1. Case Study 1 – Use of segmental financials for benchmarking purposes

1.1. ABC Co Pvt Ltd (‘ABC’) is a wholly owned subsidiary of XYZ Ltd, UK (‘XYZ’) and is engaged in the manufacturing and trading of specialty chemicals used in the paints, cosmetics, textile etc industries. It markets and sells such goods all over India as well as the Asia Pacific region.

1.2. During AY 2011-12, ABC imported certain raw materials required for manufacture of finished goods from XYZ. It also sold a small value of manufactured finished goods to its overseas group companies including XYZ.

1.3. Further, having regard to customer requirements, ABC procures certain specialty chemical products from local third parties when ABC itself cannot manufacture the same on account of capacity limitations, time constraints etc. ABC has only one marketing team for selling all its products (manufactured as well as traded). The trading turnover constitutes approximately 40% of the total turnover.

1.4. Apart from import/ export of goods, ABC also availed IT support services from its AE as well as entered into certain reimbursement transactions.

1.5. For benchmarking its international transactions, ABC selected TNMM as the most appropriate method. It prepared segmental accounts for manufacturing and trading activities. No segmental data was disclosed in its audited financial statements as it is engaged in only one segment of specialty chemicals.

1.6. While preparing the segmental accounts, sales as well as COGS could be directly identified between manufacturing and trading activities from the SAP system. However, other common costs, such as personnel, operating and other administration costs were allocated between the two segments in the “sales” ratio. As regards depreciation, other than depreciation on office assets, the entire cost was attributed to the manufacturing segment. Once the above was done, the manufacturing segment reflected a profit of 10.80% on sales and the trading segment 4.5% on sales. Having regard to the comparables selected, ABC concluded that its international transactions were at arm’s length.

1.7. The TPO rejected the segmental analysis conducted by ABC on the basis that there was no sanctity for the same and that the audited financial statements did not contain any such bifurcation. He calculated the margin earned by ABC on an entity level basis at 8.28% and made an adjustment considering the comparables’ margin at 14.5%.

1.8. Points for discussion

- Whether benchmarking approach of ABC is correct given the fact that there were no international transactions in the trading segment?
- Whether reasons given by the TPO for rejecting segmental analysis were valid?
- Whether better analysis could have been done?
2. **Case Study 2 – Deduction of Abnormal / non-recurring costs due to business dynamics**

2.1. MNC Inc., incorporated in USA, is engaged in the business of providing information technology (IT) services based on the requirements of the clients / end-users. It has incorporated a subsidiary in India for its operations i.e. MNC (India) Ltd.

2.2. MNC (India) Ltd. has invested in the full-furnished infrastructure facilities at Bangalore and Pune for carrying out its Indian operations of rendering of services. The details of the infrastructure capacity available with the company up to 31.03.2011 are as under:

<table>
<thead>
<tr>
<th>Premises</th>
<th>Status</th>
<th>Seating Capacity</th>
<th>Utilised Capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangalore</td>
<td>Rented Premise</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Pune</td>
<td>Owned Premise</td>
<td>300</td>
<td>200</td>
</tr>
</tbody>
</table>

2.3. MNC (India) Ltd. has been trying to reach-out and capture the Indian domestic market for the solution-based IT services. During the FY 2010-11, it has rendered services to both its parent company and domestic clients. Since the company was in its initial period of expansion, around 30 per cent of the man-hours available with the company could not be utilised and remained idle.

2.4. While carrying out the benchmarking analysis required under the transfer pricing regulations, Transactional Net Margin Method was selected as the most appropriate method. MNC (India) Ltd. while calculating its operating margin from the rendering of IT services has excluded certain costs based on non-utilisation of capacity. The company has also made a deduction of the excess idle capacity i.e. bench-cost.

2.5. However, TPO during the assessment proceedings pointed out that such an exercise cannot be carried out for the comparable companies due to unavailability of data in the public domain and hence, rejected the deduction of such abnormal / non-operating costs from the margin calculation of the company, resulting in lowering of the company’s margin below the comparables’ margin.

