16. Case Law

16.1. Court rulings with relevance to transfer pricing

16.1.1. Supreme Court cases

16.1.1.1. *Morgan Stanley and Co. v. DIT* (2007) 292 ITR 416 (SC)

This is a landmark decision on various aspects of international taxation. In fact, this decision lays down rules regarding several fundamental issues in international taxation, such as fixed and service permanent establishments, transfer pricing and attribution of profits to permanent establishments. In early 2006, the Authority of Advance Ruling (AAR) in the case of *Morgan Stanley & Co Inc, USA* (MSCO) had held that MSCO had a PE in India considering deputation of employees by MSCO to India and stewardship services rendered by it to Morgan Stanley Advantage Services Private Limited (MSAS). It was further held that as long as the payment by MSCO to MSAS is at arm's length, no further income can be attributed to the PE of MSCO in India. MSCO as well as the revenue authorities had filed a special leave petition against this ruling before the Supreme Court.

In its judgement, the Supreme Court held that provision of back office and other outsourced services by MSAS, a captive service provider, did not constitute a PE of MSCO in India. However, the Court held that deputation of personnel to MSAS would constitute a service PE. On the issue of attribution of income, the Court held that as a principle, there cannot be any attribution if the associated enterprise (MSAS) that constituted a PE is remunerated on an arm's length basis determined on a proper transfer pricing analysis.

Facts of the case

(1) MSCO is an investment bank engaged in the business of providing financial advisory services, corporate lending and securities underwriting services. MSCO outsourced activities such as equity and fixed-income research, data processing, account reconciliations and IT-enabled services to MSAS. MSCO deputed employees to India for stewardship and management activities to ensure the quality of the outsourced services. It also deputed its employees to MSAS who worked under the control and supervision of MSAS. Under the service agreement, MSAS was remunerated on a cost-plus-markup basis by MSCO for providing back office services.

(2) The AAR ruled that:

- although the place of business of MSAS was no doubt a fixed place, there was no evidence that the business of MSCO was carried on through that place. Thus, MSAS could not be treated as a fixed place PE of MSCO;
- MSAS was not securing orders in India wholly or almost wholly for MSCO and, therefore, MSAS would not constitute an agency PE;
- MSCO would be regarded as having a service PE in India under Art. 5(2)(l) of the India-United States treaty on account of deputation arrangement and stewardship services; and
- no further income can be attributed to the PE as long as MSAS is remunerated for its services at arm's length by MSCO.

(3) MSCO and the revenue authorities challenged the ruling of the AAR before the Supreme Court on the following issues:

- constitution of PE of MSCO in India; and
- attribution of income to PE in the case of arm's length compensation to MSAS.

Decision of the Supreme Court

PE of MSCO in India

Fixed place PE

MSCO cannot be said to have a fixed place PE in India in terms of Art. 5(1) of the US treaty in respect of the back office operations performed by MSAS, as the condition of carrying on MSCO's business through such fixed place was not satisfied.

Further, the back office functions performed by MSAS in India, being in the nature of preparatory or auxiliary in character, fall under Art. 5(3)(e) of the US treaty and thereby are excluded from the fixed-place characterization of PE.

Agency PE

As MSAS had no authority to enter into or conclude contracts on behalf of MSCO and the contracts would be concluded in the United States, MSAS would not constitute an agency PE under Art. 5(4) of the US treaty.

Service PE

The stewardship activities carried out by employees of MSCO were to protect its own interest and involved monitoring of its outsourced operations without day-to-day management of operations of MSAS. As MSCO was not rendering any services to MSAS, these activities would not constitute a service PE under Art. 5(2)(l) of the treaty.

The Supreme Court observed that where the activities of a multinational enterprise entails it being responsible for work of deputationists and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service PE can emerge. With this background, the Court held that deputed employees created a service PE under Art. 5(2)(l) of the US treaty as employees lend their experience to MSAS as employees of MSCO while continuing to be on the payroll of MSCO or retaining their lien on their employment with MSCO.

Attribution of profits to the PE of MSCO

A foreign enterprise is liable to be taxed in India on its business profit that is attributable to the PE in India. Only the profits of MSCO that have an economic nexus with the PE in India would be taxable in India. A PE is to be treated as if it is an independent enterprise (profit centre) outside the head office which deals with the head office at arm’s length.

Economic nexus is an important aspect of the principle of profits attributable to the PE.

No further profits will be required to be attributed to the foreign enterprise where an associated enterprise that constitutes a PE is remunerated on an arm’s length basis, taking into account all the risk-taking functions of the enterprise.

Only where a transfer pricing analysis does not adequately reflect the functions performed, assets deployed and risks assumed by the enterprise, would there be need to attribute profits to the PE for those functions, assets and risks that have not been considered.

Most appropriate method

The TNMM is the appropriate method for determination of the arm’s length price in respect of transactions between MSCO and MSAS.

Important inferences

Implications of a service PE would need to be considered while putting in place employee deputation arrangements.

A robust transfer pricing analysis adequately reflecting the functions performed, assets deployed and risks assumed by the enterprise can mitigate any further attribution of profits to the PE.

16.1.1.2. *Commissioner of Income Tax-IV v. M/s GlaxoSmithKline Asia(P) Ltd*

Facts of the case

The assessee M/s GlaxoSmithKline Asia Pvt Ltd is a company engaged in the business of manufacture and sale of fast-moving consumer products. It did not have any employee other than a Company Secretary. The administrative services relating to marketing, finance, human resources, secretarial services, etc. were provided by GlaxoSmithKline Consumer Healthcare Limited (GSKCH), a widely held public limited company. The agreement between GSKCH and the assessee was that the assessee would reimburse the costs incurred by GSKCH for providing the various services plus 5% (referred to as “cross charges”). As this agreement did not provide for any basis for the allocation of costs incurred towards various services, a study was made by PricewaterhouseCoopers (PWC) to determine the basis for allocation of reimbursable costs, and the cross charges were worked out accordingly. However, the assessing officer held that the increase in payment of cross charges to GSKCH was not fully and exclusively for the purpose of business of the assessee, and therefore could not be justified in terms of its legitimate business requirements. He held that the payment of cross charges/administrative expenses to the extent of 7% of net sales alone was justified, and disallowed the balance amount. Although the CIT (A) confirmed the disallowance, the Tribunal allowed the assessee’s appeal, holding that there is no provision to disallow any expenditure on the grounds that such expenditure is excessive or unreasonable unless the case of the assessee falls within the scope of Sec. 40A(2) and that there was no material on record to show that such provisions could be attracted. The appeal by the tax authorities to the High Court was also dismissed.

For subsequent years, however, the AO continued to disallow the claim and recovered the demand through attachment. The assessee obtained relief from the Tribunal, and the appeal by the tax authorities is pending with the High Court. However, for the delay by the tax authorities to give effect to the Tribunal’s order, the assessee filed a writ petition with the High Court. The High Court issued a direction by way of a mandamus to the tax authorities to refund the amount, and also held that the assessee would also be entitled to interest on such amount of refund, as well as

interest on any delayed refund under the Act.

Decision of the Supreme Court

Against the above-mentioned order of the High Court, the tax authorities filed a special leave petition (SLP) before the Supreme Court. The Supreme Court, having reviewed the materials, held that:

- The tax authorities have recorded a concurrent finding that the two companies are not related companies under Sec. 40A. As far as this SLP is concerned, no interference is called for, as the entire exercise is a tax-neutral exercise. Thus, this special leave petition filed by the Department stands dismissed.
- However, the tax authorities will examine whether there is any loss of revenue in any of the assessment years in question. If the tax authorities find that the exercise is a tax-neutral exercise, the matter may be decided accordingly.
- The main issue is whether the Transfer Pricing Regulations should be limited to cross-border transactions or whether the Transfer Pricing Regulations should be extended to domestic transactions. In the case of domestic transactions, the under-invoicing of sales and over-invoicing of expenses ordinarily will be tax-neutral in nature, except in two circumstances involving tax arbitrage, namely where:
  - one of the related companies is loss making and the other is profit making, and profit is shifted to the loss-making concern; and
  - there are different rates for two related units (on account of different status, area-based incentives, nature of activity, etc.) and if profit is diverted towards the unit on the lower side of tax arbitrage.
- All these complications arise in cases where fair market value is required to be assigned to the transactions between related parties in terms of Sec. 40A(2) of the Income Tax Act, 1961. To get over this situation, the matter needs to be examined by the CBDT. The Court was informed that the matter has been examined by the CBDT and the CBDT was of the view that amendments would be required to the Act if such transfer pricing regulations are required to be applied to domestic transactions between related parties under Sec. 40A(2) of the Act.
- In order to reduce litigation, certain provisions of the Act, like Sec. 40A(2) and Sec. 80IA(10), need to be amended so as to empower the assessing officer to make adjustments to the income declared by the assessee, having regard to the fair market value of the transactions between the related parties. The assessing officer may thereafter apply any of the generally accepted methods of determination of an arm's length price, including the methods provided under Transfer Pricing Regulations.
- In a number of matters, it is found that many a times, the assessing officer is constrained by the taxpayer's failure to maintain relevant documents, as currently there is no specific requirement for the maintenance of documents or completion of specific transfer pricing audits by taxpayers in respect of domestic transactions between related parties. One of the suggestions that needs consideration is whether the law should be amended to make it compulsory for the taxpayer to maintain books of accounts and other documents along the lines prescribed under Rule 10D of the Income Tax Rules in respect of such domestic transactions, and whether the taxpayer must obtain an audit report from its chartered accountant so that the taxpayer maintains proper documents and requisite books of accounts reflecting the transactions between related entities as at arm's length prices, based on generally accepted methods specified under the Transfer Pricing Regulations.

Significant inferences

Owing to recommendation made by the Supreme Court, there is a possibility that the CBDT/Ministry of Finance may propose the amendment to curb tax evasion in domestic transactions.

16.1.2. High Court cases

16.1.2.1. *Moser Baer India Ltd & Others v. The Additional Commissioner of Income Tax* [2008] [221 CTR 97 (Del HC)]

Facts of the case

(1) In the given facts of the case, six individual writ petitions were each filed by six different companies. In each of these writ petitions, the order of the TPO was challenged on the grounds that the TPO had not granted an oral hearing before determining the arm's length price in respect of international transactions entered into by the petitioners with their associated enterprises, even though the petitioners had asked for such hearing in the reply pursuant to the last show-cause notice.

(2) The fact that the order(s) of the TPO were passed in breach of the principles of natural justice and without considering the information furnished by the petitioners was also challenged in the writ petitions.

Decision of the High Court

The provisions of Sec. 92CA(3) cast an obligation on the TPO to afford a personal hearing to the taxpayer before the TPO proceeds to pass an order of determination of the arm's length price in terms of Sec. 92CA(3). It was also held that the determination of the arm's length price by the TPO cannot be sustained by taking recourse to the fact that the

taxpayer did not demand an oral hearing.

The High Court observed that the authorities which have a power to decide and whose decisions would prejudice a party, entailing civil consequences, would be required to accord an oral hearing even where the statute is silent.

The show-cause notice issued by the TPO prior to the determination of the arm's length price under Sec. 92CA(3) should refer to the documents or material available with the Assessing Officer in relation to the international transaction in issue.

Such show cause notice should give an option to the taxpayer to:

- inspect the material available with the Assessing Officer, and give an opportunity to file further material or evidence if he so desires; and
- seek a personal hearing in the matter.

16.1.2.2. *Coca Cola India Inc. v. Assistant Commissioner of Income Tax, Gurgaon & others* [2008] [309 ITR 194] (Punjab and Haryana)

In a significant judgement, the Punjab and Haryana High Court, while dismissing the writ petition filed by Coca Cola India Inc., held that there is no need to establish a diversion of profits outside India to determine applicability of the TPR. It was further held that assessments relating to periods prior to the introduction of the TPR could be reopened on the basis of subsequent transfer pricing orders passed under the TPR.

Facts of the case

(1) Coca Cola India Inc. had a branch office in India, which was engaged in rendering advisory services to an associated enterprise in India.

(2) The AO, on the basis of order passed by the TPO for the financial year 2001/02, issued notice for past 4 years after forming an opinion that the income had escaped assessment.

(3) Further, the TPO on reference made by AO issued a transfer pricing notice for these 4 years.

(4) Coca Cola India Inc. filed a writ petition before the Punjab and Haryana High Court.

Decision of the High Court

The Court held that assessments for the periods before the introduction of detailed TPR can be reopened on the basis of subsequent transfer pricing orders as the provision on the reassessment of escaped income under Sec. 147 of the Act is not in any manner controlled by Sec. 92 of the Act, nor was there any limit to the consideration of any material having nexus with the opinion on the assessment of escaped income.

The scope of the TPR is wide and squarely applicable in the case of any international transaction between two associated enterprises either or both of whom are non-residents. In the event the above conditions are fulfilled, there is no prerequisite to prove shifting of profits outside India/erosion of tax base in India.

The AO is not required to provide the taxpayer with an opportunity of being heard when referring the matter to the TPO for determination of the arm's length price.

This decision has reiterated that the scope of the TPR is wide and applicable to any "international transaction" between two associated enterprises.

16.1.2.3. *SET Satellite (Singapore) Pte Ltd v. Deputy Director of Income Tax* [2007-TIOL-116-ITAT-MUM]

In an important ruling, the Bombay High Court, in the case of *SET Satellite (Singapore) Pte Ltd* held that payment of a correct arm's length price to a dependent agent extinguishes the tax liability of a foreign entity having a PE in India on account of the dependent agent (i.e. DAPE).

Facts of the case

(1) SET Satellite (Singapore) Pte Ltd "(SET Satellite"), a foreign telecasting company, resident in Singapore, is engaged in the business of creating and operating satellite television channels, marketing and distributing such channels in India and providing related support services to Indian customers.

(2) SET Satellite through its dependent agent (which constituted a PE) carries on marketing activities in India by canvassing advertisements in India and remunerates the agent on an arm's length basis.

(3) The AO determined that SET Satellite earned income taxable in India and computed the tax base at 10% of the advertisement revenue.

(4) However, the CIT(A) affirmed SET Satellite's position that because the remuneration was made on arm's length terms, it had no further tax liability in India.

(5) Subsequently, the Mumbai ITAT reversed the decision of the CIT(A) and held that mere payment of arm's length remuneration to a dependent agent does not necessarily extinguish the tax liability of the foreign company in India. Aggrieved by the order of the Mumbai ITAT, SET Satellite filed an appeal before the High Court.

Decision of the High Court

The High Court, relying on the judgement of the Supreme Court in *Morgan Stanley*, held that if the correct arm's length price is applied and paid, then nothing further would be left to be taxed in the hands of the foreign enterprise.

SET Satellite had paid a service fee at 15% of gross advertisement revenue to its Indian agent (i.e. dependent agent PE) for procuring advertisement. The fact that the 15% service fee is an arm's length remuneration is supported by Circular 742 issued by the CBDT, which recognizes that the Indian agents of foreign telecasting companies generally retain 15% of the advertisement revenues as service charges.

In Circular 23, dated 23 July 1969, the CBDT had clearly laid down that where a non-resident's sales to Indian customers were rendered through the services of an agent in India, the assessment in India of the income arising out of the transaction shall be limited to the profit attributable to the agent's services.

Based on the above, the High Court set aside the order of the ITAT and held that advertisement revenue received by SET Satellite was not taxable in India. This ruling by the Bombay High Court provides reassurance to foreign enterprises with a dependent agent PE on the issue relating to attribution of profits, which has been resolved after the Supreme Court's ruling in the case of *Morgan Stanley*.

16.1.2.4. *Commissioner of Income Tax v. Gujarat Guardian Limited* [2008] 222 CTR 526 (Del)

In an important case of Gujarat Guardian Limited, the Delhi High Court allows commission payment for exports as deductible even when the export price for the goods is less than cost of production.

Facts of the case

(1) Gujarat Guardian Limited ("the Company") is a joint venture company which was engaged in the manufacturing of float glass in India under a collaboration agreement with its partners including a non-resident.

(2) Within the confinement of the said collaboration agreement, the Company could enter into an export sales agreement with the non-resident partner or any of its affiliates for the sale of float glass and the agent thus formed would be paid a commission of 5 per cent on the export price.

(3) The government accepted the collaboration agreement and the commission rate with a condition that the Company would export a minimum of 25% of its total production of float glass.

(4) The Company entered into an export sales agency with an affiliate of the non-resident partner ("Affiliate") and paid a commission of 12.5% on the export price to the affiliate and claimed a deduction for the above commission payment in its return of income.

(5) The Assessing officer (AO) disallowed the deduction entirely on the ground that exports were made at a price less than the cost of production resulting in losses.

(6) The CIT(A) accepted to the extent of 5% which was approved by the government of India in the collaboration agreement on the basis that exports were made at a price prevailing in the international markets even though it was less than the cost of production. The CIT(A) also observed that the affiliates had provided necessary sale services for promotion of exports which could be demonstrated by increase in turnover of the Company.

(7) The Tribunal held that once it is decided that services were rendered by the affiliate, the quantum of commission paid is purely at the unconstrained choice of the Company. Unless Revenue produces some contrary evidence, disallowance cannot be made under Sec. 40A(2) and also under Sec. 92 as the TPO had already accepted the same.

Decision of the High Court Delhi

The Court upheld the decision of the Tribunal and pronounced no further adjustment.

16.1.2.5. *Maruti Suzuki India Ltd v. ACIT* (2010) W.P.(C) 6876/2008 (NEW DELHI)

Facts of the case

Maruti Suzuki India Limited (Maruti) is engaged in the business of manufacturing passenger cars and spare parts in

India. Suzuki Motor Corporation, Japan (Suzuki) holds the majority of shares in Maruti. The trademark (logo) “M” is the registered trademark of Maruti. In 1992, Suzuki entered into an agreement under which Suzuki agreed to grant a license to Maruti for the manufacture and sale of specified models of cars. Under this agreement, Maruti was obligated to use the trademark “Maruti Suzuki” on all the products and parts manufactured pursuant to this agreement. Further, since 1993, Maruti replaced the logo “M” of Maruti by “S”, being the logo of Suzuki on the front of the cars manufactured and sold by it. At the same time it started using the “Maruti” mark along with the word “Suzuki” on the rear side of the vehicles.

For assessment year 2005-06, the transfer pricing officer issued a notice to Maruti alleging that the change of logo from “M” to “S” amounted to sale of brand “Maruti” to Suzuki. The transfer pricing officer computed the value of brand at INR 4420 crore by adding a markup of 8%.

Maruti challenged the jurisdiction of the transfer pricing officer as well as the proposed approach in determining transfer pricing adjustment. It argued that it continued to use its brand and logo “Maruti” on its products and even on the rear side of the cars the “Maruti” trademark was used along with the word “Suzuki”. It also argued that Suzuki allowed Maruti to use the “Suzuki” name and logo to ward off competition from multinationals in India without any charge from Suzuki.

Being dissatisfied with the approach of the officer, Maruti filed a writ petition seeking stay of the proceedings before the transfer pricing officer. The Delhi High Court gave an interim order wherein it allowed the proceedings but said that the order of the transfer pricing officer, if passed, would not be given effect until the final order of High Court in the matter.

While the writ petition was pending, the transfer pricing officer passed his final order, observing that Maruti created the Suzuki brand by incurring more than routine advertisement expenses; he also disallowed a part of the royalties paid to Suzuki.

Writ Petition before the High Court

The notable issues dealt with by the High Court in the writ petition filed by the taxpayer are discussed below.

A. Defect in the show cause notice (the notice) issued by the transfer pricing officer

Based on the observation that there was a serious disconnect between the show cause notice and the final order, the High Court came to the conclusion that the transfer pricing officer had not provided sufficient opportunity to the taxpayer. The High Court proceeded to examine the order of the transfer pricing officer to decide whether to quash the proceedings or to remit the matter back to the transfer pricing officer for a fresh decision.

B. Determination of arm’s length price of royalties paid for use of Suzuki brand by Maruti

The transfer pricing officer noted that Maruti had paid royalties of INR 198.6 crore to Suzuki as a consolidated payment for both the technical know-how and use of the trademark of “Maruti Suzuki”. The transfer pricing officer apportioned 50% of the payment towards the use of the trademark and arrived at royalties of INR 99.3 crore for such trademark.

The basic observation of the transfer pricing officer was that the “Suzuki” and “S” trademark had piggybacked on the trademark of the assessee “Maruti” or “M”, which was developed as a super-brand over a period of time at a tremendous economic cost without any compensation to the assessee. On the other hand, Suzuki charged royalties to the assessee for use of its “Suzuki” brand in co-branded trademark without any gain to Maruti. It was argued that these two were comparable; and as Maruti did not charge anything from Suzuki, the latter should not have charged for the use of the brand name. Based on this, the payment of INR 99.3 crore paid to Suzuki was considered to be not at arm’s length and was valued at nil.

Maruti argued against this on the following grounds:

- de-licensing of the passenger car industry in India led to a massive increase in competition and posed a great threat to Maruti. It therefore felt a need to project itself as an international brand, so as to counter the competition. Use of the “Suzuki” trademark helped the assessee to ward off the competition; and
- Maruti had received a subsidy from Suzuki in payment of royalties, as Reserve Bank of India guidelines permitted payment of royalties up to 5% of the turnover, while it paid royalties at lesser rate.

