WIRC

Recent Indian Case Laws on Transfer Pricing

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Glossary of terms

AAR	Authority for Advance Ruling
AE	Associated Enterprise
ALP	Arm's Length Price
AY	Assessment Year
AO	Assessing Officer
CUP	Comparable Uncontrolled Price Method
CIT(A)	Commissioner of Income-tax (Appeals)
FAR	Functions Assets and Risk Analysis
FEMA	Foreign Exchange Management Act, 1999
FY	Financial Year
HC	The High Court

Glossary of terms

ITAT	Income Tax Appellate Tribunal
PE	Permanent Establishment
SC	The Supreme Court of India
TP	Transfer pricing
TPO	Transfer Pricing Officer
The Act	The Income-tax Act, 1961
TNMM	Transactional Net Margin Method

Contents

- Moser Baer
- Skoda
- UCB
- MSS
- Rolls Royce

Moser Baer India Ltd. and Others vs. ACIT(Delhi HC) December 2008

moserbaer

Moser Baer – High Court (Delhi)

Brief Facts / Assessee's contentions

- Writ petitions were filed before the Delhi HC by six taxpayers against the orders passed by the TPOs in their respective cases
- As all the writ petitions had a common issue on violation of the principle of natural justice, the same were clubbed together
- Orders passed by TPOs without giving oral hearings as required under the Act
- Taxpayers were not provided an opportunity to verify or rebut the material used by the TPOs during assessments
- In some of the cases, adjustments made were not in synch with the show cause notices

Moser Baer – High Court (Delhi)

Revenue's contentions

- In the absence of a specific requirement, oral hearing was not a necessary facet of natural justice and a right to effective representation (by way of submissions etc.) would suffice

- Failure to afford oral hearings does not render the decision invalid as the same can be cured during appellate proceedings

- Decision / Observations

- Order passed by the TPO is in breach of the principles of natural justice and is a nullity in the eye of law

- Oral hearing is required to be accorded

Moser Baer – High Court (Delhi)

- Section 92CA(3) of the Act has cast an obligation on the TPO to grant an opportunity of oral hearing even in cases where no specific request is made by the tax payer for oral hearing
- Additional evidences before the CIT(A) can be submitted subject to satisfaction of certain conditions as are laid down in the Rules; therefore the Appellate proceedings as provided for under the Act are not a substitute for the original proceeding before the TPO
- Show-cause notice issued by the TPO should make a reference to the materials and evidence available and also give an option to the assessee to inspect materials available with the TPO
- Order passed by the TPO should not travel beyond the show cause notice
- Proper analysis should be carried out by the TPO for accepting / rejecting any comparables and the reasons for the same should be provided to the tax payer, so that the tax payer can rebut the same

Skoda Auto India Pvt. Ltd. vs. ACIT (ITAT Pune) March 2009

Skoda – ITAT Pune

Brief Facts

- The Assessee/taxpayer is an Indian company engaged in the business of manufacturing and selling of passenger cars
- The international transactions consisted purchase of raw material and payment of royalty and technical know how fees
- Assessee used TNMM as most appropriate method
- Assessee corroborated the raw material purchase transaction by using CUP method
- TPO rejected certain comparables used viz. General Motors (on account of persistent losses) and Ford India (on unavailability of contemporaneous data)
- TPO relied on the remaining comparables and made an adjustment to the tune of Rs.23.59 crores

Skoda – ITAT Pune

Assessee's Contentions

- If any company is functionally comparable, it cannot be rejected on account of sustained losses
- Benefit of (+/-) 5 percent variation from the arm's length price should be allowed
- Adjustment towards differences between comparables and the assessee on account of high import by taxpayer not considered
- Adjustments on account of lower capacity utilization affecting the profitability were not considered by the TPO
- Use of multiple year data should be allowed

Decision / Observations

- Application of CUP:
  - Rejected the CUP analysis observing that a transaction can be considered as an internal CUP only when it has been entered into between two independent parties

Skoda – ITAT Pune

- **Determination of ALP under TNMM:**
  - **The vast variation in proportion of imported raw materials could be on account of difference in the functionality. Hence, adjustment for high content of imported raw materials is required**
  - **It is permissible in principle to make adjustments in the costs and profits in fit cases**
  - **If information required for making the adjustment as available in the public domain is not sufficient, it is permissible to make some approximations and reasonable assumptions while making the adjustments for functional and other differences**
  - **TPO should provide adequate opportunity to the assessee to support its claim in relation to the multiple year data since its use hinges on the impact of product life cycle on the profitability**
  - **TPO should give due consideration to the proportion of raw materials imported by the assessee in the succeeding years while deciding whether an adjustment on account of high content of imported raw materials is warranted**
- **Benefit of 5% range given based on the decision in case of Sony India Private Limited**

