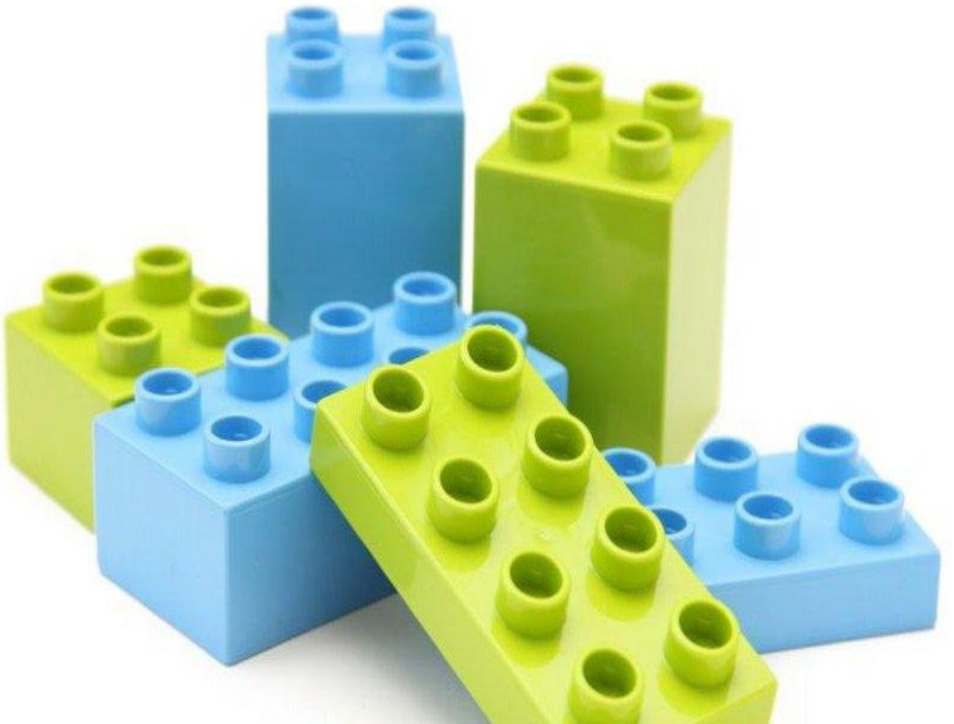
Role of Transfer Pricing Rules in business profit allocation

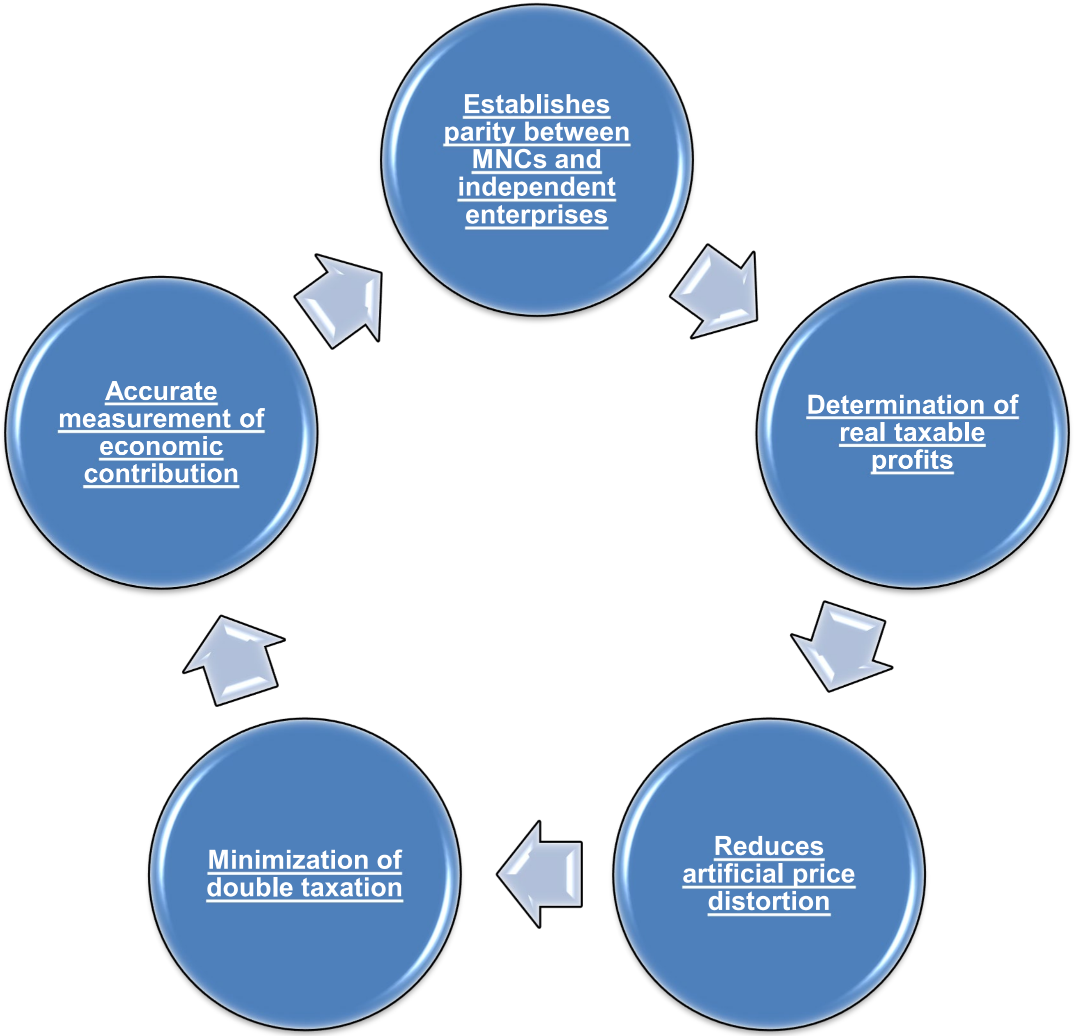


Transfer Pricing Concepts – Quick Recap of last sessions

- What, why and How of Transfer Pricing
- Associated Enterprises, International Transactions and different methods of determining the Arm's Length Price
- Article7 and Article 9 of UN Model Convention
- Provisions of Transfer Pricing in the Domestic Law
- FAR and its Importance in determining the characterization of the entities
- Penalties of non-compliance and Secondary Adjustment
- Safe Harbour Rules
- Advance Pricing Arrangement

Role of Transfer Pricing Rules

Role of Transfer Pricing Rules



Role of Transfer Pricing Rules

Establishes parity between MNCs and independent enterprises

A major reason is that the Transfer Pricing provides broad parity of tax treatment for MNCs and independent enterprises. Since it puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages and disadvantages that would otherwise distort the relative competitive positions of these entities. Thus, it promotes the growth of international trade and investment by removing these tax considerations from economic decisions

Determination of real taxable profits

The transfer price adopted by a multinational has a direct bearing on the proportional profit it derives in each country in which it operates. If inadequate or excessive consideration is paid for the transfer of goods, services or intangible property between the members of an MNC group, the income calculated for each of those members will be inconsistent with their relative economic contributions. An 'arm's length' price – a price two independent firms operating at arm's length would agree on – is needed to determine taxable profits earned in each country. The arm's length doctrine permits the taxing authorities to rectify the accounts of the enterprise so as to reflect correctly the income that the establishment would have earned if it were an independent enterprise

Role of Transfer Pricing Rules

Reduces artificial price distortion

If transfer pricing is not followed, an MNC will sell goods/ provide services to a controlled entity in a high tax regime at a high price (which exceeds the market price) and to an entity in a low-tax regime or a tax haven at a low price (which is lower than the market price). This would result in extreme price distortion of goods and services in the international market

Minimization of double taxation

Transfer Pricing is an international concept and it represents the international norm. The potential for double taxation is minimized, since in international transfer pricing, adjustment to the transfer price in one tax jurisdiction requires a corresponding adjustment in the other tax jurisdiction

