

Ranbaxy Laboratories Ltd. Vs. Addl. Commissioner of Income Tax,

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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Jan-22-2008

Reported in : (2008)299ITR175(Delhi)

Judge : V Gandhi, P Jagtap

Appellant : Ranbaxy Laboratories Ltd.

Respondent : Addl. Commissioner of Income Tax,

Judgement :

1. This appeal by the taxpayer for the AY 2004-05 is directed against the order of Commissioner of Income-tax (CIT) partially setting aside assessment under Section 263 of IT. Act made vide order dated 30 March, 2005 with directions to the Assessing Officer for the fresh determination of Arm's Length Price of international transaction with AEs in the light of his directions.

2. The facts of the case are that the taxpayer is a multinational company carrying on the business of manufacture and sale of pharmaceutical products as one of the leading concerns in India. It submitted its return disclosing income of Rs. 3,30,64,05,014 for Asstt.

Year 2004-05 (F.A. 2003-04). The taxpayer admittedly carried international transactions worth Rs. 1435,03,46,825 to which provision of transfer pricing was attracted in the relevant year. This figure was disclosed in the audit report filed in Form 3CEB along with the Return.

A copy of said report is available at page 1-14 of the paper book of the taxpayer placed before the Appellate Tribunal. The Assessing Officer took up the assessment and examined various questions involved in the case of the taxpayer under Section 35B, 35(2AB) and 35(2AA) and under Chapter VIA etc. He found as recorded in the assessment order that 62% of taxpayer's turnover represents export of drugs and pharmaceuticals products to overseas markets. The taxpayer has further exported goods and services to its joint venture companies, wholly owned subsidiaries and stepped down subsidiaries located in Thailand, Malaysia, Nigeria, Brazil, Peru, China, Ireland, Germany, South Africa, Egypt, Vietnam, Hong Kong, Netherlands, USA and UK which were "Associated Enterprises" (AE) under Section 92A of the I.T. Act. The taxpayer was asked to explain/give a note on application of provisions of Section 92 of the Act somewhere in the last week of March 2005. The note of taxpayer on Arm's Length Price was accepted by the Assessing Officer in the assessment order dated 30.3.2005.

3. In the light of above comments, the prices charged by the taxpayer for transactions with the associated enterprises (AE) were held to be at arm's length and no adjustment was made in the assessment order.

4. The Commissioner of Income Tax (CIT) later called for and examined the case record and formed the opinion that assessment made was erroneous in so far as it was prejudicial to the interest of the revenue. He initiated action under Section 263 of the I.T. Act by issuing the following notice dated 9.3.07 to the taxpayer. The said notice is as under: Sub: Show cause notice under Section 263 of the I. T. Act 1961 for revision of

Order passed under Section 143(3) of the I.T. Act in your case for ASSTT. YEAR 2004-05 reg.

In your case, return of income was filed on 20.10.2004 declaring an income of Rs. 330,64,05,014/-. Assessment order under Section 143(3) of the Income Tax Act was passed on 23.6.06 at an income of Rs. 630,96,80,542-. Subsequently various orders under Section 154 of the Act were passed and effect to the order of CAT(A) was also given.

Thus, the assessed income of the assessee stands at Rs. 3,63,45,44,930 (Taxes were paid as per provisions of under Section 115JB at Rs. 3,98,48,660).

1. The assessee had undertaken International Transaction with Associate Enterprises (A.E.) to the tune of Rs. 1435,03,46,825/- as per Audit Report in Form 3CEB attached with the return. However, the issue of determination of 'Arms Length price' was not referred to the Transfer Pricing Officer as required by Instruction No. 3 of 2003 dated 20.5.03. It is further observed that the Transactional Net Margin Method (TNMM) was used by the assessee taking Operating Profit upon Sales as Profit Level Indicator. (PLI). For this purpose, the assessee has taken overseas entities as 'tested parties' and their margins on mean basis and compared the same with mean of identified comparables. The approach of the assessee is not in consonance with Rule 10B(2) and Rule 10B(3) of the I.T. Rules, considering the diverse conditions in which A.E.s are operating.

Hence, treating the tested parties to be A.E.s of the assessee bunched in a group does not go well with the law and spirit of the Transfer Pricing legislation in force in India. Thus the method of determining of ALP employed by the assessee does not appear to be correct. However in the assessment order, the assessee's version has been accepted without considering the points mentioned above.

2. Considering the aforesaid, to arrive at the ALP of the International Transactions, the assessee should have been made the tested party in the assessment order. If that is done, then by applying the TNMM with PLI as operating profit/sales taking major India Pharma Companies as comparables using Captiline Database, the following comparable figures emerge: The operating margin of the assessee can be calculated as under: (In Million INR) The Arms Length profit margin based upon above data is calculated as under: Thus, it appears that the income of the assessee is under assessed by Rs. 224.50 crores in the assessment order passed.

3. Item No. 31 of 3CD Audit Report under Section 44AB states that audit under Central Excise Act was conducted in the case of the Assessee. The case of the assessee has not been examined with reference to the said Audit Report conducted under Central Excise Act.

I therefore, in view of the above facts, consider the assessment order under Section 143(3) dated 23.06.2006 passed in your case erroneous in as much as prejudicial to the interest of revenue. In view of the above, I propose to invoke the provisions of Section 263 of the I.T. Act. You are hereby given an opportunity to appear before the undersigned on 16.03.2007 at II.30 AM in Room No. 419, C.R. Building, New Delhi to state your case and show cause as to why the above assessment order be not subjected to the provisions of Section 263 of the Act.

If you do not attend on the said date, it will be assumed that you have nothing to say in this regard and order under Section 263 shall be passed accordingly.

5. The show cause notice was replied by the taxpayer. It claimed that show cause notice was defective as date of the assessment was wrongly mentioned. As regards transfer pricing issue, it was pointed out that the taxpayer (RLL) is involved in multiple operations which, inter alia, include complex research and development, manufacturing operation at various locations, quality control processes besides owning valuable intangibles. On the other hand, its AEs are engaged in sales and distribution activities, few are engaged in secondary manufacturing.

AEs assume less risk as compared to RLL. On the merit of transfer pricing, the assessee submitted as under: It

is evident that the Legislature intended to ensure that international transactions with AE's took place at a price that was not detrimental to revenue in India, i.e. the price charged by an Indian party for goods and services provided to an AE situated outside India was not lower than the market price on account of their relationship. It is also a fact, as can be seen from the records, that the operating profit margin earned by each of the AE was less than the mean of the operating profit margin of the comparable companies in some cases the AEs have suffered losses). In such circumstances and based on the facts, the international transactions entered into by the assessee with its AEs have been concluded to be at arm's length.

6. Referring to the reasons stated in the show cause notice, the taxpayer claimed that reasons given were not valid for invoking provision of Section 263. In support of claim, reference was invited to the decision of Hon'ble Supreme Court in the case of Malabar Industrial Co. Ltd. v. CIT 243 ITR 83. It was claimed that non-reference to TPO is at best a procedural flaw and on this ground, assessment could not be held to be erroneous and prejudicial to the interest of the revenue. It was claimed that Assessing Officer, having reached satisfaction on due verification, that transactions between the taxpayer and AEs were at arm's length, the assessment order could not be held to be erroneous and prejudicial to the interest of the revenue. The taxpayer further submitted and explained that assessment order was not "erroneous" and was quite in conformity with the Circulars of CBDT and provisions of Section 92C to which reference was made during the course of hearing.

It further emphasized that Assessing Officer, after making due inquiries about the correctness of determination of Arm's Length Price, accepted the case. His decision cannot be stated to be erroneous. The taxpayer placed reliance on the case of CIT v. Gabriel India Ltd. 203 ITR 108 and two other decisions of Rajasthan High Court. The taxpayer further claimed that order could not be treated as erroneous even if some procedural irregularities were involved in the assessment. In this connection, the taxpayer relied upon three decisions, first on the case of CIT v. Sakthi Charities 244 ITR 226 and on two decisions of ITAT referred to at page 152 of the paper book. It further claimed that Circular No. 3 of CBDT runs counter to express provisions of the Act contained in Section 92CA.7. As regards the ground that report of audit conducted under Central Excise Act was not considered by the Assessing Officer, the taxpayer claimed that no report was received by the assessee after the show cause notice from the Excise Deptt. No charge of any underpaid excise duty on account of under valuation or wrong classification was made against the taxpayer. Therefore, non-examination of Central Excise Audit report could not make assessment erroneous so as to empower the CIT to invoke the provisions of Section 263.

8. Without prejudice to the above claim, the taxpayer contended that initiation of action under Section 263 was without jurisdiction and bad in law. The section cannot be invoked to correct each and every type of mistake or error committed by the Assessing Officer. In support of the submission, reliance was placed on decision of ITAT Pune Bench in case of Fattechand Rajmal Jain v. IAC: 60 ITD 47.

9. In its reply, the taxpayer further contended that overseas AEs of the taxpayer were rightly taken as "tested parties" and their margin of profit was compared with mean of profit margin of identified comparable. This was in consonance with Rule 10B(2) and Rule 10B(3) of IT Rules. The taxpayer claimed that it did not compare the margin of its overseas AE on mean basis bunched in a group as stated in the show cause notice. Provisions of Rule 10B(2) and 10B(3) were cited by the taxpayer and TNMM method was also explained in its reply. The taxpayer further claimed that it had followed OECD guidelines and US regulations on transfer pricing. The taxpayer also gave reasons as to why overseas AEs were selected as tested parties as they were less complex compared to Indian taxpayer. In order to substantiate that Arm's Length Price was charged, the taxpayer claimed that FAR analysis was carried. It also claimed that it had undertaken group research and development activities. It listed six functional and other reasons following the particular course for justification of Arm's Length Price. The taxpayer again emphasized that research and development work was carried by the taxpayer. Some details of research carried out and expenditure incurred were given in reply. Ultimately, the assessee stated as under: RLL on R&D activity which was 7.13% of the turnover for the year ending 31.3.2003 and increased to 14.39% for the year ended 31.3.2005. It is submitted that incurrence of

such substantial sums on Research & Development activity (followed by manufacture at various locations) make RLL a complex entity.

On the other hand, none of the AEs of RLL are involved in any R&D activity except Runbacks Pharmaceutical Inc. ('RPI') which has incurred a minor expense of Rs. 2.40 crores on such activity.

It was further asserted that taxpayer has carried on production of bulk drugs and formulations adopted by it at its plants are duly approved by Regulatory Authority in UK, Africa and other countries. It gave detail of places where manufacturing facilities of RLL in India are provided.

