

IN THE INCOME TAX APPELLATE TRIBUNAL “C” BENCH: KOLKATA
[Before Shri M. Balaganesh, AM & Shri S. S. Viswanethra Ravi, JM]

I.T.A No. 37/Kol/2012
Assessment Year: 2007-08

&

I.T.A No. 1623/Kol/2012
Assessment Year: 2008-09

Landis + Gyr Limited
(PAN: AAACV9922B)
(Assessee)

Vs. Deputy Commissioner of Income-tax,
Circle-1, Kolkata.
(Respondent)

Date of hearing: 21.06.2016
Date of pronouncement: 03.08.2016

For the Assessee: Shri Rahul Mitra, AR
For the Respondent: Shri G. Mallikarjuna, CIT, DR

ORDER

Per Shri M. Balaganesh, AM:

Both these appeals by assessee for AYs 2007-08 and 2008-09 are arising out of separate orders of Dispute Resolution Panel, Kolkata vide their F. No. DRP/KOL/2011-12/278-285 dated 29.09.2011 and F. No. DRP/KOL/2011-12/327-331 dated 24.08.2012 in which directions are given to the Learned AO u/s 144C(5) read with section 144C(8) of the Income Tax Act, 1961 (hereinafter referred to as the ‘Act’). As the issues involved in both the appeals are identical in nature, they are taken up together and disposed off by this common order for the sake of convenience.

2. Disallowance of Provision for Leave Encashment – Rs. 5,27,580/-

The assessee claimed deduction towards provision for leave encashment in the return of income to the tune of Rs. 5,27,580/- which was disallowed by the Learned AO by invoking the provisions of section 43B(f) of the Act. The same was also upheld by the Learned Dispute Resolution Panel (DRP in short). Aggrieved, the assessee is in appeal before us.

2.1. We have heard the rival submissions. At the outset, we find that the CIT(A) confirmed the disallowance as made by the Ld. AO on account of claim for provision for

leave encashment. Ld. counsel for the assessee stated that the deduction on account of provision for leave encashment was made on the basis of the judgment of Hon'ble jurisdictional High Court in the case of Exide Industries Ltd. Vs. Union of India (2007) 292 ITR 470 (Cal) but he fairly conceded that subsequently Hon'ble Supreme Court has stayed this judgment of Hon'ble jurisdictional High Court vide order 08-05-2009 by following observations:-

“Pending hearing and final disposal of the Civil Appeals, Department is restrained from recovering penalty and interest which has accrued till date. It is made clear that as far as the outstanding interest demand as of date is concerned, it would be open to the Department to recover that amount in case Civil Appeal of the Department is allowed.

We further make it clear that the assessee would, during the pendency of this Civil Appeal, pay tax as if section 43B(f) is on the Statue Book but at the same time it would be entitled to make a claim in its returns.”

In view of the above, Ld. counsel for the assessee fairly stated that let Hon'ble Supreme Court decide the issue and by that time the matter can be remitted back to the file of Id AO for fresh adjudication in terms of the decision of Hon'ble Supreme Court. On this, Ld. CIT DR has not objected to the same. Accordingly, we set aside this issue to the file of the AO to await the decision of Hon'ble Supreme Court and decide the issue accordingly. This issue of assessee's appeal is remitted back to the file of AO and accordingly **ground no. 1 in ITA No. 37/Kol/2012 raised by assessee is allowed for statistical purposes.**

3. Disallowance of Depreciation on Intellectual Property Rights and Goodwill

The assessee is a closely held company engaged in the business of manufacturing and distribution of electric meters and related components. The assessee had been a manufacturer and supplier of electro-mechanical meters till 2005 while the market had migrated from electro-mechanical meters to static meters due to availability of anti tampering features and communication facilities in static meters. It also did not have any dedicated Research & Development wing to support any electronic business. The Central Electricity Authority vide its notification no. 502/70/CEA/DP&D dated 17.3.2006 notified the Central Electricity Authority (Installation and operation of meters) Regulations, 2006 which inter alia, provided that all interface meters, consumer meters and energy accounting and audit meters shall be of static type. The meters not complying with these regulations were to be replaced as per the direction of the Central Electricity Authority. Faced with this challenge, assessee wanted to quickly set up its R&D department and acquire some of the intellectual property in this field. Accordingly, it acquired a sole proprietorship unit named

“Technology & Research – STPI (TECRES)” vide Business Transfer Agreement dated 12.11.2006. The sole proprietorship concern was run by Mr. Guljeet Singh Gandhi (an unrelated party to the assessee). Mr Gandhi through his business unit named TECRES had developed certain metering related software and was engaged in the business of sale (both domestic and export) of such software along with related services. Research and development expenses were incurred in the said business. Mr Gandhi and his personnel through their technical intelligence and expertise developed know-how for producing metering related softwares. Since TECRES possessed the requisite know-how, a key to survival in the market for static meters, the assessee entered into Business Transfer Agreement for acquisition of business of TECRES. The entire team of the said TECRES along with their developed codes and domain repository had joined the assessee pursuant to the Business Transfer Agreement. The intellectual property rights acquired by the assessee consisted of designs, software, data base, research and development material and facility, technical know-how, process know-how, confidential information, basic and detailed drawings, operation and maintenance manuals relating to the business carried out by TECRES. The Id AO observed that the Income Tax Rules recognizes intangible assets such as knowhow, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature and these assets must possess certain certification / authenticity / sanctity and or recognition from Government or from competent authority. He further observed that the nature of the IP assets acquired by the assessee does not fall in any of the category or similar nature as mentioned in IT Rules. Therefore, he held that the assets are not intangible assets eligible for depreciation and disallowed the claim of Rs. 61,50,000/- in the draft assessment order. The assessee preferred objections before the Hon’ble Dispute Resolution Panel (DRP). The Id DRP approved the contentions of the Id AO. Aggrieved, the assessee is in appeal before us on the following grounds:-

“2. (a) That on the facts and in the circumstances of the case the Assessing Officer erred in disallowing depreciation on the intellectual properties (IP) acquired by the assessee without appreciating that such IP is an intangible assets in the nature of know-how on which depreciation as per the provision of the Act is allowable.

(b) That on the facts and in the circumstances of the case, the Assessing Officer erred in stating that intangible assets specified in the Act must possess certification or recognition from government or competent authority for being entitled to tax depreciation.

c) That on the facts and circumstances of the case, the Assessing Officer erred in confirming the order of the DRP where the Hon'ble Members of the Panel had questioned the business expediency of the assessee in acquiring the new company TECRES thus violating the settled principle of law that the revenue authorities cannot step into the shoes of business man.

d) That on the facts and in the circumstances of the case, the Assessing Officer erred in confirming the order of the DR where the Hon'ble Members of the Panel had decided the issue against the assessee on grounds on which no opportunity for hearing had been given, thus violating the principles of natural justice."

3.1. The Learned AO erred in alleging that the intellectual property needs to have recognition from government and does not fall in any of the category of intangible assets as mentioned in the Income Tax Rules and accordingly denied the claim of depreciation. He argued that the TECRES, which was taken over from Mr. Gandhi had total assets of Rs 40.17 lakhs and current liabilities of Rs. 4.69 lakhs, was evaluated at Rs. 4.92 crores wherein the major share of the consideration was attributed towards the intellectual property the said business possessed. The entire team together with the domain knowledge had been transferred to the assessee pursuant to the agreement. The same had been used by the assessee for its very survival in the business of static meters to be in line with the regulations of the Central Electricity Authority and hence the use of intellectual property for the purpose of business had been duly demonstrated by the assessee and it is not a colourable device as alleged by the Learned DRP. He argued that the allegation of the Learned DRP is without any basis by ignoring the fact that the knowhow in the instant case has been actually acquired by paying a consideration of Rs.4.92 crores (pursuant to independent valuation by an expert) to Mr Gandhi pursuant to business transfer agreement. He argued that the provisions of the Act in more than one section had, in its wisdom, had defined intangible assets as knowhow, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature. Hence knowhow is an independent item of intangible asset. Similarly patent is an independent item of intangible asset. The Learned DRP had erred in mixing the term patent with knowhow and observed that since the knowhow acquired had not been registered with Indian Government and hence the same does not have any recognition from Government and accordingly does not fall in the category of intangible assets. He further argued that there is no mandate in the law that the knowhow needs to be registered with the Indian Government to fall under the category of intangible asset for claiming depreciation u/s 32 of the Act. He further stated that the Id DRP had allowed the claim of depreciation on actual cost basis in the subsequent year and if the claim of depreciation is directed to be allowed in the year under appeal, then a direction may be given to the Id AO to revise the Written Down Value (WDV) accordingly and rework the depreciation in subsequent year accordingly as it is consequential. He

alternatively argued that if the consideration paid in the sum of Rs. 4.92 crores towards knowhow is not accepted by the revenue, then the same has to be accepted as paid towards acquisition of Goodwill of the concern (i.e. TECRES) which again entitles the assessee to claim depreciation as per the ratio laid down by the Hon'ble Apex Court in the case of CIT vs Smifs Securities Ltd reported in (2012) 348 ITR 302 (SC) as the assessee had paid the consideration of Rs. 6,07,89,093/- in toto and after bifurcating the same towards the specific assets, the balance left over i.e. Rs. 4,92,00,000/- should be attributed towards acquisition of Goodwill.

