

SAP LABS INDIA (P) LTD. vs. ASSISTANT COMMISSIONER OF INCOME TAX

ITAT, BANGALORE 'A' BENCH

N.K. Saini, A.M. & George George K., J.M.

Misc. Petn. No. 102/Bang/2010 in ITA Nos. 398 & 418/Bang/2008; Asst. yr. 2003-04

9th November, 2011

(2011) 30 CCH 0571 BangTrib

(2012) 145 TTJ 0521 : (2012) 69 DTR 0145 : (2012) 134 ITD 0253 : (2012) 015 ITR 0506

Legislation Referred to

Section 92C

Case pertains to

Asst. Year 2003-04

Decision in favour of:

Assessee (partly)

Transfer pricing—Computation of arm's length price—Comparable cases and risk adjustment etc.—'S' company, whose financial statement was publicly known to be falsified, could not be taken as a comparable company to arrive at the ALP—Tribunal having taken a conscious decision after elaborate consideration that the companies having margin less than 6 per cent is to be excluded from the comparables on facts and circumstances of the case, this issue cannot be revisited in a miscellaneous application—Further, Tribunal having allowed benefit of deduction of 5 per cent under proviso to s. 92C(2), no separate adjustment is required on account of risk functional difference moreso, when the assessee made claim of risk adjustment for the first time before Tribunal

(Paras 7.22 & 8.3)

Conclusion:

On miscellaneous application, one of the companies whose financial statement was publicly known to be falsified directed to be rendered from comparable cases in computation of ALP but pleas as regards exclusive of certain other companies risk adjustment rejected.

In favour of:

Assessee (partly)

Transfer pricing—Computation of arm’s length price—Two prices determined by application of most appropriate method—When there are two arm’s length prices determined by most appropriate method, the arithmetic mean of the two has first to be taken and thereafter only the adjustment of +/- 5 per cent is to be done—This having not been done, matter remanded to AO

Held:

When there are two prices determined by the most appropriate method, the first step is to take the arithmetical mean of such prices as ALM. However, the assessee has the option to adjust the above ALM by +/- 5 per cent. Here, the two different prices are 20.57 by the AO and 8.80 by the assessee. The adjustment of 5 per cent is done on assessee’s computation to arrive at 13.80 per cent. However, the arithmetical mean of two prices has not been done. Only after arriving at the arithmetical mean of two prices, the adjustment of 5 per cent can be done. For this purpose, this issue is restored to the file of the AO, who shall in turn, may refer the matter to the TPO.

(Para 10.2)

Conclusion:

When there are two arm’s length prices determined by most appropriate method, the arithmetic mean of the two has first to be taken and thereafter only the adjustment of +/- 5 per cent is to be done.

In favour of:

Matter remanded

Case referred to

Agnity India Technologies (P) Ltd. (ITA No. 3856/Del/2010)
Philips Software Centre (P) Ltd. vs. Asstt. CIT (2008) 119 TTJ (Bang) 721 : (2008) 15 DTR (Bang)(Trib) 505
Symantec Software Solutions (P) Ltd. vs. Asstt. CIT (ITA No. 7894/Mum/2010, dt. 31st May, 2011)

Counsel appeared:

Rajan Vora, for the Appellant : Etwa Munda, for the Respondent

ORDER

GEORGE GEORGE K, J.M. :

ORDER

This miscellaneous application filed by the assessee arise out of the Tribunal order dt. 30th Aug., 2010 in ITA Nos. 398 and 418/Bang/2008.

2. Briefly stated the facts are as follows :

The assessee is a company incorporated in India on 7th Aug., 1995 and is a wholly

owned subsidiary of **SAP** AG, Germany. **SAP Labs** has entered into a Research & Development agreement (R&D agreement) with **SAP** AG and is remunerated on a cost plus 6 per cent basis or 1.5 times the wage bill, whichever is higher. The assessee conducted a transfer pricing ("TP") study to substantiate that its international transactions during the asst. yr. 2003-04 were at arm's length, based on the functions, assets and risks analysis of the assessee's business and adopting transactional net margin method ("TNMM") for determining the arm's length price ("ALP").

2.1 The AO passed an assessment order under s. 143(3) of the Act with the following adjustments :

- Disallowance of compensation charges on termination of lease agreement; and
- TP adjustment of Rs. 11,42,86,466 (as proposed by the TPO) in his order dt. 15th March, 2006, pursuant to a reference of the assessee's case by the AO.

