

IN THE INCOME TAX APPELLATE TRIBUNAL  
(DELHI BENCH 'I-2', NEW DELHI)

BEFORE SHRI I. C. SUDHIR, JUDICIAL MEMBER  
AND SHRI INTURI RAMA RAO, ACCOUNTANT MEMBER

I.T.A. No.3547/Del/202010

Assessment year : 2003-04

HCL Technologies BPO Services Ltd., Vs. ACIT, CC-2,  
(Now stands amalgamated with New Delhi  
HCL Technologies Limited),  
806, Sidharth, 96, Nehru Place,  
New Delhi-110 019  
GIR / PAN:AAAOE1028C

I.T.A.No. 5071/Del/2010

(Assessment Year 2003-04)

ACIT, CC-2,  
New Delhi

Vs. HCL Technologies BPO Services Ltd.,  
806, Sidharth 96, Nehru Place,  
New Delhi-110 019

(Appellant)

(Respondent)

Assessee by : ShriAjay Vohra, Sr. Adv.  
Shri Neeraj Jain, Adv &  
Ms. Deepika Agarwal, CA  
Department by : ShriVijay Chaudhary, Sr. DR

Date of hearing : 11.06.2015

Date of pronouncement : 10.07.2015

**ORDER**

**PER INTURI RAMA RAO, AM:**

These are cross appeals filed by assessee company in I.T.A. No. 3547/Del/2010 as well as Revenue in I.T.A. No. 5071/Del/2010 for the Assessment Year 2003-04. These appeals involve the issue of Transfer Pricing Adjustment (TPA) for the Assessment Year 2003-04. The Revenue

had come up with the present appeal challenging the order of Ld. CIT(A) that the TPA should be restricted to gross revenue receipt by the associate enterprises from its customers.

2. We first take up the Revenue's appeal in I.T.A. No. 5071/Del/2010. The grounds of appeal raised by Revenue are noted below:

*"1. On the facts and in the circumstances of the case, the CIT (A) has erred in law and on facts in restricting the addition of Rs.1703,05,993/- to Rs. 1,19,60,457/-made by the Assessing officer on the basis of adjustment computed by the TPO u/s 92CA(3) of the Income tax Act, 1961.*

*2. On the facts and in the circumstances of the case, the CIT (A) has erred in law and on facts as he has failed to appreciated the fact that when the com parables were making average profit @ 13.56% then the assessee would have earned the same profit in international transactions?"*

3. The brief facts of the case are that the appellant is a private limited company and is engaged in providing IT Enabled Services (ITES) e.g. voice/web based contact and front office services (hereinafter referred as business process outsourcing (BPO) services). For the relevant previous year, the return of income of the appellant was filed declaring loss of Rs.12,85,57,867/-. The appellant had during the relevant previous year entered into the international transaction of provision of information technology enabled services, amounting to Rs.13,06,79,399/- with the various associated enterprises. For application of TNMM, the appellant was considered to be the tested party and operating profit/total cost was taken as the profit level indicator (PLI). The operating results of the appellant were computed as follows:

Operating income	209,032,558
Less: Operating expenses	
Personnel expenses	13,38,59,484

Administration selling & other expenses	15,13,90,147
Finance charges	7,68,060
Depreciation	4,42,53,507
Miscellaneous expense written off	37,71,203
Total Operating Cost	33,40,42,401
Operating profit	12,50,09,843
Operating profit ratio	(-)37.34%

4. The assessee had conducted transfer pricing analysis by using multiple year data of previous financial year in which data of the 3 years is on actual basis and for 2 years on project basis. The appellant also selected the TNMM to determine the arms length price for the transactions with AE on transactions and for the application of TNMM, the appellant selected ..... operating profit /on total cost was taken as profit level indicator (PLI).

5. For application of TNMM, the appellant identified the eight comparable companies engaged in rendering voice based I web based BPO/ITES. Further, the appellant considered the Profit Level Indicator ("PLI"), i.e., Operating Profit /Total Cost of the comparable companies for the financial years 2001-02 and 2002-03, as under:

S. No.	Name of the Company	Margins (OP/TC)		Weighted average
		2003	2002	
1.	Ace Software Exports	11.64%	17.63%	14.88%
2.	Allsec Technologies Ltd	12.55%	9.53%	11.65%
3.	Apex Logical Data	14.30%	22.26%	17.80%
4.	Compudyne 0.18% Winfosystems Ltd.	52.78%	20.05%	
5.	Fortune Infotech Limited	107.46%	68.03%	96.87%
6.	Nucleus Netsoft and GIS India Limited	(17.70) %	(10.37) %	(13.92)%
7.	Twinstar Software Exports Limited	(73.35) %	(25.81) %	(45.80)%
8.	Zigma Software Limited	0.78%.	17.05%	6.96%
	Mean	6.98%	1.8.89%	13.56%

