

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

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

ITA No. 674/Bang/2016
Assessment year: 2011-12

M/s.SAP labs India Private Limited, (successor in interest of erstwhile M/s. Success Factors Business Solutions India Private Limited, No.138, Export Promotion Industrial Park, White field, Bengaluru-560 066. PAN : AAMCS9736N	Vs.	The Income-tax Officer, Ward-6(1)(4), Bangalore.
APPELLANT		RESPONDENT

Appellant by	:	Shri Aliasgar Rampurwala, CA
Respondent by	:	Shri Muzaffar Hussain, CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	13.08.2020
Date of Pronouncement	:	31.08.2020

ORDER

Per N.V. Vasudevan, Vice President

This is an appeal by the Assessee against the order dated 31.3.2015 of ITO, Ward-6(1)(4), Bangalore (hereinafter referred to as the Assessing Officer, “AO” in short) passed u/s.143(3) read with Section 144C(13) of the Income Tax Act, 1961 (Act) in relation to assessment year 2011-12.

2. The Assessee is engaged in the business of provision of Software Development Services (SWD services), and Marketing and sales Support

Services (MSS) to its wholly owned holding company. In terms of the provisions of Sec.92-A of the Act, the Assessee and its wholly owned holding company were Associated Enterprises ("AEs"). In terms of Sec.92B(1) of the Act, the transaction of providing SWD Services and MSS were "international transaction" i.e., a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises. In terms of Sec.92(1) of the Act, the Any income arising from an international transaction shall be computed having regard to the arm's length price. In this appeal by the Assessee, the dispute is with regard to determination of Arms' Length Price (ALP) in respect of the aforesaid two international transaction of (i) rendering SWD services to the AE and (ii) rendering of MSS to the AE. We shall deal each of the international transactions separately.

SOFTWARE DEVELOPMENT SERVICES SEGMENT

3. As far as the provision of Software Development services are concerned, the Assessee filed a Transfer Pricing Study (TP Study) to justify the price paid in the international Transaction as at ALP by adopting the Transaction Net Margin Method (TNMM) as the Most Appropriate Method (MAM) of determining ALP. The Assessee selected Operating Profit/Total Cost (OP/TC) as the Profit Level Indicator (PLI) for the purpose of comparison. The OP/TC of the Assessee was arrived at 12.00% by the Assessee in its TP study. The operating income was Rs.14,79,85,314/-

and the Operating Cost was Rs.13,21,27,866/-. The Operating profit (Operating income – Operating cost was Rs.1,58,57,448/-. Thus the OP/TC was arrived at 12.00%. The Assessee chose companies who are engaged in providing similar services such as the Assessee from the Prowess and Capitaline Plus Data Base. The Assessee identified 7 companies whose average arithmetic mean of profit margin was less than and comparable the Operating margin of the Assessee. The Assessee therefore claimed that the price it charged in the international transaction should be considered as at Arm's Length.

4. The TPO to whom the determination of ALP was referred to by the AO, accepted TNMM as the MAM and also used the same PLI for comparison i.e., OP/TC. He also selected comparable companies from the same database from which the Assessee had chosen comparable companies, viz., Prowess and Capitaline Plus. The TPO rejected all the 7 companies chosen by the Assessee as comparable companies. The TPO on his own identified 13 companies as comparable with the Assessee company and worked out the average arithmetic mean of their profit margins as follows:-

A.6. Comparables selected by TPO and their arithmetic mean:

Sl. No.	Name of the Company	Mark-up on Total Costs (WC-unadj) (in %)	Mark-up on Total Costs (WC – adj) (in %)
1	Acropetal Technologies Ltd. (seg)	31.98	30.17
2	e-Zest Solutions Ltd.	21.03	20.43
3	E-Infochips Ltd.	56.44	57.63
4	Evoke Technologies Pvt. Ltd.	8.11	9.45
5	ICRA Techno Analytics Ltd.	24.83	24.30
6	Infosys Ltd.	43.39	44.95
7	Larsen & Toubro Infotech Ltd.	19.83	21.35
8	Mindtree Ltd. (seg)	10.66	10.70
9	Persistent Systems & Solutions Ltd.	22.12	22.66
10	Persistent Systems Ltd.	22.84	23.09
11	R S Software (India) Ltd.	16.37	17.68
12	Sasken Communication Technologies Ltd.	24.13	26.00
13	Tata Elxsi Ltd. (seg)	20.91	20.42
AVERAGE MARK-UP		24.82	25.29

5. The TPO computed the Addition to total income on account of adjustment to ALP as follows:-

Computation of arm's length price by TPO and the adjustment made

Arm's Length Mean Margin on cost		24.82%
Less: Working Capital Adjustment		1.63%
Adjusted mean margin of the comparables	A	23.19%
Operating Cost	B	Rs. 13,21,27,866/-
Arm's length Price (123.19% of Operating Cost)	$C=B*123.19\%$	Rs. 16,27,68,318/-
Price Received	D	Rs. 14,79,85,314/-
Short fall being adjustment u/s. 92CA	E=C - D	Rs. 1,47,83,004/-

Thus a sum of Rs.1,47,83,004/- was added to the total income of the Assessee on account of determination of ALP for provision of SWD services by the Assessee to its AE.

