Global Transfer Pricing Battleground: Nigeria Tax Appeal Tribunal ruling on selection of MAM and Profit Level Indicator

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The benchmarking analysis has been a cornerstone of Transfer Pricing (“TP”) analysis, as it contains an analysis of the economic conditions and tests the arm’s length nature of the transaction. The benchmarking analysis contains selection of most appropriate method (“MAM”), profit level indicator (“PLI”), comparable analysis and arm’s length computation. Hence, it’s been always subject to microscopic review and prone to litigation.

Recently, the Nigerian Tax Appeal Tribunal (“TAT”) has issued its maiden TP ruling in case of Prime Plastichem Nigeria Limited (“Prime Limited” or “the Company”) vs Federal Inland Revenue services (“FIRS”) wherein the TAT has upheld the additional assessments made by FIRS on the Company on account of TP adjustments on transactions between the Company and its related party supplier i.e. Vinmar Overseas Limited (“VOL”). The brief analysis of the ruling has been detailed below:

Synopsis of the Ruling

The Company was engaged in importing plastics and petrochemicals from VOL for resale to Nigerian customers. In FY 2013, VOL had entered into transactions with independent third parties in Nigeria for similar products (which the Company has imported), however, VOL had not entered into similar third-party transactions in FY 2014. Accordingly, based on the data available, the Company has benchmarked the import transaction using Comparable Uncontrolled Price (“CUP”) Method for FY 2013 by using the price charged by VOL to Nigerian third party for similar products, as the arm’s length price (“ALP”). However, for FY 2014, the Company adopted Transactional Net Margin Method (“TNMM”) using Operating Profit Margin (“OPM”) i.e. EBIT/ Operating Revenue, as PLI to benchmark the import transaction, since CUP data was not available for comparison for application of CUP method. The Company filed its TP documentation with FIRS for FY 2013 (using CUP method) and FY 2014 (using TNMM) in respect of transactions with VOL.

Both FY 2013 and FY 2014 were subject to TP audit by FIRS. The FIRS rejected the Company’s approach to benchmark the transaction with VOL for FY 2013 using CUP as MAM and for FY 2014 the FIRS accepted Company’s approach to adopt TNMM as MAM but rejected Company’s method of using OPM as PLI. Further, FIRS adopted TNMM as MAM for both FY 2013 and FY 2014 to benchmark the transaction of the Company with VOL considering Gross Profit Margin (“GPM”) as PLI instead of OPM. Accordingly, based on the arm’s length price (“ALP”) arrived by FIRS, an additional assessment was served to the Company of ₦1.74 billion approx. (USD 4.46 million approx.) including penalty and interest. Dissatisfied with the additional assessment made and issue of demand notice by FIRS, the Company filed an appeal with TAT.

The key issues to be decided by the TAT along with the contentions of the Company and FIRS are elucidated in table below:

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<th>S. No.</th>
<th>Issues</th>
<th>Contentions of the Company</th>
<th>Contentions of FIRS</th>
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<td>1.</td>
<td>Selection of MAM for FY 2013 and FY 2014</td>
<td>· The Company has provided all relevant documentation and information with regards to application of CUP as MAM.</td>
<td>· The Company failed to provide reliable information for selection of CUP as MAM for FY 2013.</td>
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<td>· FIRS has agreed to the selection of CUP as MAM for FY 2013 in correspondences between Company and FIRS.</td>
<td>· Change in methodology from FY 2013 to FY 2014 for the same transaction was contrary to the consistency principle, which is also advocated by the Organisation for Economic Co-operation and Development TP Guidelines, 2017 (“OECD TP guidelines”).</td>
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<td>· As reliable internal data was not available for FY 2014 for selecting CUP as MAM for FY 2014, accordingly, TNMM has been considered as MAM.</td>
<td>· As the Company applied TNMM in FY 2014, the same should be applied in 2013.</td>
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<td>· Company admitted that CUP has been applied in error in FY 2013.</td>
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<td>2.</td>
<td>Selection of PLI for application of TNMM</td>
<td>· GPM used by FIRS for application of TNMM is not envisaged in TP regulation of Nigeria.</td>
<td>· Use of GPM as PLI was based on the functional characteristics of the controlled transaction.</td>
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<td>· Usage of GPM by FIRS for application of TNMM is neither elucidated in OECD TP guidelines, nor United Nation Practice Manual on TP, 2017 (“UN TP Manual”).</td>
<td>· Difference in accounting system in different jurisdictions would distort the comparability analysis under OPM.</td>
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<td>· As GPM only considers elements related to the controlled transactions, the comparability is enhanced. Such approach is in line with OECD TP guidelines.</td>
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Apart from the above issues, the Company has also raised grounds with regards to validity of penalties and interest charged by FIRS and existence of Decision Review Panel (“DRP”).