3.2. The Learned DR argued that the IP's acquired by the assessee have not been approved by any authority and hence not recognized by the Indian Government. Hence the claim of purchase of IP from a private unrelated entity is merely a self serving statement and not supported by any evidences. He further argued that the unit having assets of just Rs 40.17 lakhs had been given a fancy valuation of Rs. 4.92 crores which is very unlikely. Moreover, the components of assets predominantly comprised of computers worth Rs 1.93 lakhs and Software of Rs 1.34 lakhs, Furniture of Rs. 10.84 lakhs , Car of Rs. 8.56 lakhs, among others.

3.3. We have heard the rival submissions and perused the materials available on record including the paper book filed by the assessee comprising of relevant extracts of Central Electricity Authority (Installation and operation of meters) Regulations, 2006 (pages 47 to 66 of paper book) with regard to this issue. We find that the assessee had capitalized the following assets under intellectual properties:-

- a. Low cost single phase static meter IP for domestic segment.
- b. Low cost single phase static meter IP for South Asian market like Vietnam, etc.
- c. RF AMR Radio frequency accelerated meter reading IP
- d. Salem 3T Metering Module IP
- e. Salem 1G HVDS IP
- f. PL Comm Evaluation Modem IP

3.3.1. It was argued that the intellectual property rights acquired by the assessee consisted of designs, software, data base, research and development material and facility , technical know how, process know how , confidential information, basic and detailed drawings, operation and maintenance manuals relating to the business carried out by TECRES. The

valuation of the same was carried out by an independent expert and valuation report is enclosed in pages 25 to 82 of paper book. We find that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued in July 2010 (enclosed in pages 67 to 73 of Part A of Paper Book) provides that the term 'intangible property' includes rights to use industrial assets such as patents, trademark, trade names, designs or models. It also includes literary and artistic property rights and intellectual property such as knowhow and trade secrets. These intangibles are assets that may have considerable value even though they may have no book value in the company's balance sheet. We find in Para 1.155 of the OECD / G20 Base Erosion and Profit Shifting (BEPS) Report on Actions 8-10 (2015) – Aligning Transfer Pricing Outcomes with Value Creation, issued in the year 2015, *'that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable knowhow or other intangibles from one associated enterprise to another'*. Even though in the instant case, the transaction is between two unrelated enterprises, the principles enunciated therein would squarely apply. Further para 6.20 of the said action plan, provide that *'knowhow and trade secrets are proprietary information or knowledge that assists or improve a commercial activity, but that are not registered for protection in the manner of patent or trademark. Knowhow and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. Knowhow and trade secrets may relate to manufacturing , marketing, research and development, or any other commercial activity. The value of know- how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know how or trade secret. In certain industries the disclosure of information necessary to obtain patent protection could assist competitors in developing alternative solutions. Accordingly, an enterprise may, for sound business reasons, choose not to register patentable knowhow, which may nonetheless contribute substantially to the success of the enterprise. The confidential nature of knowhow and trade secrets may be protected to some degree by (i) unfair competition or similar laws, (ii) employment contracts, and (iii) economic and technological barriers to competition. Knowhow and trade secrets are intangibles.'*

Hence, it could be safely concluded that even OECD has laid down the principle that intellectual property in the form of knowhow is not required to be registered.

3.3.2. We find that the assessee had filed a copy of the Business Transfer Agreement (BTA) entered into with Mr. Gandhi as an additional evidence. It was submitted by the Id AR that the said agreement was never called for by the lower authorities and hence there was no occasion for the assessee to file the same and it was also submitted that the acquisition of business from Mr Gandhi by the assessee was never a subject matter of debate. In these circumstances, we deem it fit and appropriate to admit the said additional evidence for better appreciation of the facts to resolve the issue under dispute before us.

3.3.3. We find force in the argument advanced by the Id AR that the transfer of employees would also result in transfer of knowhow also. We find that the Explanation 4 to section 32(1) of the Act defines 'knowhow' as any industrial information or technique likely to assist in the manufacture or processing of goods or in the working of a mine, oil-well or other sources of mineral deposits (including searching for discovery or testing of deposits for the winning of access thereto). Section 32(1)(ii) of the act provides for depreciation on intangible assets including knowhow, patents, copyrights, trade marks, licences, franchises, or any other business or commercial rights of similar nature, being intangible assets acquired on or after 1st day of April 1998. Hence from the combined reading of OECD, definition of knowhow and provisions of section 32 of the Act in respect of intangible assets, it could be safely concluded that depreciation is allowed on intellectual property being knowhow and such intellectual property is not required to be registered with any government authority. Know how is an intangible property, rights in respect of which can be bought and sold. As per the Law Lexicon dictionary, 'knowhow' indicates something essentially different from secret and confidential information. It indicates the way in which a skilled man does his job with his skill and experience. It was also stated that knowhow is a closely held unpatented inventions, formulae, design, drawings, procedures and methods together with accumulated skills and experience in the hands of a licensor firm's professional personnel.

3.3.4. It is not in dispute that assessee had acquired from TECRES six different IPs which were independently valued by the independent expert before the company was taken over by the assessee company. Admittedly TECRES was engaged in the research and development of metering related to software and communication technology which is useable in measurement of electrical and management of energy. It is not in dispute that the said

company had been delivering service in the field of metering software development of static meters for major Indian manufacturers in the metering industry namely L & T , Genus, HPL Socomec etc apart from doing work for other overseas clients. We find that the assessee in order to migrate into the new lucrative business of manufacturing static meters was looking for partner which could help it out in its new venture. Therefore, after a detailed study and informed business decision, the assessee decided to buy out the entire unit of TECRES along with its specialized research engineers who had enormous experience and domain knowledge in respect of static meters which the assessee could leverage in developing new marketable products. Therefore, in essence what the assessee has acquired is knowhow in developing new type of meters which were digital meters with anti-tampering and other communication facilities. We find that the reliance placed by the Id AR on the *Co-ordinate bench decision of Pune Tribunal in the case of Modular Infotech P Ltd vs DCIT reported in 131 TTJ 243 (Pune)* is well founded. In the said case, the assessee company was engaged in the business of software development and also licensing of software. It had taken over the business of a firm namely M/s Modular Systems and claimed depreciation @ 25% on an amount of Rs. 4,27,00,000/- pertaining to the value of IPR paid to the firm. The AO disallowed the claim of depreciation on IPR against which assessee filed appeal before the Id CITA. During the appellate proceedings with the CITA, the assessee pointed out that the amount of Rs. 4.27 crores included composite consideration in respect of all the intangible assets of the firm namely IPRs and the goodwill and submitted a fresh valuation of the assets including that of the goodwill at Rs. 79,50,000/-. The CITA disallowed depreciation on goodwill of Rs. 79,50,000/- and allowed assessee's claim of depreciation in respect of balance IPR payment. On appeal filed before the Tribunal, it was held that where assessee company took over business of a firm at value assessed by professionals and value so determined was made part of agreement, it was wrong to presume that there was a notional amount which was transacted between parties, hence disallowance of depreciation on intellectual property rights on ground that value was assigned to an asset which was non-existent was not justified. We find that the facts of the assessee's case are also similar to the facts before the Pune Tribunal supra. It is not in dispute that the turnover of the assessee had substantially increased from the year under appeal on account of activities of the R&D Centre which the assessee had acquired from Mr Gandhi. The element of know how is inherent in the static meters manufactured by the assessee pursuant to acquisition of TECRES. It is not in dispute that the entire Research & Development team of TECRES

