* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **ITA Nos. 288/2011, 294/2008, 96/2008, 1202/2005**

RESERVED ON: 15.02.2011

% PRONOUNCED ON: 11.5.2011

(1) ITA 288/2011

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. ...RESPONDENT

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates

(3) ITA 1202/2005

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. ...RESPONDENT

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

RESERVED ON: 15.02.2011
PRONOUNCED ON:11.5.2011

(4) ITA 288 OF 2011

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. ...RESPONDENT

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

(5) ITA 96 OF 2008

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. ...RESPONDENT

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

(6) ITA 294 OF 2008

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. **...RESPONDENT**

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

CORAM :-

HON'BLE MR. JUSTICE A.K. SIKRI
HON'BLE MR. JUSTICE M.L. MEHTA

1. Whether Reporters of Local newspapers may be allowed to see the Judgment?
2. To be referred to the Reporter or not?
3. Whether the Judgment should be reported in the Digest?

A.K. SIKRI, J.

For orders, see ITA No. 662 of 2005.

(A.K. SIKRI)
JUDGE

(M.L. MEHTA)
JUDGE

MAY 11, 2011
Skb

REPORTABLE

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **ITA 662/2005, 288/2011, 294/2008, 96/2008,1202/2005**

RESERVED ON: 15.02.2011

% PRONOUNCED ON: 11.5.2011

(1) ITA 662/2005

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. . . . RESPONDENT

Through:. Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

(2) ITA 288/2011

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. ...RESPONDENT

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates

(3) ITA 1202/2005

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. **...RESPONDENT**

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

RESERVED ON: 15.02.2011
PRONOUNCED ON:11.5.2011

(4) ITA 288 OF 2011

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. **...RESPONDENT**

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

(5) ITA 96 OF 2008

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. **...RESPONDENT**

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

(6) ITA 294 OF 2008

COMMISSIONER OF INCOME TAX . . . APPELLANT

Through : Mr. Sanjeev Sabharwal & Ms. Rashmi Chopra, Sr. Standing Counsel.

VERSUS

M/S NESTLE INDIA LTD. ...RESPONDENT

Through: Mr. Dinesh Vyas, Sr. Advocate with Mr. Rupesh Jain, Ms. Kavita Jha and Mr. Somnath Shukla, Advocates.

CORAM :-

HON'BLE MR. JUSTICE A.K. SIKRI
HON'BLE MR. JUSTICE M.L. MEHTA

1. Whether Reporters of Local newspapers may be allowed to see the Judgment?
2. To be referred to the Reporter or not?
3. Whether the Judgment should be reported in the Digest?

A.K. SIKRI, J.

1. The questions of law which arise for consideration in these appeals are common. These appeals concern with the same assessee though it pertain to different assessment years. The issue is with regard to deduction claimed by the assessee in

respect of remuneration/royalty paid by it to other subsidiaries and the assessee's holding companies. Only the amount of royalty paid in two years is different. To recapitulate briefly the circumstances under which the aforesaid payments of royalties are claimed, the assessee company is involved in the business of manufacturing and marketing of various food products and beverages. In the Income Tax Return filed for the assessment year 1997-98 it had declared total income of ₹ 17,99,29,538/-under Section 115 JA of the Income-Tax Act (hereinafter referred to as 'the Act'). The case was selected for scrutiny and in the assessment made by the Assessing Officer, several additions/disallowances were made. Here we are concerned with only one disallowance which was made, as aforesaid, i.e. qua the royalty payment made by the assessee.

The Assessing Officer noticed that the assessee had debited the amount of ₹ 47,00,41,000/- on account royalty payable to two overseas companies namely Nestec S.A. and Societe Des Produits Nestle S.A., Switzerland. These payments were claimed as business expenditure on account of technical assistance rendered by the two companies to the assessee. The Assessing Officer took this payment of royalty as huge when the book profit of the assessee after pay in that assessment years were ₹ 53.43 crores. The AO asked for various details with supporting evidence and

