Resale of goods purchased from AE to be benchmarked at RPM even if assessee was full-fledged distributor of goods

Summary – The Delhi ITAT in a recent case of Horiba India (P.) Ltd., (the Assessee) held that where assessee, in capacity of distributor, purchased goods from AE and resold same to other independent entities without any value addition, in such a case, resale price method (RPM) was to be reckoned as MAM for determining ALP

Facts

- The assessee-company was a subsidiary of 'Horiba Ltd., Japan' which was mainly engaged in manufacturing and sale of measuring instruments. The assessee undertook the distribution of various finished goods manufactured by its holding company (AE) in India. The distribution of finished goods included 'automotive test equipment' and 'medical diagnostic equipment'.
- In the transfer pricing study, the assessee benchmarked the purchase of goods for resale by adopting Resale Price Method (RPM) as the most appropriate method. To benchmark the overall gross profit margin of 36.47 per cent, the assessee had chosen 12 comparable companies which were mostly dealing in medical equipment or auto components. The average arithmetic mean of these comparables was arrived at 16.24 per cent. Accordingly, it was claimed that assessee's gross profit margin was at arm's length.
- The TPO re-characterized the assessee as full risk distributor and performing a whole range of marketing and selling functions by assuming various risks such as inventory risk, bad debt risk and market risks etc.
- He thus concluded that RPM would not be the appropriate method; instead TNMM should be adopted as MAM for benchmarking the net profit margin of the assessee.
- The DRP also took a view that once the assessee was full-fledged distributor carrying various functions as illustrated by the TPO, then in such a situation, RPM could not be adopted. Accordingly, the DRP confirmed the application of TNMM as the correct method.
- On appeal:

Held

- It is undisputed fact that the assessee under the segment of purchase of goods for resale from its AE is purely into distribution of finished goods in India. It purchases automotive test equipment and medical diagnostic equipments, manufactured by its AE and is sold to third party customer in India without any further value addition. Since it was purely performing the distribution function, therefore, to benchmark the arm's length transaction, assessee adopted RPM is the Most Appropriate Method (MAM).

- The RPM method identifies the price at which the product purchased from the A.E. is resold to an unrelated party. Such price is reduced by normal gross profit margin, *i.e.*, the gross profit margin accruing in a comparable controlled transaction on resale of same or similar property or services. The RPM is mostly applied in a situation in which the reseller purchases tangible property or obtain services from an A.E. and reseller does not physically alter the tangible goods and services or use any intangible assets to add substantial value to the property or services, *i.e.*, resale is made without any value addition having been made.
- In case of a distributor, wherein the goods are purchased from AE and resold to other independent entities without any value addition, in such a case resale price method (RPM) was to be reckoned as MAM for determining ALP. One of the main reason given by the TPO as well as the DRP is that the assessee is a full-fledged/full risk distributor and performing host of functions, therefore, RPM should not be taken as the MAM, because all these functions required huge cost which may not represent correct gross profit margin. Such a proposition can not be appreciated because in a comparable uncontrolled transactions scenario, a normal distributor will undertake all kind of functions which are related to sales of the product.
- The functions like market research, sales and marketing, ware-housing, inventory control, quality control *etc*. and also risk like market risk, inventory risk, credit risk *etc*. all are undertaken by any distributor for sale of products. No comparable instances have been brought either by the TPO or by the DRP that the other distributors are not performing such functions. What is important is to see is, whether there is any value addition or not on the goods purchased for resale? If there is no value addition and if the finished goods which are purchased from AE are resold in the market as it is, then gross profit margin earned on such transaction becomes the determinative factor to analyse the gross compensation after the cost of sales. Thus, under the facts of the present case, RPM should be held as MAM.
- The other main objection of the department is that there is a huge variation in the gross profit margin of the two products distributed by the assessee and, therefore, under the RPM same cannot be clubbed together, because it will not yield proper arm's length result. As already clarified by the assessee that it has separately worked out the gross profit margin for both the items distributed and even then the assessee's gross profit margin is higher than the comparables.
- However, in order to examine whether the gross profit margin for both the products are at arm's length margin or not *vis-à-vis* the comparables, for the limited purpose of benchmarking the gross margins of the comparables selected by the assessee for both the products, *i.e.*, automotive components and medical equipment should be separately benchmarked; and if on comparison it is found that the gross profit margin of these comparables chosen by the assessee as well as accepted by the department are within the arm's length range, then no adjustment should be made. With this limited direction the matter is remitted back to the TPO/Assessing Officer only to verify the gross margins of the comparable companies.