*** IN THE HIGH COURT OF DELHI AT NEW DELHI**

% **Judgment reserved on: 14 May 2024**
Judgment pronounced on: 11 July 2024

\+ ITA 40/2018

PRINCIPAL COMMISSIONER OF INCOME TAX-8
..... Appellant
Through: Mr. Sanjay Kumar and Ms. Easha Kadian, Advocates

versus

SAMSUNG INDIA ELECTRONICS PVT. LTD.,
..... Respondent
Through: Mr. Himanshu Sinha, Mr. Bhuwan Dhoopar and Mr. Parash Bisvval, Advocates

CORAM:
HON'BLE MR. JUSTICE YASHWANT VARMA
HON'BLE MR. JUSTICE PURUSHAINDRA KUMAR KAURAV

J U D G M E N T

YASHWANT VARMA, J.

1. The Principal Commissioner impugns the order of the **Income Tax Appellate Tribunal**[1] dated 23 May 2017 rendered for **Assessment Year**[2] 2008-09. By our order of 09 February 2018, we had admitted the appeal on the following solitary question of law: -

> "Whether the ITAT erred in deleting the TP adjustments of Rs. 1,99,57,161/- on the ground of payment of royalty in the circumstances of the case?"

2. The record would reflect that **Samsung Telecommunications**

[1] Tribunal
[2] A.Y.

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India[3]**,** the respondent-assessee, was incorporated in October 2005 and is a wholly owned subsidiary of **Samsung Electronics Co. Ltd., Korea**[4] and is engaged, inter alia, in the manufacture and sale of mobile phones under the Samsung brand. Admittedly, STI manufactures and sells mobile handsets in India as well as overseas. The design, know-how and other critical components are provided to it by Samsung Korea in terms of a Technology License Agreement dated 26 February 2006 and which obliges STI to pay for technical assistance as well as royalty.

3. During the A.Y. in question, STI paid a sum of INR 15,59,64,867/- towards technical assistance fee and royalty. A further sum of INR 1,99,57,161/- was paid by it as royalty on sales made to other **Associated Enterprises**[5]. For the year in question, a Return of Income was filed on 30 September 2008 which was selected for scrutiny pursuant to which notices under Section 143(2) as well as Section 142(1) of the **Income Tax Act, 1961**[6] came to be issued.

4. On 12 September 2011, a Show Cause Notice was issued to STI by the **Transfer Pricing Officer**[7] in the course of examining a reference which was made to it pertaining to the payment of royalty to Samsung Korea. Responding to the same, STI is stated to have submitted that the royalty payment to Samsung Korea was in consideration of receipt of technical know-how and expertise. It was further averred that STI operates as a licensed manufacturing company

[3] STI
[4] Samsung Korea
[5] AE
[6] Act
[7] TPO

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as contrasted from a contract manufacturer and that the export sales made by it to AEs' are driven by open market conditions which was a position which obtained even in respect of sales made to unrelated parties. It was further asserted that since it affects sales to other overseas group entities, it would be incorrect to deprive Samsung Korea of its right to earn an arm's length return on those sales as a return for the research and development investments made by it over the years.

5. By an order of 17 October 2011, the TPO determined the **Arm's Length Price**[8] of royalty paid by STI to its AEs' for exports made as 'Nil'. Consequently, the TPO recommended addition of INR 1,99,57,161/- to the total income of the assessee. Based on the above, a Draft Assessment Order came to be framed on 29 December 2011. The aforesaid was assailed by way of objections preferred before the **Dispute Resolution Panel**[9]. The DRP, however, in terms of an order of 27 September 2012 upheld the additions which were proposed. Basis the above, a final assessment order came to be framed on 26 October 2012.

6. It becomes pertinent to note that during the pendency of the aforesaid proceedings, identical questions arose for A.Y. 2007-08. The appeal for that year reached the Tribunal which rendered a final decision thereon on 21 June 2013. While dealing with the issue of royalty and the additions which were made in that respect pursuant to the recommendations of the TPO as affirmed by the DRP, the Tribunal held as follows: -

[8] ALP
[9] DRP

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"**6.2** We have carefully heard the submissions and perused the records. We find that assessee in this case has paid the royalty to its AEs on total exports sales of Rs. 1,724,554,461/- to AE, the assessee had deducted the cost of goods sold and on the net sales of Rs. 333,522,421/- royalty @ 8% at Rs. 26,681,794/- had been paid. The TPO observed from the transfer pricing documentation that the assessee has received all technological inputs from its parent/group companies for the manufacture of mobile phones. It also receives IT related services from its group companies which specifically cater to its technological needs. For the purpose of its manufacturing activity, the company procures proprietary/critical raw materials, components etc. from group companies. The critical fixed assets etc required for manufacturing are also procured from overseas group entities. The TPO opined that position of the assessee company with regard to manufacturing for the AEs was that of a Contract Manufacturer. That the assessee company is purchasing raw material from the AEs. Goods are manufactured in India and then part of it is exported to AEs. TPO opined that the royalty paid as a percentage of sales to the associated enterprise is not at arm's length because it amounts to collecting royalty on the sales to itself. That all the AEs are typically within the umbrella of the multinational corporation. Even though it appears that the technical know-how is commercially exploited in India, in reality, the price for these activities are not fixed by the market force.

