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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

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\+ **ITA 102/2015**

RAMPGREEN SOLUTIONS PVT LTD ..... Appellant
Through: Mr Ajay Vohra, Sr. Advocate with Mr Aditya Vohra, Advocate.

versus

COMMISSIONER OF INCOME TAX ..... Respondent
Through: Ms Suruchi Aggarwal, Sr. Standing Counsel with Ms Lakshmi, Jr. Standing Counsel.

CORAM:
HON'BLE DR. JUSTICE S.MURALIDHAR
HON'BLE MR. JUSTICE VIBHU BAKHRU

O R D E R

% 10.08.2015

VIBHU BAKHRU, J.

1. The Assessee has filed the present appeal under Section 260A of the Income Tax Act, 1961 (hereafter 'the Act') impugning the order dated 22nd March, 2013 passed by the Income Tax Appellate Tribunal (hereafter 'Tribunal') in ITA No. 6286/Del/2012. The Assessee had preferred the aforesaid appeal before the Tribunal, impugning the assessment order passed by the Assessing Officer (hereafter 'AO') making the Transfer Pricing Adjustments (hereafter 'TP Adjustments') in respect of the Assessment Year (hereafter 'AY') 2008-09 as finalised by the Transfer Pricing Officer

(hereafter 'TPO') pursuant to the directions issued by the Dispute Resolution Panel (hereafter 'DRP').

2. The Assessee is, essentially, aggrieved by the TP Adjustments made in respect of the consideration for the services rendered by the Assessee to its overseas holding company. The TP Adjustments have been made on the basis of the average operating profit margin (operating profit as a percentage of operating costs) declared by other companies – eight in number – selected as comparables for the purposes of ascertaining the Arm's Length Price (hereafter 'ALP'). According to the Assessee, two of the companies chosen as comparable by the concerned authority, namely, Vishal Information Technology Ltd. (hereafter 'Vishal') and eClerx Services Ltd. (hereafter 'eClerx') could not be considered as comparables as the functions performed and the services rendered by the said companies were materially different from those performed by the Assessee.

3. This Court, by an order dated 27th February, 2015, admitted the present appeal and framed the following questions of law:-

> "1. Did the ITAT fall into error in the given circumstances of the case in confirming the transfer pricing adjustment to the extent of Rs.5,92,07,428/- upholding the inclusion of

two comparable, i.e., e-Clerx Services Limited and Vishal Information Technologies Limited, now called as Coral Hub Ltd.?

2. Did the ITAT fall into error in not appreciating the terms of Rule l0B (2) of the Rules in respect of the analysis of functionally comparable companies?

4. The factual context in which the aforesaid questions of law arise are briefly stated as under:-

4.1 The Assessee is a wholly owned subsidiary of vCustomer, USA, (an Associated Enterprise - hereafter 'AE'). The Assessee is engaged in providing voice-based customer care to the AE's clients. The Assessee renders Call Center services, which fall within the broad description of Information Technology Enables Services (hereafter 'ITeS'). The Assessee has two units registered under the Software Technology Park Scheme of the Government of India, which are located at New Delhi and Pune. The Assessee is remunerated for the voice call services on cost plus basis. The Assessee explained that the AE undertakes all activities such as marketing and enters into contracts with its customers seeking voice call services. The AE bears all the business risks and the Assessee only acts as an offshore service provider to the customers of the AE. In consideration for the

services, the AE remunerates the Assessee by payment of all costs incurred by the Assessee plus a mark up of fifteen percent of the costs.

4.2 During the previous year, relevant to the AY 2008-09, the Assessee received an amount of Rs. 91,73,94,525/- for voice-based call center services. The Assessee sought to justify the consideration received for the international transactions entered into with the AE to be at ALP. The Assessee submitted a Transfer Pricing Report adopting operating profit margin as the Profit Level Indicator (hereafter 'PLI') for the transfer pricing studies. The Assessee applied the Transactional Net Margin Method (hereafter 'TNMM'), which was considered to be the most appropriate method for the purposes of benchmarking the international transaction. The Assessee's operating profit margin (i.e. operating profit/total cost) was computed at 14.83% and the Assessee claimed that the same was comparable with other companies rendering voice call services. For the purposes of the transfer pricing study, the Assessee chose eight comparable entities and the arithmetic average of the operating profit margins of the said comparables was computed 15.74%. According to the Assessee, its PLI was within the acceptable range as indicated under the second proviso to Section

92C. The Assessee further claimed that the PLI was liable to be adjusted on account of (i) working capital provided to the Assessee by the AE and (ii) the risks of the business borne by the AE.

