



Location savings is relevant for investigating the transaction, cannot be a sole basis for ALP determination

Background

Recently, the Bangalore Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of Parexel International Clinical Research Pvt. Ltd.¹ (PICRPL or the taxpayer) held that, location savings and its advantages are very much relevant in the cross border transaction but for the limited purpose of carrying out exercise of examination and investigation of the transaction and not as a basis for determining the Arm's Length Price (ALP) and consequently adjustment.

Relying on the Mumbai Tribunal's decision in the case of Watson Pharma Pvt. Ltd.² and Syngenta India Ltd.³, the Tribunal upheld that, location savings and conditions are available to all parties irrespective of the fact whether the transaction is between the related party or unrelated party. Therefore, if the comparable uncontrolled price is available in the same jurisdiction, then the location saving or condition cannot be itself the basis for determination of ALP and any consequential adjustment cannot be made. The Tribunal adjudicated that it can be a relevant factor for conducting a proper enquiry for determination of arm's length price of the international transactions, however, cannot be the sole basis for arriving at ALP.

Facts of the case

- PICRPL is a wholly owned subsidiary of Parexel International Holdings BV, Netherlands and is engaged in providing clinical research services in India. PICRPL has been compensated at cost plus 15 per cent mark-up for the services provided to the Associated Enterprises (AEs). PICRPL used Transactional Net Margin Method (TNMM) as the most appropriate method to benchmark the international transaction with its AEs.

- During the course of transfer pricing assessment, Transfer Pricing Officer (TPO) observed that conducting a clinical trial in India through PICRPL has resulted in location savings to the AEs as the regulatory, compliance and investigatory costs are significantly lower in India in comparison to other developed countries.
- TPO opined that benchmarking study conducted by the taxpayer using local comparables does not take into account the benefit of location savings. Relying on some journals and websites, TPO arrived at location savings and applying profit split method allocated the same on ad-hoc basis i.e. by dividing the location savings equally (50:50) between PICRPL and its AEs.
- The Dispute Resolution Panel (DRP) concurred with the view of the TPO and concluded that the location saving exists in the current business model of the taxpayer and therefore the decision of the TPO was upheld.

Taxpayer's contentions

- The taxpayer contended that, since it has benchmarked its international transactions by selecting the comparable companies engaged in clinical research at same location/ geography, location savings are already embedded in the margins of the taxpayer as well as comparables.
- The taxpayer relied on the decision of the Mumbai Tribunal in the case of Watson Pharma Pvt Ltd. and Syngenta India Limited, wherein the Tribunal held that when the comparables operating in the local market are available then specific adjustment on account of location savings is not required.

¹ Parexel International Clinical Research Pvt. Ltd. v. DCIT (IT(TP)A No. 254/Bang/2016 and 292/Bang/2017) – Taxsutra.com

² Watson Pharma Pvt Ltd v. DCIT [2015] 168 TTJ 281 (Mum)

³ Syngenta India Limited v. DCIT [2017] 77 taxmann.com 220 (Mum)

Tax department's contentions

- TPO contended that benchmarking against local comparables does not take into account the benefit of location savings.
- TPO as well as DRP submitted that the business model of the taxpayer does provide an opportunity for location savings and hence they were justified in working out the location savings per clinical trial in respect of the clinical trial conducted in India in comparison to the U.S. The same was multiplied by the number of clinical trial sites of the taxpayer. The total cost saving was allocated in the ratio of 50:50 for determining the ALP and consequently the TPO made a transfer pricing adjustment.
- TPO further contended that, the case laws relied upon by the taxpayer are not applicable in the present situation as the business and functions of the Watson Pharma Pvt. Ltd and Syngenta India Limited are different from the taxpayer.

Tribunal's decisions

The Tribunal observed/ruled as follows:

- The Tribunal stated that location saving is one of the primary factors of all cross border trade activities which includes exports and imports of articles, goods, and services. The Tribunal opined that the benefit of low cost of regulatory and other compliances are relevant factors which lead to location saving for a particular region.
- The Tribunal also appreciated that, the benefits of location savings are available to all the independent parties operating in that location irrespective of the fact whether the transaction is between a related party or unrelated party.
- Further, location savings can be a relevant factor for conducting a proper enquiry for determination of arm's length price of the international transactions.
- The Tribunal agreed with the concept of OECD and Base Erosion and Profit Shifting (BEPS) that location saving and advantage are universally accepted in cross border transactions so far as they are not entered into solely for the purpose of avoiding tax. Particularly location saving is relevant where the transactions are entered between the related parties with an intention of avoiding tax and treaty shopping.
- The Tribunal placed reliance placed on the ruling of Mumbai Tribunal in the case of Watson Pharma Pvt. Ltd. and Syngenta India Ltd.
- In the light of the above, the Tribunal concluded that where comparable uncontrolled price is available, then the location saving or condition cannot itself be the basis for determination of ALP and consequential adjustment cannot be made.

- The Tribunal also disregarded the basis for arriving at location savings as adopted by the TPO stating that the same is based on assumptions and not in accordance with the provisions of the Income Tax Act, 1961.
- Considering the fact that TPO/Assessing Officer (AO) has not examined the functional comparability of the companies selected by the taxpayer and no steps were taken to identify the comparables, the Tribunal sets aside the matter to TPO/AO for fresh adjudication.

Our comments

The judgement upholds the landmark ruling of Mumbai Tribunal in the case of Watson Pharma Pvt Ltd. which addressed various aspects related to the issue of location savings and its transfer pricing implications.

This ruling of Bangalore Tribunal also gains its significance in the light of revised UN TP Manual (India Chapter) and OECD BEPS Action Plan 8, where principles relating to taxability of location savings are discussed.

UN TP Manual acknowledges the concept of location savings and envisages on the increased efforts made by the MNEs to lower their cost in order to increase their profit. As per UN TP Manual, (India chapter), the meaning of location savings goes beyond the issue of relocating a business from high cost to low-cost locations and covers any cost advantage that a location can provide.

UN TP Manual (India Chapter) clearly highlights that under situations where comparable uncontrolled transactions are available in the same jurisdiction, the comparability analysis and benchmarking by using profitability of such local comparable companies will already capture the benefits of location savings. Therefore, the UN TP Manual also appraises that in the case of comparable companies operating in the same jurisdiction, the concept of location savings loses its significance for arriving at the arm's length price.

One of the key factors for attracting foreign direct investment (FDI) into the economy is the cost arbitrage. Location savings along with skilled labour and infrastructure facilities provides a competitive advantage for India to invite FDI. MNEs leverage on such location savings to achieve the objective of cost efficiency. MNEs may achieve this objective by either directly procuring products/services from independent third parties, or they may consider setting up a branch/subsidiary in such jurisdictions. Imposing taxes on MNEs for location savings would be deterrent to their interest for setting-up a branch/ subsidiary in India and also infringe the basic objective of economic principles.

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