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IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCHES "L" : MUMBAI

BEFORE SHRI B.R. MITTAL, JUDICIAL MEMBER
AND
SHRI J.SUDHAKAR REDDY, ACCOUNTANT MEMBER

ITA. No. 5272/Mum/2007
Assessment year 2004-2005

ACIT-10 (3) Mumbai – 400 020. (Appellant)	vs.	M/s. Genom Biotech Pvt. Ltd. Mumbai – 400 076 PAN AABCG1013B (Respondent)

For appellant : Shri Ajit Kumar Jain
For respondent : Shri Firoze B. Andhyarujina

Date of Hearing : 25-04-2012
Date of pronouncement : 16-05-2012

ORDER

PER J.SUDHAKAR REDDY, A.M.

1. This is an appeal filed by the Revenue directed against the Order of the Commissioner of Income Tax (Appeals)-10, Mumbai dated 8-5-2007 for the assessment year 2004-2005.

2. Facts in brief. The assessee is a company and engaged in the business of manufacturing and export of pharmaceutical products. It filed its return of income for assessment year 2004-2005 on 27-10-2004 declaring total income at Rs.2,12,88,722/-. Along with return of income, the assessee-company filed audit report under section 92E in the prescribed Form No.3CEB in relation to international transactions along with other audit reports and Forms.

3. The assessee has entered into international transactions with Associated Enterprises for (a) export sale of pharma products and (b)

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reimbursements of business promotion expenses. The matter has been referred to the Transfer Pricing Officer. The Transfer Pricing Officer-IV, West Zone, India vide Order dated 8-12-2006 passed under section 92CA(3) had determined the arms length price of the international transaction of reimbursement of business promotion expenses at Rs.2,13,46,528/- as against the arms length price of Rs.32,11,57,736/- determined by the assessee and made an upward adjustment to the tune of Rs.29,98,11,208/-. The arms length price of export sales was accepted by the TPO. The CIT(A) at pages 1 to 3 of his order has brought out the report of the TPO. At page 5, the TPO's findings were summarized which is extracted hereunder for ready reference :

"To summarise the TPO has based his findings on -

a) The assessee should have it's AEs at Ukraine or Russia instead of Cyprus.

b) The money earned from the business in India is largely transferred to assessee's two A.Es in Cyprus, a tax heaven.

c) Allowability of expenditure is primarily the subject matter of A.O. The A.O. is required to look into this matter and find out the ways in consultation with FTD, CBDT to carry out the investigation outside the boundaries of India as these transaction prima facie appear doubtful.

d) Since direct investigation is not possible, the other best method as prescribed in law is application of TNMM.

e) There is greatest difficulty in commenting upon this Xerox copies is to decipher what is written in foreign language and carrying out actual physical verification of these expenses as they have been incurred outside the territory of India. As such, these papers neither prove nor disprove anything.

f) Assessee is selling products which are high in demand and cater to niche market, throughout the world, products related with

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enhancement of sexual potency are sold at premium and hardly any advertisement is required.

g) These products are not sold directly in Ukraine market but to the consignees namely, Optima Farmi Ltd., Trigam International, DP Apollo & DP Osian Pharma, Ukraine.

4. The Assessing Officer after considering the submissions of the assessee made a T.P. adjustment based on the TPO's Order. There is no addition as far as export sale of pharma products are concerned. The Transfer Pricing adjustment is only on the issue of reimbursement paid for business promotion expenses.

5. Aggrieved, the assessee carried the matter in appeal before the first appellate authority. The first appellate authority deleted the addition on the following grounds :

(a) *There are no defects in respect of information and documents kept under section 92D and as prescribed under Rule 10B(b).*

(b) In the previous year the total amount paid to AE for advertisement was Rs.6,43,58,749/-, which corresponded to 30.92% of total sales and these transactions of the earlier years were accepted by the Assessing Officer. The TPO's assumption to restrict advertisement and marketing expenses to 10% of total sales of Rs.54 crores is not supported with any logic.

(c) That operating margins to sales and operating profit to cost were not comparable with the study of 17 units carried out by TPO.

(d) Even the study carried out for those companies, the advertising and marketing expenses vary between 5.27% to

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31.89% and taking mean of all companies for benchmarking is not justified.