along with their developed codes and domain depository have joined the assessee. Hence it cannot be said that the assessee had not acquired any intellectual properties from Mr Gandhi. The total consideration paid by the assessee in the sum of Rs. 6,07,89,093/- to Mr. Gandhi has not been disputed. Out of this total consideration, the assessee had bifurcated the value towards IP rights to the tune of Rs. 4.92 crores based on an independent valuation from an expert. The main emphasis for disallowance is only on the point that the intellectual properties is not approved by any government or any competent authority. Nowhere the income tax act mandates the registration of the intellectual properties for the purpose of granting depreciation u/s 32 of the Act. Getting the intellectual properties registered is within the domain of the assessee and it only offers protection to the assessee from preventing other parties to use the same. The revenue cannot thrust the mandate of registration of the same and mere non-registration of the same does not make the transaction ingenuine or sham. Hence the version of the revenue that IP should be certified by the government authority and it does not fall within the assets specified in IT Rules is without any basis and not tenable.

3.3.5. In view of the aforesaid findings and respectfully following the judicial precedent relied upon hereinabove, we allow the grounds 2(a) to 2(d) raised by the assessee for the Asst Year 2007-08 and grounds 12(1) to 12(c) raised for the Asst Year 2008-09. The Id AO is also directed to rework the opening WDV of this asset in the subsequent year and rework the allowability of depreciation on the same pursuant to this order. In view of this decision, we are not inclined to entertain the alternative claim of the assessee vide ground no. 1(a) that the consideration so paid in the sum of Rs. 4,92,00,000/- has to be construed as Goodwill and depreciation has to be granted accordingly.

3.3.6. With regard to the additional ground raised by the assessee vide ground no. 1(b) and 1(c) on the allowability of depreciation on goodwill amounting to Rs. 93,41,680/- for Asst Year 2007-08 and Rs. 81,73,970/- for Asst Year 2008-09, we find that the *Hon'ble Apex Court in the case of CIT vs Smifs Securities ltd reported in 348 ITR 302 (SC)* had held that the assessee is entitled for depreciation on goodwill. It is not in dispute that the assessee had paid consideration towards acquisition of Goodwill. This issue is now well settled and not with any dispute. We find lot of force in the argument advanced by the Id AR that the

benefit of decision of the apex court supra was not available during the pendency of proceedings before the Id AO and Id CITA. The facts relating to the same are already on record and does not require any investigation. Accordingly we admit the additional ground raised by the assessee with regard to the claim of depreciation on goodwill in the light of the decision of the Hon'ble Apex Court in the case of NTPC Ltd vs CIT reported in 229 ITR 383 (SC). **Respectfully following the ratio laid down in the apex court's decision in 348 ITR 302 supra, we allow the claim of the assessee and the additional ground raised by the assessee for both the years in that regard.**

4. Levy of Interest u/s 234 C

The ground no. 3 raised by the assessee on the chargeability of interest u/s 234 C of the Act. We find that the provisions of section 234C of the Act are very clear without any ambiguity that the same is chargeable only on the returned income. Hence, the Ground No. 3 raised by the assessee is allowed.

5. Adjustment to Arm's Length Price – ITA No. 37/Kol/2012 – Asst Year 2007-08

The assessee is a closely held company engaged in the business of manufacturing and distribution of electric meters and related components. In the course of its business operations, the assessee has entered into certain international transactions. For the purpose of benchmarking the prices of the international transactions, the assessee in its transfer pricing report, segregated the above transactions into two broad segments- 'Manufacturing' and 'Trading'. The international transactions entered into by the assessee under each of the above depicted segments, have been summarized below:

International Transactions of the assessee with its associated enterprises	Segment of the assessee	Amount (Rs.)
Import of raw materials & components	Manufacturing segment Domestic Sales	2,31,08,062
Payment of Royalty		1,99,84,917
Software revision charges		5,61,600
Technical support charges		6,54,363
Export of finished goods	Manufacturing Segment Export	7,22,26,989
Purchase of finished goods	Trading of finished goods	3,93,62,040
Payment of management fees	Others	1,81,96,263
Reimbursement of expenses		12,93,345
Payment of bank guarantee fees		5,94,482

The Id AO based on the order passed by the Id TPO u/s 92 CA(3) of the Act had made additions/disallowances against the international transactions undertaken by the assessee as encompassed under the 'Manufacturing Segment - Domestic' and 'Trading Segment' by imputing a downward adjustment of Rs. 43,27,604/- and Rs. 51,29,012/- respectively. All other international transactions of the assessee have been determined to be at arm's length.

5.1 Trading Segment

The transactions encompassed under the Trading Segment have been summarized below:-

- a) Purchase of Finished Goods - Rs. 3,93,62,040/-
- b) Payment of consultancy charges for EMPS - Rs. 9,25,716/-

The assessee had justified the Arm's Length nature of its international transactions under the trading segment by considering itself as the tested party, wherein it benchmarked the profitability of its trading segment using Resale Price Method (RPM) against third party companies engaged in comparable activities. Accordingly, GP / Sales was considered to be the appropriate Profit Level Indicator (PLI). Accordingly, 11 comparable companies were identified by the assessee. The arithmetic mean of the PLI for all the 11 comparable companies considering 'multiple year data' (as the 'single year data' were not available at the time of transfer pricing documentation) came to 14.81% . The margin earned by the assessee from the international transactions entered into under this segment is 18.70%. Accordingly , the value of the international transactions encompassed under the Trading Segment was determined to be at Arm's Length by the assessee. The Id TPO accepted the Resale Price Method adopted by the assessee as the Most Appropriate Method (MAM) and GP/ Sales as the most appropriate PLI. However, with respect to selection of comparable companies, the Id TPO rejected 4 out of 11 comparable companies on the basis of incomparability of products. The Id TPO then considered the single year margin i.e FY 2006-07 for 3 comparable companies out of 7 comparable companies selected by the assessee as the single year margin were not available for the other 4 companies. The Id TPO accepted the following 3 comparables of the assessee :-

<u>Name of the Company</u>	<u>GP / Sales for FY 2006-07</u>
Gemini Traze R Fid Pvt Ltd	23.49%
Media Video Ltd	33.90%
Tak Machinery & Leasing Ltd	25.60%

The Id TPO rejected the following 4 comparables of the assessee :-

<u>Name of the Company</u>	<u>GP / Sales for FY 2006-07</u>
Chloride International Ltd	11.97%
Priya Ltd	14.61%
Redington (India) Ltd	0.52%
Vivek Ltd	NA

5.1.1. The Id AR submitted before us that though the Id TPO had rejected comparables on the basis of product non-comparability of the products, the Id TPO's real intention was to reject low profit making companies and retain high profit making companies in the final set of comparables chosen by the Id TPO. Accordingly, the Id TPO computed the arithmetic mean rate of GP/Sales for 3 comparable companies which came to 27.66% and concluded that the international transactions under the Trading Segment of the assessee were not at Arm's Length and hence a downward adjustment of Rs. 51,29,012/- was warranted on the prices of the international transactions.

5.1.2. The Id AR submitted the 'single year margins' of remaining 4 comparable companies, which could not be produced before the Id TPO as the same were not available at the time of transfer pricing assessment, as below:-

<u>Name of the Company</u>	<u>GP / Sales for FY 2006-07</u>
Amzel Automotive Ltd	NA
Alert Fire Protection Systems Ltd	NA
Remi Sales & Engg. Ltd	NA
Digitechtronics Ltd	NA

5.1.3. The Id AR argued that, as per paragraphs 2.23 and 2.24 of 'Chapter II : Transfer Pricing Methods' of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations – 2010 , with regard to the extent of product comparability when RPM is considered as MAM, broader differences are more likely to be reflected in differences in functions performed between the parties to the controlled and uncontrolled transactions. Hence, less product comparability is to be compared while using the RPM while more emphasis should be laid on the functional comparability of the comparables.

