IN THE HIGH COURT OF DELHI AT NEW DELHI

% Judgment delivered on: 22 .07.2016

+ ITA 381/2013

SUMITOMO CORPORATION INDIA PVT. LTD. THROUGH MASAHIRO MARUYAMA ..... Appellant

versus

COMMISSIONER OF INCOME TAX ..... Respondent

WITH

+ **ITA 738/2015**

SUMITOMO CORPORATION INDIA PVT. LTD. THROUGH MR. MITSUTAKA YASUDA ..... Appellant

versus

COMMISSIONER OF INCOME TAX ..... Respondent

WITH

+ **ITA 382/2013**

SUMITOMO CORPORATION INDIA PVT. LTD. THROUGH MASAHIRO MARUYAMA ..... Appellant

versus

COMMISSIONER OF INCOME TAX ..... Respondent

AND

+ **ITA 702/2014**

SUMITOMO CORPORATION INDIA PVT. LTD. THROUGH MR. MITSUTAKA YASUDA ..... Appellant

versus

COMMISSIONER OF INCOME TAX ..... Respondent

Advocates who appeared in these cases:

For the Appellants : Mr. C.S. Aggarwal, Senior Advocate With Mr. Prakash Kumar and Mr. Himanshu Sinha, Advocates.

For the Respondents : Mr. Ashok K Manchanda, Senior Standing counsel.

CORAM:
JUSTICE S.MURALIDHAR
JUSTICE VIBHU BAKHRU

JUDGMENT

VIBHU BAKHRU, J

1. The Assessee has preferred these appeals under Section 260A of the Income Tax Act, 1961 (hereafter 'the Act') impugning the orders passed by the Income Tax Appellate Tribunal (hereafter 'the Tribunal') in respect of Assessment Years (hereafter 'AYs') 2007-08, 2008-09, 2009-10 and 2010-11.

2. The controversy in these appeals relates to the Transfer Pricing Adjustments directed by the Tribunal in respect of the commission earned by the Assessee with respect to certain international transactions with its Associated Enterprises (hereafter 'AEs') which are referred to as "indenting transactions". The Tribunal has directed that the Arms Length Price (hereafter 'ALP') in respect of such transactions be determined on the basis of the average rate of commission earned by the Assessee in respect of

transactions with unrelated parties ('Non-AEs'). The Assessee claims that the said direction is patently erroneous as the indenting transactions with Non-AEs are not comparable with indenting transactions with its AEs; the volume of the indenting transactions with Non-AEs is only a small fraction of such transactions and the concerned products are also different. It is also the case of the Assessee that the Tribunal has not followed any particular method in directing the determination of ALP and as such, the same is wholly arbitrary. The Assessee urges that it is incumbent on the Tribunal to first determine the most appropriate method for determining the ALP and, thereafter, compute the ALP in conformity with the discipline of that method.

3. The controversies involved in these appeals as well as the material facts are similar. The questions of law framed in these appeals are also identical and read as under:

> "(1) Whether the Income tax Appellate Tribunal was right in applying and computing arms length price with associated enterprise on indenting transactions by applying average rate of commission with non-associated enterprise in spite of difference in the turnover and the purported segments and no such correction/computation on this account was made by the Transfer Pricing Officer?

> (2) Whether the Income Tax Appellate Tribunal has disregarded the assessee's claim that they had followed Transactional Net Margin Method? (This question will include the submission of the appellant that the Transfer Pricing Officer's order does not adopt any specified method)"

4. For the purposes of addressing the above questions, only the facts obtaining in ITA No. 381 relevant to AY 2007-08 (ITA No.381/2013) are referred herein.

5. The Assessee was incorporated in 1997 and has its offices in Delhi, Mumbai and Chennai. The Assessee is a subsidiary of Sumitomo Corporation Japan (hereafter the 'SCJ') which is one of the largest general trading companies (*Sogo Shosha*) of Japan. SCJ is the flagship company of the Sumitomo group which is a large conglomerate of companies. The Assessee has seven operating divisions and deals in various products.

