Evolving Transfer Pricing Jurisprudence in India

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Transfer Pricing practice in India has evolved a long way. In thirteen years of implementation of the transfer pricing regulations (TPR) and nine rounds of completed audits (assessments), transfer pricing (TP) has depicted a changing landscape, wherein the revenue authorities position on various issues have highlighted the future course that practice of transfer pricing is going to tread, albeit full of controversies.

The buoyant Indian economy and impressive financial performance of Indian companies have guided the revenue authorities' outlook that multinational enterprises (MNEs) operating in India should have robust transfer pricing between group companies, resulting in healthy margins for the India operations.

Laws were not made in a day. They have evolved over years. Its birth had reasons; growth was a straddle, but existence inevitable. Law today personifies a magic stick which guides the obedient and whips the one who dares to cross it.

Transfer pricing provisions are reflective of such transition. Though seemingly simple, the intricacies in its implementation have caught many unaware. Various amendments have been made post 2001 in Chapter X of the Income-tax Act, 1961 (the Act), dealing with the transfer pricing legislation both in respect of substantive and procedural law. The amendments have far reaching consequences and have nullified some of the decisions of the Income-tax Appellate Tribunal (ITAT) / Courts. Even after a decade, the transfer pricing law is still evolving. It is volatile and unpredictable and its practice demonstrates the contrasting positions taken by the taxpayer and the revenue authorities.

The introduction to transfer pricing provisions and the detailed explanation of the six specified methods for benchmarking the controlled transaction i.e. comparable uncontrolled price (CUP) method, resale price method (RPM), cost plus method (CPM), profit split method (PSM), transactional net margin method (TNMM) and the Other method as prescribed by Rule 10AB were explained earlier in various articles. Further, this article analyses the legal jurisprudence landscape that is slowly emerging, which throws light on the various intricacies of transfer pricing law in India.

Recent important transfer pricing judgments have been analysed to bring out these intricacies.

1. *Toll Global Forwarding India Pvt. Ltd.*[1]

Facts of the case:

Toll Global Forwarding India Pvt. Ltd. (the taxpayer) is a joint venture between BALtrns International (BVI) Limited, a company listed in Hong Kong Stock Exchange, holding 74% equity, and KapilDevDutta, holding balance 26% equity. The taxpayer was primarily engaged in the business of freight forwarding through air and ocean transportation which includes rendition of related services outside India as well. In the course of conducting this business, the taxpayer picked up / received freight shipments from its customers, consolidated these shipments of various customers for common destinations, and, at destination, distributed these shipments and effected delivery to the consignees.

The taxpayer entered into two types of international transactions:

a) *Arranging import of cargo from other countries to India by air and sea transportation and delivering the same to consignees in India and*

b) *Arranging export of cargo from India to other countries by air and sea transportation wherein consignments are picked up in India by the taxpayer and are sent to the destination as per instructions of consigners for the purpose of delivering to consignees through its AEs*

The taxpayer controlled the pricing to the end customers in domestic market and pricing for the end customers in connection with consignment picked up abroad was essentially determined by the AEs. The global practices followed by the similar companies in freight forwarding industry was such that the profits earned after deducting transportation costs, in respect of import and export of cargo, were to be shared equally i.e. 50:50 ratio between the taxpayer and its AEs or independent third party business associates.

In the transfer pricing study report submitted by the taxpayer, for the AY 2006-07, the taxpayer adopted the CUP method for determining the arm's length price (ALP). However, the Transfer Pricing Officer (TPO) rejected the business model and applied TNMM and proposed an adjustment of INR 2.09 crores. The adjustment was confirmed by Dispute Resolution Panel (DRP). Aggrieved, the taxpayer appealed before Delhi bench of ITAT.

Key Observations and decision of the Delhi ITAT:

- ITAT observed that in the taxpayer's industry it was a standard practice to share profits in 50:50 ratio, even for transactions with unrelated parties, and that the CUP method was the most direct method of ascertaining ALP. The ITAT observed that "the trouble however is that while there is a standard

[1] Toll Global Forwarding India Pvt. Ltd VS. DCIT Circle 2(1), ITA No. 5025/Del/10, AY 2006-07, Pronounced on 18.11.14

formulae for computing the consideration, the data regarding precise amount charged or received for precisely the same services may not be available for comparison."

'Price' as per Rule 10B - purposive and realistic interpretation

- ITAT proceeded to analyze the definition of ALP determination under Rule 10B of the Income-tax Rules, 1962 (the Rules) which sets out that the CUP method cannot be applied unless the amount charged for similar uncontrolled transaction was the same as international transaction between the AEs. However, the ITAT questioned whether 'price' as per Rule 10B(1)(a) covers not only the amount but also the formulae according to which price was quantified.

