TRANSFER PRICING ISSUES IN MEDIA & ENTERTAINMENT

Transfer Pricing Regulations were introduced in India by Finance Act 2001 by the government accepting the recommendations of Raj Narain Committee. Earlier Finance Act 1968 introduced Section 40A(2) which provided for a disallowance of the expenditure/payment made to related parties which is excessive or unreasonable with regard to the fair market value of the goods, services & facilities, however the said section didn't provided the computation & compliance mechanism thereon, also only the payments were covered under the ambit of the said section. Therefore to remove the limitations of the Section 40A(2) and to bring additional but specific provisions the Transfer Pricing Regulations has been enacted in the Indian Income Tax Act to monitor the increasing cross-border transactions between Indian & overseas related parties which was increased significantly after the liberalization of the Indian Economy since 1992.

Chapter X in the Income Tax Act covering the 'Special Provisions Relating to Avoidance of Tax' such as Section 92A to 92F which prescribes the Transfer Pricing regulations in India. These regulations are applicable to all the transactions which have a bearing on profits, income, losses or assets of the enterprise. From its inception in Financial year 2001-02, the Indian transfer pricing regulations has been evolving at a good pace due to approach adopted by the Indian Tax consultants and revenue authorities which has bought considerable clarity to the subject, however due to gigantic volume of this subject there are still many more issues on which there is no clarity till date.

This article is aimed at sharing my views & experiences with respect to the Transfer Pricing scenario in 'Media & Entertainment Industry' and some vital issues of this sector which needs the attention of the tax experts and revenue authorities.

Q. 1 WHY THE TRANSFER PRICING STUDY IS NECESSARY FOR INDIAN MEDIA & ENTERTAINMENT (M & E) INDUSTRY?

It is rightly said by the Tax Experts that the transfer pricing is about putting business first, if you can understand the business well then it's the half battle won. Therefore the transfer pricing analysis should always start with precise business study followed by applying the tax provisions, infact this should be the case with all the tax advisory assignments.

Let us have the brief overview of the M & E sector in India, this sector primarily comprised of Television contributing about 44% of the total revenue of the sector, followed by Print Media, Filmed Entertainment, Music, Radio and others contributing 29%, 19%, 1.50%, 1.25% & 5.50% respectively. In 2007, the total revenue from M & E was INR 513 billion and with a CAGR of 19% this industry is certainly geared for great prospects. This significant growth is mainly due to Industry friendly government policy,

increasing per capita spending on the entertainment, professional approach in the industry etc. has lured lot of big corporate houses and investors both from India as well as overseas to this Sector. There is lot of happening on this counter since past few years in terms of investment both inbound & outbound, few noticeable example are Times of India's partnership with Reuters and BBC, CNBC joining hands with TV 18, CNN coming together with IBN, Sony & Star establishing their firm presence in India, ADAG's Group's Big Entertainment going global and entering into co-production agreements with Steven Spielberg, Tom Hanks, Brad Pitt, Vijay Amritraj etc, Walt Disney investing in India with Yashraj Films, these are only few name as list is quite big.

All these happenings have increased the traffic of cross-border transactions significantly in the M & E sector and hence transfer pricing became one of the top priority for this sector.

Q. 2 WHAT ARE THE MAJOR TYPES OF CROSS-BORDER TRANSACTIONS ENTERED IN THE INDIAN M & E INDUSTRY?

The Key cross-border transactions executed in the M & E sector are as follows;

- Overseas Film Distribution,
- Setting up of Company in India or Overseas for business support, marketing etc.,
- Availing services of the professionals employed by the overseas counterpart,
- Financing the Overseas Subsidiary,
- Reimbursement of Expenses,
- Use of loss making company as comparables in the benchmarking study

The transfer pricing implications on the above transactions has been explained hereunder in detail with the case study.

Q. 3 TRANSFER PRICING IMPLICATIONS ON INDIAN DISTRIBUTOR DISTRIBUTING ITS FILMS OVERSEAS THROUGH ITS OVERSEAS SUBSIDIARY?

<u>CASE STUDY</u>

ABC Ltd has acquired the overseas rights of a Hindi Film from a producer. ABC has subsidiaries in USA, UK & South Africa through which it distributes its films overseas and in rest of the world it has third party agents. The terms of the arrangement of overseas distribution with various entities are as follows;

Country	***Terms of Film Distribution***	***Terms regarding the advertisement and other related expenses***

USA	No Minimum Guarantee & 10% Commission on net revenues[1]	Reimbursed on actuals without any markup
UK	No Minimum Guarantee & 10% Commission on net revenues[1]	Reimbursed on actuals without any markup
South Africa	No Minimum Guarantee & 10% Commission on net revenues[1]	Reimbursed on actuals without any markup
UAE	No Minimum Guarantee & 5% Commission on Gross revenues	Reimbursed on actuals without any markup
Nepal	No Minimum Guarantee & 15% Commission on net revenues[1]	Reimbursed on actuals without any markup
Malaysia	Certain Minimum Guarantee & 30% Commission	Reimbursed on actuals without any markup
Germany	No Minimum Guarantee & 5% Commission on net revenues[1]	Reimbursed on actuals without any markup
Russia	No Minimum Guarantee & 5% Commission on net revenues[1]	Reimbursed on actuals without any markup
France	Outright Purchase	Not Applicable
Canada	Outright Purchase	Not Applicable
Australia	Outright Purchase	Not Applicable

