IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCHES : I-1 : NEW DELHI

BEFORE SHRI R.S. SYAL, AM & SHRI KULDIP SINGH, JM

ITA No.1075/Del/2016
Assessment Year : 2011-12

JCB India Ltd., B-1/I-1, 2nd Floor, Mohan Cooperative Industrial Estate, Mathura Road, New Delhi. PAN: AAACE0078P	Vs.	DCIT, Circle 13(1), New Delhi.
(Appellant)		(Respondent)

Assessee By	:	Shri M.S. Syali, Sr. Advocate & Shri Tarandeep Singh, CA
Department By	:	Shri Amrendra Kumar, CIT, DR

Date of Hearing	:	29.03.2016
Date of Pronouncement	:	31.03.2016

ORDER

PER R.S. SYAL, AM:

This appeal filed by the assessee is directed against the final assessment order passed by the Assessing Officer (AO) on 30.1.2016 u/s

143(3) read with section 144C(1) of the Income-tax Act, 1961 (hereinafter also called 'the Act') in relation to the assessment year 2011-12.

2. The only grievance raised in this appeal is against the addition of Rs.156,38,82,889/- made by the AO on account of transfer pricing adjustment.

3. Briefly stated, the facts of the case are that the assessee is a wholly owned Indian subsidiary of J.C. Bamford Excavators Ltd., UK. It commenced its operations in the year 1979 and is engaged in the manufacture of Earthmoving and Construction equipments. The assessee reported 19 international transactions for the year in question in Form No. 3CEB including 'Payment of royalty' with transacted value of Rs.185,76,44,174/-. The assessee used the Transactional Net Margin Method (TNMM) to benchmark its major international transactions. Profit Level Indicator (PLI) of Operating Profit to Total Cost (OP/TC) was adopted. The assessee employed Comparable Uncontrolled Price (CUP) Method *qua* the international transaction of `Payment of royalty'

to demonstrate that the same was at arm's length price (ALP). On a reference made by the AO to the Transfer Pricing Officer (TPO), the latter disputed only the international transaction of 'Payment of royalty.' The TPO observed that out of total royalty payment of Rs.185.76 crore, the assessee paid a royalty amounting to Rs.164,74,23,297/- in respect of product 3DX to its associated enterprise (AE) @ 5% of domestic sales and 8% of export sales. A show cause notice was issued requiring the assessee to explain as to why such royalty of Rs.164 crore and odd was paid on model 3DX machine which was nothing, but replication of model 3D, whose patent expired long back. At this stage, we consider it relevant to mention that the view point of the TPO that the assessee did not pay any royalty on model 3D during the period 1987 to the financial year 2005 on account of unexpired patent, is factually incorrect. The ld. AR has candidly admitted during the course of hearing before us that no royalty was paid for the product 3D during the period 1987 to financial year 2005 because the agreement between the assessee and its AE for such payment of royalty expired in 1987 and a new agreement was entered into only w.e.f. 5.3.2004. The ld. AR stated that no royalty was

paid during the above period due to non-existence of any agreement between the assessee and its AE and not due to any unexpired patent. Coming back, the assessee was also called upon by the TPO to file agreements along with necessary annexures for products 3D and 3DX and also to substantiate new inventions/improvements in product 3DX *vis-à-vis* product 3D. The assessee furnished such details along with agreements and also a technical report of some professor from IIT Delhi on the study made by him on the features of models 3D and 3DX. The TPO noticed that such report was also filed by the assessee before the Dispute Resolution Panel (DRP) during the course of proceedings for the assessment years 2008-09 and 2009-10. The assessee justified payment of royalty on 3DX model by submitting that it received technical knowhow, information and assistance from JCB group for its manufacturing activities. Various documents were filed to indicate difference in products 3D and 3DX. The assessee also submitted that it was granted an exclusive non-transferrable license in India to manufacture, assemble, use and sell products and, for that purpose, to use the know-how inventions covered by the patent rights. The assessee

still further submitted that it did not own any patent rights in India for 3D and the design registrations were done in its name to protect the potential infringements of designs in India. The TPO observed that there was a change in the approach of the assessee in this year *vis-à-vis* the earlier years inasmuch as the assessee benchmarked the international transaction of `Payment of royalty' by using CUP as the most appropriate method in contrast to the TNMM used for earlier years on entity level. He further observed that the facts for this year regarding payment of royalty were similar to those for preceding years in which it was held that - payment of royalty requires separate analysis on the basis of transaction by transaction approach and for that CUP method is to be applied as the most suitable method for the royalty payment transaction; new product 3DX is existing old product 3D with the same Indian manufacturer of Kirloskar Ltd.; and the assessee had not paid any royalty on product 3D from the year 1987 to financial year 2005-06. As regards the use of the CUP method by the assessee for benchmarking the international transaction of `Payment of royalty' on 3DX for the year under consideration, the TPO did not find any convincing reasons to

