

IN THE INCOME TAX APPELLATE TRIBUNAL  
“C” BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, JUDICIAL MEMBER  
AND SHRI ABRAHAM P. GEORGE, ACCOUNTANT MEMBER

IT(TP)A No. 192/Bang/2015
Assessment year : 2010-11

The Deputy Commissioner of Income Tax, Circle 5(1)(1), Bangalore.	Vs.	M/s. Trident Microsystems India Pvt. Ltd., No.2924, 3 <sup>rd</sup> Floor, 14 <sup>th</sup> Cross, K.R. Road, BSK 2 <sup>nd</sup> Stage, Bangalore – 560 070. <b>PAN : AADCN 1384L</b>
APPELLANT		RESPONDENT

Appellant by	:	Shri T.S.N. Murthy, CIT-III(DR)
Respondent by	:	None

Date of hearing	:	09.06.2015
Date of Pronouncement	:	29.06.2015

**ORDER**

*Per N.V. Vasudevan, Judicial Member*

This appeal by the Revenue is against the order dated 30.1.2015 of the DCIT, Circle 5(1)(1), Bangalore passed u/s. 143(3) r.w.s. 144C(13) of the Income-tax Act, 1961 [“the Act”] for the assessment year 2009-10.

2. The sole ground of appeal by the Revenue reads as follows:-

“Turnover filter: The learned DRP erred in holding that the size, turnover and brand of the company are deciding factors for treating a company as a comparable and accordingly erred in excluding M/s. Infosys Technologies Ltd.”

3. The assessee is a company engaged in the business of providing sales, marketing, research and development services. The assessee entered into an agreement for provision of software R&D services with Trident Microsoft Systems (Fareast) Ltd. It is not in dispute that the aforesaid transaction was an international transaction with AE and therefore the price charged by the assessee has to pass the arm's length test as laid down u/s. 92 of the Act.

4. After rejecting the TP study conducted by the assessee, the TPO to whom the determination of ALP was referred to by the AO, chose 11 comparable companies, the arithmetic mean of the profit margins of those 11 companies was 22.71%.

5. The financial results of the assessee were as follows:-

	Rs.
Operating Revenues *	18,47,25,719
Operating Expenses **	17,26,70,219
Operating (Profit)/Loss	1,20,55,500
Op Profit on cost %	6.98%

\* Excluding other income

\*\* Excluding forex & financial charges.

6. The TPO accordingly made an addition to the total income by way of adjustment to ALP after working capital adjustment as follows:-

“Computation of Arms Length Price:

The arithmetic mean of the Profit Level indicators is taken as the arms length margin. Please see Annexure B for details of computation of PLI of the comparables. Based on this, the arms length price of the services rendered by the tax payer to its AE(s) is computed as under:

SOFTWARE DEVELOPMENT SERVICES

Arm’s Length Mean Margin on cost	22.71%
Less: Working Capital Adjustment (As per Annex. C)	1.98%
Adjusted margin	20.73%
Operating Cost	17,01,47,362
Arms Length Price (ALP) (120.73% OF Operating Cost)	20,54,18,910
Price Received	18,19,81,626
<b>Shortfall being adjustment u/s. 92CA</b>	<b>2,34,37,284</b>

The above shortfall of Rs.2,34,37,284/- is treated as transfer pricing adjustment u/s. 92CA in respect of software development segment of the taxpayer’s international transactions.”

7. The assessee filed its objections to the proposals of the TPO before the DRP. Amongst other objections, the principal objection of the assessee was that out of 11 comparable companies chosen by the TPO, the turnover of Infosys Ltd., L&T, Mindtree Ltd., Persistent Systems Ltd., Sasken Communication Technologies, Tata Elxsi were beyond Rs.200 crores and therefore they cannot be compared with a company like the assessee,

whose operating margin was only Rs.18.47 crores. The assessee relied on the decision of ITAT Bangalore Bench in the case of *Genesis Integrating Systems (supra)*.