Let us start the Transfer Pricing analysis,

STEP 1 – BUSINESS STUDY

As mentioned above the 'Film Distribution business' is mainly carried on in 3 business models which are explained hereunder in brief;

a. License on Outright Basis

License of exhibition granted on outright basis for a specific period authorizes the distributor to release the picture in the contracted territory and retain with itself all the realizations of the film, irrespective of its fate. The producer is not obliged to give any compensation in case of any failure of the film or entitle for any share from the income if the film succeeds at the box office during the contracted period.

b. License on Minimum Guarantee Basis

In respect of the license agreement on minimum guarantee basis, the distributor is entitle to release and exhibit the film in the contracted territory by paying some specific amount to the producer/main distributor, which is called 'Minimum

[1] *Net revenues refer to all income / realizations from the distribution, exhibition of the said film by way of exploitation of rights being the total box office receipts less taxes, cost of prints & theatre owner share of the box office receipts from the territory.*

Guarantee'. After the release of the film in the first instance, it recover its investments i.e. minimum guarantee amount from the realizations of the film and then also recovers all the expenses incurred towards the film and further in the mutually agreed ratio, a share which generally ranges from 20% to 25% of the expenses incurred. After these recoupment, any surplus in the ratio of 50: 50 or any such agreed ratio between the producer and the distributor.

c. **Pure Commission Basis**

In respect of the license agreement on pure commission basis, the distributor is entitled to release and exhibit the film in the contracted territory. After the release of the film in the first instance, it recover all the expenses incurred towards the film and after these recoupment, any surplus is shared in the agreed ratio between the producer and the distributor.

STEP 2 – FUNCTION, ASSET & RISK (FAR) ANALYSIS

Even though the function performed by all this distributors related as well as unrelated are identical but the Risk undertaken by them are significantly different due to business model adopted by these distributors some of them are following Pure Commission Model whereas some of them have adopted Minimum Guarantee Model. Hence, the vital & deciding factor for comparison between the above two scenarios is the 'Minimum guarantee amount' paid by the party. In this business higher margins are paid when the exhibitor provide the minimum guarantee to the distributor. Minimum guarantee carries higher risk, hence, the profit sharing ratio with such dealer is significantly high depending on the amount of risk which it takes by paying a lump sum amount upfront and carrying a huge risk of potential loss in the event of movie not doing well. This profit sharing ratio in case of minimum guarantee also varies from each film & each territory depending on the chances of that film doing well in that particular territory & amount of minimum guarantee paid by that distributor. E.g. for a Yash Chopra, Karan Johar, Shahrukh Khan & Akshay Kumar film in a overseas market carries lesser chance of film not doing well at the box office, hence, if everything remains the same the profit sharing ratio in this scenario will be very less since there is a assurance of a good business. But when a newcomer's film or movie of a film star who does not have a good box office records in the overseas markets is being released and a distributor is paying a minimum guarantee for such film then the profit sharing between the said distributor & the producer may be significantly high because of the heavy potential risk carried by the distributor.

If in the instant case, when we compare the Subsidiaries with the third parties then we can notice that they merely distribute the films on behalf of distributor and they don't take any risk of film not doing well at the box office. Hence, the said subsidiary performs limited functions of merely facilitating the distribution for which they are remunerated at profit sharing ratio of 90:10.

STEP 3 – SELECTION OF METHOD

Based on the analysis & observations, it is evident that in such type of transactions the Comparable Uncontrolled Price ('CUP') Method is preferable over all the other methods i.e. Transactional Net Margin Method ('TNMM'), Cost Plus Method ('CPM'), Resale Price Method ('RPM') & The Profit Split Method ('PSM'). The results derived from applying CUP method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction, if an uncontrolled transaction has no or only minor differences with the controlled transaction that would affect the price. The CUP method compares the price in a controlled transaction with a price in a comparable uncontrolled transaction entered into the same or similar circumstances. Thus, it is clear that CUP depends on the existence of similar transactions between the taxpayer and the uncontrolled/non-associated parties.

It may be noted that the transactions entered into by associated enterprises with unrelated party (called 'internal comparables') would provide more reliable and accurate data as compared to transactions by and between third parties (called 'external comparables'). OECD Guidelines recognizes the fact that external comparables are difficult to obtain and, also it may be incomplete and difficult to interpret. Hence, for these reasons, internal comparables are preferred over external comparables.

STEP 4 – ANALYSIS & SELECTION OF COMPARABLES

The transactions with USA, US & South Africa subsidiaries are on 'No Minimum Guarantee & 10% Commission on net revenues'[2], hence ***first step*** is to apply the comparability analysis on the available internal cups for the Subsidiary which are as under;

Country	***Terms of Film Distribution***	***Accept / Reject***
UAE	No Minimum Guarantee & 5% Commission on Gross revenues	**Accepted** because Comparable business model
Nepal	No Minimum Guarantee & 15% Commission on net revenues[1]	**Accepted** because Comparable business model
Malaysia	Certain Minimum Guarantee &	**Rejected** because different business model

[2] *Net revenues refer to all income /realizations from the distribution, exhibition of the said film by way of exploitation of rights being the total box office receipts less taxes, cost of prints & theatre owner share of the box office receipts from the territory.*

	30% Commission	
Germany	No Minimum Guarantee & 5% Commission on net revenues[1]	**Accepted** because Comparable business model
Russia	No Minimum Guarantee & 5% Commission on net revenues[1]	**Accepted** because Comparable business model
France	Outright Purchase	**Rejected** because different business model
Canada	Outright Purchase	**Rejected** because different business model
Australia	Outright Purchase	**Rejected** because different business model

