$~

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

% **DECIDED ON: 08.03.2017**

\+ W.P. (C) 11596/2016, CM APPL.45660-61/2016

LI & FUNG INDIA PVT. LTD. ..... Appellants

Through: Mr. Porus Kaka, Sr. Advocate with Mr. Neeraj Jain and Mr. Manish Kant, Advocates.

Versus

ASSTT. COMMISSIONER OF INCOME TAX & ANR. ..... Respondents

Through: Mr. Ruchir Bhatia with Mr. Puneet Rai, Advocates.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE NAJMI WAZIRI

S.RAVINDRA BHAT, J.

1. The petitioner is aggrieved by a show cause notice issued by the respondents (hereafter called "the Revenue") and argues that it is beyond the scope of the remit by the Income Tax Appellate Tribunal (ITAT) and that the respondents are seeking to re-open issues that have attained finality in judicial orders.

2. The Petitioner-company is engaged in the business of providing support services for sourcing of garments, handicrafts, leather products, etc. to its associated enterprises. It charges a markup of 5% on its total cost in consideration for provision of sourcing support services to the associated enterprises ("AE"). For AY 2007-08 the Transfer Pricing Officer ("TPO") accepted the application of the Transactional Net Margin method

("TNMM") to benchmark the petitioner's international transactions. By order dated 18 October, 2010, the benchmarking methodology by adoption of comparables was accepted by the TPO, who however concluded that the petitioner was a trader and substituted its cost base from total costs to the FOB value of the goods exported to the third party customers. The DRP approved the order of the TPO in changing the cost base of the petitioner. However, the DRP restricted the mark up to 4% of the FOB value of goods.

3. The petitioner had appealed to the ITAT, which remanded the matter (by the order dated 5 March, 2014) to the TPO with a direction to undertake fresh determination of arm's length price on the basis of correct cost base of the Petitioner in line with the judgment of this Court in the Petitioner's case for assessment year 2006-07. The ITAT's operative order is as follows:

> *"6. In so far as the markup on the wrong base of FOB value of goods between the third party enterprises, applied by the TPO at 5% and reduced to 40/0 by the DRP is concerned, we find that the same would become irrelevant because the base being, the 'total cost' in the denominator will stand changed to the 'total cost' incurred by the assessee instead of the FOB value of goods between third party enterprises. Since, necessary details for the determination of ALP with the correct base of the assessee as well as comparables are not readily available on record, we consider it expedient to set aside the impugned order and remit the matter to the file of AO/TPO for a fresh determination of ALP with the correct cost base of the 'total cost' incurred by the assessee in line with the above judgment of the Hon'ble Jurisdictional High Court in the assessee's own case."*

4. The impugned show cause notice, the Revenue facially rejected the data relating to comparable concerns and stated as follows:

"this office has conducted a fresh search on the Prowess database regarding Provision of Business Support Services. After a careful study, following filters were applied by this office which may lead towards selecting proper comparables which are functionally similar to the tested party. These filters and the rationale for applying these filters is as follows: -

• Companies whose data is not available/or the FY 2006-07 are excluded. As per the Rule 10B (4), it is mandatory to use the current year data i.e. the data for the FY 2006-07. The proviso to Rule 10B(4) says that data for earlier two year can also be used if it is shown that such earlier year's data had an influence in determining the transfer price. Further, the use of earlier year data in addition to the current year data can be resorted to provided certain conditions are satisfied, which is not applicable in the instant case. This view is upheld by various ITAT decisions. Hence companies, for whom data for FY 2006-07 is not available, are excluded.

• Companies whose Business Support Services Income <Rs. 1 Crore excluded. By taking companies whose receipts from Business Support Services is less than Rs. 1 Crore, the analysis may not lead to a proper comparability as these companies may not be representing the industry trend. Moreover their low cost/sales base makes their results unreliable.

• Companies whose revenue from Business Support Services is less than 75% of the total operating revenues are excluded. The companies whose revenues from Business Support Services are more than 75% of their operating revenues are selected as comparables. This is an appropriate filter as this is the stage which will determine the correct comparability. In respect of enterprises whose main source of income is from service segment, the companies whose income from Business Support Services is more than 75% of the operating revenues have been considered for the ALP study so that the other segment may not materially affect the financial results of the

company.

• Companies who have persistent losses for the last two out of three years including FY 2006-07 are excluded. This filter is essential as such companies having peculiar economic circumstances are not in line with industry trend.

