

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

BEFORE DR. O. K. NARAYANAN, VICE PRESIDENT

AND

SMT. P. MADHAVI DEVI, JUDICIAL MEMBER

I.T.A No.423 /Bang/2009
(Assessment Year : 2004-05)

M/s. Logix Micro Systems Ltd.,
177/2C, Bilekahalli Industrial Area, Bannerghatta Road,
Bangalore 560 076 .. Appellant

v.

Asst. Commissioner of Income-tax,
Circle - 11(5), Bangalore .. Respondent

I.T.A No.524 /Bang/2009
(Assessment Year : 2004-05)
(By the Revenue)

Assessee by : Shri. K. R. Pradeep, Chartered Accountant
Respondent by : Smt. Preethi Garg, Commissioner of Income-tax -III

ORDER

PER DR. O. K. NARAYANAN, VICE PRESIDENT :

These two appeals are cross appeals filed by the assessee and the Revenue, for the assessment year 2004-05. These cross appeals are directed against the order of the Commissioner of Income-tax(A)-IV, at Bangalore, dated.26.02.2009. The appeals arise out of the assessment completed u/s.143(3) r.w.s.92CA of the IT Act, 1961.

2. The only issue raised in the present appeal is against the additional income of Rs.56,60,486/- determined by the Transfer Pricing Officer ('TPO' for short) in her proceedings concluded u/s.92CA. The assessee is a company carrying on the business of software development in the field of providing business and technology solutions. The return of income filed by the assessee company for the impugned assessment year 2004-05 reflected a loss of Rs.1,31,53,534/-. In the course of assessment proceedings, the matter was referred to the TPO who has determined an additional income of Rs.56,60,486/- u/s.92C as Arms Length Price ('ALP' for short) adjustment. As a result of the above, the loss determined in the case of the assessee company came down to Rs.74,93,048/-.

3. The assessee company M/s. Logix Micro Systems Ltd., ('Logix India' for short) is having an Associate Enterprise ('AE' for short) in USA as 100% subsidiary known as Logix America Inc.USA (Logix USA) for short). Logix USA in turn holds 76% of the shares in another US company by name M/s. Homestar LLC (USA) ('Homestar-USA' for short). Because of the above share holding, pattern Homestar-USA stands in the position of AE to the assessee-Logix India.

4, The assessee, Logix India has entered into a product development services agreement and a professional services agreement, both separately, with its AE -Homestar USA. As the transactions of the assessee company had been with its AE at USA, the Assessing Officer made a reference u/s.92CA to the TPO to decide the matter of ALP. The TPO found that the international transactions reported by the assessee company were in the categories of purchase of capital equipment, purchase of computer software, provision for software development and consultancy services and bad debts previously written off restated in the relevant previous year. She examined the pricing of all the above transactions by analysing under Transactional Net Margin Method. She found that the transactions were entered at ALP. She, therefore, accepted the prices in respect of the above transactions as ALP compatible.

5. But the TPO further found that on the last day of the previous year a total amount of Rs.7,73,23,619/- has shown as debts receivable from its AE-Homestar USA. She further noticed that out of the above, an amount of Rs.5,52,25,261/- was outstanding for more than six months. She found that by parking this huge amount at the disposal of Homestar USA, the AE, the assessee is depriving the funds otherwise available in its hands and adversely affecting the profitability of the

assessee. The assessee's explanation before the TPO was that the delay in collecting the receivables was due to the difference in the billing patterns followed by Logix India and Homestar USA. But the TPO held that in spite of such a difference in the billing patterns, there is no justification for parking a huge sum of money at the disposal of the AE.

6. Therefore, she held that a reasonable amount of income should be attributed to the funds parked with the AE. She adopted the amount of Rs.5,52,24,261/- being the debts outstanding for more than six months, as the amount parked with assessee's AE and worked out an interest income of Rs.56,60,486/-. This interest income was worked out at the rate of 10.25% being the Prime Lending Rate (PLR) approved by the State Bank of India during the relevant previous year period. This amount of Rs.56,60,486/- was recommended by the TPO as the additional income of the assessee and in turn the amount was deducted by the Assessing Officer from the loss reported by the assessee company.

