Transfer Pricing
Assessments, Safe Harbour, Advance Pricing Arrangement and Case Laws

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Indian Transfer Pricing Regulations
Brief History

2001-02: TP regulations Introduced

2004-05: First year of TP Audits

2009-10: Dispute resolution panel setup

2011-12: Advanced pricing agreement Scheme Notified

2012-13: Safe harbor rules notified, Regulations applicable to domestic transactions

Dispute Resolution

Trend of adjustments over the years

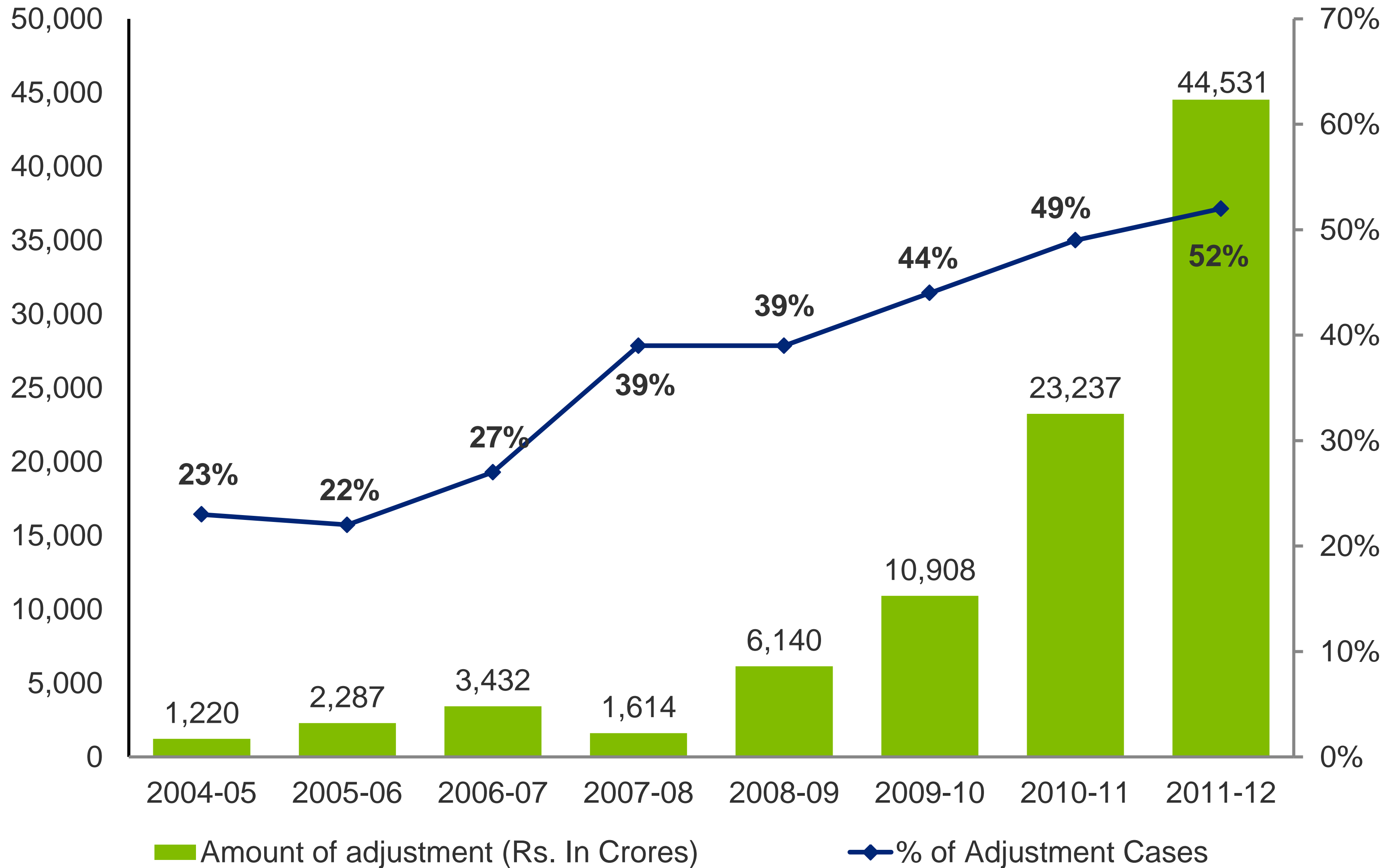
Status of TP assessments

Financial Year	No. of TP Audits Completed	Number of Adjustment Cases	% of Adjustment Cases	Amount of Adjustment (Rs. in Crores)
2004-05	1,061	239	23	1,220
2005-06	1501	337	22	2,287
2006-07	1,768	471	27	3,432
2007-08	219	84	39	1,614
2008-09	1,726	670	39	6,140
2009-10	1,830	813	44	10,908
2010-11	2,301	1,138	49	23,237
2011-12	2,638	1,343	52	44,531

