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1000 HE Amsterdam
The Netherlands
Tel.: 31-20-554 0100
Fax: 31-20-622 8658
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Articles

India

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The Bombay High Court Decides Whether the CUP Method Can Be Applied to Customized Goods

In its ruling in *Amphenol Interconnect India (P.) Ltd.*, the Bombay High Court affirms the action of the Pune Income-Tax Appellate Tribunal that the transaction net margin method is the most appropriate method for determining the arm's length price relating to the transactions of export/import of goods and payment of commission by the taxpayer with its associated enterprises. The comparable uncontrolled price method applied by the transfer pricing officer had been rejected because the goods are customized and differences due to e.g. geographical location, order volume and different market conditions exist. The High Court thus dismissed the appeal of the revenue authorities.

1. Introduction

In the recent case of *Amphenol Interconnect India (P.) Ltd.* [1] under the Income-tax Act, 1961 (ITA),[2] the taxpayer (i.e. the company Amphenol) was required to benchmark the export/import of customized goods to/from its associated enterprises (AEs) and payment of commission to its AEs. The taxpayer benchmarked the international transactions with its AEs (controlled transactions) by adopting the transaction net margin method (TNMM) as the most appropriate method to determine the arm's length price (ALP).

The transfer pricing officer (TPO) (i.e. the first tax officer looking into transfer pricing audits), in the course of the transfer pricing audit adopted the comparable uncontrolled price (CUP) method as the most appropriate method for determining the ALP in respect of the goods that were sold by the taxpayer to its AEs as well as third parties,.

The TPO stated that the taxpayer did not submit any data for the adjustments to be made on account of the differences in respect of sales to AEs and third parties. Accordingly, the TPO made an addition in respect of those goods wherein the average selling price charged by the taxpayer to the AEs was less than the average selling price charged to third parties.

In this regard, the taxpayer contended that the CUP method was not the most appropriate method to determine the ALP because the function of the taxpayer was to manufacture customized goods. In the export of goods, the product price depends on various factors such as the geographical location of the customer, the volume of the order, the timing of the order, the urgency of the order, market competition, etc. The pricing of goods therefore depends upon many economic factors, and suitable adjustments could not be made to the price of these goods in order to account for such economic differences. The taxpayer pointed out that it had charged different prices for the same product and from the same party, which itself indicates that the pricing depends on various other factors. Suitable adjustments could not be made to align these prices, as the goods were customized to the requirements of the customer. Thus, the taxpayer contended that the transfer pricing adjustment made by the TPO for export/import of goods by application of the CUP method was not appropriate.

However, the Income Tax Appellate Tribunal (Tribunal), the highest fact-finding body under the ITA, is akin to a tax court, and upheld the action of the taxpayer in benchmarking the relevant international transactions by application of the TNMM. The Tribunal's decision was subsequently approved by the Bombay High Court.

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* **Vispi T. Patel & Associates, Chartered Accountants, Mumbai. The authors can be reached at vispitpatel@vispitpatel.com and suresh@vispitpatel.com, respectively.**

1. IN: Bombay High Court, 7 Mar. 2018, *PCIT v. Amphenol Interconnect India (P.) Ltd.*, Income Tax Appeal 1131, 1102 and 1100 of 2015, and IN: Pune Tribunal, 30 May 2014, *Amphenol Interconnect India (P.) Ltd v. DCIT*, IT Appeal nos. 1486 of 2010, 1548 of 2011 and 140 (PN) of 2013.
2. IN: Income-tax Act, 1961 [ITA].

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2. Facts of the Case

The taxpayer was mainly engaged in the business of manufacturing of electric connectors, accessories, cable assemblies and system integration for application in various industries such as military, aerospace, telecom, etc. The sort of goods concerned specialty goods as they were being used in specific areas such as defence and aerospace. Moreover, as the goods were manufactured only against the specific orders, they were considered customized goods. The taxpayer was part of Amphenol Group, one of the largest manufacturers of electric connectors, accessories, cable assemblies and system integration products in the world.

In the year under consideration, the taxpayer entered into the international transactions with its AEs as shown in Table 1.

Table 1

	Details of transaction	Amount (INR)	Method adopted
1	Purchase of raw material	142,193,087	TNMM
2	Export of connectors, i.e. finished goods	286,438,138	TNMM
3	Import of finished goods	3,725,099	TNMM
4	Import of capital goods	13,160,258	TNMM
5	Receipt of indenting commission received	4,752,346	TNMM
6	Reimbursement of expenses	8,301,205	TNMM
	Total	458,570,133	

In the course of the audit, the TPO made transfer pricing adjustments with respect to the price of import of raw material/finished goods, export of finished goods and the payment of commissions.

