

**IN THE INCOME TAX APPELLATE TRIBUNAL,
DELHI BENCH: 'B' (HEARING THROUGH VIDEO
CONFERENCING)', NEW DELHI**

**BEFORE SHRI BHAVNESH SAINI, JUDICIAL MEMBER
AND
SHRI O.P. KANT, ACCOUNTANT MEMBER**

ITA No.7167/Del./2019
Assessment Year: 2016-17

DE Diamond Electric India Pvt. Ltd., C/o- Kapil Goel, Adv. F-26/124, Sec-07, Rohini, New Delhi	Vs.	ACIT, Special Range-3, New Delhi
PAN :AACCD6324B		
(Appellant)		(Respondent)

Appellant by	Shri Kapil Goel, Adv.
Respondent by	Shri Jagdish Singh, Sr. DR

Date of hearing	16.07.2020
Date of pronouncement	23.07.2020

ORDER

PER O.P. KANT, AM:

This appeal has been preferred by the assessee against the order dated 17/06/2019 passed by the learned CIT(Appeals)-34, New Delhi [in short 'the Ld. CIT(A)'] for assessment year 2016-17 raising following grounds:

Jurisdictional Ground Notice u/s 143(2) is invalid

1. That order passed by Ld AO dated 20/12/2018 and further order passed by ld CIT A dated 17/06/2019 are bad in law in as much as mechanical notice u/s 143(2) on basis of CASS is not in accordance with

jurisdictional conditions stipulated under the Act so it shows grave and patent non application of mind on part of Ld AO in issuing notice u/s 143(2) and accordingly all subsequent proceeding including orders passed by Ld AO and Ld CIT-A are void ab initio.

Other grounds on merits

Qua disallowance of u/s 40A(2)(b) (Rs.366,82,337)

2. That order passed by Ld AO dated 20/12/2018 and further order passed by Id CIT A dated 17/06/2019 are bad in law in as much as disallowance of Rs 366,82,337/- u/s 40A(2)(b) is made without appreciating that throughout revenue has consistently allowed subject royalty expense in assessment orders dated 16.12.2016 (AY 2014-2015) and 23.10.2017(A.Y 2013-2014) and moreover there is no scrutiny examination in identical facts for AY 2015- 2016 and AY 2017-2018 and when such are the facts isolated disallowance in subject period is against the principle of uniformity, consistency and predictability and thus on this short count itself addition sustained needs to be reversed;

3. That order passed by Ld AO dated 20/12/2018 and farther order passed by Id CIT A dated 17/06/2019 are bad in law in as much as disallowance of Rs.366,82,337/- u/s 40A(2)(b) is made without appreciating that there is no tax evasion plan which is must to invoke section 40A(2)(b) as stipulated in mother circular of CBDT no 6P of 1968 explaining that sans tax evasion provisions of section 40A(2) cant be pressed into service where as in extant case not only due tax is deducted u/s 195 of Rs 68,83,862 on said payment of royalty but same is remitted on sound and rational basis of commercial expediency principles which has been unlawfully interdicted by Ld AO/Ld CIT-A on mere basis of assumption and presumption only.

4. That order passed by Ld AO dated 20/12/2018 and further order passed by Id CIT A dated 17/06/2019 are bad in law in as much as disallowance of Rs 366,82,337/- u/s 40A(2)(b) is made without appreciating that burden lying on revenue to invoke section 40A(2)(b) is patently un-discharged in present case as no effort is made at any stage to demonstrate so called alleged excessiveness in payment of subject royalty sans which entire disallowance becomes ultra vires to provisions of the Act;

5. That order passed by Ld AO dated 20/12/2018 and further order passed by Id CIT A dated 17/06/2019 are bad in law in as much as disallowance of Rs 366,82,337/- u/s 40A(2)(b) is made without appreciating that law does not allow revenue to put itself in armchair of business man and dictate business expediency which is in exclusive domain of assessee ;

6. That the appellant craves leave to add add/alter any/all grounds of appeal before or at the time of hearing of the appeal.

