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## Section 92B(2) not applicable where (i) transaction is between domestic entities (ii) global agreement has no role in/ effect on relevant transaction

### In brief

Kodak India Pvt. Ltd. (the taxpayer) sold its medical imaging business to Carestream Health India Pvt. Ltd. (Carestream India). In its return of income, the taxpayer disclosed the sale as a transaction between domestic entities. However, the Transfer Pricing Officer (TPO) proceeded to determine arm's length price (ALP) of this transaction by invoking section 92B(2) of the Income-tax Act, 1961 (the Act) on the premise that this sale transaction was an international transaction as it had been undertaken pursuant to a larger sale transaction, wherein, the holding company of the taxpayer sold its medical imaging business to the holding company of Carestream India, on a global basis. The Mumbai bench of the Income-tax Appellate Tribunal (the Tribunal) ruled in favour of the taxpayer, and the following key principles emerge from the ruling:

- After examining the provisions of section 92(1), section 92A(1) and section 92B(1) of the Act, and the relevance of the phrase "*for the purposes of sub-section (1)*" in section 92B(2) of the Act, as well as the intent of this deeming provision, the Tribunal concluded that section 92B(2) cannot be read independently of section 92B(1), and thus section 92B(2) cannot apply to transactions between domestic entities.

- Though the sale transaction in India was a consequence of the global agreement between the holding companies, yet from an analysis of facts and review of the underlying agreements, it was concluded that there was no prior agreement and/or terms and conditions of the sale transaction in India were not dictated by the global agreement. The global agreement did not have any role in/ effect on the sale transaction in India. Applicability of section 92B(2) of the Act could not be triggered on this account either.

- Matter cannot be restored to TPO for determination of ALP if in the first instance itself the TPO had ignored the relevant mandatory provisions of law. Such an action by the TPO impacts its jurisdiction.

- ALP must be determined only based on the prescribed methods, and not any other method.

## Facts

The taxpayer sold its medical imaging business to Carestream India. The taxpayer filed its return of income disclosing the sale as a transaction between domestic entities.

On *suo moto* assumption of jurisdiction over this transaction, the TPO proceeded to determine its ALP on the premise that this sale transaction was not a transaction between domestic entities. As per the TPO, it was an international transaction because it had been undertaken pursuant to a larger sale transaction, wherein, the holding company of the taxpayer (Kodak Inc. or Kodak US) sold its imaging business to Carestream Inc., the holding company of Carestream India, on a global basis. The TPO invoked section 92B(2) of the Act.

The TPO determined the ALP based on the worldwide revenue break-up amongst countries. The TPO concluded that since India's revenues accounted for 1.4% of the total, the sale consideration should have accordingly been a certain sum which worked out to be more than what had been actually received by the taxpayer. The TPO, thus, made an adjustment for the difference. The Dispute Resolution Panel upheld the TPO's order. Aggrieved, the taxpayer appealed to the Tribunal.

## Key contentions of the taxpayer

### Applicability of Section 92B(2)

- To invoke the deeming provision in section 92B(2), three conditions are necessary, i.e., a) there must be two associated enterprises (AEs); b) one of them must be a non-resident; c) there must be a sale of some property.

- The transaction in question was executed in India between two domestic companies, where neither of them were AEs. Hence, the TPO did not have jurisdiction to compute ALP. Even if there was a prior agreement between the two holding companies, at no stage did the TPO conclude that the contracting entities were through the AEs or that either of them was a non-resident. The prior agreement, if at all, was between Kodak US and Carestream Inc, i.e., two independent foreign companies, and moreover, it did not influence the sale transaction for the following reasons:

  a) Terms and conditions of the sale were determined solely by the taxpayer and not by Kodak US.
  b) Valuation of the business was undertaken by the taxpayer through its independent valuers.
  c) Kodak US did not charge the taxpayer any fees in relation to this sale transaction.
  d) The taxpayer received entire sale proceeds, and nothing was transferred to Kodak US.
  e) There was no prior agreement between Carestream India and Kodak US for this sale transaction [as required by section 92B(2) of the Act].

