

**IN THE INCOME TAX APPELLATE TRIBUNAL  
Hyderabad 'A' Bench, Hyderabad**

*(Through Video Conferencing)*

**Before Smt. P. MADHAVI DEVI, Judicial Member  
AND  
Shri D.S. SUNDER SINGH, Accountant Member**

ITA No. 160/Hyd/2017		
Assessment Year: 2012-13		
M/s Commvault Systems (India) Private Limited 5 <sup>th</sup> floor, Plot no.39, Phase II Block A, Ananth Info Park Hitech City, Madhapur Hyderabad  PAN: AACCC3708L	Vs.	DCIT, Circle 1(2) Hyderabad
(Appellant)		(Respondent)
Assessee by:		Sh. Ajeet Tolani
Revenue by:		Smt. Anjala Sahu, D.R.
Date of hearing:		01/09/2020
Date of pronouncement:		04/09/2020

**ORDER**

**Per Smt. P. Madhavi Devi, J.M.**

This is an appeal filed by the assessee for the A.Y. 2012-13 against the final assessment order dated 26.12.2016 passed u/s 143(3) r.w.s. 144C(13) of the I.T. Act, 1961.

**2.** Brief facts of the case are that the assessee company, engaged in the business of software development services & unified data storage solutions, e-filed its original return of income for the A.Y. 2012-13 on 11.10.2012 admitting total income of

Rs.2,43,86,576/- under normal provisions after setting off of the brought forward losses of Rs.1,26,86,715/- and Rs.3,46,41,182/- under the provisions of Sec.115 JB of the I.T.Act, 1961. During the assessment proceedings u/s 143(3) of the Act, the AO observed that the assessee has entered into international transactions with its associate enterprises during the year. Therefore, a reference was made to the Transfer Pricing Officer (TPO) for determination of the ALP. The TPO passed an order under section 92CA(3) on 30.01.2016 proposing an adjustment of Rs.1,73,05,026/-. The assessee filed its objections before the DRP who directed the AO to retain the comparables selected by the TPO and to compute the adjustment accordingly. DRP also directed the AO to allow working capital adjustment and risk adjustment. Accordingly, final assessment order was passed against which assessee is in appeal before the Tribunal.

**2.1.** This appeal is taken up for hearing on 01.09.2020 through Video Conferencing and both the parties were heard.

**3.** The Ld.Counsel for the assessee submitted that the assessee had entered into three international transactions i.e. Software Development Services, Software Support Services and Distribution of products. The assessee treated the first two activities as falling under the definition of 'international transactions' and accordingly bench marked the same. As far as distribution activity is concerned, the assessee had stated that its Associate Enterprise (AE) has supplied the products to the assessee free of cost for sale in India and therefore it was not reported as an international transaction. However, the TPO held that the assessee is rendering services to its AE and therefore it

has to be marked up. He accordingly computed the ALP at Rs.6,21,26,401/- and accordingly proposed an adjustment. He submitted that the very same issue had arisen in the first year of its activity i.e. in F.Y. 2011-12 and the issue had come up for adjudication before the Coordinate Bench of this Tribunal and the Tribunal has held the activity to be a distribution activity and not as rendering of services by the assessee to its A.E. A copy of the said order is placed before us. It is further submitted that the Tribunal in the earlier year remitted the matter to the file of AO with a direction to conduct fresh TP analysis by treating the assessee's transaction as a distribution agreement and by determining the most appropriate method afresh and after allowing the necessary adjustments ad further that if the loss declared by the assessee is increased by such TP study, then no TP adjustment can be made as provided in section 92(3) of the Act. Hw prayed for similar relief for this year also, but prayed that since the value of the transaction was 'nil' the further direction to apply Sec.92(3) may not be given.

**3.1.** Ld.DR, on the other hand, supported the orders of the authorities below.

**4.** Having regard to rival contentions and material placed on record, we find that the issue under consideration was decided in favour of assessee by the Coordinate Bench of this Tribunal for previous A.Y. i.e. 2011-12 in ITA no.343/Hyd/2016 dated 11.04.2018. For the sake of ready reference, the relevant paras of the order are extracted hereunder.

