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Arm’s length price for sourcing services – cost based remuneration model adjudged most appropriate for limited risk procurement support service provider

Background

In the case of GAP International Sourcing (India) Pvt. Ltd[1]. (GIS India or the taxpayer), the Delhi Bench of the Incometax Appellate Tribunal (the Tribunal) adjudged that a cost based remuneration model was most appropriate for low risk procurement service providers, rather than a commission based remuneration. The Tribunal acknowledged that procurement service providers could operate on various remuneration models including percentage of value of goods procured and cost *plus* mark up based on the facts of each case. However, in either case, the transacting parties would need to set their contractual terms in adherence with market forces to ensure a reasonably acceptable profitability. This ruling also distinguishes the taxpayer's facts and circumstances from an earlier precedent of the coordinate bench in the case of Li & Fung India Pvt. Ltd.[2] wherein the Tribunal had upheld a commission based remuneration for procurement services rendered by Li & Fung India Pvt. Ltd.

[1] GAP International Sourcing (India) Pvt. Ltd *v.* ACIT [ITA Nos. 5147/Del/2011(AY 2006-07) and 228/Del/2012 (AY 2007-08)]

[2] Li and Fung India Pvt Ltd v. DCIT [TS-583-ITAT-2011 (DEL)]. Please refer to PwC Tax News Alert dated 17 October, 2011

Facts

The taxpayer is a group company of the famous retail brand, 'GAP'; and was incorporated during financial year (FY) 2005-06. GIS India was engaged in facilitating the sourcing of apparel from India for its group companies. The primary activity of the taxpayer comprised of assistance in identification of vendors, provision of assistance to vendors in procurement of apparel, inspection and quality control and coordination with vendors to ensure delivery of goods to group companies. The necessary technical and intellectual inputs for the discharge of these services were provided by the group companies.

The taxpayer adopted the transaction net margin method (TNMM) to benchmark the service fee determined at full cost *plus* 15% from the foreign group company for its transfer pricing (TP) documentation for the FYs 2005-06 and 2006-07.

During the TP audits, the transfer pricing officer (TPO) disregarded the Functional, Asset and Risk (FAR) profile and characterisation of GIS India by assuming that the FAR profile of taxpayer was substantially higher than those of limited risk support service providers. The TPO alleged that a cost *plus* form of remuneration did not take into account substantial intangible assets owned by the taxpayer. These intangibles were primarily construed by the TPO to be in the nature of human asset intangibles, supply chain intangibles and location savings.

Based on above, the TPO ascertained that the taxpayer ought to have earned a commission of around 5% on the free on board (FOB) value of the goods procured by the group companies. Accordingly, the TPO imposed TP adjustments of INR 2.36 billion and INR 2.63 billion for FYs 2005-06 and 2006-07 respectively. The TP adjustments resulted in imputed returns on the operating expenses of the taxpayer to the extent of 830% and 660% for FYs 2005-06 and 2006-07 respectively. The taxpayer initially approached the Dispute Resolution Panel (DRP) for FY 2005-06, which confirmed the adjustment of INR 2.36 billion vide a non speaking order. Subsequently, in response to an appeal made by the taxpayer before the Tribunal, the subject matter was restored to the DRP for fresh adjudication.

During the pendency of the set aside proceedings of FY 2005-06, the DRP upheld similar adjustments for FY 2006-07. Thereafter, the DRP re-heard the matter for FY 2005-06; and upheld the entire adjustment made by the TPO earlier. The taxpayer appealed against the total addition of INR 4.99 billion made for FYs 2005-06 and 2006-07 before the Tribunal.

Revenue's contentions

The Revenue primarily relied on the orders of the TPO and DRP while presenting the following key contentions to support a remuneration model, based on commission percentage on FOB value of good sourced, instead of the cost *plus* remuneration, as followed by the taxpayer

- The revenue contended that the taxpayer is a wholly-owned subsidiary of its foreign associated enterprises (AE) and therefore, supporting agreements and similar documentary evidences are irrelevant for the purposes of determination of arm's length price (ALP) since TP authorities have statutory duty to evaluate such transactions on the basis of comparables and other relevant parameters and not on the basis of convenient agreements.

- In Revenue's view, the taxpayer performed all the critical functions, assumed significant risks and used unique intangibles developed by it over a period of time. Some of the functions like quality management, involve great care to be taken at the sourcing stage and any defect or infirmity in these functions may result in huge adverse impact on the whole supply chain.

- Revenue claimed that in a third party scenario, for similar services, the charging basis would be a percentage of value of goods procured rather than cost *plus*.

