IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCH "L", MUMBAI

BEFORE SHRI D.MANMOHAN, VICE PRESIDENT &
SHRI R.K.PANDA, AM

I.T.A. No. 6194/Mum/2008
(Assessment year 2004-05)

DCIT 9(2) R. No. 218, 2nd Floor, Aayakar Bhavan, M.K. Road, Mumbai-400 020 Appellant	Vs.	M/s. Indo American Jewellery Ltd., B-203, The Nightingale CHS Ltd., Charkop Road, Kandivli (West), Mumbai-67 PAN: AAACI5033J Respondent

Appellant by : Mr. Narender Singh
Respondent by : Mr. K. Shivaram

ORDER

Date of hearing: 09.03.2010
Date of order: 31.05.2010

PER R.K.PANDA, AM,

This appeal filed by the Revenue is directed against the order dated 12th August, 2008 of the CIT(A)-XIX, Mumbai relating to assessment year 2004-05.

2. Facts of the case, in brief, are that the assessee company M/s. Indo American Jewellery Pvt. Ltd., previously known as Suashish Jewellery Ltd., is a closely held Indian company incorporated on 16th July, 1999. It is engaged in the business of manufacturing and export of plain and studded jewellery of gold, platinum, silver and other precious/semi precious diamonds, synthetic stones in the form of rings, pendants, ear rings, bracelets, etc. The company's products are exported mainly to US and UK.

3. During the year the assessee has entered into international transaction with the following AEs:

a) Suashish Diamonds, Hong Kong Ltd.
b) Suashish Star Inc. (SSI)
c) Ishish Jewellery LLC
d) Star Diamond Group Inc., USA ('STAR')

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On being questioned by the TPO, the assessee justified the transactions under the overall TNM Method. It was submitted that the assessee's operating profit margin is 3.56% on sales and 3.70% on cost while that of comparables used by it is 3.27% on sales and 3.83% on cost. On the basis of details provided by the assessee it was submitted that the assessee earns a net margin of 5.38% on sale to the AEs and net margin of 1.77% on sale to non-AEs. Accordingly it was submitted that the same is to be at arms length.

4. The TPO perused the split financials provided by the assessee and rejected the same on the ground that the allocation keys used by the assessee for the purpose of split of the expenses are not appropriate. He observed that in case of allocation of manufacturing expenses like employees' remuneration, rent, etc., the allocation key used is sales which is not appropriate. According to him the ideal allocation keys should have been the number of employees, space utilised, etc. Since the segmental accounts prepared by the assessee are not based on proper allocation key, the TPO considered the entity level profitability of the assessee for the purpose of benchmarking. The TPO adopted a fresh search to find companies in the comparable business as that of the assessee as per para 10 of the TPO's order and asked the assessee to explain as to why margin of the above comparables engaged in the business of manufacturing jewellery could not be applied to benchmarking the assessee's transactions.

5. It was explained by the assessee that some of the above companies as pointed out by the TPO are not comparable with that of the assessee company on the basis of their turnover and their location in Seepz, etc. However, the TPO rejected the arguments advanced by the assessee on the ground that if arithmetic mean is taken, the differences are averaged out. The various other arguments put forth by the assessee were also rejected by the TPO. The TPO observed that the average operating profit

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margin on cost of the comparable companies comes to 7.25% which he took as the arms length operating margin. Accordingly he made the adjustment in respect of sales to AEs, the details of which are as under:

Particulars	Assessee's Margin (Rs.)	Arms Length (7.25% on costs)
Operating cost	891376402	891376402
Operating margin	30661123	64624789
Turnover	922037525	956001191
Uncontrolled	609586554	609586554
Controlled	312450971	346414637

95% of Rs.346414637 = Rs.329093905 i.e., not falling with arms length. He observed that the Arm's Length Price of the international transactions with AE, comes to Rs.346414637 as compared to the transaction value of Rs.312450971. He also observed from the above analysis that the assessee's international transaction relating to sales does not fall within a range of +/- 5% of the Arm's Length Price.

He accordingly made adjustment of Rs.33,963,606 to the value of international transactions.

The Assessing Officer thus made an addition of Rs.3,39,63,606 on account of disallowance of arms length u/s. 92C(4) of the Act.

