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CUP upheld to be the most appropriate method for benchmarking broking transactions; arithmetic mean and not weighted average to be considered for determining ALP; adjustments for differences in volume and functions need to be considered

In a recent ruling, the Mumbai bench of Income-tax Appellant Tribunal (Tribunal) in the case of RBS Equities (India) Ltd. (the assessee)¹ has held that comparable uncontrolled price (CUP) method is the most appropriate method (MAM) for determining the arm's length price (ALP) for the broking transaction. The Tribunal restored the case to the assessing officer (AO) with directions to consider adjustment for marketing function, research function and differences in volumes after verifying the supporting documentary evidence to be furnished by the assessee.

Facts

- The assessee is engaged in the business of broking and trading in shares as a corporate member of Bombay Stock Exchange and National Stock Exchange. The assessee had provided stock broking services to its associated enterprise (AE) ABN Ambro Asia (Mauritius) Ltd., a Foreign Institutional Investor (FII). The AE had not transacted with any other broker in India.
- In the transfer pricing (TP) documentation, the assessee had used the transactional net margin method (TNMM) as the MAM to benchmark the said transaction.

¹RBS Equities (India) Ltd. (Formerly known as ABN AMRO Asia Equities (India) Ltd. v. ACIT [I.T.A. No. 3077/Mum/2009] for AY 2003-04 and [I.T.A. No. 1236/Mum/2010] for AY 2005-06

- During the course of the assessment proceedings, the transfer pricing officer (‘TPO’) held CUP as the MAM to benchmark the said transaction and made an adjustment by using the simple average broking commission rate charged to top 10 FIIs of 0.408% as against the weighted average commission rate of 0.24% charged to the AE.
- The assessee contended that if CUP was to be used as the MAM, then appropriate adjustments should be made for the following material differences:
 - differences in volume: AE trades constitutes 42.7 % of the total trades of the assessee
 - marketing function: performed only for third party customers
 - research function: performed only for third party customers
- On appeal, the order of the transfer pricing officer (TPO) was upheld by the Commissioner of Income-tax (Appeals) (CIT(A)). Aggrieved, the assessee preferred an appeal with the Tribunal.

The Tribunal’s verdict on the various contentions of the assessee has been tabulated below:

| Issue | Decision of TPO/AO/CIT(A) | Assessee's contentions | Decision of the Tribunal |
|---|--|--|--|
| TNMM v. CUP as the MAM | Upheld CUP as MAM; internal comparables preferred over external based on the facts and circumstances of the case | <ul style="list-style-type: none"> • TNMM was used as the MAM in the TP Study and TPO was not justified in adopting CUP. • Even if CUP was to be considered then adjustment for differences on account of volume, marketing cost and research should be allowed. | <ul style="list-style-type: none"> • Use of CUP is upheld as internal CUP is available. (CUP being the direct and traditional method) • CUP is the MAM given that there are no material differences between the AE and other FIIs i.e. they operate from similar geographical regions without being present in India and their perception of the India market in terms of risks and rewards would be the same. |
| Simple average v. Weighted average | Simple average of Top 10 FIIs was adopted for computing the mean commission rate | <ul style="list-style-type: none"> • Weighted average should be considered to make a fair comparison. | <ul style="list-style-type: none"> • Upheld the view of TPO/CIT(A). The Tribunal explained that there is no provision in the statute which allows use of weighted average (first proviso to section 92C of the Income-tax Act, 1961 (the Act) contemplates the use of arithmetic mean of more than one ALPs as against weighted average) |

