

आयकर अपीलिय अधिकरण, 'डी' न्यायपीठ, चेन्नई

**IN THE INCOME TAX APPELLATE TRIBUNAL
'D' BENCH, CHENNAI**

श्री जॉर्ज माथन, न्यायिक सदस्य, न्यायिक सदस्य एवं
श्री ए. मोहन अलंकामणी, लेखा सदस्य केसमक्ष

**BEFORE SHRI GEORGE MATHAN, JUDICIAL MEMBER AND
SHRI A. MOHAN ALANKAMONY, ACCOUNTANT MEMBER**

आयकरअपीलसं./I.T.A.No.2118/Mds/2011
(निर्धारणवर्ष / Assessment Year: 2007-08)

M/s. FL Smidth Private Limited, 34, Egatoo, Kelambakkam, Rajiv Gandhi Salai, Chennai – 600 103.	Vs	The Deputy Commissioner of Income Tax, Company Circle II(1), Chennai
PAN : AAACF4997N		
(अपीलार्थी/Appellant)		(प्रत्यर्थी/Respondent)

अपीलार्थीकीओरसे/ Appellant by	:	Shri Girish Dave for Shri S.P. Chidambaram, Advocates
प्रत्यर्थीकीओरसे/Respondent by	:	Shri Pathlavath Peerya, CIT

सुनवाईकीतारीख/Date of hearing	:	12.07.2017
घोषणाकीतारीख /Date of Pronouncement	:	05.09.2017

आदेश / ORDER

PER: A. MOHAN ALANKAMONY, AM:-

This appeal by the assessee is directed against the order passed by the Dispute Resolution Panel, Chennai F.No.DRP/Chennai/Sectt./33/2011 dated 28.09.2011 for the assessment year 2007-08 passed u/s.143(3) r.w.s.144C of the Act.

2. The assessee has raised several grounds in its appeal and the concise grounds are briefly stated herein below for adjudication:-

Corporate Tax issues:-

- (i) The Ld.AO/DRP has erred in applying Rule 8D of the rules while computing disallowance U/s.14A of the Act, because the aforesaid rule came into effect from 24.03.2008 and therefore not applicable for the relevant assessment year 2007-08.
- (ii) The Ld.AO/DRP had erred in disallowing the sales commission paid for Rs.25,49,750/- by invoking the provisions of Section 40(a)(ia) of the Act, because the entire services was rendered outside India by M/s. Maple Leaf International, Bangladesh.
- (iii) The Ld.AO/DRP had erred in confirming the disallowance of Rs.64,69,066/- U/s. 40(a)(ia) of the Act being expense incurred for import of project specified engineering drawings from FL Smidth Automation A/s, Denmark by holding that the expenditure is in the nature of "Fees for technical services".
- (iv) The Ld.AO had erred in levying interest U/s.234B & 234C of the Act.
- (v) The Ld.AO had erred in initiating penalty proceedings U/s.271(1)(c) of the Act.

Transfer Pricing Issues:

- (vi) The Ld.DRP has erred in upholding the order of Ld.TPO/A.O, who had compared the international transaction of the assessee with the companies providing software development service when the fact was that the assessee was providing only basic engineering services.

3. The brief facts of the case are that the assessee is a limited company engaged in the business of manufacturing and supplying of cement machinery, filed its return of income electronically for the assessment year 2007-08 on 31.10.2007. The return was processed initially U/s.143(1) of the Act and thereafter the assessment was reopened and finally the assessment was completed U/s.143(3) r.w.s 144C of the Act.

