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Tax controversy in Asia Pacific: Implications and takeaways (Part 2)

The Dbriefs Corporate Income Tax series

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Agenda

- Introduction
- Transfer pricing methods and evidence in light of Glencore case
- Recent transfer pricing disputes in Southeast Asia
- Recent transfer pricing audit trends and jurisprudence in India
- Panel session
- Questions and answers

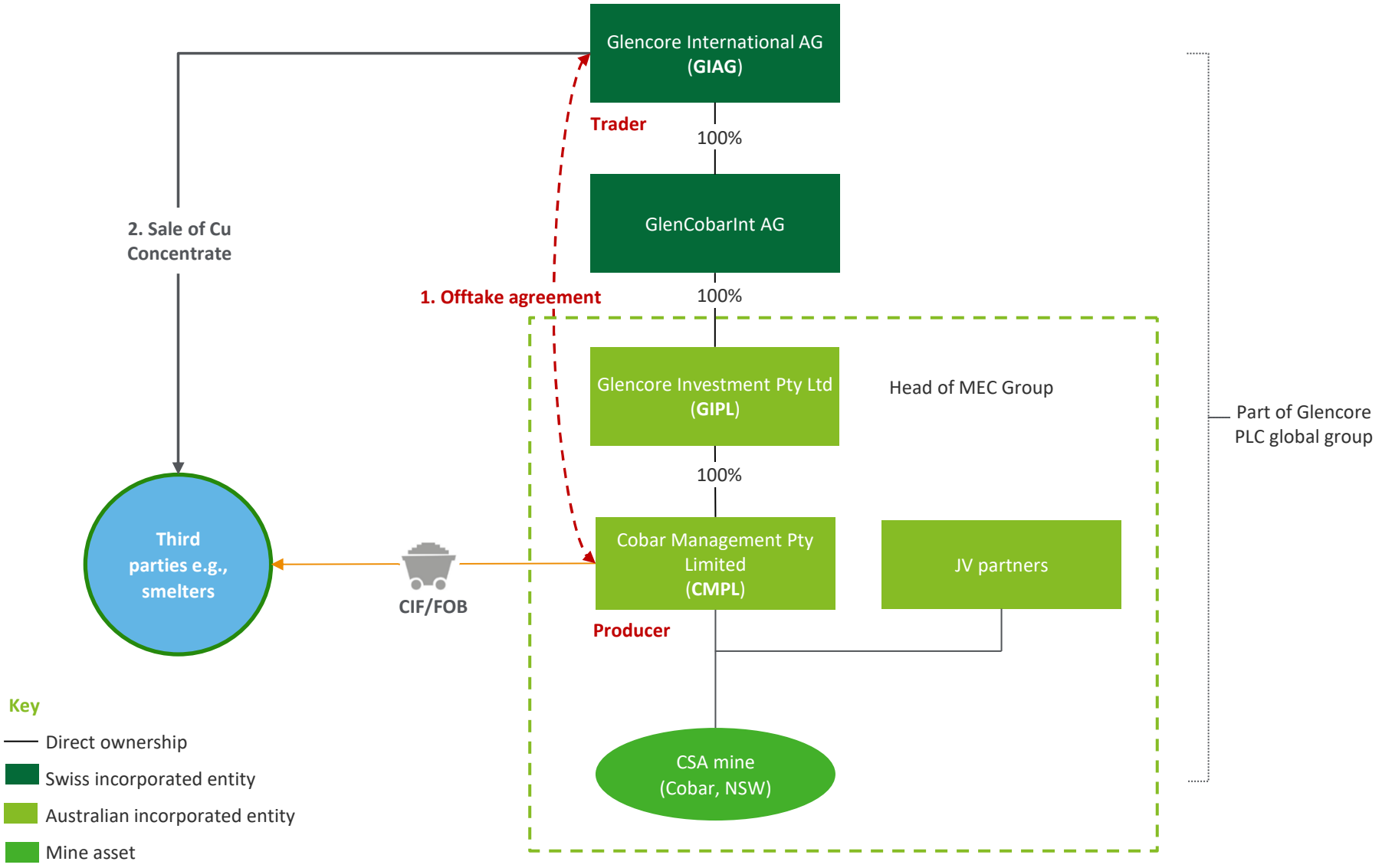
Polling question 1

What has been your recent experience with the tax office in relation to transfer pricing reviews or audits in Asia Pacific?

