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TAX

Transfer pricing provisions would be applicable to a transaction entered with an unrelated entity which is deemed associated enterprise

The Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Diageo India Private Limited[1] (the taxpayer) held that the contractor of bottling unit of the taxpayer and the overseas Diageo group entities are Associated Enterprises (AEs) and transaction entered between them are covered by the provisions of the Indian transfer pricing regulations.

Further the reference made by the Assessing Officer (AO) to the Transfer Pricing Officer (TPO) is transaction specific and not enterprise specific. The TPO has no power to scrutinise the transactions which are specifically not referred to him by the AO.

Facts of the case

- The taxpayer is engaged in the business of manufacturing and marketing of various international brands of alcoholic beverages.
- The entire manufacturing operation was done through Contract Bottling Units (CBU).
- The business of the taxpayer can be divided into two distinct segments - namely Whiskey which was manufactured using imported concentrates and flavor, and OTW (i.e. alcoholic beverages other than whiskey, such as rum, vodka etc.) which was manufactured using locally procured material.

[1] Diageo India Private Limited v. ACIT [ITA No 8602/Mum/2010 dated 7 September 2011 (AY 2006-07)]

- The taxpayer paid fixed percentage of profit on the cost to CBU. Under both segment, CBU realised sale proceeds and incurred all manufacturing costs. The balance amount out of gross sales after deducting all costs and agreed profit margin was passed by the CBU to the taxpayer.

- Out of abundant caution, the taxpayer reported transactions entered between CBU and overseas Diageo Group entities in its Form 3CEB.

Issue 1 - Adjustment on account of concentrates and flavour imported by CBU from AEs;

Taxpayer's Contention

Whether a deemed AE?

- CBU, is an unrelated party and, therefore, it cannot be treated as an associate enterprise of the taxpayer and hence, the transaction entered between CBU and overseas Diageo group entities ought not to be covered by the provision of Indian transfer pricing regulations.

Benchmarking - Internal Transactional Net Margin Method (TNMM) Analysis

- The taxpayer contended that since the whisky segment and OTW segment operate in the same line of business, the OTW segment should be considered as comparable of the whisky segment.

- The taxpayer has earned higher profitability in the whisky segment (wherein imported concentrates and flavor are consumed) as compared to the OTW segment and hence no adjustment is warranted.

Benchmarking - External TNMM Analysis

- If the external comparables were to be selected then the taxpayer contended that high profit / high loss making companies should be rejected from the set of comparables.

Tax department's contention

CBU a deemed AE

- The definition of associated enterprises as per Section 92A(1) of the Act is wide enough to cover situation in which taxpayer controls, directly or indirectly other enterprises.

- CBU was wholly dependent on the trademark owned by Diageo Group. In view of the deeming fiction set out under Section 92A(2)(g) of the Act, the transaction entered between CBU and overseas Diageo group entities is covered by the provision of Indian transfer pricing regulations.

Benchmarking

- The TPO asked the taxpayer to furnish Net Profit Margin with respect to the tested party vis-à-vis comparable cases which is as under:

Particulars	**Whiskey Segment** **(Imported purchases)**	**OTW Segment** **(Local purchases)**	**Total**
Tested Party	1.14 %	(4.93%)	(3.07%)
Comparables	5.25%		

- The TPO compared the NPM earned by the taxpayer from the Whiskey segment with the NPM earned by comparable companies and made an adjustment of 12 million in respect of purchases made by CBU from overseas Diageo Group entities.

Tribunal's ruling

CBU a deemed AE

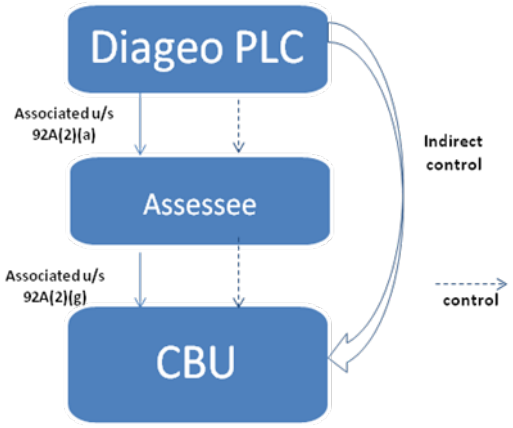
- The Tribunal observed that the expression 'participation in control or management or capital' in Section 92A(1) of the Act refers to 'de facto' control on decision making.

- Section 92A (2) of the Act gives practical illustrations of kinds of control. All the illustrations deal with simple situation involving two enterprise, but these illustrations are equally good for application in situations involving more than two enterprises as envisaged in Section 92A(1)(b) of the Act.

- The Tribunal observed that the CBU was wholly dependent on use of trademarks on which the taxpayer has exclusive right. This relationship meets the test of de facto control on decision making as set out in Section 92A(2)(g) of the Act.

- Thus Diageo PLC (through the taxpayer as intermediary), indirectly controls CBU. Therefore the taxpayer, overseas Diageo Group entities and CBU are AE.

