आयकर अपीलीय अधीकरण, न्यायपीठ – "C" कोलकाता,
IN THE INCOME TAX APPELLATE TRIBUNAL "C" BENCH: KOLKATA
(समक्ष) Before **श्री ऐ. टी. वर्की,** न्यायीक सदस्य **एवं/and** श्री एम .बालागणेश, लेखा सदस्य)
[Before Shri A. T. Varkey, JM & Shri M. Balaganesh, AM]

I.T.A. No. 550/Kol/2014
Assessment Year: 2007-08

Income-tax Officer, Wd-2(3), Kolkata	Vs.	I.T.C. Infotech India Ltd. (PAN: AAACI7376Q)
Appellant		Respondent

Date of Hearing	22.11.2018
Date of Pronouncement	05.12.2018
For the Appellant	Shri Sanjoy Paul, Addl. CIT, Sr. DR
For the Respondent	Shri J. P. Khaitan, Sr. Counsel

ORDER

Per Shri A.T.Varkey, JM

This appeal preferred by the revenue is against the order of the Ld. CIT(A)-VI, Kolkata dated 27.12.2013 for AY 2007-08.

2. The following effective ground nos. 1 and 2 raised by the revenue read as under:

"1. That on the fact and circumstances of the case the Ld. CIT(A), by deleting the transfer pricing adjustment of Rs.5,73,70,465/-, failed to appreciate that arm's length pricing adjustment was not arbitrary but is a benchmark determined on similar instances.

2. That on the facts and circumstances of the case Ld. CIT(A) erred in deleting the addition of Rs.35,41,376/- (Rs.76,55,910/- minus Rs.41,14,534/-) made on purchase of software wrongly interpreting it as an expense revenue in nature whereas the expenditure is of capital nature."

3. Coming to ground no.1. At the outset itself the Ld. Sr. Counsel for the assessee submitted that the issue raised in ground no.1 of the revenue is no longer res integra. According to him, this issue has already cropped up in AYs 2005-06 and 2006-07 and the Tribunal in assessee's own case for these Assessment Years in ITA Nos. 2222 & 2223/Kol/2010 was pleased to uphold similar action of the ld CIT (A) and against the same

the revenue preferred an appeal before the Hon'ble High Court which has been dismissed by the Hon'ble High Court in GA No. 2314 of 2015 by order dated 08.01.2016 and thus Hon'ble High Court confirmed the order of the Tribunal. We note that the Tribunal in assessee's own case wherein the Ld. CIT(A) had deleted the addition made by the AO/TPO as per the transfer pricing adjustment made by them, was challenged by the revenue before this Tribunal for AYs. 2005-06 and 2006-07 wherein the Tribunal upheld the action of Ld. CIT(A) by holding as under:

> *"13. We noted from factual aspects of the case that the TPO perceived that functional and risk profile of the assessee and its AEs are different in both the business models wherein the assessee assumes larger share of risks when contracts are entered by it with customers (Business Model-I) as compared to arrangements wherein the AEs executes the contract with customer (Business Model-II). The two business models are optically different (in terms of contractual party), but the functional and risk profile of both the assessee and its AEs remain ITA No. 2222 & 2223/Kol/10 ITC Infotech India .Ltd 15 the same in both the models, which is evident not only from the terms of the MSA but also from the conduct of the parties. The assessee has explained the business model followed by it along with its functional and risk profile. The assessee explained the "global Delivery Model" as adopted and forming the very basis of two alternative inter-company invoicing models. The business model followed by the assessee and 12A/12B is summarised below:-*
>
> *Model I – Where the customer directly enters into the contract with the respondent; and*
>
> *Model II – Where the customer directly enters into the contract with 12A/12B*
>
> *The assessee explained the economic substance underlying the two arrangements, the roles and responsibilities and the functional profile of the assessee as well as that of its AEs 12A/12B. Further, it explained that inter-company invoicing agreements and contractual terms entered with the AEs. Under both the business model, the basic functions of the subsidiaries, with regard to the administrative functions i.e. account management, are same. On the other hand, assessee is performing non-administrative functions under both the business models and thus entire risks with regard to non-administrative services are being borne by the assessee irrespective of the business model. Furthermore, it was also explained that customers enter into contract with either assessee or 12A/12B with the basic understanding that the activities/services in connection with development of the assignment/project would be essentially driven by assessee in adherence with various commercial and technical qualification parameters/norms specified by the customer namely share capital, average revenue over a period of time, brand value, reputation in the market, track record of successful project, vast and experienced resource pool with expertise in various areas of work, etc. Hence, the essential factor for awarding a service contract would always be technical and commercial expertise and experience of the assessee in handling such similar projects. The local presence of the AEs or it stand-alone financial or technical capabilities hardly influence the decision of the customer to sign the agreement with the AEs. The assessee stated that the possibility of a customer raising any claim for deficiency in administrative services are very remote, as they are rendered to the assessee as an internal arrangement and the customers are not affected by it. Only possibility of any customer raising a claim would be in respect of non-administrative services which are exclusively provided by ITA No. 2222 & 2223/Kol/10 ITC Infotech India .Ltd 16 the assessee irrespective of the*

