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Transfer Pricing

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Ruling by Delhi Income Tax Appellate Tribunal on Transfer Pricing

Executive Summary

This Alert summarises a recent decision of an Indian Income Tax Appellate Tribunal ("ITAT") in Delhi in the case of a transfer pricing adjustment to the taxable income of an Indian Company ("Ind Co" or the "Taxpayer"), a captive service provider to its US parent company. The ruling relates to the Indian tax year 2001-02, the first year of transfer pricing rules in India. The ITAT, while ruling in favour of the Taxpayer, observed that the Transfer Pricing Officer ("TPO") had failed to apply the Indian transfer pricing rules or the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations released in 1995 ("OECD Guidelines") appropriately while selecting comparable companies for determination of the Arm's Length Price. The ITAT rejected the comparability analysis carried out by the TPO and ruled that the Taxpayer had carried out a proper process of selecting comparables, which took into accounts functions, assets and risks. Based on the above, the ITAT held that the Taxpayer's transactions with its associated enterprise were arm's length in nature.

FACTS OF THE CASE

Ind Co was engaged in providing software development services to its parent company in USA. In consideration for the services rendered, Ind Co was compensated by its parent at a price of US$ 180 per man-day. While preparing its transfer pricing documentation under Indian transfer pricing Rules for the relevant tax year (2001-02), the Taxpayer selected the Transactional Net Margin Method ("TNMM") as the most appropriate method for determining the arm's length price. The Taxpayer had earned an operating margin on total costs of 6.99 per cent. As the Taxpayer's operating margin on total costs was within the permissible range of the margins of the comparable companies, the Taxpayer concluded that international transaction of providing software development services were arm's length in nature.

The TPO rejected the transfer pricing analysis undertaken by Ind Co on several grounds and determined the arm's length margin to be 24.53 per cent. On the basis of the TPO's order, the Assessing Officer ("AO") made adjustments to the total income of the Taxpayer. The transfer pricing adjustment was upheld by Appellate Commissioner of Income Tax ["CIT(A)"], the first-level appellate authority. Aggrieved by the CIT (A) ruling, the Taxpayer filed an appeal before the ITAT, the second-level appellate authority.

ITAT JUDGEMENT

In its ruling, the ITAT has laid down the following general principles for selection of comparable data for performing a transfer pricing analysis:

- While transfer pricing is not an exact science, it has to be shown that analysis carried was judicous and was done after taking into account all the relevant facts and circumstances of the case. Minimum requirement is to prima facie show that controlled international transaction was properly examined, comparable and arms' length price fixed objectively, honestly and in a bona fide manner as required by the statutory regulations.

- For determination of Arm's Length Price, the transfer pricing rules require that all the characteristics of the controlled transaction which are likely to affect its open market value must be taken into account. Thereafter, functional analysis of uncontrolled transactions should be carried out and comparison should be done with characteristics of the controlled transaction.

- **Risks assumed by the respective parties is a very important consideration in a transfer pricing analysis. Based on the fundamental principle of economics (i.e. the greater the risk, the greater the expected return), the ITAT observed that while performing searches for potentially comparable companies, not only turnover and operating profit but functions performed and risk profile are also to be considered.**

- If there are material and significant differences between the controlled enterprise and the comparable companies, the differences may need to be eliminated by making appropriate adjustments. Further, if the difference between the companies is so material that adjustment is not possible, then the identified comparables are required to be rejected. The ITAT also referred to the U.S. Court decision in the case of ***DuPont de Nemours & Co. v. United States (1979) 608 F2nd 608*** to highlight the importance of comparability in a transfer pricing analysis.

- Depending on facts of the case, final set of comparables may need to be adjusted for following differences:
  - working capital
  - adjustment for risk
  - adjustment of R&D expenses

In light of the above general principles, the ITAT rejected the analysis performed by the TPO for the following reasons:

- The TPO has not given due consideration to the above mentioned factors for judging comparability and concluded that TPO has committed several minor and major errors while computing the Arm's Length Price. The key observations of ITAT were as under:

  - Conclusion drawn based on certain presumptions is not authorized and cannot be accepted. Any conclusion needs to be substantiated based on facts.

