Deemed International Transaction – A Deep Dive!

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Transfer pricing (TP) regulations are in existence in India for more than 15 years. TP provisions have always been a subject matter of dispute between tax administration and taxpayers. TP Issues in dispute till date were mainly on selection of comparables, grant of economic adjustments (such as working capital adjustments, idle capacity adjustments etc), use of multiple year vs single year data, etc. However, with evolution of TP regulations over a period of time in India, these issues seem to be settled now. Interestingly, the next wave of litigation for multinational companies seems to be around applicability of basic TP concepts such as base erosion under section 92(3) of the Income-tax Act, 1961 (the Act), deemed international transaction under Section 92B(2) of the Act, scrutiny of arrangement involving transactions undertaken in concert etc. Recently, Hon ble Kolkata Special Bench in case of **Instrumentarium Corporation Limited** [TS-467-ITAT-2016(Kol)-TP] had ruled on applicability of base erosion concept under the Indian TP regulations.

Indian transfer pricing regulations always had in-built deeming provision whereby transaction entered between Indian taxpayer and unrelated third party enterprise could be deemed to be an international transaction, subject to satisfaction of certain condition and consequently, all the provisions of transfer pricing regulations be equally applicable to such deemed international transaction. In this article, we have endeavoured to discuss the concept of deemed international transaction under Section 92B(2) of the Act, controversies surrounding section 92B(2) and illustrative cases for applicability of Section 92B(2).

(A) Background of Deemed International Tax provisions â€“ Pre and post Finance Act 2014 amendment:

- Sub-section (1) to Section 92B of the Act defines the term international transaction as the transaction between two or more associated enterprises (AE) either or both of whom are non-residents. The said definition makes it amply clear that the transaction between two AEs would be regarded as international transaction provided at least one of the transacting entity is non-resident in India. Characterization of transaction as international transaction carries significance since transfer pricing provisions would be applicable only to international transaction.

- Subsection (2) to Section 92B of the Act is a deeming fiction which broadens the ambit of international transaction as defined under Section 92B(1) of the Act. As per section 92B(2) of the

Act, for the purpose of subsection (1) , a transaction entered between the Indian taxpayer with a person other than AE (hereinafter referred as unrelated third party) shall be deemed to be an international transaction if there exists:

(a) a prior agreement between AE of the Indian taxpayer and such unrelated third party in relation to transaction under consideration; or

(b) terms of the relevant transaction are determined in substance between AE of India taxpayer and such unrelated third party.

- However, unlike Section 92B(1) which clearly states that at least one of the transacting entity should be non-resident, Section 92B(2) did not provide any such clarification as to whether unrelated third party with whom Indian taxpayer transacts is required to be non-resident or not. Hence, on combined reading on Section 92B(1) and 92B(2) and specifically considering the language in Section 92B(2) i.e. for the purpose of subsection (1), certain taxpayers interpreted that provisions of Section 92B(2) of the Act are applicable in following scenario:

- Thereafter, Finance Act, 2014 amended Section 92B(2) of the Act - prospectively with effect from 1 April 2015 - to clarify that transaction between the Indian taxpayer and unrelated third party would be deemed to be an international transaction irrespective of the fact whether such unrelated third party is non-resident in India or not - subject to satisfaction of either of the two conditions provided in the section (as mentioned above). Hence, from FY 2015-16 and onwards, even transactions between two resident entities are brought under the ambit of international transaction . The same could be better understood with the help of following pictorial representation:

(A) Controversies surrounding deemed international transaction provisions and related jurisprudence:

- In pre-Finance Act 2014 scenario, major issue of controversy was application of deemed international transaction provisions by tax authorities to transactions between Indian taxpayer and unrelated third party which is resident in India. Indian taxpayers always contended that since both the transacting entities are resident in India, deemed international transaction provisions cannot be applied to such transaction. In various decisions[1], judicial authorities have upheld the view that deemed international transaction provisions cannot be applied in cases where both transacting entities are resident in India.

- Similar view was expressed by Hon ble Mumbai Tribunal in case of **Kodak India Private Limited Vs Addl. Commissioner of Income-tax** [TS-471-HC-2016(BOM)-TP]. Aggrieved by the order of Tribunal, tax department had filed appeal before the Bombay HC which was recently dismissed by Bombay HC.

- Brief facts about Kodak India s case (supra): Eastman Kodak Co. USA entered into an agreement with Carestream Inc, USA for sales of its medical business stream on global basis. Pursuant to this agreement, Kodak India entered into an agreement with Carestream Health India Private Limited (Carestream India) for sale of its medical imaging business. Terms and consideration of sale were independently determined by Indian companies without any influence by agreement between overseas holding companies.

- During the course of assessment proceedings, TPO treated the transaction of sale of imaging business segment by Kodak India to Carestream India as deemed international transaction under Section 92B(2) of the Act and proceeded to make upward adjustment for the same. While making adjustment, TPO arrived at ratio of Kodak India s revenue from imaging business segment to overall revenue of group from the said business segment and applied the same to the sale consideration received by US parent company to determine value of Kodak India s business. This

adjustment was made by TPO without application of any of the method specified under Section 92C of the Act. On filing of objections before Dispute Resolution Panel (DRP), DRP upheld the order of TPO. Aggrieved by the actions of TPO and DRP, Kodak India filed appeal before Mumbai Tribunal.

- After hearing arguments of both the parties, Mumbai Tribunal held that transaction of sale of imaging business by Kodak India to Carestream India cannot be considered as deemed international transaction on the ground that:
    - Both the transacting entities are domestic entities which are resident in India;
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    - Even though the transaction of sale of imaging business segment in India is in consequence of global agreement between overseas holding companies, there was no prior agreement and/ or terms and conditions for sales were not dictated by non-resident agreement; and
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    - TPO has not applied one of the method specified under Section 92C[2] read with Rule 10B, while arriving at the amount of TP adjustment.