Significant observations and ruling of High Court

The High Court appreciated the need for a royalty agreement and the need to use the Suzuki brand name. The Court observed that this was necessary to challenge competition in the market. It expressed the view that the department failed to establish that Maruti had become a super-brand and, therefore, Maruti did not need Suzuki’s brand name and logo on its products. The Court also observed that it was not obligatory for

Maruti to use the Suzuki logo on the products manufactured and sold by it in India, although Maruti, at its discretion, could use that logo on those products, as well.

The High Court noted that Maruti was contractually obligated to use the joint trademark "Maruti Suzuki" on all the vehicles, as well as the parts manufactured and/or sold by Maruti in India. Compulsory use of the trademark, even when the domestic entity does not require it, indicates a benefit to Suzuki in the form of brand building in the domestic market by its display and use on the product, as well as its packaging. The Court opined that had Maruti had discretion to use the joint brand name "Maruti Suzuki", this would not necessarily have entailed payment from Suzuki to Maruti for use of the name "Suzuki" in the joint trademark "Maruti Suzuki". The High Court went on to rule that it may not always be possible for the transfer pricing officer to devise an objective and fair method to assess the monetary value of the benefit obtained by Suzuki on account of compulsory use of the joint trademark "Maruti Suzuki". In such a situation the transfer pricing officer should determine the arm's length price in respect of benefits obtained and obligations incurred by both Maruti and Suzuki under the composite agreement by finding out what payment, if any, a comparable independent domestic entity would have made in respect of an agreement of the nature entered into between Maruti and Suzuki.

C. Determination of arm's length price for developing the brand of Suzuki, if any, in India by Maruti

The transfer pricing officer noted that Maruti incurred advertisement expense in excess of what comparable companies would have incurred. While arriving at this conclusion, he compared the advertisement expense/sales ratio of Maruti with the advertisement expense/sales ratio of Hindustan Motors, Tata Motors and Mahindra and Mahindra Limited. As Hindustan Motors and Tata Motors did not incur any advertisement expense, comparison was made with Mahindra and Mahindra Limited which incurred advertisement expense to the tune of 0.876% of sales (as against 1.843% in case of Maruti).

The assessee argued that incurring advertisement expense does not give rise building of Suzuki brand in India. It was argued that Maruti had benefited from the marketing efforts made by it, as it had achieved average growth of 18% per year in the last 13 years, and the advertisement, marketing and promotion expense incurred by Maruti is in line with the advertisement, marketing and promotion expense of industry.

Significant observations and ruling of the High Court

Unless it is shown that the expenses incurred by the Indian entity towards the marketing, promotion and advertisement of its product, using the brand or logo of the foreign entity on promotions and advertisements, etc. are more than what a comparable independent entity would have incurred, it cannot be presumed that the additional expense incurred by the domestic entity was aimed at benefiting a non-resident associated enterprise entity and was influenced by it on account of managerial and/or financial control, which it exercised over the domestic entity. It observed that the transfer pricing officer should have found and selected appropriate companies that could have been good comparables, considering its nature of products; number of products launched by it in the market; the territories served by it; and the turnover and profit achieved by it. Having observed the above, the High Court ruled that the transfer pricing officer must take an overall view of all the rights obtained and obligations assumed by Maruti vis-à-vis Suzuki, and then determine the appropriate arm's length price of international transactions.

Conclusion

The High Court concluded that that the order passed by the transfer pricing officer was without any basis and could not be substantiated by evidence. The procedure followed by him was faulty, the approach adopted by him was erroneous and the order passed by him was arbitrary and irrational. Therefore, the order passed by the transfer pricing officer was set aside and he was directed to determine the appropriate arm's length price in respect of international transactions in terms of Sec. 92C of the Income Tax Act, 1961, bearing in mind the observations made by the High Court.

16.1.3. Income Tax Appellate Tribunal (ITAT) cases

16.1.3.1. *Aztec Software & Technology Services Limited v. ACIT* [2007] 294 ITR (AT) 32 (Bang.)

In this case, the Special Bench of the ITAT, Bangalore pronounced its decision on the various legal, procedural and factual issues pertaining to transfer pricing. Observations were also made in respect of the principles governing the selection of comparables and the most appropriate method by the taxpayer and the Transfer Pricing Officer (TPO).

Facts of the case

(1) The taxpayer is engaged in the business of development and export of software and enjoys the tax benefits under the Act.

(2) During the financial year 2001/02, the taxpayer had international transactions with its subsidiary in the United States in respect of availing itself of marketing services and onsite software development services.

(3) The taxpayer had remunerated the US subsidiary for these services on a cost-plus basis.

(4) The TPO had made adjustments in respect of both the international transactions on the basis of industry-average hourly rates available on the website of industrial association (NASSCOM data) and certain lateral comparables when determining the arm's length price.

(5) In the first level of appeals, the CIT(A) deleted the addition and the taxpayer as well as the tax authorities were in appeal before the ITAT on various issues.

Decision of the ITAT

Although the TPR are placed in the Act under the chapter on special provisions relating to avoidance of tax, it is not necessary that the Assessing Officer (AO) demonstrate avoidance and diversion of tax before invoking the TPR.

The AO is not required to record the reason or opinion before seeking the approval of the Commissioner.

The AO only has to be satisfied that it is "necessary" or "expedient" to make a reference to the TPO. It is not necessary that the taxpayer be given an opportunity before a reference is made. However, the AO should have some material with him to justify reference to the TPO.

Instruction issued by the CBDT, stating a quantifiable criterion of INR 50 million (which is now increased to INR 150 million) as total value of international transactions for selection of cases for audit, is valid in law.

The order of the TPO is not binding on the AO (prior to 1 June 2007).

The ITAT accepted that transfer pricing is a subjective exercise and is fact based. It made several observations; some of the more important ones are as follows:

- the burden of proof is on the taxpayer to establish the arm's length price and to maintain the related prescribed documentation;
- a proper function, asset and risk analysis would be very relevant and has direct bearing on the determination of comparables and the arm's length price;
- for resolving transfer pricing disputes, useful reference can be made to the OECD TP Guidelines; and
- the TPO should give a valid reason for rejecting the method adopted by taxpayer. Adjustment is warranted only if there are material differences between the price shown and the arm's length price.

The ITAT remanded the matter back to the AO for determination of an arm's length price.

16.1.3.2. *I-Gate Global Solutions Limited v. ACIT* [2007] 112 TTJ 1002 (Bang.)

This case is important from the perspective of a software or service exporter. Sec. 10A of the Act provides that under specified conditions such income would be exempt from taxation. However, if an adjustment under the TPR is made on such income, then the benefit under Sec. 10A of the Act is denied.

Facts of the case

(1) I-Gate Global Solutions Limited ("I-Gate") had entered into transactions with an associated enterprise and determined the arm's length price.

(2) Since the arm's length price so determined was more than the consideration at which the transactions were shown in the books of account, I-Gate, *suo moto*, made an adjustment to its total income and accordingly claimed a deduction under Sec. 10A of the Act.

(3) The AO, however, rejected the claim and denied deduction under Sec. 10A on the adjusted income so returned by I-Gate. The position of the AO was confirmed by the CIT(A).

Arguments of I-Gate

(1) The representative of I-Gate referred during the course of proceedings to the word "enhanced". In case the income is enhanced, then deduction is not permissible under Sec. 10A of the Act. However, in the instant case, income had not been enhanced because it was already returned by the taxpayer.

(2) In the Memorandum explaining the provisions of the Finance Bill 2006, it has been stated that:

> Under Subsec. (4), it has been provided that on the basis of arm's length price so determined, the AO may compute the total income of an assessee. First proviso to Subsec. (4) provides that where the total income of the assessee as computed by AO is higher than the income declared by the assessee, no deduction under

the assessee as computed by AO is higher than the income declared by the assessee, no deduction under Sec. 10A or Sec. 10B or under Chapter VI-A of the Act will be allowed in respect of the amount of income, by which the total income of the assessee is enhanced after computation of income under Subsec. [...]

(3) From the memorandum explaining the provisions of Finance Bill, 2006 as well as from the literal meaning of the word “enhanced”, it is clear that if income increased as a result of computation of the arm’s length price, such increase is not to be considered for deduction under Sec. 10A of the Act. In the instant case, the taxpayer itself had computed the arm’s length price and disclosed the income on the basis of such price. It is not a case where there is an enhancement of income due to determination of the arm’s length price by the AO.

(4) I-Gate contended that there was no income that had been enhanced by the AO since it had already declared such adjusted income considering the arm’s length price when filing its return of income and, consequently, was eligible for deduction under Sec. 10A of the Act on such enhanced income.

Decision

The ITAT accepted the contentions of I-Gate and observed that I-Gate had itself computed the arm’s length price and disclosed the income on the basis of such arm’s length price.

The ITAT further observed that this was not a case where there was an enhancement of income due to determination of the arm’s length price by the AO.

Based on the above, the ITAT held that I-Gate was entitled to deduction under Sec. 10A of the Act on the adjusted returned income.

16.1.3.3. *Cargill India (P.) Ltd v. Deputy Commissioner of Income Tax* [2008] 110 ITD 616 (Delhi)

This case emphasized the procedural provisions and principles of natural justice based on a meaningful interpretation of the law.

The taxpayer has been spared from the levy of penalty of INR 400 million by the tax authorities on account of improper application of the provisions relating to furnishing of information and documents required under the TPR, especially in view of the voluminous documentation requirements under Rule 10D.

The ITAT concluded that initiation of penal proceedings for a mere delay of about a month or so in the submission of the information or the documents is not imposable.

Considering the current trend of aggressive positions taken by the TPOs, the decision comes as a welcome relief to taxpayers, as it provides assurance to taxpayers that the powers conferred to the tax authorities would be judiciously exercised.

Facts of the case

(1) The taxpayer, an Indian subsidiary of a Mauritian-based company with ultimate control in the United States, is engaged in the business of import, export and domestic trading of food products, and had international transactions with its associated enterprises during the relevant financial year 2002/03.

(2) Pursuant to the notice under Sec. 92CA(3) of the Act, the taxpayer filed all the required information, i.e. balance sheet, profit and loss account and audit report.

(3) The TPO concluded the case by making an adjustment. The AO on recommendation of the TPO levied the penalty for not furnishing information within the stipulated time.

(4) The CIT(A) upheld the order of the AO.

Decision of the ITAT

Basic/initial data for initiating determination of the arm’s length price is contained in the Audit Report and Form 3CEB, which was filed on time by the taxpayer.

The TPO should not “casually” ask for information under all clauses and/or sub-rules of the TPR in a mechanical manner, without drawing references to specific clauses under the Rules where any information/document are required from the taxpayer.

Specific clauses with reference to which there was failure to furnish information should be mentioned in the show-cause notice issued to afford reasonable and adequate opportunity to the taxpayer to present the case and serve the purpose of the notice.

No penalty can be imposed for failure to furnish documents on time if such failure is proved to be due to a “reasonable cause” by the taxpayer.

16.1.3.4. *Development Consultants Pvt Ltd v. DCIT* [2008] 23 SOT 455 (Kol.)

In this case, the ITAT focuses on the concept of tested party, use of foreign comparables and the 5% range.

Facts of the case

(1) The taxpayer is an Indian construction and engineering services company providing concept-through-completion services for implementing diverse core sector and high-technology projects around the world.

(2) During the financial years 2002/03 and 2003/04, the taxpayer had undertaken various international transactions with its associated enterprises based in the Bahamas and the United States.

(3) The TPO ignored the contention of the taxpayer and made a transfer pricing adjustment for both financial years. The CIT(A) upheld the order of the AO.

Decision of the ITAT

The arm’s length price should be determined on a transaction-by-transaction basis and not on an aggregate basis, as had been done by the TPO.

It is first necessary to select the “tested party”, which should be the least complex of the controlled taxpayers engaged in the transaction, which does not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.

Application of the resale price method is proper, whereby the gross margins of the foreign tested party as the distributor of services is compared with the gross margins of comparable uncontrolled foreign comparables obtained through a foreign database.

16.1.3.5. *Egain Communication Pvt Ltd v. ITO* [2008] 23 SOT 385 (Pune)

The ITAT pronounced its decision involving factual issues pertaining to transfer pricing on the selection of reliable comparables.

Facts of the case

(1) The taxpayer is a captive service provider engaged in the business of rendering software development services to its parent company in the United States. During the financial year ended 31 March 2004, this international transaction was benchmarked by the taxpayer, applying the TNMM, based on a net cost plus markup of 5%.

(2) During the course of audit, the TPO rejected the comparables selected by the taxpayer. Based on new comparables, with a turnover ranging from INR 82.9 million to INR 3,606.1 million, the TPO computed an average net cost plus markup at 16.12% and made an adjustment accordingly.

(3) The CIT(A) considered the net cost plus markup of companies having a smaller range of turnover and upheld the order of the TPO. Subsequently, the taxpayer filed an appeal before the ITAT.

Decision of the ITAT

The ITAT in its order appreciated that the taxpayer, being a risk-free captive service provider, did not bear any transactional risk on its international transaction with the US parent and that hence risk adjustments were required to enhance comparability with comparable companies.

Importantly, it was held that depreciation computations are required to be worked out under the Indian Companies Act (and not US GAAP) and that the profitability of the taxpayer needs to be appropriately adjusted on account of depreciation. The ITAT also excluded certain companies from the final list of comparables for reasons of non-comparability with the taxpayer.

Based on the principles mentioned in the OECD TP Guidelines and the above facts, the ITAT held that the arm’s length price as determined by the TPO was not sustainable.

The ITAT made several observations, the more pertinent ones being the following:

- turnover alone is not the relevant factor for comparability purposes; it is also necessary that functions performed, assets employed and risks borne be taken into consideration;
- parameters such as nature or line of business, product or service market, the assets employed, size and scope of operation and the stage of business or product cycle should be considered in ascertaining comparability;
- it is appropriate to adjust the operating profit of both the tested and comparable parties to enhance comparability; and
- adjustments should be made for material differences during a comparability analysis. If the differences between

the companies are so material that adjustment is not possible, then the comparables should be rejected.

The order of the ITAT focused on addressing issues of comparability frequently faced by taxpayers. Further, the reference to the OECD TP Guidelines will be helpful in resolving transfer pricing disputes and align Indian comparability analysis with established global norms.

Based on the ITAT's observations, this may be an opportune moment to consider the introduction of the arm's length range concept for benchmarking analysis in India. This will largely assist the tax authorities, as well as the taxpayers, to reduce the administrative burden and litigation.

16.1.3.6. *Mentor Graphics (Noida) (P.) Ltd v. DCIT* [2007] 109 ITD 101 (Delhi)

In this case, the ITAT pronounced a decision on the important issues of selection of appropriate comparables and the importance of undertaking a robust economic, functional and risk analysis when determining the arm's length price.

The observation of the ITAT on the selection of comparables and the due emphasis on function, asset and risk analysis will assist in resolving transfer pricing disputes, especially in cases of outsourcing units.

Facts of the case

(1) Mentor Graphics (Noida) Private Limited is a captive service provider engaged in the business of rendering software development services to its parent company (IKOS Systems Inc. USA). During the financial year ended 31 March 2002, this international transaction was benchmarked by the taxpayer applying the transactional net margin method (PLI – net cost plus).

(2) During the audit, the TPO rejected the comparables (except for one) selected by the taxpayer and selected new comparables in computing the average cost-plus at 24.53% and made an adjustment accordingly.

(3) The CIT (A) upheld the order of the TPO; the taxpayer was in appeal before the ITAT.

Decision of the ITAT

The ITAT appreciated that transfer pricing is not an exact science but is an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out. A minimum requirement is to show, prima facie*,* that the controlled international transaction was properly examined, and that comparable and the arm's length price were fixed objectively and honestly, and in a bona fide manner as required by the statutory regulations.

The ITAT, after a detailed discussion, held that the taxpayer had carried out a valid characterization of itself as an entity bearing limited risk and had selected comparables with proper screening and a detailed analysis. The TPO did not specifically reject the comparables, which were selected by the taxpayer.

The ITAT further observed that the TPO did not establish that the comparables selected by him carried a functional and risk profile similar to those of the taxpayer; this was also reflected in the high profit margin of such comparables. Additionally, there were inconsistencies in the application of screening factors by the TPO.

Under these facts, the ITAT accepted a smaller range of comparables (ignoring highly profit or loss-making companies) and held that the entire range is representative of an arm's length range. Accordingly, the ITAT did not approve the order of the TPO and held that the arm's length price determined by the TPO was not sustainable.

The ITAT has made several observations; some of the more important ones are as follows:

- selection of comparables is to be made considering the specific characteristics of the controlled transaction – functions performed and assets deployed (including intangibles), rather than a broad comparison of activities;
- if there are differences in the functions, assets and risks profile of the taxpayer and that of comparables that can be adjusted for, then adjustments (working capital, risk and growth, R&D expenses) should be made. If the differences between the companies are so material that adjustment is not possible, then comparables should be rejected;
- risk can be borne in many varied forms and a sound risk analysis comparing the risk profile of the taxpayer and that of comparables is necessary when selecting the comparables. Certain significant risks such as market risks, contract risks, credit and collection risks, infringement of intellectual property rights, etc., are material and can lead to major differences in the value of a transaction; and
- the arm's length principle does not mean the maximum price or maximum profit in the range should be used. It is not necessary for the taxpayer to satisfy all points (margins) in the range. Even if one point (margin) is satisfied, the taxpayer can be taken to have established its case.

16.1.3.7. *Ranbaxy Laboratories Ltd v. Additional Commissioner of Income Tax* [2008] 110 ITD 428 (Delhi)

This decision deals with revision of the transfer pricing order by the Commissioner of Income Tax (CIT) under Sec. 263 of the Act and certain transfer pricing principles.

Facts of the case

(1) The taxpayer is engaged in the business of manufacture and sale of pharmaceutical products.

(2) During the financial year 2003/04, the taxpayer exported goods and services to its associated enterprises. The prices charged by the taxpayer from its associated enterprises were determined to be at arm's length, using TNMM with the PLI of operating margin on sales (OPM). The OPMs of the associated enterprises were lower than the average OPM of the overseas comparable companies.

(3) The CIT invoked the provisions of Sec. 263 based on the following grounds:

- the determination of the arm's length price was not referred by the AO to the TPO as required by Instruction 3/2003 dated 20 May 2003 of the CBDT; and
- TNMM was used as the MAM and the PLIs of the associated enterprises were tested instead of the PLI of the taxpayer.

Decision of the ITAT

The ITAT held that officers functioning under the CBDT must follow instructions issued by the CBDT to regulate the assessment proceedings, and thereby upheld the decision made by the CIT for invoking the provisions of Sec. 263 of the Act.

The tested party normally should be the party for which reliable data for comparison are easily and readily available and for which fewer computational adjustments are needed.

The ITAT contended that no transfer pricing adjustment should be made if the tested party (i.e. the foreign distributor of services) earns gross margins within the arm's length level as determined through the foreign benchmarking exercise, after allowance of the 5% flexibility from the arithmetical mean as per provisions of the Act. As a result, the assessee was allowed significant relief on the transfer pricing adjustments for financial years 2002/03 and 2003/04.

16.1.3.8. *Rolls Royce Plc v. Dy. Director of Income Tax* [2007] 125 ITD 136 (Delhi)

In this case, the ITAT held that Rolls Royce Plc, UK has a PE in India for marketing activities and that 35% of the company's profits are attributable to such PE.

Facts of the case

(1) Rolls Royce PLC (RRP), incorporated in the United Kingdom and a tax resident of that country, being a non-resident foreign company for the purpose of tax assessment in India, had not filed any income tax returns in India.

(2) RRP supplied aeronautical engines and spare parts to certain defence establishments in India. It had a wholly owned subsidiary in India, Rolls Royce India Ltd (RRIL). The Assessing Officer was of the view that RRP had a business connection in India under Sec. 9 of the Act as well as a PE in India under Art. 5 of the India-United Kingdom treaty.

(3) The AO found that RRP was marketing and selling goods to Indian customers through its PE in India and that the profits attributable to the PE were subject to tax in India under Art. 7 of the treaty.

(4) The AO invoked Rule 10 and attributed 75% of the company's profits in assessment years 2002/03 and 2003/04 to such PE in India. The CIT(A) upheld the AO's order.

Decision of the ITAT

The employees of RRP visited India frequently and the premises of RRIL were occupied and used during such visits. RRP reimbursed RRIL the expenses for the operation and maintenance of the office in India and also compensated RRIL for the support services it rendered.

The ITAT found that the premises, although in the name of RRIL, were occupied by RRP for purposes of its business operations in India. Accordingly, the ITAT held that RRP had a PE in India within the meaning of Art. 5(1) of the India-United Kingdom treaty.

The ITAT held that the profits accruing directly or indirectly from the marketing activities in India were taxable in India.

The ITAT allocated 50% of the profits to manufacturing activity that could not be taxed in India and 15% of the profits to research and development activity conducted outside of India. The balance of 35% of the profits was attributable to the marketing activity that was carried out in India and was therefore taxable in India.