Source: White Paper May 2012, Ministry Of Finance, Department Of Revenue

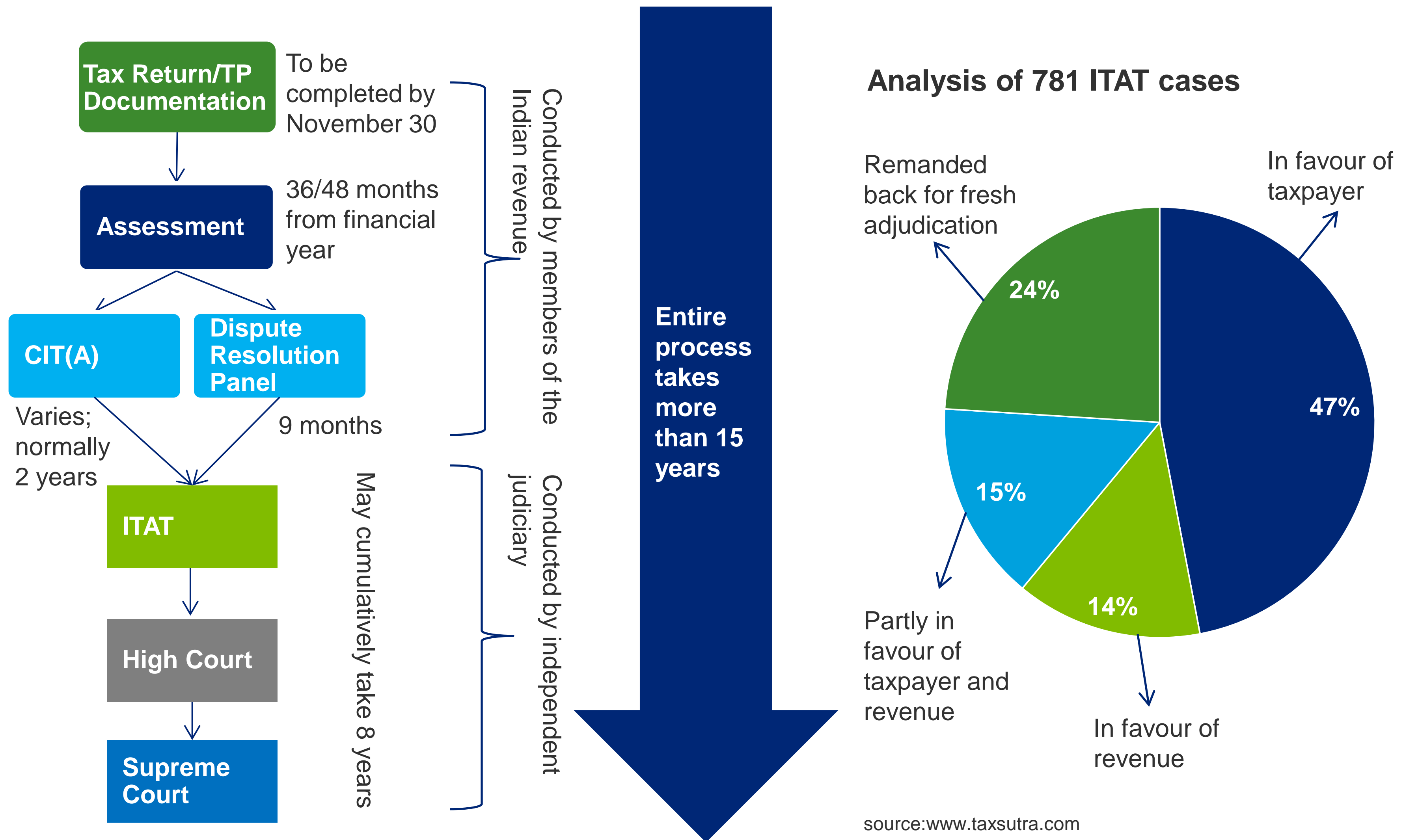
Trend of adjustments over the years

Status of TP assessments



Existing dispute resolution mechanism

Long drawn and uncertain



Dispute Resolution Routines

Reactive Approach

Dispute resolution panel

- Stated purpose not achieved –
  - Perceived bias
  - Amended to permit revenue to appeal against the DRP order
- Lack of fact findings and investigation – lesser room for negotiations
- Tendency to follow earlier order despite different set of facts
- Deferment of cash flow (tax demand)
- Disposal in 9-12 months

Commissioner of Income Tax (Appeals)

- Prolonged delay in disposal – no time limits
- Pressure on cash flows
- Higher interest costs

Income-tax Appellate Tribunal

- Initial trend generally in favor of taxpayer (refer statistical analysis on previous slide)
- A number of “reasonable” judgments; but some level of unpredictability/inconsistency
- Focus on strong footprint of evidence at first stage

Dispute Resolution Routines

Reactive Approach

High Court

- Only substantial question of law can be applied
- Delay in disposal
- Higher Costs
  - Tax and Interest
  - Litigation expense

Mutual Agreement Procedure

- Back log of MAP filings
- MAP negotiated result will be applicable only for single year unlike an APA which can be applied for 5 years forward and 4 years backward

Decision of ITAT's

Statistical analysis

- Focus on detailed and well laid out documentation
- Transfer pricing report
- Develop process map to evidence key "decision nodes"
- Inter-company agreements
- Supporting documents
- Develop alternate arguments / positions
- Evidence of global consistency (wherever possible)
- Indicate willingness to share information

Safe Harbour Rules

Safe Harbour Rules

Background

- Law introduced in India in Finance (No.2) Act, 2009
- Rangachary Committee set up to recommend Safe Harbour Rules for a number of sectors
- Draft Rules, released by Central Board of Direct Taxes in August 2013, are based on the Committee's report
- Consultative approach adopted by the Government in finalizing rules – certain changes were made based on stakeholders comments
- Final rules have been notified in September 2013
- Provide that the transfer price declared by the "eligible assessee" in respect of "eligible transaction", shall be accepted by tax authorities in specified circumstances

Safe Harbour Rules

Key Concepts

- Safe Harbour
  - Circumstances in which income tax authorities shall accept the transfer price declared by the assessee
- Eligible Assesee
  - Person who has exercised valid option for application of safe harbour rules &
  - Is engaged in certain eligible international transaction
- Eligible Transaction
  - Provision of software development service
  - Provision of information technology enabled service
  - Provision of knowledge process outsourcing service
  - Advance of intra-group loan
  - Provision of corporate guarantee
  - Provision of contract research and development service to wholly or partly relating to software development / generic pharmaceutical drugs
  - Manufacture and Export of core auto components / non-core components

Safe Harbour Rules

Key Concepts

- Operating Expense
  - Costs incurred during normal course of operations including “depreciation and amortization” but not including interest, provision for unascertained liabilities, pre-operating expense, loss on account of foreign currency fluctuation, extra-ordinary expense, loss on transfer of assets or investments, expense on account of income-tax and other expense not relating to normal operations

- Operating Revenue
  - Revenue earned during course of normal operations, but not including interest income, income arising on account of foreign currency fluctuations, income on transfer of assets or investments, refund of income-tax, provisions written back, extraordinary incomes and other incomes not relating to normal operations

Safe Harbour Rules

Snapshot

Nature of international Transaction	Condition	Safe Harbour operating margin on operating expenses
Software development services with insignificant risk	Aggregate value of transactions does not exceed Rs.500 crores (Approx USD 80 Mn)	Not less than 20 per cent
	Aggregate value of transactions exceeds Rs.500 crores (Approx USD 80 Mn)	Not less than 22 per cent
IT enabled services with insignificant risk	Aggregate value of transactions does not exceed Rs.500 crores (Approx USD 80 Mn)	Not less than 20 per cent
	Aggregate value of transactions exceeds Rs.500 crores (Approx USD 80 Mn)	Not less than 22 per cent
Knowledge Process Outsourcing (KPO) services with insignificant risk	No turnover threshold	Not less than 25 per cent
Contract R&D services (wholly or partly), with insignificant risk, relating to • software development • Generic pharmaceutical drugs	No turnover threshold	 • Not less than 30 per cent • Not less than 29 percent
Manufacture and export of • core auto components • non-core auto component	90 per cent or more of total turnover are in nature of Original Equipment Manufacturer sales	 • Not less than 12 per cent • Not less than 8.5 percent

Safe Harbour Rules

Nature of international Transaction	Condition	Safe Harbour operating interest rate / fee
Advancing intra-group loan	• To wholly owned non-resident subsidiary • Loan sourced in Indian Rupees • Excludes loans by enterprises engaged in lending or borrowing in the normal course of business • Excludes credit line or any other loan facility with no fixed term for repayment	Interest rate is not less than base rate of SBI as on 30th June of the relevant previous year plus • 150 basis points [where amount of loan does not exceed Rs. 50 crores (approx USD 8 Mn)] • 300 basis points [where amount of loan exceeds Rs. 50 crores (approx USD 8 Mn)]
Providing explicit corporate guarantee	• On behalf of wholly owned non-resident subsidiary • Amount of guarantee does not exceed Rs.100 crores (Approx USD 16 Mn)	Commission or fee at the rate of not less than 2 per cent per annum on the amount guaranteed
	• Amount of guarantee exceeding Rs.100 crores ((Approx USD 16 Mn)) and the credit rating of the borrowing AE done by an agency registered with SEBI is of adequate to highest safety • excludes performance guarantees and letters of comfort	Commission or fee at the rate of not less than 1.75 per cent per annum on the amount guaranteed

Safe Harbour Rules

Global Scenario

Country	Eligible tax payers / transaction	Safe Harbour arms' length range
Australia	• Low value adding intra-group services	Cost of providing the services plus a markup of 5 -7.5% are acceptable for services supplied to foreign associated enterprises
Japan	• Low value adding intra-group services • Loan	Cost of providing the service Interest that would be normally earned if the funds were invested in government securities
Netherland	• Low value adding intra-group services	All relevant actual costs
New Zealand	• Low value adding intra-group services • Loan	Cost of providing the services plus a markup of 5 -7.5% are acceptable for services supplied to foreign associated enterprises 3 % over the relevant base indicator
Singapore	• Low value adding intra-group services	IRAS accepts 5% mark-up adopted for routine services
South Africa	• Loans	• Prime plus 2% for South African Rand (ZAR) denominated loans • LIBOR plus 2% for foreign denominated loans are allowed.

