IN THE INCOME TAX APPELLATE TRIBUNAL
Pune Bench B, Pune

Before Shri I.C. SUDHIR, Judicial Member
and Shri D. KARUNAKARA RAO, Accountant Member

ITA No.120/PN/2011
Assessment Year : 2006-07

Demag Cranes & Components (India) Pvt. Limited Pune	**Vs.**	**DCIT, Circle-1(2) Pune**
(Appellant) PAN No.AABCM 9351Q		(Respondent)

Appellant By: **Shri M.P. Lohia, Shri Amit B. Jain & Shri Rajendra Agiwal**
Respondent By: **Shri S.K. Singh CIT-DR & Shri Tejendra Singh CIT**

Date of hearing: **15.11.2011**
Date of pronouncement: **04.01.2012**

ORDER

Per Shri D. Karunakara Rao, Accountant Member:-

This appeal is preferred by the assessee against the order of the CIT(A). There are 15 grounds with corresponding sub-grounds raised in this appeal.

2. Briefly the heading of the grounds read as follows.

1. *Making of **adjustments of** Rs 11,961,693/- to international transactions of provision of materials handing solutions- vide grounds 1 to 10;*
2. *Non consideration of **comparability analysis** in matters of benchmarking the above said international transactions - vide ground 2;*
3. *Rejection of the **aggregation** of international transactions entered into pertaining to manufacturing and trading activities - vide ground 3;*
4. *Incorrect determination of **margin** of manufacturing activities - vide ground 7;*
5. *Non granting of the **adjustments** ie (i) **working capital,** (ii) provision for Warranty and (iii) **expenses relating to import of raw material** - vide ground 4;*
6. *Incorrect computation of transfer pricing adjustment to the manufacturing activity - vide ground 10;*
7. *Use of multiple year data vide ground 5;*
8. *Use of contemporaneous data vide ground 6;*
9. *International transaction pertaining to export of components and spares - vide ground 8;*
10. *Transfer Pricing adjustment **without giving benefit of =/-5%** as available under erstwhile proviso to sec 92C(2) of the Act –vide ground 9;*
11. *Restricting the allowance in respect of the provision for warranty claim to Rs 13,437,207 - vide ground 11;*
12. *Error in not reducing the appellant's sales by the amount of disallowance in respect of provision for warranty claims – vide ground 12;*
13. *Short grant of credit for TDS/SA- vide ground 13;*
14. *Levy of interest u/s 234B & 234C of the Act – vide ground 14 & 15;*

3. Relevant facts of the case as culled out from the available records before us are that the assessee is engaged in **manufacturing of material handling equipment** viz. industrial cranes like standard cranes, process cranes, jib cranes and KBK Cranes. In the process, the assessee serves industries like automotives, auto ancillaries, engineering and manufacturing cement, foundries, steel sector, power sector, agro and bio-tech, paper petro chemical and fertilizers, textiles, Parma industries etc. Assessee filed the return of income declaring the total income of **Rs 6.4 cr,** rounded off. The assessee is a fully owned subsidiary of M/s Demag Cranes and Components Gmbh, Germany. Assessee reported dutifully of having international transactions with its associate enterprises (AE) abroad and also the details of methods ie Transactional Net Margin Method (**TNMM)** and CUP as the case may be, followed by the assessee for pricing of the same. In compliance of the provisions of section 92CA(3) of the Act, the case was referred to the TPO, Pune for determination of arm's length price (ALP). During the proceedings before the TPO, it was noticed that the assessee benchmarked all the transactions (i) on a **combined** or **aggregate basis;** (ii) using **multiyear** (FYs 2004-05 & 2005-06) data; (iii) comparing the **entity level margins** of the assessee with that of the comparables cases ignoring requirements of the adjustments. The operating margins of (a) the assessee at the entity level; and (b) the averaged margins of the comparable companies are **11.70**% and **2.76**% respectively. Thus, the assessee's operating margin is obviously higher and therefore, as per the assessee, its operating margins is at arm's length and it does not call for any additions by the TPO. Further, the assessee has the protection of safe harbor in the form of standard deduction of +/–5% out of the variation in case of any adjustment on account of transfer pricing guidelines. As per the assessee, transaction wise segregation for arriving at their respective margins is not possible as the business of the assessee constitutes an integrated business, involving manufacturing, trading, commissioning, servicing etc. Assessee reported **six comparables** namely, *Action Construction Equipment Ltd, Brady & Morris Engg Co Ltd, Elecon Engineering Co Ltd, Escorts Construction equipment Ltd, TRF Ltd and WMI Cranes Ltd*.

4. During the proceedings before the TPO accepted the six comparables filtered by the assessee; but he rejected the above said way of benchmarking the international transactions reported by the assessee. On the demand of the TPO, the assessee submitted **segment-wise details** of the alleged integrated business of the assessee. **Manufacturing, trading and servicing** are the relevant segments required for the proceedings under consideration. Further, the assessee also submitted the **current year data** of the comparables in place of the multiple year data mentioned in the provisions of Rule 10B(4) of IT Rules,

1962. Thus, there is no dispute between the parties about (i) the selection and the applicability of TNM Method and (ii) the selection of the six comparables from the Public data base source ie *Prowell* and *Capitaline*.

5. Thus, the assessee filed the current year and contemporaneous data ie FY 2006-07 relating to the entity level margins of the said comparables on the demands of the TPO. Further, the assessee supplied the segment wise operating margins ie manufacture, trading and services and the net margin at the entity level ie manufacture segment as an entity, is 2.41%. TPO compared the same with that of the average of the six comparables at their entity level margin without entertaining any adjustments on any account. TPO is of the opinion, the comparables since supplied by the assessee after use of the requisite filter, no further adjustments needs to be entertained. Thus, the TPO worked out the arithmetic mean at the entity level and profit level indicator (PLI) of the proposed set of comparables at **7.18%** using the current year data and then, compared the same with that of the assessee's case **2.41%** of the **manufacturing segment** of the assessee to work out the variance and in turn the ALP. The said variance works out to **4.77**% (i.e. 7.18% - 2.41%) and the corresponding quantum of adjustment on this account is **Rs 1,11,25,670/-** (ie 4.77*23,32,42,565/100). Undisputedly, Rs 23,32,42,565/- is the total sales of the assessee for the year. To sum up, the TPO not only compared the PLI of the comparables at entity level with the segment level profit margin of the assessee to arrive at the ALP of the impugned international transactions but also denied both (i) adjustments on account of working capital, expenses etc and (ii) the benefits of the provisions of the proviso to section 92C(2) of the Act. Therefore, the additions on account of the above exercise works out to **Rs 1,11,25,670/-.**

6. Further, TPO picked up the international transactions appeared in the **trading segment** and made **second** addition in connection with the said segment. TPO benchmarked the international transaction of export of components and spares to AEs using the Resale Price Method ie RPM and made adjustments to the extent of difference in the arithmetic mean of the GP margin of sale of traded goods to the third parties (33.62%) and GP margin from the tested party to AEs (20.20%) and GP margins difference works out to 13.42%. Using the net sales of Rs 62,31,693/-, TPO determined the adjustment on this account at **Rs 8,36,293/-** (i.e. 13.42 multiply by Rs 62,31,693/100). Thus, on accounts of the above two adjustments, the total addition works out to Rs **1,19,61,693**/- as mentioned in ground 1 of the appeal.

7. Further also, the AO proposed to make addition on account of the disallowance of **provision of warranty to the extent of Rs 2,26,20,069/-**

and such additions were in earlier years too. Finally, the AO proposed to determine the assessed income at **Rs 9,88,12,740/-** against the returned income of **Rs 6,40,30,984/-** and finalized the draft assessment order.

