IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCHES : I : NEW DELHI

BEFORE SHRI R.S. SYAL, AM AND SHRI GEORGE GEORGE K., JM

ITA No.242/Del/2010
Assessment Year : 2002-03

CO No.77/Del/2010
(ITA No.178/Del/2010)
Assessment Year : 2002-03

Nokia India (P) Ltd., 1st & 2nd Floor, Tower-A, SP Infocity, Plot No.243, Udyog Vihar, Phase-I, Dudahera, Gurgaon. PAN : AAACN2170R	Vs.	DCIT, Circle-13(1), CR Building, New Delhi.

ITA No.178/Del/2010
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DCIT, Circle-13(1), CR Building, New Delhi.	Vs.	Nokia India (P) Ltd., 1st & 2nd Floor, Tower-A, SP Infocity, Plot No.243, Udyog Vihar, Phase-I, Dudahera, Gurgaon. PAN : AAACN2170R
(Appellant)		(Respondent)

Assessee By	:	S/Shri Atul Ninawat, AR, Vikas Srivastava, Atul Mittal & Ms Varsha Bhattacharya, Advocate
Department By	:	Shri Peeyush Jain, CIT, DR

ORDER

PER R.S. SYAL, AM:

These two cross appeals – one by the assessee and the other by the Revenue along with a cross objection filed by the assessee arise out of the order passed by the CIT(A) on 16.11.09 in relation to the assessment year 2002-03.

2. Ground Nos. 2 and 3 of the assessee's appeal and Ground Nos. 3, 4, 5 and 6 of the Revenue's appeal are against the partial sustenance/reduction in the addition on account of transfer pricing adjustment under the Nokia Mobile Phone Sales Division (NMP Sales) [hereinafter also called the 'Trading segment'].

3. Briefly stated, the facts of the case are that the assessee is a wholly owned subsidiary of Nokia Corporation, Finland. Nokia Group is engaged in providing network solutions for phone operators and internet service providers; manufacturing and distributing mobile phones; providing strategic inputs for business developments; and providing R&D support to the group entities for maintaining its technological leadership and competitiveness. The assessee has four distinct business segments. The major segment is Nokia Mobile Phones Sales Division or the Trading segment.

Under this segment, the assessee acts as a distributor of mobile phones imported from Nokia affiliates throughout India, mainly through HCL Infosystems (third party distributor). To be more specific, the assessee acts as a trader of Nokia phones which are sold mainly to single customer, HCL Infosystems, after importing from its Associated enterprises (AEs). HCL Infosystems further distributes the phones through its own network of dealers. The assessee declared sales of ₹59 crore and operating loss of ₹13.9 crore under this segment. In benchmarking this international transaction, the assessee selected Resale Price Method (RPM) as the most appropriate method. Gross profit margin under this segment at 11% was stated to be more than the arithmetic mean of such margin, on a multiple year data basis, of 9% in respect of 23 comparable companies chosen by the assessee. The assessee's list of 23 comparables with the business description and the ratio of GP/sales has been tabulated on pages 3 and 4 of the Transfer Pricing Officer's (TPO) order. That is how, it was claimed that the international transactions under this segment were at arm's length price (ALP). The TPO observed that the companies chosen by the assessee were engaged in altogether different nature of business. Some were distributing food products, while others were trading in electronic goods or textiles etc. On being called upon to explain as to why RPM adopted by the assessee be not rejected on account of high degree of functional and economic divergence among the comparables and the assessee, it was stated that all the comparables performed the basic function of trading and distribution. Unconvinced with the assessee's submissions, the TPO held that such a method was not capable of application because apart from dissimilarity of the products dealt with by the assessee *vis-a-vis* the so-called comparables, even the data of the comparables chosen by the assessee was not appropriately available. He, therefore, rejected the application of RPM and proceeded to determine the ALP under the Transactional Net Margin Method (TNMM). He adopted profit level indicator (PLI) of the international transactions under this segment at Operating profit margin/Sales. By applying certain filters, the TPO shortlisted six comparables as listed on page 11 of his order, giving arithmetic mean of 3.5%. Considering the fact that the assessee spent 23% of its sales on marketing, whereas this expenditure was much less in the comparables so chosen by him, the TPO suitably amended the rate of operating profit. However, vide para 11.2 of his order, the TPO noticed that accounts of one of the close competitors of the assessee (whose name was not disclosed for reasons of confidentiality) gave OP/Sales at 2.64%, whereas this ratio in the case of the assessee was at (-) 23%. After considering certain factors and allowing the effect of higher marketing expenses, the adjusted profit margin of the assessee was worked out at (-) 8.99%. That is how, the transfer pricing adjustment amounting to ₹7,37,39,213/- in this segment was made at 12.49% [3.5%- (-) 8.99%].

4. In the first appeal, the ld. CIT(A) came to hold that RPM was not capable of application as it was difficult to compute gross margin by analyzing costs and then establish the functional comparability of the comparables chosen by the assessee. He upheld the TPO's action in employing TNMM as the most appropriate method. He further noticed that both the assessee as well as the TPO were not justified in not using the current year data. Relying on certain decisions, it was held that only the current year's data was required to be employed. Then, he proceeded to examine the comparable companies as offered by the assessee and also those chosen by the TPO. Out of 23 comparables chosen by the assessee, the ld. CIT(A) shortlisted four companies as functionally comparable under the TNMM. From the companies chosen by the TPO as comparable, the ld. CIT(A) accepted four companies as comparable, one of which is common

to both the assessee as well as the TPO. That is how the ld. CIT(A) initially shortlisted the following seven companies:-

(i) Compuage Infocom Ltd.

