Applying the Turnover Filter in Transfer Pricing

The rejection of comparables on the basis of turnover is a vexed matter, on which there have been conflicting judicial decisions. The fact is that there is scant empirical evidence of any relation between profitability and turnover. Underlying the legal argument is the presumption that market dominance may have a role in determining profitability. This article, one of the first studies of its kind, uses market shares instead to demonstrate the lack of comparability of profit-level indicators of dominant firms and smaller firms. Except for cost-based indicators, we find that for traditional as well as technology-driven sectors, large firms cannot be compared with firms with smaller market shares. The study also finds a cut-off for market share, beyond which profitability is not comparable.

1. Comparability Challenge

A company that undertakes an international transaction with an associated enterprise must submit a transfer pricing report along with the annual return. In the report, the company must establish that the transaction undertaken was at arm’s length, and to do so it may use a profit indicator derived from a comparable transaction between the company and an independent entity. To determine the arm’s length price, the Income Tax Act suggests that any of the five methods – comparable uncontrolled price method, resale price method, cost-plus method, profit split method or transactional net margin method (TNMM) – that have been recommended in UN and OECD guidelines, or such other method prescribed by the Central Board of Direct Taxes, may be chosen as the most appropriate, bearing in mind the nature of the transaction, the class of the transactions, the class of the associated enterprise and the functions performed. Thus, there is flexibility in the method adopted.

Despite the variety of measures available to the assessees, it has been observed in India that TNMM has found favour among taxpayers. While the choice of TNMM as the appropriate method has frequently been questioned, it has been upheld in cases such as Morgan Stanley (2007). The appeal of TNMM lies in the fact that it can be applied more broadly. However, a more vexed matter in the application of TNMM has been the appropriateness of the comparables. This is demonstrated in numerous cases before the Income Tax Appellate Tribunal (ITAT) and High Courts.

Typically, a taxpayer finds appropriate market comparables from an appropriate database of companies. The Operating Profit Margin (OPM) of the taxpayer (“tested party”) is compared with the OPM of these comparable companies. The average of the comparable companies’ OPM is considered the arm’s length OPM. If the taxpayer’s OPM is within a +/- 3% range of the average OPM, then the taxpayer is considered to be at arm’s length. If the case is selected for a transfer pricing audit, however, the Transfer Pricing Officer (TPO) may challenge the comparables selected by the taxpayer. The principle behind the use of comparables is that the functions, assets and risks (FAR) of appropriate comparables should be similar to those of the tested party. If the TPO finds the taxpayer’s comparables inappropriate, or materially different from the tested party, then the TPO may reject the taxpayer’s arm’s length exercise and conduct their own exercise to identify an arm’s length price. If the taxpayer does not agree with the TPO’s comparables, then the taxpayer can appeal to the immediately superior authority.

The issues raised before different courts are briefly summarized section 2 of this article through a review of rulings of ITAT and High Court pertaining to the information technology (IT) and IT-enabled services (ITES) sectors. The choice of these sectors is based on the observation that they operate under peculiar economic conditions. That is, they comprise of large number of multinational companies (MNCs) that run captive IT or ITES centres. These centres provide services to their group companies located in various countries. The captive centres are reimbursed at cost plus a markup profit margin by related parties. Hence, a large fraction, if not all, of the sales of the captive centres are to related parties. This can pose a significant transfer pricing risk. It may be seen from court rulings that the most frequent ground for rejection of comparables to tested parties providing IT/ITES solutions to group companies is that large companies such as Infosys or Wipro cannot be treated as comparable to the

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1. IN: Income Tax Act 1961, sec. 92B (as amended), Primary Sources IBFD.
2. Sec. 92A(1) ITA 1961.
4. Sec. 92C(1) ITA 1961.
7. See Singh, supra n. 5.
tested party, given the size of their operations and the fact that they consequently benefit from economies of scale. The taxpayer often requests the exclusion of such companies from the analysis, as scale of operation is assumed to have a bearing on profitability. Revenue, conversely, has often argued that this does not hold where the company operates in a labour-intensive sector. There is, however, no consensus on whether to exclude such companies based on a turnover filter. While some tribunals have ruled in favour of such an approach, others have taken an opposite stance.8 This is an economic argument and it is important that it is empirically verified. In section 2., therefore, facts of some of the cases are summarized. Section 3. then engages in a detailed analysis of company-level data to establish whether there is indeed a relationship between the size of the company and the profit level indicators.

