

IN THE INCOME TAX APPELLATE TRIBUNAL
“B” BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENT
AND SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER

IT(TP)A No.2657 /Bang/2018 & IT(TP)A No.2365/Bang/2019 Assessment years : 2014-15 & 2015-16
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M/s Yahoo Software Development India Pvt. Ltd. Torrey Pines, Embassy Golf Links Business Park, Off Indira Nagar - Koramangala Intermediate Ring Road, Bengaluru – 560071. PAN: AAACY 1876D	Vs.	The Joint Commissioner of Income Tax, Special Range - 7, Bengaluru. The Deputy Commissioner of Income Tax, Circle 7(1)(2), Bengaluru.
APPELLANT		RESPONDENT

Appellant by	:	Shri, Sriram Seshadri, CA
Respondent by	:	Shri, CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	24.02.2020
Date of Pronouncement	:	28.02.2020

ORDER

Per N.V. Vasudevan, Vice President

IT(TP)A No.2657/Bang/2018

This appeal by the assessee is against the final order of assessment dated 25.7.2018 of the DCIT, Circle 7(1)(2), Bengaluru passed u/s. 143(3) r.w.s. 144C of the Income-tax Act, 1961 [the Act] relating to assessment year 2014-15.

2. The only issue that arises for consideration in this appeal is with regard to determination of ALP in respect of an international transaction of rendering software development services [SWD services] by the assessee to its Associated Enterprise (AE) under the provisions of section 92 of the Act.

3. The assessee is a company engaged in the business of software design, development, testing, support and implementation of computer software. The assessee is a wholly owned subsidiary of Yahoo (non-resident). During the previous year, the assessee provided SWD services to Yahoo for which it received a payment of Rs.867,17,41,441. Since the aforesaid transaction was an international transaction, the income arising from such international transaction has to be determined in accordance with the provisions of section 92 of the Act. To justify the price received in the international transaction as one at arm's length, the assessee filed a Transfer Pricing (TP) analysis adopting the Transactional Net Margin Method (TNMM) as the most appropriate method for determining the arm's length price (ALP). The Profit Level Indicator (PLI) chosen for the purpose of comparing the assessee's profit margin with the comparable companies profit margin was Operating Profit to Operating Cost (OP/OC). The OP/OC of the assessee was arrived at in the TP analysis as follows:-

Particulars	Amount (Rs)
Income from provision of services	8671741441
Add: Exchange gain (Net)	86765355
Operating revenue	8758506796
TOTAL EXPENSES (as per P&L)	7322770620
Less: Provision for doubtful advances	6751270
Less: Provision for loss on fixed assets held for sale	5244587
Less: Donations	7271536
Operating Expenses	7303503227
Operating Profit	1455003569
OP/OC	19.92%

4. The assessee chose 7 comparable companies and the arithmetic average profit margin of those 7 companies was arrived at 11.41%. Since the profit margin of assessee was much higher than the profit margin of the comparable companies, the assessee claimed that the price received in the international transaction has to be regarded as at arm's length.

5. The Transfer Pricing Officer (TPO) to whom the question of determination of ALP was referred by the AO as required u/s.92CA of the Act, however, rejected all the 7 comparables chosen by the assessee and he chose a set of 8 comparable companies. The average arithmetic profit margin of 8 companies chosen by the TPO was as follows:-

S NO	NAME OF TAX PAYER	Amounts in Rs. Lakh			OP/OC (in %)
		OR/ SALES	OC	OP	
1	Infosys Ltd.	46,91,700	32,77,700	11,84,200	36.13%
2	Larsen & Toubro Infotech Ltd.	4,54,360	3,64,619	89,741	24.61%
3	Mindtree Ltd.	2,99,010	2,48,290	5,072	20.43%
4	Persistent Systems Ltd.	1,18,412	87,649	3,07,625	35.10%
5	R S Software (India) Ltd.	35,188	28,321	6,867	24.25%
6	Cigniti Technologies Ltd.	5,563	4,359	1,204	27.62%
7	5 Q S India B F S I Ltd.	20,061	16,394	3,667	22.37%
8	Thirdware Solution Ltd.	19,883	13,742	6,140	44.68%
	Average				29.40%

6. The assessee had computed working capital adjustment and had given a detailed working in this regard. Before the AO the said details in this regard are at pages 186 to 223 of assessee's PB. The TPO, however, did not allow working capital adjustment as worked out by the assessee in its reply. The TPO did not allow working capital adjustment for the reason that the assessee failed to demonstrate the impact of difference in working

capital on its profit as well as the comparables profit. The TPO was also of the view that some of the companies chosen for the purpose of comparison were engaged in multiple business segments and segmental working capital is not disclosed in the annual report. He also held that cost of working capital is different for different companies, depending upon the source of funds and credit standing of the borrower and therefore assumption of prime lending rate as interest rate applicable for making the working capital adjustment would suffer from risks of inaccuracy.

