

**IN THE INCOME TAX APPELLATE TRIBUNAL,
KOLKATA 'C' BENCH, KOLKATA**

**Before Shri P.M. Jagtap, Vice-President (KZ)
and Shri A.T. Varkey, Judicial Member**

**I.T.A. No. 1335/KOL/2010
Assessment Year: 2005-2006**

***Organon (India) Limited,.....Appellant
Platina, 7th Floor, Plot No. C-59,
G Block, Bandra Kurla Complex, Bandra (East),
Mumbai-400 098, Maharashtra
(PAN: AAACI 6949 R)***

-Vs.-

***Additional Commissioner of Income Tax,.....Respondent
Circle-12, Kolkata,
Aayakar Bhawan,
P-7, Chowringhee Square, Kolkata-700 069***

Appearances by:

*Shri Puskar Gupta, C.A. and Shri Shasank Kajat, C.A, for the Appellant
Shri P.K. Srihari, CIT, D.R., for the Respondent*

Date of concluding the hearing : March 15, 2019
Date of pronouncing the order : May 15, 2019

O R D E R

Per Shri P.M. Jagtap, Vice-President (KZ):-

This appeal filed by the assessee is directed against the order of Id. Commissioner of Income Tax (Appeals)-12, Kolkata dated 29.03.2010.

2. Grounds No. 1 to 5 of this appeal involve a common issue relating to disallowance of Rs.41,20,200/- made by the Assessing Officer under section 40(a)(i) of the Act and confirmed by the Id. CIT(Appeals) for the alleged non-deduction of tax at source from the payment made for Microsoft licence fees.

3. The assessee in the present case is a Company, which is engaged in the business of manufacturing, trading and sale of pharmaceutical products as well as manufacturing of ready-to-eat foods products on

contract basis for Government. The return of income for the year under consideration was filed by it on 31.10.2005 declaring total income of Rs.24,50,77,530/-. As noted by the Assessing Officer during the course of assessment proceedings, the assessee had paid an amount of Rs.41,20,200/- to its Associated Enterprise at Netherland namely M/s. Organon NV and the same was claimed to be towards reimbursement of expenses. It was claimed on behalf of the assessee-company in this regard that its Netherlands based Associated Enterprise had purchased Software on licence from Microsoft for use by all its Group entities and the licence fees paid by M/s. Organon NV for the software to Microsoft was apportioned at actuals to all the Group entities on the basis of number of employees. It was submitted that the share of the assessee worked out to Rs.41,20,200/-, which was reimbursed to M/s. Organon NV on the basis of actuals. It was contended that the said amount thus represented purely reimbursement of expenses to M/s. Organon NV and since it did not include any income element, the assessee was not liable to deduct tax at source from the payment of the same. The Assessing Officer did not find merit in this contention raised on behalf of the assessee. According to him, the amount in question was paid by the assessee for the use of software and since it was taxable as royalty as per the provisions of the Act as well as the DTAA between India and USA, the assessee was required to deduct tax at source under section 195 of the Act from the payment made to M/s. Organon NV. As the assessee had failed to comply with the said requirement, the Assessing Officer invoked section 40(a)(i) and disallowed the sum of Rs.41,20,200/-.

4. The disallowance made by the Assessing Officer under section 40(a)(i) was disputed by the assessee in the appeal filed before the Id. CIT(Appeals). During the course of appellate proceedings before the Id. CIT(Appeals), the main contention raised on behalf of the assessee-company in support of its case on this issue was that the amount in question represented mere reimbursement of expenditure being a part of

licence fees apportioned by M/s. Organon NV as a share of the assessee-company and since the same had not given rise to any income in the hands of M/s. Organon NV, the provisions of section 195 were not attracted and the assessee-company was not required to deduct tax at source from the payment made to M/s. Organon NV. The Id. CIT(Appeals) did not accept this stand of the assessee-company. He agreed with the view taken by the Assessing Officer that the amount in question having been paid by the assessee indirectly to Microsoft through its Netherlands based Associated Enterprise for use of Software was in the nature of royalty and since the same was chargeable to tax in India in the hands of Microsoft, the assessee was liable to deduct tax at source under section 195. He accordingly held that the failure of the assessee to deduct tax at source from the said amount attracted the provisions of section 40(a)(i) and the disallowance made by the Assessing Officer by invoking the said provision was confirmed by the Id. CIT(Appeals). He also took note of the fact that a similar issue was involved in assessee's own case for A.Ys. 2003-04 and 2004-05 and the same was decided by the first appellate authority.

5. The Id. Counsel for the assessee submitted that a similar issue was involved in assessee's own case for earlier years i.e. A.Ys. 2003-04 and 2004-05 and the same has already been decided by the Tribunal in favour of the assessee vide its common order dated September 20, 2017 passed in ITA Nos. 863/KOL/2008 and 978/KOL/2009. He also invited our attention to the relevant portion of the order of the Tribunal as contained in paragraph no. 14 to 18 and submitted that a similar amount paid by the assessee-company to its Netherlands based Associated Enterprise for its share of the expenditure incurred on purchase of Software on licence from Microsoft USA was held to be not liable for deduction of tax at source by the Tribunal and the disallowance made under section 40(a)(i) was deleted.

6. The ld. D.R., on the other hand, submitted that even though the Tribunal has decided a similar issue in favour of the assessee for A.Ys 2003-04 and 2004-05 vide its order dated September 20, 2017 (supra), the decision of Hon'ble Calcutta High Court in the case of CIT -vs.- Andaman Sea Food Pvt. Limited (ITAT No. 19 of 2013 dated 23.07.2014) supports the stand of the Revenue taken on this issue.

7. In the rejoinder, the ld. Counsel for the assessee submitted that the decision of the Hon'ble Calcutta High Court in the case of CIT -vs.- Andaman Sea Food Pvt. Limited (supra) cited by the ld. D.R. is distinguishable on facts. He submitted that the transactions involved in the said case were not covered by DTAA while the transactions involved in the present case are not only covered by DTAA but the provisions of DTAA are in favour of the assessee as found by the Tribunal in A.Ys. 2003-04 and 2004-05. He also submitted that even otherwise the non-discrimination clause is applicable in the case of the assessee and the assessee is entitled for relief as per the said clause as held by the Tribunal in A.Ys. 2003-04 and 2004-05.

