

**IN THE INCOME TAX APPELLATE TRIBUNAL  
(DELHI BENCH 'D' : NEW DELHI)**

**BEFORE SHRI C.L. SETHI, JUDICIAL MEMBER  
and  
SHRI B.C. MEENA, ACCOUNTANT MEMBER**

**ITA No.5156/Del./2010  
(Assessment year : 2006-07)**

M/s. Li & Fung (India) Pvt. Ltd.,  
202 – 206, Dua Associates,  
Tolstoy House, 15, Tolstoy Marg,  
New Delhi – 110 001.

vs. DCIT, Circle 4 (1),  
New Delhi.

**(PAN : AAACL1663M)**

(APPELLANT)

(RESPONDENT)

ASSESSEE BY : Shri Ajay Vohra & Neeraj Jain, Advocates  
REVENUE by : Shri Jayant Mishra, DR

**ORDER**

**PER B.C. MEENA, ACCOUNTANT MEMBER :**

This appeal filed by the assessee arises out of the order dated 08.10.2010 passed u/s 144C/143(3) of the Income-tax Act, 1961.

2. The return of income was filed for the assessment year 2006-07 on 1.12.2006 declaring income of Rs.3,08,26,448/-. The return was duly processed u/s 143(1). The case was selected for scrutiny. Notice u/s 143(1) was issued on 23.11.2007. A draft assessment order u/s 144C was made and a copy was forwarded to the assessee on 21.12.2009. The assessee preferred an appeal against the draft order before the Dispute Resolution Panel-II, New

Delhi (hereinafter referred to as DRP). The DRP issued the directions u/s 144C. The Assessing Officer passed the final order on the basis of the directions issued by DRP u/s 144C. The assessee is a company incorporated under the Companies Act, 1956. The assessee is a subsidiary company of Li & Fung (South Asia) Limited, a company incorporated in Mauritius, which is a part of the Li & Fung Group. Li & Fung Group world wide which has a network world over in export trading. The assessee is providing buying / sourcing services to clients located world over. During the financial year 2005-06 relevant to assessment year 2006-07, the assessee entered into the international transactions for its affiliated Li & Fung (Trading) Limited, Hong Kong. As declared, the assessee received service charges for providing buying services as cost plus mark up of 5%. As per the provisions of section 92D of the Income-tax Act read with Rule 10B of Income-tax Rules, the assessee maintained and determined Arms Length Price (hereinafter referred to as ALP) of the international transaction of provision of buying services applying Transactional Net Margin Method (hereinafter referred to as TNMM) and assessee identified this method as the most appropriate method for such transactions.

3. On the reference to the Transfer Pricing Officer (hereinafter referred to as TPO), the TPO held that cost plus compensation @ 5% of cost of the assessee is not at arm's length and he decided that it is not reflecting the profit

attributable to the assessee. The TPO held this cost plus 5% is not at arm's

length for the following reasons :-

“a) The appellant has performed all the critical functions, assumed significant risks and used both tangibles and unique intangibles developed by it over a period of time.

b) There is no evidence that the AE has either technical capacity or manpower to assist the appellant and that in the absence of any credible evidence, such general remarks to somehow prove the involvement of the AE cannot be accepted (Refer page.

c) The appellant has developed several unique intangibles which have given an advantage to the AE in the form of the low cost of the product, quality of the product and enhanced the profitability of the AE. These intangibles have increased profit potential of the AE though cost for development and use of intangibles was not taken for computations of routine markup of 5% considered by the appellant.

d) The appellant has developed the supply chain management which manages the link between and organization and its suppliers and customer to achieve strategic and pricing advantage.

e) The appellant has developed and owned human capital intangible at its own cost and all the related risks in creation and maintenance of human intangible are borne by the appellant.

f) The AE has recognized that India offers both cost and operational advantage such as lower salaries for the employees, low cost material and low cost manufacture. Accordingly, the appellant has neither quantified locational saving nor the AE has attributed any part of the additional profit on account of locational saving to the appellant, in India.”

The TPO applied the mark up of 5% of FOB value of exports. The total exports were of Rs.1202.96 crores and accordingly he computed net operating income on the FOB value of exports at Rs.60,14,80,000/-. The assessee approached the DRP and the DRP has given the following directions :-

"International transactions have to be judged at a different level as opposed to transactions covered by the domestic law. The OECD also recognizes the fact that related parties may fashion their transactions in such a manner that may call for looking at the substance of transactions over the form they are given. The relevant portions of the OECD guidelines issued on 22.07.2010 are as below:

[QUOTE]

1.67. Associated enterprises are able to make a such greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in the particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. In such instances tax administrations would have to determine what the underlying reality is behind a contractual arrangement in applying the arm's length principle.

1.68 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfied the arm's length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled

transaction and the alternative and the quality of any other evidence that may be available.

[UNQUOTE]

Therefore, the assessee's claims that it does not bear the risks of a normal trader have to be tested in this light. Accordingly, we are inclined to accept the TPO's conclusion that the FOB value of goods should form part of the cost base for calculating the remuneration that should accrue to the assessee. That leads to the next question as to what should be the correct markup that should be applied. The TPO has applied the markup of 5% because the assessee is operating on a cost plus 5% model. However, when we are increasing the cost base manifold, the application of a markup of 5% will be excessive.

We accordingly hold that given the facts and circumstances of the case a markup of 3% will be reasonable. This will adequately cover the valuable intangibles that have been developed and used by the assessee as also the location saving that the assessee is passing on to its AE."

4. After considering the assessee's pleadings before the DRP, they uphold the TPO's conclusion that FOB value of goods exported should form part of the cost base for calculating the remuneration that should accrue to the assessee. However, the DRP considered the mark up of the 5% as excessive and considered 3% as reasonable. They have also noted that 3% mark up will adequately cover the valuable intangibles that have been used and develop by the assessee as also the location saving that the assessee is passing on to its Associated Enterprises (AE) and on that basis, the addition was made of Rs.33,59,69,186/-.

