

**IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH 'I-1', NEW DELHI**

**BEFORE SH. N. K. BILLAIYA, ACCOUNTANT MEMBER
AND
SH. KULDIP SINGH, JUDICIAL MEMBER**

ITA No.5053/Del/2019
Assessment Year: 2005-06

EDAG Engineering & Design (India) Pvt. Ltd. (Now known as EDAG Production Solutions P. Ltd.) 125-B, Somdatt Chamber-1, 5- Bhikaji Cama Place, New Delhi PAN no.AAACE6666K	Vs	DCIT Circle – 11 (1) New Delhi
(APPELLANT)		(RESPONDENT)

Appellant by	Sh. G. C. Srivastava, Advocate Sh. Suvinay K. Dagh, Advocate Sh. Parichay Solanki, CA Sh. Mayank Patawari, CA
Respondent by	Sh. Subha Kant Sahu, Sr. DR.

Date of hearing:	21/10/2019
Date of Pronouncement:	22/10/2019

ORDER

PER N. K. BILLAIYA, AM:

This appeal by the assessee is preferred against the order of the CIT(A)-44, New Delhi dated 16.04.2019 pertaining to A. Y.2005-06.

2. The grievance of the assessee read as under :-

1. *The order of the Ld. Commissioner of Income-tax (Appeals) is contrary to law and to the facts and circumstances of the case.*
2. *The CIT(A) as well as TPO has not gone through the submission of appellant company and passed the order without providing any further opportunity which is against the principle of natural justice.*
3. *The CIT(A) erred in law by not accepting the quantitative adjustments made by the Appellant company on comparables as per the observation of Hon'ble ITAT on account of under capacity utilization of fixed costs i.e. rent, salary and depreciation in the same ratio of tested party.*
4. *The Appellant had claimed an adjustment for differences in capacity utilization vis-a-vis the comparable companies on the basis of data available in public domain. The TPO/CIT(A) should have verified data/information under Section 133(6) from respective comparables to give the benefit of under capacity utilization as claimed by the appellant.*
5. *The CIT(A) erred while stating that no documents have been provided relating to financial assistance of Rs. 10,288,176 wherein the same had been duly filed before TPO during assessment proceedings and accepted by TPO after going through the details of financial assistance. The same is available as per the records of tax authorities.*
6. *The CIT(A) erred in facts and on the basis of her own presumption that appellant company is 100% captive unit without providing an opportunity to the appellant company in this regard.*
7. *The CIT(A) erred in holding that the appellant is 100% captive unit without appreciating that the appellant is developing/having significant dealing with third parties both in India and in overseas market.*
8. *The Above grounds are independent and without prejudice to each other.*

The Appellant craves leave to add, alter, supplement, amend, vary, withdraw or otherwise modify the ground mentioned herein above at or before the time of hearing.

3. This being the second round of litigation, the counsel for the assessee explained the facts considered in the first round by the

AO/TPO. The counsel further explained how the matter travelled up to the Tribunal and referred the decision of the Tribunal.

4. It is the say of the counsel that the CIT(A) did not appreciate the directions of the Tribunal in true spirit and confirmed the adjustments made by the AO/ TPO. The counsel referred to the submissions and the details furnished before the CIT(A) and pointed out that the detailed submission supported by evidences were not considered by the CIT(A).

5. Per contra the DR strongly supported the findings of the CIT(A), though, fairly conceded that the CIT(A) has not considered the submissions made by the assessee at the appellate stage.

6. We have given a thoughtful consideration to the orders of the authorities below. The appellant company is engaged in providing software added design and engineering services. As mentioned elsewhere in the first round of litigation the matter travelled up to the Tribunal wherein the quarrel was in respect of the addition of Rs.1,65,87,730/- on account of arms length price adjustment. The bone of contention was the effect not given to the capacity under utilization by the TPO. The CIT(A) granted the impugned relief by making adjustments on account of capacity under utilization. Revenue agitated the matter before the Tribunal and the Tribunal in ITA No.549/Del/2011 held as under :-

