

HC ruling on diversion of liquor profits to Diageo - An analysis on TP-principles

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Transfer Pricing (TP) documentation and compliance regulations have been formally in vogue in India since 2001, namely for almost two decades. From what was initially perceived by various constituents in the nascent years, namely being a mere compliance exercise, TP in India has actually traversed much beyond routine compliance, to setting up of proper supply chain structures within large business conglomerates, both for their international and domestic businesses, in order to ensure that each entity within an MNC group is entitled to the correct share of remuneration/ results, as commensurate to its functional, asset and risk profile; and also aligned to value creation. The theories and principles of TP can be judiciously applied for resolving cases even under GST, particularly customs duty; and also corporate taxation under the IT Act.

The present article deals with a recent ruling of the Karnataka High Court in the case of Chamundi Winery and Distillery (Chamundi), dealing with the allowability of a payment to a rank third party for the purposes of computing business profits under the IT Act. The facts of the case, as understood from a reading of the ruling; and also the overall knowledge of the industry within which Chamundi operated, namely liquor industry, were that Chamundi owned a distillery for the manufacture and sale of alcoholic beverages under a license obtained from the State Government. The relevant industry being highly regulated, particularly in some of the States, it is not possible for any company to set up a distillery and manufacture and sell alcoholic beverages without an express license granted by the State Government.

Diageo India, being an Indian subsidiary company of the renowned Diageo Group of companies, which is one of the largest global players in the liquor industry, carried necessary license to sell alcoholic beverages in India under various well-known trademarks, which it had obtained from its overseas group entities. Since Diageo India did not possess necessary license from the relevant State Government to manufacture and sell alcoholic beverages within the particular State in India, it entered into an agreement with Chamundi, wherein Chamundi would manufacture alcoholic beverages by using necessary technology/ processes of Diageo India; and thereafter sell the same under various trademarks of Diageo India, against orders obtained by Diageo India from different distributors. As per the terms of the agreement, Diageo India also provided several strategic support functions in favour of Chamundi; and also guaranteed a minimum volume of orders for Chamundi in a month.

Since the sale of liquor to the distributors was effectuated by Chamundi, albeit against orders obtained by Diageo India, the entire profits arising out of the business rested within Chamundi. As a reward for rendition of such services by Chamundi, the two parties agreed that Chamundi would retain INR 45 per case; and the balance amount of the profits, namely after deducting from the proceeds on sale of liquor, – (a) all the expenses incurred by Chamundi; (b) applicable indirect taxes; and also (c) the reward of INR 45 per case, as above, would be paid by Chamundi in favour of Diageo India. It is important to note that the aforesaid arrangement was otherwise within the contours of the regulatory regime of the State in the matter of liquor business.

In the corporate tax assessments relating to Chamundi, the Assessing Officer had disallowed the aforesaid payment made by Chamundi in favour of Diageo India, as per the terms of the arrangement explained above, on the ground that the same constituted mere application of profits, after they had duly accrued in favour of Chamundi. As the matter travelled to the High Court, through a winding journey, wherein Chamundi had met with successes both at the destinations of the Appellate Commissioner and Tax Tribunal, the High Court upheld the views of the Assessing Officer; and decided the matter against Chamundi. The High Court's judgement exuberated complete mastery over the subject of income tax, particularly the general concepts of diversion of income by overriding title; and application of income post its accrual, as explained by the Supreme Court in a plethora of cases; and in the end it was pleased to hold that the payments made by Chamundi in favour of Diageo constituted application of income after its accrual in the hands of Chamundi; and thus the same could not be allowed as an allowable expenditure while computing the business profits of Chamundi.

The High Court also hastened to add that had Chamundi paid royalty in favour of Diageo for the rights and licenses granted under the agreement or arrangement, as referred to above, then such royalty would have been allowed as deduction in the hands of Chamundi.

As explained earlier, while one would bow to the mastery of the general principles of income tax law, as enunciated by the High Court in its judgement, at the same breath, one is constrained to ponder as to whether the High Court would have been pleased to rule in the contrary had the matter been represented before the High Court under the touchstone of TP; or by following the concepts and principles of TP ?

One needs to bear in mind that Diageo India had resorted to the aforesaid arrangement with Chamundi due to regulatory restrictions prevalent in the relevant State with respect to the liquor industry, which prevented Diageo to set up a distillery for manufacture of alcoholic beverages; and also sell the same through regulated channels, in absence of license available from the State Government. However, it is important to note that the aforesaid arrangement, which has been explained in detail hereinabove, was otherwise within the regulatory regime of the State Government; and also the payment of residual profits by Chamundi in favour of Diageo India had blessings of similar regulatory regime.