Accurate measurement of economic contribution

Transfer Pricing provides accurate measurement of the fair market value of the economic contribution units of an MNC. The focus of transfer pricing is to ensure that the proper amount of income is attributed to where it is earned. This result in each unit of the MNC earning a return commensurate with its economic contribution and risk assumed

Structuring a Transfer Pricing policy

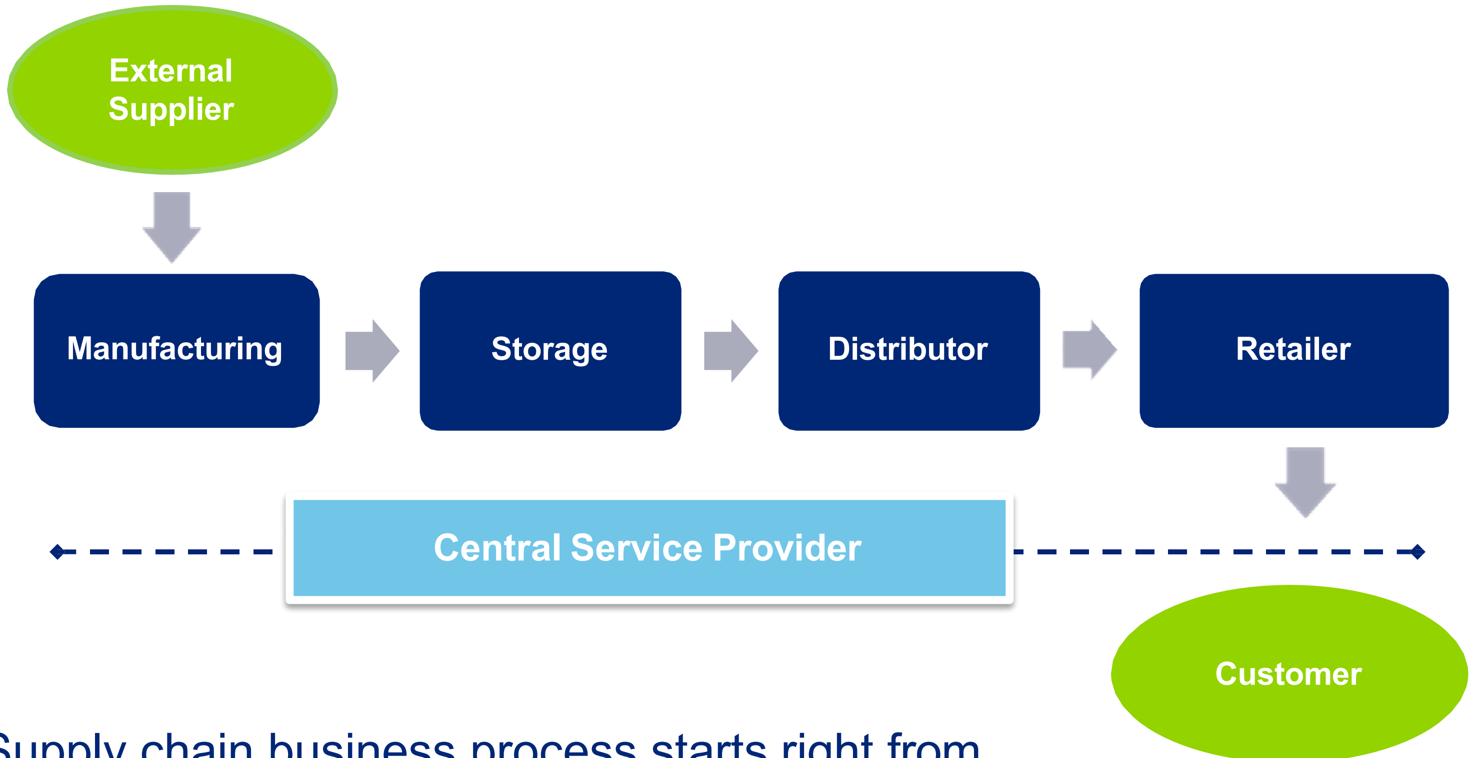
Key considerations for Transfer Pricing policy

General issues

Issues to be kept in mind while structuring a global transfer pricing policy:

- MNCs should prepare a customized pricing policy for key risk jurisdictions. Such policy should be based on the global pricing policy
- Global Transfer Pricing policy should clearly define and document the global supply chain of the multinational group
- Terms and conditions of cross-border transactions between related parties should, as far as possible, be substantiated by an agreement:
  - would ensure transparency in inter-company dealings
  - provide comfort during audit proceedings
- Need to strengthen internal systems and processes in order to maintain transactional level data and collate contemporaneous documents
- Transfer Pricing documentation should be robust, updated and monitored on a yearly basis based on the jurisdictions requirement

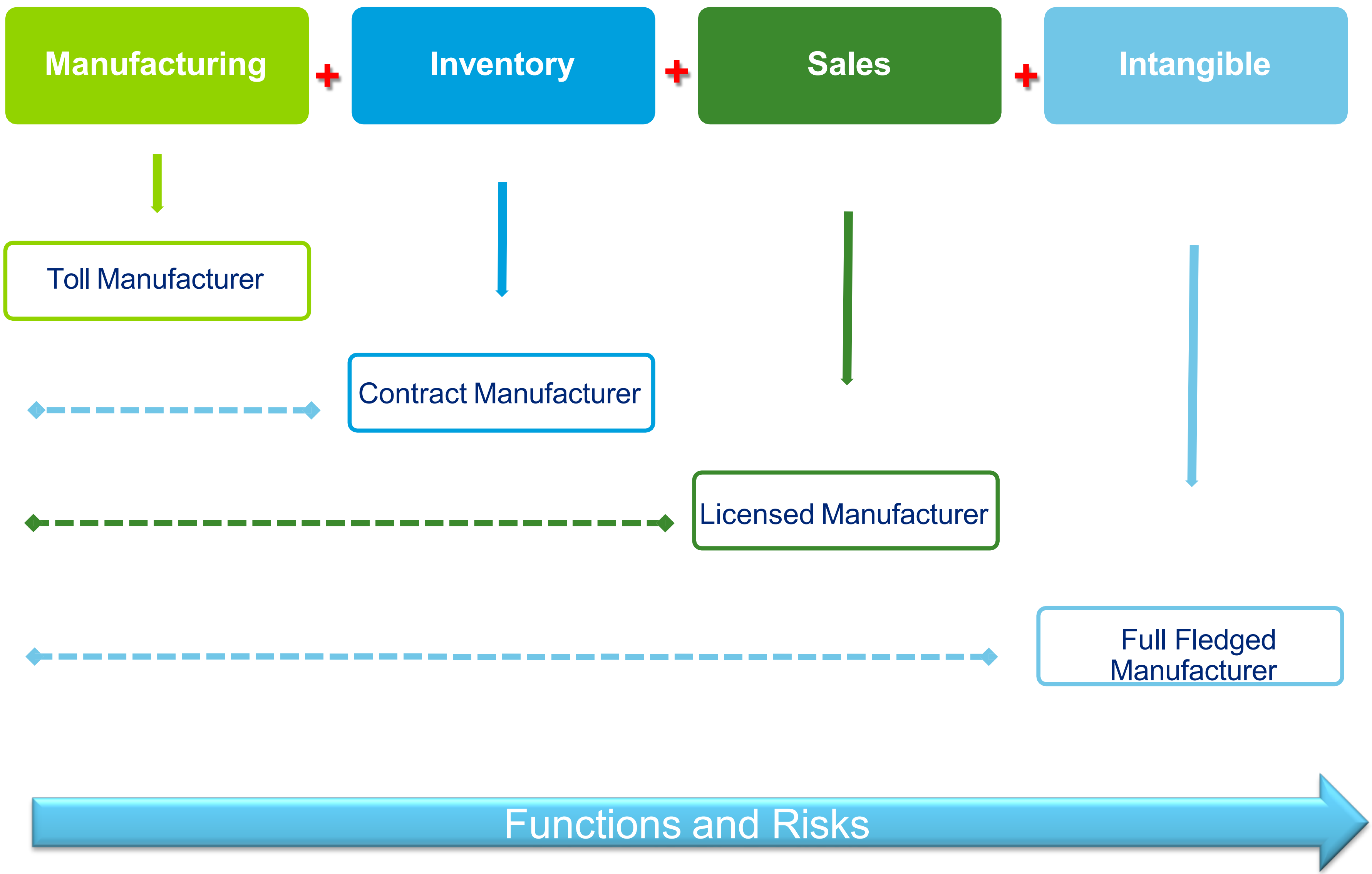
Supply Chain Management Process



Supply chain business process starts right from

- Supply chain planning
- Forecasting, sales and marketing
- Sourcing and procurement
- Manufacturing
- Order management & Logistics management
- Delivery to customer

