IN THE INCOME TAX APPELLATE TRIBUNAL
'B' BENCH, BANGALORE

BEFORE SHRI VIJAY PAL RAO, JUDICIAL MEMBER
and
SHRI INTURI RAMA RAO, ACCOUNTANT MEMBER

IT(TP)A No.1748/Bang/2013
(Assessment year: 2005-06)

M/s.KHF Components Pvt. Ltd.
Site Nos.20, 20/1,Survey No.12, Double Road
Opp. To Vishakapatnam Steel Stock Yard,
Visvesvaraya Industrial Estate,
Mahadevapura Post,
Bangalore-560048. … Appellant
PA No.AABCK 5195 N

Vs.

Income-tax Officer,
Wad 11(2),
Bangalore. … Respondent

Appellant by : Shri Padamchand Khincha,CA
Respondent by : Shri P.Chandrashekar, CIT(DR)

Date of hearing : 17/05/2016
Date of pronouncement : 17/06/2016

O R D E R

Per INTURI RAMA RAO, AM :

This is an appeal filed by the assessee-company directed against the order of the CIT(A)-IV, Bangalore, dated 31/10/2013 for the assessment year 2006-07.

2. Briefly, facts of the case are that assessee is a company duly incorporated under the provisions of the Companies Act, 1956. It is engaged in the business of manufacture of miniature ball bearings. Its parent company is FMC Sales Co. Ltd., Japan. The assessee-company purchases components, consumables etc., from M/s.Dynacrart Inc. for the purpose of manufacture of ball bearings. M/s.Dynacrart Inc is a proprietary concern of Shri Masaru Murakami, President & Chairman of the assessee-company. The assessee-company exports miniature ball bearings to FMC Sales Co. Ltd.,, Japan.

3. The assessee-company filed return of income for the assessment year 2003-04 on 25/11/2003 declaring loss of Rs.2,15,482/-. After processing the return of income under the provisions of sec.143(1) of the Income-tax Act, 1961 [hereinafter referred to as 'the Act' for short], the case was selected for scrutiny by issuing statutory notice u/s 143(2) of the Act. The assessee-company reported the following international transactions:

- Import of components, machinery tools etc from Dynacrart Inc: 6.13 crores
- Export of miniature ball bearings to FMC sales: 7.69 crores
- Purchase of machinery from Dynacrart Inc: 0.04 crores.

The assessee-company sought to justify the above international transactions entered with its AE to be at arm's length. The assessee-company also submitted transfer pricing study report

adopting Comparable Uncontrolled Price (CUP) method as most appropriate method. AO after obtaining necessary approval from the CIT, made a reference to the Transfer Pricing Officer [TPO] for the purpose of determining the arm's length price [ALP] in respect of the above international transactions. The TPO, vide order dated 20/03/2006 passed u/s 92CA of the Act, computed the transfer pricing adjustment at Rs.69,74,195/-. The TPO rejected the transfer pricing study report of the assessee-company and also rejected CUP as most appropriate method. The TPO proposed the cost plus method as most appropriate method. The assessee-company objected to the adoption of Cost Plus Method [CPM] on the ground that manufacturing process was not identical and gross margins were calculated without taking into account all costs of production. The proposal made by the assessee-company before TPO that Transactional Net Margin Method (TNMM) may be adopted for bench marking the transaction was accepted by the TPO. The total operating profit/total cost was adopted as profit level indicator (PLI). The TPO proceeded to identify different set of comparable entities for the purpose of determining the ALP. While doing so, the TPO had applied the following filters:

i) Only those companies whose economic activity was shown as Manufacture of Ball bearings were taken.

ii) The entities whose turnover is more than Rs.30 crores and less than Rs.1 crore were excluded.

iii) The entities making consistent losses were also excluded.

iv) The entities whose manufacture sales are less than 60% of total sales were excluded.

v) Only current year data was used.

Applying the above filters, the TPO finally selected the following comparables:

- Austin Engineering Co. Ltd.
- SNL Bearing Ltd.
- HMT Bearings Ltd.

