

Substance Over Form - The New Mantra in the BEPS World!

Backdrop:

Tax laws have been in existence for centuries and have evolved over time to account for the changing business environment. Globalization coupled with the unprecedented spurt in the digitalization of the economy, prompted a revisit of the existing tax laws to keep pace with the new age business models. In this backdrop, the G-20 countries mandated the OECD¹ in 2012 to develop a program to address BEPS² which was estimated to lead to potential revenue losses of USD 100-240 billion annually (equivalent to 4-10% of global corporate income tax revenues). The outcome of the program was the prescription of the 15 Action Plans (BEPS AP) meant to be effective deterrent of BEPS activities. One of the key themes of the BEPS AP is the 'substance over form' concept that intends to align the profits with the underlying value creation activity.

This article analyses the espousal of the said concept in the real world scenario by considering the verdict of the **Swedish Tax Agency ('STA')** in case of **PUMA Nordic AB ('PUMA Sweden')**- a Swedish distributor wherein the said principles were methodically applied to:



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- ◆ delineate the inter-company transactions;
 - ◆ marry the contractual obligations with actual conduct;
 - ◆ identify the economically significant risks and parties exercising the control over the same; and
 - ◆ finally align the transfer pricing outcomes to value creation based on the above.
- parent company has presence across the globe through its distribution and sales companies including in Sweden (PUMA Sweden). One of the group companies - PUMA International Trading GmbH (PIT) was entrusted with the responsibility for liaising with contract manufacturers for manufacture of the of PUMA products.

Setting the context:

PUMA, the German sportswear group with PUMA SE as the

The value chain of the group revolves around three most critical functional drivers:



¹ Organization for Economic Co-operation and Development

² Base Erosion and Profit Shifting

International Taxation

With a focus on marketing, design and product development, the manufacturing was predominantly outsourced to third party contract manufacturers.

Taxpayers Position

As per the licensing agreement, PUMA Sweden was designated as the entrepreneur distributor for the Swedish market with the following attributes:

- ◆ Responsible for the development of the market for PUMA in Sweden by incurring the necessary promotion & marketing spend (without any compensation from PUMA SE);
- ◆ Payment of royalty to PUMA SE for marketing license; and
- ◆ Import of goods from PIT on a cost plus basis (cost plus 8.5%)

PUMA Sweden was entitled to retain the residual return (profit/loss) from the sales in Sweden. Result of the arrangement was that PUMA Sweden incurred a loss in range of 7-10% over the years 2015-17, with the local marketing spend for brand promotion being the significant contributor of the losses.

In line with the contractual arrangement, PUMA Sweden contended that as it is an entrepreneurial entity for

market, it was responsible for undertaking effective local marketing & sales strategy without any interference from PUMA SE (or any other Group entities) and in turn was entitled to bear the losses from the said business.

Critical Analysis by the STA

STA assessed the arm's length nature of the arrangement on the touchstone of the guidance provided in AP 8-10 which emphasizes on

The **functional and risk analysis** undertaken by the STA is summarised below:

A. Functional Analysis:

Function	Performed by and Observations by STA	Controlled by
Design and product development	PUMA SE (parent company) Strategic design and development decisions undertaken by PUMA SE	PUMA SE
Manufacturing & procurement	External contract manufacturers Purchase price / o other Contractual terms / quality control & oversight with external manufacturers negotiated by PITand	PIT with support from PUMA SE
Marketing and brand strategy	PUMA SE PUMA SE is the legal and economic owner of the brand & IP of PUMA group	PUMA SE
Sales & Distribution	PUMA Sweden PUMA Sweden has its own customer relationships and it sells products to external retailers in Sweden.	PUMA Sweden subject to a Framework Purchase Agreement and an International Marketing Agreement with PIT

the actual conduct (of the concerned parties) rather than the contracts. STA undertook a detailed study, critically analyzing the various functions performed by the relevant group entities (PUMA Sweden, PIT and PUMA SE), identifying the economically significant risks - owner of such risks and thus defining the commercial or financial relationship between the parties in order that the controlled transaction is accurately delineated.