| Issue | Decision of TPO/AO/CIT(A) | Assessee's contentions | Decision of the Tribunal |
|---|--|--|--|
| FII clients only v. All clients (FII+ Indian Financial Institutions) | Brokerage rate charged to Top 10 FII clients was considered | <ul style="list-style-type: none"> • Functions performed and risks assumed by the assessee for providing services to all clients are same. • Rate does not differ on account of classification of customer; other factors like volume, client relationship, expected future business, negotiation power, etc. affect pricing | <ul style="list-style-type: none"> • Upheld the view of TPO/CIT(A). • The CIT(A) held that the TPO had maintained high standard of comparability by taking into consideration the Top 10 FIIs which were similarly placed as the AE |
| Adjustment for Volume | Rejected the claim of the assessee | <ul style="list-style-type: none"> • 42.7% of the total trades have been executed for the AE and thus adjustment for volume should be granted. | <ul style="list-style-type: none"> • The department representative (DR) argued that no volume adjustment need to be allowed since the volume of Top 10 FIIs has been considered which is close to the volume of transactions of the assessee with its AE. |
| Adjustment for Marketing and sales efforts | TPO granted part relief. CIT(A) upheld the stand of the TPO by stating that no evidence or material was provided by the assessee to support this argument. | <ul style="list-style-type: none"> • Marketing cost comprises of salary and related cost of two employees whose role was restricted only to interacting and maintaining relationship with third party clients. Accordingly, this adjustment should be allowed if CUP is used as the MAM. | <ul style="list-style-type: none"> • The Tribunal restored the case to the AO to consider the assessee's claim of adjustment for differences (on account of marketing function, research function and differences in volume) after verifying the details and documentary evidence. The Tribunal however agreed in principle that if CUP is used as the MAM, then adjustments for these differences should be allowed. |
| Adjustment for research | Rejected the claim of the assessee stating that the claim is based merely on assumptions and there was no basis to justify the same. | <ul style="list-style-type: none"> • The assessee undertakes research in providing services to third party clients and thus these costs should be allowed as an adjustment, if CUP is used as the MAM. | |

PwC observations

The broking industry players have seen significant TP adjustments over the years. This being the first ruling in this industry would be referred to for guidance, going forward. However, it will be critical for taxpayers to cautiously apply the learnings of this case in light of their specific facts and circumstances.

While considering the ruling in the present case, it is relevant to take cognizance of the following:

CUP v. TNMM

- Given that the pricing of broking transactions is influenced by various qualitative and quantitative factors like volume, client relationship, expected future business, negotiation power of the client, credit standing of the client, etc., using CUP as the MAM requires a closer introspection in terms of
 - the degree of comparability between transactions with AE *vis-a-vis* third party clients, and,
 - the possibility of making reliable adjustments to account for the various differences described above.
- It is primarily for the aforesaid reasons and the fact that a net/operating level analysis is less affected by transactional differences, that the taxpayers have resorted to TNMM while preparing their TP documentation. The Tribunal has not deliberated on this aspect in detail before concluding on the use of CUP, the reliability of which is greatly affected by the degree of accuracy with which the adjustments can be made to achieve comparability.
- The above mentioned principles for evaluating the applicability of CUP have also been upheld by the Tribunal in case of taxpayers in other industries.²

Adjustments for differences in volume, marketing and research

- The Tribunal has in principle allowed the adjustment for differences on account of volume, marketing and research function, subject to the verification of documentation by the AO. While this is a welcome step in the right direction, no guidance has been provided on how the adjustments need to be made and what aspects should be considered, thus leaving room for ambiguity on the approach that could be adopted by the AO/TPO.
- The importance of volume has been recognised and partially provided for by considering brokerage rate charged to Top 10 FIIs for comparability purposes. However, it needs to be ascertained whether such an approach is an adequate measure to provide for volume adjustment and accordingly this approach would need to be analysed on a case specific basis.

Conduct of parties to be adequately supported by documentation

- It is noteworthy that while there is recognition of the fact that volume differences impact prices; emphasis has been laid on 'committed' volumes and the need to substantiate AE commitment through documentary evidence. Of course the relevance of these aspects to this industry, which is heavily impacted by market movements and volatility, needs to be borne in mind.

Simple average v. weighted average

- While rejecting the use of weighted average, the Tribunal has pointed out that the statute only allows the use of arithmetic mean i.e. simple average. Weighted average has been used by industry players to factor volume adjustment in the past. However, in view of this ruling, alternate ways need to be considered to factor in volume differences and align computation of ALP within the statutory framework.

² Schutz Dishman Biotech v. DCIT [ITA No. 3590 &3571/Ahd/2007] and Essar Shipping Ltd. v. DCIT [2009] 27 SOT 409 (Mum.)

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