Recent developments in Transfer Pricing

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Chennai
Agenda

Recent developments in Transfer Pricing

1. Recent Trends
2. Key Issues
3. Deemed International transactions
4. Multiple year data and range concept
5. APA & Roll back
6. New powers to the TPO
7. Safe harbour provisions
8. Way forward
Recent trends
Transfer Pricing – Recent Trends

- Introduced with effect from July 1, 2012, detailed rules prescribed on August 31, 2012 and guidance on APA with FAQs issued on April 2013

- TP additions of USD 41 billion approx

- India contributes to more than 70% of the TP global disputes

- Separate tribunal for TP disputes still under consideration

- TP Week ranked India #1 on Top 10 Toughest Tax Authorities for TP

- APA Programme introduced*

- Final Safe harbour rules notified**

TP Adjustment (in INR crores)

* Introduced with effect from July 1, 2012, detailed rules prescribed on August 31, 2012 and guidance on APA with FAQs issued on April 2013

** Draft rules introduced on August 14, 2013 inviting public comments and Final rules introduced on September 18, 2013
Key Challenges
Key Challenges

1. Undervaluation of shares
2. Marketing intangibles
3. Royalty Pay-outs
4. Management Charges
5. Single year data
6. Arithmetic Mean
7. IT / ITES Margins
8. Loan and Guarantee Fee
Deemed International transactions
Erstwhile Provisions

Section 92B(1)
“For the purposes of this section and sections 92, 92C, 92D and 92E, “international transaction” means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of....

Section 92B(2)
“A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise”
Facts of the Swarnandhra Case

- IJM India (“IJMII”) entered into a joint venture with Andhra Pradesh Housing Board (“AP-HB”) and formed Swarnandhra IJMII Integrated Township Development Company (“Swarn”)

- IJMII rendered project management services to Swarn pursuant to an agreement between IJM AE and Swarn

- T1 → Payment to IJMII (construction contractor)

- Swarn entered into transactions with IJMII → TPO applied Section 92B(2); as per TPO, terms determined in substance between the Swarn and the AE

Question before the Tribunal:

Whether transaction between IJM India and Swarn fall within the purview of Section 92B(2)

Question of interposing independent third parties between two AEs to avoid transfer pricing applicability
Key findings of ITAT – Mumbai & Hyderabad

Swarn case:

• Though Section 92B(2) is a part of section 92B it is to be read as an extension of Section 92A(2) of the Act and not as an extension of Section 92B(1).

• For Section 92B(2) to apply, Section 92B(1) should first be attracted → in this case Section 92B(2) cannot be applied/ attracted
  
  • **Domestic companies →** As both the parties are residents, the transaction between the Swarn and IJMII do not constitute an international transaction. The basic premise for invoking section 92B(2) does not arise.

  • IJMII was the **actual provider of services to Swarn →** it was not a company interposed between AE & Swarn to circumvent the TP provisions.

  • **Influence** - In view of the active participation of the government in the functioning of the Swarn, it cannot be said that the AE would influence the entering into the contract by the taxpayer or its terms and conditions.

• Section 92B(2) is transaction specific and does not apply to all transactions between the enterprise and the unrelated person.

• **Legislative intent →** Identify transactions wherein intermediary is used to break a transaction in order to circumvent TP provisions i.e. substance over legal form
**Facts of the Kodak Case**

- **T1** → Sale of ‘Medical Imaging segment’, global basis vide **Global Agreement** between Kodak US and Carestream Inc

- **T2** → Pursuant to T1, Kodak India sells India business (segment) vide **Agreement** between Kodak India and Carestream India

- TPO invoked Section 92B(2) of the Act on the premise that India sale pursuant/ consequential to a larger sale transaction

**Question before the Tribunal:**

Whether the sale of Indian business by Kodak India to Carestream India is a deemed international transaction?
Key findings of ITAT – Mumbai & Hyderabad

Kodak case:

- Language of Section 92B(2) → “for the purposes of sub section (1)” i.e. either party has to be a non-resident (a strict interpretation is needed)
- Domestic companies → individual and independent; no transaction involving a non-resident company
- No relationship established i.e. no connect has been established for the relevant transaction (Sale of India business) between Kodak India and Care Inc. or between Care India and Kodak US

- the preconditions are:
  - the existence of a prior agreement between the other entity and the AE in relation to the relevant transaction, or
  - there should be AE involvement in determining (in substance) the terms of the transaction.

