



Berry ratio can only be applied in limited circumstances where value of the goods are not directly linked to the quantum of profits and the profits are mainly dependent on expenses incurred

Background

The Delhi High Court (High Court) in the case of Sumitomo Corporation India Pvt. Ltd.¹ (the taxpayer) asserted the principles based on which Berry Ratio can be applied. High Court held, inter-alia, that Berry ratio can only be applied where the value of the goods is not directly linked to the quantum of profits and the profits are mainly dependent on expenses incurred. Berry ratio can effectively be applied only in certain cases, such as stripped down distributors as they have no financial exposure and risk in respect of goods distributed by them.

Facts of the case

- The taxpayer is a subsidiary of Sumitomo Corporation Japan (SCJ) which is one of the largest general trading companies (Sogo Shosha) of Japan. Taxpayer entered into transactions of (a) purchase, and sale of goods (trading transactions) where purchase and sale are back to back transactions and title to goods is acquired only briefly (i.e. flash title) and (b) provision of support services (indenting transactions), where goods are supplied directly by the supplier to the purchaser with its Associated Enterprises (AEs).
- In the Transfer Pricing report, the above international transactions were benchmarked on a combined basis, wherein, Transactional Net Margin Method (TNMM) was applied as the Most Appropriate Method (MAM) using Berry ratio, i.e. Gross Profit (GP) to operating costs, as the Profit Level Indicator (PLI).

- For computing GP on trading transactions, the taxpayer reduced the cost of sales from aggregate value of sales made to AEs and non-AEs. This GP was then added to commission earned from indenting transactions to compute the total GP which was then divided by operating expenses to compute the Berry ratio. The Berry ratio was computed at 1.79 per cent. The weighted average PLI of comparables was computed at 1.18 per cent, and the transactions were demonstrated to be at arm's length.
- The Transfer Pricing Officer (TPO) rejected the use of Berry ratio citing the following reasons – (a) since the denominator excluded the cost of goods, the PLI worked out for TNMM was not in accordance with Rule 10B(1)(e) of the Income-tax Rules (the Rules) as the TNMM could be applied only in determining the net profit in relation to the costs incurred, sales affected or assets employed; (b) Berry ratio cannot be used in case where intangibles are used and in the given case, the taxpayer had developed supply chain and human assets intangibles which resulted in commercial and strategic advantage of the taxpayer resulting in enhanced profit potential of the AE; (c) Berry ratio was sensitive to the cost base, and it was difficult to accurately compute the cost base of comparable companies due as costs are accounted by companies differently.

¹ Sumitomo Corporation India Pvt. Ltd. v. CIT – (ITA 381/2013, ITA 738/2015, ITA 382/2013, ITA 702/2014 - Assessment Years (AYs) 2007-08, 2008-09, 2009-10 and 2010-11) (Delhi High Court)

- The TPO further held that functions performed and risks undertaken in trading and indenting transactions were similar and compared AE transactions in the indenting segment with Non-AE transactions in the trading segment.
- The TPO proposed an adjustment in taxpayer's indenting segment considering the gross margin of 4.45 per cent earned in the trading segment with Non-AEs as the rate of commission on the Free on Board (FOB) price of the goods sourced through the taxpayer in respect of indenting transactions with the AEs.
- The Dispute Resolution Panel (DRP) upheld the order of the TPO.
- Tribunal had erred in accepting the taxpayer's submission that the commission from Non-AEs be compared with the commission from AEs because this was an alternative submission coupled with a claim to make an economic adjustment on account of volume and the difference in products.

Tax department's contentions

- Comparable Uncontrolled Price (CUP) method is the most reliable method in such a situation where an internal comparable transaction is used for comparability. This method of proposed by the taxpayer with certain economic adjustments which the Tribunal found was not justified.
- In order for the taxpayer to make good his claim that a comparison between AE segment and the Non-AE segment was to be made product wise, the taxpayer was required to produce every contract/agreement and invoice in the two segments which the taxpayer had failed to do.

