

IN THE INCOME TAX APPELLATE TRIBUNAL
"B" BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, JUDICIAL MEMBER
AND SHRI JASON P. BOAZ, ACCOUNTANT MEMBER

IT(TP)A No.1167/Bang/2010
Assessment year : 2006-07

M/s. Cypress Semiconductor Technology India Private Limited, # 65/2, 'Laurel', Bagmane Tech Park, Block 'C', C.V.Raman Nagar, Bangalore 560 093. PAN : AABCC 2470Q	Vs.	The Deputy Commissioner of Income-Tax, Circle 11(2), Bangalore.
APPELLANT		RESPONDENT

Appellant by	:	Shri T. Suryanarayan, Advocate
Respondent by	:	Shri Farahat Hussain Qureshi, CIT-II(DR)

Date of hearing	:	19.03.2015
Date of Pronouncement	:	27.03.2015

ORDER

Per N.V. Vasudevan, Judicial Member

This appeal by the assessee is against the order dated 12.10.2010 of the Deputy Commissioner of Income Tax, Circle 11(2), Bangalore passed u/s. 143(3) r.w.s. 144C of the Act relating to AY 06-07.

2. The Assessee is a leading supplier of high-performance solutions for personal, network access, enterprise, metro switch and core-communications system applications. It designs, manufactures and

markets silicon-based products and solutions for a range of markets. The Assessee, is a subsidiary of Cypress Semiconductor Technology Ltd., Cayman Island and is engaged in providing software development and testing services to its associated enterprises (AEs) as a captive service provider in the areas of integrated circuits for memory, interface and data communication applications. The above transaction was an international transactions with an Associated Enterprise (AE) and have to pass the Arm's Length Price (ALP) test as provided u/s.92 of the Income Tax Act, 1961 (Act). In this appeal the dispute is with regard to addition made consequent to determination of ALP and consequent upward revision and adjustment made to the price at which international transactions were carried out by the Assessee with its AE in respect of Software development Services.

3. Financial Results of Cyprus India for the F Y 2005-06

Description	Amount
Operating Revenue	Rs.46,66,89,135
Operating Cost	Rs.42,36,90,759/-
Operating Profit (PBIT)	Rs. 4,29,98,376/-
Operating Profit to Cost Ratio	10.15 %

4. Comparable ultimately selected by TPO and their arithmetic mean :

Sl. No	Name of company	OP / TC (FY 2006-07)	Sales (Rs.Cr.)
1	Aztec Software Limited	18.09	128.61
2	Geometric Software Limited (Seg.)	6.70	98.59
3	Infosys Ltd	40.38	9028.00
4	KALS Info Systems Limited	39.75	1.97
5	Mindtree Consulting Ltd	14.67	448.79
6	Persistent Systems Ltd.	24.67	209.18
7	R.Systems International Ltd. (Seg.)	22.20	79.42
8	Sasken Communications Ltd. (Seg.)	13.90	240.03
9	Tata Elxsi Ltd (Seg.)	27.65	188.81
10	Lucid Software Ltd	8.92	1.02
11	Mediasoft Solutions Ltd	6.29	1.76
12	R S Software (India) Ltd	15.69	91.57
13	S I P Technologies & Exports Ltd	3.06	6.53
14	Bodhtree Consulting Ltd.	15.99	5.32
15	Accel Transmatic Ltd. (Seg.)	44.07	8.02
16	Synfosys Business solutions Ltd.	10.61	4.49
17	Flextronics Software Systems Ltd.	27.24	595.12
18	Lanco Global Solutions Ltd	5.27	35.63
19	Megasoft Ltd	52.74	56.15
20	iGate Global solutions Ltd.(Seg.)	15.61	527.91
Arithmetic Mean		20.68%	
Appellant's OP / TC for FY 2006-07		10%	

5. The TPO finally passed an order u/s. 92CA of the Act and on the basis of the comparables set out above, arrived at arithmetic mean of 20.68%. After factoring negative working capital adjustment of 1.31%, the adjusted arithmetic mean was determined at 19.37%. The computation of the ALP by the TPO in this regard was as follows:-