Section 92B(2) not triggered
Key findings of ITAT – Mumbai & Hyderabad

Kodak case:

- In this regard, the following important submissions made by the taxpayer are relevant:
  - Terms and conditions of the sale were determined solely by the taxpayer and Carestream India and not by Kodak US;
  - Valuation of the business was undertaken by the taxpayer through its independent valuers;
  - The taxpayer received entire sale proceeds, and nothing was transferred to Kodak US;
  - There was no prior agreement between Carestream India and Kodak US for this sale transaction [as required by section 92B(2) of the Act].

- Though, India agreement is a consequence of global agreement but this agreement did not have any role in/effect on sales transaction.

- Matter cannot be restored to TPO for ALP determination if TPO in the first instance has ignored mandatory provisions of law.

Section 92B(2) not triggered
Impact of the amendment to Section 92B(2)

Impact of participation of another entity/ shareholder, Terms to be determined in substance.

The current Section 92B(2) provides that transaction by an enterprise with an unrelated party shall be deemed to be a “transaction” between two associated enterprises if there exist a prior agreement between the unrelated party and Associated Enterprise of the enterprise or where terms of relevant transaction are determined in substance between the unrelated party and AE.

The ambiguity in the current section was whether or not the unrelated party has to be a non-resident for the transaction to be deemed international transaction.

Even though prior agreement, must have influence or effect, Document critical – showing no influence.

The Finance Bill 2014 has amended section 92B(2) to state that the residential status of the unrelated party is immaterial for determination of deemed international transaction.

From April 2015
**Key Questions**

1. What could be the **intent** of providing this disclosure requirement?

2. What terms needs to be covered in the prior agreement – if the prior agreement is not **on pricing** would it still be a prior agreement for Section 92B(2)?

3. Many MNCs have such **Master Service Agreement** (MSA) with vendors along-with Local Services Agreements (LSA) with local / overseas arm of vendor.
Multiple year data & Range
Multiple year and Inter quartile range

Current legislation

Restricted use of multiple year data #

The revenue authorities insisted on use of data of the single year to which the transaction pertains.

Arithmetic mean (as against universal standard of inter quartile range)

Considered as a measure of central tendency for computing arm’s length price of international transactions

Finance Minister proposed to amend provisions to allow use of multiple year data and range concept to align with international best practices

# Proviso to rule 10B(4)

* Section 92C – third proviso to sub-section (2) w.e.f April 2015

Proposed legislation

Multiple year*

"Provided also that where more than one price is determined by the most appropriate method, the arm’s length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply."

Interquartile range

Current arithmetic mean concept to continue where number of comparables is inadequate
Multiple year data

- ‘Use of single year data’ has contributed to significant amount of litigation in India.
- Multiple year data – factors business cycle impact, provides better comparability results
- Global best practices on use of multiple year data

<table>
<thead>
<tr>
<th>Country</th>
<th>Use of Multiple year data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>3 out of 5 years</td>
</tr>
<tr>
<td>China</td>
<td>2 out of 3 years</td>
</tr>
<tr>
<td>UK</td>
<td>3 out of 5 years</td>
</tr>
<tr>
<td>US</td>
<td>2 out of 3 years</td>
</tr>
</tbody>
</table>
**Impact of Inter-quartile range**

**DRP**

*Lionbridge Technologies Private Limited Vs ITO-822, Mumbai-21 ITA (No.7498/Mum/2012)*

