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IN THE INCOME-TAX APPELLATE TRIBUNAL
BANGALORE BENCH 'A', BANGALORE

BEFORE SMT. P. MADHAVI DEVI, JUDICIAL MEMBER
AND
SHRI A. MOHAN ALANKAMONY, ACCOUNTANT MEMBER

I.T.A. No.1231(Bang.)/2010
(Assessment Year : 2006-07)

M/s Genisys Integrating Systems (India) Pvt. Ltd,
No.43-46 & 33-36, Export Promotional Industrial Park,
Whitefield Road,
Bangalore-560 066. Appellant

Vs

The Deputy Commissioner of Income-tax ,
Circle-11(3),
Bangalore. Respondent

Appellant by : Shri Padam Chand Khincha, CA
Respondent by : Shri Etwa Munda, CIT-II

O R D E R

PER SMT P. MADHAVI DEVI, JM;

This is an appeal filed by the assessee. The relevant assessment year is 2006-07. The appeal arises out of the assessment completed u/s 143(3) r.w.s.144C of the IT Act, 1961.

2. The assessee is aggrieved by the order of the Dispute Resolution Panel Board dated 20.9.2010 approving the draft order of Assessing Officer making Transfer Pricing adjustments as suggested by the Transfer Pricing Officer (TPO)u/s 92 CA of the IT Act.

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2.1 The brief facts of the case are that the assessee is a company which is engaged in the business of providing software development and IT enabled services. It is part of M/s Genisys Group. The assessee exports its services to its AE and also other clients. For the year under consideration, a return of income was filed by the assessee declaring a total of income of Rs.81,75,080/-. During assessment proceedings u/s 143(3), it was also noticed that the assessee has received payments from its AE clients for providing the software development services and also IT enabled services exceeding Rs.15 Crores. In view of the same, a reference was made to the TPO (Transfer Pricing Officer) u/s 92CA of the IT Act for determination of ALP of the international transaction. The TPO issued initial notice asking the assessee to furnish the documents required to be maintained u/s 92D and the same was furnished by the assessee. The TPO also issued notice relating to determination of arm's length price (ALP) for Software Development Services and also with regard to the Information Technology Enabled Services(ITES in short). These notices contained remarks on assessee's study, new search methodology adopted for selecting the comparables, new comparables selected by the TPO and copies of replies received u/s 133(6) from these other companies. The assessee filed a detailed reply for both the

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notices and also raised various objections to the comparables selected by the TPO. The TPO however, was not convinced by these objections and made adjustments u/s 92CA of the Income-tax Act, by making the following observations;

a) The assessee extends software development services and also extends its information technology enabled services to M/s Genesis MNC, which in turn helps its US customers through all the stages of the product lifecycle i.e from visualization to post launch support. M/s Genesis has extensive experience in developing and supporting the Microsoft technology including SQL Server and related tools. It also has offshore development centre. In order to arrive at the ALP for the international transactions, the assessee, after making the search on the prowess and capitaline data bases, has selected 15 comparables for the software development services and had adopted the TNMM (Transactional Net Margin Method) as the most appropriate method for arriving at the Arms Length Price. The assessee applied the following filters for finalizing the 15 comparables.

1) Companies for which sufficient financial data was not available to undertake analysis

2) Selection of companies having sales turnover of more than 1 crore and less than 200 crores;

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3) Elimination of companies having export sales less than 25% of their total revenues

4) Elimination of companies which are functionally different

5) Companies which have been making persistent operating losses;

6) Companies that had substantial (excess of 25%) transactions with related parties;

7) Companies that had exceptional years of operation.

b. After applying the above filters, the assessee arrived at 15 comparables with an average profit margin of 6.36% on cost. As the margin earned by the assessee was 6.61% i.e more than the adjusted mean margin, the assessee submitted that price charged by it in international transaction of software development services is to be treated as being at arm's length. The Transfer Pricing Officer, however held that the companies engaged in software development services were treated by the assessee as comparables irrespective of the verticals of software. She held that the assessee is mostly an offshore software development provider i.e akin to software development service provider and derives 100% of its Revenue from export services to its AE in US. She held that the filters adopted by the assessee for arriving at the 15 comparables have several defects and the following are the defects:-

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i) **Verticals of Software Development not considered**

The tax payer has not gone into the verticals within the software industry in its comparability study. 'Vertical' is the 'industry segment' like banking, finance, insurance, healthcare, retail etc., to which the services of the company cater to. The functional or service lines may include but not limited to application, development and maintenance, package implementation services, independent validation services, enterprise application services, testing services, embedded software services, web development, inter-net based applications, e-commerce applications, consulting services etc. The tax payer has searched for comparables which are engaged in the software development services but has not considered the verticals/functional or service lines in which the company is engaged. Thus, the tax payer considered companies that are into different verticals and functional lines, though the tax payer is involved in software development activities catering to telecommunications and inter-net sector.

ii) **Filters or criteria adopted by the tax payer in its TP study.**

The selection of companies having sales turnover of more than 1.00 crore but less than 200 crores. According to the TPO, The tax payer hypothesis that there is a direct co-relation

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between turnover and profit margins of the company, is not acceptable because the transfer pricing rules or the OCED guidelines do not prescribe any specific range of turnover for comparability to size and scale of the turnover, size or scope of operations. Once functional similarity is accepted, companies can be compared irrespective of their turnover, size or scope of operation. Particularly, in the service industry where not much of infrastructure is needed to set up a business, the fixed costs in the software/ITES industry are insignificant compared to the manufacturing industry, because, the major costs in the software and ITES industry (which includes the tax payer) are variable costs such as salary, traveling expenses, communication expenses etc. The margins in any industry vary with the change in turnover only when the fixed costs involved are significant and in absence of any a significant fixed costs, the margins in the software/ITES industry are not linked to the turnover of the company. The TPO, after considering the comparables selected by her and also comparables selected by the assessee irrespective of the turnover, observed that the margin difference is very meagre showing that there is no direct co-relation between turnover and profit margin of the company.

