**IN THE INCOME TAX APPELLATE TRIBUNAL**
**HYDERABAD BENCHES "B", HYDERABAD**

**BEFORE SMT. P. MADHAVI DEVI, JUDICIAL MEMBER**
**AND**
**SHRI B. RAMAKOTAIAH, ACCOUNTANT MEMBER**

| ITA No. | A.Y. | Appellant | Respondent |
|---|---|---|---|
| 305/Hyd/15 | 2010-11 | The Deputy Commissioner of Income Tax, Circle-8(1), HYDERABAD | M/s. Value Labs LLP, HYDERABAD **[PAN: AAEFV9532G]** |
| 405/Hyd/15 | | M/s. Value Labs LLP, HYDERABAD **[PAN: AAEFV9532G]** | The Deputy Commissioner of Income Tax, Circle-8(1), HYDERABAD |

For Revenue : Shri K. Ashok Kumar, CIT-DR
For Assessee : Shri P. Murali Mohan Rao, AR

Date of Hearing : 13-02-2018
Date of Pronouncement : 27-04-2018

**O R D E R**

**PER B. RAMAKOTAIAH, A.M. :**

These are cross-appeals by Revenue and Assessee against the order(s) of the Assessing Officer (AO) u/s. 143(3) r.w.s. 144C(5) of the Income Tax Act [Act].

2. Brief facts of the case are that, assessee is a partnership firm (LLP) registered with Registrar of Firms under Partnership Act, 1932. Value Labs Sdn. Bhd, ValueLabs Inc &

ValueLabs UK Limited are wholly owned subsidiaries of assessee.

2.1. Major business activities of assessee are as under:

i) Providing software development services, maintenance, testing, remote infra management, etc. to its customers.

ii) Software development services required for Associated Enterprises (AEs) like ValueLabs Inc & ValueLabs Sdn Bhd.

Assessee has registered with the Software Technology Park of India (STPI). It provides offshore software development services to its various clients in various countries. It also develops the software required for various clients of their AEs.

3. During the year under consideration, assessee has entered into the following transactions with its AE.

| Sl. No | AE | Nature of Transaction | Amount (Rs) | Method |
|---|---|---|---|---|
| 1 | Value Labs USA | Software Development Services | 11,83,39,958 | TNMM |
| 2 | Value Labs Sdn, Bhd, Malaysia | Software Development Services | 2,92,77,281 | TNMM |
| 3 | ValueLabs FZ LLC Dubai | Software Development Services | 7,01,31,450 | TNMM |
| 4 | ValueLabs Sdn, Bhd, Malaysia | Purchase of Date Service Platform (DSP) Software and IP rights | 69,40,25,750 | TNMM |

Assessee benchmarked by aggregating all the transactions and adopting Transactional Net Margin Method [TNMM] as the most appropriate method and submitted Form 3CEB. Assessee has compared its Profit Level Indicator (PLI) of 65.09% with the comparable companies average PLI of 29.19% and found the transactions to be at Arm's Length Price [ALP].

4. As the matter was referred to TPO for determining the ALP of the transactions, TPO has determined the ALP of the DSP software and IP rights as Nil in page 24 of the TPO order and recommended the ALP adjustment of Rs. 69,40,25,750/- u/s. 92CA(3) of the Act. TPO has also recommended to make ALP adjustment of Rs. 4,63,99,830/- in respect of software development services, if the ALP adjustment in respect of DSP Software and IP rights gets deleted in any of the appellate stages. AO has passed the draft assessment order dated 24-03-2014 by making the following additions:

a. ALP adjustment of Rs.4,63,99,830/- in respect of software development services;
b. ALP adjustment of Rs.41,75,25,442/- u/s.92CA(3) of the Act in respect of DSP Software and IP rights;

Against the draft assessment order, assessee filed objections before Dispute Resolution Panel (DRP).