- ITAT thus relying on the decision of Agility Logistics Pvt Ltd[2] and DHL Danzas Lemuir Pvt Ltd[3] noted that in both cases, 'price' under rule 10B(1)(a) was treated to include even the mechanism in terms of formulae to arrive at the consideration. ITAT also held that this was a very 'purposive and realistic interpretation'.

Price Vs. Amount

- ITAT distinguished the use of the expression 'amount' as per US TP Guidelines, with the term 'price' in Indian domestic TP regulation, in cases when *"agreed price or service rendered to, or received from, an associated enterprise is not stated in terms of an amount but in terms of a formulae which leads to quantification in amount."*

- On a conceptual note, ITAT noted that 'price' in economic and business terms, could be interpreted as rewards for functions performed, assets employed and risks assumed (FAR), while 'amount' is a relatively mundane quantification in terms of a currency. Providing various examples, ITAT extended the application of the expression 'price' beyond specific 'amounts' and held that the stand of revenue authorities that in such cases CUP method cannot be applied, because of non availability of data in terms of comparable amount having been charged for the same service is irrelevant.

Procedural issues

- The ITAT expressed that there could be procedural issues, owing to limitations of methods prescribed under Rule 10B, and stated that *"transfer pricing, by itself, is not, and should not be viewed as, a source of revenue; it is an anti –abuse measure in character and all it does is to ensure that the transactions are not so artificially priced with the benefit of inter se relationship between associated enterprises, so as to deprive a tax jurisdiction of its due share of taxes. Our transfer pricing legislation as also transfer pricing jurisprudence duly recognize this fundamental fact and ensure that such pedantic and*

[2] ACIT Vs Agility Logistics Pvt Ltd (136 ITD 46)
[3] ACIT Vs DHL Danzas Lemuir Pvt Ltd [TS-752-ITAT-Mum (2012) TP]

unresolved procedural issues, as have arisen in this case due to limitations of the prescribed methods of ascertaining arm's length price, are not allowed to come in the way of substantive justice, particularly when it is beyond reasonable doubt that there is no influence of intra AE relationship on the determination of prices in respect of intra AE transactions."

- ITAT also observed that the methods of determination of arm's length prices have to be essentially implemented in a reasonable and pragmatic manner so as to achieve its laudable objectives without any collateral damage.

- The Central Board of Direct Taxes (CBDT) vide notification[4] dated 23rd May 2012 w.e.f 1.4.2012 introduced the *"Any Other Method"* under section 92C(1)(f) read with rule 10B(1)(f). The said method is not a residual method but is at par with other methods of determining ALP, and that as long as the method satisfied the test of being the 'most appropriate method (MAM)', it could be applied to a fact situation.

CUP Vs. Sixth Method

- The connotations of 'price', as set out in rule 10B(1)(a) are required to be taken to be something much broader than the expression 'amount' in as much as it is required to cover not only quantification of price in terms of an amount, but also in terms of a formulae including interest rate, according to which the price is quantified. Such an interpretation is a very purposive and realistic interpretation.

- In any case, when the expression "*price which would have been charged or paid"* is used in rule 10AB, compared with the CUP method where the expression is *"price charged or paid"*, as is used in rule 10B(1)(a), not only covers the actual price but also the price as would have been hypothetically speaking, paid if the same transaction was entered into with an independent enterprise. In this view, the business model adopted by the taxpayer, in principle, meets the test of arm's length price determination under rule 10AB as well.

6th method, being direct method has edge over other indirect methods

- ITAT relied upon the decision of the Tribunal in the case of MSS India Pvt Ltd[5] and Serdia Pharmaceuticals Pvt Ltd[6] wherein it was held that the direct methods have an inherent edge over indirect methods.

[4] Notification No 18/2012, dated May 23, 2012 thereby inserting Rule 10AB to the Rules

[5] ACIT Vs MSS India Pvt Ltd (25 DTR 119)

[6] Serdia Pharmaceuticals Pvt Ltd Vs ACIT (44 SOT 391)

Retrospective applicability of Rule 10AB

- Though Rule 10AB as also the corresponding enabling rule 10B(1)(f) are inserted by the Rules and are specifically stated to be effective from 1st April 2012, i.e. assessment year 2012-13 onwards, it has to be treated as being retrospective in view of the law laid down in a Supreme Court's five judge constitutional bench's landmark judgment in the case of Vatika Townships Pvt Ltd[7] wherein it was held that *"if a legislation confers a benefit on some persons but without inflicting a corresponding detriment on some other person or on the public generally, and where to confer such benefit appears to have been the legislators object, then the presumption would be that such a legislation, giving it a purposive construction, would warrant it to be given a retrospective effect."*

Following the ratio of SC ruling, ITAT held that operation of Rule 10AB which confers the benefit of an additional method of ascertaining arm's length price and, inter alia, relaxes the rigour of CUP method, can only be retrospective in effect. Thus, applying the 'Other Method', the ITAT held that the controlled transaction was at arm's length; and in essence approved the methodology of splitting the revenue on a 50:50 proportion basis.