business model. It was also emphasised that it is the assessee, which has adequate capital and technical expertise to bear the risks arising from deficiency in services, which neither 12A nor 12B possess. Thus even if a customer raises any claim on 12A/12B, such risk would be eventually passed on to the assessee.

14. There is contractual relationship among the assessee, its subsidiaries and third parties. The subsidiaries, based on agreement entered into with the assessee, engage in marketing of the IT service capabilities of the assessee in their respective countries and try to win contract for providing IT services. Once a customer is identified, the subsidiaries in coordination with the assessee try to win the customer contract. As it has been explained through the sample customer proposals, the customer is made aware of the assessee's technical expertise, experience, resource pool etc. from initial stages of the proposal/bidding stage. Once the customer is won, the subsidiaries download the non-administrative services to the assessee. There may be some customers who may not be at all willing to enter into a contract with the subsidiaries as the subsidiaries on a stand-alone basis may not be fulfilling the conditions set by the customers for awarding the contract for provision of IT services. However, these customers may be willing to enter into a contract with the assessee as it has the requisite man power for providing IT services, vast and experienced resources pool with expertise in various areas of work, adequate share capital for bearing the risk arising out of the contract, average revenue over a period of time, brand value, reputation in the market, track record of successful projects, etc. In such cases, the contract is entered into between the customer and the assessee but the functions and risks undertaken by both the assessee and its subsidiaries remain the same as they are when the customers enter into the contract with the subsidiaries. Ld. counsel explained the concept of 'conduct of the parties' and risks associated with it. He referred to para 5.3.2.22 and 5.3.2.23 of the United Nations Practical Pricing Manual on Transfer Pricing for Developing Countries ('Practice Manual') wherein, allocation of risk and conduct of parties is explained that:-

> *'It is not only necessary to identify the risks but also to identify who bears such risks. The allocation of risks is usually based on the contractual terms between the parties. However, contacts between associated enterprises may not specify the allocation of all the risks.*
>
> *Even where a written contract is in place, an analysis of the conduct of the parties is critical in order to determine whether the actual allocation of risk conforms to the contractual risk allocation'*
>
> *'When analysing the economic substance of a transaction, it is necessary to examine whether the conduct of the associated enterprises over time has been consistent with the purported allocation of risk and whether changes in the pattern of behaviour have been matched by changes in the contractual arrangements (emphasis added)*

Furthermore, in relation to contractual relationship and conduct of the contracting parties, para 5.3.2.30 states that:

> *The conduct of the contracting parties is generally a result of the terms of the contract between them. The contractual relationship thus warrants careful analysis when computing the transfer price. Other than a written contract, the terms of the transactions may be found in correspondence and communications between the parties involved. In cases where the terms of the arrangement between the two parties are not explicitly defined, the contractual terms have to be deduced from their economic relationship and conduct. (emphasis added)*

It is also pertinent to mention at this juncture that the concept of business risk in transfer pricing context has been discussed at length in the recent amendments to the OECD Transfer Pricing Guidelines 2010 (hereinafter referred to as "OECD Guidelines") under the new Chapter IX (Transfer Pricing Aspects of Business Restructuring). As per this new guidance, para 9.10 provides that:

> *"Risks are of critical importance in the context of business restructurings. An examination of the allocation of risks between associated enterprises is an essential part of the functional analysis. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized."*

Under para 9.11 and 9.12:

> *"... .. the examination of risks in an Article 9 context starts from an examination of the contractual terms between the parties, as those generally define how risks are to be divided between the parties. Contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it ... .."*
>
> *... a tax administration is entitled to challenge the purported contractual allocation of risk between associated enterprises if it is not consistence with the economic substance of the transaction . Therefore, in examining the risk allocation between associated enterprises and its transfer pricing consequences, it is important to review not only the contractual terms but also the following additional questions:*
>
> *· Whether the conduct of the associated enterprises conforms to the contractual allocation of risks,*
>
> *· Whether the allocation of risks in the controlled transaction is arm's length, and*
>
> *· What the consequences of the risk allocation are."*

Specific attention was drawn to the concept of 'risk allocation' and 'control', on which para 9.22 and 9.23 of the OECD Guidelines state that:

> *"In the absence of comparables evidencing the consistency with the arm's length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances. In such situations, if risks are allocated to the party to the controlled transaction that has relatively less control over them, the tax administration may decide to challenge the arm's length nature of such risk allocation.*
>
> *..."control" should be understood as the capacity to make decisions to take on the risk (decision to put the capital at 5risk)) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the*

fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party."