documents about the nature of technical assistance and the basis on which the assessee had entered into agreement to pay the aforesaid amounts. The AO also noticed that the two foreign companies were 100% subsidiaries of the assessee's holding company and therefore the agreement/transactions were not at arm's length. The AO referred to Sections 40A (2) (b) and Section 92 of the Act and held that he was entitled to go into the question of reasonableness of the said payments and find out whether the said expenditures were wholly and exclusively for the purpose of carrying out business. He also referred to Article 9 of the DTAA wherein it is specifically provided that when management, control or capital of an enterprise in a contracting state, directly or indirectly controls management of an enterprise in another contracting state, then profit of that enterprise can be calculated after excluding conditions different from those, which would have been incorporated in a contract made between two independent entity. The AO noticed that there were eight agreements entered into between the assessee and the aforesaid two companies and only two agreements were specifically approved by the Government of India. He was of the view that even this approval did not prevent him to go into the question as to whether or not alleged expenditure should be allowed as a deduction. After examining the issue he formed the view that the payment made

by way of commission/royalty was highly excessive in nature and there was no justification for making payment of this magnitude which was 40% of the gross profits. The Assessing Officer wanted the assessee to furnish details regarding valuation of technical service received, impact of such technical service and working profits of each product which according to the AO the assessee failed to produce. Thus, the Assessing Officer formed an opinion that the assessee was not able to justify such a huge payment. He specifically referred to the payment of ₹ 20.72 crores made on the product *Coffee* which the company had started manufacturing in the year 1964 and disallowed an amount of Rs 10 Crores out of this payment. With regard to other products, a similar disallowance of ₹ 5 crores was made. In this manner, out of ₹ 47 crores paid by the assessee to the aforesaid two overseas companies, by way of commission/royalty, a sum of ₹ 15 crores was disallowed.

2. The assessee felt aggrieved by this order of the Assessing Officer and went in appeal. In this appeal, the assessee triumphed as the CIT (A) accepted the contention of the assessee and allowed the entire amount of royalty. In this manner, disallowance of ₹ 15 crores made by the AO was deleted by the CIT (A). It was inter alia, held by the CIT (A) that royalty payment in

terms of sales at 3.5% to 5% as against the Government norms of 5-8% was reasonable. It was further held that the royalty payments for technical know-how are linked to sales and not to profit which is a derived figure that can vary from year to year. It would be relevant to state here that for the assessment year 1998-99, the Assessing Officer had made a similar disallowance of ₹ 17 crores. However, the appeal preferred by the assessee against that order was dismissed by the CIT (A) sustaining the disallowance made by the Assessing Officer.

3. In so far as the assessment year 1997-98 is concerned, the CIT (A) had allowed the appeal of the assessee. The Revenue approached the Tribunal challenging the order of the CIT (A). The assessee, on the other hand, filed appeal in so far as order of CIT (A) in respect of assessment year 1998-99 is concerned. These appeals have been decided by the Tribunal in favour of the assessee. Thus, the order of CIT (A) in respect of assessment year 1997-98 was affirmed dismissing the appeal of the Revenue. Likewise, the appeal of the assessee in respect of assessment year 1998-99 has been allowed. Effect is that the Tribunal has held that the payment of commission was not huge or unreasonable and since it was a business expenditure the entire expenditure incurred by the assessee in both these years by way of payment of

royalty/commission to the aforesaid two overseas companies is entitled for deduction.

4. Though, we shall take note of the order of the Tribunal in detail immediately hereafter, three significant aspects which influenced the Tribunal in arriving at the aforesaid decision are as follows:-

> (i) Royalty was paid on the basis of turn-over of the assessee/Indian company and the rate fixed was 3.5% of the turnover. The two overseas companies had given similar know-how to various companies world-wide with similar clause for payment of royalty and the average was 3.55%. Thus from the Indian companies, the royalty was fixed at lesser rate than the rate at which these two overseas companies were claiming royalty from other companies in other countries.
>
> (ii) The two agreements out of eight which were approved by the Reserve Bank of India provided stipulation as per which the Reserve Bank of India had authorized the assessee to pay royalty upto 5%. Thus, the Reserve Bank had, under the given circumstances, found even 5% of the turn over as royalty to be reasonable. (we may observe that it may not be a relevant ground).
>
> (iii) The royalty was paid for giving technical know-how by the said companies to the assessee. But for the said technical know-how, there could not even be production of any of the food and beverage items undertaken by the assessee here in India. Furthermore, the two overseas companies had been in continuous research and development activity whereby they were improving upon the products. All

such improvements which were the result of R & D was provided to the assessee on continuous basis. The assessee had thus received the services from the said two companies and as a consideration thereof, paid the aforesaid royalty. This was, therefore, clearly a business expenditure allowable.