16.1.3.9. *Star India Pvt Ltd v. ACIT* [2008] TIOL-426-ITAT-MUM

Facts of the case

(1) Star India Pvt Ltd ("Star") was engaged in the business of: (a) distribution of satellite television channels of the Star group in the designated regions; (b) providing agency services in connection with the advertisement sales in the assigned territory of India to the Star Group; and (c) content procurement services and acting as a creator/producer of various types of content for sale to its group entities.

(2) For the purpose of benchmarking, Star treated the above three activities as distinct businesses and carried out a transfer pricing analysis in respect of each activity separately.

(3) However, during the course of assessment, the TPO rejected the transaction/business-wise analysis undertaken by Star and aggregated all the businesses and benchmarked the entire company using a new set of comparables. Based thereon, the TPO made an adjustment to the value of the international transactions.

(4) The CIT(A) upheld the order of the TPO; the taxpayer was in appeal before the ITAT.

Decision of the ITAT

Aggregation of transactions

The ITAT accepted the position of Star that the international transactions must be analysed on a transaction-by-transaction basis and concluded that the aggregation of the three business activities was not appropriate.

Determination of arm's length price

The ITAT held that the computation of the arm's length price is a factual exercise and that each case has its peculiar facts and circumstances. There should be proper analysis with reference to the functions performed, assets employed and risks assumed by the respective parties with reference to the transactions in question.

However, the ITAT found that Star had not used appropriate comparables in its analysis and that the TPO had not determined the arm's length price in accordance with judicial precedents. Accordingly, the ITAT sent the matter back to the AO and TPO for proper determination of the arm's length price of the international transactions.

Burden of proof

The ITAT observed that the burden of proving the arm's length nature of the international transactions is on the taxpayer. In a situation where the tax authorities are not satisfied with the analysis undertaken by the taxpayer, the responsibility of determining such arm's length nature shifts to the tax authorities to determine the same in accordance with statutory regulations.

16.1.3.10. *Sony India P. Ltd v. CBDT (Del)* [2007] 288 ITR 0052

The Delhi ITAT decided on various transfer pricing issues, including comparables selection, inclusion/exclusion of income/expenditure items in computation of operating profit and application of the +/- 5% range (safe harbour) in the determination of the arm's length price.

Facts of the case

(1) Sony India (P) Limited ("Sony") is a wholly owned subsidiary of Sony Corporation, Japan. Sony is engaged in assembly and distribution of colour televisions and audio products.

(2) For the assessment years 2002/03 and 2003/04, Sony had claimed before the tax authorities that all its international transactions with its associated enterprises were at arm's length.

(3) Sony was subjected to certain adjustments in respect of its international inter-company transactions by the TPO.

(4) Subsequently, on appeal to the CIT(A), the CIT(A) affirmed the order of the TPO on most of the grounds. Being aggrieved by the order of the CIT(A), both taxpayer and the Revenue preferred the appeal before the ITAT.

Decision of the ITAT

The ITAT upheld the contention of Sony that certain comparables should not be excluded on account of insignificant related-party transactions. It was held that an entity can be taken as uncontrolled if its related-party transactions do not exceed 10% to 15% of total revenue.

The ITAT held that if there are differences between the comparable and the tested party and adjustments are possible, then such adjustments are to be made. Based thereon, the ITAT upheld the order of the TPO in relation to allowability of deduction of 20% from the mean margin of comparable companies on account of difference in risk profile, ownership of intangibles and R&D, etc.

In relation to export of television sets to the associated enterprises, the ITAT held that under-utilization of capacity cannot justify export of finished goods at a price less than the price to any unrelated party. It should be shown that a

cannot justify export of finished goods at a price less than the price to any unrelated party. It should be shown that a similar price was charged for similar items in similar circumstances.

In relation to inclusion of reimbursement of marketing costs received by Sony from the associated enterprises, it was held that the actual transaction entered into with the associated enterprises has to be considered and that the authorities have no right to rewrite the transaction unless it is held that it is a sham or is entered into to avoid and evade taxes. The Tribunal was of the view that the TPO and other revenue authorities were not justified in equating this reimbursement with equity, a windfall gain, a subsidy or some ad hoc payment.

It was held that the marginal benefit of applying a +/- 5% range applied to arm's length prices under the TPR is applicable to all cases irrespective of whether the price of international transactions disclosed by the taxpayer is beyond (outside) the +/- 5% range. The ITAT observed that legislation allowed the marginal benefit of the +/- 5% range considering that the arm's length price determined on application of the MAM is only an approximation and is not a scientific evaluation.

16.1.3.11. *Amadeus Global Travel Distribution S.A.* similar facts and decision in the case of *Galileo International Inc.*

Facts of the case

(1) Amadeus Global Travel Distribution S.A. ("Amadeus"), a resident of Spain, was in the business of maintaining and operating a system, referred to as "Amadeus System", for providing electronic global distribution services to airlines by connecting them to travel agents (TAs), utilizing the Computerized Reservation System (CRS) (which, inter alia, includes a system that receives, processes, stores and disseminates data about flight schedules, seat availability, fare information and provision for booking capabilities, etc.).

(2) Amadeus entered into a distribution agreement (DA) with a national marketing company incorporated in India, viz. Amadeus India Pvt Limited (AIPL), for exclusive marketing and distribution of the CRS services to the TAs in India (for a mutually agreed fee, which was based on the net segment processed through the Amadeus System by TAs located in AIPL's territory).

(3) The AO alleged that Amadeus had a "business connection" as well as an agency PE/fixed place PE in India. Based thereon, the entire income generated by Amadeus from bookings made from the Indian territory was held to be taxable in the hands of Amadeus in India.

(4) The CIT(A) confirmed that on the facts of the case, income is deemed to accrue or arise in India as Amadeus had a business connection/PE in India and assets of Amadeus through which display is made were located in India.

Decision of the ITAT

While referring to the provisions under the Act, the ITAT held that the availability of access to the CRS and configuration of subscribers, i.e. TAs in India, and the consequent performance of ticketing and booking functions, result in a business connection as per Sec. 9(1)(i) of the Act. However, only income which is reasonably attributable to the Indian operations based on functions performed, assets used and risks undertaken is liable to be taxed in India; as this income was less than the remuneration paid to the Indian agents, there will be no further income liable to tax in India, considering Circular 23 of July 1969.

Referring to the India-Spain treaty, the ITAT held that existence of CRS in India in the form of configuration and connectivity of such system through which booking activities can be performed in India was held to constitute a fixed-place PE. The services provided by the Indian distributor in relation to marketing and distributing the CRS in India were held to constitute an agency PE.

In order to determine the profits to be attributed to such PE, one has to look into factors such as functions performed, assets used and risks undertaken by the PE. As long as the agent is remunerated fully, nothing further is left to be attributed to the PE and therefore there will be no further income liable to tax in India.

Only 15% of the revenue accruing to Amadeus in respect of bookings made in India was considered as income accruing or arising in India.

16.1.3.12. *Philips Software Centre Private Limited v. Asst. Commissioner of Income Tax* [119 TTJ 721 (Bangalore) (ITAT)]

The ITAT delivered an important judgement on various aspects of transfer pricing. The ITAT dealt with the core transfer pricing issues relating to the trigger point for the TPO to conduct an audit, use of contemporaneous data by "specified date", rejection of related-party transactions, quantification of adjustments, confirmation of safe-harbour provisions, etc.

Facts of the case

(1) Philips Software Centre Private Limited, India ("Philips"), a wholly owned subsidiary of Royal Philips Electronics NV, the Netherlands, is engaged in provision of software development services to associated enterprises. Philips is entitled to a tax holiday under Sec. 10A of the Act relating to the financial year 2002/03.

(2) While preparing the transfer pricing documentation for the financial year 2002/03, Philips selected the CPM as the MAM for determining the arm's length price. Further, Philips undertook a corroborative analysis using the TNMM. Based on the analysis, it was concluded that as the net profit margin of Philips was higher than the arm's length price, the international transactions with the associated enterprises are at arm's length.

(3) The TPO rejected the transfer pricing analysis conducted by Philips and proposed an adjustment by determining the arm's length margin on cost of 21.14% as against the margin of 5.7% earned by the taxpayer.

(4) The above adjustment was upheld by the CIT(A), providing a marginal relief to Philips by reducing the arm's length margin from 21.14% to 20.47%.

(5) Aggrieved by the order of the CIT(A), Philips approached the ITAT.

Decision of the ITAT

In the instant case, since Philips was availing itself of the benefits of Sec. 10A, it would be devoid of logic to argue that it had manipulated prices and shifted profits to an overseas jurisdiction for avoiding taxes in India.

The ITAT held that Philips had discharged its onus by conducting a proper comparability analysis. There was nothing in the order of the AO/TPO to suggest that any one of the four conditions in Sec. 92C(3)(c) were satisfied.

It was held that Philips conducted its analysis by using a database in October 2003, which was close to the "specified date" of 30 November 2003, whereas the TPO conducted a fresh comparability analysis during the course of audit proceedings, which was beyond the "specified date". Such an analysis was conducted by the TPO using data which was not "contemporaneous" and, hence, the analysis conducted by the TPO was not in compliance with the provisions of Rule 10D(4).

The ITAT held that, as there were no shortcomings in the method adopted by Philips, the TPO was not justified in considering another method as the MAM.

The ITAT held that a company having even a single rupee of related-party transactions should not be considered as a comparable company for the purpose of comparability analysis.

The ITAT upheld the contention of Philips relating to adjustment to the margin of comparables to eliminate differences on account of functions, assets and risks. The ITAT agreed to the approach adopted by Philips with regard to quantifying the risk adjustment that was derived by subtracting the risk-free "bank rate" from the prime lending rate (PLR). Further, approving the basis for computing working capital adjustment adopted by Philips, the ITAT held that the computation was within the guidelines of the draft guidance on comparability issued by the OECD.

The TPO had grossly erred in "normalizing" the profits of super-profit-making companies. Such companies should have been excluded from the list of comparables.

The ITAT held that the proviso to Sec. 92C(2) of the Act provides a standard deduction of 5% to taxpayers. The only condition for availing of this benefit is that it is subject to the option of the taxpayer.

The ITAT also upheld the ratio of the decisions of the ITAT in the cases of *Mentor Graphics (Noida) (P) Limited* and *E-gain Communications Ltd*.

The ITAT made several observations; some of the more important ones are as follows:

- since the basic intention behind introducing the transfer pricing provisions in the Act is to prevent shifting of profits outside India, and the taxpayer is claiming benefit under Sec. 10A of the Act, the transfer pricing provisions ought not to be applied to the taxpayer. Circular 14/2001 issued by the CBDT is binding upon the TPO;
- there was no infirmity in the transfer pricing study conducted by the taxpayer and the TPO erred in disregarding it for the purpose of computing and framing the assessment and making the transfer pricing adjustment. The TPO or the AO needs to satisfy and communicate to the taxpayer the relevant clause under Sec. 92C(3), which has been triggered by the taxpayer, that has necessitated the application of provisions of the transfer pricing provisions in the instant case. Since this was not demonstrated to the taxpayer, the transfer pricing order is void;
- the TPO erred in disregarding the most appropriate method adopted by the taxpayer in the transfer pricing study and also in using the PROWESS database. The TPO did not provide any reason for deviating from the transfer pricing study in respect of these matters. The transfer pricing study cannot be ignored by the TPO in the absence of any deficiency or insufficiency. Further, the order passed by the TPO appears to have been passed with the intention of making a higher transfer pricing adjustment;

- adjustments need to be made to the margins of the comparables to eliminate differences on account of different functions, assets and risks. More specifically, adjustments need to be made for: (a) differences in risk profile; (b) differences in working capital position; and (c) differences in accounting policies.

The ITAT concluded that the transactions of Philips with its associated enterprises satisfied the arm's length test and that the order of the TPO was bad in law and on the facts. This ruling may be of practical assistance to taxpayers in transfer pricing audits.

16.1.3.13. *Honeywell Automation India Ltd v. Dy. Commissioner of Income Tax* [2009] TIOL-104-ITAT-PUNE ITA No. 4/PN/08

The ITAT held that the data of current-year and operating items of the income statement be considered for analysing the comparability under the TPR.

Facts of the case

(1) Honeywell Automation India Limited ("Honeywell") is engaged in the business of providing integrated automation and software solutions.

(2) The TPO carried out a fresh analysis and, after finding five uncontrolled comparables, worked out a mean margin of the operating profit (OP) on sales (OP/sales) of such comparables at 0.42% as against a negative figure of (0.84%) disclosed by Honeywell, and made an adjustment.

(3) The adjustment made was appealed by Honeywell before the CIT(A). However, the CIT(A) upheld the adjustments made by the AO/TPO. Aggrieved by the order of CIT(A), Honeywell preferred an appeal before the ITAT.

Decision of the ITAT

The ITAT made an observation in the order that under the provisions of the TPR, data for the relevant financial year in which the international transaction was entered into should be considered for analysing the comparability of an international transaction.

The ITAT has the power to consider and decide those questions of law that were not raised during the audit proceedings before the TPO or before the CIT(A) during appellate proceedings. Based thereon, the ITAT permitted Honeywell to raise alternative grounds of appeal on the question of deduction of a provision for future losses debited in the profit and loss account and held that while performing comparability analysis, income/expenses having no connection with the operating profits have to be ignored.

16.1.3.14. *Customer Service India Private Limited* [2009] 30 SOT 486 (Del)

In this case, the Income Tax Tribunal, Delhi, reaffirmed the importance of use of current year data over multiple year data while conducting benchmarking analysis.

Facts of the case

(1) Customer Service India Private Limited (the Company), 100% subsidiary of a US company engaged in providing call centre/IT enabled services to customers of its Holding company.

(2) During the assessment, the Company used relevant year data while calculating margins of the comparables. However, the TPO took two previous year data and ignored the financial year data in the analysis.

(3) The TPO disallowed the benefit of 5% margin of the arithmetical mean.

(4) The CIT(A) held that the TPO can invoke the provision of rule 10B(4) of the Income Tax Rules, 1962 for using prior year's data, provided such data influences the determination of transfer price, otherwise it is mandatory for the TPO not to ignore data relating to pertinent financial year in which transactions with associated enterprise has taken place. Aggrieved by the order of the CIT(A), tax authorities approached the ITAT.

Decision of the ITAT

The ITAT held that Rule 10B(4) is clear in the context of use of multiple year data which specifies that data to be used in analysing the comparability of an uncontrolled transaction shall be the data relating to the financial year in which the international transactions has been entered into. Data relating to prior 2 years data may be considered if such data reveals facts which could have influence on the determination of transfer prices in relation to the transactions being compared.

ITAT further held that it is settled law that for making adjustment the assessee is entitled to avail 5% margin and it cannot be denied.

16.1.3.15. *Essar Shipping Limited* [2009] 27 SOT 409/(2008) ITA No. 4624/MUM/2006 (Mum)

Facts of the case

(1) Essar Shipping Limited ("the Company") was engaged in the business of operations of ships. The Company hired a ship from its wholly owned subsidiary ("AE") outside India. The Company paid charter hire charges to its AE and applied CUP as the MAM for benchmarking the said international transaction. For application of CUP, reliance was placed on an external publication called "Clarkson Report".

(2) The TPO rejected the Company's analysis and proposed an addition.

(3) During the course of hearing before the TPO, the Company furnished an alternate working on the application of the cost plus method (CPM). While applying the CPM, the AE has been chosen as the tested party. The Company considered interest on loan for purchase of ship, notional dividend payable by AE and depreciation as the cost component for CPM without adding any mark up on cost. The TPO reduced the notional dividend while determining the cost and concluded that transaction was not at arm's length.

Decision of the ITAT

The ITAT observed that while applying the CUP methodology, there should be some real comparison and the cited comparable should fall in near vicinity of the transaction to be compared with. The ITAT further held that, although the comparability analysis was rejected, in principle, the use of external publication as CUP was not drawn any adverse inference.

On the rejection of the notional dividend as a part of cost while applying the CPM, the Company contended before the ITAT that the AE is the wholly owned subsidiary of the Company and the dividend declared by the AE would be taxable in the hands of the Company. The ITAT rejected the argument of the Company on inclusion of dividend while determining cost base for CPM. The ITAT considered 10% gross profit rate to be reasonable for inclusion over the cost in the relevant case. As the mark up of 10% was approximately equal to the amount of dividend which was considered as part of the cost by the Company, the transactions of the taxpayer were considered to be at arm's length.

16.1.3.16. *Schefenacker Motherson Ltd* [2009] 123 TTJ 509 (Del)/(2009) ITA No. 4459/DEL/07 (Del)]

The Delhi ITAT pronounced an important decision on the use of cash profit/sales or cash profit/cost as an appropriate PLI for defending the use of the TNMM as the MAM without consideration of depreciation charge to adjust material differences in asset profile.

Facts of the case

(1) Schefenacker Motherson Ltd ("the Company") is a joint venture company engaged in the manufacture and sale of rear view mirrors and cable assemblies in the domestic market.

(2) During the assessment proceedings of the two AYs i.e. 2003-04 and 2004-05, the Company had entered into the international transactions relating to sale of goods, purchase of parts and components, royalty/testing charges and cost recharges with its associated enterprises (AEs).

(3) The TNMM was adopted as the most appropriate method for both the years under consideration with the cash profit/sales (cash profit defined by operating profit excluding depreciation and amortization charges) as a PLI to eliminate the differences of capacity utilization, depreciation policies adopted by the Company, etc.

(4) The TPO rejected the PLI used by the Company and also rejected some of the comparables on the basis of functional differences. The TPO adopted the ratio of operating profit/cost and the ratio of the operating profit/sales as PLIs for AYs 2003-04 and 2004-05 respectively and made an upward adjustment to the income of the Company.

(5) Aggrieved by the orders of the TPO, the Company approached the Commissioner of Income Tax (Appeal) ("CIT(A)"). The CIT(A) also upheld the orders of the TPO.

Decision of the Tribunal

The Tribunal held that no standard test exists for deciding as to what constitutes "operational income" (or profit). Accordingly, this would depend upon the nature of the business and facts and circumstances of each case. Reliability, efficiency and effectiveness of transfer pricing analysis lies in finding close comparables, their proper evaluation and making suitable adjustments for differences. Therefore, if the comparability analysis warrants adjustments for differences between the tested party and the selected comparables, then such adjustments should be made to increase comparability.

Indian regulations do not provide mandatory deduction of depreciation and amortization charges. If depreciation is not leading to any difference, its exclusion is immaterial and if it is leading to differences then differences are required

to be adjusted. Material differences in the size and age of the assets need to be considered while undertaking comparability analysis. In case reliable adjustments cannot be made, it should be disregarded in comparability analysis.

Further, the ITAT reconfirmed the exercise of (+/–) 5% range by the taxpayer.

16.1.3.17. *Assistant Commissioner of Income Tax v. SDRC India Pvt Ltd* [(2009) ITA No. 477/DEL/2006 (Del)]

The ITAT, Delhi Bench, held that transfer pricing provisions should only be invoked if there is sufficient evidence which suggests that the business arrangement was entered with a motive to avoid tax.

Facts of the case

(1) SDRC India Private Limited ("Company") is engaged in providing software development services to its US parent company. In consideration for the above services, the parent company pays to the Company an amount equal to the cost of providing software development services plus a markup of 5%.

(2) During the AY 2001-02, the Assessing Officer (AO) made a "transfer pricing adjustment" by increasing the markup of 5% to 10% without referring the case to the TPO.

(3) The Company appealed before the CIT (A). The CIT(A), after considering the relevant facts, deleted the additions made by the AO. Consequently, the tax authorities filed an appeal before the Tribunal.

Decision of the ITAT

The ITAT observed that, in immediately succeeding assessment year viz, AY 2002-03, a reference was made by the AO to the TPO. The TPO had concluded that the international transaction was at arm's length with a markup of 6.45%:

- as per the CBDT Circular, the AO shall not make adjustments to the arm's length price determined by the taxpayer, if such price is up to 5% less or up to 5% more than the price determined by the AO;
- the AO should have referred the case to the TPO, if the AO is of the opinion that provision under Sec. 92 of the Income-tax Act, 1961 is applicable;
- the ITAT in its decision upheld the order of the CIT (A).

16.1.3.18. *Skoda Auto India Pvt. Ltd.* [2009] 30 SOT 319 (Pune)/(2009) ITA No. 202/PN/07 (Pune)]

The ITAT, Pune, held that an appropriate economic adjustment must be made for the functional differences and different phases of the business cycle while conducting a comparability analysis to determine an arm's length price.

Facts of the case

(1) Skoda Auto India Private Limited ("the Company") is engaged in the business of manufacturing and selling passengers cars. The Company was incorporated on 23.12.1999 and started its commercial operations in November 2001.

(2) During the year, the Company had entered into the international transactions relating to purchase of materials and payment of royalty and fees for technical know-how with its associated enterprises ("AEs").

(3) The Company adopted the TNMM as the MAM and supported TNMM analysis with the internal CUP analysis for benchmarking import of material.

(4) The Company also contended that the cost of raw material imported by Company is higher than that of comparables and therefore comparables margin should be adjusted to account for the import cost inconsistency. This contention was rejected by the TPO.

