Reference to and Proceedings before TPO, DRP and Valuation Officer

Bhavesh P Dedhia

17th January 2015
Current Transfer Pricing Landscape
Transfer Pricing in News… Winds of change…

**Vodafone Wins Rs 3,200-cr Transfer Pricing Case in HC**

By PTI  Published: 10th October 2014 07:18 PM  Last Updated: 10th October 2014 07:18 PM

**Government proposes separate unit for disposal of transfer pricing case**

ET Bureau  Dec 18, 2014, 04.00AM IST

**Shell India wins 17,920-crore transfer pricing case**

**India signs first bilateral APA with Japanese company**
Transfer Pricing Litigation Scenario in India


<table>
<thead>
<tr>
<th>Particulars</th>
<th>Adjustments (in INR Cr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AY 2002-2003</td>
<td>1,403</td>
</tr>
<tr>
<td>AY 2003-2004</td>
<td>2,631</td>
</tr>
<tr>
<td>AY 2004-2005</td>
<td>3,947</td>
</tr>
<tr>
<td>AY 2005-2006</td>
<td>5,060</td>
</tr>
<tr>
<td>AY 2006-2007</td>
<td>10,000</td>
</tr>
<tr>
<td>AY 2007-2008</td>
<td>23,237</td>
</tr>
<tr>
<td>AY 2008-2009</td>
<td>44,531</td>
</tr>
<tr>
<td>AY 2009-2010</td>
<td>70,016</td>
</tr>
<tr>
<td>AY 2010-2011</td>
<td>60,000</td>
</tr>
</tbody>
</table>
Transfer pricing income adjustments decline 14% in 2013-14

Santosh Tiwari Posted online: Monday, Mar 10, 2014 at 0000 hrs
New Delhi: After a 54% jump in transfer pricing (TP) adjustments to Rs70,000 crore last year, additions to the income of companies conducting international transactions has dropped by over 14% to Rs60,000 crore in FY14.
Reference and proceedings before the TPO and Valuation Officer
CBDT has laid down following procedure and criteria for manual selection of returns/cases for scrutiny during for Transfer pricing matters:

- CBDT has dropped the Rs 15-crore threshold for referring cases for compulsory scrutiny. Instead, a risk-based approach is adopted to identify international transactions

- Cases involving addition in an earlier assessment year on the issue of transfer pricing in excess of Rs. 10 Crores or more which is confirmed in appeal or is pending before an appellate authority.

Either AO can do the transfer pricing assessment or can refer the computation to the TPO
Reference to Transfer Pricing Officer

- S 92CA (1) – if AO considers it necessary or expedient so to do, he may refer the computation of arm's length price to the TPO with the previous approval of the Commissioner – prima facia view

- S. 92CA (2) TPO to serve notice on the Assessee requiring him to produce evidence in relation to arm’s length price computed

- S. 92CA(2A) and (2B) – TPO can *suo motto* take cognizance of the transaction not reported by the Assessee or nor referred by the AO

- S 92CA(3) provides that the TPO after taking into account the material available with him shall, by an order in writing, determine the arm's length price in accordance with s 92C(3).

- S 92CA(3A) Time limit for passing an order - 60 days prior to the date of limitation referred in S. 153.

- S. 92CA(4) Provides that on receipt of the order of the TPO, the AO shall proceed to compute the total income of the assessee in conformity with the ALP as determined by the TPO.

- S. 92CA(5) and (6) refers to rectification for mistake apparent from record in TPO’s Order

- S. 92CA(7) exercise of power specified under
  - 131(1) - Power regarding discovery, production of evidence, etc.
  - 133(6) - May require any person to furnish information or
  - 133A - Power of Survey
Audit Process

1. File tax return & Accountant’s Report (30th November)

2. Reference to be made to TPO by the AO based on risk based assessment approach.

3. Notice to be issued by the TPO - TPO calls for supporting documents & evidence

4. TP Audit

5. Based on results of above mentioned procedure assessing officer passes the order

6. Rectification application can be made against the order of TPO for apparent mistakes [Section 92CA (5)]

7. Options of Filing an appeal

8. CIT (Appeals)

9. Dispute Resolution Panel

1. TPO issues a preliminary questionnaire.

2. We file all the relevant documents with the TPO’s office (TP Report, AR, Agreements, etc) ~ adjourned sine die;
   - Passes an order/ issues direction

