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

\+ **ITA 346/2015**

Reserved on: September 21, 2015
Date of decision: December 23, 2015

HONDA SIEL POWER PRODUCTS LIMITED ..... Appellant
Through: Mr. Ajay Vohra, Senior Advocate with Mr. Neeraj Jain and Mr. Aditya Vohra, Advocates.

versus

DEPUTY COMMISSIONER OF INCOME TAX ..... Respondent
Through: Mr. G.C. Srivastava and Mr. D.S. Bhardwarj, Advocates.

**CORAM:**
**JUSTICE S.MURALIDHAR**
**JUSTICE VIBHU BAKHRU**

**JUDGMENT**

**% 23.12.2015**

**Dr. S. Muralidhar, J.**:

1. This appeal by the Assessee, under Section 260A of the Income Tax Act 1961 ('Act') is directed against the impugned order dated 12th December, 2014 passed by the Income Tax Appellate Tribunal (ITAT) in ITA No.6023/Del/2012 for the Assessment Year (AY) 2008-2009.

2. Admit.

***Background facts***

3. The facts are that the Assessee, Honda Siel Power Products Ltd

('HSPP'), is engaged both in the manufacture of licensed products as well as the distribution of goods manufactured by its associated enterprises. The Assessee is engaged in the business of manufacturing of portable generating sets, IC engines, water pumping sets and manufacturing and processing of pressure die casting parts. The HONDA trademark is owned by Overseas Associated Enterprise (AE), i.e. Honda Motor Company, Japan ('Honda Japan'). During the AY in question, the Assessee entered into the following international transactions with its AE:

| Sl. No. | International transactions | Amount (in Rs.) | Method used by Assessee |
|---|---|---|---|
| i. | Payment for purchase of raw material and components | 19,69,25,346 | TNMM |
| ii. | Payment for purchase of spares | 35,15,973 | TNMM |
| iii. | Payment for purchase of finished goods | 9,57,55,661 | TNMM |
| iv. | Receipt for Sale of Spare Parts | 21,60,059 | TNMM |
| v. | Receipt for Sale of Finished Goods | 13,28,37,585 | CUP/TNMM |
| vi. | Payment of Royalty | 8,77,14,255 | CUP/TNMM |

| | | | |
|---|---|---|---|
| vii | Payment of Technical Guidance Fee | 17,464,121 | TNMM |
| viii. | Payment towards Commission on Exports | 51,996,673 | TNMM |
| ix. | Expenses Reimbursement Received | 199,078 | TNMM |
| x. | Payment for purchase of fixed assets | 12,600,659 | TNMM |
| xi. | Expenses Reimbursement Paid | 513,920 | TNMM |

4. The Assessee filed its return of income for the AY in question on 30th September, 2008, declaring a total income of Rs. 37,15,72,026. The return was picked up for scrutiny and notices under Sections 143(2) and 142(1) of the Income Tax Act, 1961 ('Act') were issued. During the course of the assessment proceedings, the Assessing Officer invoked Section 92CA(1) of the Act and referred the case of the Appellant to the Transfer Pricing Officer (TPO) for determination of Arm's Length Price ('ALP') in relation to the international transactions undertaken by the Appellant with its AEs.

5. The total advertisement, marketing and sales promotion ('AMP') expenses of the Assessee was Rs. 12,39,19,327/-, which was 4.46 per cent of its sales, and comprised the following:

| S.No. | Name of Expenses | Amount (Rs.) |
|---|---|---|
| 1. | Commission on sales | 1,22,95,327 |
| 2. | Advertisement and publicity | 6,26,52,000 |
| 3. | Sales promotion | 3,42,80,000 |
| 4. | Sales discount | 1,46,92,000 |
| | Total | 12,39,19,327 |

6. The TPO benchmarked the AMP expenses incurred by the Appellant, by applying the Bright Line Test ('BLT'), and compared the percentage of such expenses incurred to total sales of the Appellant with that of comparable companies. It was found that the AMP expenses of the Assessee as a percentage of sales at 4.46 per cent was higher than 1.87 per cent incurred by the comparable companies. The TPO concluded that the AMP expenses incurred by the Appellant, in excess of the Bright Line must be regarded as having been incurred for promoting the brand name HONDA and further that this was for creating marketing intangibles owned by the AE and for which the Appellant was required to be suitably compensated by the AE. The TPO passed an order dated 28th October, 2011 determining the ALP of the Assessee's international transactions with respect to AMP expenses.

7. The TPO further charged a mark-up of 15% and accordingly made a Transfer Pricing (TP) adjustment *inter alia* of Rs. 8,27,61,669/- on account of AMP expenses. The TPO also passed a rectification order dated 12th January, 2012 wherein it restricted the disallowance of royalty paid to Rs. 53.34 lakhs instead of the inadvertent figure of Rs. 1.53 Crore, as stated in the order. The Dispute Resolution Panel ('DRP') by

an order dated 24th September, 2012 negated the objections to the draft assessment order by the Assessee and sustained the TP adjustment in respect of AMP expenses proposed by the TPO. The AO then completed the adjustment and passed the final assessment order on 31st October, 2012 *inter alia* making an addition of the said sum of Rs. 8,27,61,669/- on account of TP adjustment in respect of the AMP expenses.

