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\* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

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**ITA 616/2015**

HONDA R&D (INDIA) PVT. LTD.

..... Appellant

Through: Mr. Nageshwar Rao D.D. and  
Mr. Sandeep S. Karhail, Advocates.

versus

THE ASSISTANT COMMISSIONER OF INCOME TAX ..... Respondent

Through: Mr. Rahul Chaudhary, Senior Standing  
Counsel.

**CORAM:**

**JUSTICE S.MURALIDHAR**

**JUSTICE NAJMI WAZIRI**

**ORDER**

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**02.08.2016**

**Dr. S. Muralidhar, J.**

1. This appeal by the Assessee Honda R&D (India) Private Limited ('HRDI') is directed against the order dated 29<sup>th</sup> January 2015, passed by the Income Tax Appellate Tribunal ('ITAT') in ITA No. 5853/DEL/2011 for the Assessment Year ('AY') 2005-2006.

2. The facts in brief are that HRDI, incorporated in India in June 2003, is a 100% subsidiary of Honda R&D Company Limited, Japan ('HRDJ'), which qualifies as an Associated Enterprise ('AE') of HRDI under Section 92A(2)(a) of the Income Tax Act, 1961 ('Act').

3. HRDI states that during the AY 2005-2006, it performed certain services

for HRDJ in the nature of market research on Indian markets and testing of products already launched in the market. It is stated to have also provided certain auxiliary administrative services to HRDJ during the AY in question. It is stated that the above services were provided pursuant to a Research and Service Agreement dated 1<sup>st</sup> August, 2003 entered into between HRDJ and HRDI. In terms of the said Agreement, HRDJ sub-contracted to HRDI a portion of the Research and Development activities ('R&D activities') related to research and development of automobiles, motorcycles, all terrain vehicles, power products, all-purpose products, associated products, components and all other products to be manufactured by Honda Motor or its licensees. HRDI was to provide the following services to HRDJ:

- i. Market research, information-gathering and analysis;
- ii. Design research and concept-making;
- iii. Product planning and proposals to HRDJ;
- iv. Study, analysis and development of the products referred to above;
- v. Technical consultation about HRDJ's designated products;
- vi. Arrangement for the purchase of goods and samples, and export and import processing for HRDJ;
- vii. Assisting HRDJ in intellectual property affairs;
- viii. Assisting HRDJ in entering into contracts with third parties;
- ix. Recruiting human resources for research and development;
- x. Administrative support and services; and
- xi. Providing services incidental to R&D activities including without limitation computer-related services.

4. HRDI was to supply HRDJ with all results of the R&D activities,

including but not limited to reports, documents, information and materials in whatever form related to the R&D activities.

5. HRDI filed its return of income for AY 2005-2006 declaring a total loss of Rs.64,03,970/-. The return was picked up for scrutiny under Section 143(3) of the Act. The Assessing Officer referred to the Transfer Pricing Officer ('TPO') the issue of determination of Arm's Length Price (ALP) of the international transactions entered into by HRDI with HRDJ during the financial year 2004-2005. On 8<sup>th</sup> October 2008, the TPO passed an order under Section 92CA(3) of the Act recommending a transfer pricing adjustment of Rs.80,99,741/-. The adjustment related to the international transaction of 'sale of services' by HRDI to HRDJ.

6. On the basis of the order of the TPO, the AO passed the assessment order making the following additions:

i. Transfer Pricing adjustment of Rs.80,99,741/-.

ii. Disallowance of 50% depreciation for putting certain assets to use for less than 180 days amounting to Rs.75,47,037/-.

iii. Disallowance of certain non-business expenditure amounting to Rs.36,22,526/-.

7. The AO also initiated penalty proceedings against HRDI under Section 271(1)(c) of the Act.

8. In the appeal filed by the HRDI against the assessment order dated 5<sup>th</sup> December 2008 passed by the AO before the Commissioner of Income Tax

(Appeals) [‘CIT(A)’], HRDI contended that the Cost Plus Method (‘CPM’) should be considered as the Most Appropriate Method (‘MAM’) for benchmarking the international transactions between HRDI and HRDJ considering the functional profile and nature of services provided by HRDI. While challenging the comparables selected by the TPO for determining the ALP, HRDI submitted a new set of comparables. It also considered margins of another comparable i.e. one segment of the operations of Indian Tourism Development Corporation (‘ITDC’) which related to activities such as providing marketing, reservation and event management services. HRDI also prayed for allowing adjustment for difference in level of working capital while comparing its margins with those of the comparables.

