

**IN THE INCOME TAX APPELLATE TRIBUNAL
HYDERABAD BENCHES "B", HYDERABAD**

**BEFORE SHRI B. RAMAKOTAIAH, ACCOUNTANT MEMBER
AND
SHRI SAKTIJIT DEY, JUDICIAL MEMBER**

I.T.A. No. 1758/HYD/2014

Assessment Year: 2010-11

Pegasystems Worldwide
India Pvt. Ltd.,
HYDERABAD
[PAN: AAACP3453F]

The Asst. Commissioner of
Income Tax,
Vs Circle-16(2),
HYDERABAD

(Appellant)

(Respondent)

I.T.A. No. 1936/HYD/2014

Assessment Year: 2010-11

The Asst. Commissioner of
Income Tax,
Vs Circle-16(2),
HYDERABAD

M/s. Pegasystems Worldwide
India Pvt. Ltd.,
HYDERABAD
[PAN: AAACP3453F]

(Appellant)

(Respondent)

For Assessee : Shri Ajit Tolani, AR
For Revenue : Shri V. Srinivas, DR

Date of Hearing : 11-08-2015
Date of Pronouncement : 16-10-2015

ORDER

PER B. RAMAKOTAIAH, A.M. :

These are Cross-appeals by Assessee and Revenue against the order of the Assessing Officer (AO) U/s. 143(3) r.w.s. 144C(5) of the Income Tax Act [Act] consequent to the directions issued by the Dispute Resolution Panel [DRP], Hyderabad dated 26-09-2014. In this appeal, Assessee has raised as many as 12 grounds. Out of which, Ground Nos. 1, 2 and 3 pertain to general objections

on procedure adopted by the Transfer Pricing Officer [TPO] which are not pressed specifically. Ground Nos. 4 & 5 pertain to selection and rejection of comparables. Ground No. 6 pertains to risk adjustment. Ground Nos. 7 & 8 pertain to interest on outstanding receivables and Ground No. 9 pertains to incorrect margin computation. Ground Nos. 10, 11 & 12 are with reference to initiation of penalties and imposing interest u/s. 234B.

2. We have heard Ld. Counsel for Assessee and Ld. DR in detail and also perused the Paper Books placed on record running to Pages 881. Arguments of the Counsels and evidence placed on record are considered as and when required.

3. Briefly stated, Pegasystems Worldwide India Pvt. Ltd., is wholly owned subsidiary of Pegasystems, USA, an Associated Enterprise (AE). Assessee is a software solution provider to business process management software solutions and business rules platform. Assessee filed return of income admitting NIL income on 15-10-2010 for the impugned assessment year. AO has referred the case u/s. 92CA(1) of the Act for determination of ALP in respect of the international transactions reported for the financial year relevant to the AY. 2010-11. Assessee has reported the following international transactions in its 3CEB report/TP document:

| A.E. | Nature of transaction | Amount (Rs) |
|----------------------------|--|--------------------|
| Pegasystems Worldwide Inc. | Provision of Software development services | 29,20,96,158 |
| Pegasystems Worldwide Inc. | Reimbursement of expenses to AEs | 3,80,14,925 |
| | | 33,01,11,083 |

4. In the Transfer Pricing document, Assessee has carried out economic analysis and used Prowess and Capitaline Plus data base. Using certain filters, Assessee used Transactional Net Margin Method [TNMM] as most appropriate method (MAM) and short listed 21 comparables with arithmetic mean, PLI (OP/OC) was computed at 11.26% Assessee's PLI on the reported

transactions was at 14.03%. The transactions relating to reimbursement to AE which are charged at cost were not considered for any analysis and Assessee held the transactions are thus arm's length. TPO vide para 6 of his order arrived at the operational revenue at 29.21 Crores and operating cost at 25.58 Crores and has taken operating profit at Rs. 3,62,49,720/-. Accordingly, he arrived at OP/OC at 14.17% and OP/OR at 12.41%. TPO also noticed that company had receivables to an extent of Rs. 21,07,53,864/- and considered that these are not reported in form 3CEB and no bench marking analysis has been done in the TP study. By stating that method of search process adopted by Assessee suffer from defects which resulted in selection of inappropriate comparables and rejection of companies that are appropriate comparables, TPO rejected Assessee's TP document and has undertaken an independent analysis. After considering the submissions of Assessee, TPO selected 18 comparables by using various filters and arrived at arm's length margin at 22.69%. By adding negative working capital adjustment, the ALP was arrived at by TPO at 25.08% and ALP of international transactions was determined at 32,00,12,725/-, thereby making adjustment of Rs. 2,79,16,567/- u/s. 92C(3) of the Act. In addition, TPO also made adjustment on receivables at Rs. 1,26,40,592/- thereby determining total adjustment at Rs. 4,05,57,159/-.