3. On appeal, the adjustment to the ALP made by the AO under s. 92CA was confirmed by the CIT(A) vide order dt. 28th Jan., 2008.

4. Being aggrieved by the order of the CIT(A), assessee preferred an appeal before the Tribunal. The Tribunal passed an order under s. 254(1) of the Act dt. 30th Aug., 2010. The Tribunal, in the order, has adjudicated on certain economic and legal issues regarding the determination of ALP in respect of transactions entered into by the assessee with its associated enterprises (AEs). The Tribunal, based on a detailed analysis of the assessee's and the TPO's approach to selection of comparable data, determined the ALP margin for the transaction at 20.57 per cent and re-worked the assessee's margin at 8.80 per cent. Further, a standard deduction of 5 per cent on the assessee's margin has been granted under proviso to s. 92C(2) of the Act, thereby increasing the assessee's margin to 13.8 per cent. Accordingly, the TP adjustment has been reduced from 16.81 per cent (as determined by the TPO) to 6.77 per cent of the operating costs of the assessee.

5. The assessee company being aggrieved by certain findings/conclusions of the Tribunal, has filed this miscellaneous application before us.

6. In the miscellaneous application, the assessee has raised four issues, namely :

- (i) Satyam Computers Services Ltd. should not be accepted as a comparable;
- (ii) Rejection of comparable companies with margins less than 6 per cent (including comparable companies with negative margins);
- (iii) Request for risk adjustment and
- (iv) Computation of the arm's length range.

7. Now let us take up each issue separately.

(1) Satyam Computers Services Ltd. should not be accepted as a comparable (page Nos.67-69, para Nos. 91-93

In the order, the Tribunal has worked out the ALP/the arithmetical mean of the comparables short listed out of the comparables identified by the TPO/assessee as follows :

"The arithmetic mean will be worked out on the basis of combined list of both TPO/AO and the assessee company, comprising 12 comparables.

The necessary working is made out below :

Sl. No.	Name of the company	Margins (In %)
1.	ADCC Research & Computing Centre Ltd.	40.96
2.	Compudyne Winfo Systems Ltd.	21.65
3.	Kashyap Radiant Systems Ltd.	13.27
4.	Lanco Global Systems	20.91
5.	Larsen & Turbo Infotech Ltd.	6.95
6.	Mascon Global Ltd.	10.26
7.	Onward Technologies Ltd.	15.45
8.	Satyam Computers Services Ltd.	30.86
9.	VMF Softtech Ltd.	6.09
10.	Xcel Vision Technologies Ltd.	35.88
11.	Kshema Technologies Ltd.	13.64
12.	Zylog Systems Ltd.	30.86
	Total Value	246.78
	No. of comparables	12
	Arithmetic mean	20.57

As computed above, the arithmetic mean to work out the ALP is 20.57 per cent (page No. 67-69, para Nos. 91-93)."

7.1 In the course of hearing of the miscellaneous petition, it was submitted that though Satyam is engaged in software development and qualifies all the comparability filters, the same should not to be considered as a comparable due to recent developments highlighting the unreliability and falsification of its audited financial statements. It was submitted that in the course of hearing of the appeal on 19th May, 2010, it specifically pleaded that Satyam should not be included as a comparable. The unreliability of the accounts has also been admitted by the managing director of Satyam in his communication to the Securities and Exchange Board of India (SEBI), the authority for regulating the capital markets in respect of listed companies in India. Therefore, it was submitted that having known the true state of affairs of Satyam as on the date of pronouncement of the order of the Tribunal i.e. 30th Aug., 2010, the assessee pleads that Satyam should not be included in the comparables set for determining the ALP of the international transactions undertaken by the assessee during the financial year 2002-03.