- Co-operative/voluntary
- Formal and involving use of statutory powers
- Adversarial and involving search and seizure powers
- A combination of the above
- Don’t know/not applicable

Transfer pricing methods and evidence in light of Glencore case

Facts – transaction and group structure



Summary

Commissioner of taxation versus Glencore investment Pty Ltd [2020] FCAFC 187

Interested parties	**Appellant**	Commissioner of taxation
	Respondent	Glencore investment Pty Ltd
Court, judgement dates	• The case was originally heard by a single judge in the Federal Court (Davies J), decided on 3 September 2019 • Appeal was heard by the Full Federal Court of Australia (Middleton, Steward, and Thawley JJ) , decided on 6 November 2020	
Income years	2007, 2008, and 2009 income years	
Relevant provisions	Division 13 of the 1936 Act and subdivision 815-A of the 1997 Act	
Intercompany transaction and relevant parties	• The case relates to an agreement for the sale and purchase of 100% offtake production of copper concentrate from the Australian mine to a related marketing entity • Australian producing entity: Cobar Management Pty Ltd (C.M.P.L.) • Swiss marketing entity: Glencore International A.G. (G.I.A.G.).	
Pricing	• Intercompany pricing in the arrangement followed industry standard terms using the London Metal Exchange (LME) pricing benchmark, and: – GIAG had the benefit of quotational period optionality (i.e., GIAG had some flexibility over which LME period would apply, including some past periods where the price was already known – i.e., back pricing) – TCRC deductions fixed at 23% of the LME copper price for 2007-2009 (i.e., price sharing) • Price supported by industry reports and comparable uncontrolled prices (CUPs) in the market	
History in brief	• The case was first heard in 2019, by a single-sitting judge of the Federal Court, where the Australian tax authorities unsuccessfully challenged the arrangement • The judgement was then appealed on 6 November 2020 under the appellate court, purporting that the – Terms under the arrangement were not arm's length and should be re-characterised; and – The pricing formula (consideration) was not arm's length • The taxpayer largely won on all grounds, but the appeal was successful in relation to one element of the pricing regarding freight • The concept of reconstruction and reliance on CUPs has extreme relevance in this case.	

