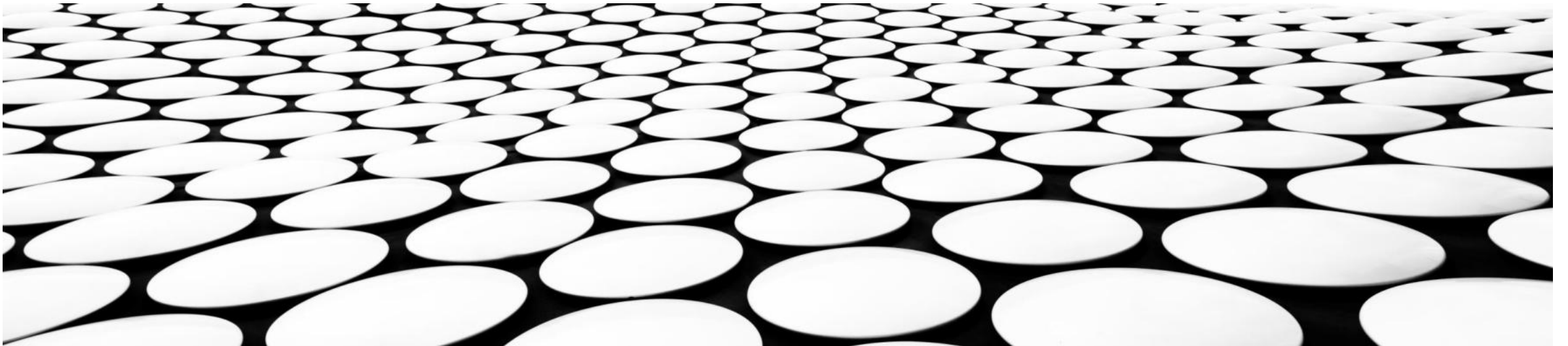

INTEREST ROYALTIES ARM'S LENGTH ADJUSTMENTS

CA BHAVYA BANSAL GOYAL



CONTENTS

- Arm's length for Interest
- Arm's length for Royalties
- Arm's length adjustments



ARM'S LENGTH FOR INTEREST



OUTLINE

Interest on Loans

- Intra Group Loans
- How Interest Rates are charged
- OECD Transfer Pricing Guidelines on Intra-Group Loans
- Interest Free Loans

Interest on Outstanding Accounts receivable

Guarantee Fee Commission Rate

- Introduction
- OECD Guidelines on Guarantee Fees
- Indian Perspective on Intra-Group Guarantee

INTRA GROUP LOAN

- A loan transaction involves a lender lending money to a borrower in return for the borrower paying the interest and, at some point, repaying the money lent
- The interest is a percentage of the amount lent (the 'loan principle')
- The interest is the consideration paid in return for the use of the money and it is therefore the relevant transfer price

HOW INTEREST RATES ARE CHARGED?

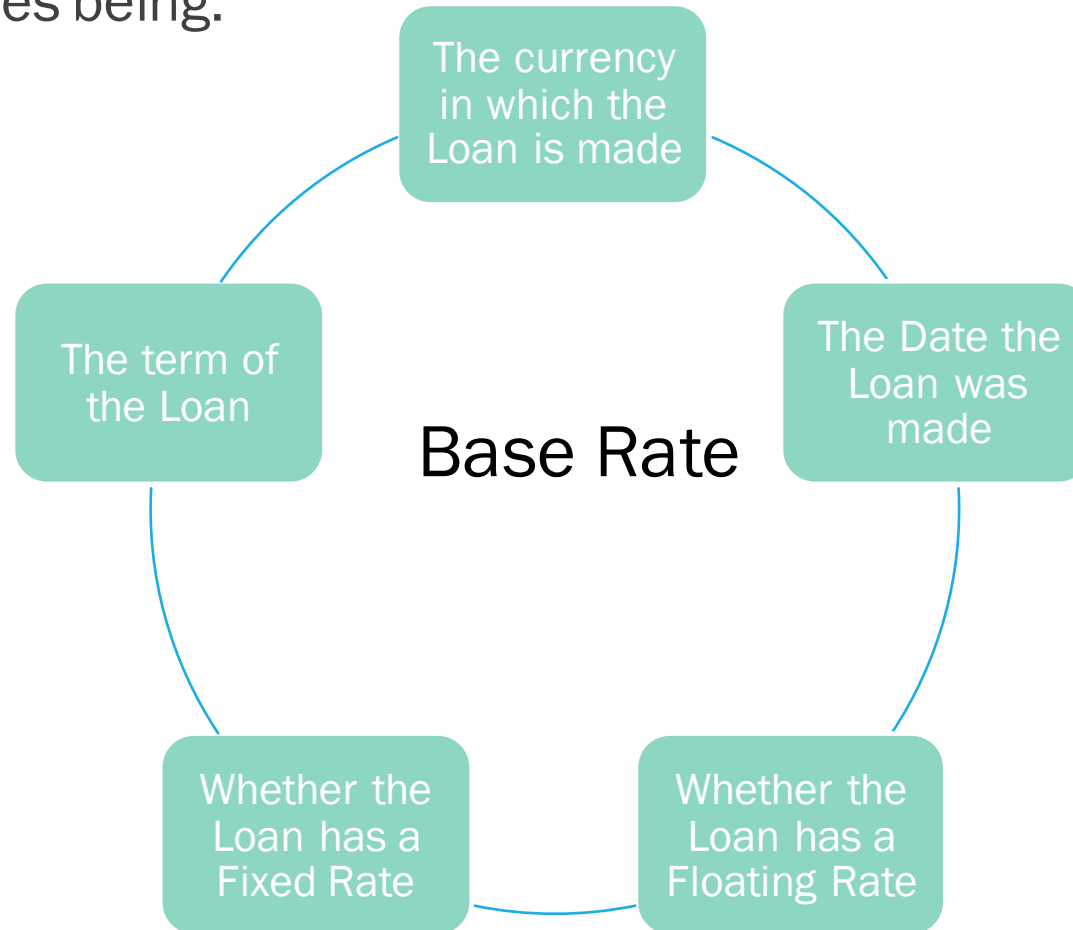
Interest rates always have two components:

Base Rate: A component of interest to reflect the use of money. Even if there is no risk that the borrower might default on the loan, the lender is still making the money available to the borrower and so there is a minimum price for the use of the money.

