

Li and Fung India Pvt Ltd – High Court- Delhi

Decision Outcome: In favour of the taxpayer

Category: Sourcing services provided to AE – Remuneration model

Background:

- Taxpayer's Associated Enterprise ('AE') subcontracted its **sourcing activities (agency activity as a part of procurement process)** to the tax payer with a remuneration model of cost plus mark up of 5 %
- Tax payer used Transaction Net Margin Method ('TNMM') to prove Arm's Length Price ('ALP'), which was rejected by the TPO and a remuneration model of 5% of FOB value was imposed. Accordingly adjustment to income proposed amounting to INR 57.65 crores. The 5% FOB value was further reduced at DRP to 3% of FOB value
- ITAT (Tax Tribunal) upheld the contentions of the TPO

The Hon. High Court observed that:

- To apply TNMM, the taxpayer's net profit margin realized from international transactions had to be calculated only with reference to cost incurred by it, and not by any other entity, either third party vendors or the AE
- Transfer Pricing regulations does not enable imputation of cost incurred by third parties or unrelated enterprises to compute the taxpayer's net profit margin for application of the TNMM
- TPO's contention to enhance the taxpayer's cost base by considering the cost of manufacture and export of finished goods, (not being cost incurred by taxpayer), is nowhere supported by the TNMM and Transfer Pricing regulations
- Taxpayer is engaged in providing support services to AE and in such cases, it is important to apply the cost plus method for performance of agency functions
- Tax officer's arbitrary exercise of adjusting the cost plus mark up of 5% on the FOB value of exports finds no mention in the IT Act nor the Rules
- The impugned order, upholding the determination of margin over the FOB value of the AE's contract, is held erroneous in law