

**IN THE INCOME TAX APPELLATE TRIBUNAL “K” BENCH, MUMBAI
BEFORE SRI MAHAVIR SINGH, JM AND SRI RAJESH KUMAR, AM**

ITA No. 1/Mum/2013

(A.Y. 2008-09)

ITA No. 416/Mum/2015

(A.Y. 2009-10)

Affinity Global Advertising Pvt. Ltd. (Formerly known as Hostway Solutions Pvt. Ltd.) Plot No. 30AB, Govt. Industrial Estate, M.G. Road, Charkop, Kandivali (W), Mumbai-400 067	Vs.	The Income Tax Officer Ward 8(2)(1), Aayakar Bhavan, M.K. Marg, Mumbai-400 020
Appellant	..	Respondent
PAN No. AABCH6781K		

Assessee by : Girish Dave &
Kadambari Dave, ARs'

Revenue by : V Jenardhanan, DR

Date of hearing: 13-12-2017 **Date of pronouncement :** 20-12-2017

ORDER

PER MAHAVIR SINGH, JM:

These two appeals by the assessee are arising out of the different orders of Commissioner of Income Tax (Appeals)-15, Mumbai, [in short CIT(A)] in appeal No. CIT(A)-15/Arr. 229&101/12-13&14-15 dated 05-10-2012 & 30-10-2014. The Assessments were framed by the Income Tax Officer, Ward 8(2)(1), Mumbai (in short ITO) for the assessment years 2008-09, 2009-10 vide order dated 29-12-2011, 05-12-2011 under section 144C(3) read with section 143(3) of the Income Tax Act, 1961(hereinafter 'the Act').



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2. The only issue common issue in these two appeals of assessee is as regards to the orders of CIT(A) confirming the action of the AO in making upward adjustment to the total income of the assessee pertaining to Cost Plus Mark Up on the un-utilized capacity and assessee's plea was no Mark Up should be charged on the un-utilized capacity as no services were rendered for such unutilized portion. The assessee in ITA No. 1/Mum/2013 for AY 2008-09 has raised the following ground No. 1: -

"Ground 1: Objection against the upward adjustment of Rs. 22,81,140/- to the total income:

a. On the facts and in the circumstances of the case and in Law, the (earned Commissioner of Income Tax (Appeal) - 15 (hereinafter referred to as the CIT(A)) has erred in upholding the upward adjustment of Rs. 22,81,140/- to the total income of your appellant pertaining to mark-up on costs relating to the unutilized capacity in your appellant's office.

b. The appellant submits that the CIT(A) has failed to appreciate that no mark-up should be charged on the unutilized capacity as no services were rendered for such unutilized portion.

C. The appellant prays that the upward adjustment of Rs. 22,81,140/- pertaining to mark-up on unutilized capacity be deleted."

The grounds No. 2 and 3 raised by assessee are alternative grounds.

The assessee in ITA No. 416/Mum/2015 for AY 2009-10 has raised the following ground No. 1: -



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“Ground 1: Objection against the upward adjustment of Rs. 33,11,413/- to the total income:

a. The learned Commissioner of Income Tax (Appeal) —15 (hereinafter referred to as 'the CIT(A)') has erred in upholding the upward adjustment of Rs. 33,11,413/- to the total income of your appellant on the basis of the adjustment made by the learned Transfer Pricing Officer (hereinafter referred to as 'the TPO') in AY 2008-2009, without appreciating the fact that your appellant has not charged a mark-up on reimbursement amount of Rs. 1,32,45,650/- because these costs pertain to unutilized capacity in your appellant's office.

b. The appellant submits that the CIT (A) has failed to appreciate that no mark-up should be charged on the unutilized capacity as no services were rendered for such unutilized portion. Your appellant respectfully submits that your appellant charges mark-up on the expenses in connection to rendering of services and only reimburses those expenses on cost-to-cost basis towards which no portion of services are provided at all.

c. The appellant prays that the upward adjustment of Rs, 33, 11,413/- pertaining to mark-up on unutilized capacity be deleted.”

3. Similarly, in ITA No. 416/Mum/2015 for AY 2009-10, the assessee has raised following alternative ground Nos. 2 and 3: -

“Ground 2: Objection against the CIT(A) not having considered the notwithstanding argument of your appellant being at Arm's Length:



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a. Notwithstanding the above ground, and based on the facts and in the circumstances of the case and in the law, your appellant humbly submits that the learned CIT(A) has erred in not considering the notwithstanding argument of your appellant, that your appellant has earned an overall net profit margin more than the arithmetical mean of margins earned by comparable companies in spite of costs pertaining to unutilized capacity being reimbursed at cost. The learned CIT(A) has placed reliance on the previous years' TPO order but has not noted that the IPO has at no point challenged the margin calculations of comparable companies and hence is at Arm's Length.

b. Your appellant prays that the learned CIT(A) has erred in not understanding the spirit of the argument made by your appellant and has wrongly held that your appellant should not have reported recovery of costs as a separate international transaction if the appellant prays that its overall net profit margin is at Arm's length and has erroneously held that since the transaction has been reported separately, a separate mark-up needs to be applied.