“6. Brief facts relating to this issue are that the assessee had entered into an agreement dated 1-4-2010 with its AE to distribute the product of the AE in India i.e. Simpana Software, a scalable unified data and information management software designed to replace several products. The products were supplied to the assessee free of cost and sales were made by the assessee to domestic parties. Therefore, the assessee did not treat the same as an international transaction. The assessee, vide letter dated 10.11.2014, had explained to the TPO that it has started the distribution activity with a separate team of 6 employees and the office is located in Mumbai and therefore, it has incurred loss in this year. It was also submitted that as per the agreement, the AE will not charge any amount to the assessee if the operating cost is more than the revenue earned. The TPO, however, was not convinced with the assessee’s explanation. He held that even though the cost price to the assessee is ‘nil’, the product has a price and that the sales are made on behalf of the AE and that the assessee company should be compensated by way of a suitable mark-up. Thus, he was of the opinion that the arrangement is nothing but in the nature of service agreement requiring a markup. The TPO, therefore, issued a show-cause notice to the assessee.

7. In reply to the show-cause notice, the assessee furnished its reply on 24.12.2014 stating that the assessee is only acting as a captive distributor and is not distributing on behalf of its AE. In addition thereto, the assessee also furnished a fresh search for comparables which resulted in 11 companies with an average margin of 0.40%. The TPO however, did not accept the assessee’s TP analysis on the ground that the TP analysis has to be reported in Form 3CEB and filed before the due date of filing of the return of income and cannot be filed subsequent thereto. Therefore, TPO carried out a fresh search for comparables and short listed 4 companies as comparables whose average margin was 1.26% as against the margin of the assessee at (-) 81.54%. Thereafter, he proposed the ALP adjustment at Rs.1,54,47,842. The AO accordingly proposed the adjustment in the draft assessment order. The assessee filed its objections before the DRP, but the DRP confirmed the adjustment and the final assessment order was passed.

8. The learned Counsel for the assessee, while reiterating the submissions made before the authorities below, submitted that the agreement between the assessee and its AE was distribution agreement, but the TPO has characterized it as a service agreement and has held that a mark-up on the operational cost is to be made to determine the ALP. He submitted that undisputedly, the assessee is not making any payment to the AE in the relevant A.Y for the products supplied to it, because, according to the

agreement between the assessee and its AE, the assessee is required to make the payment to the AE only in the year where the revenue exceeded the operating cost of the assessee i.e. on making of profit. He submitted that this financial year is the first year of the distribution activity of the assessee company and therefore, it had to take premises on rent and pay its employees for carrying on distribution work and thus has incurred the expenses resulting in a loss to the company and therefore, the assessee has not made any payment to the AE during the year and hence the provisions of section 92 do not apply. He placed reliance upon sub-section 3 of section 92 of the I.T. Act to argue that where no income is chargeable to tax or it goes to increase the loss, then the TP proceedings are not applicable. He has also drawn our attention to the T.P study of the assessee and particularly, para 7 thereof, wherein the assessee has reported that the goods are supplied to the assessee at 'Nil' cost and therefore, the TP proceedings are not applicable to such distribution activity. Further, he also argued that the TPO u/s 92CA of the Act, can only compute/determine the ALP of the international transactions but cannot re-characterize the transaction according to his understanding.

9. The learned DR, however, supported the orders of the authorities below and submitted that the assessee was providing services of selling the products of AE in India and therefore, it should be considered as a service agreement and should be compensated with a mark-up.

10. Having regard to the rival contentions and the material on record, we find that admittedly, the assessee has received the goods from its AE free of cost and the assessee has not made any payment whatsoever to the AE during the relevant A.Y or in the subsequent A.Ys till the A.Y 2013-14. We have also gone through the copy of the agreement between the assessee and its AE wherein it was clearly spelt out that the assessee is a distributor and is not required to make the payments to the AE for the goods supplied to it till the assessee makes profit from the transactions.