Proceedings before Tribunal

- The Income-tax Appellate Tribunal (the Tribunal) accepted the taxpayer's contention that the indenting transactions were different from trading transactions. The trading transactions involved certain risks and finances whereas, in respect of indenting transactions, the taxpayer did not incur any financial obligation or carry any significant risks as it was just trade facilitation.
- The Tribunal though accepted taxpayer's contention of that it would be appropriate to compare commission income earned by the taxpayer in respect of transactions with AEs with the similar transactions with Non-AEs, however, it rejected the taxpayer's claim for an appropriate adjustment on account of the difference in volumes and associated risks.
- The Tribunal directed that the commission earned in respect of transactions with Non-AEs be taken as the benchmark for determining the ALP for commission earned in the AE segment.

High Court's ruling

- Before making an ALP adjustment, MAM must be identified for computation of ALP. TPO rejected Berry ratio and discarded TNMM but did not select the MAM for computation of ALP and imputed the character of trading transactions to the indenting transactions which was rightly rejected by the Tribunal as it was not permissible for TPO to re-characterise the tested transaction. Tribunal's finding that indenting transactions of the taxpayer were in the nature of facilitating trade is correct.
- Tribunal erred in proceeding to determine the ALP on the basis of the rate of commission for indenting transactions with Non-AEs, without further examination as to the similarity between the two transactions. Tribunal effectively used CUP Method for imputing the ALP of taxpayer's indenting transaction with AEs, but since CUP requires a high degree of similarity between controlled and uncontrolled transactions, it was necessary for the Tribunal to conduct a further in-depth inquiry as to the relevant uncontrolled transactions.

Proceedings before the High Court

Taxpayer's contentions

- The Tribunal has not followed any particular method in directing the determination of ALP. Tax authorities could have substituted the Berry ratio with an appropriate PLI but could not have rejected the TNMM as that was accepted as the MAM in the preceding years.
- Directions of the Tribunal are erroneous as Indenting transactions with Non-AEs are not comparable to Indenting transactions with AEs. The volume of transactions with Non-AEs is only a small fraction of such transactions, and the concerned products are also different from the products in the AEs segment.

- The taxpayer had claimed that volume of transactions in the Non-AEs segment was insignificant as compared to the transactions in the AE segment. Thus, if the average rate of commission on such transactions were to be applied to the FOB value of the goods involved in the indenting transactions with AEs, the Tribunal would have to satisfy itself that there is no significant variation in the rate of commission between different products. The Tribunal/ TPO did not conduct any such enquiry.
- The High Court held the TPO's decision of rejecting the use of Berry ratio by the taxpayer as unsustainable, citing the following reasons:

- Rule 10B(1)(e)(i) mandates that the net profit margin realised could be computed having regard to 'any other relevant base'. Berry ratio is a ratio of operating profits to operating expenses. In cases where operating expenses are considered as a relevant base, there would be no difficulty in using Berry ratio as the PLI in terms of Rule 10B(1)(e)(i) of the Rules.
- The High Court placed cited the use of Berry ratio by the Internal Revenue Service (IRS) in the U.S. in the case of E.I. Du Pont DE Nemours & Co. v. United States: 608 F.2d 445 (1979) and further mentioned that Berry ratio is held to be appropriate by OECD Guidelines issued and Treasury Regulations of U.S. in certain circumstances. Recently, in the tax legislation reforms, Japan has also accepted the use of Berry Ratio in certain circumstances.
- There is no cogent material to hold that the taxpayer had developed supply chain and human resources intangibles.

- Berry ratio has limited applicability and can be used effectively only in cases where the value of goods have no role to play in the profits earned by a taxpayer and the profits earned are directly linked with the operating expenditure incurred by the taxpayer.
- Fundamentally, operating expenses adequately represent all functions performed and risks undertaken. For this reason Berry ratio is effectively applied only in case of stripped down distributors, i.e. distributors that have no financial exposure and risk in respect of the goods distributed by them.

- Berry ratio would not be an appropriate PLI in cases of taxpayers who have substantial fixed assets or where a taxpayer uses intangibles as a part of its business.
- The use Berry ratio will give unreliable results if the product mix of the comparables is different from the product mix of the taxpayer.
- Accordingly, High Court remanded the matter back to the Tribunal for a fresh examination of the issues.

Our comments

Berry ratio has been time and again questioned by the Revenue Authorities. In the above ruling, the High Court has analysed the various aspects relating to the application of Berry ratio and has affirmed that it has a legal sanction under TNMM.

The High Court has given observations with regard to the various situations wherein Berry ratio can be effectively applied which provides certain guiding principles for taxpayers looking to use Berry ratio in their relevant cases.



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