

**Aztec Software and Technology Vs. Acit**

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**Court :** Income Tax Appellate Tribunal ITAT

**Decided On :** Jul-12-2007

**Reported in :** (2007)107ITD141(Bang.)

**Judge :** V Gandhi, K Singhal, P K Reddy, N Kalra, A.Ms.

**Appellant :** Aztec Software and Technology

**Respondent :** Acit

**Judgement :**

1. The President, Income-tax Appellate Tribunal vide order dated 17<sup>th</sup> October, 2006 and 6.11.2006 constituted the present Special Bench to dispose of the captioned appeals as well as to adjudicate the following questions of law: 1. Whether, it is a legal requirement under the provisions of Chapter-X of the Income-tax Act, 1961 that the Assessing officer should prima facie demonstrate that there is tax avoidance before invoking the relevant provisions and if so, what is the degree of proof required to be brought on record by him? 2. Whether, before making a reference to the Transfer Pricing Officer under section 92C(3) read with Section 92CA(1), is it a condition precedent that the Assessing officer shall provide an opportunity of being heard to the assessee? 3. Is the approval granted by the Commissioner of Income-tax under section 92CA(1) justifiable? If so, can it be called in question in appeal on the ground that it was accorded without due diligence or application of mind? 4. What is the legal effect of Instruction No. 2 of 2003 issued by the Central Board of Direct Taxes on Transfer Pricing proceedings? 2. At the suggestion of the learned Counsel for the intervener and

with the mutual consent of the parties, the aforesaid questions were permitted to be modified and certain additional questions were also allowed to be raised. Hence, the revised questions to be adjudicated by the present Bench are these: 1. Whether it is a legal requirement under the provisions contained in Chapter X of the Income tax Act, 1961 that the Assessing officer should prima facie demonstrate that there is tax avoidance before invoking the relevant provisions? 2. Whether it is a legal requirement under the provisions contained in Chapter X of the Incometax Act, 1961 that the Assessing officer should prima facie demonstrate that any one or more of the circumstances set out in Clauses (a), (b), (c ) and/or (d) of Sub-section (3) of Section 92C of the said Act are satisfied in the case of any assessee, before his case is referred to the Transfer Pricing Officer under Sub-section (1) of Section 92CA for computation of the arm's length price? 3. Whether the Assessing officer is required to record his opinion/reason before seeking the previous approval of the Commissioner Under Section 92CA(1) of the Income-tax Act, 1961.

4. Whether before making a reference to the Transfer Pricing Officer Under Section 92CA(1) read with Section 92C(3) of the Income-tax Act, 1961, is it is a condition precedent that the Assessing officer shall provide to the assessee an opportunity of being heard?

5. Is the approval granted by the Commissioner under section 92CA(1) justiciable? If so, can it be called in question in appeal on the ground that it was accorded without due diligence or proper application of mind?

6. What is the legal effect of Instruction No. 3 of 2003 dated 20<sup>th</sup> May, 2003 issued by the Central Board of Direct Taxes on Transfer Pricing matters?

7. What is the role of the Assessing officer after receipt by him of the order passed by the Transfer Pricing Officer Under Section 92CA(3) of the Income-tax Act, 1961?

3. Before proceeding to consider above questions, we deem it necessary to make short and general observations on concept of "Transfer Pricing" and "Arms' Length Price". This concept is new to Indian taxation, although tax authorities in United

States and other developed countries have applied it for the last three decades. In about 1991, India gave up its restrictive approach in matters of foreign import and foreign exchange and adopted liberalized economic and fiscal policies. This change paid good dividends and large foreign multi national companies set up their business and industries in India. With opening up of economic and rise "Brand India" abroad international tax gained ground and it became imperative to make changes in Indian tax structure. The multi national enterprises and their ability to allocate profits to sister concern (associated enterprises) outside Indian jurisdiction by controlling prices in group transactions became matter of great concern. The purposes of Transfer Pricing regulations have been aptly put in Circulars No. 12 & 14 of Central Board of Direct Taxes, issued after enactment of regulations: The new provision is intended to ensure that profits taxable in India are not understated (or losses are not over stated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances.

X x x x x The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base.

4. Accordingly, legislative changes through Finance Act, 2001 and 2002 were made. It was provided in Section 92(1) that income arising from international transaction between associated enterprises shall be computed having regard to the arms length price. In other words, results under contractual obligation of parties, notwithstanding the authorities will examine whether there is scope to make adjustments, by fixing arms length price in respect of goods, services etc. provided to or by an associated enterprise (AE). The price charged or paid in international transaction by associated enterprise is called "controlled price". Price fixed between two independent concerns relating to a similar transaction carried in a similar circumstance as "international transaction" is termed "uncontrolled price" or "Arm's length price". Adjustments are made in the controlled price by determining Arm's length price through different methods. This exercise to evaluate controlled and uncontrolled transactions by finding comparables and

making adjustments for the difference, if any, through different methods of fixing Arm's length price is known world over as "transfer pricing". ` 5. It would now be appropriate to refer to the relevant facts giving rise to the captioned appeals. The assessee is an Indian company engaged in the business of development and export of software. The assessee was also entitled to deduction Under Section 10A of the Income-tax Act, 1961 (the Act) in respect of the profits and gains derived from export of software. The assessee company filed its return of income for asstt. year 2002-03 declaring total income of Rs.44,60,830/- after claiming deduction of Rs.6,53,69,376/- Under Section 10A of the Act. The said return was processed Under Section 143(1) of the Act but subsequently, the return of the assessee was selected for scrutiny since there were international transactions exceeding Rs.5 crores. The notice Under Section 143(2) was issued on 27<sup>th</sup> October, 2003. In the course of assessment proceedings, it was noticed that assessee had received the sum of Rs.7,96,26,846/- from its associate enterprise - DB Software Solutions, LLC, USA and had paid the sum of Rs.37,64,86,959/- i.e., on account of marketing services (Rs.9,32,66,856/-) and on site software development services (Rs.28,32,20,103/-) to its subsidiary company Aztec Software Inc., USA. The auditor's report Under Section 92E in Form No. 3CEB was also filed along with the return. However, in view of the Board's instruction No.3 of 2003 dated 20<sup>th</sup> May, 2003, the AO made a reference to the Transfer Pricing Officer (TPO), Bangalore Under Section 92CA for determining the Arm's Length Price (ALP). Subsequently, the TPO passed an order Under Section 92CA of the Act on 21<sup>st</sup> March, 2005 wherein the following adjustments were made:- Adjustment towards on site services Rs. 9,06,93,275/-- Adjustment towards marketing services Rs. 9,11,23,568/- ----- On receipt of the order of the TPO, an opportunity in terms of Section 92CA(4) was granted to the assessee vide letter dated 23<sup>rd</sup> March, 2005. In response to the same, the representative of the assessee attended the office of AO and made the same objections which were raised before the TPO. Apart from the said objections, it was also submitted by the assessee that the order of TPO was erroneous for two reasons, namely, (i) the TPO was required to determine ALP only and could not make adjustment; and (ii) the order lacks jurisdiction since Commissioner's approval had not been obtained before referring the computation of ALP to the TPO. The AO was not

convinced with the objections filed by the assessee. The AO also observed that the permission of the Commissioner had already been obtained before making a reference to the TPO and the same was on record. According to him, there is no provision in the Act for furnishing the copy of the approval of CIT to the assessee. Consequently, the adjustments amounting to Rs.18,18,16,843/- were made by the AO Under Section 92C(4) read with section 92CA(4) of the Act vide order dated 30<sup>th</sup> March, 2005.

6. The said order of the AO was challenged before the CIT(A) on various grounds which inter alia included the ground challenging the jurisdiction of AO Under Section 92C of the Act for the following reasons: a) There is no finding anywhere before or after reference in the communication Under Section 92CA that transactions were entered into in a manipulative manner so as to avoid the tax payment in India as mentioned in Circular No. 12 of 2001 issued by the Board. In this case no such possibility exists as the entire income from the new industrial undertaking is eligible for deduction Under Section 10A, hence the very assumption of jurisdiction for ALP determination is erroneous and unsustainable in law.

b) The reference made to the TPO is without jurisdiction as reasons for such reference has not been furnished to the assessee.

c) The TPO ought to have insisted from AO the material in his possession which would conclusively establish that the impugned transaction were entered into by the assessee with an intention to avoid the tax before acting upon the purported reference. It may be noted that only those cases which have been entered into with an intention to avoid tax alone are covered under Chapter X and not regular commercial transaction. It is essential that incontrovertible evidences are in the possession of the AO before a reference is made as held by the Supreme Court in 131 ITR 597. The onus is on the revenue to establish any transaction leading to the avoidance of tax. From the Circular No. 12 of 2001 issued, under Transfer Pricing, it is clear that only in cases where profits taxable in India are diverted only then transfer pricing provisions are applicable. In this case no such findings are given.

d) In the absence of any evidence to show that the assessee has paid or received or entitled to receive more than what is accounted for, the reference to the TPO could not be made.

e) The mandatory conditions provided in sub section (3) to section 92CA have not been followed.

f) The order of the TPO passed Under Section 92CA is not binding on the assessing officer and the assessing officer has to independently verify and convince himself of the legality of the order before any action is taken.

7. Reference to the TPO Under Section 92CA of the Act was further challenged on following grounds vide letter dated 25.7.2005: 1) The reasons for making a reference Under Section 92CA of the Incometax Act, 1961 has not been furnished till date, in spite of specific request for the same. This non-furnishing of the reasons militates against the decision of the Supreme Court in GKN Driveshaft 259 ITR 19 and renders the assessment invalid.

2) A reference purportedly Under Section 92CA is incorrect. The assessment year involved is 2002-03 and the relevant previous year is from 1.4.2001 to 31.3.2002, whereas the provisions of section 92CA was brought into the Income-tax Act by the Finance Act of 2002 w.e.f. 1.6.2002. Section 42 of the Finance Act, 2002 specifically mentions that section 92CA has been inserted w.e.f. from 1<sup>st</sup> day of June, 2002. Reading of section 92CA(1) makes it clear that it applies to transactions entered in any previous year, thereby meaning that it applies to transactions which are entered after the insertion of section and does not apply to transactions entered into prior to the insertion of Section 92CA. Reliance is placed on Supreme Court judgments i.e., Karimatharuvi Tea Estate Ltd. v. State of Kerala 60 ITR 2 (SC) and CIT v. Scindia Steam Navigation Co. Ltd. 42 ITR 589 (SC).

The other grounds of appeal challenging the order of the TPO would be referred to at the appropriate stage in the latter part of the order 8. After considering the contentions of the assessee, the CIT(A) laid down various legal prepositions. The first preposition is that invocation of the provisions under Chapter X of the Act pre-supposes existence of an avoidance of tax by way of transfer price mechanism.

Thus, the assessing officer must demonstrate on the basis of material, information and documents in his possession that there is an avoidance of tax by the assessee on account of international transactions before he invokes the provisions of Chapter-X of the Act. Further, the invocation of these provisions cannot be resorted to in a mechanical manner. In coming to this conclusion, following reasons were given by the CIT (A): (a) The Scheme contained in Chapter-X has to be understood in accordance with the intent of the legislature which is apparent from the heading of Chapter X of the Act - "Special Provisions relating to Avoidance of Tax" which, according to him, signifies two dominant aspects defining the motive as well as purpose of the enactment of the said chapter. Reliance can be placed on decisions of the Supreme Court, namely, *Indira Nehru Gandhi v. Raj Narain* 1975 SC 2299 and *Raghu Nath Rao Ganpat Rao v. Union of India* 1993 SC 1267 in support of the proposition that the heading or titles prefixed to sections or a group of sections can be referred to in construing the Act of the Legislature.

(b) The intent of the legislature is also apparent from the following portion of the Budget Speech of the Finance Minister for the year 2001.

176. The presence of multinational enterprises in India and their ability to allocate profits in intra-group transactions has made the issue of transfer pricing a matter of serious concern. I had set up an Expert Group in November, 1999 to examine the issues relating to transfer pricing. Their report has been received, proposing a detailed structure for transfer pricing legislation. Necessary legislative changes are being made in the Finance Bill based on these recommendations.

(c) The following portion of the Notes on Clauses to the Finance Act, 2001 also shows the said intent of the legislature: The new section further provides that where during the course of any proceeding for the assessment of income the assessing officer is, on the basis of material or information or document in his possession, of the opinion that the price charged in the international transaction has not been determined in accordance with Sub-sections (1) and (2) or information and documents relating to the international transaction have not been kept and maintained by the assessee in accordance with the provisions contained

in Sub-section (1) of Section 92D, and the rules made in this behalf or the information or data used in computation of the arm's length price is not reliable or correct or the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under Sub-section (3) of section 92D, the assessing officer may proceed to determine, after giving an opportunity of being heard to the assessee, the arm's length price in relation to the said transaction in accordance with Sub-sections (1) and (2) of this section, on the basis of such material or information or documents available with him.

(d) The Memorandum of Finance Bill, 2001 also support the proposition that Chapter X was introduced as a measure to curb tax avoidance.

(e) Circular No. 12 dated 23<sup>rd</sup> August, 2001 and Circular No. 14 of 2001 leads to the same conclusion. The relevant portions of Circular No. 12 may be usefully referred to as under: The aforesaid provisions have been enacted with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profit and tax in India so that the profits chargeable to tax in India do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions leading to erosion of our tax revenues.

(iii) it should be made clear to the concerned Assessing officer s that where an international transaction has been put to a scrutiny, the Assessing officer can have recourse to Sub-section (3) of section 92C only under the circumstances enumerated in Clauses (a) to (d) of that sub-section and in the event of material information or documents in his possession on the basis of which an opinion can be formed that any such circumstance exists. In all other cases, the value of the international transaction should be accepted without further scrutiny.

the new provision is intended to ensure that profits taxable in India are not understated (or losses are not over stated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances.

the basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The new section 92 is, therefore, not intended to be applied in cases where the adoption of the Arm's length Price, determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

Under the new provisions the primary onus is on the taxpayer to determine an Arms length Price in accordance with the rules, and to substantiate the same with the prescribed documentation. Where such onus is discharged by the assessee and the data used for determining the Arms length price is reliable and correct there can be no intervention by the Assessing officer. This made clear by sub section (3) of Section 92C of the Income-tax Act which provides that the Assessing officer may intervene only if he is, on the basis of material or information or document in his possession, of the opinion that the price charged in international transaction has not been determined in accordance with sub section (1) and (2) or information and documents relating to the international transaction have not been kept and are maintained by the assessee in accordance with the provisions contained in sub section (1) of section 92D of the Income-tax Act and the rules made there under; or the information or data used in computation of the Arms length price is not reliable correct; or the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub section (3) of section 92D. If any one of such circumstances exists, the Assessing officer may reject the price adopted by the assessee and determine the Arms length Price in accordance with the same rules.

(f) The concept of the 'Mischief Rule' or 'Heydon's Rule' of interpretation of Statutes applies in interpreting the provisions contained in Chapter X of the Act. These provisions were purely intended to curb the mischief of avoidance of payment of tax in India either by understating the receipt or by over-stating the expenses in respect of international transactions with associate enterprises and similar other methods by way of transfer pricing mechanism. Since the earlier existing law was not adequate and competent to control the mischief of tax

avoidance through the transfer pricing mechanism, the provisions in Chapter X were brought on the statute book.

9. In view of the above discussion, it was held by the Id. CIT(Appeals) that AO has to first form an opinion on the basis of material or information or document in his possession that there is a valid reason for avoiding the tax burden in India. The provisions of Chapter X of the Act not only presupposes the arrival at the prima facie satisfaction or formation on an opinion of tax avoidance but it also lays down the process through which such satisfaction of tax avoidance through transfer pricing mechanism are to be arrived at. To buttress his view, reference was also made to the provisions of Section 52 of the Act which, according to him, are similar to the provisions of Chapter X. Section 52 could be invoked where the consideration for transfer of capital asset was understated by the assessee. The burden was also held to be on revenue to prove understatement. 131 ITR 597 SC. On the similar analogy, it has been observed by him that revenue must prove the avoidance of tax before invoking the provisions of Chapter X of the Act. Reference was also made to the provisions of Section 40A(2) of the Act which existed before enactment of Chapter X. This section takes care of any excessive or unreasonable payment or expenditure having regard to the fair market value of goods or services or facilities for which payment is made to a related party. According to him, this provision can be invoked in general situation while similar provisions qua international transactions contained in Chapter X of the Act are special provisions. Both the provisions intend to curb the avoidance of tax through payment to related parties. Being special provisions, the provisions of Chapter X can be invoked only under the specific circumstances i.e., avoidance of tax through specific transfer pricing mechanism qua international transactions with associate enterprises. In view of the above discussion, it was held by him that provisions of Chapter X of the Act could not be invoked by the Assessing officer unless it is shown that there is avoidance of tax by the assessee through the transfer pricing mechanism.

Secondly, it was held by him that before embarking on any determination of ALP, the Assessing authority has to pass through the process as prescribed under Clause (a) to (d) of sub section (3) of section 92C of the Act not only where the

Assessing authority does it himself but also where a reference to the TPO is made by the AO. Thirdly, it was held by the CIT(A) that jurisdiction Under Section 92C/92CA can be invoked only where there is sufficient material/information/documents in the possession of the AO on the basis of which AO either could form an opinion that Clauses (a) to (d) of section 92C are satisfied or could form an opinion that it was necessary or expedient to refer the computation of ALP to the TPO. Thus, there must be rational connection between the material / information on one hand and formation of the opinion on the other hand.

Consequently, the invoking of the provisions of Chapter X, in the absence of such satisfaction / formation of the opinion, would be without jurisdiction and bad-in-law.

Fourthly, it was held that section 92CA(1) itself does not have an independent existence and derives its strength and relevance from section 92C of the Act. The expression 'said international transaction', in section 92CA(1) has to be read with section 92C of the Act. Therefore, before referring the determination of ALP to TPO, the AO must satisfy that circumstances mentioned in Clause (a) to (d) of sub section (3) of section 92C are satisfied. Once provisions of sub section 3 of Section 92C are complied with, the AO can consider whether it is necessary or expedient to refer the determination of ALP to the TPO. Fifthly, it was held that reference to TPO Under Section 92CA of the Act cannot be made in a routine or mechanical manner. Before a reference is made, the Assessing officer must form an opinion that it is necessary or expedient to do so. As per the grammatical meaning, the word 'necessary' means unavoidable, essential etc., while the word 'expedient' means appropriate, advantageous and convenient. Thus, Assessing officer has to consider these aspects before he refers the computation of ALP to TPO. That means, that formation of opinion and satisfaction of Assessing officer must be in an objective manner.

Further, formation of an opinion and satisfaction of AO must be at two levels - firstly, the AO must satisfy himself through the mechanism as prescribed Under Section 92C(3) that re-determination of ALP is called for- secondly, he has to satisfy that reference to TPO is unavoidable and essential.

Sixthly, it was held that approval of CIT should also not be in mechanical manner. He should also satisfy himself that provisions of section 92C/92CA are fully satisfied. Prior approval is not a mere formality. It involves application of mind by CIT to find out whether Assessing officer has complied with the relevant provisions or not.

Therefore, the Courts can interfere in appropriate cases. Reliance was placed on various cases: Central Warehousing Corp. v. Secretary, Department of Revenue 277 ITR 452 (Del.

Peerless General Finance and Investment Co. Ltd. v. DCIT 236 ITR 671 (Cal.) It was also held that previous approval of higher authority is an internal matter of the department since it does not decide the rights of the assessee. Therefore, an opportunity by such authority is not required. But it does not preclude the AO to do so before forming an opinion and before sending the proposal to higher authority. Reliance was placed on the jurisdictional High Court judgment in the case of Rishabh Chand Bhansali v. DCIT 267 ITR 577 (Kar).

10. In view of the legal findings mentioned above, the CIT (A) held that legal requirements of the provisions of Chapter X were not met by the Assessing officer in the present case as is apparent from his following observations at Page-140 of his order : That the legal requirements of reaching the prima facie satisfaction through the mechanism of Section 92C(3) of the Income Tax Act for altering the arm's length price determined by the Appellant was not met at all is quite apparent from the perusal of the Assessment Record and the Transfer Pricing Record in the case of the Appellant.

Similar is the position with regard to meeting the legal requirements to arrive at the satisfaction necessitating reference to the Transfer Pricing Officer as opposed to completion of the exercise himself by the assessee authority. Likewise the record suggest that proposal to refer the matter to the Transfer Pricing Officer in terms of Section 92CA(1) of the Income-tax Act was sent to the Commissioner of Income Tax in a mechanical and routine manner without indicating any exercise in terms of Clauses (a) to (d) of Section 92C(3) of the Income Tax and the approval of the Commissioner of Income Tax also was accorded in a similar predetermined

manner.

Proceeding further, it was noticed by him that the sole explanation of the department for non meeting the requirement of Chapter X was attributed to the instruction No. 3 dated 20.05.03 issued by the CBDT which were binding on the Assessing officer and therefore rendered the act of reference to TPO a mere mechanical and clerical activity. After going through the above instruction, he observed that the Board had correctly recognized: that power to determine ALP is contained in section 92C(3) of the Act, that before referring the matter to TPO, Assessing officer has to satisfy himself that assessee has entered into an international transaction with an associate enterprises, that factual information can be gathered by Assessing officer from the report in Form No. 3CEB. However, according to the CIT(A), the Board was incorrect in stating-- (1) that Assessing officer can arrive at the prima facie belief merely on the basis of these details and (2) that a reference to the TPO can be made merely on the basis of limited and primary details contained in report in Form No. 3CEB. After going through the said form, the CIT(A) observed that only the following information can be gathered by Assessing officer : the nature of relationship of assessee with the associate enterprises, brief description of the business carried out by the associate enterprises, the nature of the services rendered and the payment made for such services, In view of the above, he posed the question whether such information was sufficient to invoke the provisions of section 92C(3) for computing the ALP other than the declared by the assessee. According to the CIT(A), the requirements of section 92C(3) could not be met unless the Assessing officer further examine the facts and evidences himself since the report of the auditor did not contain any other information or detail on the basis of which Assessing officer could differ from the findings of the auditor. Therefore, the direction contained in the instruction of the Board to the effect that Assessing officer can arrive at a prima facie belief on the basis of details available in Forms No. 3CEB that re-determination of ALP is required either by himself or through reference to TPO. Therefore, the suggestion/direction contained in the aforesaid CBDT instruction that no detailed enquiry is needed at this preliminary stage i.e. prior to making a reference to the TPO is erroneous, since each case has to be examined independently on its own facts. Therefore, the jurisdiction Under Section. 92C or

92CA could not be assumed on the basis of general directions of CBDT. Proceeding further, it was held by him that though the circulars are binding on the Assessing officer yet they are not binding on the CIT(A) or tribunal or the courts. Reference was made to the judgment of the apex court in the case Bengal Iron Corporation v.CTO 90 STC 47. The circulars would be binding if they are beneficial to the assessee but the same are to ignored if they are contrary to the law. In view of the same, it was held the Board instruction no 3 is to be ignored being contrary to the requirements of the provisions of sections 92C/92CA of the Act.

11. On consideration of totality of facts and circumstances the Id. CIT (Appeals) held that additions based on determination of arm's length price on the basis of order of T.P.O. can not be justified and was unsustainable. Accordingly addition made was deleted.

The above findings have been challenged by the Revenue in its appeal before the Tribunal. The assessee has also filed cross appeal against order of CIT (Appeals). We have considered grounds raised in both the appeals. While deciding above legal questions, we shall also be disposing of relevant objections raised by the parties in these cross appeals as also by the Intervener.

