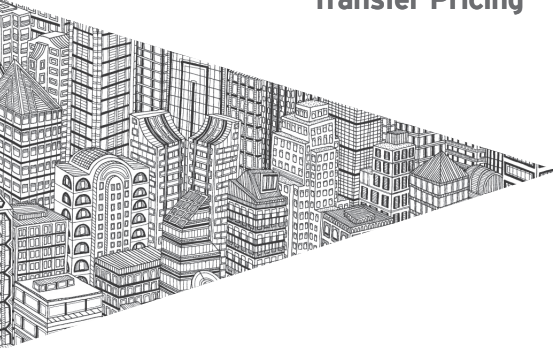


International Tax Alert

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Transfer Pricing



Mumbai Tribunal ruling on transfer pricing issues

**“Cost only” reimbursement unjustified, taxpayer’s
aggregation approach inappropriate**

Executive summary

The Mumbai Income-tax Appellate Tribunal (Tribunal), in a ruling¹ in the case of M/s. Exxon Mobil Company India Private Ltd (Taxpayer) has adjudicated on certain transfer pricing (TP) issues with respect to transactions entered into by the Taxpayer with its associated enterprises (AEs).

The Tribunal held that “cost only” reimbursement (without any mark up) is not justifiable as no part of the income derived by the AE from the activity of the Taxpayer is shared with the Taxpayer and the entire benefit of the activity is enjoyed by the AE. The Tribunal also agreed with the findings of the Transfer Pricing Officer (TPO) that the taxpayer would not have rendered similar services to any third party without charging any mark up.

The Tribunal also held that the aggregation approach adopted by the taxpayer is not appropriate. The Tribunal held that use of data from two years prior to the subject transactions is only an exception subject to the burden of proof on the Taxpayer to demonstrate that the prior year data has an influence on the determination of arm’s length price. The Tribunal stated a general point that it is not acceptable to assume multiple year data would provide for better comparability. The Tribunal held, as a general principle, both loss making comparable companies and high profit companies cannot be eliminated from the analysis unless, there are specific reasons for eliminating the same. The basis of elimination should be other than the general reason that a company has incurred a loss or made abnormal profits. In the context of rejecting a loss making company, the Tribunal observed that as the taxpayer is a captive unit that does not

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1 ITA No. 8311/Mum/2010; as reported in <http://www.itatonline.org>.

bear market risk, a company that has incurred losses on account of level of competition in the market cannot be used as a comparable.

Background and facts of the case

The Taxpayer, an Indian subsidiary of Exxon Mobil Corp (an international oil and gas company), is engaged by its associated enterprises to provide research and development services, back office support services and marketing support services. For the financial year 2005-06, the Taxpayer reported its operations as follows:

1) Technical services segment - comprising application research, application of technical development services and promotion of licensing of technology, 2) Back office support segment - services rendered to AEs on a cost plus arrangement and 3) Marketing support services segment - comprising services for market development, disseminating information and soliciting business in India for the AE.

The technical services segment revenues comprise a) application research activity for which only direct and indirect cost incurred by the Taxpayer is reimbursed by the AE, b) compensation of cost and travelling expenses of managers/engineers with a markup of 10% by the AEs and c) promotion services for licensing of technology compensated on a lump sum basis. The Taxpayer aggregated the above services and concluded the net margin earned from all technical services to be at arm's length in the documentation study. During the TP audit, the "cost only" reimbursement for application research and the

cost allocation of personnel expenses from technical services to marketing services segment was challenged by the TPO. The TPO segregated the activities undertaken in the technical service segment, considered updated margins using single year data and excluded loss making/low margin companies to arrive at the arm's length margin. The TPO determined the TP adjustment for the application research activity priced by the Taxpayer under a cost only reimbursement model. While the TPO provided working capital adjustments, the Taxpayer's risk adjustment analysis using a Capital Asset Pricing Model was rejected citing various shortcomings of the model.

For the back office support services, even though the Taxpayer earned a net margin of 21%, more than double the contractual arrangement of 10%, and determined the international transaction to be at arm's length, the TPO rejected the actual margins for the back office support services and considered the contractual markup for the purpose of comparison.