5. The AO referred the matter to the TPO. The TPO, by an order dated 19th October, 2011, passed under section 92CA(3) of the Act, computed the TP Adjustment at Rs. 11,00,35,400/- (Rupees Eleven Crore Thirty Five Thousand and Four Hundred). The TPO accepted the method adopted by the Assessee (i.e. TNMM), but rejected the benchmarking report. The TPO also rejected the Assessee's claim for any adjustment on account of working capital provided to the Assessee and/or risks borne by the AE. The TPO proceeded to identify a different set of comparable companies for the purposes of determining the ALP. The companies selected by the TPO which were considered to be comparables included eClerx and Vishal (subsequently known as Coral Hub Ltd.). The TPO computed the average operating profit margin of the comparable companies at 28.96% on the basis of the average operating profit margin of eleven companies selected by the TPO as comparables for the purposes of benchmarking the international transactions. On the aforesaid basis, the TPO computed the TP Adjustment

at Rs. 11,00,35,400/-. The AO incorporated the aforesaid adjustment in the draft assessment order passed under Section 144C(1) of the Act on 20th December, 2011. The Assessee objected to the draft assessment order dated 20th December, 2011 before the DRP. The Assessee impugned the draft assessment order on several grounds including selection of certain companies as comparables and exclusion of other companies considered as appropriate comparables by the Assessee.

6. The DRP accepted the Assessee's contention with respect to certain companies, which were considered as comparables by the TPO and directed that the said companies be excluded for the purposes of determining the (i.e. average operating profit margin). However, the Assessee's contentions with regard to the exclusion of Vishal and eClerx were rejected by the DRP. The DRP held that these companies were also providing Information Technology Enabled Services (ITeS) and, thus, could be used as comparables. Insofar as eClerx is concerned, the DRP held that although there were functional dissimilarities, the same were not significant enough to warrant a rejection of the said company as a comparable. With respect to Vishal, the DRP held that the difference in business model of Vishal would not materially affect

the profit margin and thus, there was no infirmity with the TPO's decision to include the said company as a comparable in its report.

7. The TPO recomputed the TP Adjustment in terms of the directions issued by the DRP and computed the TP Adjustment at Rs. 5,92,07,428/-. The AO also made certain additions on account of excess deduction claimed under Section 10A of the Act and disallowance under Section 14A of the Act.

8. The Assessee appealed against the final assessment order dated 9th October, 2012, *inter alia*, on the ground that eClerx and Vishal could not be considered as comparable entities for the purpose of calculating the benchmark operating profit margin. The Assessee claimed that the said companies were engaged in the business of Knowledge Process Outsourcing (hereafter 'KPO') and, thus, could not be included as comparables for the purposes of benchmarking studies. According to the Assessee, although KPO services were ITeS but the nature of the said services was materially different from the services rendered by the Assessee. It was asserted that eClerx is engaged in financial services in the nature of account

reconciliation, trade order management services and has been rated as a leading KPO by Nelso Hall. It was contended that similarly Vishal was engaged in the services of data analytics and providing data processing solutions to some of the largest brands in the world. Vishal too had been rated as a leading KPO by Nelso Hall. In addition, it was pointed out that whilst the employee costs incurred by Vishal was relatively low and constituted only 4.39% of its total cost during the relevant year, the hire charges, vendor payments constituted almost 87% of the total costs. According to the Assessee, this evidenced that Vishal's business model was different and Vishal had outsourced significant part of its operations.

9. The Tribunal rejected the Assessee's contention and held that both eClerx and Vishal were engaged in providing ITeS and once a service fell within that category then no sub-classification of the segment was permissible. The Tribunal held that KPO is a term given to the branch of BPO Services where apart from processing of data, knowledge is also applied. The Assessee's objection that the said two companies had abnormally high profits and thus ought to be excluded as comparables was also rejected.

10. The learned counsel for the Assessee submitted that eClerx and Vishal were KPO service providers and could not be considered as comparables for the purposes of benchmarking the Assessee's international transactions with the AE. The learned counsel referred to the decision of the Special Bench of the Tribunal in ***Maersk Global Centers (India) Pvt. Ltd. v. ACIT, ITA 7466/Mum/2012***, dated 7th March, 2014 and submitted that the issue of whether Vishal and eClerx could be used as comparables was decided in favour of the Assessee.