6. The Assessee filed its return of income for AY 2007-08 on 25.10.2007 declaring a total income of Rs.15,35,40,749/-.

7. The Assessee reported the following international transactions for FY 2006-07:-

S. No.	Type of International transaction	Total value of transaction (Rs.)
1.	Purchase of goods	102,825,122
2.	Sale of goods	1,294,774
3.	Rendering of support services	304,525,711
4.	Interest Earned	722,621
5.	Services received	10,335,041
6.	Reimbursement of expenses (payment)	628,502
7.	Reimbursement of Expenses (receipts)	14,036,868

8. The Assessee claimed that the transactions of purchase and sale of goods with its AEs were on principal to principal basis. And, the income from rendering support services was in relation to transactions (referred to as indenting transactions) where the Assessee only rendered assistance by following up with the customers and the sale/purchase of goods was done directly by the AE. The Assessing Officer (hereafter 'the AO') made a reference to the Transfer Pricing Officer (hereafter 'TPO').

The Transfer Pricing (TP) approach of the Assessee

9. In terms of Section 92E of the Act read with Rule 10E of the Income Tax Rules, 1962 (hereafter 'the Rules'), the Assessee furnished the transfer

pricing report in respect of its international transactions with AEs. The Assessee considered Transactional Net Margin Method (hereafter 'TNMM') as the most appropriate method and selected the ratio of gross profit to operating costs - Berry Ratio - as the Profit Level Indicator (hereafter 'PLI'). The Assessee computed its gross profit on trading transactions (sales on principal to principal basis) by reducing the cost of sales from the aggregate value of sales made to AE as well as Non-AEs. The gross profit on trading segment so computed was then added to commission earned to compute the total gross profits. This amount was taken as the numerator and was divided by operating expenses to compute the Berry Ratio (the PLI selected by the Assessee) at 1.79%

10. The Assessee claimed that its transaction with the AE's were on arms length basis and supported this claim by the data relating to a set of 23 comparable companies. The weighted average arithmetic mean (adjusted using data for financial years 2004-05, 2005-06 and 2006-07) of the PLI of these comparable companies was computed at 1.18%.

Proceedings before the TPO/AO

11. The TPO noticed that the Assessee's transactions could be classified into two types - "Indent sales" and "Proper sales". In respect of "Indent

sales", the Assessee merely indents for the goods which are supplied directly by the supplier to the purchaser; the Assessee only receives commission on the value of the invoice or the quantity of goods supplied. In case of "Proper sales", the Assessee purchases the goods and sells the same. The purchases made are against confirmed orders and thus, the transactions of purchase and sale are back to back. The Assessee acquires the title to goods only for a brief moment; this is described as a "flash title". Such sale transactions are on a profit margin.

12. The TPO examined the transfer pricing report submitted by the Assessee and noticed that the PLI used by the Assessee did not take into account the cost of sales. The TPO held that the use of such ratio (Berry ratio) as the PLI was not permissible under Rule 10B(1)(e) of the Rules which contained provisions for computation of ALP by TNMM. According to the TPO, the TNMM could be applied only by determining the net profit margin in relation to the costs incurred, sales affected or assets employed. He reasoned that since the denominator used by the Assessee for computing the Berry ratio excluded the cost of goods, the PLI so worked out was not in accordance with Rule10B(1)(e) of the Rules. The TPO further proceeded to hold that the Assessee had itself indicated that

functions performed and risks undertaken in respect of the international transactions of "Proper sales" and "Indent sales" were similar and, accordingly, held that the indenting transactions with AE ought to be compared with the trading transactions entered into by the Assessee with Non-AEs.

13. He held that the commission earned by the Assessee ought to be expressed as a percentage of FOB price of goods sourced through the Assessee because the Assessee had played a major role in identifying suppliers, support in after sales services, business promotion, etc. He further held that the Assessee had assumed significant risks and the commission/service income model did not account for the fair compensation for the value addition made by the Assessee.

14. The TPO rejected the use of Berry Ratio as the PLI for several reasons. First of all, he held that the Assessee had developed unique intangibles like supply chain intangibles and human assets intangibles, which according to him had resulted in huge commercial and strategic advantage to the AE and had enhanced the profit potential of the AE. The Berry Ratio could not be used in cases where the Assessee was using valuable and unique intangibles. Secondly, he held that Berry Ratio was

very sensitive to cost base and it was difficult to accurately compute the cost base of comparable companies on the basis of the available data as different companies had accounted for their costs differently.