The Assessee meets the arm’s length criteria under the inter-quartile method

<table>
<thead>
<tr>
<th>Particulars</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean of comparables</td>
<td>30</td>
</tr>
<tr>
<td>Mark-up of Assessee</td>
<td>18</td>
</tr>
<tr>
<td>Inter-quartile range</td>
<td>14–35</td>
</tr>
<tr>
<td>+/- 5% range</td>
<td>12–24</td>
</tr>
</tbody>
</table>

**ITAT**

→ Tribunal ordered the TPO to remove certain comparables

⇒ The revised arithmetic mean and inter-quartile is as under:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>%</th>
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<td>14–35</td>
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<tr>
<td>+/- 5% range</td>
<td>12–24</td>
</tr>
</tbody>
</table>

DRP Range concept to go a long way in reducing the TP litigations in India

The Assessee meets the arm’s length criteria under the inter-quartile method as well as the arithmetic mean method (after availing the benefit of +/- 5% range)
New powers to the TPO
Takeaways from Cushman and Wakefield – Delhi High court ruling

1. Jurisdiction of the AO and the TPO are distinct

2. Reference to TPO is only for the limited purpose of determining the arm’s length price of the international transactions

3. Authority of a TPO is to conduct a transfer pricing audit and not to determine existence of a service from which the assessee benefits

4. The exercise of factual verification is retained by the Assessing officer under Section 37
New powers to the TPO

The existing provisions of section 271G of the Act provide that if any person who has entered into an international transaction or SDT fails to furnish any information/document as prescribed by the transfer pricing provisions, then such person shall be liable to a penalty up to 2% of the value of international transactions (or SDT) which may be levied by the AO or the CIT(A).

“In section 271G of the Act, after the words “the Assessing officer”, the words, figures and letters “or the Transfer Pricing Officer as referred to in section 92CA shall be inserted with effect from the 1st day of October, 2014.”
APA – Rollback provisions
**APA – Roll back provisions**

**APA**
An APA is an agreement between the taxpayer and the tax authority on the pricing of future intercompany transactions.

The taxpayer and tax authority mutually agree on the transfer pricing methodology (‘TPM’) to be applied and its application for a certain future period of time for covered transactions.

**APA Procedure**
APAs are presently available for a period not exceeding five years, starting from April 1, 2013.

**APA Rollback Procedure**
The amendment to Section 92CC w.e.f October 1, 2014 will allow an APA entered into to be applied to four previous years for the transactions covered in the APA. *

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*Subject to such conditions, procedure and manner as may be prescribed, provide for determining the arm’s length price or specify the manner in which arm’s length price shall be determined in relation to the international transactions*
### Roll back Provisions

<table>
<thead>
<tr>
<th>Country</th>
<th>Roll Back Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>May conduct a risk assessment of past years to provide for roll back</td>
</tr>
<tr>
<td>China</td>
<td>Upto 10 years</td>
</tr>
<tr>
<td>Japan</td>
<td>Upto 3 years</td>
</tr>
<tr>
<td>Singapore</td>
<td>Upto 2 years</td>
</tr>
<tr>
<td>U K</td>
<td>May be considered</td>
</tr>
<tr>
<td>U S</td>
<td>May be considered</td>
</tr>
</tbody>
</table>

### Indian APA Scenario

- Pre-filing meeting without filing fees (also on anonymous basis)
- APA Applications ➔ conversion of unilateral to bilateral & vice versa possible
- Approximately 150 applications filed in year 1 and 240 in year 2
- Site visits by APA team had been completed in most cases
- 5 Unilateral APAs signed on March 31, 2014
- APA team is positive & pragmatic and relates to business/ practical realities
- Past litigation would not automatically impact favourable APA resolution
Safe harbour provisions
## Snapshot of Indian Safe Harbour Rules