  - Commenting on TPO's observation (based on the OECD Guidelines) that TNMM is more tolerant to minor functional and risk level differences, ITAT, also relying on the OECD Guidelines, mentioned that the TPO's inference was one-sided and even while applying TNMM, similarity of functions, risks and assets would need to be considered.

  - The wide difference in operating margins of comparables selected by TPO was a clear pointer that the selection made was faulty and warranted that the TPO undertakes detailed analysis of companies selected to confirm whether such variation is on account of differences in functions and risks.

  - The TPO should have carried out a new comparable search only if the comparables selected by the Taxpayer were insufficient or had other deficiencies.

- Based on the above, the ITAT held that the approach adopted by the TPO in selecting comparable data had serious defects which materially affected the determination of arm's length price and cannot be said to be legally correct. The ITAT also observed that the TPO's approach was not consistent with the transfer pricing rules nor were in conformity with the OECD Guidelines and had therefore resulted in a faulty comparison.

- The ITAT also observed that the Taxpayer had carried out a proper screening for comparable companies, which considered functions, risks and assets. The ITAT also acknowledged that though identical transactions could not be located even by the Taxpayer, an attempt was made to find comparable transactions as close as possible to the controlled transaction.

- While concluding, the ITAT held that there was no requirement to determine an arithmetic mean of the margins of the comparable companies. According to the ITAT any point on the arm's length range would satisfy the arm's length requirement and as long as the margin earned by the Taxpayer is more than the margin earned by any of the comparable companies, the international transaction can be said to be arm's length. As this was established by the Taxpayer, the ITAT deleted the transfer pricing adjustment.

OBSERVATIONS

Being one of the first rulings by an ITAT on a substantive transfer pricing issue of determining arm's length price, the ruling does provide general guidance on the approach to be adopted in selecting comparable data. The ruling reinforces the importance of well documented comparability assessment in a transfer pricing analysis. The emphasis placed by the ITAT on the relevance of risk in transfer pricing would be useful for captive service providers who assume very little risk in their international transactions. The reference made by the ITAT to OECD Guidelines and international case laws seems to suggest that in the absence of adequate guidance in India, Courts are inclined to rely on international practices for resolving these issues. The ruling also highlights the importance of proper transfer pricing documentation and the need to ensure objectivity in selecting comparable data for defending a transfer price.

While the ruling has provided some guidance on the contentious issue of selecting comparable data for a transfer pricing analysis, it has not addressed a number of other controversial issues. For instance, while the ruling acknowledges that risk differences could have a significant impact on a transfer price, no guidance has been provided on the approach to be adopted for making such adjustments. Similarly, the ruling has not addressed the impact on transfer pricing, if any, on account of "location savings" likely to arise from outsourcing services to an Indian affiliate. From the ruling it appears that these issues were not presented by either party before the ITAT.

One aspect of the ITAT ruling which is likely to raise a number of questions is the conclusion that if application of a transfer pricing method results in more than one arm's length price, any point on the range can be regarded as the arm's length price. It is relevant to note that Section 92C of the Income-tax Act, 1961 specifically provides for determination of an arithmetic mean, with a permissible variance of 5 per cent from that mean.

While the ruling is likely to be welcomed by a number of other taxpayers, it is important to note that keeping in mind the factual nature of transfer pricing disputes, the ruling may have limited precedent value in cases where there are even minor variations in facts. Nevertheless, the general principles emerging from the ruling can be expected to have some persuasive value. Further, as matters relating to selection of comparable data are largely factual, it needs to be seen if a High Court accepts an appeal against the ruling (if the Revenue prefers to do so) as only matters involving question of law may be appealed to the High Court and the ITAT is the final fact-finding authority.

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