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IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCHES: I-1 : NEW DELHI

BEFORE SHRI R.S. SYAL, AM AND SHRI A.T. VARKEY, JM

ITA No.1456/Pune/2010
Assessment Year :2006-07

JCB India Limited (formerly known as JCB Manufacturing Ltd.), Talegaon Floriculture & Industrial Park, Village Ambi, Navlakh Umbhre, Tal. Maval, Talegaon Dabhade, Dist. Pune – 410 507. PAN: AABCJ4286D	Vs.	ACIT, Circle-9, Akurdi, Pune.
(Appellant)		(Respondent)

Assessee By	:	Shri G.C. Srivastava, Advocate & Shri Saurabh Srivastava, FCA
Department By	:	Shri Vikram Sahay, CIT, DR & Ms Y.S. Kakkar, Sr. DR

Date of Hearing	:	08.06.2015
Date of Pronouncement	:	10.06.2015

ORDER

PER R.S. SYAL, AM:

This appeal by the assessee emanates from the final order passed by the Assessing Officer (AO) on 20.10.2010 u/s 143(3) read with

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section 144C(13) of the Income-tax Act, 1961 (hereinafter also called 'the Act') in relation to the assessment year 2006-07.

2. The first challenge in this appeal to the addition on account of transfer pricing adjustment amounting to Rs.21,75,42,500/-.

3.i. Briefly stated, the facts of the case are that JCB, UK, is a major player in the global construction and agriculture sectors. JCB India Ltd., is a wholly owned subsidiary of JCB, UK. In turn, JCB Manufacturing Ltd. (i.e., the assessee) was set up by JCB India as its 100% subsidiary on 21.06.2004. The assessee commenced its business on 20.6.2005. It is a matter of record that the assessee company got merged with JCB India by virtue of the judgment of the Hon'ble High Court dated 26.5.2010 w.e.f. 1.4.2009. Thus, in so far as the year under consideration is concerned, the assessee was a subsidiary of JCB India. The assessee manufactured components such as back blades, buckets, dippers, chassis, loader arm, track beam, etc., which form parts of earth moving machines. Five international transactions were reported by the assessee in Form No.3CEB for the year in question. First transaction is

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'Export of finished goods' amounting to Rs.20,21,62,339/- and the second transaction is 'Import of raw materials' to the tune of Rs.73,73,270/-. The assessee benchmarked these two international transactions jointly by applying the Transactional Net Margin Method (TNMM). Apart from the above two, the assessee also entered into three more international transactions, namely, 'Import of machinery, jigs and fixtures', `Reimbursement of expenses paid' and `Reimbursement of expenses received.'. These three international transactions were demonstrated at arm's length price (ALP) by applying the Comparable Uncontrolled Price (CUP) method. There is no dispute in so far as the last three international transactions are concerned. On a reference made by the AO to the Transfer Pricing Officer (TPO), it was found by the latter that the assessee adopted Profit level indicator (PLI) of Operating profit to Sales for the international transaction of `Import of raw material' and Operating profit/Total cost for the international transaction of `Export of finished goods'. The assessee aggregated these two international transactions of import of raw materials and export of finished goods and carried out entity level benchmarking. The

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TPO did not dispute the application of TNMM as the most appropriate method, nor did he disagree with the aggregation of these international transactions. The assessee used 10 companies as comparables, which have been enlisted on page 5 of the TPO's order. The TPO excluded two companies from such list, namely, Ahmedabad Steelcraft Ltd. with OP/TC at (-)16.71% and Shiv Agrico Implements Ltd. (Seg.) with OP/TC at (-)50.79%. Arithmetical mean of the remaining 8 comparable companies was computed by the TPO at 13.47%.

3.ii. On perusal of the details furnished by the assessee on the issue of its determination of PLI, the TPO observed that the assessee had adjusted its PLI to 10.79% as against the unadjusted OP/TC at (-) 45.23%. On being called upon to explain as to how it could substitute its actual operating profit margin with some hypothetical adjusted figure, the assessee submitted that because of its first year of operation, the operating costs were high due to lower productivity on account of workmen being in learning phase; higher consumption of electricity on account of diesel gensets; and higher distribution cost and fixed

