**IN THE ITAT MUMBAI BENCH 'K'**

**Welspun Zucchi Textiles Ltd.**

**v.**

**Assistant Commissioner of Income-tax-2(3), Mumbai***

**D.K. AGARWAL, JUDICIAL MEMBER**

**AND P.M. JAGTAP, ACCOUNTANT MEMBER**

**IT APPEAL NOS. 6539 (MUM.) OF 2009 & 898 (Mum.) of 2010**

**[ASSESSMENT YEAR 2005-06]**

**JANUARY 11, 2013**

**ORDER**

**P.M. Jagtap, Accountant Member -** These two appeals, one filed by the assessee being ITA No. 6539/Mum/2009 and the other filed by the Revenue being ITA No. 898/Mum/2010, are cross appeals which are directed against the order of learned CIT(Appeals)-15, Mumbai dated 25-11-2009.

**2.** Ground No.1 of the assessee's appeal relates to the issue of disallowance of Rs.1,45,192/- made by the AO and confirmed by the learned CIT(Appeals) as per the provisions of section 14A read with Rule 8D of Income Tax Rules.

**3.** The assessee in the present case is a Company which is engaged in the business of manufacturing of bathrobes. The return of income for the year under consideration was filed by it on 29-10-2005 declaring total income of Rs.2,91,83,540/-. In the said return, dividend income of Rs.3,17,224/- received on mutual fund units was claimed to be exempt by the assessee u/s 10(38) of the Act. No disallowance on account of expenses incurred in relation to the earning of the said income, however, was made by the assessee as required by the provisions of section 14A. The AO, therefore, worked out such expenses at Rs.1,45,192/- by applying Rule 8D and made a disallowance to that extent u/s 14A. On appeal, the learned CIT(Appeals) confirmed the said disallowance relying on the decision of Special Bench of ITAT in the case of *ITO* v. *Daga Capital Management (P.) Ltd.* [2009] 117 ITD 169 (Mum.)(S.B.) wherein it was held that Rule 8D has a retrospective application.

**4.** We have considered the arguments of both the sides and also perused the relevant material on record. As agreed by the learned representatives of both the sides, the issue involved in this appeal now stands squarely covered by the decision of Hon'ble Bombay High Court in the case of *Godrej Boyce Manufacturing Co. Ltd.* v. *Dy. CIT* [2010] 194 Taxman 203, wherein it has been held that Rule 8D of Income-tax Rules, 1962 is applicable only from assessment year 2007-08. As further held by Hon'ble High Court, the disallowance u/s 14A for the years prior to assessment year 2007-08 has to be made by adopting some reasonable method. Respectfully following the said decision of Hon'ble jurisdictional High Court, we set aside the impugned order of the learned CIT(Appeals) on this issue and restore the matter to the file of the AO with a direction to recompute the disallowance of expenses to be made u/s 14A by applying some reasonable method after giving the assessee an opportunity of being heard.

**5.** Ground No. 1 of the assessee's appeal is accordingly treated as allowed for statistical purposes.

**6.** Ground No.2 of the assessee's appeal and ground No. 4 of the Revenue's appeal involve common issue relating to addition made by the AO/TPO by way of transfer pricing adjustment which has been deleted by the learned CIT(Appeals).

**7.** During the year under consideration, the assessee company had exported bathrobes to its associated enterprises, namely, Vincenzo Zucchi S.p.A., Italy and Basettil S.p.A., Italy of Rs. 13,57,47,189/- and Rs. 1,11,59,013/- respectively. The said transactions were benchmarked by the assessee using CUP method as the most appropriate method. In order to determine the arms length price of these transactions entered into by the assessee company with its associate enterprises, a reference was made by the AO to the TPO u/s 92CA(1) of the Act. Before the TPO, the assessee submitted the comparative chart of sales to AEs and non AEs. It was submitted that out of the total bathrobes exported to non AEs, about 95% bathrobes were exported to Wallmart USA at an average unit price of US Dollars 6.42 while the average unit price of export made by the assessee to its AEs in Italy was US Dollars 8.80. It was contended that since the price charged to AEs was more than the price charged to non AEs, the international transactions with AEs involving export of bathrobes should be considered at arms length.

