Two enterprises cannot be treated as an associated enterprise unless both the parameters laid down in Section 92A of the Income-tax Act are fulfilled

Background
The Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Page Industries Ltd. (the taxpayer) held that the taxpayer and Jockey International Inc, U.S. (JII) are not associated enterprise(s) (AE or AEs) for Assessment Year (AY) 2010-11 as their relationship does not meet the parameters of Section 92A(1) of the Income-Tax Act (the Act) which requires direct/indirect ownership in the management/control/capital of the other enterprise. The Tribunal agreed with the taxpayer that they are a mere licensee of the brand-name 'Jockey' for exclusive manufacturing and marketing of goods under the license agreement with JII.

The Tribunal rejected Transfer Pricing Officer’s (TPO) view that the two enterprises (i.e. the taxpayer and JII) should be treated as associated entities under Section 92A(2) of the Act considering the amendment made to Section 92A(2) vide Finance Act, 2002 with effect from 1 April 2002 which provides that ‘in order to constitute relationship of an AE, the parameters laid down in both subsections (1), and (2) of Section 92A of the Act should be fulfilled’. Thus, the Tribunal concluded that ‘since the parameters laid down in sub-section (1) are not fulfilled, there is no relationship of AE between the taxpayer and JII and therefore, the provisions of Chapter X of the Act have no application.’

Facts of the case
- The taxpayer is engaged in the business of manufacture and sale of ready-made garments. The company is a licensee of the brand-name ‘Jockey’ for the exclusive manufacturing and marketing of Jockey’s readymade garments under the license agreement with Jockey International Inc, U.S. (JII), a company incorporated in U.S. and the owner of the brand Jockey. The taxpayer owned the entire manufacturing facility, capital investment, employees and there was no participation of JII in the capital and management of the taxpayer.

- In consideration for granting the right to use the brand-name, the taxpayer paid consideration in the form of royalty at the rate of 5 per cent of the sales to JII. The Form 3CEB was filed by the taxpayer disclosing the payment of royalty transaction.

- During the AY 2010-11 the taxpayer incurred expenditure on Advertisement, Marketing and product Promotion (AMP) to increase its sales. The TPO stated that the AMP expenditure incurred by the taxpayer was done on behalf of JII to promote their brand name and hence, such costs should have been recovered by the taxpayer from JII. The TPO categorized the said expenses as an international transaction in the nature of the brand building and determined the Arm’s Length Price (ALP) by applying Bright Line Method.
• The TPO proposed adjustment in relation to both royalty and AMP expenses.

Issue before the Tribunal

In the absence of participation by JII in the management/control/capital of the taxpayer, whether the relationship between the taxpayer and JII can be treated as that of an AE as per Section 92A(1) and 92A(2) of the Act.

Taxpayer’s contentions

• The primary contention of the taxpayer is that the transaction pertaining to payment of royalty was reported in the accountant’s report only out of abundant caution, and actually there does not exist an AE relationship with JII, which would invoke the provisions of Chapter X of the Act.

• Without prejudice to the above, the taxpayer also contended that the TPO erred in concluding that AMP expenses are an international transaction and computing ALP for the same, without appreciating that the AMP expenses were incurred by the taxpayer for its own business purposes and not for the brand building of JII.

• The TPO erred in aggregating royalty and advertisement expenditure for determining ALP without appreciating the fact that both the transactions are distinct and have different FAR and without considering the fact that the royalty payments have nothing to do with the incurring of AMP expenses.

• The TPO unilaterally adopted comparables selected by the taxpayer under Transactional Net Margin Method as comparable under Comparable Uncontrolled Price (CUP) method without demonstrating how they remain comparable under the CUP method also.

Tax department’s contentions

• The Assessing Officer/TPO contention is that the taxpayer and JII are AEs as per the deeming provision laid out in Sec 92A(2)(g) of the Act.

• The TPO contended that the payment of royalty to JII is intrinsically linked to the AMP expenditure as per the content of the license agreement and hence both of them are international transactions and needs to be tested as per the ALP.

• JII has neither incurred expenditure on its own account, nor it has compensated the taxpayer towards the advertisement expenditure incurred at the instance of the AE, out of international transactions towards royalty and advertisement, therefore an amount INR20,20,07,861 is proposed to be added to the total income of the taxpayer.

Tribunal’s ruling

• The Tribunal rejected TPO’s view that the two enterprises (i.e. the taxpayer and JII) should be treated as associated entities under Section 92A considering the amendment made to Sec 92A(2) vide Finance Act, 2002 with effect from 1 April 2002, which provides that ‘in order to constitute a relationship of an AE, the parameters laid down in both subsections (1) and (2) of Section 92 should be fulfilled’.

• Tribunal observed that while interpreting a provision in a taxing statute, the construction should preserve the purpose of the provision. If more than one construction is possible, that which preserves its workability and efficacy is to be preferred to the one which would render it otiose or sterile.

• In the above context, Tribunal held that even if the taxpayer and JII may be related as per Section 92A(2)(g) but till the time their relationship will not satisfy the conditions laid down in 92A(1) they cannot be construed as AEs, and therefore the provisions of Chapter X of the Act have no application.

• Consequently, the Tribunal held that the transfer pricing adjustment made by the TPO is not valid in law.

Our comments

The Tribunal held that satisfaction of the deeming provisions set out under Section 92A(2) of the Act alone is not sufficient to qualify that two entities are associated enterprises, provisions of subsection (1) to section 92A also needs to be fulfilled. This implies that in order to constitute a relationship of an AE, the parameters laid down in both subsections (1) and (2) should be fulfilled.

This Tribunal ruling highlights that Section 92A(1) and 92A(2) cannot be read independently while determining the relationship between the enterprises. This view pronounced by the Tribunal could be the subject matter of intense debate. The ruling by Mumbai Tribunal in the case of Kaybee Private Limited², held that two enterprises will be treated as AEs if the conditions of Section 92A(1) of the Act are independently satisfied irrespective of the deeming fiction set out under Section 92A(2) of the Act.

2 Kaybee Pvt Ltd vs ITO (ITA No. 3749/Mum/2014)
In the present case, the taxpayer is using the brand name of JII under the license agreement which clearly falls under Section 92A(2)(g), as has been reported in its From 3CEB. However, in the case of Diageo India Private Limited\(^3\) the Mumbai Tribunal held that the contract bottling unit (CBU) of Diageo India and the overseas Diageo group units are AEs, because the CBU is wholly dependent on the trademark owned by Diageo Group and hence clearly falls under the deeming provision set out under Section 92A(2)(g) of the Act to be considered an AE.

The provisions of sub-section (2) to section 92A supplements the definition of AE relationship given in sub-section (1) by enlisting various situations under which two enterprises shall be deemed to be an AE. Given the above, the moot point is that can an enterprise after satisfying the specific provision of Section 92A(2) fall short of satisfying the provision of Section 92A(1) of the Act.

\(^3\) Diageo India Pvt Ltd v. ACIT (ITA No. 8602/Mum/2010)
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