8. The appeal filed by the Assessee before the ITAT, being ITA No. 6023/Del/2012, was disposed of by the impugned order dated 12th December, 2014.

***The decision of the Special Bench of the ITSAT in LG Electronics***

9. In the meanwhile a Special Bench of the ITAT considered the issue of TP adjustment in the context of incurring of AMP expenses by Indian entities using brand names of foreign AEs in ***LG Electronics India Pvt. Ltd. v. ACIT (2013) 140 ITD 41 (Del)***. By a majority of 2:1, the Special Bench of the ITAT *inter alia* decided as under:

> (i) A TP adjustment in relation to AMP expenses incurred by the Assessee for creating and improving the marketing intangibles for its foreign AE was permissible.
>
> (ii) Earning the mark up from the AE in respect of AMP expenses incurred by the foreign AE was also allowed.

10. The majority of the ITAT adopted the BLT for determining the existence of an international transaction involving AMP expenses as well as for determining its ALP. If the expense incurred by the Assessee on AMP was higher than what was incurred by an independent entity

behaving in a commercially rational manner, then the TPO would determine whether the said transaction required re-characterisation. If the Assessee failed to supply the details of the value of such international transaction, the onus was on the TPO to determine its ALP it on some rational basis by identifying the comparable domestic cases. It was further held that the initial burden to show that the international transaction with the AE was at ALP was on the Assessee.

***The decision of this Court in Sony Ericsson***

11. The correctness of the decision of the Special Bench of the ITAT in ***LG Electronics*** (*supra*) was considered by this Court in ***Sony Ericsson Mobile Communications India P. Ltd. v. Commissioner of Income Tax (2015) 374 ITR 118 (Del).*** This Court heard a batch of appeals in the aforementioned decision and disposed of in particular the appeals concerning the Indian entities who were distributers of products manufactured by their respective foreign AEs including Sony Ericsson Mobile Communications India Pvt. Ltd, Discovery Communications India, Daikin Air-conditioning (India) Pvt. Ltd., Reebok India Company and Canon India Pvt. Ltd. The Court explained the features particular to three of the said Assessees i.e Sony Mobile Communications India Pvt. Ltd., Reebok India Company and Canon India Pvt. Ltd. In the case of Sony Mobile Communications India Pvt. Ltd., TNMM had been followed. In respect of Reebok India, the TNMM had been followed for the sourcing of goods and exports from India, the CUP method had been followed in respect of the royalty paid by the Indian entity to the foreign AE and for import of apparels and footwear for re-sale, the re-sale price ('RP') method had been followed. In the case of Cannon India, the RP method was adopted for import of finished goods for resale.

12. The following questions were addressed by the Division Bench in ***Sony Ericsson*** (*supra*):

> "(i) Whether the additions suggested by the Transfer Pricing Officer on account of Advertising/Marketing and Promotion Expenses (AMP Expenses' for short) was beyond jurisdiction and bad in law as no specific reference was made by the Assessing Officer, having regard to retrospective amendment to Section 92CA of the Income Tax Act, 1961 by Finance Act, 2012.
>
> (ii)Whether AMP Expenses incurred by the assessee in India can be treated and categorized as an international transaction under Section 92B of the Income Tax Act, 1961?
>
> (iii) Whether under Chapter X of the Income Tax Act, 1961, a transfer pricing adjustment can be made by the Transfer Pricing Officer/ Assessing Officer in respect of expenditure treated as AMP Expenses and if so in which circumstances?
>
> (iv) If answer to question Nos.2 and 3 is in favour of the Revenue, whether the Income Tax Appellate Tribunal was right in holding that transfer pricing adjustment in respect of AMP Expenses should be computed by applying Cost Plus Method.
>
> (v) Whether the Income Tax Appellate Tribunal was right in directing that fresh bench marking/comparability analysis should be undertaken by the Transfer Pricing Officer by applying the parameters specified in paragraph 17.4 of the order dated 23.01.2013 passed by the Special Bench in the case of LG Electronics India (P) Ltd.?"

13. The summary of the conclusions of the Division Bench in ***Sony Ericsson*** (*supra*) was as under:

> (i) The Court concurred with the majority of the Special Bench of the ITAT in the LG Electronics case qua the applicability of 92CA

(2B) and how it cured the defect inherent in 92CA (2A). The issue concerning retrospective insertion of 92CA (2B) was decided in favour of the Revenue.

(ii) AMP expenses were held to be international transaction as this was not denied as such by the assessees.

(iii) Chapter X and Section 37(1) of the Act operated independently. The former dealt with the ALP of an international transaction whereas the latter deals with the allowability/disallowability of business expenditure. Also, once the conditions for applicability of Chapter X were satisfied nothing shall impede the law contained therein to come into play.

