Key Transfer Pricing Rulings

8 Sept 2017

- Prasad Pardiwala

Case Law - 1

Instrumenterium – Special bench on Base Erosion

Facts/ Issue:

- The taxpayer advanced an interest free loan to its wholly owned subsidiary in India (the Indian AE)
- Revenue authorities contented AL interest on this loan was required
- Notional interest was brought to tax in the hands of the taxpayer
- Taxpayer's primary argument was that an AL interest charge would lead to erosion of tax base in India, tax payer contended that TP should not apply to the transaction in dispute

Key observations of the ITAT Ruling:

- Interpretation of Section 92(3):
  - refers to the computation of income in the hands of the assessee whose income is being computed under section 92(1) of the Act
  - Does not contemplate taking a holistic view
  - To look at impact on profits / losses for the year under consideration and not subsequent years
  - Mere possibility of a set off of future profits against losses incurred by Indian AE cannot be taken into account nor can time value of money be ignored
- Role of intent of legislature comes into play only when there in ambiguity
- SB rejected the base erosion argument of the taxpayer

(*) Instrumentarium Corporation Limited [TS-467-ITAT-2016(Kol)-TP]

Instrumenterium - Post Special bench?

Illustration:

Facts of the case:

- Indian company (I co) pays royalty of 5 and its taxable income in India on the basis of book entry is 100.
- A foreign co (F co) receives royalty of 5 and its taxable income in India on the basis of book entry is 5
- The ALP is determined at 10.
- Applying ALP of 10 to Fco will result in Fco taxable income increasing to 10
- Applying ALP of 10 to Ico will result in Ico taxable income decreasing to 95
- Tax rate for F co is 10% and tax rate for Ico is 30%
- This results in erosion of tax base in India.
- Therefore ALP is inconsequential.

Points to note:

- SB Ruling advocates one sided approach – Against basic premise of TP
- Section 92(3) can not be applied only with respect to one of the party to transaction
- SB's discussion on set off of loss in future unwarranted
- Our position on flipside entities has not undergone change

Case Law - 2

Paraxel International (*) – Location Savings

Facts/ Issue:

- The group which the tax payer is a part of is a clinical research organisation based in UK and USA
- The AE have outsourced the work of clinical trial and research services to the assessee in India
- TPO accepted the benchmarking as per TP study and held the international transaction of facilitation and coordination services for performing clinical trial services in India to be at arms' length
- TPO computed location saving adjustment on the basis of an article in the public domain containing an analysis of costs on clinical trial activities in different jurisdictions

ITAT Ruling:

- Location saving relevant for examination and investigation of the transaction and not for determining ALP and consequently adjustment
- BEPS relevant in respect of transactions with sole purpose of avoiding tax
- Good local comparables are available - benefits of location savings are captured in the ALP
- Comparables should have 75% earning in foreign currency as assessee was having 100% revenue in foreign exchange
- Relies on Watson Pharma and Syngenta India

(*) Parexel International Clinical Research Pvt Ltd [TS-580-ITAT-2017(Bang)-TP]

Case Law - 3

Foreign AE – tested party

Facts/ Issue:

- The assessee, software solution/ ITES services provider, benchmarked transaction of provision of ITES to AE using TNMM
- AE was selected as tested party being least complex amongst parties
- TPO rejected AE as tested party stating absence of reliable data

ITAT Ruling:

- ITAT stressed on 3 parameters to select tested party –
  - the **least complex party** to the controlled transaction;
  - the party in respect of which **most reliable data** for comparability is available and;
  - which **does not own valuable intangible** or unique assets.
- Based on businesses of Assessee and AE, ITAT agreed that AE was least complex party
- Noted that database **Global symposium** has data from four public sources and data was presented before TPO
- Reliance on Ranbaxy ruling upheld

Takeaway – One more positive ruling on acceptance of foreign AE as tested party. However divergent views of Tribunal continue to pose challenges!