**8.** The TPO did not find the stand of the assessee to be acceptable. According to him, the exports to AEs in Italy could not be compared with exports to non AEs such as Wallmarts Store in America as these two markets were entirely different with one in Europe and the other in America. He held that the prices were likely to be varied depending on the size of the market, extent of competition, the availability of substitute goods etc. He also held that the price of bathrobe was likely to be varied depending upon the size, sheds, fabric, design, style etc. He was also of the opinion that there was no point in comparing the average price of bathrobe supplied by the assessee to AEs in Italy with the average price of bathrobes supplied to Wall Mart in USA as the average price was dependant on the type and quality of bathrobes which varied in wide range. He held that the CUP method used by the assessee for benchmarking the international transactions with AEs thus was not the most appropriate method and the TNMM should be considered as the most appropriate method for the benchmarking. Accordingly, a search was undertaken by the TPO under the industry head "Textiles - Terry Towels" and he identified 11 companies as comparables being broadly similar functionally to the assessee. Since the average rate of net profit to total cost of the said comparables was found to be 13.05% as against 5.04% shown by the assessee, the assessee was called upon by the TPO to explain why TP adjustment should not be made in its case by applying arms length margin of 13.05%. In reply, the assessee primarily objected to the use of TNMM as the most appropriate method for benchmarking as proposed by the TPO by contending that in the facts of its case, CUP was the most appropriate method. As regards the comparables selected by the TPO for applying TNMM, the assessee submitted that all of them were in the business of manufacture of Terry Towels while the assessee was in the business of manufacture of bathrobes which is a different commercial product. It was also pointed out that the assessee had got DEPB benefit from export of Rs. 2.18 crores in the year under consideration and if the same was considered as part of sales, its profit margin would come to 10.30% and not 5.4%.

**9.** The TPO did not find merit in the submissions made on behalf of the assessee. He noted that there was no comparable available on the data base which was engaged in the manufacture of bathrobes and, therefore, manufacturers of Terry towels were taken as comparable having business line closely related with that of the assessee. As regards the plea of the assessee that DEPB benefit should be considered as a part of the same, the TPO held that the same was not acceptable since DEPB benefit was a part of other income which could not be considered as part of the total income of the assessee. Accordingly, the net margin of 13.05% was taken by the TPO as arms length margin for the export of bathrobes by the assessee to its AEs and the arms length profit was worked out by him at Rs. 3,93,14,936/- as against the profit of Rs. 1,51,82,698/- shown by the assessee. TP adjustment of Rs. 2,41,32,238/- thus was made by him and addition to that extent was made by the AO to the total income of the assessee in the assessment completed u/s 143(3).

**10.** The addition made by the AO/TPO by way of TP adjustment was disputed by the assessee in an appeal filed before the learned CIT(Appeals) and elaborate submissions were made on its behalf on this issue which, as summarized by the by the learned CIT(Appeals) in his impugned order, were as under :

"(*i*) It had adopted standard or traditional method (CUP) while benchmarking its transactions. This mode is preferred to the TNMM which is a method of last resort.

(*ii*) The appellant also submitted that price charged per bath robe to the AE was US $8.18 where as the price charged to it None AE was in the range of US $5.37 - 6.42. the Non AE in this case was worlds largest retail departmental chain of "Wal Mart".

(*iii*) The CUP method was stated to be most appropriate as the appellant has exported the same product albeit having slightly different construction/characteristics of almost same volume to the AE as well as to the Non AE under the said condition.