Safe Harbour Rules

Key Highlights

- Provide option for five financial years beginning Financial Year 2012-13
- Need to furnish prescribed Form to exercise option
- Provide timelines for conclusion of taxpayers eligibility by the authorities
- Lay down procedure for audit of eligibility, mechanism for review of adverse decisions of lower authorities
- Under certain specified facts and circumstances, tax authorities can examine the taxpayers' eligibility
- No turnover threshold for eligibility to opt for safe Harbour in case of certain category of transactions / taxpayers undertaking insignificant risks

Except for Financial Transactions, no differentiation between Indian or foreign MNCs… Only criteria is the risks borne by the entity

Safe Harbour Rules
Issues

Classification of activities - IT and ITeS industries

- **Ambiguous definition of contract R&D relating to software development**
  - can they be differentiated from software development services
- **KPO**
  - Is the classification right?
  - possibility of ITeS companies being classified as KPO
- *Vague terms used in the definitions*
  - Support for existing systems - in IT services
  - Support centers - in ITeS
  - Human resource services - in KPO
  - Development of internet technologies - in contract R&D in IT
  - Upgradation of existing products where source code has been provided

Contract R&D relating to pharmaceutical drugs

- Restricted only to contract R&D in generic drugs

Safe Harbour Rules

Issues

Auto component industry

- Restricted applicability, given the condition of 90 percent or more OEM sales
- Prescribed rates (12 percent and 8.5 percent) for core and non-core auto components are very high

Financial transactions

- Coverage restricted to loans/ guarantee provided by taxpayer to/for
  - wholly owned subsidiary and
  - Rupee-sourced loans
- Interest rate for loans on higher side ranging from 11 per cent to 13 per cent (applying the SBI base rate as on 30 June 2013)
  - Use of SBI base rate instead of rates in international market for similar loans
  - LIBOR was accepted as the base rate Tribunals
- Opportunity cost concept is not rational

Safe Harbour Rules

Challenges

- Prescribed Safe Harbour margins are higher than taxpayers expectations
- Potential double taxation for the MNE, in case safe harbour margin is not accepted by the tax authorities in overseas jurisdiction
- Continued burden of documentation and audit
- Audit by authorities to continue for uncovered and examination of covered transactions
- Not available for transactions with AEs located in low tax or no tax country despite of satisfying substance test
- Uncertainty in the first year of selection of Safe Harbour Rules

Advance Pricing Arrangement (‘APA’)

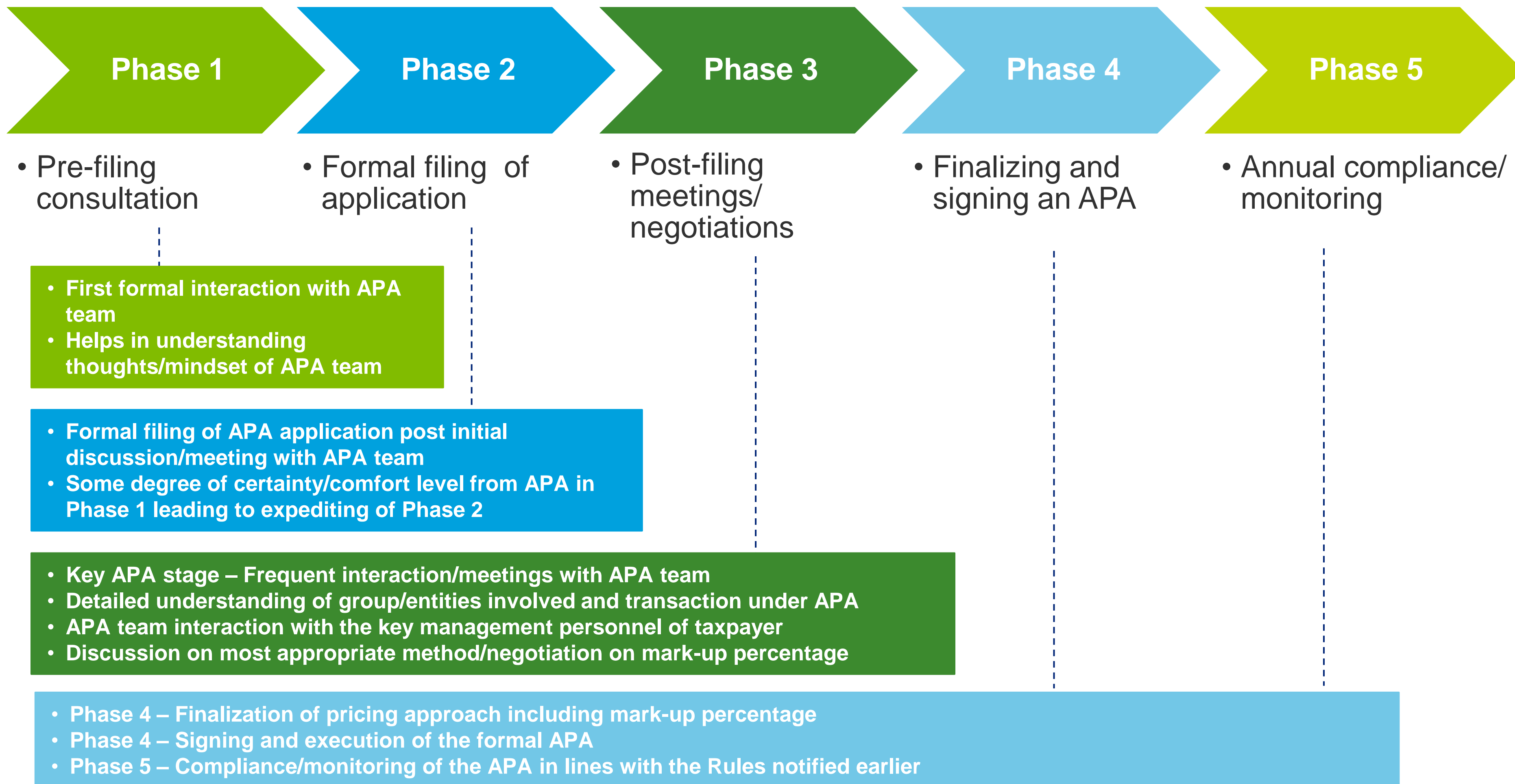
Advance Pricing Arrangement

Key Features

- APA program introduced from July 01, 2012
- Detailed rules and forms announced on August 30, 2012
- Broadly similar to APA Schemes of other countries
- Agreement between taxpayer and Central Board of Direct Taxes (CBDT):
- To determine arm’s length price (ALP)
- Specify the manner in which ALP has to be determined
- Can be unilateral, bilateral, or multilateral
- Binding on taxpayer and tax authority
- Use of any method (whether specified or not) with adjustments/ variations as necessary
- Application can be filed:
  - Before undertaking a proposed transaction; or
  - For continued transactions before the first day of the relevant fiscal year (FY 2013-14 would be the first year)
- Valid for the maximum period of 5 consecutive years
- Provision for renewal
- Rollback provision introduced vide Finance Act No. (2), 2014