7. When the matter came up before the Commissioner of Income-tax(A) in first appeal, he agreed with the finding of the TPO that the outstanding receivables partake the character of loan, interest-free in

nature availed by the AE in USA at the cost of the assessee company. Therefore, he upheld the decision of the TPO and the assessing authority in working out the interest income attributable to the receivables outstanding as on the last day of the previous year. But regarding the rate of interest to be applied, the Commissioner of Income-tax(A) did not approve the PLR of the State Bank of India. First of all he held that the said PLR rate cannot be taken as CUP method. Secondly he held that the billing is done by the assessee in USD and debts are borne in the accounts of Homestar USA in USD and, therefore, the rate of interest should be comparable to the rate of interest that would have been suffered by Homestar USA if funds were borrowed in USA. Accordingly, the Commissioner of Income-tax(A) directed the Assessing Officer to calculate the interest by adopting the LIBOR/US-FED rate as the bench-mark and to determine the actual rate after providing for appropriate adjustments relating to the nature of loan, term of loan, credit standing of Homestar USA, security for loan etc., He also directed that the Assessing Officer to allow a reasonable period as the collection period of the receivables and to compute the interest only for the period over-flowing the reasonable time limit. With these directions the first appeal was disposed off.

8. The assessee company is aggrieved by the order of the Commissioner of Income-tax(A) in all its entirety and, has filed the second appeal before us. The Revenue is aggrieved on the direction of the Commissioner of Income-tax(A) that LIBOR/US FED rate should be taken as the interest-rate. This is the only dispute in the appeal filed by the Revenue.

9. We heard Shri. K. R. Pradeep, the learned Chartered Accountant appearing for the assessee company and Smt. Preethi Garg, the learned Commissioner of Income-tax-III, appearing for the Revenue.

10. The detailed grounds raised by the assessee in its appeal are reproduced below :

"i) That the order of the authorities below in so far as it is against the appellant is against the law, facts, circumstances, natural justice, equity, without jurisdiction, bad in law and all other known principles of law ;

ii) The total income/loss computed is hereby disputed ;

iii) That the arm's length interest of Rs.56,60,486/- determined by the TPO and adopted by the Assessing Officer is hereby disputed ;

iv) That the communication/order of the Transfer Pricing Officer is without jurisdiction, against the law, facts, circumstances, natural justice, equity and all other known principles of law;

v) That no copy of the reasons recorded before making the reference to the TPO has been furnished nor copy of the approval obtained for making the reference has been furnished to the appellant ;

vi) No opportunity was given to the assessee before making the reference and before according approval by the Commissioner of Income-tax. This is against the principles set out by the Hon'ble Supreme Court in Sahara India (Firm) v. Commissioner of Income-tax-200 ITR 403 ;

vii) The onus is on the department to establish there is any tax avoidance and it is essential that incontrovertible evidences are in the possession of the Assessing Officer before a reference is made as held by the Supreme Court in 131 ITR 597 ;

viii) That the findings, reasons, conclusions of the TPO are a bundle of contradictions and clearly unsustainable in law and the order u/s.92CA is totally against the circular and legislative intent ;

ix) The authorities below erred in holding that ipso facto the determination/calculation of arm's length price amounts to earning of income by the appellant, thereby taxable in its hands ;

x) The order of the TPO and that of the Assessing Officer is in clear violation of the law on this issue and the principles enunciated by various courts more particularly on the issue of reference, sanction of approval, recording of reasons and lack of satisfaction ;

xi) The Assessing Officer erred in believing that the suggestions made by the TPO is binding and compels him to make the adjustment ;

xii) The authorities below failed to identify the International Taxation which requires Arms Length Price adjustment, thus the order suffers from basic infirmity and hence liable to be vacated ;

xiii) The authorities below have failed to identify a comparable in terms of Rule 10B(3) ;

xiv) The Commissioner of Income-tax(A) erred in ignoring the fact that before making an adjustment neither a comparable transaction entered into has been identified nor the enterprise which has entered into such a transaction has been identified. Unless these two are identified as explained in Rule 10B(2) no further proceedings are possible. In this case, in view of non-identification, the entire order requires to be vacated ;

xv) The Commissioner of Income-tax(A) erred in overlooking the fact that there was no method prescribed under the Act or the Rules, having regard to the nature of transaction entered into by the assessee. Consequently, as per law no uncontrollable Arm's Length transaction could be identified ;

xvi) The Commissioner of Income-tax(A) erred in restoring the matter back to TPO/Assessing Officer even after the TPO confirming that there were no comparable transaction."

