



Transfer Pricing Insight with information

No separate TP
adjustment for
Location Savings

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Executive Summary

The Mumbai Bench of the Income-tax Appellate Tribunal (Tribunal) recently pronounced its ruling in the case of Watson Pharma Pvt. Ltd (taxpayer). The Tribunal, placing reliance on the Organization for Economic Cooperation and Development (OECD) Guidance on Transfer Pricing Aspects of Intangibles [issued under Action item 8 of the Base Erosion and Profit Shifting (BEPS) project] [OECD guidelines on Intangibles], held that where the operating margin earned by a taxpayer is at arm's length based on local market comparables operating in similar economic circumstances as the taxpayer; and the taxpayer as well as AEs operate in perfect competitive business environment, further return for location savings is not warranted.

Facts

- The taxpayer was engaged in provision of contract manufacturing and contract Research and Development (R&D) services to its Associated Enterprises (AEs). The taxpayer adopted Transactional Net Margin Method (TNMM) and selected Indian comparable companies for benchmarking its international transactions with its AEs to substantiate the arm's length nature of these transactions.
- The Transfer Pricing Officer (TPO) deleted/ added certain comparables in the comparables set submitted by the taxpayer and arrived at a higher arm's length margin. Accordingly, the TPO proposed an adjustment for the shortfall in the taxpayer's actual operating margin vis-à-vis the alleged arm's length margin.
- Additionally, the TPO contended that the taxpayer's AEs enjoyed locational advantage on account of lower costs in India by shifting contract manufacturing and contract R&D activities to the taxpayer in India vis-à-vis undertaking the same in the US. Further, relying on research paper/ articles, the TPO held that there is approximately 40% and 50% cost reduction in India to the AEs on contract manufacturing and contract R&D activities respectively. Based on this analysis, the TPO computed the overall cost savings to AEs from these activities in India and attributed 50% of such savings to the taxpayer on the ground that such arrangement was mutually beneficial for the AEs and the taxpayer.
- Accordingly, the TPO proposed an adjustment for location savings in respect of both these activities.

- The Dispute Resolution Panel (DRP) confirmed the adjustment made by the TPO. Consequently, the taxpayer filed an appeal before the Tribunal.

Issues before the Tribunal

- Whether the Revenue authorities were justified in making an adjustment for Location Savings in determining the Arm's Length Price (ALP) of the international transactions of the taxpayer?
- Whether a separate adjustment on account of Location savings is justified when TNMM is adopted as the most appropriate method and benchmarking is done using local comparables?
- Whether the comparables set used by the TPO for determining arm's length margin was appropriate?

Observations & Ruling of the Tribunal

- The Tribunal upheld the taxpayer's contention that the taxpayer's group operated in a perfectly competitive market and did not have exclusive access to the factors providing location specific advantage resulting in super profits in the supply chain as compared to its competitors. If there would have existed any location savings, it would have been passed on to the customers of AEs. Hence, no specific adjustment was required.
- The Tribunal also relied on the OECD Guidelines on Intangibles and observed that location savings is not regarded as an intangible asset unless specific advantages are capable of being owned or controlled by an individual enterprise. Therefore, in the instant case, location savings could not be regarded as intangibles asset. Further, the profit split method can be applied only in case of transfer of unique intangibles or where the international transactions are so interrelated that they cannot be evaluated separately.
- Placing reliance on OECD Guidance on intangibles and Delhi Tribunal Ruling in case of GAP International¹, the Tribunal held that when local Indian comparables which are operating in similar economic circumstances as that of the taxpayer are considered for benchmarking, any benefit (if at all) on account of location savings would have already got

¹ GAP International Sourcing India Private Limited vs ACIT (2012) 149 TTJ 437(Del ITAT)

embedded in the operating margins of the comparable companies. Since the taxpayer's operating margin is higher than the arm's length margin based on such local comparables, specific adjustment for location savings is not required. While holding this position, the Tribunal also observed that G20 countries have given their consensus to the above view in OECD Guidance on Intangibles and India is part of G20 countries.

- The Tribunal further observed that once TNMM has been accepted as the most appropriate method and the taxpayer is considered as a tested party, then benefit/ advantage accruing to AE is irrelevant once the profit margin earned by the taxpayer is at arm's length based on the margins earned by comparable companies.
- The Tribunal disregarded the contention of the TPO that in the absence of the various details regarding AEs (such as cost of manufacturing in the US and ultimate selling price by them to the distributors), it could be assumed that location savings arise to the AEs. The Tribunal held that the financial results of the AEs are not relevant for determining the arm's length margin of the taxpayer.
- The Tribunal also observed that the reliance placed by the TPO on research papers for computation of location savings is ad hoc, based on assumptions and cannot be accepted. The Tribunal observed that the research papers were only web based articles and were not accepted by any forum.
- The Tribunal disagreed the revenue's reliance on India chapter in United Nations' (UN) TP Manual which advocates the use of profit split method for allocation of location specific advantage on the ground that the views expressed therein are the views of the tax administration and not of the Indian Government and hence is not binding on Indian Appellate authorities.
- The Tribunal thus directed deletion of the adjustment on account of location savings.
- In respect to selection of comparables, the Tribunal upheld that selection based on broad functional comparability reigns over product comparability in application of TNMM. The Tribunal placing reliance on various rulings of the co-ordinate benches, rejected the modification to the comparables set proposed by the TPO for determining higher arm's length margin and accordingly deleted the adjustment on that account as well.

Conclusion

This is a first and a very significant ruling wherein the Tribunal has analyzed the concept of location savings in a TP context. Concept of location savings has been a major topic for discussion and dispute in the international Transfer Pricing arena since there are divergent views and lot of ambiguity on this aspect. The Tribunal's reliance on OECD Guidelines on Intangibles (which has been issued under the BEPS Project) for location savings evidences the Indian Government's inclination to adopt globally accepted best practices and Transfer Pricing principles.

Source : Watson Pharma Pvt Ltd Vs DCIT 8(3), Mumbai, ITA No. 1423 & 1565 / Mum/2014; 9 January 2014

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