6. Before CIT(A) it was submitted that using financial data of the entities from the new set of comparables derived by TPO's office tantamount to rejecting the set of comparables provided by the assessee in its TP Study is unjust and goes against the principles of natural justice. It was submitted that the assessee has followed the basis as prescribed in the law and under the OECD principles in respect of its search for comparables to justify the ALP. The assessee has selected itself as tested party and its result has been benchmarked with the result of the comparable companies. The provisions of Rule 10B(2) of the Income-tax Rules, 1962 (the Rules) and provisions of section 92CA(3) r.w.s. 92C(3)(c) were brought to the notice of the CIT(A) and it was submitted that the assessee company has duly complied with the above provisions. It was submitted that as per the OECD transfer pricing guidelines if the tax payer

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presents a reasonable argument and evidence to suggest that its transfer pricing was the ALP, the burden of proof may legally and de facto shift to the tax administration to establish why the tax payer's transfer pricing was not at arms length. The CBDT circular No. 12 dated 23rd August, 2001 and circular No. 14 dated 22.11.2002 was also brought to the notice of the CIT(A) according to which ALP could not be disturbed unless the pricing is not based on the prescribed method or appropriate documents/ information has not been furnished within the prescribed timeframe and data for computing ALP is not reliable. It was submitted that it is not clear as to how the TPO has carried out the search strategy for arriving at the proposed list of comparables since the TPO has not considered the entire jewellery manufacturing industry to arrive at a more meaningful comparability. It was submitted that the TPO has not considered the FAR (functions performed, assets employed and risk assumed) of the various comparables before applying the same in the context of the assessee. Various judicial decisions were also relied upon and it was submitted that in this case it has been highlighted that selection of comparables should be based on FAR of both the parties. It was submitted that the TPO has selected companies having wide range of turnover starting from Rs. 3 crores to Rs. 723 crores. Therefore such yardstick cannot be applied to the assessee company whose turnover is about Rs.91 crores only. It was further submitted that the companies selected by the TPO are mainly situated in Seepz area which get various benefits on account of customs and octroi duties, concessional municipal/property taxes, cheaper finance on lower rate of interest, rebate of duty on electricity charges, easy availability of labour, lower sales promotion expenses, logistical advantage of Seepz etc., apart from income-tax benefits for which their profit margin is more than that of the assessee which is situated in a non-Seepz zone. It was accordingly submitted that the TPO has wrongly made excess adjustment.

7. Based on the arguments advanced by the assessee, the learned CIT(A) deleted the addition of Rs.3,39,63,666. While doing so he

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observed that the law of transfer pricing is still an area at a nascent stage, as such much importance has to be given to the methodology and procedure which needs to be followed for arriving at a fair decision. Referring to the various decisions cited before him, he observed that the transfer pricing is not an exact science and some degree of estimation is inbuilt with the whole process. He observed that the initial onus to establish that the international transaction is within the ALP lies with the assessee and the assessee has discharged its burden of proof by filing the detailed transfer study. The TPO should make a proper study and analysis on the basis of the data available as well as the proper method to be followed. He referred to the CBDT instruction and the provisions of section 92C(3) and 92CA(3). He observed that in the instant case the TPO has not considered the various factors which require the adjustments in the industry margin calculated on the basis of the comparables of the assessee and it is not clear as to why the TPO did not reject the transfer pricing study submitted by the assessee and still went ahead making the transfer pricing adjustments in a summary manner. He also questioned the selection of various companies as comparables. Considering the operating profit/sales of the assessee at 3.56% which was higher than the industry margin he observed that the transactions between the assessee and its AEs were at arms length. Since the assessee in the instant case has selected the external comparables from the public data base and has followed a detailed search process and made an analysis considering the various factors or selecting the external comparables as required under the transfer pricing regulations and guidelines, he accepted the TP study of the assessee and ALP of international transaction determined on the basis of the same. He thus deleted the addition made by the Assessing Officer.

8. Aggrieved with such order of the CIT(A), the Revenue is in appeal before us with the following grounds:

1. *The Ld. CIT(A) has erred on facts and in law in deleting the addition of Rs.3,39,63,666/- on account of*

adjustment made to Arms' Length Price in respect of international transactions with Associated Enterprises without appreciating that the arms length operating margin of 7.25% was taken by the Assessing Officer on the basis of average operating profit margin on cost of comparable cases listed in para 10 of the order u/s. 92CA(3) dated 22.12.2006 passed by the Addl. CIT, Transfer Pricing-III, Mumbai.