(iv) Even the Assessing Officer did not dispute this position and he joined the issue only on the quantum of the royalty paid which according to the AO was unreasonably high. The Tribunal on the facts of the case found that the amount of royalty was neither unreasonable nor exorbitant.

5. These appeals are against the order of the Tribunal which were admitted on the following substantial question of law:-

"Whether the Income Tax Appellate Tribunal in law in deleting the addition of ₹ 15 crores made by the Assessing Officer on account of alleged remuneration/royalty paid by the Assessee top 100% subsidiaries of the Assessee's holding companies by relying upon Section 40A (2) (b) and Section 92 of the Income Tax Act, 1961 and Article 9 of the Double Taxation Avoidance Agreement?"

"(2) Whether the Income Tax Appellate Tribunal was correct in law in holding that the Assessing Officer could not have examined reasonableness and genuineness of the alleged expenses/ payments made by the Assessee to 100% subsidiaries of the Assessee's holding companies in view of the permission given by the Reserve Bank of India?"

6. The aforesaid questions were formulated in respect of assessment year 1997-98 as mentioned above. In so far as

assessment year 1998-99 is concerned, there is only a difference in amount which is ₹ 17 crores instead of ₹ 15 crores in this year. The perusal of question no.1 would demonstrate that the AO had invoked the provisions of Section 40A (2) (b) of the Act to deny the deduction in respect of entire amount of royalty and disallowing part thereof as noticed above. The reasons given by the AO for invoking this provisions was that the two overseas companies to whom the payments were made are the companies in which the assessee has substantial interest as they are 100% subsidiaries of the assessee's parent company and, therefore, as per the aforesaid provision, it was open to the Assessing Officer to form an opinion as to whether the expenditure was excessive or unreasonable having regard to the fair market value of the good, services or facilities for which the payment was made.

7. Section 91 of the Act deals with the arms length price. The reason for invoking this provision was again the same namely close relation between the assessee and the two overseas companies to whom the payment was made.

8. We may point out at this stage that Nestec S.A. is the parent company with its headquarter at Switzerland. It has various subsidiary companies. Nestec S.A. and Societe Des Produits

Nestle S.A. Switzerland, are the 100% subsidiary company of the said company. Likewise, the assessee is the subsidiary company of the aforesaid parent company. In this manner, though there is no direct inter-se link between the assessee and the aforesaid two companies to whom the royalty is paid, at the same time, the assessee as well as the two companies are the subsidiary of the same parent company. In that manner, we can say, these assessee and recipients of royalty are the siblings and this kind of co-relation exists between the assessee and the aforesaid two companies with whom agreements have been signed and royalty paid.

9. In so far as Article 9 of the DTAA is concerned, it is brought into focus because of the reason that the royalty is paid to the foreign companies and there is a Double Tax Avoidance Agreement between the Indian Government and the Switzerland Government. Before discussing as to how these three aspects are dealt with by the Tribunal in the impugned order, it would be advisable to take note of the nature of agreements signed between the assessee and the aforesaid licensor specifying the kind of technical know-how which has been given by those licensor to the assessee and the nature of technical know-how provided to the assessee under these agreements.

10. Nine agreements which are signed between the parties relate to different products, like coffee, pasta, noodles, dry mix infant foods, chocolates, infant weaning foods, dairy whitener etc. By virtue of these agreements, the assessee is permitted to manufacture and sell in India, the Nestle S.A. branded products under the same brand name, logo and packing etc. These agreements have various parts, part-A relates to "Manufacturing Licence". As per the provisions contained in this part, the assessee is granted licence during the term of the agreement to use the know- how for the manufacture of the products. The said know-how which the assessee is allowed to use, remains the property of the parent company. Not only the existing know-how but any improvement or development thereto are also to be given and communicated to the assessee. Part-B of the agreement deals with "duties and obligation of SPN". Under this part clause relating to "Scope of Assistance" is provided as per which technical assistance to be given to the assessee is all pervasive in the operations of the assessee company. It includes oral advice or supply of documents or samples, manuals, plans, papers and/or other material. The recipient companies have undertaken to supply the complete technical documentation to the assessee. The technical assistant is to be provided from Switzerland in India

