आयकर अपीली यअधिकरण "के" न्यायपीठ मुंबई में।

IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCH "K", MUMBAI

श्री आर. सी. शर्मा, लेखा सदस्य एवं श्री विवेक वर्मा, न्यायिक सदस्य के समक्ष ।

BEFORE SHRI R.C. SHARMA, ACCOUNTANT MEMBER AND SHRI VIVEK VARMA, JUDICIAL MEMBER

ITA No. : 1423/Mum/2014

(Assessment year: 2009-10)

M/s Watson Pharma Pvt Ltd, 51 Kalpataru Square, 21/22, Kondivita Lane, Off Andheri Kurla Road, Andheri (East), Mumbai -400 059 स्थयी लेखा सं.:PAN: **AACW 6074 D**	Vs	Dy Commissioner of Income Tax -8(3), Mumbai
अपीलार्थी (Appellant)		प्रत्यर्थी (Respondent)

ITA No. : 1565/Mum/2014

(Assessment year: 2009-10)

Dy Commissioner of Income Tax - 8(3), Mumbai	Vs	M/s Watson Pharma Pvt Ltd, Mumbai
अपीलार्थी (Appellant)		प्रत्यर्थी (Respondent)
Appellant-assessee by	:	Ms. Karishma R Phatarphekar Mr. Prashant Maheshwari Mr. Varun Sankhesara Ms. Keerthiga Padmanabhan
Respondent-revenue by	:	Shri. Kishan Vyas

सुनवाई की तारीख /Date of Hearing : 30-10-2014

घोषणा की तारीख /Date of Pronouncement : 09-01-2015

आदेश
ORDER

श्री विवेक वर्मा, न्या स:

PER VIVEK VARMA, JM:

Cross appeals have been filed by the assessee and the department against the order of Dispute Resolution Panel –II, Mumbai, dated 31.12.2013, passed u/s 144C(5) of the Income Tax Act, 1961.

ITA No. : 1423/Mum/2014 : Assessee's appeal :

2. The basic facts of the case are that the assessee is a wholly owned subsidiary of Watson Labs, Carona California, USA. The assessee had its facility for research and development, located at Ambernath, Dombivli and Mumbai. In August, 2007, the assessee received approval to manufacture products at the solid dosage manufacturing from Goa. The assessee, from its facilities manufacture of raw materials, API & intermediate to support is internal product development. Assessee's facilities also develops APIs for third parties as well. On the whole, the assessee provides contract manufacture, contract research and development to its parent AE at the US. The parent AE in the US is engaged in development, manufacture and sale and distribution of proprietary and off patent generic pharmaceutical products.

3. Though the parent AE and its associates develop manufacture the products in three core areas, i.e. Specialty Products, Nephrology Products and Generic Products, its association with the assessee summarily rallies around contract Research and Development services, contract manufacturing at their facilities and commercial sales.

4. Since there is involvement of international transactions between the AEs the assessee justifies its ALP with its AE by using TNMM method.

5. In so far as R&D activities which included manpower recruitment are concerned, the assessee explained to the revenue authorities with regard to its functions relating to generic pharma products, its selling and marketing functions. Based or this functional analysis, to justify its transactions with AEs, the assessee identified 6 comparable companies, that were

engaged in similar contract R&D activities, computed mean profit margin at 14.50%, against 17.43% declared by the assessee.

6. In respect of contract manufacturing activity, the assessee undertakes trial packs in its R&D Laboratory where detailed tests are undertaken and on computation of such tests, the assessee files its results with US FDA. After getting the approval, the assessee manufactures the products for its AE. The assessee to justify its ALP adopted TNMM and identified 7 comparables, whose mean profit margin marked out at 11.90% against its profit margin taken at 15.66%.

7. The assessee, therefore, submitted before the revenue authorities that in both the above activities, the bench mark was well within ± 5% and therefore, were at arm's length.

8. In the proceedings before the TPO, the TPO after considering the reports submitted by the assessee changed the comparables in respect of contract manufacturing and worked out the mean profit margin at 23.61% against assessee profit margin of 17.43%. He, therefore, computed the adjustment at 1.93 crores.

9. In respect of product development and R&D activity, the TPO computed the adjustment on location saving. The TPO worked out the adjustment of product development on the basis of the fact that manufacturing activity which were being undertaken in the US and European countries/locations were being transferred to Indian locations subject to FDA norms. This transfer of manufacturing process to India gave average cost adequate at merely 40%. Since the AE enjoyed locational advantage on product development and R&D activity, the computation of differential costs were worked out at Rs. 25.19

crores on contract manufacturing segment and Rs. 9.04 crores on R&D segment.

10. Against these directions by the DRP, the assessee is in appeal before the ITAT. Before us, the AR reiterated the submissions made before the revenue authorities and the DRP and made further submissions that the working arrived at by the assessee was a correct and therefore, the computation of adjustment made by the revenue authorities were infirm.

11. The AR submitted that the basis of arriving at the mean PLI Indicator, the assessee had made the following analysis:

Description	***Amount(Rs.)***
Operating Revenue	*36,69,84,790*
Operating Cost (TC)	*31,25,25,091*
Operating Profit (OP)	*5,44,59,699*
OP/TC	*17.43*

The assessee has used TNMM as Most Appropriate Method to benchmark the transaction, using OP/TC (Operating profit to Operating Cost) as PLI".

based on the following comparables

Sr. No.	***Name of Comparable***	***Average PLI Based on Multiple Year Data***
1	*Choksi Laboratories Ltd*	*32.45%*
2	*Vimta Labs Ltd*	*20.09%*
3	*Dolphin Medical Services Ltd*	*10.22%*
4	*NG Industries Ltd.*	*20.04%*
5	*Max Neeman Medical International Ltd.(Seg.)*	*-5.39%*
6	*Pfizer ltd. (Seg.)*	*9.57%*
	Mean	*14.50*
	Assessee's PLI	*17.43*

12. The TPO after considering the comparables, observed,

"In response, the assessee submitted that it considered companies engaged in research and testing services and diagnostic and testing services. The reason given by the assessee to broaden the search is that, as adequate companies could not be found whose business was closely comparable to that of the assessee's R&D segment. In this regard, it is to be stated that there are sufficient number of comparable companies are available in the R&D sector, as evidenced by the comparables considered by the TPO. Secondly, even under TNMM, the primary emphasis is on to search for comparables, as close as possible to the functions carried by the

assessee. So, when comparables are available in the R&D sector, there is no reason why the assessee has to broaden the search. It is the qualify of comparables rather than the quantity of comparables that is important.

6.3 It is to be noted that the companies providing medical diagnostic/testing services and can not be comparable to the assessee's function of providing R&D services to its AE in the fields of formulation, development, Bio-chemical research etc. The functional profile of the assessee is that of a "Research and Development" Services Provider which involves reverse engineering of drugs and creating new drugs as per specification of the AE. Any company doing broadly similar job would be considered comparable to the assessee. The core point here is providing "Research and Development Support" to an industry. The above two companies are running medical and diagnostics centres from which they are treating inbound patients. They are not undertaking any kind of medical search with the function of providing research and technical services".

rejected four of the comparables, observed,

Sr. No.	***Company***	***Reason for rejection***
1	*Dolphin Medical Services Ltd*	*The company mainly provides medical diagnostic and ophthalmologic services to patients. None of the steps followed by assessee in its research activities are involved in the functioning of the company.*
2	*N. G. Industries Ltd*	*The company has medical centres, which are engaged in providing diagnostic/pathological services. The company carries on no research activities for the FY 2008-09.*
3	*Max Neeman Medical International Ltd*	*It has related partly transaction exceeding 25% of the revenue for the FY 2008-09*
4	*Pfizer Ltd*	*Firstly the company has different accounting year ending with November, 2009. Further, the Services segment is into Clinical Development Operations, which primarily include conducting clinical trials, new product development and undertaking comprehensive data management for new drug development. The segment revenue for the FY 2008-09 is of Rs. 22.09 crores and Rs. 21.95 crores are with related parties (Source: Annual Report for FY 2008-09). Thus, the services segment is a captive centre for Pfizer group and thus the segment fails 25% related party transactions filter.*

13. On the final analysis, the AO lay his basis on the following final comparables

"As a result, after considering the objections of the assessee and also examination of additional companies submitted by the assessee, the

following are the final comparables that are used for benchmarking the ALP of the transactions entered by it with its AE under the Contract R&D Segment:-