Conclusion

The purposive construction applied by the ITAT in trying to analyse the business model of the taxpayer, and in giving a retrospective effect to the 'Other Method' probably had one focus that the aim of Section 92(1) was to determine the fair arm's length price of the controlled transaction, and the specified methods are nothing but a tool to achieve this purpose. Chapter X should not be viewed as a rigid structure, but only a means to fairly evaluate the essence of the business setting from wherein the transaction emanates.

The Delhi ITAT also recently in two cases *viz* Toll Global Forwarding Pvt India for AY 2007-08[8] and Geodis Overseas Private Ltd[9] have also relied on the same principles as held in Toll Global Forwarding Pvt India for AY 2006-07 as stated above.

2. *Watson Pharma Private Limited*[10]

Facts of the case

Watson Pharma Private Limited (the taxpayer), a wholly owned subsidiary of Watson Laboratories Inc. (Watson Inc.) was engaged in contract manufacturing for its AEs and provided contract research and

[7] CIT Vs. Vatika Townships Pvt Ltd (2014 TIOL 78 SC)

[8] Toll Global Forwarding India Pvt Ltd Vs. ITO Ward 2(2), ITA No. 774/Del/2012, AY 2007-08, Pronounced on 18.11.14

[9] Geodis Overseas Pvt Ltd Vs. DCIT Circle 12(1), ITA No. 916/Del/12, 5825/Del/11and 6289/Del/12, AY 2006-07, 2007-08, 2008-09, Pronounced on 18.11.14

[10] M/s. Watson Pharma Pvt Ltd Vs. DCIT [ITA No. 1423/Mum/2014 & 1565/Mum/2014], AY 2009-10

development services to its AEs. For these transactions, the taxpayer was compensated by its AEs on a total operating cost plus arm's length mark-up. The taxpayer used TNMM as the MAM to benchmark the said transactions.

The TPO/ DRP made primary adjustment on account of locations savings, purportedly accruing to AEs owing to transfer of these activities from the USA (location of the AE) to India subject to FDA norms. According to the TPO, the taxpayer ought to have received extra compensation on account of location savings over and above the margins earned by the comparables and computed location savings based on certain articles appearing in some journal and websites. The location savings so computed was then allocated on an ad-hoc basis by dividing the savings equally between the taxpayer and the AEs. The ITAT deleted the adjustment citing several reasons, notably including the following:

Key Observations and decision of the Mumbai ITAT

- Revenue authorities were unable to substantiate their adjustments from any authenticated/ global material. Further, non-submission of records could not form the basis of making adjustments in ALP on bald assertions. Therefore, one of the reasons for making the ALP adjustment was without any basis. Reliance was placed on the Mumbai ITAT decision in the case of UCB India (P) Ltd.[11]

- The taxpayer as well as the AE operates in a perfectly competitive market and the taxpayer does not have exclusive access to the factors that may result in the location specific advantages. As a result, there is no super profit that arises in the entire supply chain. Thus there is no unique advantage to the taxpayer over competitors.

- Comparables selected by the taxpayer to determine ALP of transaction relating to contract manufacturing and contract research and development are local Indian comparables operating in similar economic circumstances as the taxpayer.[12]

- The articles relied upon by the TPO were web articles and not accepted by any forum, and reliance on them could thus not be treated as acceptable. Further, these articles were published in 2012 whereas the taxpayer's case related to FY 2008-09, and thus interpolation could not be taken into consideration, unless specified.

[11] UCB India (P) Ltd . vs ACIT, reported in 124 TTJ 289

[12] Reliance placed on the decision of the co-ordinate bench of the Delhi ITAT in the case of GAP International Sourcing (India) Pvt Ltd vs. ACIT [149 TTJ 437] and on the OECD Guidance on Transfer Pricing Aspects of Intangibles (released pursuant to Action 8 of OECD/ G20 BEPS Project). Tribunal noted that G-20 countries had given their concurrence to this position, and India was a part of G-20.

- The TPO arrived at the cost savings to AEs on the basis of articles which provided an analysis of costs undertaken in different jurisdictions. If at all this aspect was to be considered, it had to be in the context of the taxpayer, and not the AE. This was because the taxpayer was the tested party, and the international transaction had to be tested by comparing the same with uncontrolled comparable transactions, and not in the context of the AE. Therefore, financial results of the AE were not relevant, and any benefit/ advantage to the AE was irrelevant if the profit level indicator (PLI) of the taxpayer was within the range of comparables.[13]

- International judicial precedents relied upon by the TPO related to fiscal years 1970 and 1980 when the economic scenario was completely different (primitive) as compared to the current economic scenario. Further, in those cases, taxpayers were not operating in a perfectly competitive market, unlike the taxpayer in the instant case. Those taxpayers instead operated in monopolistic economic situations and there were intangibles held by, or transferred to them.

