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

Reserved on: 18.09.2019
Pronounced on: 18.05.2020

\+ **ITA 201/2018**

PRINCIPAL COMMISSIONER OF INCOME TAX-7 .....Appellant

Through: Ms. Vibhooti Malhotra, Standing Counsel for Department of Income Tax.

versus

OPEN SOLUTIONS SOFTWARE SERVICES PVT. LTD.
..... Respondent

Through: Mr. Sachit Jolly, Advocate.

CORAM:
HON'BLE MR. JUSTICE VIPIN SANGHI
HON'BLE MR. JUSTICE SANJEEV NARULA

J U D G M E N T

SANJEEV NARULA, J.

1. By way of the present appeal under Section 260A of the Income Tax Act, 1961 ('the Act'), the Appellant (Revenue) assails the order dated 17.04.2017 ('impugned order') passed by the Income Tax Appellate Tribunal ('ITAT') in ITA No. 7078/Del/2014 for the Assessment Year ('AY') 2010-11. The grievance of the appellant is against the exclusion of four comparables introduced by the Transfer Pricing Officer ('TPO') for benchmarking the international transaction of rendition of software services by the Respondent-

assessee to its parent company -Open Solutions Inc., USA, the Associated Enterprise ('AE').

Facts in brief

2. The respondent-assessee is engaged in the business of development of computer software and related services. It was set up in India as a separate entity to specifically provide software development, research and other services to its AE. During the relevant previous year, respondent had rendered services to its AE and declared its income at Rs.6,060/- and a book profit of Rs.4,37,12,441/- under section 115JB of the Act. The price for the international transactions with its AE was valued at Rs.38,40,88,682/-. The assessee benchmarked the aforesaid international transaction using Transactional Net Margin Method ('TNMM') and computed the Profit Level Indicator ('PLI') of the international transaction at 11.87%. The assessee selected 14 comparable companies engaged in software development services and the arithmetic mean of the PLI was computed at 11.91%. Based on the above, the assessee declared that its profit margins were at arm's length price ('ALP') when compared to similarly situated companies.

3. The Assessing Officer ('AO') picked up the case for scrutiny and a reference was made to the Transfer Pricing Officer ('TPO') under section 92CA of the Act to determine the ALP. The TPO vide order dated 16.01.2014 rejected the transfer pricing study undertaken by the assessee and further undertook an extensive study by applying fresh filters for benchmarking the international transaction entered into by the respondent-assessee and substituted its own ALP with the ALP determined by the

respondent. In this exercise, the TPO, *inter alia* introduced the four comparables which are subject matter of the present dispute: (i) Infosys Ltd, (ii) Wipro Technology Services Ltd., (iii) Persistent Systems Ltd. and (iv) Thirdware Solutions and Sales Ltd. By taking the aforesaid comparables into consideration, the TPO computed the arithmetic mean of PLI of transactions entered by similarly situated 21 companies at 27.86%, and, therefore, an addition of Rs. 5,49,05,106/- was proposed to the total taxable income of the assessee.

4. A draft assessment order was passed by the AO under Section 143 (3) read with Section 144C (1) of the Act and the total assessed income was computed at Rs. 5,76,91,078/-, by making two-fold additions to the assessee's taxable income: (a) Addition on account of transfer pricing adjustment at Rs. 5,49,05,106/- ; (b) Disallowance of excess depreciation at Rs. 27,79,910.

5. Aggrieved by the draft assessment order, assessee filed its objections before the Dispute Resolution Panel ('DRP') with regard to the inclusion of the above-noted four comparables. However, the DRP vide order dated 29.10.2014 partially allowed and affirmed the inclusion of the said comparables. Accordingly, the TPO vide order dated 11.11.2014, complied with the direction of the DRP and revised the ALP adjustment at Rs.3,59,52,769/- to the income of the respondent. The final assessment was completed vide order dated 25.11.2014, assessing the total income of the respondent at Rs.3,59,58,831/- after making a transfer price addition of Rs.3,59,52,769/-.

6. Aggrieved by the final assessment order, the respondent preferred an appeal before the ITAT, *inter alia* assailing the inclusion of the aforesaid four comparables.

Impugned order of the Tribunal:

7. The Tribunal undertook the FAR analysis i.e. examination of functions performed, assets employed and risks assumed as provided under Rule 10B (2) (b) of the IT Rules, and vide order dated 17.04.2017, it directed the deletion of the four comparables in question. As regards inclusion of Infosys Ltd, it was held that the said comparable is functionally different from the assessee company, since it has a diversified profile which entails product conceptualization, core design, research and development, marketing, sales and post sales services, none of which is performed by the assessee company. The asset profile of Infosys Ltd. consists of significant brand value and intangibles. It assumes huge entrepreneurial risk, market risk, commercial risk, project liability risk, technology risk and credit risk, whereas the assessee is risk mitigated captive service provider and therefore such a giant company cannot be compared with the assessee. Wipro Technology Services Ltd. was deleted since its transaction failed the Related Party Transaction (RPT) filter. It was held that the comparable had rendered services to the Citi Group as part of the pre-acquisition understanding, and, therefore, the revenue of the comparable is on account of related party transactions, making the company an unviable comparable . As regards Persistent Systems Ltd, the Tribunal examined its Annual Report and observed that no segmental information is available, as to the revenue earned

on account of software services and on account of sale of software products and in absence of such segmental information it could not be added as a comparable. Likewise, the fourth comparable- Thirdware Solutions and Sales Ltd. was deleted by the Tribunal since it was functionally dissimilar to the assessee company and therefore, a proper comparability analysis could not be carried out since the assessee herein is only engaged in providing software development services. It was also observed that segmental data of products and services is not available and moreover, the said comparable had been rejected in the case of Finserv India Pvt Limited, a group company of the assessee.