Proceedings before the DRP:

8. These issues travelled to the Dispute Resolution Panel - DRP, Pune as per the provisions of the Act and the assessee filed various objections opposing the above said three adjustments, namely adjustments to manufacturing and trading segments and disallowance on account of warranty provisions. The assessee's written objections relating to adjustments to **manufacturing and trading** segments are briefly as under:

- *Non consideration of the compatibility analysis as documented in the TP report.*
- *Rejecting the aggregation of international transactions entered into by the assessee pertaining to manufacturing and trading activities.*
- *Incorrect determination of margin of manufacturing activity*
- *Non-grant of **working capital adjustment***
- *Use of single year data pertaining only to F.Y. 2005-06*
- *Use of financial information of the comparables pertaining to F.Y. 2005-06 which was not available at the time of preparing the documentation report.*
- *Non-inclusion of high sea sales and services income for the purpose of computing appellant's margin for manufacturing activity*
- *Not granting adjustment on account of provision for warranty claims and **expenses on account of import raw** materials, components and spares attributable for lower margins of assessee in respect of manufacturing activity.*
- *Using Resale price method as the most appropriate method for analyzing the arms length nature of the transaction of export of components and spares*
- *Computation of transfer pricing adjustment from the arithmetic mean of the arm's length price instead of lower 5% arithmetic mean of arm's length price.*
- *Incorrect computation of transfer pricing adjustment to the manufacturing activity.*

9. At the end of the proceedings before the DRP, the adjustments to manufacturing segment were **upheld.** The other directions of the DRP, relating to (i) disallowance of warranty provision and (ii) adjustments to the international transactions of the trading segment, are given as under.

(a) **On the adjustment of Rs 2,28,20,059/- on account of Provision of Warranty:** Vide the paragraphs 3.3.2, DRP directed the AO to verify the **actual** expenditure on warranty expenses incurred during the year and allow the same on **actual-basis** and accordingly, the provisions as well as the reversals should not be allowed as a deduction or taxed respectively.

(b) **On the adjustment of Rs 8,36,293/- relating to trading segment**, as per the assessee's claim, the DRP upheld the assessee's views that the Resale Profit Method - RPM is not an appropriate method for benchmarking purpose and the directed the AO to compute the arm's length nature of the adjustments by comparing the net margins earned by the assessee from its sale to third parties (17.74%) as against the margin earned by the assessee on its sales to the AEs (4.65%). Otherwise, the TPO adopted **gross** margin. Thus, the issue was remanded to the files of the AO for an appropriate recomputation. However, in view of the DRP's silence on the need for using the TNMM and also clear direction to consider the variance of 13.42%, the AO complied with the direction of the DRP scrupulously.

Proceedings before the ITAT:

10. Aggrieved with the (i) above directions of the DRP; (ii) the findings of the AO/TPO; and (iii) non consideration of the arguments of the assessee, the present appeal is filed before us with the grounds summarized above in the language of the assessee. During the proceedings before us, the assessee was represented by Shri M.P. Lohia, Shri Anil B. Jain & Shri Rajendra Agiwal and the revenue is represented by Shri S.K. Singh CIT-DR & Shri Tejendra Singh CIT. The grounds are categorized into two categories (i) those which should be disposed as NOT PRESSED or ACADEMIC ones and (ii) the ones that requires adjudication. Firstly, we shall take up the ones categorized as (i) above.

(i) GROUND TOBE DISMISSED AS NOT PRESSED OR ACADEMIC:

11. Shri M.P. Lohia took the lead and stated that the grounds raised in the appeal essentially revolve around the above three adjustments made by the revenue. The issues in the grounds relate to both academic as well as on merits of the additions. As per the assessee, the AO/PTO/DRP denied various claims, which are legally due to the assessee. Sri Lohia dutifully explained the need for adopting (i) the multiyear data as existed at the time of compliance to the guidelines; (ii) approach of aggregation of international transactions entered into by the assessee pertaining to both manufacturing and trading activities. He also questioned the order of the DRP in not granting adjustment on account of (a) working capital; and (b) import cost. Ld Counsel raised other issues and they are: (i) non granting of the standard deduction as per the proviso to section 92C(2) of the Act; (ii) rejection of claims on use of multiyear data and adoption of contemporaneous data ie as existed at the time of assessment; (iii) merits of adjustments made by the revenue on accounts of both manufacturing and trading activities. (iv) other issues in the grounds number 15 raised in appeal.

12. Summarizing the said grounds, Sri Lohia mentioned that the ground 1 is general and gets covered by the decision of the Tribunal on the other specific

grounds of the appeal. Accordingly, the same may be **dismissed** as general in nature. We find the request of the AR is n order. Accordingly, ground 1 is **dismissed** as general.

13. Referring to the **grounds at 2, 3, 5, 6 and 7,** Ld Counsel for the assessee mentioned that these grounds either tweak into the legalities or academic aspects of the transfer pricing guidelines. Further, he mentioned that the same are not pressed if the assessee earns relief on additions made by the revenue. Ld Counsel also referred to a rectification application pending before the AO, who has not yet acted on the same. We have gone through the said grounds and find that they are academic in nature. Considering the assessee's concession, we **dismiss** the same as an academic exercise.

14. Next, Ld Counsel brought our attention to **grounds 11, 12 and 4(b) (partly) & (c)** and referred to the issue relating to '**provisions for warranty'** and need for granting adjustment on this account. Revenue rejected the assessee's claim on the ground that the provision, being the **unascertained liabilities**, has no role to play in matters of computation of net margin. They restricted the allowance to the extent of the actual expenditure on account of Warranty'. In this regard, Ld Counsel fairly mentioned that the same is not pressed. Considering the non objection of the revenue, without going into the merits, we proceed to dismiss the same summarily as **not pressed.**

15. The issue on **ground no.8** relates to international transaction pertaining to export of components and spares using and the decision of the revenue authorities to resort to resale price method (RPM) while TNM method is an applicable one to the impugned international transactions. Ld counsel mentioned that the difference in figures between the TNMM method and the resale price method is small and seeks direction of the Tribunal to the AO. On the other hand, the Ld. D.R. for the revenue also mentioned that the revenue will take necessary action to correct the mistake in this regard in an appropriate manner. We have heard the parties and perused the facts and the proceedings in the matter and find that the DRP has erred in not granting non contradicting directions to the AO. As discussed above, the DRP has not approved the RPM as an appropriate method to the sale/trading activities involving the AEs or third parties for arriving at the arm's length margins. On the other hand, it recommended the net margins analysis of AEs and the third parties, which is essential ingredient of the TNMM method. If the TNMM with the due adjustments is applied, the addition is meager. Considering the promise of the Ld DR, we proceed to remit the issue to the AO for deciding the issue after applying the TNMM in its true spirit. Accordingly, ground no.8 is **allowed**.

16. Regarding the **Grounds 13 to 15** relating to the issue of short grant of TDS/SA and charging of interest u/s 234B and 234C of the Act, Ld Counsel mentioned that they are either consequential in nature or covered issues as the case may be, in favour of the assessee. In any case they are settled issues in faour of the assessee. Considering the settled nature of these issues, we direct the AO to grant necessary relief. Accordingly, ground nos.13 to 15 are remitted to the files of the AO for recomputation after hearing the assessee.

(ii) GROUNDS FOR ADJUDICATION:

17. That leaves **ground 4(a)** relating to working capital related adjustments, **ground 4(b)** relating to import expenses related adjustments, **ground 9** relating to applicability of proviso to section 92C(2) of the Act and **ground 10** relating to incorrect computation of TP adjustments linking the adjustments to the gross manufacturing segment sales of Rs 23.32 cr (rounded off) instead of the proportionate sales, which is 40 of the total sales, relatable only to the imports of raw materials, components and spares etc. Balance of the 60% of the sale relates to the indigenously acquired purchases. Issue wise adjudication is given in the succeeding paragraphs of this order.

