# Transfer Pricing – Quarterly Edition

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CHARTERED ACCOUNTANTS

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## Delhi High Court confirms Tribunal decision on deletion of adjustment on account of re-characterization of indent based transaction as trading transaction in respect of Sogo Shosha entities and recognition of Berry Ratio

The taxpayer, *Marubeni Itochu Steel Pvt Ltd*[1] had imported steel products from its associated enterprise ("AE") for the purpose of resale in India. In order to benchmark this transaction, Transactional Net Margin Method ("TNMM") was selected as the most appropriate method ("MAM"), with net operating profit margin based on sales ("OP / Sales") as the Profit Level Indicator ("PLI"). Further, the taxpayer also rendered support services to its AEs in respect of the products directly sold in India for which it was getting remunerated by way of commission (indenting transaction). In order to benchmark this transaction, TNMM was selected as the MAM with net operating profit margin based on value added expenses ("OP / VAE", popularly known as Berry Ratio) as the PLI. The Transfer Pricing Officer ("TPO") drew no adverse inference on the trading segment of the taxpayer. But the TPO re-characterized the indent based transactions as trading transactions on the premise that the taxpayer had performed all the critical functions, assumed significant risks and had also utilized unique intangibles, supply chain and human capital, developed by it over a period of time.

Further, the TPO held that the taxpayer had also provided certain advantages to the AEs on account of location savings, which had resulted in the enhancement of its profit. Based on such assertions, the TPO added the FOB value of goods to the cost base on which the taxpayer earned commission under this segment. The TPO further held that application of Berry Ratio is contrary to Rule 10B(1)(e) of the Income-tax Rules, 1962 ("the Rules"). The Dispute Resolution Panel ("DRP") upheld, in principle, the adjustments made by the TPO, but reduced the FOB value of goods thereby granting partial relief on the TP adjustment.

The Tribunal decided the case in favor of the taxpayer. It held that the allegations of the TPO as regards critical functions and significant risks are not based on any cogent reasons. The Tribunal further held that the taxpayer has developed only routine intangibles during the course of its business. As regards locational savings, the Tribunal observed that the findings of the TPO are based on vague generalities devoid of any legally sustainable foundation. The Tribunal reiterated that Rule 10B(1)(e) of the Rules restricts imputation of cost incurred by third parties or AEs to the net profit earned by the taxpayer and also held that Rule 10B(1)(e) of the Rules is exhaustive as it ends with the expression "or having regard to any other relevant base" and upheld the use of Berry Ratio by the taxpayer.

Aggrieved by the order of the Tribunal, Revenue authorities took up the matter before the Delhi High Court. The Delhi High Court, placing reliance on other judgements such as in the case of *Mitsubishi Corporation India Pvt Ltd*[2], *Li & Fung India Pvt Ltd*[3], *Marubeni India Pvt Ltd*[4], and *Mitsui & Co. India Pvt Ltd* [5] confirmed the order of the Tribunal in favor of the taxpayer.

### Syngenta India Ltd (Mumbai Tribunal) - Accepts the claim of the taxpayer for adjustment on account of market driven factors*

The taxpayer, *Syngenta India Ltd*[6], is a public limited company engaged in the business of manufacturing and trading of agro chemical products, crop protection chemicals, multiplication and trading of seeds. The taxpayer had classified its business operations into two primary segments, namely, ‘Crop Protection’ and ‘Seeds’. The ‘Crop Protection’ segment was further divided into ‘Licensed Manufacturing’ and ‘Contract Manufacturing’. Under ‘Licensed Manufacturing’, the taxpayer operated as a full-fledged manufacturer of chemicals for crop protection. It also imported pesticides and formulations which were repacked and sold in the Indian markets. Under ‘Contract manufacturing’, the taxpayer manufactured active ingredient Thiamethoxam (“TMX”) and its derivative products. This involved import of raw materials from its AE, Syngenta Asia Pacific Pte Ltd (“SAPL”) and sale of finished goods to it. During assessment year 2007-08, the taxpayer entered into various international transactions with its AE under ‘Crop Protection’ segment and the sub- segment of ‘Licensed Manufacturing’. For benchmarking the transactions, taxpayer selected TNMM as the MAM and determined operating profit / sales of comparables at 5.84 percent vis-à-vis taxpayer at 4.21 percent and held that same to be arm’s length as the same fell within + / - 5 percent range.