(*iv*) The TPO proceeded with application of TNMM method and close companies that are engaged in the manufacturing of 'terry towels'. In fact, terry towels are akin to the raw material for the manufacture of bathrobe. The costs and the expenditure cannot be compared as almost all the manufactures of terry towels convert cotton yarn into fabric and hence their risks and rewards are entirely different from that of the assessee company. The manufacturing process of terry towel manufacturing verticals (cotton spinning, weaving, dyeing & processing, cutting, slitting, hemming and packaging), are entirely different from the simple stitching process required for a bathrobe manufacturing unit. Thus the technology requirements, the capex requirements and the technical manpower requirements are all significantly higher than that required for simple bathrobe stitching unit. This terry fabrics is cut as per required sizes/patterns and stitched into a bathrobe. On the other hand, terry towel manufacturers weave cotton yarn into fabric and hence, their costs, expenditure and margin cannot be compared with that of the Appellant. Further, the marketing strategy for sale of bathrobes is very different from that of sale of terry towels. Whereas, the bathrobes are sold as lingerie products, the terry towels are sold as bath products. Thus, bathrobes cannot be equated with terry towel manufacturers with that of a bathrobe manufacturer is grossly incorrect and invalid.

(*v*) Having wrongly selected companies/enterprises engaged in the manufacture of 'terry towels' which business is inherently different from the business of manufacturing bathrobes, the ld. AO has simply computed average profit margin of these companies and compared the same with the assessee's margin without adjusting for differences in characteristics of product, differential manufacturing process, risks assumed, market conditions etc. Another error of principle made by the ld. AO is applying average profit margin rate of 13.05% to the entire operating costs of the Appellant as operating cost relatable to international transaction. In the process, he has disturbed the margin on transactions with the non-AE. Thus, application of TNMM is not as per the provisions of the Income-tax Act, 1961.

(*vi*) The export sale is also eligible for DEPB benefit and the Appellant has earned such export benefits to the tune of Rs. 2,18,78,013/- during the year. This income has been included under the head "Other Income". There is no manner of doubt that the export benefit is inextricably linked with the export sale. Therefore, while negotiating he price with the AE and for that matter with any other party, the Appellant has been taking into consideration the export benefits that would accrue to the Appellant on export of such goods. In other words, the Appellant may quote a lower price as it is already certain that export benefits will accrue. The only impact on the financial statements is that due to the accounting practice that the export benefit is grouped under other income when in real sense it is nothing but part of sales consideration. Hence, while calculating the margins, DEPB and other export benefits should be considered as part of total sales. It was submitted that incidentally the AO has considered the database of Welspun India Ltd. which holding around 50% shares in the Appellant company. The data of profit of Welspun India Ltd. includes DEPB. In support thereof we submit herewith audited statement of accounts of Welspun India Ltd. for the year ended 31-3-2005. Same is the case with other parties referred by the ld. AO. All these parties have considered DEPB as part of their turnover. In support it submitted herewith a Statement showing profit margin together with notes to accounts downloaded from Capitaline Databases. It is submitted that there can be comparision of like to like. It has also held by the Courts and the Tribunals in a number of cases that export benefits such as DEPB are chargeable to tax as business profits. If the export benefits are considered as part of sales then the profit margin of the company would be 12.30% and not 5.04% as worked out by the ld. AO A detailed Annexure of the working was submitted for the ld. AO vide letter dated 5-12-2008. Copy of the same is submitted.

(*vii*) As regard, computation of profit margin, the ld. AO has applied ratio of PBDIT/total expenditure of other terry towel manufacturing companies to the entire expenditure of the company i.e. Rs.30.12 crores. It was submitted that the total expenditure of Rs.30.12 crores includes expenditures incurred for sale of products to the non-AE and it amounts to disturbing the profit margins of transactions with the non-AE. The impact of the sales to the non-AE and its related expenditure needs to be eliminated to derive the correct ratio. The Appellant has worked out net profit margin attributable to sale of products to the AE is 13.50% which is comparable with the net margin of terry towels manufacturers at 13.05%. The ld. AO rejected this working for the reason that the Appellant has not maintained separate books of account for transactions with the AE and the non-AE. In this regard we would like to submit that there is no such requirement of maintaining separate books of account under the Transfer Pricing regulations.

(*viii*) Even otherwise, without prejudice to our contention in paragraph 1 & 2 above, even if the margin is computed for the Appellant as a whole, it works to 12.30% and not 5.04% considering DEPB benefits.