The TAT after taking into consideration the arguments placed by the Company and FIRS, decided the appeal in favour of FIRS in entirety. The TAT accepted TNMM as MAM for both the FY 2013 and FY 2014 based on consistency principle as laid down in para 29.4 OECD TP guidelines and on the inefficiency of the Company to provide reliable information for selection of CUP as MAM for FY 2013. Further, the TAT upheld the FIRS approach of considering GPM as PLI for application of TNMM which is in accordance with best practices and it took into account various factors as recommended by the OECD TP guidelines.

**Key observations from the Ruling**

The two main issues discussed in the above ruling are - (i) whether the Taxpayer can change the MAM across years in case of non-availability of reliable data; and (ii) whether GPM can be appropriate PLI while applying
TNMM. Both these issues were ruled in favour of FIRS due to lack of adequate reasoning provided by the Company. Further, inconsistent representations made by the Company to the FIRS also played a role for the negative ruling of TAT. However, the TAT reliance on para 29.4 of OECD TP Guidelines which requires TP method to be consistent from year to year seems to be misplaced as para 29.4 is neither present in 2010 and nor in 2017 version of OECD TP guidelines.

As per the UN TP Manual, para B.3.1.3.3 requires change in method in cases where there is any change in the facts, functionalities or availability of data. The Company’s case was based on non-availability of reliable data for application of CUP for FY 2014, however, the TAT has considered it as an additional evidence to cogitate data used in CUP in FY 2013 as not reliable instead of considering it as a reason for change of TP method in FY 2014.

With regards to GPM as PLI, the TAT did not verify the assertions made by FIRS. The PLI to be used in application of TNMM is discussed in para 2.64 of OECD TP guidelines wherein “... the TNMM examines the net profit relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction”. Further, similar guideline is also provided in para B.3.3.2.1. of UN TP Manual.

Also, para B.3.3.2.2. of UN TP Manual, clarifies that as TNMM use net margin to determine ALP, it is less direct method than Cost Plus Method (“CPM”) and Resale Price Method (“RPM”) that compares gross margins. Accordingly, it is distinct in the guidelines that when TNMM is applied the net profit margin i.e. OPM in the ruling, is a correct PLI. However, if at all the FIRS were to use GPM as PLI, then FIRS should have considered RPM as MAM.

Further, as per para B.3.3.12.2 of UN TP Manual, TNMM may be more attractive if the data on gross margins are less reliable due to accounting differences between the tested party and the comparable companies for which no adjustments can be made. Accordingly, FIRS argument of accounting difference to apply GPM was inauspicious. Also, para B.3.3.12.5 of the UN TP Manual, specifies that in cases where available comparables differ significantly with respect to products and functions, making it difficult to reliably apply CPM and RPM, it may be more appropriate to apply TNMM because net margins are less affected by such differences.

Strictly on the TP principles, there was no discussion on Functional, Asset and Risk analysis (“FAR analysis”), entity characterization and comparables. Thus, the efficacy of the analysis/ ruling seems to have lost steam, on the basic principles of TP. In addition, there was no analysis on the categorization of Prime Limited, as a Limited Risk Distributor (“LRD”) or Risk bearing distributor. Without such analyses and attribution to the facts of the case, a simple discussion on method for ALP determining, would lend less credibility to the final outcome of the case.

