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TPO not justified in recalculating royalty based on his own interpretation of term, 'Net Sales'

In brief

In a recent ruling[1], the Pune Income-tax Appellate Tribunal (the Tribunal) held on the facts of the case that:

- The Transfer Pricing Officer (TPO) erred in re-working the stated value of the international transaction of royalty payment by making changes in the prescribed[2] computation methodology on the basis of his own interpretation of the expression, 'Net Sales' considered for royalty computation purposes;
- The royalty rates between two controlled entities could not be considered as comparable rates under the comparable uncontrolled prices (CUP[3]) method for determining the arm's length price of the royalty payments made by the taxpayer;
- Adjustments were warranted for existence of various transactional differences while computing the arm's length price of similar goods sold to Associated Enterprises (AEs) and third parties under the CUP method.

[1] Akzo Nobel Chemicals (India) Ltd *v.* DCIT [TS-45-ITAT-2014(PUN)-TP]
[2] As per the provisions of provisions of Foreign Exchange Control Manual of RBI

[3] Comparable Uncontrolled Price Method

Facts

- Akzo Nobel Chemicals (India) Limited (hereinafter referred to as 'taxpayer' or 'the Company' or 'ANCIL'), was a subsidiary of Akzo Nobel N.V Netherlands. The taxpayer was primarily engaged in the business of manufacturing and sale of speciality chemicals which acted as polymerization initiators.

- The international transactions between ANCIL and AEs were segregated into (i) Manufacturing segment which comprised of import of raw materials, export of finished goods, import of bulk raw material for trading and repacking and payment of royalty; and (ii) Marketing and Sales support segment, for the purposes of benchmarking under the transaction net margin method (TNMM[4]).

- The taxpayer had entered into a technical collaboration agreement with its AE and paid royalty on net sales at the rate of 5 percent for domestic sales and 8 percent for export sales. These rates were approved by the Government Authorities for a period of seven years. The royalty amounts paid to the AE were computed on 'Net Sales' in accordance with the provisions of Foreign Exchange Control Manual of Reserve Bank of India (RBI).

- During assessment proceedings, with respect to the royalty payment, the Transfer Pricing Officer (TPO) made an addition of INR 9,166,061 by:

  – Rejecting the method adopted by the taxpayer for computing 'Net Sales' for the purpose of computing royalty amount

  – Concluding that the cost of certain raw materials, which were constituent chemicals (not having any value addition during the manufacturing process followed by the taxpayer) and equivalent to the expression of bought out components[5], should be deducted from the sales value to arrive at the 'Net Sales' on which royalty is to be computed;

  – Disregarding the taxpayer's contention that the 'Net Sales' computation adopted by the TPO was in contradiction to the prescribed formula for 'Net Sales';

  – Considering the royalty rate(s) agreed by another group company, i.e. Tianjin Akzo Nobel Peroxides China (TANPC), with its AE as comparable rate(s) for determining the arm's length price of the royalty payment made by the taxpayer;

- As regards transactions pertaining to export of finished goods, in respect of a product 'Trigonox 25C75', which had been sold to the AE as well as to third parties in India, the TPO concluded that an internal CUP existed, and had accordingly made an addition of INR 1,134,000 to the export price of this product sold to the AE (after comparing prices charged to the AEs with those charged to third parties).

- Aggrieved by the TPO's order, the taxpayer moved an application with the Dispute Resolution Panel (DRP). The DRP upheld the TPO's order without providing any cogent reasons.

- Aggrieved by the DRP's order, the taxpayer filed an appeal with the Tribunal.

Taxpayer's contentions

Payment of Royalty

- 'Net Sales' required to be interpreted in accordance with the standard terms and conditions prescribed by the RBI. 'Net Sales' for technology royalty computation[6] was arrived at after deducting the cost of standard bought out components and the landed cost of imported components. As the raw materials consumed by the taxpayer were not akin/ equivalent to bought out components, the cost of such raw materials did not need to be deducted from sales value to arrive at 'Net Sales' value for the purposes of royalty computation.

[4] Transactional Net Margin Method
[5] As referred in the royalty computation prescribed in the provisions of Foreign Exchange Control Manual of RBI

[6] As per Chapter III of the Foreign Direct Investment Policy & Procedures issued by the Department of Industrial Policy & Promotion ("DIPP"), Ministry of Commerce & Industry, Government of India.

- Interpreting 'Net Sales' in a different manner was beyond the TPO's jurisdiction.

- Clarifications obtained from Department of Industrial Policy and Promotion (DIPP) supported the stand adopted by the taxpayer for computing 'Net Sales' for the royalty computation.

