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IN THE HIGH COURT OF DELHI AT NEW DELHI

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RESERVED ON: 08.07.2013**PRONOUNCED ON: 16.12.2013**

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ITA 306/2012

LI AND FUNG INDIA PVT. LTD. Appellant
Through: Mr. Porus Kaka, Sr. Advocate with
Mr. Neeraj Jain, Mr. Manish Kanth and
Mr. Ramit Katyal, Advocates.

Versus

COMMISSIONER OF INCOME TAX Respondent
Through: Mr. N.P. Sahni, Sr. Standing Counsel
and Mr. Ruchesh Sinha, Advocate.

CORAM:**HON'BLE MR. JUSTICE S. RAVINDRA BHAT****HON'BLE MR. JUSTICE R.V. EASWAR****MR. JUSTICE S.RAVINDRA BHAT**

1. The present appeal under Section 260A of the Income Tax Act, 1961 (hereafter '*the IT Act*') impugns the order dated 30.09.2011 of the Income Tax Appellate Tribunal, Delhi Branch 'D', New Delhi (hereafter '*the Tribunal*') in ITA No. 5156/Del/2010, for the assessment year 2006-07. The present appeal concerns the alleged apportioning of consideration between the Appellant (i.e. the assessee, M/s Li Fung (India) Pvt. Ltd, hereinafter '*LFIL*') and its Associated Enterprise (hereinafter '*AE*') in order to arrive at the arm's length price for the transactions between the two entities, using the Transactional Net Margin Method (TNMM). The following questions of law arise from the appeal:



- a. Whether the assessment of the Revenue of arm's length price applying the TNMM method was contrary to the transfer pricing provisions under the IT Act and Rules?
 - b. Whether the Transfer Pricing Officer's (TPO's) apportionment by considering the cost plus mark up of 5% on FOB value of goods between third party enterprises, sourced through the appellant is in compliance with the law?
2. The facts that give rise to these questions of law are as follows. LFIL is a wholly owned subsidiary of Li & Fung (South Asia) Ltd., a company incorporated in Mauritius as a captive offshore sourcing provider. Li & Fung (Trading)(the AE), is a group company incorporated in Hong Kong, which enters into contracts with customers viz. retail chains overseas, for rendering sourcing support services for the supply of high volume, time sensitive consumer goods. The appellant entered into an agreement dated 4.12.1997 with the AE, whereby the contract for rendering sourcing services is outsourced or subcontracted to LFIL, for which it is remunerated at cost plus a mark up of 5% for services rendered to the AE, and ultimately, the AE's customers.
3. LFIL previously received buying support services fees amounting to Rs. 47, 69, 83, 904 from the AE, which ought to be considered as an international transaction of rendering buying support services to AE under the Transfer Pricing provisions under Sections 92 to 92F of the IT Act. To justify that the transaction was at arm's length, LFIL applied the Transactional Net Margin Method (TNMM) as the most appropriate, considering Operating Profit Margin divided by Total cost as the Profit level indicator. Since the operating profit margin at 5.17% exceeded the weighted average operating margin of 26 other comparable companies at



4.07%, LFIL contended that such a transaction of rendering of sourcing services was at arm's length on an application of the TNMM method.

4. During the course of the Transfer Pricing assessment, LFIL contended that it was a low risk captive sourcing service provider performing limited functions with minimal risk as an offshore provider and substantial functions relating to buying services was performed by the AE, which also assumed various enterprise risks. Thus, the compensation paid to the appellant at cost plus 5% as remuneration was to be considered at arm's length while applying the TNMM. Alternatively, the AE entered into contracts with unrelated third parties for rendering buying services @ 4% to 5% of the FOB value of exports. LFIL had in turn received service fee of Rs.47.69 crores which is equivalent to nearly 4% of the FOB value of the export (by the vendors) from the AE, which constituted 80% of the consideration received by the AE, which, in LFIL's opinion ought to have been considered at arm's length.
5. The Transfer Pricing Officer by an order dated 28.10.09 under Section 92CA(3) of the IT Act did not dispute the selection of the comparable companies for application of TNMM by LFIL. However, he held that the cost plus compensation @ 5% of cost of incurred by LFIL was not at arm's length and applied a mark up of 5% on the FOB value of export of Rs. 1202.96 crores made by the Indian manufacturer to overseas third party customers.
6. The reasons given by the TPO were that:
 - a) LFIL was performing all the critical functions, assumed significant risks and used both tangible and unique intangibles developed by it over a period of time;



- b) there was no evidence that the AE had either technical capacity or manpower to assist LFIL and that in the absence of any credible evidence, the involvement of the AE could not be accepted;
 - c) LFIL had developed several unique intangibles which had given an advantage to the AE in the form of low cost of the product, quality of the product and enhanced the profitability of the AE, though the cost for development and use of intangibles was not taken for computation of routine mark up of 5% considered by LFIL;
 - d) LFIL had crucially developed supply chain management which provided the link between the suppliers and customer to achieve strategic and pricing advantage;
 - e) LFIL owned human capital intangible, developed at their own cost with all related risks in creation and maintenance of such intangible;
 - f) the AE recognised that India offers both cost and operational advantage such as lower salaries for the employees, low cost material and low cost manufacture. LFIL had neither quantified this locational saving nor had the AE attributed any part of the additional profit on account of locational saving to LFIL.
7. The TPO did not, as stated earlier, dispute the analysis undertaken by LFIL, but for the above reasons applied the 5% mark up to FOB value of exports made by Indian manufacturer to overseas third party customers, amounting to Rs 1202.96 crores and accordingly computed an addition of Rs 57, 65, 61, 186/- to the appellant's income on account of the alleged difference in calculation of the arm's length price of the above transactions. Thus, the Assessing officer in the draft assessment order passed under section 144C(1) of the Act made an addition, *inter alia*, on account of transfer pricing adjustment of Rs. 57,65,61,186 on the basis of the order passed by the TPO. The reasoning of the TPO is as follows:



“5.2.5 The compensation model of the assessee does not include the profit attributable to the assessee on account of location saving:

Globalization and continuous search for lower cost has resulted in transfer of manufacturing and procurement activities from high cost economy like European Union, Japan, UK and United States, to lower cost economies like India to stay competitive and to increase profits. In this case, the AE has recognized that India offers both cost and operational advantage such as lower salaries for the employees, low cost material and low cost manufacture. Accordingly, it has established a trading company in India for procurement of goods. Location savings generally emerge when companies transfer their operation site from high cost economy to economies with low cost. That is, they take advantage of price differences in the factors for production or procurement across the countries. In many cases, the location saving arise from differences of low labour cost, low raw material and finished goods cost, low logistic cost and lower quality control cost. The net location saving represent saving from moving to low cost economy. In this case, the assessee is operating in low cost economy has generated location saving due to huge difference in cost of procurement between high cost economy and low cost economy like India. From a trading pricing prospective the common question in this case is: “who is entitled to additional profits in form of locational saving?” or “which country should tax the profits?” In this case, the assessee has established its sourcing subsidiary in India in order to earn or to have the advantage of the locational saving. However, the assessee has neither quantified locational saving nor has attributed any part of the additional profit on account of locational saving to the assessee, in India. It is pertinent to mention here that the assessee is the most critical part of global supply chain of the AE. It is responsible for identifying and qualifying the contracted manufacturer, for working with them and other designers to manufacture garments in the technical specifications, for selection of fabrics, for control over the manufacturer, for identifying appropriate sourcing of fabrics and accessories, for quality insurance, for transportation logistics and for coordinating logistics. The compensation model for the assessee which is based on reimbursement of the cost with the percentage mark up has not included locational saving attributable to the assessee. These facts prove that cost plus compensation @ 5% of



cost of the assessee is not at arm's length because it does not include profit attributable to the assessee on account of locational saving.