(e) *That Assessing Officer has not pointed out any defects in the bill for reimbursement supported with vouchers.*

(f) *That the remittance bear approval of RBI and other monitoring agencies.*

(g) *That TPO has accepted the sale transaction with CUP/CPM method was adopted and gave a finding that the margin declared was better than the industry average of 55% - 65%.*

(h) *That TPO allowed 10% of total sales, which included expenses incurred in India and this assumption is illogical.*

(i) *The Assessing Officer and TPO have not brought out any evidence on record that part of money paid to the AEs was return back to assessee.*

(j) *That shares in the AEs were transferred to other unrelated parties on 20-10-2003 and thereafter, the assessee had no control over AEs after that date. It would be wrong to presume that the assessee has transferred funds to AEs which it has ultimately lost control off.*

He deleted the addition".

6. Aggrieved, Revenue filed this appeal on the following grounds :

"1. On the facts and in the circumstances of the case as well as in law, the learned CIT(A) has erred in allowing Rs.32,11,57,736/- i.e., 87.73% as advertisement expenses on sale of Rs.36,60,04,484/- made through the Associated Enterprises.

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2. *On the facts and in the circumstances of the case as well as in law, the learned CIT(A) has erred allowing 60.33% of the net sales as marketing expenses as against the industry average of 5.16% and the top 17 companies average of 10.66%.*

3. *On the facts and in the circumstances of the case as well as in law, the learned CIT(A) has erred not taking into account the fact that in the immediately preceding year, the expenditure on advertisement was only to the tune of 30.92% of the total sales.*

4. *On the facts and in the circumstances of the case as well as in law, the learned CIT(A) has erred in accepting the additional evidence in the form of the copies of the bills of the parties who carried out the advertisement without giving an opportunity to the Assessing Officer as provided under Rule 46A.*

5. *On the facts and in the circumstances of the case as well as in law, the learned CIT(A) has erred in allowing the expenditure on advertisement merely on the basis of bills of the parties who carried out the advertisement work without verifying the genuineness of the same.*

6. *On the facts and in the circumstances of the case as well as in law, the learned CIT(A) has erred in accepting the contention of the assessee that since the shares of the associates enterprises were transferred to unrelated persons during the year, the assessee had no control over them, without verifying the genuineness of the factum of transfer."*

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7. Learned D.R. Mr. Ajit Kumar Jain submitted that the TPO order should have been upheld by the Commissioner of Income Tax. He took this Bench through the Order of the TPO passed under section 92CA(3) of the Act on 8-12-2006 specifically finding at para-5. He pointed out that the TPO recorded that, for the export sale of Rs.50.12 crores, the advertisement expenses are at Rs.32.58 crores which is 60.33% of total sales. He pointed out that assessee's net profit before tax was 5.8% of the sales. He submitted that the assessee has incurring unusually high expenditure on advertisement abroad. He submitted that though the assessee has produced all details, the TPO was not able to decipher the documents in foreign language or actually carry-out the physical verification of the expenses. He submitted that it is evident that two of the assessee's AEs are located in Cyprus which is a tax heaven. He supported the finding of the TPO that the transactions prima facie appear to be doubtful.

7.1. Thereafter, he took this Bench to the finding of the TPO wherein arms length price has been determined, by taking the average of expenditure incurred on marketing and advertisement, by 17 top pharma companies. He submitted that the Assessing Officer has correctly took the industry average on marketing expenditure of 17 pharma companies and held it to be a benchmark, for determining the arms length price.

7.2. He questioned the findings of the CIT(A) and submitted that most of the conclusions are against the law specifically the finding (a) that money has not been returned, to the AE, (b) regulatory authorities have granted approvals, (c) auditors have verified etc., as there are not tests laid own in computing arms length price and making an adjustment. As per the learned D.R. the basic question is, who is the owner of the product and who is to get the benefit of intangibles ? He submitted that the product is manufactured by the assessee and the benefit is derived by the AEs and hence, the expenditure

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should be borne by the AEs and not by the assessee-company. He prayed that the Order of the Assessing Officer be upheld.

