

Robust Transfer Pricing Documentation: Can Recharacterization Be Avoided?

There is an increased focus on the commercial rationality of an international transaction which needs the support of a robust transfer pricing document, particularly in these times of low profits during COVID-19.

With the ever-growing emphasis on 'substance over form' and 'commercial rationality' globally, there is an increased focus on analysis of functions performed, assets utilised, and risk assumed.

The principle of substance over form typically allows tax authorities to disregard the written contractual terms between parties and consider the actual substance to recharacterize/disregard a transaction. In the light of this, it is imperative to support the international transactions with well-drafted transfer pricing documentation, agreements, and transfer pricing policies. Read on...



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Transfer Pricing rules were enacted in the Indian Income Tax Act in 2001. Over the years there have been substantial developments in the jurisprudence of transfer pricing. With thousands of court rulings on varied issues, transfer pricing legislature has truly evolved.

With the Base Erosion and Profit Shifting ("BEPS") guidelines, evolution of e-commerce and globalisation of companies the significance of transfer pricing cannot be stressed enough.

The article discusses the elementary issue of preparing

a robust transfer pricing documentation. With the ever-growing emphasis on 'substance over form' and 'commercial rationality' globally, there is an increased focus on the functional asset and risk analysis. Transfer Pricing as a subject is not merely a mechanical exercise, it involves knowledge of economics, business, and industry in which both the company and its comparables operate.

Background : Transfer pricing (TP) documentation consists of analysis of functions performed, assets utilised, and risks assumed (FAR analysis) as well as an economic analysis.





Every transfer pricing report is unique to each international transaction. The comparables must be similar in all material aspects and be compared based on products/services, characteristics, functions undertaken, assets used, and risks assumed.

The functional asset and risk analysis documents the actual conduct of the related parties in an international transaction and provides insight into the functions and risks they undertake. On the other hand, economic analysis aims to establish the arm's length nature of an international transaction. Therefore, before commencing the economic analysis, one first needs to do a functional and risk analysis of the tested party and thereafter identify comparables that closely match the tested party's functional profile.

The Indian TP law and the Institute of Chartered Accountants of India (ICAI) guidance note on transfer pricing provide that the documentation on economic analysis shall provide for the details of the “*data used and data rejected with reasons thereof. Also, different*

companies follow different accounting policies. There may be differences in terms of sale, etc. These variations call for certain adjustments in the financials to make the data comparable. The reasons and the adjustments so made should also be recorded”.

Every transfer pricing report is unique to each international transaction. The comparables must be similar in all material aspects and be compared based on products/services, characteristics, functions undertaken, assets used, and risks assumed. Merely because a certain comparable has been upheld for its exclusion/inclusion by various decisions should **not necessarily** lead to exclusion/inclusion in other cases as well. Therefore, exclusion/inclusion of any comparable must strictly be based on **functional, asset and risk (FAR) analysis**, which is in accordance with Rule 10 B (2) of the Income Tax Rules.

Various Court rulings reinforce the importance of robust FAR analysis in the transfer pricing documentation. There have been multiple rulings across the globe that re-emphasize the need to document the actual conduct of the parties¹.

Increased Focus on ‘Commercial Rationality’ of an International Transaction

The Indian Tax Tribunals and courts have increased

focus on the substance of the transaction and analysing the parties' conduct before delivering a judgment. The Bangalore Income Tax Appellate Tribunals (“ITAT”) in the case of Google India noted that characterisation of functions cannot be based on merely terms of contract or description of the services given by the assessee-company. It must be determined with regard to the actual conduct of the parties².

To justify the actual functions a well-maintained TP, documentation is a must. In cases where there is inaccurate or lack of documentation, it can even give rise to complete disregard or recharacterization of a transaction.

On the issue of recharacterization in one of the ITAT rulings it was held, “*that tax authorities can recharacterize the transaction in accordance with its substance only when 1. the economic substance of the transaction differs from its form and 2. the form and substance are the same but the arrangement, in totality, differs from that which would have been adopted by the independent enterprise behaving in a commercially rational manner*”³.

The principle of ‘substance over form’ typically allows tax authorities to disregard the written contractual terms between parties and

1. *Netherlands vs Zinc Smelter B.V., March 2020, Court of Appeal; -Denmark vs. Software A/S, September 2020, Tax Court; -France vs. Piaggio, July 2020, Administrative Court of Appeal;*

2. *Google India Private Limited [TS-335-ITAT-2018(Bang)-TP]*

3. *Roche Products (India) Private Limited [TS-154-ITAT-2016(Mum)-TP]*

consider the actual substance to recharacterize/disregard a transaction. The principle may seem relevant in cases where tax authorities are doubtful as to whether the legal form of transaction varies from its actual substance. The issue has been gaining popularity in the recent years given the recommendations arising from the BEPS project of the OECD.