12. Now we proceed to adjudicate the revised questions referred to us.

The first question reads as under: 1. Whether it is a legal requirement under the provisions contained in Chapter X of the Income tax Act, 1961 that the Assessing officer should prima facie demonstrate that there is tax avoidance before invoking the relevant provisions? The special counsel for the Revenue Shri Seshachala has contended before us that the language employed by the legislature either in section 92C or section 92CA or any other section in Chapter X of the Act nowhere says that AO is required to demonstrate the avoidance of tax before invoking the jurisdiction Under Section 92C/92CA of the Act.

According to him, if the language of the Act is clear and unambiguous then resort cannot be made to the aids to the interpretation.

Consequently, it was argued by him the headings or marginal notes as well as the speech of the Finance Minister, notes on clauses or the Board's circulars cannot be considered in interpreting/construing the provisions enacted by the legislature if the language employed by the legislature is plain and unambiguous. Under Section 10. Proceeding further, it is submitted that revenue is not disputing the decisions of the apex court relied on by the CIT(A). According to the revenue, those decisions are distinguishable since the court itself has ruled that in those very cases that reference to external aids was made in order to resolve the controversy arising out of the ambiguity in law. Reliance has been placed on number of decisions of the apex court and other high courts mentioned in the written submissions. On the other hand, the learned Counsel for the assessee has completely relied on the reasons given by the CIT(A). Since the reasons given by the CIT(A) have been set out in detail by us, it is not necessary for us to repeat the same at this stage.

13. Rival contentions of the parties have been considered by us carefully. It is the cardinal rule of interpretation that where the language used by the Legislature is clear and unambiguous then the plain and natural meaning of the words should be supplied to the language used and resort to any rule of interpretation to unfold the intention is permissible only where the language is ambiguous. Plethora of decisions of the Apex court are there to support the proposition.

The Hon'ble Supreme Court, in the case of Smt. Tarulata Shyam v. CIT 108 ITR 345 SC, approved the observations in the case of Cape Brandy Syndicate v. Inland Revenue Commission (1921) 1 KB 64 by observing as under: To us, there appears no justification to depart from the normal rule of construction according to which the intention of the Legislature is primarily to be gathered from the words used in the statute. It will be well to recall the words of Rowlatt, J. in Cape Brandy Syndicate v. Inland Revenue Commissioners (1921) 1 KB 64 (KB) at page 71, that : ...in the taxing Act one has to look merely at what is clearly said.

There is no room for any intendment. There is no equity about a tax.

There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.

Once it is shown that the case of the assessee comes within the letter of the law, he must be taxed, however, great the hardship may appear to the judicial mind to be.

In the case of *Keshavji Ravji & Co. v. CIT*, the Apex Court observed as under: As long as there is no ambiguity in the statutory language, resort to any interpretative process to unfold the legislative intent becomes impermissible. The supposed intention of the Legislature cannot then be appealed to whittle down the statutory language which is otherwise unambiguous. If the intendment is not in the words, it is nowhere else. The need for interpretation arises when the words used in the statute are, on their own terms, ambivalent and do not manifest the intention of the Legislature. *Guru Devdata VKSSS Maryadit v. State of Maharashtra*, their Lordships of the Apex Court held as under: It is a cardinal principle of interpretation of statute that the words of a statute must be understood in their natural, ordinary or popular sense and construed according to their grammatical meaning, unless there is something in the context or in the object of the statute to suggest to the contrary. The golden rule is that the words of a statute must prima facie be given their ordinary meaning.

It is yet another rule of construction that when the words of the statute are clear, plain and unambiguous, then the Courts are bound to give effect to that meaning irrespective of consequences. It is said that the words themselves best declare the intention of the Law give. The Courts have adhered to the principle that effort should be made to give meaning to each and every word used by the Legislature and it is not a sound principle of construction to brush aside words in a statute as being inapposite surplus if they can have a proper application in circumstances conceivable within the contemplation of the Statute.

Though there are various judgments upholding the above principle but we may only mention that Constitution Bench of the Hon'ble Supreme Court in the case of *CIT v. Anjum M.H. Ghaswala*, has This exercise of purposive interpretation by looking into the object and scheme of the Act and the legislative intendment would arise, in our opinion, if the language of the statute is either ambiguous or conflicting or gives a meaning leading to absurdity.

Similarly in the case of Prakash Nath Khanna and Anr. v. CIT and Anr.

266 ITR 1 (S.C), their Lordships have observed as under: It is well settled principle in law that the court cannot read anything into a statutory provision which is plain and unambiguous.

A statute is an edict of the Legislature. The language employed in a statute is the determinative factor of legislative intent. The first and primary rule of construction is that the intention of the legislation must be found in the words used by the Legislature itself. The question is not what may be supposed and has been intended but what has been said. "Statutes should be construed, not as theorems of Euclid". Judge Learned Hand said, "but words must be construed with some imagination of the purposes which lie behind them.

While interpreting a provision the court only interprets the law and cannot legislate it. If a provision of law is misused and subjected to the abuse of process of law, it is for the Legislature to amend, modify or repeal it, if deemed necessary. (see Rishabh Agro Industries Ltd. v. P.N.B. Capital Services Ltd. ).

The legislative *causus omissus* cannot be supplied by judicial interpretative process.

Two principles of construction - one relating to *causus omissus* and the other in regard to reading the statute as a whole - appear to be well settled. Under the first principle a *causus omissus* cannot be supplied by the court except in the case of clear necessity and when reason for it is found in the four corners of the statute itself but at the same time a *causus omissus* should not be readily inferred and for that purpose all the parts of a statute or section must be construed together and every clause of a section should be construed with reference to the context and other clauses thereof so that the construction to be put on a particular provision makes a consistent enactment of the whole statute.

14. The above judgments made it clear beyond doubt that Courts are not required to look into the object or intention of the Legislature by resorting to aids to interpretation where the language of provision is clear and unambiguous.

Consequently, the meaning of each word used by the Legislature is to be given its plain and natural meaning and no word should be ignored while interpreting a provision of a statute.

15. Let us now consider the relevant provisions contained in Chapter X of the Act relating to transfer pricing. Section 92 mandates that "any income arising from an international transaction between two or more associated enterprises shall be computed having regard to the arm's length price". Section 92A defines the term 'Associated Enterprises' while section 92B defines the term 'international transaction'. Section 92C provides that ALP in relation to international transaction shall be determined by any of the methods specified therein, being the most appropriate method, shall be applied in the manner as may be prescribed. The proviso to sub section (2) provides a different method of computation where more than one price is determined by the most appropriate method. Sub section (3) provides the circumstances under which the AO may proceed to determine the ALP after giving an opportunity of being heard to the assessee. Sub section (4) provides for determination of total income having regard to the ALP while the first proviso provides that deduction under sections 10A/10AA/10B/Chapter VIA of the Act shall not be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this section. Section 92CA authorizes the AO to refer the matter to the TPO if he considers it necessary or expedient so to do subject to the prior approval by the CIT. The procedure is also prescribed for computing the ALP by the TPO. Section 92D provides that every person entering into an international transaction shall keep and maintain such information and document in respect thereof as may be prescribed. Section 92E provides that every person entering into an international transaction shall obtain a report from an accountant and furnish the same alongwith the return. Sections 93 & 94 are not relevant for our purposes since these provisions are to be invoked under different circumstances i.e. where there is transfer of assets or securities.

In order to appreciate the question posed before us, it would also be appropriate to refer to the provisions of section 92C and section 92CA which have been invoked by the AO for determining ALP. The same are, therefore, being reproduced as

under: 92C. (1) The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class relevant factors as the Board may prescribe, namely: (2) The most appropriate method referred to in Sub-section (1) shall be applied for determination of arm's length price, in the manner as may be prescribed: Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.

(3) Where during the course of any proceeding for the assessment of income, the Assessing officer is, on the basis of material or information or document in his possession, of the opinion that - (a) the price charged or paid in an international transaction has not been determined in accordance with Sub-sections (1) and (2); or (b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in Sub-section (1) of Section 92D and the rules made in this behalf; or (c) the information or data used in computation of the arm's length price is not reliable or correct; or (d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under subsection (3) of Section 92D, the Assessing officer may proceed to determine the arm's length price in relation to the said international transaction in accordance with Sub-sections (1) and (2), on the basis of such material or information or document available with him: Provided that an opportunity shall be given by the Assessing officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arm's length price should not be so determined on the basis of material or information or document in the possession of the Assessing officer.

(4) Where an arm's length price is determined by the Assessing officer under Sub-section (3), the Assessing officer may compute the total income of the assessee having regard to the arm's length price so determined.

Provided that no deduction under section 10A or Section 10AA or section 10 or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section: Provided further that where the total income of an associated enterprise is computed under this sub-section on determination of the arm's length price paid to another associated enterprise from which tax has been deducted or was deductible under the provisions of Chapter XVII B, the income of the other associated enterprise shall not be recomputed by reason of such determination of arm's length price in the case of the first mentioned enterprise.

Section 92 CA (1) Where any person, being the assessee, has entered into an international transaction in any previous year, and the Assessing officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm's length price in relation to the said international transaction under section 92C to the Transfer Pricing Officer.

(2) Where a reference is made under Sub-section (1), the Transfer Pricing Officer shall serve a notice on the assessee requiring him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the arm's length price in relation to the international transaction referred to in Sub-section (1).

(3) on the date specified in the notice under Sub-section (2), or as soon thereafter as may be, after hearing such evidence as the assessee may produce, including any information or documents referred to in Sub-section (3) of Section 92D and after considering such evidence as the Transfer Pricing Officer may require of any specified points and after taking into account all relevant materials which he has gathered, the Transfer Pricing Officer shall, by order in writing, determine the arm's length price in relation to the international transaction in accordance with Sub-section (3) of Section 92C and send a copy of his to the Assessing officer and to the assessee.

(4) On receipt of the order under Sub-section (3), the Assessing officer shall proceed to compute the total income of the assessee under Sub-section (4) of Section (3) by the Transfer Pricing Officer.

(5) With a view to rectifying any mistake apparent from the record, the Transfer Pricing Officer may amend any order passed by him under Sub-section (3), and the provisions of Section 154 shall, so far as may be, apply accordingly.

(6) Where any amendment is made by the Transfer Pricing Officer under Sub-section (5), he shall send a copy of his order to the Assessing officer who shall thereafter proceed to amend the order of assessment in conformity with such order of the Transfer Pricing Officer.

(7) The Transfer Pricing Officer may, for the purposes of determining the arm's length price under this section, exercise all or any of the powers specified in Clauses (a) to (d) of subsection (1) of Section 131 or Sub-section (6) of Section 133.

Explanation - For the purpose of this section, "Transfer Pricing Officer " means a Joint Commissioner or Deputy Commissioner or Assistant Commissioner authorized by the Board to perform all or any of the functions of an Assessing officer specified in sections 92C and 92D in respect of any person or class of persons.

16. The perusal of the above provisions reveals that these provisions can be invoked by the Assessing officer and he can proceed to determine arm's length price where he either finds the existence of the circumstances mentioned in Clauses (a) to (d) of sub section (3) or where he considers it necessary and expedient to refer the determination of ALP to the TPO. There is no other requirement for invoking these provisions by the AO. Besides as per mandate of section 92(1) income from international transaction between associated enterprises has to be computed having regard to arm's length price.

Therefore, question of tax avoidance is to be established by following mandatory provisions. Therefore, in our opinion, the language used by the legislature is plain and unambiguous and there is nothing in the language employed by the legislature on the basis of which it can be said that AO must demonstrate the avoidance of tax before invoking these provisions. As per the settled legal position mentioned by us earlier, we are not required to find the intent of the legislature by referring to

the Budget Speech of the Finance Minister, notes on clauses, circulars etc. when language of the statute is clear and unambiguous.

Much reliance has been placed on the Heading of Chapter X of the Act.

It is also the settled legal position that headings or marginal notes do not control a provision where the plain and unambiguous language has been used by the legislature. It is only when the language is unambiguous that help can be taken from the headings or marginal notes or the Finance Minister speech or the notes on clauses etc. Reference can be made to the judgment of Supreme Court in the case of *Frick India Ltd. v. Union of India* wherein at page 693, it was held as under: It is well settled that the headings prefixed to sections or entries (or a Tariff Schedule) cannot control the plain words of the provision; they cannot also be referred to for the purpose of construing the provision when the words used in the provision are clear and unambiguous; nor can they be used to cutting down the plain meaning of the words in the provision. Only in the case of ambiguity or doubt the heading or sub-heading may be referred to as an aid in construing the provisions but even in such a case it could not be used for cutting down the wide application of the clear words used in the provision.

Reference can also be made to the decision of Supreme Court in the case of *CIT v. Ahmed Bhai Umar Bhai* wherein at page 141, it was observed as under: Marginal notes in an Indian Statute, as in an Act of Parliament cannot be referred to for the purpose of construing the Statute. *Western India Theatres Ltd. v. Municipal Corporation, Poona* AIR 1959 SC 586; *Nandini Satpathy v. P.C. Dani* 17. In view of the above judgments, the CIT(A) was not justified in holding that avoidance of tax is a condition precedent for invoking the provisions of section 92C/92CA of the Act. He was also not justified in attaching too much importance to Budget speech, Notes on clauses, Memorandum to Finance Bills, apart from heading of the Chapter. The assessee can further derive no support from provision of Section 52 or decision of the Hon'ble Supreme Court in the case of *K.P. Varghese v. ITO* 131 ITR 597 wherein profit on account of understatement of consideration was held to be essential special requirement of the provision. There is no such requirement of establishment of "tax evasion" before initiation of

proceedings for determination of Arm's length price as discussed above. Contrary view held by the Id. CIT (Appeals) is accordingly held to be unsustainable.

18. Before parting with this issue, we would like to deal with another contention of the Learned Counsel for the assessee that where any payment is made in respect of an expenditure which is excessive or unreasonable having regard to the fair market value of goods, services or facilities to the concern in which assessee has substantial interest, the disallowance is permissible Under Section 40-A of the Act which overrides the other provisions of the Act and consequently, the provisions of Section 92CA could not be invoked. We are unable to accept such contention of Learned Counsel for the assessee for the reasons given hereafter. Sub-section (1) of section 40-A on which reliance has been placed, reads as under: 40A. (1) The provisions of this section shall have effect notwithstanding anything to the contrary contained in any other provision of this Act relating to the computation of income under the head "Profits and gains of business or profession".

19. The perusal of the above provisions shows section 40-A has overriding effect over the provisions relating to the computation of income under the head "Profit & Gain of Business or Profession". That means, it has overriding effect over the provisions contained in Chapter-IVD i.e., sections 28 to 44-DA only. Hence, the provisions of Section 40-A(2) would not and cannot override the provisions contained in Chapter X of the Act. Even otherwise, if there are different provisions over the same subject then in law the specific provisions would prevail. So, even assuming that provisions of section 40A are attracted, these are the general provisions applicable to all transactions while the provisions of Chapter-X are specific provisions relating to international transactions only. Therefore, the provisions of Chapter X which are more specific would apply to the present case.

20. At one stage of hearing, learned Counsel for assessee has also submitted before us that income of the assessee is exempt Under Section 10A of the Act and, therefore, the over-pricing or under pricing of an international transaction would not affect the computation of income.

This argument is without force in view of the specific provisions contained in the first proviso to sub section (4) of section 92C wherein it has been clearly stated

that no deduction under Section 10A/10AA or Section 10B or under Chapter VIA shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this section.

21. It is abundantly clear that Legislature while introducing the enactment did comprehend a situation requiring investigation and addition on account of computation of arms' length price in cases of the assessee entitled to benefit under sections 10A/10AA or section 10B of the Act. In the light of specific provision, it is difficult to contend that arms' length prices cannot be determined Under Section 92C or 92CA where assessee is entitled to benefit of above sections.

22. In the light of above discussion, we hold that although Chapter-X has title "Special provision relating to avoidance of tax" and aim of various sections under Chapter-X is to check avoidance of taxes, diversion of income and funds by non residents from India, it is not necessary that Assessing Officer must demonstrate such avoidance and diversion of tax before invoking provisions of section 92C and 92CA. Consequently, question No. 1 is answered in negative i.e. against the assessee and in favour of the Revenue. It is further held that the Id.CIT (Appeals) was wrong in attaching importance to the fact that the tax payer is entitled to benefit under sections 10A/10AA of Income-tax Act.

2. Whether it is a legal requirement under the provisions contained in Chapter X of the Income-tax Act, 1961 that the Assessing officer should prima facie demonstrate that any one or more of the circumstances set out in Clauses (a), (b), (c) and/or (d) of Sub-section (3) of section 92C of the said Act are satisfied in the case of any assessee, before his case is referred to the Transfer Pricing Officer under Sub-section (1) of Section 92CA for computation of the arm's length price? The parties to the appeals as well as the intervener have been heard at great length. At the out set, it may be mentioned that at the suggestion of the Learned Counsel for the assessee, Mr. Pradeep, and with the leave of the Bench, the lead arguments were made by Mr.

Poddar, the Learned Sr. Counsel for the intervener with reference to questions No. 2 to 7. In respect of question No. 2 mentioned above, it has been contended by

Mr. Poddar, that the Assessing officer acquires jurisdiction to re-determine or re-compute the ALP if he is satisfied on the basis of material or information in his possession that the circumstances mentioned in Sub-section (3) of section 92C of the Act exist. Once such jurisdiction is acquired then the Assessing officer can refer the matter to compute the ALP to the TPO Under Section 92CA(1) of the Act if he forms an opinion that it is necessary or expedient to do so. According to him, such reference can only be made if he acquires the jurisdiction Under Section 92C(3) of the Act.

Therefore, in the absence of acquiring such jurisdiction, the Assessing officer cannot refer the matter to the TPO Under Section 92CA(1) of the Act. This argument is based on the principle "what cannot be done directly, cannot be done indirectly". Reliance has been placed on the judgment of the Hon'ble Supreme Court in the case of Paharpur Cooling Towers Pvt. Ltd. 219 ITR 618, in support of the above proposition.

Particular reliance was placed on the following observations of their Lordships at Page-627.

Section 245E ...which empowers the Commission to reopen any completed proceedings connected with the case before it but this power is circumscribed by the requirement expressly stated in the section that such reopening of completed proceedings should be necessary or expedient for the proper disposal of the case pending before it. There are two other limitations upon this power, viz., that this reopening of the completed proceedings can be done, even for the aforesaid limited purpose, only with the concurrence of the assessee and secondly that this power cannot extend to a period beyond eight years from the end of the assessment year to which such proceeding relates. These two features make it abundantly clear that the section contemplates reopening of the completed proceedings not for the benefit of the assessee but in the interest of the Revenue.

It contemplates a situation where the case before the Commission cannot be satisfactorily settled unless some previously concluded proceedings are reopened which would normally be to the prejudice of the assessee. It is precisely for this reason that the section says that it can be done only with the concurrence of the

assessee and that too for a period within eight years. This section cannot be read as empowering the Commission to do indirectly what cannot be done directly.... The power conferred by Section 245E is thus a circumscribed and a conditional power. It can be exercised only in accordance with and subject to the conditions aforementioned and in no other manner.

24. In view of the above arguments, it has been submitted that the requirement of provisions of section 92C(3) of the Act must be read into the provisions of section 92CA(1) of the Act, meaning thereby, the Assessing officer must demonstrate that circumstances mentioned in Sub-section (3) of section 92C exists before referring the matter to the TPO under Sub-section (1) of section 92CA of the Act. The Learned Counsel for the assessee, Mr. Pradeep, has also adopted the above reasonings.

25. On the other hand, the Learned Special Counsel for the Revenue has submitted that the provisions of both the Sections are independent of and distinct from each other and there is no requirement of section 92CA that the circumstances mentioned in Sub-section (3) of section 92C of the Act must exist. According to him, the only requirement of section 92CA is that, in the opinion of the Assessing officer , it is necessary or expedient to refer the matter of computation of ALP to the TPO. Proceeding further, it is submitted that the provisions of Sub-section (4) of section 92C of the Act have been incorporated in section 92CA by virtue of the provisions of Subsection (iv) of section 92CA of the Act. Had it been the intention of the legislature as contended by the Learned Sr. Counsel for the intervener, then the legislature would have provided specifically in section 92CA of the Act. According to him, the decision of the Hon'ble Supreme Court was rendered in a different context and the same cannot be applied in deciding this issue. In fact, according to him, the issue is squarely covered by the decision of the Hon'ble Delhi high court in the case of Sony India Pvt Ltd (supra) where the proposed question has been answered in the negative vide para 20 of the judgment and there is no judgment to the contrary.

26. Rival submissions of the parties have been considered carefully.

After giving our deep thoughts to the submissions of the parties, we are of the view that the AO is not required to demonstrate the existence of the circumstances set out in Clauses (a) to (d) of sub section (3) of section 92 C of the Act before referring the case of the assessee to the TPO for determining the ALP Under Section 92CA(1) of the Act for the reasons given hereafter.

27. A close reading of sections 92C and 92CA, which already have been reproduced by us in the earlier part of the order, in our opinion, reveals that proceedings in both the sections are quite independent of and distinct from each other and the proceedings Under Section 92CA(1) of the Act are not dependent on the proceedings Under Section 92C(3) of the Act. This is due to historical reasons as two provisions were introduced at different times as noted above. The provisions of section 92C(3) of the Act confers powers on the AO to determine the ALP himself where the circumstances mentioned in Clauses (a) to (d) of the sub section exist. This is apparent from a bare reading of the provision.

In such cases, the A.O is not bound to refer the case of the assessee to the TPO. On the other hand, the AO may refer the case of the assessee to the TPO if he considers it necessary or expedient to do so.

The expression "necessary" or "expedient" is quite distinct from and independent of the circumstances mentioned in section 92C(3). The AO may consider it necessary or expedient to refer the case of the assessee to the TPO even without considering existence of circumstances mentioned in section 92C of the Act. The Assessing Officer has only to be satisfied that it is necessary or expedient to make a reference to the T.P.O. No other condition is prescribed in the provision. Now under what circumstances, AO would consider it "necessary" or "expedient" would depend upon facts of each case. No doubt, even in cases covered by section 92C(3) of the Act, the AO may in appropriate cases consider it necessary or expedient to refer the case of the assessee to the TPO for determining the ALP but that does not mean that powers of the AO to refer the case to the TPO is restricted to those cases which are covered by section 92C(3) of the Act. Had the legislature contemplated to refer the case of the assessee to the TPO only in the circumstances mentioned in section 92C(3) then the legislature would have to

provide such conditions in place of words "necessary" or "expedient" in sub section (1) of section 92CA. The requirements under both the sections are quite distinct as procedure to be followed in the sections is different. In the above Sub-section 92CA(1) there is no reference to section 92C(3). Moreover it is mandatory for T.P.O. to determine arm's length price in accordance with Sub-section (3) of Section 92C. If above section to be applied by TPO under sec. 92CA(3) at the prescribed stage, there is no question of applying the same provision at the stage of making reference. What purpose would be served by applying same provision again and again. Therefore, on plain and clear language of statutory provision, we do not find any force in the claim of the assessee. It would be sufficient for invoking provisions of section 92CA(1) if it is shown that there existed circumstances which prompted the AO to consider it necessary or expedient to refer the computation of ALP to the TPO. Once it is shown that there existed circumstances on the basis of which the AO could consider it necessary or expedient, the matter ends. The CIT(A) has emphasized on the words "the said international transaction Under Section 92C". These words, in our opinion, only refers to the transaction in respect of which reference can be made to the TPO but the same does not, in our opinion, lead to the conclusion that the requirement of section 92C(3) can be read into section 92CA(1) of the Act.

