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Tax and Transfer Pricing Alert

Insight with information

Reimbursement of cost incurred towards "excess capacity" or "infrastructure set up" to be excluded for earning mark-up while determining the arm's length price

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Executive Summary

The Delhi High Court ("HC") pronounced its ruling in favour of CPA Global Services Private Limited ("CPA GSPL" / "the taxpayer" / "the Company") pertaining to assessment year ("AY") 2011-12 upholding the ruling passed by the Income Tax Appellate Tribunal ("ITAT").

The HC observed that the ITAT had come to a definite factual conclusion on the reimbursement of infrastructure costs of the taxpayer, without any mark up. HC went on to conclude that no substantial question of law arises and dismissed appeal of the Revenue.

Facts

- The taxpayer offers a comprehensive range of legal support services to its Associated Enterprises ("AEs") and to independent third parties. During the year under consideration, the AEs remunerated the taxpayer on cost plus basis for the services rendered by it. The taxpayer had also incurred certain costs such as "spare capacity" or "infrastructure set up", for which the AEs had remunerated the taxpayer on a cost-to-cost basis (i.e. without any mark-up).
- The controversy before the ITAT was whether exclusion of cost reimbursement of spare capacity received from AEs from the cost base in computation of Profit Level Indicator ("PLI") was appropriate.
- The ITAT after perusing inter-company agreement, analysed facts of the case, and ruled in favour of the taxpayer, holding that since these costs did not involve any function to be performed, the same should be excluded from profitability computation.
- Aggrieved by the decision of the Tribunal, Revenue preferred an appeal before the Hon'ble HC. Main thrust of the appeal before the HC was that the ITAT had overlooked the binding precedent laid down in the matter of *Commissioner of Income Tax-I v. Cushman and Wakefield (India) (P.) Ltd. (2014) 367 ITR 730 (Del).*
- Also, during the course of the proceedings before the HC, the Revenue contended that the ITAT order was perverse.

Issue before the High Court

Validity of the direction issued by the ITAT in the impugned order to the Transfer Pricing Officer ("TPO"), to exclude reimbursement cost while calculating the operating cost to determine cost base in computation of arm's length price of the international transaction.

Observations and Ruling of the High Court

- The HC adjudged that the case of *Commissioner of Income Tax-I v. Cushman and Wakefield (India) (P.) Ltd. (2014) 367 ITR 730 (Del)* was an instance of reimbursement by the Indian entity whereas the situation in the present case is the converse.
- The HC further differentiated the case of the taxpayer from the case of Cushman (supra) by observing that there was no categorisation of the reimbursement costs as cost of infrastructure (with no mark-up) and cost of services (with mark-up).
- The HC held after the above differentiations that each case will have to turn on the peculiar facts considering the clauses of the agreement and the arrangement between the Indian entity and its AE.
- On the ground taken by the Revenue that the ITAT order is perverse, the HC held that the ground of perversity ought not to be casually pleaded; and rather it should be specified in the memorandum of appeal, detailing in what manner there is perversity by the ITAT and that should also be supported by relevant documents.
- The HC further held that unless there is a specific plea to the effect that the factual finding is perverse, the Court cannot at the instance of a general plea of perversity entertain such as a ground of appeal by the Revenue.
- Based on et above, the HC held that no substantial question of law arises from the impugned order of the ITAT and dismissed the departmental appeal.

Conclusion

The above ruling is significant as the HC ruled in favour of the taxpayer by upholding the decision of the ITAT to exclude the reimbursement cost while calculating the operating cost to determine arm's length price of the international transaction. The decision stressed the importance of the inter-company agreement.

The observation by the HC on the manner in which the appeal was filed by the Revenue is also noteworthy. The HC made it clear that unless there is a specific plea to the effect that the factual finding of the ITAT is perverse, the Court cannot at the instance of a general plea of perversity entertain such a ground of appeal by the Revenue.

Source: Pr. CIT vs CPA Global Services Pvt Ltd [ITA 266/2017 – Delhi HC]

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