

IN THE INCOME TAX APPELLATE TRIBUNAL
BANGALORE BENCHES “ C ” BENCH: BANGALORE

**BEFORE SHRI B.R. BASKARAN, ACCOUNTANT MEMBER
AND
SHRI PAVAN KUMAR GADALE, JUDICIAL MEMBER**

ITA No. 466/Bang/2019
(Assessment Year: 2011-12)

M/s. Mann & Hummel Filter Private Limited, 2 nd Floor, Prasad Enclave, 118, 119 Industrial Suburb, 2 nd Stage, 5 th Main, Yeshwantpura, Bangalore-560 022 PAN AAECM4056D	Vs.	Dy. Commissioner of Income Tax, Circle 4(1)(2), Bangalore.
(Appellant)		(Respondent)

Assessee By:	Shri T. Suryanarayana, Advocate.
Revenue By:	Shri M. Vijay Kumar, Addl. CIT (D.R)

Date of Hearing :	04.11.2019
Date of Pronouncement :	20.11.2019

ORDER

PER SHRI PAVAN KUMAR GADALE, JM :

The assessee has filed an appeal against the Assessment order passed under Section 143(3) r.w.s. 254 of the Income Tax Act, 1961 dt.28.12.2018 in pursuance to the directions of Dispute Resolution Panel (DRP) order dt.17.12.2018.

2. The assessee has raised the following grounds of appeal :

Sl. No	Grounds of Appeal	Tax effect (in INR)
1.	Assessment and reference to Transfer Pricing Officer are bad in law and on facts	1,377,379
(a)	The learned Deputy Commissioner of Income-tax – Circle 4(1)(2) ('Ld. AO') / learned Additional Commissioner of Income-tax – Range 2(1) ('Ld. TPO') erred in law and on facts in making an addition to the total income of the Appellant on account of adjustment to the arm's length price with respect to computer aided design ('CAD / CAM') services rendered by the Appellant to its associated enterprises.	
(b)	The Ld. AO / Ld. TPO/ Hon'ble Dispute Resolution Panel ('Hon'ble DRP' or 'the Ld. Panel') erred in law and on facts in failing to establish that the Appellant shifted profits outside India.	
2.	Determination of arm's length price of international transactions	
(a)	The Ld. AO / Ld. TPO grossly erred on facts and in law in rejecting the filters and search process adopted by the Appellant in the Transfer Pricing Study without considering the Appellants facts. Further, the Ld. AO/ Ld. TPO also erred on facts and in law by conducting a fresh benchmarking	

	<p>analysis in respect of captive CAD / CAM services provided by the Appellant and wrongly comparing the Appellant's activities with companies operating as full-fledged entrepreneurs without considering the differences in functions performed, assets employed and risks assumed by the Appellant vis-à-vis comparable companies.</p>
(b)	<p>The Ld. AO / Ld. TPO erred in law in applying arbitrary filters as criterion for rejection of companies identified by the Appellant in the Transfer Pricing Study such as (i) companies whose data for financial year ('FY') 2010-11 was not available, (ii) companies having related party transactions greater than 25% of the sales, (iii) companies with export sales less than 75% of total sales, (iv) companies with software development revenue less than 75% of total sales, (v) companies with employee cost less than 25% of total revenues, (vi) companies with different financial year ending (i.e. other than 31 March 2011), (vii) companies having persistent losses up to and including financial year 2010-11, and (viii) companies having peculiar economic circumstances. The Ld. Panel has erred in upholding the application of the aforementioned filters applied by the Ld. AO/ Ld. TPO.</p>
(c)	<p>The Ld. AO / Ld. TPO erred in law in applying an arbitrary filter to reject companies having related party transactions greater than 25% of sales. Further, the Ld. Panel also erred in upholding the related party transaction filter at 25%, disregarding the Appellant's ground for application of the related party transaction filter at a threshold of 10% or 15% of sales.</p>
(d)	<p>The Ld. AO / Ld. TPO / the Ld. Panel erred on facts and in law in considering e-Zest Solutions Limited, ICRA Techno Analytics Limited, Infosys Ltd, Larsen & Toubro Infotech Limited, Persistent Systems Limited, Persistent Systems & Solutions Limited, Sasken Communication Technologies and Tata Elxsi Limited as comparable to the captive software development services function rendered by the Appellant</p>
(e)	<p>The Ld. AO/ Ld. TPO erred on facts in wrongly computing the margins of a certain companies (Larsen & Toubro, Tata Elxsi, Persistent Systems and Solutions Limited) identified as comparable by the TPO and the Ld. Panel also erred in confirming the same.</p>
(f)	<p>The Ld. AO/ Ld. TPO erred on facts in arbitrarily accepting companies without considering the turnover and size of the Appellant and</p>