Sr. No.	***Name of Comparable***	***OP/TC (%) FY 2008-09***
1	*Choksi Laboratories Ltd*	*23.67*
2	*TCG Lifesciences Ltd*	*41.33*
3	*Vimta Labs Ltd*	*13.04*
4	*Alphageo (India) Ltd*	*20.25*
5	*Jubilant Chemsys Ltd*	*27.18*
6	*GVK Biosciences Pvt. Ltd*	*16.61*
7	*Siro Clinpharm Pvt Ltd*	*25.59*
8	*Syngene Intl Ltd.*	*28.87*
9	*Research Support Intl Pvt Ltd*	*23.30*
10	*Aurigene Discovery Technologies Ltd.*	*16.23*
	Mean	*23.61*
	Assessee's PLI	*17.43*

and arrived at the following result

"In view of the above discussions, the international transactions on account of Contract R&D services provided by the assessee to its AE are proposed to be benchmarked to determine the ALP, by applying the mean margin of 23.61% of the nine comparables finally selected and retained from the list of the nine comparables finally selected and retained from the list of comparables suggested by the assessee. Accordingly, the ALP of the transactions is computed as follows:

Operating Revenue	*36,69,84,790*
Operating Cost(TC)	*31,25,25,091*
Operating Profit(OP)	*5,44,59,699*
OP/TC	*17.43%*

14. Similarly, on the product development, the TPO went on the location saving bench mark and extracted the excerpts of Clinical Trial Magnifier paper written by Mr. Johan PE Karlberg, MD, Phd. of Clinical Trial Centre, Li Ka Shing Faculty of Medicine, The University of Hong Kong, Hong Kong, P R China, who gave the following analysis.

Table 2. Country-wide annual estimates; the number of study sites, study subjects and cost has been estimated for the fifty most active countries according to the assumptions provided in the Method and Assumption Session.

		Estimated Annual		Per Subject Cost			Cost All Subjects			External Cost Distribution			Fee Reduction*	
Region	Country	Sites N	Subjects N	Total US$	Internal US$	External US$	Total US$M	Internal US$M	External US$M	Inv. US$M	Lab US$M	CRO US$M	Inv. US$M	%**
N America	US	43,899	567,064	30,000	7,500	22,500	17,012	4,253	12,759	4,210	638	7,911	0	0.0
N America	Canada	3,995	45,873	30,000	7,500	22,500	1,376	344	1,032	341	52	640	0	0.0
L America	Argentina	977	15,763	30,000	7,500	22,500	473	118	355	117	18	220	59	16.5
L America	Brazil	986	8,119	30,000	7,500	22,500	244	61	183	60	9	113	30	16.5
L America	Mexico	380	10,369	30,000	7,500	22,500	311	78	233	77	12	145	38	16.5
L America	Chile	218	3,565	30,000	7,500	22,500	107	27	80	26	4	50	13	16.5
L America	Peru	176	2,218	30,000	7,500	22,500	67	17	50	16	2	31	8	16.5
L America	Colombia	150	3,411	30,000	7,500	22,500	102	26	77	25	4	48	13	16.5
Europe	Germany	5,825	77,756	30,000	7,500	22,500	2,333	583	1,750	577	87	1,085	0	0.0
Europe	France	4,504	56,053	30,000	7,500	22,500	1,682	420	1,261	416	63	782	0	0.0
Europe	UK	2,802	33,292	30,000	7,500	22,500	999	250	749	247	37	464	0	0.0
Europe	Spain	2,650	27,444	30,000	7,500	22,500	823	206	617	204	31	383	0	0.0
Europe	Italy	2,453	26,808	30,000	7,500	22,500	804	201	603	199	30	374	0	0.0
Europe	Belgium	1,416	17,028	30,000	7,500	22,500	511	128	383	126	19	238	0	0.0
Europe	Netherlands	1,231	14,152	30,000	7,500	22,500	425	106	319	105	16	198	0	0.0
Europe	Sweden	1,073	12,900	30,000	7,500	22,500	387	97	290	96	15	180	0	0.0
Europe	Denmark	761	14,380	30,000	7,500	22,500	431	108	324	107	16	201	0	0.0
Europe	Austria	749	13,505	30,000	7,500	22,500	405	101	304	100	15	188	0	0.0
Europe	Finland	567	19,717	30,000	7,500	22,500	592	148	444	146	22	275	0	0.0
Europe	Norway	529	6,672	30,000	7,500	22,500	200	50	150	50	8	93	0	0.0
Europe	Switzerland	420	10,285	30,000	7,500	22,500	309	77	231	76	12	143	0	0.0
Europe	Greece	393	4,337	30,000	7,500	22,500	130	33	98	32	5	61	0	0.0
Europe	Portugal	385	4,287	30,000	7,500	22,500	129	32	96	32	5	60	0	0.0
Europe	Ireland	167	1,802	30,000	7,500	22,500	54	14	41	13	2	25	0	0.0
East Europe	Poland	1,734	24,619	30,000	7,500	22,500	739	185	554	183	28	343	91	16.5
East Europe	Russia	1,695	15,249	30,000	7,500	22,500	457	114	343	113	17	213	57	16.5
East Europe	Hungary	968	9,425	30,000	7,500	22,500	283	71	212	70	11	131	35	16.5
East Europe	Czech Rep.	977	13,274	30,000	7,500	22,500	398	100	299	99	15	185	49	16.5
East Europe	Ukraine	662	5,498	30,000	7,500	22,500	165	41	124	41	6	77	20	16.5
East Europe	Romania	522	4,498	30,000	7,500	22,500	135	34	101	33	5	63	17	16.5
East Europe	Slovakia	444	3,731	30,000	7,500	22,500	112	28	84	28	4	52	14	16.5
East Europe	Bulgaria	255	2,678	30,000	7,500	22,500	80	20	60	20	3	37	10	16.5
East Europe	Turkey	252	4,771	30,000	7,500	22,500	143	36	107	35	5	67	18	16.5
East Europe	Lithuania	187	3,896	30,000	7,500	22,500	117	29	88	29	4	54	14	16.5
East Europe	Estonia	168	3,337	30,000	7,500	22,500	100	25	75	25	4	47	12	16.5
East Europe	Latvia	152	1,265	30,000	7,500	22,500	38	9	28	9	1	18	5	16.5
East Europe	Croatia	127	1,454	30,000	7,500	22,500	44	11	33	11	2	20	5	16.5
Middle East	Israel	626	6,929	30,000	7,500	22,500	208	52	156	51	8	97	26	16.5
Africa	S. Africa	769	14,228	30,000	7,500	22,500	427	107	320	105	16	198	53	16.5
Asia	Japan	2,016	36,295	30,000	7,500	22,500	1,089	272	817	269	41	506	0	0.0
Asia	India	926	11,678	30,000	7,500	22,500	350	88	263	87	13	163	43	16.5
Asia	China	686	20,538	30,000	7,500	22,500	616	154	462	152	23	286	76	16.5
Asia	Korea, South	625	11,516	30,000	7,500	22,500	345	86	259	86	13	161	43	16.5
Asia	Taiwan	472	7,683	30,000	7,500	22,500	231	58	173	57	9	107	29	16.5
Asia	Philippines	224	14,045	30,000	7,500	22,500	421	105	316	104	16	196	52	16.5
Asia	Malaysia	191	2,838	30,000	7,500	22,500	85	21	64	21	3	40	11	16.5
Asia	Thailand	152	3,854	30,000	7,500	22,500	116	29	87	29	4	54	14	16.5
Asia	Hong Kong	142	2,300	30,000	7,500	22,500	69	17	52	17	3	32	9	16.5
Oceania	Australia	1,454	18,428	30,000	7,500	22,500	553	138	415	127	21	257	0	0.0
Oceania	New Zealand	177	2,455	30,000	7,500	22,500	74	18	55	18	3	34	0	0.0

15. The TPO, therefore, observed,

> *"On an analysis of this article following points are worth considering:*
>
> - *There is 50% reduction in investigator fees in India and other emerging conttries.*
>
> *Thus, based on the above, the overall cost of Research & Development, excluding raw material, is estimated to be around 50% of what is costs in USA. Based on this reasonable assumption, with backing of a research article, the location savings are computed as follows:*

Amount in INR	***Contract R & D***
Formulation R & D	
Material Cost	*2,63,44,433.17*
Facility Overheads allocation on batches	*36,88,019.18*
Allocated R & D Overheads	*5,24,47,957.71*
Total formulation R & D Expenses	***8,24,80,410.06***
API R & D	
Material Cost	*5,23,54,759.51*
Facility Overheads allocation on E batches	*83,32,958.76*
Allocated R & D Overheads	*3,69,48,070.88*
Total API R & D Expenses	***9,76,35,789.15***
BEC	***7,94,51,778.21***
Grand Total (Formulation + API + BEC)	***25,95,67,977.42***
Cost excluding materials	***18,08,68,785***
Cost in US for similar activity (Cost in India is 50% cheaper as compared to US)	*36,17,37,570*
Cost Savings	*18,08,68,785*
***Less**: Cost dis-savings*	*0*
Location Savings	***18,08,68,785***

Thus, in the case of assessee, and Watson Group, the location savings arising due to R & D facility located in India is Rs. 18,08,68,785/-, as the assessee could not submit any details to substantiate that any of such benefit would be/will be passed on to the customers/distributors in USA.

