IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI'J' BENCH, MUMBAI

[Coram: Pramod Kumar (Vice President)
And Pawan Singh (Judicial Member)

ITA No. 2969/Mum/15
Assessment year: 2009-10

Softdel Systems Pvt Ltd ……………….………**Appellant**
86 Jolly Maker Chambers II
225, Nariman Point, Mumbai 400 021
[PAN: AAECS0576Q]

Vs

Dy Commissioner of Income Tax
Circle 3(3), Mumbai ……………………**Respondent**

Appearances by

Nitesh Joshi *for the appellant*
Uodhavraj Singh *for the respondent*

Date of concluding the hearing: : December 17,2019
Date of pronouncement : March 12, 2020

ORDER

Per Pramod Kumar, VP:

1. This appeal is directed against the learned CIT(A)'s order dated 2nd March 2015 in the matter of assessment under section 143(3) r.w.s 144C of the Income Tax Act, 1961, for the assessment year 2009-10.

2. One of the grievances raised by the assessee appellant, which relates to the arm's length price adjustment being challenged in appeal before us, are as follows:

> **2.1 The learned CIT(A) grossly erred on facts and circumstances in upholding the transfer pricing adjustment of Rs. 1,71,39,344/- on marketing fees paid to its Associated Enterprise ('AE')- SoftDEL USA by disregarding the foreign Associated Enterprise as tested party and instead considering the Appellant as the tested party, thus violating the basic principles of Transfer Pricing (TP) that the last complex entity has to be considered as the tested party.**
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> **2.2 The learned CIT(A) grossly erred in upholding the contention of the Assessing Officer/Transfer Pricing Officer ('Ld. AO/TPO') by stating that the foreign comparables selected by the Appellant are functionally dissimilar and no**

verifiable data was available, without appreciating that the Assessing Officer in AY 2008-09 had accepted the foreign AE as a tested party and the same foreign comparables were selected and accepted by the Assessing Officer.

3. To adjudicate on this issue, only a few material facts need to be taken note of. The assessee before us is 100% Export Oriented Unit (EOU) set up under STPI scheme of the Government of India, and is engaged in the business of providing software development services, through an offshore development centre located at Pune, to its associated enterprise Softdel Systems Inc USA. During the relevant previous year, the assessee had entered into international transactions, aggreating to Rs 8,91,81,569, with this AE. In the course of scrutiny assessment proceedings, the determination of arm's length price of this transaction was referred to the Transfer Pricing Officer. The TPO noted that the assessee had adopted the foreign AE as a tested party, and based on search carried out on 'one source' database, selected three comparables- namely Tech Target Inc, Bidz.com Inc, and Com Score Inc. However, he rejected this selection of testing party, and, as a justification thereof, observed that,"**On analysis of annual reports of the above three comparables, were found to be functionally dissimilar and were not found to be having verifiable data**". The tested party was thus rejected "**in the absence of reliable and accessible information of the comparables in USA**". The TPO then proceeded to treat the assessee as the tested party and compute the arm's length price on the basis of TNMM, but then we are not really concerned, for the reasons we will set out in a short while, with the mechanism of determination of arms length price at this stage. It was on this basis that the ALP adjustment proposed by the TPO were incorporated in the assessment. Aggrieved, assessee carried the matter in appeal before the CIT(A) but the learned CIT(A) has also confirmed the said ALP adjustment, and also held that foreign AE cannot be taken, in principle, as tested party. The assessee is not satisfied and is in further appeal before us.

4. We have heard the rival contentions, perused the material on record and duly considered facts of the case in the light of the applicable legal position.

5. As regards learned CIT(A)'s confirming the action of the TPO on the ground that foreign party cannot be taken as tested party, we donot think that is correct legal position as on now. The coordinate benches are consistently holding that foreign AEs can be taken as tested party as long as these entities are indeed least complex entities in the transaction, and as long as the requisite details are available. While on this issue, we may usefully refer to the following observations made by a coordinate bench of this Tribunal, in the case of**General Motors India Pvt Ltd Vs DCIT [(2013) 37 taxmann.com 403 (Ahmedabad - Trib.)]:**

11.1 We shall now proceed to peruse the judicial views on the issue. The case laws relied on by the assessee is as under:

(*i*) *Mastek Ltd.* (*supra*)

