

INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH "I-2": NEW DELHI
BEFORE MS SUSHMA CHOWLA, VICE PRESIDENT
AND
SHRI PRASHANT MAHARISHI, ACCOUNTANT MEMBER
(THROUGH VIDEO CONFERENCING)

IT(TP) APPEAL No. 4765/Del/2015
(Assessment Year: 2010-11)

Marathon Electric India Pvt. Ltd, Sector-11, Model Town, Faridabad PAN: AAACG5525H (Appellant)	Vs.	The Deputy Commissioner of Income Tax , Circle-1, Faridabad (Respondent)
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Assessee by :	Shri Tarandeep Singh, Adv
Revenue by:	Shri M. Bavanwal, Sr. DR
Date of Hearing	17/08/2020
Date of pronouncement	31/08/2020

ORDER

PER PRASHANT MAHARISHI, A. M.

1. This appeal is filed by the assessee against the order of the Id CIT (A), Faridabad dated 12.06.2015 for AY 2010-11 wherein, the appeal filed by the assessee against the assessment order passed u/s 143(3) of the Act on 11.04.2014 by the Id Dy Commissioner of Income Tax, Circle-1, Faridabad was partly allowed.
2. The assessee has raised the following grounds of appeal:-
 - “1. That on the facts and in the circumstances of the case and in law, the order passed by the Learned Commissioner of Income Tax (Appeals) [“Ld. CIT (A)”] under section 250 of the Indian Income Tax Act (“the Act”) is bad in law.
 2. That on the facts and circumstances of the case and in law, the Ld. CIT (A) erred in determining the arm's length price of the international transaction of reimbursement of expenses paid to the AE to be Nil, thereby making an addition to the total income of Rs. 5,870,089. In doing so, the Ld. CIT (A) grossly erred in:
 - 2.1 not appreciating the characterization of the entities involved in the transaction;
 - 2.2 disregarding the fact that the conduct of the appellant conforms to the allocation of risk i.e. the entity bearing product liability risk is undertaking decisions in relation to the same;

- 2.3 *questioning the commercial/business wisdom of the Appellant for undertaking the said transaction and ignoring the vast jurisprudence on the matter; and*
- 2.4 *not appreciating the fact that no benefit has been passed on to the AE since it is recovering the same amount that has been paid to an independent third party.*
- 3. *The Learned Assessment Officer (“Ld. AO”) grossly erred in initiating penalty proceedings u/s 271 (1)(c) of the Act mechanically without recording any satisfaction for its limitation.*
- 4. *That the Ld. AO grossly erred in levying an interest u/s 234B, 234C and 234D of the Act to the taxable income of the Appellant.”*

- 3. Ground No. 1 is general in nature, Ground No. 3 is against the initiation of penalty proceedings u/s 271(1)(c) of the Income Tax Act is premature and ground No. 4 is against levy of interest u/s 234 B, 234C and 234D which is consequential in nature, therefore, ground Nos. 1, 3 and 4 are dismissed.
- 4. The only remaining ground is ground No. 2, which is against the confirmation of the order of the ld AO/ TPO in determining the Arm’s length price of the international transaction of reimbursement of expenses paid to the associated enterprises determined by the ld TPO at Rs. Nil. Thereby an adjustment of Rs. 5870089/- was made to ALP of International Transaction and consequent addition to total Income.
- 5. Brief facts of the case shows that the assessee is a company who filed its return of income on 13.10.2010 declaring income of Rs. 41976399/-. The assessee has entered into an international transaction and therefore, the ld AO referred to the Ld Transfer Pricing Officer for determination of Arm’s Length Price of the international transaction. The assessee has entered into several international transactions, such as purchase of raw material, export of motors, import of capital goods, provision of services and reimbursement of expenses paid and received.
- 6. Only dispute is with respect to the reimbursement of expenses paid by the assessee to its associated enterprises having the value of transaction of Rs. 5870089/-.
- 7. The assessee is engaged in manufacturing and sale of fractional Horse Power electric motors, which find wide application in domestic use products like air conditioners, coolers, washing machines etc and electric fans. It has

one manufacturing unit set up as an Export Oriented Unit (EOU) and second was in the domestic Tariff Area (DTA) Unit.

