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Time-travel in the Era of Taxation: The Story of How the Indian Tax Courts Retroactively Opted to Treat Two Independent Parties as Associated Entities

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ABSTRACT

The Income Tax Appellate Tribunal of the Bangalore Bench in India laid down a crucial verdict in relation to a question of law that arose in 2018 concerning the tax assessment year 2014-2015. It finally reached its final destination, after a series of appeals, in February 2023 in the case of Palmer Investment Group Ltd vs. DCIT. In a nutshell, the Tribunal decreed that a transaction with an unrelated entity would be subjected to TP regulations if the said entity later becomes a related party in the same tax year. This begs the question: can a tax administration or a court retrospectively treat independent parties to an independent transaction as Associated Entities ("AE") to a transaction which would then be deemed as a related party ("RP") transaction? This jurisprudence is unique in itself as it is a one-of-a-kind situation, probably unseen in any other fiscally advanced country, and provides an interesting interpretation of the law taking into account the intention of the parties.

Keywords: *OECD; Transfer pricing; Transfer pricing methodology; International taxation; Tax administrations.*

1.0 Statement of Facts

The taxpayer under scrutiny Palmer Investment Group Ltd. ("Palmer" or "Taxpayer") was established in British Virgin Islands and is primarily engaged in investment activities. The taxpayer is a wholly owned subsidiary of M/s. United Spirits Ltd. ("USL") which is primarily involved in the business of selling liquor and commercialises brands such as "Black Dog" Scotch whiskey, "Blue Riband" gin, "White Mischief" vodka, etc.

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It is pertinent to note that USL is a listed company on the stock exchange in India and is by default subject to stock exchange regulations. The first transaction took place in November 2012, when the Taxpayer along with its AEs forming part of the USL Group held a certain number of shares in its holding entity USL. Palmer, along with its AEs, entered into share purchase agreement ("SPA") with Relay BV, a company incorporated in Netherlands. Relay BV is an independent company and an investment holding company of the Diageo group. Pursuant to the SPA, the taxpayer sold 4,376,771 equity shares of USL to Relay BV at INR 1,440 per share. The share transfer was completed in July 2013 (i.e., to be taken into account during the relevant assessment year 2014-15) after necessary approvals were obtained. This is how Relay BV came to have an ownership share of 3.35% in the USL Group.

The second transaction under scrutiny occurred in November 2013 when Relay BV further acquired 1,967,940 shares from unrelated shareholders on stock market and the said acquisition only resulted in Relay BV having controlling stake in USL, i.e., more than 26%.

Thereafter, upon being brought under the scrutiny of the tax administration, the TP Officer ("TPO") decreed an order concerning the two transactions under Section 92CA of the Income Tax Act[1]. The TPO stated that pursuant to the acquisition of shares as a result of the SPA, Diageo Pic (the ultimate holding company of Rely BV) acquired a controlling stake in USL and, hence, the determination of Arm's length Price ("ALP") must be determined based on a valuation of USL as an entity. Therefore, the TPO held that the price of USL shares in the stock exchange could be considered as a valid comparable for the purpose of determination of ALP of the transaction.

The TPO proceeded to conduct an independent valuation of shares of USL by applying the Discounted Cash Flow ("DCF") method based on the data available on the Bloomberg database. Based on such computation, the share value of USL was determined to be INR 2,038.79 per share as against INR 1440 per share agreed in the SPA. The TPO concluded that the shares were undervalued, thus not in compliance with the Indian TP regulations.

The Taxpayer appealed against the preliminary decision rendered by the TPO. The appeal case was decided in February 2023.

2.0 The Decision of the Appellate Court

The Court rejected the argument of the Taxpayer which claimed that as on the date of execution of the SPA and even after acquisition of shares from the Taxpayer, Relay BV and the Taxpayer were not associated enterprises.

Under Section 92A (2) of the Act, two enterprises shall be deemed to be an associated enterprises *if, at any time during the previous year*, one enterprise holds, directly or indirectly, shares carrying not less than 26% of the voting power in the other enterprise. In the instant case Relay BV holds controlling stake in USL of more than 26% i.e., 26.37% as of November 2013 i.e., during the year directly preceding the year of assessment i.e., 2014. Therefore, in light of the clear provisions of Section 92A (2) of the Act, which uses the expression "if at any time during the previous year", the arguments raised by the Taxpayer were rejected.

