

**IN THE INCOME TAX APPELLATE TRIBUNAL
"A" BENCH : BANGALORE**

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

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| IT(TP)A No.2632/Bang/2019 |
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| Assessment year : 2012-13 |
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| M/s.ISG Novosoft Technologies Ltd., Second Floor, Maruthi Sapphire, No.128/9, Madiwala Machideva Road, Murugeshpalya, Bengaluru. PAN No. AABCI 2488 Q | Vs. | The Deputy Commissioner of Income Tax, Circle 3(1)(1), Room No.227, 2 nd Floor, BMTC Building, Koramangala, 6 th Block, Bangalore. |
| APPELLANT | | RESPONDENT |

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| Assessee by | : | Shri. Padamchand Khincha, CA |
| Revenue by | : | Ms.Neera Malhotra, CIT(DR)(ITAT), Bengaluru. |

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| Date of hearing | : | 21.01.2021 |
| Date of Pronouncement | : | 22.01.2021 |

ORDER

Per N.V. Vasudevan, Vice-President

This is an appeal by the Assessee against the order dated 1.10.2018 of DCIT-3(1)(1), Bengaluru, relating to AY 2012-13.

2. The grounds raised in the appeal by the Assessee are with regard to determination of Arm's Length Price (ALP). As far as the issue of determination of ALP of international transactions carried out by the assessee with its Associated Enterprise (AE) is concerned, the same is in respect of Information Technology Enabled Services (ITeS). During the previous year, the assessee rendered Information Technology Enabled Services [ITES] to its AE. As required under the provisions of section 92 of the Income Tax Act, 1961 (Act), income arising from international transaction with AE has to be computed having regard to the arm's length price [ALP].

3. 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/Operating Cost (OP/OC) as the Profit Level Indicator (PLI) for the purpose of comparison. The OP/OC of the Assessee was arrived at 17.48% by the Assessee in its TP study. The operating income was Rs.94,37,10,000/-and the Operating Cost was Rs.80,32,95,000/-. The Operating profit (Operating income – Operating cost was Rs.14,04,15,000/-. Thus the OP/TC was arrived at 17.48%. The Assessee chose companies who are engaged in providing similar services such as the Assessee. The Assessee identified companies whose average arithmetic mean of profit margin was comparable with 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 Transfer Pricing Officer (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 database. The TPO on his own identified companies as comparable with the Assessee company and worked out the average arithmetic mean of their profit margins as follows:

| Sl. No. | Name of the Case | Operating Income | Operating Cost | OP/OC |
|----------------|---------------------------------------|-------------------------|-----------------------|--------------|
| 1. | Accentia Technologies Ltd. | 126,38,02,000 | 112,89,16,000 | 11.75 |
| 2. | Universal PrintSystems Ltd.(Seg)(BPO) | 6,17,67,000 | 3,87,49,000 | 52.46 |
| 3. | Informed Technologies India Ltd., | 1,96,36,431 | 1,82,45,770 | 6.08 |
| 4. | Infosys B P 0 Ltd. | 1316,75,11,974 | 962,91,06,964 | 36.30 |

| | | | | |
|-----|--|---------------|---------------|---------------|
| 5. | Jindal Intellicom Ltd. | 30,27,51,875 | 30,29,02,990 | 0.05 |
| 6. | Microgerietic Systems Ltd. | 1,29,93,217 | 1,08,63,390 | 19.61 |
| 7. | T C S E-Serve Ltd. | 15,78,44,000 | 9,64,28,000 | 63.69 |
| 8. | B N R Udyog Ltd.(Seg)(Medical Transcription) | 1,47,04,000 | 97,87,000 | 50.61 |
| 9. | Excel InfowaysLtd.(Seg)(IT/B VPO) | 790,96,95,000 | 559,06,04,000 | 29.79 |
| 10. | e4e Healthcare Services Pvt Limited | 89,50,04,209 | 74,59,23,078 | 19.85 |
| | Average PLI | | | 28.11% |

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

“12.4 Computation of Arm's Length Price:

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

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|--|-----------------------|
| <i>Arm's Length Mean Margin on cost</i> | <i>28.11%</i> |
| <i>Less: Working Capital Adjustment (As per Annex. C)</i> | <i>-3.17%</i> |
| <i>Adjusted margin</i> | <i>31.21%</i> |
| <i>Operating Cost</i> | <i>80,32,95,000</i> |
| <i>Arms Length Price(ALP)</i> | <i>1,05,45,65,676</i> |
| <i>131.28% (of Operating Cost)</i> | |
| <i>Price Received</i> | <i>90,10,93,000</i> |
| <i>Shortfall being adjustment u/s 92CA:</i> | <i>15,34,72,676</i> |
| <i>5% of price received</i> | <i>4,50,54,650</i> |
| <i>Since the shortfall is exceeding 5% of the International Transaction, adjustment is made</i> | |

Thus, a sum of Rs.15,34,72,676/- 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 gave certain directions to exclude 3 comparable companies chosen by the TPO. Based on the directions of the DRP, the AO passed the final order of assessment. To the extent the Assessee did not get relief from the DRP, the Assessee preferred appeal before the Tribunal.

7. Aggrieved, the Assessee filed an appeal against the final order of the AO. The Hon'ble Tribunal vide its order in IT (TP) A No. 244 (Bang) 2017 dated 28.07.2017 remanded back to the AO/TPO with the following direction:-

7. We have considered the rival submissions. First of all, we reproduce para-33 of the judgment of the Hon'ble Delhi High Court rendered in the case of Chryscapital Investment Advisors (India) Private Limited (Supra) as under:-

"33. Such being the case, it is clear that exclusion of some companies whose functions are broadly similar and whose profile in respect of the activity in question can be viewed independently from other activities cannot be subject to a per se standard of loss making company or an abnormal profit making concern or huge or mega turnover company. As explained earlier, Rule 108 (2) guides the six methods outlined in clauses (a) to (f) of Rule 108(1), while judging comparability. Rule 108(3) on the other hand, indicates the approach to be adopted where differences and dissimilarities are apparent. Therefore, the mere circumstances of a company otherwise conforming to the stipulations in Rule 10B(2) in all details, presenting a peculiar feature such as a huge profit or a huge turnover, ipso facto does not lead to its exclusion. The TPO first has to be satisfied that such differences do not materially affect the price or cost. Secondly, an attempt to make reasonable adjustment to eliminate the material effect to such differences has to be made".

8. In the present case, the assessee is requesting for exclusion of 5 comparable companies on account of high turnover i.e., More than 10 times of the turnover of

the assessee company and on this basis, the assessee is requesting exclusion of 2 companies i.e., Infosys BPO Limited and TCS e4e Healthcare Business Services Private Limited (Supra). The assessee is also requesting for exclusion of 3 comparable companies on the basis of low turnover i.e., less than 1/10th turnover of assessee company and these companies are;

- 1) Informed Tech. India Limited*
- 2) Microgenetic Systems Limited*
- 3) BNR Udyog Limited*

As per the judgment of the Hon'ble Delhi High Court rendered in the case of Chryscapital Investment Advisors (India) Private Limited (Supra), the matter should go back to the file of the AO/TPO to examine these aspects as to whether the difference in turnover is affecting the price or cost and this attempt is also to be made regarding reasonable adjustment to eliminate the material effect of such difference in turnover and thereafter only, any comparable can be excluded on the basis of turnover filter i.e., whether high turnover or low turnover. We also feel that when the matter is to be re-decided by the AO, he will examine this claim of this assessee also that there is margin computation error in respect of 2 comparables i.e., M/s Accentia Tech. Limited and M/s e4e Healthcare Business Services Private Limited. On both these issues, we restore the matter back to the file of the AO/TPO for fresh decision as per the above discussion, after providing adequate opportunity of being heard to the assessee.

9. In the result, the appeal of the assessee stands allowed for statistical purposes.

8. Further vide its order in M.P. No. 250/Bang/2017 in IT (TP) A No. 244/Bang 22017 dated 15.12.2017, the Hon'ble ITAT Bangalore gave the following direction:-

We have considered the rival submissions. We find that at the time of hearing of the appeal, the Id. AR of assessee has filed a chart and the appeal was heard on the basis of chart. In the said chart, the contentions are raised regarding margin computational error in the respect of two comparables i.e., Accentia Technologies Ltd. and e4e Healthcare Business Private Limited and for the remaining four comparables, the only contention raised was regarding turnover filter and there is no contention raised regarding the functionality aspect. Hence on this aspect, we find no apparent mistake in the impugned Tribunal order because it appears that no argument was made in respect of this aspect.

