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TAX FLASH NEWS

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Rejection of Internal CPM for export to AE by placing importance on various factors relevant for comparability

Background

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Inductotherm (India) Pvt. Ltd.[1] (the taxpayer), held that internal Cost Plus Method (CPM) by comparing profit margin on sales to Associated Enterprises (AEs) vis-à-vis sales to non-AE cannot be adopted to benchmark export of finished goods to AE in a case where there is a difference in the geographical location of the market and also in the value chain and utility of the product.

With regard to payment of royalty to AEs, the Tribunal held that to benchmark royalty payment to AEs (parent company), intra-AE transactions (rates payable by other group entities for royalty to parent company) cannot be adopted as a valid Comparable Uncontrolled Price (CUP) input. Further, difference in royalty rates applicable for domestic sales vis-à-vis export sales by Indian entities is duly recognised and accepted by the regulatory framework in India.

Facts of the case

- The taxpayer is engaged in the business of manufacturing induction melting systems and is a market leader in induction technology for melting, heating and welding equipments. It is a part of Inductotherm Group and is a subsidiary of Inductotherm Industries Inc USA (Inductotherm USA).

Export of Finished Goods to AE

- During the year under consideration (AY 2006-07), the taxpayer had exported finished goods worth INR12.40 crores to its AE, which accounted for 165 types of products out of its entire gamut of 2500 types of products. In order to benchmark the aforesaid transaction, taxpayer considered CPM as the most appropriate method considering the facts and circumstances of the case.

- During the course of scrutiny before the Transfer Pricing Officer (TPO), it was observed that out of 165 types of products exported to AE, the taxpayer had sold 31 types of products to the non-AEs as well. Against a margin of 47.06 per cent on exports to the AEs, the taxpayer had earned a margin of 194.43 per cent on sales to the non-AEs. It was mainly in this backdrop that the TPO required the taxpayer to show cause as to why the margin of 194.43 per cent cannot be adopted under Internal CPM.

Royalty Payment

- For AY 2008-09, the taxpayer had paid royalty of INR8.48 crores to its parent company, i.e., Inductotherm USA which was computed at 5 per cent in respect of domestic sales and at 8 per cent in respect of export sales.

- The taxpayer had aggregated its payment of royalty with other international transactions and the entity level profits were benchmarked on the basis of Transactional Net Margin Method (TNMM) and was justified to be at arm's length. During the course of scrutiny, TPO raised various contentions with respect to the said transaction. Detailed contentions raised by the taxpayer and TPO are discussed below in respective sections below.

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[1] Inductotherm (India) Pvt Ltd v. DCIT (ITA Nos. 3108/Ahd/2010 AY 2006-07), Inductotherm (India) Pvt Ltd v. JCIT (ITA Nos. 2609/Ahd/2012 AY 2008-09), Inductotherm (India) Pvt Ltd v. DCIT (ITA Nos. 671/Ahd/2014, 243/Ahd/15 and 370/Ahd/16 AY 2009-10, 2010-11 and 2011-12) – Taxsutra.com

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Issues before the Tribunal

- Whether Internal CPM considered by the TPO is justified for benchmarking export of finished goods to AE for various Assessment Years under consideration?

- Whether higher rate of royalty in respect of exports vis-à-vis royalty for domestic sales justified and whether the rates payable by other group entities for royalty to the parent company can be treated as valid inputs?

Taxpayer contentions

Export of Finished Goods to AE

- Vide its response to the show cause notice raised by the TPO, the taxpayer explained that it had dealt in about 2500 types of products, whereas the transactions with AEs were only in respect of 165 types of products, out of which comparable, or near comparable, were available in respect of only 31 products. Therefore, adopting Internal CPM for benchmarking the export of finished goods to AE was bound to be a failure.

- The taxpayer further mentioned that there is a sea change in the ground realities as far as the market in the case of AE vis-à-vis Non AE is concerned. The products supplied to the AEs are used as raw materials whereas the products sold to non-AEs are used for repairs and replacements in products supplied by the taxpayer.