6. The actual operating profits margin (OPITC) was (-) 37.35% in the financial year 2002-03, (-)2.94% in 2003-04 and (+)20.94% in 2004-05. Further, the projected operating profits margin (OPITC) was 19.14% in the financial year 2005-06 and 18.29% in 2006-07. The weighted average operating margin or these five financial years was computed as 14.09%. The weighted operating" profit on total cost margin of 14-.09% during the abovementioned financial ears, being higher than that of the comparable companies at 13.56%, the "international transactions" of rendering business process outsourcing services were considered being at arm's length.

7. On noting of above transactions, the A.O. made reference to transfer pricing officer. The Transfer Pricing Officer (TPO), however, in his order held that the arm's length operating profit to the total cost ratio in the above business being 13.56%, viz., average operating profit / cost margin of 8 companies was considered as comparable by the TPO. The TPO accordingly, in the order passed under section 92CA(3) of the Act, determined adjustment of Rs. 17,03,05,993 to the arm's length price of 'international transactions' of provision of business process outsourcing services applying TNMM, as under:

<u>Calculation of arm's length price</u>	<u>Amount</u>
Total operating cost	Rs. 33,40,42,401
Arm's length margin	13.56%
Profit which the appellant would have earned	Rs.33,40,42,401
	Rs. 4,52,96,150
Less: Operating loss posted by the appellant	Rs. (-)12,50,09,843
Difference	Rs.17,03,05,993

8. The TPO held in this regards as follows:

*"6.0 In the transfer pricing approach the assessee has used data for five financial years out of which data of three years is on actual basis and for two years on projected basis. Such kind of approach permitting use of financial data for multiple years' of the taxpayer for working operating profits is not provided in the Indian Transfer, Pricing regulations. The provisions of Rule 108(1)(e) of Income Tax rules contains method of application of Transactional Net Margin Method. It emphasizes use of data for the year in which transaction took place. It may further be mentioned that Rule 108(4) categorically restricts that the data for the comparables should be contemporaneous 'and drily in exceptional circumstances data for two prior years can be used along with data for the year under consideration. In fact all the provisions emphatically and with no ambiguity cast an obligation of benchmarking transaction on the basis of information as close as possible to the year in which the with the AE(s)' has been entered into international transaction. IT is understandable that since in. modern economics situations change so fast, use of non contemporaneous data can throw up slanted results.*

*6.1 In order to compare operating margins the assessee has used data of eight comparable companies using data' for the year ending March 2002 and March 2003 in each case. The data for multiple years has been used on the argument that it is permitted as per rule 108(4) of Income tax rules. In this case since the assessee company is in its start up phase therefore special conditions of even out results of more than one year of financial performance exist as enshrined in proviso to the above said rule deserving use of financial data for the multiple year. Therefore, the approach of the assessee in respect of use of multiple year data of comparables is not disturbed. It is also not out of place to mention that the comparables used by the assessee company has functional and product differences with the assessee company but for the year under consideration these comparables are not being disturbed for the reasons that the assessee company has apparently chosen best possible comparables which could functionally take care of start up phase of the assessee company. Some of these comparables are persistently loss making and are predominantly into hardware but since in the transfer pricing proceedings the assessee company has*

*been vehemently arguing that during the year assessee was deploying assets and manpower to build the facilities for IT Enabled Services, therefore, to pass the benefit of any such functional difference between the assessee and the comparables the approach of the assessee for the year under reference is not disturbed being the start up phase. The eight comparables adopted by the assessee for Transactional Net Margin Method are accepted for year under consideration only for the specific reasons mentioned above.”*

9. The A.O. based on the report of TPO made addition of Rs.17,03,05,993/- on account of transfer pricing adjustment. Aggrieved by the said order appeal was filed before Ld. CIT(A). However, Ld. cia accepted the plea of assessee company that Transfer Pricing Adjustment should be actually restricted to the amount actually retained by associated enterprises.

