IN THE ITAT MUMBAI BENCH 'K'

Petro Araldite (P.) Ltd.

v.

Deputy Commissioner of Income-tax -8(2), Mumbai*

R.S. SYAL, ACCOUNTANT MEMBER
AND VIVEK VARMA, JUDICIAL MEMBER
IT APPEAL NO. 6217 (MUM.) OF 2012
[ASSESSMENT YEAR 2008-09]
JANUARY 18, 2013

ORDER

R.S. Syal, Accountant Member - This appeal by the assessee arises out of the order passed by the AO under section 143(3) w.r.s. 144C(13) of the Income Tax Act, 1961 (the Act) on 21/8/2012 in relation to the A.Y. 2008-09.

2. First issue raised in this appeal through grounds No. 1,2,3,6 and 7 is against the inclusion and exclusion of certain cases in the final list of comparables for benchmarking the assessee's international transactions of imports and exports. Briefly stated, the facts of the case are that the **assessee is a concern engaged in the manufacture of `Specialty Chemicals'. Its main product is Epoxy Resins. It sources its raw material by imports and from Tamil Nadu Petroproducts Limited(TPL).** The assessee purchases Epichlorohydride and Caustic Soda as basic raw material from TPL. **The chemicals manufactured by it are used in the industries operating in Paints, Civil engineering applications, Structural composites, Electrical insulation material, Adhesive and Tooling material.** The AO made reference to Transfer Pricing Officer (TPO) for determination of Arm's Length Price (ALP) of the international transactions of the assessee. **The international transactions of the assessee comprised of Export of finished goods worth Rs.46.48 crores, Import of raw materials at Rs.3.06 crores and Payment for management services to the tune of Rs.3.11 crores. The assessee followed Transactional Net Margin Method (TNMM) to benchmark its international transactions in a composite way for all such transactions taken together. It adopted Profit Level Indicator (PLI) as Operating Profit / Sales which was shown at 4.20%.** The assessee selected the following four comparable cases to benchmark its international transactions : -

1. Dai- Ichi Karkaria Ltd.
2. Sunshield Chemicals Limited.
3. Indo-Nippon Chemicals Company Ltd.
4. Resinova Chemie Limited.

3. The TPO did not find any of the cases selected by the assessee as comparable for the reasons given in his order. Initially, he selected more number of comparable cases but finally shortlisted the following four cases for benchmarking :-

1. Atul Ltd.
2. IG Petrochemicals Ltd.
3. Micro Inks Ltd.
4. Pidilite Industries Ltd.

4. The TPO accepted the most appropriate method as TNMM as adopted by the assessee but proceeded with PLI as OP/Total Cost. The assessee has no objection to the adoption of PLI as OP/TC. **As the assessee's PLI of OP/TC at 2.70% was found by the TPO to be at a lower level when compared with the arithmetic average of OP/TC of the comparable cases chosen by him at 11.423%, he proposed an adjustment of Rs. 20,70,86,000/-.** The assessee raised certain objections before the Dispute Resolution Panel (DRP) against such adjustment, but without any success. Final order was passed by AO on 21.8.2012 making addition as proposed by the TPO.

5. In the present appeal, the assessee has assailed only on the aspect of selection of comparable cases on this issue. The ld. AR's objection in this regard as to the selection of comparable cases is two-fold. Firstly, **the assessee is aggrieved against the exclusion of two cases out of the list of four comparable cases given by it, namely, Dai- Ichi Karkaria Ltd. & Sunshield Chemicals Limited. Secondly, it is also not happy with the inclusion of two cases by the TPO, namely, Micro Inks Ltd. & Pidilite Industries Ltd.** In other words, the assessee has no objection to the exclusion of two cases claimed by it as comparable, namely, Indo-Nippon Chemicals Company Ltd & Resinova Chemie Limited; and also no objection to the inclusion of two cases, namely, Atul Ltd. & IG Petrochemicals Ltd, chosen by TPO for incorporating in the final list of comparables. The controversy is centered around the decision as to inclusion or exclusion of these four cases, which we will take up and deal with one by one.

i. Dai-Ichi Karkaria Ltd.(DIKL):