28. The view taken by us is also fortified by the decision of the Hon'ble Delhi High Court in the case of Sony India (P) Ltd. 288 ITR 52, wherein the Court considered the similar question. At Page-66 of the report, their Lordships referred to the question in Para-19 as under: ... whether the reference to the Transfer Pricing Officer by the Assessing officer has to be made by the Assessing officer only after he is satisfied by going through the steps enlisted at section 92C(1) to (3) and concluding that the price declared by the assessee is not to be accepted or can he make such a reference at an anterior stage? The above question was answered by their Lordships at the same page by observing as under: There is nothing in section 92CA itself that requires the Assessing officer to first form a considered opinion in the manner indicated in section 92C(3) before he can make a reference to the Transfer Pricing Officer. In our view, it is not possible to read such a requirement into section 92CA(1). However, it will suffice if the Assessing officer forms a prima facie opinion that it is necessary and expedient to make such a

reference. One possible reason for the absence of such a requirement of formation of a prior considered opinion by the Assessing officer is that the Transfer Pricing Officer is expected to perform the same exercise as envisaged under section 92C(1) to (3) while determining the ALP under section 92CA(3). The latter part of section 92CA(3) unambiguously states that the Assessing officer shall "by order in writing, determine the arm's length price in relation to the international transaction in accordance with Sub-section (3) of the section 92C". It will be pointless to have a duplication of this exercise at two stages one after the other.

The judgment of the Hon'ble Supreme Court in the case of Paharpur Cooling Towers Pvt. Ltd. (supra) relied upon by the Learned Counsel for the intervener does not help the assessee for the reasons given hereafter. In that case, a search and seizure action was carried out at various premises of the assessee on 27.10.1976, in the course of which, a number of documents were seized. At that point of time, the assessments for assessment years 1970-71 to 1974-75, had been completed but the assessment proceedings for assessment year 1975-76 were pending. On 24.1.1977, the assessee approached the Settlement Commission with an application Under Section 245C of the Act, wherein against Col.5, the assessment year 1975-76 and any other proceedings that may be decided by the Settlement Commission was mentioned while against Col.8 regarding particulars of matters to be settled, the assessee stated assessment of total income for assessment year 1975-76 and any other matter that may be decided by the Settlement Commission.

The application of the assessee was forwarded to the CIT for his report Under Section 245-D of the Act. In his report dated 6.7.1977, the Commissioner stated that he has no objection to the application being processed in respect of assessment year 1975-76. Thereafter, the Settlement Commission admitted the application of the assessee vide order dated 21.7.1977. Before the Settlement Commission, the assessee admitted the under valuation of the stock at the end of the assessment year 1975-76 as well as on 31.10.1975. However, it was submitted that value of opening stock was also required to be amended for the earlier years also i.e., assessment years 1970-71 to 1974-75. In view of the same, it was requested by the assessee that earlier years be reopened Under Section

245E of the Act. The Commission called upon the CIT to file his response to the statement of facts filed by the assessee. In response to the same, the CIT objected to the reopening of the earlier years. Thus, the question arose before the Commission whether earlier years' assessments could be reopened by the Settlement Commission. The Settlement Commission, by majority opinion, held that it had wide powers to reopen the assessment in view of Section 245E of the Act. The matter reached before the Hon'ble Supreme Court. After considering the arguments of the parties before them, their Lordships, considering the language of section 245E, held that section 245E empowers the Commission to reopen the completed proceedings but such power is circumscribed by the requirement expressly stated in the section i.e., that the reopening of the completed proceedings can be done only for the limited purpose with the concurrence of the assessee and secondly the power should be exercised within the period prescribed. In view of the said language of the section, the Apex Court held that section contemplates reopening of the completed assessment not for the benefit of the assessee but in the interest of Revenue. It is in this context that their Lordships observed "this section cannot be read as empowering the Commission to do indirectly what cannot be done directly." So, the close reading of the judgment reveals that reopening of the assessment Under Section 245E is permissible only for the benefit of the Revenue and, therefore, the Settlement Commission could not reopen the assessment indirectly for the benefit of the assessee.

But in the present case, section 92C as well as section 92CA provide the procedure for determining the ALP and both the sections are independent sections as observed by us earlier. If the circumstances provided in section 92CA are satisfied, then the reference could be validly made in the absence of any prohibition contemplated by the legislature. Accordingly, the said judgment, in our opinion, cannot be applied to the present case.

29. In view of the above discussion, we answer the question no 2 in negative i.e. in favour of Revenue and against the assessee. Contrary views expressed by the Id. CIT (Appeals) are, therefore, erroneous and can not be sustained.

30. Questions No. 3 to 6 are being considered together since these are interrelated in connection with the interpretation of section 92CA(1) of the Act. These questions read as under: 3. Whether the Assessing officer is required to record his opinion/reason before seeking the previous approval of the Commissioner Under Section 92CA(1) of the Income-tax Act, 1961.

4. Whether before making a reference to the Transfer Pricing Officer Under Section 92CA(1) read with Section 92C(3) of the Incometax Act, 1961, is it is a condition precedent that the Assessing officer shall provide to the assessee an opportunity of being heard?

5. Is the approval granted by the Commissioner under section 92CA(1) justiciable? If so, can it be called in question in appeal on the ground that it was accorded without due diligence or proper application of mind?

6. What is the legal effect of Instruction No. 3 of 2003 dated 20th May, 2003 issued by the Central Board of Direct Taxes on Transfer Pricing matters?

31. The Learned Counsel for the intervener, Mr. Poddar, has contended before us that reference by Assessing officer to the TPO Under Section 92CA(1) is not automatic but is circumscribed by certain conditions which must be satisfied before reference is made. The conditions are that, the Assessing officer first form an opinion that it is necessary or expedient to refer the computation of ALP by TPO. The formation of opinion is a quasi judicial act and, therefore, such opinion must be objective one and not merely subjective. That means, there must be some material or information in his possession having nexus for formation of such opinion. Since prior approval has to be obtained from the CIT, the Assessing officer must record his reasons so that CIT may apply his mind to satisfy himself that Assessing officer has exercised his discretion correctly. Further, the exercise of discretion by the Assessing officer is the subject matter of judicial review which cannot be made unless the appellate authorities or the Courts have these reasons before them. Therefore, the recording of reasons is necessary in law being part of the principles of natural justice. Proceeding further, it has been submitted by him that an opportunity must be granted to assessee before making a reference Under Section 92CA(1) of the Act so that assessee may demonstrate that conditions

specified by such provisions are not satisfied.

32. In support of his above submissions, he drew our attention to the judgment of the Hon'ble Delhi High Court in the case of Sony India Pvt.

Ltd. 288 ITR 52 and the judgment of the Apex Court in the case of Rajesh Kumar and Ors. 287 ITR 91 (SC). He drew our attention to Para-19 of the judgment of the Hon'ble Delhi High Court to point out that the Court has accepted the legal position that exercise of the discretion by Assessing officer must be preceded by the formation of an opinion of the Assessing officer regarding necessity or expediency of making reference to the TPO though such opinion need not be considered opinion. It would be sufficient if the Assessing officer forms a prima facie opinion on the basis of material / information that it is necessary or expedient to refer the computation of ALP to the TPO. However, it was further submitted by him that decision of the Hon'ble Delhi High Court to the effect that no opportunity is required to be given to assessee before making such reference is contrary to the later judgment of the Apex Court in the case of Rajesh Kumar (supra). It was submitted by him that the Apex Court was concerned with the interpretation of the provisions of Section 142(2A) of the Act, which provides that having regard to the nature and complexity of the accounts of the assessee and the interest of Revenue if the Assessing officer is of the opinion that it is necessary to do, he may, with the previous approval of the Chief CIT or CIT, direct the assessee to get the accounts audited by an accountant nominated by the Chief CIT / CIT. He drew our attention to the relevant observations of their Lordships to the effect that (i) where an authority, be it administrative or quasi judicial, adjudicates on a dispute and if its order is appealable or subject to judicial review, it would be necessary to spell out the reasons therefor, (ii) when a statutory power is exercised by the Assessing officer in exercise of its judicial function which is detrimental to the assessee, the same cannot be administrative in nature, (iii) where by reason of an action on the part of a statutory authority, civil or evil consequences ensue, the principles of natural justice are required to be followed even though no specific provision is made in this regard, (iv) even the principles of natural justice i.e., audi alteram partem would be applicable not only to quasi judicial orders but also to administrative orders affecting prejudicially the party in question unless application

of such rule is expressly excluded, (v) the assessment proceedings are judicial proceedings in view of section 136 of the Act and, therefore, any order of the Assessing officer in the course of assessment proceedings cannot be considered on administrative order, (vi) justice is not only to be done but manifestly seem to be done and, therefore, assessee should be put to notice so that he may show that exercise by the Assessing officer is not required. He also drew our attention to the fact that earlier decision of Delhi High Court in the case of Yum Restaurants India Pvt.

Ltd. 278 ITR 401, relied upon in the case of Sony India Pvt. Ltd. (supra) has been overruled by the Apex Court in the case of Rajesh Kumar (supra). Further reliance is placed on the decisions of Hon'ble Supreme Court in the cases of Pannalal Biriraj v. UOI 31 ITR 565 and Ajantha Industries v. CBDT 102 ITR 281, wherein it has been clearly held that where a case of assessee is transferred from one income tax officer to another income tax officer, within the state or outside the state, the reasons for making the order should be recorded in writing spelling out the necessity for transfer of the case and the assessee must be afforded a reasonable opportunity of being heard and representing his views on the question even though such requirement is not laid down in the statutory provisions. Reliance is also placed on CBDT Circular No. 12 of 2001 dated 23.8.2001, wherein it has been stated that implementation of the transfer pricing regulations may cause hardships to the tax payers. Therefore, it is submitted that principle of natural justice must be complied with. Hence, it has been finally contended that recording of reasons and providing of an opportunity to the assessee before referring the matter to the TPO are conditions precedent which must be complied with and failure of which would render such proceedings as bad-in-law.

Proceeding further, it has been submitted that grant of approval Under Section 92CA is also not mechanical and, therefore, the same should be done having regard to the materials on record. According to him, the Learned CIT (Appeals) can correct the Assessing officer if the Assessing officer has not exercised the discretion correctly. Hence, it is pleaded that separate opportunity must also be provided by the Learned CIT (Appeals) before granting the approval so that the assessee may point out the shortcomings in the reasons recorded by the

Assessing officer. He distinguished the decision of the Hon'ble Karnataka High Court in the case of Rishabchand Bhansali, 267 ITR 577, relied upon by the Revenue by submitting that the Court proceeded on the footing that order of the JCIT granting approval is an administrative order which proposition is contrary to the judgment of the Hon'ble Supreme Court in the case of Rajesh Kumar (supra), wherein it has been held that rules of natural justice applies to administrative order also.

Lastly, he supported his argument by referring to following decisions rendered in connection with provisions of Section 148, Section 263 and Section 158 BD of the Act, wherein similar prepositions were laid down by various Courts: Union Bank of India v. Raj Singh Deb Singh Bist (1973) 83 ITR 200 (SC); CIT v. G.M. Mittal Stainless Steel Pvt. Ltd. j) Janki Exports International Ltd. v. Union of India ; Dr. Arjun D. Bharad v. ITO 33. Coming to impact of CBDT instruction No. 3 dated 20.05.2003, it has been submitted that it does not and cannot take away the requirement of Section 92CA(1). According to him, the Hon'ble Delhi High Court has only declared that the said instruction does not violate the provisions of Article 14 of the Constitution of India and nothing more. Even the Hon'ble Court has clearly stated that provisions of Section 92CA(1) are to be complied with. It was further submitted that circulars may be binding on the income tax authorities but is not binding on the appellate authorities like CIT(A)/ITAT or the higher courts. Therefore, the assessee can always challenge the action of the assessee if it contravenes the requirement of the relevant provisions. In such cases, the appellate authorities can ignore such circular and correct the mistakes committed by the tax authorities. Reliance is placed on various decisions; Kerala Financial Corporation v. CIT 210 ITR 129 (SC), CWT v. Balbhadradas Bangur 148 ITR 149 (Cal.), Paper Products Ltd. v. CSE 247 ITR 128 (SC) and CST v. India Industries 248 ITR 338 (SC). In view of the same, it has been argued that the instruction No.3 is binding so long as it is benevolent i.e. no reference can be made where the aggregate value of the transactions does not exceed 5 crores.

However, where the aggregate value exceeds 5 crores, the reference to TPO can be made subject to the conditions specified in the provisions and rules of natural justice. In no case, CBDT circular can take away the requirement of the relevant

provisions.

34. Mr. Pradeep, the Learned Counsel for assessee has adopted the arguments of Mr. Poddar. However, it has been submitted by him that where there is non compliance of the provisions of Section 92CA or the rules of natural justice, the resultant assessment should be quashed or in the alternative the resultants additions should be deleted. Reliance was placed on the judgment of the apex court in the case of *Amiya Bala Paul v. CIT* 262 ITR 407. Proceeding further, it has also been contended that since the provisions of Section 92CA were brought on the statute book later on by Finance Act 2002 w.e.f. 1.6.2002, the same cannot be applied vis-is the international transactions effected prior to 1.6.2002.

35. On the other hand, the Special Counsel for Revenue has vehemently opposed the arguments of the learned Counsel for the assessee as well as the intervener by raising various submissions. The first contention is that there is no requirement of law that reasons should be recorded in writing. Whenever the legislature contemplated the necessities of recording the reasons, it specifically provided for the same. Reference has been made to Section 148 of the Act. Thus, in the absence of such requirement in Section 92CA, the same cannot be imported in the statutory provisions. Even otherwise, the Assessing officer has recorded his reason for making reference in his letter to the CIT seeking approval. Since the total value of transactions exceeded 5 crores as per CBDT instruction No. 3, the Assessing officer considered it necessary or expedient to make reference to TPO.36. Regarding the aspect of providing opportunity by Assessing officer before referring the matter to the TPO, it has taken the same plea that whenever the legislature contemplated, it has specifically provided for the same, for example, the proviso to Section 92C(3) and Section 92CA(3) of the Act. According to him, such requirement cannot be read into the provisions of Section 92CA(1). Further, the decision of the apex court cannot be applied since no civil consequences ensue or vested right of assessee is effected. It has been submitted by him that assessee would not be saddled with financial burden by making reference to the TPO Under Section 92CA(1) unlike the direction Under Section.

142 (2A) of the Act as the assessee can always demonstrate before the TPO that international transactions are at arms length. Further, the expression 'having regard to the nature and complexity' appearing in Section 142(2A) is absent in Section 92CA. According to him, there is no internal remedy against the direction Under Section. 142 (2A) while Under Section. 92CA, the assessee can always demonstrate before the TPO that such transactions are at arms length. Further, the assessee has another opportunity before the Assessing officer Under Section. 92CA(4) as well as another remedy Under Section. 144A of the Act. Further, the assessee has also external remedy by way of appellate proceeding and in fact, it availed such benefit before the learned CIT(A). Thus, it cannot be said that civil consequences ensue. Consequently, the ratio laid down by the Apex Court in the case of Rajesh Kumar (supra) cannot be applied in the present case. Lastly, it is submitted that a decision is an authority for what it decides and it is neither desirable nor permissible to read observations from a judgment divorced from the context. Reference is made to various decisions: 271 ITR 450 (Guj.), 267 ITR 200 (Bom.), 75 ITR 373 (SC), 255 ITR 247 (SC) and 262 ITR 135 (Kar.).

37. Regarding the approval by the CIT Under Section. 92CA, it has been submitted that the CIT is required to perform certain administrative functions such as to ensure that Assessing officer has adopted uniform approach in the matter of reference Under Section. 92CA and Assessing officer has not made any discrimination between various assessees.

Hence, no opportunity is required at this stage as held by the Hon'ble Karnataka High Court in the case of Rishabchand Bhansali, 267 ITR 577, while adjudicating similar issue vis-s Section 158 BD of the Act.

Further, reliance is placed on the decision of ITAT in the case of Kailash Moudgil, 72 ITD 97. Proceeding further, it has been submitted that the CIT has satisfied himself that reference is in accordance with the instruction No. 3 dated 20.05.2003 and the Assessing officer has adopted the uniform approach. It has also been stated that such instruction was binding on the tax authorities and therefore, all the authorities discharged their functions in accordance with law. Further, the said instruction has also been held to be intra vires of Article 14 of the Constitution of

India by the Hon'ble Delhi High Court in the case of Sony India Pvt. Ltd. and therefore, no fault can be found with the approval granted by the CIT.<sup>38</sup> Lastly, it has been submitted that provisions of Section 92CA are procedural and machinery provisions to facilitate the assessment of income and therefore, would apply to the pending proceedings as held by the apex court in the case of CWT v. Sharvan Kumar Swarup & Sons 210 ITR 886. Therefore, assessee's Counsel is not correct in arguing that provisions of Section 92CA cannot be applied to international transactions effected prior to 1.6.2002.

39. Rival submissions of the parties have been considered carefully. In our opinion, there is some merit in the submissions of Mr. Poddar. It is the settled legal position that (i) the tax authorities under taxing statute are quasi judicial authorities, (ii) the assessment proceedings under the Income Tax Act, 1961 are judicial proceedings in view of the provisions of Section 136 of the Act, as held by the apex court in the case of Rajesh Kumar (supra), (iii) the action or orders of such authorities are amenable to judicial review. Above legal position is not disputed even by the Revenue. In this background, we proceed now to consider the issues raised in the proposed questions.

40. We are required to construe the provisions of Section 92CA(1) of the Act. Therefore, it would be appropriate, even at the cost of repetition, to reproduce the provisions of Section 92CA(1) as under: Where any person, being the assessee, has entered into an international transaction in any previous year, and the Assessing officer considers it necessary or expedient so to do, he may, with the previous approval of the Commissioner, refer the computation of the arm's length price in relation to the said international transaction under section 92c to the Transfer Pricing Officer.

A perusal of above provision clearly shows that the Assessing Officer has to exercise his power in the circumstances mentioned therein i.e.

by words "necessary or expedient". The dictionary meaning of the words "necessary" and "expedient" used by the Legislature.

"that must be; that cannot be otherwise; unavoidable; inevitable; predestined; indispensable", etc.

(1) "requiring to be done, achieved, etc.; requisite, essential".

(2) "determined, existing, or happening by natural laws, predestination, etc., not by free will; inevitable" etc.

"An indispensable thing; essential; absolutely needed; required", etc.

"Unavoidable (1) that cannot be done without; essential; indispensable (2) that must happen; inevitable (3) that must be done; required (4) that follows logically; undeniable", etc.

The word "expedient" means: "Suitable or appropriate; profitable or convenient rather than fair and just; advisable; expeditious; (n) a means suitable to an end; something which serves to promote", etc.

(1) advantageous, advisable on practical rather than moral grounds.

(2) suitable, appropriate, (n) a means of attaining an end; a resource", etc.

Expedit rei publicae ut sit finis litium - the principle in Roman law - "It is for the public good that there should be an end to litigation".

(1) useful for effecting a desired result; suited to the circumstances; convenient (2) based on what is of use or advantage rather than what is right or just; guided by self interest", etc.

"Apt and suitable to end in view. Whatever is suitable and appropriate in reason for the accomplishment of a specified object." 41. Having in mind the above meaning of two words "necessary or expedient" and their setting and purpose of Legislation, it is clear to us that discretion is given to the Assessing Officer to refer question of computation of ALP to TPO if he consider that it is suitable, appropriate, profitable or convenient to the Revenue. Two words are separate by word "or" and not by word "and" and, therefore, should not be read as "necessary and expedient" as done by the Id. CIT(Appeals) which can lead to a different

meaning. The procedure to determine ALP in section 92CA is different from the one provided in section 92C. Under section 92C, the Assessing Officer has himself to determine the ALP whereas Under Section 92CA, he can refer the matter to TPO. There is nothing in the section to suggest that Assessing Officer should hear the assessee or record reasons before making reference to TPO. There is further nothing in the section to suggest that AO should ask the assessee whether he should himself proceed to determine ALP or should involve TPO for this purpose. It is no doubt true that the assessment under the Income-tax Act is quasi judicial and principle of natural justice are applicable. But it can not follow that every step taken by the Assessing Officer must satisfy principles of natural justice or must be "judicial" in character. It has to be accepted that Assessing Officer has to play a dual role. He is also an adjudicator and assessor while remaining to the Assessing Officer; a quasi judicial authority.

He is obliged to collect material from various sources and it is not provided that assessee should be associated with such collection of material. It is neither possible nor desirable to hear the assessee on every step that Assessing Officer is contemplating to take. To hold otherwise might totally defeat, jeopardize the purpose of the whole assessment and bring to a halt the entire machinery. Yes, if any collected material is to be used against the assessee, then it should be put to the assessee. That is how principle of natural justice are required to be applied and satisfied. So it is at the stage of use of material, the assessee is to be associated and not at the stage of collection of material. It is therefore, not possible to accept that even before making reference, a step in the process of collection of material, the assessee should be heard and his objection taken note of, elaborate reasons recorded and pucca case made out. Such view would make statutory machinery unworkable.

In this context it is relevant to consider what is provided in section 143(2)(ii) which is as under: [(2) Where a return has been furnished under Section 139, or in response to a notice under Sub-section (1) of Section 142, the Assessing Officer shall, (ii) notwithstanding anything contained in Clause (i), if he considers it necessary or expedient to ensure that the assessee has not understated the income or has not computed excessive loss or has not underpaid the tax in any

manner, serve on the assessee a notice requiring him, on a date to be specified therein, either to attend his office or to produce, or cause to be produced, any evidence on which the assessee may rely in support of the return: Provided that no notice under 73[clause (ii)] shall be served on the assessee after the expiry of twelve months from the end of the month in which the return is furnished.] The language and purpose of above provision is quite similar to the section we are dealing with but nobody has to this day contended that before proceedings to issue notice Under Section 143(2)(ii), the Assessing Officer should record reasons or that he should hear the assessee whether notice should be issued or not.

Clause (ii) above authorizes the Assessing Officer to issue notice to the assessee if he considers it necessary or expedient to ensure that assessee has not understated the income etc. etc. a purpose quite similar to purpose of section 92CA(1). The plain language of the provision does not support any of arguments taken by the Id. Counsel for the intervener or the assessee. The question of issuing notice to the assessee, hearing him or recording reasons before making reference to TPO for computation of ALP does not arise. The reference is a step in the collection of material which might be useful for making assessment.

No violation of any civil rights of assessee is involved here. Mere reference does not tantamount to any adverse assessment or use of adverse material. As per the statutory provision, the TPO is required to provide opportunity of being heard to the assessee in the process of determination of ALP. Besides, with respect, the assessee can not be asked to have a choice whether in his case ALP should be determined by the AO or by TPO. Having made above observations, we must add that Assessing Officer cannot make a reference for some ulterior motive or for the sake of mere pleasure or in a mechanical manner. The assessing Officer should have some material with him to justify reference to TPO. Availability of some material on record is essential as he has to obtain approval of the Commissioner for his action. It is settled law that the Commissioner cannot grant approval in a mechanical manner, and this provision is clearly understood to provide some check on arbitrary exercise of power by the Assessing Officer. Therefore, Assessing Officer must have some material with him which would enable him to get approval of the Commissioner for making a reference to the TPO. We, with

respect, agree with the view taken by their Lordship of Delhi High Court in the case of Sony India Pvt.Ltd (supra). In para 18 of the judgment it has been clearly observed as under: There is no gainsaying that power conferred on an authority, particularly a discretionary power, cannot be exercised mechanically. What is "necessary or expedient" will depend on the facts and circumstances of every case and the satisfaction of the Assessing officer in this regard will have to be based on some objective criteria. On the other hand, the relatively insignificant value of the transaction may make it inexpedient for the matter to be referred to the Transfer Pricing Officer. It is not possible to anticipate the instances that may necessitate the invoking of the discretion vested in the Assessing officer in this regard. It is trite that any misuse of such exercise of discretion can be corrected by way of judicial review by statutory appellate authorities and ultimately the courts. The words "necessary and expedient" occurring in other provisions of the Act and other statutes have been interpreted judicially to admit of a strict construction permitting the power to be used only in the manner and subject to the conditions stipulated in the provision.