9. The submissions made by HRDI were referred by the CIT(A) to the TPO for his comments. A remand report dated 14<sup>th</sup> December 2010 was submitted by the TPO where *inter alia* he stated that Transactional Net Margin Method (‘TNMM’) was the MAM. He also rejected three of the comparables suggested by HRDI, viz., Cyber Media Limited, Capital Trust Limited and ITDC, since they were performing functions different from those undertaken by HRDI. However, the TPO stated that three other comparables suggested by HRDI, i.e., Idma Laboratories, Hi Tech Laboratories and Venus Diagnostics could be taken into consideration with an average of 11.10%. The TPO was of the view that no adjustment be made for working capital difference since the comparables were chosen by HRDI itself.

10. As regards disallowance of 50% depreciation in respect of assets

acquired by HRDI from the Liaison Office ('LO') of HRDJ, it was submitted before the CIT(A) that the fixed assets were legally transferred by the LO to HRDI only in the month of September, 2004 although the sale/purchase agreement was entered into on 1<sup>st</sup> April, 2004. It was explained that the approval of the Reserve Bank of India ('RBI') for the transfer of assets was obtained only on 30<sup>th</sup> July, 2004 and for the closure of the LO on 10<sup>th</sup> September, 2004. Therefore, at the time of transferring of the assets, the assets were in the same premises from which both the LO and HRDI were operating and the legal transfer did not require any physical movement of the assets. Accordingly the assets had been put to use for more than 180 days by the Assessee and, therefore, it was entitled to 100% depreciation thereon. It was further clarified that the physical movement of the fixed assets had already taken place in June, 2003, itself from Delhi to Gurgaon where both the LO and HRDI were operating. At the time of legal transfer of the assets in September, 2004, there was no physical movement of the assets.

11. By a detailed order dated 31<sup>st</sup> October, 2011, the CIT(A) deleted the addition of Rs.80,99,741/- made by the AO on account of TP adjustment. In doing so, the CIT(A) referred to the directions issued by the Dispute Resolution Panel ('DRP') in an order dated 12<sup>th</sup> July 2011 for AY 2007-2008 in HRDI's own case holding that its activities did not involve any core R&D and was limited to providing market research services and testing services. The CIT(A) also considered the DRP's inclusion of ITDC as an appropriate comparable for determining the ALP of HRDI's international transactions. The CIT(A) also allowed 100% depreciation on fixed assets

acquired by HRDI from LO of HRDJ. The CIT(A) allowed deduction for the expenditure incurred by HRDI for residential accommodation of its employees and also for international holiday trips to its employees as per the terms of employment agreement aggregating to Rs. 36,22,526/-.

12. The Revenue then went in appeal before the ITAT in which the impugned order was passed on 29<sup>th</sup> January, 2015. The ITAT concluded that HRDI had undertaken core R&D activities and that ITDC could not be considered as a comparable. The ITAT also held that the CIT(A) failed to consider the inclusion of three of the comparables suggested by the TPO, viz., National Research Development Corporation Limited, Panacea Biotech and Suven Life Sciences. Accordingly the matter was remitted to the file of the CIT(A) for deciding the issue afresh. The ITAT also disallowed the depreciation for the full year against half year that was allowed on the basis that the assets had been put to use for less than 180 days in the AY in question.

13. While admitting the present appeal on 26<sup>th</sup> November, 2015, the Court framed the following questions for consideration:

“(i) Whether the ITAT was justified in concluding that the Assessee is involved in the research and development activity and not provision of market support services?

(ii) Whether the ITAT was justified in remanding the matter to the CIT (A) on the issue of appropriate comparables?

(iii) Whether the ITAT was justified in remanding the matter concerning disallowance of 50% of depreciation on fixed assets acquired from the liaison office of the parent company?”

14. This Court has heard the submissions of Mr. Nageshwar Rao, learned counsel for HRDI and Mr. Rahul Chaudhary, learned Senior Standing Counsel, for the Revenue.

15. At the outset, it requires to be noticed that the first year of operation of HRDI was AY 2004-2005. Cross-appeals were filed both by the Assessee as well as the Revenue against the order dated 13<sup>th</sup> October, 2009 of the CIT(A) before the ITAT for AY 2004-2005. The CIT(A) had by the said order upheld the addition of Rs.1,27,02,704/- made by the AO by way of TP adjustment on account of international transactions relating to sale of services by HRDI to HRDJ. *Inter alia* the CIT(A) adopted the profitability of four comparables after adopting TNMM instead of CPM. The Revenue's appeal was directed against the deletion by the CIT(A) for disallowance of Rs. 10 lakh on account of estimated addition of depreciation claimed by HRDI and a similar addition made of Rs. 15,67,537/- which had been upheld.