In this case, the question came up for consideration before the earlier Bench of this Tribunal was as to whether a minute examination of functional profile is necessary for the selection of comparables and the answer given was that functional profile must be first examined and after that proceed to select the comparable. In this case, the comparables chosen by the assessee were discussed by the TPO and those were discarded for the basic reason that the companies those quoted by the assessee were dealing in product distribution whereas the TPO was of the view that the AE was nothing but 'front office' of the assessee and simply engaged in marketing activity. After due consideration of the issue, the Hon'ble Bench had observed thus:

> **"16.1… (on page 47) It is clear that arm's length price is to be determined by taking result of comparable transactions and those transactions must be in comparable circumstances. It is therefore required to have a proper study of specific characteristics of controlled transaction. It is also required that there should be proper study of functions performed so as to match the identical situations under which functions have been performed. Then risk profile is also required to be compared. We may like to add that there are so many perspectives which were required to be compared and in this connection the Hon'ble Courts have also suggested so, such as, comparison of functional profile, similarity in respect of assets employed and a thorough screening of the comparables etc. Hence, in the present case, it is necessary to consider an analysis that whether the comparables selected by the TPO had analogous functional profile to that of functional profile of the assessee. It is true that functional profile and assets and risk analysis was made available but that is to be correctly understood in the light of the nature of International transaction carried out by the assessee with the said AE. A similar problem was considered by ITAT Delhi Bench in the case of Bechtel India Pvt. Ltd v. DCIT (2011-TII-07-ITAT-DEL-TP) where the assessee stated to be engaged in the business of providing electronic data support service to AE and the difficulty arose that the said function was compared with the companies engaged in the business of development of software. So the question was that whether a minute examination of functional profile is necessary for the purpose of selection of comparables and the answer given was that functional profile must be first examined and after that proceeds to select the comparables. Interestingly, in the present case now before us, comparables chosen by the assessee were discussed by the TPO and those were discarded. The basic reason for rejection of those comparables was that the companies those were quoted by the assessee were dealing in product distribution whereas the TPO was of the view that the AE was nothing but 'front office' of the assessee and simple engaged in marking activity. In this context, we are of the view that in order to determine the most appropriate method for determining the arm's length price, first it is necessary to select the 'tested party' and such a selected party should be least complex and should not be unique, so that prima facie cannot be distinguished from potential uncontrolled comparables."**

We are in agreement with the findings of the earlier Bench (supra) that such a selected party should be least complex and should not be unique.

(*ii*) *Development Consultants (P) Ltd.* (*supra*) followed by *Sony Indis (P.) Ltd.* v. *Dy. CIT* [2008] 114 ITD 448 (Delhi)

The issue before the Tribunal was that the CIT (A) had confirmed the adjustments to the international transactions of the assessee with its AEs based at Bahamas, USA without considering the submissions and the financial of the AEs explaining the facts etc. In case of the merits of the case for international transactions entered by the assessee with TKC, the submission made on behalf of the assessee was as under:

> **"26.1 and 2, 3** ** ** **
>
> **4. TKS is the entrepreneur company and has created significant marketing intangibles over the years. It uses its marketing intangibles to generate the work and assumes all the market, price and product risks. TKC came out the work on its own, only parts of the job are sub-contracted to the assessee for its convenience. Futher, being an entrepreneur company, it is difficult to determine the profits of ATKC with respect to work downloaded to India (as the revenue received for work off-shored to India cannot be separately identified). Further, the revenue generated from the services provided by the assessee would form only a small part of the entire operations. The value of engineering drawing and design services rendered by the assessee to TKC for AY 2002-04 was Rs.1,58,43,923/- and for AY 2004-05 it was Rs.1,45,77,704/-. The value of service forms approximately 6% to 7% of the Cost of Sales to TKC. HENCE, THIS Shri Rahul Mitra argued, shows that testing the margins of TKC would not serve the purpose of determining the arm's length nature of the transactions undertaken by the assessee with TKC. Hence, the recourse available to test the arm's length price of the services rendered by the assessee to TKC is to test the margins from the Indian side. In view of the discussion on tested part earlier, the assessee was selected as the tested party being least complex of the two entities. Hence, the transfer pricing analysis in this case was done from the Indian side, wherein, the margins of the assessee with respect to services provided to TKC were compared internally with services provided to other third parties in foreign market."**

Taking into account the divergent submissions, the Hon'ble Tribunal had recorded its findings that —

