IN THE INCOME TAX APPELLATE TRIBUNAL
PUNE BENCH "C", PUNE

BEFORE SHRI R.S. SYAL, VICE PRESIDENT AND
SHRI PARTHA SARATHI CHAUDHURY, JUDICIAL MEMBER

आयकर अपील सं. / ITA No.148/PUN/2017
निर्धारण वर्ष / Assessment Year : 2009-10

INA Bearings India Pvt. Ltd., Plot No.A3, Talegaon Industrial Area, Navalkh Umbre, Tal. Maval Talegaon, Pune – 410507 PAN : AAACI7163H	**Vs.**	DCIT, Circle-1(2), Pune
(Appellant)		(Respondent)

आयकर अपील सं. / ITA No.281/PUN/2017
निर्धारण वर्ष / Assessment Year : 2009-10

ACIT, Circle-11, Pune	**Vs.**	INA Bearings India Pvt. Ltd., Plot No.A3, Talegaon Industrial and Floriculture Area, Navlakha Umbre, Tal. Maval, Talegaon Dabhade Pune – 410507 PAN : AAACI7163H
(Appellant)		(Respondent)

Appellant by	Shri Milin Mehta
Respondent by	Shri Shivraj B. Morey
Date of hearing	04-06-2019
Date of pronouncement	07-06-2019

आदेश / ORDER

PER R.S.SYAL, VP :

These two cross appeals – one by the assessee and other by the Revenue - arise out of the order passed by the CIT(A)-13, Pune on 15-11-2016 in relation to the Assessment year 2009-10.

2. Briefly stated, the facts of the case are that the assessee is one of the companies of INA brand of Schaeffler group worldwide. It is a wholly owned subsidiary of Schaeffler KG, Germany. The assessee is engaged in the business of manufacturing, development, marketing and distribution of roller bearing, linear bearings system and engine components. The assessee filed its original return declaring loss of Rs.8,89,36,198/-. This return was revised to total loss of Rs.19,80,74,542/-. The assessee reported certain international transactions entered into with its Associated Enterprises (AEs). The Assessing Officer (AO) referred the matter of determination of the arm's length price (ALP) of the international transactions to the Transfer Pricing Officer (TPO). The TPO observed that though the assessee reported twelve international transactions, but it categorized its business into two segments viz., Distribution business and Production business. In the Transfer Pricing study report, the assessee included certain

purchases and sale of goods along with other expenses under the Distribution business segment. In the Production business segment, the assessee recorded import of raw material, export of manufactured goods and certain other expenses like Payment for services/product development, technical and management support and Payment of charges for SAP software and IT costs. Whereas the assessee's appeal is focused only on the Production Business or Manufacturing segment, the Revenue's appeal is based on Distribution Business or Trading segment.

3. Espousing the assesssee's appeal first, it is seen that the assessee employed the Transactional Net Marginal Method (TNMM) as the most appropriate method for benchmarking the international transactions under the Manufacturing segment. Profit Level Indicator (PLI) of Profit before Depreciation, Interest and Taxes (PBDIT)/sales was adopted. Four comparable companies were chosen with their average operating profit margin of 5.38%. That is how, it was shown that the international transactions under this segment were at ALP. The assessee emphasized on the adoption of PBDIT/Sales as PLI on the ground that it charged depreciation at rates higher than those prescribed under the

Companies Act, 1956 and such higher rates of depreciation resulted into excess depreciation to the tune of Rs.6,,77,83,377/- and further that the depreciation cost on overall basis was substantially higher than the comparables. The TPO did not concur with the PLI adopted by the assessee. Instead, he held that Profit before Interest and Taxes (PBIT)/Sales should be adopted. Such a view point of the TPO was accorded imprimatur by the ld. first appellate authority. The assessee has assailed this point of view.

4. We have heard both the sides and gone through the relevant material on record. The assessee's grievance in this regard is two-fold, viz., first being the adoption of PBIT/Sales instead of PBDIT/Sales, that is, the inclusion of amount of depreciation in total operating costs for the purpose of determination of the operating profit rate; and second, in the alternative, in not allowing appropriate adjustment on account of excess amount of depreciation in the case of the assessee vis-à-vis other comparables.