- Incorrect reliance was placed by the TPO on the UN TP manual, which was a view of the Indian tax administration and was not binding on appellate authorities.

- Facts remaining the same, no adjustment was made in the preceding assessment year on account of location savings, and therefore, the TPO's approach was inconsistent. The ITAT cited various case laws which the taxpayer had relied upon in this context.[14]

- Method followed by the TPO in making the adjustment was not prescribed by the provisions of the Act, and hence his computation was based on an incorrect method.

Conclusion

Based on all of the above, the ITAT concluded that the TPO erred in making the adjustment on account of location savings, and eventually deleted the same. It covers technical arguments including the India Chapter in the UN TP Manual and the OECD BEPS Action 8: Guidance on Transfer Pricing Aspects of Intangibles related to the issue of location savings. The Tribunal has clarified that such arguments are not binding on appellate authorities. The ITAT has also brought out and upheld the rule of consistency if facts have remained unchanged.

[13] Reliance placed on the decision of Mumbai Tribunal in the case Syscom Corporation Ltd. vs ACIT, reported in 35 taxmann.com 600

[14] McCann Erickson India Pvt Ltd (ITA No. 5871/Del/2011), Brintons Carpets Asia P Ltd. vs DCIT (ITA No. 1296/Pune/2008)

3. ***Vodafone India Services Pvt. Ltd***[15]

Facts of the case

The taxpayer, Vodafone India Services Pvt. Ltd., is a wholly owned subsidiary of a non-resident company, Vodafone Tele-Services (India) Holdings Limited. The taxpayer required funds for its telecommunication services project in India. Thus, it issued 2,89,224 equity shares of the face value of INR 10/- each on a premium of INR 8,509/- per share to its holding company which was determined in accordance with the methodology prescribed by the Government of India under the Capital Issues (Control) Act, 1947.

However, the AO / TPO valued each equity share at INR 53,775/- and on that basis made an adjustment of INR 45,256 per share (amounting to INR 1308.91 crores), by treating the shortfall in premium as income. Further, as a consequence of the above, the AO/ TPO treated the same as deemed loan given by the taxpayer to its holding company and also contended that periodical interest of INR 88.35 crores had to be charged to tax as interest income.

The taxpayer filed a Writ Petition (Vodafone-III) before the HC challenging the jurisdiction of the AO/ TPO to tax the above transaction of issue of shares considering that the same did not generate any income as defined under the Act. Further, the HC in Vodafone-III accepted the plea of the taxpayer and directed the DRP to first decide only the preliminary jurisdictional issue raised by the taxpayer. Consequent to these directions, the DRP considered the issue of jurisdiction and rejected the taxpayer's preliminary objection thereto.

Hence, the taxpayer filed a Writ Petition (present) before the HC, challenging the DRP's order which had held that the AO/TPO had jurisdiction to tax such shortfall in receipt of premium under Chapter X of the Act, as income arose in the above international transaction.

Key observations and decision of the Bombay HC

The word income as defined in section 2(24) of the Act, though an inclusive definition, cannot include capital receipts unless it is so specified, as in section 2(24)(vi) of the Act. Further, capital gains chargeable to tax under section 45 of the Act are, defined to be income. The amounts received on issue of share capital including the premium were undoubtedly on capital account. Therefore, due to absent express legislation, no amount received, accrued or arising on capital account transaction can be subjected to tax as income[16];

[15] Vodafone India Services Pvt. Ltd. vs. Union of India, Additional Commissioner of Income-tax, DCIT, DRP-II [Writ Petition No. 871 of 2014]

[16] Reliance placed on the decision of Bombay High Court in the case of Cadell Weaving Mill Co. vs. CIT [249 ITR 265], which was upheld by the Apex court in CIT v. D. P. Sandu Bros. Chember (P) Ltd. [273 ITR 1]

The High Court followed the principle of ex abundanti cautela (out of abundant caution), rejecting the assertion by the tax authorities that, as the taxpayer had itself reported the transaction in Form No. 3CEB, it could not raise the issue of jurisdiction to apply Chapter X of the Act.

Further, the Hon'ble HC did not accept the Revenue's contention that Chapter X of the Act is a complete code by itself and not merely a machinery provision to compute the ALP. The HC also did not accept that, it is a hidden benefit of the transaction which is being charged to tax and the charging section is inherent in Chapter X of the Act. It is a well settled position in law that a charge to tax must be found specifically mentioned in the Act i.e. in the absence of there being a charging Section in Chapter X of the Act, it is not possible to read a charging provision into Chapter X of the Act. There is no charge express or implied, in letter or in spirit to tax issue of shares at a premium.