It is to be noted that based on the bargaining power of the AEs, the entire location savings cannot be attributed to India. In the instant case, AE requires the assessee with its FDA approved R&D sites along with technical manpower; whereas the assessee requires E for introducing new generic products to be launched in US market in generic drugs. As the association is mutually beneficial, the split of location savings between assessee and its AE are treated as 50%:50% and accordingly, the location savings of Rs. 18,08,68,785/- is divided between the assessee and the AE on a 50 : 50 basis.

In light of above, an adjustment of Rs. 9,04,34,392/- is proposed to the arm's length of the price of the international transactions of assessee on account of location savings.

7. Summary

The transfer pricing adjustments made in this order are summarized as under:

Sr. No.	***Nature of adjustment***	***Amount (Rs)***
1	*Location Savings arising in the manufacturing segment*	*25,19,22,871*
2	*Adjustment in product development R & D segment under TNMM*	*1,93,27,475*
3	*Location Savings arising in the product development R&D segment*	*9,04,34,392*
	TOTAL	***36,16,84,738***

16. The TPO, therefore, suggested the TP adjustment at Rs. 36,16,84,738/-. The adjustment so made has been sustained by the DRP, hence, the instant appeal before the ITAT.

17. Before us, the AR submitted, in order to determine arm's length price of international transaction relating to provision of contract research and development services to AE, Assessee considered Transactional Net Margin Method ("TNMM") as Most Appropriate Method and selected Operating Profit to Total Cost ("OP/TC") margin as Profit Level Indicator. The assessee selected 6 comparables in its Transfer Pricing Study Report with three years average OP/TC margin of 14.50%. As against this the Assessee earned OP/TC margin of 17.43% during AY 2009-10. However, during Transfer Pricing Assessment, the TPO directed assessee to compute OP/TC margin of comparables using single year data (i.e. data for Financial Year 2008-09). Further, out of 6 comparables selected by the assessee in its Transfer Pricing Study Report, the TPO rejected 4 comparables and added 8 new comparables. Based on this approach TPO computed OP/TC margins of the comparables at 23.61%. The DRP confirmed the approach of TPO/AO, except that the DRP directed TPO/AO to exclude Alphageo Ltd. from the set of comparables. Consequently, it resulted in transfer pricing adjustment of Rs. 2,04,84,562/-".

18. While referring to the comparables adopted by the assessee in its TP study, the reasons given are

> *"Inclusion of Dolphin Medical Services Ltd in comparable set*
> *Before TPO and DRP, Assessee inter-alia contented that Dolphin Medical Services Ltd selected as comparable company by the Assessee in its Transfer Pricing Study Report should not be rejected from the set of comparables for following reasons:*
>
> - *The company provides testing and clinical trial services.*

- *Functional profile of Dolphin Medical Services Ltd. is broadly similar to those rendered by the Assessee (DRP PB - Page 20).*
- *Functionally similar companies can be treated as comparable. This view is also supported by Rule 1OB(2) of the Income tax Rules, 1962 ("the Rules") and also in para 2.62 of OECD Guidelines issued in July 2010"*

19. To support the above contention, the AR submitted and placed reliance on the following decisions

- *"Dolphin Medical Services Ltd is also into the business of clinical trial services which is broadly comparable to the activity of contract research and development services. This is also reflected in the Annual Report of the Dolphin Medical Services Ltd for financial year 2008-09. The relevant extracts of the report are as follows:*
  "…The company was able to achieve this goal and ensured that no loss was incurred on it. In addition to this due to global recession, the outsourcing of clinical trials from USA and Europe has slowed down and the company needs to explore local opportunities also to fulfil the business requirements of the CR0 venture. The huge monthly rentals for this building will also he a burden to the company in case of any potential problem in getting the Clinical Trails/ CR() contracts from the west … " (refer page no 311 of the paper book).
  The above extracts demonstrate that they are into clinical trials and contract research (CR0) like the assessee.
  11. Another company accepted by TPO namely Siro Clinpharm Pvt. Ltd. is also engaged in Clinical Research & Development Services apart from other services. Thus, the TPO has also considered broadly comparable companies. The relevant extract of Annual Report of Siro Clinpharm Pvt. Ltd. is as follows:
  "Revenue from clinical trial research activities is accounted for as and when the services are rendered as per the terms and conditions of the respective agreements under the proportionate completion method. Revenue relating to the work accomplished is recognized when no significant uncertainty as to measurability or collectability exist. *"(refer page II of the annual report of Siro Clinpharm Pvt. Ltd).*

  Hence, Dolphin Medical should also be accepted as a comparable".
  "In number of rulings Hon'ble Income Tax Appellate Tribunal has recognized that TNMM requires only broad functional and product/ services similarity. These rulings are cited below:

  - *GE India Technology Centre (P.) Ltd. vs. DCIT 30taxman.com249(Bang)*
  - *Lloyds TSB Global Services P Ltd v DCIT 33taxman.com259(Mum-Trib)*

- *ACIT v Schafhorst marketing Co Ltd 13taxman.com 104(Mum-Trib)*
- *Tecnimont ICB P Ltd. v ACIT vs ACIT 24taxman.com28(Mum-Trib)*
- *William Hare India P Ltd vs ACIT (ITA 2071/Mds/2012)*

20. The AR, therefore submitted that in case results of Dolphin Medical Services Ltd. is included, as included by the assessee before the TPO/DRP, then the margin shall come within the +/-5% range and therefore no adjustment of Rs. 2,04,84,562/- shall be required. To substantiate, the AR gave the following comparison

Sr. No.	***Name of the Comparable***	***Final Comparables Margin as per DRP's Direction***	***Final + Dolphin Medical***
1	*Choksi Laboratories Ltd*	*23.67%*	*23.67%*
2	*TCG Lifesciences Ltd*	*41.33%*	*41.33%*
3	*Vimta Labs Ltd*	*13.04%*	*13.04%*
4	*Jubilant Chemsys Ltd*	*27.18%*	*27.18%*
5	*GVK Biosciences Pvt. Ltd*	*16.61%*	*16.61%*
6	*Siro Clinpharm Pvt Ltd*	*25.59%*	*25.59%*
7	*Syngene Intl Ltd.*	*28.87%*	*28.87%*
8	*Research Support Intl Pvt Ltd*	*23.30%*	*23.30%*
9	*Aurigene Discovery Technologies Ltd.*	*16.23%*	*16.23%*
10	*Dolphin Medical Services Ltd*	-	*7.14%*
	Average margins of comparables	***23.98%***	***22.30%***
	Margin of Watson Pharma Pvt Ltd.		***17.43%***

<u>Computing of +/-5% Range</u>

Particulars		***Amount***	***Amount***
Total Cost	*A*	*31,25,25,091*	*31,25,25,091*
Arm's Length Operating Profit Margin	*B*	*23.98%*	*22.30%*
Arm's Length Operating Profit	*C=A*B*	*7,49,43,517*	*6,96,80,594*
Arm's Length Operating Income	***D=A+C***	***38,74,68,608***	***38,22,05,685***
Value of International Transaction	***E***	***36,69,84,790***	***36,69,84,790***
Difference between Arm's length price of operating income and value of international transaction	*F=D-E*	*2,04,83,818*	*1,52,20,895*
5% of value of international transaction		*1,83,49,240*	*1,83,49,240*
Transfer Pricing Adjustment		***2,04,83,818***	***NIL***

21. In the above analysis, what is seen and to be decided is whether to include the results of M/s Dolphin Medical Services Ltd. or not. From the final analysis, except for M/s Dolphin, all other comparables as taken by the TPO are accepted by the assessee.

22. As per the submissions of the AR and DR, we find that the reasoning given by TPO to exclude Dolphin was primarily on an argument that functioning of Dolphin Medical Services Ltd. is different. How it is different, the revenue authorities did not make elaborate analysis. On the other hand, the AR submitted detailed reasoning before the revenue authorities and now before us, as to why the assessee had included the results of Dolphin.