<table>
<thead>
<tr>
<th>Nature of transaction</th>
<th>Quantum of International transaction</th>
<th>Safe Harbour Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Software development services / ITeS</td>
<td>Less than INR 5 Billion</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>Exceeding INR 5 Billion</td>
<td>22%</td>
</tr>
<tr>
<td>KPO</td>
<td>No range</td>
<td>25%</td>
</tr>
<tr>
<td>Contract R&amp;D services</td>
<td>No range</td>
<td>30% (software)</td>
</tr>
<tr>
<td></td>
<td>No range</td>
<td>29% (generic pharma)</td>
</tr>
<tr>
<td>Intra – Group Loan to wholly owned subsidiaries</td>
<td>Less than INR 500 Million</td>
<td>SBI Base rate + 1.50%</td>
</tr>
<tr>
<td></td>
<td>Exceeding INR 500 Million</td>
<td>SBI Base rate + 3.00%</td>
</tr>
<tr>
<td>Corporate Guarantee to wholly owned subsidiaries</td>
<td>Less than INR 1 Billion</td>
<td>2% pa</td>
</tr>
<tr>
<td></td>
<td>Exceeding INR 1 Billion*</td>
<td>1.75% pa</td>
</tr>
<tr>
<td>Manufacture and export of auto components</td>
<td>No Range</td>
<td>12% (core)</td>
</tr>
<tr>
<td></td>
<td>No Range</td>
<td>8.50% (non-core)</td>
</tr>
</tbody>
</table>

* credit rating of “Adequate to highest safety” from agency registered with SEBI
**Safe Harbor India - Services**

The description of an eligible taxpayer with insignificant risk is in line with criteria prescribed in a recently issued Circular (No. 6/2013 dated 29 June, 2013)

<table>
<thead>
<tr>
<th>Foreign Principal</th>
<th>Indian Service Provider (ICo)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economically significant functions (Conceptualisation, Design, etc.)</td>
<td>ICo is largely involved in economically insignificant functions</td>
</tr>
<tr>
<td>Funds/capital and other economically significant assets including intangibles</td>
<td>ICo does not use any other economically significant assets including intangibles</td>
</tr>
<tr>
<td>Capability to control or supervise through its strategic decisions to perform core functions as well as monitor activities</td>
<td>ICo works under direct supervision of foreign principal</td>
</tr>
<tr>
<td>Assumption of risks</td>
<td>ICo does not assume or has no economically significant realised risks</td>
</tr>
<tr>
<td>Ownership right (legal or economic) on outcome of research</td>
<td>ICo has no ownership right on outcome of research which shall also be evident from conduct of the parties</td>
</tr>
</tbody>
</table>
# Financial Transactions

<table>
<thead>
<tr>
<th>#</th>
<th>Eligible International Transaction</th>
<th>Proposed Safe Harbour</th>
</tr>
</thead>
</table>
| 1. | Loans provided by Indian companies to their wholly owned subsidiaries                              | The Interest rate is equal to or greater than the base rate of State Bank of India as on 30th June * of the relevant previous year plus:  
• 150 basis points in case the loan does not exceed INR 500 Million (USD 8.5 Million approx)  
• 300 basis points in case the loan exceeds INR 500 Million ((USD 8.5 Million approx)       |
| 2. | Provision of corporate guarantees by Indian companies to their wholly owned subsidiaries          | The commission or fee is **2.00%** or more per annum if the amount guaranteed is less than INR 1 Billion (USD 17 Million)  
The commission or fee is **1.75%** or more per annum if the amount guaranteed exceeds INR 1 Billion (USD 17 Million) *subject to the credit rating of the AE, done by an agency registered with the SEBI, is of the adequate to highest safety* |

• Base rate for FY 2012-13 – **10.00% p.a**  
• Base rate for FY 2013-14 – **9.70% p.a**  

Interest on inbound loans not covered  
**Other instruments such as debentures or bonds not specifically provided for**  
**Letter of comfort, implicit guarantee, performance guarantee etc. not covered**

