

ITAT remanded matter as TPO had characterized distribution agreement as a service agreement

Summary – The Hyderabad ITAT in a recent case of Comm Vault Systems (India) (P.) Ltd., (the Assessee) held that where assessee had entered into an agreement with its AE to distribute product of AE in India, and TPO had characterized said agreement as a service agreement and had held that a mark-up on operational cost was to be made to determine ALP, since transaction was a distribution transaction and not service agreement, TP analysis had to be done afresh

Facts

- The assessee had entered into an agreement with its AE to distribute the product of the AE in India, *i.e.*, software, a scalable unified data and information management software designed to replace several products. The products were supplied to the assessee free of cost and sales were made by the assessee to domestic parties.
- The TPO, however, was not convinced with the assessee's explanation. He held that even though the cost price to the assessee was '*nil*', the product had a price and that the sales were made on behalf of the AE and that the assessee-company should be compensated by way of a suitable mark-up. Thus, he was of the opinion that the arrangement was nothing but in the nature of service agreement requiring a mark-up.
- The assessee furnished its reply stating that the assessee was only acting as a captive distributor and was not distributing on behalf of its AE. In addition thereto, the assessee also furnished a fresh search for comparables which resulted in 11 companies.
- The TPO carried out a fresh search for comparables and short listed 4 companies as comparables whose average margin was 1.26 per cent as against the margin of the assessee at (-) 81.54 per cent. Thereafter, he proposed the ALP adjustment. The Assessing Officer, accordingly, proposed the adjustment in the draft assessment order.
- The assessee filed its objections before the DRP, but the DRP confirmed the adjustment and the final assessment order was passed.
- The assessee, submitted that the agreement between the assessee and its AE was distribution agreement, but the TPO had characterized agreement as a service agreement and had held that a mark-up on the operational cost was to be made to determine the ALP.

Held

- The assessee has reported as to why no TP analysis was undertaken for the distribution activity and has relied upon the provisions of section 92(3).
- Thus, from the recitals in the agreement, it can be seen that the intention of the parties is clear that the assessee shall be a distributor of AE's products in India.
- In the *instant* case, there is no difference between the form and substance of the transaction of distribution to recharacterise the transaction as a service agreement. As per the agreement, the AE

is entitled to a specified percentage of the distributor's sales revenue less operating costs/expenses of the distributor. Since the assessee had no revenue left after reducing the operating cost/expenses, the AE was not paid any percentage. The revenue generated by selling the goods is retained by the assessee. The TPO had instead computed the mark-up on the operating cost of the assessee to determine the ALP and brought the notional income to tax which is not justified. Therefore, the additional grounds of appeal are allowed.

- It is the contention of the assessee that if the transaction is taken as distribution as agreed to between the parties, then the TP analysis would go to increase the loss. If the provisions of section 92(3) would apply, then the provisions of sub-sections (1) and (2A) of section 92 would not be attracted. Since, the transaction was a distribution transaction and not service agreement, then the TP analysis had to be done afresh and then it has to be seen if the provisions of section 92(3) would apply.