Tax alert: Comparability analysis during COVID-19

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We are pleased to enclose our alert on a recent ruling of the Hon'ble Chennai Tribunal in the case of Heidelberg India (P.) Ltd., dealing with significant transfer pricing issues relating to benchmarking during the COVID-19 period and determination of arm's length price (ALP) of management service charges.

In a nutshell

The Tribunal held that where business operations were materially impacted by the COVID-19 pandemic, affecting like-to-like comparability, the arm's length analysis under the Transactional Net Margin Method (TNMM) should be undertaken using the Assessee's single-year margins vis-à-vis single-year margins of comparable companies, rather than relying on three-year weighted average margins.

The Tribunal further reiterated that the Transfer Pricing Officer cannot determine the ALP of management services at Nil merely on the basis of perceived lack of commercial benefit, where the taxpayer has substantiated receipt of services through adequate documentary evidence.

The Hon'ble Tribunal allowed single year comparable data for benchmarking to factor in the extraordinary economic events during COVID-19. The ruling also reinforces established judicial principles that transfer pricing provisions are intended to determine arm's length pricing and not evaluate the commercial wisdom of taxpayers.

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Background

- Heidelberg India Pvt. Ltd. is engaged in the business of marketing and distribution of graphic arts machinery and related after-sales services in India, Bhutan and Nepal.
- The taxpayer aggregated international transactions relating to distribution activity and benchmarked them using the Transactional Net Margin Method (TNMM). One of the international transactions of the taxpayer was payment for management service charges of about INR 4.05 crore to its Associated Enterprise (AE) towards management, finance, HR, technical, logistics and quality-control support services which were also aggregated under TNMM. The taxpayer also contended that FY 2020-21 was an abnormal year owing to economic slowdown caused by the COVID-19 pandemic.
- The TPO compared the taxpayer's single-year margin with three-year weighted average margins of comparable companies and proposed the TP adjustment. Additionally, the TPO determined the ALP of management service charges at Nil and made a separate TP adjustment.
- DRP upheld the TPOs approach. Aggrieved, the taxpayer filed an appeal before the Chennai ITAT.

Decision of the Tribunal

- **COVID-19 impact on benchmarking**

  The Tribunal observed that FY 2020-21 was an extraordinary year marked by operational shutdowns, travel restrictions and depressed business activity caused by the pandemic. Accordingly, it is noted that the use of three-year weighted average margins of comparables adopted by the TPO was not appropriate in such circumstance. The Tribunal directed the TPO to compare the taxpayer's single-year margin with the single-year margins of comparable companies for AY 2021-22 computed from annual reports. The Chennai Tribunal relied on its earlier decisions on the issue of single year comparability.

- **Management service charges cannot be determined at Nil**

  The Tribunal noted that the taxpayer had furnished substantial documentary evidence including emails, reports, training documents and operational support records demonstrating actual receipt of services from its AE. The Tribunal observed that these services were directly connected with the taxpayer's operations and administration and that the taxpayer had substantiated the benefits received.

  The Tribunal held that the TPO cannot determine the ALP at Nil merely because the TPO considers that the assessee does not derive any adequate benefits from the service. Such an approach amounts to questioning the commercial expediency of the expenditure, which falls outside the scope of transfer pricing provisions. Relying on the Delhi High Court's decision in *EKL Appliances Ltd.*, the Tribunal reiterated that the TPO's jurisdiction is restricted to determining the arm's length price through an appropriate benchmarking exercise.

- **Aggregation under TNMM upheld**

  The Tribunal further held that management support services were inextricably linked to the taxpayer's core business operations. Therefore, such services could not be carved out for separate benchmarking under any other method once they formed part of the aggregated transaction benchmarked under TNMM. Since the overall transactions were at arm's length under TNMM, no separate TP adjustment is warranted in respect of management service charges. Accordingly, the TP adjustment relating to management service charges was deleted.

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Comments

This ruling provides important guidance for transfer pricing assessments involving years affected by extraordinary economic circumstances. It confirms that COVID-19-related disruptions may warrant the use of single-year comparable data to achieve a reliable comparability analysis.

The ruling also reinforces the settled principle that the role of the TPO cannot determine the ALP of intra-group services at Nil merely because the taxpayer allegedly failed a benefit test. Where receipt of services is substantiated and the transaction is appropriately benchmarked, the TPO cannot substitute its own view of commercial necessity of the taxpayer.

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