News Alert*

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- Arm's length price determined by assessee based on a transfer pricing study shifts the burden of proof on to the Revenue
- Rejection of the transfer pricing study by the Revenue should be based on cogent reasons

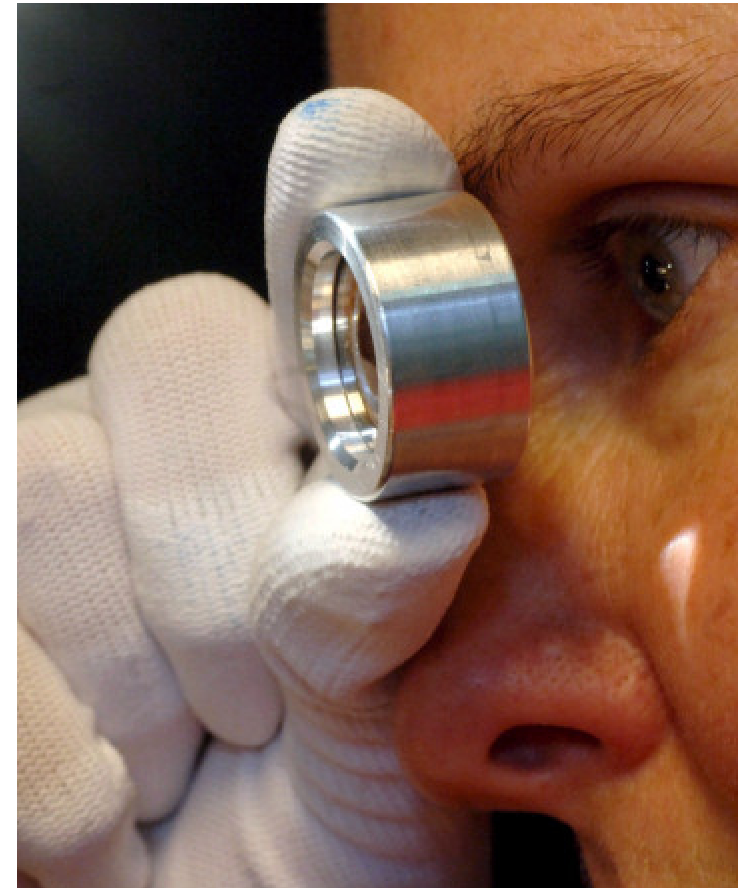
Background

The Mumbai Bench of the Income-tax Appellate Tribunal ("the Tribunal") in its ruling in the case of Indo American Jewellery Pvt. Ltd.[1] ("the assessee") has concluded that the arm's length price ("ALP") determined by the assessee on the basis of a transfer pricing study cannot be rejected by the Revenue in the absence of any cogent reasons. In addition, the Tribunal held that for the purpose of determining the arm's length price, comparable companies should be selected based on the business profile of the assessee. As a result, any differences in turnover, availability of tax incentives, etc. should be considered in the selecting comparable companies. The Tribunal also commented that where there was no motive for the assessee to shift profits to high tax regions, this would also substantiate the arm's length nature of the assessee's international transactions with its affiliates.

Facts

The assessee, an Indian company is engaged in the business of manufacturing and export of plain and studded jewellery. The company's products were mainly exported to the US and the UK. During the relevant assessment year, the assessee entered into international transactions involving export of manufactured products to its associated enterprises ("AEs").

On a reference made to the Transfer Pricing Officer ('TPO'), the assessee justified the arm's length nature of the international transaction by applying the Transactional Net Margin Method ('TNMM'). Based on application of TNMM and benchmarking analysis using external comparables, the assessee stated that its operating margin of 3.56% on sales and 3.70% on cost was higher than the operating margin earned by comparable companies of 3.27% on sales and 3.83% on cost. In addition, the assessee used an internal TNMM approach and submitted that the operating margin of 5.38% earned on sales to its associated enterprises was higher than the margin of 1.77% earned by the assessee from sales made to third parties. On the basis of this two-pronged approach, the assessee justified that the international transaction with the associated enterprises were made at arm's length.