xxxx xxxx xxxx

"**6.4** As against the above, it is the submission of the assessee that royalty is paid by the assessee to SEC Korea for the receipt of technical know-how and expertise. That the Assessee cannot carry out manufacturing activity, (either in the export markets or the domestic market), without access to the technical know-how and expertise developed by SEC Korea. We find that this aspect of the submissions of the assessee has not been cogently rebutted by the TPO or the Ld. Departmental Representative. Under such circumstances, there is considerable cogency in the assessee's submission that assessee operates as ful-fledged licensed manufacturing company and not as a contract manufacturer. That FAR profile of the assessee remains same/similar in respect of its overall operations i.e. for sales made to group companies as well as for sales made totally unrelated parties. Further, it has been submitted that export sales made by the assessee to group companies are also driven by open market conditions just as sales made by the assessee to unrelated parties. In this regard, TPO and Ld. Departmental Representative have not able to establish that exports sales made by the assessee to group companies are not

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driven by open market conditions. It is further noted that exports sales to AE were to fellow subsidiary (i.e. Samsung Singapore, Samsung UAE and Singapore, Phillipines). The royalty in this regard was paid to SEC Korea. In these circumstances, we find considerable cogency in the assessee's Submissions that owning to the fact that the assessee has made some sales to some other overseas group companies, SEC Korea cannot be deprived of its right to earn an arms length return on these sales, in return for the R&D investments it has made over the years.

6.5 We further note that the contract manufacture has not been defined under the Income Tax Act. The definition of contract manufacture, as per OECD commentary at para 7.40 is stated as under:-

> "7.40 Contract manufacturing is another example of an activity that may involve intra-group services. In such cases the producer may get extensive instruction about what to produce, in what quantity and of what quality. The production company bears low risks and may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a service, and the cost plus method could be appropriate, subject to the principles in Chapter II."

6.6 From the above definition, it is clear that there must exist:-

(i) Extensive instruction should exist as regards nature, quantity and quality, and

(ii) An assurance should exist that the entire production will be purchased.

6.7 In this regard, we note that SEC, Korea keeps a close watch on the quality of the raw-material and the production process. However, it does not determine the quantity of production and the terms of sales. There is no assurance to the assessee company that its entire production will be purchased. Ld. Counsel of the assessee has submitted the sale prices to the AEs are determined by market force and not dictated by the SEC Korea. It is noted that in the relevant assessment year only small portion of assessee's total sales are to AEs (i.e. approx. 33.40% in AY 07-08 and 16.40% in AY 08-09). Bulk of the other sales (i.e 66.60% approx in AY 07-08 and83.60% in AY 08-09) are to non AE's. In these circumstances, assessee cannot be termed as contract manufacturer.

Thus, Revenue has not been able to bring on record any evidence that assessee is mandated to sell goods to overseas group

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companies in any manner. It has been claimed by the Id. Counsel of the assessee that just like in arms length/third party situation, the sales made by the assessee to assessee group company is dependent at the outcome of the negotiation between the overseas group companies and assessee on the terms of the contract. It has further been submitted that at any point of time the assessee obtains better terms of contract from unrelated party, than the related then it, will enter into ·a formal engagement with the unrelated party like any prudent businessman. The above submissions of the assessee has not been controvered by the Revenue in any cogent manner.

6.8 It has further been submitted by the ld. Counsel of the assessee that the TPO has in his order blown hot and cold on same sets of facts. TPO has alleged that vis-a-vis export sale to AE's only assessee is a contract manufacturer. That had this been so then assessee's class I transactions should have been divided by TPO into two different functional sets. Further he should have then benchmarked the same accordingly. That however, TPO doesn't doubt assessee's benchmarking of class I transactions other than the Royalty payments made on AE related export sales. It has been submitted that for balance export sales also royalty was being paid by the appellant @ 8% under the same royalty agreement to SEC Korea. It has been submitted that the TPO has ignored the crucial fact that in the instant case, the basis of payment of royalty is not lump sum but on a percentage of per unit basis of sale. It is same whether the sales are domestic or export sales. For even export sales made to third independent parties royalty is being collected by SEC at the same rate.

6.9 Thus, we agree with the ld. Counsel of the assessee that TPO has confused the issue by noting that the payment of royalty is "*to itself*" i.e., holding company. In this regard, it has been submitted that TPO at page 127, para 7.2 has observed that "*all the AE's typically are within the broad umbrella of the multinational corporation*". It has been rightly submitted by the ld. Counsel of the assessee that that while doing so TPO endeavoured to reach the so called economic substance ignoring the legal substance accepted and admitted in separate jurisdictions. In such a situation the veil has only to be looked at and not looked through.

6.10 Furthermore, it has been contended by the ld. Counsel of the assessee that TPO in support of his views has relied upon para 6.14 and 6.17 of the OECD Commentary. That it will be relevant to note that para 6.14 of the OECD guidelines deals with benefits derived by the assessee by making the royalty payments. In this regard, ld. Counsel of the assessee has rightly pointed that the TPO in his

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order has not doubted the benefits received by the assessee from the payment of royalty. That in fact by accepting the arms length nature of royalty paid on sales made to third party, the TPO has implicitly accepted the benefit derived by the assessee by making royalty payment (irrespective whether it is made to group companies or third parties). Thus, we agree with the contention of the ld. Counsel of the assessee that in these circumstances, the statement of the TPO that assessee has not been able to demonstrate the benefit is not sustainable and hence reliance placed on para 6.14 is devoid of cogency.

6.11 It has further been pointed by the Id. Counsel of the assessee that para 6.17 of the OECD Commentary states that in some circumstances, the price of the intangibles may stand included in price of goods transacted with AEs and consequently, any additional royalty would have to be disallowed in the case of the buyer. In this regard, we agree with the ld. Counsel of the assessee that in his order the TPO has not provided any specific reason for placing reliance on the above para. Further, the TPO has not demonstrated any facts or circumstances substantiating that the transfer price of goods include license charge/royalty and therefore, any additional payment for intangibles needs to be disallowed. That if that was the case, then the TPO should have demonstrated the impact of the same in the transaction value of raw material purchased from group companies. On the contrary TPO has accepted the transaction value of purchase of raw material and consumables to be at arm's length using the TNMM.