by way of spot assistance as well as training of personnel of the assessee companies. Part–C of the agreement pertains to "Duties and Obligation" of the assessee. Part-D deals with "Consideration" and it is under this part it is agreed that royalty to be paid by the assessee to the recipient companies would be 3.5 percent of the turnover. Part –E stipulates "Terms and Termination" and Part –F includes "Miscellaneous Provisions". Clause 32 of the agreement under the caption "Confidentiality" binds the assessee to keep secret and confidential all information and documentation and, in particular, the compliance of this provision by the assessee's staff, employees and workers. All the nine agreements are on same terms. The Tribunal in its detailed order took into consideration the aforesaid aspects and particularly the nature of know-how and services provided by the recipient companies to the assessee. Various documents and material supplied to the assessee in this behalf discuss in minute detail the services rendered and the benefit which accrued to the assessee as a result thereof. The remuneration which the assessee got was not for any single purpose but a bundle of benefits were accrued to the assessee namely; brand, know-how, technical upgradation, technical supervision, collaboration and assistance. The Tribunal also noticed that the assessee had supplied plethora of documents before the lower authorities in

respect of both the assessment years and tabulated those documents in the impugned order and found that the Assessing Officer had not discussed or referred to even those documents. So much so, even a suggestion was given to the AO to visit the factory premises of the assessee in order to enable him to have a spot observation of the technical know-how which was received by the assessee enabling it to produce the aforesaid products. He was even invited to have a meeting for a full and comprehensive presentation on technical assistance.

11. In addition, the Tribunal took note of the following significant features/aspects:-

> (i) The assessee was a widely held Public Limited Company and had more than 60,000 shareholders. About 2500 shareholders attended the Annual General Meeting of the Company every year where the annual accounts and major issues of the company were placed and approved. The local shareholders of the company benefited tremendously. A person who held 100 shares in 1970 had received dividend of ₹ 2,66,563/- and the value of his holding as a result of bonus shares and attractive right shares was nearly ₹ 19 lakhs.
>
> (ii) The parent company had been in this line of business for the last 135 years. Nescafe as a product grew and developed over a period of 60 years. In the beginning, it was 12 minutes coffee brew; today it is instant coffee with improved test profile. It was necessary for the assessee to

receive continuous technical assistance. The Assessing Officer however, did not appreciate the need of continuous assistance from the collaborator.

(iii) During the year 1997, the assessee had achieved the record level of exports and had established itself as a leading exporter of Value Added Instant coffee. The company's products were available in 600000 outlets in 3000 towns throughout the country, serviced by 3900 distributors. The assessee exported instant coffee from India to Russia, Hungary, Poland, Taiwan and instant tea to the USA and Japan. During the year 1997, the company's export was over ₹ 330 crores.

(iv) Emphasising the tremendous value of nutrition in the foods that form our daily diets The science and technology of food was being given high priority and nowhere that was more true than at Nestle who had been in the food business for 125 years. Through constant Research and Development , Nestle sought to improve the quality of food and thereby quality of life itself. The learned counsel took us through the report of the Directors' of the assessee company relating to structure of Nestle Research; Technological Development; Quality Assurance, Nestle India Access to Global Technology Bank. Referring to these reports, the learned counsel highlighted some examples of technology advancement directly relating to the business of the assessee company. For example, in 1992 weaning food manufacturing technology was enhanced through the introduction of "Z line" manufacturing process. This process was developed by NESTEC to meet the specific needs of overseas market and was found to meet the requirements of the Indian scenario. As a result, Nestle India was able to introduce weaning foods that ensured improved bioavailability of carbohydrates through the process of Enzymation, providing higher nutrition per meal and enhanced digestibility. It was clearly visible achievement of the global Nestle R & D. The