2. *The Ld. CIT(A) has erred on facts and in law in accepting the assessee's operating profit margin of 3.7% on cost (and 3.56% on sales) by erroneously holding that operating profit margin sh own by the assessee was higher than the average industry margin of 3.27% of external comparable whereas the average industry margin of 3.27% worked out by the assessee is not based on proper comparables.*

3. *The Ld. CIT(A) has erred on facts and in law in accepting the assessee's operating profit margin (disclosed at 3.7% on cost and 3.56% on sales) by erroneously holding on irrelevant consideration that there was no transfer of profit by the assessee outside India as its Associate Enterprises earned either meagre profit or incurred losses and that the tax rate was higher in US than in India*

4. *Your appellant prays that the order of the CIT(A) on the grounds be set aside and that of the Assessing Officer be restored.*

9. The learned DR relied on the order of the Assessing Officer and the TPO. He submitted that the assessee has allocated all expenses on the basis of turnover which is not correct. He submitted that in case of allocation of manufacturing expenses like employees remuneration, rent, etc., the ideal allocation key should have been – No. of employees, space utilised, etc. which the assessee has not done. He accordingly relied on the order of the Assessing Officer.

10. The learned counsel for the assessee, on the other hand, while supporting the order of the CIT(A) submitted that the assessee has shown operating profit margin of 3.56% on sales and 3.70% on cost while that of comparable used by the assessee is 3.27% on sales and 3.83% on cost. He

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submitted that net margin of 5.38% on sale to AEs and net margin of 1.77% to non AEs as disclosed by the assessee is justified who abides by the OECD Transfer Pricing Guidelines and which has used TNM method. He submitted that the Assessing Officer failed to appreciate that internal comparables are more reliable as compared to external comparables. Referring to the fresh benchmarking, he submitted that the transactions entered into by the assessee with its AEs are at arms length. He submitted that the comparables chosen by the TPO cannot be applied to the assessee's case as most of them are either located in Seepz or had their jewellery manufacturing in Seepz since out of 18 comparable companies 13 are located in Seepz. He submitted that the Seepz units get a number of benefits which were pointed out before the CIT(A) and which are enumerated in the order of the CIT(A). As regards the remaining 5 entities located outside Seepz, two units viz., Deep Diamonds India Ltd. and Su-raj Diamonds and Jewellery Ltd., are not at all comparables. He submitted that for the financial year 2003-04 Deep Diamonds business comprises of domestic operations only whereas the assessee had export sales of 95% of total turnover. Further Deep Diamonds had a turnover of Rs.3.70 crores whereas the assessee has a turnover of Rs.91 crores. Similarly in the case of Su-raj Diamonds, the turnover was Rs.724 crores out of which major amount was for diamond at Rs.521 crores. Therefore, the above two cases are not at all comparable. As regards the balance three companies he submitted that average operating profit to total cost of these entities works out to 2.87% as against 3.69% of the assessee company. He submitted that for making a fair study as per the provisions of the Act it is necessary that a proper FAR analysis should be carried out and relevant adjustments should be made. For this proposition he relied on the decision of the Delhi Bench of the Tribunal in the case of Mentor Graphics P. Ltd. vs. DCIT reported in 109 ITD 101 (Del). Referring to the decision of the Pune Bench of the Tribunal in the case of DCIT vs. MSS India Pvt. Ltd. reported in 32 SOT 132, he submitted that when an assessee has followed one of the standard methods for determining the

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ALP such an effort cannot be discarded in preference over transactional profit method unless the Revenue authorities are able to demonstrate fallacies in application of the standard method. Referring to the decision in the case of Schefenackr Mothersons Ltd. vs. ITO reported in 123 TTJ 509, he submitted that for determination of ALP under TNMM the assessee was justified in taking profit level indicators of comparable companies. He submitted that since the AEs are mainly based in USA and since the tax rates are higher in USA than in India it is unlikely that the assessee will gain anything. Further during the relevant assessment year the assessee is also eligible for deduction u/s. 80HHC. Therefore, there cannot be any basis to presume that the assessee has charged less. He submitted that the AO/TPO has not made out a case to establish that the comparables used by the assessee deserved to be rejected. Referring to CBDT circular No. 12 dated 23rd August, 2001 and circular No. 14 dated 22.11.2002, he submitted that the ALP should not be disturbed unless the pricing is not based on the prescribed methods. Since the assessee has shown operating profit on sales at 3.5% which is higher than the industry margin at 3.27%, therefore, the transaction between the assessee and its AEs were at arms length. He accordingly supported the order of the CIT(A) and submitted that the grounds raised by the Revenue should be dismissed.