2. Guidance and Case Law

Guidance has been issued by professional and international organizations on the issue summarized in section 1., which supports the view that large corporations may not be comparable because they possess economies of scale, higher risk-taking capabilities, tested business models and robust global delivery models. The Institute of Chartered Accountants of India (ICAI) has observed that:

If there are no differences, the transactions are comparable straightforward. If the differences can be adjusted with reasonable accuracy, then the transactions are comparable, subject to adjustments. If, however, the differences cannot be adjusted with reasonable accuracy, the transactions are to be ignored and the search for comparable transactions would need to commence all over again. For instance, under [the] TNMM where margins are to be compared, the margin of a 1,000 crore company cannot be compared with that of a 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate. The fact that they operate in the same market on a “playing field” may not make them comparable enterprises.9

Further, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2017) makes the following observation:

In practice, both quantitative and qualitative criteria are used to include or reject potential comparables. Examples of qualitative criteria are found in product portfolios and business strategies. The most commonly observed quantitative criteria are:

- Size criteria in terms of Sales, Assets or Number of Employees. The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability.10

While the ICAI and the OECD both allude to the relevance of this factor, these are not standards but only guidance or suggestions. In practice, as will be shown in this section, judicial processes have reached conflicting decisions, with some concluding that size does not affect profitability, while others allow a large company to be treated as comparable to mid-sized companies with suitable “comparability adjustments”. Comparability adjustments are permitted under rule 10B of IT Rules 196211, which provides that companies that do not initially approximate the functions, assets and risks of the tested party may, after suitable adjustments, be treated as comparable.

In Willis Processing Services (2013),12 the Mumbai ITAT ruled that classification of comparables on the basis of fixed slabs of turnover is not acceptable. The ITAT deliberated over whether comparables should be selected from “turnover slabs”. It said that when a tested party with turnover below INR 2 billion is compared only with companies with turnover below INR 2 billion, it creates a situation in which companies with turnover of INR 1.99 billion are comparable but companies with turnover of INR 2.01 billion are not. The ITAT went on to observe that:

When the assessee has not made out a case as to how the low or high turnover has influenced operating margin and on the contrary there is no direct relation between the turnover and margin as clear from the details and graphic chart reproduced above [in the judgment], then a comparable cannot be rejected solely on the basis of high turnover. Even otherwise, the larger turnover and size of the entity may have an impact of economical cost of production in the manufacturing industry due to huge cost of fixed asset but not in service sector.13

On the other hand, the Mumbai ITAT analysed the matter in greater detail in the case of Capgemini India Pvt. Ltd (2013),14 and confirmed that turnover of a company does not materially affect profitability in the software industry:

5.3.5 […] The various reasons given for applying the turnover filter for comparison of margins are economy of scale, greater bargaining power, more skilled employees and higher risk-taking capabilities in cases of high turnover companies, which increase the margins with rise in turnover. However, in the Tribunal decisions cited, no detailed examinations have been made as to how these factors increase the profitability with rising turnover. The concept of economy of scale is relevant in manufacturing concerns, which have high fixed assets and, therefore, with the rise in volume, cost per unit of the product decreases, which is the reason of increase in margin as scale of operations goes up because with the same fixed cost there is more output when the turnover is high. The same is not true in case of service companies, which do not require high fixed assets. In these cases, employees are the main assets, who in the case of the assessee are software engineers, who are recruited from project to project depending upon the requirement. The revenue in these cases is directly related to manpower utilized. With rise in volume cost goes up proportionately. Therefore, as rightly pointed out by the ld. CIT-DR the concept of economy of scale could not be applied to service oriented companies. The ld. CIT-DR has also placed a graph plotted between margin and, turnover in case of the comparables selected by the assessee, which shows no linear relationship between margin and turnover. In fact, the graph shows that the margin has come down with the rise in turnover in some

10. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations para. 3.43 (OECD 2017), Primary Sources IBFD.
13. Id., at para 47.
cases. Such detailed study was not available before the various Benches of the Tribunal mentioned earlier, who have applied the turnover filter. Therefore, in view of the fresh material, in our view, the decisions of the Tribunal can[not] be followed.

