cutting through complexity

30 April 2015

Delhi High Court rules that higher or abnormal profits / losses cannot be a factor for exclusion of a comparable

Background

Recently, the Delhi High Court (High Court), in case of ChrysCapital Investment Advisors (India) Pvt Ltd[1] (the taxpayer) upheld the findings given by the Delhi Bench of Income-tax Appellate Tribunal (the Tribunal) that if an entity makes high/extremely high profits/losses, it does not, ipso facto, lead to its exclusion of the said comparable company from the list of comparable for the purposes of determination of arm's length price (ALP). A detailed analysis of services provided, assets employed, risks assumed, etc. should be carried out to determine the comparability. The High Court also rejected the taxpayer's justification for relying on previous years' data and added there may be a wide fluctuation in the profit margins of comparables from year-to-year, this by itself does not justify the need to take into account previous years' profit margins. Also the ruling specifies, that India is not a member of the OECD[2] , and hence these Guidelines have only persuasive status; and do not have any legal sanction.

Facts of the case

- The taxpayer is a private limited company incorporated under the Companies Act, 1956 and is engaged in providing investment advisory services, which were reimbursed on a cost-plus mark-up basis. The taxpayer used the Transactional Net Margin Method (TNMM) and identified four entities: IDFC Investment Advisors Limited (IDFC), Future Capital Holdings Limited (Future Capital), Khandwala Securities Limited (Khandwala), Sumedha Fiscal Services Limited (Sumedha), which were engaged broadly in the same economic activities as in its case and identified as comparables.

- The taxpayer computed the arithmetic mean of the margins of the comparables using multiple year data. The taxpayer contended that because of fluctuation in the margins of the comparable entities, multiple year data of the comparables was warranted to remove the effect of year specific aberrations.

- The Transfer Pricing Officer (TPO) computed the Operating Margins of the four comparables using single year data and concluded that multiple year data for the taxpayer's comparables could not be used and also introduced two new comparables with abnormal business profits. The TPO held that the taxpayer had not furnished any detail as to how the data for the earlier years had an impact on the profits in the concerned assessment year of the taxpayer or the comparables, which would then substantiate the use of multiple year data.

- All the lower authorities included three entities [Brescon Corporate Advisors Limited (Brescon), Keynote Corporate Services Limited (Keynote) and Khandwala] as comparables which had very high profit margins as compared to that of the taxpayer. They also rejected three other comparables (IDFC, Future Capital and Sumedha) selected by the taxpayer. They also accepted the single year margins inspite of exceptionally high margins of the companies.

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[1] ChrysCapital Investment Advisors (India) Pvt Ltd vs DCIT (ITA No 417 of 2014, dated 27 April 205)- Taxsutra.com
[2] Organisation for Economic Co-operation and Development

- The Tribunal upheld these findings and held that current year data should be used in the absence of abnormal or exceptional facts/circumstances in existence which could have an influence on the results as well as the determination of the transfer prices for the year under consideration.
- Further, the Tribunal held that Rule 10B does not provide any basis to exclude an entity or eliminate it from the list of companies solely on the basis of high profitability.
- The Assessing Officer (AO) disallowed the bonus paid by the taxpayer to its shareholders (who were also full time employees) under Section 36(1)(ii) of Income-tax Act, 1961 (the Act).
- Aggrieved, the taxpayer preferred an appeal before the High Court.

Taxpayer's contention

- Companies which were functionally different (like Keynote and Brescon) should be rejected since they are risk bearing entities and the taxpayer is a limited risk bearing cost plus entity, wherein a guaranteed return of 25% on costs is assured to it.
- The taxpayer argued that Keynote's profit margins showed volatility over the years which could be attributed to abnormal business conditions and therefore Keynote should be rejected as a comparable.
- ALP of an international transaction has to be determined by applying one of the methods provided in Section 92C(3) of the Act; it should be the most appropriate method and should also take into account prescribed factors. This is elaborated in Rule 10B of the Income-tax Rules, 1962 ('the Rules'), which contemplates adjustment on account of functional and other differences.
- The taxpayer referred to the OECD guidelines and argued that accurate ALP determination is dependent on flexibility and sound exercise of discretion. Chapter III of the OECD guidelines was relied on to say that they recommend that where it can be determined that some uncontrolled transactions have a lesser degree of comparability than others, they should be eliminated.
- The Dispute Resolution Panel (DRP)'s order for AY 2006-07 had accepted the taxpayer's argument and excluded the Keynote from the list of comparables, on the ground that the company had earned abnormally high or super profits.
- The taxpayer relied on various rulings of various Benches of the Tribunal, which supported the ground of rejecting high profit/abnormal loss making companies. The entities earning "super normal" or "abnormal" profits should be excluded from the list of comparables.
- The taxpayer argued that the rejection of the previous year's data, in the facts of the case, was unwarranted.

Tax Department's contention

- The tax department contended that Rule 10B(1) makes it clear that specific characterisation of the property transferred or services is not relevant for TNMM and this position is in conformity with the relevant OECD guidelines which suggest that broad comparability of functions should be done for TNMM.
- It specified that neither the Act, nor the Rule contemplate exclusion of relevant transactions of like enterprises, in any manner other than what is prescribed. A comparable cannot be removed from consideration merely because it suffers loss; or enjoys higher profit or even one making a so called "super profit" too cannot be eliminated, unless statutorily permitted by Rule 10B(2) or (3).
- It was pointed out that Rule 10B(3)(ii) and Rule 10C(2)(e) permitted adjustment to eliminate material defects of the difference between the taxpayer and comparables.
- The ruling in case of Mentor Graphics[3] was reiterated, wherein it was held that OECD guidelines cannot be applied because there are specific provisions of Rule 10B (2) & (3) and the first proviso to Section 92C(2) which apply.

