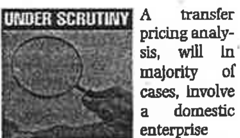
Transfer pricing: Reconciling treaty with domestic law



A transfer pricing analysis, will in majority of cases, involve a domestic enterprise and a foreign enterprise. As the first step, one will be required to determine whether such enterprises are associated enterprises. Section 92A gives the definition of associated enterprises.

India has also entered into tax treaties with its major trading partners and investors, viz. US, EU countries, Japan and Korea. The treaties contain a specific article under the heading associated enterprises for application of arm's length principle (ALP). It is therefore relevant to consider the implications of the article under treaty vis-a-vis domestic law.

Domestic Law

Section 92A(1) defines associated enterprises as an enterprise which participates directly or indirectly or through one or more intermediary in the management or control or capital of the other enterprise or such participation is by the same persons either directly or indirectly or through one or more intermediary in both the enterprises.

Section 92A(2) deems existence of certain commercial/financial relationship at any time during the year as to constitute associated enterprises. Such relationship are equity holding of 26 per cent, control of board of directors, giving of loans or guarantee for a specified limit, influence over supply of raw materials or finished products, dependency for business or commercial rights etc.

The words 'through one or more intermediaries' in section 92A(1) seems to have been added out of abundant caution as the words 'indirectly' do take care of the situation of fulfilling the chain principle of ultimate parent or entity in control. There is no precise definition for determining what constitutes a participation in management, control or capital of an enterprise. One can however interpret section 92A(1) as referring to a situation whereby one enterprise is exercising control not merely by ownership but having control in substance or exercise of influence. Such controls can be personnel control, transactional control, financial control, etc.

The above control factors can be seen in section 92A(2) in the deemed definition of associated enterprises. A harmonious reading of section 92A can mean that control tests required under sub-section (1) have been outlined in more specific form in sub-section (2). However, it may be difficult to contend that sub-section (2) provides an exhaustive list of the situation of control and other situations of control need not be examined.

Treaty v Domestic Law

Definition of associated enterprises given in the article (normally article 9) under the treaty is similar to section 92A(1) of the Act and OECD model convention. This article further mentions that if as a result of special relations between the enterprises, a true taxable profit is not reflected, appropriate adjustment can be made in such circumstances. The issue that arises for consideration is whether it is possible to take a view that rigor of domestic law can be substantially reduced if one can fall under the relevant article of the associated enterprises under the treaty. One arguable view is that international meaning should be given to "associated enterprises" and "control" and in the case of contrary provisions in the domestic law, treaty may prevail. Wide meaning is given by other countries in their domestic law as tabulated in table-1. (See this column 19.02.01).

It is, therefore, relevant to determine what is the scope and purpose of article 9(1) of the treaty. Model commentary does little to clarify the issue further. However, it does mention that article 9 does not prevent domestic law on thin capitalisation so long as it follows ALP. One view is that the article authorises the adjustment at arms' length basis. The other view is that it merely permits the states to enact and apply separate domestic law for adjustment following ALP.

The OECD in its report on transfer pricing guidelines mentions ALP as the underlying assumption in article 9(1). The likely purpose of article 9(1) as explained by learned author Baker is that it restricts the domestic law only to the extent of application of ALP for the purpose of adjustment. This may be so because the treaty always restricts rather than generate domestic law.

> The likely purpose of article 9(1) is that it restricts the domestic law only to the extent of application of arm's length price for adjustment purpose

SAMIR GANDHI
Chartered Accountant, Mumbai

Article 9(1) can, therefore, said to prohibit only domestic legislation which may not apply arm's length principle for determining profits in transactions between the associated enterprises. For eg. if a domestic legislation provides that such profits will be determined on unitary allocation basis or minimum profitability standard are fixed (example Brazil), such action can said to be beyond the outer limit set by the treaty. Accordingly, domestic law can be the only legal basis for income adjustment within the outer limit placed by article 9.

Article 9(1) can also be said to provide the legal basis for avoiding economic double taxation by permitting corresponding adjustment under article 9(2). However, this can be achieved if both the States follow the same rule. Protocol to the treaty between Germany and USA mentions that article 9 is not to be interpreted as limiting the scope of domestic law to ignore commercial or contractual relationship resulting in controlling influence.

In fact, US model treaty specifically does not limit the power of the domestic law in this regard. One can also refer to the definition article under the treaty and specifically, article 3(2) which mentions the general rules of interpretation, that if any terms not defined in the treaty, will be given the meaning under the domestic law.

Article 7 v Article 9

Article 7 & article 9 aim to tax profits based on economic activities carried out in a state. Article 7 deals with the method of attributing income to the permanent establishment (PE). This rule requires computation of profits of PE as if it is a separate and distinct enterprise dealing independently with its head office.

Application of article 7 can be made to only one enterprise whereas article 9 will require two legal enterprises which are associated. However, section 92F(iii) defines enterprise as including a PE. However, it can be noted that though article 7 and article 9 are distinct, both aim to apply ALP. One important issue to note here is that article 7 does not contain corresponding adjustment provision similar to article 9(2).

Interest & Royalties

The above articles contain provisions of applying the relevant article only to the amount determined under ALP. An adjustment of interest or royalty payment will be permissible in case 'special relationship' between two parties have led to excessive payment. However, in such a case, the balance amount remains taxable in the hands of recipient. One can refer to second proviso to section 92C(4) in this regard.

To summarise the provisions of article 9 are to be read harmoniously with the provisions in the Indian Income Tax Act dealing with transfer pricing issue. As discussed earlier, there cannot be major differences between the control tests specified at both the places.

Moreover, the purpose of the treaty is to provide a means of settling on a uniform basis the most common problems of economic double taxation and article 9 cannot be read independently of this purpose.

In cases where the above harmonious reading and reconciliation with domestic law is not possible, one may require to refer to mutual agreement procedure for its resolution. However, one may keep in mind the control definition given by other countries which is not very different from control tests specifically given in section 92A. ◆