8. We have considered the rival submissions and also perused the relevant material available on record. It is observed that a similar issue involving identical facts and circumstances was considered by the Tribunal in assessee's own case for A.Ys. 2003-04 and 2004-05 vide its common order dated September 20, 2017 and after considering all the relevant aspects including the provisions of DTAA, the case laws on the points etc. it was held by the Tribunal that the amount in question paid by the assessee was not in the nature of royalty. It was held that since the said amount was paid towards purchase of software, it would have been assessable as business profits in the hands of Netherland based Associated Enterprise and since the said Associated Enterprise did not have a permanent establishment in India, the business profits could not be taxed in India under Article 7 of the Indo Netherland DTAA. It was held

by the Tribunal that there was no element of profit involved in the transactions representing remittance made towards purchase of licence software for use by the assessee, which was taxable in India in the hands of the Associated Enterprise and the assessee, therefore, was not required to deduct tax at source from the said payment under section 195. It was further held by the Tribunal that the assessee was entitled for relief on this issue even on the basis of non-discrimination clause contained in Article 24(4) of the Indo-Netherland DTAA. The Tribunal accordingly deleted the disallowance made by the Assessing Officer under section 40(a)(i) of the Act and confirmed by the Id. CIT(Appeals) in both the years i.e. A.Ys. 2003-04 and 2004-05.

9. At the time of hearing before us, the Id. D.R. has not disputed the fact that this issue stands squarely covered in favour of the assessee by the decision of the Tribunal rendered in assessee's own case for A.Ys. 2003-04 and 2004-05. He, however, has relied on the decision of the Hon'ble Calcutta High Court in the case of CIT -vs.- Andaman Sea Food Pvt. Limited (ITAT No. 19 of 2013 dated 23.07.2014) which, according to him, supports the revenue's stand on this issue. However, as rightly contended by the Id. Counsel for the assessee, the said case decided by the Hon'ble Calcutta High Court is distinguishable on facts, inasmuch as, the transactions under consideration in the said case were not covered by the relevant DTAA, whereas the amount in question paid by the assessee in the present case to its Netherland based Associated Enterprise is not taxable in the hands of the Associated Enterprise in India as per the relevant clause of the DTAA as found by the Tribunal in the assessee's own case for A.Ys. 2003-04 and 2004-05. Moreover, as held by the Tribunal in its order for A.Ys 2003-04 and 2004-05, the assessee was entitled for relief on this issue even as per the benefit conferred under non-discrimination clause of the DTAA. We, therefore, respectfully follow the decision of the Tribunal rendered in assessee's own case for A.Ys. 2003-04 and 2004-05 vide its order dated September 20, 2017 (supra)

and delete the disallowance made by the Assessing Officer under section 40(a)(i) and confirmed by the Id. CIT(Appeals). Grounds no. 1 to 5 of the assessee's appeal are accordingly allowed.

10. Grounds no. 6 to 8 involve a common issue relating to disallowance of conversion charges of Rs.35,87,454/- as made by the Assessing Officer and confirmed by the Id. CIT(Appeals) on account of prior period expenses.

11. The assessee-company during the relevant period had entered into an agreement with a third party manufacturer, who was required to manufacture goods on behalf of and under the license of the assessee-company. The assessee-company was liable to pay conversion charges to the said party and as per the terms of the agreement, the assessee-company was committed to pay minimum amount of conversion charges every calendar year to the said party i.e. January to December called as "Minimum Conversion Charges". Accordingly if the actual conversion charges paid on the basis of actual production during the year was short of a minimum conversion charges, then the assessee-company was required to make the short-fall good. There was such a short-fall to the extent of Rs.35,87,454/- pertaining to Financial Year 2004-05 and Rs.4,51,83,246/- pertaining to Financial Year 2005-06. After settling and finalizing these amounts in the F.Y. 2006-07, a total amount of Rs.4,87,70,700/- was debited by the assessee to the Profit & Loss Account of F.Y. 2006-07 on account of prior period expenses. Since the assessee-company was following the mercantile system of accounting, it suo moto offered the entire amount of Rs.4,87,70,700/- in the computation of income for F.Y. 2006-07 relevant to A.Y. 2007-08 being the expenditure of prior period. During the course of assessment proceedings for the year under consideration, i.e. A.Y. 2005-06, the assessee claimed a deduction of Rs.35,87,454/- being the expenditure incurred on conversion charges pertaining to A.Y. 2005-06. Since the said deduction was not claimed by

the assessee either in the original return or even in the form of revised return, the Assessing Officer did not entertain the claim of the assessee for the said deduction by relying on the decision of the Hon'ble Supreme Court in the case of Goetze India Limited [284 ITR 323]. On appeal, the Id. CIT(Appeals) upheld the action of the Assessing Officer on this issue by observing that the assessee was not entitled to make any fresh claim, which was not made either in the return of income originally filed or by way of filing a revised return.

12. The Id. Counsel for the assessee submitted that the assessee was liable to make good any short-fall in the minimum conversion charges payable as per the agreement entered into with a contract manufacturer. He submitted that such short-fall pertaining to the year under consideration i.e. A.Y. 2005-06 as well as for A.Y. 2006-07 was settled and finalized in the previous year relevant to A.Y. 2007-08. He submitted that the amount of such short fall accordingly was debited by the assessee to the Profit & Loss account for A.Y. 2007-08 and in the computation of total income for A.Y. 2007-08, the amount so debited was offered to tax being prior period expenses. He invited our attention to the Audit Note given on this issue placed at page no. 380 of the paper book and pointed out that the amount to the extent of Rs.35,87,451/- being pertaining to the year under consideration, i.e. A.Y. 2005-06 was claimed by the assessee as deduction during the course of assessment proceedings He contended that since the said amount undisputedly pertained to the year under consideration and even the debit notes for the same were raised by the concerned party during the year under consideration, the assessee was entitled for deduction of the same and the authorities below were not justified in disallowing the deduction claimed by the assessee merely on the ground that the same was not claimed either in the return of income originally filed or by way of revised return. He contended that since the amount in question was settled and finalized subsequently, it was not

possible for the assessee to claim the same either in the original return or by way of revised return.