11. The grounds raised by the assessee regarding the jurisdiction of the TPO, recording of reasons before making reference to TPO, providing opportunity to the assessee before making the reference, the onus of the department to establish tax avoidance, all are rejected in the light of the decision of ITAT, Bangalore, Special Bench, rendered in the case of Aztec Software and Technology Services Ltd., (2007) 107 ITD 141.

12. Another legal objection raised by the learned Chartered Accountant appearing for the assessee is that the reference made by the Assessing Officer related only to the point of ALP in respect of international transactions and the said reference does not cover the aspect of delay in collecting the receivables and the potential loss

raising therefrom and, therefore, the adjustment directed by the TPO on the question of interest chargeable to outstanding receivables is without jurisdiction and against law.

13. We gave our anxious consideration to the above argument. We should say that, we are not inclined to agree with the argument of the learned Chartered Accountant. A reference made by the Assessing Officer to the TPO on matters of ALP is not made in piece-meal. The Assessing Officer while referring a file to the TPO is contemplating an overall examination and analysis of the entire aspects relating to international transactions concluded by an assessee. The assessing authority is not expected to classify the areas of international transactions into different segments and refer only certain segments to the consideration of the TPO. Therefore, when a file is referred to TPO for the purpose of examining the matter relating to ALP, the assessing authority is referring the entire gamut of international transactions for the consideration of the TPO. The purpose of an ALP analysis itself is in the larger context of anti-evasion measures. In the present case, the outstanding balance of receivables did not generate out of domestic transactions. Those receivables did generate from international transactions carried out by the assessee with its AE in USA. Therefore, there is no basis in arguing that the receivables are

strange to the international transactions and, therefore, those receivables would not come under the purview of the jurisdiction of the TPO. The outstanding receivables is the financial result of the international transactions concluded by the assessee company with AE in USA and, therefore, the income effect arising, if any, to that outstanding receivables is very much a relevant aspect of ALP. Therefore, as a legal proposition we hold that the TPO is having the jurisdiction to examine the issue of outstanding receivables and non-charging of interest thereon.

14. Another legal argument advanced by the learned Chartered Accountant is that the Assessing Officer and the TPO should have considered the outstanding balance of receivables as a separate transaction different from the international transactions. This contention also fails in view of our discussion made in paragraph above.

15. Next we will examine the merit of the addition suggested by the TPO and made by the assessing authority. It is a fact that huge amount of receivables were outstanding at the end of the relevant previous year. The receivables were due from the AE in USA with which the assessee has concluded international transactions. The total

of such outstanding balance as on 31.03.2004 was Rs.7,73,23,609/- out of which an amount of Rs.5,52,24,261/- were outstanding for more than six months. The reason stated by the assessee company for the delay in collecting the receivables is that there is a difference in the billing patterns followed by the assessee and Homestar USA, the AE. But in spite of such a contention before the lower authorities as well as before the Tribunal, the assessee has not demonstrated the real difference between the billing patterns and that how the difference would contribute to the accumulation of receivables to such a huge extent. We find that the said explanation offered by the assessee company is rather logical than substantive. Of course, to a certain extent, there may be a timing difference because of the different billing patterns followed by the assessee company, its AE- Homestar USA and the clients of the AE. But the timing difference could be acted upon only if the impact is established to be decisive and overwhelming over a period of time. Therefore, the observation of the TPO cannot be ignored only on the basis of the above argument advanced by the assessee company. It is also not seen from the submissions the assessee was running its business with its own funds and the assessee was not at all paying any interest in India for borrowed funds.

16. In the light of the above, we cannot accept the contention of the assessee that, the AE was not retaining any funds of assessee in its hands and the funds are immediately remitted to the assessee as and when received from its clients. As the assessee is not having any dealings with the clients of the AE, assessee cannot be a witness for the delayed payments by AE customers. It is for the AE to see that its customers are paying in time so that it can pay the assessee in time. If the contentions of the assessee is accepted, it would also mean that the AE has no working capital of its own to pay the assessee in time. It means that the AE was doing the business using the capital of assessee. AE collects money from clients as and when received even beyond normal period. It shows assessee is in fact financing the business of AE by accommodating delayed remittance of receivables.