learned counsel pointed out that coffee-manufacturing facility of the assessee-company at Nanjangud was comparable with the best in the world; as a result agglomerated instant coffee was introduced in India for the first time. The introduction of Maggi Noodles revolutionized the eating habits in the country and added a new dimension to convenience foods. The Noodle plant was feasible only because of the know-how and expertise received from NESTEC. The learned counsel for the assessee pointed out that quality assurance aspect of the assessee-company's product could never be over emphasized. For this purpose, vitamins, and amino-acid analyses were carried to ensure correct proportions in the finished product, Contaminants like affatoxins and pesticide residues were regularly monitored on sensitive raw materials and finished products. Additionally intensive on-going microbiological analyses were conducted to search for pathogens like salmonella and staph aureus. In the field of packaging, Nestle India introduced for the first time in the country polyester/low density polyethylene. 2 Minute Noodles sachet with reduced oxygen permeability enables consumers to get a fresher product on the shelf. Nestle India also brought about successful shift from traditional rigid tin containers to flexible packs in regard to its milk products, instant foods and weaning foods not only resulted in significant reduction in foreign exchange outflow through imported tinplate but also resulted in cost savings in excess of 35 per cent. Reading from the annual report for the year 1996, the leaned counsel referred to continuous Business Excellence & Common Application (BEGA) Initiative. He pointed out that in a country as diverse as India, supply chain management was critical to rapid growth. The BECA concentrated heavily on streamlining and improving supply chain management. The major benefits included reduction in working capital through lower inventories of finished goods and material, better stock availability, reduction in obsolescence of materials. Further, the Moga Factory was chosen

as a pilot plant and the Moga Improvement Team (MIT) was put in place. The team members comprising international experts from Nestle Technical Services (NESTEC) and local staff embarked on a programme in 1996 with the single-minded objective of optimizing production cost while enhancing product quality so as to make Nestle product even more competitive in the market place. The team identified the following areas for detailed study :

-Process improvement to ensure optimal usage of resources;

-Improvement of operational efficiency;

-Cost optimization.

A series of small but critically important initiatives ranging from redesigning of laboratories to palletisation of raw materials and improvements in on-line analyses led to significant reduction in raw and packing material utilization, manufacturing and filling losses and labour manhours resulting in substantial savings and improved productivity and machine utilization. The pilot project in Moga having proved successful, the company intended to implement key learnings of the MIT in other factories. During later part of 1996, an international Sales and Marketing Improvement Team (SMIT) undertook a 4 months' SMIT exercise in India as a part of major global initiative of Nestle to enhance sales and marketing productivity on a worldwide basis. Following three critical areas were identified from the point of view of the growth objectives of the sales :

- Ensure direct coverage of all urban towns in India;

- Expand distribution to reach one million retail outlets on a regular basis;

- Work in partnership with the distributors.

The aim was to access and evaluate various operations with a view to optimize the company's secondary sales from distributor to the retailer. SMIT took step-by-step approach, the team continued to focus solely on actionable solutions that were not only achievable but also sustainable over the long-term. The pilot project having been successful in Chennai, the company intended to implement key learning all over India.

(v) It took note of the detailed technical instructions provided to the assessee, the detailed manufacturing instructions, the material relating to control procedure, technical manuals, lab instructions, drawing and R &D aspects of technical assistance agreements. The Tribunal also noted the quality assurance aspects of the products of the assessee company which it could achieve because of the nature of technical know-how as well as the advancements made in the field of technology.

(vi) The Tribunal also noted that training was an integral and indispensable part of Nestle. It was a major investment in the future of the company and imperative because it was an investment in people. To this end, Nestle India benefited greatly from the training programme offered at the Rive Reine International Training Centre at Vevey, Switzerland. These programme were an irreplaceable part of Nestle India's overall training plan. In addition to Rive Reine courses, in-house Training & Development programme within the country received considerable support from the international exports who visited India.

(vii) The Tribunal also took note of the argument of the learned counsel for the assessee and found substance therein namely providing this technical know-how for the first time to the assessee company was not possible without such rigorous and continuous R& D activities undertaken by the recipient companies/parent company. It was noticed that R & D budget of Nestle, SA, Switzerland was over ₹ 2000 crores. The assessee participated in a scheme to reap benefits of the same on payment of a very small amount. R& D achievements mostly were invisible but were of paramount importance. Specialists at the Headquarters in Switzerland or at Product Technology Research Centres wrote technical know-how documents. The documents were validated through industrial usage and were continuously updated. With a strong centralized research, 7 development s and the very long experience in setting up and operation of factories, Nestle had been able to develop a vast knowledge base, which was essentially proprietary. To be able to impart this knowledge to the Nestle organizations entitled to receive it, Nestle had created the Technical Instruction system that guided the creation, distribution and management of "know-how" flow. These instructions covered product specific information, like Recipes and Manufacturing Instructions, Operational Aspects of factory operations as well as Safety, Environment Protection and Quality Assurance.