(iv) Chapter X dealt with ALP adjustment whereas Section 40A (2)(b) dealt with the reasonability of quantum of expenditure.

(v) TNMM applied with equal force on single transaction as well as multiple transactions as per the scheme of Chapter X and the TP Rules. Thus, the word 'transaction' would include a series of closely linked transactions.

(vi) The TPO/AO could overrule the method adopted by the Assessee for determining the ALP and select the most appropriate method. The reasons for selecting or adopting a particular method would depend upon functional analysis comparison, which required availability of data of comparables performing of similar or suitable functional tasks in a comparable business. When suitable comparables relating to a particular method were not available and

functional analysis or adjustment was not possible, it would be advisable to adopt and apply another method.

(vii) Once the AO /TPO accepted and adopted the TNMM, but chooses to treat a particular expenditure like AMP as a separate international transaction without bifurcation/segregation, it would lead to unusual and incongruous results as AMP expenses was the cost or expense and was not diverse. It was factored in the net profit of the inter-linked transaction. The TNMM proceeded on the assumption that functions, assets and risks being broadly similar and once suitable adjustments have been made, all things get taken into account and stand reconciled when computing the net profit margin. Once the comparables pass the functional analysis test and adjustments have been made, then the profit margin as declared when matches with the comparables would result in affirmation of the transfer price as the arm's length price. Then to make a comparison of a horizontal item without segregation would be impermissible.

(viii) The Bright Line Test was judicial legislation. By validating the Bright Line Test the Special Bench in ***LG Electronics Case*** went beyond Chapter X of the Act. Even international tax jurisprudence and commentaries do not recognise BLT for bifurcation of routine and non-routine expenses.

(ix) Segregation of aggregated transactions requires detailed scrutiny without which there shall be no segregation of a bundled transaction. Set off of transactions segregated as a single

transaction is just and equitable and not prohibited by Section 92(3). Set-off is also recognized by international tax experts and commentaries.

(x) Segregation of bundled transactions shall be done only if exceptions laid down in the ***EKL Appliances Case*** are justified. Re-categorisation and segregation of transactions are different exercises; former would require separate comparables and functional analysis.

(xi) Economic ownership of a brand would only arise in cases of long-term contracts and where there is no negative stipulation denying economic ownership. Economic ownership of a brand or a trade mark when pleaded can be accepted if it is proved by the Assessee. The burden is on the Assessee. It cannot be assumed.

(xii) After the order of the Supreme Court in the *Maruti Suzuki* case, the judgment of the Delhi High Court does not continue to bind the parties. This position was misunderstood by the majority of the Special Bench in the ***LG Electronics Case***.

(xiii) The RP Method loses its accuracy and reliability where the reseller adds substantially to the value of the product or the goods are further processed or incorporated into a more sophisticated product or when the product/service is transformed. RP Method may require fewer adjustments on account of product differences in comparison to the CUP Method because minor product differences are less likely to have material effect on the profit margins as they do on the price.

(xiv) Determination of cost or expense can cause difficulties in applying cost plus (CP) Method. Careful consideration should be given to what would constitute cost i.e. what should be included or excluded from cost. A studied scrutiny of CP Method would indicate that when the said Method is applied by treating AMP expenses as an independent transaction, it would not make any difference whether the same are routine or non-routine, once functional comparability with or without adjustment is accepted.

(xv) The task of arm's length pricing in the case of tested party may become difficult when a number of transactions are interconnected and compensated but a transaction is bifurcated and segregated. CP Method, when applied to the segregated transaction, must pass the criteria of most appropriate method. If and when such determination of gross profit with reference to AMP transaction is required, it must be undertaken in a fair, objective and reasonable manner.

(xvi) The marketing or selling expenses like trade discounts, volume discounts, etc. offered to sub-distributors or retailers are not in the nature and character of brand promotion. They are not directly or immediately related to brand building exercise, but have a live link and direct connect with marketing and increased volume of sales or turnover. The brand building connect is too remote and faint. To include and treat the direct marketing expenses like trade or volume discount or incentive as brand building exercise would be contrary to common sense and would be highly exaggerated.

Direct marketing and sale related expenses or discounts/concessions would not form part of the AMP expenses.

(xvii) The prime lending rate cannot be the basis for computing mark-up under Rule 10B(1)(c) of the Rules, as the case set up by the Revenue pertains to mark-up on AMP expenses as an international transaction. Mark up as per sub-clause (ii) to Rule 10B(1)(c) would be comparable gross profit on the cost or expenses incurred as AMP. The mark-up has to be benchmarked with comparable uncontrolled transactions or transactions for providing similar service/product.

(xviii) The exceptions laid down in ***EKL Appliances Case*** were neither invoked in the present case nor were the conditions satisfied.