5. The grounds of appeal read as under :-

“1. That the assessing officer erred on facts and in law in completing the assessment under section 144C/143(3) of the Income-tax Act, 1961 ('the Act') at an income of Rs.36,67,95,634 as against the income of Rs.3,08,26,448 returned by the appellant.

1. That the assessing officer erred on facts and in law in making an adjustment of Rs.33,59,69, 186 to the arm's length price of the' international transaction of Provision of Buying Services on the basis of the order passed under section 92CA(3) of the Act by the Transfer Pricing Officer ("the TPO").

1.2 That the assessing officer erred on facts and in law in arbitrarily determining the arm's length price of rendering of buying services undertaken by the appellant at 3% of the FOB value of export made by unrelated party vendor.

1.3 That the assessing officer! TPO erred on facts and in law in not appreciating that the international transaction of Provision of Buying Services was at arm's length and no adjustment to the price thereof was called for being made.

1.4 That the assessing officer/ TPO erred on facts and in law in arbitrarily including the FOB value of exports in the cost base (i.e. sales made through the appellant) of the appellant, for the purpose of computing the arm's length profit margin of the appellant.

1.5 That the assessing officer/ TPO erred on facts and in law in not appreciating that in terms of rule 10B(1)(e) of the Income-tax Rules, it was impermissible to consider the cost incurred by unrelated enterprise to compute net profit margin of the appellant while applying TNMM.

1.6 That the assessing officer / TPO erred on facts and in law in not appreciating that the appellant does not undertake significant functions of manufacture and sale of garments, nor does not employ the assets and assume risks in relation to such activities and it was inappropriate to consider the cost of such third party vendors as part of the cost of the appellant to

determine the arm's length price of the international transactions of rendering buying services.

1.7 That the assessing officer/ TPO erred on facts and in law in holding that the appellant has borne all the major risks associated with the functions performed by the appellant and that since significant value added benefit and strategic advantages have been provided to the AE by the appellant, the appellant should be allowed to share the benefit in the cost plus arrangement.

1.8 That the assessing officer/ TPO erred on facts and in law in holding that the appellant is the owner of supply chain management and human asset intangibles in India and was entitled to a return/ mark-up including cost of goods sourced by it, cost of development and use of intangibles.

1.9 That the assessing officer! TPO erred on facts and in law in holding that no evidence has been proved that the AE has either technical capacity or manpower to assist the appellant without appreciating that the functions of the AE were elaborated in the Transfer pricing Documentation.

1.10 That the assessing officer/ TPO erred on facts and in law in disregarding the functional, asset and risk profile of the appellant as submitted in its Transfer Pricing Documentation on the basis of preconceived notions and without any basis or evidence.

1.11 That the assessing officer/ TPO erred on facts and in law in not appreciating that the appellant is a low risk captive contract service provider and does not bear significant business and operational risks.

1.12 That the assessing officer / TPO erred on facts and in law in not appreciating that, since the appellant is merely rendering buying support services to the associated enterprise under risk free model for export of goods by unrelated party vendor to the overseas customers, no benefit allegedly on account of location saving could be attributed to the appellant.

1.13 Without prejudice that the assessing officer / TPO erred on facts and in law in not appreciating that the appellant has received nearly 80% of the entire consideration received by the associated enterprise for rendering sourcing services and the associated enterprise has retained only 20% of the total consideration on account of functions performed, assets utilized and risks assumed at their own, there could not be any allegation as to transfer of profit from India.

1.14 Without prejudice that the assessing officer / TPO erred on facts and in law in not appreciating that while the appellant has earned operating profit margin of 5.46%, the associated enterprise had earned a meager profit margin of 0.99% and, therefore, addition on account of alleged difference in arm's length price of international transactions is not warranted.

1.15 Without prejudice that the assessing officer / TPO erred on facts and in law In not appreciating that the adjustment on account of the alleged difference in arm's length price could not exceed the total amount of revenue retained by the associated enterprise in respect of such international transactions of rendering buying services after reducing the appropriate cost in relation thereto.

1.16 Without prejudice that the TPO erred in law in not allowing variation to the extent of (+/-)5%, while determining the arm's length price of the 'international transactions'

The appellant craves leave to add, alter, amend or vary from the aforesaid grounds of appeal before or at the time of hearing.”

6. The Learned AR for the assessee pleaded that the appellant is a company incorporated under the Companies Act, 1956, engaged in the business of providing buying and sourcing services to the customers abroad. The appellant is a subsidiary company of Li & Fung (South Asia) Ltd., a



company incorporated in Mauritius and is a part of the Li & Fung Group, which is one of the world leaders in export trading, having a worldwide network, substantial experience, know-how and market presence. The appellant provides buying/sourcing services to the group companies for supply of high volume, time sensitive consumer goods. The appellant is paid service charges for the buying/sourcing services rendered to the group companies at cost plus markup of 5%. For the previous year relevant to assessment year 2006-07, the appellant filed its return of income on 01-12-2006, declaring income of Rs.3,08,26,448. The assessment was, however, completed, vide order dated 08.10.2010 passed under section 143(3) read with section 144C of the Income Tax Act, 1961 (the 'Act'), at an income of Rs.36,67,95,634, after making an addition of Rs.33,59,69,186 on account of difference in the arm's length price of the international transactions undertaken by the appellant. He further submitted that during the financial year 2005-06, the appellant entered into the international transaction of provision of buying services for sourcing of garments, handicrafts, leather products, etc. in India for its affiliate Li & Fung (Trading) Limited, Hong Kong. The appellant is paid service charges for providing buying services computed at cost plus mark up of 5 per cent. In the transfer pricing documentation maintained in terms of section 92D of the Act read with rule 10B of the Income-tax Rules, determined arm's length price of the