5.1.4. The Id AR argued that in any case, the margins of the comparable companies selected by the Id TPO should be computed from the audited financials which has more authenticity and if it is considered, then the international transactions of the assessee would be at Arm's Length on account of 5% tolerance limit permitted u/s 92C(2) of the Act. He submitted the following table in support of his contentions:-

<u>Name of the Company</u>	<u>GP / Sales for FY 2006-07</u>
Gemini Traze Rfid Pvt Ltd	23.47%
Media Video Ltd	11.29%
Tak Machinery & Leasing Ltd	27.98%
Average	20.91%

5.1.5. The Id AR stated that the Id TPO and Id DRP contradicted themselves by accepting Gemini Traze Rfid P Ltd as a comparable company which trades in 'computer network products' in spite of the Id TPO explicitly rejecting companies dealing in 'computer peripherals' namely, Redington India Ltd and Priya Ltd. Similarly he argued that the lower authorities contradicted themselves by accepting Media Video Ltd as comparable company which trades in 'VCD/DVD' inspite of the Id TPO explicitly rejecting a company dealing in 'Television and Audio products' being Vivek Ltd. Accordingly he requested for exclusion of both the companies from the list of comparables. He placed a table excluding Gemini Traze Rfid P Ltd wherein the average margin was arrived at 15.97% as against the GP/Sales earned by the assessee at 18.70%. Similarly he placed a table excluding Media Video Ltd wherein the average margin was arrived at 14.91% as against the GP/Sales earned by the assessee at 18.70%. He also said that the arm's length margin on inclusion of Redington India Ltd and Priya Ltd as well into the final list of comparables would work out to 14.58% as against 18.70% earned by the assessee. Accordingly he argued that in all the cases, the transactions as encompassed under the trading segment would be at Arm's Length. He prayed for setting aside of this aspect for verification by the Id TPO to proceed with the determination of Arm's Length Price based on the margins computed from the audited financials with either of the following options:-

- a) To accept the comparables as selected by the assessee at the time of transfer pricing documentation with the margins computed from audited financials , or

- b) To accept the comparables as selected by the Id TPO whose single year margins were available at the time of transfer pricing assessment with the margins computed from audited financials , or
- c) To accept the comparables as selected by the Id TPO including the comparables whose margins were not available at the time of transfer pricing assessment with the margins computed from audited financials.

5.1.6. In response to this, the Id DR fairly agreed for setting aside of this issue to the file of the Id TPO for determine the margins based on audited financials and also give the benefit of 5% tolerance limit.

5.1.7. We have heard the rival submissions and perused the materials available on record including the paper book comprising of relevant extract of OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations issued in July 2010 (pages 67 to 73) ; relevant extract of OECD / G20 Base Erosion and Profit Shifting (BEPS) Report on Actions 8-10 (2015) – Aligning Transfer Pricing Outcomes with Value Creation (pages 74 to 79) among others. The facts stated hereinabove remain undisputed and hence the same are not reiterated for the sake of brevity. There is no dispute with regard to the Most Appropriate Method (in the instant case Resale Price Method) chosen by the assessee for its trading segment. There is no dispute with regard to the identification of Profit Level Indicator. The dispute is only on account of selection of related comparables and adoption of single year margins based on audited financials. In view of the detailed submissions made hereinabove , **we deem it fit and appropriate, to set aside this issue to the file of the Id TPO / Id AO to accept the comparable companies who are engaged in the related field as that of assessee and adopt the single year margins based on audited financials of those comparable companies for the purpose of determination of Arm's Length Price. The adjustment towards the tolerance limit of 5% is also entitled for the assessee while determining the Arm's Length Price.**

5.2. Manufacturing Segment

The assessee had entered into the following international transactions with regard to its manufacturing segment (domestic) :-

International Transactions of the assessee with its associated enterprises	Segment of the assessee	Amount (Rs.)
Import of raw materials & components	Manufacturing segment Domestic Sales	2,31,08,062
Royalty		1,99,84,917
Software revision charges		5,61,600
Technical support charges		6,54,363

The assessee had manufactured single and poly phase electro mechanical energy meters during the year under consideration importing raw materials and components from its group companies. It has claimed to have paid Royalty for the technology relating to the manufacturing activity. The assessee uses the brand name 'Landis + Gyr' for marketing the meters in India, the customers being usually the State Electricity Boards in the Government Sectors. For the manufacturing segment with two further sub-segments of domestic sales and exports, the Id TPO found its bifurcation untenable because despite calling two sub-segments as two separate ones, the assessee had merely divided various costs on the basis of turnovers, except the Export Incentive and Excise Duty which had been done on the actual basis. The cost of raw materials and cost of manpower had merely been proportionately allocated. The Id TPO was of the view that the combined Profit Level Indicator (PLI) would reflect a more appropriate indicator. The assessee had justified the Arm's Length nature of the aforesaid international transactions selecting itself as the tested party wherein it benchmarked the gross profitability of its manufacturing segment using Cost Plus Method (CPM). The Id TPO rejected some of the comparables selected by the assessee in its transfer pricing study either on the contention that these comparables do not have import of raw materials as their international transactions or because they had high export to turnover ratio. For the remaining comparables, the Id TPO rejected application of CPM as the Most Appropriate Method (MAM) and adopted Transactional Net Margin Method (TNMM) for benchmarking international transactions under the manufacturing (domestic) segment and considered net margins [operating profit / sales (OP / Sales)] of the assessee as well as the comparables instead of the gross margins [Gross Profit / Direct and Indirect Cost of Production (GP / DICOP)]. As a result, the Id TPO arrived at results which showed that the international transactions undertaken by the assessee under the manufacturing (domestic) segment were not at Arm's Length. Accordingly, the Id TPO made a downward adjustment of Rs. 43,27,604/- to the international transactions. This action of the Id TPO

was approved by the Id Dispute Resolution Panel (DRP). Aggrieved, the assessee is in appeal before us.

5.2.1. The Id AR argued that in transfer pricing analysis a transaction by transaction approach should be undertaken for bench marking analysis to determine the arm's length price of the international transactions being entered into. The principle of undertaking transaction by transaction analysis for determination of arm's length price has been embedded under the Indian Transfer Pricing Regulations, OECD Transfer Pricing Guidelines, 2010 updated via Base Erosion and Profit Shifting Action Plan 8-10, 2015 (herein referred to as 'OECD TP Guidelines') and UN TP Manual, 2013.

5.2.2. He argued that a plain reading about the application of the methods from the Income-tax Rules, 1962 would amply clear assessee's contention: -

10B (1)(a) comparable uncontrolled price method, by which,-

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified; ...

10B (1)(b) resale price method, by which,-

(i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified; ...

10B(1)(c) cost plus method, by which,-

(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined; ...

10B(1)(d) profit split method, by which-

(i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined:

10B(1)(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;

Therefore, it has been warranted in each of the methods that the price/profit earned from 'the (relevant) international transaction' should be tested.

5.2.3. The OECD TP Guidelines also states in para 3.9 of the document as under:

3.9 Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis....

5.2.4. The United Nations Practical Manual on Transfer Pricing for Developing Countries, 2013 also states in para 5.3.1.6 of the document as under:

5.3.1.6. The transfer pricing analysis should ideally be made on a transaction-by-transaction basis. However, there are cases where separate transactions are so closely linked that such an approach would not lead to a reliable result. Where transactions are so closely interrelated or continuous that application of the arm's length principle on a transaction-by-transaction basis would become unreliable or cumbersome, transactions are often aggregated for the purposes of the analysis ...

