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Selection of Foreign AE as Tested Party – Indian Transfer Pricing Regulations

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A recent ruling in GE Money Financial Services Pvt. Ltd. v. DCIT, the Income Tax Appellate Tribunal (ITAT) has further contributed to the uncertainties in Transfer Pricing in India. The ruling is a drastic departure from international transfer pricing norms especially the OECD Transfer Pricing Guidelines and UN Transfer Pricing Manual.

Brief Facts

GE Money (taxpayer) had entered into two international transactions with its Associated Enterprises (AE) located in USA and Asia for availing consulting, IT and administration services. For the purpose of transfer pricing, the taxpayer applied Transactional Net Margin Method (TNMM) as the appropriate method and chose its foreign AE as the tested party. The Assessing Officer referred the determination of Arm's Length Price with respect to these transactions to the Transfer Pricing Officer who held that taxpayer should be the tested party and not the foreign AE. Aggrieved by this holding, the taxpayer approached the Dispute Resolution Panel which also held in favour of the authorities causing the taxpayer to move before the ITAT.

The Tribunal's Ruling

Whether the foreign AE can be taken as the tested party?

The foreign AE in the transaction was a provider of these services to other AEs across the globe, which according to the taxpayer would make it the least complex party in the transaction and therefore would be ideal as the tested party for the transfer pricing exercise. This argument though consistent with OECD guidelines should still satisfy the prior conditions i.e. the party should be one on which the transfer pricing can be applied in the most reliable manner and one for which reliable comparables can be easily found. The Tribunal never verified the claim of the taxpayer but instead moved onto the bigger question of whether a foreign entity as tested party is permissible under Indian transfer pricing regulations?

To ascertain the permissibility, the Tribunal analysed Rule 10B(1)(e) of the Income Tax Rules which provides for determining ALP using TNMM. The Rule states that *the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base*. The Tribunal's literal

interpretation of the rule was that only the taxpayer could be the enterprise as Indian law is concerned only with the computation of ALP with respect to the profits realised by the taxpayer. Taking the foreign AE as the enterprise would amount to computing ALP on the profits realised by the foreign AE which is not permitted by this rule. This holding of the Tribunal goes against the very fundamentals of Transfer Pricing as the ultimate objective of the exercise is to determine if the transaction is ALP and not determining profits arising out of a transaction.

Tested Party in Indian Law

Rule 10B of the Income Tax Rules provides for computing ALP using TNMM in an international transaction. In the judgment, the Tribunal stopped with a plain reading of the rule and failed to further analyse the definitions of enterprise and associated enterprise mentioned in the rule. An enterprise is defined in the statute to mean any person and a person is defined to include any company incorporated in India or abroad. Going by the definition, the rule allows an enterprise to be a foreign company for the purposes of determining ALP using TNMM. Once this is possible, then the only requirement is to establish that the taxpayer and the foreign company are associated enterprises which are by satisfying the conditions in Section 92B. The wide definition of an enterprise along with the OECD guidelines on selection of tested party should have been considered and persuasive enough for the Tribunal to allow the taxpayer to take its foreign AE as the tested party.

However, the problem lies in the reluctance of the Tribunals and Tax Authorities to accept OECD Transfer Pricing guidelines. The reason usually stated for the rejection is that India is not a member of OECD and therefore its Transfer Pricing guidelines cannot be applied in Indian law. The same goes with the UN Practice Manual on Transfer Pricing. This is not entirely true. India as an observer actively participated in the preparation of the BEPS Report which was incorporated into the Transfer Pricing Manual. India was also a co-drafter of UN Practice Manual on Transfer Pricing and that manual very definitely supports the notion of the tested party being a foreign party, when that is the most reliable party for comparability purposes. Taking both the guidelines and India’s involvement in its preparation into account, the Courts and authorities have enough reason to adopt the same into the domestic regulations.

The Way Forward

The ideal way forward would be for the Government to formally recognise this concept into the existing tax laws so as to bring it in line with the international principles. However, as seen from above, without an amendment the existing law is wide enough to accommodate the concept of tested party. Therefore, the tax authorities recognising the concept through an issuance of formal guidelines on selection of tested party would be sufficient to resolve this ambiguity.

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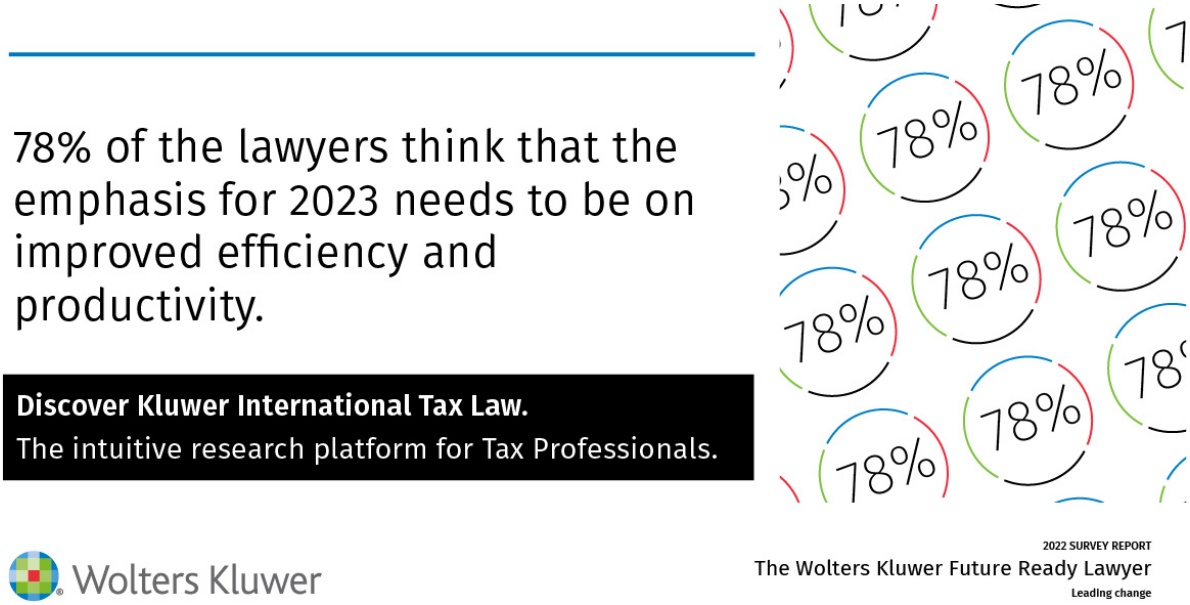

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