During assessment proceedings, the TPO accepted most of the comparables, except for Sudarshan Chemicals Industries Ltd and also rejected taxpayer’s claim for adjustment on account of market driven factors. Therefore, the TPO made an adjustment amounting to INR 20.73 crore in the segment of ‘Crop Protection - License Manufacturing’.

The DRP confirmed the adjustment made by the TPO. Aggrieved by the order, the taxpayer preferred an appeal before the Tribunal.

In order to put forth its claim for adjustment for market driven factors, the taxpayer brought out that its profit margins in earlier assessment years ranged between 10.43 to 15.41 percent, which had reduced substantially to 4.21 percent in the subject assessment year. This sharp decline was attributable to the unfavorable market conditions, inter alia, increased competition, relative pricing pressures in the current year, change in demand patterns and climatic conditions. The taxpayer contended that the ‘Crop Protection’ industry was affected adversely by bad monsoon and climatic conditions. He further brought to the notice of Tribunal that the low margin is also attributable to severe competition faced in the sale of its premium product “Topik Formulation” due to the entry of different generic substitutes into the market. This severe competition triggered substantial reduction in the sale price of the product “Topik Formulation” in order to maintain presence in the market.

The Tribunal appreciated the fact that low margin of the taxpayer was attributable to prevailing market conditions and adjustment on account of market driven factors can be considered. In this regard, the Tribunal acknowledged the fact that price of one of the premium products of the taxpayer, “Topik”, which contributed 15-20 percent of the total sales of the segment and 35 percent of the gross profit, was reduced

substantially by 45 percent. The Tribunal also observed that if the product “Topik” was sold at a price commanded by the taxpayer in the earlier years then the operating profit on the sale would have been 9.72 percent, which falls within the arm’s length range vis-à-vis comparables. Further, the Tribunal placed reliance on the para 1.60 and 1.62 of the Organization for Economic Co-operation and Development (“OECD”) Transfer Pricing guidelines for Multinational Enterprises and Tax Administrations, July 2010 (“OECD TP guidelines”), to hold that the business strategy adopted by the taxpayer to sustain in the market amidst severe competition warranted consideration for adjustment to eliminate material differences existed between taxpayer and comparables, and accordingly, allowed the claim for adjustment on account of market driven factors. The Tribunal held that the contentions of the taxpayer as regards climatic conditions does not warrant need for adjustment as these factors affected agro chemical / seed industry as a whole.

### DQ Entertainment (International) Ltd (Hyderabad Tribunal) - Rejects use of actual revenues for valuing intangible under DCF approach

The taxpayer, *DQ Entertainment (International) Ltd*[7], is a producer of animation visual effects, game art and entertainment content for the Indian as well as global media and entertainment industry. It is involved in the production and distribution of cartoon TV series, direct-to-home videos and feature films, real time game animation for online mobile and next gen console games, 3D stereoscopic animated feature films.

During the year, taxpayer sold the Intellectual Property ("IP") rights of the Jungle Book animation series, which was in development phase, to its AE, DQE Ireland. The sale price was based on the average of the values arrived by two independent valuers, using 'Relief from Royalty method' and 'Discounted Cash Flow ("DCF") approach' and accordingly value of Indian Rupee ("INR") 5.36 crore was determined for the IP. The profit on account of the same was offered to tax in India as short term capital gains.

During assessment proceedings, the TPO substituted the projected cash flows as per DCF approach with the actual total revenues of DQE Ireland for the financial year(s) 2009-10 and 2010-11 and determined the sale consideration for IP rights at INR 12.35 crore as against INR 5.36 crore computed by the taxpayer. For the purpose of computation, TPO considered total revenue generated by DQE Ireland as against the revenue attributable to the IP rights of Jungle Book only. To support his action, TPO placed reliance on paras 9.87 and 9.88 of the OECD TP guidelines which permit application of hindsight approach when the difference between expected future profits ascertained at the time of valuation and actual profits is substantial, warranting independent entities in uncontrolled transaction to renegotiate or make adjustment to the negotiated price.

Further, the TPO contended that sale of IP rights is in the nature of business restructuring and applied profit split method ("PSM") to attribute 80 percent of the total profit earned during the year by DQE Ireland to the taxpayer. The TPO highlighted the issues outlined in OECD TP guidelines, OECD's Base Erosion and Profit Shifting Action Plan 8-10

("BEPS Report") and relied on several decisions examining substance over form and re-characterization of transactions to conclude that even though the legal ownership of IP of Jungle Book had been transferred to DQE Ireland, but the economic ownership continued to be with the taxpayer. To support his contention, the TPO argued that DQE Ireland is a shell company which is located in a low tax jurisdiction and is being run by only two persons. It was further stated that DQE Ireland has capitalized on the presence and brand value of taxpayer to tap the right contacts in the industry and that even after the sale of IP rights, DQE Ireland continues to assign production work to the taxpayer for development of said IP. The TPO further contended that in an arm's length situation, no independent enterprise would allow its valuable IP to be sold at a low value which has potential of earning huge revenues, unless it has undertaken distress sale.