In such premise, one would need to ascertain the exact nature of the payment made by Chamundi in favour of Diageo India. Under the aforesaid facts, notwithstanding any nomenclature affixed to it, the payment was, in essence, one of royalty or industrial franchisee fee, determined under a residual profit split method (RPSM) of TP. When clinically analysed, Chamundi never had access to the superior intellectual property (IP), in the form of technology/ process and trademarks, belonging to Diageo India; and thus whatever product, in the form of alcoholic beverage, it would have otherwise been able to produce in its distillery; and also sell through regulated channels, on the strength of the license obtained from the State Government, would have never fetched the sort of premium rewards or profits, which one may associate with the liquor produced and sold using the world renowned IP of Diageo Group, of which Diageo India was a beneficiary under a license agreement.

Chamundi was in essence a contract manufacturer of Diageo India, though optically it never appeared to be so, as Chamundi sold products to third party customers, instead of to the principal, namely Diageo, again due to regulatory restrictions. Had Diageo India been permitted to sell the products to third party customers, albeit through regulated channels of the State Government, then Diageo India would have paid an arm's length reward to Chamundi for the products manufactured by Chamundi; and there would not have been any occasion for Chamundi to pay any reward to Diageo India for granting the license of IP and rendition of strategic services.

However, since Chamundi had to mandatorily sell products to third party customers, in view of the regulatory regime, all the profits, including the adequate or arm's length rewards of Diageo India; remained trapped within the coffers of Chamundi; and the only way to make available such rewards in favour of Diageo India, was through the mode of royalty or industrial franchise fee, notwithstanding any nomenclature, which the two parties would have accorded to such payment in any agreement executed between themselves. The arrangement is generally referred to as the "non-integrated principal structure", which is well understood and accepted globally, including in India, in the parlance of TP.

Thus, Chamundi would have been entitled to routine returns for manufacturing the liquor in its distillery. In case the license obtained from the State Government was to be considered as a routine intangible, then any rewards associated with the same would have been subsumed within the routine returns for manufacturing, as above; and all the residual profits would have belonged to Diageo India, being attributed to valuable IP, in the form of technology and trademarks, customer references, rendition of strategic services relating to the business of Chamundi, etc.; and such reward would have flown in the form of bundled royalty or industrial franchise fee.

On the other hand, in case such license constituted a non-routine or unique intangible in the hands of Chamundi, then Chamundi would have been entitled to, over and above the routine returns for manufacturing of liquor, a slice of residual profits, attributable to such non-routine intangible; and the balance amount of residual profits would have still been repatriated in favour of Diageo India, as explained above, as bundled royalty or industrial franchise fee.

Now, it appears that the two unrelated or rank third parties, namely Chamundi and Diageo India, had entered into an agreement or arrangement, exactly on the lines discussed above, except for the precise nomenclature accorded to the payment to be made by Chamundi in favour of Diageo India. When Chamundi had quoted; and agreed to, the reward of INR 45 per case of liquor, manufactured and supplied by it, having regard to the guarantee of a minimum number of orders made available by Diageo India, Chamundi would have been satisfied that the net profits emanating from such arrangement would provide adequate rewards, both for its routine functions of manufacturing the liquor; and also license obtained from the State Government; and thus the payment of balance of the residual profits in favour of Diageo India would be the just and adequate remuneration for Diageo's contribution in the entire arrangement, namely valuable IP, in the form of technology and trademarks, customer references, rendition of strategic services relating to the business of Chamundi, etc.

Further, when the arrangement was entered into between two rank third parties, it would have been a foregone conclusion that Chamundi would have bargained hard with Diageo India in order to ensure that the reward of INR 45 per case, with a

minimum guarantee of orders, would only be fair and just to cover all its contributions under the arrangement, as above.

It needs to be understood that Chamundi and Diageo had not entered into any sort of an unincorporated partnership or joint venture arrangement to share profits of the business through joint operations, in which case the entity for the purposes of taxation, would have been an association of persons between the said two companies. The aforesaid case related to the appointment of Chamundi as a contract manufacturer or limited risk manufacturer by Diageo India, who was the owner of extremely valuable IP; and also rendered significant strategic services to the business of Chamundi.

One needs to bear in mind that High Courts and the Supreme Court are sacred institutions, being temples of justice; and if facts are placed and explained before the Courts in a proper and appropriate manner, the exposition of law thereon would be sacrosanct. Analysing the aforesaid payment made by Chamundi in favour of Diageo India under the cornerstone of TP, would lead to an unassailable conclusion that the same constituted adequate and arm's length reward in the form of royalty or industrial franchise fee, for the valuable contributions made by Diageo India under the license agreement; and should be allowed as business expenditure in the hands of Chamundi. There might not have been any need or necessity to view the payment from the perspectives of diversion of profits by overriding title and application of profits post accrual.