The author reviews a recent transfer pricing ruling in relation to BMW India’s payment of market survey charges and technical support service fees to its associated enterprise. The author highlights some important aspects that should have been considered by the tax authorities and tribunal before they drove their way to conclusion.

1. Background

BMW India Pvt. Ltd (“BMW India”) is a distributor of cars imported from its associated enterprise. During financial year 2006/07, BMW India carried out several intercompany transactions, the arm’s length price of which were accepted by the tax authorities, except in the case of two intercompany transactions (the payment of market survey costs and the payment of technical support services), where the tax authorities made transfer pricing adjustments.

The following sections provide an issue-wise analysis of the approach adopted by BMW India to determine the arm’s length price, the tax authorities’ contentions, the ruling of the Income Tax Appellate Tribunal (the “Tribunal”) and the author’s opinion.

2. Charging Market Survey Costs to Associated Enterprise

During financial year 2006/07, the associated enterprise of BMW India arranged a market survey report for India. The market survey was conducted by a third party and the cost incurred by the associated enterprise for this survey was charged on a cost-to-cost basis to BMW India.

In the transfer pricing study report, BMW India selected the comparable uncontrolled price (CUP) method as the most appropriate method to benchmark this transaction. Since the amount charged by the third party was passed on to BMW India without any markup, such a third-party cost was considered as the comparable uncontrolled price.

During the course of the transfer pricing audit, BMW India submitted that the market survey report prepared by a third party was entirely for the Indian market. According to BMW India, the research findings and analysis of this report were only for its own benefit. However, the tax authorities rejected BMW India’s submission for the following reasons:

- The market survey report was prepared by a third party at the request of an associated enterprise. The fact that the associated enterprise was involved in the preparation of this report confirms the assumption that the report was carried out to benefit the associated enterprise.

- The Indian automobile market, being huge in size, carries an immense strategic importance for the associated enterprise and the BMW Group as a whole.

- The fact that BMW India reimbursed these expenses was inconsequential to the need for carrying out the survey and the associated enterprise undertook the survey in any case in view of its strategic importance for the BMW Group.

For the above reasons, the tax authorities disallowed the entire amount paid by BMW India to its associated enterprise. Aggrieved by this order, BMW India appealed before the Commissioner of Income Tax (Appeal) (CIT(A)), which agreed with the tax authorities’ allegation and upheld the adjustment. Thus, BMW India contested this order of the CIT(A) before the Tribunal.

Before the Tribunal, BMW India reiterated its stance that the market survey report is for its own use and benefit. The associated enterprise or other members of the BMW Group neither use nor benefit from this survey report. BMW India also stated the fact that the associated enterprise does not directly sell cars on the Indian market and thus the report would not benefit it. It was also argued before the Tribunal that the cost charged for the market survey is not shareholder service provided by the associated enterprise as shareholder services are essentially related to the juridical structure of the parent company, consolidation of financial statements for reporting purpose, etc.

On the contrary, arranging for an India-specific market survey report is for the use and benefit of BMW India and so its cost is rightly charged to India. There is no justification for an associated enterprise to bear the cost of such a country-specific market survey report. The benefit for an associated enterprise, if any, is incidental or indirect in nature, for which there is no justification that the cost should be borne by the associated enterprise.

BMW India also relied on several rulings wherein it has been held that the tax authorities cannot question the commercial decision of a businessman. How a company runs its business is entirely its own prerogative and challenging the commercial expediency of the same is not within the purview of the tax authorities.1

It was also argued by BMW India that the tax authorities did not provide details of a comparable uncontrolled


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transaction on the basis of which the arm’s length price has been calculated as nil. Accordingly, BMW India alleged that the tax authorities had not appropriately determined the arm’s length price.\(^2\)

The Tribunal observed that BMW India was established in 1997 in India, long before carrying out the market survey, and also that there were no direct sales made by an associated enterprise in India. Further, in light of the facts and arguments presented by BMW India, the Tribunal was of the view that the market survey report cannot be considered as shareholder activity, as it is a country-specific report benefiting BMW India. The Tribunal also accepted various case laws relied upon by BMW India and held that the tax authorities were not justified in determining the arm’s length price of the transaction as nil.

The above ruling of the Tribunal is dubious as it appears that the Tribunal has not analysed the functional profile and characterization of the transacting parties. Whether the cost of the market survey report should have been borne by BMW India, by its associated enterprise or partly by both parties is dependent on the facts of the case and the characterization of the parties to the transaction. The ruling provides limited information about BMW India being a distributor of cars imported from an associated enterprise. The Tribunal should have further analysed whether BMW India is a limited-risk distributor or a full-fledged distributor. A limited-risk distributor undertakes many of the same activities as a full-fledged distributor but the primary distinction between the two entities is the degree of involvement in strategic marketing decisions. In many industries, a limited-risk distributor has little or no strategic marketing responsibility, but may undertake the day-to-day risks delegated by the manufacturer whose products the limited-risk distributor purchases and resells. Typically, limited-risk distributors are entitled to steady but low net margins return for their limited functional profile.