The Hon'ble HC did not accept the Revenue's contention on the applicability of section 92(2) and concluded that section 92(2) would have no application in the taxpayer's case, as there was no occasion to allocate, apportion or contribute any cost and/or expenses between the taxpayer and the holding company.

The Hon'ble HC also did not accept the Revenue's contention that in view of Chapter X of the Act, the notional income is to be brought to tax and real income will have no place. With regards to the same, the HC observed that the revenue seems to be confusing the measure to a charge and calling the measure a notional income.

The HC observed that the Parliament consciously has not brought to tax amounts received from a non-resident for issue of shares, as it would discourage capital inflow from abroad;

The HC further noted that income tax is not a tax on capital receipts. The issuance of shares at a premium is a capital account transaction and not income. The classical distinction between income and capital is that which exists between a fruit and a tree. Income is a flow, while capital is a fund. The High Court relied on the decision in the Shaw Wallace case, which stated that "income has been likened pictorially to the fruit of a tree or the crop of a field".[17]

Chapter X of the Act is a machinery provision to arrive at the ALP of a transaction between AEs. The substantive charging provisions are found in Sections 4, 5, 15 (Salaries), 22 (Income from house property), 28 (Profits and gains of business), 45 (Capital gain) and 56 (Income from other Sources) of

[17] CIT v. Shaw Wallace & Co. Ltd., 6 ITC 178 (PC)

the Act. Relying on the observations of Supreme Court in the case of B. C. Srinivas Shetty[18], the HC held that a machinery section cannot be read de-hors the charging section. Thus, the HC observed that even international transaction between AEs must satisfy the test of income under the Act and must find its home in one of the above heads i.e. charging provisions.

Based on all the above reasons and findings, the HC concluded that the issue of shares at a premium by the taxpayer to its non-resident holding company does not give rise to any income from an admitted international transaction. Thus, there was no occasion to apply Chapter X of the Act in such a case. Regarding the subsequent secondary adjustment of notional interest income, the High Court held that such an adjustment may not be sustained, as it is based on mere estimates and assumptions that the taxpayer "would have invested the same", which is not acceptable. The High Court quashed all the orders of the tax authorities (i.e. those of the assessing officer, transfer pricing officer and Dispute Resolution Panel) and set them aside as being without jurisdiction, null and void.

Other Connected decisions

1. Shell India Markets Pvt. Ltd. v. ACIT et al., Writ Petition 1205 of 2013
2. Equinox Business Parks Pvt. Ltd. v. Union of India et al., Writ Petition 1273 of 2014
3. Leighton India Contractors Pvt. Ltd. v. Union of India et al., Writ Petition 732 of 2014
4. Essar Projects (India) Ltd. v. Union of India et al., Writ Petition 1399 of 2014

Conclusion

This judgment reinstates the first principles of taxation under the Act. It has brought out the important aspect of the jurisdictional issue for the applicability of Chapter X. It re-emphasises that Chapter X of the Act is a machinery section and not a charging section.

The Bombay High Court quoted a passage by Rowlatt J. in the *Cape Brandy Syndicate* case,[19] approved by the House of Lords in the *Canadian Eagle Oil Co. Ltd.* case,[20] to emphasize the above: *"In a taxing Act, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used".*

The above principle was restated by Justice J.C. Shah (as he then was) in the *Modi Sugar Mills* case, as follows:

[18] CIT v. B. C. Srinivas Shetty 128 ITR 294

[19] Cape Brandy Syndicate v. Inland Revenue Commissioners, (1921) 1 KB 64 (statement by Rowlatt J.)

[20] Canadian Eagle Oil Co Ltd v. The King, 27 TC 205

"In interpreting a taxing statute, equitable considerations are entirely out of place. Nor can taxing statutes be interpreted on any presumptions or assumptions. The court must look squarely at the words of the statute and interpret them. It must interpret a taxing statute in the light of what is clearly expressed."[21]

The Vodafone judgment demonstrates that there is a conceptual difference between transfer pricing literature and the scope of Indian domestic tax law, to bring within its net all such concepts debated in such literature.

Further, the CBDT vide an Instruction[22] has accepted the above decision and directed that the ratio decidendi of the judgment must be adhered to by the field officers in all cases where this issue is involved; *"wherein the Court has held, inter-alia, that the premium on share issue was on account of a capital account transaction and does not give rise to income and, hence, not liable to transfer pricing adjustment"*. Also, the acceptance of the decision by the CBDT would mean that no further appeal is to be filed against the Bombay High Court decision before the Supreme Court.

