Transfer Pricing Perspectives – Recent judicial developments on significant issues

- Sanjay Tolia, Darpan Mehta, Jay Mankad and Vinay Desai

Introduction

Transfer pricing has become the most significant source of litigation in India and is increasingly becoming a regular discussion point in the boardroom of large Indian and global Multinational Enterprises ('MNEs'). Indian Tribunals[1] have issued around 650 rulings over the last decade on transfer pricing issues, setting precedents for taxpayers on a wide range of issues.

In this article, the Authors discuss the following significant issues with reference to recent Tribunal rulings and provide their perspective in context of fundamental transfer pricing principles and international guidance.

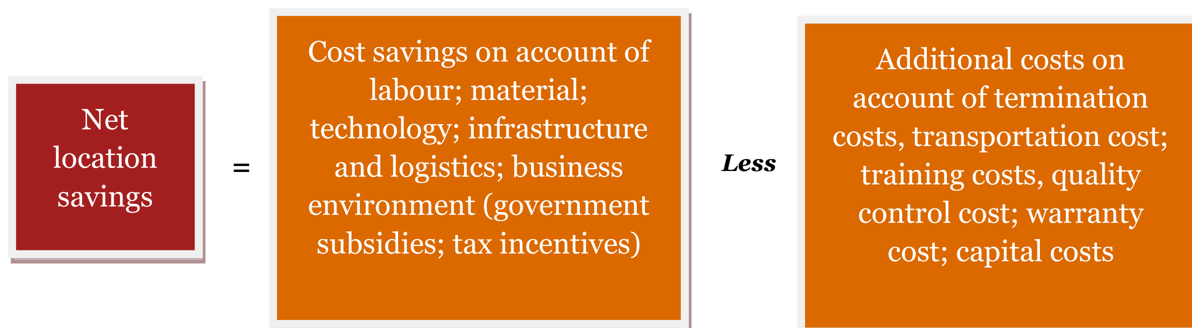
- Location savings – A case of 50:50?
- Tested Party – The right questions?
- Marketing intangibles – Focus on fundamentals?
- Deemed International transactions – A matured approach
- Contract Research & Development – the path to profit splits!
- Foreign exchange fluctuations – Rupee @ 60?

1. <u>Location savings – A case of 50:50?</u>

Issue

Movement of operations / activities from high cost jurisdictions to low cost jurisdictions has given rise to the debate between the taxpayers and tax administration as to which jurisdiction enjoys the additional profits from such movement. The quantification and allocation of such profits (also known as location savings) has become an important issue in transfer pricing audit resulting in litigation.

Indian regulations do not provide any guidance on the location savings. The OECD Guidelines, in the Chapter relating to Business Restructuring, provide a brief discussion of location savings. Simply put –



[1] Tribunals in India are the second level of appeal, as well as the final fact finding body.

In recent audits, Indian authorities have made upward adjustments to the income of the Indian taxpayer by splitting the net location savings between the Indian taxpayer and overseas enterprise. In many cases, the location savings are simply split equally between the Indian taxpayer and overseas enterprise assuming equal bargaining power.

In the India Chapter to the recently released United Nations Transfer Pricing Manual for Developing Countries (UN Manual), the Indian authorities has advocated that, in the quantification and allocation of location savings amongst the parties, the profit split method (PSM) can be used wherein the functional analysis and bargaining power of the parties to the transaction would be relevant factors for consideration – benchmarking against local comparables does not take into account the benefit of location savings. Further, an arm's length compensation should reflect an appropriate split of cost savings between the parties.

