



Appropriate Economic Adjustments may be Required to Increase Comparability

The Pune Bench of the Income-tax Appellate Tribunal (Pune Tribunal), in the recent case of Skoda Auto India Pvt. Ltd. (SAIPL)¹ held that appropriate economic adjustments may be required while undertaking comparability analysis to account for differences in functional profile under different business models. The comparability analysis should also consider unusually high costs incurred by the taxpayer during its start-up phase. While so holding, the Tribunal referred the matter back to the Transfer Pricing Officer (TPO) for fresh adjudication with specific instructions.

In addition, the Tribunal re-affirmed the availability of the benefit of +/- 5 percent range (safe harbour provisions) to the taxpayers. This is in line with the recent rulings of co-ordinate benches in this regard.

Facts of the Case

- SAIPL, an Indian Company, is engaged in the business of manufacturing and selling passenger cars. The company was incorporated in India on 23 December 1999. The financial year for consideration before the Tribunal (i.e. FY 2002-03) was the first full year of operations of the company.
- The key international transactions of the company with the associated enterprises (AEs), namely Skoda Auto a/s, Czechoslovakia, and Volkswagen AG, Germany, comprised of purchase of material (INR 2243.40 million) and payment of royalties and technical know-how fees (INR 445.72 million).
- SAIPL selected Transactional Net Margin Method (TNMM) as the most appropriate method for benchmarking its international

¹ Skoda Auto India Pvt. Ltd. V. ACIT [Source : I.T.A. No. 202/ PN/ 07, Order dated 12 March 2009] (Pune ITAT)

transactions. SAIPL compared the operating margins (using multiple year data) of six comparable car manufacturing companies and concluded its transactions to be consistent with arm's length price.

- During the course of proceedings before the TPO, SAIPL also relied on Comparable Uncontrolled Price (CUP) method as a corroborative analysis to substantiate the arm's length price of purchase of material from its AE. It was contended that ex-factory selling price of material by the parent company would remain same for all AEs, although final selling price of cars to end buyers by the AEs could vary on account of functional and geographical differences.
- The TPO, however, rejected two of the six comparables relied upon by SAIPL as under:
 - General Motors: Rejected on account of persistent losses. This, according to the TPO, was indicative of certain abnormalities.
 - Ford Motors: Rejected on account of non-availability of contemporaneous data for the relevant financial year.
- On the basis of margins earned by the remaining four comparables, transfer pricing adjustment to the tune of INR 235.90 millions was made by the TPO. Further the TPO did not provide the benefit of +/- 5 percent range, prescribed under proviso to section 92C(2) of the Act.
- Aggrieved by the order of the TPO, SAIPL filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)]. However, the CIT(A) upheld TPO's assessment and dismissed most grounds raised by SAIPL.

Tax Payer's Contentions before the Tribunal

SAIPL raised the following objections against the transfer pricing adjustment –

- A corroborative CUP analysis provided by SAIPL was not considered
- In relation to exclusion of the two comparable companies, SAIPL contended that functionally similar companies should not be excluded merely on account of sustained losses. The importance has to be given to the business activities and not profitability.
- Adjustments towards transactional differences between comparables and SAIPL on account of high level of import content of raw material are required to be considered by the TPO. SAIPL contended that the relevant year being the first full year of operations, it was required to have higher import content of raw material as the indigenous vendor development was not complete.
- Adjustments on account of lower capacity utilization affecting the profitability of SAIPL were not considered by the TPO while undertaking comparability analysis - SAIPL had utilized only 37.19 percent of its capacity whereas average capacity utilization of comparable companies was 68.15 percent.
- SAIPL also contended the use of multiple year data for undertaking comparability analysis with the comparable companies. SAIPL submitted that one year results viewed in isolation would lead to

incorrect results, since the comparables had introduced new models and phased out several models during the three year period.

- The contentions by SAIPL as regard differences in business models, higher import content of raw materials, impact of low-capacity utilization and product cycle were not raised before the TPO. SAIPL raised these issues for the first time before the Tribunal.
- Benefit of +/- 5 percent variation from the arm's length price ought to have been considered by the TPO.

Tribunal's Ruling

- The CUP analysis was rejected by the Tribunal. The Tribunal observed that the transactions between the AEs cannot be considered for determining the existence of an internal CUP. For applicability of CUP method, the transaction has to be between two entities which cannot influence or control each other's decision.
- The adjustments are required to be made on account of functional differences between SAIPL and the comparables companies. The Tribunal observed that the business models of the comparable companies having an import content ranging from 26 percent to 56.83 percent is fundamentally different from that of SAIPL having import contents as high as 98.55 percent. The business model of SAIPL is virtually an assembly job of imported knocked down units. In order to increase the comparability, the impact of import contents is required to be eliminated.
- The Tribunal further observed that even if the business models are considered to be similar, an adjustment would be required since SAIPL could be regarded as having incurred unusually high costs on account of initial stages of its business.
- For the purpose of comparability, it is inevitable that approximations and reasonable assumptions would be made in cases of non-availability / insufficient availability of information in the public domain. The taxpayer cannot be expected to get the details and particulars which are not in public domain.
- The Tribunal referred the matter to the TPO for fresh adjudication. The Tribunal directed the TPO to consider:
 - analysis of import content of the raw materials in the succeeding years. If the same has substantially reduced then the conclusion should consider such decline or consistency;
 - impact of non-deductible import duty additionally borne by SAIPL;
 - other options to neutralize the impact of higher costs during set-up phase; and
 - effect of product cycle on the use of multiple-year data.
- The Tribunal also directed the TPO to consider providing the benefit of +/- 5 percent to SAIPL. The said issue also stands covered in favour of the taxpayer in a series of earlier Tribunal decisions.

Other Issues

- Tribunal rejected preliminary objection raised by the Revenue that it should not deal with the matter on merits as SAIPL has not cooperated in the first appellate proceedings. Since the information called for by the CIT(A) was not available with SAIPL and the rest of information was available with TPO, the Tribunal rejected this plea and proceeded to decide the matter in its entirety on merits.

Our Comments

This ruling lays down certain important principles as regard making adjustments in proper and fit cases for the purpose of comparability analysis. This judgment is significant for the companies in start-up stages and recognizes that differences in business models and higher cost incurred during the set-up phase calls for economic adjustments. Such adjustment should be factored into the comparability analysis. Also, it would be beneficial that the taxpayers raise all important issues and contentions at the TPO level. The Tribunal would then be able to adjudicate the matter on case specific merits, instead of sending back the matter for fresh adjudication by the TPO.

The Tribunal further emphasized that for the purpose of comparability analysis, the taxpayer cannot be expected to get the details and particulars which are not available in the public domain.

The Tribunal has also confirmed the availability of benefit of +/- 5 percent range to the taxpayer which is in line with the recent rulings of coordinate benches in this regard.

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