



Turnover filter considered at 10 times; Comparables with RPTs up to 15 percent accepted; standard deduction of +/- 5 percent benefit under the erstwhile provisions of Income-tax Act confirmed

Background

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of McAfee Software (India) Pvt Ltd ¹ (the taxpayer) has ruled on the comparability parameters for selection of companies – functional similarity, Related Party Transactions (RPTs) upto 15 percent, turnover filter ranging from one-tenth of the taxpayer's turnover and upto ten times as the upper limit. Further, the Tribunal also upheld the allowance of a standard deduction of +/- 5 percent.

Facts of the case

- The taxpayer, part of the McAfee Group, renders software development services to its Associated Enterprise (AE) McAfee Ireland Holdings Ltd. The taxpayer is remunerated on a cost +15 percent basis for the services rendered.
- During the Financial Year (FY) 2004-05, the taxpayer earned a 15 percent margin on the total operating cost. The taxpayer selected Transactional Net Margin Method as the most appropriate method in its Transfer Pricing (TP) study and selected nine comparable companies to justify the arm's length.

- The Transfer Pricing Officer (TPO) rejected the TP study, used various filters and selected 17 comparables with an unadjusted arithmetic mean of 26.59 percent and adjusted the arithmetic mean of 23.74 percent (working capital adjustment).
- Based on the above, the TPO arrived at a shortfall in profits and made an adjustment of INR5.11 crore.
- On appeal by the taxpayer, the Commissioner of Income-tax (Appeals) [CIT(A)] partly allowed the appeal by excluding 10 comparables selected by the TPO by applying a zero percent RPT filter, and four more comparables for functional dissimilarity, resulting in a final selection of three comparables and computed an adjustment of INR3.94 crore. Further, Ld. CIT(A) also allowed a standard deduction of +/- 5 percent as provided in the proviso to Section 92C(2) of the Income-tax Act, 1961 (the Act).

¹ ACIT v. McAfee Software (India) Pvt Ltd [IT(TP)A No.1388/Bang/2011 and IT(TP)A No. 04/Bang/2012 – AY 2005-06] – Taxsutra.com

Taxpayer's contentions

- The taxpayer contended that companies who are functionally not similar, having an RPT of more than 15 percent and are high turnover cases require reconsideration.
- However, during the course of the proceedings, the taxpayer admitted that it will not contest the RPT and turnover filters issue and restricted the arguments to the comparability of companies based on functionality.
- Further, the taxpayer also contended that the amendments to the proviso to Section 92C(2) were applicable only for cases pending as on 1 October 2009. The order of the taxpayer was passed by the Assessing Officer (AO) prior to that date. Hence, the standard deduction of +/- 5 percent granted by the CIT(A) was correct.
- References were drawn from principles laid down in SAP Labs India Pvt. Ltd.² and Synopsis India P. Ltd.³.

Revenue's contentions

- Revenue was mainly aggrieved on the RPT filter adopted by the Ld. CIT(A) at zero percent whereas the Co-ordinate Benches have been accepting it up to 15 percent and in some orders even up to 25 percent.
- Further, the Revenue also contended that the standard deduction of +/- 5 percent as provided under the proviso to Section 92C(2) is not permissible consequent to the amendment made to the proviso. Reliance was placed on the decision of the Co-ordinate Bench in the case of Sunquest Information Systems (India) Private Limited⁴.

Tribunal's ruling

The Bangalore Tribunal held that, as part of the Functions Assets Risks analysis, various filters are required to be adopted in selecting a company as a comparable.

- The Tribunal held that various filters were required to be adopted in selecting a company as a comparable as part of the FAR analysis. Drawing reference to the decision of the Co-ordinate Bench in the case of Sunquest Information Systems (India) Private Limited¹ which has followed the other decisions on the issue, the Tribunal held that companies having related party transactions up to 15 percent of total revenues could be considered as comparables.
- The Tribunal held that the turnover filter is adopted to avoid selection of high-end companies (big companies) with that of 'minnows' in a similar line of business. The range cannot be fixed and how to adopt the filter depends on the facts of each case. Simply because the turnover of a comparable exceeds the upper limit, it cannot be rejected given that in a number of cases, no objections were raised on the inclusion of companies with very small turnovers. Given the above, the Tribunal ruled that, based on broad parameters, what one has to consider is, the turnover/receipts of the taxpayer and the range of the upper limit at ten times as well as the lower limit at ten times i.e. one-tenth with a margin of variation.
- Drawing references from various pronouncements, the Tribunal ruled on the comparability of companies selected by the TPO as mentioned below:
 - (i) *Bodhtree Consulting Ltd* – The Tribunal directed exclusion of this company for significant RPT exceeding 15 percent as well as functional dissimilarity since it was engaged in website development and other customised software and provision of IT-enabled services like e-paper solutions, data cleansing software, etc.