	comparables and the Ld. Panel also erred in confirming the same.	
(g)	The Ld. AO/ Ld. TPO erred on facts in arbitrarily accepting companies without considering the significant onsite revenue earned by comparables. The Ld. Panel also erred in confirming the same.	
3.	Erroneous data used by the Ld. TPO	
(a)	The Ld. AO / Ld. TPO has erred in law and the Ld. Panel further erred in confirming use of data, which was not contemporaneous and which was not available in the public domain at the time of conducting the transfer pricing study by the Appellant.	
(b)	The Ld. AO / Ld. TPO erred in law erred in disregarding the application of multiple-year data while computing the margin of comparable companies. The Ld. Panel erred in confirming the same.	
4.	Non-allowance of appropriate adjustment to the comparable companies by the Ld. Panel and the Ld. AO/ Ld. TPO	
(a)	The Ld. AO / Ld. TPO/ Ld. Panel erred in law and on facts in not allowing appropriate adjustments under Rule 10B of the Rules to account for, inter alia, differences in (i) accounting practices, (ii) marketing expenditure adjustment, (iii) research and development expenditure between the Appellant and the comparable companies.	
(b)	The Ld. AO/ Ld. TPO erred in law and on facts in restricting the working capital adjustment to 1.63% as against 4.23% originally computed by the Ld. TPO in the transfer pricing order. The Ld. DRP erred in upholding the actions of the Ld. AO / Ld. TPO.	
5.	Variation of 5% from the arithmetic mean	
(a)	The Ld. AO / Ld. TPO/ Ld. Panel erred in law in not granting the variation as per proviso to Section 92C(2) of the Income-tax Act, 1961 ('The Act')	
6.	Initiation of penalty proceedings	
	The Ld. AO has erred in initiating penalty proceedings under Section 271(1)(c) of the Act.	

7. Relief	
	The Assessee prays that the Ld. AO be directed to grant all such relief arising from the preceding grounds as also all relief consequential thereto.
Total tax effect	1,377,379

3. At the time of hearing, the learned Authorised Representative submitted that the assessee is only praying for exclusion of 8 comparables and filed Chart and judicial decisions. The Brief facts of the case are that the assessee is wholly owned subsidiary of Mann Hummel Filter Technology (S.E.A) PTE Ltd., Singapore and is engaged in the business of manufacturing of and trading in air intake systems and filters for automotive and heavy engineering industry and rendered services to its Associated Enterprises (AEs) in the nature of services using CAD and computer aided manufacturing software tools and filed the Return of Income for Assessment Year 2011-12 on 28.09.2011 with a total loss of Rs.16,57,89,697. Subsequently, the assessee company filed Revised Return of Income with a total loss of Rs.15,43,98,328. The case was selected for scrutiny and Notice under Section 143(2) and 142(1) of the Act were issued. In compliance, the ld. AR appeared from time to time and furnished the details. The Assessing Officer on perusal of the Audit Report, Form 3CEB found that the assessee has entered into international transactions exceeding Rs.15 Crores. Hence the matter was referred with the prior approval of CIT for determination of Arm's Length Price (ALP) to TPO. Whereas the TPO observed that the assessee had international transactions referred

at para 4 of TPO order and the financial results with the Operating Profit / Operating Cost and Operating Profit / Operating Revenue are read as under :

4. INTERNATIONAL TRANSACTIONS FOR THE F.Y 2010-11:

Sl. no	Nature of Transaction	Amount received/receivable
1	Purchase of raw materials for manufacture	77,301,666
2	Purchase of hydromation materials	5,768,799
3	Purchase of finished goods *	266,783,675
4	Sale of finished goods	9,109,136
5	Purchase of capital goods	1,948,807
6	Provision of license by Mann+ Hummel GmbH	3,423,919
7	Provision of product know-how by M& H Group	37,755,356
8	Provision of service by MHFPL	44,909,691
9	Provision of Guarantee by Mann + Hummel Holding GmbH	2,093,050
10	Internet lease & SAP charges	19,119,535
11	Recovery of expenses	939,372
12	Reimbursement of expenses	38,634,385
13	Issue of share capital	357,000,000
14	Share application money received	412,318,000

4.1 THE FINANCIAL RESULTS OF THE COMPANY FOR THE F.Y. 10-11 :

Particulars	Amount	Amount
Total Operating Income	741384445	
Less: Other Income	67206409	
Operating Income		674178036
Total Operating Cost	985025291	
Less: Provision for doubtful debtors	9236319	
Provision for obsolete inventory	123670	
Provision for claims	89950000	
Provision for warranties	7924575	
Foreign Exchange loss	3719199	
Finance charges	2089329	
Operating Cost		871982199
Operating Profit		-197804163
OP/OC		-22.68%
OP/OR		-29.34%

The assessee's margin computed on OP/OC, is – 22.68%. The assessee is into Software Development Services segment and the TPO found that the Transfer

Pricing Document contains 9 comparables on software development activities with applied filters and TNMM is considered as MAM further assessee has selected the comparables engaged in the same industry verticals i.e. Aero Space, Rail and Defense industries. The TPO has rejected the TP Study and applied the filters on usage of current year data, the companies of software development with Revenue less than Rs.1 Crore are excluded, companies with Software Development Services and related services is less than 75% of operating revenue were excluded and companies who have more than 25% Related Party Transactions (RPT) of sales, companies who have precedent losses for the last three years upto and including Assessment Year 2010-11 are excluded and companies having different financial years are excluded and companies having a peculiar economic circumstances are excluded companies having less than 75% of export sales in software and with Employees Cost less than 25% of turnover were excluded and finally the TPO has rejected the comparables of Software Development Services segment selected by the assessee in para 6.1 as under :

6.1 The taxpayer has selected 9 comparable companies in respect of **Software Development Services** the details of which are as under:

Sl. No.	Name of the comparable	TPO's Remarks
1	Akshay Software Technologies Ltd	functionally different. Hence rejected
2	Chakkilam Infotech Limited	No data available in the public database . Rejected
3	CSS Techenergy Limited	No data available in the public database . Rejected
4	I-Design Engineering Solutions Limited	No data available in the public database . Rejected
5	KLG Systel Limited	Fails the employee cost filter. Rejected .
6	Neilsoft Limited	Fails forex earning filter. Hence, rejected
7	Powersoft Global Solutions Ltd	No data available in the public data base. Rejected .
8	Tata Elxsi Ltd	Qualifies all filters. Accepted
9	Vama Industries Ltd	Fails forex earning filter. Hence, rejected