10. It was submitted that from the gross revenue received from the end customers in respect of various contracts, the associated enterprise retained in aggregate only a sum' of Rs.1,19,60,457 at their end the balance amount has been passed on to the appellant, as follows:

Associated Enterprises	Gross Billing to End-Customer	Amount Retained by AE Amount INR	%	Net amount remitted to HCL-BPO
HCL-AMERICA	71,073,269	7,107,327	10%	63,965,942
	15,507,867	-	0%	15,507,867
	431,660	28,650	7%	403,010
Sub Total	87,012,796	7,135,977		79,876,819
HCL T NI	23,280,234	2,328,023	10%	20,952,210
Infosystem America	5,412,892	541,289	10%	4,871,603
Infinet Acquisition Revenue	18,796,957	1,879,696	10%	16,917,261
HCLT Europe	7,547,211	75,472	1 %	7,471,739
Grand Total	142,050,089	11,960,457		130,089,632

11. Without prejudice to the assessee company's contention that the adjustment made by the TPO is not sustainable, it was submitted that the adjustment at best could be made only to the extent of Rs. 11,960,457, being the amount which has been retained by the associated enterprise.

12. The Ld. CIT(A) in his order restricted the Transfer Pricing adjustment to Rs. 1.19 crores holding as under:

*"The Transfer Pricing Officer has computed an adjustment of Rs. 17.04 crores while the value of international transactions is Rs. 13,00,89,632. The total revenue received by the associated enterprises in respect of BPO services rendered by the appellant amounting to Rs.13,00,89,632 is Rs.14,20,50,089. In other words, the associated enterprise has retained Rs. 1, 19,60,457 out of the total proceeds received from the customers. The adjustment computed by the TPO in the order passed under section 92CA(3) of the Act at best cannot exceed the net amount retained by the associated enterprises in respect 'of international transactions, i.e., gross revenue' received from the end customers less amount paid' to the appellant and, other operating expenses. It is observed that the gross revenue received from the end customers in respect of various contracts, the associated enterprise have retained only Rs. 1,19,60,457 at their end and the balance has been passed on to the appellant."*

*12.3 The issue has been considered in the recent decision of Delhi Bench of the Tribunal in the case of DCIT vs. Global Vantage P. Ltd., wherein, the Tribunal held that adjustment on account of arm's length price of international transactions cannot exceed the maximum arm's length price, i.e., the amount received by the associated enterprise from the customer and the actual value of international transactions, i.e., the amount received by the assessee in respect of international transactions.*

*12.4 In view of the same I am of the considered view that the adjustment to the income of the appellant has to be restricted to Rs. 1, 19,60,457- being the amount retained by the associated enterprises."*

13. Aggrieved with this order, the Revenue had come up in the present appeal. Ld. D.R. placed reliance on the order of Ld. CIT(A) and had prayed for quashing of CIT(A)'s order on this issue. On the other hand, Ld. Sr., Counsel submitted that the appellant could not have expected to receive from the customers of the AEs of the appellant, anything more than the amount paid by some customer to the AE, if the appellant were to be obtain the contracts for services from the customers directly, i.e., without the involvement of the AEs of the appellant. Thus, at the most the consideration received by the appellant from the AEs may be replaced by the consideration received by the AEs from its customers, for the services provided by the appellant; the price charged by AEs to the customers being the CUP. Reliance is placed in this regard on the decision of the Hon'ble Delhi High Court in the case of Sony India P. Ltd. vs. CBDT (Delhi) ; 288 ITR 52 has at pages 61-62, observed as under:

*"The concept of transfer pricing leading to tax avoidance has been acknowledged in the Act only recently. It is a concomitant of the operations of multinational corporations (MNCs) that set up base by incorporating a local subsidiary in a country where they seek to operate. It is often seen that the MNC transfers goods and services to its local subsidiary at a price not reflective of the market price (or arm's length price as if is referred to in the present context) and in turn the subsidiary is able to avoid, partly or wholly, payment of the local tax, Alth9ugh the expression "transfer price" has not been defined in the Act,' it is 'understood to mean "that price which is arrived at when two associated or related' enterprises deal with each other".*

14. Reference was made to the Finance Minister's Budget Speech for the year 2001 that the presence of multinational enterprises in India and their ability to allocate profits in different jurisdictions by controlling prices in intra-group transactions has made the issue of transfer pricing a matter of

serious concern. The purpose of inserting these provisions is therefore to determine the arm's length price (ALP) of an international transaction involving an MNC and its local associate."

