IN THE INCOME TAX APPELLATE TRIBUNAL
Hyderabad ' B ' Bench, Hyderabad

Before Smt. P. Madhavi Devi, Judicial Member
AND
Shri B.Ramakotaiah, Accountant Member

ITA No.213/Hyd/2016
(Assessment Year: 2011-12)

M/s. Cambridge Technology Enterprises Ltd Hyderabad PAN:AAACC 3358 G	Vs	Dy. Commissioner of Income Tax, Circle 1(2) Hyderabad

For Assessee : Shri P. Murali Mohan Rao
For Revenue : Shri K.P.C. Rao, CIT (DR)

Date of Hearing: 28.11.2016
Date of Pronouncement: 16.12.2016

O R D E R

Per Smt. P. Madhavi Devi, J.M.

This is assessee's appeal for the A.Y 2011-12. In this appeal the assessee is aggrieved by the assessment order passed u/s 143(3) r.w.s. 144C(1) of the Act.

2. Brief facts of the case are that the assessee company, engaged in the business of development and export of software, e-filed its return of income for the A.Y 2011-12 on 23.09.2011 admitting a total income of Rs.Nil. Subsequently, the assessee company filed revised return on 30.11.2011 admitting income of Rs.1,71,77,250 under the normal provisions and book profits of Rs.1,86,55,763 under section 115JB of the Act. The return was

initially processed u/s 143(1), but subsequently was taken up for scrutiny.

3. The AO observed that the assessee has furnished a report in Form No.3CEB in accordance with provisions of section 92E and as per this report, the assessee had entered into international transactions with its AE. Therefore, a reference was made to the TPO u/s 92CA of the Act for determination of the Arm's Length Price. The TPO passed the order u/s 92CA of the Act on 31.10.2014 proposing the TP adjustment of Rs.5,89,28,768.

4. Further, from the P&L A/c, the AO also observed that under the head "general & administrative expenses", the assessee had debited an amount of Rs.13,73,745 as loss on sale of asset but the assessee did not add back the amount in the computation of income. Observing that the loss on sale of asset is not allowable, the AO disallowed the same and added it back to the returned income. Accordingly, the AO passed the draft assessment order and furnished a copy to the assessee. Aggrieved, the assessee preferred its objections before the DRP against the TP adjustment and also against bringing to tax the loss on sale of asset.

5. The DRP, however, confirmed the draft assessment order and in consonance therewith, the AO has passed the final assessment order and the assessee is in appeal before us. The assessee has raised the following precise grounds of appeal:

"Each of the grounds of appeal is mutually exclusive of, independent and without prejudice to other.

Based on the facts and the circumstances of the case and in law, the learned Assessing Officer (AO), learned Transfer Pricing Officer (TPO) and the Hon'ble Dispute Resolution Panel (DRP)

1. Erred in law in making the reference to the TPO without meeting the preconditions for such reference under section 92CA of the 1.T. Act, 1961.

2. Erred in calculating the operating margin of the company at Rs. 2,88,92,826/- and PLI(OP/OC) of 9. 60% without appreciating that operating margin after excluding depreciation is calculated at Rs.12,56,42,745/ - and PLI(OP/OC) of 61.54%.

3. Erred in not following the Directions of the Hon'ble DRP dated 30.12.2015 wherein it is directed as under:

" .... consider the margin in the case of the assessee as well as comparables after excluding depreciation."

4. Erred in making the addition of Rs. 4,06,86,257/- towards the shortfall of ALP adjustment in respect of transactions of rendering of Software Development Services.

5. Erred in calculating adjusted Arm's Length margin (ALM) of comparables at 23.04% (ALM at 20.79% - WCA at (-)2.23%).

6. Erred in not giving the risk adjustment to the assessee company without appreciating the fact that assessee company having high risk in the market.

7. Erred in not giving the benefit of +1- 5%, as provided under first proviso to section 92C(2) of the Act.

8. Erred in making the addition of Rs. 43,81,006/- towards the shortfall of ALP adjustment by charging 5% mark-UP on reimbursement of expenses transactions.