Out of the 9 comparables selected by the assessee, the TPO has accepted one comparable Tata Elxsi Limited and rejected 8 comparables. Further on application

of the selected filters, the TPO has selected 13 comparables at para 9 as final set of comparables which are as under :

FINAL SET OF COMPARABLES CONSIDERED BY THE TPO :

After considering the objections of the taxpayer to the comparables proposed in the show-cause notice, perusal of relevant annual reports and examination of additional comparables suggested by the taxpayer on the touchstones of filters and functionality, the final set of comparables are arrived as per the discussions in the following paragraphs.

Sl.No	Name	Sales	Cost	PLI
1	Acropetal Technologies Ltd.(seg)	814,016,893	616,754,876	31.98%
2	e zest solutions (from Capitaline)	112866098	93255341	21.03%
3	E-Infochips Ltd	260384251	166447527	56.44%
	Evoke (from Capitaline)	144869912	133996568	8.11%

5	I C R A Techno Analytics Ltd. (in 000)	158401000	126894000	24.83%
6	Infosys Ltd	253850000000	177,030,000,000	43.39%
7	Larsen & Toubro Infotech Ltd.	23318122096	19,764,861,289	19.83%
8	Mindtree Ltd.(seg)	8,783,000,000	7,937,143,242	10.66%
9	Persistent Systems & Solutions Ltd,	189,490,457	155,172,089	22.12%
10	Persistent Systems Ltd,	6,101,270,000	4,971,860,000	22.84%
11	R S Software (India) Ltd.	1,882,638,471	1,617,804,170	16.37%
12	Sasken Communication Technologies Ltd	3,941,962,000	3,175,616,000	24.13%
13	Tata Elxsi Ltd (seg)	3,581,985,000	2,962,533,352	20.91%
	AVERAGE MARGIN			24.82%

Further the TPO worked out Working Capital Adjustment and risk adjustment and computed the ALP of Software Development Services at para 12.4 of the order as under :

Computation of Arms Length Price:

The arithmetic mean of the Profit Level indicators is taken as the arms length margin. Please see Annexure B for details of computation of PLI of the comparables. Based on this, the arms length price of the services rendered by the taxpayer to its AE(s) is computed as under:

SOFTWARE DEVELOPMENT SERVICES

Arm's Length Mean Margin on cost	24.82%
Less: Working Capital Adjustment (As per Annex. C)	1.63%
Adjusted margin	23.19%
Operating Cost	41,273,496
Arms Length Price(ALP) 123.19% of Operating Cost)	50,844,820
Price Received	44,909,691
Shortfall being adjustment u/s 92CA:	5,935,129

The above shortfall of Rs. 59,35,129/- is treated as transfer pricing adjustment u/s 92CA in respect of software development segment of the taxpayer's international transactions

The TPO made Adjustments on the provision of Software Development Services to the extent of Rs.59,35,129 and passed order under Section 92CA r.w.s. 143(3) r.w.s. 144C dt.30.01.2015. Aggrieved by the draft assessment order, the assessee filed objections with DRP in Form 35A whereas the DRP has passed the order considering the objections of the assessee, the TP adjustment and TPO findings vide order dt.17.12.2015. Subsequently, the Assessing Officer passed final assessment order dt.19.01.2016 with TP adjustment to the extent of Rs.55,22,394. Aggrieved by the TPO order, the assessee has filed an appeal with the Tribunal in IT(TP)A No.586/Bang/2016 whereas the Tribunal remanded the matter to the file of DRP for fresh consideration by way of speaking and reasoned order vide order dt.8.9.2017. The DRP after considering the directions of the Tribunal and the

submissions of the assessee has passed order dt.17.12.2018 partly allowing the assessee's objections. The TPO in pursuance to the directions of the DRP passed the final assessment order under Section 143(3) r.w.s. 254 on 28.12.2018. Aggrieved by the order, the assessee is in appeal before the Tribunal.

4. At the time of hearing, the ld. AR submitted that the assessee is in Software Development Services and has international transactions and the comparables selected by the TPO are to be excluded. The ld. AR emphasized that the comparables selected by the TPO are functionally different and are to be excluded and filed chart and relied on the decision of the co-ordinate Bench of the Tribunal. Contra, the ld. DR supported the orders of the TPO and DRP and filed written submissions.

5. We heard the rival contentions and perused the material on record. Prima facie, the learned Authorised Representative has made submissions on 8 comparables selected by the TPO for examination and Working Capital Adjustment.

First we shall deal with the exclusion of comparables as under :

(i) E-Zest Solutions Limited : This company is functionally different and has on-site services and significant presence of inventory and is functionally incomparable and is engaged in product development, web development and KPO services and segmental details are not available. We found that this comparable was excluded in the case of co-ordinate Bench decision Applied Materials India Limited Vs.

