

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

% Judgment delivered on: 9th April, 2018

+ ITA 403/2017

STERIA INDIA LTD. (EARLIER KNOWN AS
XANSA (INDIA) LTD.)

..... Appellant

Versus

DEPUTY COMMISSIONER OF INCOME-TAX Respondent

Advocates who appeared in this case:

For the Appellant : Mr. Ajay Vohra, Senior Advocate with Mr.
Neeraj Jain & Mr. Aniket D. Agrawal, Advs

For the Respondent : Mr. Zoheb Hossain, Sr. Standing Counsel
for Revenue.

CORAM:-

HON'BLE MR. JUSTICE S. RAVINDRA BHAT

HON'BLE MR. JUSTICE SANJEEV SACHDEVA

SANJEEV SACHDEVA, J.

1. The question of law arising for consideration in this appeal by the assessee under Section 260A of the Income Tax Act, 1961 (hereinafter referred to as the Act), impugning the judgment dated 04.11.2016 of the Income Tax Appellate Tribunal (hereinafter referred to as the tribunal) is as under:-

“Did the Tribunal fall into error in including M/s. Thirdware Solutions Limited in the List of Comparables and excluding M/s. CG-VAK Software and Exports Limited and Quintegra Solutions Limited in the arm's length price determination with regard to the facts and circumstances of the case?”

2. The appellant- Steria India Ltd. is a subsidiary of Steria UK Corporate Ltd., which is an associated enterprise ('AE') of the appellant under section 92A of the Act. The appellant is engaged in providing software and BPO services to its AE.

3. For the financial year 2009-10 (corresponding to assessment year 2010-11), the appellant reported international transaction of provision of software services. The appellant selected Transactional New Margin Method (TNMM) as the most appropriate method for benchmarking the international transaction under the software development services segment.

4. The Transfer Pricing Officer (TPO) passed an order on 17.01.2014, under Section 92 CA(3) of the Act, inter alia, recommending upward transfer pricing adjustment of Rs.93,53,35,000 to the software development services segment of the appellant. The TPO rejected some comparables selected by the appellant and added fresh comparables, thereby selecting 16 final comparables for benchmarking the international transaction.

5. On 20.10.2015 the Dispute Resolution Panel (DRP) passed an order under Section 144C (5) of the Act, inter-alia, excluding three companies from the final set of comparables drawn by the TPO. Subsequently on 17.12.2015, DRP passed rectification order excluding one comparable. The order was further rectified by an order dated 28.04.2016.

6. Aggrieved by the final order dated 30.11.2015 as well as rectification orders dated 17.12.2015, 26.04.2016 and 28.04.2016, the appellant approached the Tribunal. The Tribunal vide the impugned order, partly allowed the appeal. However, ruled against the appellant upholding the inclusion of M/s Thirdware Solutions Limited and exclusion of M/s CG-VAK Software and Exports Limited and Quintegra Solutions Limited as comparables for benchmarking the international transaction under the software development services segment.

7. The TPO by its order dated 17.01.2014 observed that Inappropriate filters had been used by the Petitioner which would lead to an incorrect choice of comparables. With regard to the filters the TPO held as under:

No.	Description of filter	Remarks of this office
i.	Reject companies that have insufficient financials or descriptive information to perform analysis	This is an appropriate filter. However, the data is to be seen with reference to current financial year i.e. FY 2009-10.
ii.	Reject companies that had been declared sick or had persistent negative net worth	This is an appropriate filter. However, the correct criteria for rejection of companies would be negative net worth and not persistent negative net worth as the company having negative net worth would also be incurring losses in the past so as to erode its positive net worth which is the norm for companies in IT industry as discussed later.
iii.	Reject companies that had ceased	The filter is insufficient. The correct filter

	Business operations/ no sales.	would be to exclude companies having sales less than 5 Cr. as it will eliminate start-up companies and also companies where there is little differentiation between profits and remuneration.
iv.	Reject companies Undertaking significantly different functions compared to assessee.	The filter is an appropriate filter. However, the same has not been correctly applied as the functions of comparables have not been correctly analyzed in the TP report as discussed later.
v.	Reject companies that have significant (less than 25%) foreign exchange earnings.	The rationale for the filter is appropriate. However, since the assessee company is having 100% of its income from exports to its AEs, the limit of 25% is inadequate and the filter is required to be applied with the thresh hold of 75%.
vi.	Reject companies that have substantial (excess of 25%) related party transactions.	This is an appropriate filter.
vii.	Reject companies incurring Persistent operating losses.	This is an appropriate filter. However, only companies which are incurring losses persistently are to be rejected as against companies which have made loss once in a while. This is an appropriate filter because of the reason that software industry has been growing at a rate of more than 20% and in such an environment, a company making persistent losses does not reflect the industry conditions and is in persistent losses because of company specific issues.
viii.	Reject companies that had exceptional year of operation.	The reasons for exceptional year need to be analysed. The company can be rejected or data may be modified to exclude the income attributable to factors other than operations.
ix.	Reject companies that were duplicated in the databases with different names or merged to form another company.	If the filter is meant to exclude only the duplicate company, the same is an appropriate filter. Otherwise it is not an

		appropriate filter as it will exclude a company for extraneous reason like change in name, merger etc. which do not have impact on the operational performance.
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8. Further the TPO found the following set of filters to be appropriate keeping in mind the profile of the company, and justified the same as under:

“a) Use of current year data: The transfer pricing provisions lay down that primarily current year data should be use. The proviso to Rule 10D(4) allows the use of multiple year data only if the assessee is able to demonstrate through relevant data that certain factors of earlier years has affected the transfer prices for the current year. There are sufficient judicial pronouncements that support the use of current year data.

b) Different financial year:- If a company is having an accounting year different from financial year for which financials of your company are being considered, the same has been excluded as the profits and revenue pertain to different period other than current year which is FY 2009-10.

c) Reject companies where turnover is less than Rs.5 Crore: This filter is applied as it will eliminate start-up companies and also companies where there is little differentiation between profits and remuneration. That apart, a company that is very small in size and the cost base is very small does not have sufficient economic significance that it be used for benchmarking.

d) Select companies where the ratio of service income to total income is at least 75%: The use of this filter is to ensure that we choose companies that are primarily in the service sector. This filter ensures that companies that

have significant incomes from manufacturing and trading activities are rejected. In your case your entire income is from provision of services and thus, the threshold for applying this filter has been taken at 75%. It would not be appropriate to benchmark your case against a company that has significant income from manufacturing or trading activities. This filter will thus ensure integrity of all comparable data.

e) *Reject companies where related party transactions exceed 25% of sales:* There is no doubt that companies with significant related party transactions need to be excluded from the benchmarking process. On the issue of threshold of related party transactions, it can be stated that when the RPT exceeds 25% of sales, it can be said to be the stage when it will start affecting the price paid/received. The rationale given for the use of the limit of 25% is sound and this threshold limit has been approved explicitly and implicitly in quite a few judicial pronouncements.

f) *Companies that have employee cost that is less than 25% of total cost:* The rationale for this filter is that companies that are engaged in providing services similar to yours will require a minimum level of expenditure as personnel expense. Employees cost constitutes the major component of cost in any service sector. Very low employee cost, viz., less than 25% of total cost, indicates that company is either engaged in some other business or it has outsourced the service functions to a third party, i.e., it is not rendering services on its own. Such companies cannot be treated as functionally comparable to the assessee.

g) *Companies that are affected by some peculiar economic circumstances:* Companies that are affected by factors like persistent losses, declining sales, extraordinary income or expense, mergers and

acquisitions or other such factors which affect the operations of the company substantially should not be used as comparables as they will not prove to be good benchmarks.

9. With regard to the proposed comparable *Thirdware Solutions Limited* the TPO held that the said comparable was available in Capitaline database and cleared all the requisite filters referred to. As per P&L Account, Income from Software services/ export of services was 67.56 crores out of total income of 74.82 crores. As per the Segment Reporting in the said Company's operation comprised of software development, implementation and support services. Primary segmental reporting was based on geographical areas, viz.. Domestic = India (products & services) and International = Rest of the World (Exports- Software Services). Said company's earnings were to a significant extent export oriented. It was maintaining separate books of account for the reported segments and wherever costs were directly identifiable with the reported segment, it had been booked to that segment- Wherever common expenses were incurred, those expenses had been considered for allocation and relevant entries in the books of account had been passed. Thus, there were no unallocable expenses. It was further observed that the revenue in the overseas segment came from export of software services, which was comparable to the assessee company. Thus it was held to be comparable by the TPO.

10. With regard to objection of the petitioner qua inclusion of *Thirdware Solutions Limited* as a comparable, the ITAT observed that

From the copy of Profit & Loss Account, it could be seen that there were items of income, viz., 'Sales' and 'Other income'. Bifurcation of 'Sales' as per Schedule 12 consisted of Export from SEZ units, Export from STPI unit, Revenue from subscription Sale of Licence & Software services. It was further discernible from the segment reporting, that the figures had, been given on the basis of Geographical segments, viz., 'India' comprising of Products and other services and 'Overseas' comprising of Software services. The TPO had taken only the 'Overseas' segment for the purposes of inclusion in the list of comparables, which encompassed only export of software services. As the segment of the assessee under consideration was also only Software services, said segment of Thirdware Solutions - taken by the TPO fully matched and was held to be comparable.

