

**IN THE INCOME TAX APPELLATE TRIBUNAL
“C” BENCH : BANGALORE**

**BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENT
AND
Ms. PADMAVATHY S, ACCOUNTANT MEMBER**

IT(TP)A No.339/Bang/2022
Assessment year : 2011-12

Walvoil Fluid Power India Pvt. Ltd., No.19, 2 nd Cross, 2 nd Main, KIADB Attibele Industrial Area, Attibele, Anekal Taluk, Bengaluru – 562 107. PAN: AAACW 5954E	Vs.	The Deputy Commissioner of Income Tax, Circle 7(1)(2), Bengaluru.
APPELLANT		RESPONDENT

Appellant by	:	Shri R.E. Balasubramaniyan, CA
Respondent by	:	Dr. Shankar Prasad, K., Addl. CIT-DR

Date of hearing	:	07.09.2022
Date of Pronouncement	:	14.09.2022

ORDER

Per Padmavathy S., Accountant Member

This appeal is against the final order of the AO passed u/s. 143(3) r.w.s. 144C(13) of the Income-tax Act, 1961 [the Act] dated 28.01.2022 for the assessment year 2011-12 on the following grounds:-

- “1. That the order of the Ld. AO insofar as it is prejudicial to the interests of the Appellant is opposed to law and facts of the case.*
- 2. That in the calculation of ALP the Ld. AO erred in including entities such as M/s DHP India Ltd and the Sundram Bleistahl*

Limited which are functionally incomparable with the Assessee.

3. *That the Ld. AO erred in including Sundaram Bleistahl Limited as a comparable entity even though the Related party transactions of the said company exceeds the accepted limits for reasonable comparison for ascertaining the ALP.*
4. *That the Operating Margin of Assessee computed by the Ld. AO is erroneous inasmuch as he has not made the same adjustments to the financial results of the Assessee as he has made for the comparable entities.*
5. *That in the Computation of the ALP, Ld. AO erred in not considering the adjustments to the respective Working Capital position of the Assessee and the Comparable Entities.”*

2. The assessee is a wholly owned subsidiary of Walvoil Group SpA, Italy and is engaged in the manufacture of Hydraulic valves and components used mainly in the construction and earth moving segments. The assessee company filed its return of income for AY 2011-12 on 30/09/2011 declaring total income of Rs. 4,84,08,820 before set off of brought forward loss and NIL income after setting off the brought forward loss. The case was selected for scrutiny and a notice u/s.143(2) was duly served on the assessee. The AO referred the case to Transfer Pricing Officer (TPO), as assessee 's international transaction exceeded Rs. 15 crore to determine the Arm's Length Price [ALP]. The TPO vide his order dated 29/01/2015 made an adjustment to the extent of Rs. 1,95,15,654/- in the ALP by recomputing the operating margins of the assessee. While making the TP adjustment the TPO included two more comparables, did not consider working capital adjustment and also made an adjustment to the operating margins of the assessee which resulted in the above TP adjustment.

3. Based on TPO's order, the AO passed a Draft Assessment order dated 16/03/2015 u/s. 143(3) r.w.s 144C of the Act incorporating the adjustment to the ALP. The AO in addition to the TP adjustments also made a disallowance towards tools claimed as revenue expenditure u/s.37(1) by the assessee, but allowed the depreciation on the same treating it as capital in nature. The assessee filed its objections before the DRP and the DRP confirmed the TP adjustments made by the TPO. Consequently, the AO passed assessment order u/s. 143(3) r.w.s 144C of the Act. Aggrieved by the final assessment order the assessee filed appeal before the Tribunal. The Tribunal vide order dated 18.02.2020 in IT(TP)A No.685/Bang/2016 remitted the issue pertaining to exclusion/inclusion of comparables to the file of the DRP on the ground that the DRP has passed a non-speaking order about the objections raised by the assessee with a direction to adjudicate / verify comparables qua filters finally selected by the TPO. The Hon'ble ITAT set aside the order of the AO accordingly and directed the AO to pass the final assessment order again once the DRP re-adjudicates the matter. With regard to disallowance made towards the tools the issue was remanded to the AO by the Hon'ble ITAT and the AO passed the order giving effect dated 26.09.2021 which has become final.