5. We espouse the first grudge first, namely, that Depreciation ought to have been excluded from the ambit of total costs in

applying the TNMM. It is clarified that there is no dispute on the application of TNMM as the most appropriate method. The mechanism for determining the ALP under the TNM method has been enshrined in clause (e) of rule 10B(1), which reads as under :

> '(i) the *net profit margin* realised by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base ;
>
> (ii) the *net profit margin* realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base ;
>
> (iii) the *net profit margin* referred to in sub-clause (ii) arising in comparable uncontrolled transactions *is adjusted* to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market ;
>
> (iv) the *net profit margin* realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii) ;

(v) the *net profit margin* thus established is then taken into account to arrive at an arm's length price in relation to the international transaction.'

6. Sub-clause (i) provides for the computation of *net operating profit* margin realized by the assessee from an international transaction. Sub-clause (ii) is the computation of *net operating profit margin* realized by an unrelated enterprise from a comparable uncontrolled transaction. Sub-clause (iii) of Rule 10B(1)(e) provides that the *net profit margin* realized by a comparable company, determined as per sub-clause (ii) above, is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, which could materially affect the amount of net profit margin in the open market. It is this adjusted *net profit margin of the comparable companies,* as determined under sub-clause (iii), which is used for the purpose of making comparison with the *net profit margin realized by the assessee* from its international transaction as per sub-clause (i). Thus, it is palpable that the *net profit margin* realised by the enterprise as well as comparables is computed in relation to a common base, such as, costs incurred or sales effected etc. So, numerator in the formula for computation of

margin is always the net profit margin and denominator varies, which may be costs incurred or sales effected or assets employed etc. Meaning of the term `net profit' in the formula has been considered by the Hon'ble Supreme Court in *DIT (IT) Vs. Morgan Stanley & Company (2007) 292 ITR 416 (SC),* in which it has been held that the : `TNMM apportions the total *operating profit* arising from the transaction on the basis of sales, costs, assets, etc.'. Ergo, it is evident that the term "Net Profit" or the "Operating net Profit" as used in Rule 10B(1)(e) is to be read as "Operating Profit". No specific definition of the term Operating Profit has been given in the I.T. Rules, 1962. In common parlance, the expression `operating profit' means profit from business operations, that is, operational revenue minus operating costs. Operating costs are the costs which are incurred in relation to the operations of a business. So, all the costs which facilitate the operation of a business are operating costs. Like raw material and labour costs, there can be no production of goods without the use of machinery or other related assets. One cannot contemplate manufacture of goods without use of assets for fetching sales revenue, which is the starting point for calculating the amount of operating profit. In fact, it is the user of the assets which results into production and the resultant operating revenue. Depreciation is an allowance for wear and tear of the assets used. Thus, depreciation is an inseparable and an integral part of the operating costs. The Hon'ble Bombay High Court in *CIT Vs. Welspun Zucchi Textiles Ltd. (2017) 292 CTR 1 (Bom.)* had an occasion to deal with the nature of depreciation. Question no. (ii) as urged before the Hon'ble High Court reads : "(ii) Whether on the facts and in the circumstances of the case and despite the prescription of parameters of comparability by Rule 10 B (2) of the Income Tax Rules, 1962, the Tribunal was correct in law, in directing the inclusion of DEPB in turnover and depreciation in net profit for the purpose of profit margin of comparables and assessee?" The Tribunal in that case held that depreciation was includible in arriving at the total operating costs. Affirming the view of the Tribunal, the Hon'ble High Court held that : `So far as depreciation is concerned, we find that the analysis done by the Tribunal to include DEPB benefit to hold it to be an operating revenue to determine operating profit, would be equally applicable in case of depreciation for the purposes of holding it to be an operating expenses to determine operating costs.' From the foregoing discussion, it is manifest that depreciation has to be necessarily considered as part of operating costs not only of the assessee but also of the comparables in the process of determining operating profit under the TNMM. As such, there can be no question of excluding depreciation from the ambit of operating costs for the purpose of determining operating profit. The contention, therefore, raised by the assessee that the numerator in the formula should be PBIT/sales rather than PBDIT/sales as applied by the TPO, is bereft of any force. We, therefore, countenance the view taken by the authorities on this score.

7. Now we take up the alternative contention of the ld. AR, who urged for a suitable adjustment in the operating profits on account of the assessee's higher amount of depreciation. It is observed from the factual matrix that the assessee contended before the TPO that the depreciation charged by the assessee was at rates higher than those prescribed under the Companies Rules and the comparables. It was further contended that there was substantial under utilization of capacity. The TPO concurred with the submissions advanced on behalf of the assessee. He granted appropriate adjustment on account of depreciation charged by the assessee at higher rates vis-à-vis its comparables and also towards under utilization of

capacity. The ld. AR has conceded this position before the Tribunal. His further argument was that *de hors* the excess rates on which the depreciation was charged by the assessee for which suitable adjustment was allowed by the TPO, the assessee should be granted further adjustment on account of the excessive amount of depreciation charged in comparison with its comparables. In our considered opinion, this contention has no merit.

