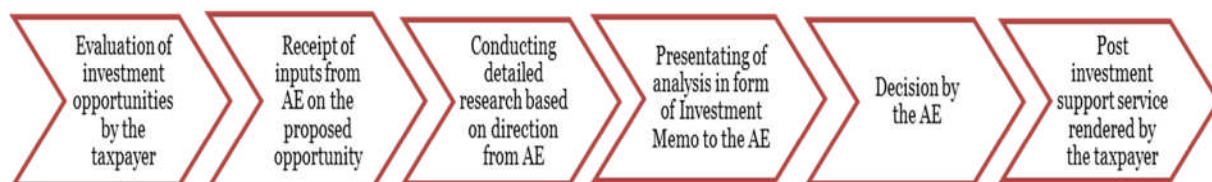


Tribunal lays down fundamental differences between merchant banking and private equity fund related activities and accepts markup earned by taxpayer for sub-advisory services

November 13, 2014

In brief

Xander Advisors India Private Limited (the taxpayer) [TS-361-ITAT-2014(DEL)-TP] was engaged in rendering advisory services to its associated enterprise (AE) in Mauritius for assessment year (AY) 2008-09. In relation to such services, the functional profile of the taxpayer *vis-à-vis* its AE was articulated as under:



For the aforesaid mentioned activity, the taxpayer was compensated with a mark-up of 20% of actual costs.

In the transfer pricing study report, the taxpayer had used a set of 17 comparables for benchmarking purposes. However, the transfer pricing officer (TPO) selected 7 comparables from the taxpayer's set to determine the arm's length price in relation to the advisory activity of the taxpayer. Further, the dispute resolution panel (DRP) also confirmed the set of comparables selected by the TPO.

Therefore, the taxpayer preferred an appeal before the Income-tax Appellate Tribunal (Tribunal) contesting removal of three companies on account of functional differences. Before the Tribunal, the taxpayer characterised itself as a private equity fund and held that the disputed companies were merchant bankers and hence not comparable.

Ruling in favour of the taxpayer, the Tribunal directed exclusion of the three disputed companies and set aside the matter before the TPO for determining the arm's length price considering the balance set of four companies.

In detail

Tribunal ruling

Some key takeaways from the Tribunal ruling that are worth highlighting have been produced below:

- The Tribunal acknowledged that merchant bankers are not comparable to private equity fund on account of the following factors

Merchant Banking activity

- Involves finance raising and consultancy based activity
- Includes project/ corporate counseling in areas of capital restructuring, amalgamations, mergers, takeovers, etc.
- Includes broking and portfolio management

Private Equity Fund related activity

- Comprises of collecting funds for investment in or buying of companies
- Involves making investment decision and managing acquired companies
- Remuneration is in the form of management fees

Based on the above analysis of both the activities, the Tribunal held that merchant banking is a **capital raising/ advisory service related activity** whereas private equity is an **investment related business**.

- The Tribunal has held that the taxpayer was a sub-advisor in the value chain and rejected the taxpayer's characterisation of a private equity fund. In doing so, the Tribunal differentiated the role of a fund, a manager and a sub-advisor in the value chain as under:-
 - Fund:** Responsible for private equity investment
 - Manager:** Provides overall investment advice
 - Sub-advisor:** Provides general advisory services to Manager
- In relation to the companies contested by the taxpayer, the Tribunal held that companies engaged in financial restructuring, syndication of debt/ loan, equity placement and Merger and Acquisition advisory activities are not comparable to advisory services of the taxpayer. The Tribunal has also held that where only a portion of the income component was comparable to the taxpayer's activity and no segment level information is available, then such companies should not be considered in the benchmarking analysis.
- Further, the Tribunal held that the taxpayer ought to be allowed an opportunity to exclude companies inadvertently considered as a part of the comparable set in the Transfer Pricing Study.

The takeaway

- This is the first ruling wherein the Tribunal has laid down key fundamental differences between a merchant banker and a private equity model.
- Though, the taxpayer characterised itself as a private equity fund, the Tribunal held that the nature of activities performed by the taxpayer were akin to that of a sub-advisor in the value chain and the fact that it is the real character of the transaction and not merely the nomenclature that is important in performing a robust comparability analysis.
- This Ruling re-emphasises principles emerging from prior rulings such as Carlyle India Advisors Private Limited ITA NO. 7901/ MUM/ 2011 (A.Y.2007-08) and ITA No. 7367/Mum/2012 (AY 2008-09) which explicitly distinguishes

merchant bankers from investment advisors and importantly distinguishes the role of the Fund, the Manager and the Advisor, as the different constituents in the investment management value chain. In this space, that has seen significant debate on characterisation and litigation around pricing models/ mark-ups, the aforesaid Ruling provides important guidance on the matter.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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