

THE HIGH COURT OF DELHI AT NEW DELHI

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Judgment delivered on: 06.05.2013

+ ITA No. 353/2011

THE COMMISSIONER OF INCOME TAX-IV

... Appellant

versus

STRATEX NET WORKS (INDIA) PVT. LTD.

... Respondent

Advocates who appeared in this case:

For the Appellant : Mr Sanjeev Sabharwal

For the Respondent : Dr Rakesh Gupta, Ms Rani Kiyala,
Mr Shubham Rastogi

CORAM:-

HON'BLE MR JUSTICE BADAR DURREZ AHMED

HON'BLE MR JUSTICE VIBHU BAKHRU

JUDGMENT

BADAR DURREZ AHMED, J (ORAL)

1. This appeal has been filed by the revenue under section 260A of the Income Tax Act, 1961 and is directed against the order dated 30.04.2010 passed by the Income Tax Appellate Tribunal, New Delhi, in respect of the assessment year 2004-05. The issue sought to be raised by the learned counsel for the appellant/revenue relates to the manner in which the profit level indicator has been computed by the Transfer Pricing Officer for the purposes of determining the arm's length price of the international transactions entered into between the respondent/assessee and its associated enterprise.

2. The Assessing Officer, on receipt of the report of the Transfer Pricing Officer under section 92CA(3) of the Income-tax Act, 1961 (hereinafter referred to as 'the said Act'), finalised the assessment of the assessee by making an addition of ₹ 1,19,41,893/- on account of the arm's length price adjustment. Being aggrieved by the said addition, the respondent/assessee preferred an appeal before the Commissioner of Income Tax (Appeals), who, allowed the appeal and deleted the said addition. The revenue preferred an appeal before the Tribunal being ITA No. 3640/Del/2007. That appeal, has been dismissed by the Tribunal by virtue of the impugned order dated 30.04.2010. That is how the revenue is in appeal before us.

3. The respondent/assessee is a wholly owned subsidiary of Digital Microwave (Mauritius) Ltd. which in turn is a wholly owned subsidiary of Digital Microwave Corporation USA. The assessee is engaged mainly in the undertaking for installation, commissioning and maintenance of microwave link equipments.

4. There is no doubt that Digital Microwave Corporation USA is an associated enterprise of the respondent/assessee. All the equipments for microwave links are manufactured by the said associated enterprise. The orders in India for installation of those equipments are booked by the respondent/assessee. However the equipments are supplied directly to the customers in India by Digital Microwave Corporation USA. For this activity, the respondent/assessee receives commission from the associated enterprise. Thus, the transaction involving commission is admittedly an international transaction. Apart from this, the equipments supplied by Digital Microwave Corporation USA are covered under a warranty given

by the said USA Company. The service under the warranty is provided by the respondent/assessee in India. Therefore, the transaction with regard to warranty is also an international transaction.

5. Apart from the two admitted international transactions involving commission and warranty, the respondent/assessee also undertakes installation of the said equipment. It also provides for annual maintenance under the head of re-engineering and maintenance contracts. The respondent/assessee, carries out these activities of installation and maintenance in India under independent contracts. It is, therefore, the case of the respondent/assessee that the transaction of installation and maintenance are not international transactions but are pure and simple domestic transactions.

6. The point in issue before us is with regard to the manner of computing the profit level indicator. The Transfer Pricing Officer had adopted the Transactional Net Margin Method (TNMM) as the most appropriate method under section 92C(1)(e) of the said Act. While doing so, the Transfer Pricing Officer had to compute the profit level indicator in respect of the international transactions of warranty services and commission income. What the Transfer Pricing Officer did was to include the operating revenue and operating cost of not only the warranty services and commission income but also the installation/commissioning and maintenance charges while computing the operating profit so as to determine the profit level indicator. This would be clear from the table as given below which has been re-produced from the Transfer Pricing Officer's report:-

“Computation of PLI of the Assessee

During the course of proceedings the assessee has filed a detail of computation of net margin from various activities. The operating (*revenue – sic*) and operating cost in respect of activities of installation and commissioning, re-engineering and maintenance, warranty support services and commission income as under:

S.No	Activity	Operating revenue	Operating cost
1.	Installation and commissioning	74,96,321	1,46,31,089
2.	Re-engineering and maintenance	3,49,91,750	3,40,30,354
3.	Warranty services	2,32,37,906	1,91,75,407
4.	Commission income	1,47,96,910	1,16,41,215
	Total	8,05,22,887	7,94,78,065

$$\begin{aligned}\text{Operating Profit} &= \text{Operating revenue} - \text{Operating cost} \\ &= ₹ 8,05,22,887 - ₹ 7,94,79,065 \\ &= ₹ 10,44,822/- \\ \text{PLI} &= 1.31\%\end{aligned}$$

7. After taking the profit level indicator to be 1.31%, the Transfer Pricing Officer then went ahead with the selection of comparables and determined the arm's length operating margin in respect of the comparables at a figure of 16.34%. Thereafter, the Transfer Pricing Officer determined the arm's length price in respect of the international transactions of warranty support services and commission income as under:-