5.3 Whether the assessed commission should be expressed as a percentage of the FOB price of goods sourced through the assessee?

In this case the AB has allowed commission of 5% of cost incurred by the assessee for its sourcing activities in India and has not computed commission on FOB price of goods sourced through the buying office. I have examined the compensation model along with the facts of the case and reached a conclusion that in this case commission should be expressed as a percentage of FOB price of goods sourced through the assessee for the following reasons:

(a) It is evident from the FAR analysis as discussed in Para 5.2.2 of this order that the assessee has played a major role in identifying suppliers, raw material, design, production control, manufacturing control, quality control, packing and export of merchandise and has been in constant touch with the buyer. It has assumed significant risks and has used both its tangibles and unique intangibles which resulted in enhancement and profitability of sourced goods as discussed in Para 5.2.4 and 5.2.5 of this order. These facts clearly prove that value addition activities of the assessee can only be expressed as a percentage of FOB of goods sourced through the assessee.

(b) The assessee is operating in a low cost country like India and its operating cost is so low that it is a very poor proxy of the value it adds to the sourced goods.

(c) The assessee has developed unique intangibles like supply chain management intangibles and Human Asset Intangible which has resulted in huge commercial and strategic advantage to the AE and these intangibles have enhanced the profit potential of the AE. However, these intangibles did not form part of the operating cost. Accordingly, the value addition made by the assessee using intangible, to the FOB value the goods sourced through it remained unremunerated and operating cost plus mark up model does not capture the compensation for value addition made through these



intangibles. Accordingly commission should be computed on FOB value of goods.

(d) The assessee has generated huge locational saving for the AE as discussion in Para 5.2.5 of this order. However, compensation model based on operating expense of the assessee does not include locational saving attributable to the assessee which could only be capture if commission is calculated on FOB value of goods sourced through the assessee.

In view of the above findings, it is held that the correct compensation model at arm's length price, in this case, would be commission of FOB cost of goods sourced from India.

6. The risk profile of the assessee has been discussed in detail in Para 5.2.1 of this order. It has been discussed in detail in this order that the assessee functions like an independent entrepreneur. Hence, it takes matching risks. For sake of convenience, risks relevant in the business of the assessee and risks disclosed in T.P. studies are analyzed in the following table:

<i>SI. No.</i>	<i>Risk matrix relevant to business of the assessee</i>	<i>The risk matrix as disclosed in transfer pricing report under Rule 10D</i>
<i>1.</i>	<i>Market Risk</i>	<i>Disclosed in transfer pricing report</i>
<i>2.</i>	<i>Service liability</i>	<i>Disclosed in transfer pricing report</i>
<i>3.</i>	<i>Capacity utilization risk</i>	<i>Disclosed in transfer pricing report</i>



4.	<i>Foreign exchange risk</i>	<i>Disclosed in transfer pricing report</i>
5.	<i>Credit & collection risk</i>	<i>Disclosed in transfer pricing report</i>
6.	<i>Scheduling risk</i>	<i>Not disclosed in transfer pricing report but actually borne by assessee.</i>
7.	<i>Government & institutional risk</i>	<i>Not disclosed in transfer pricing report but actually borne by assessee.</i>
8.	<i>Operational risk</i>	<i>Not disclosed in transfer pricing report but actually borne by assessee.</i>
9.	<i>Asset redundancy risk</i>	<i>Not disclosed in transfer pricing report but actually borne by assessee.</i>
10.	<i>Infrastructure failure risk</i>	<i>Not disclosed in transfer pricing report but actually borne by assessee.</i>
11.	<i>Human capital intangible related risk (manpower risk)</i>	<i>Disclosed in transfer pricing report.</i>
12.	<i>Security risk</i>	<i>Not disclosed in transfer pricing report but actually borne by</i>



		<i>assessee.</i>
13.	<i>Environmental risk</i>	<i>Not disclosed in transfer pricing report but actually borne by assessee.</i>

It is evident from the risk analysis, as mentioned in the table above that the assessee is a risk bearing entity and it cannot be said that assessee- is a risk-free entity. It is an independent entrepreneur. Hence, there is no case for risk adjustment in the assessee's case. Without prejudice to the above finding that the assessee is a risk bearing entity and does not require any adjustment on account of risk, the claim of the assessee is not admissible on the following grounds:

- (a) *The assessee has not conducted risk analysis either in case of tested party and comparables and has not demonstrated its risk matrix of comparables as different from tested party.*
- (b) *No computation of risk adjustment is filed.*
- (c) *The onus to support risk adjustment is on the assessee, who has not discharged that onus.*

8.1 *The assessee has adopted TNMM with a PLI of OP/OC. It may be pointed out that it is not the intention of this order to change the method adopted by the assessee. The method adopted by the assessee is accepted. The only change being made is on the cost base being applied while applying the PLI, chosen by the assessee. It has already been pointed that the costs do not include cost of sales made through the assessee. This being the case, the mark-up of 5% should obviously be calculated on the full FOB value of exports in on Rs.1202.96 Crores. Following the discussion in the preceding paras, the operating income shall be calculated as a mark-up the FOB value of exports that have been facilitated by the assessee.*



9. *Calculation of arm's length price*

The assessee has credited total receipt of Rs.476,983,904 on the basis of operating cost of the assessee plus a markup of 5% and at the net level the net operating margin of Rs.24,914,814 comes to 5.22%. This is in consonance with the assessee's claim it is operating on cost plus 5% markup basis. Following the discussion in the preceding paras, the receipt as claimed by the assessee, shall be substituted by the FOB value of exports being Rs.1202.96 crores. The markup of 5% that shall be applied to this and the same shall be credited to the Profit & Loss Account. After taking into account this gross income, the net operating income is computed at Rs.601,480,000. Thus, the arm's length price is calculated as below:

<i>Net Operating income (as calculated above)</i>	<i>Rs.601,480,000</i>
<i>Operating income shown by assessee</i>	<i>Rs.24,918,814</i>
<i>Difference</i>	<i>Rs.576,561,186</i>

Accordingly, the value of the international transaction of the assessee shall be adjusted upward by Rs.576,561,186 to bring it to arm's length. Since the difference computed as a percentage of the Arm's Length Price is more than 5% no benefits under the proviso to Section 92C(2) is available to the assessee.

