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TAX FLASH NEWS

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Transfer Pricing adjustment in relation to intra-group services deleted; payment of 2 per cent on sales considered to be at arm's length

Background

Recently, the Kolkata Bench of the Income Tax Appellate Tribunal (the Tribunal), in the case of NLC Nalco India Ltd.[1] (the taxpayer) for the Assessment Years (AYs) 2003-04 and 2004-05 deleted the adjustment made by the Transfer Pricing Officer (TPO)/Commissioner of Income Tax (Appeals) [CIT(A)] with respect to the payment for intra-group services to Nalco Pacific Pvt Ltd, Singapore (Nalco Pacific) by the taxpayer of 2 per cent on sales. It rejected NIL Arm's Length Price (ALP) determined by the TPO. Further, the Tribunal also deleted the Transfer Pricing (TP) adjustment in respect of export of chemicals to Associated Enterprises (AEs) by applying the Comparable Uncontrolled Price (CUP) method, observing that the taxpayer was bound to sell the chemicals at a low price to AEs as the stock was obsolete.

Intra-group service payment

Facts of the case

- The taxpayer company was engaged in manufacturing and dealing with water treatment chemicals, industrial additives and oilfield chemicals, etc.
- For AY 2004-05, the taxpayer paid an intra-group service charge of INR15,174,980 to Nalco Pacific, under the Technical and Management Assistance Agreement. The taxpayer received technical and management assistance from Nalco Pacific. As per the agreement, the taxpayer was to pay the intra-group service charge upto a maximum of 2 per cent on net sales.
- The taxpayer justified the ALP of the charge on the basis of the Transactional Net Margin Method (TNMM).
- However, the TPO observed that the services rendered by Nalco Pacific were more in the nature of directions/management decision/ routine advice which were provided by Nalco Pacific to the taxpayer to take care of its own interests rather than to meet the identified needs of the taxpayer. The TPO further noted that though some incidental benefits accrued to the taxpayer, yet such benefits would not be ones for which an independent enterprise would be willing to pay. Accordingly, the TPO determined the ALP of this transaction at NIL.
- The Assessing Officer (AO) made the disallowance of INR15,174,980 in respect of the intra-group service charge as per the recommendations made by the TPO in his order. The AO observed that no independent

[1] N L C Nalco India Ltd. v. DCIT (ITA No 529/Kol/2008 – AY 2003-04) and N L C Nalco India Ltd. v. ACIT (ITA No 1256/Kol/2009 – AY 2004-05)

documentary evidence had been furnished by the taxpayer to show that actual services have been rendered to the taxpayer. Nalco Pacific too could not substantiate the claim for provision of actual services with documentary evidence. Further, the remuneration was fixed not with reference to any particular service. It was at a fixed amount, calculated at a fixed percentage of sales of the taxpayer, irrespective of which services were actually received by the taxpayer or whether or not any services were received by it.

- Aggrieved, the taxpayer preferred appeal before the CIT(A), who also confirmed the adjustment of INR15,174,980 made by the AO based on the recommendation of the TPO.

- Aggrieved, the taxpayer then preferred an appeal before the Tribunal.

Taxpayer's contentions

- The taxpayer claimed that it had discharged its onus by filing all the relevant data, and the data used for determining the ALP is reliable and correct, and there can be no intervention by the AO without pointing out any defect in the same. If any circumstances mentioned in Section 92C(3) of the Income-tax Act, 1961 (the Act) existed, then the AO may reject the price adopted by the taxpayer and determine the ALP in accordance with the same rules.

- The taxpayer relied on the Supreme Court decision in the case of Walchand & Co.[2], wherein it was held that while applying the test of commercial expediency for determining whether the expenditure was wholly and exclusively laid out for the purpose of business, the reasonableness of the expenditure had to be judged from the point of view of the businessman and not from Revenue's standpoint.