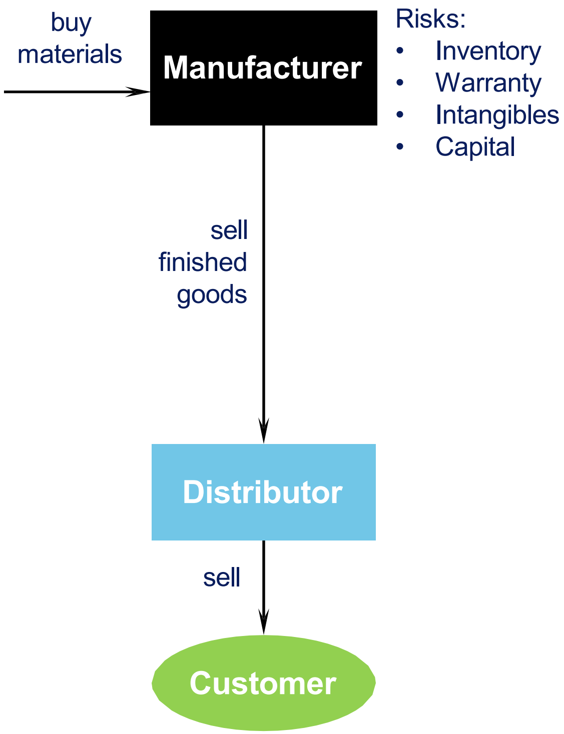
Manufacturing Functions



Manufacturing Models

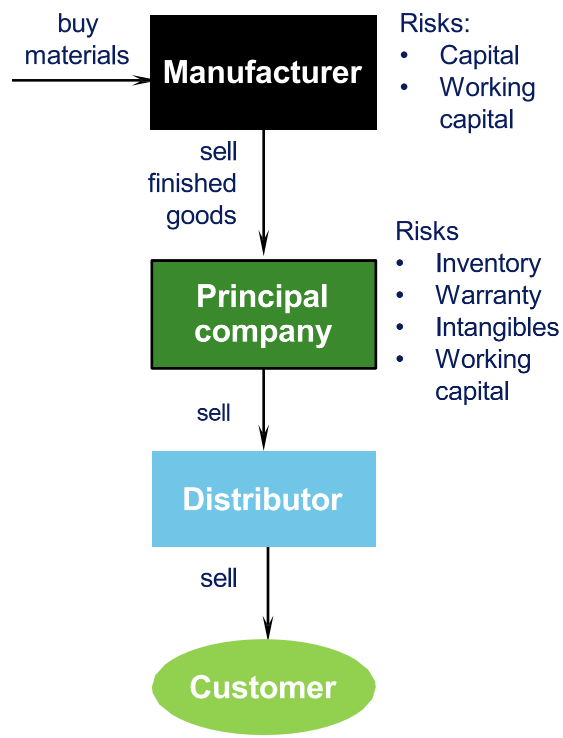
Traditional / "Fully fledged" Manufacturing

The manufacturer owns intangibles and manufactures product for its own risk and reward.



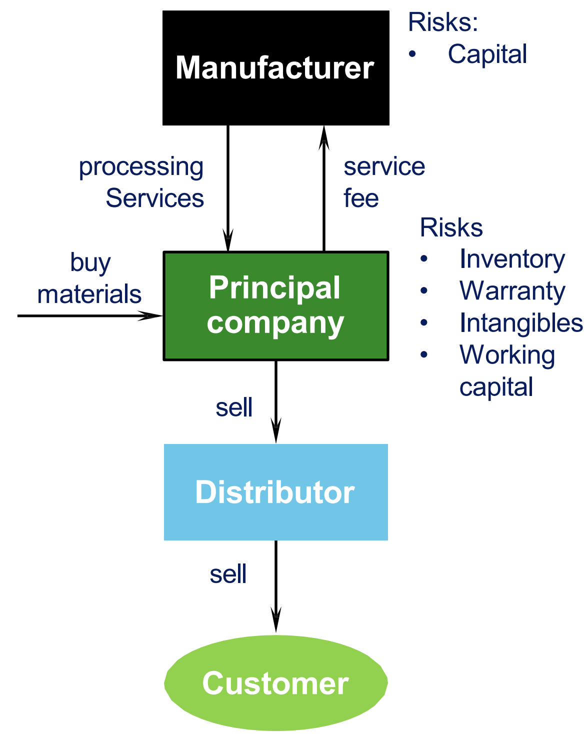
Contract Manufacturing

A contract manufacturer produces goods to order for and for the risk of the principal company. A contract manufacturer buys materials and sell finished goods to principal. However, it has less risk and earns a lower profit than a traditional manufacturer.



Toll / Consignment Manufacturing

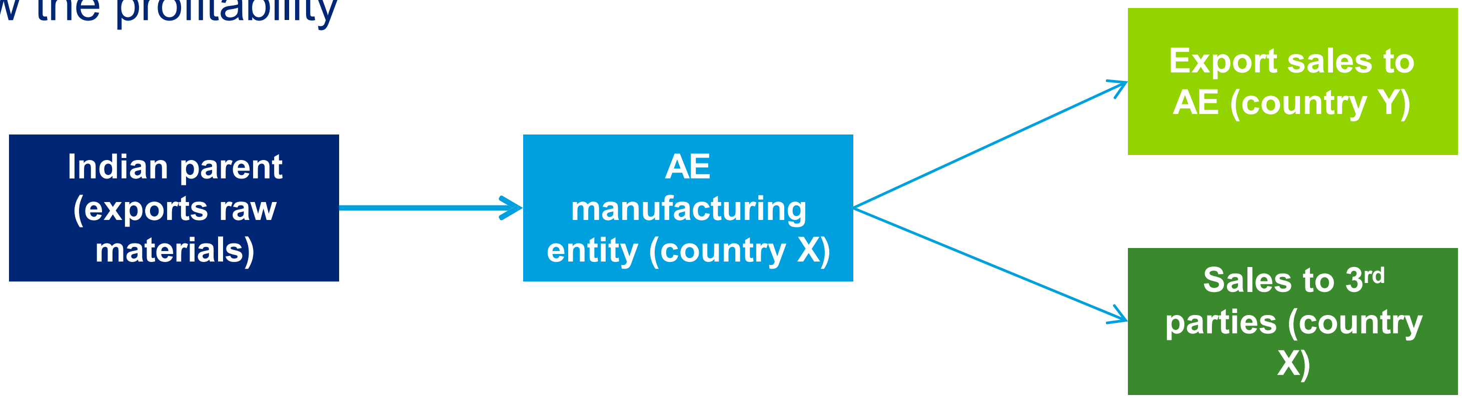
A toll / consignment manufacturer processes goods belonging to the principal company and never takes ownership. It assumes less risk and earns a lower return than a traditional manufacturer.