4. In the remand proceedings the DRP confirmed the inclusion of comparables done by the TPO. In the final assessment order the original TP adjustment was retained as it is since the DRP in the remand proceedings confirmed the comparables and in the original DRP order the working capital adjustment and adjustment to margins were confirmed the DRP. The assessee is in appeal once again against

the final assessment order passed by the AO as per the revised directions of the DRP.

Exclusion of certain comparables

5. As per the TP study of the assessee during the year under consideration the assessee's purchases from AE constituted 42% and sales to AE was 9%. The assessee has chosen Transaction Net Margin Method (TNMM) as the most appropriate method for computation of ALP. Operating Profit / Operating Cost is the Profit Level Indicator. The assessee chose 4 comparables whose average margin was at 8.77% and since the operating margin of the assessee was at 7.10%, the assessee concluded that the international transactions are at arm's length. The TPO added two more comparables i.e. Sundram Bleistahi Ltd., DHP India Ltd and arrived at the operating margin of 17.51%. The TPO also did not consider the working capital adjustment and excluded the interest paid as the non-operating expense. The entire TP adjustment was confirmed by the DRP in the first round. The ITAT remanded the issue of comparables back to the DRP and the DRP in the remand proceedings confirmed the two additional comparables added by the TPO.

6. The Id AR made the following submissions with regard to the comparables.

DHP India Limited

The company manufactures Propane regulators, Butane regulators, LPG regulators, Hose assemblies and Brass fittings. These are used ONLY for allowing or restricting the passage of gases through a tube or confined space for domestic or very light industrial purposes. The

company is functionally different from the assessee which is in the business of manufacture of Hydraulic valves and components used mainly in the construction and earth moving segments. Therefore the company cannot be included as a comparable

Sundram Bleistahl Limited

The company manufactures Engine Valve Guides and Blanks, which are used in holding and positioning the valves, which in turn are found in automotive applications, such as engines of cars, trucks, buses and lorries. A valve guide is a cylindrical piece of metal, pressed or integrally cast into the cylinder head. Guides also serve to conduct heat from the combustion process out from the exhaust valve and into the cylinder head where it may be taken up by the cooling system. They are primarily parts of Internal Combustion (IC) engines and have no relation to the mobile control valves manufactured by the assessee. In addition to functional dissimilarities, SBL is also having related party transactions which is above the acceptable limits for a meaningful comparison. SBL has a RPT ratio of 29.84% and thus to be excluded from the list of comparables.

7. We have considered the rival submissions and perused the material on record. The assessee followed TNMM as the Most Appropriate Method [MAM] for the determination of ALP. Before going into the merits of this case, we will first look into the legal position with regard to the TNMM used for determining the ALP between the AEs. The Transfer Pricing Regulations (i.e. Section 92C of the Act, read with rule 10B of the Income-tax Rules) as well as the OECD Transfer Pricing Guidelines provide the 5 common transfer

pricing methods for evaluating the related party transactions undertaken between entities. Of these TNMM is the most common method that is used for determining the arm's length nature of transactions. It compares the operating/ net margins of companies to analyse if the related party transactions have been undertaken on an arm's length basis. Rule 10B (1) (d) states as under:

"10B . (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction [or a specified domestic transaction] shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—

** ** *

(e) transactional net margin method, by which,—

(i) the net profit margin realised by the enterprise from an international transaction [or a specified domestic transaction] entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction [or the specified domestic transaction] ;"

(2) For the purposes of sub-rule (1), the comparability of an international transaction [or a specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following, namely:—

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail.

8. Considering the above, we will now look into the inclusion and exclusion of comparables sought by the assessee. The products manufactured by **DHP India Limited** are basically regulators used for allowing or restricting the passage of gases through a tube or confined space for domestic or very light industrial purposes. Though under TNMM the level of comparability is at a broad level of product comparability and high level functional comparability other factors like assets employed, risk assumed also needs consideration. In the case of DHP India Limited, the product manufactured is regulators are different from what the assessee is manufacturing which is hydraulic valves. Further the company supplies the products for usage in domestic gas cylinders which would have a different risk profile and

the assets employed would also be different from that of the assessee. Sub rule (2) of rule 10B provides that the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to functions performed, assets employed, risk assumed, market size etc. Therefore in our considered view, DHP India limited cannot be considered as comparable since the company products, functions, assets and risk (FAR) is different from that of the assessee.

