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CASE LAW UPDATE

Compiled by Kushal Dedhia

Dell International Services India Private Limited vs. JCIT, Bangalore [IT(TP)A No. 130/Bang/2014: Assessment Year 2009-10]

❖ **Summary :-**

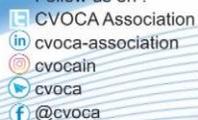
- In the given case, with respect to the transfer pricing grounds, Bangalore ITAT held that
 - royalty payment can be benchmarked by aggregating it with the main transaction under Transactional Net Margin Method; and
 - interest on outstanding receivables can be benchmarked by comparing the working capital operating margin of the tested party for the underlying transaction vis-à-vis the working capital operating margin of the comparable companies.

❖ **Facts :-**

Transaction of payment of Royalty

- Dell International Services India Private Limited (Dell India or the Assessee) was engaged in the business of development and export of Computer Software and rendering of Information Technology Enabled Services (ITeS). The Assessee had entered into an inter-company sublicense agreement with its Associated Enterprise (AE) for payment of royalty to use trade name, corporate name and as part of internet domain name. As per the agreement, the Assessee had to pay its AE royalty equal to 3% in respect of third party gross revenues to its AE.
- For the Assessment Year 2009-10, the Assessee's case was selected for scrutiny assessment and considering the fact the Assessee had international transactions with its AEs, the case was transferred to the Transfer Pricing Officer (TPO) to determine the Arm's Length Price (ALP) for various international transactions.
- The Assessee had benchmarked the transaction of payment of royalty by aggregating it with the main transaction of software development (SWD) services and comparing its net operating margin in SWD segment vis-à-vis the margins of the third party comparable companies and thereby concluded the transaction of royalty to be at the ALP.
- However, the TPO held that no independent party would pay royalty under similar circumstances and therefore, determine the ALP in respect of payment of royalty transaction as Nil by in an arbitrary manner.

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- Aggrieved by the TPO's order, the Assessee filed DRP application and the DRP too upheld the order of the TPO with respect to the transaction of payment of royalty which was subsequently affirmed by the AO in its Final Order.
- Aggrieved by the same, the Assessee filed an appeal before the ITAT bench of Bangalore.

Transaction of outstanding receivables

- The Assessee had debt outstanding for the period of more than six months from its AEs and unrelated parties and from both there was no interest charged by the Assessee for the overdue receivables.
- However, the TPO treated the transaction of aforesaid outstanding receivables as a deemed loan and applied CUP method to benchmark the said transaction on adhoc basis.
- Aggrieved by the TPO's order, the Assessee filed DRP application and the DRP directed the AO/TPO to verify if the working capital adjusted margins of the Assessee from which the outstanding receivables emanated is better than that of the third party comparable companies then no adjustment on this ground is warranted. However, the AO while passing the final assessment order confirmed the addition made in the TPO's order by observing that the DRP has no power to set aside/ remand the matter.
- Aggrieved by the same, the Assessee filed an appeal before the ITAT bench of Bangalore.

❖ **Taxpayer's Argument :-**

Transaction of payment of Royalty

- The Authorised Representative (AR) of the Assessee argued that the license to use brand name is generally permitted only amongst group Companies and not to third parties, hence it would be difficult to find external CUP details on the database and even if one is able to find similar royalty agreements, the same again would be tainted/ controlled transactions between related parties and cannot be used as valid CUP. Therefore, in the absence of CUP data, adopting TNMM cannot be faulted with.
- hence it would be difficult to find external CUP details on the database and even if one is able to find similar royalty agreements, the same again would be tainted/ controlled transactions between related parties and cannot be used as valid CUP. Therefore, in the absence of CUP data, adopting TNMM cannot be faulted with.
- Additionally, reliance was placed on RBI circular no. 76 which states that royalty at 8% of the export sales and 5% of the domestic sales can be charged without any approvals. Accordingly, in the absence of CUP data an alternate rate prescribed by RBI could be considered as CUP. The said argument was supported by various Judicial pronouncement stated in the Order (at page 16) which upheld the said principle.



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- Lastly, the AR argued that the TPO rejected the ALP determination in totally arbitrary manner without rejecting the benchmarking adopted by the Assessee. Even if TPO rejected the method adopted by the Assessee, the TPO then had to adopt one of the methods prescribed u/s.92C read with Rule 10B of the Income-tax Rules, 1962 to determine the ALP.

Transaction of outstanding receivables

- The AR argued that unpaid purchase price is not a loan and is a consequence of an international transaction of rendering of software service and cannot be treated as a separate international transaction.
- The AR further contended that the amendment to Section 92B was being made by the Finance Act 2012 with prospective effect and hence cannot apply retrospectively for the AY 2009-10.
- Further, the AR contended that even if the amendment was to apply retrospectively, clause(c) i.e. on financing arrangement was to apply only in case where the agreement provided for charge of interest beyond the credit period which was not so in the present scenario.
- Separately, the AR argued that AO grossly erred in law by not giving effect to the directions of the DRP which was binding on them and observing that the DRP had no power to set aside/ remand the matter to the AO/TPO.