> **"33. Based on facts and our findings of the case, after due consideration of all the facts, we conclude that the analysis undertaken by the assessee to determine the arm's length price of the international transaction with Datacore USA is correct and on the basis of the analysis it is seen that transaction undertaken by the taxpayer with Datacore US is at arm's length for both the assessment years."**

(*iii*) **In the case of** *Ranbaxy Laboratories Limited* (*Supra*) **the Hon'ble Delhi Tribunal had recorded its findings that —**

> **"58.... The tested party normally should be the party in respect of which reliable data for comparison is easily and readily available and fewest adjustments in computations are needed. It may be local or foreign entity,**

i.e., one party to the transaction. The object of transfer pricing exercise is to gather reliable data, which can be considered without difficulty by both the parties, i.e., taxpayer and the revenue. It is also true that generally least of the complex controlled taxpayer should be taken as a tested party. But where comparable or almost comparable, controlled and uncontrolled transactions or entities are available, it may not be right to eliminate them from consideration because they look to be complex. If the taxpayer wishes to take foreign AE as a tested party, then it must ensure that it is such an entity for which the relevant data for comparison is available in public domain or is furnished to the tax administration. The taxpayer is not then entitled to take a stand that such data cannot be called for or insisted upon from the taxpayer."

In substance, a foreign entity (a foreign AE) could also be taken as a tested party for comparison.

11.2 At this juncture, we would like to refer to the United Nation's Practical Manual on Transfer Pricing for Developing Countries wherein the selection of the tested party has been dealt with. This Manual has been the work of many authors which included India, Norway, Nigeria, Italy, USA, Netherlands, Brazil, China, OECD, Japan etc. For ready reference, the relevant portion of it observation is extracted as under:

"5.3.3. Selection of the Tested Party:

5.3.3.1. When applying the Cost Plus Method, Resale Price Method or Transactional Net Margin Method (see further Chapter 6) it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the controlled transaction. Attributes of controlled transaction(s) will influence the selection of the test party (where needed). The tested party normally should be the less complex party to the controlled transaction and should be the party in respect of which the most reliable data for comparability is available. It may be the local or the foreign party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it and sufficient data on comparables is furnished to the tax administration and vice versa in order for the latter to be able to verify the selection and application of the transfer pricing method."

With regard to the challenges emerging in transfer pricing in India, it has been observed as under:

"10.4. Emerging Transfer Pricing Challenges in India

10.4.1 Transfer pricing Regulations in India

10.4.1.1 to 10.4.1.3 ** ** **

The Indian transfer pricing administration prefers Indian comparables in most cases and also accepts foreign comparables in cases where the foreign

associated enterprise is the less or least complex entity and requisite information is available about the tested party and comparables."

11.2.1 It was also vouched during the course of hearing by the learned Sr. Counsel that the financial details including operating margin of comparable companies along with the back-up computations were furnished before the TPO in the transfer pricing documentation [Source: Pages 113 to 210 of the Transfer Pricing Study]. This contradicts the assertion of the learned DR that the assessee had not furnished any financial information of the comparable companies.

11.2.2 The United Nation's Practical Manual on Transfer Pricing also contradicts the TPO's argument that GMDAT should not be selected as the tested party as the comparable companies selected by the assessee doesn't fall within his jurisdiction and he can neither call for any additional information nor scrutinize their books of accounts etc.,

11.2.3 However, we find inconsistency in the stand of the TPO to the effect that while rejecting the assessee's approach for selecting GMDAT as the tested party by citing a reason that there was no reliable data available for both GMDAT and comparables and, therefore, GMDAT cannot be taken as the 'tested party', however, on the same breath, as rightly highlighted by the assessee, the TPO had taken GMDAT as the tested party while making adjustment to transaction relating to payment of royalty by GMI to GMDAT.

11.2.4 Rebutting the Revenue's allegation made during the course of proceedings that the segmental financial statement of GMDAT was not reliable, the assessee reiterates that the segmental data relied upon for benchmarking international transactions relating to import of CKD Kits and components was completely reliable and was based on sound allocation keys. To substantiate its claim, the assessee has also furnished a report on factual findings certified by the statutory auditors - Deloitte Anjin LLC.