5.2.5. The Id AR argued that it could be observed from the above readings of International Guidelines that both OECD TP Guidelines and UN TP Manual have given primary preference to undertake a transaction by transaction analysis. It is only under certain exceptional circumstances, where separate transaction level analysis could not be undertaken or separate transactions are so closely inter-linked, that aggregation of transaction approach has been warranted. However, in the instant case, each of the transactions undertaken by the assessee on which TP adjustment has been imputed were distinct, independent and warrant separate analysis to determine the arm's length price. Like for instance, payment for royalty is in relation to technology received from AE to enable to manufacture the product for the purpose of business, whereas, with respect to purchase of components, the assessee needs to ensure that those are appropriately used in its manufacturing process to produce goods with desirable performance quality and meet end customers requirement. Thus, the two primary impugned transactions i.e. payment of royalty and purchase of raw materials are separate and distinct from each other and do require a separate transaction level analysis to determine arm's length price. In support of his contention, he placed reliance on the Co-ordinate Bench decision of Delhi Tribunal in the case of Benetton India (P) Ltd vs ITO reported in (2012) 134 ITD 229 (Delhi Trib.) wherein it was held that :-

7 ... The first and foremost question in this case is to determine whether the action of TPO in undertaking entity level bench marking by TNM method combining all the international transactions is justifiable or the TP analysis provided by assessee, based on "transaction to transaction" basis in respect of different segments should be adopted.

7.1 From the facts mentioned above, it is clear that assessee's manufacturing export activities: buying/sourcing and commission earning activities are independent of each other. Each activity has different factors in respect of source, identification of vendors, merchandise, designs quality control, handling etc. The FAR analysis in each of the activity will have distinct and separate considerations.

7.2 We find merit in the argument of the learned counsel that the TPO should have accepted the method of assessee's benchmarking analysis on the basis of transaction to transaction basis in respect of different segments of assessee's international transactions with associated enterprises. In our view, assessee's functions, risk and assets FAR considerations, which are given in the above table, deserves to be merited. TPO did not appreciate the assessee's transactions correctly and applied entity level bench marking on TNMM method by combining assessee's all international transactions with associated enterprise without justification.

7.3 Our view is supported by ITAT judgments - Mumbai Bench in the cases of UCB India (P) Ltd. Vs. ACIT (2009) 30 SOT 95 (Mum.); ACIT v. Star India Ltd. (ITA NO.s 3585 & 3846 (M) of 2006); and Kolkata Bench in the case of Development Consultants (P) Ltd. (2008) 23 SOT 455 (Kol.). All these cases clearly lay down that ALP would be determined based on the nature of service provided by assessee for each class of transaction based on various factors and analysis. In the case of Star India Ltd. (supra), also the TPO treated all the activities of the assessee as one and determined the ALP at entity level without appreciating that one cannot compare the FAR of a principal and agent on same footing.

7.4. In our view, in the assessee's case there are different segmental activities, which are independent of each other. They are required to be analyzed on transaction to transaction basis and not by combining all activities. Consequently, we uphold the assessee's method of ALP.

Consideration of transaction by transaction approach for determination of the arm's length price has also been upheld in the following mentioned judicial precedents:

- *Ankit Diamonds* (2011) 43 SOT 523(Mumbai Trib.)
- *Avineon India (P) Ltd*, TS-308-ITAT-2013(Hyd)-TP
- *DCIT -vs- M/s Starlite* (133 TTJ 425) (Mumbai Trib.)
- *Symantec Software Solutions (P) Ltd.*, (2011) 46 SOT 48 (Mumbai Trib)
- *Tecnimount ICB (P) Ltd.*, (2011) 11 taxmann.com 49 (Mumbai Trib.)

Accordingly, he argued that the 'transaction by transaction approach' adopted by the assessee should be considered for benchmarking the international transactions undertaken by the assessee.

5.2.6. In response to this, the Id DR filed a written submission and also made arguments in support of his written submissions. The Id DR vehemently relied on the decision of the *Coordinate Bench of Mumbai Tribunal in the case of Onward Technologies Ltd vs DCIT reported in (2014) 44 taxmann.com 295 (Mumbai Trib.)* wherein it was held that AE

profitability cannot be considered for benchmarking the profitability of international transactions.

5.2.7. We have heard the rival submissions and perused the materials available on record including the paper book filed by the assessee and the written submissions of the Id DR. We find that the assessee had imported raw materials and components from the following Associated Enterprises (AEs) :-

Name of AEs	Raw materials imported	Amount (in Rs.)
Landys+Gyr (Based in Greece)	i) Graphite Bearing ii) Hollow Rivet Fo iii) MM Base Assembl	8,489,007
Landys + Gyr (Based in USA)\	iv) MM Base Assembl (Voltage Assy) v) Rotor Assy	13,885,122
Ampy Email Metering (Based in Australia)	vi) Rotor Spindle vii) Tab for Base AU viii) Terminal Cover	30,213
Dalian Email Metering (Based in China)	ix) Voltage Element x) suspension Magnet xi) Sensor Assemblies xii) Theread Cutting screws	703,720

We find that the assessee had contended that under the manufacturing (domestic) segment, the assessee being engaged in importing raw materials and components (i.e. semi finished goods from its AEs for manufacturing electric meters which are subsequently sold in the domestic market, the goods so purchased by the assessee being semi-finished in nature, finding close comparable companies engaged in import of such products becomes difficult. Hence, in such a situation it would be ideal to benchmark the transaction of the overseas entities (i.e the AEs) –manufacturing and sale of those semi-finished goods to the assessee. The assessee had further stated that since the bulk of the purchases of raw materials and components were made by the assessee for two of its AEs based in USA and Greece and therefore, it had conducted a benchmarking analysis by using the widely recognized Global Symposium database to identify potentially uncontrolled comparables located in USA and Greece which are engaged in the sale of parts and components/ semi finished goods similar to that sold by the assessee's AE based in USA and Greece. The Id AR also submitted a brief note on each of the transactions and benchmarking methodology adopted by the assessee to determine the arm's length price.

5.2.8. Purchase of raw materials & components - Manufacturing Domestic segment

With respect to the above, an adjustment computed as a percentage of transaction value to the total costs of the Manufacturing Segment was undertaken by the Ld. TPO. We find that the assessee is trying to justify its Arm's length price by following transaction-by-transaction approach, encompassed in its 'Manufacturing - Domestic' segment, selecting itself as the tested party wherein it bench marked the gross profitability of its manufacturing segment using Cost Plus Method (CPM) against third party companies engaged in comparable activities. Accordingly, Gross Profit/Direct & Indirect Cost of Production (GP/DICOP) was considered to be the appropriate Profit Level Indicator (PLI). A search for uncontrolled comparable companies were undertaken and PLI was determined for comparison with assessee's PLI.

5.2.9. We find that the Id TPO had rejected the comparables chosen by the assessee in its transfer pricing study for the following reasons :-

1. Accurate Transformers Ltd	Functionally incomparable	Page 89 of Part B
2. RTS Power Corporation Ltd	as they have significant	of Paper Book
3. Gupta Machine Tools Ltd	export transactions	
4. Controls and Switchgears Contractors Ltd	Functionally incomparable	Page 89 of Part B
5. Pitti Laminators Ltd	as they have no imports	of Paper Book
6. Remaining 7 Companies	TPO adopted TNMM by rejecting CPM and considered OP / Sales instead of GP / DICOP	Page 89 of Part B of Paper Book

5.2.10. As a result, the Ld. TPO arrived at results which showed that the arm's length OP/Sales of comparable companies is 13.09% vis-a-vis 3.24% for the assessee. Consequently, the international transactions undertaken by the assessee under the manufacturing (domestic) segment were not at arm's length. Accordingly, the Ld. TPO made a downward adjustment to the international transactions included under the Manufacturing Domestic segment. (enclosed in page 90 and 91 of Part B of the paper book) . It is well settled that for the purpose of transfer pricing analysis and selecting most appropriate method, i.e. either CPM or TNMM, one needs to appropriately evaluate the functions performed, risks assumed and assets utilized of the parties involved in the

transaction and identify the least complex party as the tested party for such transaction. The concept of least complex party has been very well explained in the OECD TP Guidelines as below:-

2.59 A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contributions, see paragraph 2.4. In such a case, a transactional profit split method will generally be the most appropriate method, see paragraph 2.109. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

5.2.11. We find that the concept of overseas tested party and foreign comparable companies is well recognized and acknowledged by Indian Revenue as could be seen from India's commentary in United Nations Practical Manual on Transfer Pricing for Developing Countries which were placed on record by the Id AR, wherein, the following has been stated:-

10.4.1. Transfer Pricing Regulations in India

10.4.1.3. The Indian Transfer Pricing administration prefers Indian comparables in most cases and also accepts foreign comparables in cases where the foreign associated enterprise is the less or least complex entity and requisite information is available about the tested party and comparables.

