

TRILOGY E-BUSINESS SOFTWARE INDIA PRIVATE LTD. vs. DEPUTY COMMISSIONER OF INCOME TAX

ITAT, BANGALORE BENCH

N. BARATHVAJA SANKAR, VP & N. V. VASUDEVAN, JM.

ITA No. 1054/Bang/2011

23rd November, 2012

(2012) 34 CCH 0329

(2013) 140 ITD 0540 (Bangalore) : (2013) 023 ITR 0464

Legislation Referred to

Section 92C(2), 35(2AB), 28 to 44, 10A, 37, 133(6)

Case pertains to

Asst. Year 2007-08

Decision in favour of:

Assessee & Revenue (Partly)

Transfer pricing—Arm's Length Price—Computation—Selection of comparables—High profit making companies—Assessee provided software research & development services to V (USA based AE) and was remunerated on a 'cost plus' basis—It adopted the TNMM as the most appropriate method for determining the ALP and adopted operating profits to cost as the Profit Level Indicator—PLI of the assessee was computed at 9.98 percent and was claimed that international transaction was at Arm Length—TPO rejected 20 out of 28 comparables selected by assessee—TPO selected 18 comparables over and above selected by assessee and computed ALP at 24.35 percent and made adjustment accordingly—DRP confirmed the findings of AO—Assessee raised objection to the order passed by TPO—Held, turnover filter is an important criteria in choosing the comparables—Assessee's turnover was Rs. 47,46,66,638, it would therefore fall within the category of companies in the range of turnover between Rs. 1 crore and Rs. 200 crores—Companies having turnover of more than 200 crores are to be excluded from the list of comparables—Provisions of the s. 92C & Rule 10B(2) provides that the comparable companies should be functionally comparable to the tested party—There are no specific standards of comparability on the basis of abnormal profits or loss—No bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally comparable—However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability—It is for the Assessee to demonstrate existence of abnormal factors—In the present case factors for abnormal profits have not been highlighted by the Assessee—Thus company having high profit cannot be excluded from list of comparables—Companies in which more than 75 percent of their export revenues come from onsite operations are to be

excluded from the comparability study as they are not functioning in similar economic circumstances to that of the tax payer—Entire operations of the assessee took place offshore i.e. in India; it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model—After considering the comparable, the differential between the margins of the assessee as and of the comparable was beyond the 5 percent range—Applying, the proviso to s. 92C(2), adjustment is required to be made to the reported values of the assessee's transactions with its associated enterprises—AO directed to make adjustment to the ALP adopting the arithmetic mean of 17.508 percent and consequent addition to the total income—Assessee's appeal dismissed

Held:

(1) Turnover Filter

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.

(Para 20)

(3) Improper selection of comparables

(a) Megasoft Ltd. :

This company was chosen as a comparable by the TPO. The objection of the assessee is that there are two segments in this company viz., (i) software development segment, and (ii) software product segment were substantially different and therefore comparison at entity level is without basis and would vitiate the comparability.

(Para 24, 25)

Alternatively it was submitted that the profit margin of 60.23 percent was abnormally high and deserves to be rejected on this ground, as not within the parameters of comparability.

(Para 30)

Companies with abnormal margins should not be regarded as comparable.

34. Provisions of the s. 92C & Rule 10B(2) provides that the comparable companies should be functionally comparable to the tested party. There are no specific standards of comparability on the basis of abnormal profits or loss. There is therefore no bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally comparable. The OECD guidelines and in US TP regulations, this question may not arise at all because those regulations advocate the quartile method for determining ALP. Indian regulations specifically deviate from OECD guidelines and provide Arithmetic Mean method for determining ALP. In the quartile method, companies that fall in the extreme quartiles get excluded and only those that fall in the middle quartiles are reckoned for comparability. Hence, cases of

either abnormal profits or losses (which are referred to as outliers) get automatically excluded. In the arithmetic mean method, all companies that are in the sample are considered, without exception and the average of all the companies are considered as the ALP. Hence, a general rule that companies with abnormal profits should be excluded may be in tune with the principles enunciated in OECD guidelines but cannot be said to be in tune with Indian TP regulations. However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability. It is for the Assessee to demonstrate existence of abnormal factors.

(Para 34, 35)

In the present case factors for abnormal profits have not been highlighted by the Assessee. In such circumstances it is not possible to accept the submission of the Assessee to exclude this company for the purpose of comparison.

(Para 36)

The next plea of the Assessee is that if at all this company is considered as a comparable then the segmental margin of 23.11 percent (which is the margin for software service segment) alone should be considered for comparability. Neither the TPO nor the DRP have noticed that there is bound to be a difference between the Assessee and Megasoft and the profit arising to the Megasoft as a result of the existence of the software product segment and no finding has been given that reasonably accurate adjustments can be made to eliminate the material effects of such differences. For this reason, we are inclined to hold that the profit margin of 23.11 percent which is the margin of the software service segment be taken for comparability. In view of the above conclusion, we do not wish to go into the question as to whether less than 25 percent of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75 percent of revenues from software development services.

(Para 37, 38)

(b) Avani Cimcon Technologies Ltd.

The plea of the Assessee has been that this company is functionally different from the assessee.

It was submitted that this company has made unusually high profit during the financial year 06-07. The operating revenues increased 63.03 percent which indicates that it was an extraordinary year for this company. Even the growth of software industry for the previous year as per NASSCOM was 32 percent. The growth rate of this company was double the industry average. It was argued that this company ought to have been rejected as a comparable. The reasons given by the Assessee for excluding this company as comparable were found to be acceptable. The decision of ITAT (Mumbai) in the case of Telcordia Technologies Pvt. Ltd. v. ACIT (supra) also supports the plea of the assessee.

(Para 39-41)

(c) Celestial Labs Ltd.

The stand of the assessee is that it is absolutely a research & development company and was not into software development activities, accordingly, this company should be

rejected as a comparable being functionally different.

This company was basically/admittedly in clinical research and manufacture of bio products and other products, there is no clear basis on which the TPO concluded that this company was mainly in the business of providing software development services. This company ought not to have been considered as comparable.

(Para 45)

(d) KALS Information Systems Ltd.

The contention of the assessee is that the company has revenues from both software development and software products. 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 Rs. 45,93,351. The same was less than 25 percent of the software services revenue and therefore the salary cost filter test fails in this case. 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. The Mumbai Bench of ITAT in Bindview India Private Limited Vs. DCI, ITA No. ITA No 1386/PN/10 has held that this company was developing software products and not purely or mainly software development service provider. The plea of the Assessee that this company is not comparable was accepted. Bindview India Private Limited Vs. DCI, ITA No. ITA No 1386/PN/10, relied on.

(Para 46, 47)

(e) Accel Transmatic Ltd.

The complaint of the assessee was that this company is not a pure software development service company. Plea of assessee that said company should not be treated as comparables was considered by the Tribunal in Capgemini India Ltd where the assessee was software developer. The Tribunal, in the said decision, has accepted that this company was not comparable in the case of the assessee engaged in software development services business and should be excluded as comparables.

(Para 50)

Assessee's comparables

The grievance of the Assessee was that the lower authorities have rejected certain comparables selected and proposed by the assessee on the ground that they have predominant onsite revenues and are functionally different.

(Para 51)

In some cases, the comparables selected by the assessee were rejected for the reason that they do not satisfy the onsite revenue filter i.e., if revenues of comparable companies from rendering onsite software exceed 75 percent of the total revenue, then they should not be regarded as comparable to the assessee where revenue is from rendering offshore software development services.

(Para 52)

Rule 10B(2) & (3) of the IT Rules, 1962, in so far as it relates to the contentions regarding application of the Onsite revenue filter, is that 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.

It is only when there are no difference between the uncontrolled transaction and the international transaction as set out above or if there are differences but such difference will not affect the price or cost charged or paid or profit arising from such transactions or if there will be differences in price or cost charged or pair or profit arising from such transactions, such differences should be reasonably capable of being quantified and adjustment made to eliminate the effect of such differences. The Indian software sector provides both on-site and offshore services. The Assessee in the present case is mainly offshore service provider and it generates income only from offshore software development service. Most of the uncontrolled enterprises follow hybrid model with revenue mix both from onsite and offshore. It is true that in terms of the functions performed both in the case of offshore service provider and onsite service provider, it is development of computer software. But having regard to Rule 10B(2)(b) it is necessary to have regard to the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions.

(Para 60-63)

The first objection of the Assessee is that the TPO observed that "market conditions" are different for on-site and offshore work, but he has not substantiated how market conditions differ was rejected. In onsite development of computer software, the Assessee does not employ assets nor does the Assessee assume many risks which the offshore software developer assumes. Even the Assessee accepts that the per hour rate will be different in the case of offshore software development and onsite software development. The next objection of the Assessee that when the most appropriate method selected for determining ALP is the TNMM there is no reason as to why one should look at price difference in offshore software development and onsite software development. It is no doubt true that in TNMM it is only the margins in an uncontrolled transaction that is tested with reference to the controlled transaction but it is not possible to ignore the fact that pricing will have an effect on the margins obtained in a transaction. The argument that if pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects cannot be accepted because the TPO has not chosen any other onsite software service provider with a revenue composition of more than 75 percent from onsite software services as comparable. As rightly observed by the TPO, the pricing is different in onsite when compared to offshore operations. The further observations of the

TPO that the reasons for the same lie in the fact that while in the case of OFFSHORE projects most of the costs are incurred in India; an ONSITE project has to be carried out abroad significantly increasing the employee cost and other costs. The next objection of the Assessee was that TPO has held that margins are lower in onsite software services and that margin is not a criteria to select or reject a comparable under Rule 10B(2) of the I.T. Rules. This argument again ignores the fact that the approach of the TPO has been to highlight the fact that there can be no functional comparability, if the assets employed and risks assumed are taken into consideration. It is in that context the TPO has referred to the margins. The companies who generate more than 75 percent of the export revenues from onsite operations outside India are effectively companies working outside India having their own geographical markets, cost of labour etc., and also return commensurate with the economic conditions in those countries. Thus assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the taxpayer. Since, the entire operations of the tax payer are taking place offshore i.e. in India; it is but natural that it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model. As already stated the Assessee has limited its analysis only to functions but not to the assets, risks as well as prevailing market conditions in which both the buyer and seller of services located. Hence, the companies in which more than 75 percent of their export revenues come from onsite operations are to be excluded from the comparability study as they are not functioning in similar economic circumstances to that of the tax payer. Hence, it is held that this filter is appropriately applied by the TPO.