16. The ITAT in its order dated 16<sup>th</sup> September, 2011 for AY 2004-05 noted the contention of the Authorised Representative ('AR') of HRDI that the case of the HRDI had been accepted by the AO in the remand report for AY 2005-2006 as well as DRP in its order for AY 2007-2008 that the activities of HRDI did not involve core R&D. Consequently the ITAT restored to the file of the CIT(A) the matter for re-adjudication and for specifically determining whether "the activities carried on by the Assessee during the year under consideration are comparable with the comparables which have been adopted to determine the arm's length price." It was left free to the

CIT(A) to re-adjudicate the matter in the manner he thought proper, to determine the issue raised by HRDI before him and call for any information from HRDI which they would be bound to furnish. The order of the CIT(A) sustaining the addition of Rs.15,67,537/- was upheld by the ITAT.

17. At this stage, it is necessary to refer to the remand report submitted by the TPO for AY in question, i.e., 2005-2006. It began with the caveat that the contents of the said remand report “are without prejudice to the TP order that has been passed for AY 2005-06”. The TP observed that HRDI was involved in R&D activities and that R&D did not necessarily mean creation of a new product. Since HRDI provided its AE services that enhanced the value of its products such activities “can well be classified as R&D.” TNMM was asserted to be the MAM in the case. It was noted that HRDI had suggested six comparables of which three i.e., Idma Laboratories, Hi Tech Laboratories and Venus Diagnostics were accepted as comparables that could be used whereas Cyber Media Limited, Capital Trust Limited and ITDC were rejected.

18. The CIT(A)’s order in the present case is largely based on the above remand report of the TPO, which implicitly accepted that HRDI was not into core R&D activities. Secondly it also accepted three of the comparables suggested by HRDI. In fact, this remand report of the TPO for the AY in question, i.e., 2005-2006 formed the basis of the order passed by the ITAT for AY 2004-2005 remanding the matter to the CIT(A), which proceedings are still pending. That order of the ITAT for 2004-2005 has not been challenged by the Revenue and has attained finality.

19. Now turning to the order of the DRP dated 12<sup>th</sup> July, 2011 for AY 2007-2008, it is seen that in para 4.5 it was stated as under:

“4.5 Facts on record show that assessee has Research, Service Agreement with its AE i.e. Honda R&D Japan. Under the agreement - HRID undertakes market research of product, styling modification and testing activities related to research and development of products to be manufactured by Honda Motors. The show cause notice dated 10.09.2010 states the functions performed by assessee are strategic management, corporate services, research services, testing services. An analysis of work done shows no hard core R&D. In our view assessee gathers information from market and analyses it for further action by its AE. **So we find that the assessee is engaged in providing "market" research services and testing services which lead to the development of better products by their associated enterprises and that the assessee does not itself develop or undertake research for these products.** In our view, the type of R&D by the assessee, cannot be compared to pure science R&D where product is developed, clinically tried, refined and soft marketing intangibles are also created. Even if there is no vertical segregation as claimed by TPO, we find there is a major functional difference. While assessee does analysis and passes it on to its AE for product development, TCG develops the products itself. This fundamental functional difference cannot be ignored. To quote from TCG's annual report for FY 2006-07:

"The year was eventful for the company in several ways including:

- Company winning recognition as the **Best Discovery Chemistry CRO** in Asia from one of the world's largest pharmaceutical companies.
- Progress towards winning a fully integrated drug discovery research program from a US pharmaceutical company.

- Expansion of service offerings.

Infrastructure:

During the year, your company decided to expand facilities at Kolkata by adding a six-storied research facility to support chemistry discovery research. The earlier plans for setting up a Greenfield facilities at Pune within the SEZ area have been has been put on hold due to delays in obtaining SEZ notification by International Biotech Park the biotech park authorities at Pune. In addition, the Company decided to expand biology operations by renting space on the second floor of Bengal Intelligent Park where the current biology operations are located.”

Thus, in our view, there is no broad functional similarity between the assessee company and TCG Lifesciences.”  
(emphasis in original)

20. Of the comparables picked up by the TPO, TCG Lifesciences was rejected as there was no functional similarity between it and HRDI. Two of the comparables suggested by HRDI, viz., Crisil and ITDC were considered. While Crisil failed the filter since it had a related party transactions, ITDC was accepted, as far as its market segment was concerned, as a comparable. However, working capital adjustments were not allowed. A direction was issued to the AO to complete the assessment in terms of the above directions by excluding TCG Lifesciences and including ITDC (seg.).

21. It must be mentioned at this stage that the DRP comprises three members, all of whom are CITs. The DRP’s order dated 12<sup>th</sup> July, 2011 attained finality as far as Revenue was concerned. There was no provision in the Act at the relevant time permitting enabling the Revenue to challenge the DRP's order. The resultant position is that:

(i) As far as AY 2004-2005 is concerned the order of the ITAT sending the matter back to the CIT(A) in light of the remand report of the AO for AY 2005-2006 attained finality. That order implicitly accepted the plea of HRDI that it was not into core R&D activities and that the comparables suggested by it based on such functional profile required to be examined by the CIT(A).

