TP ordeal for STP units: Advantage swings back to Revenue

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FOR those of us who deal with the transfer pricing provisions, especially as applicable to 100% Export Oriented Units / STP Units, the decision of the Bangalore ITAT in the Philips Software case reported in 2008-TIOL-471-ITAT-BANG, delivered in September 2008 came as a landmark judgment. The news that this decision has been stayed by the Karnataka High Court on an appeal by the Revenue, therefore, reported in 2009-TIOL-123-HC-KAR-IT comes as a rude shock.

While congratulating TIOL for breaking this very important decision from the Karnataka High Court, we will proceed to try and understand its implications for the exporting community and especially to the IT Exporters who operate as 100% Export Oriented Units, under the Government of India's Software Technology Parks Scheme.

The Karnataka High Court's decision staying the decision of the Bangalore ITAT, as aforesaid, has admitted the following questions of law:

34. Whether the Tribunal was correct in holding that the transfer pricing provisions cannot be invoked and applied in the case where the provisions of section 10A of the Act, is availed of by the assessee, particularly when the language of the statute is plain and unambiguous?

36. Whether the Tribunal was correct in holding that the taxpayer was justified in using earlier year data in comparability analysis though it is mandatory as per rule 10B(4) to use the current year's data and also that the data available in the public databases in test by the specified data should alone be used and the TPO cannot use data becoming available subsequent to the specified date?

37. Whether the Tribunal was correct in holding that the proviso to section 92C(2) of the Act provides for a standard deduction of 5% in all the TP cases?

38. Whether the Tribunal was correct in allowing a flat comparability adjustment of 11.72% (6.46% working capital adjustment + 5.25% risk adjustment) ignoring all important issues like the quality of adjustment data, purpose and reliability of the adjustment performed to be considered before making adjustment on account of capital and risk, which was contrary to Rule 10B(3)(ii) which provides for only reasonably accurate adjustment ?

39. Whether the Tribunal was correct in holding that the companies with even a single rupee worth related party transactions should not be selected as a comparable and still proceeded to accept the taxpayer's comparable which had significant related party transactions ?

40. Whether the Tribunal was correct in upholding the arm's length price determined by the taxpayer which suffered from various defects and rejecting the arm's length price determined by the TPO which was based on cogent evidence and correct analysis of the data ? "

The most critical point of law arising of the stay relates to the applicability of the transfer pricing provisions to companies which claim 100% exemption of the export profits under Section 10A of the Income tax Act. These are typically, companies from the IT sector which export software and other services. The popular belief that has been prevalent, till now, is that, companies claiming exemption under Section 10A (or for that matter, under Sections 10AA and 10B) are not required to pay any income tax in any case, and any upward adjustment of the profits of such companies by the Transfer Pricing Officer, would not result in any tax being payable to the Government, as the exempting Sections clearly specify that no tax is payable by these undertakings.

In Aztec Software & Technology Services Ltd. Vs Assistant Commissioner of Income-tax, Circle 11(1), Bangalore, (2007-TIOL-210-ITAT-BANG-SB) which was heard by a 5 member Special Bench of the Bangalore ITAT, a comprehensive look was taken at the TP provisions and especially those related to the highly contentious Sections 92C and 92CA of the Income tax Act.

The Special Bench of the Bangalore ITAT had categorically held as under, in Paras 21 and 22 of its order as under:

21. It is abundantly clear that Legislature while introducing the enactment did comprehend a situation requiring investigation and addition on account of computation of arms' length price in cases of the assessee entitled to benefit under sections 10A/10AA or section 10B of the Act. In the light of specific provision, it is difficult to contend that arms' length prices cannot be determined under section 92C or 92CA where assessee is entitled to benefit of above sections.

22. In the light of above discussion, we hold that although Chapter-X has title "Special provision relating to avoidance of tax" and aim of various sections under Chapter-X is to check avoidance of taxes, diversion of income and funds by non-residents from India, it is not necessary that Assessing Officer must demonstrate such avoidance and diversion of tax before invoking provisions of section 92C and 92CA. Consequently, question No. 1 is answered in negative i.e. against the assessee and in favour of the Revenue. It is further held that the ld. CIT (Appeals) was wrong in attaching importance to the fact that the taxpayer is entitled to benefit under sections 10A/10AA of Income-tax Act.

It therefore came as a relief to the STP Units, when the Bangalore ITAT, in the Philips Software case, though referring to the decision in the Aztec case, held that the basic intention behind introducing transfer pricing provisions in the Income tax Act being to prevent shifting of profits outside India, where an assessee is entitled to claim benefit under section 10A, transfer pricing provisions cannot be applied. With the staying of the Bangalore ITAT decision in the Philips Software case by the Karnataka High Court, the land reverts back to the decision laid down by the Bangalore ITAT in the Aztec case, which is that, the transfer pricing provisions are applicable to all companies including those which claim exemption under Sections 10A, 10AA and 10B.

With the successfully appeal by the Revenue and the staying of the decision given by the Bangalore ITAT in the Philips Software case, it is clearly Advantage Revenue. We are already hearing that TPOs are working overtime to pass orders under the transfer pricing provisions in respect of the large STP Units and with stay orders practically hard to come by, it is clearly bad times for the STP Units.

Another very interesting point of law which has got stayed is the applicability of the Tribunal decisions in the Mentor Graphics case (2007-TIOL-382-ITAT-DEL) and the E-Gain Communications case (2008-TIOL-282-ITAT-PUNE). These two Tribunal decisions, from out of the dozens of decisions that have come out over the last two or three years, had brought some ray of hope for the hapless STP Units, under attack from the TPOs (who were too eager to pass orders fixing the value of the international transactions between the STP Units and their Principals who, in most cases, were their own holding companies registered abroad at levels which were significantly higher than those followed by these STP Units).

The TPOs are either holding that the method followed by the STP Unit is not the most appropriate method or that, the margins that are assumed for the international transactions under a particular method, do not match comparable transactions of comparable companies. Incidentally, both the Tribunal decisions mentioned above, had upheld relatively lower margins for that the appellants had assumed for justifying the valuation of their international transactions, on an 'arms length' basis. Interestingly, in the E-Gain Communications case, the Pune ITAT had upheld the 5.16% cost plus method followed by the Company, while in the Mentor Graphics case, the Delhi Tribunal had upheld the 6.99% margin adopted under the TNMM method. It may not be out of place to mention that, amongst hundreds of orders passed by the TPOs across the country, significantly increasing the profits of the STP Units, by following the transfer pricing provisions, these two Tribunal decisions had provided some sort of a relief and one was happy to see the Bangalore ITAT hold that these two decisions were 'squarely applicable' to the Philips Software case.

By staying the Bangalore ITAT decision, the Karnataka High Court would seem to have shifted the advantage squarely in favour of the Revenue.

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