Domestic TP on Inter-unit transactions – Treading the path of evolution!!

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With the proliferation of globalization over last two decades, Multinational Enterprises ("MNEs") have established highly spread out supply chain across geographies which had exponentiated the adoption and application of Arm's Length Principle ("ALP") in cross border transfer pricing with focus on base erosion and profit shifting control mechanisms. As globalization exploded, so did the governmental policies of each country to attract investments by providing incentives to set up business operations in respective country including tax sops and exemptions. From India Tax standpoint, this was led by the Software Technology Park of India ("STPI") and Special Economic Zone ("SEZ") schemes amongst other incentives which led to variable tax exemptions. This accentuated businesses to register multiple undertakings under respective schemes withing a single legal entity, as per the requirements, scale of operations and future business plans. Further, MNEs expansion and decentralized/outsourcing outlook led to setting of multiple business entity in each jurisdiction. While there may be obvious reasons to reduce and manage the effective tax rates by availing benefits of such incentives, practical issues surfaced regarding shifting of profits between tax holiday units (i.e. eligible units – "EU") vs non tax holiday units (i.e. non eligible units – "NEU") and/or between two legal entities having differential tax rates (or even a loss making group entity).

This necessitated the introduction of Specified Domestic Transaction ("SDT") under Section 92BA in Finance Act 2012 by borrowing the transfer pricing regulations to establish arm's length nature of such inter-unit transactions with references to provisions under Section 80IA(8) or 80IA(10) applicable for 10AA exempted units or exemption under Chapter VI-A of Income Tax Act, 1961 ("the Act").

In line with suggestion given by the Supreme Court of India in its order in the case of Glaxo SmithKline Asia (P) Ltd.[1] , the Indian government in financial year 2012-13, expanded the scope of Indian transfer pricing regulations to cover SDTs also. At present, the scope of SDTs is limited to situations where one party is liable to pay tax at a lower rate in comparison to the other such as tax holiday units along with applicability de-minimis monetary limit of aggregate value of such transactions to INR 20 Crores.

In the ruling of **Wipro Limited [TS-528-ITAT-2020(Bang)-TP]** (relevant to AY 2013-14 which was first year of SDT applicability), Income Tax Appellate Tribunal ("ITAT" or "the Tribunal") Bangalore, evaluated some of the obscurity in SDT regulations and held that the transactions between two eligible units are out of the horizon of SDT and that the ALP determined for the service provider should be considered as the ALP for the cost incurred by the service receiver. The ruling has demystified some of the important aspects in a detailed discussion although finally restoring back the matter to the files of the lower level tax authorities.

Synopsis of the ruling

Brief facts of the Case

Wipro Limited ("the Assessee") is engaged in diverse business activities, including providing information technology ("IT") and software services through various units located in SEZ or STPI or other places, that may be EUs or NEUs. Each of the undertakings are owned by the Assessee and would independently enter into a contract with each of its customers for providing software and IT services on comprehensive basis.

On certain occasions where the contracting undertaking ("primary unit") did not have adequate staff or staff with some requisite skill sets to provide the services, such undertaking sub-contracted the job to another undertaking ("secondary unit") that had the availability of staff with required skill sets. In such cases, the secondary unit invoiced the primary unit for rendering the requisite services to the primary unit. In compliance with Section 92BA of the Act for AY 2013-14, the Assessee furnished TP documentation

determining the ALP of the SDT in respect of these inter-unit transactions. The margins declared in various EBU in the range of 21.02% to 159.36%, was more than the average margin of the comparable companies and hence the Assessee determined SDT to be at ALP at 15.58%. However, the Transfer Pricing Officer ("TPO") took a view that the EUs have earned extraordinary profits compared to 15.58% average margin earned by the comparable companies and hence has shifted profits to the EUs. As a result, the TPO proposed to restrict the profit of EU to 15.58% and assessed the profits declared by the undertakings over and above 15.58% as transfer pricing adjustment, leading to a direct addition to total income instead of Assessing Officer ("AO") considering the differential amount for re-computation of the deduction available to EU's. The main contention of the Assessee was regarding applicability of SDT between two EUs, and also providing corresponding adjustment to other units, should there be an adjustment to the EUs.

TPO's and Assessee's contentions before ITAT

The contentions of TPO and Assessee are summarised below:

· The TPO observed that the EUs consist of undertakings claiming both 100% and 50% exemption and that for certain EUs, only 50% of profit is exempted from tax. The TPO hence considered that transaction between all EUs is not having full tax incentive and hence the benchmarking cannot be restricted only for NEUs. In this regard, the Assessee submitted that under Section 80IA(8) of the Act, ALP is to be determined for transactions between EU and NEU; or any other Assessee and does not exclude any EU from the category of "eligible units" based on quantum of deduction.

· Assessee also submitted that ALP adjustment of SDT transaction in respect of EUs cannot be mechanically added to Total Income. Adjustment should be made in relevant turnover and profits in the formula prescribed in Section 10AA(7) of the Act and the deduction under Section 10AA of the Act should be accordingly recomputed.

