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India Transfer Pricing Alert

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First Ruling by Income Tax Appellate Tribunal on Transfer Pricing

This Alert summarises a recent decision of a Special Bench of the Income Tax Appellate Tribunal, Bangalore in the case of a transfer pricing adjustment to an Indian software services company

Executive Summary

- *Legal Positions*

The Special Bench, in conformity with the Delhi High Court's ruling in Sony India's case in October 2006, has held that the procedural requirements for transfer pricing assessments were valid.

- *The Assessing Officer [AO] is not obligated to demonstrate tax avoidance before invoking transfer pricing provisions*
- *The AO is not required to satisfy himself that arm's length price ("ALP") is incorrect [conditions of section 92C(3)of the Act] before making a reference to the Transfer Pricing Officer [TPO]*
- *There is no need to record reasons or provide an opportunity of being heard to the taxpayer before seeking the approval of Commissioner for making a reference to the TPO*
- *Internal instructions issued by The Central Board of Direct Taxes [CBDT]requiring the AO to refer all cases with aggregate international transactions of more than Rs. 5 crores to a TPO are binding on AOs and are legally valid*

- *Transfer Pricing Analysis*

Further, on transfer pricing principles, the Special Bench has laid down certain positions:

- *Reference can always be made to the OECD commentary for resolving transfer pricing disputes*
- *Units availing of tax holidays under Sections 10A/10B would also be subject to transfer pricing rules*
- *Proper application of the CUP method requires strict product comparability and hence industry averages cannot be used unless such comparability criteria are met*
- *Burden of proof to establish ALP principally lies with the taxpayer*
- *Appellate authorities are under an obligation to determine the ALP. and mere rejection of the TPO's analysis is not sufficient*

FACTS OF THE CASE

Aztec India provides software development services to unrelated customers located mainly in the United States (“ the US”). Aztec India is eligible for a tax holiday under section 10A of the Income tax Act, 1961 (the “Act”). The taxpayer has a wholly owned subsidiary (“Aztec US”) in the US which renders marketing services and onsite software services to Aztec India under the terms of an agreement. In consideration for the services rendered, Aztec US charged Aztec India on a cost plus basis. The mark-up was agreed at 10% for marketing services and 5% for onsite software services.

As the value of international transactions of Aztec India was more than Rs. 5 Crore, a reference was made to the Transfer Pricing Officer (“TPO”) in accordance with the internal circular issued by the Central Board of Direct Taxes (“CBDT”). The TPO rejected the transfer pricing analysis undertaken by Aztec India on multiple grounds. Subsequently, on the basis of the TPO’s order, the Assessing Officer (“AO”) made adjustments to the total income of the taxpayer. Aggrieved with the AO’s order, the taxpayer preferred an appeal with the Appellate Commissioner of Income Tax [“CIT(A)”].

RULING OF THE CIT(A)

The CIT(A) passed its order on the appeal filed by the taxpayer and decided the matter in favor of the taxpayer both on procedural as well as on legal grounds. The main grounds of decision of the CIT(A) are summarised below:

1. Transfer pricing provisions are special provisions relating to avoidance of tax and should be invoked by the AO only when he is satisfied that there is a motive and act by the taxpayer to avoid taxes in India.
2. Reference to TPO to be made only when “necessary or expedient” to do so.
3. Reference merely on the basis of value of the international transactions is bad in law.
4. An order of the TPO is not necessarily binding on the AO.
5. Use of industry averages for the purpose of comparability is inappropriate.

Being aggrieved by the CIT (A) ruling, the Revenue filed an appeal before the Bench. Further, the taxpayer also filed a cross appeal against the CIT(A) order.

For a detailed analysis of the ruling please refer to our Tax Alert of May 2006

PRONOUNCEMENT BY THE BENCH

The decision pronounced by the Bench primarily covers the following transfer pricing (“TP”) issues:

- Legal positions raised before the Special Bench, and
- Certain transfer pricing principles arising from the orders of the TPO and CIT(A).

