

IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCH "L"

Before Shri N.V. Vasudevan (JM) & J. Sudhakar Reddy (AM)

I.T.A.No. 2279/Mum/06 (Assessment year : 2002-03)

DCIT 16(3)
Matru Mandir
Tardeo Road
Mumbai-400 007.

Vs.

M/s. Starlite
801/805, Magestic Shopping Centre
8th Floor
144, Girgaum
Mumbai-400 004.

APPELLANT

RESPONDENT

I.T.A.No. 925/Mum/06 (Assessment year : 2002-03)

M/s. Starlite
801/805, Magestic Shopping Centre
8th Floor
144, Girgaum
Mumbai-400 004.

Vs.

DCIT 16(3)
Matru Mandir
Tardeo Road
Mumbai-400 007.

APPELLANT

RESPONDENT

PAN/GIR No. : AALFS9218D

Assessee by : Shri Apurva Shah
Department by : Shri Aarsi Prasad

ORDER

PER J. SUDHAKAR REDDY, AM :-

These are cross appeals directed against the order of learned CIT(A)-XVII, Mumbai dated 23.1.2006 for A.Y. 2002-03.

2. Facts in brief :

The assessee is a partnership firm and in the business of import, manufacture and export of diamonds and Jewellery. During the year, the assessee has shown export sale of polished diamonds and claimed deduction u/s. 80HHC. The assessee also filed an Audit Report in the Form No. 3CEB. The Assessing Officer referred the case to the Transfer Pricing Officer (TPO) for determination of Arms Length Price (ALP) u/s.

92CA(3). TPO vide her order dated 9.3.2005 brought out the fact at paragraph 3&4 of her order, which is extracted for ready references :-

- 3) The assessee is a partnership from the six partners, having specified profit-sharing ratio's. The assessee is engaged in the business of manufacturing of patent polished diamonds. It imports rough diamonds from overseas entities and exports patent polished diamonds to the same entities and others. During the previous year, the total turnover of the assessee company is Rs. 41.42 crores giving a net profit of Rs. 0.87 crores. The assessee has been availing exemption under the provisions of section 80HHC of the Income Tax Act in respect of the exports made by it. The assessee has been carrying on this business for more than 14 years.
- 4) One of the main partners of the assessee firm having 40% shares in the profits has a brother located at Belgium. The brother has the management and control over a firm in Belgium called Sunshine Gems. Hence, the assessee and the firm in Belgium are associated enterprises of one another in terms of section 92CA(2)(j) of the Income Tax Act.

3. The assessee contended before the TPO that, for the purpose of benchmarking the assessee's international transactions, none of the methods prescribed under the income tax act are applicable in its case. In the transfer pricing study report, the assessee for the reasons given therein i.e, impossibility of adopting one of the prescribed methods as the most appropriate method, has not determined any ALP for its various international transactions. TPO at paragraph 9 responded as follows :-

"Under the Indian Transfer Pricing Provisions, it is necessary to determine the arms length price for the various international transactions entered into by the assessee in accordance with any one of the prescribed methods provided by the Act. It is seen that normally, if no other method is possible to apply, then the transactional net margin Method can invariably be applied to determine the ALP in respect of international transactions. Accordingly, a letter dated September 15, 2004 was issued to the assessee wherein it was specifically stated that if no other method is possible to apply, then the assessee may justify the ALP -----, determining the same under the transactional net margin Method. Further as the assessee had contended that the import of rough

diamonds was examined by the customs authorities. It was requested to provide details of any valuation report or other order passed by the customs authorities in particular in respect of its transactions during the relevant previous year."

4. Thereafter, the TPO found that the assessee had compared, his profit margin at the entity level, with another comparable company i.e. M/s. Suraj Diamonds and justified its international transactions with its associated enterprise, as having been done at ALP. TPO thereafter collected information, data etc. from, among other firms, engaged in the activities of cutting and polishing diamonds and also of exporting the same. After taking larger sample of comparables, TPO, made certain adjustments, by observing that operational profit to sales ratio, averages to 9.57%, when all the comparables are taken into account and whereas operational profit of cost ratio, averages to 11.28%, on these very comparables. The assessee was given an opportunity. The submissions of the assessee and findings of the TPO are brought out at para 14-15 of the TPO's order, which is extracted for ready reference :-

14 In this connection, the main contentions of the assessee are as follows :-

- 1) The assessee contends that profits of the cutting and polishing business in diamonds is influenced by various factors and by mere inspection of the balance sheet of the comparables, it cannot be determined whether they are properly comparable to the assessee.
- 2) The assessee has also considered the case of Hope India polishing work to be not comparable for the reason that they are primarily engaged in job work.
- 3) The assessee has further considered the case of Dharamanandan Diamonds and contended that they are not comparable to the assessee in view of the fact that the quality of diamonds polished by them are of much superior level as compared to the assessee. Further, the assessee contends that they use a laser machine for the purpose of cutting and polishing whereas the assessee does not have such machines. In view of the same, the assessee

contends that this company should not be considered as a comparable.

