AO's referral to TPO doesn't take away his powers of determining nature of exp. under sec. 37(1)

Summary – The High Court of Delhi in a recent case of Cushman and Wakefield (India) (P.) Ltd., (the Assessee) held that jurisdiction of Assessing Officer under section 37(1) and TPO under section 92CA is distinct and, therefore, a referral made by Assessing Officer to TPO for limited purpose of determining ALP does not take away power of Assessing Officer to determine as to whether payment made by assessee to its AE for services rendered was basically an expenditure incurred for purpose of business so as to allow same under section 37(1).

Facts

- The assessee, an Indian company, was engaged in the business of rendering services connected to acquisition, sales and lease of real estate. These services were provided to several clients within and outside India.
- During relevant year assessee entered into international transactions relating to payment of referral fee and reimbursement to AEs namely CWS and CWHK for costs incurred by them for certain coordination and liaison services in respect of their client IBM.
- As regards the payment of the referral fee, the TPO stated that "no adverse inference is drawn". However, in respect of the reimbursement of costs to the AEs, the TPO disallowed deduction of the expenditure.
- The Assessing Officer, basing himself on this order, made a draft assessment order disallowing the reimbursement. Additionally, the Assessing Officer disallowed the referral fees as a deductible expenditure, stating that no benefit was derived by the assessee from the referral fees paid to the AEs.
- The DRP concurred with the Assessing Officer, leading to a final assessment order under section 143(3) read with section 144C. The assessee then appealed to the ITAT, which held in its favour.
- On revenue's appeal:

Held

- The arguments advanced before the Court appears to divide the issue in two parts: first, whether services have indeed been provided by CWHK and CWS to the assessee, and second, whether these services ought to be benchmarked to determine ALP considering the provisions of section 92(3).
- The TPO, in this case, and so the Assessing Officer, denied the reimbursement deduction claimed from the taxable income on the ground that no services were provided, whereas arguments advanced before Court were concerned whether benchmarking ought to have been done, considering the services *were* provided (as held by the ITAT).
- This distinction however divides two fundamentally connected matters. Deduction of business expenditure under section 37 for work undertaken by the AEs allows only for deduction of *such*

amounts as incurred *for the benefit* of the assessee. The reimbursement claimed by the assessee, therefore, should relate to work done by the AEs that has benefited it - the presence of a benefit and the costs incurred in creating that benefit form part of the same matrix of consideration under section 37. They cannot be segregated. Quintessentially, only those costs incurred by CWS and CWHK which led to a benefit to the assessee can be claimed by it under section 37. Creating a distinction would lead to an illogical position where once the *factum* of benefit is established, the amounts claimed as a deduction for creating that benefit would be considered autonomously.

- The core of argument advanced by the assessee is that once the accrual of benefit to the assessee is established, the expenditure falls within section 37, and there is no need for further assessment of the ALP under section 92(3).
- The costs incurred by CWS and CWHK have not been disputed by the revenue. They were actually incurred. Equally, it is an admitted fact that the assessee did not attempt to benchmark this international transaction through any of the methods indicated under Rule 10C of the Income Tax Rules, 1962, to determine the ALP for these transactions. Neither was such an exercise conducted by the TPO, and accordingly, till date, that vacuum exists. This vacuum remains despite section 92(3).
- Section 92 creates a regime for determining the true value of a transaction between two related parties, in this case, the assessee and CWS/CWHK, to ensure that taxable income is not transferred to another entity or jurisdiction. The very purpose of section 92 thus is to ensure that the total taxable income is reported correctly to increase tax collection. Naturally, clause (3) provides that *if* such an ALP results in a decrease in the tax incidence in India, the true value of the transaction will be the value stated by the assessee and not the ALP.
- In other words, if an assessee is paying greater income tax than would otherwise be paid in an uncontrolled transaction, section 92 will not alter the income stated in the return. This conclusion, however, can only be reached after an assessment of the ALP and comparison with the income stated in the return.
- The argument in this case is that the assessee only paid for the cost incurred, while an uncontrolled transaction would involve an additional element of profit, thus Assessing Officer leading to a greater claim for reimbursement. If true, this would no doubt place this transaction within section 92(3). However, this, cannot be the case. Undoubtedly certain amounts were charged by the AEs as reimbursement for actual costs incurred. Nevertheless, whether a third party - in an uncontrolled transaction with the assessee would have charged amounts lower, equal to or greater than the amounts claimed by the AEs, CWS and CWHK has to perforce be *tested* under the various methods prescribed in section 92C.
- The question thus required to be addressed and determined, is whether an independent entity - for the same liaisoning and client interaction services as were provided by CWS and CWHK - charges an amount less than or equal to or more than price charged by these two entities. An independent entity would quite possibly include a mark-up over and above the cost, and thus, exceed the value charged by the AEs in this case. The sequitur cannot be that the cost incurred by those entities

would be the same as the AEs in this case. It may be greater (in which case section 92(3) would clearly apply), or lower.