9. The next comparable Sundram Bleistahl Limited (SBL) is mainly manufacturing Engine Valve Guides and Blanks. It is submitted that a valve guide is nothing but a device that holds the valve in its place just as a bookshelf or a coat stand holds books and coats in proper position. On perusal of the records, it is noticed that the products manufacture by SBL are different from the Hydraulic Valves manufactured by the assessee. The product manufactured by SBL is a component of the valve, whereas what the assessee is manufacturing is an equipment which is the hydraulic valves. The FAR of the assessee and SBL is different considering the fact there is no product level comparison. Further we see merit in the argument of the Id AR that SBL is having related party transactions i.e. @ 29.84% which is above the acceptable limits for a meaningful comparison which is substantiated by the details submitted by the Id AR in pg 5 of paper book. Sub rule (2) of rule 10B provides that the comparability of an international transaction with an uncontrolled transaction shall be judged with reference to functions performed, assets employed, risk

assumed, market size etc. Therefore in our considered view, SBL cannot be considered as comparable since the company products, functions, assets and risk (FAR) is different from that of the assessee

10. The next issue in ground No.6 raised by the assessee is relating to exclusion of working capital adjustment while computing the ALP. We notice that the this Tribunal in assessee's own case (*supra*), has decided this issue in favour of the assessee with the following observations:-

“26. In the case of Nagravisision India (P.) Ltd., (*supra*), the Tribunal held that the working capital adjustment should be allowed. For holding so, the Tribunal has followed the decision rendered by another Bench in the case of Huawei Technologies (India) (P.) Ltd. v. Jt. CIT [2019] 101 taxmann.com 313 (Bang. - Trib.). The decision rendered in the case of Huawei Technologies (India) (P.) Ltd. (*supra*) are extracted below:—

'10. The next grievance projected by the Assessee in its appeal is with regard to the action of the CIT (A) in not allowing any adjustment towards working capital differences. On this issue we have heard the rival submissions. The relevant provisions of the Act in so far as comparability of international transaction with a transaction of similar nature entered into between unrelated parties, provides as follows:

Determination of arm's length price under section 92C.

10B. (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction [or a specified domestic transaction] shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely ;—

(a) to (b)** ** **

(e) transactional net margin method, by which,—

(i) the net profit margin realised by the enterprise from an international transaction [or a specified domestic transaction] entered into with an associated enterprise is computed in relation to

costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction [or the specified domestic transaction] and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction [or the specified domestic transaction];

(f)** ** *

(2) For the purposes of sub-rule (1), the comparability of an international transaction [or a specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following, namely:—

(a) the specific characteristics of the property transferred or services provided in either transaction;

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic

development and level of competition and whether the markets are wholesale or retail.

(3) An uncontrolled transaction shall be comparable to an international transaction [or a specified domestic transaction] if—

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

11. A reading of Rule 10B(l)(e)(iii) of the Rules read with Sec. 92CA of the Act, would clearly shows that the net profit margin arising in comparable uncontrolled transactions has to be adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, which could materially affect the amount of net profit margin in the open market.

12. Chapters I and III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter the "TPG") contain extensive guidance on comparability analyses for transfer pricing purposes. Guidance on comparability adjustments is found in paragraphs 3.47-3.54 and in the Annex to Chapter III of the TPG. A revised version of this guidance was approved by the Council of the OECD on 22 July 2010. In paragraph 2 of these guidelines it has been explained as to what is comparability adjustment. The guideline explains that when applying the arm's length principle, the conditions of a controlled transaction (i.e. a transaction between a taxpayer and an associated enterprise) are generally compared to the conditions of comparable uncontrolled transactions. In this context, to be comparable means that:

◆ None of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or

◆ Reasonably accurate adjustments can be made to eliminate the effect of any such differences. These are called "comparability adjustments.