- 4) The assessee contends that if these two entities are removed from the list of comparables its operating profit margin would be comparable, to the operating profit margin.

15. The various contentions of the assessee are considered as follows :-

- 1) The assessee's contention regarding M/s. Hope India Polishing Works is accepted and the same is not included in the list of comparable cases.
- 2) The various objections raised by the assessee in connection with the Dhamanandan Diamonds are not acceptable. Under the transactional net margin method the only requirement is of functional comparability. The assessee is engaged in the business of cutting and polishing diamonds, and all the comparables identified by this office are also engaged in the same business activity. Hence, there is no reason for rejecting any of the other comparables.
- 3) As the comparison has been made at the operating profit level, any differences in the intensity of various functions performed or assets employed would get automatically evened out. Further, as more than one entity has been considered in the sample of comparables, they would take care of minor variations.
- 5) It has been pointed out that two of the comparables namely M/s. Blue Star Industries and M/s. Akshay Diamonds are engaged in related party transactions. Hence, these two entities cannot be considered as comparables as they are not uncontrolled transactions.
- 6) Some minor mistakes in the calculation of profit margins were found and the same have been corrected. The operating profit is calculated by considering the net profit before interest and sale tax. To the said profits, all non operating expenses are added and non operating incomes are excluded there from. The cost base considered is all costs excluding non operating costs. The revenue based considered is all revenue excluding non operating

income such as interest, dividend etc.. As already stated the assessee was given full opportunity to examine all the balance sheets and take a copy thereof.

5. Thereafter, the TPO made an adjustment of Rs. 1.69 crores on purchase or alternatively an adjustment of Rs. 2.16 crores on sales.

The Assessing Officer after giving an opportunity to the assessee, adopted report of TPO and made an addition of rupees 1.69 crores.

6. On appeal by the assessee, First Appellate Authority considered the objections of the assessee and by not disturbing the methodology adopted by the TPO, came to the conclusion that, inclusion of trading results of Dhamanandan Diamonds and Royal Diam as comparables, had given a distorted working of operating profit margin to sales and cost. After excluding trading results of these two entities, from the list of comparables, that the TPO has adopted, First Appellate Authority came to the conclusion that the profit margin to sales works out at 5.46% and to cost at 5.80%, which were then range of plus or minus 5% variation as stipulated u/s. 92C(2) of the T.P. Rules and Regulations. In view of his above findings, he deleted the addition of Rs. 1,69,91,181/-.

7. There was one more issue with regard to computation of relief u/s. 80HHC. Learned CIT(A), on the issue of treatment of exchange difference of earlier years, followed his Predecessor's order and granted relief. On the issue of head of income, under which, interest income is taxable, learned CIT(A) dismissed the claim of the assessee that the same is business income.

Aggrieved, both the assessee and the revenue are in appeal.

8. The Revenue has filed its appeal on the following two effective grounds :-

- 1) That learned CIT(A) has erred in law and on facts in directing the Assessing Officer to delete the addition of Rs. 1,69,91,181/- being adjustment to the value of

international transactions with associated enterprise which was made u/s. 92CA(3) as per order of the Addl.CIT, TP-III dated 15.3.2005.

- 2) That the learned CIT(A) has erred in law and on facts in directing the Assessing Officer to consider foreign exchange rate difference gain of Rs. 24,17,607/-, pertaining to the exports of earlier years as part of export turnover for the purpose of deduction u/s. 80HHC of the I.T. Act, 1961 without appreciating the facts that the said amount did not form part of export turnover for the assessment year under question as defined in Clause (b) of Explanation below sub-section 4C of section 80HHC of the I.T. Act, 1961.