6. The assessee included this case in its list of comparables which was excluded by the TPO. **From the Transfer pricing study conducted by the assessee, a copy placed in the paper book, it can be seen that DIKL manufactures specialty chemicals used for imparting lubrication and antistatic properties to textile filaments and yarns.** It also set up a unit to manufacture certain bulk drugs omeprazole, menadione and calcium pentothenate. DIKL also had joint venture as project consultant for effluent treatment plants for increasing business. It can further be observed from the assessee TP study that during the year 1999-2000, DIKL also introduced eight new products in therapeutic areas of cardiovascular, anti-histaminics, analgesics, anxiolytic, anti-depressant and anticonsulgants. The **TPO ignored this case by observing that DIKL is engaged in the manufacture and sale of specialty chemicals primarily for the petroleum industry in India and its products include surface active agents, oil filled chemicals, Synthetic Polymers.** He noted the names of seven products with which DIKL is dealing in. It was found that **three of the products,** namely, Trimetazidine, Tramadolc and Carboprost **were functionally different. In view of such functional differences, he ordered for the exclusion of this case from the assessee's list of comparables.**

7. The ld. AR submitted that the case of DIKL ought not to have been excluded by the TPO because the **overall segment in which the assessee and DIKL are engaged in, is similar. He**

submitted that both assessee and DIKL are dealing with specialty chemicals industry and hence no distinction could have been justifiably made. On the other hand, the ld. DR supported the impugned order on the question of exclusion of this case.

8. Having heard the rival submissions and perused the relevant material on record, it is found that there is no dispute that DIKL is also partly engaged in manufacture of specialty chemicals, being, the same line in which the assessee is involved, apart from manufacturing bulk drugs and acting as project consultants. However, it is pertinent to mention that specialty chemicals have a variety of kinds with different ingredients, qualities, compositions and costs. Such different chemicals satisfy the needs of a range of industries as per their respective requirements. It can be noticed from the assessee's TP study that the **specialty chemicals manufactured by it are used in Paint industries, Civil engineering application, Structural composites, Electrical insulation material, Adhesive and Tooling material, whereas the specialty chemicals manufactured by DIKL are basically used in textile filaments and yarns.** We fail to appreciate as to how the specialty chemicals manufactured by the assessee can be said to be comparable with those manufactured by DIKL. **The chemicals manufactured by both the assessee and DIKL cater to the needs of altogether different types of industries**. The TPO discussed three products of DIKL, namely, Trimetazidine, Tramadolc and Carboprost tramethamine as different. No where any finding has been given that the other products of DIKL are similar to those manufactured by the assessee. We have noticed from the assessee's TP study that DIKL is engaged in manufacture of specialty chemicals which are used in the entirely different industries with no resemblance whatsoever to those which use the specialty chemicals manufactured by the assessee. Other than that, DIKL is also in manufacturing bulk drugs and project consultants. It is beyond our comprehension as to how this case can be considered as comparable with the assessee.

9. At this juncture it is relevant to note the criterion for selection of comparable cases. **The first and the foremost factor of relevance is the functional comparability. Once functional profile of two cases is found to be similar, then comes the question of examining the assets employed and risks undertaken by such functionally comparable cases. If the other case is functionally incomparable, that goes out of the reckoning at the very threshold. A case is said to be functionally comparable if it is in the same activity of business. If the activity of such case is by and large similar to the assessee's case with some minor exceptions here and there, then also we can include such a case in the list of comparables provided the incomparable part of the functional profile of the other case is not such so as to have damaging influence over its overall profit rate**. **But if the other case is largely different in the functional profile, but comparable part is minimal, such case can not be considered as comparable. The main factor to be taken into consideration is the comparability of two cases. It is no doubt true that the TNMM is tolerant to functional differences between two cases to some extent, but at the same time the broader functional dissimilarities cannot be overlooked in selecting comparables.** In view of the foregoing discussion, we are of the considered opinion the case of DIKL cannot be considered as a comparable one.

10. One more factor which needs to be accentuated is the selection of number of comparable cases. The most appropriate method for determining ALP in the extant case is admittedly TNMM. **Rule 10B(1)(e)(ii) provides that 'the net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction or a number of such transactions is computed having regard to the same base. Section 92C(2) provides that**

: 'The most appropriate method referred to in sub-section (1) shall be applied for determination of arm's length price, in the manner as may be prescribed'. First proviso to this provision provides : 'that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices'. These provisions make it amply manifest that the attempt should be to first find out a really comparable case and then in the alternative the endeavour should be to find out more than one comparable uncontrolled case, if these are available. There is no warrant in the relevant provisions that one must choose more than one case for benchmarking, even at the cost of comparability. If the number of comparable cases is more than one, then it is advisable to pick all such cases so as to iron out the peculiarities of a particular case. But when the number of comparable cases is limited to one or more, then no futile attempt should be made to find out even some incomparable cases with a view to swell the list of comparables and ultimately distort the profit rate of the really comparable case(s). The crux of the matter is that the comparability cannot be sacrificed at any cost at any stage.