23. The AR submitted that functional profile of Dolphin was broadly similar to that of the assessee. The AR submitted that besides the OECD Guidelines issued in July 2010 in para 2.62, and the relevant Income Tax Rules 1962 i.e. Rule 10b(2) also emphasize that functionally similar companies can be treated as comparables. The AR submitted that Dolphin is into the business of clinical trial services, which is broadly similar to the function of the assessee. This fact, it is noted is not countered by the DR, who submitted that when TPO and DRP have excluded the results of Dolphin, then it is necessary that the results should be kept excluded. This bald reasoning, in our view cannot be reasonable ground for exclusion. The coordinate Benches at the ITAT at Mumbai, Chennai and Bangalore have consistently came to the conclusion that functionally similar comparables have to be taken. In GE India Technology Centre (P) Ltd. vs. DCIT 30 taxman.com 249 (Bang) in para 34, it has been observed,

> *"In general, closely comparable products/services are required if the comparable uncontrolled price (CUP) method is used for arms' length pricing, the resale price, cost-plus methods generally require a lesser degree of products or services comparability and may be appropriate if functional comparables are available. The TNMM requires only broadly functional end product/services comparability. In many instances, it will be possible to use imperfect comparables, e.g. comparables from another industry sector, possibly adjusted to eliminate or reduce the differences between them and the controlled transaction. Hence, contention that comparables have to be of R&D companies from the same industry is not appropriate for TNMM".*

The AR also placed reliance on the decision of of the coordinate Bench at Mumbai, in the case of Lloyds TSB Global Services P Ltd. v DCIT 33.taxman.com 259 (Mum-Trib), wherein it has been observed in para 22 of the order,

> *"Moreover, going by functional profile specifically that ICRA Management Consultant Services, prima facie, it is seen that it is also engaged in the business of support servces like stategy risk management, process consulting, transaction advisory policy and regulation and development consulting. These functions are, by and large, similar to the assessee's activities. Therefore, this company on merits also is includable in the set of companies".*

In the case of ACIT v Schafhorst Marketing Co. Ltd. 13 taxman.com 104 (Mum-Trib), in para 14 of the order, it has been held,

> *"TNMM is more broad based and the variation in the type of services, as in this case can be absorbed in this method".*

In the case of Tecnimont ICB P Ltd. v ACIT vs ACIT 24 taxman.com 28(Mum-Trib) in para 10, it has been observed,

> *"The assessee had submitted that while it was engaged in mainly execution of engineering services through specilised software, ICBC was engaged in mainly execution of electrical and instrumentation projects, including onsite erection and allied activities which were labour intensive, but the transactional net margin method is more tolerant to differences in functions. It cannot be open to him to contend that there are slight differences at functional level and, for that reason alone, comparables should be rejected".*

The AR also placed reliance on the decision of William Hare India P Ltd. vs ACIT (ITA 2071/Mds/2012), and submitted that the deision was more on the point of view that in TNMM functional comparability is important then product similarity.

24. In the light of the above, we are of the considered opinion that results of Dolphin should not be excluded, as Dolphin is

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functionally acceptable comparable, whereby, the resultant PLI shall fall within safe harbor of +/-5 and no adjustment shall be required.

25. We therefore, direct the revenue authorities to delete the addition made on contract research and development segment, made at Rs. 2,04,84,562/-.

26. Another aspect intrinsically attached to the above ground is the risk adjustment, not taken into consideration by the TPO/DRP. It had been contended

> *"Before Hon'ble DRP, Assessee contended that economic adjustment for difference in risk profile of Assessee vis-à-vis comparables should be allowed for following reasons:*
> *Research and Development activities pertaining to pharmaceutical industry (clinical trial, chemical research, formulation development etc) can be broadly classified under two models (a) where risks are borne by service provider and (b) where risks are not borne by service provider. By and large, all Indian research and development service providers would fall under category (a) whereas research and development service providers set by multinational companies in India would fall under category (b) Contract research and development service providers set by multinational companies operate on shared service concept basis. Revenue models are generally cost plus. They do not take any entrepreneurial liability and associated risks as parent compensates for all costs. No marketing element involved.*
> *Entire risk of research and development activities undertaken by Assessee resides with the AE. Even if the Assessee's research and development fails to meet the objectives, still it would recover the total cost of research and development plus mark up.*
> *Assessee performs as captive service provider and thus assumes limited risks. Accordingly, risk adjustment should be allowed for difference in risk of Assessee vis-à-vis comparable companies in India.*
> *On this point Assessee placed reliance on Rule IOB (1)(d)(iii) of the Rules and OECD Transfer Pricing Guidelines Para 1.23*
> *Also reliance was placed on the decision of Pune ITAT in the case of E-Gains (ITA No. 1685/ PN/ 2007) Reference also made to Rule 10B(3)*
> *vi. Contention of TPO/DRP*
> *17. Hon'ble DRP held that the Assessee has made the claim for risk adjustment in a routine manner and no facts or other material has been brought on record to*

specify such risk adjustment computation. Accordingly, placing reliance on following rulings, DRP denied to grant risk adjustment (Page 7 of DRP Order):
The primary contention of revenue was computation not provided.
Wills Processing Services vs. DCIT(2013)
Marubem India (P) Ltd vs. DCIT
Interra Information Technologies India Pvt. Ltd. vs. DCIT (2013)
General Atlantic Pvt. Ltd. vs. ACIT (2013)
vii. Argument of the Assessee before Hon'ble Income Tax Appellate Tribunal Risk Adjustment should be allowed
17. In case Dolphin Medical Services Ltd is added to the comparables set then the Assessee's margin falls within +/- 5% range. Therefore in such case risk adjustment would become academic. However, assessee's argument for risk adjustment are as follows:
19. Before Your Honor's the Assessee would like to submit that risk adjustment should be allowed for following reasons:
19.1 Assessee vide submission dated 17/09/2013 has filed detailed working of risk adjustment using CAPM (Capital Asset Pricing Model) Method before Hon'ble DRP (refer page no. 314 to 316 of the paper book for submission of Risk Adjustment made to Hon'ble DRP)
19.2 Research and development activities pertaining to pharmaceutical industry (clinical trial, chemical research, formulation development etc) can be broadly classified under two models (a) where risks are borne by service provider and (b) where risks are not borne by service provider
19.3 By and large all Indian research and development service providers would fall under category (a) whereas research and development service providers set by multinational units would fall under category (b)
19.4 Contract Research and development service providers set by multinational companies operate on shared service concept basis. Revenue models are generally cost plus. They does not take any entrepreneurial liability and associated risks as parent compensates for all costs. No marketing element involved
19.5 Assessee performs as captive service provider and thus assumes limited risks
19.6 Entire risk of research and development activities undertaken by Assessee resides with the AE. Even if the Assessee's research and development fails to meet the objectives still it would recover the total cost of research and development plus mark up
19.7 Further Assessee would like to place reliance on ruling in case of Motorola Solutions India Private Limited vs. ACIT (ITA No. 5637/Del/2011) wherein CAPM method of computing risk adjustment has been upheld by the Hon'ble Delhi Bench of Income tax Appellate Tribunal
Thus, risk adjustment should be allowed in the case of Assessee".

27. On going through the rival contentions, we are of the view that on the issue of risk adjustment, detailed analysis had been provided. Since we have allowed the inclusion of PLI results of Dolphin, the adjustment fell within the +/-5% range. The AR submitted that The assessee being a captive service provider hence undertakes lesser risk as compared to comparable companies which undertakes higher risk. This fact has not been disputed by the revenue authorities. Mumbai Bench of Income Tax Appellate Tribunal in the case of Symatec (supra) contemplates the standard deduction of 5% for risk adjustment. However, if not 5% then risk adjustment upto 2.25% which is the difference between Bank Fixed deposit rate (which undertakes little more risk) and risk free government bond (which undertakes risks) should be allowed. The AR further submitted that even if minimum risk adjustment at rate of 1% is allowed, even then the assessee shall fall within the tolerance range of +/-5% as per second proviso to section 92C(2) of the Act.

28. Even when we consider the risk adjustment, the assessee's case would fall within the tolerance range and therefore, no TP adjustment would be called for.

29. Adjustment of location saving on contract manufacturing of Rs. 25,19,22,871/- and contract R & D of Rs. 9,04,34,392/-.