Margin: Except in cases where the borrower is risk-free, there would normally be a margin added on top of the base rate, to reflect the additional reward required by the lender to compensate for the risk that the borrower might default

BASE RATE

The base rate that is appropriate for a particular loan will vary according to a number of factors, the key ones being:



INTEREST RATE MARGIN

It is required to determine the interest rate margin that would have been agreed between the lender and borrower in an uncontrolled transaction

The interest range margin should, in broad terms, reflect two key factors:

- i. Creditworthiness of the borrower; and
- ii. The macroeconomic conditions affecting credit spreads

INTEREST RATE MARGIN

Creditworthiness of the borrower

There is a very wide range of factors that potentially affect the creditworthiness of a borrower, including the following:

Collateral given by the borrower	Security given by the borrower	Asset backing for the loan	The level of other loans taken out by the borrower The ranking of the debt
Gearing/leverage	Interest cover	Cashflow	Industry prospects
Guarantee	Business risks and volatility	Track record	Purpose of the Debt and business plan

INTEREST RATE MARGIN

The macroeconomic conditions affecting credit spreads:

- Market sentiment: economic cycles mean that commercial lenders change their views about the level of interest rate margin that they expect/require for a given level of creditworthiness
- Supply and demand for credit: this is closely linked with market sentiment, although there are other factors that affect the supply and demand for credit, including government intervention, such as the quantitative easing policies used by many governments when required. If such rises, interest rates for a given level of creditworthiness will fall, and vice versa
- Country/region – The preceding two factors vary from country to country at any one time. It is therefore important to consider the country in question



OECD GUIDANCE ON INTRA-GROUP LOANS

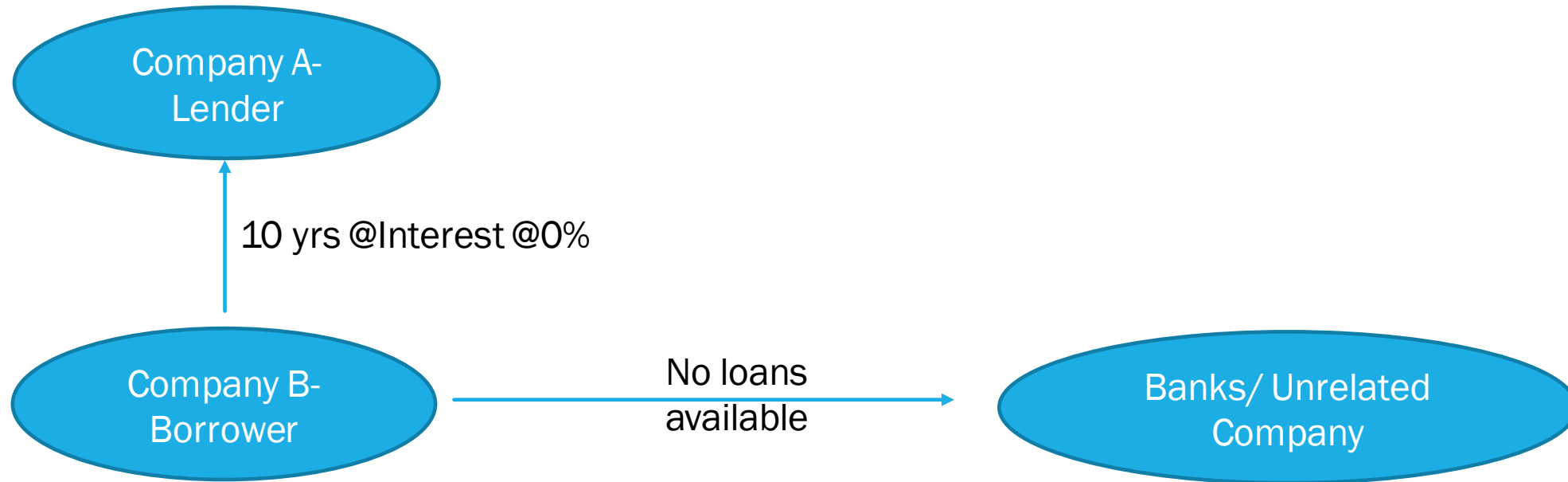
- OECD Transfer Pricing Guidelines;
- BEPS Action 4- Limiting base erosion involving interest deductions and other financial payments
- BEPS Action 8-10- Aligning Transfer Pricing Outcomes with Value Creation
- Transfer pricing guidance on financial transactions

OECD GUIDANCE ON INTRA-GROUP LOANS

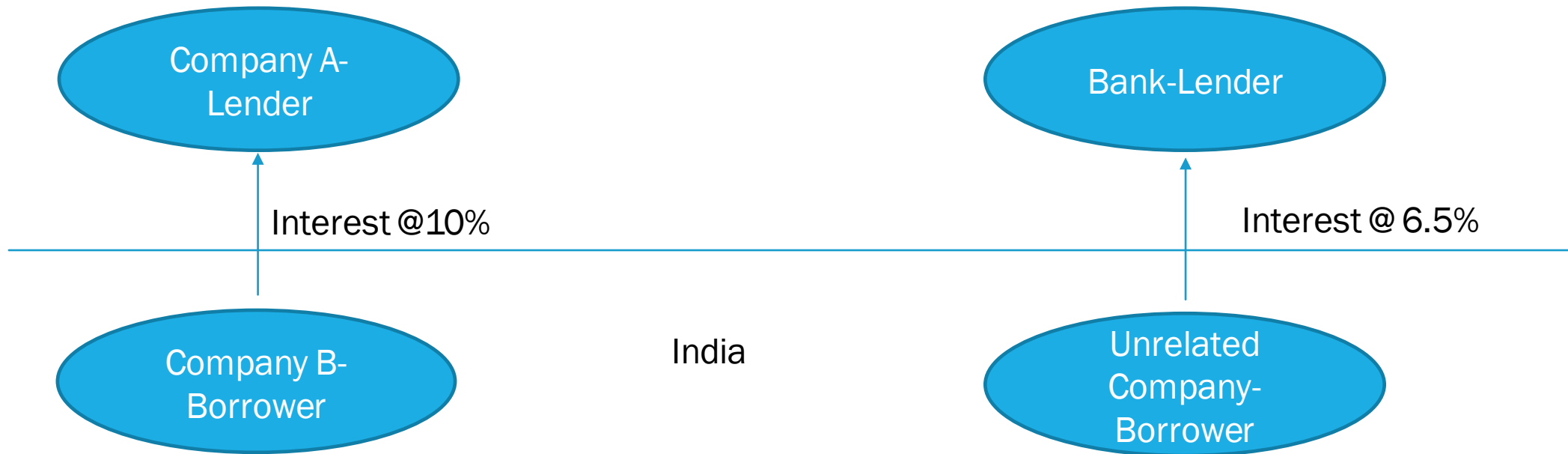
List of factors relevant for accurate delineation of financial transactions (Para. 10.12 OECD Transfer Pricing Guidelines):

