

IN THE INCOME TAX APPELLATE TRIBUNAL

"E" BENCH, MUMBAI

BEFORE SHRI, J. SUDHAKAR REDDY, ACCOUNTANT MEMBER AND

SHRI VIJAY PAL RAO, JUDICIAL MEMBER

ITA no. 8311/Mum./2010

(Assessment Year : 2006-07)

Date of Hearing: 11.4.2011

Exxon Mobil Company India P. Ltd.
Kalpataru Point, Plot no.107
Road no.8, Sion (East)
Mumbai 400 092 – AAACE3157H

..... Appellant

v/s

Dy. Commissioner of Income Tax
Circle-3(1), Mumbai

..... Respondent

Assessee by : Mr. Saurabh Soparkar
Revenue by : Mr. D. Songate

ORDER

PER J. SUDHAKAR REDDY, A.M.

This appeal preferred by the assessee, is directed against the impugned order dated 20th September 2010, passed by the Assessing Officer under section 143(3) r/w section 144C(13) of the Income Tax Act, 1961 (for short "*the Act*").

2. The assessee company filed its return of income on 30th November 2006, declaring total income of ₹ 22,17,44,830. The assessee company is stated to be engaged in the business of market development, dissemination of product information of speciality chemical and polymers. It also carries out research and development activities and also provides on-site and back

office support services. The Assessing Officer made a reference to the Addl. Commissioner of Income Tax (Transfer Pricing), Mumbai, under section 92CA(1) for computation of Arm's Length Price (herein after for short "ALP") in relation to international transaction. The TPO, vide order dated 29th October 2009, arrived at a Transfer Pricing adjustment of ₹ 1,94,44,068. The assessee made submissions before the Assessing Officer against the proposed adjustment. The Assessing Officer rejected the same and issued a draft assessment order. The assessee filed objections against the proposed variation to the income before the Dispute Resolution Panel-1, Mumbai on 22nd December 2009. The panel, vide its order dated 6th August 2010, has issued certain direction under section 144C(4) of the Act. The Assessing Officer passed the order under section 143(3) r/w section 144C(13) of the Act on 20th September 2010. Aggrieved the assessee is in appeal before us.

3. The facts, as far as the company and the issues are concerned, have been brought out in the order dated 29th October 2009, passed by the Transfer Pricing Officer (herein after for short "TPO") under section 92CA(3) of the Act, which is extracted for ready reference:-

"3. The assessee is a company of the Exxon Mobile Corp. Group of US and is responsible for information dissemination, maintaining customer relationship and market development for its AE Exxon Mobile Chemical Co. USA. It is also providing application research and technical services and back office support services to the AE.

4. The international transactions of the assessee are as under:

S.No.	Details of transaction	Amount (₹) 2006-07
1	Technical Services	62871933
2	Back office support services	44866645
3	Marketing services	282980046
4	Global Support services fees	20663082
5	Reimbursement of expenses (recd)	2590571
6	Reimbursement of expenses (paid)	960283

5. For the purpose of benchmarking segmental financial results have been prepared by the assessee working out profitability separately in respect of:

1. Marketing services
2. Provision of application research and technical services
3. Provision of back office services.

The assessee has adopted TNMM method to support its benchmarking and has filed a transfer pricing report in support thereof.

6. To ascertain the nature of the services and the price setting mechanism, the assessee was asked to furnish the copy of agreement entered into by the assessee with its AEs. The same has been furnished by the assessee vide its submission dated 25th Feb, 2009. The salient features of some of the agreements are discussed as under:

1. *Marketing services:* The agreement is entered into between the assessee and Exxon Mobil Chemicals Asia Pacific. The agreement is entered into w.e.f. 1/5/2003 for performing certain market services for the AE and for the benefit of customers in India. The services to be rendered include disseminating information, develop the market and solicit business in India. For these services the assessee gets a compensation ranging from 2 to 4% of the net invoice value.

2. *Technical services:* The assessee has two agreements with its AEs for the provisions of technical services.

i) This agreement is with Exxon Mobil Chemical Asia Pacific (EMCAP). Under this agreement, the assessee provides the following services.

1. Application technical development services to Butyl and Ethylene Elastomers customers of EMCAP in Asia Pacific and other regions.
2. Develop product applications and undertake new applications development.
3. Such other technical services as and when require by EMCAP:

All these activities are to be carried out at the Bangalore Research and Development Technology Centre (BRDTC), which has been set up for this purpose. For the services rendered the AE undertakes to reimburse the entire costs for running BRDTC. This includes the direct cost represented by compensation for employees for materials and supplies and other costs including travel, bonus etc. of employees. The indirect costs comprising of utilities, rentals, supervisory and administrative costs plus general overheads including apportionment

of the supporting departments etc. The AE also compensates direct expenses of application technical developments managers and expenses on seminars and conferences etc. However, the assessee does not get any compensation in respect of the services rendered to the AEs.

ii) The second agreement is called Technical Representation Agreement entered into by the assessee with Exxon Mobil Research & Engg. Company. Under this agreement the assessee has to assist its AE in promotion of its various petroleum processes and other technologies listed out in para 3 of the agreement. In consideration of the services rendered the assessee is paid \$40000 per annum + 5% of the royalty payments received by the AE in respect of execution of process license agreement exceeding USD 800000 per calendar year. The traveling expenses are also reimbursed on actual basis.

3. Bank office support services: The assessee has back office support services agreement with Exxon Mobil International Services Ltd., Exxon Mobil Chemical International Services Ltd., Exxon Mobil Chemical Middle East and Africa and Exxon Mobil Chemical Asia Pacific for rendering various back support services. All the AEs have decided to provide a mark up 10% on the various direct and indirect costs incurred by the AEs for rendering such services.

7. Assessee has preferred a transfer pricing report to justifying the bench marking of its various transactions. As per the TP report, the benchmarking has been carried out under TNMM method as tabulated below:

Nature of international transactions	Most Appropriate Method	Profit Level Indicator	EMCIPL's Margin	Comparables Margin
Provision of marketing services in India and designated territories	TNMM	Operating Profit/ Total costs (OP/TC)	142.93%	3.15%
Provision of back office support services	TNMM	OP/TC	13.13%	18.82%
Provision of back office support services	TNMM	OP/TC	21.30%	10.80%
Reimbursement of expenses (Receipts and payments as applicable)	CUP	NA	NA	NA

8. The assessee was asked to furnish segmental accounts duly reconciled with its annual report to substantiate the margins worked out by him. In response to the same, the assessee has given the detailed information vide its submission dated 4th March, 2009. The marks up as worked out on the basis of are given as under :

1. Marketing services	142.93%
2. Application Research & Technical Services	13.13%
3. Back office support services	21.30%

A copy of the segmental analysis so furnished is enclosed as Annexure A to this order. Since the margins mentioned in the agreements and the ones worked out as per the accounts were at a large variance, the assessee was asked to reconcile the same and for this purpose a detailed questionnaire was issued to him 23.3.2009, the salient issues are reproduced below :-

3. Provision of technical services

3.1 As per your TP report the Bangalore Research & Development Technology Centre (BRDTC), division of EMC IPL (the assessee) is one of the Exxon Mobil Chemical US research centers, others being in US and in Belgium. This centre offers technical services to its associated enterprises and it concentrates primarily on developing new customer centric applications for the Butyl Polymers and Ethylene Elastomers line of products.

3.2

3.3

3.4 The centre of Bangalore is being run pursuant to an agreement between Exxon Mobil Co. India Pvt. Ltd. and Exxon Mobil Asia Pacific P. Ltd. A perusal of the agreement, dated. 17.5.2004 shows that as per Article 2 th eassessee (BRDTC) shall provide the following services :

2.1 Application technical development services to Butyl and Ethylene Elastomers customers of EMCAP in Asia Pacific and other regions.

2.2 Develop product applications and undertake new applications development.

2.3 Such other technical services as and when required by EMCAP BRDTC ill undertake the above projects as per requests received from EMCAP or its nominees and provide a report of its findings/analysis.

3.5 Further in consideration of these services the assessee receives only a reimbursement of the direct and indirect cost incurred on the

Bangalore Research Centre. Plus compensation and traveling expenses of managers/engineers with a mark up of 10% and also expenses incurred on scenario and conference.

3.6 The agreement clearly shows that in respect of rendering specialize services in the filed of application reserves the assessee is not charges anything on account of technical service charges.