“Computation of Arms Length Price:

The arithmetic mean of the Profit Level indicators is taken as the arms length margin. (Please see Annexure B for details of

computation of PLI of the comparables). Based on this, the arms length price of the software development services rendered by you is computed as under:

Arithmetic mean PLI	20.68%
Less: Working capital	
Adjustment(Annexure-C)	<u>1.31%</u>
Adj.Arithmetic mean PLI	<u>19.37%</u>

Arm's Length Price:

Operating Cost	Rs.42,36,90,759
Arms Length Margin	19.37% of the operating cost
Arms Length Price (ALP) At 119.37% of operating cost	Rs.50,57,59,659/-

Price received vis-à-vis the Arms Length Price:

The price charged by the tax payer to its Associated Enterprises is compared to the Arms Length Price as under:

Arms Length Price (ALP) At 119.37% of operating cost	Rs.50,57,59,659
Price charged in the international transactions	Rs.46,66,89,135
Shortfall being adjustment u/s.92CA	Rs.3,90,70,524

The above shortfall of Rs.3,90,70,524/- is treated as transfer pricing adjustment u/s 92CA.”

6. Against the said adjustment proposed by the TPO which was incorporated in the draft assessment order by the AO, the assessee filed objections before the DRP. The DRP rejected those objections and confirmed the transfer pricing adjustment suggested by the TPO. The adjustment confirmed by the DRP was added to the total income of the

assessee by the AO in the fair order of assessment. Against the said order of the Assessing Officer, the assessee has preferred the present appeal before the Tribunal.

7. The assessee filed a chart showing how the TPO has not given working capital adjustment as prayed for by the Assessee, the turnover and the margins of the 20 comparable companies finally chosen by the TPO after giving effect to adjustment towards working capital as allowed by the TPO and also as claimed by the Assessee. The Chart also explains as to how some of the comparable companies chosen by the TPO are not comparable for the reason that these companies were not functionally comparable. The Chart also gives the cases decided by various Benches of the ITAT where the comparable companies have been held to be not comparable with that of an Assessee providing IT Software development Services. The learned DR placed reliance on the order of the TPO/DRP. We will proceed to consider the comparability of companies chosen by the TPO and listed in para- 4 of this order.

8. The Id. counsel for the assessee brought to our notice that out of the 20 comparable companies chosen by the TPO, KALS Information Systems Limited and Accel Transmatic Ltd. are not functionally comparable with that of the Assessee. In this regard our attention was drawn to the decision of the Hon'ble ITAT Bangalore Bench in the case of Trilogy E-Business Software India Pvt.Ltd. Vs. DCIT ITA No.1054/Bang/2012 (AY 07-08)

wherein this company was held to be not functionally comparable with that of a pure software developer like the Assessee. The following were the relevant observations of the Tribunal on the aforesaid comparable companies in the case of Trilogy E-Business Software India Pvt.Ltd.(supra):

9. **Improper selection of comparables:** It was submitted by the learned counsel for the Assessee that the following companies are not functionally comparable with that of the Assessee.

- a) KALS Information Systems Limited
- b) Accel Transmission Limited.

10. In this regard our attention was drawn to the decision of the Hon'ble ITAT Bangalore Bench in the case of Trilogy E-Business Software India Pvt.Ltd. (supra) wherein these companies were held to be not functionally comparable with that of a pure software developer like the Assessee.

11. The following were the relevant observations of the Tribunal on the aforesaid comparable companies in the case of Trilogy E-Business Software India Pvt.Ltd.(supra):

“(d) KALS Information Systems Ltd.

