Future projections alone should be adopted in respect of valuation of intangibles, and such valuation cannot be reviewed with actuals at a later date

Background
The Hyderabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of DQ (International) Ltd\(^1\) (the taxpayer) held that for valuation of an intangible asset only the future projections can be adopted, and such valuation cannot be reviewed with actuals figures at a later date. The Tribunal further held once the Intellectual Property (IP) is transferred to the Associated Enterprise (AE) at an Arm’s Length Price (ALP), such IP becomes the property of the AE, and the taxpayer cannot claim any further benefits from the IP including attribution of any revenue derived by the AE from such IP.

Facts of the case
- The taxpayer is engaged in producing animation visual effects, game art and entertainment content for Indian as well as global media and entertainment industry. DQE Plc., Isle of Mann, is the holding company of DQE (Mauritius) Ltd (DQE Mauritius), which is the holding company of the taxpayer. Further, the taxpayer is the holding company of DQE (Ireland) Ltd (DQE Ireland).
- For the Assessment Year (AY) 2010-11, the taxpayer had international transactions in the nature of the sale of intangible assets, payment of management charges and reimbursement of travel expenses incurred on behalf of its AE.
- The taxpayer determined the ALP of the international transactions relating to the sale of IP rights of the ‘Jungle Book’ Animation series to DQE Ireland based on an average of the value’s arrived at by two independent valuation reports. The valuation was conducted using the relief from royalty method and Discounted Cash Flow (DCF) analysis.

\(^1\) DQ (International) Ltd v. ACIT (ITA No. 151/Hyd/2015) – Taxsutra.com
• Considering the international transactions, the taxpayer’s case was referred to the Transfer Pricing Officer (TPO) for determination of ALP of the international transactions. In the Transfer Pricing order, the TPO made adjustment to all the international transactions by applying the following methodology:

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<th>International transaction</th>
<th>TPO’s approach</th>
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| 1      | Sale of intangible asset (IP rights) | • The TPO accepted the valuation method adopted for determining the sale consideration in the case of sale of IP by the taxpayer to its AE. However, the TPO replaced the projections considered in DCF analysis for the purpose of valuation with actual total revenue of DQE Ireland for the FY2009-10 and 2010-11 and arrived at a higher value of INR12.35 crore as compared to INR5.36 crore arrived at by the taxpayer.  
• Further, since the IP right was sold under the development phase, the TPO alleged that the taxpayer has deliberately shifted the potential revenue earning IP to Ireland being a low tax regime jurisdiction. Therefore, the TPO adopted Profit Split Method (PSM) and attributed 80 percent of the total profits earned by DQE Ireland for the year ending 31 March 2010 to the taxpayer. |
| 2      | Payment towards management consultancy service | The TPO observed that the taxpayer failed to furnish any evidence in support of receipt of the tangible benefits for which the payment was made to its AE and hence treated the ALP as nil. |
| 3      | Recovery of travel expenses | The TPO applied a mark-up on reimbursement of travel and other expenses at 10 per cent, stating that the same was reasonable which any independent party would be willing to pay. |

• The Dispute Resolution Panel (DRP) upheld the adjustment made by the TPO. Aggrieved by the final order of the Assessing Officer (AO) passed pursuant to DRP directions, the taxpayer filed an appeal before the Tribunal.

**Taxpayer’s contentions**

**Sale of intangible assets (IP rights)**

**Transfer of IP rights to AE**

• It was submitted by the taxpayer that external valuation under the DCF or any other method is applied by considering projections of revenues and cannot be tinkered at a later point of time by substituting it with actuals. The above point was upheld by the Bangalore Tribunal in the case of Tally Solutions (P.) Ltd.².

• The taxpayer contended that projections are based on normal market scenarios which are volatile and based on which any valuation exercise is completed, which is accepted worldwide. This principle remains same even if the transaction is entered into with a third party. Further, projections for 15 years have been considered which regularise ups and downs over a period of time.

• The taxpayer relied on the decision of the Tribunal in the case of Social Media India Ltd.³ wherein it was held that the taxpayer’s valuation has to be accepted as it was supported by an independent valuer.

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² Tally Solutions (P.) Ltd. v. DCIT [2011] 14 taxmann.com 19 (Bang)
³ Social Media India Ltd. v. ACIT (ITA No. 1711/Hyd/2012)
• Additionally, the taxpayer contended that an outright sale of the IP rights had been made to DQE Ireland and the capital gains arising from the transaction was offered as short-term capital gains.

**Profit attribution and application of PSM**

• The taxpayer submitted that PSM is applicable only when the intangibles are jointly owned by both the taxpayer and AE under cost contribution arrangement. However, in the present case an outright sale of the intangible asset ‘Jungle Book’ was made to DQE Ireland on 30 September 2009 at an ALP based on external valuation. Hence, there is no joint ownership scenario.

