



TRANSFER PRICING ALERT

N. A. SHAH **BULLETIN**

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EXECUTIVE SUMMARY

- ITAT rejects the assessee's base erosion argument and held that Indian tax authorities is entitled to make a transfer pricing adjustment in respect of interest free loan advanced by an assessee (a non-resident company) to its Indian subsidiary.
- Since in the present case, Indian subsidiary is a loss making entity, on one side no tax will arise to Indian subsidiary and on other hand, Indian tax authorities will lose the taxability of interest in the hands of the assessee @ 10% and accordingly, base erosion will take place. Hence, by not making the adjustment, tax authorities is certain to have its tax base eroded by 10%.
- Income is to be computed based on entries in books in respect of previous year in which the international transaction was entered into and thus no scope at all for taking into account the impact on taxes for the subsequent year.
- ITAT rejected the assessee's plea that if there is an enhancement to an income, corresponding deduction cannot indeed be given to the related AE, but if an altogether new income is brought to tax in the hands of the assessee as a result of ALP adjustment, corresponding deduction is required to be given to the Indian AE.

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Instrumentarium Corporation Limited, Finland vs. Assistant Director of Income Tax, International Taxation-I Kolkata (Kolkata Tribunal - Special Bench)

ITA Nos. 1548 and 1549/Kol/2009

Facts:

1. Instrumentarium Corporation Limited ("ICL Finland" or "the assessee") a non-resident company incorporated in Finland. ICL Finland is engaged in the business of manufacturing and selling medical equipment, and it has a wholly owned subsidiary in India i.e. Datex Ohmeda India Pvt Ltd ("Datex India" or "Associated Enterprise" or "AE") which acts as ICL Finland's marketing arm for its products in India.
2. The assessee has advanced an interest free loan to Datex India. In the assessment order of the assessee, the AO has also noted that the Datex India is a loss making concern and it has accumulated losses and unabsorbed depreciation.
3. The Assessing Officer ("AO") has computed an arm's length interest on the said loan and made an arm's length price ("ALP") adjustment to the income of ICL Finland.
4. Aggrieved, the assessee filed an appeal before CIT(A). CIT(A) rejected the objections of the assessee on this issue and confirmed the order of the AO.
5. Aggrieved, the assessee preferred an appeal before the Tribunal and the division Bench referred the issue to the Special Bench.

Issue

1. Whether an ALP adjustment, was required to be made, in respect of interest free loan granted by the assessee, a non-resident company, to its wholly owned subsidiary in India?

Contentions of the assessee:

1. The primary argument of the assessee was that since there was no erosion of tax base in India by the assessee giving an interest free loan to its wholly owned subsidiary Indian company, the provisions of the transfer pricing cannot be invoked. In other words, in a situation in which result or consequence of an arm's length price adjustment is erosion of domestic tax base, the provisions of transfer pricing cannot be invoked.
2. The assessee pointed out that if the computation of interest is imputed to the loan, the net result will be:
 - a. Interest income will be taxable in the hands of the assessee @10% on gross basis,
 - b. Deductibility of the said expenses in the hands of the resident AE which will give benefit of 36.75% tax;
 - c. A resultant base erosion of 26.75% to the Indian revenue authorities.
3. The assessee also placed reliance on **CBDT circular no. 14 of 2001** which states that "*...the basic intention underlying the new transfer pricing regulations is to prevent shifting of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base...*" and that "*...the new section 92 is, therefore, not intended to be applied in cases where adoption of arm's length price, determined under the regulations, will result in a decrease in overall tax incidence in India in respect of parties involved in the international transactions...*".
4. Further, the assessee placed reliance on **ruling no. 1 of 2007 issued by the Australian Tax Office ("ATO")** which held that "*ALP adjustments are not required to be made in the cases of interest free loans granted by the non-resident company to the domestic company even if the domestic company is incurring losses.*"
5. The assessee also pointed out that the bar on corresponding adjustments as provided in second proviso to section 92C(4) of the Act, comes into play only when arm's length price is paid to the AE. In the present case, since no payment has been made by the Indian AE, i.e. Datex India, the bar on deduction does not come into play.