In addition to the filters applied by the tax payer which are accepted by the department, the TPO adopted further filters

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as appropriate for selection of suitable comparables. Additional filters adopted by the TPO are as under;

1) Minimum employee cost of 25% over sales.

The tax payer is a software development service provider and incurs 73% of sales as salary expenditure. In the case of software development company employees are the main assets of the company and directly reflect the nature of business undertaken by the company. In the case of a software service provider company an average salary costs comprises from 24% to 42% of the revenue. As per the prowess database, in the average employee costs works out to about 35% over sales in the case of companies having turnover more than Rs.1.0 Crore for the FY: 2005-06. Extremely low expenditure on salary/employee cost is a definite indication that the company is either into further outsourcing of the work or is a software product developer or a software trading company. In view of these facts, filter of 25% of minimum salary expenditure was applied while examining the comparables selected by the tax payer and also while searching for additional comparables.

2. Different year ending filter;

The tax payer follows the financial year ending 31st March, whereas in some of the comparables companies selected by the tax payer, the accounting year ends with June or

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September or any other month. Those companies whose accounting year does not end with March 31, 2005 were proposed to be rejected, because it ensures that the transactions being compared took place during the same period/financial year either in the tax payer's case or in the comparable company's case and is also being in conformity with Rule 10B(4).

3. Diminishing Revenue Filter

As per this filter the companies with diminishing revenue for the last three years upto and including FY:2005-06 were rejected as comparables.

4. Software Development Service revenue 75%

For the Transfer Pricing study, the search criterion should basically be to search for companies which are mainly engaged in software development service or whose significant activities or functions relate to software development service and therefore, it is appropriate to apply the filter that the comparable company should have at least 75% of its revenue from software development services.

5. Onsite revenue filter.

According to this filter, the companies whose onsite revenue exceed 75% of export revenues from software

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development are rejected as comparables. This filter is adopted because, the Indian software sector provides both onsite and offshore services and the Indian vendors have succeeded in raising the share of offshore revenue from 44% in 2000-01 to 64%in 2003-04, 71% in 2004-05 and to 74% in 2005-06 and most of the uncontrolled enterprises follows hybrid model with revenue mix both from onsite and offshore. The assessee is mainly offshore service provider and it is difficult to get independent companies which generate revenue only from offshore development services. The pricing is different in onsite operations when compared to offshore operations as is evident from the quarterly report of the Mphasis BFL Ltd, for the quarter ended with March 31, 2006 in the year 2005-06 and according it, the average rate per man hour in the case of off shore projects was US$21, whereas the same was considerably higher in the case of onsite projects at about US$64 per man hour, due to which the profit margin also varies significantly. This is because, in the case of off shore projects most of the costs are incurred in India, while onsite projects were carried out abroad significantly increasing the employee cost and other costs. The companies which generate more than 75% of the export revenue from onsite operations outside India are effectively companies working outside India having their own

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geographical markets, cost of labour etc. and also return is commensurate with the economic conditions in those countries. Thus, assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the tax payer.

6. Functionally different filter;

The assessee is engaged in providing the software development services and the software development process is a structure imposed on development of software products. Often, the first step in attempting to design a new piece of software is to decide whether it would be in addition to existing software or is it new application, a new subsystem or a whole new system. This is what is generally referred to as 'Domain Analysis'. Assuming that the developers are not sufficiently knowledgeable in the subject area of the new software, the first task is to investigate the so called 'domain' of the software, because more knowledgeable they are about the domain already, the less the work that is required. Another objective of this work is to make the analysts who will later try to elicit and gather the requirements from the area experts or professionals, speak with them in the domain's own terminology and to better understand what is being said by these people because otherwise they will

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not be taken seriously. The next most important task in creating a software product is extracting the requirement of the customers and then precisely describing the software to be written possibly in a rigorous way. In practice, most successful specifications are written to understand and fine tune applications that were already well developed, although safety critical software systems are often carefully specified prior to application and development. The architecture of a software system refers to an abstract specification of the software system and is concerned with making sure that the software system will meet the requirements of the product as well as ensuring that future requirements can be addressed. The architecture step also addresses interfaces between the software system and other software products, as well as the underlying hardware or the host operating system. Thereafter, a design is reduced to code and where the code is to be written by two different engineers, they must work together and the testing of software falls on to the shoulders of software engineers. The next important task is documenting the internal design of software for the purpose of future maintenance and enhancement. A large percentage of software projects fail because the developers fail to realize that it does not matter how much time and planning a development team puts into creating a software if

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nobody in the organization ends up using it. Therefore, it is very important to have training classes for the most enthusiastic software users, shifting the training towards the neutral users intermixed with the avid supporters and finally incorporate the rest of the organization into adopting the new software. The next important step is the maintaining and enhancing software to cope with newly discovered problems or new requirements. This can take far more time than the initial development of the software and about 2/3rd software engineering work is maintenance and a small part of it i.e. fixing bugs. The best known and oldest process of software development is the waterfall model which follows all the above processes and after each step is finished, the process proceeds to the next step just as builders do not revise the foundation of a house after framing has been erected.

3. From the above analysis, it can be seen that a company which develops a software product by following all the above steps involved in creating a software is a software development company and in this case, intellectual property generated belongs to the company and the products are generally sold on license basis wherein the right to use the software is transferred without giving the source code. Unlike these software development companies, pure software development service

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provider does a portion of the described software development life cycle. It does not generate any intellectual property of its own. The intellectual property generated belongs to the customer and not to the service provider. A software customization company buys software products in the form of licenses from third party or uses its own software products for customization to suit the requirements of the customer and in this case, only the right to use the software is passed on to the customer and therefore, the same is also considered as software development service providers. A software trading company purchases software products in the form of licenses or on royalty basis as a right to use and sells these products as a reseller.

3.1 The assessee being a software development service provider, it cannot be compared to a software development company or a software trading company. Therefore, the companies that are functionally different from that of the tax payer are to be excluded.