3.7 In your explanation dated 4.3.2009, while presenting the segmental accounts you have stated that the application reserves and technical services segment resulted into and operating margin in relation to total cost of 13.13%. For this purpose you have allocated the expenses on the basis of head count. It was observed that the total expenses incurred had been reduced under the following four account heads.

- 1. Foreign exchange gain/loss-*
- 2. 1% R &D Lab testing India to marketing-*
- 3. % Butile ATD India cost transfer to marketing*
- 4. 25% EEB ATD cost transfers to marketing.*

3.7.1 The exchange gain/loss is a result of allocation of the Exchange Gain to the company as a whole over the year, on the basis of sales. The exchange fluctuation was a result of variation in dollar vis-à-vis over the year and is also not allocated on the basis of actual receipt of money time to time. Moreover any exchange fluctuation may result in better Margin at the end of the year. But it cannot justify the price fixation margins at the initial price fixation itself.

3.7.2 Items at Sl. No. 2, 3 & 4 have been explained to be allocation of costs of the personnel employed at BRTDC for the purpose of marketing activities. It has been stated that technical people have to be taken by the marketing team to inform the customers about the various chemical properties etc. You have not been able to provide the basis of allocation of the cost and identification of the cost while computing the percentages of 1% 10% & 25% respectively. Actually it appears that you have artificially shifted expenses of ₹ 22,86,447 from the application research head to the marketing services.

3.7.2 It is a matter of fact that the personnel at BRTDC had been employed for the purpose of research only and their cost is being entirely reimbursement by your associated entity. Just because they provided some assistance in marketing (if any), cannot lead to allocation of their cost for marketing. They were full time employees of BRTDC and any such activity would have been possible only in their spare time. This cannot result in allocation of their costs between the marketing & the application research segments. Further there is no evidence to substantiate claim the assessee, nor have you maintained any log book or carried out any time and motion study to explain the percentage of 1, 10 & 25%. Moreover as a matter of fact out of total

study 36 persons employed only 9 persons are stated to be employed in application research and they were stationed at Bangalore. Just because they happened to be with the marketing team for some clarifications cannot be any basis of allocated their cost towards marketing. It is also a fact that the assessee while claiming the reimbursements has claimed the entire establishment cost.

3.7.3 The allocation of expenses therefore, cannot be accepted as a proper allocation of cost in segmental analysis.

3.7.4 As already stated the assessee has not charged any price for the services being rendered by it to its associated enterprise. Only amount it has received from its AE i.e. ₹ 4,98,14,572/- represents the reimbursement of costs. Same is also relected in Balance sheet, P & L A/c. of the company.

3.7.5 Further it also appears from your segmental analysis that the common administrative expenses in relation to the Managing Director's office, his staff and Finance office expenses etc. have not been allocated to the 3 segments which would have further increased the recovery of expenses.

3.7.6 In such a scenario you are required to show cause as to why your segmental study be not rejected and the comparable PLI ratio to be worked out for Application Research be not applied to the entire reimbursement receipt without any credit for OP/TC ratio 13.13% worked out by you.

8.2 The assessee has filed detail explanation of the same in its letter dated April 28, 2009, which is being discussed as under:

The assessee has aggregated the various technical services rendered under one category (total amount ₹ 6,28,71,933). It is mentioned that a mark up of 10% has been charged on ATD activities (₹ 1,13,04,961) and in relation to technical representation (₹ 17,52,400) the mark up has been around 80%. It has however not denied the fact that it has not been separately compensated for services rendered at BRDTC (₹ 4,98,14,572). The assessee had allocated a part of cost of the application and research technical segments toward marketing services. They are as under :

a)	1% R & D lab testing	₹ 4,45,507
b)	10% Butile ATD India cost on	₹ 8,47,107
c)	25% AEB ATD costs	₹ 9,93,833

The assessee had explained that since the personnel involved in scientific research and ATD mangers assists the marketing team in marketing the products, a proportionate cost has been allocated out of the costs incurred on them towards the marketing segment. As far as

allocation of costs incurred under the head marketing to technical services is concerned, the assessee has furnished certain correspondence and confirmations from its Manager employees relating to the time spent by their research personnel for marketing. Assessee has furnished some correspondence from its own employees. One such letter furnished is by Shri B. B. Sharma, who estimates that the time spent on butile ATD and R & D lab would be 10% and 1% respectively. Similarly, there is another letter from Pradeep Patki, who has enumerated the activities which he has undertaken.

8.3 I have gone through the various correspondences which are addressed to the Taxation Department. The email correspondence which has initiated from the head office itself mentions the percentage of allocation carried out and seeks instances of work being done for justifying this allocation. None of the executives have any basis to justify the percentages of 1, 10 & 25 as mentioned above. The correspondences are self serving documents without any supporting log books or time and motion studies. Such self serving documents do not carry any evidential value.

The total staff strength of the employees is only about 36 persons as stated by the assessee. Out of these 9 persons are in the application research and technical team stationed at Bangalore. There are 14 persons under the marketing segments and 13 another in back office services. These also include the persons in the head office administrating the overall affairs. The Technical agreement with Exxon Mobil Chemical Asia Pacific clearly shows that BRTDC has been carrying out analytical research to the AE. It is precisely for this reasons that the AE has agreed to reimburse the entire cost whether direct or indirect in respect of the expenses incurred for BRTDC. The ATD Managers and the technical persons employed under BRTDC are dedicated employees of the BRTDC, kept for the purposes of research as desired by the AE. Being the employees of the assessee, they can assist other divisions but not at the cost of their primary duty. If some assistance is provided to marketing division in their spare time, the same cannot warrant allocation of a proportionate cost to the marketing division. This is supported by the fact that the assessee in fact has claimed reimbursement in respect of the entire cost relating to such personnel and not after deducting the allocated costs.

It the circumstances of the case it appears that the allocation of expenses is only a financial jugglery to improve the margins for the technical segment at the cost of marketing divisions which has sufficient margins otherwise. This is substantiated by the fact that the receipts on account of research services from Exxon Mobil Chemical Asia Pacific are shown at ₹ 4,98,14,572 and this is the exact amount which is shown as recovery of expenses from AEs in Profit and Loss Account (i.e. 100% of revenue expenses of BRTDC and 38.1% of administrative expenses in respect of Kalparu Point office at Mumbai).

8.4 The arbitrary and unwarranted allocation of these expenses from technical services segment to marketing segment is therefore, rejected. The fact of the matter remains that the assessee has not received any compensation for services rendered to Exxon Mobil Chemical Asia Pacific. Therefore, the transactions of the assessee with this, AE are not at arm's length. The assessee would not have rendered similar services to any third party without charging any mark up. It would have charged reasonably industry mark up for rendering its services, which has been forgone.

8.5 The total costs allocated to the technical services segment of the assessee is ₹ 5,78,63,688 out of this the expenses towards Banaglore Research Centre are ₹ 4,98,14,572. This leaves the remaining amount of ₹ 80,49,116 against the representation and ATD services of ₹ 1,30,57,361 giving a mark up of 62.22% on costs. The adjustment in respect of the compensation for BRTDC is being worked out as under.

8.6 Selection of comparables and their operating margins: The assessee had undertaken a detailed search in its transfer pricing report and selected following 7 comparable companies for working out arithmetic mean of 18.47%.

Sr. No.	Name of the company	Average adjusted OP/TC
1	Alphageo (India) Ltd.	24.74%
2	Dolphin Medical Services Ltd.	11.46%
3	N. G. Industries Ltd.	29.60%
4	Vimta Labs Ltd.	69.49%
5	Neeman Medical International (Asia) Ltd.	-0.89%
6	ADS Diagnostic Ltd. – seg.	-9.20%
7	Pfizer Ltd.- service seg.	4.07%
	Arithmetic mean	18.47%

As discussed above, on his own segmental analysis it has worked out its PLI of 13.13% and considered its pricing to be at arm's length. A perusal of the comparable shown that the assessee had adopted multiple year data for working out the PLI of the comparables and further some of the companies so selected could not be considered as comparable companies. Accordingly, the assessee was issued a show cause notice dated 17th July, 2009 confronting the above facts and also the reasons for rejection of a few office comparable companies. The correct operating margin was also worked out.