10. *The transfer pricing approach may be summarized as below.*

- (i) The assessee has used TNMM as the method and OP/TC was claimed to be the PLI.*
- (ii) It was noticed that the cost of goods sold through the assessee has not been included in the cost base while computing the margin.*
- (iii) A show cause in this regard was issued to the assessee. The same is reproduced at Para 5.1.*



- (iv) *The assessee markup has been calculated on the FOB value of exports made through the assessee. The rationale for this has been given at para 5.3.*
- (v) *An adjustment of Rs.576,561,186 was made to the value of international transaction.*
- (vi) *The assessee was afforded reasonable opportunity of being heard (including personal hearing) as mentioned on page 1 of this order.”*

8. The Dispute Resolution Panel (DRP) by order dated 30.09.2010 passed under Section 144C (5) of the Act reduced the said mark up of 5% of FOB value of exports to 3%. The Assessing Officer accordingly in the final assessment order dated 8.10.2010 passed under section 143(3)/144C(3) of the IT Act computed LFIL's income at Rs 36, 67, 95, 634/- as against the returned income of Rs 3,08,26,448 after making the addition on account of transfer pricing adjustment. The material part of DRP's reasoning is as follows:

“After going through the functions of the assessee, we find that it has assumed the role of a full risk bearing trader. Therefore, the plea of the assessee that the cost of goods should not be part of the cost base cannot be allowed. The assessee's plea that the Hon'ble ITAT and the Delhi High Court, have held that it is eligible for deduction u/s 80-O of the Income Tax Act has no application in the instant case as the decisions were not rendered in the context of setting the arms length price of the assessee's international transactions.

International transactions have to be judged at a different level as opposed to transactions covered by the domestic law. The OECD also recognizes the fact that related parties may fashion their transactions in such a manner that may call for looking at the substance of transactions over the form they are given. The relevant portions of the OECD guidelines issued on 22.07.2010 are as below:-



“1.67 Associated enterprises are able to make a such greater variety of contracts and arrangements than can independent enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between independent parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in the particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole, and such alterations may even be made retroactively. In such instances, tax administrations would have to determine what the underlying reality is behind a contractual arrangement in applying the arm’s length principle.

1.68 In addition, tax administrations may find it useful to refer to alternatively structured transactions between independent enterprises to determine whether the controlled transaction as structured satisfied the arm’s length principle. Whether evidence from a particular alternative can be considered will depend on the facts and circumstances of the particular case, including the number and accuracy of the adjustments necessary to account for differences between the controlled transaction and the alternative and the quality of any other evidence that may be available.”

Therefore, the assessee’s claims that it does not bear the risks of a normal trader have to be tested in this light. Accordingly, we are inclined to accept the TPO’s conclusion that the FOB value of goods should form part of the cost base for calculating the remuneration that should accrue to the assessee. That leads to the next question as to what should be the correct markup that should be applied. The TPO has applied the markup of 5% because the assessee is operating on a cost plus 5% model. However, when we are increasing the cost base manifold, the application of a markup of 5% will be excessive.

We accordingly hold that given the facts and circumstances of the case a markup of 3% will be reasonable. This will adequately cover the valuable intangibles that have been developed and used by the assessee as also the location saving that the assessee is passing on to its AE.

Directions under Section 144C(5) of the IT Act



In view of the discussion on each of the grounds of objections above, the Assessing Officer is directed to complete the assessment as per the draft order forwarded by him to the assessee subject to modification as discussed in Para 3 above. The Assessing Officer may incorporate the reasons given by the Panel at appropriate places in respect of the various objections while passing the final order. He is also directed to append a copy of these directions to the assessment order.

The objections of the assessee are disposed of as above.”

9. LFIL preferred an appeal to the Tribunal against the assessment order, which by the impugned order dated 30.09.2011, even while accepting that the TNM Method was the appropriate method for calculation, rejected the LFIL's contention that under Rule 10B (1)(e) of the Income Tax Rules (“the Rules”) made no provision for considering the cost incurred by third parties or an unrelated enterprise to compute net profit margin. The Tribunal by its impugned order held that the appellant was performing all critical functions with the help of tangible and unique intangibles as well as supply chain developed, which helped the AE to enhance its business and resulted in location saving to the consumer, compensation for the services rendered by LFIL to the AE, equivalent to the cost plus 5% mark-up, was not at arm's length. Since LFIL was providing crucial sourcing services and the AE was remunerated by third parties based on such services, the Tribunal relied upon the mark up on FOB value of goods sourced through LFIL as the appropriate method to work out arm's length compensation. The tribunal accepted the TPO's reasoning for applying the 5% of the FOB value of exports to third parties by Indian manufacturers. The relevant part of the reasoning in the impugned order is reproduced below:

“The TPO did not consider the cost plus compensation @ 5% at arms length by holding that assessee is performing all critical



functions, assuming significant risks and used both tangibles and unique intangibles developed by it over a period of time. The associated enterprise is not having technical capacity and manpower to assist the assessee in this regard. The assessee has developed several unique intangibles which has been given advantage in the form of low cost of product, quality of the product and enhanced the profitability of AE. These intangibles have developed profit potential of AE. The assessee has developed the supply chain management which gives customer a strategic and pricing advantage. The assessee has also developed its own human capital intangible at its own cost. The cost for the same is born by assessee. The AE has recognized that India offers both cost and operational advantage on account of lower salaries for the employees, low cost material and low cost manufacture.

The associated enterprise is charging from the purchasers on the basis of FOB value of exports up to 5%. The total exports effected by the assessee during the year were Rs.1202.96 crores. Assessee has been paid in respect of the international transaction effected in the form of exports on the basis of cost plus 5%. The Learned AR's plea that no adjustment has been made in the earlier years. For this, he has submitted assessment order for AY 2002-03 to 2005-06 wherein the transaction net marginal method with operating profit over total cost (OP/TC) as a profit level indicator has been accepted. This TNMM method has been accepted in these years. Reliance is also placed on the decision of Hon'ble Supreme Court in the case of Radhasoami Satsang Vs. CIT, cited supra and CIT vs. New Poly Pack (P) Ltd., 245 ITR 492, other case laws. In this regard, we hold that the principle of res judicata is not applicable in the income-tax proceedings. Each assessment year is a separate unit and what is decided in one year shall not ipso facto apply in the subsequent years. We have gone through the orders passed in the earlier years which has been placed in the paper book at pages 293 to 305 and for all these assessment years starting from 2002-03 to 2004-05, we find that while accepting profit level indicator nothing has been said about the basis on which the compensation has been received by the associated enterprise on the goods exported from India through assessee. As we have already stated earlier, the associated enterprise was receiving the compensation as a percentage of the FOB value of the goods exported through the assessee and as per the guidelines of the OECD which recognizes that the related party may fasten their transaction in such a manner



that may call for looking at the substance of transactions over the form they are given. In this case, the associated enterprise was receiving the compensation on the basis of FOB value while the Indian associate (assessee) was compensated only by cost plus 5% mark up. When the associated enterprise are receiving the compensation at FOB value and the assessee which is providing critical functions with the help of tangible and unique intangibles developed over the years and with the help of supply chain management which are important to achieve the strategic and pricing advantage. All these help the associated enterprise to enhance and retain the business and also contributes towards the locational savings on account of low cost salary, low cost material and low cost manufacture in India. Therefore, in our considered view, the cost plus 5% mark up is definitely not on the arms length while working out the compensation for the services rendered by the assessee to the associated enterprise. In such a situation, mark up on the FOB value of the goods sourced through the assessee shall be the most appropriate method to work out the correct compensation at arms length price. Therefore, the rules of consistency cannot be applied forever when such facts have not been considered/discussed at all in the earlier years.

It is also pleaded that the assessee has received 80-O deduction in the earlier years in respect of providing these professional and technical services. In this regard, we hold that every assessment year is a separate assessment year for income-tax purposes and the principle of res judicata is not applicable. Further during this year, the assessee has not claimed or entitled for 80-O deduction. Therefore, it cannot be a plea to justify the transaction at the arm's length.