(xix) An order of remand to the ITAT for *de novo* consideration would be appropriate because the legal standards or ratio accepted and applied by the ITAT was erroneous. On the basis of the legal ratio expounded in this decision, facts have to be ascertained and applied. If required and necessary, the assessed and the Revenue should be asked to furnish details or tables. The ITAT, in the first instance, would try and dispose of the appeals, rather than passing an order of remand to the AO /TPO. An endeavour should be to ascertain and satisfy whether the gross/net profit margin would duly account for AMP expenses. When figures and calculations as per the TNM or RP Method adopted and applied show that the net/gross margins are adequate and acceptable, the appeal of the

assessed should be accepted. Where there is a doubt or the other view is plausible, an order of remand for re-examination by the AO/TPO would be justified. A practical approach is required and the ITAT has sufficient discretion and flexibility to reach a fair and just conclusion on the ALP.

14. However, as far as the present case is concerned, at the time the ITAT decided the appeal of the Assessee, the decision in ***Sony Ericsson*** (*supra*) had not been rendered. The ITAT accordingly followed the decision of the Special Bench in ***LG Electronics*** *(supra)* and referred back the matter to the assessing authority for fresh consideration.

15. It is the case of the Revenue in this appeal that the decision in ***Sony Ericsson*** *(supra)* would cover the present case as well and, therefore, in the light of the directions issued by this Court in ***Sony Ericsson*** *(supra)*, this appeal should also be referred back to the ITAT for a fresh decision.

16. This is, however, contested by the Assessee which states that the decision in ***Sony Ericsson*** *(supra)* was in the context of the three Assessees whose cases were covered being distributors of the products manufactured by a foreign company.

17. Another issue which arises as contended by the Assessee is whether there exists any international transaction between the Assessee and its foreign AEs in relation to AMP expenses. A further question is if such a transaction does exist, how should the ALP of such a transaction be determined?

***Questions of law***

18. Accordingly, the following questions of law are framed for consideration:

i. Is the case of the Assessee covered by the decision of this Court in ***Sony Ericsson*** *(supra)* and is it required to be referred back for a fresh decision in terms of the said judgement?

ii. If the answer to question (i) is in the negative has the Revenue been able to demonstrate the existence of international transaction between the Assessee and its AE in relation to AMP expenses?

iii. If the answer to question (ii) is in the affirmative how is the ALP of international transaction to be determined and to what effect?

19. At the outset, it must be observed that this appeal was heard along with appeals for certain other Assessees including ITA No.610/2014, titled ***CIT-LTU v. Whirlpool of India Limited***. The questions that arise in the present appeal also arose in the case of ***Whirlpool of India Limited*** *(supra)* and ITA No.643/2014, titled ***Bausch & Lomb Eyecare (India) Pvt. Ltd. v. The Additional Commissioner of Income Tax***. Earlier the Court had also decided similar questions in its judgement dated 11th December, 2015 in ITA No.110/2015 titled ***Maruti Suzuki India Limited v. Commissioner of Income Tax***.

***Question (i): Does the decision in Sony Ericsson apply?***

20. As far as question (i) is concerned, it was observed in ***Maruti Suzuki India Limited*** (*supra*) (MSIL) as under:

> "25. Several appeals and cross-appeals filed by the Assessees and the Revenue before this Court against the decision of the Special Bench of the ITAT in ***LG Electronics*** and other decisions of the ITAT that followed the decision of the Special Bench in ***LG Electronics***. Although arguments were heard in all the appeals, the Court decided the appeals of only six Assessees i.e. Sony Ericsson Mobile Communications India Pvt. Ltd, Discovery Communications India, Daikin Air-conditioning India Pvt. Ltd., Haier Appliances (India) Pvt. Ltd., Reebok India Company and Canon India Pvt. Ltd.
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> 26. The Court explained that all the above six Assessees were engaged in distribution and marketing of imported branded products. In other words, none of the Assessee whose appeals were decided was a manufacturer. The second common factor noted by the Court was: "There is no dispute or lis that the assessee are AEs who had entered into controlled transactions with the foreign associated enterprises". Thirdly, the Court noted: "It is also uncontested that the controlled international transactions can be made subject-matter of the transfer pricing adjustment in terms of Chapter X of the Income Tax Act, 1961".
>
> 27. The Court further explained the features particular to three of the said Assessees i.e Sony Mobile Communications India Pvt. Ltd., Reebok India Company and Canon India Pvt. Ltd. In the case of Sony Mobile Communications India Pvt. Ltd., TNMM had been followed. In respect of Reebok India, the TNMM had been followed for the sourcing of goods and exports from India, the CUP method had been followed in respect of the royalty paid by the Indian entity to the foreign AE and for import of apparels and footwear for re-sale, the re-sale price ('RP') method had been followed. In the case of

Cannon India, the RP method was adopted for import of finished goods for resale."

