IN THE INCOME TAX APPELLATE TRIBUNAL,
CHENNAI D BENCH, CHENNAI

[Coram: Pramod Kumar AM and G Pavan KumarJM]

I.T.A. No. 771/CHNY/2016
Assessment year: 2011-12

Orchid Pharma Limited **.....Appellant**
(earlier known as Orchid Chemicals and Pharmaceuticals Ltd)
Orchid Towers 313, Valluvarkottam High Road,
Chennai 600 034 [PAN: AAAC00402B]

Vs

Deputy Commissioner of Income Tax
Co Circle 5(1), Chennai **.....Respondent**

Date of concluding the hearing : November 3, 2016
Date of pronouncing the order : November 30, 2016

Appearances by:

T Banusekar *for the appellant*
S Bharat *for the respondent*

O R D E R

Per Pramod Kumar AM

[1] This appeal, filed by the assessee, calls into question correctness of the order dated 26th February 2016 passed by the Assessing Officer under section 143(3) r.w.s. 144C (13) of the Income Tax Act, 1961, for the assessment year 2011-12.

[2] Ground no. 1 is general in nature and it does not call for any adjudication by us.

[3] In the second ground of appeal, the assessee has raised the grievance to the effect that the authorities below ñ**erred in confirming that the Distribution Partners (DPs) are deemed AEs u/s 92A(2)(i) of the Income Tax Act, 1961".**

[4] To adjudicate on this appeal, a few material facts need to be taken note of. The assessee before us, to use the words of the Transfer Pricing Officer, is ña global pharmaceutical company with established research, manufacturing and marketing capabilitiesò. It produces active pharmaceutical ingredients (APIs) and finished dosage forms (FDFs), including formulations, and sells them around the world. While the assessee has a strong presence in the less regulated markets like India, China, Latin American and CIS countries, Far East Asia, Africa and Middle Eastern countries, the assessee is increasingly focussing on well regulated markets like USA, Canada, Europe and Australia. It is in this context perhaps that the assessee had entered into distribution channel arrangements with certain entities which is well entrenched in these markets and are in a position to market the products of the assessee. In certain cases, one more entity, which assists is developing the products for the related market, is also roped in. The way this business model works is that the profits are worked out by reducing, from sale realization from the end customer, cost of products sold and the marketing costs, and the profits so worked out are shared, in an agreed ratio, between the parties to this arrangement. As for the cost of goods sold, it is an agreed amount between the parties, and in that sense, rather than being the precise cost of goods sold, it is a notional price which is taken as, by the parties, cost of goods sold. Out of the total sales of Rs 1,57,512.88 lakhs, total exports of the assessee is Rs 1,32,549.88 lakhs out of which total exports, though distribution partner, is only Rs 7,452.15 lakhs. In percentage terms thus, the exports through this distribution partner channel works out to under 5% of total sales and under 6% of total exports. In the relevant previous year, the assessee was in an agreement with Northstar Healthcare Ltd, a non resident company with its principal place of business in Cork, Ireland (**Northstar**, in short). In terms of the said agreement, the Northstar was to pay, in addition of the agreed price which was defined as ócost of goods soldô in the said, fifty percent of excess of sale price realized by Northstar from end customers of such products plus marketing costs over the agreed price i.e. cost of goods sold as specified in the agreement. The additional payments, over and above the agreed price, was thus worked out as follows:

Price at which Northstar sells the products to the end customer	a
Minus**:** Marketing expenditure actually incurred by Northstar	b
Reference Price	a-b

Minus: Agreed price i.e. cost of goods sold, as specified in the agreement	c
Excess of sale price realized by Northstar over the cost of goods sold (i.e. agreed price) and marketing exps incurred by Northstar i.e. profit through Distribution channel	**(a-b) – c** or, **a – (b+c)**

Profit through distribution channel to be shared Equally between the assessee and the Northstar

Northstar	**50%**
The assessee	**50%**

In effect thus, the realization by the assessee, with respect to its sales, under the aforesaid agreement was agreed price (i.e. agreed cost of goods sold under the contract), plus 50% of the profits from distribution channel mechanism

[5] On somewhat similar lines, the assessee also had a tripartite agreement with Northstar and another non-resident by the name of Actavis Elizabeth LLC, USA (**Actavis**, in short). Under this arrangement, Northstar was to do distribution channel marketing and distribution arrangement, Activas was to do necessary research and development work and the assessee was to manufacture the products. The distribution channel profit were to be computed in the same manner as illustrated above, but the sharing of distribution channel profit was to be done as follows- Northstar 50%, Activas 25% and the assessee 25%.