Views from the Tribunal

The Tribunal ruling in the case of **GAP International**[2], has not echoed the above views of the Indian authorities and held that:

"the intent of sourcing from low cost countries for a manufacturer/retailer is to survive in stiff competition by providing a lower cost to its end-customers. Generally, the advantage of location savings is passed onto the end-customer via a competitive sales strategy. The arm's length principle requires benchmarking to be done with comparables in the jurisdiction of tested party and the location savings, if any, would be reflected in the profitability earned by comparables which are used for benchmarking the international transactions. Thus in our view, no separate / additional allocation is called for on account of location savings..." (emphasis supplied)

Perspectives

In the market reality of perfect competition, location savings would not automatically lead to premium profits, as the same would be passed on to the ultimate customer due to competitive pressures. The UN TP Manual acknowledges this important principle. The Tribunal in the above case also echoes this view.

The UN TP Manual recognises that location savings could lead to premium profits in the initial years (in case of a first mover advantage) or where a particular entity has exclusive access to location specific advantages. However, the UN rightly acknowledges that with the passage of time, the premium would dissipate due to competitive pressures. The UN TP Manual provides an example whereby the foreign AE has a unique production intangible which enables its local subsidiary to manufacture at lower costs than competitors as such intangibles are not available with competition. In such circumstances, the owner of the intangible, i.e., the foreign AE would have the bargaining power by virtue of it owning the intangible, and would thus be entitled to the profit from such cost savings, assuming that it has a realistic alternative to undertake production elsewhere at similarly low costs using the intangible.

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2 GAP International Sourcing (I) Pvt. Ltd *v.* ACIT [2012] 25 taxmann.com 414 (Delhi)

In the above example, the cost savings are on account of the intangible and also theoretically, on account of savings arising out of operating in a low cost jurisdiction. If competitors have access to similar location specific advantages, then the premium on account of location savings would not exist. However, if that is not the case, and the foreign AE also has a realistic alternative of undertaking production in another low cost jurisdiction, then the premium would be largely allocated to the foreign AE. This would be so because the realistic alternative of undertaking production in another low cost jurisdiction available to the foreign AE significantly enhances the foreign AE's bargaining power. In the absence of any other benchmark, the relative bargaining power of the transacting parties is therefore a critical factor when determining allocation of the premium. This view is also shared by the UN in the Manual.

To summarize, taxpayers should maintain robust transfer pricing documentation and undertake a detailed FAR analysis to support the commercial conduct, relative bargaining power, competitive forces and substance of the parties to the transaction.

2. Tested Party – The right questions?

Issue

The two critical elements of a Transfer Pricing analysis, viz. The Functions, Assets and Risk analysis (FAR analysis) and the economic analysis, cannot be isolated. The selection of tested party is the first step in any economic analysis and must find it's "connect" back with the FAR analysis. The "connect" is the characterisation of the transacting entities, which a FAR analysis must necessarily conclude with. The characterisation of the transacting entities is the critical determinant in deciding which entity would be the tested party.

While the concept of "tested party" does not find any mention in Indian regulations, the concept has been laid down in the US regulations, OECD Guidelines as well as the recently released UN TP Manual.

Views from the Tribunal

In the cases summarised below, the apparent facts typically involved an Indian outbound multinational (taxpayer) with overseas subsidiaries (AEs) engaged in marketing and distribution in overseas markets.

Sr	Ruling (year)	Disputed Issue	Ratio of ruling
1	Development Consultants[3] (2008)	Selection of tested party – Whether taxpayer or the AE?	The Tribunal accepted the characterization of the AE as a distributor and selection of the AE as a tested party, since the Indian taxpayer was considered as a more complex entity. Further, the Tribunal accepted the international benchmarking exercise supporting the margins earned by the AE.
2	Mastek[4] (2012)	Whether the AE's compensation as a % of sales is at arm's length	There was no dispute about selection of AE as the tested party. Considering the significant selling functions undertaken by the AE and related risks, the Tribunal accepted that the AE's compensation can be determined with reference to sales rather

[3] Development Consultants Private Limited (79 & 80/ Kol/2008)
[4] Mastek Limited (3120/Ahd/2010)