Commissioner's views

In the full court, the commissioner took issue with the following

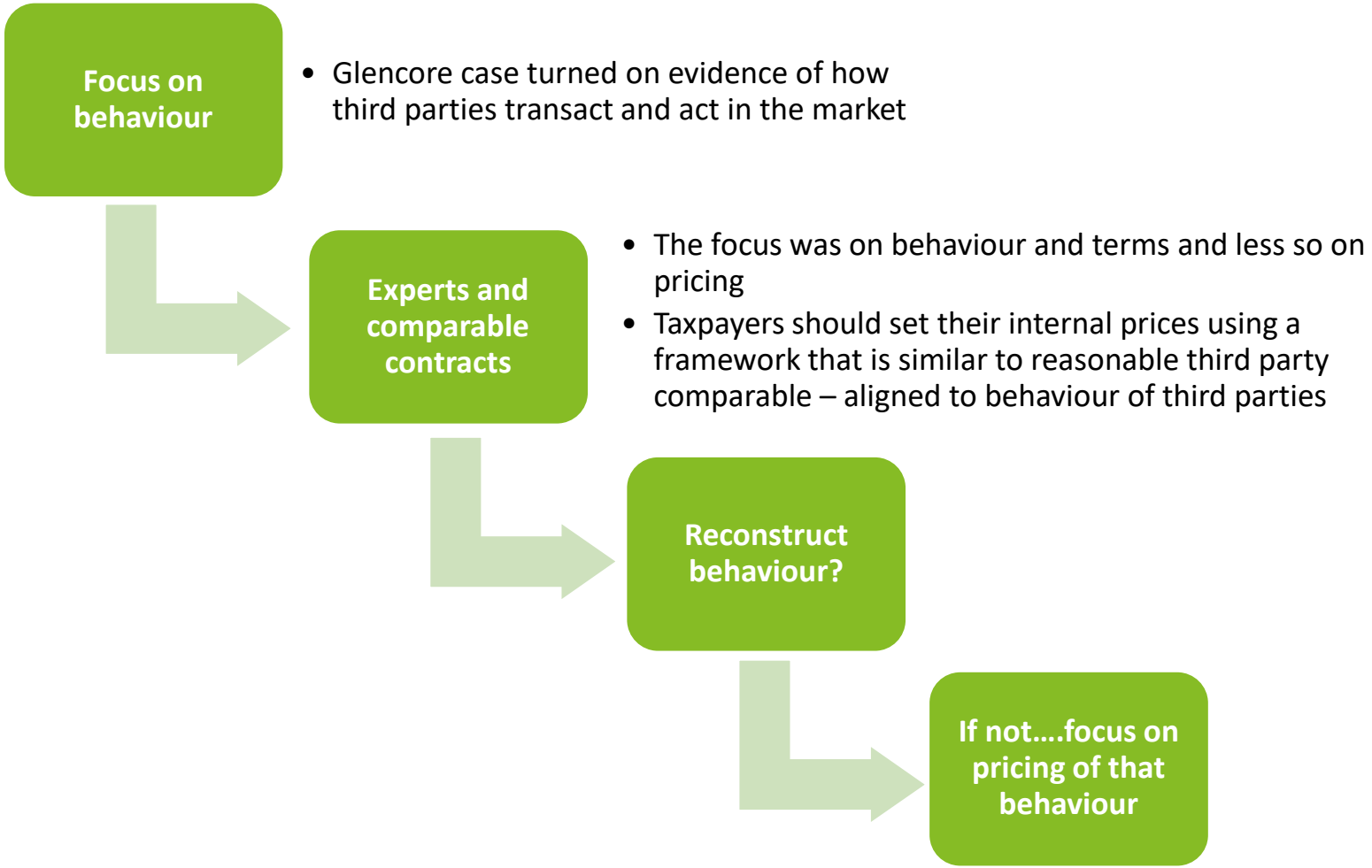
- The commissioner raised challenges on basis that "that there was no range of possible outcomes for this particular mine, but just one outcome, namely retention of the pre-existing terms as they were just before February 2007"
- Furthermore the commissioner argued
  - The arrangement left Australia taking a "bet" with no "quid pro quo" in terms of pricing for accepting less favourable terms (i.e., allowing GIAG to have greater QP optionality and fixing the TCRC deduction ratio to the LME price and fixing the freight terms)
  - The arrangement left Australia commercially worse off and an independent entity operating at arm's length would not have agreed to it
  - There was no positive evidence provided about either parties' attitudes to risk taking as at February 2007
  - This is not a reconstruction case; the commissioner can substitute a different pricing formulation or another term of the contract that directly affects price – probably couldn't have reconstructed the transaction per OECD guidelines

- **ATO seeks to reprice (but not reconstruct)**

Key focus of case

Evidence of behaviour not pricing

- Commissioner argument: third parties would not have entered into the amendment in February 2007
- Judges concluded: whether AL parties would have accepted the amendment was the wrong question – do not focus on whether the amendment was in the taxpayer's interests
- Right question: is there evidence of third parties behaving this way? Confirm behaviour post amendment is AL and then focus on pricing based on that behaviour