[6] On these facts, the Transfer Pricing Officer was of the view that the assessee and its distribution partners (namely Northstar and Activas in this year) were associated enterprises under section 92A(2)(i). The legal provision relied upon provides that ñ**For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year…….(i) the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise**". The Transfer Pricing Officer relied upon the findings of the Settlement Commission, vide order dated 28.3.2012, for the assessment year 2006-07 to 2010-11. This order takes note of the statement of Shri Krishnan, CFO of the assessee company, to the effect that selling prices are

determined exclusively by the distribution channel partners and the assessee has no control or influence over the matter. It is also noted that these distribution channel partners exercise substantial control, in the form of management committees and executive committees etc. inasmuch as even sourcing of raw material is subject to approval by such committees. This influence is not only on the existing products but also on what products the assessee is to develop in future. It is in the background of these observations that the Settlement Commission held that the assessee and the distribution partners, including Northstar, were associated enterprises. Since the Transfer Pricing Officer has simply relied upon the order of the Settlement Commission, and, to that extent, adopted the reasoning taken by the Settlement Commission, we consider it appropriate to reproduce the relevant observations in the said order:

> ***Export to Distribution Partners***
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> ***2.2.4.3 The first objection of the Applicant is that the Department has not been able to establish that the Distribution Partners (DPs) and the Applicant are "Associated Enterprises". It has been argued that the sub-section (2) of Section 92A can come into play only if sub-section (1) is satisfied. It is submitted that Section 92A(1) requires direct/indirect participation in the management / control / capital of one enterprise of the other and such participation in management/control/capital should be at the enterprise level and not at the transaction level. It is the case of the Applicant that, in its case, it has not been established that there is any participation at enterprise level and only influence at transaction level has been attempted to be established.***
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> ***2.2.4.4 This argument of the learned A.R. is not acceptable as sub-section (2) of Section 92A is a deeming provision and the Applicant and the DP have been considered be "Associated Enterprises" under Section 92A(2)(i). In our view, Section 92A(1) specifies what "Associated Enterprises" means and lays down the conditions which should be satisfied for treating an enterprise as an "Associated Enterprise". On the other hand, sub-section (2) contains the deeming provisions. It has specified certain situations where two enterprises shall be "deemed" to be "associated enterprises". In other words, if an enterprise is not directly covered by Section 92A(1), it can still be deemed to be an "Associated Enterprises" if any one of the conditions specified in sub-section (2) of Section 92A is satisfied.***
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> ***2.2.4.5 The next objection raised by the learned A.R. is that clause (i) of the sub-section (2) of Section 92A is not satisfied by the Applicant and hence it cannot be deemed to be an "associate enterprise" of the Distribution Partner (DP). In support of this contention the Applicant has raised two objections. According to the learned A.R. clause (i) specifies that 100% of the goods manufactured or processed by one enterprise are sold to the other enterprise which is not a fact in the***

Applicant's case and secondly the prices and other conditions relating thereto are influenced by such other enterprise. He stated that, in the Applicant's case, the prices and other conditions are not influenced by the DPs.

2.2.4.6 (a) We are unable to agree with the learned A.R. on this ground also. His argument is that, while percentages are mentioned in other clauses, it is not specified as to which percentage of the goods or articles manufactured or processed by one enterprise are required to be sold to the other enterprise for the applicability of the clause. He also stated that the use of the article "the" in the provision also indicates that the entire or 100% of the goods manufactured or processed by an enterprise are required to be sold to the other enterprise if the provisions of the clause are to come into play. We are of the considered view that such is not the position. Clause (g), (h) of (i) of Section 92A(2) relate to "control" as envisaged in Section 92A(1). In clause (g) the word "wholly" has been mentioned. In clause (h) the phrase "90% or more" has been used. Hence, if it had been the intention of the legislature that 100% of the goods or the whole of the goods manufactured or processed by one enterprise were to be sold to the other enterprise, the clause would have specified that situation. In other words, in the Applicant's case, it is sufficient if only a part of the goods manufactured by it are sold to the DPs because, in our opinion, the emphasis in the clause are on the words "the prices and other conditions relating thereto are influenced by such other enterprises". The sale of goods or articles is only a condition which should precede the influencing of prices and other conditions. In other words, even if 1/2% of goods or articles manufactured or processed by one enterprise is sold to the other enterprise (as long as they are manufactured or processed by the enterprise concerned) clause (i) would still come into play if the prices and other conditions relating to the sale are influenced by the other enterprise. The quantum of sales (%) has no relevance as long as the other limb of the clause (viz. "influence" on prices and other conditions) is satisfied.

(b) We would like to point out one more aspect. In our view, in the situations sought to be covered by clause (i) of Section 92A(2), what is imperative to be established is that there is an influence on 'sale price and other conditions' -- the quantum or percentage of sale is immaterial. This is because it is this "influenced price" which would be required to be adjusted to determine the arms length price. This must have been another intention of the legislature in not specifying a percentage in clause (i) unlike what has been done in some of the other clauses of Section 92(A)(2).

2.2.4.7 The second objection of the learned A.R. is that the DPs are not in a position to influence the prices and other conditions relating to the sale of goods by the Applicant.

2.2.4.8 We are unable to agree with this proposition. The amount which the Applicant ultimately receives for the products supplied by it to the DPs (subsequently sold to the end customers) consists of two components. The first component constitutes the cost of manufacturing such products and the second component is the 50% share of profit

computed after deducting the marketing cost from the selling price to the ultimate customer. Though the Applicant contended that the selling price is determined jointly by itself and the respective DPs, this contention is not borne out by the facts. We find that the final price (at which the goods are sold to the end customers) is exclusively decided by the DPs. As has been argued before us, it is possible that this price may be influenced by market forces. However, the fact remains that the ultimate determination of the price is done by the DPs. In other words, market forces may influence the judgement of the DPs but do not determine the final selling price as such determination remains the exclusive prerogative of the DPs. Thus, in effect, the amount which the Applicant ultimately gets by way of 50% share of the profits is also determined by the DPs. The share of profits + cost of manufacturing/marketing - both constitute the selling price of the Applicant's products to the DPs which is fully influenced and in fact is determined by the DPs.