(ii) Media Video Ltd.

(iii) Business Link Automation

(iv) Procal Electronics India Ltd.

(v) Redington (India) Ltd.

(vi) Amzel Automotive Ltd.

(vii) Gold Rock Investments Ltd.

Out of these seven companies, the ld. CIT(A) excluded Procal Electronics India Ltd. which had a high negative margin of (-) 39.58% during the financial year relevant to the assessment year under consideration, primarily due to excess depreciation cost along with significant drop in the sales as compared to the previous year. He further excluded Redington (India) Ltd. on the premise that it had very high turnover in comparison with the assessee. That is how, the ld. CIT(A) was finally chose five companies as comparable with their respective OP/Sales margin as hereunder:-

(i)	Compuage Infocom Ltd.	2.25%
(ii)	Media Video Ltd.	6.77%
(iii)	Amzel Automotive Ltd.	3.88%
(iv)	Business Link Automation (India) Ltd.	2.81%
(v)	Gold rock Investments Ltd.	0.35%
	Average	3.21%

He held that only the current year's data should have been considered. He further held that the TPO was not justified in benchmarking the assessee's international transactions under this segment with a competitor whose name was not disclosed. In his opinion, a detailed review of Annual report and Director's report, etc., must be made available to the assessee before considering any case as comparable. He, therefore, excluded the secretly selected case chosen by the TPO. Then, he went on to consider advertisement and marketing expenses incurred by the assessee as well as the final five comparables. After allowing a suitable adjustment on this score, the TPO reduced the addition on account of transfer pricing adjustment to ₹ 3,41,62,617/-. Both the sides are in appeal against their respective stands.

5. We have heard the rival submissions and perused the relevant material on record. The first major controversy raised by

the assessee is on the selection of the most appropriate method for determining ALP of the international transactions under this segment. Whereas, the stand of the assessee is that RPM was correctly employed by it for benchmarking its international transactions under this segment, the stand of the Revenue is that TNMM has been rightly held to be the most appropriate method for the purposes of determination of the ALP.

6. Section 92C(1) of the Income-tax Act, 1961 (hereinafter also called 'the Act') provides that "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 transactions or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe." Five specific methods have been given, which include, RPM and TNMM. The sixth method is general as may be prescribed by the Board. There is no quarrel on the point that the sixth method, now prescribed under rule 10AB, is not applicable to the assessment year under consideration as the same is operative from the A.Y. 2012-13. Sub-section (2) of section 92C provides that the most appropriate method referred to in sub-section (1) shall be applied

for determination of ALP in the manner as may be prescribed. Rule 10B sets out the procedure under the above referred five methods. Sub-rule (1) of Rule 10B reiterates that the ALP in relation to an international transaction shall be determined by any of the prescribed methods being the most appropriate method. When we read section 92C in juxtaposition to Rule 10B, two things become vivid. First is that the ALP of an international transaction is required to be determined by a most appropriate method which has to be either of the five given in section 92C(1) at the material time. Second is that such computation can be done only in the manner as is prescribed under the rule. The instant controversy narrows down to examining and deciding as to whether RPM or TNMM is the most appropriate method in the present circumstances.

7. Before ascertaining the most appropriate method as may be applicable in the factual scenario obtaining instantly, it is crucial to have a look at the functions performed and the nature of activity undertaken by the assessee under this segment. At the cost of repetition, we are mentioning that the assessee purchased mobile phones and accessories from Nokia group companies situated outside India and sold the same to local independent customers,

mainly, HCL Infosystems. The TPO has also admitted this fact that the international transactions under this segment involve import of mobile phones and accessories from foreign AEs which are resold in India to HCL Infosystems, which is an unrelated party. Thus, it is palpable that the nature of work done by the assessee under this segment is that of pure a trader inasmuch as the mobile phones and accessories imported from foreign AEs have been resold as such to the local customers without doing any value addition or any other sort of processing whatsoever.

8. We take up the first issue that the ALP of an international transaction should be determined by a most appropriate method which has to be either of the five given in section 92C(1) at the material time. It will be apposite to first set out the *modus operandi* of the RPM, being the method chosen by the assessee as the most appropriate method, given under Rule 10B(1)(b) for determination of ALP as under:-

> (b) resale price method, by which,—
>
> (i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified ;

(ii) such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions ;

(iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services ;

(iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, 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 gross profit margin in the open market ;

(v) the adjusted price arrived at under sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise ;