15. Reliance is placed on the decision of Delhi Bench of the Tribunal in the case of DCIT vs Global Vantage P. Ltd., (ITA No. 1432 & 2321/0eII2009 and 116/0eI/2011), wherein, the Hon'ble Tribunal held that adjustment on account of arm's length price of international transactions cannot exceed the amount received by the associated enterprise from the customer and the actual value of international transactions, i.e., the amount received by the assessee in respect of international transactions. The Hon'ble Jurisdictional High Court vide order dated 14-03-2013 (in ITA Nos. 1828/2010, 1829/2010 & 1254/2011) had dismissed the Revenue's appeal against the said order of the Tribunal. The Special Leave Petition (SLP) of the Revenue against the said order has also been dismissed by the Supreme Court vide order dated 02-01-2014 (CC No. 22166 of 2013).

16. Further reliance in this regard is placed on the following observation of the Hon'ble Delhi bench of the Tribunal in the case of Li & Fung (India) Pvt. Ltd. vs. DC IT (ITA No 5156/DeI/2010):

17. The Hon'ble Delhi High Court recently vide order dated 16-12-2013 (in ITA No.306/2012), while adjudicating on the said decision of the Tribunal, held in paragraph 40 of the order that "the approach of the TPO and the tax authorities in essence imputes notional adjustment / income in the assessee's hands on the basis of a fixed percentage of the free on board value of export made by unrelated party vendors. " .....

18. Reliance in this regard is also placed on the recent decision of Delhi Bench of the Tribunal in the case of Hyper Quality India Pvt. Ltd. vs. ACIT (ITA No. 5630/0ell2011 ), wherein, it has been held as under:

*"7. Ld. TPO erred in evaluating FAR (Functions performed, Assets. employed and Risk assumed) analysis which has been summarily confirmed by DRP. To support its case, assessee furnished split financials of the appellant and its AE. Whereas the appellant has been .able to earn profit in India its counterpart the AE has continuously sustained losses. There being no element of profit in the hands of the AE, there is no case of shifting of profits, practicable or probable. Invoking a higher ALP on the appellant is only anticipatory and complete ignorance of fact. The facts and figures produced before the Ld. TPO establish that there is no commercial profit available in the hands of the AE. In absence of profit availability, the any enhancement of the ALP results in artificial profit anticipated by the Ld. TPO and not earned by the Appellant. The order of the LD, TPO in enhancing the ALP offered by the appellant is in ignorance of valid FAR and factual considerations and is bad in law and facts."*

19. Reliance in this regard is placed on the recent decision of Delhi High Court in case of Sony Ericsson Mobile Communications India Pvt. Ltd. vs. CIT III (ITA No. 16/2014) where in it has been held that the arm's length seeks to correct distortion and shifting of profits of tax the actual income earned by a resident. The Hon'ble Delhi High Court held as under:

*'77. As a concept and principle Chapter X does not artificially broaden, expand or deviate from the concept of "real income". "Real income", as held by the Supreme Court in Poona Electricity Supply Company Limited versus CIT, [1965J 57 ITR 521 (SC), means profits arrived at on commercial principles, subject to the provisions of the Act. Profits and gains should be true and correct profits and gains, neither under nor over stated. Arm's length price seeks to correct distortion and shifting of profits to tax the actual income earned by a resident/domestic AE. The profit which would have accrued had arm's length conditions prevailed is brought to tax. Misreporting, if any, on*

*account of non-arm's length conditions resulting in lower profits, is corrected.*

*XXX*

*(xii) When segmentation or segregation of a bundled transaction is required, the question of set off and apportionment must be examined realistically and with a pragmatic approach. Transfer pricing is an income allocating exercise to prevent artificial shifting of net incomes of controlled taxpayers and to place them on parity with uncontrolled, unrelated taxpayers. The exercise undertaken should not result in over or double taxation. Thus, the Assessing Officer/TPO can segregate AMP expenses as an independent international transaction, but only after elucidating grounds and reasons for not accepting the bunching adopted by the assessed, and examining and giving benefit of set off. Section 92(3) does not bar or prohibit set off."*

20. In view of the aforesaid, it is respectfully submitted that the adjustment shall be restricted to Rs. 1.19 crores.

21. We have head rival submissions and perused the material on record. Ld. CIT(A) had followed the ratio laid down in the case of Global Ventedge P. Ltd. (supra) (in I.T.A. No. 1432 & 2321 / Del/2009 and 116/Del/2011). This decision was affirmed by both Hon'ble High Court and Hon'ble Supreme Court and his ratio was followed in subsequent decisions as submitted earlier and, therefore, the order of Ld. CIT(A) on this issue is reasonable and we do not find any reason to interfere with this finding of Ld. CIT(A) and hence, the grounds of appeal filed by revenue are dismissed. Accordingly, appeal filed by revenue is dismissed.