C. Aggrieved by the non-consideration of the above notwithstanding plea, your appellant humbly prays that the upward adjustment to total income of Rs. 33,11,413/- be deleted as the overall net profit margin of your appellant is at Arm's Length.

Ground 3: Additional evidence being addendum to the agreement not taken on record by the learned CIT(A):



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a. Your appellant had submitted additional evidence being addendum to agreement vide letter dt. 14.10.2014 at appellate stage in order to further substantiate its claims. However, the additional evidence was not accepted by the Learned CIT (A).

b. Aggrieved by the non-consideration of the above notwithstanding plea, your appellant humbly prays to allow admission of additional evidence as it constitutes an integral and crucial part of assessment proceedings.”

4. At the outset, the learned Counsel for the assessee Shri Girish Dave and Ms Kadambari Dave referred to additional evidences filed on 01-06-2016 containing the following: -

“a. Memorandum of Association,

b. Addendum to customize software development and support agreement.”

5. According to the learned Counsel, these documents were filed during the preceding years 2009-10, where these documents were not admitted as additional evidences. According to him, these are vital for deciding the issue and he particularly referred to the addendum to the customize software development and support agreement between the assessee and its AE in USA. The learned Counsel for the assessee referred to Page 112 of assessee's paper book, whereby he pointed out to the vacant portion of 6th Floor, which is vacant and hence, no services were rendered by the assessee for which, the AO has applied cost plus markup of 25%. On the other hand, Ld SR DR relied on the orders of lower authorities.

6. We have heard rival contentions and gone through facts and circumstances of the case. The facts are that the assessee i.e. Hostway



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India has entered into an agreement' with Hostway Corporation Ltd ('Hostway US') and as per the terms of the agreement, it carried on the following activities:

a) IT enabled services developing customized software applications and

b) Provision of technical support services

Hostway India acts as a captive service provider and is compensated with a Cost plus 25% mark-up. Hostway USA had anticipated provision of certain additional services by Hostway India in the nature of 'web hosting services' and for that purpose predicted capacity requirements corresponding to the requirements of Hostway USA. Accordingly, the plans for the office of Hostway India were created and the same were duly approved by Hostway USA. Hostway India has a total installed capacity of 102 personnel as per the approved plans. This was explained by Ld Counsel Sh Dave by way of a floor plan attached vide letter dated 09.05.2011, which was filed before lower authorities. All the expenses are accordingly attributed over installed capacity in the office as per the floor plan. By the end of March 2008, the office was being used for the services mentioned above at approximately 90 percent of its installed capacity. The balance capacity meant for providing the proposed web hosting services remained unutilized for the reason that these services were not provided by assessee during these years. Certain indirect expenses were however incurred in relation to the entire installed capacity and such expenses were apportioned over the entire installed capacity. The expenses incurred for proportion of capacity utilization were recovered from Hostway USA at a cost plus mark-up of 25 percent. Balance unutilized portion was recovered at cost without applying the mark-up.



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7. Hostway India functions on a zero-risk model since it is a captive service provider for Hostway USA. Hostway India does not bear the burden of even a single rupee of cost on its own self for the reason that it performs all its functions based on the requirement of Hostway USA and all its expenses are incurred with the approval of Hostway USA. All costs incurred in relation to the unutilized capacity for functions performed are charged to Hostway USA at a cost plus 25 percent mark-up, and other indirect costs in relation to unutilized capacity are reimbursed by Hostway USA on a cost-to-cost basis. Considering no services were rendered for the unutilized portion, it is only prudent and appropriate that Hostway India passes on such costs to Hostway USA at cost. Further, the key consideration is whether the company incurring the expenses initially has performed any functions in relation to the same. Since no service has been rendered by Hostway India in relation to indirect expenses in proportion to unutilized capacity, no income will be deemed to accrue in the said transaction and the reimbursement without any mark-up is appropriate. In view of the same and having regard to the fact that the costs were reimbursed on a cost to cost basis, and all expenses were fully reimbursed by Hostway US, the international transaction in the nature of reimbursement of expenses is at arm's Length.

8. According to the assessee, the AO has erred in making an upward adjustment of Rs. 22,81,136/- to the total income of assessee on the basis of the adjustment stated by the TPO without appreciating the fact that assessee has not charged a mark-up on reimbursement amount of Rs. 91,24,560/- because these costs pertain to unutilized capacity in office of assessee. The TRO proposed a mark-up on such costs without considering the submissions of assessee. The CIT(A) also confirmed the action of AO/TPO.



