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Hon'ble Delhi High Court holds Birlasoft's benchmarking of STP units at entity level, no functional difference in transactions

FACTS OF THE CASE

- Birlasoft Ltd is engaged in the business of software development and related services. The assessee has six units, which includes three units that have been set up under the Software Technology Park [STP] Scheme. Two of its units are located overseas – one in Singapore and the other in Australia.
- During AY 2004-05, the assessee had entered into international transactions with its Associated Enterprises [AE's] in USA & UK to provide software services, which were in the nature of developing and supplying customized software and related software services. Assesse used Transactional Net Margin Method [TNMM] as Most Appropriate Method [MAM] for benchmarking the captioned transaction with the ratio of Operating Profit (OP) to Total Cost [OP/TC] as the Profit Level Indicator [PLI]. It had computed the mean PLI of the comparable entities at 11.7% and its PLI at 13.86%.
- The return was picked up for scrutiny and matter was referred by Assessing Officer [AO] to Transfer Pricing Officer [TPO]. The TPO conducted its own studies and finalized a list of thirteen comparable entities and determined the mean PLI of the comparable entities at 14.01%.

- Post above, TPO conducted unit wise margin analysis by considering each STP as "Enterprise" as defined u/s 92F of the Income Tax Act, 1961 [the Act].The TPO found that the profit margin of the new unit (NOIDA-II unit) was 17.11% [Comparable PLI-14.01%] and therefore no transfer pricing adjustments were recommended in respect of the said unit. However, in respect of the other two units [NOIDA-I unit and Chennai unit], the PLI was lower and the TPO directed the transfer pricing adjustment of Rs. 4.96 Crs and AO incorporated the same among other adjustments. There was no dispute regarding the appropriateness of method and PLI used for benchmarking by assessee.

- **CIT(A):** Aggrieved by above, the assesee filed an appeal before CIT(A). CIT(A) rejected the TPO's unit-wise segmentation on the grounds that there were no significant functional differences between the STP units and accordingly deleted the adjustment holding entity level TNMM as MAM for benchmarking transactions with AE.

- **ITAT:** ITAT declined to interfere with CIT(A)'s order stating that TPO erred in ignoring the unity of the business, administrative control and unity of funds across three STPs.

ISSUES BEFORE THE HON'BLE DELHI HIGH COURT

- Whether the ITAT was right in setting aside the order of the AO on the question of transfer pricing on the following accounts:

  (a) Benchmarking was to be done separately and the profits had to be determined of the entity as a whole;

  (b) FAR analysis in respect of three units was not possible;

  (c) There were functional differences between the three units.

RULING OF THE HON'BLE DELHI HIGH COURT

- The Hon'ble HC found that the services rendered by all three STP units were functionally similar and governed by a single agreement with AEs. Also, there was interlacing of funds and unity of management in case of 3 STPs.

- Further, the Court observed that uncontrolled transactions margins at segmental level should be compared with controlled transaction margins at segmental level so as to draw a parallel comparison. However, the TPO benchmarked each of the three STP units separately and the profit margin of external uncontrolled transactions was determined at entity level and not on a unit or segmental level. Further, HC observed that it would be impermissible to use uncontrolled comparable transaction with different parameters than that of controlled international transactions.

- HC rejected the unit-wise approach, stating that it failed to consider the singularity of agreement, unity of operations, and the overall profit profile.

- HC emphasized that there were no substantial functional differences between the units, as all provided similar software development and maintenance services to the same AEs.
- HC upheld the assessee's contention that entity-level benchmarking under the TNMM was appropriate.

KEY TAKEAWAYS

- Delhi HC upheld that entity-level benchmarking shall be more appropriate as compared to undertaking wise benchmarking using TNMM when undertakings are functionally similar and governed by a single agreement.
- The judgement also highlights the importance of unified agreements and interlinked operations in transfer pricing assessments while applying entity level TNMM.

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