Advance Pricing Arrangement

Practical insight into the APA process



Advance Pricing Arrangement

APA Application Process

- In Form 3CED with prescribed documents to Competent Authority (CA) – bilateral APA (Rule 10I)
- With proof of payment of following fee:

International transaction Value (in INR)	APA filing fee (in INR)
Value <= 1 billion	1 million
Value > 1 billion <= 2 billion	1.5 million
Value > 2 billion	2 million

- Before start of the financial year for which application is made in respect of ongoing transactions; or
- Before undertaking the international transaction
- Taxpayer to propose number of years, maximum being five
- AE must initiate APA process in other country for bilateral APA

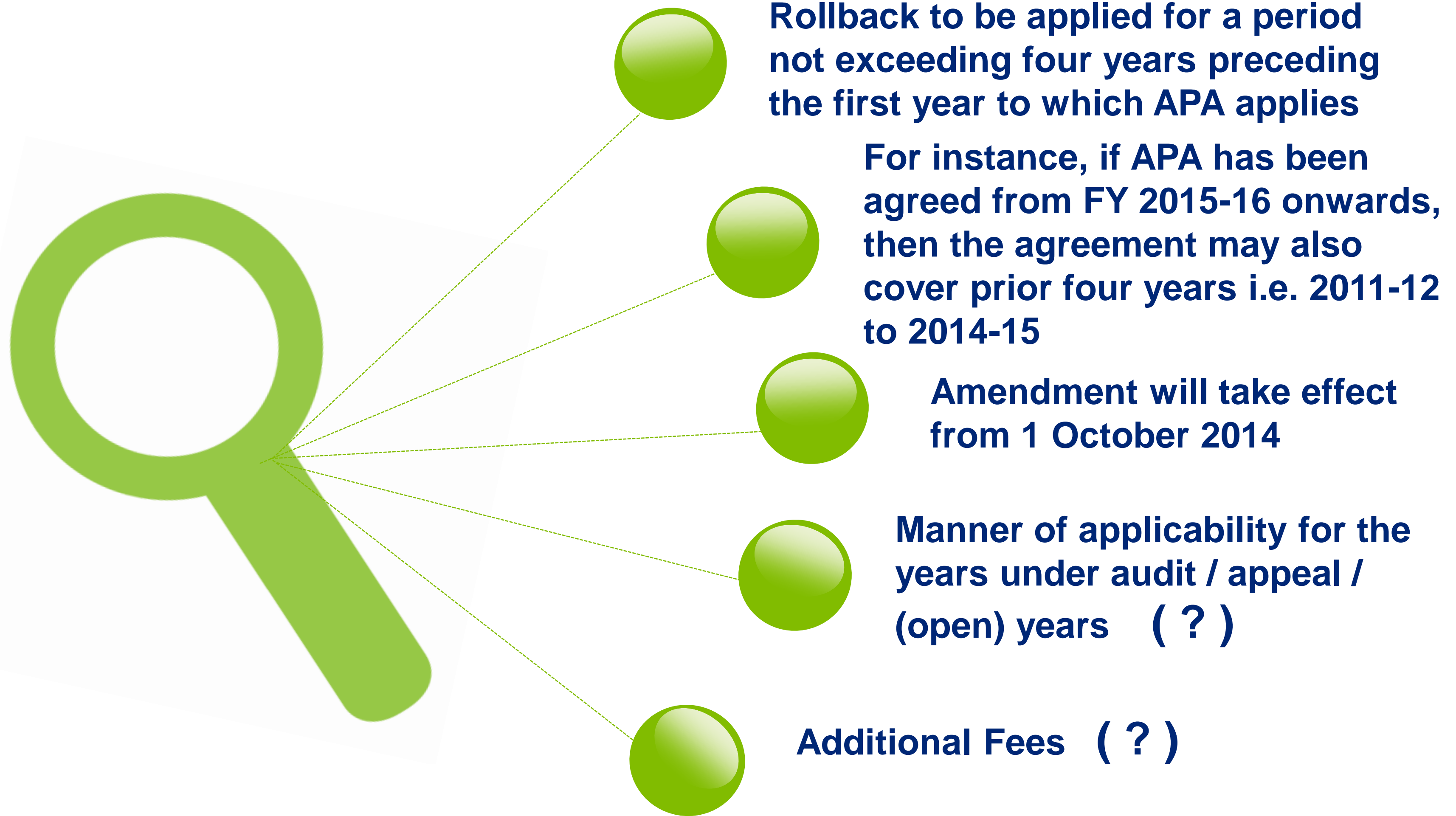
Advance Pricing Arrangement

First and Second Years of APA in India

- APA program introduced – expected to provide certainty, removal of audit threat and substantial reduction in compliance cost
  - First and Second round of APA applications filing completed in March 2013 and March 2014 respectively – overwhelming response, 146 applications filed in first year and 232 applications in second year (maximum anywhere in the world)
- Five APA cases were concluded and signed in March 2014 and few are close to conclusion
- Positive response from APA authorities during pre-filing and post-filing meetings/discussions
- Though a forward looking agreement but has potential to resolve historical issues – likely to have persuasive value

- **Total cost of annual domestic litigation (till higher levels) for each year**
- **Interest cost on account of disputed demand for each year**
- **Time involved in arriving at closure for each year under domestic litigation**
- **Additional tax costs (even if disputed)**

Advance Pricing Arrangement
Roll Back Provision



Advance Pricing Arrangement

Key Benefits

- A forward looking tax planning mechanism (TPM) for maximum of 5 years and provides certainty in doing business
- Reduced TP compliance and audit defense costs
- Simplifies financial reporting process
- Possibility of renewal at reduced cost
- Potential to resolve historical issues – APA may have a persuasive value
- Unilateral APA can be converted into bilateral APA at a later stage

Advance Pricing Arrangement
Key Takeaways

On APA

- Unilateral APA can be converted into bilateral at any stage of the proceedings before conclusion of such unilateral APA
- Roll-back of APA – 4 years (newly introduced in 2014 India Budget)

On Safe Harbour

- Opting for safe harbour will not prejudice going for APA in future years
- Safe harbour rules will not be considered as benchmark/starting point during APA negotiation
- Safe harbour rules will be reviewed continuously/periodically

On information sharing with field officers

- There is no specific ''firewall'' provision in India's APA structure
- The APA team respects the sensitive nature of certain information, which is kept in the personal custody of APA team members

Litigation, Safe Harbour Rules, APA Comparison

Pros & Cons	Safe Harbour	Litigation	APA
Relief from potential double taxation	Low	Moderate	Yes, with bilateral APA
Certainty	Yes	No	Yes
Complexity of process	Low	High	Moderate
Associated costs (including tax)	High	Moderate - High	Moderate
Timeline convenience	Yes	No	Yes
Non-financial pain points	Low	High	Low
Possible resolution for past years	None	None	Yes, through MAP