Sr	Ruling (year)	Disputed Issue	Ratio of ruling
			than SG&A costs.
3	AIA Engineering[5] (2012)	Whether the AE's compensation as a % of sales is at arm's length	In this case involving a similar fact pattern as Mastek, the Tribunal reached a similar conclusion.
4	Onward Technologies[6] (2013)	Selection of tested party – Whether taxpayer or the AE?	While the taxpayer had selected the AE as a tested party, the Tribunal held there can be no question of substituting the profit realised by the Indian enterprise from its foreign AE with the profit realised by the foreign AE from the ultimate customers and accordingly, the margin of the taxpayer (and not the AE) has to be tested.
5	Cybertech Systems[7] (2013)	Most appropriate transfer pricing method (Internal TNMM[8] v. External TNMM)	The AE retained 12% of the client revenues for its marketing, coordination, client liaisoning, credit risk and market risk and the taxpayer had a similar arrangement with a third party. While the issue of tested party was not articulated and disputed, in its final ruling, the Tribunal has remanded the case to examine the application of internal TNMM vs external TNMM to the taxpayer's margins, thereby treating the taxpayer as a tested party.

Perspectives

As a general rule, entrepreneurs should not be considered as "tested parties" and accordingly benchmarked, since, by virtue of their complex functional and risk profiles, their margins fluctuate heavily with the vagaries of the economy, thus making comparability analysis extremely difficult and unreliable. Further, the financial results of the entrepreneur, being the ultimate fall out of third party business, often depend on external economic factors in the market and not on the internal pricing policies.

Typically, a "tested party" would be the least complex of the transacting entities, i.e. the simpler entity in terms of intensity of functions performed and risks assumed. It would not own valuable intangibles or assume significant risks. The "tested party" would be the entity to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparable data can be found. Therefore, the concept of tested party becomes relevant when selecting and applying the prescribed transfer pricing methods.

Accordingly, it is imperative for taxpayers' documentation to capture a detailed functional analysis highlighting the characterisation of the parties to the transaction in an appropriate manner and concluding the tested party based on basic principles of transfer pricing. Fundamentally, the pricing policy implemented by the taxpayer should also be aligned, which inter alia, specifies the party to the transaction who will retain the residual profit.

[5] AIA Engineering Limited (580/Ahd/2011)
[6] Onward Technologies Limited (7985/Mum/2010)
[7] Cybertech Systems and Software Limited (7303/Mum/2012)
[8] TNMM – Transactional Net Margin Method

3. Marketing intangibles – Focus on fundamentals?

Issue

Indian tax authorities have been identifying excessive advertising, marketing and promotion (AMP) expenses incurred by the Indian taxpayer by applying the brightline test and applying a markup on such expenses to allege that the taxpayer was provide a service to the foreign brand owner, for which a compensation is due.

Views from the Tribunal

The much awaited ruling of the special bench of the Delhi Tribunal in respect of marketing intangibles in the case of LG Electronics India Private Limited[9] was pronounced in January this year. The Tribunal held that TP adjustments in relation to the AMP expenses incurred by the Indian taxpayer for creating and improving the marketing intangible for and on behalf of the foreign parent company is permissible.

More importantly, the special bench has interalia, specified the following considerations which need to be applied to a taxpayers' facts in determining whether any adjustment needs to be made:

- Whether the foreign enterprise is compensating the Indian taxpayer for promotion of brand in any manner such as subsidy on goods sold to the taxpayer?
- Whether the level of subsidy is commensurate with the brand promotion expenditure?
- Whether the brand is at an entry level or at an established stage?
- Whether there have been any new product launches or continuation of existing product range?
- How the brand will be dealt with after termination of the agreement with the Indian taxpayer?

Following the LG ruling, there have been series of other rulings on marketing intangibles in the case of Rayban Sun Optics[10], Glaxo Smithkline[11], Canon India[12], Haier India[13] and Ford India[14].

