

**IN THE INCOME TAX APPELLATE TRIBUNAL  
DELHI I BENCH, NEW DELHI  
[Coram: Pramod Kumar AM and C. M. Garg JM]**

I.T.A. No.: 549/Del/2011  
Assessment year: 2005-06

**Deputy Commissioner of Income Tax  
Circle 11(1), New Delhi**

.....**Appellant**

**Vs.**

**EDAG Engineers & Design India Pvt Ltd**  
Sankalp, C 227 Ground floor, Westend Marg,  
Paryavaran Complex, New Delhi 110 030  
[ PAN: AAACE6666K]

.....**Respondent**

**Appearances by:**

**Peeyush Jain and Yogesh Kumar Verma, for the appellant**  
**G C Srivastava, Saurabh Srivastava and Arun Bansal, for the respondent**

Date of concluding the hearing : September 03, 2014

Date of pronouncing the order : October 13<sup>th</sup>, 2014

**O R D E R**

**Per Pramod Kumar:**

1. By way of this appeal, the appellant Assessing Officer has challenged correctness of learned Commissioner (Appeals)'s order dated 29<sup>th</sup> November, 2010, in the matter of assessment under section 143(3) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'), for the assessment year 2005-06, on the following ground:

**On the facts and in the circumstances of the case and in law, learned CIT(A) has erred in deleting the addition of Rs 1,65,87,730 on account of arm's length price (ALP) adjustment made as per TPO order under section 92CA (3) of the Act.**

2. Briefly stated, material facts of the case, as culled out from material on record, are like this. The assessee before us is a subsidiary of a German company by the name of EDAG Engineering & Designs AG, engaged in the business as an engineering expert in the automotive industry and is said to be one of the global leaders in offering 'closed process chain' services i.e. complete services for integrated development- including design and product development, template and prototype construction and from testing division to turnkey manufacturing facilities. The assessee is a captive unit for its German parent company and is engaged in the business of providing computer aided services, for engineering and design of automobile components, on project basis. During the relevant financial year, the assessee reported international transactions in respect of (1) Design and development of automobile part and production equipment, with the aid of computer software (2) Technical consultancy received; (3) Sales commission; (4) Language translation charges; and (5) Purchase of capital goods. While arm's length price in respect of last item, i.e. purchase of capital goods, was ascertained on the basis, in respect of all other items, the assessee had used TNMM, with operating profit margin on sales as PLI, for benchmarking the arm's length price. While the TPO did not dispute the method employed by the assessee, the TPO did reject the adjustments carried out by the assessee on account of underutilizations of (i) employee cost, (ii) licenced cost, and (iii) depreciation. While rejecting these financial adjustments, the TPO observed that the assessee had mechanically carried out these adjustments without justifying the cause of adjustment, that the assessee has delivered services only its AE, and, as such, the assessee did not assume any kind of third party risk, and that since the assessee was a captive unit, any underutilization of capacity was to be compensated by the AE. The TPO did not dispute the comparables selected by the assessee and computed the operating profit margin ( i.e. OP/TC) of these comparables at 5.59% and computed the arm's length revenue at 105.59% of the cost incurred by the assessee, which came to Rs 6,91,13,540 as against book value of these revenues at Rs 4,22,37,633. The difference thus came to Rs 2,68,75,906. However, as the assessee had subsequently received a

financial support, by way of waiver of dues by the AE, amounting to Rs 1,02,88,176, the ALP adjustment was reduced by this amount. The ALP adjustment was thus computed at Rs 1,65,87,730. In the course of the assessment proceedings, the Assessing Officer made this ALP adjustment to the value of transaction entered into with the AE. Aggrieved, *inter alia*, by the ALP adjustment so made by the AO, assessee carried the matter in appeal before the CIT(A). Learned CIT(A) noted that as against 28,020 man hours available with the assessee, only 13,288 man hours were actually put to use. The unutilized manpower so computed, according to the CIT(A), was 52.58%. Learned CIT(A) further noted that **“the assessee is a 100% captive unit and has to keep minimum staff of technical engineers for smooth functioning of its operation”** and that **“the fixed costs like administration cost, salary, depreciation has to be incurred even though there is no revenue or less revenue”**. She further observed that, the assessee **“has submitted details to the TPO for capacity underutilization .... which was totally ignored by the TPO”**. On the basis of primarily this line of reasoning, he upheld the grievance of the assessee and concluded as follows:

**25. Considering the submissions filed by the appellant from time to time regarding the capacity underutilization and EDAG Germany's annual accounts which show huge losses, and various case laws cited by the appellant, I hold that an appropriate adjustment should be allowed to the assessee on capacity underutilization. The margin of the appellant company, after such adjustment, is 9.69% which is much higher as compared to the industry margin determined by the TPO at 5.59% considering the seven comparables taken by the TPO in his order.**

**26. Therefore, ground nos. 1 and 2 of the appellant are allowed.**

**27. In view of the above, the appeal is allowed.**

3. The Assessing Officer is aggrieved of the relief so granted by the CIT(A) and is in appeal before us.

4. We have heard the rival contentions, perused the material on record and duly considered factual matrix of the case in the light of the applicable legal position.

5. We find that learned CIT(A) has granted the impugned relief by making adjustments, on account of capacity underutilization, in the results shown by the tested party and thus computing hypothetical financial results which the tested party would have achieved in perfect conditions. Such an exercise, in our humble understanding of law, is impermissible. As is the undisputed legal position, such comparability adjustments can only be made in the comparables and not the tested party itself. It is specifically provided in Rule 10B (1)(e)(iii) that adjustments for variations, which could materially affect the amount of net profit margin in the open market in comparable uncontrolled transactions, are to be made in respect of net profits realized by the comparable transactions or enterprises. Learned CIT(A) was thus clearly in error in proceeding to make capacity underutilization adjustments in the profits earned by the assessee. That apart, in the case of a one hundred percent captive service unit, as is the assessee before us, the very concept of capacity underutilization may not really make any sense unless the assessee has not been able to offer, for reasons beyond its control, the underutilized capacity to its AE. There is no finding on this aspect of the matter. As the assessee does not have the liberty to work for any other customer, and is wholly dependent on its AE for productive use of its capacity to work, the AE should normally make good any losses to the captive unit caused by its not being able to make use of the available capacity. In the case before this, the AE has indeed given some financial support to the assessee which has been reduced from the ALP adjustment figure, and the business rationale of AE's extending financial support to the assessee is thus not in doubt. However, there is nothing on record to show how this financial support has been computed and is on what ground, and on what basis, this financial support is given. The reason for underutilized capacity and the facts regarding financial support extended to the assessee are not clear from the material on record. Learned CIT(A) has granted the impugned relief merely by making capacity