Procedural aspects

File of corporate tax return. Example- on Nov 20, 2014

File Form 3CEFA. Example on Nov 29, 2014

AO to verify the application or refer to TPO on or before Jan 31, 2015

Commissioner to verify the application within 2 months from the end of the month in which the assessee has requested. On or before Jun 30, 2015, if the Assessee has appealed on April 14, 2015

Assessee can appeal to commissioner within 15 days from the end of the month in which the rejection is communicated to Assessee (Example, if March 29, 2015 is date of rejection, then by April 15, 2015 assessees has to appeal

TPO to verify the application within 2 months from the end of the month in which AO has referred. TPO has to verify on or before Mar 31, 2015, if the AO has sent for reference on Jan 29, 2015

AO will verify the application of safe harbour rate

Normal TP Assessment to continue

Accept

Reject

Refer to TPO

Accept

Refer to TPO

Refer to TPO
Procedural aspects

- Applicable for Financial Years 2012-13 and subsequent four years
- Documentation as per Section 92D of the Act and Accountant’s Report in Form 3CEB as per Section 92E of the Act to continue, despite adoption of Safe Harbour rules.
- The Safe Harbour rules are voluntary; in case the same are not opted for, the determination of arm’s length price to be made *without having regard to the Safe Harbour rules*.
- Time bound verification of eligibility and redressal forum. No penalties.
- The Assessing Officer shall declare the option exercised by the taxpayer to be invalid if taxpayer does not furnish adequate information or the requirement prescribed under the rules are not satisfied.
- No Safe Harbour for International transactions with no tax or low-tax jurisdictions (countries with maximum marginal tax rate less than 15%) and notified areas as provided under section 94A of the Act.
- A taxpayer opting for Safe Harbour rules would not be entitled to invoke Mutual Agreement Procedure.
## Safe harbour rules around the world

<table>
<thead>
<tr>
<th>Country</th>
<th>Transaction</th>
<th>Arms Length Safe Harbour</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Non-core services (i.e., where revenues / expenses from such services do not exceed 15% of the Company's total revenues / expenses)</td>
<td>Generally, a 7.5% mark-up on cost accepted</td>
</tr>
<tr>
<td>USA</td>
<td>Routine intra-group services</td>
<td>Routine services such as payroll compilation, processing workers compensation, posting payments etc., charged at cost (without mark-up) are considered at arm’s length</td>
</tr>
<tr>
<td>Japan</td>
<td>Low value intra-group services</td>
<td>Low value services such as accounting, tax or legal services, debt collection etc., charged at cost (without mark-up) are considered at arm’s length</td>
</tr>
<tr>
<td>Brazil</td>
<td>Import of goods, services and rights</td>
<td>20% gross profit for resale transactions, 60% gross profit for manufacturing</td>
</tr>
<tr>
<td></td>
<td>Exports</td>
<td>Export price to be higher or equal to 90% of the average price in Brazilian market for same or similar products sold to unrelated parties by the entity or other companies</td>
</tr>
<tr>
<td>Singapore</td>
<td>Routine intra-group services (where similar services are not provided to unrelated third parties)</td>
<td>5% mark-up on cost accepted</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Non-core services under a NZD 100,000 de minimis threshold. Non-core activity is defined as an activity that is not integral to profit earning or economically significant activities</td>
<td>7.5% mark-up on cost accepted</td>
</tr>
</tbody>
</table>
Points to Ponder

- High margins for becoming popular dispute resolution route; however given the low cost base (for many small/ mid sized companies), Safe Harbour may still be worth evaluating to address the administrative burdens and achieving certainty, particularly for captive IT & ITeS companies.

- While the Safe Harbour rules are optional, one will have to wait and watch the influence it has on the conduct and decision making of tax authorities.

- Impact in case of overlapping services to be evaluated before hand.