13. In Paragraphs 13 to 16 of the aforesaid OECD guidelines, need for working capital adjustment has been explained as follows:

"13. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the immediate payment price. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.

14. The opposite applies to higher levels of accounts payable. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.

15. A company with high levels of inventory would similarly need to either borrow to fund the purchase, or reduce the amount of cash surplus which it is able to invest. Note that the interest rate July 2010 Page 6 might be affected by the funding structure (e.g. where the purchase of inventory is partly funded by equity) or by the risk associated with holding specific types of inventory)

16. Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables, with an assumption that the difference should be reflected in profits. The underlying reasoning is that:

◆ A company will need funding to cover the time gap between the time it invests money (i.e. pays money to supplier) and the time it collects the investment (i.e. collects money from customers)

◆ This time gap is calculated as: the period needed to sell inventories to customers + (plus) the period needed to collect money from customers - (less) the period granted to pay debts to suppliers."

14. Examples of how to work out adjustment on account of working capital adjustment is also given in the said guidelines. The guideline also expresses the difficulty in making working capital adjustment by concluding that the following factors have to be kept in mind (i) The

point in time at which the Receivables, Inventory and Payables should be compared between the tested party and the comparables, whether it should be the figures of receivables, inventory and payable at the year end or beginning of the year or average of these figures, (ii) the selection of the appropriate interest rate (or rates) to use. The rate (or rates) should generally be determined by reference to the rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. The guidelines conclude by observing that the purpose of working capital adjustments is to improve the reliability of the comparables.

15. In the present case the TPO allowed working capital adjustment accepting the calculation given by the Assessee. The CIT (A) in exercise of his powers of enhancement held that no adjustment should be made to the profit margins on account of working capital differences between the tested party and the comparable companies for the following reasons:

(i) The daily working capital levels of the tested party and the comparables was the only reliable basis of determining adjustment to be made on account of working capital because that would be on the basis of working capital deployed throughout the year.

(ii) Segmental working capital is not disclosed in the annual reports of companies engaged in different segments and therefore proper comparison cannot be made.

(iii) Disclose in the balance sheet does not contain break up of trade and non-trade debtors and creditors and therefore working capital adjustment done without such break up would result in computation being skewed.

(iv) Cost of capital would be different for different companies and therefore working capital adjustment made disregarding this different based on broad approximations, estimations and assumptions may not lead to reliable results.

16. The CIT (A) also placed reliance on a decision of Chennai ITAT in the case of Mobis India Ltd. v. Dy. CIT [2013] 38 taxmann.com 231/[2014] 61 SOT 40. That decision was based on the factual aspect that the Assessee was not able to demonstrate how working capital adjustment was arrived at by the Assessee. Therefore nothing turns on the decision relied upon by the CIT (A) in the impugned order. In the matter of determination of Arm's Length Price, it cannot be said that the burden is on the Assessee or the Department to show what is the Arm's Length Price. The data available with the Assessee and the Department would be the starting point and depending on the facts

and circumstances of a case further details can be called for. As far as the Assessee is concerned, the facts and figures with regard to his business has to be furnished. Regarding comparable companies, one has to fall back upon only on the information available in the public domain. If that information is insufficient, it is beyond the power of the Assessee to produce the correct information about the comparable companies. The Revenue has on the other hand powers to compel production of the required details from the comparable companies. If that power is not exercised to find out the truth then it is no defence to say that the Assessee has not furnished the required details and on that score deny adjustment on account of working capital differences. Regarding applying the daily balances of inventory, receivables and payables for computing working capital adjustment, the Delhi Bench of ITAT in the case of ITO v. E Value Serve.com [2016] 75 taxmann.com 195 (Delhi - Trib.) has held that insisting on daily balances of working capital requirements to compute working capital adjustment is not proper as it will be impossible to carry out such exercise and that working capital adjustment has to be based on the opening and closing working capital deployed. The Bench has also observed that that in Transfer Pricing Analysis there is always an element of estimation because it is not an exact science. One has to see that reasonable adjustment is being made so as to bring both comparable and test party on same footing. Therefore there is little merit in CIT (A)'s objection on working adjustment based on unavailable daily working capital requirements data. There is also no merit in the objection of the CIT (A) regarding absence of segmental details available of working capital requirements of comparable companies chosen and absence of details of trade and non-trade debtors of comparable companies as these details are beyond the power of the Assessee to obtain, unless these details are available in public domain. Regarding absence of cost of working capital funds, the OECD guidelines clearly advocates adopting rate(s) of interest applicable to a commercial enterprise operating in the same market as the tested party. Therefore this objection of the CIT (A) is also not sustainable.