15. The TPO finally concluded that the gross margin earned by the Assessee in its trading segment with Non AEs - computed at 4.45% - ought to be taken as the rate of commission on the FOB price of the goods sourced through the Assessee in respect of indenting transactions with the AEs. He, accordingly, computed the arms length commission income from indenting transaction with AEs at Rs.85,68,44,783/- (being 4.45% of Rs.19,25,49,38,946) and accordingly directed enhancement of Assessee's income by an amount of Rs.55,26,16,748/- after reducing the commission of Rs.30,42,28,035/- as declared by the Assessee.

16. Pursuant to the order dated 28th October, 2010 passed by the TPO, the AO issued a draft assessment order on 23rd December, 2010. The Assessee filed objections against the draft assessment order before the Dispute Resolution Panel (hereafter 'DRP') which were not accepted and the DRP issued its directions on 27th September, 2011. The AO passed the final assessment order on 25th October, 2011 pursuant to the DRP's directions.

Proceedings before the Tribunal

17. Aggrieved by the final assessment order, the Assessee preferred an appeal before the Tribunal urging several grounds. The Assessee, *inter alia*, contended that the functions performed and the risks undertaken in respect of principal to principal transactions with Non-AEs were not similar to the indent based transactions with AEs and that the TPO had erred in proceeding on the basis that the said transactions were comparable. The Assessee claimed that in respect of indent transactions, the credit risks and foreign exchange fluctuation risks were negligent and the Assessee's function was merely to follow up on behalf of the customers and not to deal with them.

18. The Assessee further claimed that the TPO had "*erred in comparing indent based transactions of AEs with principal based transactions of Non-AEs and not with indent transaction of Non-AE after allowing appropriate adjustments*" and, therefore, the addition was misconceived, misplaced and unsustainable.

19. The Assessee contended that the TPO/DRP had erred in disregarding the transfer pricing approach adopted by the Assessee for determining the ALP of its international transactions. It was urged that the Assessee's use of TNMM with Berry Ratio as the PLI had been discarded without any valid justification.

20. The Tribunal referred to the tabular statement wherein the TPO had computed the gross profit margin from trading transactions with AEs at 4.80%; gross profit margin on trading transactions with Non-AEs at 4.45%; and commission earned at 1.61%. The Tribunal also referred to the order of the TPO wherein he had referred to the Assessee's letter dated 19th October, 2010 in which the Assessee had bifurcated the commission earned between commission from AEs and Non-AEs; the commission from Non-AEs was declared as 2.26% on value of goods while the commission from AE transactions was computed at 1.58%.

21. The Tribunal accepted the Assessee's contention that the nature of indenting transactions were different from trading transactions. The trading transactions involved certain risks and finances whereas in respect of indenting transactions, the Assessee did not incur any financial obligation or carry any significant risks. The Tribunal found that the indent business

of the Assessee was nothing but trade facilitation, both in form as well as in substance. It further noted that there was no material on record to regard the indent transactions as trading transaction. The Tribunal further proceeded to note and accept the Assessee's contention that it would be appropriate to compare commission/service income earned by the Assessee in respect of transactions with AEs with the similar transactions with Non-AEs. However, the Tribunal rejected the Assessee's claim for an appropriate adjustment on account of difference in volumes as well as the associated risks. The Tribunal held that in the facts and circumstances of the case, no adjustment as to the extent of volume was necessary as the Assessee had entered into separate contracts for each transaction and it was not the Assessee's case that each of such separate transaction with an AE was greater in volume as compared to a similar transaction in the Non-AE segment. The Tribunal then proceeded to direct that the commission computed at the rate of 2.26% (i.e. the rate of commission in respect of transactions with Non-AE's) be taken as the bench mark for determining the ALP for commission earned in the AE segment.

22. The Assessee has impugned the above decision before us in ITA 381/2013.

Submissions

23. Mr C.S. Aggarwal, learned Senior Advocate, appearing for the Assessee contended that the fundamental issue in these appeals related to the determination of the most appropriate method to be adopted for determining the ALP. He submitted that the Assessee in its TP studies found TNMM to be the most appropriate method for determination of the ALP and this method was also accepted in the preceding years. However, the TPO had rejected the same and made the ALP adjustment without reference to any particular method. He contended that the Tribunal also fell in error in making an adjustment without reference to any particular method.