² SAP Labs India Pvt. Ltd., v. ACIT [2010] 6 ITR (Trib) 81 (Bang)

³ DCIT v. Synopsis India P. Ltd. [IT(TP)A No. 1107 & 1093/Bang/2011]

⁴ ITO v. Sunquest Information Systems (India) Private Limited, (IT(TP)A No. 1302/Bang/2011)

- (ii) *Lanco Global Systems Ltd* – Though this company was excluded by the CIT(A) owing to a low-profit margin, the Tribunal directed inclusion of the company and ruled that only continuous loss-making companies are to be excluded from comparability.
- (iii) *Exensys Software Solutions Ltd* – The Tribunal directed exclusion of this company for functional dissimilarity as it earned extraordinary profits from the amalgamation of companies.
- (iv) *Sankhya Infotech Ltd* – The Tribunal directed exclusion of this company on account of functional dissimilarity as it was engaged in development and ownership of software products, software services, and training; but segmental information was not available.
- (v) *Four Soft Ltd* – The Tribunal directed exclusion of this company for functional dissimilarity as it was engaged in the development of software products and possessed Intellectual Property rights towards the same.
- (vi) *Thirdware Solution Ltd* – The Tribunal directed exclusion of this company for functional dissimilarity as it was engaged in the sale of software licence and related services and earned extraordinary profits from intangibles owned by the company; however the segmental information was not available.
- (vii) *Geometric Software Solutions Company Ltd* – The Tribunal directed exclusion of this company for functional dissimilarity as it was engaged in software product development.
- (viii) *Tata Elxsi Ltd* – The Tribunal directed exclusion of this company for functional dissimilarity as it was a specialised embedded software development service provider and cannot be compared to the software service provider.
- (ix) *Flextronics Software Systems Ltd* – The Tribunal directed exclusion of this company for functional dissimilarity as it incurred expenses for the sale of products and Research & Development expenses for the development of software products; however, segmental information was not available.
- (x) *Satyam Computer Services Ltd* – The Tribunal directed exclusion of this company due to non-reliability of financial data.
- (xi) *Infosys Technologies Ltd* – The Tribunal directed exclusion of this company on account of functional dissimilarity due to the different functionality of products, having a high turnover and brand name.
- (xii) The Tribunal directed inclusion of Sasken Network Systems Ltd, R S Software (India) Ltd, Visualsoft Technologies Ltd and Sasken Communication Technologies Ltd selected by the TPO, as the taxpayer did not raise any objection.
- (xiii) Further, the Tribunal also directed inclusion of Igate Global Solutions Ltd and L&T Infotech Ltd selected by the TPO as the taxpayer did not press the issues on turnover filters applied.
- Placing reliance on the analysis undertaken by the Coordinate Bench in the case of SAP Labs India Pvt. Ltd. and drawing reference to the CBDT Circular 5/2010⁵, the Tribunal held that

⁵ CBDT Circular 5/2010 dated 3 June 2010 – Explanatory notes to the provisions of the Finance (No.2) Act, 2009

the standard deduction permitted by the CIT(A) was in accordance with the provisions since the amendment to the proviso is applicable from Assessment Year (AY) 2009-10 onwards and hence the pre-amended proviso shall apply.

- The Tribunal additionally observed that the explanation brought in by the Finance Act, 2014 also specifies that the provisions of the second proviso shall also be applicable to all assessments or reassessment proceedings, pending before the AO as on the first day of October 2009. Considering that the present proceedings were concluded before that day, the Tribunal held that the second proviso did not apply, and granted the standard deduction of +/-5 percent.

Our comments

Yet another ruling pronounced by the Bangalore Bench of the Income Tax Appellate Tribunal hovers around the much-debated aspects of the choice of comparables. This judgment lays emphasis on functional comparability as an eminent factor for selection of companies.

Setting aside the general practice of considering the range of INR1 crore to INR200 crore turnover for selecting comparables, the Tribunal suggests that the turnover filter be capped at ten times the turnover/receipts of the taxpayer as the upper limit and up to one-tenth on the lower end.

This broadened range may widen the scope for inclusion of more companies; however, subject to functional comparability. In addition, the Tribunal also accepts companies with related party transactions up to 15 percent as comparable.

Though not applicable in the present day scenario, another point relevant to note in case of appeals against assessment orders passed before 1 October 2009, is the availability of a marginal relief of +/- 5 percent from the arithmetical mean of comparable prices as provided under the proviso to Section 92C(2) of the Act.



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