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TAX

Mumbai Tribunal held in favour of the taxpayer certain core issues in Transfer Pricing

Recently, the Mumbai bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Emerson Process Management India Pvt. Ltd[1](the taxpayer) held that certain core issues in Transfer Pricing such as selection of comparables, working capital adjustments, availability of standard deduction of +/-5 percent, adjustment to be restricted only to the international transactions with the Associated Enterprises(AE's), in favour of the taxpayer.

Facts of the case

- The taxpayer is engaged in the business of providing process management solutions, which helps to automate, control, manage complex plant processes. The taxpayer manufactures mass flow meters, liquid and gas analytical instrumentation and systems. Temperature transmitters and level instrumentation.

- The taxpayer has entered into various international transactions with its AEs such as import of raw material and other supplies, export of finished goods, import of testing material, etc. The taxpayer benchmarked these transactions under Transaction Net margin Method (TNMM) after identifying 12 comparable companies.

- The taxpayer had also claimed adjustment for difference in working capital and also in respect of abnormal provisions for doubtful debts in the transfer-Pricing documentation.

- During the assessment proceedings, the Transfer Pricing Officer (TPO), recommended adjustment to the International Transactions by including three additional companies (i.e. Aplab Ltd., Ashco

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[1] Emerson Process Management India Pvt. Ltd. v. ACIT (ITA No. 8118/Mum/2010) (Assessment Year 2006-07)

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Industries Ltd., and Elecon Engineering Co. Ltd.) as comparable on the ground that those companies were selected by the Appellant itself in the preceding year. In the process the TPO disregarded functional comparability for the year under review.

- TPO allowed Working capital adjustment, however he excluded inventory while computing the same.

- While computing the taxpayer's operating margin, the TPO considered commission income as non-operating in nature. He also rejected the benefit of +/-5 percent claimed by the taxpayer.

- Aggrieved by the same, the taxpayer filed objections with the Dispute Resolution Panel (DRP). The only relief given by the DRP was in excluding Elecon Engineering Co. Ltd., one of the companies added as comparable by the TPO.

- The Assessing Officer passed the final order under Section 143(3) read with Section 144C (6) of the Income-tax Act, 1961 (the Act). Aggrieved by the said order the taxpayer preferred an appeal before the Tribunal.

Tribunal's Ruling

Selection of the Comparables companies

The Tribunal held that the selection of a comparable company should be determined having regard to its functional comparability for the year under review and not with reference to preceding years.

In particular, the Tribunal observed " ... *The fact that this company was selected as one of the comparables, by assessee himself, in the preceding assessment year cannot be put against the assessee, as whether or not a comparable is to be included must depend on its merits rather than be solely guided by events of an earlier year - particularly when assessee is successfully able to demonstrate that the entity sought to be used as comparable is not engaged in same or materially similar business at least in the present year."*

Accordingly, on the grounds of functional non-comparability for the previous year, the tribunal rejected both the TPO's alleged comparables that had survived the DRP.

The Tribunal observed that when TPO is insisting for inclusion of a comparable, the onus is on him to demonstrate that the comparability criteria are met.

Working Capital Adjustments

The Tribunal held that once in principle working Capital adjustment (WCA) is allowed, inventory which is an essential ingredient for working out the same should not be excluded.

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Working of the profitability margins taking Operating margins to Sales as the PLI

As mentioned earlier the TPO did not consider Commission income as operating income while arriving at the profitability margins of the Company. The ITAT observed that since the taxpayer was engaged in rendering warranty services for direct sales on which commission was earned and part of marketing efforts also contributed to commission earning, the commission income on direct sales should not be excluded while computing the operating margins of the taxpayer.

Benefit of deduction of +/-5 percent

The Tribunal held that the adjustment of 5 percent is to be allowed even in cases where difference in value of international transactions and its ALP is more than 5 percent. The Tribunal followed the ruling in the case of UE Trade Corporation India Pvt Ltd[2], wherein a Delhi bench had taken the view that the amendment effected to Section 92C(2) of the Act is only prospective in nature, and that so far as pre 1October 2009 position is concerned, the adjustment of 5 percent is to be allowed even in the cases where difference in value of international transactions and its ALP is more than 5 percent.

Transfer pricing adjustments to be restricted to the International transaction

The Tribunal further concluded that TP adjustment has to be worked out in respect of taxpayer's international transaction only, and not with respect to the entire sales of the taxpayer company.

Incorrect Computation of the margins

In respect of error in the calculation of margin by the TPO, the Tribunal remitted the matter to the file of AO for dealing with the computation of correct margins after giving the taxpayer an opportunity of hearing.

Technical issues such as proper references to the TPO, use of multiple year data

In respect of other technical issues such as validity of reference to the TPO, use of multiple year data etc. the Tribunal chose not to adjudicate on these issues as the Appellant had already succeeded on factual issues on merits.

Our Comments

The above decision of the Tribunal highlights and reinforces the point that comparability has to be determined with reference to the previous year in question and merely because a Company is selected as Comparable in the preceding year cannot be a reason for considering it as Comparable in the later year without a proper justification.

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[2] ACIT v. UE Trade Corporation India Pvt Ltd [2010] 44 SOT 457 (Del)

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More importantly, the favorable ruling on the issue of deduction of +/-5 percent is welcome considering a recent adverse ruling on this issue by the Hyderabad bench in the case of Deloitte Consulting.

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