9. Erred in dlsaliowin9 an amount of Rs.13,73,745/- towards loss on sale of asset claimed by the assessee.

10. Erred in initiating penalty proceedings u/e· 271(1)(c), 271BA and 271AA of the Income Tax Act.

11.The assessee may add, alter or modify any other point to the Grounds of appeal at any time before or at the time of hearing of the appeal".

6. At the time of hearing, it is submitted by the learned Counsel for the assessee that grounds of appeal No.1 and 11 are general in nature and need no adjudication.

7. As regards grounds 2 to 7, the learned Counsel for the assessee submitted that the assessee company is a business solution provider focusing on building and integrating business applications. It has entered into an international transaction with its AE at USA for provision of software development services. In its TP study, the assessee had adopted the TNMM as the most appropriate method and has arrived at the margin of 9.6% as against the margin of the comparables of 6.68%. Therefore, the assessee treated the international transaction to be at ALP, but the TPO rejected the assessee's TP study and has adopted the

TNMM as the most appropriate method and has taken 18 companies as comparables and has arrived at the mean margin of the comparables at 20.81% resulting in the adjustment of Rs.1,82,42,500. The learned Counsel for the assessee submitted that for the A.Y 2010-11, the assessee company had calculated the operating margin of the assessee company before depreciation as the depreciation cost of the assessee to the total cost is 32.09%, which is very high and has an adverse impact on the operating margin but the TPO has computed the operating margin of both the assessee as well as the comparables after depreciation resulting in the huge adjustment. It is submitted that the assessee has objected before the DRP that the operating margin of the assessee company is hugely impacted when the amount of depreciation is included in the operating cost and hence the margin of the assessee company before depreciation and also the margins of the comparable companies before depreciation should be taken for arriving at the correct ALP. He submitted that even the DRP has accepted that "as claimed by the assessee, the margin in the case of the case as well as comparables can be considered before allowing depreciation to arrive at a correct comparability in the circumstances mentioned by the assessee" and for coming to this conclusion, the DRP placed reliance upon the decision of the Hon'ble Andhra Pradesh & Telangana High Court in the case of BA Continuum India Pvt Ltd vs.CIT-1 in ITTA No.440/2014 and directed the AO to consider the margin in the case of the assessee as well as the comparables after excluding depreciation. He submitted that the AO has erroneously has not followed this direction of the DRP and has computed the ALP after including the depreciation cost to the operating cost of both the

assessee as well as the comparables. He also drew our attention to the order of this Tribunal in the assessee's own case in ITA No.364/Hyd/2015 for A.Y 2010-11 wherein the Tribunal has considered this issue at length and at Para 6 held as under:

> "6. Having regard to the rival contentions and the material on record, we find that it has been held in the above decisions relied upon by the Ld. Counsel for the assessee that all the possible discrepancies have to be removed and the assessee's comparables have to be brought on par with each other before comparing the assessee's financial results with those of the comparable companies. As demonstrated by the assessee, the ratio of depreciation to operating cost in the case of the assessee is very high as compared to the comparable companies, the average of which is 5.71% only. Therefore, we are convinced with the arguments of the Ld. Counsel for the assessee that the PLI has to be calculated before depreciation to bring comparable companies and the assessee on par with each other. The Coordinate Bench of this Tribunal in the case of Qual Core Logic Ltd., (cited supra) at para 57 of its order has held as under :
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> > "57. We have heard both the parties on this and perused the material on record. In the present appeal, ALP of transactions carried was to be determined by comparing net profit of the taxpayer (tested party) with mean net profit of comparables. Only receipts and expenditure, having connection with international transactions, were required to be taken into account. Any receipt or expenditure having no bearing on price or margin of profit could not be taken into consideration. It is evident from statutory provisions that it is nowhere provided that deduction of depreciation is a must. Depreciation can be taken into account or disregarded in computing profit depending upon the context and purpose for which profit is to be computed. There is no formula which would be applicable universally and in all circumstances. "Net profit" used in Rule 10B can be taken to mean commercial profit. But depreciation in such profit on commercial principles has to be the "actual" amount by which the assets of business got depleted between the two dates separated by a year. It cannot be depreciation under tax or companies rules or as per policy of the company. In the case in hand, Revenue authorities went wrong in disregarding the context and purpose for which the "net profit" was to be computed. Depreciation, which can have varied basis and is allowed at different rates, is not such an expenditure which must be deducted in all situations. It has no direct connection or bearing on price, cost or profit margin of the international transactions. Object and purpose of the transfer pricing to compare like with the like, and to eliminate differences, if any, by suitable adjustment is to be seen. Therefore, there was justification on the part of the assessee in pleading that profits be taken without deduction of depreciation as depreciation