Perspectives

The special bench, in the LG ruling, has discarded the concept of economic ownership of intangibles for the purpose of transfer pricing. However, a blanket dismissal of the same does not seem appropriate for the primary reason that the worth of a brand arises essentially from its usage and where its value is created or enhanced. If the significant people functions around advertising and marketing are performed by the licensee leading to brand value creation or enhancement, then the licensee becomes the economic owner of the brand to that

9 LG Electronics India Pvt. Ltd. v. ACIT [2013] 29 taxmann.com 300 (Delhi)(SB)
10 RayBan Sun Optics India Limited v. DCIT (ITA No. 5933/Del/2012)
11 Glaxo Smithkline Consumer Healthcare Ltd. v. ACIT (ITA No. 1148/Chd/2011)
12 Canon India Pvt. Ltd. v. DCIT (ITA Nos. 4602/Del/2010, 5593/Del/2011 & 6086/Del/2012)
13 Haier Appliances India (P) Ltd. V. DCIT (ITA Nos. 4680/Del/2010 & 5235/Del/2011)
14 Ford India Pvt. Ltd. v. DCIT (ITA No. 2089/MDS/2011)

extent. In which case, if the rights of the licensee impaired at the time the legal owner sells the brand, the licensee may seek compensation for the brand value created or enhanced by it, depending on the terms of the license agreement, the level of investment made in the brand by the licensee, etc. This finds support in the guidelines provided by the OECD and the Australian Taxation Office on business restructuring in the context of 'exit charge'.

The issue of marketing intangibles becomes important in the context of a distributor, who buys products from the principal manufacturer and sells the same in its jurisdiction under license to exploit the trademark or brand belonging to the legal owner. A relevant question in this regard – Is the distributor adequately remunerated for the distribution function including advertising and marketing the product or brand since the function of distribution is predominantly a service.

There is substantial guidance available on the issue of marketing intangibles in the context of a distributor in the rulings issues by the ATO and also the draft OECD guidelines on intangibles.

The answer lies in the characterisation of the distributor i.e. whether the distributor is characterised as limited risk distributor or normal risk taking distributor, as analyzed below:

Type of Distributor	Profile	Remuneration Model	Marketing Intangible / Remuneration for excess AMP expenses
Limited Risk Distributor	• Limited function and risk profile • Key people functions performed by principal • Marketing strategies determined by manufacturer – Distributor merely executes the strategy • AMP expenses incurred by Distributor - not significant • Unlikely to incur start up losses	• Low and steady returns guaranteed by the manufacturer – achieved either through (i) adjustment of pricing of products or (ii) reimbursement of expenses • Arm's length return on sales ensures AMP expenses incurred by distributor are "picked up" by principal	• Remuneration model of guaranteed return on sales automatically mitigates any further issue on account of marketing intangibles • Economic ownership and associated rewards of marketing intangibles vest with the principal
Full-Fledged Distributor	• Takes necessary decisions and performs functions with respect to Advertising & Marketing and other distribution strategies • Bears entrepreneurial risks • Can suffer start up losses, entitled to future higher profits	• Ideally remunerated with reference to gross margin and bears the volume risk – commensurate to comparable companies' gross margin having similar "intensity of functions"	• In case the "intensity of functions" i.e. advertising and marketing function intensity is higher than comparable distributors, there is a need for higher remuneration – such extra remuneration can even come either through reduction in purchase price of products and can be addressed through the intercompany pricing

Type of Distributor	Profile	Remuneration Model	Marketing Intangible / Remuneration for excess AMP expenses
			policy • Above guidance provided by Australian Revenue and the OECD • Reimbursement of AMP expenses not the only way of compensation

In addition to the above two cases, there would be a third category of taxpayers, who are entrepreneurs. Such entrepreneurs could be licensed manufacturers, who actually manufacture and sell products in their respective countries under license of intellectual property (IP) in the form of technology and brand of other companies of the group; or they could also be buy-sell entities with a high functional and risk profile.