2.2.4.9 In this context we would like to refer to the Applicant's agreement with Par Pharmaceuticals. Clause 4.4.1 of that agreement clearly states that the element of responsibility and decision making control with regard to marketing and pricing of the products shall belong solely with Par Pharmaceuticals. There are similar stipulations in the agreement with North Star Healthcare Ltd……. Relevant clauses of those agreements with the Applicant are reproduced as under :-

> ***Agreement with NHL***
>
> ***"Clause 6.1 Prices: NHL shall pay to Orchid for each Product supplied a Price in an amount equal to the Cost of Goods Sold, plus fifty percent (50%) of the difference between the Reference Price less the Cost of Goods Sold. The current Cost of Goods Sold for each Product is set forth on Schedule 2 attached hereto next to such Product. There shall be no increase in the API Conversion Cost nor the Finished Dosage Form Conversion Cost during the initial three (3) year term of this Agreement. Any increases thereafter will be discussed between Orchid and NHL in good faith based on market conditions and such increases will be subject of NHL approval. If, in connection with the half-yearly analysis, it is determined that the Cost of Goods Sold as set forth in Schedule 2 are less than or greater than the actual Cost of Goods Sold, then Schedule 2 shall be amended to reflect such new Cost of Goods Sold for the six (6) month period following such half-yearly inspection and thereafter, unless further revised pursuant to this Clause 6.1."***
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> ***"Clause 2.10 Half-Yearly Cost Analysis. Within thirty (30) days of the end of each half-year anniversary of the Effective Date, Orchid shall submit to NHL a detailed breakdown of Cost of Goods Sold. NHL shall have the right upon providing at least two (2) weeks advanced written notice (but no more than twice per year) to audit the books and records of Orchid during normal business hours to verify the accuracy of the analysis: provided however, that NHL shall have the right to audit such books and***

records of Orchid solely to the extent they relate to the subject matter of this Agreement. In the event that Orchid and NHL disagree with respect to any such analysis, the senior accounting executives of both Orchid and NHL shall meet and attempt in good faith to resolve any disputed matters".

2.2.4.10 As we have stated earlier, though such selling prices may be relatable to prevailing market forces, this does not neutralize the control of the DPs as the decision to finalise the sale price to the end customers remains with the DPs. The final selling price so determined is merely communicated to the Applicant. In fact, the Applicant has admitted that it has no mechanism for verifying if the final selling price has been fixed correctly or not and it accepts the selling price fixed by the DPs in good faith.

2.2.4.11 We also find that the DPs also influence "and other conditions relating thereto" as contemplated in clause (i) of Section 92A(2). Such control is exercised by the DPs for the entire value chain of the products concerned. The DPs have influence in deciding which products are to be developed, the production plan and the manufacturing process. They also have the sole discretion to reject the products supplied to them. The agreements with the DPs contain provisions for having joint committees for taking certain decisions relating to production and other activities.

2.2.4.12 In view of the above, we are satisfied that the Applicant is covered by clause (i) of sub-section (2) of Section 92A and thus can be deemed to be an associate enterprise of the DPs for the purpose of Section 92A(1). The provisions of Transfer Pricing, therefore, would come into play.

2.2.4.13 Here we would like to discuss the argument of the Applicant that, though there are similar agreement of one of the DPs (North Star) with other Indian companies, the Department has not initiated any transfer pricing proceedings in the hands of such Indian companies. It is contended that since the DP concerned (North Star) is sharing profits at 50:50 (i.e. in the same ratio as with the Applicant) with the other Indian companies, the same ratio should be accepted as reasonable in the Applicant's case also. The Department had been directed by us to make enquiries in this respect and report the findings. The Department has made enquiries and reported to us that it is true there are similar agreements of North Star with a few other Indian pharmaceutical companies and such agreements are on the same lines (sharing of profit in addition to recovery of cost, etc.). However the learned CIT-III has also pointed out that, just because no transfer pricing proceedings have been initiated in other cases, it does not mean that the issue cannot be considered in the Applicant's case on merits. We agree with the contentions of the learned CIT-III. It is not the case of the Applicant that enquiries in respect of transfer pricing issue have been made in the case of those Indian pharmaceutical companies and then dropped. The issue has not at all been examined by the Department in their cases. Apparently the transactions of such pharmaceutical companies with the North Star have not been reported by them as an international transaction in the report in Form 3 CEB under Section 92E. In fact, even

> ***the Applicant had not reported the transactions with the DPs as an international transaction. It is only subsequent to the directions u/s 245D(3) given by us that this issue has been examined and it has been found that the transaction in question were actually international transactions and that the DPs and the Applicant were "Associated Enterprises". Therefore, it is irrelevant that the transfer pricing issue has not been considered in the hands of the other Indian pharmaceutical companies though they have similar agreements with one of the DPs of the Applicant.***

