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Tribunal endorses adjustment to account for foreign exchange rate fluctuation

Relevant facts and the Tribunal's ruling for FY 2006-07

Honda Trading Corp India Private Limited (the taxpayer) is engaged in the buy-sell of certain auto components. The taxpayer had determined and agreed its sales price to customers after considering the past six months' foreign exchange rate (INR to Thai Baht). However, the taxpayer's imports from its associated enterprise (AE) were undertaken at the exchange rate prevalent as on the date of transaction (spot rate). Contrary to the taxpayer's expectations, owing to sudden political and economic reform in Thailand, the INR depreciated vis-à-vis the Thai Baht, thereby making imports costlier. However, the sale price had been fixed with customers and could not be changed. Since imports became costlier and the sale price did not change, the taxpayer incurred losses. To eliminate the impact of depreciation in the INR, the taxpayer proposed an adjustment and submitted that it would have earned a high profit margin (higher than that of comparables) had the INR not depreciated. The transfer pricing officer (TPO) disregarded the adjustment put forth by the taxpayer, and made a transfer pricing adjustment.

The Tribunal acknowledged the depreciation in the INR to be an important factor, materially affecting the price in the open market. The Tribunal held that for a credible comparison with comparables, the difference on account of foreign exchange rate fluctuation in favour of the Thai Baht and against the INR should have been removed, and the margin of the taxpayer should have been accordingly adjusted. Thus, the Tribunal directed the revenue authorities that necessary adjustments pertaining to the huge and abnormal fluctuation in foreign exchange may be allowed to the taxpayer.

PwC observations

After providing its in-principle sanction on adjustments on account of working capital, risk, capacity utilisation and depreciation, the Tribunal has, with this ruling, endorsed the need to adjust for foreign exchange rate fluctuation, which could have a material impact on prices. This endorsement by the Tribunal is positive and indeed well-timed as Indian importers are already feeling the burden of continued depreciation in the INR on their margins.

The mechanics of how to make this adjustment have not been discussed in this case. However, having got the Tribunal's sanction, there is now the need to develop a robust methodology based on sound economic principles.

If your interest lies in a specific area or subject, do advise us so we can send you only the relevant alerts.

For any additional information, please reach out to your PwC relationship manager or write in to ***pwctrs.knowledgemanagement@in.pwc.com***

With Best Regards
PwC TRS Team

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