24. Mr Aggarwal submitted that even if the TPO or the Tribunal found that Berry ratio was not an acceptable PLI, the said authorities could have substituted the same with an appropriate PLI but could not have rejected the TNMM as that was accepted as the most appropriate method in the preceding years, that is, 2003-04 to 2006-07. He contended that there was no material difference in the business model of the Assessee and, thus, there was no reason for the TPO to depart from the method adopted in the preceding years.

25. Next, Mr Aggarwal contended that the Tribunal had erred in accepting the Assessee's submission that the commission from Non-AEs be compared with the commission from AEs for two reasons. First of all, this was a submission in the alternative; and secondly, this proposition was coupled with a claim to make an economic adjustment on account of volume and the difference in products. He further submitted that the products in respect of which commission was earned in the Non-AE segment were different from the special products in the AEs segment. He handed over a tabular statement in support of his contention. This statement indicated the products in respect of which indenting transactions were entered into in the Non-AE and the AE segments. He pointed out that in respect of products classified under the automotive, chemicals (plastic), construction, machinery, minerals and energy, power, steel pipes, etc. divisions, there were no indenting transactions in the Non-AE segment and, therefore, there would be no comparable standards on the basis of which an ALP adjustment could be made.

26. Mr Manchanda, learned Senior Standing Counsel countered the submissions made by Mr Aggarwal. He earnestly contended that the Tribunal had applied the Comparable Uncontrolled Price (CUP) Method

and had used an internal comparable transaction, which was from the same company and the same industry, for determining the ALP. He submitted that this was the most reliable method for computing the ALP and the Assessee could not be heard to dispute the same. He earnestly contended that the above method was proposed by the Assessee with certain economic adjustments which, the Tribunal found were not justified. He submitted that the Assessee had canvassed an adjustment on account of volume of transactions between AE and Non-AEs segment and in support of its claim had produced the brokerage rates for transactions in the security markets. The Tribunal had rejected the same as it found that each transaction was a separate transaction in terms of a separate contract and, therefore, any discount on volumes was not warranted.

27. With respect to the contention that the products dealt in the AE segment were different from those in the Non-AEs segment, Mr Manchanda, contended that there were only two product categories, namely, telecom and transport where there were no comparables in the Non-AEs segment. He urged that the commission earned by the Assessee in respect of these two segments was at the rate in excess of 5% which was above the average rate of commission of 2.26% in the Non-AE segment. He

argued that if the said two product categories were excluded, the ALP adjustment would increase. He further submitted that in order for the Assessee to make good his claim that a comparison between AE segment and Non-AEs segment was to be made product wise, the Assessee was required to produce every contract/agreement and invoice in the two segments which the Assessee had failed to do.

28. Mr Manchanda further sought to contend that the Assessee had also earned service fee for services which had been excluded while calculating the commission earned in the Non-AE segment. He contended that if such fees was included in the commission earned in the Non-AE segment, the profit margin calculated in respect of such segment would increase substantially from 2.26% and would result in a higher ALP adjustment.

Reasoning and Conclusion

29. Before proceeding to address the issues, it would be relevant to refer to Section 92C of the Act. The relevant extracts of which are set out below:-

> "92C. (1) The arm's length price in relation to an international transaction or specified domestic transaction shall be determined by any of the following methods, being the most

appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely :—

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed :

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction has actually been undertaken does not exceed such percentage not exceeding three per cent of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price:

Provided also that where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply.

> Explanation.—For the removal of doubts, it is hereby clarified that the provisions of the second proviso shall also be applicable to all assessment or reassessment proceedings pending before an Assessing Officer as on the 1st day of October, 2009."

30. It is apparent from the above that ALP has to be computed by the most appropriate method as is referred to in Section 92C(1). Sub-rule (1) of Rule 10C of the Rules postulates that the most appropriate method would be one which is best suited to the facts and circumstances of each particular international transaction and which provides the most reliable measure of an ALP in relation to that transaction. It is, thus, necessary that before an exercise is undertaken for making an ALP adjustment, the Assessee/TPO must identify the most appropriate method for computation of ALP. Sub-rule (2) of Section 10C of the Rules that postulates that the following factors shall be taken into account for selecting the most appropriate method:-

> "(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:—
>
> (a) the nature and class of the international transaction [or the specified domestic transaction];
>
> (b) the class or classes of associated enterprises entering into the transaction and the functions performed by

them taking into account assets employed or to be employed and risks assumed by such enterprises;

(c) the availability, coverage and reliability of data necessary for application of the method;

(d) the degree of comparability existing between the international transaction [or the specified domestic transaction] and the uncontrolled transaction and between the enterprises entering into such transactions;

(e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(f) the nature, extent and reliability of assumptions required to be made in application of a method."