- The cost of imported concentrates and flavor, though incurred by CBU, is effective picked up by the taxpayer. (i.e. the balance amount out of gross sales after deducting all costs and agreed profit margin was passed by the CBU to the taxpayer). Thus the transaction is entered between the taxpayer and overseas Diageo group entities.



Benchmarking - Internal TNMM Analysis

- The Tribunal rejected the taxpayer's internal TNMM analysis on the following premise:

  - Whisky is an established product with a mass base and OTW products are yet to be established and comparatively at initial stages in the Indian market; and

  - Huge difference in the level of marketing and overhead expenditure incurred by taxpayer for Whisky segment and OTW segment.

Benchmarking - External TNMM Analysis

- The Tribunal held that comparable companies could not be rejected merely because of high profits or high losses, unless accompanied by other relevant factors (such as related party transactions or functional dissimilarity, etc).

- The Tribunal held there is some merit in excluding comparables at top end and bottom end of the range. However, in the absence of the specific provision, such as inter-quartile range in the Indian transfer pricing regulations, the comparables could not be excluded based on first quartile and fourth quartile.

Standard Deduction as per Section 92C of the Act

- Relying on decision in case of UE Trade Corporation India Ltd[2], the Tribunal allowed the benefit of 5 percent reduction while computing the arm's length price. The Tribunal observed the amendment to Section 92C of the Act w.e.f. October 2009 is prospective.

[2] ACIT Vs UE Trade Corporation India Ltd [2011] 44 SOT 457 (Delhi)

The Tribunal therefore held that import transaction between CBU and overseas Diageo group entities are covered by the provision of Indian transfer pricing regulations.

Further, the Tribunal also upheld the approach adopted by the TPO of using external TNMM analysis, as against internal TNMM analysis, to benchmark purchases made by the CBU from overseas Diageo group entities. Thus Tribunal confirmed an adjustment of INR 12 million made by the TPO.

Issue 2 – Marketing Intangible - Disallowance of excessive advertising, marketing and promotion expenses

Tax department's contention

- The taxpayer had incurred an expenditure of Rs 372.20 million (40.64 percent of turnover) on advertising, marketing and promotion of products.

- The taxpayer has incurred substantial advertising expenditure which would result in creation of a marketing intangible.

- The taxpayer has acted to increase the value of brand names owned by AE. Therefore taxpayer ought to have charged AE for rendering brand promotion services.

- The TPO compared the ratio of advertisement, marketing and promotion expenses to sales incurred by taxpayer vis-a-vis one of the comparable company i.e. United Spirits Limited which incurred highest advertisement, marketing and promotion expenses (6.2 percent of sales) as compared to other comparables.

- The TPO disallowed the advertising, marketing and promotion expenses in excess of 6.2 percent (INR 315.40 million) incurred by taxpayer alleging "contribution by the taxpayer towards the strengthening the brands owned by the AE"

Taxpayer's contention

- No reference was made to the TPO by the AO for ascertaining arm's length price in respect of advertising, marketing and promotion expenses. The taxpayer placed reliance on the decision of 3i Infotech Ltd[3].

[3] 3i Infotech Ltd v. DCIT [2011] 136 TTJ 641(Mum)

Tribunal's ruling

- The Tribunal held that reference made by the AO to the TPO under Section 92 CA(3) of the Act, is transaction specific and not enterprise specific.

- The TPO has no powers to scrutinise transactions which have not been referred to him by the AO.

- Instructions issued by the Central Board of Direct Taxes (Instruction No. 3 of 2003, dated. 20 May 2003) are binding on all field authorities.

- The Tribunal deleted entire adjustment of INR 315.40 million and held that the TPO's order in respect of this adjustment is to be treated as nonest.

Our comments

In this judgment the Tribunal has evaluated situations wherein a unrelated enterprises (i.e. third parties) could be considered as deemed AE as per criteria laid under section under Section 92A(2) of the Act and transfer pricing regulation could be made applicable to such entities.

The Tribunal has also held that the TPO has no jurisdiction to adjudicate transactions which are specifically not referred by the AO, in line with the earlier ruling of the Mumbai Tribunal in the case of 3i Infotech Ltd.

This is the welcome judgment, as the taxpayer can place reliance on same to defend their position against adjustment, if any, made by the TPO in respect of certain transaction (such as marketing intangible, quasi equity, guarantee etc) that may not have been specifically referred by the AO. However, the Finance Act 2011 by virtue of amendment has empowered the TPO to adjudicate such transaction with effect from June 1, 2011. Accordingly, this judgment should be helpful for cases before the amendment becomes applicable.

Further, the matter relating to elimination of high profit making / high loss making companies has always been a subject matter of debate between the tax department and the taxpayer. In light of this judgment, it is imperative that while rejecting high profit making / high loss making companies, the taxpayers should conduct additional analysis to identify functional differences that could have influenced the financial outcome of such companies.

Generally, internal comparable has a more direct and closer relationship with controlled transaction and are based on identical accounting standards and practices, as compared to external comparable. Therefore internal TNMM analysis is preferred over external TNMM analysis. In this judgment, it appears that due to the specific facts of the case the

Tribunal has rejected internal TNMM analysis and selected external TNMM analysis.

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