11. Adverting to the facts of the instant case, it is seen that the ld. AR has fairly admitted that two cases chosen by the TPO, namely, Atul Ltd and IG Petrochemicals Ltd. are, in fact, comparable. When such comparable cases are available, then there is no need to attempt the inclusion of some other cases which are not at all or negligibly comparable. We, therefore, uphold the impugned order on the exclusion of DIKL from the eventual list of comparables.

ii. Sunshield Chemicals Ltd (SCL):

12. The second case which was included by the assessee but excluded by the TPO in the list of comparables is that of SCL. From the assessee's TP study it can be observed that SCL is engaged in manufacture of Specialty chemicals which find application in the industries like Agro-chemicals, fertilizers, paints, textiles and petroleum etc. The TPO ordered for the exclusion of this case on the ground that there was difference in the product profile of two companies. Both the sides opposed and supported the impugned order to their respective stands.

13. After considering the rival submissions and perusing the relevant material on record it is observed from the order of the TPO that SCL is basically engaged in manufacture of chemicals used in textiles, agrochemicals, mineral oils, coning oils, orchard, or tree spray oils, and THEIC, an EO based specialty surfactant, which is an additive used in insulation enamels, PVC stabilizers, and paints industry, as well as used as anti foaming agents for paints and lubricants and in metal treatment as cleaning and corrosion inhibitors. The company also provides aminic and phenolic antioxidants for additives, polymers, lube, plastics, rubber, latex, tyre, resins and other industries. The list of the chemicals manufactured by SCL, as given the TPO, is found to be quite exhaustive as against only a few items shown by the assessee in its TP study as being manufactured by SCL. The position so stated by the TPO has not been contraverted by the ld. AR. On the other hand, specialty chemicals manufactured by the assessee under the brand name of "Araldite" are meant for use in the industries such as paint, civil engineering application, structural composites, electrical insulation material, adhesives and tooling material. From several items which are used in the chemicals manufactured by SCL, we can find that the only common industry in using the chemicals manufactured by the assessee and SCL, is paint industry. When we view the wide range of industries using chemicals manufactured by SCL in contrast to the limited range of industries using the chemicals manufactured by assessee, it can be observed that

there is a predominant difference in the functional profiles. The ld. AR could not point out the percentage of specialty chemicals manufactured and sold by the assessee for use in paint industries and such percentage in the case of SCL to demonstrate that it constituted main business in both the cases. Considering the test laid down above for selection of comparable cases, viz., if the other case being largely different in the functional profile, but comparable part is minimal, such case can not be considered as comparable, we find no difficulty in upholding the impugned order in rightly excluding the case of SCL from the final list of comparables drawn by the TPO.

iii. Micro Ink Ltd. (MIL):

14. Now we espouse this case which was included by the TPO at his own in the list of comparables against which the assessee is aggrieved. The assessee vide its letter dated 5.9.2011 addressed to the TPO objected to the inclusion of this case by mentioning that MIL is a seamless ink manufacturing unit and is present across the value chain of the ink industries viz. Pigments, Flush Pigments, Wire enamels resins etc. The assessee also argued before the TPO that MIL has related party transactions at 52% of its net sales as against the assessee's related party transactions at less than 20% and hence the same should not be included. Not convinced, the TPO stuck to his view in including this case in the list of comparables.

15. After considering the rival submissions and perusing the relevant material on record, we find that the contention raised by ld. AR about the variation in percentage of related party transactions in the case of assessee and that of MIL, is not properly demonstrated from the material on record. It is pertinent to note that the assessee requested the TPO to consider all of its international transactions as one unit and apply TNMM on entity level to benchmark them. While calculating the percentage of Related party transaction at 52% in the case of MIL, what the assessee has done is that it computed percentage of all its international transactions of sale of goods and services, royalty, reimbursement of expenditure, gain/loss on exchange rate fluctuation, other expenditure and purchase of goods and service with only the total net sales. It is but natural that the contents of the numerator and denominator must be similar. Finding a percentage of all types of the related party transactions with only sales on entity level, has vitiated such calculation. As such, we are not inclined to accept the contention raised by ld. AR to reject the case of MIL on the question of variation in the percentage of related party transactions.