8. We have noticed supra from the extraction of rule 10B(1)(e) that sub-clause (iii) provides that the net profit margin realized by a comparable company, determined as per sub-clause (ii) above, is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, which could materially affect the amount of net profit margin in the open market. It is this adjusted net profit margin of the comparable companies, as determined under sub-clause (iii), which is used for the purpose of making comparison with the net profit margin realized by the assessee from its international transaction as per sub-clause (i).

9. There can be no dispute on the principle that calculation of 'Operating profit' as envisaged under Rule 10B(1)(e) embraces cumulative effect of all the items of income and expenses which are of operating nature. Ordinarily, there can be no question of considering each item of such operating expenses or income in isolation *de hors* the other expenses/income to claim adjustment on the ground of such expenditure or income of the assessee being on the higher or lower side seen individually or as a percentage of other operating expense/incomes in comparison with its comparables. The reason is obvious that when we consider the operating profit margin, the effect of all the individual higher or lower items of expenses or incomes is subsumed in the overall operating profit margin, ruling out the need for any adjustment on comparison of one-to-one items resulting into the determination of the operating profit margin.

10. A company may have taken a building on rent for carrying on its business, in which case, it will pay rent which will find place in the operating costs. For the purpose of making comparison, one cannot contend that the payment of rent by one enterprise in comparison with a non-payment of rent by another, should be

neutralized by giving proper adjustment from the operating profit of the comparable. The manifest reason is that the other enterprise may have its own office premises and in that case, the amount of depreciation on such premises will also form part of its operating cost. When we consider the operating profit of the first enterprise which is paying rent and then compare it with that of the second enterprise which is not paying any rent but is claiming depreciation on its own premises, the overall effect of rent in one case gets counterbalanced with depreciation on premises of the other.

11. In the like manner, a company may have purchased new assets charging higher amount of depreciation allowance in its books of accounts *vis-a-vis* another comparable company using old assets with lower amount of depreciation. No adjustment on account of difference in the amount of depreciation of two companies is called for when the operating profits are determined because in the case of a company having purchased new asset, there will be higher depreciation and simultaneously lower repair cost and *vice versa*. The effect of all the individual items of operating expenses and incomes culminates into the overall

operating profit margin. That is why, the legislature has provided for comparing the ratio of 'operating profit margin' to a similar base of the assessee with that of its comparables, thereby dispensing with the need for making any adjustment on account of higher or lower amount of individual items of expenses or incomes. Merely because the amount of depreciation of one enterprise is more or less than the other, can never be a ground for seeking adjustment. Such higher amount of depreciation may be due to large scale of the company and host of other factors. By considering percentage of operating profit margin under the TNMM of the assessee as well as comparables, the higher or lower volume of two companies becomes immaterial and so is the quantum of depreciation. The nitty-gritty of the matter is that no adjustment can be allowed simply for the reason that one company has charged higher amount of depreciation *vis-a-vis* its comparable companies. Not only no adjustment on this score is permissible, the assessee cannot also seek an exclusion or inclusion of a company on the ground that the ratio of its depreciation to total expenses or sales etc. is more or less in comparison with comparables. It is so for the reason that such higher percentage of depreciation to total expenses is marginalized by the lower percentage of repairs and other incidental costs of the assets and *vice versa*. Thus the contention of the ld. AR in this regard, being devoid from any substance, is liable to be and is hereby jettisoned.

12. However, the position may be different when there is a difference in the rates of depreciation charged by two companies on similar category of assets. One company may adopt the policy of charging depreciation on its assets in conformity with the rates prescribed in Schedule XIV of the Companies Act and other company may adopt a policy of charging depreciation at the higher rates than those prescribed under Schedule XIV. In such a situation, although both the companies use similar type of assets and everything else is also equal, but their respective operating profit percentages undergo change due to higher or lower rate of depreciation, thereby distorting their comparability. It is this difference in the amounts of depreciation due to different rates of depreciation and not due to different quantums of depreciation simplicitor, which calls for bringing both the companies at par. It is an agreed proposition on behalf of the assessee that the TPO himself allowed adjustment on account of excess rate of depreciation claimed by the assessee in its accounts. We, therefore,

uphold the impugned order in sofaras the numerator of PBIT in the TNMM is concerned, that is, inclusion of depreciation in the operating costs; and also in not allowing any further adjustment on account of higher amount of depreciation (other than higher rates for which suitable adjustment was granted by the TPO). The grounds taken by the assessee in this regard, therefore, fail.