ACIT in IT(TP)A Nos.17 & 39/Bang/2016 Dt.21.09.2016 for the Assessment Year 2011-12. The Tribunal has observed at page 17 para 9.1.3 as under :

“ 9.1.3 We have considered the rival submissions as well as the relevant material on record. We find that the assessee has raised objections against this company before the DRP. However the DRP did not adjudicate the objections raised by the assessee. The decision of this Tribunal in the case of M/s. Electronics for Imaging India Pvt. Ltd. Vs. DCIT (supra) relied upon by the learned Authorised Representative is based on two aspects. (i) The information received under Section 133(6) of the Act was considered by the TPO without sharing with the assessee and (ii) nature of the activity is KPO. It is pertinent to note that the question of BPO and KPO is relevant only in ITES segment and not for software development services segment. On the contrary, the decision in the case of Toluna India Pvt. Ltd. Vs. ACIT (supra), pertains to the Assessment Year 2007-08, therefore the facts of the different year cannot be applied without verification. Accordingly, we set aside this issue of comparability of **E-Just Solution Ltd.** to the record of the Assessing Officer / TPO for deciding the same after verification of the relevant facts as well as considering the objections of the assessee.”

(ii) Iera Techno Analytics Limited : This company is functionally different and significant RPT of 24.81% with margin of 24.83% and predominantly into Software Development Services and which is engaged in diversified activities and no segmental details are available and further concentrated in niche area of business intelligence and analytics space and has revenue from licensing activities. The Id. AR demonstrated Annual Report where the comparable company has significant growth in business intelligence and analytics space which are different from activities of the functional profile of the assessee and engaged in licensing activity. We found the said comparable was excluded by the co-ordinate Bench of

the Tribunal in the case of Applied Materials India Limited (supra) at pages 32 & 33 paras 17.1 & 17.2 as under :

“ 17.1 We have heard the learned D.R. as well as learned A.R. and considered the relevant material on record. The DRP has rejected this company by recording the fact as under :

“ We examined the annual report from which it is evident that the entire revenue has been shown under service segment which indicates that the revenue from software development, consultancy, licensing and sub-licensing, annual maintenance charges for software support. WEB development and hosting has been reported in one segment, thus in absence of segmental information, we concur with the view of the DRP in preceding year and accordingly direct the Assessing Officer to exclude this company from comparables.”

17.2 We further note that the Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) has considered the comparability of this company in paras 14 to 16 as under :

“(1) ICRA Techno Analytics Ltd. (seg)

14. At the outset, we note that apart from having the related party revenue at 20.94% of the total revenue, this company was also found to be functionally not comparable with software development services segment of the assessee. The DRP has given its finding at pages 13 to 14 as under:-

“Having heard the contention, on perusal of the annual report, it is noticed by us that the segmental information is available for two segments i.e., services and sales. However, it is evident from the annual report that the service segment comprises of software development, software consultancy, engineering services, web development, web hosting, etc. for which no segmental information is available and therefore, the objection of the assessee is found acceptable. Accordingly, Assessing Officer is directed to exclude the above company from the comparables.”

15. We find that the facts recorded by the DRP in respect of business activity of this company are not in dispute. Therefore, when this company is engaged in diversified activities of software development and consultancy, engineering services, web development & hosting and substantially diversified itself into domain of business analysis and business process outsourcing, then the same cannot be regarded as functionally comparable with that of the assessee who is rendering software development services to its AE.

16. In view of the above facts, we do not find any error or illegality in the findings of the DRP that this company is functionally not comparable with that of a pure software development service provider.”

Nothing has been brought before us to show that the facts recorded by the DRP as well as by the co-ordinate bench of this Tribunal are not correct. Accordingly, in view of the decision of the co-ordinate bench of this Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra), we do not find any error or illegality in the order of the DRP on this issue.”

(iii) Infosys Limited : The comparable company is functionally dissimilar as it is engaged in development of software products and has inventories, ownership and marketing intangibles and Intellectual Property Rights (IPR), with High brand value and incurred huge expenditure towards R & D to the extent of Rs.527 Crores and has high turnover and more than 50% of revenue are from on site services. We found that the co-ordinate Bench in the case of Applied Materials India Limited (supra) has dealt on this issue at page 34 para 18 as under and excluded the comparable :

“18. We have heard the learned D.R. as well as learned A.R. and considered the relevant material on record. At the outset, we note that the co-ordinate bench of this Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) has considered this issue in para 17 as under :

“(2) Infosys Ltd.

17. The assessee objected against the selection of this company on the ground that this company has a big name and brand value and therefore it has a bargaining power. It also contended that the turnover of this company is Rs.21,140 crores, which is 442 times higher than the assessee.”

Following the decision of this Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) , we do not find any reason to interfere with the directions of the DRP on this issue.”

(iv) M/s. L & T Infotech Limited : The said comparable company has site revenues more than 50% of total revenue with three different segments being financial services, manufacturing and telecom as per the Annual Report of the company and further no segmental results are available and cannot be functionally comparable. The comparable company is a market leader and on account of ownership marketing, intangibles IPRs for the proprietary software products developed in House and during the year the company has acquired Canadian Transfer Agency business which has impact on the profitability of the company and has to be excluded being dissimilar to the assessee's functional profile. We found that the co-ordinate Bench of the Hon'ble Tribunal in the case of Applied Materials India Limited (supra) has dealt on the issue at page 35 para 19 as under :

“ 19. We have heard the learned D.R. as well as learned D.R. and considered the relevant material on record. The DRP rejected this company by recording the facts at page 15 as under :

On perusal of schedule to the notes of the accounts, it is noticed by us that expenses incurred in foreign currency are 938.94 crore (48.84%), out of the total expenses of ₹ 1920.46 crore debited in profit and loss account, these expenses include the sub contracting expenses to the extent of ₹ 118.01 crore, which indicates that the company has the on-site revenue of about 50%, it is also noticed by us that in the profit and loss account, the revenue has been shown from software development services and products, in the segmenting account it is mentioned that the segment revenue include sales directly identifiable with/allocable to the segment. In Schedule 18, the revenue have been shown from 3 segments i.e. financial services, manufacturing and telecom. However, in paragraph 23, it is mentioned that the company is mainly engaged in the business of software development. The assessing officer has considered entire revenue from 3 segments from the software development services. Out of the software development expenses of ₹ 1,488.30 crore debited in profit and loss account, salary to overseas staff is ₹ 1200.28 crore which also indicates that the company is predominantly engaged in development of software on-site. In view of the above differences, in our view the above company cannot be retained as comparable, the assessing officer is accordingly directed to exclude the above company from comparable.