5. With respect to ALP adjustment of Rs.4,63,99,830/- in respect of software development services, the DRP has directed in para No.10, to exclude cost of depreciation from the

companies in arriving at operating cost and to arrive at profit margin accordingly and rework the ALP as per law. With respect to ALP adjustment of Rs.41,75,25,442/- u/s.92CA(3) of the Act in respect of DSP Software and IP rights, the DRP has directed in para No.12 to restrict the ALP adjustment to Rs.19,22,44,500/ - in respect of ALP adjustment towards DSP Software and IP rights;

6. Consequent to the Directions of the DRP, AO has passed the order 30-01-2015 making addition of Rs.19,22,44,500/- towards ALP adjustment in respect of DSP Software and IP rights. With respect to adjustment on software services, after due verification, AO has mentioned that the margin of the taxpayer after excluding depreciation was 73.62% and the average margin of the comparable companies after excluding depreciation was 29.43%, hence no ALP adjustment was required to be made in respect of Software development services. Aggrieved, both Revenue and Assessee filed appeals raising various grounds.

7. The major issue of contention between the assessee and the Revenue is with reference to purchase of DSP Software totaling to Rs. 69,40,25,750/- during the year from Value Labs Sdn, Bhd, Malaysia. Assessee has purchased the DSP Software for the above amount from it's AE and TPO in his analysis of the ALP however relied on a statement of an Executive Mr. Suresh to submit that the entire product was developed in India and based on that TPO was of the opinion that there was no need to pay any amount for the software purchased and he determined

the ALP at NIL. Assessee made detailed submissions before the DRP which were extracted in para 11 of the DRP order from paras 11.1 to 11.19. The DRP has partly considered the assessee's submissions and decided the issue as under:-

> "*12. The panel considered the detailed submissions of the assessee and perused the contentions of the TPO on this ground. The contention of the assessee about lack of jurisdiction of TPO regarding the redetermination of value of the purchase of software is not tenable as the AO had incorporated in the draft assessment order which is the subject matter of appeal before the panel. Since the draft assessment order is passed by the Assessing Officer, the objection raised by the assessee does not merit consideration. Since the impugned order is the draft assessment order as the TP order merges with it. Hence, the draft assessment order is disputed for adjudication. Therefore, the panel is of the view that the assessees contention is to be rejected on the legality of addition*
>
> *12.1 Having said that it has to be seen whether the TPO 1 AO is justified in recomputing the value of the DSP software at NIL as against the claim of the assessee at Rs.62,17,81,2501- and Rs.7,22,44,5001-. From the submissions, it is clear that initially the Indian entity has started work on DSP software and developed certain prototypes in this regard. Subsequently, in 2004/2005, VL Malaysia had taken up further work of development of software in its own hands. Though, a part of the activity is outsourced to the Indian entity for a payment, the ownership rests with the VL Malaysia. For the services obtained from the Indian entity, the Malaysian company had duly compensated by making payments from year after year. After development of the software, the same has been transferred to the Indian entity for a consideration and it is also a fact that the Indian entity had been compensated out of such acquisition to diversify its ambit of technical services provided to various clients.*
>
> *12.2. It is also clear that the assessee has expanded its clients by providing technical services after acquiring the DSP software. This was evidenced by the increase in the revenue in the subsequent year of acquisition. Therefore,*

*there is benefit accrued to the assessee company by virtue of acquisition of DSP software in its armory.*