Decision of the court

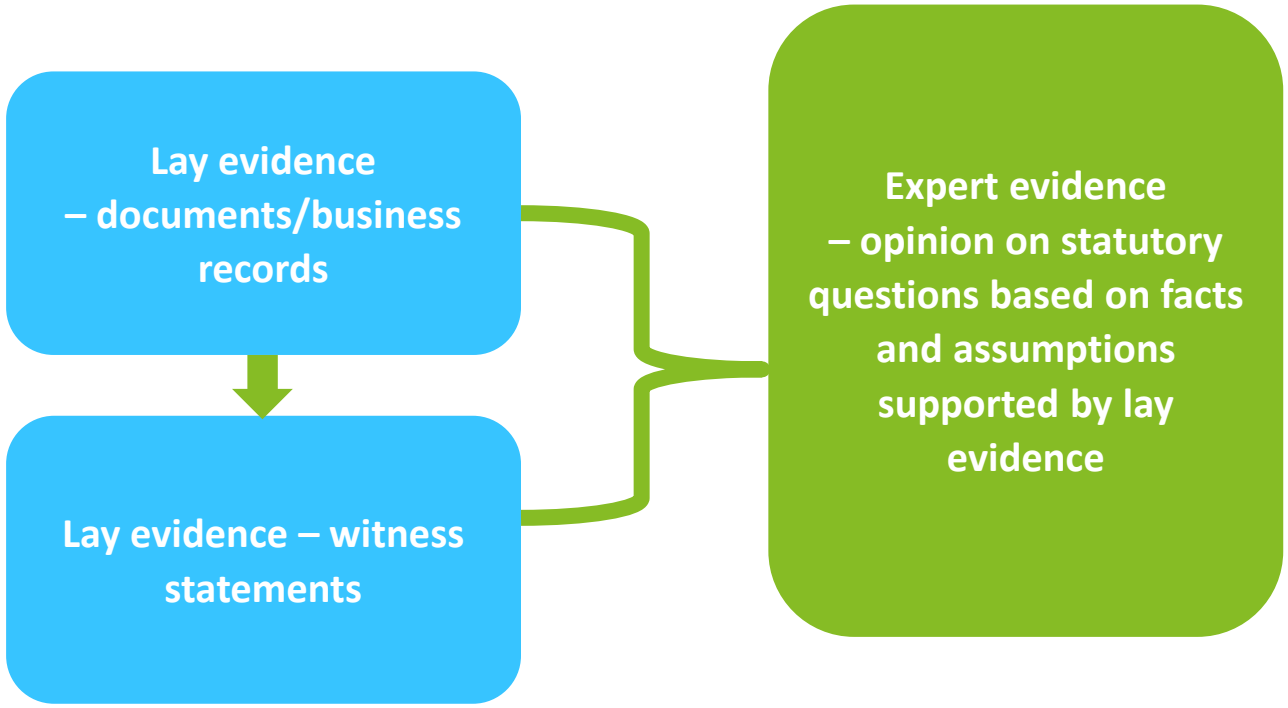
Comparable contracts

- In the first hearing the taxpayer had led evidence of numerous contracts between unrelated parties for the sale of copper concentrate. None was exactly the same as the CMPL/GIAG agreement and differed on volume, date and term, the stage in production, the role of financiers, and etc.
- Davies J did not make any adjustments therefore the contracts were not reliable as Comparable Uncontrolled Prices (CUPs)
- Middleton and Steward JJ described the submissions of the parties on this issue as reflecting "a degree of unnecessary energy about an issue which is perhaps not as nuanced or as sophisticated as the parties might have thought". They said
  - … many of the differences identified by the commissioner are relatively important. They diminish the probative value of the contracts said to be comparable. But they do not negate that value entirely. The contracts were valid "**reference points**" both for the purpose of considering the type of pricing formula chosen by C.M.P.L. and G.I.A.G. under the C.M.P.L. G.I.A.G. agreement, and also, in a more general sense, both the rate of price sharing and the detail of the quotation period optionality which was selected. The contracts were a **sounding board**. … Because of the differences identified by the commissioner, the contracts **cannot be determinative** of the application of Div. 13 or Subdiv. 815-A to the facts here

