



Mumbai Tribunal rules that application of TNMM at the entity level not appropriate and high degree of comparability required under the CUP method

In determining the arm's length price, the Mumbai Bench of the Income-tax Appellate Tribunal (Tribunal), in the case of UCB India Private Limited (UCB)¹ rejected the Transactional Net Margin Method (TNMM) adopted by the taxpayer at the entity level and also rejected the Comparable Uncontrolled Price method (CUP) adopted by the Revenue for lack of information and data on the comparables. The Tribunal remanded the matter to the Assessing Officer (AO) for fresh adjudication with specific directions.

Facts of the Case

- UCB, a wholly owned subsidiary of a Belgian Pharma Company [UCB S.A. (AE)], is engaged in the business of manufacture and marketing of prescription drugs in certain therapeutic areas.
- The international transactions of UCB include, *inter alia*, purchase of two Active Pharmaceutical Ingredients (APIs) i.e. "Piracetam" and "Mesna" from its AE for INR 45.70 million.
- The finished drug formulations (FDFs) manufactured out of Piracetam is sold by UCB under the brand name "Nootropil" and Mesna is marketed under the brand name "Mistrabun".
- The APIs are purchased by UCB only from its parent company (i.e. the AE) and the parent company does not sell these two APIs to any other company in India
- In its transfer pricing analysis, UCB characterized itself as a 'licensed manufacturer' exposed to less than normal risks associated with carrying out such business operations.

¹ *UCB India Private Limited V. ACIT* [Source: I.T.A. No.428 & 429 /MUM/2007 (Mumbai ITAT)]

- 50 percent of UCB’s production is from APIs imported from the AE and the balance is production from APIs purchased from Non-AEs. UCB also undertakes trading activity.
- UCB selected TNMM as the most appropriate method on an entity wide basis. The price paid to the AE for purchase of APIs was concluded to be at arm’s length upon comparison of the operating profit margin earned by UCB (27.54 percent) with the arithmetic mean of the operating profit margin of thirty-six comparable companies (8.86 percent).
- During the course of the proceedings before the Transfer Pricing Officer (TPO), UCB expressed its difficulty in furnishing the details of prices charged by the AE to other independent customers in different countries on the ground that it was not in possession of such details.
- The TPO issued notice² to three companies which are competitors to UCB’s products and sought information on the purchase price of the two APIs.
- The TPO also summoned the managing director and marketing manager of UCB and questioned them on oath.
- The TPO determined the arm’s length price for the import of APIs by applying the CUP method, based on the prices obtained from the three competitor companies as under:

API	Purchase Price (INR per kg)	Comparable Price (INR per kg)	TP Adjustment (INR)
Piracetam	1,700	381	20,444,500
Mesna	32,385	27,075	531,000
Total -			20,975,500

- Aggrieved by the TPO’s order, UCB filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)]. However, the CIT(A) dismissed the contentions of UCB and upheld the TPO’s assessment. Aggrieved by the decision of the CIT(A), UCB appealed before the Tribunal. The appeal was preferred for Assessment Years 2002-03 and 2003-04 as the grounds were common.

Taxpayer’s Contentions

- UCB submitted that it had complied with the mandatory documentation requirement as prescribed under Rule 10D(1) of the Income-tax Rules, 1962 (the Rules) and justified its selection of TNMM as the most appropriate method.
- As regard non-furnishing of invoice details of prices charged by the AE to third parties, UCB contended that the tax authority cannot

² Under section 133(6) of the Income-tax Act, 1961 the Revenue authorities (including the TPO) have been vested with an authority to call for relevant information. The Revenue authorities may require any person to furnish information on such points/matters, which in the opinion of the tax authorities may be relevant for proceedings under the Act.

insist on the taxpayer to furnish information which is either not in its possession or is not required to be maintained under the Rules. UCB was ready to file, as additional evidence, sample invoices issued by the AE to third parties located in USA and Indonesia which evidenced that the price at which the APIs were sold to UCB was lower than that at which it was sold to the third parties.