11. We have heard the counsel for the parties.

12. At the outset, it is necessary to bear in mind that the object and purpose of introducing provisions relating to transfer pricing adjustment in the Act. By virtue of Finance Act, 2001, Section 92 of the Act was substituted by Sections 92 to 92F of the Act with effect from 1st April, 2002. Section 92 of the Act, as was in force prior to 1st April, 2002, enabled the AO to bring the correct profits to tax in relation to certain cross-border transactions. However, with a large number of multi-national companies establishing operations in India, either through their subsidiaries or through other related ventures, a need was felt to provide a statutory framework to

ensure that there is no avoidance of tax by transfer of income from India to other tax jurisdictions. Circular no. 14 of 2001 issued by the CBDT indicates that the provisions of Section 92 to 92F of the Act were introduced "*With a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India".*

13. The heading of Chapter X also clearly indicates that it contains *"special provisions relating to avoidance of tax"*. The object of Chapter X of the Act is not to tax any notional income but to ensure that the real income is brought to tax under the Act. This has also been explained by a Division Bench of this Court in ***Sony Ericsson Mobile Communications India Pvt. Ltd. and Ors. v. Commissioner of Income Tax-III and Ors. 374 ITR 118*** in the following words:-

> "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, : [1965] 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."

14. The substratal rationale of the transfer pricing regulations is to ensure that the true income of an Assessee is brought to tax under the Act and there is no avoidance of tax by transfer of income from India to any other tax jurisdiction by virtue of the influence exercised by the associated enterprises. The aim of the provisions of Chapter X of the Act is to compute the income in relation to a controlled transaction between an Assessee and its associated enterprise having regard to ALP, in order to nullify the effect of transfer of income to a jurisdiction outside India, if any, in respect of the controlled transactions.

15. The exercise of determining the ALP in respect of international transactions between the related enterprises is aimed to determine the price, which would have been charged for products and services, as nearly as possible, in case such international transactions were not controlled by virtue of them being executed between related parties. The object of the exercise is, thus, to remove the effect of any influence on the prices or costs that may have been exerted on account of the international transactions being entered into between related parties. It is, at once, clear that for the exercise of

determining ALP to be reliable, it is necessary that the controlled transactions be compared with uncontrolled transactions which are similar in all material aspects.

16. We may now refer to the relevant provisions of Chapter X of the Act keeping in view the aforesaid purpose and object of introducing the said provisions in the Act.

17. Section 92 of the Act provides that the income arising from an international transaction would be computed having regard to the ALP. The said section further provides for cost and expenses to be allocated and apportioned between two or more associated enterprises with regard to ALP.

18. Section 92C of the Act provides for provisions relating to computation of ALP. Sub-section (1) of Section 92C of the Act provides for the methods of computing the ALP and sub-section (2) of Section 92C of the Act mandates that the most appropriate method that has been referred to in Section 92C(1) be applied for determination of ALP. Sub-section (1) and (2) of Section 92(C) of the Act reads as under:-

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

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed:

Provided 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:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction or specified domestic transaction has actually been undertaken does not exceed such percentage not exceeding three per cent of the latter, as may be notified by the Central Government in the Official Gazette in this behalf, the price at which the international transaction or specified domestic transaction has actually been undertaken shall be deemed to be the arm's length price :

Provided also that where more than one price is determined by the most appropriate method, the arm's length price in relation to an international transaction or specified domestic

transaction undertaken on or after the 1st day of April, 2014, shall be computed in such manner as may be prescribed and accordingly the first and second proviso shall not apply.

Explanation.—For the removal of doubts, it is hereby clarified that the provisions of the second proviso shall also be applicable to all assessment or reassessment proceedings pending before an Assessing Officer as on the 1st day of October, 2009."

19. It is also necessary to refer to Rule 10B of the Income Tax Rules, 1962 which provides for determination of ALP under Section 92C of the Act. Sub-rule(1) of Rule 10B contains provisions in relation to various methods of calculation of ALP as provided under Section 92C of the Act and reads as under:-

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

(a) comparable uncontrolled price method, by which,—

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

(ii) such price is adjusted to account for differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions or between the enterprises

entering into such transactions, which could materially affect the price in the open market;

(iii) the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction or the specified domestic transaction;

(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 or the specified domestic 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;

(c) cost plus method, by which,—

(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined;

(ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined;

(iii) the normal gross profit mark-up referred to in sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market;

(iv) the costs referred to in sub-clause (i) are increased by the adjusted profit mark-up arrived at under sub-clause (iii);

(v) the sum so arrived at is taken to be an arm's length price in relation to the supply of the property or provision of services by the enterprise;

(d) profit split method, which may be applicable mainly in

international transactions or specified domestic transactions involving transfer of unique intangibles or in multiple international transactions or specified domestic transactions which are so interrelated that they cannot be evaluated separately for the purpose of determining the arm's length price of any one transaction, by which—

(i) the combined net profit of the associated enterprises arising from the international transaction or the specified domestic transaction in which they are engaged, is determined;

(ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in similar circumstances;

(iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under sub-clause (ii);

(iv) the profit thus apportioned to the assessee is taken into account to arrive at an arm's length price in relation to the international transaction or the specified domestic transaction:

Provided that the combined net profit referred to in sub-clause (i) may, in the first instance, be partially allocated to each enterprise so as to provide it with a basic return appropriate for the type of international transaction or specified domestic transaction in which it is engaged, with reference to market returns achieved for similar types of transactions by independent enterprises, and thereafter, the residual net profit remaining after such allocation may be split amongst the

enterprises in proportion to their relative contribution in the manner specified under sub-clauses (ii) and (iii), and in such a case the aggregate of the net profit allocated to the enterprise in the first instance together with the residual net profit apportioned to that enterprise on the basis of its relative contribution shall be taken to be the net profit arising to that enterprise from the international transaction or the specified domestic transaction ;

(e) transactional net margin method, by which,—

(i) the net profit margin realised by the enterprise from an international transaction or a specified domestic transaction entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;

(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;

(iii) the net profit margin referred to in sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of net profit margin in the open market;

(iv) the net profit margin realised by the enterprise and referred to in sub-clause (i) is established to be the

same as the net profit margin referred to in sub-clause (iii);

(v) the net profit margin thus established is then taken into account to arrive at an arm's length price in relation to the international transaction or the specified domestic transaction;

(f) any other method as provided in rule 10AB."

For the purposes of the present case, clause (e) of sub-rule (1) of Rule 10B is relevant as it pertains to determination of ALP by TNMM.

20. In order for the benchmarking studies to be reliable for the purposes of determining the ALP, it would be essential that the entities selected as comparables are functionally similar and are subject to the similar business environment and risks as the tested party. In order to impute an ALP to a controlled transaction, it would be essential to ensure that the instances of uncontrolled entities/transactions selected as comparables are similar in all material aspects that have any bearing on the value or the profitability, as the case may be, of the transaction. Any factor, which has an influence on the PLI, would be material and it would be necessary to ensure that the comparables are also equally subjected to the influence of such factors as the tested party. This would, obviously, include business environment; the

nature and functions performed by the tested party and the comparable entities; the value addition in respect of products and services provided by parties; the business model; and the assets and resources employed. It cannot be disputed that the functions performed by an entity would have a material bearing on the value and profitability of the entity. It is, therefore, obvious that the comparables selected and the tested party must be functionally similar for ascertaining a reliable ALP by TNMM. Rule 10B(2) of the Income Tax Rules, 1962 also clearly indicates that the comparability of controlled transactions would be judged with reference to the factors as indicated therein. Clause (a) and (b) of Rule 10B(2) expressly indicate that the specific characteristics of the services provided and the functions performed would be factors for considering the comparability of uncontrolled transactions with controlled transactions.

21. Rule 10B(2) reads as under:-

> "(2) For the purposes of sub-rule (1), the comparability of an international transaction or a specified domestic transaction with an uncontrolled transaction shall be judged with reference to the following, namely:—
>
> (a) the specific characteristics of the property transferred or services provided in either transaction;
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> (b) the functions performed, taking into account assets

employed or to be employed and the risks assumed, by the respective parties to the transactions;

(c) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;

(d) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail."

22. In the facts of the present case, it is not disputed that Vishal and eClerx are entities engaged in Knowledge Process Outsourcing Services (KPO Services). Thus, the principal question to be addressed is whether a KPO Service provider could be considered as a comparable for benchmarking international transactions entered into by an entity rendering voice call services – such as the Assessee –with its associated enterprise by using TNMM and taking operating profit margin as the PLI .

23. In this case, the Tribunal noted that eClerx was engaged in data processing and analytics services and held that the activities of the Assessee

were functionally similar to those of eClerx. The Tribunal concluded that voice call services and KPO services were essentially ITeS and, therefore, entities rendering the aforesaid services could be considered as comparables for the purpose of benchmarking international transactions by using TNMM. The Tribunal held that further sub-division of ITeS was not permissible. The Tribunal followed its earlier decision in ***Willis Processing Services (I) (P.) Ltd.*** **v.** ***Dy. CIT 30 ITR (Trib)129 (Mumbai) 2014.***

24. It is not disputed that voice call services are considered to be the lower-end of ITeS. KPO on the other hand are ITeS where the service providers have to employ advanced level of skills and knowledge. Notification No. SO2810(E) dated 18th September 2013 issued by the CBDT notifying Safe Harbour Rules also indicates the above. Rule 10TA(g) of the said Rules defines KPO Services as under:-

> " (g) "knowledge process outsourcing services" means the following business process outsourcing services provided mainly with the assistance or use of information technology requiring application of knowledge and advanced analytical and technical skills, namely:-
>
> (i) geographic information system;
>
> (ii) human resources services;

(iii) engineering and design services;

(iv) animation or content development and management;

(v) business analytics;

(vi) financial analytics; or

(vii) market research,

but does not include any research and development services whether or not in the nature of contract research and development services;"