7. The TPO ultimately computed the ALP and consequent addition to the total income of assessee as follows:-

15.4. Computation of Arm's Length Price:

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

SWD

Arm's Length Mean Margin on cost	29.40%
Operating Cost (OC)	7303503227
Arm's Length Price(ALP) of the OR (@ 129.40% of OC)	94507,33,176
Operating revenue (OR)	8758506796
Variation in Price	6:922,26,380
3% of price received	2627,55,204
Shortfall being adjustment	6922,26,380

15.4.2 The above shortfall of Rs. 6922,26,380/- is proposed as transfer pricing adjustment u/s 92CA in respect of software development segment of the taxpayer's international transactions. No adverse inference is drawn for other transactions reported by the taxpayer based on the submissions made by the taxpayer before the TPO and material available on record.

8. Aggrieved by the aforesaid order of the TPO which was incorporated in the draft assessment order by the AO, the assessee filed objections before the Dispute Resolution Panel (DRP). The DRP retained all the comparables chosen by the TPO and further directed 3 comparables chosen by the assessee to be included in the final list of comparable companies viz., CG Vak Software & Exports Ltd., E-Zest Solutions Ltd. & Daffodils Software Ltd. The DRP upheld the order of TPO regarding non-grant of working capital adjustment. Consequent to the order of DRP, the arithmetic average mean of the comparable companies stood at 24.46% and still the price was not at arm's length and the addition made in the draft assessment order stood reduced from 69,22,26,380 to Rs.35,26,13,483 in the final assessment order against which the Assessee has filed the present appeal. The assessee is aggrieved by the aforesaid addition which was retained in the final order of assessment and hence has preferred the present appeal before the Tribunal.

9. We have heard the rival submissions. At the time of hearing, it is noticed that if 3 out of 11 comparable companies that remain after the order of DRP are adjudicated and excluded then that would mean that the profit margin of the Assessee with the remaining comparable companies would be at Arm's length and hence there would be no necessity to adjudicate on the choice of comparable companies. The 3 companies whose exclusion from the list of comparable companies was argued before us are (1) Thirdware Solutions Ltd., (2) Infosys Ltd. & (3) Persistent Systems Ltd.

10. As far as exclusion of aforesaid 3 companies from the list of comparable companies is concerned, the Id. counsel for the assessee brought to our notice the decision of ITAT Hyderabad Bench in the case of *Kony IT Services P. Ltd. V. DCIT, ITA No.2304/Hyd/2018 for AY 2014-15, order dated 20.11.2019*. In the aforesaid decision was rendered in the

case of assessee engaged in software development services, exclusion of the aforesaid 3 companies came up for consideration and the Tribunal held as follows:-

“(ii) Thirdware Solutions Limited:

(a) As argued by the Ld. AR it is evident from the Annual Report (page No.235 of PB-II) that the company has derived revenue from sale of products amounting to Rs. 206.75 Crs. Further, there is no revenue from sale of services during the previous year. The assessee has also purchased stock amounting to Rs. 40.21 Crs. While as the assessee company is not engaged into any activity of producing physical goods.

page No.235 of PB-II

Unless otherwise specified, all monetary values are in Lakhs of INR.

	01/04/2013 to 31/03/2014	01/04/2012 to 31/03/2013
Statement of profit and loss [Abstract]		
Disclosure of revenue from operations [Abstract]		
Disclosure of revenue from operations for other than finance company [Abstract]		
Revenue from sale of products	20,675.74	14,225.84
Revenue from sale of services	0	0
Total revenue from operations other than finance company	20,675.74	14,225.84
Total revenue from operations	20,675.74	14,225.84
Other income	225.24	322.44
Total revenue	20,900.98	14,548.28
Expenses [Abstract]		
Cost of materials consumed	0	0
Purchases of stock-in-trade	4,021.19	2,482.34
Changes in inventories of finished goods, work-in-progress and stock-in-trade	0	0
Employee benefit expense	8,549.31	6,905.07
Finance costs	14.64	0.12
Depreciation, depletion and amortisation expense [Abstract]		
Depreciation expense	268.65	236.91
Total depreciation, depletion and amortisation expense	268.65	236.91
Other expenses	903.42	1,100.44
Total expenses	13,757.21	10,724.93

(b) It is also apparent that the company is receiving revenue from various streams and none of them were pertaining to software development services. As apparent from page 237 of PB-II, the company has received Revenue from training and subscription amounting to Rs. 59.32 lakhs and sale of licenses Rs. 7.98 lakhs. The assessee company is only engaged in ITES.

Extraction from page no.237 of PB-II:

Footnotes

(A) Export of Software Services : 20194.37 Software Services from local unit : 414.07 Revenue from Subscription & Training : 59.32
Sale of Licence : 7.98

(B) Export of Software Services : 13532.8 Software Services from local unit : 465.97 Revenue from Subscription & Training : 112.89
Sale of Licence : 114.18

(c) It is also apparent from page no. 217 of PB-II that the company has not disclosed segmental details between software development services and products. The relevant portion is extracted hereinbelow for reference:-

“34) Segment Reporting The company’s cooperation comprises of software development, implementation and support services.