9. The assessee filed an appeal on the following two grounds :-

Learned CIT(A)-V Mumbai erred in :-

- 1) not considering the following arguments of the appellant while adjudicating on the addition made based on the order passed by the TPO and adding a sum of Rs. 1,69,91,181/- to the appellant's income:-
- a) in holding that the Transaction Net Margin Method (TNMM) was the most appropriate method when the assessee had explained in detail why the said method was not an appropriate method.
 - b) In using comparables for the TNMM that were not strictly comparable to the business income the appellant. In particular, in not including the results of Akshay Diamonds and Blue Star Industries merely on the grounds they had related parties.
 - c) In suggesting that the Comparable Uncontrolled Price (CUP) method was the most appropriate method for arriving at ALP and sending show cause notice to appellant of her proposal to use CUP as the most appropriate method but in not ultimately using the same when the appellant had shown how the transactions with the AE were at ALP using the CUP method as suggested by the Assessing Officer.
- 2) In holding that the interest income of Rs. 5,23,230/- was 'income from other sources' instead of 'business income', notwithstanding the nature of the deposits. Without prejudice in not allowing interest expenses as a deduction u/s. 57(iii) if interest income was chargeable as income from other sources.

10. We have heard Mr. Apurva Shah, learned counsel for the assessee and Mr. Aarsi Prasad, learned DR. On careful consideration of the facts and circumstances of the case, perusal of the papers on record and order of authorities below as well as case laws cited, we hold as follows :-

Ground No. 1 in both assessee's appeal, as well as revenue's appeal, pertain to adjustments made consequent to, determination of ALP, in an international transactions with an associated enterprises under transfer pricing regulations, laid down under Chapter-X of the Income Tax Act 1961.

Learned counsel for the assessee has not disputed the fact that transactions in question, were in fact with associated enterprises as defined in section 92A of the Act. The assessee had voluntarily filed Transfer Pricing Report in Form No. 3CEB for transactions with the A.E. Thus, this issue is not before us and we cannot comment on the same. There is no dispute raised by the assessee in this regard.

Coming to the issue of determination of ALP, we agree with the findings of TPO at paragraph No. 9 of her order, which is already extracted in para 3 of this order. It is mandatory under special provision stipulated in Chapter-X of the Income Tax Act, 1961, to compute the ALP in one of the methods specified under Statute. Section 92(1) reads as follows :-

Meaning of international transaction.

92B. (1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction" means a transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

Section 92(C) reads as follows :

Computation of arm's length price.

92C. (1) The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe⁷⁸, namely :—

- (a) comparable uncontrolled price method;
- (b) resale price method;
- (c) cost plus method;
- (d) profit split method;
- (e) transactional net margin method;
- (f) such other method as may be prescribed⁷⁹ by the Board.

Rule 10B reads as follows :

Determination of arm's length price under section 92C.

10B. (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely

11. Plain reading of the above provisions in the Act as well as in the Rules, show that it is mandatory for the assessee, to follow one of the prescribed method and demonstrate that the international transactions, entered into by it, with an associated enterprise, are at Arms Length Price. By simply saying that none of the methods can be applied and citing excuses for the same, in our considered opinion does not absolve the assessee of its statutory duty in determining ALP as per the law. In a number of cases, where different assesses, are having similar lines of business, transfer pricing report has been filed and one of the methods specified under the act was used to arrive at as most appropriate method. Surprisingly, in this case, the assessee in our humble opinion, contrary to the stand of many similar organizations, has taking unsustainable stand that none of the methods prescribed under law, can be followed by it. Thus, on this aspect, we uphold the order of the TPO.

12. Coming to the computation of income ALP by TPO, as well as by the assessee, we find that TPO has adopted enterprises level operating margins, as TNMM for the purpose of comparison. In our considered opinion, Transactions Net Margin Method (TNMM) does not permit the assessee or the Assessing Officer, to compare enterprise level profits and make adjustments under Chapter-X. This Bench of the Tribunal in ITA No. 5034/Mum/07 dated 15.2.2010, 'L' Bench in the case of Addl. CIT Vs. M/s. Tej Diam at paragraph 6 onwards held as follows :-

“6. Rival contentions heard. On a careful consideration of the facts and circumstances of the case and a perusal of the papers on record and the orders of the authorities below, we hold as follows.

7. The following definitions are extracted for ready reference :

Section 92F(ii) arm's length price:

“ arm's length price” means a price which is applied or proposed to be applied **in a transaction** between persons other than associated enterprises, in uncontrolled conditions.”

(v) - transaction.