6. The Assessee filed objections before the Disputes Resolution Panel (DRP) against the draft assessment order passed by the AO wherein the addition suggested by the TPO as adjustment to ALP was added to the total income of the Assessee by the AO. The DRP excluded 6 comparable companies viz., Infosys Ltd., Larsen & Toubro Ltd., (iii) Mindtree Ltd., (iv) Persistent Systems Ltd., (v) Sasken Communication Technologies Ltd., and (vi) Tata Elxsi Ltd., on the application of turnover filter of more than Rs.200 crores. The Assessee's claim for allowing working capital adjustment on actual basis without restricting the working capital adjustment to the working capital mean margin of comparable companies was not given by the DRP. The DRP also did not agree to plea of the Assessee for exclusion of Acropetal Technologies Ltd., E-Infochips Ltd., ICRA techno Analytics Ltd., and E-Zest Solutions Ltd., To the extent the Assessee did not get relief from the DRP, the Assessee has preferred appeal before the Tribunal. The specific grounds of challenge are contained in the revised grounds of appeal filed before the Tribunal. The

grounds relating to SWD services segment that were pressed for adjudication were Ground No. 2.6 in which the Assessee has projected grievance with regard to non-exclusion of the following four companies by the DRP viz., of Acropetal Technologies Ltd., E-Infochips Ltd., ICRA techno Analytics Ltd., and E-Zest Solutions Ltd. Gr.No.2.6 reads as follows:-

“2. On the facts and circumstances of the case and in law, the DRP/AO/TPO erred in:

.....

2.6 including ‘Acropetal Technologies Ltd.’, ‘E-Zest Solutions Limited’, ‘E-Infochips Ltd.’ and ‘ICRA Techno Analytics Ltd.’ in its comparability analysis that fail the test of comparability as compared to the appellant in respect of software development services (**corresponding to original ground 2.6**.)”

7. Out of the 4 comparable companies, the Assessee did not press for exclusion of comparable company E-Zest Solutions Ltd.

8. The other ground pressed for adjudication in the SWD services segment is Gr.No.2.10 regarding the action of the DRP in not allowing working capital adjustment on actual basis without restricting the working capital adjustment to the working capital mean margin of comparable companies. Gr.No.2.10 reads as follows:-

“2. On the facts and circumstances of the case and in law, the DRP/AO/TPO erred in:

.....

2.10 erroneously computing the working capital adjustment and limiting the working capital adjustment for software development services and in not providing the working capital adjustment for sales and marketing support services rendered by the Appellant, to account for the working capital difference based on the actual working capital position of the Appellant vis-à-vis comparable companies (**corresponding to original ground 2.8**.)”

9. We will first deal with the plea of the Assessee for exclusion of comparable companies chosen by the TPO. The first company which the Assessee seeks exclusion is Acropetal Technologies Ltd. On exclusion of this company, we have heard the rival submissions. We find that the TPO has himself applied a filter for exclusion of companies for the purpose of comparison, viz., revenue from software development service should be more than 75% of the total operating revenue. The admitted factual position is that revenue from software development service of this company was 81.40 Crores out of the total operating revenue of Rs.141 Crores. Thus the revenue from software development is admittedly less than 75% of the total operating revenue of this company. Therefore his company has to be excluded from the list of comparable companies. It was also brought to our notice that the ITAT Bangalore in the case of Applied Materials Pvt. Ltd., in IT (TP) A.No.17 & 39/Bang/2016 for AY 2011-12 order dated 21.9.2016 noticing the aforesaid facts excluded this company from the list of comparable companies in the case of a software development service provider such as the Assessee. We therefore hold that this company should be excluded from the list of comparable companies.

10. The next company that is sought to be excluded by the Assessee is ICRA Techno Analytics Ltd. As far as ICRA Techno Analytics Ltd., is concerned, this Tribunal in the case of Applied Materials India Pvt. Ltd., (Supra) took the view that this company was engaged in diversified activities like software development, consultancy engineering services, web development and hosting and substantially diversified itself into domain of business analysis and business process out sourcing. Therefore, it was held that this company is functionally not comparable with a software development services provider.

