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No disallowance of Royalty paid to AE as a percentage of sales on ground that no benefit was derived by payment of Royalty.

Summary – The Delhi bench of the ITAT has recently pronounced a decision in the case of Samsung India Electronics (P.) Ltd, (the Assessee) and held that where TPO accepts arm's length nature of royalty paid to AE (foreign parent company) on third party sales as a % of sales, he cannot disallow royalty paid to AE at same % on AE sales on the ground that no benefit was derived from royalty on AE sales as AE sales are sale by assessee to itself.

Facts

- The Assessee paid royalty of 8% of sales to its foreign parent on both domestic sales and export sales irrespective of whether sales were to AEs or non-AEs. The TPO disallowed royalty paid on export sales to AEs by holding that the position of the assessee company with regard to manufacturing for the AEs is that of a Contract Manufacturer. The assessee company is purchasing raw material from the AEs and thereafter manufacturing goods in India and then part of it is exported to AEs. The TPO opined that the royalty paid as a percentage of sales to the associated enterprise is not at arm's length because it amounts to collecting royalty on the sales to itself.
- TPO opined that whether the sales of the assessee are made within India to its AE or to the parent company does not make much difference to the principles of arm's length transactions.
- TPO further observed that in some circumstances the price of intangibles may stand included in price of goods either sold by the associated enterprises or purchased from the associated enterprise by the related party. In such circumstances, associated enterprises may build in value of intangible in cost of goods transacted. In this regard, TPO referred the OECD guidelines.
- TPO observed that the assessee had not been able to demonstrate as to the benefit it has derived from the payments of royalty. No independent party would enter into such kind of contract in which royalty is being paid to the AE to whom export of goods are being made.
- The TPO treated the above arrangement as a transfer of profits out of India in the garb of royalty and held that the payment of royalty to the extent of Rs.266,81,794/- in the international transaction is treated to be a payment against services having arms length value being NIL.
- The DRP agreed with the action taken by the TPO.

Held

- The ITAT held that the TPO in his order has not doubted the benefits received by the assessee from payment of royalty.

- By accepting the arm's length nature of royalty paid on sales made to third parties, the TPO has also implicitly accepted the benefit derived by the appellant by making royalty payment (irrespective whether it is made to group companies or third parties).
- The ITAT held that the statement of TPO that the appellant has not been able to demonstrate the benefit is baseless. Further, para 6.17 of OECD Guidelines states that in some circumstances, the price of the intangibles may stand included in price of goods transacted with AEs and consequently, any additional royalty would have to be disallowed in the case of the buyer. The TPO has not provided any specific reason for placing reliance on this paragraph of the OECD guidelines.
- The TPO has also not demonstrated any facts or circumstances substantiating that the transfer price of goods include license charge/ royalty and therefore, any additional payment for intangibles needs to be disallowed.
- It is the submission of the assessee that royalty is paid by the assessee to foreign parent company for the receipt of technical knowhow and expertise. The Assessee cannot carry out manufacturing activity, (either in the export markets or the domestic market), without access to the technical know-how and expertise developed by foreign parent company - this issue has not been cogently rebutted by the TPO or the Ld. Departmental Representative.
- Therefore, there is considerable cogency in the assessee's submission that assessee operates as full-fledged licensed manufacturing company and not as a contract manufacturer.
- Further, it has been submitted that export sales made by the assessee to group companies are also driven by open market conditions just as sales made by the assessee to unrelated parties. This fact has not been controverted by the TPO and Ld. Departmental Representative.
- There is considerable cogency in the assessee's submissions that owing to the fact that the assessee has made some sales to some other overseas group companies, its foreign parent company cannot be deprived of its right to earn an arms length return on these sales, in return for the R&D investments it has made over the years.
- The learned counsel of the assessee has submitted that the sale prices to the AEs are determined by market force and not dictated by the foreign parent company. In the relevant assessment year only a small portion of assessee's total sales are to AEs. The other sales are to non AE's and in such circumstances; the assessee cannot be termed as contract manufacturer.
- The ITAT held that the Revenue authorities have not been able to bring on record any evidence that assessee is mandated to sell goods to overseas group companies in any manner.
- The TPO has also ignored the crucial fact that in the instant case, the basis of payment of royalty is not lump sum but on a percentage of per unit basis of sale. It is same whether the sales are domestic or export sales. For even export sales made to third parties royalty is being collected by foreign parent company at the same rate.
- TPO in his order has not doubted the benefits received by the assessee from the payment of royalty.
- Thus, in these circumstances, the statement of the TPO that assessee has not been able to demonstrate the benefit is not sustainable and accordingly the assessee's appeal was allowed.