11.2.5 Moreover, we find that the DRP had not considered in great detail the plea of the assessee as to why GMDAT should not be selected as the tested party for analyzing the inter-company transactions. Instead, the DRP had, in a cryptic manner, concluded that the results of assessee have to be compared with the stand alone results of Mahindra & Mahindra in the automotive segment.

11.2.6 In this connection, we tend to recall the ruling of the Hon'ble Jurisdictional High Court in the case of *AIA Engg. Ltd.* v. *Dispute Resolution Panel* [2012] 341 ITR 145/[2011] 196 Taxman 477/[2010] 8 taxmann.com 293 (Guj.). After due consideration of rival submissions, the Hon'ble Court had ruled thus -

"16....If the Dispute Resolution Panel was of the opinion that the application dated 22.4.2010 could not have been entertained, it should have considered the objections filed by the petition on merits. As a consequence of the impugned order, firstly the objections raised by the petitioner have not been decided, secondly, in view of the directions issued by the Dispute Resolution Panel, the petitioner would not be in a position to avail of the remedy of appeal before commissioner (Appeals) against the draft assessment order; and thirdly, in the light of the observation made by the dispute Resolution

Panel that the petitioner has chosen to withdraw the objections, preferring any appeal against the impugned order before any forum would be an exercise in futility, as no appeal would be entertained against an order passed on a concession. Thus, the dispute Resolution Panel has virtually closed all doors for the petitioner. In the circumstances, impugned order of the Dispute Resolution Panel suffers from the vide of being contrary to the record as well as non-application of mind, in as much as the petitioner had never sought withdrawal of the objections filed by it. The impugned order also causes immense prejudice to the petitioner as recorded hereinabove. In the circumstances, the impugned order of the Dispute Resolution Panel, therefore, cannot be sustained…."

11.3 We shall now peruse the case laws on which the learned DR had placed reliance in the findings of the Hon'ble Mumbai Tribunals in the cases of (i) *Aurionpro Solutions Ltd.* (*supra*) and (ii) *Onward Technologies Ltd.* (*supra*).

(*i*) In the case of *Aurionpro Solutions Ltd.* (*supra*), the issue before the Hon'ble Bench was that the assessee engaged in the business of software development and web designing services and that the assessee had lent loans to its AEs stationed at USA, Singapore and Bahrain. The assessee had claimed that the said loans as working capital advanced to its 100% subsidiary outside India. When the issue was referred to TPO, the TPO took a view that as in a third party comparable situation, advances would bear interest and, therefore, need to charge a markup as per CUP method. Accordingly, the TPO proposed to benchmark the loans at dollar denominated LIBO [London Inter Bank Operative] rate plus mark up of 3%. When the issue landed up before the DRP, the DRP had, after analyzing the issue, directed the AO/TPO to compute the interest on loans to AE @ 14% per annum thereby enhanced the transfer pricing adjustment. Aggrieved assessee took up the issue with the Tribunal. The Hon'ble Tribunal, after due consideration of the issue in depth and for the reasons recorded therein, directed the AO/TPO to determine the arm's length interest at Libor plus 2% on the monthly closing balance of advances during the FY.

We have, with due regards, perused the issue and the findings of the Hon'ble Bench in detail. Ironically, the main issue before the Bench was the percentage of the interest to be calculated on the loan advanced by the assessee to its foreign AEs. We are, therefore, of the view that this case is not directly applicable to the issue under dispute.

(*ii*) In the case of *Onward Technologies Ltd*. (*supra*) as relied on by the Revenue, it is observed that the assessee, a parent company had international transaction with its AEs. With regard to IT enabled services provide to its AEs, the assessee had chosen six comparables with its foreign AEs as a tested party. The TPO had ignored the working of the assessee whereby selecting 20 comparable cases. When the issue reached before the Tribunal for resolve, the Hon'ble Bench had, after having considered rival submissions, recorded its findings, among others, as under:

"11.2.2. (On page 12).... So, it is the profit actually realized by the Indian

> **assessee from the transaction with its foreign AE which is compared with that of the comparables. There can be no question of substituting the profit realized by the Indian enterprise from its foreign AE with the profit realized by the foreign AE from the ultimate customers for the purposes of determining the ALP of the international transaction of the Indian enterprise with its foreign AE. The scope of TP adjustment under the Indian taxation law is limited to transaction between the assessee and its foreign AE. It can neither call for also roping in and taxing in India the margin from the activities undertaken by the foreign AE nor can it curtail the profit arising out of transaction between the Indian and foreign AE at arm's length. The contention of the ld. AR in considering the profit of the foreign AE as 'profit A' for the purposes of comparison with profit or comparables, being 'profit B', to determine the ALP of transaction between the assessee and its foreign AE, misses the wood from the tree by making the substantive section 92 otiose and the definition of 'internal transaction' u/s 92B and rule 10B redundant. This is patently an unacceptable position having no sanction of the Indian transfer pricing law. Borrowing a contrary mandate of the TP provisions of other countries and reading it into our provisions is not permissible. The requirement under our law is to compute the income from an international transaction between two AEs having regard to its ALP and the same is required to be strictly adhered to as prescribed. This contention is, therefore, repelled."**

With have duly perused the findings of the Hon'ble Bench cited supra. In this connection, we would like to point out that various Tribunals have taken divergent views in respect of selection of 'tested party'. To illustrate, the earlier Bench of this Tribunal in the case of *Mastek Ltd.* (*supra*) had stressed that (at the cost of repetition) "we are of the view that in order to determine the most appropriate method for determining the arm's length price, first it is necessary to select the 'tested party' and such a selected party should be least complex and should not be unique, so that prima facie cannot be distinguished from potential uncontrolled comparables".

The Hon'ble Calcutta Tribunal in the case of *Development Consultants (P) Ltd.* (*supra*) had recorded its findings that "33. Based on facts and our findings of the case, after due consideration of all the facts, we conclude that the analysis undertaken by the assessee to determine the arm's length price of the international transaction with Datacore USA is correct and on the basis of the analysis it is seen that transaction undertaken by the taxpayer with Datacore US is at arm's length for both the assessment years."

Thirdly, the Hon'ble Delhi Tribunal in the case of *Ranbaxy Laboratories(P) Ltd.* (*supra*) took a stand that 'If the taxpayer wishes to take foreign AE as a tested party, then it must ensure that it is such an entity for which the relevant data for comparison is available in public domain or is furnished to the tax administration.'

Then, the United Nation's Practical Manual on Transfer Pricing for Developing Countries had observed that "5.3.3.1…… The tested party normally should be the less complex party to the controlled transaction and should be the party in

> **respect of which the most reliable data for comparability is available. It may be the local or the foreign party. If a taxpayer wishes to select the foreign associated enterprise as the tested party, it must ensure that the necessary relevant information about it and sufficient data on comparables is furnished to the tax administration…."**
>
> **11.4 Considering the divergent views expressed by various Tribunals (*supra*) and majority of them were in favour of selecting the 'tested party' either from local or foreign party and the United Nation's Practical Manual on transfer pricing for developing countries had observed that 'It may be the local or the foreign party', we tend to agree with the same.**

6. In principle, therefore, there cannot be objection to the foreign entity being taken as an AE. We further find that the TPO has rejected the foreign party as the tested party with a cryptic remark that "**On analysis of annual reports of the above three comparables, were found to be functionally dissimilar and were not found to be having verifiable data**" but then these remarks lack any specific factual aspect and what the AO has overlooked is that the same foreign tested party with the same comparables were accepted by the TPO in the preceding assessment year. It is not clear as to what has changed in the meantime. Be that as it may, we deem it fit and proper to remit the matter to the assessment stage with a direction to the TPO to deal with the matter by afresh by way of a speaking order in accordance with the law, by way of a speaking order and after giving yet another opportunity of hearing to the assessee. With these directions the matter stands restored to the file at the assessment stage for fresh determination of arm's length price.

7. As the matter regarding determination of arm's length price is being remitted to the assessment stage, all other issues, raised by the assessee in this regard, are dismissed as infructous.

8. The assessee had also raised an issue a grievance regarding addition of Rs 89,745, on the basis of the AIR inputs, but the same was not pressed before us. This grievance is thus dismissed as not pressed.

9. In the result, the appeal is partly allowed for statistical purposes. Pronounced in the open court today on the __th day of March, 2020.

Sd/- Sd/-

Pawan Singh **Pramod Kumar**
(Judicial Member) (Vice President)
Mumbai, dated the day of March, 2020

Copies to: *(1) The appellant (2) The respondent*
(3) CIT (4) CIT(A)
(5) DR (6) Guard File

By order

Assistant Registrar
Income Tax Appellate Tribunal
Mumbai benches, Mumbai