

**IN THE INCOME TAX APPELLATE TRIBUNAL
“A” BENCH: BANGALORE**

**BEFORE SHRI GEORGE GEORGE K., JUDICIAL MEMBER
AND
SHRI B.R. BASKARAN, ACCOUNTANT MEMBER**

IT(TP)A No.2603/Bang/2018
Assessment Year : 2013-14

M/s. Toyotetsu India Auto Parts Private Limited Onsite Supplier Park, Building No.7, Bidadi Industrial Area, Plot No.1, Bidadi, Ramanagara District 562 109 PAN NO : AADCT0768L	Vs.	ACIT Circle-3(1)(1) Bangalore
APPELLANT		RESPONDENT

Appellant by	:	Shri K.R. Vasudevan, A.R.
Respondent by	:	Shri Kannan Narayan, D.R.

Date of Hearing	:	29.03.2021
Date of Pronouncement	:	18.06.2021

ORDER

PER B.R. BASKARAN, ACCOUNTANT MEMBER:

The appeal filed by the assessee is directed against the order dated 12.7.2018 passed by Ld. CIT(A)-7, Bengaluru and it relates to the assessment year 2013-14. All the grounds urged by the assessee relate to transfer pricing adjustment made in respect of royalty payments.

2. The facts relating to the issue are stated in brief. The assessee manufactures pressed and welded components for Toyota Kirloskar Motor parts. Basically, tax payer manufactures auto sheet metal parts that are made of steel alloys and are used as metal body in four wheelers. During the year under consideration, the assessee had entered following international transactions with its A.Es.

<i>Toyotestu India Auto Parts P. Ltd.</i>	
<i>Particulars</i>	<i>Amount</i>
<i>Royalty vide technical Assistance contract</i>	<i>45,360,082</i>
<i>Instructor fee vide instructor contract</i>	<i>9,035,729</i>
<i>Trainee fee vide trainee contract</i>	<i>Nil</i>
<i>Guarantee commission</i>	<i>8,558,511</i>
<i>Reimbursement of expenses</i>	<i>138,507</i>
<i>Rights shares issued in the ratio of 1.25:1.00 to shareholders</i>	<i>940,500,000</i>
<i>Total</i>	<i>1,003,592,829</i>

We are now concerned with royalty payment of Rs.4.53 crores. The assessee had paid royalty @ 5% as approved by the RBI as per FDI policy. Since the payments have been made in accordance with the FDI policy, the assessee submitted that the same was at arms length. According to the Ld. A.R., RBI approved rate would constitute a “comparable rate” under CUP method.

3. The TPO however took the view that the assessee has not done any bench marking for royalty payment. The TPO took the view that Profit Split Method (PSM) is the

appropriate method to determine arms length price of royalty payment made by the assessee. The TPO observed that there are 3 kinds of methods under PSM, viz., Contributory PSM, Comparable PSM and Residual Profit Split Method. He initially proposed to split the profit in the ratio of 80:20 between assessee and the A.E. The TPO determined EBDIT ratio of the assessee, which worked out to 8.57%. Average EBDIT margin of comparable companies worked out to 4.87%. The difference between the two was 3.73%. Then the TPO assigned weights to functions, assets and risk carried out by the assessee and its A.E. According to the said analysis, A.E. should be allotted 75% of the profit. Accordingly, the A.O. worked out 75% of 3.73%, which came to be 2.80%. Accordingly, he made transfer pricing adjustment of Rs.85,34,627/-. The Ld. CIT(A) also confirmed the same.

4. The ld. A.R. submitted that profit split method was not held to be appropriate method for royalty payments in the case of a group company named Toyota Kirloskar Auto Parts Pvt. Ltd., by the coordinate bench in the order passed on 18.3.2020 in IT(TP)A No.1915/Bang/2017 & IT(TP)A No.3377/Bang/2018. Accordingly, the Ld. A.R. submitted that the tax authorities are not right in law in determining the ALP of royalty payments under PSM method.