4. **Corporate Tax Issues:**

4.1 **Ground No. 2(i) : Disallowance of Rs.71,36,053/-**

U/s.14A r.w.r. 8D of the Rules:-

During the course of scrutiny assessment, it was observed by the Ld.AO that the assessee had made investment in shares

and mutual funds to the tune of Rs.130,30,92,373/- and earned a dividend income exempt from tax of Rs.9,35,92,674/-. However, the assessee had not disallowed any expenditure for earning exempt income, which is to be, disallowed U/s.14A of the Act. On query, the assessee agreed to disallow a portion of the salary of its directors and other managerial staff U/s.14A of the Act and thereby worked out the disallowance at Rs.78,000/-. Since the assessee has not apportioned the expense incurred for earning exempt income to the satisfaction of the Ld.AO, the Ld.AO applied clause (iii) Rule 8D of the Rules and computed the disallowance at Rs.71,36,053/-. Before the DRP the Ld.AR argued stating that Rule 8D of the Act is not applicable for the relevant assessment year 2007-08 and prayed for estimating the expenditure keeping in view of the decision of the Chennai Bench of the Tribunal in the case Rane Brake Linings Ltd vs. DCIT in ITA No.745/Mds/2006 dated 23.03.2007, wherein such disallowance was directed to be made at 2% of the exempt income. It was further argued that the assessee had not incurred any direct expenditure for earning dividend income. However the Ld.DRP rejected the argument of the Ld.AR and since the issue was not settled by the Hon'ble High Court & Apex Court upheld the order of the Ld.AO.

4.1.1 At the outset, the Ld.AR submitted before us that the Hon'ble Madras High Court in the case Indian Nippon Electricals Ltd., vs. DCIT in T.C.(A). Nos.1305 & 1306 of 2007 vide order dated 2nd February 2015 had held the Order of the appellate Tribunal to be right in law for upholding the estimate of expenses at 2% of the dividend income while computing disallowance U/s.14A of the Act. The Ld.DR could not controvert to the submission of the Ld.AR.

4.1.2 We have heard the rival submissions and carefully perused the materials available on record. We find merit in the submission of the Ld.AR. Rule 8D came into effect only from 24.03.2008. Therefore it is not applicable to the relevant assessment year 2007-08. Further the Hon'ble Madras High Court has held in its decision cited *supra that* in circumstances where the indirect expenses related to exempt income cannot be reasonably worked, an estimate @ 2% of dividend income earned by the assessee would suffice to make disallowance U/s.14A of the Act. From the facts of the case, we find that the Ld.AO as well as the Ld.DRP did not have the benefit of the order of the Hon'ble High Court, since the

order of the Hon'ble High Court was passed subsequently. Therefore respectfully following the Order of the Hon'ble High Court we hereby direct the Ld.A.O to estimate 2% of the exempt dividend income for the purpose of disallowance of expenditure U/s.14A of the Act. **However, we also make it clear that if any interest expenses or other expenses which are directly attributable for earning exempt income, the same has to be disallowed as per the provisions of Section 14A of the Act apart from the disallowance @ 2% of exempt income which was not the issue before the Hon'ble High Court, hence not addressed in its Order.**

4.2 Ground No.2(ii) : Disallowance of Sales commission by invoking provisions of Section 40(a)(ia) of the Act:-

During the course of scrutiny assessment proceedings, it was noticed by the Ld.AO that the assessee had paid sales commission amounting to Rs.25,49,750/- to M/s. Maple Leaf International, Bangladesh on which tax was not deducted at source in accordance with Section 195 of the Act. On query the assessee submitted before the Ld.AO that the commission was paid for promoting/marketing the products of the company in Bangladesh, for providing valuable inputs to the company for securing contracts,

canvassing the customers in Bangladesh, for delivering annual forecast and periodic reports of prospective business in Bangladesh and furnishing the financial conditions of the customers of the assessee in Bangladesh, etc., hence the income to the recipient of the commission had not accrued in India and therefore the provisions of Section 195 of the Act is not applicable, hence Section 40(a)(ia) is not attracted. However, the Ld.AO opined that M/s. Maple Leaf International, Bangladesh does value added service to the assessee and it is not a mere commission agent who derives commission based on turnover. The Ld.AO further observed that the CBDT Circular No.7 of 2009 dated 22.10.2009, Circular No.23 of 1969 and Circular No.786 of 2000 was withdrawn and therefore there was no immunity to the assessee against Section 195 & 40(a)(ia) of the Act, with respect to the payment of commission made abroad to non-resident. The Ld.AO further opined that the provisions of Section 9 of the Act will be applicable and accordingly income will be deemed to have arisen in India to the recipients of the payment made by the assessee towards commission outside India. On appeal, the Ld.CIT(A) concurred with the view of the Ld.AO and upheld his order.