If BMW India’s functional profile is akin to a limited-risk distributor, in such a case, the cost of a market survey report should not have been charged by the associated enterprise to BMW India. A marketing survey is undertaken to formulate an appropriate marketing strategy, which is the responsibility of an associated enterprise and not of a limited-risk distributor. Thus, in such a scenario, the cost of the market survey should have been borne by the associated enterprise and not by BMW India.

If BMW India is a full-fledged distributor, it is its responsibility to fulfill a strategic and operational marketing function. These marketing functions may include conducting market researches or surveys, developing advertisement or campaign material, etc. In such a case, charging the market survey report to BMW India is justified. However, another question that arises here is whether the cost of the entire market survey report should be charged to BMW India or part of it. One may argue that both BMW India and the associated enterprise would reap the benefit of a market survey by augmenting their sales. Accordingly, the cost of a market survey should be allocated between BMW India and its associated enterprise proportionally, according to a benefit analysis.

3. **Payment of Technical Support Services**

During financial year 2006/07, BMW India had entered into a service level agreement with its associated enterprise to receive technical training for setting up and operating a facility in India. This facility related to all production-related processes, such as plant logistics, assembly, mechanical and electrical rework, paint rework and quality audits. The associated enterprise charged BMW India a rate of EUR 700 per man day. To benchmark this transaction, BMW India used the CUP method and, to apply this method, BMW India carried out a search on the RoyaltyStat database to identify comparable agreements. Based on the search, BMW India identified two comparable agreements with an average rate of EUR 719 per man day. Since the price charged by the associated enterprise was lower, the payments were claimed to be at arm’s length price.

However, in the view of the tax authorities, the rate charged by the associated enterprise was exorbitant and hence they rejected it. The tax authorities disregarded the methodical search conducted by BMW India on the basis that the comparable uncontrolled data was not from Germany, the country where the associated enterprise is located. The tax authorities carried out their own search of various websites to find the hourly rate for automotive engineers in Germany and arrived at results ranging from EUR 250 to EUR 350 per man day. Considering EUR 300 as reasonable, the tax authorities proposed an adjustment of INR 16.8 million. In appeal, the CIT(A) reduced the quantum of adjustment.

The Tribunal observed that the approach adopted by the tax authorities while rejecting the agreements was incorrect and the rates available on random websites were not reliable or not acceptable as comparable uncontrolled transactions. The Tribunal also noted that BMW India had carried out comprehensive research on the RoyaltyStat database for identifying third-party agreements involving provisions of similar services in developed countries and identified two comparable agreements with an average per man day rate of EUR 719 (which is higher than the rate that BMW India pays its associated enterprise). The Tribunal also considered BMW India’s submission that the pricing/cost structures and market dynamics of developed countries like Germany, Japan etc. were similar. Thus, the Tribunal relying upon the coordinate bench ruling in Bharti Airtel Ltd. (TS-77-ITAT-2014(DEL)-TP) stated that the difference in geographical location of the market was not sufficient reason to reject a comparable until it could be substantiated that the same resulted in different market conditions.

The Tribunal further accepted BMW India’s submission that the rates available on websites were not contemporaneous and were not actual rates charged, which is a pre-

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\(^2\) AWB India (P) Ltd v ACIT [TS-67-ITAT-2013(DEL)-TP], Citicorp Maruti Finance Ltd [TS-500-ITAT-2017(DEL)-TP] and Fabindia Overseas Ltd [TS-333-ITAT-2016(DEL)-TP].
condition to application of the CUP method. Accordingly, the Tribunal deleted the adjustment made by the tax authorities.

The ruling underscores the importance of a methodical process when searching for comparable data. The approach of cherry-picking comparable details from websites is outright incorrect and also the data gathered is dubious. The Tribunal’s view that a difference in the geographical location of the market was not sufficient reason to reject a comparable until it could be substantiated that the same resulted in different market conditions, may be right in some situations but not always. Generally, in service transactions, the man-hour rates are derived taking into consideration the salary or compensation and other overhead costs. These costs could vary significantly from country to country. It is not clear from the ruling whether the Tribunal considered this point before giving its ruling.

4. Conclusion

With regard to the market survey cost charged to BMW India, the ruling missed the point on the characterization of BMW India, which may have flipped the outcome. With regard to the adjustment relating to technical support services, the Tribunal rightly rejected the outlandish approach of randomly selecting man-hour rates from a website. However, accepting man-hour rates from a different geographical market may not be an appropriate manner of conducting comparability analysis, particularly in service transactions where labour costs can vary significantly. Albeit the ruling went in favour of BMW India, in the view of the author, it somehow managed to drive home safely.