As far as this company is concerned, the contention of the assessee is that the aforesaid company has revenues from both software development and software products. Besides the above, it was also pointed out that this company is engaged in providing

training. It was also submitted that as per the annual report, the salary cost debited under the software development expenditure was Q 45,93,351. The same was less than 25% of the software services revenue and therefore the salary cost filter test fails in this case. Reference was made to the Pune Bench Tribunal's decision of the ITAT in the case of *Bindview India Private Limited Vs. DCI*, ITA No. ITA No 1386/PN/IO wherein KALS as comparable was rejected for AY 2006-07 on account of it being functionally different from software companies. The relevant extract are as follows:

"16. Another issue relating to selection of comparables by the TPO is regarding inclusion of Kals Information System Ltd. The assessee has objected to its inclusion on the basis that functionally the company is not comparable. With reference to pages 185-186 of the Paper Book, it is explained that the said company is engaged in development of software products and services and is not comparable to software development services provided by the assessee. The appellant has submitted an extract on pages 185-186 of the Paper Book from the website of the company to establish that it is engaged in providing of IT enabled services and that the said company is into development of software products, etc. All these aspects have not been factually rebutted and, in our view, the said concern is liable to be excluded from the final set of comparables, and thus on this aspect, assessee succeeds."

Based on all the above, it was submitted on behalf of the assessee that KALS Information Systems Limited should be rejected as a comparable.

We have given a careful consideration to the submission made on behalf of the Assessee. We find that the TPO has drawn conclusions on the basis of information obtained by issue of notice u/s.133(6) of the Act. This information which was not available in public domain could not have been used by the TPO, when the same is contrary to the annual report of this company as highlighted by the Assessee in its letter dated 21.6.2010 to the TPO. We also find that in the decision referred to by the learned counsel for the Assessee, the Mumbai Bench of ITAT has held that this company was developing software products and not purely or mainly software development service provider. We

therefore accept the plea of the Assessee that this company is not comparable.”

“(e) Accel Transmatic Ltd.

48. With regard to this company, the complaint of the assessee is that this company is not a pure software development service company. It is further submitted that in a Mumbai Tribunal Decision of *Capgemini India (F) Ltd v Ad. CIT 12 Taxman.com 51*, the DRP accepted the contention of the assessee that Accel Transmatic should be rejected as comparable. The relevant observations of DRP as extracted by the ITAT in its order are as follows:

“In regard to Accel Transmatics Ltd. the assessee submitted the company profile and its annual report for financial year 2005-06 from which the DRP noted that the business activities of the company were as under.

(i) Transmatic system - design, development and manufacture of multi function kiosks Queue management system, ticket vending system

(ii) Ushus Technologies - offshore development centre for embedded software, net work system, imaging technologies, outsourced product development

(iii) Accel IT Academy (the net stop for engineers)- training services in hardware and networking, enterprise system management, embedded system, VLSI designs, CAD/CAM/BPO

(iv) Accel Animation Studies software services for 2D/3D animation, special effect, erection, game asset development.

4.3 On careful perusal of the business activities of Accel Transmatic Ltd. DRP agreed with the assessee that the company was functionally different from the assessee company as it was engaged in the services in the form of ACCEL IT and ACCEL animation services for 2D and 3D animation and therefore assessee’s claim that this company was functionally different was accepted. DRP therefore

directed the Assessing Officer to exclude ACCEL Transmatic Ltd. from the final list of comparables for the purpose of determining TNMM margin.”

49. Besides the above, it was pointed out that this company has related party transactions which is more than the permitted level and therefore should not be taken for comparability purposes. The submission of the Id. counsel for the assessee was that if the above company should not be considered as comparable. The Id. DR, on the other hand, relied on the order of the TPO.

50. We have considered the submissions and are of the view that the plea of the assessee that the aforesaid company should not be treated as comparables was considered by the Tribunal in *Capgemini India Ltd (supra)* where the assessee was software developer. The Tribunal, in the said decision referred to by the Id. counsel for the assessee, has accepted that this company was not comparable in the case of the assessee engaged in software development services business. Accepting the argument of the Id. counsel for the assessee, we hold that the aforesaid company should be excluded as comparables.”

12. The facts and circumstances under which the aforesaid companies were considered as comparable are identical in the case of the Assessee as well as in the case of Trilogy E-Business Software India Pvt.Ltd. (supra). Respectfully following the decision of the Tribunal referred to above in the case of Trilogy E-Business Software India Pvt.Ltd.(supra), we direct that KALS Information Systems Limited and Accel Transmatics Ltd., be excluded from the list of 20 comparable arrived at by the TPO.