accept three comparables chosen by the assessee on several grounds tabulated on para 14 of his order including difference in type of technology and different geographical locations inasmuch as both the payers and payees were foreign parties. Then, the TPO viewed the assessee's annual reports for earlier years which indicated the carrying on of R&D activity by it in respect of the products including 3DX. Considering the fact that there was not much difference between the product 3D, on which the assessee did not pay any royalty from 1987 till the financial year 2005 on one hand and product 3DX on the other on which the said royalty has been paid and the further fact that the assessee itself carried out R&D activity in respect of 3DX model during earlier years, the TPO came to hold that no independent person would have paid royalty on product 3DX under the comparable uncontrolled circumstances. Determining the ALP of this international transaction at Nil, the TPO recommended transfer pricing adjustment of Rs.164.74 crore. The assessee assailed the draft order, incorporating the transfer pricing adjustment proposed by the TPO before the Dispute Resolution Panel. Vide its direction dated 23.12.2015, the DRP noticed it to be a

recurring issue from the assessment year 2006-07 onwards for which the Tribunal has remanded the matter back to the TPO/AO for fresh determination of ALP of international transaction of payment of royalty. The DRP approved the findings given by the TPO in applying the 'benefit test' and in coming to the conclusion that the assessee did not receive any significant benefit from the payment of royalty to its AE because product 3DX was developed in India. Considering that the DRP for earlier years determined ALP of royalty on 3DX model at 0.25% on sales, it gave similar direction for the extant year as well. That is how, the AO vide his final order, reduced the amount of addition to Rs.156.38 crore, after allowing the benefit of 0.25% as directed by the DRP. The assessee is aggrieved against this addition.

4. We have heard the rival submissions and perused the relevant material on record. The controversy in the present appeal is against the international transaction of `Payment of royalty' and that too, only on model 3DX. It is manifest that the TPO, following his findings given for earlier years, initially determined Nil ALP of the international

transaction by noticing, *inter alia*, that the assessee did not pay any royalty for use of technology of product 3D for the years 1987 to the financial year 2005 and further that it developed technology for 3DX model through its own R&D division and as such the assessee did not receive any benefit from the so-called use of the technology of 3DX from its AE for which the royalty was paid. He approved, in principle, the application of CUP method by the assesee for the year under consideration in contrast to the TNMM on entity level for earlier years, which was not accepted by him as the most appropriate method. However, on merits it was found that no companies cited by the assessee were comparable and that since the assessee did not derive any benefit, the ALP of this transaction was Nil. It is only pursuant to the direction of the DRP that finally the ALP was determined at 0.25% of the amount of sales as against 5% and 8% paid by the assessee on domestic and export sales. It is an admitted position that this is a recurring issue from the A.Y. 2006-07 when the assessee started paying royalty on product 3DX. The Tribunal vide its combined order dated 18.9.2013 for the assessment years 2006-07 to 2008-09 has not approved the assessee's approach in

following the TNMM for benchmarking all its international transactions including `Payment of royalty' in an aggregated manner. It has been held that the benchmarking should be done on a transaction to transaction basis. In simple words, the Tribunal recommended the following of the CUP method *qua* the international transaction of payment of royalty. It further found that the ALP of the international transaction could not be taken 0.25% on *ad hoc* basis. In the ultimate analysis, it restored the matter to the file of the AO/TPO for determining the ALP of the international transaction of payment of royalty afresh. This view has been consistently followed by the tribunal for the assessment year 2009-10, a copy of which order is available on page 107 onwards of the paper book and for the assessment year 2010-11, a copy of which order is available on page 111 onwards of the paper book. It was fairly admitted before us on behalf of the assessee that the facts and circumstances of the instant year are *mutatis mutandis* similar to the earlier years.

5. The ld. Sr. AR, however, put forth two fold submissions, viz., first that no addition on account of transfer pricing adjustment is permissible as the AO has not made any disallowance u/s 37(1), and second, the application of the TNMM on entity level should be upheld covering the international transaction of payment of royalty.