Regarding the purchases made by overseas AE, it was submitted as under: The overseas AEs, on the other hand, purchase the APIs and the dosage form from RLL. In respect of the active pharmaceutical ingredient, the AEs convert these into dosage forms which are thereafter sold by the AEs. In respect of the dosage forms, the AEs merely import the finished goods from RLL, in some cases repack it in smaller packs and market it. In both these situations, the AEs convert the API into dosages and develop a marketing network and sell the products.

In case of branded products sold by the AEs, generally all brands are owned by RLL and the local (overseas) approvals and registrations for products sold in those markets are also obtained by RLL. The AEs render only support to RLL for obtaining these approvals and registrations.

The overseas AEs undertake secondary manufacturing activity, develop and maintain the marketing network, assist RLL in obtaining product approvals/registrations and undertake the relevant administrative functions.

10. It was stated that for management support to its subsidiaries, the taxpayer was normally charging royalty from the entity receiving services. The assessee further stated as under: Since RLL undertakes a very significant part of the entire range of activities of a pharmaceutical company - i.e. product development, manufacture and export of pharmaceutical products, it assumes all risks and rewards for this.

It was explained that the AEs undertake secondary manufacturing/trading activities and undertake the normal risks associated with running of their business.

11. It is claimed that the details of assets employed were also furnished by the taxpayer. With reference to four Indian companies taken as comparable by the Id. CIT in the show cause notice, the taxpayer submitted that the profit margin in the show cause notice was wrongly computed. In fact, margin of profit of taxpayer at 26.51% was higher than the average margin of the companies referred to in the notice. It was further emphasized that while working out the profit margin, non-operating income like interest, dividend and profit on sale of fixed assets was also erroneously taken into consideration. In justification of price fixed for transfer of goods and services to AEs, the taxpayer further submitted as under: We may draw your goodself's attention to another fact that none of the AE's of RLL is located in a tax heaven. The AEs located in Malaysia, Peru, China, Vietnam were incurring losses. The tax rates in all other major countries i.e. US, UK, Nigeria, Thailand, Germany, Egypt etc. where the remaining AE 's were located were not lower than India. It is a matter of record that RLL is eligible for certain deductions under Chapter VI-A of the Act and thus the average tax rate payable in its case is less than prevailing tax rate. Thus, without prejudice to various contentions raised in the earlier paragraphs of these submissions, it is reiterated that there is no incentive whatsoever for RLL to shift any profits out of India. In this regard, a chart showing the prevailing tax rates of the countries where AEs of RLL are located is enclosed as Annexure 12. The taxpayer also raised the following objection, in relation to adjustments proposed to be made in the show cause notice: 2.3.2 In this regard, attention is invited to Section 92 of the Act which reads as under: (1) Any income arising from an international transaction shall be computed having regard to the arm 's length price....

On a perusal of the above, it may kindly be noted that under transfer pricing regulations the income is to be determined only with regard to international transactions entered into by the assessee with its AEs.

Transactions with non-AEs are not governed by these regulations.

2.3.3 In view of the above, it is respectfully submitted that the assessee has entered into international transaction aggregating to approx. Rs. 1400 crores only with its AEs. Thus, without prejudice, it is respectfully submitted that the total turnover of the assessee amounting to Rs. 3506 crores as mentioned in the notice of your goodself cannot be considered as base for any alleged adjustment under Section 92 of the Act.

13. In the light of above, taxpayer claimed that assessment made by the Assessing Officer could not be treated as erroneous and prejudicial to the interest of the revenue.

14. The taxpayer accordingly submitted that assessment order be upheld and proceeding taken under Section 263 of the Act be dropped.

15. Ld. CIT examined the objections raised on behalf of the taxpayer.

He accepted that there was a clerical error in noting the date of the assessment order, which was wrongly mentioned as "30.3.06" instead of correct date of 30.3.05. On the question of failure of the Assessing Officer to refer the matter of Arm's Length Price to the Transfer Pricing Officer, the Id. CIT relied upon Instruction No. 3 of 2003 of CBDT and decision of Jurisdictional High Court in the case of Sony India (P) Ltd. 288 ITR 52. He reproduced certain portion of the decision wherein it has been observed that the classification brought about by Instruction No. 3 is based on a straightforward recognizable basis giving no room for confusion. Transactions of a high value require a careful examination to determine if declared price is, in fact, an acceptable Arm's Length Price. It may not be expedient for the Assessing Officer to efficiently deal with the assessment involving such an exercise. In that sense, it achieves the expeditious disposal of the assessment by the Assessing Officer if the exercise is referred for a specialized determination by the Transfer Pricing Officer. The classification certainly bears a nexus to this objective.

16 Ld. Commissioner also referred to the case of M/s Gee Vee Enterprises 99 ITR 375 wherein the Jurisdictional High Court has categorically laid down that failure of the Assessing Officer to conduct the required inquiry and accepting the statement of the assessee without due verification renders the order erroneous as well as prejudicial to the interest of the revenue. The Id. Commissioner also referred to decision of Allahabad High Court in the case of Jagdish Kumar Gulati v. CIT 269 ITR 71 and to the case of Saroogi, Duggal & Co. 220 ITR 456 (Delhi) as also the decision of Hon'ble Madras High Court in the case of K.A. Ramaswami Chettiar 220 ITR 657 (Mad). In all the above cases, it was held that absence of proper inquiry by the Assessing Officer would render the assessment order erroneous as well as prejudicial to the interest of the revenue.

17. The Id. CIT held that the Assessing Officer in the instant case did not consider Instructions of the Board to refer the matter to the Transfer Pricing Officer under Section 92C(3). He further held as under: The CBDT's Instruction lays a guideline which is binding on the Assessing Officer. It has been judicially held that not conducting properly enquiry in a case renders an order erroneous inasmuch as it is prejudicial to the interest of the Revenue. This is especially relevant when a well-placed mechanism has been provided by the law in such cases to undertake necessary enquiries. Thus, it can be said that in this case there is an incorrect application of the provisions of law as laid down in Section 92CA(1) read with relevant Board's Instructions on the subject.

In view of above, I am of the opinion that non-reference by Assessing Officer to the TPO for determining Arm's Length Price (ALP) is erroneous and also prejudicial to the interest of Revenue inasmuch as the matter could not be examined by the TPO as instructed by the Board in instruction No. 3, as mentioned above, having regard to the fact that the international transaction was more than Rs. 5 crores.

18. The Commissioner (CIT) further examined transfer pricing report filed during the assessment proceedings and the data utilized in that report. He found that financial results of US based companies having US SIC

codes were utilized. The data base made no mention that companies taken for comparability analysis are based in the same jurisdiction.

For example it is not clear whether for comparison of Ranbaxy - PRP (Peru) S.A.C. Peru, the comparable companies taken were that based in the same geographical jurisdiction. The Id. CIT listed defects in the report as per item (a) and (b) of his order. He held that the claim of taxpayer could not be accepted on the face of it without further inquiry and verification. He also held that the Assessing Officer did not inquire as to why companies having different business profiles or business lines came up in data base as admitted in the report.

According to him, this needed explanation and it was also not clear why loss making companies were eliminated for comparison. He noted that in the final analysis, six companies from EXTL data base were selected for comparison and from the Hoovers data base of 12 companies, only one company was selected on similar ground. One more company namely Fornix Biosciences was selected merely because this company was also selected in T.P. report 2002-03. The Id. CIT further observed as under: Geographical locations of the entities are one of the most important factors for the determination of Arm's length price. This is apparent from the fact that the different associate enterprises of the assessee are located in different geographical jurisdictions and involved in almost similar transactions are showing such a diverse net profit results. Therefore, the identification of comparable data and its reliability are the main basis on which the transfer pricing regulations stand. In the instant case both the identification of correct comparable data and its reliability are in question which needed examination by the specialized wing of the Department entrusted with the task of analysis of the transfer pricing documentation submitted by the assessee and passing suitable orders on a reference from the Assessing Officer as per Section 92CA(1) read with Instruction of the CBDT New Delhi in this regard (Instruction No. 3/2003).

19. Id. Commissioner also held that the question whether TNMM is the most appropriate method was also an issue involved for consideration.

20. On the question that assessee could not be selected as a tested party because of its involvement in complex business activities, the Id. CIT observed, "but as seen earlier that the comparable in the cases of overseas AE are not proper entities with whom comparison can be made". Most importantly, reliable data for comparison in respect of the taxpayer is available in India. Here are other similar pharmaceutical companies engaged in similar business and undertaking similar transactions with overseas AE. The Assessing Officer failed to look into this aspect. He only accepted the version of the assessee without making proper inquiry. Therefore, assessment was held to be erroneous and prejudicial to the interest of the revenue.

21. The Id. CIT also held assessment as erroneous as Assessing Officer failed to look into the report of the audit conducted under Central Excise Act.

22. As regards the claim of the assessee that average operating profit margin of the taxpayer was much higher at 26.51% against average margin of profit (17.26%) of 20 companies operating in India and that in the margin of profit shown in the show cause notice, non-business profit like profit from partnership, sale of fixed assets/investment was also included, the Id. CIT held that these questions involved verification of facts which can be taken at the level of A.O./T.P.O.23. In the ultimate analysis, the Id. CIT set aside the assessment with the following observations: As discussed above, I have concluded that the Assessment Order passed by the Assessing Officer is erroneous in so far as prejudicial to the interest of Revenue on three counts i.e., non-reference of the case to TPO, taking overseas AEs of assessee as tested party and non consideration of findings of Audit of Central Excise Department. The Assessment Order is, therefore, set aside on these three issues. The Assessing Officer will examine the issues afresh on these points and reframe the assessment order in this regard after giving proper opportunity to the assessee. The A.O. is further directed to refer the case to the TPO for determination of Arm's Length Price as per the Instruction No. 3 of the CBDT, which has been held to be necessary by Hon'ble Delhi High Court in the case cited above. The TPO will naturally take into consideration all relevant issues including selection of tested party and the most appropriate method

including the submission of the assessee at para 6 of this order for determining Arm 's Length Price.

i) Non-reference to T.P.O. was an error in view of Instruction No. 3 of 2003 dated 25.2.2003 of CBDT which is mandatory. Reliance is placed on the decision in case of Sony India (P) Ltd. Further, it would be expedient for the T.P.O. to efficiently deal with question of arm's length price.

ii) Audit report and transfer pricing report filed during assessment have several defects listed in para 4.3 of the above order.