9. Sub-clause (i) of clause (b) of Rule 10B(1) deals with identifying the price at which the goods purchased from an AE is resold. Sub-clause (ii) of clause (b) of Rule 10B(1) talks of reducing the amount of normal gross profit margin of comparable uncontrolled transactions from such resale price of the assessee. Sub-clause (iii) states that the result of sub-clause (ii) is further reduced by the expenses incurred in connection with the purchase of goods and sub-clause (iv) provides that the amount so deduced under sub-clause (iii) is adjusted on account of differences in the international transaction and comparable uncontrolled transactions which materially affect the amount of gross profit margin in the open market. Finally, sub-clause (v) provides that the adjusted price found under sub-clause (iv) is taken as arm's length price in respect of purchase of goods from the AE. When we consider the methodology given under RPM, more specifically sub-clauses (i) and (v), it becomes patent that sub-clause (i) refers to '*property purchased by the enterprise … is resold* ' and sub-clause (v) refers to *'arm's length price in respect of the purchase of the property … by the enterprise* '. A close scrutiny of the above two sub-clauses along with the remaining sub-clauses of rule 10B(1)(b) makes it clear beyond doubt that RPM is best suited for determining ALP of an international transaction in the nature of purchase of goods

from an AE which are resold as such to unrelated parties. Ordinarily, this method pre-supposes no or insignificant value addition to the goods purchased from foreign AE. In a case the goods so purchased are used either as raw material for manufacturing finished products or are further subjected to processing before resale, then RPM cannot be characterized as a proper method for benchmarking the international transaction of purchase of goods by the Indian enterprise from the foreign AE.

10. Adverting to the facts of the instant case, we find that the assessee simply purchased mobile phones and accessories from Nokia group companies situated outside India and resold the same as such without any further value addition, mainly, to HCL Infosystems in India. Since the goods imported from the foreign AEs representing the international transaction under this segment were neither processed further nor used as raw material for manufacturing any other product, in our considered opinion, RPM is the first choice as the most appropriate method for determination of ALP of the international transaction under this segment.

11. The ld. DR vehemently argued against the application of RPM in the given circumstances as the most appropriate method by contending that the assessee incurred huge advertisement and

marketing expenses. In view of such incurring of expenses, the ld. DR stated that the better course would be to apply TNMM which would consider operating profit. We are unable to accept the contention advanced on behalf of the Revenue. The obvious reason for this is that the incurring of high advertisement and marketing expenses by the assessee *vis-a-vis* the other comparable companies does not in any manner affect the determination of ALP under the RPM. When we consider gross profit in numerator and net sales in denominator, all the expenses debited to the Profit & loss account automatically stand excluded. It is but natural that only those expenses can have bearing on the gross profit that are debited to the Trading account. As the amount of advertisement and marketing expenses falls 'below the line' and finds its place in the Profit and loss account, the higher or lower spend on it cannot affect the amount of gross profit and the resultant ALP under the RPM. If the assessee has incurred more expenses on advertisement and promotion, which, in the opinion of the ld. DR went on to brand building for an AE, then, the transfer pricing adjustment on account of such AMP expenses was separately called for. Since the TPO has not made any separate adjustment on account of AMP expenses and has given effect to the same under TNMM, we hold that the incurring of such higher advertisement and marketing spend would not affect the calculation of ALP under the RPM. *Ex consequenti*, we hold that RPM *prima facie* appears to be the most appropriate method in the facts and circumstances of the instant case.

12. At this juncture, we note the mandate of Rule 10C which defines the 'Most appropriate method'. Sub-rule (1) of Rule 10C states that: "For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction, and which provides the most reliable measure of an arm's length in relation to the international transaction." Sub-rule (2) of Rule 10C lists certain factors which should be taken into account in selecting the most appropriate method as specified in sub-rule (1). These factors, *inter alia*, include - '(c), the availability, coverage and reliability of data necessary for application of the method'; and '(d) the degree of comparability existing between the international transaction and the uncontrolled transaction ...'. An overview of the factors prescribed for choosing the most appropriate method indicates that firstly, the data necessary for application of the given method should be available and secondly, the uncontrolled transactions should be functionally

similar, if not identical. A company, in order to be ranked as comparable under the RPM, should preferably be engaged in doing similar activity as that of the assessee or at least of the same genus of the activity albeit with a different species. The above discussion boils down that if a particular method though on the face of it appears to be the most appropriate method by considering the nature of transaction and other relevant factors, but, is incapable of application either because of the non-availability/unreliability of the data of the comparables as required under the given method or for want of functional similarity of the available cases or for any other reason as given in clause (2) of rule 10C, then, such a method initially chosen as comparable, is required to be discarded for replacement with the second best method that satisfies the requirements of rule 10C(2).

13. We have noticed above that in the given circumstances, RPM is the first choice for consideration as the most appropriate method. While discussing the *modus operandi* given under RPM, we have noticed that sub-clause (ii) provides for calculation of gross profit margin as a percentage of sales in respect of comparable uncontrolled transactions. This primarily contains two

things, viz., first, the selection of comparables and second, the availability of their data enabling computation as prescribed.

14. Espousing the first issue of selection of comparables, it is seen that the assessee chose the RPM as the most appropriate method by selecting 23 companies as comparable in its TP study report. A cursory look at the functional profiles of these companies transpires that some of them are in entirely different line of business. Obviously, such companies cannot be considered as comparable. The ld. AR was fair enough to concede this position by admitting that the companies which are not comparable should be excluded from the list of comparables. To cut short the controversy, it was stated by the ld. AR that he was agreeable with the four companies chosen by the ld. CIT(A) as comparable with the exception of Media Video Ltd. whose exclusion was assailed. Apart from that, the ld. AR further requested for the inclusion of Procal Electronics India Ltd., which was included by the ld. CIT(A) in the initial list of seven comparables, but, was later on excluded by stating that it had high negative margin of 39.58%.