Key considerations for Transfer Pricing policy

Manufacturing activity

- Transfer Pricing policy for manufacturing is complex and has to take into consideration possibility of internal comparable
- Typical manufacturing structures may include a) few subsidiaries focused on manufacturing and rest distribution b) one overseas entity in manufacturing (mother plant) rest all distribution entities
- In the below structure, AE manufacturing entity imports raw materials from parent and manufactures component for domestic and export consumption
- Gross level comparison of sales to AE vis-à-vis 3rd party sales can be made to review the profitability



Key considerations for Transfer Pricing policy

Manufacturing activity

- Pricing of imported raw materials by the AE is an essential consideration for establishing a effective TP policy:
  - Price sensitivity of the sale market also important consideration
  - Local regulatory environment favoring manufacturing (e.g., special economic zones) also impacts costs and price
- Another important issue is the extent of value addition made by the AE in manufacturing process
- Manufacturing set-up could range from assembly operation at the very low end of the scale to fully integrated manufacturing activity and being an OEM
- The extent of value addition would be a key determinant in establishing transfer pricing allowing an arm‟s length compensation for such functions
- The overseas AE may be licensed to use technology and know-how in return for royalty payments
- Separate benchmarking for royalty and benefit test documentation

Judicial precedents

Sona Okegawa Precision Forgings (2011)

- TPO disallowed royalty payment considering that the assesse is a contract manufacturer and no royalty needs to be paid if it is using the technical know how to manufacture goods and sell the same to its group companies itself.
- ITAT has upheld that it is not a contract manufacturer as it manufactures goods and sells only a fraction of the goods to the group companies and rest of it is sold to the third parties and thus allowed the payment of royalty.

SC Enviro Agro India Pvt. Ltd. (2013)

- Assessee purchased raw material and other consumables on its own account and entire risk of manufacturing was borne by the assesse.
- TPO has disallowed royalty payment considering that the assesse is a contract manufacturer and no royalty needs to be paid.
- ITAT was of the opinion that the assessee was manufacturing goods only on the instructions of the principal company but however, selling goods to third parties also and the facts of the case were unlike a contract manufacturer.
- Thus, ITAT allowed the payment of royalty to its group company.

Key considerations for Transfer Pricing policy

Distribution activity

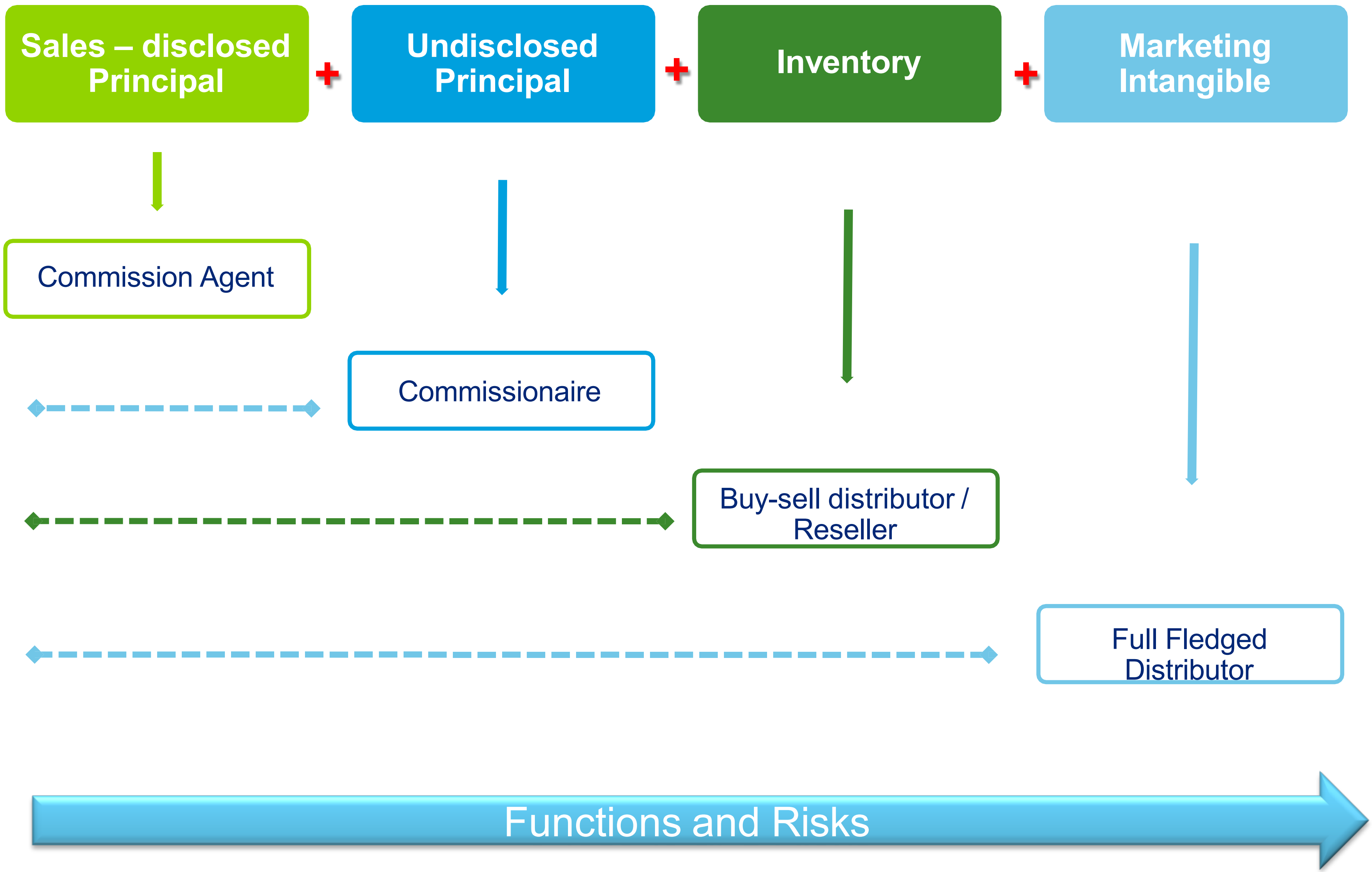
- Transfer Pricing policy for distribution has to take into consideration the positioning of the distributor i.e., low-risk distributor, full fledged distributor or somewhere in between
- In the below structure, AE distribution entity imports finished goods from parent and sells it in its domestic market
- Under a low risk distribution model the transfer pricing method should be such that it results in a consistent margin over a period of time
- Return for low risk distributors in developing markets are general higher than corresponding margins in developed economies

Key considerations for Transfer Pricing policy

Distribution activity

- In contrast, a full fledged distributor would:
  - take marketing and credit risk
  - perform significant brand building exercises
  - be willing to dynamically change pricing strategies to increase its market share
  - Perform value added services such as packing and labeling, logistics, pre-sales presentation and after sale services
- Accordingly, a full fledged distributor has to have a policy that compensates for such value added functions
- The determination of the "most appropriate method" will depend on the level of value addition also considering any marketing intangibles created
- Profitability of a distributor also depends on the selling strategy and channel adopted
- If distributor undertakes to establish its own distribution network it may result in initial year losses do to disproportionate costs incurred
- However in later years greater profits are expected on account of improved efficiencies

Distribution Functions



Sales Models

Fully fledged Distributor

A full distributor bears market risk, holds inventory for its own risk and sells to the customer as principal. The distributors profit margin reflects its risks and functions.