'international transaction' of Provision of Buying Services applying Transactional Net Margin Method ("TNMM"), by comparing operating profit margin of the appellant with that of the comparable companies, as under:

Weighted average OP/ OC % of 26 comparable companies	4.07%
OP/ OC % of the appellant	5.17%

Having regard to the aforesaid analysis, such international transactions entered into by the appellant are considered to be at arm's length as per the Transactional Net Margin Method, which is identified as the most appropriate method for such transactions in terms of section 92 of the Act. The Transfer Pricing Officer ("TPO") in his order dated 28.10.2009, however, held that the cost plus compensation @ 5% of cost of the appellant is not at arm's length because it does not include profit attributable to the appellant due to the following reasons-

- a) The appellant has performed all the critical functions, assumed significant risks and used both tangibles and unique intangibles developed by it over a period of time.
- b) There is no evidence that the AE has either technical capacity or manpower to assist the appellant and that in the absence of any credible evidence, such general remarks to somehow prove the involvement of the AE cannot be accepted (Refer page.
- c) The appellant has developed several Unique intangibles which have given an advantage to the AE in the form of the low cost of the product, quality of the product and

enhanced the profitability of the AE. These intangibles have increased profit potential of the AE though cost for development and use of intangibles was not taken for computations of routine markup of 5% considered by the appellant.

- d) The appellant has developed the supply chain management which manages the link between and organization and its suppliers and customer to achieve strategic and pricing advantage.
- e) The appellant has developed and owned human capital intangible at its own cost and all the related risks in creation and maintenance of human intangible are borne by the appellant.
- f) The AE has recognized that India offers both cost and operational advantage such as lower salaries for the employees, low cost material and low cost manufacture. Accordingly, the appellant has neither quantified locational saving nor the AE has attributed any part of the additional profit on account of locational saving to the appellant, in India.

On account of the aforesaid, the TPO applied the mark-up of 5% to the FOB value of exports being 1202.96 crores and accordingly computed an addition of Rs.57,65,61,186 to the income of the appellant, as under:

<b>Description</b>		<b>Rupees</b>
Net operating income (5% on the FOB value of exports Rs.1,202.96 crores)	<b>A</b>	601,480,000
Operating income shown by the assessee	<b>B</b>	24,918,814
Difference	<b>A-B</b>	576,561,186

The Dispute Resolution Panel, however, vide order dated 30-09-2010 issued following directions in terms of section 144C(5) of the Act:

"International transactions have to be judged at a different level as opposed to transactions covered by the domestic law. The OECD also recognizes the fact that related parties may fashion their transactions in such a manner that may call for looking at the substance of transactions over the form they are given. The relevant portions of the OECD guidelines issued on 22.07.2010 are as below:

[QUOTE]

1.67. Associated enterprises are able to make a such greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in the particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. In such instances tax administrations would have to determine what the underlying reality is behind a contractual arrangement in applying the arm's length principle.

1.68 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfied the arm's length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled

transaction and the alternative and the quality of any other evidence that may be available.

[UNQUOTE]

Therefore, the assessee's claims that it does not bear the risks of a normal trader have to be tested in this light. Accordingly, we are inclined to accept the TPO's conclusion that the FOB value of goods should form part of the cost base for calculating the remuneration that should accrue to the assessee. That leads to the next question as to what should be the correct markup that should be applied. The TPO has applied the markup of 5% because the assessee is operating on a cost plus 5% model. However, when we are increasing the cost base manifold, the application of a markup of 5% will be excessive.

We accordingly hold that given the facts and circumstances of the case a markup of 3% will be reasonable. This will adequately cover the valuable intangibles that have been developed and used by the assessee as also the location saving that the assessee is passing on to its AE."

Accordingly, the addition on account of the alleged difference in the arm's length price of international transactions of provision of buying / sourcing services was computed at Rs.33,59,69,186, as follows:

Description	Rupees
Net operating income (3% of the FOB Value of exports, i.e. 3% of Rs.1202.96 crores)	36,08,88,000
Operating income shown by the assessee	2,49,18,814
Difference of the above	33,59,69,186

The addition of Rs.33,59,69, 186 made on account of difference in the arm's length price of international transactions of buying / sourcing services, as aforesaid, is unlawful and not sustainable for the reasons that the I.T.O. applied TNMM method against the T.P. regulations. For the purpose of determining the arm's length price in relation to the international transactions, in terms of sub-section (2) of section 92C of the Act, Rule 10B of the Rules provides the manner of application of the various prescribed methods. Clause (e) of sub-rule (1) of Rule 10B of the Rules provides for application of Transactional Net Margin Method as under :-

- "(e) transactional net margin method, by which,--
  - (i) the net profit margin realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
  - (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;
  - (iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

- (iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
- (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction. "