8. The international transaction of reimbursement of expenses paid by the assessee relates to testing/ firewall charges on a cost-to-cost basis. Assessee exports Motors. These motors are tested by third party in destination of export. Testing is done by third party. Third party is paid by AE and assessee reimburses that payment to its AE. These charges are paid by the assessee to its associate enterprises exactly the same amount, which AE paid to third party performing the testing services charges from its AE. Assessee selected the CUP method as the most appropriate method for benchmarking the international transactions. The Id TPO issued a show-cause notice on 19.12.2013 stating that assessee has paid a sum of Rs. 5870089/- to its associated concern on account of testing and warranty service charge. According to TPO same is not at Arm's Length Price. The reason is that as once sale has been affected the responsibility rests with the buyer and there is no case for bearing this charge by the seller i.e. assessee. Therefore, the Arm's length price of such charges should be Nil.
9. Assessee explained that when the finished goods are shipped to its associated enterprises from Indian ports there is time lag before the products reached to destination port. At times, motors capture moisture during the transit period, which can adversely impact its performance. Therefore, on the request of the assessee, associated enterprises engaged a third party for testing of the motors to ensure the desired quality standards of the US Market. These charges are paid on all motors those are tested in adherence to quality standards. Therefore, in order to determine that motors exported, meets the desired quality standards, they are tested. Such expenses are incurred by AE and same are reimbursed at cost to cost by the assessee.
10. The Id TPO rejected the contentions of the assessee and concluded that such payments are not at arm's length principle. The reason of the TPO was that assessee is not only to provide warranty but also pays the associated enterprises for testing charges of all motors. According to him, an unrelated party would not pay on account of motors that do not have a fault. Accordingly, he determined the ALP of these transactions at Rs. Nil and

proposed adjustment of Rs. 5870089/-. The ld TPO passed an order u/s 92CA(3) on 22.01.2014 including the above adjustment. The ld TPO also made certain other adjustment with which we are not concerned in this appeal.

11. The ld AO passed an assessment order on 11.04.2014 u/s 143(3) of the Act making the addition of the above adjustment along with other adjustment proposed. Total income of the assessee was assessed at Rs. 55487350/- against the return income of Rs. 41976399/-.
12. The assessee preferred an appeal before the ld CIT (A). He confirmed the above adjustment. The reasons was that he concurred with the views of the ld AO/ TPO that no unrelated party would make payment for testing of motors when there is remote possibility that fault would be found and further when the goods are covered by warranty. He also noted that in assessee's own case for AY 2008-09 the ld DRP-1, New Delhi as per their direction dated 27.08.2012 have upheld the action of the ld AO making the identical adjustment. Thus, this addition was upheld. Therefore, assessee is in appeal before us on this ground as per Ground no [2] of this appeal.
13. The ld AR firstly referred to submission made before the ld TPO and then submitted that in AY 2007-08 and 2009-10 in ITA No. 5257/Del/2014 and in ITA No. 1060/Del/2014 per order dated 19.02.2020 the issue has been decided by the coordinate bench in favour of the assessee. Thus, issue is squarely covered in favour of the assessee. He even otherwise relied upon the decision of the Hon'ble Delhi High Court in EKL Appliances Ltd in ITA No. 1068/2011.
14. The ld DR vehemently supported the orders of the lower authorities and reiterated the same reasons for which the lower authorities confirmed the addition.
15. We have carefully considered the rival contentions and perused the orders of the lower authorities. We have also considered the decision of the coordinate bench in assessee's own case for AY 2007-08 and 2009-10. The identical issue was considered by the coordinate bench and deleted the addition. The findings of the coordinate bench were as under:-

“5. Ground no. 9 to 13 of the appeal are related to the Transfer Pricing Adjustment. The learned counsel for the assessee referred to paper-books filed in two volumes from pages 1 to 715 and submitted that international transaction is in respect of 'firewall charges' reimbursement to AE. He submitted that when finished goods are shipped to the AE in US from Indian Ports, there is a time lag before the products reach the destined port. At times, motors capture moisture during the transit period and this can adversely impact their functioning. The moisture in the motor may cause sparking at the time of usage and can cause harm to the user. On the request of the assessee, the AE engages a third party that tests all the motors to ensure the desired quality standards of the US market. The learned counsel for the assessee further submitted that in order to determine whether all motors meet the desired quality standards, each motor needs to be tested individually. He submitted that such testing charges incurred are paid by assessee to the AE which the AE pays to the third party on cost-to-cost basis without any mark-up. He submitted that the third party, i.e., Commercial Warehouse & Cartage Inc. ("CWC") USA undertakes functions of unpacking, testing and repacking of motors. He submitted that payment of firewall charges was made by the assessee to its AE was an integral part of the manufacturing function, the same was aggregated and benchmarked using the TNMM as the most appropriate method. The learned counsel submitted that the learned TPO rejected the arguments put-forth by the assessee stating the following reasons:

- a) An unrelated party would not make such a payment;
- b) If the AE wishes to test all the motors for its satisfaction, then it amounts to duplicative service and no separate payment is required to be made by the assessee.
- c) No unrelated party would make payment for testing of motors in which no fault is detected;
- d) No independent party would pay such testing charges when goods are covered by warranty;

5.1 The learned TPO in view his observations, benchmarked the transaction applying CUP method and valued at nil.

5.2 The learned counsel for the assessee submitted that the learned TPO/DRP has ignored the following points which are primary reasons for which the assessee is incurring such expenses:

"(i) Impact on the brand reputation: It is important to understand that the main reason behind incurring such expenses is to ensure that none of the motors are defective when sold to the customer in the overseas market. It is pertinent to note that the product liability risk, in a value chain, is that of a manufacturer. Since in the instant case. MEIPL is the manufacturing entity, any defect in the product

will have a detrimental effect on the brand reputation of MEIPL. In case any defect is identified in the goods which are being sold in the US market, the reputation of MEIPL would be impacted and not that of the distributor as the distributor is earning a gross margin by just rendering distribution services. Adverse brand reputation would lead to drastic reduction in sales in subsequent years and hence the profitability of the Assessee.

(ii) Penal charges: It is important to understand that US being the most developed country in the world has the most stringent laws against the damages caused by the use of faulty/ defective items. A company could even face trial for providing faulty products. In the instant case, if the motors supplied by MEIPL to the customer is used in a building and due to a short circuit in the motor (because of the moisture) it catches fire, then this could lead to huge product liability claims been initiated against the manufacturer i.e. MEIPL and not the distributor. The Assessee could also face trial for the same apart from huge damages claim which will impact the overall reputation/ functioning of the Assessee.

(iii) Cost to cost charges: An important point which must be considered while evaluating arm's length nature of this transaction is that, on request of MEIPL, the AE appoints the third party that performs unpacking, testing and repacking of motors. The cost of such activities is borne by the AE which then recovers exactly the same from MEIPL i.e. without charging any mark-up. In other words, this is a cost to cost reimbursement and hence the AE has not benefitted anything from this arrangement. These motors ought to have been tested in US only and could not have happened in India (as testing is performed to check moisture in motors during transit). If testing was possible in India, MEIPL would have directly appointed the third party. In this case, since the AE is familiar with the US market, has appointed this third party for the purpose of testing. Back to back invoices have already been submitted by the Assessee to the Ld. TPO / Ld. DRP (on sample basis for AY 2007-08) (For back-to-back invoices please refer pg 611-693 of PBII).

(iv) Cost not related to AE: It is hereby stated that the AE is a distributor of goods which are manufactured by the Assessee. It has also been stated before the lower authorities that the AE retains only 10% of revenue and the balance is remitted back to the Assessee. Hence, the profit is that of the Assessee with limited returns to the AE - a gross margin of 10%. Under these circumstances it that the AE would not bear such expense of testing when it is earning only minimal returns. Should the AE start to bear these expenses it's margins would take a hit. In any third party set-up such costs can never be passed onto the distributor."

5.3 Further, the learned counsel also submitted that why such testing was required and how it was different from warranty and other expenses, which are as follows:

"11. The Ld. TPO has compared this expense with warranty' expenses. It is true that Assessee provides warranty, but this expense is separate and distinct to firewall charges. Any motor that does not contain moisture may also have functional problems (i.e. other problem relating to functionality of the motor) because of which MEIPL could bear the warranty charges. But it is the responsibility of the Assessee to provide the motors in working conditions. It is also important to point out that if products are sold without testing, it can lead to extra claims on warranty - which not only is economically non-viable but also impacts reputation of the company's brand.

12. The Ld. TPO has also stated that this is a duplicative service. Again, the Ld. TPO/Ld. DRP has not appreciated or understood the nature of the transaction. This testing can never be done in India as the purpose is to check faults due to moisture while still in transit. It is beyond the understanding how this can tantamount to duplication.