Comparable data and its reliability needed examination by specialized wing of the department entrusted with task of analysis of transfer pricing and its policy implementation.

iii) Overseas AE, instead of the taxpayer were wrongly taken as a tested party when reliable data for comparison in respect of taxpayer is available in India. There are several other pharmaceutical companies engaged in a similar business and undertaking similar transactions.

iv) The Assessing Officer has not looked into above aspects of the case. He has only accepted the version of the assessee without making proper enquiry. Therefore in view of the decisions cited above, the Assessment Order is erroneous and prejudicial to the interest of Revenue.

v) Assessing Officer is also wrong in not examining the case with reference to report of Audit conducted under Central Excise Act.

vi) The claim of the taxpayer that it was making more profit than similar concerns in India needed verification at Assessing Officer/T.P.O. level.

23.2 On above grounds, the assessment order was held to be erroneous in so far prejudicial to the interest of the revenue under Section 263 of the I.T. Act.

24. The taxpayer is aggrieved and has brought the issue in appeal before the Appellate Tribunal.

25. We have heard both the parties. The taxpayer has impugned order of the Id. Commissioner on several grounds which in a summary manner can be stated as under: i) That the assessment order was neither erroneous nor prejudicial to the interest of the revenue and, therefore, Id. CIT had no justifiable reason to assume jurisdiction under Section 263 of the Act to revise the same.

ii) That decision in the case of Sony (India) Ltd. has clearly laid down that Circular No. 3 of CBDT did not affect the jurisdiction and discretion of the Assessing Officer under Section 92CA(1) to refer or not to refer the matter of transfer pricing to the Transfer Pricing Officer (T.P.O.). The Assessing Officer was fully competent to determine the question whether international transactions with AE was carried at Arm's Length.

iii) That the decision of the Special Bench of the Tribunal in the case of Aztec Software & Technology Services Ltd. v. CIT 249 ITR (AT) 32 was contrary to the decision of Delhi High Court in the case of Sony Ltd. and, therefore, cannot be considered to be good law.

iv) That even if it is held that Assessing Officer was duty bound to refer the question of determination of Arm's Length Price to the Transfer Pricing Officer, the non-reference is only a procedural error for which provisions of Section 263 of the Income Tax Act could not be invoked. Reference in this connection was made to certain decisions where procedure as laid down under Section 144B was not followed but courts did not hold that assessment so made could be revised under Section 263 of the Act.

v) That perusal of assessment order and other relevant record would clearly show that the Assessing Officer had applied mind to the detailed submission made by the taxpayer during the course of assessment and had taken a reasonable view of the matter. Merely because another reasonable view was also possible, the assessment could not be treated as erroneous and prejudicial to invoke provisions of Section 263 of the

vi) That Id. CIT failed to appreciate that under the transfer pricing mechanism "tested party" out of two parties of a multinational involved in the transaction, the least complex party not owning intangible assets is to be taken as a tested party. The taxpayer had placed sufficient material on record to show that taxpayer was a complex party whereas other associated parties were less complex. That Id. CIT did not properly appreciate that under transfer pricing more than one transaction could be grouped for purposes of comparison and that is what the taxpayer had done in the present case. So no fault could be found with the audit report or other explanation furnished by the taxpayer to show that transactions were carried out at arm's length.

vii) That taxpayer had clearly shown that margin of profit earned by it was more than other Indian pharmaceutical companies carrying on similar business. The Id. CIT, instead of examining the claim of the assessee by recording a clear finding, sidetracked the issue by observing that the question could be verified by the Assessing Officer/T.P.O. Without recording a definite finding on the claim, powers under Section 263 could not be exercised and, therefore, impugned order of CIT was illegal and without jurisdiction.

25.1 On the basis of above submissions, Shri Ajay Vohra claimed that the order of the CIT should be set aside and assessment order be restored. Shri Vohra further argued that profit earned by the taxpayer was much more than profit of the associated concerns and, therefore, no diversion of funds or profit could be presumed in this case. Provisions of transfer pricing had no application whatsoever. This was another ground on which impugned order should be set aside.

26. Id. DR, on the other hand, supported the impugned order of the CIT, which according to her was fully justified in the light of legal and factual errors committed by the Assessing Officer, which caused prejudice to the interest of the revenue. She further argued that the matter was fully covered in favour of the revenue as per the Special Bench decision in the case of Aztec Software & Technology Services Ltd. (supra).

27. We have given careful thought to the rival submissions of the parties. There can be no dispute that powers under Section 263 can be invoked only when assessment is established to be erroneous and prejudicial to the interest of the revenue. It cannot be invoked merely for making a fishing inquiry. The Id. Counsel for the taxpayer is also right in arguing that assessment can not be revised merely because another reasonable view of the matter is possible in the case. At the same time, it is a settled law that assessment made without conducting proper inquiry and investigation as enjoined by law and warranted in the facts of the case is to be treated to be erroneous and prejudicial to the interest of the revenue. Assessment made in haste or without application of mind falls in the same category. Even in the case of Malabar Industrial Co. Ltd. v. CIT 243 ITR 83, the decision of Supreme Court strongly relied upon by the Id. Counsel by the taxpayer, their lordships have held as under: An incorrect assumption of facts or an incorrect application of law will satisfy the requirement of the order being erroneous. In the same category fall orders passed without applying the principles of natural justice or without application of mind.

28. With reference to facts involved in that case, their Lordships further observed as under: In the instant case, the Commissioner noted that the Income-tax Officer passed the order of nil assessment without application of mind. Indeed, the High Court recorded the finding that the Income-tax Officer failed to apply his mind to the case in all perspective and the order passed by him was erroneous. It appears that the resolution passed by the board of the appellant company was not placed before the Assessing Officer. Thus, there was no material to support the claim of the appellant that the said amount represented compensation for loss of agricultural income. He accepted the entry in the statement of the account filed by the appellant in the absence of any supporting material and without making any inquiry. On these facts the conclusion that the order of the Income-tax Officer was erroneous is irresistible. We are, therefore, of the opinion that the High Court has rightly held that the exercise of the jurisdiction by the Commissioner under Section 263(1) was justified.

29. In the case of Jagdish Kumar Gulati v. CIT 269 ITR 71, their Lordships observed as under: It is well settled

that if the Assessing Officer fails to make a proper enquiry this is erroneous and prejudicial to the interests of the Revenue vide K.A. Ramaswamy Chettiar v. CIT (Mad)Addl. CIT v. Mukur Corporation ; Gee Vee Enterprises v. Addl. CIT ; Malabar Industrial Co.

Ltd. v. CIT [2000] 243 ITR 83 (SC); CIT v. Active Traders (P) Ltd. ; Swarup Vegetable Products Industries Ltd. (No. 1) v. CIT ; CIT v. Rampiyari Khemka ; Bagsu Devi Bafna v. CIT ; CIT v. Kiran Debt Singhee ; CIT v. Mahavar Traders ; CIT v. Everest Cold Storage and Duggal and Co. v. CIT , etc.

It was not disputed by Shri Ajay Vohra, Id. Counsel appearing for the taxpayer that an assessment would be erroneous and prejudicial to the interest of the revenue if it is made without application of mind or without making proper inquiries into the facts and without considering statutory regulations applicable thereon. His submission was that Assessing Officer was not duty bound to refer the question of determination of Arm's Length price to the Transfer Pricing Officer (T.P.O.) as he has ample power and discretion to carry that exercise.

Even if it was necessary to refer the matter to the TPO, such failure was merely "procedural" and on account of the same, assessment could not be treated as erroneous and prejudicial to the interest of the revenue. On facts of the case, we see no justification to accept above argument of Id. Counsel of the taxpayer. The revenue has been able to establish fully that assessment in this case was made without considering relevant and pertinent questions and without application of mind.

30. under Section 92(1), it is provided that any income arising from an international transaction shall be computed having regard to the Arm's Length Price. It is therefore mandatory that in case of every international transaction, the price charged as per books must be shown to be Arm's Length Price. In the case of Mentor Graphics (Noida) Pvt.

Ltd. in ITA No. 1969/D/2006, Delhi 'H' Bench, reported in 109 ITD 101, after taking into account decision of the Hon'ble Supreme Court in the case of Morgan Stanley 292 ITR 416, that of Special Bench of ITAT in the case of Aztech Software & Technology Services Ltd. v. ACIT 249 ITR (AT) 32, and also relevant provisions of Rules relating to Transfer Pricing observed as under: Computation of the arm's length price is essentially a factual exercise. Each case depends on its own peculiar facts and circumstances. In certain cases where an identical or almost similar uncontrolled transaction is available for comparison determination of the arm's length price is an easy task. However, it is not so in most transactions and rarely is one able to locate an identical transaction. In such cases the arm's length price is determined by taking the results of a comparable transaction in comparable circumstances and making suitable adjustments for the differences.

The fundamental requirement, in any of the methods 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. Whatever methodology is chosen for the purpose of determination of the 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 a direct bearing on the pricing of products/services. The provision also provides scope for carrying out adjustments in case where there are some differences or variations to make two transactions commercially comparable, for the purpose of benchmarking. 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.

23. In the case of DIT (International taxation) v. Morgan Stanley 292 ITR 416, the Hon'ble Supreme Court after considering relevant Indian regulations on transfer pricing made some pertinent observations which are noted as under: The object behind enactment of transfer pricing regulations is to prevent shifting of profits

outside India.

The impugned ruling is correct in principle in so far as an associated enterprise, that also constitutes a P.E., has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise.

where the transaction between the two are held to be at arm's length basis taking into account all the risk-taking functions of the multinational enterprise. In such a case nothing further would be left to attribute to the P.E. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a case, there would be need to attribute profits to the P.E. for those functions/risks that have not been considered.

24. It is true that "transfer pricing" is not an exact science, evaluation of transactions through which the process of determination is carried in an art where mathematical certainty is indeed not possible and some approximation cannot be ruled out, yet it has to be shown that analysis carried was "judicial" and was done after taking into account all the relevant facts and circumstances of the case. Minimum requirement is to prima facie show that controlled international transaction was properly examined, comparable and arms' length price fixed objectively, honestly and in a bona fide manner as required by the statutory regulations. The requirement of the statutory regulation has been thoroughly discussed by the Appellate Tribunal in the case of Aztech Software (supra), but in order to dispose of this appeal, these are reiterated here: 25. The comparability of an international transaction i.e.

uncontrolled transaction and a controlled transaction is to be judged under Rule 10B(2) 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.

Further caution required to be adopted while looking to the differences between controlled and uncontrolled transaction is provided in Sub-rule (3) of Rule 10B which is 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.

Further "Rule 10B(1)(e) of Income Tax Act providing for determination of Arm's Length Price under Section 92C required that following steps are to be taken while applying TNMM after selection and evaluation of controlled transactions. It is as under: (i) the net profit margin realized by the enterprise from an international transactions 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.