We further find that the comparability of this company has been considered by the co-ordinate bench of this Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) in paras 62 to 65 as under :

“ 62. The assessee has raised objection against this company on the basis of high turnover in comparison to the assessee. It was also contended that related party transaction (RPT) of this company is 18.66%. The DRP rejected objections of the assessee on the ground that TPO has applied 25% filter of RPT and annual report of the company does not show any other services rendered other than software development services provided by this company. Thus the DRP held that software development segment is comparable to the assessee and therefore this company has to be retained as comparable.

63. We have heard the Id. AR as well as Id. DR and considered the relevant material on record. The Id. AR has submitted that this company is having 18.66% RPT and further this company earns revenue from both services and products. Thus, the Id. AR submitted this company is also in the software products and therefore cannot be considered as good comparable. He has further contended that in a series of decisions, the Tribunal has applied 15% RPT filter and since this company is having more than 15% RPT, the same cannot be considered as a good comparable.

64. On the other hand, the Id. DR has submitted that TPO has applied RPT filter of 25% and therefore only for this company, the RPT cannot be reduced to 15%. Further, the DRP has examined annual report of this company and found that this company earns revenue from software development services and accordingly is comparable.

65. We have considered the rival submissions and relevant material on record. We find that in the normal circumstances the tolerance range of RPT should not be more than 15%. In the case of the assessee, the availability of the comparable is not an issue and therefore we do agree with the view taken by the coordinate Benches of the Tribunal that the threshold limit of tolerance range should not exceed 15% as far as RPT revenue is concerned. Therefore, we direct the AO/TPO to apply 15% RPT filter in respect of all the comparables.”

In view of the facts recorded by the DRP as well as the decision of the co-ordinate bench, we do not find any reason to interfere with the directions of the DRP.”

(v) Persistent Systems and solutions Limited : The company is functionally not comparable as it is engaged in diversified activities of rendering Software Development Services, License and Royalty of software products and also has abnormal increase in turnover from year on year, the company is growing over ten times the industry average and functionally dissimilar and has invested in IPR solutions and created several Intellectual Properties (IP) such as Chem, LMS, Viewmor and during the F.Y. 2010-11 and the company earns 8.8% of its total revenues related to activities of IPs and also engaged in Information Technological services and no segmental information available. We support our view relying on the decision of the co-ordinate Bench of the Hon'ble Tribunal in the case of Applied Materials India Limited (supra) has dealt on the issue at pages 20 & 21 para 9.2.4 which read as under :

“ 9.2. (4) Persistent Systems Ltd.

24. We have heard the Id. DR as well as Id. AR and considered the relevant material on record. The assessee raised objections against selection of this company on the ground that this company is functionally not comparable as engaged in the product development. The segmental information for services and product is not available. Further, the assessee has also pointed out that there was an acquisition and restructuring during the year under consideration.

25. The DRP has noted the fact that this company has reported the entire receipt from sales and software services and product. Therefore, no segmental information was found to be available for sale of software services and product. Further, the DRP has noted that as per Note 1 of Schedule 15, this company is predominantly engaged in outsource software development service. Apart from the revenue from software services, it also earns income from licence of products, royalty on sale of products, income from maintenance contract, etc. These facts recorded by the DRP has not been disputed before us.

26. Therefore, when this company is engaged in diversified activities and earning revenue from various activities including licencing of products, royalty on sale of products as well as income from maintenance contract, etc., the same cannot be considered as functionally comparable with the assessee. Further, this company also earns income from outsource product development. In the absence of any segmental data of this company, we do not find any error or illegality in the findings of the DRP that this company cannot be compared with the assessee and the same is directed to be excluded from the set of comparables.”

We further find from the Annual Report that there is no change in the activity and functions of these companies during the year under consideration in comparison to the Assessment Year 2010-11. Accordingly, following the decisions of the co-ordinate benches of this Tribunal (supra), we direct the A.O./TPO to exclude these two companies from the set of comparables.”

(vi) **Sasken Communication Technology Limited** : The company is engaged in software products and presence inventory and intangible assets, with High expenditure on R & D and no segmental details are available, income from sale of products amounting to 9.4% of total revenue of software services include net work services. We support our view based on the decision of the co-ordinate Bench of the Hon'ble Tribunal in the case of Applied Materials India Limited (supra) has dealt on the issue at page 23 para 9.3.3 which read as under :

“ 9.3.3 We have considered the rival submissions as well as the relevant material on record. The co-ordinate bench of this Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) has considered the comparability of this company in paras 27 to 29 as under :

“(5) Sasken Communication Technologies Ltd.

27. The assessee raised objection that this company has revenue from software services, software products and other services. The DRP has come to the conclusion that this company earned revenue from 3 segments.

However, no segmental information is available. Accordingly, the DRP directed the AO to exclude this company from the comparables.