(Para 63-67)

Admittedly the onsite revenue in the case of the following comparable companies identified by the Assessee was more than 75 percent of its export revenues viz., a) Visu International Ltd.

b) Maars Software International Ltd. c) Akshay Software Technologies Ltd. d) VJIL Consulting Ltd. e) Synfosys Business Solutions Ltd. These companies were therefore rightly not considered as comparable by the TPO.

(Para 68)

Another reason given by the TPO for rejecting E2E Infotech Ltd., a comparable identified by the Assessee but rejected by the TPO, was for the reason that the details of this company was insufficient. This company does not figure in the list of comparable selected by the Assessee in its TP study. In the circumstances when the comparability has neither been considered by the TPO or the DRP, This Court at this stage cannot take a view on comparability or otherwise of this company. In any event the details furnished are sketchy and it is not possible to take one view or the other on the claim of the Assessee. This company has been rightly not considered for comparability.

(Para 70)

M/s. Indium India Ltd., a comparable considered by the Assessee in its TP study was rejected by the TPO as not comparable on the ground that the said company was rendering software testing services. Software testing is only part of software development life cycle. It cannot be equated with software development services. The TPO rightly excluded this company for comparability purposes.

(Para 71)

Goldstone Technology Ltd., the same was rejected as a comparable by the TPO for the

reason that it was engaged in I.T. enabled services. The rejection by the TPO of this company as a comparable is on sound basis and the same is upheld.

After considering the comparable, the differential between the margins of the assessee as and of the comparable was beyond the 5 percent range. Applying, the proviso to s. 92C(2), adjustment is required to be made to the reported values of the assessee's transactions with its associated enterprises. The AO is directed to make adjustment to the ALP adopting the arithmetic mean of 17.508 percent and consequent addition to the total income.

(Para 77)

The other issues raised by the Assessee viz., (i) the reference to TPO being bad in law; (ii) the CIT's approval for reference to TPO also being bad in law; (iii) the additions being unsustainable as the definition of income or the computation process under section 28 to 44 not envisaging a reference to or incorporation of an adjustment proposed under Chapter X are without any merit and are contrary to the ruling of the Special Bench of the Tribunal in the case of Aztec Software 107 ITD 141 (SB)(Bang).

(Para 78)

Other objections were also raised by the Assessee regarding determination of ALP:

Treating foreign exchange gain or loss and provision for bad debts as non-operating in nature and fringe benefit tax as part of operating cost:

As far as foreign exchange gain/loss being considered as not forming part of the operating cost, the reasoning of the revenue is that such loss or gain cannot be said to be one realized from international transaction though they may form part of the gain/loss of the enterprise and therefore they should be excluded while determining operating cost.

Conclusion:

No bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally comparable.

In favour of:

Revenue

Income tax authorities—Power to call for information—Use of information received by the TPO by issue of notice u/s.133(6) without affording opportunity of cross examining the companies concerned—Held, Assessee cannot ask for a right to cross examine on a surmise that the information given in response to notice u/s.133(6)—Only if assessee is able to show prima facie that the information available in public domain is incorrect then only opportunity to cross examine can be granted—Assessee's appeal dismissed

Held:

The use of information received by the TPO by issue of notice u/s.133(6) of the Act without affording opportunity of cross examining the companies concerned, required to be dealt with. The basis on which the Assessee challenges the information received u/s.133(6) of the Act is not sound. The right to cross examine this company will not

serve any purpose. The other objection of the Assessee was that TVS Infotech was considered as a comparable initially by the TPO because as per information furnished by this company in response to notice of TPO u/s.133(6) this company did not have any related party transaction. The Annual report of this company however showed that this company fails RPT filter. The TPO therefore rejected this company as comparable. The TPO in the case of this company has not used information u/s.133(6) of the Act and therefore the Assessee can have no grievance. If on the other hand the Assessee wants to show that information available in public domain is not correct then the onus would be on the Assessee to establish the same. The Assessee cannot ask for a right to cross examine on a surmise that the information given in response to notice u/s.133(6) of the Act would be correct and that given in the annual report is incorrect. The Assessee if he is able to show prima facie that the information available in public domain is incorrect then we will be persuaded to afford opportunity to the Assessee but not on a claim which lacks substance and is based on surmises.

(Para 75)

Conclusion:

Only if the assessee is able to show that information available in public domain was not correct, opportunity to cross-examine comparables can be granted to assessee.

In favour of:

Revenue

Transfer pricing—ALP—Computation of—Operating cost—Foreign exchange gain/loss, provision for bad debts and fringe benefit tax were not considered as part of the operating cost—Held, Foreign Exchange Fluctuation gains are required to be added to operating revenue—AO directed to accept the claim of the Assessee—TPO has accepted that provision for bad debt would be part of operating expenses provided the same is incurred every year for at least three years and the manner in which provision was made was consistent—Assessee given opportunity to furnish details in this respect—Fringe Benefit Tax (FBT) was not considered by the TPO as part of operating cost in the case of comparables and therefore the same should also not be considered as part of operating cost of the Assessee—Assessee's appeal partly allowed

Held:

The Bangalore Bench of ITAT in the case of Sap Labs India (P) Ltd. Vs. ACIT (2011) 44 SOT 156 (Bang.) has taken the view that Foreign Exchange Fluctuation gains are required to be added to operating revenue. Following the same, the AO was directed to accept the claim of the Assessee. As far as provision for bad debts are concerned, the TPO has accepted that the same would be part of operating expenses provided the same is incurred every year for at least three years and the manner in which provision is made is consistent. The Assessee in reply to the query of the TPO on the above aspect has not furnished any details. The Assessee should be afforded opportunity to explain its position on the above and the AO was directed to consider the same in accordance with law. As far as Fringe Benefit Tax (FBT) is concerned, the same was not considered by the TPO as part of operating cost in the case of comparables and therefore the same should also not be considered as part of operating cost of the Assessee. Sap Labs India (P) Ltd. Vs. ACIT (2011) 44 SOT 156 (Bang.), followed.

(Para 79)

Conclusion:

Foreign exchange gain/loss would form part of operating expenses.

Fringe Benefit Tax (FBT) was not considered by the TPO as part of operating cost in the case of comparables and therefore the same should also not be considered as part of operating cost of the Assessee

In favour of:

Assessee (Partly)

Business expenditure—Allowability of—Deduction in respect of expenditure incurred on research and development was claimed by assessee—AO disallowed research and development expenses under s. 37 on ground that said expenditure was not revenue in nature—Assessee claim of deduction under s. 35 was also rejected—Held, before tribunal assessee submitted that expenses were incurred for website development, same was contrary to the stand of the Assessee before DRP/AO that these expenses were for exploring the possibility of domestic market through pilot projects—Unless the nature of the expenses is examined it is not possible to decide as to whether the same were revenue in nature and that it relates to existing business of an Assessee—Alternative contention of the Assessee that the claim should be examined u/s.35 also cannot be decided unless the correct description of the expense is considered—Matter remitted to AO

Held:

The assessee submissions before the tribunal that expenses were incurred for website development was contrary to the stand of the Assessee before DRP/AO that these expenses were for exploring the possibility of domestic market through pilot projects. Unless the nature of the expenses is examined it is not possible to decide as to whether the same were revenue in nature and that it relates to existing business of an Assessee. The alternative contention of the Assessee that the claim should be examined u/s.35 of the Act also cannot be decided unless the correct description of the expense is considered. The order of the AO set aside and matter was remitted.

(Para 86)

Conclusion:

Matter remitted to AO to consider the issue whether expenditure incurred on research and development were allowable under s. 37 or 35.

In favour of:

Matter remitted

Business expenditure—Travel expenses—Disallowance was made for the reason that expenditure cannot be claimed on the basis of provision and that the liability in respect of the expenditure has not accrued to the Assessee during the previous year—This cannot be the basis to disallow the claim of the Assessee for deduction—Assessee had system of reversing expenses wherever the same was not incurred by the Assessee, in the succeeding Assessment years—AO directed to examine the issue afresh in the light of the decision of

the Hon'ble Supreme Court in Bharat Earth Movers Vs CIT and ascertain as to the reasonableness of the basis on which the provision was made—Matter remitted

Held:

The disallowance was made for the reason that expenditure cannot be claimed on the basis of provision and that the liability in respect of the expenditure has not accrued to the Assessee during the previous year. This cannot be the basis to disallow the claim of the Assessee for deduction. Bharat Earth Movers Vs CIT 245 ITR 482(SC), relied on.

The Assessee has the system of reversing expenses wherever the same was not incurred by the Assessee, in the succeeding Assessment years. The AO should be directed to examine the issue afresh in the light of the decision of the Hon'ble Supreme Court in Bharat Earth Movers Vs CIT and ascertain as to the reasonableness of the basis on which the provision is made, examine as to whether the Assessee reverses excess provision when the actual expenses details are available and also see if the Assessee follows the method of accounting consistently. The AO will afford opportunity of being heard to the Assessee and decide the issue afresh.