16. However, we find from the annual accounts of MIL that they are mainly engaged in the sale of inks and other intermediaries and are also in the business of manufacture of certain specialty chemicals. No bifurcation of profits on segmental level is available from such annual accounts of MIL. Since this party, apart from manufacturing some specialty chemicals, is also engaged in business of inks and earning processing income, the same cannot be compared with that of the assessee which is engaged in manufacture of specialty chemicals alone. It goes without saying that the comparison can be made with the comparables and not incomparables. As no segmental data of MIL dealing with the manufacture of specialty chemicals, more specifically which are manufactured by the assessee, is available, such a case cannot be included in the list of comparables. We, therefore, set aside the impugned order on this issue and order for the exclusion of this case from the list of comparables.

iv. Pidilite Industries Ltd. (PIL):

17. This case was included by the TPO in the list of comparables at his own. Relying on certain orders passed by various benches of the Tribunal, the ld. AR contended that **the extraordinary cases involving acquisitions, mergers or de-merger during the relevant period lose the tag of comparability**. Inviting our attention towards the annual accounts of PIL, the ld. AR submitted that the figures of PIL include the figures of the operations of the de-merged units of the VAM Manufacturing unit at Mahad of Vinyl Chemicals (India) Ltd. into the company, which scheme was sanctioned by the Hon'ble High Court of Judicature at Bombay in 2007. Similarly there was acquisition of Pulvitec do Brasil Industries by PIL which merged into the assessee company in the relevant year. In the light of these facts and the orders passed by various benches of the Tribunal, the ld. AR submitted that this case should not have been included by the TPO. On merits also, the ld. AR submitted that there were several distinguishing features in the facts of PIL vis-à-vis those of assessee company, which necessitated the exclusion of this case from the list of comparables. The ld. DR, except for relying on the impugned order, could not bring to our notice any contrary decision mandating the inclusion of the cases in which there are mergers and/or de-mergers etc. Further, on merits he stated that the facts of these two cases are similar.

18. Having heard the rival submissions and perused the relevant material on record, it is found as an admitted fact that there is acquisition and de-merger in the case of PIL during the year under consideration. **Hyderabad Bench of Tribunal in the case of *Capital IQ Information Systems (India) (P.) Ltd.* v. *Dy. CIT* [ITA No.6961/Hyd/2011 has held, vide its order dated 23.11.2012], that a company cannot be considered as a comparable because of exceptional final results due to mergers/de-mergers.** In reaching this conclusion, the Tribunal also relied on certain other cases holding accordingly. As the case of PIL has also acquisition and demergers during the relevant year, respectfully following the above precedents, we hold that the such a case cannot be included in the final list of comparables. In view of our this decision, there is no need to look into the comparability or otherwise of the factual aspects of this case with that of the assessee. This case is directed to be excluded from the eventual list of comparables.

19. Now we espouse the next objection of the ld. AR against the **making of transfer pricing adjustment on the entity level without restricting it to the transactions with the Associated Enterprises (AEs). The TPO applied the arithmetical mean of OP/TC of the comparables cases chosen by him on the total costs incurred by the assessee, that is, relating to transactions with the AEs and non-AEs.** The assessee objected to the same before the DRP by arguing that **transfer pricing adjustment should have been made only in respect of transaction with the AEs.** The DRP rejected the assessee's contention for want of any segregated figures made available by the assessee.

20. After considering the rival submissions and perusing relevant material on record it is seen that Chapter-X of the Act contains special provisions relating avoidance of tax. Section 92, which is the substantive section of Chapter, provides that : 'Any income arising from an international transaction shall be computed having regard to the arm's length price'. **The term "international transaction" has been defined in section 92B as " …. a transaction between two or more associated enterprises, either or both of whom are non-residents ……..". The term 'associated enterprise' has been defined in section 92A. A conjoint reading of these provisions divulges that the transfer pricing adjustment is required to be made only in respect of transactions between the AEs.** In the provisions as are applicable to the assessment year under consideration, it is wholly impermissible to apply such provisions in respect of transactions with non-AEs. We, therefore, overturn the impugned order on this score.

The assessee is directed to supply necessary figures for the purposes of the proper determination of this aspect of the matter.

21. To sum up, we hold that the cases of DIKL and SCL were rightly excluded by the TPO and the cases of MIL and PIL were erroneously included in the list of comparables. The impugned order is, therefore, set aside and it is directed to determine the arm's length margin afresh on the basis of the remaining two cases, namely, Atul Ltd. and IG Petrochemicals Ltd. It is further held that the scope of the transfer pricing adjustment should be restricted to the international transactions, which means, transaction between AEs alone and not non-AEs. The AO/TPO is further directed to give effect to the provisions of section 92C by making of + 5% adjustment, if permissible, in the fresh exercise to be done in compliance with our above directions. Needless to say, the assessee will be allowed a reasonable opportunity of being heard in such fresh determination of the ALP.

