

**THE HON'BLE SRI JUSTICE SANJAY KUMAR
AND
THE HON'BLE SRI JUSTICE M.S.K.JAISWAL**

I.T.T.A.NO.595 OF 2016

J U D G E M E N T

(Per Hon'ble Sri Justice Sanjay Kumar)

This appeal by the Revenue under Section 260A of the Income Tax Act, 1961 (for brevity, 'the Act of 1961') is directed against the order dated 04.02.2015 passed by the Income Tax Appellate Tribunal, Hyderabad Bench "A", Hyderabad, in I.T.A.No.1492/Hyd/2014 in relation to the assessment year 2010-11. The following substantial questions of law are sought to be raised by the Revenue:

i. In the facts and circumstances of the case, whether the Hon'ble Tribunal (ITAT) is correct in law in directing the Assessing Officer in deleting the addition made on account of transfer pricing adjustments to royalty payment made by the Transfer Pricing Officer in terms of Section 92CA of the Income Tax Act 1961 ?

ii. In the facts and circumstances of the case, whether the Hon'ble Tribunal (ITAT) is correct in law in upholding the payment of royalty at the rate of 2% as against 3% restricted by the Transfer Pricing Officer, when the Respondent-assessee company could not satisfy the benefit test?

Heard Sri B.Narasimha Sarma, learned senior standing counsel for the Revenue, and Sri S.Ravi, learned senior counsel representing Sri Ch.Pushyam Kiran, learned counsel for the respondent assessee.

The assessee, M/s R.A.K.Ceramics India Private Limited, is a wholly owned subsidiary of RAK Ceramics PSC, United Arab Emirates (UAE). The assessee manufactures vitrified tiles and sanitary ware products in India for sale in domestic and international markets. The assessee entered into a Royalty Agreement on 01.04.2009 with its Associated Enterprise (AE), RAK Ceramics PSC, UAE. As per Clause

3.1 of this agreement, in consideration of the ongoing technical assistance on process and product improvement to be provided to the assessee or any other services as specified in the agreement, including any technology or services provided, the assessee was to pay to the AE royalty equivalent to 3% of the net ex-factory sale price of the products on both domestic and export sales during the tenure of the said agreement. The first such royalty payment was made during the financial year 2009-10. In its return filed for the assessment year 2010-11, the assessee claimed deduction in respect of this royalty amount paid by it to the AE. The Transfer Pricing study by the assessee in relation to this component was by adoption of Transaction Net Margin Method. However, the Deputy Commissioner of Income Tax (Transfer Pricing), Hyderabad, the Transfer Pricing Officer (TPO), rejected this study on the ground that the assessee had clubbed an intangible transaction with tangible transactions and applied the Transaction Net Margin Method.

The TPO held that the assessee did not fulfill the conditions of the 'benefit test' and that there was no perceptible change in the sale or profit which could be attributed to receipt of technical know-how from the AE to justify payment of royalty at 3% to it. The TPO further found that substantial expenditure had been incurred by the assessee on advertisement and marketing and it was these efforts which had yielded increased revenue and profit. The TPO accordingly restricted the royalty payment to 2% instead of 3% of the net ex-factory sale proceeds. The alternate study undertaken by the assessee applying the Comparable Uncontrolled Price method, on the strength of three comparable cases, was also rejected by the TPO on the ground that the data base used by the assessee was in relation to

US based companies and copies of their agreements had not been furnished. The TPO concluded that to justify payment of such royalty, the assessee had to satisfy the 'benefit test' and as it had failed to do so, the royalty payment was pegged at 2% instead of 3%, as provided in the agreement. This determination by the TPO under Section 92CA of the Act of 1961 was confirmed by the Dispute Resolution Panel (DRP), Hyderabad, *vide* order dated 25.06.2014 and was acted upon by the Deputy Commissioner of Income Tax, Circle-3(1), Hyderabad, the Assessing Officer, as evidenced by the Assessment Order dated 24.07.2014.

Aggrieved by such assessment in so far as it related to the payment of royalty, the assessee filed I.T.A.No.1492/Hyd/2014 before the Tribunal. The Tribunal took note of the fact that no analysis had been undertaken by the TPO in fixing the arm's length price of the royalty payment made by the assessee to the AE. The Tribunal further found that the TPO had not adopted any of the methods prescribed under Section 92CA of the Act of 1961 read with Rule 10B of the Income Tax Rules, 1962 (for brevity, 'the Rules of 1962') and rejected the application of the 'benefit test' adopted by the TPO. The assessee's appeal was accordingly allowed holding that the reduction of the rate of royalty from 3% to 2% by the TPO was without basis and could not be accepted.

