This article considers the recent ruling of the Income Tax Appellate Tribunal in the Diageo case, which is especially notable as the first instance in which an Indian court has expounded on the meaning of the term “associated enterprise” and has laid down what to apply as the true test for determining an associated enterprise.

1. Introduction

The Income Tax Appellate Tribunal (the Tribunal) in the case of Diageo India Private Limited v. Deputy Commissioner of Income Tax¹ had the opportunity to consider whether the exercise of de facto control triggers the classification of a transaction as an “international transaction” and whether transfer pricing rules would be attracted. The Tribunal also observed that the term “associated enterprise” has not come up for judicial consideration, and the Diageo case is probably the first one which has looked in detail and has interpreted the meaning associated with the term “associated enterprise”.

2. Facts of the Case

Diageo India Private Limited (the taxpayer) is engaged in the business of procuring and marketing alcoholic beverages in India, and also provides sales agency services to one of its associated enterprises, Diageo Scotland Limited. The taxpayer’s procurement of alcoholic beverages is carried out by having them manufactured at the vendor’s facilities in India or by way of import from its associated enterprises abroad. The taxpayer imports the bottled drinks from associated enterprises abroad and markets them in India. However, the manufacturing of alcoholic beverages in India is done through contract bottling units.

The taxpayer follows two distinct approaches in two distinct segments, namely the whiskey segment and the other-than-whiskey segment (e.g. rum, vodka). In the whiskey segment, the taxpayer imports concentrates or flavours and uses these imports to bottle the beverages in India. In the other-than-whiskey segment, the taxpayer obtains the beverages manufactured in India with the help of inputs that are available locally in India. In short, the manufacturing is done through contract bottling units, and there are no imported flavours in manufacturing under the other-than-whiskey segment; in the whiskey segment, the concentrates and flavours are imported from associated enterprises abroad.

The pricing structure for manufacturing done by the contract bottling units under the two segments is structured such that the manufacturers are to meet all the costs by themselves and are to realize all the sales proceeds on their own. However any difference, over their costs and agreed margin of profit, is to the credit of the taxpayer.

Regarding the agreement with one of the contract bottling units, Konkan Agro Marine Industries Private Limited (KAMPL), to which the present dispute relates, the profit permitted to this contract bottling unit consisted of several factors such as (1) a basic minimum monthly sum, (2) an additional sum based on outputs and (3) incentives based on quality norms. The balance amount out of gross sales after deducting all the eligible costs (such as excise duty, sales tax or value added tax, raw materials, distribution costs and other eligible costs) and the profit margin permitted to KAMPL was to the taxpayer’s account.

In the course of its filings with the income tax department, the taxpayer reported all its international transactions with associated enterprises, including purchases of concentrate and other inputs by the contract bottling units, in Form 3CEB.²

3. Assessment Proceedings

During the assessment proceedings of the taxpayer, the assessing officer made a reference to the transfer pricing officer for determination of the arm’s length price with respect to all the transactions reported in Form 3CEB by the taxpayer.

4. Reference to Transfer Pricing Officer

4.1. Adjustment to purchases of raw materials made by the taxpayer

Following reference by the assessing officer to the transfer pricing officer, the transfer pricing officer noted that the taxpayer has incurred a loss of 4.93% in the other-than-whiskey segment involving no associated enterprise.

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2. Under the Act, sec. 92E provides that every person who has entered into an international transaction during a previous year must obtain a report from an accountant and furnish such report on or before the specified date in the prescribed form and manner. Rule 10E of the Income Tax Rules is the rule formed to the corresponding sec. 92E, and prescribes Form 3CEB. Using this form, the accountants report requires the furnishing of factual information only relating to international transaction entered into, the arm’s length price determined by the assessee and the method applied in such determination. It also requires an opinion as to whether the prescribed documentation has been maintained.
transactions and made profits of 1.16% in the whiskey segment involving associated-enterprise transactions. Overall, the transfer pricing officer noted that the taxpayer suffered a loss of 3.07%, and was of the view that as computation of gross profit margins is not required to be shown and the same may not be in the public domain, the right course would be to compare operating profit to total sales. On being directed by the transfer pricing officer, the taxpayer submitted the figures of net profit margins and net cost-plus markup of the comparable cases, and the arithmetic mean of these figures worked out to 5.25% and 7.07%, respectively. The transfer pricing officer accordingly made the arm’s length price adjustment of INR 10.2 million in respect of purchases from associated enterprises in respect of profitability of the whiskey segment. Accordingly, the transfer pricing officer recommended an arm’s length price adjustment of INR 10.2 million in respect of the purchases of raw materials made by the taxpayer from KAMPL. The transfer pricing officer further noted that the difference between the arm’s length price determined by the transfer pricing officer and the transaction value taken by the taxpayer is more than 5%, and, accordingly, the adjustment contemplated in proviso to section 92 C(2) of the Indian Income Tax Act, 1961 (the Act) was not admissible.

