

## Tested Party: Concept Vs. Reality

July 28, 2016 | [2016] 71 taxmann.com 348 (Article)


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### Concept

Choice of 'tested party' forms one of the basic steps of robust transfer pricing ("TP") analysis. Globally, as well as in India, two kinds of methods have been prescribed for any kind of TP analysis, these are profit based methods and price based methods. Selection of tested party is an important part of a TP analysis where one of the profit based methods (except profit split method) has been selected as the most appropriate method. Tested party as a concept is not relevant where price based methods like comparable uncontrolled price method or other method are used.

Although the concept of tested party does not find any specific mention in Indian regulations, the term "enterprise" used while defining the various methods to compute the arm's length price under rule 10B of the Income Tax Rules, 1962 ("the Rules"), does not categorically refer to the Indian taxpayer. Hence, it can be inferred that Indian TP regulations does not restrict the choice of tested party to only Indian entity.

The concept of tested party has been explained in detail in the TP guidelines issued by Organisation for Economic Corporation and Development ("OECD Guidelines") and United Nation's Practical Manual on Transfer Pricing for Developing Countries ("UN Manual"). The OECD Guidelines define 'tested party' as "the one to which a TP method can be applied in the most reliable manner and for which the most reliable comparable can be found, i.e. it will most often be the one that has the less complex functional analysis" UN Manual defines the tested party in a similar manner.

Typically, tested party would be the least complex of the transacting entities, i.e., the simpler entity in terms of severity of functions performed, assets employed and risks assumed ("FAR analysis"). It should not own valuable intangibles or assume significant risks. The two crucial aspects of a TP analysis i.e. FAR analysis and choice of tested party cannot be isolated. The characterisation of the transacting entities determined based on the FAR analysis plays a pivotal role in ascertaining which entity would be the tested party. As a general rule, entrepreneurs should not be considered as "tested party" on account of their complex functional and risk profiles which results in vulnerable profits margins making comparability analysis a difficult proposition.

Consider a situation where an Indian entity i.e. ABC limited, an entrepreneur, is engaged in manufacturing of auto components for automobile companies globally. ABC Limited is also a recipient of routine marketing support services from its related party i.e. XYZ Inc., a US based entity. Indian entity has incurred losses at the net level while XYZ Inc. has earned arm's length margin in relation to marketing support services rendered to ABC Limited. In such a scenario, selection of Indian entity as tested party will be in contravention of TP principles since the financial results of ABC Ltd, being an entrepreneur, will largely depend on its sales to automobile companies and other external economic factors in the market rather than on internal pricing policies alone.

Thus, conceptually, selection of method and tested party is dependent on the nature of the international transaction, availability of reliable data for comparability analysis and FAR profile of the entities involved in the international transaction.

### Reality

Paucity of guidance in the Indian TP regulations has led to divergent judicial views on whether a foreign associated enterprise ("AE") can be selected as the tested party.

While the tax authorities in India generally prefer selection of Indian entities as the tested party having no regard to the FAR analysis and other pertinent factors involved in the inter-company transactions, the taxpayer, on the other hand, follows the dictum of selecting the method and tested party based on nature of international transactions in question, FAR analysis of the entities involved in the international transaction and the availability of data for comparability analysis. Availability of data on overseas comparable companies is no longer a constraint due to the increased accessibility to paid global databases like Orbis, Amadeus, Standard & Poor, Osiris, CompuStat, etc.

There have been judgements both in favour and against of selecting the foreign entity as tested

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party. The Mumbai benches in the cases of Onward Technologies and Aurionpro Solutions Limited, have held, as a general proposition, that the Indian taxpayer would always need to be taken as the "tested party" for the purposes of TP analysis; and the foreign AE cannot be selected as the "tested party". On the other hand, the coordinate benches in the case of Tata Motors European Technical Centre PLC, GE Money Financial Services Private Limited, General Motors India Private Limited has upheld the conceptual position that least complex entity should be selected as the tested party subject to a condition that reliable data is available in the public domain to analyse the arm's length nature of the transaction.

Recently, two contrasting decisions were pronounced by the Delhi Income tax appellate tribunal ("ITAT") on the issue pertaining to 'choice of tested party' i.e. *Ranbaxy Laboratories Limited v. ACIT* [TS-173-ITAT-2016(DEL)-TP] and *GE Money Financial Services Pvt Ltd. v. DCIT* [TS-457-ITAT-2016(DEL)-TP].

In the case of Ranbaxy Laboratories Limited for assessment year ('AY') 2008-09, the Delhi ITAT vindicated selection of foreign AE as tested party, being the least complex entity, for comparability analysis of its international transactions. While arriving at its conclusion, the ITAT drew support from OECD Guidelines, UN TP Manual as well as Sec 482 of US TP regulations. The ITAT also accredited significant importance to assessee's Advance Pricing Agreement for AY 2014-15 wherein CBDT approved selection of foreign AEs as tested party. Distinguishing the decision in assessee's own case for AY 2004-05, the Hon'ble ITAT held that in that year, assessee (Indian entity) had been chosen as tested party only due to non-availability of comparable data whereas for the year under consideration, assessee had produced reliable comparative data for analyzing the results of foreign AEs. The ITAT specifically relied on the ruling of Ahmadabad Bench in the case of General motors India Private Limited vs DCIT (ITA No3096/Ahd/2010) and (ITA No.3308/Ahd/2011) noting that majority of the divergent views on the issue of 'selection of tested party' were covered in the subject decision and accordingly allowed selection of foreign AEs as the tested party.

Contrary to the principles laid down by the Delhi Bench in the case summarized above, another Delhi Bench in the case of GE Money Financial Services Pvt Ltd explicitly discarded assessee's selection of foreign AE as tested party. While arriving at its conclusion, ITAT categorically held that under transactional net margin method ("TNMM"), it is the net margin earned by the Indian assessee and not it's foreign AE which is compared with that of the comparable companies. The ITAT interpreted the meaning of word 'enterprise' used in Rule 10B(1)(e) of the Income tax rules, 1962 ("Rules") (which describes the manner of application of TNMM) as 'Indian entity'. The Hon'ble ITAT also held that adoption of foreign AE as tested party has no legal sanctity under the Indian transfer pricing regulations. Furthermore, the ITAT also mentioned that the data used by the assessee with respect to the comparable companies does not conform to the comparability standard laid down under Rule 10B of the Rules.

Though there are plenty of judgements to indicate India's convergence towards the globally accepted practice for choice of tested party yet acceptance of foreign entity as tested party is not a settled position in India. It is also to be noted that choice of foreign entity as tested party is not a matter of convenience and the onus is on the tax payer to substantiate its choice of tested party with robust documentation.

*(The article was co authored by Vaishali Mane, Chartered Accountant)*

*Note:- Views expressed are personal and readers may seek specific professional advice based on their facts.*

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