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Ruling in *Marubeni* Case on Benchmarking and Determining Arm's Length Consideration for the International Provision of Agency and Marketing Support Services

The authors analyse the *Marubeni* case concerning a typical business model and its nuances for benchmarking the international transaction of provision of agency and marketing support services, as well as the Court's determination as to whether the consideration for such services was at arm's length under the Income Tax Act, 1961.

1. Introduction

In the recent *Marubeni India*[1] case, the taxpayer's role was to provide agency services and marketing support services, to a limited extent by providing necessary information, thereby facilitating its associated enterprises in taking relevant decisions. The taxpayer also acted as a mediator between the associated enterprises and the Indian suppliers in the course of their independent dealings. The taxpayer liaises between various business departments of its associated enterprises and its suppliers/customers in India.

The transfer pricing officer (i.e. the first tax officer looking into transfer pricing audits), without prompting from another party, focused on certain human chain and valuable intangibles that were being created by the taxpayer, and on that basis assumed that the taxpayer bore higher risk and was using its highly valued intangibles, in the course of providing above-mentioned services to its associated enterprises. On the basis of these vague assumptions, the transfer pricing officer concluded that the profit split method was the most appropriate method under the Indian transfer pricing regulations for benchmarking the international transaction of provision of agency and marketing support services. The transfer pricing officer relied on the decision of the Delhi bench of the Income Tax Appellate Tribunal (the Tribunal) (i.e. the highest fact-finding authority under the Income Tax Act, 1961 (the ITA)) in the *Li & Fung*[2] case, and thus made a transfer pricing adjustment to the relevant transaction, specifically the provision of agency and marketing support services.

However, the Delhi bench of the Tribunal upheld the action of the taxpayer in benchmarking the relevant international transactions by application of the transactional net margin method (TNMM). The Tribunal's decision was subsequently approved by the Delhi High Court.

2. Facts of the Case

The taxpayer is a wholly owned subsidiary of Marubeni Corporation, Japan (Marubeni Japan). It provided agency services on behalf of Marubeni Japan and other group companies across the globe, and liaised between departments of Marubeni Japan group companies and their customers in India. The taxpayer also coordinated the import and export of goods between group companies and their customers in India. Thus, the taxpayer's primary activity was to act as a mediator between its associated enterprises and suppliers/purchasers from India.

There were three types of parties involved in each transaction, namely customers/vendors from India, associated enterprises and the taxpayer. The responsibilities of associated enterprises extended to include contracting, pricing, sourcing, scheduling, procuring, inventory management, logistics, marketing, credit management, quality and compliance of global laws, whereas the responsibilities of the customers/vendors from India extended to include contracting, pricing, scheduling, negotiating and inventory.

Further, it was the taxpayer's responsibility to act as a mediator between the associated enterprises and the customers/vendors, for supplying marketing information, liaising with vendors and coordination, which could aid the associated enterprises in taking their business decisions as to which items could be purchased or sold by the associated enterprises with reference to the macro-opinion of Indian market made available by the taxpayer. This activity was done by sending certain articles or newspaper cuttings or other data from India, with a view to assisting the associated enterprises in identifying the areas in which they could undertake the transactions.

The taxpayer was adequately compensated with a fixed fee from its associated enterprises for extending such market support activities, amounting to INR 32.18 crores[3] (approximately USD 5.4 million). The risk of the taxpayer in mediating between its associated enterprises on

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1. IN: HC Delhi, 23 Apr. 2015, *Marubeni India Pvt. Ltd.*, Income Tax Appeal 94/2015.
2. IN: ITAT Delhi, 30 Sept. 2011, *Li & Fung (India) Pvt. Ltd.*, Income Tax Appeal 5156/Del/2010.
3. A crore is an Indian unit equal to 10 million.

the one hand and suppliers/purchasers from India on the other, was limited and minimal with a low level of capital employed.

Further, the taxpayer was also engaged in arranging for feasibility studies, industry analysis and project evaluation, but such activities were done for non-associated enterprises. The taxpayer was also independently engaged in trading activities.