[7] It is on the basis of the aforesaid reasoning of the Settlement Commission that the Transfer Pricing treated Northstar and Actavis as associated enterprises of the assessee. The TPO, inter alia, observed that ñ**There is no need to give a separate finding on the objections raised** *(which included objections against Northstar and Activas being treated as AEs)* **since they have been adjudicated by a higher forum**ò and that ñ**since the facts have not undergone any change for this year, it is desirable to stick to the same stand**é ò When assessee raised the objection before the Dispute Resolution Panel, against the Assessing Officer proposing to make ALP adjustments by treating Northstar and Activas as AEs of the assessee, the DRP also confirmed the stand of the TPO by simply brushing aside all these submissions and rather mechanically giving a one sentence decision to the effect that ñ**In view of the justification given by the TPO and completing the TP adjustment following the decision of Hon'ble Settlement Commission, the objections of the assessee cannot be accepted**ò The assessee is not satisfied and is in appeal before us.

[8] We have heard the rival contentions, perused the material on record and duly considered facts of the case in the light of the applicable legal position.

[9] We find that there is no dispute about the fundamental legal position that the decisions of the Settlement Commission do not constitute a binding precedent and, therefore, the only way the reliance of the authorities below, on the order of the Settlement Commission, can be rationalized is that these authorities have adopted the same line of reasoning as adopted by the Settlement Commission in their order dated 28th March 2012. It is in these circumstances, and for the limited purpose of deciding correctness of the impugned ALP adjustments, that we deal with the reasoning adopted by the authorities below. As we do so, we may take note of the relevant legal provision, i.e. 92A, as follows:

Meaning of associated enterprise.

92A. (1) ***For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, "associated enterprise", in relation to another enterprise, means an enterprise—***

> *(a)* ***which participates, directly or indirectly****, or through one or more intermediaries****, in the management or control or capital of the other enterprise****; or*
>
> *(b) in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.*

(2) ***For the purposes of sub-section (1), two enterprises shall be deemed to be associated enterprises if, at any time during the previous year,—***

(a) one enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in the other enterprise; or

(b) any person or enterprise holds, directly or indirectly, shares carrying not less than twenty-six per cent of the voting power in each of such enterprises; or

(c) a loan advanced by one enterprise to the other enterprise constitutes not less than fifty-one per cent of the book value of the total assets of the other enterprise; or

(d) one enterprise guarantees not less than ten per cent of the total borrowings of the other enterprise; or

(e) more than half of the board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of one enterprise, are appointed by the other enterprise; or

(f) more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons; or

(g) the manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula

or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights; or

(h) ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise; or

(i) ***the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise****; or*

(j) where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual; or

(k) where one enterprise is controlled by a Hindu undivided family, the other enterprise is controlled by a member of such Hindu undivided family or by a relative of a member of such Hindu undivided family or jointly by such member and his relative; or

(l) where one enterprise is a firm, association of persons or body of individuals, the other enterprise holds not less than ten per cent interest in such firm, association of persons or body of individuals; or

(m) there exists between the two enterprises, any relationship of mutual interest, as may be prescribed.

[Emphasis, by underlining, supplied by us]

[10] A plain reading of this statutory provision makes the legal position quite clear. The basic rule for treating the enterprises as associated enterprises is set out in Section 92A(1). The illustrations in which basic rule finds application are set out in Section 92A(2). Section 92A(1) lays down the basic rule that in order to be treated as associated enterprise one enterprise, in relation to another enterprise, participate, directly or indirectly, or through one or more intermediaries, ñin the management or control or capital of the other enterpriseò or when ñone or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterpriseò . Section 92(A)(2) only

provides illustrations of the cases in which such an enterprise participates in management, capital or control of another enterprise. In other words, what Section 92A (1) decides is the principle on the basis of which one has to examine whether or not two or more enterprise are associated enterprise or not. The principle is, as we have noted above, that one of the enterprise, in relation to other enterprise, participate, directly or indirectly, in the management or control or capital of the other enterprise and that persons who participate in such management, control or capital of both the enterprises are common. As long as an enterprise participates in any of the three aspects of the other enterprise, i.e. (a) management; (b) capital; or (c) control, these enterprises are required to be treated as associated enterprise, as also is the position when common persons participate in management, control or capital of both the enterprises. However, the expression ópparticipation in management or capital or controlô is not a defined expression. To find the meaning of this expression, one has take recourse to Section 92(2) which gives practical illustrations, which are exhaustive and not simply illustrative- as clarified in the Memorandum explaining the provisions of the Finance Bill 2002 which, while inserting the words ñ**For the purpose of sub section (1)** *of section 92A*ò in Section 92A(2), observed that **"It is proposed to amend sub-section (2) of the said section to clarify that the mere fact of participation by one enterprise in the management or control or capital of the other enterprise, or the participation of one or more persons in the management or control or capital of both the enterprises shall not make them associated enterprises, unless the criteria specified in sub-section (2) are fulfilled**ò. In this sense, Section 92A(2) governs the operation of Section 92A(1) by controlling the definition of participation in management or capital or control by one of the enterprise in the other enterprise. If a form of participation in management, capital or control is not recognized by Section 92A(2), even if it ends up in *de facto* or even *de jure* participation in management, capital or control by one of the enterprise in the other enterprise, it does not result in the related enterprises being treated as óassociated enterprisesô Section 92A(1) and (2), in that sense, are required to be read together, even though Section 92A(2) does provide several deeming fictions which *prima facie* stretch the basic rule in Section 92A(1) quite considerably on the basis of, what appears to be, manner of participation in ñcontròof the other enterprise.

