it shall apply retroactively as of 1 January 2008 to related party loans that meet the above conditions that were issued in 2008 onwards.

The Amendment also provides that the general concept of taxation of currency fluctuations on an accrual basis shall not apply to such loans, and currency exchange income or loss on such instrument is likely to be taxed as capital gain upon repayment (i.e., on a cash basis).

As a result, there may be advantages of investments through such interest-free loan instruments and multinationals may be interested to review their financing structures based on this new piece of legislation.



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