5. The Ld. A.R. submitted that in the above said case, the Tribunal has held that TNMM method is the appropriate method. He further submitted that the assessee has paid the royalty @ 5% which is RBI/FIPB approved rate. It has been held in the following cases that RBI rate can be considered as CUP rate for royalty.

a) SGS India Pvt. Ltd. (ITA No.1807/13 dated 18.11.2015)

b) A.W. Faber Castell (India) Pvt. Ltd. (IT(TP)A No.1018/Mum/2016, dated 30.9.2016.

Accordingly, the Ld. A.R. submitted that the PSM method cannot be adopted as most appropriate method.

6. On the contrary, the Ld. D.R. supported the order passed by Ld. CIT(A).

7. We heard the rival contentions and perused the record. The issue whether royalty can be bench marked under PSM method has been examined by the coordinate bench in the case of Toyota Kirloskar Auto Parts Pvt. Ltd. (supra) and it has been held that PSM is not the appropriate method of bench marking royalty. For the sake of convenience, we extract below the decision rendered by the coordinate bench.

"15. We have considered the rival submissions. We are of the view that the issue with regard to Most Appropriate Method in the case of assessee had already been settled by the Tribunal. The TPO as well as the DRP have not followed the aforesaid decision of the Tribunal on the ground that economic life of the technology had an impact on the MAM and that technology in question was to be used by start-ups and since the assessee was using the technology for a fairly long

period of more than 5 years, it would not be proper to adopt the TNMM as the MAM, as the economic life of the technology would no longer exist. In our view, there is no basis for the TPO as well as the DRP to come to a conclusion that technology in question was to be used by a start-up. There is no basis for the TPO and DRP to come to a conclusion that the Assessee is a start up in manufacture of various parts for automobiles. The technology in question was that of TMC Japan. The technology is being used by the Assessee even today. There is no basis for the TPO/DRP's conclusion, that the useful economic life of the technology would be only 5 years. In any event passage of time cannot be the basis to discard TNMM which is already held by the Tribunal and upheld by the Hon'ble High Court as no longer the MAM because the conditions necessary for PSM as MAM are not met in the case of the Assessee. Even going by Rule 10B(1)(d), there should be contribution by each of the parties to a transaction for earning profits from sale of goods or provision of services. Then the contribution of each of the parties is identified and the profit is split between those parties. In the case of the Assessee the technology is given by TMC, Japan for which royalty is paid. The use of the technology in manufacturing and the sale of the product so manufactured contribute to the profit of the Assessee and TMC, Japan has nothing to do with that. There is therefore absence the first condition for application of PSM as MAM. As submitted by the Assessee PSM is used as MAM only in a case involving transfer of unique intangible or in multiple inter-related international transactions which cannot be valued separately for determining the ALP. The OECD guidelines cited on behalf of the assessee clearly supports the aforesaid approach and the OECD guidelines in this regard reads as follows:-

“Further reliance is also placed on OECD Guidelines, which clearly lay down the situations in which the PSM is selected as an appropriate method of benchmarking. The relevant extract from the OECD Guidelines (para 2.109) is as below:-

“A transactional profit split method may also be found to be the most appropriate method in cases where both parties to a transaction make unique and valuable contributions (e.g. contribute unique intangibles) to the transaction, because in such a case independent parties might wish to share the profits of the transaction in proportion to their respective contributions and a two-sided method might be more appropriate in these circumstances than a one-sided method. In addition, in the presence of unique and valuable contributions, reliable comparables information might be insufficient to apply another method. On the other hand, a transactional profit split method would ordinarily not be used in cases where one party to the transaction performs only simple functions and does not make any significant unique contribution (e.g. contract manufacturing or contract service activities in relevant circumstances), as in such cases a transactional profit split method typically would not be appropriate in view of the functional analysis of that party”.

16.The **revised guidance (June 2018) on the application of transactional PSM**, provided by the OECD state the importance of delineating the transactions in determining whether the PSM is applicable or not. The relevant extract from the OECD Guidelines is provided below:

"2.125. The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. This process should have regard to the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place. That is, the accurate delineation of a transaction requires a two-sided analysis (or a multi-sided analysis of the contributions of more than two associated enterprises, where necessary) irrespective of which transfer pricing method is ultimately found to be the most appropriate.