[11] As a matter of fact, when we look at all the clauses of Section 92A(2)- barring clause (i) which we shall deal with a little later and clause (m) which is a

residuary clause enabling any other test being prescribed by the Government, the common factor in all these clauses is that all the clauses therein refer to control by one enterprise over the other enterprise- whether by way of participation in capital or in management or through any other mechanism. The situations envisaged by the statue, and the parameters set out by the statute, unambiguously demonstrate the scheme of the Act in this respect. An analysis of Section 92A(2) shows that there are three distinct segments of this sub section- participation in capital, participation in management and participation by way control otherwise. First segment consists of clauses (a) to (d). Clause (a) refer to shareholding with 26% of voting power in other enterprise, clause (b) refers to common shareholding with 26% of voting powers in both the enterprise, clause (c) refers to advance by one enterprise to the other to the tune of 51% or more of the books value of the assets of the latter, and clause (d) refers to one enterprise guaranteeing not less than 10% of borrowings of the other enterprise. In all the four situations above, what is clear is that role played by one of the enterprise in the capital of the other enterprise, whether equity capital or loan capital or even by guaranteeing borrowings by the other enterprise, is so significant that one enterprise has de facto control over the other. The second segment, which consists of clause (e) and clause (f), covers participation in management. Clause (e) refers to the situation in which more than half of the board of directors can be appointed by the other enterprise, and clause (f) enterprise refers to the situation in which more than half of the board of directors of both the enterprise can be appointed by the same person. These two segments thus refer to the participation in the capital and the management. That leaves us with third segment of the basic rule, enshrined in section 92A(1), i.e. ñcontrolò, and interestingly, this expression ócontrolô finds way in addition to the control which is inherent in participation in capital and participation in management. Such a control could either be on account of commercial relationships or personal relationships. In our considered view, third segment, which consists of clauses (g) to (l), refers to the situations in which relationship between the two enterprises is of such a nature that one enterprise has *de facto* control over the other enterprise, and the control is not on account of participation in capital or management. Clauses (g), (h) and (i) refer to the control by one of the enterprise over the other enterprise on account of commercial relationship. Clause (g) refers to a situation in which manufacture or processing of products of one of the enterprise is ñwholly dependentò on certain types of intellectual properties etc owned by the other enterprise or in respect of which such other enterprise has exclusive rights. Clearly, the role of these valuable

inputs is so significant that the enterprise owning or having exclusive rights has *de facto* control over the other enterprise. Clause (h) refers to the situation in which ninety per cent or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by one enterprise, are supplied by the other enterprise, or by persons specified by the other enterprise, and the prices and other conditions relating to the supply are influenced by such other enterprise. Here also the role of the enterprise supplying or controlling the supplies of raw materials and consumables is so significant that it virtually ends up having control over the enterprise. Clause (m), which is at the core of this dispute before us, refers to the situation in which the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise but then interestingly no quantitative threshold finds place in the statute. We will deal with this clause in greater detail a little later but one thing which is immediately discernible is that if this clause is interpreted literally,. even when sales of one enterprise to the other enterprise constitute less than one percent and that other enterprise can influence the prices at which the goods are sold, these two enterprise will be treated as associated enterprises on account of commercial relationship. That is clearly incongruous and infact absurd because the level of commercial relationship, in such a situation, will be so insignificant that there cannot be any ñcontrolò by one of the enterprise over the other, which is a *sine qua non* for invoking the status of associated enterprises under third limb of test laid down by Section 92A(1). Thatôs clearly a case in which the prescription of Section 92A(2) has gone far beyond the mandate of Section 92A(1). Be that as it may, let us move on to the last segment of situations dealing with participation in control over the other enterprises, i.e. control by way of relationships other than commercial relationships. Clauses (j), (k) ad (l) deal with this segment. Clause (j) refers to the situation in which an enterprise is controlled by an individual and the same person controls, either on his own or along with his relatives, the other enterprise and when relatives of that person control the other enterprise. Essentially, the emphasis is on control of the enterprises, though by way of relationships other than commercial relationships. Clause (k) is a slight variation of clause (j) dealing with a situation in which an enterprise is controlled by an HUF and the other enterprise is controlled by member of such an HUF or relative of its member- jointly or independently. The element of control is fundamental in the situation envisaged by clause (j) as well. Clause (k) deals a situation in which an

enterprise is a partnership firm, body of individuals or association of persons, and the other enterprise holds at least ten percent interest in the same. The threshold limit of ten percent essentially relates to significance of the quantum of holding and the control through the same. The common thread in all the clauses of Section 92A(2), barring section 92A(2)(i) with which we will be dealing separately and section 92A(2)(m) which is a dead letter as on now as nothing has been prescribed thereunder, is that one of the enterprise has participation in capital of the other enterprise (clauses a, b, c and d), participation in management of the other enterprise (e and f) or participation by way some of degree of control over the other enterprise (g and h due to commercial relationship and j, k and l due to other than commercial relationships between the enterprises).