31. The Assessee had, for reasons indicated in its transfer pricing report, adopted TNMM as the most appropriate method with Berry ratio as the PLI. Although, the TPO found fault in the use of Berry ratio - according to him, the same was not permissible under Rule 10B(1)(e) of the Rules - he did not proceed to select the most appropriate method for computation of ALP. This, in our view, would be essential as the reliability of the determination of the ALP is in turn dependent on the effectiveness of the method in relation to the controlled transaction being tested. In the present

case, the dispute essentially relates to the commission earned by the Assessee in respect of transaction with its AEs.

32. We are inclined to accept Mr Aggarwal's contention that although the TPO had discarded the method adopted by the Assessee, it had not followed any particular method in making the ALP adjustment. It appears that the TPO has adopted a hybrid method. He imputed the character of trading transactions to the indenting transactions entered into by the Assessee with its AEs. Having done so, he compared the profit margin realized by the AE from such transactions with profit margin realized by the AE from a comparable uncontrolled transaction. The said approach was rejected by the Tribunal - and, in our view, rightly so - as it was not permissible for TPO to re-characterize the tested transaction.

33. We find no infirmity with the Tribunal's finding that indenting transactions reported by the Assessee were plainly in the nature of facilitating trade where the Assessee was required to do nothing more than to follow up the customers for facilitation of the transaction. The Assessee was not required to raise any invoice for sale and purchase and its financial commitment and risk were inconsiderable.

34. However, we find that the Tribunal erred in proceeding to determine the ALP on the basis of the rate of commission reported by the Assessee in respect of indenting transactions with Non-AEs, without further examination as to the similarity between the two transactions. The Tribunal effectively used the CUP Method for imputing the ALP of Assessee's indenting transaction with AEs. This may well be the most appropriate method to be used for determining the ALP. However, if the Tribunal thought that this was the case, it was necessary for the Tribunal to conduct a further in-depth inquiry as to the relevant uncontrolled transactions. It is well settled that in applying the CUP Method, a very high degree of similarity between the controlled and uncontrolled transactions is required. It is the Assessee's case that volume of such transactions in the Non-AEs segment was insignificant as compared to the transactions in the AE segment against such transactions were only in a few product categories. If the average rate of commission on such transactions was to be applied to the FOB value of the goods involved in the indenting transactions with AEs, the Tribunal would have to satisfy itself that there is no significant variation in the rate of commission between different products. This would confirm that the dissimilarity between the product categories did not have a

vital bearing on the rate of commission. The Tribunal did not conduct any such enquiry and it is material to note that the TPO also did not conduct any such exercise. In our view, this methodology was used by the Tribunal at a stage at which - given the extent of the examination required - it may not be feasible.

35. One of the principal issues before the Tribunal concerned the applicability of TNMM with Berry ratio as the PLI, as the most appropriate method. Mr Aggarwal had sought to contend before us that the TPO had rejected the PLI of Berry ratio but had not rejected the TNMM as the most appropriate method and, therefore, it was incumbent upon him to replace the PLI with whichever ratio he considered appropriate as had been done in the preceding years. He contended that on principles of consistency, he was required to follow the TNMM method. There is much merit in the contention that a method once considered appropriate should be consistently applied unless for good reasons, the TPO decides otherwise. However, this is a salutary guiding principle and would not fetter the TPO from independently examining the transfer pricing approach reported by the Assessee. The purpose of imputing ALP to international transactions is to ensure that the real income of the Assessee in respect of international

transactions (and with effect from 1st April, 2013 certain domestic transactions) are charged to tax under the Act. It is thus, implicit that the exercise to determine such income be undertaken for each assessment year.

36. The special provisions for assessing income from international transactions having regard to ALP is of a recent vintage and was introduced by the Finance Act, 2001. The provisions under Chapter X of the Act have undergone significant changes over a period of time. The principles for computation of ALP are also evolving and as such, we are not persuaded to accept that the TPO was required to simply follow the transfer pricing methodology adopted in the preceding years. It is also well settled that principles of *res judicata* do not apply in assessment proceedings as assessment for each year is a separate proceeding and inquiry into the ALP in respect of international transactions under Section 92 of the Act is in aid of assessing the income chargeable to tax for the year under consideration.

