IN THE INCOME TAX APPELLATE TRIBUNAL
HYDERABAD BENCH "A", HYDERABAD

BEFORE SHRI P.M. JAGTAP, ACCOUNTANT MEMBER
AND SHRI SAKTIJIT DEY, JUDICIAL MEMBER

ITA No. 1492/Hyd/2014
Assessment Year: 2010-11

R.A.K. Ceramics India Pvt. Ltd., Secunderabad. PAN – AACCR6424N	Dy. Commissioner of Income-tax, Circle – 3(1), Hyderabad
(Appellant)	(Respondent)
Assessee by	Shri Kanchun Kaushal & Shri Abhiroop Bhargav
Revenue by	Smt. G. Aparna Rao
Date of hearing	22-01-2015
Date of pronouncement	04-02-2015

O R D E R

PER SAKTIJIT DEY, J.M.:

This is an appeal by assessee against the order of assessment dated 24/07/2014 passed u/s 143(3) r.w.s. 144C(5) & 144C(13) of the Act, for assessment year 2010-11, in pursuance to directions of Dispute Resolution Panel (DRP). Grounds raised by assessee are as under:

"*1. The ld. AO/Ld. Panel has erred in making an adjustment to the arm's length price of appellant's international transaction relating to payment of royalty by INR 32,086,570.*

2. The ld. Panel failed to appreciate that ld. AO/ld. Transfer Pricing Officer (TPO) has grossly erred by not satisfying any of conditions prescribed under section 92C(3) of the Act while making transfer pricing adjustments and accordingly the order passed by ld. AO/Ld. Panel should be set aside in entirety.

3. The ld. AO/Ld.TPO/Ld. Panel have erred by disregarding the benchmarking approach and methodology followed by the

appellant with regard to payment of royalty to Associated Enterprise.

4. The ld. AO/Ld. TPO/Ld. Panel erred by acting in arbitrary and ad-hoc manner by determining the arm's length price of payment of royalty to be 2% of net sales, and also by not following any prescribed transfer pricing methodology, as required u/s 92C of the Act while determining arm's length price for payment of royalty."

2. As can be seen from the grounds, solitary issue arising for consideration is with regard to determination of arm's length price (ALP) of royalty paid to AE by Transfer Pricing Officer (TPO) and confirmed by DRP at 2% as against 3% claimed by assessee.

3. Briefly the facts relating to the aforesaid issue in dispute are, assessee an Indian company is a wholly owned subsidiary of RAK Ceramics PSC, United Arab Emirates (RAK Holdings). Assessee manufactures vitrified tiles and sanitary ware products in India. The products manufactured by assessee are sold in domestic and export market. During the relevant FY, assessee has also sold products to its AE. The details of international transactions entered into by assessee with its AE during the relevant FY are as under:

S.No.	Nature of transaction	Amount (Rs.)
1.	Purchase of raw materials	10,71,25,849
2.	Resale of raw materials	34,50,965
3.	Sale of finished goods	7,76,13,306
4.	Payment of royalty	9,62,59,711
5.	Sale of capital items	85,99,307
6.	Payment of interest on ECB	2,01,96,839

As far as international transactions at Sl. No. 1 to 4 are concerned, assessee in its TP study bench marked them by adopting transaction net margin method (TNMM) as most appropriate method and operating profit to sales as profit level indicator (PLI). By carrying out search in prowess & capitaline data bases, assessee searched for comparables which yielded 14 companies with average margin of 4.32%. As assessee's margin is 11.69%, prices of the international transaction were considered to be within arm's length. Further, as far

as payment of royalty is concerned, assessee also undertook an alternative analysis under comparable uncontrolled price method (CUP) by bringing in three comparables with average royalty payment of 3.65% as against assessee's rate of royalty at 3%. Hence, payment of royalty at 3% to AE was found to be within arm's length. For the impugned assessment year, assessee filed its return of income declaring total income at 'nil' after set off of brought forward losses and unabsorbed depreciation under the normal provisions. Assessee also declared book profit of Rs. 40,18,18,315 u/s 115JB of the Act. During the assessment proceeding, AO noticing that assessee has entered into international transactions with its AE, made a reference to the TPO for determining ALP of the international transactions. In course of proceeding before TPO, he called for production of books of account and also various other informations and documents. After examining the books of account, financial statements as well as other relevant informations, TPO was of the view that the TP analysis done by assessee cannot be accepted as assessee has aggregated intangible transactions like payment of royalty with tangible transactions, such as, sale and purchase of goods. Further, he observed that as assessee has considered three years data, which is not as per the TP provisions, TP analysis cannot be accepted. Accordingly, AO was of the view that an independent analysis under the TNMM has to be undertaken by using contemporaneous data. Since the only adjustment made by TPO is confined to payment of royalty, it is appropriate to confine the discussions to that issue alone. As can be seen from the discussions made by TPO, he rejected analysis done by assessee under TNMM, as far as payment of royalty is concerned. TPO also rejected alternative analysis done by assessee under CUP by observing that comparables selected being USA companies, the analysis made cannot be accepted. Having rejected assessee's TP analysis both under TNMM as well as CUP, AO proceeded to determine arm's length percentage of royalty payment by applying the benefit test. TPO observed, though assessee