12. It is in this background that we have to address ourselves to the scope of Section 92A(2)(i) which provides that ñé é **two enterprises will be deemed to be associated enterprises……when the goods or articles manufactured or processed by one enterprise, are sold to the other enterprise or to persons specified by the other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprise**ò As we do so, we may take note of the fact, as discussed earlier as well, that the definition of associated enterprises in the cases covered by Section 92A(1), which refers to the participation in management, control or capital of the other enterprises, extend only to such extent as covered by Section 92A(2). In other words, even when it is an admitted situation that the assessee has participated in control, capital or management of the other enterprise, the assessee will not be treated as an AE of the other enterprise unless the conditions set out in one of the clauses of Section 92A(2) are satisfied. It is in this sense that both the limbs of Section 92A are required to be read together. However, the situation that we are dealing with is exactly contrary to the situation so visualized by us. We have a case in which wordings of Section 92A(2) are admittedly satisfied, but the mandate of Section 92A(1) is not satisfied inasmuch as the scale of *inter se* business relations between the two enterprises is so insignificant, at less than 5% of entire sales, that there is no element of *de facto* control over the other enterprise so as hold that two enterprises are associated enterprises.

13. We may, at this stage, take note of decision of a coordinate bench of this Tribunal, in the case of **Page Industries Limited Vs DCIT [(2016) 159 ITD 680 (Bang)]**. That is a case in which the coordinate bench has held that even though the provisions of Section 92A(2)(g) are satisfied in a case, the assessee cannot be treated as an associate enterprise of the non resident company granting it licence to manufacture its products, because the provisions of Section 92A(1) are not satisfied.

14. As evident from the limited narration of facts in the said decision, the assessee-company (i.e. Page Industries Ltd; PIL in short) was ñ**a licensee of the brand- name 'Jockey' for exclusive manufacture and marketing of goods under license agreement**ò but ñ**the assessee-company owns entire manufacturing facility, capital investment of Rs.100 crores and 15000 employees**ò and ñ**there is no participation of JII** *(i.e. Jockey International Inc., USA*) **in the capital and management of the assessee-company**ò. On these facts, the coordinate bench has held that JII and PIL are not associated enterprises as there is no participation by JII in ñ**management or capital** of PIL*(emphasis supplied by us)*ò. We have our reservation, whatever be itôs worth, on the conclusions arrived at in this case but that does not dilute our highest respect for an important principles of law laid down by the coordinate bench. The reasons for this approach are as follows. The expression ócontrolô appearing in Section 92A(1) is very crucial and the manner in which control is exercised could go well beyond capital and management, but the coordinate bench had no occasion to deal with the ñcontrolò aspect at all. As held in the case of **Diageo India Pvt Ltd Vs DCIT [(2011) 47 SOT 252 (Mum)],** even when an enterprise exercise control over the other enterprises by way of controlling the supply of raw material or use of trade marks, this also constitutes óparticipation in controlô leading to the status of associated enterprises under section 92A(1). It appears that this aspect of the matter has not been brought to the notice of, or pleaded before, the bench. While the conclusion arrived at by the bench clearly overlooks the specific mention of the word ñcontrolò in both limbs of the basic rule under section 92A(1) (i) as also under section 92A(1)(ii), and to that extent we are unable to concur that in the absence of participation in capital or management, two enterprises cannot be óassociated enterprisesôunder section 92A, what is important to us is that the coordinate bench has, *inter alia*, also held that, ñé .**in order to constitute relationship of an AE, the parameters laid down in both sub-**

sections (1) and (2) should be fulfilled" and justified this approach by observing that **"if we were to hold that there is a relationship of AE, once the requirements of sub-sec.(2) are fulfilled, then the provisions of sub-sec.(1) renders otiose or superfluous"** and that **"it is well settled canon interpretation of statutes that while interpreting the taxing statute, construction shall not be adopted which renders particular provision otiose".** The coordinate bench then further observed that **"when interpreting a provision in a taxing statute, a construction, which would preserve the purpose of the provision, must be adopted**ò. The legal position thus summed up by the coordinate bench is that in a situation in which the conditions, with respect to a set of enterprises, set out in section 92A(1) are clearly not fulfilled, even if the conditions under one of the clauses of section 92A(2) are fulfilled, such enterprises cannot be treated as associated enterprise under section 92A. To the limited extent of the principle so laid down by the coordinate bench, we are in considered agreement with the views of the coordinate bench, and it is this principle which is relevant for the purposes of our adjudication. It does directly affect the issue in appeal before us inasmuch as we are also dealing with a situation in which admittedly words of section 92A(2)(i) are clearly satisfied on the facts of this case, the scale of commercial relationship is so insignificant vis-à-vis total business operations of the assessee that there is admittedly no participation in control by one of the enterprise over the other enterprise so as to satisfy the mandate of Section 92A(1).

