

**IN THE INCOME TAX APPELLATE TRIBUNAL,  
BANGALORE BENCH 'B'**

**BEFORE SHRI N.V VASUDEVAN, VICE-PRESIDENT  
AND  
SHRI B.R.BASKARAN, ACCOUNTANT MEMBER**

IT(TP) A Nos.481/Bang/2016  
(Assessment year : 2011-12)

The Dy. Commissioner of Income-tax,  
Circle-1(1)(2), Room No.242, 2<sup>nd</sup> Floor, BMTC Building  
80 Feet Road, Koramangala,  
Bengaluru-560095.

.... Appellant

Vs.

M/s BrocadeCommunications Systems Pvt.Ltd.  
7<sup>th</sup> Floor, A Wing, Tower 3, Phase I,  
Vrindavan Tech Village, SEZ Outer Ring Road,  
Deverabeesanahalli Village, Varthur Hobli,  
Bangalore-560 037.  
PAN – AACCB4490N

..... Respondent

CO No.59/Bang/2017  
(By Assessee)  
(Assessment year : 2011-12)

Assessee by : Shri T.Suryanarayana & Ms.Manasa Ananthan, Advocates  
Revenue by : Mr.Muzaffar Hussain, CIT (DR)

Date of Hearing : 17-02-2020  
Date of Pronouncement : 19-02-2020

**ORDER**

**PER SHRI N.V VASUDEVAN, VICE-PRESIDENT:**

This is an appeal by the Revenue against the final order dated 19/01/2016 of Dy. Commissioner of Income-tax, Circle-1(1)(2), Bangalore relating to assessment year 2011-12 in respect of an order passed u/s 143(3) r.w.s 144C(13) of the Income Tax Act, 1961 (Act). The Assessee has also filed a Cross Objection against the very same order.

2. The Assessee is a subsidiary of Brocade Communications, Switzerland SARL, Switzerland with the latter holding 99.99% of equity shares of the Assessee. The Assessee is engaged in the business of providing contract software development services(SWD Services) and marketing support services to its Associated Enterprises (AE). In the appeal by the revenue and the C.O. by the Assessee the disputes relate to determination of Arm's Length Price (ALP) in respect of provision of SWD services to the AE.

3. Grounds No. 1 to 8 raised by the revenue relates to the issue of determination of Arm's Length Price in respect of international transaction of rendering of SWD services by the Assessee to its AE for which the AE paid the Assessee a sum of Rs.96,08,41,988/-. Since the transaction of provision of Software service by the Assessee to its AE was an international transaction, income from such international transaction has to be determined having regard to Arm's Length Price (ALP) as laid down in the provisions of Sec.92 of the Act.

4. The TPO to whom the question of determination of ALP of the international transaction of providing software development services by the Assessee to its AE suggested an addition to the total income of the Assessee consequent to determination of Transfer Price of a sum of **Rs.5,95,55,635/-**.

5. The Assessee in support of its stand that the price paid to the AE for rendering software development services was at Arm's Length filed a Transfer Pricing Analysis containing the following details:

Operating Income	Rs.96,08,41,988/-
Operating Cost	Rs.82,83,12,057/-
Operating Pr Operating Profit (Op. Income – Op. Cost)	Rs.13,25,29,930/-
<b>Operating/Net margin (OP/OC)</b>	<b>16%</b>

In arriving at the above OP/TC the TPO excluded foreign exchange gain treating them to be not operational in nature. The Assessee as well as the TPO adopted Transaction Net Margin Method as the Most appropriate Method for determination of ALP and the Profit Level Indicator for comparison was Operating Profit to Total Cost (OP/TC)

6. The Assessee selected 12 companies as comparable companies and computed the arithmetic mean of the profit margins of those companies at 14.43% which was much lower than the profit margin of the Assessee which was 16%. The Assessee therefore claimed that the price received in the international transaction was higher than the arithmetic mean of profit margin of comparable companies and therefore the price received is at Arm's Length.

7. The TPO rejected the Transfer Pricing Study of the Assessee and chose only three of the 12 companies selected as comparable companies by the Assessee viz., Acropetal Technologies Ltd., Persistent Systems & Solutions Ltd., and R.S.Software (India) Ltd. The TPO identified 10 other companies as comparable companies and arrived at a set of 13 comparable companies with that of the Assessee and arrived at arithmetic mean of the profit margin of those 13 companies at 24.82% before working capital adjustment and 22.04% after working capital adjustment. The following chart will show the list of 13 comparable companies ultimately chose by the TPO and the arithmetic mean of the profit margin of those companies and determination of ALP by the TPO.

