



## Transfer pricing provisions do not apply in respect of transactions between the Indian head office and its overseas branch office

### Background

The Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in case of Aithent Technologies Private Limited<sup>1</sup> (taxpayer), held that Transfer Pricing (TP) provisions cannot apply in respect of transactions between the Indian Head Office (HO) and its overseas Branch Office (BO) in Canada.

### Facts of the case

The taxpayer is an Indian company having an overseas BO in Canada and a 100 per cent subsidiary in USA. Transactions between the taxpayer and its overseas BO were treated as international transactions and their arm's length price (ALP) was determined by the Transfer Pricing Officer (TPO). The taxpayer also entered into an international transaction with Aithent Inc., USA, and adopted Transactional Net Margin Method (TNMM) as the most appropriate method. The TPO adopted a number of search filters for selecting the comparable companies and accordingly made a TP adjustment.

### Tribunal's ruling

#### **Issue - Determination of ALP in respect of transactions of the taxpayer with its overseas Branch Office**

- The Tribunal, placing reliance on precedents set by the Supreme Court of India<sup>2</sup> and various Indian High Courts<sup>3</sup>, endorsed the 'Principle of Mutuality' and held that there can be no profit from trade with self and there cannot be a valid transaction of sale between BO and its HO.

- However, it clarified that if a foreign general enterprise has a BO in India, such BO will be considered as an 'enterprise' under Section 92F(iii) of the Income-tax Act, 1961 (the Act) and the transactions between the foreign HO and the Indian BO will be considered as an 'international transaction' in terms of Section 92B of the Act.
- This is because of the fact that, as per Section 5(2)<sup>4</sup> of the Act, the scope of total income in case of non-residents only include such income which is received or deemed to be received in India or which accrues or arises or is deemed to accrue or arise in India. In such circumstances, non-resident taxpayers may resort to under/over-invoicing so as to mitigate the tax burden in India.
- In the instant case, even though prima facie it appears that the overseas BO of the Indian HO is covered under the term 'enterprise' as defined under Section 92F(iii), but considering the fact that, in terms of Section 5(1)<sup>5</sup> of the Act, a tax-resident of India is liable to be taxed on its global income, the argument that a transaction between an overseas BO of an Indian HO and the HO itself is subject to TP provisions loses its substance.

<sup>1</sup> Aithent Technologies Private Limited v. DCIT (ITA No.6446/Del/2012 - Assessment Year : 2008-09)

<sup>2</sup> Sir Kikabhai Prem Chand v. CIT [1953] 24 ITR 506 (SC)

<sup>3</sup> Betts Hartley Huett & Co. Ltd. v. CIT [1979] 116 ITR 425 (Cal) and Ram Lal Bechiram v. CIT [1946] 14 ITR 1 (All)

<sup>4</sup> Section 5(2) of the Act includes all income from whatever source derived which (a) is received or is deemed to be received in India in such year by or on behalf of such person or (b) accrues or arises or is deemed to accrue or arise to him in India during such year.

<sup>5</sup> Section 5(1) of the Act - "Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which (a) is received or is deemed to be received in India in such year by or on behalf of such person ; or (b) accrues or arises or is deemed to accrue or arise to him in India during such year; or (c) accrues or arises to him outside India during such year".

- It further stated that on aggregation of accounts of the HO and its overseas BO, any additional profit earned by the HO would be set off with the equal amount of expense of the BO, thereby not leaving any separately identifiable income on account of this transaction. Thus, over/under invoicing between the Indian HO and its overseas BO is always income-tax neutral.
- Making a TP adjustment with respect to international transactions between the Indian HO and its overseas BO will result in charging tax on income which is more than legitimately due to the exchequer which is impermissible. In the instant case, the taxpayer has rightly offered to tax, not only the amount earned by the Indian HO, but also the income earned by its overseas BO.

### **Issue - Application of certain filters resulting in TP adjustment on transactions with AE in USA**

- Non-application of upper turnover filter - Averaging of the profit rates of a whole lot of functionally similar companies having higher or lower turnover vis-à-vis the taxpayer, irons out the effect of such differences. Thus, in view of the Delhi High Court judgment in the case of ChrysCapital Investment Advisors (India) Pvt. Ltd.<sup>6</sup> wherein it was held that high profit/turnover cannot be criteria to exclude an otherwise comparable company, TPO in the instant case was justified in not applying the upper turnover filter.
- Companies who have less than 25 per cent of the revenues as export sales were excluded – Since the taxpayer's export revenue is roughly 21 per cent of total revenue, applying the filter of excluding the companies having less than 25 per cent of the revenue's from export sales, would eliminate companies which are similarly placed as the taxpayer. Both, taxpayer and revenue have now agreed to apply the filter of excluding the companies with export sales of more than 30 per cent of the total revenue.
- Companies with more than 25 per cent have related party transactions (RPT) [sales as well as expenditure combined] of the operating revenues were excluded - Both the numerator and denominator should have the same nature of contents. This can be ensured by comparing RPT of purchase with the total purchases or RPT of sales with the total sales of the

company. Inclusion/ exclusion of a comparable by applying the filter of more than 25 per cent RPT, would depend on the outcome of two such percentages of RPT. If the company fails the threshold in either case, then it will cease to be comparable.