8. The DRP accepted the aforesaid objection of the assessee with the following observations:-

“10.65 Turnover Filter: The TPO had applied the turnover filter with Rs. 1 crore at the lower end but with no cap at the upper end. The assessee submitted that companies having varied turnovers cannot be compared to each other as the difference in their size and scale of operations have a direct impact on their profitability. In this regard, the concept of ‘Economies of Scale’ was explained before the Panel, wherein, an increase in the size and scale of operations lead to a decrease in the long run average cost of each unit produced or each service project delivered. Thus, the ‘per unit’ fixed cost of a small size company would be much higher than that of a medium / large sized organisation.

The Hon’ble Bangalore ITAT in the case of *Genisys Integrating Systems (supra)* had provided a guideline in the matter of turnover filter by suggesting that the categorization of software companies in the Dun & Brad Street Study be adopted as a method of classification of companies by size. According to this study, 3 categories of firms were identified i.e. “small” with turnover less than Rs.200 crore, ‘medium’ with turnover between Rs.200 crore to Rs.2000 crore and ‘large’ with turnover greater than Rs. 2,000 crore.

The Panel finds that although various studies on segmentation of the IT export industry in India are available in the public domain, the above study provides one convenient thumb measure for segmentation by size. For purposes of a rough and ready organization of companies it can be relied upon as a convenient tool and this seems to have been the guiding motive behind reliance on this study by the Hon’ble ITAT Bench. We, therefore, respectfully hold that the Dun and Bradstreet categorization on the basis of sales can be adopted for the present purpose of identifying a filter of turnover at the upper end.

Although the ITAT Mumbai in the case of Capgemini India Pvt Ltd vs ACIT (ITA No. 7861/Mum/2011 for AY 2007-08) have held that the concept of economy of scale cannot be applied to service delivering companies and that there is no empirical evidence to suggest that margins are related to turnover, this Panel is bound by the decision of the jurisdictional ITAT.

Going by the taxpayer's ITS revenue of Rs.17,01 crores it would fall in the category of a 'small' sized firm as per the Dun & Brad Street categorization. Companies with a turnover higher than Rs. 200 crore, suggest that margins are related to turnover, this Panel is bound by the decision of the jurisdictional ITAT.

Going by the taxpayer's ITS revenue of Rs.17.01 crores it would fall in the category of a 'small' sized firm as per the Dun & Brad Street categorization. Companies with a turnover higher than Rs. 200 crore, therefore, should be excluded from the comparability analysis. The appellant's objections on the turnover issue, therefore, are accepted and directions issued accordingly."

9. Aggrieved by the aforesaid direction of the DRP, the Revenue has preferred the present appeal before the Tribunal.

10. We have heard the submissions of the Id. DR, who reiterated the stand of the Revenue as contained in the ground of appeal. We are of the view that the objections raised by the Revenue in this appeal are not sustainable.

11. The Id. counsel for the assessee brought to our notice the observations of the Tribunal in the case of *Trilogy E-Business Software India Pvt.Ltd. (supra)* (ITA No.1338/Bang/2010) for assessment year 08-09, on the application of turnover filter and how the said filter is a valid filter in choosing comparables. It was therefore argued that the learned CIT(A)

was fully justified in applying the aforesaid filter and excluding comparable companies chosen by the TPO which did not pass the test as laid down in the aforesaid decision. The learned DR reiterated the stand of the revenue as reflected in the grounds of appeal of the revenue.

12. We have considered the submission of the learned counsel for the Assessee and the learned DR. In the case of *Trilogy E-Business Software India (P) Ltd. (supra)*, this Tribunal on application of the turnover filter while selecting comparable companies for comparability analysis held as follows:

13. **“(1) Turnover Filter**

11. The Id. counsel for the assessee submitted that the TPO has applied a lower turnover filter of RS. 1 crore, but has not chosen to apply any upper turnover limit. In this regard, it was submitted by him that under rule 10B(3) to the Income-tax Rules, it was necessary for comparing an uncontrolled transaction with an international transaction that there should not be any difference between the transactions compared or the enterprises entering into such transaction, which are likely to materially affect the price or cost charged or paid or profit arising from such transaction in the open market. Further it is also necessary to see that wherever there are some differences such differences should be capable of reasonable accurate adjustment in monetary terms to eliminate the effect of such differences. It was his submission that size was an important facet of the comparability exercise. It was submitted that significant differences in size of the companies would impact comparability. In this regard our attention was drawn to the decision of the Special Bench of the ITAT Chandigarh Bench in the case of *DCIT v. Quark Systems Pvt. Ltd. 38 SOT 207*, wherein the Special Bench had laid down that it is improper to proceed on the basis of lower limit of 1 crore turnover with no higher limit on turnover, as the same was not reasonable classification. Several other decisions were referred to in this regard laying down identical proposition. We

