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Practitioners Say Delhi ITAT's *GAP* Ruling Will Influence Other Procurement Cases

The Delhi Income Tax Appeals Tribunal's ruling favoring GAP International Sourcing (India) is useful for taxpayers not only because the court rejected an extremely large adjustment by a transfer pricing officer, but also because the court's reasoning on location savings and profit-level indicators can be applied to other selling and procurement agents as well as distributors, practitioners say.

BY KEVIN A. BELL

The Delhi Income Tax Appellate Tribunal's recent ruling in *GAP International Sourcing (India) Private Ltd.* is a well-reasoned decision that provides a guidepost for determining whether other Indian related-party procurement companies are providing routine, low-risk services, or are instead engaged in the provision of high-value procurement functions, according to Indian practitioners. [***GAP International Sourcing (India) Private Ltd. v. Assistant Commissioner of Income Tax*** **Delhi ITAT, ITA No. 5147 of 2011 and No. 228 of 2012, Order entered 9/18/12**]

Among the key findings in the case, they said, were the court's analysis of the following factors:

- the taxpayer's functional, asset, and risk profile;
- the selection of a profit-level indicator (PLI) linked to the choice of comparables;
- the importance of maintaining and presenting robust documentary evidence;
- whether human capital and supply chain intangibles are created; and
- whether location savings should be attributed to a taxpayer in a low-cost country.

Because so many transfer pricing rulings are fact-specific, when a ruling lays down principles of general applicability, it becomes the guiding post for transfer pricing planning and decision making in similar cases, said Ashutosh Mohan Rastogi of Amicus Advocates & Solicitors in New Delhi. "The *GAP* ruling is one such ruling that lays down principles of far-reaching importance and universal application," he told BNA Jan. 24.

Ruling

The Delhi ITAT in its Sept. 18 decision rejected the transfer pricing officer's commission model, selecting a PLI of return on costs given the functional profile of the company, GAP International Sourcing (India) Private Ltd.

The tribunal found that GAP (India) was a routine service provider and that it should charge a cost plus markup of 32 percent to its overseas affiliates for facilitating the sourcing of raw materials from Indian vendors in order to manufacture clothing.

GAP (India), a wholly owned subsidiary of GAP International Sourcing Inc. USA, originally was remunerated by its overseas subsidiaries on a cost plus 15 percent basis for its procurement services. GAP (USA) was the centralized procurement company for the GAP group.

The ITAT rejected the TPO's "phenomenally exorbitant" transfer pricing adjustment of nearly 5 billion rupees (US$92 million). It said the TPO reconstructed GAP (India)'s profit and loss account "by notionally bringing the value of goods sourced by overseas [associated enterprises] from India, which were neither fully sourced through it nor routed through its financial accounts and its Profit & Loss account."

The tribunal found that the adjustment imposed by the TPO—a commission of 5 percent of the volume of goods sourced from India, paid by GAP group affiliates overseas—would have resulted in an "unrealistic, impractical, and absurd" ratio of operating profits to

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value-added expenses for GAP (India) of 831 percent for the year of assessment 2006-07.

The tribunal's Sept. 18, 2012, decision appears in the Text section of this issue.

'Business As Usual?'

Rahul K. Mitra of PricewaterhouseCoopers in Gurgaon, who represented GAP International before the Delhi ITAT, told BNA Jan. 24 that even though the revenue authority at the lower levels might go ahead with ''business as usual'' following the decision ''there are very good chances of success before the ITATs with reference to the principles decided in the *GAP* case, and also before the advance pricing agreement program.''

Mukesh Butani of BMR Legal in New Delhi told BNA Jan. 23 that if the tax administration does not appeal further—an unlikely situation—the transfer pricing officers would take their cue from the ruling and would be ''more fair and non-adversarial in concluding audits.''

The time limit for the revenue to file an appeal with the high court is 120 days from receipt of the tribunal's order by the Commissioner of Income Tax. The official date of receipt by the Commissioner may occur much later than the date of the tribunal's ruling because the ITAT's order must be delivered to the Commissioner through the official channels of the Ministry of Finance, so the time limit may not yet have expired.