Assessee claims that there is no provision in the Rule 10B(1)(e) to include the cost incurred by third parties or unrelated enterprise to compute the net profit margin of the assessee. For this proposition, we do not agree in view of the fact that assessee is providing all critical functions and the majority of work related to these exports is performed by assessee itself. Associate enterprise had no capacity to execute the work. The associated enterprise is charging from the third party on the basis of FOB value of the exports made possible by assessee. Assessee is providing sourcing services through its tangible and intangible capacity to these third party clients in the form of low cost product resulting into profitability and pricing advantage. The assessee's reliance on



DCIT vs. Cheil Communication India Pvt. Ltd., cited supra, is not of much help as in that case, the facts were different. In that case, the assessee was providing to their party/media agency for and on behalf of the principal. In that case, the advertising space has been let out to the third party vendor in the name of ultimate customer and the beneficiary of advertisement. The assessee in that case was simply acting as intermediary between ultimate customer and the third party vendor in order to placement of advertisement. In assessee's case, the associated enterprise has been receiving the mark up as 5% of the FOB value of exports effected by assessee by applying its tangible and intangible capacity. The critical and all crucial work is done by assessee. The AE is paying back to the assessee only on the basis of cost plus 5% mark up. Such an arrangement cannot be said at arms length. In our considered view, such method will go against the basic normal business sense, as inefficient and high cost services provided by assessee shall fetch more revenue to the assessee. Such an arrangement on the face of it cannot be said to be at arm's length. The AE is getting remuneration on FOB value of export for which critical and main functions are performed by assessee. We also uphold that the assessee has developed a technical capacity and owns manpower which had developed human intangibles to perform all the critical functions. These tangible and unique intangible have been developed over the years. In view of these facts, we hold that to arrive at arm's length of these transactions, the mark up must be on the basis of FOB (free on board) value of the exports. Since the AE is receiving 5% of FOB value then the total receipt by AE must be Rs.60.148 crores. Thus, the attribution between assessee and AE must be from this amount.

AO made addition of Rs.33.60 crores. If it is added to the actual receipts of assessee then it is much more than the total amount received by associated enterprise regard to these exports. Thus, the way in which this adjustment has been made gives abnormal / absurd results which cannot be sustained. The assessee was performing critical functions with the help of tangible and unique intangibles developed over the period of time and with the help of supply chain management which the assessee had developed, the majority of compensation based on the FOB value of the exports materialized through the assessee must come to the assessee. So the correct compensation at the arms length price based on the FOB cost of the goods sourced from



India needs to be decided. The total export during the year was Rs.1202.96 crores. AE received in total of Rs.60.148 crores.

The assessee's claim that no agreement was entered by the assessee with the ventures to whom the goods are sourced shall not justify the cost plus mark up. The associate enterprise entered into the agreements for sourcing the goods and the compensation is based on the FOB value of the goods sourced from the India and the assessee performing all crucial and critical function to fulfill the conditions to execute the agreements. Therefore, we find no merits in this plea. The other claim of the assessee that location savings attributable to the end purchaser is also not justified as the assessee has developed many unique intangibles and also human capital intangibles which gives the locational advantage to procure low cost goods which helps the associated enterprise to obtain/retain the business and also benefits the end purchaser. These tangibles and unique intangibles developed over the period of time and the developed supply chains of the management owned by assessee benefits the ultimate purchaser and also provide locational savings to the all including the associated enterprise. As we have already said that the amount of adjustment computed by the TPO cannot exceed the amount which could have been received by the associated enterprise. There is nothing on the record from where we could gather that the compensation @ 5% on FOB value received by AE is depressed or on lower side. In view of these facts, we are of the view that the amount of adjustment so computed should not exceed the amount received by the associated enterprise. In our considered view, the AO as well as the DRP has proceeded on a wrong footing which have given absurd results of adjustments. In view of the fact that majority and crucial services rendered by assessee, the distribution of compensation received by AE @ 5% of the FOB value of the exports between the assessee and the associated enterprise should be in the ratio of 80 : 20. The assessee must get 80% of the total receipt by AE from the ultimate purchasers. AO is directed to compute the arm's length price in the above manner."

10. LFIL's counsel argued that the addition of Rs. 33, 59, 69, 186/- made on account of difference in the arm's length price of international transactions of buying/sourcing services is not sustainable for the reason that the TPO



applied the TNMM method contrary to the Transfer Pricing Regulations. Section 92 of the Act stipulates that any income arising from an international transaction shall be computed having regard to the arm's length price. Further, Section 92F(ii) defines arm's length price as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions. For the purpose of determining the arm's length price in relation to an international transaction, various methods are prescribed under section 92C(2) of the Act and Rule 10B of the Rules provide the manner in which such methods should be applied by the assessee, assessing officer, Transfer Pricing Officer, etc.

11. Mr. Porus Kaka, learned senior counsel, while stating that the TNMM was chosen by LFIL as the appropriate method to calculate the arm's length, provided the court with an interpretation of the provision. He argued that for applying TNMM, it would be noted that the net profit margin realized from the international transactions by the appellant is to be computed only with reference to the cost incurred by LFIL itself. The provision does not consider or impute cost incurred by the third parties or unrelated enterprises, to compute net profit margin of the appellant enterprise.
12. The learned counsel stated that the TPO, in the impugned order, enhanced the cost base of the appellant enterprise artificially by considering the cost of manufacture and export of finished goods by third party vendors which is clearly inconsistent with the manner of application of TNMM as provided in Rule 10B(1)(e). He argued that the TPO's enhancement of LFIL's cost base, by artificially considering the cost of manufacture and export of finished goods, clearly amounts to imputing notional adjustment/income in LFIL's hands on the basis of a fixed percentage of the FOB value of export made by unrelated party vendors. Thus, the value



of exports by third party vendors or customers does not provide any benchmark for determining arm's length price.

13. The learned counsel for LFIL submitted that, while applying the TNMM method, payment made by an assessee to third party vendors for and on behalf of the principal (which was reimbursed by the AE), cannot to be included in the total cost for determining the profit margin and the mark up is to be applied to the cost incurred by the appellant company. The value of export by third party vendors to third party customers does not provide any substantial basis for determining the arm's length price
14. Counsel further submitted that the mark up upon the entire FOB value of the AE would artificially enhance the LFIL's cost base for applying the OP/TC margin. He urged that LFIL's compensation model should be based on functions performed by it and the operating costs thereby incurred and not on the cost of goods sourced from third party vendors in India. Thus, allocating a margin of the value of goods sourced by third party customers from exporters/vendors in India is inappropriate and unjustified.
15. Learned senior counsel further argued that in terms of the Transfer Pricing documentation, LFIL had established the international transactions of rendering buying services to be at arm's length price having regard to the operating profit margin earned by comparable companies having similar functional profile. The computation of LFIL's operating profit margin (OP/TC%) by enhancing the cost base i.e. by increasing the cost of sale facilitated by the assessee would lead to an arbitrary adjustment to the income of the appellant which was never intended by the legislation.
16. The learned counsel further contended that LFIL is performing such functions which undertake a limited risk, and do not involve the direct manufacture of goods. This is evident from the fact that LFIL has made no investment in the plant, inventory, working capital, *inter alia* nor does it



bear any enterprise risk for manufacture and export of the goods. Thus, LFIL's functional and risk profile is entirely different and has nothing to do with manufacture and export of consumer goods by unrelated third parties. Counsel argued that LFIL was merely involved in rendering buying or sourcing support services with regard to such goods and received a handsome remuneration on a cost plus mark-up of 5% which adequately highlights the functions performed, assets utilized and risks borne by the appellant on application of TNMM.