(Para 91 & 92)

Conclusion:

If a business liability has definitely arisen in accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date.

In favour of:

Matter remitted

Case referred to

DCIT vs. Quark Systems Pvt. Ltd. 38 SOT 207
Genesis Integrating Systems (India) Pvt. Ltd. vs. DCIT, ITA No.1231/Bang/2010
M/s Kodiak Networks (India) Private Limited vs. ACIT (ITA No.1413/Bang/2010)
M/s Genesis Microchip (I) Private Limited vs. DCIT (ITA No.1254/Bang/2010)
Bindview India Private Limited vs. DCI, ITA No. ITA No 1386/PN/10
Sap Labs India (P) Ltd. vs. ACIT (2011) 44 SOT 156 (Bang.)
Alembic Chemicals Works Co. Ltd. vs. CIT 177 ITR 377 (SC)
Bharat Earth Movers vs. CIT 245 ITR 482(SC)

Counsel appeared:

Padamchand Khincha, C.A. for the Appellant.: S. K. Ambastha, CIT-I(DR) for the Respondent

ORDER

N. V. VASUDEVAN, JM. :

1. This appeal by the assessee is against the order dated 30.09.2011 of the Dy.CIT, Circle 12(4), Bangalore passed u/s. 143(3) r.w.s. 144C of the Act.

2. Ground Nos. 1 to 16 raised by the assessee is with regard to the addition to the total income by way of adjustment to the Arms' Length Price ("**ALP**") to an international transaction carried out by the assessee u/s. 92CA of the Act. These grounds read as follows:-

"The learned Assessing Officer, learned Transfer Pricing Officer and Honorable Dispute Resolution Panel have erred in :-

1. passing the Order which is bad in law;
2. passing the order disregarding the principles of natural justice;
3. making a reference to Transfer Pricing Officer for determining arms' length price;
4. passing the order without demonstrating that appellant had motive of tax evasion;
5. ignoring the fact that the members of Dispute Resolution Panel also being jurisdictional Commissioner/Directors of Income Tax of the appellant, the constitution of the Dispute Resolution Panel is bad in law;
6. not appreciating that the charging or computation provision relating to income under the head "Profits & Gains of Business or Profession" do not refer to or include the amounts computed under Chapter X and therefore addition under Chapter X is bad in law;
7. adopting a flawed process of issuing notices u/s 133(6) and relying on the same without providing complete information and an opportunity to cross examine the companies concerned;
8. rejecting the comparables selected by the appellant and rejecting transfer pricing analysis of the appellant;
9. performing fresh transfer pricing analysis and adopting inappropriate filters in doing fresh transfer pricing analysis;
10. selecting inappropriate comparables;
11. rejecting additional comparables proposed by the appellant;
12. inappropriately computing the operating margins of comparables and the appellant;
13. treating foreign exchange gain or loss and provision for bad debts as non-operating in nature and fringe benefit tax as part of operating cost;
14. not making proper adjustment for enterprise level and transactional level differences between the appellant and the comparable companies;
15. not appreciating that the law does not compel adopting many (or any minimum) companies as comparables and that the appellant could justify the price paid/charged on the basis of any one comparable only;
16. not allowing the benefit of the +/-5 percent range mentioned in the proviso to section 92C(2)."

3. The assessee is a company. It was incorporated in June, 2000. M/s. Versata International Inc., USA holds the entire share capital of the assessee, except two shares. The assessee provides software research & development services for Versata International Inc. on a contract basis and as requested by Versata International Inc. It is not in dispute before us that the transaction of providing software research & development support services by the Assessee to Versata International Inc., was an international transaction with the Associated Enterprise ("**AE**") and therefore the price at which the assessee renders services to its AE has to pass the Arm's Length Price (ALP) test as laid down by section 92C of the Act. During the financial year 2006-07, the assessee provided software research & development support services to its AE and was remunerated on a 'cost plus' basis. The total value of international transaction with respect to the provision of software research & development support services by the assessee to its AE was Q 47,46,66,638.

4. In support of the assessee's claim that the price charged by it for services rendered to its AE was at arms' length, the assessee filed a report as required by the provisions of section 92E of the Act in Form 3EB together with detailed analysis. The assessee adopted the Transactional Net Margin Method ("**TNMM**") as the most appropriate method for determining the ALP. The assessee adopted operating profits to cost as the Profit Level Indicator ("**PLI**"). The list of comparables ultimately chosen by the assessee for comparability is annexed as **Annexure-I** to this order and the process by which the same was arrived at is detailed in the Annexure to the report in Form 3EB. The PLI of the assessee as arrived at in the said report is annexed as **Annexure-II** to this order. It can be seen from Annexure-I that the arithmetic mean of comparables was computed at 14.53 percent. The PLI of the assessee (as per Annexure-II) was computed at 9.98 percent. It was the claim of the assessee that exercising the option of determining the ALP between +/- 5 percent of the arithmetic mean of the comparable prices, the range of operating margin would be between 8.80 percent & 20.25 percent on operating costs. Since the assessee's operating margin on operating cost was within the arms' length range, the assessee claimed that its international transaction was at arms' length.

5. The filters or criteria adopted by the tax payer in its TP study and the remarks of the Transfer Pricing Officer ("**TPO**") to whom the AO referred determining of ALP on such approach were as follows:-

"Filters or criteria adopted by the taxpayer in its TP study:

Sl. No.	Particulars	Remark of the TPO
1	Companies for which sufficient financial data is not available to undertake analysis	This is an appropriate filter. Hence, it is accepted.
2	Companies that have ceased business operations or are currently inactive	This is an appropriate filter. Hence, it is accepted.
3	Companies undertaking significantly different functions compared to tested party	This is an appropriate filter provided the decision is based on objective criteria and not by selecting / rejecting based on the margin of a company.

- 4 Companies that do not have significant (>25 percent) foreign exchange earnings This is an appropriate filter. Hence, it is accepted.
- 5 Companies which have been making persistent operating losses This is an appropriate filter. Hence, it is accepted.
- 6 Companies that had substantial (excess of 25 percent) transactions with related parties It is an appropriate filter to eliminate the influence of controlled transactions.
- 7 Companies that had exceptional year(s) of operation It will be an appropriate filter provided if one gives reason for such exceptional performance. Also the companies being service providers, one may not get exceptional sales without the service being rendered also exceptional i.e., one may not get any income without doing any work.
- 8 Companies that are duplicated in the database with different names merged to form another company It is an appropriate filter. Hence, it is accepted.

6. Thereafter the TPO was of the view that it would be appropriate to apply the following filters for selection of comparables:-

"10.8 Final filters selected by the TPO for selection of comparables:

As per the above discussion, the following are the filters applied by the TPO for making the comparables functionally similar and also making economic circumstances similar as per the provisions of Rule 10B(2). These filters include the filters that are applied by the tax payer and accepted by the TPO.

- Companies whose data is not available for the FY 2006-07 were excluded.
- Companies whose software development service revenue
- Companies whose Software Development Service revenue is less than 75 percent of the total operating revenues were excluded unless segmental details are available and the segment qualifies this filter.
- Companies who have more than 25 percent related party transactions (income as well as expenditure combined) of the operating revenues were excluded
- Companies who have less than 25 percent of the operating revenues as export sales were excluded

- Companies who have diminishing revenues/persistent losses for the period under consideration were excluded
- Companies having different financial year ending (i.e. not March 31, 2006) or data of the company does not fall within 12 month period i.e. 01-04-2005 to 31-03-2006, were rejected
- Companies whose employee cost to operating revenues is less than 25 percent of the revenues were excluded
- Companies whose onsite revenue is more than 75 percent of the export revenues were excluded."

7. The TPO rejected 20 out of 28 comparables given by the assessee in its TP report (**Annexure I to this order**). The assessee before the TPO had also given some other additional comparables which was also rejected by the TPO. The TPO on his own, on a search carried on in Prowess Database arrived at a set of 18 comparables over and above the 8 comparables relied upon by the assessee in its TP study, which the TPO accepted were comparable. Thus, the TPO arrived at a set of 26 comparables. The set of 26 comparables is given as **Annexure-III**.

8. The assessee raised various objections to the methodology adopted and the reasons assigned by the TPO for rejecting the comparables chosen by the assessee in its TP study. In the course of proceedings before the TPO, notice u/s. 133(6) has been issued to the companies that were chosen as comparable by the assessee as well as the TPO and on the basis of the replies received in response to such notices, certain inferences were drawn by the TPO. The action of the TPO in relying on some of those information was also challenged by the assessee. The TPO finally passed an order u/s. 92CA of the Act and on the basis of the comparables set out in **Annexure-III** to this order, arrived at arithmetic mean of 25.14 percent. After factoring the working capital adjustment of 0.79 percent, the adjusted arithmetic mean was determined at 24.35 percent. On the basis of that adjusted arithmetic mean and after factorizing of the operating profits to cost of the assessee which was 9.98 percent, the AO arrived at Q 6,20,48,644 as an addition by way of adjustment to ALP. The computation of 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 the taxpayer to its AE(s) is computed as under:

Arithmetic mean PLI :25.14 percent

Less: Working capital adjustment (Annexure-C): 0.79 percent

Adj. Arithmetic mean PLI :24.35 percent

Arm's Length Price:

Operating Cost	Rs.43,16,16,632/-
Arms Length Margin	24.35 percent of the Operating Cost

Arms Length Price (ALP at 124.35 percent of operating cost Rs.53,67,15,282/-

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 at 124.35 percent of operating cost	Rs.53,67,15,282/-
Price charge in the international transaction	Rs.47,46,66,638/-
Shortfall being adjustment u/s 92CA	Rs. 6,20,48,644/-

The above shortfall of Rs.6,20,48,644/- is treated as transfer pricing adjustment u/s 92CA."

