

IN THE INCOME TAX APPELLATE TRIBUNAL
"C" BENCH : BANGALORE

BEFORE SHRI N.V VASUDEVAN, VICE PRESIDNET AND
SHRI B.R BASKARAN, ACCOUNTANT MEMBER

IT(TP)A No.1610/Bang/2017

Assessment year : 2013-14

M/s Essentra (India) Pvt. Ltd., No.3 (old plot Nos.18 and 23) 3 rd Main Road, Peenya Industrial Area, Phase-1, Yeshwanthpur Hobli, Bengaluru-560 058. PAN -	Vs.	The Income-tax Officer, Ward-2(1)(4), Bengaluru.
APPELLANT		RESPONDENT

Assessee by	:	Shri T Suryanarayana, Advocate
Revenue by	:	Shri Pradeep Kumar, CIT (DR)

Date of hearing	:	04.06.2020
Date of Pronouncement	:	05.06.2020

ORDER

Per B.R Baskaran, Accountant Member

The appeal has filed this appeal challenging the asst. order dated 24/5/2017 passed by the AO for asst. year 2013-14 u/s 143 r.w.s 144C(13) of the Act in pursuance of directions given by 1d Dispute Resolution Panel (DRP).

2. Though the assessee has raised many grounds, the 1d AR restricted his arguments with regard to non-granting of "Capacity under utilization adjustment" while determining Arms length price of international transactions.

3. The Id AR submitted that the assessee is engaged in the business of manufacture and sale of self adhesive tear tapes. It is successor of M/s Payne (India) Pvt. Ltd and is a wholly owned subsidiary of M/s Cigarette components Ltd., UK. The ultimate holding company of the group is M/s Filtrona Pic., UK

4. During the year under consideration, the assessee had entered into following transactions.

Particulars	Amount (in Rs.)
Purchase of Raw Materials Packing Materials	165026279/-
Sale of Self-adhesive tear tapes	80723204/-
Payment for Management Support Services	6616106/-
Recovery of Expenses	27592033/-
Issue of Share	43050000/-

The assessee selected TNMM method as most appropriate method for benchmarking the transactions. The same was accepted in respect of all items except Payment for management support services. The operating profit to total cost was taken as “profit level indicator” (PLI).

5. The Id AR submitted that the only dispute between the assessee and the AO/TPO pertains to “under-capacity utilization adjustment” claimed by the assessee in its Profit. He submitted that assessee has operated during the year under consideration at a level of 28.95% installed capacity only and hence un-utilized capacity was 71.05%. Accordingly, while determining its PLI, the assessee

deducted a sum of Rs.2.48 crores as “adjustment towards cost of unutilized capacity”. The assessee substantiated its claim by stating that it had to incur huge fixed expenses irrespective of the capacity utilization, which will badly affect its profitability in the event of under utilization of the capacity. Hence the assessee has allocated a sum of Rs.2.48 cores out of fixed expenses towards “unutilized capacity” and claimed the same as deduction as “adjustment towards under-utilized capacity”. It is pertinent to note that the assessee has presumed that the comparable companies have operated at 100% capacity and accordingly it has computed the amount of adjustment towards unutilized capacity. The Ld A.R fairly admitted that the assessee did not have details of actual capacity utilization of comparable companies, since the same is not available in public domain.

6. The ld AR further submitted that though the adjustment is required to be made in the hands of comparable companies in the normal circumstances, yet the Bangalore Bench of Tribunal, in the case of IKA (India) Pvt. Ltd. Vs. DCIT (2018) 98 Taxmann.com 312, has taken the view that the capacity utilization adjustment could be made in the hands of tested party also.

7. The ld AR submitted that the details relating to capacity utilization of comparable companies are not available in public domain and hence the assessee was constrained to compute the adjustment towards under-utilization of capacity by presuming that the comparable companies are operating at 100% capacity level. The ld AR submitted that the TPO is empowered to collect the

details of capacity utilisation from the comparable companies by issuing notices u/s 133(6) of the Act to them. The ld AR accordingly submitted that the matter may be restored to the file of the TPO to collect the details of capacity utilization of comparable companies so that the capacity under-utilization adjustment can suitably be modified, if the same is not 100% in the case of comparable companies as presumed by the assessee. He submitted that, in the case of IKA (India) Pvt. Ltd (supra), the Tribunal has restored the matter to the file of TPO with similar directions.

