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SB refrains from bifurcating KPOs and BPOs, yet allows dissection of ITES based on functional mapping

Facts

ABC (India) Private Limited (the taxpayer) was engaged in providing IT and IT enabled services (ITES) services to its Associated Enterprises (AEs). The arm's length price (ALP) determination of these international transactions was in dispute. The taxpayer had selected Transactional Net Margin Method (TNMM) as the most appropriate method to benchmark these transactions. The Transfer Pricing Officer (TPO), however, rejected the taxpayer's TP study and proceeded to determine ALP on his own. The taxpayer objected before the Dispute Resolution Panel (DRP). Eventually, a set of 10 comparables, with an operating profit/ total cost ratio of 28.04% (after allowing working capital adjustment), was finalized to benchmark both, IT and ITES services being provided by the taxpayer.

In its appeal before the Special Bench of the Income-tax Appellate Tribunal (the SB), the objections raised by the taxpayer essentially related to selection of comparables. The taxpayer objected to itself being compared with Knowledge Process Outsourcing (KPO) companies when in fact it was providing low-end services as a business process outsourcing (BPO) service provider. The taxpayer also objected to high profit margin companies being included in the set of comparables. In line with these objections, two questions were framed for the SB to address. The SB's ruling on both these questions is detailed below.

Question 1

Whether, for the purpose of determining ALP of international transactions of the taxpayer involved in providing back office support services to their overseas AEs, companies performing KPO functions should be considered as comparable?

I. The SB ruling on Question 1:

1. Broad functionality test

Under TNMM, comparability had to be judged with reference to FAR as provided in Rule 10B(2)(b) of the Income-tax Rules, 1962 (the Rules). The specific characteristics of property or services as provided in Rule 10B(2)(a) were not that relevant to judge comparability when applying TNMM. The emphasis was on functional similarity than on product similarity, and depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of comparability analysis to include uncontrolled transactions involving products that were different, but where similar functions were undertaken[1].

Therefore, when performing a comparability analysis in cases belonging to ITES sector, and in order to attain 'relatively equal degree of comparability', the first step would be to apply a broad functionality test and select potential comparables at the ITES sector level. The common thread that ran through companies engaged in ITES was that rendering of these services involved extensive use of information technology.

2. Whether further dissection, bifurcation or classification of ITES can be done?

The next issue that arose was whether further dissection or bifurcation of ITES was possible for rejecting or selecting the potential comparables.

There was no bar in the Indian TP regulations to exclude certain entities selected as potential comparables after applying broad functionality test, by further applying the functional test at narrow or micro level in order to attain 'relatively equal degree of comparability'.

In fact, Rule 10B(3) clearly provided for further exclusion of comparables selected by applying the test/criteria given in Rule 10B(2) if there was any difference found between the enterprises entering into the transactions, which materially affected the cost charged or the profit arising from such transaction in the open market.

Further, even the OECD Guidelines in paragraph 3.56 stated that in some cases, all comparable transactions examined would not have a 'relatively equal degree of comparability'. It was suggested that where it was possible to determine that some uncontrolled transactions had a 'lesser degree of comparability' than others, they should be eliminated.

In view of the above, further dissection or classification of ITES services could be done depending on facts and circumstances of each case, so as to select the entities having a 'relatively equal degree of comparability'.

'Relatively equal degree of comparability' could be achieved by comparing the functional profile (principal functions) of the tested party with that of the potential comparables which were selected based on broad functionality test. The ones with lesser degree of comparability had to be eliminated.

3. Whether further classification can be done into BPO and KPO?

Based on material[2] placed before the SB, the SB observed as follows:

[1] Reliance placed on paras 1.38, 1.40, 1.41, and 2.68 to 2.75 of OECD Transfer Pricing Guidelines (OECD Guidelines). Reliance also placed on Chapter II, Part III, Section B-2, and Sections A-1, A-2, A-5 of Chapter III, of OCED Guidelines.

[2] The SB referred to a report filed by the interveners, and prepared by National Skill Development Corporation (NSDC) on Human Resource and Skill Requirements in the IT and ITES Sector (2022). The SB also referred to an article, viz., "KPO - An Emerging Opportunity for Chartered Accountants" published in 2006 in the Journal "The Chartered Accountants". The SB noted the following from this report and article: - (i) skill sets required for BPO services were very different from KPO services (ii) Indian BPO industry was moving up the value chain through KPO service offerings (iii) While BPOs would contribute large volumes, KPOs would be a "value play" (iv) Unlike conventional BPOs, where the focus was on process expertise, the focus in KPO was on knowledge expertise (v) KPO required

- Even though there appeared to be a difference between BPO and KPO services, the line of difference was very thin.

- Although BPO services were generally referred to as low-end services while KPO services were referred to as high-end services, the range of services rendered by the ITES sector was so wide that a classification of all these services either as low-end or high-end was always not possible. Even within the KPO segment, the level of expertise and special knowledge required to undertake different services could be different.