12. Taking note of all these aspects, the Tribunal came to the conclusion that the Assessing Officer was not correct in his observation that information and material asked by him was not provided by the assessee. On the contrary, by and large, the assessee furnished entire information, material and evidence as was asked for by the AO having regard to the nature of the technical know-how and other services provided by the recipient

companies, the Tribunal went into the question of quantum of remuneration and arrived at a finding that this remuneration was not unreasonable or excessive but was justified. We may reproduce below:-

> "94.We now come to the question as to whether the quantum of remuneration as agreed upon in the agreements in question and actually paid during the course of the assessment years before us is justified on the facts and in the circumstances of the case. In other words, whether both the AO in the assessment order for asst. yr. 1997-98 and the learned CIT(A) in the appellate order for asst, yr. 1998-99 are justified their conclusion that the assessee in collusion with parent company in Switzerland adopted a colourable device whereby the profits of Indian company were siphoned away to be aggrandized by the Swiss company. The learned AO has argued in the assessment order for asst. yr. 1997-98 that from the very fact that no evaluation and analysis of technical assistance had been made at the time of entering into agreements and subsequently to determine the impact of technical assistance on the business of the company, it was clear that these agreements had been entered into with the sole object of diverting profit of the assessee-company. In this context, the learned AO even asked the assessee to produce a certificate from an independent technical agency that the payments were commensurate to actual services received. Besides, both the learned AO in the assessment proceedings for the asst. yr. 1997-98 and the learned CIT(A) in the order for the asst. yr. 1998-99 emphasised that the assessee was already well established and well versed in the business of products in question, and was not new to the business of manufacture and sale

of those products and, therefore, the assessee could not by any stretch of imagination be considered to need further technical assistance of the magnitude so as to part with a substantial chunk of its business profit.

95. The authorities below in their orders and the learned CIT (Departmental Representative) in his arguments before us have relied upon certain charts indicating 78.37 per cent and 49.95 per cent of the profit had been paid off by the assessee-company under the agreements in relation to the asst. yrs. 1997-98 and 1998-99 respectively. During the course of hearing before us, the learned counsel for the assessee has attacked the very rationale of the exercise done in these charts by the IT authorities. According to him, the quantum of remuneration could not, in any case, be linked with the profit. The profit was a derivative figure depending on various factors outside the direct and reasonable control of the technical assistance providers. Contracting for a fixed amount of royalty could be disastrous if the product did not click in the market. In the sale-linked agreement, the technical assistance providers interest in the success of the product was highest and ensured maximum assistance was received. Moreover, intangible benefit of technical assistance could not be gauged by the performance of the same year in which the investment in technology was made. The benefit could be gauged only over sufficiently long-term allowing the technical initiative to bear fruits. That apart, the learned counsel for the assessee pointed out that the working done by the Department was highly unreasonable inasmuch as the payments were compared with the profit of the company after payment of remuneration in question. The learned counsel, therefore, furnished a separate chart to show that even on imperfect and irrational

basis of comparison with the profit adopted by the assessing authority, the payments in question constituted only 34.89 per cent and 26.59 per cent of the profits for asst. yrs. 1997-98 and 1998-99, respectively. The learned counsel further argued that the percentage was higher during asst. yrs. 1997-98 and 1998-99 because the net profit as percentage of turnover itself was lower in those assessment years. As to the question that no independent evaluation of the value and utility of technical services were carried out, the learned counsel argued that such was never a practice in a case where highly specialized and restricted technology was imparted. Technology provided to the assessee by the parent company and its subsidiary had always been and was intended to always remain the property of the parent company and its subsidiaries. The assessee had been given a right to use only that technology for manufacture and sale of products under the parent company's brand name. The technology was highly sensitive and confidential and, therefore, in every agreement, the assessee was bound by confidentiality clause. In such circumstances, to invite an independent agency for evaluation and certification as desired by the AO was unthinkable. As to the basis on which, the quantum of remuneration for technology assistance was fixed, the learned counsel argued that at the time of entering into the agreement, it was not possible to predict accurately the amount of remuneration to be paid to technical assistance providers. That depended on the success of the product launched and actual working of the project in India and subject to several imponderables. It was for that reason that there was no specific working made at the time of entering into agreements in question and insistence of the learned AO on production of the same was not justified. The assessee as well as the technical assistance providers were in the line of business and had experience for a long