6.12 We further find that reliance placed by the ld. Counsel of the assessee upon the decision of the I.T.A.T, Delhi in the case of *Sona Okegawa Precision Forging Ltd. (Supra)* is also germane and supports the case of the assessee on the facts and the circumstances of the case. In this case, the ITAT has held as under:-

> "16. The royalty was paid by the assessee under the Technology Agreement, computed on the basis of the entire production/sales. This remains undisputed. Further, it is also undisputed, as noted by the ld.CIT(A), that for the purpose of computing the fees to be paid for production, no distinction was made between the products sold to the AE or to independent parties. As such, the fee was paid on the sales made to the AE also. There was no material brought by the TPO to demonstrate that the price on sales made to the AE was not at an arm's length. That being so, it was at market determined prices that the sales were made by the assessee. Moreover, it goes

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> unchallenged that the fees paid under the Technology Agreement comprises an integral part of the cost of production, which was recovered from the sale price. It was thus, that so far as regards the sales made to the AE, the amount of fees paid under the Technology Agreement was recovered by the assessee from the AE as part of sale price. This being so, such fee paid became revenue neutral, that is to say, in case the assessee did not pay the fees on. the sales made to the AE, a corresponding reduction in the price charged to the AE would have to be given by the assessee, lest the cost for the sale come down. Such latter methodology was not advisable, for it would create problems in the accounting. Also, the impact on the taxable profits would be nil.
>
> 17. It was on taking into consideration all of the above that the ld. CIT(A) deleted the addition wrongly made by the AO. We do not find any reason to record any variance with the well reasoned elaborate findings of fact recorded by the ld. CIT(A). The same are hereby upheld. The grievance sought to be raised by the Department is thus found to be without substance and shorn of merit. The same is hereby rejected."
>
> **6.13** We find that the facts of the above case are similar to the facts of this case as discussed hereinabove. Hence, the above decision also supports the case of the assessee.
>
> **7.** In the background of the aforesaid discussions and precedents, we hold that royalty payment on exports sales by the assessee to the AE's @ 8% at Rs. 266,81, 794/- has been rightly paid the royalty paid is at arm's length and no adjustment in this regard is called for."

It becomes pertinent to note that although the aforesaid decision of the Tribunal was assailed by way of ITA 324/2017, the said appeal came to be dismissed consequent to the condonation of delay application being rejected by the Court on 28 April 2017.

7. Reverting then to the facts of the present case, we note that the respondent-assessee assailed the directions of the DRP by filing a separate appeal and which has come to be allowed by virtue of the

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order impugned herein. While dealing with the issue of royalty and the deductions made by the TPO, the Tribunal has in essence followed its decision rendered in the case of STI itself pertaining to AY 2007-08.

8. As would be evident from a reading of the order passed by the TPO, it essentially took the view that the position of STI while undertaking manufacturing for supplies to AEs', was liable to be recognized as that of a contract manufacturer. It was also observed that the royalty paid as a percentage of sales to AEs' was not at arm's length since it would amount to collection of royalties on sales *"to itself"*. It observed that all the AEs operate under *"the broad umbrella of the multinational corporation"*. It is this fundamental premise which permeates the view taken by the AO as well as the DRP. Both those authorities appear to have been swayed by the fact that STI was a wholly owned subsidiary and there would thus be no justification for it having paid any consideration to Samsung Korea, the parent entity.

9. Mr. Kumar, learned counsel appearing for the appellant during the course of oral arguments submitted that STI was operating in the capacity of a contract manufacturer on behalf of Samsung Korea, inasmuch as STI purchased raw material to manufacture goods in India and exported the same to its AEs'. Learned counsel contended that royalty, as a concept, in the context of the present appeal, envisages payments made to a third party for its intangible expertise, i.e., the technical know-how required for the manufacture of goods. It was on this basis that Mr. Kumar commended for our acceptance the findings of the TPO, which had determined the ALP of the royalty paid by STI to be 'Nil', since the transaction was not at arm's length

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and amounted to the collection of royalty payments on exports made "to itself".

10. It is in the aforesaid backdrop that Mr. Kumar drew our attention to the judgement of the Court in **Sony Ericsson Mobile Communication India P. Ltd. v. Commissioner of Income-tax**[10] and to the following observations as rendered in that decision:

> "**147.** The tax authorities examine a related and associated parties' transaction as actually undertaken and structured by the parties. Normally, the tax authorities cannot disregard the actual transaction or substitute the same for another transaction as per their perception. Restructuring of legitimate business transaction would be an arbitrary exercise. This legal position stands affirmed in EKL Appliances Ltd. (supra). The decision accepts two exceptions to the said rule. The first being where the economic substance of the transaction differs from its form. In such cases, the tax authorities may disregard the parties' characterisation of the transaction and re-characterise the same in accordance with its substance. The Tribunal has not invoked the said exception but the second exception, i.e., when the form and substance of the transaction are the same but the arrangements made in relation to the transaction, when viewed in their totality, differ from those which would have been adopted by the independent enterprise behaving in a commercially rational manner. The second exception also mandates that the actual structure should practically impede the tax authorities from determining an appropriate transfer price. The majority judgment does not record the second condition and holds that in their considered opinion, the second exception governs the instant situation as per which, the form and substance of the transaction were the same but the arrangements made in relation to a transaction, when viewed in their totality, differ from those which would have been adopted by an independent enterprise behaving in a commercially rational manner. The aforesaid observations were recorded in the light of the fact in the case of L. G. Electronics (supra). Commenting on the factual matrix of L. G. Electronics case (supra) would be beyond our domain; however, we do not find any factual finding to this effect by the Transfer Pricing Officer or the Tribunal in any of the present cases. However, in L.G. Electronics decision (supra), it is observed that if the AMP expenses and when such expenses are beyond the bright