• Companies having more than 25% related party transactions (sales as well as expenditure combined) of the sales are excluded. Companies having related party transactions of more than 25% are proposed to be excluded. A threshold of 25% is being applied following the provisions of Section 92A(2) (a) which provides a limit of 26% for treating an enterprise as Associated Enterprise. If the limit is reduced further it would only result in eliminating more companies and on the other hand if the limit is relaxed then companies with predominantly related party transactions would get included which would not represent uncontrolled transactions. Therefore, on a balancing note, 25% is a proper threshold limit for related party transactions. The companies having more than 25% related party transactions should therefore be rejected as comparables.

• Companies having different financial year ending (i.e. not March 31, 2007) or data of the company does not fall within 12 month period i.e. 01-04-2006 to 31-03-2007, are rejected. Since the tested party ends its financial year in March, hence, taking companies whose financial year ends in March will be an appropriate filter and may lead to a proper comparability.

• Companies that are functionally different from the tax payer are excluded.

• Companies that are having peculiar economic circumstances are excluded.

Any other peculiar circumstances of a company which is divergent from the tax payer and the environment in which the tax payer and the

comparables are working makes it incomparable. Thus peculiar economic circumstances which are specific to the comparable enterprises are being looked into to check whether the enterprise is going along with the industry trend, if not whether suitable adjustments can be made to that effect. If suitable adjustments cannot be made, the same is rejected as a comparable.

8. Based on the remarks above, all the 53 comparables given by you in the TP report are discussed as under:-…"

The show cause notice thereafter stated that the Revenue proposed to reject the 53 comparable entities and instead, take into consideration the other comparables whose income and profits were to be taken into account were Cameo Corporate Services Ltd; BVG India Ltd; ICRA Management Consulting Services Ltd and ICC International Agencies Ltd. The show cause notice therefore, proposed to add Rs.7,63,85,807.

5. The petitioner relies on its replies to the show cause notices urging that the exercise proposed rejection of the comparable and inclusion of other entities was unlawful. Those arguments were reiterated by Mr. Porus Kaka, learned senior counsel. It was argued that the Revenue exceeded the scope of the remand in issuing the show cause notice. Counsel highlighted that the ITAT's finding are unequivocal and based on the Revenue's acceptance of the comparables offered. Having not questioned the inclusion of the 53 comparable entities whose profits were taken into account in the TP report (and on which there was no dispute between the parties) the Revenue could not have sought to inquire into the merits of their inclusion in an extremely limited remand, i.e., working out of the profit level in the light of the existing comparables. It was also argued that the inclusion of fresh

comparables as the basis for judging the ALP was unwarranted in law. Besides, submitted counsel, the ground for rejection of the comparables were unsustainable, given the reasoning of this court in the assessment for AY 2006-07 which attained finality, with the judgment in *Li and Fung v Commissioner of Income Tax* 361 ITR 85. It was also argued that the functionalities of the proposed comparables were entirely different from the activities of the assessee.

6. The Revenue argues that the ITAT had directed the TPO to determine the ALP of the transaction after excluding the FOB value of exports. For the purpose of determination of ALP, functional analysis of the comparables with FAR of assessee is required, which has been done by the TPO. Therefore, the TPO acted within his jurisdiction and examined the comparables. In the original order the TPO had not analyzed the comparables selected or rejected by the assessee in its TP study as it had accepted the mark up of 5%, which the assessee received from its AE as remuneration for the functions performed and the risk undertaken. Pursuant to the ITAT's direction the TPO examined the assessee's comparables in its TP. The assessee adopted 53 comparables to determine its ALP. The assessee applied TNMM for determination of Arms Length Price of the transaction and OP/TC was claimed to be PLI. The assessee had computed OP/TC at 7.56% while the OP/TC of the comparables selected by the assessee were computed at 8.32% by the assessee. The assessee claimed that the transaction was at Arm's Length Price and the difference was within +/- 5%.

7. It is urged that for ALP determination - on the basis of FAR/

Comparability analysis, it was found that out of 53 comparables 51 could not be accepted to compute the markup because:

a) 6 comparables had different financial year from the assessee and had to be rejected.

b) 44 comparables were functionally dissimilar to the assessee and hence had to be rejected. The OECD guidelines and the provisions of the Income Tax Act and Rules stipulate that the comparables should discharge the same functions as the assessee and hence the TPO rightly rejected these 44 comparables.

c) 1 Comparable was rejected because data for current year was not available.

d) The assessee had taken weighted average margins of the comparables while Rule 10-B (4) of the Income Tax Act specifies that only the single year margin has to be taken.

