COVID-19: NEED FOR ADJUSTING COST BASE AND REVISING MARK-UP FOR SERVICES OF CAPTIVE SERVICE PROVIDERS

COVID-19 presents an extraordinary and unprecedented situation impacting the economic environment, which needs to be factored, while undertaking transfer pricing analysis of transactions effected by captive service providers during FY 2019-2020 and also in the next financial year. In the aftermath of COVID-19, benchmarking of profit margins of the low risk captive service providers from Transfer Pricing perspective would present complexity, as the combined profitability in the value chain is shrinking and the associated enterprise would be seeking to renegotiate the remuneration paid as a cost plus mark-up, to reflect the margins in the current economic scenario.

Captive service providers, generally characterized as limited risk service providers, are compensated on a cost-plus basis. Whether Nil or lower cost plus mark-up would have to be recovered by such captive IT/software/ITES/R&D service providers during the period of lock down considering that they are claimed to be low risk entities may have to be evaluated within the four corners of the Transfer Pricing regulations and the prevailing judicial position. Such an exercise would require an analysis of the contractual understanding between the associated enterprise and the Indian taxpayer and an analysis as to which entity assumes the risk relating to such unexpected disruption in business.

While charging for services rendered during the current financial year a captive service provider may be required to make all or any the following adjustments:

a) **Adjusting/excluding idle/extra-ordinary cost not related to services rendered to the associated enterprises for determining the net operating margins of the Indian taxpayer:** For undertaking the benchmarking analysis in this extra ordinary economic scenario, the first step would be to exclude extra-ordinary cost and determine the normalized net operating profit margin of the tested party and that of the comparable companies. In terms of Rule 10B(1), only the cost which is related to provision of services to the associated enterprises is required to be taken into consideration for the purpose of undertaking benchmarking analysis. Therefore, cost related to the extra-ordinary circumstances arising due to the COVID-19 pandemic, which is not incurred for provision of services to the associated enterprises will have to be excluded from the cost base for the purpose of benchmarking analysis / charging a cost plus mark up.

   The Delhi Bench of the Tribunal in the case of HCL Technologies BPO Services Ltd (ITA No. 3547/Del/2010) upheld the comparability adjustment on account of abnormal cost to calculate the normalized profit for the purpose of undertaking benchmarking analysis. To the same effect is the decision of the Tribunal in the case of Delhi ITAT in Transwitch India Pvt Ltd (I.T.A. No. 6083/Del/2010) (approved by Delhi High Court). Similarly, the Bangalore Bench of the Tribunal, recently, in the case of Trident Microsystems India Pvt Ltd. (ITA No.

842/Bang/2016) held that expenses incurred during the period when no revenue was generated is not to be taken into consideration for the purpose of benchmarking analysis. The OECD guidelines too, provide for exclusion of exceptional and extraordinary items of non-recurring nature while determination of profits for undertaking benchmarking analysis. Para 2.86 of the OECD guidelines states that "Exceptional and extraordinary items of a non-recurring nature should generally also be excluded".

The revenue may contend that since the taxpayer is operating at a cost plus mark-up model, it is risk free entity and therefore, the entire cost including the cost attributable to the extra-ordinary circumstances ought to be borne by the associated enterprises. A counter argument would be that the taxpayer who is remunerated on a cost plus mark-up basis would not as such qualify as a risk insulated entity. In any case merely because the tax payer is compensated on a cost plus basis cannot be a reason to characterize the taxpayer as a risk free entirety. A factual and functional analysis would have to be undertaken to establish that even though the Indian entity is a limited risk entity, it is not a risk free entity.

Therefore, there is sufficient legal support for the proposition that comparability adjustments may be made to account of extra-ordinary situation and operating margins of the Indian service providers / comparable companies may be calculated after making such comparability adjustments.

b) **Comparability adjustment to the operating margins of the comparable companies for the years not impacted by COVID-19:** Considering that Rule 10CA now requires the use of three years data of comparable companies for the purpose of benchmarking analysis, comparability adjustment may be required to be made to the margins of the comparable companies in respect of the margins earned during the two years preceding the relevant financial year which were not impacted by COVID-19.

c) **Reduced margins of comparable companies for financial year 2020-21:** Considering the industry wide disruption in business, the Indian service providers will have to take into consideration the possible fall in the margins of comparable companies for financial year 2020-21. However, the data with respect to margins earned by comparable companies for financial year 2020-21 would only be known in the first or second quarter of financial year 2021-22. The Indian service providers, however, would have to charge cost plus mark up during the financial 2020-21 itself. Under such circumstances, Indian captive services providers may resort to statistical tools such as linear regression etc. for arriving at the anticipated margins of comparable companies for financial year 2020-21. Alternatively, an analysis of quarterly results declared by the listed companies may be undertaken to arrive at the reduced cost plus mark-up.

Based on the above adjustments, the Indian captive service providers may examine the possibility of charging lower mark up on adjusted cost base (i.e. cost after excluding extra-ordinary expenses incurred on account of business disruption caused due to COVID-19 / lockdown) in consideration of provision of services to the associated enterprises.

TP Team at Vaish Associates, Advocates would be happy to discuss and undertake analysis of data to provide plausible solution to issues, which would arise while pricing of services rendered by captive service providers and undertaking TP benchmarking analysis in the aftermath of COVID-19.

For any clarifications, please write to TP Team:

Mr. Ramit Katyal: ramit@vaishlaw.com

Mr. Abhishek Agarwal: abhisheka@vaishlaw.com

…