UCB India Pvt. Ltd. vs. ACIT (ITAT Mumbai) February 2009

UCB – ITAT Mumbai

Brief Facts

- UCB India Pvt. Ltd. ('UCB India'), is a 100% subsidiary of UCB SA, Belgium ('UCB Belgium'),
- Engaged in the business of manufacturing and marketing of prescription drugs
- During AY 2002-03 and AY 2003-04 UCB India had imported raw materials i.e. Active Pharmaceutical Ingredients ('APIs') from UCB Belgium
- UCB India characterised itself as a 'licensed manufacturer' and selected TNMM as the most appropriate method
- Dissatisfied with the analysis carried out by UCB India, the TPO questioned the veracity of the analysis and posed UCB India certain questions regarding applicability of CUP method
- TPO also gathered information from UCB India's competitors by issuing notices to them u/s 133(6) of the Act
- TPO summoned the managing director and marketing manager of UCB India and recorded their statements on oath
- While rejecting the application of TNMM and applying the CUP method, the TPO proposed an addition to the UCB India's transfer price

UCB – ITAT Mumbai

Questions before the ITAT

- Aggrieved by the order of the TPO, on filing of an appeal before the CIT(A) part relief was granted to UCB India. UCB India further carried the appeal to the ITAT and raised objections and disputed the determination of arm's length price by the TPO, especially with regard to following matters
- Non acceptance of TNMM by the TPO, especially in light of scientific and robust process followed
- Erroneous application of CUP by the TPO

Assessee's contentions

- UCB India had complied with all the documentation requirements
- Robust analysis carried out and accordingly TNMM was selected as a most appropriate method
- CUP was rejected due to absence of information in the public domain
- Revenue department did not carry out proper analysis and also failed to substantiate the comparability of the companies selected by them

UCB – ITAT Mumbai

Revenue's contentions

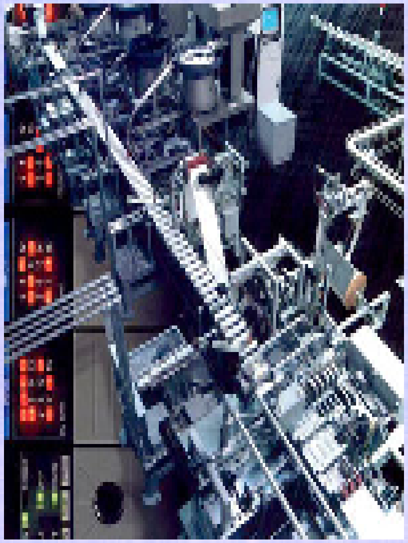
UCB India failed to produce documentation as required by Rule 10D

- Rejected the whole entity approach followed by UCB India while carrying out TNMM
- UCB India did not produce information to demonstrate the non-comparability of the transactions selected by the department
- Decision / observations
- Non-maintenance of or deficiency in the maintenance of some records should be seen in light of fact that whether such non-maintenance fundamentally affects or distorts the computation of ALP
- What needs to be seen is that the assessee has substantially complied with the law in relation to maintenance of records
- <u>On issue of entity level margin</u>: The international transaction contributed only to 50% of UCB India's production and that UCB India also had trading activity, Hence, the analysis carried out by UCB India by aggregating all the transactions is not in accordance with the law and hence not correct;

UCB – ITAT Mumbai

- **<u>With regard to comparability analysis carried out by UCB India</u>: The revenue of comparable companies consisted of licensed manufacturing, patented drugs, trading and other revenues. Hence, UCB India's comparability analysis, without making any adjustments to the comparables for the aforementioned factors, was wrong and hence was set aside**
- **<u>On applicability of CUP</u>: While considering whether controlled and uncontrolled transaction are comparable, regard should be had to the effect on price of broader business functions and not just the product comparability. Accordingly, ITAT set aside the CUP analysis as it suffered from many deficiencies and infirmities**
- **The ITAT remanded the matter to the files of the assessing officer for adjudication of the issue afresh. While doing so the ITAT directed as under:**
  - **UCB India may file fresh documentation report and any other document or evidence to support its report**
  - **UCB India is to apply any of the prescribed methods, even the TNMM**
  - **The assessing officer to adjudicate issue afresh after giving adequate opportunity to UCB India and after examining the documents placed on record with an open mind**

MSS India Pvt. Ltd.
(ITAT Pune)
June 2009



MSS India – ITAT Pune

Brief Facts

- MSS India, a 100% EOU, was engaged in business of manufacturing and supplying of strap connectors
- International transactions and methodology of justification was as under:

