TAXSUTRA All rights reserved

Tribunal ruling on "Sogo Shosha" companies - Relevance of "Berry Ratio" not considered

Date : 10 October 2013

It is in general news that the Japanese "Sogo Shosha" or trading companies, are facing large scale transfer pricing (TP) disputes & litigations in India. The first ever ruling for any such "Sogo Sosha" company at the level of the Tax Tribunal, has been recently issued by the Delhi Tribunal last month, in the case of Mitsubishi Corporation India Private Limited (Mitsubishi India), as available in the public websites.

The Tribunal has decided the case against the taxpayer on "principle", though the matter has been restored to the file of the transfer pricing officer (TPO) for selection of proper comparables, in line with the TP methodology laid down by the Tribunal.

The contents of the ruling, in so far as the same relate to the adjustment around TP; and also the related arguements made both by the taxpayer & the Revenue, are not very elaborate, however some very pertinent issues arise from the ruling, which are highlighted below -

1. Generally, "Sogo Sosha" companies provide services to their foreign principals for both sides of the supply chain, namely procurement & selling. Though such companies are engaged in buy & sale of goods, they typically do not stock & sell; and take flash title to the goods, against confirmed orders from customers, namely foreign principals, in case of procurement related functions; and third party customers, in case of selling related functions.

2. Thus, though optically, such "Sogo Sosha" companies carry out buy sell activities through taking of title to the goods, albeit flash title, the same are basically in the nature of service providers, facilitating their principals for procurement & selling related activities.

3. A pertinent question arises, namely, given their functional, asset & risk (FAR) profiles, what would be the remuneration or TP model for such "Sogo Shosha" companies, i.e. -

(a) should it be a function of cost, i.e. a mark up on only the operating or value added expenses (VAE) of such companies, by using the profit level indicator (PLI) of operating profits (OP)/ VAE, being a dialect of Berry Ratio, being a measure of gross profit (GP)/ VAE; or

(b) should it be a function of value of goods handled by such companies, i.e. a mark up or return on value of goods, by using the PLI of OP/ total cost (TC), in case of procurement functions; and OP/ Sales, in case of selling functions ?

4. The "Sogo Shosha" companies generally contend that given their FAR profiles of being

TAXSUTRA All rights reserved

essentially service providers, their remuneration model should be based upon a function of cost, or in other words, they should expect a mark up or return only on their VAE or operating expenses; and not on the value of goods handled by them.

5. The Delhi Tribunal, in the aforesaid case of Mitsubishi India, has held, without much detailed analysis, which again does not seem to have been fuelled by detailed arguements made by the taxpayer & the Revenue, at least as it appears from face of the ruling, that since the taxpayer had been taking title to the goods, one could not consider it to be a service provider for being entitled to a return only on its VAE, but should be awarded a return on the value of goods handled by it as well.

6. Having so held, the Tribunal was pleased to restore the matter to the file of the TPO for selecting comparables engaged in trading activities, as against service providers. It is presumed that the TPO might have initially selected service providers as comparables; and applied their average OP/ VAE, given that service providers do not carry value of goods in their books, on the total cost of Mitsubishi India, namely including the cost of goods, thus resulting in an astronomical TP adjustment.

7. Now, with a very brief analysis of the FAR profile of the taxpayer, as being available on the face of the ruling, it may not be possible to make any comments on the correctness or otherwise of the ruling, though it is difficult to resist the temptation of making an "off the cuff" generic comment that the mere taking of title to goods, where the same is in the nature of flash title, might not be enough entitlement for the taxpayer to a return on value of the goods, where say the significant functions & accordingly, the risks related to the goods, are not performed & borne respectively, by the taxpayer, in substance.

8. On the other hand, even a high-end agent, who might be carrying out intense procuring or selling functions, may be entitled to a remuneration based on value of goods handled by it, in the form of a commission, though such agent would never take title to the goods.

9. Thus, the answer to the fundamental question of whether a taxpayer should be entitled to a return on the value of goods handled by it, would actually depend on the functions performed & the related risks borne by it, with respect to the goods; and not on whether the taxpayer has merely taken title to the goods, shorn of its FAR profile.

10. However, since no FAR analysis of Mitsubishi India has been made or discussed in detail, in the ruling, one would need to refrain from commenting on the correctness of the answer to the fundamental question of whether Mitsubishi India should have earned a return on the value of goods handled by it, which the Tribunal had opined in the affirmative.

11. That brings us to another very important matter, which has not been touched upon or dealt with by the Tribunal; and again, not sure whether & in what perspective, the same

might have been argued by the taxpayer, namely whether there should be an interplay between Berry Ratio & return on value of goods ? The matter is briefly discussed as follows -

(a) Even if an agent or buy sell company receives a revenue linked remuneration, should a sanity check, in the form of Berry Ratio, be applied, in order to ensure that a return on the value of goods does not lead to an exorbitant return on the operating expenses or VAE ?

(b) This is the exact path on which the Delhi Tribunal had walked in the case of GAP India.

(c) In the case of Mitsubishi India, the taxpayer had relied upon the aforesaid ruling in the case of GAP India for the proposition that the taxpayer was in essence a service provider; and therefore, in line with the ruling of GAP India, the taxpayer should be entitled to a mark up only on the VAE & not on the value of goods.

(d) Though the Delhi Tribunal did not specifically refer the ruling of GAP India, it was pleased to lay down the dictum with reference to an entirely different factual finding that the taxpayer, namely Mitsubishi India, was not a service provider, but a buy sell company; and therefore it should receive a return on the value of goods, being something, which should not be accepted as a general proposition, as discussed above.

(e) However, the ratio of the ruling in the case of GAP India has much wider import & reach than the mere end-result of the said ruling, that based upon the facts found by the Tribunal that GAP India was in reality a service provider, it was entitled to only a return on the VAE; and not the value of goods.

(f) The Delhi Tribunal, in the case of GAP India, had accepted the concept of Berry Ratio as a sanity check even for cases where the taxpayer would have received a revenue linked remuneration, since significant divergence between the intensity of functions, measured as the ratio of VAE to the value of goods, of the taxpayer & the comparable companies, might result in exorbitant Berry Ratios, representing return on the operating expenses or VAE, which purely from the fundamentals of economics & TP, should not be accepted.

(g) However, this subtle but significant dictum around sanity check in the form of Berry Ratio, as promulgated by the Tribunal in the case of GAP India, was not captured in the ruling in the case of Mitsubishi India; or the same might not also have been brought up before the Tribunal in the proper perspective.

(h) Thus, while restoring the matter to the file of the TPO with the direction of selecting comparable companies who are into buy sell functions, the Tribunal should have held; or could have been persuaded to hold, that the resultant analysis would need to be sanitised through the application of the Berry Ratio, lest a return on the value of goods handled by Mitsubishi India, as pegged with reference to the return on sales of comparable companies,

TAXSUTRA All rights reserved

yield exorbitantly high return on the operating expenses or VAE of Mitsubishi India, which is possible if the intensity of functions of Mitsubishi India are far lower than those of the comparable companies.

12. It would be interesting to see as to how the Tribunals would deal with the relevant issue while dealing with the matters relating to the other Japanese "Sogo Shosha" companies, in case the aforesaid arguements are made by the taxpayers during the hearings of such appeals.

13. It may sound cliche, however, the best solution available for "Sogo Shosha" companies is to obtain up-front resolution through the newly introduced mechanism of Advance Pricing Agreements.