claims that it has been benefitted by technical know-how received from the AE, but, such claim of assessee is not supported by facts and figures. TPO observed that increase in sales is because of assessee's own advertisement and marketing skills and also commission and discount given by assessee. Thus, on consideration of the aforesaid facts, TPO observed that as assessee has not been able to conclusively establish the benefit test for the receipt of technology, the arm's length percentage of royalty payment may be allowed at 2% as against 3% claimed by assessee. As a result of reduction of royalty payment from 3% to 2%, the difference of Rs. 4,61,65,103 was treated as transfer pricing adjustment to be made u/s 92CA of the Act. In terms with the order passed by TPO, AP framed the draft assessment order making addition of Rs. 4,61,65,103. Assessee objected to the addition made in draft assessment order before the DRP.

4. The DRP, however, upheld TPO's decision of restricting the royalty payment of 2% on the net sales. However, DRP directed that sales made to AE should not be excluded from payment of royalty as long as price of goods sold to AE and Non-AE are similar. As a result of such direction of DRP, AO examined the issue which resulted in reduction of TP adjustment to Rs. 3,20,86,570 in the final assessment order.

5. The ld. AR submitted before us that this is the first year of payment of royalty and assessee does not own any intangibles. It was submitted that all the intangibles were owned by AE. As per the terms of royalty agreement, AE has to provide the technical know-how and assistance for manufacturing products. Assessee is also required to manufacture the products strictly in terms with the technical know-how and the guidelines set by AE keeping with the international standards. Royalty payment has also been made by assessee at 3% on the net sales in terms with the agreement. Ld. AR submitted that

assessee to bench mark the royalty payment has not only made analysis under TNMM, but, has also undertaken the study under the CUP method. It was submitted, assessee has brought comparables under both the methods to justify the royalty payment of 3%. However, AO without following any of the methods and without assigning valid reasons has rejected the analysis made by assessee under both the TNMM as well as CUP, and has adopted a very strange method for determining the arm's length percentage of royalty at 2%. Ld. AR submitted that TPO while determining the ALP has to act strictly in conformity with the statutory provisions and cannot examine the necessity of a transaction or payment by assuming the role of AO. The specific duty of the TPO is to determine ALP by following the method prescribed under the statute. TPO cannot apply the benefit test for determining ALP as he cannot assess the benefit derived by assessee in a particular transaction. Further, ld. AR submitted, the benefit derived by assessee from technical know-how and assistance is proved from the fact that not only the sales have increased many fold while production remained same which is a result of premium pricing but also there is minimal product recalls, low after sales maintenance cost which proves the fact that such achievements could not have been possible without upgradation of technology. Thus, TPO having not controverted the fact that assessee has been benefitted from the technical know-how and assistance provided by AE, the reduction of royalty form 3% to 2% on adhoc basis is unreasonable and unjustified. Ld. AR submitted, TPO has not brought on record a valid reason why the comparables brought by assessee both under TNMM as well as CUP should not be accepted. It was submitted, had TPO brought his own set of comparables justifying the rate of royalty at 2%, then, he could have reduced the rate of royalty from 3% to 2%, however, without bringing any comparable case, TPO cannot reduce royalty from 3% to 2% by simply applying the benefit test. In support of such contention, ld. AR relied upon the following decisions:

1. DCIT Vs. M/s Owens Corning Industries (India) P. Ltd., ITA Nos. 549 and 595/Hyd/14, order dated 13/10/14.
2. Kirby Building Systems India Ltd. Vs. Addl. CIT, ITA Nos. 1651/H/10 and 1975/H/11, order dated 18/07/14.
3. M/s Toyota Kirloskar Motor (P) Ltd. Vs. ACIT, IT(TP)A No. 1315/Bang/11, order dated 11/07/14.
4. Lumax Industries Ltd. Vs. ACIT, [2013] 157 TTJ (Del) 412
5. M/s Castrol India Ltd., ITA No. 1292/Mum/07 and others, order dated 20/12/2013.