- i. The presence or absence of a fixed repayment date
- ii. The obligation to pay interest
- iii. The existence of financial covenants and security
- iv. The source of interest payments
- v. The ability of the recipient of the funds to obtain the loans from unrelated lending institutions

EXAMPLE



BENCHMARKING OF INTEREST



Methodology: Comparable uncontrolled price method for an intra-group loan

IS THIS TRANSACTION AT AN ARM'S LENGTH?

Bank letter/opinions are not to be regarded as evidence of an arm's length price as the funds have not been provided

INTEREST FREE LOAN

- Not acceptable under the arm's length principle because an independent lender would not lend at an interest rate of 0%
- it may be possible to justify an interest-free loan, on the grounds that the loan is in substance fulfilling an equity function and therefore it is not appropriate to require interest
- The tax authorities generally view the provision of interest free outbound loans from an Indian parent to its overseas subsidiary in the nature of an activity which should result in an arm's length consideration
- Indian courts have rejected “interest-free” loans advanced by an Indian entity to its overseas AE

CASE LAWS ON INTEREST RATE

- CIT vs M/S Cotton Naturals (I) Pvt. Ltd. {Delhi HC 55 Taxmann.com 523;
- Everest Kanto Cylinders vs DCIT {ITA NO.550/Mum/2014};
- Manugraph India Ltd Vs DCIT- TS-113-ITAT-2015(Mum)-TP;
- Kohinoor Foods Ltd [2014] [ITA Nos 3688-3691/Del/2012

IBOR TRANSITION

- The EUR Libor and the CHF Libor rates are no longer published as of January 1, 2022
- GBP Libor and JPY Libor rates (only for 1- 3- and 6-month tenors) are artificially issued by their administrators during 2022 to assure legacy contracts remain effective for a longer period to assure an easier transition.
- USD Libor will continue to be published until June 30, 2023. The USD regulators have implemented legislation to assure no new USD Libor contracts may be issued as of January 1, 2022.
- The alternative for the IBORs is expected to be several other government-sanctioned benchmarks for a Risk-Free Rate or RFR.

ALTERNATIVE RISK FREE RATE (RFR)

- Secured overnight financing rate (SOFR) for USD
- Unsecured Sterling overnight index average (SONIA) for GBP
- Unsecured Tokyo overnight average rate (TONAR) for JPY
- Secured Swiss average rate overnight (SARON) for CHF
- Unsecured Euro short-term rate (€STR) for the Euro (replacing EONIA)
- The alternative RFRs are mostly published as overnight rates.

INTEREST ON ACCOUNTS RECEIVABLE

- **Interest on accounts receivables balance:** TPOs have resorted to adding a notional interest on the outstanding balances of accounts receivable beyond a reasonable period. They have considered accounts receivable as an international transaction.
- **Explanation to Section 92B-the expression "international transaction" shall include**
- (c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;

CASE LAWS

- As regards notional interest addition on account of delayed payments by AEs, there are conflicting decisions on this account by various ITATs.
 - *Rusabh Diamonds* [TS-145-ITAT-2016(Mum)-TP],
 - *Bausch & Lomb Eyecare (India) Pvt. Ltd.* [TS-152-ITAT-2014(DEL)-TP]
 - *Kusum Health Care Pvt. Ltd* [TS-412-HC-2017(DEL)-TP]
 - *Techbooks International (P) Ltd* [63 Taxmann.com 114]
 - *Bt E-Serv (India) Pvt. Ltd* (ITA No. 6690/Del /2016)

GUARANTEE FEE

- If a loan to a company is guaranteed by another company in the same group, this can reduce the lending risk for the lender, because the guarantor is agreeing that it will meet the liabilities if the borrower defaults and the guarantor also defaults
- The borrower is effectively ‘piggybacking’ on the credit rating of the guarantor
- As this is a clear benefit for the borrower, it would normally be expected that it should pay a guarantee fee to the guarantor.
- In practice, the guarantee fee is normally set to be lower than the benefit so that both the guarantor and the borrower benefit from the transaction
- It is often difficult to determine exactly how the benefit should be split, but the decision should be based on the relative bargaining power of both the parties

INDIAN PERSPECTIVE

Retrospective amendment to section 92B *vide* Finance Act, 2012.

Explanation (i) to section 92B was inserted with effect from 1 April 2002, wherein the term ‘international transaction’ shall include--

“(c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance payments or deferred payment or receivable or any other debt arising during the course of business.”

GUARANTEE FEE-INDIAN CASE LAWS

- *Bharti Airtel Limited* [TS-76-ITAT-2014(DEL)-TP]
 - *Micro Ink Limited* [TS-568-ITAT-2015(Ahd)-TP]
 - *Prolifics Corporation Limited* [TS-497-ITAT-2014(HYD)-TP]
 - Nimbus Communication Ltd 42 taxmann.com 139
- Arm's length rate of Guarantee commission-Bank Guarantee rate??***
- *Everest Kanto Cylinders* [TS-200-HC-2015(BOM)-TP]
 - *Glenmark Pharmaceuticals Limited* [43 taxmann.com 191]



ARM'S LENGTH FOR ROYALTIES



DEFINITION OF ROYALTY

- Royalty is generally a payment received by the owner of an intangible right or knowhow under license in any technology transfer. Such intangible rights are often for making use of intellectual property
- Outright sale vs Royalty
- Intellectual property;
- Proprietary rights