TNMM examines the net profit margin relative to an appropriate base (e.g. cost, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the transfer pricing principles). The method compares the profitability of either of the controlled parties with the profitability of the uncontrolled comparable(s). For application of TNMM in terms of Rule 10B(I)(e) of the Income-tax Rules ("the Rules"), net profit margin realized by the enterprise from an international transaction entered into with the associated enterprise, is computed in relation to cost incurred or sales affected or assets employed or to be employed by the enterprise. For applying TNMM, therefore, it would be noted, net profit margin realized from the international transactions by the appellant, is to be computed only with reference to cost incurred by the appellant itself. There is no provision under Rule 10B(1)(e) of the Rules to consider or impute cost incurred by third parties or unrelated enterprises, to compute net profit margin of the appellant enterprise for application of TNMM. The TPO, in the impugned order enhanced the cost base of the appellant enterprise artificially by considering the cost of manufacture and

export of finished goods, i.e., readymade garments by third party vendors (which cost is certainly not the cost incurred by the appellant), which is clearly inconsistent with the manner of application of TNMM as provided in Rule 10B(1)(e) of the Rules. The TPO's contention of enhancing the cost base of the appellant artificially by considering the cost of manufacture and export of finished goods, i.e., readymade garments by third party vendors (which cost is certainly not the cost incurred by the appellant), clearly amounts to imputing notional adjustment / income in the hands of the appellant on the basis of a fixed percentage of the FOB value of export made by unrelated party vendors. Therefore the value of exports by the third party vendors to third party customers does not provide any benchmark or basis for determining arm's length price. Reliance is also placed on the decision of the Hon'ble Delhi Bench of the Tribunal in the case of DCIT VS. M/s. Cheil Communication India Pvt. Ltd. : (ITA No. 712/Del/10), wherein, it has been held that, for application of TN MM, payment made by the assessee to 3rd party vendors / media agency for and on behalf of the principal (which has been reimbursed by the AE), not to be included in the total cost for determining the profit margin and the mark-up is to be applied to the cost incurred by the assessee company. The relevant extract of the order is as under:

“40. The rival contentions of both the parties have been considered and orders of the authorities below have carefully



been perused. The only question that falls for our consideration is with regard to the method of computing profit/TC margin whether on gross basis as done by the TPO or net basis as worked out by the assessee. In this case the assessee has applied TNM method to determine arm's length price, which has also been accepted by the revenue authorities. The comparables cited by the assessee has also been accepted by the TPO as appropriate. It is also found by us that in the regular financial accounts maintained by the comparable companies, the comparables recognize revenue on a net basis. The assessee has also recognized revenues on a net basis in its financial account, which had been duly audited by the auditor. The assessee has computed the margin of operative profit on the total cost on the basis of net revenue by way of markup received from the associate concern. The payment made by the assessee to third party vendor/media agencies for and on behalf of the principal has not been included in the total cost for determining the profit margin, though, on the other hand, the TPO has included the payment reimbursed by the assessee's associate enterprise to the assessee on account of payment made to third party vendor/media agencies. It is not in dispute that the assessee is engaged in undertaking advertising services for its customers/associate enterprises in the capacity of an agent. As part of its business operation, the assessee facilitates placement of advertisement for its associate enterprise in the print/electronic etc. media and for that purpose, the assessee is required to make payment to third parties for rendering of advertisement space on behalf of its customers or associated enterprises. It is, thus, clear that the assessee's business is not sale of advertising slots to its customers or associate concern. For performing the functions for and on behalf of associated enterprises, the assessee is remunerated by its associated enterprises on the basis of a fixed commission/charges based on expenses or cost incurred by the assessee for release of a particular advertisement. It is also to be noted that advertising space (be it media, print or outdoor), has been let out by third party vendors in the name of ultimate customers and beneficiary of advertisement. We have gone through the invoices and purchase orders from third party vendors and find that they contain customers' name, and all the terms of advertisement are finalized after taking the approval from the customers. The assessee simply acts as an intermediary between

the ultimate customer and the third party vendor in order to facilitate placement of the advertisement. The payment made by the assessee to vendors is recovered from the respective customers or associate enterprises. In the event customer fails to pay any such amount to the advertisement agency, the bad debt risk is borne by the third party vendor and not by the advertising agency i.e. the assessee. It is, thus, clear that the assessee has not assumed any risk on account of non-payment by its customers or associated enterprises. At this stage a useful reference may be made to ITS 2009 Transfer Pricing Guidelines accepted by the OECD where it is laid down that when an associate enterprises is acting only as an agent or intermediary in the provision of service, it is important in applying the cost plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves, and, in such a case, it may be not appropriate to determine arm's length price as a mark-up on the cost of services but rather on the cost of agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than would be appropriate for the performance of the services themselves. In this type of cases, it will be appropriate to pass on the cost of rendering advertising space, to the credit recipient without a mark up and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function. These guidelines are as under:-

3.41 In applying the transactional net margin method, various considerations should influence the choice of margin used. For example, these considerations would include how well the value of assets employed in the calculations is measured (e.g. to what extent there is intangible property the value of which is not captured on the books of the enterprise) and the factors affecting whether specific costs should be passed through, marked up, or excluded entirely from the calculation.

41. In the proposed revision of Chapter I-III of the Transfer Pricing Guidelines issue on 9th September, 2009 - 9th January, 2010 by GECD, it has been provided in Para 2.134 as under:-

"2.134 In applying a cost-based transactional net margin method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. The question can arise whether and to what extent it is acceptable at arm's length to treat a significant portion of the taxpayer's costs as pass through costs to which no profit element is attributed (i.e. as costs which are potentially excludable from the denominator of the net profit margin indicator). This depends on the extent to which an independent party at arm's length would accept not to be remunerated on part of the expenses it incurs. The response should not be based on the classification of costs as "internal" or "external" costs, but rather on a comparability (including functional) analysis, and in particular on a determination of the value added by the tested party in relation to those costs."

42. Further, OECD in ITS 2009 Transfer Pricing Guidelines has laid down as under:-

"7.36 When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than would be appropriate for the performance of the services themselves. For example, an associated enterprise may incur the costs of renting advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass on these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred by the intermediary in performing its agency function. "

43. In the light of these guidelines, it would be, therefore, clear that a mark-up is to be applied to the cost incurred by the assessee company in performing its agency function and not to the cost of rendering advertising space on behalf of its associate enterprises. We further find that the method adopted by the assessee while submitting transfer pricing study based on net revenue has been accepted by the department in earlier year and, therefore, there is no reason to depart from that stand already accepted by the department in earlier year. In the light of the view we have taken above, we therefore, uphold the order of the learned CIT(A) on this issue and reject the ground raised by the revenue.”