8.6.1 In reply to the show cause the assessee has furnished its submission on 28th July, 2009. His main argument is regarding the rejection of loss making companies, he has analysed the companies and reasons for losses as under :

(i) AVS Diagnostic Ltd. – it is stated that the income of diagnostics services has reduced due to stiff competition around Delhi and therefore, losses have been incurred.

(ii) Neeman Medical International (Asia)-it is stated that a clinical tier income is reduced and, therefore, there is loss. The company has involved upon a long term strategy to move up the value change. Keeping the future perspective the company should be accepted. The assessee has not mentioned anything specific about any company which may suggest that the loss in the current year was only an anomaly. The circumstances suggested are faced by all other companies in the public domain. If the other companies can make adequate profits in similar circumstances there is no reason why these two companies should incur losses in a year to year basis. This shows that either they operate in abnormal circumstances or there are certain issues of management and conduct o affairs which is not normal in the industry. Therefore, these two companies deserved to be rejected.

8.6.2 Another company namely Pfizer Ltd. is also rejected. This is a multinational pharmaceutical company with a turnover of nearly 700 crores. In its financial results, it has reported a segment called services. The turnover of this division is only ₹ 25.66 crores. i.e. only 3.7% of the total turnover. The profits in this segment are Rs.2.62 crores, before allocation of common expenses. The allocable expenses are to the tune of ₹ 28.51 crores i.e. more than the total turnover of this segment. Therefore, it shows that the segmental analysis about the profitability of the diagnostic segment cannot be worked out accurately. Alternatively, this activity is only subservient and dedicated to the main activity in the field of pharmaceuticals. This company is therefore, also rejected. The operating margins were reworked on the basis of annual reports and final comparable after considering the submissions are given below:

Sr. No.	Name of the Company	Return on total costs
1	Alphageo (India) Ltd.	47.79
2	Dolphin Medical Services Ltd.	14.52
3	N. G. Industries Ltd.	31.26
4	Vimta Labs Ltd.	57.68
5	Choksi Laboratory Ltd.	32.22

6	Transgene Biotech Lt. - segmental	8.16
7	Medinova Diagnostics Services Ltd.	7.26
	Arithmetic mean	28.41%

The assessee has further sought working capital adjustments of 0.47% in respect of the working capital being employed by the comparables and the assessee. The assessee has further sought risk adjustments by following the capital asset pricing model. The issue of risk adjustments and the short comings of CAPM model adopted by the assessee are discussed in detail later in the order and therefore, I do not allow any risk adjustments in this case.

The assessee will, therefore, suffer an adjustment in respect of services rendered from BRDTC to its AE viz, Exxon Mobil Chemical Asia Pacific as under :-

Cost of services rendered ₹ 4,98,14,572

Mark up as per the comparables

$$(28.41 - 0.47) = 27.94\% = ₹ 1,39,18,191$$

9. Back office support services:

As already mentioned above, the AEs has entered into an agreement with the assessee to provide a mark up 10% on total costs. The segmental results of the assessee however, show a mark up of 21.3% as mentioned above a detailed questionnaire was issued to assessee on 23.3.2009, the salient issues are reproduced below:

4.1 As per your segmental study you have shown a margin of 21.30% under the segment back office support services. The perusal of the various agreements furnished by you vide submission dated 25.2.2009 at annexure F to J show that you have agreed to be reimbursed at the margin of 10% to the direct or indirect cost as specified in the agreements.

4.2 During the course of discussion I had asked you to substantiate as to how your segmental results were showing a margin of 21.3% as against the agreed compensation of 10% you have stated. You had stated that this office should not have any problem if the assessee was getting of higher margin as compare to the agreed compensation. The fact however remains that why should the AE give a higher margin. In fact as submitted by you markup has been increase to 15% in the next year. If the AE knowing well that, you are showing 21.3% increases the margin further from 10 to 15% there has to some anomaly in the accounts or their presentation. The assessee has been billing the AE on budgeted basis and any shortages or excess in the previous Bills have to be made up in the next bill. In any case at the end of the year of the AE i.e. 31.12.2005 all adjustments regarding the shortages and

excesses reimbursement would have been made to arrive at the correct figure of compensation.

In such a scenario you were asked to match your back office service receipts and expenses with the budgeted estimates to bring out the reasons for variations from the agreed 10% return to 21.3%. In your reply you have stated that the persons concerned dealing with the matter had left the company, but this cannot be accepted as a basis for non explanation of the variation which is apparent.

4.3 The non explanation of the precise reasons for variation will lead to a conclusion that the segmental financial information furnished by you is not reliable. This could be on account of incorrect allocation of headcount or some different basis of allocation at the time of budgeting.

4.4 The essence remains that you have agreed for the being remunerated at only 10% markup to cost. You have requested to show cause why the segmental results not to rejected and your total receipts on account of BPO be bench marked at the comparable PLI considering your PLI to be 10% instead of 21.3% as shown by you in your TP Report.

9.1 In his explanation the assessee has stated that the billings are made on budgeted costs while the books of accounts show the actual cost incurred and there is likely to be variation. Further, the accounts of the AEs are maintained on calendar year basis while the accounts of the assessee are on financial year basis. This generally results in variations. The assessee has again failed to provide his budgetary figures. It has filed certain reconciliations. In its working it has shown that the budgeted cost was USD 437,000 (₹ 1,93,18,000) after adjusting the differences in respect of Jan to Mar.2005 (USD 115,000) and Jan 06 to March, 2006 (USD 115,000). Since the actual cost (₹ 1,58,27,000) was lower than the billed costs, they could achieve a higher mark up.

The explanation of the assessee does not seem to be acceptable. The AEs have agreed to provide a mark up of 10% on costs. The accounts of the AEs closed on 31st Dec. of each year. Therefore, while finalizing their accounts there will take into account the actual costs incurred by the assessee duly adjusted for the cost for January and December 2005. They will take into account the actual costs incurred by the assessee from January, 05 to December, 05 for providing the expenses in respect of the services rendered by the AEs. In case, the budgeted billings were lower than the actual cost they would pay a higher amount in the next quarter. However, if the budgeted billings were higher, then the amount payable in the next quarter would be lower. Whatever variations would have arisen between the budgeted and actual cost would have been adjusted in the last quarter. As per the assessee the budgeted figures for the first quarters of Calendar

Years 2005 and 2006 were the same and the difference was in the actual figures for Jan to Dec. 2005. Such difference if any would definitely have been taken into account by the AEs while finalizing their accounts. Every AE is an independent Company and a separate profit centre. None would like to provide a higher expenditure than warranted. The AEs have allowed a mark up of 10% only and if they were finding that the AE is actually making profit of 21% they would have reduced their mark up in the first quarters of 2006 so as to make an overall mark up of 10% for the year. The assessee is not an independent company which can befooled the various group companies by charging a mark up of 21.3% against agreed margins of 10%. In fact, the assessee has reported that in the next years the mark up has been increased for 10 to 15%. If the assessee was actually making a margin of 21.3% no AEs would have increased the margin from 10 to 15%.

While filing the explanation the assessee has not been able to explain the head-wise variation and the specific reasons on account of which those variations have arisen. It therefore appears that the allocation of expense by the assessee is not as per the actual budget exercise but only with a basis to work out better margins for the lower priced segments. The explanation/the segmental allocation of the assessee therefore, is rejected."

4. The TPO observed that the assessee has aggregated various technical services rendered into one category (total amount of ₹ 6,28,71,633). He observed that the assessee mentioned that a mark up of 10% has been charged on ATD activities of ₹ 1,13,04,961 and in relation to technical representation ₹ 17,52,400, the mark-up is around 80%. He also observed that the assessee has not denied the fact that, it has not been separately compensated for services rendered at Bangalore Research and Development Technology Centre (for short "BRDTC") (₹ 4,98,14,572). The assessee allocated a part of cost of the application and research technical segment, towards marketing services as follows:-

a)	1% R&D testing	₹ 4,45,507;
b)	10% Butile ATD India cost on	₹ 8,47,107;
c)	25% EEB ATD costs	₹ 9,93,833.

