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TAX FLASH NEWS

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Royalty received from franchisee remitted to an overseas AE without value-addition to be treated as a 'pass-through' cost for computation of operating profit margin

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of McDonald's India (P) Ltd.[1] (the taxpayer) has held that while computing operating profit margin applying Transactional Net Margin Method (TNMM), royalty income received from the sub-licensee i.e. franchisees/JVs in India and subsequently, royalty reimbursed to the Associated Enterprise (AE) for availing non-exclusive marketing and operational rights to McDonald's system, being non-value adding transactions, should be considered as pass-through and therefore, not be considered as operating in nature.

While doing so, the Tribunal has relied upon ruling by the Delhi Tribunal in the case of Cheil Communications India[2], ruling by the Delhi High Court in the case of Johnson Matthey India[3] and co-ordinate bench ruling in the taxpayer's own case in Assessment Year (AY) 2001-02.

Facts of the case

- The taxpayer is engaged in the business of providing management services for fast foods. It has entered into master license agreement with its AE, i.e. McDonald Corporation, U.S. (MDC or AE). Under this agreement, a license has been granted to the taxpayer with respect to non-exclusive marketing and operational rights of McDonald's system, for which the taxpayer is required to make a payment of a royalty of 5 per cent on gross sales in India. As per the said agreement, royalty is to be remitted by the taxpayer to MDC within five days of the end of the month.

- The taxpayer also created two Joint Ventures (JVs) who in turn are the sub-licensee and are supposed to pay royalty at 5 per cent to the taxpayer. The taxpayer was further obliged to pay USD45,000 as a franchisee fee (reduced to USD22,500 with effect from 1 July 2002) for each of the new restaurants taken on franchise the obligation of which has also been passed on to the JVs.

- During the AY 2003-04, the taxpayer entered into international transactions with its AE in the nature of provision of consultancy services, payment of royalty and payment of franchise fee. The taxpayer applied Comparable Uncontrolled Price (CUP) method to benchmark the impugned international transactions of payment of royalty and franchisee fee.

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[1] Mc Donald's India (P) Ltd v. DCIT (ITA No. 961/DEL/2010) (Assessment Year: 2003-04)
[2] DCIT v. Cheil Communications India (P) Ltd. [2011] 11 taxmann.com 205 (Del)
[3] Johnson Matthey India (P) Ltd. v. DCIT [2015] 63 taxmann.com 2 (Del)

- The Transfer Pricing Officer (TPO) rejected the taxpayer's approach and applied TNMM by aggregating all the three transactions, viz. rendering of consultancy services, payment of royalty and payment of franchise fee. Thereafter, the Ld. TPO determined a margin of 2.68 per cent against the average margin of comparables of 9.89 per cent and proposed an adjustment.
- While computing operating profit margin applying TNMM, the Ld. TPO included royalty income received from the JVs and subsequently paid to MDC as operating income and operating expenses, respectively.
- The TPO's primary argument was based on a clause in the agreement which provided that in the case of default in the payment of royalty by JVs, the taxpayer would make good the AE to the extent of such amount.
- Further, the TPO excluded part of franchise fee received during the year from the operating income as it was not remitted to MDC in the absence of necessary RBI approvals as it was not recognised as expenses in the books of the taxpayer.
- The CIT(A) upheld the TPO's action of rejecting the CUP method applied by the taxpayer for benchmarking the impugned transactions citing geographical differences and concurred with aggregation of transactions as done by the Ld. TPO. Aggrieved, the taxpayer filed an appeal before the Tribunal.

Taxpayer's contentions

The taxpayer contended that TPO/CIT(A) were not justified in including royalty amount in the taxpayer's operating income and operating expenses while computing operating profit margin due to following reasons:

- The taxpayer is a service provider and is charging 10 per cent mark-up on all other operating costs, and the mark-up is not charged on non-value added services. Therefore, royalty and franchisee fees being risk-free and non-value adding, no mark-up is charged.
- The taxpayer merely receives royalty fees for onward remittance to MDC, and there is no income left to the taxpayer as per the master license agreement and the franchises agreement.
- The taxpayer does not assume any onerous responsibility in collection or payment of royalty and by virtue of conduct of the parties, the whole transaction is risk-free and non value adding;
- The risk arising from default in payment by JVs is just a hypothetical risk, and there are such instances of default in the previous or subsequent years.
- The premise for payment of royalty is the usage of McDonald Brand (owned by MDC), and since the taxpayer is not engaged in actual operations of restaurants itself, the question of any payment for royalty by the taxpayer does not arise.
- The taxpayer referred to the Tribunal's decision in the taxpayer's own case for AY 2001-02 where the co-ordinate bench had held that the taxpayer is not earning anything on account of royalty, and the entire royalty is to be passed on to MDC.
- The taxpayer also relied on para 2.93 of the OECD guidelines[4], ruling by the Delhi Tribunal in the case of Cheil Communications India Pvt. Ltd. and the decision of Delhi High Court in the case of Johnson Matthey India Pvt. Ltd.