After the analysis, we left with four comparables from UAE, Nepal, Germany & Russia. The ***Second step*** is to analyze whether we can compare the markets of UAE, Nepal, Germany & Russia with that of USA, UK & South Africa which will make them comparable. For this we have to take into consideration the main ingredient for the overseas market for Indian Cinema which is the population of Non Resident Indians (NRIs) & Person of Indian Origin (PIOs) outside India. Hence to determine the comparability of the regions first we have to compare the prime factors of those regions which drives the overseas business for Indian Cinema, the comparability analysis of such factor is as follows;

Country	***Population of NRI's & PIO's***	***Accept/Reject***
USA	3,000,000	N. A.
UK	1,600,000	N. A.
South Africa	1,160,000	N. A.
UAE	1,400,000	**Accepted,** because location conditions are comparable
Nepal	4,000,000	**Accepted,** because location conditions are comparable
Germany	80,000	**Rejected,** because location conditions are not comparable
Russia	16,000	**Rejected,** because location conditions are not comparable

After the analysis, we left with two comparables from UAE and Nepal. The ***third step*** is to analyze whether the terms are ***identical*** with those at which the transactions are

executed with the associated enterprises. The terms can be made identical in the following manner;

Particulars	***Associated Enterprises***	***Third Party in UAE***	***Third Party in Nepal***
Terms of Arrangement	10% on net revenues	5% on Gross revenues	15% on net revenues
Gross Collections of the movies (*net of taxes*)	100	100	100
Less: Theatre Share on the above	45	45	45
Less: Cost of prints	10	10	10
Net Collection from Film distribution	45	45	45
Less: Share of trade proceeds to on net collections	4.5	N. A.	6.75
Less: Share of trade proceeds to on Gross Collections	N. A	5	N. A
Net Collection received by ABC, India	**40.5**	**40**	**38.25**
Percentage share of trade profits given to Overseas Exhibitor	**10%**	**11.11%**	**15%**

From the above analysis, it can be safely concluded that Associated Enterprises are being remunerated at arms length according to the Indian Transfer Pricing regulations as the Indian Party is being beneficially remunerated from its transactions with the associated enterprises. Also the lower remuneration to overseas associated enterprises can be even be justified in those country as this subsidiaries are merely a Captive Service Provider which carry limited entrepreneur risk as compared to the third parties which are complete entrepreneurs.

Q. 4 TRANSFER PRICING IMPLICATIONS ON OVERSEAS M & E COMPANY SETTING UP A COMPANY IN INDIA TO PROVIDE BUSINESS SUPPORT SERVICES?

CASE STUDY

WDV Inc a USA based company engaged in media & entertainment business has set up a company in India for carrying out its business support function exclusively for its parent. The business model followed by the company is 'Cost plus' i.e. invoicing by adding up a fixed percentage above its total revenue costs.

STEP 1 – BUSINESS STUDY

The USA based company is engaged in media & entertainment and has set up an Indian company primarily to cater to its Indian administrative requirements and assistance in marketing of its products in India. Its prime function is to act as communication channel between its overseas parent and its client in India.

STEP 2 – FUNCTION, ASSET & RISK (FAR) ANALYSIS

The functions performed by the Indian Company are of business support and assistance in the marketing of parent's company's products in India. The assets and risk undertaken by both the companies can be tabulated in the following manner;

Asset Employed

Type of Assets	WDV India	WDV USA
Employees	Yes	Yes
Property, Plant & Equipment	Limited	Yes
Intangible such as Trade Licenses, Know How etc.	No	Yes

Risk Assumed

Type of Risk	WDV India	WDV USA
Entrepreneurship Risk	No	Yes
Market Risk	No	Yes
Manpower Risk	Yes	Yes
Credit & Collection Risk	No	Yes
General business risks	Limited	Yes
Foreign Exchange Risk	Yes	Yes
Legal Risk	No	Yes

Thus it is clear from the above analysis that the 'WDV India' performs limited functions, owned limited assets and bears less risk under all the circumstance as compared to WDV USA. Accordingly, WDV USA should be characterized as the 'Entrepreneur' because of its function performed, assets employed & assumed risk and WDV India should characterized as the 'Limited Risk Bearing enterprise'.

STEP 3 – SELECTION OF METHOD

As WDV India is 'Captive Service Provider' hence there are no internal cups available, also as the data regarding same or similar comparables transactions is not available in the public database the CUP method can not be used in the instant case. Other methods such as RSM, PSM & CPM is also ruled out due to their inherent limitations in such type of transactions. Such as RSM is most useful in transactions when tested party purchases and

resells products or services to the related party, PSM method is used when there in an involvement of two complex entities performing the equal or almost equal Function, Assets & Risk while executing the transactions whereas CPM deals with gross profit margins hence the same can not be used in India as there is no uniform parameters exist in India to compute the Gross profit margin therefore the gross profit margins of the companies in India can not compared.

The TNMM method is generally known as the method of last resort, when applicability of all the other methods to any particular transaction is difficult as TNMM examines the ***net margin*** relative to an appropriate base (e.g. Costs, sales, assets) that a taxpayer realizes from a controlled transaction. This means in particular that the net margin of the taxpayer from the controlled transaction should ideally be established by reference to the net margin that the same taxpayer earns in comparable transactions. Where this is not possible, the net margin that would have been earned in comparable transaction by an independent enterprise may serve as a guide.