21. Having noticed the above factual features, the Court in ***Maruti Suzuki India Limited*** (*supra*) further noticed as under:

"42. As already noticed, the judgment in ***Sony Ericsson*** does not seek to cover all the cases which may have been argued before the Division Bench. In particular, as far as the present appeal ITA No. 110 of 2014 is concerned, although it was heard along with the batch of appeals, including those disposed of by the ***Sony Ericsson*** judgment, at one stage of the proceedings on 30th October 2014 the appeal was delinked to be heard separately.

43. Secondly, the cases which were disposed of by the ***Sony Ericsson*** judgment, i.e. of the three Assessees Canon, Reebok and Sony Ericsson were all of distributors of products manufactured by foreign AEs. The said Assessees were themselves not manufacturers. In any event, none of them appeared to have questioned the existence of an international transaction involving the concerned foreign AE. It was also not disputed that the said international transaction of incurring of AMP expenses could be made subject matter of transfer pricing adjustment in terms of Section 92 of the Act.

44. However, in the present appeals, the very existence of an international transaction is in issue. The specific case of MSIL is that the Revenue has failed to show the existence of any agreement, understanding or arrangement between MSIL and SMC regarding the AMP spend of MSIL. It is pointed out that the BLT has been applied to the AMP spend by MSIL to (a) deduce the existence of an international transaction involving SMC and (b) to make a quantitative 'adjustment' to the ALP to the extent that the expenditure exceeds the expenditure by comparable entities. It is submitted that with the decision in ***Sony Ericsson*** having disapproved of BLT as a legitimate means of determining the ALP of an international transaction

> involving AMP expenses, the very basis of the Revenue's case is negated."

22. The Court is of the view that the above decision in ***MSIL*** (*supra*) holding that the decision in ***Sony Ericsson*** *(supra)* would not cover the case of MSIL would also apply as far as the present Appellant is concerned. As noticed in ***MSIL*** (*supra*) the facts of the cases of the Assessees in ***Sony Ericsson*** *(supra)* did not give rise to a dispute that there is no international transaction involving the Assessee therein and its AEs. In fact each of the Assessees were receiving subsidies/subventions from their respective AEs.

23. The second factor taken note of by the Court is that as BLT was invalidated as a means of determining the existence of an international transaction, the onus was on the Revenue to show the existence of an international transaction. In the present case, the existence of such a transaction was ascertained only by applying the BLT. For the above reasons, the Court is satisfied that the case of the present Appellant would not stand covered by the decision in ***Sony Ericsson*** *(supra)*. Question (i) is accordingly answered in favour of the Assessee and against the Revenue.

***Question (ii): Existence of an international transaction***

24. The central question which arises in the present case is question (ii), which is whether the Revenue has been able to discharge the initial onus of showing that there was an international transaction concerning the Assessee and its foreign AEs.

25. If the BLT is kept aside as a valid means of determining the existence of an international transaction concerning AMP expenses, the Revenue would have to make out its case on the basis of the other tangible material which might show the existence of any 'arrangement' or 'understanding' or any conduct of either party to show that they were 'acting in concert' as far as the Assessee having to promote the brand of the foreign AE is concerned.

26. The relevant facts are that under a Technical Collaboration Agreement, the Assessee is granted exclusive license to manufacture and sell the products of the foreign AEs against payment of royalty of 4% on sales. Additionally, the Assessee entered into agreement dated 19th March, 2007 for obtaining license to use the trademark HONDA. The consideration for use of such trademark is determined at 1 per cent of the sales of licensed products. The mere existence of such an agreement whereby a license has been granted to the Assessee to use the brand name would not *ipso facto* imply any further understanding or arrangement between the Assessee and its foreign AE regarding the AMP expense for promoting the brand of the foreign AE.

27. Turning to the TP report, a reference has been made by the Revenue to para 4.8 thereof which shows that market development is the function of the AE as well as the Assessee in India. Para 4.9 of the TP report has been referred for the purposes of pointing out export market related information for the products and the competitors and other assistance in tapping potential export markets is provided by the Honda Group. It is further pointed out that para 4.47 of the TP report records that HSPP is

responsible for "brand building and maintaining brand loyalty in domestic market." Reference is made to the statement that "this brand name has been developed and popularised by HSPP in India." According to the Revenue, therefore, there is no dispute that the Assessee is engaged in "developing and maintenance of brand/trade name in India."

28. A reference is made by the Revenue to the Export Agreement whereunder the Assessee has been granted rights to export products to certain 'permitted countries' for payment of royalty of 8 per cent of the export price, which was subsequently raised to 12.25 per cent from 1st February 2008. Honda, Japan reserved the right to change the permitted countries at any time. According to the Revenue this indicates that the Assessee has not been an independent manufacturer and is only functioning as a contract manufacturer for the AE. It is also pointed out that the list of countries to which export is permitted by Honda, Japan included the countries falling in the same geographical location as India. It is stated that the terms of the agreement with such distributors in other countries "could have worked as a sound comparable" but that the Assessee had not chosen to make any such attempt in its TP documentation.