4. *Cushman and Wakefield India Private Limited*[23]

Facts of the case

Cushman and Wakefield India Private Limited (the taxpayer), a subsidiary of M/s Cushman and Wakefield Inc, its US-based parent company, is engaged in the business of providing services connected to acquisition, sales and lease of real estate and other services such as the provision of advice and research on such matters & project management. These services are provided to several clients within and outside India.

The taxpayer entered into six international transactions with its AE for AY 2006-07, out of which two of its international transactions *viz.* payment of referral fees to AE of INR 1,73,26,631 and reimbursement of expenses to its AEs of INR 1,06,39,865 were the subject matter of appeal before the HC.

Key Observations and decision of Delhi ITAT

- *Reimbursement of expenses*

TPO found that no intra group services existed in this case and disallowed the said expenditure after considering the transfer pricing report provided by the taxpayer. The AO, on the basis of TPO's order, made a draft assessment order disallowing the said reimbursement expenses as no benchmarking of the costs claimed as reimbursement has been conducted. The DRP concurred with this finding, which

[21] Sales Tax Commissioner v. Modi Sugar Mills, 1961 (048) AIR 1047
[22] CBDT, 29 Jan. 2015, Instruction No. 02/2015
[23] CIT Vs. M/s. Cushman & Wakefield India Private Limited, ITA No. 475/2012

formed the basis of the AO's final assessment order.

On appeal before the ITAT, the ITAT held the issue in favour of taxpayer, on the ground that AEs have, in accordance with the agreements concluded; only charged costs without any mark-up. It was submitted that on reference to any other uncontrolled transaction, the amount payable by the taxpayer would necessarily be greater, as the cost would be supplemented with some profit margin. The ITAT's approach is statutorily sanctioned under section 92(3), which states that the provisions of section 92 will not apply if the result of the ALP determination is a reduction of the overall tax incidence.

Key Observations and decision of the Delhi High Court

High Court divided this issue in two parts:

- *Whether services have indeed been provided by AEs to the assessee?*
- *Whether these services ought to be benchmarked to determine to ALP considering the provisions of Section 92(3)?*

HC observed that when a third party in an uncontrolled transaction with the taxpayer would have charged amounts lower, equal to or greater than the amounts claimed by the AEs and taxpayer had to *perforce* be tested under the various methods prescribed in section 92C of the Act. This being a transaction between related parties, whether that cost itself is inflated or not, is a matter to be tested under a comprehensive transfer pricing analysis. The taxpayer did not benchmark these costs in its transfer pricing study.

TPO did not conduct any transfer pricing study nor stated that the amount claimed were at ALP. He, instead disallowed the expenditure altogether on the ground that there were no services rendered to begin with. The ITAT overruled the finding of the TPO on that limited ground, but did not concern itself with a transfer pricing analysis as contemplated under section 92; to the contrary, it accepted the taxpayer's stated return (absent any benchmarking) as the true and correct value under an implicit (and incorrect) understanding of section 92(3) of the Act.

The precise activities conducted by the AEs for the benefit of the taxpayer out of the entire range of activities conducted by it, and the cost applicable to such activities had not been provided. The details of the specific activities for which cost was incurred by AEs and the benefit to the taxpayer were not considered. This must be provided, in addition to a consideration of the ALP *vis-à-vis* the total cost claimed by these AEs. To this extent, for the consideration of ALP in respect of these transactions, the matter was remanded back to the file of the concerned AO, for an ALP assessment by the TPO, followed by the AO's assessment order in accordance with law.

- *Payment of referral fees*

  The taxpayer paid certain referral fees to its AEs on account of business generated through AEs, calculated @ 19% of the revenue generated. The taxpayer claimed that it was normal practice to pay referral fees to the persons referring the business. The TPO accepted the transaction to be at arm's length.

  However, the AO held that there was no evidence regarding services provided by the group entities. He rejected evidence presented by the taxpayer, in the form of emails, observing that emails were cryptic and details like name of the client, nature of requirement, etc. were not mentioned in the emails. The AO accordingly disallowed the deduction for expenses.

  The ITAT held that the order of TPO was binding on the AO u/s 92CA(4) of the Act as amended by Finance Act, 2007 with effect from 1 June 2007. ITAT further held that once the ALP was determined by the TPO, the AO did not have any jurisdiction to re-examine the transaction. ITAT also reversed the disallowance on merits.

Key Observations and the decision of the High Court

HC observed that powers of the AO u/s 37 and powers of TPO u/s 92CA of the Act are different. HC observed that a referral by the AO to the TPO is only for the limited purpose of determining the ALP, based on a prima facie view that such a referral is necessary. It does not imply a concrete view as to the existence of services, or the accrual of benefit (such that allowance under Section 37 must be permitted).