Moreover, the Court assessed the concept of a controlling interest by relying on the case law *Vodafone International Holdings B.V. vs. Union of India*[2] that "*each share represents a vote in the management of the company and such a vote can be utilized to control the company. Further, the Hon'ble Supreme Court has held that controlling interest is not a distinct capital asset independent of holding of shares and the nature of the transaction has to be ascertained from the terms of the contract and the surrounding circumstances*."[3] Accordingly, the Court analysed the terms in the SPA signed between the Taxpayer and Relay BV to ascertain the intention of the parties.

Upon analysing the SPA, the Court found that Relay BV has set out a minimum target of 25.1% of equity capital of USL to be acquired under the SPA. Therefore, the intention of Relay BV was to exercise 25% or more of the voting rights in USL. Thus, even though the Taxpayer under the SPA had transferred only 3.35% of the total shares of USL to Relay BV, each share represents a vote in the management of the company and such a vote can be utilized to control the company. The Taxpayer had contributed and assisted Relay BV in acquiring controlling interest in USL along with other associates.

Lastly, the Court held that the transaction had been put through the test of benchmarking by the TPO which valued the shares using the DCF method (the Taxpayer had opted for 'any other method' and stated the shares were valued at market price on the stock exchange, so the TPO applied the DCF).

The Court stated that "*In the present case, the SPA was entered into for transfer of 25.1% of shares of USL. If non-AEs had entered into similar agreement, they would not have agreed for the transfer of shares at the stock exchange price as it involves transfer of control. Transfer of shares in stock exchange cannot be equated with transfer of shares involving transfer of control.*" Therefore, the shares were not originally priced at Arm's Length, and the price determined by the TPO was upheld for the above reasons.

3.0 The CARA Analysis

The precedent is crucial as it brings to light the importance of not only the concept of AEs but also the validity of the methods used by the Taxpayers to justify the ALP.

3.1 A comparison of the concept of associated entities

The definition of an AE is a lot more stringent in India. Section 92A (1) uses the words '*through one or more intermediaries'* in other words, under section 92A (1), even if the participation is through an intermediary, the investor and the investee could be considered as an associated enterprise. Since no reference is explicitly made to the residency aspect of it, it could also apply to non-residents. The controlling interest is capped at a minimum of 26%.

In that context, it's worth looking at a few external references:

- Under UK law, a company is an associated company of another company if one has control of the other, or both are under the control of the same person or persons. This includes non-UK resident companies but excludes dormant and some 'passive' entities.[4] The controlling interest is capped at a minimum of 30%.[5]
- Under French law, a French company is dependent on a foreign company when the latter directly or indirectly owns a preponderant share of its capital or the absolute majority of voting rights in the majority of the voting rights in the shareholders' or partners' meetings. In practice, the holding of a majority of the capital (more than 50%) is sufficient to characterize dependence[6].
- Under the US law, an associated entity is "a person who directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the owner or operator of a source."[7] Whereby the term "controlling interest" refers to owning, controlling, or holding not less than 20%, by vote or value, of the outstanding amount of any class of equity interest in an entity.[8]
- Similarly, under the OECD, enterprises are associated where the same persons participate directly or independently in the management, control or capital of both enterprises, i.e., both enterprises are under common control.[9] However, Article 9 of the OECD or the UN Model Convention apply to a transaction, only if one of the enterprises is a resident of one Contracting State and the other enterprise is a resident of the other Contracting State (non-resident). Thus, excluding two non-residents from scrutiny.

The bottom line is that the global trend is to relate the level of association between two or more entities to the control exerted by one entity over another.

As unlikely as it would seem that a court in the present could actually change the nature of the past relationship shared by two independent entities, it has now become possible and the same has been demonstrated by the Appellate Tax Court in India. The Court's reasoning based on *the intention of the parties* stipulated under the SPA and the mere *timing* of the completion of the two transactions seems stupidly simple. The Court's order discourages against the transgression of tax regulations, while also subtly underlining a very clever way of avoiding a sticky situation- by merely controlling the *timing*.