WHAT IS AN INTANGIBLE

- Ever wondered why an Ipad from Apple is more costlier than the tablet by Amazon, even though they are both manufactured in China or
- Why a Bentley is more expensive than a top end Volkswagen model even though they are owned by the same parent company.
- The simple reason is the brand value associated with it.
- In today's economy a company's value is not measured by its physical assets but is a combination of its physical and non physical assets, where the non-physical being the intangible assets forming a major part of the economic value.
- Intangibles are the key drivers of value in the innovation based economy today. Therefore, there pricing is a concern as they used by multinational enterprises (MNEs) to strip their profits and shift them to low taxed jurisdiction, which is major concern across the globe

THREE ATTRIBUTES OF AN INTANGIBLE ASSET:

1

- Identifiability

2

- Control (power to obtain benefits from the asset)

3

- Future Economic Benefits (such as revenues or reduced future costs)

DEFINITION OF INTANGIBLES

OECD Defines intangibles as:

“something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction”

Refer to 2017 OECD TPG, Para 6.6

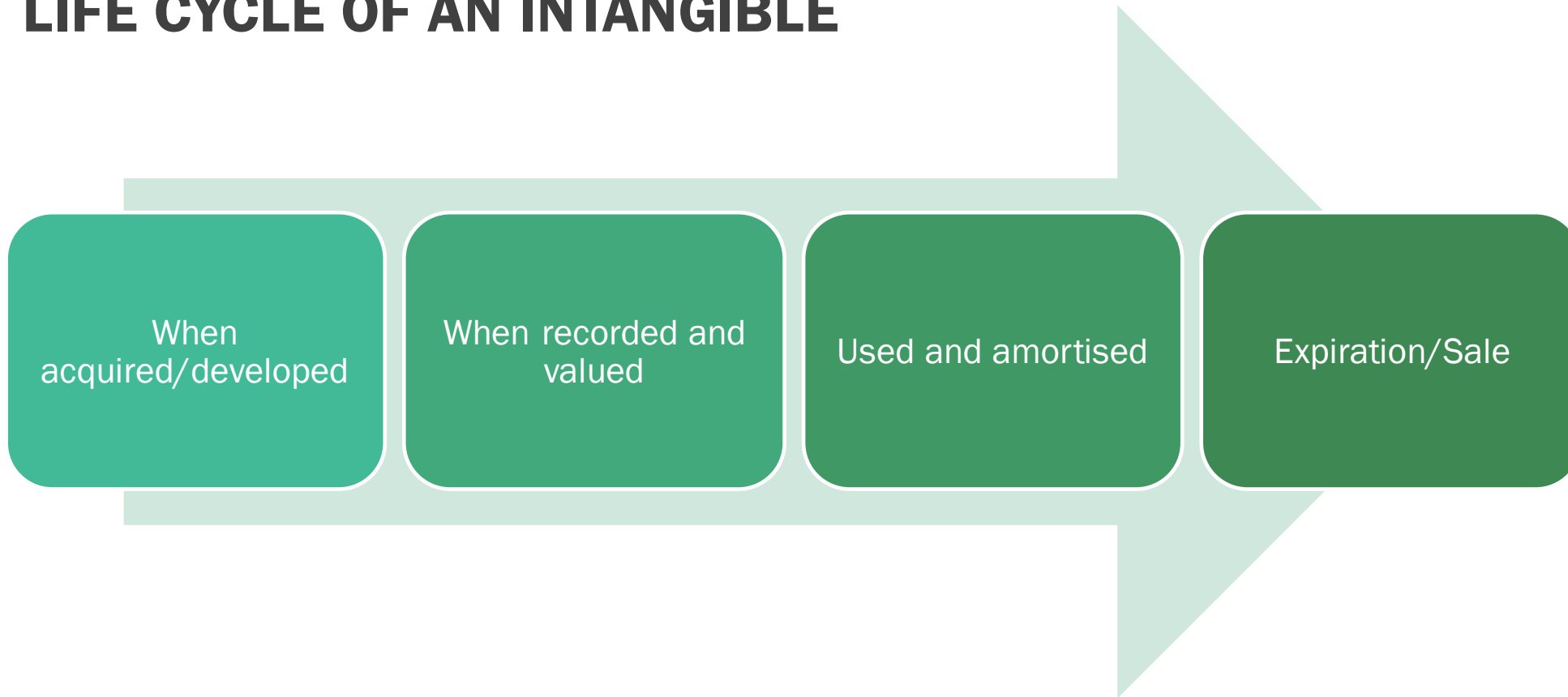
- UN Definition aligned with the OECD Guidelines
- Indian laws – Section 2 (11)(b) and Explanation (ii) of Section 92B (2) of the Income Tax Act, 1961

EXAMPLES/ILLUSTRATIONS OF INTANGIBLES (OECD TPG, PARA 6.18 TO 6.27)

- ❖ Patents;
- ❖ Know-how and trade secret;
- ❖ Trademark, trade names and brand;
- ❖ Rights under contracts and government licenses;
- ❖ Licenses and similar limited rights in intangibles; and
- ❖ Goodwill and ongoing concern value.

On the other hand, *group synergies* and *market specific characteristics* are not recognized as intangibles as they cannot be controlled by any party of the group. (OECD TPG, Paras 6.30 and 6.31)

LIFE CYCLE OF AN INTANGIBLE



Development of Intangibles

```
graph TD; A[Development of Intangibles] --> B[Contract R&D]; A --> C[CCAs/Cost Sharing];
```

Contract R&D

- MNE might have a separate entity set up and then contracted to do R&D
- Set up in low tax jurisdictions
- Complex ownership
- Tax authorities look at control or risks assumed

CCAs/Cost Sharing

- Centralisation of development of intangibles
- Commercial considerations like efficiency and cost saving
- costs and benefits are shared proportionately

CATEGORIES OF INTANGIBLES

Manufacturing

- Manufacturing or Trade Intangibles are characterized as one of two types
 - Patented or
 - Not patented technical know how arising out of research and development Activity

Marketing

- Trademarks
- Corporate reputation
- Distribution network
- Ability to provide services
- Created by marketing activities
- Impact brand value

Registered IP, Non Registered IP

- IP which can be registered such as patents, trademarks
- IP which can contractually/legally protected like copyrights, design, trade secrets. Depending on local laws

Others

- Intangibles that are valuable to businesses but not legally protected or registered
- Substantially impact business and have to be considered in a transfer pricing analysis

FORM OF PAYMENTS

- There are many ways to remunerate such licensing agreements, the simpler among them may be in these forms:

(i) A fixed annual fee

(ii) A fee based on a percentage of licensee's sales of the licensed products

Such a payment is called royalty.

