

## TAX FLASH NEWS

### Profit Split Method considered as the most appropriate method if activities performed by taxpayer and its associated enterprises are inextricably linked, and both the entities contribute to the value chain

#### Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (Tribunal), in the case of Infogain India Pvt. Ltd.<sup>1</sup> (the taxpayer) upheld the application of Profit Split Method (PSM) where different activities performed by the taxpayer as well as its Associated Enterprises (AEs) were inextricably linked and both the entities contributed significantly to the value chain of provision of software services to the end customer. The Tribunal rejected the transfer pricing officer's (TPO) conclusion that PSM was adopted only to camouflage loss at net level and held that 'the decision as to what is the most appropriate method does not depend on the fact as to whether an assessee is having loss or has a profit'. In reaching the above conclusion, the Tribunal also observed that in the taxpayer's case for the preceding and successive years, PSM was accepted by the tax department. Further, the Tribunal has set aside the issue of allocation of profit split between the taxpayer and its AE i.e., 40:60 to the file of Assessing Officer (AO)/TPO with a clear direction that since the split was accepted by the tax department in the preceding and succeeding years, no deviation shall be done if the facts are similar for the year under consideration as well.

#### Facts of the case

- The taxpayer was established in 1997 as a back-end software service provider mainly for its parent company viz. Infogain Corporation, USA (Infogain US).

- The taxpayer was engaged in providing back-end software services to its AEs, since, the initial year of establishment. However, during AY 2008-09, there was a re-structuring of the client service and delivery function. Consequently, there was a significant change in the business profile of the taxpayer as a result of which, it undertook critical delivery function to the end-customers.
- The taxpayer, in its transfer pricing study report (TPSR), selected PSM as the most appropriate method (MAM) to benchmark its transactions with its AEs. A profit split ratio of 60:40 in favour of Infogain US was arrived at, based on the functions/responsibilities of the taxpayer and interviews/discussions with the key management personnel of the taxpayer and Infogain US.
- The TPO rejected the approach adopted by the taxpayer and considered transactional net margin method (TNMM) for the purpose of arm's length analysis and proposed an adjustment at INR16.87 crore.
- The Dispute Resolution Panel (DRP) upheld the order of the TPO, on the grounds that the taxpayer did not demonstrate the comparability under the PSM in its TPSR. Accordingly, the adjustment was finalised at INR14.53 crore after providing some marginal relief.
- Aggrieved, the taxpayer preferred an appeal before the Tribunal.

#### Taxpayer's contentions

- Infogain India or the taxpayer, assumed critical delivery functions as a result of a change in the functional matrix of the Infogain Group. There was a process shift with the formation of Global Delivery Organization (GDO) in Infogain India and

<sup>1</sup> DCIT v. Infogain India Pvt. Ltd. (ITA No. 6134/Del/2012)

Client Service Organisation (CSO) in Infogain US. The taxpayer provided services to end customers under the following two models:

*Offshore Service Delivery Model:* Under the Offshore Service Model, the entire project was developed and managed by the taxpayer in India and an employee of the AE acted as an onsite coordinator for communication with clients and managing client requirements.

*Dual Shore Service Deliver Model:* Under the Dual Shore Model, the AEs outsourced only a part of the software project to Infogain India, while the other parts such as requirement analysis, design and implementation were executed by the onsite team of AEs under the direction of Practice Directors stationed in India.

- In the pre-restructuring phase, Infogain US was solely responsible for determining key terms and conditions of the contract with the end customers, including pricing. Post the functional shift, Infogain India played a significant role to provide inputs in the entire pricing decision based on project costing estimates, resource requirements, time commitments, etc., as the entire delivery responsibility had migrated to Infogain India. This arrangement reflected that the taxpayer and Infogain US were jointly responsible for determining the pricing. However, the ultimate decision-making regarding closing a sales deal rested with Infogain US.
- It was contended by the taxpayer that it was responsible for the significant delivery functions while Infogain US was responsible for the marketing, client identification and customer relationship management functions. Such functional analysis reflected an inextricable linkage and a collaborative nature in the activities performed by the taxpayer and Infogain US. Consequently, PSM was adopted as MAM for the determination of arm's length price.
- A split ratio of 40:60 between the taxpayer and Infogain US was finally arrived at, based on the interviews and discussions with the key management personnel of the taxpayer and Infogain US. Further, based on functions performed in the value chain and based on the fact that end-customers were based in U.S., weights were assigned and subsequently functions were allocated between the taxpayer and Infogain US. The taxpayer contended that this methodology was also supported by the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines, 2010.
- The taxpayer also highlighted that PSM was accepted as the MAM in its case in AY 2009-10, AY 2011-12, and as a matter of consistency, the department ought to have accepted the PSM adopted by the taxpayer.

- Reliance was placed by the taxpayer on various decisions<sup>2</sup>.

## Tax department's contentions

- The DRP rejected the transfer pricing documentation maintained by the taxpayer stating that the documentation undertaken to justify arm's length analysis was subjective and inadequate.
- It was contended by the tax department that taxpayer did not quantify the risks in a scientific manner on credible objective information for application of PSM, and no external data was available for uncontrolled transaction to substantiate the relative contribution by each entity thereby, resulting in an uneven split of profits between the taxpayer and its AE.
- It was stated that PSM was not applicable in the taxpayer's case as there were gaps in identifying functions, involved subjective estimation and lacked a basis for assigning weightage. Thus, TNMM was appropriately adopted by the TPO for arm's length analysis. Reliance was placed by the tax department on various decisions<sup>3</sup>.

