



Transaction-by-transaction analysis to be considered; Bundled benchmarking approach is neither automatic nor mandate of law; provision for warranty not created on historical trend is allowable as deduction both under normal and MAT provisions

Background

The Kolkata Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of Landis+Gyr Limited¹ (the taxpayer) has churned out a favourable ruling on Transfer Pricing (TP) asserting the use of transaction-by-transaction approach over entity level approach for determining Arm's Length Price (ALP) for varied nature of international transactions. It upheld overseas Associated Enterprise (AE) as tested party for certain class of transactions and provided for consideration of certified segmented financial statement for benchmarking purposes.

In relation to payment for management services, the Tribunal upheld that wherein the taxpayer has established receipt of services and benefits derived therefrom, the services could not be regarded as stewardship in nature. In relation to payment of royalty, the Tribunal upheld Comparable Uncontrolled Price (CUP) method as the Most Appropriate Method (MAM) and relied on 'RoyaltyStat' database for determining ALP.

The Tribunal also dealt with a critical aspect on deductibility of provision for warranty and provision for obsolescence of inventory and based on various facts brought on record, allowed the claim of the appellant.

Facts of the case

- The taxpayer is a closely held company engaged in the business of manufacturing and distribution of electric meters and related components. In the course of its business operations, the taxpayer has entered into

certain international transactions in the nature of import of raw materials, export of finished goods, purchase of finished goods, payment of royalty and payment of management fees.

- For the purpose of benchmarking, the international transactions of import of raw materials/purchase of finished goods and sale of finished goods, the taxpayer in its TP report, segregated the above transactions in two broad segments- **'Manufacturing' and 'Trading'** (subsuming transaction of purchase of finished goods). The manufacturing segment was further subdivided into **'Manufacturing-Domestic' Segment** (subsuming transaction of import of raw materials), and **'Manufacturing-Export' Segment** (subsuming transaction of export of finished goods).
- The Trading segment was benchmarked by the taxpayer using the Resale Price Method (RPM) as MAM and gross profitability (GP/sales) based on the segmented financial details as the appropriate Profit Level Indicator (PLI).
- As for the **'Manufacturing Segment – Export'**, was benchmarked using the Transactional Net Margin Method (TNMM) as MAM and the segmented financial margin of the taxpayer. For the **'Manufacturing Segment – Domestic'**, the transaction of purchase of raw materials was benchmarked using Cost Plus Method (CPM) as the MAM and the gross profitability margin earned by the AEs from sale of materials to the taxpayer.

¹ DCIT vs Landis + Gyr Ltd. (ITA No. 584/Kol/2015 and ITA No. 549/Kol/2016), Landis + Gyr Ltd. v. DCIT (ITA No. 687/Kol/2015 and ITA No. 619/Kol/2016)

- The transaction of payment for management support services was benchmarked considering overseas AE as tested party and TNMM as the MAM. The transaction of payment of royalty was benchmarked using CUP as the MAM and comparable uncontrolled royalty rates using 'RoyaltyStat' database.
- During the relevant year, the taxpayer had also claimed deduction towards provision for warranty amounting to INR20,667,831 which comprised of two parts, a specific provision on account of sale of electric meters to West Bengal State Electricity Distribution Company Ltd (WBSEDCL) based on complaint received from buyer and other on account of sale to other parties based on scientific trends. The Assessing Officer (AO) denied the said claim contending that such deduction is provided if scientific data is systematically maintained on the basis of past event.
- Similarly, claim for provision towards obsolescence of inventory was denied by the AO under normal provision as well as in computation of book profit contending that it was an unascertained liability.
- In relation to payment for management support services, the TPO ignored the benchmarking analysis adopted by the taxpayer and considered CUP as the MAM without providing any comparable price. The TPO also ignored the e-mail, correspondences evidencing receipt of services and benefits therefrom and broadly classified the services as stewardship in nature and determined ALP as INR Nil.
- In relation to payment of royalty, the TPO ignored the benchmarking analysis adopted by the taxpayer, held that the technology received by the appellant was not unique in nature and consequently concluded that the amount of royalty was not justified and determined its ALP as Nil.
- The Dispute Resolution Panel (DRP) accepted TPO's conclusion on segmental analysis for transaction involving sale/purchase of meters. However, with respect to management service fee and royalty, the DRP accepted the benchmarking approach of the taxpayer, thereby concluding those transactions to be at arm's length.