As noted in the case of Aztech Software (supra) "rarely one is able to locate an identical uncontrolled transaction ". The Arms' Length Price is determined by taking result of a comparable transaction in comparable circumstances and by making suitable adjustments for the differences.

26. The first step in the determination of Arms Length Price is to analyse the specific characteristics of the controlled transaction whether it relates to transfer of goods, services or intangible.

Without proper study of specific characteristics of controlled transaction, no meaningful comparison or location of comparable is possible. For example, a mere consideration that controlled transaction relates to "software supply " is not sufficient as there are hundreds of softwares with different characteristics which materially affect their open market value. The characteristics that are required to be considered include in case of transfer of tangible property, the physical feature of the property, its quality, reliability and availability (supply). In case of provisions of services, the nature and extent of services and where tangible property is involved for comparison, the form of transaction. To put it in other words, all the characteristics of the controlled transaction which are likely to affect its open market value must be taken into account. The study should include analysis of functions, risk and assets of the controlled transaction for correct location of similar or nearly similar characteristics in uncontrolled transactions. Specific characteristics are necessary to carry search of similar comparable with similar characteristics.

27. After the selection of the comparables, best method of determining Arms' Length Price is selected. Thereafter, functional analysis is carried to identify functions, risk and assets of uncontrolled transactions and comparison is carried with characteristics of the controlled transaction. This is necessary to find whether comparable selected are really comparable and reliable.

Comparison based on functional analysis include economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises. The structure and organization of the group and more particularly the judicial relationship between different entities of same group are to be seen. The function that need to be identified while carrying comparison as per OECD guidelines include design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financial and management activities. It is also necessary to examine as to what is the principal function of the entities. The analysis of comparison should consider total assets employed and assets used to earn profit. The risk assumed by respective parties is a very important consideration. It is a simple principle of economics that the greater the risk, the greater the expected return (compensation). If there are material and significant differences in the risk involved, then the comparable identified are not correct as appropriated adjustments for differences in such cases are not possible.

Therefore, while performing searches for potential comparable companies, not only turnover and operating profit but functions performed and risk profile are also to be considered. However, it can always be shown on the given facts of the case that comparable found are similar or almost similar to the controlled transaction and no adjustments are needed. It is useful to see the level of intangible assets in comparable to an appropriate base. Depending on facts of the case, final set of comparables may need to eliminate differences by making adjustments for the following: 27.1 The risk not only due to human resources, infrastructure and quality which are normally taken into account yet more significant risks like market risk, contract risk, credit and collection risk and risk of infringement of intellectual property are being ignored here. In most of the comparable analysis carried in India, the latter type of risk are not being taken into consideration although these can lead to major difference in Market Value of transactions.

27.2 The European tax authorities are reluctant to accept "adjustments" because adjustments necessarily involve consideration of question whether they are appropriate or not and therefore it is always better to find

comparable requiring the least or no adjustment. The position in India as per Indian regulations on the subject has been noted earlier. If there are differences which can be adjusted, then adjustments are required to be made. If the difference between the companies are so material that adjustment is not possible, then comparables are required to be rejected.

27.3 Further in the analysis numerous ratio are applied, depending on the specific of the comparables. The search may include the following: Inventory/sales; operating assets to total assets, fixed assets to total sales, fixed assets to number of employees, operating expenses to sale, cost of sales.

28. In the present case, there is agreement between the parties that Transaction Net Margin Method for determination of Arm's Length Price was the most appropriate method. It was attempted to be applied by both the parties.

31. It is worthwhile to refer again to provisions of Sub-rule (2) and (3) of Rule 10B of I.T. Rules as under: 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.

(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.

32. It is clear from above rule that specific characteristics of property transferred or services provided is first to be taken into consideration. Thereafter, functions performed, assets utilized or risk assumed (FAR) would have to be considered. Considerable significance is also attached to contractual terms relating to explicit and implicit division of responsibility, risks and benefits divided between the respective parties to the transaction. Economic conditions prevailing in the market including geographical locations, size of market, government orders in force are also required to be considered. Transfer pricing is an exercise of comparison of controlled and uncontrolled transaction between independent parties under similar or almost similar circumstances. If circumstances of transactions under comparison are different, then question of adjustment and their evaluation assumes importance; what are the differences and whether it is possible or not to adjust and what adjustments are needed.

33. Without going into the niceties, the characteristics of transactions are required to be seen as a first step. If one does not have the detail of transaction/transactions, what he is going to compare? 34. Before considering facts and circumstances of the present case, it is also necessary to bear in mind that as per the accepted view, the initial burden to prove that the international transaction was carried out at arm's length is on the taxpayer. This has been fully discussed by the Special Bench in the case of Aztec Ltd. (supra) where after considering Indian regulations and regulations of several other countries, it has been held that such initial burden is on the assessee to show that transfer of goods and services is at ALP.³⁵ The assessing officer (A.O.) in the instant case accepted above audit report and taxpayer's transfer pricing study without raising any objection or query. But the Id. CIT rejected above report/study and gave direction for further investigation and enquiry. The taxpayer did not give in the report or in any other paper/document specific characteristics of

the transactions, of property transferred or services provided except for giving the amount of the transactions merely mentioning that pharmaceuticals were sold either in the shape of dosages or API, technical know-how etc. From what is stated in the audit report, no information relating to correctness of transfer pricing could be gathered nor mechanism of Arm's length price applied.

The taxpayer is manufacturing and selling pharmaceutical products. It is manufacturing medicines mostly for human consumption. Such medicines have specific names. It is reasonable to assume that these very medicines or formula (or with some differences) were sold in India and were also exported to other countries or to independent concerns. Arm's Length Price or transfer pricing could be seen or determined only if name and quantity of the product was made known. Only then it could be determined whether the taxpayer had sold same or similar or almost similar medicine to other independent concerns: Difference in transactions on comparison could be considered. Whether a similar product was sold by other pharmaceutical concerns in India and if sold, at what price. The taxpayer in the audit report, as stated earlier, did not give details and specific characteristics of property transferred.

The column title "description of the transaction" only states "Sale of API/Raw Material", "Sale of Spare parts", "Sale and purchase of dosages", "provision of technical assistance" and know how. For an illustration see below the disclosure of transactions with AEs at Thailand, Malaysia and Nigeria in report: The column "quantity" in the above chart refers to Note 2 below. The said Note 2 is as under: In view of the numerous products and voluminous transactions, it is not possible to give these details.

36. Similar is the position of all other International transactions with AEs. It is clear from above that taxpayer did not give description of the international transaction as "numerous products and voluminous transactions" were carried out by it. Can this be a ground for holding back the information about the description of the transactions? Now, if quantity and volume of goods transferred or services is not disclosed, can anybody find the price charged for goods? Therefore, it is clear that the taxpayer did not wish to give either name or volume of goods on which the price shown was charged by the assessee in transactions with its associated enterprises (AE). The Assessing Officer did not bother that basic and fundamental information to consider application of transfer pricing formulation was not available in this case. He did not bother to examine Note No. 2 or see its implications. He accepted what was stated by the taxpayer in the Note furnished in the fag end of March 2005 and completed the assessment four days thereafter on 30.3.2005. The Assessing Officer failed to examine fundamental questions relating to application of transfer pricing regulations i.e.

characteristic of transactions.

37. As regards application of TNMM method, the taxpayer in the audit report stated as under: In applying the Transactional Net Margin Method for determining the Arm's Length Price (ALP), the assessee has, having regard to the facts of the case, considered the net profit margin before tax of the entire business of Its Overseas Associated Enterprises, who are the tested parties. As the net profit margin before tax of such business is lower than the arithmetical mean of the net profit margin before tax of the overseas comparable companies, the assessee is of the opinion that transaction value of the aforesaid transactions as per its book of accounts meets with the arm's length principle.

38. No detail whatsoever of the company (enterprise) taken into consideration for comparison or working of their margin of profit or of overseas comparable companies taken into account was made available in the report in form 3CEB (We are not referring to note given in March 2005). No calculation was available in the audit report on form 3CEB. However, the Assessing Officer failed to note these deficiencies in the audit report. The AO should have prima facie rejected such report as not conforming to statutory provisions of I.T. Rules on transfer pricing or should have raised pertinent questions relating to transfer pricing. The Assessing Officer only asked for the note on transfer pricing to be produced by the taxpayer. There was patent lack of application of mind to the requirement of transfer pricing regulations and also to what taxpayer had given in its report on Form 3CEB. The Id.Counsel for the assessee argued that when TNMM method is applied and

profit margin of tested party is taken into consideration for comparison, individual transactions lose their significance. Even effect of Functions, assets and risks (FAR) is minimized. He has referred to OECD guidelines. In the light of clear provisions of Rule 10 of I.T. Rules duly considered in the case of Mentor Graphics (supra), we do not see any justification to accept above claim. The bench, in the above case, after considering above guidelines of OECD and relevant Indian regulations observed as under: 36.2 In TPO's views, the Transaction Net Margin Method being more tolerant to minor functional differences, there was no need to carry functional and other analysis to find difference in transactions.

For this purpose, he relied upon para 3.27 of OECD report of July 1995. In our opinion, para 3.27 has been taken by TPO out of context. In the Guidelines the strength and weaknesses of the Transaction Net Margin Method has been compared with other methods and one strong point stated has been overemphasized by the T.P.O. This is what has been stated in para 3.27: 3.27 One strength of the transactional net margin method is that net margins (e.g. return on assets, operating income to sales, and possibly other measures of net profit) are less affected by transactional differences than is the case with price, as used in the CUP Method. The net margins also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins. Differences in the functions performed between enterprises are often reflected in variations in operating expenses. Consequently, enterprises may have a wide range of gross profit margins but still earn broadly similar levels of net profits.

36.3 Extracts from other Paras 3.29, 3.34, 3.35, 3.37 and 3.39 of the same guidelines would clearly show that the inference drawn is one-sided. These paras are as under: 3.29 There are also a number of weaknesses to the transactional net margin method. Perhaps the greatest weakness is that the net margin of a taxpayer can be influenced by some factors that either do not have an effect, or have a less substantial or direct effect, on price or gross margins. These aspects make accurate and reliable determinations of arm's length net margins difficult. Thus, it is important to provide some detailed guidance on establishing comparability for the transactional net margin method, as set forth in Sub-section (c)(1) below.