For the year under consideration, the taxpayer had recorded a total sales turnover of 84.16 crores[3] Indian rupees (INR) and had declared a net profit before tax of INR 24.33 crores.

With regard to the taxpayer's business model, it is important to note that the transactions of export and import of goods were all intertwined and formed an integral part of the taxpayer's manufacturing business. Further, the commission paid to various parties was meant to boost the sales of the taxpayer's goods. Therefore, the transactions of exports, imports and the payment of commission to agents were closely interrelated and were part of a single business, i.e. the manufacturing activity of the taxpayer. The profit earned by the taxpayer was a collective result of all these transactions and, hence, it was impractical and economically impossible to analyse and derive the profit of each individual transaction.

Accordingly, the taxpayer had aggregated the above-mentioned transactions in order to determine the ALP by selecting and applying the TNMM as the most appropriate method under the ITA. While doing so, the taxpayer had contended that its net operating margin was much higher than that of the comparable companies, and hence all its international transactions were at ALP.

The taxpayer, in the course of benchmarking, identified 12 companies as functionally comparable companies. The average operating margin of these companies was 7.71%, while the operating margin earned by the taxpayer was 26.59%. Accordingly, the taxpayer was of the opinion that the international transactions entered into with its AEs were at ALP.

3. Action of the Transfer Pricing Officer

Under section 92C of the ITA, the TPO did not accept the taxpayer's contention and made an adjustment to the following international transactions, as shown in Table 2.

3. A crore is an Indian unit equal to 10 million.

Table 2

Particulars	Amount (INR)
Export of goods to AEs	4,397,063
Import of goods from AEs	255,003
Commission paid to AEs	1,637,200
Total transfer pricing adjustment	6,289,266

According to the TPO, the taxpayer was not justified in aggregating the transactions of export and import of goods and the commission paid into a single activity for the purposes of determining the ALP under the TNMM, as the transactions were distinguishable in their nature and scope, and separate benchmarking could be performed in respect of these transactions, which according to the TPO, was in conformity with the law.

Adjustment on export of goods

The taxpayer made total export sales of INR 286,438,138 to its AEs. Of these exports, the TPO accepted the application of the TNMM for exports amounting to INR 272,419,025. However, in respect of part of the exports amounting to INR 14,049,113, the TPO stated that similar goods had also been sold by the taxpayer to third parties, wherein a lower price was charged to the AEs. The TPO further stated that the taxpayer did not submit any data for the adjustments to be made on account of the differences in prices, with respect to sale of goods to AEs and third parties.

Accordingly, the TPO held that in respect of such exports, the CUP method should be applied, as it was more suitable than the TNMM applied by the taxpayer. In order to determine the ALP of the taxpayer's export of goods to its AEs, the TPO computed the average sale price of the goods sold to AEs and average sales price of goods sold to third parties. Thus, the TPO held that in case of certain goods, the average selling price charged by the taxpayer to its AEs was lower than the average selling price charged to third parties and, based on this, he applied the CUP method and adjusted the value of exports to INR 4,397,063.

Adjustment on import of goods

The taxpayer imported goods of INR 145,918,186 from its AEs. Of these imports, the TPO accepted the application of the TNMM for imports amounting to INR 137,210,348. However, in respect of that part of the imports amounting to INR 8,707,838, the TPO stated that similar goods had also been purchased by the taxpayer from third parties and in some cases, the taxpayer had paid a higher price to the AEs compared to the third parties. Furthermore, the TPO stated that the taxpayer did not submit any data for the adjustments to be made on account of the differences in prices, with respect to purchase from AEs and third parties.

Accordingly, the TPO held that in respect of such imports, the CUP method should be applied as the most appropriate method, as it was more suitable than the TNMM applied by the taxpayer. In order to determine the ALP of the taxpayer's import of goods from its AEs, the TPO computed the average purchase price of the goods purchased from AEs and third parties. Thus, the TPO held that in case of certain goods, the average purchase price paid by the taxpayer to its AEs was higher than the average purchase price paid to third parties and hence, the TPO applied the CUP method and adjusted the value of the import of goods by INR 255,003.

