



### **Cash profit/sales or cash profit/cost<sup>1</sup> allowed as a PLI under TNMM for mitigating the differences in asset profile, if circumstances warrant**

In a recent decision in the case of Schefenacker Motherson Ltd (SML)<sup>2</sup>, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal), held that cash profit on sales “CP/Sales” or cash profit on total cost excluding depreciation “CP/TC<sub>dep</sub>” can be adopted as an appropriate profit level indicator (PLI) under Transactional Net Margin Method (TNMM), to adjust for material differences in the assets utilized between tested party and comparable companies and thereby enable better comparability analysis.

#### **Facts of the Case**

- SML, a joint venture between Motherson Sumi Systems Ltd, India and Schefenacker International Gm B&H, Germany manufactures rear view mirrors and cable assemblies for the automobile industry.
- SML imports components from its associated enterprises (AEs) and also exports cable assemblies to AEs. Schefenacker Group Companies also supply technical know-how for design, technical engineering instructions, trainings, quality control etc. to SML in return for royalty.
- For Assessment Year 2003-04 and Assessment Year 2004-05, TNMM was applied adopting CP/Sales as the PLI to establish the arm’s length price of the international transactions on an aggregate basis.
- The justification given by the taxpayer for usage of CP/Sales as the PLI was to eliminate differences in technology used, age of assets used in production, differences in capacity utilization and different

<sup>1</sup> Total cost excluding depreciation

<sup>2</sup> Schefenacker Motherson Ltd v. ITO, ITA No.4459/DEL/07 for AY 2003-04 and Schefenacker Motherson Ltd v. DCIT, ITA No.4460/DEL/07 for AY 2004-05

depreciation policies adopted by various companies in the auto component industry.

- The Transfer Pricing Officer (TPO) rejected the PLI of CP/Sales and applied OP/TC in Assessment Year 2003-04 and OP/Sales in Assessment Year 2004-05 based on the following reasons:
  - While applying TNMM, transfer pricing provisions do not provide an option to use a numerator other than net operating profit.
  - Rule 10B(1)(e)(iii) of the Income Tax Rules, 1962 (the Rules) provides for adjustment to be made only to the results of comparable companies and not to the tested party.
  - Making a depreciation adjustment has no sanction in law.
- Since accurate adjustments could not be made for different levels of capacity utilization, TPO selected comparables having similar ratio of depreciation to total cost. Certain comparables were also rejected by the TPO on the basis of differences in product profile.
- Adjustment of INR.11.6 million was made on value of sales made to associated enterprises for Assessment Year 2003-04 and adjustment of INR 11.1 million was made to the value of purchases from associated enterprises for Assessment Year 2004-05.
- Further, the TPO held that since the value of international transaction falls outside the +/- 5% range [permissible under proviso to section 92C(2) of the Income tax Act, 1961 (the Act)] of the revised arm's length price, the benefit of the proviso cannot be extended while determining the adjustment.
- The Commissioner of Income-tax (Appeals) (CIT[A]) also rejected the use of CP/Sales as a PLI and accepted the PLIs used by the TPO.
- However, the CIT(A) held that the taxpayer and the AO / TPO made an error in relying on previous year data of the comparable companies as the same was not according to the rule 10B(4) of the Rules. The adjustments were therefore recomputed using single year data to INR 11.1 million for Assessment Year 03-04 and INR 8.6 million for Assessment Year 04-05.

#### **Issues for consideration before the Tribunal**

- Whether excluding depreciation from total cost and adopting cash profits as PLI is justified under the transfer pricing regulations?

#### **Taxpayer's contentions**

- OP/TC or OP/Sales, as applied by TPO and upheld by CIT(A), are not appropriate PLIs, given the facts of the case.
- Cash profit is computed for both the tested party and the comparable companies to remove the effect of differences in capacity utilization. Accordingly excluding depreciation while computing total cost is valid.

