

# Transfer Pricing e-Alert

21 MARCH 2019

## Arm's Length Principle And Purchase Of Shares

Under transfer pricing laws around the world, related parties are compelled to adhere to the arm's length principle for all transactions executed between them. While the applicability of this principle generally extends to all transactions relating to the provision of services and the sale of goods, there remains some uncertainty where share transactions — namely, the issuance and acquisition of shares by and between related companies — are concerned.

The Bombay High Court had occasion to examine this interesting issue in *Pr. Commissioner of Income Tax v PMP Auto Components Pvt Ltd* (Income Tax Appeal No 1685 of 2016), which was decided on 20.2.2019.

### Facts And Issues

The taxpayer had paid about INR27 million to acquire shares in its wholly owned foreign subsidiary, which had a fair market value of INR819,000. The Indian Tax Authority (**Tax Authority**) sought to tax the difference between the acquisition price and the fair market value of the shares under the transfer pricing provisions set out in Chapter X of the Indian Income Tax Act 1961 (**the Indian ITA**). Further, the Tax Authority also treated the excess amount as a deemed loan by the taxpayer to its subsidiary and sought to tax the interest chargeable on such loan.

In the appeal before the Income Tax Appellate Tribunal, the Tribunal rejected the Tax Authority's contentions and relied on the decision in *Vodafone Services Pvt Ltd v Union of India* 368 ITR 1, in which it was held that the amount received in respect of the issue of shares is on capital account and does not give rise to any income to trigger the transfer pricing provisions of the Indian ITA. Accordingly, the Tribunal in *PMP Auto Components* held that no adjustment should be made in respect of any interest payable on the additional amount paid to acquire the shares.

### Contact persons:



**Datuk D. P. Naban**  
Senior Partner  
Tax, SST & Customs Practice  
T: +603 6208 5858  
E: [dpn@lh-ag.com](mailto:dpn@lh-ag.com)



**S. Saravana Kumar**  
Partner  
Tax, SST & Customs Practice  
T: +603 6208 5813  
E: [sks@lh-ag.com](mailto:sks@lh-ag.com)

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## Appeal Before The Bombay High Court

On appeal to the High Court, the Tax Authority submitted that:

- (a) The transaction was an international transaction and thus, subject to the transfer pricing provisions under Chapter X;
- (b) The decision in *Vodafone* was inapplicable as it was concerned with inbound, and not outbound, investment as in the current case; and
- (c) In any event, a potential loss may arise if the taxpayer sells the shares in subsequent years as the shares were purchased at a price much higher than the fair market price and thus, the difference between the prices must be brought to tax.

## Decision

The High Court noted that a similar issue was raised in the *Vodafone* case, where the court observed that Chapter X is the mechanism provision to arrive at the arm's length price of transaction between associated enterprises. However, before Chapter X can kick in, income must arise under the substantive charging provisions found in the Indian ITA under the headings of salaries, income from house property, profits and gains of business, capital gain, and/or income from other sources. This is because Section 92 of the Indian ITA requires income to arise from an international transaction while determining the arm's length price.

In the current case, the Tax Authority sought to tax the difference between the share acquisition price and the fair market value of the shares without specifying the substantive provision under which income would arise and be chargeable. Therefore, the High Court held that the issue stood concluded based on *Vodafone*.

The distinction between inbound and outbound investment was of no significance as the legislature had made no such distinction while providing for the determination of any income on adjustments to ascertain the arm's length price arising from an international transaction.

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Level 6, Menara 1 Dutamas  
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No. 1, Jalan Dutamas 1  
50480 Kuala Lumpur  
Malaysia  
Tel: +603 6208 5888  
Fax: +603 6201 0122  
Email: [tax@lh-ag.com](mailto:tax@lh-ag.com)

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Further, in respect of the Tax Authority's contention that the taxpayer may in the future sell the shares at a loss, thus giving rise to a reduction of its future tax liability, the High Court held that this submission was in the realm of speculation. At the current stage, the situation was hypothetical. No provision of the Indian ITA was raised that allowed the Tax Authority to tax a potential income on the facts.

The High Court also noted that with effect from 1.4.2013, the Indian ITA had been amended to provide as income the aggregate consideration received for the issue of shares that exceeded the fair market value of the shares. However, this was irrelevant as the years of assessment in dispute were 2010 and 2011 and the Tax Authority made no contention on the applicability of the provision.

The court also affirmed that no amount paid by the taxpayer to acquire the equity shares of its subsidiary can be considered a loan to the subsidiary. Accordingly, the Tax Authority's appeal was dismissed.

### Comments

It must be borne in mind that the decisions in *PMP Auto Components* and *Vodafone* were based on the wording of Section 92 of the Indian ITA, which required income to arise before the arm's length principle was required to be applied. Section 92(1) provides that "any income arising from an international transaction shall be computed having regard to the arm's length price".

However, Section 140A(1) of our Income Tax Act 1967 (**the ITA**) merely provides that where a person enters into a transaction with an associated person for the acquisition or supply of property or services, then, that person shall determine and apply the arm's length price for such acquisition or supply. Thus, the Malaysian transfer pricing provision appears to be wider and any transaction with foreign subsidiaries for the acquisition or sale of their shares, on the face of it, seems to be subject to transfer pricing rules and the arm's length principle.

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Solaris Dutamas  
No. 1, Jalan Dutamas 1  
50480 Kuala Lumpur  
Malaysia  
Tel: +603 6208 5888  
Fax: +603 6201 0122  
Email: [tax@lh-ag.com](mailto:tax@lh-ag.com)

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Be that as it may, it is arguable that Section 140A(1) does not apply to acquisition of shares, as it is generally a capital expenditure, and any income received from the issuance of shares is correspondingly a capital receipt. It is accepted that only revenue receipts are taxable and only revenue expenditure is an allowable deduction under the ITA. Therefore, although Section 140A(1) makes no mention of income, it could be contended that reading the ITA as a whole, the applicability of the transfer pricing provision is limited to transactions which have an impact on taxable income, i.e. which are revenue in nature. Hence, any taxpayer subjected to transfer pricing adjustments by the Inland Revenue Board on the acquisition of shares could put forward this argument to the Malaysian courts.

The High Court in *Vodafone* had also recognised that the transfer pricing provisions in the Indian ITA did not replace the concept of income or expenditure as normally understood in the Act for the purposes of Chapter X. The arm's length price was meant to determine the real value of the transaction entered into between related companies and arriving at the arm's length price does not convert non-income into income.

Hence, despite the difference in legislation, Malaysian courts may adopt a similar position as that in India in holding that the transfer pricing provisions do not apply to acquisitions of shares in a related company where there is no effect on taxable income.

Please contact our tax partners **Datuk D P Naban** or **S Saravana Kumar** at [tax@lh-ag.com](mailto:tax@lh-ag.com) if you have any queries on transfer pricing matters.

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