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After considering divergent judicial views, Tribunal upholds selection of foreign AE as tested party in accordance with international best practices

In brief

In a welcome decision, the Tribunal has, after considering divergent views in the past, eventually ruled in accordance with international best practices with regard to selection of tested party. The Tribunal acknowledged that tested party should be the least complex entity for which reliable data in respect of itself and in respect of comparables is available. The Tribunal accepted that tested party could be the local entity or a foreign associate enterprise (AE), and upheld selection of foreign AE as tested party in the instant case.

Facts

General Motors India Pvt. Ltd.¹ (the taxpayer) was engaged in manufacture and trading of automobiles and its parts. The taxpayer entered into several international transactions with its associated enterprises. The key international transaction under dispute was purchase of CKD kits from General Motors Daewoo Auto & Technology (GMDAT), an AE. The taxpayer adopted a transaction-by-transaction² approach to benchmark its international transactions. In respect of the transaction of purchase of CKD kits, the taxpayer selected the AE (i.e.,

¹ General Motors India P Ltd v. DCIT [ITA nos. 3096/Ahd/2010 and 3308/Ahd/2011]

² Taxpayer drew support from section 92(1) of the Income-tax Act, 1961, para 3.9 of OECD Guidelines, and various judicial precedents, which prefer a transaction-by-transaction approach over the aggregation approach.

GMTAD) as the tested party and benchmarked using foreign comparables. The transfer pricing officer (TPO) rejected this approach, and proposed an adjustment by selecting the taxpayer as the tested party instead, and benchmarking it against local comparables. The DRP upheld the TPO's approach. Aggrieved, the taxpayer appealed to the Tribunal.

The key contentions raised by both, the taxpayer and the Revenue, primarily revolved around two aspects, viz., functional profile of the taxpayer vis-à-vis that of the AE; and data on foreign AE and foreign comparables.

Taxpayer's contentions

1. The taxpayer contended that with respect to CKD kits manufactured and sold by the AE, the functional and risk profile of the taxpayer were more complex than that of the AE. AE acted as a contract manufacturer for the taxpayer. It assumed limited risks and undertook limited functions, such as production, procurement, quality control, packing, storing, shipping, etc.

The taxpayer, on the other hand, performed an entrepreneurial role in relation to sale of GM cars in India. Its functions included identification of market opportunities; production and assembly; purchasing; designing; managing supply chain and logistics; R&D (on its own account) for indigenisation³ and for adopting the cars' basic technology to suit the Indian environment⁴; building the dealer network; and performing the overall sales and marketing function (including after-sales service).

The taxpayer was responsible for developing the market, and for developing local marketing intangibles for competing in the Indian market. The taxpayer assumed market risk, product failure risk, obsolescence risk, etc. Its profitability was impacted by a number of factors including external market conditions and competition. Thus, it was difficult to accurately adjust the taxpayer's financials.

2. Financial and other data on comparable companies had been provided. From the financial data, the PLI could be reliably computed, and the same had also been audited by independent auditors and was hence reliable. Further, segmental financial data of the AE had been furnished for benchmarking a part of the AE's business which related to manufacturing and sale of CKDs to the taxpayer. The segmental data was based on sound allocation keys and had been independently reviewed by a third party who had also issued a report thereof that the allocation was reasonably accurate.
3. To support selection of foreign AE as tested party, reliance was placed on decisions in cases of Development Consultants, Mastek Ltd, and AIA Engineering⁵.

Revenue's contentions

1. GMDAT was an entrepreneur and cannot be the tested party. It was a complex entity with operations across multiple geographies, having substantial related party transactions, and owing intangibles.
2. Sufficient and reliable data on foreign comparables was not available. They were in different geographies, and no adjustment had been made for the many geographic differences that existed. There were functional dissimilarities too, and segmental data for the specific comparable function may not have been available.

Tribunal Ruling

The Tribunal acknowledged that tested party should be the least complex entity, for which reliable data in respect of itself and in respect of comparables is available. The Tribunal accepted that tested party could be the local entity or a foreign AE, and upheld selection of foreign AE as tested party in the instant case. In doing so, the Tribunal:

³ Replacing imported components with alternative local ones.