(*ix*) It was further submitted that comparison could be made between two concerns of the similar size in term of capital employed and volume of business i.e. like to like. The Appellant is a small size concern having turnover of around Rs. 32 crore whereas the ld. AO has considered the database of company having large turnover. The profit margin always depends on the size of the business activity. Large organizations earn more profit in comparison to small organization.

Even if one consider database of the similar concerns from the database considered by the ld. AO the result will be comparable with the result of the Appellant.

(*x*) In the past CUP method has been accepted by the Department and nothing has been bought on record by the ld. AO in deviation from the accepted method. The Courts have held time and again that normally the rule of consistency should prevail on the similar facts of the case unless there are strong reason for deviation. However, ld. AO could not assign any such reason for deviation.

(*xi*) In the course of the assessment proceedings your Appellant vide letter dated 30-11-2007 submitted Profit & loss account split into three categories i.e. (i) sales to AE, (ii) sales to Non-AE and (iii) sales in domestic market where the gross profit margin reveals 17%, 6% and 1% respectively. However, the ld. AO has ignored and brushed aside these information in violation of the principle of natural justice.

(*xii*) Attention was also invited to the recent ITAT, Pune Bench decision in the case of MSS India Pvt. Ltd. (ITA No. 393/PN/07). It was laid down by the bench in this decision that in a situation in which the revenue authorities seek to disturb the method of determining the arm's length price (ALP, as adopted by the assessee, it is necessary for them to demonstrate that, on the given facts of the case, a particular method will be more appropriate vis-à-vis the method adopted by the assessee and such an appropriateness of method must be shown on the touchstone of the factors set out in Rule 10C(2).

(*xiii*) Without prejudice to the above, it contended that the special provisions relating to the Transfer Pricing have been enacted with a view to provide a statutory frame work which can lead to computation of reasonable, fair and equitable profit and tax in India so that the profit 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 Indian tax revenue. It is submitted that in making the addition on account of arm's length price the ld. AO has considered the entire sales i.e. sales to AE (42.33%), sales to non-AEs (57.67%) and sales in domestic market (negligible) and estimated profit on arm's length price of the entire sales irrespective of fact that the sales is also made to non-AEs. It is submitted that the estimate of arm's length price could be made in respect of sales to AE only. Hence the addition made by the ld. AO is excessive and without any authority."

**11.** After considering the submissions made on behalf of the assessee as above as well as the relevant material available on record including the orders of the AO and TPO, the learned CIT(Appeals) held that although CUP was a direct and most reliable method for benchmarking, it required a high degree of comparability in respect of product. He held that although the products exported by the assessee company to its AEs and non AEs were comparable, the markets involved were geographically different. Accordingly, the learned CIT(Appeals) upheld the action of the AO/TPO in rejecting CUP method and applying TNMM for benchmarking for the following reasons given in paragraph No. 6.6 and 6.7 of his impugned order:

"6.6 The only non-AE is Wal Mart stores which is the worlds largest Retail chain. The Wal Mart stores are operated as a "pure" discount store. That is it busy in includible bulk, eliminating middlemen and working closely with suppliers to get every possible price break since the Wal Mart's guiding principle is "Low prices". It is because of the strategy it obtains huge volume discounts which makes its cost of goods low as it has to sell at the cheapest price. The appellant in order to access the large USA market has sold to Wal Mart at lower prices. Had the appellant sold to any other distributor in USA its price could have been considered as internal CUP. But since it has sold to Wal Mart directly whose business model is entirely different the same is not accepted as such. It is because of the reason that price charged to an Non-AE in comparison to its AE at Italy does not qualify as a CUP in this instance.

6.7 Further, there is a difference in the Geographical markets also. While the AE is in Italy while the Wal Mart is based in USA. The USA market is much bigger than an Italian Market. The differences on this account are difficult to adjust or impossible to make."