For assessment year 2008-09, five international transactions were reported by the taxpayer. The taxpayer had prepared separate segmental accounts for each of its activities i.e. for transactions between associated enterprises and non-associated enterprises. The taxpayer was compensated INR 321,811,018 for marketing and support services. The taxpayer selected the TNMM as the most appropriate method, using the profit level indicator of operating profit to operating cost, and reported a profit rate of 16.87% in respect of its international transactions, with the same profit level indicator of operating profit to operating cost of certain unrelated comparables at 13.81% on the basis of multiple-year data. Thus, the taxpayer claimed that its international transactions were at arm's length, as its margin was higher than that of comparable companies.

3. Action of the Transfer Pricing Officer and Dispute Resolution Panel[4]

During the course of the transfer pricing assessment, the transfer pricing officer observed that five international transactions were reported by the taxpayer on Form 3CEB. There was no dispute by the transfer pricing officer regarding four transactions. Rather, the issue arose for the international transaction involving the provision of agency and marketing support services, for which the taxpayer was compensated INR 321,811,018. The transfer pricing officer noted that the taxpayer provided some crucial services to its associated enterprises which formed the basis of sourcing activities carried out by the associated enterprises from or to India. According to the transfer pricing officer, the taxpayer's functions to its associated enterprises were not confined to merely providing marketing support services, but also involved arranging for feasibility studies, industry analysis and project evaluation for potential projects identified by the associated enterprises.

The transfer pricing officer also observed that besides providing agency support and acting in the capacity of liaising agent for various associated enterprises, the taxpayer helped the associated enterprises to make sale and purchase decisions. He noted that the taxpayer was making sizeable investments in exploring and analysing the Indian market. Further, the taxpayer could not substantiate the involvement of its associated enterprises in either technical capacity or manpower in the entire supply chain developed by it, for use by all the associated enterprises.

The transfer pricing officer rejected the taxpayer's contention that it was only a limited-risk service provider performing basic functions of agency, and concluded that the taxpayer failed to recognize that the functions performed by it were very critical in assuming significant risk and using both its tangible and intangible assets created over a period of time.

The transfer pricing officer further concluded that although the taxpayer developed several unique intangibles that gave advantage to its associated enterprises, the cost incurred for their development and use was not taken into consideration in determining compensation. He also concluded that the taxpayer performed all the critical functions in the process of rendering services to its associated enterprises by assuming significant risks.

Based on the above findings and observations, the transfer pricing officer concluded that the taxpayer was inadequately compensated by its associated enterprises and that the profit split method had to be applied as the most appropriate method for determining the arm's length price of the international transaction under consideration. In reaching this conclusion, the transfer pricing officer mainly relied on an order passed by the Delhi bench of the Tribunal in the *Li & Fung* case.

The transfer pricing officer further concluded that the taxpayer was required to be compensated on the total profits from the free-on-board (FOB) value of the goods that were the subject of transaction of the foreign associated enterprises. Further, relying on the decision in *Li & Fung*, where a ratio of 80:20 was held to be appropriate, the transfer pricing officer applied a conservative ratio of 70:30 in favour of the taxpayer, by concluding that 70% of the total profit earned by its associated enterprises from the goods traded from or to India should have been compensated to the taxpayer.

The transfer pricing officer considered the total volume of trading transactions of the Marubeni Japan group on a global basis at approximately INR 435,000 crores (approximately USD 73 billion) and determined the FOB value of goods outsourced from India at INR 24,208 crores (approximately USD 4 billion) and applied a ratio of 1.78% on such FOB value to determine the total operating profit attributable to Indian turnover at INR 43.05 crores. Thereafter, the transfer pricing officer determined the taxpayer's 70% share in such profits and proposed a transfer pricing adjustment at INR 30.14 crores.

Alternatively, the transfer pricing officer proceeded to benchmark the taxpayer's international transactions under the TNMM by treating the taxpayer as a commission agent. The transfer pricing officer selected nine comparables and – without any discussion about the names or other details of the relevant comparables – determined an arithmetic mean margin of profit at 42.13% on cost.