2.6. **Points for discussion**

- Whether reasons given by the TPO for rejecting such deduction of abnormal costs were valid?
- Discuss various nuances relating to this case study
3. Case study 3 – Change in business model – whether exit charge warranted?

3.1. SMART, based out of US, is amongst the world’s largest specialty chemical manufacturers with subsidiaries around the globe. It has been selling its products under various reputed brand names, which have been built based on consistent research and development efforts and focus on quality over the past several years.

3.2. DUMB, set up in May 2002, is a wholly owned Indian subsidiary of SMART and has been engaged in the manufacture and sale of specialty chemicals using trademarks owned by SMART. DUMB had its factory at Chennai, Tamil Nadu wherein it was manufacturing specialty chemicals using proprietary technology owned and provided by SMART. It had a huge capacity of about 50,000 metric tonnes p.a.

3.3. DUMB had been posting a net profit of approximately 10% on a year-on-year basis. However, since past 5 years, DUMB’s profitability was on the decline primarily on account of rising costs at its factory. This was due to under-utilisation of capacity on account of severe competition coupled with rising manpower and other running costs.

3.4. Thus, during FY 2009-10, DUMB shut down its plant after seeing no signs of a significant turnaround. Further, an analysis of import vis-a-vis manufacture also revealed that under the current scenario as well as going forward, DUMB would not be much worse off in import and resale (i.e. trading) vis-a-vis manufacture and sale.

3.5. During TP assessment proceedings, the TPO took a view that the above would tantamount to a transaction of business restructuring or reorganization falling under clause (e) of the Explanation to Section 92B of the Income-tax Act, 1961. Accordingly, the TPO held that the fact that DUMB would lose its manufacturing profit and the AE would gain (by way of sale of products to DUMB) warranted an exit charge to be paid by the AE to DUMB. He worked out the estimated profits that would be foregone on account of closure of manufacturing operations of DUMB for the next 5 years (less estimated trading profits), discounted the same to calculate the present value of such profits and made an adjustment.

3.6. Points for discussion

- Whether such a situation would fall within the definition of international transaction u/s 92B of the Act?
- Whether methodology adopted by the TPO is justified?
4. **Case study 4 – Applicability of Section 263 to a TP order**

4.1. Sun India Private Limited (‘assessee’ or ‘company’ or ‘taxpayer’) an Indian resident company is in the business of manufacture and sale of electrical goods. During the financial year 2009-10, the company sold the said finished products to various AEs outside India. It also paid royalty to its AE for providing technical know-how @ 5%. The assessee has fully complied with the provisions of section 92E of the Income-tax Act, 1961, (the Act) wherein it has disclosed all its international transactions with its AE in Form 3CEB and in the transfer pricing study report.

4.2. The Assessing Officer (AO) made a reference under section 92CA(1) of the Act to the transfer pricing officer (TPO) for the computation of arm’s length price (‘ALP’) in relation to the said international transactions. In pursuance thereof, the TPO with the approval of the Director of Income Tax (‘DIT’) - (TP-I) and after examining the entire details, transactions and methodology adopted by the assessee, passed an order under section 92CA(3) of the Act proposing an adjustment of INR 2.11 crores to the transaction of sale of products to AEs. The payment of royalty was accepted to be at arm’s length based on the TNMM analysis conducted by the assessee.

4.3. Further, the Assessing Officer incorporated the order of the TPO as per Section 92CA(4) of the Act. Thereafter, on the basis of the transfer pricing order, the Commissioner of Income-tax (CIT) came to a conclusion that the order passed by the TPO was erroneous inasmuch as it was prejudicial to the interests of Revenue and, therefore, the assessment order passed by the Assessing Officer was also erroneous. Accordingly, CIT set aside the assessment order with direction to re-examine the transaction of payment of royalty.

4.4. **Points for discussion**

- Can CIT revise the order of the AO and consequently the order of the TPO for computation of ALP which has been approved by DIT?

- Will the AO, for the purposes of Sec 263, also include the TPO?