(5) During the course of the assessment, the TPO rejected the CUP method adopted by the assessee, as the comparable transaction relied upon by it was between controlled parties and not between independent parties. Further, the TPO also rejected two comparables from the set selected by the Company, one for non-availability of data for the relevant period and the other on the basis of sustained losses. Consequently, the TPO made an adjustment to the value of international transactions of the Company. The CIT (A) upheld the order of the TPO.

Decision of the ITAT

Following were the key observations of the ITAT:

- For an internal CUP analysis, the comparable prices adopted by the Company to benchmark the inter-company transfer price for purchase of materials are not correct as the comparable prices are a result of the transactions between two AEs.
- Start-up phases of business might result into unusual high costs and proper adjustments should be made to eliminate the impact of such costs and increase comparability

eliminate the impact of such costs and increase comparability.

- The business model of the Company and the comparable are fundamentally different and a comparison is only possible if the impact of the import content is eliminated and calls for an adjustment in the operating margins, if the high import content was necessitated by circumstances beyond the control of the Company.
- The Company is not expected to arrange for information which is not available on the public domain. To increase the comparability, reasonable assumptions and approximations should be made.
- The impact of the non-CENVATable import duty additionally borne by the Company should be considered to neutralize the impact of higher costs.
- A difference in product cycles might have an impact on the operating profit margins. Relevance of multiple year data hinges on the theory about relevance of product cycles.
- Relaxation of 5% in the arm's length price under Sec. 92C(2) of the Income-tax Act, 1961 should be allowed to the Company following the decision of Delhi ITAT in case of Sony India Private Limited.

16.1.3.19. *UCB India Private Limited* [2009] 30 SOT 95 (Mum)

Facts of the case

(1) UCB India Pvt. Ltd. ('the Company') is a 100% subsidiary of UCB S.A. Belgium ('AE') and is engaged in the business of manufacture and marketing of prescription drugs. The Company is engaged in manufacturing and distribution of pharmaceutical products in three therapeutic segments.

(2) 50% of the Company's production is from Active Pharmaceutical Ingredient (APIs) imported from the AE whereas the balance is purchased from third parties. 80% of the Company's activity is manufacturing whereas the balance comprises of trading and services.

(3) The TNMM has been adopted as the MAM and the overall profit of the Company was compared with overall profits of comparable companies. Company's operating margin was 27.54% compared to an arm's length margin of 8.86% of comparables determined by the Company in its benchmarking study.

(4) The TPO observed that the Company has not separated its manufacturing and non manufacturing transaction. The TPO also concluded that UCB's transfer pricing documentation was incomplete as it had not furnished information such as forecasts or budgets. The TPO rejected the use of the TNMM at Company level and mentioned that arm's length price should be determined on transaction to transaction basis.

(5) The TPO considered CUP, being a direct method, as the MAM to benchmark the international transaction and proposed the adjustment. The CIT (A) upheld the decision by the TPO.

Decision of the ITAT

The ITAT made the following observations:

- On Sec. 92D and Rule 10D (for failure to maintain documentation), the ITAT held that there was no violation and the Company had substantially complied with law. If non-maintenance or deficiency in maintenance do not fundamentally effect or distort the computation of ALP, the defects are not fatal.
- The TNMM at company level is permissible only when transactions of the same type, class and similar variety are undertaken and the enterprise does not have any dissimilar transaction.
- There should be a scientific basis to say that the APIs imported by the Company from its parent and the APIs imported by comparables from the Chinese company are identical with the same purity, potency and other characteristics.
- The ITAT found the adjustments proposed by the tax authorities are erroneous, that APIs are identical merely because there were government guidelines to ensure uniformity in standards of quality, efficacy and safety of pharmaceutical products. The ITAT noted that drugs supplied by the Belgian parent were backed by exclusive research and patent protection, which cannot be compared with the APIs by an unknown Chinese manufacturing company, upon which no Function-Asset-Risk (FAR) analysis was possible.

Accordingly, the matter was set aside for fresh adjudication as the ITAT felt it did not have the right information and data to decide the case.

16.1.3.20. *Dy. Commissioner of Income-tax v. Vertex Customer Services (India) Pvt. Ltd.* ITA No. 1506/DEL/08

In this case, it was held by the Delhi Tribunal that assessee cannot be held liable for penalty under Sec. 271(1)(c) of Income-tax Act for any transfer pricing adjustment if the conduct of the assessee is proper and it has acted in good faith or diligently.

Fact of the case

(1) Vertex Customer Services (India) Private Limited ("the assessee") is in the business of running a call centre. During the Financial Year (FY) 2002-03, the assessee had incurred losses of about INR 42.7 million. The loss was

During the Financial Year (FY) 2002-03, the assessee had incurred losses of about INR 42.7 million. The loss was primarily attributable to certain costs related to excess capacity, costs related to the year being first year of operations and also on account of provision for doubtful debt.

(2) During the course of the audit, the TPO accepted reasons for losses relating to excess capacity and start-up expenses. However, the TPO did not accept the reason for the provision for doubtful debts and recomputed the arm's length price. The assessee did not opt to file appeal against the adjustment made by the TPO.

(3) Subsequently, the AO initiated penalty proceedings for the levy of penalty under Sec. 271(1)(c) of the Act on the amount of adjustment to the arm's length price. During the proceedings before the AO, the assessee explained that full disclosure of the facts was made in the tax return. Further, the provision of doubtful debts was added back in the computation of income. The AO disregarded these facts and levied penalty for not fully and truly disclosing the real operating cost and the comparable profit margin on the same as required under Sec. 92C of the Act.

(4) The CIT (Appeals), on an appeal by the assessee, deleted the levy of penalty by the AO. The CIT (Appeals) observed that the AO did not bring out any evidence to show that the assessee had not computed the transaction price in good faith and with due diligence. The adjustment to the arm's length price was made by the TPO only on account of the difference in opinion between him and the assessee as to whether provision of doubtful debt was to be considered as an ordinary operating expense or an extraordinary expense which needs to be adjusted while computing the operating costs. Therefore, the CIT (Appeals) held that it does not warrant for levy of penalty under Sec. 271(1)(c) of the Act.

The ITAT ruling

The ITAT observed that the CIT (Appeals) in his order has noted the facts relating to the provisions of bad debts as disclosed by the assessee to the Revenue Authorities at various stages. According to the facts of the case, the assessee had provided services to 7C Limited UK which was indebted to the tune of GBP 307,810. The assessee also owed 7C Limited UK a sum of GBP 529,000, being the expenses incurred by 7C Limited UK towards the formation of the assessee. These expenses were to be cross charged to the assessee. In the year 2002, 7C Limited UK as well as 7C Holding Ltd. went into liquidation. The Administrator appointed to oversee the liquidation proceeding cancelled both the debts. In light of this development, the assessee created a provision for bad and doubtful debt.

In light of the above facts, the ITAT observed that in case the amount owed by the parent company becomes bad, the same can be considered as an extraordinarily item. The acceptance of the transfer pricing adjustment was accepted as the assessee did not change the nature of the item i.e. extraordinary item does not change to ordinary. The ITAT further observed that since the issue involved is debatable one, two views are certainly possible.

The ITAT also observed that the parent company owed lesser amount than the amount owed by the assessee to the parent company. Had this amount not been cancelled, the assessee's costs would have been further loaded by a larger amount.

Based thereon, the ITAT held that in the given circumstances and the facts, the assessee cannot be held liable for penalty under Sec. 271(1)(c) of the Act as the assessee has acted in good faith and with due diligence.

16.1.3.21. *Perot Systems TSI India Ltd. v. Dy. Commissioner of Income-tax* (2009) ITA No. 2320, 2321 and 2322/Del/2008 ITAT (Delhi)

In the ruling, the Delhi ITAT has held that the interest free loan granted by an Indian entity to its associated enterprise is required to comply with arm's length principle and cannot be characterized as quasi-equity.

Facts of the case

(1) Perot Systems TSI (India) Private Limited ('assessee') is engaged in the business of designing and developing technology enabled business transformation solutions and providing consulting, systems integration and software solution services.

(2) The assessee extended two interest free foreign currency loans to its associated enterprises (AEs) located in Bermuda and Hungary.

(3) During the course of audit proceedings, the TPO held that the said international transaction was not at arm's length and made an upward adjustment to income of the assessee by imputing interest on loans granted. Subsequently, the assessee's appeal before the Commissioner (Appeals) was also rejected and hence the matter was before the ITAT.

Ruling of ITAT

The ITAT rejected the arguments of the assessee that loans were in the nature of quasi-equity and characterized the

The ITAT rejected the arguments of the assessee that loans were in the nature of quasi-equity and characterized the said transactions as loan. Below is the ruling given by the ITAT:

- inter-company loan agreement puts it beyond doubt that the transaction in question is nothing but loan. There is nothing in the contract that makes the transaction as equity capital in nature;
- the contention of having actually not earned any income cannot come to the rescue of the assessee. The decisions relied upon by the assessee relating to the concept of the real income, i.e., grant of interest free advances to the subsidiaries on the ground of commercial expediency, are not in the context of Chapter-X of the IT Act;
- in case of loan to subsidiary in Bermuda, it is reasonable to accept the arguments put forth by the TPO that transaction has been routed through Bermuda to shift profit out of India;
- reliance by the assessee on Hungarian thin-capitalization rule is misplaced, as the rule is for disallowance of interest expense in order to ensure compliance with thin-capitalization rule and there is no restriction in respect of outward remittances in respect of debt finance; and
- the provision Sec. 92C (2) which allows a variation of 5% from the arm's length price applies only when "more than one price is determined" and an arithmetic mean is adopted. In the given facts, only one LIBOR rate was applied by the TPO with some adjustment for basis points. This cannot be equated with more than one price in respect of each transaction and hence benefit of +/- 5% range cannot be availed.

Conclusion

The ruling emphasizes that grant of loan by an Indian entity to its AEs is subject to arm's length principle. Based on the specific facts and circumstances of the case, loan by an Indian enterprise may require imputation of interest.

16.1.3.22. *CA Computer Associates Pvt Ltd v. Dy. Commissioner of Income-tax* (2010) ITA No. 5420 and 5421/Mum/2006 ITAT (Mumbai)

In this case, it was held that the Transfer Pricing Officer cannot exceed his limitation by following any method to determine the arm's length price which is not authorized by the Income Tax Act or the Income Tax Rules.

Facts of the case

CA Computer Associates Pvt. Ltd. ('assessee') is engaged in the licensing and distribution of software products in India. The assessee was appointed as the sole distributor of the products of Computer Associates International Inc. USA (CA – USA) in India. The assessee had also set-up a Technical Support Centre in Chennai to provide support services to end users of the software products on behalf of the CAMI – USA.

The assessee for the assessment year (A.Y.) 2002-03 has paid royalty to CAMI – USA for distribution of the software products in India. The assessee had benchmarked this royalty payment using Comparable Uncontrolled Price Method. However, the TPO had determined the ALP at NIL in relation to the royalty corresponding to sales which was written off as bad debts in the books of account, on the following grounds:

- the assessee had written off certain sales as bad debts and the invoices pertaining to these sales were also raised by the assessee during the same financial year relevant to assessment year under consideration. Further, the decision of write off was also taken in the same financial year. Thus, CA – USA was regularly intimated about the collection position and hence should have claimed royalty on such amounts collected from the third party customers;
- any independent entity, acting as a sole distributor of the off-the-shelf product of a licensor, would have sought for a waiver of royalty payable, considering the huge amount of non-receivables which ultimately it is forced to write off as bad debts;
- the independent entities acting independent of each other would certainly enter into agreement for payment of Royalty, on the basis of actual collections made and not on the basis of just invoicing.

The assessee filed an appeal against the adjustment made by the TPO, which had, however, been upheld by the Commissioner of Income Tax (Appeals) [CIT(A)]. Aggrieved with the above order, the assessee filed an appeal before the ITAT.

Ruling of ITAT

The ITAT has observed that the manner in which the ALP is to be determined by any of the method is prescribed in Sec. 92C of the Act r.w.r 10B of the Rules. After examining the parameters prescribed in Rule 10B, it can be seen that bad debts written off cannot be factor to determine the ALP of any international transaction.

The TPO has exceeded his limitation by following the method which is not authorized under the Act or Rules. Therefore the ALP determined by the TPO and adopted by the AO to the extent of royalty payable to the CAMI USA is not as per the procedure prescribed and same cannot be sustained. The AO has been directed to adopt the ALP of the royalty payable to CAMI-USA as declared by the assessee.

16.1.3.23. ***Global Vantedge Pvt. Ltd. v. Dy. Commissioner of Income-tax*** **(2009) ITA No. 2763 and 2764/Del/2006 ITAT (Delhi)**

This judgement emphasizes the fact that total amount of transfer pricing adjustment cannot exceed the absolute amount of revenue realized by the associated enterprise from third parties and idle capacity adjustment should be allowed to the taxpayer to improve the comparability analysis.

Facts of the case

Global Vantedge Private Limited ('assessee') is engaged in rendering IT enabled services in the field of credit collection and telemarketing services. RCS Centre Corporation, USA, (RCS), a related group company of the assessee, is engaged in the business of contracting with clients located in USA to provide them debt collection and telemarketing services. RCS outsources work to the assessee.

During the financial year 2002-03, the assessee received revenue from RCS for client services (which constitutes 90.6% of the revenue earned by RCS from third party clients). The assessee is also engaged in rendering services to other independent clients and which consist of approximately 18% of the total revenue.

For the purpose of benchmarking the aforesaid transaction, the assessee selected its AE as tested party, as it performed simpler functions of marketing support services. The TPO concluded that, in given circumstances, AE should not be treated as a tested party. The TPO chose the assessee as the tested party and identified nine Indian companies as comparables. The average operating margin of the comparables was 11.88% as against the loss of 53.5% incurred by the assessee. Applying the arm's length margin of 11.88% on the total operating cost, the TPO/AO made an adjustment.

Aggrieved by the above order, the assessee preferred an appeal before the CIT(A). Following issues were raised by the assessee:

(1) Assessee being the complex entity, should not be chosen as the tested party.

(2) ALP of the international transaction between the assessee and its AE cannot exceed the total amount of revenue earned from third party clients.

(3) In case, the ALP determined by the assessee and the TPO/AO is found to be improper, then what should be the appropriate ALP?

The decision of CIT(A) on the above said issues is summarized hereunder:

With respect to issue (1) stated above, the CIT(A) agreed with the contentions of the assessee that the least complex party needs to be selected as the tested party. However, it was concluded that absence of adequate information regarding the foreign comparables, difficulty in comparing the remuneration in different jurisdictions, RCS cannot be selected as the tested party.

In regard to the second issue of sharing of revenue between AEs, the CIT(A) accepted the contention of the assessee and ruled in assessee's favour. The CIT(A) observed that the Indian Transfer Pricing Regulations only require us to analyse the transactions between associated enterprise and not the transactions with third parties since extraneous factors cannot be controlled. If an entity is unable to earn adequate profits on account of legitimate business exigencies and not due to manipulation of transactions undertaken by the associated enterprises, such entity cannot be penalized. The CIT(A) also mentioned that before proceeding to determine the revenue to be allocated to the assessee, it is pertinent to determine the fair amount of revenue to be received by RCS for its marketing support services.

With regard to the question as what would be the appropriate ALP in case the ALP determined by both the assessee and by the TPO found to be improper, the CIT (A) selected assessee as tested party and applied the TNMM to determine the ALP of international transaction. While determining the ALP, the CIT (A) determined the percentage of revenue to be received by RCS for its functions. Such percentage was determined on the basis of industry report prepared by ICRA, wherein marketing expenses were shown in the range of 1.4% to 4.4% of the turnover. This range was further substantiated by mean percentage of marketing expense/turnover incurred by BPO comparable companies which was computed at 1.64%. Based thereon, the CIT (A) concluded that RCS is entitled to 1.4% of the revenue as against 9.6% retained by it. Therefore, maximum revenue that may be allocated to the assessee cannot exceed 98.6% of the revenue earned by the Global Vantage group. Further, while applying TNMN to determine the arm's length price, the CIT (A) reduced the cost base of the assessee for international transaction by 18.14% of the operating cost base on the premise that the assessee earns revenue from third parties to the extent of 18.14%. also, idle capacity adjustment to the extent of 33.33% was allowed as the assessee was in its start-up phase.

Based on the above, the CIT (A) recomputed the additions on account of transfer pricing adjustments proposed by the transfer pricing officer.

the transfer pricing officer.

Ruling of the ITAT

Aggrieved by the order of the CIT (A), both the assessee and the department preferred cross appeals before the ITAT. The ITAT ruled that since both the parties have not been able to controvert the findings recorded by the CIT (A) or point out any material to enable the ITAT to take a view other than view taken by the CIT (A), ITAT is inclined to uphold the order of CIT (A) on the point of determination of ALP in respect of the transaction entered into by the assessee with its associated enterprise.

16.1.3.24. *Intel Asia Electronics Inc v. Asstt Director Of Income Tax* (2010) (ITA 131/Bang/2010) (Bangalore)

Facts of the case

Intel Asia Electronics Inc. (the assessee) is a foreign company having a branch office in India and also has an associate enterprise, M/s. Intel Technologies India Pvt Ltd primarily engaged in providing sales and marketing support service. The assessee decided to close down its branch office with effect from 1 April 2003 and transfer all its assets and liabilities to its associated enterprise as a going concern, for a consideration to be determined by the difference between the value of assets and liabilities on the books of the assessee. On a reference from the assessing officer, the transfer pricing officer determined a shortfall in the arm's length price, holding that: in the CUP method adopted by the assessee, the value of assets should be comparable (and a comparable was not possible to determine in this case); depreciation was worked out by the valuer arbitrarily; and that because the entire business of the PE in India was transferred to an associated enterprise, the best method would be to adopt the net book value.

On appeal, the CIT (A) confirmed the order rejecting outright the valuation report of the registered valuer, holding that the fair market value computed by him was based on arbitrary rates and unreasonable assumptions rather than on any sound basis, and that the valuer adopted an unduly high rate of depreciation without any scientific or rational basis.

On further appeal before the Tribunal, it was argued that the concept of fair market value and book value are totally different; that different Acts provide for different rates depending on their perception; that the valuer engaged is not a related party and there is no reason to doubt his bona fides; that the department has not pointed out any specific defects in the report but has made generalized comments; and that the rates prescribed under the Companies Act have remained static over a long period and such rates do not reflect the correct diminution in value.

Ruling of the Tribunal

The Tribunal observed that in the absence of identical or similar transaction(s), a valuation report could be the most appropriate means for benchmarking under the CUP method. However, the registered valuer did not explain with proper reasoning why varying depreciation rates were considered when depreciating the value of an asset. As such, the valuation carried out without any reasoned basis was held to be erroneous.

In the absence of a reliable valuation report, the only option is to adopt the value of the assets under the Companies Act or the Income Tax Act. Depreciation rates prescribed by the Companies Act are static and therefore the written-down value of the assets so determined cannot be considered to be at par with the net present market value. The Tribunal held that the only reasonable approach is to value the assets by applying the depreciation rates as provided by the Income Tax Act, for it is more dynamic and so devised to bring in a notional charge on the profit and loss account to arrive at the actual income of an assessee, bearing in mind the depletion of the assets. Accordingly, the matter was remitted back to the assessing officer with a direction to determine the arm's length price by adopting the value of assets using the written-down value as under the Income Tax Act.

While passing the order, the Tribunal observed that in the sale of a going concern, factors such as profitability of the branch office, goodwill and various other commercial and technical aspects will have a bearing on the arm's length price. However, neither the assessing officer nor the CIT (A) made any reference to any factors in this regard in this case and, therefore, the Tribunal refrained from making any comments on this issue here.

16.1.3.25. *Adobe Systems India Private Limited v. ACIT* (2010) (ITA No.5043/Del/2010)(Delhi)

Facts of the case

Adobe Systems India Private Limited (Adobe India) is engaged in providing software development services to its associated enterprises. For financial year 2005-06, Adobe India had an operating profit margin on costs of 14.96%, which was claimed to be higher than the margins earned by comparable companies. Accordingly, the international transactions were demonstrated to be at arm's length. However, during the course of assessment proceedings, the tax authorities conducted a fresh search and determined the average profit margin on costs of 24.91% as the arm's length margin, and made an upward adjustment to the value of the international transactions.

Aggrieved by the order of the transfer pricing officer, Adobe India filed its objections with the Dispute Resolution

Aggrieved by the order of the transfer pricing officer, Adobe India filed its objections with the Dispute Resolution Panel. The Panel upheld the transfer pricing adjustment proposed by the tax authorities. Consequently, Adobe India filed an appeal before the Tribunal.

Adobe India's arguments

Adobe India argued that the three companies making super-normal profits should be excluded from the comparable set, as such companies have a tendency to skew the results and cannot be regarded as representative of the industry at large.

In addition, it was argued that GDA Technologies Limited (one of the above-mentioned three companies) was primarily engaged in developing and licensing products – which is not similar to the services provided by Abode India. Further, this company had significant related-party transactions and should be rejected. As regards Jayamaruthi Software Systems Limited, it was argued that this company has negligible employee expense, which is extraordinarily low for a service company. Regarding Cranes Software International Limited, it was argued that this is a product-based company that owns proprietary products. The company owns significant intangibles, which shows that the company is performing research and development functions and, thus, it cannot be compared with Abode India.