30. The assessee is engaged in providing contract manufacturing and contract research & development services to its AE(s). In consideration of the said services, the AE(s) compensate the assessee on a total operating cost plus arm's-length mark-up basis. In the Transfer Pricing Study Report prepared by the assessee, search was performed to identify comparable companies engaged in providing

similar Pharmaceutical contract manufacturing and contract research and development services in India.

31. During the course of proceeding before the DRP, TPO/DRP accepted the TNMM method and also the comparables selected by assessee for benchmarking contract manufacturing services provided by the assessee to its AEs.

32. However, the TPO/DRP contended that the assessee ought to have received extra compensation on account of location savings over and above the margins earned by the comparables. The TPO/DRP then proceeded with the computation of location savings by use of articles appearing in journals and websites.

33. The TPO/DRP, allocated the location savings on ad-hoc basis by dividing the savings equally between Assessee and its AE. Based on this approach TPO/DRP made an adjustment of Rs. 34,23,57,263/- on account of location savings in respect to the contract manufacturing segment and contract research and development segment. The break-up of the adjustment is as follows:

Sr. No.	***Particulars***	***Amount***
1	*Location Savings adjustment in respect to Contract Manufacturing segment*	*25,19,22,871*
2	*Location Savings adjustment in respect of Contract R & D segment*	*9,04,34,392*
	Total Location Savings adjustment	***34,23,57,263***

The contentions of the TPO for making such an adjustment on account of locations savings are that the main aim of Watson Group is to reduce cost by transferring several solid dosage products from its facilities in US to Watson India's facilities in Goa, India by referring to 10K (public document) filed by Watson India.

34. In the proceedings before the TPO, TPO called for the details of cost of manufacturing in USA and ultimate selling price to the distributors in respect of products manufactured in assessee's facility in India. These details were not filed by assessee, as the assessee was not privy to such details of its AE. Since the assessee did not provide these details, being not available with it, the TPO assumed that the location savings does arises and therefore results into increased profits *or location rents.*

35. TPO therefore, relied on US Tax Court's Cases on Location savings namely

Sundstrand Corporation and Subsidiaries vs. Commissioner (Fiscal Year 1977-78)
Compaq Computer Corporation and Subsidiaries vs. Commissioner (Fiscal Year 1986-92)
Eli Lily & Co vs. US (Fiscal Year 1971-72)
National Semiconductor Corporation vs. Comm (Fiscal Year 1976 to 1981)
Bausch & Lomb vs. Comm (Fiscal Year 1980)

36. TPO also relied on the position taken by India tax administration in UN TP Manual Chapter 10.

37. Further, TPO held that the assessee did not prove with proper documentary evidence that Watson's competitors in USA having manufacture base in India, so that all the competitors are in sync, and thus made the basis to reduce the prices due to cost savings arising in India

38. In order to allocate location savings, TPO relied upon a research article on the website of Frost and Sullivan, written by Aiswariya Chidambaram in respect of Contract Manufacturing segment and an article "Clinical Trial Magnifier Vol. 1:6 June 2008" in respect of Contract R&D segment.

39. Based on these articles TPO concluded that, in case of

Contract Manufacturing, cost in India is around 40% of cost in USA (excluding raw material cost) and in case of Contract R&D, the cost of R&D in India (excluding raw material cost) is around 50% of cost in USA.

40. TPO thus computed location savings and apportioned the same on basis of 50:50 ratio between the assessee and its AE. He therefore, suggested an adjustment of Rs. 25,19,22,871/-.

41. Aggrieved by this adjustment/addition, the assessee approached the DRP.

42. Before DRP, the assessee contented that adjustment in respect of location savings is not warranted because, the assessee had complied with the provisions of Section 92C(1) and 92C(2) of the Act for determining arm's length price of international transactions with AE. That the TPO erred in disregarding the transfer pricing analysis carried out by the assessee and has failed to appreciate that in the case of the assessee none of the conditions set out in Section 92C(3) of the Act get satisfied.

43. It was argued that the assessee does not have exclusive access to the factors that may result in the location specific advantages. As a result, there is no super profit that arises in the entire supply chain.

44. It was further pointed out that the comparables selected by the assessee are local Indian comparables, operating in similar economic circumstances as the assessee, and accordingly, if at all, there is any benefit on account of location savings, that has already got embedded in the operating margins of the comparable companies. On this point assessee relied on the decision of the coordinate Bench of the

ITAT at Delhi, in the case of GAP International Sourcing (India) Pvt. Ltd. vs ACIT, reported in 149 TTJ 437 (Del ITAT) wherein it was held that:

> *"The arm's length principle requires benchmarking to he done with corn parables in the jurisdiction of tested party and the location savings, if any, would be reflected in the profitability earned by corn parables which are used for benchmarking the international transactions. Thus in our view, no separate /additional allocation is called for on account of location savings".*

45. The AR submitted that the assessee operated in perfectly competitive market and does not have any monopoly in the market in which they operate. If in case, there exists any location savings because of market forces, they would be passed on to the final customer of Watson US. *(DRP Form 35A, Page 40-43)*

46. The assessee further submitted before the DRP that the arm's length allocation should be determined based on the bargaining power of the assessee as well as the AE. In the instant case, the AE has operations across the globe and could procure the finished goods/services either from the assessee or any other group companies or even third parties. Thus, there are various alternatives available to AE, which confers bargaining power in hands of the AE. Besides this, there are numerous third party contract manufacturing and R&D service providers in India, which could provide bargaining power to the AE.

47. In any case, as per OECD Guidelines, location savings is not an intangible asset, till such time, where specific advantages are capable of being owned or controlled by an individual enterprise.

48. Profit Split method would be applicable mainly in international transaction involving transfer of unique

intangibles, or where international transactions are so interrelated that they cannot be evaluated separately. In the instant case, location specific advantages cannot be called as intangible asset. Thus, the TPO's approach of following India chapter in UN TP Maunal (which is the opinion of tax administration and not the view of Indian Government) which advocates use of profit split method for allocation of location savings is not correct.

49. The assessee also argued that once it is remunerated at an arm's length price by taking regular comparables under this jurisdiction then no location saving is to be attributed. This argument of the assessee was rejected by the DRP stating that it cannot be said that the assessee has been remunerated at the arm's length price. In support of its contention assessee has submitted that as its margins are better than full fledged manufacturers of pharma in India or research and development service providers, the price realized by it from its AE is at arm's length. However in this regard comparing profits is not reliable. As stated by the assessee, it is selling generic pharma products to its AE for which there are number of competitors in the market. So, the more reliable measure of the arm's length price will be sale price of *other manufacturers in USA.*

50. DRP further asked assessee to provide information relating to sale price prevailing in the US market in respect of the goods exported by the assessee to its AE. Assessee furnished a reply dated December 17, 2013 wherein details of only 19 stock keeping units (SKUs) (out of 79 SKUs) was available with customs database which comprised of only 23 crores of assessee's exports. Each unit of product exported is termed as Stock Keeping Units. It was observed that assessee is not

earning arm's length profit as price to AE in 5 out of 19 cases are unfavorable. No details of comparable prices was given with respect to balance 100 crores i.e. balance 60 SKUs. In the absence of details of sales prices with respect to SKUs it cannot be said that the assessee is deriving arm's length price for goods supplied to its AE. Assessee did not submit any evidence that location savings has been passed on to the end customer.

51. DRP, to strengthen its case, referred to a table showing prices at which assessee has exported to AE and comparable retail price of same drug in India which also shows that the sale price in India is higher than assessee's sale price in most cases. It was also observed that the assessee failed to produce relevant information in respect of the Contract R&D services and thereby attribution to income under that segment remained unverifiable. It also observed that the assessee failed to show that there was no location savings by not producing details of cost of production of the products manufactured by assessee, before and after the transfer of manufacturing site to India.