5. The allocation has been justified on the ground that the personnel involved in scientific research and ATD managers, do assist marketing team in marketing the product. On the cost incurred under the market head, which is to be allotted to technical service, the assessee furnished correspondence from its employees wherein some employees have estimated that the time spent by them on Botile ATD and R&D laboratory would be 10% and 1% respectively. Similar correspondence from other employees was furnished. The correspondence was rejected by the TPO as self-serving documents which are not supported by any log books and motion studies and for the reasons given in Para-8.3 of the order. He came to a conclusion that allocation of expenses is only a financial jugglery, done by the assessee, to improve margins for the technical segment, at the cost of marketing division which has sufficient margin otherwise. He substantiated this finding by the fact that, receipts on account of research services from Exxon Mobil Chemical (Asia) Pacific (for short "EMCAP") which shows ₹ 4,98,14,572, is the exact amount reflected as amount recoverable from A.Es in the Profit & Loss account. He rejected the allocation of expenditure as unwarranted and came to a conclusion that the fact of the matter is that the assessee has not received any compensation for service rendered to EMCAP, hence, he held that transaction of the assessee and with the A.Es are not at Arm's Length. He commented that the assessee would not have rendered similar services to any other third party without charging a mark-up. He held that the assessee should have charged reasonable industry mark-up, for rendering its service and that this has been forgone. At Para-8.5/Page-6, the TPO observed as follows:-

"8.5 The total costs allocated to the technical services segment of the assessee is ₹ 5,78,63,688, out of this the expenses towards Bangalore Research Centre are ₹ 4,98,14,572. This leaves the remaining amount of ₹ 80,49,116 against the representation and ATD services of ₹ 1,30,57,361, giving a mark-up of 62.22% on costs.

8.6 *Selection of comparables and their operating margins: The assessee had undertaken a detailed search in its transfer pricing report and selected following 7 comparable companies for working out arithmetic mean of 18.47%.*

Sr. No.	Name of the company	Average adjusted OP/TC
1	Alphageo (India) Ltd.	24.74%
2	Dolphin Medical Services Ltd.	11.46%
3	N. G. Industries Ltd.	29.60%
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5	Neeman Medical International (Asia) Ltd.	-0.89%
6	ADS Diagnostic Ltd. – seg.	-9.20%
7	Pfizer Ltd.- service seg.	4.07%
	Arithmetic mean	18.47%

As discussed above, on his own segmental analysis it has worked out its PLI of 13.13% and considered its pricing to be at arm's length. A perusal of the comparable shown that the assessee had adopted multiple year data for working out the PLI of the comparables and further some of the companies so selected could not be considered as comparable companies. Accordingly, the assessee was issued a show cause notice dated 17th July, 2009 confronting the above facts and also the reasons for rejection of a few office comparable companies. The correct operating margin was also worked out."

6. Thereafter, the TPO observed that the assessee had undertaking research in its transfer pricing report and selected seven comparable companies for working out the arithmetic means of 18.47%. He also observed that the Profit Level Indicator (PLI) of 13.13% was worked out by the assessee on its own segment analysis and this was taken by the assessee to be the ALP. The assessee adopted multiple data for working out the PLI of comparables. The TPO, on the ground that certain comparables selected by the assessee have to be rejected, issued a show cause notice to the assessee on 27th July 2009. The assessee gave a detailed reply. Additionally, it sought working capital adjustment of 0.47% It also sought

risk adjustment by following the capital asset pricing model. The Assessing Officer rejected these submissions, except the request for working capital adjustment.

7. From out of the seven comparables selected by the assessee company, the Assessing Officer eliminated ADS Diagnostic Ltd, Neeman Medical International (Asia) Ltd. and Pfizer Ltd., and instead including Choksi Laboratories Ltd., Transgene Biotek Ltd. and Medinova Diagnostic Services Ltd. He arrived at an arithmetic means of 28.41%. After granting working capital adjustment @ 0.47%, the mark-up as per comparables were arrived @ 27.94%. Thus, he proposed an addition of ₹ 1,39,18,191, on provisions of technical services.

8. The TPO then considered the ALP of back office support services. The Assessing Officer noted that as per the agreement entered into with the A.E., 10% mark-up was provided on total cost. He observes that in the segmental results shown by the assessee, the mark-up was 21.3%. Hence, a detailed questionnaire was issued to the assessee. The Assessing Officer explained that the billings are made on budgeted costs, while the books of account show the actual cost incurred, hence, the variation. He further explained that the accounts of the A.E. are maintained on calendar year basis while the accounts of the assessee are maintained on financial year basis. These reasons were rejected by the TPO. The assessee tried to furnish reconciliation but the same were rejected by the TPO after verification. He observed that the actual cost of ₹ 1,58,27,000, was lower than the billed costs and, hence, they could achieve a higher mark. He observed that if the A.E closed its accounts on 31st December each year, the actual costs incurred by the assessee from January to December each year after due adjustment would have been considered. He also observed that if budgeted billing was lower than the actual cost in a particular quarter, the same would be adjusted in next quarter. He held that such differences, if any, would

have definitely been taken into account by the A.Es while finalizing the accounts. At Page-8, the TPO observed as follows:-

Every AE is an independent Company and a separate profit centre. None would like to provide a higher expenditure than warranted. The AEs have allowed a mark up of 10% only and if they were finding that the AE is actually making profit of 21% they would have reduced their mark up in the first quarters of 2006 so as to make an overall mark up of 10% for the year. The assessee is not an independent company which can befool the various group companies by charging a mark up of 21.3% against agreed margins of 10%. In fact, the assessee has reported that in the next years the mark up has been increased for 10 to 15%. If the assessee was actually making a margin of 21.3% no AEs would have increased the margin from 10 to 15%.

While filing the explanation the assessee has not been able to explain the head-wise variation and the specific reasons on account of which those variations have arisen. It therefore appears that the allocation of expense by the assessee is not as per the actual budget exercise but only with a basis to work out better margins for the lower priced segments. The explanation/the segmental allocation of the assessee therefore, is rejected."

9. Thereafter, the TPO made his own transfer price study to ascertain the mark-up on back office support service the methodology of which is explained in Paras-9.3 to 9.3.5 at Page-9 to 11 of his order. The final list of comparables were taken as follows:-

9.3 In the TP report, the assessee has selected comparables from the ITES industries to benchmark its back office services. Again it was found that the assessee has calculated the PLIs as an average of the preceding three years and further many of the companies could not be considered to be proper comparables. The reasons for rejection of these companies were confronted to the assessee and also reproduced below:-

S.No.	Name of Company	Accepted / Rejected	Reasons for Rejection
1.	Airline Financial Support Services (I) Ltd.	Rejected	Financial data is not available.
2.	Allsec Technologies Ltd.	Accepted	- -

3.	Ask Me Info Hubs Ltd. (Now Known as CSS Technology Ltd.)	Rejected	Exports < 25%
4.	C.S. Software Enterprise Ltd. (Now known as CSS Technology Ltd.)	Rejected	The company is engaged in development of software. No segmental data is available
5.	Fortune Infotech Limited	Rejected	100% related party
6.	NIIT Smart Serve Ltd.	Rejected	Consistent loss
7.	Nucleaus Netsoft & Gis India Ltd.	Accepted	Now Asit C. Mehta & Co.
8.	Tata Services Ltd.	Rejected	Registrar
9.	Transwork Information Service Ltd.	Accepted	- -
10.	Tricom India Ltd.	Rejected	Financial data not available
11.	Vishal Information Technologies Ltd.	Accepted	- -
12.	Wipro BPO Solutions Ltd.	Rejected	No financial data available
13.	Ace Software Exports Ltd.	Accepted	- -
14.	BT Tech Net Ltd.	Rejected	No financial data available
15.	Tulsyan Technologies Ltd. (Formerly known as Cosmic Global Ltd.)	Accepted	- -
16.	Goldstone Teleservices Ltd. BPO segment	Accepted	- -
17.	Hypersoft Technologies Ltd. BPO segment	Rejected	Consistent loss
18.	CMC Ltd. – ITES segment	Rejected	It failed in export filter. Its export is only 9%
19.	Indus Networks Ltd.	Rejected	Consistent loss
20.	Mapro Industries Ltd.	Rejected	Consistent loss

9.3.1 the department has conducted the separate search for selection of comparables in the IT industry. The search strategy and the comparables are reproduced below. This was confronted to the assessee vide questionnaire dated 17th July 2009. The search for suitable comparables is conducted based on the data available in

Prowess and capitalinedatabases. These two databases were searched and the filters are applied on these data. The information on related party transactions is taken from these databases and Annual Reports. In some of the cases, either the Annual Reports or the information in respect of export turnover, related party transactions, etc. are not available. Such information is asked from the companies under the express provisions of section 92CA(7) read with sec. 133(6) of the Act. Based on the information received as on date, the search process and results thereon are given below:-

9.3.2 Prowess Database

Key Word Search

The search process in Powess Database was carried under the head "Company Classifications" and under the subheading "Non-financial Services" – "Services (Other than Financial) – "Information Technology" – ITES. Thus, the search for suitable comparables is based on the key word "ITES". The search was carried on 29.1.2009. It has thrown up 97 companies. The search process is elaborated as under:-

Step	Description	No. of Companies Resulted	No. of companies eliminated
1.	Number of companies resulted by the key word "ITES"	97	
2.	The companies for which the data is available for the F.Y. 2005-06	50	47
3.	The companies which have service income.	42	8
4.	The companies whose turnover is more than ₹.1 crore.	32	10
5.	The companies whose service income is more than 75% of the revenues.	32	0

6.	<i>The companies whose export revenues are more than 25% of the revenues.</i>	24	8
7.	<i>Related party transactions < 25% of the revenues (based on the data available in the databases)</i>	17	7
	<i>Balance companies for further examination.</i>	17	

The balance 17 companies were examined further as follows. In some of the companies, the RPT information, segmental information, export earnings and other information relating to functionality is not available. The same were asked u/s 133(6) from the companies. Based on the information received 7 companies have been selected as comparables.