Had the parties spread out and executed the two transactions two years apart instead of one, they could've most likely avoided penalties related to transfer pricing. This is only extrapolation, of course, nothing is certain when it comes to tax administrations and the weather- they could even surprise Darth Vader himself.

3.2 The choice of the method and its consequences

The OECD prescribes five types of methods for the determination of the ALP and allows taxpayers the freedom to choose any of the applicable methods. These methods are standard given that they are widely practiced in the world i.e., the traditional and the transactional methods. However, there are several countries that permit the *"other method*", which basically refers to any other method enabling a fair valuation of the transaction, subject to countries' preferences.

India prescribes the OECD methods plus *the other method*. Essentially, it is any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transactions, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts (like an external CUP). The most appropriate method may be chosen.

In Brazil, for instance, methods such as the Transactional methods (TNMM and Profit Split Method) and other methods (e.g., valuation techniques) are not foreseen in the domestic framework. Moreover, it is so stringent that with respect to commodities and interest on intra-group loans, the use of specific methods is mandatory.

The UK absolutely doesn't accept any other methods except for the said 5 methods, in contrast to France where the methods prescribed include the regular 5 methods *plus* any other method as long as it is the most appropriate method.

To that end, we see that Brazil provides the most amount of security to its taxpayers despite its stringency. It provides the most amount of certainty to the taxpayer as derogation from specific methods for specific transactions is not permitted. In

consequence, in Brazil, the taxpayers are bound to avoid future scrutiny on past actions, hence avoiding a time-travel kind of situation.

On the other hand, we see that French rules do not permit as much security to its taxpayers as Brazil does, because it allows for subjectivity that may eventually be struck down by the tax administration, thus resulting in consequences whereby the taxpayers are caught off-guard.

India remains in the grey despite being specific. In light of the given case, the Taxpayer merely valued its shares as projected on the stock market at the time of the transaction when selling to Relay BV under the SPA, sort of equating to a CUP. However, the TPO applied the DCF method (which does not even slightly resemble the CUP) calculating the long-term worth of the investment. The DCF is generally used to project the future worth of mergers or acquisitions. The TPO rejected the Taxpayer's valuation, deemed it inappropriate, and then proceeded to conduct its own. Lucky for the TPO, its credibility was determined by the Bloomberg database, despite of having derogated from the other method prescribed by the tax administration.

The solution to this issue would be for the taxpayers to choose the methods that have stood the test of time with their own tax administrations, and probably avoid choosing the road not taken.

4.0 Conclusion

The decision in the given case throws caution into the wind to taxpayers all over the world to not take issues of transfer pricing lightly, especially in the event of mergers and acquisitions. However, it also proves that tax courts deciding on a matter would be willing to investigate factors such as the intention of the parties and be open to a wider interpretation of the facts, even in cases concerning taxation.

In conclusion the message to the taxpayers, as Obi-Wan Kenobi would say, is "*May the force be with you*", and if possible, the tax administrations too.

Endnotes

1. The Section refers to the computation of the ALP and the prescribed methods applicable to intragroup cross-border transactions
2. Vodafone International Holdings B.V. vs. Union of India (2012) 341 ITR 1 (SC)
3. Supra note 1

4. "*HMRC publish guidance on 'associated companies' definition*", P. Freeman, KPMG in the UK (January 2023) https://kpmg.com/uk/en/home/insights/2023/01/tmd-hmrc-publish-guidance-on-associated-companies-definition.html#:~:text=In%20broad%20terms%2C%20a%20company,and%20some%20'passive'%20entities
5. ITA07/S192(1)(l) and S199; ITA07/S303(1)(l) and S310
6. L-233-3 Code de Commerce
7. 40 CFR § 66.3 - Definition
8. 12 U.S. Code § 4703a
9. Glossary of Tax Terms, OECD available https://www.oecd.org/fr/ctp/glossaryoftaxterms.htm