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

Decided on : 27.03.2015

\+ **ITA 217/2014**

THE COMMISSIONER OF INCOME TAX-II……Appellant
Through: Sh. Kamal Sawhney, Sr. Standing Counsel.

Versus

MCKINSEY KNOWLEDGE CENTRE INDIA PVT. LTD.
……..Respondent
Through: Sh. Porus Kaka, Sr. Advocate with Sh. Divesh Chawla and Sh. N. Ganapathy, Advocates.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE R.K. GAUBA

MR. JUSTICE S. RAVINDRA BHAT (OPEN COURT)

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1. This appeal under Section 260A of the Income Tax Act, 1961 by the Revenue, challenges an order dated 13.09.2013 of the Income Tax Appellate Tribunal ("ITAT") in ITA No.2195/Del/2011 for the assessment year (AY) 2006-07. The ITAT by the impugned order confirmed the order of the Commissioner of Income Tax (Appeals) ("CIT(A)") and allowed the assessee's claim for certain deductions under Section 10A of the Income Tax Act, 1961 (hereafter referred to as the "the Act").

2. Briefly, the facts of the case are that, the Assessee Company was incorporated on 15.02.1999 under the Companies Act, 1956. The Assessee

is a wholly owned subsidiary of McKinsey Holdings Inc. which is in turn held by McKinsey & Co., Inc. The Assessee was incorporated in India to provide various support services in the area of export computer software, IT-enabled services including data processing, customization of data, back office operations and acting as a support center to provide research analysis and information to various McKinsey entities/holdings across the globe. The Assessee is duly registered as a unit exporting computer software under the Software Technology Parks (STP) scheme of the Ministry of Communication and Information Technology, by the Government of India on 20.04.1999 and launched commercial operations on 01.03.2000. It filed its return of income declaring a total income of ₹ 69,49,857/- which was processed under Section 143(1) of the Act and selected for scrutiny. A statutory notice under Section 143(2), dated 26.11.2007 was issued and served upon the Assessee. The Assessee filed an objection against the draft of the proposed order dated 18.12.2009 before the Dispute Resolution Panel ("DRP") on 29.01.2010 and later withdrew the same on 23.02.2010. After accepting the withdrawal, the Assessing Officer ("AO") was allowed to pass the order as per law. The Assessing Officer computed the Assessee's income at ₹ 27,21,57,968/- and completed the assessment after disallowing the deduction claimed u/s 10A and also, making an additional revision of income by ₹ 59,09,890/- pertaining to transfer pricing (TP) adjustments. The Assessee appealed against the order of the AO; the CIT (A) by its order on 28.02.2011, deleted both the additions.

3. Being aggrieved with the said order, the Revenue appealed to the ITAT which concurred with the findings of the CIT (A), confirmed its order and dismissed the appeal, by its impugned order dated 13.9.2013. The ITAT

held that the appellant was entitled to claim enhanced deduction based on the facts indicated, which reflect upon the nature of the service rendered as covered under Section 10A which is mentioned by the CBDT notification. The ITAT acknowledged the role of these services which added value for the customers generated through networked software. Further, applying the principle of consistency, it was held that the Assessee deserved the deduction claimed by it under Section 10A as it had been granted in the previous years. With regard to the comparables, the ones initially rejected by the AO were admitted based on the grounds that all of them were functionally similar and only varied in terms of certain common parameters considered for the assessment. It is against this order that the Revenue is in appeal before this Court.

4. The Revenue challenges both the deletions made to the assessment made by the AO. It argues that the ITAT erred in deleting the addition of ₹ 26,32,11,737/-, thereby allowing the deduction under Section 10A of the Act ignoring the fact that the Assessee is not fundamentally engaged in IT enabled services and therefore not entitled to the deduction and further questioned the deletion of an additional ₹ 59,09,890/- made by the Transfer Pricing Officer ("TPO") u/s 92CA on account of Transfer Pricing Adjustment and the acceptance of the comparables that were initially rejected in the AO's assessment.

5. The question of law that arises before this Court for consideration is whether the deduction should be allowed to the Assessee under Section 10A, on the ground that it is indeed entitled to the benefit under the particular provision. The Revenue argues that for the Assessee to be eligible for such deduction, the services so rendered must be IT enabled and the role of

networked software within the provision is seen as vital. Emphasis is drawn to the nature of the service and the value added to the customer is taken into account and the assessment order reflects IT enabled services as being equal to solutions whose added value for the customer is generated significantly through the use of information and communication technologies that used networked software. It was contended that the use of networked software in the case of the Assessee is limited to transmission of customized data to its parent company.