Ground 4(a) - Working Capital Adjustment:

18. We will take up the issue relating to the 'working capital' raised in sub ground 4(a) of the appeal. At the outset, Sri Lohia mentioned that in principle, the TP guidelines advocate in favour of making of adjustments to the unadjusted margins of the tested parties and six comparable on account of 'working capital'. Referring to the contents of para 7.3.1 of the 'Directions of the DRP' dated 14.9.2010, given u/s 144C(5) of the Act, Ld Counsel mentioned that the DRP merely and passively relied on the 'detailed reasoning for adopting the PLI of the proposed set of comparables at 7.18%'. DRP failed to pass directions on this issue of working capital related adjustments to be made to the martins of the tested parties. Sri Lohia demonstrated the fact of raising of the issue before the DRP and non adjudication of the ground by the DRP and took us through the contents of the impugned orders/directions. On this issue of requirement of making of the working capital adjustments to the margins of the comparable, Ld Counsel for the assessee mentioned that the AO/DRP/TPO have erred in not following the TP guidelines on one side and the existing decisions of the Tribunal directly on this issue. Referring to the decision of the Tribunal in the case of Mentor Graphics (Noida) (P) Ltd. 109 ITD 101, Ld Counsel mentioned that the '*final set of comparables may need to eliminate differences by making adjustments for the following: (a) Working capital……." (para 27).* Further,

referring to the decision of Pune bench in the case of E-gain Communication P Ltd reported in 118ITD 243, Ld Counsel mentioned that when TNMM is applied to a case, *'the differences which are likely to materially affect the price, cost charged or paid in, or the profit in the open market are to be taken into consideration with the idea to make reasonable and accurate adjustment to eliminate the differences having material effect.'* If these differences are not eliminated or removed, the comparison becomes unsound and unreliable. Further also, the decision of the Delhi Bench in the case of Sony India P Ltd (114 ITD 448) was cited for the proposition that deduction of 20% is allowable for various differences on account of intangibles, R&D, risk factors, **working capital**, etc. Referring to contents of the para 132 and 137 of the said decision, Sri Lohia stated that in that case the CIT(A) allowed adjustment to the extent of 10% against the 20% allowed by the TPO. Tribunal upheld the views of the TPO in the mater. Further also, referring to para 13.2 of the order of the Tribunal, Bangalore Bench, in the case of TNT India P Ltd, Ld Counsel mentioned that '*similarly, the working capital adjustments also have to be considered while arriving at the operating net margins.*

Written submissions of the DR

19. Per contra, Sri S K Singh CIT DR and Shri Tejendra Singh CIT relied on the written submission sent by the present Sri Sajnay Singh Addl DIT (TP)-1, Pune. Briefly, the revenue's contentions include (i) assessee did not make the claim for adjustment on account of 'working capital'; (ii) any adjustment has to be allowed in accordance with the provisions of Rule 10B(1)(e) relating to TNMM and relied on sub-clause (iii) for the proposition that the assessee failed to demonstrate that the impugned 'working capital' adjustment materially affect the price/cost/profit of relevant international transactions in the open market. (iv) as per the revenue, in the absence any definition, the *'net profit margin'* normally mean the profit before tax (PBT); (v) there is elaboration on the expression 'difference' used in the said sub clause (iii) and detailed the fact that the six comparable are filtered by the assessee himself on being satisfied about their fulfillment of the comparability on the functionality filter. Assessee never demonstrated the existence of difference on account of working capital before the TPO; (vi) Further, the revenue holds that the PLI to be adopted in the TNMM should be real and not notional one for benchmarking the arm's length margins.

Decision of the Tribunal on Working Capital Adjustment:

20. We heard the parties on this issue and examined the facts of the case in the light of the documents available before us. It is a fact that there is no dispute on the applicability of the TNMM for computing Arm's Length Margin.

21. The undisputed areas between the parties include (i) there is no issue on the six comparable identified and supplied for the benchmarking of the Arm's Length Margin; and (ii) there is no dispute on the requirement of elimination of the differences, if any for arriving at the credible ALP realized by the enterprise or by the unrelated enterprise from a comparable uncontrolled transactions in the benchmarking exercises. However, we find there is dispute on (i) if the 'working capital' constitutes a '*difference, if any between the international transactions and the comparable uncontrolled transactions of between the enterprises entering into such transactions,' as mentioned in sub-clause (iii) of* clause (e) of Rule 10B(1) of the Income Tax Rules, 1962; and (ii) if the answer to first issue at (i) above is positive, next issue relates to if the said difference '*could **materially** affect'* the amount of net profit margin of relevant transactions in the open market. We shall take up the first dispute mentioned above ie If the 'working capital' in instant case constitutes a '*difference, if any*.

(i) If the 'working capital' (WC) constitutes a '*difference, if any:*

22. For adjudication of the above, in our opinion, there is need for explaining the relevant provisions of Rule 10B of the income tax Rules 1962, meaning and impact of the WC on the pricing or margin or profiting of the transactions, the decided cases on this issue of WC. We shall take up the meaning and relevance of Working Capital.

(A) **Meaning of WC**: *Working capital is a financial metric which represents operating liquidity available to a business…. Along with fixed assets such as plant and equipment, working capital is considered a part of operating capital. Net working capital is calculated as current assets minus current liabilities. If current assets are less than current liabilities, an entity has a **working capital deficiency**, also called a **working capital deficit**. **Current assets and current liabilities** include **three accounts** which are of special importance. They are: accounts receivable (current asset)/inventory (current assets), and/accounts payable (current liability). These accounts represent the areas of the business where managers have the most direct impact. (Source: www.wikipedia.com)*

(B) **Effect of working capital** on the Transactional pricing in turn on the Prices/ Net Profit Margin of the transactions: TNMM requires the comparing the operating profit relative to an appropriate base ie PLI of the tested party ie the controlled enterprise or transactions. Appropriate base/PLIs in controlled transaction in the TNMM are cost, sales and assets. PLI includes (i) rate of returns on capital employed ie operating profit to operating expenses (ii) financial ratios –relationships between profit and costs/sales revenue (iii) other if they provide reliable measures of the income. Therefore, the question is if the

Net working capital, ie current assets (accounts receivables + inventory) minus current liabilities (accounts payable), effects the pricing and therefore the net martins and therefore does it constitutes the 'difference' for the purpose of the provisions of sub clause (iii) of 10B(1)(e). The answer is affirmative. The reasons are that the 'accounts receivable' is generally with reference to the sundry debtors and the 'inventory' refers to the available raw materials or finished products or the stocks in trade. All these accounts traces their origin to the working capital inputs. The sources of these inputs are capital/equity/advances from the parties/unsecured loans etc, and each of them has an element of cost. This cost shall certainly affect the pricing of the product or service or others as the case may be, which the subject matter of the international transaction is. Thus, the Working capital constitutes an item of difference in matters of computation of arm's length price/net margin. Therefore, the Tribunal has already decided this issue in the case of Mentor Graphics (Noida) (P) Ltd (Supra) that the 'working capital' constitutes a subject matter for adjustments in the matters relating to ALP in Transfer Pricing.

23. Now we shall undertake to explain the provisions of Rule 10B of the Income Tax Rules 1962 in the succeeding paragraphs. The said Rules read as under:

Determination of arm's length price under section 92C.

10B. (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :-

(a)……….

(b)…………..

(c)…………

(d)…………..

(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 realized 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 profit margin referred to in sub-clause (ii) arising is 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 realized 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.

(2) For the purposes of sub-rule (1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following namely :-

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction if –

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) 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 :

***Provided** that data relating to a period no being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared."*

24. What does Rule 10B say in general: Thus, generally, as prescribed in rule 10B(1) of the Income Tax Rules, 1962, (i) the net profit margin (NPM) **realized from international transaction** is computed in relation to relevant base ie the (a) costs incurred or (b) sales effected or (c) assets employed or (d) any other relevant base; (ii) the said NPM **realized from the comparable uncontrolled transaction** is computed having regard to the same base; (iii) NPM realized from the comparable uncontrolled transaction mentioned in (ii) above is **adjusted** to taken into account the differences, if any; (iv) the ***differences, if any*** mentioned are of that type which affect the amount of NPM in the open market; (v) finally the NPM at (i) above is established to be the same as the adjusted NPM mentioned at (iii) above. (vi) the said NPM shall be taken into account to arrive at the ALP in relation to the international transaction. Rule 10(3) also provides that, if none of the differences, if any are likely to materially affect the NPM or if such differences are adjusted with reasonable accuracy to eliminate the said differences.