*12.3. The TPO largely guided by some answers given by one of the executive of the Indian Company to the officers of the International Transactions in the course of survey. The TPO has not taken totality of the issue involved, instead proceeded on the basis of few answers given by such executive. From the statement of the Sudhir John it is clear that the technical personnel who are competent to develop the software are the employees of Malaysian entity, though one of them left the company subsequently. Further, the assessee also stated that the VL Malaysia engaged the services not only the Indian entity but also the infrastructure facilities provided in MCS for the development of the software. Therefore, it is clear that the DSP son ware was developed by the Malaysian company and sold to the Indian entity. The issue in question is whether the value paid by the assessee towards purchase of DSP software at Rs. 62,17,81,250/- is justified or not. One important point to be considered here is that initially the Indian entity had started the work on DSP and subsequently the Malaysian Company taken over the activity from where the Indian company left. But for all the work done in the 4 years by the Indian Company, no proper compensation at Arm's length level was paid. The argument of the assessee that the Indian company had acquired first charge is not convincing to pass on the prototypes developed by the Indian entity to the Malaysian company. There is no doubt nor dispute about basic work done by the Indian Company towards DSP software. The Indian company deserves to be compensated at a reasonable price. In any case, being the AE, the Malaysian entity would have given preference to the Indian entity rather than sale to outside companies. Therefore, such clause does not supercede the compensation point to be received by the Indian company. Accordingly, the panel is of the view that for the services rendered in respect of R&D work, development of prototypes and proof of concept, the Indian company should deservingly to receive a sum of Rs. 12 crores. @ Rs 3 crores per annum. It has been arrived based on service charges paid by AE to assessee company in subsequent years when it undertook to work on DSP software. Considering the basic and fundamental research work initiated and conceptualized by Indian entity, the panel is of the opinion, it should have been*

*compensated for its contribution. Consequently, the value of DSP software is to be reduced to that extent. Accordingly out of the prices of software paid by the assessee at Rs.62,17,81,250/-, Rs.12,00,00,000/- should be deducted and the balance of Rs.50,17,81,250/- only to be considered as the ALP for the purchase of software.*

*12.4. As regards acquisition of IP rights and the payment of Rs.7,22,44,500/ -, we find that the TPO and the AO is fully justified in rejecting the claim, as the assessee could not establish with any reasonable evidence to show that the IP rights have been transferred to the Indian Company. Accordingly, the payment of Rs.7,22,44,500/- towards IP rights cannot be allowed as purchase value in the hands of the assessee. Thus, in totality the value of the DSP software is redetermined as Rs.50, 17,81,250/ - as against NIL adopted by TPO & AO and Rs.69,40,25,750 (Rs.62,17,81,250 + Rs.7,22,44,500/-) shown by the assessee."*

8. On the above issue, the assessee has contested the bifurcation of the amount and partial confirmation by the DRP whereas the Revenue has aggrieved not only on the reduction of the price by the DRP but also the direction of the DRP in excluding the depreciation from the operating cost while examining the ALP in software development.

9. Learned Counsel for the assessee referring to the submissions made before the DRP reiterated that the DSP Software package was developed by Value Labs, Malaysia for which assessee has undertaken certain software programming for which it was remunerated in the respective years. It was submitted that the software development services at Malaysia are considered at Arm's Length by the orders i.e., in FY 2005-06 by the order dated 01-01-2009, for the FY 2006-07 by the order dated 30-08-2010, for FY 2007-2008 by the order dated 05-10-

2011 and for the FY 2008-09 by the order dated 31-10-2012. In view of the series of the orders given by the different officers in different years, the direction of the DRP that assessee should have been compensated by further sum of Rs. 12 Crores is not warranted and was without considering the facts on record. It was further submitted that there is no basis for arriving at the above opinion when the purchase of the software was supported by a proper valuation and also by the orders of the Deputy Commissioner of Customs, Special Valuations Branch vide order dated 10-03-2010. It submitted that that there is no need to register any IP Rights under the Malaysian law or under the Indian Copy Right Law and submitted that even after purchase, assessee has also not registered under any Copy Right / IPR Law. Therefore, the stand taken by the DRP is not correct. Elaborating further, it was submitted that the Copy Right comes into existence as soon as the work is created and no formality is required to be completed for acquiring Copy Right. Learned Counsel relied on various case law given in context of Copy Right Act to support that registration is not *sine que non* or condition precedent to the subsistence of Copy Right or acquisition of ownership thereof. It was further submitted that the DRP itself has agreed that the assessee has purchased the software from Malaysia and in that context when rights are available with Value Labs Malaysia the price paid has to be accepted. It was further submitted that TPO has not analysed the transaction under any of the provisions of section 92C of the Act and hence TPO was not correct in determining the value at NIL and further DRP was also not correct in restricting the amount to Rs. 19,22,44,500/- in their order.