17. In the light of the above discussion we are of the view that the CIT (A) was not justified in denying adjustment on account of working capital adjustment. Since, the CIT (A) has not found any error in the TPO's working of working capital adjustment, the working capital adjustment as worked out by the TPO has to be allowed. We may also add that the complete working capital adjustment working has been given by the Assessee and a copy of the same is at pages 173 & 192 of the Assessee's paper book. No defect whatsoever has been pointed out in these working by the CIT (A). We may also further add that in terms of rule 10B(1)(e) (iii) of the Rules, the net profit margin arising

in comparable uncontrolled transactions should be adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions which could materially affect the amount of net profit margin in the open market. It is not the case of the CIT (A) that differences in working capital requirements of the international transaction and the uncontrolled comparable transactions is not a difference which will materially affect the amount of net profit margin in the open market. If for reasons given by CIT (A) working capital adjustment cannot be allowed to the profit margins, then the comparable uncontrolled transactions chosen for the purpose of comparison will have to be treated as not comparable in terms of rule 10B(3) of the Rules, which provides as follows:

"(3) An uncontrolled transaction shall be comparable to an international transaction if-

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged to paid in, or the profit arising from, such transactions in the open market; or

(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences."

18. In such a scenario there would remain no comparable uncontrolled transactions for the purpose of comparison. The transfer pricing exercise would therefore fail. Therefore in keeping with the OECD guidelines, endeavor should be made to bring in comparable companies for the purpose of broad comparison. Therefore the working capital adjustment as claimed by the Assessee should be allowed. We hold and direct accordingly.'

27. Respectfully following the judicial pronouncement above we hold that the AO is not justified in denying the working capital adjustment to the assessee. We accordingly direct the AO to allow the working capital adjustment. The assessee appeal on this ground is allowed."

11. Following the above decision of this Tribunal, we direct the AO to allow the working capital adjustment to the assessee. This ground of the assessee is allowed.

12. The next ground pertains to the adjustment made to the operating margin of the assessee by considering the interest paid as non-operating expense. The Id AR contended that the TPO has excluded the interest paid as the non-operating cost while recomputing the operating profit of the assessee, whereas the similar adjustment is not made in the operating profit of the comparable companies which according to the Id AR is distorting the comparison and is not a consistent approach for comparison.

13. We heard the DR who supported the order of the lower authorities. The TPO in para 5 of the order has stated that the interest received is considered as non-operating for arriving at the operating margin of the assessee as well the comparables. On this ground the TPO has considered the interest paid also non-operating. However we notice that the TPO has excluded the interest paid from operating cost only for the assessee's computation of operating profit and did not carry out a similar adjustment for comparable companies. This in our considered view is not correct since the adjustment only to the assessee's operating margin and comparing the said margin with the comparables without making similar adjustment would give a distorted result. We therefore remit this issue back to the AO/TPO with a direction to consider adjustment in the computation of operating margin of both the assessee as well as the comparables. This issue is allowed in favour of the assessee for statistical purposes.

14. The TPO is directed to recalculate the ALP as per directions contained in this order.

15. In the result, the appeal by the assessee is allowed.

Pronounced in the open court on this 14th day of September, 2022.

Sd/-
(N V VASUDEVAN)
VICE PRESIDENT

Sd/-
(PADMAVATHY S)
ACCOUNTANT MEMBER

Dated, the 14th September, 2022.

/Desai S Murthy /

Copy to:

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

By order

Assistant Registrar
ITAT, Bangalore.