Transfer Pricing Jurisprudence

Transfer Pricing Jurisprudence
Domestic Ruling

- **Brand Fee / Royalty :**
  - EKL Appliances Limited

- **Advertising, Marketing and Promotion Expenses :**
  - L.G. Electronics India Private Limited

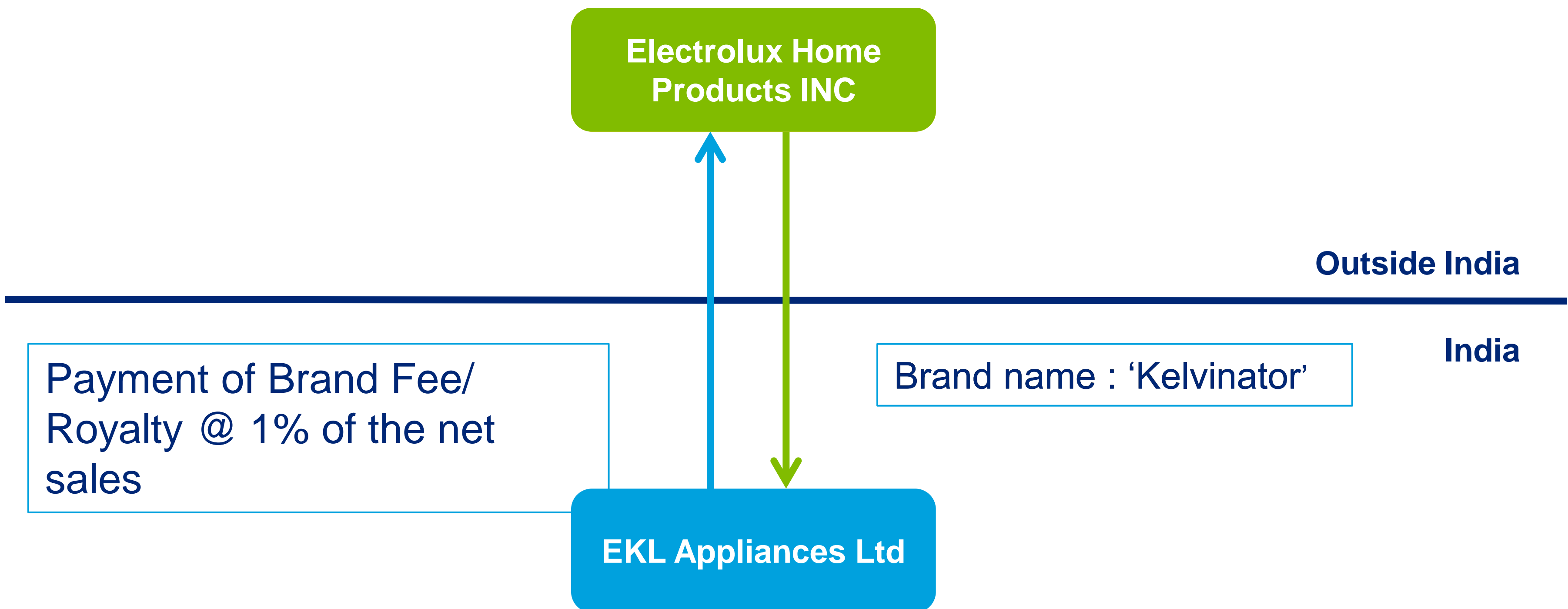
- **Management Charges**
  - Gemplus India Private Limited
  - Dresser Rand India Private Limited

- **Interest Free Loan**
  - Perot System TSI India Limited

EKL Appliances Limited (Brand Fee/Royalty) ([2012] 345 ITR 241 [Delhi]) Assessment Year 2002-03 & 2003-04

Facts of the case

- EKL Appliances Ltd ('the taxpayer/ Assessee') is engaged in the business of manufacturing and trading of electronic appliances.
- International transaction under dispute (Payment of Brand Fee/Royalty):-During AY 2002-03 and AY 2003-04, the taxpayer paid INR 3,99,51,000 and INR 3,42,97,910 respectively to its Associated Enterprise (AE) .



Proceedings before the Transfer Pricing Officer

TPO's Contention	Assessee's Rebuttal
• The taxpayer incurred perpetual losses & hence no benefits received by the taxpayer from royalty payment in achieving profits from operations.	• Allowance of brand fee as expenditure not dependent on profitability of the entity but on the utility of the brand name to the entity. • Payment of brand fee to be examined on merits for each year.
• TPO questioned upon the justification for payment of brand fee during the year under reference.	• Increase in turnover of the company year on year is attributable to the brand name ' Kelvinator '. • AE had entered into a similar brand fee transaction with unrelated party & hence there was no doubt regarding the genuineness of the ALP. • Certification of CUP (Comparable Uncontrolled Price) by a third party consultant that Brand Fee paid by the assessee was lower than the uncontrolled brand fee.

Proceedings before the Commissioner of Income Tax (Appeals) - CIT(A) & ITAT

- CIT (A) held that :-
  - Usage of brand by the taxpayer for which it made a royalty payment, had helped the taxpayer to reduce it's operating losses
  - The reason for perpetual losses was on account of increase in employees cost, finance charges, administrative expenses, depreciation and installed capacity and was not linked to the brand fee/ royalty payment
  - The commercial expediency of the business expenditure incurred by the taxpayer should not be questioned
  - Business strategies/economic circumstances needs to be considered for determining comparability of prices between controlled and uncontrolled transactions
- CIT (A) decided the issue in favor of the Assessee

ITAT upheld the decision of Commissioner of Income Tax (Appeals) for both the years

Ruling of the High Court

High Court upheld the view of the Tribunal. The salient observations of the High Court order were as follows:-

- Relied on the OECD Transfer Pricing Guidelines & concluded that the tax administration should not disregard the actual transaction
- TPO's jurisdiction extends to evaluating the quantum of the expenditure based on evidences produced by the taxpayer and disallowance of such expenditure cannot be made solely on the basis of the fact that taxpayer is suffering continuous losses.
- The High Court referred to other Court rulings regarding the justification of the business expenditure.

