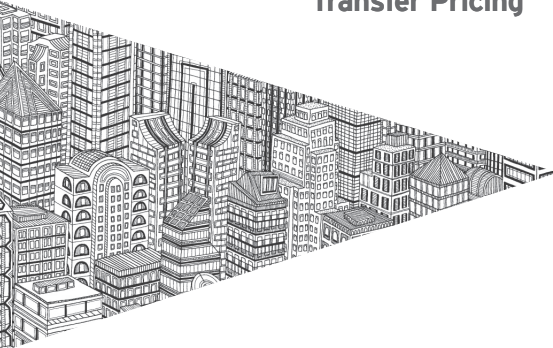


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Transfer Pricing



Delhi Tribunal ruling on transfer pricing issues in the case of a captive service provider

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Executive summary

The Delhi Income-tax Appellate Tribunal (Tribunal), in a ruling¹ in the case of *M/s. ST Microelectronics Private Limited* (Taxpayer) has adjudicated on certain transfer pricing (TP) issues with respect to transactions entered into by the Taxpayer with its associated enterprises (AEs). The Taxpayer in this case is an Indian company engaged in providing integrated circuit design and software development services to its AEs. The Taxpayer's transfer pricing documentation supported its margins on total costs (operating margins/operating costs) in the range of 9% to 11% as being arm's length for the relevant years under dispute. The Transfer Pricing Officer (TPO) made adjustments to the margins in the range of 17% to 18%. The TPO determined the adjustment by relying on only the relevant financial year comparable data (as opposed to the Taxpayer's use of multiple year data) and identifying comparable companies based on quantitative and qualitative criteria not considered by the Taxpayer. In addition, the TPO denied the benefit of a 5% range around the comparable company benchmark. Subject to allowing the marginal relief provided by the first appellate authority to the Taxpayer for two of the three years under dispute, the Tribunal largely upheld the adjustments made by the TPO.

Consistent with earlier rulings, the Tribunal held that multiple year data cannot be used in all cases but has to be used in limited circumstances where such data has an influence on the determination of the transfer

¹ 2011-TII-63-ITAT-DEL-TP.

price. With respect to the approach of the taxpayer on selection of comparables, the Tribunal held that the operations carried out by the Taxpayer within India are to be compared with other taxpayers and not with its AEs. It is not relevant that the Taxpayer is rendering routine services vis-à-vis its AEs in the value chain within the group. The Tribunal also held that the TPO is not required to record a specific finding before proceeding to select fresh comparables if it is established by the TPO that the taxpayer has not considered various aspects and has not applied appropriate filters while identifying comparables. With respect to the benefit of the +/- 5% range, the Tribunal held that the tolerance band provided in Indian tax law (ITL) should not be construed as a standard policy. If the transfer price shown by the taxpayer was outside the 5% range of the arm's length price (ALP) determined by the TPO, then the benefit of the range is not available.

Background and facts of the case

The Taxpayer, an Indian company, is engaged in the business of rendering integrated circuit design and software development services to its AEs. During the three financial years (FYs) 2002-03 to 2004-05, the Taxpayer, based on a TP study, submitted that its operating profit on operating costs was within the arm's length range permitted by ITL and accordingly, the international transactions are at arm's length. In the TP study, the Taxpayer characterized itself as a low risk captive service provider performing

routine service functions in the value chain of semiconductor chip design. The Taxpayer selected companies engaged in software development services as comparables.

During the audit proceedings, the TPO held that the Taxpayer had characterized its functional profile improperly and had selected incorrect comparables by applying wrong quantitative and qualitative filters. After undertaking a functional analysis of the Taxpayer, the TPO noted that the Taxpayer had one of the largest design centers of the group outside of Europe and was engaged in high end intangible creation activity. The Taxpayer also employed highly qualified, experienced and skilled engineers and designers for undertaking its functions. Thus, the TPO characterized the Taxpayer as a performer of high end activity relating to a value added segment of "embedded technologies."

The TPO observed that the Taxpayer had treated all companies engaged in software development services at par without making an analysis of their position in the value chain. The TPO also observed that use of multiple year data is not permissible in the law. After pointing out the defects in the selection of the comparables by the taxpayer, the TPO conducted a fresh comparable search and made an upward TP adjustment to the value of the international transactions undertaken by the taxpayer without giving the benefit of the 5% range.

The Taxpayer had an operating margin on cost in the range of 9% to 11% for the three years under dispute. The TPO made adjustments to the margins in the range of 17% to 18%. Being aggrieved by the TPO order, the Taxpayer made an appeal at the first-level appellate authority for the FYs 2002-03 and 2003-04. The first appellate authority provided marginal relief to the Taxpayer and primarily decided the matter in favor of the revenue authority. For FY 2004-05, the Taxpayer filed its objections with the Dispute Resolution Panel (DRP), an alternate dispute resolution mechanism under ITL. The DRP upheld the TP adjustment proposed by the TPO.

