

**IN THE INCOME TAX APPELLATE TRIBUNAL
BANGALORE BENCH ' C '**

**BEFORE SHRI VIJAY PAL RAO, JUDICIAL MEMBER AND
SHRI INTURI RAMA RAO, ACCOUNTANT MEMBER**

I.T. (T.P) A. No.52/Bang/2017
(Assessment Year : 2012-13)

M/s. Arowana Consulting Ltd.,
No.90/B, Survey No.18, 2nd Main,
Electronic City, Phase-1, Bangalore-560 100. Appellant.

Vs.

Income Tax Officer,
Ward 1(1)(4), Bangalore. Respondent.

Appellant By : Shri Padamchand Khincha, CA
Respondent By : Shri R. N. Prabhat, CIT-III (D.R)

Date of Hearing : 18.09.2017.
Date of Pronouncement : 23.10.2017.

ORDER

Per Shri Vijay Pal Rao, J.M. :

This appeal by the assessee is directed against the assessment order dt.8.12.2016 passed under Section 143(3) r. w. s. 144C of the Income Tax Act, 1961 (in short 'the Act') in pursuant to the directions of the Dispute Resolution Panel (in short 'DRP') dt.22.11.2016 for the Assessment Year 2012-13.

2. The assessee has raised the following grounds :

1. The lower authorities (the learned Assessing Officer, learned Transfer Pricing Officer and Honorable Dispute Resolution Panel) have erred in passing the Order which is bad in law and disregarding the principles of natural justice.

Legal Grounds relating to Transfer Pricing:-

2. The AO has erred in making a reference to Transfer Pricing Officer for determining arm's length price of international transactions. The learned DRP has erred in confirming the action of the AO.
3. The lower authorities have erred in
 - a) Not appreciating that there is no amendment to the definition of "income" and the charging or computation provision relating to income under the head "Profits & Gains of Business or Profession" do not refer to or include the amounts computed under Chapter X and therefore addition under Chapter X is bad in law.
 - b) Passing the order without demonstrating that the Appellant had motive of tax evasion.
 - c) Adopting flawed methodology for issuing Notice u/s 133(6) and relying on the information collected u/s 133(6) without providing the Appellant complete information and an opportunity to cross examine the companies concerned or their authorized representatives.

Computation of Arm's Length Price:-

4. Without prejudice, the lower authorities have erred in:
 - a) Rejecting the comparables selected and transfer pricing analysis undertaken by the Appellant on unjustifiable grounds and conducting a fresh transfer pricing analysis despite absence of any defects in the transfer pricing analysis submitted by the Appellant;

- b) Adopting inappropriate filters like 25% RPT filter, one sided turnover filter, etc in the process of selecting comparables;
- c) Not adopting onsite revenue filter while selecting comparables ignoring the fact that the Appellant is primarily an onsite software service provider;
- d) Selecting inappropriate comparables and selecting companies as comparables despite unusual business circumstances, high margin, high turnover and which are not functionally comparable.
- e) Rejecting additional comparables proposed by the Appellant on unjustifiable grounds.
- f) Adopting operating profit to operating cost as PLI without appreciating that the Appellant's operating cost includes substantial payment to AE, which are to be tested on arm's length principle;
- g) Inappropriately computing the operating margins of comparables and the Appellant and treating provision for bad & doubtful debts and foreign exchange gain or loss as non-operating in nature while computing the margin of the comparables and the Appellant;
- h) Not making proper adjustment for enterprise level and transactional level differences between the Appellant and the comparable companies
- i) Not appropriately computing the working capital adjustment while computing the ALP.
- j) Not recognizing that the Appellant was insulated from risks, as against comparables, which assume these risks and therefore have to be credited with a risk premium on this account; and
- k) Not allowing the benefit of the +/-5% range mentioned in the proviso to section 92C (2).