3.34 Prices are likely to be affected by differences in products, and gross margins are likely to be affected by differences in functions, but operating profits are less adversely affected by such differences. As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons. Assuming similar functions can be isolated from among the wide range of functions that enterprises may exercise, in order to apply the method, the profit margins related to such functions may still not be automatically comparable where, for instance, the enterprises concerned carry on those functions in different economic sectors or markets with different levels of profitability. When the comparable uncontrolled transactions being used are those of an independent enterprise, a high degree of similarity is required in a number of aspects of the associated enterprise and the independent enterprise involved in the transactions in order for the controlled transactions to be comparable; there are various factors other than products and functions that can significantly influence net margins.

3.35 The use of net margins can potentially introduce a greater element of volatility into the determination of transfer prices for two reasons. First, net margins can be influenced by some factors that do not have an effect (or have a less substantial or direct effect) on gross margins and prices, because of the potential for variation of operating expenses across enterprises. Second, net margins can be influenced by some of the same factors, such as competitive position, that can influence price and gross margins, but the effect of these factors may not be as readily eliminated. In the traditional transaction methods, the effect of these factors may be eliminated as a natural consequence of insisting upon greater product and function similarity.

3.37 Assume, for example, that a taxpayer sells top quality video cassette records to an associated enterprise, and the only profit information available on comparable business activities is on generic medium quality VCR sales. Assume that the top quality VCR market is growing in its sales, has a high entry barrier, has a small number of competitors, and is with wide possibilities for product differentiation. All of the differences are

likely to have material effect on the profitability of the examined activities and compared activities, and in such a case would require adjustment. As with other methods, the reliability of the necessary adjustments will affect the reliability of the analysis. It should be noted that even if two enterprises are in exactly the same industry, the profitability may differ depending on their market shares, competitive positions, etc.

3.39 The transactional net margin method may afford a practical solution to otherwise insoluble transfer pricing problems if it is used sensibly and with appropriate adjustments to account for differences of the type referred to above. The transactional net margin method should not be used unless the net margins are determined from uncontrolled transactions of the same taxpayer in comparable circumstances or, where the comparable uncontrolled transactions are those of an independent enterprise, the differences between the associated enterprises and the independent enterprises that have a material effect on the net margin being used are adequately taken into account. Many countries are concerned that the safeguards established for the traditional transaction methods may be overlooked in applying the transactional net margin method. Thus where differences in the characteristics of the enterprises being compared have a material effect on the net margins being used, it would not be appropriate to apply the transactional net margin method without making adjustments for such differences. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the transactional net margin method.

37. It is clear that even when TNMM method is applied to determine arm's length price as per OECD guidelines, functional profile, assets, assumed risks of controlled and uncontrolled transaction are to be seen while screening. Besides, it is not possible to ignore specific Indian regulations on the subject. We have already noted the relevant rule (2) and (3) 10B of I.T. Rules, which specifically require to consider for comparison "the functions performed assets employed...and risks assumed by respective parties" In Rule 10(B)(1)(e) of I.T. Rules providing for determination through TNMM, it is clearly provided in Clause (iii) "the net profit margin referred to in Sub-clause (ii) arising in comparable uncontrolled transactions is adjusted to take into account the difference if any". These regulations have force of law and notwithstanding OECD guidelines, the T.P.O. can not refuse to consider specific characteristics of transaction, functions performed and assets employed as has been done in this case. Total disregard of regulations non-application of filters as above has resulted in faulty selection of comparison. All sizes of companies have been selected, only commonality being their dealings in softwares. We are unable to hold and approve the approach of T.P.O. as correct. The wide difference in the ratio of operating margins between 3.16% to 37.89% in final selection of comparable by the T.P.O., is a clear pointer to the fact that the selection made was faulty. It was imperative for the TPO to carry on further analysis and evaluation of companies selected and to see whether this variation is on account of FAR etc. The OECD guideline on this point is as under: 1.47 Where the application of one or more methods produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

It is evident from above that even as per OECD guidelines while applying TNMM method not only comparability of transactions are to be kept in view but FAR analysis is also to be considered in evaluation.

Enterprises carrying same functions in different economic sectors and markets can have different level of profitability. Further, OECD as per draft notes dated 10.5.2006 has accepted to exclude loss as well as high profit making enterprises from comparison where taxpayer is a captive enterprise like Mentor Graphics Ltd. (supra).

40. The taxpayer submitted note on transfer pricing Study before the Assessing Officer along with the letter dated 24.3.05, which is a document running to 104 pages (pages 15 to 123 of the paper book). The taxpayer claimed that average profit earned by each of its enterprises was less than the profit earned by independent enterprise as per the following details in the note/transfer study filed in March 2005: The profitability

estimates of the overseas AEs, based on the audited financial statements, indicate the following net margin on sales for each of the overseas AEs during 2003: The above net margins have been considered for the comparability analysis. In this regard, we have relied upon the information provided by RLL for our analysis of arm's length price. Further, we have not validated/verified the basis of determining the profit margins and the completeness of transactions contained therein.

(underlined by the bench to emphasise but even these remarks were not considered by the A. O.) 9.5.2 In the instant case, the Transfer Pricing Study has been carried out to determine net profit margin arising in a comparable uncontrolled transaction for ascertaining an arm 's length price in respect of Export of Pharmaceuticals.

9.5.3 The net margins earned by the comparable companies have been compiled in Annexure 7 as mentioned above. The proviso to Section 92C of the Act provides that where more than one price is determined by the most appropriate method, then the arm 's length price shall be the arithmetical mean of such prices. In the instant case, TNMM results in determination of net profit margins of 8 comparable uncontrolled companies, the arithmetical mean of the above 8 net profit margins before tax said comparable companies, which works out to 14.88%. As can be seen from the table in paragraph 9.4.2, the maximum net margin on sales is earned by Ohm Laboratories Inc., USA which is 11.22%, which is less than the average net margin earned by comparable overseas companies at 14.88%. The other AEs earn a margin which is lower than the margin earned by Ohm Laboratories and hence meet with the arm's length principle.

41. On consideration of above submissions/details we do not find detail of job profile/or of location of 8 companies in the above chart or other record. What constituted "Turnover" and "Total cost" of comparable and each of foreign AEs were important in order to see reliability of data for comparison, but these were left out and not disclosed. Only from column "Currency" one can presume that comparable companies were operating in Europe, America or Malaysia (RM). These companies are taken as comparable to taxpayer's foreign enterprises because these were manufacturing drugs in some part of the world. The taxpayer had transferred goods or services to its 17 associated enterprises detailed above spread over different continents operating in different environments which are significant factors as noted hereinafter. The taxpayer did not furnish details of transaction nor claimed that some or similar transaction with same profit margin were carried with all foreign AEs. It is not the case of the taxpayer that the price at which goods and services were transferred to all the 17 concerns was responsible for the margin of profit of the AEs. Influence of several other circumstance on "turnover" or "total cost" on margin of profit could not be ruled out. Other factors responsible for diversified margin of profit were required to be examined. Nothing was stated about those factors and whether any adjustment was required to be made for differences. The Assessing Officer in the assessment also showed least concern for above crucial aspect of the matter. It would have been appreciated if each of the foreign company was taken as a tested party, say AE in Peru and was compared with profit margin of pharmaceutical companies of same size carrying similar transactions in Peru. Malaysian AE was required to be compared with similar Malaysian companies with environmental advantages or disadvantages and after applying FAR test, results required to be seen. Similar exercise was required to be performed in respect of other companies situated in different countries or shown how selected companies were better placed than companies operating in India for comparison. This could have lent some credibility to transfer pricing study filed by the taxpayer in March 2005 although as noted earlier, no information was available in the audit report. Taking of companies with different locations and worked mean profit of 14.88% without relevant details, could not be accepted particularly when it is not stated whether selected companies could also use or not use brand name. Examination and investigation of several circumstances in 17 countries was involved in the transactions.

The Id. CIT, therefore, rightly directed the Assessing Officer/TPO to re-do the assessment on the transfer pricing, with which one cannot find any fault. We see no logic in the comparable basis put forward by the taxpayer and in selecting companies without care for their geographic location, economic background and evidence of FAR analysis.

On facts, we see no good reason to accept mean margin at 14.88% as benchmark representing uncontrolled transaction or enterprise for all the 17 AEs. The Id. CIT rightly applied provisions of Section 263. We agree with the facts recorded by him in the impugned order on above aspects.

42. On the grouping of all the transactions and selection of the tested party, the taxpayer, in its note to the Assessing Officer, had submitted as under: When assessing whether cross border related party transactions are at arm's length, either of the following transfer pricing methods may be applied to the relevant transactions: To each separate transaction that occurs, i.e. for every invoice raised; or To all cross border related party transactions as a single group of transactions. This occur by aggregating: In this regard, Rule 10A(d) of the IT Rules defines the terms transaction to include a number of closely linked transactions.

Further, the transaction-wise arm's length method could be more appropriate where CUP method is to be applied. However, given the range of transactions and services involved it would not be appropriate to apply the arm's length price on a transaction-by-transaction basis. In such a scenario, aggregation approach would be more relevant for determination of arm's length price.

Transfer pricing methods could be applied by grouping international transactions that involve the performance of similar functions, use of same or similar assets and assumption of similar risks and justify the transfer prices based on the functionally comparable companies, or functionally comparable uncontrolled transactions performed by the same company.

Further, at many instances, companies enter into various international transactions with overseas affiliates, which are linked or inter-related to the primary business activity of the company/the primary international transaction of the company. In such instances, at times it may not be practical to independently evaluate the arm 's length standard for each such international transaction. In this regard, Para 1.42 of the OECD TP Guidelines reads as under: Ideally, in order to arrive at the most precise approximation of fair market value, the arm 's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Such transactions should be evaluated together using the most appropriate arm 's length method or methods.

43. Ideal situation of comparing, as accepted above, is transaction by transaction basis. Grouping of all the transactions is justified as "these can not be evaluated adequately on a separate basis". Guidelines are further interpreted and applied by the taxpayer for transfer pricing and the following conclusion is drawn: Having regard to above, if the profit/loss of the tested party is within the arm 's length range of profit/loss of the uncontrolled comparables, then it could be contended that the group of inter-related international transactions has been conducted at arm 's length.

The aforesaid aggregation approach (b) is considered appropriate since the primary activity of RLL constitutes only cross-border related party operations. Accordingly, comparison of the entity's profitability as a whole would bring out the fact that the related party transactions are arm's length.

8.2 In order to identify the Most Appropriate Method for establishing the arm's length price, determination of the tested party plays a key role, since one needs to identify comparables and compare the same with the transfer prices of the tested party.