- UCB contended that APIs procured by it from the AE cannot be compared to those selected by the TPO for CUP analysis on the following parameters:
 - the AE is a pioneer in these drugs and spends 15 percent of its turnover on research and development
 - high technical specifications and standards maintained by the AE
 - higher purity levels of the said APIs manufactured by the AE
 - higher market share of UCB's FDFs in spite of the higher price demonstrates higher quality, efficacy and proven standards
- UCB had discharged the burden of proof cast on it by doing a proper transfer pricing study and therefore the burden of proof shifted to the Revenue; and the Revenue has not discharged the proof.
- Comparison of net margins needs to be given a rational interpretation. A transaction-wise TNMM analysis may not be always possible on account of:
 - Non-availability of segmental data of the comparables in the public domain
 - Segmental data may not be available with the taxpayer; no statutory requirements to maintain segmental data and segregation of costs relating to different products is not practical

Key issues for consideration before the Tribunal

- Whether the taxpayer failed to maintain and produce the documents required by law; and
- Whether the taxpayer failed to discharge the onus cast upon it to determine the arm's length price in accordance with the most appropriate method.

Tribunal's Observations and Ruling

Maintenance of prescribed documentation

- Substantive compliance should be the criteria and the test should be as to whether non-maintenance/deficiency in maintenance of some records fundamentally effects or distorts the computation of arm's length price; if it does not make a material difference then the effect is not fatal.
- Where no records relating to market analysis, budgets, forecasts, and price negotiations are prepared, the same need not be furnished.

The Tribunal held that UCB had substantially complied with the law in respect of maintenance of prescribed documentation.

TNMM Analysis undertaken by UCB

- The Tribunal disapproved the use of TNMM analysis on an entity wide basis by UCB. The Tribunal observed TNMM refers to only net profit margin realized by an enterprise from an international transaction or a class of such transactions, but not operational margins of the enterprise as a whole.
- The class of transactions of an enterprise may be evaluated on an aggregated basis in cases where only similar transactions are undertaken, i.e. all the transactions are of the same type; same class and of similar variety and the enterprise does not have any other transaction which is not similar.
- The Tribunal did not accept UCB's arguments that it was not practically possible to look at transaction level margins. It held that if a taxpayer wants to adopt a particular method as the most appropriate method, then it is the taxpayer's duty to maintain and furnish the required data.

CUP Method adopted by Revenue

- Just because CUP method is the only direct method, it does not automatically become the most appropriate method. Much depends on the availability of data on comparables.
- CUP method requires a high degree of comparability. Under the CUP method, product comparability is absolutely key, in particular physical features such as size, weight, appearance along with volume, reliability/storage requirements, regulatory requirements etc. Pricing of product is a very subjective exercise.
- The Revenue's contention that the APIs imported by UCB were identical/ similar to the APIs purchased by chosen comparables was held to be erroneous and without any suitable basis. The Tribunal noted that there should be some scientific basis to demonstrate that the products were identical with the same purity, potency and characteristics.
- The Tribunal rejected the adoption of the CUP method by the Revenue on the basis that it suffers from many deficiencies and infirmities, specifically the lack of information and data on comparables.

Ruling

- The Tribunal noted that as the transfer pricing regulations were relatively new, the case requires special consideration.
- The matter was remanded to the AO for fresh adjudication with specific directions that if external comparables are not available due to lack of data in the public domain, the AO may accept internal comparables including segmental data or internal TNMM.
- While so remanding, the Tribunal allowed UCB to adopt any method prescribed under law that it considers as the most appropriate method. It also allowed UCB to submit additional evidences, information and fresh transfer pricing study to support its case.

Our Comments

This Tribunal ruling emphasizes the importance for companies to maintain detailed segmental information of transactions with AEs and non-AEs and the basis of pricing of the international transactions.

Another key proposition re-affirmed by the Tribunal is that once the Revenue is not satisfied with the taxpayer's determination of arm's length price, the onus is shifted to the Revenue.

Given that the transfer pricing regulations are relatively at a nascent stage in India, rather than remanding the matter to the AO, adjudication by the higher level appellate authorities on case specific principles would go a long way in settling divergent views on contentious issues.

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