Limited Risk Distributor

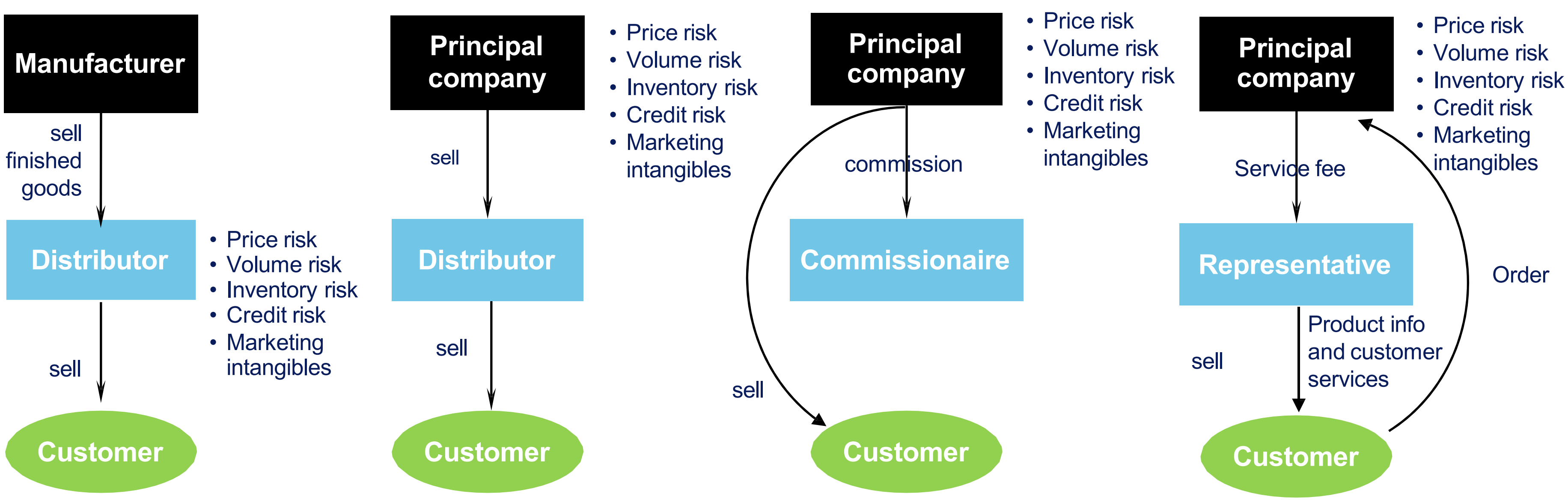
A master distributor bears market risk and inventory risk. The local limited risk distributors buy product from the master distributor and resell the product to the customer. The limited risk distributors earn a lower profit than a full distributor, consistent with their reduced functions and risks.

Commissionaire

A civil law concept whereby the commissionaire sells product in its own name but for the account of the principal. The risks and benefits of the sale (and the profit) rest with the principal. The commissionaire receives a commission which provides it with a lower profit than a full distributor, consistent with its reduced functions and risks.

Representative

The local sales company acts as a representative that is not directly involved in making sales. It merely provides product information and performs customer service. The principal receives sales orders directly from customers - either in a call centre or electronically. The local representative earns a lower profit than a full distributor, consistent with its reduced functions and risks.



Distributorship and Berry Ratio

Berry ratio is the ratio of gross profit to operating expenses.

It is primarily used in the case of

- pure/routine distributors;
- entitled to a return on its operating expenses alone;
- the return is primarily dependent on the extent of services provided and not on the market value of the products distributed;
- does not perform any value addition to goods; and
- does not own non-routine intangibles.

It relies on the fact that there is consistency between the level of gross margins and operating expenses (i.e. greater the operating expenses, greater is the gross profit needed, to sustain the operating expenses).

Judicial precedents

Mitsubishi Corporation India Pvt. Ltd. (2014)

- Assessee was acting as a medium of communication through which they can compete with its associated enterprises competitors in India performing distribution activities.
- Assessee believed since it was only front ending the group companies operations, it was a service provider.
- However, ITAT stated that the assesse was an intermediary (distributor) performing buy sell activities and not carrying inventory risk and since all its expenses which an assesse needs to be compensated for, were captured in its operating expenses, berry ratio would be appropriate to be used.

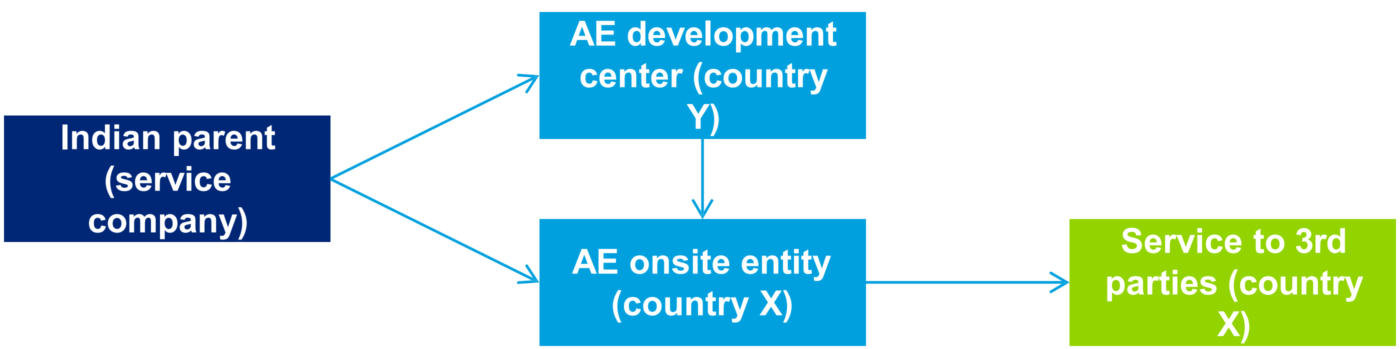
E.I. DuPont de Nemours & Co. (2011)

- The assessee performed distribution services for its associated enterprise in US.
- Since distributors should earn a return commensurate to its services and the cost of which is covered in its operating expenses, Berry suggested berry ratio as an appropriate profit level indicator for a pure distributor not owing non routine intangibles.

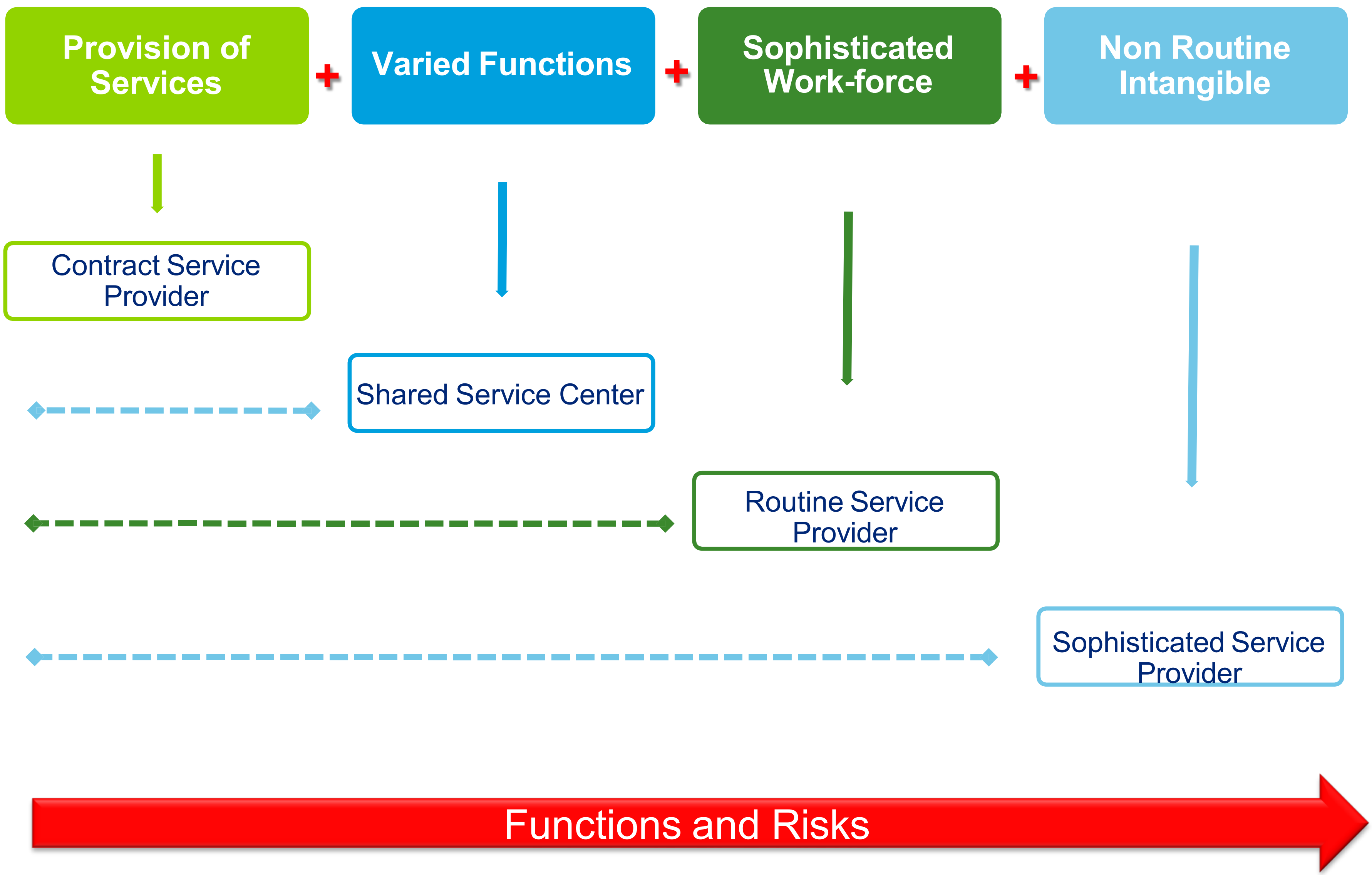
Key considerations for Transfer Pricing policy