4.2. Advertisement and promotion activities

The transfer pricing officer further noted that the taxpayer had incurred an expenditure of INR 30.722 million on account of sales promotion and advertising, which comes to approximately 40.64% of the entire turnover of INR 90.158 million. The transfer pricing officer was of the view that the taxpayer spent huge amounts on advertisement and sales promotion pertaining to the brands owned by the associated enterprises, and the taxpayer did not receive any compensation from its associated enterprises for the brand promotion. The transfer pricing officer noted as follows:

The assessee has incurred substantial advertising expenditure. This would result in creation of a marketing intangible. The value of the brand in the concerned markets would increase. This would benefit the owner of the brand. Suppose the owner subsequently decides to sell the brands, then it would sell the brand for these markets at a much higher premium. The assessee would not benefit from the same. It also indicates that the assessee may not be able to benefit from marketing and distribution expenditure it incurs at its own risk. The assessee has acted to increase the value of brand names owned by the associated enterprise. The associated enterprise should, therefore, have compensated the assessee for promoting this brand.

The transfer pricing officer also made a reference to the definition of ‘international transaction’, which covers

an arrangement, understanding or action in concert (1) whether or not such arrangement, understanding or action is formal or in writing or (2) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding.

Based on the above observation, the transfer pricing officer held that the transaction relating to brand promotion was an international transaction, as it would have a bearing on profit, income, loss or assets of the taxpayer. The transfer pricing officer then computed how much advertisement expenses the taxpayer ought to have incurred, and, in doing so, relied upon the highest advertisement expenses incurred by any of the comparable cases selected by the taxpayer for the purpose of computing the arm’s length price of purchases from an associated enterprise. The transfer pricing officer noted that the highest advertisement expenditure incurred in these cases is by United Spirits Limited, which is 6.2% of sales, and the amount spent by the taxpayer in excess of this ratio was considered to be for purposes of the associated enterprise owning the related brands. Accordingly, the transfer pricing officer concluded that out of advertisement and sales promotion expenses incurred to the tune of INR 30.722 million, only INR 50.68 million can be said to be for the purposes of business of the taxpayer, and the balance (INR 30154 million) should have been reimbursed by the associated enterprise to the taxpayer. Accordingly, the transfer pricing officer disallowed the deduction of INR 30.154 million and held it to be a transfer pricing adjustment which was towards strengthening the brands owned by the associated enterprise. Based on the report so given by the transfer pricing officer, the assessing officer proceeded to disallow the deduction of INR 30.154 million.

5. Objection before the Dispute Resolution Panel

The taxpayer filed its objection to this action of the assessing officer before the Dispute Resolution Panel. However the Panel summarily rejected the objections of the taxpayer. Aggrieved by this, the taxpayer filed an appeal before the Income Tax Appellate Tribunal, Mumbai Bench (the Tribunal).

6. Proceedings before the Tribunal

6.1. Issue before the Tribunal

The issues before the Tribunal were whether:

– the assessing officer was justified in making transfer pricing adjustment of INR 30.154 million on account of advertising, marketing and promotion expenses alleged to have been incurred towards strengthening the associated enterprise; and

– the assessing officer was justified in making an arm’s length price adjustment of INR 10.2 million in respect of purchases made by the taxpayer’s contract bottling unit, KAMPL?
6.2. Proceedings

6.2.1. First objection raised by the taxpayer

6.2.1.1. Taxpayer’s arguments

The taxpayer raised certain objections before the Tribunal with regard to the arm’s length price adjustments applied by the assessing officer. The taxpayer argued as follows:

- KAMPL was not a related party and, therefore, it cannot be treated as an associated enterprise of the taxpayer;
- the assessing officer erred in considering purchases of raw materials by this contract bottling unit from the taxpayer’s associated enterprises, as international transactions with associated enterprises of the taxpayer;
- it was only as a measure of abundance and caution that the taxpayer disclosed the transactions with associated enterprises in Form No. 3CEB, and the mere fact that a transaction has been reported in Form No. 3CEB cannot convert a transaction with independent enterprises into a transaction with associated enterprise; and
- the taxpayer stated that there is nothing on record to suggest that the enterprises from which the contract bottling unit imported raw materials was covered by the deeming fiction under the Act. It was further pointed out that the contract bottling unit had entered into arrangements with the taxpayer and, as a result of this association, the relationship as associated enterprises could at best be between the taxpayer and the contract bottling unit, and does not extend beyond that.