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overheads on account of lower volumes. The assessee invited the attention of the TPO towards Annexure H to the Transfer pricing study report, giving the working of the adjusted operating profit. The TPO observed that nothing was mentioned as to how the adjusted figures were arrived at and, further, the basis of such adjustment was unknown. He refused to allow this adjustment as, in his opinion, any adjustment can be made only to the profit margin of the comparables under Rule 10B(1)(e)(iii) and not to the profit margin of the assessee under Rule 10B(1)(e)(i). Discarding the adjusted positive profit margin declared by the assessee at 10.79% on a hypothetical basis, the TPO adopted unadjusted profit margin of the assessee at (-)45.23%. By considering the arithmetical mean of the operating profit margin of the comparables at 13.47%, the TPO applied benchmark of Operating profit/Total cost at 58.70% (45.23% +13.47%) on the international transaction of 'Export of finished goods.' This resulted into recommendation for a transfer pricing adjustment to the tune of Rs.2175.425 lac. The assessee remained unsuccessful before the Dispute Resolution Panel (DRP). That

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is how, the AO in the impugned order made addition for a sum of Rs.21.75 crore and odd. The assessee is aggrieved against this addition.

4. We have heard the rival submissions and perused the relevant material on record. The assessee is not satisfied with the order of the AO/TPO only on two counts viz., (i) non-adoption of adjusted operating profit rate; and (ii) removal of two companies from the list of comparables. Apart from the above, all other aspects of the TP analysis carried out by the TPO, have been accepted by the assessee. We will deal with the above referred two issues one by one.

I. Non-adoption of adjusted PLI of the tested party.

5. It is an undisputed position that the assessee's unadjusted PLI (OP/TC) stood at loss of (-)45.23%. The assessee, however, adjusted such PLI to 10.79%. This was done by adopting the amount of operating expenses for transfer pricing analysis at Rs.1831.98 lac as against the actual operating expenses incurred by it during the year in question at Rs. 3706.55 lac. Thus, it is apparent that the assessee has reduced operating expenses by more than 50% of actual amount spent

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for the purposes of transfer pricing analysis. This was tried to be justified before the TPO by arguing that the company started its operation in June, 2005 and, hence, the year under consideration was not even first full year of operations. It was further submitted that it had incurred costs which were extraordinary and non-operating in nature due to the start-up related reasons. It was further submitted through its letter dated 15.6.2009 that the costs for the current year were considered on the basis of the costs incurred for the financial year 2008-09 as a first point of reference and also the audited accounts for financial year 2007-08, where the figures for financial year 2008-09 were not available. This has been mentioned in para 2.7 of the assessee's letter dated 15.6.2009 addressed to the TPO during the course of the TP proceedings. Thus, it is apparent that instead of the actual costs incurred by the assessee during the year under consideration in respect of the international transaction, it opted for the figures of standard costs by relying on the figures for the assessment years 2009-10 and 2008-09. The question arises as to whether the course of action adopted by the assessee in substituting the actual costs incurred with some standard

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costs is permissible under law. To be more precise, whether any adjustment is permissible *in the assessee's own profit margin?*

6. In order to answer this question, we need to have a look at the provisions relating to computation of income from international transaction having regard to the arm's length price contained in Chapter-X of the Act. Sub-section (1) of section 92 provides that: 'Any income arising from an international transaction shall be computed having regard to the arm's length price.' Computation of arm's length price has been enshrined in section 92C of the Act. Sub-section (1) of section 92C provides that: `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, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe….' . Then five specific methods have been set out in this provision and the sixth one is: 'Such other method as may be prescribed by the Board.' Rule 10B deals with the determination of arm's length

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price u/s 92C with the methods as prescribed under the Act. Adverting to the facts of the instant case, it is found that the assessee applied the TNMM as the most appropriate method, which has been concurred with by the TPO. The *modus operandi* for the computation of ALP under this method has been set out in Rule 10B(1)(e) as under:-

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

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(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."

7. Rule 10B(2) provides that for the purposes of sub-rule (1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to various factors given in this provision, such as, the specific characteristics of the property transferred or services provided in either transaction ; the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions ; 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 ; and 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,

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overall economic development and level of competition and whether the markets are wholesale or retail.