11. We have considered the rival submissions made by both the sides, perused the orders of the Assessing Officer and the CIT(A) and the Paper Book filed on behalf of the assessee. We have also considered the various decisions cited before us. There is no dispute to the fact that the assessee during the relevant assessment year has entered into international transactions with four AEs, the details of which are already given at para 3 of this order. We find the assessee in the instant case has adopted TNM method. We find the split financials provided by the assessee were rejected by the TPO on the ground that allocation of manufacture expenses like employees remuneration, rent, etc., the allocation key used is sales whereas according to the TPO the ideal allocation key in this case

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could have been – number of employees, space utilised, etc. We find while rejecting the method adopted by the assessee, the TPO conducted fresh search to find companies in the comparable business as that of the assessee. However, we find those comparables as selected by the TPO cannot be compared with that of the assessee. We find out of the 18 comparables 13 of them are situated in Seepz which cannot be compared with that of the assessee because they get various benefits like customs and octroi duty, concessional municipal/property taxes, cheaper finance at lower rates of interest, rebate of duty on electricity charges, easy availability of labour, lower sales promotion expenses, etc., apart from Income-tax benefits for which their profit margin is more than that of the assessee which is situated in non-Seepz zone. Out of the remaining five companies, we find in case of Deep Diamonds India Ltd., the business for the A.Y. 2004-05 comprised of domestic operations only whereas the assessee's export turnover was around 95% of its total turnover. Further the turnover of Deep Diamonds was only Rs.3.5 crores as against the assessee's turnover of Rs.91 crores. Similarly in the case of Su-Raj Diamonds and Jewellery Ltd., the turnover was about Rs.724 crores and out of which major amount was for diamonds at Rs.521 crores. Therefore, this also cannot be compared with that of the assessee company. As far as the remaining three companies are concerned, we find the submission of the learned counsel for the assessee that the average profit to total cost of these companies at 2.87% is much less than the operating profit to total cost ratio at 3.69% of the assessee company could not be controverted by the learned DR. We also find merit in the submission of the learned counsel for the assessee that since the tax rates were higher in USA compared with those of India, therefore, there would not be any incentive to transfer the profits to higher tax chargeable regions especially when the company enjoys deduction u/s. 80HHC of the Act. Further the AEs have earned meagre profit or incurred losses as compared to the profit of the assessee and, therefore, the submission of the assessee that there was no transfer of profit by the assessee out side

India finds merit. It has been held by various judicial pronouncements that unless proper method is followed, comparables are chosen and selected after doing a proper FAR study as well as adjustments are made to the extent possible it would be unfair to summarily reject the transfer pricing analysis made by the assessee. We find in the instant case the Assessing Officer/TPO has not made out a case to establish that the comparables used by the assessee deserve to be rejected.

12. We further find the learned counsel for the assessee on being asked by the Bench, filed additional details explaining the compliance to Rule 10B of the I.T. Rules, 1962. The learned counsel for the assessee explained in writing that the assessee company has complied with Rule 10B(2)(a), 10B(2)(b), 10B(2)(c) and 10B(2)(d) and the learned DR could not controvert the above submissions of the learned counsel for the assessee. We find the assessee's operating profit margin is 3.56% on sales and is 3.70% on cost whereas that of the comparables used by the assessee is at 3.27% of sales and at 3.82% on cost. Further from the details provided and as mentioned in TPO's order at para 7 we find it was submitted that the assessee earns a net margin of 5.38% on sales to AEs and net margin of 1.77% on sales to non-AEs which remains uncontroverted. We, therefore, find merit in the submission of the learned counsel for the assessee that the operating profit/sales of the assessee at 3.56% being higher than the industry margin, therefore, the transactions between the assessee and its AEs are at arms length. We further find the external comparables selected by the assessee are from the public data base and the assessee has followed a detailed search process and made an analysis considering the various factors of selecting the external comparables as required under Transfer Pricing Regulations and Guidelines. Therefore, the transfer pricing study of the assessee and ALP of international transactions determined on the basis of such study simply cannot be rejected without any cogent reasons. In this view of the matter and in view of the detailed order passed by the CIT(A) deleting the addition of Rs.3,39,63,656, we do not find any infirmity in the same and

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accordingly uphold the order of the CIT(A). The grounds raised by the Revenue are accordingly dismissed.

13. In the result, the appeal filed by the Revenue is dismissed.

Pronounced on 31st May, 2010

Sd/-	Sd/-
(D. MANMOHAN)	(R.K. PANDA)
VICE PRESIDENT	ACCOUNTANT MEMBER

Mumbai, dated 31st May, 2010

Copy to:

1. The Appellant
2. The Respondent
3. The CIT(A)-XIX, Mumbai
4. The CIT-9, Mumbai
5. The DR "L" Bench.

//True copy//

BY ORDER

ASSISTANT REGISTRAR
ITAT Mumbai Benches, Mumbai

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