(ii) For AY 2005-2006, the remand report of the TPO accepted three of the comparables suggested by HRDI while again implicitly proceeding on the basis that the Assessee was not into core R&D activity.

(iii) The DRP, for AY 2007-2008, accepted ITDC (Seg.) while excluding TCG Lifesciences as comparable.

22. In the above background, the approach of the ITAT in the impugned order for AY 2005-2006 appears to take a contrary view which does not appear to be supported by any of the other findings referred to above. The ITAT appears to have discarded ITDC as a comparable by taking up all of the functions of ITDC whereas only one segment of its activities were offered by HRDI for comparison, viz., the market research segment. Therefore, the conclusion of the ITAT that “ITDC is in entirely different activity bearing no resemblance worth the name with HRDI’s nature of activity, which is R&D” is erroneous as it is not the entire activity of the ITDC which was the subject matter of comparison.

23. The ITAT appears to have ignored the effect of the finality attached to

the DRP's order dated 12<sup>th</sup> July 2011. Merely because the Revenue was not empowered to file an appeal against that order did not mean that its binding nature could be ignored.

24. Strangely the ITAT again picked up three comparables, i.e., National Research Development Corporation Limited, Panacea Biotech and Suven Lifesciences, which had been rejected as comparables by the TPO in its remand report for AY 2005-2006. The CIT(A) has given cogent reasons why the TPO's report ought to be acted upon. The ITAT also appears to have overlooked the fact that an order of another Co-ordinate Bench of ITAT in HRDI's own case for AY 2004-2005 had remanded the matter to the CIT(A), acting on the remand report of the TPO for AY 2005-06. By taking a different view and by again sending to the CIT(A) the entire issue of determining which comparables were best suited for the exercise of determination of ALP, the ITAT was adding to the confusion resulting from contradictory orders.

25. The Court is of the considered view that the ITAT did not have sufficient material before it to come to the conclusion that HRDI was into core R&D activity. That finding of the ITAT would only cause confusion before the CIT(A) in the remand proceedings. On the other hand there was sufficient material in the form of the remand report of the TPO for AY 2005-2006 as well as DRP's order for 2007-2008 to show that HRDI was not into core R&D activity.

26. Accordingly Question (i) is answered in the negative by holding that the ITAT was not justified in concluding that HRDI was involved in R&D

activity and not provision of market support services. The order of the CIT(A), which was reversed by the ITAT, is restored.

27. As far as Question (ii) is concerned, as already noticed the ITAT overlooked the fact that the TPO in his remand report had accepted three comparables suggested by HRDI. The DRP in its order dated 12<sup>th</sup> July, 2011, gave cogent reasons why ITDC should be included as a comparable. This is consistent with the conclusion reached by the CIT(A). Consequently, Question (ii) is also answered in the negative, i.e., in favour of the Assessee and against the Revenue and it is held that the ITAT was not justified in remanding the matter to the CIT (A) on the issue of appropriate comparables.

28. Turning to Question (iii), the ITAT appears to have misunderstood the purport of the submissions made by HRDI before CIT(A) regarding the transfer of the assets from the LO of HRDJ to HRDI. One is the issue of physical transfer of the assets. It appears that this took place in June, 2003 when the assets were shifted from New Delhi to Gurgaon where both the LO of HRDJ and HRDI shared a common office. Thereafter there was no occasion for any further physical transfer of the assets. As far as legal transfer of the assets was concerned it could not have taken place unless approvals from the RBI were obtained both for transfer of the assets which approval was granted on 13<sup>th</sup> July, 2004 and for closure of LO which was granted on 30<sup>th</sup> September, 2004. Till then the Assessee had physical possession of the assets. Therefore, it could not be said that during the AY in question the assets had been put to use for less than 180 days.

29. In the considered view of the Court, the CIT(A) was fully justified in accepting the plea of HRDI for grant of 100% depreciation on the assets transferred to it from the LO of HRDJ. Consequently Question (iii) is answered in the negative, i.e., in favour of the Assessee and against the Revenue. It is held that the ITAT was not justified in remanding the matter concerning disallowance of 50% of depreciation on fixed assets acquired from the liaison office of the parent company.

30. Resultantly the impugned order of the ITAT is set aside and the order of the CIT(A) is restored. The appeal is allowed in the above terms but, in the circumstances, with no orders as to costs.

**S. MURALIDHAR, J**

**NAJMI WAZIRI, J**

**AUGUST 02, 2016**

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