Cushman HC ruling - Who should apply benefit test - AO or TPO?

Jun 13, 2014

Amod Khare
Partner - Transfer Pricing, BMR Advisors

Cushman and Wakefield (I) P. Ltd. ('Taxpayer') vs. CIT

Recently the High Court of Delhi ('Delhi HC') delivered a landmark ruling on transfer pricing of intra-group services, and the deductibility of such expenses for the purposes of computation of total income of the Taxpayer.

Facts

The Taxpayer was engaged in rendering services in connection with acquisition, sale and lease of real estate property, and other services such as advisory and research, facilities management, project management, etc. in the real estate sector. In FY 2005-06, the Taxpayer had entered into several international transactions, amongst which reimbursement of expenses and payment of referral fees were subject matter of appeal before the Delhi HC.

Reimbursement of expenses

The Taxpayer had availed liaison and co-ordination services from its associated enterprises ('AEs') Cushman and Wakefield, Singapore ('CWS') and marketing support services from Cushman and Wakefield Hong Kong ('CWHK'), against which it hadreimbursed cost (direct and indirect) incurred by the AEs.

The Transfer Pricing Officer ('TPO') determined the arm's length price ('ALP') of the transactions to be 'nil', stating that economic / commercial benefit derived by the Taxpayer was not sufficiently evidenced with supporting documents,and to the extent benefit was derived,the same was incidental.

Payment of referral fees

The Taxpayer had made certain payment to its AEs for referral of clients in the real estate business, which the TPO concluded to be at ALP. The Assessing Officer ('AO'), however, while determining the total income of the Taxpayer, disallowed such referral fee stating that the receipt of services was not sufficiently evidenced, and that the Taxpayer failed to establish the link between the clients and its AEs which could have facilitated a referral.

On appeal, the Dispute Resolution Panel upheld the disallowances made by the TPO / AO.

Income-tax Appellate Tribunal ('Tribunal') proceedings

The Tribunal was of the view that the Taxpayer had furnished ample and adequate evidence to substantiate receipt of services and the same could not be categorized as incidental in nature. It was also noted that it was necessary to provide such services in order to earn revenue from clients. Had the Taxpayer itself rendered such services, it would have resulted in extra expenditure, and if such services were outsourced to a third party, it would invariably include a profit element to it. Since, the Taxpayer

had only reimbursed cost incurred by the AEs, and had furnished adequate evidence to demonstrate the benefit received by it, the Tribunal deleted the disallowances.

In connection with the referral fees, the Tribunal noted that once the ALP had been determined by the TPO, the AO did not have the power to re-examine the transaction. The Tribunal even on merits concluded that the Taxpayer had furnished adequate evidence in support of the payment of referral fee, and hence, the same had to be allowed by the AO.

Delhi HC proceedings

Aggrieved, the Revenue Authorities challenged the order passed by the Tribunal, asserting that substantial questions of law arose from the order of the Tribunal. The following table summarizes the arguments put forth by the RevenueAuthorities and the Taxpayer:

Revenue Authority's Contentions	**Taxpayer's Contentions**
• No benchmarking exercise conducted in accordance with the Rules, which effectively results in a by-pass of the TP provisions. • The allowance of such expenditure as a deduction is only subsequent to ALP determination.	• The Tribunal's conclusions are sanctioned under the TP provisions. • Since, only the costs incurred by the AEs is recharged, any mark-up would result in reduction of the overall tax incidence in India.

Upon detailed discussions, the HC arrived at the following conclusions:

Reimbursement of expenses

- Actuality of cost has not been disputed, although the ALP of the transaction needs to be determined as per the provisions of section 92 of the Act;
- Mere claim of a reimbursement, does not imply that the costs may not have been inflated, and only once the ALP is determined, it can be verified whether section 92(3) can be invoked;
- Although the OECD TP Guidelines are relevant and are an important source of guidance, they are not binding in Court and determination of ALP depends on individual facts and circumstances;
- Furthering the principle upheld in *Dresser-Rand India*[1] and *Deloitte Consulting India*[2], the HC noted that the authority of the TPO is only restricted till determination of the ALP, not deciding the deductibility of the expense;
- It is the prerogative of the AO to factually verify the existence of services and benefit derived by the Taxpayer, in order to determine the extent of deductibility of the expense;
- In line with established jurisprudence, the HC noted that it is neither for the Revenue Authorities, nor the Courts to question the commercial wisdom of the Taxpayer;

Payment of referral fee

- The jurisdiction of the AO under section 37 and that of the TPO under section 92CA are clearly demarcated;
- The role of the TPO is limited to determining the price an independent third-party would be willing to pay in comparable circumstances;
- Post determination of the ALP, the AO must verify the existence of servicesand accrual of actual benefit;
- The AO is bound by the order of the TPO in as much as the quantum / percentage of referral fee is concerned, while it is up to the AO to determine the actual existence of the 'referral', and consequentially allow deduction for such expense;

Accordingly, the Delhi HC remanded the matter back to the TPO, to determine the ALP of the transaction in accordance with the provisions laid down under the Act, and for the AO to determine the deductibility of the expense vis-à-vis the benefit accrued to the Taxpayer.

Key Takeaways

In its ruling, the Delhi HC has set out factors to be examined in the determination of allowability of group recharges, which tax payers should make a note of:

- Correct identification of the allocated costs;
- The activities for which the costs were incurred;
- Whether the benefit that accrued from these activities has been established; and
- Whether the amount recharged meets the arm's length test.

The Delhi HC has held that the authority of the TPO is to conduct a TP analysis to determine the ALP and not to determine whether the tax payer derives a benefit from the service. The Delhi HC has opined that the determination of benefit to the tax payer is in the domain of the AO. However, the Delhi HC does state that the TPO could conclude that the ALP is 'nil' on the basis that an independent entity in a comparable situation would not pay any amount for the service.

Besides the apparent learnings from the ruling (cost pool should be verifiable, TP documentation should be descriptive about services provided vis-à-vis benefits received, the transaction should be benchmarked with the method being clearly identified), tax payers should note the guidance provided by the Delhi HC – "the devil here lies in the detail". While the Tribunal seemed to be satisfied with the documentation provided by the tax payer, the Delhi HC apparently was not and hence, directed the AO to undertake a detailed verification of the facts and provide reasoned conclusions.

While directing the TPO to determine whether an independent entity would have paid for the service in question, the Delhi HC has categorically stated that in the determination of the ALP, the commercial rationale for incurring of expenditure cannot be questioned. If this position is accepted by the Revenue Authorities, it should bring in reasonableness in the process of determination of the ALP and indeed deductibility of these types of charges.

While the Ruling provides guidance to tax payers and the Revenue Authorities on the complex issue of deductibility of payments for intra-group services, the Ruling could possibly muddy the waters on the responsibility for establishing benefit.

The Ruling states that the process of determination of the ALP for group services should NOT take into account the benefit that a tax payer receives from the services – it seems difficult to conclude on whether a third party would pay for the service without concluding on whether there is a benefit for the tax payer. If this proposition is accepted as the correct one, it seems the effort at demonstrating benefit may be required to be duplicated – once with the TPO to establish that a third party would indeed pay for the service, and then once again with the AO to establish that the service benefits the tax payer and is resultantly incurred in connection with the tax payer's business.

[1] Dresser-Rand India Pvt. Ltd. vs. Addl. CIT [TS-545-ITAT-2011(Mum)]

[2] Deloitte Consulting India Pvt. Ltd. vs. DCIT [TS-224-ITAT-2012(Mum)]