13. The Id. D.R., on the other hand, submitted that neither the Assessing Officer nor the Id. CIT(Appeals) has decided this issue on merit and the claim of the assessee for deduction of the amount under consideration was disallowed by them on the ground that the same was not claimed either in the return of income originally filed or by way of revised return. He contended that the assessee, however, is not entitled for this deduction on merit because even though the Debit Notes were raised by the concerned party in the year under consideration, there was a dispute about this contractual liability payable by the assessee which was finally settled in the subsequent year relevant to A.Y. 2007-08. By relying on the decision of the Hon'ble Kerala High Court in the case of CIT -vs.- Seshasayee Bros. (Travancore) [82 ITR 442], he contended that the deduction on account of contractual liability can be claimed by the assessee only in the year in which it is finally settled and crystallized.

14. We have considered the rival submissions and also perused the relevant material available on record including the Audit Note on the issue under consideration as given at page no. 380 of the paper book. It is observed that there was a difference between the actual conversion charges and minimum conversion charges for the year under consideration as payable by the assessee to M/s. ASG Bio Chem Limited in terms of the Loan Licensing Agreement dated 1st January, 2005. It is also observed that Debit Notes for such difference were raised by M/s. ASG Bio Chem Limited during the year under consideration on 15.02.2005 and 15.03.2005. However, the amount raised in the said Debit Notes was not accepted by the assessee and the same was in dispute. The said dispute was finally settled in the financial year 2006-07 relevant to assessment year 2007-08 and accordingly the amount of difference payable by the assessee to M/s. ASG Bio Chem Limited was debited to the Profit & Loss

Account for the F.Y. 2006-07. It is thus clear that the amount in question payable by the assessee on account of difference between the actual conversion charges and minimum conversion charges for the year under consideration representing contractual liability was in dispute and the same was settled and crystallized only in the F.Y. 2006-07 relevant to A.Y. 2007-08. As rightly contended by the ld. D.R., the assessee, therefore, was not entitled for deduction on account of this contractual liability pertaining to the year under consideration as the same represented disputed liability and since this dispute was settled and the liability was crystallized only in the F.Y. 2006-07, the assessee was entitled for the deduction of the same only in A.Y. 2007-08. We, therefore, find no infirmity in the impugned order of the ld. CIT(Appeals) confirming the disallowance made by the Assessing Officer on this issue and upholding the same, we dismiss Grounds No. 6 to 8 of the assessee's appeal.

15. The common issue raised in Grounds No. 9 to 13 relates to the addition of Rs.1,54,04,816/- made by the Assessing Officer and confirmed by the ld. CIT(Appeals) on account of Transfer Pricing Adjustment.

16. During the year under consideration, the assessee-company had entered into certain international transactions with its Associated Enterprises involving, inter alia, purchase of raw materials from related parties and sale of goods manufactured from the said raw materials to unrelated parties in the domestic market and to the Associated Enterprises in the overseas market. There were thus two segments, one involving purchase of raw material from related parties and sale of the manufactured products to unrelated parties and second involving purchase of raw materials from related parties and sale of manufactured products to the Associated Enterprises. In order to determine the Arm's Length Price of the second segment involving transactions with Associated Enterprises, a reference was made by the Assessing Officer to the Transfer Pricing Officer under section 92CA(1) of the Income Tax Act,

1961. During the course of proceedings before the Transfer Pricing Officer, segmental Profit & Loss Account of these two segments was prepared and furnished by the assessee showing the following results:-

Particulars	Purchase of RM from related, Export of MFG goods to Related (RS.	Purchase of RM from Related, Export of MFG goods to unrelated
Sales/Commissioner income	7,50,96,654	5331094
Material consumed	51401792	1425626
Adjustment for difference	-18275397	-200396
Material consumed	33126395	1225230
Purchase for trading	NIL	NIL
Excise duty	NIL	NIL
Adjustment for difference	NIL	NIL
Purchases for trading	NIL	NIL
Gross Margin	23694862	3905468
Value Adding expenses(VAE)		
Manufacturing cost	14198328	563338
Trade discount	NIL	NIL
Apportioned expenses		
Advertisement and product promotion	NIL	NIL
Administrative, other allocable expenses	NIL	1451892
Depreciation	961848	68281
Commission	NIL	142239
Discount	NIL	NIL
Total VAE	15160176	2225750
Total cost	66561968	3658376
RM/Total cost	77%	39%
Operating margin	8534686	1679718
Non-operating incomes	NIL	NIL
Non-operating expenses	NIL	NIL
Profit before tax(as per accounts)	NIL	NIL
Gross margin to sales(0%)	NIL	NIL
Operating margin to sales (0%)	11.36%	31.51%
Gross margin to VAE (0%)	NIL	NIL
GP/OICOP	NIL	NIL

17. From the above segmental Profit & Loss Account, the Transfer Pricing Officer found that administrative and other allocable expenses had not been allocated by the assessee to the segment, wherein sales were made to the Associated Enterprises and the same were entirely allocated to the segments where sales were made to the unrelated parties. He also found that operating margin to sales in case of sale made to unrelated parties was 31.51% as compared to 11.36% in case of sales made to Associated Enterprises. As noted by the Transfer Pricing Officer, if the administrative and other expenses had been allocated to the segment involving sales made to the Associated Enterprise, profit of the said segment would have further gone down. He accordingly required the assessee to explain as to why the transactions of the segment involving sales made to Associated Enterprise should not be considered as not being entered into at Arm's Length since both the purchases and sales were controlled transactions entered into with the related parties. In reply, the following explanation was offered by the assessee:-

"On and from Financial Year 2003-04, Organon India Limited (OIL), apart from having its own manufacturing facilities, also started sub-contracting manufacturing operations to subcontractors, known as 'Loan Manufacturers'. All the necessary raw materials and technologies are supplied by OIL to the contract manufacturer who does all the necessary processing operations. OIL in turn pays conversion charges to the loan manufacturers for the processing work carried on by them.