8. We heard Ld DR and perused the record. The only issue urged by the assessee relates to non-granting of “capacity under-utilization adjustment” to the assessee while computing PLI. The assessee also sought to avail the above said adjustment to its PLI instead of the PLI of comparable companies. We notice that an identical issue has been examined by the coordinate bench in the case of IKA India Pvt. Ltd., (Supra). For the sake of convenience we extract below relevant observations made in the above case by coordinate bench.

Ground No.7: The learned CIT(A) has erred, in law and in facts, by upholding the action of the AO/TPO in rejecting capacity adjustment to account for differences in capacity utilization of the Appellant vis-à-vis the comparable companies.

21. The assessee in its TP documentation as well as before the TPO and the CIT(A), highlighted the fact that there are significant differences in the capacity utilization between

the assessee vis-à-vis the comparables. It was also brought to the notice of the TPO and the CIT(A) that the assessee was incorporated in FY 2008-09 and FY 2011-12 (i.e., FY relevant to the impugned AY) was just the third year of commercial operation of the assessee during which the installed capacity was under-utilized to a significant extent. The assessee pleaded before the TPO and CIT(A) to provide an adjustment for idle capacity. However, the TPO/CIT(A) did not allow any adjustment to account for the differences in the capacity utilization by the assessee vis-à-vis the comparables while computing profit margin of assessee as well as the comparable companies.

22. We have heard the submissions of the assessee and the Id. DR on the issue raised by the assessee in ground No. 7. We shall first see the statutory provisions relevant to the issue. Rule IOB(l)(e) of the Rules states that adjustments should be made to account for:

"...the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market"

23. Rule 10B(2) of the Rules provides comparability of an international transaction with an uncontrolled transaction needs to be judged with reference to certain specified factors. One such factor is 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.

24. Rule 10B(3) of the Rules provide that:

"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 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."

25. As per Section 92C of the Act, ALP is required to be computed using any of the given six methods and in the manner as is prescribed in Rule 10B of the Rules. Rule 10B in turn states that the most appropriate method would be one which inter alia provides the most reliable measure of ALP, and one of the important factors to be taken into account herein is the ability to make reliable and accurate adjustments.

26. The OECD Guidelines on this aspect is as follows: Para 1.35 of the OECD Guidelines states as follows:

"Where there are differences between the situations being compared that could materially affect the comparison, comparability adjustments must be made, where possible, to improve the reliability of the comparison. Therefore, in no

event can unadjusted industry average returns themselves establish arm's length conditions"

Para 1.36 of the OECD Guidelines states as follows:

".....material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings. Attributes that may be important include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties."

Further. Para 2.74 of the OECD Guidelines while laying down the comparability criteria to be adopted while applying the transaction net margin method states as follows:

".....Thus where the differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the transactional net margin method" (Emphasis supplied)

27. *US transfer pricing Regulations on this aspect is as follows:*

In addition, the US transfer pricing regulations, u/s. 482 of the Internal Revenue Code (hereinafter referred to as 'the US regulations') also support the above. Regulation 1.482-1 (d)(2) of the US regulation states as follows:

"In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this section, a material difference is one that would materially affect the measure of an arm's length result under the method being applied."

28. *The Indian transfer pricing regulations, OECD Guidelines and the US transfer pricing regulations call for an adjustment to be made in case of material differences in the transactions or the enterprises being compared so as to arrive at a more reliable arm's length price! margin. While the Indian transfer pricing regulations refer to the adjustments on uncontrolled transactions, however the same has to be read with Rule 10B(3) of the Rules which clearly emphasizes the necessity and compulsion of undertaking adjustments. Hence in case appropriate*

adjustments cannot be made to the uncontrolled transaction, due to lack of data, then in order to read the provisions of transfer pricing regulations in harmony, the adjustments should be made on the tested party. In the following decisions it has been held that adjustment to the profit margins have to be made on account of underutilization of capacity:

(I) In the case of Mando India Steering Systems (P.) Ltd. v. Asstt. CIT [2014] 45 taxmann.com 160/149 ITD 284 (Chennai Trib) the Tribunal upheld the contention of the taxpayer for making a suitable adjustment on account of idle capacity for the purpose of margin computation. The relevant extract is reproduced as below:

"10. We are of the considered view that under-utilization of production capacity in the initial years is a vital factor which has been ignored by the authorities below while determining the ALP cost. The TPO should have made allowance for the higher overhead expenditure during the initial period of production."

