

Differential tolerance range - Does it meet Doctrine of Reasonable Classification?

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In April this year, the Central Board of Direct Taxes notified the revised tolerance band of 3 percent available to taxpayers in determination of arm's length price. While it is unfortunate that the band has been reduced from 5 to 3 percent – imposing an even more onerous exactitude on taxpayers - the tolerance band revision was accompanied by a somewhat perplexing differentiation between 'wholesale traders' and 'all others'. As per the CBDT notification (Notification No. 30/2013 dated 15 April 2013), the three percent tolerance band is available for any and every business activity except for 'wholesale trade' to which the 1 percent band applies.

While there certainly are some definition issues surrounding 'wholesaler trader', this article focuses on the possible intent for such classification (which has not been spelt out in any official document) and whether the classification would stand the test of 'reasonable nexus' as spelt out by Indian Courts – the time-tested guardians of Constitutional rights. Such an exercise inevitably calls for an enquiry into the object underlying the tolerance band.

Objective of Tolerance Band

Way back in 2001 when comprehensive Transfer Pricing Regulations were originally introduced, there was a conspicuous absence of the range concept under Indian regulations. Contrary to internationally accepted norms, no leeway around the arm's length price was available to taxpayer while planning Transfer Prices. Indian regulations imposed an unrealistic exactitude of being 'at' or 'above' the arm's length price determined as the *arithmetic mean* of comparable prices.

For the first time, the Finance Act 2002 introduced an amendment whereby a narrow band of (+/-) 5 percent range was made available around the arm's length price. Transfer Prices were not to be adjusted if they fell within the (+/-) 5 percent range around the arm's length price. The amendment came in response to widespread demand for rationalization of law and flexibility to taxpayer in line with transfer pricing best practices. Circular No. 12/2001 (dated 23-8-2001) states the rationale for introduction of tolerance band:

"...this is a new legislation, in the initial years of its implementation, there may be room for different interpretations leading to uncertainties with regard to determination of arm's length price of an international transaction. While it would be necessary to protect our tax base, there is a need to ensure that the taxpayers are not put to avoidable hardship in the implementation of these regulations."

As can be seen from the above extract, the objective of introducing the tolerance band was to "avoid hardship to taxpayers" by allowing flexibility in determination of the arm's length price.

Reasonable Classification Doctrine under Article 14

Article 14 of the Constitution ensures equality among equals; its aim is to protect persons similarly placed against discriminatory treatment. It does not however operate against rational classification. A classification is *reasonable or rational* when it is not an *arbitrary selection* but rests on differences pertinent to the subject in respect of which classification is made. The classification or differentia adopted as the basis of classification must have a rational or reasonable nexus with the object to be achieved.

Justice PN Bhagwati in *Ajay Hasia vs. Khalid Mujib Sehravardi (1981 AIR 487)* laid down the reasonable classification test to determine whether any legislation or executive action is violative of Article 14:

- Classification must be based on **intelligible differentia**- which distinguishes persons or things that are grouped together from others left out of the group;

- That differentia has a **rational relation to the object** sought to be achieved by the impugned legislative or executive action.

Any classification in order to be constitutional must rest upon distinctions that are substantial and not merely illusory. The test is whether there is reasonable basis free from artificiality and arbitrariness embracing all and omitting none naturally falling into that category.

Having found that the differentia adopted by legislature is intelligible, what is required further to satisfy Article 14 is that such differentia must have a reasonable relation ('nexus') to the object of legislation.

Applying 'reasonable classification' test to Tolerance Range Classification

Having briefly reviewed the 'reasonable classification' test, we undertake a step by step application of the test to the 'wholesalers' versus 'all others' classification made under the CBDT Circular:

Step 1 - Identify the object sought to be achieved by legislative or executive action

As the CBDT circular (cited above) itself states, the object sought to be achieved through the tolerance band is to minimize the "*room for different interpretations leading to uncertainties*" as well as "*avoid hardship to taxpayers*".

Step 2 – Identify the intelligible differentia

Based on a plain reading of the CBDT Circular, only one differentia seems to be adopted ie 'Wholesalers' versus 'All others'

Step 3 – Whether the differentia has any reasonable nexus with the object sought to be achieved

This is perhaps the most critical step in the application of the test. If the object of the tolerance band is to avoid hardship to taxpayer and provide flexibility, one wonders why 'wholesalers' should be allowed less flexibility compared to other businesses. Is there any evidence to suggest that price determination in case of wholesale trade is easier compared to other businesses? Is third party data on wholesalers more easily available compared to other businesses which should lead to more accurate outcomes for arm's length analysis warranting a narrower range? Even if such data/ evidence is indeed available would such a presumption apply equally to all categories of wholesalers?

The presumption for any classification made by the legislature/ executive is that such classification is valid unless demonstrated otherwise. In the defense of the CBDT classification one could argue that for wholesale businesses for which data is available publicly (for example food grains, minerals and other commodities whose prices are publicly quoted), the Government has allowed lesser leeway in as much as the arm's length price for such commodities can be more easily determined. However, there are several categories within wholesale business, for example a wholesaler of designer furniture/ products, artifacts, diamonds etc in case of which arm's length price determination may be as much or more difficult than other businesses. The more unique a product, the more difficult it becomes to determine the arm's length price.

While this is a policy question and a Government prerogative, if the object of the range is to allow flexibility/ reduce hardship to taxpayers and a differential range has to be prescribed, one wonders why different ranges should not be prescribed for pricing of intangibles on one hand and routine returns on another since more subjectivity is surely inherent in determination of non-routine versus routine returns.

Concluding Remarks

Experts and taxpayers for long have been clamoring for introduction of inter-quartile range with the potential to reduce Transfer Pricing adjustments and time consuming litigation. Legislature, however, has preferred to grant only the limited leeway of a narrow percentage band around the arm's length price. While one can debate policy choices, there are no apparent constitutional issues inherent in such prescriptions. The 5% band

is now reduced to 3% - again no constitutional complaints as this is again a policy decision - though the noose is further tightened and Transfer Pricing legislation starts looking more and more as a levy rather than anti-avoidance measure. Then comes the CBDT Circular prescribing a differential band for 'wholesale business' (only '1%' leeway) and 3% of other businesses. The notification itself doesn't hint at any scientific or economic analysis supporting the classification or the fact that how and why it would be easier for those in wholesale business to determine the arm's length price as opposed to any other business. While the validity of the CBDT Circular (or administrative action taken pursuant to the Circular) could surely be examined on the facts of a 'live' case, the author feels that there undoubtedly are some 'nexus' issues in the 'wholesale' application of the 1% range to all categories of wholesalers.

In order to survive challenge, the application of 1% range should be restricted to those cases where commodity prices are publicly quoted (say on an index) and/ or proved to be easily available – perhaps this also falls in line with the deliberate choice of words wholesale *“trader”* as against wholesale *“distributor”* in the Government notification. In other cases, the absence of a reasonable nexus may needlessly put bonafide taxpayers in a disadvantageous position and made to suffer consequences of a seemingly arbitrary classification.