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The use of multiple year data allowed in a case where the condition prescribed in Transfer Pricing Rules is satisfied

Background

Recently, the Delhi Bench of the Income Tax Appellate Tribunal (the Tribunal) in the case of Innodata Isogen India Private Limited[1] (the taxpayer), upheld the Commissioner of Income Tax (Appeals) [CIT(A)]'s decision to consider multiple year data for the determination of arm's length price (ALP), as the taxpayer's case was directly covered under the proviso to Rule 10B(4) of the Income-tax Rules, 1962 (the Rules). The Tribunal distinguished the case of the taxpayer from that of a typical cost-plus service provider and held that considering the project-based revenue model of the taxpayer, where the customer price is agreed upfront for a fixed number of years, and the margins fluctuate on a year-on-year basis, the use of multiple year data is necessary for an accurate and a true reflection of the arm's length nature of transfer prices.

Facts of the case

- The taxpayer was engaged in the business of providing content related services to its parent company. During the year, the taxpayer undertook various international transactions with its Associated Enterprises (AEs), all of which were accepted by the Transfer Pricing Officer (TPO) to be at arm's length except the primary transaction of provision of IT enabled services. To benchmark the subject international transaction of provision of IT enabled services, the taxpayer applied the Transactional Net Margin Method (TNMM) and used multiple year data for the Financial Years (FYs) 2002-03, 2003-04 and 2004-05 (to the extent available) in its Transfer Pricing (TP) documentation.

Proceedings before the TPO

- The TPO rejected the taxpayer's approach of using multiple year data and determined the ALP of the said international transaction using the current year data i.e. FY 2004-05.
- The TPO observed that the taxpayer is earning only 60 per cent of the overall profit, while the AE is retaining the remaining 40 per cent, which is not commensurate with the functions performed, as the AE is merely involved in the marketing and co-ordination activities while the taxpayer performs all the other major functions in India.
- Using single year data, the TPO arrived at an arm's length operating profit margin (on operating expenses) of 17.70 per cent as against an arm's length margin of 10.25 per cent computed by the taxpayer in the TP documentation, for making an adjustment to income.

Proceedings before the CIT(A)

- The CIT(A) deleted the addition made by the TPO by holding that it is incorrect for the TPO to state in his order that the parent company performs only the marketing and co-ordination functions while the taxpayer performs all the other major functions.
- The CIT(A) clarified that the taxpayer is not a back office or a captive unit, but faces market and other related risks/uncertainties just like the AE, as both the AE and the taxpayer are exposed to volume fluctuations in the business. Thus, the taxpayer is not a risk free service provider who is typically compensated on a cost-plus basis and earns a low and consistent return on a year-on-year basis.

[1] DCIT v. Innodata Isogen India Pvt. Ltd. [ITA 1528/Del/2011 (Assessment Year: 2005-06)] – Taxsutra.com