> was leading to large differences in margins for various reasons. Contention that depreciation would depend upon type of technology employed, age and nature of machinery used, is quite well-founded. Above, along with size of enterprise and investment in plant/machinery were important factors to be taken into account for comparison and for computing profit. There is considerable support for the contention raised on behalf of the assessee in the OECD Guidelines on Transfer Pricing. The claim of depreciation can lead to great difference in computing profits of comparables as depreciation is permitted depending upon nature of plant/machinery and year of use. Obviously there are differences between the machinery employed by the taxpayer and other comparable concerns which is reflected in amount and percentage of depreciation claimed. How this variation and difference could be ignored under TP Regulations is neither shown nor explained. The assessee has debited high amount/ratio of depreciation. Other enterprises have claimed depreciation at much lower amounts. Size of the assets besides the age of the assets of comparables was leading to difference in the profit margins and in mean margin. On the contrary, claim of depreciation is eating up large chunk of profit in the case of the taxpayer. The CIT(A) has not said a word on "asset" employed and "risks" suffered by the tested party and the comparables. Thus, material differences needing suitable adjustment were ignored and a flawed analysis was carried even in appellate proceedings. Without considering obvious material differences, the contention of the assessee to take profit without depreciation was rejected. This rejection is not sound in law. This ground is allowed. Accordingly, we direct the Assessing Officer to re-compute the ALP."
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> 6.1. Respectfully following the above decision which has also been followed in the case of BA Continnum India in ITA.No.1154/Hyd/2011 dated 24.10.2013, we direct the A.O. to re-compute the ALP by taking the operating cost before depreciation into consideration. Thus, grounds of appeal Nos. 10 and 11 are treated as allowed.

Therefore, according to the learned Counsel for the assessee, the assessment order needs to be redone in accordance with the directions of the DRP.

8. The learned DR supported the orders of the authorities below.

9. Having regard to the rival contentions and the material on record, we find that in the assessee's own case for the earlier A.Y, this Tribunal has directed the AO to recompute the ALP by taking the operating cost before depreciation into consideration. To give this direction, we have followed the decision of the Hon'ble jurisdictional High Court in the case of B.A. Continuum India Pvt. Ltd vs. CIT-1 (cited Supra) which has also been followed by the DRP for the relevant A.Y before us. In view of the same, we direct the AO to compute the ALP before depreciation both in the case of the assessee as well as the comparable companies and work out the margins accordingly.

10. Further, the learned Counsel for the assessee has submitted that if the ALP is so calculated, then the margin of the assessee would be within (+_) 5% of the average margins of the comparables and therefore, the TP adjustment would not have required at all and other grounds need no adjudication. Therefore, we see no reason to adjudicate the other grounds of appeals. Accordingly Grounds 2 to 7 are treated as allowed for statistical purposes.