3.2 Applying the above filters, the TPO rejected ten of the comparables adopted by the assessee and made a search of his own for the appropriate comparables on the prowess database as well as capitaline data bases and arrived at final 20 comparables. After arriving at the 20 comparables, the TPO

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issued notices u/s 133(6) to the companies where complete information is not available in the data base or in the annual reports. All the information received from the companies were provided to the tax payer for its comments and the adverse inference, if any, drawn based on the replies received from the companies were also communicated to the tax payer. She even considered five companies as comparables, though they have lower margins than the arithmetical mean margin of 28.68% considered by the TPO. In the annexure to the draft OCED guidelines, the working capital adjustment is at 0.88%. She however, rejected the risk adjustment computed by the assessee and arrived at the arithmetic mean of the profit level indicator (PLI) at 19.80% and arrived at the arms length price (ALP) at the rate of 119.80% of operating cost at Rs.20,00,47,069/- and made the adjustments u/s 92CA of the short fall of Rs.2,20,12,927/- between the ALP and the price shown in the international transactions.

4. With regard to Information Technology Enabled Services (ITES) also, the assessee computed the ALP for the international transactions adopting the TNMM method. The TPO observed that the assessee has used the prowess and capitaline database for searching the comparables and has arrived at 7 comparables. The filters used by the assessee for

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arriving at the comparables for ITES are also the same which were used for arriving at the comparables for the TP study of software development services.

4.1 The TPO observed that there are certain defects in the filters adopted by the assessee which are almost the same as found by her for the software development services. Thereafter, she proceeded to reject four of the comparables selected by the assessee on the ground that they are functionally dissimilar to that of the assessee or otherwise unsuitable as a comparable.

She thereby accepted only three comparables selected by the assessee.

4.2 Thereafter, she also proceeded to select some more comparables by using the same database i.e. prowess and capital line and arrived at 10 more comparables, after issuing notices u/s 133(6) of the IT Act. The response given by the comparables to the notices u/s 133(6) was also supplied to the assessee. Thereafter, the TPO worked out the average profit margin at 24% and worked out the working capital adjustments at 1.72%. She also rejected the assessee's quantitative computation of the risk adjustments and arrived at the ALP at 22.28% of the operating cost. She computed the ALP at 22.28% of the operating cost of Rs.4,23,23,860/- and made the adjustments of the short fall i.e.Rs.66,38,48/- towards the TP

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adjustments u/s 92CA of the Act for the ITES. Thus, the total adjustments made to the TP adjustments for the AY: 2006-07 was Rs.2,86,51,575/-.

Aggrieved by the draft order of the AO, the assessee preferred objections to the DRP which approved the draft order and the assessee is in appeal before us.

4.3 The assessee has raised the following grounds of appeal.

"1. Grounds relating to natural justice: The lower authorities have erred in passing the order.

a. Without considering all the submission and/or without appreciating properly the facts and circumstances of the case and law applicable.

b. At the fag end of the limitation period; and

c. without affording a proper opportunity of being heard to the appellant.

2. Grounds relating to procedure: The lower authorities have erred in

a. Making a reference for the determination of the Arms Length Price of the international transactions to the TPO without demonstrating as to why it was necessary and expedient to do so.

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b. Passing the order without demonstrating that the appellant had any motive of tax evasion.

3. Without prejudice, the Dispute Resolution Panel, not being Income-tax authority has erred in passing the order and in the manner passed by them.

4. The members of Dispute Resolution Panel also being jurisdictional Commissioner/Directors of Income Tax of the appellant, the constitution of the Dispute Resolution Panel itself being bad in law and hence the order passed by the Panel also bad in law.

5. Grounds relating to charge of income-tax: The lower income-tax authorities have erred in not appreciating that:

a. There is no amendment to the definition of the term 'Income' to include amounts computed under Chapter X;

b. The charging or computation provision relating to income under the head Profits & Gains of Business or Profession' do not refer to or include the amounts computed under Chapter X.

c. There is no provision in Chapter X including that it would override the computation provisions of business income or the normal understanding of the term 'income'.

6. Grounds relating to notice under 133(6); The lower authorities have erred in:

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a. Adopting a flawed process in issuing notices /s 133(6) and relying upon such replies to compute ALP.

b. Not giving complete information to the appellant; and

c. Not giving an opportunity to the appellant to cross examine the parties involved.

7. Grounds on comparables and rejection of TP analysis of the appellant;

a. Rejecting the comparables selected by the appellant on unjustifiable grounds; and

b. Rejecting the transfer pricing analysis undertaken by the appellant on unjustifiable grounds,

in the case of both software as well as ITES segments.

8. Grounds relating to TP analysis of the TPO:

a. Doing a fresh transfer pricing analysis despite absence of any defects in the transfer pricing analysis submitted by the appellant.

b. Adopting inappropriate filers in the process of selecting comparables;

c. Adopting companies as comparables even though they are not comparables in respect of functions performed, risks assumed, assets utilized, size turnover etc.

d. In adopting companies having unusual circumstances resulting in high margins; and

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e. Inappropriate computing the operating margins of the comparables and the appellant.

In the case of both software as well as ITES segments.

9. Grounds on adjustment for differences:

The lower income-tax authorities have erred in not making proper adjustments for enterprise level and transactional level differences between the appellant and the comparable companies.

10. The lower authorities have erred in;

a. Ignoring the business, commercial and industry realities and economic circumstances applicable to the appellant vis a vis the comparables;

b. Not making any adjustments for qualitative and quantitative difference between the business of the appellant and those of the comparable companies.

c. Not recognizing that the company was insulated from risks, as against comparables, which assume these risks and therefore, have to be credited with a risk premium on this account; and

d. Not appropriately computing the working capital adjustment while computing the margins of the comparables.

11. Grounds relating to one comparable:

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a. The lower income tax authorities have erred in not appreciating that law does not compel adopting many (or any minimum) companies as comparables and that the appellant could justify the price paid/charged on the basis of any one comparable only.

12. Grounds on benefit of 5% range;

a. Assuming without admitting that the adjustment is to be made, the lower income tax authorities have erred in not allowing the benefit of the +/- 5% range mentioned in the proviso to section 92C(2).