- These rules does not cover Domestic Transactions (i.e. Domestic Transfer Pricing).

- Neither the comparability adjustments are permitted, nor the benefit of tolerance band (+/- 3 % or 1%) is made available.

- Given the high margins proposed under Safe Harbour, MNCs may consider APAs, preferably bilateral.
Way forward
Way Forward

01 Location Savings

02 Thin Cap

03 BEPS
Location savings
Concept...

Location savings

- “Net cost savings” realized by a MNE usually as a result of relocating some of its operations from a “high cost” to a “low cost” location in order to obtain competitive advantage.

- Factors to be considered to derive net location savings:
  - Sources of cost savings: labour (wages, training, conditions, availability); material (cost, access, reliability); capital; technology; infrastructure and logistics; business environment (government subsidies; tax incentives)
  - Sources of dis-savings to be accounted for (to achieve net savings), such as transportation cost; quality control cost; capital costs
Concept...

Location Specific Advantages (LSAs)

- Location specific advantageous refers to access to factors of production and distribution that can be exploited to produce a particular product or service cheaper, better or with less risk, or to increase the ability of a company to sell more product or achieve a larger market share.

- Examples: Access and proximity to the growing local / regional market, large customer base with increased spending capacity, advanced infrastructure etc.

Location rent

- Incremental / super profits (if any) derived from the existence and exploitation of the LSAs.
Global Guidance

OECD View

Para 9.148 states that “Location savings can be derived by an MNE group that relocates some of its activities to a place where costs... are lower than in the location where the activities were initially performed, account being taken of the possible costs involved in the relocation .....”

Para 9.149 states that “Where significant location savings are derived further to a business restructuring, the question arises of whether and if so how the location savings should be shared among the parties. The response should obviously depend on what independent parties would have agreed in similar circumstances. The conditions that would be agreed between independent parties would normally depend on the functions, assets and risks of each party and on their respective bargaining powers.”

US IRS View

Treas. Reg. §1.482 -1(d)(4)(ii)(C ) “If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market.”
10.3.7.1. It is view of the Indian transfer pricing administration that the concept of “location savings” - which refer to cost savings in low cost jurisdiction like India – should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits. Location savings has a much broader meaning; it goes beyond the issue of relocating a business from a ‘high cost’ location to a ‘low cost’ location and relates to any cost advantage.

MNEs continuously search options to lower their costs in order to increase profits. India provides operational advantages to the MNEs such as labour or skill employee cost, raw materials cost, transaction costs, rent, training cost, infrastructure cost, tax incentive, etc.

• India provides following LSAs to Multinational Enterprises (MNE) in addition to location savings such as
  - highly specialized skilled manpower and knowledge;
  - access and proximity to growing local/regional market;
  - large customer base with increased spending capacity;
  - superior information network;
  - superior distribution network;
  - Incentives; and
  - market premium.
**GAP Ruling**

**Background**

- GAP India is engaged in facilitating the sourcing its apparel from India to its group companies.
- Main functions are - assistance in identification of vendors, assistance to vendors in procurement of apparel, inspection and quality control, and ensure timely delivery
- All technical and intellectual input provided by overseas entity
- Characterised as a limited risk provider earning a cost plus 15% mark up

**Revenue’s contentions**

- The TPO rejected the FAR analysis and characterised GAP as high risk service provider
- TPO ascertained that GAP ought to have earned a commission of 5%
- Revenue contended that Location Savings should be attributable to GAP India since GAP US saved huge costs by procuring such services from a low cost economy like India
GAP Ruling

Tax Payer’s contentions

• Tax payer was not involved in end customer pricing
• The intent of GAP US to source from a low cost economy like India was to pass on the benefit of saved costs to the ultimate customer