5.3.6 The manpower requirement of software companies var[ies] from project to project and, therefore, all the companies engaged in this line recruit employees depending upon the nature of project as per required skills and abilities. Therefore, it cannot be said that only the high turnover companies have skilled employees. Moreover, in case of high skilled employees, cost of employee also increases along with output and, therefore, margins are not much [a]ffected. As for the risk, all the comparable companies have similar levels of risk as they operate in the same field and similar environment. Under the provisions of rule 10B(2), comparability of international transactions with uncontrolled transactions has to be judged with reference to functions performed, asset employed and risk assumed but the functions performed by all comparable companies are [the] same as it is because of [these] same functions [that] they have been selected by the assessee as comparables. The asset employed has two dimensions i.e. quantity and quality. More employees would mean more turnover but as we have seen ear-lier, there is no linear relationship between margin and turn-over. As regards quality of employees, this will depend upon the nature of projects and since the comparables are operating in the same field having similar nature of work, and employee cost being more in case of more skilled manpower, it will not have much impact on the margins. As for the bargaining power, the assessee is part of a multinational group and well established in the field and, therefore, it can not be accepted that it has less bar-gaining power than any of the India[n] Companies, however big it may be. Therefore, in our view, it would not be appropriate to apply turnover filter for the purpose of comparison of margins.

The above order brings to light some important points. To ascertain whether there is a relationship between turn-over and profitability requires a thorough economic esti-mation. Where tribunal rulings are based on economic arguments that are not fully or thoroughly substantiated, this may lead to conflicting outcomes. Furthermore, it is argued that the economies of scale are more likely to have an effect in sectors with high fixed costs, such as manufac-turing. As a result, transfer pricing analysis is circumstanc-ial and it is possible to distinguish a transaction on basis of subtle economic differences. In order to find a solution to this recurring problem, it is imperative to empirically examine the validity of the arguments.

Similar to the Mumbai ITAT’s findings, the Delhi ITAT held in the case of Calibrated Healthcare Systems (2014) that “when a company is functionally similar to that of the assessee company, the same cannot be excluded merely because its turnover is at a lower or a higher level”.15

In the case of Société Générale Global Solution (2016), the taxpayer challenged the decision of the TPO before the Bangalore ITAT on the grounds that the companies Mindtree and Persistent Systems were not fit comparables to it because they had a much higher turnover. The Bangalore ITAT held that “turnover cannot be [a] relevant criter[ion] in a service sector where fixed overheads are nominal and the cost of service is in direct proportion to the services rendered”.

It ruled that size does not affect comparability.

The arguments in support of applying a turnover filter rely on the cost and price advantages that may arise at a large firm. The Bombay High Court ruled in the case of Pentair Water (2015) that turnover is a relevant factor in deciding on comparability. In the case of Agnity India Technologies (2010), the Delhi ITAT observed that Infosys, a company with a huge turnover, should be excluded from a list of comparables of the taxpayer because it is a large company in the area of software development. The Delhi ITAT’s ruling was challenged by Revenue in the Delhi High Court. The Delhi High Court upheld the ITAT’s judgment.19 In another case, the Delhi High Court deliber-ated on whether Wipro, another company with huge turnover, could be treated as comparable to the taxpayer, which had a much smaller turnover. It ruled that:

As to the exclusion of M/s Wipro Limited, here too, the Court is of the opinion that the brand value of an entity has a signifi-cant role in its ability to garner profits and negotiate contracts. Thus, while considering the comparables, the likelihood of prof-its derived or attributable to the brand having regard to the con-sistency of the quality of services that an entity is able to offer would be relevant, although functionally, the two entities may be similar in terms of the services and products they offer, brand does play its own role in price or cost determination. If this singular aspect is kept in mind, the ITAT’s approach cannot be faulted...

Many other tribunals have ruled that appropriate turn-over filters should be applied when selecting comparables for any tested party in a transfer pricing analysis.21

However, a more critical aspect is where the turnover filter must be set, even if it is accepted. ITAT judgments have recommended various turnover filters. Of course, every tested party is different, and any filter – if applicable – would vary with the nature of tested party. Yet, ITATs have used two distinct approaches in applying turnover filters. In one approach, some ITAT benches have used a range from INR 10 million to INR 2 billion, and a second for tested parties that have turnover above INR 2 billion.

The Bangalore ITAT gives a rationale for this in the decision of Genisys Integrating Systems (2011):

For the purpose of classification of companies on the basis of net sales or turnover, we find that a reasonable classification has to be made. Dun & Bradstreet and NASSCOM have suggested

15. IN: ITAT Delhi, 4 Dec. 2014, ITA 5271/Del/2012, Calibrated Healthcare Systems India Pvt. Ltd v. ACIT, para. 7, Case Law IBFD.