The TNMM is a more generally applicable method for evaluating transfer prices than other specified methodologies, since the strength of transactional net margin method is that net margins are less affected by transactional differences. The net profit margins are more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits, only functional similarity is required.

In the present case, since other methods cannot be applied to establish the arms-length price and data being available on the public database of the peers primarily operating in the Business Support industry. Therefore, it can be opined that the TNMM is residual and the only method which can be considered as appropriate method to determine the arms length price of the transaction in the instant case.

STEP 4 – ANALYSIS & SELECTION OF COMPARABLES

As concluded above, TNMM is the most appropriate method to evaluate the arm's-length nature of inter-company transactions and Operating EBIT as a percentage of Sales is taken as the profit level indicator (PLI's) among the other PLI's such as Return on Capital and Operating profit to cost.

After running search on the public database for the following key words such as;
'Business Auxiliary & Other Services', 'Business Support Services', etc. etc.

Also the result of this search is further filtered by selecting companies fitting into the following parameters;

1. Companies with available financial data for atleast one of the two previous financial years,
2. Companies with Sales income within a range of INR XXX Cr to INR XXX Cr
3. Companies with less than 25% of its income from related party transactions from this Income segment
4. Companies other than those with abnormal results

After all the above analysis the net results is as under;

The EBIT of this company of the most recent two-year period (March 2005 & March 2006) is summarized in table below;

Sr. No.	*Company Name*	*EBIT of FY 20XX-XX*	*EBIT of FY 20XX-XX*	*Average of 2 years*
1	AL	XX%	XX%	XX%
2	IOL	XX%	XX%	XX%
3	TCL	XX%	XX%	XX%
	Average (*Arithmetic mean*)	XX%	XX%	XX%

As can be seen from above, the arithmetic mean of arm's length margin for net operating margins (EBIT) of comparables in the final sample works out to XX%. The prime factor which distinguish WDV India from the above companies is its '*Captive service provider*' status, hence it doesn't undertake any of the following function & risks

- Marketing Function & Risk
- Credit Risk

Therefore, the said margin needs to be discounted to make it comparable with the margin of WDV India for the benchmarking analysis under Indian Transfer Pricing regulations. The discounting in the derived margins of the comparables companies is justified by the principals laid down by the recent judicial pronouncements given in case of *Mentor Graphics (Noida) Pvt. Ltd. v. DCIT (2007) 109 ITD 101 (Del.)*, E-*gain communication Private Limited. V. Income tax Officer (ITA No. 1685/PN/2007)* and *Philips Software Center Private Limited v. ACIT (ITA No. 218(BNG)/08)*. The rulings affirms a key principle of importance of judging factor influencing comparability while selecting comparable data and need to either adjust for material difference or reject comparable if such difference cannot be adjusted. The discounting should be made to EBIT of comparable for function or risk undertaken by them not matching with Tested party.

Further in case of *Mentor Graphics Delhi Tribunal 109 ITD 101* had pronounced that 'Transfer Pricing' is not an exact science. The evaluation of transaction through which process of determination is carried is an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out, yet it has to be shown that analysis

carried was judicial and was done after taking into account all the relevant facts and circumstance of the case.

In case of WDV India to arrive at the arms length price which can be compared with WDV India's operating margin, we will have to discount the Arithmetic Mean of margins of available comparables with the normal margins which can be attributable to the marketing functions and related activities, till date there are following three judicial precedents which has computed the margins which can be attributed to the marketing activities those are as follows;

Sr. No.	**Company Name**	**Margin attributable marketing Activities**
1	Ahmad Bhai Umar Bhai (SC), 18 ITR 472	35.00%
2	Carborandum Co. Vs CIT (SC), 108 ITR 335	10.00%
3	M/s Rolls Royce Plc, Delhi Tribunal, 1496 to 1501/Del of 2007	35.00%
	Simple Average (Arithmetic mean)	**26.67%**

Therefore, the arithmetic mean of net operating margin (EBIT) of comparables in the final sample works out to XX% as in the instant case for 'Captive Service Provider' this margin can be further discounted by 26.67%, hence the final arms length margin comes to XX%. (*XX% - (XX*26.67%) = XX%*) and the arms length range as per the Indian Income Tax Act is XX% *(-5% of XX%)* to XX% *(+5% of XX%)*. As WDV India's net operating margin (EBIT) on sales (*after excluding the other income and extra-ordinary items***) is XX% which commensurates with the arm's length range confirmed by this analysis.**

Q. 5 TRANSFER PRICING IMPLICATIONS ON AVAILING SERVICES OF THE PROFESSIONALS EMPLOYED BY THE OVERSEAS COUNTERPART?

CASE STUDY

PQR Ltd based in United Kingdom has special effects Studio in India. PQR India has bagged a Big Budget Hindi Cinema's contract to do its high level special effects, but they do not have sufficient experts available in India to carry out this work. Therefore PQR UK sent its elite team to POR India to supervise the assignments. PQR Ltd is asking on the pricing arrangement at which this arrangement should be carried out.

STEP 1 – BUSINESS STUDY

It is very important to know that the Special Effects work is secret and vital business know-how hence the information of key assignments cannot be shared with the outsiders. This work has to be carried out by the internal group of expert rather than by

other local Indian experts outside the group, therefore first the availing of services of experts of PQR UK by PQR India is making a business sense hence it is justified.

STEP 2 – FUNCTION, ASSET & RISK (FAR ANALYSIS)

All the key functions, Asset & Risk for the said assignments are being undertaken by PQR UK and PQR India played a limited role of a Contractor bearing the obligations towards the client.