25. **What does sub-clause (e) of Rule 10B(1) say, in particular:** We have examined the provisions of 10B(1)(e)(iii) of the Income tax Rules, 1962, which provides for the adjustments in the context of TNMM. From the above, it is explicitly clear that the for the arriving at the arm's length price (ALP) as per TNMM, the net profit margin arising out of the comparable uncontrolled transactions is adjusted to take into account differences, if any between the (i) international transactions and filtered comparables of uncontrolled transactions or enterprises entering into such transactions, which could materially affect the amount of the net profit margin in the open market. It is a fact the differences, if any mentioned in the said sub-clause (iii) are not specified in the Act. However, as evident from the above extract of the provisions, they provide for certain guidelines i.e. any differences, which could materially affect the amount of net profit margin fall in the scope of adjustments. Further, we may also take help of the available material in the form of the I T rules, explanation-memoranda, commentaries, OECD guidelines, various judicial decisions etc. In the light of the above scope of the rule 10B and the effects of the WC on the price/profit margin, we shall now discuss the existing law on hand on the issue of adjustments on accounts of the WC related differences between the tested party and the benchmarked comparable.

26. We shall undertake to discuss the precedents here under.

A. **Mentor Graphics (Noida) (P) Ltd reported in 109 ITD 101:** On such precedent brought to our notice by the assessee before us relates to a decision of the Tribunal in the case of Mentor Graphics (Noida) (P) Ltd. 109 ITD 101. The assessee referred to the contents of para 27 of the order of the Tribunal for the proposition that the WC adjustments constitutes one which is required to be adjusted for the purpose of establishing the ALP. Relevant para reads as under.

> "*It is a simple principle of economics that the greater the risk, the greater the expected return (compensation). If there are material and significant differences in the risk involved, then the comparables identified are not correct as appropriate adjustments for differences in such cases are not possible. Therefore, while performing searches for potential comparable companies, not only turnover and operating profit but functions performed and risk profile are also to be considered. However, it can always be shown on the given facts of the case that comparables found are similar or almost similar to the controlled transaction and no adjustments are needed. It is useful to see the level of intangible assets in comparison to an appropriate base. Depending on facts of the case, final set of comparables may need to eliminate differences by making adjustments for the following:*
>
> *(a) **Working capital**;*
> *(b) Adjustment for risk and growth;*
> *(c) Adjustment of R&D expenses.*
>
> *The risk not only due to human resources, infrastructure and quality which are normally taken into account yet more significant risks like market risk, contract risk, credit and collection risk and risk of infringement of intellectual property are being ignored here. In most of the comparable*

analysis carried in India, the latter type of risks is not being taken into consideration although these can lead to major difference in market value of transactions."

B. E-gain Communication P Ltd reported in 118 ITD 243: The decision of Pune bench in the case of E-gain Communication P Ltd reported in 118ITD 243, is relevant and when TNMM is applied to a case, *'the differences which are likely to materially affect the price, cost charged or paid in, or the profit in the open market are to be taken into consideration with the idea to make reasonable and accurate adjustment to eliminate the differences having material effect.'* If these differences are not eliminated or removed, the comparison becomes unsound and unreliable. Further also, the decision of the Delhi Bench in the case of Sony India P Ltd (114 ITD 448) was cited for the proposition that deduction of 20% is allowable for various differences on account of intangibles, R&D, risk factors, **working capital**, etc. referring to contents of the para 132 and 137 of the said decision, Sri Lohia stated that in that case the CIT(A) allowed adjustment to the extent of 10% against the 20% allowed by the TPO. Tribunal upheld the views of the TPO in the mater. Next one relates to an order of the Tribunal, Bangalore Bench, in the case of TNT India P Ltd supra, wherein it is mentioned that '*similarly, the working capital adjustments also have to be considered while arriving at the operating net margins.*

27. Now, we shall cull out the relevant gist from the orders of the revenue and discuss the arguments of the parties:

Written submissions of the assessee in this regard are as under:

"*Non grant of working capital adjustment: Hon'ble DRP in its directions has erred in not granting working capital adjustment to the unadjusted margins of the comparable companies for F.Y. 2005-06.*

In this regards, the appellant would like to bring to the notice of your Honors that the margin of comparables for the FY 2005-06 after considering working capital adjustment is determined at 3.77% as against the unadjusted arm's length margin of the comparable companies of 7.18% determined by learned TPO considering data for FY 2005-06 only.

The appellant in this regard, wishes to place reliance on following decisions which has upheld working capital adjustment:

Case law
Mentor Graphics (Noida) Pvt. Ltd. (112 ITJ 408) (Delhi ITAT)
Egain Communication (P) Ltd. V. ITO (118 ITD 243)
Sony India (P) Ltd v DCIT (114 ITD 448)
UCB India P Ltd Vs. ACIT (ITA 428 & 429/Mum/07) (Mum)
TNT India Ltd. Vs. ACIT (ITA No.1442 (BNG)/08)

The appellant prays that in determining the arm's length price for the international transaction entered into by the appellant, the differences in working capital employed by the assessee vis-à-vis the comparables needs to be factored into. Also, after considering the benefit of the provisions of section 92C(2) of the Act providing for (+)(-) 5% adjustment, the appellant is at arm's length in relation to its manufacturing imports.

Summarized below are the key figures/details calculating the adjustment after taking into consideration working capital adjustment:

Particulars	
Relevant Operating Margin of Tested party -assessee	*2.41%*
Arm's length Operating Margin of Comparables (unadjusted)	*7.18%*
Arm's length Operating Margin of Comparables (after considering working capital adjustment)	*3.77%*
Adjustment after considering working capital adjustments (3.77% - 2.41%)	*3,172,099*
Adjustment after considering working capital adjustment and benefit of +/- 5%	*101,997*

28. Elaborating on the above written submissions, the Assessee submitted before us that the issue of adjustments relating to Working Capital was raised before the revenue authorities and they passively allowed the issue to slip out of the active consideration. In this regard, Ld Counsel read out the contents of para 7.3.1 of the guidelines of the DRP and the same read as follows.

> *7.3.1 As regards the* ***adjustment made to the manufacturing activity****, as a result of which the income of the assessee has gone up by Rs 1,11,25,670/-, it may be mentioned that after careful consideration of material on record, we are of the view that the* ***ld TPO has given cogent reasons*** *for coming to the conclusion that the benchmarking of assessee's international transactions falling under manufacturing activity is required to be done following the TNMM and taking comparables as has been adopted by the assessee in the Transfer Pricing study Report and considering their data for the AY 2005-06…. The TPO has already given detailed reasons for adopting PLI of proposed set of comparables at 7.18%. On the given facts, the same is found to be acceptable. Therefore, ….the action of the TPO …does not require any interference.*

29. As seen from the above, the DRP passively relied on the TPO's findings by stating that '***ld TPO has given cogent reasons*** *for coming to the conclusion that the benchmarking of assessee's international transactions falling under manufacturing activity is required to be done following the TNMM and taking comparables as has been adopted by the assessee'*. On receipt of the said guidelines of the DRP, the AO dutifully adopted the same in his order. But the fact is that the written objections raised by the assessee before the DRP are left unattended by Ld DRP. To be specific, there is no discussion either in the order of the AO or in the guidelines of the DRP on if the 'working capital' adjustments fall within the zone of eligible adjustments and if they constitute material difference or otherwise. We infer that the revenue is of the implied opinion that the assessee becomes ineligible for any adjustments the moment the set of comparable are provided by him. In our opinion, this approach of the revenue is supported by the law or rules in existence. Rule 10B(3) provides for the guidelines as to eliminate the difference, if any and the legitimate way of benchmarking of the International transactions for ALP purpose involves such eliminations. It is the duty of the AO/TPO/DRP to minimize/eliminate the difference if any, which is likely to materially affect the price as discussed in Rule

10(3) of the Income tax rules, 1962. At the end of the assessment proceedings, the prayer of the assessee relating to the adjustments on account of working capital, was not attended either by the DRP by the AO. Yes, it is true that the assessee did not raise this issue before the TPO as evident from the order of the TPO but the same were raised before Ld DRP, who summarily relied on the order of the TPO as discussed in para 7.3.1 extracted above and without even examining if the request for working capital adjustment was raised at all before the TPO.