Other Grounds:-

The learned AO has erred in levying a sum of Rs. 2,05,555/- interest under section 234B and a sum of Rs. 1,48,288/- u/s 234C. On the facts and in the circumstances of the case, interest under section 234B and 234C is not leviable. The Appellant denies its liability to pay interest u/s 234B and 234C;

3. The assessee provides software development services in the area of ERP Implementation. During the year under consideration, the assessee has shown the international transactions of payment for supply of man power by the Associated Enterprise of Rs.23,09,87,035. The assessee bench marked its international transactions by selecting only one comparable company namely **Akshay Software Co. Ltd.** The TPO rejected the TP Study of the assessee and selected 10 companies in the final set of comparables as under :

Comparables selected by the TPO in TP Order

Sl.No.	Name of the Company	Operating Margin on Cost	W.cap adjusted Margin
1	Datamatics Global Services Ltd.	14.57%	14.91%
2	Genesys International Corporation Ltd.	30.09%	25.59%
3	I C R A Techno Analytics Ltd.	17.24%	16.07%
4	Infosys Ltd.	43.10%	41.94%
5	Larsen & Toubro Infotech Ltd.	25.47%	25.61%
6	Mindtree Ltd.	15.01%	14.86%
7	Persistent Systems Ltd.	27.20%	27.07%
8	R S Software (India) Ltd.	15.34%	17.69%
9	Sasken Communication Technologies Ltd.	12.15%	13.22%
10	Spry Resources India Pvt. Ltd.	26.18%	11.07%
	Arithmetic Mean	22.63%	20.79%

4. The TPO has arrived at adjusted mean margin of 20.79% and proposed an adjustment under Section 92CA of Rs.5,04,81,052. The assessee challenged the action of the TPO/A.O. before the DRP and

raised objection that the assessee earns its 90% of revenue by providing on site services. Therefore the companies selected by the TPO cannot be considered as comparable to the assessee. The DRP though found that six out of the 10 companies selected by the TPO are not comparable to the assessee however, since the mean margin of the remaining 4 companies was still more than the mean margin of the TPO therefore, the DRP retained the set of comparables selected by the TPO.

5. We have heard the learned Authorised Representative as well as learned Departmental Representative and considered the relevant material on record. The learned Authorised Representative has pointed out that on site revenue and expenses is a relevant filter. This Tribunal in assessee's own case for the Assessment Year 2010-11 has accepted this issue and decided in favour of the assessee. Further for the Assessment Year 2011-12 again the Tribunal has rejected all the companies selected by the TPO and retained by the DRP and upheld the comparability of **Akshay Software Technology Limited** as selected by the assessee. Hence he has submitted that when none of the companies selected by the TPO have any on site activity of providing services then the same cannot be compared with the assessee.

6. On the other hand, the learned Departmental Representative has relied upon the orders of the authorities below.

7. Having considered the rival submissions as well as the relevant material on record, we note that for the Assessment Year 2009-10, the Tribunal vide order dt.28.08.2014 in the assessee's own case in IT(TP)A

No.21/Bang/2014 has considered the issue of on site revenue filter in paras 13 to 15 as under :

13. We have considered the rival submissions. In our view the on-site revenue filter is an appropriate filter to be applied in the cases where ALP is determined for an Assessee rendering off-shore soft-ware development services. In this regard, we have seen that this Tribunal in the case of Triology E-Business (supra) has extensively dealt with this issue. The argument for and against adoption of on-site revenue filter have all been extracted therein. According to the Revenue in the case of Triology E-Business (supra), if revenue of comparable companies from rendering onsite software exceeded 75% of the total revenue, then they should not be regarded as comparable to the assessee where revenue is from rendering offshore software development services. The TPO had given the following reasons for applying the onsite revenue filter:

- 1. The market conditions are different for onsite than offshore work.*
- 2. The pricing structure is different in onsite work.*
- 3. The assets are negligible in the onsite companies.*
- 4. The margins for onsite are lower when compared to offshore work.*
- 5. The labour markets are different for offshore and onsite work, as the people who are working on onsite get competitive salaries of the resident countries.*
- 6. Cost arbitrage is not available for the onsite work.*
- 7. The companies whose revenues are generated mainly from onsite work almost mimic a company which is resident in that country.*

The stand of the Assessee on the above aspects was:

- 1. whether a company operates onsite or offshore, the functions performed are the same. What is important from an arms' length*

perspective are the functions performed and not the place of its performance. It is not that a company performs altogether different functions under onsite assignments.