ANALYSIS

The questions of law adjudicated by the Bench and the decision pronounced are summarised below:

- ***Legal Positions***

1. Is there a legal requirement for the AO to prime facie demonstrate tax avoidance before invoking TP provisions?

The question was **decided in favour of the Revenue** as under:

- Where the language of the statute is clear and unambiguous, there is no need for the Courts to find the intent of the legislature. Since the language used by the legislature is plain and unambiguous, there is no basis to say that the AO must demonstrate the avoidance of tax before invoking these provisions.
- Commenting on the question of applicability of transfer pricing in case of tax exempt units, it was held that since a specific reference has been made in the legislation to say that no exemption would be allowed if a transfer pricing adjustment is made in the case of tax exempt units, it is abundantly clear that Legislature did comprehend the situation requiring additions on account of TP adjustments in case of tax exempt units. Hence, it is difficult to contend that an ALP should not be determined where the taxpayer is entitled to a tax exemption under sections 10A/10B.

2. Before making a reference to TPO, is the AO required to form an opinion to the effect that the ALP has not been correctly determined by taxpayer, or transfer pricing documentation has not been properly maintained or incorrect data has been used or the required information has not been furnished by the taxpayer?

The question was **decided in favour of the Revenue** as under:

- The conditions for making a reference to TPO (Section 92CA (1) are in no manner linked to conditions mentioned in the question above. The AO has only to be satisfied that it is “necessary” or “expedient” to make a reference to the TPO. No other condition is prescribed in this section. Had

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the legislature wanted the same conditions to be fulfilled, it would have provided similar conditions instead of conditions of ‘necessary’ or ‘expedient’.

3. Is the AO required to record his opinion/reasons before seeking approval of the Commissioner?

The question was **decided in favour of the Revenue** as under:

- Discretion is given to the AO to refer the case to a TPO if he considers that it is suitable, appropriate, profitable or convenient to the Revenue and it is not mandatory for him to consider it both necessary and expedient. There is nothing in the section to suggest that the AO should hear the taxpayer or record reasons before making a reference to the TPO.

4. Is it a condition precedent that the AO shall provide to the taxpayer an opportunity of being heard before making a reference to the TPO?

The question was **decided in favour of the Revenue** as under:

- The AO is not required to follow natural justice at every stage. However, if any material is used against the taxpayer, then it should be brought to the knowledge of the taxpayer. Mere reference does not tantamount to any adverse assessment and no civil rights of taxpayer are violated Hence, there is no need of providing an opportunity of being heard.

- The Bench also drew an interesting analogy that despite having similar language in the charging section for regular assessment, it has never been contended that before issuing a notice, the AO should record reasons or that he should hear the taxpayer.

5. Is the approval granted by the Commissioner justifiable? If so, can it be appealed on grounds that it was accorded with due diligence or proper application of mind?

The question was **decided in favour of the Revenue** as under:

- The Bench held that the directions of CBDT Circular are mandatory and binding on the Commissioner. Further, it was concluded that the Commissioner cannot grant approval in a mechanical manner and it is responsible to ensure that the AO has complied with the internal instructions.

6. What is the legal effect of internal instruction issued by the CBDT requiring reference of all cases where aggregate international transactions exceed Rs. 5 crores to TPO

The instruction is **binding on the Revenue** :

- The Bench held that the circulars are binding on the Revenue . Further, when provisions are read with the CBDT’s Circular, the AO has no discretion in the matter in light of the limit fixed by the board.

- The Hon’ble Delhi High Court in the case of Sony India has also upheld validity of the internal directions issued by the CBDT.

7. Is the AO bound by the order of the TPO?

Prior to April 1, 2007, the AO is not bound by the order of the TPO:

- Concurring with the Delhi High Court in the case of Sony India, the Bench held that the order of the TPO was not binding on the AO. This implies that the taxpayer could file evidence before the AO and demonstrate that an ALP should be accepted.

- However, the Bench also commented that the AO should ordinarily not challenge the transfer pricing determined by the TPO without strong reasons.

- Subsequent to amendment made by the Finance Act 2007, the TPO’s order is binding on the AO.

- ***Transfer Pricing Analysis***

1. Unadjusted industry average benchmarks cannot be used as comparable uncontrolled price

Relying on the OECD TP Guidelines and the US TP Regulations on the issue, the Bench held that **the use of unadjusted industry average returns by the TPO was not valid and should be set aside**. The bench while recognising that the data to be used should be public data, also observed that data from public exchanges, media quotations etc should not be used in extra-ordinary circumstances such as war, economic depression etc.