13. Other Grounds

The learned AO has erred in levying a sum of Rs.46,37,782/- as interest u/s 234B and a sum of Rs.5,22,960/- as interest u/s 234D. On the facts and in the circumstances of the case, interest u/s 234B and u/s 234B and u/s 2334D are not leviable.

14. In view of the above and other grounds to be adduced at the time of hearing, the appellant prays:

a. That the order passed by the AO be quashed, or in the alternative.

b. The deficiencies/shortcomings in the process as details under the various grounds above be made good/rectified.

c. The adjustments made by the TPO/AO and confirmed by the Dispute Resolution Panel varying the reported value of the international transaction be deleted; and

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d. Various adjustments not made, as requested, be directed to be made;

e) Interest levied u/s 234B and u/s234D be deleted.

In addition thereto, the assessee has also raised further additional ground of appeal which is as follows;

Additional Grounds of appeal:

"The lower income-tax authorities have erred in not restricting the TP adjustment to AE transactions only and thereby making an adjustment in respect of transactions with non-associated enterprise also".

5. As regards ground no.1 relating to compliance of principles of natural justice and also ground no.2 to 4 with regard to procedure followed by the AO in making a reference to TPO and the order passed by the DRP, the learned counsel for the assessee submitted that the assessee does not wish to press the same. These grounds are accordingly, rejected as not pressed.

5.1 As regards the ground of appeal relating to the ALP adjustments suggested by the TPO by rejecting the comparables adopted by the assessee and taking into consideration the other comparables by conducting a fresh TP analysis, the learned counsel for the assessee has submitted the following;

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5.2 The assessee is a company engaged in the business of providing software development services and Information Technology Enabled Services segment (ITES). The assessee exports its services to its AE as also other clients. The assessee also renders services to domestic clients. The assessee renders its services to its AE on man day/man hour basis.

5.3 During the year under consideration, the assessee had the following international transaction with its AE (i) rendering of software development and (ii) ITES services and (iii) receipt of interest free loan. There is no objection by the TPO with regard to receipt of interest free loan by the assessee. The international transactions with respect to rendering of services to AE are as follows;

i). Software development services	8,13,17,968/-
ii) ITES	3,50,70,406/-
Total	Rs.1,16,388,374/-

5.4 As the assessee renders service to AE as well as to non-AE, the AE exports are to the tune of Rs.8,13,17,968/-. The assessee has adopted the transactional net margin method (TNMM) to justify the price charged in the international transactions. In order to identify the comparable companies the assessee has adopted a search process on prowess database

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and after applying various filters, the assessee selected 15 companies as comparables which are as follows;

Sl. No. Name of the Company	Operating Turnover	Operating cost (INR in Crores)	Operating profits (INR in Crores)	Average unadjusted margins
1. Aztec Software & Techn. Services Ltd.,	128.62	109.77	18.86	17.18
2. Bodhtree Consulting Ltd.,	5.43	4.70	0.73	15.63
3. Compulink Systems Ltd.,	2.93	4.67	(1.74)	(37.20)
4. Goldstone Tech.Ltd.,	35.87	34.56	1.31	3.78
5. Helios & Matheson Information Technology Ltd.,	120.12	88.87	31.25	35.17
6. Lanco Global Systems Ltd.,	35.86	33.85	2.01	5.94
7. Maars Software Int.Ltd.	51.84	46.01	5.83	12.67
8. Melstar Inf. Tech. Ltd.,	18.19	17.31	0.87	5.04
9. Orient Inf. Tech.Ltd.,	25.57	31.04	(5.47)	(17.63)
10.R..S.Software (ind.) Ltd.,	91.60	79.44	12.16	15.30
11. SIP Technologies & Exports Ltd.,	12.30	10.15	2.15	21.14
12.T.V.S.Infotech Ltd.,	1.92	2.30	(0.37)	(16.28)
13. V.M.F Softech Ltd.,	2.95	2.79	0.15	5.46
14.Visu International Ltd.,	70.09	62.48	7.61	12.19
15. Visualsoft Tech.Ltd.,	157.57	134.73	22.83	16.95
Arihmetic mean	54.14	47.00	7.14	6.36

The arithmetic mean of these comparables came to 6.36% and the assessee's operating margin cost was 7.96%. Since assessee's margin was greater than the arithmetic mean of the comparables, it was concluded that the international transactions under the software segment are at arm's length. The learned TPO issued a show cause notice dated 31-08-2009 proposing to re-determine the arm's length price for software development services. The notice contained remarks on assessee's study, new search methodology and comparables proposed (14) and copies of the replies received u/s133(6) from other companies(in CD). In reply thereto, the assessee filed a letter dated 14-09-2009 raising various objections to the

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proposed action of the TPO. However, the TPO passed a final order u/s 92CA selecting 20 companies as comparables, thus the TPO has considered additional companies as comparables without proposing the same to the assessee or affording an opportunity to the assessee to present its objections to their adoption. The arithmetic mean was determined at 20.68% and after making the working capital adjustments of 0.88%, the adjusted arithmetic mean was determined at 19.80% and the transfer pricing adjustments for the software segment was determined at Rs.2,20,12,927/-. However, while computing the transfer pricing adjustments, the TPO has taken the operating cost at Rs.16,69,84,198/-(being the entire cost of the software segment) and operating revenue at Rs.17,80,34,142/- (being the entire revenue of software segment including non-AE and domestic revenue) instead of the costs & revenues referable to the international transaction only.

5.5 Aggrieved by the said transfer pricing adjustments, the assessee filed detailed objections before the dispute resolution panel (DRP) on 27-01-2010 and the DRP approved the draft order except rectifying an error in the margin computation of one comparable namely M/s Megasoft.