“Determination of Arm's Length Price

The arm's length price of the international transactions entered into with the AE is computed in the flowing manner:-

Total Cost	₹ 7,94,78,065
Operating Profit	₹ 10,44,822
Operating Profit margin	1.31 %
Arm's Length Operating profit Margin	16.34%
Arm's Length Operating Profit	₹ 1,29,86,715
Difference being adjustment required	₹ 1,19,41,893

Accordingly, the adjustment of ₹ 1,19,41,893/- is required to be made value of International transaction related to commission on sales and warranty support services. The adjustment is being made proportionately to both the transactions. The arm's length price of these transactions is computed in following manner:-

S.No .	International transaction	Value of international transaction	Proportionate adjustment	Arm's length price of international transaction
1	Warranty support service	2,32,37,906	72,95,302	3,50,33,208
2	Commission Income	1,47,96,910	46,46,591	1,94,43,501

The Arm's Length Price of the international transaction related to warranty support services has thus been computed at ₹ 3,05,33,208/-. The (\pm) range of the Arm's Length Price is ₹ 3,20,59,868/- (+5%) to ₹ 2,90,06,547/- (-5%). Since the value of international transaction is ₹ 2,32,37,906/-, which falls outside the (\pm 5%) tolerance band, the assessee is not entitled to the benefit of proviso to sub-section (2) to section 92C of the Income Tax Act.

The Arm's Length Price of the international transaction related to commission income has thus been computed at ₹ 19,45,43,501/-. The (\pm) range of the Arm's Length Price is ₹ 2,04,15,676/- (+5%) to 1,84,71,325/- (-5%). Since the value of

international transaction is ₹ 1,47,96,910/-, which falls outside the (\pm 5%) tolerance band, the assessee is not entitled to the benefit of proviso to sub-section (2) to section 92C of the Income Tax Act.

No adverse inference is drawn in respect of other international transactions.”

8. From the above, it is apparent that while computing the profit level indicator, the Transfer Pricing Officer took into account not only the operating revenue and operating costs of the international transactions involving warranty services and commission income but, he also took into account the operating revenue and operating costs of the installation/commissioning and maintenance services which were domestic transactions. It is also evident that the Transfer Pricing Officer, himself, did not consider installation/commissioning and maintenance to be international transactions inasmuch as no adjustment was made by him in respect thereof. The adjustments made to the extent of ₹. 1,19,41,893/- were only with regard to the value of international transactions relating to commission on sales and warranty support service.

9. Mr Sabharwal, the learned counsel appearing on behalf of the revenue submitted that there was nothing wrong in taking the operating cost and operating revenue of the installation and commissioning services as also the maintenance services while computing the profit level indicator because the said services were intricately connected with the international transactions of warranty support services and commission income. However, we find, on going through the order passed by the Commissioner of Income Tax (Appeals) as also the impugned order passed by the Tribunal, that both these authorities have returned a finding

of fact that the installation/commissioning and maintenance services were not part of the international transactions. In fact, the Tribunal held that the installation/commissioning and maintenance agreements were independent agreements unconnected with the transactions of warranty support services and the transaction which generated the commission income. The Tribunal noted that the equipment had been supplied to 40 customers by the respondent's/assessee's associated enterprise. However, only three of them had availed of the installation services from the assessee. The Tribunal also noted that a corroborative circumstance for construing the transactions of installation/commissioning and maintenance as domestic transactions was that, in the order of the Transfer Pricing Officer itself, no adjustment was made in respect of these transactions. The Tribunal further held that since the profit level indicator shown by the assessee on the international transactions of warranty service and commission income was 18.98%, there was no need for any adjustment in the arm's length prices of these transactions inasmuch as the profit level indicator of the comparables were determined by the Transfer Pricing Officer at 16.34%, which was lower. It is in this backdrop that the Tribunal felt that there was no reason to examine the issue on the argument of the assessee that the Transfer Pricing Officer had not applied the proper comparables while working out the profit level indicator of comparables.

10. From the foregoing discussion, it is evident that the transactions pertaining to the installation/commissioning and maintenance services were not international transactions as contemplated under section 92B(1). They were also not deemed international transactions under section

92B(2) of the said Act because none of the conditions stipulated therein of a prior agreement existing between the customers of the respondent/assessee and the associated enterprises have been established as a fact. Moreover, there is no finding that the terms of the transaction of installation/commissioning as well as maintenance had been determined in substance between the customers and the respondent/assessee by the associated enterprise. In the absence of such findings, it cannot be deemed that the transaction of installation/commissioning as well as provision of maintenance services by the respondent to its domestic customers in India were international transactions falling within section 92B(2) of the said Act.

11. Consequently, the findings of fact do not support the contention raised by Mr Sabharwal. As such, no substantial question of law arises for the consideration of this court.

12. The appeal is dismissed.

BADAR DURREZ AHMED, J

VIBHU BAKHRU, J

MAY 06, 2013
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