6.2.1.2. Arguments of the Deputy Commissioner of Income Tax

In response to the taxpayer’s assertions, the Deputy Commissioner of Income Tax (the Department) responded as follows:

- the taxpayer’s objection is devoid of legally sustainable merits;
- what was being manufactured by the contract bottling unit was wholly dependent on the trademark owned by the Diageo group, and on which the Diageo group had exclusive rights;
- the entities within the Diageo group are clearly covered by the scope of section 92A(1)(a) as also the deeming fiction set out in section 92A(2)(g); and
- the definition of associated enterprise, under section 92A(1), is comprehensive enough to cover situations in which the taxpayer controls, directly or indirectly, the other enterprises.

6.2.1.3. Observations of the Tribunal on the first objection

Before delving into the above issues, the Tribunal examined the provisions of section 92A of the Act which defines the term “associated enterprises”. Following a review of section 92A(1)(a), the Tribunal held that the term “associated enterprises” refers to an enterprise “which participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise”. The term “associated enterprises” is further expanded under section 92A(1)(b), taking into account group concerns, and it is provided that “associated enterprises” covers an enterprise:

- in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

In effect, when same persons participate, directly or indirectly or through an intermediary, in the management, control or capital of two or more enterprises, such enterprises are required to be treated as “associated enterprises”. The Tribunal noted that even as the definition of associated enterprise contains crucial references to “participation in management or control or capital”, the precise scope of this expression has not been defined under the provisions of the Act, nor has it come up for judicial consideration.

Although this expression has been used in article 9(1) of OECD and UN Model Conventions, this is of no benefit to the Tribunal. The Tribunal observed that all that the OECD commentaries state that the scope of this expression refers to “parent and subsidiary companies and companies under common control”. Thus, following review of the above, the Tribunal held that the true test of associated enterprise thus is that of control by one enterprise over the other, or control of two or more associated enterprise by common interests, and such control is essentially an effective control in the decision making process.

The Tribunal held that the definition of associated enterprise in section 92A(1)(a) and (b) is what can be called a basic rule, which can be stated as follows:

- when one enterprise participates in the control, management or capital of the other enterprise (directly or indirectly or through one or more intermediaries);
- when persons participate (directly or indirectly or through one or more intermediaries) in control or management; or
- when the capital of two or more enterprise is the same the enterprises are said to be associated enterprise.

4. Sec. 92A (2)(g): Meaning of associated enterprise: "The manufacture or processing of goods or articles or business carried out by one enterprise is wholly dependent on the use of know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, or any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process, of which the other enterprise is the owner or in respect of which the other enterprise has exclusive rights.”

5. Sec. 92A (1): Meaning of associated enterprise: “For the purposes of this section and sections 92, 92B, 92C, 92D, 92E and 92F, associated enterprise’, in relation to another enterprise, means an enterprise in which the taxpayer controls, directly or indirectly, the other enterprises.
The Tribunal further held that the expression used in the Act is "participation in control or management or capital", but essentially all three of these elements refer to the de facto control of decision making. Thus, in terms of the basic rule, whether one enterprise controls the decision making of the other or whether the decision making of two or more enterprise are controlled by the same interests, these enterprises must be treated as "associated enterprises". The Tribunal further observed that section 92A(2) gives practical illustrations of this kind of control. All of these illustrations deal with simple situations of dealings among two enterprise, as envisaged in section 92A(1)(a), but are equally appropriate for application in situations involving more than two enterprises, as envisaged in section 92A(1)(b).

Section 92A(2)(e), for example, refers to a situation in which "more than half of the directors or members of the governing board, or one or more of the executive directors or members of the governing board, of each of the two enterprises are appointed by the same person or persons", but this deeming fiction is equally applicable when the same person appoints, say, more than half of the directors of the governing board for three or more enterprises.

Therefore, a literal interpretation of this section will mean that if this relationship is between two enterprises, these two enterprises are required to be treated as associated enterprises, but when the same basis extends to more than two enterprises, these enterprises will not be treated as associated enterprises. Therefore, according to the Tribunal, this results in an incongruous result which was not the intention of the legislators. The Tribunal held that as all clauses of deeming fictions set out in section 92A(2) are only illustrations of the manner in which the de facto control of decision making exists, it is necessary that, when interpreting these deeming fictions, they be interpreted so as to make them workable rather than redundant, and that the same test of effective control of decision making as are implicit in the deeming fiction under section 92(A)(2), would apply to situations involving more than two associated enterprises as envisaged in section 92A(1)(b).