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5.6 Aggrieved by this order of the DRP and the consequential assessment made by the AO the assessee has filed this appeal and has raised the following points;

1. Restrict TP adjustments to AE transactions only:- The transactions with AE only are international transactions and it is only with reference to these transactions that it could be alleged that the prices are manipulated to result in a flight of profit from India and it is only such flight of profits that needs correction. In support of his contention that only international transactions with AE are to be considered, the learned counsel for the assessee placed reliance upon the following decisions

1. DCIT Vs Starlite ITA No.2279/Mum/06

2. IL Jin Electronics (I) Pvt.Ltd., Vs ACIT 2010-TIOL-151 ITAT-Mumbai

3. ACIT Vs T Two International Pvt.Ltd., 2010-TIOL-166-ITAT-Mumbai

4. Global Vantedge Pvt.Ltd.,(2010-TIOL-24-ITAT-DEL.

5. DCIT Vs Startex Networks (Ind.) Pvt.Ltd.,2010-TII-13-ITAT-DEL-TP

6. ACIT Vs Wockhardt Ltd., (6 Taxman.com 78 Mum-ITAT);

7. Addl.CIT Vs Tej Diam (2010-TII-27-ITAT-MUM-TP):

8. Abhishek Auto Industries Ltd., (2010-TII-54-ITAT-DEL-TP); and

9. Ankit Diamonds 43 SOT 523(Mum.)

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6. Based on all the above decisions, the learned counsel for the assessee submitted that the transfer pricing adjustments should be restricted to transactions with the AE only and also that operating cost of the software segment referable to AE transactions only should be taken into consideration. The learned DR however, supported the orders of the authorities below.

6.1 Having heard both the parties and having considered their rival contentions, we find that Sec.92B of the IT Act gives the meaning of 'international transactions' to mean "a transaction between two or more associated enterprises either or both of whom are non-resident.....".

Chapter-X of IT Act relates to special provisions relating to avoidance of tax and sec.92 therein relates to computation of income from international transactions having regard to ALP. Thus, it can be seen that only international transactions between the associated enterprises either or both of whom are non-resident are to be computed having regard to ALP. This issue is also covered by the decisions relied upon by the learned counsel for the assessee. Accordingly, the AO is directed to make the transfer pricing adjustments by restricting the adjustments to the transactions of the AE only by adopting the

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operating revenue and operating costs of these transactions only.

7. As regards the filters selected by the assessee in making the transfer pricing study, the learned counsel for the assessee submitted that the assessee has adopted a turnover range of Rs.1.00 crore at the lower end and Rs.200 Crores at the higher end while choosing the comparables. He submitted that this adoption of upper limit of Rs.200 Crores is based on the Dun and Bradstreet's analysis which has classified the software companies into the following categories;

1. Large size firms (Rs.20,000 Mn)
2. Medium size firms (Rs.2,000-20,000 Mn)
3. Small size firms (Rs.2,000 Mn)

7.1 The learned counsel for the assessee submitted that the TPO has rejected the upper limit of Rs.200 Crores on the ground that there is no relationship between sales and margins in the service sector as fixed assets are very minimal. He submitted that this is not correct because, the size of the comparable is an important factor of comparability and that it is also recognized by the statute, especially the Rules. He submitted that Rule 10B(3) lays down guidelines for comparing an uncontrolled transaction with an international transaction

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and as per the said Rule difference for transfer pricing purposes can be of two types;

1. Difference in transactions being compared or
2. Difference in enterprises

8. According to learned counsel for the assessee size is an important facet of an enterprise level difference. He submitted that comparables should have something similar or equivalent and should possesses same or almost the same characteristics. To use a simile, he submitted that a Maruti 800 Car cannot be compared to Benz Car, even though both are cars only. He submitted that unusual pattern, stray cases, wide disparities have to be eliminated as they don't satisfy the test of comparability. Companies operating on large scale benefit from economies of scale, higher risk taking capabilities, robust delivery and business models as opposed to the smaller or medium sized companies and therefore, size matters. Two companies of dis-similar size therefore, cannot be assumed to earn comparable margins and this impact of difference in size could be removed by an quantitative adjustment to the margins or price being compared if it is possible to do so reasonably accurately. He submitted that size as one of the selection

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criteria has also been approved by various benches of the Income-tax Appellate Tribunal, in the following cases;

1. *DCIT Vs Quark Systems Pvt.Ltd., 38 SOT 307 (SB*), wherein it was held that even the filter of lower turnover of Rs.1.00 crore is without any reasonable basis and there is no filter for higher turnover also. The application of turnover filter also leaves much to be desired and has to no rationale basis. In our considered view, it is improper to proceed on the basis that the turnover of Rs.1.00 core to infinite is a reasonable classification as turnover base.

2. M/s Egain Communications Pvt. Ltd., Vs ITO 118 TTJ 354.(ITAT,Pune)

3. M/s Sony India (P)Ltd., Vs DCIT 114 ITD448 (ITAT Delhi)

4.DCIT Vs Indo American Jewellery Ltd.,ITA No.6194(ITAT, Mum.)

5.M/s Philips Software Centre Pvt.Ltd.,26 SOT 226

6. ACIT Vs NIT 10 Taxman.com 42

8.1 He further submitted that size as a criteria for selection of comparables is also recommended by OCED in its TP guidelines. The observation of OCED in para-3.43 of the Chapter on guidelines reads as follows;

" Size criteria in terms of sales, assets or number of employees: The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative

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competitive positions of the buyer and seller and therefore comparability".

8.2 The learned counsel for the assessee submitted that similar observations were also made by ICAI in para15.4 of TP guidance Note. He submitted that TPO's range of Rs.1.00 crore to infinity has resulted in selection of companies like M/s Infosys which is having a turnover of Rs.9,028 cores which is 1,1007 times bigger than the assessee company which has a turnover of Rs.8.15 crores. He further submitted that NASSOM was also categorized the companies based on the turnover as follows;

1. Greater than USD 1 Billion (approximately 5,0000 crores)
2. Between USD 100 Million to USD 1 Billion(Rs.500 crores to Rs.5,000 crores) and
3. Others having less than USD 100 Million (Rs.500 croes)

Thus, the learned counsel for the assessee submitted that an appropriate turnover range should be applied in selecting a comparable of uncontrolled companies and the assessee has accordingly, applied the turnover range of Rs.1.00 crore to 200 crores based on Dun and Bradstreet's analysis. He submitted

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that in the alternative, the categories recognized by1 NASSCOM may also be applied in selecting comparables.