9.3.4 Segment Search

The segmental search is also carried to search for companies who have segment relating to IT enabled services. Under the main head "Query by Product / Segment" in Prowess Database, and sub-head "Segment-wise information", the keyword "IT Enabled Services / BPO" was searched. This search has thrown 41 companies. In some of these 41 companies, the annual reports, related party transactions information, segmental information etc. is not available. Thus, these companies were issued notices u/s 133(6) to submit this information. 3 Companies have been selected as comparables from the Prowess segment search.

<i>Step</i>	<i>Description</i>	<i>No. of Companies Resulted</i>	<i>No. of companies eliminated</i>
1.	<i>Number of companies resulted by the segment search</i>	41	
2.	<i>Number of companies not already covered under the key word search as above</i>	36	5

3.	ITES revenue / segment available for the F.Y. 2005-06	29	7
4.	Replies u/s 133(6) in respect of segmental data	22	7
5.	Number of companies with less than 25% RPT	14	8
6.	Number of companies with turnover more than ₹ 1 cr.	12	2
7.	Number of companies with export revenue more than 25% of the revenues	4	8
8.	Reliability of data (Satyam Computer Services Eliminated)	3	1
	Balance	3	

9.3.5 Capitaline Plus Database

Key Word Search

The search process in Capitaline Plus Database was carried under the head "Industry" based on the key word "IT Enabled Services / Business Process Outsourcing". The search was carried on 03.02.2009. It has thrown up 73 companies. The search process is elaborated as under:-

Step	Description	No. of Companies Resulted	No. of companies eliminated
1.	Number of companies resulted by the key word "IT enabled Services / Business Process Outsourcing"	73	
2.	The companies for which the data is available for the F.Y. 2005-06	26	47
3.	Companies exclusively in Capitaline (and not in Prowess)	14	12
4.	The companies whose turnover is more than ₹ 1 cr.	12	2

5.	<i>The companies whose export revenues are more than 25% of the revenues.</i>	10	2
6.	<i>Related party transactions < 25% of the revenues (based on the data available in the databases)</i>	8	2
	<i>Balance companies for further examination</i>	8	

The balance 8 companies were examined further as follows. In some of the companies, the RPT information, segmental information, onsite revenues information and other information relating to functionality is not available. The same were asked under section 133(6) from the companies. Out of these, none of the companies has been selected as comparables based on the information received from the companies.

9.3.6 Segment Search

The segmental search is also carried to search for companies who have segment relating to IT enabled services. The search criteria are as under:-

Domain – companies – select all companies (17435)

Filters – Segment Finance

Keywords used (for company segment name)

- *BPO*
- *BPO Services*
- *Back Office Transactions Processing*
- *ITES*
- *ITES / BPO*
- *IT Enabled Services*
- *IT Enabled Services*
- *IT & ITes*
- *Medical Transcription*
- *Call Centre Operation*
- *Content Management BPO*
- *GIS Based Services*
- *Office Back Up Operations*
- *Software & BPO*

The above key words are used for segmental search for the F.Y. 2005-06. This search was carried on 3.2.2009 and has thrown 23 companies. In some of these 23 companies, the Annual Reports, related party transactions information, segmental information etc. is not available. Thus these companies were issued notices u/s 133(6) to submit this information. Out of these, none of the companies has

been selected as a comparable based on the information received from the companies u/s 133(6).

Additional Comparables:-

While doing the search process for suitable comparables in the software sector, some of the companies though categorized as software service provider are in fact either in the IT enabled services sector or have IT enabled services as one of the business segment.

The search criteria for the software sector are summarized as under:-

Database	Description of the Search	Keywords used
Prowess	Keyword Search	Computer Software
Prowess	Segment Search	Computer Software, Software Services & Consultancy
Capitaline	Keyword Search	Computer – Software – Converts, Computer – Software – Large and Computer – Software – medium / small.
Capitaline	Segment Search	<ol style="list-style-type: none"> 1. Software 2. Software & BPO 3. Software & Processing charges 4. Software activities 5. Software Development 6. Software Development & Related 7. Software Development & Sal 8. Software Development & Ser 9. Software Development & Ser 10. Software Development India 11. Software Division 12. Software Maintenance 13. Software Production 14. Software Products & Services 15. Software Services 16. Software Solutions & Services 17. Software Training & Develop

As a result of above search, the probable comparables were also examined to see whether those companies are into IT enabled services based on their annual reports and / or information submitted in response to 133(6) notices. These companies are discussed as under:-

S.No.	Name of Company	Reason for acceptance / rejection
1.	Apex Knowledge Solutions Ltd.	<i>In response to notice u/s 133(6), the company categorically stated that they are into IT enabled services. It also qualifies all the filters applied by the TPO. The same is considered as a comparable.</i>
2.	Cepha Imaging Pvt. Ltd.	<i>Though the company is not IT enabled services, 100% of its services are rendered to its related parties and thus fails 25% related party transactions filter.</i>
3.	ICRA Techno Analytics Ltd.	<i>The company was asked u/s 133(6) to submit segmental financial pertaining to ITES segment. The company is yet to submit information. At this stage, the company is not considered as a comparable due to lack of segmental data for the FY 2005-06 & failing the export filter.</i>
4.	IT People (India) Ltd.	<i>The functionality of the company is not clear from the annual report as it runs a job portal which is not akin to rendering IT enabled services. The company was asked u/s 133(6) to submit the information. Thus, at this stage, the company is not considered as a comparable due to lack of information on functionality for the FY 2005-06.</i>
5.	R. Systems International Ltd.	<i>Based on the segmental information submitted by the company in response to notice u/s 133(6), the company has an ITES segment and this segment qualifies all the filters applied by the TPO.</i>
6.	Wipro Ltd.	<i>The company's annual report for the FY 2005-06 did not have segmental results for BPO segment on stand alone basis. The company was asked under section 133(6) to submit segmental information pertaining to BPO segment. But the company said that it is not able to submit segmental information on stand alone basis. Therefore rejected.</i>

7.	<i>Syntle (India) Ltd.</i>	<i>Annual report is not available for the FY 2005-06. As per the information and annual report submitted by the company, in response to 133(6) notice, the company has stated that it is into software services and ITES segment. 92% of IT enabled services are rendered to its AEs. Thus it fails RPT filter and is not considered as a comparable.</i>
8.	<i>Mold Tek Technologies Ltd.</i>	<i>AS per the information submitted by the company, the company is into IT enabled services segment. The company earned a profit of ₹ 1,60,28,000 on an operating cost of ₹ 2,14,77,839. As the company's operating profit is 74.63% on cost, the same is not considered as a comparable as it has very high margin by any standard. Thus, it is not considered as a comparable.</i>
9.	<i>Sitel India Ltd.</i>	<i>The company is an IT enabled service provider. But, based on the information and the annual report submitted by the company in response to 133(6) notice, almost 100% of its revenue are generated from its AEs for the FY 2005-06. Thus, it fails RPT filter and is not considered as a comparable.</i>
10.	<i>Autoline Dimensions Software P. Ltd.</i>	<i>As per the information submitted by the company, in response to notice u/s 133(6), the ITES segment of the company fails 25% export earning filter. Its ITES segment has only 19.55% of its revenues as exports. Thus the company is not considered as a comparable.</i>
11.	<i>Flextronics Software Systems Ltd. (Seg.)</i>	<i>Based on the segmental information submitted by the company in response to notice u/s 133(6), the company has an ITES segment and this segment qualifies all the filters applied by the TPO.</i>
12.	<i>Ace Software Exports Ltd.</i>	<i>As the company is into IT enabled services and qualifies all the filters applied by the TPO, the same is considered as a comparables.</i>