The value of export by the third party vendors to third party customers does not provide any benchmark or basis for determining the arm's length price. The TPO for computing the remuneration for buying services rendered by the appellant on a cost plus basis, has sought to include in the cost of the services rendered by the appellant the entire cost of goods sold / exported by such third party exporters / vendors.

Learned AR further submitted that this would artificially enhance the cost base of the appellant for applying the OP/TC margin. It would be appreciated that the compensation model of the appellant should be based on functions performed by it and the operating costs incurred by it and not on the cost of goods sourced from third party vendors in India. Thus, allocating a margin of the value of goods sourced by the third party customers from exporters / vendors in India for computing the profit margin of the appellant is inappropriate and unjustified. For applying TNMM, therefore, it would be

noted, net profit margin realized from the international transactions by the assessee, is to be computed only with reference to cost incurred by the assessee itself. There is no provision under Rule 10B(1)(e) of the Rules to consider or impute cost incurred by third parties or unrelated enterprises, to compute net profit margin of the assessee enterprise for application of TNMM. It is also submitted that the contention of the TPO of enhancing the cost base of the assessee enterprise artificially by considering the cost of manufacture and export of finished goods, i.e., readymade garments by third party vendors (which cost is certainly not the cost incurred by the assessee), is clearly inconsistent with the manner of application of TNMM as provided in Rule 10B(1)(e) of the Rules. The aforesaid action of the TPO, it would further be appreciated, amounts to imputing notional adjustment / income in the hands of the assessee on the basis of a fixed percentage of the FOB value of export made by unrelated party vendors. The appellant has, in the Transfer Pricing documentation, established the international transactions of rendering buying services to be at arm's length price having regard to the operating profit margin earned by comparable companies having similar functional profile. The computation of the operating profit margin (OP/TC%) of the appellant by enhancing the cost base i.e. by increasing the cost of the sales facilitated by the assessee would lead to an arbitrary adjustment to the income of the appellant which was never intended by the legislation. It would be

appreciated that the appellant is performing functions of a limited risk offshore service provider and is not engaged in manufacturing of garments. The appellant neither made investment in the plant, inventory, working capital, etc., nor does it have expertise to manufacture garments. The appellant does not bear the enterprise risk for manufacture and export of garments. In other words, functional and risk profile of the appellant are entirely different and has nothing to do with the manufacture and export of garments by the unrelated party vendors. The appellant has merely rendered buying / sourcing support services in relation to such exports. The remuneration received by the appellant on a cost plus mark-up of 5% adequately represents the functions performed, assets utilized and risks assumed by the appellant. If the TPO's contention is to be considered it would amount to treating the appellant as partner of the vendors / exporters in their manufacturing business which is certainly not the case.

Learned AR pleaded that the above basis of determining the arm's length price of international transactions applying TNMM was accepted in the Transfer Pricing assessment consistently year after year. The TPO in the earlier years, it is respectfully submitted, did not dispute the aforesaid functional analysis undertaken by the appellant. In the relevant previous year, too, the facts with regard to the operations of the appellant and the functions performed, assets utilized and risks assumed by the appellant remain the same

as in the earlier years. It is the respectful submission of the assessee that although there is no res judicata in Income-tax proceedings, the Supreme Court in the case of Radhasoami Satsang Vs. CIT: 193 ITR 321 held that where a fundamental aspect permeating through the different assessment years is accepted one way or the other, a different view in the matter is not warranted, unless there be any material change in facts. The relevant observations at page 329 of the judgment are reproduced as under:

"We are aware of the fact that, strictly speaking, res judicata does not apply to income-tax proceedings. Again, each assessment year being a unit, what is decided in one year may not apply in the following year but where a fundamental aspect permeating through the different assessment years has been found as a fact one way or the other and parties have allowed that position to be sustained by not challenging the order, it would not be at all appropriate to allow the position to be changed in a subsequent year. "

The Delhi High Court in the case of CIT vs. Neo Polypack (P) Ltd: 245 ITR 492 on the rule of consistency observed as under:

"We are of the view that no fault can be found with the order of the Tribunal declining to make a reference on the proposed question. It is true that each assessment year being independent of the other, the doctrine of res judicata does not strictly apply to income-tax proceedings, but where an issue has been considered and decided consistently in a number of earlier assessment years in a particular manner, for the sake of consistency, the same view should continue to prevail in subsequent years unless there is some material change in the facts. In the present case, learned counsel for the Revenue has not

been able to point out even a single distinguishing feature in respect of the assessment year in question which could have prompted the assessing officer to take a view different from the earlier assessment years, in which the same income was brought to tax as income from business". (emphasis supplied)

In the following decisions, too, the Courts have held that though the doctrine of res-judicata does not strictly apply to the income-tax proceedings but in order to maintain consistency, the Revenue cannot be permitted to rake up settled issues.

- DIT (E) V. Apparel Export Promotion Council: 244 ITR 734 (Del)
- CIT V. Girish Mohan Ganeriwala: 260 ITR 417 (P&H)
- CIT V. Dalmial Promoters Developers (P) Ltd: 200 CTR 426 (Del.)
- CIT vs. A.KJ. Security Printers: 264 ITR 276(Del)
- MIS Escorts Cardiac Diseases Hospital: 2007-Tiol-52-Del-Hc-It
- Vesta Investment & Trading Co. (P) Ltd: 70 ITD 200 (Chd.)
- Udaipur Distillery Co. Ltd V. JCIT: 100 ITD 422 (Jodh.)