11. The next company that is sought to be excluded by the Assessee is E-Infochips Ltd. As far as E-Infochips Ltd., is concerned our attention was drawn to decision of the Delhi ITAT in the case of Saxo India Pvt. Ltd., Vs. ACIT 67 taxmann.com 155 wherein the Delhi Tribunal took note of the fact that the operating revenue of this company was from software development, hardware maintenance, information technology, consultancy etc. The Tribunal found that 15% of the total revenue was from hardware maintenance. The other segmental information was not available. Since no segmental data was available indicating operating profit from software development services, this company was excluded from the list of comparable companies. Thus Gr.No.2.6 is partly allowed.

12. As far as Gr.No.2.10 relating to the action of the DRP in not allowing working capital adjustment on actual basis without restricting the working capital adjustment to the working capital mean margin of comparable companies, is concerned, it was submitted by the learned counsel for the Assessee that the TPO, while granting working capital adjustment in respect of the Assessee's SWD segment, has arbitrarily and unreasonable restricted the same at 1.63% , without providing any legal basis or rationale for limiting the working capital adjustment to the said percentage. The DRP also, vide its directions upheld this action of the TPO. It was submitted that this direction of the DRP is erroneous and merits the interference of this Hon'ble Tribunal. It was submitted that working capital adjustment must be granted in full without there being any arbitrary and adhoc upper cap or restriction to the same, as has been done by the TPO. The working capital adjustment has been arrived at by the TPO on the basis of a scientific calculation and by adopting the methodology prescribed by the OECD Guidelines. Thus, once a working capital adjustment is arrived at in the manner prescribed by law, the consequences of such an adjustment on a

comparable's profit margin cannot be the reason for applying a cap on such adjustment. Rule 10B(3) of the Income-tax Rules, 1962 ('the IT Rules' for short), provides that an adjustment ought to be provided for any differences in the economic factors between the tested party and the comparables. A working capital adjustment is one such adjustment which is to be applied in order to adjust for the differences between the working capital positions of the tested party and of the comparable. The IT Rules do not provide for the requirement of application of any cap or upper limit to such adjustments. This position under the Act and the IT Rules is also evident from the OECD Guidelines. In this regard, our attention was drawn to a decision of Hon'ble Tribunal in ARM Embedded Technologies P. Ltd v. ITO [IT(TP)A No. 1659 and 1560/Bang/2014] (paragraph 24-25) (2015) 64 Taxmann.com 445 (Bang-Trib) which supports the contention of the learned counsel for the Assessee. Hence it was submitted that the above action of the TPO and subsequent confirmation of the same by DRP is wholly erroneous and liable to set aside by this Hon'ble Tribunal. The learned DR relied on the order of the TPO/DRP. In the light of the decision cited by the learned counsel for the Assessee, we are of the view that the working capital adjustment has to be allowed on actual and there cannot be any cap that can be imposed in allowing adjustment to the margins of comparables or that of the tested party towards working capital adjustment. Gr.No.2.10 to this extent is allowed.

13. The TPO is directed to compute the ALP in accordance with the directions contained in this order after affording Assessee opportunity of being heard.

MARKETING SUPPORT SERVICES SEGMENT (MSS)

14. As far as the provision of MSS is concerned, the Assessee filed a Transfer Pricing Study (TP Study) to justify the price paid in the

international Transaction as at ALP by adopting the Transaction Net Margin Method (TNMM) as the Most Appropriate Method (MAM) of determining ALP. The Assessee selected Operating Profit/Total Cost (OP/TC) as the Profit Level Indicator (PLI) for the purpose of comparison. The OP/OC of Assessee was 12.00%. The TPO to whom the determination of ALP was referred to by the AO, accepted TNMM as the MAM and also used the same PLI for comparison i.e., OP/TC. The TPO rejected all the companies chosen as comparable company by the Assessee and on his own chose three companies and worked out the average arithmetic mean of their profit margins and adjustment to ALP as follows:

E.6. Comparables selected by TPO and their arithmetic mean:

Sl. No.	Name of the Company	Mark-up on Total Costs (in %)
1.	Asian Business Exhibition & Conferences Ltd.	19.51
2.	Cyber Media Research Ltd.	10.59
3.	ICC International Agencies Ltd.	24.66
AVERAGE MARGIN		18.25

15. The TPO computed ALP and consequent addition to the total income as follows:-

Computation of arm's length price by TPO and the adjustment made

Arm's Length Mean Margin on cost		18.25%
Operating Cost	B	Rs. 1,08,16,416/-
Arm's length Price (118.25% of Operating Cost)	C=B*118.25%	Rs. 1,27,90,412/-
Price Received	D	Rs. 1,21,14,385/-
Short fall being adjustment u/s. 92CA	E=C - D	Rs. 6,76,027/-

16. The Assessee filed objection before the DRP against the draft order of Assessment wherein the addition suggested by the TPO was added to the total income of the Assessee. The DRP however confirmed the order of the AO. Before the Tribunal, the Assessee seeks exclusion of two out of the three comparable companies chosen by the TPO viz., Asian Business Exhibition & Conferences Ltd., and ICC International Agencies Ltd. in Gr.No.2.7 which reads as follows:-

““2. On the facts and circumstances of the case and in law, the DRP/AO/TPO erred in:

.....