"The court should acknowledge, and take into account, the practical difficulties faced by both the taxpayer and the commissioner in finding evidence that grounds what is sufficiently reliable, or which demonstrates that something is insufficiently reliable. The answer is not always to be found in overly lengthy and complex expert reports. Common sense is required" [186]

The role of CUPs /reference points is still the gold standard of admissible evidence in TP court cases in the E&R sector

Evidence overview



- **At the outset**
  - Ideally structure transactions in a manner that reflects industry/standard practice

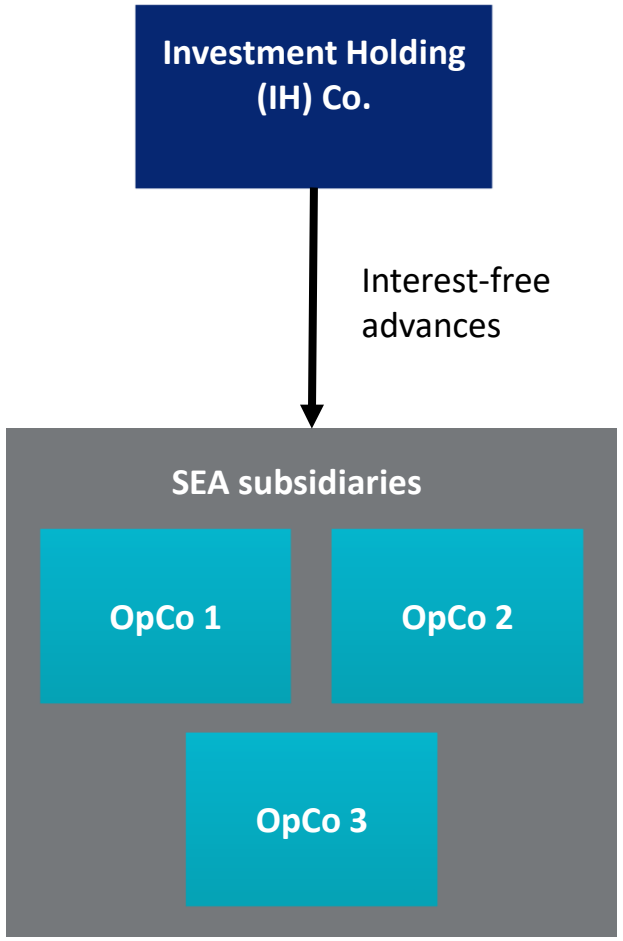
Warnings from the court on expert evidence

- The expert reports provided opinions on matters outside their specialist knowledge, and even without a foundation for the view expressed
- It is not the role of the expert to be an advocate for the party
- An expert should make it clear when a matter falls outside his or her expertise
- Unfounded or speculative reasoning may undermine or diminish the persuasiveness and cogency of the opinions
  - Uncertain that the expert had authored the report versus “had input into”
  - “Take care to comply with the code of conduct in expressing their views”

- **What steps can you take early to put yourselves in the best position to defend a transfer pricing position?**
- **Post Glencore taxpayers need to show that the terms of the transaction are not different to the terms that might reasonably be expected to be agreed between arm’s length parties – but this is a point now on appeal**
  - **This can be done through a combination of lay and expert evidence**