The exercise of the discretion by the Assessing officer is required to be preceded by the formation of an opinion by the Assessing officer of the necessity or expediency of making such a reference.

42. The learned Counsel for the assessee and Shri Poddar for the Intervener has referred to several decisions in support of their contentions. But those decisions Under Sections 147, 245 or 142(2A) have no application to the interpretation of provisions before us.

Those provisions have been held to effect civil rights of the assessee or related to matters involving final disposal of the issue and do not relate to some interim order or to a step in the process of the assessment. There it was not the question whether Assessing Officer should himself determine ALP or should get help from TPO. Those matters related to transfer of cases from one station to another or initiation of reassessments or acquisition proceedings. Thus reopening of closed assessments or matters involving civil rights of assessee cannot be compared with situation where Assessing Officer has merely to decide whether he should himself

determine ALP or it would be "necessary or expedient" to get it determined from TPO. There is no vested right with the assessee to force the revenue to follow a particular course and not the other alternative.

43. The case of Rajesh Kumar and Ors. v. DCIT 287 ITR 91, strongly relied upon by learned Counsel for the assessee has already been discussed earlier. The case has no application here. We state again the following basis for the decision. In the first place, their Lordships of the Supreme Court has referred the matter to a larger Bench, for review of the decision. Irrespective of the outcome of the larger Bench, while holding that notice of hearing should be provided to the assessee before special audit Under Section 142(2A) is directed by the Assessing Officer, their Lordships observed that formation of opinion Under Section 142(2A) that accounts of the assessee require an expert audit, should be based on objective consideration. Secondly, the decision to refer the case to special audit is detrimental to the assessee and, therefore, cannot be administrative in nature. Thirdly, civil consequences ensue from such a decision. Fourthly, direction to get accounts audited by special auditor involve principle of natural justice and, therefore, the authority taking the decision has to bear in mind the theory of useless formality and the prejudicial doctrine.

None of the above factors are involved in the present case. Besides the language of the provision with which we are concerned is quite different from the language used in Section 142(2A) of the I.T. Act.

Therefore decisions cited supra do support the case of the assessee or the intervener with reference to the provisions under consideration.

For the above reasons, we answer question No. 3 & 4 against the assessee. Question No. 5 has been separately answered.

However, aforesaid observations are to be read subject to our answer to question No. 6.

44. Now we proceed to answer question No. 6 to see legal effect of Instruction No. 3 dated 20<sup>th</sup> May, 2003 issued by the C.B.D.T. on Transfer Pricing. As per above

instruction, CBDT has directed all Officers of the Department where the aggregate value of international transaction and transactions exceed Rs 5 crores, to refer the matter of determination of ALP to TPO. The relevant portion of Circular is as under: ...In the initial years of implementation of these provisions and pending development of adequate data base, it would be appropriate if a small number of cases are selected for scrutiny of transfer price and these are dealt with effectively. The Central Board of Direct Taxes, therefore, have decided that wherever the aggregate value of international transaction exceeds Rs.5 Crores, the case should be picked up for scrutiny and reference under section 92CA be made to the TPO. If there are more than one transaction with an associated enterprise or there are transactions with more than one associated enterprises the aggregate value of which exceeds Rs.5 Crores, the transactions should be referred to the TPO. Before making reference to the TPO, the Assessing Officer has to seek approval of the Commissioner/Director as contemplated under the Act.

Under the provisions of section 92CA reference is in relation to the international transaction. Hence all transactions have to be explicitly mentioned in the letter of reference. Since the case will be selected for scrutiny before making reference to the TPO, the Assessing Officer may proceed to examine other aspects of the case during pendency of assessment proceedings but await the report of the TPO on the value of international transaction before making final assessment.

The threshold limit of Rs.5 Crores will be reviewed depending upon the workload of the TPOs.

The work relating to selection of cases for scrutiny and reference to TPO on the above basis in respect of pending returns filed for the assessment year 2002-2003 should be completed by June 30, 2003.

It is not in dispute that above said Circular was issued by CBDT Under Section 119 of the Income-tax Act. Aforesaid section authorizes the Board to issue orders, instructions and directions to Income-tax authorities as it may deem fit for proper administration of the Income-tax Act. Authorities are duty bound to observe and execute orders, instructions and directions of the Board. Under Sub-section (2) Clause (a) it is provided that where the Board considers it necessary and

expedient for purpose of proper and efficient management of the work of assessment and collection of revenue, it may issue orders and directions in respect of any class of income or class of cases setting forth directions or instructions so as to guideline principle or procedures to be followed by income-tax authorities.

As is clear from the circular, the idea of issuing instructions under reference is to avoid selection of small cases with international transaction less than Rs 5 crores for scrutiny of transfer price and to avoid arbitrariness in the application of the provision. All cases where aggregate value of international transactions exceed Rs 5 crores, are required to be referred to the TPO by the Assessing Officer. The limit has now been increased to Rs 15 crores. Having regard to the object stated in the circular, no fault is found nor any illegality seen in the instructions. Union of India and Anr. v. Azadi Bachao Andolan and Anr.

263 ITR 706, their Lordship of Supreme Court have observed as under: Apart from Sub-section (1), Sub-section (2) of section 119 also enables the central Board of Direct Taxes "for the purpose of proper and efficient management of the work of assessment and collection of Revenue, to issue appropriate orders, general or special in respect of any class of incomes or class of cases, setting forth directions or instructions (not being prejudicial to assessee) as to the guidelines, principles or procedures to be followed by other income-tax authorities in the work relating to assessment or collection of Revenue or the initiation of proceedings for the imposition of penalties". In our view, the High Court was not justified in reading the circular as not complying with the provisions of section 119. The circular falls well within the parameters of the powers exercisable by the Central Board of Direct Taxes under section 119 of the Act.

Therefore, when provisions of section 92AC(i) are read with Circular of CBDT (Instruction No. 3) dated 20.5.2003, it becomes "necessary" for the A.O. to refer the question of determination of transfer pricing of international transactions to the TPO. He has no discretion in the matter in the light of limit fixed by the Board. The Assessing Officer has only to look at the aggregate value of international transactions disclosed by the assessee in the audit report and then follows

directions of CBDATED The Assessing Officer, therefore, is left with a very limited role Under Section 92AC(i). Likewise, while granting approval to the action of the Assessing Officer, the Commissioner has only to see whether aggregate value of international transaction is more than Rs 5 crores or not. If it is more, he has also to grant approval in the light of directions of CBDATED These directions are mandatory and binding on the Assessing Officer and the Commissioner.

The fact that directions are not binding on the assessee or courts is immaterial. The relevant question to be answered is whether circulars are binding on the departmental authorities. The question has an obvious answer.

The issue of legality and validity of above directions was raised before Hon'ble Delhi High Court in the case of Sony India Ltd. (supra).

Their Lordships have also upheld validity of directions of CBDATED 45. In the light of above discussions, we do not find any illegality in the directions issued by the Board of Direct Taxes (CBDT). This question is also answered against the assessee. Observations of the Id.CIT (Appeals) holding the contrary are set aside.

7. What is the role of the Assessing officer after receipt by him of the order passed by the Transfer Pricing Officer Under Section 92CA(3) of the Income-tax Act, 1961? Under above question the Special Bench has to determine whether order of the Transfer Pricing Officer (TPO in short) issued under Sub-section (3) of section 92CA is binding on the Assessing Officer, in the sense that he has to make assessment taking arms' length price determined by the TPO without making any change Under Section 92CA(3).

47. The learned Standing Counsel for the revenue did not take any clear stand on this question. He drew our attention to decision of Hon'ble Delhi High Court in the case of Sony India Pvt. Ltd. v. C.B.D.T. 288 ITR 52 wherein their Lordships have held that Assessing Officer in view of section 92C(4) and 92CA(4) has not only to consider the report of the TPO but any other material that may be placed before him by the assessee to arrive at a different conclusion. As per their Lordships, the provision strengthen the position that report of the TPO is not binding on the Assessing Officer.

48. The stand of the respondent assessee was that it is not binding. It is just like any other opinion given or received by the Assessing Officer. The Assessing Officer can modify and change the ALP determined in the order of the TPO. Shri Poddar, learned Counsel for the intervener, on the other hand, argued that order of TPO was binding on the Assessing Officer. In this connection, he drew our attention to Sub-section (6) of Section 92CA which provides that A.O.," after receipt of copy of amended order of TPO shall thereafter proceed to amend the order of assessment in conformity with such order of Transfer Pricing Officer". According to Shri Poddar, Sub-section (6) clearly suggest that order of the TPO even under Sub-section (3) of section 92CA is binding on the Assessing Officer. Otherwise Sub-section (6) would have no meaning if in the assessment order arms' length price has not been taken as determined by the TPO. The question of amending such assessment order in conformity with order of TPO can not arise. Thus Sub-section (6) would have no meaning or operation. He argued that as per settled law, all the sub-sections i.e. Sub-section (4), (5) and (6) of section 92CA are to be read together and harmoniously and should be interpreted in a rational manner to advance the purpose of the provision. If under Sub-section (6), the Transfer Pricing Officer has to amend his assessment order in conformity with amended order of the TPO, the original assessment is also required to be made in conformity with arms' length price determined under Sub-section (3).

49. When attention of Shri Poddar was drawn to the decision of Delhi High Court in the case of Sony India Pvt.Ltd. (supra), he submitted that in above case, attention of their Lordship was not drawn to Sub-section (6) of section 92CA, otherwise their Lordship would have taken a different view. Shri Poddar also cited decision of Supreme Court in the case of Rajesh Kumar and Ors. v. Deputy CIT and Ors. 287 ITR 91. In the said case, their Lordship of Supreme Court made the following observation: The expression "having regard to" in this context assumes some significance. An opinion must be formed strictly in terms of the factors enumerated therein. The expression indicates that in exercising the power regard must be had also to the factors enumerated therein together with all factors relevant for exercise of that power.

In the said case, the question was whether Assessing Officer should hear the assessee before directing special audit Under Section 142(2A).

The said section, so far it is relevant here, provides that Assessing Officer at any stage of the proceedings before him having regard to the nature and complexity of the accounts of the assessee and the interest of the revenue, is of the opinion that it is necessary so to do, he may with the previous approval of the Chief Commissioner or Commissioner direct the assessee to get the accounts audited by a Accountant...nominated by the Chief Commissioner or Commissioner in this behalf. Their Lordship of Supreme Court while holding that it is necessary to hear the assessee before directing audit of assessee's accounts from a special auditor, took into account the expression "having regard to" in arriving at above conclusion, along with several other facts and circumstances detailed in the judgment. In the light of above decision and provisions of Sub-section (6), Shri Poddar argued that T.P.O's order was binding on the Assessing Officer.

50. We have given careful thought to rival submissions of the parties.

We, with respect, agree with the view taken by their Lordship of Delhi High Court in the case of Sony India Pvt. Ltd. v. CBDT 288 ITR 52.

Their Lordship in that case not only took into account decision of Supreme Court in the case of Juggilal Kamlapat Bankers v. WTO 145 ITR 485 but also the decision of the Apex Court in the case of CIT v. Gangadhar Banerjee and Co. Pvt. Ltd. 57 ITR 176 wherein the Apex Court had accepted the reasoning and interpretation of Privy Council of words "having regard to" in CIT v. Williamson Diamonds Ltd. 35 ITR 290. The Privy Council had held: The form of words used no doubt lends itself to the suggestion that regard should be paid only to the two matters mentioned, but it appears to their Lordships that it is impossible to arrive at a conclusion as to reasonableness by considering the two matters mentioned isolated from other relevant factors. Moreover, the statute does not say 'having regard only' to losses previously incurred by the company and to the smallness of the profits made. No answer, which can be said to be in any measure adequate, can be given to the question of 'unreasonableness' by considering these two matters alone. Their Lordships are of the opinion that the statute by the words used, while making sure

that 'losses and smallness of profit' are never lost sight of, requires all matters relevant to the question of unreasonableness to be considered. Capital losses, if established, would be one of them.

In view of the settled legal position, we are of the view that the expression "having regard to" in section 92C(4) and section 92CA(4) enables the Assessing Officer to consider not only the report of the Transfer Pricing Officer but any other material that may be placed before him by the assessee to arrive at a different conclusion. This also strengthens the position that the report of the Transfer Pricing Officer is not binding on the Assessing Officer.

51. Shri Poddar's argument that if their Lordship in the case of Sony India P.Ltd. (supra) had taken into account Sub-section (6) of section 92CA, their decision would have been different is required to be rejected. Subsection (6) above would come into operation only in the cases where the Assessing Officer in the assessment order has adopted the order of the TPO. Now if subsequently TPO rectified his order in terms of Sub-section (5) of Section 92CA, the Assessing Officer is duty bound to pass an order in conformity with order of TPO. Otherwise it can lead to anomaly and therefore, it is provided where TPO's order is amended to rectify a mistake apparent from record, the Assessing Officer must also rectify assessment order in conformity with above order. We are, therefore, of the opinion that TPO's order under Sub-section (3) of section 92C cannot be treated as final and binding on the Assessing Officer. Having said so, we do not mean to suggest that order of TPO is of no value or consequence. The words "having regard to" convey definite meaning and are strong enough to enjoin upon the Assessing Officer to pass order and adopt transfer pricing as determined by the TPO, unless there are very good grounds to modify or alter the transfer pricing ordered by the TPO. Only after recording reasons, as above, the Assessing Officer can take transfer pricing other than one determined by the TPO. There may be cases in which the assessee after arms' length price is determined by the TPO and before his order is made the basis of assessment, may get such authentic material to show that transfer pricing determined by the TPO is not correct or should not be blindly adopted without modifying it. However, in the cases before us, The A.O. adopted the orders of the T.P.O. and computed assessments accordingly. We see

no illegality in the procedure followed by the A.O. and, therefore, do not approve of the contrary observations of the Id. CIT(Appeals) in the impugned order.

52. As for as decision of Supreme Court in the case of Rajesh Kumar and Ors. v. Dy. CIT and Ors. 287 ITR 91 is concerned on which strong reliance was placed, their Lordship, as already noted, have observed that the expression "having regard to" in this context assumes some significance. An opinion must be formed strictly in terms of the factors enumerated therein. The expression indicates that in exercising the power regard must be had also to the factors enumerated therein together with all factors relevant for exercise of that power.

Their Lordship further quoted the following extracts from two decisions of Supreme Court in the above report: The meaning of the expression 'having regard to' is well settled. It indicates that in exercising the power, regard must be had also to the factors enumerated together with all factors relevant for exercise of that power.

ii) Delhi Farming and Construction Pvt.Ltd. v. CIT , The words 'having regard to' used in the section do not restrict the consideration only to two matters indicated in the section as it is impossible to arrive at a conclusion as to the reasonableness by considering only the two matters mentioned isolated from other relevant factors. It is neither possible nor advisable to lay down any decisive tests for the guidance of the Income tax Officer. The satisfaction depends upon the facts of each case. The only guidance is his capacity to put himself in the position of a prudent businessman or the directors of a company and his sympathetic and objective approach to the difficult problem that arises in each case.

It is clear from above that decision of Supreme Court in the case of Rajesh Kumar (supra) itself indicate that words 'having regard to' suggest that assessment is to be made having regard to the report of the TPO which is required to be considered with other relevant material available on record.

There is nothing to suggest that TPO's report on transfer pricing is conclusive and debars Assessing Officer from looking at any other material.

The aforesaid conclusion is also in line with latest change made in Section 92C by the Legislature through the Finance Act, 2007.

Sub-section (4) of Section 92CA has been substituted with the following sub-section w.e.f. 1.6.2007: [(4) On receipt of the order under Sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under Sub-section (4) of section 92C in conformity with the arm's length price as so determined by the Transfer Pricing Officer] 53. Now words "having regard to" have been replaced by words "in conformity with". So now Assessing Officer after introduction of subsection (4) above is required to pass assessment order in conformity with the order of the Transfer Pricing Officer determining arm's length price. Now the order of the TPO has been expressly made binding on the Assessing Officer. From the above it is clear that there was a lacuna in the Act as appropriate language was not used earlier. This has been modified and w.e.f. 1.6.2007, the order of TPO is binding on the Assessing Officer who now has no choice but to pass an order in conformity with the order of the TPO. The word "having regard to" did not convey the same meaning. For all the aforesaid reasons, we hold that prior to substitution of Sub-section (4) by a new section, the order of the TPO was not binding on the Assessing Officer.

54. In the course of hearing, Shri N.K.Poddar argued that in the case of the intervener in appellate proceedings, the learned CIT (Appeals) had remitted the question of determination of transfer pricing again to the TPO. After discussion with assessee, the TPO accepted the transactions to be arm's length transactions. However, the Department has not accepted the order of the TPO and are agitating the matter in appeal. As all the facts and circumstances of the case are not before us, we can not express final view and accordingly leave the question to be determined by the Bench, before whom the matter is pending.

Ordinarily without strong reasons, the Assessing Officer should not challenge the transfer pricing determined by the TPO and bring to naught his efforts after receipt of the reference. Our observations that it was not binding on the Assessing Officer, prior to 1.6.2007 are meant to convey that the assessee even before the Assessing Officer could file evidence and show that arm's length price shown by

the assessee is quite reasonable and should be accepted. This question is decided accordingly.

Transfer pricing shown, its determination by T.P.O. and the CIT (Appeals) 55. We have considered legal aspects of transfer pricing raised before the Special Bench. We now proceed to consider controversies on "transfer pricing" raised by the assessee (taxpayer), and arising from the orders of the Transfer Pricing Officer and the Id. CIT (Appeals).

56. The taxpayer is engaged in providing specialized software services to customers based mainly in the USA which involves the following steps: 57. The steps 1, 4 and 5 are done at client's site abroad and are collectively termed as "Onsite software services" whereas the steps 2 & 3 are done from India and are called "Offshore Services". Here steps 1, 4 and 5 were carried at site by Aztec, US a wholly owned subsidiary of the Taxpayer in the USA (associated concern) and for these services Taxpayer paid to Aztec US a sum of Rs.28,32,20,103/-. The assessee debited above expenses in its profit and loss account under the general heading "software development expenses" (Schedule 12) as "onsite service charges". The payment was made by the Taxpayer to Aztec, US under an agreement titled "Master Agreement" in operations since 1.4.2001 wherein the Taxpayer is described as "Company" and Aztec US as "service provider". The pertinent Clause of the agreement is as under: ... The Company intends to engage the services of the service provider to provide onsite software and allied services to the Company's customers in the USA, for and on behalf of the Company.

58. Then taxpayer issued work orders to Aztec US for every client's project. The professionals under the employment of Aztec US performed the stipulated tasks based on the specifications given in the work orders. Sometimes the personnel from the taxpayer were also deployed to assist them. The payment to Aztec US was made on a cost + Markup basis.

The Mark up charged was 5% of the Cost. (Master Agreement - Page 4, Clause 3.1) The term "Cost" is, however, nowhere defined in the agreement.

59. The Taxpayer had further appointed Aztec US as its marketing agent in USA. As per the marketing agreement dated 1.4.2001, Aztec US was to perform the following functions: Deputing personnel to sell products of Aztec- India, Ensuring minimum number of orders & 60. The Taxpayer was to compensate Aztec-US for its services by reimbursing "cost of service" with a 10% Markup. During the period relevant to the Assessment Year under consideration the Taxpayer paid a sum equal to Rs.9,32,66,856/- towards sales commission to Aztec-US as it's marketing agent.

61. The above "international transactions" having been carried with an associated concern, the Taxpayer, in terms of section 92F, furnished auditor's report in from 3 CEB to show that transactions with associated enterprise can not be said to be inconsistent with Arm's Length basis as net operating profit of Aztec US is comparable to 10 similar U.S. based companies in the information technology business.

The Assessing Officer referred the question of determination of arms length price (ALP) of above transactions to the T.P.O as value of such transactions between associated enterprises exceeded Rs 5 crores.

62. The Transfer Pricing Officer, for determining arm's length price of the aforesaid transactions, required the taxpayer to submit copies of the following documents :  
(b) Copy of statement of income filed with return of income for the Assessment Year 2002-03  
(d) Copies of agreements, if any between the Taxpayer and it's associated enterprises.

63. Copies of above documents were submitted by the Taxpayer vide letters dated 16.2.2004 and 5.8.2004, which showed that the taxpayer had received "onsite revenues" and "off site revenue" to the tune of Rs.25,69,25,805/- and Rs.44,58,09,936/- respectively for the financial year 2001-02. The company had paid Rs.28,32,20,103/- for on- site services and Rs.9,32,66,856/- as sales commissions to Aztec US.64. As per the Taxpayer, it has reimbursed the cost of services rendered with 5% markup for onsite software services in US dollar as under:  
Expenses in \$ Markup 5% Total in \$  
5,648,232 282,42 5,930,644  
65. In respect of sales commission, mark up was 10% instead of 5% besides expenses

reimbursed. The position is as under: 66. Since the onsite revenue earned by the assessee taxpayer was less than charges paid to associated enterprises Aztec US, the T.P.O. required the assessee to explain the reasons for higher payments to associated enterprise for onsite services. It was explained that the Taxpayer entered into contract with end customers and services of Aztec US are used for providing onsite development services to customers. The taxpayer also pointed out as follows. "Aztec US functions as a contract service provider and operates in a risk-mitigated environment. Aztec US is insulated from entrepreneurial risks. Hence, payments to Aztec US are independent of the commercial outcome of the contracts entered into by Taxpayer with the customers. Aztec US is reimbursed the expenses plus a reasonable mark up for the functions performed. Transactions involving availing of services of Aztec US are separate and distinct from the transactions relating to services rendered by Taxpayer under the contracts with customers in U.S. Hence, these should not be compared to ascertain the transfer price." 67. The Transfer Pricing Officer, vide letter dated 20.9.2004, further required the assessee to explain/furnish the following details.

(a) Whether Aztec US rendered marketing support services in the period prior to 1.4.01? (b) With reference to justification of sales commission to Aztec US on TNMN method, T.P.O. observed that "comparables" chosen were in the business of computer system design, software development etc.

and not the business of rendering marketing support of services. How such "comparables" could be used to justify sales commission.

(c) Commission paid is 13.2% of total revenue. Prowlers data base of Indian Software companies showed that average amount spent on marketing is around 1.55% of the revenue by companies whose sales ranged between Rs.50 to 100 crores. Why above percentage (1.55%) be not used to determine arm's length price.

(d) Details of onsite services provided to customer and billing rate, details of onsite services provided by Aztec US etc. were sought.

68. In response to above, the Taxpayer submitted that comparable independent companies are engaged in USA in the development of software and also performing marketing activities and therefore such companies provided a reasonable level of comparability for Arm's Length Price.

69. In respect of marketing expenses by various companies used for comparison, it was pointed out that most companies disclosed such expenditure on nature basis and not on function carried. Salary and travel expenses of employees engaged in marketing might have been booked under "salary" and "travelling". It was further argued that "marketing expenditure of a company cannot be subject of challenge under "transfer pricing".