4.2.1 At the outset the Ld.AR submitted that on the identical issue the Hon'ble High Court of Madras in the case CIT vs. Faizan Shoes Pvt. Ltd. T.C. (A) No.789 of 2013 vide order dated 22.07.2014 has held in favour of the assessee. It was therefore pleaded that the same decision may be followed in the case of the assessee and accordingly relief may be granted. The Ld.DR though stoutly argued in support of the orders of the Ld.Revenue authorities, could not controvert to the submission of the Ld.AR.

4.2.2 After hearing both sides, we find merit in the submission of the Ld.AR. The Hon'ble High Court of Madras in the order cited *supra* has held as follows:

“FACTS

- *The assessee was a company engaged in the business of manufacture and export of articles of leather. It entered into an Agency Agreement with a non resident agent to secure orders from various customers, including retailers and traders, for the export of leather shoe. As per the terms of the Agency Agreement the business was transacted by opening letters of credit or by cash against document basis. The non-resident agent was responsible for prompt payment in respect of all shipments effected on cash against document basis. The assessee undertook to pay commission of 2.5 per cent on FOB value on all orders procured by the non-resident agent. It*

claimed commission paid as expenditure in terms of section 37.

- *The Assessing Officer held that payment of commission to non-resident agent was to be dealt with in accordance with the provisions of section 9(1) read with section 195. He conducted that since the assessee had not deducted tax at source on the payments made to the non-resident agent, as required under section 195, the claim made by the assessee was disallowed under section 40(a)(i).*

- *On appeal, both authorities decided matter in favour of assessee and allowed his claim.*

- *On appeal by the Revenue to the High Court:*

HELD

- *For procuring orders for leather business from overseas buyers - wholesalers or retailers, as the case may be, the non-resident agent is paid 2.5 per cent commission on FOB basis. That appears to be a commission simpliciter. The opening of letters of credit for the purpose of completing export obligation is an incident of export and, therefore, the non-resident agent is under an obligation to render such services to the assessee, for which commission is paid. The non-resident agent does not provide technical services for the purposes of running of the business of the assessee in India. The services rendered by the non resident agent can at best be called as a service for completion of the export commitment. Therefore, the commission paid to the non-resident agent will not fall within the definition of 'fees for technical services'.*

[Para 7]

- *The assessee engaged the services of non-resident agent to procure export orders and paid commission. [Para 11]*

• *The services rendered by the non-resident agent can at best be called as a service for completion of the export commitment and would not fall within the definition of 'fees for technical services'. Section 9 is not applicable to the case on hand and consequently, section 195 of the Act does not come into play. [Para 12]”*

The issue in the case of the assessee is also identical to the case decided by the Hon'ble Madras High Court Supra and is not disputed by the Revenue either. Therefore respectfully following the decision of the Hon'ble Madras High Court, we hereby hold that in the case of the assessee provisions of Section 195 of the Act will not be applicable with respect to payment of sales commission of Rs.25,49,750/- to M/s. Maple Leaf International, Bangladesh for services rendered outside India. Consequently, the provisions of Section 40(a)(ia) of the Act will not be attracted in the case of the assessee. Therefore we hereby direct the Ld.AO to delete the addition of Rs.25,49,750/- in the hands of the assessee.