In the case of a licensed manufacturer, it would ideally import some raw materials and spare parts from foreign group companies and also pay royalty to the legal owner of IP for the exploitation of technology and brand. The raw materials and spare parts are generally supplied by such group companies under a cost plus policy. The rate of royalty for legal ownership of the brand (which is licensed to the taxpayer), is also set using the Comparable Uncontrolled Price (CUP) method, with reference to third party license agreements available from global databases. Since the taxpayer would be an entrepreneur and accordingly a complex entity, one would not test or benchmark its results with similar comparable entrepreneurs of its country or region. The international transactions entered into by such licensed manufacturer with its foreign group entities would have been adequately tested and benchmarked under the transaction by transaction approach, as above.

The fundamental approaches to TP need to be followed by appreciating the characteristics of the entities based on the FAR profile and accordingly, selecting the correct tested party. The genesis of the entire dispute around marketing intangibles in the case of licensed manufacturers lie in the incorrect approach of TP through wrong tested party for the purpose of benchmarking analysis. It is imperative to select the right tested party and to undertake transaction by transaction analysis demonstrating that the residual profits resides in India and the Indian entrepreneur is the economic owner of the marketing intangibles.

4. Deemed International Transactions – A matured approach

Issue

Multinational enterprises enter into global contracts with suppliers and service providers, which are leveraged by their group companies. Under a global contract, the parent entities enter into an umbrella contract and their respective affiliates in the respective jurisdiction /

region enter into a separate contract to maintain consistency in the practice and products / services.

As per Section 92B(2) of the Act, a transaction entered into with a person other than AE shall is deemed to be a transaction between two AEs, if there exists a prior agreement in relation to the relevant transaction between such other person and the AE or the terms of relevant transaction are determined in substance between such other person and the AE.

Views from the Tribunal

A recent ruling by the Mumbai Tax Tribunal in the case of Kodak India[15] is relevant. Kodak India sold its medical imaging business to Carestream India. The TPO invoked provisions of section 92B(2) and proceeded to determine its arm's length price on the premise that this transaction was an international transaction and had been undertaken pursuant to a larger sale transaction, wherein, the holding company of Kodak India (Kodak US) had sold its imaging business to the holding company of Carestream India (Carestream US) on a global basis.

Though the domestic transaction was a consequence of the global agreement, the Tribunal held that there was no prior agreement, and/or terms and conditions for sale were not dictated by the overseas agreement and interalia relied on the following aspects:

a) Terms and conditions of the sale were determined solely by Kodak India and Carestream India and not by Kodak US.

b) Valuation of the business was undertaken by Kodak India through its independent valuers.

c) Kodak US did not charge Kodak India any fees in relation to this sale transaction.

d) Kodak India received entire sale proceeds, and nothing was transferred to Kodak US.

e) Further, from a reading of the global agreement between the holding companies, the global agreement did not have any role in/ effect on the sale transaction between the domestic companies.

Accordingly, section 92B(2) would not be triggered.

It is also worthwhile to note a recent Delhi High Court judgement in the case of Stratex Net Works[16], wherein an Indian taxpayer had agreements with local clients to install and maintain equipment supplied by its overseas associated enterprises. In this case, the High Court upheld the Tribunal's ruling that the installation and maintenance services were not deemed international transactions u/s 92B(2) because none of the conditions stipulated u/s 92B(2) existed.