70. In respect of software development services provided to customers, it was clarified: (a) Taxpayer had entered into contracts with customers in the U.S. for rendering software development services.

(b) Software development under the contract include both offshore and onsite software development.

(d) Onsite software development under the above contract of the company with its customer was subcontracted to Aztec US. Since Aztec US was insulated from most entrepreneurial risks and earned only a fixed percentage of markup for its services, the company did not maintain a one-to-one co-relation between the: (i) Charges paid to Aztec US for the onsite software development services rendered and (ii) Invoices raised on the customers for the onsite services rendered by Aztec US to them on company's behalf.

71. The Taxpayer provided details of onsite services billed. There are 22 customers and billing rate varied from 55 to 210 dollars per man hour. The average rate realized worked out to 79 dollars per man hour.

72. After considering the submissions of the Taxpayer, the T.P.O. put her proposed Arm's Length determination to the Taxpayer for its objection vide TPO's letter dated 2.11.2004. The matter was fixed for final hearing. The proposal is summarized as under: (a) Certain companies included in working the average

marketing expenditure did not show any such expenditure nor could have included them under other heads and hence such companies are being excluded from consideration. After exclusion of such companies, average marketing expenditure works at 2.52% as against 13.22% claimed by the Taxpayer. The contention of the assessee that companies included in the list might have misclassified certain expenditure could not be accepted as no evidence was placed in support of such claim.

(b) In respect of on-site services, T.P.O. proposed the arm's length price as the amount equivalent to onsite service charges received by assessee as per accounts ascertained at 22.3%.

73. The Taxpayer company filed further objections vide letter dated 25.11.2004. As per the transfer pricing study claimed to be carried by the company, the most appropriate method to ascertain arm's length price in respect of services rendered was TNMN (method). Attention of the TPO was drawn to pages 17 to 21 of the transfer pricing study to support the contention that other methods were not appropriate. It was pointed out that the Assessing Officer was empowered to determine the arm's length price, under the following circumstances which were not attracted in this case: (i) The price of international transaction has been determined not using the most appropriate method or most appropriate method not applied in the manners prescribed; or (iii) Data or information used in determining the arm's length price is not reliable or incorrect; or 74. The assessee further raised an objection that no reasons have been given by TPO for rejecting TNMN method. It was also submitted that the objection of TPO that companies selected as "comparable" to the operations of Aztec US are not engaged in rendering marketing support services was not valid.

75. Moreover, it was pointed out that arithmetic mean of marketing expenses of the companies selected in the power database was being used by the T.P.O. as a benchmark for determining the arm's length price.

The companies comprised in the proposed set could not be said to be comparable based solely on the economic activity (i.e. software in the instant case) under which they were classified in the powers database, coupled with a turner criterion.

Economic circumstances relevant to availing of marketing support services by the Taxpayer from Aztec US in the U.S. market and scope of marketing activity conducted by the set of companies was not evaluated. The arrangement of these companies for undertaking the functions of marketing is not compared vis-à-vis of the company's arrangement in performing these functions.

76. The Taxpayer further objected by stating that as per part II Schedule VI of the companies Act 1956, every company was required to disclose expenditure under different heads mentioned therein. Marketing expenditure was not one of such heads. Miscellaneous, expenses were required to be shown by a company under a separate head if such expenditure exceeds 1% of the revenue of company or Rs.5000 whichever was higher. Thus companies were not required to disclose marketing expenses under separate head and hence data used by the taxpayer was reliable. In respect of onsite software development services, it was submitted that Aztec. functioned as a contract service provider and such payments were not at all comparable to the revenue received by the Taxpayer from its clients on account of on site services.

77. It was also submitted that T.P.O. was proposing to allow only Rs.21,73,40,292/- as expenditure as against Rs.35,45,21,482/- actually incurred and such disallowance of expenditure under the guise of arm's length procedure was not warranted. Had the assessee opened a branch in the USA instead of a subsidiary, then all such expenses would have been allowable; it was further contended 78. After considering the submissions of the assessee, T.P.O vide order dated 21.2.05 determined arm's length price. The T.P.O. rejected the contention of the assessee that payments were made to Aztec US on the basis of contract and therefore could not be questioned. The TPO took into account Article 9 of OECD Model Tax convention providing that any condition, "which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly." 79. The Transfer Pricing Officer noted peculiarity of transaction as under: The consideration receivable by Aztec-India from its customers is on time & material basis i.e. depending upon the number of

technical personnel deployed and the actual period of deployment. This is the normal commercial yardstick or unit of payment prevalent in software industry. As stated earlier, these rates are found to be well above the market average and doubtless illustrate the value of the brand name Aztec. The consideration receivable by Aztec-US from Aztec-India on the other hand is on a cost+ basis. Aztec-US will be reimbursed all its cost along with an assured markup of 5%. If Aztec-US spends more for delivering the same services it will earn more. In a normal transaction an enterprise increases its margin when it is efficient.

In Aztec-US's case however inefficiency brings in a premium.

Moreover the actual rates charged by Aztec-US is well above the cost + 5% rates also. As a result Aztec-India ended up paying Aztec-US @ US \$ 85 per man-hour as against US\$ 79 it was receiving from unrelated customers thereby making a gross loss from the transaction. As shown earlier on-site software development has procured a profit of Rs.9,18,66,337/- for Aztec-group a lion's share of which should have gone to Aztec-India. But Aztec-India suffered a loss of Rs.2,62,94,298/- from it. Thus the conditions imposed in the controlled transaction has prevented the accrual of due profits to Aztec-India. This calls for re-computation of profits for taxation purposes as provided in the Article 9 of OECD convention as well as sec.92 of Income Tax Act.

80. The Transfer Pricing Officer also rejected that cost recovered by Aztec US was Arm's Length price taking into account the following circumstances: (a) Aztec US in the controlled transaction had limited functions and operated in risk free environment.

(b) The Taxpayer Aztec India has brought in a marketing intangible being the brand name Aztec to the transaction. The brand-name was a valuable asset and in order to support this conclusion TPO referred to the fact that Aztec India was billing its customer at average rate of US\$ 79 per man hour for on-site services against industry average of US\$ 58-65 per hour during the same period. The TPO was of the view that on account of above factors downwards adjustments needs to be made to the CUP- or the price charged in comparable uncontrolled transaction to arrive at the Arm's length price as laid down in Rule 10B(1)(a). The TPO

suggested the following adjustments in internal and external CUP. Internal CUP represent the price charged by Taxpayer to the end customers in respect of onsite software services outsourced to Aztec-US. The adjustment should account for the following differences: The return for extra functions performed by Aztec-India including administrative & sale functions in addition to the technical functions outsourced to Aztec-US The return for additional assets deployed by Aztec-India, in particular the trade name Aztec.

Even after accepting that "these factors influence the pricing in any market condition", the T.P.O. did not make any adjustments as "in the instant case the challenge was to reduce it to so many USD per man hours", which according to the TPO, "was not an easy task".

External CUP working were based on the industry average billing rate. The NASSCOM average rates of USD 58-65 per man-hour, according to the T.P.O. were wide enough to account for a variety of functional differences. Still, these represented rates charged by independent entrepreneurs with a full risk profile. Therefore, a downward adjustment was necessary to serve as arms length rate that could be commanded by a no-risk sub-contractor. Therefore the rate of USD 58- per manhour was taken as the Arm's Length Rate. This, according to the T.P.O. gave an advantage to the taxpayer as the rate was definitely higher than the Arm's Length Rate payable to a subcontractor. Yet, according to the Transfer Pricing Officer, to avoid subjectivity in quantifying of adjustment, this "extra leverage was given to the taxpayer.

81. The TPO further observed that no independent party would get away with an order for 69505 manhours of on-site work for Rs.25,69,25,805/- @ 79 US\$ per man hour and then outsource it to a subcontractor for a sum of Rs.28,32,20,103/- @ US\$ 85/ manhour and earn a gross loss. The TPO found that assessee had paid to its associated concern Aztec US @ 85 US\$ per man hours against arm's length price of 58US\$ per-man hour.

This way assessee had paid to its associated concern 46% higher than Arm's Length Rates. On above basis the TPO determined the following amount required to be adjusted: Arm's Length Price of Services in US Dollars USD 4,031,522Arms

Length Price in INR Rs. 19,25,26,828 Amount paid as per Books Rs. 28,32,20,103 Adjustment Under Section 92CA Rs. 9,06,93,275 82. The TPO further justified above adjustment by applying internal comparable. He found that the profit margin earned on offshore software development services by the Taxpayer to other independent concerns was 63.74 %. as per the following calculations: Income from software services 44,58,09,936 Software development expenses (excluding onsite charges paid to Aztec US) 16,16,49,904/- Profit 28,41,60,032 Percentage of profit 63.74% 83. In respect of payment made by the assessee to Aztec-US as marketing agent for the TPO worked out "payable" amount at US\$ 0.0076 Million, but found that the assessee had actually paid 1.9 Million US\$ to its associated function. The TPO thus concluded that entire bills of annual salary of all non-software personnel of Aztec US along with a 10% Markup which was quite in excess of the arm's length price were raised on the assessee. To show that the transaction was not at arm's length the TPO further took into account revenue receipts of the assessee and totals recoverable debts for the years ending 31.3.2000 and 31.3.2001. She concluded that payment of Rs.9.62 Crores by the assessee to Aztec US resulted in decrease of revenue of 8.6 Crores and further resulted in outstanding debts (beyond six months) at Rs. 1.13 Crores. The Id. TPO accordingly noted that tax payer has justified the amount paid both for marketing and software services with common analysis. She rejected the analysis and working of ALP of tax payer by observing that US enterprises selected for comparison were in software business and there was no evidence to show that these companies were carrying on marketing functions as were rendered by Aztec US. 84. The TPO determined ALP in respect of transactions relating to marketing commission paid to Aztec US, by applying TNMM method. She took Taxpayer as the tested party for determining the arm's length price of marketing expenditure (sales commission), profit level indicator chosen being net margin (PBDIT) and 11 companies carrying on similar business in US were identified. The basis adopted and difference found between arm's length price and expenditure claimed by the Taxpayer is recorded by the TPO as under: Using the CMIE database Prowess a search was conducted for enterprises whose main business activity was shown as Computer Software. From among the companies selected, companies with turnover below Rs.50 Crores and above 100 crores were excluded, so as to

identify companies whose size is more or less the same as yours. This resulted in a list of 18 companies which incidentally included your company as well. From these, concerns showing no marketing expenses were also excluded. Barring Aztec India, 11 companies were thus identified as comparables. Arithmetic mean of PLIs (PBDIT / Marketing Expenses) of the 11 companies came to 82.77.

PLI of Aztec India calculated in the same manner came to 1.91. In other words, whereas the average spending by the comparable companies on marketing came to around 1.208% (1/82.77) of the Profit earned, spending on marketing by Aztec-India came to 52.36 % (1/1.91).

85. The Transfer Pricing Officer accordingly worked out Arm's Length Price of marketing expenses (commission) as under: Arm's Length Price of = PDIT of taxpayer / 82.77 (As per marketing expenses Prowess database) incurred by taxpayer = 1774 / 82.77 86. The TPO then considered in detail the objections raised by the assessee-taxpayer against ALP earlier put to the assessee. These have been discussed and considered in para 7 and 8 of the T.P.O's order.

Reference has already been made to these and it is not considered advisable to repeat them here. Ultimately the Id.TPO made the following adjustments on account of ALP determined by him relating to two international transactions between the assessee and its associated concern: Adjustment towards onsite services Rs. 9,06,93,275/- Adjustment towards marketing services Rs. 9,11,23,568/- Total Rs. 18,18,16,843/- 87. During the course of the appellant proceedings before the Id. Commissioner of Income-tax (Appeals) the Taxpayer submitted his objections against assessment and order of the T.P.O. These are summarized as under: (a) It is not correct to say that the Taxpayer's auditor did not compute the arm length's price correctly in accordance with law.

The company had conducted transfer pricing analysis and the same was submitted to T.P.O. vide letter dated 16.2.2004 (b) The Taxpayer had identified 10 companies based in U.S. which were business wise comparable to Aztec US. These companies were providing similar services and operating profit margin of these companies was comparable to the operating profit margin of Aztec US. (c) In the transfer pricing study, the company had evaluated the applicability of all the

possible methods and considered transactional Net Margin Method (TNMM) to be the most appropriate method.

(d) The arm's length price is also to be seen from the angle of Taxpayer having a branch in US. In such circumstances, all the expenses incurred would have been allowable. Thus the issue under discussion could only be the mark up amount that has been paid by the company to its associated enterprise. Such mark up is at arm's length.

(e) Adjustment made by T.P.O. tantamount to disallowance of actual expenditure.

(f) If operating profit margin of 6.5% is reasonable for an Indian subsidiary of a foreign company then such margin should also be considered as reasonable in the hands of Aztec U.S. (g) As per the terms of master agreement, the assessee had to reimburse the "cost" incurred by Aztec US while rendering "marketing" and "onsite software development" services and therefore T.P.O. should have found Comparable transactions of Reimbursement for computing the ALP as correct and reasonable. Such claim was raised in letter dated 13.2.2006 filed before the Id. CIT(A).

(h) The T.P.O. further failed to consider cost incurred towards maintaining of resources, which are in the nature of indirect costs to be aggregated with the direct cost. The T.P.O. has only considered the direct cost in respect of the services available and wrongly determined arm's length price.

(i) Prices paid by the company are at arm's length if one considers the return of capital employed.

88. The learned CIT (A ), after considering the submissions and counter submissions of the Taxpayer and taking into account the comments of the TPO and the A.O. recorded his decision which can be summarized as under: (i) On the question of reference to the T.P.O., the Id. CIT( A) held that reference to the Transfer Pricing Officer is in relation to the international transaction and hence all transactions have to be explicitly mentioned in the letter of reference. Contrary to this legal and procedural requirement, the Assessing Officer has referred the

matter in a general mechanical manner along with a copy of Form No. 3CEB not only in the case of this specific Appellant but also combined with similar transactions involving various other assessees. This was in contravention of the letter and spirit of the law and procedure in the matter.

(ii) The Id. Commissioner of Income-tax (Appeals) rejected objection of the assessee on reference to the TPO by observing that the claim of the Appellant that only the amount representing the mark up over the reimbursement could form subject matter of international transaction is not understandable. Not only the mark up amount but also the reimbursement amount to the associated enterprise could bear the characteristic of an international transaction in terms of Section 92B(1) of the Income-tax Act.

(iii) On approach and determination of ALP by TPO, the Id. Commissioner of Income-tax (Appeals) has observed that in the nutshell what has been done in the order of the Transfer Pricing Officer is that it has been presumed that Aztec US as respective associated enterprises had less of functions, asset deployment and risk sharing that were disproportionate to the presumed excessive payments made to them by Aztec India. Such presumed excessive payments to these associated enterprises i.e., Aztec US have been tried to be justified by arguing that they are not in commensuration with and are disproportionately excessive to the revenue earned by the Appellant from its different end customers. To justify this proposition the Transfer Pricing Officer has tried to demonstrate as to how the Appellant has charged from its Customers the revenue for the services rendered to them for different activities at lower than the accepted market rate (based on lesser amount of man hour), which in a jargonized scenario is termed as uncontrolled price, despite heavy and higher rate of reimbursements to the respective associated enterprises against the services rendered by them. The relationship and comparability between these two characteristically different transactions is however incomprehensible.

(iv) In order to justify the above position the Transfer Pricing Officer has done certain presumed re-working as to how in line with the amounts paid or reimbursed to the associated enterprises, the Appellant could have billed its customers for

excessive number of man hours and the higher rate for the man hours. For this the Transfer Pricing Officer has resorted to compare the man hour rate worked out in the case of the Appellant with that of the average rate given by the NASSCOM. This re-worked analysis is termed to be relevant for the CUP method to be adopted. To summarize this reworked analysis it can be said that first of all the Transfer Pricing Officer converted total receipts of the Appellant from its different customers, who are the third unrelated parties into Dollars. This was then divided by the estimated figures of man hours obtained from the Appellant. The figure so arrived of per hourly rate in the case of the Appellant was compared with average rate given by NASSCOM respectively for offshore and for onsite services.

Since the average rate arrived by the Transfer Pricing Officer was not within the average rate given by NASSCOM the transaction was not considered at arm's length price. Therefore, the same was re-worked in line with the average rate given by NASSCOM".

(v) According to the Id. CIT (Appeals), what needed was, "to be actually compared is the similar data of reimbursement for similar kind of situation and service rendered between two unrelated parties. First of all this would require availability of similar data and related comparisons of the relevant criteria and parameters for such reimbursement...a reimbursement can not be linked and compared with the probable and possible generation of revenue which the appellant would receive. This cannot be treated as comparisons between similar nature of transactions.

For the above reasons, the Id. CIT (Appeals) deleted the addition made on the basis of order of the T.P.O.89. The grounds of appeals, against the above order of the CIT(A), as raised in assessee's appeal ITA No. 584/Bang/06 are: 1. That the orders of the authorities below in so far as it is against the assessee is against the law, facts, circumstances, natural justice, equity and all other known principles of law.

2. That the total income computed and the total tax computed is hereby disputed.
3. The learned authorities below erred in holding the sum of Rs 1.00 crore paid for termination of the lease/rent agreement as capital expenditure. The appellant

- submits that expenditure is revenue in nature and prays that the amount paid for termination of lease be allowed as claimed in the interest of justice.
4. That the learned authorities below have not appreciated the entire issue in the right perspective and the findings are totally against the facts emerging on record.
  5. The order of CIT (Appeals) on the issue of Transfer Pricing Order in so far as it is against the appellant is in error.
  6. The CIT (A) erred in holding that ipso facto the determination / calculation of arm's length price amounts to earning of income by the appellant.
  7. The order of the Transfer pricing officer and that of the AO is in clear violation of the law on this issue and the principles enunciated by various courts more particularly on the issue of reference, sanction of approval, recording of reasons and lack of satisfaction.
  8. The AO erred in believing that the suggestions made by the Transfer pricing officer is binding and compels him to make the adjustment.
  9. The authorities below erred in holding that the provisions of section 92CA which came into effect from 1.6.2002 as procedural law and applies to all pending assessments.
  10. The authorities below erred in ignoring the fact that there was no prescribed method for computation of arm's length price having regard to the nature of transactions carried out by the appellant.
  11. That the authorities below erred in holding that deduction Under Section 10A is not available for the adjustment made in respect of business carried on by new Industrial Undertaking eligible for deduction Under Section 10A.
  12. No interest Under Section 234A and 234B can be levied on the adjustment made Under Section 92CA of the Act.
  13. For the above and other grounds and reasons which may be submitted during the course of hearing of this appeal, the assessee requests that the appeal be allowed as prayed and justice be rendered.

90. The grounds of appeal raised by the Revenue in Department's appeal ITA No. 585/Bang/06 are: 2. The CIT (A) erred in deleting the Arms Length Price determined by the Transfer Pricing Officer.

3. The CIT (A) erred in holding that instruction No. 3 of 2003 issued by CBDT is bad in law.

4. The CIT (A) erred in adjudicating the propriety and legality on the granting of approval of CIT. 5. The learned CIT (A) failed to see that the Instruction issued by CBDT requires the Assessing Officer assessing a particular company to see if any foreign transactions are involved with its associated enterprise and in case of transactions above a certain limit, refer the same to the Transfer Pricing Officer who being an expert and dealing with only such transactions, goes on to determine whether the Arm's Length Price has been arrived at in a fair manner. The Transfer Pricing Officer thus takes over the role of the Assessing Officer when the provisions of Chapter X are involved. The CIT (A) has failed to appreciate the above position.

6. The entire thrust of the appellate order has been on improper application of mind and non-determination of a clear case of tax avoidance by the Assessing Officer and also by the Administrative Commissioner before making the reference to the Transfer Pricing Officer. The learned CIT (A) has failed to see that this responsibility of determination and quantification of the Arm's Length Price has been cast on a specialized Assessing Officer called the Transfer Pricing Officer who deals exclusively with international transactions and its provisions under Chapter X. 7. The CIT (A) erred in holding that the provision of Chapter X can be invoked in cases when there is a presupposition of Avoidance of tax.

8. The learned CIT (A) erroneously projected the requirements laid down in sections 52(2), 142(2A), 245E and spirit of Section 147 into the simple act of reference to the Transfer Pricing Officer by the Assessing Officer. The provisions have been thus misquoted and misread.

9. The CIT (A) erred in holding that the burden is on the revenue to show tax avoidance by comparing the provisions of Chapter X and deleted Section 52.

10. The learned CIT (A) summarily allowed the appeal on merits without any speaking order. The thrust was on procedure of reference to Transfer Pricing Officer rather than merits of determination of the Arm's Length Price by the Transfer Pricing Officer.

11. The CIT (A) ought to have considered the fact that Circular No. 14 gives the rationale for denial of Section 10A/10B on such enhanced income (there is no actual cash flow and hence, no actual foreign exchange remittances). The Circular nowhere states that the proviso is applicable only under exceptional circumstances.

12. For these and such other grounds that may be urged at the time of hearing of the appeal, it is requested that the order of the CIT (A) may be set-aside and that of the Assessing Officer restored.

13. The appellant craves leave to add/ alter/ amend/ delete any of the grounds on or before the hearing of the appeal.

91. We consider above grounds relating to transfer pricing hereinafter.

It is submitted by the Revenue that the Taxpayer has not computed the arm length's price as per audit report, but has only drawn a conclusion that transactions between Taxpayer and Aztec US "cannot be said to be inconsistent with the arm length's basis" as net operating profit of Aztec US is comparable with 10 selected U.S. based companies engaged in I.T. business. The taxpayer has chosen TNMM method to justify payment for the services rendered at arm's length price. It is further claimed that other 4 methods are not applicable in these cases. In this connection Definition of TNMM found in OECD's transfer pricing guidelines for multinational enterprises and Tax Administrators, is brought to our notice.

92. It is argued that learned CIT (A) has not commented on the Arms' Length Price computation of the tax payer. Taxpayer has done comparability analysis using date of "comparables" pertaining to the year 1999, 2000 & 2001 which is not permissible as per statutory requirements. Earlier year's data can be used only when such data influenced the determining of the transfer price. No claim has

been made to this effect nor any material brought on record to show such influence. Hence results of earlier years were not relevant and rule 10B(4) was not applicable. OECD guidelines also do not support the use of earlier year data as a statistical in the actual arithmetical computation of arm's length price. Such multiple year data could be used merely when such data explains certain trends in the current year.

The weighted averages of earlier years could not be used in the actual computation of ALP. It was submitted that the comparability analysis furnished by the taxpayer was thus not in accordance with the rules.

The taxpayer had used non-contemporaneous data.

93. It is contended that order of Id. Commissioner of Income-tax (Appeals) striking down computation of ALP by TPO in respect of provision of onsite software services by Aztec US on the following count was not justified: (a) The Taxpayer was permitted to raise for the first time a new plea that the transactions under consideration were actually in the nature of reimbursement of expenses and hence the TPO should have compared it only to transactions of reimbursements and not to software development transaction.

(b) The Id. CIT(A ) erred in accepting Taxpayer's contention that external comparable used (Average onsite billing rate charged by the India Software companies during the relevant financial year as reported by NASSCOM) was not a transaction but an average of a number of transactions and hence could not be used as a comparable uncontrolled transaction and that Aztec US was only an agent of Aztec India and had received expenditure actually incurred by Aztec US plus Benchmark. It was a case of reimbursement of expenditure actually incurred on behalf of Aztec India.