13. As far as comparable Tata Elxsi Ltd., is concerned, the comparability of this company with that of the software service provider was considered by the Mumbai Bench of this Tribunal in the case of Logica

Pvt.Ltd. IT (TP) 1129/Bang/2011 (AY 07-08) wherein on the aforesaid company, the Tribunal held as follows:-

“14. As far as comparable at Sl.No.6 & 24 are concerned, the comparability of the aforesaid two companies with that of the software service provider was considered by the Mumbai Bench of the Tribunal in the case of *Telcordia Technologies India Private Ltd. (supra)* wherein on the aforesaid two companies, the Tribunal held as follows:-

“7.6 Flextronics Software Systems Ltd.

7.7.Tata Elxsi Limited.:

From the facts and material on record and submissions made by the learned AR, it is seen that the Tata Elxsi is engaged in development of niche product and development services, which is entirely different from the assessee company. We agree with the contention of the learned AR that the nature of product developed and services provided by this company are different from the assessee as have been narrated in para 6.6 above. Even the segmental details for revenue sales have not been provided by the TPO so as to consider it as a comparable party for comparing the profit ratio from product and services. Thus, on these facts, we are unable to treat this company fit for comparability analysis for determining the arms length price for the assessee, hence, should be excluded from the list of comparable parties.”

15. In view of the above, the Id. counsel for the assessee fairly admitted that comparable company at Sl.No.6 viz., Flextronics Software Systems Pvt. Ltd. should be taken as a comparable, while comparable at Sl.No.24 viz., Tata Elxsi Ltd. should be rejected as a comparable.”

14. In view of the aforesaid decision, we hold that Tata Elxsi has to be excluded from the list of comparable chosen by the TPO.

15. As far as the comparable chosen by TPO viz., Infosys Limited is concerned, it has been held by the co-ordinate bench of ITAT Bangalore in the case of Logica Pvt.Ltd. Vs. ACIT ITA No.1129/Bang/2011 (AY 07-08) that this company is a full fledge risk assuming entrepreneur, holds technology and marketing intangible and is functionally different providing end-to-end solutions encompassing technical consulting, design, development, re-engineering, maintenance, systems integration and package evaluation and implementation. The company generates around 3.96% of its revenue from software products. The relevant observations of the Tribunal in the case of Logical Pvt. Ltd. (supra) were as follows:

“13. So also, the comparables listed at Sl.Nos. 10, 14 and 26 have to be rejected as functionally not comparable with that of the assessee in view of the decision of the Mumbai Bench of the Tribunal in the case of *Telcordia Technologies India Private Ltd. in ITA No.7821/MUM/2011*, wherein it was held as under:-

“7.2 Lucid Software Limited

.....

.....

7.4 Infosys Technologies Ltd.:

The parameter for identifying comparable entity has to be seen from the angle of functions formed by the company, size of the company in terms of the sale revenue, stage of business cycle and company's growth cycle. In the case of Infosys, there are huge intangible assets which as per the information provided by the learned AR are valued at Rs.69,522 crores, which comprises of brand value itself at Rs.22,915 crores. Based on such fund valuation, the profit of Infosys is predominantly due to its premium branding. It is India's No.2 software service exporter and Third in the

World as an IT Service company. It is a giant company which is evident from its revenue fund from the sales which itself is more than Rs.13145 crores and expenditure on advertisement/sales promotion and expenditure on R&D is at Rs.69 crores and Rs.167 crores respectively, whereas in the case of the assessee the revenue is only 10.7 crores with no expenditure on advertisement, sales and promotion etc., which are borne by the associated enterprises. Even from the test of 'FAR' ie. function performed, assets employed and risk assumed, comparability analysis miserably fails in this case. The comparison of function and profile as has been reproduced in para 6(iv) above, mostly shows that the profit level indicators in relation to return of cost, return of sales and return of assets are huge between Infosys and the assessee company and therefore, the Infosys cannot be treated as comparable entity for making comparability analysis with the assessee company. The comparability of Infosys Technology of the company as that of an assessee has been dealt with ITAT Delhi Bench in the case of 'Agnity India Technologies Private Limited' (ITA No.3856/Delhi/2010), wherein it was held that Infosys is a giant in the area of development of software and it assumes all risks, leading to higher profit and cannot be compared with the company which is a captive unit of its parent company assuming only limited currency risk. In view of the above finding, we hold that the Infosys cannot be taken as a comparable for determining the arms length price in the case of the assessee."