The relevant clause is reproduced hereunder for ready reference:

"11. Transfer Pricing and Remuneration:

a) In consideration for the rights provided to Distributor hereunder, Distributor shall pay to Comm Vault US an amount (the "Payment Amount") equal to a specified percentage (the "Specified Percentage") of Distributor's sales revenue less operating costs/expenses of Distributor ("Operating Costs/Expense"), The parties agree to negotiate in good faith at arm's length to set the initial Specified Percentage. Thereafter the Specified Percentage may be amended from time to

time by mutual agreement of the parties to reflect changes in market conditions. If the parties determine necessary, the Specified Percentage will be revised in accordance with a transfer pricing study.

b) For purposes of this Agreement, Operating Costs/Expenses include but are not limited to personnel costs, depreciation on fixed assets, rental costs, postage charges, telecommunications and processing costs, electricity and maintenance expenses, legal and accounting fees and expenses, and other similar expenses. Such Operating Costs/Expenses shall be determined and apportioned on a basis consistent with that used internally by Distributor for similar costs and expenses.

c) If Distributor's Operating Costs/Expenses exceed the sales revenue of Distributor during a fiscal year, no Payment Amount shall be paid by Distributor to Comm Vault US in connection with that fiscal year and such excess Operating Costs/Expenses shall be considered in determining the Specified Percentage for the subsequent fiscal year.

d) The Payment Amount paid by Distributor to Comm Vault US shall be exclusive of all Indian taxes”.

11. In Form No.3CEB, the assessee has reported as under:

“The company has received software free of cost from its Associate Enterprise i.e. Commvalut Systems Inc, for distribution in the Indian Market. Since no purchase price was paid for the software received, as per the management, section 92(3) of the Act provides that transfer pricing provisions do not apply in a case where computation has the effect of reducing the income chargeable to tax. Hence, no analysis was undertaken for the software received free of cost”.

12. Thus, the assessee has reported as to why no T.P. analysis was undertaken for the distribution activity and has relied upon the provisions of section 92(3) of the Act. For the sake of clarity and ready reference, the provisions of section 92(3) are reproduced hereunder:

**“Section 92(3)**

(3) The provisions of this section shall not apply in a case where the computation of income under sub-section (1) [or sub-section (2A)] or the determination of the allowance for any expense or interest under [that sub-section], or the determination of any cost or expense allocated or apportioned, or, as the case may be, contributed under sub-section (2) [or sub-section (2A)], has the effect of reducing the income chargeable

to tax or increasing the loss, as the case may be, computed on the basis of entries made in the books of account in respect of the previous year in which the international transaction [or specified domestic transaction] was entered into.

13. Thus, from the recitals in the agreement, it can be seen that the intention of the parties is clear that the assessee shall be a distributor of AE's products in India. The Hon'ble Delhi High Court in the case of Sony Ericson Mobile Communications India (P) Ltd. v. CIT reported in (2015) , 374 ITR 118 (Del.) discussed the context and ruling in EKL Appliances Ltd, reported in 345 ITR 241 (Del.) to hold as follows:

*“CIT versus EKL Appliances Ltd - Disregarding actual transaction 147. Tax authorities examine a related and associated parties' transaction as actually undertaken and structured by the parties. Normally, tax authorities cannot disregard the actual transaction or substitute the same for another transaction as per their perception. Restructuring of legitimate business transaction would be an arbitrary exercise. This legal position stands affirmed in EKL Appliances Ltd. (supra). The decision accepts two exceptions to the said rule. The first being where the economic substance of the transaction differs from its form. In such cases, the tax authorities may disregard the parties' characterisation of the transaction and re-characterise the same in accordance with its substance. The second exception also mandates that the actual structure should practically impede the tax authorities from determining an appropriate transfer price.*

14. In the case before us, there is no difference between the form and substance of the transaction of distribution to recharacterise the transaction as a service agreement. As per the agreement, the AE is entitled to a specified percentage of the distributor's sales revenue less operating costs/expenses of the distributor. Since the assessee had no revenue left after reducing the operating cost/expenses, the AE was not paid any percentage. The revenue generated by selling the goods is retained by the assessee. The TPO has instead computed the mark up on the operating cost of the assessee to determine the ALP and brought the notional income to tax which is not justified. Therefore, the additional grounds of appeal are allowed.