9.3.6

FINAL SET OF COMPARABLES

Step	Name of Company	Sales ₹ in crore	OP to Total cost %
1.	Ace Software Exports Ltd.	4.97	7.72
2.	Allsec Technologies Ltd.	92.25	28.51
3.	Apex Knowledge Solutions P. Ltd.	4.92	20.48
4.	Asit C. Mehta Financial Services Ltd. (Earlier known as Nucleus Netsoft & GIS (I) Ltd.)	5.68	34.52
5.	Cosmic Global Ltd. (Seg.)	3.11	16.03
6.	Datamatics Financial Services (Seg.)	2.31	24.99
7.	Flextronics Services Systems (Seg.)	21.41	14.54
8.	Goldstone Infratch Ltd. (Seg.) (Earlier known as Goldstone Teleservices Ltd.	5.03	29.01
9.	Maple eSolutions Ltd.	7.43	32.66
10.	R Systems International Ltd. (Seg.)	9.17	15.11
11.	Spanco Ltd. (Seg.) (Earlier known as Spanco Telesystems & Solutions Ltd.)	82.32	20.86
12.	Trensworks Information Services Ltd.	163.3	19.56
13.	Vishal Information Technologies Ltd.	25.64	48.03
	Arithmetic mean		24.00%

NOTE:

1. All the figures are taken from the annual reports;
2. Costs taken for the computation of margins are the costs before interest charges;
3. Forex gain/loss is not taken as part of the operating expenses as forex gain is categorized as other income; and
4. Loss of sale of assets, etc., are not taken as expenditure.

21. The assessee gave its objections. The Assessing Officer, after considering various contentions, held that the assessee had worked out the adjusted average PLI of the comparables @ 24.43% and this would be used for bench marking the back office support services. Thereafter, the TPO considered the submissions of the assessee, in respect of adjustments of risk being a captive unit. He came to a conclusion that there is no difference

between the assessee and the comparable companies. He computed ALP of service would be ₹ 4,76,49,682, as against the actual receipt of ₹ 4,21,23,805, and arrived at an adjustment of ₹ 55,25,877. On the request of the assessee for benefit of +/- 5% in respect of the adjustment in terms of the provisions of section 92C(4), the Assessing Officer held that the variation in price is more than 5% and, hence no relief can be given and concluded that the total adjustment should be ₹ 1,94,44,068. The draft of the proposed assessment order was forwarded to the assessee on 26th November 2009. The assessee carried the matter before the Disputes Resolution Panel (DRP). Before the DRP, the assessee is recorded as having raised two main objections i.e., with respect to transfer pricing adjustment of ₹ 1,39,18,191, on account of technical service and (ii) adjustment of ₹ 55,25,877, on account of back office support service. The DRP rejected the objections of the assessee on exclusion of three loss making companies on the ground that they are not comparable companies. As regards elimination of Pfizer Ltd., from the list of comparables the DRP directed the Assessing Officer to include Pfizer Ltd. On the issue of back office support service, it observed that the assessee has argued that the actual profit shown by it is 21% as against 24% margin worked out by the Assessing Officer. It held that this falls within +/-5% range. It observed that the Assessing Officer cannot ignore the actual mark-up earned by the assessee while comparing the average mean worked out by him with the mean shown in the agreement. It held that the Assessing Officer's action cannot be sustained. The DRP directed the Assessing Officer to compare the average mean worked out by him with 21% actual profit shown by the assessee and then to apply the range +/-5% and in case the adjustment falls within the range, it directed that the Assessing Officer should not make any adjustment. The Assessing Officer, in his order dated 20th September 2010, made an adjustment of ₹ 1,24,03,828, on account of technical services and also retained the transfer pricing adjustment of ₹ 55,25,877 with regard to back office support service.

He held that the assessee does not get the benefit of +/-5% range as the amount of ₹ 4,21,23,805, shown by the assessee for back office support service is beyond the limit of the ALP of such service determining at ₹ 4,76,49,682. Aggrieved, the assessee filed this appeal before the Tribunal on the following grounds:-

"1. The Assessing Officer passed in pursuance of the directions issued by the DRP is a vitiated order, as the DRP erred both on facts and in law in partially confirming the addition made by the Dy. CIT, to the appellant's income.

2. The Assessing Officer erred in facts and in law in concluding the assessment under section 143(3) r/w section 144C(13) of the Act in -

2.1 making an adjustment to your appellant's international transactions of provisions of technical services and back office support services at ₹ 1,24,03,828 and ₹ 55,25,877 respectively.

2.2 disregarding the arm's length price (ALP) and the methodical benchmarking process carried out by the appellant in the Transfer Pricing (TP) documentation maintained by it in terms of section 92D r/w Rule 10D of the I.T. Rules, 1962.

2.3 not allowing the use of multiple year data as prescribed under Rule 10B(4) of the Rules r/w the OECD TP guidelines, and determining the arm's length price on the basis of financial information of the comparables for the year ended March 31, 2006 identified pursuant to a fresh search for comparables performed during the assessment proceedings. The A.O./TPO/DRP erred in rejecting the contemporaneous documentation maintained by the appellant as required under the Indian TP regulations;

2.4 not granting risk adjustment to the appellant to account for the differences in the risk profile of the comparables vis-à-vis the technical services and back office support services carried out by appellant.

2.5 not correctly granting the benefit of working capital adjustment in relation to technical services; and

2.6 denying the benefit of (+/-) 5% range mentioned in proviso to section 92C(2) of the Act while computing the ALP.

The appellant prays that the book value of the international transactions of technical services and back office support services, should be held to be the arm's length price of the said transactions as per the appellant's Transfer Pricing documentation, and the A.O. be directed to delete the addition made keeping the aforesaid grounds in perspective.

Without prejudice to the above, the A.O. erred in not following the directions of the DRP, in relation to back office services, whereby the DRP directed to delete the adjustments in relation to back office services, if the appellant's margin is within +/- 5% of the margin proposed by the TPO and your appellant's margin is within the said 5% range.

The above grounds are without prejudice to each other.

3. The A.O. erred in facts and in law in disallowing a sum of ₹ 2,61,761 being 25% of the total entertainment expenses of ₹ 40,47,046 incurred by the appellant during the year under consideration."

22. Learned Counsel, Mr. Sourabh Soparkar, appearing on behalf of the assessee, listed out the issues that arise for adjudication in this appeal on the issue of transfer pricing adjustment on technical service segment, as follows:-

- i) Whether it is proper for the TPO to exclude the loss making unit from comparables and if so, whether highly profit earning comparables should also be excluded for the same reason.*
- ii) Whether working capital adjustment and risk adjustment has to be taken into account while arriving at ALP.*

23. Though a number of grounds were raised and papers were filed, the learned Counsel restricted his submission to only the above issues and stated that other issues were not pressed. He submits that in the transfer pricing study, the assessee has taken average of two years' data for

comparison but the TPO has taken only one year. He submits that for various reasons, the assessee does not want to press this issue. In view of the above submissions, we dismiss this argument of the assessee.

24. On the second issue of rejection of loss making comparables, the learned Counsel drew the attention of the Bench to Page-226 of the paper book and submits that it is clear from the director's report of the comparable company, ADS Diagnostic Ltd. that the decrease in scanning income is due to stiff competition from the existing and new diagnostic centres that are coming up in and around Delhi. He pointed out that the loss after depreciation has, in fact, decreased from ₹ 21,76,000 to ₹ 14,32,000. His case is that, the company should be accepted as functionally comparable.