8. Learned Senior Counsel, appearing on behalf of the assessee, Mr. Firoze B. Abdhyarujina on the other hand has submitted that there are number of mistakes in the grounds of appeal. He submitted that fundamentally the TPO has exceeded its jurisdiction under the law. He argued that section 92F of the I.T. Act have come into force w.e.f. the year 2002-2003 and under section 92CA the TPO is required to determine the arms length price of an international transaction. He pointed out that it is only the Assessing Officer who is required to compute the income. He relied on Board Instruction No.3 dated 20-5-03, paragraphs II and III and submitted that the TPO has committed an error by going into the aspect of genuineness of the expenditure and also the aspect of as to whether the expenditure should be borne by the assessee or AE. He submitted that Transaction Net Margin Method (TNMM) has been discussed in the Income Tax Rules and what the TPO did is against the Rules. He submitted that taking all industry average of advertising and marketing expenditure incurred and then treating it as the arms length percentage, is not contemplated as per Rules. He submitted that no defect in information was pointed out by TPO or Assessing Officer and that the Revenue has accepted that there is no mark-up on expenses. He filed the Order of the TPO for the assessment year 2003-2004 dated 9-3-2006 and submitted that the reimbursement of expenses for marketing and advertisement was accepted and no adjustment was suggested. He argued that Cyprus is not a tax heaven and due to the fact that the banking system in Ukraine and other such countries, was not accepted by the Government, Cyprus was the place where AEs were located. He pointed out the assessee adopted CUP method and the Assessing Officer has not rejected the same. He relied heavily on the Order of the CIT(A).

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9. In reply, the learned DR submitted that the fundamental issue to be decided is whether the expenditure on marketing and advertisement, is to be borne by the assessee or the AE ?

10. Rival submissions heard. On a careful consideration of the facts and circumstances of the case and a perusal of the papers on record and the Orders of the authorities below we hold as follows :

10.1. Assessee has used cost plus method to justify that the transactions are at arms length. The assessee ultimately sold products in Ukraine but routed the same through its Associated Enterprise located in Cyprus. Reason given by the assessee is that Ukraine is politically and economically very instable in that period after disintegration from USSR and that the banking system is not reliable and currency was devalued from time to time. It was also pointed that Indian banks are not recognising nor are ready to deal with Ukraine Banks favourably in those years.

10.2. We find that the TPO in his Order has not given any reason as to why he is rejecting the CUP method adopted by the assessee for determining the arms length price for reimbursement of business promotion expenses by the assessee to the AEs. It is well settled that no method can be rejected without giving cogent reasons. The TPO has to state why CUP method is not applicable in this case. After assigning reasons, then the TPO has to state as to how "TNMM" is the most appropriate method, to be applied on the facts and circumstances of this case. This is not done. There is no whisper on these issues in the order of the TPO. Without giving any reasons for the rejection of "CUP" method, the TPO, applies the mean of percentage of expenditure incurred by 17 pharmaceutical companies on advertisement and marketing and terms the same as arm length price arrive by using "TNMM". This is not "TNMM".

10.3. Section 10B(e) reads as follows :

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"(e) transactional net margin method, by which, -

(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;

(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 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."

10.4. A plain reading of this Rule demonstrates that the methodology adopted by the Assessing Officer is against the law. It is not right to pick-up 17 pharmaceutical companies, look into the percentage of expenditure incurred by each one of them on marketing and advertisement and then arrived at a

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average or mean and hold that this average percentage is the industry average and apply the same as the arms length percentage of expenditure to be incurred by the assessee. Mean of percentage of a certain type of expenditure cannot be "arms length price". The method followed by TPO is not "TNMM".

10.5. This Tribunal in the case of UCB India (P.) Ltd. vs. ACIT (2009) 121 ITD 131 held as follows :

> ***68.*** *We now consider the second limb of invoking provisions of section 92C, i.e., the adoption of TNMM by the assessee. The assessee has adopted the TNMM by comparing the overall operating profits of the assessee company with the overall operating profits of certain other organizations or companies which were the comparable companies selected by it, from out of data available in the public domain, by using the software 'Prowess' and adopting various filters for elimination of uncomparables as listed out by it. The assessee classifies itself as a licensed manufacturer and thus having lesser risks. While so the learned Senior Departmental Representative is right in pointing out that the comparables selected by the assessee are not of licensed manufacturers of the similar commodity. The TNMM compares net margins of uncontrolled transactions between independent entities, with those achieved in controlled transactions between related parties. The Tribunal in the case of Aztec Software & Technology Services Ltd. (supra) on page 238 observed as follows:*
>
> *"The TNMM requires establishing comparability at a broad functional level. It requires comparison between net margins derived from the operation of the uncontrolled parties and net margin derived by an associated enterprise on similar operations.*
>
> *Under this method, the net profit margin realized by an associated enterprise from an international transaction is computed in relation to a particular factor such as costs incurred, sales, assets utilized, etc. The net profit margin realized by an associated enterprise is compared with net profit margin of the uncontrolled transactions to arrive at the ALP. The TNMM is similar to RPM and CPM to the extent that*

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it involves comparison of margin earned in a controlled situation with margins earned from comparable uncontrolled situation. The only difference is that, in the RPM and CPM methods, comparison is of margins of gross profits and whereas in TNMM the comparison is on margins of net profit.

