



IN THE INCOME TAX APPELLATE TRIBUNAL
"K" BENCH, MUMBAI
BEFORE SHRI SAKTIJIT DEY, JUDICIAL MEMBER AND
SHRI RAJESH KUMAR, ACCOUNTANT MEMBER

ITA no.2590/Mum./2017
(Assessment Year : 2012-13)

Firmenich Aromatics India P. Ltd.
9th Floor, Arena Space, CTS 20
New Shyam Nagar Road
Behind Majas Bus Depot
Jogeshwari (E), Mumbai 400 060
PAN – AAACF1621M

..... Appellant

v/s

Dy. Commissioner of Income Tax
Circle-9(3)(1), Mumbai

..... Respondent

Assessee by : Shri Dhanesh Bafnaa/w
Ms. Hirali Desai
Revenue by : Shri Jayant Kumar

Date of Hearing – 26.04.2018

Date of Order – 23.07.2018

ORDER

PER SAKTIJITDEY, J.M.

Aforesaid appeal by the assessee is directed against the assessment order dated 31st January 2017, passed under section 143(3) r/w section 144C(13) of the Income Tax Act, 1961 (for short "*the Act*") for the assessment year 2012-13 in pursuance to the directions of the Dispute Resolution Panel (DRP).

2. The assessee has raised five grounds.

3. At the outset, the learned Authorised Representative on the instructions of the assessee did not want to press grounds no.3 and 4, hence, these grounds are dismissed.

4. In ground no.1 along with its sub-grounds assessee has challenged transfer pricing adjustment made of ₹ 18,10,72,120, to the arm's length price of royalty paid to Associated Enterprise (A.E) for technical knowhow.

5. Brief facts are, the assessee an Indian Company is engaged in the business of manufacturing and marketing of industrial flavours, fragrances and chemical specialties. The assessee in the year 2005 had entered into an agreement with A.E. Firmenich S.A., Switzerland for availing technical knowhow which has been renewed from time-to-time. The relevant flavours and fragrances licence agreement which is applicable to the impugned assessment year was entered into between the assessee and the A.E. on 1st April 2009. As per the terms of the agreement, the assessee was required to pay royalty @ 5% on local sales and 8% on value of export sales net-of Indian taxes. The technical knowhow is in the nature of licensor secret formula, trade secret, manufacturing procedures, methods and other technical information relating to the manufacturing, compounding, quality control, testing and servicing of the licensed products. For the

impugned assessment year, the assessee had filed its return of income on 30th November 2012, declaring loss of ₹ 6,12,59,849. During the assessment proceedings, the Assessing Officer noticing that the assessee has entered into international transaction with its A.E. made a reference to the Transfer Pricing Officer to determine the arm's length price of the international transactions. During the proceedings before him, the Transfer Pricing Officer found that in the transfer pricing study the assessee has benchmarked the arm's length price of the payment made towards technical knowhow by applying Transactional Net Margin Method (TNMM) as the most appropriate method. As alleged by the Transfer Pricing Officer, the assessee failed to furnish the details called for by him and simply submitted that the technical knowhow is in the nature of licensor's secret formula, trade secrets, manufacturing procedures, methods and other technical information relating to the manufacturing, compounding, quality control, testing and servicing of the licensed product. It was further stated by the assessee, solely on the basis of technical knowhow provided by the A.E. it manufactures various new type of fragrances and flavours in India. The assessee also stated that the assessee is paying royalty at the same rate from 1997 onwards and there is no increase in the royalty payment even though there is increase in sale and profit. It was submitted that royalty paid at the same rate for

assessment years 2009–10 and 2010–11 and 2011–12 have been accepted by the Transfer Pricing Officer. The Transfer Pricing Officer did not find merit in the submissions of the assessee. Further, the Transfer Pricing Officer alleged that the assessee failed to furnish the details of intellectual properties input provided by the A.E. in last three years along with documentary evidences. Thus, the Transfer Pricing Officer issued a show cause notice requiring the assessee to explain the reason for the change in system of payment of royalty to A.E. from net sales to gross sales w.e.f. 1st April 2009. Further, the Transfer Pricing Officer also called upon the assessee to explain why the A.E. is not charging royalty from another sister concern in India doing similar nature of business. Without prejudice to the above, the Transfer Pricing Officer on the basis of a search conducted in royalty stat data base offered three agreements stated to be in similar line of business wherein royalty was paid @ 1% on net sales. Thus, the Transfer Pricing Officer called upon the assessee to explain why such agreements should not be considered as external Comparable Uncontrolled Price (CUP) to determine the arm's length price of royalty payment to the AE by restricting to 1% of the net sales. In response to the show cause notice, the assessee submitted as under:–

- *The entire production and sale of the assessee are relating to the formulae / concept developed by the licensor;*