The TPO also computed the arm's length price of management support charges paid by the taxpayer to be at "nil", citing failure on the part of the taxpayer to produce any evidence in support of receipt of the tangible benefits for such payment. He further argued that such services are part of the shareholder activities by the AEs and do not form part of the intra group services as per the OECD TP guidelines. The TPO further applied a mark-up of 10 percent on the recovery of expenses in the nature of travel and other expense, incurred by the taxpayer on behalf of DQE Ireland.

The DRP confirmed the adjustments made by the TPO.

Aggrieved by the order of the TPO / DRP, the taxpayer preferred an appeal before the

Tribunal and placed the following contentions before it:

> a)That the valuation under DCF approach always considers revenues projected at the time of making the decision and cannot be adjusted at a later point of time by substituting actuals and that the taxpayer would have followed a similar approach had it entered into a similar transaction with an unrelated party. The taxpayer placed reliance on the judgements passed in the case of *Tally Solutions Ltd*[8] wherein the substitution of actual revenues with the projected revenues was repelled and in the case of *Social Media India Ltd*[9], wherein, it was held that the valuation submitted by the independent valuers has to be accepted without any modifications.

b)That PSM is applicable only when intangible is jointly owned by both the AEs, whereas in the taxpayer's case it is an absolute sale of the intangible. To bolster its contentions that the profit generated from intangible so transferred wholly belongs to DQE Ireland, the taxpayer submitted that the intangible was sold to DQE Ireland in September 2009, while it was in development phase and that no revenue was generated in the hands of the taxpayer or DQE Ireland prior to September 2009. The taxpayer further highlighted that revenues were generated from the intangible during last quarter of financial year 2009-10 only, when the ownership of intangible was with DQE Ireland. The taxpayer further contended that revenue attributed to taxpayer included the revenue generated by DQE Ireland from various other projects, which are in no way related to the taxpayer.

c)That management support services were in the nature of administrative, general management and professional services. It was further explained that the payment of management fees was to the AE on account of invaluable advice and guidance provided by its board of directors to the taxpayer, which has been instrumental in bringing business to the taxpayer. The taxpayer, while placing reliance on several judgements, contended that the legitimacy of the expenditure cannot be questioned. As regards the mark-up on expenses recovered by the taxpayer, it was submitted that such expenses were in the nature of travel and other expenses which were incurred by the taxpayer on behalf of DQE Ireland and were recovered at cost. It was further contended that no service was rendered by the taxpayer on account of the same and such recoveries had no impact on the profit & loss account of the taxpayer.

The Tribunal deleted the entire adjustment made by the TPO / DRP. As regards the adjustment made on account of substitution of actual revenue with the projected revenue, the Tribunal concurred with the findings of the coordinate benches in the cases of *Tally Solutions Ltd* and *Social Media India Ltd* and held that for the purpose of valuation of intangibles, future projections alone can be adopted and such valuation cannot be reviewed with the actuals as this would tantamount to "evaluation" and not "valuation". It further held that the commercial wisdom in adopting the value at the time of making a business decision cannot be questioned.

On the action of the TPO / DRP to apportion the profits of DQE Ireland to the taxpayer by using PSM, the Tribunal held that there is no international transaction (under section 92B of the Income-tax Act, 1961) after the outright sale of IP rights as DQE Ireland has not entered into any transaction relating to IP with the taxpayer post sale.

The Tribunal further observed that once the IP is sold and arm's length price is determined, IP becomes the property of DQE Ireland and the taxpayer has no right to claim any benefit arising out of it in respect of transaction undertaken with the third parties relating to subject IP. The Tribunal also observed that for the purpose of apportionment of profits, TPO considered the capital gain arising out of sale of IP rights even though the same was offered to tax in India. Further, the adjustments made by the TPO / DRP on account of management support charges and reimbursement of expense were deleted by the Tribunal.