9. 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.

10. The Id. counsel for the assessee as well as the Id. DR made rival submissions on various aspects of the adjustment made by the TPO. These objections will be dealt with under different heads.

(1) Turnover Filter

11. The Id. counsel for the assessee submitted that the TPO has applied a lower turnover filter of Q 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."

12. 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."

13. 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.

14. 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 arc 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."

15. 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.

16. 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.

17. 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:

18. 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."

19. 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.

20. 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.,

Turnover Q

- (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.

(2) Use of information received in pursuance of notice u/s. 133(6) of the Act.

21. The main submission of the Id. counsel for the assessee on the use of information received u/s. 133(6) of the Act by the TPO in determining ALP was that the TPO acted on the information received rather than on the information available in the public domain. It is his submission that there was an arbitrary selection of companies by the TPO for issuing notice u/s. 133(6) of the Act. It is also the complaint of the assessee that the TPO had relied on incomplete information. It is also the complaint of the assessee that whenever the information received u/s. 133(6) was favourable to the revenue, the same had been adopted even when that information was at variance with the information available in the annual report. The further contention of the Id. counsel for the assessee was that the TPO had not given opportunity of cross-examining the companies who had given information to the TPO, pursuant to the notice u/s. 133(6) of the Act. Attention was drawn to the decision of the ITAT Bangalore in the case of Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT (supra) wherein it was held as follows:-

"13. We have already held that if any information is sought to be used against the assessee, the same has to be furnished to the assessee and thereafter, taking into consideration the assessee's objections, if any, only then can the TPO proceed to take a decision. If the assessee seeks an opportunity to cross examine the party, the assessee shall be provided such an opportunity. It is only during a cross examination that the assessee can rebut the stand of that particular company."

Besides the above, several other decisions were also referred to for identical proposition. In the final analysis, it was submitted that the information obtain u/s. 133(6) in so far as it is contrary to the information available in the public domain should be rejected.

22. The Id. DR however submitted that the power u/s. 133(6) of the Act is absolute and cannot be questioned by the assessee, unless the assessee is able to establish that the same is incorrect.

23. We will deal with this aspect after considering the other submissions made by the assessee on the transfer pricing adjustments, if necessary and required. If on other parameters on which the ALP has to be determined, it is found that the price charged by the Assessee is at Arm's Length, we need not decide this aspect in this case.

(3) Improper selection of comparables

(a) Megasoft Ltd. :

24. This company was chosen as a comparable by the TPO. The objection of the assessee is that there are two segments in this company viz., (i) software development segment, and (ii) software product segment. The Assessee is a pure software services provider and not a software product developer. According to the Assessee there is no break up of revenue between software products and software services business on a standalone basis of this comparable. The TPO relied on information which was given by this company in which this company had explained that it has two divisions viz., BLUEALLY DIVISION and XIUS-BCGI DIVISION. Xius- BCGI Division does the business of product software. This company develops packaged products for the wireless and convergent telecom industry. These products are sold as packaged products to customers. While implementing these standardized products, customers may request the company to customize products or reconfigure products to fit into their business environment. Thereupon the company takes up the job of customizing the packaged software. The company also explained that 30 to 40 percent of the product software would constitute packaged product and around 50 percent to 60 percent would constitute customized capabilities and expenses related to travelling, boarding and lodging expense. Based on the above reply, the TPO proceeded to hold that the comparable company was mainly into customization of software products developed (which was akin to product software) internally and that the portion of the revenue from development of software sold and used for customization was less than 25 percent of the overall revenues. The TPO therefore held that less than 25 percent of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75 percent of revenues from software development services. The basis on which the TPO arrived at the PLI of 60.23 percent is given at page-115 and 116 of the order of the TPO. It is clear from the perusal of the same that the TPO has proceeded to determine the PLI at the entity level and not on the basis of segmental data.

25. In the order of the TPO, operating margin was computed for this company at 60.23 percent. It is the complaint of the assessee that the operating margins have been computed at entity level combining software services and software product segments. It was submitted that the product segment of Megasoft is substantially different from its software service segment. The product segment has employee cost of 27.65 percent whereas the software service segment has employee cost of 50 percent. Similarly, the profit margin on cost in product segment is 117.95 percent and in case of software service segment it is 23.11 percent. Both the segments are substantially different and therefore comparison at entity level is without basis and would vitiate the comparability (submissions on page 381 to 383 of the PB-I). It was further submitted that Megasoft Limited has provided segmental break-up between the software services segment and software product segment (page 68 of PB-II), which was also adopted by the TPO in his show cause notice (Page 84 of PB-I). The segmental results i.e., results pertaining to software services segment of this company was:

Segmental Operating Revenues Rs.63,71,32,544

Segmental Operating Expenses Rs.51,75,13,211

Operating Profit Rs.11,96,19,333

OP/TC (PLI) 23.11 percent

26. It was reiterated that in the given circumstances only PLI of software service segment viz., 23.11 percent ought to have been selected for comparison.

27. It was further submitted that the learned TPO in case of other comparable, similarly placed, had adopted the margins of only the software service segment for comparability purposes. Consistent with such stand, it was submitted that the margins of the software segment only should be adopted in the case of Megasoft also, in contrast to the entity level margins.

28. The margins at entity level and segment level of other comparables considered by the TPO in his first show cause notice were as follows (page 382 of PB-I):

Sl.No.	Company Name	Segment Margin	Company- wide Margin
1	Geometric	10.71 percent	8.51 percent
2	Kals Info Systems	30.55 percent	20.12 percent
3	R Systems	15.07 percent	9.64 percent
4	Sasken Communication	22.16 percent	10.57 percent
5	Tata Elxsi	26.51 percent	26.47 percent

29. In case of all the above comparables, the learned TPO has used segmental margins for comparability purpose. In all these cases, the revenues from software development exceeded 75 percent of the total revenues of the entity. Considering margins of Megasoft at the entity level would be inconsistent with the TPO's position in case of other comparables. It was submitted that a different approach was adopted in case of Megasoft possibly because in case of Megasoft, the margins at the entity level are higher than that at the segment level; whereas in case of other comparables (Eg: Kals, Sasken, Tata Elxsi, Geometric, R Systems) margins at the segment level were higher. It was submitted that learned TPO's approach is arbitrary and without basis. The Assessee therefore submitted that if at all Megasoft is considered as comparable then only the segmental margins, if at all, should be used for comparability purpose. Both the segments being substantially different, considering the margins at entity level would vitiate the comparability.

30. Alternatively it was submitted that the profit margin of 60.23 percent was abnormally high and deserves to be rejected on this ground, as not within the parameters of comparability. In this regard, reference was made to the decision of Special Bench of ITAT Chandigarh in the case of Quark Systems Pvt. Ltd. (supra) besides several other tribunal decisions laying down identical proposition. Further it was submitted that Visual Soft Technologies Ltd. merged with Megasoft Ltd. w.e.f. 01.10.2006. Therefore the book results in the year in which the merger has taken place cannot be taken as a comparable. In this regard, reliance was placed on the decision of the Mumbai Bench of the ITAT in the case of Emersons & Process Management India Pvt. Ltd. v. Addl. CIT 13 Taxmann.com 149.

31. The learned DR relied on the order of the TPO and the DRP on this aspect.

32. We have considered the rival submissions. First we will consider the submission of the Assessee that companies with abnormal margins should not be regarded as comparable. In the case of Quark Systems Pvt. Ltd. (supra), the Special Bench had to deal with cases where the results were abnormal. The special Bench observed as follows:

"Even if the taxpayer or its counsel had taken Datamatics as comparable in its T.P. audit, the taxpayer is entitled to point out to the Tribunal that above enterprise has wrongly

been taken as comparable. In fact there are vast differences between tested party and the Datamatics. The case of Datamatics is like that of "Imercius Technologies" representing extreme positions. If Imercius Technologies has suffered heavy losses and, therefore, it is not treated as comparable by the tax authorities, they also have to consider that the Datamatics has earned extraordinary profit and has a huge turnover, besides differences in assets and other characteristics referred to by Shri Aggarwal."

The above observations of the special Bench is a pointer to the fact that where there are extraordinary profits and those companies are considered by the TPO for comparability but loss making companies are not considered as comparable, that would be improper. The Tribunal found that such contradiction in approach should not be permitted. Similarly in the case of M/S. Sap Labs India Pvt. Ltd. 2010-TII-44-ITAT Bang-TP had observed as follows:

"86. At the cost of repetition, we have to say that extreme cases should not be included in samples and extreme comparables mean not only the positive higher side but also the lower side. In the list of 22 comparables, many of them are having very low margin rate, not only less than 10 or 5, even below that. We have already considered that the agreement entered into by the assessee with its German associate concern has contemplated a compensation of cost plus 6 per cent, or 1.5 times of the total wages bill, whichever is higher. This point we have to consider in the light of the fact that the assessee is working in a risk mitigated environment. That is why we have agreed with the argument of the assessee-company that there may not be extreme profits in the case of the assessee. When extremes are excluded from the samples, all sorts of extremes should be avoided. Otherwise, samples selected for comparative study may not be representative."

33. Even in the aforesaid decision the point that has been emphasized is that when the margins of comparable companies are either extremely low or high, the approach should be to eliminate both and not consider only the high or low margin comparables as it suits either the TPO or the Assessee.

34. As far as the provisions of the Act are concerned, they lay down that the comparable companies should be functionally comparable to the tested party. There are no specific standards of comparability on the basis of abnormal profits or loss. Rule 10B(2) provides that 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.