28. We have heard the Id. DR as well as Id. AR and considered the relevant material on record. The DRP has reproduced the break-up of revenue in the impugned order as under:-

Amount in Rs. lakhs

	Year ended March 31, 2010	Year ended March 31, 2019
Software Services	37,736.22	40,531.20
Software products	2,041.00	6,146.43
Other services	372.77	1,297.05
Total revenues	40,150.89	47,974.68

29. Thus, there is no dispute that this company earns revenue from 3 segments. However, the segmental operating margins are not available. Therefore, in the absence of segmental relevant data and particularly operating margins, this composite data cannot be considered as comparable with the assessee for software development services segment. Accordingly, we do not find any error or illegality in the findings of the DRP."

We further note that the DRP has not adjudicated the objections of the assessee whereas for the Assessment Year 2010-11, the DRP rejected this company as comparable. Accordingly, we set aside this issue to record of the A.O./TPO to verify the relevant facts and compare with the facts recorded by the Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) for the Assessment Year 2010-11 and then decide the issue after giving an opportunity of hearing to the assessee."

(vii) Tata Elxsi Limited : This company is functionally dissimilar and engaged in provision of niche products and development services which are dissimilar to assessee's services and has substantial R & D, and failed the export revenue filter at 75% and has incurred an amount of Rs.12.65 Crores towards R & D expenditure and incurred significant expenditure in foreign currency to the extent of 21.26% of total sales with High turnover. We support our view relying on decision of the co-ordinate Bench of the Hon'ble Tribunal in the case of Applied Materials India

Limited (supra) which has dealt on the issue at pages 37 to 39 para 20 which read as under :

“ 20. We have heard the learned Departmental Representative as well as learned Authorised Representative and considered the relevant material on record. The DRP has rejected this company by discussing the fact at page 16 as under :

Directed to exclude as per paragraph 2.7 of the order, further, on perusal of annual report, it is noticed by us from page 14 that software development and services consist of embedded product design, industrial design and visual computing labs which are not comparable to the software development services provided by the assessee and therefore, we direct the assessing officer to exclude the above company from the comparables.

We further note that the DRP has also recorded the fact that export revenue of this company is 73.30% which is less than 75% applied by the TPO. Therefore this company does not qualify the export earning filter applied by the TPO. Further the co-ordinate bench of this Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (supra) has considered this issue in paras 30 to 33 as under :

30. The assessee has raised objections against this company on the ground that the company is functionally different from the assessee. Though the TPO has considered the software development and services segment of this company as comparable to that of assessee, however, the assessee contended that even within the software segment, this company is engaged in diverse activities. The assessee placed reliance on the information in the annual report under the Directors Report and submitted before the DRP that even under the software development services segment, this company is engaged in various diversified activities including product design service, innovation design, engineering service, visual computing labs, etc. The assessee also placed reliance on the decision of Mumbai Bench of the Tribunal in the case of *Telcordia Technologies Pvt. Ltd. v. ACIT, 137 ITD 1 (Mum)*.

31. The DRP found that this company is not functionally comparable with assessee company as it is engaged in diversified activities even in the software development services. The DRP has followed the decision of the Mumbai Bench of the Tribunal in the case of *Telcordia Technologies Pvt. Ltd. (supra)*.

32. We have heard the Id. DR as well as Id. AR and considered the relevant material on record. We find that this company even in the software development segment is

engaged in diversified activities of product design services, innovation design, engineering services, visual computing labs, etc. We further note that in the case of *Telcordia Technologies Pvt. Ltd. (supra)*, the Mumbai Bench of the Tribunal vide its order dated 11.5.2012 in para 9.7 has held as under:-

“7.7 From the facts and material on record and submissions made by the learned AR, it is seen that the Tata Elxsi is engaged in development of niche product and development services which is entirely different from the assessee company. We agree with the contention of the learned AR that the nature of product developed and services provided by this company are different from the assessee as have been narrated in para 6.6 above. Even the segmental details for revenue sales have not been provided by the TPO so as to consider it as a comparable party for comparing the profit ratio from product and services. Thus, on these facts, we are unable to treat this company as fit for comparability analysis for determining the arm's length price for the assessee, hence, should be excluded from the list of comparable parties.”

33. No contrary view has been brought to our notice regarding comparability of this company with that of a pure software development service provider. Accordingly, in view of the decision of the Mumbai Bench of the Tribunal in the case of *Telcordia Technologies Pvt. Ltd. (supra)*, we do not find any reason to interfere with the finding of the DRP.”

In view of the facts recorded by the DRP as well as the decision of the Tribunal in the case of DCIT Vs. Electronics for Imaging India Pvt. Ltd. (*supra*), we do not find any error or illegality in the directions of the DRP to exclude this company from the set of comparables.”

We considering the dissimilarities of the comparable companies which are functionally different from assessee's profile and rely on the judicial decisions and direct the following comparables to be excluded by the TPO from the final list of comparables selected for determination of ALP.

- i) E-zest Solutions Ltd.
- ii) ICRA Techno Analytics Limited
- iii) Infosys Limited
- iv) Larsen & Toubro Infotech Ltd.
- v) Persistent Systems & Solutions Ltd.