- *The formula is the root of the item produced by the assessee. In the absence of specific formula, the items cannot be produced;*
- *The royalty payments are cost of acquisition of right to use, technical knowhow, which is directly used for manufacturing, marketing and sale;*
- *Knowhow for which royalty is paid is indivisible part of the business operation;*
- *The assessee does not have the formula of the products dealt in, hence, it has to use someone else's formula by paying royalty; and*
- *Royalty payment is an acquisition cost of knowhow, without knowhow the production in which the assessee is dealing is not possible.*

6. Justifying the change in the method of royalty payment from net sales to gross sales, the assessee submitted that the licensor always intended to collect royalty on gross sales. However, it was not able to do so prior to 2009 owing to the restrictions in the Foreign Direct Investment policy (FDI) prevalent at that time which required net sales to be calculated as per the prescribed formula. As regards the three external CUP proposed by the Transfer Pricing Officer, it was submitted that none of the cases could be considered as external CUP because in the case of the agreement between Strategic Diagnostic Inc. and Romer Labs Technology Inc. is a asset purchase agreement and both the parties are outside India, hence, not governed by Indian

rules and regulations. As regards the second agreement between Blackman Ulher LLC and Green Ville Colorants LLC, again it is an asset purchase agreement and both the parties are outside India. As regards the third agreement between Biospherics, USA and M.D. Foods Ingredients, Amba, Denmark, though, termed as agreement and license, however, it is actually in relation to the transfer of intellectual property rights to the buyer. Further, both the parties are outside India, hence, not governed by the Indian rules and regulations. The assessee also objected for not providing the reasons for rejecting the other fourteen companies found by the Transfer Pricing Officer in the data base. It was submitted, in view of FDI policy directive for payment of royalty, no third party comparable is otherwise necessary to establish the arm's length price. The assessee submitted that the royalty paid as per Indian rules to the A.E. is lesser as compared to royalty paid by other A.Es. Thus, it was submitted by the assessee that the payment made by the assessee towards royalty for availing technical knowhow is at arm's length. The Transfer Pricing Officer did not find merit in any of the submissions of the assessee. He was of the view that the payment of royalty is not at all justified in the absence of any documentary evidences produced by the assessee to demonstrate transfer of inputs by the A.E. to the assessee which were utilised for manufacturing of fragrances and flavours. The Transfer Pricing Officer

observed, when the assessee is availing the technical knowhow on payment of royalty since 1997, there is no need for any help from the A.E. in manufacturing process. He observed, in an uncontrolled third party transaction no enterprise will pay royalty to another unrelated enterprise continuously for more than 18 years. The Transfer Pricing Officer observed, while the assessee is paying royalty to its AE, another sister concern in India which is in similar line of business is not paying any royalty. As regards assessee's contention that TNMM is the most appropriate method, the Transfer Pricing Officer referring to a decision of the Tribunal, Mumbai Bench, in case of Skol Breweries Ltd. v/s ACIT, TS-10-ITAT-2013 observed that CUP method for bench marking royalty payment should be preferred. Thus, the Transfer Pricing Officer ultimately held that the payment of royalty in the given facts and circumstances of the case is not justified, hence, has to be disallowed under section 37(1) of the Act. Further, he observed, considering that the assessee might be getting some technical inputs to run his manufacturing plant, the assessee would be required to pay 10% of the royalty which was paid during the year. Therefore, he determined the arm's length price of the royalty payment for availing technical knowhow at ₹ 2,01,19,124. Without prejudice to the aforesaid observations, the Transfer Pricing Officer held that if at all assessee's claim of royalty payment is to be allowed, it should be

calculated on the basis of net value added sales which is equal to net of Indian taxes, of the net ex-factory sale price of the licensed product, exclusive of excise duty, minus the cost of standard bought out component and landed cost of imported components irrespective of source of procurement. He observed that the assessee was paying royalty on the basis of such formula as per the agreement with the A.E. dated 1st January 2005. Therefore, the change in method of royalty payment on gross sales should not be accepted. Thus, ultimately he held that royalty payment should be allowed on the basis of net sales excluding taxes, sales rebate and all the imports. On the basis of adjustment made by the Transfer Pricing Officer to the arm's length price the Assessing Officer framed the draft assessment order. Against the draft assessment order so passed, the assessee preferred objections before the DRP.

7. The DRP, after considering the submissions made by the assessee, however, upheld the adjustment made by the Transfer Pricing Officer by estimating the royalty payment @ 10% of the amount actually paid by the assessee. As regards the alternative bench marking of the Transfer Pricing Officer by applying external CUP, the DRP did not decide the issue.

