

**IN THE INCOME TAX APPELLATE TRIBUNAL
HYDERABAD BENCH "A", HYDERABAD**

**BEFORE SMT P. MADHAVI DEVI, JUDICIAL MEMBER
AND SHRI S. RIFAUR RAHMAN, ACCOUNTANT MEMBER**

**ITA No. 102/Hyd/2015
Assessment Year: 2010-11**

Srini Pharmaceuticals Ltd., vs. Dy. Commissioner of Income-
Hyderabad. tax, Circle – 3(2), Hyderabad.

PAN – AACCS 8456 P
(Appellant)

(Respondent)

Assessee by : Shri C.S. Subramanyam
Revenue by : Shri J. Siri Kumar

Date of hearing : 14-12-2017
Date of pronouncement : 19-01-2018

ORDER

PER S. RIFAUR RAHMAN, A.M.:

This appeal is preferred by the assessee against the order passed u/s 143(3) r.w.s. 144C(13) of the Income Tax Act, 1961 (in short 'Act') dated 29/11/2014 relating to AY 2010-11.

2. The assessee has filed grounds of appeal, in which, it has raised 10 grounds of appeal. Ground Nos. 1 & 2 are general in nature and ground Nos. 3 & 4 are relating to non-selection of internal TNMM as the most appropriate method by the TPO/DRP, even though, there is absolute functional similarity between AE segments and non-AE segments. The other grounds 5 to 10 are alternate pleas of the assessee.

3. First, we intend to adjudicate on the main issue of non-adoption of internal TNMM.

4. Brief facts of the case are, assessee company engaged in the business of manufacture and sale of bulk drugs and intermediates. For the AY 2010-11, the assessee company filed its return of income on 25/09/2010 declaring an income of Rs. 16,61,857/-. Since the assessee had international transactions with its associate enterprises which necessitated reference to the Transfer Pricing Officer (TPO) as per the provisions of section 92CA for determination of Arm's Length Price. Accordingly, the case was referred to the TPO for determination of Arm's Length Price with the prior approval of the CIT-III, Hyderabad.

4.1 Assessee's Profile:

The assessee, Srini Pharmaceuticals Ltd., was incorporated under the Companies Act, 1956, on 24th February, 1995. Its main objectives are to manufacture various drugs, trading in chemicals, import and export and generally dealing with all types of pharmaceuticals, drugs and intermediates and to develop new products and substitute for imported products and technical consultation in drugs and pharmaceuticals. Srini Pharmaceuticals Ltd. has commenced its commercial production during the FY 1998-99. The factory is situated at Survey No. 247, Choutuppal Manda & Village 508 252, Nalgonda District, AP.

4.2 International Transactions:

As per 3CEB report/TP Document submitted, the international transactions are as under:

S. No.	Classification	AE	Paid/ received	Amount (In Rs.)	Method applied
1	Sale of intermediates & APIs	Apotex Pharmachem Inc., Canada	Received	531405608	TNMM
2	Purchase of lab materials	-do-	Paid	84514	-
3	Reimbursement of expenditure	-do-	Paid	64963	

4.3 Analysis of the Transaction:

As per the audited statement of accounts the financials of the assessee are as under:

Description	Amount (in Rs.)
Operating revenue	597094012
Operating cost	607633729
Operating profit	(-)10539717
OP/OR (%)	(-)1.73%
OP/OC	(-)1.76%

4.4 The TPO examined the TP study furnished by the assessee and summarized as under:

a. Based on the FAR analysis, the assessee has been characterized as an entrepreneur, exposed to normal risks while undertaking manufacturing of API activities.

b. The assessee is selected as tested party

c. In respect of the sale of goods to its AE viz., Apotex Pharmachem Inc., Canada, TNMM is taken as most appropriate method.

d. The assessee has selected PBDIT on cost as profit level indicator (PLI)

e. The assessee has conducted search using Prowess database and has selected 7 companies as final comparables. The arithmetic mean PBDIT on cost is computed as 14.51% whereas the same of the assessee is 10.22% and it is claimed that the assessee is within the plus/minus five per cent range of the ALP. Prowess data base was searched for selecting comparables. The search started with total universe of the companies from which companies were selected under the following broad categories:

- * Drugs & Pharmaceuticals
- * Drugs, Medical and allied products
- * Bulk Drugs
- * Pharmaceuticals
- * Formulations
- * Active Pharma ingredients
- * API