Ruling of the Tribunal

The Tribunal ruled as follows:

- The tax authorities brushed aside the contentions of Abode India without providing cogent reasons and by ignoring the documents submitted by Abode India. The tax authorities have also not given any comment regarding the objections raised by Abode India against one of the companies.
- The transfer pricing officer rejected the contentions of Abode India regarding the three companies showing super-normal profits, without giving any cogent reasons. It is undisputed that the three companies have shown super-normal profits as compared to other comparable companies, and exclusion from the list of comparable companies is quite correct. After excluding these three companies, the average margins of the comparable data would be 17.5%, and Abode India's margin falls within the permitted +/-5% range.
- Despite the voluminous submissions and paper book filed, the Dispute Resolution Panel passed a very cursory and brief order without going into the details of the submissions, which is quite contrary to the mandate of Sec. 144C of the Act.

16.1.3.26. *DCIT v. Indo American Jewellery Ltd* (2010) (I.T.A. 6194/Mum/2008)(Mumbai)

Facts of the case

Indo American Jewellery Ltd (the assessee) is engaged in the business of manufacture and export of plain and studded jewellery of gold, platinum etc., and has entered into international transactions with its associated enterprises. The assessee entered into transactions involving the sale of jewellery with both associated enterprises as well as non-associated enterprises. The assessee adopted overall the TNNM as the most appropriate method and argued that the transactions were at arm's length on the basis that its operating profit margin was 3.56% on sales and 3.70% on costs, whereas that of the comparables was 3.27% of sales and 3.82% on costs.

It was also submitted that the assessee earns a net margin of 5.38% on sales to associated enterprises and a net margin of 1.77% on sales to non-associated enterprises. Accordingly, it was submitted that the transactions with the associated enterprises are at arm's length. In this regard, segmental profitability with respect to transactions with the associated enterprises were considered by the assessee. Further, in preparing segmental profitability, operating expenses were allocated on the basis of sales.

However, the transfer pricing officer rejected the method on the basis that the allocation of expenses on the basis of turnover was not correct and it ought to have been effected based on other parameters. Further, the transfer pricing officer applied the operating profit margin of 7.25% of the comparable companies engaged in the business of manufacturing jewellery as the arm's length margin, and proposed as an upward adjustment.

The assessee filed an appeal with the CIT (A) against the order passed by the transfer pricing officer. The CIT (A) deleted the addition and held that the transfer pricing officer has arbitrarily rejected the comparables selected by the assessee, and the comparables selected by the transfer pricing officer were not comparable to the assessee's business. Aggrieved by the order of the CIT (A), the tax authorities filed an appeal before the Tribunal.

Ruling of the Tribunal

The Tribunal's concluded as follows:

- The external comparables selected by the assessee were from a public database, and the assessee followed a detailed search process and made an analysis considering various factors of selecting the external comparables

as required under the Transfer Pricing Regulations and Guidelines. Therefore, the transfer pricing study undertaken by the assessee and arm's length price determined on the basis of such study simply cannot be rejected without any cogent reasons. Comparables are chosen and selected after doing a proper functions-assets-risks study, and adjustments are made to the extent possible, and it is unfair to summarily reject the transfer pricing analysis made by the assessee.

- The comparables selected by the transfer pricing officer were not comparable with the assessee because:
  - some of the comparables were situated in Santacruz Electronics Export Processing Zone (SEEPZ), received various benefits not available to others and could earn higher profit margins;
  - the turnover was predominantly domestic; and
  - the total turnover was either much higher or lower than that of the assessee.
- The fact that the associated enterprises earned meagre profits or incurred losses as compared to the profit of the assessee, showed that there was no transfer of profit by the assessee outside India.
- As the tax rates were higher in the United States compared to those in India, there would be no incentive to transfer profits to a higher tax jurisdiction, especially when the assessee enjoyed deduction under Sec. 80HHC of the Act.

16.1.3.27. *Nimbus Communications Ltd v. ACIT, Mumbai* (2010) (ITA 6597/Mum/09)

Facts of the case

Nimbus Communications Ltd (the assessee) did not charge any interest on overdue payments from its associated enterprise, and it justified the same on the ground that it does not charge any interest on debit balances with independent parties, nor does it pay any interest to international creditors. The transfer pricing officer rejected this argument and held that interest at 2.19% LIBOR on outstanding balances after a 30-day period should be the arm's length consideration. Aggrieved by this transfer pricing order, the assessee brought the matter on appeal before the CIT (A), who upheld the decision of the transfer pricing officer. Consequently, the assessee filed an appeal before the Tribunal.

Ruling of the Tribunal

On appeal, the Tribunal reversed the order of the CIT (A). The notable reasons stated by the Tribunal in its order are as follows:

- A continuing debit balance is not an "international transaction" under Sec. 92B of the Act per se, but is a "result" of the international transaction. Arm's length price adjustments may be made only in respect of an "international transaction". A continuing debit balance reflects that the payment, even though due, has not been made by the debtor. It is not necessary that a payment be made as soon as it becomes due. Many factors, including terms of payment and normal business practices, influence the fact of payment in respect of a commercial transaction.
- Unlike a loan or borrowing, a continuing debit balance is not an independent transaction that can be viewed on a stand-alone basis. What must be examined under the arm's length principle is whether the commercial transaction and terms and conditions (including terms of payment) are arm's length due to which overdue amount has come into existence.
- Even the residual clause in the definition of "international transaction" (i.e. "any other transaction having a bearing on the profits, incomes, losses or assets of such enterprises") does not apply to a continuing debit balance, as there is nothing on record to show that as a result of not realizing the debts from the associated enterprise, there has been an impact on the profit, income, loss or assets of the assessee.
- When an arm's length price is determined (taking into account an excessive credit period) allowed under the CUP method, the comparable must be an amount due recoverable. The adoption of interest at 2.19% LIBOR on balances which exceed 30 days is not justified because LIBOR is relevant only in the case of lending or borrowing of funds and not to commercial balances dues.
- Assuming that the continuing debit balances can be treated as an "international transaction", the transfer pricing officer ought to have applied the CUP method by considering whether the assessee had charged interest on balances past due from independent enterprises (internal CUP) or whether other enterprises had charged interest in respect of balances past due in similar business transactions from independent enterprises (external CUP). No such exercise was carried out by transfer pricing officer in this case.

16.1.3.28. *Agnity India Technologies Pvt Ltd v. Income Tax Officer* (2010) (Delhi) (ITA 3856(Del)/2010)

Facts of the case

Agnity India Technologies Pvt Ltd (the assessee), a wholly-owned subsidiary of BayPackets Inc. US, is engaged in the provision of software development services in the field of telecommunications, and such services are rendered to its holding company (associated enterprise). For the provision of these services, the assessee is remunerated by its associated enterprise on a cost-plus 17% basis. Further, the assessee was entitled to tax holiday under Sec. 10A of the Income Tax Act, 1961.

In its transfer pricing documentation for financial year 2005-06, the assessee chose 23 comparable companies and arrived at a mean operating profit margin on total cost of 10% (after working capital adjustment). Based on the above, it was concluded that the international transactions of the assessee adhered to the arm's length principle as laid down in the Indian transfer pricing regulations.

However, the transfer pricing officer rejected the arm's length analysis undertaken by the assessee and arrived at a different set of comparables. He rejected many comparable companies selected by the assessee based on criteria such as different functional profile, inappropriate application of ratio of wages to sales filter and declining/fluctuating/static sales trend. Further, he included Infosys Technologies Limited and retained Satyam Computers in the final set of comparables. He also did not allow the assessee's claim of economic adjustments on account of risk and working capital. Based on the above analysis, the transfer pricing officer selected 20 comparable companies and recomputed the arm's length margin as 27.08%.

Aggrieved by this transfer pricing order, the assessee filed its objections before the Dispute Resolution Panel. Before the Panel, the assessee objected against the use of arbitrary financial criteria like the wages to sales filter and declining/fluctuating/static sales trend to reject comparable companies. It also objected to the inclusion of Infosys Technologies Ltd in the comparability analysis, as it had a different functional and economic profile, as well as to the retention of Satyam Computers in the comparable analysis, as its financial data were unreliable for financial year 2005-06. Further, the assessee sought a risk adjustment and submitted that as it was entitled to a tax holiday, it had no untoward motive to shift profits.

The Dispute Resolution Panel passed a very cryptic order and agreed with the assessee on only one issue, namely that the financial data of Satyam Computers were unreliable and accordingly should be rejected from the set of comparable companies. Accordingly, the arm's length margin was reduced to 25.6% (from 27.08%).

Ruling of the Tribunal

Subsequently, the assessee appealed before the Tribunal. The assessee argued against inclusion of Infosys Technologies Ltd as a comparable company. It highlighted the differences, including the following:

- Infosys Technologies Ltd is several times bigger than the assessee in respect of share capital, reserves and revenue;
- Infosys Technologies Ltd presents a different functional profile as compared to the assessee;
- it was engaged in both onsite and offshore services, while the assessee was engaged only in offshore services. Typically, onsite services command higher billable rates;
- it incurred significant expenditure on advertisement and research and development, while expenditure incurred by the assessee in this regard was nil;
- it owns proprietary products and has significant intangible assets; and
- Infosys Technologies Ltd is a full-fledged risk-taking entrepreneur, while the assessee was a captive service provider that was exposed to only minimal risks. Assumption of greater risks leads to greater rewards.

Based on the above, it was submitted that the assessee was very small vis-à-vis the giant Infosys Technologies Ltd, and thus was not comparable. The Tribunal accepted the importance of the above differences and emphasized that comparable companies should be selected after a due functions-assets-risks analysis of both the tested party and comparable companies. Based on such analysis, Infosys Technologies Ltd was rejected by the Tribunal from the set of comparable companies. The exclusion of Infosys Technologies Ltd reduced the average margin of the comparable companies, making the international transactions of the assessee at arm's length.

16.1.3.29. *Cheil Communications India Private Limited v. DCIT* (2010) (Delhi) (ITA 712/Del/2010)

Facts of the case

Cheil Communications India Pvt Ltd (the assessee), a wholly-owned subsidiary of Cheil Communications Inc. Korea (Cheil Korea), is engaged in providing advertising, communications and other related services to its associated enterprises. The assessee charges a fixed commission/charge to its associated enterprise, depending on different types of services rendered.

As a part of its business operations of preparation of advertisements and provision of related consultancy services, the assessee facilitates placements of such advertisements on hoardings and print and electronic media. For this purpose, the assessee makes payments to third parties (advertisement agencies, printing presses, etc.) for renting of advertising hoardings, air-time on television, etc. The assessee makes the payments on behalf of its clients (associated enterprises) to these third parties only upon the receipt of an equivalent amount from its client on a back-to-back basis. Such third party payments do not represent any value-added functions undertaken by the appellant.

In its transfer pricing documentation report prepared for financial year 2004-05, the assessee computed the markup by including all the value-added costs (costs incurred for the agency functions carried out by the assessee) and

excluded all the costs in the nature of pass-through costs (i.e. the costs of renting advertising space on behalf of the associated enterprises). During the proceedings before the transfer pricing officer, the assessee substantiated its position by stating that the corresponding costs were disclosed net of pass-through costs in the books of account, and thus the assessee had computed the net profit margin accordingly.

However, the transfer pricing officer rejected the approach followed by the assessee and held that the assessee should account for gross receipts as operating revenue, and the corresponding gross costs (including the pass-through costs) should form a part of the operating expenses in the assessee's profit and loss account to arrive at the net profit margin. He further held that the comparability analysis must be conducted on the basis of current year data. He also rejected all of the nine comparables considered by the assessee in its transfer pricing report on the ground that the comparable companies are functionally different, have different revenue realization models and are based outside India, etc. The transfer pricing officer proceeded with his own chosen comparable set of two companies to compute the arm's length price, and made an upward adjustment of INR 3,52,25,101 to the value of the international transactions declared by the assessee.

Aggrieved by this transfer pricing order, the assessee filed an appeal before the CIT (A). The CIT (A) deleted the adjustment made by the transfer pricing officer and stated in his order that the agreements, along with the supporting invoices for expenditure incurred with regard to advertisement placements, supported and substantiated the fact that the assessee operates only as an agent for its associated enterprises and thus the costs incurred for the above activity do not warrant a markup. Consequently, the tax authorities filed an appeal against the order of the CIT (A).

Ruling of the Tribunal

The notable aspects of the Tribunal's order are as follows:

- The Tribunal accepted the net basis of accounting followed by the assessee and upheld that the markup should be applied to the cost incurred by the assessee in performing its agency function, and not to the cost of renting advertising space on behalf of the associated enterprises. This is because the assessee merely acts as an intermediary between the associated enterprises so as to facilitate the placement of advertisements, and thus the same is not in the nature of a value-added function.
- The payment made by the assessee to the third-party vendors for the advertisement slots is recovered by the assessee from its associated enterprises on a cost-to cost basis, and thus the bad debt risk is borne by the third-party vendor and not by the assessee.
- The Tribunal endorsed the OECD's view that it may not be appropriate to determine the arm's length price after including the cost of services (cost of renting the advertising hoardings, air-time on television, etc.) for which no value added services were performed. These costs may be passed to the customers or associated enterprise without any markup, and a markup may be applied only on the costs that are incurred by the assessee in performing agency functions.
- The Tribunal also observed that as the department had accepted the method followed by the assessee in computation of the net revenue in earlier years, there was no reason to depart from the same.

16.1.3.30. *Abhishek Auto Industries Ltd v. DCIT* (2010) (Delhi) (2010-TII-54-ITAT-DEL-TP)

Facts of the case

Abhishek Auto Industries Ltd (the assessee) is engaged in manufacturing car seat belts for independent third-party car manufacturers in the domestic market. For certain categories of seat belts, the assessee imports complete knock-down kits and assembles the seat belts with the technical know-how received from its associated enterprises.

In its transfer pricing documentation for financial year 2003-04, the assessee noted that as the raw material imported from its associated enterprise was not available from any other supplier, it was difficult to ascertain the arm's length price of these products. Further, for the international transactions of royalties for technical know-how received from its associated enterprise, as all government approvals were obtained and these payments were in accordance with the agreement, the question of determining the arm's length price did not arise.

During the course of the transfer pricing audit proceedings, the assessee selected the cost-plus method as the most appropriate method to determine the arm's length consideration in its international transactions. The assessee submitted that its gross margin rates on the sale of seat belts manufactured from the raw materials procured from the associated enterprise were higher than the gross margin rates earned from selling seat belts manufactured from raw materials procured from other suppliers. Accordingly, the international transactions adhered to the arm's length principle as laid down in the Indian regulations.

However, the transfer pricing officer rejected the arm's length analysis undertaken by the assessee and held as follows:

- The value of the payment of royalties and know-how was nil in view of the fact that no transfer of technology or know-how had taken place, the price of know-how and royalties were bundled in the price charged for the supply

of material and the assessee was under no obligation to incur the expenses on expatriates for the know-how.

- The transfer pricing officer further determined the TNMM as the most appropriate method and undertook a fresh search for comparable companies. Under this analysis, the transfer pricing officer arrived at a set of external comparable companies. He determined that the average operating profit margin of these companies was higher than that of the assessee, and accordingly effected a transfer pricing adjustment by decreasing the value of purchases and disallowing the payments for royalties and technical know-how.

Aggrieved by the transfer pricing order, the assessee appealed before the CIT (A). The CIT (A), however, based on the updated margins of the comparable companies selected by the transfer pricing officer, enhanced the transfer pricing adjustment made by the transfer pricing officer and decided the case in favour of the tax authorities.

Ruling of the Tribunal

Subsequently, on appeal the Tribunal ruled in favour of the assessee and held as follows:

- Legally binding agreements between unrelated parties may not be disregarded without assigning any cogent reasons. The Tribunal observed that commercial transactions are the domain of the businessman, and the Income Tax Department may not intervene in the intricacies of commercial expediency unless it has been imputed that these agreements were not-genuine or sham based on sound reasons, particularly when these agreements were approved by the Reserve Bank of India and other regulatory agencies.
- The Tribunal also found merit in the assessee’s contention that technical know-how and assistance were required for effective use of the machinery purchased.
- The Tribunal observed that internal comparables are preferable over external comparables. Thus, as the profitability of the assessee in its associated enterprise transactions was more than the non-associated enterprise transactions, the internal transactions of the assessee adhered to the arm’s length principle as laid down under the Indian regulations.
- Further, as the transfer pricing provisions deal with international transactions only, the basis of making entity level adjustments by aggregating associated enterprise and non-associated enterprise segments is not correct.

16.1.3.31. *ACIT v. Firmenich Aromatics (India) Pvt Ltd* (2010) (Mumbai) (ITA No.4654 /Mum /2009)

Facts of the case

For assessment year 2003-04, Firmenich Aromatics (India) Pvt Ltd (the assessee) selected and applied the TNMM as the most appropriate method to benchmark its international transactions. During the course of assessment, the transfer pricing officer rejected the TNMM and applied the CUP method as the most appropriate method, resulting in an addition of INR 643,311 to the income of the assessee. Further, while passing the order, the assessing officer also imposed a penalty under Sec. 271(1)(c) of the Act on the ground that that the assessee has furnished inaccurate particulars of income, thereby concealing the income.

Aggrieved by the order, the assessee filed an appeal with the CIT (A), which was granted in the assessee’s favour. Consequently, the tax department appealed to the Tribunal.

Ruling of the Tribunal

The Tribunal upheld the order of the CIT (A) and held that a mere difference in opinion on the most appropriate method adopted (in the course of determination of the arm’s length price of an international transaction) can only be considered as a bona fide difference of opinion and cannot lead to the imposition of a penalty under Sec. 271(1)(c) of the Act. In this regard, the Tribunal referred to the Supreme Court decision in the case of *Reliance Petroproducts Pvt Ltd*, in which it was held that for Sec. 271(1)(c) of the Act to be applicable, there must be concealment of income, wherein the assessee should have furnished inaccurate particulars of income. In the above-mentioned ruling, the Supreme Court categorically stated that where there is no finding that any details supplied by the assessee in its return are found to be incorrect, erroneous or false, there is no question of imposing the penalty under Sec. 271(1)(c) of the Act.

The Tribunal held that the assessee could not be expected to imagine that a different method would be adopted by the transfer pricing officer in the course of evaluation of the international transaction and would arrive at a disallowance. As the basic data that were furnished by the assessee were not refuted, but indeed were used by the transfer pricing officer to apply the CUP method, it cannot be stated that the assessee furnished inaccurate information.

16.1.3.32. *DCIT v. Quark Systems Pvt Limited and Quark Systems Pvt Ltd. v. DCIT* (2010) (Spl. Bench – Chandigarh) (ITA 100 and 115/CHD/2009)

Facts of the case

Quark Systems Private Limited (the assessee) is a subsidiary of Quark Systems SARL, Switzerland (QSSS). QSSS is

in the business of making specialized software for media companies that is used for layout of newspapers and periodicals. The assessee assisted QSSS by way of providing help to its customers facing technical problems, and was a dedicated service provider to QSSS. In consideration for these services, the assessee received a fees computed at cost-plus 13.5%.

The assessee selected the TNMM as the most appropriate method for the purpose of computing the arm's length price of its international transactions. During the course of assessment proceedings, one of the comparable companies, namely Imercius Technologies India Pvt Ltd (Imercius), showing a negative margin of 74%, was rejected by the transfer pricing officer in computing the arm's length margin. While rejecting this comparable, the transfer pricing officer reasoned that Imercius is in its start-up phase and is a consistent loss-making company having a negative net worth and low turnover, in comparison to the assessee. The assessee filed an appeal before the CIT (A), but the same was upheld by the CIT (A) in favour of the tax department. Consequently, the assessee filed an appeal before the Tribunal.

Before the Tribunal, the assessee argued and emphasized that the rejection of Imercius is without any justification. Further, the assessee asserted that Datamatics Technologies Ltd (Datamatics), being one of the companies selected as comparable by the assessee itself, should be excluded from the set of comparable companies because:

- Datamatics has significant related-party transactions to the extent of 31% of its turnover;
- Datamatics shows an abnormally high margin to the extent of 138%; and
- as very high loss-making company was rejected by the lower authorities, any company showing abnormally high profitability should also be rejected.

Ruling of the Tribunal

The Tribunal held that authorities below were quite justified in excluding Imercius from the list of comparables for purposes of ascertaining the arm's length price. The Tribunal gave the following reasons for upholding the order of the lower authorities:

- Imercius is functionally different from the assessee, as sales support and technical services are inherently of different character and scope than telemarketing services;
- the earnings of a telemarketing company are usually a percentage of the sales generated. By comparison, in sales and technical support provided by the assessee, the gains are not dependent on the business results generated by the services rendered; and
- a company having negative net worth and low turnover as compared to the tested party cannot be considered as a comparable company.

On the additional ground raised by the assessee, the Tribunal admitted that there is a prima facie merit in the contentions raised by the assessee regarding the exclusion of Datamatics. However, the Tribunal remanded the matter to the file of the assessing officer for fresh adjudication on the additional ground, considering new facts produced by the assessee.