11. As regards ground of appeal No.8, the learned Counsel for the assessee submitted that this issue had arisen in the assessee's own case for the A.Y 2010-11 and the Tribunal at Paras 20 & 21 of its order has held as under:

> "20. Having regard to the rival contentions and the material on record, we find that the Tribunal in the assessee's own case for the A.Y. 2009-2010, has considered the decision of the Coordinate Bench in the case of Mylan Laboratories in ITA.No.66/2013 dated 10.01.2014 to hold that the reimbursement expenses not debited to the P & L account is only a

balance sheet entry and hence, there cannot be any mark-up on such expenditure and income computed thereon. The relevant portion of the decision is reproduced hereunder for ready reference :

> "5. With respect to reimbursement of expenditure in the case of Mylan Laboratories Ltd., in ITA.No.66/Hyd/2013 dated 10.01.2014 the Bench observed as follows :
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> "31. ..... In case of reimbursement at cost of the expenditure incurred on behalf of the AEs and has not formed part of the expenditure claimed as operating cost of the assessee then, the reimbursement should not be considered as part of assessee's sales. The amounts should be excluded in computing the operating profits. Since the Assessing Officer has not examined and it is also not on record whether the said expenditure was not part of claim under section 37(1) of the I.T. Act in the regular computation or not, in the interest of justice, we remit the matter back to the file of the TPO to examine the facts and to exclude only in the case the said amount is reimbursement of expenditure and there was no claim by the assessee in its computation of income. Ground No.9 of the assessee is allowed for statistical purposes.
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> 5.1. However, in this case we find that the A.O. himself has agreed that the reimbursement of expenditure does not figure in the P & L account and perusing the paper book at pages 1, 3 and 11 we are convinced that it is only a balance sheet entry and not debited to the P & L account. Hence, we allow the ground with respect to reimbursement of expenditure raised by the assessee before us."
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> 21. Respectfully following the same, we hold that the reimbursement of expenditure cannot be marked-up by the A.O. for computing the ALP adjustment.

Therefore, according to him, similar direction is to be given for the A.Y before us as well.

12. The learned DR, however, supported the orders of the authorities below.

13. Having regard to the fact that the issue had arisen in assessee's own case for the earlier A.Y and the Tribunal has held that the reimbursement of the expenditure cannot be marked up

by the AO for computing the ALP adjustment, we allow the assessee's ground of appeal.

14. As regards ground No.9, it is the case of the assessee that the assessee has sold an asset and the loss on such sale has been reduced from the block of assets and the depreciation has been claimed after such reduction in the value of the asset. Therefore, according to him, there is no impact on the income of the assessee and therefore, it cannot be brought to tax.

15. The learned DR, on the other hand, supported the orders of the authorities below and submitted that this issue needs verification by the AO as Schedule 5 giving the details of the fixed assets, does not reflect the reduction in the value of the asset.

16. Having regard to the rival contentions and the material on record, we are of the opinion that the assessee's contentions needs verification by the AO as the specific asset which has been sold and the loss thereon is not evident from either the assessment order or the DRP's order and therefore, the assessee's contention that the loss has been reduced from the block of assets is not acceptable at this stage without the specific details. Therefore, this issue is set aside to the file of the AO for verification after giving the assessee a fair opportunity of hearing and considering the assessee's submissions on the issue.

17. In the result, ground of appeal No.9 is treated as allowed for statistical purposes.

18. Ground No.10 is only against initiation of penalty proceedings u/s 271(1)(c), 271BA and 271AA of the I.T. Act and this ground is dismissed as premature.

19. In the result, assessee's appeal is partly allowed.

Order pronounced in the Open Court on 16th December, 2016.

Sd/-	**Sd/-**
(B. Ramakotaiah)	**(P. Madhavi Devi)**
Accountant Member	**Judicial Member**

Hyderabad, dated 16th December, 2016.

Vinodan/sps

Copy to:

1 P. Murali & Co. CAs, 6-3-655/2/3, 1st Floor, Somajiguda, Hyderabad 500082
2 Dy. Commissioner of Income Tax, Circle 1(2) Hyderabad
3 Dispute Resolution Panel (DRP) Hyderabad
4 Director of Income Tax (International Taxation) IT Towers, Hyderabad
5 The Addl. CIT (T.P) Hyderabad
6 Guard File
7 The DR, ITAT Hyderabad

By Order