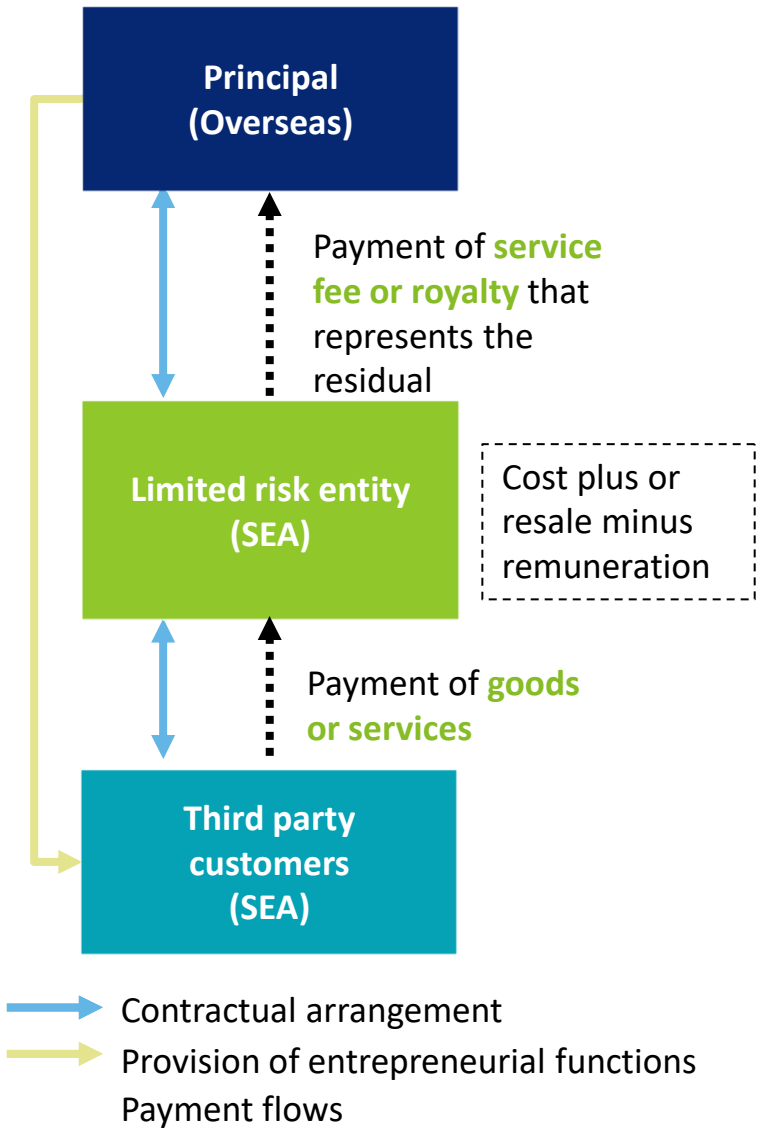
Recent transfer pricing disputes in Southeast Asia

Re-characterization of interest-free advances as loans



- **Issue**
  - Tax office re-characterized the interest-free advances as **loans** and **imputed interest** was applied on the deemed loans
    - Interest is non-deductible and subject to WHT
- **Defense**
  - Delineated the nature of advances and argued that the advances partake the nature of **equity**
- **Theme**
  - Delineating the arrangement and demonstrating that the transaction is equity in **substance**
    - No maturity and obligation to re-pay
    - Intention of the parties to assist the growth of the affiliate and recoup investment through dividends
    - Conversion of the advance into equity as per shareholder agreement
    - Functions and risks borne by the party in relation to the advance
  - Once deemed as equity, it helps in managing debt-to-equity ratios required in SEA

Extraction of residual in principal model



- **Issue**
  - Maintaining a routine return while extracting the full residual – balancing act
  - Whether the payment for residual should be included in the cost base of the LRE for purposes of determining the routine return
- **Defense**
  - Establish substance of the principal
    - Prove **functions, risks, and assets** (FRA) of the principal and LRE – to show that LRE does not have capability to perform functions of principal
    - Prove principal has sufficient resources and employees that will allow it to perform functions which entitle it to residual compensation
  - Demonstrate that LRE did not add value to the functions performed by principal
- **Theme**
  - Establishing substance
    - LREs were established to meet local regulatory requirements
    - Third parties are willing to pay for the brand and the services even without LRE's involvement
  - No added value contributed by LRE to principal's functions