5. Assessee raised objections before DRP, Hyderabad, who considered 14 objections raised by Assessee and rejected most of them except deletion of Infosys Technologies Ltd., as a comparable out of 18 comparables selected by TPO and also directing to delete the negative working capital adjustment of (-) 2.39% made by TPO. Thus, Assessee got partial relief from DRP on the TP adjustment. DRP also directed AO to recalculate the computation of deduction u/s. 10AA following Special Bench decision of the ITAT in the case of ITO Vs. M/s. Saksoft Ltd reported as 121 TTJ Chennai (SB): 313 ITR (AT) 353 and CIT Vs. Gem Plus Jewellery India Ltd. [233 CTR 248] of Hon'ble Bombay High Court. Revenue is aggrieved on the relief granted by DRP, whereas Assessee is aggrieved on the TP adjustments made.

T.P. Adjustments:

6. As briefly stated above, TPO has selected 18 comparables and arrived at the PLI which was reduced to 21.35% after excluding (Infosys Technologies Ltd.,) by DRP. Final selection of comparable companies after DRP's order is as under:

| | OP/OC % |
|---|---------|
| 1. Avani Cimcon Technologies Ltd., | - 3.39 |
| 2. CAT Technologies Ltd., | - 13.04 |
| 3. Evoke Technologies Pvt Ltd., | - 18.61 |
| 4. E Zest Solutions Ltd., | - 22.10 |
| 5. Kulilza Technologies Pvt Ltd., | - 25.92 |
| 6. Mindtree Ltd (Seg) | - 20.47 |
| 7. Persistent Systems and Solutions Ltd., | - 11.37 |
| 8. RS Software India Ltd., | - 9.88 |
| 9. Thinksoft Global Services Ltd., | - 11.22 |
| 10. Zylog Systems Ltd., | - 18.62 |
| 11. E infochips Bangalore Ltd., | - 72.32 |
| 12. Comp-U-Learn Tech India Ltd., | - 19.96 |
| 13. Kals Information Systems Ltd (Seg) | - 22.05 |
| 14. Persistent Systems Ltd., | - 31.57 |
| 15. Tata Elxsi Ltd (Seg) | - 17.24 |
| 16. Sasken Communication Technologies Ltd., | - 25.23 |
| 17. L&T Infotech Ltd., | - 19.97 |

7. Out of the above 17 comparables, Assessee has no objection in selecting the comparables at Item No. 1 to 10, Assessee is objecting to the comparables from 11 to 17. The 18th comparable of Infosys Technologies Ltd., which was excluded by DRP is being contested by Revenue. Apart from selection of comparables, Assessee is also contesting the comparable companies rejected by TPO in Ground No.5. Out of the three companies, Assessee has not

pressed for Satyam Computer Services Ltd., mentioned in the ground. Assessee's request is for inclusion of two companies, which will be dealt with at a later point of time. Assessee's objections on inclusion of the comparables and the decisions are as under:

E infochips Bangalore Ltd., :

8. This company is selected by TPO even though Assessee objected to the same (vide page 34 and 35 of the order of TPO). Assessee objected that the information for FY. 2009-10 was not available in public domain. It was further contended that company is functionally different and is having two different segments i.e., software development services and ITES. Company offers broad portfolio of services comprising new products, product development, product sustenance and maintenance, Product Qualitative Analysis (QA) and independent testing hardware and software design etc. TPO did not accept Assessee's documents by referring to the schedules like research and development, inventories, sales and other incomes. He also reported that company in the notes to the accounts has stated that it is engaged in the development and maintenance of computer software. The production and sales of software cannot be expressed in any generic unit. Thus, TPO rejected Assessee's objections and retained it as a comparable. DRP also agreed with TPO.

8.1. It was contended that AO relied on the annual report of FY. 2010-11 and used the information applicable to FY. 2009-10 from that report, as the information for FY. 2009-10 was not available in public domain. It is also submitted that this company was never selected either by TPO in earlier year or in later year. It was also submitted that profitability varies from year to year and in this year, there was abnormally very high margin, the reasons of which could not be analysed in the absence of annual report. It was further contended that segmental information was not available. On the argument that the said company is providing both software development and IT enabled services Ld. Counsel placed the disclosures in annual report of FY. 2008-09 and annual

report of FY. 2009-10 to submit that the company is primarily engaged in software development and IT enabled services and has reported both of them as one segment. Therefore, company is not comparable with Assessee on functional analysis. It was further submitted that company has merged in 2012 with another company and it will be difficult to obtain further information/segmental information about the company now. In view of its fluctuating profits over the years, this company was not selected as a comparable earlier or in later years by Revenue. Since the disclosure in annual report is common, Assessee relied on the decision of Ahmadabad Bench of ITAT in the case of All Scrips (India) Private Ltd., in ITA No. 771/AHD/2014 for AY. 2009-10, wherein this comparable was rejected on the basis of lack of segmental information. Assessee relied on para 10 of the Co-ordinate Bench order, which is as under:

"Para 10 – "With respect to E-Infochip Bangalore Ltd., we find that in the annual accounts of the company, with respect to the segment information it is stated that the company is primarily engaged in software development and I.T enabled services which is considered the only reportable business segment as per Accounting Standard AS-17 "segment reporting" prescribed in Companies (Accounting Standard) Rules, 2006. We thus find that no segmental information is availableConsidering the aforesaid facts, we are of the view that the aforesaid two companies needs to be excluded while working out the comparability analysis and therefore uphold the plea of the Assessee in excluding the margins of the aforesaid 2 companies".

8.2. Ld. DR, however, referred to the extracts made by TPO in the order to submit that Assessee is a comparable company with that of Assessee.

8.3. After considering the rival contentions and perusing the annual reports placed on record, we are of the opinion that this company cannot be selected as comparable company for TP analysis. First of all, this company is engaged in both software development as well as ITES. Assessee being only captive service provider, the above company cannot be considered as comparable on functional basis. Not only that, as pointed out, segmental

information pertaining to the above company is not available. As seen from the TP orders, documents placed on record, TPO relied on later year's annual report in extracting the information. Variation in profitability over the years alone cannot be a reason to exclude the company from comparability analysis but as rightly pointed, the absence of segmental information, how much profit earned was on the software development or ITES cannot be examined. In the absence of clarity on operational details and comparable company having diversified activities, we are of the opinion that this company cannot be chosen as a comparable company in Assessee's case in this assessment year. We are also aware of the decision of the Co-ordinate Bench given in earlier assessment year on the reason that segmental reporting was not available. Be that as it may, since the said company is functionally different from Assessee's activities and in the absence of segmental information, we direct AO/TPO to exclude the above while working out the comparability analysis. We uphold the plea of Assessee in this regard.

Comp-U-Learn Tech India Ltd., :

9. This company was selected by TPO as one of the comparable companies. Assessee objected stating that this company is engaged in two segments ie. IT enabled services and software products solutions as per the annual report and it has exceptionally abnormal growth of profits of 160% as against industrial norm of 13 to 15%. It was also objected stating that the growth is more than 10 times the industrial growth and company in its standard financial performance has mentioned that it has spent sizeable amount towards R&D in pharmaceutical sector for the purpose of coming out with unique products and solutions for facilitating operational efficiency, effective inventory management and complete financial control for the sector. TPO however, considered the exceptional growth was only 1.6 times compared to last year and not an exceptional increase. Further, he extracted schedule 12, to come to a conclusion that as per annual report income from software development was about Rs. 14.11 Crores as against total income of Rs. 14.31 Crores. The Software services worked out to 98% of total revenue. He concluded that the

company is predominantly software development services and accordingly comparable for software development services provider for the year. He also stated that company categorically stated that it was pure software development services provider. He also rejected objection on strategic acquisitions stating that the same does not have any impact on standalone financials of Assessee-company. With regard to objection on R&D, he considered that it was a general note as no expenditure appears to have been booked in P&L A/c. He was of the opinion that in most of the cases, R&D will actually be activities aimed at cost cutting and improving organizational set up etc. In view of the above, the contentions of Assessee are rejected and company is retained as comparable.

9.1. Relying on the objections raised before DRP who rejected the same, Ld. Counsel submitted that this year is an exceptional profit year for the company and referred to the report of the company for the year under consideration. Vide page 207 of the Paper Book, Ld. Counsel referred to the structural initiatives, wherein it was stated "*your company was originally into business of software development and education training. During the past two years, our focus was shifted to e-governance solutions to Government departments of State and Central Governments.* Further, as explanatory statement to Section 173(2) of the Companies Act, at item No. 8, it was reported as under:

'As part of overall growth strategy, company had exceptionally its operations in its core activity, software development, e-governance solutions, IT Services, IT enabled services etc.' In Item No. 9, it was reported that *'the company presently carries on business of software development, E-Governance solutions, IT and IT enabled services'*.

Referring to page 213 of the Paper Book, it was stated that it has spent sizeable amount towards R&D in pharmaceutical sector for the purpose of coming out with unique products and solutions for facilitating operational efficiency, effective

inventory management and complete financial control for the sector. He later referred to the 'strategic acquisitions, alliances and subsidiaries' reported in the annual report of the company. Referring to pg. 215, it was submitted that R&D Sector was established to enhance the quality of its products. Further, referring to revenue recognition in schedule 14 (page 219 of the Paper Book), it was submitted that *'revenue in respect of brand license fee is accounted on execution of agreement. Revenue for software development is recognized on the basis of chargeable time or achievement of prescribed milestone as relevant to each contract. Revenue from sale of software products and courseware materials is recognized when the same has been completed with the passing of title or licenses or raising invoices as the case may be'*. Referring to the above, it was submitted that, that company is in diversified activities and not exclusively as software development service provider in which Assessee is functioning. Therefore, the company is functionally different.