time and based on their experience and perception, by mutual discussion, the rate of remuneration was fixed. It was not possible to physically demonstrate that intangible exercise. The fact of the matter was that the remuneration was fixed at a very reasonable rate in spite of the Government regulations having permitted payment of remuneration at much higher rate. The justification of remuneration paid was to be seen in the voluminous material and evidence filed by the assessee during the course of the assessment proceedings and the proceedings before us. It was totally inappropriate to test the reasonableness of the remuneration on the yardstick of profit of the year in which the payment was made. This issue required a long-term view to be taken. On careful consideration of the detailed submissions made by the assessee in this behalf and briefly enumerated by us in paras 37 to 65 of this order, we find ourselves in substantial agreement with the assessee. In the first instance, the assessee only had license to use the technology and, therefore, the assessee could not have continued the manufacture of any Nestle brand product without the consent of the parent company. We do not subscribe to the argument of the learned CIT (Departmental Representative) that as intellectual property rights were not recognized in India, the assessee could have snapped ties with the foreign company and carry on its business as before. We also find that the technical assistance provided by the parent company was all pervasive in the operations of the assessee-company and permeated into almost every detail. The assessee-company in India was reaping harvest of fine production technology evolved by the parent company over 125 years by virtue of presence in more than 70 countries. For continuing to harvest the benefit, it was essential for the assessee to have a perennial source of supply of all the technological innovation, advancement and upgrade. It

would not be an exaggeration to say that in modern times, no businessman can afford to be oblivious of the fast moving technology related to his business on the ground of contented with the knowledge and experience already gathered. The assessee did not contribute a single penny to R&D cost of Nestle SA stated to be over Rs. 2,000 crores per year. Nestle India received tested technology and therefore, did not have to suffer loss of any failed technology or project. The assessee had access to all the required technology available with the parent company not only in respect of manufacturing but also in various other fields like quality control, personnel, staff management, marketing, storage and so on. The kind of technical assistance received by the assessee was of such nature as to sustain its position as number one manufacturer in India in respect of the products being manufactured by it. During the course of hearing before us, the learned counsel for the assessee has given several examples of major technological advancements that had taken place in the area of the assessee's products. He explained to us in detail the major changes that took place in the field of coffee manufacturing and state of art technology that allowed to capture the aroma of fresh coffee in the products of the assessee. The learned counsel dwelt at length on the unique technology in relation to extraction process called MUCH process resulting into better-finished product from the same coffee beans. He made reference to the changes in the manufacturing process of weaning foods that ensured bio availability of carbohydrates through the process of Enzymation to provide higher nutrition in meals and enhanced digestibility. These were just a few examples from out of the many advancements and changes taking place every year. The learned counsel pointed out that during the period under consideration, more products were launched by Nestle than

> in the immediately preceding two decades. He also emphasized with considerable justification that several thousand Indian shareholders of the assessee-company were tremendously benefited. An investor who purchased 100 shares in 1970 had grown into shareholding of 3700 shares of the market Value of Rs. 19 lakhs after having received the dividend totaling to Rs. 2,66,653. The learned counsel argued that these aspects were required to be appreciated rather than merely suspecting that the remuneration for technical assistance was nothing but a camouflage to siphon away and repatriate the profits of Indian operations. On careful consideration, we see considerable force and justification in these arguments of the assessee."

13. The Tribunal also considered the question of applicability of Section 40 A(2) and Section 92 of the Act and held that these provisions were not applicable. The matter was required to be looked into having regard to the provisions of Section 37 (1) of the Act and once it was found that it was a business expenditure, the same was allowable under the aforesaid provision.

14. In so far as nature of services provided against the consideration in the form of royalty paid by the assessee, the findings are recorded by the Tribunal on the analysis of the relevant documents and material and we do not find any perversity in the same. In fact, once it is found that having regard to the nature, quantum and quality assurance, the technical know-how and other services provided to the assessee,

the compensation paid in the form of royalty/consideration is not excessive but reasonable and justified, question formulated need not even be gone into. However, we would like to answer these questions as the appeal was admitted on the same.

15. We take up question of law no.2 in the first instance. We are of the view that the Tribunal is not correct in observing that since the permission is given by the Reserve Bank of India, the reasonableness and genuineness of the expenditure could not have been gone into by the AO. The purpose for which such permission is given by the RBI is totally different. The RBI is only concerned with the foreign exchange and, therefore, would look into the matter from that point of view. The RBI, at the time of giving such permission would not keep in mind the provisions of the Income Tax Act and that is the function of the income tax authorities and, therefore, they can validly go into such an issue. Thus, we answer question of law no.2 in favour of the Revenue and against the assessee but hasten to add that it has no bearing on the outcome of the case as the payment is found to be reasonable and genuine, even otherwise.