Adjustment on commission paid to AEs

The taxpayer paid commission of INR 2,098,224 to its AEs at an average rate of 9.33% of sales made to clients identified by AEs. This commission had been paid by the taxpayer to its AEs located in Europe for the various functions performed by them. The rate of commission paid to different AEs varied from 3.50% to 10.50%.

The TPO compared the rate of commission paid by the taxpayer to unrelated domestic agents against the rate of commission paid to the AEs located in Europe. The TPO observed that the weighted average rate of commission paid by the taxpayer to unrelated domestic agents was 2.05%, as compared to the weighted average rate of commissions paid to AEs of 9.33%. Thus, the TPO applied the CUP method as the most appropriate method for computing the ALP of the commission payment made by the taxpayer to its AEs, and consequently made an adjustment of INR 1,637,200.

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4. Objections before Dispute Resolution Panel[4] (DRP)

The taxpayer raised objections before the DRP against the draft order passed by the assessing officer (regular tax officer) after giving effect to the transfer pricing adjustments. The DRP, without granting any relief, approved the CUP method applied by the TPO. Aggrieved by the transfer pricing adjustment of INR 62.89 crores, the taxpayer approached the Tribunal.

5. Observations of the Tribunal

- The Tribunal observed that out of the total exports to AEs of INR 28.64 crores, the TPO accepted exports of INR 27.24 crores to be at ALP. The TPO applied the CUP method only with respect to a part of these exports, i.e. INR 1.40 crore, which accounts for only 5% of the total exports, merely on the basis that there was product similarity. Similarly, the Tribunal observed that out of the total imports of raw material and finished goods of INR 14.59 crores from its AEs, the TPO accepted imports amounting to INR 13.72 crores to be at ALP. The TPO applied the CUP method only with respect to a part of these import of goods amounting to INR 0.87 crores, which accounted for 6% of total imports, merely on the basis of product similarity.
- The taxpayer manufactured customized goods and therefore the TPO could not apply the CUP method as the most appropriate method to determine ALP.
- The Tribunal further observed that in the case of taxpayer, the pricing of the product depended on various factors such as the geographical location of the customer, the volume of the order, the timing of the order, urgency of the order, functional differences, market competition, etc. The pricing of goods thus depends upon multiple economic factors, for which suitable adjustments cannot be made to the price of goods to account for such economic differences. Thus, it would be impractical to make such adjustments for determining the price of such international transactions under the CUP method.
- The Tribunal also pointed out that in respect of the same party and the same product, the taxpayer had charged different prices, which itself indicated that the pricing was dependent upon various business and economic factors for which suitable adjustments for determining the price under the CUP method could not be made.
- The Tribunal rejected the argument of the counsel for revenue authorities, the Departmental Representative, that the taxpayer was not justified in aggregating the transactions of export/import of goods and commission paid, into a single activity for the purposes of determining the ALP by applying the TNMM. Further, that the transactions are distinguishable in their nature and scope and separate profitability can be arrived at in respect of these transactions and hence, the aggregation approach adopted by the taxpayer was not justified.
- The Tribunal accepted the taxpayer’s contention that the transactions of export/import of goods and the commission paid to boost the sales of taxpayer’s goods, are all part of the taxpayer’s business activity of manufacturing electric connectors and other goods, and subsequently selling the same to various parties. Therefore, the transactions of exports, imports and payment of commission to agents are closely interrelated and are part of a single business activity of the taxpayer and the profit earned by the taxpayer is a combined result of all these transactions, hence it is impractical to analyse the profit of each individual transaction.
- The Tribunal further stated that even if the various transactions are evaluated independently, the net final profits will remain the same.
- The Tribunal analysed various judgments on which by the revenue authorities had placed their reliance, and rejected the reliance on those judgments, concluding that the CUP was not the most appropriate method while determining the ALP of the international transactions of export/import of goods and the payment of commission as referred to above.
- The Tribunal also relied on the decision in the *Gharda Chemicals* [5] case, wherein the Tribunal concluded that the internal CUP method was not suitable in the circumstances of that case, on the reasoning that, for determining the ALP under the internal CUP method, the price charged to Gharda Chemicals’ AEs should be consistent with the price charged to its third parties under “similar circumstances”.