- While KPO was termed as an upward shift of the BPO industry in the value chain, it had also been stated that the evolution of majority of Indian BPO sector has given rise to KPOs. BPO trying to upgrade to KPO is likely to render both, BPO as well as KPO services, in the process of evolution. Such entity therefore could not be considered strictly either as a BPO or KPO – it would provide mixed services, and determining exact portion of BPO and KPO services may not be possible in absence of relevant data maintained by the entity. Also, it may not be possible to create a third category which was somewhere in between BPO and KPO.

- KPO segment was referred to as a growing area, moving beyond simple voice services, suggesting thereby that only the simple voice and data services were the low-end services of BPO sector while anything beyond that was KPO services. The definition of ITES given in the safe harbour rules, on the other hand, included *inter alia* data search integration and analysis services and clinical database management services, excluding clinical trials. These services, which were beyond the simple voice and data services, were not included in the safe harbour definition of KPO services.

Accordingly, the SB concluded that keeping in view the large number of services falling under ITES; the difficulty in classifying these services either as low-end BPO services or high-end KPO services; the difficulty in creating a third category of entities falling in between BPO and KPO; and lesser degree of comparability even within BPO and KPO sector – the ITES services could not be further bifurcated or classified as BPO and KPO services for the purpose of comparability analysis. There could exist significant overlap between the ITES activities or functions with some activities/functions being very fact-sensitive. Introducing an artificial segregation within ITES may lead to creation of more problems in the comparability analysis than solving them.

4. Conclusion on Question 1 in the context of the taxpayer:

In general:

The answer to whether companies performing KPO functions should be considered as comparable to a taxpayer providing back office support services would depend on the facts and circumstances of each case. If a taxpayer was found to have provided low-end back office support services like voice or data processing services as a whole, or substantially the whole, then companies providing mainly high-end services by using their specialized knowledge and domain expertise could not be considered as comparables.

On specific comparables:

Based on a detailed examination of the functional profile of the taxpayer, only a small proportion (10%) of the services rendered by it were not in the nature of low-end services such as voice or data processing as they required some degree of special knowledge and domain expertise. Moreover, these services were only incidental to the main services rendered by the taxpayer, which could be classified as low-end back office support services. The qualifications and profile of the work force employed by the taxpayer also supported this classification.

Based on a detailed examination of the functional profile of Mold-Tek Technologies Ltd.[3] and eClerx Services Limited[4], it could be concluded that these

domain expertise and high-end qualifications (vi) KPO required moving away from the simple execution of standardized processes to the implementation of processes that demanded advanced analytical and technical skills together with some decision-making.

[3] Mold-Tek was engaged in providing engineering and design services with specialization in civil, structural and mechanical engineering.

companies were engaged in providing high-end services involving special knowledge and domain expertise, unlike the taxpayer who was essentially a low-end services provider. It would thus be difficult to attain 'relatively equal degree of comparability' between these companies and the taxpayer, and these companies should therefore be excluded from the list of comparables.

II. PwC observations on the SB ruling on Question 1:

- Based on material filed before it, the SB makes the following key observations:
  - There is only a thin line of differentiation between KPOs and BPOs
  - Since the range of ITES is so wide, classifying the services into high-end and low-end may not always be possible.
  - BPOs try and upgrade to KPOs, and in this process of evolution, one company may at one time do both KPO and BPO activities, making it difficult to identify that company as either a KPO or a BPO.

These are some of the practical challenges recognized and acknowledged by the SB, in view of which, the SB refrains from bifurcating ITES into KPOs and BPOs.

- Although the SB does not segregate between KPOs and BPOs, it nonetheless allows broadening of the scope of a comparability analysis when applying TNMM to include companies where functions undertaken are similar to the tested party even if products are different. The SB also sanctions the dissection of ITES at a narrow or micro level based on mapping of functional profile (principal functions) so as to achieve 'relatively equal degree of comparability' – uncontrolled transactions having 'lesser degree of comparability' are to be eliminated. The SB appreciates that such mapping of principal functions would be a fact-sensitive and a fact-intensive exercise. Notably, a couple of key facts considered by the SB while deciding in the context of the taxpayer were (i) whether or not the services rendered required specialized knowledge and domain expertise, and (ii) what were the qualifications and profile of the work force.

- By not setting forth any stringent criteria for segregating KPO from BPO, but yet allowing the broadening of scope of a comparability analysis and a dissection of ITES at a micro level, the SB has provided sufficient flexibility to taxpayers for selecting or rejecting comparables based on a fact-specific analysis. It is recommended that taxpayers leverage from this flexibility and make the most of it, particularly when justifying their selection or rejection of comparables in any dispute resolution forum.

Question 2:

Whether, based on the facts of the taxpayer's case, companies earning abnormally high profit margin should be included in the list of comparable cases for the purpose of determining the ALP of international transactions?