52. DRP, on these grounds sustained the approach of TPO and upheld the adjustment on account of location savings. According to the DRP, *Conditions of section 92C(3) have been fulfilled as the information asked by TPO was not produced by the assessee. That the assessee failed to show that there was no location savings by not producing details of cost of production of the products manufactured by assessee, before and after the transfer of manufacturing site to India. That the AE's Annual Report clearly refers to relocation of manufacturing facility.*

53. The DRP, therefore, sustained the additions made by the AO/TPO.

54. Against this order of DRP, the assessee, now is in appeal before the ITAT.

55. Before us the AR reiterated the submissions made before the revenue authorities and submitted that adjustment on account of location savings is not at all warranted, as location saving arises in not perfectly competitive market. In the case of the assessee there is no economic rationale for location savings adjustment as Watson US faces stiff competition in the US market which is evident from the Annual Report of Watson Pharmaceutical Inc. (Page 10 & 32 of Form 10K and DRP Form 35A Page 41 to 43). The relevant extract of Form 10K of Watson Pharmaceutical Inc. is as follows:

> *"We actively compete in the generic pharmaceutical industry. Revenues and gross profit derived from the sales of generic pharmaceutical products tend to follow a pattern based on certain regulatory and competitive factors. As patents and regulatory exclusivity for brand name products expire or are successfully challenged, the first off-patent manufacturer to receive regulatory approval for generic equivalents of such products is generally able to achieve significant market penetration. As competing off-patent manufacturers receive regulatory approvals on similar products, market share, revenues and gross profit typically declines, in some cases dramatically. Accordingly, the level of market share, revenues and gross profit attributable to a particular generic product normally is related to the number of competitors in that product's market and the timing of that product's regulatory approval and launch, in relation to competing approvals and launches. Consequently, we must continue to develop and introduce new products in a timely d cost-effective manner to maintain our revenues and gross profit. In addition to competition from other generic drug manufacturers, we face competition from brand name companies in the generic market. Many of these companies seek to participate in sales of generic products by, among other things, collaborating with other generic pharmaceutical companies or by marketing their own generic equivalent to their brand products as Authorized Generics. Our major competitors in generic products include Teva Pharmaceutical Industries, Ltd., Mylan Inc., Mallinckrodt*

Pharmaceuticals Generics (a subsidiary of Covidien AG) and Sandoz." (refer page 10 of Form 10K)

"Revenues and gross profit derived from the sales of generic pharmaceutical products tend to follow a pattern based on certain regulatory and competitive factors. As patents for brand name products and related products exclusivity periods expire. The first generic manufacturer to receive regulatory approval for generic equivalents of such products is generally able to achieve significant market penetration. As competing off-patent manufacturers receive regulatory approvals on similar products or as brand manufacturers launch generic versions of such products (for which no separate regulatory approval is required), market share, revenues and gross profit typically decline, in some cases dramatically. Accordingly, the level of market share, revenue and gross profit attributable to a particular generic product normally is related to the number of competitors in that product's market and the timing of that product's regulatory approval and launch. Consequently, we must continue to develop and introduce new products in a timely and cost-effective manner to maintain our revenues and gross margins. Additionally, as new competitors enter the market, this may increase pricing pressure on certain products, which would result in lower gross margins. This is particularly true in the case of certain Asian and other overseas competitors, who may be able to produce products at costs lower than the costs of domestic manufacturers. If we experience substantial competition from Asian or other overseas competitors with lower production costs, our profit margins will suffer". (page 32 of Form 10K)

Many of the Watson's peer group companies in North America have themselves outsourced manufacturing and/or research facilities in India or China. This is evident from the Form 10K of peer group companies i.e. Mylan Inc. and Teva Pharmaceutical Industries Ltd.

56. According to the AR, neither Watson US (i.e. AE) nor the assessee have any monopoly in the market in which they operate and neither the assessee has general access to all the location specific advantages. Accordingly, if there exists any location savings because of market forces, they would be passed on to the ultimate customers of Watson US (i.e. AE). On this point the AR relied on the decision of Hon'ble Delhi Income Tax Appellate Tribunal in the case of GAP International Sourcing (India) Pvt. Ltd vs. ACIT (2012) 149 TTJ 437 (Del ITAT) at Para 9.2 (vii) Page 43 held, *"… the intent of sourcing from low cost countries for a manufacturer/retailer is to survive in stiff competition by providing a lower cost to its end-customers.*

Generally, the advantage of location savings is passed onto the end-customer via a competitive sales strategy....". The AR to clarify that no additional evidence had been submitted, submitted that the 10K document, as referred to in the arguments, is a public document and therefore, it cannot be taken to be additional evidence.

57. The AR reiterated that in any case, benefit on account of location savings (if any) is factored in the profit margin of the local comparables selected for benchmarking the international transaction. The AR *placed reliance on case of GAP International (Supra) and Action 8: Guidance on Transfer Pricing Aspects of Intangibles (OECD/G20 Base Erosion and Profit Shifting Project).*

58. After hearing the detailed arguments from either side, and after going through the evidence and the case cited before us, we are of the opinion, that the assessee as well as the AE operates in a perfectly competitive market and the assessee does not have exclusive access to the factors that may result in the location specific advantages. As a result, there is no super profit that arises in the entire supply chain. Thus there is no unique advantage to the assessee over competitors. We are basing our opinion on the fact that the revenue authorities were not able to substantiate the adjustments made either from the present day scenario or any authenticated and globally material.

59. The factum of non submission of details became the subject matter of dispute in the case of UCB India (P) Ltd. vs ACIT, reported in 124 TTJ 289, wherein the Special Bench held, *"The assessee's case is that it has never prepared the records as laid down by Rule 10D(1)(f). When no such analysis or estimates*

or forecasts or budgets are prepared by the assessee for its business, non furnishing of such non existent records cannot lead to a conclusion that the assessee has not furnished the information and documents prescribed under r. 10(D(1)(f). The maintenance of these records is procedural and non maintenance of the same is not such that it would affect the determination of ALP.....". The Special Bench in this case noted that the relevant provisions have used the words *"if any"*, which means that non submission of records cannot form the basis of making adjustments in the ALP on bald assertions. In such a case, we are of the opinion that one of the reasons for making ALP adjustment is without any basis.

60. We find that the comparables selected by the assessee to determine arm's length price of transaction relating to contract manufacturing and contract research and development are local Indian comparables operating in similar economic circumstances as the assessee. This according to us are in line with the decision of coordinate bench of the ITAT, Delhi, in the case of GAP International Sourcing (India) Pvt. Ltd. *(supra)*, wherein the Tribunal held,

> *"The arm's length principle requires benchmarking to be done with comparables in the jurisdiction of tested party and the location savings, if any, would be reflected in the profitability earned by comparables which are used for benchmarking the international transactions. Thus in our view, no separate/ additional allocation is called for on account of location savings".*

61. Further, OECD and G20 in *Action 8: Guidance on Transfer Pricing Aspects of Intangibles* which is part of Base Erosion and Profit Shifting Project, has provided guidance on issue of location savings and concluded that where local market comparables are available specific adjustment for location saving is not required. All the G20 countries have give their concurrence to this position and India is part of G20

countries. Relevant extracts of Action 8 are as follows:

> *"1.83 Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required".*

62. Further, we are of the opinion that, the calculation based on location savings by TPO is also infirm, as it is based on assumptions and not in accordance with the provisions of the Income Tax Act, 1961, because for computing cost savings TPO has relied on an article published in year 2012 whereas assessee's case is for Financial Year 2008-09. Therefore interpolation cannot be taken into consideration, unless specified.

63. For determining cost of production (in case of contract manufacturing segment) and cost of conducting research and development activities (in case of contract research and development segment) in developed/western countries, TPO relied on following articles:

Sr. No.	***Relevant segment of Watson India***	***Article relied upon***
1	*Contract manufacturing segment*	*Indian Generic Pharmaceuticals Market-A Snapshot* *(Source:- http://www.frost.com/sublib/display-marketinsight-top.doid=264038078)*
2	*Contract R&D segment*	*Clinical Trial Magnifier Vol. 1:6 Jun 2008 (source: www.clinicaltrial magnifier.com*

64. At the outset, the above reliance could not be treated as acceptable, because, these were web articles and not accepted by any forum. In any case, if at all, this aspect has to be considered, then it has to be considered in the context of the AE and not the assessee, because the tested party is the

assessee and the international transaction entered into by the assessee has to be tested by comparing the same with uncontrolled, unrelated comparable transaction, as held in the case of Syscom Corporation Ltd. vs ACIT, reported in 35 taxmann.com 600 (Mumbai - Trib).

65. The tested party is the assessee and the international transaction entered into by the assessee has to be tested by comparing the same with uncontrolled, unrelated comparable transaction only and not in the context of AE. The issue of comparability analysis, was dealt with by the coordinate Bench of the Mumbai ITAT, in the case of Lloyds TSB Global Services (P) Ltd., reported in 33 taxmann.com 259, wherein the ratio laid down was, *"For carrying out comparability analysis, it is to be seen as to whether comparable company is comparable having regard to characteristic of property and services, functions performed, assets used and risk assumed"*.