Perspectives

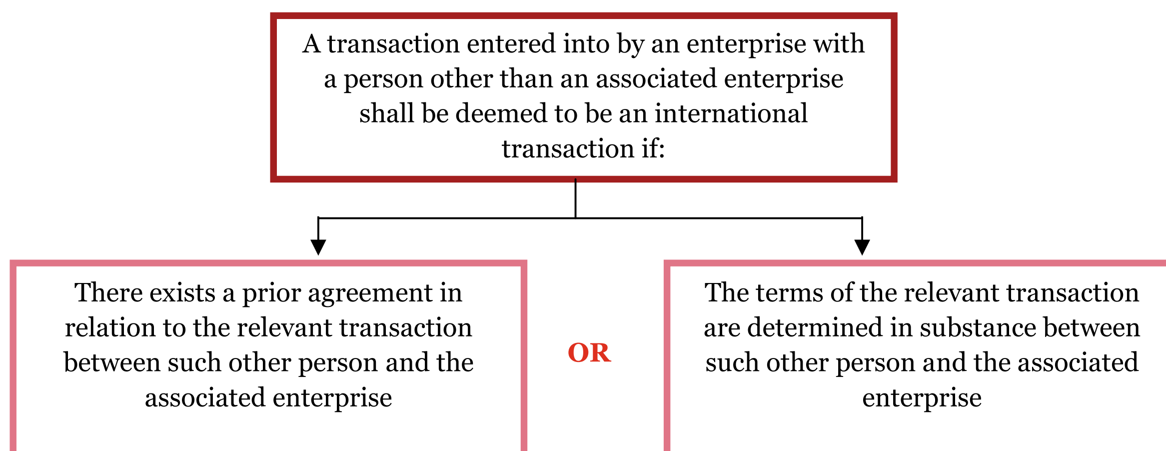
In the Kodak case, the Tribunal discussed the provisions of section 92(1), section 92A(1) and section 92B(1), and the inter-linkage between them, to establish that they all relate to an international transaction between AEs, where both the AEs are non-residents or at least one of them is. Further, the Tribunal also concluded that section 92B(2) cannot be read

[15] Kodak India Private Limited (7349/Mum/2012)

[16] Stratex Networks (India) Private Limited (353/2011)

independent of section 92B(1), and thus section 92B(2) cannot apply to transactions between domestic entities. A similar judicial precedent was laid down in the Tribunal ruling in the case of Swarnandhra[17].

Having said that, there are two other, and very critical, preconditions for the applicability of section 92B(2), failing which, section 92B(2) could cease to apply ie (i) the existence of a prior agreement between the other entity and the AE in relation to the relevant transaction, or (ii) there should be AE involvement in determining the terms of the transaction.



Accordingly, the deeming provisions should not apply where there are appropriate underlying agreements and all other documentation which supports the independent nature of the relevant transaction (delinked from any AE involvement). Needless to say, the conduct of the parties would need to necessarily conform to the underlying agreements and other supporting documentation.

5. Contract Research and Development – the path to profit splits!

Issue

In some cases, Indian Tax Administration has disregarded a "contract R&D service provider" adopting a cost plus service model and applied a PSM to determine the service provider's compensation, on the basis that the service provider develops the intangibles through the R&D functions virtually on its own.

The India chapter in UN TP Manual specifically takes an example of contract R&D activities undertaken by Indian related parties of MNEs, and the Indian administration has objected to these entities being risk free entities entitled to (low) cost plus remuneration. The Indian administration has challenged the ability of the overseas group entity to exercise control remotely, and has stated that most overseas group entities are unable to submit relevant documents to justify their claim of exercising control. The Indian administration has further contended that the Indian related parties undertake the core R&D activities and their monitoring, and also take strategic operational decisions and decisions relating to allocation of budget (although the funds are provided by overseas group entities), and thus control substantial part of the risks. Based on the above, the Indian administration has stated that in

[17] Swarnandhra IJMII Integrated Township Development Co. Pvt. Ltd. v. DCIT (ITA No. 2072/Hyd/2011)

such cases, it believes that allocation of routine cost plus return to the Indian related parties will not be arm's length.

Further, the Central Board of Direct Taxes (CBDT) has recently come out with two circulars – (i) on identification of contract R&D service provider with insignificant risk and (ii) on application of profit split method. Under this Circular, the CBDT has emphasised on "substance" at the level of the foreign principal, as summarised below.