25. Whilst Voice Call Center represents the lower-end of ITeS, KPO represents services involving a higher level of skills and knowledge. India has vast human resources and a large number of highly-skilled technical professionals. The expression "KPO" indicates the involvement of domain knowledge in providing ITeS. Typically, KPO includes involvement of advance skills; the services provided may include analytical services, market research, legal research, engineering and design services, intellectual management etc. On the other hand, Voice Call Centers are normally involved in customer support and processing of routine data. In the case of ***Maersk Global Centers (India) Pvt. Ltd. v. ACIT (supra)*** a Special Bench of the Tribunal had referred to a report prepared by National Skill Development Corporation (NSDC) on Human Resource and Skill Requirements in IT and ITES Sector (2022) and noted that the KPO sector

has been described as "a value play". The said report also indicates that KPO services are likely to span activities such as "patent advisory, high-end research and analytics, online market research and legal advisory".

26. A Knowledge Process is understood as a high value added process chain wherein the processes are dependent on advanced skills, domain knowledge and the experience of the persons carrying on such processes.

27. The Government of Rajasthan (Department of Information Technology & Communication) has also floated a scheme on 12th December, 2011 known as "The Rajasthan Incentive Scheme for BPO Centers and KPO Centers, 2011". The said scheme is for providing incentives to promote ITeS and to generate further employment opportunities. In terms of the said scheme, "Business Process Outsourcing (BPO)" is defined to mean *"the transfer of an organization's entire non-core but critical business process/function to an external centre which uses an IT-based service delivery"* and "Knowledge Processing Outsourcing (KPO)" has been defined to mean *"allocation of relatively high-level tasks to an outside organization or a different group (possibly in a different location) within the*

same organization. KPO is, essentially, high-end Business Process Outsourcing (BPO)".

28. In our view, the definition of KPO provided under the afore-mentioned scheme also indicates that KPO services are understood as the higher-end of ITeS in terms of value addition.

29. It is apparent from the above that while entities rendering Voice Call Center services for customer support and a KPO service provider may be employing IT-based delivery systems, the characteristics of services, the functional aspects, business environment, risks and the quality of human resource employed would be materially different. It plainly follows that benchmarking international transactions on the basis of comparing the PLI of high-end KPO service providers with the PLI of Voice Call Centers would be unreliable and possibly flawed.

30. As indicated above, in order to determine the ALP in relation to a controlled transaction, the analysis must include comparables which are similar in all aspects that have a material bearing on their profitability.

Paragraph 1.36 of the "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" published in 2010 (hereafter 'OECD Guidelines') indicates the "comparability factors" which are important while considering the comparability of uncontrolled transactions/entities with the controlled transactions/entities. Sub-rule (2) of rule 10B of the Income Tax Rules, 1962 also mandates that the comparability of international transactions with uncontrolled transactions would be judged with reference to the factors indicated under clauses (a) to (d) of that sub-rule, which are similar to the comparability factors as indicated under the OECD Guidelines. These include characteristics of property or services transferred and functions performed. The relevant extract from the OECD Guidelines are quoted below:

> "1.36 As noted above, in making these comparisons, material differences between the compared transactions or enterprises should be taken into account. In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length transactions. Attributes or "comparability factors" that may be important when determining comparability include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies

pursued by the parties. These comparability factors are discussed in more detail at Section D.1.2 below.

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1.39 Differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market. Therefore, comparisons of these features may be useful in determining the comparability of controlled and uncontrolled transactions. Characteristics that may be important to consider include the following: in the case of transfers of tangible property, the physical features of the property, its quality and reliability, and the availability and volume of supply; in the case of the provision of services, the nature and extent of the services; and in the case of intangible property, the form of transaction (e.g. licensing or sale), the type of property (e.g. patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

1.40 Depending on the transfer pricing method, this factor must be given more or less weight. Among the methods described at Chapter II of these Guidelines, the requirement for comparability of property or services is the strictest for the comparable uncontrolled price method. Under the comparable uncontrolled price method, any material difference in the characteristics of property or services can have an effect on the price and would require an appropriate adjustment to be considered (see in particular paragraph 2.15). Under the resale price method and cost plus method, some differences in the characteristics of property or services are less likely to have a material effect on the gross profit margin or mark-up on costs (see in particular paragraphs 2.23 and 2.41). Differences in the characteristics of property or services are also less sensitive in the case of the transactional profit methods than in the case of traditional transaction methods (see in particular paragraph 2.69). This however

does not mean that the question of comparability in characteristics of property or services can be ignored when applying these methods, because it may be that product differences entail or reflect different functions performed, assets used and/or risks assumed by the tested party. See paragraphs 3.18-3.19 for a discussion of the notion of tested party.