· Assessee further submitted that, if revenue of "service providing unit" is reduced, then corresponding cost in the hands of "service receiving unit" should also be reduced and the deduction under Section 10AA of the Act should be recomputed. Requirement of determination of ALP value under Section 80IA(8) of the Act is there for both service provider and service receiver.

· The other contention of Assessee was that the restriction placed in first proviso to Section 92C(4) of the Act denying deduction in respect of TP adjustment is applicable only where total income is enhanced and not in a case where such income is reduced.

The Judgement

The Bangalore Tribunal, after considering the contentions of the Assessee and the Tax Department, pronounced that the transactions entered between two eligible units are outside the scope of SDT as Section 80IA(8) of the Act cover only the transactions entered between "eligible units" and "non-eligible units". Tribunal opined that, even if differing rate of deduction between two eligible units may result in tax arbitrage, the same shall be outside the scope of provisions of Section 10AA of the Act / Transfer pricing provisions and that there may be a lacunae in the Income tax Act, but the said lacunae could be cured only by the Parliament.

Further, the Tribunal, on basis of evaluation of Sections 80IA(8) and 92C(4) of the Act, upheld the application of Section 92C(4) of the Act and held that unless the ALP is adopted in both the "service providing unit" and "service receiving unit" in respect of their inter-unit transactions, the total income cannot be computed having regard to the arms' length price.

Accordingly, the Tribunal held that the ALP of the inter-unit transactions should be applied in both the eligible and non-eligible unit. However, the Tribunal has not provided any reason for considering Section 92C(4) of the Act to be the overriding provision vis-à-vis Section 80IA(8) of the Act. The only plausible reason could be that Section 92C(4) of the Act is part of the TP provisions and for the TP adjustment to be sustained the TP provisions should be considered prior to the other Sections of the Act.

Tribunal further conferred that the exercise of recomputing total income would become tax neutral, considering its ruling that ALP be applied to both revenue and cost. However, the Tribunal held that this exercise would eventually have effect of reducing the deduction and further held that the "reduction", if any, in the quantum of deduction after application of the ALP would be a Transfer pricing adjustment contemplated in Section 92 of the Act.

Key principles and considerations for SDT - Treading the path of evolution

Though the SDT regulation were introduced from AY 2013-14 with ALP being the standard for testing the

transactions, the concept of "fair market value" was always in existence in different Sections of the Act. During the initial years of audit, there were multiple challenges which were faced by Taxpayers as well as Tax authorities with reference to availability of data, benchmarking process (whether individual transaction analysis or consolidated TNMM analysis), demonstrating business rationale and providing back up documentation to substantiate the cause. While transactions under Section 40A(2)(b) of the Act were the most frequently picked up for scrutiny (now deleted from SDT provisions), inter-unit transfer of goods and services also posed challenges in analysis (similar to the current ruling which is for AY 2013-14). The ruling has laid down some crucial principles which are outlined below, as well as some of other key considerations for SDT analysis which could be worthwhile to note.

Coverage of SDT for inter-unit transfer

The ruling has laid down important principle of non-applicability of SDT provisions to transactions between two EU's, by taking a very strict interpretation of Section 80IA(8) of the Act which clearly mentions transactions between "eligible units" and other business units. While acknowledging the "tax arbitrage" possible even between two EU's (where the quantum of deduction is at different rates), the ITAT has gone by the rulebook to clarify the legal aspect of the provision and applicability.

Corresponding adjustment for any SDT adjustment to EU

An important principle which the ITAT has outlined is on the corresponding adjustment arising out of SDT adjustment. While the ITAT negated the possibility of corresponding adjustment under Section 80IA(8) of the Act (given that this sections covers only eligible units deduction), the ITAT observed that adoption of ALP to both eligible and non-eligible units is correct for the purposes of application of the TP provisions. The TP provisions under Section 92(2A) of the Act requires that the ALP be adopted for expenditure as well as income and in relation to SDT, an income and the corresponding expenditure are two limbs of the same transaction. Hence, the income of both the service-providing unit and the service-recipient unit is required to be computed at ALP and if revenue of "service providing unit" is reduced, then corresponding cost in the hands of "service receiving unit" should also be adjusted.

Re-computation of total income and deduction

Section 92C(4) of the Act provides that AO may re-compute the total income of the Assessee having regard to ALP. Considering that the ALP is to be adopted for both expenses and income in respect of inter-unit transactions and that total income of the Assessee be recomputed, this would result in recasting the Profit and Loss Account of the Assessee. Though adopting ALP for both expenses and income would be a tax neutral exercise, the re-computation is required to determine the profit of the individual units based on ALP and recompute the amount of deduction that the Assessee is eligible to claim. As in the instant case, the ITAT disapproved the Tax authorities' approach of directly enhancing the income rather than re-computing the deduction itself and the issue was restored to the file of AO/TPO. Nevertheless, this is an important aspect, which although being there in the law, has been explicitly clarified by the ITAT by way of illustrations highlighting the point that SDT provisions should be for merely allowing deduction from the total income and not for changing the total income.

