KPMG

TAX FLASH NEWS

14 March 2023

The Bengaluru Tribunal upholds the application of transfer pricing provisions to transactions between unrelated enterprises and the DCF method to benchmark the transfer of listed equity shares with controlling interest

Executive Summary

Recently, the Bengaluru Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Palmer Investment Group Ltd[1] has held that a transaction with an unrelated entity would be subjected to India Transfer Pricing regulations if the said entity later becomes an Associated Enterprise (AE) during the year under consideration. The Tribunal has relied on the literal interpretation of the phrase “if at any time during the previous year” in Section 92A(2) of the Income-tax Act, 1961 (the Act).

Based on the facts of the case and relying on the Supreme Court ruling in the case of Vodafone International Holdings B.V.[2], the Tribunal also held that the transfer of shares on the stock exchange cannot be equated with the transfer of shares involving controlling interest[3] and that the Discounted Cash Flow (DCF) method as used by the Transfer Pricing Officer (TPO) was appropriate for valuation of listed equity shares.

Facts of the case

- The Assessee, a British Virgin Islands based Investment Company, was a wholly owned subsidiary of United Spirits Limited (USL), an Indian listed Company. The Assessee held 3.35% shares of USL as a part of its investments.
- The Assessee along with other group entities of USL had entered into a Share Purchase Agreement (SPA) on 9 November 2012 (AY 13-14) to sell shares of USL at INR 1,440 per share to the Dutch entity, Relay BV. At the same time, an open offer was made by Relay BV for acquisition of USL shares from the public at the same price in compliance with the SEBI Regulations. Pursuant to the SPA, the Assessee transferred 3.35% shares of USL to Relay BV in July 2013 (AY 14-15). Also, a preferential allotment of USL shares was made to Relay BV. As a result of the above transactions and the subsequent equity shares acquisition by Relay BV in the open market, Relay BV’s equity stake in USL exceeded 26 percent in November 2013 (AY 14-15).
- The transaction of sale of USL shares by the Assessee to Relay BV was a transaction between two unrelated enterprises as on the date of the transaction. However, Relay BV became an AE of the Assessee subsequently in the same financial year, thus the said transaction was disclosed as ‘international transaction’ in the Accountant’s Report[4] of the Assessee for AY 14-15 and the transaction was benchmarked under ‘other method’.

---

[1] Palmer Investment Group Limited – (ITA No: 2929 and 2930 /Bang/2018) (Bang)– (Assessment year 2014-15)
[2] Vodafone International Holdings B.V. v. Union of India [2012] 341 ITR 1 (SC)
[3] Effectively affirming a premium for transfer of controlling stake

[4] One of the grounds of appeal filed by the Assessee mention that “the transaction of sale of shares by the Appellant to Relay B.V. was reported as an international transaction in the Accountants Report for FY 2013-14 only to be compliant with the definition of associated enterprises under Section 92A(2) of the Act, and such disclosure does not take away the arm’s length nature of the arrangement entered into between two third parties”

© 2023 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

- Stock exchange price as on the date of the SPA (i.e. INR 1,376 per share), the price at which shares were bought by Relay BV through open offer process (i.e. INR 1,440 per share), the price at which shares were issued to Relay BV under preferential allotment (i.e. INR 1,440 per share), CA certificate (average of weekly high and low of the closing prices of the USL's share quoted on NSE during the 26 weeks preceding the relevant date was INR 917.27 per share) and the price at which other group companies sold shares (i.e. INR 1,440) were considered as the basis by the Assessee to justify the arm's length nature of the transaction.

TPO's Approach

- The TPO held that the transaction of transfer of USL shares by the Assessee (along with group entities) to Relay BV was not a transaction of transfer of shares simpliciter, but it involved the transfer of controlling interest to Relay BV. Thus, the stock exchange price of the USL shares cannot be considered a valid comparison. Asserting that the determination of transfer price should be based on the valuation of USL as an entity, the TPO conducted an independent valuation of USL shares by applying the DCF method and arrived at an arm's length price (ALP) of INR 2,038.79 per share.

- The Dispute Resolution Panel (DRP) principally confirmed the view of the TPO but directed to consider cash flow projections as on the date of the SPA/valuation i.e. 9 November 2012 as against 9 December 2012 considered by TPO. Accordingly, the revised ALP was determined at INR. 2,039.25 per share.

Tribunal's Decision

Application of transfer pricing provisions to transactions between unrelated enterprises

- The Assessee contended that the transaction of sale of USL shares by the Assessee to Relay BV in July 2013, when the two entities were not related, should not be covered within the ambit of transfer pricing. The two entities only became AEs on 28 November 2013 when the stake of Relay BV in USL exceeded 26 percent. The Tribunal observed that Section 92A(2) states that two enterprises shall be deemed to be AEs 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 light of the clear provisions of Section 92A(2), which uses the expression "if at any time during the previous year" there is no merit in the contentions of the Assessee. The Tribunal thus held that the transaction was rightly put through the test of benchmarking by the TPO.

DCF method upheld for valuation of listed equity shares with controlling interest

- The Tribunal referred to the Supreme Court ruling[5] wherein it was held that the controlling interest is an inalienable part of the share itself and the nature of the transaction has to be ascertained from the terms of the contract and the surrounding circumstances. Thus, the Tribunal analysed the terms of the SPA and the circumstances surrounding the transaction. The Tribunal concluded that a lot of clauses as included in the SPA would not have been required if it was a mere acquisition of equity shares in a company. Relay BV had intended to acquire a controlling interest in USL through the SPA. While the Assessee had transferred only 3.35% shares of USL to Relay BV, it had contributed and assisted Relay BV in acquiring a controlling interest in USL along with other associates.

