

Indian tribunal rules on intragroup services case involving cost contribution arrangement

The Mumbai bench of the Income Tax Appellate Tribunal recently pronounced its ruling in the case of Dresser-Rand India Private Limited (the taxpayer), wherein the tribunal held that the taxpayer's commercial wisdom in incurring any expenditure for the conduct of its business cannot be questioned by the tax authorities. Importantly, the tribunal held that the determination of arm's length price for intragroup services should be based on the price an independent enterprise would be willing to pay for the said transaction and whether the assessee has benefitted from such services or expenses is not the determinant of the arm's length price. The tribunal also held that documents like reports, exchanges of emails, and guidance notes are contemporaneous evidence.

Facts

The taxpayer, a wholly owned subsidiary of Dresser Rand Co – USA (DRUS), is engaged in the business of manufacturing various types of gas compressors, horsepower reciprocating compressors, and accessories, and providing field services. During assessment year 2006-07, the taxpayer incurred an expenditure of INR 10.55 crores toward cost contribution allocation by DRUS. The taxpayer had also provided certain field services to DRUS and other associated enterprises. The taxpayer had applied the transactional net margin method (TNMM) as the most appropriate method to benchmark the international transactions. The focus of this alert is on the CCA arrangement and the issues surrounding the same.

During the course of the transfer pricing assessment proceedings, the transfer pricing officer requested certain documents pertaining to the CCA transaction. Per the CCA, the taxpayer would compensate DRUS for the expenses incurred by DRUS toward the resources shared by it with the taxpayer. Detailed documentation in the form of email communications, copies of reports, and other documents evidencing rendering of services relating to (a) legal services, (b) human resource services, (c) treasury services, (d) technical support services, (e) marketing services, (f) global business oversight services, (g) internal audit and controls, and (h) other services by DRUS was furnished by the assessee to the TPO. Further, it was explained by the assessee that the costs incurred by DRUS were allocated to its associated enterprises based on two allocation keys, namely, headcount and sales proportion of each of the participating entities in the CCA.

Based on the documents and various submissions made by the taxpayer, the TPO concluded that no services were availed by the taxpayer from DRUS, and hence determined the arm's length price to be nil. Further, the TPO also questioned the allocation keys adopted by the taxpayer, and emphasized that the cost sharing should be (i) based on actual services availed, and (ii) if at all costs were to be charged to the assessee, the same should be based on Indian employees costs.

The taxpayer raised its objections to the TPO's order before the Dispute Resolution Panel (DRP). The DRP disposed of the objections and confirmed the adjustments proposed by the TPO/Assessing Officer with the following observations:

- With respect to the CCA, the documentary evidence submitted did not prove the receipt of services by the taxpayer from its associated enterprises; and
- With respect to field service, the DRP directed the assessing officer to verify and rectify the computational errors and restrict the disallowance to the extent of the discount granted (10 percent).

The taxpayer disagreed with the order of the DRP and the assessing officer, and filed an appeal before the tribunal.

Issue before the Tribunal

Were the revenue authorities justified in holding the arm's length price of the CCA transaction to be nil?

Ruling

With respect to the CCA, the tribunal held that payment by the taxpayer toward the CCA was at arm's length, observing the following:

- Conducting business is entirely taxpayer's prerogative and revenue authorities should not decide whether a particular expense is necessary for the taxpayer or not;
- The tribunal observed that when evaluating the arm's length price of a service, it is not relevant whether the service was beneficial to the assessee, and the tax authorities must restrict themselves to determining whether the price paid by the taxpayer would be comparable to the price paid by an independent enterprise for the same transaction;
- Documentary evidence like copies of report; emails and guidance notes etc. filed with the tax authorities by the taxpayer, being contemporaneous in nature, demonstrate that the taxpayer had received the services from DRUS that year;
- The tribunal found no infirmity in the method of allocation of cost charged by DRUS on the basis of average of headcount to total headcount and sales revenue to total revenue. The tribunal held that the assessee's share in the costs should be consistent with the expected benefits to it. Since there was no objective way in which the use of services could have been measured, the allocation undertaken was in line with commercial practice in market-driven situations, where costs are shared per some objective criteria, including sales/ revenues and employees. Further, the tribunal held that the allocation of cost charged by DRUS should be on the basis of actual costs incurred, and the allocation could not have been on the basis of domestic employee cost because such an allocation would have meant dealing with hypothetical pricing;
- The taxpayer had adopted the TNMM as the most appropriate method, and the revenue authorities neither disputed the method nor prescribed any other method for determining the arm's length price of the service received under the CCA, and therefore the assessee's transactions were at arm's length.

Conclusion

This is a major decision addressing the issue of cross-charge of costs incurred in relation to common services rendered by associated enterprises. The tribunal held that tax authorities cannot question the taxpayer's commercial wisdom in undertaking any expenditure for its business, and it is not correct for the revenue authorities to ask the taxpayer to prove that all expenses incurred for its business should result in some kind of benefit to the taxpayer. This judgment is contrary to the earlier decision of the Bangalore Tribunal in the *Gemplus India Pvt Ltd* case, wherein the tribunal ruled that payments should be commensurate with the benefits received. Another critical takeaway of this ruling is that taxpayers must maintain documentary evidence of receipt of services, which must be carefully examined by the revenue authorities while determining the pertinent arm's length price.

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