However, the order does not mention any evidence adduced by the Revenue to support this contention.

- The Revenue alleged that the taxpayer had adequate resources, establishment, well organized work force, etc, which indicated that the taxpayer had developed substantial intangibles in terms of supply chain and human resources, for which it should be suitably remunerated. The compensation model currently followed by the taxpayer lacked proper valuation of use of such intangibles, which were availed by the AE.

- The Revenue alleged that the taxpayer had proprietary information of the supply chain, such as knowledge of vendors, products and designs, acquisition and supply, quality control, storage and logistic involved, etc, but it had not been adequately compensated for the same.

- Location savings should be attributable to the taxpayer since, by operating in low cost economy, it had generated location savings for AEs due to huge difference in cost of procurement between high cost economies and low cost economy like India. Hence, the Revenue claimed that the taxpayer had not earned its share of location savings through the cost *plus* remuneration.

Taxpayer's contentions

The taxpayer contested the Revenue's views by presenting the following key arguments:

- The taxpayer was a low risk captive contract service provider rendering sourcing support services to its AE. In the course of provision of such services, the taxpayer merely acted as a facilitator/co-ordination arm between its overseas AE and the third party vendors for sourcing of apparel from India.

- The taxpayer did not bear the key business risks such as market risk, product liability risk, product design and development risk, credit risk, price risk, foreign exchange risk etc. On the other hand, the AE bore all the relevant risks in connection with undertaking the procurement activities and no risk was attributable to the taxpayer, which is a key factor in determining the FAR.

- In performance of the procurement support service functions, the necessary inputs i.e. specifications and designs of the products to be sourced, names and addresses of vendors/manufacturers, detailed information on potential or new vendors, operating softwares, training material, operating and process know-how etc., were all provided by the AE. Also, the relevant intangible assets required for the business, like vendor lists, business information, software, business processes, etc. were developed and owned by the AE.

- The TPO made a futile assumption that the taxpayer had created valuable supply chain and human asset intangibles without giving proper reasoning and evidential data to suggest that any intangibles have been created. In the process, the TPO erroneously presumed that the taxpayer's employees were performing key decision making functions.

- The TPO and the DRP had not considered the legal agreement between the taxpayer and the AE and also overlooked the voluminous documents presented by the taxpayer in support of its claims. The TPO also did not produce any supporting information or documents to oppose the taxpayer's contentions.

- The taxpayer had no role to play in the end customer pricing and therefore there was no question of allocating any location savings to the taxpayer. The intent of sourcing from low cost countries for a manufacturer or retailer, in any case, is to provide a lower cost to its end-customers. Even if location savings had arisen, the allocation of the same would really depend upon the relative bargaining powers of the parties concerned, which in turn would depend on the ownership of intangibles and the competitive market position of the company based in the

low cost jurisdiction. In the present case, the taxpayer's relative bargaining power as a routine support service provider (which also did not own any valuable intangible asset) was negligible as compared to its AEs and thus it could not be entitled to any location savings.

- The taxpayer relied upon an international ruling passed by the Supreme Court of Netherlands in the case of a Belgian Coordination Centre (BCC), wherein, the judgment adjudicated upon the arm's length remuneration model to be followed in respect of procurement/ purchasing coordination activities performed by BCC. The judgment accepted the remuneration model of charging a mark-up on the value adding costs incurred by the appellant in its procurement/purchasing coordination/support services activity.

- The taxpayer also contended that the TPO had drawn wrong reference to an out-of-court settlement between US tax authorities and Tommy Hilfiger, wherein a commission based remuneration was allegedly agreed to. The said settlement did not have the persuasive effect of a judicial pronouncement and further, there was no information on the actual facts and circumstances of the settlement.

- The taxpayer's only costs were operating costs or value added expenses (VAE), as it did not pay for the price of goods sourced by the AEs and therefore, the profit level indicator (PLI) used by the taxpayer, in its own case was actually operating profit/total cost (OP/TC) since its VAE was equal to TC. The selection of OP/VAE as a valid PLI under TNMM, is well supported by the ruling by the coordinate bench of the Tribunal in the case of Cheil Communications[3]. The taxpayer also referred to the well known concept of 'Berry Ratio'[4], which propounds that routine distributors and service providers should a return on VAE and not on the value of products dealt with. The concept of Berry Ratio is a variation of the Cost Plus Method or TNMM, in the case of service providers. The taxpayer demonstrated through benchmarking search results that for a set of distributors, one cannot simply adopt a PLI of return on sales (or commission rate) without taking into consideration the corresponding OP/VAE, being a dialect of Berry ratio, of those companies.