Rastogi said the tax authority may have difficulty appealing the case. He noted that the high court can adjudicate only questions of law and does not have the jurisdiction to reopen or reconsider the factual matrix. ''The tax tribunal is the last fact-finding authority under the Indian tax appellate mechanism,'' he said.

As are most transfer pricing cases, Rastogi said, the *GAP* ruling is fact-specific, presumably leaving little room for the revenue authorities to contest substantial questions of law in the high court. ''Since the characterization question is largely a fact-driven exercise, it appears that there may be little or nothing for the revenue authorities to take up in appeal to the higher court.''

But Rohan K. Phatarphekar of KPMG India Pvt. Ltd. in New Delhi agreed with Butani that the tax authority is likely to appeal. He told BNA Jan. 29 that the issue of location savings is being raised by TPOs in some current transfer pricing audits, and also has been raised in earlier audits, with the auditors seeking an overall profit split attributing profits to the Indian associated enterprise on account of location savings. Because an appeal is likely, Phatarphekar said, examiners can be expected to continue taking these positions.

Even if the high court affirms the judgment of the Delhi ITAT, he added, the tax authorities would have the option of appealing the case to the Supreme Court—an option also available to the taxpayer in the case of an unfavorable high court ruling.

Limited-Risk Service Provider

The Delhi ITAT determined that a cost plus remuneration model was appropriate for GAP (India) based on the functions, assets, and risks undertaken by the taxpayer and its overseas related parties.

GAP (India) said it acted as a facilitator between Indian third-party apparel manufacturers and the overseas affiliates of the GAP group. The Indian third-party manufacturers sold the manufactured clothing directly to the overseas GAP group companies. During the years of assessment—2006-07 and 2007-08—GAP (India) calculated its intercompany prices using the transactional net margin method and used the return on costs as the PLI. It was remunerated by its overseas group companies on a cost plus 15 percent basis for its services.

Looking to the company's voluminous documentary evidence, the tribunal found that GAP (India) was a limited-risk provider of support services, performing only routine services in accordance with the instructions from its overseas affiliates. The court thus rejected the TPO's contention that the Indian company performed key supply chain functions and bore significant risks.

Phatarphekar said the ruling emphasizes the importance of maintaining robust documentation to substantiate the taxpayer's functional, asset, and risk (FAR) profile ''and accordingly support[ing] the remuneration model most appropriate for the level of activities carried on by the taxpayer.'' The ruling also reiterates that irrespective of the remuneration model adopted by the procurement service provider, the model should not lead to absurd or abnormal results.

Role of GAP (India)

Rastogi said a fundamental principle emerging from the *GAP* case is that one needs to understand the true characterization of the taxpayer with reference to its intercompany agreements and supporting facts. For example, he said, one cannot impose a remuneration model on a low-value-added procurement service provider without understanding the nature of procurement services provided.

The tribunal found that under the service and support agreement with its parent, GAP (India) was required to provide the following liaison support services to its overseas affiliates:

- identify new third-party Indian clothing manufacturers;
- help the Indian third-party manufacturers obtain raw materials from Indian vendors;
- conduct quality control;
- coordinate with manufacturers to ensure timely delivery of goods to the overseas affiliates according to a schedule supplied by GAP (USA); and
- act as a liaison between GAP (USA) and the manufacturers.

The tribunal also found that the legally binding agreement defined the roles, responsibilities, and remuneration to GAP (India) from GAP (USA) and that the agreement ''should have been duly considered and appreciated'' by the TPO. GAP (India), the court said, operated within the standards prescribed by its overseas affiliates, performed strictly low-value-adding activities, and did not make the key decisions, nor bear the risks, involving selecting the manufacturer, product liability, product design and quality, credit, pricing, and foreign exchange.

GAP Group Companies

According to GAP (India), its parent GAP (USA) formulated key supply chain strategies, owned significant intangibles, and performed the key functions. Under the service and support agreement, GAP group companies, including GAP (USA), were to provide the following services to GAP (India):

- specifications and designs for the clothing;
- sample clothing;
- a list of existing clothing manufacturers and their contact information;
- detailed information on potential new manufacturers including contact information, production capacity, and number of employees;
- a list of vendors sourcing yarn, fabrics, trim, and packaging, and their production capacity, price, production lead time, and quality;
- information on procuring branded labels, zippers, buttons, plastic notions, snap fasteners, hasp and sliders, interlining, metal buttons, and rivets;
- software and business processes used to order and track merchandise;
- training materials; and
- operating and process know-how, and processes and trade secrets relating to sourcing activities.