6.2.1.4. Application of the above to the facts of the Diageo case

The manufacture of goods is carried out by KAMPL, which is controlled by the taxpayer inasmuch as the contract bottling unit is wholly dependent on the use of trademarks to which the taxpayer has exclusive rights. This relationship meets the test of de facto control of decision making as set out in section 92A(2)(g).

The taxpayer, as evident from information submitted in Form 3CEB, is controlled, by way of equity participation, by Diageo PLC, which also similarly controls other entities in the Diageo group, including the entities from which the contract bottling unit imported the raw materials. Thus, Diageo PLC, through the taxpayer as an intermediary, controls the contract bottling unit as well as the Diageo group entities from which the contract bottling unit imported raw materials.

This clearly shows that the taxpayer, KAMPL and the Diageo group are associated enterprises and, de facto, all these enterprises are controlled, directly or indirectly or through intermediaries, by the same person, namely Diageo PLC. Therefore, in view of the Tribunal, the relationship of associated enterprises exists between the taxpayer, KAMPL and Diageo group entities from which raw materials were purchased by KAMPL. In any case, as the cost of all the raw materials is picked up by the taxpayer, for all effective purposes, the transaction is actually between the taxpayer and the Diageo group with regard to the supply of raw material to KAMPL. As the taxpayer and these vendors are admittedly under the control of Diageo PLC, the transactions are clearly between associated enterprises.

The Tribunal therefore rejected the objection raised by the taxpayer that the transactions involving the importation of raw material by KAMPL cannot be treated as international transactions between associated enterprises.

6.2.2. Second objection raised by the taxpayer

The second objection of the taxpayer was that:

- there is no need to search for the margins of profit outside the taxpayer’s own operations, as the taxpayer was involved in the same line of business in two different segments, namely whiskey and other-than-whiskey;
- the best comparable for the whiskey segment is the other-than-whiskey segment, and the results shown by the taxpayer in the whiskey segment, showing better profitability than the other-than-whiskey segment, should be accepted; and
- the taxpayer’s profitability in the same line of business in the segment in which the taxpayer had transactions with associated enterprises, is better than the profitability in the segment in which the taxpayer had no transactions with the associated enterprises. Thus, the impugned TNMM adjustment should be quashed.

The Tribunal observed that the whiskey segment and other-than-whiskey segment of the taxpayer are not functionally comparable inasmuch as whiskey is an established product with a mass base, as opposed to other-than-whiskey products in India which are at initial stages by comparison. Further, India is traditionally a whiskey market.

The Tribunal also noted that from the segmental results, the advertisement costs and other overhead in the other-than-whiskey segment were higher as compared to the whiskey segment. Therefore, segregating all spirits other than whiskey and comparing the results in that segment with the results of the whiskey segment would not be appropriate.
6.2.3. **Third objection raised by the taxpayer**

6.2.3.1. **Taxpayer’s contention**

The third objection of the taxpayer was that the decision of the transfer pricing officer in relation to the addition of INR 30.154 million for the building of the brand of the associated enterprise was not an issue which was referred to the assessing officer.

6.2.3.2. **Tribunal’s observation**

The Tribunal relied on the decision of the Court in 3i Infotech Ltd v. DCIT and held that the reference to the transfer pricing officer is transaction-specific and not enterprise-specific. Thus, the transfer pricing officer has no authority to delve into a matter which has not been referred by the assessing officer. To this extent, the transfer pricing officer’s order is to be treated as non est, and any arm’s length price adjustments made based on such an order from the transfer pricing officer cannot be legally sustained. Thus, the Tribunal directed the assessing officer to delete the impugned addition of INR 30.154 million in respect of building the brand of the associated enterprise.

7. **Judgement of the Tribunal**

The Tribunal held as follows:

– the arm’s length price adjustments of INR 30.154 million in respect of alleged brand promotion of associated enterprise were non est; and

8. **Conclusion**

Through its judgement in this case, the Tribunal has elaborated on the definition of “associated enterprise” – a matter which had not come up for judicial consideration prior to this case. The Tribunal further explained situations which set a benchmark in identifying unrelated entities as deemed associated enterprises, and therefore the transfer pricing provisions would apply to such unrelated entities.

The Tribunal also laid down the true test for determining status as an associated enterprise. The true test is that of control by one enterprise over the other, or control of two or more associated enterprises by common interests, and such control is essentially effective control of the decision making process.