International Transaction	MAM Selected	Comparable Selected
Import of raw material and components (Copper and lead)	Cost Plus Method	London Metal exchange prices plus a mark-up
Sale of finished goods	Cost Plus Method	Internal – Gross margin earned from sale to unrelated parties
Interest paid on foreign currency loan	CUP	

MSS India – ITAT Pune

TPOs's Order

- Import of raw materials – MSS India having losses at the net level;
- Sale of finished goods – MSS India's allocation basis is inconsistent and ambiguous;
- The TPO selected TNMM as the MAM and proposed an adjustment to MSS India's international transactions

CIT(A) order

- MSS India being a 100% EOU didn't have reasons to manipulate prices;
- No TP adjustment therefore can be made to MSS India's international transactions (Relied on Philips Software [119 TTJ 721])

MSS India – ITAT Pune

Revenue's contentions

- The decision of Aztec Software should have been adopted by the CIT(A), being a special bench decision
  - The decision had held that for application of transfer pricing provisions it is not necessary for the revenue to establish any tax evasion;
- TNMM was the most appropriate method best suited to the facts and circumstances of the case and same should have been adopted by the CIT(A)

MSS India's contentions

- The decision of Philips India should be applied as it had considered the decision of Aztec India while delivering judgment;

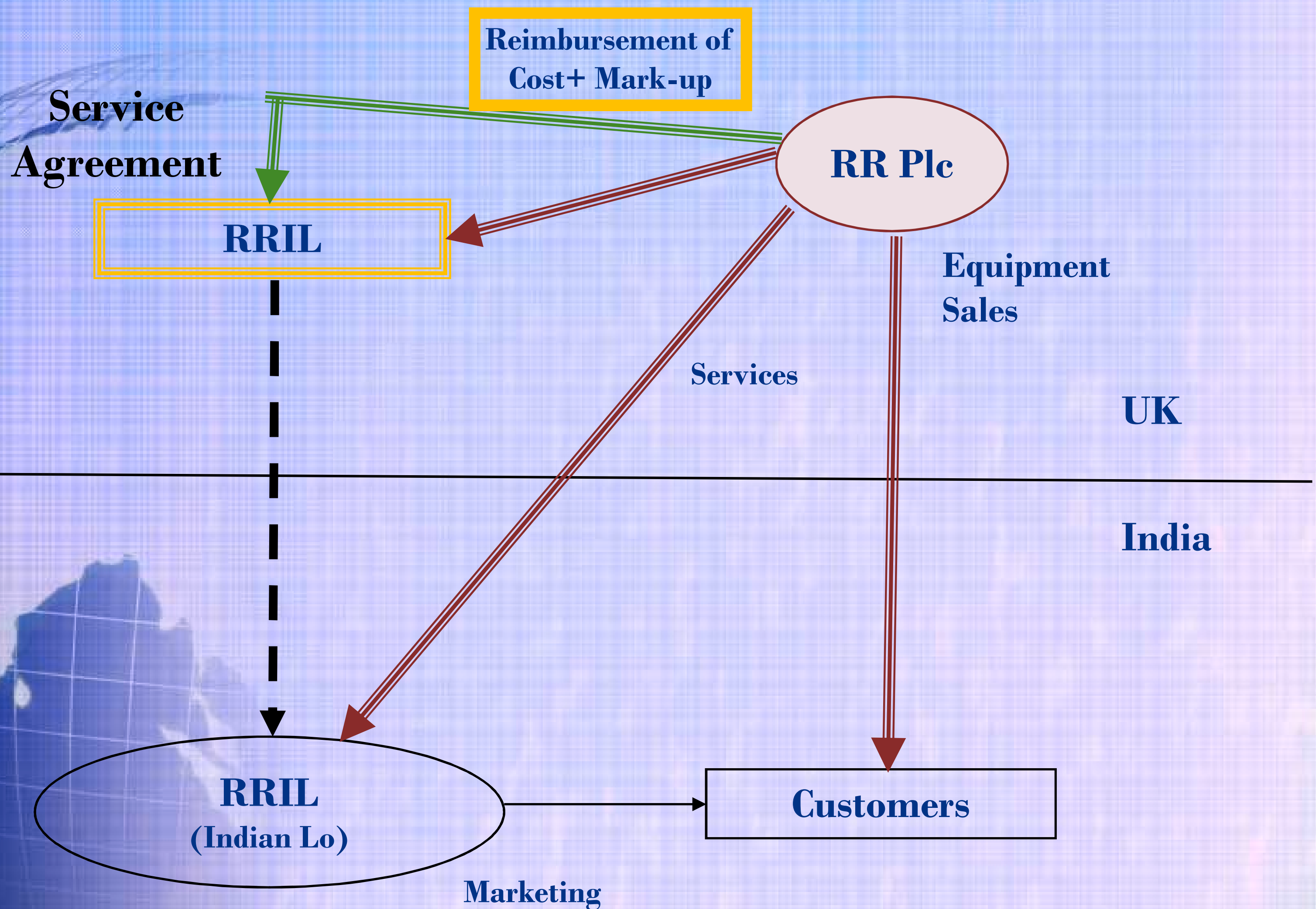
MSS India – ITAT Pune

Decision / observations by ITAT

- Decision of special bench (Aztec India) prevails over the divisional bench (Philips India)
- Traditional methods shall have preference over profit based methods; profit based methods shall be applied only when application of traditional method fails;
- Less than industry average profits or losses per se cannot lead to the conclusion that the taxpayer's international transactions are not at arm's length;
- Prices quoted on independent organization like LME can provide most reliable prices vis-à-vis comparable uncontrolled transactions and therefore can be adopted;
- When internal comparison is made, as log as the taxpayer does not follow different accounting norms for different transaction, the nuances of allocation of costs are not relevant

Rolls Royce Plc. vs. DDIT (ITAT Delhi) October 2007

Rolls Royce – ITAT Delhi



Rolls Royce – ITAT Delhi

Facts

- Rolls Royce PLC (RR Plc), a UK resident company, was a 'non-resident' for the purpose of the Income Tax Act and was not filing return in India
- RR Plc was supplying aero-engines and spare parts of Indian Customers, mainly to M/s. Hindustan Aeronautics Limited (HAL), Indian Navy and Indian Air force
- RR Plc entered into support service agreement with Rolls Royce India Ltd. (RRIL) and remunerated at 5.1% to 6% over cost
- RRIL has a liaison office in India which was carrying out activities only in respect of RR Plc in India. RRIL's responsibility included securing orders and soliciting requests for quotation / purchase price of RR Plc's products
- The employees of RR Plc visit India frequently and use premises of RRIL
- Employees of RRIL participate in the meetings with customers where matters regarding contracts with RR Plc are discussed and decisions are taken