- The taxpayer strongly distinguished its functional profile with that in case of the Li & Fung India Pvt. Ltd. (above) by stating that contrary to TPO's contentions which were upheld by the Tribunal in Li & Fung India Pvt. Ltd's case, all intangibles including trademarks, processes, knowhow, technical data, operating/quality standards etc. were developed and owned by the taxpayer's AEs and the taxpayer did not create any unique intangibles and did not undertake any activity on its account that led to the development of unique intangibles.

- The taxpayer provided detailed explanations to differentiate between the facts of Li & Fung India Pvt. Ltd and its own. It was also highlighted that Li & Fung India Pvt. Ltd. carried out significantly high-end & value added functions in India, which was borne out from the fact that the intensity of functions of Li & Fung India Pvt Ltd., measured as a percentage of operating expenses or VAE of Li & Fung India Pvt. Ltd. to the value of goods procured, was 3.78%, as opposed to the meagre percentage of approx 0.75% in the case of the taxpayer. In other words, Li & Fung India Pvt. Ltd. had carried out virtually five times greater functions as compared to the taxpayer India. Despite that, the taxpayer explained, even if the entire commission of Li & Fung Group was assigned to Li & Fung India Pvt. Ltd. (based on financial information available in the ruling itself), then the resultant OP/VAE of Li & Fung India Pvt. Ltd. would have worked out to approximately 32%, as compared to the exorbitant OP/VAE of 830% or 660% as derived by the TPO in its order.

- The taxpayer also explained different iterations of the arm's length cost *plus* mark up based on different set of comparables submitted before the TPO, as well as the Li & Fung India Pvt. Ltd. ruling. This analysis showed that the margin

[3] DCIT *v.* Cheil Communications India Pvt. Ltd. [2011] 137 TTJ 539 (Del) . Please refer to PwC Tax News Alert dated 7 December, 2010

[4] Berry ratio is calculated as Gross Margin/VAE

could at best be as high as 32%, without prejudice to the primary contention that the taxpayer's own margin of 15% remained uncontroverted by the TPO and DRP.

Tribunal ruling

After considering the rival contentions, the Tribunal's key conclusions were as follows

Importance of functional/risk profile

The Tribunal has stated that for determining the ALP of every international transaction, it is imperative to take the characterisation of an assessee and its AEs into consideration through FAR analysis of international transactions. While stating this, the Tribunal has observed the following specifically for the taxpayer's case, while holding that the taxpayer, for its limited functions, deserved a 'cost *plus*' remuneration & not a revenue linked one

1. No significant business risks were borne by the taxpayer: No supporting material had been brought on record by the Revenue that the taxpayer had borne any business risks arising from its activities with its AE. Also, there were no adverse facts, material, evidence, examples or comparables brought forward by the Revenue to support its contention.

2. GAP India did not have capacity to assume business risks: The Tribunal had referred to the plethora of documents filed by the taxpayer and held that the taxpayer had no capacity to take key business risks and that the Revenue had drawn a flawed correlation to conclude that it undertook key functions and therefore it had also borne the consequent risks.

3. No human resource intangibles were developed by the taxpayer: On the issue of development of human resource intangibles, the Tribunal held that the Revenue had failed to demonstrate that none of the employees who were on the payroll of the taxpayer, were any acclaimed personalities or indispensable in garment procurement trade so as to constitute any human intangibles, as alleged. On the contrary, the employees were engaged in execution of preordained support activities, their qualifications were general and routine in nature; and the employees with such educational qualifications were abundantly available in the Indian recruitment circles.

4. No supply chain intangibles were developed by the taxpayer: On the issue of alleged development of supply chain intangibles, the Tribunal held that the taxpayer's role and activities; and also suppliers, were already identified and earmarked by the AE; and merely following the guiding instructions of the AE could not result in creation of supply chain intangibles by the taxpayer.

5. Location savings could not be attributed to the taxpayer: On the issue of location savings, the Tribunal has observed that location savings to a developing economy arise to the industry as a whole; and there was nothing on record that the taxpayer, on a stand-alone basis, was the sole beneficiary of the same. Also, the Tribunal noted that the very objective of moving to a low-cost location was to survive in stiff competition by providing a lower cost to end-customers. Thus, the advantage of location savings was passed on to the end-customers through a competitive sales strategy. Thus, the Tribunal concluded that no additional allocation was needed for location savings.

A choice of PLI should not lead to absurd results in terms of profitability

1. On the issue of choice of PLI under TNMM, the Tribunal has ruled that the method and PLI used should not lead to manifestly absurd results. An interesting observation of the Tribunal is that an absurd and distorted PLI would lead to creating aberrations, which should be best avoided.