1.41 In practice, it has been observed that comparability analyses for methods based on gross or net profit indicators often put more emphasis on functional similarities than on product similarities. Depending on the facts and circumstances of the case, it may be acceptable to broaden the scope of the comparability analysis to include uncontrolled transactions involving products that are different, but where similar functions are undertaken. However, the acceptance of such an approach depends on the effects that the product differences have on the reliability of the comparison and on whether or not more reliable data are available. Before broadening the search to include a larger number of potentially comparable uncontrolled transactions based on similar functions being undertaken, thought should be given to whether such transactions are likely to offer reliable comparables for the controlled transaction.

D.1.2.2 Functional analysis

1.42 In transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Therefore, in determining whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. This functional analysis seeks to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. For this purpose, it may be helpful to understand the structure and organisation of the group and how they influence the context in which the taxpayer

operates. It will also be relevant to determine the legal rights and obligations of the taxpayer in performing its functions.

1.43 The functions that taxpayers and tax administrations might need to identify and compare include, e.g. design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

1.44 The functional analysis should consider the type of assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc., and the nature of the assets used, such as the age, market value, location, property right protections available, etc.

1.45 Controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made. Functional analysis is incomplete unless the material risks assumed by each party have been considered since the assumption or allocation of risks would influence the conditions of transactions between the associated enterprises. Usually, in the open market, the assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realised.

> 1.46 The types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.
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> 1.51 In some cases, it has been argued that the relative lack of accuracy of the functional analysis of possible external comparables (as defined in paragraph 3.24) might be counterbalanced by the size of the sample of third party data; however quantity does not make up for poor quality of data in producing a sufficiently reliable analysis. See paragraphs 3.2, 3.38 and 3.46. "

31. In the present case, the Tribunal noted that Vishal and eClerx were both engaged in rendering ITeS. The Tribunal held that, "once a service falls under the category of ITeS, then there is no sub-classification of segment". Thus, according to the Tribunal, no differentiation could be made between the entities rendering ITeS. We find it difficult to accept this view as it is contrary to the fundamental rationale of determining ALP by comparing controlled transactions/entities with similar uncontrolled transactions/entities. ITeS encompasses a wide spectrum of services that use Information Technology based delivery. Such services could include rendering highly technical services by qualified technical personnel,

involving advanced skills and knowledge, such as engineering, design and support. While, on the other end of the spectrum ITeS would also include voice-based call centers that render routine customer support for their clients. Clearly, characteristics of the service rendered would be dissimilar. Further, both service providers cannot be considered to be functionally similar. Their business environment would be entirely different, the demand and supply for the services would be different, the assets and capital employed would differ, the competence required to operate the two services would be different. Each of the aforesaid factors would have a material bearing on the profitability of the two entities. Treating the said entities to be comparables only for the reason that they use Information Technology for the delivery of their services, would, in our opinion, be erroneous.

32. It has been pointed out that whilst the Tribunal in ***Willis Processing Services (India) Pvt. Ltd. v. DCIT (supra)*** held that no distinction could be made between KPO and BPO service providers, however, a contrary view had been taken by several benches of the Tribunal in other cases. In ***Capital IQ Information System India (P.) Ltd. v. Dy. CIT, (IT) [2013] 32 taxmann.com 21*** and ***Lloyds TSB Global Services Pvt. Ltd. v. DCIT, (ITA***

No. 5928/Mum/2012 dated 21th November 2012), the Hyderabad and Mumbai Bench of the Tribunal respectively accepted the view that a BPO service provider could not be compared with a KPO service provider.

33. The Special Bench of the Tribunal in ***Maersk Global Centers (India) Pvt. Ltd. (supra)*** struck a different cord. The Special Bench of the Tribunal held that even though there appears to be a difference between BPO and KPO Services, the line of difference is very thin. The Tribunal was of the view that there could be a significant overlap in their activities and it may be difficult to classify services strictly as falling under the category of either a BPO or a KPO. The Tribunal also observed that one of the key success factors of the BPO Industry is its ability to move up the value chain through KPO service offering. For the aforesaid reasons, the Special Bench of the Tribunal held that ITeS Services could not be bifurcated as BPO and KPO Services for the purpose of comparability analysis in the first instance. The Tribunal proceeded to hold that a relatively equal degree of comparability can be achieved by selecting potential comparables on a broad functional analysis at ITeS level and that the comparables so selected could be put to further test by comparing specific functions performed in the international

transactions with uncontrolled transactions to attain relatively equal degree of comparability.

