



CUP method accepted for purchase of heavy earthmoving machinery and change of method by the taxpayer during TP assessment proceedings upheld

Background

The Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal), in the case of Liugong India Private Limited¹ (the taxpayer) upheld Comparable Uncontrolled Price (CUP) method as the Most Appropriate Method (MAM). It is also held that merely for the reason that Transactional Net Margin Method (TNMM) has been used in the Transfer Pricing (TP) report cannot refrain the taxpayer from using CUP during the proceedings if reasonable data is available for comparability purposes. The Tribunal also emphasized on the need for making accurate adjustments to eliminate material factors (including geographical differences) affecting price [which may include adjustment of freight and other relevant expenses to arrive at the Free on Board (FOB) value from Cost, Insurance and Freight (CIF) values, cost or the profit arising from such transaction.

Facts of the case

- The taxpayer operates as a sole distributor of heavy earth moving machines and spare parts thereof manufactured by its Associated Enterprise (AE) for sale to independent customers in India and South Asia except Pakistan. It is also engaged in the business of manufacturing of machinery started by the end of 2009 itself and also provides warranty and after sale services to its customers.
- The international transactions included the purchase of machinery, heavy earthmoving machines, purchase of machines [Completely Knocked Down (CKD) and Semi Knocked Down (SKD)], purchase of spare parts, purchase of plant and machinery and receipt of commission income from its AE.
- In respect of the above international transactions, the taxpayer had selected TNMM as the MAM with Net Profit on Sales (NPM) as the Profit Level Indicator (PLI) in the TP Report. Average NPM of 1.64 per cent from the set of two comparables was compared against taxpayer's NPM of (-)2.12 per cent which fell within 5 per cent variation range.
- The Transfer Pricing Officer (TPO), during the proceedings, by applying certain additional filters, rejected one of the taxpayer's comparable and introduced 12 more comparables. The TPO computed average NCP (as against NPM used by the Taxpayer) of 13 comparable companies as 20.81 per cent and proposed an adjustment in respect of an international transaction relating to the purchase of machinery, CKD/SKD and spare parts.
- In addition to the above, TPO also proposed an adjustment on account of selling and distribution expenses by using bright-line test. The TPO further added 15 per cent of markup on the bright line and made an adjustment towards the creation of marketing intangibles for AE.
- Before the Dispute Resolution Panel (DRP), the taxpayer requested for adopting CUP method as MAM for the international transaction of purchase of machinery. The comparable price data of the sales of the products sold by the AE to the independent distributors in different geographical locations and to the taxpayer was submitted.

¹ Liugong India Private Limited v. ACIT (ITA No. 1482/Del./2015)

- The DRP rejected taxpayer's plea for a change of MAM and it also rejected all other pleas of the taxpayer, and prima facie upheld the approaches adopted by the TPO.

Taxpayer's contentions

- The FOB sale price of the products sold by AE to the taxpayer and FOB sale price to the products sold by AE to independent distributors in other countries constitute effective CUP and since the price paid by the taxpayer to AE is less than the price paid by the third party distributors, it corroborates the arm's length nature of the international transaction of purchase of goods.
- Adequate reasons were furnished for the adoption of CUP method and comparability, sufficient data has also been provided for.
- The TPO in principle accepted the CUP method but disregarded the same commenting that no extra efforts have been put on record in this regard.
- DRP did not verify that the details of products sold to various independent third party distributors in other countries were provided and incorrectly observed that comparable price indicated by the taxpayer is charged to related parties.
- Merely because TNMM method has been adopted by the taxpayer for the purpose of benchmarking, the same can be considered later on. As soon as the taxpayer realizes the error in choice of MAM, it was submitted before the TPO as well as before DRP for the adoption of CUP method.
- With regard to comparability under CUP method, in the geographical region-wise sale price which is shown to be CIF value, adequate adjustment of freight and expenses have been made to arrive at FOB value and therefore, the observation of DRP regarding the absence of adequate comparable data, is not correct.

Tax department's contentions

- The CUP method though may be appropriate, but in the absence of any comparable price, comparability analysis fails and hence, CUP method needs the requisite data.
- Due to lack of availability of data of comparable companies, CUP was rejected as MAM by the taxpayer.

- There is no reliable basis for verifying data which is submitted by the taxpayer.

Tribunal's ruling

- Where the comparables are available, CUP is undisputedly, the best method for computing the Arm's Length Price (ALP). Accordingly, in the instant case, CUP method is the MAM. One of the essential pre-requisite is to undertake reasonably accurate adjustment to eliminate material factors affecting price, cost or the profit arising from such transaction. Adequate weightage is also required to be given to the market condition of different geographical locations.
- Merely for the reason that in its TP study report, the taxpayer has adopted TNMM as the MAM, cannot prevent the taxpayer to apply CUP method if there is reasonable data available for comparability analysis.
- In relation to the reliability of the data, it would always be the onus of the taxpayer to show the basis of comparability analysis and veracity of the data used for comparability.
- Taxpayer to furnish revised its TP study report on the basis of CUP method. It shall be the duty of the taxpayer to provide the sale data of the AE in terms of the sale price of the taxpayer in India as well as other geographical locations, which are claimed to be a comparable price.
- The TPO/Assessing Officer (AO) shall compute the ALP using this data applying CUP method. In case the data is found to be not adequate, and no adjustment can be made to eliminate material differences, the TPO/AO shall proceed to determine ALP in accordance with other methods upon granting adequate opportunity of hearing to the taxpayer.
- As the Tribunal allowed CUP as the MAM for the transaction of purchase of machinery, it remitted the grounds in relation to adjustment on account of transactions of Purchase of finished goods CKD/SKD and spare parts back to the file of TPO for fresh comparability analysis.

Our comments

The Delhi Tribunal in the instant case has dealt with two critical issues:

- Change of method by the taxpayer during the course of TP proceedings provided there are sufficient evidences and adequate data available and is submitted before the tax authorities. This shall give an opportunity to the taxpayer to improvise its position on the arm's length nature of its related party transactions at later stages instead of merely limiting itself to the TP documentation.
- Applicability of CUP with comparable data from different geographical locations, with appropriate adjustments thereof. The Tribunal has emphasized that the CUP method (if available) is the best method for computing the ALP of an international transaction but has placed the onus on the taxpayer to demonstrate comparability aspects. Similar to several other rulings such as in the cases of Bharti Airtel Limited², Isagro (Asia) Agrochemicals³, Moser Baer India Limited⁴ and Clear Plus India⁵, the Tribunal has adjudicated in favour of the taxpayer on the issue of geographical differences after making reasonably accurate adjustments (such as adjustment of freight and other relevant expenses to arrive at FOB value from CIF value).

On the issue of selling and marketing expenses, the Tribunal in the instant case has simply placed reliance on the Delhi High Court ruling in case of Maruti Suzuki India Limited⁶ which now would linger to the day when the Supreme Court of the country would adjudicate on the subject matter.



² Bharti Airtel Limited v. ACIT (ITA No. 5636/Del/2011)

³ Isagro (Asia) Agrochemicals Pvt. Ltd v. DCIT (ITA No.2044/Mum/2010)

⁴ Moser Baer India Limited v. DCIT (ITA No.882/Del/2008)

⁵ Clear Plus India Pvt. Ltd. v. DCIT (I.T.A. No.3944/D/2010)

⁶ Maruti Suzuki India Limited v. CIT (ITA 110/2014 & ITA 710/2015)

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