19. IN: HC Delhi, 10 July 2013, ITA 1204 of 2011, Agnity India Technologies Pvt Ltd v. CIT, [2013] 36 taxmann.com 289 (Delhi), Case Law IBFD.


different ranges. Taking the Indian scenario into consideration, we feel that the classification made by Dun & Bradstreet is more suitable and reasonable. In view of the same, we hold that the turnover filter is very important and the companies having a turnover of Rs. 1.00 crore to 200.00 crores have to be taken as a particular range and the assessee being in that range having turnover of 8.15 crores, the companies which also have turnover of INR 150 million is applied and an upper turnover filter of INR 15 billion. Companies with turnover above or below this range in the year under review will be excluded from the list of comparables. An advantage of this filter is that it is dynamic and varies according to the tested party. It is not a static filter; however, such a filter must be prescribed on the basis economic rationale. Given that the state of economy can also influence profitability, as will be shown in section 3, the setting of such thresholds would pose an additional challenge of making frequent revisions based on evolving market conditions. Finding a condition that is robust over a long period may mitigate disputes. This article attempts to find such a measure.

3. Economic Analysis to Define the Filter

In case law, the argument for the application of a turnover filter rests on the more nuanced premise that the company operates with an advantage captured by the scale of its operations. It could manifest in lower fixed costs at higher scale of operations, a greater ability to negotiate better prices, and market dominance. However, other ITATs have followed a dynamic filter that includes comparables with turnover ranging from one tenth of the tested party’s turnover to ten times the tested party’s turnover. For instance, if a tested party has a turnover of INR 1.5 billion, a turnover filter of INR 150 million is applied and an upper turnover filter of INR 15 billion. Companies with turnover above or below this range in the year under review will be excluded from the list of comparables. An advantage of this filter is that it is dynamic and varies according to the tested party. It is not a static filter; however, such a filter must be prescribed on the basis economic rationale. Given that the state of economy can also influence profitability, as will be shown in section 3, the setting of such thresholds would pose an additional challenge of making frequent revisions based on evolving market conditions. Finding a condition that is robust over a long period may mitigate disputes. This article attempts to find such a measure.

Underlying all such arguments is a more fundamental assumption that firms with market dominance may be able to earn higher profits. In theory, a dominant firm may possess a cost advantage and, unlike the monopolist, must make price and output decisions bearing in mind fringe firms. Studies in India suggest that Indian manufacturing has a handful of dominant firms that possess cost advantage. Therefore, one must first establish if there is market dominance and then if this impacts comparability. However, in doing so, the application of filters based on absolute value of sales is not tenable. Defining such a threshold can be difficult, particularly as it may vary as per sector and time frame. It is proposed herein that the share of sales, representing the market power of a firm, may be a superior measure for applying filters. The economic analysis in this article demonstrates that, if there exists a relationship between share in total market sales in a given sector and the profit margin, and if a threshold may be defined for share in sales, then firms on either side of the threshold may be rendered incomparable.

3.1. Brief note on the statistical analysis

As the application of a turnover filter has been debated widely in the context of IT companies, the economic analysis concentrates on this industry and, in addition, compares two other sectors (pharma and steel manufacture) to establish whether the argument extends across industries – in particular, because it is often claimed that economies of scale are significant in the manufacturing sector. The reason for selecting pharma is that intellectual property forms a critical element of the production process in that sector, which makes it similar to IT in that respect; steel sector has been selected because it represents traditional manufacturing with a relatively high degree of concentration. Note that the IT sector has been split between ITES and computer software. Market shares and profit margins are calculated annually for each firm during the period 2000-2019. These firms include listed and unlisted companies, and government or public sector enterprises have been excluded so that the margins are not the result of any other policy action. The analysis is therefore based on the sample of companies available and reported in the Prowess database of the Centre for Monitoring Indian Economy (CMIE).

**References**

Figure 1 shows that the number of companies with a share of more than 1% of overall market sales has declined for ITES since 2013 whereas for the computer software and steel sectors the numbers have remained stable during that time. There was an increase for the pharmaceutical industry, after a brief decline between 2012 and 2015. In addition, for each of the selected sectors, the number of companies that account for more than 1% of the market share remains lower than 30 for most of the period, and substantially less for the steel and computer software industries.

While there are a number of companies that contribute more than 1% of the total market sales, the dominance of these firms can be inferred from the total share they account for. As can be seen in Figure 2, for almost all industries there was an increase in the share, especially after 2015. In the ITES and computer software industries, around 20 companies account for more than 70% of the market share.