[10] 2015 SCC OnLine Del 8083

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> line, the transaction viewed in their totality would differ from one which would have been adopted by an independent enterprise behaving in a commercially rational manner. No reason or ground for holding or the ratio is indicated or stated. There is no material or justification to hold that no independent party would incur the AMP expenses beyond the bright line AMP expenses. Free market conditions would indicate and suggest that an independent third party would be willing to incur heavy and substantial AMP expenses, if he presumes this is beneficial, and he is adequately compensated. The compensation or the rate of return would depend upon whether it is a case of long-term or short-term association and market conditions, turnover and ironically international or worldwide brand value of the intangibles by the third party."

11. Learned counsel for the appellant relying upon the decision in *Sony Ericsson*, argued that the transaction between the parties was lacking in economic substance because royalty payments were in effect payments made by STI to itself. The arguments of Mr. Kumar proceeded on the premise that STI was a contract manufacturer which purchased raw materials from its AEs' and utilized the same for the manufacturing and subsequent export of goods to its AEs, because of which payments made to Samsung Korea ought to be treated as capital expenditure. Accordingly, learned counsel urged that the transaction between STI and its AEs' could not be considered to be at arms' length because of which the TPO was justified in determining the arms' length value of royalty payments at 'Nil'.

12. Mr. Kumar additionally drew our attention to the observations appearing in the Directions of the DRP dated 27 September 2012, wherein it was observed that the gross profit earned by STI on the export sales made to the AEs was 19.18%, contrasted with the gross profit of 23.24% made to independent parties demonstrating that STI charged independent entities a price higher than that charged to its

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AEs. The DRP accordingly held that STI had not charged its AEs' for technical know-how and had embedded the value of the said intangible in the sale price of the goods sold to independent parties. As a result, the DRP concluded that STI was acting as a contract manufacturer because it had not been remunerated as if it were an independent manufacturer that utilized intangibles in the form of technical know-how in its own right to independently manufacture goods which would eventually be sold to group entities.

13. We deem it apposite to extract the said observations rendered by the DRP hereinbelow:

> "**6.3.** The Panel has considered the contention of the assessee. As discussed above, OECD guidelines recognizes that payment for intangibles could be embedded in the value of purchases/sales to the AEs. From the table given in para 6 above, it can be seen that gross profit earned by the assessee on the export sales made to the AEs is 19.18% as against the gross profit of 23.24% on the export sales made to independent parties. It indicates that the assessee has charged a higher price from independent parties as compared to that charged from its AEs. If we apply the gross profit rate earned by the assessee on the sales made to the independent parties to the sales made to the AEs, the gross profit of the assessee on the sales made to the AEs would have been Rs. 27,23,43,818/- as against the actual gross profit of Rs. 24,94,64,510/-, i.e., the assessee has under charged its AEs by an amount of Rs. 2,28,79,308/-. It leaves us in no doubt that the value of intangibles is embedded in the sale price of the goods sold to the independent parties while it is not so in the case of goods sold to the AEs, i.e., the assessee has not charged its AEs for the intangibles deployed, i.e., technical know how. In fact, the business model of the assessee is consistent with the business model followed in the case of contract manufacturers where no royalty is paid in respect of goods manufactured and sold on contract basis to the group entities. If the assessee has not been remunerated as if it was an independent manufacturer using intangibles in its own right to manufacture the goods sold to group entities. it is obvious that it was acting as a contract manufacturer and there was no reason that why it should have paid any royalty to SEC Korea in respect of sales made to the group entities. In fact. the amount of Royalty disallowed by the TPO is much less than the

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> amount foregone by the assessee from its group entities by way of earning a lower Gross Profit."

14. It was on the aforesaid basis that Mr. Kumar, drawing strength from the observations of the DRP, contended that STI had not charged its AEs for the technical know-how utilized for the manufacture of goods but had embedded the cost of the same in the sales price of goods sold to those entities. Resultantly, Mr. Kumar argued that the entire transaction was in effect a profit shifting mechanism, particularly because royalty payments made by STI to Samsung Korea would not be computed towards profit.

15. Before us, Mr. Sinha, learned counsel appearing for the respondent-assessee commended for our acceptance the view that was taken by the Tribunal while deciding the appeal for A.Y. 2007-08 and submitted that the Tribunal was clearly justified in setting aside the Draft Assessment Order bearing in mind the undisputed position that STI had exported mobile phones not only to its group companies but also to third parties. Mr. Sinha highlighted the fact that a majority of those export sales had been made to third parties and that a minuscule percentage of the said exports pertained to group entities.

16. According to learned counsel, the AO as well as the DRP had committed a manifest illegality in holding that while affecting sales to group companies, the assessee had acted merely as a contract manufacturer. Mr. Sinha submitted that the aforesaid view is rendered wholly untenable and proceeds in ignorance of the fact that STI operated as a full-fledged licensed manufacturer in its own right and could not be viewed as a contract manufacturer. Sustenance in this

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regard was also sought to be drawn from the findings which ultimately came to be recorded by the Tribunal and stand embodied in its order of 21 June 2013 pertaining to AY 2007-08.