6. The ld. DR, on the other hand, relied upon the reasoning of DRP and TPO.

7. We have considered the submissions made by learned counsels from both the sides and perused the orders of departmental authorities as well as other materials on record. We have also carefully examined the decisions placed before us. At the outset, it needs to be mentioned, the only dispute arising for consideration before us is determination of ALP of royalty at 2% by TPO as against 3% claimed by assessee. Undisputedly, assessee on 01/04/2009 has entered into a royalty agreement with its AE, RAK, UAE. As per clause 1.1 of the agreement, RAK, UAE will provide the technology assistance and on-going process, product improvement and complete know-how assistance to assessee. Clause 2.1 of the agreement stipulates, assessee shall manufacture the products in keeping with the highest quality standards, rules, and specifications internationally available and in accordance with guidelines established from time to time by RAK, UAE. Further, assessee shall use apparatus, ancillary equipment, accessories and materials that will ensure that such standards, rules, specifications and guidelines are met. Clause 3.1 of the agreement provides, in consideration of the ongoing technical assistance on process and product improvement to be provided or any other services as specified in the agreement, including any

technology or services provided, assessee shall pay to RAK, UAE royalty equivalent to 3% of the net ex-factory sale price of the products on both domestic as well as export sales during the tenure of the royalty agreement.

8. From the clauses of the royalty agreement referred to above, it becomes clear not only RAK, UAE, will provide the technical know-how and assistance for manufacturing products, but, assessee will also have to manufacture by using such technical know-how, assistance in accordance with international standards and guidelines set by RAK, UAE. For using such technical know-how, assistance, etc. assessee is required to pay royalty of 3% to its AE both on domestic and export sales. Department has not denied existence of royalty agreement nor the fact that payment of royalty at 3% is as per the terms of the agreement. TPO has also not disputed the fact that there is transfer of technical know-how and assistance from the AE to assessee. What the TPO disputes is the quantum of royalty paid. As can be seen from the TP report of the assessee as well as other materials on record, assessee has benchmarked ALP of royalty paid to AE by applying TNMM. As average margin of comparables selected was 4.32% as against assessee's margin of 11.69%, payment of royalty was found to be within arm's length. Assessee also undertook alternative analysis under CUP method. Assessee has searched Royalstat database which yielded three companies as comparables with average royalty paid of 3.65% on net sales as against 3% by assessee. Therefore, even under CUP method also payment of royalty at 3% was found to be within arm's length. The TPO did not accept assessee's TP analysis under TNMM by observing that payment of royalty being an intangible transaction should not have been aggregated with tangible transactions. As far as, assessee's analysis under CUP method is concerned, TPO has rejected it citing following reasons:

i) it is an alternate analysis

ii) database used is for US based companies

iii) copies of agreements not furnished; and

iv) bench marking has to be done for Indian companies in similar trade making royalty payment.

9. Further, it is evident from TP order, though, TPO has not brought any material to controvert assessee's claim of receiving pecuniary benefit from the technical know-how provided by AE, in terms of sizeable sales, garnering of creditable market share, minimal product recalls, low after sales maintenance cost etc. but he tried to overcome it by observing that such increase in sale is as a result of increase in advertisement & marketing expenses and also on payment of commission and discount. TPO observed, upgradation in technical expertise of AE is as a result of inputs by the assessee with regard to market trends in India. TPO also observed that royalty payment will also depend upon market share, which according to TPO, RAK, UAE is not having. Thus, TPO finally concluded as assessee has failed to satisfy the benefit test, payment of royalty at 3% on net sales to AE is not justified. TPO, therefore, held that arm's length percentage of royalty payment should be 2%.

10. We are really surprised to see the reasoning of TPO in fixing the ALP of royalty payment at 2%. It is manifest from TPO's order he has rejected assessee's TP analysis under TNMM. Further, in para 6.4 of his order, TPO has mentioned of undertaking an independent analysis under TNMM for selecting comparables and determining ALP. However, even after repeatedly scanning through his order, we failed to find any such analysis being done by him. Similarly, though in para 5.1.1, ld. DRP has observed that TPO has benchmarked intangible transactions by using CUP, but, the order passed by TPO does not support such conclusion. It is an accepted principle of law that TPO has to determine the ALP by adopting any one of the methods prescribed u/s 92C of the Act. Mode and manner of