Primary segmental reporting is based on geographical areas viz., Domestic = India (Products & Services) and International = Rest of the world (Exports-software services).

In primary segment, revenue and all expenses, which relates to a particular geographical segment, are reported. Fixed Assets, Current Assets, Loans and Advances, Current Liabilities and provisions are classified based on specific geographical segment’s business. The company maintains separate books of account for the reported segments.

Wherever the costs are directly identifiable with the reported segment, it has been booked to that segment. Wherever common expenses are incurred, those expenses

have already been considered for allocation and relevant entries in the books of account have been passed. Hence there are no un-allocable expenses.

Further, cash, investment (net of provision) and bank balances are reported at the enterprise level. Current assets and current liabilities relating to the specific business segments are identified and reported. Those, which are not identifiable, are reported as common assets / liabilities.”

(d) As disclosed in the annual account it is also apparent that the company has acquired intangibles during the year. Relevant portion of page 210 of PB-II is extracted hereinbelow for reference:-

“d) Intangible Assets and Amortization

Acquired intangible assets relating to software purchased for company’s internal use are capitalised at the cost of acquisition and is amortised on the straight line method over its estimated useful life of three years, as perceived by the management or useful life of asset as per contract whichever is earlier.

Depreciation on intangible assets is calculated on pro-rata basis with reference to date of addition over its useful life of three years, as perceived by the management or useful life of asset as per contract, whichever is earlier.

The intangible assets acquired by the respective units of Thirdware Solution Limited are used in relation to the operation / services by the respective units only.

Intangible assets internally developed by the company are capitalised at the total cost attributable towards the development of the product and is amortised on the straight-line method over its estimated useful life of three years, as perceived by the management.”

10.1. In the case of the assessee company neither such expenses are incurred, or any intangibles are acquired during the relevant period. 11. Since the assessee company is primarily engaged in custom-built mobile applications and software support and maintenance related services to M/s. Kony Group of Companies,

we are of the considered view that M/s. Third-ware Solutions Limited cannot be considered as a comparable company because of the reasons stated hereinabove.”

11. The Id. DR submitted that the functional profile of the assessee in the present case and that of the case decided by the ITAT Hyderabad Bench in the case of *Kony IT Services P. Ltd. (supra)* are different. In this regard, it was submitted that the in the decision rendered in the aforesaid case, there is a reference to assessee in that case being engaged in software development services, whereas in the TPO's order in the case of assessee in this appeal, services provided are different.

12. We have considered the rival submissions and are of the view that description of services as mentioned in the TPO's order in the case of assessee in this appeal is akin to software development services and it cannot be said that the functional profile of assessee in this case and that of assessee in the case of *Kony IT Services P. Ltd. (supra)* are different. Moreover, the choice of comparables in both the cases by the TPO is identical, which by itself would show that the functional profile of the Assessee and that of the Assessee in the case of *Kony IT Services Pvt. Ltd. (supra)* are identical. We find that the ITAT Hyderabad has clearly brought out in its order that the functional profile of the assessee in this appeal and comparable companies viz., Thirdware Solutions Ltd., Infosys Ltd. & Persistent Systems Ltd. are different inasmuch as the common difference is being that these companies are not pure software development services, but are also engaged in product development and the segmental profits of the software development services segment is not available. Besides the above, company like Infosys Ltd. owns Intellectual Property Rights (IPRs), besides having big brand value and the company like Persistent Systems Ltd. also own significant intangibles, besides owning IPRs and deriving income from such IPRs. We are therefore of the

view that the aforesaid 3 comparable companies should be excluded from the list of comparable companies. We hold and direct accordingly.

13. The only other issue which was argued before us was action of the revenue authorities in not providing working capital adjustment to the profit margin of the comparable companies and that of the assessee. In this regard, as we have already seen, the primary reason assigned by the TPO which was endorsed by the DRP is that the assessee has not demonstrated the impact of working capital adjustment on the profit margin of the assessee as well as comparable company.

14. We have heard the rival submissions. The relevant provisions of the Act in so far as comparability of international transaction with a transaction of similar nature entered into between unrelated parties, provides as follows:

Determination of arm's length price under section 92C .

10B . (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction [*or a specified domestic transaction*] shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—

(a) to (d).....

(e) transactional net margin method, by which,—

- (i) the net profit margin realised by the enterprise from an international transaction [*or a specified domestic transaction*] entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;
- (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

- (iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction [*or the specified domestic transaction*] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
- (iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
- (v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction [*or the specified domestic transaction*];

(f).....

(2) For the purposes of sub-rule (1), the comparability of an international transaction [*or a specified domestic transaction*] with an uncontrolled transaction shall be judged with reference to the following, namely:—

- (a) the specific characteristics of the property transferred or services provided in either transaction;
- (b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
- (c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;
- (d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government

orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction [*or a specified domestic transaction*] if—

- (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.

15. A reading of Rule 10B(1)(e)(iii) of the Rules read with Sec.92CA of the Act, would clearly shows that the net profit margin arising in comparable uncontrolled transactions has to be adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, which could materially affect the amount of net profit margin in the open market.