13. The next issue raised by the assessee in its appeal is against the exclusion of Federal-Mogul Bearings India Ltd. (FMBIL) from the list of comparables drawn by the assessee.

14. The facts relating to this issue are that the assessee selected four companies as comparable including FMBIL. The TPO in his final set of comparables considered three companies from the assessee's list except FMBIL. In addition, he added three new companies. The average PLI of the six companies was computed at 4.11%. This led to the recommendation of the transfer pricing adjustment of Rs.12,45,49,000/- in the Manufacturing segment. The assessee has accepted all the six companies as comparable. It disputed only the exclusion of FMBIL before the ld. CIT(A), but failed to convince the ld. first appellate authority to its line of reasoning. This is how, the assessee is in appeal before the

Tribunal only against the exclusion of FMBIL from the final tally of comparables.

15. We have heard both the sides and gone through the relevant material on record. The TPO excluded this company by, *inter alia,* observing on pages 6 and 29 of his order that its manufacturing turnover was less than 90% of total turnover and further that the activities of this company also extended to Power Production and Aluminum Tins other than the bearings. He further held that there were significant Related Party Transactions (RPTs).

16. It goes without saying that the first and the foremost crucial test in a comparability analysis is the functional similarity. If a company fails on this count, then it loses the tag of comparability. In such a situation, there is no need to examine other factors. Once the functional similarity is established, only then it is further examined if the comparability is not dislodged even on other filters, such as, extraordinary events like acquisition and mergers etc. or the extent of the related party transactions or the magnitude of the operations.

17. As against the assessee engaged only in the manufacturing of bearings in this segment, the TPO noted that FMBIL was engaged in manufacturing of Powder and Aluminum Tins apart from Bearings. In this regard, it is relevant to note that this company declared turnover of Rs.39.36 crore inclusive of `Other income' of Rs.3.11 crore. Bifurcation of `Other income' has been given in Schedule 13 of the Annual report of this company, a copy of which has been placed on record by the ld. AR. `Other income' include Sale of scrap to the tune of Rs.2.05 crore and Interest, Insurance claim and bad debts recovered etc. The ld. AR has drawn our attention towards bifurcation of sales of this company given at page 161 of the paper book. For the year under consideration, this company made sales of Powder products at Rs.3.42 crore, Scrap at Rs.2.05 crore, Aluminum Tins and large size Rs.0.55 crore in addition to Bimetal Bearings at Rs.35.17 crore. All these items total up to Rs.42.06 corre. This figure of Rs.42.06 crore is inclusive of Trading sales and Manufacturing sales. Out of such total sales of Rs.42.06 crore, this company made sales of Bearings at Rs.35.17 crore, which are similar to the product manufactured by the assessee. Sales of Powder and Aluminum Tins & large size etc. made is peculiar to this company alone inasmuch as the

assessee is not into manufacturing of any Powder and Aluminum Tins and large size. What we are contemplating to compare is the profit rate of the assessee's manufacturing of bearings. Per contra, the profit figure of this company, apart from trading, also includes profit from the sale of Powder and Aluminum and large size. What is the impact of profit from the sale of Powder and Aluminum and large size on the overall profitability of this company is not ascertainable, which renders it incomparable. The contention of the ld. AR that comparability can be compromised under the TNMM is not tenable. The Hon'ble Delhi High Court in *Rampgreen Solutions Pvt. Ltd vs. CIT (2015) 377 ITR 533 (Del)* has held that selection of comparables does not differ with the method adopted. It held that comparables should be selected on the basis of similarity, even under the TNMM.

18. In addition, we find that the assessee has two segments, namely, Manufacturing segment and Trading segment. Separate profitability and benchmarking has been done for the Trading segment. In order words, the extant Manufacturing segment is exclusive of trading goods and has only the profit from the manufacture and sale of bearing products. Thus, in order to make

a comparison of the Manufacturing segment with another company, it is *sine qua non* that such other company should also be engaged in manufacturing activity only of similar products or if it is engaged in both the manufacturing and trading, then segmental information *qua* the manufacturing segmental should be discernible from its Annual report. It is observed that FMBIL is engaged both into trading and manufacturing and further no segmental information of its manufacturing segment is available and the assessee has considered this company at entity level as comparable with its manufacturing segment. Once the position is such, we are unable to hold this company as comparable.