- Aggrieved by the order of Tribunal, tax department filed appeal before Bombay HC. Key question of law before consideration of Bombay HC was whether provisions of section 92B(2) are applicable to sale transaction between two domestic companies? .

- Bombay HC noted that Revenue authorities have accepted the observations of the Tribunal on two counts - (1) terms of sale of business were independently determined by Indian entities without any influence by global agreement and (2) Assessee had reasonably determined the arm s length price, while Revenue Authorities had not used one of the prescribed methods and hence, matter cannot be remanded back for determination of arm s length price. Based on these factual aspects, Bombay HC held that appeal under consideration is academic in nature since there would not be any adjustment on Kodak India even if question is answered in favour of tax department and hence, Bombay HC dismissed the appeal filed by tax department without providing any ruling on the question of law. However, while concluding, Bombay HC has provided an interesting observation that question of law raised in the appeal is left open for consideration in an appropriate case .

- Point to ponder upon is whether finding of Bombay HC would have been different, had tax department applied an appropriate method as prescribed under the then Section 92C and had it resulted in upward adjustment to the transaction under dispute? Hence, it appears that Bombay HC has opened the pandora s box on applicability of provisions of Section 92B(2) of the Act to transaction between two domestic entities, which looked settled in the backdrop of various jurisprudence (supra) and prospective amendment made by Finance Act 2014.

- At this juncture, it is imperative here to note the ruling of Bangalore Tribunal in case of **Novo Nordisk**[3]. In respect of amendment made by Finance Act 2014 to the definition of Section 92B(2) of the Act, Tribunal observed that the concept of transaction between two residents who are AEs, being regarded as international transaction, was implicit in the scheme of TP provisions in India, if it impacted or eroded tax base in India. Amendment to Section 92B(2) by Finance Act 2014 was inserted only way of abundant precaution. It is made with a view to clarify the position that by entering into series of transactions with third parties who are not associated enterprises or non-residents, one cannot claim that TP regulations were not applicable, if in reality and in substance transactions were with related parties - one or both of whom might be non-residents.

- In principle, Tribunal held that even in Pre-Finance Act 2014 scenario, transaction undertaken between Indian taxpayer, its non-resident AE and unrelated third party in India which could be regarded as action in concert or arrangement (though with a view to avoid applicability of Section 92B(2) transaction) should be evaluated from tripartite perspective wherein one of the party becomes non-resident (i.e. AE of Indian taxpayer) and provisions of Section 92B(2) could be applied in such case to evaluate tax base erosion in India as a result of such arrangement.

(B) Illustrative cases wherein applicability of deemed international transaction

provisions needs to be evaluated cautiously:

(i) Plain and strict reading of Section 92B(2) of the Act covers situations of prior agreement or determination of terms in substance in triangular arrangement . However, careful analysis needs to be undertaken even in cases where more than three parties are involved. Such kind of more than three party arrangements are very common in case of IT/ ITeS companies wherein centralised departments are set-up for procurement of laptops, servers, storage devices etc, global contracts for system maintenance etc.

(ii) Transaction involving dealings between two resident enterprises in India for transfer of business/ assets pursuant to global restructuring arrangement could need evaluation for existence of deemed international transaction.

(iii) Cases wherein Indian company renders services to another unrelated Indian company pursuant to global arrangement between overseas holding companies could also need evaluation for existence of deemed international transaction.

(iv) Transactions involving payments such as salary or other expenses by Indian company to employees depurated by AE in India (who are registered on the payroll of India entity) could also trigger deemed international transaction provisions and may warrant compliance.

(v) Certain other global arrangements which could need evaluation for existence of deemed international transactions are logistics services agreement, global advertisement arrangements, agreements with recruitment agencies etc.

(C) Concluding remarks:

In nutshell, multinational enterprises need a careful re-evaluation of the entire supply chain arrangement to identify existence of deemed international transaction. Once existence of deemed international transaction is established, companies would need to comply with Indian TP regulation requirements such as reporting of such deemed international transaction in Form 3CEB, maintaining transfer pricing documentation and benchmarking of the same for arm s length test from Indian transfer pricing regulations perspective. Considering the strict penal provisions in place for non-compliance with TP regulations, it is imperative to undertaken this analysis and complying with the requirements.

Separately, it is worthwhile here to mention that not only the written agreements/ arrangement would be the driving factor while determining the applicability of deemed international transaction provisions but also the actual conduct of the transacting parties (given definition of Transaction under section 92F(v) of the Act). In cases, where conduct of parties demonstrates that the terms and conditions of such transactions are in substance determined by AE, such transaction could still be covered as deemed international transaction and consequent compliances would need to be undertaken from Indian transfer pricing regulations perspective.

Further, in cases, where Indian company has identified certain transactions as deemed international transaction, it could also explore resolution through Advance Pricing Agreement to agree on arm s length pricing for such deemed international transaction and also to achieve certainty from future litigation.

***Disclaimer**: The views and opinions expressed in this article are those of the authors and do not necessarily reflect the view of the firm.*

[1] Swarnandhra IJMII Integrated Township Development Co. P. Ltd vs. DCIT [TS-762-ITAT-2012(HYD)-TP] and Vodafone India Services P Ltd v UOI (262 CTR 133) (Bom HC)

[2] At the time of TP assessment proceedings, other method under section 92C(1)(f) of the Act was not prescribed

[3] Novo Nordisk India Pvt Ltd Vs DCIT [TS-249-ITAT-2015(Bang)-TP]