17. As we peruse the order which was rendered by the Tribunal for the aforesaid year, we find that the Tribunal had on that occasion found that royalty payments were indelibly connected to the receipt of technical know-how and expertise from Samsung Korea. Since those facts had remained unchallenged, the Tribunal ultimately came to conclude that STI had operated as a licensed manufacturing company and not as a contract manufacturer. The aforesaid view as taken stands further fortified when we bear in mind the findings which came to be rendered in the context of **Functions, Assets and Risks**[11] of the assessee and which clearly records that the FAR remained unchanged in respect of the overall operations of STI, be it for sales made to group companies or to wholly unrelated parties. The Tribunal had also found that sales to those categories of procurers were driven by open market conditions and were at par with the position which would have prevailed in case those sales had been made to unrelated parties. The record further reflects that all royalty payments were made to Samsung Korea and this too lent credence to the position which was taken by the respondent/ assessee.

18. Of equal significance were the findings arrived at by the Tribunal to the effect that while Samsung Korea exercised a close watch and overview with respect to the quality of raw materials utilized and the production process, it neither controlled nor

[11] FAR

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determined the quantity of production or for that matter the terms on which sales were to be or had been affected. It significantly found that the dealings between the two entities were not based on any assurance that the entire production of STI would be accepted or purchased by its parent entity. The Tribunal had also found a complete absence of a directive operating upon the respondent-assessee mandating it to compulsorily sell goods to its AEs' overseas. The assertion of STI that the sales made to AEs' was on the basis of independent negotiations between the two sides and governed by independent contracts had gone unquestioned. It was on an overall conspectus of the aforesaid that the Tribunal had ultimately come to conclude that the assumption of the respondent- assessee being a contract manufacturer as well as the premise of payment of royalty *"to itself"* could not be sustained.

19. We note that dealing with a similar question, the Court in **Commissioner of Income-tax v. Keihin Panalfa**[12] had held that while examining the issue of ALP, the royalty payment made by an assessee to its group companies could not be determined at 'Nil'. We deem it apposite to extract the following passages from that decision: -

> "**12.** The contention that the adjustment on account of expenses as determined by the Transfer Pricing Officer must be attributed entirely to the international transaction is bereft of any merits. During the financial year 2003-04 relating to the assessment year 2004-05, the assessee had reported an operating income of Rs. 72,24,22,000. The total expenses for the said period amounted to Rs. 68,00,88,000. Admittedly, the international transactions in question amounted to Rs. 15,90,66,935 which were only 23.38 per cent. in value of the total expenses. The Transfer Pricing Officer had determined the profit level indicator (operating profit over total cost) of comparable cases at 8.29 per cent. against 6.22 per cent. as declared by the assessee. Applying the profit level indicator of

[12] 2015 SCC OnLine Del 14574

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> comparable cases, the adjusted total expenses were computed at Rs. 66,71,17,924, thus, indicating an adjustment of Rs. 1,29, 70,076. As is apparent from the above, the said adjustment related to the entire expenses and not just the international transactions alone. Since the international transactions only constituted 23.38 per cent., a transfer pricing adjustment proportionate to that extent could be made in respect of such international transactions. Thus, only an adjustment of Rs. 30,33,593 could be attributed to the international transactions in question. The same was accepted by the Commissioner of Income-tax (Appeals) as well as the Tribunal. We do not find any infirmity with their decision.
>
> **13.** We also find no infirmity with the view of the Commissioner of Income- tax (Appeals) and the Tribunal that the assessee had acted like any other original equipment manufacturer (OEM) and could not be treated as a job worker or a contractor.
>
> **14.** We find no substantial question of law that arises for our consideration in these appeals. Accordingly, the appeals are dismissed. No order as to costs."

20. We also find merit in the contention of Mr. Sinha, who adverted to the scope of the powers that could have been exercised by the TPO in terms of Rules 10A to 10E of the **Income Tax Rules, 1962**[13]. As was rightly contended by Mr. Sinha, the statutory authority conferred upon the TPO can only extend to an examination of the appropriateness of the method adopted for the purposes of determining ALP or evaluating the enlistment of comparables. However, Mr. Sinha submitted, the TPO would neither be justified nor could it be countenanced to have the jurisdiction to question commercial expediency or genuineness of need. According to learned counsel, these aspects stand duly elucidated in **Commissioner of Income-tax. v. EKL Appliances Ltd.**[14], where the Court had explained the scope of the authority of the TPO in the following

[13] Rules
[14] 2012 SCC OnLine Del 1897

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> "**22.** Even rule 10B(l)(a) does not authorise disallowance of any expenditure on the ground that it was not necessary or prudent for the assessee to have incurred the same or that in the view of the Revenue the expenditure was unremunerative or that in view of the continued losses suffered by the assessee in his business, he could have fared better had he not incurred such expenditure. These are irrelevant considerations for the purpose of rule 10B. Whether or not to enter into the transaction is for the assessee to decide. The quantum of expenditure can no doubt be examined by the Transfer Pricing Officer as per law but in judging the allowability thereof as business expenditure, he has no authority to disallow the entire expenditure or a part thereof on the ground that the assessee has suffered continuous losses. The financial health of the assessee can never be a criterion to judge allowability of an expense; there is certainly no authority for that. What the Transfer Pricing Officer has done in the present case is to hold that the assessee ought not to have entered into the agreement to pay royalty/brand fee, because it has been suffering losses continuously. So long as the expenditure or payment has been demonstrated to have been incurred or laid out for the purposes of business, it is no concern of the Transfer Pricing Officer to disallow the same on any extraneous reasoning. As provided in the OECD guidelines, he is expected to examine the international transaction as he actually finds the same and then make suitable adjustment but a wholesale disallowance of the expenditure, particularly on the grounds which have been given by the Transfer Pricing Officer is not contemplated or authorised."