5. We find that learned CIT(A) has granted the impugned relief by making adjustments, on account of capacity underutilization, in the results shown by the tested party and thus computing hypothetical financial results which the tested party would have achieved in perfect conditions. Such an exercise, in our, humble understanding of law, is impermissible. As is the undisputed legal position, such comparability adjustments can only be made in the comparables and not the tested party itself. It is specifically provided in Rule 10B (l)(e)(iii) that adjustments for variations, which could materially affect the amount of net profit margin in the open market in comparable uncontrolled transactions, are to be made in respect of net profits realized by the comparable transactions or enterprises. Learned CIT(A) was thus clearly in error in proceeding to make capacity underutilization adjustments in the profits earned by the assessee. That apart, in the case of a one hundred percent captive service unit, as is the assessee before us, the very concept of capacity underutilization may not really make any sense unless the assessee has not been able to offer, for reasons beyond its control, the underutilization capacity to its AE. There is no finding on" this aspect of the matter. As the assessee does not have the liberty to work for any other customer, and is wholly dependent on its AE for productive use of its capacity to work, the AE should normally make good any losses to the captive unit caused by its not being able to make use of the available capacity. In the case before this, the AE has indeed given some financial support to the assessee which has been reduced from the ALP adjustment figure, and the business rationale of AE's extending financial support to the assessee is thus not in doubt. However, there is nothing on record to show how this financial support has been computed and is on what ground, and on what basis, this financial support is given. The reason for underutilized capacity and the facts regarding financial support extended to the assessee are not clear from the material on record. Learned CIT(A) has granted the impugned relief merely by making capacity underutilization adjustments to the profits achieved by the tested party, but then such an approach, as we have noted earlier, is wholly unsustainable in law.

6. In view of the above discussions, as also bearing in mind entirety of the case, we deem it fit and proper to vacate the impugned order and direct the CIT(A) to decide the matter afresh after giving an opportunity of hearing to the assessee, in accordance with the law and by way of a speaking order. We order so."

7. During the fresh appellate proceedings before the CIT(A) the assessee vide reply dated 14.06.2018 made the following submissions :

“Submission of the Appellant dated 14.06.2018:

5. The appellant made the following submissions dated 14.06.2018 during the course of appellate proceedings:-

“This is reference to the notice issued by your goodself vide F. No. CIT(A)-44/Notice/2018-19/128 dated 15/05/2018 wherein hearing date is fixed on 08/06/2018 and re-fixed for today. In this regard, we on the behalf of our client submit as below:-

*EDAG Engineering & Design India Private Limited (herein after referred as “appellant”) is a company incorporated under Indian Companies Act, 1956 engaged in providing software-aided services for engineering and design of automobile and automobile components. The appellant provides these services on project basis to its AE in Germany. During the year under consideration, the transfer pricing officer (TPO) /Assessing officer (AO) has made addition ' 16,587,730/- without giving adjustment of capacity utilization to the appellant company. Copy of transfer pricing order is enclosed herewith (refer **Annexure-I**). Thereafter, aggrieved appellant company filed an appeal to CIT(A)-XX and the learned CIT(A)-XX has deleted the transfer pricing addition made by TPO/AQ after allowing adjustment of capacity utilization. Copy of order passed by CIT(A)-XX is enclosed herewith (refer **Annexure-II**). In response of aforesaid CIT(A) order, tax department filed an appeal to Hon’ble ITAT and Hon’ble ITAT after allowing the appeal for statistical purposes directed the CIT(A) to decide the matter afresh after giving an opportunity of hearing to appellant in accordance with the law and by way of speaking order. Copy of IT A T order is enclosed herewith (refer **Annexure-III**).*

Your goodself will appreciate that the appellant company has under-utilization capacity during the year under consideration and the learned CIT(A) has given the relief of under capacity utilization to the profits achieved by tested party. The comparable companies normally working under optimum capacity and publically data is not available regarding capacity utilization during the year. The issue of adjustment on account of idle capacity hinges on the concept of the leverage that fixed cost offers to the profitability ratio of business. The variable overheads vary in proportion to the sales and they therefore do not have any effect on the profit margin as a result of difference in capacity utilization. The fixed overheads, on the other hand, do not vary with the volume of sales and since they remain by and large static irrespective of level of capacity utilization, the profit margin gets affected as a result of difference in capacity utilization on this count. The underutilization of capacity results in over allocation or over absorption of fixed overheads resulting into under-recovery of fixed overheads which adversely affects the profit margin. As the level of capacity utilization goes up, the rate of allocation or absorption of fixed overheads to sales comes down resulting into higher profit margin. The difference in capacity utilization thus materially affects the profit margin and if there is a difference in the level of capacity utilization of the assessee and the level of capacity utilization of the comparable companies, adjustment is required to be made to the profit margin of the comparables on account of difference in capacity utilization as per clause (e)(iii) of sub-rule (I) of Rule 10-D of the Income Tax Rules, 1962.