computation of ALP under different methods have been laid down in rule 10B. Even, assuming that TPO has followed CUP method for determining ALP of royalty payment, as held by ld. DRP, it needs to be examined if it is strictly in compliance with statutory provisions. Rule 10B(1)(a) lays down the procedure for determining ALP under CUP method. As per the said provision, TPO at first has to find out the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions. Thereafter, making necessary adjustments to such price, on account of differences between the international transaction and comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market, TPO will determine the ALP. It is patent and obvious from TPO's order, the determination of ALP at 2% is not at all in conformity with Rule 10B(1)(a). The TPO has not brought even a single comparable to justify arm's length percentage of royalty at 2% either under CUP or TNMM method. On the contrary, observations made by TPO gives ample scope to conclude that adoption of royalty at 2% is neither on the basis of any approved method nor any reasonable basis. Rather it is on adhoc or estimate basis, hence, not in accordance with statutory provisions. The approach of TPO in estimating royalty at 2% by applying the benefit test, in our view, is not only in complete violation of TP provisions but against the settled principles of law. ITAT, Mumbai Bench in case of M/s Castrol India Ltd. Vs. Additional CITY, ITA No. 1292/Mum/2007 dated 20/12/2013 while examining identical issue of determination of ALP at 'Nil' by applying the benefit test held as under:

> *"11. We have considered the rival submissions and perused the relevant material on record. It is observed that the impugned royalty was paid by the assessee company to its AE namely Castrol Ltd. UK at 3.5 % of the net exfactory sale price of products manufactured and sold in India as per the technical collaboration agreement. This international transaction involving payment of royalty to its AE was bench-marked by the assessee*

by following CUP method in its TP study report and since average rate of royalty of three comparables selected by it was higher at 4.67% than the rate at which royalty was paid by the assessee to its AE, the transaction involving payment of royalty was claimed to be at arm's length. A perusal of the order passed by the TPO u/s 92CA (3) of the Act shows that neither these comparables selected by the assessee in its TP study report were rejected by her nor any new comparables were selected by her by making a fresh search in order to show that the payment of royalty by the assessee to its AE was not at arm's length. She simply relied on the approval of SIA to hold that any royalty paid by the assessee on exports and other income was not allowable and disallowed the royalty payment to the extent of Rs. 40,51,486/- treating the same as the royalty paid by the assessee in respect of exports sale and other income. We are unable to agree with this strange method followed by the TPO to make a TP adjustment in respect of royalty payment which is not sustainable either in law or on the facts of the case. She has neither rejected the method followed by the assessee to bench-mark the transaction in respect of payment of royalty nor has been adopted any recognized method to determine the ALP of the said transactions. The approval of SIA adopted by the TPO as basis to make TP adjustment in respect of royalty payment was untenable and even going by the said basis wrongly adopted by the TPO, no TP adjustment in respect of royalty payment was liable to be made. As per the said basis, the net sales of the assessee after excluding export sale and other income were to the extent of Rs. 1118.70 crores and the royalty paid thereon at Rs. 24.38 crore being less than the rate of 3.5% approved by SIA, there was no case of any excess payment made of royalty by assessee than approved by SIA to justify its disallowance by way of TP adjustment. In our opinion, the ld. CIT (A) could not appreciate these infirmities in the order of the TPO despite the same were specifically brought to his notice on behalf of the assessee and confirmed the TP adjustment made by the TPO in respect of royalty payment which was totally unjustified. We therefore, delete the addition made by the AO/TPO and confirmed by the ld. CIT on account of TP adjustment in respect of royalty payment and allow ground no. 3 of the assessee's appeal."

11. Similar view has also been expressed in the other decisions relied upon by ld. AR. At the cost of repetition, it needs reiteration, assessee has benchmarked the royalty payment by bringing comparables both under TNMM as well as CUP. Whereas, TPO has

rejected the analysis done by assessee under both the methods without any reasonable basis nor has brought a single comparable to justify ALP of royalty at 2%. Unfortunately, ld. DRP has approached the entire issue in rather mechanical manner without examining whether approach of the TPO is in accordance with statutory mandate. Therefore, determination of ALP of royalty at 2% cannot be supported, hence, deserves to be struck down. Moreover, theory of benefit test applied by TPO also falls flat considering the fact that TPO does not question the necessity of paying royalty but only objects to the quantum. Further, quantum increase in sale with no apparent increase in production, minimal product recalls, low after sales maintenance cost certainly goes to prove assessee's claim that these could be achieved due to utilization of advanced technical know-how transferred by AE. The TPO has not been able disprove these facts with any sound argument. Considering the totality of facts and circumstances, we are of the opinion, reduction of rate of royalty by TPO from 3% to 2% is without any basis, hence, cannot be accepted. Accordingly, we delete the addition made on account of TP adjustment to royalty payment. Grounds raised are allowed.

12. In the result, assessee's appeal is allowed.

Pronounced in the open court on 04/02/2015.

Sd/-	**sd/-**
(P.M. JAGTAP)	**(SAKTIJIT DEY)**
ACCOUNTANT MEMBER	**JUDICIAL MEMBER**

Hyderabad, Dated: 4th February, 2015

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Copy to:-

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