3. TPO’s send a fresh notice for hearing ~ ask for updated margins, RPT details, eliminating loss-making companies;
   - Income Tax Appellate Tribunal

4. We file 2nd Submission which includes updated margins, etc;

5. TPO may ask for further queries, if required ~ pertaining to business profile of assessee and comparables, specific details on economic analysis;

6. We file 3rd Submission, if required;

7. TPO issues a show-cause notice (SCN) which includes the reasons as to why the TPO believe that an adjustment should be made;

8. We file a reply to the SCN ~ research, detailed response filed;

9. TPO passes the order and sends a copy to the AO;

10. AO passes a draft order u/s 144C.

Options of Filing an appeal

- Rectification application can be made against the order of TPO for apparent mistakes [Section 92CA (5)]
- CIT (Appeals)
- Dispute Resolution Panel

- Appeal to CIT (Appeals)/ DRP
- Supreme Court
- High Court – relating to question of law
- Income Tax Appellate Tribunal
Pursuant to the Supreme Court’s direction in case of CIT, Delhi v. Bharti Cellular Ltd. [2010] 193 Taxman 97 (SC)

“We are directing CBDT to issue directions to all its Officers, that in such cases, the Department need not proceed only by the contracts placed before the officers. With the emergence of our country as one of the BRIC countries and with the technological advancement matters such as present one will keep on recurring and hence time has come when Department should examine technical experts so that the matters could be disposed of expeditiously and further it would enable the appellate Forums, including this Court, to decide legal issues based on the factual foundation. We do not know the constraints of the Department but time has come when the Department should understand that when the case involves revenue running into crores, technical evidence would help the Tribunals and courts to decide matters expeditiously based on factual foundation.”

CBDT issued INSTRUCTION No. 5/2011- The AO/TPO should frame assessments only after taking opinion of technical/valuation experts and bringing on record technical evidence in cases involving complex issues of technical nature and substantial revenue

S. 50C – AO may refer the valuation of the capital asset to a Valuation Officer, if the taxpayer claims that stamp duty valuation is higher than the fair market value (FMV) and such valuation has not been disputed

S. 55A – With a view to ascertaining the FMV of a capital asset, the AO may refer the valuation of capital asset to a Valuation Officer, if AO is of opinion that having regard to the nature of the asset and other relevant circumstances, it is necessary so to do
Reference to Valuation Officer - Statutory provisions

- **S. 142A** – For the purposes of assessment or reassessment, **AO** may make a reference to a **Valuation Officer** to estimate the value, including FMV, of any asset, property or investment whether or not he is satisfied about the correctness or completeness of the accounts of the taxpayer.

- **S 269L** - For the purpose of initiating proceedings for the “acquisition of any immovable property” (by Central Government) under certain circumstances (tax evasion or concealment of income), the **competent authority** (Jt. Commissioner) may require a **Valuation Officer** to determine the FMV of such property.

Reference to Valuation Officer – Procedural aspects (section 16A of the Wealth Tax Act, 1957)

- **VO** may serve a notice on the **taxpayer** requiring him to furnish the accounts, records and other relevant documents for the purpose of valuation.

- If the VO is satisfied that the value declared by the taxpayer is correct, then he shall pass an order in writing and send a copy of his order to the **AO** and the taxpayer.

- If not, he shall serve a notice on the taxpayer intimating the value which he proposes to estimate and give an opportunity to state his objections. After hearing the taxpayer’s contentions and other evidences as may be produced by him, the VO shall pass an order estimating the value of the asset and send a copy of his order to the **AO** and the taxpayer.