8. Shri Dhanesh Bafna, the learned Authorised Representative for the assessee submitted that the assessee is manufacturing industrial flavours and fragrance which are used as raw materials. He submitted, though, the assessee has entered into agreement with the A.E. w.e.f. 1st April 2005, which has been renewed from time-to-time, however, in sum and substance agreement remains the same except for the fact that the impugned assessment year royalty is paid on the basis of gross sales instead of net sales due to change in the FDI policy. He submitted, the assessee had been manufacturing products in India by utilising the process / formula provided by the A.E. He submitted, the assessee does not undertake any research and development activity. He submitted, in all the preceding assessment years the Transfer Pricing Officer has accepted the payment of royalty @ 5% for domestic sales and 8% for overseas sales to be at arm's length price. He submitted, the assessee has started its production activity in the year 1997 by utilizing the technical knowhow provided by its A.E. He submitted, all research and development activities are being carried out by the A.E. and the assessee is using intangibles developed by the AE. Referring to different clauses of the agreement, the learned Authorised Representative submitted, royalty has to be paid on yearly basis, since, the agreement gives the assessee a right to manufacture the products by utilising the technical knowhow of the AE. He

submitted, if the assessee stops paying royalty, it will have to stop all its manufacturing activity. In this context, he specifically drew our attention to Article-2, 3 and 5 of the agreement. Referring to the transfer pricing study report, the learned Authorised Representative submitted, the AE in Switzerland looks after scientific research for the whole group which enables it to discover over 1,000 new molecules and chemical substances every year, out of which, the most effective are marketed commercially. Looking at the demand of the products thousands of different compositions are created and produced which requires continuous and intensive research. He submitted, all intellectual property rights (IPR) remains with the A.E. in Switzerland. The learned Authorised Representative submitted, while determining the arm's length price the Transfer Pricing Officer has not followed any of the prescribed method as provided in the statute and simply made an ad-hoc adjustment on estimated basis which is not legally permissible. In support of such contention, the learned Authorised Representative relied upon the following decisions:-

- i) *R.A.K. Ceramics India Pvt. Ltd. v/s DCIT, [2015] 169 TTJ 759 (Hyd.);*
- ii) *Reebok India Co. v/s ADIT, [2014] 146 ITD 469 (Del.);*
- iii) *CIT v/s Johnson and Johnson Ltd., ITA no.1030/2014, dated 07.03.2017 (Bom.); and*
- iv) *DCIT v/s R.A.K. Chemicals India Pvt. Ltd. ITPA no.595/2016.*

9. With regard to Transfer Pricing Officer's alternative benchmarking by applying external CUP, the learned Authorised Representative submitted, TNMM has to be adopted as it is inextricably linked to other transactions. He submitted, payment of royalty being closely connected to manufacturing activity, benchmarking of royalty independently was improper. He submitted, the assessee has shown a growth of 22% in this year. Challenging the comparables selected by the Transfer Pricing Officer under CUP, the learned Authorised Representative submitted that none of the three companies are comparable to the assessee due to their functional profile. He submitted, though, the assessee has brought this fact to the notice of the Transfer Pricing Officer, he has completely overlooked assessee's objections. He submitted, the Transfer Pricing Officer has also not provided any basis / reasoning why the other companies selected by him were not found to be comparable to the assessee. He submitted, determination of arm's length price being on an estimation basis cannot be accepted, hence, the adjustment made should be deleted. Finally, the learned Authorised Representative submitted, in no other assessment year right from A.Y. 2006-07 to 2014-15, adjustment was made in respect of similar transaction made with the AE. Thus, applying the rule of consistency also, no adjustment should be made in the impugned assessment year.

10. The learned Departmental Representative supporting the view expressed by the Transfer Pricing Officer and the DRP submitted that the assessee has aggregated all the transactions for bench marking purpose which is not at all a correct approach. He submitted, unless the transaction with the A.E. is a composite transaction, it cannot be aggregated. In this context, he relied upon the decision of the Hon'ble Punjab & Haryana High Court in Knorr Bremse India Pvt. Ltd. v/s CIT, [2016] 380 ITR 307 (P&H). The learned Departmental Representative submitted, the assessee has determined the arm's length price on the basis of a circular issued by the Ministry of Commerce, which is also not in accordance with the statutory provisions. He submitted, if the ad-hoc adjustment made by the Transfer Pricing Officer is held to be not in accordance with the statutory provision, the alternative bench marking made by the Transfer Pricing Officer applying CUP method should be upheld. The learned Departmental Representative submitted, since, the international transaction between the assessee relates to payment of royalty to the AE, CUP is the most appropriate method. Finally, the learned Departmental Representative submitted, if there is any deficiency in the order of the Transfer Pricing Officer, it can be restored back to him for determining arm's length price denovo by applying a correct method. In support of his contention, the learned Departmental Representative relied upon the following decisions:—

- i) *M/s. Gemplus India Pvt. Ltd. v/s ACIT, ITA no.352/Bang./2009, dated 21.10.2010;*
- ii) *Cranes Software International Ltd. v/s DCIT, [2014] 52 taxmann.com 19 (Bang.);*
- iii) *Taegu Tec India Pvt. Ltd. v/s DCIT, [2017] 83 taxmann.com 81 (Bang.);*
- iv) *Cairn India Ltd. v/s DCIT, ITA no.1459/Del./2016, dated 09.10.2017;*
- v) *M/s. Volvo India Pvt. Ltd. v/s CIT, IT(TP)A no.384/Bang./2013, dated 16.12.2016; and*
- vi) *M/s. Knorr-Bremse India Pvt. Ltd. v/s ACIT, etc., ITA no. 182 of 2013 (O&M), dated 06.11.2015;*