The tested party is generally the participant in the international transaction whose transfer price/profitability attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments and for which reliable data regarding uncontrolled comparable companies can be located. Consequently, in most cases, the tested party will be the least complex of the transacting AEs and does not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparable companies.

Any transaction involves at least two enterprises. In the instant case, the first enterprise is RLL and the other enterprises are the overseas AEs. The Most Appropriate Method for determining the arm's length price can be determined/applied with reference to either RLL or its AEs. The enterprise to which the method is applied is called the "Tested Party".

Based on our discussions above, the Overseas AEs were selected as the tested party last year since they performed simpler functions, used fewer intangibles and assumed minimal risks. Further, it was also possible to verify their operating profit using the most reliable data, making the fewest and most accurate adjustments.

44. The aforesaid claim of the taxpayer for aggregation of all the associated enterprises as tested parties in taking their margin of profit for comparison with some American companies and six other companies with location not disclosed is very difficult to understand.

It is true that under Rule 10AD, "transaction" include number of closely linked transactions. As is clear from record, it is not even stated that all transactions carried with 17 AEs are closely linked transactions. Justification given for taking all of them as one tested party/ parties is not convincing and difficult to accept on the facts of the case. Relevant details were not filed before Assessing Officer nor shown to be examined by him. How transactions carried with 17 AEs situated in South East i.e. in Thailand and Malaysia; in Africa i.e. in Nigeria; in South America i.e. in Brazil and Peru; in China, Republic of Ireland, Germany, Egypt, Netherlands, UK and several other places and related not only to pharmaceuticals but also transfer of know-how and technology, sharing of expenses could be taken as linked transactions to treat them as a single transaction and conclusion drawn about numerous transactions at arm's length price. The Id. CIT in the impugned order rightly rejected all such claims.

45. The taxpayer has itself quoted para 1.42 of OECD TP guidelines wherein it is emphasized that "ideally in order to arrive at most precise approximation of fair market value, the Arm's Length transaction should be applied on a transaction-by-transaction basis.

Why this ideal situation was not accepted and why transaction-to-transaction basis was not adopted is explained away in general reference "they cannot be evaluated adequately on a separate basis". Separate transaction with far-flung situated entities are taken as closely linked or connected transactions for evaluation on above general observations. In fact, difficulty or inability to evaluate arises when all the transactions with all the 17 AEs are taken as a single transaction for comparison and conclusion of Arm's Length Price is drawn. As noted earlier, the aggregation is done by the taxpayer observing "the primary activity of RLL constitute only cross border related party operation". This assertion is factually wrong as multifarious activities are carried by RLL. On facts, no justification is shown for clubbing fundamentally separate and independent transactions carried at different times and related to different parties situated in different continents.

46. The taxpayer is wrong in selecting overseas AEs as tested party for purposes of comparison to apply TP regulations. Shri Vohra Id. Counsel for the taxpayer has vehemently contended that out of two entities in a group, one which is less complex and own no intangibles is to be adopted as a tested party for comparison. According to him, the Id. Commissioner was wrong in taking the taxpayer as a tested party and comparing its result with other Indian pharmaceutical companies. It was contended that the taxpayer assessee on account of its assets, R&D and numerous activities was a complicated enterprise as compared with foreign AEs not possessing any valuable intangible property etc. In support of above claim, Shri Vohra relied upon the following observations from the US TP regulations on tested party: ...the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located.

Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled

comparables.

47. Shri Vohra also drew our attention to Para 3.43 of the Transfer Pricing Guidelines issued by Organization for Economic Co-operation and Development ('OECD') which provides in this regard as follows: The associated enterprise to which the transactional net margin method is applied should be the enterprise for which the reliable data on the most closely comparable transactions can be identified.

This will often entail selecting the associated enterprise that is the least complex of the enterprises involved in the controlled transaction and that does not own valuable intangible property or unique assets.

48. Significant words "verified using the most reliable data - requiring the fewest and most reliable adjustments" in US regulations and "reliable data can be identified" are being conveniently ignored by the taxpayer in this case. It is no doubt true that under certain circumstances, foreign AE can be taken as a tested party for comparison. It will depend on facts and circumstances of each case.

However, the spirit and purpose of OECD guidelines is not being adhered to and followed. Selective observations from the guidelines are picked up against the spirit of the guidelines to defeat the very purpose of the guidelines. Besides it is important to consider Indian Regulations and relevant facts. Guidelines cannot be treated of universal application irrespective of differences in situations and facts and circumstances involved. In the present case, taxpayer had transferred pharmaceutical goods or know how from India to 17 different associated enterprises (AE) all over the world and, therefore, the following circumstances/conditions were also relevant.

49. Although not taken into consideration in the sweeping comparison of entities in 17 countries in this case, the Market and economic conditions of enterprises in different geographies widely differ from one and other. This cannot be disputed US transfer price regulations emphasise their relative importance for comparison as under: "Economic conditions. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include: (B) The relative size of each market, and the extent of the overall economic development in each market; (D) The relevant market shares for the products, properties, or services transferred or provided; (E) The location-specific costs of the factors of production and distribution; (F) The extent of competition in each market with regard to the property or services under review; (G) The economic condition of the particular industry, including whether the market is in contraction or expansion; and (H) The alternatives realistically available to the buyer and seller." (Internal Revenue Service, Treasury Para 1.482-1 page 599) 50. Further, on selection of comparable from different locations U.S.Regulations provide as under: In general. Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

Reference is also invited to para 3.34 of OECD guidelines quoted above in extracts of case Mentor Graphics (supra).

51. It is admitted by the taxpayer that similar transactions were carried out by the taxpayer with independent parties. While giving reasons that CUP method was not applicable while returning Arm's Length Price, the auditor of the taxpayer stated as under: We have been informed that RLL exports both the API and the

dosage form to third parties. However, in respect of exports to third parties, RLL does not assume any responsibility once the transaction is concluded with the third party, other than normal contractual obligations and risks which is unlike the role that it performs when exporting to its AEs.

As has been stated in para 4.2, the role played by RLL while dealing with its AEs is that of an "entrepreneur" and RLL bears the ultimate risk of the success or failure of the product sold by its AEs in the overseas markets. In fact, it is in this direction that RLL has to render the support functions and services to its AEs in addition to the sale of the pharmaceutical products. Such support or service is not rendered by RLL to third parties in transactions entered into with them. Moreover, the third parties do not inherit the right to convert the API procured from RLL to a "Ranbaxy" brand dosage form, while the overseas AEs of RLL convert the API into "Ranbaxy" brand dosage form.

In view of the above, the exports made to its AEs and the exports to non-AEs are not comparable and it can be said that no direct, reliable internal comparable exists.

52. It is evident from above that the "uncontrolled transactions" carried out by the taxpayer were available. These transactions were not taken into account as in those cases, according to the taxpayer, it did not undertake risk of success or failure of product which were undertaken in transactions with its associated concern. Success or failure of a product is normal incident of business. If terms here were different, these needed examination. Whether above risk did affect the comparable price and to what extent and so, what adjustments were required to be made is/was a pertinent question which was required to be looked into. The AO should have called for terms of contracts and details of similar controlled and uncontrolled transactions. It is settled position that for taking risks higher and additional compensation is demanded and this position is admitted even by the taxpayer (see quoted portion in para 10 above). However, whether in fact higher than Uncontrolled price was charged has not been stated anywhere. It was to be seen whether the taxpayer has charged for additional risks. If not why not Contractual terms of the transactions were required to be placed on record as per Rule 10B(2)(c) of the I.T.Rules. Without the contractual terms, benefit of the transaction could not be apportioned between the entities of the group to the International transactions. If independent Uncontrolled parties buying API from the taxpayer could not convert the API in "Ranbaxy" brand dosage form then under what brand name these could be sold? This was required to be examined and evaluated. Substance of controlled and uncontrolled transactions were to be examined. Question of adjustment was also to be considered in the light of terms of the contract. Above fundamental material without which no meaningful comparison was possible was neither placed on record nor examined. Without examination of cogent material, the claim of the taxpayer that uncontrolled transactions were not comparable was wrongly accepted by the Assessing Officer. Those transactions were not taken for comparison as according to assessee, the assessee had undertaken risk in those transactions, which could not be evaluated. But the taxpayer has neither alleged nor proved that the uncontrolled enterprises selected for comparison had carried transactions with similar risks and were therefore selected.

Further, on account of risk, the price charged from the associated concern has to be market price + compensation for the risk undertaken.

But no evidence to the above effect is available on record: It cannot be disputed that there are about 20 multinationals manufacturing and selling pharmaceutical products in India and, therefore, it would have been worthwhile comparing international transactions with transactions carried out by those concerns. The taxpayer is now itself relying upon enterprises operating in India and is seeking adjustments for differences which the CIT has asked to examine. Foreign AEs situated at different locations are operating under different market condition and economic realities. Evidence on record clearly show that some AEs are making huge losses whereas others are making marginal profit or slightly more. How entities with different market and economic conditions could be taken as if it is single entity like that of taxpayer. Therefore, the taxpayer was not right in not selecting itself as a tested party.

53. On examination of above facts, it is clear that the taxpayer failed to give specific details of International transactions carried out with 17 AEs although required to be given as per TP regulation noted above.

The pretext was the involvement of "numerous products and voluminous transaction. This untenable plea has already been rejected for reasons which need not be repeated again. Next step is selection of reliable comparables. Uncontrolled transaction carried out by the taxpayers were available but not considered as comparable because with related AEs additional risks were undertaken by taxpayer. If it is done as per normal business practice, no adjustment is needed. But if it is abnormal favour to an associated enterprise, as it appears to be, the question was required to be examined and evaluated. This crucial aspect needed examination. Entire transfer pricing regulations are concerned with adjustments of favourable treatment meted to related (associated) concerns. How such a situation was not examined is beyond comprehension. Next step in exercise of taxpayer is selection of tested party in respect of transfer of goods and services. Here again instead of selecting taxpayer as similar pharmaceuticals are operating in India, 17 foreign AEs are selected. The Id. CIT has given list of 5 companies and taxpayer additionally 3-4 companies which are carrying on similar business with some difference. There is thus good and reliable evidence for taking taxpayer as a tested party for comparison with Indian companies yet foreign companies with different market conditions and economic realities were taken for comparison. OECD guidelines providing for selection of least complex party with no valuable tangibles was relied upon although the taxpayer did not satisfy above parameters. Relevant circumstances i.e. market conditions and economic realities, size of company etc. which materially affect determination of ALP were not considered. It is even evident from variations reflected., in result of 17 AEs of the taxpayer. Thus instead of proceeding on the basis of reliable and easily comparable data and transactions for determining Arm's length price, OECD guidelines were wrongly quoted. Actions of the taxpayer were accepted by the Assessing Officer without application of mind. On facts, in the instant case, interference by the Id. CIT is fully justified.