(ii) In the ruling of Dy. CIT v. Panasonic AVC Networks India Co. Ltd. [2014] 45 taxmann.com 420/63 SOT 121 (URO) (Delhi - Trib.) it was held that:-

"5.....Capacity underutilization by enterprises is certainly an important factor affecting net profit margin in the open market because lower capacity utilization results in higher per unit costs, which, in turn, results in lower profits. Of course, the fundamental issue, so far as acceptability of

such adjustments is concerted, is reasonable accuracy embedded in the mechanism for such adjustments, and as long as such an adjustment mechanism can be found, no objection can be taken to the adjustment."

(iii) In the case of Biesse Mfg. Co. Ltd. v. Asstt. CIT 120161 69 taxmann.com 428 (Bang. Trib.) the Tribunal held as follows:

*"10.4.1. We have heard the rival contentions and perused and carefully considered the submissions made and material on record; including the judicial pronouncements cited. The issue for consideration is whether adjustment for under-utilisation of capacity is allowable in the case on hand and if so, the manner of computation thereof and the quantum of adjustment ** ***

10.4.5 In the above cited case of the Mumbai Tribunal i.e. Petro Araldite P. Ltd. (supra), the Tribunal has upheld the principle that adjustment for capacity underutilisation can be grantedFollowing the decision of the ITAT, Mumbai in the case of Petro Araldite P. Ltd. (supra), we hold that any adjustment for capacity underutilisation can be granted

(iv) In the recent case of GE Intelligent Platform (P.) Ltd. (IT(TP)A No. 148fBang/2015 and 164/BangI2015) for AY. 2010-11 was held as follows:

"8now the law is quite settled to the extent that once there is unutilized capacity or men power, such underutilization impacts margin and therefore, the adjustment should be made while computing the ALP

.....If the underutilization is more than average underutilization of the industry then necessary adjustment is required to be made to the margin of computing ALP"

29. Moreover, the above argument of the assessee for grant of capacity utilization adjustment is also supported by the following decision of Bangalore ITAT in the case of Genisys Integrating Systems (India) (P.) Ltd. v. Dy. CIT[2012]120 taxmann.com 7.15/53 SOT 159. Relevant extract of the decision is under:—

"15.2 We agree with this contention of the counsel for the assessee. All the comparables have to be compared on similar standards and the assessee cannot be put in a disadvantageous position, when in the case of other companies adjustments for under utilization of manpower is given. The assessee should also be given adjustment for under utilization of its infrastructure. The AO shall consider this fact also while determining the ALP and make the TP adjustments. With these directions, the appeal of the assessee is disposed of."

30. The reliability and accuracy of adjustments would largely depend on availability of reliable and accurate data. For certain types of adjustments, relevant data for comparables may either not be available in public domain or may not be reliably determinable based on information available in public domain, whereas, it may be possible to make equally reliable and accurate adjustments on the tested party (whose data would generally be easily accessible).

31. In such a scenario, one has to resort to the provisions of Rule IOB(3)(ii) which provides for making "reasonably accurate adjustments" for eliminating any material differences between the two transactions being compared. The purpose or intent of the comparability analysis is to examine as to whether or not, the values stated for the international transactions are at ALP i.e., whether the price charges is comparable to the price charges under an uncontrolled transaction of similar nature. The regulations don't restrict or provide that the adjustments cannot be made on the results of the tested party. Therefore, keeping in mind the aforesaid objective, the net profit margin of the tested party drawn from its financial accounts can be suitably adjusted to facilitate its comparison with other uncontrolled entities/transactions as per sub-clause (i) of rule 10B(1)(e) of the Rules itself. The absence of specific provision in Rule 10B(1)(e)(iii) of the Rules does not impede the adjustment of the profit margin of tested party. The above view has also been upheld in the following decisions:-

Capgemini India Pvt. Ltd. v. Asstt. CIT [2013] 33 taxmann.com 5/120141 147 ITD 330 (Mum. - Tub.)

Demag Cranes & Components (India) (P.) Ltd. v. Dy. CIT [2011] 21 17 taxmann.com 190/49 SOT 610 (Rune)

32. As far as data of comparable companies on capacity utilization being not available in public domain is concerned, it is practically not possible to obtain data on capacity utilization of comparable companies and

consequently compute adjustment on the comparable companies, the operating cost of the tested party is adjusted for capacity utilization adjustment.