Humble Prayer:

- i) *To delete the sole addition of Rs 366,82,337/- on a/c of alleged excessive royalty payment to related party u/s 40A(2)(b) ;*
- ii) *To restore returned income.*
- iii) *Any other appropriate relief.*

2. Briefly stated facts of the case are that the assessee company was engaged in business of manufacturing and trading of ignition coils for motor vehicle engines. For the year under consideration, the assessee filed return of income on 29/11/2016 declaring total income of ₹ 19,12,01,440/- under normal provisions of the Income Tax Act, 1961 (in short 'the Act') and book profit ₹ 17,11,37,860/- under section 115JB of the Act. The case was selected for scrutiny assessment and statutory notices were issued and complied with. The scrutiny assessment was completed on 20/12/2018 under section 143(3) of the Act, after making certain additions/disallowances. One of the disallowance made is of ₹ 3,66,82,337/- under section 40A(2)(b) of the Act on account of the excessive royalty payment made to related party. On appeal by the assessee, the Learned CIT(A) upheld this addition. Aggrieved with the finding of the Ld. CIT(A), the assessee is in appeal before the Income Tax Appellate Tribunal (in short the 'Tribunal') raising the grounds as reproduced above.

3. Before us, the parties appeared through video conferencing. The Learned Counsel of the assessee filed a paper-book containing pages 1-49. The learned Counsel did not raise any

argument in support of the jurisdictional ground raised in the appeal. Instead he raised a legal issue that disallowance under provision of section 40A(2)(b) of the Act cannot be made in the case of the assessee as the transaction under reference is an international transaction with the associated enterprise, however, no transfer pricing provisions have been invoked by the Assessing Officer that too when subject transaction in earlier years has gone under transfer pricing adjudications. According to him, the transaction of the royalty expenses falls under transfer pricing provisions, which being a specific provisions, the general provisions under section 40A(2)(b) cannot be invoked for making addition of excessive royalty expenses.

4. On the merit of the addition, the learned Counsel submitted that in assessment year 2013-14 and 2014-15 the scrutiny assessments have been carried out and the royalty expenses have been consistently allowed. He submitted that in identical facts in assessment year 2015-16 and 2017-18 no scrutiny as been carried out and returned income has been accepted. He referred to a chart on page 1 of the paper-book of average royalty payment in percentile terms paid from financial year 2012-13 to financial year 2016-17. He submitted that in the year under consideration average royalty payment is 2.77 percentage of net sales, whereas royalty payment at 2.99% has been accepted by the Department in financial year 2012-13 corresponding to assessment year 2013-14. He submitted that in assessment year 2013-14, the transfer pricing adjustment made by the learned Transfer Pricing Officer (TPO) was deleted by the learned Dispute Resolution Panel (DRP) and issue has not been further litigated by the Department.

According to him, once the Department has already accepted the average rate of 2.99% of royalty payment in the assessment year 2013-14, the action of the Assessing Officer for considering the royalty payment at the rate of 2.77% as excessive is not justified.

5. The Ld. DR, on the other hand, relied on the order of the lower authorities and submitted that the Assessing Officer has not been barred from invoking the provision of section 40A(2)(b) of the Act in the case of international transactions particularly when such transaction is not reported by the assessee to the Department. On the merit of the royalty expenses, he submitted that royalty payment in the immediately preceding assessment year was 1.78% of the sales and in the year under consideration, there is a abnormal increase to 2.77%, which has not been explained by the assessee. He further submitted that the Assessing Officer has pointed out increase in the royalty in case of few items ranging from 39% to 67.5%. He submitted that when as compared to the immediately preceding year there was excessive increase in the royalty expenses, the onus was on the assessee to substantiate the increase and in failure to do so, the learned Assessing Officer was justified in invoking the section 40A(2)(b) of the Act. In support, he relied on the decision of the Hon'ble Bombay High Court in the case CIT Vs. Shatrunjay Diamonds (2003) 261 ITR 258 wherein it is held that once purchases are made by the assessee from the persons falling under any of the categories under section 40A(2)(b), the burden is upon the assessee to establish the price paid by it is not excessive or unreasonable and it is duty of the assessee to prove and

discharge its burden by leading proper evidence subject to cross-examination by the Department.

