Capacity Utilization Adjustment for Fixed Personnel Cost – A Practical Approach

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Personnel costs can be fixed such as those of key management or senior resources or variable i.e. primarily labour costs that vary with output. While capacity utilization adjustments for fixed cost attributable to fixed assets such as plant & machinery are well recognized and accepted in Transfer Pricing jurisprudence there could also be instances when similar adjustments are required on account of fixed personnel cost especially during formative years of a company.

Such an adjustment may be particularly relevant for high value service companies wherein employees are the most valuable asset. High salary cost of key employees is an unavoidable cost which must be incurred irrespective of the size/ turnover of firm as senior management personnel are essential for launching and setting up of operations and cannot be dispensed with even when turnover declines. Moreover, these costs may constitute a critical component irrespective of whether it is a manufacturing or service company (particularly true of the auto and heavy machinery sector that requires a minimum number of senior and experienced staff even before operations become full swing).

In ***DCIT vs. Innodata Isogen India Pvt. Ltd*** ***[TS-183-ITAT-2015(DEL)-TP]*** fixed personnel cost pertaining to management salaries, general and administrative staff was demonstrated to be more or less constant over a five year period while variable costs as a percentage of sales fluctuated drastically. It was held that the core reason for capacity under-utilization was global meltdown in United States resulting in decline of work outsourced to assessee. In these circumstances, it was held that assessee was justified in reducing idle fixed expenses from operating cost while testing the arm's length nature of its international transactions.

In ***ACIT vs. FIAT India Pvt. Ltd*** ***[TS-198-ITAT-2010(Mum)-TP]***, adjustments were made by the assessee company to account for fixed overheads including employee salary cost as the assessee always required a certain minimum number of specialized and trained labour to keep 'plant' operative irrespective of number of cars manufactured. Further, it was also demonstrated that the salary cost incurred vis-a-vis capacity utilisation and production remained more or less constant over the period. It was held that the Transfer Pricing Officer failed to appreciate that there wasa substantial reduction in production on a year on year basis without any proportionate reduction in salary cost. Hence, adjustments made by assessee in respect of capacity utilisation for employee cost were accepted by the Court on the facts of the case.

Undertaking a personnel cost adjustment – Practical Aspects

The fixed personnel cost may be adjusted to the level of capacity utilization of the taxpayer vis-à-vis the average for comparables. A critical factor in making such adjustment is data availability. Normally detailed break-down of salaries into fixed and variable is available only for the taxpayer and not the comparables (audited accounts only provide composite wages & salaries without bifurcating into fixed and variable) which necessitates that adjustment be made with respect to taxpayer's operating profit.

The adjustment thereafter can be approached in any one of the following ways:

1. Fixed personnel cost may be adjusted with respect to the average capacity utilization rate for

comparables (where available); or

2. Fixed personnel cost may be proportionately reduced to the average fixed personnel cost ratio (with respect to an appropriate base) of comparables which may be taken as an industry proxy.

Conclusion

As sales decline but senior management cost remains same, average fixed cost may rise and a corresponding adjustment may be required especially if comparables are not subject to a similar decline in output. Fixed personnel cost adjustments are necessary to account for economies of scale with respect to such costs as companies with larger turnover can reap managerial economies from fixed personnel costs while at smaller turnover the fixed cost is a necessary burden that must be borne anyhow.

Depending upon the facts and circumstances, Courts have allowed capacity utilization adjustments even in cases of high fixed personnel cost appreciating that even fixed personnel expenses can be responsible for a dip in operating profitability. Relevant documentation/trend analysis for personnel cost is a pre-requisite for claiming a personnel cost adjustment. Undertaken carefully, such adjustments can go a long way in resolving Transfer Pricing dilemma for start-ups with high salary cost and even for companies faced with systemic reduction in output.