Question of law:

8. The following question of law arises for our consideration:

> *"Whether the ld. Tribunal was correct in deleting four comparable companies for the purpose of assessment of the arm's length price for benchmarking the present assesee's international transaction?"*

Submissions on behalf of the Appellant/ Revenue

9. Ms. Vibhooti Malhotra, learned senior standing counsel for the appellant/Revenue has assailed the findings of the ITAT for exclusion of the said comparables, *inter alia* contending that under the TNM method, greater latitude is allowed in choice of comparables. This implies that a broad similarity in the functions of the tax-payer and the comparable is sufficient for the application of the TNM method. She further argued that high turnover of the comparable companies cannot *ipso facto* be a criteria for excluding them, unless there is functional dissimilarity. Once a comparable

passes the filters applied by the TPO, and the same are accepted by the tax-payer-assessee, no further challenge can be made to allege functional dissimilarity between the tested party (taxpayer) and the comparable. The Tribunal erred in deleting the comparable without considering the specific findings of the TPO and DRP on their comparability. Ms. Malhotra filed a detailed note discussing the concept of TNM method *viz* impact of turnover, size, brand, equity and other related intangibles to explain the comparability analysis done during the application of said method. She relied on the definition of TNMM provided in Rule 10 B (1)(e) of the Income Tax Rules, which reads as under:

> *"(e) transactional net margin method, by which,—*
>
> *(i) the net profit margin realised by the enterprise from an international transaction [or a specified domestic transaction] entered into with an associated enterprise is computed in relation to costs incurred or sales effected or assets employed or to be employed by the enterprise or having regard to any other relevant base;*
>
> *(ii) the net profit margin realised by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base;*

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

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

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

10. Further elaborating her submissions, Ms. Malhotra argued that TNM method allows for comparison of net margins earned from international transaction (of the tested party) and the uncontrolled transaction (of the comparable company) as opposed to the other methods such as Comparable Uncontrolled Price (CUP), which is based on comparison of price charged; and Cost Plus Method (CPM) which is based on a study of gross margins; TNM method does not require a very strict functional similarity between the controlled and the uncontrolled transaction. Since the TNM method is a study of net margins, functional differences which may affect the gross margins of operating expenses, will have a limited effect in the case of net

margins. She further relied on OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, 2017, which reads as under:

> *"2.68**... One strength of the transactional net margin method is that net profit indicators (e.g. return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP method. Net profit indicators also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, this may lead to a wide range of gross profit margins but still broadly similar levels of net operating profit indicators**. In addition, in some countries the lack of clarity in the public data with respect to the classification of expenses in the gross or operating profits may make it difficult to evaluate the comparability of gross margins, while the use of net profit indicators may avoid the problem."*
>
> [Emphasis Supplied]

11. Ms. Malhotra also contended that material differences between enterprises can be made subject to adjustments. TNM method, being a study of net margins, is a more reliable measure of transfer pricing, even though functional dissimilarity exists between the comparable and the tested party. Therefore, she argued that it can be seen that differences in turnover, size, brand, equity and other related intangibles of the tested party and the comparable is not an evaluating factor once TNMM has been applied.

12. She also made elaborate submissions with respect to deletion of the four comparables. As regards Infosys Ltd., she argued that only 4.38% of itsoperating revenue is earned from the sale of its software product, whereas

around 95% is earned from software development services. The assessee itself had adopted an approach of selecting comparables which are engaged in software development services and, therefore, Infosys is functionally similar and thereby comparable with the assessee. She further contended that since the expenses incurred by Infosys are primarily in relation to development of software services, the difference in expenditure between the assessee and the comparable is not a significant reason to exclude the comparable. Factors such as heavy marketing expenses and recognizable brand value of the comparable are not substantial factors to allow exclusion of the comparable. Brand building and marketing expense constitute only 0.34% of the comparable company's total revenue, which in turn, substantially increases the cost factor of services rendered by the comparable. These factors do not render Infosys Ltd. unsuitable for comparability.

13. The deletion of Wipro Technology Services Ltd., was challenged by contending that Section 92 B (2) of the Act has no applicability in the present case as the comparable and Citi Group are unrelated parties and therefore, the transaction between them could not be held to be a related party transaction.

14. She further argued that the third comparable, Persistent Systems Ltd. was included by the TPO after analyzing its Red Herring Prospectus and it was observed that it is predominantly engaged in outsourcing of software services, just like the assessee. The comparable company does sell some products, but the product revenue comes out to be only 5% of the total

revenue. Therefore, the company should be included in the list of comparables.