Contentions of the tax department:

1. The tax department contested that the assessee was earlier charging interest on loans given to Datex India. However, subsequently stopped charging interest due to losses suffered by Datex India and not gaining any tax advantage from these interest payments.

Held:

1. The Tribunal stated that according to section 92(3) of the Act, what is to be seen is impact on profits or losses for the year in consideration itself, as it is to "*be computed on the basis of entries made in the books of accounts in respect of previous year in which the international transaction was entered into.*", thus the impact on taxes for the subsequent years is irrelevant.
2. ITAT rejected the assessee's plea that if there is an enhancement to an income, corresponding deduction cannot indeed be given to the related AE, but if an altogether new income is brought to tax in the hands of the assessee as a result of ALP adjustment, corresponding deduction is required to be given to the Indian AE.
3. The second proviso to section 92C(4) of the Act constitutes a bar against lowering income of the non-resident AE, as a result of lowering the deduction in the hands of the Indian AE, rather than enabling a higher deduction in the hands of the Indian AE as a result of increasing non-resident AE's income.
4. ITAT distinguished the ATO ruling vis-a-vis section 92 of the Act and stated that unlike the provisions of section 92, wherein use of arm's length principle is mandatory in computation of income arising to an assessee from the international transactions, Section 136 AD of the Australian Income Tax Assessment Act 1936 ("AITA") provides discretionary power to Commissioner for computation of income on the basis of arm's length price in respect of an international transactions between the AE. Further, Special Bench distinguished the AITA such that consequential adjustments are permissible in certain conditions under section 136AF of the AITA, and no such adjustments are permissible under the Indian Act.
5. The CBDT circular (supra) relied on by the assessee only states the intent of the legislature in so many words. However, it is not an order, direction or instruction to the field authorities to the effect that section 92 is not to be applied when

overall tax incidence in India, in respect of the parties involved in the international transaction, will decrease.

6. Special Bench placed reliance on the divisional bench ruling in the case **Tata Tea Ltd vs JCIT [(2003) 87 ITD 351 (Kol)]**, and stated that even if the intent of the legislature is that the transfer pricing provisions should not to be invoked in the cases where there is lowering of the overall profits of all the AEs connected with the transactions; since the words of the statutory provision did not translate the said intent into the law, it is not open to hold that even when there is no erosion of Indian tax base, transfer pricing provisions are not to be applied, especially in the light of the legal provisions as stated under section 92(3) of the Act.
7. Based on all the above observations, the Tribunal declined to accept the base erosion argument of the assessee in principle nor did they find anything in the facts on record to even support the factual elements embedded in the plea of the assessee.
8. It further held that the commercial expediency of a loan to subsidiary is wholly irrelevant in ascertaining arm's length interest on such a loan.
9. It stated that, in the assessee's case, there was no re-characterization of the transaction, as the transaction continued to be a loan transaction and the substitution of zero interest by arm's length interest does not alter the basic character of transaction. The question of re-characterization arises only when the very nature of transaction is altered, such as capital subscription being treated as loan or such a trade advance received being treated as a borrowing.
10. It rejected the plea of the assessee that when the assessee has not reported any income from a particular international transaction, the ALP adjustment cannot compute the same. The computation of income on the basis of arm's length price does not require that the assessee must report some income first, and only then it can be adjusted for the ALP.
11. Special Bench also distinguished the assessee's reliance on the decision of **Hon'ble Bombay High Court in the case of Vodafone India Services Limited Vs ACIT [(2015) 368 ITR 1 (Bom)]** which deals with a situation in which the international transaction was inherently incapable of producing the income chargeable to tax as it was in the capital field, on the contrary, in the case of assessee the consideration for a loan, i.e. interest, is inherently in the nature of income.

12. The Tribunal concluded that even when no income is reported in respect of an item in the nature of income, such as interest, but the substitution of transaction price by arm's length price results in an income, it can very well be brought to tax under Section 92. It rejected the plea of the assessee that no arm's length price adjustments can be made in respect of the interest free advances granted by the assessee to its Indian AE.

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