4.5 Comparables selected by the assessee are as under:

Sl.No.	Name of the comparable	% of PBDIT on Cost
1	BDH Industries Ltd.	9.62%
2	Fermental Biotech Ltd.	20.71%
3	Hab Pharmaceuticals & Research Ltd.	12.30%
4	Novodigm Ltd. (Merged)	11.23%
5	Syncom Formulations (I) Ltd.	11.58%
6	Tonira Pharma Ltd. (Merged)	21.60%
7	Tyche Industries Ltd.	14.51%
	Arithmetic Mean PBDIT/Cost	14.51%

4.6 Comments of TPO on comparables selected by the Assessee, which are as under:

1. The assessee has not used any explicit RPT filter. The TPO checked the related party transactions of the comparables selected by the assessee and found that the company Novodigm Ltd. has substantial related party transactions and it cannot be selected as comparable.

2. The assessee has not applied its filter of 'companies having line of activity other than bulk drugs eliminated' properly. This resulted in selection of some companies which are not functionally similar.

4.7 The TPO rejected the segmental details furnished by the Assessee, by observing as under:

"At Annexure No-4 of the TP report, the taxpayer has apportioned costs among the sales made to its AE and non-AE in exports market and sales made in domestic market. The allocation of direct & indirect cost has been done without any basis. Out of the total miscellaneous income of Rs 13.72 Lakhs the taxpayer has considered Rs 12.71 Lakhs in AE segment, which is 92.63% of miscellaneous income. However this has been done without any basis. Similarly out of scrap sale of Rs 5.19 Lakhs, an amount of Rs 4.80 Lakhs has been attributed to AE segment. This is again done without any basis. Therefore, the calculation of PLI cannot be accepted since the direct & indirect cost for AE and non-AE sales has been determined without any basis and no such segmental break-up is given in the Annual Report for FY 2009-10.

The taxpayer has not filed any supporting documentary evidence in support of the above discussed AE and non-AE profit margin calculation. Therefore, the profit margin calculation of the AE and non-AE segment as given in Annexure 4 of the TP document is hereby rejected.”

4.8 In view of the above shortcomings, the TPO reexamined 54 companies shortlisted at page 4 of assessee’s search process after applying the turnover filter of selecting companies with turnover between Rs. 30 crores to Rs. 90 crores. It was found that the following two companies are functionally similar and qualify all the filters applied by the assessee:

1. Vivimed Labs Ltd.
2. Embio Ltd.

After reexamining the comparables selected by the assessee and all the companies rejected by the assessee on functional grounds, the TPO has selected the following companies as comparables:

Sl.No.	Name of the comparable	OP/Sales %	OP/Cost %
1.	Fermenta Biotech Ltd.	12.99	14.93
2.	Hab Pharmaceuticals & Research Ltd.	8.45	9.23
3.	Tonira Pharma Ltd. (Merged)	11.28	12.72
4.	Tyohe Industries Ltd.	10.84	12.16
5.	Vivimed Labs Ltd. (Pharma Seg.)	28.24	39.35
6.	Embio Ltd.	14.92	17.54
	Total	86.72	105.93
	Average	14.45	17.65

The arithmetic mean of the PLI (OP/OC) which comes to 17.65% is taken as arm’s length margin. The arm’s length price of the international transactions entered into by and between the assessee and Apotex Canada computed as under:

Particulars	Rs.
Total operating costs	60,76,33,729
Total operating revenue	59,70,94,012
Sales to AE	53,14,05,608
Sales to AE as percentage of total operational revenue	89.01%
Operational cost in proportion to AE sale to total sales	54,08,65,112
Arm's length margin	17.65%
Arm's length sales @ 117.65%	63,63,27,804
Price received from AE	53,14,05,608
Shortfall being the adjustment u/s 92CA(3)	10,49,22,196/-.

Accordingly, the total income of the assessee was enhanced by the adjustment of Rs. 10,49,22,196/- in respect of sales made to its AE, Apotex Canada u/s 92CA(3) of the Act.

5. Aggrieved by the TPO's order, the assessee raised objections before the DRP and the DRP rejected the objections of the assessee by observing as under:

"07.0 Objection No.3 & 4 : Internal TNMM to be adopted & Segmented results as one of comparables. Since both the objections are inter-related, they have been taken up together. The assessee submitted that the product sold to both the segments i.e., AE & Non-AE are identical in all respects, the products are similar and the functions performed, assets employed and risks assumed are similar to both the segments. The products sold to AE & non-AE are either active pharmaceutical ingredients or intermediates of pharmaceutical Products. Both the Products are identical in their usage and application and only the chemical composition may be different from one product to the other. It was also submitted that in order to eliminate the differences on account of capacity under utilization and shift from license to generic, an alternate approach would be to consider the non-AE segment as internal comparable to bench mark the AE transactions and TNMM since both the segments are functionally comparable. It was also submitted that the external comparables adopted by the TPO suffer from the limitation of non-adjustment for lower capacity utilization and shift from license to generic as the same are not estimated and not adjusted while arriving at ALP.