7.2 We have heard the rival submissions and perused the material on record. We

noticed that the assessee company selected 22 comparables in the transfer pricing document and M/s Satyam Computers Services Ltd. was listed at serial No. 18 (source p. 54 of Annex. A-6 of paper book Vol. I). The TPO vide his order dt. 15th March, 2006 selected 8 comparables and excluded Satyam Computers Services Ltd. selected by the assessee. The exclusion of Satyam by the TPO was for the reason that he determined a turnover filter of Rs. 50 crores to Rs. 150 crores would ensure comparability of the companies with the assessee. Consequently, Satyam, which reported a turnover of Rs. 2,023.65 crores was excluded from the lists of comparable companies as it did not fall within the above turnover range. The above selection criterion adopted by the TPO was upheld by the CIT(A) vide order dt. 28th Jan., 2008, disregarding the submissions made by the assessee that the turnover filter adopted by the TPO should not be used in identifying comparable companies. The Tribunal in the process of arriving at the final list of comparable companies for determining the ALP, combined the separate lists prepared by TPO/CIT(A) and the assessee and finally determined 12 companies in all, including Satyam, which was picked from and formed part of the assessee's set in its original TP study undertaken in 2003.

7.2.1 In this regard, we have to mention that Satyam was already excluded in the lists of comparable companies by the TPO as well as by the CIT(A), therefore, neither ground nor written submission could have been raised for its exclusion before the Tribunal. The assessee's ground/prayer before the Tribunal was that adoption of turnover filter by the TPO to identify the new list of comparable companies is not justified. It was submitted by the learned Authorised Representative that during the course of hearing of appeal, it was specifically pleaded that Satyam should not be included in the comparables list in the event the assessee's ground/prayer to reject TPO's identification of comparables on the basis of turnover filter is not acceded to. In this regard, it was submitted that the extract from Satyam's managing director's communication to the SEBI was read out by the Authorized Representatives of the assessee during the hearing of appeal on 19th May, 2010. It is an admitted position that Satyam company's statements of affairs were falsified during the period 2002 to 2008 and it became publicly known in January, 2009. When a responsible and respectable counsel submits before the Bench that he had pleaded during the course of hearing of the appeal that Satyam should not be taken as a comparable, we see no reason to doubt the authenticity of his statement.

7.2.2 Moreover, various Tribunals have taken note of the fact that Satyam cannot be accepted as a comparable. For instance, in the case of Agnity India Technologies (P) Ltd. (ITA No. 3856/Del/2010), the Tribunal agreed to the conclusion of the DRP for exclusion of Satyam on the ground that it was publicly known that its financial statements were not reliable. For the above said reasons, we direct that Satyam Computers Services Ltd. should not be taken as a comparable company to arrive at the ALP. Hence, this plea of the assessee is allowed.

8. Rejection of comparable companies with margins less than 6 per cent (including comparable companies with negative margins) In arriving at the set of comparable companies, the Tribunal has shortlisted comparables out of those identified by the TPO/assessee in the following manner :

"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. Therefore, we are inclined to exclude those comparables having very low margin. Then what should be the cut of rate ? The assessee has agreed for a working contract of cost + 6 per cent Therefore, as a reasonable profit level indicator (PLI), we hold that all the comparables, having margin less than 6 per cent, have to be excluded from the list relied on by the assessee.

Accordingly, the following comparables are excluded from the assessee's list :

Sl. No.	Name of the company	Margins (in %)
1.	Bangalore Softsell Ltd.	2.27
2.	Cherry Soft Technologies Ltd.	3.67
3.	Goldstone Technologies Ltd.	5.37
4.	Mascot Systems	5.59
5.	Unitech Info solutions Ltd.	5.52
6.	VJIL Consulting Ltd.	5.51

We have so far excluded two comparables of negative margin and six comparables of very low margin, totalling to eight. (Page Nos. 63 to 65, para Nos. 85-86)."

8.2 The learned counsel for the assessee, in the course of hearing of miscellaneous petition submitted that the methodology adopted by the Tribunal would always result in the arithmetical mean of the arm's length margins of the comparable companies to be higher than 6 per cent, thereby resulting in an upward ALP adjustment in every scenario. Based on such an inference, the price of the taxpayer's international transactions would never be considered to be at arm's length. Alternatively it was argued that if 6 per cent is to be taken as the "cut-off rate" and all comparables having margins less than 6 per cent are regarded as extreme cases, then all comparables having margins more than 6 per cent should also be excluded, on the same footing that there are no extremities (on the higher and lower side) since the assessee is working under a risk mitigated environment.