66. The concept of Transfer Pricing is based on the principle that instead of entering into a transaction with related party, if the assessee had entered into a similar transaction with unrelated party, what would have been the prices of said transaction between the assessee and unrelated party. The comparison is always in the context of the effect of the related party transaction and unrelated party transaction in the hands of the assessee. Therefore, the financial results of the AE are not at all relevant for the purpose of determination of arm's length price in relation to the international transaction entered into by the assessee. This ratio laid down by the Co-ordinate Bench at t Mumbai in the case of *Syscom Corporation Ltd. vs. ACIT, reported in 35 taxmann.com 600 (Mumbai - Trib.). Relevant extract of the Syscom Corporation Ltd. (supra) is as follows:*

> *"In the ground No. 14 the assessee has raised the ground that the AE of the assessee has been consistently suffering from operational loss and therefore no adjustment can be made in respect of international transaction. We have heard the Ld. AR as well as the Ld. DR and considered the relevant material on record. Under the Transfer Pricing regulation/provisions the testing party is the assessee and the international transaction entered into by the assessee has to be tested by comparing the same with uncontrolled, unrelated comparable transaction, Therefore, the price of international transaction in the hand of the AE of the assessee is absolutely irrelevant. The concept of Transfer Pricing based on the principle that instead of entering into a transaction with related party if the assessee had entered into a similar transaction with unrelated party what would have been the prices of said transaction between the assessee and unrelated party. The comparison is always in the context of the effect of the related party transaction and unrelated party transaction at the hand of the assessee. Therefore, the financial results of the AE are not at all relevant for the purpose of determination of arm's length price in relation to the international transaction entered into by the assessee. Accordingly, we do not find any merit in the ground raised by the assessee. The same is dismissed".*

67. Thus, once the TNMM method is accepted as method of considering assessee as a tested party then any benefit/advantage accruing to AE is irrelevant if the PLI is within the range of comparables.

68. The facts in the decision relied upon by the TPO, are completely different as compared to assessee's case as these case laws were related to the fiscal years (1970's and 1980's) in which economic scenario was completely different but in so far as present scenario is concerned, primitive. Further in above mentioned case, taxpayers were not operating in perfectly competitive market unlike in the case of the Assessee. Summary bringing out difference in facts is provided below:

Sr. No.	Name of case law	Facts in this case	Outcome	Distinguishing points
1	**Sundstrand Corp. & Subs vs. Comm. (Fiscal Year 1977-78)**	Location Savings estimated with the costs of setting up/ operating new hypothetical US factory. Manufacturing license agreement gave to Singapore subsidiary monopolistic position. A third party would have kept all location savings. **(Page 9 of TPO Order)**	Location savings 100% to low cost manufacturer	• It is evident that the Singapore subsidiary (contract manufacturer) had monopolistic position in the market unlike our case. Thus due to monopolistic position the contract manufacturer itself enjoyed location saving rather than passing it on to end user/ ultimate customer. The assessee functions in perfectly competitive market. Thus there is no question of retaining any benefit arising on account of location saving **(refer page 10 of the TPO Order).**
2	**Compaq Computer Corp & Subs vs. Comm. (Fiscal Year 1986-92)**	Electronic circuits market is global and a world price should have been produced by competition within the market; moreover Compaq Asia had market power resulting from its ability to meet the product quality and flexibility requirements of its customer. Thus relevant market was US and Court accepted CUP paid by Compaq to unrelated subcontractors **(Page 10/11 of the TPO Order)**	Location savings 100% to low cost manufacturer	• The contract manufacturer was the only manufacturer in Asian Market that could meet the quality standards and provide the product flexibility that its foreign AE needed. Thus it had unique market advantage. Under this scenario location saving was retained with contract manufacturer. Whereas the assessee functions in perfectly competitive market. Thus there is no question of retaining any benefit arising on account of location saving **(refer page 10 of the TPO Order).** • Further there was no separate adjustment on account of location saving since the Court has accepted margin of comparables computed using CUP method. Similarly in our case as well, main argument is to rely on comparables (profit margin in instant case). • Compaq Asia owned the intellectual property whereas no intellectual property is owned by the assessee

	1980)	a mere subcontractor given that neither volumes nor prices were guaranteed		contract manufacturer was at arm's length or not • No prices nor volume were guaranteed in B&L's case, whereas in appellant case since total cost plus mark up was adopted, pricing was guaranteed.
3	**Eli Lily & Co. vs. US. (Fiscal Year 1971-72)**	US parent purchased pharmaceuticals from Puerto Rican subsidiary and resold them in the US. Combined profit split as follows: returns to routine functions (production – 100% to Puerto Rico and selling 100% to US). Location savings (100% to Puerto Rico) and return on intangibles (55% Puerto Rico for IP – 45% US for marketing intangibles)	Location savings 100% to low cost manufacturer	• No intangibles were transferred to assessee whereas intangibles were transferred to Puerto Rico subsidiary. Thus Puerto Rico subsidiary had IP rights and hence location savings was attributed to Puerto Rico subsidiary. However, in our case appellant has no such IP's.
4	**National Semiconductor Corp. vs. Comm. (Fiscal Year 1976 to 1982)**	Mutually dependent business relationship. NSC US needed the labour cost savings provided by NSC Asia to remain competitive and NSC Asia needed a high and steady volume of orders to justify heavy investments in equipment etc. At arm's length NSC Asia could not afford to risk losing NSC US's business by allowing NSC to suffer heavy losses	Mutually dependent business relationship implies that location savings should be shared between parent and subsidiary	• This was case where both the parties were mutually dependent on each other for their survival. However, in assessee's case AE is not dependent on assessee as it has other plants of its own in Florida & California plus other external FDA approved options.
5	**Bausch & Lomb vs. Comm. (Fiscal Year**	Implicitly allocated location saving to subsidiary by rejecting its characterization as	Location savings 100% to low cost manufacturer	• Location saving was never an issue in this decision. The actual issue was whether remuneration paid by foreign AE to

69. We also take into consideration the reliance placed on UN TP Manual by the TPO, about which we are convinced was incorrect reliance, because UN Manual, is basically view of Indian tax administration and is not binding on Appellate authorities, the relevant extract of which is given below:

> *"consensus has been sought as far as possible, it was considered most in accord with a practical manual to include some elements where consensus could not he reached, and it follows that specific views expressed in this Manual should not he ascribed to any particular persons involved in its drafting. Chapter 10 is different from other chapters in its conception, however. It represents an outline of particular country administrative practices as described in some detail by representatives from those countries, and it was not considered feasible or appropriate to seek a consensus on how such country practices were described. Chapter 10 should be read wit/i that difference in mind".*

70. In fact in *Action 8: Guidance on Transfer Pricing Aspects of Intangibles* issued by OECD and G20 states that where local market comparables are available specific adjustment for location saving is not required. G20 countries have also give their concurrence to this position and India is part of G20 countries.

71. This, in any case is inconsistent with TPO's own approach for assessment year 2008-09.

72. In assessment year no adjustment has been made by the TPO on account of alleged location savings on Contract Manufacturing and Contract Research and development segment of the assessee. As the facts in assessment year 2009-10 are same as in the current year, i.e. 2008-09, no location saving adjustment should be allowed to be made. On this point Assessee would like to place reliance on the following decisions wherein it has been held that in the absence of any material change in the circumstances no different view can taken by assessing officer then taken in earlier year.

73. The issue gets strength from the decision of the coordinate Bench at Mumbai in the case of Tecnimont ICB (P) Ltd. vs Add. CIT, reported in 24 taxmann.com 28, wherein the Third Member decision held, *"Net profit margin realized from a transaction with an AE cannot be taken as a comparable being internal comparable for computation of ALP of an international transaction with another AE even though said net margin from a transaction with AE is found and accepted as ALP".*

74. Last but not the least, the TPO has based his computation on a method, which is not ascribed by the provisions of the Act. No doubt, clause (f) of section 92C(1) says, *"such other method as may be prescribed by the Board"*. For adoption of this method, the TPO has to take care that the method has to be prescribed by the Board, which can do so through relevant Rules. Even relevant Rules do not talk about the method adopted by the revenue authorities. This, in unison with the decision of the coordinate Bench on incorrect method of computation, we are of the view that the TPO/AO and DRP erred in making the adjustment on account of location savings.

75. We, therefore, set aside the order of the DRP and direct the AO to delete the addition.

76. Ground no. 6 pertain to directing the revenue authorities to make adjustments, taking into account the safe harbor range of +/- 5%. Since the safe harbor range has been allowed by the legislature itself, the revenue authorities are bound to follow the same.

77. Since we have set aside the order of the DRP, we, direct the AO to consider the safe harbor zone and compute the income

accordingly.