16. Respectfully following the decision of the Tribunal referred to above, we direct Infosys Limited should be excluded from the list of comparable companies chosen by the TPO. We order accordingly.

17. As far as comparable companies chosen by the TPO viz., iGate Global Solutions Ltd., Mindtree Consulting Ltd., Sasken Communications Ltd., and Flextronics Software Systems Ltd., are concerned, this Tribunal in

the case of Trilogy E-Business (supra) has by applying turnover filter held that while selecting comparable companies for comparability analysis turnover will be a relevant criteria and held as follows:

“(1) Turnover Filter

11. The ld. counsel for the assessee submitted that the TPO has applied a lower turnover filter of Rs. 1 crore, but has not chosen to apply any upper turnover limit. In this regard, it was submitted by him that under rule 10B(3) to the Income-tax Rules, it was necessary for comparing an uncontrolled transaction with an international transaction that there should not be any difference between the transactions compared or the enterprises entering into such transaction, which are likely to materially affect the price or cost charged or paid or profit arising from such transaction in the open market. Further it is also necessary to see that wherever there are some differences such differences should be capable of reasonable accurate adjustment in monetary terms to eliminate the effect of such differences. It was his submission that size was an important facet of the comparability exercise. It was submitted that significant differences in size of the companies would impact comparability. In this regard our attention was drawn to the decision of the Special Bench of the ITAT Chandigarh Bench in the case of *DCIT v. Quark Systems Pvt. Ltd.* 38 SOT 207, wherein the Special Bench had laid down that it is improper to proceed on the basis of lower limit of 1 crore turnover with no higher limit on turnover, as the same was not reasonable classification. Several other decisions were referred to in this regard laying down identical proposition. We are not referring to those decisions as the decision of the Special Bench on this aspect would hold the field. Reference was also made to the OECD TP Guidelines, 2010 wherein it has been observed as follows:-

“Size criteria in terms of Sales, Assets or Number of Employees: The size of the transaction in absolute value or in proportion to the activities of the parties might affect the relative competitive positions of the buyer and seller and therefore comparability.”

The ICAI TP Guidelines note on this aspect lay down in para 15.4 that a transaction entered into by a Rs. 1,000 crore company cannot be compared with the transaction entered into by a Rs. 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate. The fact that they operate in the same market may

not make them comparable enterprises. The relevant extract is as follows [on Rule 10B(3)]:

“Clause (i) lays down that if the differences are not material, the transactions would be comparable. These differences could either be with reference to the transaction or with reference to the enterprise. For instance, a transaction entered into by a Rs 1,000 crore company cannot be compared with the transaction entered into by a Rs 10 crore company. The two most obvious reasons are the size of the two companies and the relative economies of scale under which they operate.”

It was further submitted that the TPO's range (Rs. 1 crore to infinity) has resulted in selection of companies like Infosys which is 277 times bigger than the Assessee (turnover of Rs. 13,149 crores as compared to Rs. 47.47 crores of Assessee). It was submitted that an appropriate turnover range should be applied in selecting comparable uncontrolled companies.