16. Coming to first question of law, it is an inter-play of section 40-A (2), Section 92 and Article 9 of the DTAA. These provisions are reproduced below:-

Section 40 A (2)

"(2) Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause 9b) of this sub-section, and the Assessing Officer is of opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction..."

Section 92

"Income from Transaction with the nonresidents, how computed in certain cases:-

Where a business is carried on between a resident and a non-resident and it appears to the Assessing Officer that, owing to the close connection between them, the course of business is so arranged that the business transacted between them produces to the resident either no profits or less than ordinary profits, which might be expected to arise in that business, the Assessing Officer shall

determine the amount of profits, which may reasonably be deemed to have been derived therefrom and include such amount in the total income of the resident."

"Article 9: Associated Enterprises

1 Where-

(a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) The same persons participate directly or indirectly in the management control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

And in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly"

17. Submissions of the learned counsel for the Revenue was that the profits earned by the assessee company are/were diverted to

the recipient foreign companies in the name of remuneration/royalty and, therefore, as per Article 9 of DTAA, this diverted amount is allowable to tax in India in the case of the assessee company. This submission has to be negatived in view of our aforesaid discussion. We may also observe that Article 9 (1) of the DTAA is relevant for the purpose of bringing back to India the income of the non-resident and as no obligation for disallowing expenditure in the hands of the Indian Resident there. This becomes abundantly clear from the language of the aforesaid Article. Insofar as Section 40A (2) of the Act is concerned, no doubt, the Assessing Officer can disallow such expenditure which is found to be excessive and unreasonable. This is a question of fact and as held so in the following cases:-

(i) Upper India Steel Manufacturing & Engg. Co. Pvt. Ltd. Vs. CIT, 117 ITR 569 (SC)

(ii) CIT Vs. Northern India Iron & Steel Co. Ltd. 179 ITR 599 (Del)

(iii) CIT Vs. Sriram Piston & Rings Ltd, 181 ITR 230 (Del)

(iv) CIT Vs. Padmini Packaging Pvt. Ltd. 155 Taxman 268 (Del)

18. Since on facts of this case, it is held that expenditure was neither excessive nor unreasonable, the same could not be disallowed under Section 40 A (2) of the Act. It is stated at the cost of repetition that the AO did not question the genuineness of the

payment namely that the payment was in fact made by the assessee to the recipient foreign company/parent company. The assessee has been able to discharge its burden namely it was a justifiable and reasonable business expenditure and thus should be allowed under Section 37 of the Act. We may recapitulate the following findings of the Tribunal in this behalf:-

(i) That the assessee has successfully discharged this burden;

(ii) That the assessee has furnished almost entire information asked for;

(iii) That technical assistance received by it was essential for its business purposes;

(iv) That the assessee highly benefited from this know-how and technical assistance;

(v) That the quantum of remuneration was justified;

(vi) That the technical assistance was all pervasive in the operation of the assessee;

(vii) That there was no camouflage to siphon away Indian profits abroad; and hence disallowance of remuneration is not called for;

19. The Tribunal has held that the assessee having discharged the initial onus, burden shifted to the Revenue to show that the payment of royalty was excessive or unreasonable having regard to the legitimate needs of business or that the assessee has made less than ordinary profits and the Revenue has not

discharged the said onus. The Tribunal has in general recorded clearly its findings of facts:-

- That no material or evidence has been brought on record by Revenue to substantiate applicability of above provisions;
- That the Revenue has not specified as to how much ordinary profit was supposed to be and basis of its determination, before treating royalty payment as excessive and unreasonable.

20. Coming to Section 92 of the Act, the CBDT has itself clarified in its Circular No. 14 dated 27.11.2001 that Section 92 of the Act does not apply in respect of 'payment of royalty etc' which are not the part of regular business carried on between a resident and a non- resident.

21. This aspect is suitably dealt with by the Tribunal and we agree with its reasoning. In view of the above, we answer the question no.1 in favour of the assessee and against the revenue. As a result, these appeals fail and hereby dismissed.

(A.K. SIKRI)
JUDGE

(M.L. MEHTA)
JUDGE

MAY 11, 2011
Skb