16.1.3.33. *M/s Gemplus India Pvt Ltd v. ACIT* (2010) (Bangalore) (ITA 352/Bang/2009)

Facts of the case

Gemplus India Pvt Ltd (the assessee), an Indian company, entered into a management services agreement with its regional headquarters in Singapore. Under the management services agreement, the associated enterprise would provide need-based services with respect to marketing and sales support, customer service support, finance, accounting, administration and legal support. According to the assessee, the compensation was on the basis of time spent for the services rendered, with an overall cap on the service cost. The assessee benchmarked the transaction under the TNMM. The transfer pricing officer held that the assessee did not derive any specific benefit from the management services, and thus the payment towards management services was not justified, and he disallowed the expenses claimed.

On appeal before the Tribunal, the assessee contended that it had achieved commendable turnover during the year which would not have been possible without the services rendered by the associated enterprise. Further, the assessee had employed only few persons in India, as the technical expertise was provided by the associated enterprise from Singapore on a need basis.

Ruling of the Tribunal

The Tribunal noted that the transfer pricing officer had found that the payment terms under the management services agreement were independent of the nature or volume of services. Further, the associated enterprise apportioned its expenses amongst various country centres on the basis of intercorporate agreements and not on the basis of actual services rendered. The Tribunal held that the burden was on the assessee to establish that the payments were made

commensurate to the volume and quality of services, and that the costs were comparable to an uncontrolled transaction. The Tribunal held that as the assessee failed to prove these elements, the management service fee was not arm's length and thus was not allowable.

16.1.3.34. *M/s Logix Micro Systems Ltd v. ACIT* (2010) (Bangalore) (ITA 524/Bang/2009)

Facts of the case

Logix Micro Systems Ltd (the assessee) had entered into international transactions with its associated enterprise in the United States, and these international transactions were found to be arm's length by the transfer pricing officer. However, he found that there was an inordinate delay in repatriating the receivables from the associated enterprise to the assessee, and to that extent, interest-free funds were parked with the associated enterprise. As such, the associated enterprise benefited from the transactions and thus the same were not arm's length. Such benefit was calculated by the transfer pricing officer taking into account the short-term lending rate of the State Bank of India. On appeal, the CIT (A) accepted the finding that there was a benefit that accrued to the associated enterprise, but he was of the view that as the amount remained in the United States, the benefit should be calculated in terms of the US dollar, and he directed the assessing officer to adopt the LIBOR. He also directed the assessing officer to allow some credit period and work out the interest only for the remaining period. Aggrieved by the order of the CIT (A), both the assessee and the tax authorities appealed to the Tribunal.

Ruling of the Tribunal

While passing the order, the Tribunal made the following key observations:

The assessee's objections regarding the jurisdiction of the transfer pricing officer, recording of reasons before making reference to transfer pricing officer, providing opportunity to the assessee before making the reference, the burden of the department to establish tax avoidance etc. are rejected in the light of the Tribunal's decision in the case of *Aztec Software and Technology Services Ltd* (supra).

The objection raised by the assessee is that the reference made by the assessing officer related only to the point of the arm's length price in respect of international transactions, and the that reference does not cover the aspect of delay in collecting the receivables and the potential loss raising therefrom and, therefore, the adjustment directed by the transfer pricing officer on the question of interest chargeable to outstanding receivables is without jurisdiction and against law. The Tribunal held that a reference made by the assessing officer to the transfer pricing officer on matters involving the arm's length price is not made in piecemeal. The assessing officer, when referring a file to the transfer pricing officer, is contemplating an overall examination and analysis of all aspects relating to international transactions concluded by an assessee. The assessing authority is not expected to classify the areas of international transactions into different segments and refer only certain segments to the consideration of the transfer pricing officer. Therefore, when a file is referred to transfer pricing officer for the purpose of examining the matter relating to the arm's length price, the assessing authority is referring the entire gamut of international transactions for the consideration of the transfer pricing officer. The purpose of an arm's length price analysis itself is in the larger context of anti-evasion measures.

The Tribunal held that there is no basis for asserting that the receivables are alien to the international transactions, and therefore those receivables would not come under the purview of the jurisdiction of the transfer pricing officer. The outstanding receivables are the financial result of the international transactions concluded by the assessee with its associated enterprise, and therefore the income effect arising to those outstanding receivables is very much a relevant aspect of the arm's length price.

The assessee has parked a vast amount of funds for a long period with its associated enterprise. Only because the pricing of international transactions was accepted for the arm's length price test, it is not possible to hold that the transfer pricing officer should not go into this question of the parking of funds with its associated enterprise. If the funds were repatriated to India within a normal period, the assessee would have been in a position to pay its working capital loan or other loans, if any, and/or to earn some income from an appropriate investment of those repatriated funds. This potential loss is definitely a factor to be considered when evaluating the financial impact of the international transactions concluded by the assessee with its associated enterprise in the United States. Therefore, additional income is to be added in the present case as part of the arm's length price analysis.

One of the directions given by the CIT(A) is that a reasonable period may be provided as an interest-free period, and no interest may be calculated for such interest-free period. Interest is to be calculated for the period beyond the interest-free period. This direction is just and proper.

Another important direction given by the CIT (A) is to adopt the LIBOR/US-FED rate for calculating the interest. This proposition was made by the CIT (A) on the premise that the arm's length price factor of interest is to be computed with reference to the benefit that would have been earned by the associated enterprise in the United States. On the other hand, in calculating the cost factors of the assessee in India, it is more appropriate to consider the potential loss

suffered by the assessee in India by not bringing the receivables within the normal period. In fact, this potential loss of

the assessee in India is the arm's length price factor that contributes to the additional income attributable to the assessee. Therefore, instead of the US rate, the transfer pricing officer is justified in adopting the Indian rate.

When adopting the Indian rate, it is not proper to rely on the prime lending rate of the State Bank of India. This is because if the funds were brought in time and those funds were properly deployed, the assessee company may earn income at the maximum rate applicable to deposits and not at the rate applicable to loans. Therefore, the direction of the transfer pricing officer to adopt the prime lending rate of 10.25% is not justifiable. Instead, it is appropriate to adopt a reasonable rate that would be available to the assessee on short-term deposits.

16.1.3.35. *ACIT v. M/s Audco India Ltd* (2010) (Mumbai)(ITA 2642/Mum/2009)

Facts of the case

Audco India LTD (the assessee) is engaged in the manufacture and export of industrial valves and oil field equipment. The assessee exported its gate, globe and check valves to its associated enterprise, the primary business of which was to source the valves from the assessee company for marketing them in US markets. While framing the assessment, the assessing officer made an upward adjustment of the assessee's income, as suggested by the transfer pricing officer to whom a reference was made to determine the arm's length price of the international transactions with the associated enterprise.

On appeal, the CIT (A) held that the aggregate sale to the United States was barely 1% of the total sales of the assessee, and it was not probable that for such a small turnover (which would have scarcely any material effect on income) the assessee would have attempted to shift its profits. Moreover, the aggregate difference between the sale price and the arm's length price was only 3.35%, being well within the 5% tolerance limit permitted by law. He also held that the assessee had at times charged higher rates to its associated enterprise as compared to third-party uncontrolled transactions, but the transfer pricing officer, in making the adjustments, took only those figures in which valves were sold at the lower prices to the US-based associated enterprise while ignoring those figures and data where the same were sold at the higher price. Had the aggregate of sales made to the associated enterprise and that to third parties been taken into account, the case would squarely fall within the 5% tolerance threshold. On the totality of the facts, the CIT (A) deleted the addition on this count, as well.

Ruling of the Tribunal

On appeal by the tax authorities, the Tribunal held that in the absence of any contrary material placed on record by the tax authorities against the finding of the CIT (A) and bearing in mind that the difference between the sale to the associated enterprise and arm's length price was only 3.35% (well within the limit of 5%), the findings of the CIT (A) were upheld.

16.1.3.36. *CIT v. Chrys Capital Investment Advisors India Pvt Ltd* (2010) (Delhi) (2010-TII-11-ITAT-DEL-TP)

Facts of the case

Chrys Capital Investment Advisors India Pvt Ltd (the assessee) is engaged in the business of carrying out research and scouting activities for management companies to identify entrepreneurs and portfolio companies requiring assistance in terms of capital infusion, strategic direction and financial advice.

Based on the search conducted by the assessee, the average margin earned by the comparables was 14.71% (as against the operating margin of 15.11% earned by the assessee), and thus the transactions were considered at arm's length.

However, during the assessment proceedings, the transfer pricing officer rejected three companies out of eight comparable entities selected by the assessee, and introduced two new companies as comparables. The transfer pricing officer also substituted the PLI used by the assessee (i.e. operating profit on operating revenue) with his own PLI (i.e. operating profit as a percentage of operating cost) and rejected multiple year data used by the assessee.

Further, the transfer pricing officer included the expenses reimbursed by the associated enterprises as a part of operating costs of the assessee, as the nature of reimbursable expenses incurred by the assessee formed part and parcel of its core activity. The transfer pricing officer also held that as the assessee was reimbursed on a fixed-fee basis by its associated enterprises and the reimbursement of the expenses was not covered by the agreement between the assessee and its associated enterprises, the reimbursement received by the assessee from associated enterprises did not form part of the operating revenue of the assessee.

The transfer pricing officer passed order under Sec. 92CA(3) determining the arm's length price of international transactions relating to advisory services and the reimbursement of expenses from associated enterprises at INR 18,29,92,017 as against the transaction value of INR 11,42,57,278 declared by the assessee.

Aggrieved by this order, the assessee filed an appeal with the CIT (A) on various grounds. After examining the contention of the assessee, the CIT (A) upheld following actions of the transfer pricing officer :

- changing the base of the PLI;
- using the current year's data as against multiple-year data used by the assessee; and
- exclusion of three comparables and inclusion of two comparables for the purpose of determination of operating margins.

The CIT (A) upheld the ground of objection raised by the assessee of exclusion of income and expense which does not form part of operations. The CIT (A) further upheld that transfer pricing officer's action of not considering the corresponding reimbursement of expenses as part of operating income, was devoid of any logic and was against the principle of financial analysis. He therefore treated the reimbursement of expenses as a part of operating income and as the assessee's margin was within the range of proviso to Sec. 92C(2), the assessee's international transaction was considered to be at arm's length. He accordingly deleted the addition of INR 6,87,34,739.

Ruling of the Tribunal

The tax authorities appealed against the order of the CIT (A). The Tribunal held as follows in upholding the order of the CIT (A):

- the non-operating income may not be included for the purpose of comparison of operating income; and
- the CIT (A) has rightly included the reimbursement of expenses in operating income (otherwise it would lead to distorted figures).

Thus, the appeal filed by the tax authorities was dismissed.

16.1.3.37. *ITO v. Zydus Altana Healthcare Pvt Ltd* (2010) (Mumbai) (2010-TI I-29-ITAT–MUM-TP)

Facts of the case

Zydus Altana Healthcare Pvt Ltd (the assessee) is a joint venture between Cadila Healthcare Ltd and Byk Gulden Lomberg GmbH Germany (BGL). The assessee, a 100% export-oriented unit, is engaged in the manufacture and export of pharmaceutical intermediates exclusively for BGL. The assessee also provides clinical trial services with respect to molecules developed from the research undertaken by BGL, for which it is remunerated on a cost-plus 5% basis. In addition, the assessee receives reimbursement from BGL of certain clinical trial expenses.

During the course of assessment proceedings, the transfer pricing officer accepted the assessee's export prices of pharmaceutical products to be at arm's length. However, the transfer pricing officer proposed an adjustment to the transaction value of clinical trial services and identified a set of companies providing clinical trial services and determined the arm's length cost-plus markup at 17.14%.

The assessee filed an appeal before the CIT (A) against this order. The CIT (A), based on the facts of the case, deleted the adjustment proposed by the transfer pricing officer. The tax authorities subsequently filed an appeal before the Tribunal.

Ruling of the Tribunal

The Tribunal held as follows:

The entire research activity relating to molecules was carried out in three phases. Under Phase 1, the main molecules were generated by BGL and their effectiveness over Indian patients was to be examined by carrying out clinical trials in Phase 2 and Phase 3. Thus, the major part of the research activity was in Phase 1, in which molecules per se were generated, and not Phase 2 or 3, which involved only clinical trials being conducted by third parties (i.e. hospitals), which the assessee only paid for. Further, the assessee's infrastructure was limited to furniture, vehicles, office equipment and computers, which were not sufficient for carrying out an entire research activity.

Therefore, the assessee's activity was more in the nature of coordinating or facilitating such clinical trials carried out at various hospitals, rather than performing the R&D function itself, for which a return of 5% markup on costs was suitable.

Referring to Rule 10B(1)(a)(ii) of the Income Tax Rules, the Tribunal held that the transfer pricing officer, when selecting comparables, should have made necessary adjustments for functional differences.

If an assessee's income is exempt from tax (and taxable in the overseas jurisdiction), this factor should be considered by the tax authorities while undertaking a tax assessment, as in such a situation there is no benefit to the assessee in charging its associated enterprise a lower markup.

Based on the above, the Tribunal upheld the order of the CIT (A) and rejected the transfer pricing adjustment made, thereby deciding the case in favour of the assessee.

16.1.3.38. *Vedaris Technology Pvt Ltd v. ACIT* (2010) (Delhi) (ITA 4372(Del)/2009)

Facts of the case

Vedaris Technology Pvt Ltd (the assessee), a wholly-owned subsidiary of Vedaris UK, supplied software to its parent company. The software was prepared on the basis of the requirements of clients of the associated enterprise. It was claimed that that the assessee charged the parent company on the basis of man-days spent for developing the software. The assessee also provided after-sale services to the clients of the associated enterprise. It was claimed that the value of the international transactions was determined based on the cost-plus method. However, no documentation was maintained to prove the afore-said assertion. The assessee was being remunerated on the basis of man-day rates. Again, no evidence was filed to prove that the charges were at arm's length. The assessing officer referred the matter to the transfer pricing officer, who concluded that the international transaction should be valued using the TNMM. After applying a functionality test, the transfer pricing officer selected 20 comparables out of 118 companies available from the PROWESS and CMIE databases. The average net profit and ratio in these cases worked out to 16.585%. The transfer pricing officer granted a 5% deduction in valuing the arm's length price determined on the basis of the above average profit ratio.

On appeal, the CIT (A) concluded that there were only five comparable cases. However, he rejected the argument that suitable adjustment be made in respect of the capital employed in the business on the ground that a reasonably accurate adjustment on this matter was not feasible.

On further appeal to the Tribunal, the assessee specifically argued against the selection of two comparable companies, on the ground that they were not valid comparables. It was submitted that if these cases were excluded, the average profit ratio of the remaining three cases would come to approximately 2.38%. The assessee showed a margin of 7.78%. Therefore, it was argued that there was no justification for making any adjustment to the total income of the assessee on account of transfer pricing. It was further argued that some adjustment ought to have been made by the CIT (A) in respect of capital, as it had received substantial advances from the associated enterprise. It was also argued that a deduction of 5% ought to have been allowed under the proviso to Sec. 92C(2).

Ruling of the Tribunal

The Tribunal held as follows:

Rule 10B(3) provides that an uncontrolled transaction will be deemed to be a comparable transaction if (i) none of the differences, if any, between the transaction and the enterprises are likely to materially affect the cost and (ii) reasonably accurate adjustments can be made to eliminate the material affects of the afore-said differences. In light of the above, the comparables were examined and it was held as follows:

- The assessee is engaged in the business of development of software, while Kushal Software Ltd is engaged in the business of trading in software. The two companies are performing totally different functions and, therefore, this case is not a valid comparable. The differences in the business models are irreconcilably different and no reasonably accurate adjustment can be made to render them comparable. In view of the basic difference in business models, Kushal is not a valid comparable.
- As for Tera Software Ltd, the company is engaged in providing technical services and integrated solutions, as well as the sale of software. Therefore, the business model of this company is also different from that of the assessee, which is stated to be development of software for the associated enterprise.
- Regarding Sark Systems India Ltd, it is in a totally different line of business (i.e. public transport solutions and e-governance), while the assessee is engaged in the area of energy. All the sales of the company are domestic sales, while all the sales of the assessee are export sales. Therefore, not only the area of functioning is different, but the market conditions prevailing in the two cases are also geographically different. As the geographical conditions are quite different (which affects the profit ratio), no guidance is needed from any decided case to come to the conclusion that it is not a comparable.
- As for Datamatics Technologies, the same is primarily a business process outsourcing (BPO) company. Its business model is totally different from that of the assessee. The finding of the CIT (A) was that the argument of the assessee is not acceptable because it is engaged in the business of IT-enabled services and software development services apart from the BPO business. However, the bulk of its export turnover is on account of BPO business. Therefore, the company also does not meet the requirement of Rule 10B(2)(a), which is a major factor in judging comparability.
- Regarding the argument that the case of Teledata Informatics Ltd was wrongly excluded by the CIT (A), it was found that the company is in a different line of business (namely the preparation of marine, educational and Internet software) and was in the nature of a project development company. That is why it had to incur expenses on selling and distribution and suffer the risk of bad debts.

Rule 10B(1)(e)(iii) provides that the net profit margin worked out under the TNMM is to be adjusted to take into

Rule 10B(1)(e)(iii) provides that the net profit margin worked out under the TNMM is to be adjusted to take into account the differences between the international transaction and the comparable uncontrolled transaction, which

differences could materially affect the amount of net profit margin in the open market. The availability of funds without stipulation of interest does make a difference in the rate of net profit. The advances received from the parent company may have an impact on the net profit margin. However, its impact on the margin has not been examined by the lower authorities, as they simply refused to make an adjustment in this regard. Therefore, this matter was restored to the file of the assessing officer to consider the working capital furnished by the assessee and decide the ground of adjustment after hearing the assessee.

Regarding the risk factor, the assessee did not furnish the terms of agreement with the associated enterprise. The assessee bears the risk associated with software development by providing on-shore and off-shore after-sales service. Therefore, there is no way in which such adjustment can be computed. Similarly, no data are available to compare R&D expenses. An overall adjustment in respect of all three grounds was sought on an ad hoc basis at 20% on the basis of the decision in the case of *Sony India Ltd*. However, no firm calculation having been furnished, it was not feasible to make an adjustment on this ground, as well.

As for the claim of adjustment to be made under the proviso to Sec. 92C(2) of the Act, the proviso as it existed for the relevant assessment year states that where more than one price is determined by the most appropriate method, the arm's length price will be taken to be arithmetical mean of such price or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding 5% of such arithmetical mean. This provision is applicable where more than one price is determined under the appropriate method. In view of the finding that there is only one comparable (Soffia Software Ltd) and the fact that more than one price has not been determined, the proviso is not applicable on the facts and in the circumstances of this case. The assessee's appeal was partly allowed.

16.1.3.39. *SAP Labs India Pvt Ltd v. ACIT* (2010) (Bangalore)(2010-TII-44-ITAT-BANG-TP)

Facts of the case

SAP Labs India Pvt Ltd (the assessee), a wholly-owned subsidiary of SAP AG, was a development centre of SAP AG in India. The assessee was engaged in the business of providing software development and related services to its associated enterprise, SAP AG. The assessee was compensated at the higher of cost-plus 6% or 1.5 times of the wages bill of assessee.

During the course of assessment, the transfer pricing officer initially worked out the arm's length price on the basis of man-hour rate charged by the assessee to its associated enterprise, but subsequently on necessary clarifications furnished by the assessee, the transfer pricing officer left behind the man-hour rate method (CUP) and adopted the TNMM as the most appropriate method. He revised the operating profit margin of the assessee, which was far below the margin reflected in comparable cases, and accordingly proposed the adjustment.

The CIT (A) confirmed the adjustment made in the transfer pricing proceedings. Consequently, the assessee filed as appeal before the Tribunal.

Ruling of the Tribunal

The Tribunal held as follows:

The assessee is enjoying a Sec. 10A benefit and no tax is payable on export income, which renders the Indian tax rate more attractive than the German tax rate. Therefore, there could be no motive to understate the assessee's income. The Tribunal observed that this argument could be logical, but only for those assessment years covered by the Sec. 10A benefit. Once the benefit is exhausted, the assessee would be liable for taxation, in which case the German tax rate may become more attractive. If the pricing for the exempted years is accepted without analysis, there is every chance that the assessing authority might be estopped, on the doctrine of consistency, from examining the pricing for the subsequent non-exempted years.

The procedural law that enables the assessing officer to refer the question of determination of the arm's length price to the transfer pricing officer, is incidental to the assessment procedure. Therefore, there is no room for the assessee to object on this point. It cannot be held that natural justice is denied to the assessee because the arm's length price was referred to the transfer pricing officer without hearing the assessee. The transfer pricing officer frames his propositions and conclusions only after hearing the assessee and considering the objections raised by the assessee. Therefore, the right of the assessee to be heard is not violated under the facts of this case.

Regarding the assessee's contention that once the transfer pricing officer has adopted a particular method for the purpose of determining the arm's length price, it was not open for him thereafter to switch to another method, the Tribunal observed that the selection of one of the methods as the most appropriate method in a given case must be made by applying human skill and expertise. It is not possible to prescribe procedure and practice for every occasion.