**I.T.A.No. 3547/Del/2010:**

22. Now, we deal with the appeal filed by assessee in I.T.A. No. 3547/Del/2010. The assessee has raised following grounds of appeal:

*"1. That the learned Commissioner of Income-tax (Appeals) erred both on facts and also in law in confirming the addition to the tune of Rs.1,19,60,457/- which the learned Transfer Pricing Officer ("TPO") has made in the case of the appellant for the impugned assessment year.*

2. *That the learned Commissioner of Income-tax (Appeals) erred both on facts and in law in failing to appreciate the fact that the approach which the appellant had adopted by taking a weighted average of its operating margins over a period of 5 years (including the impugned financial year) of business cycle and then comparing the same with the arithmetic mean of the companies selected as comparable companies for applying the TNMM as the most appropriate method is in conformity with the well established OECD guidelines in case of Start-up Companies.*

3. *That the learned Commissioner of Income-tax (Appeals) erred in failing to appreciate that since the appellant was a start up enterprise and the impugned financial year was effectively the first year of commencement of operations by the appellant, there was no justification for drawing an adverse inference by the learned TPO regarding the net margin of the appellant merely by comparing the appellant with the other companies which were well established companies.*

4. *That the learned Commissioner of Income-tax (Appeals) erred in ignoring the fact that since the profits of the appellant were deductible under Section 10A of the Income Tax Act, 1961, there was no motive on the part of the appellant to divert its profits outside India.*

5. *That, without prejudice, the learned Commissioner of Income-tax (Appeals) erred in concluding that the TPA has correctly not allowed the variation to the extent of (+1-) 5%, while determining the arm's length price of the international transactions, in the case of the appellant."*

23. The main grounds raised by the assessee in its appeal relate to the adjustment of operating profit as well as selection of comparables. During the course of appellate proceedings, Ld. Counsel for the Assessee had not pressed other grounds relating to adjustment of operating profit. The factual matrix relating to the grounds of appeal is noted below:

24. Computation of Operating Profit Margin of the appellant:

The appellant, it is submitted, is engaged in the business of software development and has set up a Business Process Outsourcing (BPO) unit for rendering IT enabled services during the previous year relevant to assessment year 2003-04. The relevant previous year, i.e. previous year 2002-03 was, thus, the first full year of operation of the BPO unit of the appellant. It is submitted that during the previous year 2002-03, the appellant was a start up enterprise, due adjustment ought to be made of the start-up/ one-time costs incurred, which inevitably lead to losses. It is submitted that operating profit/ loss of the appellant for the relevant previous year are required to be adjusted to exclude items of abnormal cost / short fall in revenue (owing to lower rate paid to the appellant as start up) to determine the normal profit that could have been earned by the appellant for the purpose of benchmarking with other companies which are not in start-up stage.

25. In case adjustment of the extra-ordinary expenses and considering the average expenses that would have been incurred in the normal operations, the operating profit margin of the appellant works out to 15% as follows:

Particulars-	Total	Optimum	Excess / Deficit -
Direct / Indirect	18,26,67,573		
Infinet Acquisition	1,69,17,261		
WIP	94,47,723		
Total Sales	20,90,32,557	22,77,90,205	(1,87,57,647)
Salary	13,38,59,483	10,45,16,279	2,93,43,204
	64%	50%	14%
Dep	4,42,53,507	2,29,93,581	2,12,59,926
	21%	11%	10%
OAG	15,13,90,147	8,49,41,671	6,64,48,476
	72%	41%	32%
Finance Charges	7,68,060	7,68,060	-
	0%	0%	0%

Misc. Exp. W /0	37,71,203	37,71,203	-
	2%	2%	0%
Total Cost	33,40,42,402	21,69,90,796	11,70,5t,606
	160%	104%	56%
Operating Profit/(Loss)	(12,50,09,844)	1,07,99,409	(13,58,09;254)
	-60%	5%	

26. It is respectfully submitted that the TPO for application of TNMM considered the operating profit margin of the appellant at a loss of Rs.(-) 12,50,09,843 without excluding from the operating results the aforesaid extra ordinary expenses/loss.

27. It is respectfully submitted that for the purpose of benchmarking the international transactions, it is imperative that the effect of such underutilization of capacity/excess fixed costs is eliminated, while computing the operating margins of the appellant.