In the instant case, all the requisite information was available for undertaking overseas benchmarking study and the same was also made available to the Id TPO and Id DRP's perusal. We find that the reliance placed by the Id AR on the decision of the *Co-ordinate Bench of Delhi Tribunal in the case of Ranbaxy Laboratories Ltd vs ACIT reported in (2016) 68 taxmann.com 322 (Delhi Trib.)* is very well founded wherein the concept of overseas tested party and foreign comparable companies for determination of Arm's Length Price has been accepted. It was held as under:-

33. Id. AR has cited many decisions, which are on the principle of selection of tested party, which is least complex. We are of the view that there is no dispute on this principle as it is well recognized and well accepted in all those decisions. This too has been held by coordinate bench in the case of the assessee for A.Y. 2004-05. We have perused those decisions and applied the same in reasoning and our findings ...

35. Therefore, for the reasons stated above, ground no. 2.2 of the appeal is allowed with a direction that overseas associated enterprises are accepted as tested party being the least complex of the transacting entity for the year for comparability analysis of international transactions of the assessee assessee.

5.2.12. We find that in the transfer pricing analysis with respect to purchase of materials, the Id TPO had continued to select assessee as the tested party for imports of raw materials of Rs. 2.31 crores which is consumed in the manufacturing segment with a turnover of Rs. 90.45 crores. The margin earned from the entire segment cannot be a representation of 2.55% of the international transaction encompassed therein. Hence the selection of the assessee as the tested party would result in an abnormal outcome in the transfer pricing adjustments. The same could be observed from the fact that post applying TNMM, the Id TPO produced an outcome wherein the value of TP adjustment (as initially arrived of Rs. 8.90 crores) was determined to be more than the value of international transactions of Rs. 4.25 crores which is practically not possible. Therefore, to cover up the fallacy in its approach of transfer pricing analysis, the Id TPO then proportioned the value of adjustment to the value of international transaction encompassed in the manufacturing segment to arrive at an adjustment value of Rs. 43,27,604/-. We find that this is modified application of TNMM and not either as per the intention of the Act or OECD Guidelines. Hence with regard to correct application of CPM or TNMM, the Associated Enterprises of the assessee should be selected as tested party to the transaction, as being the least complex entity. Subsequently, an analysis of gross margin or net margin by applying either CPM or TNMM retained by AEs should be undertaken for benchmarking the transaction price pertaining to purchase of materials and components. In this regard, we find that the assessee had submitted the economic analysis for the consideration of Id DRP and Id TPO in the course of proceedings wherein AEs were selected as tested party for the analysis and profitability retained by them were benchmarked. The assessee provided the Id TPO with the group transfer policy wherein it was stated that the supplier of the components would retain a maximum margin of 5% on costs on supply of materials to members of the group (vide page 215 of the paper book). Accordingly, the comparable companies were identified and arithmetic mean was computed. The prices of such transfer of materials and components were determined to be at Arm's Length. The detailed benchmarking analysis as submitted before the Id DRP and Id TPO is enclosed in pages 211 to 227 of the Paper book. However, we find that the Id TPO in his remand report dated 8.8.2011 had rejected the analysis on the following grounds (vide pages 228 to 236 of the Paper Book) :-

- a) Stating that product profile of the comparable companies is not comparable with assessee .*

We find that no cognizance of differences was brought into the records by the Id TPO.

b) Use of multiple year data

We find from the workings that even considering the single year data, it comes under the Arm's Length Price.

c) No FAR analysis undertaken and it could not be determined that the comparable companies have a branch or AE in India.

We find that this is irrelevant whether the comparable companies have a PE or a branch in India as the assessee had benchmarked the profitability earned in the regions of the AEs.

5.2.13. We find that the Id DRP failed to understand the benchmarking approach as submitted by the assessee. The Id DRP did not recognize the fact that assessee was comparing AEs margin with comparable companies in AEs region rather than comparing the latter with assessee's margin earned in India (vide page 316 of the Paper Book). Thus the Id DRP summarily rejected the transaction by transaction approach adopted by the assessee. We find that the revenue had not brought anything concrete on records either factually or legally to negate the assessee's approach of determining the Arm's Length Transaction Price.

5.2.14. Payment of Royalty – Manufacturing Domestic Segment

We find that the assessee had received technology and technical assistance for manufacture of electric and static meters under a Technology License Agreement entered into with the AEs. The assessee had duly documented the terms of such agreement, description of technology, technical assistance etc in the transfer pricing study report prepared and submitted for the perusal of the Id TPO vide page 39 of the Paper Book. The Id AR fairly submitted that with regard to international transaction pertaining to payment of royalty, due to paucity of accessibility to the relevant information, the assessee, at the time of maintaining contemporaneous documentation, had clubbed the benchmarking analysis for its international transaction, payment of royalty with the international transactions encompassed under 'Manufacturing – Domestic' Segment. However, in subsequent years, the assessee got access to a database named RoyaltyStat which has repository of royalty agreements entered into between the parties around the world. The details about RoyaltyStat database has been provided by the assessee in Page 1 of the Paper Book as Additional Evidence. Consequently, the assessee undertook a separate benchmarking study for payment of royalty, considering Comparable Uncontrolled Price (CUP) method as the

Most Appropriate Method. The details of the benchmarking study has been provided as Exhibit A of the paper book relating to additional evidence filed before us. The Id AR provided the summary of benchmarking study as below:-

Rate of royalty paid by the assessee to its AE - 4%
Arm's Length rate of royalty as determined from benchmarking study- 4.34%

5.2.15. We have gone through the rival submissions and we deem it necessary to admit the additional evidences filed by the assessee together with the relatable paper book for better appreciation of the facts relating to the payment of royalty by duly appreciating the genuine hardship suffered by the assessee at the time of initially benchmarking the transfer pricing study in respect of payment of royalty. We also find that the CUP method is the most appropriate method to determine the Arm's Length Price of international transaction being payment of royalty. We would like to place reliance on the following decisions in support of this proposition :-

Benetton India P Ltd vs ITO reported in (2012) 134 ITD 229 (Delhi Trib.)
Castrol India Limited vs DCIT reported in (2014) 40 CCH 764 (Mumbai Trib.)

The Id AR submitted that in the course of TP assessment for subsequent years i.e AYs 2009-10, 2010-11 & 2011-12 , the said transaction has been considered to be at Arm's Length by the Id TPO (for AY 2009-10 & AY 2011-12) and also confirmed by the Id DRP (AY 2010-11) wherein, same economic analysis has been adopted by the assessee to determine the Arm's Length Price of the transaction. **We hold that the study made by the assessee with regard to payment of royalty using CUP method as the MAM and using specific database 'RoyaltyStat' for benchmarking royalty transactions which has been accepted by the revenue in the subsequent years, should be applied for the years under appeal also to put an end to this controversy. Hence in order to meet the ends of justice, we direct the Id TPO/ Id AO accordingly.**

5.2.16. We find that adoption of TNMM by the Id TPO for purchase of raw materials & components under manufacturing domestic segment, had resulted in an abnormal outcome in the transfer pricing adjustment which was even more than the value of international transactions. Hence it would be just and fair to ignore the same. The Id TPO had made the adjustment of Rs. 43,27,604/- to Arm's Length Price based on a fallacious approach which

is neither intended by the Act nor in OECD guidelines. **In view of the above discussions, in order to meet the ends of justice in the facts and circumstances of the case, we deem it fit and appropriate, to set aside this issue to the file of the Id TPO / Id AO for determination of Arm's Length Price based on transaction to transaction approach submitted by the assessee taking the AE as a tested party using CPM as the Most Appropriate Method.**

Accordingly, the grounds raised in this regard are allowed for statistical purposes.