STEP 3 – SELECTION OF METHOD

Based on the analysis & observations, it is evident that in such type of transactions the Comparable Uncontrolled Price (CUP) Method is preferable over all the other methods i.e. Transactional Net Margin Method ('TNMM'), Cost Plus Method ('CPM'), Resale Price Method ('RPM') & The Profit Split Method (PSM). The results derived from applying CUP method will generally be the most direct and reliable measure of an arm's length price for the controlled transaction, if an uncontrolled transaction has no or only minor differences with the controlled transaction that would affect the price. The CUP method compares the price in a controlled transaction with a price in a comparable uncontrolled transaction entered into the same or similar circumstances. Sometimes, even CPM can be a business model in inter-company services; however in specialized services the use of CPM is not appropriate. The use of CUP depends on the existence of similar transactions between the taxpayer and the uncontrolled/non-associated parties.

It may be noted that the transactions entered into by associated enterprises with unrelated party (called 'internal comparables') would provide more reliable and accurate data as compared to transactions by and between third parties (called 'external comparables'). OECD Guidelines recognizes the fact that external comparables are difficult to obtain and, also it may be incomplete and difficult to interpret. Hence, for these reasons, internal comparables are preferred over external comparables.

STEP 4 – ANALYSIS & SELECTION OF COMPARABLES

In charging for provision of services, a service provider could adopt a direct charge method or an indirect charge method. The ***direct charge method*** involves identifying clearly the actual work done, the cost expended for providing the services and the basis of charging. This method facilitates review and examination by tax authorities. Therefore, wherever possible, taxpayers should adopt the direct charge method in charging for related party services. This method is appropriate for specific services rendered to related parties, where the beneficiary of the services and the costs incurred for performance of the services are usually clearly identifiable.

Indirect charge methods entail the use of an appropriate apportionment basis/allocation keys to charge/bill for the service provided, such as gross sales, income or receipts, loans and deposits, staff numbers, floor area and asset size, etc. It may not be practical for taxpayers to adopt the direct charge method for all related party services. For instance, it may not be possible for a taxpayer, which provides accounting services for all members belonging to the same group to identify the benefits received by, or the service performed specifically for individual recipients. In such a case, an indirect charge method will have to be used to approximate the charges. The main consideration for using an indirect charge method is the appropriateness of the apportionment basis or allocation key. This, in turn, is dependent on the nature and the usage of the service. Generally, the most appropriate allocation key is one which most accurately reflects the share of benefits received or is expected to be received by the beneficiaries. While the choice of an appropriate allocation key is largely a question of judgement, taxpayers are expected to demonstrate that due consideration and analysis have been undertaken in arriving at the choice of the allocation key. Revenue Authorities are prepared to accept the allocation key adopted by the taxpayer as long as it is reasonable, founded on sound accounting principles and has been consistently applied year to year throughout the group.

In the instant case, the high-end professional services have been under consideration hence 'Direct Charge Method' seems an appropriate method. When performing the comparability analysis for related party services, it may be useful to undertake the analysis from the perspective of both the service provider and the recipient i.e. how much the provider would charge an independent party, taking into account its cost and how much the recipient is willing to pay for the service, considering what it would have otherwise paid to independent parties for similar services under similar circumstances.

For the analysis of the Comparable the following factors should be analysed in details between the contracts entered with associated enterprises vis-à-vis unrelated parties;

- **Hourly Rates charged by the Service Providers and charging terms such as Credit Period, Traveling Time charge, Out of Pocket Expenses etc,**
- **Terms of the business arrangements,**
- **The nature of services provided,**
- **The contribution made by the Service recipient in the projects executed,**
- **The personnel used in those projects & their expertise,**
- **The time sheet maintained in the projects based on which the invoices are being raised,**
- **The reports/output of the project,**
- **Memorandum of Understanding (MOU) of the business arrangement,**
- **Proper authorization of the timesheet and supporting thereon,**
- **Discounting policy of the service provider company and the various basis of discounting,**

After the analysis and study of all those factors a price can be determined after the due discounting which can said to be at arms-length in such type of cross-border transactions between the associated enterprises where professional services has been rendered.

Q. 6 TRANSFER PRICING IMPLICATIONS ON FINANCING THE OVERSEAS SUBSIDIARY?

CASE STUDY

KHJ Ltd based in India has set up a subsidiary in Mauritius which is engaged in film distribution and global expansion. KHJ India wishes advance a significant amount to its overseas subsidiary for starting up of business. The query has been raised before us whether an interest free loan can be granted to this overseas subsidiary in Mauritius.

STEP 1 – BUSINESS STUDY

It is always very difficult to study the Transaction which involves financing arrangement between associated enterprises. Hence it is very important to understand the prevailing business conditions at that time and the terms of arrangement.

STEP 2 – FUNCTION, ASSET & RISK (FAR ANALYSIS)

It is evident that KHJ India is bearing the entire entrepreneur risk in the said transaction by financing KHJ Mauritius.

STEP 3 – SELECTION OF METHOD

Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. One party transfers to another goods or services, for a price. That price is known as transfer price. This may be arbitrary and dictated, with no relation to cost and added value, diverge from the market forces. Transfer price is, thus, a price which represents the value of good; or services between independently operating units of an organisation. But, the expression transfer pricing generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between non associated enterprises. Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. The transfer pricing regulations aims at preventing erosion of tax base due to such manipulative transfer pricing policies adopted in the cross-border transactions by the related entities where the transaction value results into unfair results

and against the normal commercial prudence under which the normal business would have been carried on its business.