29. In response, it is pointed out on behalf of the Assessee that the payment of royalty fee for the HONDA trademark are separately benchmarked by the Assessee. That is not the subject matter of the dispute in the present case. It is further pointed out that the agreement whereunder license has been granted to the Assessee, does not contain

any stipulation concerning the promotion of the brand name HONDA or for incurring AMP expenses for that purpose. There is, according to the Assessee, no tangible material to show that any arrangement or understanding, even an informal one, exists between the Assessee and its foreign AE in relation to AMP expenses.

30. At the outset, it requires to be noticed that Section 92B defines 'international transaction' as under:

> **"Meaning of international transaction**.
>
> **92B.**(1) For the purposes of this section and sections 92, 92C , 92D and 92E , "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.
>
> (2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise."

31. Under Sections 92B to 92F, the pre-requisite for commencing the TP exercise is to show the existence of an international transaction. The next step is to determine the price of such transaction. The third step would be to determine the ALP by applying one of the five price discovery methods specified in Section 92C. The fourth step would be to compare the price of the transaction that is shown to exist with that of the ALP and make the TP adjustment by substituting the ALP for the contract price.

32. A reading of the heading of Chapter X ["Special provisions relating to Avoidance of Tax "] and Section 92 (1) which states that any income arising from an international transaction shall be computed having regard to the ALP, Section 92C (1) which sets out the different methods of determining the ALP, makes it clear that the transfer pricing adjustment is made by substituting the ALP for the price of the transaction. To begin with there has to be an international transaction with a certain disclosed price. The TP adjustment envisages the substitution of the price of such international transaction with the ALP.

33. The TP adjustment is not expected to be made by deducing from the difference between the 'excessive' AMP expenditure incurred by the Assessee and the AMP expenditure of a comparable entity that an international transaction exists and then proceed to make the adjustment of the difference in order to determine the value of such AMP expenditure incurred for the AE.

34. It is for the above reason that the BLT has been rejected as a valid method for either determining the existence of international transaction or for the determination of ALP of such transaction. Although, under Section 92B read with Section 92F (v), an international transaction could include an arrangement, understanding or action in concert, this cannot be a matter of inference. There has to be some tangible evidence on record to show that two parties have "acted in concert".

35. The expression "acted in concert" has been interpreted by the Supreme Court in ***Daiichi Sankyo Company Ltd. v. Jayaram Chigurupati 2010(6) MANU/SC/0454/2010,*** which arose in the context of acquisition of shares of Zenotech Laboratory Ltd. by the Ranbaxy Group. The question that was examined was whether at the relevant time the Appellant i.e., Daiichi Sankyo Company and Ranbaxy were "acting in concert" within the meaning of Regulation 20(4) (b) of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. In para 44, it was observed as under:

> "The other limb of the concept requires two or more persons joining together with the shared common objective and purpose of substantial acquisition of shares etc. of a certain target company. There can be no "persons acting in concert" unless there is a shared common objective or purpose between two or more persons of substantial acquisition of shares etc. of the target company. For, *de hors* the element of the shared common objective or purpose the idea of "person acting in concert" is as meaningless as criminal conspiracy without any agreement to commit a criminal offence. The idea of "persons acting in concert" is not about a fortuitous relationship coming into existence by accident or chance. The relationship can come into being only by design, by meeting of minds between two or more persons leading to the shared

> common objective or purpose of acquisition of substantial acquisition of shares etc. of the target company. It is another matter that the common objective or purpose may be in pursuance of an agreement or an understanding, formal or informal; the acquisition of shares etc. may be direct or indirect or the persons acting in concert may cooperate in actual acquisition of shares etc. or they may agree to cooperate in such acquisition. Nonetheless, the element of the shared common objective or purpose is the *sine qua non* for the relationship of "persons acting in concert" to come into being.”

36. Additionally it may be noticed that a similar submission was made by the Revenue in ***MSIL*** *(supra)* to the effect that: "the only credible test in the context of TP provisions to determine whether the Indian subsidiary is incurring AMP expenses unilaterally on its own or at the instance of the AE is to find out whether an independent party would have also done the same." It was asserted: "An independent party with a short term agreement with the MNC will not incur costs which give long term benefits of brand & market development to the other entity. An independent party will, in such circumstances, carry out the function of development of markets only when it is adequately remunerated for the same". In ***MSIL*** *(supra)* the above submission was rejected by the following reasoning:

> “68. The above submissions proceed purely on surmises and conjectures and if accepted as such will lead to sending the tax authorities themselves on a wild-goose chase of what can at best be described as a 'mirage'. First of all, there has to be a clear statutory mandate for such an exercise. The Court is unable to find one. To the question whether there is any 'machinery' provision for determining the existence of an international transaction involving AMP expenses, Mr. Srivastava only referred to Section 92F (ii) which defines ALP to mean a price "which is applied or

proposed to be applied in a transaction between persons other than AEs in uncontrolled conditions". Since the reference is to 'price' and to 'uncontrolled conditions' it implicitly brings into play the BLT. In other words, it emphasises that where the price is something other than what would be paid or charged by one entity from another in uncontrolled situations then that would be the ALP. The Court does not see this as a machinery provision particularly in light of the fact that the BLT has been expressly negatived by the Court in ***Sony Ericsson***. Therefore, the existence of an international transaction will have to be established *de hors* the BLT.