Sl. No.	Name of the Company		Mark-up Total Costs (in (WC-adj))
1	Acropetal Technologies Ltd. (seg)	31.98	27.32
2	eZest Solutions Ltd.	21.03	17.63
3	E-Infochips Ltd.	56.44	54.64
4	Evoke Technologies Pvt. Ltd.	8.11	6.68
5	ICRA Techno Analytics Ltd.	24.83	21.46
6	Infosys Ltd.	43.39	42.02
7	Larsen & Toubro Infotech Ltd.	19.83	18.49
8	Mindtree Ltd.(seg)	10.66	7.94
9	Persistent Systems & Solutions Ltd.	22.12	19.82
10	Persistent Systems Ltd.	22.84	20.26
11	R S Software R.S.Software (India) Ltd.	16.37	14.88
12	Sasken Communication Technologies Ltd.,	24.13	23.12
13	Tata Elxsi Ltd.(seg)	20.91	17.59
<b>AVERAGE MARK-UP</b>		<b>24.82</b>	<b>22.04</b>

Arm's Length Mean Margin on cost	24.82%
Less: working capital Adjustment	1.63%
(As per Annex -C)	
Adjusted margin	23.19%
Operating cost	Rs. 828,312,057/-
Arms Length Price (ALP)	Rs.1,02,03,97,625/-
123.19% of Operating cost)	
Price Receive Price Received	Rs.960,841,988
<b>Shortfall bei Shortfall being adjustment u/s. 92CA</b>	<b>59,555,635</b>

9. The Assessee objected to the manner of determination of ALP by the TPO before the DRP. Briefly, the directions issued by the DRP are as follows:

**Functionality Filter:**

The following companies were directed to be excluded by accepting the contentions of the Assessee:

- i) E-Infochips Limited
- ii) CRA Techno Analytics Ltd.
- iii) Infosys Ltd.
- iv) Larsen & Toubro Infotech Ltd.
- v) Infosys Ltd.
- vi) Tata Elxsi Ltd.

The DRP, however, rejected the contentions of the Assessee that Persistent Systems Ltd. and Sasken Communication Technologies Ltd. were not functionally comparable to it and consequently upheld their inclusion in the final list of comparables. The DRP also *suo moto* directed R S Software (India) Ltd., Mindtree Ltd., and Evoke Technologies Pvt. Ltd.

**Onsite Software Development activities:**

In addition to the above, the DRP rejected the following companies selected by the TPO on the basis that they were predominantly engaged in onsite activities, although no onsite revenues filter had not been applied by the TPO:

- (a) L & T Infotech Ltd. (rejected by DRP *suo moto* on other grounds also);
- (b) RS Software (India) Ltd. (rejected by DRP *suo moto* only on this ground);

**List of Comparables post the DRP's Directions:**

On giving effect to the above directions issued by the DRP, the final list of comparables is as follows:

Sl. No.	Name of the Company
1.	E-Zest Solutions Limited
2	Persistent Systems & Solutions Ltd.
3.	Persistent Systems Ltd.
4.	Sasken Communication Technologies Ltd.,
5	Mindtree Ltd.,
6	Acropetal TechnologiesLtd.,

DRP also directed the AO to consider the gain/loss arising from fluctuation of foreign exchange as operating in nature while computing the margins of the Assessee and the comparable companies.

10. Pursuant to the directions of the DRP, as the arithmetical mean of the working capital adjusted margins of the above comparables was within the +/- 5% range of the Assessee's NCP mark-up for provision of SWD services, the TP adjustment made towards the said international transaction came to be deleted in the final assessment order.

11. Aggrieved by the directions of the DRP which were incorporated by the AO in the final order of assessment, the Revenue has preferred appeal before the Tribunal. Briefly, the grounds in Revenue's appeal are as follows:

(i) That the DRP erred in directing the exclusion of M/S.Larsen & Toubro Infotech Ltd., & RS Software (India). Ltd., by applying onsite revenue filter and holding them to be functionally dissimilar despite the said companies satisfying the quantitative and qualitative filters applied by the TPO. **(Ground No.2 & 3)**

(ii) That the DRP erred in excluding ICRA Techno Analytics Ltd., Infosys Ltd., and M/S.TATA Elxsi from the list of comparable companies on the ground that these companies are functionally not similar. (**Ground No.4 to 7**)

(iii) Directing that the foreign exchange fluctuation to be treated as operating revenue in nature. (Gr.No.8)