• Besides, the adjustment has been made by the TPO by allocating 80 per cent of the entire revenue of DQE Ireland which includes revenue generated from other intangible assets. The taxpayer additionally contended that no revenue had been generated during the period April 2009 to September 2009 from the IP ‘Jungle Book’ either in the hands of the taxpayer or its AE, hence apportioning revenue of DQE Ireland to the taxpayer is not appropriate. Revenue from IP ‘Jungle Book’ commenced from the last quarter of Financial Year (FY) 2009-10, when the ownership of the intangible asset was with DQE Ireland and therefore the revenue generated from the IP ‘Jungle Book’ belongs to DQE Ireland. Therefore, the taxpayer challenged the basis for attribution of 80 percent of the profits of DQE Ireland.

**Tax department’s contentions**

**Sale of intangible assets (IP rights)**

**Transfer of IP rights to AE**

• The tax department asserted that the projections have been provided by the management without proper justification and thus it is appropriate to determine the fair price by replacing the projected figures with actual figures from the audited financial statements. Further, relying on the OECD Transfer Pricing Guidelines, the tax department was of the view that since the difference between the projections as provided in the valuation and the actual transaction was substantial, uncontrolled independent parties would have entered into a renegotiation or an adjustment to the negotiated price.

**Profit attribution and application of PSM**

• The tax department contended that even though the legal ownership of the IPs of ‘Jungle Book’, has been transferred to DQE Ireland, the economic ownership lies with the taxpayer. Further, the tax department alleged that sale of the intangible asset to AE is in the nature of business restructuring involving the transfer of valuable intangible assets at development stage itself into a tax favoured nation like Ireland.

• In addition to the above, it was contended that PSM might be used in respect of transactions involving the transfer of unique intangibles. The tax department contended that both the AE and the taxpayer are involved at some stages in the exploitation of the IP even after the legal ownership of the IP is transferred to DQE Ireland, and therefore the application of PSM is proper. The residual analysis was adopted to split the profits between the taxpayer and DQE Ireland in the ratio of 80:20.

• The tax department argued that DQE Ireland has only two directors and one employee and that the only activity carried out by the company is hiring of artists which are evident from the financials as 96.85 per cent of the expenditure is to freelancers. There is no expenditure on rent or own premise. Thus the company appears to be working from some place other than Ireland and appears to be a shell company.
• As regards the profit sharing in the ratio of 80:20, the tax department argued that the taxpayer is an established entity in the global arena and has been in existence for ten years with a brand value which has been capitalized by the AE to tap the right contacts in the industry. It is in this scenario that the profits have been shared in the ratio of 80:20.

**Tribunal's ruling**

**Sale of intangible assets (IP rights)**

**Transfer of IP rights to AE**

• Based on the rulings relied upon by the taxpayer, the Tribunal stipulated that in the case where a valuation method is adopted, the projections cannot be replaced with actuals at a later date, as the valuation may go either way. The method adopted should be consistent and should be documented to review in the future. The review does not mean replacing projections with actuals. It is reviewing the rationale for adopting the values for decision-making at the point in time of making the decision. Further, the Tribunal also observed that the revenue adopted for valuing the IP should be in relation to the transferred IP ('Jungle Book') and that the TPO cannot adopt such values without proper verification.

**Profit attribution and application of PSM**

• The Tribunal held that there is no international transaction after an outright sale and as per section 92B of the Income Tax Act, 1961. Upon the sale of IP and determination of ALP, the intangible asset is the property of the AE and neither the taxpayer has any right to claim benefit nor the revenue. In respect of planning amongst the Group companies, the Tribunal observed that tax planning might be done within the four corners of taxation laws. The Tribunal stated that there is enough mechanism in the existing Act and Double Taxation Avoidance Agreement with Ireland to manage situations of tax avoidance and in the absence of any cogent evidence to prove the existence of tax avoidance. The Tribunal allowed the taxpayer’s grounds.

**Payment of management consultancy service fees**

• The Tribunal following the taxpayer’s own case in the earlier year adjudicated that services have been rendered by the taxpayer’s holding company and hence the TPO cannot consider the ALP of management consultancy fees as Nil, thereby allowing the payment made to the Holding company.

**Recovery of travel expenses**

• The Tribunal following the Chennai Tribunal decision in the case of Cognizant held that since the taxpayer had incurred travel and other expenses on behalf of its AE, there is no element of service involved and therefore adding a markup is not justified and deleted the adjustment.

**Our comments**

The ruling emphasises on the fact that in the case of a transaction involving the sale of IP due consideration needs to be given to the independent valuation report and that the tax department cannot replace projected cash flows with actual revenues of AE at a later date for valuing such IP. Further, the ruling also states that an adjustment cannot be made merely on the grounds of tax planning on the part of the taxpayer unless evidence has been obtained on tax avoidance. The commercial expediency of transactions and legitimacy of business decisions needs to be given precedence.

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4 Cognizant Technology Solutions India Pvt. Ltd v. ACIT [ITA Nos.114 & 2100(Mds)/2011]