In this regard, the two existing manufacturing facilities were disposed off by OIL with effect from financial year 2004-05 and hence all its manufacturing activities are being carried out through the above mentioned loan manufacturers. Since, OIL subcontracts its manufacturing operations to sub-contractors, allocation of administrative overhead would not reflect the true and correct profitability of the said segment. Allocation of administrative overhead would distort the profitability of the above segment.

Based on the above rationale, administrative overhead has not been allocated in Segment 2- Contract Manufacturing Segment. In this regard, reference can also be made to page no. 10 and 11 of the Transfer Pricing Study for Financial

Year 2004-05 filed as Appendix-5 through our submission dated 31st June, 2008”.

“The manufacturing facilities which were disposed off on ‘as is where is’ basis to the loan manufacturers with effect from financial year 2004-05, were engaged in full fledged manufacturing. In the said units, various other products along with those referred to in Segment 2 were also being manufactured. However, in respect to segment 2, the functional profile of the assessee is different from that in respect of other manufacturing segments. With respect to segment 2, that is the contract manufacturing segment. Organon India Ltd. (OIL) enters into the following international transactions:-

-Import of raw materials

- Export of manufactured finished goods

Though the nature of transaction for Segment 2 and the other manufacturing segments, i.e. Segments 1, 3 & 4 are similar, yet there are significant functional differences, between these segments as stated in paragraph 4.2.21 (page 25) of the Transfer Pricing Study for FY 2004-05 already submitted before your goodself. Such functional difference explain the reason for not allocating administrative expenses to segment 2. To elaborate on such differences, the functions performed by OIL with respect to the above mentioned international transactions has been summarised as under:-

OIL imports raw materials from group companies as well as non group companies, which are used in the manufacturing of the final products, the nature of the pharmaceutical industry is such that the quality of inputs (specially the active ingredients) is of paramount importance in determining the quality of the end product. Before a raw material can be used in the production process, the quality parameters need to be set. Once the raw materials pass the quality control procedure, they can be used for the production process. In the case of OIL, such quality testing is generally done by the associate enterprise from whom the raw materials are purchased. In the case of imports from non group entities (i.e. third parties) quality testing is done by OIL.

The other general functions performed in the course of purchase of raw materials are receiving an indent, obtaining quotations, placing of

purchase orders, making timely shipments and payment to the suppliers.

In relation to segment 2, OIL does not perform any quality control functions and also does not perform any functions in relation to sourcing of raw materials (such as receiving an indent, obtaining quotations, placing of purchase orders, making timely shipments) because the active ingredients are supplied by the associated enterprise (after necessary quality control) for contract manufacturing purposes. Thus, for this segment OIL does not incur any significant administrative expenses in relating to import of raw materials”.

In addition to the above explanation, it was also submitted by the assessee that the two segments are not functionally similar since in the segment under question goods had not been manufactured by the assessee itself but were manufactured by a loan manufacturer i.e. a sub-contractor and in the segment which is being compared to, the manufacturing process was done by the assessee-company itself.

18. The Transfer Pricing Officer found the explanation offered by the assessee to be un-acceptable. According to him, there was hardly any difference between the own manufacturing activity of the assessee-company and the contract manufacturing done for the Associated Enterprises. He held that the assessee-company was required to ensure the quality of finished goods manufactured by the contract manufacturing as per the specific requirements of the Associated Enterprise and since it was the liability of the assessee-company, administrative and other expenses ought to have been allocated to the said activity. He held that both these segments were functionally comparable and the only difference was that in one case, the export was to Associated Enterprise and in other case, the export was to unrelated party. He observed that even though in one segment, manufacturing had been done by a sub-contractor but the cost of the manufacture of these goods was debited by

the assessee in its books of account as manufacturing expenses. He held that the said activity thus was deemed to be the manufacturing activity of the assessee-company for all practical purposes and there was hardly any difference whether the manufacturing was done by the assessee-company by using its own facility or somebody else's facilities. He also held that there was nothing to show that any risk involved in the transactions was transferred by the assessee-company to the sub-contractors/loan manufacturers. He accordingly rejected the assessee's contention that two segments could not be functionally compared and applying the operating profit margin to sales of 31.51% of the segment involving export of goods to unrelated parties after allowing the adjustment of 1.51% on account of commission/charges paid to the loan manufacturer in lieu of the services, he determined the arm's length operating margin of the assessee-company of the segment involving export to Associated Enterprise at Rs.2,25,38,783/- as against the operating margin of Rs.85,34,686/- shown by the assessee. Accordingly Transfer Pricing Adjustment of Rs.1,40,04,097/- (Rs.2,25,38,783/- minus 85,34,686/-), was worked out by the Transfer Pricing Officer in respect of these international transactions of the assessee-company with its Associated Enterprise and in the assessment completed under section 143(3) vide an order dated 22.12.2008, an addition to that extent was made by the Assessing Officer to the total income of the assessee on account of transfer pricing adjustment.

19. The addition of Rs.1,40,04,097/- made by the Assessing Officer on account of transfer pricing adjustment was challenged by the assessee in the appeal filed before the Id. CIT(Appeals) and the following submissions were made on behalf of the assessee before the Id. CIT(Appeals) in support of its case that the addition on account of transfer pricing adjustment made by the Assessing Officer was not sustainable:-

"TPO / AO failed to communicate to the Appellant the relevant clause under section 92C(3) of the Act, which triggers the application of provisions of the transfer pricing.