2. Discussing further on the issue of the appropriate PLI, the Tribunal has clearly stated that the Revenue had failed to produce a single comparable supporting its stand with respect to use of PLI of percentage of FOB value of goods procured by the AE of the taxpayer.

<u>The taxpayer's facts were different from Li & Fung India Pvt. Ltd.</u>

1. The Tribunal has differentiated between the facts of Li & Fung India Pvt. Ltd's case and that of the taxpayer. The Tribunal categorically mentioned that in case of the taxpayer, all significant directions relating to procurement of goods from third party vendors in India, namely –
   (a) designs & trends of apparel,
   (b) quality parameters of materials,
   (c) terms & conditions for dealing with vendors, etc,
   were provided by the AE to the taxpayer through the voluminous vendor handbook and other correspondences, which are placed on record and had not been controverted by the TPO. For such pre-ordained support services, the taxpayer could not be held to be entitled to remuneration in terms of Li & Fung India Pvt. Ltd. case on FOB value of goods procured by the taxpayer's AEs from third party vendors in India because in the case of Li & Fung India Pvt. Ltd., the Indian company actually carried out significantly value added functions in India.

2. The Tribunal concluded by stating that the appropriate PLI for the taxpayer would be profit on its operating costs and not a percentage of the FOB value of good sourced by the AEs.

<u>Determination of arm's length cost *plus* mark-up</u>

1. While determining the cost *plus* mark-up for the taxpayer, the Tribunal again referred to the specific financials of Li & Fung India Pvt. Ltd's case, firmly stating that even if one were to assign the entire commission of Li & Fung Group to Li & Fung India Pvt. Ltd., then the cost *plus* mark-up for Li & Fung India Pvt. Ltd. actually worked out to approximately 32%.

2. Referring to a recent discourse by the Indian Finance Minister, the Tribunal made a very positive remark with respect to India income-tax assessments and appellate proceedings, stating that proceedings should be non-adversarial in nature and should be an exercise of fair determination of tax liability payable by taxpayers. On the other hand, in the present case, the Tribunal noted that the sweeping observations of the TPO and DRP give an impression of being adversarial.

3. In view of all of the above, the Tribunal held that the arm's length cost *plus* mark up for the taxpayer should be 32% for the both FYs 2005-06 and 2006-07, as opposed to the exorbitant numbers of 830% and 660% imputed by the TPO in a derived manner, by resorting to a commission based model of 5% on the FOB value of goods procured by the AE directly from Indian vendors.

4. This resulted in significant relief for the taxpayer to the tune of INR 2.31 billion and INR 2.56 billion for the FYs 2005-06 and 2006-07 respectively.

PwC observations

The dispute related to determination of an appropriate remuneration model for procurement companies started with the Li & Fung ruling, and this ruling delves further in to the issue.

In terms of key takeaways, the following aspects are worth mentioning:

- While procurement companies may have different remuneration models based on their FAR profiles (e.g. cost <u>*plus*</u>, commission or buy-sell margin), it is important to ensure that the ALP is determined using the appropriate PLI and suitable benchmarking method. The ALP as determined by either the taxpayer

or Revenue cannot lead to manifestly absurd or abnormal financial results, as had happened in the present case.

- It is extremely critical to determine the substantive FAR profiles of both the taxpayer and the other transacting entity for deciding upon the appropriate remuneration model. For example, if a procurement company is merely providing liaison and support services, then a commission based remuneration would not be appropriate in most cases. On the other hand, if the procurement company is actually providing a higher level of services so as to deserve a commission on value of good procured, then the commission rate should be linked to the intensity of functions of the entity. If such linkage is not done while determining the arm's length commission rate, then one may end up with abnormal financial results which defies the basic tenets of arm's length pricing.

- The selection of the correct PLI (such as OP/ sales or OP/ VAE, being a dialect of Berry Ratio) is intricately linked to the selection of the right set of comparables, which in turn would depend on the commercial and economic realities. Thus, one should not simply take a same set of comparables and derive alternate financial results using different PLIs.

- The ruling also highlights the importance of maintaining and presenting robust documentary evidence to substantiate the FAR profile as well as the commercial conduct and substance of the parties to the transaction.

- Lastly, but most importantly, the Tribunal has gracefully championed the cause of taxpayers by stating that tax proceedings should be fair and non-adversarial in nature. Thus, tax administrations should follow a rule of law, which is predictable and based on sound reasoning and which should not be fraught with the perils of uncertainties and adversities for taxpayers.

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