## McDonald's India Pvt Ltd (Delhi Tribunal) - Mere collection and remittance of royalty to AEs without any value addition to be treated as pass through cost

The taxpayer, *McDonald's India Pvt Ltd*[10] had entered into a master service agreement with its parent entity, Mc Donald's Corporation, US ("Mc Donald's US"). Under this agreement, a license was granted to the taxpayer with respect to marketing and operational rights of Mc Donald's restaurants on non-exclusive basis. These rights were for promoting and developing McDonald restaurants in India. Further as per agreement, the taxpayer can operate the restaurants under McDonald's system on its own or through franchises. In both the situations, the taxpayer had to pay royalty to McDonald's US at 5 percent on gross sales on all operations on restaurants in India and the same was to be remitted by the taxpayer to Mc Donald's US each month. Further, the taxpayer was obligated to pay USD 45,000 to Mc Donald's US for each new restaurant taken on franchise and spend an equivalent of 5 percent of gross sales on advertising.

The taxpayer had created two joint ventures with two other parties, who in turn are the sub licensee and were supposed to pay royalty at the rate of 5 percent to the taxpayer and spend another 5 percent on advertisement. Further, the obligation relating to franchise fee had also been passed on to the joint ventures. For the purpose of benchmarking transaction relating to payment of royalty and initial franchise fees, the taxpayer had adopted Comparable Uncontrolled Price (“CUP”) as the MAM.

The taxpayer also provided management services for fast food business and had charged 10 percent margin on all operating costs except royalty and initial franchise fees. The taxpayer contended that the role of the taxpayer was limited to mere collection of the royalty and franchise fees from the joint ventures and remittance to the McDonald’s US and that no value addition had been done in respect of such payments by the taxpayer. In order to benchmark said transaction, the taxpayer had adopted TNMM as the MAM and had accordingly, treated royalty and initial franchise fees as pass through cost. The TPO rejected the CUP method adopted by the taxpayer to benchmark transactions relating to royalty and franchise fees because of the difference in geographical regions and applied entity wide TNMM. For the purpose of computation of arm’s length profit under TNMM, the TPO included royalty income received from sub-licensee and paid to parent entity in operating income and operating expense respectively and determined arm’s length margin at 2.68 percent. as against the comparables’ margin of 9.89 percent. The TPO contended that there is a difference in amount of royalty collected from joint ventures and remittance to McDonald’s US and therefore, there is an inherent profit or loss element. Hence, royalty payment is not a pass through cost. He further contended that significant risk has been assumed by the taxpayer by stating that any default on account of royalty payment carries the risk of cancellation of agreement. He further rejected various risk adjustments undertaken by the taxpayer. The Commissioner of Income-tax (Appeals) confirmed the adjustments made by TPO.

The aggrieved taxpayer filed an appeal before the Delhi bench of Tribunal, which observed that the pass through cost is a cost incidental to the main activities of the business and held that the taxpayer has not provided any value addition to the collection and payment of royalty and franchise fees, nor it has performed any significant function or assumed any significant risk in relation to the pass through costs. Specifically with regard to TPO’s contention on risks assumed by the taxpayer, the Tribunal appreciated that no default on account of royalty payment has occurred in past. The Tribunal, while placing reliance on OECD TP guidelines and judgements delivered in the case of *Cheil Communications India Pvt Ltd*[11] and *Johnson Matthey India Pvt Ltd*[12], opined that the cost which does not involve any value addition should not form part of the PLI computation. It is imperative to understand that when an entity performs an agency function (performs services as an agent for another entity), that entity is required to charge mark-up on the cost related to agency function and not on the cost of services itself. The Tribunal further held that the burden to prove that an independent entity in the comparable uncontrolled circumstance would not have performed function of collection and remittance of royalty amount without getting any extra remuneration, when it is already getting compensated for its agency function, has not been sufficiently discharged by the Revenue. The Tribunal further observed that the ground relating to MAM has not been pressed by the taxpayer before the Tribunal, therefore, the same was dismissed.

## India Debt Management Pvt Ltd (Mumbai Tribunal) - Interest rate should be based on market determined rate applicable to currency in which loan or interest is to be paid

The taxpayer, *India Debt Management Pvt Ltd*[13], as its business strategy, acquires and makes investment in midsized enterprises which are financially distressed but otherwise have potential or viable business proposition. Due to this strategy of being a highly risky enterprise, the taxpayer had a low credit rating of BBB(-). The funding of these investments is primarily done through intra group financing, wherein, taxpayer raises money through debt in the form of series of Compulsory Convertible Debentures (“CCD”). These CCDs are denominated in INR and the interest paid on such CCDs is in INR only.