37. We may now also consider Mr Aggarwal's contention that Berry ratio had been accepted as the appropriate PLI in respect of *Sogo Shosha* establishments and, therefore, the same should also be accepted in the case of the Assessee. The term '*Sogo Shosha'* is used in respect of large general trading companies that include within their fold a large network of

subsidiary and affiliated companies, thus, enabling the said companies to leverage their network for their business. It is reported that these companies account for a substantial portion of the Japan's overall trade across the world. However, it is not necessary that the trading arrangement between *Sogo Shosha* enterprises and their affiliates/ subsidiaries in India be identical or similar. It is also not possible to assume - without it being established as a fact - that all international transactions entered into by Indian enterprises with their related *Sogo Shosha* enterprises would be on identical footing. Thus, it is not apposite to determine the ALP without examining the nature of international transaction in each case.

38. Insofar as the use of Berry ratio as a PLI is concerned, the TPO had rejected the same for three reasons. First of all, he held that the same is not permissible under Rule 10B(1)(e) of the Rules; secondly, he held that the Assessee had acquired substantial intangibles in the form of supply chain intangibles and human resources intangibles and Berry ratio was not an apposite PLI in cases where an Assessee used substantial intangibles for its business. Thirdly, the TPO held that the rate of commission on indenting transaction was determined in reference to the value of goods and not on the basis of any cost incurred by the Assessee.

39. In our view, the decision of the TPO that Rule 10B(1)(e) of the Rules does not permit use of Berry ratio is not sustainable. The TPO had reasoned that under Rule 10B(1)(e) of the Rules, only the total costs incurred, sales effected or assets employed could be used as denominator of the ratio chosen as the PLI. This is plainly erroneous. Rule 10B(1)(e)(i) of the Rules reads as under:-

> "10(e) transactional net margin method, by which,—
>
> (i) the net profit margin realised by the enterprise from an international transaction or a specified domestic transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;"

40. It is clear from the plain language of the above quoted clauses that the net profit margin realised could be computed having regard to "any other relevant base". Berry ratio is a ratio of operating profits to operating expenses. In cases where operating expenses is considered as a relevant base, there would be no difficulty in using Berry ratio as the PLI in terms of Rule 10B(1)(e)(i) of the Rules.

41. Insofar as the other two reasons are concerned, it is necessary to understand the substratal rationale of using Berry ratio as the PLI. The said ratio was used by the Internal Revenue Service (IRS) in the USA in the case of ***E.I. Du Pont DE Nemours & Co. v. United States: 608 F.2d 445 (1979)*** to sustain their stand that substantial part of the profits of a subsidiary in Switzerland were rightly allocated to Du Pont. Charles H. Berry, an economist (since deceased) provided necessary evidence in support of IRS's stand by using the ratio of Operating Profits to Selling, General and Administration Expenses to show that more than fair share of profits had been transferred to Du Pont's Swiss subsidiary. This ratio came to be known by the name of the economist who had used it in the aforementioned case. The aforesaid case concerned the allocation of profits between Du Pont De Nemours, an American Company engaged in manufacture of chemicals, and its wholly owned subsidiary established in Switzerland (Du Pont International S.A. referred to as 'DISA'). The said subsidiary was established in 1959. At the material time, Section 482 of the Internal Revenue Code empowered the Secretary of the Treasury (or his delegate) to "*distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or*

businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

42. The Treasury Regulations as in force during the relevant period contemplated determination of ALP for sale by one controlled entity to another by four methods (in order of preference); comparable uncontrolled price method; the resale price method; cost plus method; and any other appropriate method. Du Pont sold its chemical products to DISA and also arranged for resale of such chemicals to the legitimate consumers. The said transactions resulted in DISA reporting a profit margin of 35%. Du Pont submitted the set of 21 comparable entities which it claimed performed functions similar to DISA. IRS, on the other hand, introduced evidence to show that six of the companies identified by Du Pont as similar to DISA had reported average selling cost which were much higher than DISA. The Court agreed with the evidence produced by IRS's expert that what a business spends to provide services would be a reasonable indication of the magnitude of those services.