11. We have carefully considered the rival submissions and perused the material on record. We have also applied our mind to the decisions relied upon by both the parties. The dispute in this ground relates to determination of arm's length price of the royalty paid by the assessee to its AE. As could be seen from the facts on record, the assessee is availing technical knowhow from its AE in Switzerland since past so many years and paying royalty for the services availed. For this purpose, the assessee has entered into a license agreement with the AE from the very inception of carrying out the manufacturing activity of industrial flavours and fragrances, which has been renewed from time-to-time. The transactions in the impugned assessment year were under a license agreement executed on 1st April 2009. Though, the assessee was required to pay royalty @ 5% on local sales and @ 8%

on export sales, net of Indian taxes, however, there is no major change in the terms of the contract, except for the fact that the in the impugned assessment year, the assessee has paid royalty on the gross sales instead of net sales as was done in the preceding assessment years. In the transfer pricing study the assessee has benchmarked the royalty payment by applying TNMM as the most appropriate method and has aggregated it with other international transactions in the manufacturing segment with operating profit / sales as the profit level indicator. The assessee has selected a set of six comparables with average margin of 7.40% as against its own margin of 5.23%. Hence, the arm's length price of the international transaction was claimed to be at arm's length. Notably, the Transfer Pricing Officer has accepted assessee's benchmarking by apply TNMM in respect of all transactions in manufacturing segment except payment of royalty. Pertinently, on a perusal of the order of the Transfer Pricing Officer, it is evident that the Transfer Pricing Officer has raised doubt / suspicion with regard to payment of royalty basically for the reason of business expediency. The Transfer Pricing Officer has observed, since the assessee was availing the technical knowhow from the AE and paying royalty since 1997, it does not require any further technical help from the AE with regard to its manufacturing activity of industrial flavours and fragrances. Thus, the Transfer Pricing Officer has ultimately concluded

that the royalty payment needs to be disallowed under section 37(1) of the Act in the absence of any evidence to suggest transfer of technical knowhow during the year. Having held so, the Transfer Pricing Officer again observed that since the assessee might be getting some technical inputs to run his manufacturing plan, he is required to pay 10% of the royalty paid to the AE during the year. Accordingly, he determined the arm's length price of the royalty payment at ₹ 2,01,19,124 as against the amount of ₹ 18,10,72,120 actually paid by the assessee. Thus, it is evident that the Transfer Pricing Officer has determined the arm's length price of royalty payment by making an ad-hoc adjustment purely on estimate basis without following any approved method for determination of arm's length price as prescribed under the statutory provisions. Thus, the primary issue which arises for consideration is, whether the Transfer Pricing Officer has power under the statute to determine the arm's length price of international transaction on estimate basis by weighing in the business expediency factor. In our considered opinion the legal principle on the issue is quite clear. As could be seen from the scheme of the Income Tax Act, 1961, Chapter-X contains special provisions relating to avoidance of tax with regard to international transaction between related parties. Section 92 of the Act provides for computation of income arising from international transaction at arm's length price. Section 92C of the Act

provides for determination of arm's length price of an international transaction by applying the most appropriate method having regard to the nature of transaction for class of transaction or functions performed, etc. The most appropriate method prescribed are as under:–

- i) Comparable Uncontrolled Price Method;*
- ii) Resale Price Method;*
- iii) Cost Plus Method;*
- iv) Profit Split Method;*
- v) Transactional Net Margin Method; and*
- vi) Such other methods, as may be prescribed by the Board.*

12. Rule 10B of Income Tax Rules, 1962 (for short "*the Rules*"), provides the mechanism for determination of arm's length price under the aforesaid methods prescribed under section 92C of the Act. If the Assessing Officer in course of assessment proceedings finds that the assessee has entered into international transactions with its AE, he may with the previous approval of the authority concerned make a reference to the Transfer Pricing Officer under section 92CA(1) of the Act to compute the arm's length price of the international transaction by applying any of the methods prescribed under section 92C of the Act. After receiving such a reference from the Assessing Officer, the Transfer Pricing Officer is required to determine the arm's length price of the international transaction as per the provisions contained under

section 92C and 92CA of the Act read with relevant rules. Thus, as could be seen from the reading of the aforesaid provisions, the duty of the Transfer Pricing Officer is restricted only to the determination of arm's length price of an international transaction between two related parties by applying any of the methods prescribed under section 92C of the Act r/w rule 10B of the Rules. Thus, there is no provision under the Act empowering the Transfer Pricing Officer to determine the arm's length price on estimation basis, that too, by entertaining doubts with regard to the business expediency of the payment and in the process stepping into the shoes of the Assessing Officer for making disallowance under section 37(1) of the Act. This, in our considered opinion, is not in conformity with the statutory provision, hence, unacceptable. The Transfer Pricing Officer is duty bound to determine the arm's length price of the international transaction by adopting one of the method prescribed under the statute and cannot deviate from the restrictions / conditions imposed under the statute. The Hon'ble Jurisdictional High Court in CIT v/s Johnson & Johnson Ltd., ITA no.1030/2014, dated 7th March 2017, while dealing with identical issue of determination of arm's length price of royalty by resorting to estimation by the Transfer Pricing Officer has held as under:—