8. It is argued that the TPO has followed the directions of the ITAT and determined the ALP. The assessee's FAR analysis and comparables adopted by it in its Transfer Pricing report were examined by the TPO. The assessee had chosen 53 comparables to determine its ALP. It applied TNMM for determination of Arms Length Price of the transaction and OP/ TC was claimed to be PLI. The assessee had computed OP/TC at 7.56% while the OP/TC of the comparables selected by the assessee were computed at 8.32% by the assessee. The assessee claimed that the transaction was at Arm's Length Price since the difference was within range of 5%.In the light of FAR analysis, it was found that only 2 comparables out of 53 given by the

assessee were functionally similar to the assessee and having the same financial year ending. Therefore a detailed show cause was issued to the assessee on 23.09.2016 explaining why the 51 comparables were not acceptable. It is lastly argued that the TPO did a fresh search to find comparables that performed similar functions as the assessee. This resulted in the inclusion of fresh comparables.

9. It is evident from the above discussion that the narrow controversy which requires resolution in this proceeding, is whether the show cause notice impugned by the assessee could have been issued, in the manner done by the Revenue. The assessee's threshold argument is that the ITAT's remit was limited to complying with its directions and did not under any circumstances extend to questioning the basis for the TP exercise. The Revenue relies on Rule 10-B of the Income Tax Rules to say that the appropriateness of the comparables adopted by the assessee had not been gone into for the previous and that it is not bound by assumption based orders; rather the remit was broad enough to allow it to consider if and to what extent, the comparable entities had similar functions.

10. The matter can best be considered if the ITAT's discussion in the order for the relevant assessment year (dated 5 March, 2014) is read in all material aspects and not only the operative portion. The same is as follows:

> *"4. We have heard the rival submissions and perused the relevant material' on record. There is no dispute on the application of TNMM as the most appropriate method. Equally, there is no dispute on PLI of OP/TC. In the like manner, the selection of comparables is also beyond any controversy. The entire point of dispute is against the base of 'Total Cost' in the PLI of Operating Profit/Total Cost.*

Whereas the assessee computed its OP/TC at7.56% based on the cost incurred by it as constituting 'Total cost', the TPO changed such base to FOB value of goods exported in the hands of the A.Es. The short question before us is about determination of the correct base in the PLI.

5. It has been brought to our notice that that the TPO in the preceding year also applied the same base of 'total cost' as in the year under consideration, which got the approval from the Tribunal. The assessee assailed the Tribunal order before the Hon'ble High Court. Vide its judgment dated 16.12.2013 in Li &Fung (India) Pvt. Ltd. Vs CIT, a copy which has been placed on record, the Hon'ble Delhi High Court has reversed the Tribunal order by holding the FOB value of goods between the third party enterprises, sourced through the assessee, was not in accordance with the law. In view of the enunciation of law by the Hon'ble jurisdictional High Court in the case of the assessee itself, there remains no doubt whatsoever that the base of 'total cost' as adopted by the TPO and approved by the DRP in considering the FOB value of goods between the third party enterprises cannot be accepted. We, therefore, set aside the impugned order and hold that the 'total cost' being the denominator in the PLI of OP/TC, has to be taken as the costs incurred by the assessee and not the FOB value of goods between third party enterprises sourced through the assessee. In other words, the tested party should be the assessee and not its A.E.

6. In so far as the markup on the wrong base of FOB value of goods between the third party enterprises, applied by the TPO at5% and reduced to 40/0 by the DRP is concerned, we find that the same would become irrelevant because the base being, the 'total cost' in the denominator will stand changed to the 'total cost' incurred by the assessee instead of the FOB value of goods between third party enterprises. Since, necessary details for the determination of ALP with the correct base of the assessee as well as comparables are not

readily available on record, we consider it expedient to set aside the impugned order and remit the matter to the file of AO/TPO for a fresh determination of ALP with the correct cost base of the 'total cost' incurred by the assessee in line with the above judgment of the Hon'ble Jurisdictional High Court in the assessee's own case."

11. It is obvious that the ITAT was not seized of any dispute with respect to the appropriateness of including any comparable or excluding any from the list furnished by the assessee. The record nowhere shows that the original TPO report, or the draft assessment order, or even the DRP's determination reflects any concern about the appropriateness of the inclusion of any comparable on the ground of its/their functionality. The ITAT's substantial ruling shows that the TPO had followed the previous order and changed the basis of PLI of Operating Profit/Total Cost to FOB value of the export goods in the hands of the AEs. The assessee had computed its OP/TC at 7.56% based on the cost incurred by it as constituting 'Total cost'. This is reflected in the finding and conclusion that *"We, therefore, set aside the impugned order and hold that the 'total cost' being the denominator in the PLI of OP/TC, has to be taken as the costs incurred by the assessee and not the FOB value of goods between third party enterprises sourced through the assessee. In other words, the tested party should be the assessee and not it's A.E*". The operative part of the ITAT's direction to carry out the exercise afresh since it did not have the figures relating to the comparables has to be therefore, seen in the context of what was actually done. Therefore, the Revenue's argument that the TPO/AO could doubt the appropriateness of the comparables used by the assessee is insubstantial and unmerited.