**12.** As regards TNMM, the learned CIT(Appeals) agreed with the AO/TPO that the distinction between a bathrobe and Terry towel as pointed out by the assessee was insignificant/tolerable and they should be taken as comparables being in the same towel market for the purpose of TNMM. Accordingly, he found the 11 comparables selected by the TPO as acceptable. He, however, noted that export benefits such as DEPB were considered as part of turnover of the said comparables while working out the profit margin. He, therefore, held that the DEPB benefit received by the assessee during the year under consideration should be considered as a part of its turnover for working out the profit margin to make the comparison of like to like and similar to similar. Since the profit margin of the assessee on such consideration was coming to 12.30% as against the average net profit margin of 13.05% of the comparables, the learned CIT(Appeals) held that no TP adjustment was required to be made in the case of the assessee. He also held that the average profit margin rate of Rs.13.05% in any case was wrongly applied by the AO to the entire operating cost of the assessee instead of the operating cost relatable to the international transaction. He also found that no TP adjustment was made in the case of the assessee for the earlier years by TPO/AO in the identical facts and circumstances. Accordingly, the addition made by way of TP adjustment was deleted by the learned CIT(Appeals). Aggrieved by the order of the learned CIT(Appeals) on this issue, the Revenue has raised its grievance in the present appeal filed before the Tribunal whereas the assessee has challenged the decision of the learned CIT(Appeals) upholding the action of the AO/TPO in rejecting the CUP method for benchmarking and applying TNMM.

**13.** As regards the issue raised in the assessee's appeal relating to adoption of most appropriate method for benchmarking, the learned counsel for the assessee submitted that the assessee is in the business of manufacture and export of bathrobes and during the year under consideration, export of bathrobes was made by it to AEs as well as to non AEs. He invited our attention to the details of such export placed at page No. 162 of his paper book to point out that 48% of the total export of bathrobes was to AEs while the balance 52% was to non AEs. He contended that bathrobe is an altogether different commercial product than towels and the authorities below are not justified to take the case of manufacturers of towels as comparables to the assessee for the purpose of TP study by adopting TNMM. He contended that when the same products were sold by the assessee to non AEs internal CUP was available and there was no justification in the action of the authorities below in rejecting the CUP method and adopting TNMM. He submitted that in assessee's own case for assessment year 2004-05, CUP method was accepted by the TPO himself and there being no change in the facts involved in the year under consideration, CUP should have been accepted as the most appropriate method. He submitted that no valid or cogent reasons were given by the TPO to justify the rejection of CUP method and the learned CIT(Appeals) was not justified in upholding the action of the TPO on this issue especially when he found that the products exported by the assessee company to its AEs and non AEs were comparable. Relying on the decision of Pune Bench of ITAT in the case of *Asstt. CIT* v. *MSS India (P.) Ltd.* [2009] 32 SOT 132, he contended that CUP is the most appropriate method and the rejection of CUP by the Revenue authorities in the present case is not justified either in law or on the facts of the case. Referring to the working given on page No. 104 of his paper book, he contended that if the CUP is accepted as most appropriate method, there is no case of any addition that is required to be made on account of TP adjustment.

**14.** In reply, the learned DR submitted that different kind of bathrobes were manufactured and exported by the assessee. In this regard, he filed the details available on the assessee's web-side to show that wide range of bathrobes are manufactured and exported by the assessee. He contended that if the bathrobes manufactured by the assessee are of different types, how their export to AEs and non AEs could be aggregated and average price could be compared as claimed by the assessee. Relying on Rule 10B(2)(d) of the I.T. Rules as well as the guidelines issued by the OECD in this context, he contended that in the absence of the availability of the exact comparable uncontrolled price of the similar products exported by the assessee company to its AEs and non AEs, CUP cannot be applied for a transfer pricing exercise as most appropriate method. He also read out and relied upon paragraph No. 6.5 of the CIT(Appeals)' impugned order and submitted that the reasons given therein by the learned CIT(Appeals) fully support the case of the Revenue that the case of the assessee is not a fit case to apply CUP for transfer pricing exercise. He contended that the issue relating to transfer pricing adjustment is a factual issue to which res judicata is not applicable and the same is to be decided independently in each year depending on the relevant facts and circumstances involved.