17. It was next urged that the said method of assessment undertaken for determining the arm's length price of international transactions applying TNMM was accepted in the Transfer Pricing assessment consistently year after year. The TPO, in the previous years, did not dispute the functional analysis taken by LFIL and the factors determining LFIL's operations, the functions performed, assets utilized and risk assumed, often having similarities with every year's assessment. Counsel cited *Radhasaomi Satsang v. CIT*, 193 ITR 321, to argue that where a fundamental aspect permeating through the different assessment years is accepted one way or the other, a different view in the matter is not warranted, unless there was any material change in facts. Similarly, he also cited this Court's decision in the case of *CIT v. Neo Polypack (P) Ltd*²⁴⁵, ITR 492 to rely on the rule of consistency despite the non applicability of the *res judicata* in tax proceedings. Thus, in conclusion it was argued that the application of TNMM by the TPO by enhancing the cost base by considering FOB value of export by unrelated party vendors was inconsistent with the Transfer Pricing regulations and thus liable to be deleted.
18. The learned counsel also pleaded that the concept of locational savings are attributed to the end purchaser only. The TPO by holding that the arm's length prices of international transactions of running, buying/sourcing



services by LFIL ought to be 5% of the FOB value of exports, clearly misunderstood the business model and international transactions undertaken by the appellant. The TPO failed to consider the fact that the transaction of export of finished goods is being undertaken by third party vendors or exporters to the overseas customers, whereas neither LFIL nor its AE are parties to such contracts. By providing sourcing support services, none of them have gained any advantage on account of locational saving associated with the export of goods between exporters and overseas customers. Thus, it is submitted that the adjustment made by the TPO on ground of locational saving, is not sustainable and liable to be deleted.

19. The learned counsel also urged that the amount of adjustment computed by the TPO in the order passed cannot exceed the net margin i.e. gross revenue received from the end customers less amount paid to LFIL, i.e. the amount retained by the AE in respect of the transactions. LFIL rendering sourcing services has facilitated exports by the vendors/suppliers of nearly (USD 273.4 million @ Rs.44/\$) Rs. 1,202.96 crores in the relevant previous year. The AE entered into the contract with the unrelated party customers for rendering buying services at 4% to 5% of FOB value of exports. The appellant has in turn received services fee (at cost +5%) of Rs. 47.69 crores which is nearly 4% of the FOB value of the export from the AE. However, the TPO/AO in the impugned order has computed the arm's length price of the appellant by considering a mark-up of 3% on the FOB value of exports that have been facilitated by the appellant computed an adjustment of Rs 33, 59, 69, 186/-.

20. The counsel argued that the adjustment made by the TPO/AO would result in LFILF, which is only a subsidiary, ended up receiving higher amount than what has been received by the AE from third party customers in lieu of facilitating the export of finished goods. This can be noted from the fact



that such adjustment proposed by the TPO/AO has resulted in the AE retaining only 1% of the FOB value of export on the entire export of Rs 1202.96 crores, with nearly 80% of the remaining consideration on FOB value of export must be borne by LFIL. The counsel for the appellant argued that since substantial functions relating to the buying services, undertaking enterprise risks, utilization of substantial assets as well as bearing L/C charges were borne primarily by the AE. Thus, the TPO/AO has erroneously held that LFIL has developed several unique intangibles and developed a supply chain management, human capital at its own risk without appreciating that the appellant was only a captive offshore service provider not undertaking any independent enterprise risk. For this line of argument, counsel relied on the judgment of the Supreme Court, reported as *DIT v. M/s Morgan Stanley & Co.*, 2007 (7) SCC 1.

Revenue's contentions

21. The learned counsel for the Revenue primarily relied upon the various orders of the AO, TPO and ITAT (Delhi Bench). His submission was that LFIL was involved in performing all of the crucial functions of the transaction. Moreover, all significant risks were borne by it, and unique intangibles developed by it over a period of time were crucial to the conduct of the transactions. These intangibles included supply chain management and human capital, which were owned and maintained by LFIL, at its cost, but were not reflected adequately in the assessment/price paid for these services by the AE on account of the relationship between the parties. These intangible provided several advantages exclusively to the AE in the form of low cost, quality of the product, strategic and pricing advantage as well as enhanced profitability. Learned counsel submits that LFIL offered cost and operational advantages including lower salaries, low cost material and low manufacturing costs, while the AE, on the other



hand, had neither quantified locational saving nor had it attributed any part of its additional profit on account of locational saving to the assessee in India. The assessee, according to counsel, did not show if the AE had any technical capacity or manpower and therefore, LFIL's claim of its involvement in execution of sourcing services could not be accepted.

22. The counsel for the Revenue urged that since the AE was receiving 5% of the FOB value from the purchasers and assessee in performing crucial and critical functions with the use of tangible and unique intangibles developed over a period of time, it is only proper that LFIL must receive the majority of the receipts with regard to the execution of work. Thus, he contends that the markup should be based on the FOB value and on that basis it was argued that the orders of lower authorities were to be sustained.
23. It was lastly argued that OECD also visualizes that AEs can structure their transactions in such manner as may require close scrutiny. The TPO's task is therefore to often look behind the facts as they seem and arrive at the substance of the transaction to compute the value of the transaction. The application of the cost plus (TNMM) method by basing the return on the FOB value therefore afforded a realistic picture. If this were not the case, learned counsel submitted that income generated by LFIL's services, but credited to the AE, would fall outside the tax net, contrary to the purpose of the transfer pricing provisions. Moreover, it was argued that if such services were directly provided by LFIL, without the AE acting as an intermediary, the payment for its services would far exceed the payment it is received from the AE, which is a crucial indicator that the transaction, as it currently stands, is not at arm's length and requires interference. Thus, it was argued by learned counsel that determination of ALP and real income was sound and did not call for interference.



Discussion regarding the relevant provisions of the IT Act and Rules

24. Companies with dispersed production facilities or those trading through different units (usually in different countries), employ transfer pricing, a mechanism that involves over or undercharging for goods or services sold between branches or constituent units at a price (usually) determined by the holding company. The main objective of transfer pricing is to take advantage of differential taxation between countries, by structuring transactions such that the legal incidence for tax occurs in a jurisdiction with lower tax rates. Accordingly, the endeavor of various states, or more precisely, their tax administrators, through various transfer pricing enactments and judicial rules, is to ensure that such devices or mechanisms are not used to locate profits and income in such a manner as to shift to low tax regimes, with the tax payer's ultimate objective of reduced tax burden, when in reality the incidence of tax in the host jurisdiction should actually be higher. Transfer pricing laws thus seek to address the tension between these competing objectives. Crucially, in India, in balancing these objectives, the precise limits of the methods and mechanics of calculating the arm's length price are provided for by the IT Act and the IT Rules made thereunder, so as to ensure certainty in these calculations rather than roving enquiries.
25. Specifically, the object behind introduction of Chapter X of the IT Act was to prevent assesseees from avoiding payment of tax by transferring income yielding assets to non-residents whilst at the same time retaining the power to benefit from such transactions i.e. the income so generated. Under the original 1961 IT Act, a similar provision was found under Section 92. By Finance Act, 2001 w.e.f. 1.4.2002, Section 92 was substituted by Sections 92 to 92F, provisions in Chapter X of the Act. The Central Board of Direct Taxes (*the CBDT*) by its Circular No. 14/2001 dated 12.12.2001 [2001



