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Tribunal upholds PSM over TNMM; adopts residual profit benchmarking considering each entity's contribution

Facts

- Global One[1] or the Equant Group of companies (the taxpayer) was engaged in providing services of seamless connectivity and transmission of data for their global customers.

- Since, as per the Group's management, each of the subsidiaries would participate in and contribute unique intangibles; and/ or transactions between them were so inter-related, the same could not be examined separately to determine arm's length price of any single transaction under any "one-sided" testing. The Group adopted residual Profit Split Method (PSM) as the Transfer Pricing (TP) method for all its subsidiaries situated across the world, by:

  a. first providing standard or routine returns for the routine functions performed by each subsidiary; and thereafter,

  b. splitting the overall residual profits/ losses of the Group amongst the various subsidiaries in proportion to actual costs incurred by each of the subsidiaries, after giving common weightages to the three significant intangibles or intangible-creating functions, which were owned or performed respectively, by the various subsidiaries, namely - sales and marketing operations; network assets and operations; and field operations.

Objections of Revenue Authorities and Departmental Representative before Tribunal

The Revenue Authorities had rejected the application of PSM on the following alleged grounds:

- Global One India was a mere service provider for the other foreign entities of the Group; and therefore should have been entitled to a return commensurate to that of a service provider, through the application of the transactional net margin method (TNMM).

- Further, in any event, the Indian TP regulations provided for the mandatory application of "comparable PSM", even in a case of residual PSM, meaning that the taxpayer had to demonstrate the splitting up of residual profits with reference to actual third party behaviour, absent which, PSM as a method could not be applied for any taxpayer in India.

The Revenue Authorities thus proceeded to apply TNMM in the case of Global One India, by applying certain markup on its total costs, *which resulted in creating of artificial profits & accordingly tax demands in India, when the Group as a whole, made loss at a global level for the relevant fiscal years, a part of which was attributable to Global One India under the residual PSM.*

Issue before the Tribunal

Based on the facts and circumstances of the taxpayer, whether Profit Split method was the most appropriate method?

Taxpayer’s arguments and Tribunal ruling:

- The taxpayer argued that the facts of the case clearly suggested that taxpayer contributed to and participated in unique intangibles, being the valuable network of the Global One Group; and further, the transactions between Global One India and its foreign associated enterprises (AEs) were so inter-related that the same could not be examined separately to determine arm's length price of any single transaction under any "one-sided" testing. Thus, Global One India could not be held to be a service provider for being subjected to TNMM. On the other hand, its case *per se* fell within the ambit of PSM.

- The Tribunal accepted the aforesaid factual matrix presented by the taxpayer, with the resultant corollary that the case of Global One India *per se* fell within the ambit of PSM.

- The taxpayer admitted before the Tribunal that Indian TP regulations [rule 10B(1)(d) of the IT Rules] prescribed that a taxpayer could adopt:

  a. either a contribution PSM, viz., where the entire system profits are split amongst the various AEs who are parties to the transactions in question, or

  b. a residual PSM, viz., where each of the AEs who are parties to the transactions in question are first assigned routine/ basic returns for the routine functions performed by them; and thereafter, the residual profits are split amongst the AEs

  however, in a manner that whether or not a taxpayer adopted a contribution PSM or a residual PSM, the profits, would need to be split amongst the various AEs who are parties to the transactions in question, on the basis of reliable external market data which indicated how unrelated parties would have split such profits in similar circumstances. In other words, as per the plain reading of rule 10B(1)(d) of the IT Rules, a contribution or residual PSM would need to be supplemented by a comparable PSM.

- PSM prescribed by the IT Rules of India was quite unique, as compared to both OECD and UN TP guidelines, in that both OECD and UN provided flexibility to the taxpayer to adopt any of the following sub-methods under the overall PSM, namely - (a) contribution PSM, (b) residual PSM or (c) comparable PSM, whereas the Indian IT Rules mandatorily required a taxpayer to adopt a comparable PSM to supplement either a contribution or residual PSM.