## Tribunal's ruling

- The primary issue before the tribunal was the selection of MAM and determination of arm's length price based on the said MAM.
- The Tribunal observed that activities performed by the taxpayer and its AE are inextricably linked and both the entities contributed significantly to the value chain of a provision of software services to the end customers.
- The Tribunal placed reliance on the case of Aztech Software and Technology Ltd<sup>4</sup>, Global One India Pvt Ltd. and OECD Transfer Pricing Guidelines 2010 to determine the MAM for the arm's length analysis.
- Further, the Tribunal observed that the TPO failed to consider the role of GDO in India, which is responsible for delivery of services to the customers globally and brought overall synergies for the group across geographies.

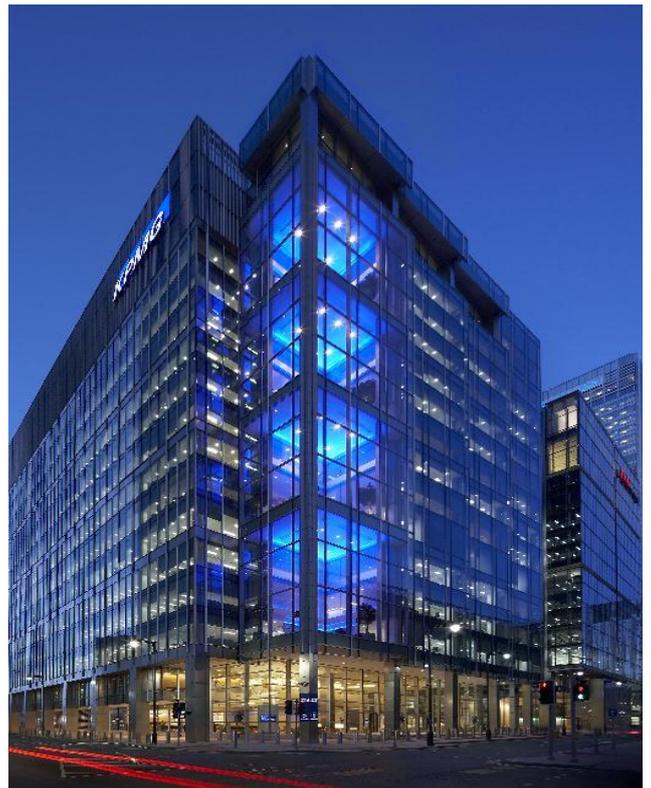
<sup>2</sup> Global One India Pvt Ltd v. ACIT (ITA/5571/Del/2011)  
Orange Business Services India Networks Pvt. Ltd. v. DCIT (ITA No. 1201/Del/2015)  
ITO v. Net Freight (India) P. Ltd. (ITA No. 4670/Del/2009)  
CIT v. Neo Poly Pack (P) Ltd. [2000] 245 ITR 492 (Del)  
Radhasoami Satsang v. CIT [1992] 193 ITR 321 (SC)  
Aztech Software and Technology Ltd. v. ACIT (ITA No.584/Bangalore/2006)  
<sup>3</sup> Haworth (India) (P) Ltd. v. DCIT [2011] 131 ITD 215 (Del)  
Sony India (P) Ltd. v. DCIT [2008] 114 ITD 448 (Del)  
<sup>4</sup> Aztech Software and Technology Ltd v. ACIT (ITA No.584/Bangalore/2006)

- With regard to the department's contention that the shift started from 2005 onwards and the taxpayer changed the MAM in the year under consideration, the Tribunal accepted the taxpayer's argument that the transition process was gradual leading to a complete shift in the functional matrix over a period of two to three years, as a result of which the pricing model was changed only from the year under consideration.
- In view of the approach adopted by the taxpayer in assigning weights to each activity in the entire value chain based on the interviews of the key management personnel and considering the fact that both the taxpayer and its AE are making contribution, the Tribunal held that PSM is the MAM to be adopted.
- The Tribunal negated the conclusion drawn by the TPO that the taxpayer changed the method due to losses and held that selection of an MAM does not depend on whether an assessee is having a loss or has a profit.
- The Tribunal also noted that PSM has been adopted as MAM in the taxpayer's own case in the preceding and succeeding years and held that there was no justification in applying TNMM instead of PSM. Reliance was placed on Global One India P. Ltd., Orange Business Services India Networks Pvt. Ltd. and Net Freight (India) P. Ltd.
- As regards allocation of residual profits, the Tribunal held that, in the absence of external uncontrolled transaction for comparison, the residual profit should be allocated on the basis of relative contribution that could have been made by the independent party based on the key value drivers. The Tribunal highlighted that a harmonious interpretation of provisions was required to make the rule workable and achieve the desired result of the determination of the ALP. Also, it was noted that the view that residual profits under PSM should be allocated, based on contributions by each entity, was in concurrence with both the OECD TP Guidelines and the UN Transfer Pricing Manual for developing countries.
- Further, the Tribunal noted that, in the taxpayer's own case the ratio of 40:60 split was accepted between the taxpayer and AE in the preceding and succeeding years. Accordingly, the issue was set aside to the TPO/AO with a clear direction by the Tribunal that no deviation shall be made if the facts of the case are similar for the year under consideration.

## Our comments

This ruling provides valuable insight on the application of PSM, where the transactions between AEs are intricately linked, and there is a significant contribution by both the parties to the value chain. The Tribunal's reliance on the OECD Guidelines and the UN TP manual on the issue of allocation of residual profits indicate that leading global practices shall have an influence where there is limited guidance on a specific subject in Indian regulations.

This ruling also signifies the importance of documenting the functions performed, assets employed and risks assumed in an exhaustive manner, especially in cases where there is a change in the functional matrix between AEs. This shall act as a justification for the change in the method adopted for arm's length analysis, which may be thoroughly tested before the appellate authorities.



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**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 (1st 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

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