16. Chapters I and III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter the “TPG”) contain extensive guidance on comparability analyses for transfer pricing purposes. Guidance on comparability adjustments is found in paragraphs 3.47-3.54 and in the Annex to Chapter III of the TPG. A revised version of this guidance was approved by the Council of the OECD on 22 July 2010. In paragraph 2 of these guidelines it has been explained as to what is comparability adjustment. The guideline explains that when applying the arm’s length principle, the conditions of a controlled transaction (i.e. a transaction between a taxpayer and an associated enterprise) are generally

compared to the conditions of comparable uncontrolled transactions. In this context, to be comparable means that:

- None of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or
- Reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called “comparability adjustments.

17. In Paragraphs 13 to 16 of the aforesaid OECD guidelines, need for working capital adjustment has been explained as follows:-

“13. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.

14. The opposite applies to higher levels of accounts payable. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.

15. A company with high levels of inventory would similarly need to either borrow to fund the purchase, or reduce the amount of cash surplus which it is able to invest. Note that the interest rate July 2010 Page 6 might be affected by the funding structure

(e.g. where the purchase of inventory is partly funded by equity)
or by the risk associated with holding specific types of inventory)

16. Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables, with an assumption that the difference should be reflected in profits. The underlying reasoning is that:

- A company will need funding to cover the time gap between the time it invests money (i.e. pays money to supplier) and the time it collects the investment (i.e. collects money from customers)
- This time gap is calculated as: the period needed to sell inventories to customers + (plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.”

18. Examples of how to work out adjustment on account of working capital adjustment is also given in the said guidelines. The guideline also expresses the difficulty in making working capital adjustment by concluding that the following factors have to be kept in mind (i) The point in time at which the Receivables, Inventory and Payables should be compared between the tested party and the comparables, whether it should be the figures of receivables, inventory and payable at the year end or beginning of the year or average of these figures. (ii) the selection of the appropriate interest rate (or rates) to use. The rate (or rates) should generally be determined by reference to the rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. The guidelines conclude by observing that the purpose of working capital adjustments is to improve the reliability of the comparables.

19. In the present case the TPO held that no adjustment should be made to the profit margins on account of working capital differences

between the tested party and the comparable companies for the following reasons:-

- (i) The daily working capital levels of the tested party and the comparables was the only reliable basis of determining adjustment to be made on account of working capital because that would be on the basis of working capital deployed throughout the year.
- (ii) Segmental working capital is not disclosed in the annual reports of companies engaged in different segments and therefore proper comparison cannot be made.
- (iii) Disclose in the balance sheet does not contain break up of trade and non-trade debtors and creditors and therefore working capital adjustment done without such break up would result in computation being skewed.
- (iv) Cost of capital would be different for different companies and therefore working capital adjustment made disregarding this different based on broad approximations, estimations and assumptions may not lead to reliable results.

20. The TPO also placed reliance on a decision of Chennai ITAT in the case of *Mobis India ITA No.2112/Mds/2011 (2013) 38 taxmann.com*. That decision was based on the factual aspect that the Assessee was not able to demonstrate how working capital adjustment was arrived at by the Assessee. Therefore, nothing turns on the decision relied upon by the CIT(A) in the impugned order. In the matter of determination of Arm's Length Price, it cannot be said that the burden is on the Assessee or the Department to show what is the Arm's Length Price. The data available with the Assessee and the Department would be the starting point and depending on the facts and circumstances of a case further details can be called for. As far as the Assessee is concerned, the facts and figures with

regard to his business has to be furnished. Regarding comparable companies, one has to fall back upon only on the information available in the public domain. If that information is insufficient, it is beyond the power of the Assessee to produce the correct information about the comparable companies. The Revenue has on the other hand powers to compel production of the required details from the comparable companies. If that power is not exercised to find out the truth then it is no defense to say that the Assessee has not furnished the required details and on that score deny adjustment on account of working capital differences. Regarding applying the daily balances of inventory, receivables and payables for computing working capital adjustment, the Delhi Bench of ITAT in the case of *ITO Vs. E Value Serve.com (2016) 75 taxmann.com 195 (Del-Trib)* has held that insisting on daily balances of working capital requirements to compute working capital adjustment is not proper as it will be impossible to carry out such exercise and that working capital adjustment has to be based on the opening and closing working capital deployed. The Bench has also observed that that in Transfer Pricing Analysis there is always an element of estimation because it is not an exact science. One has to see that reasonable adjustment is being made so as to bring both comparable and tested party on same footing. Therefore there is little merit in TPO/DRP's objection on working adjustment based on unavailable daily working capital requirements data. There is also no merit in the objection of the TPO/DRP regarding absence of segmental details available of working capital requirements of comparable companies chosen and absence of details of trade and non-trade debtors of comparable companies as these details are beyond the power of the Assessee to obtain, unless these details are available in public domain. Regarding absence of cost of working capital funds, the OECD guidelines clearly advocates adopting rate(s) of interest applicable to a commercial enterprise operating in the same market as the

tested party. Therefore this objection of the TPO/DRP is also not sustainable.