22. Next issue raised by the assessee through ground nos. 4 and 5 is against the disallowance of management service charges paid to the AEs claimed as deduction by the assessee to the tune of Rs.3,11,52,568/-. Briefly stated the facts of the issue are that the assessee procured services from its group companies, viz., Huntsman Advanced Materials (Switzerland) Gmbh (HAM) and Vantico AG for which it claimed deduction towards the payment of Rs.3,11,52,568/-. The TPO proposed adjustment for the equal amount of Rs.3.11 crores on the ground that the assessee could not produce any evidence to show as to whether any services were requested for; whether a written agreement existed for the services; when and how the services were actually received; at what rate similar services were available in the open market; if there was any duplication of services. This amount was finally added in the assessee's total income.

23. Before us ld. AR submitted that the assessee entered into an Agreement with HAM on 30.4.2003 for procuring services listed in Annexure-2 to the agreement as per page 90 of the paper book. Similarly another agreement was entered into between Vantico AG and the assessee on the same date i.e. 30.4.2003 for receiving services explained in Annexure-2 at page 102 of the paper book. The ld. AR explained that no such disallowance has ever been made in the past on account of payments made by the assessee under these two agreements. However, the ld. AR was fair enough to accept that this issue was not examined properly at the lower level and requested for restoration of this matter to the AO /TPO.

24. Per contra, the ld. DR submitted that sufficient opportunity was granted by the TPO to the assessee for satisfying him about the availing of any services and further whether payment was at ALP or not, which the assessee miserably failed to avail.

25. Having regard to the facts of the instant issue, we find that there can be no dispute that ALP of an international transaction in the nature of expense claimed can be computed at Nil, if the assessee fails to prove the factum of having availed any services from the AE. Even if the services are availed, the consideration paid has to be proved at ALP, failing which adjustment is inevitable. Adverting to the facts of the instant case, we find that the assessee claims to have availed such services in the past as well for which deduction was not denied. At the same time, it is equally essential on the part of the assessee to prove in the first instance that it, in fact, availed the services provided by its AEs in the current year and also that the payment is at ALP. As the assessee failed to substantiate its claim for deduction in this regard before the AO/TPO and it is further claimed that adequate opportunity was not provided by the concerned authorities, we are of the considered opinion that it will be in the fitness of the things if the impugned order on this

issue is set aside and the matter is restored to the file of AO/TPO for deciding this issue afresh as per law after allowing a reasonable opportunity of being heard to the assessee. While deciding this issue in the fresh proceedings, the assessee's other objections on this score shall also be dealt with.

26. Ground No.8 is against the addition under section 145A in connection with the value of closing stock. During the course of assessment proceedings it was observed by AO that the assessee was following 'exclusive method' of valuing the cost of its inventory by not increasing it with the amount of excise duty paid thereon, although as per section 145A purchases and inventories are required to be grossed up to include to duty element. That is how an addition of Rs. 1,25,91,360/- was made.

27. After considering the rival submissions and perusing the relevant material on record it is observed that section 145A came to be inserted by the Finance (No.2) Act, 1995 w.e.f. 1.4.1999 providing for the valuation of purchase and sale of goods and inventory in accordance with the method of accounting regularly employed by the assessee and further adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods to the place of its location and condition as on the date of valuation. Pursuant to insertion of section 145A it has now become mandatory to value inventory on 'inclusive' and not 'exclusive' method which was followed by the assessee. Under the section, not only purchase and sale of goods but also the inventory is required to be valued as inclusive of the amount of tax, duty or fee etc. Further, such duty is to be included not only in the value of closing stock but also the opening stock. The Hon'ble jurisdictional High Court in the case of *CIT* v. *Mahalaxmi Glass Works (P.) Ltd.* [2009] 318 ITR 116 (Bom) has held that where unutilized Modvat credit is adjusted in the closing stock, similar adjustment should also be made to the opening stock as well. The Hon'ble Delhi High Court in the case of *CIT* v. *Mahavir Alluminium Ltd.* [2008] 297 ITR 77/168 Taxman 27 has also canvassed similar view. Respectfully following the above precedents, we set aside the impugned order on this issue and direct the AO to decide it as per law. Needless to say, the assessee will be allowed a reasonable opportunity of being heard in this regard.

28. Ground No.9 about the addition under section 40(a)(ia) was not pressed by the ld. AR. The same is, therefore, dismissed.

29. The last effective ground about charging of interest under section 234B and 234C of the Act is consequential.

30. In the result, the appeal is partly allowed for statistical purposes.