11. This court is also of the view that said Company's operation comprised of software development, implementation and support services. Primary segmental reporting is based on geographical areas. Said company's earning are to a significant extent export oriented. Separate books of account were maintained for the reported segments and wherever costs are directly identifiable with the reported segment, Revenue in the overseas segment came from export of software services, which are comparable to the assessee company. It is discernible from the segment reporting, that the figures had, been given on the basis of Geographical segments, i.e. 'India' comprising of Products and other services and 'Overseas' comprising of Software services. The TPO had taken only the 'Overseas' segment for the

purposes of inclusion in the list of comparables, which encompassed only export of software services. The segment of the assessee under consideration is also only Software services, said segment of Thirdware Solutions - taken by the TPO fully matched and was held to be comparable. These are findings of facts based upon record. Consequently, taking of *Thirdware Solutions Limited* as a comparable was in order and cannot be interfered with.

12. With regard to the exclusion of *CG Vak Software & Exports Ltd.* TPO was of the view that the said company did not qualify employee cost filter as its employee cost was 5.56% which is less than 25% of total cost. Said company was making persistent losses in software services segment, a filter applied by the assessee itself it was found to be not a good comparable.

13. The ITAT considered the Annual report of said company and from the 'Profit & Loss Account' it was that the first item under head 'Income' is Income from Software Development, Services & Products', which had been split into two parts, namely, 'Overseas' and 'Domestic' markets. Under the head 'Significant Accounting Policies', said company had provided under the head 'Revenue recognition' – that the revenue from software development services and products were recognized on completion of contract or stage of completion as per the applicable terms and conditions agreed with customers. Perusal of Schedule-12 detailing 'Income from Software Development, Services & Products' in 'Overseas' market, showed

that apart from earning income from Software services, said company also earned income from 'Business process outsourcing services', which fell in the realm of I.T. enabled services. 'Note no. 6 to Notes annexed and forming part of the accounts for the year' further divulges that said company earned income from 'Medical transcription', which was categorized as 'Business process outsourcing' services. Directors' report under the head 'Review of Business' disclosed that: 'The contributions of business from various markets were: Software services contributed to 86% and BPO services 14%'. Since the income of said company also included income from IT. enabled services and there was no segmental information *qua* the software services alone, it could not be treated as a comparable.

14. This court finds that the TPO found that said company did not qualify the employee cost filter. It was making persistent losses in software services segment. Apart from earning income from Software services, said company also earned income from 'Business process outsourcing services', which fell in the realm of I.T. enabled services. TPO found that there was no segmental information *qua* the software services alone. Consequently, exclusion of *CG Vak Software & Exports Ltd.* was in order and cannot be interfered with.

15. Coming to the third company in issue i.e. *Quintegra Solutions Ltd.* TPO held that the said company was an abnormal company as on one hand, sales were declining, receivables and write-offs were also increasing. Further, the debtors of earlier years were affecting the

working capital adjusted OP/TC of the company significantly. It was held that in a normal situation, there would be some debtors pertaining to earlier years, but they would be limited and would be counter balanced by creditors. In the said company same was not happening and there were significant debtors from previous year which though were not affecting the normal OP/TC of the company but were affecting working capital adjusted OP/TC so significantly that it was clear that said company did not have a sustainable business model. Further, it was found that as per the Annual Report there appeared to be different export percentages as per different portions of the annual report and the figures did not appear to be reliable. Said Company has thus not been taken as a comparable.

16. The ITAT found that the sales of said company were on falling trend. In the year ending 31.3.2008, it made sales of Rs.88.12 crore which in the next year stood reduced to Rs.77.2 crore and in the year under consideration to Rs.37.38 crore, with a further slide to Rs.17.69 crore in the next year. “Review of Operations and Outlook” given in the Director’s Report made it explicit that: “The company has not recovered from the burden of the heavy loss incurred by takeover of some companies as briefed in the last annual report.” The ITAT held that the company was regularly incurring losses, which fact was further borne out from its Profit & Loss Account indicating having incurred loss of Rs.15.77 crore in relevant year and Rs.21.30 crore in the preceding year. It held that persistent losses coupled with declining turnover over the period indicated abnormal functional

circumstances, which rendered it non-comparable and justified the exclusion of such a company from the list of comparables.

17. Factually, it has been found that said company *Quintegra Solutions Ltd.* was an abnormal company; as on one hand, sales were declining, receivables and write-offs were increasing. Debtors of earlier years were affecting the working capital adjusted OP/TC of the company significantly. Said company was regularly incurring losses. Persistent losses coupled with declining turnover over the period indicated abnormal functional circumstances, which rendered it non-comparable and justified the exclusion of such a company from the list of comparables. Consequently, exclusion of *Quintegra Solutions Ltd.* was in order and cannot be interfered with.

18. In view of the above findings, this Court is of the opinion that no substantial question of law arises. The appeal is dismissed.

SANJEEV SACHDEVA
(JUDGE)

S. RAVINDRA BHAT
(JUDGE)

APRIL 9TH, 2018
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