Out of the above comparables, HMT Bearings Ltd. was eliminated on account of falling revenues and finally the TPO computed the arithmetic mean of margins of operating cost of comparables finally selected at 10.03% as follows:

Austin Engineering	5.77% of operating costs
SNL Bearings	14.3% of operating costs
Arithmetic Mean	10.03%

The TPO finally computed transfer pricing adjustment as follows:

Operating cost as per P&L Account	Rs.7,44,25,098/-
Arms length margin	10.03%
Arms length margin	Rs.74,64,837/-
Margin earned	Rs.4,90,642/-
Adjustment u/s 92CA	Rs.69,74,195/-

4. The AO passed order u/s 143(3) dated 27/03/2006 incorporating the above adjustments. The AO also made addition of unabsorbed depreciation of Rs.4,19,853/- to the book profits for the purpose of computing tax liability under section 115JB of the Act.

5. Being aggrieved, an appeal was preferred before the CIT(A). It was contended before the CIT(A) *inter alia* that the very reference made by the AO to TPO is invalid in law. The CIT(A), after upholding the validity of reference to the TPO, held that the TPO was justified in rejecting the transfer pricing study analysis conducted by the assessee-company. On the issue of selection of comparables, the ld.CIT(A) had upheld the selection of comparables by the TPO, however, directed the TPO to grant working capital adjustment as per norms.

6. Being aggrieved, the assessee-company is before us in the present appeal. The assessee-company raised the following grounds of appeal:

1.1 The order passed by the learned CIT(A)-IV, Bangalore to the extent prejudicial to the appellant is bad in law and liable to be quashed.

2.1 The learned ITO, Ward 11(2) and the learned Addl. Director of Income-tax (Transfer Pricing)-I have erred in passing the orders at the fag end of the limitation period, in a hurried manner and without affording a proper opportunity of being heard to the appellant. The orders having been passed in violation of the principles of natural justice and in a hurried manner, is bad in law.

3.1 The learned ITO, Ward 11(2), has erred in making a reference for the determination of the Arm's Length price of the international transaction entered into by the appellant to the Transfer Pricing Officer, without establishing as to how it was necessary or expedient so to do. The reference made to the Transfer Pricing Officer is therefore bad in law and consequently the orders passed by the learned income tax authorities are bad in law.

4.1 The learned ITO, Ward 11(2) and Addl. Director of Income-tax (Transfer Pricing)-I, have erred in not appreciating that Chapter X only provides for computation of income and there is however no amendment to the definition of the term "income" to include the amounts computed under Chapter X. The order passed by the learned income tax authorities is therefore bad in law.

5.1 On the facts and in the circumstances of the case and on the basis of the prevalent law, the method and the comparables chosen by the appellant deserve to be adopted; and even under the method initially proposed or that ultimately applied by the Transfer Pricing Officer, the profits earned from price paid/charged in the transactions with the associated enterprises compares favourably with the profits of the comparable companies and consequently the transfer pricing addition is to be deleted in entirety.

5.2 The learned ITO, Ward 11(2) and Addl. Director of Income tax (Transfer Pricing)-I, having admitted that the product manufactured by the appellant has no market in India, and nobody else in India manufactures such products (para 4.1 and 4.2 of the order under section 92CA), erred in not appreciating that in the light of such conclusions the cases of companies adopted as comparable would be unsuitable and also incorrect.

5.3 The learned ITO, Ward 11(2) and Addl. Director of Income tax (Transfer Pricing)-I, have erred in not appreciating that the appellant during the year was involved only in the assembling operations which yield lower margins while the companies adopted as comparables were engaged in the full cycle of manufacture capable of getting better margins. The comparables adopted are therefore incorrect. At any rate, no adjustments have been made to account for the differences in the functions performed and the assets employed and therefore the comparability analysis is bad in law.

5.4 The learned ITO, Ward 11(2) and Addl. Director of Income-tax (Transfer Pricing)-I, have erred in initially proposing to analyse the transaction on the basis of the cost plus method, but, ultimately adopting the Transaction Net Margin method without any justifiable reasons. The learned ITO,

Ward 11(2) and Addl. Director of Income tax (Transfer Pricing)-I, have erred in changing the method when it dawned upon them that the comparability analysis in the basis of the method originally proposed would have justified the price charged by the appellant in the international transactions.

5.5 On facts and in the circumstances of the case and law applicable, the transfer pricing adjustment should be deleted in entirety.

6.1 The learned ITO, Ward 11(2), and the learned CIT(A) has erred in not granting or considering the deduction under section 10B, while computing the book profits under section 115JB.

7.1 The learned ITO, Ward 11(2) has erred in levying a sum of Rs 9,41,850/- as interest under section 234B and a sum of Rs 1,351/- as interest under section 234D of the Income Tax Act. On the facts and circumstances of the case interest under section 234B & 234D is not leviable. The appellant denies its liability to pay interest under section 234B & 234D.