TNMM requires comparison between net margins derived from the operations of the uncontrolled parties and net margins derived by an associated enterprise from similar operations. Net margin is indicated by the rate of return on sales or cost of operating assets, and this forms the basis for TNMM. A functional analysis of the tested party or the independent enterprise, as the case may be, is required to determine whether the transactions are comparable and the adjustments that are required to be made to obtain reliable results. The tested party would have to consider other factors, like cost of assets of comparable companies, etc., while applying the return on assets measure. Ordinarily, the tested party, has to be the party provided services because it is on the basis of rate of return on sales or cost or operating assets that transactional margin is computed. These parameters generally available in the case of a party providing services."

69. *Under the Transfer Pricing Regulations the following steps are to be taken to determine the TNMM :*

Step 1 : The net profit margin realized by an enterprise from an international transaction entered into with an AE 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.

Step 2 : The net profit margin realized by the enterprise or by an unrelated enterprise, form a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base.

Step 3 : The net profit margin referred to in step 1 arising in comparable uncontrolled transactions is adjusted taking into account the differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprise entering into such transactions, which would materially affect the amount of net profit margin in the open market.

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Step 4 : The net profit margin realized by the enterprise and referred to in step 1 is established to be the same as the net profit margin referred in step 3.

Step 5 : 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.

70. *Section 92C(1) refers to arm's length price in relation to an international transaction. Rule 10B(1)(e) read with section 92C deals with TNMM, and it refers to only net profit margin realized by an enterprise from an international transaction or a class of such transaction, but not operational margins of enterprises as a whole. Paragraph 3.26 of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by OECD reads as follows :*

"3.26 The transactional net margin method examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. A functional analysis of the associated enterprise and, in the latter case, the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. Further, the other requirements for comparability, and in particular those of paragraphs 3.34 to 3.40, must be applied."

71. *Paragraph 3.42 of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued by OECD reads as follows :*

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"3.42 An analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise. Similarly, when analyzing the transactions between the independent enterprises to the extent they are needed, profits attributable to transactions that are not similar to the controlled transactions under examination should be excluded from the comparison. Finally, when profit margins of an independent enterprise are used, the profits attributable to the transactions of the independent enterprise must not be distorted by controlled transactions of that enterprise."

71A. *The arguments of Shri Rajan Vora that entity level comparison is permitted both by the OECD commentary as well as by the commentaries by eminent authors like Robert T. Cole, J. Harold Mc Lure and others, in our considered opinion is not correct. In the book "Transfer Pricing Note Book Third Edition Robert T. Cole at Chapter XXV what is said is that the regulator should also note that segmentation of transaction does not always lead to more reliable results and that the combined effect of two or more separate transactions may be considered, if such transactions are taken as a whole and are so inter-related with consideration of multiple transactions, is the most reliable means of determining the arm's length consideration of the transactions. At paragraph 25.4 the learned author states that OECD guidelines may also require some segmentation of the inter- company transactions. The issue whether further disaggregation is required, depends on practical issues. Such comments cannot be interpreted as permitting entity level comparison. Similarly, Taxman's book on "Law of Transfer Pricing" by D.P. Mittal, Second Edition paragraph 7.9 has been cited and the book "US Transfer Price" by Robert T. Cole paragraph 2.06 was relied upon by Shri Rajan Vora. On a perusal of all these material we find that none of them suggests entity level comparison. Reliance was also placed on paragraph 1.20 of "Transfer Pricing Guidelines" of OECD. From a perusal of this paragraph it is*