Example: Denmark Co. has given IP for manufacture of Vito A(health supplement) in India to Indian subsidiary @ 4% of annual sales.

Vito C Sales	INR 2 crores
Vito A Sales	INR 5 crores
Total sales	INR 7 crores

How much royalty is payable by the Indian subsidiary?

COMMON ISSUES

- Whether the payment of royalty from one of the related parties (typically located in a less developed country) is necessary or not?
- Whether the payment of royalty is excessive?
- Whether the economic ownership is same as legal ownership? Concept of substance over form
- Benefit test



BENCHMARKING OF ROYALTY

- Arm's length price of royalty:
- Method used: comparable uncontrolled price method (“CUP”) or Transaction Net Margin Method (“TNMM”)
- Databases available for comparable royalty data

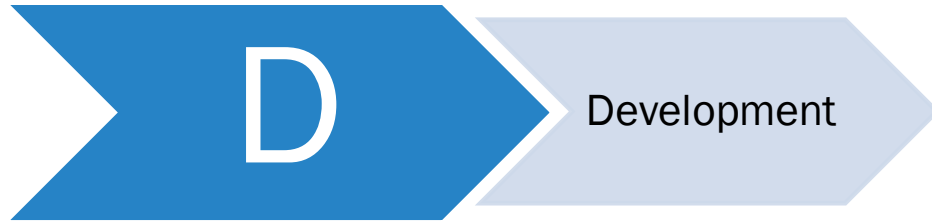
EXAMPLE OF ROYALTY BENCHMARK

Related Company transaction	Unrelated company data
Royalty paid @ 5%	Company X @ 2%
	Company Y @ 3%
	Company Z @ 4%
	Average @ 3%

Related company paying much higher than industry unrelated company data. Will be subject to transfer pricing adjustments

BENEFIT TEST

- Justify that benefit is derived;
 - TPO may disallow royalty payments if benefit not shown;
 - Business and commercial expediency comes into play;
 - Documents to support that IP actually received
 - Evidence to support that the taxpayer received commensurate economic and commercial benefits
-
- CIT v. EKL Appliances Ltd. [2012] 345 ITR 241/209 Taxman 200/24 taxmann.com 199 (Delhi)
 - Ericsson India (P.) Ltd. v. Dy. CIT [2012] 25 taxmann.com 472 (Delhi)



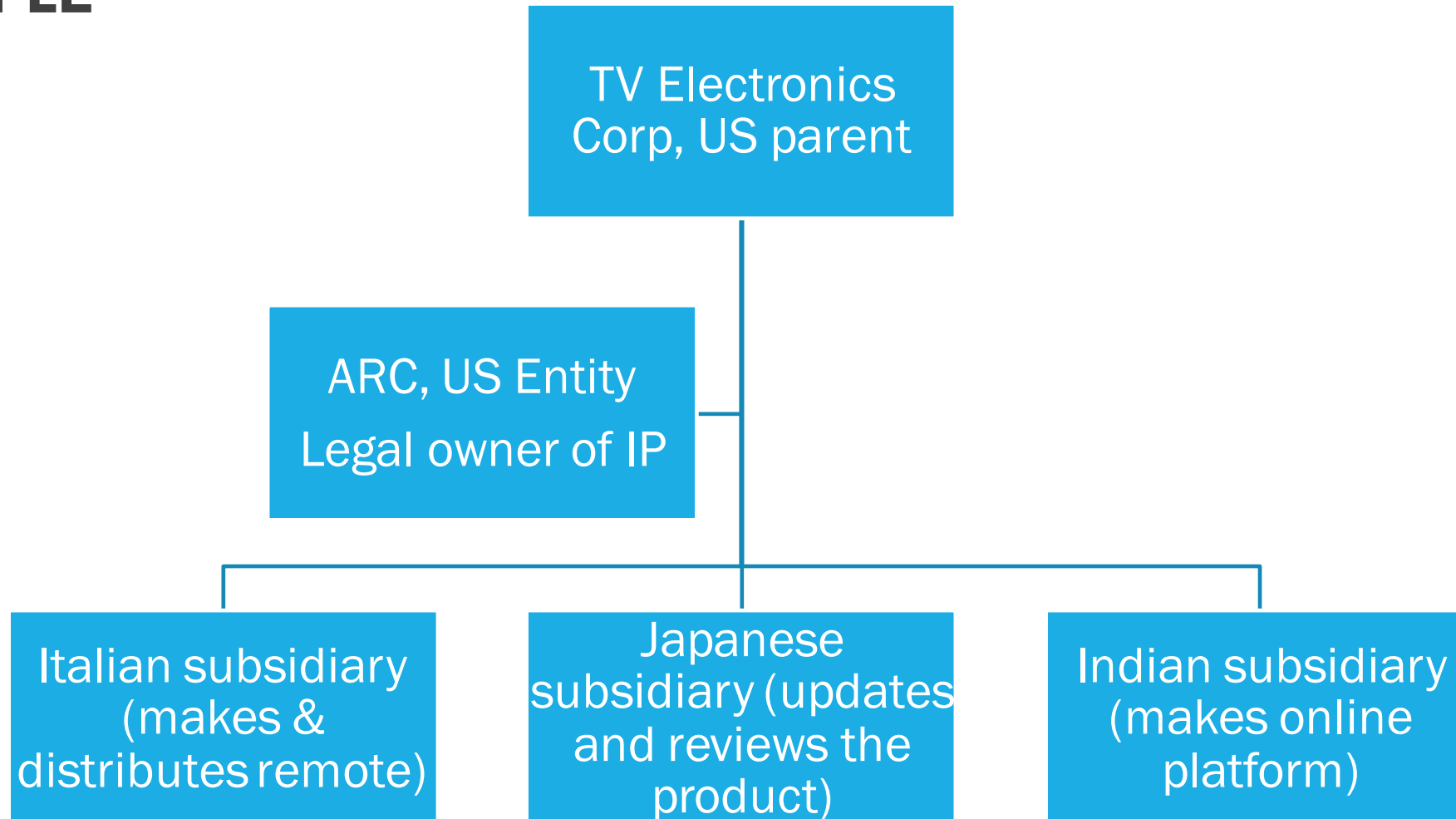
DEMPE FUNCTIONS

- Taken into consideration by the UN and OECD for TP Analysis of transactions involving intangibles (Para 6.34):
 - I. Identify the intangibles and risks within a particular transaction
 - II. Identify the contractual agreements relating to the transaction in question
 - III. Identify which parties performed DEMPE functions, by means of a functional analysis
 - IV. Determine whether the conduct of the parties was consistent with the contractual assumption of risk
 - V. Delineate the actual controlled transactions relating to DEMPE
 - VI. Determine arm's length prices for the transactions