TPO's/AO's contention

- The Transfer Pricing Officer (TPO) ignored the taxpayer's segmentation of its Meter segment into Manufacturing segment (further segmented into Manufacturing – Export and Manufacturing – Domestic) and Trading segments and considered the margin from entire Meter business (which included third party revenue of around 95 per cent of the total revenue) to separately benchmark the transactions subsumed under each of the segment.
- The TPO held that segmentation of transactions into Manufacturing Domestic, Manufacturing Export and Trading is not backed by sufficient documentation and is a far-fetched approach. He also contended that segmental statement was not forming part of audited financial statements and hence could not be considered.
- For the purpose of benchmarking, the TPO adopted TNMM as the MAM and OP/Sales as the Profit Level Indicator (PLI) and benchmarked the same with uncontrolled comparable companies engaged in manufacturing and trading of products similar to electric meters.
- As the PLI of uncontrolled comparable companies was higher than the margin earned by the taxpayer for its entire Meter business, an adjustment proportionate to the value of international transactions was imputed.

Taxpayer's submission

TP issues

- With regard to TPO's action of clubbing the transactions as encompassed under 'Manufacturing Segment' and 'Trading Segment' and determining the ALP, the taxpayer emphasized on the need to undertake a transaction-by-transaction approach relying on Indian TP Regulations, International Guidelines (OECD guidelines, United Nation TP Manual etc.) and Indian judicial pronouncements.
- While presenting the importance of transaction-wise analysis, the taxpayer also highlighted the improved comparability factor by drawing attention to para 1.51 of the OECD TP guidelines. This is further augmented based on the co-ordinate bench decision of Delhi Tribunal in the case of Mentor Graphics (Noida) Pvt. Ltd.², wherein emphasis was laid on examination of the principal functions of the entities involved in related party transaction for benchmarking, thereby implying that transactions with distinctly different functions need to be addressed separately. The taxpayer, thereafter contended that each of the transaction should be benchmarked separately as under:

² Mentor Graphics (Noida) Pvt. Ltd v DCIT [2007] 109 ITD 101(Del)

- **Sale of finished goods**, the taxpayer considered itself as the tested party and adopted TNMM as the MAM considering net level profitability.
 - **Purchase of raw materials & components**, the taxpayer considered the AEs as the tested party and adopted CPM as the MAM with GP/DICOP as the PLI.
 - **With regards to purchase of finished goods**, the taxpayer considered itself as the tested party and adopted RPM as the MAM considering GP/sales as the appropriate PLI.
- The taxpayer submitted certified segmental financials to substantiate the allocation of costs and margin earned while undertaking respective international transactions. On considering the relevant segment/transaction level profitability, the transactions were determined to be at arm's length.
 - For **payment of royalty**, the taxpayer defended DRP's directions by emphasizing on CUP as the MAM and using 'Royaltystat' database to identify comparable agreements for determining ALP.
 - For **payment of management services fees**, the taxpayer defended DRP's directions by establishing evidence of services and benefits received therefrom.

Other matters

- The specific provision for warranty in respect of meters sold to WBSEDCL was based on complaint raised by the customer and the balance provision was based on systematic historical data of past 10 years.
 - Reliance was placed on the decision of the Apex Court in the case of Rotork Controls India (P) Ltd³ and Bharat Earth Movers⁴ to support its claim that liability on account of such provision was definitely an ascertained liability eligible for deduction both under normal computation and while computing book profit.
 - As far as provision for obsolescence of inventory is concerned, the appellant mentioned that basis a notification issued by Central Electricity Authority, all energy meters had to be static type in contrast to the existing technology which was being used. The meters not complying with these regulations were to be replaced as per the direction issued by the board. Accordingly, the appellant creation provision for obsolescence of stock of materials which was held to meet its warranty liability against the old meters.
- In terms of Accounting Standard (AS) 2 issued by the Institute of Chartered Accountants of India (ICAI), inventories were to be valued at lower of cost or market value. The inventories identified as obsolete had lost the consumer acceptability, and accordingly, provision had to be created for its obsolescence. Reliance was placed by the appellant on the decision of the Delhi HC in the case of Hotline Teletube & Components Ltd.⁵, wherein it was held that for valuing stock, principle of cost or realisable market price whichever is lower is applicable.