6. The Assessee placed reliance upon several factors, i.e that it is a duly established STP unit which is engaged in the provision of IT-enabled services to the parent company acting as its back office and thereby entitled to the benefit under the expanded definition of the term 'computer software'. Its activities are in the nature of data processing, customization of data, acting as the back office of the parent company and acting as support center to the parent company. The AO in the order questioned the Assessee's eligibility for the said deduction and relied upon the decisions in *Rao Bahadur Ravalu Subba Rao* v. *CIT*[1] and *Karamchari Union* v. *Union of India*[2] where the Supreme Court held that eligibility has to be seen within the provisions of the Act as it is a self-contained code.

7. And as for the purpose of applicability of Section 10A of the Act, the question in consideration was not the nature of the services provided by the company in general but the nature of services being exported or transmitted outside of India; and whether or not it falls within the ambit of 'services of

[1] [1956] 30 ITR 163 (SC)
[2] [2000] 243 ITR 143 (SC)

similar nature' within the meaning of Explanation – 2, to Section 10A of the Act. The provision reads as follows:

> ***"10A**. Special provision in respect of newly established undertakings in free trade zones, etc.*
>
> *(1) Subject to the provisions of this section, a deduction of such profits and gains as are derived by an undertaking from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce such articles or things or computer software, as the case may be, shall be. allowed from the total income of the assessee…*
>
> *XXXXXX XXXXXX XXXXXX*
>
> ***Explanation 2** - For the purposes of this section, -*
> *(i) "computer software" means,--*
> *(a) Any computer programme recorded on any disc, tape, perforated media or other information storage device; or*
> *(b) Any customized electronic data or any product or service of similar nature, as may be notified by the Board, which is transmitted or exported from India to any place outside India by any means."*

8. A perusal of the above provision and the explanation implies that the two conditions so mentioned must be cumulatively satisfied in order to be eligible for the deduction. While the Assessee claims itself to be covered under the broader definition of 'Computer Software' and more particularly under clause (b) of Explanation – 2 under 'services of similar nature', the Assessment Order was based on the decisions in *S. Gopal*

Reddy v. *State of Andhra Pradesh*[3], *K. P. Varghese* v. *ITO*[4] and *Indian Hotels Co. Ltd.* v. *ITO*[5] and relying upon the purposive approach to interpret the Act reflects that the services are being performed in India and the end product, which is not software within the meaning of Section 10A is being exported outside India and thus not making services of a similar nature as such services can only be rendered on real time basis electronically to qualify for the purpose of Section 10A. Also, the TPO, by his order of 92CA(3) dated 09.10.2009 advised the concerned officer to make an upward adjustment of ₹ 59,09,890/- to the total income declared and the AO allowed the adjustment. Apart from holding that the Assessee company has furnished inaccurate particulars (the report of the auditor considered *non est)* with a view to evade the tax, the AO also initiated penalty proceedings under section 271(1) (e) of the I.T. Act, 1961 for filing inaccurate particulars and concealment of income.

9. Aggrieved by the Assessment Order, the Assessee appealed against that to the CIT (A) who thereby held that by making the disallowance, the AO erroneously concluded that the appellant is engaged in the business of analysis of financial and business information and not in the business of data processing. CIT (A) in its findings, notes that it is evident that the appellant is customizing data, what is accessed by the appellant in the databases and what is delivered to its parent company are two different products, i.e. data is customized to suit the needs of the requester and thereafter exported out of India.

[3] [1996] 6 JT 268
[4] [1981] 13 I ITR 597 (SC)
[5] [2000] 245 ITR 538 (SC)

10. This Court, while considering the question involved in the applicability of deduction under Section 10A notes that in *CIT* v. *M.L. Outsourcing Services (P) Limited*[6] the assessee's contention of entitlement to claim deduction u/s 10A of the IT Act, 1961 read with Notification No. bearing SO 890 (E) dated 26th September, 2000 was upheld. In the above mentioned case, it was observed that,