I. The SB ruling on Question 2:

After taking into consideration guidance provided in OECD Guidelines[5], precedent decisions[6], and the Indian TP Regulations, the SB concluded as follows:

- Potential comparables which satisfied comparability conditions could not be excluded merely on the ground that their profit was abnormally high. The exclusion or inclusion would depend on the facts and circumstances of each case.

- Abnormally high profit margin should trigger further investigation. Such investigation would be to ascertain reasons for unusually high profit, and to determine whether earning of high profit reflected a normal business condition

[4] Solutions offered by eClerx included data analytics, operations management, audits and reconciliation, metrics management and reporting services.

[5] As per para 2.63 of the OECD Guidelines, where one or more of potential comparables had extreme results consisting loss or unusual high profits, further examination would be needed to understand the reasons for extreme results.

[6] BP India Services Private Limited, 24/7 Customer.Com Pvt. Ltd, Trilogy E-Business Software India Ltd., and Stream International Services Pvt. Ltd.

or whether it was the result of some abnormal conditions prevailing in the relevant year.

- The profit margin earned by such an entity in the immediately preceding year/s may also be taken into consideration to find out whether the high profit margin represented the normal business trend.

- If the high profit margin did not reflect normal business conditions, the high profit margin making entity should not be included in the list of comparables.

- Other observations made by the SB in the context of Question 2:

  – When measuring central tendency or averages (as also contemplated by the Indian TP Regulations), 'arithmetic mean' had to be taken as the sum of values of all observations divided by number of observations. This was regardless of the dictionary meaning of 'arithmetic mean'.

  – Extreme values at both ends of the spectrum would not materially affect the arithmetic mean and such extreme values were taken care of when the arithmetic mean was used as a measure of central tendency.

  – In precedent decisions such as in the cases of BP India Services Private Limited, 24/7 Customer.com Pvt. Ltd, Trilogy E-Business Software India Ltd., and Stream International Services Pvt. Ltd., the Tribunal had ruled in favour of the Revenue in relation to the issue under consideration in Question 2, and in doing so the Tribunal passed well discussed and well reasoned orders after taking into consideration not only the relevant Indian TP Regulations but also the relevant OECD Guidelines.

II. PwC observations on the SB ruling on Question 2:

- The SB has rightly held that companies with abnormally high margins should trigger further investigation, i.e., reasons for abnormally high margins should be investigated. The SB has then, in all fairness, opined against selection of companies with high profit margins which do not reflect 'normal business conditions'. This principle should apply equally to taxpayers and the Revenue. Therefore, if the Revenue introduces companies with abnormally high margins, then the onus should lie with the Revenue to establish that abnormally high margins have arisen in the normal course of business, and that there is no extraordinary factor contributing to the same.

- It is worth noting that during the course of the SB proceedings, an important argument was raised by the taxpayer, which the SB, however, did not opine upon. The taxpayer referred to paragraph 55.10 of CBDT Circular No. 14[7] of 2001, wherein the purpose of arithmetic mean is explained. A reading of paragraph 55.10 clearly indicates that the expectation of the legislature is that there would not be any significant diversion between various ALPs if the different sets of comparable data are equally reliable. In essence, the legislature does not contemplate outliers in a reliable comparable set. The application of the above can be better explained by means of an example. Let's assume the comparable set to be the following:

Comparable	Comparable 1	Comparable 2	Comparable 3	Comparable 4
Margins (%)	13	9	17	56

If the SB's diktat were to be followed, then abnormal margins of comparable 4 would need to be investigated further, say by examining past profitability trends, which may reveal the following:

Comparable 4's margins (%)	Year 1	Year 2	Year 3	Year under consideration
	13	21	18	56

Going by the above trend, the margins of Comparable 4 for the year under consideration do not appear to reflect normal business conditions, and Comparable 4 may thus need to be rejected in line with the SB ruling.

[7] [252 ITR (St.) 103]

However, instead, the past profitability trends may possibly reveal the following:

Comparable 4's margins (%)	Year 1	Year 2	Year 3	Year under consideration
	54	49	58	56

If past profitability trends reveal the above, then, it may not be possible to reject Comparable 4 going by the SB's dictat, because Comparable 4's high margin in the year under consideration seems like a normal phenomenon. However, following paragraph 55.10, Comparable 4 may still be liable for rejection, as it continues to be an outlier, whereas the legislature does not contemplate outliers in a reliable comparable set.

Accordingly, the argument taken by the taxpayer around paragraph 55.10 was a very valid argument and taxpayers are advised to continue to take such an argument in assessment/ judicial proceedings.

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Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	**Bangalore** 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	**Chennai** 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006, India Phone +91 44 4228 5000	**Hyderabad** #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600	**Kolkata** 56 &57, Block DN. Ground Floor, A-Wing Sector - V, Salt Lake. Kolkata -700 091, West Bengal, India Telephone: +91-033 - 2357 9101/4400 1111 Fax: (91) 033 - 2357 2754
Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122 002 Phone: +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com	

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