- OECD Guidelines<sup>3</sup> on Transfer Pricing and The Guidance Note<sup>4</sup> on Transfer Pricing issued by The Institute of Chartered Accountants of India provide considerable support on the approach of adopting CP/Sales as the PLI for computing the arm's length price.

### Revenue's Contentions

- The claim of the taxpayer for ignoring depreciation cannot be considered. Depreciation is an important element of total cost in a manufacturing unit.
- Since no accurate adjustment could be made to account for different levels of capacity utilization, selection of comparables themselves have to be made on the basis of similar ratio of depreciation to total cost. .
- Analysis of functions performed, assets deployed and risks assumed (FAR analysis) is to be conducted first by the taxpayer. This onus was not completely discharged by the taxpayer.
- Neither the importance of fixed cost element is documented in the transfer pricing report as a part of FAR analysis of comparables, nor has any evidence been brought on record to show the difference in the capacity utilization status of the comparables and the taxpayer.
- OP/TC or OP / Sales are appropriate PLIs in the instant case.

### Tribunal's Ruling

- The observation of the Tribunal was that depreciation can be taken into account or disregarded in computing profit depending upon the context and purpose for which profit is to be computed. There is no formula which would be applicable universally and in all circumstances.
- Depreciation, which can have varied basis and is allowed at different rates under Income Tax Rules or Company Law, is not such an expenditure which must be deducted in all situations.
- The Tribunal also discussed the concept of "Operating Income" and held that there is no standard test for deciding what constitutes operational income (or profit) and that it would depend on the facts and circumstances of each case. In this context, the decision of the Bombay High Court made in the context of Section 80 HHC of the Act was also relied upon<sup>5</sup>.
- There was justification on the part of the taxpayer in pleading that profits be taken without deduction of depreciation as depreciation charge had significant variations for various reasons and thereby lead to huge difference in margins.

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<sup>3</sup> Para 1.22 of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

<sup>4</sup> *Guidance note on report of international transactions under Section 92E of the Income Tax Act, 1961*

<sup>5</sup> *CIT v. Bangalore Clothing Co.[2003] 180 CTR 127(Bom)*

- Based on the above, the Tribunal held that the taxpayer can use CP/sales or CP/TC<sub>dep</sub> as an appropriate PLI. The impugned order of the revenue authorities including the TPO was set aside and the matter was restored to the file of the assessing officer for verification of the figures and computation of the CP/Sales or CP/TC<sub>dep</sub>.
- Tribunal has also reiterated on the allowability of +/-5% range as a standard deduction based on precedence from Sony India Private Limited<sup>6</sup> & Development Consultants Private Limited<sup>7</sup>.

#### *Other Issues*

- The taxpayer requested to file an additional ground for presenting segmental accounts along with the filing of a 'fresh' transfer pricing report with segmental benchmarking for a 'fresh' examination.
- Although the Tribunal recognized the appropriateness of segmental comparison, the request was denied to maintain the sanctity of the earlier assessments and to avoid fresh assessment of the case.

#### **Our Comments**

The Tribunal's decision has highlighted the commercial and economic aspects to be considered during a transfer pricing analysis and the importance of adjustments for ensuring robust comparability.

It has been made clear that there is no standard formula for "Operating Income" and it would depend on the facts and circumstances of each case. Further, as the Transfer Pricing legislation nowhere suggest the use of any 'particular' PLI under TNMM; the same may be modified to enhance the comparability standards.

Tribunal has accepted that depreciation cost may be adjusted to eliminate material differences in the 'asset profile' of the taxpayer vis-à-vis comparables based on sufficient evidence on record, thereby enabling use of CP/sales or CP/TC<sub>dep</sub> as PLI.

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<sup>6</sup> *Sony India (P) Ltd. vs DCIT [2008] 114 ITD 448 (Del.)*

<sup>7</sup> *Development Consultants (P) Ltd. vs DCIT [2008] 115 TTD 577 (Kol.)*

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