INDIAN PERSPECTIVE

- Circular 6/2013
- Decision of Delhi High Court dated 16.03.2015 in Sony Ericsson vs. CIT being ITA No. 16 of 2014
- FAR versus FARM – Has India added the 'M'

EXAMPLE



VALUATION OF INTANGIBLES

- OECD Based on BEPS Action Plan 8 has released a Guidance on Guidance for Tax Administrations on the Application of the Approach to Hard-to Value Intangibles
- Valuation of intangibles involves an element of subjectivity and therefore often scrutinized by tax authorities
- Economic value is based on the economic and legal environment in which the intangibles are created and exist
- Assumption are made for valuation
- Refer to Paras 6.182 to 6.184 of the OECD TPG

**OECD (2018), Guidance for Tax Administrations on the Application of the Approach to Hard-toValue Intangibles - BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris.
www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-tohard-to-value-intangibles-BEPS-action-8.pdf*

HARD-TO-VALUE-INTANGIBLE (HTVI)

- An HTVI is an intangible for which a comparable uncontrolled transaction (CUT) does not exist and for which projections will be necessary.
- Defined at Para 6.189 of the OECD TPG to include intangibles or rights in intangibles for which at the time of the transaction
 - (i) no reliable comparable exist, and
 - (ii) the projections of future cash flows or expected income, or the assumptions used in their valuation are highly uncertain.

FOOD FOR THOUGHT !

- Almost all intangibles seem to fall in the category of HTVI.
- However, the OECD has given examples that shed some light on the HTVI definition.
- For example, intangibles that are only partly developed, intangibles whose commercial exploitation will only take place after several years, and intangibles that will be exploited in a manner that is novel may be mentioned as examples. (Para 6.190)

CASE LAWS

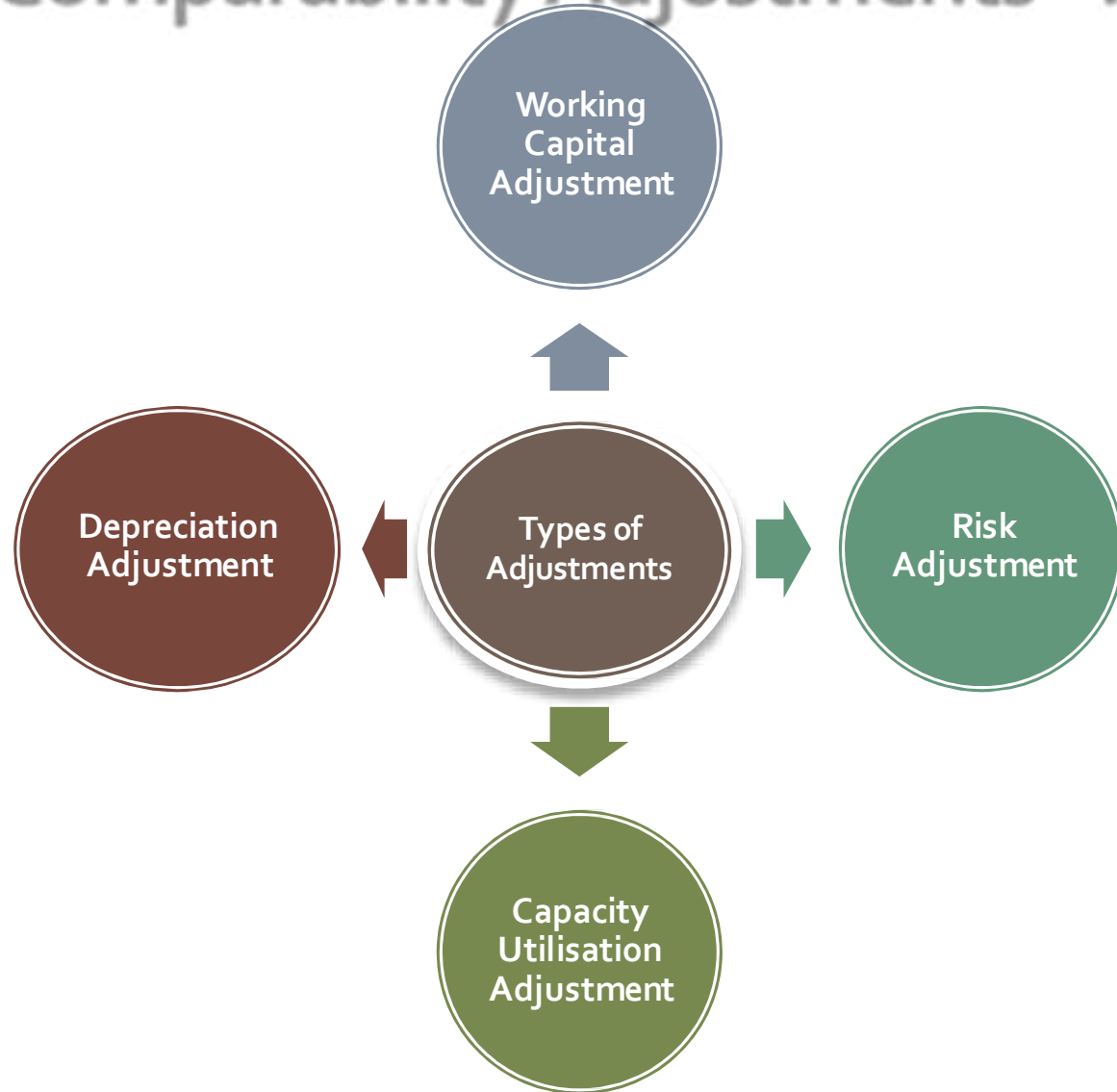
- Assistant Commissioner of Income-tax -10(2)v. Dow Agro sciences India (P.) Ltd. [2014] 43 taxmann.com 63 (Mumbai – Trib.)
- Cadbury India Ltd. v. Addl. CIT [2013] 40 taxmann.com 529
- Maruti Suzuki case



ARM'S LENGTH ADJUSTMENTS



Types of Comparability Adjustments - Illustrative





1. Working Capital Adjustment

Working Capital (WC) Adjustment

Concept

A working capital adjustment is therefore an adjustment of the time value of money invested/blocked in the operating activities of a company.