In this regard, reliance was also placed on the Special Bench decision in the case of LG Electronics India (Private) Ltd.[1], as per which the legal character of the Indian AE cannot be ignored.

- To invoke section 92B(2), the legislature has used the words, "*for the purposes of sub section (1)*", i.e., definition of international transaction, by which either of the AEs had to be a non-resident.

- Para 55 of Circular no. 14 of 2001 issued by CBDT[2] specifies "*one of the parties in a contract has to be a non-resident*".

- In the case of Swarnandhra IJMII Integrated Township Development Company Pvt. Ltd.[3], it was held that section 92B(2) of the Act would not apply as the transaction in dispute was a transaction between domestic entities.

- Strict interpretation of a deeming fiction has to be made, and the scope of the fiction must be confined to the purpose of the fiction[4]. In section 92B(2), the context was to examine the transaction entered into by the taxpayer or the other party with the AE, for the purposes of subsection (1), i.e., international transaction.

**Determination of ALP**

- As regards computation of ALP, the TPO did not apply any of the above methods, but instead computed the ALP, prescribing his own method, i.e. "ratio of revenue". Reliance was placed on the decision in the case of LG Electronics (*supra*), wherein it was held that ALP determination can be done only by way of methods specified by the statute.

- For ALP determination, the case cannot be set aside to the TPO (as suggested by the Revenue). This is because the TPO cannot be allowed to rectify a mistake by giving him a second chance, as it was incumbent upon the TPO, in the first instance itself, to follow the law.

- Without prejudice, out of the six prescribed methods for determination of ALP, "cost plus" was the only relevant method, because the transfer of assets were primarily limited to debtors and inventories. Debtors already had the element of cost plus gross profit and inventories were already at cost, and could become cost plus. The plus could be the mean of last four year gross profit, which in monetary terms came to less than the actual gross profit declared by the taxpayer.

## Key contentions of the Revenue

- Section 92B(2) of the Act nowhere prescribes that for invoking the provisions of section 92B(2), one or both parties should be non-resident.

- The decision in the case of LG Electronics (supra) pertained only to section 92B(1) of the Act. It did not examine the circumstances under which provisions of section 92B(2) of the Act could be invoked.

- In the case of Swarnandhra (supra) there was no prior agreement, and hence it is distinguishable on facts and cannot be relied upon in the instant case.

[1] LG Electronics India (Private) Ltd. *v.* ACIT, reported in [2013] 29 taxman.com 300 (Delhi SB).
[2] Reported in 252 ITR 65 (ST) at page 103.
[3] Swarnandhra IJMII Integrated Township Development Company Pvt. Ltd. *v.* DCIT, in ITA no. 2072/Hyd/2011.
[4] Relied on CIT *v.* C.P. Sarathy Mudaliar, reported in 83 ITR 170(SC) at 173; CIT *v.* Mother India Refrigeration Industries P. Ltd., reported in 155 ITR 711 (SC) at pages 718 and 719; Special Bench case of Sumitomo Mitsui Banking Corp. *v.* Dy Director of Income Tax (SB), reported in 16 ITR 116 (Trib).

## Tribunal ruling

### Applicability of Section 92B(2)

Section 92(1) begins with the expression, "*Any income arising from an international transaction……*". It means that Chapter X gets its jurisdiction if there is an international transaction between AEs. Further, from a reading of section 92A(1) and 92B(1), a transaction could only become an international transaction, if either both the AEs or one of them is a non-resident. To come within the purview of section 92(1) and 92A(1), the transaction must go through the needle hole definition provided in section 92B(1).

Section 92B(2), prescribes, "……*the transaction between such other person and the associated enterprise*, ….". Thus, first, there has to be an "AE", with whom there exists an international transaction, only then it could be examined as to whether the international transaction with "such other person" exists or not.

