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TAX FLASH NEWS

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Taxpayer's aggregation of IT services and ITeS provided to Associated Enterprises under a single composite contract upheld

Background

The Kolkata Bench of Income-tax Appellate Tribunal (the Tribunal), in the case of Data Core (India) Pvt. Ltd.[1] (the taxpayer), dismisses Revenue's appeal, upholds taxpayer's aggregation of Information Technology (IT) services and Information Technology enabled services (ITeS) provided to Associated Enterprises (AEs) under a single composite contract for Assessment Year (AY) 2010-11. It refers to OECD's TP guidelines with specific reference to BEPS Action 8-10, UN TP Manual and UK Transfer Pricing Guidelines wherein due recognition has been given to contractual terms of the agreement for undertaking TP analysis and provides for aggregate analysis of transactions encapsulated under a bundled arrangement. Giving due recognition to the taxpayer's consistent conduct of rendering bundled service under IT and ITeS, the Tribunal holds that comparisons should be done only with the total services (i.e. IT and ITES) rendered by the taxpayer as per the Cummins India Ltd, Boskalis International, and Birla Soft Tribunal rulings. Further, Tribunal states that TPO's reliance on AS-17 Segment Reporting for comparison of the margins of AE and non-AE transactions is highly unwarranted since the purpose of the Segmental Reporting is totally different and cannot be used to bifurcate between AE and non-AE transactions. Thereby Tribunal deletes TP-adjustment noting that taxpayer's 27.50 per cent margin was above 20 per cent margin specified in Safe Harbour Rules and also at arm's length with reference to comparables, wherein, separately for AY 2011-12, dismisses Revenue's appeal and includes Akshay Software Technologies Ltd and Thinksoft Global Services Ltd as comparables following precedents.

[1] Data Core (India) Pvt. Ltd. vs ITO (ITA No. 387/Kol/2015)

Facts of the case

- The taxpayer is a subsidiary of Development Consultants Private Limited. The taxpayer is engaged in providing routine software development (SD) and back-office processing services (BPO), pursuant to a single composite contract, to Data Core Systems Inc. USA for enabling it to service the same to end customers. In addition, the taxpayer also provides similar services to third parties in its independent capacity.
- The taxpayer for establishing the arm's length nature of the services (SD - IT & BPO - ITeS) rendered to its AE benchmarked the transaction level analysis with reference to the composite contract and considering a 'bundled pricing arrangement'. The segmented margin of the service rendered to AE was benchmarked against third-party comparable price for IT & ITeS companies.

TPO's & DRP's contention

- The TPO rejected the taxpayer's bundled price contention and characterised it as only an ITeS entity, thereby rejecting all IT comparables. The TPO accepted the method and profit level indicator adopted by the taxpayer but selected a set of ITeS companies only to benchmark and make adjustments.
- The Dispute Resolution Panel (DRP) however, accepted the taxpayer's contention that it provides both IT & ITeS and directed the TPO to consider both sets of companies to arrive at the comparable benchmark. The DRP at the same time is silent on both the audited segment data used for benchmarking and the composite contract argument for the bundled price arrangement.

Tribunal's decision

- The Tribunal observed that the terms of the composite agreement entered into with its AE for the totality of services on the basis of 'bundled pricing approach' had been consistently followed by the taxpayer and the pricing had been made in such a manner so as to ensure that the same was always at arm's length. Further, the Tribunal noted that the assets employed and risks assumed were the same for both SD and BPO services.

- Thus, the Tribunal opined that "there is nothing wrong in working out the composite remuneration for both SD and BPO services based on a composite agreement" and held that there was no good reason to disbelieve this pattern of undertaking transactions by the taxpayer with its AE. In fact, the Tribunal also recognised that the taxpayer had tried to justify its transactions with its AE by presenting the segmental profitability statement duly certified by a chartered accountant during the course of TP assessment proceedings by taking into account 'Rendering of both SD and BPO services' to both AE and non-AE separately.

- The taxpayer also submitted that the Guidance Note issued by ICAI on Accountant's Report under Section 92E of the Act supported its case. The Tribunal observed that the co-ordinate bench of Pune Tribunal in the case of Cummins India Ltd[2] had upheld aggregation of closely linked transactions to determine the Arm's Length Price (ALP), Mumbai Tribunal in the case of Boskalis International Dredging International CV[3] had upheld the portfolio approach and in case of Birla Soft Limited[4] also, aggregation approach was upheld.