Services

- Indian MNCs provide a variety of IT and ITeS to global multinationals, including engineering design, back office, procurement, financial and analytical services
- In the below structure, Indian parent has a central development center in country Y and an onsite delivery entity in country X to provide the final product
- Most development centers are set-up as risk free service providers which are guaranteed return on a time-cost basis or a cost plus mark-up basis
- The intellectual property rights for the software they develop vests with the Indian parent
- The onsite entity is primarily engaged in marketing, understanding client requirements and implementation of the software developed



Service Providers



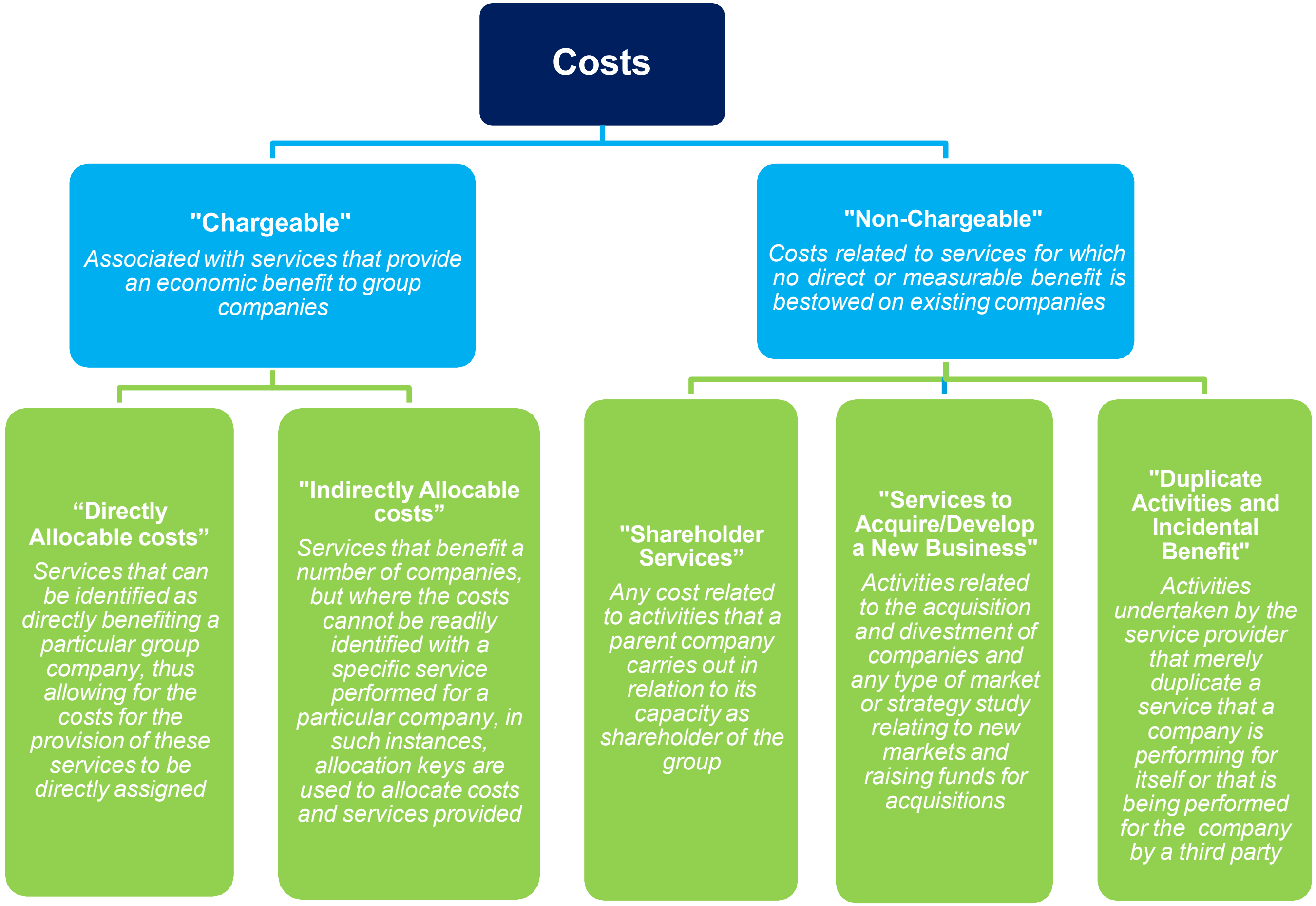
Key considerations for Transfer Pricing policy

Services

- Foreign parent takes decision on conceptualization and functionality of the software and the development center operate in India on the instructions of the Foreign parent
- The key issue is between adopting a cost-based model or a man-hour rate model for the development center
- Cost based model would ensure a risk free return without regard to efficiencies and capacity utilization
- Man-hour rate model is now increasingly used for reasons that it addresses issues of efficiency and idle time

Intra group services

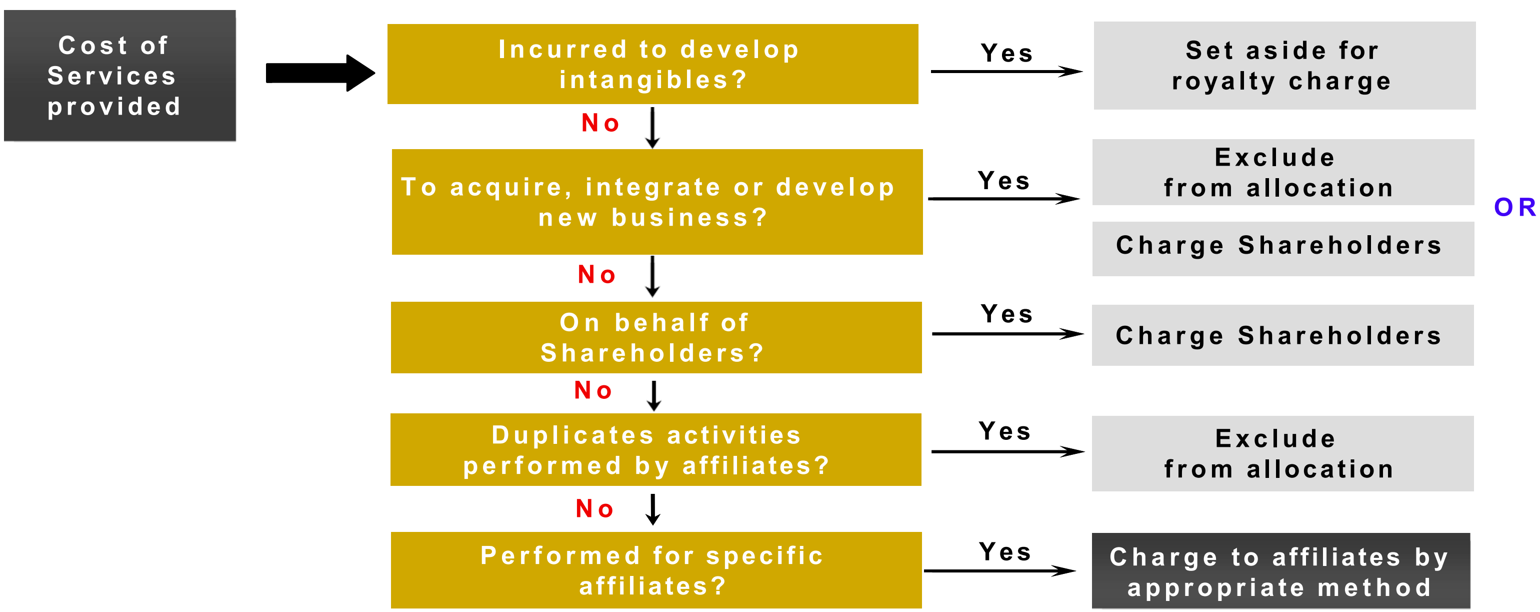
The OECD Guidelines categorize costs incurred in relation to the intra-group services according to their type and purpose; of which the key segment involves categorization of costs as chargeable and non-chargeable :-