**15.** We have considered the rival submissions and also perused the relevant material on record. As regards the adoption of most appropriate method for benchmarking the international transactions with AEs in the assessee's case, it is observed that CUP no doubt is the most appropriate method for such benchmarking provided the comparable prices of similar products or almost similar products in case of uncontrolled transactions are available. The learned counsel for the assessee in this regard has contended that similar products as supplied to associated enterprises viz. bathrobes were also supplied by the assessee to non-AEs and, therefore, internal CUP was very much available. It is, however, observed that a wide variety of bathrobes were manufactured and exported by the assessee to AEs as well as non-AEs and the information obtained by the learned DR from the website of the assessee and placed on record before us shows that there were different types of bathrobes manufactured and exported by the assessee such as, Kimono, Hood, Shawl, Luxury, Hotels, Kids, Zipper etc. Even these products were further divided into sub types such as Kimono Piece Dyed and Kimono Piece Dyed Velour, Hood Piece Dyed and Hood Yam Dyed Ribbed, Hood with Embroidery and Kimono with Embroidery etc. In the comparable analysis done by applying CUP method, the assessee had not done the comparison between the price of each type of bathrobes but the average price of all the bathrobes supplied to the AEs and non-AEs was taken. In our opinion, such average price which is likely to be varied depending on the type of bathrobes supplied as well as product mix of different types of bathrobes cannot be taken as comparable uncontrolled price (CUP) for the purpose of transfer pricing exercise since the said price cannot be taken as price of the similar products supplied by the assessee to AEs and non-AEs. As already observed, such average price of bathrobes is likely to vary in a wide range depending on the type of bathrobes supplied and their product mix and in the absence of exact data made available by the assessee to compare the prices of similar products supplied to AEs and non-AEs, CUP cannot be applied as most appropriate method for the transfer pricing exercise. Moreover, there was also a difference in geographical location and size of the markets also in as much as the AEs of the assessee were in Italy whereas the non-AEs i.e. Wal Mart was based in USA having much bigger market than Italy. We, therefore, find no infirmity in the impugned order of the learned CIT(Appeals) confirming the action of the AO in rejecting the CUP method for benchmarking and applying the TNMM and upholding the same, we dismiss the appeal of the assessee.

**16.** As regards the issue raised in the Revenue's appeal challenging the relief allowed by the learned CIT(Appeals) by deleting the addition made by the AO by way of TP adjustment applying TNMM, the learned DR at the time of hearing before us has strongly relied on the order of the AO/TPO in support of Revenue's case. The learned counsel for the assessee, on the other hand, has relied on the order of the learned CIT(Appeals) submitting that the DEPB benefit was rightly considered by him for the purpose of working out the profit margin of the assessee for comparability analysis as the same was also taken into account in working out the profit margins of the comparable cases.

**17.** After considering the rival submissions and perusing the relevant material on record, it is observed that the DEPB benefit was not taken into consideration by the AO/TPO for the purpose of working out the profit margin of the assessee whereas such benefit was taken into account in the comparable cases while working out their profit margin as found by the learned CIT(Appeals). Before us, nothing has been brought on record to controvert or rebut this finding recorded by the learned CIT(Appeals) and this being so, we find no justifiable reason to interfere with the decision of the learned CIT(Appeals) that the DEPB benefit received during the year under consideration should be considered as part of the turnover of the assessee for working out the profit margin to make the comparison of like to like and similar to similar. Since the profit margin of the assessee after taking into consideration the DEPB benefit as part of its turnover comes to 12.30% as against the average net profit margin of 13.05% of the comparables which is within the safe limit of 5%, we find ourselves in agreement with the learned CIT(Appeals) that no TP adjustment in respect of transactions made with the associated enterprises was required to be made in the case of the assessee. We, therefore, uphold the impugned order of the learned CIT(Appeals) deleting the addition made by the AO by way of TP adjustment and dismiss the appeal of the Revenue.

**18.** In the result, the appeal of the Revenue and that of the assessee are dismissed.