- With regard to the appropriateness of price for the transfer of controlling interest, the Tribunal relied on the Mumbai Tribunal ruling[6] which holds that where an Assessee sold controlling interest in a company, addition on account of control premium is justified. The said decision relied on a research report by Phillip Sounders Jr (Phd) which showed that the mean control premium varied from 30 to 50 per cent of the quoted price. The Tribunal noted that the ALP determined by the TPO/DRP fell within the price range determined by applying these premium rates to the market price of INR 1,440 and hence it was reasonable.

- The stock exchange prices as on the date of SPA was not considered as a comparable by the Tribunal as such market price would have been relevant only if the fact of transfer of control was in the public domain. The Tribunal noted that while the announcement of the public offer was done on 9 November 2012, the tendering period for the same was in April 2013. It was at this juncture that the fact of transfer of control was in the public domain and it could be said that the average price of INR 2011.66 per share during this period reflects the value of shares with controlling interest which is in line with the ALP determined by the TPO.

- The open offer price was also rejected by the Tribunal as it was noted that Relay BV could purchase only 0.1499% of the total shares offered at the offer price of INR1,440 per share. Also, the ratio of number of shares transferred through the SPA and the number of shares purchased through the open offer worked out to 0.2603% only indicating differences in volume.

---

[5] Vodafone International Holdings B.V. v. Union of India [2012] 341 ITR 1 (SC)
[6] Lanxess India (P.) Ltd v ACIT [2013] 36 taxmann.com 350 (Mum)

© 2023 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

- The Tribunal also disregarded the Assessee's argument that the public offer price of INR 1,440 per share was in accordance with SEBI regulations and hence should be considered at ALP. The Tribunal held that SEBI regulations do not regulate the price to be negotiated between the buyer and seller of shares. It only provides that in case of transfer of controlling stakes a public offer is mandatory and the formula prescribed to arrive at the offer price is only to safeguard the interest of other shareholders and not representative of ALP for transfer of controlling stakes.

- The Assessee had also argued that since the price charged by the other group companies for transfer of shares under SPA at INR 1440 per share was accepted at ALP, upon application of the CUP method, the same price charged by the Assessee also ought to be accepted. Relying on the Chennai Tribunal decision[7], the Tribunal held that SPA was one agreement under which all the group companies sold shares to Relay BV and therefore the rate at which other group companies sold their shares to Relay BV cannot be considered an uncontrolled transaction.

- The Tribunal also noted that the SPA provided for transfer of a total of 25.1 percent shares of USL. If non-AEs had entered into a similar agreement, they would not have agreed to the transfer of shares at the stock exchange price as it involves a transfer of control. Therefore, the Tribunal held that the transfer of shares in the stock exchange cannot be equated with the transfer of shares involving transfer of control and accordingly upheld the determination of price by the TPO.

Our comments

This is an important ruling that could have a far-reaching impact on the transfer pricing analysis of various M&A deals. Valuation aspects are prone to protracted litigation in India and are increasingly coming under renewed focus. The ruling emphasises that transfer pricing is a detailed fact-intensive exercise, and it is critical to evaluate the underlying documents, circumstances, and intentions of the parties to the transaction. It is important to analyse whether it is a simpliciter transfer of equity shares or it's a transfer of equity shares with controlling interest. Arm's length analysis accordingly needs to factor in various nuances of the transaction and the market dynamics, for instance, while considering stock exchange prices, one may also look into the trade volumes, price range, fluctuations, historic price actions, binding offer, fairness opinion reports, etc.

The interpretation of the term 'Associated Enterprise' has long been a contentious issue in India. The literal interpretation of the phrase "if at any time during the previous year" in Section 92A(2) as done by the Tribunal would bring transactions entered between unrelated parties within TP ambit if they later become AEs during the same year. The intent of the parties (unrelated parties at the time of entering into the transaction) and possibly the lack of motive to misprice the transaction, especially in the regulatory environment should be factored in before applying the rigors of transfer pricing regulations. It would be interesting to see whether this ruling is litigated further and how the Courts interpret this aspect. In the past, the Ahmedabad Tribunal[8] had also interpreted Section 92A(2) similarly and concluded to exclude transactions entered during the year with the third party before they became AE from the comparability analysis under the CUP method. However, the said ruling does not provide any comments on reporting transactions entered during the period when the AE relationship did not exist.

With this ruling, Assessees need to revisit their positions, evaluate appropriate reporting/disclosure in Form 3CEB, and maintain robust and contemporaneous transfer pricing documentation to justify the arm's length nature of the international transaction.

[7] Ascendas India P Ltd v. DCIT [2013] 33 taxmann.com 295 (Chny)

[8] Lonsen Kiri Chemical Industries Ltd. v. DCIT (ITA No. 1116/Ahd/2015) (Ahd)

© 2023 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
2nd Floor, Block T2 (B Wing),
Lodha Excellus, Apollo Mills Compound, N M
Joshi Marg, Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

home.kpmg/in

home.kpmg/in/socialmedia

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000

© 2023 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

This document is meant for e-communication only.