252 ITR (ST.) 65] spelt out the scope and effect of these provisions. The rationale for substituting the existing Section 92 of the IT Act was explained in the following extract of the said Circular:

“55.2 Under the existing section 92 of the Income Tax Act, which was the only section dealing specifically with cross border transactions, an adjustment could be made to the profits of a resident arising from a business carried on between the resident and a non-resident, if it appeared to the Assessing Officer that owing to the close connection between them, the course of business was so arranged so as to produce less than expected profits to the resident. Rule 11 prescribed under the section provided a method of estimation of reasonable profits in such cases. However, this provision was of a general nature and limited in scope. It did not allow adjustment of income in the case of non-residents. It referred to a ‘close connection’ which was undefined and vague. It provided for adjustment of profits rather than adjustment of prices, and the rule prescribed for estimating profits was not scientific. It also did not apply to individual transactions such as payment of royalty, etc., which are not part of a regular business carried on between a resident and a non-resident. There were also no detailed rules prescribing the documentation required to be maintained.

55.3 With a view to provide a detailed statutory framework which can lead to computation of reasonable, fair and equitable profits and tax in India, in the case of such multi-national enterprises, the Act has substituted section 92 with a new section, and has introduced new Sections 92A to 92F in the Income Tax Act, relating to computation of income from an international transaction having regard to the arm’s length price, meaning of associated enterprise, meaning of international transaction, computation of arm’s length price, maintenance of information and documents by persons entering into international transactions, furnishing of a report from an accountant by persons entering into international transactions and definitions of certain expressions occurring in the said sections.”

26. Chapter X opens with Section 92 which provides that the income arising from “international transactions” shall be calculated having regard to the



ALP. The explanation to Section 92 clarifies that allowance for any expense or interest arising from an international transaction shall also be determined having regard to the ALP. Section 92A defines as to which the enterprises would, for the purposes of the provisions of Chapter X, come within the purview of an AE. Section 92A (1) generally defines an AE as one, which is, directly or indirectly, managed and controlled by another. The one appropriate mode, amongst the several, through which control can be exercised by one enterprise on the other is provided in sub-section (2) of Section 92A. In the eventuality of an enterprise fulfilling any of the attributes provided in sub-clause (a) to clause (m), the two enterprises under Section 92A(2) is deemed to be AE. Section 92B defines as to what would be construed as an “*international transaction*”. In order to appreciate the full width, amplitude of an “*international transaction*” the meaning of which is provided in section 92B one would have to in addition read the definition of “*transaction*” given in Section 92F(v).

27. Section 92C is the provision enabling determination of ALP. Section 92C (1) states that ALP in relation to an “*international transaction could be determined by any of the methods provided in the said sub-section which is “most appropriate”*” having regard to the nature of transactions or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors which may be prescribed by the Board. The methods provided being (a) comparable uncontrolled price method; (b) resale price method; (c) cost plus method; (d) profit split method; (e) transactional net margin method and; (f) such other method as may be prescribed by the Board. In determining the most appropriate method, regard is to be had to Rules 10A and 10B of the IT Rules, 1962. Section 92C(3) casts the obligation of computing the ALP on the assessee, at the first instance. The AO then would proceed to determine the ALP in



relation to an “*international transaction*” in accordance with Section 92C (1) and (2) only if he is of the opinion that any of the circumstances as indicated in Section 92Cs (3)(a) to sub-clause (d) of sub-Section (3) of Section 92C prevails. These circumstances are that the price charged or paid for international transaction has not been determined as prescribed under sub- section (1) and (2) of section 92C or, the assessee has not kept information and documents of its international transactions in the form prescribed under Section 92D (1) and the Rules made in that regard or, the information or data used by the assessee in computing the ALP is not reliable or correct or, that the assessee, failed to furnish, within the specified time the information sought pursuant to a notice issued under Section 92D (3). The first *proviso* to Section 92 (3) mandates that before the AO proceeds to determine the ALP on the basis of the material or information or document available with him he shall give an opportunity by serving upon the assessee a show cause notice fixing thereby a date and time for the said purpose. Under Section 92C (4) the Assessing Officer is empowered to compute the total income of the assessee only after the ALP has been determined by the Assessing Officer in terms of the provision of sub-section (3) of Section 92C.

28. Under Section 92CA (inserted w.e.f. 1.6.2002), the AO is empowered to refer the computation of ALP, in relation to, an “*international transaction*” under Section 92C to the TPO, if he considers it “*necessary*” or “*expedient*” to do so with the prior approval of the Commissioner. It is only after a reference is made under Section 92CA (1) that the TPO gets a mandate to approach upon the assessee by issuing him a notice calling upon him to produce or cause to be produced on a date to be specified therein, any evidence on which the assessee may rely in support of the computation made by him of the ALP. Section 92CA (3) provides that the



TPO, by an order in writing, will determine the ALP in relation to an “*international transaction*” in accordance with Section 92C (3) after hearing such evidence as the assessee may produce including any information or documents referred to in Section 92D (3), after considering such evidence as the TPO may require on any specified points, and after taking into account all relevant material which the TPO has gathered. The TPO has to send a copy of the order, by which a determination of ALP is made both to the Assessing Officer and the assessee. Section 92CA (3A) provides the time frame within which the TPO has to pass an order under Section 92CA (3).

29. Prior to the Finance Act, 2007, Section 92CA (4) read as follows: “*On receipt of the order under sub-section (3), the Assessing Officer shall proceed to compute the total income of the assessee under sub-section (4) of section 92C having regard to the arm’s length price determined under sub-section (3) by the Transfer Pricing Officer.*”
30. It would be useful to recollect that the IT Act draws heavily from the Organization for Economic Co-operation and Development Model Tax Convention’s interpretation under Article 9. In terms of Article 9, when conditions are made or imposed between two AEs in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have so accrued, may be included in the profits to bring them to a level that would prevail when independent enterprises would enter into comparable transactions under comparable conditions. Section 92F(ii) specifically defines Arm’s Length Price as a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises in uncontrolled conditions.



31. To compute arm's length price of an assessee, several methods are prescribed under Section 92C of IT Act. As per this provision, the arm's length price in relation to an international transaction shall be determined by the '*most appropriate method*' out of the prescribed methods i.e.

a) comparable uncontrolled price method; b) resale price method; c) cost plus method; d) transactional net margin method; e) profit split method and f) any method as prescribed by the Revenue. In case where more than one price can be determined by the most appropriate method, the arm's length price calculated is the arithmetic mean of such two or more prices. Thus, the provision does not entail any preference of methods and adopts the 'best method rule'.

32. Rules 10B and 10C of the IT Rules prescribe different measures on application of the methods prescribed for calculation of the arm's length price. In terms of Rule 10B (1)(e), while applying the TNMM, the normal margin of profit that is expected in the same line of trade forms the basis of turnover of either purchases or sales, whichever is considered more reliable. It examines the net profit margin relative to an appropriate base that a tax payer realizes from a controlled transaction and compares the profitability of either of the controlled parties with the profitability of the uncontrolled comparables. The net profit envisioned has to be computed with reference to the cost incurred or sales effected or assets employed or required to be employed by the enterprise or having regard to any other relevant base indicating that determination of the net profit is not a matter which can be carried out on an *ad hoc* basis.