34. We have reservations as to the Tribunal's aforesaid view in ***Maersk Global Centers (India) Pvt. Ltd. (supra)***. As indicated above, the expression 'BPO' and 'KPO' are, plainly, understood in the sense that whereas, BPO does not necessarily involve advanced skills and knowledge; KPO, on the other hand, would involve employment of advanced skills and knowledge for providing services. Thus, the expression 'KPO' in common parlance is used to indicate an ITeS provider providing a completely different nature of service than any other BPO service provider. A KPO service provider would also be functionally different from other BPO service providers, inasmuch as the responsibilities undertaken, the activities performed, the quality of resources employed would be materially different. In the circumstances, we are unable to agree that broadly ITeS sector can be used for selecting comparables without making a conscious selection as to the quality and nature of the content of services. Rule 10B(2)(a) of the Income Tax Rules, 1962 mandates that the comparability of controlled and uncontrolled transactions be judged with reference to service/product characteristics. This

factor cannot be undermined by using a broad classification of ITeS which takes within its fold various types of services with completely different content and value. Thus, where the tested party is not a KPO service provider, an entity rendering KPO services cannot be considered as a comparable for the purposes of Transfer Pricing analysis. The perception that a BPO service provider may have the ability to move up the value chain by offering KPO services cannot be a ground for assessing the transactions relating to services rendered by the BPO service provider by benchmarking it with the transactions of KPO services providers. The object is to ascertain the ALP of the service rendered and not of a service (higher in value chain) that may possibly be rendered subsequently.

35. As pointed out by the Special Bench of the Tribunal in ***Maersk Global Centers (India) Pvt. Ltd. (supra)***, there may be cases where an entity may be rendering a mix of services some of which may be functionally comparable to a KPO while other services may not. In such cases a classification of BPO and KPO may not be feasible. Clearly, no straitjacket formula can be applied. In cases where the categorization of services rendered cannot be defined with certainty, it would be apposite to employ

the broad functionality test and then exclude uncontrolled entities, which are found to be materially dissimilar in aspects and features that have a bearing on the profitability of those entities. However, where the controlled transactions are clearly in the nature of lower-end ITeS such as Call Centers etc. for rendering data processing not involving domain knowledge, inclusion of any KPO service provider as a comparable would not be warranted and the transfer pricing study must take that into account at the threshold.

36. As pointed out earlier, the transfer pricing analysis must serve the broad object of benchmarking an international transaction for determining an ALP. The methodology necessitates that the comparables must be similar in material aspects. The comparability must be judged on factors such as product/service characteristics, functions undertaken, assets used, risks assumed. This is essential to ensure the efficacy of the exercise. There is sufficient flexibility available within the statutory framework to ensure a fair ALP.

37. Applying the aforesaid principles to the facts of the present case, it is

once again clear that both Vishal and eClerx could not be taken as comparables for determining the ALP. Vishal and eClerx, both are into KPO Services. In ***Maersk Global Centers (India) Pvt. Ltd. (supra)***, the Special Bench of the Tribunal had noted that eClerx is engaged in data analytics, data processing services, pricing analytics, bundling optimization, content operation, sales and marketing support, product data management, revenue management. In addition, eClerx also offered financial services such as real-time capital markets, middle and back-office support, portfolio risk management services and various critical data management services. Clearly, the aforesaid services are not comparable with the services rendered by the Assessee. Further, the functions undertaken (i.e. the activities performed) are also not comparable with the Assessee. In our view, the Tribunal erred in holding that the functions performed by the Assessee were broadly similar to that of eClerx or Vishal. The operating margin of eClerx, thus, could not be included to arrive at an ALP of controlled transactions, which were materially different in its content and value. In ***Maersk Global Centers (India) Pvt. Ltd. (supra)***, the Special Bench of the Tribunal had noted the same and had, thus, excluded eClerx as a comparable. It is further observed that the comparability of eClerx had also been examined by the

Hyderabad Bench of the Tribunal in ***M/s Capital Iq Information Systems (India) (P.) Ltd. v. Additional Commissioner of Income-tax (supra)***, wherein, the Tribunal directed the exclusion of eClerx as a comparable for the reason that it was engaged in providing KPO Services and further that it had also returned supernormal profits.

38. In our view, even Vishal could not be considered as a comparable, as admittedly, its business model was completely different. Admittedly, Vishal's expenditure on employment cost during the relevant period was a small fraction of the proportionate cost incurred by the Assessee, apparently, for the reason that most of its work was outsourced to other vendors/service providers. The DRP and the Tribunal erred in brushing aside this vital difference by observing that outsourcing was common in ITeS industry and the same would not have a bearing on profitability. Plainly, a business model where services are rendered by employing own employees and using one's own infrastructure would have a different cost structure as compared to a business model where services are outsourced. There was no material for the Tribunal to conclude that the outsourcing of services by Vishal would have no bearing on the profitability of the said entity.