15. Ms. Malhotra, further contended that the fourth comparable company, Thirdware Solutions and Sales Ltd., was removed on the ground of diversified operations and absence of any segmental data of revenue. The TPO had included this company after observing its annual report and noting that it is a software service company. Software development, implementation and support services are various sub-segments of software development services. Even other services provided by the comparable, such as implementation and management services of software applications, are in the realm of software services and are performed by software engineers. The sale of license by the comparable constitutes only 2.2% of its total sales and therefore the said comparable ought not to be deleted from the list of comparables. She further argued that ITAT cannot engage in "cherry-picking" of comparable companies and delete the companies which they feel are not suitable for calculation of arm's length price, in the case of the assessee. In support of her submissions, Ms. Malhotra relied upon the judgments of this court in ***Rampgreen Solutions Pvt. Ltd. v. CIT,***[2015] 60 taxmann.com 355 (Delhi) and ***Chryscapital Investment Advisors (India) Pvt. Ltd. v DCIT,***[2015] 56 taxmann.com 417.

Submissions on behalf of the Respondent/Assessee

16. Mr. Sachit Jolly, learned counsel for the respondent/ assessee submitted that the issue regarding the applicability of TNMM in the context of ITeS companies is no longer *res integra*. He also placed reliance on ***Rampgreen***

(supra) wherein the Court held that even while applying TNM method, the actual functional profile of the comparable and the assessee should be similar. He submitted that in comparability analysis, the business environment, demand and supply of services, assets employed and competence to provide different services are factors which would have a material bearing on the profitability of these entities. He also argued that the reasoning given in ***Rampgreen (supra)*** was followed by this court in ***M/s Avaya India Pvt. Ltd. V. ACIT***, (2019) 416 ITR 638, wherein the impact of brand value in comparability analysis of captive software service providers was examined by this Court. The relevant paragraphs of the said judgment are extracted herein under:

> *"27. There is merit in the contention of the Assessee that the scale of operations of the comparables with the tested entity is a factor that requires to be kept in view. TCS E-Serve has a turnover of Rs.1359 crores and has no segmental revenue whereas the Assessee"s entire segmental revenue is a mere 24 crores. As observed by this Court in its decision dated 5th August 2016 in ITA 417/2016(PCIT v. Actis Global Services Private Limited) "Size and Scale of TCS"s operation makes it an inapposite comparable vis-a-vis the Petitioner." As already pointed out earlier there is a closer comparison of TCS E-Serve Limited with Infosys BPO Limited with each of them employing 13,342 and 17,934 employees respectively and making Rs.37 crores and Rs.19 crores as contribution towards brand equity. When Rule 10(B) (2) is applied i.e. the FAR analysis, namely, functions performed, assets owned and risks assumed is deployed then brand and high economic upscale would fall within the domain of "assets" and this also would make both these companies as unsuitable comparables.*
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> *28. The Director"s report of TCS E-Serve Limited bears out the contention of the Assessee that both entities have been leveraging TCSs scale and large client base to increase their business in a*

significant way. The submission that the two comparables offer an illustration of "an identical transaction being conducted in an uncontrolled manner" overlooks the effect of the Tata brand on the performance of the impugned comparables. The question was not merely whether the margins earned by the Tata group in providing captive service to the Citi entities were at arm's length. The question was whether they offered a reliable basis to re-calibrate the PLI of the Assessee whose scale of operations was of a much lower order than the two impugned comparables. The mere fact that the transactions were identical was not, in terms of the law explained in the above decisions, either a sole or a reliable yardstick to determine the apposite choice of comparables."

17. Mr. Jolly concurred with the established principle of law that a comparable cannot be deleted on the sole ground of high turnover and supernormal profits, as held in ***Chryscapital (supra)***, however, he argued that in assessee's case, the Tribunal deleted the four comparables on multiple grounds. The comparable - Infosys Ltd. was deleted due to the presence of high brand value, size of their operations, difference in the services rendered and the risk profile. He also highlighted the fact that the said comparable has been deleted in the proceedings in the case of a sister company of the assessee- *Fiserv India Ltd*., for the same AY 2010-2011 in ITA 602/2016. Besides, the same comparable was also deleted in another case of ***CIT v. Agnity India technologies Pvt. Ltd.,*** 2013 SCC OnLine Del 2521. This company also operates in the same business vertical i.e. captive software development services. Both the aforementioned orders have been upheld by this Court.

18. As regards to the second comparable- Wipro Technology Services Limited, Mr. Jolly contended that as per the pre-acquisition understanding,

Wipro Technology Services has only rendered services to the Citi Group. The entire revenue of Wipro Technology Services is on account of these related party transactions and hence it fails the filter of 25% RPT to sales as applied by the TPO in the original round of proceedings, which was also confirmed by the DRP and such transaction would be a 'tainted transaction' as per Section 92B (2) of the Act.