"(d) We find that the impugned order of the Tribunal upholding the order of the CIT(A) in the present facts cannot be found fault with. The TPO is mandated by law to determine the ALP by following one of the methods prescribed in section 92C of the Act

read with Rule 10B of the Income Tax Rules. However, the aforesaid exercise of determining the ALP in respect of the royalty payable for technical knowhow has not been carried out as required under the Act. Further, as held by the CIT(A) and upheld by the impugned order of the Tribunal, the TPO has given no reasons justifying the technical know how royalty paid by the Assessing Officer to its Associated Enterprise being restricted to 1% instead of 2%, as claimed by the respondent assessee. This determination of ALP of technical know how royalty by the TPO was ad-hoc and arbitrary as held by the CIT(A) and the Tribunal."

13. The Tribunal, Hyderabad Bench in R.A.K. Ceramics India Pvt. Ltd. (supra) while dealing with identical nature of dispute relating to determination of arm's length price of royalty payment by estimation held as under:-

"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, Id. 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 Id. 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 Castrol India Ltd. (supra) 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 Id. 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 Id. 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 Id. 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, Id. 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."

14. The aforesaid view of the Tribunal, Hyderabad Bench, was affirmed by the Hon'ble High Court of Telangana and Andhra Pradesh, in ITTA no.590/2016, dated 23rd December 2016. While upholding the decision of the Tribunal, the Hon'ble High Court held as under:-

"Having considered the rival submissions, we find that the assessee offered two transfer pricing studies in relation to payment of royalty. In so far as the acceptable study adopting the Comparable Uncontrolled Price method is concerned, it is not in dispute that the assessee offered three comparables with an average royalty payment of 3.65% as against its own rate of

royalty at 3%. Significantly, the TPO rejected these comparable on the ground that they were US based, while the AE of the assessee was UAE based. Having rejected these comparables, it was for the TPO to come up with other comparables, it was for the TPO to come up with other comparables so as to justify reduction of the royalty payment. However, no such exercise was undertaken by the TPO determined that the reason for the same was increased marketing along with offer of discounts and that there was no justification for payment of royalty at 3% to the AE by the assessee. This reasoning is without legal basis of law as it is not for the TPO to decide the best business strategy for the assessee.

In WALCHAND AND CO. PRIVATE LTD. the Supreme Court observed in the context of the Income-tax Act, 1922 that when a claim is made for an allowance by the assessee, the income tax authorities have to decide whether the expenditure claimed as an allowance was incurred voluntarily and on grounds of commercial expediency. The Supreme Court pointed out that in applying the test of commercial expediency for determining whether the expenditure was wholly and exclusively for the purpose of business, it has to be adjudged from the point of view of the businessmen and not of the revenue. The Supreme Court concluded that it is open to the revenue to come to the conclusion that the alleged payment was not real or that it had not been incurred by the assessee in the character of a tender or that it was not laid out exclusively for the purpose of the business so as to disallow it but it is not the function of the revenue to determine what remuneration should be paid to an employee by the assessee.

Applying the same logic to the case on hand, once it is admitted by the Revenue that the assessee entered into a royalty agreement with the A.E. and the assessee claimed benefit from such agreement, in the form of quantum increase in sales with no apparent increase in production, minimal product recalls and low after sales maintenance cost, and consequently paid royalty in terms thereof, it was not for the TPO to determine as to what would be the other reasons for increase in the assessee's sales and profit.

Above all, there is no explanation forthcoming as to why the TPO decided upon 2% instead of the contractual rate of 3% for payment of royalty. No reason is offered by the TPO for picking on 2%. This whimsical fixation by the TPO amounts to an arbitrary and unbridled exercise of power. In consequence, we find that the TPO having rejected the comparables cited by the assessee, did not take the trouble to examine alternate comparables so as to

justify reduction of the rate of payment of royalty and by applying a wholly inapplicable methodology of determining the benefit from payment of such royalty, he capriciously reduced the rate for payment of such royalty from 3% to 2%.

On the above analysis, we find no grounds to interfere with the cogent and well reasoned order passed by the Tribunal. No question of law, much less a substantial question of law, therefore, arises for consideration in this regard."