Recent transfer pricing audit trends and jurisprudence in India

Preference of CUP over other methods

Indian jurisprudence

1

- Revenue authorities often reject CUP analysis citing **lack of comparability** and seek to apply TNMM

2

- Revenue authorities often reject TNMM analysis citing **availability of CUP**, brushing aside **difference in comparability** highlighted by taxpayers

3

- Revenue authorities seek to apply CUP, basis information obtained through **customs authorities** and quotes from vendors, without adequate data points to consider quality comparability

4

- Royalty, Intra-group services etc. ipso facto **cannot be aggregated** with other transactions, ALP ought to be benchmarked using CUP method

1. iMedX Information Services (P.) Ltd. V. ITO [2017] 79 taxmann.com 20 (Hyderabad - Trib.)
2. PCIT versus Amphenol Interconnect India (P.) Ltd. [2019] 410 ITR 373 (Bombay)
3. Serdia Pharmaceuticals (India) (P.) Ltd. v. CIT [2013] 37 taxmann.com 198 (Mumbai - Trib.)
4. JCB India Ltd. V. DCIT [2016] 69 taxmann.com 383 (Delhi - Trib.)

Whether AMP expenses incurred by Indian subsidiaries create marketing intangibles?

Persistent issue in transfer pricing audits

Issue	Maruti Suzuki ruling (2015 Delhi HC)	Sony Ericsson ruling (2015 Delhi HC)	LG special bench ruling (2013 Delhi ITAT special bench)
Whether an international transaction	No	Yes	Yes
Whether bright line test is a valid method	No	No	Yes
Economic ownership acceptable or not	Yes	Yes	No
Aggregation of transactions	Yes	Yes	No
Transfer pricing approach	• If payment of royalty and import of raw materials tested separately, no additional benefit flowing by way of AMP expense	• AMP function is closely linked to and a part of overall distribution activity, can be aggregated for transfer pricing analysis	• Purchase of goods and AMP expense are separate transaction and cannot be aggregated

Whether AMP expenses incurred by Indian subsidiaries create marketing intangibles?

Persistent issue in transfer pricing audits (cont'd)

AMP issues pending at SC

Maruti Suzuki India Ltd.

- **Manufacturing companies**
- **Revenue challenged HC decision that it is not an international transaction**

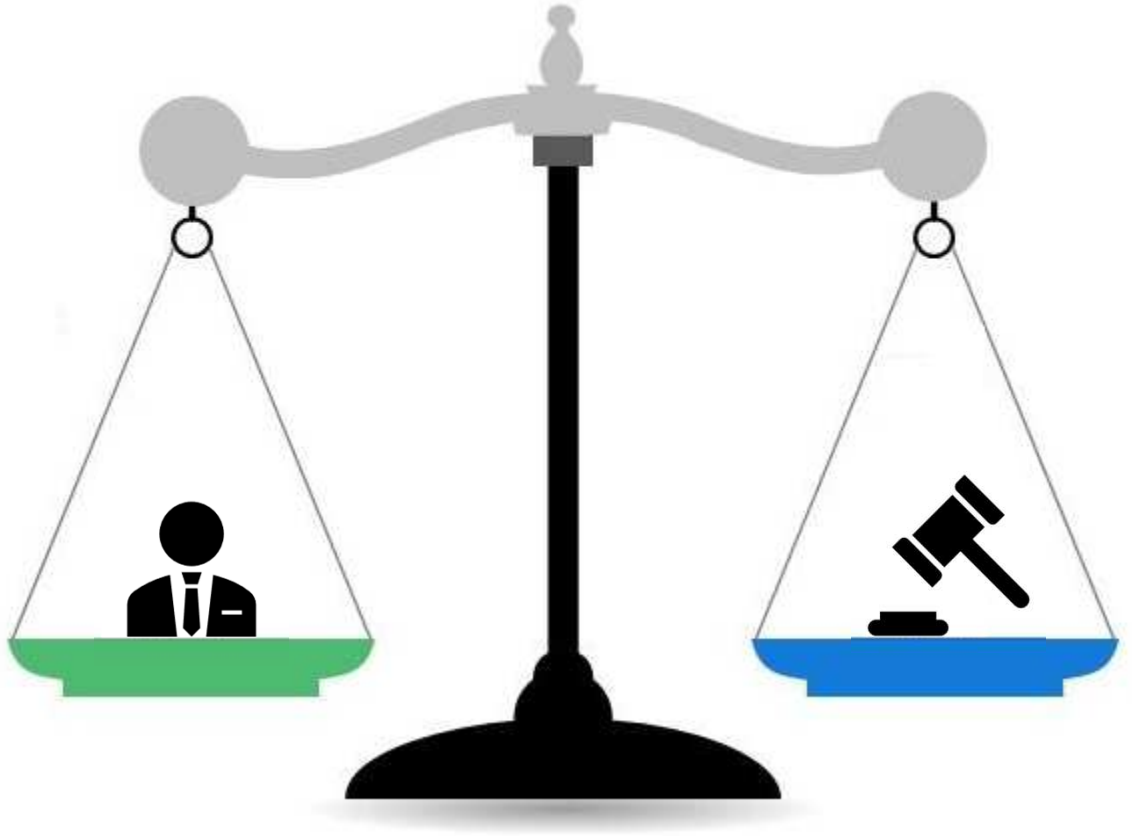
Sony Ericsson mobile communications India (P.) Ltd.