Profit could be shifted through the transaction of borrowing and lending. There are a number of factors to be taken into account in the context of Arms Length Price (ALP) between related party debts, few are listed below:

- The nature & purpose of the loan,
- The market conditions at the time the loan is granted,
- The principal amount, duration & terms of the loan,
- The currency in which the loan is denominated,
- The exchange risks borne by the lender or the borrower,
- The security offered by the borrower,
- The guarantees involved in the loan,
- The credit standing of the borrower,
- The interest rate prevailing at the situs of the lender or the borrower for comparable loans between unrelated parties.

In April 2002, the Central Government of India constituted an Expert Group to recommend transfer pricing guidelines for companies for pricing their products in connection with the transactions with related parties and transactions between different segments of the same company. Report given by Expert Group on Transfer Pricing Guidelines specifies that all the transaction between a company and a related party or between two business segments of a company shall be at ALP. *However in exceptional cases (kindly refer paragraph 3.2 of the report), the company may decide to use a non-arms length price provided:*

- *The board of director as well as audit committee of board are satisfied for reasons to be recorded in writing that its in the interest of company to do so, and*
- *The use of a non-arms length transfer price, the reason therefore, and the profit impact thereof are disclosed in the annual report.*

Remarks: <u>Examples of such exceptional cases could be a company giving an interest free loan to a loss making subsidiary</u> or a company accepting the offer of a controlling shareholder to work as the CEO on a nominal salary.

According to the expert group disclosure in annual account *(kindly refer paragraph 3.4 of the report)* should include following factors;

a) *The Transfer Pricing Policy Statement would be annexed to and form part of the Directors' Report.*

b) *The Directors' Report would also certify that the Transfer Pricing Guidelines have been complied with and that transactions entered into are at arm's length unless otherwise stated and are not prejudicial to the company.*

c) *The Directors' Report would disclose any use of a non-arms length transfer price, the reasons therefore, and the profit impact thereof.*

d) *The Auditors would certify that they have examined the implementation of the transfer pricing policy and found it to be in conformity with the Transfer Pricing Guidelines and with the Policy Statement.*

In the instant case, when an Holding company gives a loan or advance to its newly started subsidiary at interest free or on certain conditions which are not comparable with the prevailing rates in the market, the only method out the 5 prescribed methods which can be used is 'Comparable Uncontrolled Price'. However, the degree of similarity required in the comparables in this method is very high, hence the transaction can not be equated with the Loan transaction between a bank & borrower or any other normal transaction between a lender & a borrower. Therefore it can be inferred that no method of transfer pricing can be applied in the instant case to analyze whether the 'Conditional Interest bearing or interest free advance/loan given to overseas subsidiary' is at ALP.

Hence to comply with the Transfer Pricing regulations, the key consideration which should be satisfied which are as under;

1. The transaction should not result into erosion of tax base, i.e. shifting of actual profits
2. The transaction should not be against the normal commercial prudence in which the normal entrepreneur will carry on his/her business; and
3. The transaction in anyway should not result into tax evasion or tax avoidance in any of the two countries of which the entities involved are the tax resident

Such types of transactions are very peculiar in nature and hence a general principal can not be applied. It is evident to analyse the facts of each case and then arrive at a conclusion.

STEP 4 – ANALYSIS & SELECTION OF COMPARABLES

KHJ Ltd started to venture into its overseas operations in current financial year; it has opened its subsidiary in various countries to test the market initially and then to expand according to the available opportunity. These days the movie distribution business has become the hot investment avenues where the opportunities are endless so as the risk due to its dependency on the movies made and the viewers choice which can be very

dynamic and highly unpredictable. Therefore, this sector is perfect example of high risk and uncertain returns.

The global economy is in a tough spot, caught between sharply slowing demand in many advanced economies and rising inflation everywhere, notably in emerging and developing economies. Global growth has decelerated significantly. In many emerging economies, there is tighter monetary policy and greater fiscal restraint, combined in some cases with more flexible exchange rate management. Global growth has decelerated to 4½ percent in the first quarter of 2008 (measured over four quarters earlier), down from 5 percent in the third quarter of 2007, with activity slowing in both advanced and emerging economies.

It is a given that when you start a business, strategic planning is essential. The company will have to undergo different tasks and use different skill sets in order to achieve their goals. In such a scenario as mentioned above it is business prudence for the parent company to give loans which are used as pre-seed capital for start-up of business ventures of subsidiary. Therefore, in our view Conditional interest bearing loan should be granted by KHJ India to its subsidiary similar to the nature of capital contribution or Venture Capital Finance. We proposed the following as the terms of the agreement's which can be said to comply with the arms-length requirement;

1. *Interest payment liability will deem to arise on subsidiary if the following conditions are met;*

   a. The borrower company has earned 2 years of consecutive cash profits

   b. The amount of loan is still unpaid when the above mentioned condition is met

2. *The applicable interest rate will be calculated as follows;*

   Prime lending rate (PLR) existed at the time of lending the money in the lender's state + XX[3]% of the PLR

3. *Once the interest liability is arises as per the above conditions mentioned in clause 1, the interest will be charged and calculated on the average amount outstanding in the end of each month and the same will be payable quarterly within 30 days from the end of every quarter.*

Analysis of Condition 1

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[3] KHJ India will not be earning any revenues till the subsidiary earns cash profits for 2 consecutive years. Hence it is bearing the entire entrepreneur risk for which it should earn 'Super Normal Profits' when the interest is due for payment.