While the intercompany agreements are the first step to understand the legal form of a transaction, the parties' actual conduct should reasonably reflect in the functional analysis (analysis of functions performed, risk undertaken, and assets employed). Any inconsistency between the two often leads to disputes in the Indian context. The discrepancies may at times be only optical yet can trigger the tax authorities to ignore the contractual arrangement and recharacterize the transaction keeping in view the substance,



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or the conduct as may reflect based on FAR analysis and other supporting facts. Over the last many years, various Courts and ITAT in India and worldwide have examined the issue of recharacterisation in the context of transfer pricing. Some of these cases are summarized below.

Indian Case Laws

In the case of **EKL Appliances Ltd** [TS-206-HC-2012(DEL)-TP], the Delhi High Court referring to the 2010 TP OECD guidelines, has stated that *“the significance of the guidelines mentioned above lies in the fact that they recognise that barring exceptional cases, the tax administration should not disregard the actual transaction or substitute other transactions for them and the examination of a controlled transaction should ordinarily be based on the transaction as it has been actually undertaken and structured by the associated enterprises. It is of further significance that the guidelines discourage restructuring of legitimate business transactions. As provided in the OECD guidelines, he is expected to examine the international transaction as he actually finds the same and then make suitable adjustments but a wholesale disallowance of the expenditure, particularly on the grounds which have been given by the TPO is not contemplated or authorised”*.

Further, in cases of **Itochu India Private Ltd** [TS-428-HC-2019(DEL)-TP] and

Aegis Limited [TS-65-HC-2019(BOM)-TP] the High Courts have upheld the ITAT's view that TPO had wrongly recharacterized the international transactions and opined that that nothing was brought on record by Revenue that the transaction was a sham. However, in **McKinsey Knowledge Centre India Pvt Ltd** [TS-49-SC-2019-TP] the Supreme Court (“SC”) dismissed McKinsey India's SLP against HC-order. The HC had upheld ITAT's characterization of research and information services rendered by McKinsey India to its AE as high-end knowledge-based research services (KPO), noting that the services rendered by assessee were “specialized and require specific skill-based analysis and research that is beyond the more rudimentary nature of services rendered by a BPO”, HC had concluded that “it would be incorrect to slot the services provided by the Assessee into that of a BPO, when it is more akin to a KPO”.

In **Sony Pictures Networks India Private Limited** (Successor of MSM Discovery Private Limited) [TS-508-ITAT-2020(Mum)-TP] issue related to recharacterization of distribution fee paid by assessee (distributor of channels) to its AE as ‘Royalty’. Relying on assessee's submission that it only acted as an intermediary between Broadcaster and the ultimate customer who views the channel and neither held any right in the content broadcasted over the channel nor any right

to make any changes thereto, ITAT had held that distribution fee paid by assessee to its AE is not 'Royalty'.

International Case laws

Canada vs Cameco Corp., February 2021, Supreme Court, Case No 39368-

This was the first-ever case where recharacterisation provision under the Canadian transfer pricing rule was interpreted. The Federal Court of Canada ("FCA") has provided textual, contextual and purposive interpretation of recharacterisation which may have a high precedential value not only from a Canadian transfer pricing litigation perspective but may also be considered while interpreting principles of recharacterisation across jurisdictions, subject to differences in the text of transfer pricing provisions of respective jurisdictions dealing with recharacterisation. In the case of **Australia vs Glencore, May 2021, High Court, Case No [2021] HCATrans 098** it was held that the transaction should be restructured only if the economic substance of the transaction differs from its form or even though the form and substance of the transaction are the same, the arrangements made in relation to the transaction differ significantly from those which would have been adopted by independent enterprises behaving in a commercially rational manner.

In the case of 'A' Group Finland, Supreme Administrative Court (SAC)

rejected recharacterization of intra-group financial restructuring sans tax avoidance allegation. Similar to the EKL case of Delhi HC (*supra*), the SAC referred to OECD guidelines, 2010 which observes that administration should not disregard actual transactions or replace them with other transactions unless in exceptional circumstances. The SAC also observed that the tax authorities have not alleged in the case that A Oyj and A Finance NV have reorganized the Group's financial operations for the purpose of tax avoidance, thus the adjustment made has no valid grounds. The **Zambian Court in Nestle Zambia Trading Limited** upheld recharacterization by the tax authority as Limited Risk Distributor. The same was upheld based on the analysis of the actual functions performed by Nestle Zambia.

As can be seen from the above rulings, while non-recognition in transfer pricing is a common approach adopted by the first level tax authorities across the world, complete disregard of a transaction is not very common. In the Indian context, non-recognition is discouraged by the ITATs and the HCs if done without any prudent reasoning. However, General Anti Avoidance Rules (GAAR) empowers the revenue to deal effectively with and guard against schemes that are designed for tax avoidance. It gives them extensive powers to disregard or recharacterize transactions and re-determine

the resultant tax consequences if the assessee fails to prove the commercial rationality of the arrangement and that tax avoidance was not the main purpose.