Regarding the second aspect i.e. regarding Foreign Exchange fluctuation gain/loss, in the chart, several judgements are cited by id. AR of assessee but in the impugned Tribunal order although ground no. 9 is reproduced by the Tribunal on page no. 4 of the Tribunal order, there is no decision on this aspect and therefore, this is an apparent mistake in the impugned Tribunal order. I-fence we decide this aspect as per ground no. 9 raised before the Tribunal. We find that the details regarding foreign gain/ loss is not available on record as to whether the gain/loss is in respect of turnover of the present year or it is in respect of the turnover of an earlier year. In respect of computation of ALP, profit margin percentage is worked out by

dividing the operating profit of the tested party by the turnover of the tested party and therefore, if the foreign exchange gain/loss is not in respect of turnover of the present year, then such gain/loss cannot be considered for computing the profit percentage even after holding the same as operating profit/loss because if the corresponding turnover is not a part of the denominator, the profit in respect of such turnover cannot be included in the numerator because if this is done, it will give an absurd result. Hence we feel it proper to restore back this matter to the file of AO/TPO for fresh decision after examining this aspect and we hold that if the foreign exchange gain/loss is in respect of the present year turnover then the same should be considered as profit/loss of the current year for working out the profit percentage of the tested party but if such foreign exchange gain/loss is not in respect of current year turnover then the same should be considered in the case of tested party. Similarly, in the case of comparable companies also, if there is any foreign exchange gain/loss and this information is available in the annual report of the concerned company as to whether the fluctuation gain/loss is in respect of the current year turnover or earlier year turnover then the same treatment should be given to foreign exchange gain/loss in case of comparable company also but if such information is not available in the annual report of such company then it should be taken as foreign gain/loss in respect of earlier year's turnover because in most of the cases, such foreign exchange gain/loss is in respect of turnover of the earlier year because any gain/loss on account of foreign exchange difference for current year turnover is generally included in sale proceeds and is not shown separately in the final accounts. The AO/TPO should decide this issue afresh as per above discussion after providing reasonable opportunity of being heard to assessee. Ground no.9 of the assessee's appeal stands allowed for statistical purposes.

9. Pursuant to the above, the TPO passed order dated 01 October 2018 giving effect to the order of the Hon'ble ITAT. In this order, the TPO considered foreign exchange gain as part of the operating profits of the Assessee for the purpose of comparing Assessee's profit margin with that of comparable companies. The TPO in this order made an adjustment of INR 14,30,29,841 in relation to the ALP of international transaction of provision of IT enabled services was re-determined. Based on this order of the TPO the AO issued a draft assessment order on which the assessee filed objections before DRP.

10. On objection by the Assessee to the order of the TPO/AO the DRP excluded BNR Udyog Ltd., from the list of comparable companies. Therefore only 6 out of the 10 comparable companies remained as comparable companies after the order of the DRP. In this appeal the Assessee seeks only two reliefs viz., (i) exclusion of two comparable

companies Infosys BPO Ltd., and TCS e-Serve Ltd. (having turnover of Rs.1312.14 Crores and Rs.1578.44 Crores respectively) and (ii) delete the addition to the average arithmetic mean margin of comparables negative working capital at -1.34% thereby increasing the average arithmetic mean profit margins of comparable companies to that extent.

11. As far as excluding the companies on the basis of turnover is concerned, the issue has been settled in several decisions of the Tribunal and has been elaborately discussed by this Tribunal in the case of *Autodesk India Pvt. Ltd. v. DCIT in IT(TP)A No.540 & 541/Bang/2013, order dated 06.07.2018*. The Tribunal in this decision after review of entire case laws on the subject, considered the question, whether companies having turnover more than 200 crores upto 500 crores has to be regarded as one category and those companies cannot be regarded as comparables with companies having turnover of less than 200 crores, the Tribunal held as follows:-