- vi) Sasken Communication Technologies Ltd.
- vii) Tata Elxsi Limited

6. The learned Authorised Representative argued that the Working Capital Adjustment computed by the TPO at 4.23% but was restricted to 1.63% without any basis. We found that the TPO has dealt on the Working Capital Adjustment in order at page 241 to 243 para 10 and finally at page 243, the TPO has restricted the Working Capital Adjustment at 1.63% which read as under :

10. WORKING CAPITAL ADJUSTMENT:

The working capital adjustment is computed as per the formula given in Annexure to the OECD Guidelines, 2009. In this case, the average PLR adopted by SBI, the largest scheduled bank, for short term working capital loans for the relevant FY 2010-11 is considered. The average PLR of 12.45% p.a was adopted by the TPO while computing the working capital adjustment. The detail working is annexed to this order as **Annexure C**. The working capital adjustment is restricted to the average working capital component of the comparables which 1.63%.

Working capital is equal to the sum total of current assets appearing in the balance sheet of the firm. It is an important accounting concept that informs as to how liquid the firm is. Current Assets are divided by Current Liabilities to find out as to how capable the firm is to meet its current liabilities when they fall due by encashing the Current Assets. Therefore, the broad category 'Current Assets' includes all those assets which are easy to convert into cash. Unless the Current Assets are sufficiently liquid they cannot be converted into cash when the liabilities mature for payment. Apart from current assets being liquid they should be sufficient to take care of current liabilities. The formula Current Assets/Current Liabilities is used to find out the current ratio. It is also known as Working Capital ratio. The general rule of thumb for the current ratio is 2 to 1. It means that current assets which are twice that of current liabilities is considered to be an ideal current ratio. However, minimum ratio of 1:1 is considered necessary as current assets having lesser ratio compared to current liabilities may create liquidity problem.

But in Transfer Pricing, we take into consideration the 'Net Working Capital'. Net Working Capital is calculated as follows

Debtors + Inventory - creditors = Net Working Capital.

In Transfer Pricing, no other Current Assets and Liabilities are considered. By using these three items of Current Assets and Current Liabilities it is found out as to how much net working capital is being utilized in operating business. This Working Capital is calculated to find out as to how much is

the cost of capital that must be recovered from the customers by increasing the sales price. The logic behind this exercise is that the firm would factor in the cost of capital in the sales price. Therefore, to find out the operating profit, the cost of capital factored in the operating price is excluded.

The Arm's length price of the operating profit when we use TNMM as the most appropriate method is found out in the case of tested party by comparing it with the average operating profit margin of the uncontrolled comparables. As in the case of uncontrolled comparables also, there is cost of working capital involved, the operating profit is computed by excluding the cost of capital factored in the net profit margin. The purpose is to find out the net operating profit margin adjusted for the cost of working capital factored in the operating margin calculated using the TNMM. Thus, the profit margin computed in TNMM is a composite figure which includes two components. They are the profit margin on account of operating profit and profit margin on account of cost of capital recovered. Therefore, when the arithmetical average of net profit margins computed in the case of uncontrolled comparables is considered as arm's length profit margin in Transfer Pricing that arise from operating business, then the average cost of capital computed in the case of uncontrolled comparables should also be considered as arm's length price of the cost of capital in Transfer Pricing exercise.

Accordingly, the average cost of capital computed in the case of the uncontrolled comparables should be an upper cap for the purpose of allowing working capital adjustment. It implies that the uncontrolled comparables have earned a profit margin on operating activities using a certain amount of working capital that has average cost of capital calculated in their case. To have further discussion in this regard, it is considered necessary to understand as to how the cost of working capital is computed. The working capital is computed as per definition by adding up all the Current Assets but in Transfer pricing, we take only the debtors and inventories as they are considered to be items of working capital relating to the operating business that have a cost which must be recovered from the customers. However, in view of the fact that some working capital calculated by adding up debtors and inventory is taken care of by the creditors in the balance sheet of the taxpayer it is reduced from it and accordingly only the net working capital requirement is found out. Thereafter the cost of capital is found out by multiplying the ratio of net working capital on the appropriate base (same which is used for arriving at the profit margin in TNMM such as sales, total cost etc.) by the prime lending rate for the relevant financial year.

In the case of wholly owned subsidiary, it is observed that the tested party receive lot of advances from their Holding company for whom they are rendering services on contract basis. Therefore, in their cases mostly there are neither debtors nor any inventory and therefore, the working capital is zero. Even if they are receiving lot of advances from the Holding company, the cost of working capital is zero because there are neither debtors nor inventory in their case. In such circumstances the issue that arises is as to whether we should find out the cost of working capital when there are neither debtors nor inventory. In Transfer Pricing, we reduce creditors from the total sum of debtors and inventory to find out the net working capital and cost thereof to recover the same by factoring it in the sales price. Therefore, in the absence of debtors as well as inventory, the creditors should not be taken into consideration as even if the creditors are there in the balance sheet, they are not being used for the operating revenues. For the academic discussion in a case where the taxpayer is receiving lot of advances but no debtors or inventory, if the cost of capital is computed for the advances received from the Holding company, then it is quite likely that it may result into abnormal adjustment in the sales price of the taxpayer on a standalone basis that even if no operating profit is

earned, the adjusted profit margin may become comparable because of cost of capital computed on the basis of creditors alone. It can be understood by the following example.

Tested Party	uncontrolled comparables	
Unadjusted profit margin	2%	8%
Cost of working capital	(-) 8%	2%
Adjusted profit margin	$2 - (-8) = 10\%$	$8 - 2\% = 6\%$

Thus, the profit margin which was nearly 2% of the tested party before working capital adjustment has increased to 10% as against profit margin of 8% in the case of the uncontrolled comparables reduced to 6% after the working capital adjustment. Accordingly, it should be accepted because adjusted profit margin is better than that of the uncontrolled comparables. In this manner, because of finding out working capital adjustment even on negative working capital the operating profit of the taxpayer may be accepted wrongly.

