

TAX FLASH NEWS

The Punjab and Haryana High Court holds that companies selected should be functionally comparable and not identical

Background

Recently, the Punjab and Haryana High Court in the case of DSM Anti Infectives India Ltd¹ (the taxpayer) upheld the Income-tax Appellate Tribunal's conclusion that certain companies would be appropriate comparables irrespective of the percentage of use of a certain raw material, Penicillin-G (PEN-G), by them since companies selected should be functionally comparable and not identical.

Facts of the case

- During the assessment year (AY) 2005-06, the taxpayer entered into various international transactions with its associated enterprises (AEs) and adopted transactional net margin method (TNMM) as the most appropriate method for determining the Arm's Length Price (ALP) and selected six comparables.
- The Transfer Pricing Officer (TPO) rejected all the comparable companies adopted by the taxpayer in the transfer pricing (TP) study on various grounds. With respect to a comparable, Torrent Gujarat Biotech Limited, the TPO held that the proportion of the main ingredient, Penicillin-G (PEN-G), as a raw material was negligible. The TPO finally selected three companies, namely, Aurobindo Pharma Ltd., Nectar Life Sciences Ltd. and Standard Pharmaceuticals Ltd. The TPO had applied a filter of 'only companies using Penicillin-G as raw material'. This filter however, did not stipulate the extent of usage of PEN-G.

- The Commissioner of Income Tax (Appeals) [CIT(A)] held only Nectar Life Sciences Limited to be the appropriate comparable and rejected Aurobindo Pharma Limited and Standard Pharmaceuticals Limited as comparables. It did not accept the taxpayer's contention that Torrent Gujarat Biotech Limited also ought to be considered a comparable.

Tribunal's ruling

- The Tribunal held four companies as appropriate comparables: Torrent Gujarat Biotech Limited, Aurobindo Pharma Limited, Nectar Life Sciences Limited and Standard Pharmaceuticals Limited and accepted the taxpayer's contention that where the facts are identical from year to year, similar filters should be adopted for benchmarking international transactions.
- The Tribunal accepted the taxpayer's contention that Torrent Gujarat Biotech Limited ought not to be rejected on the ground that its use of PEN-G was only 7.60 per cent of its total sale. The filter applied by the TPO of selecting only companies using PEN-G as raw material did not specify the extent of use of PEN-G by the company. The TPO himself had selected Standard Pharmaceuticals Limited to be one of the comparables, although this company's usage of PEN-G was only 5.23 per cent of its total sales (i.e. less than the proportionate usage of PEN-G by Torrent Gujarat Biotech Limited which was 7.60 per cent).

¹ CIT-I v. DSM Anti Infectives India Ltd. - ITA No.116 of 2014 (O&M) – High Court of Punjab and Haryana (Assessment year 2005-06)

Question before the High Court

“Whether the Tribunal has erred in directing the TPO to include Torrent Gujarat Biotech Limited and Standard Pharmaceuticals Limited as comparables, considering the fact that they were using only a very small percentage of Penicillin-G as raw material as compared to taxpayer and could not have been used as a filter?”

High Court’s ruling

- The High Court held that the Tribunal’s conclusion that the said companies would be appropriate comparables irrespective of the percentage of use of PEN-G by them since companies selected should be functionally comparable and not identical, cannot be said to be perverse or absurd.
- Tribunal also included Standard Pharmaceuticals Limited as a comparable which was logical in view of its finding that a company ought to be considered as an appropriate comparable irrespective of its percentage of use of PEN-G.
- The TPO had himself considered Standard Pharmaceuticals Limited to be a comparable. The Tribunal’s conclusion was not based merely upon the TPO having initially considered Standard Pharmaceuticals Limited to be a comparable but also on the ground that the filters adopted by the TPO did not stipulate the percentage of use of PEN-G by a company of its total sales or use of raw material.
- The Revenue had contended that Torrent Gujarat Biotech Limited had made a reference under the Sick Industrial Companies (Special Provisions) Act, 1985 which indicated that it had a negative net worth. The Revenue’s contention that Torrent Gujarat Biotech Limited did not fulfil the filters of not being a company having a negative net worth was not raised before the lower authorities. In this regard, the High Court held that it would be unfair to permit the appellant to raise this contention before the High Court. The High Court also held that prima facie there is nothing to indicate that in the financial year 2004-05, Torrent Gujarat Biotech Limited had a negative net worth. If the issue is raised before the authorities, while giving the matter appeal effect or in any other proceedings, it could be decided in accordance with law. The contentions of the parties including as to the maintainability of such a contention were kept open.

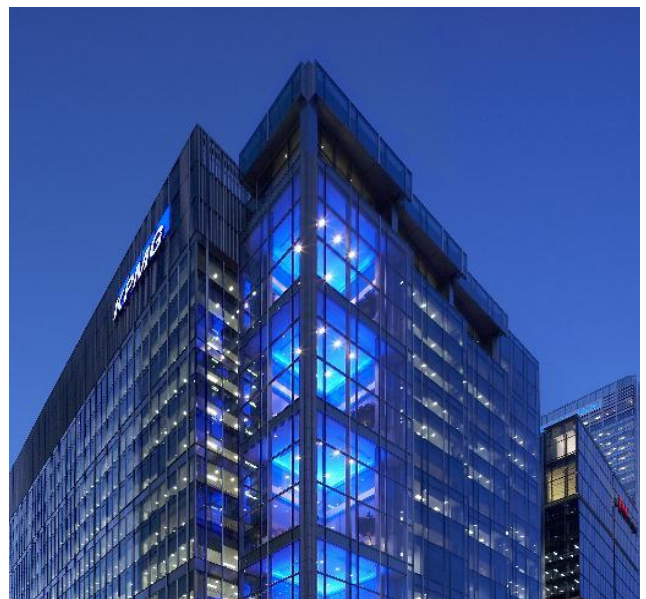
- Most importantly, the High Court held that the issues in the case did not raise a question of law, much less a substantial question of law. It was held that the Tribunal’s order was not perverse or absurd. It was in fact in line with the view that the TPO himself took by selecting Standard Pharmaceuticals Limited where use of PEN-G was only 5.23 per cent as against the 7.60 per cent use of PEN-G by Torrent Gujarat Biotech Limited. The High Court therefore dismissed the appeal.

Our comments

An important principle highlighted by the High Court in this case is that while using margin based method, especially TNMM, as long as there is functional similarity between the comparables, they need not be identical.

Further, the High Court has also emphasised on the fact that if an issue or contention is not raised in front of the lower authorities (i.e. Tribunal or CIT (A)), then it would not be admissible before the higher authorities. Thus, it is imperative for the taxpayers to prepare their grounds, arguments and submissions to be filed at the lower level authorities very carefully and after thorough analysis.

In the above case, the High Court has also ruled that the issues before the Court like percentage of use of raw material by comparable companies and whether the company’s net worth was negative were merely questions of fact, and not questions of law, leave alone substantial questions of law. The taxpayers should be aware that the Tribunal is the final fact finding authority and any questions of facts put before the High Court would only lead to wastage of time, resources and efforts of the Judiciary as well as the taxpayers.



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