15. The same view has also been expressed by the Tribunal, Delhi Bench, in case of Reebok India Co. (supra). As could be seen from the facts of the present case, there is no dispute that the assessee by virtue of a license agreement entered with the AE from past several years had been availing technical knowhow for utilization in manufacturing of flavours and fragrances. It is also evident on record, the assessee does not undertake any research and development activity and all research and development activities are carried out by the AE in Switzerland. All intellectual property right in relation to R&D activities remains with the AE. It is also a fact on record that the assessee is paying royalty to the AE for availing technical knowhow from the very inception of its manufacturing activity. Therefore, only because the manufacturing activity is being carried on from past several years, it does not mean that the assessee would not require the technical knowhow of the AE, hence, there is no necessity for paying royalty to the AE. More so, when the Department accepts availing of technical knowhow while allowing a part of royalty even on

estimate basis. Therefore, keeping in view the relevant statutory provisions and the principles laid down in the judicial precedents discussed herein above, we hold that determination of arm's length price @ 10% of the amount paid by the assessee on mere assumption and presumption and without any reasonable basis cannot be upheld. Unfortunately, the DRP has not examined the issue in proper perspective keeping in view the relevant statutory provisions. Having held so, it is necessary to deal with the Transfer Pricing Officer's alternative bench marking under CUP method. Though, DRP has not dealt with this issue, however, we deem it appropriate to render our finding with regard to the alternative benchmarking suggested by the Transfer Pricing Officer. As could be seen from the order passed by the Transfer Pricing Officer, referring to three agreements / comparables stated to have been selected by him on search of a particular data base, he found that the arm's length price of the royalty payment to the AE should be @ 1% of the net sales. However, the fact on record reveal that during the transfer pricing proceedings, in response to a show cause notice issued by the Transfer Pricing Officer, the assessee has specifically objected to the comparables proposed by the Transfer Pricing Officer by stating that none of the comparable are functionally similar to the assessee since all of them related to asset purchase agreement and further all the parties relating to such agreement are

located outside India, hence, are not governed by Indian rules and regulations. The aforesaid objection of the assessee has neither been dealt with nor controverted by the Transfer Pricing Officer. Thus, when the comparable proposed by the Transfer Pricing Officer are in different geographical location we do not understand how they can be compared to the assessee. It is further necessary to observe that the payment of royalty by the assessee in the preceding assessment years, though, identical in nature but they have been accepted by the Transfer Pricing Officer in course of Transfer Pricing proceedings from assessment year 2006-07 onwards. This is evident from the Transfer Pricing Officer's order passed for the assessment year 2010-11 and 2011-12, copies of which are placed before us. Further, the Transfer Pricing Officer having not determined the arm's length price in conformity with statutory provision and in the process having failed to demonstrate that arm's length price shown by the assessee is incorrect, the contention of the learned Departmental Representative to restore the issue to Transfer Pricing Officer for fresh determination of arm's length price is unacceptable. Thus, on overall consideration of facts and material on record, we hold that the adjustment made to the arm's length price of royalty payment is unsustainable; hence, the addition made in this regard is deleted. This ground is allowed.

16. In ground no.2, the assessee has challenged the addition made of ₹ 11,34,38,330, on account of adjustment made to the arm's length price of payment to the AE towards availing Information Systems (IS) services.

17. Brief facts are, in the course of proceedings before him, the Transfer Pricing Officer noticed that the assessee has paid an amount of ₹ 12,96,43,330, for availing Software Services, out of which, the assessee has capitalized an amount of ₹ 5,34,68,651, and claimed the balance amount of ₹ 7,61,74,677, as revenue expenditure. After calling for necessary details relating to the payment made, use of software and actual services provided by the AE, basis for allocation of cost to the assessee, cost incurred by the A.E. and evidences for third party payment made by the AE the Assessing Officer alleged that the assessee failed to furnish the necessary details. Therefore, the Transfer Pricing Officer called upon the assessee to show cause as to why the arm's length price of IS services should not be taken as nil. In response, it was submitted by the assessee that it has switched over the accounting software, stock maintenance software and software for other services into S3-ERP software developed / acquired by the AE it was submitted that the capital expenditure incurred by the AE towards development of such software was apportioned amongst the group companies which use the said software. Drawing the Transfer Pricing

Officer's attention to IS agreement, Chartered Accountant firm report on cost allocation, sample invoices, etc. the assessee submitted that the cost of software charges is substantial and mandatory and has to be incurred by the assessee either through AE or directly, since, the business of the assessee has to be run, controlled, managed by the computer system with the help of application software. Assessee submitted, if it would have made such arrangement from outside / third parties, it would have been costlier than the cost paid to the AE. Accordingly, the assessee justified the payment towards information services. The Transfer Pricing Officer, however, did not find merit in the submissions of the assessee. Referring to certain clauses of the IS services agreement between the assessee and the AE, the Transfer Pricing Officer observed that the onus is on the assessee to prove that services were actually rendered and received from the AE. He observed, one more factor which is required to be examined with regard to such intra-group services is the quantification of such services in terms of actual expenditure incurred and commensurate benefits derived therefrom. The Transfer Pricing Officer after referring to OECD guidelines, internal revenue code (US regulations) and certain judicial precedents ultimately concluded that the assessee has failed to demonstrate that services have in fact been provided, the basis for quantification of the payment made, etc. Though, the Transfer Pricing