10. In reply, Learned Departmental Representative reiterated the stand taken by the TPO and referred to the various annual statements of Malaysian company to submit that TPO order determining the NIL price is correct. With reference to Revenue's appeal, it was the contention the DRP has erred in taking the pre-depreciation operating cost as basis and accordingly supported the order of the TPO.

11. Learned Counsel for Assessee in reply submitted that this issue is considered by the ITAT in favour of the assessee in other cases and relied on the following decisions:-

(1) BA Continuum India Private Limited (ITAT, Hyd.) ITA No. 1154/Hyd/2011;

(2) Market Tools Research Pvt. Ltd. Vs. DCIT, ITA No. 1150/Hyd/2011;

(3) Schefenackerj Motherson Ltd vs. ITO (123 TTJ 509);

(4) Qual Core Logic Limited vs. DCIT, ITA No.893/Hyd/2011;

(5) M/s. BA Continuum India Private Limited (Telangana & AP High Court) ITTA No.440 of 2014 dated 16.07.2014 and

(6) Cambridge Technology Enterprise Limited, ITA No. 364/11/2015.

12. We have considered the rival contentions and perused the paper book on record. On the issue of taking pre-operative cost as a basis for arriving at the ALP, the order of the DRP is as under:

*"9.1 The assessee argued in respect of computation of PL! that the TPO has taken number of comparable companies which are totally dissimilar in function, having extraordinary features like merger, acquisitions etc. Apart from the above contention, the AR also contested the action of the TPO on the ground that the assessee being a firm claimed the depreciation as per the Income-tax Act at the rate of 60%, whereas the comparables being the companies adopted the depreciation as per the Companies Act which comes to around 16.21%. Thereby, the assessee firm claimed more depreciation cost which resulted in lowering of operating margins. Whereas comparables with lower depreciation cost declared higher profit margins. Therefore, such comparison cannot be made to calculate PLI of the assessee and thereby making Arm's Length Price adjustments. Further, it is submitted by the assessee that if the taxpayer followed the depreciation rates as provided in the Companies Act, 1956, the profit margin comes to around 38.6% which is very high when compared to the companies selected for comparables. Accordingly, the AR submitted that the lower profit margin declared in the books of account is on account of higher cost of depreciation not because of the lower transaction value as alleged by the TPO. Accordingly, it is argued to provide level playing field to arrive the correct profit margin on the international transaction executed by the taxpayer. In support of such contention, the assessee placed reliance on the decision of the ITAT Hyderabad in the case of M/s. Market Tools Research Pvt. Vs. DCIT (lTAT-Hyderabad), ITA No.1150/Hyd/2011 which in turn taken the support of Delhi ITAT decision in the case of Schefenacker Motherson Ltd. vs ITO (123 TTl 509) for AY 2003-04 and Schefenacker Motherson Ltd. vs DCIT in ITA No. 4460/Delj07 for AY 2004-05 and in the case of M/s. Qual Core Logic Limited Vs. DCIT, Circle-16(3), Hyderabad in ITA No. 893/Hyd/2011.*

*10. The panel noted the detailed submission of the assessee made in presence and also in writing on this issue and found some merit in the submissions of the AR in respect of variable cost of depreciation in assessee's own case being the firm and comparable companies etc. In order to compare the profit margins of comparable companies and assessee company, it is necessary to exclude the depreciation cost from the operating cost in both assessee company and comparable companies. In view of variable cost of depreciation, it is necessary to exclude this item. Accordingly, the panel directs the TPO to verify the*

*depreciation claims of comparable companies and the assessee and to exclude cost of depreciation from companies in the operating cost and arrive profit margin and accordingly rework the Arm's Length Price as per Law."*

13. Since the DRP has followed the Coordinate Bench decisions and also on the fact that the depreciation claims of the partnership firm of the assessee as that of companies under Company Law are being different, we do not find any reason to interfere with the decision of the DRP, in taking the operating cost exclusive of depreciation for comparison. Accordingly, the order of the DRP is confirmed and Revenue's grounds on this issue are rejected.

