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TAX FLASH NEWS

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Aggregation of transaction under TNMM is rejected since facts of the case indicated unusual features which remained unexplained by the taxpayer - Delhi High Court

Background

Recently, the Delhi High Court (High Court), in the case of Denso India Limited[1] (the taxpayer), rejected aggregation of import transaction under Transactional Net Margin Method (TNMM), since facts of the case demonstrated that the arrangements made in relation to the transaction, when viewed in their totality, differed from those which would have been adopted by independent enterprises behaving in a commercially rational manner. The High Court upheld the approach of the Transfer Pricing Officer (TPO) to scrutinise and benchmark the transaction pertaining to import of components separately.

Facts of the case

- The taxpayer was engaged in manufacturing and sale of auto electrical products such as Starters, Alternators, Wiper Motors, CDI, Magnetos, etc., for four wheel and two wheel vehicles. The promoters of the taxpayer included Denso Corporation, Japan (Denso) and Sumitomo Corporation, Japan (Sumitomo) who held 47.93 per cent and 10.27 per cent respectively.
- In Assessment Year (AY) 2002-03 and AY 2003-04, the taxpayer had various international transactions with its Associated Enterprises (AEs), such as payment of royalty, technical know-how, testing fees, etc. It had benchmarked these international transactions along with the import of components on an aggregated basis using TNMM as the Most Appropriate Method (MAM). During AY 2002-03, the taxpayer imported raw material components from Sumitomo, which constituted around 86.3 per cent of the total imports and 37.5 per cent of the total raw material consumed. The taxpayer had taken a stand that since shareholding of Sumitomo is less than 26 per cent; it is not its AE and hence did not report this purchase transaction as an international transaction in Form 3CEB. The facts were similar in AY 2003-04.
- During the course of assessment proceedings, the TPO accepted all the transactions at arm's length based on the benchmarking conducted by the taxpayer using TNMM as the MAM. However, the TPO noticed that the components imported from Sumitomo were, in fact, manufactured by Denso and it was so routed through an intermediary with the sole objective of camouflaging the actual transaction of purchases being made from an AE.

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

- The TPO treated this transaction of purchase of components from Sumitomo as an international transaction under 92B(2) of the Income-tax Act, 1961 (the Act). This finding is not disputed by the taxpayer. The TPO, however, rejected taxpayer's submission to treat TNMM for benchmarking this transaction and applied Comparable Uncontrolled Price (CUP) method by comparing the price of components imported with that of the price of indigenous components purchased from domestic suppliers.
- Aggrieved by the said order, the taxpayer appealed to the Commissioner of Income Tax (Appeals) [CIT(A)], who directed deletion of the said adjustment. The Revenue appealed the CIT(A)'s order before the Tribunal and was successful in restoring the transfer pricing (TP) adjustment pertaining to the transaction of import of components with directions on the proper application of CUP method.

Taxpayer's contentions

- The contention of the taxpayer is that, it was carrying on manufacturing activity and that all its international transactions including that of import of components were inextricably interlinked and interrelated to each other to carry out the function relating to manufacture and sale of automotive components. It was argued that for the purpose of benchmarking the transactions, the same cannot be analyzed on a transaction-by-transaction basis, as all the transactions were incidental and ancillary to the main operation of manufacture of automotive components.
- The taxpayer urged that to determine if the transaction value of the various raw materials, including payment of royalty, technical knowhow fees, etc., is at arms' length, the net profit margin contemplated under Section 92C of the Act is determinative and that the value of each transaction in respect of every component is to be judged within the net margin derived by the entity.
- The taxpayer relied on Organization for Economic Co-operation and Development (OECD) Transfer Pricing guidelines for Multinational Enterprises and Tax Administrations, July 2010 (OECD TP Guidelines), particularly para 3.9, in support of the argument that the value of each transaction in respect of every component is to be judged within the net margin derived by the entity. It was emphasized that all transactions which are integral and ancillary to the main operation of the entity – in the present case, one which engages in manufacturing, have to be taken together. The taxpayer, also relying on para 3.10 of the OECD TP guidelines submitted that autonomy is granted to the entity to adopt a portfolio approach as a business strategy where in the taxpayer bundles transactions for the purpose of earning appropriate return across portfolios rather than on a single product.
- Since the TPO had accepted the value of all other international transactions under TNNM, it could not reject it for the purpose of one particular transaction by segregating it from the rest and proceed to apply an entirely different method to benchmark the same.