69. There is nothing in the Act which indicates how, in the absence of the BLT, one can discern the existence of an international transaction as far as AMP expenditure is concerned. The Court finds considerable merit in the contention of the Assessee that the only TP adjustment authorised and permitted by Chapter X is the substitution of the ALP for the transaction price or the contract price. It bears repetition that each of the methods specified in S.92C (1) is a price discovery method. S.92C (1) thus is explicit that the only manner of effecting a TP adjustment is to substitute the transaction price with the ALP so determined. The second proviso to Section 92C (2) provides a 'gateway' by stipulating that if the variation between the ALP and the transaction price does not exceed the specified percentage, no TP adjustment can at all be made. Both Section 92CA, which provides for making a reference to the TPO for computation of the ALP and the manner of the determination of the ALP by the TPO, and Section 92CB which provides for the "safe harbour" rules for determination of the ALP, can be applied only if the TP adjustment involves substitution of the transaction price with the ALP. Rules 10B, 10C and the new Rule 10AB only deal with the determination of the ALP. Thus for the purposes of Chapter X of the Act, what is envisaged is not a quantitative adjustment but only a substitution of the transaction price with the ALP.

70. What is clear is that it is the 'price' of an international transaction which is required to be adjusted. The very existence of an international transaction cannot be presumed by assigning some price to it and then deducing that since it is not an ALP, an 'adjustment' has to be made. The burden is on the Revenue to first show the existence of an international transaction. Next, to ascertain the disclosed 'price' of such transaction and thereafter ask whether it is an ALP. If the answer to that is in the negative the TP adjustment should follow. The objective of Chapter X is to make adjustments to the price of an international transaction which the AEs involved may seek to shift from one jurisdiction to another. An 'assumed' price cannot form the reason for making an ALP adjustment.

71. Since a quantitative adjustment is not permissible for the purposes of a TP adjustment under Chapter X, equally it cannot be permitted in respect of AMP expenses either. As already noticed hereinbefore, what the Revenue has sought to do in the present case is to resort to a quantitative adjustment by first determining whether the AMP spend of the Assessee on application of the BLT, is excessive, thereby evidencing the existence of an international transaction involving the AE. The quantitative determination forms the very basis for the entire TP exercise in the present case.

72. As rightly pointed out by the Assessee, while such quantitative adjustment involved in respect of AMP expenses may be contemplated in the taxing statutes of certain foreign countries like U.S.A., Australia and New Zealand, no provision in Chapter X of the Act contemplates such an adjustment. An AMP TP adjustment to which none of the substantive or procedural provisions of Chapter X of the Act apply, cannot be held to be permitted by Chapter X. In other words, with neither the substantive nor the machinery provisions of Chapter X of the Act being applicable to an AMP TP adjustment, the inevitable conclusion is that Chapter X as a whole, does not permit such an adjustment.

73. It bears repetition that the subject matter of the attempted price adjustment is not the transaction involving the Indian entity and the agencies to whom it is making payments for the AMP expenses. The Revenue is not joining issue, the Court was told, that the Indian entity would be entitled to claim such expenses as revenue expense in terms of Section 37 of the Act. It is not for the Revenue to dictate to an entity how much it should spend on AMP. That would be a business decision of such entity keeping in view its exigencies and its perception of what is best needed to promote its products. The argument of the Revenue, however, is that while such AMP expense may be wholly and exclusively for the benefit of the Indian entity, it also enures to building the brand of the foreign AE for which the foreign AE is obliged to compensate the Indian entity. The burden of the Revenue's song is this: an Indian entity, whose AMP expense is extraordinary (or 'non-routine') ought to be compensated by the foreign AE to whose benefit also such expense enures. The 'non-routine' AMP spend is taken to have 'subsumed' the portion constituting the 'compensation' owed to the Indian entity by the foreign AE. In such a scenario what will be required to be benchmarked is not the AMP expense itself but to what extent the Indian entity must be compensated. That is not within the realm of the provisions of Chapter X.

74. The problem with the Revenue's approach is that it wants every instance of an AMP spend by an Indian entity which happens to use the brand of a foreign AE to be presumed to involve an international transaction. And this, notwithstanding that this is not one of the deemed international transactions listed under the Explanation to Section 92B of the Act. The problem does not stop here. Even if a transaction involving an AMP spend for a foreign AE is able to be located in some agreement, written (for e.g., the sample agreements produced before the Court by the Revenue) or otherwise, how should a TPO proceed to benchmark the portion of such AMP spend that the Indian entity should be compensated for?