13. The Ld. TPO has mentioned that 'no third party ' would incur such expenses in which no fault is detected. While saying this, the Ld. TPO has not given any reference to any third party not incurring such expense. It is apparent, that fault or no fault in the motors can only be determined once all the motors are tested. Hence this argument is also flawed. Further, the Assessee believes that it is the responsibility of the manufacturer to provide goods in working conditions to its distributor. Hence all third-party manufacturers are likely to incur such expenses."

5.4 The learned counsel for the assessee also argued that this was a genuine business expenditure, incurred wholly and solely for the purpose of the business of the assessee and cannot be disallowed by the learned TPO. He submitted that the AE is merely acting as a distributor who is never liable for the goods manufactured. On the issue of application of the CUP method by the learned TPO, the learned counsel for the assessee submitted as under:

"16. The learned TPO has further rejected the aggregation approach and benchmarked the transaction using CUP method. In this regard, the Assessee submits that subject transaction is interlinked with the primary transaction and the reason for the same is already mentioned in the TP study. However, without prejudice to the above, even if the approach of the Ld. TPO is to be selected, the Assessee furnished third party invoices which

represented CUP for the subject transaction. However, the Ld. TPO ignored the same and determined the value to be 'Nil' without identifying a single comparable. In relation to the same, the Assessee wishes to rely on the following judicial rulings, wherein it has been held that it is imperative to have a Comparable uncontrolled transaction.

17. In the case of Gates Unitta India Company Private Limited (ITA No. 2745/Chny/2017) (refer para 8, page 8 of the ruling; to be handed over by the counsel) wherein it was held that:

"8. From the above, it is obvious that for selecting a Comparable Uncontrolled Price method, the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transaction is to be identified. In this case, admittedly, no such companies were identified by the TPO or DRP. Therefore, this Tribunal is of the considered opinion that the matter needs to be reconsidered by the authorities below. "

18, In the case of SNF (India) Pvt. Ltd. (ITA No. 279 & 280/VIZ/2017) (refer para 15, page 22 & 23 of the ruling; to be handed over by the counsel) wherein it was held that:

"15. During the appeal hearing, the Id.AR argued that the payment of royalty is interlinked with the manufacturing activity and other trading transitions, therefore, the TNMM is most appropriate method at the entity level and it is necessary to aggregate the entire transactions without delinking with the royalty payments. The Department could not establish that the royalty is independent and separate transaction for unbundling the royalty from the other transactions to determine the ALP independently. Once it is accepted that the technical support is required for manufacturing the product and it is interrelated the payment of royalty cannot be segregated and the transactions required to be aggregated at the entity level and the ALP required to be determined on the whole transactions. Though the TPO held that the CUP is most appropriate method for determining the transfer pricing of the royalty but did not bring any comparables for determination of the royalty payment.....

.....In the instant case assessee has not availed similar technology from any other third party and the associated enterprise has not provided the technology to any other third party. The Ld. TPO has not brought any comparable cases under CUP method for determination of ALP. Therefore taking in to consideration the entire facts and the materials placed before us we, agree with the Ld.CIT(A) that the TNMM is most appropriate method to determine the ALP at entity level. "

19. Further, reliance is placed on Trinita Advanced Software Labs Pvt. Ltd. (ITA No. 1427/Hyd/2014) (refer para 11, page 8 of the ruling; to be handed over by the counsel)

20. Furthermore, in the case of Spencer Stuart (India) Private Limited (ITA No. 7117/2012, 1680/2014, 922/2015 and 1832/2016) it was held that if reimbursements are back by third party invoices, the same cannot be benchmarked as 'Nil'. The relevant extract of the same is given below:

"20. In view of the above and respectfully following the decision of the Co-ordinate Bench in case of assessee "v AE, we hold that reimbursements paid being backed by third party invoices without any element of mark-up, cannot be benchmarked at NIL as done by TPO. Accordingly, we delete the addition so made by the AO. "

22. It is also important to note that the Assessee has provided back to back invoices that act as CUP. Hence Assessee has demonstrated arm's length using third party data."