Accounting Definition

$$\text{Net Working Capital} = \text{Total Current Assets} - \text{Total Current Liabilities}$$

Transfer Pricing Definition - Components of WC Adjustment

**Net Working
Capital =**

Accounts Receivable (credit period extended to debtors)

Accounts Payable (credit period availed from suppliers)

Inventory (Carrying cost of traded goods / raw materials)

Rationale for WC Adjustment

Inventory Differences

A company with high levels of inventory presumably is offering its customers more convenience through faster shipment, greater variety, etc. For the provision of this embedded service, the company is generally compensated in the form of:

(a) higher sales prices paid by the customers; and/or (b) lower cost of goods sold charged by the suppliers.

Debtors' Differences

- As the creation of Accounts Receivables (AR) provides easier payment terms for the customers, it is an additional financing service and for this, the company is generally compensated in the form of higher sales prices paid by the customers. An adjustment is necessary for AR due to difference in credit periods provided to the customers of comparable company and tested party.

Creditors' Differences

- Accounts Payable (AP) held by a company can be viewed as an additional financing service received by the tested party, for which the supplier charges a higher cost of goods sold to the company. An adjustment is necessary for AP due to difference in credit periods provided by the suppliers of comparable company and tested party.

Need for WC Adjustment & Rulings

- Adjustment for the opportunity cost of capital for investments made in WC.
- Investments in WC (i.e. inventories, accounts receivable/debtors and accounts payable/creditors) requires capital and operating assets.
- An uncontrolled entity is expected to **earn a market rate of return** on such capital.
- Third party comparable companies may **provide more/less levels of service due to increased/decreased** capital investment. For example, a company with high levels of accounts receivable is providing a credit extension service to its customers in addition to its main operations.

Rulings on Working Capital Adjustment

- Ognibene India Pvt. Ltd. [TS-907-ITAT-2019(PUN)-TP]
- Inteva Products India Automotive Pvt. Ltd. [TS-110-ITAT-2019(Bang)-TP]
- India Medtronics Pvt Ltd [TS-898-ITAT-2019(Mum)-TP]
- Finastra Software Solutions (India) (P.) Ltd. vs. ACIT [2018] 93 taxmann.com 460 (Bangalore -Trib.)
- JDSU Indian (P.) Ltd. v/s DCIT [2018] 93 taxmann.com 295 (Delhi -Trib.)

WC Adjustment – OECD Approach

- Identify differences in the levels of working capital. Generally trade receivables, inventory and trade payables are the three accounts considered. The transactional net margin method is applied relative to an appropriate base, for example costs, sales or assets. If the appropriate base is sales, for example, then any differences in working capital levels should be measured relative to sales.
- Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base reflecting the time value of money by use of an appropriate interest rate.
- Adjust the result to reflect differences in levels of working capital.

WC Adjustment – Example

Working Capital Details of tested party

Particulars	Amount(₹)
Trade Receivables (A_1)	120.00
Inventories (B_1)	180.00
Trade Payables (C_1)	70.00
Working Capital ($A_1 + B_1 - C_1$)	230.00
Working Capital/Sales*100 (D_1)	23.00%

Working Capital Details of Comparable Companies

Particulars	Comparable P (Amount)	Comparable Q (Amount)
Trade Receivables (A_2)	200	100
Inventories (B_2)	240	150
Trade Payables (C_2)	110	70
Working Capital ($A_2 + B_2 - C_2$)	330	180
Working Capital/Sales (D_2)	30%	20%

Unadjusted PLI of tested party

Particulars	Amount(₹)
Sales of tested party (X_1)	1000
Profit Before Tax (Y_1)	10
$PLI_1 = PBT/Sales (Z_1 = Y_1/X_1 * 100)$	1.00%

Unadjusted PLI of Comparable Companies

Particulars	Comparable P (Amount)	Comparable Q (Amount)
Sales of comparable (X_2)	1100	900
Profit Before Tax (Y_2)	16.5	12
$PLI_2 = PBT/Sales (Z_2 = Y_2/X_2 * 100)$	1.50%	1.33%

WC Adjustment – Example

Particulars	Comparable P	Comparable Q
Working Capital/Sales of taxpayer/tested party = D_1	23.00%	23.00%
Working Capital/Sales of comparable = D_2	30.00%	20.00%
Difference ($F = D_1 - D_2$)	-7.00%	3.00%
Interest rate (Lending Rate = G)	12%	12%
WC Adjustment - interest expenses in the profit of comparable company additionally to be borne by comparable if it was also subject to the same blockage of funds in WC in relation to sales as the tested party $= (H = F * G)$ (Refer Note on Interest Rate)	$= -7\% * 12\%$ $= -0.84\%$	$= 3\% * 12\%$ $= 0.36\%$
$PLI_2 = PBT/Sales$ of comparable company (Z_2)	1.50%	1.33%
Adjusted $PLI_2 = PLI_2 + WC$ Adjustment ($I = Z_2 + H$)	$= 1.5\% - 0.84\%$ $= 0.66\%$	$= 1.33\% + 0.36\%$ $= 1.69\%$
Arithmetical Mean of Adjusted PLIs	1.175%	

Indicative rate - LIBOR/MCLR/PLR/Base Rate – depending on the currency in which the transaction is denominated or effective interest rate of the tested party.