8.3 We have heard the rival submissions and perused the material on record. This issue now raised by the learned counsel for the assessee has been elaborately dealt with by the Tribunal from pp. 55 to 57 of the impugned order. The Tribunal was of view that extreme cases should not be included as comparables. Extreme comparables of positive higher and also lower side should be excluded. From the same, it can be seen that the comparables selected by the TPO/AO, the profit margins ranging between 22.75 to 111.45 had been directed to be excluded by the Tribunal from the list of the comparables. The reason for exclusion being profit level indicator (PLI) being extreme profit. Similarly, in order to equalize the comparable, the Tribunal on facts concluded that companies having margin less than 6 per cent is to be excluded from the list of comparables. The Tribunal has taken a conscious decision and arrived at a conclusion that the companies having margin less than 6 per cent is to be excluded from the comparables on facts and circumstances of the case. When the Tribunal has elaborately considered and taken conscious decision, we are of the view that this issue cannot be revisited by us in a miscellaneous application. Hence, this plea of the assessee is

rejected. It is ordered accordingly.

9. Request for risk adjustment

It was submitted that while arriving at the ALP/arithmetical mean of prices, the Tribunal has not considered the assessee's plea that "the lower authorities have also erred in law and facts by not making suitable adjustments to account for the differences in the risk profile of the comparable companies and the assessee". It was further submitted that in view of the limited functions performed and limited risk borne by the assessee in respect of the provision of software services, the assessee can be characterized as a contract service provider operating in a risk mitigated environment, whereas the comparable companies was functioning "entrepreneurial risk taking functions". It was submitted that the TP regulations in India recognize that adjustments should be made for the differential risks; however, they did not provide any specific methodology for making such adjustments. The assessee relied on the decision in the case of Philips Software Centre (P) Ltd. vs. Asstt. CIT (ITA No. 218/Bang/2008) [reported at (2008) 119 TTJ (Bang) 721 : (2008) 15 DTR (Bang)(Trib) 505—Ed.] and submitted that the Tribunal ought to have been provided risk adjustment relief while computing the margins of comparable companies. Accordingly it was pleaded that the ALP should be reduced after negating the risk differential. It was prayed that a risk adjustment relief of 5.2 per cent be provided while computing the margins of comparable companies.

9.1 The learned Departmental Representative submitted that the issue now raised by the assessee has not been raised before the authorities below. It was submitted that functions discharged, asset deployed and risk undertaken by the enterprises vary from case to case, therefore, risk adjustment as a static factor cannot be applied in all the cases uniformly.

9.2 We have heard the rival submissions and perused the materials on record. In this case, the assessee in its TP study has not made any working risk adjustment. The AO/TPO has not granted any risk adjustment. This claim of risk adjustment was made by the assessee before the Tribunal for the first time. It is not clear as to how the assessee had arrived at the risk adjustment relief at 5.25 per cent.

9.3 The Tribunal, Mumbai 'E' Bench in the case of Symantec Software Solutions (P) Ltd. vs. Asstt. CIT in ITA No. 7894/Mum/2010, dt. 31st May, 2011 for asst. yr. 2006-07 wherein it was held that (para 16) :

"As regards the difference in function and risk level adjustment; the assessee has raised this issue without quantification of such adjustment on this account. Even otherwise until and unless such difference results in deflation or inflation of financial result of the comparables, it is not general rule of standard adjustment. The assessee has not brought on record how such functional difference and risk has influenced the result of the comparables with quantified data to the satisfaction of the authorities. The assessee did not quantify the alleged adjustments on account of difference in risk. However, the assessee, first time filed certain calculation before the DRP in support of its claim. The said calculation is also not on the basis of any formula or principle rather it is general in nature. In our opinion, second proviso to sub-s. (2) of s. 92C cover and take care of these aspects. Since it is impossible to have a perfect comparable without any difference or variation regarding turnover risk profile and functional differences; therefore, the legislature has provided a margin of +/- 5 per cent while determining the ALP. Therefore, when the assessee is having benefit of choice/option as per the said provision as existed at the relevant point of time, no separate adjustment is required on account of risk and functional differences. Therefore, we do not find any merit and substance in the claim of the assessee for adjustment in respect of risk and functional differences."

In the instant case, the Tribunal has allowed benefit of deduction of 5 per cent (para 64) under proviso to s. 92C(2) and in view of the decision of Tribunal, Mumbai (supra), no separate adjustment is required on account of risk functional difference. Therefore, this plea of the assessee is dismissed.