- The taxpayer further submitted that as a corroborative measure, the benchmarking is also done on the basis of TNMM which shows the mean margin at 4.99 per cent and the highest comparable margin at 10.58 per cent, as against the taxpayer's margin of 30.29 per cent.

Royalty Payment

- In response to the questions from the TPO, it was explained by the taxpayer that regulatory environment in India recognizes the difference in the treatment and puts the cap on allowability of such royalty at 5 per cent in respect of domestic sales and at 8 per cent in respect of export sales.

- Similar royalties paid by the taxpayer in the earlier year have been held to be, though at the Dispute Resolution Panel (DRP) level at an arm's length price (ALP) and the matter rests there.

- The taxpayer explained that at the entity level, the profits in respect of all the transactions taken together had been benchmarked at an arm's length price, on the basis of TNMM, and there was no reason to disturb the arm's length price of royalty paid. It was explained by the taxpayer that the effective rate of royalty works out to almost the same in case adjusted sales, after adjusting for the cost of imports, is taken into account in respect of the exported goods. On the basis of the calculations furnished by the taxpayer, the effective rate of royalty for exports works out to 2.86 per cent and royalty for domestic sales works out to 3.0029 per cent.

Tax department's contentions

Export of Finished Goods to AE

- None of the contentions raised by the taxpayer impressed the TPO and he continued arguing that the sale to the AEs was at nominal profit margin in comparison with sales to non-AEs. He was also of the view that the taxpayer has acted malafide in not furnishing costing details in respect of all the items, so as to suppress the relevant information.

- Finally for the said international transaction, the TPO, proceeded to adopt 213.44 per cent[2] operating profit margin, as against 45.54 per cent shown by the taxpayer, and recommended an ALP adjustment of INR14.30 crores.

- In appeal, the DRP upheld the stand of TPO in principle but restricted the ALP adjustment in respect of only such items for which comparable were available, i.e. 31 items. The ALP adjustment was thus, scaled down to INR2.31 crores. Hence, the aggrieved by this adjustment the taxpayer appeared before the Tribunal.

Royalty Payment

- During the TP proceedings, the TPO rejected the taxpayer's stand and opined that the aggregation of all the transactions is warranted only in such a situation when these transactions cannot be segregated which was not the case under consideration.

- Further, the TPO opined that there was no conceptual justification for adjusting the cost of imports from value of exports for computing effective rate of royalty. TPO also rejected taxpayer's claim for RBI approved differential rates for domestic and export sales by placing reliance on the judgment of Punjab & Haryana High Court in the case of Coca Cola India Inc[3].

- Based on above, TPO considered ALP rate to be 5 per cent and proposed an adjustment of INR0.82 crores. Aggrieved by the stand so taken by the TPO, the taxpayer raised an objection before DRP.

- In DRP proceedings, the DRP upheld the adjustment by opining that effective rate of royalty in taxpayer's case worked out to be much higher

[2] Basis of working out this rate as ALP is not provided in the order.
[3] Coca Cola India Inc v. CIT [2009] 17 DTR 66 (P&H)

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when compared with other group concern and there was no rationale for payment of higher royalty in case of exports when there is no difference in the technology used in domestic and export segments. Since the taxpayer was not satisfied by the aforesaid directions of DRP and hence appealed before the Tribunal.

Tribunal's ruling

Export of Finished Goods to AE

- The Tribunal placed reliance on Rule 10B(2)(d), wherein it is mentioned that the comparability of an international transaction with an uncontrolled transaction is to be judged with reference to interalia, conditions prevailing in the market in which respective parties to the transactions operate including geographical location, size of the markets, level of competition and whether the markets are wholesale or retail. Having placed reliance on the aforesaid rule, the Tribunal mentioned that the case of sale to the end consumer which has to essentially buy the product from the same vendor who supplied him the furnace or other equipment is not the same thing as sale to the manufacturer or dealer a particular type of product, which uses the material so sold as input raw material etc. The distinction between these markets is so fundamental that the comparison is meaningless.