19. In respect of the deletion of Persistent Systems Private Ltd. and Thirdware Solutions and Sales Ltd., Mr. Jolly argued that the said comparables are functionally dissimilar from the assessee and are engaged in carrying out sales of software products, unlike the assessee company. Moreover there is no separate segmental information available regarding the revenues earned for separate activities conducted by the comparables. He pointed out that the Tribunal has rightly observed that the domestic sales of Persistent Systems Pvt. Ltd. is Rs. 30.4 Crores as compared to '*nil*' of the assessee and the commission paid to the agents on sales is calculated at Rs. 3.31 Crores, which indicates that this company derives substantial income from sales. Both Wipro Technology Services and Persistent Systems Ltd. have been deleted in the case of assessee's group company in ***CashEdge India Pvt. Ltd,*** in ITA 279/16 for the same AY 2010-11.Thirdware Solutions and Sales Ltd. is also engaged in sale of licenses, software services and revenues from subscription and that the said comparable was deleted in the case of assessee's sister company-Fiserv India, and the said order was affirmed by this Court vide order dated 06.01.2016 in ***Pr. Commissioner of Income Tax vs. Fiserv India***, ITA 17/2016.

Analysis/Reasoning

20. We have considered the rival submissions of the parties. We have also carefully perused the records and examined the case laws cited by both the parties. The issues raised by the appellant are in fact no longer *res integra*. This Court has consistently held that only those comparables which are functionally similar to the assessee (tested party) and operate in a similar business environment as that of the assessee should be used for benchmarking to arrive at an accurate calculation of arm's length price.

21. We do not agree with the contention of the appellant that TNMM does not require functional similarity between the tested party and the comparable. Section 92C (1) of the Act contains provisions relating to various methods for calculation of ALP. Rule 10B of the IT Rules provides for calculation/determination of ALP. Rule 10B (2) describes the grounds on which the comparability of an international transaction (or a specified domestic transaction) with an uncontrolled transaction should be based on. This sub-rule reads as follows:

> *"Determination of arm's length price under section 92C*
>
> *10B(2) For the purposes of sub-rule (1), the comparability of an international transaction [or a specified domestic transaction] with an uncontrolled transaction shall be judged with reference to the following, namely:*
>
> *(a) the specific characteristics of the property transferred or services provided in either transaction;*

(b) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;

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

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

The above Rule manifests that in order to ensure a correct estimation of the ALP, it is critical that the entities chosen as comparables are functionally similar to the assessee. In ***Chryscapital (supra)***, the Division Bench of this Court held that if the comparable and the assessee are functionally similar, then the comparable cannot be excluded only on the ground that it is operating on supernormal profits. A comparable could nonetheless be included if the material difference on account of such high profits could be eliminated. The relevant portion of the judgment reads as under:

"39. This Court proceeds on the basis that there is sufficient guidance and clarity in Rule 10B on the principles applicable for determination of ALP. These include the various factors to be taken into consideration, approach to be adopted (functions performed, taking into account risks borne and assets employed, size of the market, the nature of competition, terms of labour, employment and cost of capital, geographical location etc). The extent of accurate adjustments possible, too, is a factor to be considered. ***Rule 10B(3) then underlines what the ALP determining exercise entails, if there are dissimilarities which materially affect the price charged etc: the first attempt has to***

be to eliminate the components which so materially affect the price or cost. *In other words, given the data available, if the distorting factor can be severed and the other data used, that course has to be necessarily adopted.*

40. ***In the present case, this Court holds that once Brescon, Keynote and Khandwala Securities are held to be functionally similar to the assessee, they would be included as comparables, notwithstanding their high profit margins, provided that the material difference on account of such high profit margins can be eliminated under the Rule 10B(3) analysis."***

[Emphasis Supplied]

22. In ***Chryscapital (supra)***it has also been held that while adopting TNMM, comparability of a controlled international transaction with the uncontrolled transaction has to be seen in the light of the *functions performed*, taking into account the *assets employed* and the *risks assumed* by the parties, as per Rule 10 B (2). These parameters cannot and should not be relaxed even while employing a method like TNMM, where the compared net margins of profit may be arguably unaffected by the external factors surrounding the companies. The determination of ALP, therefore, has to necessarily confirm to the mandate of Rule 10B. The characteristics of the services provided, contractual terms of the transaction indicating how the responsibilities, risks and benefits are to be shared between the parties, conditions prevailing in the markets, the size of the geographical markets, can be some of the factors in respect of which the similarity and dissimilarity has to be evaluated. The Court in ***Chryscapital (supra)*** further noticed clause (f) of the Rule 10C(2), and held that the TPO can make the requisite adjustments to account for

differences in such factors, if any. An attempt should be made to eliminate the components which may materially affect the price.

23. Let's now take note of the views of this Court in ***Rampgreen (supra)***. This Court in the said case also held that a further enquiry by the TPO needs to be undertaken to ascertain whether such differences materially affect the cost or the price of the service rendered by the comparable and whether such differences could be reasonably adjusted. On a perusal of the OECD Guidelines, it was concluded that the entities selected as comparable should be functionally similar and entertain similar business environment and risks as the tested party. This Court held as under:

> *"21.**In order for the benchmarking studies to be reliable for the purposes of determining the ALP, it would be essential that the entities selected as comparables are functionally similar and are subject to the similar business environment and risks as the tested party. In order to impute an ALP to a controlled transaction, it would be essential to ensure that the instances of uncontrolled entities/transactions selected as comparables are similar in all material aspects that have any bearing on the value or the profitability, as the case may be, of the transaction. Any factor, which has an influence on the PLI, would be material and it would be necessary to ensure that the comparables are also equally subjected to the influence of such factors as the tested party. This would, obviously, include business environment; the nature and functions performed by the tested party and the comparable entities; the value addition in respect of products and services provided by parties; the business model; and the assets and resources employed.** It cannot be disputed that the functions performed by an entity would have a material bearing on the value and profitability of the entity. **It is, therefore, obvious that the comparables selected and the tested party must be functionally similar for ascertaining a reliable ALP by TNMM.** Rule 10B(2) of the*

Income Tax Rules, 1962 also clearly indicates that the comparability of controlled transactions would be judged with reference to the factors as indicated therein. Clause (a) and (b) of Rule 10B(2) expressly indicate that the specific characteristics of the services provided and the functions performed would be factors for considering the comparability of uncontrolled transactions with controlled transactions...

