Sharing of net revenues consistently in controlled and uncontrolled transactions held as a valid comparable uncontrolled price

**In brief**

In a recent ruling in the case of Agility Logistics Pvt. Ltd.¹ (the taxpayer), the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) has held that the sharing of net revenues (i.e., amounts billed to customers less third party costs) in a 50:50 ratio between the origin and destination companies in a consistent manner in controlled as well as uncontrolled transactions, constitutes a comparable uncontrolled price (CUP). In coming to its conclusion, the Tribunal took into account the fact that the 50:50 model is a common industry practice.

**Facts**

The taxpayer is a logistics service provider, offering a comprehensive portfolio of international, domestic and specialised freight handling services.

For the freight forwarding transactions, the taxpayer adopted a policy of sharing net revenues (i.e. amounts billed to the customers less third party costs) between

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¹ Agility Logistics Pvt. Ltd. [ITA No. 2000/Mum/2010, ITA No. 6004/Mum/2010 and ITA No. 8146/Mum/2010]
the origin and the destination companies in a 50:50 ratio. Since the policy was being consistently applied in controlled and uncontrolled transactions, the taxpayer adopted the CUP method to determine the arm’s-length price of the net revenue share payments to and receipts from associated enterprises (AE).

Further, the taxpayer undertook a corroborative analysis using the transactional net margin method (TNMM), wherein the margin earned by the taxpayer was compared with the arithmetic mean margin of a set of comparable companies in the logistics industry. In this regard, the taxpayer considered payments made to third parties (e.g., freight paid to airlines, ocean lines etc) as ‘pass through’ costs and used the ratio of operating profit to value-added expenses (OP/VAE) as the profit level indicator (PLI).

During the assessment proceedings, the transfer pricing officer (TPO) rejected the CUP method by stating that the application of the 50:50 model between origin and destination companies in different geographical locations would not provide a realistic measure owing to differences in economic conditions and policies of the governments, which would affect costs and profitability. He also contended that the agreements between the related and unrelated parties were entered into on a profit split basis, and not on the basis of a rate.

Further, the TPO rejected the use of OP/VAE as the PLI on the ground that such a calculation gives a distorted view of the taxpayer’s margins. Instead, he used the ratio of operating profit to total cost (OP/TC) as the PLI to benchmark the transactions.

For assessment year (AY) 2004-05, the TPO rejected certain comparables selected by the taxpayer and instead used private limited companies (for which data was not available in the public domain) as comparable companies. On this basis, the TPO made adjustments to the value of the international transactions of the taxpayer.

**Proceedings before the Commissioner of Income-tax (Appeals)**

Aggrieved by the order of the TPO for AY 2004-05 and 2005-06, the taxpayer preferred an appeal before the Commissioner of Income-tax (Appeals) (CIT(A)). For AY 2006-07, the taxpayer disputed the adjustment before the Dispute Resolution Panel (DRP).

**Taxpayer’s arguments on the comparable uncontrolled price method**

- The taxpayer contended that the mechanism of splitting net revenues in a 50:50 ratio was followed consistently in transactions with related as well as unrelated parties.
- It was emphasised that even in India’s neighbouring countries where the economic conditions are similar to those in India, the contractual terms agreed between AEs and third parties were the same.
- The functions performed by both the origin and destination countries were similar (i.e., coordination with third party service providers), and the risks assumed and assets employed were also comparable. Accordingly, the taxpayer contended that the sharing of net revenues in a 50:50 ratio was appropriate.
- The sharing of net revenues in a 50:50 ratio was a norm usually adopted by the players in the logistics industry.
The taxpayer relied upon Organisation for Economic Co-operation and Development (OECD) guidelines\(^2\) to contend that the CUP method is the most reliable and direct way to test the arm’s length price.

**Taxpayer’s arguments on the use of operating profit to value-added expenses as the profit level indicator**

- The taxpayer submitted that it acts as an intermediary while undertaking freight forwarding functions. Therefore, its operational efficiency is best measured by evaluating whether the gross margin earned is adequate to cover the costs associated with its own functions, and not those of third parties (such as airlines).

- Referring to the OECD guidelines, the taxpayer contended that agency service providers need not apply a mark-up on ‘pass through’ expenses. It was submitted that a qualitative analysis of costs by differentiating between ‘pass through costs’ and ‘agency costs’ is essential to reach correct transfer pricing conclusions.

- Additionally, the taxpayer submitted that in the preceding years i.e., AY 2002-03 and 2003-04, the TPO had accepted the CUP method and the corroborative TNMM analysis undertaken by the taxpayer. It was submitted that since the pricing arrangements had remained unchanged, the TPO should not have deviated from his earlier stand.

Based on the above arguments, the CIT(A) in AY 2004-05 and 2005-06 upheld the use of the CUP method supported by third party agreements and deleted the adjustment made by the TPO. Since the CUP method was upheld, the CIT(A) did not adjudicate on the appropriateness of the use of OP/VAE as the PLI.

For AY 2006-07, the DRP upheld the actions of the TPO.