(c) An average of different figures could not be used as arms length price.

(d) TNMM (method) furnished by the assessee was not most appropriate method yet Id. Commissioner of Income-tax (Appeals) failed to reject the same. In fact, Id. Commissioner of Income-tax (Appeals) by deleting computation made by TPO

impliedly re-stored computation of the assessee.

94. Elaborating on the above, the Revenue has contended that findings of Id. Commissioner of Income-tax (Appeals) were not justified, the claim that transaction was one of reimbursement, was raised for the first time before the Commissioner of Income-tax (Appeals) who wrongly accepted this in violation of provision of Rule 46A of I.T. Rules.

Besides the claim raised was contrary to all the documents maintained by the taxpayer included the following: (i) Audit report under section 92E in Form 3CEB filed alongwith the return.

95. The Revenue drew our attention to the following portion of master agreement between associated concerns dated 1.4.2001.

...the Company intends to engage the services of the service provider to provide onsite software and allied services to the Company's customers in the USA, for and on behalf of the Company.

96. The Taxpayer could not revise its claim changing nature of transaction from "provision of onsite software services" to "reimbursement" without revising the claim by filing revised return.

The Id. Commissioner of Income-tax (Appeals) also fell in error in not providing any opportunity of being heard to TPO on this new claim. The Id. CITA further failed to appreciate that primary "onus" of computation of ALP was on the taxpayer and the same was not discharged 97. The revenue has challenged the finding of the Id Commissioner of Income-tax (Appeals) that computation of ALP by TPO is not based on comparability analysis using transactions involving reimbursement. It is argued that if learned Commissioner of Income-tax (Appeals) was convinced that international transactions were one of reimbursement, the correct procedure was to ask the taxpayer to compute ALP, based on comparable transaction and then give the revenue an opportunity to examine such a claim. The claim was accepted in violation of principles of natural justice and procedure laid under the law.

98. CIT(A)'s rejection of average rate of NASSCOM on the ground that it is not a single transaction, but multiple transactions is urged to be considered against specific provision of IT Rule 10B (1)(a). The aforesaid rule allows use of multiple comparable transactions. Further Proviso to section 92C(2) explicitly states that when the most appropriate method gives more than one price, the arithmetic mean (average) of such prices should be taken. Accordingly, it has been submitted by the revenue that the stand of the Id. CIT(A) is contrary to the provisions of law. The Revenue also drew our attention to the definition of "transaction" as per Clause (v) of section 92F and showed that it includes arrangement, understanding or action with associated enterprises. The Revenue also drew our attention to the meaning of "transaction" as per Clause (d) of Rule 10A of IT Rules, which means to include a number of closely linked transactions. Therefore, it was prayed that "transaction" cannot be construed in a narrower manner and would include number of transactions or class of transactions.

Accordingly, it has been prayed that Id. CIT(A)'s objection that reference of the Assessing Officer to TPO by taking all the transactions together was bad in law is wrong and liable to be set aside.

99. The Revenue on the basis of financial results available at page 67 of Annual Report of the assessee, has contended that over all profit in software development business was quite high i.e. 36.69%. Yet as far as dealing with Aztec US was concerned the assessee suffered loss and paid 10.24 % of Revenue to Aztec US out of its own pocket. It suffered loss of Rs.2,62,94,298/- on on-site software services got carried through Aztec US. On the contrary Aztec US earned profit of 41.65% from business dealing with the assessee. Working of this huge profit is claimed to be given at page 34/35 of the paper-book/written submission filed by the revenue. It was accordingly submitted that it was a clear case of shifting and diversion of profit by the assessee to US Company.

100. The Revenue has also objected to the stand of the assessee that only "markup portion" of the compensation, attracted application of transferpricing provision as the rest represents third party cost incurred by the Aztec US exclusively for the benefit of the Taxpayer.

This argument was rejected by the Id. CIT (Appeals) also.

101. It is contended by the Revenue that analysis furnished by the assessee did not satisfy the requirement of section 92C(1) & (2) and relevant rules governing the computation of arm's length price. It is pointed out that arm's length price is to be determined by the following most appropriate method. It is pointed out that taxpayer had chosen Transactional Net Margin Method (TNMM) as most appropriate method, on the ground that other 4 methods given under section 92 C(1) are not applicable. This claim is seriously challenged by the Revenue as wrong by referring to the definition of TNMM method in OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators. Revenue also drew attention to TNMM Method as prescribed under Rule 10B (1)(e) of I.T. Rules. It is pointed out that under correct application of TNMM method in the instant case computation of net margin (with reference to a suitable base) realized by the assessee taxpayer from relevant international transaction on onsite software services and benchmarking it against the net margin earned by it from a comparable uncontrolled transaction or net margin earned by another unrelated enterprise from a comparable uncontrolled transaction was to be found. Instead what the taxpayer has done is to benchmark net margin earned by the other party to the transaction i.e.

the associate enterprise. Not just from relevant international transaction, but from its entire business activities which was compared against margin earned by set of other companies. This claim was untenable. The Taxpayer did not take into account net margin realized by taxpayer from international transactions but based the claim put forward on net margin realized by the associated enterprises from its entire business activities.

102. The Revenue authorities also challenged US Companies taken by the taxpayer as "comparable" cases in the process of application of TNMM Method. It is contended that cases of companies taken by the taxpayer were not comparable as they were not involved in a similar business as carried by Aztec US.103. The observation of the learned CIT (A ) that while estimating the figure of revenue generation on the basis of man hours the order of the Transfer Pricing Officer did

not take into consideration the man hours unutilized on account of idle time, leaves and overtime etc. have also been challenged as untenable.

104. It is submitted that every software developer maintains a bench.

But nobody raises an invoice for the unutilized or wasted man-hours.

The invoices are raised only for utilized man-hours. The billing rates are charged only for those man-hours spent on client's work and accepted by the client. Just as Aztec India as the service provider cannot expect its end customers to pay for unbilled hours (man-hours not accepted by the client or wasted the bench man-hours), Aztec India cannot be expected to pay for the un-billable hours of the service provider either. The amount debited is clearly described in the P& L Account of Aztec India (schedule 12) as Onsite Service Charges. Hence, this cannot be treated as payment for anything other than Onsite Services. Therefore, the rate of payment (billing rate) can be calculated only with reference to the onsite man-hours billed and nothing else. Every service provider incurs cost towards surplus capacity or bench. Every service provider does man-hours of work, which cannot be billed to the customer or are rejected by the customer.

Billing rates are always calculated without taking these into account.

105. The most serious objection of the revenue is that after rejecting ALP determined by the TPO the Id. CIT( A) accepted ALP of the assessee impliedly although it suffered from various defects and was unsustainable under the law.

106. In respect of marketing commission, it has been submitted that learned CIT (A ) allowed relief without any discussion or reason and without consideration of objection of the parties.

107. The Id. AR Shri. K.R. Pradeep has also filed his comments/objects on the written submissions filed by the revenue. The learned AR has submitted that the department has not made the assessment record and approval of T.P. records available for perusal. The communications inter-se the authorities and referred to by the Id. CIT (A) in pages 3 to 98 of his order have not been fully made available for perusal.

Copies of NASSCOM report and other materials relied on by TPO i.e.

results of 12 companies listed in Annex of TPO notice dated 24.01.05 have not been given. The T.P.O. has not furnished any document, evidence or information in public domain on the comparables he has chosen for the T.P. Comparison. Since report of NASSCOM has ever been put to the assessee or Bench, the same can be admitted only as additional evidence as per rules of the Tribunal. Regarding submission of the revenue that claim of reimbursement of expenses was made for the first time before the learned CIT( A), the learned AR submitted that letter dated 13.2.2006 available at page 280 & 281 of the paper book does not refer to reimbursement for the first time. The learned CIT (A) has given sufficient opportunity to A.O. and T.P.O. on the issue that assessee has reimbursed the expenses. The taxpayer also submitted that the determined transfer pricing and adjustment by T.P.O. was contrary to transfer pricing regulations. The Id. Counsel wanted opportunity to address oral arguments.

108. We have given careful consideration to oral and written submission of the parties on merit of transfer price disclosed by the taxpayer and determined by the Transfer Pricing Officer. We have also considered in detail, the order of the Id. Commissioner of Income-tax (Appeals). The transfer pricing concept, no doubt, is new to Indian tax system, but for the last several decades, the tax authorities and courts have been determining "open market value" of properties of all kinds. For example, under Section 23 of the Land Acquisition Act, the courts are required to determine the amount of compensation of acquired property and in the process have to find its "open market value". Under section 7(1) of the Wealth-tax Act, the value of an asset owned by the taxpayer, is provided "to be the price which, in the opinion of the Assessing Officer, it would fetch in the open market". Under section 40A(2) of the Income-tax Act, tax authorities, in case of claim of payment to a close relative or a sister concern, are empowered to substitute for such payment the market value of goods, services or facilities provided where it is found that the payment is excessive and unreasonable. Under above provisions and several other enactments, courts in India have laid useful guidelines to help determine the open market value of property / transaction. These guidelines for the determination of fair market value are quite well-settled. All circumstances surrounding the

transaction, influencing its market value, are required to be considered. Rule to compare like with like is firmly established. However, technical terms like 'controlled transaction', 'uncontrolled transaction', 'international transaction' etc., various methods of determination of Arm's Length Price, obligation of the tax payer to maintain record of international transaction and such other material as are needed to determine Arm's Length Price were introduced in India only in 1991-92 for the first time as noted earlier. India is not a Member of the Organization for Economic Cooperation & Development (OECD). However, the organization has been supporting efforts of tax administration in India to properly and effectively administer and implement Transfer Pricing Policy. A useful reference can always be made to OECD Guidelines, for the purposes of resolving dispute of transfer pricing in India, subject, however, to statutory regulations.

109. Computation of arm's length price is essentially a factual exercise. Each case depends on its own peculiar facts and circumstances. In certain cases where identical or almost similar uncontrolled transaction is available for comparison; determination of Arm's Length Price is an easy task. However, it is not so in most of transactions and rarely one is able to locate an identical transaction.

In such cases Arm's Length Price is determined by taking results of a comparable transaction in comparable circumstances and make suitable adjustments for the differences. The Legislature in India, in order to take true income of taxpayer, has prescribed certain universally accepted methodologies to compute arm's length price under the Income-tax Act read with the Income-tax Rules.

110. Section 92C of the Act lays down the methodology of computing arm's length price. It reads as follows: 92C. - (1) The arm's length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely: (2) The most appropriate method referred to in Sub-section (1) shall be applied, for determination of arm's length price, in the manner as may be prescribed : Provided that where more than one price may be determined by the most appropriate

method, the arm's length price shall be taken to be the arithmetical mean of such prices; or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.

Where in an international transaction, two or more associated enterprises enter into a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises, the cost or expense allocated or apportioned to, or, as the case may be, contributed by, any such enterprise shall be determined having regard to the arm's length price of such benefit, service or facility, as the case may be.

112. The transfer pricing methods prescribed in section 92C, are further described and explained in Income-tax Rules 10A and 10B and 10C. Though section 92C(2) specifies that the Board may prescribe certain other methods of computation of arm's length price, no other method has been prescribed by the CBDT till date.

113. Before we go into each one of these methods, the fundamental requirement, in any of the method selected, is the selection of "comparables", for benchmarking international transactions. This selection of a comparable should be based on functional, asset, and risk analysis of both the parties and transactions. Section 92C prescribed that the most appropriate method has to be selected by having regard to (a) the nature of transaction, class of transaction, (b) class of associated persons, (c) function performed by such persons or other relevant factors as the Board may prescribe. Rule 10C(2) elaborates these parameters as follows: (2) In selecting the most appropriate method as specified in Sub-rule (1), the following factors shall be taken into account, namely: (b) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises; (c) the availability, coverage and reliability of data necessary for application of the method; (d) the degree of comparability existing between the international transaction and the uncontrolled transaction and between the enterprises entering into such transactions; (e) the extent to which reliable and

accurate adjustments can be made to account for differences, if any, between the international transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions; (f) the nature, extent and reliability of assumptions required to be made in application of a method.

114. Rule 10B Sub-section (2) also lays down the criteria for judging the comparability of an international transaction with an uncontrolled transaction as follows: (2) For the purposes of Sub-rule (1), the comparability of an international 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.

115. The parameters for taking a controlled transaction as "comparable" to an uncontrolled transaction are provided in Sub-rule (3) of Rule 10B. Subrule (4) of the aforesaid rule states the period for which data should be collected. These are as under: (3) An uncontrolled transaction shall be comparable to an international transaction if (i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or (ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(4) The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:

Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared.

116. Meaning of Arm's Length Price is given in Clause (ii) of Section 92F as under: 92F (ii) "Arm's Length Price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions; 117. Thus whatever methodology is chosen for the purpose of determination of arm's length price under section 92C, these criteria, as specified in the Act and the Rules have to form a basis of judging the comparability. Thus there should be a proper analysis of such transactions with respect to, the functions performed, the assets employed and the risk assumed by the respective parties with reference to the transaction in question. This can be termed as functional, asset, risk analysis i.e. FAR analysis. All the three ingredients of FAR have direct bearing on the pricing of products / services. The provision also provides scope for carrying out adjustments in cases where there are some differences or variations to make two transactions commercially comparable, for the purpose of benchmarking. In other words, an uncontrolled transaction selected for benchmarking should be adjusted by employing certain techniques like FAR analysis, to be selected on its peculiar factual matrix, for the purpose of enabling comparison of the same with a controlled international transaction so that the differences or variations are ironed out or minimized. The underlying principle being that only likes can be compared with like.

The adjustments are suggested to achieve the object of testing and trying to see if both the parties or / and the transactions are similar or nearly similar. At times even after adjustments, the transaction/s or parties sought to be compared may not be identical or there might not be a possibility of adjustment. This is a very subjective exercise and fact based.

118. The selection of the most appropriate method (MAM) is based on the nature of transaction, the availability of relevant data and the possibility of making appropriate adjustments.

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified; (ii) such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market; (iii) the adjusted price arrived at under Sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction.

This is essentially comparison of prices charged for the property or services transferred in a controlled transaction to a price charged for property or services transferred in a comparable uncontrolled transaction. The bedrock of this method is the identification of an identical transaction, in a situation where a price is charged for products or services between unrelated parties.

While applying CUP the comparability between controlled and uncontrolled transactions should not be only judged from the point of product comparability, but should also take into consideration the effect on price of other broader business functions. Even minor differences in contractual terms or economic conditions, geographical areas, risks assumed, functions assumed etc. could affect the amount charged in an uncontrolled transaction. Comparability under this method depends on close similarities with respect to various factors.

The CUP can be internal or external. The internal CUP is the price that the assessee has paid/charged in a comparable uncontrolled transaction with an independent party when compared to the price paid / charged in a controlled transaction. External CUP is a price charged in comparable uncontrolled transactions between third parties when compared to the price of a controlled transaction. However, where CUP method is to be applied on the basis of public data, it is provided in Regulation 1.482-3(b)(5) that following requirements must be met : The data is widely and routinely used in ordinary course of business in the industry to negotiate prices for uncontrolled sales.

The data is used to set prices in the controlled transaction in the same way that it is used by uncontrolled taxpayers in the industry; and The amount charged in the

controlled transaction is adjusted to reflect product and service variations.

The US regulations further warn that data from public exchanges, quotation media should not be used in extraordinary situations such as war period, economic depression, natural calamities period. We are of the considered view that above principles are of universal application and there is no good reason why they should not be applied in transfer pricing determination in India.

(i) the price at which property purchased or services obtained by the enterprise from an associated enterprise is resold or are provided to an unrelated enterprise, is identified; (ii) such resale price is reduced by the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the purchase and resale of the same or similar property or from obtaining and providing the same or similar services, in a comparable uncontrolled transaction, or a number of such transactions; (iii) the price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the purchase of property or obtaining of services; (iv) the price so arrived at is adjusted to take into account the functional and other differences, including differences in accounting practices, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect the amount of gross profit margin in the open market; (v) the adjusted price arrived at under Sub-clause (iv) is taken to be an arm's length price in respect of the purchase of the property or obtaining of the services by the enterprise from the associated enterprise; The RPM is to be applied when a property purchased or services obtained from an associated enterprise is resold to an unrelated enterprise.

The RPM is based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by resale price margin for arriving at the ALP. The resale price of goods is reduced by the direct expenditure and the normal gross profit margin that would have been earned by an unrelated enterprise in a similar transaction. The price is further adjusted on account of different accounting practices and other differences between the transactions. There may be an internal RPM or external RPM as in

the case of a CUP. Benchmarking of the margins is critical in this process. RPM could be reasonable method to apply to transactions involving resale of tangible property or in cases where the services are resold without value addition. This method is particularly suitable in cases where goods are sold within a short period of purchases and influence of other factors is found to be minimal.

(i) the direct and indirect costs of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise, are determined; (ii) the amount of a normal gross profit mark-up to such costs (computed according to the same accounting norms) arising from the transfer or provision of the same or similar property or services by the enterprise, or by an unrelated enterprise, in a comparable uncontrolled transaction, or a number of such transactions, is determined; (iii) the normal gross profit mark-up referred to in Sub-clause (ii) is adjusted to take into account the functional and other differences, if any, between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions, which could materially affect such profit mark-up in the open market; (vi) the costs referred to in Sub-clause (1) are increased by the adjusted profit mark-up arrived at under Sub-clause (iii) (v) the sum so arrived at is taken to be an arms length price in relation to the supply of the property or provision of services by the enterprise; This method is ordinarily used where some semi-finished goods are sold between related parties or similar situations or in respect of joint facility agreements, long-term buy and supply arrangements of provisions of services etc.

This is a method, which uses the costs incurred by the supplier of the property or services in a controlled transaction. Here also as in the case of RPM benchmarking of normal gross profit margins is necessary.

The cost plus mark up of the supplier in a controlled transaction should ideally be established by reference to the cost plus mark up with the supplies of functional similarity earned in a comparable uncontrolled transaction.

Cost Plus Method is adopted in situations where comparable transactions are of functional similarity with that of controlled transactions. In other words, under Cost Plus Method, there is no necessity to benchmark with such product, which is 100%

identical. Products, which are functionally comparable, are good enough for benchmarking under Cost Plus Method. Even in this regard FAR analysis is critical in identifying functionally similar comparable transactions.

As in other methods, the assets employed, the functions performed, the risk assumed, the contractual terms and other differences have to be taken into account. The mark up must be measured consistently between the associated enterprises and independent enterprises.

(i) the combined net profit of the associated enterprises arising from the international transaction in which they are engaged, is determined; (ii) the relative contribution made by each of the associated enterprises to the earning of such combined net profit, is then evaluated on the basis of the functions performed, assets employed or to be employed and risks assumed by each enterprise and on the basis of reliable external market data which indicates how such contribution would be evaluated by unrelated enterprises performing comparable functions in the similar circumstances; (iii) the combined net profit is then split amongst the enterprises in proportion to their relative contributions, as evaluated under subclause (ii); (iv) the profit thus apportioned to the assessee is taken into account to arrive at an ALP in relation to the international transaction.

This method may be applicable in cases where transactions involved transfer of unique, intangible or any multiple interrelated international transactions, which cannot be evaluated separately for determining the ALP of any one transaction.

The profit split method first identifies the profit to be split for the associated enterprise from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the parties, such as the profit arising from high value, sometimes unique, intangibles.

The contribution of each enterprise is based upon a functional analysis and valued to the extent possible by any available reliable external market data.

The functional analysis is an analysis of the functions performed (taking into account assets used and risks assumed) by each enterprise.

The external market criteria may include, for example, profit split percentages or returns observed among independent enterprises with comparable functions.

(i) the net profit margin realized by the enterprise from an international 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 realized 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 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 realized 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.

The TNMM requires establishing comparability at a broad functional level. It requires comparison between net margins derived from the operation of the uncontrolled parties and net margin derived by an associated enterprise on similar operation.

Under this method, the net profit margin realized by an associated enterprise from an international transaction is computed in relation to a particular factor such as costs incurred, sales, assets utilized, etc. The net profit margin realized by an associated enterprise is compared with net profit margin of the uncontrolled transactions to arrive at the ALP. The TNMM is similar to RPM and CPM to the

extent that it involves comparison of margin earned in a controlled situation with margins earned from comparable uncontrolled situation. The only difference is that, in the RPM and CPM methods, comparison is of margins of gross profits and whereas in TNMM the comparison is on margins of net profit.

TNMM requires comparison between net margins derived from the operations of the uncontrolled parties and net margins derived by an associated enterprise from similar operations. Net margin is indicated by the rate of return on sales or cost or operating assets, and this forms the basis for TNMM. A functional analysis of the tested party or the independent enterprise, as the case may be, is required to determine whether the transactions are comparable and the adjustments that are required to be made to obtain reliable results. The tested party would have to consider other factors, like cost of assets of comparable companies, etc., while applying the return on assets measure. Ordinarily, the tested party, has to be the party provided services because it is on the basis of rate of return on sales or cost or operating assets that transactional margin is computed. These parameters generally available in the case of a party providing services.

120. We may now refer to the proviso to Section 92C(2) which specifically provides that: Where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetic means of such prices. An option has been given to the assessee that he can take a price which may vary from the arithmetical mean by an amount not exceeding 5% of such arithmetical mean.

121. The burden is on the assessee to select the most appropriate method (MAM). This decision of selecting MAM is to be substantiated by the assessee by an appropriate documentation as well as by substantiating why a particular method is considered best suited to the facts and circumstances of the international transaction and as to how it provides the most reliable result of the ALP. Rule 10C(2) of the I.T. Rules lays down the factors to be considered in selection of MAM. These have been extracted in the previous paragraphs.

122. Hence, while making the selection of the transfer pricing method, one would be required to evaluate each method vis-à-vis the factors / parameters prescribed in

Rule 10C(2).

123. Once MAM, i.e. most appropriate method, is selected, the next step is to collect the inputs for computing arms length price under that method. The question arises as to who has the onus of collecting and furnishing the requisite inputs for determining the ALP.<sup>124</sup> To answer the above question, we find guidance from Sub-section (1) of Section 92 which, for a ready reference, is reproduced below

92(1) Any income arising from an International Transaction shall be computed having regard to the Arm's Length Price.

Explanation:- For the removal doubts, it is hereby clarify that the allowance for any expense or interest arising from an International Transaction shall also be determined having regard to the Arm's Length Price.