Particulars	Foreign Principal	Indian Development Centre (IDC)
Economically significant functions	✓	IDC is largely involved in economically insignificant functions
Funds/capital and other economically significant assets including intangibles	✓	IDC does not use any other economically significant assets including intangibles
Capability to control or supervise R&D function through its strategic decisions to perform core functions as well as monitor activities	✓	IDC works under direct supervision of foreign principal
Assumption of Risks	✓	IDC does not assume or has no economically significant realised risks
Ownership right (legal or economic) on outcome of research	✓	IDC has no ownership right on outcome of research which shall also be evident from conduct of the parties

Further, the CBDT has discouraged the use of transfer pricing methods [like TNMM] that seek to estimate the value of intangible based on cost of intangible development (R&D cost) plus a return and preferred the application of profit split methods.

Views from the Tribunal

Recently, the Delhi Tribunal[18] made some interesting observations in relation to Contract R&D services, as under:

> *"Identification of risk and the party who bears such risks are important steps in comparability analysis. The conduct of the parties is key to determine whether the actual allocation of risks conforms to the contractual risk allocation. Allocation of risk depends upon the ability of the parties to the transaction to exercise control over risk. Core functions, key responsibilities, key decision making and level of individual responsibility for the key decisions are important factors to identify the party which has control over the risks.........The notion that risk can be controlled remotely by the parent company and that the Indian subsidiary engaged in core functions, such as carrying out research and development activities or providing services are risk free entities is something which needs to be demonstrated by the assessee."* (emphasis supplied)

The question as to "who exercises control" is a factual exercise i.e. the significant people functions and conduct of the parties involved must be necessarily substantiated and documented by taxpayers.

Perspectives

[18] GE India Technology Centre Pvt. Ltd. v. DDIT (ITA Nos. 789/Bang/2010, 487 & 925/Bang/2011)

As regards the comments of the Indian tax administration on "allocation of risks", the same appears to be a very generalized one. Evaluation of structures would have to be case specific and would need to be undertaken independently based on a review of the significant people functions and conduct of the parties in each case.

The UN has adopted a more pragmatic approach on such operational structures, which can be observed from the two examples which have been put forth in the UN TP Manual entailing performance of R&D activities. In one example, control is exercised by the subsidiary, while in the other example, control is exercised by the parent. Therefore, the UN distinguishes the entity which exercises 'control' based on ability to take strategic decisions, monitoring activities of the other entity, bearing risk of unsuccessful R&D, controlling the budget for R&D activities, etc. Even the OECD in its recent discussion draft on intangibles, reiterated vide examples 9 to 11 of the discussion draft, that the entity which performs key people functions, controls associated risks is entitled to intangible related returns for the R&D activity.

The answer to the question as to who exercises control is based on a factual analysis. If the Indian taxpayer has to win an argument on facts, then, needless to say, the facts must be entirely substantiated and documented. Notably, even in the examples in the UN TP Manual, significant reliance is placed on evidence put forth to substantiate claims relating to who exercises control.

As regards the CBDT circulars, it appears to be a very welcome move on the part of the CBDT in proactively introducing guidelines and clarifications in the form of the above circulars. These put additional onus on the taxpayers to have robust documentation in place to establish the functional profile of the India R&D centre to demonstrate that it is low risk service provider bearing insignificant risks. At the same time, the profile and functional analysis of the overseas principal alongwith the group organization structure should also receive focused attention.

6. Foreign exchange fluctuations – Rupee @ 60?

Issue

The need to make comparability adjustment for accuracy and reliability is laid out in Rule 10B and the OECD guidelines and has been endorsed by various Tax Tribunal rulings. An adjustment to factor in the foreign exchange fluctuation is one such adjustment gaining importance for importers owing to the recent steep depreciation of Indian Rupee (INR).

