Use of Berry ratio as PLI upheld

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In brief

In a recent ruling, the Delhi Bench of the Income-tax Appellate Tribunal (Tribunal), placing extensive reliance on the ruling made by the same bench in the case of Mitsubishi Corporation India Private Limited (Mitsubishi)[3], has:

- Upheld the use of the 'Berry ratio' as profit level indicator (PLI).
- Rejected the transfer pricing officer's (TPO's) re-characterisation of the taxpayer's service activity to a trading activity.
- Rejected the TPO's contentions pertaining to attribution of additional returns on account of location savings and certain supply chain and human intangibles owned/ developed by the taxpayer.

In detail

Background

The business of the taxpayer[1], an Indian subsidiary of a Japanese general trading company (Sogo Shosha[2]) dealing in steel, comprised of:

i. Provision of support services – entailing the taxpayer rendering facilitation and liaising services to its group companies for purchase/ sale of goods from/ into India; and

ii. Trading – purchase of steel products (on the basis of confirmed orders) from group companies for re-sale in India.

In the transfer pricing (TP) documentation maintained by the taxpayer, the taxpayer selected and applied the transactional net margin method (TNMM) as the most appropriate method using operating profit/ value added expenses (OP/ VAE) and OP/ Sales as the PLI in respect of the provision of support services and the trading segment respectively.

During the TP assessment, the international transactions pertaining to the trading segment were accepted to be at arm's length. However, in case of provision of support services segment, the TPO re-characterised the service activity as a trading activity, included the value of the goods on which the taxpayer had earned service income in the cost base, applied OP/ total operating costs as the PLI, and re-computed the arm's length price for the said segment, thereby making a TP adjustment.

TPO's key contentions

The key contentions made by the TPO for making the TP adjustments were as follows:

i. Rule 10B(1)(e)(i) did not prescribe the use of value added costs/ value added expenses as a cost base for computing the net profit margins, and accordingly the taxpayer's claim for use of Berry ratio was not acceptable, being contrary to Rule 10B(1)(e) of the Income-tax Rules, 1962 (the Rules).

ii. The commission business of the taxpayer was equivalent to the trading business.

iii. The existing cost plus model of the taxpayer did not compensate the taxpayer for the unique intangibles developed by the taxpayer, like supply chain management and human assets intangibles.

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[1] ITA No. 761/DEL/2015
[2] Sogo Shosha companies are general trading companies, which deal in diverse range of products, linking the buyers and sellers and performing the role of trade intermediaries

iv. The compensation model did not remunerate the taxpayer for location savings.

Aggrieved by the TPO's order, the taxpayer filed its objections with Dispute Resolution Panel (DRP). The DRP issued directions, in principle, upholding the TPO's order, but directing the TPO to include correct Free on Board (FOB) value of goods for the purpose of computing adjustment for the international transactions. Aggrieved by the DRP's directions, the taxpayer preferred an appeal before the Tribunal.

Issues before the Tribunal

The following were the key issues for adjudication before the Tribunal:

- Was the use of the 'Berry ratio' allowed under the Indian TP regulations?
- Was re-characterisation of the taxpayer's service activity to that of a trading activity valid?
- Had the taxpayer developed/ did it own unique intangibles in the nature of supply chain management and human assets?
- Did any location savings accrue to the taxpayer?

Tribunal ruling

Permissibility of the 'Berry ratio'

The Tribunal, placing reliance on the ruling of the same bench in the case of Mitsubishi[3], upheld the use of 'Berry ratio' as a PLI.

In the case of Mitsubishi[3], the Tribunal had made the following observations:

- With respect to the contention of the revenue that use of 'Berry ratio' was not permitted under Rule 10B(1)(e)(i) of the Rules, the Tribunal ruled that the PLI computation methodology set out in the said Rule was illustrative and not exhaustive and it ended with the phrase, 'or having regard to any other relevant base'. In a situation like the taxpayer's, where the significant functions and risks pertaining to inventories were not undertaken, the cost of inventory became irrelevant, and only the value added expenses needed to be considered in the cost base for computing the PLI.
- With respect to the contention of the revenue that the differences in cost classifications precluded the application of the Berry ratio, the Tribunal rejected the TPO's contention by relying upon the co-ordinate bench ruling made in the case of GAP International Sourcing India Private Limited[4], further adding that the TPO had not brought forward any specific issues as regards cost classifications which could hamper the appropriateness of selecting the Berry Ratio as the PLI.
- With respect to the revenue's contention that the taxpayer had high levels of current assets, the Tribunal, while agreeing with the principle that the 'Berry ratio' could only be used in a situation where the current assets were not significant, ruled that in the taxpayer's case, the TPO had not been able to demonstrate that the taxpayer had significant current assets.

Our observation:

The acceptance of 'Berry ratio' as a PLI is indeed a welcome step, in keeping with TP fundamentals that the arm's length remuneration should be consistent with the functions performed, risks assumed and assets employed. This reinforces the approach of the taxpayers to use Berry ratio for determining the arm's length remuneration for distributors and agents undertaking limited functions and bearing limited risks in connection with inventory handled.

Re-characterisation of services activity to trading activity

The Tribunal, relying on the Delhi High Court (HC) (the jurisdictional HC)) ruling in the case of Li & Fung India Private Limited[5] and of the same bench of the Tribunal in the Mitsubishi case[3], rejected the re-characterisation of the taxpayer's services activity to that of a trading activity.