35. There is therefore no bar to considering companies with either abnormal profits or abnormal losses as comparable to the tested party, as long as they are functionally

comparable. The OECD guidelines and in US TP regulations, this question may not arise at all because those regulations advocate the quartile method for determining ALP. Indian regulations specifically deviate from OECD guidelines and provide Arithmetic Mean method for determining ALP. In the quartile method, companies that fall in the extreme quartiles get excluded and only those that fall in the middle quartiles are reckoned for comparability. Hence, cases of either abnormal profits or losses (which are referred to as outliers) get automatically excluded. In the arithmetic mean method, all companies that are in the sample are considered, without exception and the average of all the companies are considered as the ALP. Hence, a general rule that companies with abnormal profits should be excluded may be in tune with the principles enunciated in OECD guidelines but cannot be said to be in tune with Indian TP regulations. However, if there are specific reasons for abnormal profits or losses or other general reasons as to why they should not be regarded as comparables, then they can be excluded for comparability. It is for the Assessee to demonstrate existence of abnormal factors.

36. In the present case factors for abnormal profits have not been highlighted by the Assessee. In such circumstances it is not possible to accept the submission of the Assessee to exclude this company for the purpose of comparison.

37. The next plea of the Assessee is that if at all this company is considered as a comparable then the segmental margin of 23.11 percent (which is the margin for software service segment) alone should be considered for comparability. On the above submission, we find that the TPO considered the segmental margin (Software service segment) in the case of Geometric, Kals Info systems, R Systems, Sasken Communication and Tata Elxsi. Before DRP the Assessee pointed out that the segmental margin of 23.11 percent alone should be taken for comparability. The DRP has not given any specific finding on the above plea of the Assessee. Perusal of the order of the TPO shows that the TPO relied on information which was given by this company in which this company had explained that it has two divisions viz., BLUEALLY DIVISION and XIUS-BCGI DIVISION. Xius- BCGI Division does the business of product software (developing software). This company develops packaged products for the wireless and convergent telecom industry. These products are sold as packaged products to customers. While implementing these standardized products, customers may request the company to customize products or reconfigure products to fit into their business environment. Thereupon the company takes up the job of customizing the packaged software. The company also explained that 30 to 40 percent of the product software (software developed) would constitute packaged product and around 50 percent to 60 percent would constitute customized capabilities and expenses related to travelling, boarding and lodging expense. Based on the above reply, the TPO proceeded to hold that the comparable company was mainly into customization of software products developed (which was akin to software development) internally and that the portion of the revenue from development of software sold and used for customization was less than 25 percent of the overall revenues. The TPO therefore held that less than 25 percent of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75 percent of revenues from software development services. Having drawn the above conclusion, the TPO did not bother to quantify the revenues which can be attributed to software product development and software development service but adopted the margin of this company at the entity level. In terms of Rule 10B(3)(b) of the Rules, 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.

38. Neither the TPO nor the DRP have noticed that there is bound to be a difference between the Assessee and Megasoft and the profit arising to the Megasoft as a result of the existence of the software product segment and no finding has been given that reasonably accurate adjustments can be made to eliminate the material effects of such differences. For this reason, we are inclined to hold that the profit margin of 23.11 percent which is the margin of the software service segment be taken for comparability. In view of the above conclusion, we do not wish to go into the question as to whether less than 25 percent of the revenues of the comparable are from software products and therefore the comparable satisfied TPO's filter of more than 75 percent of revenues from software development services.

(b) Avani Cimcon Technologies Ltd.

39. As far as this company is concerned, the plea of the Assessee has been that this company is functionally different from the assessee. Based on the information available in the company's website, which reveals that this company has developed a software product by name "DXchange", it was submitted that this company would have revenue from software product sales apart from rendering of software services and therefore is functionally different from the assessee. It was further submitted that the Mumbai Bench of the Tribunal to the decision in the case of Telcordia Technologies Pvt. Ltd. v. ACIT – ITA No.7821/Mum/2011 wherein the Tribunal accepted the assessee's contention that this company has revenue from software product and observed that in the absence of segmental details, Avani Cincom cannot be considered as comparable to the assessee who was rendering software development services only and it was held as follows:-

"7.8 Avani Cincom Technologies Ltd. ('Avani Cincom'):

Here in this case also the segmental details of operating income of IT services and sale of software products have not been provided so as to see whether the profit ratio of this company can be taken into consideration for comparing the case that of assessee. In absence of any kind of details provided by the TPO, we are unable to persuade ourselves to include it as comparable party. Learned CIT DR has provided a copy of profit loss account which shows that mainly its earning is from software exports, however, the details of percentage of export of products or services have not been given. We, therefore, reject this company also from taking into consideration for comparability analysis."

It was also highlighted that the margin of this company at 52.59 percent which represents abnormal circumstances and profits. The following figures were placed before us:-

Particulars FYs 05-06 06-07 07-08 08-09

Operating Revenue	21761611	35477523	29342809	28039851
Operating Expns.	16417661	23249646	23359186	31108949
Operating Profit	5343950	12227877	5983623	(3069098)
Operating Margin	32.55 percent	52.59 percent	25.62 percent	- 9.87 percent

40. It was submitted that this company has made unusually high profit during the financial year 06-07. The operating revenues increased 63.03 percent which indicates that it was an extraordinary year for this company. Even the growth of software industry for the previous year as per NASSCOM was 32 percent. The growth rate of this company was double the industry average. In view of the above, it was argued that this company ought to have been rejected as a comparable.

41. We have given a careful consideration to the submissions made on behalf of the Assessee and are of the view that the same deserves to be accepted. The reasons given by the Assessee for excluding this company as comparable are found to be acceptable. The decision of ITAT (Mumbai) in the case of Telcordia Technologies Pvt. Ltd. v. ACIT (supra) also supports the plea of the assessee. We therefore accept the plea of the Assessee to reject this company as a comparable.

(c) Celestial Labs Ltd.

42. As far as this company is concerned, the stand of the assessee is that it is absolutely a research & development company. In this regard, the following submissions were made:-

- In the Director's Report (page 20 of PB-II), it is stated that "the company has applied for Income Tax concession for in-house R&D centre expenditure at Hyderabad under section 35(2AB) of the Income Tax Act."

- As per the Notes to Accounts - Schedule 15, under "Deferred Revenue Expenditure" (page 31 of PB-II), it is mentioned that, "Expenditure incurred on research and development of new products has been treated as deferred revenue expenditure and the same has been written off in 10 years equally yearly installments from the year in which it is incurred."

- An amount of Rs. 11,692,020/- has been debited to the Profit and Loss Account as "Deferred Revenue Expenditure" (page 30 of PB-II). This amounts to nearly

8.28 percent of the sales of this company.

It was therefore submitted that the acceptance of this company as a comparable for the reason that it is into pure software development activities and is not engaged in R&D activities is bad in law.

43. Further reference was also made to the decision of the Mumbai Bench of the Tribunal in the case of Teva Pharma Private Ltd. v. Addl. CIT – ITA No.6623/Mum/2011 (for AY 2007-08) in which the comparability of this company for clinical trial research segment. The relevant extract of discussion regarding this company is as follows:

"The learned D.R. however drew our attention to page-389 of the paper book which is an extract from the Directors report which reads as follows:

'The Company has developed a de novo drug design tool "CELSUITE" to drug discovery in, finding the lead molecules for drug discovery and protected the IPR by filing under the copy if sic (of) right/patent act. (Apprised and funded by Department of Science and Technology New Delhi) based on our insilico expertise (applying bio-informatics tools). The Company has developed a molecule to treat Leucoderma and multiple cancer and protected the IPR by filing the patent. The patent details have been discussed with Patent officials and the response is very favorable. The cloning and purification under wet lab procedures are under progress with our collaborative Institute, Department of

Microbiology, Osmania University, Hyderabad. In the industrial biotechnology area, the company has signed the Technology transfer agreement with IMTECH CHANDIGARH (a very reputed CSIR organization) to manufacture and market initially two Enzymes, Alpha Amylase and Alkaline Protease in India and overseas. The company is planning to set up a biotechnology facility to manufacture industrial enzymes. This facility would also include the research laboratories for carrying out further R & D activities to develop new candidates' drug molecules and license them to Interested Pharma and Bio Companies across the GLOBE. The proposed Facility will be set up in Genome Valley at Hyderabad in Andhra Pradesh.'

According to the learned D.R. celestial labs is also in the field of research in pharmaceutical products and should be considered as comparable. As rightly submitted by the learned counsel for the Assessee, the discovery is in relation to a software discovery of new drugs. Moreover the company also is owner of the IPR. There is however a reference to development of a molecule to treat cancer using bio-informatics tools for which patenting process was also being pursued. As explained earlier it is a diversified company and therefore cannot be considered as comparable functionally with that of the Assessee. There has been no attempt made to identify and eliminate and make adjustment of the profit margins so that the difference in functional comparability can be eliminated. By not resorting to such a process of making adjustment, the TPO has rendered this company as not qualifying for comparability. We therefore accept the plea of the Assessee in this regard.' "

44. It was submitted that the learned DR in the above case vehemently argued that this company is into research in pharmaceutical products. The ITAT concluded that this company is owner of IPR, it has software for discovery of new drugs and has developed molecule to treat cancer. In the ultimate analysis, the ITAT did not consider this company as a comparable in clinical trial segment, for the reason that this company has diverse business. It was submitted that, however, from the above extracts it is clear that this company is not into software development activities, accordingly, this company should be rejected as a comparable being functionally different.