9.2. After considering the rival contentions, we are of the opinion that on the basis of information available, Comp-U-Learn Tech India Ltd., cannot be selected as a functionally comparable company as it has diversified activities. Only if there are segmental reports pertaining to software development services, then only the company can be taken as comparable company. In the absence of such information, it is very difficult to hold that the selected company is comparable to Assessee-company. There is no information about the segmental profits. What that company has reported in its annual report is 'Income from software development' which cannot be equated as 'Income from services'. The software development may include sale of products. In the absence of segmental information, this case cannot be selected as comparable. However, whether TPO could obtain any segmental information is not known to us. we are of the opinion that TPO should examine whether there are any segmental information which can be obtained from the company or available in the public domain so as to compare Assessee's software development services with that of software development services of Comp-U-Learn Tech India Ltd. Therefore, we

are of the opinion that the issue of selection of this company is a comparable should be restored to the file of AO/TPO to examine the available data in public domain/or obtaining information U/s. 133(6) of the Act for segmental information pertaining to software development services and then decide after giving due opportunity to Assessee whether the said company can be selected as comparable. For the time being, Assessee's objections are considered valid and issue is restored to the file of AO for undertaking analysis afresh as far as this company is concerned.

Kals Information Systems Ltd :

10. Assessee objected to the above company before TPO stating that the above said company is functionally different as it is engaged in the development of software and software products. It has inventories equivalent to 27% of the revenue. TPO however rejected Assessee's contentions stating that company classified itself as pure software development service provider. Further, extracting page No. 22 of the annual report of the company, TPO opined that the segmental information indicates that revenue is shown to have been earned from application software and training. Accordingly, he rejected Assessee's objections and included as the comparable company. DRP confirmed the same.

10.1. Assessee's main objection before us is on functionality of the comparable company. As seen from the annual report of 2008-09 and 2009-10 and comparative statement placed by Assessee, the company classified itself as 'the company engaged in development of software and software products since its inception'. The company consisting of STPI unit engaged in development of software and software products and a training centre engaged in training of software professionals on on-line projects. This indicates that company is engaged in development of software and products and its inventory also indicates that Assessee has been using its readymade libraries for sales. This company was rejected in earlier year on functional analysis by ITAT in the case of Planet Online Pvt. Ltd., in ITA No. 464/Hyd/2014 where in it was held that

company is engaged in development of software products. Since its annual report states the same facts in this assessment year also, we are of the opinion that the company cannot be selected as a comparable as it was engaged in development of software and software products. Accordingly, Assessee's objections are accepted and AO is directed to exclude the company.

Persistent Systems and Solutions Ltd. :

11. This comparable was not objected to earlier by Assessee, therefore, there is no discussion on Assessee's objections either in TPO's order or in DRP's order. It was the submission by Assessee that above said earned revenue from sale of software services and products. Ld. Counsel referred to the similarity in information disclosed in annual report of the earlier year and in this year and relies on the decision of the Hon'ble ITAT in case of Planet Online Pvt. Ltd., in ITA No. 464/Hyd/2014 AY. 2009-10 (supra), wherein this company was rejected as it is engaged in outsourcing software product development and product designing. Further, segmental details were not available. Since there is no analysis on the objections of Assessee by TPO as Assessee has not objected earlier, we are of the opinion that Assessee's objections require re-examination by TPO. Therefore, without giving any opinion, whether the company can be selected as comparable or not issue of selection of this company as comparable is restored to the file of TPO to re-examine afresh. Therefore, it is restored to the file of TPO for fresh examination.

Tata Elxsi Ltd (Seg):

12. Before TPO, Assessee contended that the above said company is functionally different as it specialized in embedded software development technology. It was also objected before TPO that in earlier year this company has clearly stated that it cannot be compared to any other software services company due to complex nature of its business. Assessee relied on the decisions of ITAT in the case of Conexant Systems India Pvt. Ltd. (ITA No.1429/Hyd/2010 and 1978/Hyd/2011) and other cases as stated by TPO in page 41 of his order. However, TPO did not agree with the objections stating that the

company has two segments including software development services and revenue from software development services is Rs. 33,649 Crores out of total turnover of Rs. 37,637 Crores, which is at 89.52%. This signified the fact that company is predominantly into software development services. TPO rejected the objections of Assessee so as DRP.