Sri B.Narasimha Sarma, learned senior standing counsel, would contend that the reasoning of the TPO ought not to have been dismissed lightly by the Tribunal. He would state that the application of the 'benefit test' by the TPO was fully justified on facts and therefore, the order under appeal requires admission for consideration of the substantial questions of law raised.

Per contra, Sri S.Ravi, learned senior counsel, would point out that Section 92CA of the Act of 1961 dealing with 'Reference to the Transfer Pricing Officer' details the procedure to be followed by the TPO in such exercise under Rule 10B of the Rules of 1962 which deals with 'Determination of the arm's length price'. Learned senior counsel would point out that there is no mention of the 'benefit test' being adopted for the purpose of determining such arm's length price. He would contend that it is not for the Revenue to dictate as to how the assessee should go about running its business or as to how it should source its technical know-how. He would place reliance on the judgment of the Supreme Court in **COMMISSIONER OF INCOME TAX, BOMBAY V/s. WALCHAND AND CO. PRIVATE LTD.**¹.

Having considered the rival submissions, we find that the assessee offered two transfer pricing studies in relation to payment of royalty. In so far as the acceptable study adopting the Comparable Uncontrolled Price method is concerned, it is not in dispute that the assessee offered three comparables with an average royalty payment of 3.65% as against its own rate of royalty at 3%. Significantly, the TPO rejected these comparables on the ground that they were US based, while the AE of the assessee was UAE based. Having rejected these comparables, it was for the TPO to come up with other comparables so as to justify reduction of the royalty payment. However, no such exercise was undertaken by the TPO and by going into the whys and wherefores of the improvement in the net sales and profit of the assessee, the TPO determined that the reason for the same was increased marketing along with offer of discounts and that there was no justification for payment of royalty at 3% to the AE by

¹ [1967]65ITR 381 (SC)

the assessee. This reasoning is without legal basis of law as it is not for the TPO to decide the best business strategy for the assessee.

In **WALCHAND AND CO. PRIVATE LTD¹**, the Supreme Court observed in the context of the Income Tax Act, 1922 that when a claim is made for an allowance by the assessee, the income tax authorities have to decide whether the expenditure claimed as an allowance was incurred voluntarily and on grounds of commercial expediency. The Supreme Court pointed out that in applying the test of commercial expediency for determining whether the expenditure was wholly and exclusively for the purpose of business, it has to be adjudged from the point of view of the businessman and not of the revenue. The Supreme Court concluded that it is open to the revenue to come to the conclusion that the alleged payment was not real or that it had not been incurred by the assessee in the character of a trader or that it was not laid out exclusively for the purpose of the business so as to disallow it but it is not the function of the revenue to determine what remuneration should be paid to an employee by the assessee.

Applying the same logic to the case on hand, once it is admitted by the Revenue that the assessee entered into a royalty agreement with the AE and the assessee claimed benefit from such agreement, in the form of quantum increase in sales with no apparent increase in production, minimal product recalls and low after sales maintenance cost, and consequently paid royalty in terms thereof, it was not for the TPO to determine as to what could be the other reasons for increase in the assessee's sales and profit.

Above all, there is no explanation forthcoming as to why the TPO decided upon 2% instead of the contractual rate of 3% for

payment of royalty. No reason is offered by the TPO for picking on 2%. This whimsical fixation by the TPO amounts to an arbitrary and unbridled exercise of power. In consequence, we find that the TPO, having rejected the comparables cited by the assessee, did not take the trouble to examine alternate comparables so as to justify reduction of the rate for payment of royalty and by applying a wholly inapplicable methodology of determining the benefit from payment of such royalty, he capriciously reduced the rate for payment of such royalty from 3% to 2%.

On the above analysis, we find no grounds to interfere with the cogent and well reasoned order passed by the Tribunal. No question of law, much less a substantial question of law, therefore arises for consideration in this appeal.

The appeal is accordingly dismissed. Pending miscellaneous petitions, if any, shall also stand dismissed. No order as to costs.

SANJAY KUMAR, J

M.S.K.JAISWAL, J

23rd DECEMBER, 2016

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