33. Accordingly, Rule 10B(1)(e) prescribes, in detail, the steps to be undertaken while applying the TNMM method: first, one must compute the



net profit margin of the assessee with the reference to the sales, costs, assets or any other relevant base. The net profit margin from an external (or internal) comparable (as discussed below) is then calculated, which is subsequently adjusted for factors materially affecting profit. This profit margin is then worked out after such adjustments is treated as the actual margin of profit, and added to the cost/other relevant base to arrive at the ALP.

34. The OECD Guidelines, which are instructive in such cases, clarify that any attempt to use TNMM should begin by comparing the net margin which the tested party makes from a controlled transaction with the net margin it makes from an uncontrolled one (an “*internal comparable*”). If this proves impossible, possibly if there are no transactions with uncontrolled parties, then the net margin which would have been made by an independent enterprise in a comparable transaction (an “*external comparable*”) serves as a guide to determine the ALP. Here, the strict criterion is of an independent enterprise, carrying out a comparable transaction, with the caveat that this will be only a guide. Indeed, the emphasis is very clearly on finding a comparable transaction. In addition, a functional analysis of both the associated enterprise and the independent enterprise is required to determine if the transactions are comparable. It might of course be possible to adjust results for minor functional differences, provided that there is sufficient comparability to begin with. The standard of comparability for application of TNMM is no less than that for the application of any other transfer pricing method.

35. The ITS 2009 Transfer Pricing Guidelines accepted by the OECD state, *inter alia*, that when an associated enterprise acts only as an agent or intermediary in the provision of the service, it is important in applying the cost plus method that, in the ultimate analysis, the return or mark-up is



appropriate for the performance of the agency function rather than for the performance of services *themselves*. Rule 3.41 of the Transfer Pricing Guidelines 2009 state that in applying the TNMM, various considerations should influence the choice of margin used. These include the reliability of the value of assets employed in the calculations is measured and the factors affecting whether specific costs should be passed through, marked up or excluded entirely from the calculation. Under Rule 2.134, while applying a cost based transactional net margin method, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. It should not be based on the classification of costs as internal or external, but rather on comparability (including functional) analysis, and in particular on a determination of the value added by the tested party in relation to those costs. Rule 7.36 of the Guidelines, further state that when an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost plus method that the return or mark-up is appropriate for the performance of an agency function rather than performance of the services themselves. In such a case it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services should be lower than would be appropriate for the performance of services themselves.

36. The appellant, during the relevant assessment year, entered into international transactions of buying services for sourcing of garments, handicrafts, leather products etc. in India for its affiliate, the AE, and was paid service charges of 5% of cost plus mark up incurred for providing these services. The assessee had worked out the arm's length of



international transaction by applying TNMM by company operating profit margin of 26 companies and assessee's OP/OC taken at 5.17%.

37. The tax authorities – i.e. the TPO, and the AO (as well as the DRP) and the Tribunal accepted the application of TNMM by LFIL as “*the most appropriate*” one. Nevertheless, they did not consider the cost plus compensation at 5% at arm's length. The reasoning for not doing so was that LFIL was performing all critical functions, assuming significant risks and used both tangibles and intangibles developed by it over a period of time. Reliance was placed upon the technical capacity, manpower, low cost of product, quality of product in India available to the assessee and the enhanced profit potential the AE. The tribunal held that the cost plus 5% mark up is definitely not on the arms length while working out the compensation for the services rendered by LFIL to the associated enterprise and mark up on the FOB value of the goods sourced through the assessee shall be the most appropriate method for calculation of arm's length price.
38. In scrutinizing Transfer Pricing documents, the TPO undertakes an exercise known as “FAR” (functions performed, assets owned and risks assumed by the associated enterprises involved). This analysis plays a critical role in determining the arm's length price of an international transaction entered into between AEs. The FAR analysis defines roles, responsibilities and risks assumed by the parties involved providing steadfast pointers into the underlying economic substance of the transactions. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations too recognize the importance of FAR in the transfer pricing context, with the arm's length compensation between AEs reflecting the functions that each enterprise performs (taking into account the assets used and the risks assumed by either party). In this



case, what prevailed with the TPO and all other authorities was the circumstance that LFI, i.e. the assessee, according to them, performed all the critical functions, assumed significant risks and used both tangibles and unique intangibles developed by it over a period of time. These intangibles included supply chain management which is important to achieve the strategic and pricing advantage, as well as human intangibles in the form of technical capacity and owned manpower to perform the critical functions. It was further held that the assessee had performed all critical functions, assumed significant risks and also developed significant supply chain intangibles in India and Li & Fung HK, the AE did not have either any technical expertise or manpower to carry out the sourcing activities in Hong Kong.

39. The TPO's determination enhanced LFIL's cost base for applying the operating profit over total cost margin. LFIL's compensation model is based on functions performed by *it* and the operating costs incurred by *it* and not on the cost of goods sourced from *third party vendors* in India. Allotting a margin of the value of goods sourced by third party customers from Indian exporters/vendors to compute the appellant's profit is unjustified. This Court is of opinion that to apply the TNMM, the assessee's net profit margin realized from international transactions had to be calculated only with reference to cost incurred by it, and not by any other entity, either third party vendors or the AE. Textually, and within the bounds of the text must the AO/TPO operate, Rule 10B(1)(e) does not enable consideration or imputation of cost incurred by third parties or unrelated enterprises to compute the assessee's net profit margin for application of the TNMM. Rule 10B(1)(e) recognizes that "*the net profit margin realized by the enterprise from an international transaction entered into with an associated enterprise is computed in relation to costs*



incurred or sales effected or assets employed or to be employed by the enterprise ...” (emphasis supplied). It thus contemplates a determination of ALP with reference to the relevant factors (cost, assets, sales etc.) of the enterprise in question, i.e. the assessee, as opposed to the AE or any third party. The textual mandate, thus, is unambiguously clear.

40. The TPO’s reasoning to enhance the assessee’s cost base by considering the cost of manufacture and export of finished goods, i.e., ready-made garments by the third party vendors (which cost is certainly not the cost incurred by the assessee), is nowhere supported by the TNMM under Rule 10B(1)(e) of the Rules. Having determined that (TNMM) to be the most appropriate method, the only rules and norms prescribed in that regard could have been applied to determine whether the exercise indicated by the assessee yielded an ALP. The approach of the TPO and the tax authorities in essence imputes notional adjustment/income in the assessee’s hands on the basis of a fixed percentage of the free on board value of export made by unrelated party vendors.
41. LFIL, in the Transfer Pricing documentation, established the international transactions of rendering buying services to be at the arm's length price having regard to the operating profit margin of comparable companies having similar functional profile. LFIL’s computation of the operating profit margin (OP/TC per cent) by enhancing the cost base, i.e., by increasing the cost of the sales facilitated by LFIL leads to an arbitrary adjustment of its income, as such an alteration resides plainly outside the Rules and the provisions of the Act.
42. Moreover, there is considerable merit in the submission that the (finding of the) lower authorities, including the Tribunal, misdirected themselves in holding that LFIL assumed substantial risk. Whilst this Court would neither state that LFIL performed functions with a limited risk component,



as it does not engage itself in manufacturing of garments (which is LFIL's stance), apart from broad assumptions made by the Revenue, no material on record testifies to that fact such that it can be the basis for an ALP adjustment. Indeed, LFIL has neither made investment in the plant, inventory, working capital, etc., nor does it claim to have any expertise in the manufacture of garments. More importantly, and given no material to the contrary, LFIL does not bear the enterprise risk for manufacture and export of garments. LFIL's functional and risk profile thus is entirely different and has nothing to do with the manufacture and export of garments by unrelated third party vendors. Simply put, LFIL renders support services in relation to the exports, which are manufactured independently. Thus, attributing the costs of such third party manufacture, when LFIL does not engage in that activity, and more importantly, when those costs are clearly not LFIL's costs, but those of third parties, is clearly impermissible. A contrary conclusion would amount to treating it (the appellant) as the vendor/ exporters' partner in their manufacturing business – a completely unwarranted inference.