In addition to the above, there is no discussion in the order on the comparables or if any adjustment is warranted in the case to arrive at the correct ALP due to some market/ economic conditions. Further, the fact pattern of the case throws light on another important aspect - the Company’s margin is at ALP when OPM is considered as PLI while applying TNMM, however, it is not at arm’s length when GPM is considered as PLI. It’s kind of reverse situation than what is generally observed. Further, there is plenty of food for thought to evaluate the comparability of the comparable companies, as these seem to be undertaking more functions than Prime Limited or there is difference in accounting treatment of expenses/ income. An interesting aspect again but no discussion on this too in the order.

India’s position

Strictly speaking on the two aspects of selection of PLI and change of method, the jurisprudence and the regulations in India, have been clear.

The Rule 10B(1)(e)(ii) of the Income Tax Rules, 1962 (“the Rules”) clearly provides for considering net profit margin as PLI while applying TNMM. Further, Rule 10B(1)(b)(ii) requires GPM to be considered as PLI while applying RPM. Accordingly, the issue related to selection of PLI is amply clear from Indian TP regulation perspective. Further, there are various judicial precedent which has confirmed the position to be adopted on PLI while applying TNMM and RPM. The Mumbai Tribunal in case of India Medtronic Pvt Ltd [TS-1046-ITAT-2019(Mum)-TP], has clarified that in case of RPM only the gross margin can be considered for comparability analysis.

Further, change in TP method has always been under dispute. However, the Tribunal has favoured the change in TP method in cases where the facts of the case has changed i.e. change in FAR, or the data is available based on which the different TP method can be applied which will provide a better arm’s length result.

In case of Sudharshan Chemical Industries Limited [TS-1078-ITAT-2016(PUN)-TP], the Pune Tribunal
approved the change of MAM from CPM adopted in TP study to CUP method before the Commissioner of Income Tax (Appeals) based on the data available for application of CUP in later stage of assessment proceedings. Further, in case of Mattel Toys (I) Pvt. Ltd. [TS-159-ITAT-2013(Mum)-TP], the Mumbai Tribunal while allowing the change in method from TNMM (used in TP documentation) to RPM for distribution activity, held that if at any stage of the proceedings, it is found that by adopting one of the prescribed methods other than chosen earlier will result in determination of the most appropriate ALP, then Tax Authorities as well as the Appellate Courts should take into consideration such a plea provided it is demonstrated as to how a change in the method has produced better or more appropriate ALP. Also, the Delhi Tribunal in case of Infogain India Pvt Ltd [TS-392-ITAT-2015(DEL)-TP], upheld Assessee’s plea for adoption of Profit Split method instead of TNMM (used in previous year TP documentation) pursuant to significant change in functional matrix of the Assessee during relevant AY wherein the Assessee had transitioned from back-end software services company of its Associated Enterprise to being fully responsible for execution & delivery of software services to end customers post restructuring.

**Conclusion**

Change in TP method has always been prone to litigation due to lack of appropriate reasoning provided for such change in TP documentation. The Indian Tribunals in their judgements have been clear that there is no bar under the Indian Income Tax Act, 1961 or the Rules that restrict an Assessee to change method of determining ALP and selection of method should be based on the principles of MAM. However, the Tribunals have also clarified that change of method should be for bonafide reasons and not in an arbitrary manner just to circumvent adjustment made by the Tax Authorities. The facts and data should support the reasons for change. Thus, it is pertinent to mention that change in TP method should be appropriately documented in TP documentation to avoid unfavourable position during TP litigation.

Additionally, as discussed above, the ruling failed on the basic TP principles as it did not capture the facts of the case, FAR analysis was found missing, no whisper on entity characterization and comparables. Without these, the judgment was found wanting on the basic premise.