Selection of Tested Party - Not So Complex Anymore

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In a recent ruling in the case of ***Virtusa Consulting Services Private Limited v DCIT, Chennai,*** the Madras High Court ("the High Court") has ruled that the *tested party* for conducting Transfer Pricing ("TP") analysis could also be the foreign associated enterprise ("AE") of the taxpayer. The ruling discussed the least complex entity theory, importance of the availability of material before the Transfer Pricing Officer ("TPO")/Dispute Resolution Panel ("DRP") and even gave a direction to the Income Tax Appellate Tribunal ("ITAT") to adjudicate all issues raised before it.

This ruling is a landmark High Court ruling which accepts selection of foreign AE as the tested party. The issue of selection of foreign AEs was the subject matter of conflicting opinions amongst the various benches of the ITAT so far.

Brief Background

Virtusa Consulting Services Private Limited ("the assessee") is engaged in the business of software development services. For the AY 2011-12, the assessee considered Transaction Net Margin Method ("TNMM") and used itself to be a tested party for the benchmarking analysis. The TPO rejected the assessee's benchmarking analysis, undertook a fresh search and made an upward adjustment.

Before the Tax authorities, the assessee changed its stand and asserted that since its foreign AE is the least complex entity, it should be selected as the tested party. However, the tax authorities as well as the ITAT did not accept this and ruled that since such a position was not taken in the TP report, the assessee ought to be taken as the tested entity. The ITAT also stated that the Indian TP provisions do not permit selecting foreign AE as a tested party, and it is only the Indian entity that should be selected as the tested party. The ITAT relied on the decision of the Mumbai ITAT in ***Aurionpro Solutions Limited vs. Additional Commissioner of Income Tax*** [TS-75-ITAT-2013(Mum)-TP], wherein the Mumbai ITAT had ruled that the tested party for the purpose of determination of Arm's Length Price ("ALP") has to be the assessee and not the AE.

In addition to the tested party issue, other issues were also raised before the ITAT relating to internal TNMM, selection of comparable companies, deduction u/s 10A, etc. However, the ITAT did not adjudicate with regard to any other issue raised before it except the selection of tested party. A Miscellaneous Application moved before the ITAT on this issue was also dismissed.

Legislative intent

A TP analysis is based on comparing the margin of the 'tested party' with the average margin of the comparables; hence the determination of the tested party is of absolute importance. The TP provisions under the Indian Income Tax Act do not lay down any guidelines on whether the tested party has to be the assessee or the foreign AE. However, there are some guiding principles available in the legislature as well as reference can be had to the TP guidelines worldwide.

The OECD TP guidelines 2017 stipulate that the tested party should be the least complex entity. As per para 3.18 of the OECD TP guidelines ***"****The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e., it will most often be the one that has the* ***less complex functional analysis."***

Further, the US Treasury Regulations 1.482 define the "tested party" as follows ***"****.....The tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding the uncontrolled comparables can be located. Consequently, in most cases,* ***the tested party will be the least complex*** *of the controlled taxpayers and* ***will not own valuable intangibles property or unique assets*** *that distinguish it from potential uncontrolled comparables.*"

To understand the concept of tested party under the Indian Income Tax Act, we must refer to the provisions of Section 92 and Rule 10B(1)(e) of the Rules, which use the term 'enterprise' for application of TNMM. Section 92F of the Act defines the term 'enterprise' as "*a person (including a permanent establishment of such person) who is, or has been, or is proposed to be engaged in any activity*.....". Section 2(31) defines a person to include a company, and in terms of Section 2(17), 'company' means an Indian Company or any body corporate incorporated by or under the laws of a country outside India.