BEPS Action 13

In 2016, the BEPS Action 13 was adopted by the Indian Tax law and included the preparation of Master File and Country by Country (CBC) reporting in the transfer pricing compliance requirements. If applicable, preparation of Master file and CBC is quite an extensive exercise, requiring detailed disclosures by the companies.

Further, BEPS Action 8 provides a framework for identifying the members of the multinational Group that contribute in the creation of valuable intangibles and determining the 'arm's length' remuneration based on their contribution in the entire value chain. Final report on OECD's BEPS Action 8-10 released in October 2015, has inter alia provided guidance on applying 'arm's length principle on intangibles, focusing on economic substance, risks/control and corresponding rewards than merely focusing on the **legal ownership**. It provides guidelines that the entity which creates the value should be entitled to commensurate returns. Therefore, it has become important to determine and establish which entity performs the Development, Enhancement, Maintenance, Protection and Exploitation ("DEMPE") functions. The



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rewards earned by an entity will change depending on this analysis. This further brought to light the importance of a detailed documentation.

In line with the provisions of BEPS action 8-10 as well as OECD TP Guidelines 2017 on business restructuring and non-recognition, increasing emphasis is being placed by various judicial decisions⁴ globally on the economic substance and commercial rationality of the transaction.

Much before the BEPS project of the OECD on DEMPE guidelines, the Central Board of Direct Taxes had vide Circular 6/2013 given a preview into the DEMPE functions and had laid importance on the parties' actual functions and actual conduct over the contractual arrangements. This was a revolutionary change in the way the international transactions would be viewed going forward.

Group Transfer Pricing Policy

While it is essential to undertake the annual TP compliances, it is also imperative to document the group Transfer Pricing Policy, which highlights the pricing policy and the flow of the international transactions between the various entities of a multinational group. Hence, it is important to have a robust transfer pricing policy which, inter alia, lists the group structure; the functions undertaken by each entity globally; the IPs owned and the pricing for inter-group transactions.

It is also advisable that periodic internal transfer pricing reviews be undertaken to ensure that the TP policies are adhered to. Let's take a simple example to emphasise this further. The TP policy may say that the factory should charge cost plus 5% for the goods produced and transferred to its group company for further sale. However, it would become pertinent to undertake regular TP reviews to assess whether the factory has considered the costs as have been defined in the TP policy or not. This is because there might be a disconnect between the documents and the actual practices which need to be corrected.

Impact of Covid-19

COVID-19 has impacted businesses and governments

across the world. Enterprises are transitioning into digital integration. The biggest challenge is to manage profitability and the disrupted supply chains. During the COVID-19 crisis, we would expect companies to record results that differ significantly from normal levels and are also likely to incur operating losses. While tax authorities appreciate that losses can be incurred in independent situations due to unfavourable economic conditions or other legitimate business factors, it remains to be seen how these factors can be identified and quantified for transfer pricing purposes.

From a benchmarking perspective, the search for comparables may entail inherent challenges particularly for FY 2020-21. At the time of preparing contemporaneous



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⁴ *Commissioner of Taxation v Glencore Investment Pty Ltd [2020]*;
Her Majesty The Queen Vs Cameco Corporation (2020 FCA 112);

documentation, the availability of data may practically get limited to two financial years (FY 2018-19 and FY 2019-20), both of which are not impacted by any COVID-19 downturn. Since impact on profitability will be visible for taxpayers and comparables in FY 2020-21 margins, taxpayers would have to take steps to mitigate potential risk appropriately. It would be imperative for the tax authorities to undertake audit considering the current economic conditions. The detailed TP documentation and economic analysis will have to factor in the changes as per each industry right up to the company level. Within the same industry, certain companies would be earning profits while others would be closing operations.

Concluding Remarks

I would like to conclude by saying that transfer pricing as a practise has gradually evolved over the last couple of decades. There is an increased focus on whether the actual transaction possesses the 'commercial rationality' of arrangements that would be agreed between unrelated parties under comparable economic circumstances. The same is in line with para 1.122 of the OECD Transfer Pricing Guidelines 2017.

From an Indian as well as a global perspective, there has been an increased focus on the substance and the commercial rationale of a transaction. Many corporates have undertaken restructuring of their businesses considering the

ongoing COVID-19 pandemic. From a business perspective, restructuring is considered a favourable business decision to help companies grow or sustain. Tax saving may not necessarily be the only driving force behind a restructuring; however, it attracts extra scrutiny from the tax authorities worldwide under transfer pricing tax laws. Therefore, robust TP documentation, well-drafted intra-group agreements, and a commercial rationale driving the transformation are essential in reducing the risk of potential tax audits and consequent adjustments. The functional analysis forms the basis of decision-making for the courts and helps them to assess the facts. Hence, it becomes important to document our transactions and their functional and economic analysis properly. ■■■