4.3 Ground No.2(iii) : Disallowance of expenses towards import of engineering drawings from the assessee's AE for Rs.64,69,066/- by invoking provisions of Section 40(a)(ia) of the Act:-

It was noticed by the Ld.AO that the assessee has incurred expenditure of Rs.64,69,663/- towards import of engineering drawings from the assessee's Associated Enterprise (AE) at Denmark. The Ld.AO opined that the payment for importing the engineering drawing from the assessee's AE would amount to payment made for "fees for technical services". Since the assessee has not deducted tax at source on the payment made for purchase of engineering drawings, the Ld.AO opined that the assessee has violated the provisions of Section 195 of the Act and accordingly penal proceedings of Section 40(a)(ia) of the Act would be attracted. Therefore the Ld.AO disallowed the amount of Rs.64,69,066/- as allowable expenditure. On appeal, the Ld.CIT(A) concurred with the view of the Ld.AO.

4.3.1 The Ld.AR vehemently argued before us stating that the issue is covered by the decision of the Hon'ble High Court of Madras in the case CIT vs. Faizan Shoes Pvt. Ltd., *supra* and pleaded for deleting the addition made by the Ld.AO. The Ld.DR on the other hand argued in support of the orders of the Ld.Revenue authorities.

4.3.2 We have heard the rival submissions and carefully perused the materials available on record. Perusing the facts of the case, we find merit in the submission of the Ld.AR. From the facts of the case, it is evident that the engineering designs and drawings are developed by the assessee's AE viz., FLSmith Automation A/s in Denmark. Therefore it is service rendered outside India towards which the assessee has made the payment. Hence as stated by the Ld.AR, the decision of the Hon'ble High Court in the case Faizan Shoes Pvt. Ltd., *supra* is squarely applicable in the case of the assessee. Therefore, we hereby direct the Ld.AO to delete the addition of Rs. 64,69,066/- in the hands of the assessee.

4.4 Ground No. 2(iv): Interest U/s.234B & 234C of the Act:-

Interest U/s.234B & 234C of the Act are consequential in nature. Therefore this ground raised by the assessee is dismissed.

4.5 Ground No. 2(v) : Penalty proceedings U/s.271(1)(c) of the Act:-

The assessee has raised the ground stating that the Ld.AO has erred in initiating the penalty proceedings U/s.271(1)(c) of the

Act. This ground raised by the assessee is premature at this stage and accordingly dismissed.

5 Transfer Pricing Issues:

Ground No.2(vi) : Wrongly adopting software companies as the comparable when the assessee company was rendering engineering services:-

The Ld.AR submitted before us that the Ld.Revenue authorities had adopted the software development companies as the comparable companies while determining the Arm's length Price of the international transaction of the assessee company while as the assessee is in the business of rendering services related to engineering services. Hence it was pleaded that the matter may be remitted back to the Ld.TPO for de-nova consideration. The Ld.AR before us further listed the comparable companies mentioned herein below which was adopted by the Ld.Revenue authorities for determining the Arm's length Price of the international transaction of the assessee company in order to justify that all those companies are software companies and cannot be compared with the activities of the assessee company:-

1. Accel Transmatics Limited: The Company is not functionally comparable to the assessee company because the company has sold “Ushus Technology / Software segment” being software on which Intellectual Property Right is applicable and thereby earns royalty income.
2. Megasoft Limited: The Company falls under the software segment and has significant related party transaction. It also has fluctuating margins and hence it has to be rejected.
3. Flextronics Software Systems Limited: The Company is not functionally comparable because it also falls under the software segment. Moreover it is oversized company and cannot be compared with the activities of the assessee company. Therefore the company has to be rejected as it is not comparable with the assessee company.
4. KALS Information System Limited: The Company is not functionally comparable to the assessee company because the company is predominantly a software product company wherein the revenue from those activities constitutes 99% of the total operating turnover. Hence the company has to be rejected as comparable.