- 2. On the reasoning of the TPO that the pricing structure was different in onsite work, it was the submission of the assessee this aspect was irrelevant. The method selected was TNMM. What is tested is margin and not price.*
- 3. On the reasoning of the TPO that the assets are negligible in the onsite companies, the stand of the Assessee was that software companies whether onsite or offshore do not require much infrastructure. Therefore question of assets being negligible only for onsite operation should not matter because as per the TPO not much assets are required for software companies.*
- 4. On the reasoning of the TPO that Margins are lower in case of onsite operations, it was the stand of the Assessee that margin is not a criteria to select or reject a comparable under Rule 10B(2) of the I.T. Rules. The assessee submitted that comparability of an uncontrolled transaction has to be tested on touchstone of the principles enunciated in Rule 10B(2). The margin of an uncontrolled transaction is not a criterion to select or reject a comparable. Taking margin as a criterion to select or reject a comparable would be incongruous because what is tested under TNMM is the margin itself.*
- 5. It was argued that under TNMM, the assessee is selected as the tested party. What is to be tested under TNMM is the net margins of the assessee. The cost for recipient of service has no bearing on the margins of the assessee. Whether the recipient of service gets cost arbitrage or not is not a consideration for testing the margins of the assessee.*
- 6. The TP Regulations or OECD Guidelines do not prescribe application of onsite filter. Therefore, onsite revenue filter should not be used.*

14. The Tribunal dealt with the above contentions in its order from para-60 to 67 of its order. The same were as follows:

“60. We have given a careful consideration to the above submissions made on behalf of the Assessee. We find that the DRP

has not dealt with any of the above submissions but have in page 23 and 24 of their order have held that the application of onsite revenue filter was justified. Rule 10B(2) & (3) of the IT Rules, 1962 would be relevant to render a decision on the above contentions of the parties before us. Those rules have already been set out in the earlier part of this order. The crux of the rules, in so far as it relates to the contentions regarding application of the Onsite revenue filter, is that 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.

61. It is only when there are no difference between the uncontrolled transaction and the international transaction as set out above or if there are differences but such difference

will not affect the price or cost charged or paid or profit arising from such transactions or if there will be differences in price or cost charged or pair or profit arising from such transactions, such differences should be reasonably capable of being quantified and adjustment made to eliminate the effect of such differences.

62. The Indian software sector provides both on-site and offshore services. The Assessee in the present case is mainly offshore service provider and it generates income only from offshore software development service. Most of the uncontrolled enterprises follow hybrid model with revenue mix both from onsite and offshore. It is true that in terms of the functions performed both in the case of offshore service provider and onsite service provider, it is development of computer software. But having regard to Rule 10B(2)(b) it is necessary to have regard to the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions.

63. The first objection of the Assessee is that the TPO has observed that "market conditions" are different for on-site and offshore work, but he has not substantiated how market conditions differ. We fail to see any substance in such objection. The fact is that in onsite development of computer software, the Assessee does not employ assets nor does the Assessee assume many risks which the offshore software developer assumes. Even the Assessee accepts that the per hour rate will be different in the case of offshore software development and onsite software development.

64. The next objection of the Assessee is that when the most appropriate method selected for determining ALP is the TNMM there is no reason as to why one should look at price

difference in offshore software development and onsite software development. It is no doubt true that in TNMM it is only the margins in an uncontrolled transaction that is tested with reference to the controlled transaction but it is not possible to ignore the fact that pricing will have an effect on the margins obtained in a transaction. The argument that if pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects cannot be accepted because the TPO has not chosen any other onsite software service provider with a revenue composition of more than 75% from onsite software services as comparable. As rightly observed by the TPO, the pricing is different in onsite when compared to offshore operations. The further observations of the TPO that the reasons for the same lie in the fact that while in the case of OFFSHORE projects most of the costs are incurred in India; an ONSITE project has to be carried out abroad significantly increasing the employee cost and other costs.

65. The next objection of the Assessee is with regard to Assets employed. The companies, which predominantly generate revenues from onsite activity, do not have significant assets as most of the work is carried on the site of customer outside India. The argument that the TPO has himself observed that software service providers do not require much assets cannot be basis to accept the Assessee's plea. Those observations are made by the TPO in the context of application of turnover filter and have been quoted out of context by the Assessee.

66. The next argument of the Assessee is that TPO has held that margins are lower in onsite software services and that margin is not a criteria to select or reject a comparable under Rule 10B(2) of the I.T. Rules. We are of the view that this argument again ignores the fact that the approach of the TPO has been to highlight the fact that there can be no functional

comparability, if the assets employed and risks assumed are taken into consideration. It is in that context the TPO has referred to the margins.