Therefore, it was submitted that the appellant financial results were hit by the said factors, the comparable cases selected were units which were already established in market who did not have such factors. Therefore, in order to facilitate appropriate comparability analysis, assessee contended before your goodself that adjustments be made to the profit margin of the appellant on account of abnormal costs and under capacity utilization during the year.

Capacity Utilization adjustment in comparables companies as per Rule 10B(l)(e)(iii) of the Rules

*'The appellant company hereby submit the comparable company's financials wherein salary cost, rent and depreciation has been considered according to tested party sales ratio (refer **Annexure-IV**). The adjusted OP/OC of 6 comparable comes to -26.93% & the difference comes to ' 5,590,062/- as per aforesaid calculation sheet. Further, arm's length addition will be NIL after considering the received support services ' 10,288,176/- as mentioned in TP order.*

Considering the aforesaid, appellant company request before your goodself to grant the appropriate relief since the same is at arm's length price.

Rule 10B(2) and 10B(3) of the IT Rules allow adjustments with regards to eliminate the material differences at the time of comparability of transactions.

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

(b) 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;

(c) 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.

Rule 10B(3)

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to 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.

From perusal of the above Rules, it is clear that the suitable adjustment should be made to ensure that there is a closer comparability between the uncontrolled and controlled transaction. If these adjustments are not made or are not possible than in that case comparables cannot be used as appropriate comparables.

The Hon 'ble IT A T in this case of Mentor Graphic's case on the issue of adjustment has held that;

Quote

"If there are differences which can be adjusted, then adjustments are required to be made. "

Unquote

The Hon 'ble Bench has further

noted that Quote

"The transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustment to account for difference of the type referred to above."

Unquote

As per the ruling, the ITAT has held that adjustment, if required, may be made while application of TNMM to ensure reliable results.

On the Issue of Adjustment Support is also drawn from Para 1.16 of OECD guidelines, which states as under;

OECD Guidelines, Para 1.16

".....adjustment must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the price charged or returned required by independent enterprises. Therefore, in no event can unadjusted average returns themselves establish arm's length conditions. "

From the above discussion, it is very clear that if the TPO finds that both controlled and uncontrolled transactions operate in different environment and circumstances etc. then in order to make the comparability analysis more reliable, fruitful and authentic, the TPO must carry out the appropriate adjustments."

8. The above submissions did not find any favour with CIT(A) who decided the appeal holding as under :-

"8. I have considered the facts in the circumstances of the case. I have also perused the order of the AO as well as the submission of the appellant and the judgments of the Tribunals and the Courts relied upon by the appellant. The Hon'ble ITAT, Delhi had remanded the issue regarding economic adjustment on account of underutilization of capacity in the profit margins of the appellant/ comparables to the file of the CIT(A). The TPO was asked to file his comments which was subsequently sent to the appellant for its reply.

9. *The Hon'ble ITAT, Delhi in its order had remanded the issue regarding adjustment on account of under-utilization of capacity in the profit margins of the appellant / comparables for the purpose of determining the arm's length price. The TPO in his letter dated 21.06.2018 has clearly stated that Rule 10B(l)(e)(iii) specifically provides that adjustments for variations, which could materially affect the amount of net profit margin in the open market in comparable uncontrolled transactions, are to be made in respect of net profits realized by comparable transactions / enterprises. The TPO, has further pointed out that the appellant is a 100% captive service unit and*

the appellant has not submitted any reasons for the un-utilized capacity. It has also been pointed out that the appellant does not have the liberty to work with any other customer and was wholly dependent on its AE for the productive use of its capacity. In fact, the AE had given some financial support to the appellant which was reduced from transfer pricing adjustment made by the TPO in his impugned order.