6. Adjustment to Arm's Length Price – ITA NO. 1623/Kol/2012 – Asst Year 2008-09

The assessee is a closely held company engaged in the business of manufacturing and distribution of electric meters and related components. In the course of its business operations, the assessee has entered into certain international transactions. For the purpose of benchmarking the prices of the international transactions, the assessee in its transfer pricing report, segregated the above transactions into two broad segments- 'Manufacturing' and 'Trading'. The international transactions entered into by the assessee under each of the above depicted segments, have been summarized below:

International Transactions of the assessee with its associated enterprises	Segment of the assessee	Amount (Rs.)
Export of Finished Goods	Manufacturing Segment - Export	7,06,66,978
Import of raw materials & components	Manufacturing segment Domestic Sales	2,53,18,093
Payment of Royalty		2,14,28,538
Payment of Management Fees		2,76,66,442
Purchase of Finished Goods	Trading of Finished Goods	6,73,03,783
Purchase of capital asset	Others	1,53,118
Reimbursement of expenses		22,95,649
Payment of bank guarantee fees		6,62,772

The Id TPO had made various disallowances against the international transactions undertaken by the assessee as encompassed under the 'Manufacturing Segment – Export' & 'Manufacturing Segment – Domestic' and imputed an adjustment of Rs. 84,35,423/-. The

Id AR reiterated his submissions made for the Asst Year 2007-08 that in transfer pricing analysis, a transaction by transaction approach should be undertaken for benchmarking analysis to determine the Arm's Length Price of the international transactions being entered into.

6.1. The Id AR reiterated the arguments advanced for the Asst Year 2007-08 with regard to the OECD TP Guidelines and UN TP Manual wherein they had given primary preference to undertake a transaction by transaction analysis. He stated that it is only under certain exceptional circumstances, where separate transaction level analysis could not be undertaken or separate transactions are so closely inter-linked, that aggregation of transaction approach could be adopted. He argued that however, in the instant case, each of the four transactions undertaken by the assessee on which TP adjustment has been imputed were distinct, independent and warrant separate analysis to determine the Arm's Length Price. Like for instance, payment of management service fee pertains to amount paid for various managerial level of services rendered from the AE in relation to undertake smooth conduct of business whereas payment for royalty is in relation to technology received from AE to enable to manufacture the product for the purpose of business. Similarly, with respect to export sale, the assessee is not required to perform certain functions like marketing activity and do not assume certain risks like product performance risks when compared to its domestic sale business. However, with respect to purchase of components, the assessee needs to ensure that those are appropriately used in its manufacturing process to produce goods with desirable performance quality and meet end customers requirement. Thus, the four impugned transactions are separate and distinct from each other and do require a separate transaction level analysis to determine arm's length price.

6.2. In response to this, the Id DR filed a written submission and also made arguments in support of his written submissions.

6.3. We have heard the rival submissions and perused the materials available on record including the paper book filed by the assessee and the written submissions of the Id DR. We would like to give our findings in respect of each of the international transactions entered into by the assessee during the financial year 2007-08 as under:-

6.3.1. Sale of finished goods – Manufacturing (Export) Segment

During the Financial Year 2007-08, the assessee manufactured and sold electric meters and components worth Rs. 108.35 crores out of which goods worth Rs. 7.35 crores were exported to AE. The details of the same are enclosed in page 306 of the Paper Book. For the purpose of determination of Arm's Length Price, the assessee undertook a detailed functional analysis and determined itself to be a tested party to the transaction. The assessee undertook segmental level profitability analysis to determine the profit earned from export of finished goods. The assessee also submitted a certified copy of the segmental profitability analysis before the Id TPO and Id DRP which are enclosed in pages 305 & 306 of the Paper Book. On evaluation of the methods prescribed under the TP regulations, the assessee considered TNMM as the MAM and OP/Sales as the most appropriate PLI. Thereafter, the assessee undertook a scientific search process to identify uncontrolled comparable companies having a reasonable level of revenue from export sales. The details of the same are enclosed in Pages 65-67 of the Paper Book. Six comparable companies were identified to be dealing in manufacturing of meter business having substantial level of export sales. On comparing the average OP/Sales of these comparable companies with OP/Sales earned by the assessee under the 'Manufacturing Export' segment, the transaction value of export sales was determined to be at arm's length, applying proviso to Section 92C(2). The Ld. TPO also acknowledged that TNMM should be the most appropriate method and OP/Sales as the most appropriate PLI. However, the Ld. TPO preferred to consider the combined 'Manufacturing Segment' of the assessee ('Manufacturing Domestic' segment and 'Manufacturing Export' segment) to determine the PLI as per certified segmental financials (enclosed in Page 306 of the paper book). Further, the Ld. TPO considered single year data of comparables selected by the assessee under both the sub-segment of 'Manufacturing Segment' to determine the arm's length PLI and imputed an adjustment on the value of international transactions of the assessee. (enclosed in Page 84 of the paper book). The contention raised by the Ld. TPO in the course of assessment to disregard the economic analysis undertaken by the assessee, are as under:

- i) A combined PLI of both the segments (Manufacturing Domestic segment and Manufacturing Export segment) would reflect the PLI of the concern more appropriately for manufacturing sector.

With regard to the above, the Id AR submitted that the functions performed and risks assumed by the assessee in case of the international transactions covered under the two segments i.e. 'Manufacturing - Domestic' segment and 'Manufacturing - Export' segment are distinct and separate from one another. It was submitted that with regard to 'Manufacturing - Domestic' segment, the assessee undertakes full-fledged marketing efforts to secure customer contracts. It has to ensure appropriate application of licensed technology from the AE for manufacturing of products to meet customer requirement and satisfaction. The assessee also has to bear product performance risks towards end customers. Further, the assessee also bears credit risk with respect to its domestic operations. While on the other hand, under 'Manufacturing - Export' segment, the assessee receives product specification from its AE and accordingly manufactures and supplies the product. It is not liable to end customers for product performance. Also, no royalty is paid by the assessee on export of products to its AEs. It is also not undertaking any marketing efforts in the export market to secure contracts and does not bear any credit risk as it receives payment from its AEs. He argued that however, the Ld. TPO and Ld. DRP has overlooked the functional and risk differences arising between under the relevant sub-segments of the Manufacturing segment. He further argued that it would be necessary to appreciate the fact that market dynamics and economic circumstances of the Export market and Domestic market cannot be compared due to varied factors. Further, the Export market is likely to have a different realization from the Domestic market and therefore the two sub-segments cannot be compared for analysis purposes. Further, it needs to be considered herein that the value of 'Manufacturing - Export' sales was only Rs. 7.35 crores whereas value of entire manufacturing segment sales was around Rs. 108.35 crores. He further argued that how can profitability from entire sales value of Rs. 108.35 crores would be a better reflection of Rs. 7.35 crores sales rather than profitability determined from Rs. 7.35 crores sales itself.

Accordingly he argued that the action of combining the segments by the Ld. TPO is erroneous and do not reflect the appropriate PLI for benchmarking purposes as it ignores the functional and risk analysis which forms the genesis of any transfer pricing analysis.

He further argued that the segmentation undertaken by the assessee was to achieve greater functional comparability and the benchmarking was also undertaken keeping in mind the specific characteristics of the international transactions captured within the relevant segments. The Indian TP regulation require a thorough analysis of the functions performed by any company before determining the arm's length nature of the international transactions. Further, in the context of comparability and FAR analysis, it would not be out of place to quote the following paras of OECD TP Guidelines since the Indian transfer pricing law is largely based on the principles and technicalities laid down in these guidelines. Para 1.51 of the OECD TP Guidelines takes due cognizance on factors determining comparability and states that,

"In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in delineating the controlled transaction and determining comparability between controlled and uncontrolled transactions or entities, a functional analysis is necessary. This functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions." [Emphasis added]

He also placed reliance on the *co-ordinate bench decision of Delhi Tribunal in the case of Mentor Graphics (Noida) Pvt. Ltd vs DCIT reported in (2007) 109 ITD 101 (Delhi Trib.)*, wherein it was held that :-

"The function that need to be identified while carrying comparison as per OECD guidelines include design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financial and management activities. It is also necessary to examine as to what is the principal function of the entities. " [Emphasis added]

We find that even for comparability purposes, the assessee has undertaken two distinct search strategies for benchmarking its international transactions encompassed under 'Manufacturing –Domestic Segment' and 'Manufacturing – Export Segment'. The assessee has given due consideration to identify comparable companies having a reasonable export operation so as to have similar economic consideration for comparability analysis. The details of the same are enclosed in Pages 61-62 and 65-67 of the Paper Book. We find that the Id TPO had failed to decipher that FAR analysis is one of the critical factors in establishing the Arm's Length Price of the international transaction and forgetting the fact that functions undertaken and risks assumed for the international transactions within the two

segments are completely different and hence a collective benchmarking analysis for the same would only distort the principles of transfer pricing and will render the comparison defective. The segmentation provided by the assessee were on proportionate basis and not on actual as could be evident from Page 311 of the paper book.

