

ITAT prescribes guidelines for treating foreign AE as a ‘tested party’ for TP benchmarking

Summary

The Delhi Bench of the Income Tax Tribunal (ITAT) in a recent decision¹ has held that an Associated Enterprise (AE) cannot be considered a tested party if sufficient details are not made available to ascertain that the AE is a tested party with least complex operations and limited risks.

Facts of the case

- The taxpayer is engaged in the business of manufacture and sale of instant velocity joints.
- During AY 2012–13, the taxpayer had entered into various international transactions and followed the transaction-by-transaction approach to determine the Arm’s Length Price (ALP).
- During the Transfer Pricing (TP) assessment proceedings for AY 2012–13, the tax officer proposed adjustment on the purchase of raw materials and components from the AE.
- The tax officer contented that sufficient details of the AE (financial statements etc.) were not provided and hence rejected the selection of the AE as a tested party.

Arguments before ITAT

- The taxpayer submitted that it had carried out procurement, manufacturing, logistics, sales, marketing and distribution activities in India and thus, considering the magnitude of functions carried out by it vis-à-vis the activities carried out by the AE, the AE should be selected as a tested party.

Held by ITAT

- The ITAT held that as a general rule, tested party is the one to which a TP method can be applied in the most reliable manner and for which the most reliable comparables can be found (most often the one that has the least complex functional analysis).
- The ITAT highlighted important aspects to be considered for selection of tested party based on Para 3.18 of the OECD guidelines:
 - The choice of selecting a tested party for comparability is only available in the comparable uncontrolled price method and transactional net margin method.
 - The tested party should be the least complex party to the controlled transactions and should be supported by sufficient data to substantiate that.
- However, on perusal of the taxpayer's TP documentation, the ITAT observed as under:
 - No details regarding the Functions, Assets and Risk (FAR) analysis of the AE were provided (only the sales of the AE for the year were provided) to ascertain it to be less complex in nature.
 - In response to the show cause notice, the taxpayer had submitted that it did not have the financials of its AE as they were not available in the public domain.
 - The taxpayer had considered comparables without having regard to functions or geographical dissimilarities.
- The ITAT decided not to set aside the matter to the tax officer as the taxpayer was unable to submit the AE's financial data before the lower authorities as well as before the ITAT.

Our comments

Accessibility to data in order to substantiate FAR or characterisation of tested party in the context of the said transaction has been the subject matter of litigation. Taxpayers need to be more careful to ensure that the data available with them in relation to AEs as well as overseas comparables is complete and transparent.



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