Officer admitted that the AE has provided the software, however, at the same time, he held that in the absence of specific details towards services rendered to the assessee, the quantification of value of the services rendered by the AE has to be done by way of estimation to the best judgment. Accordingly, the Transfer Pricing Officer proceeded to quantify the arm's length price of the payment made by stating that the number of man hours rendered by the employees towards rendering of services to the assessee is two man hour per day i.e., 365 man hour per year. Applying the man hour rate of ₹ 8,05,000 per hour, which according to the Transfer Pricing Officer can be considered as a CUP, he determined the arm's length price of the services availed by the assessee at ₹ 62,05,000. In addition, the Transfer Pricing Officer estimated an amount of ₹ 1,00,00,000 towards cost of software to be paid annually by the assessee. Thus, he determined the arm's length price of the services rendered by the AE at ₹ 1,62,05,000 as against the payment made by the assessee at ₹ 12,96,43,330. Accordingly, he made an adjustment of ₹ 11,34,38,330. While, framing the assessment order the Assessing Officer added back the same amount to the income of the assessee.

18. Being aggrieved, the assessee filed appeal before the DRP. However, the DRP did not find any merit in the submissions of the assessee and upheld the estimation made by the Transfer Pricing

Officer as reasonable. However, the DRP directed the Transfer Pricing Officer to verify assessee's claim that a part of the charges have already been capitalized and to restrict the adjustment to the charges debited to the Profit & Loss account as reduced by the service charges allowed by the Transfer Pricing Officer as arm's length price of the transaction. Further, the DRP directed the Transfer Pricing Officer to reduce the capitalized IS charges from the cost of asset eligible for depreciation.

19. The learned Authorised Representative submitted, the AE has developed the ERP software for group companies which took five years to develop. He submitted, the AE has allocated the cost of the ERP software to all group companies in 40 countries. He submitted, the assessee has implemented the software developed by the AE and the impugned assessment year is the second year where the assessee has made payment for information services. He submitted, the cost paid to the AE for information services is in terms with the agreement which provides for cost allocation mechanism. In this context, the learned Authorised Representative drew the attention of the bench to the relevant clauses of the agreement between the A.E. and group companies. The learned Authorised Representative submitted, the assessee in the course of transfer pricing proceeding has submitted all documentary evidences relating to availing of services as well as mode

and manner of cost allocation between the AE and the group companies. Referring to Page-483 of the paper book the learned Authorised Representative submitted, the cost charged to the AE by SAP and Oracle for development of the software were also produced before the Transfer Pricing Officer. Referring to Page-487 of the paper book, he submitted that the details of users of the software were also furnished before the Transfer Pricing Officer. The learned Authorised Representative submitted, in spite of all documentary evidences submitted by the assessee, the Transfer Pricing Officer without properly verifying them on mere assumption and presumption has concluded that the assessee has not availed services from the AE and accordingly proceeded to determine the arm's length price on pure estimation basis. The learned Authorised Representative submitted, such ad-hoc determination of arm's length price is not permissible under the Act. Further, the learned Authorised Representative submitted, though, similar payment was made by the assessee in assessment year 2011-12, no adjustment was made by the Transfer Pricing Officer. Thus, he submitted, the adjustment made to arm's length price by the Transfer Pricing Officer deserves to be struck down. In support of his contention, the learned Authorised Representative relied upon the following decisions:-

- i) *McCann Erickson India Pvt. Ltd. v/s ACIT, ITA no.587/Del./2011, dated 08.06.2012;*
- ii) *TNS India Pvt. Ltd. v/s ACIT, [2014] 39 CCH 032 (Hyd.);*
- iii) *Dresser-Rand India Pvt. Ltd. v/s ACIT, [2011] 141 TTJ (Mum.) 2010;*
- iv) *DCIT v/s M/s. UCB India Ltd., ITA no.1218/Mum./2014, dated 27.04.2016;*
- v) *AWB India Pvt. Ltd. v/s DCIT, ITA no.6480/Del./2012, dated 13.10.2014; and*
- vi) *Merck Ltd. v/s DCIT, [2014] 148 ITD 513 (Mum.); and*
- vii) *DCIT v/s M/s. Diebold Software Services Pvt. Ltd., ITA no. 4347/Mum./2012, dated 02.04.2014.*

20. The learned Departmental Representative relying upon the observations of the DRP and the Transfer Pricing Officer submitted that the assessee did not file proper documentary evidences before the Transfer Pricing Officer to prove availing of services. He submitted, the only evidence submitted by the assessee was a certificate from KPMG which is qualified. He submitted, the assessee failed to substantiate that allocation of cost is at arm's length with uncontrolled transactions. Thus, he submitted, in the absence of proper documentary evidences, the Transfer Pricing Officer was compelled to determine the arm's length price of the price paid for services availed on estimation basis. The learned Departmental Representative submitted, if the Bench feels that the determination of arm's length price is not in accordance with the statutory provision, the matter may be restored to the Transfer

Pricing Officer for determination of arm's length price afresh by following the method prescribed under the statute.