B. Reasons why segment 2 (Contract Manufacturing Segment) cannot be compared to segment 3.

- Functional profile of segment 2 and 3 not correctly appreciated by the TPO*
- Both segment 2 and 3 cannot be compared since both the segment have related party transactions.*
- The two segments cannot be compared since the volume of transactions for segment 2 is almost 15 times more than segment 3.*
- The Transfer Pricing Officer and accordingly the Assessing Officer has erroneously took an adhoc view while computing the commission charges at 1.51 % and thus computing the total adjustment for 'segment 2' at 30% (OP/ Sales) without any basis in law nor any scientific basis of calculation.*

C. Interpretation of internal audit services as shareholder service

The appellant, humbly submits that identical issue has been decided in favour of the appellant in respect of AY 2004-05, wherein the CIT(Appeals) held that" the fact that the expenditure has been actually expended is not disputed and the assessee has claimed that it has immensely benefited by such audit by way of better control, better administration and better functioning of the company. Considering the fact that the CIT(Appeals), in the assessee's own case for AY 2003-04 has held that such expenditure as allowable, the TPO's observation that no tangible benefit has accrued to the assessee company directly or indirectly by this internal audit is held to be not correct. Therefore, he should have computed the arm's length price for the said transaction. Though, in the preceding year the disallowance was made under the normal provisions of the Act and in the present year the same was done under the provisions relating to Transfer Pricing, but in both the years the disallowance was made following the same principle that there was no apparent purpose or utility of such audit to the assessee. Therefore, I find no merit in the decisions of the TPO in this respect and hence, the AO. is directed to allow the claim "

Based on the judgment of the CIT (Appeals), the appellant humbly submits before your goodself, that, the adjustment of Rs. 1,400,719 made by the TPO and as accepted by AO is erroneous and bad in law since the same is in contradiction of

the provisions of the Act and against the decision of various Tribunal."

D. Variance of 5% from the arithmetical mean as provided under the Act has not been allowed by the TPO and the Assessing Officer.

Further, the Ld. A.R. made submissions vide his letter dt. 24-09-2009 as under:

"Adhoc allowance by the Transfer Pricing Officer ("TPO") and the Assessing Officer ("AO") of 1.51 % as commission charges payable to the loan manufacturer

1.0 The appellant would like to reiterate from the submission dated 5th June dated 2009 (Copy of the same is attached as Appendix 1) that the TPO has wrongly compared 'segment 2' with 'segment 3' (where purchases are made from related entities and finished goods are exported back to unrelated parties). The TPO at page 9 para 3 of his order has contended that "this particular set of transactions have been taken as the benchmark, as functionally this sector resembles the most with the activity that has to be adjusted. In both the cases, the raw materials have been purchases from related enterprises, and goods have been manufactured and the manufactured goods have been exported. Thus functionally both the set of transactions are comparable." (Copy of the TPO order is attached as Appendix 2)

1.1 In this regard, the appellant humbly submits that the TPO grossly erred in comparing 'segment 2' with segment 3. The TPO while comparing the two segments has specially commented that in both the segments, the raw materials have been purchased from related enterprises and manufactured goods are exported back. The contention of the TPO is against the principles of transfer pricing. The Act and the Income-tax Rules, 1962 (hereinafter referred to as 'Rules') specifically provides that for comparability purposes on international transaction needs to be compared or adjusted to an uncontrolled transactions. In this case both the segments have related party transactions and hence cannot be compared.

2.0 Based on the above submission, the appellant would also like to submit before your goodself that the Rules also lays down certain specific parameter, which if satisfied,' then only comparison can be possible. Reference can be drawn from Rules 10B(2) of the Rules;

10B. (2) For the purposes of sub-rule (1), the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to the following, namely:-

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

The TPO' and accordingly the AO while comparing the two segments and also computing the adjustment did not take cognizance to the parameters laid down in Rule 10B of the Rules.

2.1 Further, the Rules also provides that an uncontrolled transaction would be comparable to an international transaction if 1. None of the differences between the transactions being compared or between the enterprises entering into such transactions materially affect the price of the international transaction, or

2. A. reasonable adjustment could be made to eliminate the effects of such differences.

In this regard, reference, can be drawn from Rules 10B (3) of the Rules, 10B (3) An uncontrolled transaction shall be comparable to an international transaction if -

i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely or materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or .

ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

2.2. The products manufactured under the two segments are significantly different in nature, namely under segment 2, the products manufactured are Nordion and Allylestrenol, while under segment 3, the products manufactured are PAVULON 2ML- 1'S PVMS, Deca Durabolin 25 mg Old, Deca Durabolin 25 mg, Durabolin 25 mg arid Sustanon 250. Since the products manufactured are different in nature, the appellant humbly submits that there cannot be any comparison.

2.3. Based, on the above, we humbly submit before your goodself that as per the provisions Rules 10B(3)(ii) no reasonable accurate adjustments can be made to Segment to eliminate the materials difference and hence accordingly, the two segments cannot be compared.

(B) Copy of the Kolkata Tribunal judgment in the case of Development Consultants Pvt. Ltd. v. DCIT (2008) 115 TTJ 577 (ITAT-Kolkata) is attached as Appendix 3".

20. The submissions made by the assessee did not find merit with the ld. CIT(Appeals), who proceeded to confirm the transfer pricing adjustment of Rs.1,40,04,097/- made by the Assessing Officer for the following reasons given in his impugned order:-

"I have carefully perused the impugned assessment orders, submissions made by the A.R of the appellant and also the judicial decisions relied upon by the A.O and the A.R. The appellant furnished form no. 3CEB being Chartered Accountants report in respect of international transactions which contained comparison of profit margin of different segments of international transactions with most appropriate method in each case and found that price of international transactions are at arm's length price. The TPO, however disregarded the report in form 3CEB and proceeded to make two adjustments to the value of international transactions. The appellant vehemently opposed the adjustments made by TPO.

5.3.1. The appellant's first challenge to A.O's action is on the ground that the TPO/AO failed to communicate to the appellant the relevant clause u/s 92C(3) of the Act which triggered the application of provisions of the transfer pricing. But this objection of the appellant has no substance at all as the reference to TPO was made by A.O u/s 92CA(1) and not u/s 92C(3). Hence appellant's objection raised vide ground no. 5 is rejected.

5.3.2. *The appellant's other objections to adjustment are on the ground of non-comparability of both segments on account of FAR differences, involvement of related party transactions in both segments etc. In this connection my observations are as under:*

(i) The appellant has imported raw materials from its AE and in turn exported goods after manufacturing to its AE's and non AE's both. The goods exported to AE's have been manufactured by- the appellant through the loan licensee (contract manufacturer) and this segment is hereinafter called 'segment 2' and the goods exported to non AE's have been manufactured by the appellant itself and this segment is hereinafter called 'segment 3'. The A/O has compared these two segments and has observed that the appellant has derived operating margin to sale of 11.36% from 'segment 2' and 31.51 % from 'segment 3'. It has also been observed that proportionate administrative expenses of Rs.1,91,42,072/- has not been allocated to 'segment 2'. In 'segment 2' the appellant sold goods to AE's which were resold by the AE's in the international market and in 'segment 3' the appellant directly sold goods in the international market. The gross margin of 'segment 2' is very low as compared to gross margin of 'segment 3' which shows that the appellant sell goods to its AE at prices lower than the market price compared to its sale to non-AE, so that on resale most of the profits would be reported in AE's jurisdiction. Thereby the appellant avoided the exposure of its real profits to taxation in India.

