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KPMG Flash News

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TAX

Markup on costs incurred is not an arm's length remuneration for sourcing support service and the taxpayer should be compensated on the basis of value of the goods sourced through it

Recently the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Li & Fung (India) Pvt. Ltd.[1] (the taxpayer) held that markup on costs incurred is not an arm's length remuneration for sourcing support service and the taxpayer should be compensated on the basis of value of the goods sourced through it.

Facts of the case

- During the financial year 2005-06 the taxpayer provided sourcing support services to its Hong Kong affiliate (AE) for which it received a remuneration of cost plus 5 percent. The taxpayer applied Transactional Net Margin Method (TNMM) to determine the Arm's Length Price (ALP) of such remuneration.

- The Transfer Pricing Officer (TPO) held that over and above the costs of the taxpayer, it should receive commission at the rate of 5 percent of the Free on Board (FOB) value of exports. The Dispute Resolution Panel (DRP) upheld the order of the TPO on principle but reduced such commission to 3 percent on FOB value of exports.

Taxpayer's contentions

- The taxpayer is a limited risk service provider and the agreements had been entered into only by the AE with third party customers. The remuneration model should be based on functions performed by the taxpayer and the operating costs incurred by it and not on the cost of goods sourced from third party vendors in India.

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[1]Li & Fung (India) Pvt. Ltd. v. DCIT [ITA No. 5156/Del/2010]

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- There is no provision under TNMM to consider or impute cost incurred by third parties (like value of goods sourced) while computing Net Profit Margin (NPM) of the taxpayer for application of TNMM.

- As the taxpayer has received nearly 80 percent of the entire consideration received by the AE for rendering sourcing services and the AE has retained only 20 percent of the total consideration, there can be no allegation of transfer of profit from India.

- The amount of adjustment of INR 336 million computed by the Assessing Officer (AO) could not have exceeded the amount of INR 124.6 million retained by the AE out of the total compensation received from third party customers.

Tax Department's contentions

- The taxpayer is performing all critical functions with the help of its technical capacity and manpower to execute the work. The taxpayer has developed unique intangibles, human asset intangible and a supply chain management which is very crucial to achieve strategic and pricing advantages.

- Since the AE was receiving 5 percent of the FOB value of exports from the purchasers and the taxpayer was performing all the critical functions, the taxpayer must receive a majority of the receipts with regard to the execution and the compensation should be based on FOB value of exports.

Tribunal's ruling

- The taxpayer's contention that it did not enter into any agreements with the third parties did not hold merit since the taxpayer performs all the critical functions to fulfill the conditions of the agreements entered into by the AE with the third parties.

- The taxpayer's contention that there is no provision in TNMM to include the cost incurred by third parties to compute the NPM of the taxpayer does not hold good in this case. The AE is charging from third party at 5 percent of the FOB value of the exports from India. Such exports are made possible because of the efforts of the taxpayer. Therefore, the taxpayer's remuneration should also be based on the FOB value of the exports.

- The cost plus markup approach rewards inefficiency and is therefore against basic normal business sense.

- The amount of adjustment cannot exceed the amount that has been retained by the AE out of the total remuneration received from third party customers. Since the majority of the functions and all the crucial functions are performed by the taxpayer therefore the distribution of compensation received by the AE (i.e. 5 percent of

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the FOB value of exports) between the taxpayer and the AE should be in the ratio of 80:20. The Tribunal directed the AO to compute the ALP in such manner.

Our comments

The Tribunal has advocated 80:20 sharing of revenue between the taxpayer and the AE without giving any explicit basis for this ratio.

It is also interesting to note that in this judgment, the Tribunal has directed the AO to compute the ALP by applying a revenue sharing methodology, which is not one of the five methods, as has been prescribed in the Indian Transfer Pricing regulations.

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