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TAX FLASH NEWS

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Overseas AEs selected as tested parties in light of the APA concluded for later year

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in case of Ranbaxy Laboratories Limited[1] (the taxpayer) held that overseas Associated Enterprises (AEs) being least complex entities in the transaction, must be selected as tested parties for the purpose of determining arm's length nature of international transactions. While doing so, the Tribunal has given due weightage to the Advanced Pricing Agreement (APA) signed between the taxpayer and the Central Board of Direct Taxes (CBDT) wherein the facts are similar to the year under consideration.

Facts of the case

- The taxpayer is engaged in the business of manufacturing and sale of Active Pharmaceutical Ingredients (APIs) (bulk drug)/formulations (dosage forms). The overseas AEs act as distributors/secondary manufacturers for the products manufactured by the taxpayer.
- During the Assessment Year (AY) 2008-09, the taxpayer entered into transactions with its AEs in the nature of the sale of APIs and drug formulations apart from other transactions which were not questioned by the Transfer Pricing Officer (TPO). The taxpayer had benchmarked the impugned international transactions by considering overseas AEs as tested parties with Transactional Net Margin Method (TNMM) as the most appropriate method. The taxpayer selected regional comparables for benchmarking the margins earned by overseas AEs.
- The TPO rejected the selection of overseas AEs as the tested parties stating the following:
  - Tribunal in the taxpayer's case for AY 2004-05 rejected overseas AEs as tested parties.
  - The financial statements of overseas AEs are for the period January to December and not April to March.
  - Relevant and sufficient financial data which is reliable and accurate as required under the Income-tax Rules, 1962 (Rules) is not available for all the comparables.
  - Region-wise benchmarking has been carried out instead of the country wise benchmarking which is not reliable since the economic conditions of any two countries might not be the same even within the same continent.

[1] Ranbaxy Laboratories Limited v. ACIT (ITA No. 196/Del/2013) – Taxsutra.com

- Appropriate comparables for all overseas AEs are not available and therefore the taxpayer should be selected as the tested party since the most reliable data is easily and readily available for the taxpayer.

- Consequently, TPO tested the company-wide margins of the taxpayer while determining the Arm's Length Price (ALP) of the international transactions. The Dispute Resolution Panel (DRP) concurred with the findings of TPO and did not provide any relief to the taxpayer. Aggrieved, the taxpayer appealed before the Tribunal.

Taxpayer's contentions

- The taxpayer has entered into an APA with CBDT in respect of AY 2014-15 wherein, based on the Functions, Asset, and Risk (FAR) analysis, it has been concluded that the taxpayer is an entrepreneurial manufacturer, and the AEs are functioning as a distributors/secondary manufacturers. Accordingly, overseas AEs should be considered as tested parties with TNMM as the most appropriate method. CBDT also approved the concept of regional benchmarking for testing the arm's length nature of the international transactions undertaken by the taxpayer.

- Though the APA concluded for a later year (AY 2014-15) does not have a statutory binding on the AY in appeal, but it shall have a persuasive value as there has been no change in the FAR profile of taxpayer and its AEs. Having principally approved overseas AEs as tested parties in the APA, the Revenue authorities must apply the same concept for the subject year under appeal.

- The taxpayer performs complex functions, owns valuable intangibles and bears significant risk as compared to the AEs and accordingly cannot be selected as the tested party.

- Reliance was placed on several case laws and international guidance such as Organization for Economic Cooperation and Development (OECD) Guidelines, United States (U.S.) TP Guidelines, United Nations (UN) TP Manual wherein the concept of tested party has been provided in detail.

- Tribunal's order passed in the taxpayer's own case for AY 2004-05 was differentiated on the ground that regional benchmarking was performed for the current year as against selecting a single set of comparables for all the AEs in AY 2004-05. For that year also the Tribunal held that least complex entity must be selected as tested party.

- Selection of comparables with December year ending financials was approved by CBDT in the APA. Therefore, reliable and sufficient data of AEs and comparables are available for comparability analysis.

- FAR analysis was also demonstrated to be identical for the year under consideration and the year for which the APA was approved.

Tax department's contentions

- Tribunal in the taxpayer's own case for AY 2004-05 held that foreign AE cannot be considered as tested party.

- APA is merely a negotiated agreement and cannot be relied upon for the AY under appeal.

- APA cannot be applied retrospectively in the present AY as it is beyond the roll back period.

- AEs cannot be taken as tested parties since data for comparables is not available.

Tribunal's ruling

- Observing the fact that Indian TP regulations do not provide any guidance on the concept of tested party, the Tribunal relied on the international guidance.

- Taking cognizance of the APA entered by the taxpayer, the Tribunal stated that principles laid down in APA by highest revenue authority (CBDT) for comparability analysis should be given highest sanctity. Witnessing the fact that the FAR analysis and nature of international transactions are identical, it was held that the APA must mandatorily be followed by TPO to determine the ALP of transactions for the year under appeal.
- Relying on Rule 10MA, the Tribunal appreciated that even in the absence of roll back, the methodology accepted in the APA may be followed for an earlier year (not covered under the APA) if the facts and nature of international transactions remain the same.
- Distinguishing the earlier years' order in the taxpayer's own case, the Tribunal held that the benchmarking approach followed in the current year was different to that undertaken in AY 2004-05. It was also noted that in the order for AY 2004-05, it was held that least complex entities must be selected as tested parties, which the taxpayer has also argued extensively.
- The Tribunal held that the taxpayer has adduced reasonably comparative data based on regional benchmarking and that the TPO was incorrect in rejecting foreign AEs as tested parties. Reliance was also placed on various case laws[2] cited by the taxpayer wherein selection of overseas tested party has been upheld.
- Based on the above, the Tribunal held that overseas AEs should be considered as tested parties and that due weightage be given to the APA on other issues as well.

Our comments

The tested party is certainly one of the most critical aspects of undertaking an economic analysis under transfer pricing. In the nine-step process suggested by the OECD Guidelines; selection of tested party (Step 3) comes much before selection of most appropriate method (Step 6) and identification of appropriate comparables (Step 7). Other international guidelines such as UN TP Manual, U.S. regulations, etc. also appreciate the importance of tested party selection. FAR analysis must be given prime importance while undertaking any transfer pricing analysis.

This ruling is certainly an important step in transfer pricing jurisprudence especially when the concept is otherwise not dealt with by the regulations. The ruling is also the first of its kinds wherein APA has been relied upon by taxpayer to settle disputes which pertain to years not specifically covered under APA. The Tribunal has also held that once CBDT has approved of a concept, the same must be appreciated and followed by the lower Revenue authorities; provided the facts remain the same. It would be interesting to see how cases involving different issues would be dealt with when other taxpayers rely on their specific APAs.

[2] Development Consultant Private Limited v. DCIT [2008] 115 TTJ 557 (Kol) and General Motors India Private Limited v. DCIT (ITA No. 3096/Ahd/2010)

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