⁴ Adopt the car's basic technology to suit the Indian environment because of regulatory changes, customer feedback etc.

⁵ Development Consultants P Ltd v. DCIT [2008] 115 TTJ 577 (Kol), Mastek Ltd. v. ACIT [2012] 53 SOT 111 (Ahd), AIA Engineering Ltd. v. ACIT [2012] 50 SOT 134 (Ahd), Ranbaxy Laboratories Ltd v. ACIT [2008] 110 ITD 428 (Delhi), and Sony India P Ltd. v. DCIT [2008] 114 ITD 448 (Delhi): [2009] 315 ITR 150 (Delhi) (AT)].

- placed reliance on the UN TP Manual⁶ and judicial precedents in the cases of Development Consultants, Mastek Ltd, AIA Engineering, Ranbaxy Laboratories, and Sony India⁵. In respect of judicial precedents, the Tribunal agreed with the majority view and accordingly, rejected the direct applicability of the divergent decision in the case of Onward Technologies⁷ to the instant case;
- acknowledged the taxpayer's submissions that all financial details of comparable companies and segmental data of the AE had been furnished and were reliable;
- found inconsistency in the stand taken by the TPO where in another transaction the TPO had proposed an adjustment by selecting the foreign AE as the tested party; and
- negated the TPO's argument that foreign comparables do not fall within his jurisdiction and he can therefore neither call for any additional information nor scrutinize their books of accounts etc. In this regard, the Tribunal stated that Revenue can get all relevant information from across the globe by using technology or by directing the taxpayer to furnish the same.

PwC Observations

The principle of "tested party" is enshrined in the fundamentals of transfer pricing. However, lack of guidance in this regard in the Indian transfer pricing regulations has led to divergent views being taken by Indian judicial authorities. In a welcome decision, the Tribunal has, after considering divergent views in the past, eventually ruled in accordance with international best practices embodied in the OECD Guidelines, US TP regulations and now, the UN TP Manual.

Although not explicitly discussed, however, by accepting the AE as the tested party, the Tribunal has implicitly accepted the relatively more complex/entrepreneurial characterisation of the taxpayer vis-à-vis the foreign AE. Notably, the characterisation of these entities is only with respect to the international transaction of purchase of CKD kits, and not for the entities as a whole. This is an important takeaway. It may be noted that the Revenue, in the instant case, evaluated the AE on an entity-wide basis and thus found it to be more complex than the taxpayer. However, in a transaction-by-transaction approach, as was adopted by the taxpayer in the instant case, the tested party must be selected with respect to that particular transaction only.

To decide which is the lesser or more complex entity, a detailed functions, assets and risks (FAR) analysis must precede the selection of tested party. Particularly while selecting a foreign AE as tested party, such FAR analysis must be elaborately documented, and it would be important for taxpayers to be able to substantiate the same as well. To substantiate, support could also be drawn from various industry factors and trends. For example, in the instant case, the auto industry in which the taxpayer operates has been faced with sluggish demand and rising input costs. These trends have compelled industry players to focus on controlling costs, and one effective way to achieve that has been to indigenise/localise, which is a lengthy process spanning over many years. Therefore, in the instant case, besides the routine functions of manufacturing, procurement, etc., the taxpayer was said to have been faced with significant market risks and was also undertaking R&D on its own account (for indigenisation, etc.). All this substantially raised the risk profile of the taxpayer vis-à-vis the foreign AE, and made the foreign AE an obvious choice for tested party.

Data availability in respect of the foreign AE and foreign comparables is the other important requisite when selecting a foreign AE as tested party. Notably, to establish reliability of the data, the Tribunal has, in the instant case, given importance to an independent audit and review of such data.

⁶ Paras 5.3.3.1. and 10.4.1.3.

⁷ Onward Technologies Ltd. v.DCIT [2013] 35 taxmann.com 584 (Mum)

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