21. Similar observations pertaining to the powers of the TPO were rendered by a Coordinate Bench of this Court in the case of **Commissioner of Income-tax v. Cushman and Wakefield (India) Pvt. Ltd.**[15], wherein it was observed:

> "**34.** The court first notes that the authority of the Transfer Pricing Officer is to conduct a transfer pricing analysis to determine the arm's length price and not to determine whether there is a service or not from which the assessee benefits. That aspect of the exercise is left to the Assessing Officer. This distinction was made clear by the Income-tax Appellate Tribunal in Dresser-Rand India Pvt. Ltd. v. Addl. CIT (2012) 13 ITR (Trib) 422 (Mumbai) (page 432):

[15] 2014 SCC OnLine Del 3215

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"We find that the basic reason of the Transfer Pricing Officer's determination of the arm's length price of the services received under cost contribution arrangement as 'nil' is his perception that the assessee did not need these services at all, as the assessee had sufficient experts of his own who were competent enough to do this work. For example, the Transfer Pricing Officer had pointed out that the assessee has qualified accounting staff which could have handled the audit work and in any case the assessee has paid audit fees to external firm. Similarly, the Transfer Pricing Officer was of the view that the assessee had management experts on its rolls, and, therefore, global business oversight services were not needed. It is difficult to understand, much less approve, this line of reasoning. It is only elementary that how an assessee conducts his business is entirely his prerogative and it is not for the Revenue authorities to decide what is necessary for an assessee and what is not. An assessee may have any number of qualified accountants and management experts on his rolls, and yet he may decide to engage services of outside experts for auditing and management consultancy; it is not for the revenue officers to question the assessee's wisdom in doing so. The Transfer Pricing Officer was not only going much beyond his powers in questioning commercial wisdom of the assessee's decision to take benefit of expertise of Dresser Rand US, but also beyond the powers of the Assessing Officer. We do not approve this approach of the Revenue authorities. We have further noticed that the Transfer Pricing Officer has made several observations to the effect that, as evident from the analysis of financial performance, the assessee did not benefit, in terms of financial results, from these services. This analysis is also completely irrelevant, because whether a particular expense on services received actually benefits an assessee in monetary terms or not even a consideration for its being allowed as a deduction in computation of income, and, by no stretch of logic, it can have any role in determining the arm's length price of that service. When evaluating the arm's length price of a service, it is wholly irrelevant as to whether the assessee benefits from it or not; the real question which is to be determined in such cases is whether the price of this service is what an independent enterprise would have paid for the same. Similarly, whether the associated enterprises gave the same services to the assessee in the preceding years without any consideration or not is also irrelevant. The

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> associated enterprises may have given the same service on gratuitous basis in the earlier period, but that does not mean that the arm's length price of these services is 'nil'. The authorities below have been swayed by the considerations which are not at all relevant in the context of determining the arm's length price of the costs incurred by the assessee in cost contribution arrangement. We have also noted that the stand of the Revenue authorities in this case is that no services were rendered by the associated enterprises at all, and that since there is no evidence of services having been rendered at all, the arm's length price of these services is 'nil'."

35. The Transfer Pricing Officer's report is, subsequent to the Finance Act, 2007, binding on the Assessing Officer. Thus, it becomes all the more important to clarify the extent of the Transfer Pricing Officer's authority in this case, which is to determining the arm's length price for international transactions referred to him or her by the Assessing Officer rather than determining whether such services exist or benefits have accrued. That exercise-of factual verification is retained by the Assessing Officer under section 37 in this case. Indeed, this is not to say that the Transfer Pricing Officer cannot- after a consideration of the facts- state that the arm's length price is 'nil' given that an independent entity in a comparable transaction would not pay any amount. However, this is different from the Transfer Pricing Officer stating that the assessee did not benefit from these services, which amounts to disallowing expenditure. That decision is outside the authority of the Transfer Pricing Officer. This aspect was made clear by the Income-tax Appellate Tribunal in Deloitte Consulting India Pvt. Ltd. v. Deputy CIT/ITO (2012) 19 ITR (Trib) 378 (Mumbai) ; (2012) 137 ITO 21 (Mumbai) (page 402 of 19 ITR (Trib)):

> "On the issue as to whether the Transfer Pricing Officer is empowered to determine the arm's length price at "nil", we find that the Bangalore Bench of the Tribunal in Gemplus India P. Ltd. 2010-TII- 55-ITAT-BANG-TP, held that the assessee has to establish before the Transfer Pricing Officer that the payments made were commensurate to the volume and quality service and that such costs are comparable. When commensurate benefit against the payment of services is not derived, then the Transfer Pricing Officer is justified in making an adjustment under the arm's length price. In the case on hand, the Transfer Pricing Officer has determined the arm's length price at 'nil' keeping in view the factual position as to whether in a comparable case, similar