21. In the light of the above discussion, we are of the view that the revenue authorities were not justified in denying adjustment on account of working capital adjustment. We may also add that the complete working capital adjustment working has been given by the Assessee and a copy of the same is at page 186 to 200 of the Assessee's paper book. No defect whatsoever has been pointed out in these working by the CIT(A). We may also further add that in terms of Rule 10B(1)(e) (iii) of the Rules, **the net profit margin arising in comparable uncontrolled transactions should be adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions which could materially affect the amount of net profit margin in the open market.** It is not the case of the TPO/DRP that differences in working capital requirements of the international transaction and the uncontrolled comparable transactions is not a difference which will materially affect the amount of net profit margin in the open market. If for reasons given by the revenue authorities working capital adjustment cannot be allowed to the profit margins, then the comparable uncontrolled transactions chosen for the purpose of comparison will have to be treated as not comparable in terms of Rule 10B(3) of the Rules, which provides as follows:-

“(3) An uncontrolled transaction shall be comparable to an international transaction if—

- (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged to 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.”

22. In such a scenario there would remain no comparable uncontrolled transactions for the purpose of comparison. The transfer pricing exercise would therefore fail. Therefore in keeping with the OECD guidelines, endeavor should be made to bring in comparable companies for the purpose of broad comparison. Therefore the working capital adjustment as claimed should be allowed. We hold and direct accordingly.

23. As we have already observed, the assessee in the present case has given all the details required for working capital adjustment and the revenue authorities were not justified in denying the claim of assessee for deduction. The TPO/AO is directed to allow working capital adjustment in the light of the material already available on record, after affording opportunity of being heard to the assessee.

24. The TPO/AO is directed to compute the ALP in the light of directions as given above, after affording opportunity of being heard to the assessee.

25. In the result, the appeal of the assessee is treated as partly allowed.

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26. This appeal by the assessee is against the final order of assessment dated 27.9.2019 of the Jt. CIT, Special Range 7, Bangalore passed u/s. 143(3) r.w.s. 144C of the Act relating to assessment year 2015-16.

27. As far as the international transaction and other details are concerned, the facts are similar to AY 2014-15. In AY 2015-16, the assessee filed a TP analysis choosing 12 comparable companies whose

average profit margin was 11.82%. The assessee's profit margin was 19.23% computed in the following manner:-

Particulars	Amount in Lakhs	Amount in Million
Revenue from operations	4,850	
Other income	120	
Operating Revenue		4,730
Total expenses	3,976	
Less: Donation	9	
Operating Cost		3,967
Operating Profit		763
OP/OC		19.23%
OP/OR		16.13%

28. Since the profit margin of the assessee was more than the average profit margin of comparable companies, the assessee claimed that the price received in the international transaction was at arm's length. The TPO accepted 3 out of 12 comparable companies chosen by assessee in its TP study viz., CG Vak Software & Exports Ltd., E-Zest Solutions Ltd. and Tata Elxsi Ltd. as comparable companies. The TPO on his own selected 13 other comparable companies and arrived at a set of 16 comparable companies. The average arithmetic mean profit of the comparable companies was as follows:-

SWD Segment

S.No.	Company Name	Financial Year wise OP/OC (%)			
		2014-15	2013-14	2012-13	Average
1	Kals Information Systems Ltd	5.77	16.94	13.51	11.88
2	E-Zest Solutions Ltd	12.59	15.80	Fails Export Filter	14.05
3	CG-V AK Software & Exports Ltd.	19.87	13.81	22.07	18.50
4	Tata Elxsi Ltd. (Seg)	23.33	22.02	11.24	19.34
5	Rheal Software Pvt. Ltd.	2.76	36.64	No data in Public Domain	19.88
6	Mindtree Ltd.	20.55	21.18	19.75	20.55
7	Larsen & Toubro Infotech Ltd.	24.22	23.54	25.10	24.21

8	R S Software (India) Ltd.	32.66	24.14	17.44	24.82
9	Infobeans Technologies Ltd.	20.70	41.95	29.22	29.91
10	Persistent Systems Ltd.	31.11	35.44	28.20	31.69
11	Nihilent Technologies Ltd.	29.19	35.72	No data in Public Domain	32.21
12	Aspire Systems (India) Pvt. Ltd.	30.98	38.04	No data in Public Domain	34.18
13	Integ Software Pvt. Ltd.	31.16	45.00	Fails Employee cost filter	37.90
14	Infosys Ltd.	40.29	36.28	39.25	38.59
15	Thirdware Solution Ltd.	43.69	44.68	32.65	41.12
16	Cybage Software Pvt. Ltd.	68.17	68.82	60.81	66.27
	35th Percentile				20.55%
	Median				27.37%
	65th Percentile				37.90%

29. The TPO did not allow the working capital adjustment and finally determined the ALP and consequent addition made to the total income as follows:-

