Application of the Doctrine of Unjust Enrichment to Cases of Transfer Pricing Additions Involving the Import of Goods or Services and Cross-Border Loans

This article deals with the issue whether tax authorities under the garb of transfer pricing adjustments are justified in recovering more taxes and duties (taken collectively) from a related-party transaction compared to a similar unrelated-party transaction and suggests measures for the interlinking of values under different taxing statutes.

Unjust enrichment as according to the Wikipedia Dictionary is a legal term denoting a particular type of event in which one party is unjustly enriched at the expense of another, and an obligation to make restitution arises, regardless of liability for wrongdoing. In the case of transfer pricing additions involving the import of goods or services wherein the value adopted for customs duty purposes or for purposes of value added tax (VAT), goods and services tax (GST) or service tax is higher, one may look at applying the doctrine of unjust enrichment against the country levying such duty or tax, as it would be adopting differing values for purposes of different statutes to its own advantage.

For example, if the value of goods imported from a related entity is accepted by the customs authorities at USD 10 million and customs duty (net) is levied at 40%, the customs duty paid on such goods comes to USD 4 million. In such a case, if for transfer pricing purposes the value adopted for the imported goods is USD 8 million and additional income tax payable as a result of such addition is USD 0.7 million, then to the extent of USD 0.7 million there is unjust enrichment on the part of the country levying such duty, as arguably there is a double benefit to that extent by way of customs duty and income tax. Simultaneously, there is unjust impoverishment of the taxpayer on account of such double hit.

This can be summarized as in Figure 1.

Similarly, if in the above example a service tax of USD 1 million was paid by the recipient/importer of services, and for income tax purposes a deduction is allowed for only USD 0.2 million, then (subject to VAT/CENVAT credit effect) one may say that there is unjust enrichment to the extent of USD 0.2 million.

This can be summarized as in Figure 2.

Another case involving transfer pricing of services/cross-border loans where one may seek to apply the doctrine of unjust enrichment is where the income tax on services or interest is to be borne by the recipient of such services or the payer of the interest. If in the above example income tax on services or interest of USD 10 million is to be borne by the recipient of the services or the payer of the interest, and the tax rate under the applicable tax treaty is 10%, one may argue that any transfer pricing adjustment to the value of such services or interest would involve a double hit for the recipient of the services or the payer of interest. However, here one should bear in mind that the doctrine of unjust enrichment is sought to be applied to a contractual tax liability which is not a direct liability of the taxpayer, but a liability that the recipient is bearing as a result of its contract with the entity rendering the services or lending the money.

This can be summarized as in Figure 3.

Normally, the concept of unjust enrichment has been applied in India in excise and customs cases involving claim of refunds by taxpayers of duty held to be not leviable but already passed on by the taxpayer to its customers.

In the case of Mafatlal Industries, the Supreme Court of India observed as follows:

It is a case of balancing public interest vis-à-vis private interest. Where the petitioner-plaintiff has not himself suffered any loss or prejudice (having passed on the burden of the duty to others), there is no justice or equity in refunding the tax (collected without the authority of law) to him merely because he paid it to the State. It would be a windfall to him. As against it, by refusing refund, the moneys would continue to be with the State and available for public purposes. The money really belongs to a third party – neither to the petitioner-plaintiff nor to the State – and to such third party it must go. But where it cannot be so done, it is better that it is retained by the State. By any standard of reasonableness, it is difficult to prefer the petitioner-plaintiff over the State. Taxes are necessary for running the State and for various public purposes and this is the view taken in all jurisdictions. (...) This would not be a case of unjust enrichment of the State, as suggested by the petitioners-appellants. The very idea of "unjust enrichment" is inappropriate in the case of the State, which is in position of parents patriae, as held in Charan Lal Sahu v. Union of India [1990 (1) S.C.C. 613 at 649]. And even if such a concept is tenable, even then, it should be noticed that the State is not being enriched at the expense of the petitioner-plaintiff but at someone else’s expense who is not the petitioner-plaintiff. As rightly explained by Saxia, J in Mahabir Kishore & Ors. v. State of Madhya Pradesh [1989 (43) E.L.T. 205 (SC) = 1989 (3) S.C.R. 596], "the principle of unjust enrichment requires - first that the defendant has been