8.3 The learned DR rebutted this argument and submitted that the Act or Rules do not provide for the turnover filter. He submitted that as rightly pointed out by the TPO in the case of service sector, the size of the company does not matter because, the infrastructure layout is very less and it will not affect the profit ratio in any way. He drew our attention to the particular portion of TPO's order wherein the TPO has the reasoning given for rejecting the turnover filter.

9. Having heard both the parties and having considered the rival contentions and also the judicial precedents on the issue, we find that the TPO himself has rejected the companies which are making losses as comparables. This shows that there is a limit for the lower end for identifying the comparables. In such a situation, we are unable to understand as to why there should not be an upper limit also. What should be upper limit is another factor to be considered. We agree with the contention of the learned counsel for the assessee that the size matters in business. A big company would be in a position to bargain the price and also attract more customers. It would also have a broad base of skilled employees who are able to give better output. A small company may not have these benefits and

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therefore, the turnover also would come down reducing profit margin. Thus, as held by the various benches of the Tribunal, when companies which are loss making are excluded from comparables, then the super profit making companies should also be excluded. For the purpose of classification of companies on the basis of net sales or turnover, we find that a reasonable classification has to be made. Dun & Bradstreet and NASSCOM have given different ranges. Taking the Indian scenario into consideration, we feel that the classification made by Dun & Bradstreet is more suitable and reasonable. In view of the same, we hold that the turnover filter is very important and the companies having a turnover of Rs.1.00 core to 200 crores have to be taken as a particular range and the assessee being in that range having turnover of 8.15 crores, the companies which also have turnover of 1.00 to 200.00 crores only should be taken into consideration for the purpose of making TP study.

10. The next issue raised by the learned counsel for the assessee is that while making the comparability analysis, the TPO conducted enquiries from certain companies by exercising powers conferred on him u/s 133(6) of the Act and these notices and the replies have been provided to the assessee. He submitted that the TPO has issued notices to 154 companies, but why these companies were selected is not clear. He

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submitted that the information had been provided to the assessee in the form of CD but it is not clear as to whether all the responses have been incorporated in the CD given to the assessee. He submitted that the entire process lacks transparency and fairness because six companies which have been finally taken by the TPO do not find place in the initial list of companies generated by the learned TPO. He submitted that the TPO selected Megasoft Ltd., as comparable and as seen from the details provided to the assessee alongwith the initial show cause notice, he rejected companies which fail in RPT and employee cost filters but M/s Megasoft Ltd., which fails RPT filter and employee cost filter was also considered and the TPO has issued a notice u/s 133(6) of the IT Act to M/s Megasoft Ltd., which clearly shows the arbitrary approach of the TPO. He submitted that the assessee has raised this issue before the DRP also, but the DRP only stated that not providing complete information received from the companies in response to notice u/s 133(6) is intentional, as the data and information is voluminous and therefore, only relevant information is given. Thus, according to him withholding of such information results in prejudice to the assessee and is against the principles of natural justice. He further submitted that Rule 10D provides that information specified in sub-rule(1) shall be supported by

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authentic documents., but the TPO has not established whether the information obtained by way of notice u/s 133(6) is authentic and complete. He drew our attention to page-341 of PB-1 to demonstrate various differences between the annual reports of the comparables and the replies received to notices u/s 133(6) of the IT Act. He submitted that inspite of all the differences, the TPO has completed the assessment by relying upon replies received to notices u/s 133(6), in preference to the annual reports of the companies which are certified by professionally qualified Chartered Accountants and approved by the Board of Directors.

10.1 The learned counsel for the assessee also submitted that the TPO has relied on segmental information received u/s 133(6) which otherwise does not form part of annual report. The bifurcation and reporting of income and expense into different segments is done by the company and is not audited by a Chartered Accountant and it is possible that the same may not be as per accounting standard-17 issued by the ICAI and hence, either the information is incomplete or unreliable apart from being unverifiable. To demonstrate this point, the learned counsel for the assessee submitted that M/s Sankhya Infotech was selected as comparable in the preceding assessment year 2005-06 on the ground that it is a software development

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company on the basis of reply received to notice u/s133(6) inspite of the objection of the assessee that this company is a software product company. But during the year under consideration, the same company has been rejected on the ground that it is a software product company which is again based on reply received to notice u/s 133(6) of the IT Act. Thus, the learned counsel for the assessee submitted that these inconsistencies in the process of TPO raises doubts regarding transparency and genuineness of the entire process.

Another point advanced by the learned counsel for the assessee is that the information obtained by the TPO by issuing notices u/s 133(6) is not available in public domain at the time of study by the assessee. He submitted that Rule-10D prescribes the documents to be kept and maintained u/s 92D and sub-rule (4) thereof deals with the process and the method to be adopted in making the comparability analysis. He submitted that as per this sub-rule, the information and documents should as far as possible be contemporaneous and should exist latest by the specified date referred to in clause(iv) of sec.92F. According to him, the dictionary meaning of contemporaneous is 'existing or occurring at the same time, of the same historical or geographical period'.

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10. 2 As per Rule 10D, the information and documents prescribed there in must be kept and maintained by the assessee latest by the prescribed date i.e for AY: 2006-07 by 31st October, 2006 and accordingly the assessee has kept and maintained the information and documents. The TPO is collecting, collating and compiling data two/three years after the date of the assessee's documentation, ignoring the fact that in choosing the most appropriate method, availability of data is a relevant factor, under /rule10C(2)(c) of the Act. He thus, submitted that the power of the TPO cannot be used to cover information that comes into public domain after the specified date. He submitted that the existence of the specified date is very important because what was correct and complete on the basis of data existing by a specified date would become unreliable or incomplete in the light of the data that comes into existence subsequently. He submitted that if subsequent information is permitted to be used, then the ALP would remain fluid before the TPO, DRP, CIT(A) and the ITAT and the higher forums and this can lead to ever changing ALP. He submitted that the ALP is not dynamic or fluid subject to vagaries of future date. He submitted that the TP analysis is an art and not a science and mathematical precision are not desired nor expected. When the assessee has placed his entire process

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before the learned TPO and there is no allegation that it was short of or that the material facts have been dodged or that it was incomplete, the same cannot be brushed aside. He thus, prayed that the data available subsequently or obtained through notice u/s 133(6) should be rejected.