(*) IDS Infotech Ltd **[TS-184-ITAT-2017(CHANDI)-TP]**

Foreign AE – tested party – Divergent views

Accept - Development Consultants (P.) Ltd - Kolkata **2008**
Indian taxpayer was considered as a more complex entity.

Reject - Global Vantedge P. Ltd. - Delhi **2009**
Unavailability of facts that lead to a proper functional analysis of the foreign AE

Reject - M/s. Onward Technologies Limited - Mumbai **2013**
Scope of Indian TP law is limited to transaction between the taxpayer and its foreign AE

Accept - General Motors India Pvt. Ltd - Ahmedabad **2013**
Relied on the UN Manual and acknowledged divergent views of Tribunals with majority being in favor

Reject - Semco Electric Pvt. Ltd - Pune **2015**
Foreign AE was not the least complex

Accept - Ranbaxy Laboratories Ltd. - Delhi **2016**
Based on APA for a future year

Reject - GE Money Financial Service – Delhi **2016**
Selection of foreign AE as the tested party lacks statutory sanction.

Case Law - 4

Subvention income – SC Rules on Capital or Revenue nature

Facts / Issue:

- Assessee engaged in manufacture of electronic products and incurred loss in year under discussion
- Received monies from its parent which were not offered to tax by the Assessee - monies represented subvention payments by the parent to make good the losses
- AO taxed the same as revenue income, Tribunal ruled in favour of Assessee, HC relied on principal that purpose of subvention is relevant, hence, upheld AO's action

SC Ruling :

- Distinguished case from past cases relied by HC (Ponni Sugars and Sahney Steels)
- SC held that the voluntary payments by the parent company to the taxpayer to make good its losses was with a view to protect its capital investment

Takeaways : The amendment to section 2(24)(xviii) relating to inclusion of subsidies and grants different from SC decision.

Primary tenet that PLI Computation is not dependent on taxability of income does not change but principles shall be applied in test of determination

(*) Siemens Communication Networks Private Limited [TS 651-SC-2016]

Subvention income in PLI – To be or not to be ?

Need to decide treatment of subvention income while PLA computation in view of SC principles, Other judicial precedents and Australian Tax Office Guidance

- Scenario 1:

A payment made to compensate / reimburse a subsidiary (engaged in distribution for its parent) for advertising, marketing and promotion (AMP) expenses which exceed the amount an independent entity would have incurred in comparable circumstances.

- Scenario 2:

Where prices of transactions are agreed based on certain assumptions and designed to achieve arm's length results. However, based on a comparability analysis the arm's length margin is not achieved at year end (there is either a loss or insufficient profit). A payment made to bridge such a gap in margins.

- Scenario 3:

Contrary to Scenario 2, a payment is simply made so as to ensure that the subsidiary achieves a specified level of profit, and which otherwise has no connection with a transaction or its pricing.

- Scenario 4:

Where the subsidiary has been making consistent losses year after year or at least in the previous year and the year under consideration, and a subvention is made to recoup all of such losses (past and present).

Case Law - 5

Sumitomo Corporation (*) – Berry Ratio

- Berry Ratio = Gross Profit / Operating Expenses (not including cost of goods dealt)
- Typically for distributors sales based PLI are used

Facts / Issue:

- The taxpayer, an Indian subsidiary of a Japanese general trading company (Sogo Shosha), was engaged in: (i) provision of indenting services; and (ii) trading for resale in India.
- In the transfer pricing study, the transaction of provision of indenting services was benchmarked by applying the Transactional Net Margin Method (TNMM) as the MAM with Berry Ratio as the PLI.

TPO:

- The TPO applied the gross margin earned from non-associated enterprise (non-AE) trading transactions to the FOB value of goods and determined the arm's length commission for the indenting segment.
- The TPO observed that there was no difference in the Functions, Assets and Risk profile (FAR) of the trading segment as compared to the commission segment.