Referring to ITAT ruling in Deloitte Consulting[24] and HC ruling in Sony India[25], HC observed that the AO can hold that expenditure has not benefited the taxpayer and therefore, disallow it. This would not restrict or bypass TPO's function. The decision as to whether the expenditure was *"laid out or expended wholly and exclusively for the purposes of the business"* is a fact determination or verification to be undertaken by the AO. Authority of AO under section 37 is not curtailed by a reference under section 92 of the Act.

The HC further noted that post 2007, TPO's determination of ALP for the referral transaction of the taxpayer was binding on AO. Therefore, AO was not correct in holding that referral fee was not at ALP. But, the AO can however, check if services or work were actually rendered as claimed by the taxpayer and if the services are genuine or real. HC observed that ITAT was not right in concluding that since the expenditure was accepted as at ALP by TPO, AO could not have disallowed it u/s 37 of the Act.

[24] Delloite Consulting India Pvt. Ltd. v. DCIT, [2012] 137 ITD 21 (Mum)

[25] Sony India Pvt. Ltd. v. Central Board of Direct Taxes and Anr., [2007] 288 ITR 52 (Delhi)

Conclusion

The HC set aside ITAT's order on both the issues and directed fresh determination as per its guidelines.

The HC's decision on the role of the AO/TPO seems to suggest that though an arm's length evaluation would encompass a complete FAR analysis, and a justification of the price paid/received, the AO could re-examine the issue. This may however, need to be seen from the perspective of the Special Bench decisions of Aztec Software & Technology Services Ltd. v ACIT [(2007) 107 ITD 141 (Bang)] and L.G. Electronics India (P) Ltd v ACIT [ITA No.5140/Del/2011] and the ITAT's decision in M/s. Toyota Kirloskar Motors (P) Ltd v ACIT [IT(TP)A No1642/Bang/2012]. In these decisions it was clearly held that section 92(1) evaluation would in principle encompass evaluation under section 37(1), 40A(2), etc, that is, transfer pricing provisions being special provisions will override the general provisions.

5. *Global Vantedge Pvt Ltd*[26]

Facts of the case

The taxpayer, Global Vantedge Pvt Limited (GV – India or taxpayer) was a subsidiary of Global Vantedge, Mauritius (GV - Mauritius) and which in turn was a wholly owned subsidiary (WOS) of Global Vantedge, Bermuda (GV – Bermuda). GV - India was engaged in rendering information technology (IT) enabled services in the field of credit collection and telemarketing services and was eligible for deduction under section 10A of the Act as a Software Technology Park of India unit.

RCS Centre Crop, a Delaware Corporation (RCS), another WOS of GV – Bermuda, was engaged in the business of contracting with clients located in USA, to provide them debt collection and telemarketing services. RCS had not owned the requisite infrastructure or capacity for execution of that work. Therefore, RCS and GV – India entered into an agreement as per which GV – India was performing the work for clients who entered into a contract with RCS. The agreement was such that once a client is identified by RCS and a contract finalizing the terms of services is entered into with it, a corresponding work order is executed by RCS with GV – India to perform that work. As GV – India and RCS have the common shareholder of GV - Bermuda, which holds more than 26% shares (directly and indirectly), they were associated enterprises (AEs) and therefore, fees received from RCS for provision of services to end customers was subject to TPR in India.

During the financial year (FY) 2002 - 03, GV – India received INR 8,32,66,596 from RCS for client services by the taxpayer (which was 90.6% of the revenue earned by RCS from clients). In addition to rendering services to clients of RCS, GV – India had also rendered services to other independent clients

[26] Global Vantedge Pvt Ltd Vs DCIT [2010-TIOL-24-ITAT-DEL], AY 2003-04 and AY 2004-05

which formed approximately 18% of the total revenue earned by GV – India. GV – India also suffered a loss and considered its AE as the tested party for benchmarking the transaction between GV – India and RCS, by comparing the profit margin of RCS with average margin of foreign comparable companies in its transfer pricing report.

The Assessing officer (AO) made a reference to TPO under section 92CA(1) of the Act for determination of ALP in respect of the above transaction. The TPO, after analyzing the international transactions and business model, concluded that the AE cannot to be taken as a tested party. The TPO chose the taxpayer itself as the tested party and arrived an average operating margin of 11.88% (on total operating cost) as ALP by using Indian comparables as against the loss of 53.5% incurred by the taxpayer. Accordingly, the TPO made an upward adjustment to the extent of INR 14,70,10,071 in relation to service charges received from RCS.

The Commissioner of Income-tax [CIT(A)] granted partial relief in favour of the taxpayer by holding that the total adjustment together with the ALP cannot exceed the total revenue earned by the taxpayer and its AE from third party independent clients and accordingly, the transfer pricing adjustment was reduced to INR 83,88,625. Further, both the taxpayer and the department filed the appeal before the ITAT against the order passed by the CIT(A).