Case Law	Findings
S.A. Builders Ltd v CIT	Revenue cannot claim to place itself in the chair of the businessman & assume the role to decide how much is the reasonable expenditure having regards to the circumstances of the case
Sassoon J David & Co. Pvt. Ltd. V CIT	Section 37(1) requires that the expenditure should be incurred wholly & exclusively for the purpose of business
CIT v Rajendra Prasad Moody	The deduction of the expenditure cannot, in the circumstances, be held to be conditional upon the making or earning of the income

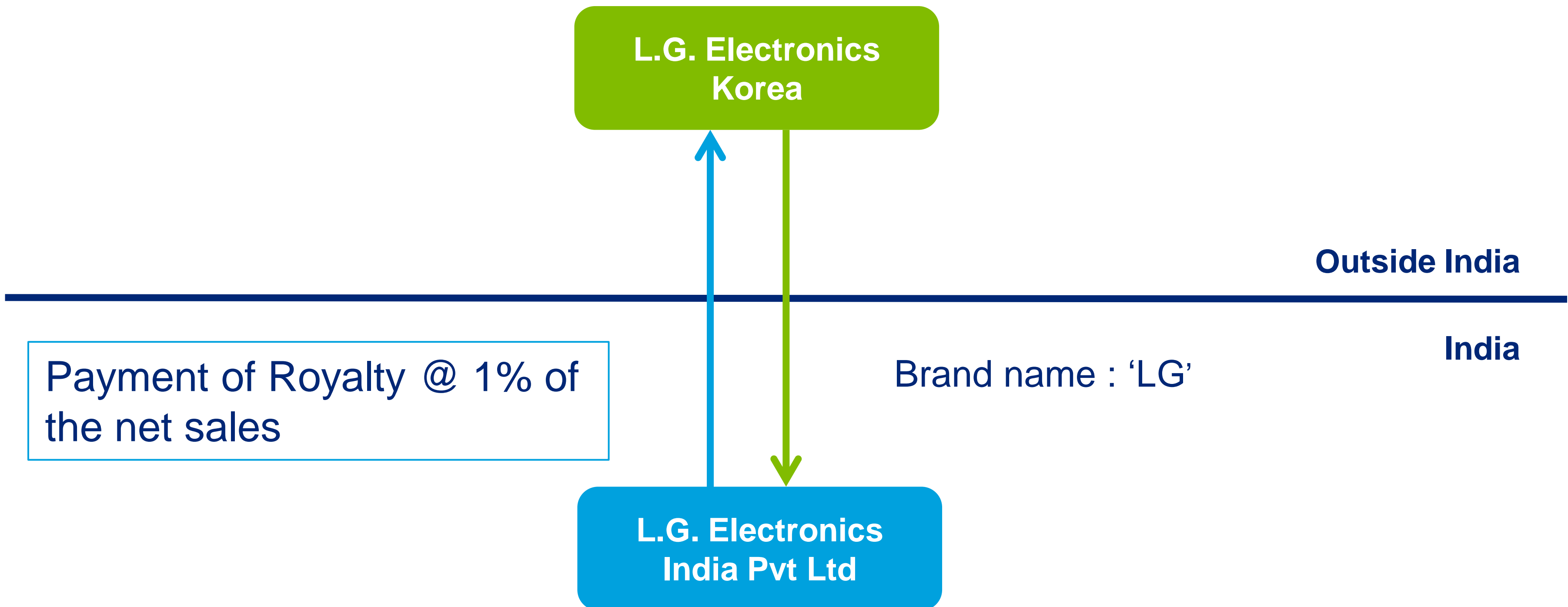
Key Takeaways

- The tax authorities cannot question the commercial rationale of legitimate business expenses incurred by the taxpayer as long as it is demonstrated that the transaction is at arm's length.
- The taxpayer need not show that any expenditure incurred by him for the purpose of business has actually resulted in profit.
- The financial health of the taxpayer can never be a criterion to judge allow ability of an expense
- Reliance on OECD guidelines
- Focus on justification of quantum
- Followed by:
  - Festo Controls P Ltd vs DCIT (2013 – Bang Trib) (62 SOT 1)

L.G. Electronics India Private Limited (Advertising, Promotion & Marketing Expense)
([2012] 345 ITR 241 [Delhi])
Assessment Year 2002-03 & 2003-04

Facts of the case

- L.G. Electronics India P Ltd ('the taxpayer/ Assessee') is engaged in the business of manufacture, sale and distribution of electronic products and electrical appliances.
- The trade mark "LG" is the registered trade mark of LG Korea. The Taxpayer entered into a License Agreement with LG Korea for the manufacture sale and distribution of LG Korea products.



TP Audit Proceedings before TPO & DRP

During the TP Audit Proceedings

- The taxpayer was promoting LG Brand as it had incurred expenses on AMP to the tune of 3.85% of sales vis-à-vis 1.39% incurred by the comparable.
- Applying the Bright Line Test, the TPO held that the expenses in excess of 1.39% of the sales are towards brand promotion of the AE and proposed a transfer pricing adjustment. (It is pertinent to note that Bright Line Test was laid down by the US Tax Court and is aimed at determining excess AMP expenditure incurred by the taxpayer over and above the average of AMP expenditure incurred by the comparable companies.)
- Accordingly, the TPO held that such "excess" AMP expenditure ought to have been reimbursed by the AE under arm's length condition.

Before the Dispute Resolution Panel ('DRP')

- The DRP not only confirmed the approach of the TPO, but also directed to charge a mark-up of 13% on such AMP expenses towards opportunity cost and entrepreneurial efforts.

Delhi Tribunal

Issues before the Delhi Tribunal – Special Bench
• Whether transfer pricing adjustment can be made in relation to advertisement, marketing and sales promotion expenses incurred by the taxpayer? ("Question 1")
• Whether the taxpayer ought to have been compensated by the AE in respect of such AMP expenses alleged to have been incurred for and on behalf of the AE?" ("Question 2")

Delhi Tribunal

Question 1

- **Confirmed validity of jurisdiction** of the TPO by observing that the taxpayer's case is covered under section 92CA(2B) of the Income-tax Act, 1961 ('the Act') which deals with international transactions in respect of which the taxpayer has not furnished report, whether or not these are international transactions as per the taxpayer.
- **Admission of additional evidences** under Rule 29 of the ITAT Rules, 1963 can be possibly requested at any stage of proceedings before ITAT, provided there is a scope for the other side to rebut it. Based on this principle, out of the two applications for allowing additional evidences filed by the Departmental Representative, it allowed the first and rejected the second.
- **There is a transaction** between the taxpayer and the AE for the promotion of LG brand in India, which is legally owned by the latter.
- The said transaction can be characterized as **an international transaction** within the ambit of Section 92B(1) of the Act, since
  - there is a transaction of creating and improving marketing intangibles by the taxpayer for and on behalf of its AE;
  - the AE is non-resident; and
  - such transaction is in the nature of provision of service.

Delhi Tribunal
Question 1

- Accepted **bright line test** to determine the **cost/ value** of the international transaction, in view of the fact that the taxpayer failed to discharge the onus by not segregating the AMP expense incurred on its own behalf vis-à-vis that incurred on behalf of the AE. The Tribunal further held that the transfer pricing provisions being special provisions, override the general provisions such as section 37(1)/ 40A(2) of the Act.
- Determination of Arm's Length Price ("ALP") based on bright line test, which is not one of the methods prescribed in section 92C of the Act, would not make the **application of Chapter-X** of the Act redundant.
- The Supreme Court of India in **Maruti Suzuki**'s case directed the TPO for a de novo determination of ALP of the transaction and such direction recognizes the fact of brand building for the foreign AE, which is an international transaction and the TPO has the jurisdiction to determine the ALP of the transaction.

Delhi Tribunal

Question No. 2 - Whether the taxpayer ought to have been compensated by the AE in respect of such AMP expenses alleged to have been incurred for and on behalf of the AE?

- The Tribunal accepted the DRP’s approach, of applying a mark-up on cost for determining the arm’s length price of the international transaction, on the ground that the same has sanction of law under Rule 10B(1)(c)(vi) of the Income Tax Rules, 1962.