(ii) It is beyond doubt that the appellant has performed less function in relation to 'segment 2' as compared to 'segment 3', but it does not mean that both segments are functionally different. In both the segments the appellant imported raw materials and after manufacturing finished goods exported them on outright basis to its AE's and non AE's both. The only difference is the outsourcing of manufacturing process in 'segment 2' and in 'segment 3' the manufacturing process has been conducted by the appellant company itself. In the field of manufacturing of pharmaceutical business, the outsourcing of manufacturing process is in vogue and it is cost effective also.

(iii) *The appellant itself submitted that 'though the apparent nature of activities for 'segment 2' and the other manufacturing segments i.e. 'segments 1, 3, & 4' are similar, 'yet there are significant functional differences between these segments as stated in paragraph 4.2.21 (page 25) of the Transfer pricing Study for FY 2004-2005. Such functional difference explains the reasons for not allocating administrative expenses to 'segment 2' while the same has been allocated to the other segments. Therefore, it is clear that the appellant has already conducted FAR analysis at the time of TP study and adjustments have already been made to mitigate the FAR differences between 'segment 2' and 'segment 3'. This implies that after making such adjustments 'segment 3' had become comparable to 'segment 2'.*

(iv) *Moreover, the manufacturing cost in case of 'segment 2' represents cost of job charges paid to loan licensee. It is observed that the ratios of manufacturing costs to raw materials consumed are 42.86% in case of segment 2 being contract manufacturing and 45.98% in case of segment 3 being own manufacturing, It means the outsourcing of manufacturing facility is beneficial in the case of the appellant also. But the ratios of gross margin to sales are 31.55% in case of 'segment 2' and 73.26% in case of 'segment 3' which shows that in spite of the fact that the contract manufacturing is beneficial the gross margin to sales in case of 'segment 2' is very low as compared to 'segment 3'. This proves that the appellant sell goods to its AE's at prices lower than the market price, so that on resale most of the profits would be reported in AE's jurisdiction.*

(v) *Reliance is placed on Ranbaxy Laboratories Ltd. Vs. ACIT (2008) 110 ITD 428 (Delhi) wherein the Hon'ble Tribunal has dismissed the assessee's contention that internal uncontrolled transactions carried out by the taxpayer were not comparable with transactions with the AE's on account of the risk differential between them because it did not undertake risk of success or failure of product which were undertaken in transactions with its AE's. The Hon'ble Tribunal held that if it's done as per normal business practice, no adjustment is needed. But if it is abnormal favour to an associated enterprise, this crucial aspect was required to be examined and evaluated as entire transfer pricing regulations are concerned with adjustments of favourable treatment meted to related (associated) concerns. The Hon'ble Tribunal held that the contractual terms for both categories of transactions should have been analysed and*

the possibility of suitable adjustments evaluated in light of the same.

(vi) Further, as per provisions of the Act, the net margin of transaction is calculated with reference to an appropriate base say costs, sales, or assets. Therefore, the net margin from the uncontrolled transaction is established by reference to net margin earned by the tax payer from comparable uncontrolled transactions or from net margin that would be earned in comparable transactions made by independent enterprises. In the instant case the net margin earned by the appellant from comparable uncontrolled sales has been taken as benchmark for comparing net margin earned by the appellant from controlled sales. Therefore, comparison of the above mentioned segments made by the AO is as per provisions of the Act and the plea of the appellant that the raw materials in both segments have been purchased from related party cannot debar the AO/TPO from such comparison since the net margin has been calculated with reference to sale and not purchases.

(vii) Coming to the case laws cited by the appellant, it is to be mentioned that the facts of the appellant case are different from that of the case cited.

(viii) Decision:-

Therefore, based on the above discussion the upward adjustment of Rs.1,40,04,097/- made by AO as per report of TPO in respect of international transactions of goods sold to AE's is proper. The ground no. 6 is not allowed".

21. The Id. Counsel for the assessee submitted that the two segments compared by the Transfer Pricing Officer were functionally different. He submitted that even though the raw material consumed in both these segments was purchased by the assessee-company from the related parties, the products manufactured from one segment and sold by the assessee to Associated Enterprises was classified as active pharmaceutical ingredients or bulk drugs while the products of the other segment manufactured and sold to unrelated parties were formulations. He also invited our attention to the list of such products manufactured in both the segments and submitted that the active pharmaceutical ingredients/bulk drugs produced by the assessee in one segment were in the nature of intermediates which were required to be further processed

by the Associated Enterprises to produce the final products for sale to their customers. He submitted that the formulations produced in the other segment by the assessee-company and supplied to the unrelated parties, on the other hand, were final products. By relying on the decision of Ahmedabad Bench of ITAT in the case of Inducother (India) Pvt. Limited -vs.- DCIT, he contended that these two segments, therefore, were not comparable and the Transfer Pricing Officer as well as the Id. CIT(Appeals) failed to appreciate and understand the difference in the functional profile pointed out by the assessee in these two segments. The Id. Counsel for the assessee further submitted that the products of the one segment supplied by the assessee-company to its Associated Enterprises were not manufactured by the assessee-company in its own facility and the same were got manufactured from the contract manufacturers. He contended that the risk undertaken by the assessee-company in respect of this segment, therefore, was limited as compared to the risk undertaken by it in case of the other segment where products were manufactured on its own by the assessee-company and supplied to the unrelated parties under its own brand name. He invited our attention to the details furnished by the assessee in this regard before the authorities below enumerating the different risks undertaken in respect of these two segments. He also invited our attention to the relevant portion of the Transfer Pricing Study Report submitted by the assessee at page no. 64 of the paper book to point out that the additional functions performed by the assessee in respect of segment where goods were manufactured and sold by the assessee-company to unrelated parties as final products under its own brand name than the other segment where the intermediate goods supplied to the Associated Enterprises were got manufactured from the contract manufacturer as per the specific requirement of the Associated Enterprise. He contended that even there was a huge difference in the volume of both these segments making them un-comparable on this ground also. He contended that all these differences pointed out by the assessee in the two segments have been

properly appreciated by the Transfer Pricing Officer in A.Y. 2007-08 and the two segments were not compared by him in that year for making any transfer pricing adjustment as done in the year under consideration.