125. The aforesaid provision does not make any reference or mention of taxpayer or of the Assessing authority. Any one, called upon to consider the question of taxability of international transaction has to take its value at ALP. The application of the provision is mandatory, both for the Assessing Officer and the taxpayer. The ALP has to be determined of every international transaction whatever may be the agreed consideration. Further under section 92E, a taxpayer who has carried an international transaction during the previous year, is required to furnish audit report in the prescribed manner on Form 3CEB. A reference to the prescribed proforma would reveal that the auditor is obliged to give information in the report relating to international transaction carried by the taxpayer in the relevant period. It is also to be shown that price charged / paid for goods, services etc. or other dealings covered by the statutory provision was ALP. Under section 92D taxpayer who has entered into international transaction is required to keep and maintain information and document as are prescribed. As to what are the documents prescribed, we are to go to Rule 10D of the Income-tax Rules, 1962. The said Rule is as under:

10D (1) Every person who has entered into an international transaction shall keep and maintain the following information and documents, namely: (a) a description of the ownership structure of the assessee enterprise with details of shares or other ownership interest held therein by other enterprises; (b) a profile of the multinational group of which the assessee enterprise is a part along with the

name, address, legal status and contrary to tax residence of each of the enterprises comprised in the group with whom international transactions have been entered into by the assessee, and ownership linkages among them; (c) a broad description of the business of the assessee and the industry in which the assessee operates, and of the business of the associated enterprises with whom the assessee has transacted; (d) the nature and terms (including prices) of international transactions entered into with each associated enterprise, details of property transferred or services provided and the quantum and the value of each such transaction or class of such transaction; (e) a description of the functions performed, risks assumed and assets employed or to be employed by the assessee and by the associated enterprises involved in the international transaction; (f) a record of the economic and market analyses, forecasts, budgets or any other financial estimates prepared by the assessee for the business as a whole and for each division or product separately, which may have a bearing on the international transactions entered into by the assessee; (g) a record of uncontrolled transactions taken into account for analyzing their comparability with the international transactions entered into, including a record of the nature, terms and conditions relating to any uncontrolled transaction with third parties which may be of relevance to the pricing of the international transactions; (h) a record of the analysis performed to evaluate comparability of uncontrolled transactions with the relevant international transaction; (i) a description of the methods considered for determining the arm's length price in relation to each international transaction or class of transaction, the method selected as the most appropriate method along with explanations as to why such method was so selected, and how such method was applied in each case; (j) a record of the actual working carried out for determining the arm's length price, including details of the comparable data and financial information used in applying the most appropriate method, and adjustments, if any, which were made to account for differences between the international transaction and the comparable uncontrolled transactions, or between the enterprises entering into such transactions; (k) the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price; (l) details of the adjustments, if any, made to transfer prices to align them with arm's length prices determined under these

rules and consequent adjustment made to the total income for tax purposes; (m) any other information, data or document, including information or data relating to the associated enterprise, which may be relevant for determination of the arm's length price.

126. A reference to sections 271AA and 271G of the Act at this stage is also appropriate. The former provides for a penalty in case of failure to keep and maintain information required Under Section 92D. The other section namely Section 271G provides for levy of penalty for a failure to furnish such information when called upon to do so by departmental authorities. The purpose of providing penal consequences for not maintaining or not producing the requisite documentation emphasizes legislative intention to insist upon and ensure compliance by the assessee to produce the necessary inputs. Therefore, it is not possible to argue that onus is not on the assessee.

127. Having regard to above statutory provisions, it is clear that burden to establish that international transaction was carried at ALP is on the taxpayer. He has also to furnish comparable transactions, apply appropriate method for determination of ALP and justify the same by producing relevant material and documents before the revenue authorities. In case revenue authorities are not satisfied with the ALP and the supporting documents / information furnished by the taxpayer, the authorities have ample power to determine the same and make suitable adjustments. In such a situation, as rightly admitted in the ground of appeal by the revenue, this responsibility of determination of ALP is shifted to the revenue authorities who are to determine the same in accordance with statutory regulations.

128. There is criticism that legislature is not justified in placing onerous burden on the taxpayer to maintain detailed documents and to justify that transaction was carried at ALP. It is contended argued that this is like insisting upon production of self-incriminating evidence and is uncalled for. This criticism, in our opinion, is without any valid basis. It is to be remembered that international transactions carried by taxpayer are crossborder transactions.

Departmental authorities in India are required to deal with and determine ALP of transactions carried in Asia, Europe, America, Australia, other developed and under-developed countries in Africa, etc. It is very difficult, if not impossible for them to find relevant data of an exact or of a similar transaction or profit made not only by the tax payer, but also by other similarly situated uncontrolled enterprises. Knowledge of economic conditions prevailing at the place where transactions are carried is also essential. The very nature of this job of collection of data is such that the assessee is in the best position to gather the requisite information.

129. The taxpayer, on the other hand, as a party to the transaction has full knowledge of the transaction carried and profit earned by him. As a person associated with that particular line of business activity, the assessee is reasonably expected to be not only aware about nuances of that business, but also about economic conditions and peculiar circumstances, if any, of that business. He is likely to know even about comparable uncontrolled transactions. Otherwise too as per the settled law every attempt to collect best evidence has to be made.

Evidence of situation has to be called from a person possessing special means to know that situation. Therefore, it is reasonable to call upon the tax payer to furnish evidence of controlled / uncontrolled transactions which are within taxpayers' special knowledge. However, tax authorities can not insist upon the tax payer to furnish information he does not possess or is not required to maintain under rules. Guidelines given in circulars of CBDT are to be followed. We, therefore, hold that burden of proof to establish ALP and to furnish relevant information has rightly been placed on the assessee.

130. It would not be out of place to mention that almost all countries world over are facing problem of diversion of income by multi national companies and other enterprises to jurisdictions where the tax burden is least or the lowest. Therefore, almost all countries have similar enactments to tackle this menace. We quote below the position of "burden of proof" in some of important countries; it being not possible and practical to note in full details of provision of all the countries. This information is being extracted from Commentaries on Transfer Pricing, 2006 published by Price Water House: The question of burden of proof has been one of

the most important issue in relation to the development of transfer pricing in Denmark.

In the Texaco and BP Denmark court cases the High Court and Supreme Court confirmed that the burden of proof lies with the tax authorities and that the taxpayer is required to disclose information relevant to the question of whether the arm's length principle has been violated. This information would include items such as prices and gross profit earned by the parent company when dealing with other group companies and with unrelated customers.

Where this information is not disclosed, the court concludes that the burden of proof on the Danish tax authorities is reduced.

As a rule, the burden of proof lies with the tax authorities, unless the transfer of profits concerns a tax haven, in which case the burden of proof is transferred to the taxpayer.

Recent developments mean that there is now a legal requirement for taxpayers to provide documentation supporting their transfer pricing policies. Though in theory the burden of proof lies with the tax administration, in practical terms the burden of proof has always fallen on the taxpayer where the tax authorities have deemed a profit shift to have taken place or inappropriate transfer pricing to exist.

Indonesia operates on a self-assessment system with companies setting their own transfer prices. The burden of proof lies with the taxpayer to prove that the original price has been set at arm's length.

Under Ireland's self-assessment system, the burden of proof in the event of a Revenue audit will fall on the taxpayer.

The general principle is that the burden of proof lies with the tax authorities. Where the tax authorities issue an assessment to additional tax, however, the taxpayer must prove there is no liability for the additional tax.

There are other circumstances in which the burden of proof lies with the taxpayer. The most important of these are the following: If an enterprise that is tax resident

in Italy wants to claim a deduction for the costs of transactions with parties that are resident in certain tax havens, then the Italian taxpayer must provide evidence that the foreign party is a genuine commercial undertaking or that the transactions were effected in connection with a real economic interest: and An Italian taxpayer would also have to be able to prove that the relevant transaction actually took place.

In the self-assessment system, the burden of proof lies with the taxpayer to clear any tax avoidance allegation and/or alleged transfer pricing abuse.

The intention of the Malaysian Transfer Pricing Guidelines is to assist the taxpayer in their efforts to determine arm's length transfer prices and at the same time comply with the local tax laws and the administrative requirements of the Malaysian tax authorities.

In this connection, upon a field audit or enquiry, the relevant taxpayers with related party transactions must be able to substantiate with documents, and to the tax authorities' satisfaction, that its transfer prices have been determined in accordance with the arm's length principle and that there has not been any abuse of the transfer prices resulting in an alteration of the incidence of tax in Malaysia.

As indicated previously, there is a legal obligation for the taxpayer to maintain certain transfer pricing documentation. To the extent that this requirement is not met, the burden of proof is ultimately transferred to the taxpayer.

In general, there are no statutory provisions to indicate how the burden of proof is divided between the taxpayer and the tax authorities. The allocation of the burden of proof between the parties is at the discretion of the court. However, in practice and as a result of Dutch case law, if the company's revenue is adjusted upwards because of transfer pricing issues, the burden of proof usually lies with the tax authorities. On the other hand, the burden lies with the taxpayer to prove the deductibility of expenses.

In transfer pricing cases the burden of proof transfers to the taxpayer if the pricing arrangements are very unusual, for example if comparable uncontrolled prices

(CUP) are available but not used, or goods or services are provided at cost or below cost. The burden of proof is also transferred to the taxpayer, and will be more onerous, if s/he refuses to provide information requested by the tax authorities where there is a legal obligation to provide that information, or if the requisite tax return is not filed. Finally, the court sometimes allocates the burden of proof to the party best able to provide the evidence.

In New Zealand, the burden of proof normally lies with the taxpayer, not the Commissioner. However, Section GD 13(9) places the burden of proof on the Commissioner where the taxpayer has determined its transfer prices in accordance with Sections 13(6) to 13(8) of the New Zealand Tax Act.

Where the Commissioner substitutes an arm's length price for the actual price, then the Commissioner must prove that either: (2) the taxpayer has not cooperated with the Commissioner. The Guidelines provide guidance on what is considered to be non-cooperation: Where the taxpayer does not provide the requested relevant information to the Commissioner: or If a taxpayer does not prepare adequate documentation , and provide it to the inland Revenue if requested.

The position after the 1999 rules is that the burden for proving that transfer prices are at arm's length falls squarely on the taxpayer's shoulders. The act of submitting the return under self-assessment implicitly assumes that the taxpayer has made all necessary adjustments to taxable profits to take account of non-arm's length pricing.

The taxpayer regarding the justification of tax deductible expenses; and The tax authorities regarding adjustments, which increase taxable income.

This effectively means that a taxpayer has to prove to the Swiss tax authorities that the price it has paid for its tangibles, intangibles and any services it has received from a related party satisfies the arm's length principle (i.e. justifies their tax deductibility). On the other side, the Swiss tax authorities' responsibility is to prove that the compensation for any services rendered by the taxpayer or any tangibles or intangibles transferred to a related party does not reach an arm's

length level. However, if a taxpayer fails to produce the documents required by the tax authorities, this burden of proof also reverts to the taxpayer.

Therefore, it is recommended that Swiss taxpayers maintain appropriate documentation to justify all income and expenses resulting from related party transactions. This is specifically also true with regard to licence fees charged to a Swiss entity or support and defence of low profits in connection with limited risk type entities.

Non-US tax authorities and practitioners alike have tended to be critical of the level of detail included in the US regulations and procedures. However, in considering the US regime, it is important to bear in mind that unlike many of its major trading partners, the US corporate tax system is a selfassessment system where the burden of proof is generally placed on the taxpayer, and where there is an adversarial relationship between the government and the taxpayer.

This additional compliance burden is not unique to the field of transfer pricing.

131. Similar provisions are available in the laws of other countries.

It would be seen that even a most advanced country like United Kingdom has provisions placing on the taxpayer the burden of proving that international transaction is carried at ALP.<sup>132</sup> A dispassionate study of provisions of various countries on Burden of Proof, would show, the following fundamental features: (i) That the burden to establish that international transaction is carried at ALP, is on the taxpayer who is to disclose all the relevant information and documents relating to prices charged and profit earned with related and unrelated customer.

(ii) If the Assessing Officer has determined an ALP, other than the price declared by the assessee, AO has to prove that the price determined by him is reliable and reasonable and confirms the statutory requirement unless the case is covered by situation No. (iii) below.

(iii) In case of failure on the part of the taxpayer to comply with the statutory provisions, the tax authorities would have to determine the ALP. In such a situation, burden of proof on tax authorities is much reduced.

133. Having regard to the statutory provisions, particularly the mandate of section 92(1) and 92D read with relevant rules, we hold that it is obligatory on the part of the taxpayer to furnish information relating to controlled international transactions, select a suitable method for determination and furnish ALP of such international transactions carried by it and give basis and supporting authentic evidence of ALP and adjustments made. The Taxpayer has further to cooperate in the determination of the ALP by the tax authorities by furnishing all relevant information. The tax authorities in cases where they are of the opinion that ALP has not been correctly determined by the taxpayer, can substitute their own ALP on the basis of material or information furnished by the assessee or collected by them. However, such ALP has to be determined having in mind provisions of sections 92 and 92C and other Rules and regulations. While determining ALP, tax authorities are bound to follow principles of natural justice and be fair and reasonable to the taxpayer. Any material collected to be used against the taxpayer is to be put to tax payer to explain. Having regard to the purpose of the legislation and application of similar enactment world over, it must further be held that adjustments made on account of ALP by tax authorities can be deleted in appeal only if the appellate authorities are satisfied and records a finding that ALP submitted by the assessee is fair and reasonable. Merely by finding faults with the transfer price determined by the revenue authorities (A.O. / TPO), addition on account of "adjustments" cannot be deleted.

This is because the mandate of section 92(1) is that in every case of international transaction, income has to be determined having regard to ALP. Therefore, unless ALP furnished by the taxpayer is specifically accepted, the appellate authorities on the basis of material available on record has to determine ALP itself. Subject to statutory provisions, Appellate authorities can direct lower revenue authorities to carry this exercise in accordance with law. The matter cannot be left hanging in between. ALP of international transaction has to be determined in every case.

134. There would be cases, where taxpayer does not cooperate and fails to furnish ALP or disclose full information, relevant for determination of ALP when called upon to do so by tax authorities. The taxpayer fails to discharge burden placed on the taxpayer. In similar enactments of other countries, it is provided that

burden on the revenue authorities in such a case would be reduced. We have not come across similar provision in Chapter X of the Act. The tax authorities therefore, have to resort to provision of section 144 of the Income-tax Act and determine the ALP on the basis of the material collected or available on record. In such circumstances, the ALP determined would be on the parity with a best judgment assessment. Such assessment (determination of ALP) would have some approximations and estimations. But even such approximation & estimations must satisfy dictates of justice and fair play and look reasonable. It cannot be arbitrary and capricious. The order of T.P.O. is appealable and therefore, it must be objective, contain detailed reasons, conform to regulations and should be seen as just and fair.

135. On consideration of the relevant provisions, it is evident that in the process of determining Arm's Length Price, the first important factor to consider is the specific characteristics of services rendered both in the international transaction as also in the uncontrolled transaction. Next important aspect required to be considered is amount of assets employed, risk involved, both in controlled and uncontrolled transactions. If there are such differences between transactions taken for comparison, which are likely to affect the price or cost charge etc in the open market then reasonable and accurate evaluation is to be done and adjustment made. Reliability of uncontrolled transaction would depend upon the degree of comparability. The uncontrolled transaction may not be taken "as comparable" if there are such material differences as can not be adjusted. If data found satisfy above requirements then further proceedings to find the most appropriate method, best suited to the facts and circumstances of a particular international transaction is to be selected. In other words, most appropriate method would be the method which provides most reasonable results having regard to the data available for determining arm's length price. If there are more than one ALPs determined on the application of most appropriate method then arithmetical mean of such prices or price at option of the assessee within 5% variation is to be adopted (Proviso to section 92C(2) ).

136. In the light of above general observations, we now proceed to consider various objections of the parties first being clubbing of international transactions

for reference to the T.P.O. The taxpayer, before the Id. Commissioner of Income-tax (Appeals), had contended that clubbing of all transactions with mere mention of aggregate value of all transactions in reference to TPO was wrong. A separate reference in respect of each international transaction should have been made.

Likewise approval granted by the learned CIT has also been challenged as mechanical and illegal. Such an objection has also been raised in the grounds of appeal. While answering seven question referred to the Special Bench, we have discussed this objection relating to approval of CIT in detail. In the light of above discussion, we do not find any substance in the technical objections raised by the assessee and accepted by the Id. CIT(Appeals) in the impugned order. It is further to be noted that in the audit report filed by the taxpayer in form 3CEB it was stated that the taxpayer had paid Rs 28,32,20,103/- to Aztec US towards onsite software services. Likewise sum paid for marketing services was also stated. Taking above details from the audit report, a reference was made by the Assessing Officer to TPO to determine ALP of international transactions. The taxpayer and TPO had fully and clearly understood what international transactions were referred for the determination of the ALP. In the light of circular No. 3 of 2003, approval was rightly given by the CIT as aggregate value of transactions exceeded Rs 5 crores. The circular being binding was required to be followed. The taxpayer filed all conceivable objections before the TPO. Although each transaction should be separately mentioned, but no prejudice is shown to have been caused to the taxpayer on account of non-mention of each transaction separately.

Therefore, in our opinion, this contention is to be rejected.

137. The next objection of the taxpayer on the validity of circular No.3 has been separately considered and rejected.

138. The taxpayer has also raised a general ground that order of Id.CIT (Appeals) on the issue of transfer pricing, in so far as it is against the taxpayer, is erroneous. Orders were passed by revenue authorities in violation of law. No separate arguments were advanced on above issue nor it has been clarified as to what is the meaning of "in violation of law and are erroneous" apart from arguments separately noted. As no specific illegality, other than being considered in this

decision, was brought to our notice, therefore, we reject these general grounds.

139. The assessee has also raised in its ground of appeal, the following ground as ground No. 4: 4. That the learned authorities below have not appreciated the entire issue in the right perspective and totally against record.

From the above ground of appeal of the taxpayer and various grounds raised by the Department, it is clear that both the parties at least accept that the learned CIT(Appeals) did not appreciate in the right perspective, the issues raised before him. For the reasons contained herein, we are inclined to agree partly with this claim.

140. We now consider the objection of the Revenue that the learned CIT (Appeals) was not justified in treating international transaction relating to "onsite software services" as reimbursement expenses and in holding that TPO should have found comparable transaction of re-imburement for computing ALP. It is further claimed such a claim of re-imburement is contrary to claim made earlier and was permitted to be raised before the CIT (Appeals), for the first time. It was done in violation of rule 46A of Incometax Rules. It is further claimed that principles of natural justice were not observed by the Id. CIT (Appeals) and no opportunity of being heard was provided to the department on the fresh case made by the taxpayer.

141. On facts of the case, we do not find any force in these technical objections of the department. We do not see any material difference between the claim of the assessee raised before the Assessing Officer, TPO or CIT (Appeals). The stand of the taxpayer was clear that it has compensated/paid its associated enterprise, Aztec US, cost + 5% markup for providing "onsite software development services", and cost + 10% markup for marketing services. The case pleaded by the assessee, right from the very beginning, was that payments to associated concern were made as per agreements. We do not see any change in the pleadings.

Agreements were produced, before the TPO and were thoroughly examined.

Same case based upon agreements was set up before the Id. CIT (Appeals) as is evident from the impugned order. Whether it is called "compensation of cost" or "re-imbusement of expenditure" or is given some other name, could not make any difference. There was no doubt on the nature of international transactions. The question required to be determined was whether international transactions were arm's length transactions. That was the question considered by TPO and his assessment challenged in appeal. Having rejected the method employed by the Taxpayer, the TPO chose comparables and selected methods, and ultimately determined ALP. This has been struck down by the Id. CIT (Appeals). Claim made by the taxpayer did not cause any confusion to Assessing Officer or the T.P.O as is evident from their replies quoted by the Id. CIT (Appeals). We see no violation of Rule 46A or principles of natural justice as far as raising of this issue is concerned and see no scope to interfere as far as this aspect of the matter is concerned.

Thus arm's length price was determined through use of some method.

Whether this has been correctly done by the TPO or not, or interference by the Id. CIT (Appeals) was justified is a question required to be considered separately. The objection regarding the alleged change made in claim by the assessee has no substance and is rejected. Connected with above is the objection of the taxpayer that transfer pricing mechanism was only applicable to "make up" portions of the transactions and not to entire cost paid by the taxpayer. This objection has also been rejected by the Id. CIT (Appeals) for good reasons and we see no error in his approach. The ground regarding non use of comparable of reimbursement is being separately considered.

142. The Department has also objected to the manner in which ALP was furnished by the taxpayer. It is contended that taxpayer did not furnish any ALP nor applied any recognized method of determination of ALP. It claimed to have applied Transitional Net Margin Method by taking profits of 10 - 11 selected companies operating in U.S. and engaged in I.T. business. Average profit for the calendar years 1999-2000 and 2000-01 of above companies was found to be 6.63% which was higher than profit of 6.59% of Aztec U.S. Accordingly it was claimed that the transactions with the taxpayer were not in-consistent with arm's length basis. In

the objection, it is claimed that only an inference, that price of international transactions was arm's length price, was drawn.

143. It is claimed that TNMM method was not correctly applied by the assessee. In support of such claim, the Revenue has brought to our notice the definition of TNMM method found in OECD Transfer Pricing Guidelines, which according to the department, is the simplest one. It is as under: A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that it is appropriate to aggregate under the principles of Chapter I) 144. The following OECD Guidelines on transactional net margin method has also been relied upon and brought to our notice: The transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means in particular that the net margin of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I) should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as guide.

145. The Departmental Representative has also brought to our notice "transactional net marginal method" as understood under Rule 10B (1)(e) of Income-tax Rules quoted earlier. On the basis of OECD Guidelines and above provision, it has been contended that for application of correct TNMM method for computing net margin (with reference to a suitable base) of taxpayer Aztec India or similar international transactions relating to "onsite software services" were to be taken into consideration and a benchmark of net margin determined from comparable uncontrolled transactions or net margin found by another unrelated

enterprises from a comparable uncontrolled transaction. But instead of taking transactions of the Taxpayer or unrelated enterprises, profit of Aztec US was taken into account and alleged TNMM method applied.

Instead of taking specific transaction, entire business activities were taken into account and this way a totally untenable claim was made by the Taxpayer. The revenue has also objected to implied acceptance of transfer pricing by the Id. CIT (Appeals) without comments.

146. The learned Departmental Representative has further argued that the Id. Commissioner of Income-tax (Appeals) could not have left the issue of transfer pricing of international transaction after finding fault with the Arm's Length Price determined by the TPO. He could not delete the addition on facts of the case. As the Id. Commissioner of Income Tax(A) was of the opinion that similar comparable transactions of reimbursement of expenses under similar situation should have been found and then adjustments made for points of differences for nature and situations of such comparables, he should have directed the tax payer to furnish Arm's Length Price on reimbursement basis supported by authentic data. Ld. Commissioner of Income Tax (Appeals) could not leave the pertinent issue of fair ALP and delete additions/adjustments without considering/accepting ALP shown by the tax payer. As pointed out above in detail, the tax payer did not furnish any Arm's Length Price of international transactions. This comparison of operational profit of companies was considered without establishing that other companies were also involved in operation of onsite software operation and marketing services at "cost" + markup. International transactions involved here cannot be taken at Arm's Length Price as the tax payer had paid more to its AE than it has realized from its customers and admitted, suffered a loss in transactions.

147. It is further stated that tax payer did not provide bills of rates charged by AE for which total payment of Rs.28,32,20,103 for total 69509 man hours was made. The average per man-hour has been worked out at 85USD. Ld. Commissioner of Income-tax (Appeals) has not accepted this rate as the Transfer Pricing Officer did not take into consideration the man-hour, unutilized on account of idle time, leaves and overtime. The finding is claimed to be untenable. It is emphasized that the

taxpayer as service provider to its customer was not expected to pay for unbilled hours. In the like manner, taxpayer cannot be expected to pay for unbillable hours of the service provider. As per business practice, the rate of payment billing, could be calculated only with reference to "on site man hours" utilized.