30. To sum up, the case of the assessee is that in TNMM, the working capital adjustments are required to be done to the margins of the comparable uncontrolled transactions to generate credible comparability data on transactional net margins. On the other hand, if appears that the case of the revenue is that the no such adjustments are called for to the set of comparable, which are supplied by the assessee.

31. We have so far analysed Rule 10B(1)(e) on one side and other subrules and in the context of the TNMM, we have analysed the need for the elimination of the difference, if any in the comparable uncontrolled transactions, which materially affect the profit margin in the open market. It is the requirement of the Rules. Who supplies the set of comparable is not the determining factor on this issue. Having noticed the difference, the revenue has to quantify the difference, if any and then revenue must decide if that difference constitutes 'materially affect' the price in open market. If the answer is affirmative, the said difference has to be removed and the margin has to be adjusted for arriving at the credible comparable PLI. Further, it is a settled proposition that the 'working capital' adjustment is one such adjustment that is required to be made in TNMM. The revenue's contention that the 'differences' specified should refer to only (i) the factor of demand and supply; (ii) existence of marketable intangibilities ie brand name etc; (iii) geographical location and the like, and such difference has to be in respect of the functions undertaken, assets employed and the risks assumed only. Further, the revenue's views that by making adjustments, the net profits arrived are not of real type of profits and they are notional ones, which goes against the spirit of TNMM. All these objections of the revenue are not based only settled propositions. The provisions of 10B(1)(e) provides for the manner of adjustments vide its sub clauses (i) to (iv), which were already analysed in the preceding paragraphs of this order. Briefly, (i) NPM realized from target transaction is computed in relation to cost incurred or sales effected or assets employed or to be employed or any other relevant base; (ii) NPM realized from a comparable uncontrolled transactions is computed having the same base; (iii) the NPM mentioned at (ii) is adjusted taking into account the differences, if

any, which could materially affect the NPM in the open market. Thus, the scope of adjustments is defined, which is discussed by us in the preceding paragraphs. The sub clause (iii) specifies that the adjustments are to be made on account of differences, if any. Therefore, in this regard, the litmus test to be applied is if the 'difference, if any, is capable of affecting the NPM in open market? If any factor is capable of such affect, yes, TPO is under statutory obligation to consider and examine and eliminate such difference. AO/TPO/DRP cannot say that difference is likely exist in all accounts appearing in P&L account or Balance sheet, which are likely to materially affect the NPM in open market and therefore, the demands of the assessee should be ignored, is not the correct approach. Revenue's reasoning that the demanded adjustments should not be entertained by the TPO merely on the basis the comparables are supplied by the assessee is not the correct. In our opinion, it is the duty of the TPO to apply the provisions of rule 10B(1)(e) to establish the ALP in relation to international transaction as per the TNPM, which is an undisputed method found applicable to the present case by both the parties. It is a settled accounting principle that the net margins can be influenced by some of the same factors which can influence price or gross margins. Further, it is the requirement of the rules / provisions that any difference which is ***likely to materially affect the NPM in open market*** has to be eliminated. TPO must know that the TNMM visualizes the undertaking of the thorough comparability analys and elimination of the differences through the requisite adjustments. Yes, data availability is the limitation and both the parties need to ensure the procurement and use of the proper documentation. Therefore, we dismiss the revenue's contention that no further adjustment if any is entertained once the comparables are supplied by the assessee and when they are accepted by the TPO. Thus, working capital is a factor which influence the price in the open market and therefore the net profit margin of the business segment of the assessee which is targeted by the TPO/AO/DRP. Hence, in principle, **we hold that the TPO/AO/DRP has failed to entertain the objections of the assessee on the 'working capital' adjustments issue**. Therefore, we direct them to allow the requisite adjustment on account of the impugned 'working capital' while determining the Arm's Length operating Margin of the Comparables. Thus, relevant grounds of assessee's appeal are allowed.

32. ***Meaning of 'Likely to materially affect*** **'- Quantification**: Now we shall take if the quantity of the said 'working capital' adjustments is that much which is likely to materially affect the price/margin of the international transactions involved. As per the assessee, unadjusted Arm's length Operating Margin of the Comparables is 7.18% and Arm's length Operating Margin after making adjustments on account of 'working capital', works out to only 3.77%. It shows the drop in margins to the extent of 3.41% in the Arm's length Operating

Margin of the Comparables. We have already discussed these figures in the preceding paragraphs and on translation to real figures, the said percentage of 3.41 works out to Rs 31,72,099/-. In our opinion, in the given case, such a difference constitutes the said '***difference, if any'*** which is ***likely to materially affect*** the ALP/ Arm's length Operating Margin of the Comparables as mentioned in Rule 10B(3) of the Income tax rules, 1962. The same needs to be eliminated as per the said sub-rule (3).

33. We have already discussed in the preceding paragraphs, this issue of adjustment on account of WC was raised for the first time before the Ld DRP and the DRP has passively relied on the order of the TPO without realizing that the said issue was never dealt with by the TPO. Therefore, the issue of granting of adjustment on account of 'working capital' for ***eliminating of the material effects*** and the issue of, if such adjustment @ 3.41% constitutes that difference, if any, which is ***likely to materially affect*** the price/profit margin, have not been examined. We find that there are written request of the assessee to the DRP to this extent and assessee furnished the relevant figures, which are enough to adjudicate the said request by the AO/DRR. It is not the case of the DRP that the above claims of the assessee are incorrect. Alternatively, it is not the request of the revenue's DR that these said issues should be remitted for another round of the proceedings before the revenue authorities. In our opinion, the existence of difference @ 3.41%, which is worth Rs 31,72,099/-, attributable to the 'working capital' ought to amount to the 'material difference' considering the existing unadjusted operating margin of the comparables at 7.18%. In these circumstances, we are of the opinion that the said working capital differences constitutes quantitatively likely to materially affect the ALP / AL Operating Margin of the comparable. Therefore, the claims of the assessee are **allowed**. Accordingly, **the grounds 4(a)** is covered by the cited decisions and is allowed *pro tanto*.

Issue of import cost of raw material, components and spares

34. **Ground 4 (b)** has two limbs i.e. warranty claim and trade import cost of raw material and components and spares. Ld counsel mentioned that the adjustments with regard to the warranty claims are **not pressed**. Therefore, the limited issue for adjudication out of this said sub ground (b) relates to the adjustment on account of **higher import cost**. In this regard, Ld counsel submitted that the assessee provided the commercial reasons in relation to grant of adjustment on account of higher import cost of the assessee vis a vis the comparable companies before the TPO/DRP. The relevant write up by the assessee on this issue of import cost related adjustment read as under:

The company has 35.71% higher imports as compared to its comparable companies. Further, the additional cost incurred by the Company as compared to comparable companies on basis custom duty, landing charges, clearing and forwarding charges and insurance & freight will be around 18% to 21%.

Summarized below are the key figures/details

Particulars	
Operating profit/total sales (adjusted for higher import cost	6.61%
Arm's length Operating Margin of Comparables (unadjusted)	7.18%
Adjustment after considering adjustment for high **import cost** (Rs 233,242,565* (7.18% - 6.61%=0.57%)	Rs 1,317,822

The appellant places reliance on rule 10B(3) of the Rules and the OECD Guidelines, which lays emphasis on adjustment for difference between the transactions being compared which are likely to materially affect the profit arising from such transactions in the open market for which reasonably accurate adjustments are possible. Thus the differences on account of higher imports and warranty provision have resulted into lower profit as compared to the transactions in the open market for which reasonable adjustment is possible.

In view of the above, the appellant submits that the margins of appellant be adjusted to take into consideration excess warranty claims and high import cost.