In view of the aforesaid, the application of TNMM by the TPO by enhancing the cost base of the appellant by considering FOB value of export by unrelated party vendors is inconsistent with the Transfer Pricing regulations and addition made on this account, therefore, is liable to be deleted.

Learned AR also pleaded that no agreements entered by the appellant with the vendors from whom goods are sourced. The TPO, while observing that for computation of OP/TC margin of the appellant the total cost component should also include cost of the sales, did not appreciate the facts of



the case of the business of the appellant. The appellant, it is reiterated, is an offshore service provider and rendering buying / sourcing services to the third party customers of the associated enterprise, viz., Li & Fung (Trading). Under the arrangement, goods and merchandize are sourced by third party customers from exporters / vendors in India. Such exporters / vendors, too, are unrelated parties and the assessee company has buying / sourcing service provider only provide necessary support services of purchase of goods and merchandize. In other words, purchases are made by third party customers outside India from the various third party exporters / vendors in India. In the present case, it would be appreciated, neither the associated enterprise nor the appellant is involved in the transaction of purchase or sale of such goods except to the extent of rendering buying / sourcing support services. In view of the aforesaid, it would be appreciated that the contract for purchase of goods and merchandize was between third party overseas customers and the vendors / exporters in India. The associated enterprise and also the appellant is engaged in rendering sourcing support services in relation to such export. There are no direct contracts entered into between the appellant and the third party vendors, therefore, it cannot be construed that the assessee is supposed to share the profit margin on the FOB value on export made by such vendors. In view of the aforesaid, it is respectfully submitted that the TPO's contention to compute the arm's length price of the appellant by allocating 5% of FOB

value of exports made by third party vendors to the AE is inappropriate and not sustainable.

Learned AR also pleaded that location savings are attributable to the end purchaser only. The TPO while holding that the arm's length prices of international transactions of running, buying / sourcing services by the appellant ought to be 5% of the FOB value of exports, clearly misunderstood the business model and the international transactions undertaken by the appellant. The TPO did not appreciate the fact that the transaction of export of finished goods, namely, readymade garments is being undertaken by third party vendors / exporters to the overseas customers. Neither the associate enterprises nor the appellant is party to the transaction of such export. The associate enterprises has only undertaken to provide sourcing support services in relation to such export made by the vendors, which services has partly been performed by the appellant in India. Neither the appellant nor the associate enterprises, it would be appreciated, gained advantage on account of location saving associated with the export of goods, viz. garments, by the exporters to the overseas customers. Such advantage on account of location saving is, therefore, at best be attributed to the vendors / exporters and the third party overseas customers. In the US Regulations, too, the location saving is applied between the buyer and the seller located in different jurisdiction, as would be

appreciated from the US Regulations [1.482-(1)(d)(4)(ii)(C)], which read as under:

"(C) Location savings. If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market."

The TPO has wrongly applied the concept of locating saving in the case of the appellant which is only a service provider and not the exporter of goods from India. In view of the aforesaid, since, neither the appellant nor the associate enterprises could be alleged to have gained any advantage on account of location saving in respect of such export of finished goods by the exporters / vendors, the adjustment made by the TPO on the ground of location saving, is not sustainable and is liable to be deleted.

Learned AR also pleaded that the amount of adjustment computed by the TPO far exceeding the amount retained by the AE. He submitted that without prejudice it is respectfully submitted that the adjustment computed by

the TPO in the order passed under section nCA(3) of the Act at best cannot exceed the net margin, i.e., gross revenue received from the end customers less amount paid to the appellant retained by the associated enterprises in respect of international transactions. The appellant company rendering sourcing support services has facilitated exports by the vendors/ suppliers of nearly (USD 273.40 million @ Rs.44/\$) Rs.1,202.96 crores in the relevant previous year. The AE entered into the contract with the unrelated party customer for rendering buying services at 4% to 5% of FOB value of exports. The assessee has in turn received services fee (at cost + 5%) of Rs.47.69 crores which is nearly 4% of the FOB value of the export (by the vendors) from the AE. However, the TPO / assessing officer in the impugned order has computed the arm's length price of the appellant by considering a markup of 3% on the FOB value of exports (Rs.1,202.96 crores) that have been facilitated by the appellant computed an adjustment of Rs.33,59,69, 186. It would also be appreciated that out of the total service fee of Rs.60.15 crores received by the associated enterprise, the appellant by no stretch of imagination could be expected to earn a profit margin of its own of 36.08 crores computed on 3% of the FOB value of such exports. It would also be noted that if the adjustment made by the assessing officer / TPO is taken into account, the appellant would end up receiving higher amount than what has been received by the AE from

the 3rd party customers in lieu of facilitating the export of finished goods as follows:

FOB value of exports	1202.96 crores
Amount received by the assessee ..... A	48.19 crores (i.e. 4% of the FOB value)
Adjustment proposed ..... B	33.60 crores
Total amount to be received by the assessee	81.79 crores (i.e. 6.8% of the FOB Value)
Total amount received by the AE 5% of 1202.96 crores	60.148 crores