- On receipt of order from the VO, the **AO** shall proceed to complete the assessment (in relation to the valuation of the asset), in conformity with the order of the VO.
Reference and proceedings before the DRP
Conventional v. Alternate Mechanisms

**Conventional mechanism**

- **TPO/ AO**
  - AO passes final order
  - Tax demand fastens on taxpayer immediately
  - Stay of demand not automatic
  - No time limit to dispose appeal
  - Taxpayer & Revenue can both challenge ruling before Tribunal
  - AO passes final order
  - Tax demand fastens on taxpayer immediately
  - Stay of demand not automatic
  - No time limit to dispose appeal
  - Taxpayer & Revenue can both challenge ruling before Tribunal

- **CIT (Appeals)**

- **Tax Tribunal (ITAT)**

- **High Court**

- **Supreme Court**

**Alternate mechanism**

- **TPO/ AO**
  - AO issues draft order based on TPO’s order
  - Taxpayer files acceptance or detailed objections to proposed additions (within 30 days of receipt of order)
  - DRP may confirm, reduce or enhance proposed additions
  - Dispute resolved within 9 months of issuance of draft AO order
  - All directions of DRP binding upon AO
  - No tax demand until DRP issues directions
  - Taxpayer can challenge ruling before Tax Tribunal
  - AO issues draft order based on TPO’s order
  - Taxpayer files acceptance or detailed objections to proposed additions (within 30 days of receipt of order)
  - DRP may confirm, reduce or enhance proposed additions
  - Dispute resolved within 9 months of issuance of draft AO order
  - All directions of DRP binding upon AO
  - No tax demand until DRP issues directions
  - Taxpayer can challenge ruling before Tax Tribunal

- **Dispute Resolution Panel (DRP)**

- **Tax Tribunal (ITAT)**

- **High Court**

- **Supreme Court**
DRP Process

1. TPO Order
2. Draft Order by AO
3. Assessee Conveys acceptance / No objection communicated
4. Assessee files objection with DRP
5. DRP passes direction
6. AO passes final order
7. Appeal before the ITAT
8. Appeal before the CIT(A)

- 9 *months
- 1 *month
- 60 *days

* Maximum time line available
DRP Mechanism – Key Aspects … (1/2)

• Introduced by Finance (No.2) Act, 2009 w.e.f 1 April 2009. Alternative dispute resolution mechanism for “Eligible Assessee”:
  ➢ **Foreign company** - Transfer pricing adjustment not necessary
  ➢ **Any other person** – If variation in pursuance to order issued by transfer pricing officer

• Objections to be filed against entire Draft Order – both transfer pricing as well as non transfer pricing (i.e. general tax issues)

• Additional evidence (not submitted to the AO) to be filed through a separate application stating the reasons for filing such additional evidence

• No payment of tax till AO issues the Final Order in pursuance of DRP directions
DRP – Powers and Duties

- DRP has powers as are vested in a ‘Court’ under Code of Civil Procedure, 1908
- DRP issues directions to confirm, reduce or enhance proposed variation
- To issue directions within nine months from end of month in which draft order is forwarded to taxpayer
- DRP cannot set aside proposed variation – Must give final directions to AO on the issue
- DRP may not condone delay - No provisions in Sec144C / DRP rules to condone delay in filling of objections
Taxpayers Experience

The 9 month timeline - Constraint

Administrative delays in bench constitution etc.

Tribunals have restored several appeals back to DRP/TPO for fresh adjudication

Non speaking orders, generally affirming AO’s draft order

Very little relief granted

Protracted litigation as the revenue is given the right to appeal against DRP directions

If department is in appeal over similar issues then unlikely any different view would be taken

Mostly ‘Legal‘ issues not dealt with

Relatively short hearing notices, time constraints

Seen as an extension of the assessment process - Absence of independent institutionalized form of Dispute Resolution

© 2010 KPMG, an Indian Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

KPMG and the KPMG logo are registered trademarks of KPMG International Cooperative ("KPMG International"), a Swiss entity.
Recent Change in DRP constitution

- CBDT revises Disputes Resolution Panel (DRP) rules w.e.f. 1 January 2015,
- DRP to be set-up 3 headquarters at Delhi Mumbai & Bangalore;
- Each DRP Headquarter to have jurisdiction over multiple states as follows:

<table>
<thead>
<tr>
<th>Headquarters</th>
<th>Jurisdiction</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Panel at Delhi</td>
<td>Delhi, Rajasthan, Himachal Pradesh, Jammu and Kashmir, Uttar Pradesh, West Bengal, Bihar, Odisha, North-east states, etc.</td>
</tr>
<tr>
<td>2 Panel at Mumbai</td>
<td>Maharashtra, Gujarat, Madhya Pradesh, Chhattisgarh, etc.</td>
</tr>
<tr>
<td>1 Panel at Bangalore</td>
<td>Karnataka, Tamil Nadu, Andhra Pradesh, Telangana, Kerala, Goa, etc.</td>
</tr>
</tbody>
</table>

- Rules also prescribed for transferring the case from one jurisdiction to another
## Reference to DRP vs CIT(A) - A Comparative

<table>
<thead>
<tr>
<th>Key</th>
<th>DRP</th>
<th>CIT(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Constitution</strong></td>
<td>Collegium of three officers of the CIT rank</td>
<td>Only one CIT</td>
</tr>
<tr>
<td><strong>Application Process</strong></td>
<td>If the taxpayer chooses this route, he is required to lodge objections within 1 month from receipt of Draft Order</td>
<td>Should file Appeal within 30 days from the receipt of Final AO Order</td>
</tr>
<tr>
<td><strong>Time limit</strong></td>
<td>Only 9 months from the date of Draft Order to examine the case, hold hearings and pass directions</td>
<td>No time limit</td>
</tr>
<tr>
<td><strong>Demand</strong></td>
<td>No demand till disposal of the matter</td>
<td>Significant portion of demand is required to be paid unless stayed</td>
</tr>
<tr>
<td><strong>Pros</strong></td>
<td>Fast track route to the ITAT</td>
<td>Detailed hearings may be granted to the Assessee to represent their case</td>
</tr>
<tr>
<td><strong>Form</strong></td>
<td>Form 35A – specific format to be followed for submission</td>
<td>Form 35</td>
</tr>
<tr>
<td><strong>Further Appeal</strong></td>
<td>Both taxpayer as well as AO can appeal to ITAT</td>
<td></td>
</tr>
</tbody>
</table>
Key Triggers – Transfer Pricing Litigation
Key Triggers and Contributors for Transfer Pricing Litigation

**Key Triggers for Aggressive Audits**

- Consistent losses / low margins of the assessee attributable to inter-company transactions
- Significant changes in profitability of the assessee and its AEs
- High Royalty / Technical fee payouts, Cost recharges, Management Fees, Cost allocations
- Net losses incurred by routine distributors
- Low mark-ups for services
- Application of Ratio's such as ROCE / Berry ratio / cash profit instead of net margins
- Significant Advertisement and marketing spends by manufacturing / distribution companies
- Use of foreign comparables

**Contributors to Aggressive Audits:**

- Mounting fiscal demand on Government
- Need to Preserve tax base
- Constant competitive pressure to restructure business operations efficiently
- Unprecedented sharing of information between revenue authorities

Substantial increase in transfer pricing audits and disputes across the Globe, India is no exception....
Emerging Transfer Pricing Issues
Key Emerging Issues in Transfer Pricing Audits

- R & D Activities
- Location Savings
- Management Service Fees
- Marketing Intangibles
**Marketing Intangibles: General Concept**

- **AMP spend by Indian licensee**
- **Excess**
  - Assumed to be incurred for strengthening of brand name of the AE

*Indian licensee:*
Must be reimbursed along with a suitable mark up.

**AMP:** Advertisement, marketing, promotion

**Bright line**

---

**Revenue’s Approach**

<table>
<thead>
<tr>
<th>Application of ‘Bright line’ test</th>
<th>Treating excess as expense incurred for creation of intangible</th>
<th>Deeming a service fee</th>
<th>Royalty payment also challenged</th>
<th>Application of Profit Split Method</th>
<th>Apportionment of global profits to India for brand/marketing intangible creation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use of comparables selected under TNMM?</td>
<td>Application of CUP while determining the excess percentage</td>
<td>Adding a profit mark-up in addition</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
• Ownership of intangibles – Legal vs. Economic