*2.126. **The existence of unique and valuable contributions by each party to the controlled transaction is perhaps the clearest indicator that a transactional profit split may be appropriate.** The context of the transaction including the industry in which it occurs and the factors affecting business performance in that sector can be particularly relevant to evaluating the contributions of the parties and whether such contributions are unique and valuable. Depending on the facts of the case, other indicators that the transactional profit split may be the most appropriate method could include a high level of integration in the business operations to which the transactions relate and /or the shared assumption of economically significant risks (or the separate assumption of closely related economically significant risks) by the parties to the transactions. It is important to note that the indicators are not mutually exclusive and on the contrary may often be found together in a single case.*

2.127. At the other end of the spectrum, where the accurate delineation of the transaction determines that one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable

"2.147. Under the transactional profit split method, the relevant profits are to be split between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. In general, the determination of the relevant profits to be split and of the profit splitting factors should:

Be consistent with the functional analysis of the controlled transaction under review, and in particular reflect the assumption of the economically significant risks by the parties, and

Be capable of being measured in a reliable manner."

17. It is clear from the above OECD guidelines that in 'order to determine the profits to be split, the crux is to understand the functional profile of the entities under consideration. Although the comparability analysis is at the "heart of the

application of the arm's length principle", likewise, a functional analysis has always been a cornerstone of the comparability analysis. In the present case the Assessee leverages on the use of technology from the AE and does not contribute any unique intangibles to the transaction. It may be true that the Assessee aggregated payment of royalty with the transaction of manufacturing as it was closely linked and adopted TNMM but that does not mean that the transactions are so interrelated that they cannot be evaluated separately for applying PSM. Further, the Assessee does not make any unique contribution to the transaction, hence PSM in this case cannot be applied.

18. Therefore, we are of the view that TNMM is the Most Appropriate Method in the case of assessee. The decision of the Tribunal in the earlier AY 2008-09 has also been upheld by the Hon'ble High Court of Karnataka in ITA No.104/2015, judgment dated 16.7.2018, which was an appeal of the revenue against the order of Tribunal for AY 2008-09. The Tribunal has upheld TNMM as MAM from AY 2007-08 to 2011-12. In those AYs the dispute was whether TNMM or CUP was the MAM. It is for the first time in AY 2013-14 that the revenue has sought to apply PSM as MAM. In the given facts and circumstances, we are of the view that TNM Method is the Most Appropriate Method and the AO is directed to apply the said method in determining the ALP, after affording opportunity of being heard to the assessee. The grounds of appeal of the assessee are treated as allowed."

8. In the above said case, TNMM method was held to be most appropriate method. The Ld. A.R. submitted that the question - whether TNMM method or CUP method is appropriate method, has to be determined on the basis of facts prevailing in each case. He submitted that the assessee had adopted CUP method and stand of the assessee is supported by the decision rendered by Mumbai bench of Tribunal in the case of A.W. Faber Castell India Pvt. Ltd. (supra). Be that as it may, in any case, it has been held that PSM method is not most appropriate method for benchmarking royalty payments. Hence, the royalty payment made by the assessee has to be examined afresh. Accordingly, we set aside the order passed by Ld. CIT(A) on this issue and restore the same to

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the file of the AO/TPO for examining the ALP of royalty payment afresh, duly examining the claim of the assessee.

9. In the result, the appeal filed by the assessee is treated as allowed for statistical purposes.

Order pronounced in the open court on 18th Jun, 2021

Sd/-
(George George K.)
Judicial Member

Sd/-
(B.R. Baskaran)
Accountant Member

Bangalore,
Dated 18th Jun, 2021.
VG/SPS

Copy to:

1. The Applicant
2. The Respondent
3. The CIT
4. The CIT(A)
5. The DR, ITAT, Bangalore.
6. Guard file

By order

Asst. Registrar, ITAT, Bangalore.