19. In view of the foregoing discussion, we are of the considered view that this company was rightly excluded by the authorities below from the list of comparables on the ground of functional differences. In view of the functional dissimilarity at the threshold, there is no need to examine certain other factors taken note of by the TPO making it incomparable. We, therefore, uphold the exclusion of this company from the list of comparables.

20. The Revenue in its appeal is firstly aggrieved by the grant of +-5% margin in determining the ALP.

21. We have hard both the sides and gone through the relevant material on record. Second proviso to section 92C(2) provides that if the variation between the ALP and the price at which the international transaction has actually been undertaken does not exceed the specified margin, which at the material time was 5%, then the price at which the international transaction has actually been undertaken shall be deemed to be the ALP. The effect of this proviso is that so long as the difference between the ALP as determined by applying one of the specified methods and the price at which the international transaction was undertaken is within the prescribed percentage, no transfer pricing adjustment can be made. This proviso was substituted by the Finance (No.2) Act, 2009 w.e.f. 01-10-2009. Explanation to sub-section (2) of section 92C has clarified : "that the provisions of the second proviso shall also be applicable to all assessment or reassessment proceedings pending before the Assessing Officer as on 1st October, 2009". Thus, it is overt that even for the assessment year under consideration, namely, 2009-10, the benefit of the second proviso would be available by virtue of the Explanation given at the end of sub-section (2) of 92C. We, therefore, hold that the ld. CIT(A) was justified in extending the benefit of +/-5% margin in

determining the ALP of the international transactions. This ground of the Revenue fails.

22. The next grievance of the Revenue is the direction of the ld. CIT(A) for inclusion of certain companies in the list of comparables, which as per the Revenue are not comparable. Here, it is relevant to mention that the ground is relevant only for the Trading segment of the assessee company.

23. The facts concerning this issue are that the TPO ventured to determine the ALP of the international transactions recorded by the assessee under the Trading segment. The TPO tinkered with the list of comparables drawn by the assessee for this segment which led to the recommendation of the transfer pricing adjustment of Rs.4.69 crore. The AO made this addition, which was challenged by the assessee before the ld. CIT(A). The ld. first appellate authority directed the TPO to include certain companies in the list of comparables, which as per the Revenue are functionally incomparable.

24. The ld. AR, at the very outset, submitted that even if all the companies directed to be included by the ld. first appellate authority, against which the Revenue has come up in appeal

before the Tribunal, are excluded, its profit margin would be within the permissible range of +/-5%. The ld. DR candidly accepted this proposition. In view of the rival but common submissions, though we technically accept the ground of the Revenue, but it would not lead to increase in the total income by reason of any transfer pricing addition under the Trading segment.

25. In the result, the appeal of the assessee is dismissed and that of the Revenue is partly dismissed on merits and partly having become academic.

Order pronounced in the Open Court on 07th June, 2019.

Sd/-	Sd/-
(PARTHA SARATHI CHAUDHURY)	**(R.S.SYAL)**
JUDICIAL MEMBER	**VICE PRESIDENT**

पुणे Pune; दिनांक Dated : 07th June, 2019
सतीश

आदेश की प्रतिलिपि अग्रेषित/Copy of the Order is forwarded to:

1. अपीलार्थी / The Appellant;
2. प्रत्यर्थी / The Respondent;
3. The CIT(A)-13, Pune
4. The Pr.CIT-1, Pune
5. विभागीय प्रतिनिधि, आयकर अपीलीय अधिकरण, पुणे "**C**" / DR 'C', ITAT, Pune;
6. गार्ड फाईल / Guard file.

आदेशानुसार/ BY ORDER,

// True Copy //

Senior Private Secretary
आयकर अपीलीय अधिकरण ,पुणे / ITAT, Pune

		Date	
1.	Draft dictated on	04-06-2019	Sr.PS
2.	Draft placed before author	04-06-2019	Sr.PS
3.	Draft proposed & placed before the second member		JM
4.	Draft discussed/approved by Second Member.		JM
5.	Approved Draft comes to the Sr.PS/PS		Sr.PS
6.	Kept for pronouncement on		Sr.PS
7.	Date of uploading order		Sr.PS
8.	File sent to the Bench Clerk		Sr.PS
9.	Date on which file goes to the Head Clerk		
10.	Date on which file goes to the A.R.		
11.	Date of dispatch of Order.		

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