- Further, the Tribunal also discussed about the importance of same geographical markets and other market conditions for the sake of comparability. It was stated that the sale made to AEs is in USA, UK, Australia, China, Brazil, Turkey, Korea, etc., while the sale to non-AEs is mostly in India. The sale to non-AEs is under nearly monopolistic environment, whereas sale to AEs is under competitive environment. All these differences render the comparison of products sold to AEs and non-AEs irrelevant.

- In case of whether CPM is the most appropriate method on the facts of this case, the Tribunal referred to the observations made by a coordinate bench in the case of Wrigley India Pvt Ltd[4] and concluded that just because the taxpayer had sold the same product, as exported to the AEs, to the domestic enterprises, CPM method cannot be applied as there is a difference in the geographical location of the market as also in the value chain and utility of the product. The tribunal highlighted that the taxpayer sold propriety products to its AEs, having unique specifications which non AEs could not obtain from others and therefore, taxpayer was in a position to fetch higher prices for the same from non-AEs.

- Thus, the Tribunal rejected TPO's imposition of internal CPM and remarked the benchmarking conducted on TNMM basis as a corroborative measure. Accordingly adjustment imputed was deleted. Following the same parity of reasoning on this issue for AY 2006-07, the Tribunal deleted adjustment for others AYs 2008-09, 2009-10, 2010-11, and 2011-12 as well.

[4] Wrigley India Pvt Ltd v. ACIT [2015] 114 DTR 1 (Del)

Royalty Payment

- The Tribunal upfront held that the both the propositions raised by the tax department are factually incorrect and legally unsustainable. As regards the difference in royalty rates applicable for domestic sales vis-à-vis export sales by Indian entities, the Tribunal noted that it was a standard norm duly recognized by the Reserve Bank of India. The Tribunal mentioned "When regulatory framework itself accepts and permits such a variation in approach to domestic sales and export sales, it is futile to suggest that it is not legally acceptable conceptual foundation".

- Even otherwise, the Tribunal observed that in case of taxpayer, TPO had adopted an intra AE transaction as a valid CUP input. The Tribunal mentioned that even in a case in which the royalty is being given to a rank outsider, by the virtue of 92A(2)(g), the entities paying and receiving royalties become AEs. It is only elementary that a transaction between the AEs can never be a valid CUP input. To substantiate this proposition, the Tribunal relied on various judicial precedents[5].

- Based on above observations, the Tribunal held that the approach adopted by the authorities is thus wholly devoid of legally sustainable merits. The Tribunal noted that for AY 2006-07, DRP had held these royalty payments at ALP. Accordingly the Tribunal deleted the adjustment for AY 2008-09 and applied the same principles *mutatis mutandis* in the following AYs 2009-10, 2010-11 and 2011-12 as well.

Our comments

Often in transfer pricing proceedings, the TPO places reliance on internal comparables. In the above ruling, it is pertinent to note that the Tribunal duly placed emphasis on various factors of comparability like geographical locations, value chain and utility of the product etc., and had rejected the internal comparable adopted by the TPO under CPM. The comparability factors have been well-recognised under Rule 10B(2) of the Indian Transfer Pricing Regulations and also in OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration.

With respect to the transaction of royalty, the Tribunal accepts the differential rate of royalty with respect to domestic sales vis-à-vis export sales as this standard norm has already been recognized by RBI. Further, the Tribunal clearly mentioned that an intra AE transaction cannot be considered as comparable. Rule of consistency has also been duly recognized in this ruling for the said transaction. In all, this ruling comes as a relief for the taxpayers facing transfer pricing adjustment on similar issues.

[5] ACIT v. MSS India Ltd [2009] 25 DTR 1 (Pune), ACIT v. Technimont ICB India Pvt Ltd [2012] 75 DTR 259 (Mum) and Sabic Innovative Plastics India Pvt Ltd v. DCIT [2013] 90 DTR 203 (Ahd)

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