“transaction includes an arrangement, understanding or action in concert,-

(A) whether or not such arrangement, understanding or action is formal or in writing; or

(B) whether or not such arrangement, understanding or action is intended to be enforceable by legal proceeding. ”

Rule 10B sub clause (e) – transaction at margin method:

- (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;
 - (ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;
 - (iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;
 - (iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the same as the net profit margin referred to in sub-clause (iii);
 - (v) the net profit margin thus established is then taken **into account to arrive at an arm's length price in relation to the international transaction.**
8. A plain reading of the above shows that TNMM requires comparison of net profit margins realised by an enterprise from an international transaction or an aggregate of international transactions and not comparisons of operating margins of enterprises. For arriving at this conclusion, we drew strength from the decision of Mumbai 'L' Bench of the Tribunal in the case of UCB India P. Ltd. vs. ACIT 121 ITD 131 (Mum.) where it is held that section 92C read with Rule 10B(1)(e) deals with Transactions Net Margin Method (TNMM) and it refers to only net profit margin realised by an enterprise from an

international transaction or a class of such transaction, but not operational margins of enterprises as a whole.

9. Respectfully following the same, we hold that the TPO as well as the AO have committed an error by wrongly applying Transaction Net Margin Method. -----

13. As in this case, TPO has not applied Transactions Net Margin Method, as contemplated in the Act, we have no other alternative but to set aside her order. In any event, as the assessee has also not fulfilled its statutory obligations contemplated in Chapter-X of the Act, we deem it appropriate, under the facts and circumstances of the case, to set aside the matter, to the file of the Assessing Officer for fresh adjudication. As both the assessee as well as the Assessing Officer have not followed the law, in the interest of justice, we deem it appropriate to permit the assessee to furnish a fresh transfer pricing study report, in support of its contention, that the transactions with associated enterprises were in fact at arms length. We make it clear that the assessee would be entitled to furnish fresh information and documentation, or chose a fresh method as prescribed, as the most appropriate method, in support of its case. The Assessing Officer as well as the TPO shall examine the report as contemplated under Section 92E de novo, after giving appropriate opportunity to the assessee. We also agree with the arguments of learned counsel for the assessee that adjustments, if any, arising due to computation of ALP should be restricted only to the international transactions and not to the entire turnover of the assessee company. No addition can be made to local transactions under Chapter X of the Act. Such things are done only when the Assessing Officer invokes section 144. We direct the Assessing Officer to restrict the adjustments, if any only to international transactions, which are found by him to have taken place at a price other than ALP.

With these observations, we set aside the matter to the Assessing Officer for fresh adjudication.

14. Coming to Ground No. 2 in the assessee's appeal, is against the Assessing Officer as well learned CIT(A) holding that the interest income from the bank deposits kept as margin money under the head 'other sources' instead of the Head of 'income from business'. After considering the facts of the case, we find that the assessee has placed certain monies with the Bank as FD and these deposits were kept as margin money for availing facilities from the bank. Under such circumstances, The Jurisdictional High Court in the case of Indo Swiss Jewels Ltd. & Another, 284 ITR 389 (Bom) and in the case of Lok Holdings, 308 ITR 356 (Bom) have held that under such circumstances, such interest income, is to be assessed only as income from business. Thus, this ground of the assessee succeeds.

15. Coming to exclusion of 90% of such income from profits of business while computing relief u/s. 80HHC, The Hon'ble Bombay High court in ITA No. 200 of 2009 in the case of CIT-III Vs. Asian Star Co. Ltd, order dated 18-19th March 2010, held that only 90% gross interest is to be eliminated. The decision of Special Bench of the Tribunal in the case of Lal Sons, 89 ITD 25 (SB) has been overruled. In view of the above binding decision, we reject this contention of netting made by the assessee.

In the result, Ground No. 1 of the assessee's appeal is allowed for statistical purposes and Ground No. 2 is allowed in part.

Coming to Ground No. 2 of the revenue's appeal, both the parties submitted that this issue stands covered by the decision of Special Bench of the Tribunal in the case of Prakash Shah, ITA No. 6349/Mum/2004 'K' Bench order dated 22.10.2008. Respectfully following the same, we set aside the matter to the file of the Assessing Officer for fresh adjudication in accordance with law.

M/s. Starlite

16. In the result, both these appeals are allowed for statistical purposes.

Order has been pronounced on 20th Day of April, 2010.

Sd/-
(N.V. VASUDEVAN)
JUDICIAL MEMBER

Sd/-
(J. SUDHAKAR REDDY)
ACCOUNTANT MEMBER

Dated : 20th April, 2010

Copy to : 1. The Assessee
2. The Respondent
3. The CIT(A)-concerned.
4. The CIT, concerned.
5. The DR concerned, Mumbai
6. Guard File

BY ORDER

True copy

ASSTT. REGISTRAR, ITAT, MUMBAI

PS