43. Indeed, having done the work, LFIL has developed experience and expertise which the Tribunal has held to be human capital and supply chain intangibles. But such description does not in any way reveal how the appellant bears any risk - either enterprise or economic. LFIL's remuneration on a cost plus mark-up of 5 per cent represents the functions performed, assets utilized and risks assumed by it.

Further, the TPO's determination that LFIL bore significant risks is not borne out from the records. In transactions in which LFIL was a party, it did not bear any financial risk. To the contrary, its costs towards establishment, transportation, salaries, etc. were fully reimbursed, and it was insulated from any economic or financial downside to any particular



transaction. In other words, its remuneration was based entirely on the costs borne by it. In essence, it is a low risk contract service provider exclusively rendering sourcing support to the AE. It does not bear any significant operational risks for its functions, rendered to the third party vendor/customers. Rather, it is the AE that undertakes substantial functions and in fact assumes enterprise risks, such as market risk, credit risk etc. It also bears the letter of credit associated charges and other expenses.

44. Another important aspect which cannot be overlooked is that the the transfer pricing documentation maintained in terms of section 92D of the Act read with rule 10B of the Income-tax Rules, determined the arm's length price of the “*international transaction*” of the provision of buying services applying the TNMM, by comparing operating profit margin of LFIL with that of the comparable companies, as under:

Weighted average OP/OC per cent. of 26 comparable companies	4.07 per cent.
OP/OC per cent. of LFIL	5.17er cent.

This exercise has not been discarded. In other words, the TPO and the appellate fora were aware that in accordance with the rules, a comparison of the profit margin of LFIL with that of other similarly functioning companies was shown, and is, at the first instance, relevant to determine the ALP. The profit margin, as well as the cost plus model adopted by LFIL, was not shown to be distorted or of such magnitude as to persuade the tax authorities into discarding the exercise altogether. Having not contradicted this comparison, the Revenue proceeded to its own determination and calculations. This, however, is improper, given that the assessment carried out by the assessee must first be *rejected*, for any



further alterations to take place. Indeed, it cannot be that the Revenue admits to the correctness of LFIL's assessment but nonetheless proceeds to adopt a different method.

45. Indeed, once the TNMM was deemed most appropriate method, the distortions, if any, had to be addressed within its framework. Here, the unrelated transactions which were compared by LFIL have not been adversely commented upon, and neither has the choice of the TNMM. The TPO, therefore, ignored the relevant and crucial material, and straightaway proceeded to broaden the base for arriving at the profit margin, for attributed income of the assessee. Not only is this a clear infraction of the terms of the Act and Rules; the TPO went ahead to introduce what is clearly alien to the provisions of law and travelled outside the Rules.
46. The assessee had argued that no such adjustment was made in the earlier assessment years, for which assessment orders of previous four years were submitted, wherein the TNMM with operating profit over total cost (OP/TC) as a profit level indicator was accepted previously. Reliance was placed on decisions of the Supreme Court in *Radhasoami Satsang* (supra) and *CIT v. New Poly Pack* (supra) to support the aforementioned argument. Although previous tax assessments do not bar subsequent claims as *res judicata*, each assessment must be justified on its own terms, and as detailed above, the assessment by the TPO/AO, and the subsequent acceptance of these methods by the appellate authorities, is inconsistent with the IT Rules and the IT Act.
47. At this point, it is useful to note that the TPO is required to scrutinize the various methods that may be employed to evaluate their appropriateness, the correctness of the data, consideration of surrounding factors, etc. The selection of the most appropriate method will depend upon the facts of



the case and factors mentioned in rules contained in Rule 10C. It would be useful here to refer to two circulars issued by the CBDT, which prescribe the ground rules defining the powers and jurisdiction of the tax authorities and administrators:

Circular No. 12 dated 23rd August, 2001 reads as follows:

“The aforesaid provisions have been enacted with a view to provide a statutory framework which can lead to computation of reasonable, fair and equitable profit and tax in India so that the profits chargeable to tax in India do not get diverted elsewhere by altering the prices charged and paid in intra-group transactions leading to erosion of our tax revenues.

.....

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

The following portions of Circular No. 14 are relevant:

“The relevant portions of Circular No. 12 may be usefully referred to as under the new provision is intended to ensure that profits taxable in India are not understated (or losses are not over stated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances.

The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The new section 92 is, therefore, no intended to be applied



in cases where the adoption of the Arm's length Price, determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

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

48. The TPO after taking into account all relevant facts and data available to him has to determine arm's length price and pass a speaking order after obtaining the approval of the Department of Income Tax (Transfer Pricing). The order should contain details of data used, reasons for arriving at a certain price and applicability of methods, subject to judicial scrutiny. The order of the TPO, in the instant case, has not provided any substantive reasons for disregarding the TNM method as applied by LFIL. Further, the TPO's arbitrary exercise of adjusting the cost plus mark up of 5% on the FOB value of exports finds no mention in the IT Act nor the Rules. Such



an exercise of discretion by the TPO, disregarding the LFIL's lawful tax planning measures with its group companies, is not in compliance with the IT Act and Rules of Income Tax.

49. This court summarizes its conclusions as follows:

- (a) The broad basing of the profit determining denominator as the entire FOB value of the contracts entered into by the AE to determine the LFIL's ALP, as an "adjustment", is contrary to provisions of the Act and Rules;
- (b) The impugned order has not shown how, and to what extent, LIFIL bears "significant" risks, or that the AE enjoys such locational advantages, as to warrant rejection of the Transfer pricing exercise undertaken by LFIL;
- (c) Tax authorities should base their conclusions on specific facts, and not on vague generalities, such as "significant risk", "functional risk", "enterprise risk" etc. without any material on record to establish such findings. If such findings are warranted, they should be supported by demonstrable reason, based on objective facts and the relative evaluation of their weight and significance.
- (d) Where all elements of a proper TNMM are detailed and disclosed in the assessee's reports, care should be taken by the tax administrators and authorities to analyze them in detail and then proceed to record reasons why some or all of them are unacceptable.
- (e) The impugned order, upholding the determination of 3% margin over the FOB value of the AE's contract, is in error of law.

50. In light of the above circumstances, this Court is of the opinion that the TPO's addition of the cost plus 5% markup on the FOB value of exports



among third parties to LFIL's calculation of arm's length price using the TNMM is without foundation and liable to be deleted. The appeal is allowed and the order dated 25/11/11 of the ITAT Tribunal, Delhi Branch is liable to be and is accordingly set aside. The questions of law framed are answered in favour of the assessee, and against the revenue. The appeal is allowed in the above terms.

**S. RAVINDRA BHAT
(JUDGE)**

**R.V. EASWAR
(JUDGE)**

DECEMBER 16, 2013