During the year, the taxpayer made payment of interest on CCDs amounting to INR 99.06 crore to its AE. Considering the various series of CCD issued, whose interest rate varied from 9.75 to 14 percent p.a., effective rate of interest was determined by the taxpayer at 11.30 percent p.a. In order to benchmark the said transaction, the taxpayer adopted CUP as the MAM. Under CUP, the taxpayer identified external comparables from Thomson Reuters, DealScan and Bloomberg databases and carried out adjustments to weed out differences in the risk profiles of the comparables on account of currency of loan, borrower’s region, and tenor to arrive at arm’s length rate of 14.50 percent p.a. This analysis was further corroborated with a secondary analysis by considering debt issuances from Bombay Stock Exchange (“BSE”) data which resulted into two comparables and after carrying out tenor adjustment to factor in long term nature of tested transaction, the taxpayer arrived at an arm’s length interest of 15.01 percent p.a.

Further, the taxpayer had also undertaken an analysis of the interest rates offered by Indian banks to borrowers which showed the average rate of interest at 12.13 percent p.a. Basis the above analysis, the taxpayer stated that its effective rate of interest of 11.30 percent p.a. is at arm's length.

During assessment proceedings, the TPO rejected entire methodology adopted by the taxpayer and made an adjustment amounting to INR 48.53 crore in respect of interest expense incurred on account of CCDs primarily on the ground that the TP study failed to identify the tested party. The TPO carried out two fresh benchmarking analysis, one by taking taxpayer as the tested party [sic] and other taking AE as the tested party.

For the first one, the TPO relied on the external commercial borrowings data as per Reserve Bank of India ("RBI") circular and websites of banks giving External Commercial Borrowing ("ECB") on LIBOR plus certain basis points to arrive at arm's length rate of 8.5 percent p.a. The TPO also carried out alternative analysis by considering AE as the tested party and relied on the US Bond rate to arrive at arm's length rate of 5.68 percent p.a. Out of the two approaches, TPO adopted second approach as the benchmark and held that arm's length rate at 5.68 percent p.a.

The DRP upheld the arm's length rate of 5.68 percent computed by the TPO, thereby, confirming the adjustment amounting to INR 48.53 crore made by the TPO.

Aggrieved by the order of the TPO / DRP, an appeal was preferred by the taxpayer before the Tribunal. The Tribunal disagreed with the TPO / DRP that selection of the tested party is a condition precedent for carrying out benchmarking analysis. The Tribunal, while placing reliance on para 5.33 of United Nations Practice Manual on Transfer Pricing for developing countries ("UN TP manual") and para 3.18 of OECD TP guidelines, held that identification of the tested party is imperative while applying Cost Plus Method ("CPM"), Resale Price Method ("RPM") or TNMM and not while applying CUP. The Tribunal further held that the selection of tested party should be done with reference to the entity which has undertaken the transaction, which in this case is the taxpayer. The Tribunal rejected the methodology adopted by TPO / DRP to benchmark interest rate on the basis of US Bond rate and held that as the tested transaction was an INR denominated debt, the interest rate must necessarily be based on economic and market factors affecting Indian currency and data available for debt issuances in India or INR denominated rather than the foreign currency rate or external data. The Tribunal further placed its reliance on the decision in the case of *Cotton Naturals India Pvt Ltd*[14] and held that arm's length interest rate should be based on the currency in which CCDs have been issued and interest is being paid (i.e. INR) and not on any foreign lending rate. Lastly, the Tribunal upheld the selection of BSE data on INR denominated debt issuances by taxpayer to benchmark the interest payment to AE and deleted the entire adjustment made by the TPO on this account.

## CITATIONS

1 TS-275-HC-2016(DEL)-TP

2 TS-330-ITAT-2014(DEL)-TP

3 TS-346-HC-2013(DEL)-TP

4 TS-168-HC-2015(DEL)-TP

5 ITA 252/2016

6 TS-366-ITAT-2016(Mum)-TP

7 TS-367-ITAT-2016(HYD)-TP

8 14 Taxmann.com 19 (Bang.)

9 ITA No. 1711 / Hyd / 2012

10 TS-236-ITAT-2016(DEL)-TP

11 DCIT vs Cheil Communications India Pvt Ltd [2011] 11 taxmann.com 205 (Del)

12 Johnson Matthey India Pvt Ltd vs DCIT [2015] 63 taxmann.com 2 (Del)

13 TS-141-ITAT-2016(Mum)-TP

14 [2015] 55 Taxman.com

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