> "*The Board has issued a notification as per the mandate and empowerment under Section 10A and this is not a case of issue of circular under Section 119, which are issued for different purposes and have another purport. Notification is a piece of delegated legislation and to that extent cannot be contrary to the principal enactment nor can it whittle down the effect of the same. Albeit, clause (b) of Explanation 2 to Section 10A has been worded in a manner which enforces the view and the opinion that Legislature, in their wisdom, has left it to the Board to decide which product or services of similar nature would qualify and should be treated as falling under clause (b), in addition to customised data processing. The intention of the Legislature was not to constrain or restrict but to enable the Board to include several services or products of similar nature in the ambit of the provision. This is what precisely the Board has done when it used the expression, 'information technology enabled products or services' in the notification.*"

11. The court relied on the circular issued by the CBDT explaining the provisions of the Finance Act, 2000, and held that the interpretation of the term 'manufacture or produce of an article or thing or computer software' by the tax authorities should be guided by the intention of the legislature (including the pronouncements of the Central Government while notifying the STP scheme) and the directions/notifications of the CBDT. Furthermore, the deductions on the same grounds were disallowed by the

[6] INCOME TAX APPEAL NO. 1255/2011

AO and later permitted by the CIT (A) and upheld by the ITAT for the AY 2002-2003 and subsequently examined and allowed in the preceding AYs 2003-04, 2004-05 and 2005-06 by the AO himself and since there has been no change either in the facts or the circumstances of the case of the appellant accordingly, in view of the foregoing the appellant is eligible to claim the deduction under section 10A of the Act being the sixth year of claim. Therefore, the CIT (A) was of the opinion that the claim of the assessee that all of its business income or profits from business or profession are exempt under section 10A of the Act is correct and the assessee is entitled to exemption and thereby reversed the finding of the AO and directed him to allow the exemption to the whole of assessee's profit as computed under the said head 'profit and gains of business.' In the present case, the ITAT held that,

> "*There is no dispute on the services provided by Assessee. The modus operandi of Assessee, as noted earlier while considering the submissions made before ld. CIT(A), makes it very clear that the assessee was acting as a back office of its parent company by providing customized electronic data as per request received by it from parent company. It is clear from the modus operandi that what was accessed by the assessee at the STP Unit and what was delivered to Mckinsey (Parent Company) after the conversion took place were two different products/services which is described as customization of data/data processing. The STP Unit undertook the series of operations on the data received from various data bases before it was finally delivered to the customer. Thus, there was value addition made by the STP Unit on the data. We, therefore, are not in agreement with the findings of AO that there was no value of addition on the data obtained from various data base from parent company. The Assessee acted as a back office of the parent company and provided support services to its parent company. Therefore, Id. CIT (A) rightly held that the activities of*

the assessee squarely fall within the expanded definition of 'computer software'..

The ITAT also relied on the principle of consistency – (Ref *Assistant Commissioner of income-tax* v. *NGC Network (India) (P)Ltd*[7], *Lenovo (India) P. Ltd* v. *Assistant Commissioner of Income-tax*[8], *Deputy Commissioner of Income-tax* v. *Cheil Communication. India P.Ltd*[9] etc.)

12. The CBDT circular relied upon by the assessee in the present case, reads as follows:

"S.O.890(E) - In exercise of the powers conferred by clause (b) of item (l) of Explanation 2 of section 10A. Clause (b) of item (l) of Explanation 2 to section 10B and clause (b) to Explanation to section 80HHC of the Income-tax Act, 1961 (43 of 1961), the Central Board of Direct Taxes hereby specifies the following Information Technology enabled products or services as the case may be for the purpose of said clauses namely :-

(l) Back-Office Operations

(ii) Call Centres

(iii) Content Development or animation

(iv) Data Processing

(v) Engineering and Design

(vi) Geographic Information System Services

(vii) Human Resources Services

(viii) Insurance claim processing

[7] [2010] taxmann.com 140 (Mum.)
[8] 46 SOT 289/21 taxmann.com 256 (Bang.)
[9] 140 ITD 127/11 taxmann.com 205 (Delhi)

(ix) Legal Databases

(x) Medical Transcription (Xl) Payroll

(xii) Remote Maintenance (xiil) Revenue Accounting

(xiv) Support Centres and

(xv) Web-site Services."

There is no dispute with respect to the findings arrived at by the lower authorities. The assessee is involved in providing back office support and thereby entitled to the benefit under the definition of the term 'computer software'. Its activities are in the nature of data processing, customization of data, acting as the back office of the parent company and acting as support center to the parent company. Clearly it could not have been deprived of the benefit of Section 10A, as is argued by the revenue. This contention is accordingly rejected as unmerited.

