

## Adhoc disallowance of royalty was unjustified if TPO failed to propose adjustments as per TP provisions

**Summary – The Pune ITAT in a recent case of John Deere India (P.) Ltd., (the Assessee) held that where TPO had not proposed adjustment as per procedure laid down under transfer pricing provisions, there was no merit in adhoc disallowance of royalty**

### Facts

- The TPO made an adjustment to the value of international transactions relating to export of tractors to the AEs. No other transfer pricing adjustment was made in respect of any other international transactions undertaken by the assessee including payment of royalty. He issued show cause notice to the assessee, wherein it was pointed out that the assessee was paying royalty on all products including old products as well as exports. He was of the view that the payment on old products was not justified. He further stated that though the royalty expenses were considered earlier, since CPM was applied to internal comparables in both of the segments, separate adjustment on account of royalty was called for. Thus, on the principle that further royalty was not justified on old products, adjustment was proposed.
- In reply to the show cause notice, the assessee submitted that royalty had already been considered as expenses in CPM applied and further addition would result in double adjustment.
- The TPO held that the same was not correct as the royalty was paid at the rate of approximately 3 per cent on both the domestic and export sales. He was of the view that it would have no bearing on internal comparability of difference in cost plus mark up of the two segments. Further, since the adjustment was being made in respect of export of tractors, no separate adjustment was made in respect of royalty by the TPO.
- The DRP asked the TPO to make certain verifications.
- The Assessing Officer in the final assessment proceedings deleted the TP adjustment. However, he observed that the question of double adjustment with respect to royalty payment did not arise. Since the show cause notice had already been issued to the assessee and its submission in response to the same was on record, he held that the said adjustment in respect of royalty needed to be made and the same was added back to the total income of the assessee.
- On appeal:

### Held

- It was incumbent upon the TPO to follow the provisions of the Act in order to benchmark the said transaction of payment of royalty and whether it warrants any adjustment on account of arm's length price. The TPO is at liberty to make any separate adjustment on this account, where adjustment is made in respect of any other international transaction. However, the TPO is not empowered to propose an adhoc adjustment which admittedly, is not as per law. The objection of the TPO was that the assessee is paying royalty to associated enterprises both on old products and

new products and as per the TPO, the payment of royalty on old products does not appear to be justified. It is not the role of TPO to determine whether the payment of royalty is justified or not, on adhoc basis but the arm's length price of same has to be determined by following the procedures laid down in the Income-tax Act. The TPO has failed to do so. Further, since the TPO had not proposed the adjustment as per the Act, there was no occasion for the assessee to raise any objections before the DRP and hence, the order of DRP is silent on this issue. The Assessing Officer while passing final assessment order under section 144C(13) has made the said addition in the hands of assessee on the ground that show cause notice was issued by the TPO in this regard and the assessee had already replied. However, such adhoc disallowance of royalty is not warranted by applying the provisions relating to transfer pricing. The procedure laid down under the transfer pricing provisions has not been followed by the TPO and hence, there is no merit in the adhoc disallowance of royalty. In any case, as is evident from the order of TPO relating to assessment year 2010-11, the assessee has also undertaken the international transactions of payment of royalty to its associated enterprises in the succeeding year also and that transaction has been accepted to be at arm's length. The revenue has failed to point out any difference in factual aspects *vis-à-vis* payment of royalty in the instant assessment year and in the succeeding year. In *Spicer India Ltd. v. ACIT* [IT Appeal No. 251 (Pune) of 2014], wherein there was similar case of payment of royalty where the TPO has violated the provisions of the Act and proposed the TP adjustment, but no separate adjustment was made on account of another adjustment and the same was subsumed in that; wherein the other TP adjustment was deleted by the DRP and the Assessing Officer in the final assessment order proposed the TP adjustment on account of royalty. Such procedure has not been followed by the TPO/Assessing Officer in the present facts and accordingly, it is held that there is no merit in the adhoc disallowance.

- Where the royalty has been paid by the assessee at a rate lesser than 3 per cent as against which the RBI has approved the rate at 3 per cent for payment of royalty, then the same is at arm's length. Accordingly, it is held that where the payment of royalty by the assessee to its associated enterprises is at rate less than 3 per cent, then the same is liable to be considered at arm's length rate and no addition is warranted on this account.