15. Now, we will examine as to whether M/s Media Video Ltd., was rightly included by the ld. CIT(A) in the list of comparables. The ld. AR contended that the related party transactions (RPTs) of

this company were more than 40% and, hence, the same should be excluded from the list of comparables. To bolster this submission, the ld. AR invited our attention towards the Annual report of this company. He referred to a chart prepared by him on page 520 of the paper book deducing figures from the Annual report of Media Video Ltd. The percentage of RPTs at more than 40 of this company was demonstrated by taking in the numerator all the international transactions of (i) purchase of goods and material; (ii) sale of goods and raw materials; (iii) rend paid; and (iv) service income. A sum total of the value of these four international transactions was taken as numerator with the figure of sales as the denominator. It was further argued that the RPT filter of 15% was reasonable. The sum and substance of his submission was that if all the RPTs of a company are more than 15% of its sales, then such company should not be considered as comparable.

16. We find that this submission has two components, viz., the composition of numerator and denominator and the percentage of such numerator to the denominator. We agree in principle that if any company though functionally comparable, but, has more than a specific percentage of the RPTs, then, the same should be ignored by treating it as a controlled transaction. However, the

percentage of RPTs to make a company as ineligible for comparison, in our considered opinion, should be taken as more than 25% and not 15% as suggested on behalf of the assessee. The view adopting more than 25% RPTs making a company incomparable has been taken by various benches of tribunal including *Aglient Technologies International P. Ltd. VS. ACIT (2013) 36 CCH 187 Del Trib* ; *Stream International Services Pvt. Ltd. VS. ADIT (IT) (2013) 152 TTJ (Mumbai) 553* ; and *Actis Advisers Pvt. Ltd. VS. DCIT (2012) 20 ITR (Trib) 138 (Delhi)*. We, therefore, hold that a company can be considered as incomparable if its RPTs exceed 25%.

17. Now, we take up the second argument of the composition of numerator and denominator. Ratio of the RPTs represents the proportion of transactions with the associated enterprises (numerator) *vis-a-vis* the total of transactions (denominator). In order to decide that what should constitute the contents of numerator and denominator for the purposes of finding out the percentage of RPTs, it is relevant to note the logic behind applying this filter. It is manifest that the aim of the transfer pricing regime is to ensure that the international transactions are recorded at arm's length price. This is done under the TNMM by comparing the

profit earned from the international transaction with that earned by the comparable independent parties in an uncontrolled situation. Thus, while choosing comparables, it must be ensured that the profit earned by them correctly reflects true profit as is earned by an enterprise from an independent third party. If such a chosen company, though functionally comparable, has also entered into international transactions beyond a particular percentage with the related parties, it is quite possible that its overall profit may have been distorted due to such transactions rendering it as incomparable. That is why, this filter is applied to make certain that a company sought to be considered as comparable should have its profit uninfluenced by the impact of the related party transactions.

18. In view of the foregoing discussion, it is manifest that the transactions which do not impact the profitability, such as loan given or taken or other items finding place in the balance sheet, can have no place either in the numerator or the denominator of this formula. However, any income or expenditure resulting/relating from/to or likely to result/relate from/to such items of assets or liabilities, should not be confused with the *per se* international transactions finding place in the balance sheet of the company calling for exclusion.

19. The numerator of this formula consists of all the related party transactions of a company sought to be chosen as comparable which affect the profit earned directly from operations. If, however a related party transaction is of such a nature which does not directly affect or insignificantly affects the profit earned from the bare profit producing activity, then it should not be taken into consideration. The reason for the exclusion of such related party transactions from the numerator is that they have not at all or very insignificantly affected the operating profit of such a company, which is the driving force for the purposes of making a comparison under the TNMM. To cite an example, the RPT of rent paid by a company which is engaged in the business of trading or manufacturing cannot constitute a part of the numerator, because transaction of rent payment has no direct bearing on the trading or manufacturing activity.

20. Now, we take up the contents of the denominator of this formula. The percentage of numerator to denominator can be calculated only when the contents of a part representing the RPT of a particular nature is seen with reference to the contents of whole of that nature. Both the numerator and denominator have to have the same nature of contents. This can be done by segregating

transactions of one nature, like, comparing RPT of purchase with the total purchases or RPT of sales with the total amount of sales of the company. It is also possible to club small transactions of a distinct but related income producing activity with a large transactions of major income producing activity as one unit, both in the numerator as well as in the denominator. For example, RPT of major sale transaction and minor job income can be combined to find out the percentage of RPTs with the total of sales and job income taken together. In a given case, similar to what is prevailing before us, where the RPTs comprise of purchase, sales, small non-operating expenses and service income, we can preferably find out two percentages of RPTs by ignoring the RPT of payment of non-operating expense of rent, which does not directly affect the profit earned from trading activity. First percentage of RPT purchases with total purchases and second of RPT sales and service income as one unit with the total of sales and service income again as one unit. The decision as to whether such a company be included in the list of comparables by applying the filter of more than 25% RPT, would depend on the outcome of two such percentages of RPTs. If either of the two breaches the 25% threshold, then the company will cease to be comparable. If however, both the percentages are less than 25%, then the company would be liable for inclusion in the list of comparables. We want to make it clear that the above discussion about the components of RPT formula is relevant only in the case of an assessee who is a Trader/Distributor and not a Service provider/receiver or a Manufacturer. Since we are concerned in the extant case with the application of RPT filter in the case of a Trader, we have restricted ourselves only to a trader and have thus desisted from examining the contents and other relevant considerations in the application of this filter to a Service provider/receiver or a Manufacturer.