Further, when we read section 92B(2), we cannot slip out of the definition of international transaction, that too, when the deeming provision itself says, "*for the purposes of sub section (1)*". The legislature could have placed section 92B(2) independently and not under the heading of international transaction, but the legislature committed the deeming provision alongside section 92B(1) by using the expression, "*for the purposes of sub-section (1)*". Section 92B(2) assumes the same significance, i.e., to define international transaction as defined under section 92B(1), to get to the true intent…", i.e., what is an international transaction.

When dealing with a deeming provision [section 92B(2) in the instant case], the purpose and purport to introduce that provision has to be kept in mind along with the intent of the legislature, i.e., the legislature intended to rope in those transactions which, though strictly not international transactions, have the colour of the same. The intention of the legislature has always been to define international transaction, which in turn is within section 92B(1). The deeming provision finds itself accosted within the definitions of international transaction and associated enterprise[5].

The transaction in dispute in the instant case involves two domestic companies, who are individual and independent subsidiaries of their own and independent holding companies. There is no transaction involving a non-resident company. To colour the transaction as international, the revenue could not establish that either Kodak India had any AE relation with Carestream Inc. or Carestream India had any AE relation with Kodak US.

The domestic companies have an independent agreement and the holding companies have an independent agreement for sale – they are not linked to each other. Though the instant transaction was a consequence of the global agreement entered by the holding companies, there was no prior agreement, and/or terms and conditions for sale were not dictated by the non-resident agreement. In this regard, the following important submissions made by the taxpayer have escaped the attention of the TPO:

a) Terms and conditions of the sale were determined solely by the taxpayer and Carestream India and not by Kodak US.
b) Valuation of the business was undertaken by the taxpayer through its independent valuers.
c) Kodak US did not charge the taxpayer any fees in relation to this sale transaction.
d) The taxpayer received entire sale proceeds, and nothing was transferred to Kodak US.
e) There was no prior agreement between Carestream India and Kodak US for this sale transaction [as required by section 92B(2) of the Act].

[5] Relied on CIT *v.* C.P. Sarathy Mudaliar, reported in 83 ITR 170(SC) at 173; CIT *v.* Mother India Refrigeration Industries P. Ltd., reported in 155 ITR 711 (SC) at pages 718 and 719; Special Bench case of Sumitomo Mitsui Banking Corp. *v.* Dy Director of Income Tax (SB), reported in 16 ITR 116 (Trib).

Further, from a reading of the global agreement between the holding companies, it is clear that the global agreement did not have any role in/ effect on the sale transaction between the domestic companies.

If there are two separate but related entities, their separate legal character cannot be disregarded, unless the revenue positively proves the influence of foreign AE over the affairs of the domestic entity[6]. In this regard, it is notable that the funds received as sale consideration were entirely received by the taxpayer. If, going by the presumption that there is influence by the foreign holding companies, and thus the transaction should be held to be bad and a sham (as the TPO talks about lifting the corporate veil), then, in that case, the instant transaction could never have taken place. In that scenario, the global transaction shall only survive, without any tax implications under domestic laws. This could never have been the intention of the revenue authorities.

Based on all the above, section 92B(2) of the Act is not applicable in the instant case. There was no international element involved in the sale transaction between the taxpayer and Carestream India, and it was a transaction between domestic entities.

**Determination of ALP**

- By the use of the word "shall" in section 92C(1) of the Act, the legislature has cast an embargo that no seventh method could be adopted by the TPO for computing the ALP[7].

- The word "any", is a suffix to "*of the following methods being the most appropriate method*". Therefore, the ambit of the word "any" in section 92C(1) has been restricted to the prescribed methods. This gathers strength from the fact that even in the Income-tax Rules, 1962 (the Rules), relevant Rule 10B provides similar wordings.

- For determination of ALP, issue cannot be restored to the TPO because the methods as prescribed by the legislature are mandatory, and not directory. When a mandatory provision is either superseded or ignored, it straightaway affects the jurisdiction. In the instant case, it was a case of *suo moto* reference to the TPO and it is the case of the revenue authorities to import the provisions of Chapter X. In this circumstance, since the TPO did not adhere to the prescribed methods consciously, another innings to rectify the mistake cannot be allowed, as the TPO infringed the relevant provision of the Act and the Rules.