The taxpayer objected to the above calculation determining the arm's length price, but the transfer pricing officer did not consider it expedient to discuss or deal with that objection, as he rejected the taxpayer's alternative approach and adhered to the transfer pricing adjustment

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.

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of INR 30.14 crores on the basis of the profit split method by relying on the Tribunal's order in the *Li & Fung* case.

The taxpayer further raised the objections before the dispute resolution panel against the draft order passed by the assessing officer (regular tax officer) giving effect to the transfer pricing adjustment. The panel, without granting any relief, approved the application of the profit split method by relying on the decision of the Tribunal in the *Li & Fung* case. Aggrieved by the transfer pricing adjustment of INR 30.14 crores, the taxpayer approached the Tribunal.

4. Observations of the Delhi Bench of the Tribunal

The taxpayer submitted to the Delhi Tribunal a supply transaction structure of the business conducted by it; the same was also submitted to the transfer pricing officer during the transfer pricing assessment. The Tribunal observed that the responsibilities of associated enterprises extended to, for example, contracting, pricing, sourcing, scheduling, procuring, inventory management, logistics, marketing, credit management, quality and compliance with global laws, whereas the responsibilities of the customers/vendors from India extended to, for example, contracting, pricing, scheduling, negotiating and inventory.

The Tribunal further noted that the taxpayer was merely acting as a mediator between the associated enterprises on the one hand and the suppliers/purchasers from India on the other, and thus, the risk of the taxpayer was limited and minimal with a low level of capital employed. It was also observed that the transfer pricing officer did not controvert any of the facts provided by the taxpayer, and – without calling for any other further details as to what specific functions were performed by the taxpayer – the transfer pricing officer proceeded to record whimsical, contrary observations to the effect that the taxpayer undertook all the critical functions of its associated enterprises.

The Tribunal also observed that there was no elaboration by the transfer pricing officer of any critical functions carried out by the taxpayer, except that the taxpayer was also engaged in arranging for feasibility studies, industry analysis and evaluation for potential projects identified by its associated enterprises.

The Tribunal noted that the finding of the transfer pricing officer – namely that the taxpayer was engaged in arranging feasibility studies, industry analysis, etc. for its associated enterprises – was incorrect, as the same was done for non-associated enterprises. The Tribunal identified the same from the taxpayer's profit and loss account. The taxpayer also placed some evidence on record before the Tribunal to demonstrate that no feasibility studies, industry analyses, etc. were conducted for the associated enterprises. That argument was not refuted by the tax authorities. Thus, the Tribunal held that the taxpayer was not engaged in arranging feasibility studies, industry analysis or project evaluation for potential projects identified by its associated enterprises. On the contrary, those activities were done for unrelated parties.

The Tribunal observed that the transfer pricing officer was deeply influenced by the order in the *Li & Fung* case. According to the Tribunal, that order was not applicable to the facts in the present case. In the *Li & Fung* case, the taxpayer was a subsidiary of a Mauritius company. The taxpayer in that case charged a cost-plus 5% margin and determined arm's length price by applying the TNMM as the most appropriate method. The Tribunal observed that the majority of the crucial services were rendered by that taxpayer in the international transactions contracted between the associated enterprises and customers in India. The Tribunal thus held that, in view of the fact that the majority of the crucial services were rendered by the taxpayer, the compensation received by the associated enterprises at the rate of 5% of the FOB value of exports should be distributed in the ratio of 80:20 between the taxpayer and the associated enterprises. It was also noted that the taxpayer in that case charged its associated enterprises a cost-plus margin of 5%.

The taxpayer in the present case was compensated under a different model, namely by way of commission on purchase/sale transactions, and a fixed fee for rendering market support services was also provided. At several places in his order, the transfer pricing officer stated that the taxpayer received compensation on a cost-plus basis, which was also true in the *Li & Fung* case. The Tribunal in the present case held that the order of the Delhi Tribunal in the *Li & Fung* case could not be sustained because of its reversal by the Delhi High Court.[5]

The Delhi High Court, in its decision in the *Li & Fung* case, reversed the order passed by the Tribunal, noting that the finding recorded by the tax authorities (that the taxpayer assumed substantial risk) was not based on any evidence. It was also observed by the Delhi High Court that the taxpayer had not made any investment in the plant or inventory, for example, nor did it bear the entrepreneurial risk.

