Delhi ITAT emphasises the importance of remuneration model/fundamentals for comparability analysis

Summary

The Delhi Bench of Income-tax Appellate Tribunal (ITAT) in a recent case[1] set aside the taxpayer's appeal which revolved around the selection/rejection of certain companies as comparables. ITAT upheld the exclusion of certain companies on the basis of difference in remuneration model and on the basis of functional dissimilarity.

ITAT allowed the principle of working capital adjustment (raised as an additional ground by the taxpayer) for improving comparability analysis.

Facts of the case

- The taxpayer is a branch office of a US company[2] and is engaged in the business of providing marketing support services and other similar auxiliary sale, support/assistance services to its Head Office (HO).
- The taxpayer is remunerated by the HO at cost plus mark-up basis.
- The tax officer accepted the method chosen by the taxpayer to determine the Arm's Length Price (ALP) of the services rendered to the HO and the Profit Level Indicator (PLI).
- However, the tax officer rejected all the 11 comparables chosen by the taxpayer in its Transfer Pricing (TP) documentation and proposed 14 new companies as comparables. The TP adjustment was proposed based on that.
- On appeal, the first appellate authority directed the tax officer to exclude two of the comparables and re-work the original TP adjustment proposed.
- Aggrieved with the order, the taxpayer filed an appeal before Delhi ITAT:
  - challenging the selection of new comparables by the tax officer, and
  - challenging the rejection of the comparables selected by the taxpayer.

[1] Brown Forman Worldwide LLC India (Branch Office) v DDIT (Int. Taxation) (ITA Nos. 433/Del/2012 and 6139/Del/2012)
[2] Brown Forman Worldwide LLC

ITAT findings and ruling

- Examining the taxpayer's business and facts of the case, ITAT observed as follows:
  - The functional profile of the taxpayer relates to provision of marketing support services for which the taxpayer is remunerated at cost plus mark-up basis.
  - Some of the companies selected by the taxpayer/tax officer which followed a business model of 'commission' are not suitable comparables to a service provider earning a cost plus remuneration. In commission-based compensation, no income is earned unless expenses incurred fructify into orders, whereas in a cost plus mark-up model, there is a fixed remuneration of all costs incurred with a pre-decided mark-up irrespective of actual sales. Therefore, the basic difference in the two business models distorts comparability and they cannot be considered as comparables.
- ITAT directed the TPO to exclude some of the companies selected by him as comparables due to their functional profiles being different from the taxpayer's business.
- The functional profiles of the companies directed to be excluded by ITAT related to processing business, commission income, consultancy and advisory services, research activities, information technology and technical support services, testing services and other diverse activities.
- Similarly, ITAT held that the companies chosen by the taxpayer whose business model was functionally different from the taxpayer were rightly excluded by the TPO.
- ITAT allowed working capital adjustment to bring the taxpayer at par with other functionally comparable entities.
- Based on the above findings, ITAT remitted the matter to the tax officer's file for a fresh determination of the ALP as per its directions.

Our comments

The ruling has emphasised that similarity in the business/remuneration models of comparable companies for determination of ALP is as significant as similarity in their functional profiles.

In line with various other rulings, the principle of working capital adjustments has been upheld in this decision as well. However, each case is required to be seen in light of its facts and data available to undertake comparability analysis and adjustments.

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