Tribunal Ruling

• Location savings to developing economy arise to the industry as a whole, there is nothing on record that assessee on standalone basis was sole beneficiary. We find merit in the argument of Mr. Mitra that the intent of sourcing from low cost countries for a manufacturer / retailer is to survive in stiff competition by providing a lower cost to its end-customers. Generally, the advantage of location savings is passed onto the end-customer via a competitive sales strategy. The arm’s length principle requires benchmarking to be done with comparables in the jurisdiction of tested party and the location savings, if any, would be reflected in the profitability earned by comparables which are used for benchmarking the international transactions. Thus in our view, no separate / additional allocation is called for on account of location savings.”
Thin Capitalisation
**Thin Capitalisation**

Thinly capitalised means - highly leveraged – i.e. capital is made up of higher proportion of debt than equity

Also known “Hidden Equity Capitalisation”

**Business motive** – to preserve mobility of funds, to ensure capital is not unnecessarily tied up in one country, etc

**Tax motive** - Interest is tax-deductible, dividend is not

Thin capitalisation, i.e., high debt/ equity ratio may be considered in various ways among multinational group companies such as
- Hybrid Financing*
- Abnormal or excessive interest on debt

**OECD paper on Thin Capitalisation**

“5. Perhaps the most important difference from the tax point of view is the fact that equity investment is designed to produce a return for the investor in the form of a distribution of taxable profits while the return on a loan investment is, for the payer, an expense which has to be met before the profits can be established.”

Debt/ equity ratio may be an indication of achieving tax advantage by use of large amount of debt

*Ex. Creditors may be able to convert their debt into a participation in the equity of the company, or interest may be closely dependent on the profits made by the entity
Convertible loans, participatory preference capital, FCCBs, etc
**Impact of High Debt/Equity ratio**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>D/E of 1:1</th>
<th>D/E of 4:1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>I</td>
<td>5,000</td>
</tr>
<tr>
<td>Debt (Interest @ 10%)</td>
<td>II</td>
<td>5,000</td>
</tr>
<tr>
<td>Profit before Interest and Tax</td>
<td>III</td>
<td>2,000</td>
</tr>
<tr>
<td>Less: Deduction of Interest</td>
<td>IV=II*10%</td>
<td>500</td>
</tr>
<tr>
<td>Profit Before Tax</td>
<td>V</td>
<td>1,500</td>
</tr>
<tr>
<td>Corporate Tax @ 30%</td>
<td>VI=V*30%</td>
<td>450</td>
</tr>
<tr>
<td>Profits After Tax</td>
<td>VII</td>
<td>1,050</td>
</tr>
<tr>
<td>Dividend Distribution Tax @ 15%</td>
<td>VIII=VII*15 %</td>
<td>160</td>
</tr>
<tr>
<td>Net Dividend distribution</td>
<td>IX</td>
<td>890</td>
</tr>
<tr>
<td>Total Taxes Paid</td>
<td>X = VIII+VI</td>
<td>610</td>
</tr>
<tr>
<td>Effective tax rate</td>
<td>XI = X/III</td>
<td>30.5%</td>
</tr>
</tbody>
</table>
**Thin Capitalisation Guidelines**

- Comprehensive Rules / Exchange control regulations or anti avoidance measures built in the domestic tax laws
- Thin capitalisation rules vary from country to country

**Fixed Debt-equity ratio**
- Maximum ratio prescribed
- If exceeds, then the interest pertaining to the excess debt is disallowed or reclassified as dividend
- Some countries have introduced “Safe Heaven Rules” - option to assessee company to show that its debt/equity ratio is an arm’s length ratio
- Different criteria for determining whether the lender and the borrower are related

**Arms length approach:**
- Unrelated lender Vs Related Lender - T&Cs - Comparison
- Excess interest - disallowed /dividend
- Debt may be reclassified as equity

**Besix Kier Dabhol, Sa vs DDIT – International Taxation – ITAT Mum**

- Project office operates out of inward remittances from Belgium
- Debt-Equity ratio – 248:1