6.1. In so far as the first contention is concerned, the ld. AR submitted that the AO did not make any disallowance u/s 37(1) of the Act on account of payment of royalty. Relying on the judgment of the Hon'ble Delhi High Court in *CIT v. Cushman & Wakefield (India) (P.) Ltd. (2014) 367 ITR 730 (Del),* he contended that not having made any addition u/s 37(1), the AO was debarred from making addition towards transfer pricing adjustment on this score. This was strongly opposed by the ld. DR.

6.2. We are unconvinced with the submission advanced on behalf of the assessee. Their Lordships in the afore referred case have held that the authority of the TPO is limited to conducting transfer pricing analysis for determining the ALP of an international transaction and not to decide

if such services exist or benefits did accrue to the assessee. Such later aspects have been held to be falling in the exclusive domain of the AO. In that case, it was observed that the e-mails considered by tribunal from Mr. Braganza and Mr. Choudhary dealt with specific interaction and related to benefits obtained by assessee, providing a sufficient basis to hold that benefit accrued to assessee. As the details of specific activities for which cost was incurred by both AEs (for activities of Mr. Braganza and Mr. Choudhary), and attendant benefits to assessee were not considered, the Hon'ble High Court remanded the matter to file of concerned AO for an ALP assessment by TPO, followed by AO's assessment order in accordance with law considering the deductibility or otherwise as per section 37(1) of the Act. In our considered opinion, the argument of the ld. AR advocating for the deletion of the addition on the sole ground of the AO not disallowing any amount u/s 37(1) of the Act is sans merit. There is no doubt that the TPO initially determined Nil ALP of the international transaction of `Payment of royalty', which was given effect to by the AO in the impugned order, after taking into consideration the direction given by the DRP. It is obvious that when the

TPO determined Nil ALP of this transaction, nothing was left with the AO to do further. In sequence, the TPO passes his order first and then after passing through the route of the DRP, the matter comes to the AO for passing the final order of assessment. Once a particular amount has been added on account of transfer pricing adjustment by relying on the TPO's order, there cannot be one more disallowance of the same amount or some part of it by the AO u/s 37(1) of the Act. Rather its converse is true. It is possible that the TPO may find a particular international transaction to be at ALP and the AO, may thereafter make disallowance by considering the applicability of section 37(1). Be that as it may, the Hon'ble High Court in this case has remitted the matter back to the authorities below for following the mandate, viz., the TPO firstly determining the ALP of the international transaction and then the AO applying the provisions of section 37(1) of the Act.

6.3. When we advert to the facts of the instant case, it turns out that the TPO proposed the transfer pricing adjustment equal to the stated value of transaction at Rs.164.74 crore with Nil ALP of `Payment of royalty'

by holding that no benefit was received by the assessee as a result of the payment of royalty and hence no payment on this account was warranted. The AO in his draft order has taken its ALP at Nil on the basis of recommendation of the TPO without carrying out any independent investigation in terms of the deductibility or otherwise of such payment in terms of section 37(1) of the Act. An addition of Rs.156.38 crore has been made by the AO in his final assessment order giving effect to the direction given by the DRP and not by invoking section 37(1) of the Act. As per the *ratio decidendi* in *Cushman & Wakefield India (P.) Ltd. (supra),* the TPO was required to simply determine the ALP of the international transaction of `Payment of royalty' unconcerned with the fact, if any benefit accrued to the assessee and thereafter, it was for the AO to decide the deductibility of this amount u/s 37(1) of the Act. As the TPO in the instant case initially determined nil ALP by holding that no benefit accrued to the assessee and the AO made the addition without examining the applicability of section 37(1) of the Act, we find the actions of the AO/TPO running in contradiction to the *ratio* laid down in *Cushman & Wakefield (supra).*

Respectfully following the precedent, we set aside the impugned order and remit the matter to the file of AO/TPO for deciding this issue in conformity with the law laid down by the Hon'ble jurisdictional High Court in the case of *Cushman & Wakefield (India) (P.) Ltd. (supra)* and also the tribunal orders in assessee's own case for immediately preceding five assessment years to the extent they accord with this judgment.

7.1. Next argument of the ld. AR was that the TNMM was applicable on entity level *de hors* the separate determination of ALP of the international transaction of payment of royalty under the CUP method by the assessee. It was argued that the assessee's main emphasis in the TP study report and also before the TPO was that the TNMM should be applied on entity level and that the determination of ALP of the international transaction of payment of royalty under the CUP method was without prejudice to its main argument of the applicability of the TNMM. Notwithstanding the fact that such a contention has been repelled by the tribunal for earlier years, still the ld. AR canvassed this

view before us by relying on the judgment of the Hon'ble jurisdictional High Court in *Sony Ericsson Mobile Communications India (P) Ltd. VS. CIT (2015) 374 ITR 118 (Del)*, which in the opinion of the ld. AR, is an authority for the proposition that aggregation of all the international transactions for benchmarking under the TNMM is permissible and, there is no need to separately determine the ALP of any international transaction including `Payment of royalty'.