The approach would be different from industry to industry. Therefore, the ultimate selection of a method in a particular case may sometimes be possible only if all other methods are sufficiently evaluated and excluded. Because of this exclusion process, shifting from one method to another method in the selection process of the most appropriate method is inherent in a transfer pricing case. The only point is that the transfer pricing officer should not compound different methods and use multiple approaches in determining the arm's length price. It is necessary for him to zero down on a particular method as the most appropriate method. Accordingly, the argument by the assessee was rejected by the Tribunal.

Regarding the argument as to the exclusion of foreign exchange fluctuations from the computation of the operating margin of the assessee, it was held that foreign exchange fluctuation gains are nothing but an integral part of the sales proceeds of an assessee carrying on export business. The courts and tribunals have held that foreign exchange fluctuation gains form part of the sale proceeds of an exporter assessee.

The contention of the assessee that the tax refund credited as other miscellaneous income in the financial accounts should be included in the operating profit for the purpose of computing the PLI, cannot be accepted. This is simply because the operating profit of an assessee is computed without considering the income tax payments or income tax refunds. Therefore, either income tax payments could not be reduced or an income tax refund could be increased in adjusting the operating profit of an assessee.

As to the donations made by the assessee, the Tribunal observed that although such donations may not be deductible in the normal course of computing the taxable income of an assessee, such donations are a regular expenditure incurred by an assessee in the ordinary course of carrying on its business. Therefore, it is not proper to argue that donations must be excluded from the expenditure side. The donations made by the assessee must be considered as normal business outgoings.

On the grounds of comparability analysis, the Tribunal observed that the assessee has only a limited role in generating "commercial profit", and therefore it cannot be compared with other leaders on the market. It is also notable that the assessee company is working in a risk-mitigated environment. When this is the position, the transfer pricing officer or assessing officer may not select extreme cases as comparables to examine the arm's length price of the assessee company under the TNMM.

The transfer pricing officer and assessing officer selected Hinduja TMT Ltd as one of the comparables. The reported margin of this company is 111.45%, which is an extreme case of super profit. Likewise, another company selected by the transfer pricing officer and assessing officer as comparable is Atek Infosys Ltd. In this case, the margin is 69.70%, which is again very much on the high side. At the same time, the transfer pricing officer and assessing officer have not explained the common thread running through all these four entities to bring out a functional similarity. In these circumstances, such super-profit making companies cannot be considered as comparables.

On the argument of the assessee to consider R.S Software Pvt Ltd (having a negative margin of -16.33) as comparable, the Tribunal observed that it excluded the cases of Hinduja TMT Ltd and Aftek Infotec Ltd from the list composed by the transfer pricing officer and assessing officer on the ground that their margins show abnormally high returns. It is for the this reason that the extreme profit margin (including losses) cases should be excluded. Extreme margins do not mean abnormally high profits alone. They include negative results, as well. For all these compelling reasons, R.S Software Pvt Ltd cannot be considered as comparable.

The Tribunal noted that the benefit of the +/-5% range would be available to the assessee under the old proviso, akin to the standard deduction of 5% in computing the adjustment to the arm's length price; however the same benefit would not be available under the new proviso to Sec. 92C(2).

16.1.3.40. *M/s Teva India Pvt Ltd v. DCIT* (2011) (Mumbai) (ITA 6107/Mum/2009)

Facts of the case

Teva India Pvt Ltd (the assessee) is engaged in the business of R&D activities relating to pharmaceutical drugs, as well as the development of pharmaceutical drugs. During the year, it provided R&D services to its associated enterprises and was compensated on a cost-plus 10% markup basis. For transfer pricing analysis, it adopted the TNMM as the most appropriate method. Not having found an adequate number of companies engaged in the business of R&D, it widened the search and included companies that performed similar functions at a broader level. Accordingly, comparables providing other business support services were selected. Based on the analysis, the arithmetic mean of the margin earned by the comparable companies was worked out at 8.59% on operating cost. As its operating margin was 11.73%, the transactions were considered at arm's length.

During the course of assessment, the transfer pricing officer did not dispute the method or the search criteria adopted by the assessee. However, the assessee was asked to conduct a fresh search considering the data available for financial year 2003-04. The transfer pricing officer, based on this fresh search, computed the arm's length margin at 33.26%. In doing so, the transfer pricing officer considered the results of the fresh search in respect of comparables

33.26%. In doing so, the transfer pricing officer considered the results of the fresh search in respect of comparables selected by the assessee, but ignored certain companies that were not considered by him to be functionally similar.

He also rejected a loss-making company and included one which was adopted by the assessee for the earlier year but not included in this year. Based thereon, an adjustment was made in the assessment.

On appeal, it was submitted that the transfer pricing officer resorted to cherry-picking of comparables by eliminating loss making or low profit making comparables even though they were engaged in functionally similar activities, rather than adopting an objective approach in identifying and screening the comparable companies. It was submitted that certain comparables selected by the transfer pricing officer had very high profit margins. It was also argued that the assessee should be allowed the benefit of +/-5% variation from the arm's length price under Sec. 92C(2) of the Act. Further, as the assessee operated in a risk-free environment, a risk adjustment of 5.25%, being the risk premium as determined by the Tribunal in the *Philips Software* case, should be given.

The CIT (A) rejected the claims of the assessee and also excluded certain companies that were not considered by him as comparables. On the basis of these inclusions and exclusions, the arithmetic mean of the comparables was worked at 28.28%. Aggrieved by this order, both the parties filed appeals before the Tribunal.

Ruling of the Tribunal

Tribunal held as follows:

As regards the rejection of a comparable merely on the ground that the comparable was incurring loss, in the case of *Sony India Pvt Ltd* it was held that a comparable could not be excluded only on the ground of losses except in cases where there are other factors justifying exclusion of these comparables. Further, regarding the disallowance of the benefit of the 5% variation, a similar issue was restored by the Tribunal to the file of the assessing officer for assessment year 2003-04. Similarly, as to the issue of the claim for adjustment in respect of difference in risks profile in the transfer pricing analysis, a similar issue was also restored by the Tribunal in assessment year 2003-04. Following this decision of the Tribunal in the assessee's own case for assessment year 2003-04 on similar issues, the Tribunal restored this issue to the file of the assessing officer for deciding the same afresh along the same lines as directed by the Tribunal in assessment year 2003-04.

As to the rejection of four other comparables by the Department, the nature of business activity carried on by the four parties in question was entirely different from the business activity of the assessee. The services rendered by these parties were in the non-technical field, whereas the assessee was found to be rendering services in the technical field of R&D. As rightly held by the authorities below, these concerns thus were functionally different from the assessee company and there was no justifiable reason to select the same as comparables for transfer pricing analysis purposes.

With regard to M/s Ujjwal Ltd, which was excluded by transfer pricing officer on the ground of functional differentiation but was accepted by the CIT (A) as comparable following his appellate order for assessment year 2003-04, the Tribunal observed that through its order dated 30 August 2010, it upheld the order of the CIT (A) for assessment year 2003-04. As the issue involved in the year under consider as well as all the relevant material facts are similar to that of assessment year 2003-04, following the order of the Tribunal for 2003-04, the order of the CIT (A) is upheld for allowing inclusion of M/s Ujjwal Ltd as a comparable for transfer pricing analysis purposes.

Regarding the assertion of the tax authorities relating to the deletion or addition in respect of unrealized foreign exchange gain, while allowing relief to the assessee on this issue, the CIT (A) followed his own appellate order passed in the assessee's case for assessment year 2003-04 on a similar issue. The Tribunal, through its order dated 30 September 2010, had already upheld the order of the CIT (A) for 2003-04 on a similar issue.

Regarding the additional ground raised by the assessee at the time of hearing, it is observed that although a detailed submission was made on behalf of the assessee before the CIT (A) on the basis of functions, assets and risks analysis to show that the selection of M/s Vimta Labs as a comparable was not justified, the CIT (A) did not accept the assertion of the assessee on this issue without giving any cogent or convincing reasons. In its recent decision in the case of *Adobe Systems India Pvt Ltd*, the Delhi Bench of ITAT held that the exclusion of companies showing super-normal profits as compared to other comparable is fully justified. The Tribunal, therefore, set aside the impugned order of the CIT (A) on this issue and restored the matter to the file of the assessing officer with a direction to decide the same afresh after taking into consideration the submissions made by the assessee before the CIT (A) and bearing in mind the conclusion of the Delhi Bench of ITAT in *Adobe Systems India Pvt Ltd*.

16.1.3.41. *M/s Amadeus India Pvt Ltd v. ACIT* (2011) (Delhi) (2011-TII-22-ITAT-DEL-TP)

Facts of the case

Amadeus India Pvt Ltd (the assessee), a joint venture between Ms Radha Bhatia and Family (95% equity capital) and German Travel Services, GmbH (5% equity capital), provides data processing and related services to its associated

enterprises and is responsible for providing software access to the subscribers of Amadeus products in the territories of India, Bangladesh and Nepal. Its main activity is to provide connectivity to the host system by creating, modifying or upgrading computer programs online. During the year, it had international transactions that were declared in Form 3CEB filed along with the return. The assessing officer, with the due approval of the Commissioner of Income Tax (CIT) referred the case to the transfer pricing officer for determination of the arm's length price for the transactions mentioned in Form 3CEB. The transfer pricing officer proposed an adjustment of INR 32,92,83,589 in respect of the arm's length price of international transactions (which were different from the ones referred by the assessing officer).

The order was passed with the approval of the Dispute Resolution Panel. On appeal before the Tribunal, it was submitted that the assessee had chosen the TNMM to justify the arm's length price of the international transactions. It had shown a net operating profit/total cost (OP/TC) of 43.46%, which was well above the average OP/TC of 8.02% of the comparables. The transfer pricing officer did not question its method or its computation of the arm's length price. However, he found that the assessee had incurred more than normal advertising, marketing and promotion expenses to build the "aMaDEUS" brand in India, which was legally owned by Amadeus Spain. The transfer pricing officer was of the view that the assessee should have been suitably compensated with an appropriate markup on such additional marketing expenses. The transfer pricing officer computed more than normal marketing expenses by comparing the advertisement, marketing and promotion expenses as a percentage to sales of the assessee, with the average advertisement, marketing and promotion percentage of three companies, namely Galileo India Private Ltd, Aztec Software Ltd and Geometric Limited. The transfer pricing officer computed the average advertisement, marketing and promotion percentage of three companies at 12.16% and concluded that any expenditure over and above 12.16% would be considered as more than routine marketing expenses. The advertisement, marketing and promotion percentage of the assessee being 40.87%, the transfer pricing officer imputed income of INR 32,92,83,589 by adding a markup of 10% on such additional advertisement, marketing and promotion cost.

The assessee argued that advertisement, marketing and promotion expenses were third-party expenses that were not recognized by the assessee as an international transaction in the transfer pricing report. The assessing officer referred the report for adjudication by the transfer pricing officer. What was not a part of the report was outside the jurisdiction of the transfer pricing officer. Under Sec. 92CA(1) of the Act, the transfer pricing officer was required to analyse the arm's length basis of the international transactions referred to him for examination by the assessing officer. Further, subsection (2) provides that the transfer pricing officer must call for information from the assessee in support of his computation of the arm's length price in respect of the international transaction referred to in subsection (1). This implied that the transfer pricing officer had the authority to determine the arm's length price in respect of only those international transactions as were referred to him by the assessing officer. It was argued that the decision to refer is not solely for the assessing officer, as it also involves the CIT's approval. Therefore, the jurisdiction of transfer pricing officer cannot be extended either by the transfer pricing officer himself or even by the assessing officer without approval of the CIT.

Moreover, in the assessee's case the assessing officer, after considering the nature of expenses, did not make any disallowance under Sec. 37(1) of the Act, thereby accepting the fact that the advertisement, marketing and promotion expenses were incurred by the assessee wholly and exclusively for the purpose of its business. As a corollary, it ruled out the contention that the expenditure either in whole or in part was incurred on behalf of someone else and thus it called for reimbursement plus a margin addition. The above argument is also bolstered by CBDT Instruction 3 of 20 March 2003, which clarifies that the transfer pricing officer has jurisdiction only in respect of specific international transactions referred to him by the assessing officer, and if the transfer pricing officer wishes to analyse any international transaction in addition to what has been so referred, the transfer pricing officer must bring the fact to the attention of assessing officer and seek a fresh reference. It was also argued that under the Indian Income Tax Act, at present there is no concept of creation of marketing intangibles or recognizing such an asset which allegedly may have resulted by virtue of extraordinary advertisement, marketing and promotion expenses unilaterally incurred by a domestic enterprise in the course of carrying on its business in India, and that the bright line test applied by the transfer pricing officer applying advertisement, marketing and promotion expense/sales as a base for benchmarking, is not one of the five methods provided under the transfer pricing regulations in India.

On the other hand, the Departmental Representative (DR)submitted that the assessing officer, in referring a file to the transfer pricing officer, contemplated the overall examination and analysis on all aspects relating to international transactions; and that the assessing authority is not excepted to classify the areas of international transactions into different segments and refer only certain segments to the consideration of the transfer pricing officer. Therefore, when a file was referred to transfer pricing officer for the purpose of examining matters relating to the arm's length price, the assessing authority was referring the entire gamut of international transaction for the consideration of the transfer pricing officer.

In the present case, during the course of proceedings under Sec. 92CA, the transfer pricing officer noticed that expenditure in respect of advertisement, marketing and promotion incurred by the assessee were also within the realm of international transactions, and he accordingly determined the arm's length price of these expenses in his

order. It is further stated that the transfer pricing regulations required not the “form” but the overall arrangement or substance of the transactions before determining the arm’s length price of an international transaction. In this case,

the assessee incurred advertisement, marketing and promotion expense for the benefit of its associated enterprise, and the assessee had incurred the expense in connection with a benefit and services provided to the associated enterprise under a mutual agreement which, according to the claim, was not in writing (but such arrangements are proved from the conduct of the assessee as mentioned in the order of the transfer pricing officer). Accordingly, the advertisement, marketing and promotion expenditure was treated as an international transaction under Sec. 92B(2) read with clause (v) of Sec. 92F of the Act.

Ruling of the Tribunal

The Tribunal held as follows:

It is settled law that where the words of the statue are in themselves precise and unambiguous, then no more can be necessary than to expound those words in their natural and ordinary sense. The words themselves alone in such cases best declare the intent of law. On a bare perusal of subsection (1) of Sec. 92CA, certain conditions are revealed, namely that the assessee should have entered into an international transaction in any previous year and the assessing officer may consider it necessary and expedient to verify the arm’s length price of the international transactions. The assessing officer would take previous approval from the Commissioner for referring the computation of the arm’s length price in relation to the said international transaction. The expression “said international transaction” employed at the end of the subsection would indicate that the operative force of this expression related to that international transaction which was considered by the assessing officer in computing the arm’s length price and for which he took approval from the Commissioner. The role of the transfer pricing officer has been restricted to that transaction which has been referred to him by the assessing officer for computation of the arm’s length price. The plain reading of this section nowhere reveals that transfer pricing officer may take any transaction *suo moto* for verification, and then suggest a necessary adjustment. A plain reading of subsection (1), according to its language, makes this meaning alone discernable. Apart from that, the Tribunal finds support from the CBDT guidance in Instruction 3/2003, wherein role of transfer pricing officer is explained.

At the time of hearing, the bench was informed that in the next assessment year (i.e. 2007-08), the transfer pricing officer had referred the matter to the assessing officer regarding these expenses, and sought a fresh reference. Although every assessment year is an independent assessment year, the facts should be seen together.

No adjustment is required to the transaction relating to incurrence of advertisement, marketing and promotion expenses in this assessment year in the present proceedings and given facts.

16.1.3.42. *M/s Tenement ICB Pvt Ltd v. ACIT* (2011) (Mumbai)(ITA 7098/Mum./2010)

Facts of the case

Tecnimount ICB Pvt Ltd (the assessee), a joint venture between Tecnimount Edison Group, Italy (Tecnimount Group) and Kapadia Group, India, is engaged in the provision of engineering design and field construction supervision services to various entities in Tecnimount Group (associated enterprises). The services provided by the assessee’s technical personnel are rendered from India, from Tecnimount Group offices or at the field construction sites. For the provision of these services, the assessee is remunerated on an hourly basis on actual man-hours spent. The assessee had transactions with associated enterprises as well as non-associated enterprises for financial year 2005-06. The assessee computed the PLI based on segmental accounts for its transactions with associated enterprises. During the proceedings before the transfer pricing officer, the assessee submitted the segmental results to support the computation.

However, the transfer pricing officer observed that the segmental data provided by the assessee lacked allocation details and were based on accounting policy difficult to comprehend. Further, the transfer pricing officer remarked that as no authenticated documents were produced by the assessee to prove the genuineness of the split profit and loss account, the segmental results could not be relied upon. Thus, the transfer pricing officer computed the PLI at the entity level. For the computation, single-year data were considered. Also, the transfer pricing officer rejected the loss-making companies as comparables. In view of the above, the transfer pricing officer proposed an adjustment.

Aggrieved by the transfer pricing order, the assessee filed its objections before the Dispute Resolution Panel on the following grounds:

- rejection of segmental accounts;
- use of single-year data;
- excluding other income from operational income;
- rejection of loss-making companies; and
- adjustment to the total cost (rather than cost attributable to the associated enterprise).

The assessee also furnished audited segmental results, which were rejected by the Dispute Resolution Panel. The

Panel agreed with the transfer pricing officer on the rejection of segmental accounts, adopting single-year data and adjustment to the total cost. Further, the Panel observed that the assessee is not entitled to the benefit of the 5% variation from the arithmetic mean under the proviso to Sec. 92C(2), as the arm's length price does not fall within the 5% range. However, the Panel did not agree with the transfer pricing officer in excluding the loss-making companies as comparables, although the transfer pricing officer did not comply with this direction of the Panel when passing the final order.

Ruling of the Tribunal

The assessee, aggrieved by the order of the transfer pricing officer pursuant to the directions of the Dispute Resolution Panel, appealed before the Tribunal. The Tribunal ruled on the grounds of appeal relating to the segmental analysis made by the assessee.

Notable aspects of the Tribunal's order are as follows:

- In accordance with Sec. 144C and Rule 4 of Income Tax (Disputes Resolution Penal) Rules, 2009, the Dispute Resolution Panel should have admitted the audited segmental accounts submitted by the assessee. The objection that the accounts were unaudited was a procedural requirement, and once the same was complied with, the audited data should have been admitted. Thus, the Tribunal admitted the audited segmental results filed by the assessee.
- In accordance with Secs. 92 to 94, segmental results should be considered for the calculation of the PLI and not the entity level results.
- The Tribunal accepted loss-making companies as comparables.
- As regards the benefit of the 5% variation from the arithmetic mean, the Tribunal relied upon the decision in the case of *Sony India Pvt Ltd v. DCIT*, (2008) 114 ITD 448 (Del.). Following that decision, the Tribunal held that the assessee is entitled to the marginal benefit irrespective of whether the arm's length price falls within the 5% range, as provision 1 of Sec. 92C(2) contemplated that the adjustment would be made at the option of the assessee.

16.1.3.43. *ADP Pvt Ltd v. DCIT* (2011) (Hyderabad Bench)(ITA 155/Hyd/2009)

Facts of the case

ADP Private Limited (the assessee) is engaged in rendering software development services to its associated enterprise. During assessment year 2004-05, the assessee provided software services to its associated enterprise at cost-plus 10% and received a sum of INR 39,04,34,858. The transfer pricing officer rejected 10 comparables from 14 comparables selected by the assessee on the ground that they had primarily related party transactions or the companies were functionally different. The transfer pricing officer computed the arithmetic mean of operating profit/cost of the remaining 4 comparables at 17.66%, and calculated the adjustment.

Aggrieved by this transfer pricing order, the assessee filed an appeal before the Commissioner of Income Tax – Appeals. The CIT (A) upheld the action of the transfer pricing officer, but accepted the contention of the assessee to provide marginal benefit of the 5% margin to the assessee. Thus, the CIT (A) reduced the adjustment to only INR 42,82,338.

Aggrieved by the order of the CIT (A), both the assessee and the tax authorities appealed before the Tribunal.

Ruling of the Tribunal

Notable aspects of the Tribunal's order include the following:

- The Tribunal rejected the contention of the assessee for providing working capital and other risk adjustments in accordance with Rule 10B(1)(e) on account of differences in the risk profile of the assessee and independent companies selected as comparables. The reasoning given by Tribunal was as follows:
  - At the time of compilation of the transfer pricing documentation (transfer pricing study), the assessee had not quantified or identified any differences while undertaking the functions-assets-risks analysis, and no adjustment was made on account of any differences.
  - Risk adjustments may be given only on a company-by-company basis, considering the unique facts and circumstances of the case. Further, there is no rule of thumb for allowing such risk adjustments.
- The assessee agreed with the rejection of eight of the 10 comparables rejected by the transfer pricing officer. However, with regard to the remaining two disputed comparables (Aztec Software and Technology Services Ltd and Quintegra Solutions Ltd), the Tribunal upheld the decision of the CIT (A) to reject them on the basis that (i) there were substantial related party transactions of more than 25% of the total sales and (ii) the financial results of one company are for different year-ends as compared to the assessee's financial year-end.
- The Tribunal upheld the decision of the lower tax authorities to reject the use of contemporaneous data (data

existing by the due date of filing of the return of income) and multiple year data (latest data of last 2 years preceding the current year) by the assessee of comparable companies in the determination of the arm's length price, as the same were not in accordance with Rule 10B(4) of the Income Tax Rules.

