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TAX FLASH NEWS

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Taxpayer's contractual obligation to make payment cannot *ipso facto* absolve such payment or taxpayer from primary duty of demonstrating the arm's length behaviour

Background

The Delhi High Court, in the case of Magneti Marelli Powertrain India Pvt. Ltd.[1] (taxpayer), held that taxpayer's contractual obligation to make a payment as per business and commercial requirements and arrangements cannot *ipso facto* be the end of the enquiry. Arm's Length Price (ALP) determination in respect of each international transaction is required be carried out irrespective of taxpayer's obligation to make payment arising out of agreement(s) between the transacting parties.

The High Court upheld the taxpayer's contention that having accepted Transactional Net Margin Method (TNMM) as the most appropriate method (MAM) for all other international transactions, it was not open to the Transfer Pricing Officer (TPO) to subject only one transaction, i.e. payment of technical assistance fee (TCA fee), to an entirely different (i.e. Comparable Uncontrolled Price - CUP) method.

Facts of the case

- The taxpayer manufactured and sold Engine Control Units (ECUs) and had entered into License and Technology Assistance Agreements (LTAAs) with its overseas associated enterprise (AE) for obtaining ECU technology for a payment of lumpsum TCA fee. Taxpayer adopted TNMM to benchmark all its international transactions and claimed that its international transactions (which included `payment of TCA fee') were at arm's length.

- The TPO rejected taxpayer's 'entity level' benchmarking approach. TPO further held that all international transactions could not be at arm's length merely because the overall operating profit was more than that of the comparable companies. Accordingly, the TPO rejected TNMM and applied CUP method in respect of the transaction of payment of TCA fee and determined its ALP to be Nil.

- The Dispute Resolution Panel (DRP) upheld the TPO's order, the taxpayer further appealed before the Tribunal.

Tribunal's ruling

- Even if a payment was capitalised and depreciation was claimed on it, the character of international transaction and need to justify the arm's length standard was left intact.

- Taxpayer's approach of combining international transactions for determining ALP on a consolidated basis is incorrect and is not in accordance with law. Merely because the overall profit earned by the taxpayer is more, would not ipso facto lead to the inference that all the international transactions are at ALP.

- Since the requirement under law is to consider the `actual' figures of the financial year in which international transaction was entered into, the taxpayer's reliance on `projected' figures and adoption of 'projected operating profit margin' to justify ALP was not justified.

[1] Magneti Marelli Powertrain India Pvt. Ltd. v. DCIT - Delhi High Court (ITA 350/2014) – Taxsutra.com

- Since the taxpayer had received technical assistance from the AEs, TPO's determination of ALP under CUP method at Nil was not appropriate.

- Neither the taxpayer followed the correct methodology for determination of ALP, nor the TPO/DRP applied the CUP method correctly.

- The order of the Assessing Officer (AO) was accordingly set aside and the matter restored to the file of TPO/ AO for a fresh determination of ALP.

Taxpayer contentions

- Relying on Section 92C(1) and (3) of the Income-tax Act, 1961 (the Act), taxpayer contended that it is not open to the TPO/AO to segregate a set of transactions from a series or class of transactions while carrying out the benchmarking exercise.

- Technology itself would not have been given to the taxpayer but for the substantial fee (paid, over and above the royalty payable).

- The international commercial transactions cannot be looked into by tax authorities in a manner so as to place themselves in the position of businessman. In this regard, the taxpayer relied on the High Court ruling in case of Sony Ericsson Mobile Communications India (P) Ltd[2].

- The law being flexible on the issue, de-segregation or separation of an integrated transaction (TCA fee in this case) and subjecting it to separate examination, was not justified.

Tax department's contentions

- The tax department contended that reliance placed on Sony Ericsson (supra) is inappropriate as it does not stipulate any invariable rule with respect to aggregation or de-segregation of transactions. It merely endorsed the view that aggregation is desirable.

- The tax department also relied on Denso India Limited[3] to say that whether to permit aggregation or de-segregate bundled transactions is entirely dependent on facts of each case.

- The TPO observed that neither any cost benefit analysis nor any benchmarking exercise was undertaken at the time of entering into the agreement. The cost-benefit analysis provided by the taxpayer did not explain why such a large amount was paid to the AE when royalty was already being paid separately.

Issues before the High Court

- Whether payments on account of royalty and TCA fee could be treated as separate transactions for purposes of carrying out the economic benchmarking exercise?

- The second question related to the choice of MAM for the purpose of determining ALP of payment of TCA fee.

High Court's ruling

First question of law

- The High Court relied on several jurisdictional High Court rulings[4] and observed that in the case of Sony Ericsson, aggregation principle was endorsed and in the case of Denso India (supra) while endorsing that view, it was also stated that whether to permit aggregation or not is a fact dependent decision.

- The lower authorities correctly turned down the method of justifying payment of a technical fee- with 'proof' of its necessity by relying on profits.

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[2] Sony Ericsson Mobile Communications India (P) Ltd v CIT [2015] 374 ITR 118 (Del)

[3] Denso India Limited v. ACIT (ITA No. 443/2013 and ITA No. 451/2013)

[4] CIT v. EKL Appliances Ltd. [2012] 345 ITR 241 (Del), Sony Ericsson Mobile Communications India (P) Ltd v CIT [2015] 374 ITR 118 (Del) and Denso India Limited v. ACIT (ITA No. 443/2013 and ITA No. 451/2013)

- The initial burden remains on the taxpayer to prove that the international transactions are at arm's length. The taxpayer's Transfer Pricing (TP) report necessarily had to draw a comparison with other entities (maybe competitors) to show the general degree of profitability of the venture in question.

- The ALP determination in respect of each international transaction is required be carried out irrespective of taxpayer's obligation to make payment arising out of agreement(s) between the transacting parties.

- If the transactions, in the opinion of TPO, are not at arm's length, the necessary adjustment(s), as provided in the Act, has to be made irrespective of the fact that the expenditure is allowable under other provisions of the Act. Merely relying upon the profitability and escaping relevant queries of the TPO in relation to arm's length justification of the technology related payment is not acceptable.

- The taxpayer cannot state that payment of a certain amount need not be justified as it is justified by later profits.

Second question of law

- Having accepted TNMM as MAM for all other international transactions, it was not open to the TPO to subject only one transaction, i.e. payment of TCA fee, to an entirely different (CUP) method. Accordingly, TNMM had to be applied by the TPO/AO in respect of the TCA fee payment too.

Our comments

The above ruling is important on two counts. First, it emphasises on the fact that taxpayers cannot merely state business/ commercial reasons as justification for transactions without backing it up with appropriate arm's length analysis. Second, the TPO cannot simply reject the method adopted by the taxpayer in the TP documentation, replace it with any other method and arbitrarily determine the ALP of the transaction to be Nil.

However, the dictum of High Court in response to both questions of law seems to be contradictory, as in response to the first question, the High Court was convinced that payment of TCA fee had to be tested/ benchmarked separately on a standalone basis whereas in response to the second question, it has relied on TNMM method as being the MAM for testing the impugned transaction.

This judgment answers or clarifies many other issues that have been subject matter of controversies. All in all, it's important to understand certain underlying principles that are brought out like (i) commercial or business obligation or arrangement is not a substitute for justification of ALP (ii) the burden of proof of justifying ALP of a transaction primarily lies on the taxpayer, (iii) tax authorities cannot reject or impose any MAM without providing basis and justification for the same and affording the taxpayers a fair opportunity for representing.

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