2.7 Including ‘Asian Business Exhibition & Conference Ltd.’, and ‘ICC International Agencies Ltd.’ in its comparability analysis that fail the test of comparability, as compared to Appellant in respect of sales and marketing support services **(corresponding to original ground 2.6).**”

17. At the time of hearing the learned counsel for the Assessee pressed for adjudication of exclusion of ICC International Agencies Ltd., alone. It was brought to our notice by the learned counsel for the Assessee that in the case of *AMD India Pvt. Ltd. Vs. ACIT* in IT(TP) A.No.1487 & 1496/Bang/2015 order dated 6.4.2017 ITAT Bangalore Bench for the very same segment for AY 2011-12 was pleased to hold that this company was with MS Services providing company. The relevant observations are as follows:-

“2. ICC International Agencies Ltd :

The assessee submitted before the DRP that this company is functionally not comparable since it is engaged in trading activity and thereby functionally different. The DRP rejected this company for the reason that this company is functionally dissimilar and for incorrect margin computation made by the TPO. The Revenue is on appeal . The assessee pleaded that this is functionally different and relies on this Tribunal decision in ITO

v Interwoven Software Services(India) P Ltd [TS -723-ITAT - 2016 -Bang-TP ay 2010-11. The relevant portion of the order IT(TP)A.1487 & 1496/Bang/2015 Page - 36 from ITO v Interwoven Software Services (India) P Ltd [IT(TP)A.No.461/Bang/2015 dt 26.8.2016 for a y 2010-11 is extracted as under :

"28. For this segment, the assessee is seeking exclusion of two comparables i.e. M/s Acentia Technologies Ltd., and M/s ICC International Agencies Ltd., The claim of assessee regarding exclusion of M/s Acentia Technologies Ltd. is also covered in favour of the assessee by the same Tribunal order rendered in the case of M/s Electronics for Imaging India (P)Ltd.,(Supra) and respectfully following the same Tribunal order, we direct the AO/TPO to exclude this company from the list of final comparable because the ld. DR of the revenue could not point out any difference in facts.

29. Regarding exclusion of second company, it was submitted by the learned AR of the assessee that i.e. M/s ICC International Agencies Ltd., (Supra) this is the claim of the assessee that annual report of this company available on page-1100 & 1104 of the paper book. As per the same, we find that this company is deriving income from trading activity and also maintaining inventories. Both these arguments are supported by annual report of this company available on page-1100 & 1104 of the paper book. Since the assessee is not engaged in trading activity, in our considered opinion, this company cannot be considered as good comparable in the present case and hence, we direct the AO/TPO to exclude his company from the list of final comparable."

18. Following the said decision, we direct exclusion of the aforesaid company ICC International Agencies Ltd., from the list of comparable companies.

19. We shall now deal with the other grounds of appeal in MS Segment regard to non-grant of working capital adjustment which is projected in Gr.No.2.10 of the grounds of appeal of the Assessee which has already been reproduced in the earlier part of this order. On this ground we find that

the grievance of the Assessee projected in objection Gr.No.5.2 was that the TPO erred in not providing working adjustment for MS segment. The DRP did not adjudicate the same in paragraph 4.1 of its order presuming that the grievance of the Assessee was only in SWD services segment on working capital adjustment being restricted to mean margin of comparable working capital requirements. Nevertheless, grant of working capital adjustment is necessary in determining ALP. We direct the TPO to compute the ALP in accordance with the directions contained in this order and allow working capital adjustment after examination of the claim of the Assessee in this regard in the TP Study and allow opportunity of being heard before deciding on the quantum of adjustment to be given on account of working capital adjustment.

20. No other grounds were pressed for adjudication.

21. In the result, appeal by the Assessee is partly allowed.

Pronounced in the open court on this 31st day of August, 2020.

Sd/-

(B R BASKARAN)
ACCOUNTANT MEMBER

Sd/-

(N V VASUDEVAN)
VICE PRESIDENT

Bangalore,
Dated, the 31st August, 2020.

/Desai S Murthy /

Copy to:

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

By order

Assistant Registrar
ITAT, Bangalore.