25. On the rejection of comparable Neeman Medical International (Asia) Ltd., he points out that gross revenue has increased during the year. He points out that company's clinical trial income has reduced as compared to last year. He submits that this company was wrongly treated as a consistent loss maker as it had a loss of ₹ 28,00,000 in financial year 2003-04 and, whereas a profit of ₹ 15,00,000 to the financial year 2004-05. For the proposition that loss making entities cannot be excluded, he relied on the following case laws:-

- ♦ *Mentor Graphics (Noida) P. Ltd. v/s DCIT, (2007) 112 TTJ 408 (Del.)*;
- ♦ *Aztec Software & Technology Services Ltd. v/s ACIT, ITA no.584 and 585/Bangl./2006*;
- ♦ *E-gain Communication Pvt. Ltd. v/s ITO, 118 TTJ 354*;
- ♦ *Sony India Pvt. Ltd. v/s DCIT, 1189/Del./2005 & Ors*; and.
- ♦ *SAP LABS India P. Ltd. v/s ACIT, ITA no.398/Bang./2008*.

26. On the issue of adjustment for working capital and adjustment for risk, the learned Counsel submits that he is not pressing for the same. Thus, these issues are dismissed as "*not pressed*".

27. Coming to the order of the Dispute Resolution Panel (for short "*DRP*"), the learned Counsel submits that detailed submissions were made and detailed objections were raised but the *DRP*, without considering any of the submissions or the material, has disposed off the case unjustly in a summary manner. He contends that no discussion was made on the 5% margin.

28. Coming to the second issue of back office services, he submits that the services include customers' support service, customer satisfaction advisory services and product stewardship advisory services. He submits that under the scheme of the Act, the Assessing Officer is bound to follow the directions of *DRP*. While submitting that the details submissions were made before the *DRP* and that the *DRP* has not taking into account any of the objections and submissions, he points out that the direction of the *DRP*, if implemented, calls for no addition in this case. He gave the following calculations in support of his submissions that no adjustment is called for after applying 5% range.

<i>Particulars</i>	<i>Profit & Loss Account</i>	<i>Computation of Arm's Length Price</i>
<i>Operating Income</i>	4,21,23,805	4,32,11,194
<i>Less: Operating Expenses (TC)</i>	3,47,27,312	3,47,27,312
<i>Operating Profit (OP)</i>	73,96,493	84,83,882
<i>OP/TC</i>	21.30%	24.43%

<i>Arm's Length price of services (ALP)</i>	4,32,11,194
<i>Application of the Range-ALP x 0.95</i>	4,10,50,635

The revised ALP (after applying 5% margin) is ₹ 4,10,50,635. As the actual income is ₹ 4,21,23,805, no adjustment would be required."

29. On the issue of ground no.3, the learned Counsel submits that he is not pressing the same. Thus, this ground is dismissed as "*not pressed*".

30. Learned Departmental Representative, Mr. D. Songate, on the other hand, controverted the submissions made by the assessee's counsel. On the first issue of adopting multiple year data or single year data, the learned Departmental Representative noted that assessee's counsel has not pressed the same and, hence, made no submissions.

31. On the issue of elimination of loss making units from the list of comparables, the learned Departmental Representative relied on the order of the DRP as well as that of the TPO and submits that consistent loss making companies cannot be treated as proper comparables. He basically relied on the order of the TPO and submits that the assessee has not been receiving any mark-up on technical services provided to its A.Es in the form of research and development at BRDTC. He points out that the result of research would be enjoyed by the A.E. with all the intellectual property rights and, at the same time, the assessee has not been compensated at arm's length. He relied on the order of the TPO and submitted that the units eliminated were not comparable as they do not give PLI in an ideal situation. Coming to the directions of DRP, the learned Departmental Representative relied on section 144C(11) and submits that the act requires the DRP to give an opportunity to the Assessing Officer, if the direction is prejudicial to the interests of Revenue. Thus, he argues that once opportunity has not been given to the Assessing Officer, the directions issued by the DRP would not be binding on the Assessing Officer. He submits that sub-section (11) is mandatory and non-observance of the same by DRP vitiates the proceedings.

32. In reply, learned Counsel submits that all the issues were before the Assessing Officer and TPO and that the learned Departmental Representative cannot raise an objection at this stage on the direction of the DRP. He vehemently contended that the Assessing Officer has not been given a statutory right to appeal against the order of the DRP and, hence, what he cannot do directly, cannot also be done indirectly. He submits that the learned Departmental Representative is challenging the DRP through a back door and this should not be permitted. He further submits that it is never the case of the Assessing Officer that he has not been heard.

33. Rival contentions were heard. On a careful consideration of the facts and circumstances of the case and on perusal of the papers on record, as well as the case laws cited before us, we hold as follows:-

i) The issues that arise for our adjudication is the transfer pricing adjustment made on provision of technical service and transfer pricing adjustment made on provisions of back office support services by the assessee to its A.Es. The other issues are not pressed by the learned Counsel and, hence, the same are not adjudicated.

ii) The first issue that we would address is the claim of the assessee on aggregation of services under the head "*technical services*". The assessee's business is divided into (i) marketing service segment; (ii) technical service segment and (iii) back office support services. There is no dispute on the marketing service segment. The dispute pertains to technical service segment and back office support service.

iii) In the technical service segment, there are three activities i.e., (a) application research at BRDTC; (b) application of technical development services and (c) promoting the licensing of technology.

iv) For application research carried out at BRDTC, no mark-up is paid by the A.E. As far as the application research is concerned, the A.E. reimbursed

cost plus 10%. For the activity of promotion of licensing of technology, US\$ 40,000 is annually reimbursed by the A.E. The assessee seeks to club all these three activities and, thereafter, determined the ALP. It is a case of the assessee that all these operations put together generated 13.13% The TPO rejected the aggregation approach on the ground already stated in the preceding paragraph. We fully agree with the findings of the TPO. We do not understand as to how carrying on application research at BRDTC can be clubbed with, the activity of promoting the licensing of technology owned by the overseas group entity. We note that the A.E. reimbursed only the cost incurred by BRDTC on research. No mark-up is given. Not charging mark-up on application research at BRDTC, in our opinion, justifies transfer pricing adjustment in this case. No part of the income derived by the A.E. from the activity of application research at BRDTC is given to the assessee. The entire benefit of the activity are taken by the A.Es only.

v) The other aspect which is in dispute is, whether the data of one year has to be taken or multiple year data has to be taken. Rule-10B(4) of the I.T. Rules, 1962, reads as follows:-

"4. The data to be used in analyzing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared."

vi) A plain reading of this rule makes it clear that the data relating to the financial year only has to be taken. As an exception, the rule also provides that the data of two years prior to the financial year may be taken, only if, such data reveals the facts which could have influenced the determination of transfer pricing. When the assessee wants to consider previous year's data,

then the burden is on the assessee to demonstrate that the previous year's data contained certain facts which would influence the determination of transfer pricing. In the case on hand, no such evidence is laid by the assessee. A general argument is made that, taking more than one year data, would give a better comparable. The rule does not provide for general submissions. In the absence of the assessee specifically demonstrating that the data of the prior financial year reveals fact which influence the determination of the transfer price of the transactions being compared, the question of taking into consideration data other than the current year's data does not arise. This brings us to the issue of rejection of loss making comparables. The Assessing Officer rejected the following comparables:-

- *ADS Diagnostic Ltd,*
- *Neeman Medical International (Asia) Ltd.*

vii) The assessee argues that on a perusal of the company's accounts of ADS Diagnostics Ltd. for assessment year 2005-06, the income from scanning services has reduced due to stiff competition from existing and new diagnostic centres that were coming up in and around Delhi and the loss is attributable to stiff competition. The assessee also points out that the statutory auditor has not mentioned that the company has been facing any going concern issues. In our opinion, the TPO has rightly rejected this comparable for the following reasons:-

The directors' report of ADS Diagnostic Ltd., reads as follows:-

"The operational income of the company has increased from ₹ 248.44 lacs to ₹ 271.69 lacs in the current year registering a growth of 9.36% for the year under review. However, income from scanning business has decreased from ₹ 174.34 lacs to ₹ 165.02 lacs during the year under review. The income from trading and servicing has been increased from ₹ 61.51 lacs to ₹ 82.26 lacs and ₹ 7.24 lacs to ₹ 23.24 lacs respectively. Overall income increased by ₹ 23.25 lacs. The decrease in scanning income is due to stiff competition from the existing and new diagnostic centres that are coming up every year in

and around Delhi. Loss after depreciation has decreased from ₹ 21.76 to ₹ 14.32 lacs during the year under review.”