> 75. As an analogy, and for no other purpose, in the context of a domestic transaction involving two or more related parties, reference may be made to Section 40 A (2) (a) under which certain types of expenditure incurred by way of payment to related parties is not deductible where the AO "is of the opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods." In such event, "so much of the expenditure as is so considered by him to be excessive or unreasonable shall not be allowed as a deduction." The AO in such an instance deploys the 'best judgment' assessment as a device to disallow what he considers to be an excessive expenditure. There is no corresponding 'machinery' provision in Chapter X which enables an AO to determine what should be the fair 'compensation' an Indian entity would be entitled to if it is found that there is an international transaction in that regard. In practical terms, absent a clear statutory guidance, this may encounter further difficulties. The strength of a brand, which could be product specific, may be impacted by numerous other imponderables not limited to the nature of the industry, the geographical peculiarities, economic trends both international and domestic, the consumption patterns, market behaviour and so on. A simplistic approach using one of the modes similar to the ones contemplated by Section 92C may not only be legally impermissible but will lend itself to arbitrariness. What is then needed is a clear statutory scheme encapsulating the legislative policy and mandate which provides the necessary checks against arbitrariness while at the same time addressing the apprehension of tax avoidance."

37. Additionally it was held both in ***MSIL*** *(supra)* as well as ***Whirlpool of India Limited*** *(supra)* that in terms of the law explained by the Supreme Court in ***CIT v. B.C. Srinivas Setty (1981) 128 ITR 294 (SC)*** and ***PNB Finance Limited v. CIT (2008) 307 ITR 75 (SC)***, in the absence of any machinery provision, bringing an imagined international

transaction to tax is fraught with the danger of invalidation. In the present case, in the absence of there being an international transaction involving AMP spend with an ascertainable price, even if such price were to be nil, neither the substantive nor the machinery provision of Chapter X are applicable to the transfer pricing adjustment exercise.

38. The Court is satisfied that in the present case, the Assessee is carrying on business as an independent enterprise and is incurring AMP expenses for its own benefit and not at the behest of the AE. The benefit of creation of marketing intangibles for the foreign AE on account of AMP expenses can at best said to be incidental. The decision in ***Sony Ericsson*** (supra) acknowledges that an expenditure cannot be disallowed wholly or partly because it incidentally benefits the third party. This was in context of Section 37(1) of the Act. Reference was made to the decision in ***Sassoon J David & Co Pvt. Ltd. v. CIT (1979) 118 ITR 26 (SC)***. The Supreme Court in the said decision emphasised that the expression 'wholly and exclusively' used in Section 10 (2) (xv) of the Act (Indian Income Tax Act, 1922) did not mean 'necessarily'. It said: "The fact that somebody other than the Assessee is also benefitted by the expenditure should not come in the way of an expenditure being allowed by way of a deduction under Section 10 (2) (xv) of the Act (Indian Income Tax Act, 1922) if it satisfies otherwise the tests laid down by the law."

39. The OECD Transfer Pricing Guidelines, para 7.13 emphasises that there should not be any automatic inference about an AE receiving an entity group service only because it gets an incidental benefit for being

part of a larger concern and not to any specific activity performed. Even paras 133 and 134 of the ***Sony Ericsson*** judgment makes it clear that AMP adjustment cannot be made in respect of a full-risk manufacturer.

40. Certain additional facts have been mentioned by the Assessee in its written note of submissions. It is pointed out that during the financial year 2007-2008 relevant to the AY in question, of the total turnover of Rs. 251.06 crore only Rs. 9.57 crore, constituting 3.81 per cent, is towards distribution activity whereas the balance revenue of Rs. 241.48 crore was from the manufacturing activity. Further it is pointed out that the contention of the Revenue that market development in India is the function of the AE is factually incorrect. It is pointed out that para 4.30 of the TP documentation has stated that the Assessee plans and executes its own marketing strategy as it considers necessary and appropriate. Further as an independent manufacturer the Assessee bears all the risks associated with its business of manufacturing and sale of products in India and abroad. The condition in the license agreement that the technology will be used for sale of goods in designated jurisdictions or specified territories is not an unusual arrangement. The question of re-characterising the Assessee as a 'contract manufacturer' was unwarranted. The Court finds that the Revenue has not been able to controvert any of the above submissions.

41. In that view of the matter, the question of a benchmarking analysis by evaluating the AMP expenses incurred by the Assessee in relation to its total sales vis-à-vis its comparables is not called for. There is nothing to indicate that the AMP expenses incurred by the Assessee is at the

instance of foreign AE and that the Assessee has to be compensated by the foreign AE in that behalf.

42. Question (ii) is answered in favour of the Assessee and against the Revenue by holding that the Revenue has not been able to demonstrate that there exists an international transaction involving the Assessee and a foreign AE on the question of AMP expenses.

43. The Court is, therefore, not called upon to answer the consequential question (iii).

44. The impugned order of the ITAT dated 12th December, 2014 is set aside. The appeal is allowed but in the circumstances no orders as to costs.

**S.MURALIDHAR, J.**

**VIBHU BAKHRU, J.**

**DECEMBER 23, 2015**
*b'nesh*