45. From the material available on record, it transpires that the TPO has accepted that up to AY 06-07 this company was classified as a Research and Development company. According to the TPO in AY 07-08 this company has been classified as software development service provider in the Capitaline/Prowess database as well as in the annual report of this company. The TPO has relied on the response from this company to a notice u/s.133(6) of the Act in which it has said that it is in the business of providing software development services. The Assessee in reply to the proposal of the AO to treat this as a comparable has pointed out that this company provides software products/services as well as bioinformatics services and that the segmental data for each activity is not available and therefore this company should not be treated as comparable. Besides the above, the Assessee has point out to several references in the annual report for 31.3.2007 highlighting the fact that this company was develops biotechnology products and provides related software development services. The TPO called for segmental data at the entity level from this company. The TPO also called for description of software development process. In response to the request of the TPO this company in its reply dated 29.3.2010 has given details of employees working in software development but it is not clear as to whether any segmental data was given or not. Besides the above there is no other detail in the TPO's order as to the nature of software development services performed by the Assessee. Celestial labs had come out with a public issue of shares and in that connection issued Draft Red Herring Prospectus (DRHP) in which the business of this company was explained as to clinical research. The TPO wanted to know as to whether the primary business of this company is software development services as indicated in the annual report for FY 06-07 or clinical research and manufacture of bio products and other products as stated in the DRHP. There is no

reference to any reply by Celestial labs to the above clarification of the TPO. The TPO without any basis has however concluded that the business mentioned in the DRHP are the services or businesses that would be started by utilizing the funds garnered through the Initial Public Offer (IPO) and thus in no way connected with business operations of the company during FY 06-07. We are of the view that in the light of the submissions made by the Assessee and the fact that this company was basically/admittedly in clinical research and manufacture of bio products and other products, there is no clear basis on which the TPO concluded that this company was mainly in the business of providing software development services. We therefore accept the plea of the Assessee that this company ought not to have been considered as comparable.

(d) KALS Information Systems Ltd.

46. 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 percent 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/10 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.

47. 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.

Assessee's comparables

51. It is the grievance of the Assessee that the lower authorities have rejected certain comparables selected and proposed by the assessee on the ground that they have predominant onsite revenues and are functionally different. The justification for retaining the comparables selected by the assessee are available on pages 318 to 331 and pages 394 to 402 of PB-I. The comparables that have been rejected by the TPO, but do not deserve to be so rejected, according to the Assessee are:

Sl. No.	Name of the Company	Operating Revenues	Operating Margin on Cost
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1	Indium Software (India) Limited	6,49,14,480	2.03 percent
2	E2E Infotech Limited	21,548,500	10.81 percent
3	Goldstone Technologies Limited	410,348,370	22.94 percent
4	Thinksoft Global Services Limited	526,597,803	19.12 percent
5	Visu International Limited	900,319,768	19.90 percent
6	Maars Software International Limited	355,488,750	-1.68 percent
7	Akshay Software Technologies Limited	71,283,298	3.98 percent
8	VJIL Consulting Limited	130,249,104	-14.92 percent
9	Synfosys Business Solution Limited	62,249,104,	12.17 percent

52. As far as the rejection of the comparables cited by the assessee in its TP study is concerned, we find the following. In some cases, the comparables selected by the assessee were rejected for the reason that they do not satisfy the onsite revenue filter i.e., if revenues of comparable companies from rendering onsite software exceed 75 percent of the total revenue, then they should not be regarded as comparable to the assessee where revenue is from rendering offshore software development services. At page 24 of the Order, the TPO has stated the following reasons for applying the onsite revenue filter:

1. The market conditions are different for onsite than offshore work.
2. The pricing structure is different in onsite work.
3. The assets are negligible in the onsite companies.
4. The margins for onsite are lower when compared to offshore work.
5. The labour markets are different for offshore and onsite work, as the people who are working on onsite get competitive salaries of the resident countries.
6. Cost arbitrage is not available for the onsite work.
7. The companies whose revenues are generated mainly from onsite work almost mimic a company which is resident in that country.

53. The stand of the Assessee on the above aspects is that the learned TPO had contended that "market conditions" are different for on-site and offshore work, but he has not substantiated how market conditions differ. The learned TPO has failed to appreciate that whether a company operates onsite or offshore, the functions performed are the same. What is important from an arms' length perspective are the functions performed and not the place of its performance. It is not that a company performs altogether different functions under onsite assignments. The margins in offshore or onsite operations are not greatly dissimilar although the rate per hour may substantially differ. Similarity of functions performed and absence of dissimilarities in margins should lead to the acceptance of onsite work and its data for comparison purposes. Accordingly, the assessee submits that this reason of the TPO is without basis.

54. On the reasoning of the TPO that the pricing structure is different in onsite work, it is

the submission of the assessee this aspect was irrelevant. The method selected is TNMM. What is tested is margin and not price. If pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects. The pricing would differ from project to project, domain to domain and on various other parameters. Such exercise has not been done. Further as admitted by the TPO, once functional similarity is accepted, companies can be compared. The attempt to separate onsite activity for comparison purposes is thus without basis.

55. On the reasoning of the TPO that the assets are negligible in the onsite companies, it is the stand of the Assessee that while discussing turnover filter, the learned TPO has stated that software companies do not require much infrastructure. The TPO in case of other assessees has held that software companies whether onsite or offshore do not require much infrastructure. Therefore question of assets being negligible only for onsite operation should not matter because as per the TPO not much assets are required for software companies.

56. On the reasoning of the TPO that Margins are lower in case of onsite operations, it is the stand of the Assessee that margin is not a criteria to select or reject a comparable under Rule 10B(2) of the I.T. Rules. The assessee submits that comparability of an uncontrolled transaction has to be tested on touchstone of the principles enunciated in Rule 10B(2). The margin of an uncontrolled transaction is not a criterion to select or reject a comparable. Taking margin as a criterion to select or reject a comparable would be incongruous because what is tested under TNMM is the margin itself. It was further pointed out that in case of service companies the return is primarily linked to functions performed rather than location of performance. This is all the more so for the IT industry and in a world that is flat. Based on the above, the assessee urged that the learned TPO's conclusion that margins are different in case of onsite revenues is without basis and ought to be rejected.

57. The learned TPO has stated that the labour markets are different for offshore and onsite work, as the people who are working on onsite get competitive salaries of the resident countries. Further, cost arbitrage is not available for onsite work. The learned TPO has stated that pricing structure is different in onsite work. In this regard, the assessee submitted that the learned TPO has not substantiated the above statements. In the absence of adequate substantiation, the statements appear fanciful and born out of imagination.

58. It was argued that under TNMM, the assessee is selected as the tested party. What is to be tested under TNMM is the net margins of the assessee. The cost for recipient of service has no bearing on the margins of the assessee. Whether the recipient of service gets cost arbitrage or not is not a consideration for testing the margins of the assessee. Two companies may have similar margins although their gross margins may differ. When net margins are being compared, difference in gross margins cannot be a factor for rejection of companies as a comparable. Similarly for software companies when net margins are being compared, price/rate differential should not be criteria for acceptance or rejection of a company as a comparable. It was pointed out that though it is true that a professional sent on onsite projects are paid higher salaries, however the billing rates are also higher. It is on the basis of the cost structure that revenues are agreed upon. In case of onsite operations both income and cost would go up. There cannot be a presumption that margins have been sacrificed to secure revenues. Such an indication of the learned TPO is without any basis.

59. The learned TPO has further stated that companies whose revenues are generated mainly from onsite work mimic a company which is a resident in that country. This again is a conclusion without basis. It is again a conclusion whose relevance to the case on

hand has not been established. The same is therefore to be ignored. Further, the TP Regulations or OECD Guidelines do not prescribe application of onsite filter. Therefore, onsite revenue filter should not be used. Accordingly the assessee submits that onsite revenue filter should not be adopted in judging whether a company is to be retained as a comparable or not.

60. We have given a careful consideration to the above submissions made on behalf of the Assessee. We find that the DRP has not dealt with any of the above submissions but have in page 23 and 24 of their order have held that the application of onsite revenue filter was justified. Rule 10B(2) & (3) of the IT Rules, 1962 would be relevant to render a decision on the above contentions of the parties before us. Those rules have already been set out in the earlier part of this order. The crux of the rules, in so far as it relates to the contentions regarding application of the Onsite revenue filter, is that 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.

61. It is only when there are no difference between the uncontrolled transaction and the international transaction as set out above or if there are differences but such difference will not affect the price or cost charged or paid or profit arising from such transactions or if there will be differences in price or cost charged or pair or profit arising from such transactions, such differences should be reasonably capable of being quantified and adjustment made to eliminate the effect of such differences.

62. The Indian software sector provides both on-site and offshore services. The Assessee in the present case is mainly offshore service provider and it generates income only from offshore software development service. Most of the uncontrolled enterprises follow hybrid model with revenue mix both from onsite and offshore. It is true that in terms of the functions performed both in the case of offshore service provider and onsite service provider, it is development of computer software. But having regard to Rule 10B(2)(b) it is necessary to have regard to the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions.

63. The first objection of the Assessee is that the TPO has observed that "market conditions" are different for on-site and offshore work, but he has not substantiated how market conditions differ. We fail to see any substance in such objection. The fact is that in onsite development of computer software, the Assessee does not employ assets nor does the Assessee assume many risks which the offshore software developer assumes. Even the Assessee accepts that the per hour rate will be different in the case of offshore software development and onsite software development.