Li & Fung Case

In making the transfer pricing adjustment, the TPO in *GAP* had relied on the Delhi ITAT's 2010 decision in *Li & Fung (India) Pvt. Ltd.*, which upheld a commission model for an Indian sourcing support service provider.

Li & Fung (India) provided sourcing support services to its related party, Li & Fung Hong Kong, and charged a markup of cost plus 5 percent. The TPO challenged Li & Fung (India)'s cost plus 5 percent model and found that it should earn a 5 percent profit on the value of products sourced from India. The dispute resolution panel reduced the 5 percent commission to 3 percent.

The Delhi tribunal then upheld 80 percent of the 5 percent commission.

Different Case

Rastogi said *GAP* and *Li & Fung* demonstrate how widely the facts can vary in procurement service provider cases.

In the *GAP* ruling, the Delhi ITAT distinguished the facts of the *Li & Fung* case, finding that GAP (USA) provided all of the significant directions regarding the procurement of goods from third-party vendors in India, including the design of the clothing and quality of materials, whereas Li & Fung (India) carried out significant value-added functions in India.

The ITAT in *GAP* pointed out that the transactional profitability earned by Li & Fung (India) resulted in a ratio of 6 percent net profit to total cost.

32 Percent Markup

Mitra argued before the tribunal in *GAP* that even if the entire 5 percent commission in the *Li & Fung* case had been retained by Li & Fung (India), the maximum return on operating costs earned by Li & Fung (India) would have worked out to be around 32 percent.

On the other hand, Mitra said, adopting the 5 percent commission for GAP (India) would have yielded an 831 percent return on operating costs for that company. Therefore, he argued, the transfer pricing adjustment should be restricted to a maximum cost markup of 32 percent.

The tribunal accepted the proposed 32 percent markup for GAP (India), finding it to be "higher than [the] markup over total cost earned by all comparables placed on record." The tribunal found that the most appropriate PLI for GAP (India) given its functional, asset, and risk profile was the cost plus model.

Rastogi cautioned that the "markup of 32 percent cannot be said to be a precedent since the markup in any transfer pricing case is a highly fact- and comparables-specific recording." He added that "there may be a slight possibility that a markup of 32 percent is applied randomly by tax authorities at lower levels, but the same shall have to stand the test of judicial scrutiny."

Location Savings

In other arguments, the TPO in *GAP* asserted that "location savings" arising from sourcing in India, a low-cost country, was not factored into the cost plus 15 percent compensation received by GAP (India).

Butani pointed out that the Delhi ITAT took a contrary view, finding that location savings are passed on to the end customer via a competitive sales strategy.

Butani said the tribunal also held that the arm's-length principle requires benchmarking to be done with comparables in the jurisdiction of the tested party and that the location savings, if any, would be reflected in the profitability earned by the comparables.

The Delhi ITAT said in *GAP* that a retailer sources from a low-cost country in order to provide a lower cost to its end customers—an advantage in a competitive industry such as garment marketing. Thus, the court said, there was no question of any allocation being attributed for location savings to GAP India, "which has no role in sale prices." In no circumstances, according to the ITAT, should GAP (India) receive a return for the manufacturing activity or from location savings "as it only functions as a mere support service provider and a watch dog ensuring that the right quality of goods reaches at right place at the right time, and operates strictly within the confines of the standards prescribed by the overseas GAP Group."

Location Savings in U.N. Manual

The Delhi ITAT's analysis of location savings in *GAP* differs from the position taken by the Indian tax authorities in Chapter 10.3 of the United Nations' *Transfer Pricing Practical Manual for Developing Countries*, published in the Text section of this issue. The court in *GAP* rejected the TPO's argument that location savings should be considered in the Indian company's compensation, while according to India's chapter of the U.N.

manual, location savings is a factor to consider in a comparability analysis.

Butani noted that Chapter 10.3 does not reflect the official view of the United Nations. Rather, ''it merely sets out the approach and the thinking of the Indian administration on various issues often faced and would not be binding on the judiciary, which will take an independent view.''