35. Elaborating the above, Ld Counsel for the assessee has mentioned that assessee imported components and spares from AE to the tune of Rs 602.18 lakhs for manufacturing segment. It works out to nearly 40% of total imports ie Rs 1557.38 lakhs. Referring to the comparables, it is brought to our notice that the imports of the comparables works out to merely 3.68% and therefore, there are differences and they have to eliminated by way of adjustments to be a credible comparables to the tested party's data. As per the assessee, the revised PLI after adjustment for excess import duty work out to around 6.6%, which falls in the permitted range of +/-5%. Further, in support of the above, Ld Counsel relied on various decisions for the proposition that the adjustment on account of import cost constitutes permissible ones.

36. In response to the above, the Ld. D.R. for the revenue submitted that the assessee has not made this sort of adjustments during the proceedings before lower authorities. Further, the Ld. D.R. argued stating that these expenses do not fall under the category of **extraordinary** expenses which requires adjustments. Further, he also mentioned that adjustments, if any, in this regard should be made only on the comparable cases of uncontrolled transactions. In this regard, the CIT relied on the provisions of rule 10B(e) of I.T. Rules, 1962. Further, he is of the opinion that, if this is the way the adjustments are periodically claimed by the assessee, there is a need for analyzing every account of the comparables relied upon by the assessee. The CIT also mentioned that the comparables supplied to the A.O are those **which are selected by the assessee** himself. In these circumstances, the assessee should not be permitted to ask for adjustments to the already benchmarked ones.

37. We have heard the parties and perused the available material on records in the light of the second limb of the ground 4(b). It is relevant mentioned that we have already analysed the relevant provisions of Income Tax rules vis avis the scope of the adjustments in the preceding paragraphs in the context of the adjustments on account of the 'working capital'. In principles, our findings on the issue remain applicable to the adjustments on account of the import cost mentioned in ground 4(b) too. The difference between the AL Margin before and after the said adjustments on account of 'import cost' works out to 0.57% (7.18%-6.61%). Revenue has not disputed the said working of the assessee. In these factual circumstances and in the light of the scope of adjustments discussed above, in our opinion and in principle, the assessee should win on this ground too. One such decision relied upon by the assessee's counsel supports our finding relates to the decision of this bench of the Tribunal in the case of Skoda Auto India p Ltd 122 TTJ 699 (Pune) dated March 2009 wherein, it is held (in para 19 of the order) that,-

> *No doubt , a **higher import content of raw material** by itself does not warrant an adjustment in operating margins, as was held in Sony India (P) Ltd.'s case (supra), but what is to be really seen is whether this high import content was necessitated by the extraordinary circumstances beyond assessee's control. As was observed by a Co-ordinate Bench of this Tribunal in the case of E-Gain Communication (P) Ltd. (supra) "the differences which are likely to materially affect the price, cost charged or paid in, or the profit in the open market are to be taken into consideration with the idea to make reasonable and accurate adjustment to eliminate the differences having material effect". We do not agree with the AO that every time the assessee pays the higher import duty, it must be passed on to the customers or it must be adjusted for in negotiating the purchasing price. All these things could be relevant only when higher import content is a part of the business model which the assessee has consciously chosen but then if it is a business model to import the SKD kits of the cars, assemble it and sell it in the market, that is certainly not the business models of the comparables that the TPO has adopted in this case. The adjustments then are required to be made for functionally differences. The other way of looking at the present situation is to accept that business model of the assessee company and the comparable companies are the same and it is on account of initial stages of business that the unusually high costs are incurred. The adjustments are thus required either way. It is, therefore, permissible in principle to make adjustments in the costs and profits in fit cases. We also do not agree with the authorities below that the onus is on the assessee to get all such details of the comparable concerns so as to make this comparison possible. The assessee cannot be expected to get the details and particulars which are not in public domain. In such a situation, i.e. when information available in public domain is not sufficient to make these comparisons possible, it is inevitable that some approximations are to be made and reasonable assumptions are to be made. The argument before us was that it was first year of assessee's operations and complete facilities ensuring a reasonable indigenous raw material content was not in place. The assessee's claim is that it was in these circumstances that the assessee had to sell the cars with such high import contents, and essentially high costs, while the normal selling price of the car was computed in the light of the costs as would apply when the complete facilities of regular production are in place. None of these arguments were before any of the authorities below. What was argued before the AO was mere fact of higher costs on account of higher import duty but then this argument proceeded on the fallacy that an operating profit margin for higher import duty is permissible merely because the higher costs are incurred for the*

inputs. That argument has been rejected by a Co-ordinate Bench and we are in respectful agreement with the views of our esteemed colleagues. This additional argument was not available before the authorities below and it will indeed be unfair for us to adjudicate on this factual aspect without allowing the TPO to examine all the related relevant facts. We, therefore, ***deem it fit and proper to remit this matter to the file of the TPO for fresh adjudication*** *in the light of our above observations.*

38. The perusal of the impugned orders shows that the above cited guidelines by way of decision of this bench of the Tribunal in the case of Skoda Auto India p Ltd (supra) were not available to the revenue authorities. Therefore, we are of the opinion, the issue should be set aside to the files of the TPO with direction to examine the claim of the assessee relating to the import cost factor and eliminate the difference if any. However, the TPO/AO/DRP shall see to it that the difference in question is ***'likely to materially affect'*** the price/profit in the open market as envisaged in sub rule (3) of Rule 10B of the Income tax Rules, 1962. Accordingly, ground **4(b)** is allowed *pro tanto*.

Issue of TP adjustment without giving benefit of +/- 5% under erstwhile proviso to section 92C(2) of the Act:

39. **Ground no.9** relates to applicability of the provisions of the proviso to section 92C(2) of the Act. We reproduce the relevant extract from the written submissions of the assessee as it is a self contained one and it bring out briefly (i) the stand of the revenue and (ii) the rebuttal of the assessee. The submissions in this regard are as follows:

"*Transfer pricing adjustment without giving benefit of +/- 5% as available under erstwhile proviso to section 92C(2) of the Act ……*

Hon'ble DRP and the learned AO/TPO have erred in facts and circumstances of the case by computing the arm's length price of the international transactions pertaining to manufacturing activity and export of components and spares without taking into account the +/- 5 percent variation from the mean, which is permitted to and which has also been opted for by the appellant under the provisions of section 92C(2) of the Act.

Hon'ble DRP and the learned AO/TPO has contended that the benefit of safe harbor of +5/-5% is not available to the appellant stating the following:

*"**In the present case it is seen that the ALP of the international transaction undertaken by the assessee falls beyond the 5% of the price of International Transaction computed by the assessee.** Therefore in view of the provisions of the law, details and intentions as are evident from the press note of govt. of India as well as circular of the CBDT, as aforementioned the benefit of the safe harbor of **+/5-5% is not available to the assessee."***

The appellant is contesting the above conclusion of the Hon'ble DRP and with respect to its contention that the transfer pricing adjustment, if any, should be made after giving the benefit of +/-5%, the appellant places its reliance on the following cases:

Case law
Cummins India Limited [ITA No.277 & 1412/PN/07] (Pune ITAT)
DCIT Vs. Sony India TS-19-ITAT-2008 (DEL)(Delhi ITAT)
ACIT vs. UE Trade Cortn (India) Pvt. Ltd (2010) – [ITA No.4405 (Del)/2009
Starent Networks (India) P Ltd v. DCIT [ITA No.1350/PN/2010] (Pune ITAT)
M/s. SAP Labs India Pvt. Ltd. v ACIT (ITA No.398/Bang/2008) Bang ITAT

Tecnimount ICB Private Limited [ITA No.7098/Mum/2919] (Mumbai ITAT)
Huntsman Advanced Materials India Pvt. Limited ITA No.8237/Mum/2010
ITO Vs. Hartland Info & Consultancy Services Ltd. ITA No.5175(Del) ITAT)

Further the appellant submits that as per the proviso to section 92C(2) of the Act, an assessee has the option of charging a price to its AEs, which may vary from the arm's length price by +/- 5 percent. The appellant also wishes to state that Section 92CA (3) of the Act provides that the Transfer Pricing Officer has to determine the arm's length price in accordance with sub-section (3) of section 92C. Section 92C(3) further states that the arm's length price shall be determined by the Assessing Officer in accordance with sub-section (1) and (2) of section 92C. Therefore, it should be appreciated that the learned Transfer Pricing Officer is mandatorily required to calculate the arm's length price in accordance with section 92C(1) and 92C(2) of the Act.