“17.7. We have considered the rival submissions. The substantial question of law (Question No.1 to 3) which was framed by the Hon'ble Delhi High Court in the case of Chryscapital Investment Advisors (India) Pvt. Ltd., (supra) was as to whether comparable can be rejected on the ground that they have exceptionally high profit margins or fluctuation profit margins, as compared to the Assessee in transfer pricing analysis. Therefore as rightly submitted by the learned counsel for the Assessee the observations of the Hon'ble High Court, in so far as it refers to turnover, were in the nature of obiter dictum. Judicial discipline requires that the Tribunal should follow the decision of a non-jurisdiction High Court, even though the said decision is of a non-jurisdictional High Court. We however find that the Hon'ble Bombay High Court in the case of CIT Vs. Pentair Water India Pvt. Ltd. Tax Appeal No.18 of 2015 judgment dated 16.9.2015 has taken the view that turnover is a relevant criterion for choosing companies as comparable companies in determination of ALP in transfer pricing cases. There is no decision of the jurisdictional High Court on this issue. In the circumstances, following the principle that where two views are available on an issue, the view favourable to the Assessee has to be adopted, we respectfully follow the view of the Hon'ble Bombay High Court on the issue. Respectfully following the aforesaid decision, we uphold the order of the DRP excluding 5 companies from the list

of comparable companies chosen by the TPO on the basis that the 5 companies turnover was much higher compared to that the Assessee.

17.8. In view of the above conclusion, there may not be any necessity to examine as to whether the decision rendered in the case of Genisys Integrating (supra) by the ITAT Bangalore Bench should continue to be followed. Since arguments were advanced on the correctness of the decisions rendered by the ITAT Mumbai and Bangalore Benches taking a view contrary to that taken in the case of Genisys Integrating (supra), we proceed to examine the said issue also. On this issue, the first aspect which we notice is that the decision rendered in the case of Genisys Integrating (supra) was the earliest decision rendered on the issue of comparability of companies on the basis of turnover in Transfer Pricing cases. The decision was rendered as early as 5.8.2011. The decisions rendered by the ITAT Mumbai Benches cited by the learned DR before us in the case of Willis Processing Services (supra) and Capgemini India Pvt. Ltd. (supra) are to be regarded as per incurium as these decisions ignore a binding co-ordinate bench decision. In this regard the decisions referred to by the learned counsel for the Assessee supports the plea of the learned counsel for the Assessee. The decisions rendered in the case of M/S.NTT Data (supra), Societe Generale Global Solutions (supra) and LSI Technologies (supra) were rendered later in point of time. Those decisions follow the ratio laid down in Willis Processing Services (supra) and have to be regarded as per incurium. These three decisions also place reliance on the decision of the Hon'ble Delhi High Court in the case of Chriscapital Investment (supra). We have already held that the decision rendered in the case of Chriscapital Investment (supra) is obiter dicta and that the ratio decidendi laid down by the Hon'ble Bombay High Court in the case of Pentair (supra) which is favourable to the Assessee has to be followed. Therefore, the decisions cited by the learned DR before us cannot be the basis to hold that high turnover is not relevant criteria for deciding on comparability of companies in determination of ALP under the Transfer Pricing regulations under the Act. For the reasons given above, we uphold the order of the CIT(A) on the issue of application of turnover filter and his action in excluding companies by following the ratio laid down in the case of Genisys Integrating (supra).”

12. In the light of the aforesaid decision of the Tribunal, we exclude the two comparable companies Infosys BPO Ltd., and TCS e-Serve Ltd. (having turnover of Rs.1312.14 Crores and Rs.1578.44 Crores respectively) by application of the turnover filter. The Assessee's turnover is only Rs.94 crores (less than 100

crores and less than 1/10th of the turnover of the aforesaid two comparable companies. Therefore the aforesaid two companies are directed to be excluded from the list of comparable companies. Grd. No.2(c) is accordingly allowed.

13. As far as Gr.No.2(d) is concerned, the same is with regard to grant of negative working capital adjustment. With regard to this ground regarding grant of negative working capital, the Id. counsel for the assessee has placed reliance on the decision of the coordinate Bench in the case of *DCIT v. M/s. Software AG Bangalore Technologies P. Ltd.*, IT(TP)A No.1628/Bang/2014, order dated 31.03.2016 wherein it was held that negative working capital should not be computed and adjusted. The Id. DR relied on the decision of the Coordinate Bench in the case of *Technotree Convergence P. Ltd. v. DCIT in IT(TP)A No.1616/Bang/2017*, order dated 27.06.2018 wherein it was held that negative working capital should be allowed.