[1] DCIT *v.* Indo American Jewellery Pvt. Ltd. [ITA No. 6194 / Mum / 2008] dated : 31 May, 2010; Source: itatonline.org

The Transfer Pricing Officer ('TPO') rejected the internal TNMM approach on the ground that the turnover allocation key used by the assessee for allocation of expenses between sales made to AEs and third parties was not appropriate. As a result, the TPO considered the entity level profitability of the assessee for the purpose of benchmarking the operating results and conducted a fresh search to identify comparable companies in order to arrive at the ALP.

The assessee contested the set of comparables identified by the TPO on the ground that the turnover of some of the companies identified by the TPO was either significantly higher or lower than that of the assessee. Further, out of 18 comparable companies selected by the TPO, 13 companies were either located in Santacruz Electronics Export Processing Zone ("SEEPZ") or had their jewellery manufacturing activity carried out in this area as a result of which they were eligible to tax incentives. The assessee submitted that the availability of tax incentives may have been the reason for higher profit margins earned by some of these companies selected by the TPO.

Based on the results of comparable companies, the TPO computed the arm's length operating mark-up on cost as 7.25% which was higher than that earned by the assessee during the year and therefore proposed a transfer pricing adjustment. Based on the order of the TPO, the Assessing Officer ("AO") gave effect to the adjustment. The assessee brought an appeal to the Commissioner of Income Tax (Appeals) ("CIT(A)") against the TPO's order.

Before the CIT(A)

The assessee submitted before the CIT(A) that it had followed the approach as prescribed under the Indian transfer pricing law and the OECD guidelines in order to arrive at the arm's length price. Therefore, the approach adopted by the TPO in selecting a new set of companies and rejecting the comparable companies selected by the assessee without any cogent reasons went against the principles of natural justice. The assessee contested that the TPO had not considered the FAR (functions performed, assets employed and risk assumed) analysis of companies before accepting them as comparables. Moreover, where there was evidence in support of the arm's length nature of the transfer price, the burden of proof would shift to the Revenue to establish that the assessee's transfer pricing was not arm's length.

Ruling by the CIT(A)

The CIT(A) accepted the assessee's contentions and observed that where the assessee has discharged the burden of proof by filing a detailed transfer pricing study, the Revenue should make a proper study and analysis before concluding on the arm's length nature of the transfer price. In the instant case, the TPO did not reject the transfer pricing study of the assessee and had still gone ahead with making transfer pricing adjustments in a summary manner.

The CIT(A) also questioned the approach adopted by the TPO in selecting companies as comparables and accepted the transfer pricing study prepared by the assessee in support of the arm's length nature of the international transactions. The transfer pricing adjustment made by the TPO was consequently quashed. Aggrieved by the order, the Revenue appealed to the Tribunal.

Before the Tribunal

The Revenue relied on the order of the AO and argued that the internal TNMM approach adopted by the assessee was flawed as it was based on application of the turnover allocation key that was not correct.

The assessee, in addition to the arguments brought before the CIT(A) emphasised the fact that the transfer pricing methodology adopted by them was consistent with that suggested in the OECD Transfer Pricing Guidelines. The assessee also submitted that the assessee enjoyed a tax benefit under section 80HHC of the Indian Income- tax Act, 1961 and since the AEs to whom the products were exported, were mainly based in USA where the tax rates are higher compared to that in India, there was therefore no motive or incentive to transfer profits to higher chargeable tax regions. Moreover, the AEs had earned meager profit or incurred losses as compared to the profits earned by the assessee.

Tribunal ruling

The Tribunal agreed with the assessee's contentions and upheld the order of the CIT(A), for the same reasons as stated by the CIT(A). In doing so, the Tribunal mentioned that it would be unfair to reject the transfer pricing analysis done by the assessee as long as

proper method is followed, comparables are chosen and selected after doing a proper FAR analysis and necessary adjustments for differences in comparability have been made to the extent possible. The burden of proof therefore rested with the Revenue and in the absence of the Revenue making out a case to establish that the comparable companies used by the assessee deserved to be rejected, the transfer pricing study of the assessee cannot be disregarded without any cogent reasons.

Conclusion

This ruling has followed the principles established in the case of MSS India Pvt Ltd and Mentor Graphics Pvt. Ltd. in as much as where the assessee has demonstrated compliance with the transfer pricing law, such an effort cannot be discarded unless the Revenue is able to point out fallacies in the approach.

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