Further, the OECD Guidelines have also discussed on the issue of "risk allocation" and "financial capacity" in para 9.29 9.30 as follows:

"Another relevant, although not determinative factor that can assist in the determination of whether a risk allocation in a controlled transaction is one which would have been agreed between independent parties in comparable circumstances is whether the riskbarer has, at the time when risk is allocated to it, the financial capacity to assume (i.e to take on) the risk.

Where risk is contractually assigned to a party (hereafter 'the transferee) that does not have, at the time when the contract is entered into, the financial capacity to assume it, e.g. because it is anticipated that it will not have the capacity to bear the consequences of the risk should it materialise and that it also does not put in place a mechanism to cover it, doubts may arise as to whether the risk would be assigned to this party at arm's length. In effect, in such a situation, the risk may have to be effectively borne by the transferor, the parent company, creditors, or another party, depending on the facts and circumstances of the case, irrespective of the contractual terms that purportedly assigned it to the transferee."

Based on the above OECD Guidelines and Practice Manuals, we are of the view that the conduct of the assessee and its AEs should be given due cognizance which in the assessee's case is same in both the business models. The assessee has also explained from the table, that the functions performed and the risks assumed by the assessee and its AEs under both the business models are the same i.e. the assessee undertakes the core delivery functions and assumes the service liability risks while the AEs are only engaged in marketing and administrative functions.

Further, the sample proposal documents submitted by the assessee also vindicates that the prospective customers are fully aware of assessee's technical capabilities and expertise while awarding a contract and even if the actual contract is executed by the AEs, the customer would presumably not tend to believe that the offshore IT/software development services under Global Delivery Model is being rendered by the AEs and not the assessee. Hence, the execution of the agreement directly by the assessee or by the AE would not create any substantial difference in the sharing of functions or risks between the parties or in turn, would not change the functional characteristic of the parties.

15. Now before us Ld. counsel explained possible claim by customer for provision of services by the assessee and 12A/12B that

· Claim for any deficiency in administrative service –

That the possibility of a customer raising any claim for any deficiency in administrative services seems to be very remote as the customer is not impacted by the services which are in the nature of travel arrangements and liasing between the customer and the respondent. It is the respondent who would be impacted for any deficiency in the services provided by the subsidiaries. The only area of any probable dispute and consequential claims is with regard to non-administrative services which are being provided by the respondent u9nde both the business models.

· Claim for any deficiency in non-administrative services –
The Ld. TPO, vide his order, has acknowledged the fact that the MSA very clearly envisage that the subsidiaries would sub-contract to the respondent the non-administrative services and the provider of these non-administrative services, i.e., the respondent would be fully liable to the user, i.e., customer for the same.

He further submitted that it has the adequate capital and the technical expertise to bear the risk that may arise for any deficiency in the services provided to the customers. The subsidiaries do not have adequate capital or technical expertise to bear such a risk. Thus, in our view, under the Business Model 2, as per terms of the MSA, in case a Customer raises any claim for non-performance of the non-administrative services, the subsidiaries would eventually pass on such risk to the assessee and the assessee has to bear such risk. The customers enter into contract with either the assessee or the subsidiaries for providing software development services. The contracts entered with customers also mention the expected standard of services to be provided for software development work. It is the internal arrangement between the assessee and the subsidiaries where the marketing and the administrative functions are performed by the subsidiaries under both the business model. The subsidiaries provide the marketing and the administrative services to the assessee and not to the clients. Thus, in both the business model the risk profiles of the subsidiaries remain the same. Further, in course of the contract negotiation and mapping of the scope of work, the customer is fully aware of the underlying delivery mechanism, since technical capabilities of the assessee are always showcased and presented before the customer. Therefore the customer based on their individual preferences and driven by the considerations, which are exclusively their own, chooses to enter into contract with 12A / 12B or the assessee, which does not make any essential variation in the business model as a global organisation. Invoicing is the derivative of the methodology proposed to be pursued by the respective client who awards the assignment. The prospective customer is also fully aware of the financial standing of 12A / 12B vis-a-vis the ITC Infotech Group even while entering into service contract with 12A / 12B in view of the fact that every service proposal specifically highlight the technical strength and the financial strength of the assessee which plays its pivotal role before the clients while entering into a contract with 12A / 12B. Hence, the presumption of the TPO that the overseas customers' decision to enter into contracts directly with 12A or 12B are essentially governed by the standalone financial or technical strengths of these entities devoid of the backup of the assessee's financial / technical strengths, is inappropriate and without any basis.