- Such prescription by the Indian TP regulations to mandatorily use comparable PSM to split entrepreneurial profits, actually would make the PSM virtually redundant in most cases, since, it was not possible to obtain reliable market data on third party behaviour in the matter of splitting profits, except in some rare cases of joint venture arrangements. However, in cases of transactions involving either contribution or exploitation of intangibles by all the parties to the transaction, or where such transactions are extremely inter-related, of the types as in the case of Global One Group, where knowledge of third party behaviour is impossible to possess, but where the case otherwise deserves the treatment of PSM, then the prescription to mandatorily use a comparable PSM would render the whole machinery of PSM under the Indian TP regulations a nullity; and impossible to be implemented.

- Therefore, the taxpayer argued that where a case deserved to be otherwise covered by either a contribution PSM or residual PSM, then it should not be denied such methodology merely due to the fact that the Indian TP regulations provided for the mandatory usage of comparable PSM as a supplement to contribution PSM or residual PSM. This is because impossibility of performance provided under a statute had to be dispensed with; and a purposive interpretation, which would give "life & force" to the statute without changing its basis fabric, should be adopted. Therefore, in deserving cases, as in the case of Global One India, a residual PSM had to be applied, without

resorting to comparable PSM.

- The Tribunal accepted the above arguments relating to applicability of residual PSM as above.
- The Tribunal also accepted the taxpayer's following alternative arguments in respect of the "other method" as introduced by CBDT with effect from 1st April 2012:

  a. the sixth or "other method", as introduced by the CBDT with effect from 1st April, 2012, i.e. on and from the assessment year 2012-13 through insertion of rule 10AB, read with clause (f) of rule 10B(1) of the IT Rules, was an omnibus or residual one, in the sense that it referred to any method, which took into account the price charged or paid or which would have been charged or paid for similar uncontrolled transactions with or between non-AEs, under similar circumstances. This method, was meant to remove lacuna & hardship latent in the existing IT Act and Rules, where the definitions accorded to the existing five methods, as contained in clauses (a) to (e) of rule 10B(1) of the IT Rules, would not have catered to any and every situation of computing the arm's length price. The Indian Revenue and judicial authorities would have needed to make alterations to the definitions of any of the existing methods to fit in any other plausible and robust method for determination of arm's length price, within the overall texture or scheme of the TP regulations of India.

  b. the insertion of the "other method" by the Indian Government, in exercise of the delegated authority granted by the IT Act, was a curative measure to remove unintended lacuna or hardship existing in the IT Rules. As per rulings of the Supreme Court, a curative amendment had to be given retrospective operation, though might have been inserted in the statute book with prospective effect.

  c. though the "other Method" was introduced with effect from 1st April, 2012 through the insertion of rule 10AB, read with clause (f) of rule 10B(1) of the IT Rules, given its curative nature, as discussed above, the same needed to be held to have retrospective effect, i.e to be operative since the inception of the TP regulations of India, thus covering the assessment years involved in the case of Global One India, namely assessment years 2007-08 & 2008-09.

  d. Thus, in view of the fact that the insertion of the "other method" might need to be construed with retrospective effect from assessment year 2002-03, given its curative nature, the case of Global One India would in any event, be covered by such "other method" and accepted even for the assessment years under consideration, namely assessment years 2007-08 & 2008-09.

PwC observations

This is a landmark ruling by the Tribunal wherein the application of PSM has been dealt with great maturity. The Tribunal not only accepted the purposive interpretation for a meaningful application of Residual Profit Split Method, but also accepted the appellant's alternative argument that if the PSM, as applied by the appellant, did not fall within the strict definition of PSM provided in Rule 10B(1)(d), then the same could be considered as the "other method" (sixth method), as provided in Rule 10AB of the Income-Tax Rules, and be applied retrospectively as the insertion of the sixth method could be considered as curative in nature.

1. Global One India Private Limited *v.* ACIT [TS-115-ITAT-2014(Del)]

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