TP adjustments for not charging cost from AEs deleted as assessee had to settle transactions at cost-plus mark up

Summary – The Mumbai ITAT in a recent case of 3i Infotech Ltd., (the Assessee) held that where charging cost for employees seconded to foreign AE would erode tax base in India, no transfer pricing adjustment should be made if assessee had not charged for transfer of employees.

Fact 1

- The assessee-company incurred expenditure on development of software related to assessee's own business activity, which was claimed as revenue expenditure. Alternatively, assessee claimed that such expenditure be allowed as research and development expenditure.
- The Assessing Officer disallowed the expenditure and held it to be capital in nature.
- On appeal, the Commissioner (Appeals) affirmed the order of the Assessing Officer.
- On assessee's appeal:

Held on Fact 1

- The expenditure incurred by the assessee on development of software relates to assessee's own business activity of development of computer software and all processes thereon, assembling and recording of programmes on any tapes, disc, perforated media etc. The assessee-company develops and keeps ready best versions of software products and customizes it based on customers specific requirements. Though such expenditure is incurred mainly on account of salary, communication, electricity, printing and stationary, rent etc. but till the product is in the state of development, the amounts spent on development of software product is debited to capital work-in-progress in the books of account maintained by the company. Only in the year of commercialization, such expenditure is capitalized in the books of account under the head 'software products'. It is in these circumstances, it was held by the Tribunal that the Commissioner (Appeals) was right in treating the expenditure as capital expenditure. Therefore, keeping in view the facts and circumstances of the case it was held by the Tribunal in the case of present assessee that assessee would be entitled to depreciation in the year of capitalization. Therefore, according to the aforementioned order of the Tribunal the expenditure incurred by the assessee during the year under consideration which has been treated as work-in-progress, is held to be capital expenditure and depreciation is held to be allowable to the assessee only in the year of capitalization of such expenditure.
- On the alternative claim of the assessee regarding allowability of these expenditure as per section 35(1)(*iv*), respectfully following the decision of Tribunal in assessee's own case in *3i Infotech Ltd.* v. *Dy. CIT* [2011] 10 taxmann.com 86/129 ITD 422 (Mum), the same was rejected.

Fact 2

- On the basis of mutual agreement, the assessee had been providing back office support services to a bank in respect of its retail lending business. For providing such services the assessee had put in place adequate resources in the terms of office space, software, IT Infrastructure, manpower sources with technical skill, managerial and other skills required to handle such activity. However, with a view to exercise direct control over these activities and to reduce cost, the bank decided to carry on these activities independently. Therefore, the bank proposed to appoint senior personnel of the assessee, who was handling these activities on their rolls. In these circumstances it was mutually agreed between the assessee and the bank that the bank shall discontinue the arrangement being handled by the assessee. As the assessee had already put in place adequate resources to handle these activities, the bank agreed to pay a sum of Rs. 15.00 crores to the assessee as compensation for the loss of business/future earning/ transfer of knowledge.
- The aforementioned amount was treated as capital receipt by the assessee on the ground that after having pre-determined the contract with the bank, the assessee has given up one source of income completely for which the compensation had been received.
- The Assessing Officer did not accept such claim of the assessee and considered the said amount as revenue receipt. The main basis on which Assessing Officer held this issue against the assessee was that there was no transfer of any asset or business expertise or IPR or such item which is normally transferred when such type of business is transferred by one entity to another.
- On appeal, the Commissioner (Appeals) deleted the addition.
- On revenue's appeal.

Held on Fact 2

- The assessee was providing back office support services to ICICI bank in respect of retail lending business of a bank and was receiving payment as per agreement entered into by the assessee with the said bank. This was one off the activity of the assessee. In respect of termination of the said agreement the sum of Rs. 15.00 crores had been given to the assessee by the bank. The assessee had also parted with the personnel who were handling this activity of the assessee-company to give them on the role of the bank.
- Thus it was a case where the compensation had been received by the assessee on losing its right to receive income in respect of services being rendered by the assessee to the bank. In the facts and circumstances of the case it is a loss of source of income to the assessee and compensation has been determined on the basis of the said loss.
- It is the case of the revenue that the amount received by the assessee should be considered as income in the nature of revenue. It has been clearly observed by the Supreme Court in the case of *Kettlewell Bullen & Co. Ltd.* v. *CIT* [1964] 53 ITR 261 that it is irrelevant that the assessee continued

similar activity with the remaining agencies. So relevant criteria to decide such issue is that whether or not the assessee has lost one of its source of income.

- In the present case the assessee has lost its source of income with respect to its agreement entered into by it with the bank. It is also the case of the assessee that it never rendered such services to any other person right from the inception and there is no material on record to contradict such argument of the assessee.
- Therefore, if the facts of the present case are seen in the light of the two decisions of the Supreme Court namely *Kettlewell Bullen & Co. Ltd. (supra)* and *Oberoi Hotels (P.) Ltd.* v. *CIT* [1999] 236 ITR 903/103 Taxman 236 there is no infirmity in the order passed by the Commissioner (Appeals) on this issue, whereby it had been held that the compensation received by the assessee was in the nature of capital.