Judicial Precedents

So far, there was a conflict of opinion amongst the various ITAT rulings on the issue of selection of tested party. A few which accepted the rule of "least complex entity" are as follows:-

- ***General Motors India Private Limited Vs DCIT*** *in* [TS-215-ITAT-2013(Ahd)-TP]
- ***DCIT Vs Global Vantedge Private Ltd*** [TS-895-ITAT-2018(DEL)-TP]
- ***Yamaha Motor India Limited vs. ACIT*** (Delhi-Trib.)
- ***Ranbaxy Laboratories Ltd. v. ACIT,*** *Range-15. New Delhi* [TS-173-ITAT-2016(DEL)-TP]
- ***Development Consultant Private Limited 2008****-* [TS-3-ITAT-2008(Kol)]

The above rulings unanimously interpreted that an entity's functional risks assume relevance while determining the *least complex entity* and the *least complex entity* has to be taken as the *tested party* whether Indian or foreign entity. It was also held that one of the features of least complex is the entity which does not own intangible property nor unique assets. Also it is pertinent to note that the onus is on the taxpayer to place sufficient material on record to show that the taxpayer was a complex party whereas other associated parties were less complex. Due importance was given to the functional and risk analysis in the process.

Madras High Court Decision

In the assessee's case, the High Court held that the principles for selection of tested party had been drawn out and the tested party usually should be the least complex party to the controlled transaction. Also, there was no bar in the legislature and the TP guidelines for selecting a foreign AE as the tested party.

The High Court distinguished ITAT's reliance on Mumbai ITAT ruling in Aurionpro Solutions Limited, *supra,* wherein it was held that the tested party for the purpose of determination of ALP was always the assessee and not the AE. **The High Court stated that this was not a case where the assessee produced no material to establish the functional risk assumed by the foreign AEs.** The material was available before the TPO. On ITAT's finding that the assessee had not shown the functional risks assumed by its associate enterprises, the High Court observed, "... *it is not a case where there were no material produced by the assessee to establish the functional risk assumed by the foreign AEs. The material was available before the TPO, but the TPO non-suited the assessee on the ground that such contention by referring to the foreign AEs as the tested party was not part of TP documentation... the grounds canvassed in the miscellaneous application filed before the Tribunal on 28.09.2017 after the impugned order was passed by the Tribunal, would clearly show that all materials were available on file. Therefore, to non-suit the assessee stating that they miserably failed to establish functional risk is incorrect. If such is the conclusion which we have to arrive at, we have no hesitation to set aside the order of the Tribunal, and we shall do so.*"

The High Court further stated that since the TPO himself rejected the TP documentation analysis of the assessee and undertook a fresh search for external comparables, he could not prevent the assessee from raising a new issue with respect to subsidiaries being least complex entities and hence to be chosen as the tested party. It was noted, "... ***when the TPO himself has not attached any sanctity to the TP documentation as submitted by the assessee,* (the ITAT) *could not have foreclosed the assessee from canvassing the issue that the subsidiaries are least complex entities which should be taken note of***".

Interestingly, the assessee had also submitted to the High Court that for subsequent assessment years, the TPO had accepted the assessee's approach on considering the foreign AE as the tested party under similar facts and circumstances.

With regard to the grounds which the ITAT did not adjudicate, the High Court found that there was nothing to show that the assessee had given up on these other contentions. The High Court held that the "*Tribunal should and shall adjudicate all such issues which have been raised before it by the assessee in the grounds and more specifically pointed out in the miscellaneous application*."

The matter was **remitted back to the ITAT with a direction to TPO** to pass the order, having due regard, to the orders passed by the TPO in the assessee's own case for the subsequent Assessment Years.

Concluding remarks

Until now, there has been a conflict of opinion amongst the various Benches of the Tribunal on this issue. This judgment will provide clarity to many existing pending litigations. The emphasis on analysis of functional and risks assumed in order to determine the least complex entity and also the importance of availability of material on record with the TPO, are key takeaways from this decision. It also reaffirms that the assessee is not barred from revisiting its TP methodology before the Tax authorities even though the same has not been assessee's first choice as documented in the TP report.

To conclude, the High Court decision is a much welcome judgment on the issue of interpretation of "tested party" as envisaged under the Indian Income Tax Act.