XXXX

*32. In the present case, the Tribunal noted that Vishal and eClerx were both engaged in rendering ITeS. The Tribunal held that, "**once a service falls under the category of ITeS, then there is no sub-classification of segment". Thus, according to the Tribunal, no differentiation could be made between the entities rendering ITeS. We find it difficult to accept this view as it is contrary to the fundamental rationale of determining ALP by comparing controlled transactions/entities with similar uncontrolled transactions/entities. ITeS encompasses a wide spectrum of services that use Information Technology based delivery. Such services could include rendering highly technical services by qualified technical personnel, involving advanced skills and knowledge, such as engineering, design and support. While, on the other end of the spectrum ITeS would also include voice-based call centers that render routine customer support for their clients. Clearly, characteristics of the service rendered would be dissimilar. Further, both service providers cannot be considered to be functionally similar. Their business environment would be entirely different, the demand and supply for the services would be different, the assets and capital employed would differ, the competence required to operate the two services would be different. Each of the aforesaid factors would have a material bearing on the profitability of the two entities. Treating the said entities to be comparables only for the reason that they use Information Technology for the delivery of their services, would, in our opinion, be erroneous"***

[Emphasis Supplied]

24. Further, the Court also expounded on the concept of functional similarity in TNM Method in the following words:

> *"42. Before concluding, there is yet another aspect of the matter that needs consideration. The Tribunal proceeded on the basis that while applying TNMM method, broad functionality is sufficient and it is not necessary that further effort be taken to find a comparable entity rendering services of similar characteristics as the tested entity. The DRP held that TNMM allows flexibility and tolerance in selection of comparables, as functional dissimilarities are subsumed at net margin levels, as compared to Resale Price Method or Comparable Uncontrolled Price Method and, therefore, the functional dissimilarities pointed out by the Assessee did not warrant rejection of eClerx and Vishal as comparables.*
>
> *43.* ***In our view, the aforesaid approach would not be apposite. Insofar as identifying comparable transactions/entities is concerned, the same would not differ irrespective of the transfer pricing method adopted. In other words, the comparable transactions/entities must be selected on the basis of similarity with the controlled transaction/entity. Comparability of controlled and uncontrolled transactions has to be judged, inter alia, with reference to comparability factors as indicated under rule 10B(2) of the Income Tax Rules, 1962. Comparability analysis by TNMM method may be less sensitive to certain dissimilarities between the tested party and the comparables. However, that cannot be the consideration for diluting the standards of selecting comparable transactions/entities. A higher product and functional similarity would strengthen the efficacy of the method in ascertaining a reliable ALP. Therefore, as far as possible, the comparables must be selected keeping in view the comparability factors as specified.*** *Wide deviations in PLI must trigger further investigations/analysis.*

44. Consideration for a transaction would reflect the functions performed, the significant activities undertaken, the assets or resources used/consumed, the risks assumed. ***Thus, comparison of activities undertaken/functions performed is important for determining the comparability between controlled and uncontrolled transactions/entity. It would not be apposite to ignore functional dissimilarity only for the reason that its impact may be reduced on account of using arithmetical mean of the PLI.*** *The DRP had noted that eClerx was functionally dissimilar, but ignored the same relying on an assumption that the functional dissimilarity would be subsumed in the profit margin. As noted, the content of services provided by the Assessee and the entities in question were not similar. In addition, there were also functional dissimilarities between the Assessee and the two entities in question. In our view, these comparability factors could not be ignored by the Tribunal.* ***While using TNMM, the search for comparables may be broadened by including comparables offering services/products which are not entirely similar to the controlled transaction/entity. However, this can be done only if (a) the functions performed by the tested party and the selected comparable entity are similar including the assets used and the risks assumed; and (b) the difference in services/products offered has no material bearing on the profitability****."*

[Emphasis Supplied]

25. The above decision was followed in ***Avenue Asia Advisors Pvt. Ltd. v. DCIT,*** 2017 SCC OnLine Del 10650, wherein the Court observed that *'though in the TNMM method there is sufficient tolerance, a mere broad functionality is by itself insufficient'*. The relevant portion is extracted as under:

"20. A perusal of the above decision reveals that the following steps ought to be undertaken in identification of comparable transactions/entities.

• The principle governing the identification of comparable transactions would be the same, irrespective of whichever transfer pricing method is adopted.

• Comparable transactions must be selected on the basis of a similarity with the controlled transaction/entity.

• Rule 10B(2) of the Income Tax Rules, 1962 ought to be borne in mind while choosing the factors of comparability in respect of uncontrolled transactions.