- The taxpayer proposed (without prejudice) that out of the prescribed methods for determination of ALP, "cost plus" was the only relevant method, because the transfer of assets were primarily limited to debtors and inventories. Debtors already have the element of cost plus gross profit and inventories were already at cost, and could become cost plus. The plus could be the mean of last four year gross profit, which in monetary terms came to less than the actual gross profit declared by the taxpayer, and should not be disturbed.

## PwC observations

**Applicability of Section 92B(2)**

A ruling relating to applicability of section 92B(2) of the Act, which preceded this particular one, was the ruling in the case of Swarnandhra (*supra*). However, the facts in Swarnandhra and in this case are different. Nonetheless, both these rulings, on one particular aspect, lay down the same judicial precedent, i.e., non-applicability of section 92B(2) of the Act to transactions between domestic entities. However, it may be worth noting that the mechanics of arriving at this conclusion, in both these rulings, are not exactly the same. In the instant case, the Tribunal discussed the provisions of section 92(1), section 92A(1) and section 92B(1), and the inter-linkage

[6] Relied on decision in case of Vodafone International Holdings BV *v.* UOI, reported in 341 ITR 1 (SC).
[7] Relied on Special Bench ruling in case of LG Electronics; and Hon'ble Supreme Court of India in the case of CIT *v.* Anjum Mohamed Ghaswalla, reported in 252 ITR 1.

between them, to establish that they all relate to an international transaction between AEs, where both the AEs are non-residents or at least one of them is. Further, on analysing the relevance of the phrase "*for the purposes of sub-section (1)*" in section 92B(2), and also the intent of this deeming provision, the Tribunal concluded that section 92B(2) cannot be read independent of section 92B(1), and thus section 92B(2) cannot apply to transactions between domestic entities.

Having said that, there are two other, and very critical, preconditions for the applicability of section 92B(2), failing which, section 92B(2) could cease to apply. In this regard, it may be worthwhile to reproduce the relevant text of section 92B(2) which reads as follows:

"*...if there exists a **prior agreement** in relation to the relevant transaction between such other person and the associated enterprise, **or** the **terms** of the relevant transaction are **determined in substance** between such other person and the associated enterprise.*"

Evidently, the preconditions are: (i) the existence of a prior agreement between the other entity and the AE in relation to the relevant transaction, or (ii) there should be AE involvement in determining the terms of the transaction. In the current case, in the first instance, there is no connect which has been established either between Kodak India and Carestream Inc. or between Carestream India and Kodak US – a prerequisite underlying both the preconditions (please refer underlined text above).

As regards, precondition (ii), the Tribunal has accepted, based on review of facts and underlying agreements, that the terms of the sale transaction in India have not been determined with any AE involvement. As for precondition (i), the Tribunal acknowledges that the sale transaction in India was a consequence of the global agreement for sale between the holding companies. However, the mere presence of the global agreement has not dissuaded the Tribunal from examining whether or not the global agreement in fact had any influence or effect on the sale transaction in India. This is an important position taken by the Tribunal, i.e., even if a prior agreement exists, it must have an influence or effect on or role in the transaction in question, without which precondition (i) would not be satisfied.

Accordingly, section 92B(2) may not apply where there are appropriate underlying agreements and all other documentation which supports the independent nature of the relevant transaction (delinked from any AE involvement). Needless to say, the conduct of the parties would need to necessarily conform to the underlying agreements and other supporting documentation.

**Determination of ALP**

In many recent and past verdicts, the Tribunals have been restoring matters to the TPOs for reconsideration. However, the Tribunal in the instant case has not agreed to doing so because the TPO in the first instance itself had ignored the mandatory provisions of law, and as per the Tribunal, this impacted the TPO's jurisdiction. This precedent set by the Tribunal in the instant case, may, going forward, provide guidance to Tribunals before they proceed to restore matters to TPOs.

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