2. Risk Adjustment

Risk Adjustment

- Risk Adjustment is made to reduce the quantum of systematic risks (such as market risks, research and development risk, technology risk, credit risk, liquidity risk etc.)
- Various risks faced by uncontrolled comparable companies as compared to a captive service provider or contract manufacturer having no risk\$ of loss and being insulated from changes in demand, pricing or competition in the market

Types of Risks

- Table pertaining to “Risks Assumed” as explained in the TP Study Report includes:
 - a) **Operational Risks** – Market Risk, Product / Service Liability Risk, R&D Risk, Credit Risk, Inventory Risk, Foreign Exchange Risk, Manpower Risk and Capacity Utilization Risk
 - b) **Non-Operational Risks** – Legal & Statutory Risk and Political Risk

Risks

Nature of risks	Particulars
Financial risk	(a) Capital Contribution (b) Method of funding (c) Funding of losses
Product risk	(a) Design and development of product (b) Upgradation of product (c) After Sales Service (d) Risks associated with R & D (e) Product liability risk (f) Intellectual property risk if any
Market risk	(a) Development of market including advertisement and product promotion etc. (b) Business volume risk (c) Assured sales risk (d) Fluctuations in demand and prices
Credit risk	(a) Risk of bad debts
Foreign exchange risk	(a) Risk on account of fluctuation of foreign currency exchange rates
Capacity utilisation risk	(a) Risks on account of under-utilisation of capacity

Risk Adjustment - Rulings

- Sony India Ltd [TS-19-ITAT-2008(DEL)-TP] (*Allowed risk adjustment of 20% from arithmetic mean of margins of comparables*)
- KOB Medical Textiles Pvt Ltd [TS-211-ITAT-2017(CHNY)-TP] (*Allowed risk adjustment of 2%*)
- LM Wind Power [TS-711-ITAT-2016(Bang)-TP] (*Allowed risk adjustment of 1%*)
- SSL TTK Ltd [TS-887-ITAT-2016(CHNY)-TP] (*Allowed risk adjustment of 1%*)
- Outsource Partners International Pvt Ltd [TS-57-ITAT-2017(Bang)-TP]
- IDS Software Solutions India Pvt Ltd [TS-1085-ITAT-2016(Bang)-TP]
- CAPCO IT Services India Pvt. Ltd. v. ITO – TS-1079-ITAT-2016–TP

3. Capacity Utilization Adjustment

Capacity Utilization Adjustment

- Capacity Utilisation Adjustment is the adjustment made to account for differences in capacity utilization between the tested party and the uncontrolled comparable transaction.

- Start-up businesses
- Loss of major business/customer
- Labour unrest
- Any abnormal situation like current COVID-19 pandemic

- **Variable Cost** : It varies directly with production level
- **Fixed Cost**: It remains the same irrespective of the production level.
- **Semi-Fixed Cost**: It contains both fixed and variable elements. It remains fixed upto a certain level and becomes variable thereafter.

Capacity Utilization Adjustment – Factors & Rulings

- Basis and method of calculation of under-utilized capacity
- Proper Justification for the idle capacity
- Business plans, capacity utilisation data and profitability for future years

- Claas India Pvt. Ltd. v DCIT [TS-371-ITAT-2015(DEL)-TP] ('Claas Ruling')
- Keihin Panalfa Limited [2018-TII-366-ITAT-DEL-TP]
- Commissioner of Income-tax-8 v/s Petro Araldite (P.) Ltd. [2018] 93 taxmann.com 438 (Bombay)
- Dover India (P.) Ltd. v/s DCIT [2017] 81 taxmann.com 245 (Pune - Trib.)
- Nippon Paint India Pvt Ltd v ACIT [TS-102-ITAT-2017(Chny)]
- DCITVs Danfoss Industries Pvt. Ltd. [TS-164-ITAT-2017(CHNY)]
- Frigoglass India Pvt. Ltd. Vs. ACIT [TS-500-ITAT-2016(DEL)-TP]

QUERIES



YOUR
QUESTIONS
PLEASE !!!

THANK YOU!

CA Bhavya Bansal Goyal
Email: bhavya@bbgtax.in



OECD GUIDANCE ON GUARANTEE FEES

- Accurate delineation will require identification of the economic benefits of the guarantee that are beyond those that result from implicit support
- The guidance states that the guarantee may allow the borrower to borrow on terms based on the credit rating of the guarantor
- The benefit of the borrower may be calculated by comparing its cost of borrowing without the guarantee to its cost with the guarantee, taking account of transaction costs and removing the impact of implicit support

OECD GUIDANCE ON GUARANTEE FEES

Pricing approaches for those circumstances where a guarantee is found to be appropriate:

- CUP is potentially the most reliable method. However, there may be difficulty in finding internal and external comparables
- Yield approach looks at the spread of the interest rate with and without the guarantee. This analysis sets a maximum fee for the guarantee that the borrower would be prepared to pay which isn't necessarily the arm's length amount that would come from negotiation.
- Cost approach looks at the cost that the guarantor would expect if the borrower defaults or alternatively the additional capital that the guarantor would require for the risk assumed
- Valuation of expected loss approach looks at the expected default and recovery rates in the event of default that may be available in the market place
- The price is then calculated using financial modelling such as the capital asset pricing model ('CAPM'). This is a theoretical model that competes risk and return
- Capital Support Method calculates the additional capital that would be needed to bring the borrowers capital up to that of the guarantor, then calculates the expected return on that amount of additional capital

APPROACHES FOR VALUATION OF INTANGIBLES :

Income Based

- Based on the present value of expected future cash flows to be derived from ownership of the asset
- DCF (Discounted Cash Flow Method)
- Relief from Royalty Method (“RFR”)

Market Based

- Based on transactions involving the sale or license of similar intangible assets in the marketplace
- Comparable Transactions Method

Cost Based

- Based on the cost to reproduce or replace the asset
- Replacement Cost Method

VALUATION OF HTVIS

- Intangibles valued on basis of projections and assumptions but that is not suitable for HTVIs
- The use of projections to value HTVI necessarily yields values that are heavily dependent on those assumptions, and tax authorities are concerned that taxpayers could potentially make assumptions that yield favorable values for the intangibles being transferred based on inappropriate assumptions.
- The use of inappropriate assumptions would necessarily be hard for tax authorities to detect, given the information asymmetries that exist between tax authorities and taxpayers.
- **The OECD introduced the HTVI Approach as a way to bridge that perceived asymmetry.**

Solution (HTVI Approach)

- The consideration of ex-post outcomes as presumptive evidence regarding the appropriateness of the ex-ante information used by the taxpayer in an HTVI transaction
- . Under the HTVI Approach, tax administrations may use ex-post outcomes to consider the reasonableness of any income or cash flow forecasts, probability weightings, and other assumptions used in the valuation at the time of the transaction.

READING MATERIAL

- Chapter VI of the OECD TPG
- OECD (2018), *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles - BEPS Actions 8-10*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris. www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf
- <https://www.royaltyrange.com/home/blog/dempe-six-steps-for-analyzing-transactions-involving-intangibles>