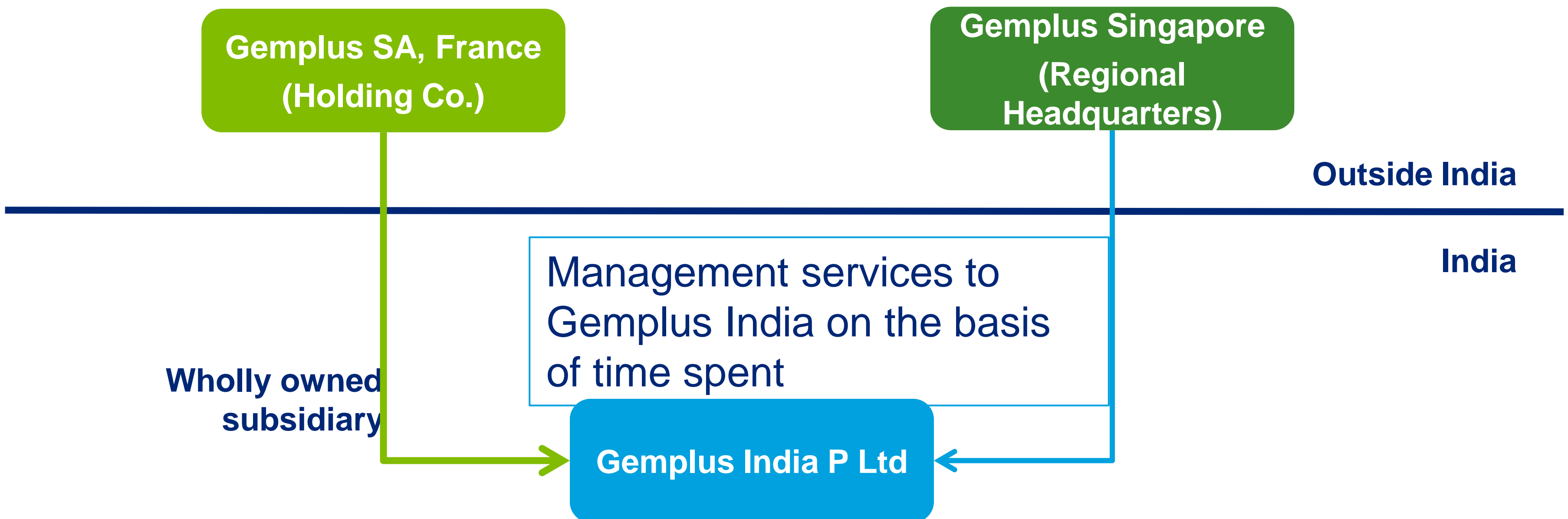
Key Takeaways

- The SB's ruling relies extensively on the facts particularly relevant to the Taxpayer in this case and therefore its impact on other taxpayers may need to be examined based on their specific facts.
- The quantification of excessive AMP expenditures may also not necessarily be based on a bright line test if taxpayers are able to provide information related to brand promotion.
- In light of the ruling, it would be useful for multinational enterprises with Indian affiliates to review their intra-group arrangements relating to sales and marketing and use of trademarks/ brand names to assess the impact of the ruling.
- Followed by:
  - Diageo India P Ltd vs DCIT (2013 – Mumbai Trib) (59 SOT 150)
  - Ford India P Ltd vs DCIT (2013 - Chennai Trib) (59 SOT 221)

Gemplus India (P) Ltd (Management Charges) ([2010] ITA No. 352/Bang/2009) Assessment Year 2003-04

Facts of the case

- Gemplus India P Ltd ('the taxpayer/ Assessee') is a wholy owned subsidiary of Gemplus SA, France and is functioning under the regional headquarters at Singapore ('Gemplus Singapore').
- The assessee company in India had entered into an agreement called Management Services Agreement (MSA) with its Singapore associate. Gemplus Singapore for providing services in respect of marketing and sales support, customer service support, finance, accounting and administration support and legal support.



TP Audit Proceedings before TPO

During the TP Audit Proceedings
• In respect of payments made towards management services amounting to Rs.1,44,98,000/-, the TPO found that the payment was not justified. TPO observed that that comparables identified by the company have not paid any management service fees thereby rejecting payment of service charges.
• The TPO concluded that the company has not derived any specific benefit from the management services stated to be advanced by Gemplus Singapore and this is more so because the company in India has already incurred separate head-wise expenses for professional and consultancy services. The TPO held that if at all any benefit is accrued as a result of the services said to be rendered by the Gemplus Singapore, the benefit was accrued to the Gemplus Singapore group as a whole and exclusively to the individual company Gemplus India.
• Accordingly, the TPO held that payment of management charges was not justified and held that the said amount is adjustable u/s 92CA.

Proceedings before the ITAT

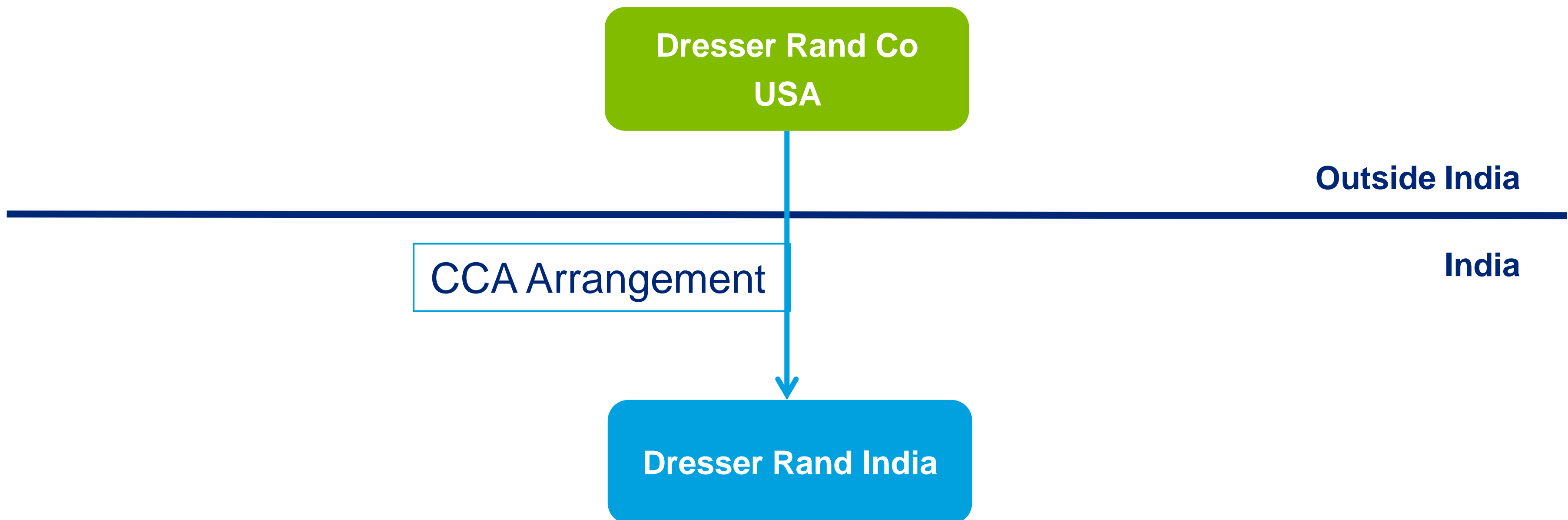
- The Tribunal held that :-
  - TPO has observed that the terms prescribed in the agreement in respect of the payments to be made by the assessee company are **independent of the nature and volume of services**, if any rendered by the Singapore Associate. This is a vital observation made by the TPO which goes to the root of the issue.
  - it is very imperative on the part of the assessee to establish before the TPO that the **payments made commensurate to the volume and quality of services and such costs are comparable.**
  - The TPO has made a clear findings that there are **no details available on record** in respect of the nature of services rendered by Singapore affiliate to the company.