54. It was emphatically and vehemently contended by Shri Vohra that Assessing Officer passed assessment order after verification and examination of full facts and, therefore, no interference under Section 263 is justified. He further argued that transfer pricing cannot be scientific and is an exercise based on approximation as held in Mentor Graphic and therefore on account of difference of opinion, assessment order can not be treated as erroneous and prejudicial to the revenue.

Although we are of the view that there is sufficient material on record to show that Assessing Officer's action was erroneous and prejudicial, we proceed to examine assessment order in the light of repeated submissions of the Id. Counsel. The Assessing Officer in the assessment order concluded as under on transfer pricing as under in Para 7.1: 7.1 In response to the above, the assessee has filed a note along with its letter dated 24.3.2005 and has also produced a copy of transfer pricing document prepared by M/s RSM Advisory Services Pvt.

Ltd. The assessee has also produced copies of audited; accounts of the above AEs for the year 2003 as well as documents/information maintained in support of the TP. After going through the report filed in Form No. 3CEB, transfer pricing documents and other details/information furnished, it is observed that M/s RSM Advisory Services Pvt. Ltd. after analyzing the comparable data compiled from EXIT & Hoovers Online and doing functional assets and risks analysis, have reached to the conclusion that as compared to the other prescribed methods, in case of the assessee, TNMM is the Most Appropriate Method. The net margins realized by the uncontrolled comparable companies were identified on similar type of transactions applying the TNMM method. On comparison of the transfer prices charged by the assessee from its Associated Enterprises and net margins thereon, in respect of these international transactions, it is observed that the prices charged by the assessee on international transactions with its Associated Enterprises and net margins thereon, in respect of these international transactions, it is observed that the prices charged by the assessee on international transactions with its Associated Enterprises were at Arms Length. I have also observed that the declared margins/profits as per the books, are higher than the profits/margins computed as per the "Most Appropriate Method" and therefore, I hold that the assessee was in compliance of the transfer pricing

provisions and the prices charged during the previous year relevant to the ASSTT. YEAR 2004-05 from its AEs in respect of goods and services were at arms length and therefore no further adjustment is required.

55. Apart from legal infirmities detailed above, the aforesaid findings are factually erroneous and against record. Where is the comparison of transfer prices charged by the assessee from its associated enterprises and net margin thereon? _As noted earlier, the assessee did not give detail of the transactions as "numerous products and voluminous transactions" were involved. The question of comparison of transfer pricing charged and net margin thereon by the assessee in respect of international transactions did not arise. As noted earlier, taxpayer withheld information relating to controlled transaction carried by it with its AEs as these were not comparable being complicated involving several risks. Further, the taxpayer was not taken as a tested party and profit margin of its 17AEs was compared. Therefore, question of taxpayer furnishing its net margin did not arise. However, the Assessing Officer went on to state "on comparison of prices charged by the assessee on international transactions and net margin thereon were at arm's length". These are erroneous observations. The Assessing Officer is also incorrect in observing that "declared margin profit as per books are higher than the profit margin computed as per Most Appropriate Method". Where is the declared profit of the taxpayer? In fact, the case of the taxpayer, as noted above, was just the reverse.

It took up some eight companies and claimed that average margin of above eight uncontrolled enterprises was 14.88%, which was higher than the margin of profit of any of its international enterprises. Wherefrom Assessing Officer found higher declared margin of profit as per books? It is quite obvious from Assessing Officer's concluding remarks that for various reasons, he failed to apply mind to the issues that arose before him. Therefore, on facts, it will not be wrong to conclude that the AO did not understand the complicated questions he was required to consider in five days between 24th March, 2005 and 30.3.05 and committed errors in passing order without understanding the case pleaded or the statutory provisions.

56. We agree with the Id. Counsel for the taxpayer that transfer pricing involves approximation. A real transaction ordinarily is sought to be compared with situation of a hypothetical willing buyer of a comparable transaction and several presumptions and adjustments are required to be made. From above it can not follow that result of transfer pricing exercise must be blindly accepted although these look patently absurd and unrealistic. In India clear rule is that any interpretation of rule leading to absurdity or inconsistency is to be avoided Here in the present case, it would be absurd to accept that goods and services transferred in all the 17 cases were at arm's length, it being immaterial whether profit margin was -42.17% or +11.22% because some formality under TNMM was carried. If -42.17% transactions with margin of profit/loss are accepted, with transaction giving margin of profit of 11.22% at ALP, without examination of other circumstances/factors, it is absurd to take variation of 53.39% (-42.17% + 11.22%). It looks absurd to accept such inconsistencies without questioning and examination of other relevant facts. Similar view is also expressed in OECD guidelines: 1.47 Where the application of one or more methods produces a range of figures, a substantial deviation among points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

57. The US Courts in the case of *Messing v. Commissioner* 48 T.C. 502, 512 (1967) *Estate of Hall v. Commissioner* 92 T.C. 312, 338 (1989) after finding considerable variation between price shown and ALP determined had observed, "Such extreme difference demonstrate the caution that is necessary in weighing expert valuation that zealously attempt to infuse the talismanic precision into an issue which should frankly be recognized as inherently imprecise." 58. We have also given careful thought to the other submissions of Shri Vohra. The tested party normally should be the party in respect of which reliable data for comparison is easily and readily available and fewest adjustments in computations are needed. It may be local or foreign entity i.e. one party to the transaction. The object of transfer pricing exercise is to gather reliable data, which can be considered without difficulty by both the parties i.e. taxpayer and the revenue. It is also true that generally least of the complex controlled taxpayer should be taken as a tested party. But where comparable

or almost comparable, controlled and uncontrolled transactions or entities are available, it may not be right to eliminate them from consideration because they look to be complex. If the taxpayer wishes to take foreign AE as a tested party, then it must ensure that it is such an entity for which the relevant data for comparison is available in public domain or is furnished to the tax administration. The tax payer is not then entitled to take a stand that such data cannot be called for or insisted upon from the taxpayer.

59. We are required to examine correctness of the claim of the taxpayer that its foreign AEs were rightly adopted as tested parties for comparison and application of TNMM method. As noted earlier, the taxpayer has carried out several separate transactions with 17 AEs situated in different continents. It could have been appreciated if a particular entity in a particular country was sought to be computed with some similar entity in that very country as geographical situations in several ways influence the transfer pricing.

60. From above facts, it is quite evident that Assessing Officer did not apply his mind or carry any inquiry or investigation. Therefore, his order was erroneous in so far as prejudicial to the interest of the revenue. The Commissioner therefore was fully justified in exercising his power under Section 263 and in setting aside the assessment with directions to re-do the exercise of transfer pricing. However, Shri Vohra vehemently argued that order of the Assessing Officer was fully justified and CIT was wrong in exercising powers under Section 263 of the I.T. Act. Apart from the oral submissions, which we have noted above, Shri Vohra also filed written submissions, which were taken on record. Opportunity was provided to the revenue to submit a reply to those submissions. Written submissions placed on record have also been duly considered.

61. We now proceed to discuss other submissions of Shri Vohra herein below. Shri Vohra has submitted that Assessing Officer had completed the assessment after considering all the relevant details and after full investigation of the claim. This argument has already been considered in depth and is held to be without any substance and is rejected.

62. We have also considered the submission that Id. CIT failed to establish that order was erroneous and prejudicial to the interest of the revenue. In our opinion, as Assessing Officer failed to apply his mind and consider relevant facts or statutory provisions and, therefore, the Id. CIT had rightly exercised his jurisdiction and we see no reason to interfere with the impugned order except on small issue discussed herein below.

63. The next argument of Shri Vohra is that the Assessing Officer was fully competent to consider the question of Arm's length price without making reference to Transfer Pricing Officer under Section 92C of the IT Act. He has further submitted that reference to TPO under Section 92CA(1) is not mandatory in the light of Instruction No. 3 of 2003 of CBDT and the contrary view taken by CIT in the impugned order is erroneous and illegal. Alternatively, it was submitted that even if Instruction No. 3 is held to be mandatory and reference to T.P.O. necessary, then also it was only a case of breach of procedural provisions not affecting the legality of the order of the Assessing Officer. It was submitted that decision of Special Bench in the case of Aztec Software & Technologies Ltd. 107 ITD 141 was contrary to the decision of Hon'ble High Court in the case of Sony India (P) Ltd. v. CBDT 288 ITR 52. Shri Vohra has further submitted that the decision of Special Bench and of Hon'ble Delhi High Court were not available to the Assessing Officer when statutory powers were exercised by him on or before 30.3.2005 and, therefore, said order cannot be held to be erroneous and prejudicial to the interest of the revenue. The Assessing Officer took a possible view and where a reasonable possible view is taken, the Commissioner has no power to revise such assessment under Section 263 of the I.T. Act. He has cited the decision of Supreme Court in the case of CIT v. Max India Ltd. 213 CTR 266 to support the contention that power under Section 263 can not be exercised where Assessing Officer had taken a possible view consistent with law prevailing at the relevant time. He has also relied upon the decision of Punjab & Haryana High Court in support of his contention.

64. We have given careful thought to the above submission of Shri Vohra. under Section 92CA(1), the Assessing Officer, if he considers it necessary or expedient so to do, may, with the previous approval of the Commissioner, refer to the computation of Arm's Length Price in relation to international transaction under

Section 92C to the Transfer Pricing Officer. However, the CBDT, in exercise of its power under Section 119 of the Income Tax Act, issued Instruction No. 3 dated 25.5.03 to all its officers. The relevant portion of the instruction as under: 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. The threshold limit of Rs. 5 crores will be reviewed depending upon the workload of the TPOs.

65. The question of binding nature of above Instructions was raised before the Special Bench in Aztec Software & Technologies Ltd. (supra) and after relying upon the decision of the Hon'ble Delhi High Court in the case of Sony India Ltd (supra), the Special Bench upheld the validity of the Circular with the following observations: 44. Now we proceed to answer question No. 6 to see legal effect of Instruction No. 3 dated 20th 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 pricked 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.

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. CTT(A) holding the contrary are set aside.