28. Rule 10B(3) of the Rules provides that an appropriate adjustment is required to be made to account for the differences between the controlled and uncontrolled transactions:

*"An uncontrolled transaction shall be comparable to an international transaction if--*

*(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or*

*(ii) Reasonably accurate adjustments can be made to eliminate the material effects of such differences."*

29. Reliance in this regard is also placed on the recent decision of Chennai Bench of the Tribunal in the case of Mando India Steering Systems Pvt. Ltd. vs. ACIT (ITA No. 2092/Mds/2012), wherein, the Hon'ble Bench has remitted the issue back to the file of the assessing officer with a direction

to consider the claim of the assessee with respect to idle capacity adjustment during the relevant period while determining the ALP cost. The relevant extract of the decision reads as under:

*"We are of the considered view that under-utilization of production capacity in the initial years is a vital factor which has been ignored by the authorities below while determining the ALP cost. The TPO should have made allowance for the higher overhead expenditure during the initial period of production. In view of the above, we deem it appropriate to remit this issue back to the Assessing Officer with a direction to consider the claim of the assessee with respect to idle capacity adjustment during the relevant period while determining the ALP cost. The assessee is also directed to produce relevant documents in comparable units for the necessary analysis. The appeal of the assessee is allowed for statistical purposes in the aforesaid terms."*

30. Reliance in this regard is placed on the decision of Pune Bench of the Tribunal in the case of Amdocs Business Services Pvt. Ltd. vs. DCIT (ITA No. 14212/PN/11), wherein, the Tribunal allowed economic adjustment on account of under capacity utilization holding that the appellant was in start up phase during the assessment year consideration. The relevant extract of the decision is reproduced as under:

*"9. The next major point made out by the appellant is that this being the first full year of operation, the assessee had incurred certain expenditure which are start-up costs and cannot be fully recovered in the instant year itself, and such an expenditure has abnormally affected the profit margin. It is also canvassed that due to the start-up year the capacity utilization was not satisfactory, whereas its profitability has been bench marked against comparables which are established entities -and have been set up over the years. The plea set-up by the assessee for economic adjustments on account of under capacity utilization and being in start up phase, is not something which is unreasonable and neither it is otiose to the mechanism of transfer pricing assessments. In fact, in principle, the plea of the assessee is in line with the decisions of the Tribunal in the, case of Global venttedge P. Ltd v. DCIT in ITA Nos. 1763-2764IDel/09 (Del);*

*Brintons Carpets' Asia (P) Ltd v. DCIT 139 TT J -177; and, Skoda, Auto India P. Ltd. v. A CIT 122 TT J 699. In our view, the matter requiring factual appreciation, the same is remanded back to the file of the Assessing Officer, who shall consider the propositions put forth by the assessee and allow appropriate economic adjustments on a reasonable basis."*

31. On the same lines, Delhi Bench of the Tribunal in the case of Global Turbine Services Inc. vs. ADIT (ITA No. 3484/0e1/2011) allowed economic adjustment on-account of under capacity utilization considering the fact that the year under consideration was the first full year of operation of the appellant. Relevant extract of the decision reads as under:

*"10. -We have heard the rival contentions and perused the material available on record. The suitable adjustment for non-utilisation of capacity is to be taken in to account after considering the ALP while working out TP adjustment, this proposition has been held by co-ordinate Bench in the case of the Amdocs Business Services (P.) Ltd. (supra) and various other cases as cited here in above .*

*11. In the given facts and circumstances it was required on the part of the lower authorities to have given due effect to under capacity utilization of the assessee which has not been done TPO for adjustment for ALP determination. In view of the facts and circumstances we are inclined to set aside the matter and restore the issue of under capacity utilization back to the file of the Assessing Officer ITPO to decide the same afresh after giving assessee adequate opportunity of being heard and to file the necessary evidence on this behalf. Needless to say that a proper and speaking order will be passed deciding the issue in accordance with law."*

32. Reliance in this regard is placed on the following observation of the Hon'ble Mumbai Bench of the Tribunal in the case of ACIT vs. Fiat India Pvt. Ltd (ITA no 1848/Mum/2009):

*"As rightly held by the Id. CIT(A), the said submission made by the appellant is sufficient to demonstrate that there was a material difference in the facts of the appellant's case and that of the*

*comparable cases in terms of capacity utilization as well as in other terms. Appropriate adjustments thus were required to be made to eliminate such differences"*