33. The assessee has under-utilized capacity during the subject AY and is accordingly factually and legally eligible to an adjustment for the same. Therefore, such a benefit cannot be denied to the assessee only for the reason that the data about comparable companies is not available. Requiring the assessee to produce such a data which is not available in public domain would tantamount to requiring the Appellant to perform an impossible task. The only way to get the data in the current case, would be where the TPO collates the same from the comparable companies by exercising his powers under section 133(6) of the Act. The relevant extracts of the section are as under:—

"(6) require any person, including a banking company or any officer thereof, to furnish information in relation to such points or matters, or to furnish statements of accounts and affairs verified in the manner specified by the Assessing Officer, the Deputy Commissioner (Appeals), the Joint Commissioner or the Commissioner (Appeals), giving information in relation to such points or matters as, in the opinion of the Assessing Officer, the Deputy Commissioner (Appeals), the Joint Commissioner or the Commissioner (Appeals), will be useful for, or relevant to, any enquiry or proceeding under this Act :"

34. In this regard, we find that the Murnbai ITAT in case of M/s Jt. CIT v. Kiara Jewelleiy P. Ltd. 120141 45

taxmann.com 548/120151 152 ITD 891 (Mum. Trib.) has directed the to obtain the exact details of capacity utilization of comparable companies, if not available in public domain. The relevant extract of the aforesaid decision is as under:—

"11. Keeping in view the decision of the Tribunal in the case of Petro Araldite (P) Ltd (supra) laying down the guidelines on the issue of capacity utilization, we consider it appropriate to restore this issue relating to adjustment on account of capacity utilization in the case of assessee company to the file of AO/TPO for deciding the same afresh keeping in view the said guidelines. If the exact details of capacity utilization of the comparable companies are not available in the public domain, the AO/TPO is directed to obtain the same directly from the concerned parties and to decide this issue afresh after giving assessee an opportunity of being heard."

(Emphasis Supplied)

35. Accordingly, we direct the TPO to exercise powers under section 133(6) of the Act to call for information on capacity utilization of the comparable companies such as -

Installed Capacity,

Actual Production in Units,

*Break-up of Fixed Cost and Variable Cost; Segmental/
product wise information, if any.*

36. Post obtaining the information, he is requested to provide the assessee an opportunity by sharing the details

so obtained, and accordingly, grant the adjustment for capacity under-utilized. Ground No.7 is decided accordingly.”

9. We also notice that the decision rendered by coordinate bench in the case of IKA India Ltd.(supra), has been followed by another coordinate bench in the case of M/s Flint Group (India) Pvt. Ltd., (IT(TP)A No.3285/Bang/2018 dated 31/10/2019. Accordingly, following the above said decisions, we hold that the assessee is entitled for deduction from its PLI towards capacity under-utilisation adjustment.

10. However, we have noticed earlier that the assessee has computed the adjustment by presuming that the comparable companies have operated at 100% of capacity. The Ld A.R also accepted that the said adjustment should have been computed by considering the details of actual capacity utilization by comparable companies. Since the said details are not available in public domain, it is imperative to restore this issue to the file of AO/TPO with the direction to collect the relevant details from comparable companies for the year under consideration and accordingly compute the adjustment. We notice that the co-ordinate bench has given certain directions to be followed by the AO/TPO in the case of IKA India Ltd (supra). Accordingly, we set aside the order passed by AO on the impugned issue and restore the same to the file of AO/TPO with similar directions.

11. Since other grounds urged by the assessee were not argued by the Ld A.R, they are not adjudicated as stated earlier.

12. In the result, the appeal filed by the assessee is treated as allowed for statistical purposes.

Order pronounced in the open court on **5th June 2020**.

Sd/-
(N.V Vasudevan)
Vice President

Sd/-
(B.R Baskaran)
Accountant Member

Bangalore,
Dated, 5th June 2020.

/ vms /

Copy to:

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

By order

Asst. Registrar, ITAT, Bangalore

1. Date of Dictation
2. Date on which the typed draft is placed
before the dictating Member
Date on which the approved draft comes to Sr.P.S
.....
3.
4. Date on which the fair order is placed
before the dictating Member
5. Date on which the fair order comes back to the Sr.
P.S.
6. Date of uploading the order on
website.....
7. If not uploaded, furnish the reason for doing so
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11. The date on which the file goes to the Assistant
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12. The date on which the file goes to dispatch section for
dispatch of the Tribunal Order
13. Date of Despatch of Order.
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