The explanatory Memorandum to Finance Bill 2002 and Notes on Clauses – Income Tax (Finance Bill, 2002) also clarifies that in case the application of the most appropriate method results in two or more prices, the appellant is required to compute the arm's length price by determining an arithmetic mean of such prices or a 5% variation of the arithmetic mean thereof. There is no ambiguity in law in respect of the same. ***Thus, any adjustment to the income of the assessee should be computed after considering +/- 5% variation from the arithmetic mean.***

With respect to the amendment made by the Finance Act 2009 and explanatory memorandum to the Finance Bill, 2009, the appellant wishes to state that the explanatory memorandum to the Finance Bill, 2009 states that "the amendment would apply to all cases where the proceedings are pending before the TPO on or after 1 Oct 2009". However, it is submitted that wordings in the explanatory memorandum which are against the language of the law should not be resorted to unless the language of the section is not clear or unambiguous.

Section 92 deals with the computation of income having regard to the arm's length price. Further, the amendment to section 92C refers to the "computation of the arm's length price." Thus, the amendment is to the substantive provisions dealing with the computation of income and not to the procedures dealing with the assessment of income. Thus, the proviso which is made effective with prospectively from 1 October 2009 should not be made applicable for the transactions undertaken by the appellant during the financial year ended 31 March 2006 i.e. before 1 October 2009.

Further the learned TPO and Hon'ble DRP has failed to appreciate the contention of the appellant documented in the TP study report that prescribing a range for determining arm's length price would help accommodate for wide differences between the functions performed, risks undertaken, business circumstances and other similar circumstances pertaining to the 'tested party' vis-à-vis the comparables. A similar view is endorsed by OECD guidelines. "It also is important to take into account a range of results when using the transactional net in the business characteristics of associated enterprises and any independent enterprises engaged in comparable uncontrolled transactions, because the range would permit results that would occur under a variety of commercial and financial conditions."

Thus, drawing reference from the position as per the provisions of the Act, also supported by various judicial precedents and OECD Guidelines, the appellant submits that benefit of +/- 5per cent variation in determining the arm's length price needs to be given in the instant case in case the Hon'ble ITAT proposes to continue with the transfer pricing adjustment in the case of the appellant. The appellant prays that the adjustment (if any) be made after *allowing the benefit of +/- 5% variation from the arithmetic mean arm's length price."*

40. On the other hand, Ld DR for the assessee filed written submissions before us and para 9 of the same is relevant. The same are made under the **presumption** that the variance is exceeded the specified limits of variance of +/- 5% . As per the revenue, in the present case, the ALP of the International transaction of the assessee falls beyond the 5% of the margin of the arithmetical mean of the multiple prices of the comparable uncontrolled transactions. Thus, in brief, the revenue is of the stern opinion that the assessee is not entitled to standard deduction of +/-5% if the variance goes beyond 5%. In this regard, Ld DRs for the revenue relied on amended provisions of the proviso to section 92C w e f 1/10.2009 on one side and the ratio of the Delhi bench decisions of the ITAT in the case of Global Vantedge P Ltd (2010)1 ITR (Trib) 326 & Merubeni India P Ltd 56 DTR 252 for the proposition that this +/-5% is not a standard deduction and this option is available only when the assessee computes the ALP and not when the AO/TPO/DRP does the same. The note also says that the said view was upheld by the Hyderabad Bench of the ITAT in the case of Deloitte Consulting India P Ltd for the AY 2004-05 vide their order dated 22/7/2011.

41. During the rebuttal time, Sri Lohia Ld Counsel for the assessee filed a chart showing a detailed working to demonstrate that the variance is not beyond +/-5% in case the adjustments on accounts of (i) working capital; (ii) expenses; (iii) correct quantification of margins realized vis a vis relatable sales as relevant base etc are allowed. Relevant working read as under:

Particulars	**Operating Revenue as PLI**
Tested Party Total Cost	227,613,571
Tested Party Total Sales	233,242,565
Tested Party Profits	5,628,994
Operating Profit/total sales	2.41%
ALOM* of Comparable after Working Capital adjustments	3.77%
Difference in Margins (3.77- 2.41)	1.36%

**Arm's Length Operating Margin*

42. Without prejudice to the above, as given in the note, Ld Counsel mentioned, that there are various decisions of the Tribunal including the decision of the coordinate bench of the ITAT, Pune in favour of grant of deduction of 5% when multiple prices are involved and cited Cummin India Ltd ITA 277/1412/PN/2007 and Starent Networks (I) P Ltd ITA NO 1350/PN/2010. In this regard, Ld Counsel cited a paragraph from the order of the Tribunal in the case of cited case from the Hyderabad Bench of the ITAT in the case of Deloitte Consulting India P Ltd, supra stating that the order of the Co-ordinate Bench of

the Tribunal will normally to be followed in case where there are contrary decisions of two Benches of the Tribunal.

43. We have perused the cited decisions of various benches in general and the decisions of the Pune Bench in particular and find that Pune Bench of the tribunal has decided in favour of the assessee in support of grant of deduction of 5%, when multiple prices in establishing the arithmetic mean are involved. It is a settled law vide Hyderabad Bench of the ITAT in the case of Deloitte Consulting India P Ltd, supra, that the order of the Co-ordinate Bench of the Tribunal will normally to be followed in case where there are contrary decisions of two Benches of the Tribunal. It is also a settled law that the judgment favourable to the assessee to be followed when there are two contrary decisions on the issue. Therefore, we find no reason to not to follow our own co-ordinate Bench decisions on this issue. Thus the assessee's ground on this issue is **allowed**.

44. Finally, to sum up, we have so far adjudicated grounds raised in ground 4(a) and second limb mentioned in ground 4(b), ground 9 and ground 10. In principle, we have allowed/allowed for statistical purpose the grounds raised by the assessee. However, it is relevant to mentioned that we have not verified the **bona fide** of the figure work submitted before us and the figure work may relate to the above said NPM of both the tested party and the comparable. While giving effect to our directions, Ld AO/TPO/DRP is required to examine the figure work as the adjustment on all account of the disputes. Accordingly, **ground 9 is allowed**.

Issue relating to computation of TP Adjustments on Proportionate Basis:
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45. **Ground 10** refers to incorrect computation of TP adjustments to the manufacturing activity. In this regard, referring to the manufacturing segment and sale affected in this segment, Sri Lohia read out that the total sale of this segment is Rs 23,32,42,565/- and the relatable cost of material is Rs 1528.65 lakhs, (of course, the assessee submitted a different figure of Rs 1557.39 lakhs in some other context). Thus, this cost of material (controlled and uncontrolled cost) of Rs 1557.39 lakhs includes the Rs 602.19 lakhs, relatable to the transactions with AEs ie controlled cost. As per the Counsel, revenue has erred in computing the TP adjustment on the entire manufacturing segment sales instead of computing the TP adjustment on those sales relatable to the import of the components and spares procured from the AEs only. While establishing the ALP on this segment, the AO worked out the said variance @ **4.77**% (i.e. 7.18% - 2.41%) and worked out the corresponding quantum of adjustment at **Rs 1,11,25,670/-** (i.e. 4.77*23,32,42,565/100). In this regard, the Ld counsel for

the assessee mentioned that if total international transactions under consideration for adjustment on account of '*Import of raw materials, components and spares for assembly/manufacture of material handling products' worth Rs 60,218,878/-* works out to only 40% of the total cost, the same proportion of the total sales has to be considered for making TP adjustments. If the assessee's manner of adjustment is considered the additions should be restricted to Rs 43,82,783/- only (Rs 11,125,670 * Rs 60,218,878/Rs 152,865,285). In this regard, Ld Counsel relied on the provisions of the Rule 10B(1)(e) and also various judicial pronouncements on the subject ie (i) Emerson process Management India P Ltd ITA NO 8118/m/2010; (II) T Two International P Ltd and others; IL Jin electronics I PLtd 36 SOT 227 Del; Starlite case 2010-TII-28-ITAT-DEL-TP; Abhishek Auto Industries Ltd 2010-TII-54-ITAT-DEL-TP etc.