07.1 The Panel has considered the submissions of the assessee. The TPO noted that as per the annexure, the total

sales of the non-AE exports segment are only Rs. 4.22 crores which is only 7.35% of the total exports whereas the AE sales are Rs.53.14 crores thus comprises of 93% and hence the non-AE export is comparatively a miniscule segment of the exports. It is also important to consider the items produced and sold in the non-AE exports segment since for any fruitful comparison it is necessary that both the AE as well as non-As exports segment operate in similar product line. Similarly, it is necessary that the AE and non-AE exports segment are selling the products in same geographic zone since the market conditions and economic and legal circumstances vary different geographic zones. In absence of these details, the comparison of the profit margin of the AE segment and non-AE exports segment is not valid. Hence, the Panel does not consider necessary to adjudicate this Objection and therefore, the objections are rejected.

8.0 Objection No.5: Adjustment for low capacity utilization. It was submitted that the assessee-company Invested huge capita' machinery which Investment could not be returned adequately due to low capacity Utilization. This low capacity utilization due to lesser demand resulted in some fixed costs remaining not recovered and the cumulative factors lead to lesser profitability and reliance was placed On the decision of Pune Bench of Tribunal in the case of MSS India Pvt. Ltd. (2009) 32 SOT 132 (Pune) where it has been held that adjustment for such under utilization of capacity needs to be given.

08.1 DRP has dealt this issue in its order for Asst. year 2008-09 in paras- 5.5 to 5.7 and rejected the objection raised by the assessee which has further been followed by the Panel in Asst.year 2009-10. Facts remaining the same, the Panel decline to entertain any adjustment to the profit margin in respect of capacity utilization for this year also."

6. Aggrieved with the above order of DRP, the assessee is in appeal before us.

7. Ld. AR submitted before us that assessee is a subsidiary of Apotex Pharmachme Inc., Canada and during this year, assessee has exported to its AE to the extent of Rs. 53.4 crores, which is 93% of the total sales and exported to non-AE to the extent of Rs. 4.25 crores, which is 7.35% of the total sales. Further, he submitted that the sales recorded during the year is only 30% of the utilization of the

total capacity installed. He submitted that DRP and TPO has refused to consider internal TNMM considering the turnover recorded with non-AE exports comparatively a miniscule segment of the exports. For the AY, even though, the project sold to both the segments i.e. AE and non-AE are identical in all respects, the products are similar and the functions performed, assets employed and risk assumed are similar. The products sold to both the segments are either active pharmaceutical ingredients or intermediates pharmaceutical products. He further submitted that in order to eliminate the differences on account of capacity underutilization and shift from license to generic, an alternate approach would be to consider the non-AE segment as internal comparable to bench mark the AE transactions and both the segments are functionally comparable in terms of TNMM. He further submitted that the external comparables adopted by the TPO suffer from the limitation of non-adjustment for lower capacity utilization and shift from license to generic as the same are not estimated and not adjusted while arriving at ALP. He submitted that with regard to low capacity of utilization, assessee has invested huge capital machinery, for which investment could not be returned adequately due to low capacity utilization, which is due to less demand resulted in fixed cost under recovery and the cumulative factors lead to negative profitability. He relied on the following cases:

1. Lummus Technology Heat Transfer BV Vs. DCIT, [2010] 42 Taxmann.com 342 (Delhi Trib.)
2. NTT Dta Global Delivery Services Ltd., Vs. DCIT, [2015] 63 Taxmann.com 92 (Hyd. Trib.)
3. Assessee's own case for earlier AY

7.1 Relying on the above cases, the Id. AR submitted that ratio laid down by the Delhi Bench of the Tribunal was that internal comparable cannot be rejected either for non-audit of segmented results or for mere reason that turnover of non-AE segment is smaller compared to AE turnover. Accordingly, he submitted that even though the turnover recorded by the assessee is similar compared to above case, the plea of the assessee should not be rejected on the basis of mere

difference in size of the non-AE turnover does not render the transaction uncomparable.