8. Rule 10B(3) stipulates that 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.

9. When we read sub-rules (2) and (3) in juxtaposition to Rule 10B(1)(e), it emerges that the arm's length price under TNMM can be determined by comparing the profitability of an international transaction with that of the comparable uncontrolled transaction. In order to make such a comparison, it is relevant to see the differences, if any, between the international transaction and comparable uncontrolled transaction. If there are no differences between the two sets of transactions or the differences, if exist, are not likely to materially affect the price/profit

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from such transaction, then, the matter ends and the comparables are determined and the ALP can be worked out. The other situation may be when there are differences between the international transaction and uncontrolled transaction, which materially affect the price or profit from such transactions. In such a situation, the law contemplates of making a reasonably accurate adjustment to the uncontrolled transaction for eliminating the material effects of such differences. Coming back to the *modus operandi* given in Rule 10B(1)(e) for the determination of ALP under TNMM, we find that sub-clause (i), being the first step, provides that the net profit margin realized by the enterprise from an international transaction should be computed in relation to a base, such as, costs incurred or sales effected or assets employed, etc. Under sub-clause (ii), which is the second step in the determination of ALP under TNMM, the net profit margin from a comparable uncontrolled transaction is computed having regard to the same base as adopted under sub-clause (i), namely, costs incurred or sales effected or assets employed, etc. Under sub-clause (iii), which is the third step, the profit margin of the uncontrolled transaction realized in sub-clause (ii) is adjusted to take

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into account the differences between the international transaction and the comparable uncontrolled transaction. It is this adjusted profit margin of comparables which is considered for benchmarking the profit margin realized by the assessee from international transaction as per sub-clause (i). On going through the mandate of Rule 10B(1)(e), it is manifest that sub-clause (i) clearly refers to the computation of `*the net profit margin realised by the enterprise from an international transaction.*' There is no stipulation under the provision which calls for adjusting the *net profit margin realized* by the assessee from its international transaction due to one reason or the other. When the prescription of the provision is explicitly patent in providing for computing the profit margin of the assessee from its international transaction as such, we fail to appreciate as to how any adjustment can be made to the profit margin of the assessee under sub-clause (i) due to reasons, such as, the incurring of extraordinary and non-operating costs due to start up related reasons. If such an adjustment is made, the resultant figure will shed the character of the *net profit margin realized,* which is contrary to the express language of the provision. It is obvious that in the computation of

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operating profit margin from an international transaction, all non-operating costs do not form part of the cost base which are thus excluded at the very outset. In so far as the operating costs are concerned, these find their place in the computation irrespective of the fact whether they are higher or lower due to any reason whatsoever. The rationale behind the entire transfer pricing regime is to compare the costs/profits incurred/earned by the assessee from an international transaction as it is with an uncontrolled transaction and compute income from such international transaction having regard to its ALP determined on the basis of a comparable uncontrolled transaction. If the operating costs incurred by the assessee from the international transaction are adjusted at the very threshold, then how the transfer pricing provisions would apply to determine the ALP of an international transaction, is beyond our comprehension. The mandate of the provision is crystal clear that whatever be the operating costs incurred by the assessee in relation to an international transaction, these are liable to be considered as such without making any adjustment whatsoever in determining the *net profit margin realized*. If any adjustments are allowed to the assessee's profit

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margin, then the entire transfer pricing exercise will be thrown to the winds, thereby making the provisions of Chapter-X as a redundant piece of legislation. Once the legislature provides for computing profit margin earned by the assessee from an international transaction without any adjustment, it has to be the operating profit margin as per the books of account strictly in conformity with the business conditions as they exist without any plus or minus.

10. The above discussed is not the end of the road. We want to make it clear that it is not as if the difference between the international transaction and comparable uncontrolled transaction, not reckoned in the operating profit margin of the assessee, remains unaddressed to. For giving effect to such differences and allowing adjustment for brining the international transaction and comparable uncontrolled transaction at par, the mandate of sub-clause (iii) of Rule 10B(1)(e) comes into play. This sub-clause provides that: ` *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

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and the comparable uncontrolled transactions…. which could materially affect the amount of net profit margin..'. Thus, it is vivid from the prescription of the provision that if there are differences in terms of Rule 10B(2) between the international transaction and uncontrolled transaction and such differences have bearing on the amount of net profit margin, then such differences should be adjusted *in the net profit margin of the comparables* as per sub-clause (iii) of Rule 10B(1)(e), so that the international transaction undertaken by the assessee becomes comparable with the uncontrolled transaction. The crux of the matter is that the adjustment due to differences between the international transaction and comparable uncontrolled transaction is always adjusted in the profit margin of the comparables as per sub-clause (iii) and not in the profit margin of the assessee as per sub-clause (i) of rule 10B(1)(e).