12.1. It was the objection of Assessee that above company is predominantly into product design services, Innovation Design Engineering and visual computing labs division which are specialized services. He referred to the order of ITAT in AY. 2009-10 in the case of Planet Online Pvt. Ltd., in ITA No. 464/Hyd/2014 (supra), wherein this company was rejected on the reason that it is engaged in multiple segments. There is no break-up in the annual report and data on which margin from software services activity only can be computed is also not available. Moreover, the company itself has indicated that it cannot be compared with any other software service company because of its complex nature. Similar view was taken by many of the Co-ordinate Benches in earlier years that Tata Elxsi Ltd., cannot be selected as comparable company. Consistent with the above view, we are of the opinion that a company like Tata Elxsi Ltd., which has complex activities and segmental information of which is not available cannot be selected as comparable company to Assessee. Moreover, as seen from the turnover as reported by TPO itself, it was many times Assessee's turnover and therefore cannot be exactly considered as a similar company unless the nature of activity, the incomes are analysed in detail. Since no segmental data is available, considering the software development services as a segment by TPO cannot be considered as segmental data, unless the services rendered by that company are similar to the services rendered by Assessee. In view of this, we are of the opinion that this company cannot be selected as comparable. AO is directed to exclude the same.

Sasken Communication Technologies Ltd:

13. This comparable was not objected to either before TPO or before DRP. Objections were raised before us on the comparability of this company on

the reason that this company is having product sales and also a provider of telecommunication software services. Since there is no break-up of cost available, Assessee submits that they have difficulty in comparing the said company on FAR analysis. Assessee also relies on the decision of ITAT in the case of Planet Online Pvt. Ltd., in ITA No. 464/Hyd/2014 (supra), wherein the ITAT remitted the issue to comparability of this company for fresh adjudication by AO/TPO in an earlier year. Considering the view taken earlier, since AO/TPO did not have the opportunity to analyse the objections of Assessee as they have not objected earlier, we are of the opinion that inclusion of this company as comparable company is to be analysed afresh by taking the objections from Assessee and then after due analysis, TPO should consider whether the same can be included as a comparable company. Therefore, without expressing any opinion or finding in this regard, we remit the issue relating comparability of this company for fresh adjudication by TPO.

L&T Infotech Ltd:

14. Assessee has objected before TPO that the department in earlier years is rejecting this comparable as it has revenue from software services and products and segmental information was not available. Further, company did not respond to the notice issued u/s. 133(6) and challenged the said notice before the Hon'ble Bombay High Court. It was further objected to on the reason that company had less margin in earlier year and therefore, rejected by the department, however, margin is high in this year, the department proposed it as a comparable and there is no consistency. These objections were rejected by TPO vide his analysis in page 40 of the order and from the earnings in foreign exchange reported, TPO considered the company as involved in software development services. The same objections were reiterated before DRP, but DRP rejected..

14.1. It was the submission of the Ld. Counsel that DRP at Hyderabad in the case of M/s. Sumtotal Systems India Pvt. Ltd., [PAN: AABCC9379C] for the same assessment year has excluded the same by stating as under:

"We have gone through the submissions of the Assessee, International Transactions involved, TP documentation of the Assessee, the most appropriate method adopted by TPO after rejecting the TP documentation of the Assessee, the filters used by TPO and also verified the financials of the comparables with reference to the notes on accounts & website notes. We noticed that certain notes on accounts made in certain cases do not match with that of the financials reported. We also noticed that meaning of the words used in the notes on accounts are not defined. Based on certain ITAT decision, the earlier directions of this panel and other panels, the huge turnovers involved, huge brand value, their predominant presence in the market, in view of incomplete details etc., this panel is of the view that the following comparables selected by TPO should be excluded from the list of final comparables chosen by TPO in the ALP computation.

- i) Infosys Technologies Ltd.,*
- ii) L&T Infotech Ltd.,*

We direct TPO to exclude the above referred comparables from the list of final comparables chosen by TPO in the ALP computation and re-compute the ALP accordingly".

14.2. It was the submission that once DRP has accepted the objections of Assessee whereas in Assessee's case DRP did not exclude L&T Infotech while excluding Infosys Technologies Ltd., it was the submission that similar facts exist for both the companies and DRP has excluded only Infosys Technologies and not L&T Infotech Ltd.,

14.3. After considering the objections of Assessee and perusing the order of DRP in the case of M/s. Sumtotal Systems India Pvt. Ltd., (supra), as extracted above, we are of the opinion that this company cannot be selected as comparable by the same reasons which DRP in the above referred case accepted. Moreover, there are no segmental details and as seen from the annual report, revenues are reported from software development services and products, how much is from services and how much is from products could not be analysed. Even though TPO considered the software exports reported in earning in foreign currency as that of software development services, we are not sure whether the software exports reported therein exclusively pertain to services or products. As there are no segmental details, it is very difficult to analyse

whether the incomes earned by the said company do really pertain to the similar services rendered by Assessee. As also seen from the income schedules, engineering services reported in earlier year were not there in this year, therefore, it is very difficult to analyse whether the company is functionally similar or not? Keeping in view of the above difficulties in analyzing the data and considering the reasons given by DRP in the case of M/s. Sumtotal Systems India Pvt. Ltd., (supra), we are of the opinion that L&T Infotech Ltd., cannot be selected as a comparable company. AO/TPO is directed to exclude the same from the list of comparables. Ground No.4 is allowed for statistical purposes.