Reference was made to the decision of the ITAT Bangalore Bench in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT, ITA No.1231/Bang/2010*, wherein relying on Dun and Bradstreet's analysis, the turnover of Q 1 crore to Q 200 crores was held to be proper. The following relevant observations were brought to our notice:-

“9. Having heard both the parties and having considered the rival contentions and also the judicial precedents on the issue, we find that the TPO himself has rejected the companies which .ire (sic) making losses as comparables. This shows that there is a limit for the lower end for identifying the comparables. In such a situation, we are unable to understand as to why there should not be an upper limit also. What should be upper limit is another factor to be considered. We agree with the contention of the learned counsel for the assessee that the size matters in business. A big company would be in a position to bargain the price and also attract more customers. It would also have a broad base of skilled employees who are able to give better output. A small company may not have these benefits and therefore, the turnover also would come down reducing profit margin. Thus, as held by the various benches of the Tribunal, when companies which are loss making are

excluded from comparables, then the super profit making companies should also be excluded. For the purpose of classification of companies on the basis of net sales or turnover, we find that a reasonable classification has to be made. Dun & Bradstreet & Bradstreet and NASSCOM have given different ranges. Taking the Indian scenario into consideration, we feel that the classification made by Dun & Bradstreet is more suitable and reasonable. In view of the same, we hold that the turnover filter is very important and the companies having a turnover of Rs.1.00 crore to 200 crores have to be taken as a particular range and the assessee being in that range having turnover of 8.15 crores, the companies which also have turnover of 1.00 to 200.00 crores only should be taken into consideration for the purpose of making TP study.”

It was brought to our notice that the above proposition has also been followed by the Honourable Bangalore ITAT in the following cases:

1. M/s Kodiak Networks (India) Private Limited Vs. ACIT (ITA No.1413/Bang/2010)
2. M/s Genesis Microchip (I) Private Limited Vs. DCIT (ITA No.1254/Bang/2010).
3. Electronic for Imaging India Private Limited (ITA No. 1171/Bang/2010).

It was finally submitted that companies having turnover more than Rs. 200 crores ought to be rejected as not comparable with the Assessee.

The Id. DR, on the other hand pointed out that even the assessee in its own TP study has taken companies having turnover of more than Q 200 crores as comparables. In these circumstances, it was submitted by him that the assessee cannot have any grievance in this regard.

We have considered the rival submissions. The provisions of the Act and the Rules that are relevant for deciding the issue have to be first seen. Sec.92. of the Act provides that any income arising from an international transaction shall be computed having regard to the arm's length price. Sec.92-B provides that “international transaction” means 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. Sec.92-A defines what is an Associated Enterprise. In the present case there is no dispute that the transaction between the Assessee and its AE was an international transaction attracting the provisions of Sec.92 of the Act. Sec.92C provides the manner of computation of Arm's length price in an international transaction and it provides:-

(1) that the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely :—

- (a) comparable uncontrolled price method;
- (b) resale price method;
- (c) cost plus method;
- (d) profit split method;
- (e) transactional net margin method;
- (f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed five per cent of the latter, the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price.

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that—

(a) the price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2); or

(b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arm's length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,

the Assessing Officer may proceed to determine the arm's length price in relation to the said international transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:

Rule 10B of the IT Rules, 1962 prescribes rules for 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 shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—

(a).....

to

(d).....

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

(i) the net profit margin realised by the enterprise from an international 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 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.

(2) For the purposes of sub-rule (1), the comparability of an international 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 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.

(4) The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into :

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.”

A reading of the provisions of Rule 10B(2) of the Rules shows that uncontrolled transaction has to be compared with international transaction having regard to the factors set out therein. Before us there is no dispute that the TNMM is the most appropriate method for determining the ALP of the international transaction. The disputes are with regard to the comparability of the comparable relied upon by the TPO.