7.2. We are unable to countenance this contention. In a group of appeals by `Distributors' (not Manufacturers) led by *Sony Ericson Mobile Communications (supra),* their Lordships espoused the determination of the ALP of Advertisement, Marketing and Promotion expenses (AMP expenses). Dealing with the computation of ALP of the international transaction of AMP expenses by a Distributor, the Hon'ble High Court held, *inter alia*, that the international transaction of AMP expenses should be bundled/aggregated with other international transaction carried out by the assessee as a distributor, who either simply acts an agent of manufacturer or purchases goods from the manufacturer

for resale at his own account. The Hon'ble High Court held that where the TNMM has been applied as the most appropriate method by a Distributor, which method has not been disturbed by the TPO, then, the international transaction of AMP and distribution activities should be clubbed. It further held that for determining the ALP of such transactions under a combined approach, only such comparables should be chosen which conform to the AMP *functions* and other distribution functions conducted by the assessee. If there is some difference in the functions under these international transactions, including that of AMP, between the assessee and the comparables, then, suitable adjustment should be made to bring both the transactions at par. If probable comparables are not performing similar functions as done by the assessee and no adjustment is possible for bringing the international transactions of the assessee in an aggregated manner at par with those undertaken by the comparables, then, segregation should be done and the international transaction of AMP should be separately processed under the transfer pricing provisions. In such a determination of ALP of

AMP expenses in a segregated manner, proper set off on account of excess purchase price adjustment should be allowed.

7.3. We can summarize the relevant position emanating from the judgment of the Hon'ble High Court in the case of a `Distributor', as under : -

- Inter-connected international transactions can be aggregated and section 92(3) does not prohibit the set-off [Paras 80 & 81];
- AMP is a separate function. An external comparable should perform similar AMP functions. [Paras 165 &166] ;
- ALP of AMP expenses should be determined preferably in a bundled manner with the distribution activity [Paras 91, 121 & others] ;
- For determining the ALP of these transactions in a bundled manner, suitable comparables having undertaken similar activities of distribution of the products and also incurring of AMP expenses, should be chosen [Paras 194(i), (ii), (viii) & others];

- If no comparables having performed both the functions in a similar manner are available, then, suitable adjustment should be made to bring international transactions and comparable transactions at par [Para 194 (iii)] ;
- If adjustment is not possible or comparable is not available, then, the TNMM on entity level should not be applied [Paras 100, 121, 194(iii) & (vi)] ;
- In the above eventuality, international transaction of AMP should be viewed in a de-bundled manner or separately [Paras 121& 194(xi)] ;
- In separately determining the ALP of AMP expenses, the TPO is free to choose any other suitable method [Para 194(xiii)];
- In so making a TP adjustment on account of AMP expenses, a proper set off/purchase price adjustment should be allowed from the other transaction of distribution of the products [Para 93] ;

7.4. Though the judgment in *Sony (supra)* lays down at length the broader principles for determination of the ALP of AMP expenses in the

case of a `Distributor', certain principles dealing exclusively with the determination of the ALP of AMP expenses in the case of a `Manufacturer' have also been laid down. Such discussion has been made in para 92 of the judgment, the relevant part of which is reproduced here as under : -

> `92. The majority judgment refers to an example where the Indian AE may have earned actual profit of Rs.140/-, but returned reduced net profit of Rs.120/- as the Indian AE had incurred brand building expenses to the tune of Rs.20/- for the foreign AE, whereas the net profit on sales declared by comparable uncontrolled transactions was Rs.100/- only. Thus, it was observed that the costs including AMP expenses are independent of cost of imported raw material/finished products having some correlation with overall profit. The example highlights the weakness of the TNM Method. The reasoning would be equally valid, where no AMP or _brand building' expenses are incurred. (See paragraph 21.8 to 22.10 of the majority decision). The net profit margins can be affected by variation of operating expenses. Thus, the requirement to select appropriate comparable and adjustment. It would be inappropriate and unsound to accept comparables, with or without adjustment and apply TNM Method, and yet conjecturise and mistrust the arm's length price. TNM Method would not be the most appropriate method when there are considerable value additions by the subsidiary AEs. In paragraph 22.9, the majority decision has observed that all costs including the AMP expenses are independent of cost of material. This indicates that the observations have been made with reference to manufacturing activities. *It would not be appropriate and proper to apply the TNM Method in case the Indian assessed is engaged in manufacturing activities and distribution and marketing of imported and manufactured products,*