22.4. Computation of Arm's Length Price:

22.4.1 The median of the weighted average Profit Level indicators is taken as the arm's length margin. Please see Annexure A& B for details of computation of PLI of the comparable. Based on this, the arm's length price of the services rendered by the taxpayer to its AE(s) is computed as under:

Particulars	Formula	Amount (in Rs. Million)
Taxpayers operating revenue	OR	4,730.00
Taxpayers operating cost	OC	3,967.00
Taxpayers operating profit	OP	763.00
Taxpayers PLI	$PLI = OP/OC$	19.23%
35th Percentile Margin of comparable set		20.55%
Adjustment Required (if PLI < 35th Percentile)		Yes
Median Margin of comparable set	M	27.37%

Arm's Length Price	$ALP=(1+M)*OC$	5,052.77
Price Received	OR	4,730.00
Shortfall being adjustment	ALP-OR	322.7679

22.4.2 The above shortfall of **Rs.322.77 Million** is treated as transfer pricing adjustment u/s 92CA in respect of software development segment of the taxpayer's international transactions.”

30. The addition suggested by the TPO was incorporated by the AO in the draft order of assessment and against such draft order, the assessee preferred objections before the DRP. The DRP excluded Thirdware Solutions from the list of comparable companies and included Sasken Communication Technologies Ltd. and Cigniti Technologies Ltd. The DRP did not grant any working capital adjustment. Consequent to the relief allowed by the DRP as above, the TP adjustment and addition to be made to total income stood reduced from Rs.32,74,23,000 to 19,86,00,800.

31. The assessee, aggrieved, by the determination of ALP as above has filed the present appeal before the Tribunal.

32. At the time of hearing, the Id. counsel for the assessee has prayed for exclusion of 4 comparable companies that remain after the order of the DRP viz., Persistent Systems Ltd., Infosys Ltd., Mindtree Ltd. and L&T Infotech Ltd. He brought to our notice that as far as Persistent Systems Ltd. is concerned, the reasoning given for excluding this company for AY 2014-15 will equally hold good for the present year as well. In this regard, our attention was drawn to page 601 of the assessee's PB wherein in the annual report of this company, Notes forming part of financial statement in Note (i) which gives the description of income from software services, there is a reference to revenue from licensing & software, which sufficiently indicates that the assessee is not a pure SWD services provider. It was

also brought to our notice that the profit & loss account which is at page 596 read with Notes forming part of the financial statement at page 604 wherein the segmental reporting is not based on different segments and the statement presents a consolidated financial statement without any segmental reporting. This company has also significant RPT transaction of 25% on sales. He pointed out that the TPO & DRP on the application of RPT filter has not expressed any opinion. The Id. DR relied on the order of DRP wherein the DRP has made extensive reference to each of the objections regarding absence of segmental revenue in the accounts and has also noticed that the software products segment had an insignificant revenue and that the ownership of intangibles by the assessee has had no effect whatsoever.

33. We have considered the rival submissions. We find that on the question of application of RPT filter, the assessee had made the following submission before the DRP:-

4. Fails the Related Party Transaction to Sales filter applied by the learned TPO

In the show-cause notice issued, the learned TPO has excluded companies for which the ratio of RPT to sales exceeds 25% during the current year i.e., during FY 2014-15. The relevant extract from the show-cause notice is reproduced below for ease of reference:

e) Companies who have more than 25% related party transactions of the sales were excluded.

Companies having related party transactions of more than 25% are proposed to be excluded. A threshold of 25% is being applied following the provisions of Section 92A(2)(a) which provides a limit of 26% of the equity capital carrying voting rights for treating an enterprise as Associated Enterprise. If the limit is reduced further it would only result in eliminating more and more companies, on the other hand if the limit is relaxed then

companies with predominantly related party transactions would get included which would not represent uncontrolled transactions. Therefore, on a balancing note, 25% is a proper threshold limit for related party transactions. The companies having more than 25% related party transactions should therefore be rejected as comparables.

The Hon'ble IT.AT has upheld the application of this filter by the TPO in its order in the case of M/s. Supporisoft India Pvt. Ltd for AY 2005-G6 in IT (TP)A 1372/B/11 & 20/2012 dated 28.03.2013 following its own decision in the case of M/s. Actis Advertisers Pvt. Ltd vide ITA No.5277/De1/2011 dated 12.10.2012.

On perusal of the Annual Report of Persistent, we observe that the company has RPT in excess of 25% of the sales. The calculation of the same has been provided below for your ease of reference:

RPT to Sales ratio for FY 2014-15	Amount
Particulars	(INR Million)
Sale of services	2,410.02
Commission received	10.26
Purchase of software	1.49
Cost of technical professional	1,339.1
Commission paid on sales	111.79
Traveling and conveyance	19.27
Total related party transactions (A)	3,891.93
Total Sales (B)	12,424.98
RPT % of Sales (A/B)	31.32%

From the above computation, it is clear that the **controlled transactions of Persistent constitutes 31.32% of sales**. Based on the above, it can be seen that Persistent fails the 'RPT to sales ratio' filter applied by the learned TPO and should therefore not be considered as a comparable."