The taxpayer in the *Li & Fung* case rendered sourcing support services to its Hong Kong-based associated enterprise, for which it received remuneration of its operating cost plus a 5% mark-up. The taxpayer applied the TNMM to determine the arm's length amount of such remuneration, using the operating profit to the total cost as the profit level indicator. The transfer pricing officer, while accepting that the TNMM was the most appropriate method for determining the arm's length price and also accepting the comparable companies selected by the taxpayer, concluded that the cost for purposes of the 5% mark-up should include the FOB value of exports from India which have been facilitated by the taxpayer. The dispute resolution panel also upheld the order of the transfer pricing officer in principle, but reduced the mark-up to 3% on the FOB value of exports.

The taxpayer appealed to the Tribunal against the order of the dispute resolution panel. The Tribunal, while upholding the transfer pricing officer's findings and observations on principle that the cost-plus mark-up methodol-

5. IN: Delhi HC, 16 Dec. 2013, *Li & Fung India Pvt. Ltd. v. CIT*, Income Tax Appeal 306/2012, Tax Treaty Case Law IBFD.

ogy adopted by the taxpayer is not at arm's length, found that the amount of the adjustment may not exceed the sum that has been retained by the associated enterprise, out of the total remuneration received from third-party customers. The Tribunal further held that the sharing of total compensation received by the associated enterprise from its customers, namely 5% of the FOB value of the exports, between the taxpayer and the associated enterprise should be in the ratio of 80:20 respectively.

The Tribunal rejected the taxpayer's contention that Rule 10B(1)(e) of the Income Tax Rules 1962 (the Rules) made no provision for consideration of the cost incurred by the third parties when computing the net margin for the international transaction. The Tribunal also held that the taxpayer performed all the critical functions with the help of tangible and unique intangibles developed by it to fulfil the conditions of the agreements entered into by the associated enterprises with the third parties.

Rule 10B(1)(e) reads as follows:

> [T]ransactional net margin method, by which:
> (i) the net profit margin realised by the enterprise from an international transaction [or a specified domestic transaction] entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
> (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;
> (iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
> (iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
> (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction [or the specified domestic transaction];

Thus, the issues before the Delhi High Court in the *Li & Fung* case were: (i) whether the assessment by the tax authorities of the arm's length nature of the transactions by application of the TNMM was contrary to the transfer pricing provisions under the ITA and the Rules and (ii) whether the transfer pricing officer's apportionment by considering a cost-plus mark-up of 5% on the FOB value of goods transacted between the associated enterprise and third parties, sourced through the taxpayer, was in compliance with the law.

The taxpayer in the *Li & Fung* case argued that the transfer pricing officer's application of the TNMM was contrary to the provisions of law, as those provisions do not consider or impute cost incurred by the third parties. The transfer pricing officer increased the cost base artificially by considering the cost of manufacture and export of finished goods by third-party vendors – which was inconsistent with the manner of application of the TNMM as provided in Rule 10B(1)(e).

The taxpayer merely rendered buying or sourcing support services and operated with limited risk. Further, it neither was involved in direct manufacturing of goods nor invested in plant, inventory, working capital, etc. According to the taxpayer, the transfer pricing officer erroneously concluded that the taxpayer had developed unique intangibles, supply chain management and human capital, without appreciating that the taxpayer was only a captive service provider not undertaking any independent entrepreneurial risk.

The taxpayer also asserted that the concept of location savings, which was considered by the Tribunal, was attributed only to the end purchaser. The transaction of export of finished goods was undertaken by third-party vendors to overseas customers. As such, neither the taxpayer nor the associated enterprise was a party to such contracts, and neither gained any advantage on account of location savings associated with the export of goods between exporters and overseas customers.