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[4] 2.93 In applying a cost based transactional net margin method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with the an appropriate allocation in respect of the overheads of the business. The question can arise whether and to what extent it is acceptable at Arm's length to treat a significant portion of taxpayer's cost as pass-through costs to which no profit element is attributed (i.e. as costs which are potentially excludable from the denominator of the net profit indicator). This depends on the extent to which an independent party in comparable circumstances would agree not to earn a mark-up of part of the costs it incurs. The response should not be based on the classification of costs as "internal" or "external" costs, but rather on a comparability (including functional) analysis.

- Regarding foreign exchange fluctuation risk borne by the taxpayer, the taxpayer submitted that the royalty and franchisee fees are required to be remitted within five days from the close of the month, and therefore no significant risk is assumed by the taxpayer on account of foreign exchange fluctuation.
- The taxpayer also argued that since the franchisee fee had been excluded (in the absence of necessary RBI approvals) by the Ld. TPO from the cost base while computing operating profit margin, royalty fee should also be excluded.

Tax department's contentions

- There is a difference in amount of royalty collected from JVs and remittance to the AE, and therefore, there is an inherent profit or loss element. Hence, royalty payment is not a pass through cost.
- The restaurants are not directly responsible for payment to MDC, and there is a risk of cancellation of agreement in the event of non-payment. Thus, the taxpayer bears the risk in the event of default of payment by the JVs as there is discretion available to MDC to compel the taxpayer to make good in case there is a default payment by the JVs and such a risk bearing activity cannot be considered as a pass through cost.
- There is a risk of cancellation of agreement and risk of foreign exchange fluctuation. The taxpayer is carrying risk associated business transaction and therefore, no further adjustment can be granted.

Tribunal's ruling

- The Tribunal interpreted 'pass through costs' as costs which are incidental to the main business activities and no significant function or significant risk is assumed in relation to such costs.
- The Tribunal observed that the taxpayer's risk to make good the AE in the event of default by JVs cannot be viewed in isolation of actual conduct of the parties as no actual default has occurred. Further, no instance has been pointed out by the TPO or CIT(A) to show that risk of non-payment by franchisee devolving on the taxpayer is imminent and a real risk. Therefore, the Tribunal concluded that no risk is assumed by the taxpayer in the collection and onward remittance of royalty.
- Taking cognisance of the fact that the taxpayer is required to remit royalty amount within five days of the end of each month, the Tribunal observed that taxpayer has also not commercially exploited or availed of any benefit on account of credit or retaining money.
- Based on the above, the Tribunal held that the royalty payment by the taxpayer to MDC is to be treated as a pass-through cost and should not be considered as operating in nature while computing the operating profit margin.
- In relation to ground pertaining to risk adjustment, the Tribunal agreed to the taxpayer's contention that it did not assume forex fluctuation risk as royalty and franchise fees were remitted within five working days from the close of the month, and has set aside the ground to AO for adjudicating this risk adjustment issue.

Our comments

The issue of treatment of certain remittances as a pass through costs forms a critical aspect for computation of operating profit margin of taxpayers. The Tribunal while adjudicating on the matter, has delved into a very important aspect that conduct of parties assumes prime significance and overrides contractual agreements in case the same do not align with actual conduct.

The Tribunal has also placed reliance on decisions of co-ordinate bench in the case of Cheil Communications India Pvt. Ltd. and the Hon'ble Delhi High Court in the case of Johnson Matthey India Pvt. Ltd. to conclude that incidental costs pertaining to business activities involving no value addition services and where no significant functions or significant risks are assumed, are to be treated as pass-through costs.

Other international guidance viz. OECD Guidelines, U.S. regulations, etc. also appreciate the fact that costs pertaining to no value adding activities should be treated as the pass through and no profit should be attributed to such costs.

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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