It would also be noted that the AE on the entire export of Rs.1202.96 crores has retained nearly 1 % of the FOB value of export, i.e. Rs.12.46 crores. [Rs.1202.96 crores X 5% = Rs.60.15 crores (-) Rs.47.69 crores received by the assessee = Rs.12.46 crores]. The TPO erroneously made adjustment of Rs.33,59,69,186 on account of alleged difference in the arm's length price of international transactions of rendering buying / sourcing services by the appellant without appreciating that out of the total service fee of 5% of FOB value of export received by the AE, only 1 % of FOB value of export, i.e. nearly Rs.12.46 crores was retained by the AE and Rs.47.69 crores being nearly 80% of the consideration received by the AE, is already paid to the appellant. It is further submitted that substantial functions relating to such buying services are performed by the AE which also assumes enterprise risk, such as, marketing risk, credit risk, etc. The assessee company, it is submitted,

operates as contract service provider and does not undertake such enterprise risk. It is further reiterated that substantial functions are performed by the AE and substantial assets are utilized and risks are assumed by the AE in relation to buying services rendered to the customers. In addition, the AE bears L/C opening charges and several other costs at its end. In other words, while the appellant is receiving 4% of FOB value of export for rendering of buying services, the AE is retaining only 1 % or less of the FOB value of export at their end. The TPO/assessing officer has erroneously held that the appellant has developed several unique intangibles and developed a supply chain management, human capital at its own risk without appreciating that the appellant was only a captive offshore service provider not undertaking any independent enterprise risk. Since the formation of the appellant company, entire cost were reimbursed by the associated enterprise, which was also bearing all enterprise risks with regard to operation undertaken by the appellant. Further, it is reiterated that substantial functions are performed by the AE and substantial assets are utilized and risks are assumed by the AE in relation to buying services rendered to the customers. The appellant company, it is respectfully submitted has received 80% of the total consideration received by the AE for rendering buying services and the AE has retained only 20% of the total consideration. For the aforesaid cumulative reasons, the

adjustment computed by the TPO / assessing officer in the case of the appellant is unlawful and is liable to be deleted.

7. Learned DR relied on the orders of the authorities below. He submitted that the assessee was performing all the critical functions with the help of technical capacity and the manpower to execute the work. In the process, the assessee has developed both tangible and unique intangible which are very crucial for executing the critical functions. These tangibles and unique intangibles enable the assessee to get the advantage of AE in the form of low cost product, to control quality of product and by doing so enhance the business profitability of the AE. These intangibles have increased the profit potential of the AE. The assessee has also developed a supply chain management which is crucial to manage the link between the ultimate customer and supply to achieve the various advantage like pricing advantage, strategic advantage, etc. etc. The assessee offers both cost and operational advantage to the AE which is possible on account of low salaries for employees in India, low cost of material and low cost of manufacturing. Further he also pleaded that since the AE is receiving 5% of the FOB value from the purchasers and assessee is performing crucial and critical functions with the help of tangible and unique intangibles develops during a period of time, the assessee must receive the majority of the receipts with regard to the execution of the work. Therefore, he pleaded that the mark up should be

based on FOB value and majority of the same must come to the assessee in terms of the arm's length transaction and he pleaded to sustain the orders of the authorities below.

8. We have heard both the sides in detail. The following facts are undisputed.

The assessee is a subsidiary company of Li & Fund (South Asia) Ltd, a company incorporated in Mauritius. Ultimately, the assessee company is a part of the Li & Fund Group which is engaged in the export trading and services and having substantial experience, know-how and market presence with a world wide network. The assessee provides buying / sourcing services for supplying the consumer goods. For the year under consideration, the return of income was filed on 01.12.2006 declaring income at Rs.3,08,26,448/-. During the relevant period, the assessee has entered into international transaction of buying services for sourcing of garments/ handicrafts/ leather products, etc. in India for its affiliate Li & Fund (Trading) Ltd., Hong Kong. The assessee has been paid service charges for providing these services, computed on the basis of cost plus mark up method. It was 5% of cost incurred by assessee. Assessee worked out the arm's length price of 'international transaction' by applying TNMM (Transactional Net Margin Method) by company operating profit margin of 26 companies and assessee's OP/OC taken at 5.17%.



The TPO did not consider the cost plus compensation @ 5% at arms length by holding that assessee is performing all critical functions, assuming significant risks and used both tangibles and unique intangibles developed by it over a period of time. The associated enterprise is not having technical capacity and manpower to assist the assessee in this regard. The assessee has developed several unique intangibles which has been given advantage in the form of low cost of product, quality of the product and enhanced the profitability of AE. These intangibles have developed profit potential of AE. The assessee has developed the supply chain management which gives customer a strategic and pricing advantage. The assessee has also developed its own human capital intangible at its own cost. The cost for the same is born by assessee. The AE has recognized that India offers both cost and operational advantage on account of lower salaries for the employees, low cost material and low cost manufacture.

The associated enterprise is charging from the purchasers on the basis of FOB value of exports up to 5%. The total exports effected by the assessee during the year were Rs.1202.96 crores. Assessee has been paid in respect of the international transaction effected in the form of exports on the basis of cost plus 5%. The Learned AR's plea that no adjustment has been made in the earlier years. For this, he has submitted assessment order for AY 2002-03 to 2005-06 wherein the transaction net marginal method with operating profit

over total cost (OP/TC) as a profit level indicator has been accepted. This TNMM method has been accepted in these years. Reliance is also placed on the decision of Hon'ble Supreme Court in the case of Radhasoami Satsang Vs. CIT, cited supra and CIT vs. New Poly Pack (P) Ltd., 245 ITR 492, other case laws. In this regard, we hold that the principle of res judicata is not applicable in the income-tax proceedings. Each assessment year is a separate unit and what is decided in one year shall not ipso facto apply in the subsequent years. We have gone through the orders passed in the earlier years which has been placed in the paper book at pages 293 to 305 and for all these assessment years starting from 2002-03 to 2004-05, we find that while accepting profit level indicator nothing has been said about the basis on which the compensation has been received by the associated enterprise on the goods exported from India through assessee. As we have already stated earlier, the associated enterprise was receiving the compensation as a percentage of the FOB value of the goods exported through the assessee and as per the guidelines of the OECD which recognizes that the related party may fasten their transaction in such a manner that may call for looking at the substance of transactions over the form they are given. In this case, the associated enterprise was receiving the compensation on the basis of FOB value while the Indian associate (assessee) was compensated only by cost plus 5% mark up. When the associated enterprise are receiving the compensation at FOB

value and the assessee which is providing critical functions with the help of tangible and unique intangibles developed over the years and with the help of supply chain management which are important to achieve the strategic and pricing advantage. All these help the associated enterprise to enhance and retain the business and also contributes towards the locational savings on account of low cost salary, low cost material and low cost manufacture in India. Therefore, in our considered view, the cost plus 5% mark up is definitely not on the arms length while working out the compensation for the services rendered by the assessee to the associated enterprise. In such a situation, mark up on the FOB value of the goods sourced through the assessee shall be the most appropriate method to work out the correct compensation at arms length price. Therefore, the rules of consistency cannot be applied forever when such facts have not been considered/discussed at all in the earlier years.