Comparable selected by Assessee, but rejected by TPO:

15. Assessee in the ground no 5 has requested for inclusion of three comparables out of which they have not pressed Satyam Computers Services Ltd. Therefore, only two companies are left for analysis.

Akshay Software Technologies Ltd:

15.1. Assessee submitted before TPO that this company satisfies all the filters and even though there is lesser profit, but there is no exceptional variation in the turnover of the company and effect on the income was due to market circumstances and external factors. As there are no external factor that affected the company or its customers, the same is includable as a comparable company. TPO however, relied on the annual report disclosures particularly results of operations noted that '90% of the revenues are from Dubai and due to steep pricing pressure and huge discounts requested by the clients, its business severely got affected'. He was of the opinion that this is an exceptional year of operation and this fails the filter adopted by TPO.

15.2. After considering the rival contentions, we are of the opinion that TPO has correctly rejected the above company as comparable. Even though Assessee submits that the company satisfies the filters but seen from the annual report placed on record at page 251, the financial results indicate that income

from software services and products to an extent of Rs. 1086.58 Lakhs. How much is from services and how much is from products is not available. Since above company also is having the products division, for the same objections raised by Assessee with reference to other comparables already selected by TPO discussed above, we are of the opinion that this company cannot be selected as a comparable for the same reasons accepted above while rejecting some companies. Since, there is no segmental data of software services and products and since the above company is also into products, the company cannot be selected as a comparable. Therefore, we agree with the rejection of this comparable by TPO and DRP, even though for other reasons also. Assessee's grounds on this is accordingly, rejected.

CG VAK Software and Exports Ltd:

15.3. It was the submission of Assessee before TPO that this company satisfies the filter of employee cost which is about 76.10% and notes to the accounts in annual report clearly mentioned that cost on services is incurred towards salaries to employees. TPO rejected the above said company on the reason that it fails employee cost filter and was also opined that there is no clarification given in the notes to amount in FY. 2009-10, whereas Assessee is relying on the notes to account for FY. 2007-08. Since Assessee did not satisfy the employee cost, no analysis can be carried out and therefore, company was not considered as comparable. It was the submission of Assessee that this company was accepted in LAM Research (India) Pvt. Ltd., in ITA No. 1437/Bang/2014 and Mindteck (India) Ltd., in ITA No. 70/Bang/2014. Since detailed information is not available, we cannot give any finding whether the company is comparable or not? As seen from the annual report placed on record, it shows income from software development services and products both the overseas the domestic, whereas in schedule-XII, the income is shown only from software services. Whereas the Director's report indicate that Assessee has software services comprising 84% of revenue, BPO services at 15% and training at 1%. This indicates that Assessee has different activities, therefore, it is difficult to analyse whether the company is strictly comparable to Assessee's

software development services. However, to give a fair opportunity to Assessee, we remit the matter to the file of TPO to obtain necessary information if required and take Assessee's objections and analyse whether the company can be selected as comparable or not? The ground no 5 is partly allowed for statistical purposes.

16. Ground No. 6 pertains to adjustment for risk differences was not pressed. Accordingly, the same is treated as withdrawn.

17. Ground No. 7 pertains to interest on outstanding receivables and 8 on incorrect computation of interest. Assessee raised the issue on separate adjustment made for receivables. TPO noticed that Assessee has receivables of Rs. 21,07,53,864/- at the end of the year. Assessee was asked to submit the details of raising the invoice and subsequent receipts. TPO proposed to charge interest at 12% on the outstanding receivables. While replying that assessee is a fully funded entity of the AE and the amounts outstanding are on services but not loan or advances given. It also does not have any working capital risk and there is no interest payment also. It relied on the order of the ITAT in the case M/s. Evonik Degussa India Private Limited in ITA No. 7653/Mum/2011, wherein it was held that TP adjustment cannot be done on hypothetical issues. Assessee also further relied on the decision of Logix Micro Systems Ltd v. ACIT [42 SOT 525] (Bang) wherein ITAT held that a reasonable period should be provided as interest free period and no interest should be calculated for such period. However, while calculating the interest of 12%, TPO neither considered the above decisions nor gave any interest free period. Not only that even though Assessee realized the amounts in later year, i.e., after 31-03-2010, interest was charged for whole of the period. As can be seen from the table in page 45 of the TP order, TPO charged interest for the supposed delay not only during the year but also for the period beyond the assessment year concerned. Thus, he made a proposal to make adjustment of Rs. 1,26,40,592/- as an adjustment u/s. 92CA and total income was enhanced accordingly. Before the DRP, Assessee objected to the same and submitted that:

- The outstanding receivables relate to the provision of services and not in the nature of any advance/loans. These are closely linked to the provision of services and hence have to be aggregated for the purpose of economic analysis.
- The company has been fully funded by its AE since its inception for all its working capital requirements and receivables are running accounts. Any fund requirement being made good by the AEs.