67. The companies who generate more than 75% of the export revenues from onsite operations outside India are effectively companies working outside India having their own geographical markets, cost of labour etc., and also return commensurate with the economic conditions in those countries. Thus assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the taxpayer. Since, the entire operations of the tax payer are taking place offshore i.e. in India; it is but natural that it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model. As already stated the Assessee has limited its analysis only to functions but not to the assets, risks as well as prevailing market conditions in which both the buyer and seller of services located. Hence, the companies in which more than 75% of their export revenues come from onsite operations are to be excluded from the comparability study as they are not functioning in similar economic circumstances to that of the tax payer. Hence, it is held that this filter is appropriately applied by the TPO.”

15. Respectfully following the aforesaid decision, we hold that the assessee is a company which earns its revenue predominantly from rendering software development services On-site and should be compared only with companies which also have revenue of software development on-site. We are of the view that the threshold limit of on-site revenue to the total revenue should be fixed at 50% or more as suggested by the learned DR so that comparable companies would be

available for the purpose of comparison. The TPO/Assessing Officer will afford opportunity of being heard to the assessee before determining the ALP. The TPO will also be at liberty to conduct his own fresh search of comparables for the purpose of applying the on-site revenue filter. We hold and direct accordingly.”

We further note that the decision of this Tribunal was again followed in assessee's own case for the Assessment Year 2009-10 vide order dt.29.6.2015 in IT(TP)A No.235 & 153/Bang/2015.

8. As regards the issue of rejection of **M/s. Akshay Software Technology Limited**, we find that this company was accepted by the Tribunal as a comparable for the Assessment Year 2009-10 and again for the Assessment Year 2011-12. The Tribunal for the Assessment Year 2011-12 vide order dt.11.1.2017 in IT(TP)A No.157/Bang/2016 has considered this issue in para 9 as under :

“ 9. Regarding inclusion of M/s. Akshay Software Technologies Ltd., we find that a categorical finding has been given by the DRP that apart from mentioning in his order, the TPO has not given any basis or reason for saying that this company is functionally not comparable. This company has been accepted as a comparable in assessee's own case for Assessment Year 2009-10 as per the Tribunal order in IT(TP)A No.21/Bang/2014 dated 28.08.2014, copy available on pages 218-244 of the paper book. Hence, on this issue also, we find no reason to interfere in the order of DRP and we approve the same.”

Though the functional comparability of this company has to be examined for each assessment year separately however, the decision of the Tribunal in assessee's own case are relevant guidelines which cannot be ignored on some of the aspects of the functional comparability.

Accordingly, in view of the above facts and circumstances of the case and following the decisions of this Tribunal in assessee's own case, we set aside the entire TP issue to the record of the TPO/A.O. for considering the comparability of **Akshay Software Technology Limited** in the light of the decisions of this Tribunal as well as the functional comparability of companies selected by the TPO and particularly applying on site revenue filter. There is no dispute that the assessee is earning its 90% revenue from on site services therefore, the TPO is directed to consider the on site revenue filter as the relevant factor for the purpose of selecting the comparable. Since the entire set of comparables selected by the TPO does not satisfy on site revenue filter therefore, the TPO is directed to carry out a fresh search and also applied the on site revenue filter. We further note that though the assessee has shown the international transactions as payment on account of supply of man power to its Associated Enterprises however, as per the agreement between the assessee and its AE, the assessee has formed a subsidiary in the middle east region and outsourced its software development services to its AE to be provided at on site of the clients of the assessee. Thus as per the agreement the assessee has to pay the service fees to the AE and it is not merely a payment of supply of man power.

9. The learned Authorised Representative has submitted that the TPO while computing the Arm's Length Price (ALP) and consequential adjustment took the operating cost into consideration instead of operating revenue. Because the operating cost itself is in dispute therefore, as per the OECD Guidelines the margin of the assessee as well

as the comparable companies should be based on the operating revenue instead of total cost. Since we have set aside the entire TP issue to the record of the TPO therefore, the TPO is directed to consider this contention of the assessee while determining the ALP.

10. No other ground has been argued or pressed by the assessee, accordingly we do not propose to go into other grounds raised by the assessee.

11. In the result, the appeal of the assessee is allowed for statistical purpose.

Order pronounced in the open court on 23rd Oct., 2017.

Sd/-
(INTURI RAMA RAO)
Accountant Member

Sd/-
(VIJAY PAL RAO)
Judicial Member

Bangalore,
Dt. 23.10.2017.

*Reddy gp

Copy to :

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

Senior Private Secretary
Income Tax Appellate Tribunal
Bangalore.