The Delhi High Court in the *Li & Fung* case thus held that the broad basing of the profit-determining denominator as the FOB value of the exports, in determining the arm's length price, was contrary to the provisions of the ITA and the Rules. In this regard, the High Court in that case held that:

- the order of the Tribunal did not show how, or to what extent, the taxpayer bore "significant" risks, or that the associated enterprise enjoyed such location savings advantages, so as to warrant rejection of the transfer pricing exercise undertaken by the taxpayer;
- the tax authorities should base their conclusions on specific facts, and not on vague generalities, such as "significant risk", "functional risk", "enterprise risk", etc. without any evidence on record to support such findings;
- if the above findings are warranted, they should be supported by provable justifications, based on some objective facts and the relative evaluation of their weight and significance;
- if taxpayer was able to disclose and provide all elements of a proper TNMM analysis, the tax authorities should examine them in a detailed manner and then proceed to record reasons why the application of the TNMM is acceptable or not;
- the Tribunal's findings, upholding the determination of the dispute resolution panel of a 3% margin over the FOB value of the associated enterprise's contracts, was incorrect and was an error in law; and
- the transfer pricing officer's addition of the cost-plus 5% markup on the FOB value of exports by application of the TNMM was without foundation and was liable to be deleted.

In the present case, the Tribunal also observed that the view asserted by the transfer pricing officer was unfounded and based either on no evidence or irrelevant evidence. Further, the tax authorities also could not submit any evidence to indicate that the taxpayer used any of its intan-

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gible assets in so far as the relevant international transactions were concerned. The transfer pricing officer was also not able to demonstrate (with the help of any document or evidence) that the risk borne by the taxpayer was beyond mediating between the associated enterprises and customers/vendors in India.

Further, the tax authorities also relied on the decision of the Delhi bench of the Tribunal in the *Mitsubishi* case.[6] The taxpayer in that case was a wholly owned subsidiary of one of the leading *sogo shosha*[7] companies in Japan. The taxpayer asserted that its role as a trade intermediary was the core of *sogo shosha* activities, and hence should be characterized as a service provider and not a trader. Further, the taxpayer excluded the cost of goods sold (as pass-through costs) when computing the profit level indicator of net revenue to operating expenses, as it was a service provider.

The transfer pricing officer rejected the profit level indicator used by the taxpayer, and rather adopted the profit level indicator of operating profit to total cost; computed the total costs so as to include the cost of goods sold; and proposed a transfer pricing adjustment. The taxpayer argued that if the cost of goods sold was considered in computing the profit level indicator, the taxpayer should be compared with limited-risk trading companies and not with service providers, as done by the transfer pricing officer. The dispute resolution panel also upheld the decision of the transfer pricing officer.

The Tribunal in the *Mitsubishi* case observed that the taxpayer held the title to the goods in purchase and sale transactions, and thus it acted on a principal-to-principal basis. Accordingly, the Tribunal remitted the matter to the transfer pricing officer to consider appropriate comparables which were akin to trading with limited risk. Subsequently, on appeal by the taxpayer, the High Court confirmed the order of the Tribunal.

Thus, the Tribunal in the present case, is distinguished from the *Mitsubishi* case, as – according to the Tribunal – reliance was placed only on some part of the decision, and the title to the goods was held by the taxpayer for some time. The Tribunal also noted that when title to goods passes to a person, the consequences differ substantially vis-à-vis a situation in which the title to the goods does not pass to the person that simply acts as an agent.

On the contrary, in the present case, the transactions turned out to be on a principal-to-principal basis i.e. the taxpayer's role was no more than that of an agent of its associated enterprises in their transactions with final buyers/sellers in India. According to the Tribunal, the risks and rewards went hand in hand with title to goods and thus the reliance placed by the tax authorities on the decision in the *Mitsubishi* case was not sustainable.

Further, the Tribunal held that the profit split method was not the most appropriate method for benchmarking the relevant international transaction, as neither the transfer pricing officer, assessing officer, dispute resolution panel nor the tax authorities placed anything on record to substantiate that the taxpayer carried out critical functions and also carried significant risk and human intangibles. In addition, the Tribunal also held that the mere fact that the profit split method was not applicable to the present case did not mean that the applicability of transfer pricing provisions under the ITA was ruled out. In such a situation, the arm's length price of the international transactions was required to be determined by means of another suitable method.