(*) Sumitomo Corporation India Pvt Ltd [TS-493-HC-2016(DEL)-TP]

Sumitomo Corporation – Berry Ratio

ITAT:

- Functional profiles of trading and indenting business could not be the same
- Compared the commission earned by the taxpayer from the associated enterprise (AE) with the commission earned from non-AEs for the indenting transaction. In doing so, the Tribunal rejected the taxpayer's contention for allowing economic adjustment due to difference in volume in the AE segment vis-à-vis the non-AE segment.

Questions before the HC

- Was the Tribunal right in applying and computing the arm's length price in respect of indenting transaction by applying the average rate of commission earned from non-AEs in spite of differences in turnover, and the fact that no such adjustment on this account was made by the TPO?
- Did the Tribunal correctly disregard the taxpayer's claim for application of the TNMM?

Sumitomo Corporation – Berry Ratio

HC Ruling :

- Disregarded the methodology adopted by the Tribunal in comparing the commission earned in the AE segment with that earned in the non-AE segment,
- Referring to provisions of 10B (1)(e)(i) HC noted that under TNMM the net profit margin realized could be computed having regard to **"any other relevant base"**
- Berry Ratio can be effectively applied only in cases of stripped-risk distributors, that is, distributors who have no financial exposure and risk in respect of the goods distributed by them
- Application of Berry Ratio would give unreliable results if the product mix of the taxpayer is different from the product mix of the comparables.
- The High Court held that the Berry Ratio would apply where:
  - the value of goods dealt with by the taxpayer have no role to play in the profits earned, which are directly linked with the operating expenditure incurred by the taxpayer;
  - the operating expenditure incurred by the taxpayer captures the entire gamut of functions performed and the risks undertaken.
- Berry Ratio would not be an appropriate PLI where:
  - the taxpayer uses intangibles as a part of its business, since the value of such intangibles would not be captured in the operating cost;
  - the taxpayer utilises substantial fixed assets, since the value added by use of such assets would not be captured by the Berry Ratio.

Case Law - 6

McKinsey Knowledge Centre Pvt. Ltd. – Business Restructuring

Facts/ Issue:

- Mckinsey Knowledge Centre Pvt. Ltd. provided research and information services to Mckinsey & Co. Inc., USA on a fixed rate remuneration model upto AY 2010-11
- From AY 2010-11 onwards, the remuneration model was changed to cost plus model
- The issue in question was whether a change in the remuneration model amounted to business restructuring and whether a separate exit charge is required for change in the remuneration model

ITAT Ruling:

- Delhi ITAT stated that the assessee has merely changed the remuneration model from fixed rate to cost plus in year under consideration and this does not amount to business restructuring
- Delhi ITAT rejected the Revenue's contention that assessee had declared higher profits in previous years to avail higher amount of deduction u/s. 10A
- Allowance of excess deduction on the basis of higher profits cannot be taken as a reason to disturb the ALP of international transaction for the year under review

Case Law - 7

Penalty risk – Issue of shares

Facts/ Issue:

- The assessee filed NIL return
- AO during assessment, noted foreign remittance from beneficial shareholder (NRI) towards share capital / premium
- AO took a view 3CEB was required. Although no adjustment to income was done, penalty was levied under section 271BA
- CIT(A) upheld penalty

ITAT Ruling:

- ITAT rejected Assessee's reliance on Vodafone case. It distinguished facts stating Vodafone had filed Form 3CEB and HC had ruled on adjustment to arm's length price
- In present case AO has not made any ALP adjustment but questioned failure for compliance
- Relied on Tribunal ruling in case of IL & FS Maritime (Pre Vodafone case)

Takeaway – Reinstates the fact that compliance by filing 3CEB and determination of ALP being covered by separate sections, pose independent requirements.

(*) BNT Global Private Limited [ITA No. 4111/Mum/2016]