Tribunal's ruling

Transaction-by-transaction analysis

- For sale and purchase meters, the Tribunal held that bundled benchmarking approach is neither an automatic application nor any mandate of law. The transactions should be bundled and benchmarked only when they could not be segregated and benchmarked independently. In the instant case, the taxpayer furnished segmental profitability statement for benchmarking transactions subsumed under each of the segment and hence transaction-by-transaction approach should be followed instead of bundled approach.
- The Tribunal accordingly directed TPO to consider the certified segmental profitability to determine the ALP of the relevant international transactions.
- Further, for **import of raw materials & components**, the Tribunal upheld AE to be a tested party and using CPM as the MAM for benchmarking the transaction.
- For **payment of royalty**, the Tribunal held that the study made by the taxpayer applying CUP as the MAM and using 'RoyaltyStat' database should be considered for determination of ALP.
- For **payment of management service fees**, it was held that the taxpayer submitted enough documents to substantiate receipt of services and benefits derived therefrom and the services could not be considered as stewardship services. Further, it is also held that benchmarking analysis undertaken by the taxpayer considering AE as tested party is appropriate to determine the ALP.

³ Rotork Controls India (P) Ltd vs CIT [2009] 314 ITR 62 (SC)

⁴ Bharat Earth Movers vs CIT [2000] 245 ITR 428 (SC)

⁵ CIT v. Hotline Teletube & Components Ltd. [2008] 175 Taxman 286 (Del)

Provision for warranty

- On perusal of materials produced by the appellant it was evident that meters were supplied to WBSEDCL and the customer had raised certain issues against quality of material.
- The Tribunal noted that the appellant had brought on records the details of number of meters identified as defective, cost of production of meter, etc and accordingly, arrived at the amount of liability that could be incurred thereon.
- Reference was drawn from the principles laid down by Apex Courts in Bharat Earth Movers wherein it is laid down that following three parameters are essential for recognizing a provision:
 - an enterprise has a present obligation as a result of a past event
 - it is probable that an outflow of resources will be required to settle the obligation and
 - a reliable estimate can be made of the amount of the obligation
- Since the appellant satisfied all the criteria's for recognition of provision, the Tribunal went on to hold that there was no doubt that the liability for meters sold to WBSEDCL was certain and had been incurred during the year, thus allowable expenditure.
- With respect to provision for warranty of which was arrived at based on the actual warranty cost for past 10 years, the Tribunal perused the detailed working furnished by the appellant which has also been reproduced in the order and re-emphasized on the principle laid down by the Supreme Court in the case of Bharat Earth Movers and Rotork Controls India (P) Ltd and allowed the claim of provision for warranty both under normal provision and in computing book profit under Section 115JB of the Income-tax Act, 1961 (the Act).

Provision for obsolescence of inventory

- The Tribunal acknowledged the fact that appellant had furnished clearly mentioned the item code, description, date of transaction, quantity, rate per unit, etc to determine the amount of provision for inventory obsolescence. Thus, it could be safely concluded that appellant was creating provision based on commercially acceptable method.
- The importance of accounting standard issued by ICAI for valuing inventory were duly recognized by the Tribunal. In view of such findings and by relying on the judgment of Delhi High Court in the case of Hotline Teletube, Tribunal has allowed the claim of provision for obsolescence of inventory under normal tax computation.

Our comments

The Tribunal held on considering transaction-by-transaction analysis over entity level approach for transactions like purchase of finished goods, purchase of raw materials and sale of finished goods,. The Tribunal echoed the fine aspects laid down in OECD guidelines and United Nation TP Manual.

Based on the concept of least complex operations (engaged in manufacturing of raw materials), accepted AE as tested party to confirm the arm's length price for purchase of manufactured raw materials. There have been several Tribunal Rulings in the past in India, where AE has been considered as a tested party, but in all those cases AE was a distributor. The same principles of determining tested party squarely apply in case of purchase of manufactured raw materials by a license manufacturer. However, there was no such existing ruling where the AE, a manufacturer has been considered as a tested party.

The Tribunal accepted the certified copy of segmented profitability of taxpayer's operations as well as overseas AE's, even when it does not form part of taxpayer's financial statement.

For payment of royalty, the Tribunal has confirmed the use of 'RoyaltyStat' global database for application of CUP method.

The Tribunal concluded arm's length payment of management charge considering AE as a tested party and benchmarking service mark-up with similar jurisdictional comparable companies.

The decision of the Tribunal with regard to allowability of provision for warranty and obsolescence of inventory, wherein the Tribunal has not merely relied on the legal principles enunciated by Apex Courts, but delved into the facts, correspondences and the basis of creation of provision as produced by the appellant on record, proves beyond doubt, that robust documentation supported by historical trend would be a key to justify such claims.

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