13. So far as the Arms Length Price (ALP) determination and the Transfer Pricing upward adjustments, are concerned, in its TP documentation, the assessee determined Transactional Net Margin Method (TNMM) as the most appropriate method to determine the ALP of the international transaction pertaining to the provision of IT support services. The TPO in the order accepted only 7 out of the 11 comparable companies and rejected the rest based on reasons that one of them, Fortune Infotech Ltd. ("FIL") had a different financial year ending, the other two - Kirloskar Computer Services Ltd ("KCSL") and Mercury Outsourcing Management Ltd. ("MOML") had a turnover of less than ₹1 Crore and finally, Genesis

International Corporation Ltd ("GICL") was rejected because it seemingly had a negative growth graph.

14. The Revenue is in appeal before this Court questioning the admissibility of the above mentioned comparables while computing Arm's Length Price regarding the IT Support services after the TPO and AO rejected the above mentioned companies but was later allowed by the CIT (A) and ITAT. While the AO had confirmed the findings of the TPO, the Ld. CIT(A) after considering the Assessee's submissions accepted all the four companies rejected by the TPO. The revenue submits that Fortune Infotech Ltd. was correctly rejected by TPO because the company had different financial year ending on December, 2006, whereas Assessee's financial year ended on March, 2006. There is nothing shown to the court that supports the revenue's argument that the ITAT fell into error in holding that if a comparable is following different financial year then the same cannot be included in the list of comparables selected for benchmarking the international transaction. Therefore, the ITAT has held that if the comparable is functionally same as that of tested party then same cannot be rejected merely on the ground that data for entire financial year is not available. If from the available data on record, the results for financial year can reasonably be extrapolated then the comparable cannot be excluded solely on the ground that the comparables have different financial year endings.

15. As far as KCSL and MOML are concerned, (again, rejected by the TPO) typically a filter of companies with less than a turnover of ₹1 crore is applied for selecting the comparables. According to the available data, the turnover of these two companies was less than Rupees one crore. However,

if this filter is applied then, as submitted by Counsel for the Assessee, the companies with a higher turnover also should have been rejected which was not the case in the said TP adjustments. Rule 10B (2) to (4) of the Income Tax Rules are relevant for this purpose. They are extracted below:

> "*10-B(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 the 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.*
>
> *(e) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction or the specified domestic transaction and the comparable uncontrolled transaction or between the enterprises entering into such transactions;*
>
> *(f) the nature, extent and reliability of assumptions required to be made in application of a method."*

Rule 10B (3) stipulates the third step, and spells out when the TPO is obliged to hold an uncontrolled transaction as comparable with others. This provision reads as follows:

> *" (3) An uncontrolled transaction shall be comparable to an international transaction or a specified domestic 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."*

Rule 10B (4) provides what should be the basis of the calculations in terms of data, its contemporaneity, etc. It stipulates that:

> *"(4) The data to be used in analysing the comparability of an uncontrolled transaction with an international transaction shall be the data relating to the financial year in which the international transaction has been entered into:*
> *Provided that data relating to a period not being more than two years prior to such financial year may also be considered if such data reveals facts which could have an influence on the determination of transfer prices in relation to the transactions being compared."*

It is evident, therefore, that functional similarity of the comparable entity is emphasized; every effort must be made in the ALP determination to ensure that the "material effects of differences" between the tested party and the comparable must be eliminated. In our opinion, the ITAT did not fall into

error in holding that the two comparables could not be rejected on the ground relating to turnover threshold of ₹1 Crore.

16. In case of GICL, the TPO in AY 2006-07 rejected this comparable on the ground that the company was in negative phase of growth which premise is strongly disputed by assessee and has not been refuted by the Department. But based on the Annual Report, 2006 available to the Court, the company exhibits a considerable rise in the income over the past year. Under such a circumstance, this Court finds that this company as a comparable was wrongly rejected by the TPO on the grounds that it is currently in a negative growth phase.

17. For the aforesaid reasons, this Court finds that the questions of law sought to be urged by the Revenue do not arise in the circumstances; the appeal is accordingly dismissed without any order as to costs.

S. RAVINDRA BHAT
(JUDGE)

R.K. GAUBA
(JUDGE)

MARCH 27, 2015