21. We have considered rival submissions and perused materials on record in the light of decisions relied upon. Though, the Transfer Pricing Officer has alleged that the assessee failed to furnish any evidence to substantiate its claim that the payment made to the AE for availing Information System Services, however, the material on record reveal that the assessee has not only undertaken a bench marking process for determining the arm's length price of the transaction in the transfer pricing study report which was filed before the Transfer Pricing Officer, but, other relevant and necessary documents like copy of the agreement, invoices raised, certificate from independent Chartered Accountant Firm, KPMG, details of users were also furnished before the Transfer Pricing Officer. Therefore, the allegation of the Transfer Pricing Officer that the assessee has not furnished the necessary details is not totally correct. In any case of the matter, non-furnishing of certain documentary evidences, as alleged by the Transfer Pricing Officer, does not empower him to embark upon determining the arm's length price of the international transaction on estimation basis. Further, a reading of the Transfer Pricing Officer's order makes it clear that his finding on the issue is contradictory. On the one hand, he has observed that the assessee has failed all the three tests, including,

whether the services have actually been provided, on the other hand, he has accepted that the AE has provided the software. Thus, ultimately, what the Transfer Pricing Officer disbelieves is the quantum of payment. Accordingly, he has proceeded to estimate the price of the services rendered by the AE at ₹ 1,62,05,000. Though, the Transfer Pricing Officer has observed that he has applied CUP method for determining the arm's length price, however, he has not brought on record even a single comparable to support the arm's length price determined by him even on estimate basis. The estimation of service charges on so called man hour basis is without any supporting material. Similarly, the estimation of cost of software at ₹. 1 crore is without any basis. Thus, it is very much clear that the determination of arm's length price by the Transfer Pricing Officer is not as per any one of the methods prescribed under section 92C of the Act r/w rule 10B. As discussed elsewhere in this order, such determination of arm's length price on ad-hoc / estimation basis is not permissible under the scheme of the Act as the Transfer Pricing Officer is duty bound to determine the arm's length price by following any one of the most appropriate method prescribed under the statute. It is relevant to observe, the DRP has approved the determination of the arm's length price by the Transfer Pricing Officer without properly appreciating the implication of the relevant statutory provisions. As regards the

observations of the DRP regarding the report of the KPMG, it is necessary to observe that the KPMG report is not an audit report but was furnished by the assessee to support the attribution of cost. Therefore, it cannot be said that it is a qualified report. It is further relevant to observe, the material submitted before us, which also forms part of the Transfer Pricing Officer's record, indicates that the cost of the software has been allocated to 40 group companies across the globe who are using the software and related services and assessee's share in cost allocation works out to 2.3%. Moreover, when the Transfer Pricing Officer himself agrees that the AE has provided software and certain services, there is no reason for not accepting the payment made to the AE to be at arm's length in the absence of any contrary evidence brought on record and by simply applying the benefit test. If the Transfer Pricing Officer did not agree to the arm's length price shown by the assessee it was open for him to determine the arm's length price by applying one of the most appropriate methods being backed by supporting material. Without complying to the statutory provisions, the Transfer Pricing Officer certainly cannot determine the arm's length price on ad-hoc / estimation basis. Our reasoning in paragraph 11 to 15 will equally apply to this issue also. Accordingly, we delete the adjustment made to the arm's length price

of payment made towards availing information system services from AE. This ground is allowed.

22. Grounds no.3 and 4 are not pressed, hence, dismissed.

23. Ground no.5, relates to levy of interest under section 234B and 234C of the Act.

24. Levy of interest being consequential, this ground does not require any adjudication.

25. In the result, assessee's appeal is partly allowed.

Order pronounced in the open Court on 23.07.2018

Sd/-
RAJESH KUMAR
ACCOUNTANT MEMBER

Sd/-
SAKTIJIT DEY
JUDICIAL MEMBER

MUMBAI, DATED: 23.07.2018

Copy of the order forwarded to:

- (1) The Assessee;
- (2) The Revenue;
- (3) The CIT(A);
- (4) The CIT, Mumbai City concerned;
- (5) The DR, ITAT, Mumbai;
- (6) Guard file.

Pradeep J. Chowdhury
Sr. Private Secretary

True Copy
By Order

(Sr. Private Secretary)
ITAT, Mumbai