Evidence of benefit – benefit test

Arm‟s length principle test for intra group services is whether the company:-

- receiving the service would have been willing to purchase the service from an unrelated company or would have incurred the cost to produce the service internally;
- the activity provides a respective group member with economic or commercial value to enhance its commercial position; and
- such service is both needed and non-duplicative.



The Optimum Business Model

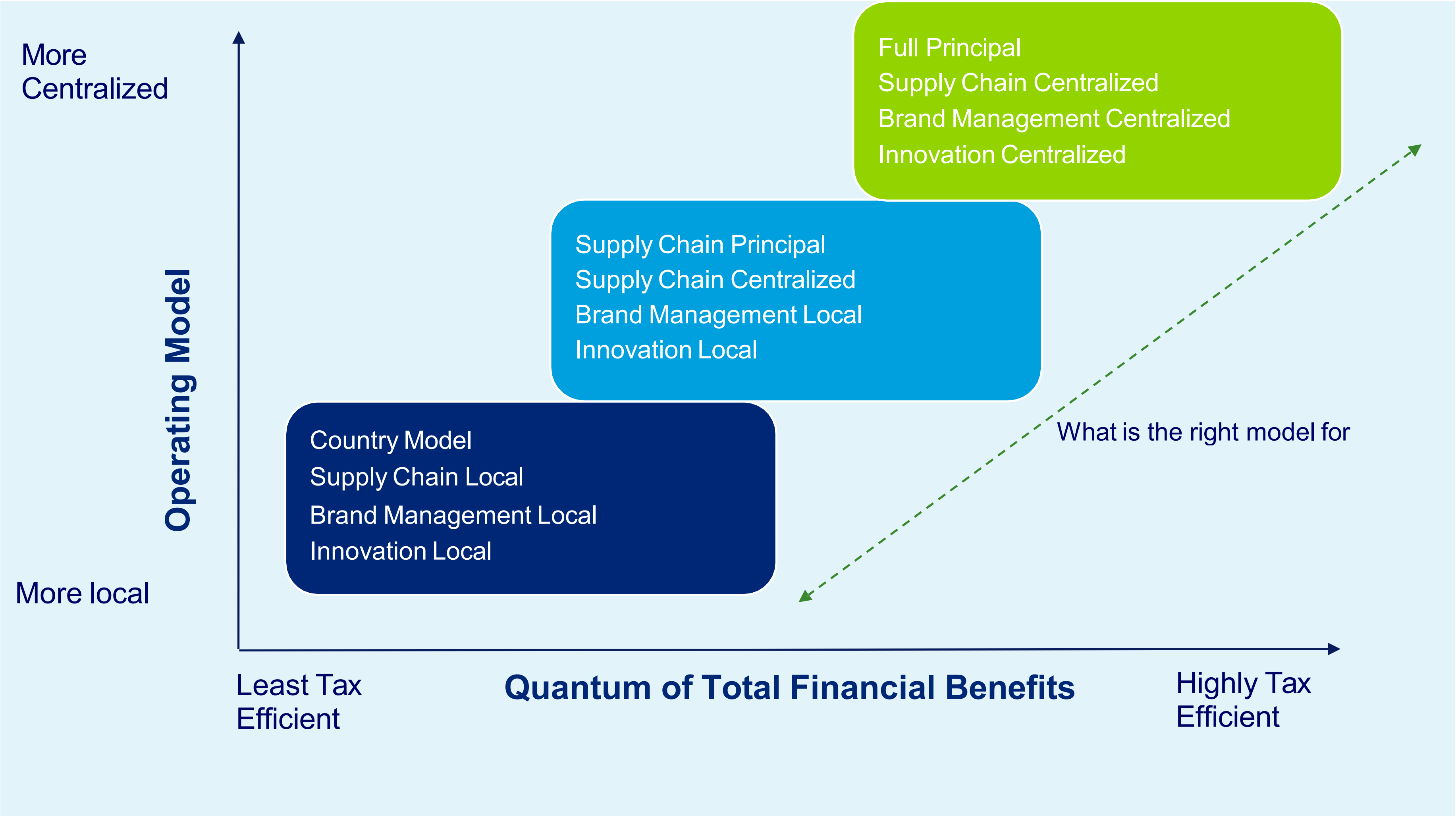
Business Model Optimization (BMO)

- Businesses essentially consist of Assets, Functions, and Risks that generate a return to their owner.
- Locating value-added Assets, Functions, and Risks efficiently can drive significant operational and tax savings
- It‟s not enough to locate just the Assets and Risks in a tax-efficient jurisdiction…must also have functions (i.e., the people)
- BMO is the methodology used to align the relevant Assets, Functions and Risks to optimize a multinational company‟s global or regional business model
- BMO is not about tax shifting but about integrating tax in operational outcome and business transformation