- Further, referring to the OECD TP guidelines for MNEs and tax administration (updated via BEPS Actions 8-10) which provides that due recognition should be given to contractual terms of the agreement for undertaking transfer pricing analysis, the Tribunal observed that these guidelines also provide for aggregate analysis of transactions encapsulated under a single portfolio. The Tribunal noted that OECD had also highlighted that under a portfolio approach, the taxpayer's objective was to earn an appropriate return across the product/service offering in the portfolio rather on any single product/service offering of the portfolio.

- Further, the Tribunal stated that UK Transfer Pricing Guidelines issued by HMRC conformed to the OECD approach on composite pricing. Thereafter, the Tribunal stated that the UN TP Manual also had acknowledged the existence of composite contracts and warranted analysing the individual element of such contracts on an aggregate basis. In the present case, the Tribunal opined that the taxpayer's conduct had been proved pursuant to the conditions stipulated in the agreement and understanding with the AE and it was evident from the margins derived and declared by the taxpayer for various years.

- The Tribunal highlighted the DRP direction of including both IT & ITeS comparables for determining the arm's length margin to establish that the Revenue had accepted the bundled nature of the service under the composite contract. The margins thus calculated also established that the taxpayer's margin was at arm's length. This acceptance of the bundled arrangement further overrules the forced segmentation performed by the TPO of the accounts into SD and BPO services and ignoring the segmentation provided by the taxpayer of the bundled arrangement between AE and non-AE segment. Thus the Tribunal observed that the forced bifurcation performed by the TPO and the workings and the margins arrived for BPO segment and in respect of the comparables was not needed at all, as the segmented profitability statement in respect of both IT and ITeS rendered to AE and non-AE was already on record before the TPO. The Tribunal explained that if the same was considered, the taxpayer's margin was very much at ALP and hence there was no question of making any adjustment to ALP.

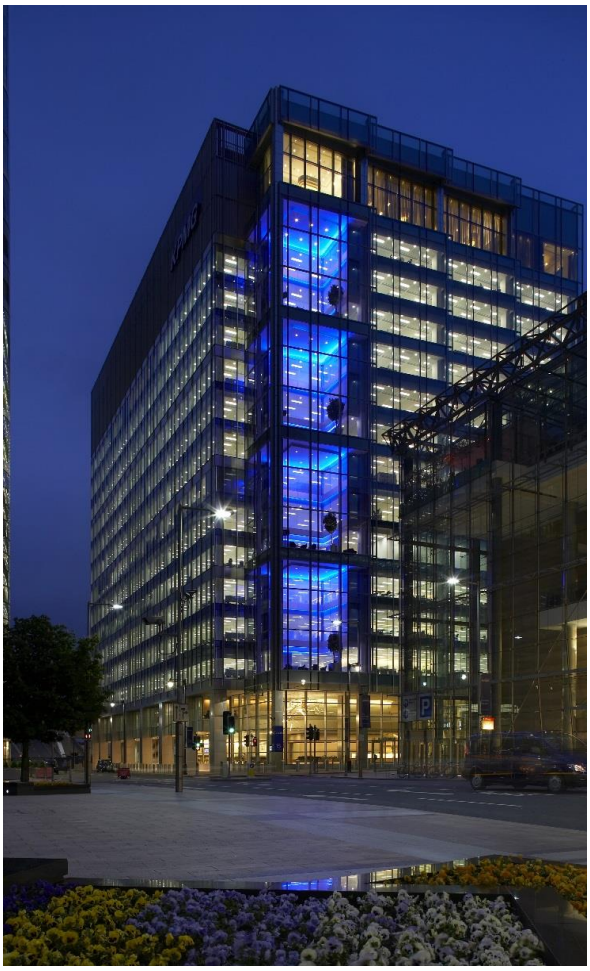
- Thus the Tribunal accepted the taxpayer's contentions and held that the other arguments advanced by the taxpayer on the principles of 'intentional set off' from one segment to another segment under Transactional Net Margin Method (TNMM) which was relied upon by the Delhi High Court in the case of Sony Ericsson Mobile Communications India (P) Ltd[5] need not be gone into.

[2] Cummins India Ltd v. ACIT (2015) 53 taxmann.com 53 (Pune)
[3] Boskalis International Dredging International CV v. DDIT (ITA No. 4862/Mum/2008)
[4] Birla Soft Limited v. ACIT (ITA No. 4001/Del/2009)

[5] Sony Ericsson Mobile Communications India Pvt Ltd v. CIT [2015] 374 ITR 118 (Del)

Our comments

The ruling categorically establishes the acceptance of a composite contract and the application of a bundled pricing in IT & ITeS, wherein the two services can be established to be closely linked. Thus the portfolio approach has been reinforced alongwith the importance of contractual terms in establishing the conformation of arm's length principle.



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