12. The grounds in the cross-objections which are being pressed are as follows:

(i) That the TPO erred and the DRP further erred in including two companies, viz. Persistent Systems Ltd. and Sasken Communications Technologies Ltd., in the list of comparables although they fail the test of comparability. (**Ground No.2 & 4**)

13. As far as Gr.No.2 & 3 in Revenue's appeal is concerned, the sum and substance of the ground of appeal is that the DRP ought not to have excluded 2 comparable companies from the list of final comparable companies chosen by the TPO for comparison of profit margin of the Assessee with comparable companies. The two companies that were excluded by the DRP which is in challenge by the Revenue before the Tribunal are (i) Larsen & Toubro Infotech Ltd., and (ii) **RS Software (India) Ltd.**

14. As far as Larsen & Toubro Infotech Ltd., is concerned it was the plea of the learned DR that the onsite revenue filter was not applied by the AO nor pleaded for application by the Assessee before DRP and in such circumstances, the DRP ought not to have applied the aforesaid filter without notice to the AO/TPO. On this objection, the learned counsel for the Assessee has rightly pointed out that the DRP in Page-8 Paragraph 2.9 of its order excluded this company by holding that this company is functionally not comparable because it has variety of sources of revenue and there were no segmental details available to know the income from SWD services. Hence, the plea of the revenue in this regard does not require to be considered. As

for **RS Software (India) Ltd.**, it was rejected by the DRP solely on the basis that it was allegedly predominantly engaged in the onsite development of software in FY 2010-11. In this regard, it is seen that this company was selected by the TPO and accepted by the Assessee as a comparable, and it was accordingly included by the TPO in the list of comparables. In the proceedings before the DRP, the Assessee did not object to its inclusion in the list of comparables. However, despite the above, the DRP on its own directed its exclusion. We are of the view that since the revenue as well as the Assessee wants to retain this company as a comparable company, this company should be regarded as comparable company.

15. As far as Gr.No.4, 5 & 7 of the revenue are concerned, it is not in dispute before us that these three companies viz., ICRA Techno Analytics Ltd., M/s Infosys Ltd., and M/sTata Elxsi Ltd., were excluded from the list of comparable companies in the case of Assessee such as the Assessee in the present appeal engaged in rendering SWD services in the case of M/s Applied Materials India Pvt.Ltd. Vs. ACIT IT(TP)A.No.17 & 39/Bang/2016 order dated 21.9.2016 by the ITAT Bangalore Bench. In Paragraph 17.2 of the aforesaid order the Tribunal held that the services and sales of this company comprises of sales of SWD services, software consultancy, engineering services, Web development etc., and no segmentation information is available and hence cannot be regarded as comparable to a SWD service provider such as the Assessee. In paragraph 18 of the said order Infosys Ltd., was excluded as comparable for the reason that the company has huge brand value and turnover. Similarly Tata Elxsi Ltd., was excluded vide paragraph 20 of the aforesaid order for the reason that it was a software products and software development company and no segmental details are available. Respectfully following the aforesaid decision we uphold the order of CIT(A) excluding the aforesaid companies from the list of comparable companies.

16. As far as Ground No.6 is concerned, this ground raised by the Revenue is to the effect that the DRP should not exactly compare comparable companies with the Assessee and should only compare similar companies and that under TNMM only if there is material differences in the comparability between the comparable companies and the Assessee they should be regarded as not comparable. According to the Revenue, the DRP failed to notice this legal position in its order. This ground is vague and does not set out any particular instance of such violation and are therefore held to be without any merit.

17. Gr.No.8 raised by the revenue with regard to the directions of the DRP directing considering foreign exchange fluctuation gain as part of the operating profit of the Assessee is without merit as the law by now is well settled that foreign exchange gain has to be regarded as part of operating profit as held by the ITAT Bangalore Bench in the case of Electronics for imaging India Pvt.Ltd. Vs. DCIT (2017) 85 taxmann.com 124 (Bangalore).

18. As far as Ground No.8 to 10 on Corporate tax issues raised by the revenue in its appeal are concerned, it is not in dispute that the Assessee was entitled to claim deduction u/s.10A of the Act on the profits derived from its Software Technology Parks of India (STPI) registered unit. Sec.10A(4) provides the methodology of computation of deduction u/s.10A of the Act and it lays down that the profits derived from export of articles or things or computer software shall be the amount which bears to the profits of the business of the undertaking, the same proportion as the export turnover in respect of such articles or things or computer software bears to the total turnover of the business carried on by the undertaking. Export turnover has been defined under Explanation 2 (iv) to Sec.10A as:-

"export turnover" means the consideration in respect of export by the undertaking of articles or things or computer software received in, or brought into, India by the assessee in convertible foreign exchange in

accordance with sub-section (3), but does not include freight, telecommunication charges or insurance attributable to the delivery of the articles or things or computer software outside India or expenses, if any, incurred in foreign exchange in providing the technical services outside India.”