are not referring to those decisions as the decision of the Special Bench on this aspect would hold the field. Reference was also made to the OECD TP Guidelines, 2010 wherein it has been observed as follows:-

“Size criteria in terms of Sales, Assets or Number of Employees: The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability.”

12. The ICAI TP Guidelines note on this aspect lay down in para 15.4 that a transaction entered into by a Rs. 1,000 crore company cannot be compared with the transaction entered into by a Rs. 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate. The fact that they operate in the same market may not make them comparable enterprises. The relevant extract is as follows [on Rule 10B(3)]:

“Clause (i) lays down that if the differences are not material, the transactions would be comparable. These differences could either be with reference to the transaction or with reference to the enterprise. For instance, a transaction entered into by a Rs 1,000 crore company cannot be compared with the transaction entered into by a Rs 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate.”

13. It was further submitted that the TPO's range (Rs. 1 crore to infinity) has resulted in selection of companies like Infosys which is 277 times bigger than the Assessee (turnover of Rs. 13,149 crores as compared to Rs. 47.47 crores of Assessee). It was submitted that an appropriate turnover range should be applied in selecting comparable uncontrolled companies.

14. Reference was made to the decision of the ITAT Bangalore Bench in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT, ITA No.1231/Bang/2010*, wherein relying on Dun and Bradstreet's analysis, the turnover of RS. 1 crore to RS. 200 crores was held to be proper. The following relevant observations were brought to our notice:-

“9. Having heard both the parties and having considered the rival contentions and also the judicial precedents on the issue, we find that the TPO himself has rejected the companies which are (sic) making losses as comparables. This shows that there is a limit for the lower end for identifying the comparables. In such a situation, we are unable to understand as to why there should not be an upper limit also. What should be upper limit is another factor to be considered. We agree with the contention of the learned counsel for the assessee that the size matters in business. A big company would be in a position to bargain the price and also attract more customers. It would also have a broad base of skilled employees who are able to give better output. A small company may not have these benefits and therefore, the turnover also would come down reducing profit margin. Thus, as held by the various benches of the Tribunal, when companies which are loss making are excluded from comparables, then the super profit making companies should also be excluded. For the purpose of classification of companies on the basis of net sales or turnover, we find that a reasonable classification has to be made. Dun & Bradstreet & Bradstreet and NASSCOM have given different ranges. Taking the Indian scenario into consideration, we feel that the classification made by Dun & Bradstreet is more suitable and reasonable. In view of the same, we hold that the turnover filter is very important and the companies having a turnover of Rs.1.00 crore to 200 crores have to be taken as a particular range and the assessee being in that range having turnover of 8.15 crores, the companies which also have turnover of 1.00 to 200.00 crores only should be taken into consideration for the purpose of making TP study.”

15. It was brought to our notice that the above proposition has also been followed by the Honourable Bangalore ITAT in the following cases:

1. M/s Kodiak Networks (India) Private Limited Vs. ACIT (ITA No.1413/Bang/2010)

2. M/s Genesis Microchip (I) Private Limited Vs. DCIT (ITA No.1254/Bang/2010).
3. Electronic for Imaging India Private Limited (ITA No. 1171/Bang/2010).

It was finally submitted that companies having turnover more than Rs. 200 crores ought to be rejected as not comparable with the Assessee.

16. The Id. DR, on the other hand pointed out that even the assessee in its own TP study has taken companies having turnover of more than RS. 200 crores as comparables. In these circumstances, it was submitted by him that the assessee cannot have any grievance in this regard.