12. As far as the assumptions upon which the comparables were sought to

be rejected are concerned, this court had, in its reported judgment, rejected the Revenue's argument that substantial risk assumption was undertaken. The finding of this court is extracted below:

> *"41. LFIL, in the Transfer Pricing documentation, established the international transactions of rendering buying services to be at the arm's length price having regard to the operating profit margin of comparable companies having similar functional profile. LFIL''s computation of the operating profit margin (OP/TC per cent) by enhancing the cost base, i.e., by increasing the cost of the sales facilitated by LFIL leads to an arbitrary adjustment of its income, as such an alteration resides plainly outside the Rules and the provisions of the Act.*
>
> *42. Moreover, there is considerable merit in the submission that the (finding of the) lower authorities, including the Tribunal, misdirected themselves in holding that LFIL assumed substantial risk. Whilst this Court would neither state that LFIL performed functions with a limited risk component, as it does not engage itself in manufacturing of garments (which is LFIL''s stance), apart from broad assumptions made by the Revenue, no material on record testifies to that fact such that it can be the basis for an ALP adjustment. Indeed, LFIL has neither made investment in the plant, inventory, working capital, etc., nor does it claim to have any expertise in the manufacture of garments. More importantly, and given no material to the contrary, LFIL does not bear the enterprise risk for manufacture and export of garments. LFIL''s functional and risk profile thus is entirely different and has nothing to do with the manufacture and export of garments by unrelated third party vendors. Simply put, LFIL renders support services in relation to the exports, which are manufactured independently. Thus, attributing the costs of such third party manufacture, when LFIL does not engage in that activity, and more importantly, when those costs are clearly not LFIL''s costs, but those*

of third parties, is clearly impermissible. A contrary conclusion would amount to treating it (the appellant) as the vendor/ exporters" partner in their manufacturing business

- a completely unwarranted inference.

43. Indeed, having done the work, LFIL has developed experience and expertise which the Tribunal has held to be human capital and supply chain intangibles. But such description does not in any way reveal how the appellant bears any risk - either enterprise or economic. LFIL"s remuneration on a cost plus mark-up of 5 per cent represents the functions performed, assets utilized and risks assumed by it. Further, the TPO"s determination that LFIL bore significant risks is not borne out from the records. In transactions in which LFIL was a party, it did not bear any financial risk. To the contrary, its costs towards establishment, transportation, salaries, etc. were fully reimbursed, and it was insulated from any economic or financial downside to any particular transaction. In other words, its remuneration was based entirely on the costs borne by it. In essence, it is a low risk contract service provider exclusively rendering sourcing support to the AE. It does not bear any significant operational risks for its functions, rendered to the third party vendor/customers. Rather, it is the AE that undertakes substantial functions and in fact assumes enterprise risks, such as market risk, credit risk etc. It also bears the letter of credit associated charges and other expenses."

13. In this view of the matter, the court is of opinion that the impugned show cause notice cannot be sustained. Firstly, when there is a remand on the basis of a specific finding (in this case, the untenability of shifting of the OP/TC to FOB) the TPO could not have travelled beyond it, given that there was no controversy ever about the inclusion of any comparable. Concededly there was no controversy about the appropriateness of inclusion

of any comparable for the ALP determination purpose. Nor was there any finding or direction on that score. In the given circumstances, the Revenue could not have seized upon the direction to determine it "afresh" as the basis for going into the merits of inclusion of such comparables. Secondly and more fundamentally, the issue of comparables' inclusion is not one that goes to define jurisdiction itself. There is authority for the proposition that invocation of jurisdiction is itself in issue, notwithstanding that being not subject to remand. However, that is not the case here. The remand was essentially consequential to give tax effect to the findings of the ITAT.

14. For the foregoing reasons, the impugned show cause notice dated 23 September 2016 and all proceedings emanating therefrom are hereby quashed. The writ petition is allowed in these terms, without any order on costs.

S. RAVINDRA BHAT
(JUDGE)

NAJMI WAZIRI
(JUDGE)

MARCH 08, 2017