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TAX FLASH NEWS

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Export commission cannot partake the character of royalty and it cannot be disallowed under Section 40(a)(i) of the Income-tax Act

Background

The Delhi High Court (the High Court) in the case of Hero Motorcorp Limited[1] (the taxpayer) has held that payment of export commission by the taxpayer to its Associated Enterprise (AE) i.e. Honda Motor Co. Ltd., Japan (HMCL) cannot be construed as payment of royalty, in light of existence of two distinct and independent agreements for payment of royalty and export commission respectively.

In doing so, the High Court rejected the tax department's stand that the export commission was a mere monetisation of the negative covenant of royalty agreement which abstained the taxpayer from exporting outside India and thus, tantamount to payment of royalty. The High Court also denied the department's contention that the export commission agreement was nothing but a device to enable the AE to avoid paying taxes on income earned as a result of use of know-how by the taxpayer.

Facts of the case

- The taxpayer is engaged in the business of manufacture and sale of motorcycles using technology licensed by HMCL.

- The taxpayer started manufacturing of motorcycles in 1984 pursuant to a technical collaboration contract with HMCL. Under this contract, the taxpayer received technical assistance for manufacture, assembly and service of the products; along with information, drawings and designs for the setting up of the plant, for which the taxpayer paid royalty to HMCL.

- The aforesaid agreement was extended, renewed and revised to form the License and Technical Assistance Agreement (LTAA) which provided for grant of an indivisible, non-transferable and exclusive right and license, without the right to grant sublicenses, to manufacture, assemble, sell and distribute the products and parts within the Territory (defined as India).

- During the Financial Year 2004-05, a separate Export Agreement (EA) was entered into between HMCL and the taxpayer whereby HMCL accorded consent to the taxpayer to export specific models of two wheelers in specific territories (where exports were earlier only made by HMCL or its other affiliates) on payment of export commission of 5 per cent of the FOB value of such exports.

- The Transfer Pricing Officer (TPO) proceeded to determine the Arm's Length Price (ALP) of the payment of export commission as Nil by applying Comparable Uncontrolled Price Method (CUP). The TPO held that the payment of export commission by the taxpayer to its AE, HMCL was unnecessary and did not lead to any economic benefits to the taxpayer. The TPO also asserted that the exports happened in a pre-determined restrictive environment regulated by the AEs. Consequently, a TP adjustment amounting to INR12.19 crore was proposed.

[1] CIT v. Hero Motocorp Limited (ITA 923/2015) (Delhi High Court)

- Apart from the transfer pricing (TP) adjustment, the Assessing Officer (AO) also disallowed the same expenditure on the following grounds:
  - The payment is in the nature of royalty/fee for technical services on which tax ought to have been deducted u/s 40(a)(i) of the Income-tax Act, 1961 (the Act). The export commission was a mere monetisation of the negative covenant of the royalty agreement.
  - The EA was for the benefit of HMCL and not the taxpayer and hence the export commission is not allowable under Section 37(1) of the Act.
  - The EA, allowing the taxpayer to export to the specific territories, is for a long period of time and therefore, constitutes an intangible asset and the expenditure of export commission is a capital expenditure.
- The Dispute Resolution Panel (DRP) concurred with the findings of TPO and did not provide any relief to the taxpayer. Aggrieved, the taxpayer filed an appeal before the Income Tax Appellate Tribunal (Tribunal).
- With respect to the TP grounds, the Tribunal held that the existence of consideration for payment for export commission, and benefits derived by the taxpayer thereof, have been clearly established.
- As regards the disallowance of export commission under section 40(a)(i) of the Act, for the corporate tax purposes, the Tribunal held that both the LTAA and EA are distinct and independent agreements. As per the EA, the taxpayer has not been transferred or permitted to use any patent, invention, model, design or secret formula. Similarly, HMCL, by way of the EA, has not rendered any managerial, technical or consultancy services. Accordingly, export commission was neither royalty nor fee for technical services and, therefore, the taxpayer was not required to deduct tax at source.
- The Tribunal also observed that the taxpayer has not acquired any asset or even the intangible right in the nature of a capital asset via EA and hence the payment of running export commission paid as a percentage of export amount every year cannot be deemed as a capital expenditure.
- Thereafter, the tax department filed petition before the High Court on the ground that the EA was designed to benefit the subsidiaries of the AE and not the taxpayer.

The taxpayer and tax department's contentions, in addition to the ones discussed above, are summarised hereunder.

Taxpayer's contentions

- The fact that the EA provided for ceding of various territories for the taxpayer to make exports, is an appropriate consideration for payment of export commission. The EA also enabled the taxpayer to use the existing distribution network of HMCL and its subsidiaries in these territories without any additional payment.
- The export sales in specified territories pursuant to EA resulted in substantial profits for the taxpayer, after payment of export commission.
- The two transactions pertaining to payment of royalty and payment of export commission are governed by two distinct and independent agreements i.e. the LTAA and EA. It was only after two decades of working out the technical collaboration agreement that HMCL agreed to permit export by the taxpayer to territories where HMCL and its subsidiaries operated.

Tax department's contentions

- The factual finding of the tribunal on the TP issue was not controverted by the department. However, the department resorted to the alternate plea that the payment of export commission was in fact payment of royalty which required deduction of tax at source by the taxpayer and the failure to do so led to disallowance of the deduction under section 40(a)(i) of the Act.
- The EA was an extension of the LTAA itself since the preamble clauses of the EA expressly referred to the LTAA and also described the parties thereto as the Licensor and the Licensee.
- The consideration for the negative covenant under the LTAA was monetized in the EA in the form of the export commission and was therefore a payment of royalty under Explanation 2 below sub-clause (vi) of Section 9(1) of the Act.
- Reliance had been placed on the decision of the High Court in Shiv Raj Gupta[2].

[2] CIT v. Shiv Raj Gupta [2015] 372 ITR 337 (Del)

High Court's ruling

Although the question of law before the High Court was on Tribunal's conclusion of benefits accruing to taxpayer on account of the EA, the High Court also delved into the tax department's alternate plea that the payment of export commission in fact tantamount to the payment of royalty.

The High Court while ruling on the above, concluded the following:

- The technical know-how was licensed by HMCL to the taxpayer since 1984 and thus the EA which was entered into on 21 June, 2004 could not be said to be contemporaneous.

- The payment of the export commission was not without consideration as it permitted the taxpayer to effect export sales in the specified countries, thereby reporting substantial profits, without having to pay for using the existing distribution and sales networks in those territories.

- The attempt at re-characterizing the transaction as one involving payment of royalty overlooks the fact that the payment under the LTAA is treated by the taxpayer itself as royalty and such royalty is also paid on the export consignments.

- Reliance of the department on the case of Commissioner of Income Tax v. Shiv Raj Gupta (supra) was misplaced on facts as it has not been able to show that the EA was a colorable device, as was the case in the judgment relied upon.

- Accordingly, the High Court upheld the Tribunal's decision and concluded that the payment of export commission by the taxpayer to HMCL was not in the nature of payment of royalty or fee for technical services attracting disallowance under section 40(a)(i) of the Act and no substantial question of law arises from the said issue.

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Our comments

The High Court has given due weightage to the facts on ground in deciding upon this very important issue of re-characterisation of a transaction. The High Court has extensively relied upon the existence and implementation of separate contractual agreements to conclude that the two transactions and considerations thereof are completely distinct. This demonstrates the importance of maintaining an appropriate documentation with respect to the intentions and conduct of the parties at the time of entering into a transaction.

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