With regard to Ld. TPO's above contention relating to determination of segmental profitability, the assessee would humbly like to submit herein that the assessee has re-submitted the segmental profitability after considering the direct cost at actual and indirect cost allocated on the basis of sales. Also, to infuse authenticity on the segmental profitability, the assessee also had the segmental financials audited and certified by a Chartered Accountant which are enclosed in Page 305 & 306 of the paper book. He submitted that where the international transaction(s) could be more specifically related to a particular business segment of the assessee and the segmented result with respect to such segments could be obtained, use of segmented profitability would provide a better and more scientific method for determining the arm's length operations of the company rather than adopting an overall/entity level TNMM approach. In this regard he drew out attention to para 2.78 of Chapter 11 of Transfer Pricing Methods of the OECD TP Guidelines as under:-

"An analysis under the transactional net margin method should consider only the profits of the associated enterprise that are attributable to particular controlled transactions. Therefore, it would be inappropriate to apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise. "

Since the assessee was able to appropriately segregate its business operations in to its various business/functional segments, the arm's length nature of the international transaction(s), which could be directly related to such segments, should be determined based on the relevant segmented profitability.

We draw support from the following decisions in support of this proposition:-

Benetton India P Ltd vs ITO reported in (2012) 134 ITD 229 (Delhi Trib.)

Birlasoft (India) Ltd vs DCIT reported in (2011) 44 SOT 664 (Delhi Trib.)

General Motors India Pvt Ltd vs DCIT reported in (2013) 146 ITD 559 (Ahd Trib.)

Moreover, we find that the Id TPO had accepted the certified segmental profitability as he has considered 'Manufacturing Segment' profitability from the same. However, he did not consider the sub-segment profitability of Manufacturing Segment into Manufacturing (Domestic) segment and Manufacturing (Export) segment based on difference in FAR analysis to determine the profitability from sale of finished goods. The Id AR further stated that the Id TPO in the earlier years has considered prices of international transaction pertaining to export of goods to AEs to be at Arm's Length wherein the assessee followed the same economic analysis to determine the Arm's Length Price.

In view of the aforesaid findings and in the facts and circumstances of the case and respectfully following the judicial precedents relied upon hereinabove, we direct the Id TPO / Id AO to consider the certified segmental profitability to determine the Arm's Length Price of the relevant international transactions and hereby reject the combined segment approach adopted by the Id TPO.

6.3.2. Purchase of raw materials & components – Manufacturing (Domestic) Segment

The observations and findings given by us for the Asst Year 2007-08 in respect of purchase of raw materials & components in Manufacturing (Domestic) Segment would apply with equal force for the Asst Year 2008-09 also. We find that the Id TPO by selection of wrong tested party produced an abnormal outcome wherein a loss of 5.81% (8.31% - 2.50%) was determined to have occurred for a transaction value of 2.47% of the entire segment. Hence it would be just and fair to ignore the same. The Id TPO had made the downward adjustment to Arm's Length Price based on a fallacious approach which is neither intended by the Act nor in OECD guidelines. **In view of the above discussions, in order to meet the ends of justice in the facts and circumstances of the case, we deem it fit and appropriate, to set aside this issue to the file of the Id TPO / Id AO for determination of Arm's Length Price based on transaction to transaction approach submitted by the assessee taking the AE as a tested party using CPM as the Most Appropriate Method.**

6.3.3. Payment of royalty – Manufacturing (Domestic) Segment

The Id TPO while passing the order u/s 92CA(3) of the Act ignored the CUP analysis undertaken by the assessee for justifying the Arm's Length nature of the international

transaction and instead went ahead and clubbed the transaction under the TNMM analysis undertaken by Id TPO with respect to manufacturing segment. Moreover, when the Id DRP remanded back the case to the file of the Id TPO for analysis of the CUP benchmarking and providing ground wise observations for grounds filed in Form 35A, the Id TPO did not offer any adverse comments with regard to the payment of royalty. These are enclosed in pages 311 and 143 of the Paper Book. **The findings given by us for the Asst Year 2007-08 would apply with equal force for the Asst Year 2008-09 also with regard to payment of royalty.**

6.3.4. Payment of Management Service fees – Manufacturing (Domestic) Segment

The assessee submitted that it had received varied nature of management services under a Service Agreement entered into with its AE. For the purpose of compliance with the transfer pricing documentation requirements, the assessee documented in its transfer pricing study report and submitted in the course of assessment, the management services framework wherein the description of services received, payment terms, details of cost allocation mechanism, evidences of benefits received from such services etc were explained to the revenue. These are enclosed in Page 39 and Pages 294 to 295 of the Paper Book. We find that the assessee had considered payment of management service fee to be a different class of transaction, distinct from other international transactions. Accordingly, based on functional analysis, AE was determined as the least complex party and accordingly determined to be the tested party for the purpose of the analysis. Further, TNMM was determined to be the MAM. We find that the assessee undertook to identify comparable companies rendering similar services and the international transaction was determined to be at Arm's Length. These are enclosed in Pages 295 -303 of the Paper Book. The Id TPO while passing the order u/s 92CA(3) of the Act ignored the separate transaction level analysis undertaken by the assessee for justifying the Arm's Length nature of the international transaction and instead went ahead and clubbed the transaction under the TNMM analysis undertaken by Id TPO with respect to manufacturing segment. Moreover, when the Id DRP remanded back the case to the file of the Id TPO for analysis of the separate transaction level analysis and providing ground wise observations for arguments raised by the assessee before the Id DRP, the Id TPO did not offer any adverse comments with respect to economic analysis carried out by the assessee for transaction pertaining to

the payment of management service fees. These are enclosed in pages 307-311 and Pages 294-303 of the Paper Book. The Id AR submitted that in the course of TP assessment for subsequent years i.e AYs 2009-10, 2010-11 & 2011-12 , the said transaction has been considered to be at Arm's Length by the Id TPO (for AY 2009-10) and also confirmed by the Id DRP (for AY 2010-11 and AY 2011-12) wherein, same economic analysis has been adopted by the assessee to determine the Arm's Length Price of the transaction. **We hold that the study made by the assessee with regard to payment of management service fees which has been accepted by the revenue in the subsequent years, should be applied for the Asst Year 2008-09 also to put an end to this controversy. Hence in order to meet the ends of justice, we direct the Id TPO/ Id AO accordingly.**

6.4. Accordingly, the grounds raised in this regard are allowed for statistical purposes.

7. In the result, the appeals of the assessee in ITA No. 37/Kol/2012 for Asst Year 2007-08 and ITA No. 1623/Kol/2012 for Asst Year 2008-09 are allowed for statistical purposes.

Order pronounced in the open court on 03.08.2016

Sd/-
(S. S. Viswanethra Ravi)
Judicial Member

Sd/-
(M. Balaganesh)
Accountant Member

Dated :3rd August, 2016

Jd.(Sr.P.S.)

Copy of the order forwarded to:

1. ASSESSEE – Landis + Gyr Limited, Diamond Harbour Road, PO Joka, 24 Parganas (South), Pin-700 014.
2. Respondent –DCIT, Circle-1, Kolkata.
3. The CIT(A), Kolkata
4. ITO, DRP, Kolkata
5. DR, Kolkata Benches, Kolkata

/True Copy,

By order,

Asstt. Registrar.