The Tribunal observed that the taxpayer selected the TNMM as the most appropriate method and computed its profit level indicator at 16.87% on cost. The taxpayer chose certain comparables on the basis of multiple-year data, and computed its profit level indicator at 13.81% on cost. This proposition by the taxpayer was rejected by the transfer pricing officer and the Tribunal. Further, it was also observed that the transfer pricing officer, through the alternative approach, chose nine comparables with an arithmetic mean margin of 43.12% on cost, but that approach was dropped by the transfer pricing officer in view of the decision of the Delhi Tribunal in the *Li & Fung* case. It was seen that the both the taxpayer and the transfer pricing officer, in an alternative approach, adopted the TNMM to determine the arm's length price of the international transactions. Thus, the Delhi Tribunal held that the TNMM was the most appropriate method to benchmark the relevant international transaction.

Finally, the Tribunal set aside the order and remanded the matter to the transfer pricing officer/assessing officer for a fresh determination of the arm's length price of the disputed international transaction and allowed the taxpayer a reasonable opportunity of being heard in such de novo determination of the arm's length price.

5. Observations of the Delhi High Court

The following questions were before the Delhi High Court in the present case:

- whether – when the taxpayer simply supplied some information to its associated enterprises and acted as a mediator between the associated enterprises and Indian suppliers in the transactions arranged independently between themselves – the taxpayer can be characterized as assuming higher risk or using its highly valued intangibles;
- whether – when taxpayer specifically submitted that its role consisted of agency services and rendering managerial support services to the limited extent of providing necessary information in aiding the associated enterprises in taking decisions – the transfer pricing officer may, of his own volition, determine certain human capital and supply chain intangibles used in the transactions without first proving their very existence; and

6. IN: Delhi ITAT, 12 Nov. 2012, *Mitsubishi Corporation India Pvt. Ltd.*, Income Tax Appeal 5147/Del/2010.
7. *Sogo shosha*, or general trading companies, are Japanese companies that trade in a wide range of products and materials. In addition to acting as intermediaries, *sogo shosha* also engage in logistics, plant development and other services, as well as international resource exploration.

– whether – where the taxpayer was engaged in the provision of agency and marketing support services to associated enterprises – the TNMM may be applied as the most appropriate method to determine the arm's length price.

The Delhi High Court considered all the facts and ultimately concurred with the Tribunal's finding that the taxpayer's risk was limited and minimal, with a low level of capital employed. The Court also held that neither the transfer pricing officer nor the tax authorities proved that the taxpayer performed all the crucial functions on behalf of the associated enterprises.

As a result, the Delhi High Court held that the Tribunal's conclusion, that the TNMM was the most appropriate method, and that the transfer pricing officer had to make a fresh determination of the arm's length price of the disputed international transactions involving the provision of agency and marketing support services amounting to INR 32.18 crores, by applying the TNMM, was reasonable. The appeal by the tax authorities was thus dismissed.

6. Conclusion

In this decision, the taxpayer – by correctly reflecting the nature of its business activities, and an in-depth functional, asset and risk analysis – was able to demonstrate that, economically, it was acting only as a support service provider. Thus, based on such analysis, the Tribunal correctly concluded that the profit split method was not applicable, but the TNMM was applicable.

This decision again brings out the importance of performing a detailed business analysis and function, asset and risk analysis, in order to correctly demonstrate a taxpayer's business model, so as to support the revenue and/or profit attributable to such controlled- or related-party transactions in a transfer pricing analysis. An in-depth business analysis also aids the taxpayer in selecting an appropriate method under the law to benchmark its related-party transactions.

This case and the *Li & Fung* case clearly bring out a significant proposition, namely that in transfer pricing analysis, income is to be attributed on the basis of the actual transactions that have taken place and not on the basis of a perceived business model.

Transfer pricing analysis can sometimes tempt one into a hypothetical examination of a "supposed to be" situation, which in reality may not exist. It is here that the law and jurisprudence should evolve to set the boundaries of such examination, so as to be in sync with the analysis of the functions, assets and risks and the actual transactions based on the documentary evidence available.

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