34. This argument has been addressed by the DRP in its order as follows:-

“4.4.9 We note that the approach of the TPO in treatment of related party transaction into two sets, are for revenue transactions and other for expense transaction is logical and correct. We also note that the RPT filter was adopted by the TPO was with the above conditions and has adopted consistently. Hence, we do not find any infirmity the approach. Hence, we reject the assessee's plea. We hold that onsite expenses do not adversely affect comparability and hence, such plea is rejected.”

35. Further, the assessee had also raised plea with regard to onsite revenue filter by pointing out that onsite revenue is substantial and therefore this company should not be regarded as a comparable company with a company which does not have any onsite revenue. In this regard, the ld. counsel for the assessee placed reliance on the decision of the ITAT Bangalore Bench in the case of *Trilogy e-business Software India P. Ltd. v. DCIT, ITA No.1054/Bang/2011* for AY 2007-08 dated 23.11.2012 wherein this Tribunal took the following view:-

“64. The next objection of the Assessee is that when the most appropriate method selected for determining ALP is the TNMM there is no reason as to why one should look at price difference in offshore software development and onsite software development. It is no doubt true that in TNMM it is only the margins in an uncontrolled transaction that is tested with reference to the controlled transaction but it is not possible to ignore the fact that pricing will have an effect on the margins obtained in a transaction. The argument that if pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects cannot be accepted because the TPO has not chosen any other onsite software service provider with a revenue composition of more than 75% from onsite software services as comparable. As rightly observed by the TPO, the pricing is different in onsite when compared to offshore operations. The further observations of the TPO that the reasons for the same lie in the fact that while in the case of OFFSHORE projects most of the costs are incurred in India; an ONSITE project has to be carried out abroad significantly increasing the employee cost and other costs.

65. The next objection of the Assessee is with regard to Assets employed. The companies, which predominantly generate revenues from onsite activity, do not have significant assets as most of the work is carried on the site of customer outside India. The argument that the TPO has himself observed that software service providers do not require much assets cannot be basis to accept the Assessee's plea. Those observations are made by the TPO in the context of application of turnover filter and have been quoted out of context by the Assessee.

66. The next argument of the Assessee is that TPO has held that margins are lower in onsite software services and that margin is not a criteria to select or reject a comparable under Rule I0B(2) of the I.T. Rules. We are of the view that this argument again ignores the fact that the approach of the TPO has been to highlight the fact that there can be no functional comparability, if the assets employed and risks assumed are taken into consideration. It is in that context the TPO has referred to the margins.

67. The companies who generate more than 75% of the export revenues from onsite operations outside India are effectively companies working outside India having their own geographical markets, cost of labour etc., and also return commensurate with the economic conditions in those countries. Thus assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the taxpayer. Since, the entire operations of the tax payer are taking place offshore i.e. in India; it is but natural that it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model. As already stated the Assessee has limited its analysis only to functions but not to the assets, risks as well as prevailing market conditions in which both the buyer and seller of services located. Hence, the companies in which more than 75% of their export revenues come from onsite operations are to be excluded from the comparability study as they are not functioning in similar economic circumstances to that of the tax payer. Hence, it is held that this filter is appropriately applied by the TPO.

68. Admittedly the onsite revenue in the case of the following comparable companies identified by the Assessee was more than 75% of its export revenues viz., a) Visu International Ltd. b) Maars Software International Ltd. c) Akshay Software Technologies Ltd. d) VJIL Consulting Ltd. e) Synfosys Business Solutions Ltd. The above companies were therefore rightly not considered as comparable by the TPO. We hold accordingly.”

36. It is seen that the TPO in coming to the conclusion that the onsite revenue filter is not applicable has placed reliance on the decision of the ITAT Mumbai Bench in the case of *Capegemini* as quoted in para 16 in para 14 of the TPO's order, but that decision does not deal with a case of onsite revenue filter and the decision was rendered on the facts of its own case.

37. On the issue of RPT filter, we notice that the TPO in para 16 has accepted that the RPT filter should be @ 25%. In the case of Persistent Systems Ltd., the RPT is at 31.32% as extracted in the earlier part of this order and therefore this company should be excluded by application of RPT filter. In view of the above, we do not wish to go into other grounds on which this company is sought to be excluded viz., that it is a product company and there is no segmental data between product and services segment, presence of onsite activity and the impact of extra-ordinary event of acquisition during the relevant previous year. Therefore, this company is directed to be excluded from the list of comparable company.

38. As far as L&T Infotech Ltd. is concerned, the Id. counsel for the assessee brought to our notice the decision of ITAT Delhi Bench in the case of *Saxo India Pvt. Ltd. v. ACIT, ITA No.6148/Del/2015 for AY 2011-12, order dated 5.2.2016*, wherein the Tribunal took note of the fact that this company was also trading in software and owned insignificant intangible assets. The company was excluded from the list of comparable companies with reference to SWD services provider such as the assessee. The Id.