10. The Hon'ble ITAT, Delhi at para 5 of its impugned order has clearly stated that Rule 10B(l)(e)(iii) specifically provides that comparability adjustments can be made only in the profit margins of the comparables and not in that of the tested party. The Hon'ble Tribunal had also noted that the appellant was wholly dependent on its AE for capacity utilization and did not have the liberty to work for any other customer and hence, it was up to the AE to make good any loss. It had also noted that the AE have given some financial support to the appellant which had been reduced from the figure for transfer pricing adjustment. However, it also noted that the appellant had not provided any document to show how the financial support have been computed and on what ground / basis the same had been given to the appellant, it was also noted that the order of 29.11.2010 had granted capacity underutilization adjustment in the margins of party which was unsustainable in law.

11. In view of the categorical findings of the Hon'ble ITAT, Delhi in the case of the appellant itself for the year under reference, it is held that no adjustment on account of under- utilized capacity can be made in the profit margins of the appellant, who is the tested party in the instant case, in view of the provisions of Rule 10B(l)(e)(iii) of the Income Tax Rules, 1962. It is also noted that the appellant has not submitted any reasons supported by evidence / documentation regarding the reason for having unutilized capacity when it was a 100% captive service provider to its AE. In fact, it is noted that the AE has compensated the appellant on account of transfer pricing adjustment, details of calculation of which have not been submitted by the appellant either during the course of assessment proceedings, appellate proceedings or remand back proceedings. In view of the same, the contention of the appellant is liable to be dismissed.

The issue referred by the Hon'ble ITAT, Delhi in the case of the appellant for AY 2005- 06 vide its order in ITA No. 549/Del/2011 dated 13.10.2014 for AY 2005-06 is accordingly decided against the appellant."

9. We are of the considered view that the CIT(A) ought to have considered the adjustments made towards under utilization of capacity in the case of the comparables furnished by the assessee in support of its claim. We find that the assessee has furnished

detailed working in respect of the comparables - software exports, Athena Global Technologies, Echo Recycling Limited, New Time Infrastructure Ltd., Telesys Software Ltd. and Tera Software Ltd. which are exhibited at pages 29 to 33 of the paper book respectively.

10. We are left with no choice but to restore this issue to the files of the TPO. The TPO is directed to verify the working of under utilization of capacity of the six comparables as furnished by the assessee. If the TPO is of the view that financials of these six comparables are not available on the public domain then he should call the related informations from the comparable companies directly exercising powers vested upon him u/s.133 (6) of the Act.

11. With these directions we restore the issue to the files of the TPO. The TPO shall examine and decide the issue after giving reasonable opportunity of being heard to the assessee.

12. In so far as the benefit of the adjustment in respect of waiver of amounts payable to the parent company of the assessee amounting to Rs.1,02,88,176/- is concerned, this benefit has already been allowed by the TPO in his order dated 27.10.2008 framed u/s. 92CA(3) of the Act and this adjustment has attained finality, therefore, no separate adjudication is required.

13. In the result, the appeal is treated as allowed for statistical purpose.

The order is pronounced in the open court on 22.10.2019.

Sd/-
[KULDIP SINGH]
JUDICIAL MEMBER

Sd/-
[N.K. BILLAIYA]
ACCOUNTANT MEMBER

Dated: 22 October , 2019

Neha

Copy forwarded to:

1. Appellant
2. Respondent
3. CITi
4. CIT(A)
5. DR

Asst. Registrar
ITAT, New Delhi

Date of dictation	21.10.2019
Date on which the typed draft is placed before the dictating Member	22.10.2019
Date on which the typed draft is placed before the Other member	22.10.2019
Date on which the approved draft comes to the Sr.PS/PS	22.10.2019
Date on which the fair order is placed before the Dictating Member for Pronouncement	22.10.2019
Date on which the fair order comes back to the Sr. PS/ PS	22.10.2019
Date on which the final order is uploaded on the website of ITAT	22.10.2019
Date on which the file goes to the Bench Clerk	22.10.2019
Date on which file goes to the Head Clerk.	
The date on which file goes to the Assistant Registrar for signature on the order	
Date of dispatch of the Order	