17. As a general rule, we agree with the learned Chartered Accountant that what is to be assessed as income is the income earned by an assessee and not the income that could have been earned by the assessee. Thus there is a real difference between the actual and the probable. But that general rule of taxation is not as such directly applicable to the present case as the TPO was really examining the financial impact of an international transaction. What is made in an analysis of ALP is the evaluation of the said financial impact. On one

side the pricing adopted by the assessee for all its international transactions with its AE is comparable and the ALP test is satisfied. To that extent in the present case, the TPO has accepted the position reported by the assessee company. But in spite of the fact that on one aspect of the transaction, the assessee has complied with the ALP parameters, on another side the assessee has parked huge amount of funds for long period with its AE in USA. Only for the reason that the pricing of international transactions has been accepted for ALP test, it is not possible to hold that the TPO should not go into this question of parking of funds with its AE in USA. If the funds are repatriated into India on ordinary within the normal period, the assessee would have been in a position to pay all its working capital loan or other loans, if any, and/or earning some income from an appropriate investment of those repatriated funds. This potential loss is definitely a factor to be considered while evaluating the financial impact of the international transactions concluded by the assessee with its AE in USA. Therefore, we agree with the arguments of the Revenue and uphold the finding of the TPO that an additional income is to be added in the present case as part of ALP analysis.

18. In the facts and circumstances of the case, the main contention of the assessee company is dismissed.

19. Next we have to consider the reasonableness of the directions issued by the Commissioner of Income-tax(A) on which the Revenue has also come in appeal.

20. One of the directions given by the Commissioner of Income-tax(A) is that a reasonable period may be provided as interest-free period and no interest be calculated for such interest-free period. Interest is to be calculated for the period overflowing the interest-free period. This direction is just and proper. Upheld.

21. The second set of direction given by the Commissioner of Income-tax(A) is that the ALP interest may be calculated after providing appropriate mark-up for the nature of loan, term of loan, credit standing of the AE- Homestar USA, security of loan etc., The funds parked with Homestar USA is not in the nature of a loan with all the legal features of a loan transaction. This is in fact parking of funds with the AE by not collecting the receivables within the normal period. Therefore, the direction given by the Commissioner of Income-tax(A) which are applicable to formal loans cannot be made applicable to the present case. As far as the present case is concerned,

those directions of the Commissioner of Income-tax(A) are more academic in nature. Therefore, all those directions are vacated.

22. Another important direction given by the Commissioner of Income-tax(A) is to adopt LIBOR/US-FED rate for calculating the interest. This proposition has been made by the Commissioner of Income-tax(A) on the premise that the ALP factor of interest is to be computed with reference to the benefit that would have been earned by the AE in USA. On the other hand, in calculating the cost factors of the assessee in India, it is more appropriate to consider the potential loss suffered by the assessee in India by not bringing the receivables within the normal period. In fact, the said potential loss of the assessee in India is the ALP factor which contributes to the additional income attributable to the assessee. Therefore, instead of the US rate, the TPO is justified in adopting the Indian rate.

23. While adopting the Indian rate, it is not proper to rely on PLR of the State Bank of India. This is because if the funds were brought in time and those funds were properly deployed, the assessee company may earn an income at the maximum rate applicable to deposits and not at the rate applicable to loans. Therefore, we vacate the direction of the TPO to adopt the PLR rate of 10.25%. Instead we find it

appropriate to adopt a reasonable rate that would be available to the assessee on short-term deposits.

24. We have held that the period chargeable to interest has to be recomputed and a reasonable deposit rate has to be applied for calculating the interest. Taking into consideration all aspects of the case like interest-free period and piece-meal remittance of the receivables, we fix the ALP interest rate at 5% and direct the Assessing Officer to compute the additional income at the rate of 5% on Rs.5,52,24,261/- as against 10.25% adopted by the Assessing Officer.

25. In result, the contentions raised by the assessee on questions of law and on merit of the case per se are rejected. But the quantum of additional amount by way of interest is modified. As far as the contentions of the Revenue are concerned, they are accepted even though is granted in the rate of interest.

26. In result, the appeal filed by the assessee is partly allowed and the appeal filed by the Revenue is allowed.

Order pronounced on Thursday, the 07th day of October, 2010 at
Bangalore.

Sd/-

(P. MADHAVI DEVI)
JUDICIAL MEMBER

Sd/-

(DR. O. K. NARAYANAN)
VICE PRESIDENT