Counsel pointed out that though this decision was rendered with reference to AY 2011-12, the same reasoning would apply to AY 2015-16 also and in this regard, he drew our attention to page 696 of assessee's PB, which gives the details of the revenue generated by this company without any segmental break-up. Our attention was also drawn to page 682 of PB which shows that there is substantial onsite revenue activity as well as cost incurred on onsite software development. We notice from page 676 of assessee's PB that this company as part of its operating profit in Schedule-O of profit & loss account contains expenditure for 'cost of bought out items for resale' and this is a significant part of the operating expenditure. When we see the revenue in Schedule M of the profit & loss account, there is no break-up of the revenue with regard to software services and software product. In our opinion, this distinction is enough to exclude this company from the list of comparable companies as held by the Hon'ble Delhi ITAT in the case of *Saxo India Pvt. Ltd. (supra)* which decision was also confirmed by the Hon'ble Delhi High Court.

39. The next company which the assessee seeks to exclude is Infosys Ltd. As far as this company is concerned, it is seen that the following are the functional dissimilarities brought to our notice:-

“Functionally dissimilar - owns intellectual properties, incurs significant R&D costs & onsite activity.

- Engaged in diversified business activities.
- Involved in development of software products in addition to software services.
- Owns intellectual property rights.
- Incurs significant research and development costs.
- Carries out significant activities based on onsite business.

- Owns products such as Finacle, Edge Verve and other product based solutions.

Extra-ordinary event of merger with Infosys Consulting India Ltd.

Segmental profit & loss account not available.

Commands substantial brand value.

40. The DRP, however, has not thought it fit to exclude this company by observing that this company has substantial pre-dominant revenue from software services and the growth was not attributable to any brand value. Presence of onsite activity and the expenses on R&D have all been brushed aside. In our view, the difference pointed out by the Id. counsel for the assessee before us show that this company cannot be compared with that of the assessee basically because of its business model, presence of onsite revenue generation and other reasons cited before us. Besides, the reason that turnover of this company is huge and more than 10 times that of the assessee.

41. The next company sought to be excluded is Mindtree Ltd. The submissions made before us were as follows:-

“Functionally dissimilar, diversified operation, significant R&D spend, ownership of intangibles.

- Also engaged in business of rendering IP-Led revenue, infrastructure management, package implementation, consultancy services, etc. constituting 45% of overall revenue during FY 2014-15.
- Diversified operation i.e. engaged in infrastructure management services, business process management, technology consulting, product engineering and SAP services. Also lacks segmental data.

- Significant research & development activity. By incurring R&D expenses, it was able to deliver IP based video surveillance management, recording and analytic products and solutions. It has filed 4 patents in India and US so far in the area of Video analysis.
- Ownership of intangibles in the form of intangible property.

Significant onsite activity:

- 46% of revenue earned under Onsite model.
- Incurred overseas branch office expenses amounting to INR 1582 crores
- Receives incentives from State of Florida in relation to the development center located overseas.

Lack of segmental data

- Does not maintain segmental information in respect of profitability reported from business activities in the nature of infrastructure management services, technology consulting and SAP services.
- Acquisition of subsidiary – Discoverture Solutions LLC.

42. The DRP while dealing with the aforesaid objections has merely taken the view that the presence of IPR revenue was insignificant and so also expenses of brand value, R&D & intangibles. More importantly, the DRP did not dispute the presence of 46% of revenue from onsite model, but went on to hold that the presence of revenue is not sufficient to exclude a company, when it is otherwise functionally comparable. On this aspect, we have already referred to the decision of the ITAT Bangalore Bench in the case of *Trilogy e-business Software India P. Ltd. (supra)* and in the light of this decision and the admitted factual position regarding presence of onsite revenue over and above the threshold limit of 25% of total revenue,

we are of the view that this company should be excluded from the list of comparable companies. We hold and direct accordingly.

43. The only other issue that was argued before us is non-granting of working capital adjustment. In this regard, the facts are identical and the reasons for non-granting working capital adjustment are also identical. The assessee has given the working capital adjustment calculations and the same are at pages 265 to 291 of the assessee's PB. These details have not been disputed by the AO as well as the DRP. We are of the view that in the light of the decision rendered on an identical issue while dealing with similar objections raised by the assessee in AY 2014-15, the working capital adjustment should be allowed to the assessee after affording opportunity of being heard to the Assessee. We hold and direct accordingly.

44. The AO/TPO is directed to compute the ALP after affording opportunity of being heard to the assessee and as per directions contained in this order.

45. In the result, the appeal by the assessee is partly allowed.

46. Thus, both the appeals are partly allowed.

Pronounced in the open court on this 28th day of February, 2020.

Sd/-

(CHANDRA POOJARI)
ACCOUNTANT MEMBER

Bangalore,
Dated, the 28th February, 2020.

/Desai S Murthy /

Sd/-

(N V VASUDEVAN)
VICE PRESIDENT

Copy to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.
6. Guard file

By order

Assistant Registrar
ITAT, Bangalore