39. It is also relevant to note that in the case of ***Maersk Global Centers (India) Pvt. Ltd. (supra)***, the DRP itself had accepted the objection of the Assessee and had excluded Vishal as a comparable for the reason as quoted below:-

> "… that it had a very low employment cost and very high cost on account of venture payment, which suggested that its business model was that of an outsourcing company and in view of this functional difference, Vishal Ltd. could not be considered as a comparable."

40. The Assessee had also sought the exclusion of eClerx and Vishal on the ground that both the companies had returned supernormal profits. Whereas the operating margins (operating margin over total cost) in case of Vishal and eClerx were 50.68% and 65.88% respectively, the PLIs of all other comparables were in the range of 2.2% to 24%. In our view, it would not be apposite to exclude comparables only for the reason that their profits are high, as the same is not provided for in the statutory framework. The OECD Guidelines suggest that a quartile method be adopted which excludes entities that fall in the extreme quartiles for comparability. However, neither Chapter X of the Act nor the Rules made by CBDT provide for exclusion for such statistical reason.

41. Having stated the same, it may be necessary to bear in mind that supernormal profits may in certain cases indicate a functional dissimilarity or dissimilarity with respect to a feature that has a material bearing on the profitability. In such circumstances, it would be necessary to undertake further analysis to eliminate the possibility of the high profits resulting on account of any material dissimilarity between the tested party and the chosen comparable. A wide deviation in the PLI amongst selected comparables could be indicative that the comparables selected are either materially dissimilar or the data used is not reliable. The Tribunal proceeded on the basis that an adjustment could be made only in cases where supernormal profits resulted from the factors indicated in Rule 10B of the Income Tax Rules, 1962. In our view, the factors mentioned in Rule 10B are not exhaustive. The principal object of benchmarking international transactions against uncontrolled transactions is to impute an ALP to those transactions. This exercise would fail if a factor, which has a material bearing on the value or the profitability, as the case may be, depending on the method used, is ignored.

42. Before concluding, there is yet another aspect of the matter that needs

consideration. The Tribunal proceeded on the basis that while applying TNMM method, broad functionality is sufficient and it is not necessary that further effort be taken to find a comparable entity rendering services of similar characteristics as the tested entity. The DRP held that TNMM allows flexibility and tolerance in selection of comparables, as functional dissimilarities are subsumed at net margin levels, as compared to Resale Price Method or Comparable Uncontrolled Price Method and, therefore, the functional dissimilarities pointed out by the Assessee did not warrant rejection of eClerx and Vishal as comparables.

43. In our view, the aforesaid approach would not be apposite. Insofar as identifying comparable transactions/entities is concerned, the same would not differ irrespective of the transfer pricing method adopted. In other words, the comparable transactions/entities must be selected on the basis of similarity with the controlled transaction/entity. Comparability of controlled and uncontrolled transactions has to be judged, *inter alia,* with reference to comparability factors as indicated under rule 10B(2) of the Income Tax Rules, 1962. Comparability analysis by TNMM method may be less sensitive to certain dissimilarities between the tested party and the

comparables. However, that cannot be the consideration for diluting the standards of selecting comparable transactions/entities. A higher product and functional similarity would strengthen the efficacy of the method in ascertaining a reliable ALP. Therefore, as far as possible, the comparables must be selected keeping in view the comparability factors as specified. Wide deviations in PLI must trigger further investigations/analysis.

44. Consideration for a transaction would reflect the functions performed, the significant activities undertaken, the assets or resources used/consumed, the risks assumed. Thus, comparison of activities undertaken/functions performed is important for determining the comparability between controlled and uncontrolled transactions/entity. It would not be apposite to ignore functional dissimilarity only for the reason that its impact may be reduced on account of using arithmetical mean of the PLI. The DRP had noted that eClerx was functionally dissimilar, but ignored the same relying on an assumption that the functional dissimilarity would be subsumed in the profit margin. As noted, the content of services provided by the Assessee and the entities in question were not similar. In addition, there were also functional dissimilarities between the Assessee and the two entities in question. In our view, these comparability factors could not be ignored by

the Tribunal. While using TNMM, the search for comparables may be broadened by including comparables offering services/products which are not entirely similar to the controlled transaction/entity. However, this can be done only if (a) the functions performed by the tested party and the selected comparable entity are similar including the assets used and the risks assumed; and (b) the difference in services/products offered has no material bearing on the profitability.

45. In view of the aforesaid, the questions of law framed by an order dated 27th February, 2015 are answered in the affirmative and against the Revenue. The impugned order dated 22nd March, 2013 of the Tribunal and the final assessment order dated 9th October, 2012 are hereby set aside. The appeal is allowed.

VIBHU BAKHRU, J

S. MURALIDHAR, J

AUGUST 10, 2015
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