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Thus, in a case (only involving refund of customs duty/1.
with a levy of interest and penalty on the income tax due
on account of transfer pricing adjustment (rate assumed: 35%)
Customs duty paid at a higher value for such transfer pricing adjustment (rate assumed: 40%)
Unjust enrichment: (lower of E or F)

<table>
<thead>
<tr>
<th>Value of goods imported as per importer</th>
<th>Value adopted for customs duty purposes</th>
<th>Value adopted for income tax purposes</th>
<th>Transfer pricing adjustment</th>
<th>Income tax implication on account of transfer pricing adjustment (rate assumed: 35%)</th>
<th>Customs duty paid at a higher value for such transfer pricing adjustment (rate assumed: 40%)</th>
<th>Unjust enrichment: (lower of E or F)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>10</td>
<td>8</td>
<td>2</td>
<td>$2*35/100=0.7</td>
<td>$2*40/100=0.8</td>
<td>0.7</td>
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* All figures are in USD million.

However, in cases of transfer pricing adjustments where customs duty/service tax/VAT/GST has been levied at a higher value (which is supposed to be at arm’s length, based on market value), any downward revision of price would amount to an unjustified double hit on the taxpayer (which cannot be said to be passed on to the buyer), simultaneously resulting in an unjustified additional collection by the tax authorities taken together. This, along with a levy of interest and penalty on the income tax due on account of transfer pricing adjustments (to the extent of the double hit) is very unreasonable and unfair to a taxpayer.

The purpose of having the arm’s length concept for purposes of customs duty/VAT/GST/service tax and income tax is to ensure that taxpayers, due to their related party transactions, do not pay taxes which are less than they would pay if the transactions were at arm’s length. The purpose of having the arm’s length concept is not to make related parties pay more taxes than what they would have paid if the transactions were at arm’s length. To put it differently, the purpose of having the arm’s length concept is to ensure that related-party transactions do not result in a loss of revenue for the taxing country as compared to unrelated-party transactions. The purpose is not to earn more tax revenue from a transaction merely because the parties are related.

One may argue that if the taxpayer voluntarily pays customs duty/VAT etc. on a certain value, the tax authorities – even if they adopt a different value for income tax purposes – cannot be said to be unjustly enriched. However, the taxpayer, when it pays customs duty/VAT etc. on a particular value, is not aware as to what will be the value adopted for income tax purposes (although the taxpayer is fully aware that a transfer pricing adjustment will be made and would expectedly have appropriate justification for his position). The tax authorities, on the other

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hand, lose nothing by accepting the value for customs/VAT etc. at a figure higher than the arm’s length price which may be determined. This makes it a case of heads the tax authorities win, tails the taxpayer loses – which is a wholly unjust manner of taxation.

It is seen that the tax authorities dealing with customs valuation and with transfer pricing are normally different and follow their own sets of rules for determining the arm’s length price.

It would therefore be better that the valuation for customs/VAT/GST/service tax on the one hand, and transfer pricing on the other, be linked; only one of the authorities be authorized to determine the arm’s length price (preferably customs for goods, as it is the first authority which realistically determines the market value at the time of importation); and the other authority be statutorily required to adopt the value determined by the first authority.

Ideally, in countries where tax revenue from the imposition of VAT/GST/service tax/customs is likely to be more than the impact on account of income tax (as in the first example given where the rate of customs duty was 40%), the customs/VAT/GST/service tax authorities may be the authorities determining the arm’s length price. This would also help the tax authorities, as sometimes (when the customs authorities determine a higher arm’s length price and for transfer pricing the value shown by the taxpayer is accepted) taxpayers contend that the customs valuation cannot exceed the value determined under transfer pricing for income tax purposes.

If revenue from income tax is likely to be higher than that on account of levy of customs/GST/VAT/service tax (as in the second example where the income tax implication is higher than the impact on account of VAT etc.), the income tax authorities may be authorized to determine the arm’s length price.

Having statutory provisions which leave a related-party transaction with adjustments to make it similar to an unrelated-party transaction but with an extra levy of taxes may amount to discrimination in contravention of GATT principles. Certain countries might already have or are currently considering such interlinking of statutory provisions so as to have only one arm’s length price for all purposes.