5.5 The learned counsel further submitted that the issue in disputed in the case of the assessee was covered by the decision of the Hon'ble Jurisdictional High Court in the case of EKL Appliances Ltd. (ITA No.1068/2011 & ITA No. 1070/2011), wherein the Hon'ble Court has held that the assessee is not required to demonstrate that the expenditure has actually resulted in profit or income either in the same year or in any of the subsequent year. The only condition is that the expenditure should have been incurred "wholly and exclusively" for the purpose of business. The relevant finding of the Hon'ble High Court (supra) is reproduced as under:

"21. The position emerging from the above decisions is that it is not necessary for the Respondent to show that any legitimate expenditure incurred by him was also incurred out of necessity. It is also not necessary for the Respondent to show that any expenditure incurred by him for the purpose of business carried on by him has actually resulted in profit or income either in the same year or in any of the subsequent years. The only condition is that the expenditure should have been incurred "wholly and exclusively" for the purpose of business and nothing more. It is this principle that inter alia finds expression in the OECD guidelines, in the paragraphs which we have quoted above."

5.6 On the contrary, learned DR relied on the order of the lower authorities and submitted that the services are in the nature of the duplicate in view of covered by the warranty and thus the learned TPO has correctly determined the ALP at Nil.

5.7 We have heard the rival submissions of the parties and perused the relevant material on record. We find that the Hon'ble Delhi High Court in the case of EKL Appliances (supra) has held that the TPO is expected to examine the international transaction as he actually finds the same and then make suitable adjustment but a wholesale disallowance of the expenditure by the learned TPO is not authorized. The relevant finding of the High Court is reproduced as under:

"22. Even Rule 10B(1)(a) does not authorise disallowance of any expenditure on the ground that it was not necessary or prudent for the Respondent to have incurred the same or that in the view of the Revenue the expenditure was unremunerative or that in view of the continued losses suffered by the Respondent in his business, he could have fared better had he not incurred such expenditure. These are irrelevant considerations for the purpose of Rule 10B. Whether or not to enter into the transaction is for the assessee to decide. " The quantum of expenditure can no doubt be examined by the TPO as per law but in judging the allowability thereof as business expenditure, he has no authority to disallow' the entire expenditure or a part thereof on the ground that the assessee has suffered continuous losses. The financial health of assessee can never be a criterion to judge allowability of an expense; there is certainly no authority for that. What the TPO has done in the present case is to hold that the assessee ought not to have entered into the agreement to pay royalty/ brand fee, because it has been suffering losses continuously. So long as the expenditure or payment has been demonstrated to have been incurred or laid out for the purposes of business, it is no concern of the TPO to disallow' the same on any extraneous reasoning. As provided in the OECD guidelines, he is expected to examine the international transaction as he actually finds the same and then make suitable adjustment but a wholesale ITA No. 5257/Del./2011 & 1060/Del./2014 disallowance of the expenditure, particularly on the grounds which have been given by the TPO is not contemplated or authorised."

5.8 In the instant case, the assessee has incurred expenditure and not making payment of mark-up is not adverse to the entity in Indian Jurisdiction. The assessee has claimed the expenditure paid by the AE on its behalf. The contention of the TPO is that the assessee was not required to incur the said expenses. But it was under jurisdiction of the Assessing Officer whether particular expenditure was incurred wholly and exclusively for the purpose of business and not in the domain of the TPO to hold that in view of the warranty etc., the assessee was not required to incur expenditure on firewall charges. The contention of the assessee seems plausible that motors were required to checked for content of moisture acquired in transport from India to the USA, i.e., the

destination point and it was the responsibility of the assessee to provide defect free motors to the end customers. Thus, respectfully following the finding of the Hon'ble Delhi High Court (supra), we delete the transfer pricing adjustment of Rs. 2,54,42,211/-. Accordingly, the appeal of the assessee is allowed.”

16. The Id DR could not distinguish the decision of the coordinate bench either on the facts or law. In view of above finding of the coordinate bench in assessee's own case, for AY 2009-10 & 2010-11, respectfully following the same, we direct the Id AO/ TPO to delete the adjustment of Rs. 5870089/- arising on account of determination of ALP of the international transaction of reimbursement of expenses paid by the assessee to its associated enterprises of Rs. 5870089/- on account of testing charges. Accordingly, ground No. 2 of the appeal is allowed.

17. In the result appeal of the assessee is partly allowed.

Order pronounced in the open court on 31/08/2020.

-Sd/-
(SUSHMA CHOWLA)
VICE PRESIDENT

-Sd/-
(PRASHANT MAHARISHI)
ACCOUNTANT MEMBER

Dated: 31/08/2020
A K Keot

Copy forwarded to

1. Applicant
2. Respondent
3. CIT
4. CIT (A)
5. DR:ITAT

ASSISTANT REGISTRAR
ITAT, New Delhi