In the case of Gharda Chemicals, the Tribunal emphasised the importance of “similar circumstances” for the purpose of application of the CUP method for determining the ALP. The Tribunal further stated that similarity between the two

4. Under sec. 144C(15)(a) of the ITA, a dispute resolution panel is a group consisting of three Principal Commissioners or Commissioners of Income-Tax constituted by the Central Board of Direct Taxes for this purpose.
5. IN: Mumbai Tribunal, 30 Nov. 2009, *Gharda Chemicals Ltd. v. Dy. CIT*, [2010] 35 SOT 406.

sets of transactions could be judged by the quality, grade and quantity of the goods, the location of the parties, the availability of raw materials, demand and supply, local factors of AEs in the other country which could have bearing on the price charged by AEs in case of import of goods and price charged to AEs in case of export of goods, etc.

Thus, the Tribunal, in the present case, held that, since the determination of price charged by the taxpayer to its AEs was not under the similar circumstances as compared to that of third parties, the CUP method could not be adopted by the TPO to determine the ALP for benchmarking international transactions.

In transfer pricing as a general proposition, it is well settled that the CUP method is the most direct method and should therefore be preferred over the TNMM when comparable transactions are available. However, in this case the Tribunal correctly pointed out that where there are various economic and business differences, such as geographical differences, volume differences, functional differences, different market conditions, etc. in the transactions entered into by the taxpayer with its AEs and with third parties, it is not possible to make suitable adjustments in respect of such differences, in order to determine the ALP. Hence, the CUP method could not be considered as the most appropriate method in the case at hand, and therefore the TNMM applied by the taxpayer to benchmark its international transactions was upheld to be the most appropriate method.

6. Observations of the Bombay High Court

The revenue authorities filed appeal before the Bombay High Court (HC) against the order of the Tribunal, urging the following grounds:

- Was the Tribunal justified in considering the TNMM as the most appropriate method, without considering the functional, asset and risk (FAR) analysis of the transactions to determine the ALP of the export sales to AEs?
- Was the Tribunal justified in differentiating the CUP analysis on the basis of geographic differences and volume differences in respect of sales commission, especially when the commission was paid on the basis of a percentage of sales?

The Bombay High Court found that the Tribunal in its order had perused the necessary FAR analysis. The Tribunal had compared the risk and functional differences involved in finished goods being sold to AEs with those sold to third parties. Further, based on the FAR analysis carried out by the Tribunal, the Bombay High Court observed the following:

- the goods manufactured and exported by the taxpayer to its AEs were specialized and customized goods, manufactured only against specific orders; and
- the pricing of the taxpayer’s product depends on various factors, such as the geographical location of the customer, the volume of the order, the timing of the order, urgency of the order, any functional differences, market competition, etc.

The HC thus arrived at the conclusion that with respect to the export of goods to AEs, the Tribunal’s decision, that the CUP method is not the most appropriate method and that the TNMM applied by the taxpayer is in fact the most appropriate method, was correct and hence no substantial question of law arose.

Further, as regards the sales commission paid to its AEs, the HC arrived at the conclusion that the Tribunal’s decision, that there were differences with respect to functions and geography, between the sales commission paid to its AEs and third parties, and hence the CUP method was not the most appropriate method but that the TNMM was in fact the most appropriate method, was correct and hence no substantial question of law arose.

Thus, the Bombay High Court dismissed the appeal filed by the revenue authorities and, as stated above, upheld the decision of the Tribunal.

7. Conclusion

This case reiterates the founding principle that comparability is at the heart of transfer pricing, in order to determine whether the controlled transactions are at arm’s length. This principle has been discussed at length in the case of *Mentor Graphics*,[6] which states as follows:

> The first step in the determination of Arm’s Length Price is to analyse the specific characteristics of the controlled transaction whether it relates to transfer of goods, services or intangible. Without proper study of specific characteristics of controlled transaction, no meaningful comparison or location of comparable is possible […]

6. IN: New Delhi Tribunal, 2 Nov. 2007, *Mentor Graphics (Noida) P. Ltd. v. DCIT*, (2007) 18 SOT 76.

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> To put it in other words, all the characteristics of the controlled transaction which are likely to affect its open market value must be taken into account. The study should include analysis of functions, risk and assets of the controlled transaction for correct location of similar or nearly similar characteristics in uncontrolled transactions. Specific characteristics are necessary to carry search of similar comparable with similar characteristics.

The arm's length price in section 92F(ii) of the ITA is defined as "a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions". This definition clearly states that the comparable price of the uncontrolled transaction should be under similar uncontrolled conditions, thus, giving importance to similar characteristics or similar circumstances of uncontrolled transactions, which has been emphasized in the transfer pricing jurisprudence in India, as discussed above.

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