> *as interconnected transactions. Import of raw material for manufacture would possibly be an independent international transaction viz. marketing and distribution activities or functions.* We have earlier used the term `plain vanilla distributor'. When we use the words `plain vanilla distributor' we do not mean plain vanilla situations, but value additions and each party making valuable unique contribution.'

7.5. It is discernible from the italicized part of the above para that the application of *TNM Method* is *not appropriate and proper in* case the assessee *is engaged in manufacturing activities.* In such circumstances, the *import of raw material for manufacture* would be *an independent international transaction viz., marketing and distribution activities or functions.* The essence of the above para is that two or more unrelated transactions cannot be aggregated and in case of a `Manufacturer', the international transactions concerned with the manufacturing activity cannot be aggregated with the AMP activities as both are separate and distinct.

7.6. Nitty gritty of the above discussion is that aggregation of related transactions is permissible, but there is no rule that all the related and unrelated transactions can be combined and shown at ALP under the TNMM on entity level. The Hon'ble Punjab & Haryana High Court in

Knorr-Bremse India P. Ltd. vs. ACIT (2016)380 ITR 307 (P&H) has held that in order to combine two or more transactions, it is essential that they should be either inextricably linked to each other either by way of a package deal or that a number of transactions are priced differently but on the understanding that the assessee will accept all of them together (i.e. either take all or leave all). It further held that merely because purchase of goods and acceptance of services lead to manufacture of final product, it does not follow that they are dependent transactions.

7.7. On going through the facts and *ratio* of the decisions in *Sony Ericsson (supra)* and *Knorr-Bremse (supra),* it is manifest that the contention of the ld. AR for aggregating all the international transactions including `Payment of royalty', and then applying TNMM on entity level, cannot be upheld because the international transaction of `Payment of royalty' is independent of other transactions. The tribunal in assessee's own case has also jettisoned such argument advanced on behalf of the assessee for earlier years and has rightly held that the ALP of the international transaction of `Payment of royalty' should be done

separately on a transaction by transaction approach, which has been rightly interpreted by the assessee as a CUP method, that was employed by the assessee in its transfer pricing study report for the year under consideration. Ergo, we turn down the argument of the ld. AR and approve in principle that the TNMM cannot be applied and the international transaction of payment of royalty in respect of model 3DX has to be benchmarked by applying CUP as the most appropriate method.

8. Now, coming to the determination of ALP of this international transaction under the CUP method, we find that the assessee chose three companies as comparable, which, in our considered opinion, have been rightly rejected by the TPO on several cogent reasons tabulated vide para 14 of his order including difference in type of technology and different geographical locations inasmuch as both the payers and payees were foreign parties. However, the fact remains that if the assessee's comparables are not correct and the assessee is not forthcoming with a new set of comparables, then, it becomes the duty of the TPO to find out

relevant comparables and proceed to determine the ALP accordingly. Coming back to the TPO's opinion about nil ALP of the payment of royalty, we find that the DRP has accepted the marginal use of technical know-how by the assessee from its AE, for which it directed to adopt 0.25% on sales as the ALP of royalty payment in respect of this model. It is this *ad hoc* approach of the DRP which has been turned down by the Tribunal for the earlier years leading to the restoration of the matter to the file of AO/TPO for a fresh determination of the ALP of this transaction by using the transaction by transaction approach, which the assessee has done for this year by applying the CUP method in respect of the international transaction of payment of royalty. As the facts and circumstances for the instant year continue to remain similar *vis-à-vis* the preceding years, respectfully following the precedent, we set aside the impugned order and remit the matter to the AO/TPO for a fresh determination of the ALP of the international transaction of `Payment of royalty' for model 3DX by applying the CUP method after affording a reasonable opportunity of being heard.

9. In the result, the appeal is allowed for statistical purposes.

The order pronounced in the open court on 31.03.2016.

Sd/-	Sd/-
[KULDIP SINGH] JUDICIAL MEMBER	[R.S. SYAL] ACCOUNTANT MEMBER

Dated, 31st March, 2016.

dk

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT (A)
5. DR, ITAT

AR, ITAT, NEW DELHI.