19. While computing the deduction u/s.10A of the Act, the AO noticed that during the relevant assessment year, the Assessee had incurred travel expenses as well as communication expenses in respect of STPI unit which was not reduced from the export turnover while computing deduction under section 10A of the Income Tax Act, 1961. The AO therefore excluded the aforesaid sum from the export turnover without excluding them from the total turnover. As a result, the deduction claimed u/s.10A of the Act by the Assessee was allowed at a lesser sum than what was claimed by the Assessee. It was the plea of the Assessee in the appeal against the assessment order before the CIT(A) that at all times during the relevant previous year, it was engaged in development of computer software and not in rendering any technical services. Communication expenses were incurred not for export of computer software outside India and therefore the exclusion from export turnover as done by the AO was not correct. Without prejudice to its contention that the aforesaid sums should not be excluded from the export turnover while computing deduction u/s.10A of the Act, the Assessee has also made an alternate prayer that expenses that are reduced from the export turnover should also be reduced from the total turnover and in this regard has placed reliance on the decision of the Hon'ble Karnataka High Court in the case of *CIT v. Tata Elxsi Ltd [2012] 349 ITR 98 (Karn)* wherein it was held that while computing deduction u/s.10A of the Act expenses that are reduced from the export turnover should also be reduced from the total turnover. The CIT(A) however upheld the alternative prayer of the Assessee.

20. Aggrieved by the order of CIT(A), the Revenue has raised Gr.No.8 & 9 before the Tribunal.

21. We have considered the rival submissions. Taking into consideration the decision rendered by the Hon'ble High Court of Karnataka in the case of *CIT v. Tata Elxsi Ltd [2012] 349 ITR 98 (Karn)*, we are of the view that the CIT(A) was justified in excluding expenses both from export turnover and total turnover. We are of the view that as of today, law declared by the Hon'ble High Court of Karnataka which is the jurisdictional High Court is binding on us. Moreover, the order of the Hon'ble Karnataka High Court has been upheld by the Hon'ble Supreme Court in the case of *CIT v. HCL Technologies Ltd. in Civil Appeal No.8489-98490 of 2013 & Ors. dated 24.04.2018.* The grounds are decided accordingly.

22. In the result, the revenue's appeal is partly allowed to the extent of its prayer for inclusion of R.S.Software Pvt.Ltd., as a comparable company and in all other respects grounds raised by the Revenue are dismissed.

23. As far as the Cross Objection of the Assessee is concerned, the limited prayer of the learned counsel for the Assessee was to adjudicate the grounds with regard to exclusion of two of the comparable companies retained by the DRP viz., Persistent Systems Ltd., and Sasken Communication Technologies Ltd.

24. As far as exclusion of Persistent Systems Ltd., is concerned, the learned counsel for the Assessee brought to our notice a decision of the ITAT Bangalore Bench in the case of *Electronics for Imaging India (P) Ltd. Vs. DCIT (2017) 85 taxmann.com 124 (Bangalore-Tribunal)* rendered in the case of an Assessee rendering SWD services such as the Assessee, wherein comparability of this company with a SWD service provider was considered and this tribunal held paragraph 9.2.4 of its order held that this company is a SWD service as well as Software Product company and the segmental details of the various segments are not available. As far as exclusion of Sasken Communication Technologies Ltd., is concerned, in the very same decision in

the case of Electronics for Imaging India (P) Ltd., (supra), this company was held to be not comparable as it had revenues both from software products and SWD services and segmental details were not available. In view of the aforesaid decisions, we direct that the aforesaid two companies be excluded from the list of comparable companies. No other grounds in the CO were pressed for adjudication.

25. The TPO is directed to compute the ALP in the light of the directions given in this order after affording opportunity of being heard to the Assessee.

26. In the result, appeal of the revenue is partly allowed while the Cross-Objection of the Assessee is also partly allowed.

Order pronounced in the open court on 19<sup>th</sup> Feb.2020.

**Sd/-**  
**(B.R.BASKARAN)**  
**ACCOUNTANT MEMBER**  
Bangalore  
Dated : 19 /2/2020

**Sd/-**  
**(N.V VASUDEVAN)**  
**VICE-PRESIDENT**

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Copy to :

1. The Assessee
2. The Revenue
3. The CIT concerned.
4. The CIT(A) concerned.
5. DR
6. GF

By order

Asst. Registrar