ITAT upheld the decision of TPO in holding that the assessee has not proved any commensurate benefits against the payments of service charges to the Singapore affiliate.

Dresser-Rand India P Ltd (Management Charges) ([2010] 53 SOT 173 [Mum Trib]) Assessment Year 2006-07

Facts of the case

- Dresser-Rand India P Ltd ('the taxpayer/ Assessee') is a wholy owned subsidiary of Dresser Rand Co, USA ('DRUS') and is engaged in the business of manufacturing various types of gas compressors, horsepower reciproicating compressors, its accessories and providing field services.
- During the AY 2006-07, the taxpayer had incurred an expenditure of Rs.10.55 crores towards cost contribution allocation ('CCA') by DRUS. The taxpayer had also provided certain field services to DRUS and other AEs.



TP Audit Proceedings before TPO

Detailed submission made by the assessee

- Per the CCA, the tax payer would compensate DRUS for the expenses incurred by DRUS towards the resources shared by it with the tax payer.
- Detailed documentation was furnished by the assesse to the TPO.
- Further, it was explained by the assessee that the costs incurred by DRUS were allocated to its AEs based on two allocation keys namely headcount and sales proportion of each of the participating entities in the CCA.

During the TP Audit and DRP Proceedings

- The TPO concluded that no services were availed by the taxpayer from DRUS and hence determined the ALP to be Nil.

- Further, the TPO also questioned the allocation keys adopted by the tax payer and emphasized that the cost sharing should be i) based on actual services availed, and ii) if at all costs were to be charged to the assesse the same should be based on Indian employees costs.

- The DRP disposed of the objections and confirmed the adjustments proposed by the TPO with the below observations:
  - With respect to CCA, the documentary evidence submitted did not prove the receipt of services by the taxpayer from its AEs.
  - With respect to field service, the DRP directed the AO to verify and rectify the computational errors and restrict the disallowance to the extent of discount granted (10%).

Proceedings before the ITAT

- The Tribunal held that payment made by the taxpayer towards CCA was at arms length by observing :-
  - Conducting business is entirely **taxpayer's prerogative** and revenue authorities **should not** decide whether a particular expense is necessary for the taxpayer or not;
  - The Tribunal observed that when evaluating the ALP of a service, it is **not relevant whether the service was beneficial** to the assessee and tax authorities must restrict themselves to determining whether the price paid by the taxpayer would be comparable to the price paid by an independent enterprise for the same transaction;
  - Documentary evidence like copies of report; emails and guidance notes etc. filed with the tax authorities by the taxpayer, being **contemporaneous in nature**, demonstrate that the taxpayer had received the services from DRUS that year;
  - Since there was no objective way in which use of services could have been measured, the allocation undertaken was in line with commercial practice in market factors driven situations, where costs are shared per some objective criteria, including sales/ revenues and employees.
  - The tax payer had adopted the TNMM as the most appropriate method and the revenue authorities neither disputed the method nor prescribed any other method for determining the ALP of the service received under the CCA, and therefore the assessee's transactions were at ALP.

Perot System TSI (India) Ltd (Interest free loan) ([2010] 37 SOT 358 [Delhi Trib]) Assessment Year 2002-03 to 2004-05

Facts of the case

- Perot System TSI (India) Ltd (‘the taxpayer/ Assessee’) is engaged in the business of designing and developing technology enabled business transformation solutions and providing consulting, systems integration and software solution services.
- The assessee extended two interest free foreign currency loans to its associated enterprises (AEs) located in Bermuda and Hungary. During the course of assessment proceedings, the TPO held that the said international transaction was not at arm's length and made an upward adjustment to income of the assessee by imputing interest on loans granted.

Contentions of the Assessee and TPO

Contentions of the Assessee

- The assessee argued that loan transactions with subsidiaries companies were not debt. The assessee's contentions are summarized below:
  - Loans were in the nature of quasi-equity and used for making investment in step down subsidiaries;
  - Subsidiaries were in start-up phase with no significant business activities and no third party lender would have lent money to such start-up company;
  - The loans were granted after taking all the requisite approvals from the RBI;
  - Debt-equity ratio of the subsidiary in Hungary was significantly higher than the thin capitalization norms in Hungary and consequently, the funds extended needs to be considered as equity and not debt.

Contentions of the TPO

- In a normal business scenario, no third party would have extended interest free loan to an unrelated entity;
- Under arm's length condition, no person would assume a risk of losing the loan amount in an event of default by the borrower without expecting a reasonable return;
- Since one of the entities is in Bermuda, a tax heaven, it becomes a case of violation of transfer pricing norms where profits are shifted to bring down the aggregate tax incidence for the group;
- The interest free loans have been used for making investment in the group entities. There appears to be no reason to route these investments through AE in Bermuda other than the shifting of profits from India to Bermuda to bring down the tax burden.

Proceedings before the CIT (A)

- While ruling the issue in favour of Revenue, the CIT (A) concluded that a careful examination of the clauses of the loan agreement, description of purpose given in the approval applications, etc. reveals that the nature of transaction is that of a debt.
- Further, while rejecting assessee's reliance on Para 1.37 of the OECD Guidelines, dealing with recharacterization of debt as equity in the hands of borrower, CIT (A) also held that under the facts of the case, the analysis has to be done from the perspective of the lender and not from that of the borrower in order to ascertain whether the transfer pricing regulations have been complied with or not.
- The CIT(A) also held that the benefit of + 5% range is not available to the assessee in the given facts.

Proceedings before the ITAT

- The ITAT rejected the arguments of the assessee and characterized the said transactions as loan. Below is the ruling given by the ITAT:
  - Inter-company loan agreement puts it beyond doubt that the transaction in question is nothing but loan. There is nothing in the contract that makes the transaction as equity capital in nature;
  - The contention of having actually not earned any income cannot come to the rescue of the assessee. The decisions relied upon by the assessee relating to the concept of the real income, i.e., grant of interest free advances to the subsidiaries on the ground of commercial expediency, are not in the context of Chapter-X of the IT Act ;
  - In case of loan to subsidiary in Bermuda, it is reasonable to accept the arguments put forth by the TPO that transaction has been routed through Bermuda to shift profit out of India;
  - Reliance by the assessee on Hungarian thin-capitalization rule is misplaced, as the rule is for disallowance of interest expense in order to ensure compliance with thin-capitalization rule and there is no restriction in respect of outward remittances in respect of debt finance;
  - Only one LIBOR rate was applied by the TPO with some adjustment for basis points. This cannot be equated with more than one price in respect of each transaction and hence, benefit of +/- 5% range cannot be availed.

QUESTIONS?

THANK YOU