**AO:** Interest payments cannot be allowed as deduction – thinly capitalised, debt is required to be recharacterised as equity capital

**CIT(A):** Upheld disallowance on the basis of violation of RBI guidelines, , India – Belgium DTAA - interest on monies lent by the head office to branches not allowable

**ITAT:** There are no limitations on deduction of interest expenses on borrowings, which can be attributed to thin capitalisation rules, in India

- Restrictions on who could lend a loan
- Debt /Equity ratio of 4:1
## Global Guidance

<table>
<thead>
<tr>
<th>Country</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Debt : Equity ➔ 3:1</td>
</tr>
<tr>
<td>Germany</td>
<td>Limit to deductibility of interest (30% of income)</td>
</tr>
<tr>
<td>Japan</td>
<td>Debt : Equity ➔ 3:1</td>
</tr>
<tr>
<td>China</td>
<td>Financial industry ➔ 5:1</td>
</tr>
<tr>
<td></td>
<td>Non-Financial industry ➔ 2:1</td>
</tr>
<tr>
<td>US</td>
<td>Debt : Equity ➔ 1.5:1</td>
</tr>
<tr>
<td>France</td>
<td>Debt:equity 1.5:1</td>
</tr>
</tbody>
</table>
BEPS
**BEPS Action Plan**

- **Action 1**: Address the tax challenges of the digital economy
- **Action 2**: Neutralise the effects of hybrid mismatch arrangements
- **Action 3**: Strengthen CFC rules
- **Action 4**: Limit base erosion via interest deductions and other financial payments
- **Action 5**: Counter harmful tax practices more effectively, taking into account transparency and substance
- **Action 6**: Prevent treaty abuse
- **Action 7**: Prevent the artificial avoidance of permanent establishment status
- **Action 8**: Consider transfer pricing for intangibles
- **Action 9**: Consider transfer pricing for risks and capital
- **Action 10**: Consider transfer pricing for other high-risk transactions
- **Action 11**: Establish methodologies to collect and analyse data on BEPS and actions addressing it
- **Action 12**: Require taxpayers to disclose their aggressive tax planning arrangements
- **Action 13**: Re-examine transfer pricing documentation
- **Action 14**: Making dispute resolutions more effective
- **Action 15**: Development of a multilateral instrument for amending bilateral treaties

**Action plan on Base Erosion and Profit Shifting (BEPS)**
BEPS Action Plan - 13 – TP Documentation

The OECD has prescribed a ‘three-tier’ documentation structure consisting of:

- **Master file** - provides an overview of the MNE group and business;
- **Local file** - provides a “zoomed-in” view of operations and transactions relevant to a particular jurisdiction; and
- **CbyC report** - provides aggregate, jurisdiction-wide information on the global allocation of income, taxes and indicators of economic activity.

### By Jurisdiction

1. Tax jurisdiction;
2. Revenues – To related party and to unrelated party;
3. Earnings before tax;
4. Income tax paid (on cash basis) and accrued;
5. Stated capital and accumulated earnings;
6. Number of employees;
7. Tangible assets (other than cash and cash equivalents)

### By Constituent Entity

1. Tax jurisdiction of organisation or incorporation if different from tax jurisdiction of residence;
2. Main business activity (options provided)
**BEPS Action Plan - 13 – Way forward**

**Process – Yet to be finalised**

- Maintained by the Parent and provided upon request to local authorities, or be submitted along with the local tax return / local file;

- Mechanism of sharing information with tax administrations in all relevant countries i.e. treaty information exchange provisions, coordinated technological platforms, etc.;

- Materiality level for reporting - whether all companies should prepare the CbyC report or a size threshold be prescribed such as only large companies should undertake such compliance

**Implementation Plan – Feb, 2015**

- India is a part of G20 countries and as a member of BEPS bureau, is actively and closely involved in the BEPS Action Plans.

- India TP documentation, largely in line with the list of information contained in the local file template.
Questions