Being aggrieved by the orders of the CIT(A) in AY 2004-05 and 2005-06, the revenue preferred an appeal before the Tribunal. For AY 2006-07, the taxpayer preferred an appeal before the Tribunal against the assessment order passed by the assessing officer pursuant to the DRP’s directions.

**Revenue’s contentions**

Before the Tribunal, the Revenue contended that:

- The taxpayer had followed the ‘Profit Split Method’ and not the CUP method. The Revenue argued that the ‘CUP’ method is a traditional transaction method which compares ‘prices’ charged for property or services of the controlled and uncontrolled transactions, whereas the ‘profit split’ is a ‘transactional profit method’ which identifies the ‘profit’ to be split between the associated enterprises in the controlled transactions.

- The functions performed by the taxpayer and its AEs in all the transactions were not identical.

- Differences in geography and size of country, variation in assets employed and risk involved are to be considered in assessing the comparability of transactions. Thus, a thumb rule analysis of equally distributing the profit and loss cannot be accepted as an appropriate method.

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\(^2\) Transfer pricing guidelines for multinational enterprises and the tax administrations issued by the Organization for economic cooperation and development
• The computation of the taxpayer’s profitability using OP/VAE is based on net figures of the profit and loss account and gives a distorted view of the taxpayer's margin.

• On the use of data not available in public domain for benchmarking, the Revenue argued that the Indian transfer pricing regulations do not specifically restrict such a usage.

**Taxpayer’s contentions**

**Use of CUP method**

Before the Tribunal, the taxpayer contended that:

• It does not split the gross profit, but rather splits the net revenue (i.e., the difference between the total freight charges collected from customers less payments made to third party service providers) in 50:50 ratio with its AE.

• ‘Net revenue split’ is a mechanism (pricing arrangement) used to derive the remuneration due to each freight provider entity (i.e., the taxpayer or its AE) for the respective functions carried out by them in the origin and destination country.

• The practice of sharing net revenues in a 50:50 ratio is consistently applied not only in transactions with AEs, but also with non-AEs.

• The practice of sharing net revenues is a practice widely followed by players in the logistics industry and supported this contention by furnishing data available in the public domain.

• ‘Rate’ as against ‘price’ is used in several cases (such as payment of interest / royalty) as a CUP to justify the arm’s length nature of the transactions.

**Use of OP/VAE as PLI**

• The taxpayer contended that while providing logistics services, as a standard business practice, the taxpayer always acts as an intermediary. The taxpayer demonstrated its role as an intermediary through documentary evidence in the form of bills of lading, international air transport association agreement etc.

• It was further submitted that the taxpayer does not own any transportation assets like trucks, ships or other transportation equipment and that it only owned office infrastructure such as office and computers, etc.

• Further, the taxpayer contended that it assumed very minimal risks (such as bad debts and inventory risks) while undertaking its business as a logistics service provider.

• For AY 2004-05, the taxpayer contended that private companies for which data is not available in the public domain should not be used as comparable companies.

**Tribunal Ruling**

After considering the rival contentions, the Tribunal ruled as under:

**CUP method**

• CUP method was regularly adopted by the taxpayer.
• The terms and conditions in the agreements between AEs and third parties were substantially the same and the profit split information contained in all the agreements is typical to the industry.

• Geographical differences are not material so far as it applies to the logistics industry.

Accordingly, the Tribunal confirmed the order of the CIT(A) and upheld the use of the CUP method to benchmark international transactions of the taxpayer for AY 2004-05 and 2005-06.

Use of OP/VAE as PLI

While the Tribunal did not adjudicate on the use of OP/VAE as the PLI, it:

• Upheld the contention of taxpayer that both the origin company and the destination company assume comparable risks.

• Relied upon the OECD guidelines and various documents/submissions and acknowledged that in both air and ocean business, the taxpayer merely acts as an intermediary.

• Found merit in the contentions of the taxpayer that unless the freight amounts paid to the third parties excluded, it will represent a skewed analysis.

• Found merit in the submissions of the taxpayer that private companies for whom data is not available in the public domain should not be used as comparables.

Thus, the Tribunal dismissed the appeal filed by the revenue for AY 2004-05 and 2005-06 and upheld the use of the CUP method for benchmarking the international transaction of net revenue share relating to freight receipts and payments.

For AY 2006-07, since the DRP had not passed a speaking order, the matter was set aside to files of DRP for fresh adjudication.

Conclusion

The ruling highlights the recognition of industry practices while determining the arm’s length nature of international transactions and highlights the wider ambit of CUP to include even ‘pricing mechanisms’. The key takeaways of the ruling are:

• Understanding of the industry and explaining the industry dynamics is of utmost importance;

• The conduct of parties needs to be supported adequately by the underlying documents;

• The term ‘price’ for the CUP method can be interpreted to include ‘pricing basis’ also;

• Private companies for which data is not available in the public domain should ideally not be used for the purpose of benchmarking; and

• The ruling once again reiterates the recognition of the principles laid down in the OECD guidelines by Indian tax dispute resolution forums.
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