- RRIL also marketed certain after sales and other services to RR Plc's existing / potential customers and also provided advice / recommendations to RR Plc as regards certain customer proposals

Rolls Royce – ITAT Delhi

Questions before the ITAT

- Whether the assessee has any income chargeable to tax in India u/s 5(2) of the Act and whether it has any business connection in India u/s. 9(1)(i)?
- Whether, in terms of DTAA between India and UK, the appellant has any PE in India?
- If answer to the above is in affirmative to what is the extent of income earned in India and whether the same can be held as paid by the appellant to RRIL and no further income is attributable to the PE in India?
- To what extent the income arises in India which can be charged to tax in India?

Rolls Royce – ITAT Delhi

Issues	Decision
Business connection	• RRIL was providing various services to RR Plc like marketing, advertising, media relations, business development etc. • Customers were requested to correspond with RRIL • Consequently, it was held RR Plc had business connection in India
Agency PE	• RRIL was totally dependent on RR Plc • RRIL was soliciting and receiving orders wholly and exclusively on behalf of RR Plc • It was held that RR Plc had Agency PE in India

Rolls Royce – ITAT Delhi

Issues	Decision
Fixed Place PE	• Fixed place PE would be constituted if foreign entity is entitled to: – Use any premises and – There is an identified distinct location on which the foreign entity can exercises control ▪ In the present case: – RR Plc employees visited RRIL regularly and – RRIL premises was available to all employees of RR Plc for business operations in India – RR Plc reimbursed the cost of maintenance of such premises ▪ RR Plc was held to have Fixed Place PE in India
Preparatory and auxiliary	• RRIL acted as marketing office to receive orders / promote business / negotiate and receive business orders • The activities were held not to be Preparatory and Auxiliary in nature

Rolls Royce – ITAT Delhi

Attribution of Profit

- The appellant has a PE in India and hence profits attributable to the PE need to be identified
- Article 7 - All the profits accruing directly or indirectly attributable to the PE are taxable in a State in which such PE is situated
- The profits attributable are to be computed as if the PE is a distinct and separate enterprise
- The profits could be determined on the basis of separate accounts maintained by the appellant for its PE operations or on the based on attribution for its significant activities
- The Tribunal identified the following economically significant activities carried on by the PE and attributed the profits as follows:
  - Manufacturing – 50% (Not liable to tax in India)
  - Research and Development – 15% (Not liable to tax in India)
  - Marketing – 35% (Liable to tax in India)

Rolls Royce – ITAT Delhi

Key Takeaways

- The decision acknowledged the principle of substance over form
- Brought to the fore the importance of economic nexus in attributing profits to a Permanent Establishment.
- Importance of FAR analysis and synchronizing business model with operational realities brought out

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