64. The next objection of the Assessee is that when the most appropriate method selected for determining ALP is the TNMM there is no reason as to why one should look at price difference in offshore software development and onsite software development. It is no doubt true that in TNMM it is only the margins in an uncontrolled transaction that is tested with reference to the controlled transaction but it is not possible to ignore the fact that pricing will have an effect on the margins obtained in a transaction. The argument that if pricing structure were to be considered as criteria, then it will have to be seen as to what is the pricing structure of all the comparable for various projects cannot be accepted because the TPO has not chosen any other onsite software service provider with a revenue composition of more than 75 percent from onsite software services as comparable. As rightly observed by the TPO, the pricing is different in onsite when compared to offshore operations. The further observations of the TPO that the reasons for the same lie in the fact that while in the case of OFFSHORE projects most of the costs are incurred in India; an ONSITE project has to be carried out abroad significantly increasing the employee cost and other costs.

65. The next objection of the Assessee is with regard to Assets employed. The companies, which predominantly generate revenues from onsite activity, do not have significant assets as most of the work is carried on the site of customer outside India. The argument that the TPO has himself observed that software service providers do not require much assets cannot be basis to accept the Assessee's plea. Those observations are made by the TPO in the context of application of turnover filter and have been quoted out of context by the Assessee.

66. The next argument of the Assessee is that TPO has held that margins are lower in onsite software services and that margin is not a criteria to select or reject a comparable under Rule 10B(2) of the I.T. Rules.

We are of the view that this argument again ignores the fact that the approach of the TPO has been to highlight the fact that there can be no functional comparability, if the assets employed and risks assumed are taken into consideration. It is in that context the TPO has referred to the margins.

67. The companies who generate more than 75 percent of the export revenues from onsite operations outside India are effectively companies working outside India having their own geographical markets, cost of labour etc., and also return commensurate with the economic conditions in those countries. Thus assets and risk profile, pricing as well as prevailing market conditions are different in predominantly onsite companies from predominantly offshore companies like the taxpayer. Since, the entire operations of the tax payer are taking place offshore i.e. in India; it is but natural that it should be compared with companies with major operations offshore, due to the reason that the economics and profitability of onsite operations are different from that of offshore business model. As already stated the Assessee has limited its analysis only to functions but not to the assets, risks as well as prevailing market conditions in which both the buyer and seller of services located. Hence, the companies in which more than 75 percent of their export revenues come from onsite operations are to be excluded from the comparability study as they are not functioning in similar economic circumstances to that of the tax payer. Hence, it is held that this filter is appropriately applied by the TPO.

68. Admittedly the onsite revenue in the case of the following comparable companies identified by the Assessee was more than 75 percent of its export revenues viz.,

a) Visu International Ltd.

b) Maars Software International Ltd.

c) Akshay Software Technologies Ltd.

d) VJIL Consulting Ltd.

e) Synfosys Business Solutions Ltd.

The above companies were therefore rightly not considered as comparable by the TPO. We hold accordingly.

69. Another reason given by the TPO for rejecting E2E Infotech Ltd., a comparable identified by the Assessee but rejected by the TPO, was for the reason that the details of this company was insufficient. On the above, the assessee has pointed out that the Annual Report of this company for FY 07-08 is available and details for FY 06-07 are available in this report. It is the stand of the Assessee that this company is comparable in all respects. The Assessee admits that there is no information on related party transactions and in the absence of such information it has to be presumed that there are no RPT.

70. We have perused the TPO's order and find that this company does not figure in the list of comparable selected by the Assessee in its TP study. In submissions before DRP the Assessee has taken a stand that this company has no related party transaction. In the circumstances when the comparability has neither been considered by the TPO or the DRP, we do not think that at this stage we can take a view on comparability or otherwise of this company. In any event the details furnished are sketchy and it is not possible to take one view or the other on the claim of the Assessee. We therefore hold that this company has been rightly not considered for comparability.

71. M/s. Indium India Ltd., a comparable considered by the Assessee in its TP study was rejected by the TPO as not comparable on the ground that the said company was rendering software testing services. It is the plea of the assessee that software testing is an integral part of software development cycle. It is further pointed out that the TPO in his analysis has selected Ishir Infotech Ltd., which renders software testing activities as comparable. This contention of the Assessee is not correct. At page 98 of the TPO's order, the objection of the Assessee for selecting Ishir InfoTech Ltd. as comparable is for the reason that this company was outsourcing software development and that the company does not satisfy 25 percent employee cost filter. Both these objections have been found to be not sustainable by the TPO. The question therefore would be as to whether software testing services would be equivalent to software development services. Software testing is only part of software development life cycle. It cannot be equated with software development services. The TPO in our view rightly excluded this company for comparability purposes.

72. With regard to Goldstone Technology Ltd., the same was rejected as a comparable by the TPO for the reason that it was engaged in I.T. enabled services. It is the claim of the Assessee that in the company's annual report, flow of revenue in this company is from software development both, onsite and offshore operations. On the above, we find that this company has clarified in response to notice of the AO u/s.133(6) of the Act that it is not in the business of software development but in ITES. The alternative plea of the Assessee is that it should be allowed opportunity to cross examine this company on its reply to the notice of TPO u/s.133(6) of the Act. We have seen the objections of the Assessee which is based only on a reading of the Annual report and the claim of the Assessee is not on sound basis and is purely on surmises. We are of the view that the rejection by the TPO of this company as a comparable is on sound basis and the same is upheld.

73. Regarding Thinksoft Global Solutions Ltd., it was submitted that this company was

rejected as comparable by the TPO for the reason that it was engaged in the software testing services. As already stated, this ground of rejection of comparable by the TPO has already been held by us to be proper.

74. Thus the claim of the Assessee to include 9 companies as comparable is found to be not acceptable.

75. The use of information received by the TPO by issue of notice u/s.133(6) of the Act without affording opportunity of cross examining the companies concerned, now needs to be dealt with. On this issue the only grievance of the Assessee which survives is the use of information received by the Assessee from Goldstone Technologies. We have already seen that the basis on which the Assessee challenges the information received u/s.133(6) of the Act is not sound. We therefore do not think that the right to cross examine this company will serve any purpose. The other objection of the Assessee was that TVS Infotech was considered as a comparable initially by the TPO because as per information furnished by this company in response to notice of TPO u/s.133(6) this company did not have any related party transaction. The Annual report of this company however showed that this company fails RPT filter. The TPO therefore rejected this company as comparable. We are of the view that the TPO in the case of this company has not used information u/s.133(6) of the Act and therefore the Assessee can have no grievance. If on the other hand the Assessee wants to show that information available in public domain is not correct then the onus would be on the Assessee to establish the same. The Assessee cannot ask for a right to cross examine on a surmise that the information given in response to notice u/s.133(6) of the Act would be correct and that given in the annual report is incorrect. The Assessee if he is able to show prima facie that the information available in public domain is incorrect then we will be persuaded to afford opportunity to the Assessee but not on a claim which lacks substance and is based on surmises.

76. The comparable now accepted as comparable and their operating margins before and after working capital adjustment are detailed in the table given below:-

TABLE 1 – TURNOVER RANGE 1 TO 200 CRORES AND AFTER CONSIDERING COMPARABLES SELECTED BY THE ASSESSEE

Sl. No.	Name of the Company	Operating Revenues	Operating Margin on Cost	Adjusted on Margin on Cost
1.	Datamatics Ltd.	545,088,027	1.38 percent	0.58 percent
2.	E-Zest Solutions Ltd.	62,594,544	36.12 percent	37.23 percent
3.	Geometric Ltd. (seg)	1,583,797,773	10.71 percent	10.81 percent
4.	Helios & Matheson Information Technology Ltd.	1,786,380,304	36.63 percent	35.62 percent
5.	Ishir Infotech Ltd.	74,209,887	30.12 percent	31.60 percent
6.	LGS Global Ltd. (Lanco Global Solutions Ltd.)	453,893,898	15.75 percent	16.36 percent
7.	Lucid Software Ltd.	16,992,078	19.37 percent	18.24 percent
8.	Mediasoft Solutions Pvt. Ltd.	18,508,785	3.66 percent	2.77 percent
9.	Megasoft Ltd (Seg.)	637,132,545	23.11 percent	17.85 percent

10.	Quintegra Solutions Ltd.	627,216,924	12.56 percent	10.42 percent
11.	R S Software (India) Ltd.	1,010,449,441	13.47 percent	14.33 percent
12.	R Systems International Ltd. (Seg)	1,120,172,651	15.07 percent	14.44 percent
13.	SIP Technologies & Exports Ltd.	37,980,955	13.90 percent	11.90 percent
14.	Thirdware Solutions Ltd. (Seg)	360,850,000	25.12 percent	22.71 percent
	Arithmetic Mean		17.508 percent	

77. The differential between the margins of the assessee as above and of the comparable in the Table given above, is beyond the 5 percent range. Applying, the proviso to section 92C(2), adjustment is required to be made to the reported values of the assessee's transactions with its associated enterprises. The AO is directed to make adjustment to the ALP adopting the arithmetic mean of 17.508 percent and consequent addition to the total income.

78. The other issues raised by the Assessee viz., (i) the reference to TPO being bad in law; (ii) the CIT's approval for reference to TPO also being bad in law; (iii) the additions being unsustainable as the definition of income or the computation process under section 28 to 44 not envisaging a reference to or incorporation of an adjustment proposed under Chapter X are without any merit and are contrary to the ruling of the Special Bench of the Tribunal in the case of Aztec Software 107 ITD 141 (SB)(Bang).

79. The following other objections were also raised by the Assessee regarding determination of ALP:

(A) Inappropriate computation of operating margins of comparables and that of the Assessee:

This objection in our view does not require any specific consideration and will be covered by the decision that will be rendered on point (B) below.