Allocation of common corporate overheads costs to eligible units

The Tribunal in analysing the SDT issue has restricted only to applicability of provisions under Section 92BA of the Act to inter-unit transactions of goods/ services under Section 80IA(8) of the Act. However, in the appeal for prior years which are also covered in the order, one of the issues have been allocation of the corporate overhead to units claiming deduction under Section 10A/ 10AA/ 10B of the Act. From a SDT standpoint, while a view can be adopted that the corporate overhead costs may not be subject to SDT if such expenditure are considered as "non-marketable" service from NEU to EU, nevertheless, such costs should be appropriately allocated to the EUs from general accounting principles based on fair and rationale cost allocation in order to compute appropriate tax deduction which should be available to EU. Hence, Taxpayers should analyse such common overhead costs or support function from a closer lens to - (1) assess whether there exists a marketable service element in such costs/activities; and (2) even if no marketable service exists, then to apply general accounting principles (borrowing some references from TP aspects of costs allocation mechanism) to demonstrate the appropriateness of such costs.

Business mapping of resources/costs for inter-unit transfers

Given the multiple undertakings which exists in same legal entity and also the geographic distribution of teams across locations, there is an imperative need for business team to engage teams/ resources from different units depending on the skillset, bandwidth, time sensitivity, etc. As business teams tend to focus only on customer delivery of contracts, appropriate mechanism should be implemented in business systems

to effectively map and track the resource time efforts, costs or product movements across units. Though the typical approach of Tax authorities has been to focus on "more than normal" profits as a starting point of analysis and compare the margins established by comparability analysis, the focus on appropriateness of costs itself is likely to be an extensive focal point as the SDT evaluations become more prevalent. Accordingly, Taxpayers should pay adequate attention to such cross engagements between units (specially in matrix organisations and multiple units).

One of the arguments which was taken by the Taxpayer, although not discussed anywhere in the ruling was the fact that the adjustment on account of SDT cannot exceed the actual transaction value. While there have been rulings in the context of international TP cases where the courts have pronounced that the TP adjustment cannot exceed the transaction value, similar arguments should also be kept in mind for inter-unit transfers as there might be instances the entire profits of the EU which is claimed to be more than normal profits may not be a result of only inter-unit transfers but could be factor of non-SDT transactions as well. Depending on the facts of the case, appropriate analysis should be performed at the time of documentation as well, to avoid potential issue which may arise similar to the case at hand.

Benchmarking of SDT for inter-unit transfer

Benchmarking of SDT for inter-unit transfer while following the normal ALP determination should be based on one of the prescribed methods provided in Section 92C(1) of the Act. As TNMM is the most commonly used method in transfer pricing analysis (due to its inherent benefits of undertaking a net margin based analysis), an important point to be considered should be appropriate exploration of using internal comparable data, there could exist transactions with third party customers where similar services could have been provided by the goods/ service provider unit to its own customers which are contracted by the individual unit. The importance of internal comparable has also been discussed and accepted by the ITAT for Wipro Limited, for issue raised regarding comparability analysis of international transactions of the Assessee for the same AY. Further, in a recent ruling of Mumbai ITAT in the case of **Reliance Industries Ltd [TS-606-ITAT-2020(Mum)-TP]** has also upheld the use of internal comparable for SDT (transaction between service receiving unit and third party). The ITAT has also upheld that the Fair Market Value ("FMV") determined under Section 80IA(8) of the Act before introduction of SDT can be considered as ALP for SDT post application of TP regulations for inter-unit transactions.

Concluding remarks

Worldwide, several countries like China, Malaysia, Indonesia, Australia, some of the EU member states, African countries, USA and other jurisdictions have implemented TP regulations for domestic transactions along with cross-border arrangements. While there may be genuine business objectives to expand and avail tax benefits offered by Tax policies, the issue of "tax arbitrage" and "tax evasion" are like a medicine with side effects, with substance over form being the critical factor. For India, the Government has already laid the tracks for reduction in such litigation by putting a sunset to many tax incentive schemes and providing reduction in corporate tax rates for entities not claiming any tax holiday/ exemptions. However, with business conglomerates and various companies having plans of expansions, and profits generally dwindling, savings by way of availing tax holidays and available exemptions may again more momentum. In such situations, determining ALP of SDT will boil down to the most elementary requirement of transfer pricing i.e., maintaining elaborate and appropriate documentation supporting the business rationale for each of the elements in the horizon. The current ruling, being the first year of SDT assessment, has definitely laid a foundation keystone for approaching SDT for inter-unit transactions and would form the basis of many rulings on SDT in times to come as well as serving as useful guidance for Taxpayers to analyze its SDT in an appropriate manner.

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[1] Commr.Of Income Tax-Iv, Delhi & Another V. M/S Glaxo Smithkline Asia(P) Ltd. – ([2010] 236 CTR [SC] 113), Page No. 3 (Supreme Court, 2010)