6. We have heard rival submission of the parties on the issue in dispute and perused the relevant material on record. Before us, no arguments had been preferred by the Learned Counsel of the assessee on ground No. 1 of the appeal, therefore same is dismissed as not pressed.

6.1 As regard to addition on merit is concerned, we find that disallowance under section 40A(2)(b) of the Act can be made by the Assessing Officer, if he is of the opinion that such expenditure is excessive or unreasonable having regard to:

- (i) the fair market value of the goods, services or facilities for which payment is made or;
- (ii) the legitimate needs of the business of profession of the assessee or;
- (iii) the benefit derived by or accruing to him therefrom.

In above circumstances, the Assessing Officer shall disallow the excessive or reasonable expenditure.

6.2 It has been held by the Hon'ble Gujarat High Court in the case of Coronation Flour Mills Vs. ACIT (2009) 314 ITR 1 (Guj.) that the AO is required to record a findings as to whether the expenditure is excessive or unreasonable in relation to any of the three requirements prescribed, which are independent and alternative to each other.

6.3 In the instant case, the Ld. CIT(A) has sustained the disallowance observing as under:

“5.4 The contention of the appellant is not acceptable as it has not furnished any justifiable reason for increment in royalty compare to previous year. The AO has prepared a chart in the assessment order para 3.2.1 and it is observed that there is increase in the rate of royalty in some product to the extent 39%, 55%, 67.5% & 71%. The appellant has not given any reason for such increase of the rate of royalty. Even the rate of royalty is much higher for new line of products. The appellant is paying royalty to its parent company and transaction are with the related party covered as per the provisions of section 40A(2)(b). Res judicata is not applicable in the income tax proceedings and each year is an independent year. It is not necessary for the AO to follow the same order as determined in the previous years. This year AO has pointed out the increment in royalty expenses and asked the appellant to justify the same. The appellant has tried to justify in a general way by stating that they are covered as per the provisions of section 37(1) and appellant is the best judge to decide the expenses but it has not justified why there is such abnormal hike in rates of the royalty within six months i.e. 01.04.2015 to 01.10.2015. The AO justified in making addition on account of excessive royalty payments by comparing it with the previous years expenses of the appellant in which it has made payment to its parent company on account of royalty. It- was 1.78% in the previous year i.e. FY 2014-15 and 2.42% in FY 2013-14, thus transaction with the related parties not at arm's length. The year under consideration it is 2.77% and there is increase in royalty expenses to the extent of Rs.3,66,82,337/-. Considering the above fact, AO is justified in making addition on account of excessive payment of royalty at Rs.3,66,82,337/- and addition made by the AO is hereby confirmed.”

6.4 The Assessing Officer has only questioned the fair market value of the expenses and not questioned to the legitimate need of the expenses or the benefit derived from the expenses. The relevant finding of the Assessing Officer is reproduced as under:

“3.2.1. The charts related to Definition of Product and the Royalty rates as on 01.04.2015 & 10.09.2015 filed the assessee

have been perused and comparative figures for some of the products are as under:

S.No.	Customer Name	Part Code	Rate of Royalty w.e.f 1.4.15	Rate of Royalty w.e.f 1.10.15	% of Increase
1	MSIL	FK0422-12S	3.4%	5.34%	55%
2	MSIL	FK0491-12S	5%	5.34%	7%
3	DEID	FK0422-12S	5%	5.29%	6%
4	DEHU	FK0422-12S	5%	5.24%	5%
5	DAIKIN	RA-063	1.8%	2.5%	39%
6	DAIKIN	RB-133	4%	6.7%	67.5%
7	VOLTAS	PCB. RB -126	4%	4.39%	10%
8	ONIDA	PCB-RB-108	4%	6.83%	71%

From the perusal the above chart it can be observed that, on the same kind of parts, the assessee company had increased the royalty without any basis in a very short time span of 6 months. In some cases this increment is only 5%,6% or 7% but in some other cases it is 55%, 67.5% - & 71%. It is common sense that rates of royalty come down for the same product with the passage of time. But here in the case of the assessee, the rates are increasing with a very rapid rate and within 6 months. Further the assessee is not able to justify the reasons of steep increment in payments for royalty on the same products that too within 6 months.