- Companies with diminishing revenues or persistent losses - The taxpayer's profit has diminished during the instant year from the preceding year. Thus, companies having diminishing revenue should not be excluded but only companies having persistent losses should be excluded.
- Companies whose onsite income was more than 75 per cent of the export revenues were excluded - If the taxpayer's argument that its BO earned only onsite services income is correct, the filter applied by the TPO excluding companies whose onsite income is more than 75 per cent of the export revenues, becomes meaningless. TPO/AO are directed to examine the break-up of the revenues earned by BO for evaluating if the same is from onsite/offsite services and decide on the application of the filter accordingly.
- Adjustment on account of idle capacity - In TNMM, the effect of differences between the international transaction and comparable uncontrolled transactions is always given in the net operating profit margin of the comparable uncontrolled transactions. There is no mandate for adjusting the taxpayer's profit margin under the provisions of Rule 10B(1)(e) of the Income Tax Rules. The adjustment, if any, could have been allowed, if the taxpayer had demonstrated that the comparable companies had more under-utilisation of their labour force vis-à-vis the taxpayer, which the taxpayer could not substantiate. Thus no such adjustment can be granted.

### **Our comments**

It is possible to take a view that the Tribunal stretched too far in analysing the term 'enterprise' as defined under Section 92F(iii) of the Act. Instead, it could have dismissed the tax authorities contention at the outset by stating that the transfer pricing provisions are not applicable where both the transacting parties namely; The Indian HO and its overseas BO, are tax-residents of India.

<sup>6</sup> ChrysCapital Investment Advisors (India) Pvt. Ltd. v. DCIT [2015] 376 ITR 183 (Del)

[www.kpmg.com/in](http://www.kpmg.com/in)

#### Ahmedabad

Commerce House V, 9th Floor,  
902 & 903, Near Vodafone House,  
Corporate Road,  
Prahlad Nagar,  
Ahmedabad – 380 051  
Tel: +91 79 4040 2200  
Fax: +91 79 4040 2244

#### Bengaluru

Maruthi Info-Tech Centre  
11-12/1, Inner Ring Road  
Koramangala, Bangalore 560 071  
Tel: +91 80 3980 6000  
Fax: +91 80 3980 6999

#### Chandigarh

SCO 22-23 (1st Floor)  
Sector 8C, Madhya Marg  
Chandigarh 160 009  
Tel: +91 172 393 5777/781  
Fax: +91 172 393 5780

#### Chennai

No.10, Mahatma Gandhi Road  
Nungambakkam  
Chennai 600 034  
Tel: +91 44 3914 5000  
Fax: +91 44 3914 5999

#### Delhi

Building No.10, 8th Floor  
DLF Cyber City, Phase II  
Gurgaon, Haryana 122 002  
Tel: +91 124 307 4000  
Fax: +91 124 254 9101

#### Hyderabad

8-2-618/2  
Reliance Humsafar, 4th Floor  
Road No.11, Banjara Hills  
Hyderabad 500 034  
Tel: +91 40 3046 5000  
Fax: +91 40 3046 5299

#### Kochi

Syama Business Center  
3rd Floor, NH By Pass Road,  
Vytilla, Kochi – 682019  
Tel: +91 484 302 7000  
Fax: +91 484 302 7001

#### Kolkata

Unit No. 603 – 604,  
6th Floor, Tower – 1,  
Godrej Waterside,  
Sector – V, Salt Lake,  
Kolkata 700 091  
Tel: +91 33 44034000  
Fax: +91 33 44034199

#### Mumbai

Lodha Excelus, Apollo Mills  
N. M. Joshi Marg  
Mahalaxmi, Mumbai 400 011  
Tel: +91 22 3989 6000  
Fax: +91 22 3983 6000

#### Noida

6th Floor, Tower A  
Advant Navis Business Park  
Plot No. 07, Sector 142  
Noida Express Way  
Noida 201 305  
Tel: +91 0120 386 8000  
Fax: +91 0120 386 8999

#### Pune

703, Godrej Castlemaine  
Bund Garden  
Pune 411 001  
Tel: +91 20 3050 4000  
Fax: +91 20 3050 4010

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

© 2016 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.