15. As regards the applicability of the provisions of section 92(3), we find that the Hon'ble Delhi High Court has considered the issue at length in the case of Sony Ericson (cited Supra) and has held as under:

“140. Sub-section (3), we do not think incorporates a bar or prohibits set offs or adjustments. It states that [Section 92](#), which refers to computation of income from international transaction with reference to arm's length price under sub- section (2) or (2A), would not have the effect of reducing income chargeable to tax or increase the loss, as the as may be, computed by the assessee on the basis of entries in the books of account. Income chargeable to tax or loss as computed in the books is with reference to the previous year. The effect of sub- section is that the profit or loss declared, i.e. computed by the assessee on the basis of entries in the books of account shall not be enhanced or reduced because of transfer pricing adjustments under sub- section (2) or (2A) to [Section 92](#). It states the obvious and apparent. In case the assessee has declared better and more favourable results as per the entries in the books of account, then the income chargeable to tax or loss shall not be decreased or increased by reason of Transfer Pricing computation. Thus, transfer pricing adjustments do not enure to the benefit or advantage the assessed, thereby reducing the income declared or enhancing the declared loss. Pertinently, the Sub-Section makes reference to the income chargeable to tax or increase in the loss on the basis of the entries in the books of account. The concept of set off or adjustments was/is well recognized and accepted internationally and by the tax experts/commentators. In case the legislative intent behind sub-section (3) to [Section 92](#) was to deny set off, the same would have been spoken about and asserted in different and categorical words. Legislative intent to the contrary should not be assumed.”

16. Thus, section 92 provides for the computation of income from international transaction having regard to the Arm's Length Price. While sub-section (1) provides the necessary jurisdiction, sub-section (2) requires that the ALP should be understood to mean that the expenses or interest incurred by the non-resident should not be overlooked, i.e. the price charged by the non-resident abroad cannot be adopted as a base for Indian income without any further adjustments. Sub-section (3) lays down that where the assessee declared better and more favourable results as per its books of account, then by reason of TP adjustment, the income chargeable to tax shall not be decreased or the loss shall not be increased. In the case before us, it is the contention of the assessee that if the transaction is taken as distribution as agreed to between the parties, then the TP analysis would go to increase the loss. If the provisions of section 92(3) would apply, then the provisions of sub-sections (1) and (2A) of section 92 would not be attracted. Since, we have already held that the transaction is a distribution transaction and not service agreement, then the TP analysis has to be done afresh and then it has to be seen if the provisions of section 92(3) would apply.

17. In the result, the additional grounds of appeal raised by the assessee are allowed and AO/TPO is directed to conduct fresh TP analysis by treating the assessee's transaction as a distribution agreement and by determining the most appropriate method afresh and after allowing the necessary adjustments. If the loss declared by the assessee is increased by such TP study, then no TP adjustment can be made as provided in section 92(3) of the Act.

**5.** Since the facts and circumstances for this year are the same, respectfully following the decision of the Coordinate Bench to which, one of us, i.e. the JM is the signatory, assessee's appeal is treated as allowed for statistical purposes.

Order pronounced on 04<sup>th</sup> September 2020.

Sd/-

Sd/-

<b>(D.S. SUNDER SINGH) ACCOUNTANT MEMBER</b>	<b>(P. MADHAVI DEVI) JUDICIAL MEMBER</b>
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Hyderabad, dated 04<sup>th</sup> September, 2020.

*\*gmv*

Copy to:

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- 2 DCIT, Circle 1(2) Aayakar Bhavan, Hyderabad 500004
- 3 Director of Income Tax (IT & TP) Hyderabad
- 4 Pr. CIT – 1- Hyderabad
- 5 The DR, ITAT Hyderabad
- 6 Guard File