17.1. It is also submitted that company does not bear working capital risk. It relied on the same objections as relied before TPO. DRP however, vide its para 17, rejected Assessee's contentions but accepted alternate plea of charging interest at LIBOR Plus 2½ points on the inter-company receivables from the overseas AE. Assessee is aggrieved.

17.2. Ld. Counsel submitted that the issue of charging of interest beyond the period was not adjudicated and DRP reduced the rate of interest from 12% LIBOR plus 2.5 points. It was submitted that Assessee was a debt free company, AE takes care of funding, no interest was charged and there is no liability of interest and therefore, notional interest income cannot be brought to tax. Assessee relied on the principles laid down by Co-ordinate Bench at Mumbai in the case of Lintas India Pvt. Ltd., in ITA No. 2024/Mum/2007 dt. 09-11-2012 and also Mastek Ltd., Vs. ACIT in ITA No. 3120/Ahd/2010 then referring to the provisions of the Act the explanation brought by amendment in 2012 Finance Act. It was submitted that even though retrospective, it does not cover Assessee's transaction as the word 'capital financing' used there particularly refers to loans or advances given for capital financing, whereas in Assessee's case, these are outstanding services rendered but not capital financing. The words are to be interpreted invoking the principles *ejusdem generis* and so the outstanding receivables cannot be equated to capital financing as amended by the provisions of the Act. It was further submitted that working capital adjustments are being made while analyzing the operational

performance of the companies, therefore, outstanding amount gets adjusted in working capital adjustments and another separate addition is not required under the TP provisions. Thus, it was contended that the outstanding amounts are not to be considered for adjustment.

17.3. We have considered the issue and examined the rival contentions. In the case of Evonik Degussa India P. Ltd., in ITA No. 7653/Mum/2011, it was already held the TP adjustment cannot be made on hypothetical and notional basis, until and unless there is some material on record that there has been under charging of real income. Thus on the facts and circumstances of the case, we are of the opinion that addition on account of notional interest relating to alleged delayed payment in collection of receivables from the AEs is uncalled for on the facts of the present case. Even though DRP tried to distinguish the above decision on facts, as seen from the facts in both the cases, we are of the opinion that the above decision will equally apply to Assessee's case. Assessee has outstanding service charges receivables and as seen from the order of TPO, the outstanding is only from 31-07-2009. There seems to be no such delay in earlier months. Assessee has no interest liability at all so notional interest cannot be brought to tax under the provisions of TP. As rightly pointed out by the Ld. Counsel, the outstanding receivables on account of services cannot be equated with capital financing as provided for in the Explanation by the amendment by Finance Act, 2012 retrospectively. Even otherwise, as rightly held by the Logix Micro Systems Ltd v. ACIT [42 SOT 525] (supra), TPO should have allowed some interest free period for receiving the outstanding service charges. While acknowledging the order of the ITAT, TPO did not even bother to exclude the reasonable period and levied interest not only from the date of invoice to the date of realization during the year but also for the period beyond 31-03-2010 in later year. We were informed that no such addition was made in the later year on Assessee's receivables. We are of the opinion that both on the facts of the case and principles of law, there is no need for bringing to tax the notional interest on the outstanding receivables. Accordingly, we allow the grounds 7 & 8 of Assessee and direct AO/TPO to delete the said addition made.

18. Ground No. 9 is regarding incorrect computation of margins of comparable companies by considering the following items as non-operating expenses:

- a. Bad and doubtful debts;
- b. Bank charges; and
- c. Un-allocable expenses in segmental financials.

18.1. Ld. Counsel submitted that these are all part of operational expenditure, hence should have been considered while computing the margins of comparable companies. However, it was fairly admitted that if some of the comparables objected to in Ground No. 4 are rejected, this ground will become academic. Hence, without adjudicating the issue, we dismiss the ground with an option to assessee to contest as and when required if need arises. However, TPO is directed to keep this in mind while completing the consequential orders with reference to some of the comparables restored to the TPO. With these observations, this ground is rejected.

19. Ground No. 10 pertains to interests which are consequential in nature. Assessee can object these once again if required, before TPO as selection of some comparables are restored to the file of AO for fresh adjudication. AO/TPO is directed to keep in mind the principles of law and the orders of ITAT/High Court on this issue before levying any interest u/s. 234B. Ground Nos. 11 & 12 pertain to initiation of penalty proceedings which are little premature to be adjudicated at this point of time. Accordingly, grounds are rejected as academic in nature.