The Bench also criticised the TPO for not making any adjustments to the NASSCOM industry rates to account for transactional level differences and rejected the TPO’s analysis on the ground that such arbitrary approach cannot meet any judicial approval.

2. Typically, the service provider should be used as tested party while applying the TNMM

The Revenue had rejected the Transactional Net Margin Method (“TNMM”) used by Aztec India based on the contention that the Rules require computation of net margin

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realised by the taxpayer (and not foreign AE) from the relevant international transaction and benchmarking it against the net margin earned by it from a comparable uncontrolled transaction or net margin earned by another unrelated enterprise from a comparable uncontrolled transaction.

In response to the same, the Bench commented that ordinarily the **tested party has to the party providing services because it is on the basis of rate of return on sales or cost or operating assets** that transactional margin is computed.

3. Impact of prior year data needs to be demonstrated while using multiple year data

The Bench has implicitly observed that use of prior year data is justifiable if it can be demonstrated that such prior year data had any influence on the determination of ALP.

4. The TPO has to reject the method used by the taxpayer

The Bench held that any changes in the most appropriate method adopted by the taxpayer have to be dealt with by way of a speaking order. While the TPO is free to collect independent relevant information to comparable uncontrolled transactions, he has to reject the method selected by the taxpayer based on proper reasoning. In the present case, the TPO did not reject the TNMM used by the taxpayer while choosing CUP.

5. The CIT (A) should also establish the appropriateness of arm's length determined by the taxpayer and mere rejection of analysis done by TPO is not sufficient.

The Bench set aside the order of the CIT(A) holding that the CIT(A) left his task incomplete by merely deleting the adjustments made by the AO/ TPO and not making any adverse comment on the ALP furnished by the taxpayer. Therefore, **unless the ALP furnished by the tax payer has been specifically accepted, the appellate authorities should, either direct lower revenue authorities to carry this exercise in accordance with law or on the basis of available material determine the ALP themselves.**.

6. Burden of collecting and furnishing requisite inputs for determining the arm' length price is on the taxpayer

In view of international practices and the provisions under the Act that require the taxpayer to maintain prescribed documentation and prescribe penalty in the event of non-compliance of such requirements, the Bench concluded that the law places the burden to select the most appropriate method (MAM) on the taxpayer who has to substantiate the same through an appropriate documentation. However, if the AO has determined an ALP, other then the price declared by the taxpayer, the AO has to prove that the price determined by him is reliable and reasonable and confirms the statutory requirement **The criticism that placing such onerous burden on the taxpayer is uncalled for, was held invalid by the Bench.** It commented that transactions are carried out by multi-national companies across borders and these companies have better access to information regarding conditions prevailing and the comparable transactions available in these geographies. The Bench clarified that almost all countries world over are facing the problem of diversion of income by multi national companies and other enterprises to jurisdictions where the tax burden is least or the lowest. Therefore, almost all countries have similar enactments to tackle this menace.

7. It cannot be contended that in a cost plus arrangement, the company is merely reimbursing third party costs incurred by the service provider and hence the international transaction is not a revenue generating transaction.

The Bench commented that to say that the TPO was bound to take into account only the reimbursement transaction in the same case and not take revenue generating transactions is to stretch things beyond the logical limits when no relevant information was made available by the tax payer. The CIT(A) failed to take into account, the contractual terms and the nature of services rendered, which clearly demonstrate that the US company acted as an independent contractor and not an agent or employee of the tax payer. Hence, it is not the case of reimbursement of expenses incurred by an agent. Further, the Bench concurred with the CIT(A) and rejected the objection of the taxpayer that the transfer pricing mechanism was applicable only to the mark-up component.

IMPLICATIONS

- This ruling is the first Tribunal decision in India encompassing both legal and economic aspects of transfer pricing. Broadly, the ruling has reaffirmed the validity of legal and procedural aspects of the Indian TP legislation, as established by the Delhi High Court in Sony India's case.

- The ruling has also made some practical and insightful observations on application of transfer pricing principles in India, by drawing reference to the OECD TP Guidelines and TP legislations in developed countries.

- Even though this ruling is the most comprehensive one on transfer pricing matters in India till date, there continues to be several areas of controversy, such as applicability of the prescribed arm's length range, acceptance of loss making comparables, updation of comparables, lack of a uniform approach by the Revenue, etc., that are not specifically covered by the ruling.

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