• Even while adopting the TNMM method, the standard for selection of the comparable transactions/entitles cannot be diluted. Wide deviation in the Profit Level Indicator ('PLI') would require further investigation/analysis.

• For comparison of transactions, factors such as the nature of capital, resources used, the risks assumed, etc. ought to be considered."

26. Again in ***Avaya India (supra)***, this Court while undertaking the FAR analysis deleted TCS E-Serve Ltd. from the list of comparables and observed that if the comparable has much larger scale of operation compared to the assessee, it would not be able to serve as a reliable foundation for calculation of the PLI for the assessee even if the transactions are said to be identical. The relevant portion of the said judgment is extracted herein below:

"*15.* ***In a large number of decisions this Court has emphasized, that for there to be reliable benchmark studies for determining ALP not only the comparables have to be functionally similar but should have similar business environment and risks as the tested party.*** *A detailed exposition of the legal position with specific reference to Rule 10B(2) of the Income Tax Rules, 1962 is found in this Court's decision in Chryscapital Investment Advisors (India) Pvt. Ltd. v. DCIT 376 ITR 183 (Del) as under:*

> *"30. The reasoning adopted in various judgments noticed above, shows that functional analysis seeks to*

identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transaction. Quantitative and qualitative filters/criteria have been used in different cases to include or exclude comparables. The intuitive logic for excluding big companies from the list of comparables while undertaking the FAR analysis of a smaller company is attractive, given that such big companies provide services to diverse clientele, perform multifarious functions, often assume risks and employ intangible assets which are specially designed, unlike in the case of smaller companies. The bigger companies have an established reputation in the segment, are well known and employ economies of scale to a telling end. On the other hand, these obvious - and apparent features should not blind the TPO from the obligation to carry out the transfer pricing exercise within the strict mandate of Section 92 C and Rules 10-A to 10-E.

31. Arm's length price determination, in respect of an international transaction has necessarily to confirm to the mandate of Rule 10B. In this case, the method followed for determining the arm's length price of the international transaction adopted by the assessee and the revenue is the TNMM. ***The comparability of an international transaction with an uncontrolled transaction has, in such cases, to be seen with reference to the functions performed, taking into account the assets employed or to be employed and the risks assumed by the respective parties to the transaction as per rule 10B(2)(b).*** *The specific characteristics of the property transferred or services provided (contemplated by Rule 10B(2)(a)) in either transactions may be secondary, for judging comparability of an international transaction in the TNMM, because the price charged or paid for property transferred or services provided and the direct and indirect cost of production incurred by the enterprise*

*in respect of property transferred or services provided go into reckoning comparability analysis in the transaction methods, i.e. the comparable uncontrolled price, resale price and cost plus whereas the profit based method such as transactional net margin method takes into account, the net margin realised**. In TNMM, comparability of an international transaction with an uncontrolled transaction is to be seen with reference to functions performed as provided in sub-rule (2)(b) of rule 10B read with sub-rule (1)(e) of that rule after taking into account assets employed or to be employed and the risks assumed by the respective parties to the transaction. As noticed earlier, Rule 10B(3) mandates that a given or select uncontrolled transaction selected in terms of Rule 10B(2) "shall be comparable to an international transaction" if none of the differences, if any, between the compared transactions, or between enterprises entering into such transactions "are likely to materially affect the price or cost charged or paid or the profit arising from such transaction in the open market or reasonably accurate adjustment can be made to eliminate the effects of such difference."***

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***27. There is merit in the contention of the Assessee that the scale of operations of the comparables with the tested entity is a factor that requires to be kept in view. TCS E-Serve has a turnover of Rs. 1359 crores and has no segmental revenue whereas the Assessee's entire segmental revenue is a mere 24 crores. As observed by this Court in its decision in Pr. CIT v. Actis Global Service (P.) Ltd. [IT Appeal No. 417 of 2016, dated 5-8-2016]"Size and Scale of TCS's operation makes it an inapposite comparable vis-a- vis the Petitioner."** As already pointed out earlier there is a closer comparison of TCS E-Serve Limited with Infosys BPO Limited with each of them employing 13,342 and 17,934 employees respectively and making Rs. 37 crores and Rs. 19 crores as contribution towards*

brand equity. ***When Rule 10(B) (2) is applied i.e. the FAR analysis, namely, functions performed, assets owned and risks assumed is deployed then brand and high economic upscale would fall within the domain of "assets" and this also would make both these companies as unsuitable comparables.***

28. The Director's report of TCS E-Serve Limited bears out the contention of the Assessee that both entities have been leveraging TCSs scale and large client base to increase their business in a significant way. The submission that the two comparables offer an illustration of "an identical transaction being conducted in an uncontrolled manner" overlooks the effect of the Tata brand on the performance of the impugned comparables. ***The question was not merely whether the margins earned by the Tata group in providing captive service to the Citi entities were at arm's length. The question was whether they offered a reliable basis to re-calibrate the PLI of the Assessee whose scale of operations was of a much lower order than the two impugned comparables. The mere fact that the transactions were identical was not, in terms of the law explained in the above decisions, either a sole or a reliable yardstick to determine the apposite choice of comparables.***

[Emphasis Supplied]