9. These facts are undisputed. We find from the facts of the case that the total installed capacity of Hostway India was initially approved by Hostway USA and total Installed capacity took into consideration, the anticipated provision of certain additional services by assessee in the nature of 'web hosting services'. However for subject year under consideration, the 'web hosting services' were not provided by Hostway India at all and the space demarcated for such proposed services was not used for the proposed web hosting services and the same was eventually used by the assessee for the provision of its other regular services. Considering no services were rendered, for the unutilized portion, the assessee acted in a prudent manner by passing on such costs towards unutilized capacity to Hostway USA at cost. We find that the TPO considered and accepted in respect of total installed capacity and a portion of such installed capacity being unutilised but he specifically disputed that the mark-up should be charged on the expenses related to unitized portion of installed capacity. We find that the the TPO has specifically recorded that, *'The assessee has entered into an agreement with the AE was developing customized software applications in providing technical support and the AE. As per the agreement, the assessee is to receive 25% markup on cost. The cost Includes more direct and indirect employee, administrative and operational, commercial, legal and other expenses, liabilities, taxes and depreciation incurred by the taxpayer. Extraordinary expenses like preoperative expenses, loss on exchange, etc. are not considered in total cost.'*

10. But the TPO failed to understand that assessee's functions on a zero-risk model and since it is a captive service provider for Hostway USA, it does not bear any cost on its own self. Accordingly, all costs incurred in relation to the utilized capacity for functions performed have been charged to Hostway USA at a cost plus mark-up, and other costs In



relation to unutilized capacity are reimbursed by Hostway USA on a cost-to-cost basis.

11. We find that in such circumstances, the contention of assessee that all expenses in relation to unutilized capacity are at Arm's Length since they are reimbursed by Hostway USA on a cost-to-cost basis is supported by the decision of Delhi Tribunal in the case of ITO Vs. CRM Services India (P) Ltd (20110 48SOT 41(Del)), wherein it was held that when additional capacity was created at the behest of the parent company, only the expenditure should be reimbursed by parent company. The Tribunal in Para 8.1 of the order held as under:-

“8.1 This brings us to the alternative argument that the assessee is entitled to get adjustment in respect of capacity under-utilization. No objection has been raised by the Id. CIT, DR in this matter. As a matter of fact, he has fairly accepted the proposition that adjustment in this regard is required to be made. It is also clear from the report of the TPO that the assessee runs substantial risk of idle capacity. In view of the aforesaid admitted position, we may deal with the matter rather in a summary manner. Rule 10B(3) specifies that an uncontrolled transaction shall be comparable to an international transaction if -(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transaction is likely to materially affect the price or cost charged or paid in, or the profit arising from such transactions in the open market; or (ii) reasonably accurate adjustment can be made to eliminate the material effect of such differences. As is our experience, it is nearly impossible to get comparable cases with no difference at all. Therefore, the question of reasonable accurate adjustment arises in almost all cases. Both the parties agree that requisite adjustment may be made in the case of the



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assessee on this issue. This is in consonance with Rule 10B(3), as the agreed position pre-supposes that reasonably accurate adjustment can be made in respect of this matter. It may also be clarified that no such argument was taken before lower authorities. However, since the assessee is a defendant in this case, such a plea can be raised and the same will have to be dealt with while disposing off the appeal. Accordingly, it is held that transfer pricing adjustment is required to be made in respect of the rent, while working out the arm's length PLI. At the same time, it is also held that suitable adjustment has to be made to such PLI in respect of idle capacity. For this purpose, the matter is restored to the file of the AO. Thus, ground no. 1 is treated as partly allowed for statistical purposes."

12. In view of the above proposition and facts of the case, we are of the view that in the given scenario where no functions have been performed and no value has been added in relation to unutilised capacity, the assessee cannot be asked to add any markup for services which were never received by the assessee. But all this is to be verified by the AO viz a viz the additional evidences. Hence, in both the years, the issue is restored back and appeals of assessee are allowed for statistical purposes.

13. In the result, both the appeals of assessee are allowed in principle but matter is remanded to the file of AO for verification of additional evidences.

Order pronounced in the open court on 20-12-2017.

Sd/-
(RAJESH KUMAR)
ACCOUNTANT MEMBER
Mumbai, Dated: 20-12-2017
Sudip Sarkar /Sr.PS

Sd/-
(MAHAVIR SINGH)
JUDICIAL MEMBER



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Copy of the Order forwarded to:

1. The Appellant
2. The Respondent.
3. The CIT (A), Mumbai.
4. CIT
5. DR, ITAT, Mumbai
6. Guard file.
//True Copy//

BY ORDER,

Assistant Registrar
ITAT, MUMBAI