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ITAT ruling relief to captive IT cos facing transfer pricing audit

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THE Indian economy's phenomenal growth in the recent past has been primarily fuelled by the services sector, comprising mainly IT and BPO companies. Several captive IT & ITeS companies are leaders in the contribution they make to the export revenues of the Indian Industry.

Majority of the captive IT and BPO companies in India function as low or stripped risk service providers, with the major market, product, credit, capacity and other associated risks vesting with the parent or principal companies abroad. The captive subsidiaries generally maintain the dedicated workforce and infrastructure, through which seamless delivery of services is ensured. Since captive units work with limited risks and functions, they work on low but steady profit margins. As these units do not face the vagaries of economy, risk of failure of intellectual capital, etc, they are not expected to earn either high profits or incur heavy losses, which would typically be associated with full-fledged entrepreneurial companies.

In the transfer pricing (TP) audits for majority of such captive units of foreign MNCs, taxpayers' TP documentation has been challenged on the basis of comparables hand picked by the revenue authorities, without any focus on the economic realities applicable to these captive units. Essentially, captives have been compared with large BPO/software entrepreneurs in India. The revenue has applied a strange and flawed logic of picking only profitable entrepreneurial companies as comparables while excluding the loss-making companies from the taxpayers' set.

In its first ruling, pronounced by any appellate revenue authority in India on the issue of captive companies, the Income-Tax Appellate Tribunal (ITAT) has decided certain fundamental issues relating to the Indian Transfer Pricing code. The case relates to the transfer pricing of captive software development services rendered by an Indian entity to its overseas parent. The primary issue was the methodology of selection of appropriate comparables for benchmarking profits of the Indian taxpayer in order to evaluate adequacy (or otherwise) of the transfer prices between the Indian entity and its overseas parent.

The taxpayer had carried out a detailed transfer pricing analysis/documentation and had chosen a set of comparables. Such set was, however, rejected by the transfer pricing officer (TPO), and the decision was also upheld by the commissioner (appeals). ITAT, after undertaking an in-depth review of taxpayers' analysis and comparables set, as well as TPO's set, reached certain fundamental conclusions, which would have farreaching implications on almost all transfer pricing cases in India.

ITAT observed that transfer pricing is not an exact science in which mathematical certainty is possible; some approximations cannot be ruled out. It needs to be shown that the transaction was properly examined; comparable prices were objectively fixed in a bonafide manner, as required by law. For this purpose, an in-depth study of all specific characteristics of the transaction needs to be undertaken, including analysis of functions, assets (including intangibles) and risks. A mere broad comparison is not sufficient enough. ITAT ruled that risks are an important consideration in any TP analysis, which are related to the economic principle that greater the risk, higher the return.

ITAT has held that TPO's order had many errors, leading to unsustainable results. ITAT ruled that TPO had failed to consider important characteristics of taxpayer's transactions while finding comparables, thus resulting in serious defects in selection of comparables. TPO had considered comparables having dealings with related parties, which is against the basics of transfer pricing. ITAT concluded that inferences and presumptions were used by the officer, which is not an authorised approach. There was lack of application of mind and arbitrariness in TPO's order.

ITAT held that TPO could undertake a fresh search only if the comparables chosen by the taxpayer were insufficient or deficient. In fact, ITAT constructed a smaller set of companies from taxpayers' set. While doing so, the tribunal mentioned that it was not selecting high-profit or high-loss companies, as the taxpayer worked in a no risk environment. The tribunal also reached the conclusion that the entire range of results/profits of such reconstructed set was representative of an arm's-length range, as in the open market, buyers and sellers would settle for a price anywhere in the range. Accordingly, the tribunal held that so long as the taxpayers' profits fall anywhere in the complete range of comparables, it was sufficient compliance by the taxpayer. Referring to a US Court decision, ITAT observed that an extremely close examination of controlled and uncontrolled entities is essential under transfer pricing. At the end, the tribunal has struck down the transfer pricing adjustment made to taxpayer's income by TPO and reinstated the transfer price of the taxpayer.

This tribunal ruling is a step in the right direction, as it focuses on economic issues and recognises commercial realities of businesses, which are fundamental in any transfer pricing analysis. The emphasis on detailed functions, assets and risk analysis, as well as recognition of the no risk, captive, contract software development support service provider characterisation of the taxpayer is an appropriate evaluation from a TP perspective. The ruling gives a direction to TPOs that once taxpayers undertake due diligence, their analysis cannot be arbitrarily rejected during audits based on inferences and presumptions.

The ruling comes as a welcome relief, as it provides some assurance that taxpayers undertaking due diligence and robust documentation are better placed to face the challenges in India. The ruling would have a persuasive effect and assist in resolving the numerous pending transfer pricing disputes before appellate authorities.

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Views are personal)