11. Having held that adjustment is warranted in the operating margin of the comparables for neutralizing the material effects of the differences between the international transaction and uncontrolled transactions, we want to accentuate that the simple fact of the assessee

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incurring a particular operating cost higher than its comparables, cannot call for any adjustment. It can be noticed that the TNMM contemplates comparison of the percentage of the operating profit margin earned by the assessee from its international transaction with such a percentage of the operating profit margin earned by comparables in uncontrolled transactions. Firstly, when we take into consideration the percentage of the operating profit margins, the effect of quantitative differences between the two sets of transactions is automatically wiped out. Secondly, when we consider the operating profit margin, it carries the overall effect of all operating costs/revenue. In the case an assessee having newly set up its business, the amount of depreciation may be higher. One cannot simply make an adjustment by comparing the higher amount of depreciation charged by the assessee *vis-à-vis* its comparables. It is so for the reason that when during the initial years, the amount of depreciation is higher, the repair costs is on the lower side. In later years of operation, when the amount of depreciation goes southwards, the repair cost goes northwards. When we take up operating profit for comparison under the TNMM, such figure of operating profit

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counterbalances the effect of all such higher and lower individual costs which eventually subsume into the operating profit. As such, it is impermissible to pick up individual items of costs or revenues for making a comparison and then adjusting them in the ultimate figure of operating profit, unless such increased or reduced cost/revenue is due to the extraordinary and abnormal factors *de hors* a mere higher or lower quantum aspect. First year of operation of a business *per se* is not an extraordinary event. The assessee, as a matter of right, can't claim any adjustment in the first year of its operation without specifically pointing out the differences with comparables indicating the incurring of abnormal costs. As a matter of fact, any year of operation can be an extraordinary depending upon the facts and circumstances of each case and there can be no thumb rule that the first year of operation is always extraordinary. Before claiming any adjustment in the first year of operation, it is incumbent upon the assessee to specifically delineate that which of its operating expenses are abnormal confined to the start up phase only, which are usually not incurred after the first year of operation. It is only when the assessee satisfies this basic condition of

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showing the presence of some specific expenses confined to the initial phase which are absent in the regular phase of business, that it becomes entitled to claim adjustment in the profit margin of its comparables. The broad-brush claim of higher unusual operating expenses in the first year of operation, without any substantiation, cannot be allowed.

12. Reverting to the facts of the instant case, it is noticed that the assessee actually incurred operating expenses for the year in question at Rs. 3706.55 lac. However, for the purposes of the Transfer pricing analysis, the assessee reduced such operating expenses to Rs.1831.98 lac and computed its profit margin with such reduced operating expenses. This exercise was done by the alleged standardization of the actual operating costs on the basis of such costs incurred by it during the periods relevant to the assessment years 2008-09 and 2009-10. The methodology adopted by the assessee for carrying out transfer pricing analysis is simply devoid of any statutory sanction, totally unacceptable and a glaring example of travesty of the transfer pricing provisions. As against this, the TP analysis should have started with the actual

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operating costs of Rs. 3706.55 lac and then the assessee specifically showing how some of the first year of operation specific expenses were absent in the case of comparables, requiring adjustment in the profit margin of the comparables. Nothing of this sort has been done by the assessee.

13. We notice that the assessee vide its letter dated 7.9.2009 addressed to the TPO, a copy of which is available on page 1004 of the paper book, submitted with prejudice to its earlier submissions that if the adjustment as computed by it was not acceptable, that is, the abnormal costs were not excluded, then the comparables so chosen by it would cease to be comparable. Similar contention was made by the assessee before the DRP vide its letter dated 20.7.2010. We find that the TPO/DRP have not considered this argument of the assesee. They simply held that no adjustment is warranted in the computation of the operating profit of the assessee, with which we also agree. However, they failed to consider if the assessee had in fact, incurred any extraordinary or abnormal costs due to its first year of operation. If, in fact, such abnormal costs were

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incurred, then it was mandatory on the part of the authorities to adjust the profit margin of comparables to that extent. It appears that both the assessee as well the TPO did not properly approach the transfer pricing analysis in a right perspective. The assessee kept on harping on the adjustment to its profit on an unrealistic basis and the TPO ignored to examine, if the assessee was at all rightly entitled to any adjustment on account of its first year of operation. In our considered opinion, the proper transfer pricing analysis can be done only by first finding out suitable comparables with or without making adjustment in their profit margins in terms Rule 10B(1)(e)(iii). If, in any case, either the comparables are not available or the adjustment as discussed above is not feasible, then, the TNMM cannot be considered as the most appropriate method, which should be ignored and substituted with another suitable method for determining the ALP of the international transaction of `Export of finished goods.'.