21. Turning to the facts of the instant case, it is seen that the assessee has computed the percentage of related party transactions of Media Video Ltd. by clubbing all the four types of international transactions in the numerator, viz., Purchase of goods and materials; Sale of goods and materials; Rent paid; and Service Income, all totaling Rs.22,43,46,000 and the amount of net sales as denominator at Rs.55,25,22,266. We fail to appreciate the rationale of the manner in which this exercise has been carried out by the assessee for computing the percentage of RPTs of this company at 40.60%. All the debit and credit items of trading and profit and loss account representing related party transactions

have been taken as numerator, but when the question of choosing denominator came, the assessee preferred to pick only the figure of net sales of this company. This approach is absolutely illogical and lacks credibility. The ld. AR argued that even if the approach adopted by him was not acceptable, still, the RPTs of Media Video Ltd., were more than 25%. However, he admitted not to readily have such figures to substantiate his contention. We find that the international transactions of rent paid by this company at ₹1,46,000 is quite insignificant and this transaction has no relation with its main source of the income producing activity, viz., Sales and Service charges. The same is, therefore, directed to be excluded from consideration in the numerator. In so far as the other international transactions of this company are concerned, their percentage of RPTs is required to be considered as discussed above by comparing the RPTs of purchases with total purchase and the RPTs of sales and service income with the total of sales and service income. Since thorough examination of the Annual accounts of this company is necessary to deduce these figures, we are of the considered opinion that this exercise should be left to be done by the TPO at his end. We, therefore, direct the TPO to redo this exercise for M/s Media Video Ltd., in accordance with our above discussion for ascertaining whether this company should continue in or be excluded from the final list of comparables drawn by the ld. CIT(A). If the percentage of RPTs as discussed above finally comes to more than 25%, then, this company should be excluded from the list of comparables. In the otherwise situation, the inclusion of this company in the list of comparables is justified.

22. Now, we turn to M/s Procal Electronics India Ltd., which the ld. AR insists for inclusion in the list of comparables. The ld. DR, on the perusal of the Annual accounts of this company, submitted that this company was engaged in manufacturing as well as trading and, hence, the same cannot be included in the list of comparables. There is no dispute on the fact that the assessee is simply engaged in the trading activity under this segment. In such a situation, a company can be included in the list of comparables only if either it is not engaged in manufacturing or the segmental results, if any of its trading segment are available. The ld. AR was fair enough to concede that if the segmental results of this company from the trading segment are not available, then, it should not be included in the list of comparables.

23. We, therefore, set aside the impugned order on this issue and remit the matter to the file of the TPO/AO for examining as to whether the financial results of M/s Procal Electronics India Ltd. are

available for the trading segment. If these are found to be available, then, such segmental results should be included. In the otherwise situation, the order excluding this company from the list of comparables is justified.

24. As far as the Revenue's ground against the exclusion of some of the companies chosen by the TPO is concerned, the ld. DR, except for relying on the order passed by the TPO, could not point out any cogent reason for including such disclosed companies in the final list of comparables which were chosen by the TPO, but, rejected by the ld. CIT(A). It can be seen that the ld. CIT(A) has given valid reasons for rejecting the declared companies chosen by the TPO, such as, M/s Batliboi Ltd. which is dealing in industrial machinery and M/s Controlled Printing India Ltd., which is engaged in the business of trading in coding and marketing machines. Ergo, we uphold the impugned order to the extent of exclusion of some of the disclosed companies which were chosen by the TPO. The ld. DR contended that the undisclosed company (secret comparable) was strictly in the assessee's line of business and presented a good comparable. It was, therefore, requested that the same be directed to be included in the list of comparables. We partly agree with the contention advanced by the ld. DR on this score. There can be no

question of a secret comparable. It goes without saying that if there is a company which is comparable, then the same should be included in the list of comparables, so as to make an effective comparison. At the same time, no company can be considered by the TPO as comparable, unless the assessee is given a chance to show that it is not comparable. This can be possibly done only when all the relevant particulars of such company including its functional profile and annual accounts are made available to the assessee giving it an effective and substantive opportunity. As such, we direct the TPO to disclose all the necessary particulars of such a secret company including its name etc., if the same is proposed to be included in the list of comparables. If the assessee succeeds in showing that this so far secret company is not comparable, then the same be excluded and *vice versa*. This disposes of the aspect of selection of companies as comparable.