8. Ld. DR on the other hand, opposed the contention of the Id. AR for considering non-AE as internal TNMM and submitted that TPO has already brought on record that segmental details furnished by the assessee are not reliable for the reason that allocation of direct and indirect cost has been done without any basis. Therefore, the PLI submitted by the assessee cannot be accepted as far as the direct and indirect cost for AE and non-AE sales has been determined without any basis and no such segmental break up is given in the final report for the current AY. He further submitted that even though ITAT has held a suitable adjustment should be made on account of idle capacity, however, from the records submitted by the assessee, it is not clear to what extent profit margin effected due to idle capacity. He further brought to our notice that the assessee is contract manufacturer and as per the product comprising clause of the shareholder agreement, the assessee has to sell the goods to its AE with a mark up of 20% in case DMF is not required and 50% in case DMF is required on the cost for manufacturing, but, the assessee is showing profit margin only (-) 1.73%. Therefore, assessee does not get any support from the directions of ITAT. He relied on the findings of the DRP.

9. Considered the rival submissions and perused the material facts on record. We have noticed that assessee has made exports to its AE for Rs. 53.14 crores and exported to non-AE for Rs. 4.23 crores as well as made domestic sale to non-AE to the extent of Rs. 2.28 crores and it has arrived the profit margin of 1.19%, (-) 31%, 58.89% to sales relating to AE, export to non-AE and domestic sales to non-AE respectively. The profit margin is arrived with the help of a Cost Accountant after observing the total cost without factoring for idle capacity. In various judicial pronouncements and ITAT, Hyderabad

Benches have always directed that for consideration of comparables there has to be an adjustment for idle capacity utilization which will have a bearing on the final outcome of the ALP. At the same time, the Bench has also considered the option of adopting internal TNMM as a comparable for determining ALP. In the given case, the question is whether the quantum of turnover of non-AE i.e. uncontrolled transactions with total turnover has to be considered for treating as comparables. As per the case law brought on record before us i.e. *Lummus Technology Heat Transfer BV (supra)*, in which, the coordinate bench at Delhi has adjudicated that the size of the uncontrolled transactions are being smaller by itself, does not make the transactions uncomparable with the transactions in controlled condition. The size of the turnover does not matter in entities level comparison because of scale of operations substantially vary and so does the underlying profitability factor, but, in a transaction level comparison within the same entity mere difference in size of the uncontrolled transaction does not render transaction uncomparable. Therefore, we are in agreement with the above decision and also we noticed that in the above case, assessee has submitted segmental accounts reflecting business with AEs, business with non-AEs and idle capacity separately. Hence, the bench has properly appreciated that there is no bar in adopting uncontrolled transaction for the purpose of internal TNMM. Whereas, the AR has submitted that assessee's capacity utilization is only 30%, even though it has not maintained records to indicate the unabsorbed overhead, which relates to underutilization of the capacity. In our view, profitability of the organization will have an impact when there is huge underutilization of the capacity. There has to be an adjustment internally within the organization by allocating overhead to the segments, for which, capacity was utilized and for idle capacity. Otherwise, there has to be an adjustment of idle capacity when compared with outside comparables. In the given case, assessee has not properly maintained allocation of overheads, even though,

assessee has relied on the services of Cost Accountant, who has allocated the overheads only to the segments, in which, turnovers were recorded and failed to allocate for the idle capacity. Therefore, in our considered view, assessee has to submit the segmental results based on the absorption of overhead on capacity utilization and idle capacity. In our view, the result will be different when assessee submits the revised profitability report based on the capacity utilization . At present, assessee has declared negative profitability of AE and non-AEs and after reallocation of overheads on the basis capacity utilization, it will not be a negative profit. This is imperative that assessee allocates manufacturing overhead, administrative overhead and other fixed overheads on the basis of capacity utilization. It is adviceable for the assessee to submit segment-wise report i.e. export to AE, export to non-AE, domestic sales to non-AE and idle capacity. Considering the above factual matrix, we direct the TPO/AO to consider the above revised segmental profit and loss reports of the assessee and arrive of the ALP adjustment by considering non-AE transactions as one of the comparable in determining ALP by following TNMM method afresh. Needless to say that an opportunity of being heard to the assessee may be provided. Accordingly, we remit this file back to the file of TPO/AO for determining the ALP afresh.

10. In the result, appeal of the assessee is treated as allowed for statistical purposes.

11. The other alternate ground Nos. 5 to 10 raised by the assessee are dismissed.

Pronounced in the open court on 19th January, 2018.

Sd/-
(P. MADHAVI DEVI)
JUDICIAL MEMBER

Sd/-
(S. RIFAUH RAHMAN)
ACCOUNTANT MEMBER

Hyderabad, Dated: 19th January, 2018

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- 6) Guard File