22. The Id. D.R., on the other hand, submitted that there was no difference between two segments compared by the Transfer Pricing Officer, inasmuch as, in both these segments, similar products were manufactured from the raw materials purchased by the assessee from the Associated Enterprises and the same were sold in one segment to unrelated parties and in the other segment to the Associated Enterprises. He contended that there was thus no functional difference in these two segments and even if there was some difference in the nature of products manufactured as pointed out by the Id. Counsel for the assessee, the same is not relevant when the method adopted is TNMM. As regards the difference in risk undertaken in two segments as pointed out by the Id. Counsel for the assessee, he contended that such difference is only marginal and not substantial. He contended that when these two segments are found to be the functionally comparable, some adjustments can be made for the marginal difference in risk undertaken while determining the transfer pricing adjustment.

23. We have considered the rival submissions and also perused the relevant material available on record. It is observed that the segment in which sales were made by the assessee to its Associated Enterprises, the products were in the nature of active pharmaceutical ingredients/bulk drugs, which were intermediates and the said intermediates were required to be further processed by the Associated Enterprises for producing the final products for sale of its customers. In the other segment where sales made by the assessee were to the unrelated parties, products manufactured were in the nature of formulation which constituted final products manufactured and sold by the assessee-company under its own name. It is thus clear that the products sold by

the assessee-company to its Associated Enterprises were being used by the Associated Enterprises as their inputs for further manufacturing while the products sold by the assessee-company in other segment to unrelated parties were final products which were meant for their consumption. In the case of Inducotherm (India) Pvt. Ltd. (supra) cited by the Id. Counsel for the assessee, it was held that a sale to dealer of the same product, much less to a manufacturer of related end product, inherently cannot be equated with the sale to the end-consumer. It was held that the comparability of an international transaction with an uncontrolled transaction under Rule 10B(2)(d) is to be judged with reference to, inter alia, the conditions prevailing in the market in which the respective parties to the transactions operate and the case of sale to the end consumer is not the same thing as sale to the manufacturer or dealer who uses the same as input raw material. It was held that this distinction is so fundamental that the comparison is meaningless.

24. It is observed that besides the difference in the nature of products manufactured in two segments compared by the Transfer Pricing Officer, even the risk undertaken by the assessee-company in these two segments was different. As pointed out by the assessee in this regard before the authorities below as well as before us, a limited risk was undertaken by it in the segment where the products were got manufactured from the third party as per the specific requirement of the Associated Enterprises whereas higher risk was taken in the other segment where products were not only manufactured mainly in the own manufacturing facility of the assessee-company but the same were sold as a final product to the ultimate consumer under its own brand. The risk undertaken in one segment involving sale of Associated Enterprise thus was limited while a full-fledged risk was taken by the assessee in the other segment involving sale to unrelated parties and the extent of such different risk undertaken in these two segments was brought to the notice of the authorities below

with reference to each and every risk involved in the relevant transactions.

25. It is pertinent to note here that the two segments compared in the process of transfer pricing analysis done in the year under consideration were also sought to be taken as comparables by the Transfer Pricing Officer in A.Y. 2007-08 and when specific query was raised by him, the difference in business profile of both these segments was explained by the assessee by pointing out that the final products exported to Associated Enterprises were active pharmaceutical ingredients, which were active chemicals with medicinal properties used in the further manufacturing of drugs (formulations), whereas the goods exported to unrelated parties were formulations being the finished products (Drugs). It was also pointed out by the assessee that the nature of risk borne by the assessee in these two segments was different, inasmuch as, the risk undertaken in the manufacturing and export of goods to Associated Enterprises was low while the risk undertaken in manufacturing and export of final products to unrelated parties was high. As pointed out by the Id. Counsel for the assessee from the Transfer Pricing Officer's order dated 28.10.2010 passed for A.Y. 2007-08, this distinction or dissimilarity brought to his notice by the assessee was accepted by the Transfer Pricing Officer and these two segments were not taken by him as comparables inspite of the fact that the PLI (OP/TC) of the segment involving export of goods to unrelated parties was substantially higher than the PLI of other segment involving export of goods to Associated Enterprise.

26. Keeping in view the above discussion, we find that not only the nature of products manufactured in both these segments compared by the Transfer Pricing Officer as well as the risk undertaken by the assessee in these two segments was different, even the business model or business process adopted by the assessee in these two segments was different and

the same cannot be taken as comparables for the purpose of transfer pricing analysis in order to determine the arm's length price. We, therefore, delete the addition made by the Assessing Officer and confirmed by the Id. CIT(Appeals) on account of transfer pricing adjustment and allow Grounds No. 9 to 13 of the assessee's appeal.

27. In Ground No. 14, the assessee has challenged the addition of Rs.14,00,719/- made by the Assessing Officer and confirmed by the Id. CIT(Appeals) on account of transfer pricing adjustment made in respect of international transactions of the assessee-company with its Associated Enterprise involving payment of audit fees.

28. During the year under consideration, a sum of Rs.14,00,719/- was claimed to be paid by the assessee for internal audit services received from its Associated Enterprise namely Akzo Nobel South East Pte. Ltd., Singapore. Although the assessee-company during the course of proceedings before the Transfer Pricing Officer furnished the relevant details including the copy of internal audit report, which contained the findings and recommendations of the internal auditors and the comments to the management of the assessee-company on such findings and recommendations, the Transfer Pricing Officer was of the view that no tangible benefit had accrued to the assessee-company directly or indirectly by such internal audit. He accordingly determined the arm's length price of the internal audit services received by the assessee-company from its Associated Enterprise at 'NIL' and proposed a transfer pricing adjustment of Rs.14,00,719/-. When the addition was made by the Assessing Officer on account of this transfer pricing adjustment, the assessee challenged the same in the appeal filed before the Id. CIT(Appeals). During the course of appellate proceedings before the Id. CIT(Appeals), it was submitted on behalf of the assessee-company that it did not have any internal audit department in its organisation and hence internal audit services were availed from external agencies in order to

have an internal audit system commensurate with its size and nature of business. The benefits received from such internal audit services were also explained by the assessee before the Id. CIT(Appeals). The Id. CIT(Appeals), however, did not find merit in the case of the assessee on this issue and confirmed the addition made by the Assessing Officer on account of transfer pricing adjustment for the same reasons as given by the Assessing Officer.