• Excess Advertisement Marketing and Promotion (AMP) expenses incurred by a brand licensee is an international transaction – Delhi ITAT Special Bench ruling – *LG Electronics India Pvt. Ltd.*

• AMP spends to satisfy the ‘bright line’ test - Identification of expenses “in connection with sales” as against “for promotion of sales”

• Revenue expects Mark-up on AMP expenses in excess of bright line – in some cases have also considered global profit split

• India’s position in the UN TP manual – Primarily based on AMP expense by no risk or limited risk distributors working on cost plus model – they should incur only routine AMP expenses

• Recent Delhi Tribunal ruling in the case of *BMW India Private Limited* drew a distinction in the facts from that of LG India’s case and held that premium profits earned by distributor are adequate compensation for excessive AMP, and deletes adjustment
**R&D Activities – new administrative guidance**

**Circular No. 2 / 3 (dt. 26/3/2013)**
Application of Profit Split Method (‘PSM’)
Conditions relevant to identify Contract R&D with insignificant risk

**Circular No. 6 (dt. 29/6/2013)**
Circular No. 2 on PSM rescinded
Circular No. 3 on contract R&D amended and reissued

<table>
<thead>
<tr>
<th>Parameters</th>
<th>Outside India</th>
<th>In India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functions</td>
<td>Economically “Significant”</td>
<td>Economically “Insignificant”</td>
</tr>
<tr>
<td>Funding/ Assets</td>
<td>Source of funds/ capital</td>
<td>No economically significant assets or intangibles</td>
</tr>
<tr>
<td>Supervision &amp; Control</td>
<td>Significant assets/ intangibles</td>
<td>Operate under Guidance</td>
</tr>
<tr>
<td>Risk Profile</td>
<td>Strategic decisions for Core Functions &amp; Monitoring</td>
<td>No significant risks</td>
</tr>
<tr>
<td>Outcome of Research</td>
<td>Significant Risks</td>
<td>No ownership of resultant IP</td>
</tr>
<tr>
<td></td>
<td>Legal &amp; economic owner of resultant IP</td>
<td></td>
</tr>
</tbody>
</table>

**Primary Coverage** - Indian Captives engaged in Research and Development Activities
Location Savings

- Refers to Cost Savings due to relocation of business from ‘high cost’ location to ‘low cost’ location and ‘Location Specific Advantages’ (e.g. skilled manpower, large customer base, superior network etc) enjoyed by growing economies like India

- Quantification and allocation of Location Savings is subject matter of controversy
  - UN and OECD Manual: Depends on functional analysis and bargaining power of the parties

- Indian Revenue authorities believe Profit Split Method (‘PSM’) may be used to allocate Location Savings

- Location Savings considered through applications of higher mark-up in low cost countries

- GAP Ruling- geographical comparability considers Location Savings

- No Location Savings where location’s benefits are actually shifted to customers
Management service fees

- Payment towards management fees is generally towards services such as Planning & Coordination, Budgetary Control, Financial advice, Accounting, Auditing, Legal services, Computer services, Financial services, Management and administrative services, Purchasing, marketing and distribution, Human resource services etc.

- Management fee charged by AEs are investigated in great detail by the Revenue department

- Robust / exhaustive documentation requirement demanded to substantiate the total receipt of services and benefits received. In absence of substantial documentation demonstrating the services received such allocations are disallowed completely or determined at a substantially lower amount

- Revenue also enquire into whether a similar charge is levied on other group entities and rates thereof are also called for and examined

- Typical mindset of the Revenue is that management charge are used for profit repatriation.
Key Points for success in Transfer Pricing audits in India

- Detailed Functions-Assets-Risks analysis
- Proactive Planning
- Agreements / contracts should exist for transactions between Associated Enterprises
- Price setting mechanisms to be documented
- Localization of Global Transfer Pricing policies
- Documentation should completely describe search methodology, basis for inclusion / exclusion of comparables, etc.
- Substantiate business, economic and commercial rationale
- Maintain detailed cost-benefit analysis with respect to cross charges (intra-group services)
- Strategizing and providing appropriate information during the audit
Thank You

Bhavesh Dedhia
Director - Global Transfer Pricing Services