

TP characterisation of an entity should be done on the basis of ‘FAR’ analysis: Delhi HC

Summary

The revenue authorities have been recharacterising sourcing support service providers as ‘trader of goods’. The Delhi High Court (HC)¹, in a recent case, has held that FAR² analysis of an entity should determine its characterisation and that it should be based on specific demonstrable facts, relative evaluation of their weightage and significance and not on vague generalities. Accordingly, the court held that mark-up on the value added expenses should suffice arm’s length pricing for the sourcing company.

Facts of the case

- The taxpayer facilitates the sourcing of apparels/merchandise by its parent entity from India. The key activities performed by the taxpayer include: (1) identification and evaluation of vendors, (2) assist vendors in procurement of raw materials, (3) assist vendors in designing, inspection and quality control and (4) coordinate with vendors in ensuring adherence to the delivery schedule of finished goods.
- The taxpayer was compensated on the total cost incurred for rendering the services plus a mark-up of 5 per cent.
- The Transfer Pricing Officer (Tax officer) applied commission on the FOB value of goods sourced from India instead of considering a mark-up on the cost incurred by the taxpayer. This resulted in a transfer pricing adjustment of INR 228.39 crore.
- Taxpayer’s objections against the transfer pricing adjustment were dismissed by the Disputes Resolution Panel.
- On appeal, the Income-tax Appellate Tribunal (ITAT³) decided the case in favour of the taxpayer based on the grounds that the taxpayer is a facilitator/service provider

¹ Gap International Sourcing Private Limited, ITA 6340/DEL/2017

² Functions Performed, Assets deployed and Risks Assumed

and is not into buy/ sell activities. ITAT relied on the decision of HC in case of Li and Fung India Private Limited³(LIFL), which was decided in favour of LIFL. The HC had held that determination of arm's length compensation for LIFL on the basis of FOB value of exports by third parties to the end customer is without foundation, based on the below analysis:

- a) Revenue authorities failed to demonstrate as to how and to what extent LIFL bears 'significant risks', or Associated Enterprise (AE) enjoys the benefit arising from 'locational advantage'
 - b) The conclusions on FAR analysis should be based on specific facts and not on vague generalities, such as Significant Risks, Functional Risks, Enterprise Risk, etc., without any material on record or supported by demonstrable reason based on objective facts and the relative evaluation of their weight and significance.
 - c) Care should be taken by the tax administrators and authorities to analyse the TP documentation in detail and then proceed to record reasons why some or all of them are unacceptable.
 - d) The cost base for application of Most Appropriate Method should be based on the costs incurred by the entity and should not include costs incurred by another entity.
- Aggrieved by the order of ITAT, the revenue authorities approached HC on the ground that ITAT erred in relying on the ruling of HC in LIFL (supra) as the taxpayer's facts differ from LIFL's as under:
 - Taxpayer renders extended support services as against just sourcing support rendered in the case of LIFL;
 - The tax officer had clearly brought out the fact that the taxpayer controlled critical functions with regard to the merchandising, fabric sourcing, product integrity, quality assurance etc. in the course of entering into international transactions;
 - There are significant differences in the functions performed by taxpayer in the course of international transactions vis-à-vis LIFL.

³ 361 ITR 85 (Del)

HC decision

The HC dismissed the appeal filed by the Revenue authorities, stating that no question of law had arisen from the ruling of the ITAT and held that:

- The functions carried on by the taxpayer vis-à-vis assessee in the case of LIFL is comparable and identical
- Taxpayer, similar to LIFL, did not assume any risk and was entirely dependent on the reimbursement of expenses by AE.

Based on the above, HC upheld the decision of ITAT that the taxpayer is only entitled to an arm's length mark-up on the actual expenditure incurred by it.

Our comments

The HC has reiterated the importance of far analysis for characterising the entity and its significance in the application of the MAM for benchmarking a transaction has been reiterated. Further, following principles have been laid down:

- FAR analysis should be based on specific demonstrable facts and their relative evaluation of their weight and significance and not on vague generalities.
- Costs of the taxpayer should alone be considered while applying the MAM and cost of third parties should not be included in the cost base.
- The TP documentation maintained by taxpayer has to be demonstrated to be non-compliant before rejecting the same and before imputing a transfer pricing adjustment.



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