Therefore, in a particular kind of business even the arm's length price of working capital can be found out by computing the same in the case of uncontrolled comparables by finding the average mean of the cost of net working capital. Therefore, in the case of wholly owned subsidiaries (WOS) receiving huge advances the right approach would be to reduce the average mean of cost of capital of the comparables from their average profit margins and in the case of the tested party, reducing the cost of capital on the net working capital computed as follows:

Net working capital of the tested party = (Debtors + Inventory) – (Payables/ advances received to the extent of debtors plus inventory)

The Balance payables not considered in calculation of net working capital of the tested party is due to the fact that they are invested either in fixed assets or in the current assets having no cost, whereas in Transfer Pricing those receivables are taken into consideration that reduce the working capital requirement and accordingly the cost of working capital that must be recovered from the customers by factoring in the sales price. Any excessive advance which is received from the Holding company by the WOS cannot be factored in reducing the sales price and less sales price cannot be defended on the ground that due to negative cost of capital it is managing to have arm's length profit margin even if it is having low profit margin on operating activity as discussed in the example given above. In a related party scenario, the entire payables/advances cannot be considered in working capital adjustment as in any business there is an optimum working capital that can be found out only on the basis of comparison with third parties as third parties alone represent the optimum working capital requirement. Accordingly the working capital adjustment is restricted to 1.63%

The contention of the learned Authorised Representative that there is no clarity and the basis of rationality computing the Working Capital Adjustment and restricting it to 1.63%. The learned Authorised Representative supported his argument relying on the judicial decisions. We found that the similar issue was dealt by the co-ordinate Bench of Tribunal in the case of ARM Embedded Technologies Pvt.

Ltd. Vs. DCIT in IT(IT)A No.1560 & 1659/Bang/2014 dt.31.08.2015 observed at paras 24 & 25 as under :

24. Now coming to the issue of working capital adjustment, findings of the TPO in this regard as it appears at para 3.7, reads as under :

"3.7 Working Capital Adjustment:

The working capital adjustment is computed as per the formula given in Annexure to the OECD Guidelines, 2009. In this case, the average PLR adopted by SBI, the largest scheduled bank, for short term working capital loans for the relevant FY 2008-09 is considered. The average PLR of 12.50% p.a was adopted by the TPO while computing the working capital adjustment. The working capital adjustment is restricted to the average cost of capital computed at 1.71% in the case of the uncontrolled comparables selected by the TPO. Hence, the working capital adjustment in the case of the taxpayer is allowed as per the calculation in annexure-C or the average cost of capital to the comparables whichever is the least. The detailed discussion on this is given in the Annexure-D to the order. The computation of the working capital adjustment is annexed to this order as Annexure C."

TPO had restricted the cost of capital to 1.71%. Rationality for such an upper limit being placed on working capital adjustment was an issue which had come up before this Tribunal in the case of *Rambus Chip Technologies (India) (P.) Ltd. v. Dy. CIT* [IT (TP) A. 23/Ban/2015, dt. 22.07.2015. Coordinate bench had held as under at para 13 and 14 of its order:

"13. As regards ground No. 3(f), learned counsel for the assessee submitted that the AO/TPO while considering the working capital adjustment, has arrived at the working capital adjustment in the case of the assessee at 5.97%, but while giving effect to the working capital adjustment, has restricted the said adjustment to 1.71% in case of uncontrolled comparables selected by the TPO. The learned counsel for the assessee submitted that the TPO has not given any basis for such restriction of the working capital adjustment. He submitted that the CIT (A) also has not applied his mind to this issue but has summarily confirmed the order of the AO and therefore it has to be set aside.

14. On going through the TPO's order as well as annexure D referred to in the transfer pricing order on working capital adjustment, we find that the AO has not given any basis for restricting the adjustment to 1.71%. In all the cases relating to transfer pricing adjustment, this Tribunal has been directing to give working capital adjustment on actual basis and the TPO having arrived at 5.97% ought to have adopted the same instead of restricting it to 1.71 %. In view of the same, we deem it proper to remand this issue to the file of the AO/TPO for working out the ALP after giving adjustment of working capital as per the calculation of the AO in annexure D annexed to the transfer pricing order. This ground of appeal is accordingly allowed."

25. Accordingly we direct the AO/TPO to correctly work out the PLI of the final comparables after giving due adjustment for the working capital on actual basis. Related ground of the assessee is therefore allowed.

7. We found the submissions of the learned Authorised Representative are realistic as the TPO has not given proper basis / findings in restricting the Working Capital Adjustment to 1.63% and we support our view on judicial decisions and

restored this disputed issue to the file of TPO for computing adjustment of working capital on actual facts and allow the grounds of appeal of the assessee for statistical purposes.

8. In the result, the assessee's appeal is partly allowed for statistical purposes.

Order pronounced in the open court on 20th November, 2019.

Sd/-

(B.R. BASKARAN)
ACCOUNTANT MEMBER

Sd/-

(PAVAN KUMAR GADALE)
JUDICIAL MEMBER

Dated: 20.11.2019.

*Reddy GP

Copy to

i)The Appellant	ii)The Respondent	iii)CIT (Appeals)
iv) Pr. CIT	v)DR, ITAT, Bangalore	vi)Guard File

By order

Assistant Registrar
Income-tax Appellate Tribunal
Bangalore