43. Berry ratio was used in the above context to show that the average ratio in the case of 21 distributors was 129.3% and in the case of DISA, it was 281.5% for the year 1959 and 397.1% in the year 1960. It is relevant to note that in that case also the Commissioner of Revenue did not reallocate the profits between DISA and Du Pont on the basis of Berry ratio but on the basis of applying the resale price method. Berry ratio was only introduced as an expert evidence by IRS to defend the challenge to such reallocation. In other words, the said ratio was only used to show that DISA had made extraordinarily high profits and IRS had rightly exercised its jurisdiction to reallocate such profits of DISA to Du Pont. The Du Pont's challenge to the said ratio as being inappropriate measure was rejected by the Court in the following words:-

> "Whatever the general limits of any particular gauge of industry profitability, plaintiff cannot escape the basic thrust of defendant's proof. Defendant has shown that DISA made extraordinarily high profits which the Commissioner reallocated to an economically reasonable level."

44. Subsequently, in 1990, Berry ratio was included as an acceptable PLI in certain circumstances under the Treasury Regulations in USA. OECD Guidelines issued in July 2010 also accepted that Berry ratio to be apposite in certain circumstances. More recently, Japan has also accepted use of

Berry ratio for purposes of transfer pricing in certain circumstances in its tax legislation reforms introduced in March 2013.

45. Traditionally, the denominator of the ratio only comprised of selling, general and administration expenses. However, the Treasury Legislation of USA also included depreciation as a part of the Operating Expenses used as a denominator in the berry ratio. As is apparent, Berry ratio has limited applicability; it can be used effectively only in cases where the value of goods have no role to play in the profits earned by an Assessee and the profits earned are directly linked with the operating expenditure incurred by the Assessee. In other words, the operating expenditure incurred by the Assessee effectively captures all functions performed and risks undertaken by the Assessee. Thus, in cases where an Assessee uses intangibles as a part of its business, Berry ratio would not be an apposite PLI as the value of such tangibles would not be captured in the operating cost and, therefore, it would not be appropriate to compute the ALP based on net profit margin having regard to the operating cost as a relevant base. Similarly, Berry ratio would not be an appropriate PLI for determining ALP in cases of Assessees who have substantial fixed assets since the value added by such assets would not be captured in Berry ratio.

46. It can be seen from the above that the Berry ratio can be used only in very limited circumstances and the limitations that we have listed above are by no means exhaustive. There is also a view expressed that use of Berry ratio as a PLI results in indicating less than fair ALPs in tax jurisdiction where the Assessees have a lower bargaining power. In the aforesaid context, in our view, the TPO had correctly reasoned that Berry ratio could not be used as a PLI in cases of Assessees which were using intangibles. However, we find that there was no cogent material for the TPO to hold that the Assessee had developed supply chain and human resources intangibles. In any event, there was no material to conclude that costs of such intangibles were not captured in the operating expenses.

47. In our *prima facie* view, the third reason stated by the TPO, that is, the rate of commission paid to the Assessee is based on the value of the goods, would be a valid reason to reject the use of Berry ratio because Berry ratio can only be applied where the value of the goods are not directly linked to the quantum of profits and the profits are mainly dependent on expenses incurred. The fundamental premise being that the operating expenses adequately represent all functions performed and risks undertaken. For this reason Berry ratio is effectively applied only in cases

of stripped down distributors; that is, distributors that have no financial exposure and risk in respect of the goods distributed by them.

48. In the present case, the Assessee asserts that its business comprises of two segments, trading segment and indenting segment and the functional risk and the reward in the two segments are different. In the trading segment, the Assessee earns a higher profit margins (calculated on the value of the goods traded) while in the indenting segment its profit margins are lower. Plainly, the use Berry ratio would give unreliable results if the product mix of the comparables is different from the product mix of the Assessee. This would make the task of finding a set of comparables fairly difficult.

49. In view of the above, the first question of law is answered in the negative and the second question of law is answered in the affirmative; that is, the questions are answered in favour of the Assessee and against the Revenue. The impugned orders are accordingly set aside and the matters are remanded back to the Tribunal to decide it afresh. It will be open for the Tribunal to further remand the matter to the TPO/AO for a fresh

examination of the issues relating to Transfer Pricing in accordance with law. The parties are left to bear their own costs.

VIBHU BAKHRU, J

S.MURALIDHAR, J

JULY 22, 2016
MK/RK