❖ **Department's Argument :-**

Transaction of payment of Royalty

- Department Representative (DR) submitted that payment of royalty is a separate international transaction between the Assessee and its AE and the Assessee ought to have made separate TP analysis for payment of royalty.
- Clubbing/ aggregation of non-international transaction with international transaction based on the economic analysis carried out for international transactions is against the TP Regulations and Guidelines laid down by the OECD.
- The rate prescribed by the RBI is not a price and is only a ceiling on the rate and the amount of remittance under difference routes like approval or automatic route and hence could not be treated as CUP.

Transaction of outstanding receivables

- DR strongly supported the Order of the TPO.



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❖ ITAT Findings :-

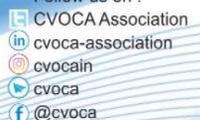
Transaction of payment of Royalty

- ITAT held that no CUP data was brought on record both by the TPO or the DRP and in the absence of CUP, ALP cannot be determined as Nil using the same CUP method. Hence, determination of ALP as Nil is unsustainable and bad in law.
- ITAT too adopted TNMM as MAM in the said case of the Assessee (where CUP was not available). ITAT observed that TNMM requires establishing comparability at a broad functional level, requiring comparison between net margin of tested party vis-à-vis the net margin of the uncontrolled comparable companies, thereby removing the limitation of other methods. ITAT further held that since the comparison is made at net operating profit level, TNMM is the only method where reasonable appropriate adjustments to the comparable company's margin could be made.
- In addition, ITAT too accepted the approach adopted by the Assessee of aggregating the transaction of royalty with the other international transactions involving software development and related services considering the fact the royalty was inextricably linked and is wholly necessary for the provision of software development services. ITAT placed reliance on the decisions of the Hon'ble HC decisions in the case of Sony Ericsson Mobile Communications India and Maruti Suzuki India, wherein the approach on benchmarking on an aggregated basis was upheld by these Courts. Thus, based on the said HC decisions, though rendered in the context of AMP expenditure but ITAT considered the rationale laid down in the said decision which equally applies in our case too for ALP determination for the transaction of payment of royalty and hence deleted the TP adjustments for the said transaction.
- Further, ITAT noted that the payment of royalty as operating expenditure was never a dispute and accordingly the royalty payment was forming part of the operating cost base of the software segment which earned net operating margin of 33.37% which was higher than the net operating margin of 21.84% of the comparable companies.
- Basis the above, the ITAT upheld TNMM as the MAM with aggregating of royalty payment under the SWD segment to arrive at the ALP.

Transaction of outstanding receivables

- ITAT observed that sales to AE is more than sales to non-AEs but the percentage of debtors to sales was less in AE as compared to that of non-AE;
- ITAT placed reliance on Rajasthan HC decision in the case of PCIT vs. Sharda Spuntex Pvt. Ltd. wherein it was held that when interest is not charged on non-AE debtors, there cannot be any notional interest charged on AE debtors;
- ITAT upheld that outstanding receivables from AE is an international transaction and opined that the same to be closely linked to the underlying transaction of sales to AE;

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- ITAT further observed that Assessee's adjusted ALP margin (i.e. after taking into account working capital adjustment) was higher than the comparables adjusted ALP margin which indicated that the compensation for the credit period in connection with the delayed receivables was already factored in the fee for the SWD services;
- Therefore, ITAT directed verification of the working capital adjusted margins of the Assessee and the Comparable Companies and if the same was found to be at ALP, then no separate adjustment for interest on outstanding receivables would be warranted.

❖ Author's Comments :-

- The issue around aggregation approach to be adopted is highly factual and depends upon the linkage of the transaction to be aggregated with the underlying or main transaction. In the given case, the transaction of payment of royalty was inevitably link with the transaction of SWD service segment and also there was no CUP data available for the transaction of payment of royalty.
- That being said, royalty payment under such circumstances cannot be considered and examined in isolation on a standalone basis which was duly accepted by the ITAT too.
- Separately, the ITAT had clearly brought out that if the Department wants to deviate from the existing methodology, then that should be backed by internal or external benchmarking analysis and cannot just be decided arbitrarily.
- With respect to outstanding receivables, there are plethora of judgments by various courts in India that have decided the issue of overdue receivables in favor of the taxpayer and one more judgement added to the favourable list, wherein ITAT confirmed that the working capital adjustments is the most appropriate barometer to verify the arm's length nature of outstanding receivables and acknowledging the practical and commercial realities.

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