- The Tribunal accepted the appeal by the tax authorities of non-allowance of the 5% adjustment under Sec. 92C(1) of the Act, reasoning as follows:
  - Where the arm's length price has been determined by applying only one of the several methods specified under Sec. 92C(1) of the Act, the assessee is not entitled to a deduction of the 5% adjustment from the arm's length price as stipulated under Sec. 92C (2) of the Act. The Tribunal relied on the decision of the Delhi Bench of the Tribunal in the case of *Perot Systems TSI (India) Ltd* (5 ITR 106)
  - The Tribunal decided that decisions relied on by the assessee, including *Sony (India) Pvt Ltd* (supra), do not apply to the facts of the instant case. Further, the Tribunal decided that even CBDT Circular 12 of 23 August 2001 does not apply to the case of the assessee, as the price variation is more than 5% and Circular 12 is applicable only if the variation in price with the associated enterprise vis-à-vis the unrelated party is within +/– 5%.

16.1.3.44. *ACIT vs. M/s. NGC Network (India) Pvt Ltd* (2011) (Mumbai) (ITA 5307/M/2008)

Facts of the case

NGC Network (India) Pvt Ltd (the assessee) is primarily engaged in the distribution and marketing of the National Geographic Channel and the Adventure One Channel, and renders post-production services to media companies. During assessment year 2003-04, the assessee had international transactions totalling INR 137,527,281 with its associated enterprise M/s. NGC Asia LLC (NGC-Asia).

The assessing officer, with the approval of the concerned CIT, referred the matter to the transfer pricing officer for determination of an arm's length price, but the reference was not accepted by the transfer pricing officer due to time constraints. Therefore, the assessing officer asked the assessee to furnish details relating to the computation of arm's length prices for its international transactions with NGC-Asia.

The assessee performed a transactional net margin method (TNMM) analysis to demonstrate the arm's length nature of its international transactions with NGC-Asia. Specifically, the assessee identified eight comparable companies (primarily software distributors) and compared their net margins from software segments for assessment year 2002-03, against the net margin achieved by the assessee for assessment year 2003-04.

Upon examination, the assessing officer rejected the comparables selected by the assessee and used a set of 11 comparables collected by himself, for the purpose of making a transfer pricing adjustment for assessment year 2003-04.

The assessee argued that it carried out due diligence in selection of comparables, and the latest data available on the date of due diligence were applied to demonstrate the arm's length nature of its international transactions with NGC-Asia. The assessee also argued that the comparables selected by the assessing officer were engaged in broadcasting on television channels which was different from the business of distribution of channels in which the assessee was engaged. The assessee explained that, given the facts and circumstances, companies trading in software were the only companies which could be considered as engaging in activities comparable to the business of distribution of channels, as both involved distribution of an intangible product.

After considering the assessee's arguments, the assessing officer concluded that the comparables selected by neither the assessee nor the assessing officer were suitable for comparison due to differences in the nature of business. Therefore, the assessing officer considered the payments made by the assessee to NGC-Asia during the immediately preceding assessment year 2002-03, for the purpose of comparison based on the premise that such payment had already been found to be at arm's length. The assessee paid license fees to NGC-Asia to the tune of USD 100,000 per month for assessment year 2002-03. Thereafter, through an agreement dated 27 January 2003, the license fees were revised to USD 183,333 per month with retrospective effect from 1 April 2002. When asked by the assessing officer to explain the reason for hike in license fees, the assessee responded that the enhanced license fees were the result of an increase in the subscriber base between 2001 and 2003. According to the assessee, the license fee of USD 100,000 per month was decided in cognizance of the fact that National Geographic Channel was a new and novel channel and would take time to establish subscriber base. According to the assessee, the subscriber base during this period had doubled and the negotiation regarding an increase in the license fees was in progress for quite some time before the agreement was reached in January 2003. Therefore, the assessee contended that the increase in the license fees as well as the retrospective effect of such increase is justified under the facts and circumstances of the case.

The assessing officer held that such steep increase in license fees by 84.66% was not justified, as the increase in the revenue over the corresponding period was only 32.26%. The assessing officer, therefore, made a transfer pricing adjustment on the basis of license fees paid in the immediately preceding assessment year (2002- 03). However, the assessing officer agreed to the increased license fees for the last 2 months of the previous year 2002-03, and made

assessing officer agreed to the increased license fees for the last 2 months of the previous year 2002-03, and made an adjustment with respect to the license fees paid for the remaining 10 months (i.e. April 2002 to January 2003).

On appeal before the CIT (A), the assessee made the following arguments:

- the assessee undertook proper due diligence in determining the arm's length price and therefore, neither the TNMM analysis performed nor the comparables selected by the assessee could be arbitrarily rejected by the assessing officer. In this context, the assessee made reference to the decision of the ITAT in the case of *Mentor Graphics (India) Pvt Ltd* (109 ITD 101);
- given the facts and circumstances of the case, the assessee's selection of comparables engaged in the distribution of software was justified;
- the assessing officer's use of the assessee's payments to NGC-Asia for license fees for the previous year 2001-02, for application of the comparable uncontrolled price (CUP) method was flawed, as the same was not an uncontrolled transaction in the first place; and
- the observation of the assessing officer that the subscriber base had stabilized was not correct because the subscriber base had almost doubled from 5 million in 2001 to 10 million in 2003.

The CIT (A) found merit in the arguments of the assessee and turned down the order made by the assessing officer based on the following observations:

- the assessing officer, after rejecting the TNMM applied by the assessee, had not made any suggestion as to which one of the five methods prescribed under Rule 10B was to be applied. The assessing officer appeared to have applied the CUP method using the assessee's own data from the previous year which could not be considered as an uncontrolled transaction;
- the same set of comparables, as well as the method of computation of arm's length prices (in this case, the TNMM) as adopted by the assessee for assessment year 2003-04, had already been accepted by the transfer pricing officer in the subsequent assessment year (2004-05); and
- the assessing officer had already accepted the increased license fees for the last 2 months of the previous year (2002- 03) to be at arm's length, but had not accepted the revised fees with retrospective effect. Besides, the decision to increase the license fees and the date from which such increase would be effective was a commercial decision that had not been examined properly by the assessing officer.

Ruling of the Tribunal

Aggrieved with the order of the CIT (A), the Department filed an appeal before the Tribunal. Judging the relative merit of the arguments made by the Department and the assessee, the Tribunal held as follows:

As the same set of comparables and the same method of computation of arm's length prices, as adopted by the assessee for assessment year 2003-04, had already been accepted by the transfer pricing officer for the subsequent assessment year 2004-05, such comparables and methodology must be adopted for the purpose of computation of transfer pricing adjustments for assessment year 2003-04, as well. However, in its analysis, the assessee used data of comparable companies pertaining to assessment year 2002-03, as at the time of undertaking the study, more recent data were not available for such comparables. Where the assessee's international transactions during assessment year 2003-04 are being examined, it is most appropriate to use data for comparables over the corresponding period to demonstrate the arm's length nature of such transactions, provided that data on comparable companies for the same assessment year (2003-04) are available.

If the computation of a transfer pricing adjustment, if any, is to be made based on figures for assessment year 2002-03, the assessee's transactions with NGC-Asia during that period can serve as basis for application of the CUP method, especially where such prior year's transactions have already been accepted to be at arm's length. The nature of the business remaining the same, such a comparison would yield better results, and cannot be rejected merely because the selected comparable transactions were not uncontrolled in the first place, particularly when such transactions had already been accepted to be at arm's length.

In light of its observations, the Tribunal set aside the order of the CIT (A), and restored the case to the file of assessing officer for reworking the transfer pricing adjustment using the TNMM, on the basis of facts and figures available for assessment year 2003-04 in respect of the comparables selected by the assessee and already agreed to by the transfer pricing officer for the subsequent assessment year 2004-05.

16.1.3.45. *Serdia Pharmaceuticals (India) Private Limited v. ACIT* (2011) (Mumbai Bench) (ITA 2469/Mum/06, 3032/Mum/07 and 2531/Mum/08)

Facts of the case

Serdia Pharmaceuticals India Private Limited (the assessee), a wholly-owned subsidiary of Servier International BV, Netherlands and Serdia (Mauritius) Limited, Mauritius is engaged in the manufacture and marketing of pharmaceutical drugs mainly in the field of anti-hypertension and metabolism. It manufactures and markets

pharmaceutical drugs mainly in the field of anti-hypertension and metabolism. It manufactures and markets pharmaceutical drugs in finished dosage forms (FDFs) for use by the end consumer. The FDFs may be in the form of tablet, liquid or gel.

The assessee imported active pharmaceutical ingredients (APIs) from its associated enterprises (Servier France and Servier Egypt) in the process of manufacturing the FDFs in assessment years 2002-03, 2003-04 and 2004-05. An API contains all the medicinal properties and is a key element and ingredient in a pharmaceutical drug. An API may be patented or generic in nature. A patented API allows the patent holder to sell the API at a premium price, allowing the company to recoup the cost involved in the course of research and development of the drug. Once the patent on an API expires in a particular geographic location, any other pharmaceutical manufacturing company can manufacture and market that API. The API then becomes generic in nature, thereby ending the monopoly of the patent holder.

For the purpose of computing the arm's length price and compliance with Indian transfer pricing regulations, a transfer pricing report was prepared and the TNMM was used as the most appropriate method. As the operating margin of the assessee was more than the mean operating margin of comparable companies, the transactions with associated enterprises were considered to be at arm's length.

In the course of proceedings before the transfer pricing officer, the assessee mentioned that the import price of the APIs is determined by the overseas entity and the assessee's judgment as regards its ability to manufacture and market the finished formulations in India using the imported raw material to generate revenues and reasonable profits. Further, the assessee submitted that the associated enterprises do not sell the APIs to any independent enterprises in India. During the course of the transfer pricing assessment, the assessee had also furnished information regarding the product details of its competitors. Based on the inputs from the assessee, the transfer pricing officer collected information on the prices at which these APIs are purchased by other manufacturers of competing FDFs. The transfer pricing officer observed that the prices at which other manufacturers are purchasing these APIs is much lower than the price paid by the assessee to its associated enterprises for the purchase of similar APIs.

The assessee contended that the quality of one of the APIs (Trimetazidine) which is imported from associated enterprises is of much superior quality, has higher purity levels, has a longer shelf life and has been launched after clinical trials as compared to its comparables that are manufactured by competitors in India. This justified the higher price paid to the associated enterprise.

The transfer pricing officer was of the view that the APIs purchased by the assessee from its associated enterprises abroad were not unique in nature, and similar APIs were being purchased by competitor pharmaceutical companies, although from different vendors. Thus, having regard to the nature of goods and after making certain economic adjustments for differences in quality and purity standards, the transfer pricing officer considered the prices at which other producers were purchasing to be a comparable uncontrolled price, and suggested an equal to the difference in prices.

With regard to the adoption of the TNMM a the most appropriate method, the transfer pricing officer was of the considered view that the TNMM should be applied only as a method of last resort, as this method is unreliable because the profits are affected by so many other factors besides the product prices. Based on the above reasoning, the transfer pricing officer chose the CUP method over the TNMM as the most appropriate method to compute the arm's length price.

Aggrieved by the transfer pricing officer's order, the assessee filed an appeal before the Commissioner of Income Tax (Appeals) (CIT (A)). On appeal, the CIT (A) upheld the transfer pricing officer's order.

Aggrieved by the stand taken by the CIT (A), the assessee filed an appeal before the Tribunal.

The assessee's contentions were as follows:

The transfer pricing officer may not reject the TNMM and adopt the CUP method solely on the grounds that the CUP method is the most direct and reliable one. The tax authorities did not provide any logical reason for non-acceptance of the TNMM.

APIs manufactured by the assessee's associated enterprises, as innovative drugs, cannot be compared with the generic APIs manufactured by other enterprises. APIs manufactured by the assessee's associated enterprises undergo extensive research and development and the associated enterprises bear the burden of proving the safety and efficacy of the drugs through clinical trials before being used by end customers.

The product efficacy of the FDFs manufactured by the assessee is better than the FDFs manufactured using APIs produced by other enterprises. The APIs purchased by the assessee from the associated enterprises were guaranteed for quality and the associated enterprises also provided product liability cover in respect of FDFs produced from such associated enterprises.

The assessee also received certain technical assistance with respect to marketing FDFs in India from its associated

The assessee also received certain technical assistance with respect to marketing FDFs in India from its associated enterprises. Therefore, the import price also reflects the technical services.

The import prices paid by the assessee to its associated enterprises for import of APIs is lower than the price at which the associated enterprises sold the APIs to third parties in other countries like Japan and Portugal.

The import price of the APIs was agreed and accepted by the Customs department in India. Therefore, the import price cannot be disregarded by another wing of the government.

Ruling of the Tribunal

The notable aspects of the Tribunal's order are as follows:

Where the transfer pricing officer finds that the selection of the most appropriate method is not appropriate considering all the relevant factors and the facts of the case, the transfer pricing officer may reject the method adopted by the assessee in determining the arm's length price with logical reasoning.

The selection of the most appropriate method is not at the unfettered discretion of the assessee and the selection should be exercised based on the Indian transfer pricing guidelines set out in Sec. 92C(1) and read with Rule 10 C(1) of the Income Tax Act 1961.

Under Indian transfer pricing regulations, there is no hierarchy for the selection of methods. However, the traditional transactional methods (CUP, resale price method and cost-plus method) have an edge over traditional profit method (profit split method and TNMM). If both methods can be applied in an equally reliable manner, the traditional transactional methods should be preferred over traditional profit methods. The revised OECD guidelines (2010 OECD Transfer Pricing Guidelines) also support the same approach.

The APIs imported by the assessee from its associated enterprises were not patent-protected during the years under consideration, and thus attributing a higher price to cost and process of developing a new drug is not a cogent justification for importing the APIs at a higher price. Therefore, FDFs manufactured by the assessee in the post-patent period are expected to compete with the FDFs manufactured by the generic drugs manufacturers based on the selling prices and market demand.

The sound manufacturing practices and high quality standards followed by the assessee's associated enterprises provide some degree of comfort; however the same does not affect the comparability with similar generic APIs.

The assessee's reliance on the Canadian Federal Court of Appeal ruling in the *GlaxoSmithKline* case was not accepted by the Tribunal. In the *GlaxoSmithKline* case the comparison of generic API prices with the API produced by the innovator of the drug was not considered appropriate on the basis of commercial requirements contained in the "license agreement" under which Glaxo Canada was obliged to purchase APIs at a higher price and also enjoyed the benefits of use of the brand name and access to a portfolio of other patented and trademarked products. This was a distinguishing factor as compared to the assessee's case. However, the observations of the Federal Court of Appeal that business realities such as the necessity to import the API from a particular company for the right to use the brand name (in the instant case, Zantac) seems not to have been dealt with by the Tribunal.

Overseas judicial pronouncements, although not legally binding, deserve the utmost consideration, as they are given by eminent judges after detailed analysis.

Acceptance of the import price by the Customs department does not justify that the import price is accepted to be at arm's length from a transfer pricing perspective, and the burden rests with the assessee to justify the arm's length price by following the mechanism prescribed under the transfer pricing regulations.

The prices at which the APIs were sold by the associated enterprises to third parties in other countries cannot be compared due to certain geographic differences and the failure to provide adequate supporting information.

The assessee had not made out a claim for a higher adjustment than those allowed by the transfer pricing officer on account of differences in quality and purity. The assessee may make a claim for higher economic adjustments on account of differences in quality etc. after proper justification in future.

16.1.4. Authority for Advance Rulings (AAR)

16.1.4.1. *Vanenburg Group BV* [2007] 289 ITR 0464 (AAR)

Applicability of TPR to sale of shares by non-residents is a matter of debate. The ruling lays down the principle that the TPR cannot be applied in the absence of tax liability.

Facts of the case

(1) The applicant M/s Vanenburg Group BV is an investment company incorporated in the Netherlands. It has a

(1) The applicant M/s Vanenburg Group BV is an investment company incorporated in the Netherlands. It has a wholly owned subsidiary, Cordys Holding BV ("Cordys BV") located in the Netherlands and another wholly owned subsidiary, Cordys R&D (India) Private Limited ("Cordys India") located in India.

(2) In the corporate reorganization, the applicant would transfer its shareholding in Cordys India to Cordys BV.

(3) Under the India-Netherlands treaty, capital gains are taxable in Netherlands and not in India. Accordingly, the applicant does not have to withhold tax at source, file an income tax return or comply with the TPR in India.

Ruling

Capital gains arising from a transfer of shares would be taxable in the Netherlands and not in India (under the relevant beneficial treaty provisions).

The TPR, which are contained in Secs. 92 to 92F of Chap. X of the Act under the heading "Special Provisions Relating to Avoidance of Tax", is designed to prevent tax avoidance in relation to international transactions and do not apply in the absence of a tax liability.

16.1.4.2. *Foster's Australia Limited* [AAR 736 of 2006]

Cross-border sales of brands, trademarks and intellectual property rights by the Indian subsidiary of an Australian company to a UK-based company are taxable in India.

Facts of the case

(1) Foster Australia Limited is a 100% subsidiary of Foster's group, Australia, which is engaged in the business of brewing, processing, packaging, marketing, promoting and selling of beer products in Australia and abroad.

(2) It holds certificates of registration of trademarks pertaining to Foster's brand. In India, it had registered the Foster trademark and "F" logo in July 1993.

(3) It had entered into a brand licence agreement with Foster India and had paid taxes under the provisions of the Act for royalty amounts received from Foster India.

(4) Dismin Investment Pty Ltd (Dismin), a Foster group company, holds 100% shares of FBG Holdings Ltd, a Mauritian company, which, in turn, directly and indirectly holds shares of Foster India Ltd. Dismin, vide the sale and purchase (S&P) agreement dated 4 August 2006, agreed to sell the shares of the Mauritian subsidiary to SAB Miller Ltd (SAB Miller). By the same agreement, it agreed to sell the trademark and brand intellectual property (IP) and to license the brewing IP to SAB Miller. The consolidated consideration payable was USD 120 million.

Ruling

Trademark and brand IP

Foster brand beer marketed with its trademark and logo acquired a high reputation in the market and generated considerable goodwill.

The trademark registered in India, together with the other features of Foster's brand, had undoubtedly generated appreciable goodwill in the Indian market and such goodwill had been nurtured in India by reason of coordinated efforts of Foster Australia Ltd and Foster India.

Business presence in India manifested itself with the tie-up it had with Foster India, which made use of the IP rights granted to it. Hence, the marketing intangibles comprising the Foster trademark and brand, which were in use for nearly a decade, had their abode in India and the capital assets transferred were situated in India.

There is no legal principle that the situs of intangible assets such as trademarks and goodwill would always go with ownership; they have no situs other than the country of fiscal residence of the owner.

Brewing IP

The core of brewing IP was the brewing manual, which was the product of research and development efforts of Foster Australia Ltd.

It contained the formula and technical aspects relating to the brewing and packaging of Foster lager beer. The brewing manual, though in a sense a trade intangible, is also in the nature of goods.

With Foster Australia Ltd severing its business ties with Foster India, the situs of brewing IP in the form of the brewing manual shifted to Australia.

The brewing IP was physically made available to the nominee of the purchaser; therefore, the brewing IP could not be said to be situated in India and hence income attributable to such IP could not be taxed in India.

The AAR also held that the "independent valuation report" can certainly be relied upon; however, it is for the concerned income tax authority to examine whether it represents a true and correct value, and apply such relevant

factors that have a material bearing on quantification of the consideration related to the taxable items.

16.1.4.3. *Instrumentarium Corporation* [2005] 272 ITR 0499 (AAR)

The AAR held that the issue raised involved determination of the fair market value of property (rate of interest on loan) that was outside its scope. The applicant would be required to adhere to the TPR in India.

Facts of the case

(1) Instrumentarium Corporation ("IC") was a company incorporated in Finland and had a wholly owned subsidiary in India called Datex-Ohmeda (India) Private Limited ("Datex").

(2) IC gave Datex an interest-free loan in the amount of INR 360 million. The loan was to be repaid within 3 years. On default in repayment of the loan, interest of 16% per annum on the principal amount of the loan was payable.

(3) If the normal rate of interest had been charged on the loan, the government of India would have lost revenue at 36.6% with the savings at 10% on the withholding of the interest income, resulting in net tax of 26% to the government of India.

Ruling

Even if the impact of applying the arm's length price between two parties was detrimental to the tax revenue, it was for the income tax authorities to determine this. The determination can also be done after the companies undergo the compliance obligation of filing a return, reports, etc.

The AAR held that the arm's length principle involves determination of a fair market rate of interest and that this is outside the purview of the AAR.

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