BMO - The critical element which links operational strategy with tax strategy

The Evolution of Operating Models

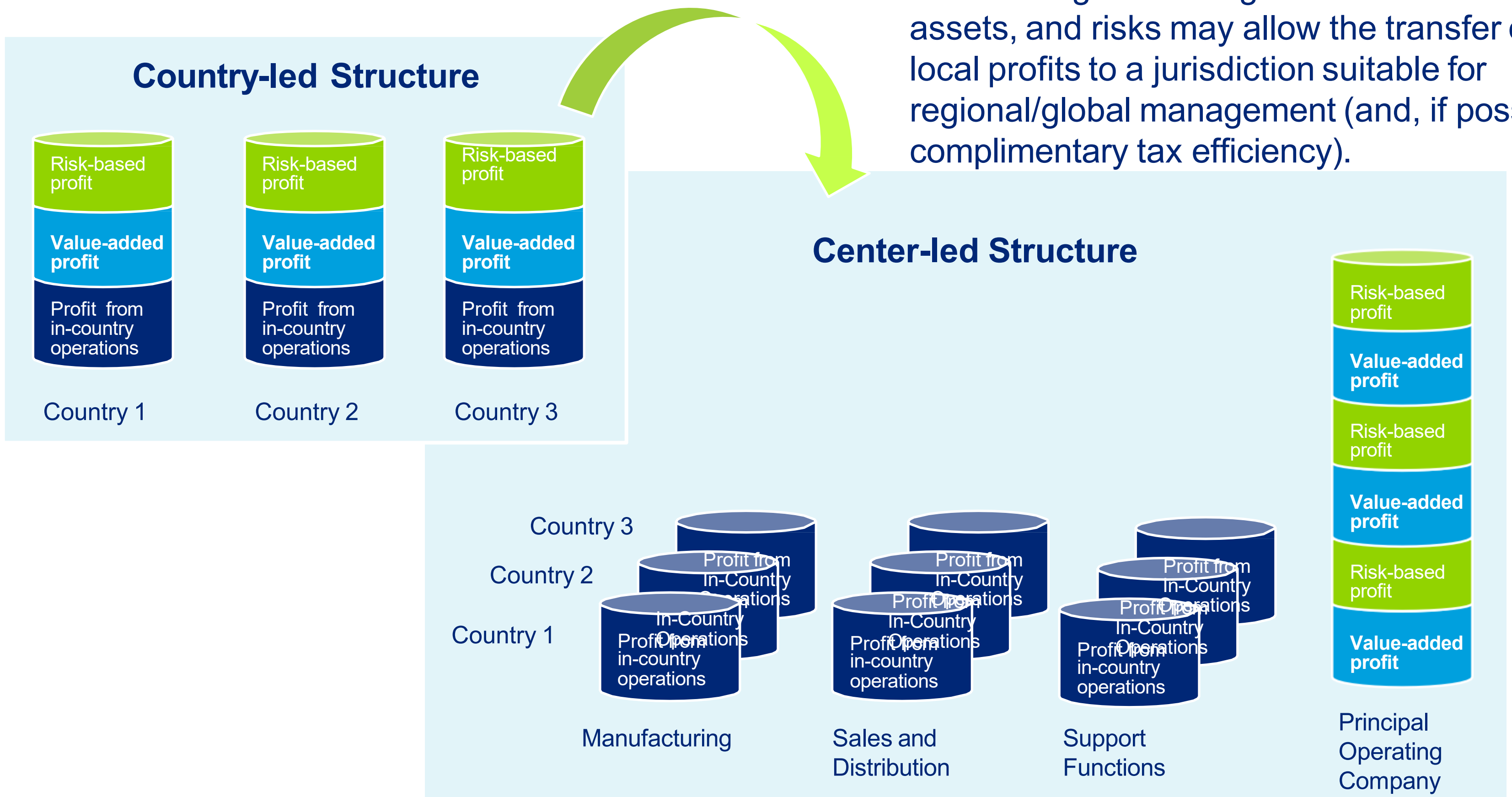
As the operating model evolves, the optimal Tax Aligned Value Chain strategy will change over time.



The trend for the centralization of management aligns with the centralization of profits

Evolving from a country-led model to a center-led model:

Transferring the management of functions, assets, and risks may allow the transfer of local profits to a jurisdiction suitable for regional/global management (and, if possible, complimentary tax efficiency).

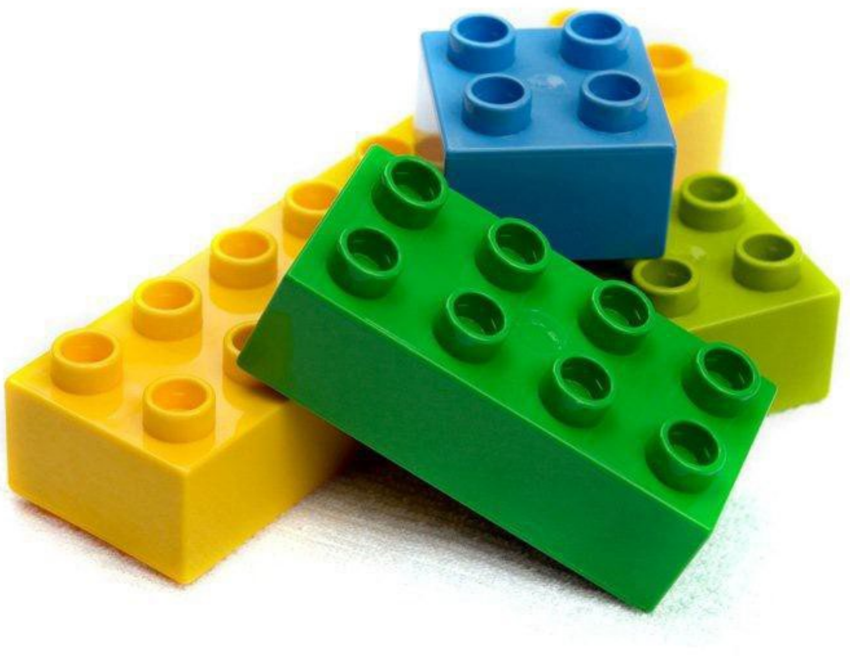


Transfer Pricing as Planning Tool

Typical Planning Objectives

Managing the Global Effective Tax Rate

Cash Repatriation



Business Model Optimization Methodology

Global Strategic Areas of Focus

- India Income Optimization
- Local Country Income Optimization
- Repatriation Maximization
- Risk Minimization

Diagnostic Analysis

- Operating Margin Analysis
- Worldwide Operating Profit Analysis
- Cost Pool Alignment Analysis
- Identification of Business Model Transformation
- Intercompany Loan Analysis
- Intellectual Property Migrations Benefit Analysis

Core Strategies

- Value Chain Strategies
  * Procurement
  * Principal Company
- Service-Fee Charge Outs
- Royalties / Franchise Fees
- Intellectual Property Strategies
- Intercompany Loan Rationalization

BEPS

BASE EROSION & PROFIT SHIFTING –

SHOULD IT CHANGE THE WAY WE DO TAX PLANNING?

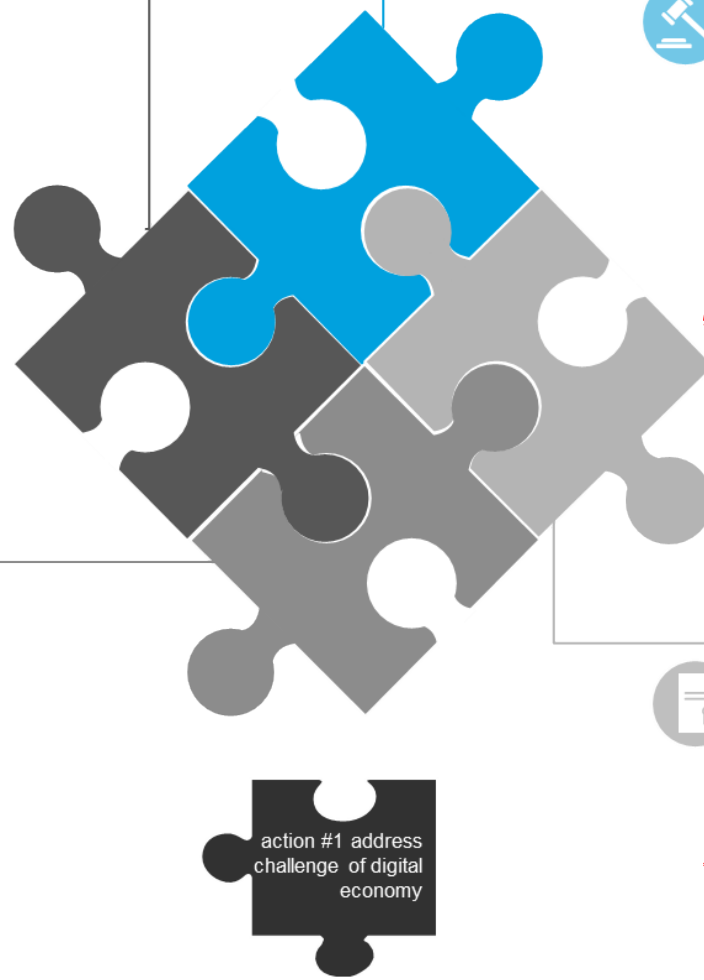
BEPS Objectives: a new global tax environment

Establishing coherence in corporate taxation

- action #2 hybrid mismatches
- action #3 CFC rules
- action #4 limit base erosion
- action #5 harmful practices

Restoring effects of international standards

- action #6 prevent treaty abuses
- action #7 artificial avoidance of PE
- action #8, 9, 10 value creation intangibles, risks and capital, high risks transactions



Turning tax policies into tax rules

- #15 develop multilateral instrument.

Ensuring transparency while promoting predictability

- action #11 data collection & analysis
- action #12 disclosure aggressive tax planning
- action #13 TP documentation & CbC reporting
- action #14 dispute resolution mechanisms

Questions?