Tax department's contentions

- It was the contention of the revenue, before the Tribunal, that the taxpayer had adopted entity level profit which is not permitted under TNMM and that Indian TP legislation has no concept of cross subsidisation. Since import of components constituted only a small portion of the total costs, it is not possible to examine the Arm's Length Price (ALP) of the international transaction by looking at the entity profits, as the influence of import price on the profitability can be masked by the impact of variation of other domestic prices on the aggregate profits of the taxpayer.

- Before the High Court, the revenue contended that the primary reason for addition which was in dispute was that Sumitomo does not manufacture but merely traded in the goods. The taxpayer was unable to shed any light why it chose to source the materials from Sumitomo, which it could have purchased directly from the manufacturer, i.e. Denso. There was no explanation that could be reasonable and of sound business practice to support the sourcing of components not manufactured by Sumitomo.
- Secondly, the taxpayer had failed to discharge its responsibility as to the application of the MAM and failed to give reasonable data pertaining to cost details in the hands of Sumitomo for ALP determination by resale price method and thus, no other method except CUP method could be applied for ALP determination of the components purchased.

Issue before the High Court

Whether in facts of the given case TNMM was the MAM and whether the Tribunal had erred in directing the Assessing Officer (AO) to apply the CUP method.

High Court ruling

- The High Court observed that the factual discussion in this case clearly reveals that, the taxpayer chose to import components, not from the manufacturer (which was its AE) but an intermediary, which normally, would have been accepted by revenue authorities as a commercial decision. However, in the instant case, the vendor of the components viz. Sumitomo was also connected with both the taxpayer and the manufacturer.
- The High Court noted that the above realities compelled the TPO to closely scrutinise the value of such imports and seek further details from the taxpayer. The onus was clearly on the taxpayer to afford a convincing and reasonable explanation. The explanations by the taxpayer that were forthcoming were apparently unconvincing.
- The High Court observed that the taxpayer's approach i.e. bundled or aggregated series or chain of transactions to benchmark the international transactions would normally be accepted by the authorities, if they did not show features that call for his interference. However, the AO/TPO should extend his inquiry critically evaluating materials, where a detailed scrutiny is required.
- The High Court thus observed that the unusual features in this case, which remained unexplained by the taxpayer, raised concerns and influenced the revenue authorities to benchmark the transaction separately.
- The High Court, while upholding the approach adopted by the TPO, relied on decision of Sony Ericsson[2], which discusses a test as to when the revenue authorities can disregard the actual transaction, and re-characterise the same, i.e. when the form and substance of the transaction though were the same but the arrangements made in relation to a transaction, when viewed in their totality, differ from those which would have been adopted by an independent enterprise behaving in a commercially rational manner.
- Thus, High Court upheld the restoration of adjustment made by the Tribunal.

Our comments

It would be pertinent to note that the Punjab and Haryana High Court in the case of Knorr-Bremse India (P.) Ltd.[3], rejecting taxpayer's stand for aggregation of transactions under TNMM, had held that merely because the purchase of each item and the acceptance of each service is a component leading to the manufacture/production of the final product sold or service provided by the taxpayer, it does not follow that they are not independent

[2] Sony Ericsson Mobile Communications India (P) Ltd v. CIT [2015] 374 ITR 118 (Delhi)
[3] Knorr-Bremse India (P.) Ltd v. ACIT [2016] 380 ITR 307 (P&H)

transactions for the sale of goods or provision of services. The High Court concluded that if the taxpayer fails to establish that the various transactions forming a composite agreement/various agreements with the various group entities, were part of one single indivisible transaction or pricing in respect of each transaction was dependent upon or interrelated to the pricing of the other transactions with the group entities, each transaction had to be treated (prima facie) as separate and independent of each other.

In contrast, recently the Delhi High Court in the case of Sony Ericsson (Supra) had observed that TNNM applied with equal force on the single transaction as well as multiple transactions as per Chapter X of the Act and the TP rules. Thus, the word ‘transaction’ would include a series of closely linked transactions. Segregation of aggregated transactions requires detailed scrutiny without which there shall be no segregation of bundled transactions. Further, set-off of transactions segregated as a single transaction is just and equitable and not prohibited by Section 92(3) of the Act.

The above decision is principally in line with the decision of Sony Ericsson i.e. in a normal situation; the revenue authorities would not have questioned this bundled approach adopted by the taxpayer. However, this will not be a thumb rule in all cases, and if there are unusual features which raise doubts regarding the form and substance of the transaction, the same may be critically analysed and could be benchmarked separately.

The decision in the case of Knorr-Bremse is also to be kept in mind, and it is important to maintain meticulous documentation to justify inter-relation of transactions aggregated and benchmarked together.

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