148. We are of view that objections by the department are well taken.

The taxpayer tried to justify payments made to Aztec US under a written contract with that concern. It was further contended on behalf of tax payer that TPO, while considering the transaction, did not take into account wasted unutilized man hours etc., suffered in the normal course of business. This happens in execution of on site services contract. On careful consideration of rival contentions, we do not find any good reason to accept the contention of the tax payer. In the first place, we see no justification for payment of Rs.28,32,20,103 by tax payer to Aztec US when for the same job, tax payer has itself realized Rs.25,69,25,805 from its customers. So, international transaction carried with Aztec US, an associated enterprise (AE) cannot, prima facie, be accepted as reasonable or Arm's Length transaction. It was for the tax payer to show that results of these international transactions were not inconsistent with results of similar uncontrolled transactions carried in similar circumstances. Instead of a transaction, entire operational profits of PE were considered. The Arm's Length Price furnished by the assessee did not meet statutory requirement. The tax payer failed to furnish relevant data of comparable controlled or uncontrolled transactions carried in same or similar circumstances. In fact, criticism of Id. C.I.T (Appeals), based on arguments taken by tax payer, that comparable reimbursement data should have been collected was equally applicable to the assessee. It is not taxpayer's case that relevant data of reimbursed transactions was furnished. The Id. C.I.T (Appeals) should have applied same standard to reject ALP furnished by the Tax Payer and considered the legal implication of such an act. In not adopting above approach and by making no adverse comment on Arm's Length Price furnished by the tax payer, the Id. C.I.T (Appeals) committed an error of law. The Id. C.I.T (Appeals) also failed to consider that Burden of proof to show that the International Transactions were Arm's Length transactions, was on the taxpayer; whether the same was discharged. Net effect of order of the Id. C.I.T (Appeals) is that international

transactions have been accepted to have been carried at Arm's Length/price although on record no such finding has been recorded by any authority. On the basis of arguments before us and material to which our attention was drawn, even we are unable to record such a finding. In not appreciating the mandate of statutory provisions that income of every international transaction is to be determined at Arm's Length Price, the Id. Commissioner of Income Tax (Appeals) left his task incomplete and was wrong in deleting the addition. For this glaring error, the order of the Id. Commissioner of Income Tax (Appeals) cannot be sustained and is liable to be set aside. We order accordingly.

149. Besides the above, the Id. Commissioner of Income-tax (Appeals) committed several factual errors and to highlight few we may refer to his wrong findings at page 173 and 174. It has been observed as under: Transfer Pricing Officer has tried to demonstrate as to how the appellant has charged from its customers the revenue for the services rendered to them for different activities at lower than the accepted market rate (based on lesser amount of man hour), which, in a jargonized scenario, is termed as uncontrolled price.

The appellant could have billed its customers for excessive number of man hours and the higher rate for the man hours. For this, the Transport Price Officer has resorted to compare the man hour rate worked out in the case of the appellant with that of the average rate given by NASSCOM.150. The findings of the Id. T.P.O. are clear that the taxpayer charged higher rates than the average industry rates. Further finding that T.P.O. could have billed its customer for excessive number of man-hours, is also erroneous. Now, to what extent these erroneous findings vitiated the impugned order is not easy to find from record.

151. The learned Commissioner of Income-tax (Appeals) has further observed "what needs to be actually compared is similar data of reimbursement for similar kind of situation and services rendered between two unrelated parties". What the appellant had been paying to its respective associated enterprises was in the nature of reimbursement of the expenses incurred on behalf of the appellant, besides the marked up amount in the nature of commission paid for the services offered to the appellant. Logically, the reimbursement cannot be linked and

compared with the probable and possible generation of revenue which the appellant would receive. This cannot be treated as comparison between similar nature of transactions. After all, the reimbursement of expenditure and generation of revenue are two exactly opposite propositions. Such comparison is also not in accordance with legal conceptualization as discussed in the earlier paragraphs. It is also not in commensuration with the prescribed method and manner to determine Arm's length Price as prescribed Under Section 92CA(1) of the Income Tax Act and the related rules. So, basic presumption itself as adopted by the Transfer Pricing Officer cannot, logically and legally, be endorsed.

152. We are unable to subscribe to the above view of the learned Commissioner of Income-tax (Appeals) either. In our opinion, the learned Commissioner of Income-tax (Appeals) was not correct in holding that Transfer Pricing Officer should have found comparable transaction of reimbursement for computing Arm's Length price of transaction in question. In holding so and in deciding the issue in favour of the taxpayer, the Id. Commissioner of Income-tax (Appeals) did not consider the background of the dispute and agreement between the taxpayer and its associated enterprises (AE) Aztec US. The agreement clearly provided that AE was to be paid cost + markup profit. It is difficult to hold that Transfer Pricing Officer was not aware of the nature of international transaction and did not carry the exercise to determine transfer price of cost + markup keeping in mind the background of the transactions. But to say that Transfer Pricing Officer was duty bound to take into account only reimbursement transactions in same situation and not revenue generating transactions is to stretch the matter beyond the logical limits when no relevant information was made available by the taxpayer. Therefore, we are unable to agree with above observation of Commissioner of Income-tax (Appeals) as correct and in accordance with law. Besides, the Id. Commissioner of Income-tax (Appeals) failed to take note of the nature of services, which AE was to provide, and actually provided on behalf of the tax payer (company). Some important features of agreement between the tax payer and AE (service provider) are as under: PERSONNEL is defined as inclusive of "employee service provider and any consultant that the service provider may outsource to undertake and perform any specific work order.

Service provider is an independent contractor and not an agent or employee of the company and is no authority to bind the company by contract or otherwise (Clause X).

153. Invoices raised on taxpayer show that these are towards "on site software development" charges but Cost incurred by AE Aztec US is not defined in the agreement. The point of dispute is the cost of services rendered by Aztech US.154. It is therefore clear from above that service provider here is an independent contractor and not an agent or employee of the tax payer.

It was to raise invoices on account of software development charges and for marketing done for the tax payer. Cost + Markup was a formula on which amount was to be determined and for which invoices were to be raised and in fact raised. There is no material nor any authority has raised any doubt on the genuineness on the above arrangements. As already expressed, having regard to the terms of the agreements, we find no difference in the claim that AE was paid cost + Markup as stated before Transfer Pricing Officer or the case set up before the Commissioner of Income-tax (Appeals). There were international transactions subject matter of transfer pricing and both the parties clearly understood the controversy involved before Commissioner of Income-tax (Appeals) or Transfer Pricing Officer. It was the same. It was not the case of reimbursement of expenditure incurred by an agent for its principal. We further find force in the argument of the revenue that if the Id. Commissioner of Income-tax (Appeals) had considered it to be the case of reimbursement, then he should have asked the assessee to furnish Arm's Length Price of reimbursement transaction. Such a course would have been fair to both the parties but was not adopted and Id. Commissioner of Incometax (Appeals). He criticized the very logic of the approach of transfer pricing. We respectfully disagree and set aside the above observations.

155. The sample size of data taken by the taxpayer, to support the arms length price, was too small to come to any general conclusion. The assessee had taken profitability figures of only ten US companies and even it was not established that activities of these ten companies were same and similar, i.e. to provide onsite and marketing services on cost plus markup basis. It cannot be said that this base data

was relevant and sufficient to come to any findings about the arms length price. The objection of the Revenue based on sub rule 4 of Rule 10 B for not confining to data for the financial year 2001- 02 is also justified as it is not shown that data for other years had any influence on the determination of ALP of the transactions involved.

156. Now we come to the crucial question of ALP determined by the T.P.O. The revenue has justified method of transfer pricing and its figure determined by the Transfer Pricing Officer. It is contended that Transfer Pricing Officer has rightly determined Arm's Length Price by using CUP method and two separate analysis; one based on external comparable and other on internal comparable. Supplementary analysis of TNMM was also carried. However, Id. Commissioner of Income-tax (Appeals) has struck down CUP analysis based on external comparable.

The impugned order, however, is silent on CUP analysis based on internal comparable as well as on TNMM analysis. In support of the claim, the CUP method as understood in the OECD guidelines were brought to our notice. The revenue further contended that external comparable chosen on average rates charged by Indian software company as provided by NASSCOM Report for the financial year 2001-02 were taken. The data was obtained from published reports available in public domain and was authentic.

157. Learned Commissioner of Income-tax (Appeals) had rejected NASSCOM average with following observations: Adoption of NASSCOM average for per hourly rate does not exactly meet the requirements as comparable uncontrolled transaction for CUP method. This is because it is the requirement of Rule 10B(1) (a) of the Income Tax Rules to first identify the comparable uncontrolled transaction. This is also because the arm's length price is expected to be determined with specific reference to specific international transaction between associated enterprises. It does not allow progression into any other parameters, which is different in nature and component as has been done in the order of the Transfer Pricing Officer. It means that each international transaction under consideration which is in the nature of reimbursement can not legally be reworked

into the probable generation of revenue on man hourly basis as has been done in the order of the Transfer Pricing Officer. After all, the average per hourly rate given by NASSCOM for Computer Software Service is not a transaction. It is an average of transactions quite different in nature and content from what has been the subject matter in the case of the Appellant. Comparables in the instant case should be reimbursements of similar nature under situations for such comparable reimbursement date between two or more similar uncontrolled transactions.

An average as in the case of NASSCOM in the present context is the resultant of the sum total of different integers divided by total number of such integers. It is not understood as to how a single integer out of the all is comparable with the average of all arrived at in the above manner.

158. The revenue has drawn our attention to Rule 10B describing/defining CUP method. In particular, emphasis has been laid on Clause (1) providing identification of price charged etc. in a comparable uncontrolled transaction or a number of such transactions.

It is urged that NASSCOM average of on site billing rates is nothing but average or rates actually charged of a number of enterprises for on site services. So, instead of a single specified transaction, number of transactions were considered. The fact that these individual transactions are not specifically named does not alter their character as transaction. Further justification for taking US\$58 for man hour as Arm's Length Price is given as under: Having identified comparable uncontrolled price or price, the next step is to make adjustments towards transactional differences. There are transactional differences. The NASSCOM average rates of USD 58-65 per man-hour is wide enough to account for a variety of functional differences. Still, these represent the charge out rates of independent entrepreneurs with a full risk profile. As such, they require a downward adjustment to serve as Arms Length Rate that can be commanded by a no-risk sub-contractor. Here again, the quantification becomes a difficult issue. Therefore, the rate of USD 58/manhour is taken as the Arms Length Rate. This gives an advantage to the taxpayer as the rate is definitely higher than the Arms Length Rate payable to a sub-contractor. Yet, to avoid subjectivity in quantifying the

adjustment, this extra leeway is given to the taxpayer.

159. The method adopted by the assessee for computing the arms length price of onsite services was 'Net Transaction Margin Method' (TNMM).

However, the Transfer Pricing Officer rejected this method on the ground that "in the instant case, the application of TNMM does not result in determination of arms length price". The Transfer Pricing Officer noted that the assessee has demonstrated that 10 United States based companies earned a bit more profit from their diverse activities in the calendar years 1999,2000 and 2001 vis-is what the assessee's US subsidiary has earned in the financial year 2001-02, but rejected the same as "too far fetched". He added that "before accepting this at face value as an adequate justification of transfer pricing, other methods of arriving at a more reliable measure of ALP have to be explored". There was no further discussion about the reasons of Transfer Pricing Officer's coming to the conclusion that TNMM is not the most appropriate method, but he adopted the Comparable Uncontrolled Price by observing that "CUP method determines the ALP by ascertaining the price charged in a comparable uncontrolled transaction. This is the most direct and hence the most accurate method. In case a Comparable Uncontrolled Price can be identified, CUP method is the most appropriate method." The use of resale price method was rejected on the ground that the assessee is not a reseller of good and services.

Application of "cost plus method" was found unsuitable on the ground that "data regarding gross mark up on the cost earned by the various software developers is not generally available in the public domain as the disclosure of the same is not mandatory under the Indian Company Law" and that "moreover, it is not necessary as the ALP can be computed by means of CUP, the most direct method". Coming to the "profit split method", the Assessing Officer observed that "PSM is not appropriate as the case does not involve either the transfer of unique intangibles or multiple inseparable transactions", and added that "also the PSM is most rarely used method". It was also pointed out by the Transfer Pricing Officer that "it is almost impossible to get the reliable data on the contribution made by various associated enterprises towards a single product or service or the ultimate profit

made from transfer of this product or service to a third party customer as these enterprises are scattered over different tax territories, many having no relationship with the Indian taxpayer". On the basis of this analysis, the Transfer Pricing Officer concluded that "CUP method is selected as most appropriate method" and that "it is supported by a supplementary analysis using TNMM". In the final computation of arms length price, only the CUP method working is taken into account. It is interesting to note that there is no specific rejection of TNMM as the most appropriate method, and yet, contrary to the scheme of Section 92F(2), arithmetic mean of the arms length arrived at by these two methods is not taken into account by the TPO. She did not feel any need to even make adjustment in the external comparables on the ground that. "The rate of US\$18 to US\$25 (for off shore) or US\$ 58-65 (for onsite) is wide enough to take care of enterprise level or transaction level differences such as differences in terms of the nature of software developed or the bargaining capacity of the developer or purchaser or any other material difference." There cannot be any rationale in such sweeping conclusions by the TPO. Not even an effort is made to take into account any sort of difference in the controlled and uncontrolled transactions. Such an arbitrary approach cannot meet any judicial approval as it cannot be subjected to any reasonable review. As against the rate of US \$ 58 per manhour which is taken into account by the TPO, the assessee was to, and in fact did, receive , for the services performed by Aztech US on his behalf, the hourly rate as follows: 160. The CIT(A)'s criticism against the above approach of the Transfer Pricing Officer is fully justified. However, the CIT(A) has also made some sweepingly generalized observations while deciding the issue. He proceeds to deal with the issue as to what should be the CUP variables to be taken into account for determining the arms length price on that basis even before deciding as to whether or not CUP method should indeed be adopted for determination of arms length price on the facts of this case. The CIT(A) did not examine, on the touchstone of parameters set out in Rule 10C(2), as to which method should for determining the arms length price will be most appropriate method on the facts of this case. The nature and class of international transactions, and other relevant factors, were required to be looked into. None of these important aspects of the matter have been dealt by the CIT(A) at all. That certainly is not judicious way of dealing with the issue as to what should be the

correct arms length price on the facts of this case, more so when one of the specific grounds of appeal before the CIT(A) was that "The Transfer Pricing Officer/Assessing Officer erred in ignoring the method (of determining ALP) followed by the appellant. The Transfer Pricing Officer/ Assessing Officer ought to have adduced cogent reasons for rejecting the method followed by the appellant before substituting and prescribing a new method." Once a particular method is found to be suitable, the next thing that the CIT(A) was required to examine was whether input variables required for ALP determination have been properly gathered; if not, then the onus of gathering those inputs arises, which have discussed above in detail. In case the CIT(A) was to come to the conclusion that CUP method is to be employed for determination of arms length price, and even if the NASSCOM averages were to be ignored as being too general, still some kind of comparable figures are to be gathered. The assessee has to furnish some comparable data vis-is the services the assessee availed from its subsidiary company. It could not be said that onus of gathering all the inputs is only on the Assessing Officer or the Transfer Pricing Officer, and that the assessee has no responsibility to furnish the relevant details in this regard.

161. Having noted that hourly rate of billing would vary depending upon qualification and experience level of personnel, and having noted the different clauses of Rule 10C(2) requiring consideration of specific characteristics of the property, functions performed, assets employed, risk assumed and other conditions of comparability, the Transfer Pricing Officer in the computation did not adopt or attach any importance to special characteristics or conditions of contract, and wrongly relied upon Article 9 of the OECD Model Convention which had no application in the matter. In our considered opinion, to apply Article 9 of OECD model, one has to find what are the conditions that have prevented accrual of profit to the enterprise. In this case, there is no reference to any term or condition, which had or could prevent accrual of profit to the taxpayer. There is no dispute that taxpayer was to pay "cost" + mark up for services rendered. Dispute is on the working of the alleged "cost" claimed to be ALP by the taxpayer but challenged by the revenue. Strangely enough the working of cost has not been examined. Therefore, Art. 9 had no application in this case. The Transfer Pricing Officer did not feel any need to find material differences between transactions even after

conceding that differences do exist. On facts, we differ with above sweeping observations.

162. Faced with above situation, one can only wonder as to the type of uncontrolled transactions was taken into consideration; what were their characteristics? Under what economic circumstances, these comparable were performed? What were the material differences between comparable transactions and how much adjustments were reasonably required to be made? If the matter is decided purely on a subjective satisfaction as done in the present case, then the appellate authorities are faced with a difficult task while examining correctness of such action. Without details, how could taxpayer effectively object that Controlled and Uncontrolled transactions are not comparable? Differences are not known and adjustments imaginary. Evaluation of transactions is the most important part of transfer pricing and T.P.O in this case failed to carry the same in accordance with law. It has vitiated determination of A.L.P. The CIT(A) also adopted similar approach enamoured with the erroneous impression that tax avoidance motive of the assessee is required to be established by the revenue authorities before initiation of action for determination of arms length price. He did not examine merits of the case from the right perspective, as discussed above.

163. The revenue has justified consideration of industrial average as comparable uncontrolled transaction. Before the Transfer Pricing Officer as also in proceedings before the Commissioner of Income-tax (Appeals) , the taxpayer had objected to adoption of average and objection is noted in para 7.13.1(page 42) of the Commissioner of Income-tax (Appeals)'s order as under: As per OECD guidelines unadjusted industry averages cannot be taken to represent arms length conditions.

164. Transfer Pricing Officer could not meet above objection and gave round about answer. But objection raised on behalf of the assessee, in our view, is valid and justified and is required to be upheld. In Commentaries on International Transfer Pricing 2006 published by Price Water House Coopers in chapter "The Work of the OECD and Other Technical Considerations", it has been observed as under: The arm's length principle is usually applied by comparing the 'conditions;

(e.g. price or margin) of a controlled transaction with those of independent transactions. The Guidelines allow the use of inexact comparables that are 'similar' to the controlled transaction but not the use of 'unadjusted industry average returns'. The factors that should be considered when assessing the comparability of a transaction, include: - the functions that each enterprise performs, including the assets used and, most importantly, the risks undertaken; - the economic circumstances of different markets, for example, different countries, wholesale versus retail; and - business strategies, for example, market penetration schemes when a price is temporarily lowered.

165. Paragraph 1.42 of OECD Guidelines on the transfer pricing provides as under: In order to arrive at the most precise approximation of fair market value, ideally the arm's length principle should be applied for each transaction. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated on a separate basis. Such transactions should be evaluated together using the most appropriate arm's length method or methods.

For example, pricing a range of closely-linked products, when it is impractical to determine pricing for each individual product or transaction.

166. Regarding application of CUP method, OECD reports in para 303 of International Transfer Pricing, 2006 published by Price Water House Coopers, proper adjustment of data has been emphasized as under: The OECD report states that, if it can be used, 'the CUP method is preferable over all other methods'. In practice, this method is often very difficult to apply as it is unusual for multinationals to have the details on appropriately comparable transactions. In response to this, the OECD report suggests that multinationals and tax authorities should take a more adaptable approach to the use of this method, possibly working with data prepared for CUP purposes supplemented by other appropriate methods. The extent of the OECD's support for the CUP method can be seen from the comment that 'every effort should be made to adjust the data so that it may be used appropriately in a CUP method'.

167. In the same publication and with reference to OECD reports, the various difficulties which are felt while making adjustment or adjustments are made impossible are stated to be on account of the following differences: differences in the amount and type of intangible property involved in the sale.

168. It is reasonable to infer that a specialist like T.P.O. was well aware of the difficulties that exist in application of CUP method in finding appropriate comparable transactions. The case in hand is good illustration of what has been observed by OECD about CUP method. No characteristic of controlled or uncontrolled transaction could be taken in account. Computations are not subject to any verifications and are seriously challenged by the Taxpayer. It is stated to have paid 52.36% of profit to Aztec US whereas the taxpayer has claimed that only at 6.5%. The assessee had all along been complaining that data used by T.P.O. was never put to the assessee nor detail of computation given to it. In the written submission filed in reply to claim of the revenue, there is reference to calculations. In the letter dated 15.2.2005 filed before the Transfer Pricing Officer, the taxpayer furnished reworked operating profit or margin of companies used as comparable basis by the Transfer Pricing Officer. It is not shown on record that reworked profits were objectively considered. For all the above reasons, we are unable to uphold the ALP determined by the T.P.O. 169. Rule 10A(d) also provides that a transaction includes a number of closely linked transactions. But here it is nobody's case that all controlled transactions carried for different customers were closely linked transactions and similar was the position of comparable uncontrolled transaction. In fact, by taking average, services of a totally different person were taken into account 170. In the light of above discussion, we set aside the impugned order of the Commissioner of Income-tax (Appeals) and restore the matter to the file of the Assessing Officer who may again refer the question of determination of Arm's Length price to the Transfer Pricing Officer. In our view, Transfer Pricing Officer should use his power and first call upon the taxpayer to furnish ALP and all material and information which he is obliged to maintain under Rule 10D of the Income Tax Rules. It would be appropriate to consider and make suitable adjustments in the Arm's Length price determined by the taxpayer and on the basis of information furnished by him or otherwise available with revenue authorities. By this, we do not mean to suggest that Transfer Pricing Officer cannot

determine ALP on some method other than furnished by the Taxpayer. However, as we have discussed above, any changes in the most appropriate method of computing the arms length price is to be dealt with by way of a speaking order. T.P.O. is also at liberty to collect independent relevant information of comparable uncontrolled transactions. Let the revenue authorities determine fresh ALP in the light of above observation and in accordance with the regulations. Be that as it may, a fair and reasonable Arm's Length Price should be determined as enjoined by the directions of the Board to its officer.

With the above hopeful observation, we remand the matter back to the file of the Assessing Officer.

171. The assessee has also challenged disallowance of payment of Rs 1 crore on termination of lease as a 'capital expenditure'. It is claimed that payment was made for purposes of running business and was, therefore, of 'revenue nature'. The contention advanced before the learned CIT (Appeals) was reiterated before us.

172. We have given careful thought to the submissions of the parties on this point. We have also seen orders of Revenue authorities on this issue. There is no dispute that amount in question was paid to M/s Prestige Estate Pvt.Ltd. from whom property was taken by the assessee on lease for expanding its business. Subsequently, the company decided not to carry the lease and agreement was terminated pre-maturely. It is claimed that Rs 1 crore was paid to the lesser under a negotiated settlement towards premature termination of lease. The amount shown as advance was written off and claimed as a revenue deduction. The reasons given for claiming it as a revenue expenditure were not accepted by the Assessing Officer and the learned CIT (Appeals). According to the revenue authorities, amount was paid for acquiring a benefit of enduring nature and, therefore, was a capital expenditure. On facts and circumstances of the case, we agree with the view taken by the revenue authorities that amount of Rs 1 crore given as advance and loan written off under the settlement, could not be treated as expenditure of revenue nature. It was rightly treated as expenditure of capital nature. The expenditure was clearly connected with apparatus with which the

business was to be carried. Therefore, we see no reason to interfere with the finding of revenue authorities on this issue. The ground of appeal is accordingly rejected.

173. The assessee has further raised a ground that proper and reasonable opportunities were not afforded to the taxpayer by revenue authorities. It is requested that Tribunal should also provide further opportunity to address oral arguments. We do not find any substance in these submissions. After hearing oral arguments for three days at Bangalore, we permitted both the parties to make written submissions for which more than a month was taken. Both the parties filed written submissions. This order has been passed after taking into account oral and written submissions. At any rate the matter is being remanded for fresh determination of ALV and that would be done after hearing the taxpayer. The ground is disposed of accordingly.

174. The assessee has further raised certain grounds relating to charging of interest Under Section 234A and 234B and some other technical grounds. The grounds can be examined by the Assessing Officer at the time of fresh assessment which has been directed to be made by us. No separate finding need be recorded on these grounds at this stage. For the reasons recorded above, the impugned order is set aside for passing a fresh order, in accordance with law and in the light of directions given above.

175. In the result, both the appeals are allowed for statistical purposes.

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