Foreign exchange risk can be of two types, (1) transactional risk, is the risk of exchange fluctuation between the time transactions are committed and settled. (2) transfer pricing policy risk, is the risk associated with the time lag between budgeting and actual transaction. The long term risk is therefore embedded in the transaction value (i.e. imports or exports). This is illustrated below for import transactions, say in USD, and there is devaluation in the local currency, say INR):

Particulars	Legend	FY 2011-12	FY 2012-13
Quantity of import	(1)	100 Kg	100 Kg
Import price in foreign currency (USD)	(2)	50 per Kg	50 per Kg
Foreign exchange rate	(3)	45	55
Total purchase cost (in INR)	(1)*(2)*(3)	225,000	275,000

Incremental charge to P&L owing to depreciation in INR		-	50,000

From an Indian accounting standpoint, the impact of a short term risk is represented as foreign exchange gain/ loss (net) in the P&L account of any enterprise[19]. Whereas, the impact of long term risk is embedded in the value of imports or exports as the case may be and is not disclosed separately in the P&L Account.

Views from the Tribunal

A recent ruling by the Mumbai Tax Tribunal in the case of Honda Trading Corp India Private Limited[20] (Honda India), has endorsed the need to adjust for long term risk due to foreign exchange fluctuation. Honda India was engaged in buying and selling of certain auto components and had agreed its sales price to customers after considering the past six months foreign exchange rate (INR to Thai Baht). However, the imports from its AE were undertaken at the exchange rate prevalent as on the date of transaction (spot rate). Contrary to Honda India'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 the customers and could not be changed. Since imports became costlier and sale price did not change, Honda India incurred losses. To eliminate the impact of depreciation in INR, Honda India 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 disregarded the adjustment put forth by Honda India, and made a transfer pricing adjustment.

However, the Tribunal acknowledged the depreciation in INR to be an important factor, materially affecting the price in the open market and held that for a credible comparison with comparables, the difference on account of foreign exchange rate fluctuation should have been removed, and the margin of the taxpayer should have been accordingly adjusted.

After providing its' in principle sanction on adjustments on account of working capital, risk, capacity utilization, 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 on their margins, of continued depreciation in INR.

Perspectives

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

It is also pertinent to note that, as against making an adjustment to the comparables as per Rule 10B of the Income Tax Rules, the Tribunal has directed to make the adjustment to the numbers / margin of the tested party. A similar approach (adjustment on numbers / margin of tested) has also been endorsed by various Tribunal rulings[21].

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[19] This includes realized as well as unrealized (owing to conversion of balances at year end) exchange gain/ loss.
[20] Honda Trading Corp India Private Limited v. ACIT (ITA NO. 5297/DEL/2011)
[21] Fiat India Pvt. Ltd. (1848/Mum/2009)
Brintons Carpets Asia P Ltd { (2011) 139 TTJ (Pune) 177; (2011) 57 DTR 121},

Concluding remarks

While the rulings discussed and issues covered are diverse, the following common themes emerge for taxpayers to focus on:

- Functional analysis, including on the functions of the overseas AEs
- Substance through evidence and conduct
- Complex issues like location savings and marketing intangibles need to be addressed as part of the industry and functional analysis
- Finally, fundamental tenets of transfer pricing need to form the bedrock of any transfer pricing analysis!

Taxpayers need to consider the impact of the above significant Tribunal rulings and the perspectives shared, in their transfer pricing planning and risk assessment. The recently introduced Advance Pricing Agreement framework affords the right opportunity to taxpayers to apply and agree on these principles and create certainty for their long term.

Amdocs Business Services Pvt. Ltd. {[2012] 54 SOT 46 (PUNE)(URO)/[2012] 26 taxmann.com 120 (PUNE)},
Brigade Global Services Pvt. Ltd. {ITA No. 1494/Hyd/2010 (AY 2004-05), ITA No. 988/Hyd/2011 (AY 2005-06)},
Skoda Auto (30 SOT 319),
Demag Cranes & Components (India) Pvt. Ltd. [49 SOT 610 (Pune)],
Transwitch (India) Pvt. Ltd. (ITA No.6083/Del/2010),
Toyota Kirloskar Motors Pvt. Ltd. (ITA No.828/ Bang/ 2010),
Capgemini India Private Limited (ITA No.7861/Mum/2011)

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