15. While dealing with this, we may also refer to some observations made by Dr Ramon Dwarkasing, an Associate Professor in Transfer Pricing at Maastricht University, the Netherlands, in his book ñ**Associated Enterprises- A Concept Essential for Application of the Arm's Length Principle**ò [ISBN: 978-90-81724-0-1, published by Wolf Legal Publishers, the Netherlands @ page 6], as follows:

> ñé ..in various countries, **the concept of associated enterprises may even cover relationships between independent enterprises, for instance, where a foreign buyer has a strong negotiating power**. For example, an Indian software company has a customer in Netherlands which is responsible for more than 90% of turnover of Indian software developer. The Dutch customer is able to dictate the prices to Indian software developer. The Indian software company is, therefore, able to charge a price with 1% margin/mark up, which is very low compared to his Indian counterparts (which apply, for instance, 6% mark up).
>
> **According to the Indian transfer pricing law, if the gods or articles manufactured or processed by one enterprises, are sold to other enterprise**

abroad or to person specified by such other enterprise, and the prices and other conditions relating thereto are influenced by such other enterprises, the two enterprises shall be deemed to be associated enterprises [See section 92A(2)(i) of the Indian Income Tax Act, 1961]

The Indian tax authorities consider the Indian software developer and its Dutch customer to be associated. They may adjust the prices and tax an unrealized profit, i.e. difference between real results and results based on prices derived from other software developers in India. The Netherlands does not consider the companies to be associated as it applies a narrow concept that does not include **"*de facto* control" as a criterion for association. "Control" in the absence of company law based relationship or in the absence of any formal right to exercise control can be described as "*de facto*" control. Participation in capital and management can be characterized as "*de jure*" concepts; concepts covered by company law**.

[Emphasis, by underlining, supplied by us]

16. While the above observations do seem to be at variance with the plain words of the statutory provision inasmuch as it refers to influence by way of ñstrong negotiating powerò rather than an influence *simplictor*- as is the apparent scheme of the statutory provision, what is immediately discernible from the above extracts is that the ó*de facto*ô control is the foundation of the wider approach to the concept of óassociated enterprises, and, of course, the impression that one of the ways in which use of expression óinfluenceô in concept of associated enterprises under the transfer pricing, can be rationalized is as dominant influence in the nature of *de facto* control. The definition of óassociated enterpriseô, as the above academic analysis shows, has two approaches- wider approach and narrow approach. A narrow approach to the concept of associated enterprises takes into account only ñ*de jure*ò association i.e. though formal participation in the capital or participation in the management. A wider approach to the concept of óassociated enterprisesôtakes into account not only the *de jure* relationships but also *de facto* control, in the absence of participation in capital or participation in management, through other modes of control such as commercial relationships in which one has dominant influence over the other. This wider concept is clearly discernible from the principles underlying approach to the definition of óassociated enterprisesôin the tax treaties and has also been adopted by the transfer pricing legislation in India in an unambiguous manner. There is no other justification in the Indian transfer pricing legislation, except the participation in capital of an enterprise, management of an

enterprise or control of an enterprise, which can lead to the relationship between enterprise being treated as ósassociated enterprisesô What essentially follows is that clause (i) of Section 92A(2) has, at its conceptual foundation, *de facto* control by one of the enterprise over the other enterprise, on account of commercial relationship of its buying the products, either on his own or through any nominated entities, from such other enterprise and in a situation in which it can influence the prices and other related conditions. The wordings of clause (i), however, do not reflect this position in an unambiguous manner inasmuch as it does not set out a threshold of activity, giving *de facto* control to the other enterprise engaged in such commercial activity, in percentage terms or otherwise- as is set out in clause (g) and (h) or, for that purpose, in all other operative clauses of Section 92A(2). If the words of this clause are to be interpreted literally, as the authorities below have read, even if there is one isolated transaction with an enterprise in such an enterprise can influence the prices, such an enterprise is to be treated as an associated enterprise- whether or not this commercial relationship amounts to control on the other enterprise. That will clearly be an incongruous result. However, as Section 92A(2)(i) is to be read alongwith Section 92(A)(1), in such a situation in which an enterprise does not participate in (a) capital, (b) management, or (c) control of other enterprise, and thus does not fulfil the basic rule under section 92A(1), even if the conditions of Section 92A(2)(i) are fulfilled, these enterprise cannot be treated as ósassociated enterpriseô In the case before us, it is not even the case of the revenue that the assessee has any participation in management or capital of the other enterprise, nor there is anything to even remotely indicate, much less establish, that one of the enterprise, by way of this commercial relationship, participates in control over the other enterprise. Viewed thus, Northstar, even if it is assumed that it can influence prices and other conditions relating to sale, cannot be treated as associated enterprise of the assessee before us. It is also important to bear in mind the fact that given the context in which the expression ñprices and other conditions relating thereto are influenced by such other enterpriseò appears in Section 92A(2)(i), this influence has to be something more than influence in the ordinary course of business and in the process of negotiation, because, even in the course of ordinary every business and in the course of day to day negotiation, selling prices as also conditions of sale are invariably, in a way, influenced by the buyer. Therefore, even when a customer offers terms to someone with a ótake it or leave itô message, such an approach, by itself, cannot be termed as óinfluenceô for our purposes, unless the seller is in such