8.1 In view of the above and other grounds to be adduced at the time of hearing the appellant prays that:

(a)the order under section 92CA by the Transfer Pricing Officer, assessment order passed by the assessing officer and the order passed by the learned CIT(A) to the extent prejudicial to the appellant be quashed;

or in the alternative;

(b)(i) the adjustment made to the income returned on the basis of the provisions of Chapter X be deleted;

(ii) the adjustment made to the computation of book profits under section 115JB be deleted;

(iii) interest levied under section 234B be deleted

(iv) interest under section 234D be deleted.

7. The assessee also raised the following additional grounds of appeal:

> "Assuming without admitting that TNMM is the most appropriate method, the learned CIT(A) has erred in confirming the action of the lower authorities in:
>
> 1. Selecting 'operating profit to operating cost' as the profit level indicator (PLI) in computing the ALP, without appreciating the facts and circumstances of the case.
>
> 2. Not appreciating in the facts and circumstances of the case, appropriate PLI to arrive at ALP would be 'gross profit to value added expenses'.
>
> 3. Not appreciating that SNL Bearings is engaged in predominantly domestic activity and therefore cannot be adopted as a comparable.
>
> 4. Rejecting HMT Bearings Ltd. as a comparable on unjustified grounds. "

8. Learned AR of the assessee-company submitted the TPO as well as the CIT(A) are not justified in excluding HMT Bearings Ltd., from the list of comparables on the ground of falling revenue. He submitted that the sales revenue of HMT Bearing Ltd., remain more or less constant over years and moreover the functional comparability is not in dispute. He submitted that the company incurred losses only account of incurring extraordinary expenditure like VRS compensation. Just because the company is incurring extra expenditure on account of VRS compensation, it does not render incomparable.

8.1 On the comparable company SNL Bearing Ltd. learned AR of the assessee submitted that this company cannot be compared

with that of the assessee-company as the exports revenue is less than 4.% of the total revenue whereas the assessee-company has 100% exports. In this connection, he relied on the decision of the co-ordinate bench of Tribunal in the case of *Bechtel India Pvt. Ltd. vs. DCIT* ((TS-487-ITAT-2015(Del)-TP. As regards the adjustment to operating profit, learned AR of the assessee has submitted that the TPO was not justified in excluding foreign exchange gain from the operating profit. In support of this, he relied on the following decisions:

i) M/s. Ameriprise India Pvt Ltd(TS-174-HC-2016(DEL)-TP)
ii) M/s. SAP Labs India Pvt. Ltd v ACIT (2010) 8taxmann.com 207(Bang)
iii) Trilogy E-Business Software India Private Limited v DCIT ITA No. 1054/Bang/2011.
iv) CSR India Pvt Ltd v ITO - IT(TP)A No.1119/Bang/2011
v) Four soft Ltd v DCIT (2011-TII-92-ITAT-HYD-TP)
vi) Capital IQ Information Systems (India) Pvt Ltd v DCIT - ITA No.1961/HYD/2011
vii) M/s Bearing Point Business Consulting Pvt. Ltd Vs. DCIT - ITA No.1124/Bang/2011

Learned AR of the assessee submitted that the TPO was also not justified in including the pre-operative and preliminary expenses written off and debited to P&L A/c as part of operating cost while computing margin of the assessee-company. He submitted that these expenses do not form part of operating expenditure and therefore, should be excluded from the operating cost while calculating operating margin. In support of this, he relied on the decision of the co-ordinate bench of Tribunal in the case of *Aris Global Software Pvt.Ltd. vs. DCIT i*n IT(TP)A No.1037/Bang/2011. On the issue of adjustment made to book profits, the learned AR of the assessee submitted that unabsorbed deprecation should not be added back to book profits in light of decisions of co-

ordinate bench in the case of *Moser Baer India Ltd. vs. DCIT* (2007) 17 SOT 510(Del.) and *DCIT vs. Roxy Investments (P) Ltd.* (2008) 24 SOT 227 (Del).

8.2 On the other hand, learned DR relied on the orders of the CIT(A) and the order of the TPO. As regards additional grounds of appeal, learned DR submitted that the grounds may be sent back to the file of TPO/AO for adjudication in accordance with law.