The condition 1 states as follows;

1. Interest payment liability will deem to arise on subsidiary if the following conditions are met;

    a. The borrower company has earned 2 years of consecutive cash profits

    b. The amount of loan is still unpaid when the above mentioned condition is met

The above condition sets out one prime condition which gives rights to the borrower that as & when the lender is financially capable; the liability to pay interest will arise. The terms used in the agreements are 'Cash Profits' which is a real parameter of the financial condition of the enterprises, when the lender i.e. associated enterprises earns cash profits for 2 consecutive years then it can be said that it is deemed to be financially capable to discharge the interest obligation.

Hence to comply with the Transfer Pricing regulations, the key consideration should be satisfied which are as under;

1. *The transaction should not result into erosion of tax base, i.e. shifting of actual profits*

- In the instant scenario, there is no erosion if tax base i.e. shifting of actual profits as foreign overseas company is not earning any cash profits which will result into shifting of profits from India. There is no point in charging and booking interest income in the initial year and then if subsidiary company couldn't perform or settled down then writing of the earlier booked income as bad debts in the books of accounts which will nullify the effect in Indian company's books making it tax neutral.

2. *The transaction should not be against the normal commercial prudence in which the normal entrepreneur will carry on his/her business; and*

- The term 'Commercial Prudence' refers to the way in which a normal entrepreneur will carry on the business. It is given that when you start a business, strategic planning is essential. The company will have to undergo different tasks and use different skill sets in order to achieve their goals. The global economy is in a tough spot, caught between sharply slowing demand in many advanced economies and rising inflation everywhere, notably in emerging and developing economies. Global growth has decelerated significantly. In many emerging economies, there is tighter monetary policy and greater fiscal restraint, combined in some cases with more flexible exchange rate management. The immediate impact of rising inflation is clearly visible on

interest rates, which have also been moving up. This in turn is also reflecting on economic and corporate growth. Such a situation brings with it a number of challenges for companies as they seek to fund their day-to-day operations as well as manage future growth. In a rising interest rates scenario, where easy money gets wiped out (thanks to equities turning unattractive), banks also turn stringent while lending to companies. Corporate spending in the industrialized world has been rather cautious.

Very little debt financing is available to early-stage entrepreneurs, because lenders expect loans to be paid back in a pre-defined and timely manner with interest. Due to their inherent high risk and lack of liquidity, early-stage companies are not considered sufficient collateral for debt financing. Debt financing is generally considered to be an inexpensive source of capital for business, especially when compared to equity, which involves giving up part of the ownership of the company. Since such a scenario is faced in the economy it is just a practice of business prudence for the parent company to provide an interest free / conditional interest bearing loan to its subsidiaries during its startup phase.

In such a scenario as mentioned above it is business prudence for the parent company to give loans which are used as used as pre-seed capital for start-up of business ventures of subsidiaries. In our view Conditional interest bearing loan granted by KHJ India to its subsidiary is similar to the nature of capital contribution only the nomenclature is changed, therefore the said loan given to the subsidiary can be justified to be a prudent business decision.

3. *The transaction in anyway should not result into tax evasion or tax avoidance in any of the two countries of which the entities involved are the tax resident*

- The Indian company is a 100% holding company, hence it will received all the future benefits either in form of dividends or Capital gains, the same is taxable in India at the applicable rates, therefore even the country of which the holding company is a resident i.e. India is not losing any tax at any point of time which ensures that there is no erosion of tax base and the cross-border transaction entered doesn't constitute 'tax avoidance' arrangement.

<u>Analysis of Condition 2</u>

The condition 2 states as follows;

1. The applicable interest rate will be calculated as follows;

Prime lending rate existed at the time of lending the money in the lender's state + XX% towards the risk taken

KHJ India will not be earning any revenues till the subsidiary earns cash profits for 2 consecutive years. Hence it is bearing the entire entrepreneur risk for which it should earn 'Super Normal Profits' when the interest is due for payment. The terms of interest payment are '*Prime lending rate existed at the time of lending the money in the lender's state + XX% towards the risk taken'*

'Prime Lending Rate' is the rate that commercial banks charge to its most creditworthy customers. The prime interest rate offers the lender sufficient earnings to cover the risk-based costs associated with loans to low-risk borrowers. The prime rate adjusts in increments called 'the margin', which compensates for factors that affect the cost of lending. These rates are influenced by the discount rate and the federal funds rate, and are not set by the Fed. It varies with the availability of funds in the banking system and the demand for credit in the marketplace. If one bank increases or decreases their current prime interest rate, then supply and demand for money dictates that the other banks follow suit. This is partly due to competition and partly because all banks are subject to the same influences on the cost of their funds, such as the monetary policy decisions of the Federal Reserve. Thus the mortgage lending rate is usually the same offer from all major banks. In India generally the Prime Lending Rates (PLR) declared by State Bank of India is taken as the base for calculating the interest rate, and PLR can be used as Comparable while measuring the Arms Length Nature of the loan transaction.

The next step will be to analyze the charging of 'XX% premium on PLR' which can be attributable to the entrepreneur risk and super normal profits thereon.

For admeasuring the comparability of the XX% premium, we feel the 'Transaction Net Margin Method' (TNMM) will be the 'Most Appropriate Method' as it will give us the net margin earn by the companies engaged in the finance sector which we can benchmark with the Premium charged by the KHJ India to its overseas subsidiaries.

