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Transfer Pricing e-Alert

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DGIR's Power To Vary Transactions

In the recent Indian case of *Pr Commissioner of Income Tax vs M/S Aegis Ltd* (Case No 1248 of 2016), one of the issues was whether the Indian Revenue Service (**IRS**) can re-characterise a share subscription transaction as an advance of unsecured loans.

The High Court held that the IRS is not entitled to do so and dismissed its appeal against the decision of the Income Tax Appellate Tribunal (**Tribunal**).

Brief Facts

The taxpayer, a company based in India, was subjected to a transfer pricing audit for the years of assessment 2009 and 2010. It was dissatisfied with the decision of the IRS to deem interest income and raise tax assessments.

During the said years of assessment, the taxpayer had subscribed to redeemable preferential shares of its associated enterprise and redeemed some of the shares at par on a later date. The IRS took the position that the preference shares were equivalent to an interest-free loan advanced by the taxpayer and accordingly, imputed deemed interest.

Two key issues that arose were whether:

- the Tribunal considered the fact that the taxpayer had actually advanced money to its associated enterprise on the pretext of acquiring preference shares despite the fact that the preferential shares do not carry any dividend and are beyond the scope of any capital appreciation; and

- the Tribunal had erred in disallowing the imputed interest on interest-free loans advanced by the taxpayer to its related companies.

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Decision

The Indian High Court upheld the Tribunal's decision that the IRS cannot disregard the transaction undertaken by the taxpayer (i.e. the acquisition of preference shares) and substitute the same without any material on exceptional circumstances to establish that the transaction at hand was a sham. In the absence of any material evidence, the IRS is not entitled to treat the transaction in question as a loan and impute deemed interest.

The court also upheld the Tribunal's observation that the IRS cannot question the commercial expediency of the taxpayer wanting to acquire the preferential shares.

Conclusion

In the Malaysian context, Section 140(1) of the Income Tax Act 1967 (**ITA**) allows the Director General of Inland Revenue (**DGIR**) to disregard or vary a transaction which he believes has the effect of evading or avoiding any duty or liability that is imposed or would otherwise have been imposed on any person by the ITA. In this respect, it is noteworthy that the DGIR's power to vary transactions entered into by the taxpayer would not apply where the taxpayer's arrangements are commercially rational. The manner in which a taxpayer conducts its business is up to the commercial judgment of the taxpayer and not for the DGIR to dictate.

This case reaffirms the principle that the DGIR cannot disregard the apparent transaction and substitute the same without any material evidence by merely alleging that the taxpayer had tried to conceal the real transaction or that the transaction in question was a sham.

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It is important that transactions between related parties are well documented as the DGIR, like the IRS, is prone to re-characterise transactions by ignoring the commercial expediency of the transactions.

In an ongoing transfer pricing dispute before the High Court, the DGIR had invoked Section 140A(3) of the ITA to re-characterise a cost-sharing arrangement to an intra-group services arrangement and raised tax assessments for more than RM50 million. The taxpayer successfully obtained leave to file judicial review and a stay order against the payment of the disputed tax assessments.

If you have any queries on transfer pricing, please contact **Datuk D P Naban** or **S Saravana Kumar** at **tax@lh-ag.com**

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