[3] CIT v. Mentor Graphics (Noida) Pvt. Ltd (ITA 1114/2008)

- It was submitted that accepting the theory of "abnormally high profits" as a ground for rejection of a comparable would lead to vagueness and confusion, since, what constitutes abnormally high has no where been spelt out in the Act or Rules.

High Court's ruling

The High court reiterated the application of Sections 92C, Rule 10B(1), 10B(2), 10B(3) and 10B(4). The court provided a tabular statement containing reasoning which persuaded the previous 21 Benches of the Tribunal to conclude on a similar ground relating to exclusion of companies making "supernormal" profits, which was relied on by the taxpayer. It also discussed the Maersk Global Centres[4] ruling, wherein a Special Bench was formed to specifically address this question.

The High Court ruled that:

- Based on the earlier rulings, it is evident that mere distortion cannot be the basis of exclusion, given the mandate of Section 92C.

- Mere circumstance of a company which otherwise conforms to all stipulations in Rule 10B, presenting a peculiar feature such as a huge profit or a huge turnover, ipso facto does not lead to its exclusion and would require an enquiry under Rule 10B(3). The material differences between the taxpayer and the comparable companies should be eliminated, and only in case such differences cannot be eliminated, can the company be rejected as a comparable.

- The general rule as prescribed in Rule 10B(4) mandates the tax authorities to take into account only the relevant assessment year's data. The use of multiple year is permitted only in the event that they have an influence on the determination of price. The Court rejected the taxpayer's contention for relying on previous years' data as well as manner of such reliance.

- The wide fluctuations in the profit margin of the comparables year-on-year, does not justify the need to take into account previous years' profit margins. While determining the comparability of transactions, multiple year data can only be included in the manner provided in Rule 10B(4). As a general rule, it is not open to the taxpayer to rely upon previous year's data.

- India is not a member of the OECD, and hence these Guidelines have only persuasive status; and do not have any legal sanction. Where they (i.e. the Act and the Rules) adequately cover a field, reliance on the OECD Guidelines is not warranted. The Court acknowledged that the OECD Guidelines and Rules in the specific case, are in consonance, since both do not in any manner, prescribe automatic exclusion of entities with extreme financial results.

- Remitted the matter with regards to Khandwala, Brescon, and Keynote to the DRP. For all the 3 companies, the DRP has been asked to carry out an analysis under Rule 10B(3) and with respect to Keynote, enquiry regarding the functional similarity also has to be carried out. Further to the analysis, if there are material differences arising out of their exceptionally high profits, which cannot be eliminated, the said company cannot be included as a comparable.

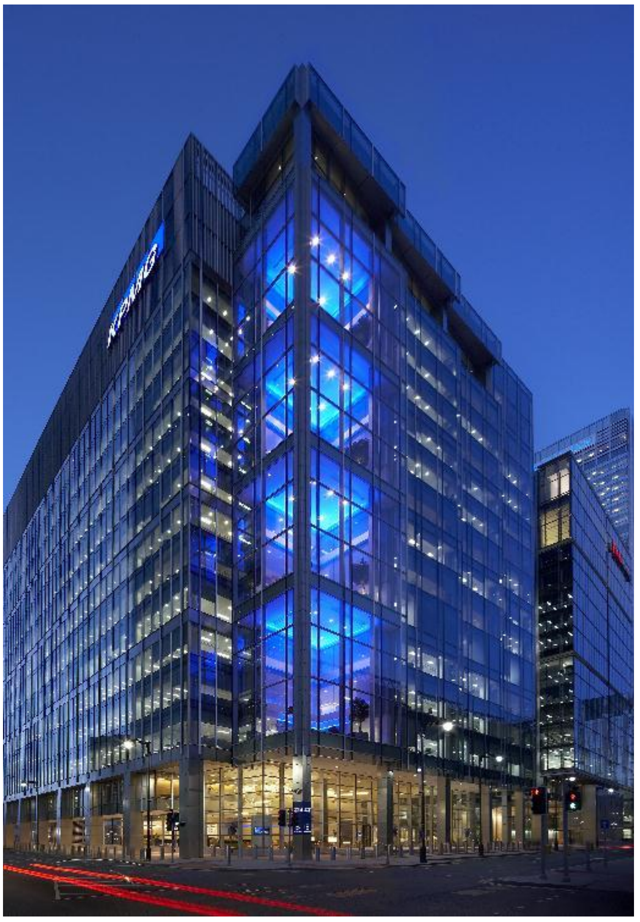
Our comments

The ruling provides an important guidance that the companies making abnormally high profits/losses cannot be out rightly rejected from the list of comparables. A detailed analysis of services provided by the said entities, assets employed, risks assumed, the contractual terms and conditions prevailing including the geographical location and size of the market, cost of labour and capital in the markets, etc. should be carried out. An analysis should also be done to determine as to whether the material differences between the taxpayer and the said entity can be eliminated. Unless such differences cannot be eliminated, the entity should not be included as a comparable.

[4] Maersk Global Centres (India) (P) Ltd.v. ACIT 43 Taxmann 100 (2014) (Mumbai Special Bench)

The Ruling also reiterates using the current year data in the absence of abnormal or exceptional facts/circumstances. It clearly states that as a general rule, it is not open to the taxpayer to rely upon the previous year's data. The use of multiple year is permitted only in the event, if the previous year's data reveals facts, which could have an influence on the determination of transfer prices in relation to the transactions being compared. The onus is on the taxpayer to show such inference.

The ruling also re-emphaises that the OECD Guidelines have only persuasive status in India. The Courts are primarily bound by the law (Income-tax Act and Rules) on the subject in India. As per the ruling, if the topic is adequately covered in the Act and Rules, the reference to OECD guidelines may not be necessary.



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