9. We have considered the rival submissions and perused the material on record. In the present appeal, the issues that arise for adjudication are whether the TPO as well as the CIT(A) were justified in excluding HMT Bearing Ltd., from the list of comparables and selecting SLN Bearings Ltd., as comparable and while calculating operating margins, whether foreign exchange gain should be considered as part of the operating income and the pre-operative expenditure and preliminary expenditure written off should be considered as part of operating expenditure.

10. Now, we shall deal with each of these issues as under.

(i) Exclusion of HMT Bearings Ltd:. This company was chosen by the TPO himself, however excluded it from the list of comparables on the ground that there is a falling revenue, work force is being phased out, reduction in employee-cost. On the other hand, learned AR of assessee-company contended that this company cannot be excluded as it is functionally similar to that of

assessee-company. There was no fall in sales revenue of the company as alleged by the TPO. Fall in profit level is on account of compensation awarded on account of VRS of employees.

We have considered the rival submissions. It is undisputed fact that this company is a public sector undertaking company. Its operations are based on policy requirements of the Government and it is a preferred company of the Govt. of India for entrusting of work and therefore, it totally operates in a controlled environment. Hence, this company cannot be compared with that of the assessee-company, which is a private company operating in uncontrolled business environment. In this regard we rely on the decision of co-ordinate bench in the case of *Delhi Adidas Technical Services (P) Ltd. vs. DCIT* (69 taxmann.com 401)(Del)

(ii) As regards exclusion of SLN Bearings Ltd., the assessee-company is seeking exclusion of this company from the list of comparables on the ground that its export sales are less than 4%. We find from the Annual Report of the company, filed in paper book at page Nos.545 to 567, that the export sales were Rs.62.03 lakhs as against total sales of Rs.1239.17 lakhs which is less than 4% and whereas exports of assessee-company are 100% of total sales. The co-ordinate bench of Tribunal in the case of *Bechtel India Pvt. Ltd.* (supra) held as follows:

> "We may also point out that the revenue of CIEL form export of surplus is 3% which is insignificant and the income from export of services by the assessee Bechtel India is 100% of operating income as there is no domestic client, thus as per Rule 10B(2)(d) of the Rules, the comparability test also fails on this count. "

Further, the pricing and profitability in export and domestic market are not likely to be the same for the following reasons:

i) Conditions prevailing in the export and domestic market in which the respective parties to the transactions operate are different.

ii) Geographical locations (domestic and export) are different.

iii) Size of the markets (domestic and export) to which companies cater to are different.

iv) Cost of labour and capital in the markets (domestic and export) are different.

v) Overall economic development and level of competition is different.

vi) Government incentives like tax incentives etc are available only for exporters.

vii) As the pricing for services differs in the domestic market vis-à-vis the export market, the level of competition, size of the market etc. are different in the domestic and export sectors.

Similarly, the co-ordinate bench of Tribunal (Mumbai) *DCIT vs. Indo American Jewellery Ltd.* (2010) 41 SOT 1 (Mum) held that company with domestic operations cannot be compared with taxpayer who has 95% exports. Respectfully following the decisions of the co-ordinate benches cited supra, we hold that this company cannot be compared with the assessee-company whose

export earnings are less than 4% as the assessee-company exports constitutes 100% of the sales.

(iii) As regards the issue whether the gains made on account of foreign exchange fluctuations should be considered as operating revenue or not? The issue is no longer *res integra* in view of the decisions cited by the learned AR of the assessee-company. Therefore, we direct the TPO/AO to include gains made on account of foreign exchange earnings as part of operating income.

(iv) As regards exclusion of preliminary expenditure and pre-operating expenditure from operating cost, this expenditure have nothing to do with operations of the company. We hold that this should not be included as part of operating cost. Accordingly, we direct the AO to exclude this expenditure from operating expenditure. We make it clear that our directions relating to adjustment of operating profits/operating cost should be made applicable even in case of comparable companies finally chosen and accordingly, the issue is restored to the file of TPO/AO on the above lines. All other grounds of appeal are neither pressed nor considered necessary for adjudication. Therefore, they are dismissed as such.

11. In the result, the appeal is partly allowed for statistical purposes.

Order pronounced in the open court on this 17th June, 2016

sd/-
(VIJAY PAL RAO)
JUDICIAL MEMBER

sd/-
(INTURI RAMA RAO)
ACCOUNTANT MEMBER

Place : Bangalore
D a t e d : 17/06/2016
srinivasulu, sps

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By order

Assistant Registrar
Income-tax Appellate Tribunal
Bangalore