B. Risk Analysis:

The STA relied on analytical framework of the OECD - the six-step procedure to identify the economically significant risks recommended under the OECD AP 9. The STA

concluded that PUMA Group's economically significant risks are linked to the ability to create value and long-term profitability and therefore focused on:

- ✓ Brand risk (building a strong international brand);

- ✓ Product risk (designing and developing new products);

The findings of the STA using the six step plan are detailed below:

Step No	Particulars	Findings of the STA
1	Identification of economically significant risks	<p>a. Brand Risk: Creating a strong and a well perceived international brand is instrumental to success;</p> <p>b. Product design & development risk: Innovative designing and development of high quality products is vital to remain competitive and create value for customers.</p>
2	Contractual obligations	PUMA Sweden was contractually obligated to compensate PUMA SE and PIT for the functions performed by them and retain the residual. Thus, PUMA Sweden implicitly bears the brand and product design & development risks.
3	Actual conduct of the parties	As evident from the above analysis, it was clear that PUMA SE had the actual control over such significant risks and also the appetite to actually bear such risks.
4	Alignment of contractual terms with actual conduct	The STA concluded that since PUMA Sweden was actually bearing the key risks though the control over such risks remained with PUMA SE, contractual terms did not marry with actual conduct of the parties.
5	Re-allocating the risks, if contractual terms are not in alignment with actual conduct	Since PUMA Sweden did not have the actual control of such key risks nor did it have the financial ability to bear such risks, these significant risks should be re-allocated to PUMA SE.
6	Correct pricing based on the re-aligned risks	Basis the above, the STA concluded that PUMA Sweden is a distributor bearing limited risks as it performed less strategic and complex functions vis-à-vis its AEs.

STA's position:

Taking cue from the OCED guidelines, the STA expressing its dissatisfaction with contractual allocation of risks determining return allocation amongst the PUMA group entities, concluded that in a third party scenario, an independent dealer would have either renegotiated the pricing of the products or may have terminated

the distribution agreement to opt for any other brand rather than incurring recurring losses thereby connecting the dots of appropriate remuneration for the functions and risks. The lack of freedom to PUMA Sweden to have done any of these indicated that PUMA Sweden was not entrepreneurial or capable of bearing economically significant risks.

Hence, the STA held that both the intercompany transactions i.e. payment of royalty and purchase of goods are intrinsically linked to one another and hence must be tested on an aggregate basis. Thus, the STA selected TNMM³ as the MAM for benchmarking both the intercompany transactions on an aggregate basis. Based on the same, the

³ TNMM= Transactional Net Margin Method

STA chose lower quartile of 3.01% as the arm's length operating margin and adjusted PUMA Sweden's results accordingly.

India Context and Key Takeaways

The ruling reinforces the criticality of conducting a robust FAR analysis and marrying it to actual conduct between parties. Articulating the value creating activities in the supply chain, identifying how it is distributed and controlled between various entities is an essential element.

While FAR analysis remains the cornerstone of TP, in the past it has often been undertaken at a prima facie basis, but nevertheless in the post BEPS era, there is a renewed focus and a dire need for both Taxpayers and Tax Authorities to take a deep dive into the "value chain" of business transactions to determine

appropriate allocation of functions and risks to ultimately determine the distribution of profit pie. The Indian company should vet the functional analysis with the Value Chain Analysis performed in the global master file to identify key risks, if any.

In other words, '*substance over form*' and '*rewards for function-performer over mere risk-taker*' would be the key determinants during an arm's length analysis. The MNEs operating in India and Indian head-quartered companies need to analyze whether the taxable outcomes of their current profit allocations would be different if they ignore the existing inter-company 'legal contracts / structures'.

The subject of TP has been traversing up the learning curve and with the Master File and CbCR⁴ data being at the disposal of the Tax authorities, the emphasis

on a detailed FAR analysis will be further intensified as this data will provide the tax administrations with the information an in-depth analysis of the value creation and profit attribution across the globe.

It is pertinent to note that the OECD is currently developing a *CbCR Tax Risk Evaluation & Assessment Tool* ('TREAT'), which will support Tax Authorities in reading and interpreting CbCRs. As per the discussion draft, TREAT will allow Tax Authorities to see quickly and easily where some of the factors could be interpreted as potential risk indicators and use this, together with other available information, to determine that an MNE group is low risk, or that further consideration is needed .

Accordingly, MNE groups should proactively identify potential areas of focus by the Tax Authorities in future audits and start preparing audit defense documentation. The time to do that is now as the current transfer pricing assessment cycle (i.e. for FY 2016-17) is the first cycle for which CbCR and master file compliances were introduced in India. Thus, it is now imperative that the FAR in today's scenario should be conducted from a holistic and synchronized perspective. ■■■



⁴ Country by Country Report