10. Computation of the arm's length range (page Nos. 44-45, para No. 63)

While interpreting proviso to s. 92C(2) of the Act, the Tribunal has made the following observations in the order :

"...at the option of the assessee, the assessee may adopt a price different from the arithmetical mean by an amount not exceeding 5 per cent of such arithmetical mean i.e. the assessee has an option to claim the tax payer's marginal relief at 5 per cent with reference to the arithmetical mean irrespective of the range of actual deviation between the margin disclosed by the assessee and the average mean margin. Therefore, in effect, this marginal relief takes the character of a standard deduction of 5 per cent. For e.g. in a case, average mean of the ALP determined by TPO/AO is 20 per cent and that one disclosed by the assessee is 10 per cent. The assessee will get a standard deduction of 5 per cent and the assessee's ALP will be increased to 15 per cent and thereafter the difference of 5 per cent between 20 per cent and 15 per cent alone shall be added as ALP adjustment. (Page Nos. 44-45, para No. 63).

We have determined the operating margin of the assessee company at 8.80 per cent. We have also accepted the contention of the assessee that it is entitled for 5 per cent standard deduction in view of the proviso to s. 92C(2), as it is stood for the asst. yr. 2003-04. When that benefit of 5 per cent is given to the assessee, its operating margin for the purpose of determining the ALP will be bloated to 13.80 per cent."

10.1 In the course of hearing of the miscellaneous application, it was submitted that the proviso to s. 92C(2) of the Act provides that the arm's length range of +/- 5 per cent should be computed from the arithmetical mean of the price of the comparable companies (and not the assessee's transfer price). The assessee's computation for determining arm's length range of +/- 5 per cent relief is as follows :

Particulars	Amount (in %)
A Transfer price determined by the appellant	108.80
B Arithmetical mean of the prices of comparable companies, as per Tribunal order dt. 30th Aug., 2010	120.57
C Lower of the arm's length range (B*95%)	114.54
D Higher of the arm's length range (B*105%)	126.60
E Adjustment to be made transfer price (C-A)	5.74

10.2 Pursuant to the impugned order of Tribunal, the TPO has computed the operating revenue, operating cost and operating profit as under :

Operating revenue as per book	Rs. 71,69,87,294
Add : Foreign exchange fluctuation gain	Rs. 1,00,48,326

Other income	Rs. 2,12,081
A. Adjusted operating revenue	Rs. 72,72,47,701
Total expenses as per book	Rs. 68,00,34,163
Less : Termination charges	Rs. 1,05,00,000
B. Adjusted operating cost	Rs. 66,95,34,163
C. Operating profit (A-B)	Rs. 5,77,13,538
Operating profit/cost	8.62%

Based on the working given above, adjustment to be made for arriving at transfer price, according to the Revenue, is as follows :

Transfer price as per given above	108.62
Arithmetical mean of the price after allowing arm's length range of +/- 5% relief	114.52
Adjustment to transfer price (114.52 - 108.62)	5.90

Thus, according to the Revenue, adjustment of transfer pricing would be 5.90 per cent instead of 5.74 as claimed by the assessee.

10.2 We have heard the rival submissions and perused the material on record. When there are two prices determined by the most appropriate method, the first step is to take the arithmetical mean of such prices as ALM. However, the assessee has the option to adjust the above ALM by +/- 5 per cent. Here, the two different prices are :

By the AO	- 20.57
By the assessee	- 8.80

The adjustment of 5 per cent is done on assessee's computation to arrive at 13.80 per cent. The relevant finding of the Tribunal at para 98 of the impugned order reads as follows :

"The Assessing Authority will further find out the operating profits at assessee's rate of 13.80 per cent and the operating profits at the arithmetic mean rate of 20.57 per cent on the basis of the revised revenue and cost computed in para above. The differential amount shall be the addition to be made in term of the ALP adjustment. This amount will be corresponding to the differential operating margin of 6.77 per cent."

However, the arithmetical mean of two prices has not been done. Only after arriving at the arithmetical mean of two prices, the adjustment of 5 per cent can be done. For this purpose, this issue is restored to the file of the AO, who shall in turn, may refer the matter to the TPO.

11. In the result, the miscellaneous petition is partly allowed as indicated above.

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