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> payments would have been made or not in terms of the agreements. This is a case where the assessee has not determined the arm's length price. The burden is initially on the assessee to determine the arm's length price. Thus, the argument of the assessee that the Transfer Pricing Officer has exceeded his jurisdiction by disallowing certain expenditure, is against the facts. The Transfer Pricing Officer has not disallowed any expenditure. Only the arm's length price was determined. It was the Assessing Officer who computed the income by adopting the arm's length price decided by the Transfer Pricing Officer at 'nil'."
>
> This is a slender yet the crucial distinction that restricts the authority of the Transfer Pricing Officer. Whilst the report of the Transfer Pricing Officer in this case ultimately noted that the arm's length price was 'nil', since a comparable entity would pay 'nil' amount for these services, this court noted that remarks concerning and the final decision relating to, benefit arising from these services are properly reserved for the Assessing Officer.
>
> **36.** In this case, the issue is whether an independent entity would have paid for such services. Importantly, in reaching this conclusion, neither the Revenue, nor this court, must question the commercial wisdom of the assessee, or replace its own assessment of the commercial viability of the transaction. The services rendered by CWS and CWHK in this case concern liaising and client interaction with IBM on behalf of the assessee-activities for which, according to the assessee's claim-interaction with IBM's regional offices in Singapore and the United States was necessary. These services cannot-as the Income-tax Appellate Tribunal correctly surmised-be duplicated in India in so far as they require interaction abroad. Whether it is commercially prudent or not to employ outsiders to conduct this activity is a matter that lies within the assessee's exclusive domain and cannot be second-guessed by the Revenue."

22. We find ourselves unable to agree with the contentions put forth by Mr. Kumar, that STI was operating as a contract manufacturer on behalf of Samsung Korea for the following reasons. A perusal of the facts on the record reveals that STI was a wholly owned subsidiary of Samsung Korea and which was engaged in the manufacture and sale of mobile handsets under the brand name of Samsung in the Indian

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and overseas market and which would invariably involve sale of the said goods to its AEs' as well. The transfer of technical know-how and licensing of technology was essential to enable STI to undertake its activities independently.

23. We note in this regard that neither the TPO nor the DRP engaged in a recharacterization of the transaction entered into between the parties nor was there any material existing on the record to demonstrate that the transaction entered into between STI and its AEs' was distinguishable from those which would have been entered into by independent enterprises behaving in a commercially rational manner. In our considered opinion, the decision of the Court *Sony Ericsson* far from lending credence to the arguments addressed by the appellant would be liable to be read as negativing the challenge which stands raised.

24. As we peruse the record, we find that neither the TPO nor the DRP rested their opinion on any material or evidence which may have tended to indicate that the transactions undertaken by STI would not satisfy the test of commercial expediency or prudence. Neither the production of the goods in question nor the supply thereof was shown to be motivated or based upon directives of Samsung Korea. Those transactions clearly appear to have been guided and informed by STI's business and commercial interests.

25. The mere factum of STI being a wholly owned subsidiary of Samsung Korea does not necessarily entail that it was engaged in the manufacture and sale of mobile handsets solely at the behest and directives of Samsung Korea or having undertaken that exercise as a

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contract manufacturer. Samsung Korea, during A.Y. 2008-09, was stated to have been in receipt of a technical assistance fee and royalty from STI necessary for the latter to engage in its manufacturing activities. There was no material placed on the record to show that the manufacture and sale of the aforenoted goods by STI was dependent on directives issued by Samsung Korea or even that STI was contractually obliged to manufacture goods on behalf of Samsung Korea.

26. We find that although the Act does not definitionally contemplate the concept of a 'contract manufacturer', the meaning liable to be ascribed to that expression can be safely discerned from the **Organisation for Economic Co-Operation and Development-Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations**[16] issued for the years 1995 and 2022. The OECD Guidelines, 1995 was relied upon by the Tribunal in its order dated 21 June 2013 for A.Y. 2007-08, while the OECD Guidelines, 2022 form the more recent set of guidelines on the issue of transfer pricing.

27. We deem it apposite to extract the following guidelines pertaining to contract manufacturing as prescribed in Chapter VII, Special Considerations for intra-group services, as provided in the OECD Guidelines of 1995 and 2022:

OECD Guidelines, 1995	**OECD Guidelines, 2022**
7.40. Contract manufacturing is another example of an activity that may involve intra-group services. In such cases the producer may get	**7.40.** Another example of an activity that may involve intra-group services is manufacturing or assembly operations. The activities

[16] OECD Guidelines

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extensive instruction about what to produce, in what quantity and of what quality. The production company bears low risks and may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a service, and the cost plus method could be appropriate, subject to the principles in Chapter II.	can take a variety of forms including what is commonly referred to as contract manufacturing. In some cases of contract manufacturing the producer may operate under extensive instruction from the counterparty about what to produce, in what quantity and of what quality. In some cases, raw materials or components may be made available to the producer by the counterparty. The production company may be assured that its entire output will be purchased, assuming quality requirements are met. In such a case the production company could be considered as performing a low-risk service to the counterparty, and the cost plus method could be the most appropriate transfer pricing method, subject to the principles in Chapter II.

28. Viewed in light of the facts of the present appeal, it becomes apparent that STI does not fall under the ambit of a contract manufacturer either in terms of the OECD Guidelines, 1995 or for that matter the OECD Guidelines, 2022. There has been no material adduced on the record to demonstrate that STI receives "*any extensive instructions about what to produce, in what quantity and of what quality*" or that it is performing any "*low risk service*" for Samsung Korea or any of the AEs'.

29. Admittedly, STI is dependent on Samsung Korea for the technological know-how required to manufacture goods out of India, without which STI would not be in a position to manufacture the said goods under the Samsung brand. However, the manufacturing of the

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goods itself is done by STI at its own behest and there is nothing on the record to demonstrate that the manufacture and sale of goods by STI falls under the discretion or control of Samsung Korea. We also take note of the fact that no evidence had been adduced to show that any of the revenue incurred by STI for the manufacture and sale of mobile handsets is in any way repatriated to Samsung Korea.