25. Having dealt with the first component of sub-clause (ii) of rule 10B(1)(b) about the selection of comparables companies, now we move on to the second component about the availability of their data enabling computation as prescribed. On being called upon to explain the working given by the assessee under the RPM in respect of companies chosen by it as comparable, the ld. AR took

us through such calculation, which brought out that the calculation of gross profit has been wrongly made by reducing purchases from the figure of sales with the adjustment on account of difference of inventory, wherever applicable. It goes without saying that the calculation of gross profit encompasses the consideration of not only the figure of purchase as well as inventories, but also of the direct expenses which are debited to the trading account. The ld. AR admitted that the figure of gross profit was computed by the assessee in the manner as demonstrated, i.e., without the effect on direct expenses incurred by the comparable companies. Such an approach is totally misplaced inasmuch as it is not possible to tinker with the *modus operandi* given in the formula for calculation of the ALP. The numerator in the formula under the RPM is gross profit. Obviously, such a numerator cannot be substituted with anything less or more than the gross profit. The Special bench of the tribunal in the case of *L.G. Electronics India (P) Ltd. VS. ACIT (2013) 152 TTJ 273 (Del) (SB)* has held that 'Rule 10B has specified a set procedure to be followed for determining the ALP distinctly under the five methods. It is ... not permissible to invent a new procedure and try to fit such procedure within any of the existing procedures prescribed as per these methods. No one is authorized to add one or more new steps in the prescribed procedure or to substitute any other mechanism with the one prescribed under the rule. It is neither possible to invent a new method nor to substitute a new methodology in place of the one prescribed in the rule.' Further sub-section (2) of section 92C makes it abundantly clear that the most appropriate method referred to in sub-section (1) shall be applied for determination of ALP *in the manner as may be prescribed*. In the light of the above discussion, it is explicit that the numerator in the formula given under the RPM cannot be substituted with anything else. To be more precise, if the figure of gross profit of the comparables is not readily available from their annual accounts, then application of the RPM as the most appropriate method would be jeopardized.

26. When this position was confronted to the ld. AR, he submitted that the assessee can try to find out the figure of gross profit of the final list of comparables for working out the ratio of GP to sales in order to benchmark the international transactions of the assessee under this segment. Under such circumstances, we are of the considered opinion that it would be in the fitness of things if the impugned order is set aside and the matter is restored to the TPO/AO. It is directed to first try to determine the ALP under RPM method strictly going by the mandate of Rule 10B(1)(b). If the

assessee succeeds in placing before the TPO the figures of gross profit of the comparables, then, the ALP should be determined by considering GP/sales of the comparable companies as discussed above and, thereafter, the prescription of other sub-clauses of Rule 10B(1)(b) be applied. If the figures of gross profit of the comparable companies are not available, then, the RPM cannot be considered as the most appropriate method. In such an eventuality, TNMM should be applied with the suitable PLI.

27. With the above directions for a fresh computation of ALP of the international transactions under the trading segment, the grounds raised by the assessee are allowed for statistical purposes. Ground No. 3 of the Revenue's appeal is dismissed inasmuch as we hold that only the current year's data should be applied for computation of PLI of the tested party as well as comparables. Ground No.5 of the Revenue's appeal in allowing relief on account of advertisement and marketing expenses cannot be decided at this stage because of our direction for firstly applying RPM. Only if RPM is found to be inapplicable, because of lack of data, etc., the TNMM will be applied. If such an eventuality arises, then, the TPO will consider the effect of advertisement and marketing expenses afresh as per law, after allowing a reasonable opportunity of being

heard to the assessee. Ground No.6 of the Revenue's appeal in allowing adjustment of (+)/(-) 5% of ALP is consequential which has to be considered in the fresh determination of profit rate of comparables as well as that of the assessee either under RPM or, alternatively, under TNMM.

28. Ground nos. 4 and 5 of the assessee's appeal are against the confirmation of disallowance of ₹26,19,816/- (after allowing depreciation @ 20% on total expenses of ₹34,93,088/-) towards marketing expenses incurred by the assessee on account of providing handsets to AMSC's, dealers and employees.

29. After considering the rival submissions and perusing the relevant material on record, we find that this issue is no more *res integra* inasmuch as the Tribunal has restored such issue to the file of AO by its order in the appeals for assessment years 2000-01 and 2001-02. Respectfully following the precedent, we set aside the impugned order and remit the matter to the AO for deciding it in conformity with the direction given by the Tribunal in its order for the immediately preceding years.

30. Ground No. 1 of the Revenue's appeal is against the deletion of disallowance of ₹ 58,72,028/- out of foreign travelling expenses. The ld.CIT (A) deleted this disallowance made by the AO by

following the order passed by the Tribunal in assessee's own case for assessment years 2000-01 and 2001-02. Respectfully following the precedent, we uphold the impugned order. This ground fails.

31. Ground No. 2 of the Revenue's appeal is against the deletion of disallowance of ₹ 77,95,857/- out of warranty provision. Here again, we find that the Tribunal has decided this issue in assessee's favour in the aforenoted order. This ground also fails.

32. Now we move on to the Revenue's ground no. 7, by which it is aggrieved against the deletion of addition on account of transfer pricing adjustment in NET R&D segment and NIC R&D segment. The factual scenario of this ground is that the assessee rendered contract services to Nokia Internet Communication (NIC) Research Centre, Hyderabad, carrying out research on network security appliances and network management solutions, for which it was remunerated at cost plus 5%. Gross revenue under this segment amounted to ₹5.9 crore. Apart from this, the assessee also rendered contract R & D services to Nokia Network Technology, R & D Division on cost plus 7%. Gross revenue under this segment amounted to ₹3.9 crore. The assessee applied TNMM as the most appropriate method for benchmarking these international transactions with PLI of OP/TC. The assessee selected 51

