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cutting through complexity

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The Assessing Officer to apply his/her mind and form a belief on the Transfer Pricing report filed by the taxpayer; failing which a Transfer Pricing addition cannot be sustained. No TP addition can be made when tax avoidance is not possible

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Tata Consultancy Services Limited[1] (the taxpayer) held that the Assessing Officer (AO) cannot mechanically refer the international transactions of the taxpayer to the Transfer Pricing Officer (TPO) for determination of the Arm's Length Price (ALP). He/she has to mandatorily apply his/her mind on the Transfer Pricing (TP) report or any other documents filed by the taxpayer and come to a conclusion that the taxpayer has not determined the ALP or maintained documents based on the provisions of Section 92C(3) of the Income-tax Act, 1961 (the Act). An order passed by the AO in conformity with the adjustment proposed by the TPO without such application of his/her mind cannot be upheld.

The Tribunal has also held that no TP adjustment can be made in cases where the taxpayer enjoys the benefit of a tax holiday under the Act, or in a case where the tax rate in the country of the Associated Enterprise (AE) is higher than the tax rate in India.

Facts of the case

- The Assessment Year (AY) under consideration was 2005-06. The AO following the Central Board of Direct Taxes (CBDT) Instruction No. 3/2003 dated 20 May 2003 (requiring a mandatory reference to the TPO to determine the ALP, where the aggregate value of international transaction(s) exceeded INR 5 crores) and after taking the approval of Commissioner of Income-tax (CIT) as per Section 92CA(1) of the Act, referred the ALP determination of the taxpayer's international transactions to the TPO.
- The TPO made a TP adjustment on the international transaction(s) which was mechanically incorporated by the AO in his order.
- The taxpayer aggrieved by the AO's order filed an appeal with the Commissioner of Income-tax (Appeals) [CIT(A)], wherein it deleted the TP adjustments.

Issues before the Tribunal

- Before the Tribunal, the taxpayer invoked Rule 27 of the Income-tax Appellate Tribunal Rules and sought to support the order of the CIT(A) by raising a plea that under Section 92C or 92CA of the Act, it was the statutory duty of the AO to decide independently, whether the determination of the ALP by the taxpayer should be accepted, or whether there was a need for the Revenue to determine the ALP. In other words, in cases where the AO does not discharge this judicial function of forming an opinion on the conditions (a) to (d) prescribed under Section 92C(3) of the Act, no TP adjustment could be made.
- Where the taxpayers enjoy the benefit of a tax holiday under the Act, or in a case where the tax rate in the country of the AE is higher than that in India, whether a TP adjustment could be made?

[1] DCIT v. Tata Consultancy Services Limited (ITA no. 7513/M/2010) – Taxsutra.com

Tax department's contentions

- Relying on the decision in the case of Sony India P. Ltd.[2], it was argued that the AO was not required to form a prior considered opinion before making a reference to the TPO under Section 92CA(1) and that CBDT Instruction No. 3/2003 dated 20 May 2003 was held to be constitutionally valid.

- The department also relied on the decision of the Special Bench (SB) in the case of Aztec Software and Technology Services Ltd.[3] and argued that the Special Bench of the Tribunal had held that in view of the plain and ambiguous language of the Act, tax avoidance was not required to be proved before invoking the provisions of Chapter X of the Act and the TP provisions were applicable even if income was exempt. No prior hearing was to be given to the taxpayer by the AO before making a reference to the TPO to determine the ALP. The conditions in Section 92CA(3) of the Act are not required to be fulfilled before making a reference to the TPO. The CBDT Instruction No.3/2003 was binding on the AO; and hence, it was necessary or expedient for the AO to refer the case to the TPO under Section 92CA(1) of the Act if the international transaction exceeded the limit mentioned therein.

- Further, the department also relied on the decision in the case of Coca Cola India Inc [4] and argued that was no need for a hearing to be given to the taxpayer before making a reference to the TPO.

Taxpayer's contentions

- It was brought to the attention of the Tribunal that the decision in the case of Sony India and Aztec was rendered in the context of the erstwhile Section 92CA(3) of the Act. The Jurisdictional High Court in the case of Vodafone India Services P. Ltd.[5] after considering the amendment to Section 92CA(3) with effect from 1 June 2007, had held that the decision in the case of Sony India was not applicable in a post-amendment scenario.

- It was urged before the Tribunal that reliance could not be placed on the Coca Cola decision since on appeal to the Supreme Court; it had directed the authorities below to decide the matter afresh uninfluenced by any of the observations made by the Punjab & Haryana High Court.

- Based on the above, it was argued that the department cannot rely on any of these three judgements.

- After establishing this position, the taxpayer relying on the case of Johari Lal[6] contended that as per Section 92C(3) read along with Section 92CA(1), it was a condition precedent for the AO to have a prima facie belief upon the application of his mind to the material or information or document in his possession that it was necessary or expedient to make a reference to the TPO. Such a prima facie belief was a condition precedent and mandatory. The absence of such a belief vitiated the entire proceedings.

- It was also urged, that it was a condition precedent and a necessary safeguard for the statutory right of the taxpayer and had to be performed not in a mechanical manner even by the CIT, while giving approval to the AO under the provisions of Section 92CA(1), for making a reference to the TPO. Reliance was placed on the decision of the Supreme Court in the case of Krishna Pvt. Ltd.[7] and the Bombay High Court in the case of German Remedies[8] for this contention.