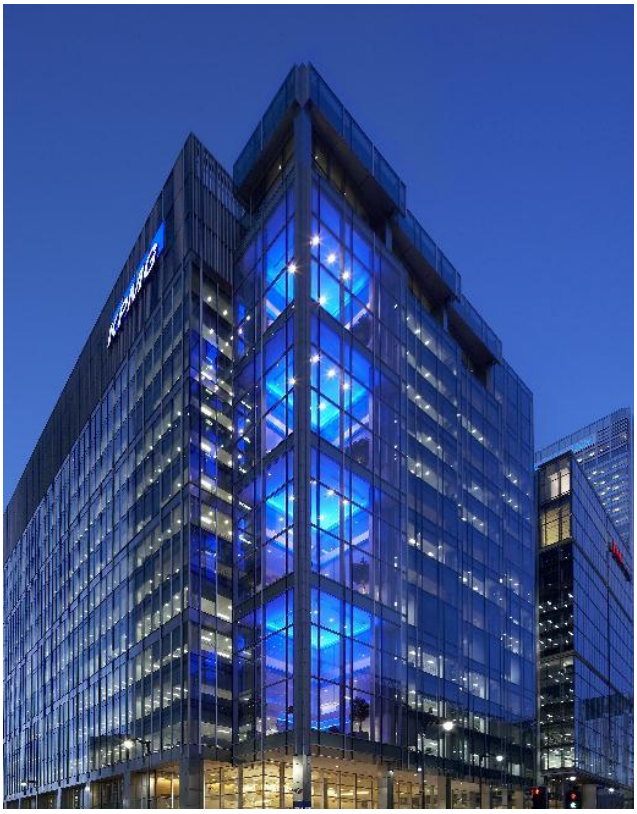
- The CIT(A) further explained that project continuity is a key determining factor in the taxpayer and AE's business. Almost 94 per cent of the taxpayer's business during FY 2004-05 constituted of recurring projects, which had been contracted at fixed billing rates in earlier years. This necessitated the use of multiple year data of the previous two financial years in order to determine the transfer prices in relation to the year under consideration. In other words, the proviso to Rule 10B(4) of the Rules directly applied to the taxpayer's case because prior years' data influenced the determination of transfer prices in relation to current year's transactions.
- Thus, the CIT(A) held that given the business model of the taxpayer which involved fixed billing rates and varying volumes on a year-on-year basis leading to wide fluctuating profit margins, the taxpayer was justified in using multiple year data for ALP determination.
- Further, as per the CIT(A), the taxpayer's revenue model is based on a price per transaction undertaken for its AE. This price received by the taxpayer is determined as a percentage of the sale price derived by the AE from sale to its end customer. During FY 2004-05, the taxpayer received 76 per cent of the end customer revenue generated by the AE, from sale of its services to the AE. Further, the AE only earned an operating profit of 3.35 per cent from the activities in India, as against an operating profit margin of 6.63 per cent earned by the taxpayer.
- In upholding the use of multiple year data, the CIT(A) also relied upon the TP orders of the taxpayer for FY 2002-03 and 2003-04, wherein the TPO had accepted the principle of multiple year data and its applicability in the taxpayer's case. In addition, the CIT(A) relied upon the submissions filed by the AE as part of the TP audit conducted by the Internal Revenue Service, US Department of the Treasury, and the Form 10K and 10Q of the AE, which justified the use of multiple year data.

Proceedings before the Tribunal

- The Tribunal concurred with the contentions of the taxpayer and the various findings of the CIT(A) on the applicability of multiple year data in the taxpayer's case.
- In particular, the Tribunal agreed with the fact that the AE was exposed to various risks on account of the market, service liability, R&D/technology, credit and price fluctuations. Moreover, majority (76 per cent) of the revenue from India's activities was transferred to the taxpayer during the year, on which the taxpayer earned a higher operating profit margin (6.63 per cent) than the AE (3.35 per cent).
- Finally, in light of the prior years TP orders of the taxpayer where multiple year data had been accepted by the TPO (the Tribunal noted that no cogent reason was given by the TPO for deviation in the current year) and the documents furnished by the taxpayer relating to the U.S. TP audit supporting use of multiple year data, the Tribunal held that the adjustment made by the TPO by ignoring multiple year data and using only the current year data was arbitrary and unjustified. Thus, the Tribunal upheld the decision of the CIT(A) of deleting the addition made to income on account of the difference in the ALP.

Our comments

The use of multiple year data vis-à-vis single year data has been a much litigated issue since the inception of TP regulations in India. Coming close on the heels of the recently released draft scheme of the Central Board of Direct Taxes, the ruling provides a welcome relief to taxpayers and supports the use of multiple year data, in cases where the condition prescribed in the proviso to Rule 10B(4) is satisfied. It also sets a good precedent of taking into due consideration, a taxpayer's business and revenue model for ALP determination. Overall, the ruling augers well for the taxpayer community who has been at loggerheads with the tax department on the data-year issue with huge adjustments being made annually.



www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010