17. We have considered the rival submissions. The provisions of the Act and the Rules that are relevant for deciding the issue have to be first seen. Sec.92. of the Act provides that any income arising from an international transaction shall be computed having regard to the arm's length price. Sec.92-B provides that "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. Sec.92-A defines what is an Associated Enterprise. In the present case there is no dispute that the transaction between the Assessee and its AE was an international transaction attracting the provisions of Sec.92 of the Act. Sec.92C provides the manner of computation of Arm's length price in an international transaction and it provides:-

- (1) that the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or

functions performed by such persons or such other relevant factors as the Board may prescribe, namely :—

- (a) comparable uncontrolled price method;
- (b) resale price method;
- (c) cost plus method;
- (d) profit split method;
- (e) transactional net margin method;
- (f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

**Provided** that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

**Provided further** that if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed five per cent of the latter, the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price.

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that—

- (a) the price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2); or
- (b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or
- (c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,  
 the Assessing Officer may proceed to determine the arm's length price in relation to the said international transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:"

18. Rule 10B of the IT Rules, 1962 prescribes rules for Determination of arm's length price under section 92C:-

"10B. (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—

(a).....

to

(d).....

(e) transactional net margin method, by which,—

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

affect the amount of net profit margin in the open market;

- (iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
- (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.

(2) For the purposes of sub-rule (1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:—

- (a) the specific characteristics of the property transferred or services provided in either transaction;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;
- (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction if—

- (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or
- (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) The data to be used in analysing 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.”

19. A reading of the provisions of Rule 10B(2) of the Rules shows that uncontrolled transaction has to be compared with international transaction having regard to the factors set out therein. Before us there is no dispute that the TNMM is the most appropriate method for determining the ALP of the international transaction. The disputes are with regard to the comparability of the comparable relied upon by the TPO.

20. In this regard we find that the provisions of law pointed out by the Id. counsel for the assessee as well as the decisions referred to by the Id. counsel for the assessee clearly lay down the principle that the turnover filter is an important criteria in choosing the comparables. The assessee's turnover is RS. 47,46,66,638. It would therefore fall within the category of companies in the range of turnover between 1 crore and 200 crores (as laid down in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT, ITA No.1231/Bang/2010*) . Thus, companies having turnover of more than 200 crores have to be eliminated from the list of comparables as laid down in several

decisions referred to by the Id. counsel for the assessee. Applying those tests, the following companies will have to be excluded from the list of 26 comparables drawn by the TPO viz.,

	<u>Turnover Rs.</u>
(1) Flextronics Software Systems Ltd.	848.66 crores
(2) iGate Global Solutions Ltd.	747.27 crores
(3) Mindtree Ltd.	590.39 crores
(4) Persistent Systems Ltd.	293.74 crores
(5) Sasken Communication Technologies Ltd.	343.57 crores
(6) Tata Elxsi Ltd.	262.58 crores
(7) Wipro Ltd.	961.09 crores.
(8) Infosys Technologies Ltd.	13149 crores.”

14. The aforesaid decision clearly sets out the reason with reference to Rule 10B(2) of the Rules which provides that uncontrolled transaction has to be compared with international transaction having regard to the factors set out therein. Respectfully following the aforesaid decision of the Tribunal in the case of *Trilogy E-Business Software India Pvt.Ltd. (supra)*, we uphold decision of the CIT(A), to exclude the aforesaid companies from the list of comparable companies on the basis of turnover and size. The AO is directed to compute the Arithmetic mean by excluding the aforesaid companies from the list of comparable. Besides the above, the Bangalore Benches of the Tribunal have been taking a consistent view as laid down in the aforesaid decision. We are therefore of the view that there is no merit in this appeal by the Revenue. Accordingly the same is dismissed.

15. In the result, the appeal by the Revenue is dismissed.

Pronounced in the open court on this 29<sup>th</sup> day of June, 2015.

Sd/-

( ABRAHAM P. GEORGE )  
Accountant Member

Sd/-

( N.V. VASUDEVAN )  
Judicial Member

Bangalore,  
Dated, the 29<sup>th</sup> June, 2015.

/D S/

Copy to:

1. Appellant
2. Respondents
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.
6. Guard file

By order

Assistant Registrar /  
Senior Private Secretary  
ITAT, Bangalore.