viii) A perusal of the same demonstrates that the decrease is of scanning income and that operational income has, in fact, increased at ₹ 2,48,44,000 from ₹ 2,71,61,000. Income from trading and servicing balance has been increased at ₹ 65,51,000 to ₹ 82,26,000 and ₹ 7,24,000 to ₹ 23,24,000 respectively. Over all income increased by ₹ 23,25,000. The loss after depreciation, during the year under review, has decreased from ₹ 21,76,000 to ₹ 14,32,000. Thus, the income from scanning business has decreased, income from trading has increased and income from services has increased. Fundamentally, in this case, the comparison itself is flawed for the reason that enterprise level profits are taken for comparison. The actual margin of servicing segment has not been identified. The main income is from scanning. The function of the assessee is not akin to scanning. Being a diagnostic laboratory it is common knowledge that one of the main expenditures is in the form of referral fees to doctors. The assets base and the machinery required for diagnostic laboratory is different from the requirements of the assessee company, whose main function is related to EMCC products. The assessee is a captive unit and has no risk in the form of stiff competition. If ADS Diagnostic Laboratory Ltd. has made a loss due to stiff competition not only from existing units, but also from new diagnostic centers that were coming up in and around Delhi, then, the loss made by such a unit cannot be taken into account bench marking, as no such circumstance exists in the assessee's case. Thus, in our opinion, this comparable is rightly rejected by the TPO.

ix) Coming to the case of Neeman Medical International (Asia) Ltd., the statement of accounts are at Pages-248 to 252 of the paper book. The learned Counsel argues that the clinical trial income of Neeman Medical International (Asia) Ltd., has reduced during the year as compared to the last year and, hence, there is a loss. It is submitted that this company is not

a consistent loss maker as it has profit of ₹ 15,00,000 for the financial year 2004-05. It further submits that the company has embarked upon a long term strategy to move up the value chain and enhance its services offering to enable the company to access a larger segment of customers and offer them a bouquet of clinical trial service under one roof. Here also, they rely on the statutory auditor's report and pointed out that no going concern issues are not raised by the statutory audit.

x) In our opinion, statutory audit not mentioning that they are going concern issue, does not help the case of the assessee. It cannot be said that the loss making units, which are only having going concern issues, are to be eliminated. In the case on hand, the gross revenue of the company has reduced from ₹ 4,45,60,000 to ₹ 2,85,68,000. In the previous year, the company earned net profit of ₹ 18,36,000, whereas in the current year, the loss is ₹ 1,28,53,000. The above figures demonstrate that there is more than a normal change in the profitability of the company. There is a fall in the profit by ₹ 1.47 crores (approx.), when there is a fall in turnover of about ₹ 1.60 crores (approx.). These figures are abnormal and without explaining a huge fall in profits as compared to the fall in turnover, the assessee cannot, in our opinion, argue for inclusion of this comparable. Thus, we uphold the findings of the TPO that these two loss making units are not to be taken as comparables.

xi) Now, coming to the alternative arguments of the assessee that abnormal profit making unit is also to be eliminated on the same analogy on which loss making units are excluded, we, in principle, do not dispute this proposition. The various case laws relied upon by the assessee lay down that a comparable cannot be eliminated just because it is a loss making unit. Similarly, a higher profit making unit cannot also be automatically eliminated just because the comparable company earned higher profits than the average. The reason for rejecting the two loss making units is not just

because they were loss making units but for the reasons which are already stated in the preceding paragraphs. If similar reasons existed in the higher profit making unit, then, it is for the assessee to bring out those reasons and seek exclusion of the same. A general argument that, you have to exclude units which have high profit range, in case you exclude units which have made loss is a general submission which cannot be accepted. In other words, as a general principle, both loss making unit and high profit making unit cannot be eliminated from the comparables unless, there are specific reasons for eliminating the same which is other than the general reason that a comparable has incurred loss or has made abnormal profits. Thus, this ground is dismissed.

xii) The other issue is grant of adjustments i.e., working capital adjustment and risk adjustment while arriving at ALP. In this case, the assessee in his transfer pricing study, has not made any working capital adjustment or risk adjustment. The Assessing Officer has, in fact, granted working capital adjustment. When the assessee is confronted with the possible transfer pricing adjustment due to change of some comparables and addition of certain other comparables by the TPO, this claim of risk adjustment is made by the assessee. Though, in principle, these adjustments have to be made while arriving at the ALP, on the facts and circumstances of the case, as the assessee has not worked out the risk adjustment and as the Assessing Officer has already allowed 0.47% as working capital adjustment, we are of the opinion that no further adjustment is necessary. In any event, as already stated, the learned Counsel has not pressed for the same and, hence, we dismiss the argument.

xiii) The next contention is that the Assessing Officer has wrongly taken the margin of Pfizer Ltd. as 4.07%, as per transfer pricing study instead of one year up / margin of 7.41%. It is also submitted that the revised ALP is

within the range of +/- 5% if the figures are correctly taken and calculations made. Detailed table and working are submitted before us. The learned Departmental Representative was not able to controvert these submissions of the assessee. Under these circumstances, we are of the opinion that the issue of computation has to be set aside to the file of Assessing Officer, for limited purpose of quantification of the transfer pricing adjustment. In case the ALP determined by the Assessing Officer is within the range of 5% of the actual income, then no adjustment need to be made. With these observations, we set aside the matter to the file of Assessing Officer.

xiv) This brings us to the second issue which relates to determination of ALP of back office support services – whether the Assessing Officer is bound by the directions of the DRP. The DRP directed as follows:-

"The next TP ground relates to back office services support. The facts are that as per agreement with the AEs, the assessee was to receive 10% market on the actual expenses but the factual position is that the assessee has earned 21% profit as a result of final accounting and hence the actual profit shown by the assessee from the service is 11% higher than the agreement amount. The A.O. conducted its TP search and chose 13 companies which resulted into average margin of 24% and the A.O. made TP adjustment by holding that the assessee has charged only 10% mark while it should be 24% mark. At the first instance, the assessee argued that actual profit shown by the assessee is 21% and in case it is compared with the 24% margin worked out by the A.O. then it falls within the plus minus range of 5% adjustment, and ultimately no TP adjustment is called for. The DRP has carefully considered the matter and is of the view that the A.O. cannot ignore the actual mark up earned by the assessee while comparing the average mean worked out by him with the mean shown in the agreement. Therefore, the A.O's action cannot be sustained. Accordingly, the A.O. is directed to compare the average mean worked out by him with the 21% actual profit shown by the assessee and then apply the range of plus minus 5% and in case of adjustment falls within the range, then he should not make any adjustment."

xv) The argument of the learned Departmental Representative that the Assessing Officer has not been given an opportunity by the DRP in terms of sub-section (11) to section 144C and, hence, sub-section (10) is not applicable, is devoid of merit for the reason that the Assessing Officer, while

passing the assessment order under section 143(3) r/w section 144C(13) on 20th September 2010, has not taken that plea. Learned Departmental Representative cannot change the basis on which the Assessing Officer based his decision and take a totally novel and new plea in the appellate proceedings. Without going into correctness or otherwise, the decision of DRP, we are of the opinion that the directions of the DRP have to be followed by the Assessing Officer.

xvi) ENCPL's margin is 21.30% and the arithmetic mean of comparable companies is 24.43%. The ALP works out to ₹ 4,32,11,194 and if 5% range is given to ALP, this works out to ₹ 4,10,50,635. This is below the operating income of ₹ 4,21,23,805 actually earned by the assessee. In view of the above figures, no adjustment is required. Thus, the adjustment made by the Assessing Officer is hereby deleted as the same is not in consonance with the direction of the DRP. This issue is decided in favour of the assessee.

xvii) The other issues being not pressed, the same are dismissed as such.

34. In the result, assessee's appeal is allowed in part.

Order pronounced in the open Court on 10TH June 2011.

Sd/-
VIJAY PAL RAO
JUDICIAL MEMBER

Sd/-
J. SUDHAKAR REDDY
ACCOUNTANT MEMBER

MUMBAI, DATED: 10TH JUNE 2011

Copy to:

(1) The Assessee; (2) The Respondent; (3) The CIT(A), Mumbai, concerned; (5) The CIT, Mumbai City concerned; (6) The DR, "E" Bench, ITAT, Mumbai.

**TRUE COPY
BY ORDER**

Pradeep J. Chowdhury
Sr. Private Secretary

**ASSISTANT REGISTRAR
ITAT, MUMBAI BENCHES, MUMBAI**