comparable cases to demonstrate that the international transactions under this segment, on a consolidated basis, were at ALP. The mean margin of these companies, by taking the weighted average for the years 1999-2000 and 2000-01, was taken at 20%. On account of economic downturn experienced in this year owing to 11th September disaster, a downward adjustment of 5% was made in such margin of the comparables. Another 5% downward adjustment was made to the mean margin on account of working capital adjustment. The TPO found that the mean margin by use of the current year data was 19.17%. He rounded it to 20%. No deduction on account of downturn, as claimed by the assessee at 5%, was allowed. He took arm's length margin at 15% after allowing adjustment of 5% on account of working capital difference. As against the assessee's list of 51 comparable cases, the TPO selected 60 companies as comparable, which have been tabulated on pages 17 and 18 of his order. This exercise done by the TPO resulted into transfer pricing adjustment of ₹85,20,942/-, which was added by the AO. The ld. CIT(A) accepted the TPO's action in not granting deduction of 5% on account of downturn. He, however, excluded three sets of companies from the list of comparables drawn by the TPO. After such exclusion and allowing (+)/(-) 5% adjustment, the ld. CIT(A) found that the price charged by the assessee from its associated enterprises was at ALP. Consequently, the addition so made by the AO came to be knocked down. The Revenue assails the deletion of this addition.

33. We have heard the rival submissions and perused the relevant material on record. It is observed that there is no dispute on any aspect other than the exclusion of three sets of companies by the ld. CIT(A), which were chosen by the TPO. We will take up these three sets of companies one by one for consideration and decision.

34. The first set contains thirteen companies tabulated on page 65 of the impugned order, which were excluded by the ld. CIT(A) on the touchstone of the filter of rejecting companies whose ratio of depreciation to the total cost was less than 5% and more than 50%. It can be seen from the TPO's order that this filter was applied by the TPO himself. However, while giving effect to this filter, the TPO inadvertently failed to exclude these thirteen companies from the list of comparables, albeit these admittedly did not qualify for the inclusion on the basis of such filter. This contention raised by the assessee before the ld. CIT(A) was remitted to the TPO for examination. Vide remand report dated 24.08.09, the TPO simply stated that: "the proportion of

depreciation as a percentage of cost is a matter of fact and the same needs to be decided accordingly.” Thus, it is amply borne out that the TPO himself applied this filter for rejecting some of the companies from the list of comparables and by application of such filter, these thirteen companies were also liable to be excluded which were inadvertently included by the TPO in the list of comparables. The application of this filter and these companies consequently not qualifying for inclusion has not been denied by the TPO in the remand report, the relevant part of which has been reproduced above.

35. Ordinarily, we would not have approved the application of the filter of excluding some companies on the basis of lower or higher depreciation as a percentage of total costs (not the simplicitor quantum of depreciation allowance) . It is axiomatic that higher amount of depreciation follows in the initial years of the installation of machinery or other assets because of the higher base. With the increase in the age of the asset, the written down value goes on decreasing, which results into downward sojourn of the annual amount of deprecation over the years. At the same time, it is equally true that when asset is new, there are low costs of repairs and other incidental expenses connected with the

operation of the assets. Thus it is evident that the effect of higher amount of depreciation in the initial years is set off by the lower amount of the cost of repairs etc. But with the increase in the age of the asset, no doubt, the amount of annual depreciation allowance declines, but at the same time, repair costs etc. boost up. Operating cost includes not only the cost of repairs etc. but also the amount of depreciation allowance. Consequently, operating profit also carries the effect of both the depreciation allowance and repairs cost etc. Under the TNMM, the numerator is always the amount of operating profit. When the amount of operating profit embraces the effect of depreciation allowance and also repairs cost etc., both of which ordinarily run in the opposite directions, there is no reason to discard an otherwise comparable case simply on the ground of higher or lower percentage of amount of depreciation allowance. As the higher amount of depreciation is usually coupled with the lower repair cost etc., and *vice versa*, there can be no justification in applying the filter of rejecting the companies with depreciation higher or lower than a particular percentage of total costs.

36. Be that as it may, it is noticed that the TPO ventured to apply this filter and by applying the same, excluded some of the

companies which were not suitable to him. However, he forgot to exclude these thirteen companies, which were probably favoring the assessee's case. As this filter has been applied and acted upon by the TPO partially, we are unable to order at this stage that this filter be not applied because the companies favoring the assessee on this filter must have already been excluded by the TPO, which now cannot be brought back. Since these thirteen companies are liable to be excluded on the basis of the filter applied by the TPO, we have no option but to countenance the view taken by the ld. CIT(A) in excluding these thirteen companies from the list of comparables on the strength of the same filter.

37. The second set of the companies excluded by the ld. CIT(A) comprises of HCL Technologies Ltd., and Mastek Ltd. These companies were excluded on the basis of the filter of rejection of companies having related party transaction over 25%. Since RPTs of these two companies stood at 36.89% and 47.45%, respectively, the ld. CIT(A) directed their exclusion. The ld. DR failed to point out with any cogent material that the related party transactions of these two companies were less than 25%. In earlier part of this order, we have held that the companies having related party transactions of more than 25% cannot be considered as

comparable as these fail the test of uncontrolled transactions. Following the same decision, we hold that the ld. CIT(A) was justified in excluding these two companies, whose percentage of RPTs stood at 36.89% and 47.45%. As such, we uphold the view taken by the ld. CIT(A) on the exclusion of these two companies.

