

TAX FLASH NEWS

The Transfer Pricing Officer, not an expert on valuation, is bound to refer the valuation report to Departmental Valuation Officer as per the procedure laid down in the statute

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal), in the case of Koch Chemical Technology Group (India) Limited¹ (the taxpayer) held that the Transfer Pricing Officer (TPO) is bound to determine the Arm's Length Price (ALP) by applying any one of the methods as prescribed under Section 92C of the Income-tax Act, 1961 (the Act). The Tribunal held that when the taxpayer has submitted a report from the approved valuer indicating the fair market value of machineries purchased, then before rejecting such a valuation report, the TPO was duty-bound to refer the valuation of the machineries to the Departmental Valuation Officer (DVO) as per the procedure laid down under the statutory provisions of the Act. Further, the Tribunal held that the ALP of the cost sharing arrangement cannot be taken as 'nil' in the absence of any valid findings by the TPO.

Facts of the case

- The taxpayer is a wholly owned subsidiary of Koch Glistch, Mauritius and ultimately held by Koch Engineering Co. Inc., U.S.A. The taxpayer is engaged in the business of manufacturing of mass transfer equipments and also in designing and manufacturing of mass transfer products for process solutions as well as critical applications process, design, engineering and field service facilities.

¹ Koch Chemical Technology Group (India) Limited v. ACIT (ITA No. 7236/Mum/2010 - AY 2006-07) & ACIT v. Koch Chemical Technology Group (India) Limited (ITA No. 8091/Mum/2011 - AY 2007-08)

- During the assessment proceedings for Assessment Year (AY) 2006-07, the TPO observed that the taxpayer has incurred an expenditure of INR 1,10,45,668 towards the purchase of fixed assets (including two second hand machineries of INR 98,59,634 and INR 1,24,272). The taxpayer submitted a report from the approved valuer in the U.S. to justify the ALP of these two machineries. However, the TPO was of the view that the valuer has not provided the basis for arriving at the valuation and proceeded to make an adjustment to the extent of 50 per cent of the value of the second hand machinery.
- Further, the taxpayer paid INR 33,72,714 and INR 8,21,370 on account of a cost sharing arrangement towards information technology, commercial, finance, legal and administrative support services wherein the Associated Enterprise (AE) was reimbursed the actual cost incurred. The TPO determined the ALP of the transaction at 'nil' stating that the information submitted by the taxpayer is incomplete.
- The Dispute Resolution Panel (DRP) upheld the aforesaid ad-hoc disallowances. Aggrieved, the taxpayer preferred an appeal before the Tribunal.

Taxpayer's contentions

Purchase of second hand machineries

- The taxpayer had also purchased other second hand machineries from the AE. The TPO accepted the value of all other machineries based on the valuation report, except two items of second hand machineries. Thus, the TPO ought to accept the ALP for these two machineries as per the valuation report.

- The taxpayer argued that the price paid to its AE towards the purchase of machineries was the same which the taxpayer would have paid to a third party, if such machineries would have been purchased from them.
- The taxpayer relied on the decision of Tecumseh Products Ltd.² and contended that the TPO could have referred the valuation to the DVO for any reservations with respect to the valuation done by the approved valuer since the TPO is not an expert in the field of valuation.
- The taxpayer urged that the TPO ought to follow any one of the methods prescribed under the provisions of the Act. However, the TPO determined the value on an ad-hoc basis at 50 per cent of the purchase price which is not in accordance with the provisions of the Act and hence, the adjustment is not legally sustainable.

Cost sharing arrangement

- The taxpayer relied on the agreement entered into between the AE and other group companies, invoices and the mail correspondences in order to demonstrate the nature of services rendered by the AE and the costs incurred.
- The taxpayer submitted that all the details pertaining to the cost sharing arrangement had been furnished to the TPO. However, the TPO determined the ALP at 'nil' based on conjectures and surmises.
- The taxpayer substantiated its claim for services availed by stating that, in the immediately succeeding AY 2007-08, the TPO had disallowed 20 per cent of the amount paid on account of the cost sharing arrangement and IT support which was deleted by the Commissioner of Income-tax (Appeals).

Tax department's contentions

Purchase of second hand machineries

- The tax department contended that the taxpayer did not furnish any details with regard to the year of purchase of the machineries by the AE and the depreciated value of the machineries in the books of the AE.
- Further, the department argued that the valuation report did not indicate the basis on which the approved valuer determined the value of machineries and hence, in the absence of such details, the approved valuer's report cannot be accepted.

Cost sharing arrangement

- The department contended that the taxpayer was required to establish through proper documentary evidences whether the AE had actually rendered services and that the said services have actually been availed by the taxpayer in order to demonstrate the necessity of such services.

Tribunal's ruling

Purchase of second hand machineries

- The Tribunal observed that the TPO was duty bound to refer the valuation of the machineries to the DVO as per the procedure laid down under the statutory provisions, before rejecting the valuation report from the approved valuer indicating the fair market value of machineries purchased.
- The Tribunal held that the TPO, not being an expert to determine the value of machineries, could not have quantified the value of the machineries at 50 per cent of the value shown by the taxpayer in the absence of any enquiry made by him to ascertain the fair market value of such machineries.
- The Tribunal observed that the TPO is bound to determine the ALP by applying any of the methods prescribed under Section 92C of the Act. However, the TPO has determined the ALP on ad-hoc basis.
- With regard to department's contention to restore the matter back to the TPO for making a reference to the DVO, the Tribunal rejected the contention on the ground that the TPO failed to refer the valuation to the DVO and proceeded to quantify the value of the machineries at 50 per cent in violation of the statutory provisions of the Act. Therefore, the matter could not be restored back to the TPO to give him a second innings.
- Based on the above, the Tribunal deleted the adjustment on account of disallowance of 50 per cent of the purchase value of second hand machineries.

Cost sharing arrangement

- The Tribunal observed that the TPO had not contested that the taxpayer and other group companies have entered into a cost sharing agreement with the AE for various support services and that the actual cost incurred was reimbursed to the AE. The Tribunal held that the TPO failed to demonstrate what information was required from the taxpayer to establish that the payments made were for availing of services from the AE.

² Tecumseh Products Ltd. v. ACIT (ITA No. 1686/Hyd/2010)

- The Tribunal held that the determination of ALP at 'nil' without applying the method prescribed under the statutory provisions was legally unsustainable.
- The Tribunal observed that the TPO in the AY 2007-08 disallowed 20 per cent of the total cost incurred by the taxpayer towards such services which demonstrated that the TPO had accepted that the AE has provided certain services to the taxpayer, and the taxpayer has availed such services in the subsequent year.
- Based on the above, the Tribunal deleted the adjustment by stating that the ALP of such services cannot be taken as 'nil'.
- The Tribunal dismissed the department's appeal for the AY 2007-08 on both the aforesaid grounds of appeal.

Our comments

This ruling reiterates the fundamental principle that the TPO can proceed to make an adjustment only based on substantive evidence or material on record and not on ad-hoc basis.

Another important point to be noted is that the TPO is not allowed to reject the valuation report of an approved valuer as he is not an expert and as provided under the statute, needs to refer the valuation to the DVO.

This decision is expected to go a long way in providing relief to those taxpayers who obtain and furnish genuine valuation reports issued by experts to determine the ALP. Also, with respect to cost sharing arrangements, once the taxpayer has filed the relevant documents, the TPO needs to specify what more information is sought to determine the ALP of the transaction. The TPO cannot determine the ALP to be 'nil' without following any of the prescribed methods under the statute.



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