Phatarphekar pointed to the following language in the U.N. manual chapter indicating that location savings should be considered a comparability factor: ''It is the view of the Indian transfer pricing administration that the concept of 'location savings'—which refer to cost savings in a low cost jurisdiction like India—should be one of the major aspects to be considered while carrying out comparability analysis during transfer pricing audits.'' The chapter goes on to state that ''location savings'' goes beyond the issue of relocating a business from a high-cost location to a low-cost location and relates to any operational cost advantage including labor and skills, raw materials, transaction costs, rent, training costs, infrastructure, and tax incentives.

Chapter 10.3 also states that ''it is possible to use the profit split method to determine arm's length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available,'' based upon a functional analysis of the related parties and their bargaining power.

Although the U.N. manual, unlike the court in *GAP*, reflects the view that some compensation may be appropriate for location savings, Phatarphekar pointed to language in Chapter 10.3 suggesting that the tax authority exercise some restraint in considering the impact of operating in a low-cost jurisdiction:

> Hypothetically, if an unrelated third party had to compensate another party to the transaction in a low cost jurisdiction that was equal to the cost savings and location rents attributable to the location, there would be no incentive for the unrelated third party to relocate business to a low cost jurisdiction. Thus, arm's length compensation for cost savings and location rents should be such that both parties would benefit from participating in the transaction.

Bargaining Power

Phatarphekar noted that although the Delhi ITAT in *GAP* rejected the applicability of location savings to the case, the tribunal did not completely reject location savings as a concept.

Rastogi said the tribunal found that the attribution of location savings ultimately depends on the relative bargaining position of the contracting parties.

The tribunal said that even assuming that location savings were present, the question of allocation would need to be addressed in light of the relative bargaining power, ownership of intangibles, and competitive market position of GAP (India) in India.

Because the overseas affiliates of the GAP group owned all of the valuable intangibles, the tribunal found their relative bargaining power was more significant than that of GAP (India), which had negligible bargaining power.

Location Rent

Butani said the Indian tax administration believes that apart from locations savings, profit from location-specific advantages—referred to as ''location rent''—also should be allocated between associated enterprises. Such advantages would include skilled manpower, access to the market, a large customer base, superior information, and distribution networks.

According to Chapter 10.3, India provides location-specific advantages in addition to location savings: highly specialized skilled manpower and knowledge, access and proximity to growing local market, a large customer base with increased spending capacity, superior information and distribution networks, incentives, and market premium.

Berry Ratio

Rastogi said one lesson from the *GAP* case is that the taxpayer's PLI under TNMM ''must be in tandem with economic reality in order to avoid distorting its financial results.''

The Delhi ITAT upheld GAP (India)'s reliance on the ratio of operating profit to value-adding operating expenses—a variant of the Berry ratio expressed OP/VAE—for use by low-value-added procurement service providers. The tribunal found that OP/VAE was a valid PLI for GAP (India) because ''GAP (India)'s only costs were operating costs/value added costs (expenses) as it did not pay for the price of goods sourced by GAP Group and therefore, never carried the cost in relation to price of goods.''

Therefore, the court said the PLI used by GAP (India) actually was operating profit to total costs because GAP (India)'s ''value adding expenses'' equaled its total costs. ''The relevant Rule clearly suggests that based on the intensity of functions performed (which is measured by value added expenses), under TNMM, a relevant cost base i.e. VAE in the instant case, can be used,'' the court said.

'Clarion Call' for Fair Proceedings

Making an overall observation about the case, the Delhi ITAT criticized the sweeping observations of the TPO and DRP, which it said were based on neither cogent reasoning nor factual reliability. The assessments as framed, the court said, indicate an adversarial approach by the tax authority toward the determination of a tax liability.

The *GAP* court said it is ''trite law that income tax assessments and appellate proceedings are non adversarial in nature, held to be an exercise of fair determination of tax liability payable by the assessee.''

Pointing to recent government statements, the tribunal noted that the ''Hon'ble Finance Minister generally and recently in particular gave a clarion call that the income tax proceedings should be fair and non adversarial in nature.'' Saying it agreed with this mandate, the court added, ''This is rightly so as it is a sine qua none of a tax administration which usher into a rule of law which is predictable and based on sound reasoning and is not fraught with the perils of uncertainties and adversities for the taxpayers.''

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