The Taxpayer filed an appeal before the Tribunal, the second level appellate authority, against the TP adjustment.

Ruling of the Tribunal

Single year data versus multiple year data

According to the Tribunal, the use of the expression "shall" in the ITL makes it abundantly clear that current year data of an uncontrolled transaction is to be used for the purpose of comparability. Hence, it is mandatory to first use the current year data. If certain other circumstances indicate an influence on the determination of arm's length transfer pricing for the transaction, other data for a period not more than two years prior to such financial year may be used.

Functional analysis and characterization of the taxpayer

The crucial issue to be examined in determining whether the Taxpayer is a high end service provider or a low end service provider is the importance of the role performed by the taxpayer vis-à-vis the role performed by similarly situated companies in an uncontrolled business environment. The operations carried out by the Taxpayer within India are to be compared to other taxpayers and not to its AEs.

The product produced by the Taxpayer is of a complex nature requiring a skilled work force. The Taxpayer has employed more than 1,600 people and it has one of the largest design centers outside of Europe. Thus, the Tribunal ruled the TPO rightly characterized the Taxpayer as a high end service provider.

Approach of the TPO

The comparability between a controlled transaction and uncontrolled transaction is a comparison of condition, which is broader than a mere comparison of price or margin. Where it is found that the conditions differ from those that would exist between independent enterprises, transfer pricing adjustments are to be made. The TPO has to appreciate the TP study submitted by the taxpayer on reasonable basis as well as prima facie.

In this case, the TPO, while evaluating the TP study made by the Taxpayer, arrived at a conclusion that the Taxpayer had

not considered various aspects conditions and had not applied appropriate filters while identifying comparables. These aspects were highlighted in order by the TPO before undertaking a fresh search for comparables. This exercise had been done after giving the Taxpayer adequate opportunity to hearings. The TPO is not required to record a specific finding before proceeding to select fresh comparables.

Thus, there is no error in the procedure adopted by the TPO for carrying out a fresh search in identifying new comparables. The TP documentation prepared by the Taxpayer indicated that different filters for selecting or eliminating the comparables, were applied in a manner that would give the result close to the financial result disclosed by the Taxpayer. Therefore, this issue was decided against the Taxpayer in all three years.

Selection of the comparable data

The comparability factors laid out in ITL indicate that various aspects of the intercompany transaction (such as the nature of the property/services, contractual terms, functions, assets and risks, etc.) vis-à-vis uncontrolled transactions are to be kept in mind while determining the ALP of an intercompany transaction. Reasonably accurate adjustments can be made to eliminate the material effects of any differences.

The ALP of an intercompany transaction cannot be determined with mathematic precision. The TPO made efforts to identify

comparables whose functions are similar to the Taxpayer. The TPO applied filters, quantitatively as well as qualitatively, to neutralize and eliminate the differences between the operations of the Taxpayer and the comparables that operate in uncontrolled conditions. The TPO started the investigation in a timely manner and provided sufficient opportunity to the Taxpayer for comments. The TPO rightly rejected the TP study of the Taxpayer.

With respect to the inclusion of Infosys Technologies Ltd as a comparable, the Tribunal held that the TPO considered this aspect and if a turnover filter is applied, this comparable ought to have been excluded. However, the Taxpayer itself did not apply this filter in its study and, hence, the contention of the Taxpayer has no merit.

Benefit of the range

The benefit of a +/- 5% range in ITL should not be construed as a standard policy. If the transfer price shown by the Taxpayer was outside the 5% range of the ALP determined by the TPO, then the benefit of the range is not available. Consequently, the TP adjustment should be made to the arithmetic mean determined by the TPO and not to the lower end of the range.

Comments

Globalization has led many multinational enterprises to establish information technology, research and development (R&D), and back office operations in India. Generally, the Indian affiliates providing services operate as

“captive service providers” and are insulated from business risks. The taxpayers operating as captive service providers have been subject to significant transfer pricing adjustments in the past few years.

This ruling highlights the importance of adequately documenting key issues such as justification for use of multiple year data, differences in functions and risks between the tested party and

the comparables and justification for use of quantitative filters for accepting/ rejecting comparable company data. The ruling specifically recognizes the use of qualitative as well as quantitative criteria to include or reject potential comparables. The ruling also highlights that undertaking a broad based analysis of the taxpayer’s circumstances, which takes into account industry factors

and analysis of the taxpayer’s value chain, is an essential step in a comparability analysis. The Tribunal’s ruling that a 5% range should not be construed as a “standard deduction” but should be seen as a “tolerance band” could be a concern for taxpayers. The interpretation appears to be inconsistent with a number of other rulings on the matter.

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