16. Further, in relation to quantification of Risk adjustment, we are of the view that the exercise of risk adjustment is not a simple exercise. A lot of research has been carried out in this field of economics over the years, as a result of which various theories have evolved, that have been applied across businesses to quantify the inherent business risks. However, the subject of risk evaluation and quantification has continued to be an area of extensive study and research.

The assessee vide submission dated 11th October, 2009 briefly discussed one such concept in the area of risk management i.e., towards risk evaluation and quantification. In case of the assessee, there is an inherent transfer of risk by 12A / 12B to the assessee vide the MSA in relation to cases where the customer contacts directly with these. AEs and there are financial claims relating to the quality of deliverables. Such a transfer of risk through contractual arrangement is a common risk management practice in commercial world and should be duly recognized. The TPO made adjustment by determining a different revenue split [15% or 13% as the case may be] from the one followed by the respondent and 12A / 12B. Such an adjustment made by the TPO was without any basis or analysis. In relation to difference in clauses in the MSA between the assessee and 12A as referred to by the TPO for making an ad-

hoc adjustment, the assessee further drew our attention towards Clauses 4A (iii) and clause 4B (ii) of the MSA which provides for the same effect in relation to exclusion of certain administrative services to be performed, Clause 4B (ii) provides that:

> *"if INFOTECH US subcontracts its obligation in accordance with this clause 4(B), the parties agree that the provisions of clause 5(iii) to (v) inclusive shall not apply and that a fee equal to 75% of the revenue derived under the applicable customer contract from non-administrative services provided by the respondent's employees shall be paid by INFOTECH US i.e '12A' to the respondent."*

Further, the assessee also calculated the effect of adjustment on profitability of ITC Infotech Group taking into consideration the risk adjustment envisaged by TPO for the AY 2006-07 and submitted that both 12A and 12B would make losses at net level if the risk adjusted pricing model, as proposed by the TPO were put in actual practice. Thus the risk adjusted business model as proposed by the TPO would result in an absurd situation from 12A / 12B's perspectives defeating the concept of stable positive return for a low risk tested party.

In the light of the above, we are of the view taking into cognizance the business model of the assessee along with the functions undertaken and risks assumed by the assessee and its subsidiaries, the facts and written submission made during the course of the proceedings for both the AYs 2005-06 & 2006-07, that the TPO totally erred in making transfer pricing adjustments in the case of assessee in both the AYs. In view of facts and circumstances, we are of the view that the TPO just on the basis of conjunctures and surmises made this transfer pricing adjustments. Hence, we dismiss this common issue of revenue's appeals in both the AYs."

4. We take note that the Tribunal's order (supra) confirming the Ld. CIT(A)'s action has been upheld at the level of the Hon'ble High Court wherein the Hon'ble High Court by order dated 08.01.2016 for both the assessment years in GA No. 2314 of 2015 and 2318 of 2015 was pleased to uphold the action of the Tribunal by holding as under:

> *"The submission of the appellant that the adjustment of TPO towards Account of Management charges is arbitrary has been dealt by the First as well as the Second Appellate Authority and a concurrent finding of fact has been recorded that the TPO in principle accepted the remuneration model of 25% revenue sharing and the same has been substantiated and justified by the documents so submitted before the authorities below. Further, the genuineness of the documents which were relied on by the authorities have not been doubted by the Department.*
>
> *Thus, in view of the above, we do not find any illegality and infirmity in the orders and further we are of the opinion that a concurrent finding of fact on the basis of the documents on records was recorded by the First Appellate Authority as well as the Second Appellate Authority.*
>
> *Accordingly, no question of law arises out of the judgment rendered by the authorities below. The appeals are devoid of merits and the same are dismissed accordingly along with the applications being GA No. 2314 of 2015 and GA No. 2318 of 2015 respectively."*

5. Therefore, respectfully following the order of the Hon'ble High Court in AYs 2005-06 and 2006-07 and taking note of the Hon'ble jurisdictional High Court decision in assessee's own case, supra, we confirm the order of the Ld. CIT(A) and dismiss this ground of appeal of the revenue.