46. We have heard the parties and perused the relevant provisions of the said rule. Sub clause (i) and (ii) of the Rule 10B(1)(e) referred to the expressions '*in relation to'* and the '*relevant base'*. They read as follows:

(i) The net profit margin realized 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 realized 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****;*

47. From the above, it is vivid that in TNMM, the net profit margin realized by the tested party, an assessee, out of the international transaction is computed in relation to sale effected (as in assessee' case), which is the relevant base. The expression '*in relation to'* means 'in connection with' and it implies connection between impugned international transactions worth Rs 60,218,878/- on account of Import of raw materials, components and spares for assembly/manufacture of material handling products' and to the **related** sales and not to the entire sales of the manufacturing segment of the assessee. The said relationship/ratio is the requirement in the present comparability analysis and not the entity level sales as wrongly considered by the TPO and relied upon by the DRP. In principle, such closure comparability analysis is needed in TNMM, when sales is used as a base for determining net profit margin. Thus, it is erroneous to bring relationship between the Rs 60,218,878/- and Rs 23,32,42,565/- ie the total sales. Assessee's failure to supply the data on relevant sales is no defense, when there are settled alternatives for adoption in such circumstances, well tested 'principle of proportionality' in our opinion should help. Thus, the base of sales does not

need to be 'total sales'; but the proportionate sales relatable to the impugned international transactions. It is a commonsensical approach.

48. In this regard, we have perused the existing decisions relied upon by the assessee and the following extracts from some of the decisions are relevant and the same read as follows.

A. <u>Emersons Process Management India P td – ITA NO 8118/M/2010 AY-2006-07 -Pg 452 of Paper Book</u>

*" 19. Fifthly, as has been consistently held by the coordinate benches, the transfer pricing adjustment is to be made **with respect to international transaction and not the entries sales…………** We, therefore, direct the Assessing Officer to compute the transfer pricing adjustment in the light of this legal position. "*

B. <u>T Two International P Ltd and Tara Jewels Eports P Ltd and Tara Ultimo P Ltd ITA NO 5644, 5645 & 5646/m/2008 Ay 2004-05 – para 13 @ page 460 of Paper Book</u>

*" 13. We have considered the rival submissions carefully. We partially agree with the submissions of the ld. Counsel for the assessee that original TPO's order is definitely erroneous because he has applied the net profit margin of 7.25% **on the gross sales** and followed a complicated procedure to arrive at the amount of adjustment. In simple terms if the sales to Associated Enterprises is taken at Rs. 25 crores and straight way 7.25% margin is applied then approximately total margin would be Rs.1.81 crores, whereas adjustment has been made at Rs2,57,26,138/-..."*

C. <u>IL Jin Electronics I P Ltd v ACIT 36 SOT 227 Page 470 of the Paper Book:</u>

*" 15. The assessee has also taken one alternative ground out of the total raw materials consumed by the assessee for manufacturing printing circuit boards, only 45.51 per cent of the total raw materials were imported through assessee's associated concerns, and , therefore, any adjustment, if any called for, can only be made to the 45.51 per cent of the total turnover, and **not to the total turnover of the assessee**. After considering the facts of the case, **we do not find any difficulty in accepting this contention of the assessee that at best only 45.51 per cent of the operating profit can be attributed to imported raw material acquired from assessee's associate concerns**. In the present case, the AO has calculated the operating profit on the **entire sales** of the assessee, which in our considered opinion, **is not justified,** when it is admitted position that only 45.51 per cent of raw material has been acquired by the assessee from its associate concerns for the purpose of manufacturing items.The assessee has stated that the operating profit if applied to 45.51 per cent of the turnover would come to Rs.35,52,573 as against operating profit of Rs.24,35,175 booked by the assessee, and the difference thereof would only be called for to be made as addition to the profit shown by the assessee. We, therefore, direct the AO to modify the assessment and **make the adjustment only to the extent of difference in the arm's length operating profit with adjusted profit with reference to the 45.51 per cent of the turnover**, and not to the total turnover of the assessee. Therefore, to this extent, the addition made by the AO and further confirmed by the CIT(A) is reduced. We order accordingly."*

D. <u>DCIT vs Starlite 133 TTJ 425 Mum AY 2002-03 Page Para 13 at 478 of the Paper Book</u>

*"13. As in this case, TPO has not applied TNMM, as contemplated in the Act, we have no other alternative but to set aside her order………. **We also agree with the arguments of learned counsel for the assessee that adjustments, if any, arising due to computation of ALP should be restricted only to the international transactions and not to the entire turnover of the assessee company.** No addition can be made to local transactions under Chapter X of the Act. Such things are done only when the AO invokes s. 144. We direct the AO to restrict the adjustments, if any only to international transactions, which are found by him to have taken place at price other than ALP."*

E. <u>Abhishek Auto Industries Ltd vs DCIT 136 TTJ 530 Del- para 8.2 at Page 494 of the Paper book:</u>

*"8.2 It has not been disputed that provisions X, s. 92C deals with international transactions only and not with transactions which have no international cross-border element at all. **Therefore, the basis of making the adjustments on the enterprise level by taking Rs.68.76 crores as the base is not correct.** What should have been taken is the sale to domestic parties using Takata technoloty and Takata raw material amounting to Rs.12.74 crores. The segment that was to be looked at was the international segment, that is domestic sale using foreign technology and foreign raw material. As given by the appellant, the operating profit margin on AE sales is 10.49 per cent whereas in the domestic sales segment it is only 2.88 per cent. …………….. We, therefore, accept this second proposition also that only international transaction is to be taken into account while calculating the ALP".*

49. All these cited decision in general and the decision in the case of M/s IL Jin Electronics I P Ltd, supra , in particular are uniform in asserting that the TP adjustments are to computed not considering the entity level sales. Rather it should be done ideally considering the relatable sales drawing the quantitative relationship to the imports from the AEs, ie controlled cost. The principle of proportionality is relevant here and it is a settled law in this regard. In the situation like the one in the instant case of the assessee, there is data relating to controlled and uncontrolled cost particulars. This undisputed data is suffice to arrive the proportionate sales relatable to the international transaction with the AEs ie controlled cost. Accordingly, the **grounds 10** relating to Incorrect computation of transfer pricing adjustment to the manufacturing activity is **allowed *pro tanto***.

50. Therefore, in principle, we accept the argument of Ld Counsel for the assessee and allowed the grounds 4 (a) and (b), grounds 9 and 10 as per the discussion above. It is mentioned before us that if the said grounds are allowed, there shall be no additions under the TP laws. This claim of the assessee has not

been tested by us after due examination of the figures placed before us. Therefore, for this limited purpose, we remand these grounds with the direction to the AO to rework the addition, if any considering the findings of the Tribunal given in the preceding paragraphs and of course, after granting reasonable opportunity to the assessee.

51. In the result the appeal of the assessee is **allowed *pro tanto*.**

Order pronounced in the open Court on 04/01/ 2012.

Sd/-	**Sd/-**
(I.C. SUDHIR)	**(D. KARUNAKARA RAO)**
JUDICIAL MEMBER	**ACCOUNTANT MEMBER**

Pune, dated the 04/01/2012

Copy of the order is forwarded to :

1. Demag Cranes & Components (India) Pvt. Limited, Gat No.330, 332,333, 334, Nanekarwadi, Chakan, Taluka Khed, Pune 410 501.
2. DCIT Circle-1(2), Pune
3. The CIT(A), Pune
4. The CIT concerned
5. D.R. "B" Bench, Pune
6. Guard File

By order

Assistant Registrar
Income Tax Appellate Tribunal
Pune