- This cannot be a matter of speculation. Nor is the application of section 92(3) a logical inference from the fact that CWS and CWHK have only asked for reimbursement of cost. This being a transaction between related parties, whether that cost itself is inflated or not only is a matter to be tested under a comprehensive transfer pricing analysis.
- The assessee did not benchmark these costs in its transfer pricing study. Neither was any transfer pricing study conducted by the TPO, who, crucially, did not say that the ALP was lower than the amount claimed. He, instead disallowed the expenditure altogether on the ground that there were no services rendered to begin with. The ITAT overruled the TPO on that limited ground, but did not concern itself with a transfer pricing analysis as contemplated under section 92; to the contrary, it accepted the assessee's stated return (absent any benchmarking) as the true and correct value under an implicit (and incorrect) understanding of section 92(3).
- The authority of TPO is to conduct a transfer pricing analysis to determine the ALP and not to determine whether there is a service or not from which the assessee benefits. That aspect of the exercise is left to the Assessing Officer.
- The TPO's Report is, subsequent to the Finance Act, 2007, binding on the Assessing Officer. Thus, it becomes all the more important to clarify the extent of the TPO's authority in this case, which is to determining the ALP for international transactions referred to him or her by the Assessing Officer, rather than determining whether such services exist or benefits have accrued. That exercise - of factual verification is retained by the Assessing Officer under section 37 in this case.
- Indeed, this is not to say that the TPO cannot - after a consideration of the facts - state that the ALP is *'nil'* given that an independent entity in a comparable transaction would not pay any amount. However, this is different from the TPO stating that the assessee did not benefit from these services, which amounts to disallowing expenditure. That decision is outside the authority of the TPO.
- This is a slender yet crucial distinction that restricts the authority of the TPO. Whilst the report of the TPO in this case ultimately noted that the ALP was *'nil',* since a comparable entity would pay *'nil'* amount for these services it was noted that remarks concerning, and the final decision relating to, benefit arising from these services are properly reserved for the Assessing Officer.
- In this case, the issue is whether an independent entity would have paid for such services. Importantly, in reaching this conclusion, neither the Revenue, nor this Court, must question the *commercial wisdom* of the assessee, or replace its own assessment of the commercial viability of the transaction. The services rendered by CWS and CWHK in this case concern liaising and client interaction with IBM on behalf of the assessee - activities for which, according to the assessee's claim - interaction with IBM's regional offices in Singapore and the United States was necessary. These services cannot- as the ITAT correctly surmised - be duplicated in India insofar as they require interaction abroad. Whether it is commercially prudent or not to employ outsiders to conduct this

activity is a matter that lies within the assessee's exclusive domain, and cannot be second-guessed by the Revenue.

- The second issue which arises in these proceedings concerned the disallowance of referral fees paid by the assessee to various AEs, for the referral of clients in the real estate business to the assessee. This was referred by the Assessing Officer to the TPO, who in this Report stated that "*no adverse inference is drawn*". The assessee had - in its own Transfer Pricing analysis - conducted a benchmarking for these transactions, through the Comparable Uncontrolled Prices ("CUP")method, with which the TPO found no infirmity. The Assessing Officer subsequently, however, found that no services were actually rendered for which referral fees was to be paid.
- The ITAT reversed this finding on two grounds. The first was that the AO, after having referred the matter to the TPO, could not reopen or re-examine the transaction, which was done in this case. Secondly, on merits, the ITAT held that "[t]he assessee has submitted ample evidence to support the expenditure and it was shown that such expenditure is incurred with respect to revenue earned by the assessee on property transaction referred to the assessee by its associate enterprise."
- On the first ground, it can be said that the jurisdiction of the Assessing Officer, under section 37, and the TPO, under section 92CA, are distinct. A referral by the Assessing Officer to the TPO is only for the limited purpose of determining the ALP, based on a *prima facie* view that such a referral is necessary. It does not imply a concrete view as to the existence of services, or the accrual of benefit (such that allowance under section 37 must be permitted).
- The Assessing Officer can, therefore, determine under section 37 that the expenditure claimed (in this case, the referral fees) was not for the benefit of the business, and thus, disallow that amount. This does not restrict or in any way bypass the functions of the TPO. Quite to the contrary, it represents the correct division of jurisdiction between the two entities.
- On merits, the Court notes that the referral fees was paid according to 'international fee sharing rules and referral fees on Tenant Representation Transactions', details of which were provided by the assessee.
- Whether these figures represented the ALP of such referral transactions was to be decided by the TPO, who concluded that "*no adverse inference is drawn*". This determination is binding on the Assessing Officer, who cannot consider the quantum of referral fees paid, but only whether such fees was backed by an *actual* referral by the AEs. In other words, the AO's jurisdiction in such case is to only verify whether the claim of the assessee is borne out by the materials relied on by it and finalize the assessment order.
- This is the distinction between the jurisdiction of the AO and the TPO; the TPO determines whether the stated transaction value represents the ALP or not (including whether the ALP is *nil*), while the AO makes the decision as to validity of the deduction under section 37. This means the decision as to whether the expenditure was "*laid out or expended wholly and exclusively for the purposes of the business*" is a fact determination or verification to be undertaken by the AO. This includes whether the referrals actually occurred (and thus took place for the 'purpose of the business'), independent