There is, accordingly, ample evidence that the degree of concentration has increased over time in the selected industries. It is to be expected, therefore, that in each industry a set of dominant companies would earn profit margins that are not comparable to other smaller companies. The analysis will now be used to identify a threshold or cut-off beyond which companies should not be selected for comparability analysis for a tested party that is within such threshold. As TNMM is a popular method, the profit margins used for the analysis are profit before interest and tax (PBIT) by sales, PBIT by assets and PBIT by total...
Figure 3 – Average PBIT by sales across selected industries

Source: Estimated from CMIE
Figure 4 – Average PBIT by total assets across selected industries

Source: Estimated from CMIE
Figure 5 – Average PBIT by total expense across selected industries

Source: Estimated from CMIE
To identify the threshold, each of these profit margins is plotted against market shares for each year and for each industry. From the data, it may be observed that, for each sector, below a certain level of market share the size of profit margins becomes incomparable and there are noticeable deviations in the margins beyond the threshold. Making use of such thresholds, the profit margins can be estimated for groups of companies below or above the threshold, instead of defining the threshold at which rates of profit in an industry switch over, taking companies with a 5%, 2% and 1% share. Through an iterative process, using three different profit level indicators, the same can be measured to find a threshold that can be used for a longer period of years. Finally, it should be examined whether the difference in profit rate between firms with varying market shares applies irrespective of the choice of indicator.

It emerges that, if a benchmark is to be selected for a 20-year period, 1% would be fairly representative across industries as the share at which the margins become incomparable between companies above and below this threshold. It may also be seen that, for IT, computer software, pharma and steel (except in 2016), PBIT by sales reported by companies with market shares in excess of 1% was substantially higher than that for companies with smaller market shares. Note that the dip in the profitability observed in the steel industry in 2016 was the result of oversupply of steel in China.27 Also notable are the similar rates of profits for the years 2000-2002 for both groups of companies in the ITES sector, possibly because the sector was nascent and opened up to large conglomerates only after 2004; these rates diverged over the years.

A similar difference in the reported profit margins is observed when the indicator PBIT by total assets is selected (see Figure 4). However, convergence in the margins is visible for steel in multiple years. As for the ITES sector, even though the profit margins of smaller companies, as defined by their market share, in 4 specific years exceed those of the large companies, the point about their incomparability is broadly sustained throughout the period. It may also be mentioned that the inversion of such tendency is associated with a significant increase in dispersion in data, as measured by the standard deviation. This result stems from an above-average financial performance by companies with a smaller market share. It is expected that the use of multiple-year data in comparability analysis can subdue such effects, thus still allowing the use of a threshold to separate companies for the purpose of comparability.

Lastly, PBIT to total expense is compared across industries (see Figure 5), and it is found that, other than in the computer software industry, there are more exceptions to this profit level indicator. It may be seen that the data is more volatile and that there are instances of convergence in the ITES sector.

4. Conclusion

The use of turnover filters to establish comparability remains an unsettled matter. This article is an attempt to present results that could potentially resolve the contention. There is merit in the argument that filters fixing a sales level at an absolute number create the problem of partitioning companies that may be fractionally above or below such a margin. In addition, finding such margin is like drawing a line in the sand. The sales turnover may shift depending on market dynamics each year. Thus, looking for a linear relationship between margins and sales may be too simplistic an approach that is likely to yield no result. The underlying premise, however, is identified in this article as being that some firms have, to some degree, significant market presence or dominance. This gives the company unique economic advantages that its peers, smaller in size, may not enjoy. Therefore, in this article a novel approach is adopted, of identifying companies with significant market share, in which significance is identified through calibration. This article examines specifically if there exists a market share at which it would be incorrect to draw sample of companies with lower shares for comparison. The profit margins of companies on either side of such threshold are compared using three different profit level indicators. It is amply clear that a company with a greater share of the market earns, in most years, higher profits benchmarked against sales as well as assets. However, when the margins are computed on the basis of expense, more convergence is seen across the two groups. The implication of this result is that the economies of scale that are conjectured to arise through a cost advantage may not be an accurate description, even of selected manufacturing industries. A variety of expenses may be booked through cost centres, be that R&D or employee expenses, which would make it difficult to argue that the large and small companies are incomparable. The argument that these two groups are indeed incomparable must therefore apply only when assessing profits in relation to the assets and sales that are the true representation of a firm’s size. In the course of this comparison, it was also noted from the case of the steel industry that economic shocks can have a discernible impact on margins and must be taken into consideration.

In sum, the empirical analysis undertaken in this study informs transfer pricing analysts and auditors that a simplistic turnover filter does not solve the debate, as it separates companies on a simplistic basis of turnover and not the profitability. Rather, the application of a filter based on the market share of comparable companies identifies those companies that have the ability to use their dominance to achieve supernormal returns, in a number of sectors. This approach also shows that the use of cost-based indicators may contribute to the difficulty in the selection of comparables.

26. Note that companies with ratios that exceed 1 or are less than -1 are trimmed out. Such numbers would indicate a higher share of income from other sources and offset losses from previous years, which need not be incorporated in the estimation.