11. The learned DR on the other hand, supported the orders of the authorities below and submitted that deals with the manner in which the ALP is to be determined u/s 92C of the Act and sub-rule(4) thereof. Sec.10B provides that the data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into. Thus, he submitted that not only the comparables adopted by the assessee but information relating to other companies which are available in the public domain at the time of determining the ALP also have to be considered by the TPO, while making the TP adjustments. He submitted that the act or Rules do not specify the date, till which only the information available in the public domain can be utilized. He submitted that though sec.92D and Rule -10D prescribes the information and documents to be kept and maintained u/s 92D of the IT Act, it is not prohibited nor is it specified therein that only the documents maintained by the

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assessee have to be taken into consideration. He submitted that the TPO is under an obligation to verify the information and documents kept and maintained by the assessee and wherever he feels that some more information is necessary for making the TP adjustment, he may also make his own search and use the relevant years data available in the public domain. Thus, in view of this power of TPO, the TPO has made the search of the databases and has issued notices to the relevant parties u/s133(6) of the Act to gather information which is not available in the public domain. After considering replies to the said notices, the TPO has rejected many companies and has selected only the relevant comparables and all the information which is sought to be used by the TPO for making the TP adjustments has been supplied to the assessee and the assessee was given ample opportunity of making its objections. He submitted that the TPO after considering the assessee's objections only has made the TP adjustments and therefore, there is no violation of principles of natural justice nor there is any lack of transparency or fairness. Thus, according to him, the TPO has been reasonable in following the procedure laid down by the Act and there is no infirmity in the order of the TPO which has been approved by the DRP.

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12. Having heard both the parties and having considered the material on record, we find that the following questions arise for our consideration on this issue;

1.What is the data to be considered by the TPO at the time of determining ALP ?

2. Whether the assessee should be given an opportunity to rebut the material sought to be used by the TPO ?

12.1 As far as the data to be used by the TPO while determining the ALP is concerned, we find that it is covered by the provisions of Rule -10D sub-rule-4 of the IT Rules, 1962. Sec.92C provides the method for computation of ALP and prescribes five methods for computing the ALP and also any other method as may be prescribed by the Board. Sec.92D provides that every person who has entered into an international transaction shall maintain and keep such information and documents in respect thereof and the Board may also prescribe the period for which the information and documents shall be kept and maintained and the AO and the CIT(A) may in the course of any proceedings under the Act, require any person who has entered into an international transaction to furnish any information and documents in respect thereof. Thus, it can be seen that the requirements is only to maintain and keep the information and documents

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relating to international transactions so that they are available as and when required during any proceedings under the Act. The section does not provides that the information and documents are to be kept and maintained for a period of 8 years. Rule 10-D of sub-sec.1 specifies the documents and information which are to be kept and maintained by the assessee and sub-rule-2 thereof provides that nothing contained in sub-rule-1 shall apply in a case where the aggregate value as recorded in the books of accounts, the international transactions entered into by the assessee does not exceed 1.00 crore rupees. Sub-rule-3 provides the supporting authentic documents which are to be kept and maintained and sub-rule-4 thereof provides that the information and documents specified under sub-rule 1 & 2 should as far as possible be contemporaneous and should exists latest by the "specified date" referred to in clause-4 of 92F. Clause-4 of sec.92F gives the definition of "specified date" to have the same meaning as assigned to 'due date' in Explanation-2 below sub-sec.1 of sec.139. Explanation-2 to sec.139 defines 'due date' in a case of a company to be '30th day of September of the assessment year'. The assessee before us is a company and therefore, as on '30th day of September' of the relevant assessment year, the assessee is supposed to maintain information and documents. After

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going through the above provisions of law, it is clear that the Act has not provided for any cut off date upto which only the information available in public domain has to be taken into consideration by the TPO, while making the TP adjustments and arriving at arm's length price. The assessee as well as the revenue are both bound by the Act and the Rules there under and therefore, as provided under the Act and Rules they are supposed to be taking into consideration, the contemporaneous data relevant to the previous year in which the transaction has taken place. The assessee had strenuously argued that the provision of sec.92D and Rule-10D is defeated if, the TPO takes the data which is available in the public domain after the specified date and the ALP would be fluid and there would be no certainty for the same. We are unable to agree with the arguments of the learned counsel for the assessee. The ALP has to be determined by the TPO in accordance with law and the Act provides that the TPO shall take into consideration the contemporaneous data. The assessee is only required to maintain the information and documents as may be necessary relating to the international transactions so that it can be made available to the TPO or the AO or any other authority in any proceedings under the Act. By providing a specified date in the Act, the obligation is cast upon the assessee to keep and

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maintain the documents for that period. But, it does not restrict the TPO from making enquiries thereafter, for determining the correct ALP. Having held so, we come to the next question, as to whether the TPO can make his own research and call for information from various entities without the knowledge of the assessee. Under sub-sec(3) & (7) of sec.92CA, the TPO is entrusted with all the powers under clauses (a) to (d) of sub-sec.1) of sec.(3) or sub-sec.(6) of sec.133 to call for and gather any information as may be required. When he is making the search for a relevant comparable, the TPO can issue notices to the parties whom he considers as relevant to gather requisite information and on being satisfied with regard to relevancy of the material which can be used against the assessee only then the assessee has to be given an opportunity of presenting its objections. Thus, the TPO need not inform the assessee about the process used by him for issuing the notices u/s 133(6) nor is he under any obligation to furnish the entire information to the assessee. The principles of natural justice requires that when any information is sought to be used against the assessee, the assessee shall be given a fair opportunity of hearing on that material. In the case before us the TPO has furnished all the information to the assessee in the form of CD and the assessee after going into the same has

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submitted a detailed submission along with its objections for taking various companies as comparables. It is another matter, if the TPO has not considered the objections of the assessee judiciously. In such a case, it would be an error of judgment and not violation of principles of natural justice. The objections of the assessee is that certain companies have been taken into consideration by the TPO as comparables without giving the assessee an opportunity of presenting its objections and also with regard to certain other companies, it had sought opportunity to cross examine them, but the said opportunity was not given.