- As per Indian Transfer Pricing Regulations[7] (ITPR), for applying the CUP method, the prerequisite was that a controlled transaction needed to be compared to a comparable uncontrolled transaction. Thus, payment of royalty @ 5 percent by TANPC to its AE, which was a controlled transaction, could not be considered as uncontrolled comparable price within the scope of CUP method. Moreover, the following differences in the technology collaboration agreement entered into by the taxpayer with the AE and the corresponding agreement between TANPC and the AE would result in rejection of CUP method[8]:

  – Period - Taxpayer's agreement is for a period of 7 years whereas TANPC's agreement if for 20 years

  – Products – Taxpayer's agreement has 22 products mentioned in the agreement whereas TANPC's agreement has 33 products.

Export of finished goods

- CUP method could not be considered as the most appropriate method on account of the following transactional differences, for which reliable and accurate adjustments could not be made between the two sets of transactions under comparison:

  – Volume difference

  – Geography differences

  – Difference in risk profiles

  – Functional differences

Tribunal Ruling

Payment of Royalty

- The action of the TPO in re-working the amount of royalty based on his interpretation of 'Net Sales' was incorrect and impermissible.

- The terms and conditions of the royalty agreement used for computing the royalty amount were approved by the Government of India and it was mandated for the taxpayer that the calculations of royalty be subject to the relevant provisions of Foreign Exchange Control Manual of RBI.

- Further, leveraging on the principles laid down by Delhi High Court in the case of EKL Appliances Ltd.[9] , which in turn leveraged on the OECD guidelines, the Pune Tribunal held that in the facts of the case of the Taxpayer , TPO had to examine the international transactions as entered into by the taxpayer, and should not have disregarded the actual transaction.

- The Tribunal took cognizance of the fact that the entire gamut of royalty payment by the taxpayer to the AE was in accordance with the Foreign Technology Collaboration agreement, which was duly approved by Government of India in accordance with its policies which were applicable across the spectrum (i.e. to all enterprises in the country).

- Accordingly, the Tribunal held that the TPO was not justified in recalculating royalty based on his own interpretation of term 'Net Sales' as the 'Net Sales' formula considered by the taxpayer was not found to be inconsistent with, or violative of, the respective Government or RBI guidelines.

- The Tribunal held that bought-out components meant such material on which no further processing was required and were directly fitted into the final

[7] Rule 10B (1) of the Income-tax Rules, 1962 ("Rules")
[8] Per principles laid down by Hon. Pune Tribunal decision in case of Kirloskar Ebara Pumps Ltd 47 SOT 20

[9] CIT *v.* EKL Appliances Ltd. [2012] 345 ITR 241 (Del)

product. In this regard, the Tribunal stated that the relevant raw materials in the instant case, which were classified as constituent materials by TPO, underwent processing and were irretrievable once the final product was manufactured, and hence these raw materials could not be equated with bought-out components.

- With respect to application of CUP method by the TPO for benchmarking the royalty transaction, the Tribunal held that the comparable transaction picked by the TPO was a controlled transaction and could not be considered for comparability analysis under the CUP method. In addition to the same, the Tribunal also held that on account of differences in the agreement period and the list of products covered in the two agreements, the royalty rates of TANPC could not be considered.

Export of finished goods

- The Tribunal held that there was no infirmity on the TPO's part in invoking the CUP method because identical products were sold to the AE and to third parties. However, the Tribunal held that certain level of adjustments were required to be made to the comparable uncontrolled price considered by the TPO for comparison purposes. The following were the differences for which an adjustment should have been made:

  – volume of sales;

  – export to AE *vis-a-vis* domestic sale to third party being to the direct customer (difference in position in the value chain);

  – a portion of the profit being retained by the AE for its functions performed;

  – the benefit on account of export linked schemes;

  – incurrence of marketing/ selling cost on domestic sales;

  – difference in credit terms; etc..

- Accordingly, the Tribunal considered the adjusted price of INR 300 per kg (on *ad hoc* basis) instead of INR 365 per kg, i.e., the price at which goods were sold to third parties, for computing the arm’s length price for Trigonox 25C75.

PwC observations

The ruling by the Pune Tribunal is a landmark ruling setting the precedent which will enable taxpayers to challenge intervention by tax authorities in royalty computation methodologies prescribed by another Government Authority. The Ruling also reiterates the principle that the TPO has to examine international transactions as have been entered by the taxpayer. Further, with respect to export of finished goods, it would have been more appropriate to reject the application of CUP method on the premise that reliable and accurate adjustments could not be made to nullify the impact of transactional differences on the price of a particular product, rather than making adjustments on *ad hoc* basis.

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