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> *clear that they are applicable to all methods, that may be adopted for arriving at the arm's length price. The learned counsel for the assessee cannot restrict para 1.20 to the method of transactional net margin. Thus, this argument cannot be accepted. Coming to the decision relied upon by the assessee in the case of Philips Software Centre (P.) Ltd. v. Asstt. CIT [2008] 26 SOT 226 (Bang.), the Bangalore Bench of the Tribunal was considering a case wherein the assessee's business was only software development. So the comparable of another assessee also only in software development was considered sufficient. This was a case of aggregation of similar transactions and where the assessee had no other transactions. In our case, 50 per cent of the assessee's production is from APIs imported from the AE and whereas the balance is production from APIs which are not imported from AE. There is also trading activity. Thus, we are unable to accept the contentions of Shri Rajan Vora.*

10.6. In the case on hand what is sought to be compared is, average of expenditure incurred in advertising by 17 pharma companies, without any analysis as to the type of the drug, the nature of markets, the period of advertisement etc., When overall profitability is compared, the assessee has shown greater profitability margins than these 17 pharma companies. Expenditure incurred by the 17 companies on other heads such as "salaries, raw material, establishment etc.," are not compared. The nature of product are different. The markets are different. Nothing common has been brought-out. This is not the way the "TNMM" is to be applied under the Income Tax Act and the Rules framed therein. At best what can be said is that the TPO has adopted an adhoc method to disallow capital expenses under the guise of Transfer Pricing provision.

10.7. The learned DR submits that the most important aspect to determine is as to who should bear the expenditure and who is getting the benefit out of this marketing and advertisement expenditure. The assessee is the manufacturer of the product and as recorded by TPO at page 3, the assessee is selling products which are high in demand and cater the niche

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market. The expenditure is of the assessee. Ofcourse the primary benefit would be that of the assessee. In any event, in our opinion, this is not the primary issue. The primary issue is, whether the TPO has arrived at the "arms length price" in accordance with law ? The answer is 'no'. Coming to the issue whether the expenditure incurred is genuine or not, as brought out in Instruction No. 3 dated 20-5-2003, the TPO's role is limited to the determination of arms length price in relation to the international transactions referred to him by the Assessing Officer and it is the role of the Assessing Officer to compute the total income of the assessee having regard to the arms length price. The TPO has doubted the expenses and has asked the A.O. to investigate. Despite this, the Assessing Officer in this case has not doubted the expenditure incurred.

10.8. Coming to the findings of the learned CIT(A), we hold that the first appellate authority was wrong in basing his decision on the fact that RBI has granted permission. This is not a ground to allow an appeal. Every remittance would bear the approval of RBI. The ground that the TPO has not brought out any evidence on record that part of the money paid to AEs was returned back to the assessee is also not a basis contemplated under T.P. provisions. The fact that expenses were audited and payments were through banking channels are not issues that determine the transfer pricing adjustment. These are not grounds on which a transfer pricing adjustment could be deleted. Hence the CIT (A) was wrong on basis in his decision on these findings.

10.9. Nevertheless as the TPO has not given any reason as to why the method adopted by the assessee i.e., CUP method is not acceptable as the most appropriate method and as the Assessing Officer has not adopted any of the methods prescribed under the Act and has method adopted by the TPO cannot be called TNMM prescribed under the Act and Rules, we have to necessarily uphold the Order of the first appellate authority, though for different reasons. Similar view is taken by the Pune Bench in 123 TTJ 657.

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10.10. We also find that on similar facts the Transfer Pricing Officer for the assessment year 2003-2004 vide Order dated 9-3-2006 under section 92CA(3) of the Act has accepted the method adopted by the assessee in determining the arms length price for reimbursement of expenses to AEs. We also pointed out that the figures and percentages mentioned in the grounds of appeal are wrong as rightly pointed out by the learned Senior Counsel. The percentages are not 87.73% or 60.33%. We do not go into these calculation as it would be an academic exercise.

11. For all these reasons, we uphold the Order of the first appellate authority and dismiss this appeal of the Revenue.

Order pronounced in the open Court on 16-05-2012.

Sd/- **(B.R.MITTAL)** **JUDICIAL MEMBER**	**Sd/-** **(J.SUDHAKAR REDDY)** **ACCOUNTANT MEMBER**

Mumbai, Date 16th May, 2012

VBP/-

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3. CIT(A)-Assessee, Mumbai
4. CIT, M.C.X, Mumbai
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(True Copy) By Order

Asst. Registrar, I.T.A.T. Mumbai Benches
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