Hence in our view, the above mentioned terms of transactions for conditional interest bearing loan to subsidiary will deemed to be at arms-length as it is complying with the key consideration of transfer pricing which are as under;

1. **The transaction does not result into erosion of tax base, i.e. shifting of actual profits**

2. **The transaction is not be against the normal commercial prudence in which the normal entrepreneur will carry on his/her business; and**
3. **The transaction in anyway does not result into tax evasion or tax avoidance in any of the two countries of which the entities involved are the tax resident**

Q.7 TRANSFER PRICING IMPLICATIONS ON REIMBURSEMENT OF EXPENSES?

The reimbursement of expenses can be treated and analysed in following two ways

- Without any mark-up
- With Mark up

The key consideration is whether the company paying the expenses initially has played any role in executing the work, if the company has paid the expenses merely for the sake of administrative convenience such as local payer requirement of vendor etc then the no-markup arrangement can be justified in other case where the company is acting as communication channel or playing some role in the entire activity then some mark-up should be charged as the service can be looked at as 'business support service'. This scenario's can be explained as under;

Without any mark-up

JJK Ltd, a UK based company has arranged an exhibition in India and deputed its personnel in India for a week. These personnel carried out the entire operations, however the Indian vendor demanded for a payment in INR only. Therefore JJK Ltd has asked its Indian Subsidiary to make the payment which was later on reimbursed by JJK Ltd.

In such scenario, it is a fit case to claim that as no service has been rendered by the Indian party to its overseas associates. No income will deemed to accrue in the said transaction and the reimbursement made by the JJK Ltd without any mark up can be justified before the revenue authorities.

With a mark-up

JJK Ltd, a UK based company has arranged an exhibition in India and deputed its personnel in India for a week. These personnel carried out the implementation work, however appointment of vendors and liaisoning with such vendors has been done by its Indian Subsidiary due to its local presence and then Indian subsidiary also made the payment in INR on behalf of JJK Ltd as Indian Vendors wanted a payment only in local currency. Later on these payments were reimbursed by JJK Ltd.

In such scenario, some functions are carried on by the Indian Subsidiary for its overseas holding company and revenue authorities can argue that service has been rendered by the Indian party to its overseas associates. Therefore some income will

deemed to accrue in the said transaction and the reimbursement made by the JJK Ltd without any mark up may not be justified before the revenue authorities.

Q.8 TRANSFER PRICING IMPLICATIONS ON USE OF LOSS MAKING COMPANIES AS COMPARABLE?

In some cases after running the search of comparables and refining the search on different parameters, the final set of comparables may include some loss making companies. It is interesting to know that whether such companies should be excluded before calculating the arithmetic mean or arithmetic mean should be calculated considering these loss making companies.

Case Study

The EBIT of most recent two-year period (March 2007 & March 2008) of the companies of the final comparable set is summarized in a table below.

Sr No.	*Company Name*	*EBIT of FY 2006-07*	*EBIT of FY 2007-08*	*Average of 2 years*
1	C I L	**XX%**	**-XX%**	**XX%**
2	H I L L	**-XX%**	**N.A.**	**-XX%**
3	I T L I L	**XX%**	**XX%**	**XX%**
4	R U & T L	**-XX%**	**N.A.**	**-XX%**
5	V A T L	**-XX%**	**-XX%**	**-XX%**

Analysis

As mentioned above in this article, in the case of *Mentor Graphics Delhi Tribunal 109 ITD 101* had pronounced that 'Transfer Pricing' is not an exact science. The evaluation of transaction through which process of determination is carried is an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out, yet it has to be shown that analysis carried was judicial and was done after taking into account all the relevant facts and circumstance of the case.

As per the normal benchmarking procedure followed by the consultants as well as IT authorities loss making companies should not be included while computing the arms length price, however in our view as derived and supported by many Indian judicial precedents, the transfer pricing is subjective and depends on the peculiar facts of the case, the comparability test has to be matching with nature of the group of comparables. In the instant case, out of 5 companies 3 companies have incurred loss, which signifies that 60% of the sector's position in that year hence it will not be a prudent step to eliminate the

majority part of the group to derive at the arithmetic means or average of that group which will not give the REAL PICTURE or TRUE CHARACTERISTIC of the set of comparables. Therefore we recommend considering the results of all the 5 companies in the set to derive at the arms-length margin. In cases such as this where sometimes the sector as whole is facing the profit-crunch, eliminating the loss making companies will tantamount to 'cherry picking' & against the principal of comparability which is a Soul of transfer pricing methodology.

'Loss' is as true as 'profit' for the business, hence the fact can not be ignored that companies do incur losses. Elimination of loss making company can be justified in the case of Captive Service Provider who doesn't bear any entrepreneur risk, however in the case of Full Fledged Entrepreneur a loss making comparables should be given a due consideration in benchmarking analysis. Therefore it is highly advisable that the parameter of elimination of loss making comparables should be executed in the end of the benchmarking study and when there are cases such as those discussed in the abovementioned case study, the loss making companies can form part of the final set of comparables to derive the arithmetic mean.

'I will like to acknowledge and be grateful to my Partner Mr. Anish B. Mehta & my team members for their inputs and co-operation & special thanks to all my clients who provided me the opportunities to test my brain & learn news things, Have A Nice Day !!!'

Author- Mr. Romesh Shrikant Anusaya Sankhe @ romesh.sankhe@bdoharibhakti.co.in
Telephone (M) + 91 9892 892504

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