33. Further, the Hon'ble Pune Bench of the of Tribunal in the case of Brintons Carpers Asia Pvt. Ltd. vs. ACIT ITA. No. 1296/PN/10) while allowing adjustment for idle capacity caused due to labour unrest/strike and relying upon the above observation of the Mumbai Tribunal held as follows:

*"15. From the above, it is clear the AO has authority vide clause (iii) above to make the adjustments. Such adjustments are necessary only to remove or minimize the differences in the comparable or anomaly in' the said comparable.*

*-Such adjustments are authenticated by the OECD guidelines too. In this regard, we have perused the important findings of the Tribunal in the case of the Fiat India P Ltd (supra) placed at page 191 of the paper book. For the sake completeness, the same is reproduced as under.*

*.....as regards the adjustments made by the appellant to work out its operating margin for comparing the same with the profit margin of comparable cases, it was held that there was a material difference in the facts of the appellant's case and that of the comparable cases in terms of capacity utilization as well as in other terms. Appropriate adjustments thus were required to be made to eliminate such differences. Further, the TPO himself has allowed similar adjustments made by the appellant in the immediate preceding years i.e. AY 2002-03, 2003-04 as well as in the immediate succeeding years i.e. 2005-06 and 2006-07 wherein the facts involved were similar to that of the year under consideration i.e. AY 2004-05;*

*+ accordingly, no infirmity is found in the impugned order of the CIT(A) as the adjustments made by the appellant in TNMM analysis were reasonable and accurate and as reflected in the said analysis, international transactions made by the appellant company with its associated concerns during the year under consideration were at arm's length requiring no adjustment/addition on this issue."*

*16. From the above, it is evident that the appellant is entitled to economic adjustments in the circumstances of under capacity utilization of the company. Of course, such adjustments must be*

*restricted to fixed cost/overheads only. In the 14 instant case, the AO/TPO did not have the occasion to go into the period or the extent of the labour unrest, break-up of the claimed adjustments amounting Rs.7.32 crores '(rounded off), fixed cost versus the variable cost etc as they' summarily rejected the external comparables in view of their preference to the operating profits of the domestic segment of the carpets. .Therefore and consequently, this key issue also has to be set aside to the files of the' TPO/AO for fresh examination of the issue."*

*Prima facie we see the need for such economic adjustments to the total cost of the carpet of the export segment. We refuse to comment on the facts relating to the figures as none of the authorities has gone into the details of such economic adjustments and they summarily rejected the claims. As such, the requisite adjustments are borne out of the relevant rules/provisions and therefore, the claim is bona fide and has support of the law. For this,' the appellant prefers to go to the files of the AO for want of a speaking order on this issue. In our opinion, the request of the appellant deserves to' be considered favourable."*

34. Also, in the case of E.I. Dupont India Pvt. Ltd. vs. DCIT (ITA No 5336/0/2010), the Hon'ble Delhi Bench of the Tribunal, while allowing the adjustment for capacity utilization held that ;

*"It is a matter of fact that fixed costs remain the same even when there is under utilization of capacity. Therefore, the case of the appellant and the comparable cases have to be examined in respect of capacity utilization so as to make the controlled and uncontrolled transactions comparable."*

*Also, the Hon'ble Delhi Bench of the Tribunal in the case of ITO vs. CRM*

*Services India Pvt. Ltd upheld the claim of the appellant towards adjustment of idle capacity:*

*"8.1 This bring us to the alternative argument that the appellant is entitled to get adjustment in respect of capacity under-utilization. No objection has been raised by the Id. GIT, DR in this matter. As a matter of fact, he has fairly accepted the proposition that adjustment in this regard is-required to be made.*

*At the same time, it is also held that suitable adjustment has to be made to such PLI in respect of idle capacity."*

35. Further, the Hon'ble Bangalore bench of the Tribunal in the case of Genisys Integrating Systems (India) Pvt. Ltd vs. DCIT (ITA No 1231/Bang/2010) the Hon'ble Tribunal held as under:

*"The appellant should also be given adjustment for under utilization of its infrastructure. The AO shall consider this fact also while determining the ALP find make the TP, adjustments. With these directions, the appeal of the appellant is disposed of. "*

36. Further, the Hon'ble Delhi' Bench of the Tribunal in the case of Transwitch India Pvt. Ltd VS. ACIT (I.T.A. No. 6083/De1/2010) held as under:

*"4.11 Another' TPO's contention is that claim of the appellant that the sealing drive reduced its revenue is unsubstantiated. In this regard, appellant has submitted that the appellant had placed on record its quarterly 'capacity' utilization statement demonstrating the fall in its capacity utilization during the quarter January to March, 2006. The capacity utilization, of the appellant during the quarter January to March, 2006 fell to 82% as against the normal capacity utilization of 87% to 94% during the financial year ending December, 31, 2005. Further, the fact that the appellant had to shift its office premises at a very short notice, sufficiently substantiates the low capacity utilization of the appellant during the last quarter of financial year 2005-06. We find out ourselves in agreement with the appellant's submission in this regard."*

37. Hon'ble Delhi High Court, in the appeal preferred by the revenue in the case of Transwitch India (supra), vide order dated 17.07.2013, upheld the adjustment claimed by the assessee on account of capacity utilization. Reliance in this regard is also placed on the recent decision Delhi Bench of the Tribunal in the case of DCIT vs. Panasonic AVC Networks India Co. Ltd. (ITA No. 4620/DeI/2011), wherein the Hon'ble Bench has held that

capacity underutilization is an important factor affecting net profit margin as lower capacity utilization results in higher per unit costs which in turn results in lower profits. The relevant finding of the decision reads as under:

*"5. Having heard the rival contentions and having perused the material on record, we see no reasons to interfere in very well reasoned findings and directions of the learned CIT (A). Rule 10B (1)(e)(ii) of the Income Tax Rules 1962 does indeed provide that the net profit margin realized in a comparable uncontrolled transaction is adjusted, inter alia, for differences in enterprise entering into such transactions, which could materially affect the net profit margin in open market. Capacity underutilization by enterprises is certainly an important factor affecting net profit margin in the open market because lower capacity utilization results in higher per unit costs, which, in turn, results in lower profits. Of course, the fundamental issue, so far as acceptability of such adjustments is concerted, is reasonable accuracy embedded in the mechanism for such adjustments, 'end as long as such an adjustment mechanism can be found, no objection can be taken to the adjustment. In our considered view, the learned CIT(A)'s approach is reasonable in this regard and the adjustments are on a conceptually sound basis. In any case, as pointed out by the learned counsel, the adjustments so directed by the learned CIT(A) have duly been made by the Assessing Officer, and there have been no issues regarding implementing these adjustments. We approve the conclusions arrived by the CIT(A) on this issue and decline to interfere in the matter."*

38. In view of the aforesaid, it is respectfully submitted that appropriate adjustment for idle capacity is required to be made while computing the operating margin of the appellant.

39. We have heard rival submissions and perused the material placed on record. We find that there is force in the argument of Ld. Counsel for the assessee that while calculating operating cost, the abnormal cost incurred on account of start-up should be excluded. Following the same parity of reasoning in the cases cited by him and keeping in view that the judgement

of ITAT co-ordinate Bench in the case of Transwitch India (supra) affirmed by Hon'ble Delhi High Court. Therefore, respectfully following the decision of Hon'ble High Court, we direct TPO / A.O. to adjust operating cost by excluding abnormal cost incurred on account of start-up company like salary, rent and depreciation. This matter is restored to the file of TPO/A.O. to re-determine the operating cost on the above lines to arrive at operating profit.

40. The other grounds of appeal filed are not pressed and, therefore, dismissed as such.

41. The appeal is partly allowed for statistical purposes.

42. Order pronounced in the open court on 10<sup>th</sup> July, 2015.

Sd./-

Sd./-

( I. C. SUDHIR)  
JUDICIAL MEMBER

Date:10<sup>th</sup> July, 2015

Sp

Copy forwarded to:-

The appellant

The respondent

The CIT

The CIT (A)-, New Delhi.

The DR, ITAT, Loknayak Bhawan, Khan Market, New Delhi.

True copy.

(INTURI RAMA RAO)  
ACCOUNTANT MEMBER

By Order

(ITAT, New Delhi).

S.No.	Details	Date	Initials	Designation
1	Draft dictated on	26/6		Sr. PS/PS
2	Draft placed before author	29/6,1,3,6,7,8,9,9,		Sr. PS/PS
3	Draft proposed & placed before the Second Member			JM/AM
4	Draft discussed/approved by Second Member			AM/AM
5	Approved Draft comes to the Sr. PS/PS	10/07		Sr. PS/PS
6	Kept for pronouncement	10/07		Sr. PS/PS
7	File sent to Bench Clerk	10/07/15		Sr. PS/PS
8	Date on which the file goes to Head Clerk			
9	Date on which file goes to A.R.			
10	Date of Dispatch of order			