Key Observations and the decision of Delhi ITAT

- *Revenue Sharing Arrangement*

In the revenue sharing arrangement between the entities, what may be questioned is the proportion of sharing between the entities and not the absolute amount of revenue itself which is the subject of sharing, because that is beyond the control of either the taxpayer or its AEs. This is in view of the fact that the Indian TPR only require analyzing the transactions between AEs and not the transactions with third parties, since extraneous factors cannot be controlled. Moreover, if an entity is unable to earn adequate profits on account of legitimate business exigencies and not due to manipulation of transactions undertaken by the AEs, such entity cannot be penalized.

In the case of a revenue sharing model between two entities (say A & B), it may be contended that the amount of revenue received by an entity (say entity A is lower than the fair amount of revenue receivable by it is due to the other entity (say entity B) receiving a larger share. Such unfairness may be mitigated by requiring the entity B to retain only its fair share and give up the balance amount in favour of entity A. In the worst case, entity B may be required to give up its entire share of revenue which would result in entity A receiving 100% of the revenue. However, it cannot be logical to say that the fair amount of revenue to be received by entity A is more than 100% of the total revenue earned by both A and B. Under such circumstances, entity B will have to pay the additional amount from its internal

sources which in addition to being a highly absurd proposition, may also lead to the bankruptcy of B since this cannot be sustained over a period of time.

Therefore, applying the above logic and considering the revenue sharing arrangement between the parties; the total adjustment made in the hands of the taxpayer together with the ALP already reported by it cannot exceed the total revenue earned by the taxpayer and its AE from third party customer.

- *Compensation for Marketing Function*

  While determining the fees payable to any agency responsible for marketing, the complexity of the process being outsourced, the operating margins that the service provider is expected to earn, the size of the contract, etc. all play an important role. Accordingly, based on the report on Indian BPO Industry prepared by INGRES, a division of ICRA Ltd., the industry average (average expenditure on selling expenses in the software industry) for FY 2003 at 1.40% is very much reliable and hence, 1.40% of the revenue is adequate to compensate RCS for its marketing function.

- *Application of TNMM*

  In cases where TNMM is used as the MAM to determine the ALP, the TNMM as the name itself suggests, evaluates profitability of transactions rather than profitability of an enterprise. Accordingly, while applying the TNMM to determine ALP, the revenue earned by the taxpayer from servicing third parties, without any involvement of AE, should not be considered, as these are uncontrolled transactions. Thus, the adjustment to the ALP was to be limited to the international transactions.

- *Adjustment to the Comparables (Idle capacity and Working capital adjustment)*

  In case the comparable companies have substantial related party transactions, the same should be rejected. Further, the data of comparables to be used for determining the ALP should be contemporaneous. As the taxpayer was in start up phase, the adjustments on account of surplus capacity should be made to the comparables.

Conclusion

This decision brings out the importance of an end-to-end analysis of the controlled transaction, and that transfer pricing cannot be viewed as a one dimensional study, but as a holistic analysis of the complete value chain, provided that the documentation supports such analysis. The revenue authorities filed an appeal before the Hon'ble Delhi High Court (HC)[27] where the appeals were dismissed. Further, the

[27] CIT Vs. Global Vantedge Pvt Ltd, ITA No. 1828/2010, ITA No. 1829/2010, ITA No. 1254/2011

Supreme Court (SC)[28] also dismissed the Special Leave Petition filed against the Delhi High Court's order.

Way Forward

The revenue authorities' perspective of transfer pricing law and its practical implications, coupled with the jurisprudence in India, tends to suggest that the risk faced by MNEs, is not only from the standpoint of tax risk, but also reputational risk. In a modern world where there is greater and greater convergence due to global connectivity, it is incumbent upon the taxpayers to demonstrate the adherence to law not only by letter but by spirit also.

MNEs will have to consider the Indian transfer pricing issues from a critical viewpoint. The current global scenario depicts that even the developed economies are now extremely zealous of protecting their tax base, and the Indian revenue authorities approach also seems to be in the same light.

To reduce transfer pricing risk, documentation of the complete transfer pricing analysis from an end-to-end perspective, which brings out the true economic substance of the controlled transactions, the depiction of risks undertaken and other relevant business analysis probably holds the key for such reduction. The importance given by the appellate authorities to the FAR analysis, comparability analysis and selection and application of MAM, are the key takeaways for the taxpayers. This again reiterates that a mechanical approach to transfer pricing, with mere stress on quantification, will not be sufficient to protect the taxpayer and discharge his burden of proof as required by the Indian TPR.

[28] CIT Vs. Global Vantedge Pvt Ltd, [CC 21808/2013]