FAR analysis can't be insisted upon in TNMM in transfer pricing

Summary – The Delhi ITAT in a recent case of Copal Research India (P.) Ltd., (the Assessee) held that In a TNMM methodology identical FAR analysis cannot be insisted upon and method is in fact resorted to when complete data is not available; in that case impact on net profitability of minor variations in comparable companies so selected is considered capable of tolerating minor variations in FAR analysis of comparables

Facts

- The assessee-company was engaged in the provision of Information Technology enabled back office support services in the nature of customized business/financial research support to its AE. In return for rendering these services the assessee was remunerated on an arm's length cost plus basis, *i.e.*, cost plus a mark-up thereon. The assessee selected Transactional Net Margin Method as the most appropriate method. Selecting 15 comparables it claimed that its transaction was at arm's length price.
- The TPO selected fresh comparables and recommended TP adjustment.
- On appeal: the grievance of the assessee was posed on the comparables excluded by the TPO.

Held

- It is very clear that Knowledge Process Outsourcing cannot be equated to a low-end IT enabled service provider. The Delhi High Court in the case of *Rampgreen Solutions (P.) Ltd*. v *CIT* [2015] 377 ITR 533/234 Taxman 573/60 taxmann.com 355 held that a company who is providing routine call centre services cannot be equated to a KPO. A KPO is understood as a high-end value added process chain wherein the processes are dependent on advanced skills, domain knowledge and the experience of the persons carrying on such processes. Thus, the prayer on facts needs to be considered. Instances where segmental have not been made available necessitate that the said comparable should be excluded. Instances where the services are shown to be outsourced or for that matter the services are performed off-site and it can be shown that the net profitability of the company is impacted would again necessitate their exclusion. Similar would be the position where related party transactions filter is not fulfilled would justify its exclusion. Instances where the assessee can demonstrate that the comparable has undergone an extraordinary event by way of amalgamation/Acquisition *etc* wherein net profitability of the specific comparable company has been impacted or by inclusion of financials of the amalgamating subsidiary having any extraordinary abnormality has impacted the net profitability, prayer for exclusion is justified. As such comparables on facts can become tainted and justify their exclusion. There is also precedent available to seek exclusion of a comparable which has been included despite owning significant IPRs brands *etc* as a

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result of impacting the net profitability of the said comparable. This is notwithstanding the fact that the Revenue at times has been able to argue and insist upon the reasoning being recorded that unless and until the impact on net profitability is demonstrated, the comparable company should not be excluded as merely because it owns IPRs and has access to brands and is considered to be thus commanding high bargaining power for services rendered in terms of prices on account of the availability of in-house IPRs or brands then the costs incurred for the usage of the IPRs and brands impacting the gross returns would be addressed in the net profitability which is what a TNMM addresses. The impact of IPRs and brands on net profitability the Revenue can argue would be negated. There may be a valid point in the said argument which is why the mere ownership of brands by itself may not be a good enough ground to exclude a comparable unless the assessee is able to demonstrate that as a result of this fact the net profitability is impacted. Mention of these basic fundamental facts is necessitated in view of the fact that on account of the intense arguments advanced by the parties before the Bench the focus is known to shift from the fundamentals of the method being applied to the hair splitting exercise of seeking inclusion/exclusion of comparables. It needs to be kept in mind that whenever the taxpayer chooses TNMM as the most appropriate method and the selection of this method has not been upset by the Revenue then it can be said to be a position that both the parties fully agree that the choice of method would dictate the selection of comparables.

- It is an accepted position that in a TNMM what is necessary to be seen is the net profitability and the minor differences in functional comparability to the extent insisted upon by the taxpayer before the Tribunal is not in the true spirit of the method and in fact violates and is contrary to the reasoning and rational of the methodology having been chosen and accepted. In the facts of the present case, intense hair splitting exercise which has been done by the taxpayer on the basis of which exclusion of the 6 comparables is sought, agreeing fundamentally that the judicial precedent is clear by the decision of the jurisdictional High Court in the case of *Rampgreen Solutions (P.) Ltd.* (*supra*) that KPO cannot be said to be equated to a low-end ITES enabled company. In the facts of the present case the FAR analysis characterization which is the fundamental foundational fact is an exercise which is required to be addressed. Considering the arguments raised, the occasion to raise argument for exclusion of six comparables and inclusion of another six comparables has arisen solely on account of the fact that the foundational exercise of proper FAR analysis of the assessee has not been done. In the facts of the present case also this fundamental exercise which is the foundation on which the case for either side is to be built is unfortunately an exercise which is attempted in haste without adequate care and attention either by the tax payer or by the tax authorities who both rush through this fundamental exercise at the initial stages in undue haste satisfied easily as long as their respective stand appears to be reflected in the comparables selected. The selection when challenged at the appellate stage often results in a situation where the entire edifice crumbles despite a valiant patch work attempt to uphold the edifice it has been seen that the entire selection process offered and considered stands wiped out. Though, the tax payer at the stage of the TP study

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no doubt may be handicapped by the insufficiency of data in the public domain as it may not be sufficiently robust and readily available completely. However at this stage availability of data cannot be a handicap. In a TNMM methodology identical FAR analysis cannot be insisted upon and the method is infact resorted to when the complete data is not available. In that case the impact on the net profitability of the minor variations in the comparable companies so selected is considered capable of tolerating minor variations in the FAR analysis of the comparables. The selection of this method is resorted to for this very purpose and the method is robust enough to tolerate minor variations if any. It is a fact that a perfect near identical comparable company is a rarity and generally can be said to be a virtually impossible condition incapable of being fully fulfilled. It is for this very purpose that TNMM as a method is often resorted to. The minor difference if any are addressed by comparing net profitability of the comparables. Thus, broad comparability of a fairly large number of comparable companies can further ensure that minor variations if any are offset by taking a fairly large sample. Any major impact of their FAR on their net profitability if still so warranted on facts can be addressed by carrying out appropriate adjustments the need for which has to be demonstrated on the basis of record so as to bring their FAR in alignment with that of the tested party *i.e*. the assessee. The Rules moreover permit adjustments in the comparables selected if it can be demonstrated that these would impact the profitability of the comparable selected. Thus before considering the comparables the FAR analysis on the basis of the functions performed assets available and risks assumed need to be analyzed in detail if need be to the level of hair splitting which the tax payers attempt for the comparables. Thereafter the selection of comparables is an exercise which would be hugely facilitated and relatively free from the need to address micro variations. Accordingly, the issue is restored to file of T.P.O to carry out this exercise.

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