The Delhi HC, in the case of Li & Fung[5], had held the following:

- Under the Indian TP regulations, for application of the TNMM, the net margin realised from international transactions had to be calculated only with reference to the cost incurred by the taxpayer, and not that incurred by any other related or third party.
- Rule 10B(1)(e) of the Rules did not enable consideration or imputation of cost incurred by third parties or unrelated enterprises to compute the taxpayer's net profit margin for application of the TNMM.
- It was not open to the revenue authorities to reconstruct the taxpayer's financial statements by including the cost of products incurred by the associated enterprise (AE), in respect of which services are rendered, in its reconstructed financial statements, and then computing hypothetical trading profit.

[3] ITA No. 5042/Del/11

[4] GAP International Sourcing India Private Limited *v.* ACIT [20 ITR (Trib) 779]

[5] Li & Fung India Private Limited *v.* CIT [2014] 361 ITR 85 (Delhi)

Our observation:

While adjudicating this issue, the Tribunal has relied on the principle laid down by the jurisdictional HC. In this case, the taxpayer, in its contentions before the Tribunal, had painstakingly brought out the differences in the functional profile of a service provider *vis-à-vis* a distributor, on account of which the TPO's re-characterisation was held fallacious. While the Tribunal had not discussed this aspect of the case while adjudicating the matter, we would like to reinforce the fact that the characterisation of a taxpayer would follow its functional profile. Hence, it was not correct to re-characterise the service provider as a distributor without taking cognizance of the difference in the functional profile of the two i.e. the service provider and the distributor.

Existence of intangibles in the nature of supply chain and human assets

The Tribunal, relying upon the same bench's ruling in case of Mitsubishi[3], rejected the TPO's contentions that the taxpayer owned supply chain management intangibles and human assets by observing that the use of intangibles could not be inferred or assumed. Rather, the same needed to be demonstrated on the basis of cogent materials. In the instant case, the TPO could not substantiate that the taxpayer's activity had resulted in development or use of unique intangibles which had an impact on determination of the arm's length price.

In the Mitsubishi case[3], the same bench of the Tribunal had held that:

- Any comparable involved in a similar activity would essentially use similar intangibles, and accordingly, an adjustment could not be made in case of routine intangibles.
- While a trained workforce was, indeed, an intangible asset, the same was a routine intangible inasmuch as anyone pursuing a business activity would develop a trained workforce for carrying out the activity.
- For an intangible to have an impact on determination of the arm's length price, not only should the intangible exist, but it should also be a unique intangible which provided an edge to the business in which the same was used.

Our observations:

The Tribunal has laid down a great principle on the aspect of intangibles having an impact on determination of arm's length price. It is very well said that it is only the non-routine or unique intangible which has an impact on the determination of arm's length price. Routine intangibles are such as are used even by comparables, and the return attributable to the same is embedded in the profit margin reflected by such comparables. This does not call for additional return. It is only in case of unique intangibles, that one needs to ascertain the additional return attributable to such unique intangibles. Thus, unless it is demonstrated based on facts that the taxpayer is using non-routine intangibles, an automatic claim for additional returns attributable to such intangibles cannot be made.

Location savings

On this issue too, the Tribunal relied on the Mitsubishi India decision[3] and concurred with its view that the adjustment pertaining to locational savings was unwarranted.

In Mitsubishi India's case[3], the same bench of the Tribunal, while agreeing to the four steps process advocated under the OECD report titled 'Guidance on Transfer Pricing Aspects of Intangibles', observed that:

- The TPO had neither followed the same, nor had he demonstrated any concrete findings as regards existence of any location savings.
- In a '*Sogo Shosha*[2]' business model, where the service provider only acted as a facilitator, there may, in fact, be no location savings for the service provider. In case of procurement of goods, location savings, even if any, would arise to the AEs actually buying the goods, and not to the taxpayer assisting such buying by way of acting as an intermediary. Further, these savings may be eventually derived by the ultimate customer.

Our observation:

The Tribunal rejected the contention of location savings on the basis that the TPO could not substantiate this with facts. However, the Tribunal did not discuss and give its finding on the aspect that as long as the comparables are also operating in similar conditions, there could not be any additional return attributable to location savings. The comparables would also have been benefitted by location savings in a similar manner and hence, the return earned by comparables would include the return for location savings, thereby resulting in no further attribution of return towards location savings. Taxpayers could also rely on this economic argument to defend the issue of location savings.

The takeaways

That the Tribunal has reiterated the principles emerging out of the Mitsubishi ruling[3] as regards usage of the 'Berry ratio' as a PLI, is welcome. This reinforces the fundamental TP principle that the arm's length return should be commensurate with functions performed, assets employed and risks assumed by the taxpayer. Thus, in case of distributors and agents undertaking limited functions and bearing no significant risks with respect to inventory and not deploying any unique intangibles, the use of Berry ratio could be an appropriate PLI for determining the arm's length remuneration. Internationally, Berry ratio is used quite frequently, especially for determining the remuneration for distribution function. The acceptance of this PLI by the Indian judiciary would give a fillip to use of this PLI by Indian taxpayers.

Having said that, while using 'Berry ratio, one needs to lay great emphasis on the functional similarity of the comparables identified *vis-à-vis* the tested party, identifying comparables not deploying or developing any unique intangibles, similarity in the cost classifications since any variation in the same could distort the comparability, etc. This calls for a detailed and an exhaustive comparability analysis.

Notwithstanding the above, this ruling, however, lays down an important judicial precedent, that the 'Berry ratio' can be used as a PLI in appropriate cases.

Let's talk

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

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