13. We have already held that if any information is sought to be used against the assessee, the same has to be furnished to the assessee and thereafter, taking into consideration the assessee's objections, if any, only then can the TPO proceed to take a decision. If the assessee seeks an opportunity to cross examine the party, the assessee shall be provided such an opportunity. It is only during a cross examination that the assessee can rebut the stand of that particular company. The assessee has also brought out various defects in the additional comparables selected by the TPO and has brought out the glaring differences between the functions of those comparables as compared to assessee and also as to how the entire revenue

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of the assessee has been taken into consideration inspite of there being income from unrelated party transactions also. All these objections have been given in detail in the written submissions. We find that the TPO has not considered these objections, while determining the ALP. Further, the learned counsel for the assessee has also submitted that the assessee should be given a standard deduction of 5% as provided under the proviso to sec.92C(2) before making adjustments for the transfer price. In support of his contention, he placed reliance on the following decisions:

1.M/s Sap Labs India Pvt.Ltd., Vs ACIT 2010-TII-44 ITAT-BANG-TP

2.Philips Software Centre Pvt.Ltd., 26 SOT 226

3. MSS India Pvt.Ltd., 32 SOT 132

4. Customer Services India Pvt.Ltd., Vs ACIT 30 SOT 486

5. Skoda Auto India Pvt.Ltd., Vs ACIT 2009-TIOL-214-ITAT-PUNE

6. Development Consultants Pvt.Ltd., Vs DCIT 23 SOT 455

7. Sony India Pvt.Ltd., 315 ITR 150

8. Cumins India Ltd., Vs DCIT ITA NO.277 & 1412/PN/07

9. TNT India Pvt.Ltd., Vs ACIT 10 Taxman.com 161

10. Abhishek Auto Industries Ltd Vs DCIT 2010-TII-54-ITAT-DEL-TP

13.1 The learned DR however, relied on the orders of the authorities and submitted that 5% is not the standard

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deduction, but it is the range within which if the ALP falls then the ALP of the assessee has to be accepted.

13.2 Having heard both the parties and having considered their rival contention, we find that this issue is already covered by the decision relied upon by the assessee.

13.3 In view of the same, we deem it fit and proper to remand the issue to the file of TPO with the following directions;

a) The operating revenue and the operating cost of the transactions relating to associated enterprises only shall be considered;

b) The comparables having the turnover of morethan 1.00 crore but less than 200.00 crores only shall be taken into consideration;

c) All the information relating to comparables which are sought to be used against the assessee shall be furnished to the assessee;

d) The assessee shall be given an opportunity of cross examining the parties whose replies are sought to be used against the assessee if the assessee so desires;

e) To consider the objections of the assessee that relate to additional comparables sought to be adopted by the TPO and pass a detailed order and

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f) To give the standard deduction of 5% under the proviso to sec.92C(2) of the Act.

14. Similarly, in the ITES segment also the assessee has raised various grounds i.e. adoption of various companies as comparables and additional filters used by the TPO. For the detailed reasoning given by us for the above software development service segment, we direct the TPO to consider the assessee's objections and compute the ALP, after giving the assessee an opportunity of hearing after observing our directions given above.

15. With regard to low capacity utilization, adjustments to be given in the determination of ALP in ITES sector, the learned counsel for the assessee submitted that during the year under consideration the assessee had under utilized its facilities to the extent of 51.89% and therefore, this adjustments also should be given while determining the ALP. After giving adjustments, according to him the net operating margin on cost would be 27.46%. He submitted that the learned TPO has rejected the adjustments on the ground that comparables have similar problem as they have idle bench strength. He submitted that the adjustments sought was for under utilization of infrastructure while in the case of comparables, it is the case of idle bench strength. He submitted that infrastructure certain

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fixed costs attached to it which would affect the operating margin of the assessee considerably.

15.1 In support of his contention, that adjustment has to be made for under utilization of the infrastructures he placed reliance upon the decision of the Tribunal at Delhi in the case of M/s Global Vantedge Pvt.Ltd., (2010-TIOL-24 ITAT- Delhi) and also the decision of ITAT in the case of M/s Fiat India Pvt.Ltd., Vs ACIT 2010-TII-30 ITAT-Mum-TP. He has also drawn our attention to the orders of the TPO in the case of other companies for the assessment year 2007-08, the extracts of which are reproduced at pages 199-200 of paper book-2, wherein the TPO has observed that the average under utilization of manpower in ITES industry is 20% as per information available in the public domain. The adjustment to the extent of difference is being allowed. He submitted that when the under utilization of manpower is allowed, similar adjustment for under utilization of infrastructure also has to be allowed.

15.2 We agree with this contention of the counsel for the assessee. All the comparables have to be compared on similar standards and the assessee cannot be put in a dis-advantageous position, when in the case of other companies adjustments for under utilization of manpower is given. The assessee should also be given adjustment for under utilization

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of its infrastructure. The AO shall consider this fact also while determining the ALP and make the TP adjustments. With these directions, the appeal of the assessee is disposed of.

16. In the result, the appeal of the assessee is partly allowed for statistical purposes.

Order pronounced in the open court on the

(A. MOHAN ALANKAMONY **(SMT. P. MADHAVI DEVI)**
ACCOUNTANT MEMBER **JUDICIAL MEMBER**
Place: Bangalore
Dated:
am* : 05-08-2011

Copy to :

1. The Assessee
2. The Revenue
3. CIT(A)
4. CIT
5. DR
6. GF(B'lore)

By Order

AR, ITAT, BANGALORE