5. R System International Limited: The Company is also not functionally comparable to the assessee company because the company generates revenue from software development & customization services (BPO). Hence it has to be rejected.
6. Tata Elxsi Limited: The Company is not functionally comparable to the assessee company because it is a hardware design company. Hence it has to be rejected.
7. Celestial Labs Limited: The Company is not functionally comparable to the assessee company because the company is engaged in software development in the field of Bioinformatics Services, Data Warehousing and mining. Hence the activities of the company are not related to the assessee and hence it has to be rejected.
8. Helios & Matheson Information Technology: In this Company there is an abnormal increase of revenue and therefore it cannot be treated as a comparable company.
9. Avani Cimcon Technologies Limited: The Company is engaged in engaged in software product development and it is not functionally comparable to the assessee company. Hence it should be rejected.

10. Ishir Infotech Limited: The Company is not functionally comparable to the assessee company because it has significantly related party transactions.
11. Lucid Software Limited: The Company is not functionally comparable to the assessee company because it is engaged in software product development.
12. E-Zest Solutions Limited: The Company is a software development service provider and rendering KPO / BPO services. Hence it is not functionally comparable to the assessee company and therefore it should be rejected.
13. Wipro Limited: The Company has to be rejected because it is a software company driven by brand having large economics and oversized. It is a leader in the industry and cannot be compared with the assessee company which is much smaller in size.
14. Presistent System Limited: The Company is not functionally comparable to the assessee company because the company is engaged in software product development and has proprietary products licensed to customers.
15. Infosys Technologies Limited: The Company has to be rejected because it is a software company driven by brand

having large economics and oversized. It is a leader in the industry and cannot be compared with the assessee company which is much smaller in size.

16. Bodhtree Consulting Limited: It is not a comparable company because it has peculiar economic circumstances during the relevant financial year and has restructured its business. Further it does not qualify the revenue filter applied by the Ld.TPO. Hence it has to be rejected.
17. Sasken Communication Technologies Limited: The core activity of the company is functionally different from the assessee company. Therefore it cannot be treated as comparable company.
18. Thirdware Solutions Limited: The activities of the company are not related to the activities of the assessee company. Hence it has to be rejected.

5.1 The Ld.DR on the other hand could not controvert to the submission of the Ld.AR because it is apparent from the comparable companies selected by the Revenue that those companies are either software development companies or not related to the business of the assessee.

5.2 After hearing both sides and perusing the materials on record, we find merit in the submission of the Ld.AR. All the companies selected by the Revenue are software development companies and not related to the business conducted by the assessee company which is the tested party. This fact is also not dispute by the Ld.Revenue Authorities and the Ld.D.R. However it is pertinent to mention that it is a preliminary requirement for the comparable companies to be functionally comparable. In the case of the assessee company the Ld.TPO has adapted companies which are not functionally comparable. Therefore, we do not have any other option but to remit the matter to the file of TPO for de-nova consideration with further directions to adapt companies which are functionally comparable with identical or with similar intrinsic characteristics in addition to adherence of the other relevant parameters while determining the Arm's length Price of the international transaction of the assessee company. Accordingly with respect to all the grounds raised by the assessee in regard to Transfer Pricing issues the matter is remitted back to the file of Ld.TPO for fresh consideration.

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

Order pronounced on the 05th September, 2017 at Chennai.

Sd/-
(जॉर्ज माथन)
(George Mathan)
न्यायिक सदस्य/Judicial Member

Sd/-
(ए. मोहन अलंकामणी)
(A. Mohan Alankamony)
लेखा सदस्य/Accountant Member

चेन्नई/Chennai,

दिनांक/Dated 05th September, 2017

RSR

आदेश की प्रतिलिपि अग्रेषित/Copy to:

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|------------------------|--------------------------|------------------------------|
| 1. अपीलार्थी/Appellant | 2. प्रत्यर्थी/Respondent | 3. आयकर आयुक्त (अपील)/CIT(A) |
| 4. आयकर आयुक्त/CIT | 5. विभागीय प्रतिनिधि/DR | 6. गार्ड फाईल/GF |