- The taxpayer also relied on the Delhi High Court's (High Court) decision in the case of EKL Appliances[3], wherein it examined the issue as to whether the TPO has the power to restrict the value of an international transaction to NIL when he/she was supposed to have determined the ALP of the international transaction. The TPO computed the ALP of intra-group services charge at NIL value without applying any of the TP methodologies prescribed under Section 92C of the Act read with Rule 10B and 10C of the Income-tax Rules, 1962 (the Rules). Accordingly, this action of the TPO was without any basis and hence, was not sustainable.

- The intra-group service charge was allowed as a deduction by the TPO for the subsequent AYs 2005-06, 2006-07, 2007-08 and 2008-09. In this connection, the decision of the Calcutta High Court in the case of Britannia Industries Ltd[4] was relied upon, wherein the High Court held that the tax department cannot take a contrary view in respect of any issue which has been accepted by the Department for succeeding AYs based upon a similar set of facts.

- The payments had been approved by the Reserve Bank of India (RBI) by way of an 'in-principle' approval for remittance of consultancy charges to Nalco Pacific at 2 per cent of net sales.

Tribunal's ruling and observation

- The Tribunal noted that nothing was found in the TPO's order which was indicative of the existence of any of the circumstances prescribed under (a) to (d) of Section 92C(3) of the Act which necessitates intervention of the AO/TPO for determination of ALP.

[2] CIT v. Walchand & Co. etc. [1967] 65 ITR 381 (Bom)

[3] CIT v. EKL Appliances Ltd. [2012] 24 taxmann.com 199 (Del)
[4] CIT v. Britannia Industries Ltd [2002] 257 ITR 225 (Cal)

- The Tribunal noted that the Supreme Court in the case of Walchand & Co. had held that a businessman himself is the best judge in determining the reasonableness/usefulness/ benefit of expenditure which is wholly and exclusively laid out for the purpose of business. The Revenue has no role to play in determining the reasonableness/usefulness/ benefit of a business expenditure.

- The Tribunal also took note of the High Court's observations in the case of EKL Appliances, wherein High Court held that Rule 10B of the Rules does not authorise disallowance of any expenditure on the ground that it was not necessary or prudent for the taxpayer to have incurred the same or that in the view of the Revenue the expenditure was un-remunerative. It was also held that the quantum of expenditure can be examined by the TPO as per law, and so long as the expenditure or payment has been demonstrated to have been incurred or laid out for the purposes of business, it is of no concern to the TPO to disallow the same on any extraneous reasoning.

- Further, the Tribunal relied on the Delhi Tribunal decision of McCann Erickson India (P.) Ltd.[5], wherein Tribunal had held that only a particular business expert can evaluate the true intrinsic and creative value of intra-group services, and further that in any case, the value of these services cannot be taken at nil. The Tribunal also referred to the Mumbai Tribunal decision in Diebold Software Services (P.) Ltd.[6] relied on by the taxpayer.

- The Tribunal also held that the TPO's action of arriving at NIL without application of any TP methodology was without any basis and hence, not sustainable.

- The Tribunal followed the principle laid down by the Calcutta High Court in the case of Britannia Industries, and held that, 'the action of the TPO in making a disallowance of the intra-group service charge paid/payable by the taxpayer to Nalco Pacific for the AY 2004-05, after allowing the same for the AYs 2005-06, 2006-07, 2007-08 and 2008-09 based on the same facts, has no leg to stand'.

- The services rendered by Nalco Pacific to the taxpayer were intra-group services for which independent enterprises would have been willing to pay for or to perform in-house for themselves and hence, the value of the services in comparable uncontrolled transactions could not be NIL. Further, Tribunal noted that in the taxpayer's case no incidental benefits as mentioned in the Organisation for Economic Co-operation and Development (OECD) guidelines accrued to the taxpayer.