14. Coming to the issue of determination of price for purchase of software, we find that TPO has not analysed the transaction under any of the methods prescribed, but interfered in the business decision by determining the price at NIL, on the basis of so called statement of Executives. DRP has rightly considered that the statement cannot be taken as basis. While accepting that the Value Labs-Malaysia has undertaken the work in it's own hands and part of the activity was outsourced to the Indian entity, DRP has erred in determining a further price to meet the price for earlier services at Rs. 12 Crores, ignoring that the services were paid at market value and there are series of orders by the different TPOs in respect of earlier years holding that the services rendered were at market value / ALP. The DRP seems to have not noticed that the TPO's accepted the remuneration received by the assessee for the part work done was at ALP. In view of that, we are not in agreement with the

DRP decision that assessee should have been compensated for its past services, which in our opinion is purely based on surmises and presumptions. Therefore, we are not in a position to uphold the DRP decision which has no basis at all. Further with reference to the IP Rights i.e., payment of 10% of the total cost towards IP Rights, this is the business decision. The DRP accepted that Value Labs Malaysia has undertaken the activity, consequentially the Copy Rights in the product lies with Value Labs Malaysia. In view of that, we do not find any reason to support the contention of the DRP that payment of 10% of total cost towards IP Rights cannot be allowed in the hands of the assessee. In fact, neither the TPO nor the DRP can question the business decision of the assessee to state that the value was NIL. The Co-ordinate Bench in the case of IWM Constructions (P.) Ltd Vs. ACIT vide order dated 20th July, 2016, relying on the decision of the Hon'ble Delhi High Court in the case of CIT Vs. EKL Appliances Ltd., (2009 Taxman 200) has held that TPO as well as AO are not correct in holding that the transaction between the assessee and it's AE are sham, particularly since the assessee (IWM Constructions (P.) Ltd) was responsible for designing Highway. Similarly, in the present case also since the product was developed by Value Labs Malaysia, it cannot be stated that it has no Copy Rights. Since the entire value for purchase of software, including Copy Rights / IP Rights, was evaluated by the Deputy Commissioner, Customs at the time of import and was also accepted by the RBI and other Authorities at the time of payment, we do not find any reason to doubt about the value of the product. As already stated, TPO has not analysed the value under any of the Five Methods and simply

determined at NIL without any basis. The DRP has also not given any verifiable reasoning in rejecting the assessee's contention that the IP Rights have been transferred to the Indian company. When the product is purchased the rights automatically transferred and asper the agreement placed on record, 10% of the cost is considered towards IP Rights on which necessary withholding taxes were already considered and paid. In view of that we do not agree with the reasoning given by the DRP in restricting the value of the IP Rights at NIL, since the Hon'ble Delhi High Court in the case of EKL Appliances Ltd (supra) has already held that TPO / DRP cannot interfere the business decision therefore determining of value at NIL cannot be upheld. In view of that, we modify the order of the DRP and direct the AO to accept the purchase price as at Arm's Length. Assessee's grounds are allowed. Consequentially, the Revenue's grounds on this issue are rejected.

15. In the result, assessee's appeal is allowed and Revenue's appeal is dismissed.

*Order pronounced in the open court on 27th April, 2018*

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|---|---|
| Sd/- | Sd/- |
| **(P. MADHAVI DEVI)** | **(B. RAMAKOTAIAH)** |
| **JUDICIAL MEMBER** | **ACCOUNTANT MEMBER** |

Hyderabad, Dated 27th April, 2018

TNMM/OKK

*Copy to :*

*1. The Deputy Commissioner of Income Tax, Circle-8(1), Hyderabad.*

*2. M/s. Value Labs LLP, Plot No. 41, Hitech City, Phase-II, Madhapur, Hyderabad.*

*3. Dispute Resolution Panel (DRP)*

*4. Director of Income Tax (IT & TP), Hyderabad.*

*5. Addl. Commissioner of Income Tax (Transfer Pricing), Hyderabad.*

*6. D.R. ITAT, Hyderabad.*

*7. Guard File.*