6. Next ground of appeal was raised by the revenue. The Ld. Sr. counsel drew our attention to the fact that this issue has also been adjudicated by the Tribunal for AY 2005-06 and 2006-07 wherein also the Tribunal upheld the action of the Ld. CIT(A) on similar facts and circumstances of the case. According to Ld. Sr. Counsel, this action of the Tribunal has not been appealed by the Department before the Hon'ble High court and so, according to him the department have already accepted the action of the Ld. CIT(A)/Tribunal on this issue and he drew our attention to para 17 to 19 of the Tribunal's order which is reproduced as under:

> *"17. The next common issue in these two appeals of revenue is against the order of CIT(A) deleting the disallowance of software expenses. For this following ground no. 4 is raised in AY 2005-06 reads as under:-*
>
> > *"4. That on the facts & circumstances of the case the Ld. CIT(A) erred in deleting the addition of Rs.6897876/- made on purchase of software in the head "operating & manufacturing expenses" wrongly interpreting it as an expense revenue in nature whereas the expenditure is of capital nature."*
>
> *18. We have heard rival contentions and gone through facts and circumstances of the case. We find that the AO made disallowance of Software expenses in AYs 2005-06 & 2006-07 amounting to Rs.68,97,876/- & 9,67,408/- respectively. But CIT(A) deleted by holding the software expenses to have been incurred for the purposes of business not resulting in any enduring benefit. Aggrieved, now revenue is in second appeal before tribunal for both AYs.*
>
> *19. We find that during the AYs 2005-06 & 2006-07, the assessee incurred expenditure in connection with the purchase of software. The assessee is engaged in the business of software development and this software was acquired by it in connection with client projects. The software acquired was application software. During assessment proceedings also the assessee asked as to why such software expenses should not be treated as capital expenditure and it explained to AO in detail about the software acquired and the business necessity of such software. It was explained that the software acquired were application software which were being used by the assessee for its business of developing software for it clients and did not result in any enduring benefit. Even now before us also it was explained that the expenditure on purchase of software represented application software exclusively used for the purpose of the business and hence these were treated as revenue expenses in line with the principles enunciated in section 37(1) of the Act. These application software, have got a limited useful life and are used as tools of business like any other component or consumable item used for the purpose of earning revenue though application in the process of customer servicing and*

does not result in any enduring benefit. It is also important to note that it is neither a stand along profit generating apparatus nor an income driving structure so as to classify the expenditure incurred towards the software as one on capital account. The application software, being the subject matter of appeal, assist the already set-up business vide enhancing its efficiency and hence can be reliably related to being on revenue account. List of software purchased are enclosed in assessee's paper book for AYs 2005-06 & AY 2006-07. On perusal of the same, we find that the parties from whom the software was acquired were Interwoven, Mercury Interactive (Singapore) Pvt. Limited, Sonata Information Technology and Tata Consultancy Services. All these companies specialize in application software which helps in increasing the efficiency of client deliverable. The details of payments made to M/s Interwoven clears that these are towards payment for renewal of software which the assessee was using for client deliverables. In view of these facts, we are of the view that software expenses are revenue in nature and allowable u/s 37 of the Act. We dismiss this common issue of revenue's appeals."

7. The Ld. DR could not controvert the fact that the revenue has not filed any appeal before the Hon'ble High court against the decision of the Tribunal (supra) on this issue and the department have accepted the view of the Ld. CIT(A)/Tribunal on this issue. Therefore, respectfully following the order of the Tribunal in AY 2005-06 as well as taking note of the Hon'ble jurisdictional High Court decision in Indian Aluminium Co. ltd. Vs. CIT reported in (2016) 384 ITR 386 (Cal) wherein the Hon'ble High Court has held that software development expenditure which was application software was revenue in nature, and also the fact that the revenue has accepted the view of the Ld. CIT(A)/Tribunal on this issue, we confirm the action of the Ld. CIT(A) and dismiss this ground of appeal of revenue.

8. In the result, the appeal of revenue is dismissed.

Order pronounced in the open court on 5th December, 2018.

Sd/-	Sd/-
(M. Balaganesh)	(A. T. Varkey)
Accountant Member	Judicial Member

Dated: 5th December, 2018

Jd.(Sr.P.S.)

Copy of the order forwarded to:

1 Appellant – ITO, Ward-2(3), Kolkata

2 Respondent – M/s. I.T.C. Infotech India Ltd., Virginia House, 37, J. L. Nehru Road, Kolkata-700 071.

3 CIT(A)-VI, Kolkata

4 CIT , Kolkata.

5 DR, Kolkata Benches, Kolkata (sent through e-mail)

/True Copy, By order,

Sr. Pvt. Secretary