3.2.2. If we compare the rates of Royalty for new line of products with the rates of royalty for old products, we find that the assessee has agreed to pay much higher rates for new line of products.

3.2.3. Validity of unregistered agreement for payment of Royalty:- As per section 68 of the Evidence Act, an unregistered document is a weak evidence. It is treated as collateral evidence and the attesting witness should give their testimony for the same. But in this case there is no attesting witness who could have been summoned for testimony, therefore the validity of this agreement remained questionable.

3.2.4. In view of the above analysis and keeping in mind that the assessee had submitted the unregistered, agreement for royalty payment which is not made on stamp paper, and not even signed by two independent witnesses, excessive royalty paid during year to the related party [Royalty paid this year (6,54,98,204)- Royalty paid in previous year (2,88,15,867) = 3,66,82,337/-] held to be excessive and hence added back to the income of the assessee u/s 40A(2)(b) of the I.T Act. Penalty proceedings u/s 271(1)(c) are initiated separately for concealing true Income by way of furnishing inaccurate particulars of such income.

[Addition of Rs. 3,66,82,337/-]”

6.5 The one of the ground taken by the AO for invoking section 40A(2)(b) is the agreement between the parties has not been registered. In our opinion, an unregistered agreement cannot be a ground for invoking provisions of section 40A(2)(b) of the Act in absence of requirement of law. If the expenses are not incurred wholly and exclusively for the purpose of the business, then disallowance could be made under section 37(1) of the Act. For invoking the provision of section 40A(2)(b) of the Act, the Assessing Officer has to form an opinion of expenses more than the fair market value or not according to the legitimate needs of the business or no benefit derived. In the instant case the Assessing Officer has only compared royalty expenses of the preceding assessment year and no efforts have been made for identifying the fair market value of such expenses during relevant period, which is one of the requirement for invoking the provisions of section 40A(2)(b) of the Act. Under transfer pricing provisions the arm's-length price is compared with similar transactions. Though the provisions of section 40A(2)(b) of the Act are general provision as compared to the specific provisions of the transfer pricing, the Assessing Officer was required to compare the royalty expenses paid in case of the similar product by other companies during the relevant period. The Assessing Officer has not done any such exercise and only made basis of expenses paid in earlier years.

6.6 The Learned Counsel of the assessee contended that in assessment year 2013-14 the transaction of the royalty expenses

were subjected to transfer pricing provisions. He submitted that in assessment year 2013-14 average royalty payment was 2.99% of the sales, which stands accepted by the Department and therefore, no disallowance should be made in the year under consideration, where the royalty expenses are only 2.77% of the sales. This contention of the learned Counsel is rejected as the fair market value of the expenses have to be identified for the relevant year and percentile of the earlier year cannot be made basis for comparison.

6.7 In view of the above discussion, the disallowance made out of royalty expenses amounting to ₹ 3,66,82,337/-is deleted. The ground No. 4 of the appeal is accordingly allowed.

7. The Learned Counsel of the assessee argued that in the case of the assessee the transaction of the royalty expenses between the assessee and its Associated Enterprises (AEs), is international transaction and therefore its arm's-length price can be determined only under the transfer pricing provisions and not under the provision of the section 40A(2)(b) of the Act. The contention of the Learned Counsel is that when there is specific provisions for dealing with the issue of expenses paid to related party under transfer pricing provisions, the general provisions under section 40A(2)(b) of the Act should not be invoked. We have noticed that this issue was not raised before the lower authorities and it has been raised before us for the first time that too as oral argument and not either as regular ground or additional ground. Since, we have already adjudicated the issue on merit, the arguments raised by the learned Counsel regarding applicability

of general versus specific provisions are rendered merely academic and we are not adjudicating the same.

8. The other grounds raised on merit are also rendered merely academic and accordingly, we are not adjudicating upon the same.

9. In the result, the appeal of the assessee is allowed.

Order pronounced in the open court on 23rd July, 2020.

Sd/-
(BHAVNESH SAINI)
JUDICIAL MEMBER

Sd/-
(O.P. KANT)
ACCOUNTANT MEMBER

Dated: 23rd July, 2020.

RK/-(D.T.D.S.)

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR

Asst. Registrar, ITAT, New Delhi