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

Revenue's Appeal in ITA No. 1936/Hyd/2014:

21. Revenue has raised three grounds which are under:

"2. DRP ought to have retained the Infosys Technologies Ltd from the list of comparables as the Transfer pricing rules or OECD guidelines do not prescribe any specific range of turnover for comparability corresponding to size and scale of operation.

3. DRP ought to have retained the rate of depreciation charged by AO/TPO.

4. DRP erred in deleting the addition towards communication expenses in view of the explanation 2 to section 10A of the IT Act".

21.1. Ground No.3 does not arise out of the order of AO/TPO, therefore, the same was withdrawn in the course of proceedings.

22. Ground No.2 pertains to rejection of Infosys Technologies Ltd., from the list of comparables by DRP. We have already considered the opinion of DRP which is consistent not only in Assessee's case but also in the case of M/s. Sumtotal Systems India Pvt. Ltd., (supra), extracted above while considering the exclusion of L&T Infotech Ltd. Since DRP's decision is consistent with the stand taken by the Revenue in other cases and also by the ITAT in a number of cases on reason of turnover, brand equity, functional dissimilarity, we are of the opinion that DRP is correct in excluding the above company from the list of comparables. Therefore, there is no merit in the Revenue's ground and the same is rejected.

23. Ground No. 4 pertains to deletion of addition towards communication expenses by AO invoking the Explanation 2 to Section 10A. Issue arises as AO reduced communication cost from export turnover and not reducing the same from total turnover. It was submitted before DRP that

Assessee has not incurred any expenses towards delivery of software outside India and the expenses are for inter office and intra-office communication over the web and for general purposes and the same is not incurred for delivery of services outside India. Even assuming but without admitting that internet service charges are incurred for delivery of software, the same is not specifically received from the customer, the same cannot be reduced from export turnover. In the alternate it was also submitted that if the same is reduced from the export turnover, the similar amount is to be excluded from total turnover also and relied on the following case law:

- i. CIT Vs. Gem Plus Jewellery India Ltd. [233 CTR 248] (Bombay)
- ii. ITO Vs. M/s. Saksoft Ltd reported as 121 TTJ Chennai (SB)
313 ITR (AT) 353

23.1. DRP has allowed Assessee's objection by stating as under:

"We have gone through the submissions and the draft order of AO. This issue has been decided by various judicial authorities and as per the jurisdictional ITAT, Hyderabad, in the case of ITO Vs. D.E. Block Indian Software Pvt. Ltd., wherein the tribunal considered the issue of adjustments of total turnover for the purpose of computing eligible profits U/s. 10A and held that the communication expenses need to be excluded from the exports as per the clause-IV of Explanation-2 to section 10A. On the same ratio, the communication cost does not have the element of profit and hence it is necessarily required to be excluded both from the total turnover and export turnover. Accordingly, AO is directed to reduce communication cost not only from export turnover but also from the total turnover for the purpose of computation of deduction U/s. 10AA".

23.2. Since the direction of DRP is consistent with the judicial principles laid down by the Hon'ble Bombay High Court in the case of CIT Vs. Gem Plus Jewellery India Ltd. [233 CTR 248] (Bombay) (supra), and also by various Co-ordinate Benches, we do not see any reason to interfere with the said direction. On principles of law, the direction is correct. However, neither AO nor DRP has given any finding whether the said communication charges are incurred for delivery outside India? Assessee's contentions on facts have not been examined

by any of the authorities. However, we are of the opinion that this will become academic in view of the direction of DRP. Revenue's ground is accordingly rejected.

24. In the result, Assessee's appeal is partly allowed for statistical purposes and Revenue's appeal is dismissed.

Order pronounced in the open Court on 16th October, 2015

Sd/-
(SAKTIJIT DEY)
JUDICIAL MEMBER

Sd/-
(B. RAMAKOTIAH)
ACCOUNTANT MEMBER

Hyderabad, Dated 16th October, 2015

TNMM

Copy to :

1. M/s. Pegasystems Worldwide India Pvt. Ltd., Building No. 12A, 13th Office Level, Mindspace, Cyberabad, Madhapur, Hyderabad.
2. The Asst. Commissioner of Income Tax, Circle-16(2), Room No. 611, 6th Floor, Aayakar Bhavan, Basheerbagh, Hyderabad.
3. Dispute Resolution Panel (DRP), Hyderabad.
4. The Director of Income Tax, (I.T & T.P), Hyderabad.
5. Dy. Commissioner of Income Tax (Transfer Pricing-II), Hyderabad.
6. D.R. ITAT, Hyderabad.
7. Guard File.