14. On this issue, we are of the view that working capital adjustment is made for the time value of money lost when credit period is given to customers. It is the submission of the Id. counsel for the assessee in this case that the assessee is a captive unit which is entirely funded by the AE. The assessee has no borrowings and is fully compensated by the parent on a total cost plus. The assessee has no working capital risk - in other words, it is a risk-insulated service provider to the parent. The only customer of the company is its parent company. The Id. counsel for the assessee has relied on a host of ITAT decisions, the main decision being that of *M/S. Software AG Bangalore Technologies Pvt. Ltd.(supra)* which in turn has relied on the decision of ITAT Hyderabad in the case of *Adaptec (India) Private Limited* and contended that no negative working capital adjustment is called for. The Id.DR's reliance is on the decision in the case of *Technotree Convergence P. Ltd. (supra)* wherein it was held that negative working capital adjustment has to be allowed.

15. Comparables chosen operate under varied economic conditions. Therefore, while comparing a company to that of similar companies, it is necessary to undertake comparability adjustments. **Balance sheet adjustments are intended to account for**

different levels of inventories, receivables, payables, interest rates etc. The most common balance sheet adjustments made to reflect different levels of accounts receivable, account payable and inventory are known as working capital adjustments. As mentioned by the OECD, comparability adjustments should not be performed on a routine or mandatory basis but rather on a case by case basis depending on the facts and circumstances. **Economic rationale of Working capital of a business is the capital used in its day-to-day trading operations. Working capital is affected by numerous business incidences. It is very common for tested party and each of the potential comparables to differ materially in the amount of working capital (inventory, accounts receivables and payable). Such differences are mainly caused due to differences in the terms of purchase and sale, levels of inventory etc. For example: If the business advances a trade credit of (say) 60 days, its cash gets locked up for 60 days and reduces the working capital. It will have to borrow from open market to meet its working capital requirement, and hence incur expenses. Similarly, if it avails of trade credit of 60 days, it has surplus cash at its disposal. It will need to borrow less money to fund operational requirements. Hence, working capital position affects the additional cost incurred by a business by way of interest on borrowing from the open market. Working capital adjustments seeks to adjust for the differences in time value of money between tested parties and potential comparables with an assumption that differences should be reflected in profits Working capital adjustment has a strong rationale in economic theory.** It facilitates to increase the comparability between the tested party and comparables working in an industry which is competitive. Working capital adjustment can work out to be positive or negative. A positive working capital adjustment (WCA) will tend to reduce the arm's length PLI while a negative WCA will tend to increase the arm's length PLI.

16. We find that the facts of the Assessee's case are similar to that of the case of the Bangalore ITAT in the case of *M/S.Software AG Bangalore Technologies Pvt.Ltd.* and therefore we are inclined to delete the negative working capital adjustment. In

determining ALP under TNMM, the correct approach would be to look at the costs incurred by the assessee only and should not impute any additional cost as done by TPO, which indirectly enhances the ALP artificially. The contrary view expressed in decision cited by the learned DR takes the view that Working capital adjustment is required in all cases as any credit extended to customers will result in cash locked up and will result in the assessee borrowing money from the banks and incur additional cost towards interest on these borrowings which cost will have effect on the price charged. It is the reasoning in these decisions that under TNM method that every ingredient of profit margins of comparable companies are analysed, whether it is positive or negative. The decision proceeds on the basis of effect on price owing to working capital requirement. We are of the view that working capital adjustment itself is computed on the basis of outstanding current assets and liabilities at the year end. It means that other things being equal, an entity having higher working capital will incur more interest cost which will reduce profitability. Hence no importance shall be given to pricing aspect. Since the assessee does not have any working capital risk, the question of negative working capital does not arise.

17. The TPO is directed to compute the ALP in the light of the directions as given above, after affording Assessee opportunity of being heard. No other grounds were pressed for adjudication except the aforesaid two issues.

18. In the result, appeal of the Assessee is partly allowed.

Pronounced in the open court on the date mentioned on the caption page.

Sd/-
(B.R.BASKARAN)
Accountant Member

Sd/-
(N.V. VASUDEVAN)
Vice-President

Bangalore,
Dated, the 22nd January, 2021.

/NS/*

Copy to:

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

By order

Assistant Registrar
ITAT, Bangalore.