27. From the exposition of law in ***Rampgreen Solutions (supra)*** and the other judgments referred above, it is clear that even while applying the TNM method, comparables cannot be picked on the basis of broad classification under various heads, and that the actual functional profile of the comparable must be similar, if not same, to that of the taxpayer-assessee. In comparability analysis, the business environment; demand and supply of the services; assets employed, and, competence to provide different services are factors which would have a material bearing on the profitability of the entities and, therefore, regard must be had to such factors. In the application

of the TNM method, broad similarity in the domain of services is not enough and the overall FAR analysis of the comparable sought to be used must be similar with the taxpayer-assessee. While there can be no quarrel with the proposition canvassed by Ms. Malhotra that a comparable cannot be excluded on the ground of high turnover alone, but the fundamental question before us is, whether the exclusions in the present case are, as a matter of fact, on this ground? On a perusal of the impugned order passed by the ITAT, we find that none of the comparables have been excluded solely on the ground of high turnover. The primary reason for excluding the four comparables in question is on account of the dissimilarity in the overall profile of the said comparables with the respondent-assessee.

28. Let us briefly evaluate the reasoning of the ITAT for deleting the comparables. As regards the first comparable-Infosys Ltd., it possesses huge tangibles of more than Rs. 1,00,000/- Crores. It is a full-fledged risk bearer with a turnover of more than Rs. 12,000/- Crores. The functions of Infosys Ltd. are highly diversified, and branching out into product conceptualization, core design, research & development to marketing and sales of products, etc. No such function is carried out by the assessee. Being a captive service provider, its function is completely confined to software development services for its AE. There are no intangibles owned by the assessee and it incurs no expenditure on research & development. We find that these distinguishing factors are highly substantial and cannot be ignored or severed from the comparison. The contractual terms of the transaction will be heavily influenced by this and other factors, such as, the overall economic standing of Infosys Ltd. in the market, thereby affecting the cost of the transaction that

it enters into. Furthermore, this comparable has been deleted in the case of assessee's sister concern in ***Fiserv India Ltd***., and the same has been upheld by this Court, therefore, we are not inclined to interfere with the order of deletion of Infosys Ltd. as a comparable.

29. As regards the second comparable- Wipro Technology Services Ltd., the comparable was a part of the Citi Group prior to 20.01.2009 and provided services to City Group and was known as "Citi Technology Services Ltd." Citi Group entered into a Master Agreement with Wipro Ltd., whereby Wipro acquired 100% interest in "Citi Technology Services Ltd." and the comparable was renamed as "Wipro Technology Services Ltd." with effect from 01.01.2009. As per the Master Agreement, Wipro Technology Services Ltd. would continue to provide services such as delivery of technology, infrastructure, services and application, development and maintenance to Citi Group, which were delivered by the erstwhile Citi Technology Services Ltd. The main ground for exclusion of this comparable is that its entire revenue is on account of related party transactions and it fails the criteria of RPT filter. The critical question is whether the pre-arrangement between the Citi group and Wipro Limited would make the subsequent rendition of services by this company to the Citi Group fall within the meaning of "deemed international transaction" as defined under section 92B(2) of the Act. At this juncture, it would be apposite to reproduce Section 92B (2) of the Act:

> *"Section 92B(2): A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1),* ***be deemed to be an international transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant***

> ***transaction between such other person and the associated enterprise,*** *or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise where the enterprise or the associated enterprise or both of them are non-residents irrespective of whether such other person is a non-resident or not."*
>
> [Emphasis Supplied]

30. A perusal of the aforenoted provision shows that the transaction between an unrelated party and an enterprise would be deemed to be an international transaction if there was any prior agreement between the parties on the basis of which the transaction is being undertaken. There was indeed a prior agreement between Citi Group and the erstwhile Citi Technology Services for rendition of software services. After acquiring Citi Technology Services (now Wipro Technology Services) by Wipro Ltd, since the comparable company continues to deliver services to Citi Group, this entire transaction would be considered as a related party transaction. The pre-arrangement between Citi group and Wipro Ltd. is a deemed international transaction as per Section 92B (2). Therefore, we are of the considered view that this comparable has been rightly deleted since it is no longer an uncontrolled transaction and cannot serve as a comparable in the benchmarking mechanism for the present assessee, since the RPT filter of this company failed to meet the filter criteria of 25% of RPT, as applied by TPO. The Tribunal in a similarly situated case, deleted Wipro Technology Services Ltd, since it had ceased to be an uncontrolled transaction under Section 92B (2) of the Act. The same order of deletion has been upheld by this Court in ***PCIT vs. Saxo India Pvt. Ltd.,*** ITA 682/16vide order dated 28.09.2016.Theassessee therein was engaged in the business of design and

development of customized software applications. The relevant paragraphs of the Tribunal's order reads as under:

> *"16.5. Adverting to the facts of the instant case, we find that Wipro Technology Services Ltd. earned a revenue from Master services agreement with Citigroup Inc. for the delivery of technology infrastructure services.* ***This agreement was, in fact, executed between the assessee's AE, Wipro Ltd., and Citigroup Inc., a third person. This unfolds that the transaction of earning revenue from software development support and maintenance services by Wipro Technology Services Ltd., is an international transaction because of the application of section 92B(2) i.e., there exists a prior agreement in relation to such transaction between Citigroup Inc. (third person) and Wipro Ltd. (associated enterprise). In the light of this structure of transaction, it ceases to be uncontrolled transaction and, hence, Wipro Technology Services Ltd., disqualifies to become a comparable uncontrolled transaction for the purposes of inclusion in the final list of comparables under Rule 10B(1)(e)(ii).*** *We, therefore, direct removal of this company from the list of comparables."*
>
> [Emphasis Supplied]

31. We also note that the aforesaid comparable has been deleted in the case of the sister company of the assessee herein. The sister company of the assessee also operates in the same business segment as the assessee. The order of deletion has been upheld by this Court in ***CashEdge India (supra)*** for the same AY 2010-11. Since, the Courts have consistently upheld the deletion of the said comparable on account of failing the Related Party Filter, we do not see any reason to interfere with the Tribunal's order of deletion of Wipro Technology Services Ltd.

32. This brings us to the third and fourth comparable, Persistent Systems Ltd. and Thirdware Solutions Ltd., which were deleted on the ground of being functionally dissimilar to the assessee and on account of absence of segmental information with regard to their earnings and sales in the field of software development. The reasoning given by the Tribunal for rejecting the aforenoted two comparables is as follows:

> *"**(iii) Persistent Systems Ltd.:-***
>
> *XXXX*
>
> *9. We have heard the rival submissions, perused relevant findings given in the impugned order as well as the material referred to before us. From a perusal of the annual report of PSL it is seen that this company deals with various products and it has been stated that it has realised more than 3000 products in the last five years and it is leader in the world of outsource software product development.* ***The break-up of income under the head "software services and products" both exports and domestic, it is seen that there is no segmental information as to how much is the revenue from software services and how much is from the products. This is evident from a detailed report given at page 46 of the paper book. In absence of such segmental information it is very difficult to come to a conclusion as to whether the margin of this company also includes the sale of products. Moreover, as pointed out by ld. Counsel, commission paid to agents on sales is also indicative of the fact that there are sale of products. Thus, we find it very difficult to include such a comparable into the basket of comparables for bench marking the assessee's margin and, accordingly, we direct the TPO to exclude this comparable from the list of comparable companies****.*
>
> ***(iv) Thirdware Solutions Ltd.:-***
>
> *XXXXX*

From the above it is not clear as to what constitutes the sale of exports, whether it is product or software development services. Revenue from subscription and sale of licence also indicate that there is income from products also which would indicate different business model and consequently the profit margin. ***Without any proper segmental information regarding revenues from software development and software products, it would be very difficult to accept that the proper comparability analysis can be carried out with the assessee which is purely providing software development services. Apart from above it is noticed that in the case of Fiserve, this comparable company has been excluded precisely on the same ground and the said order of the Tribunal stands affirmed by the Hon'ble High Court also. Accordingly, we direct the TPO to exclude the said comparable from the list of comparables."***

[Emphasis Supplied]

33. Both the aforenoted comparables have been excluded on the ground that apart from rendering software services, the companies are engaged in sale of software products and the segmental data of product and services is not available. Firstly, this is a finding of fact and secondly, in the grounds urged in the present appeal, the Revenue has not disputed this factual position. In the note of arguments filed by the appellant also, there is no challenge to this factual position. We would like to add that the respondent had brought to our notice that this Court in ***CashEdge (supra)***for the very same AY 2010-11 and in identical business vertical i.e. captive software development services had upheld the exclusion of Persistent Systems Ltd. With respect to Thirdware Solutions and Sales Limited, we find that the ITAT has undertaken a detailed factual analysis and has given cogent reasons for the exclusion of the comparables in question. The ITAT has noted that there is

no segmental data to work out the separate margin from software services. Further, this comparable was also rejected in the case of assessee's sister concern, Fiserv India Ltd on the ground of non-availability of segmental data. The said decision was affirmed by this court vide order dated 06.01.2016 in ***Pr. Commissioner of Income Tax-3 versus Fiserv India Pvt. Limited***, ITA N0. 17/2016. The absence segmental data is a factual finding that is not in serious challenge before us. Thus, the Court is not persuaded to find any infirmity in the view taken by ITAT viz the third and fourth comparables.

34. In view of the above, it emerges that none of the comparables have been excluded on the ground of high turnover alone. The test of functional similarity applied by the Tribunal is in consonance with the legal position discussed hereinabove. Therefore, we do not find merit in the contentions urged by the Revenue on this ground. Equally meritless is the contention of the Revenue regarding the bar to challenge the comparables after the acceptance of the filters. The filters are applied to narrow down the search to find the comparables that are closest to the assessee. The use of filters has to be necessarily validated from the annual reports. Since the TPO would have to do this exercise on the basis of the actual data in the report of the comparables, he would surely have the freedom to adopt or reject the comparables. We cannot hold that merely because a comparable clears the filters, its inclusion in the list of comparables is immune to challenge by the assessee.

35. In view of the aforegoing discussion, the question of law framed by us is answered against the Revenue and in favour of the assessee. The appeal is dismissed with no order as to costs.

SANJEEV NARULA, J

VIPIN SANGHI, J

MAY 18, 2020
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