30. We also find ourselves unable to agree with the submissions rendered by Mr. Kumar, that the entire transaction between STI and its AEs' was meant to operate as a profit shifting mechanism, merely because independent entities were charged a higher price in comparison with the AEs' of STI. In our view, it would be erroneous to conclude that the sale of goods manufactured by STI to its AEs was done with a view to shift profits across jurisdictions, even if the price of royalty was embedded in the sale price of the goods sold to its AEs. To that end, we deem it apposite to extract the following guidelines rendered regarding the Arm's Length Principle in Chapter I of the OECD Guidelines, 2022:

> "**1.2.** When independent enterprises transact with each other, the conditions of their commercial and financial relations (e.g. the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other, as discussed in paragraph 1.5 below. Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits. There may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to bear in mind that the need to make adjustments to approximate arm's length conditions arises irrespective of any contractual obligation

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> undertaken by the parties to pay a particular price or of any intention of the parties to minimise tax. Thus, a tax adjustment under the arm's length principle would not affect the underlying contractual obligations for non-tax purposes between the associated enterprises and may be appropriate even where there is no intent to minimise or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes."

31. At this juncture, we additionally observe that Samsung Korea, as the owner of the technological know-how which was inherently required for STI to manufacture the mobile handsets under the brand name of Samsung, was entitled to receive an arms' length return on the value of the intangibles provided by it to STI in the form of royalty payments. As discussed hereinabove, STI was engaged in the manufacture of goods as per its own volition and not as per the directives of Samsung Korea and undertook decisions related to the manufacture and sale of goods independent of Samsung Korea. As a result, Samsung Korea cannot be deprived of the right to obtain an arms' length return on the utilization of its patented or proprietary technology and know-how. This in light of the undisputed fact that the latter could not have engaged in the manufacture and sale of goods without the technological know-how provided by Samsung Korea.

32. We find that the aforenoted position is affirmed by the following guidelines appearing in Chapter VI of the OECD Guidelines, 2022 regarding Special Considerations for Intangibles:

> "**6.48.** In identifying arm's length prices for transactions among associated enterprises, the contributions of members of the group related to the creation of intangible value should be considered and appropriately rewarded. The arm's length principle and the principles of Chapters I-III require that all members of the group receive appropriate compensation for any functions they perform,

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> assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles. It is therefore necessary to determine, by means of a functional analysis, which member(s) perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which member(s) provide funding and other assets, and which member(s) assume the various risks associated with the intangible. Of course, in each of these areas, this may or may not be the legal owner of the intangible. As noted in paragraph 6.133, it is also important in determining arm's length compensation for functions performed, assets used, and risks assumed to consider comparability factors that may contribute to the creation of value or the generation of returns derived by the MNE group from the exploitation of intangibles in determining prices for relevant transactions."

33. We are of the view that if the submission of learned counsel for the appellant were to be accepted, it would logically follow that any **Intellectual Property Rights**[17] that may be vested in the ownership, technological know-how of a parent entity would never be subjected to royalty, if it be a transfer or an exchange between AEs.

34. We additionally take note of the findings of the Tribunal in its order dated 21 June 2013 regarding the scope of oversight maintained by Samsung Korea over STI and which had found that although Samsung Korea was involved in overseeing the quality of raw materials and the production process of goods, it was not associated with controlling the quantity of production or the terms and conditions underlying the sale of goods. This is in addition to the absence of evidence adduced on the record to demonstrate that STI was bound by directives issued by Samsung Korea compelling STI to mandatorily sell goods to its AEs' overseas. Furthermore, the assertion that independent negotiations and independent contracts underlie the sales

[17] IPR

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by STI to its AEs remained uncontroverted. This leads us to the inevitable conclusion that the view taken by the AO and DRP, that STI was a contract manufacturer and had made royalty payments to 'itself' was thoroughly misconceived. Accordingly, and for all of the aforesaid reasons, we are of the view that the premise of the payment of royalty being to self in the case of and where such a payment be made to a holding company is wholly untenable.

35. It becomes pertinent to observe that the broad generalization which appears to have weighed upon the TPO as well as the DRP is clearly erroneous and fails to bear in consideration the indubitable fact that the ascertainment of an ALP could well be in relation to transactions entered into between related parties.

36. In our considered opinion, the observations rendered by the DRP with regard to the contrast between the gross profit earned by STI on export sales to AEs' and to other independent entities ought to be appreciated while bearing in mind the distinguishable characteristics underlying those sale transactions and which would have in turn been dependent upon the nature of the products, features of the mobile phones, the individual value of the mobile handsets and other distinguishing factors. In the absence of specific data pertaining to the said transactions or of any evidence suggesting that Samsung Korea was in control of the overseas sales by STI to AEs' or unrelated parties, we find ourselves unable to conclude that the AEs' of STI had not been charged for the cost of technological know-how obtained or that STI had not been renumerated as an independent manufacturer by its AEs'.

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37. Additionally, bearing in mind the observations of the Tribunal in its order dated 21 June 2013 that FAR remained unchanged for STI's overall operations, we find merit in the finding that sales made by STI to its group companies was driven by open market conditions and was at par with sales made to unrelated parties. We are of the opinion that the Tribunal was thus justified in observing that the adoption of the aforenoted tests was demonstrative of the TPO seeking to question the economic substance of the underlying contract. Thus, the TPO as well as the DRP clearly appear to have misconstrued the agreement in terms of which know-how and expertise stood licensed to STI.

38. On an overall conspectus of the aforesaid, we would answer the question which stands posited in the instant appeal in the negative and against the appellants.

39. The appeal consequently fails and shall stand dismissed.

YASHWANT VARMA, J.

PURUSHAINDRA KUMAR KAURAV, J.

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