In this regard we find that the provisions of law pointed out by the Id. counsel for the assessee as well as the decisions referred to by the Id. counsel for the assessee clearly lay down the principle that the turnover filter is an important criteria in choosing the comparables. The assessee's turnover is Q 47,46,66,638. It would therefore fall within the category of companies in the range of turnover between 1 crore and 200 crores (as laid down in the case of *Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT, ITA No.1231/Bang/2010*). Thus, companies having turnover of more than 200 crores have to be eliminated from the list of comparables as laid down in several decisions referred to by the Id. counsel for the assessee. Applying those tests, the following companies will have to be excluded from the list of 26 comparables drawn by the TPO viz.,

	<u>Turnover Rs</u>
(1) Flextronics Software Systems Ltd.	848.66 crores
(2) iGate Global Solutions Ltd.	747.27 crores
(3) Mindtree Ltd.	590.39 crores
(4) Persistent Systems Ltd.	293.74 crores
(5) Sasken Communication Technologies Ltd.	343.57 crores
(6) Tata Elxsi Ltd.	262.58 crores
(7) Wipro Ltd.	961.09 crores.
(8) Infosys Technologies Ltd.	13149 crores.”

18. Respectfully following the aforesaid decision of the Tribunal in the case of Trilogy E-Business Software India Pvt.Ltd. (supra), we hold that the following companies should be excluded from the list of comparable companies.

(1) Flextronics Software Systems Ltd.	595.12 crores
(2) iGate Global Solutions Ltd.	527.91 crores
(3) Mindtree Ltd.	448.79 crores
(4) Sasken Communication Technologies Ltd. (Seg.)	240.03 crores
(5) Persistent Systems Limited	209.18 crores.

19. The AO is directed to compute the Arithmetic mean by excluding the aforesaid companies from the list of comparable.

20. The learned counsel for the Assessee brought to our notice that the comparable company chosen by the TPO viz., Lucid Software Limited, has to be excluded as functionally not comparable with that of the assessee in view of the decision of the Mumbai Bench of the Tribunal in the case of *Telcordia Technologies India Private Ltd. in ITA No.7821/MUM/2011*, which was followed by the ITAT Bangalore Bench in the case of Logica Private Ltd. ITA No.1129/Bang/2011 for AY 07-08, wherein it was held as under:-

“7.2 Lucid Software Limited

It has been submitted before us that this company, besides doing software development services, is also involved in development of software product. The learned AR has tried to distinguish by pointing out that product development expenditure in this case is around 39% of the capital employed by the said company, and, therefore, such a company cannot be considered as tested party. Even as per the information received in response to notice under Section 133(6), the company has described its business as software development company or pure software development service provider. This information itself is very vague as the segmental details of operating revenue has not been made available to examine how much is the ratio of sale from

software product and sale of software service and development. Looking to the fact that it has developed a software product named as “Muulam” which is used for civil engineering structures and the product development expenditure itself is substantial vis-a-vis the capital employed by the said company, this criteria for being taken as comparable party, gets vitiated. For the purpose of comparability analysis, it is essential that the characteristics and the functions are by and large similar as that of the assessee company and T.P. analysis/study can be made with fewest and most reliable adjustment. If a company has employed heavy capital in development of a product then profitability in the sale of product would be entirely different from the company, who is involved in service sector. Therefore, this company cannot be treated as having same function and profitability ratio.

In our view, due to non-availability of full information about the segmental details as to how much is the sale of product and how much is from the services, therefore, this entity cannot be taken into account for comparability analysis for determining arms length price in the case of the assessee.”

21. The facts and circumstances under which the aforesaid companies were considered as comparable is identical in the case of the Assessee as well as in the case of Logica Private Ltd., (supra). Respectfully following the decision of the Tribunal referred to above in the case of Logica Pvt.Ltd.(supra), we direct that the said company be excluded from the list of 20 comparable arrived at by the TPO.

22. As far as comparable companies chosen by the TPO viz., Aztec Software Limited and Geometric Software Ltd. (Seg.) and Megasoft Ltd., are concerned, it is not in dispute before us that the related party transaction in the case of companies exceeds 15% and in view of the

decision of the Tribunal in the case of 24 X 7 Customer.Com Pvt. Ltd. in ITA No.227/Bang/2010, followed by this Tribunal in the case of Logica Private Ltd. (supra) wherein it was held that where the RPT exceeds 15%, such companies should not be taken as comparable companies. Following the said decision, we hold that said companies should be excluded from the list of the comparable companies chosen by the TPO while working out the ALP.