78. Ground no. 6, is therefore, treated as allowed.

79. Grounds no. 4 & 5 pertain to disallowing interest income of Rs. 2,10,65,566/- for the purposes of computing deduction u/s 10B.

80. The AO found that the assessee had taken into consideration the income generated as interest and sale of scrap, for the purposes of computation of deduction u/s 10B. He treated the same as income from other sources, being not derived from the operations of business. He relied on various decisions, which were countered by the assessee, but the AO excluded the income from interest and sale of scrap from the computation.

81. Against this, the assessee along with TP issues approached the DRP, who sustained the disallowance made by the AO.

82. Against these disallowances, the assessee is now before the ITAT.

83. Before us, the AR submitted that the instant issue is covered by the decision in the case of Maral Overseas Ltd. vs Add. CIT, reported in 16 ITR 565 (Trib-Indore) and also by the Bangalore Bench of the ITAT in the case of GE India Technology Center (P) Ltd. vs DDIT, reported in 30 taxmann.com 249 (Bang) and is now covered by the Hon'ble Karnataka High court in the case of CIT vs Motororala India Electronics (P) Ltd. reported in 265 CTR 94, wherein it has been observed,

> *"For the purposes of sub-section (1), the profits derived from export of articles or things or computer software shall he the amount which bears to the profits of the business of the undertaking, the same proportion as the export turnover in respect of such articles or things or computer software bears*

to the total turnover of the business carried on by the undertaking.

By Finance Act, 2001, with effect from 01.04.2001, the present Subsection (4) is substituted in the place of old Subsection (4). No doubt Subsection 10(B) speaks about deduction of such profits and gains as derived from 100% EOU from the export of articles or things or computer software. Therefore, it excludes profit and gains from export of articles. But Subsection (4) explains what is the profit derived from export of articles as mentioned in Subsection (1). The substituted Sub-section (4) says that profits derived from export of articles or things or computer software shall be the account which hares to the profits of the business of the undertaking and not the profits and gains from export of articles. Therefore, profits and gains derived from export of articles is different from the income derived from the profits of the business of the undertaking. The profits of the business of the undertaking includes the profits and gains from export of the articles as well as all other incidental incomes derived from the business of the undertaking. It is interesting to note that similar provisions are not there while dealing with computation of income under Section 80HHC. On the contrary there is specific provisions like Section 80HHB which expressly excludes this type of incomes. Therefore, in view of the aforesaid provisions, it is clear that, what is exempted is not merely the profits and gains from the export of articles hut also the income from the business of the undertaking.

8. In the instant case, the assessee is a 100% EOU, which has exported software and earned the income. A portion of that income is included in EEFC account. Yet another portion of the amount is invested within the country by way of fixed deposits, another portion of the amount is invested by way of loan to the sister concern which is deriving interest or the consideration received from sale of the import entitlement, which is permissible in law. Now the question is whether the interest received and the consideration received by sale of import entitlement is to be construed as income of the business of the undertaking. There is a direct nexus between this income and the income of the business of the undertaking. Though it does not par take the character of a profit and gains from the sale of an article, it is the income which is derived from the consideration realized by export of articles. In view of the definition of 'Income from Profits and Gains' incorporated in Subsection (4), the assessee is entitled to the benefit of exemption of the said amount as contemplated under Section 10B of the Act. Therefore, the Tribunal was justified in extending le benefit to the aforesaid amounts also. We do not find any merit in these appeals".

84. Similar view was taken in the decision rendered earlier by Hon'ble Bombay High Court in the case of CIT vs Lok Holdings, reported in 308 ITR 356 (Bom), wherein it was held,

"interest earned by the assessee, a property developers, by making temporary deposits of surplus money out of advances received by it from intending purchaser is business income and

cannot be assessed as "income from other sources".

85. In such a situation where the incomes sought to be taxed are intrinsically connected to the business of the assessee and also that provisions falling under section 10A & 10B form a code within the code, we are of the opinion that no disallowance is called for.

86. We therefore, set aside the order of the DRP and direct the AO to compute the deduction, taking into account the interest income as well as sale scrap as business income.

87. Ground no. 7 pertains to assessee's objection with regard to initiation of penalty u/s 271(1)(c).

88. This issue is premature and, therefore, we refrain ourselves to go into the merits of this stage. Hence the ground is rejected.

89. To come to the above opinion, we have taken into consideration all the case laws cited before us, out of which we have extracted the case laws and evidence, which according to us were important and relevant to the issues involved.

90. In the result, the appeal as filed by the assessee is treated as partly allowed.

ITA No. : 1565/Mum/2014 : Department Appeal :

91. The department has raised the following grounds:

> *"(i) Whether on the facts and circumstances of the case and in law, the Hon'ble DRP erred in directing the AO to allow deduction u/s 10B of the Act in respect of its Goa unit without setting off unabsorbed depreciation of another eligible unit situated in Ambernath relying on the decision of Hon'ble Bombay High Court in the case of Black & Veatch Consultancy (I) Limited [334 ITR 72].*
>
> *(ii) Whether on the facts and circumstances of the case and in law, the Hon'ble DRP erred in directing the AO to allow deduction u/s 10B of the Act in respect of its Goa unit without setting off unabsorbed depreciation of another eligible unit*

situated in Ambernath without taking cognizance of CBDT Circular F no. 279/Misc/M-116/2012-IT dtd. 16.07.2013
2. The appellant prays that the order of the DRP on the above grounds be set aside and that of the AO be restored.
3. The appellant craves leave to amend or alter any grounds or add a new ground which may be necessary".

92. Both the grounds are connected, we, therefore, take up the two grounds.

93. At the time of hearing, the AR submitted that the issue, as raised by the department is covered by the decision of Hon'ble Bombay High court in the case of CIT vs Black & Veatch Consulting Pvt Ltd. reported in 348 ITR 72 (Bom), wherein it has been held,

> *"… deduction under s. 10A, has to be given effect to at the stage of computing the profits and gains of business. This is anterior to the application of the provisions of s. 72 which deals with the carry forward and set off of business losses. A distinction has been made by the Legislature while incorporating the provisions of Chapter VI-A. Section 80A(1) stipulates that in computing the total income of an assessee, there shall be allowed from his gross total income, in accordance with and subject to the provisions of the Chapter, the deductions specified in ss. 80C to 80U. S. 80B(5) defines for the purposes of Chapter VI-A 'gross total income" to mean the total income computed in accordance with the provisions of the Act, before making any deduction under the Chapter. What the Revenue in essence seeks to attain is to telescope the provisions of Chapter VI-A in the context of the deduction which is allowable under s. 10A, which would not be permissible unless a specific statutory provision to that effect were to be made. In the absence thereof, such an approach cannot be accepted. Thus ITAT was correct in holding that the brought forward unabsorbed depreciation and losses of the unit the Income which is not eligible for deduction under s. 10A of the Act cannot be set off against the current profit of the eligible unit for computing the deduction under s. 10A of the IT Act. Brought forward unabsorbed depreciation and losses of unit the Income which is not eligible for deduction under s. 10A cannot be t off against current profit of the eligible unit for computing the deduction under s. 10A".*

94. The DR accepted the fact that the issue is in favour of the assessee in the light of the referred case law.

95. In the circumstance, we reject the grounds taken by the department.

96. As a result, the appeal, as filed by the department is dismissed.

To sum up:

Assessee's appeal in ITA No. 1423/Mum/2014 is treated as partly allowed;

Department appeal in ITA No. 1565/Mum/2014 stands dismissed.

Order pronounced in the open Court on 9th January, 2015.

Sd/-	**Sd/-**
(आर. सी. शर्मा)	**(विवेक वर्मा)**
लेखा सदस्य	**न्याईक सदस्य**
(R C SHARMA)	**(VIVEK VARMA)**
ACCOUNTANT MEMBER	**JUDICIAL MEMBER**

Mumbai, Date: 9th January, 2015

प्रति/Copy to:-

1) अपीलार्थी /The Appellant.
2) प्रत्यर्थी /The Respondent.
3) The DRP-II, Mumbai.
4) The CIT- Concerned ________, Mumbai.
5) विभागीय प्रतिनिधि "के", आयकर अपीलीय अधिकरण, मुंबई/
   The D.R. "K" Bench, Mumbai.
6) गार्ड फाईल
   Copy to Guard File.

आदेशानुसार/By Order

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उप/सहायक पंजीकार
आयकर अपीलीय अधिकरण, मुंबई
Dy./Asstt. Registrar
I.T.A.T., Mumbai

*चव्हान व.नि.स
*Chavan, Sr.PS