It is also pleaded that the assessee has received 80-O deduction in the earlier years in respect of providing these professional and technical services. In this regard, we hold that every assessment year is a separate assessment year for income-tax purposes and the principle of res judicata is not applicable. Further during this year, the assessee has not claimed or entitled for 80-O deduction. Therefore, it cannot be a plea to justify the transaction at the arm's length.

Assessee claims that there is no provision in the Rule 10B(1)(e) to include the cost incurred by third parties or unrelated enterprise to compute the net profit margin of the assessee. For this proposition, we do not agree in view of the fact that assessee is providing all critical functions and the majority of work related to these exports is performed by assessee itself. Associate enterprise had no capacity to execute the work. The associated enterprise is charging from the third party on the basis of FOB value of the exports made possible by assessee. Assessee is providing sourcing services through its tangible and intangible capacity to these third party clients in the form of low cost product resulting into profitability and pricing advantage. The assessee's reliance on DCIT vs. Cheil Communication India Pvt. Ltd., cited supra, is not of much help as in that case, the facts were different. In that case, the assessee was providing to their party/media agency for and on behalf of the principal. In that case, the advertising space has been let out to the third party vendor in the name of ultimate customer and the beneficiary of advertisement. The assessee in that case was simply acting as intermediary between ultimate customer and the third party vendor in order to placement of advertisement. In assessee's case, the associated enterprise has been receiving the mark up as 5% of the FOB value of exports effected by assessee by applying its tangible and intangible capacity. The critical and all crucial work is done by assessee. The AE is paying back to the assessee only on the

basis of cost plus 5% mark up. Such an arrangement cannot be said at arms length. In our considered view, such method will go against the basic normal business sense, as inefficient and high cost services provided by assessee shall fetch more revenue to the assessee. Such an arrangement on the face of it cannot be said to be at arm's length. The AE is getting remuneration on FOB value of export for which critical and main functions are performed by assessee. We also uphold that the assessee has developed a technical capacity and owns manpower which had developed human intangibles to perform all the critical functions. These tangible and unique intangible have been developed over the years. In view of these facts, we hold that to arrive at arm's length of these transactions, the mark up must be on the basis of FOB (free on board) value of the exports. Since the AE is receiving 5% of FOB value then the total receipt by AE must be Rs.60.148 crores. Thus, the attribution between assessee and AE must be from this amount.

AO made addition of Rs.33.60 crores. If it is added to the actual receipts of assessee then it is much more than the total amount received by associated enterprise regard to these exports. Thus, the way in which this adjustment has been made gives abnormal / absurd results which cannot be sustained. The assessee was performing critical functions with the help of tangible and unique intangibles developed over the

period of time and with the help of supply chain management which the assessee had developed, the majority of compensation based on the FOB value of the exports materialized through the assessee must come to the assessee. So the correct compensation at the arms length price based on the FOB cost of the goods sourced from India needs to be decided. The total export during the year was Rs.1202.96 crores. AE received in total of Rs.60.148 crores.

The assessee's claim that no agreement was entered by the assessee with the ventures to whom the goods are sourced shall not justify the cost plus mark up. The associate enterprise entered into the agreements for sourcing the goods and the compensation is based on the FOB value of the goods sourced from the India and the assessee performing all crucial and critical function to fulfill the conditions to execute the agreements. Therefore, we find no merits in this plea. The other claim of the assessee that location savings attributable to the end purchaser is also not justified as the assessee has developed many unique intangibles and also human capital intangibles which gives the locational advantage to procure low cost goods which helps the associated enterprise to obtain/retain the business and also benefits the end purchaser. These tangibles and unique intangibles developed over the period of time and the developed supply chains of the management owned by assessee benefits the ultimate purchaser and also provide locational savings to

the all including the associated enterprise. As we have already said that the amount of adjustment computed by the TPO cannot exceed the amount which could have been received by the associated enterprise. There is nothing on the record from where we could gather that the compensation @ 5% on FOB value received by AE is depressed or on lower side. In view of these facts, we are of the view that the amount of adjustment so computed should not exceed the amount received by the associated enterprise. In our considered view, the AO as well as the DRP has proceeded on a wrong footing which have given absurd results of adjustments. In view of the fact that majority and crucial services rendered by assessee, the distribution of compensation received by AE @ 5% of the FOB value of the exports between the assessee and the associated enterprise should be in the ratio of 80 : 20. The assessee must get 80% of the total receipt by AE from the ultimate purchasers. AO is directed to compute the arm's length price in the above manner.

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

**Order pronounced in open court on this 30<sup>th</sup> day of September, 2011.**

**Sd/-  
(C.L. SETHI)  
JUDICIAL MEMBER**

**sd/-  
(B.C. MEENA)  
ACCOUNTANT MEMBER**

**Dated the 30<sup>th</sup> day of September, 2011  
TS**

Copy forwarded to:

- 1.Appellant
- 2.Respondent
- 3.CIT
- 4.CIT (A)-VIII, New Delhi.
- 5.CIT(ITAT), New Delhi.

AR, ITAT  
NEW DELHI.