For the marketing support services, the Taxpayer was remunerated on a percentage of net sales basis. The net margin earned from this segment was accepted and the international transaction was determined to be at arm's length.

Being aggrieved by the TPO order, the Taxpayer filed its objections with the DRP, an alternate dispute resolution mechanism under the Indian Tax Law (ITL). The DRP passed its directions as follows:

- ▶ With respect to the comparability analysis for the technical service transaction, DRP upheld the rejection of two loss making companies. However, DRP directed to include the low margin company in the comparable list and determine the ALP.
- ▶ With respect to the back office support services, DRP observed that the AO cannot ignore the actual mark-up earned by the Taxpayer while comparing the net margin with the arm's length margin so determined. If the actual margin of the Taxpayer falls within the permissible 5% range, no adjustment is warranted. However, the AO while passing the final order disregarded the DRP directions and proceeded with the adjustment for the back office support services transaction.

Ruling of the Tribunal

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

"Cost only" reimbursement

The reimbursement of the cost incurred (without any mark up) is not justifiable as no part of the income derived by the AE from the activity of the Taxpayer is shared with the Taxpayer and the entire benefit of the activity is enjoyed by the AE. The Tribunal also agreed with the findings of the TPO that the taxpayer would not have rendered similar services to any third party without charging any mark up. As the Taxpayer has not received any compensation for the services rendered, a TP adjustment

for the technical services undertaken on a cost only basis is justified.

Aggregation of transactions

Consistent with earlier rulings, the Tribunal held that the aggregation approach adopted by the Taxpayer is not appropriate since the activity of promoting licensing of technology cannot be combined with application research activity undertaken by the Taxpayer.

Single year data vs multiple year data

The ITL provides that the data to be used in analyzing the comparability of uncontrolled transactions with an international related party transaction shall be the data relating to the relevant financial year in which the intercompany transaction was entered into. The use of the data two years prior is only an exception and has a limited role to the extent the same has an influence on the determination of the transfer prices in relation to the intercompany transaction that is being compared. The burden is on the Taxpayer to demonstrate that the previous year's data has an influence on the determination of the subject year arm's length price and in absence of specific supportive evidence, the contention of the Taxpayer to use multiple year data to arrive at better results is not acceptable.

Exclusion of high profit making companies

A higher profit making unit cannot be automatically eliminated just because the comparable company earned higher profits than the average. The Tribunal held that as a general principle, both loss making companies and high profit making companies cannot be eliminated from the comparables analysis unless, there are specific reasons for eliminating the same, which is other than the general reason that a company has incurred loss or made abnormal profits. While considering the Taxpayer's objections to the rejection of a loss making company, the Tribunal observed that the loss incurred by the potential comparable was due to the level of competition in the market. As the Taxpayer's functional profile is of a risk mitigated service provider, a circumstance of incurred loss due to increased competition does not exist in the case of the Taxpayer. Accordingly, the Tribunal upheld the rejection of the loss making company as a comparable.

DRP directions to be followed by AO

For the back office services transaction, although the Tribunal did not rule on the correctness of the directions passed by the DRP regarding actual margins versus contractual arrangement, it held that the directions of the DRP have

to be followed by the AO while issuing the final order under section 143(3) r/w section 144C(13) of the ITL.

Comments

In recent years, the arm's length transfer price for intra-group services has become one of the critical transfer pricing issues in India. This ruling emphasizes that under the arm's length principle, based on the overall benefit derived from undertaking a particular activity, the parties to the intercompany transaction need to be adequately compensated and a "cost only" charge for intra-group arrangements may not sustain the test.

The ruling also highlights the importance of adequately documenting key issues such as justification for use of multiple year data, rationale for inclusion of loss making companies and / or exclusion of high profit companies and the need to ensure that selection of comparable data is consistent with the functional and risk profile of the tested party.

In light of the present ruling, it would be useful for multinational enterprises with Indian affiliates to review the impact of the principles emerging from this ruling on their transfer pricing policy and documentation.

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