38. The last set of companies excluded by the ld. CIT(A) on turnover filter includes seventeen names. The TPO applied the filter rejecting companies having sales less than ₹5 crore without any upper cap. The assessee argued before the ld. CIT(A) that its turnover under this segment amounted to ₹9.72 crore and, as such, there was no justification in either excluding the companies with sales less than ₹5 crore or including the companies with turnover of more than ₹50 crore. After obtaining the remand report from the TPO, the ld. CIT(A) held that these seventeen companies with sales of more than ₹50 crore be excluded from the list of comparables.

39. After considering the rival submissions and perusing the relevant material on record, we find that the assessee's turnover under this segment is to the tune of ₹9.72 crore. The TPO excluded the companies with the turnover of less than ₹5 crore without applying any upper limit of the turnover. The preliminary question

which looms large before us is whether the application of this filter is correct? In this regard, it is relevant to note that the computation of arm's length price under the Indian transfer pricing provisions is embodied in section 92C of the Act. Sub-section (1) of this section provides that the arm's length price in relation to an international transaction shall be determined by any of the given methods, being the most appropriate method, having regard to certain factors. Proviso to sub-section (2), which assumes significance for the present purpose, states that : 'where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the *arithmetical mean of such prices'*. In contrast, some countries have adopted the interquartile range, which is also called the midspread or middle fifty, instead of arithmetic mean of all, as used in India. When arithmetic mean is taken of the all the otherwise comparables companies, it tends to iron out the differences due to higher or lower size of a company or vacillating profitability rates. A company otherwise found to be functionally comparable cannot be excluded either on the ground of higher or lower profit rate or higher or lower turnover. There is no mention in the language of the provisions for the exclusion of potential comparable companies simply on account of high or low turnover or profit rate. The Special bench of the tribunal in *Maersk Global Centres (India) (P.) Ltd. VS. ACIT (2014) 147 ITD 83 (Mum)(SB)* has also held that potential comparables cannot be excluded merely on the ground that their profit is abnormally higher. There can be no justifiable reason to exclude such high or low profit companies unless it is shown that such high or low profit was due to abnormal factors. Same logic applies to the high or low turnover companies also. The mere fact that a company has a high or low turnover can be no reason to justify its exclusion if it is otherwise functionally comparable. The exclusion of companies on such a rationale runs contrary to the express provisions of the Act.

40. At this stage, we consider it our duty to go through the judgment of the Hon'ble jurisdictional High Court in *CIT VS. Agnity India Technologies (P.) Ltd. (2013) 219 Taxman 26 (Del)*. In that case, the assessee was a captive unit providing software services to its associated enterprises. The Hon'ble High Court directed the exclusion of Infosys Ltd. from the list of comparables, which list otherwise included several companies with huge turnover. The exclusion was ordered on account of the giantness of this company, which was, in turn, determined by seeing the cumulative effect of several factors, including risk profile, nature of services,

turnover, ownership of branded/proprietary products, onsite vs. offshore services, expenditure on advertisement and R&D etc. The higher turnover was only one of the criterion and not the sole criteria for the exclusion of this company. In view of the above discussion, we hold in principle that no potentially comparable company can be expelled from the list of comparables simply for the reason of high or low turnover.

41. Adverting to the facts of the instant case, it is seen that the assessee's turnover under this segment amounted to less than ₹10 crore. The TPO has applied the turnover filter by setting a lower limit of turnover at ₹5 crore without setting any upper ceiling of turnover. We fail to comprehend any legally sustainable reason for applying the filter setting a lower limit of turnover at around half of the assessee's turnover and leaving the upper limit uncapped. It is trite that law does not permit a person to both approbate and reprobate. This proposition has sanction of the Hon'ble Supreme Court in *R. N. Gosain Vs. Yashpal Dhir (1992) 4 SCC 683*. Under this rule, a person cannot be permitted to blow hot and cold in the same breath. As the TPO has himself applied the lower limit at half of the assessee's turnover, there is justification in applying some upper limit as well. Taking a holistic

view of the matter, we approve the view taken by the ld. CIT(A) in the present peculiar facts and circumstances by fixing the upper limit of turnover filter at ₹50 crore. The situation would have been different if the TPO had either set no or a nominal lower limit of the turnover filter, leaving the upper limit open. In that situation, there would have been no reason to set any upper turnover filter as well. Ergo, we countenance the conclusion drawn by the ld. CIT(A) in the present unusual circumstances.

42. When the above three sets of companies are held to be rightly excluded, the price charged by the assessee from its associated enterprises in this segment of international transactions comes within (+)/(-) 5% range as per proviso to section 92C(2) of the Act, warranting no addition on account of transfer pricing adjustment. We, therefore, uphold the deletion of the addition of ₹85.20 lac.

43. The cross objection filed by the assessee is simply in support of the impugned order granting relief to the assessee on the grounds which are subject matter of the Revenue's appeal. In view of our decision on the appeal filed by the Department, the Cross objection of the assessee has become infructuous.

44. In the result, the appeals of the Revenue and the assessee are partly allowed for statistical purposes and the Cross objection of the assessee is dismissed.

The order pronounced in the open court on 31.10.2014.

Sd/-	Sd/-
[GEORGE GEORGE K.] JUDICIAL MEMBER	[R.S. SYAL] ACCOUNTANT MEMBER

Dated, 31st October, 2014.

dk

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT (A)
5. DR, ITAT

AR, ITAT, NEW DELHI.*

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