

Royalty payout upheld – taxpayer not a contract manufacturer

Relevant facts and the Tribunal's ruling

Samsung India Electronics Private Limited¹ (the taxpayer) paid royalty to Samsung Electronics Company Limited, Korea (Korea AE). Royalty was paid (@ 8%) on sales to AEs as well as on sales to non-AEs. The TPO held that the taxpayer is a contract manufacturer. On this basis, the TPO objected to royalty paid on export sales to AEs, and determined its arm's length value as Nil. The DRP upheld the findings of the TPO. Aggrieved, the taxpayer appealed to the Tribunal.

The Tribunal agreed with the taxpayer that it operates as a full-fledged licensed manufacturer and not as a contract manufacturer. The Tribunal eventually held in favour of the taxpayer and deleted the adjustment. In doing so, the Tribunal primarily relied upon the submissions made by the taxpayer, of which the following are noteworthy:

- The FAR profile of the taxpayer is similar for sales made to AEs and those made to non-AEs.
- Sale prices and terms agreed to with AEs are driven by open market conditions, and are dependent on the outcome of negotiation between the AEs and the taxpayer. Further, if the taxpayer obtains better terms from non-AEs, then it will transact with the non-AE, just like any prudent businessman.
- “Contract manufacturer” has not been defined under the Income-tax Act, 1961. Accordingly, the definition of contract manufacturer, as per OECD Guidelines (para 7.40), was relied upon. Para 7.40 reads as follows:-

“7.40 Contract manufacturing is another example of an activity that may involve intra-group services. In such cases the producer may get extensive instruction about what to produce, in what quantity and of what quality. The production company bears low risks and may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a service, and the cost plus method could be appropriate, subject to the principles in Chapter II. ”

The Tribunal stated that in the instant case, Korea AE keeps a close watch on the quality of the raw-material and the production process. However, it does not determine the quantity of production and the terms of sales. Further, there is no assurance that the entire production of the

taxpayer will be purchased.

- AE sales were to fellow subsidiaries, for which royalty was paid to Korea AE. Owing to the fact that the taxpayer sold to other AEs, Korea AE cannot be deprived of its right to earn an arm's length return on such sales, in return for the R&D investments it has made over the years.
- As per OECD Guidelines (para 6.17), in some circumstances, price of intangibles may be included in price of goods transacted with AEs and consequently, any additional royalty paid by the buyer would have to be disallowed. However, in the instance case, the TPO has accepted the transaction value of purchase of raw material and consumables to be at arm's length using TNMM.

PwC observations

It has been rightly held that Korea AE cannot be deprived its right to earn an arm's length return for the R&D investments made by it. However, the important question is "who should pay the royalty?". Royalty would not be paid by a contract manufacturer. Instead, it should be paid by the entity which exploits the intellectual property and also retains the residual profits arising from such exploitation and manufacturing (i.e., a licensed or an entrepreneur manufacturer).

In the instant case, while agreeing that the taxpayer is a licensed manufacturer, and also upholding its royalty payout, the Tribunal acknowledged two factual aspects, viz., similarity in FAR profile of the taxpayer w.r.t. AEs and non-AEs; and the negotiated and market driven nature of prices to AEs. These are certainly notable observations in the context of a licensed manufacturer. However, the key lies in a taxpayer's ability to demonstrate these.

Separately, when evaluating the transaction of royalty, the Tribunal's reference to OECD Guidelines (para 6.17) is pertinent, as it highlights an important consideration when pricing intangibles.

¹

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