- The Tribunal observed that the CIT(A) tried to relate the intra-group service charge paid by the taxpayer to Nalco Pacific to the specific services rendered by Nalco Pacific to the taxpayer, which constituted the direct-charge method as provided by the OECD Guidelines. However, it also observed that Nalco Pacific did not render same/similar services to third parties (i.e. independent customers) during the relevant financial year and hence, Nalco Pacific, did not have the ability to demonstrate a separate basis for the charge by recording the work done and costs expended in fulfilling its third party contracts. Accordingly, the Tribunal held that 'the application of the direct charge method, as desired by the CIT(A), was not feasible for Nalco Pacific that rendered services only to the group companies. The only alternative pricing arrangement available to Nalco Pacific was the indirect-charge method'. Under the agreement, the taxpayer agreed to a net remittance for the intra-group services up to a maximum of 2 per cent of net sales for each calendar year, which is a method of allocation approved by the OECD Guidelines, and hence, the Tribunal rejected the CIT(A)'s ground of disallowance.

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[5] McCann Erickson India (P.) Ltd v. ACIT [2012] 24 taxmann.com 21 (Del)
[6] DCIT v. Diebold Software Services (P.) Ltd. [2014] 48 taxmann.com 26 (Mum)

- The Tribunal held that the payment made to Nalco Pacific at 2 per cent of net sales, having been the rate of consultancy charges approved by the RBI, was at ALP. It further deleted the addition in respect of both AYs[7].

Disallowance of export of chemicals

- The taxpayer exported chemicals to its AE and applied the TNMM on an aggregate basis. However, the TPO applied the CUP method to determine the ALP with reference to the uncontrolled transactions between the taxpayer and third party customers. Accordingly, an adjustment of INR0.40 crore was made. The CIT(A) rejected the taxpayer's contentions that functions performed by AEs and unrelated parties were different and that geographical differences also caused significant variation. The CIT(A) held that there was no rationale for price differentials between controlled and uncontrolled transactions.
- The taxpayer argued that the rationale for price differentials between controlled and uncontrolled transactions was that the product was manufactured to cater to the Indian customers. However, as demand declined in India and the same became part of the obsolete stock, the taxpayer had to sell the chemical to its AEs as obsolete stock.
- The Tribunal held that the application of the CUP method by the TPO was inappropriate. It observed that differences in factors such as geographical location of the parties, availability of raw material, demand and supply equation also play an important role in the application of the CUP method. The Tribunal observed that the chemicals were sold to AEs at a low/discounted price when the same had shelf life issues, no local demand and was on the verge of expiry.

Our comments

Considering that payments in the nature of intra-group services are one of the most litigated issues in India, the ruling comes as a relief for the taxpayers facing TP adjustments by TPOs/CIT(A) on similar basis i.e. the ALP for intra-group services being determined as NIL.

The Tribunal has placed reliance on the guidance contained in the OECD Guidelines regarding considerations for intra-group services and has also appreciated the fact that all intra-group services cannot be presumed to accrue incidental benefits.

The Tribunal's opinion that the TPO cannot question the commercial rationale or reasoning for procuring the services is welcome as it respects the business judgement of a taxpayer.

Further, considering that in quite a few cases, the intra-group service charge is allocated on the basis of an indirect-charge method, its acceptance by the Tribunal shall be welcome news for the taxpayers.

The Tribunal has opined that considering the RBI has approved the payment of intra-group service charges, it can be concluded that such payments are at ALP. Though, there are divergent views on this aspect by various Tribunals, the onus eventually lies on the taxpayer to maintain comprehensive analysis/proper supporting documentation/other evidences to substantiate the need for such services and the benefit derived from such services, which might form a concrete basis for considering the payments for intra-group services to be at an arm's length.

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[7] The Tribunal referred to the decisions of the Mumbai Tribunal in the cases of Thyssenkrupp Industries India and Cadbury India, wherein the Tribunal had held that in the event of payment of royalty/technical know-how/fee for drawing etc. is approved by the RBI/Government of India, and then such a payment has to be considered at ALP.

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