23. After excluding the aforesaid comparable from the list of comparable chosen by the TPO, the arithmetic mean of profit margin of the remaining 7 comparable would be 11.30% (unadjusted) and 9.87% after working capital adjustment. The Assessee's profit margin operating profit on cost is 10.15% which is within the + / - 5% range permitted under second proviso to Sec.92CA(2) of the Act and therefore the addition made by the TPO and confirmed by the DRP needs to be deleted. Accordingly the same is deleted. The relevant grounds of appeal of the Assessee are allowed.

24. The next issue that arises for consideration in this appeal by the Assessee is with regard to disallowance of deduction claimed u/s.10A of the Act in respect of profits of the Assessee's Bangalore unit of Rs.2,35,44,629/-. The Assessee has three units through which it conducts its business. Out of the three units 2 are STP units entitled to deduction u/s.10A of the Act. In so far as one of the STP units at Bangalore, which was taken over from Lara Networks, it claimed a deduction of

Rs.2,35,44,629/- u/s.10A of the Act. The said deduction was however disallowed by the AO on the ground that the said unit was formed by reconstruction of an existing unit and that the business of the said unit had commenced prior to registration with the STPI. In doing so, he relied on the assessment orders for the Assessment years 2002-03 to 2004-05. The said assessment orders for AY 02-03 to 04-05 was subject matter of appeal before this Tribunal in ITA Nos. 748, 852 and 819/Bang/2007 and this tribunal by its order dated 21.6.2008 was pleased to hold that the Bangalore unit was not formed by reconstruction of an existing unit or the business of the new unit had not commenced prior to registration with the STPI and therefore deduction u/s.10A of the Act ought not to have been denied on the profits of the Bangalore unit. The said decision of the Tribunal has since been confirmed by the Hon'ble Karnataka High Court in ITA Nos.1013 to 1015/2008 dated 7.11.2014. Copies of the order of the Tribunal and the Hon'ble High Court were filed before us. In view of the said decision of the Tribunal on identical facts, we are of the view that the Bangalore unit was not formed by reconstruction of an existing unit or the business of the new unit had not commenced prior to registration with the STPI and therefore deduction u/s.10A of the Act ought not to have been denied on the profits of the Bangalore unit. The deduction claimed by the Assessee is directed to be allowed. The relevant grounds of appeal of the Assessee are allowed.

25. The Assessee in the grounds of appeal before the Tribunal has also projected its grievance regarding the action of the learned Assessing Officer and Honorable Dispute Resolution Panel in excluding from the export turnover, while computing deduction u/s.10A of the Act lease line expenses of Rs.5,40,722 being data link charges on the ground that these expenses are attributable to delivery of software outside India. Without prejudice to its contention that the aforesaid sums should not be excluded from the export turnover while computing deduction u/s.10A of the Act, the Assessee has also made an alternate prayer that expenses that are reduced from the export turnover should also be reduced from the total turnover and in this regard has placed reliance on the decision of the Hon'ble Karnataka High Court in the case of *CIT v. Tata Elxsi Ltd [2012] 349 ITR 98 (Karn)*.

26. We have heard the Id. counsel for the assessee and the Id. DR on the issues raised in this regard. Taking into consideration the decision rendered by the Hon'ble High Court of Karnataka in the case of *CIT v. Tata Elxsi Ltd [2012] 349 ITR 98 (Karn)*, we are of the view that it would be just and appropriate to direct the Assessing Officer to exclude telecommunication charges and insurance charges incurred be excluded both from export turnover and total turnover, as has been prayed for by the assessee in the alternative. In view of the acceptance of the alternative prayer, we are of the view that no adjudication is required on the ground

whether the aforesaid sums are required to be excluded from the export turnover.

27. In the result, the appeal by the Assessee is allowed.

Pronounced in the open court on this 27th day of March, 2015.

Sd/-

(JASON P. BOAZ)
Accountant Member

Sd/-

(N.V. VASUDEVAN)
Judicial Member

Bangalore,
Dated, the 27th March, 2015.

/D S/

Copy to:

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

By order

Assistant Registrar
ITAT, Bangalore.