II. Removal of two comparables

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14. The assessee has, by means of specific grounds, objected to the removal by the TPO of Ahmedabad Steelcraft Ltd. and Shiv Agrico Implements Ltd. (Seg.) from the list of comparables. Here it is pertinent to mention that the assessee chose some companies as comparable under the TNMM and the TPO, accepting the applicability of this method, excluded these two companies. As such exclusion has been challenged, we need to examine whether these two companies are in fact comparable. It is significant to mention that the following evaluation is on the presumption that the TNMM is applicable as the most appropriate method. As such, we proceed to examine the comparability or otherwise of these two companies, one by one.

(i) Ahmedabad Steelcraft Ltd.

15. The assessee chose this company as comparable with OP/TC at

(-)16.71%. The TPO removed it from the final set of comparables by noticing that the same apart from being functionally different, also suffered losses because of change in the Government policy and on

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account of retrenchment of employees and other extraordinary factors. The assessee is aggrieved against the exclusion of this company.

16. After considering the rival submissions and perusing the Annual report of this company, which is available on pages 553 onwards of the paper book, it can be seen that this company is using its own wind mill against the assessee using generator sets of production. These two models of production have different implications on the operating costs. Apart from that, it is observed that the turnover of this company significantly reduced to Rs.9.92 crore in the current year from Rs.36.68 crore in the preceding year due to change in the Government policies. It has been so recognized in the director's report of this company. It has further been mentioned in such report that this company retrenched 105 employees and compensation aggregating to Rs.42.39 lac was paid during the year. In our considered opinion, the above cited extraordinary and abnormal differences make this company incomparable with the assessee. We, therefore, hold that the TPO was right in excluding this company from the list of comparables.

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(ii) Shiv Agrico Implements Ltd. (Seg.)

17. The assessee included this company on segment level in the list of comparables with OP/TC at (-)50.79%. The TPO held this company to be non-comparable by observing that it has three business segments, namely, Foundry, rolling and forging; Engineering & Fabrication; and Others. He noticed that all the products made by the company from Foundry, rolling and forging division pass on to the Engineering & Fabrication unit, thereby impacting the profitability of the Engineering division. He further noticed that the fixed assets used in these two segments were not properly identifiable. The assessee is aggrieved against the exclusion of this company on segment level.

18. Having heard the rival submissions and perused the relevant material on record including the Annual report of this company for the year in question, we find that this company has reported its revenues in three segments as discussed above. The assessee has chosen 'Engineering and Fabrication' segment of this company to be comparable. We are disinclined to accept the view point of the TPO/AO

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in excluding this company for the reason of the goods from Foundry, rolling and forging segment moving to Engineering and Fabrication segment. It is obvious that when the goods move from one segment to another, their profitability is accordingly taken into consideration under the respective segment. Once this company has shown its segmental results and the TPO has not pointed out as to how its Engineering and Fabrication segment is dissimilar with that of the assessee, we hold that this company on segment basis should be included in the final set of comparables.

19. In view of the foregoing discussion, we set aside the impugned order and remit the matter to the file of TPO/AO for a fresh determination of the ALP of the international transaction of `Export of finished goods' in accordance with our above observations/directions. Needless to say, the assessee will be allowed a reasonable opportunity of being heard in such fresh proceedings.

20. The only other ground which survives in this appeal is against the *ad hoc* disallowance of expenses to the tune of Rs.2 lac. The facts

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apropos this ground are that the assessee appointed a Clearing & Forwarding agent, viz., Haulage Corporation. On being called upon to produce details of such expenses, the assessee submitted all the necessary details along with sample supporting invoices and corresponding confirmation from Haulage Corporation. The AO observed that these expenses were in the nature of transportation charges, custom clearing and reimbursement of expenses. He disallowed a sum of Rs.2 lac on *ad hoc* basis by mentioning that the assessee failed to furnish invoices in support of reimbursement of expenses, which were to the tune of Rs.34.81 lac. The assessee has assailed this addition.

21. After considering the rival submissions, it is observed that these expenses have been incurred by the assessee by way of payment to Clearing & Forwarding agent, viz., Haulage Corporation. Even the reimbursement of expenses have been made to such agent only. When the assessee furnished all the details about such expenses including sample supporting invoices and confirmation from Haulage Corporation,

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we cannot countenance the addition made on *ad hoc* basis without the AO specifically pointing out any lacuna in the details submitted by the assessee. We, therefore, order for the deletion of this addition.

22. In the result, the appeal is partly allowed.

The order pronounced in the open court on 10.06.2015.

Sd/-	Sd/-
[A.T. VARKEY] JUDICIAL MEMBER	[R.S. SYAL] ACCOUNTANT MEMBER

Dated, 10th June, 2015.

dk

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT (A)
5. DR, ITAT

AR, ITAT, NEW DELHI.