- Reliance was also placed on Para 55.11 of the CBDT Circular No.14 of 2001, and it was contended that the primary onus was on the taxpayer to determine an ALP in accordance with the Income-tax Rules, 1962 and to substantiate the same with the prescribed documentation. Where such onus was discharged by the taxpayer and the data used for determining the ALP was reliable and correct, there could not be any intervention by the AO as made clear by Subsection (3) of Section 92C of the Act.

- The Supreme Court in the case of Sirpur Paper Mills[9] had held that the CBDT instructions (like the Instruction No.3 of 2003) issued under Section 119 of the Act, could control the exercise of the powers of the officers of the Department only in administrative matters and not in quasi-judicial matters. Hence, it was urged that it was imperative for the AO and the CIT to discharge their judicial function as mandated by Section 92C(3) read along with Section 92CA(1) and not merely rely mechanically on Instruction No. 3 of 2003.

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[2] Sony India P. Ltd. v. CBDT & Ors. [2007] 288 ITR 52 (Del)
[3] Aztec Software and Technology Services Ltd. v. ACIT 294 ITR (T) 32 (Bang) (SB)
[4] Coca Cola India Inc v. ACIT [2009] 309 ITR 194 (P&H)
[5] Vodafone India Services P. Ltd. v. Union of India [2014] 361 ITR 531 (Bom)
[6] Johari Lal(HUF) v. CIT [1973] 88 ITR 439 (SC)
[7] Krishna Pvt. Ltd. v. ITO [1996] 221 ITR 538 (SC)
[8] German Remedies v. DCIT [2006] 287 ITR 494 (Bom)
[9] DCIT v. Sirpur Paper Mills [2006] 237 ITR 41 (SC)

- On the second issue of whether there could not be any TP addition in cases where the income derived from an international transaction was exempt from tax in India, reliance was placed on various decisions[10]. In all these decisions it was held that the Revenue authorities cannot contend that the taxpayer had a motive or intention to shift profits outside India, where the income derived from international transactions is exempt from tax in India or where the tax rates in the country of the AE were higher than the tax rates in India.

Tribunal's ruling

- The Tribunal held that the taxpayer was correct in supporting the order of the CIT(A) on both of its arguments.
  - where the AO does not discharge this judicial function of forming an opinion on the conditions (a) to (d) prescribed by Section 92C(3) of the Act, no TP adjustment could be made.
  - where the taxpayer enjoys the benefit of a tax holiday under the Act, or in a case where the tax rate in the country of the AE is higher than that in India, whether a TP adjustment could be made.
- The Tribunal appreciated the taxpayer's contention that the Bombay High Court in the case of Vodafone had overruled the decisions in the case of Sony and Aztec. Also, the Tribunal noted that the issue sought to be argued in the case at hand were never argued in the decisions relied by the Department. Hence even on that count, the decisions relied on by the department were of no help to them. Having come to this conclusion, the Tribunal proceeded to decide the points argued by the taxpayer.
- The Tribunal agreed with the contention of the taxpayer that it was a condition precedent for the AO to have a prima facie belief upon the application of his mind to the material or information or document in his possession that it was necessary or expedient to make a reference to the TPO. Such prima facie belief was a condition precedent and mandatory. The absence of such a belief would vitiate the entire TP proceedings.
- It was held that even the CIT erred in not applying his mind to the TP report filed or any other material or information or document furnished by the taxpayer before granting approval for reference to the TPO under Section 92CA(1) of the Act. This failure on the part of the CIT would also vitiate the entire TP proceedings.
- It was also held that no TP adjustment could be made in a case where the taxpayer enjoyed the benefit of a tax holiday, or where the tax rate in the country of the AE was higher than the rate of tax in India and where the establishment of tax avoidance or manipulation of prices or shifting of profits out of India was not possible.

Our comments

This decision of the Mumbai Bench of the Tribunal is certainly a welcome decision for taxpayers. This decision correctly brings out the judicial procedure that the AO should have been following before proceeding to redetermine the ALP. This decision will serve as an immense aid in the ongoing litigations where taxpayers may be able to directly challenge the jurisdiction of the AO's order, in so far as the TP adjustment is concerned. One should also explore demonstrating no tax advantage or no intention or motive to shift profits out of the country in relevant cases, as, in the absence of such an intention or motive, the TP adjustment will not be upheld as per this decision. This decision can help end, to a large extent, the long pending TP controversies where the taxpayers are enjoying tax holidays.

It is also important to understand the implications of the above decision going forward in light of the new Instruction No. 15 issued by the CBDT recently on 16 October 2015 on the implementation of TP provisions (the New Instruction). As per the New Instruction, except in certain specific situations, the AO is allowed to arrive at a prima facie belief based on basic factual details of international transactions, nature of documents maintained and method followed that would normally be available in the Accountant's Report filed by the taxpayer and not go into a detailed enquiry of scrutinising the correctness or otherwise of the price of the international transaction(s). We are attaching herewith our Flash News on the New Instruction for your quick reference.

[10] ACIT v. Motif India Infotech Pvt. Limited [ITA No. 3043/Ahd/2010], Cotton Naturals (I) Pvt. Ltd. v. DCIT 22 ITR (T) 430 (Del) (Trib), DCIT v. Indo-American Jewellery [2010] 41 SOT 1 (Mum), DCIT v. Lumax Industries Ltd. [2014] 36 Taxmann.com 380 (Del) and ACIT v. Philip Software [2008] 119 TTJ 721 (Bang)

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