a position and under such an influence that he has to simply accept the dictated terms. Any other view of the matter will result in all the enterprises dealing with each other as every party to a transaction has an influence over the price and conditions relating to the sale, and will lead to a situation in which all the enterprises dealing with each other on negotiated prices will have to be as associated enterprises. That again is a clearly absurd and unintended result, and it is only elementary that law is to be interpreted in such a manner as to make it workable rather than redundant. This principle is expressed in the latin maxim ñ***ut res magis valeat quam pereat***ò. Explaining this principle, Hon'ble Supreme Court has, in the case of **CIT Vs Hindustan Bulk Carriers [(2003) 259 ITR 449 (SC)],** has observed that ñ***A construction which reduces the statute to a futility has to be avoided"*** and that ***"A statute or any enacting provision therein must be so construed as to make it effective and operative on the principle expressed in maxim utres magis valeat quam pereat i.e., a liberal construction should be put upon written instruments, so as to uphold them, if possible, and carry into effect the intention of the parties. [See Broom's Legal Maxims (10th Edition), p. 361, Craies on Statutes (7th Edition) p. 95 and Maxwell on Statutes (11th Edition) p. 221.]"*** It is, therefore, important that the expression ó*influence*ôis given a sensible meaning so as to make the provisions of Section 92A(2)(i) workable rather than adopting a literal meaning which will lead to wholly incongruous results.

17. Viewed in this perspective, we must adopt a sensible meaning of expression ó*influence*ôwhich advances the scheme of the transfer pricing provisions rather than making these provisions unworkable. That meaning had to be a dominant influence which leads to *de facto* control over the other enterprise rather than an influence *simplictor.* If we are to adopt literal meaning of influence, as has been adopted by the authorities below, all the transactions on negotiated prices will be hit by the provisions of Section 92A(2)(i). In the light of the discussions above, the expression ó*influence*ô, in the present context, must remain confined to dominant influence which amounts to *de facto* control. Acceptance of terms of the buyer on commercial considerations, as in this case, cannot be treated as influence of the buyer. It is a commercial decision whether to accept the terms of the buyer, with respect to the price or related conditions, or not. It becomes influence, for the purpose of Section 92A(2)(i), when the seller is placed in such a situation that he has no choice, because of buyerôs dominant influence, but to accept it. It is thus clear that context in which a reference is made to the expression ó*influence*ô in section 92A(2)(i)

requires this expression to be read as a dominant influence in the sense of control by one enterprise over the other. Given the fact that the assesseeôs exports through the distribution part constitutes less than 5% of its entire exports, and less than 6% of its entire sales, Northstar is certainly not in a position to exercise any dominant influence, over the assessee. The assesseeôs decision to accept the terms set out by Northstar, even if that be so, may be justified on account of commercial expediencies or warranted by business exigencies or may simply be compulsion of this somewhat unique and complex business model, but it cannot, by any stretch of logic, be on account of dominant influence of Northstar as a customer. It may even be a sound business strategy to accept a rather passive and back seat role, if one can term it that way, in day to day decision making under this business model, but cannot be on account of dominant influence that Northstar exercises on buying of products from the assessee. The influence of Northstar, given the scale of business through Norrthstar as a distribution part, is too modest to make it a dominant influence in the nature of control. In this view of the matter, as also bearing in mind the earlier discussions on the issue, the assessee and Northstar can not be treated as ôassociated enterprisesô under section 92 A. We uphold the plea of the assessee.

18. Ground no. 2 is thus allowed.

19. In view of the fact that we have already held that the assessee and Northstar can not be treated as associated enterprises, transfer provisions will not come into play on the facts of this case, and, therefore, all other issues raised in the present appeal, which are in respect of the quantification of the armôs length price adjustments with respect to transactions with Northstar, are rendered academic and infructuous. We need not deal with those issues at this stage. Once the assessee and Northstar are held to be independent enterprise, outside the scope of Section 92A, the very basis of ALP adjustments ceases to hold good in law. The impugned ALP adjustment of Rs 2,51,91,556 must stand deleted for this short reason alone. Ground nos. 3,4 and 5 are thus dismissed as infructuous, but the relief prayer for, in this appeal, is granted.

20. As we part with this matter, we may only add that *prima facie* there is an inadvertent omission, with respect to threshold for application of Section 92A(2)(i)- whether in terms of a percentage of such sales or otherwise, in the statute. It is this

apparent omission which is resulting in wholly avoidable litigation on the applicability of Section 92A(2)(i). However, once this omission is supplied, Section 92A(2)(i) may indeed be successfully put into service to check and neutralize the impact of control of one enterprise over the other enterprise in the form of dominant influence as a buyer. Whether such a check is justified on policy considerations or not, is altogether a different issue, and we must stay away from the same. All we can emphasize is that Section 92A(2)(i) as it exists, and for the detailed reasons we have set out earlier in this order, does call for a reconsideration. We leave it at that.

21. In the result, the appeal is allowed in the terms indicated above. Pronounced in the open court today on 30th day of November, 2016.

Sd/-	***Sd/-***
G Pavan Kumar	**Pramod Kumar**
(Judicial Member)	(Accountant Member)

Dated: the 30th day of November, 2016.

Copies to:	*(1)*	*The appellant*	*(2)*	*The respondent*
	(3)	*CIT*	*(4)*	*CIT(A)*
	(5)	*DR*	*(6)*	*Guard File*

By order

Sr Private Secretary
Income Tax Appellate Tribunal
Chennai benches, Chennai