66. Shri Ajay Vohra has contended that above view is contrary to view of Delhi High Court in the case of Sony India P. Ltd. (supra). He has extensively quoted from the said decision to support his contention that as per the decision, the discretion of the Assessing Officer to determine transfer price has been maintained. He has referred to para 21 of the decision where the Court has specifically observed, "Secondly, provisions do not

mandate that Assessing Officer is bound to accept the Arm's Length Price as determined by the Transfer Pricing Officer". He also referred to the observation where it has been held that power of Assessing Officer cannot be usurped by transfer pricing officer or any other party. More specifically, he has referred to the observation/finding of Hon'ble High Court in para 37 and 39: 37. The other ground on which the instruction is challenged is that it completely takes away the discretion of the Assessing Officer in relation to an international transaction of the value exceeding Rs. 5 crores. A reading of the impugned instruction indicates that it acts as a guideline to the Assessing Officer in the exercise of the discretion conferred under Section 92CA(1). This instruction is in fact helpful in ensuring that the discretion of the Assessing Officer will not be abused. It correctly interprets the law as requiring only a formation of a prima facie opinion by the Assessing Officer at the stage of the reference. Therefore, the question of the Central Board of Direct Taxes supplanting the judicial discretion of the Assessing Officer does not arise. It is perfectly possible that, independent of the circular, the Assessing Officer might still "consider it necessary or expedient" to refer an international transaction of such value to the Transfer Pricing Officer for determination of the ALP. At the same time it is not as if the transactions of the value of less than Ms 5 crores cannot be referred to the Transfer Pricing Officer by the Assessing Officer.

Ultimately, any exercise of discretion by the Assessing Officer is bound to be judicially reviewed by the statutory appellate authorities as well as by the courts. Therefore, it is not as if there is no check on the exercise of discretion by the Assessing Officer.

39. For these reasons, we hold that the impugned instruction No. 3 dated May 20, 2003 issued by the Central Board of Direct Taxes is consistent with the statutory objective underlying Section 92CA(1) and acts as a guidance to the Assessing Officer in the exercise of discretion in referring a international transaction to the Transfer Pricing Officer for determination of its ALP. It is neither arbitrary nor unreasonable, and is not ultra vires the Act.

67. It was accordingly contended that decision of Special Bench of ITAT in the case of Aztec Software is contrary to the decision of Hon'ble Delhi High Court in the case of Sony India P. Ltd. (supra) and that power of the Assessing Officer to carry out exercise and determine Arm's Length price has remained unaffected and, therefore, assessment without making reference to TPO could not be termed as illegal.

68. On careful consideration of decision of Sony India P. Ltd. (supra) and that of Special Bench in the case of Aztec Software (supra), we do not find any good reason to accept the argument of Shri Vohra and interpretation he has put on the decision in the case of Sony India P.Ltd. leading to his inference that it is not necessary for Assessing Officer to make a reference to T.P.O. even when value of international transaction exceeds Rs. 5 crores. The constitutional validity of above Instructions dated May 20, 2003 was challenged under Article 226/227 of the constitution and contentions of the petitioner are recorded at page 59 of the report. It was claimed that classification of international transaction into two categories, those of value exceeding Rs. 5 crore and others less than Rs. 5 crores was not based on any intelligible differentia and, therefore, such instructions were violative of Article 14 of the Constitution. Instructions issued under Section 119 of the I.T. Act were ultra vires of the statutory provision. The quasi-judicial discretion of the Assessing Officer has been taken away.

69. Their Lordships considered relevant scheme of the Act relating to transfer pricing under Indian regulation, its purposes and the legal validity of above instructions. The matter for consideration was taken in two parts: Firstly, statutory provisions were considered in detail without going into the question of validity of the Instruction; and secondly, the question of validity of instructions was considered in the light of Article 14 of the Constitution. It is quite clear from what is stated above in paras 12, 29 and 31 of the judgment. Shri Vohra has referred to that part of the decision where discretion of Assessing Officer to determine Arm's Length Price in respect of transaction of value of less than Rs. 5 crore remaining unaffected is discussed. While maintaining the validity of the Instructions, their lordships made pertinent observations in para 32 and 37. Para 37 has already been quoted. Para 32 is as under: 32 Applying the above test, the impugned instruction cannot be

held to violate Article 14 The classification brought about by the impugned instruction is based on a straightforward recognizable basis giving no room for confusion. Transactions of a high value require a careful examination to determine if the declared price is in fact an acceptable ALP. It may not be expedient for the Assessing Officer to efficiently deal with the assessment involving such an exercise. In that sense it achieves the expeditious disposal of the assessment by the Assessing Officer if the exercise is referred for a specialized determination by the Transfer Pricing Officer. The classification certainly bears a nexus to this objective. We are of the considered view that the challenge to the impugned instruction on the ground of "suspect classification " must fail.

70. It is clear from above that validity of instruction was upheld, reason and need for making reference to TPO of international transaction exceeding Rs. 5 crore was emphasized.

71. We are astonished at the submission of Shri Vohra to the effect that it is still open to the Assessing Officer even in cases where value of international transaction exceeded Rs. 5 crore to refer or not to refer the matter to the TPO as the instructions did not affect discretion vested in the Assessing Officer. If it was so, then what was the need to challenge the instructions and its classifications before the Hon'ble High Court? Shri Vohra sated that perhaps the petitioner in that case did not correctly interpret the relevant statutory provision and instructions and therefore rushed to the Court We are unable to agree with above submission of Shri Vohra. It is not possible for us to hold that Instructions issued by CBDT under Section 119 Of I.T. Act to regulate assessment proceeding can be treated as a waste paper by officers functioning under the Board (CBDT). If such a view is taken, it would lead to chaos in the country. If various guidelines issued by CBDT for administration of Income Tax Department and for regulation of assessment etc. are not adhered to or made optional, then all schemes of assessment may fail and jeopardize the working of the department.

This is neither the law of land nor there is any justification to accept such an argument. We are therefore of the view that Assessing Officer, in the light of instruction of CBDT, was duty bound to refer the matter to the TPO, having regard to the purpose of specialized cell created by the revenue department to deal with complicated and complex issues arising under the transfer pricing mechanism. This case itself is a good example as to how department can be hoodwinked unless case is properly examined by persons having knowledge of principles of transfer pricing. The contention of Shri Vohra is accordingly rejected.

72. We are also not convinced that in not referring the question of determination of Arm's Length Price to the TPO, the Assessing Officer merely committed a procedural error and, therefore, legality of assessment order to invoke provision of Section 263. In our considered opinion, the Assessing Officer failed to follow statutory regulations on a complicated issue like transfer pricing and made an assessment without application of mind. Accordingly, powers by Commissioner under Section 263 were rightly exercised on facts and in the circumstances of the case. Even if for the sake of argument, it is accepted that reference to TPO is not mandatory and instructions not binding; on peculiar facts of this case, as discussed above, the assessment made without application of mind for purposes of Section 263 was erroneous and prejudicial to the interest of the revenue. The Id. CIT rightly exercised his jurisdiction under Section 263 in this case. Cases relating to non-application of provision of Section 144B or other procedural errors stand on a different footing as basic jurisdiction to make assessment rests with the Assessing Officer. There is marked difference between purpose of transfer pricing regulations and scheme involved in Section 144B, now deleted. At any rate, we have referred in detail to statutory provisions and material on record to show that assessment made was erroneous and prejudicial to the interest of the revenue. We, therefore, do not find any substance in above argument of Shri Vohra.

73. The other contention of Shri Vohra that decision of Hon'ble Delhi High Court and Special Bench were not available to the Assessing Officer at the relevant time when assessment was made is also of no avail. The Assessing Officer was duty bound to consider statutory provisions and rules and examine relevant facts and circumstances of the case. This was not done as explained above and, therefore, Section 263 of I.T. Act was rightly applied.

74. We have further discussed in detail as to why foreign enterprise of the taxpayer could not be taken as tested party. It would have been more reasonable and logical to compare taxpayer's performance with several Indian companies carrying on similar business. This has also been rightly highlighted by the learned Commissioner in the impugned order. In the light of above evidence, it was not necessary to take into account foreign companies for comparison.

75. The Id. Counsel for the taxpayer has also stated that CIT was wrong in saying that Central Excise Department had carried some audit and the Assessing Officer erroneously completed assessment without considering the said audit report. It was the stand of the taxpayer that no adverse finding was recorded nor any additional excise duty was charged from the taxpayer. In spite of our direction, neither the taxpayer nor the Id. Representative of the department furnished to us any audit report of Central Excise Department. The taxpayer, in reply to show cause notice of the Commissioner, took a categorical stand that no audit report was given to the taxpayer by Excise Department. The claim made by the taxpayer on facts has not been refuted by Commissioner in the impugned order or by the Id. Departmental representative during the course of hearing before us. So, nobody has seen the said alleged audit report of Central Excise Department. In these circumstances, we see no justification for the directions given by Id. CIT relating to the audit of the Central Excise Department. These limited directions are vacated, which, in our considered opinion, do not affect the validity of the other part of the impugned order.

Shri Vohra has further submitted that Id. CIT should have considered the claim of the taxpayer that it had shown more profit than other Indian companies taken into account for comparison by Id. CIT. As pointed out by taxpayer in his written submissions, the aforesaid question raised by the taxpayer could not be left and referred to the Assessing Officer for verification. The Id. CIT was duty bound to verify the claim on merit. We are unable to agree with the above submissions. The Id. Commissioner under Section 263 has power to, "pass such order thereon as the circumstances of the case justify, including the order enhancing or modifying the assessment, or canceling the assessment and directing a fresh assessment". He thus has sufficient statutory power to direct fresh assessment. The question raised about the margin of profit of the taxpayer and comparable Indian pharmaceutical company requires detailed investigation/verification, which could not possibly have been carried by the Id. CIT under Section 263. Therefore, instead of rejecting the claim of the taxpayer, he has asked the TPO to look into the said claim. We do not find any legal infirmity in the approach of the Id. CIT. The taxpayer had vehemently claimed that its margin of profit is higher than Indian comparables (uncontrolled transaction) in respect of international transaction.

This question in the light of order of CIT is wide open and can be considered and determined by TPO/Assessing Officer.

76. In the light of above discussion, we do not find any error in the approach of the Id. CIT. We confirm his action. We have tried to record all the facts and circumstances placed before us. In the process, to meet the claim of the assessee that there was no "error" or no "prejudice" was caused by assessment order of the Assessing Officer, we have gone into depth to see what was placed before the AO and how the matter was dealt by him. In this process, certain facts not mentioned by Id. CIT have also been recorded. But we must make it clear that it was not our intention to go beyond the order of the Id. CIT and to give any direction beyond the impugned order. Besides, we do not mean any disrespect to the Id. Assessing Officer in whatever we have said nor it is our intention to attribute any motive while pointing out errors in the assessment. On facts and for the reasons given above, we are convinced that impugned order of CIT is fully justified and is required to be upheld. We order accordingly.