29. We have heard the arguments of both the sides on this issue and also perused the relevant material available on record. Although the Id. D.R. has strongly relied on the orders of the authorities below in support of the revenue's case on this issue, it is observed that a similar issue was involved in the assessee's own case for the immediately preceding year i.e. A.Y. 2004-05 and the similar addition made by the Assessing Officer on account of transfer pricing adjustment made in respect of the international transactions of the assessee-company entered into with its Associated Enterprise availing of internal audit services was deleted by the Id. CIT(Appeals) after rejecting the TPO's case that no tangible benefits had accrued to the assessee directly or indirectly by the internal audit. The relevant portion of the Id. CIT(Appeals)'s order giving his conclusion on this issue for A.Y. 2004-05 is reproduced hereunder:-

"In the instant case the fact that the expenditure has been actually expended is not disputed and the assessee has claimed that it has immensely benefited by such audit by way of better control, better administration and better functioning of the company. Considering the fact that the CIT(Appeals) in assessee's own case for AY 2003-04 has held such expenditure as allowable, the TPO's observation that no intangible benefit has accrued to the assessee company directly or indirectly by this internal audit is held not to be correct. Therefore, he should have computed the arm's length price for the said transaction. Though, in the preceding year the disallowance was made under the normal provisions of the Act and in the present year the same was done under the provisions relating to Transfer Pricing, but in both the years the disallowance was made following the same principle that there was no apparent purpose or utility of such audit to the assessee. Therefore, I find no merit in the decision of the TPO

in this respect and hence, the AO is directed to allow the claim of Rs.13,61,864/- of the assessee”.

30. As submitted by the Id. Counsel for the assessee, the decision of the Id. CIT(Appeals) giving relief to the assessee on this issue in A.Y. 2004-05 was challenged by the revenue by filing an appeal before the Tribunal but the said appeal involving low tax effect was dismissed by the Tribunal as not maintainable without going into merit of the issue. It appears that the decision rendered by his predecessor on a similar issue in the immediately preceding year i.e. 2004-05 in assessee's own case was not taken into consideration by the Id. CIT(Appeals) while deciding this issue vide his impugned order passed for the year under consideration. As found by the Id. CIT(Appeals) in A.Y. 2004-05, the assessee-company was benefited by the internal audit by way of better control, better administration and better functioning and keeping in view the same, the Transfer Pricing Officer's conclusions that no tangible benefit had accrued to the assessee-company directly or indirectly by such internal audit was held to be incorrect by the Id. CIT(Appeals) in A.Y. 2004-05. Even in his impugned order passed for the year under consideration, the Id. CIT(Appeals) accepted the fact that the internal audit conducted by the parent company was to ensure that the affairs of the assessee-company are carried out as per the global practices of the group. He, however, held that the parent company was not willingly appointed by the assessee-company to conduct the audit and, therefore, there was no additional benefit that had accrued to the assessee directly or indirectly from such audit. Keeping in view all the facts of the case as well as the decision of the Id. CIT(Appeals) in assessee's own case for the immediately preceding year i.e. A.Y. 2004-05, we are unable to subscribe to the view taken by the Id. CIT(Appeals) in the year under consideration.

31. As already noted, the relevant details of the internal audit services rendered from its Associated Enterprise were furnished by the assessee including the internal audit report which contained findings and recommendations of the internal auditors and the comments to the

management of the assessee-company on such findings and recommendations. It was specifically pointed out on behalf of the assessee-company that it did not have any internal audit department and hence the internal audit services were required to be availed in order to have an internal audit system commensurate with its size and nature of business. Even the benefits received from such internal audit services were explained by the assessee by pointing out that the focus of the said audit was on business risk aspect and it provided certain assurance/comfort to the management that the operations of the assessee-company were well managed and efficient. As pointed out on behalf of the assessee-company, key findings and recommendations under various financial and operational areas of the assessee-company were made in the internal audit report and implementation of such recommendations by the management had resulted in better control and functioning of the business of the assessee-company. Having regard to all these facts of the case, we are of the view that certain specific benefits were derived by the assessee-company from the internal audit services rendered by its Associated Enterprise and the authorities below were not justified in making the impugned addition on account of transfer pricing adjustment by taking the arm's length price of the internal audit services rendered by its Associated Enterprise to the assessee at 'nil' on the ground that no benefit, directly or indirectly, was received by the assessee by availing the said services. In that view of the matter, we delete the addition made by the Assessing Officer and confirmed by the Id. CIT(Appeals) by way of transfer pricing adjustment on this issue and allow Ground No. 14 of the assessee's appeal.

32. In the result, the appeal of the assessee is partly allowed.

Order pronounced in the open Court on May 15, 2019.

Sd/-
(A.T. Varkey)
Judicial Member

Sd/-
(P.M. Jagtap)
Vice-President (KZ)

Kolkata, the 15th day of May, 2019

- Copies to :
- (1) **Organon (India) Limited,
Platina, 7th Floor, Plot No. C-59,
G Block, Bandra Kurla Complex, Bandra (East),
Mumbai-400 098, Maharashtra**
 - (2) **Additional Commissioner of Income Tax,
Circle-12, Kolkata,
Aayakar Bhawan,
P-7, Chowringhee Square, Kolkata-700 069**
 - (3) *Commissioner of Income Tax (Appeals)-12, Kolkata,*
 - (4) *Commissioner of Income Tax- ,*
 - (5) *The Departmental Representative*
 - (6) *Guard File*

By order

*Assistant Registrar,
Income Tax Appellate Tribunal,
Kolkata Benches, Kolkata*

Laha/Sr. P.S.