of their valuation which the TPO determines. That determination is not and cannot be made by the TPO. Nor is the authority of the AO under section 37 curtailed in any manner by a reference under section 92C.

- This distinction is crucial in order to maintain the statutory authority of the Assessing Officer to assess the stated income as against the provisions, rather than accept the assessee's assertions by foreclosing the enquiry. The finding of the ITAT that the AO could not have gone into the matter of whether the referral actually took place (based on evidence provided by the assessee) after referring the matter to the TPO is thus incorrect. The AO can and indeed should conduct that exercise, lest correctly priced deductions based on non-existent paper transactions funnel through section 37.
- In view of the above discussion and analysis of the statutory provisions, two issues on the merits of the AO's assessment assume importance. Firstly, having regard to the TPO's stamp of approval to the fees charged for the stated (though still not proven) referral transactions, the AO was bound to accept that finding; it is, post 2007, binding.
- The quantum of payment, *i.e.* the value of transaction or the percentage referral fees paid was confirmed by the TPO in his determination. The payment was at arm's length; the Assessing Officer cannot reassess that issue or draw adverse conclusions from the percentage value of the referral fees. The AO can, however, in his assessment under section 37 decide whether work or services were actually rendered as claimed by the assessee. In other words, the Assessing Officer may determine whether the stated transactions are real and genuine, i.e. the existence of a referral from the AE to the assessee. This, as part of the broader exercise to determine whether the expenditure was for the purposes of the business, lies unquestionably within the domain of the Assessing Officer.
- Based on the evidence provided by the assessee, the AO found that there was no underlying referral that justified the payment of fees (which, if the transactions were genuine, would have been at arm's length as per the TPO) and, thus, the expenditure was not for a business purpose. This clearly lies within the AO's jurisdiction; a ruling to the contrary would mean that the expenditure cannot be tested as against the legal standard under section 37. The ITAT reasoned that this amounts to doing something indirectly that cannot be done directly. Quite to the contrary, this is something that the AO can do, and has done, directly.
- The other aspect is that the ITAT dismissed the assessment order on merits as well. It held that the AO's assessment of evidence was incorrect, because "*[t]he assessee had submitted ample evidence to support the expenditure.*" Having set aside the ITAT's reasoning that the TPO's report was binding on this issue, this bare assertion of 'ample evidence' remains the only reference to the merits of the AO's order. Neither the AO (who did admittedly deal with the issue at some length) nor the ITAT (which summarily noted that presence of evidence) have discussed what such evidence is. Details of the e-mails, and why they do or do not disclose the existence of referral transactions, or any other material concerning the transactions, have not been disclosed, let alone discussed in any detail. In

such a case, one is faced with contrary assertions of the Assessing Officer and the ITAT, and nothing more. No conclusions about the correctness of either approach can be taken in this background.

- The finding of the ITAT on this count are, therefore, liable to be set aside, and this aspect of the matter is to be remanded to the file of the Assessing Officer for a detailed verification of facts and provision of reasoned conclusions, with the Assessing Officer being bound by the TPO's approval of the pricing of the referral fees.
- Accordingly, the findings of the ITAT concerning reimbursement of costs and payment of referral fees to the foreign AEs are set aside. On the question of reimbursement of costs, the matter is remanded to the file of the AO, for an ALP assessment by the TPO, followed by the AO's assessment order in accordance with law. On the question of referral fees, the report of the TPO validating the arm's length price of the transactions is binding on the Assessing Officer, who may verify the transactions and assess the deductions under section 37 in accordance with law. For these reasons, the appeal is partly allowed.