- **Distribution companies**
- **The appellant has filed SLP inter-alia challenging existence of international transaction**

Payment for intra-group services

Persistent issue in transfer pricing audits

- **Revenue authorities focus areas**
  - **Rendition of services** – whether services were received from related party
  - **Quantification of services** – nature of services including quantum of services
  - **Need** – whether services were provided in order to meet specific need of recipient
  - **Benefits** – economic and commercial benefits derived by recipient
  - **ALP principle** – whether in comparable circumstances an independent enterprise would be willing to pay a price for such services



- **Principle emerging from judicial precedents**
  - Rendition of services needs to be demonstrated[1]
  - In case of retainer arrangements, taxpayer need not prove rendition of every service in the agreement[2]
  - Commercial prudence (need and benefit) cannot be questioned by the department[3]
  - Transfer pricing addition made without following any one of the prescribed methods is unsustainable[4]
  - TNMM is an acceptable method; appropriate allocation keys are an acceptable method[5]

1. Deloitte Consulting India Pvt. Ltd. v. ACIT [2014] 46 taxmann.com 89 (Mumbai); 2. UT Worldwide India Pvt. Ltd. v. DCIT [2019] 103 taxmann.com 422 (Mumbai) ; 3. CIT v. EKL Applicances Ltd. [2012] 20 taxmann.com 509 (Delhi) ; 4. CIT v. Lever India Exports Ltd. [2017] 78 taxmann.com 88 (Bombay) ; 5. Knorr Bremse India Pvt. Ltd. v. ACIT [2017] 77 taxmann.com 101 (Delhi)

Novel issues in focus of Indian revenue authorities

01 **Free of cost goods – interplay between TP and GST**

02 **Revenue authorities moving away from using bank guarantee rates to using hull white model**

03 **Non-resident entities also having to comply with documentation requirements failing which exposure to penalty implications**

04 **Increasing trend by revenue authorities to use approaches like revenue split, quotations, global formulatory under the umbrella of “other method”**

05 **Imminent ruling from the supreme court resolving divergent high court views on whether transfer pricing appeals involve any question of law or they are purely factual issues**

Panel session

Question and answers

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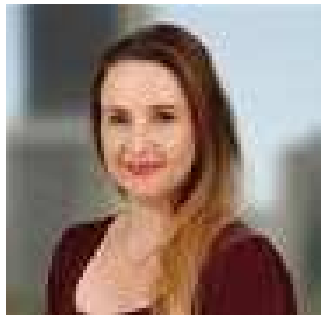

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