(B) Treating foreign exchange gain or loss and provision for bad debts as non-operating in nature and fringe benefit tax as part of operating cost:

As far as foreign exchange gain/loss being considered as not forming part of the operating cost, the reasoning of the revenue is that such loss or gain cannot be said to be one realized from international transaction though they may form part of the gain/loss of the enterprise and therefore they should be excluded while determining operating cost. On the above issue we find that the Bangalore Bench of ITAT in the case of Sap Labs India (P) Ltd. Vs. ACIT (2011) 44 SOT 156 (Bang.) has taken the view that Foreign Exchange Fluctuation gains are required to be added to operating revenue. Following the same, the AO is directed to accept the claim of the Assessee in this regard. As far as provision for bad debts are concerned, the TPO has accepted that the same would be part of operating expenses provided the same is incurred every year for at least three years and the manner in which provision is made is consistent. The Assessee in reply to the query of the TPO on the above aspect has not furnished any details. We are of the view that the Assessee should be afforded opportunity to explain its position on the above and the AO is directed to consider the same in accordance with law. As far as Fringe Benefit Tax (FBT) is concerned, the same was not considered by the TPO as part of operating cost in the case of comparables and therefore the same should also not

be considered as part of operating cost of the Assessee. We hold accordingly and direct the AO to compute the operating cost of the Assessee.

(C) Not making proper adjustment for enterprise level and transactional level differences between the Assessee and comparable companies.

(D) Adjustment for differential in risk to be given.

As far as point (C) and (D) are concerned, the arguments advanced are general with no supporting facts, hence rejected. The submissions of the Assessee in this regard are at pages 413 to 422 of the paper book.

80. Thus Gr.No.1 to 16 is decided as indicated above and the AO is directed to work out the adjustment to ALP keeping in mind the directions as given above.

81. Grounds 17.1 to 17.4 raised by the assessee reads as follows:-

"The learned Assessing Officer and Honorable Dispute

Resolution Panel have erred in:-

17. Excluding a sum of Rs. 1,78,58,079/- being expenses incurred in foreign currency from export turnover on the ground that these expenses are incurred in rendering technical services rendered to clients outside India while computing deduction under section 10A;

17.2 Not appreciating that the appellant, at all times during the relevant previous year, was engaged in development of computer software and not in rendering of technical services;

17.3 Excluding a sum of Rs.24,29,913/- being telecommunication and insurance expenses from export turnover; and

17.4 not appreciating that expenses that are reduced from the export turnover should also be reduced from the total turnover."

82. Ground 18 raised by the Assessee reads as under:-

"The learned Assessing Officer and Honorable Dispute Resolution Panel have erred in:-

18. disallowing a sum of Rs. 1,76,98,160/- being research and development expenses under section 37 of the Act stating that the said expenditure is not revenue in nature;

83. The Assessee had debited in the profit and loss account a sum of Rs.1,76,98,160 under the head Research and Development. The Assessee explained that these expenses were incurred for developing/improvising new products in domestic markets. Admittedly these expenses were not incurred for M/S. Versata International Inc., the Assessee's holding company and this is evident from the fact that the TPO while computing the ALP of the international transaction between the Assessee and the AE (Holding company) took operating profit to cost as PLI and has not considered this expenditure as part of the cost for providing services by the Assessee to the holding company. The break-up of these expenditure is given in Schedule-10 to the Profit and Loss account and are in the nature of salary, rent, staff welfare, electricity communication expenses, legal charges, bank charges, insurance etc., which are basically revenue expenses in nature. The plea of the Assessee was that it was in the business of rendering software development

services and as a continuous process to develop and improvise new products in domestic market, it has to indulge in research and development. The expenses were for exploring the possibility of domestic market through pilot projects. The expenses were wholly and exclusively for the purpose of existing business carried on by the Assessee. The expenses were revenue in nature and did not result in any advantage/benefit of enduring nature to the Assessee. It was the plea of the Assessee that the information technology industry is fast changing and there is a great degree of obsolescence and therefore expenses of this nature cannot be said to result in any enduring benefit to the Assessee. Among other decisions the Assessee relied on the decision of the Hon'ble Supreme Court in the case of Alembic Chemicals Works Co. Ltd. Vs. CIT 177 ITR 377 (SC).

84. In the assessment order, the learned AO has disallowed a sum of Rs. 1,76,98,160/- being research and development expenses under section 37 of the Act stating that the said expenditure is not revenue in nature. The Assessee pleaded before DRP that the expenditure should be allowed as deduction u/s37 of the Act or alternatively, if considered as capital expenditure, deduction should be allowed u/s.35 of the Act as expenditure incurred on Scientific Research. The DRP however proceeded under an erroneous assumption that these expenses were incurred on behalf of the AE. The DRP thereafter held that the Assessee has not explained as to how these expenses were deductible.

85. Before us, the assessee submitted that these expenses were incurred by it in developing two websites by name www.billbuddy.com and www.carbuy.com. In case of www.billbuddy.com, a customer could upload his telephone bill and the website would analyze the call charges and give output. In case of www.carbuy.com, the website would give comparison of various cars etc, to make informed decision to buyers. The assessee during the year incurred expenses like salaries and related benefits paid to employees, outsourcing charges, rent, electricity, insurance, travelling & conveyance, trainings etc for development of the above website. The Assessee submitted that these expenses should be considered as revenue expenditure. It was submitted that in the following decisions it has been held that website development expenses are revenue in nature.

1. CIT v Indian Visit.com (P) Ltd 176 Taxman 164

2. Lyons Technologies Ltd. v ACIT - I.T.A. No.3060/ AHD/2004

3. M/S. Kisan Ratilal Choksey Shares & Securities Pvt. Ltd. v Addl. CIT — ITA No.4821 /Mum/2009

The learned DR relied on the order of the AO.

86. We have considered the rival contentions. The submissions made before us that the above expenses were incurred for website development is contrary to the stand of the Assessee before DRP/AO that these expenses were for exploring the possibility of domestic market through pilot projects. Unless the nature of the expenses is examined it is not possible to decide as to whether the same were revenue in nature and that it relates to existing business of an Assessee. The alternative contention of the Assessee that the claim should be examined u/s.35 of the Act also cannot be decided unless the correct description of the expense is considered. We therefore set aside the order of the AO on this issue and remand the issue for consideration afresh by the AO after affording opportunity of being heard to the Assessee.

87. Grounds No.19 & 20 raised by the Assessee reads as follows:

"19. disallowing a sum of Rs. 12,50,000 being provision for building registration charges without appreciating that same has been written back in the later assessment year and

therefore is deductible expenditure; and

20. disallowing a sum of Rs. 28,25,890 being provision towards foreign travel expenses on the ground that these are liabilities on provisional basis."

88. During the previous year, the assessee had made provision of Rs.12,50,000/- towards building registration charges. The AO has disallowed the same on the ground that it is a provision. The assessee submitted that the provision has been reversed and offered to tax during the AY 2009-10 and therefore same should not be taxed in the year under consideration. The limited plea of the Assessee before us is that if the sum is disallowed in this year the same should not be taxed in AY 09-10. We are of the view that it would be appropriate to direct the AO not to tax the same sum in AY 09-10 as the sum has already suffered tax by disallowance in the present AY. With the above directions, Gr.No.19 is dismissed.

89. As far as Gr.No.20 is concerned, the facts are that the AO disallowed a sum of Rs. 28,25,890/- being travel expenses on the ground that the appellant did not furnish the name of employees who have travelled with details of the places including the invoices, bills and the amount thereof. In this regard, it was submitted that its employees go for foreign travel for onsite jobs. The assessee gives travel advance to the employees before their foreign travel. If the employees return before 31st March, their accounts are settled. However some time, the employees return after 31st March. In such cases, the appellant makes a provision in the books of account from the date of travel to 31st March based on its per diem policy. The same is settled in the succeeding year after return of the employees. The provision being towards actual expenditure incurred is allowable as deduction. The portion of provision is towards hotel and boarding charges. A provision is made towards hotel and boarding charges from the date of booking to 31st March. A provision is made based on the details of expenditure provided by AE who make the payment. The appellant reimburses these expenses at cost to the AE subsequently. The assessee submits that expenditure for the purposes of section 37 includes amounts which the assessee has actually expended or which the assessee has provided for or laid out in respect of an accrued liability. The assessee submits that the additions made by the AO are to be deleted.

90. With respect to AO's and DRP's contention that the assessee did not submit details, the assessee brought to our notice that the details were never called for by the AO. The assessee also submitted these details before the DRP (employee wise provision details alongwith month of settlement as Annexure 4 to DRP submissions — pages 502 to 505 of PB). The learned DR relied on the order of the AO.

91. We have considered the rival submissions. The disallowance in question has been made for the reason that expenditure cannot be claimed on the basis of provision and that the liability in respect of the expenditure has not accrued to the Assessee during the previous year. In our view this cannot be the basis to disallow the claim of the Assessee for deduction. The law in this regard is now well settled. The Hon'ble Supreme Court in the case of Bharat Earth Movers Vs CIT 245 ITR 482(SC) had an occasion to consider the claim for deduction on account of a contingent liability. The following principles were laid down by the Hon'ble Supreme Court:-

'If a business liability has definitely arisen in accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible if these requirements are satisfied the liability is not as contingent one. The liability is in present though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain'.

92. In the present case, we find from the details of expenses which were claimed as a provision, the Assessee has the system of reversing expenses wherever the same was not incurred by the Assessee, in the succeeding Assessment years. We are of the view that the AO should be directed to examine the issue afresh in the light of the decision of the Hon'ble Supreme Court referred to above and ascertain as to the reasonableness of the basis on which the provision is made, examine as to whether the Assessee reverses excess provision when the actual expenses details are available and also see if the Assessee follows the method of accounting consistently. The AO will afford opportunity of being heard to the Assessee and decide the issue afresh.

93. Ground No.21 is with regard to levy of Q 86,13,925 as interest u/s. 234B of the Act, which is purely consequential. The AO is directed to give consequential relief.

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