

Deduction under section 10A cannot be denied to a taxpayer unless an ‘arrangement’ as required under section 80-IA(10) is proved

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In brief

In a recent decision, the Income-tax Appellate Tribunal (the Tribunal) held that for invoking section 10(A)(7) of the Income-tax Act, 1961 (the Act) read with section 80-IA(10) of the Act, it was essential on the part of the tax officer (TO) to first demonstrate that the transaction between the taxpayer and another related person was ‘arranged’ with a view to yield more profit to the taxpayer carrying out eligible business.

In detail

Facts

- For assessment year (AY) 2009-10, the taxpayer M/s A.T. Kearney India Private Limited¹ claimed deduction of INR 82.2 million under section 10A of the Act from the export (eligible business) to overseas associated enterprises (AEs).
- During the assessment proceedings, on perusal of the transfer pricing (TP) study report², the TO alleged that the taxpayer and its AEs, owing to their close connection, had

arranged the course of business in such a manner as to yield more than ordinary profits in the eligible business of the taxpayer. Invoking the provisions of section 10A(7) of the Act read with section 80-IA(10) of the Act, the TO considered a profit margin of 20% of operating cost as reasonable as against the taxpayer’s margin of 101.19%.

- Accordingly, the TO reduced the eligible deduction under section 10A to INR 26.3 million from INR 82.2 million as originally claimed. On appeal, the Commissioner of Income-tax (Appeals) confirmed the TO’s order and denied relief to the taxpayer, following which the taxpayer preferred an appeal before the Tribunal.

Issues before the Tribunal

- Whether section 10(A)(7) read with section 80-IA(10) of the Act could be applied to a transaction between two enterprises, one of which was non-resident in India?
- Whether it was necessary to have ‘arranged course of business’ between related parties for invoking section 10A(7) read with section 80-IA(10) of the Act?
- Whether the proviso³ to section 80-IA(10) of the Act dispenses with the need to establish such ‘arrangement’?

¹ A.T. Kearney India Private Limited v. ACIT [TS-527-ITAT-2014(Delhi)]

² The arithmetic mean of the margin of comparables as per the TP study report was 16.22% as against the taxpayer’s margin of profit at 101.19%

³ Proviso inserted by the Finance Act, 2012 with effect from April 1, 2013 for enabling use of the arm’s length price for determining of reasonable profits of the eligible business in the case of the specified domestic transactions referred to in section 92BA of the Act.

Taxpayer's contentions

- The intention of section 80-IA(10) of the Act was to restrict manipulation of profits between two enterprises to avoid tax liability⁴ - which was only possible where both enterprises are resident in India. Where a non-resident was involved, the alleged manipulation in profits does not result in avoidance of taxes in India.
- Two conditions, 'close connection' and 'arranged', need to be cumulatively satisfied for invoking the provisions of section 10(7) read with section 80-IA(10) of the Act.
- Merely because extra-ordinary profit has been made, it would not lead to a conclusion that the business transaction was 'arranged' for the purpose of claiming higher deduction under section 10A of the Act⁵.
- The TP study report could not be the only basis for concluding that excess profit has been earned⁶. The TO had failed to demonstrate that higher profits in eligible business had resulted due to existence of an 'arrangement'.

⁴ Reliance was placed on paragraph 6.10 of Circular No. 308 dated 29.6.1981 - *intent behind the provision is to avoid abuse of the tax concession by manipulation of profits between associate concerns or different units of the same concern*

⁵ Reliance was placed on the Bombay High Court ruling in the case of *CIT v. Schmetz India Private Limited* [2012] 254 CTR 504 (Bombay).

⁶ Reliance was placed on the Chennai Tribunal ruling in the case of *M/s Visual Graphics Computing Services (India) Private Limited v. ACIT* [2012] 15 ITR(T) 393 (Chennai-Tribunal) and also the Hyderabad Tribunal in the case of *Zavata India Private Limited v. ITO* [2013] 141 ITD 456 (Hyderabad - Tribunal)

Revenue's contentions

- The essential requirement for invoking section 80-IA(10) of the Act was that a business transaction between the taxpayer (having eligible business) and 'any other person' who was closely connected to the taxpayer, should be arranged in such a manner to yield more than ordinary profits in the eligible business. The language of the section was clear; it nowhere specified that 'any other person' had to be resident in India.
- Reliance on the TP study was sufficient to conclude that excessive profits were on account of 'arrangement' between the taxpayer and its closely connected associate, specifically in light of the insertion of the proviso to section 80-IA(10) of the Act which stated that reasonable profits had to be determined with regard to the arm's length price basis of the TP study.

Tribunal's ruling:

On applicability of section 80-IA(10) of the Act where the closely connected enterprise is non-resident:

The provisions of section 80-IA(10) of the Act do not distinguish between a closely connected enterprise being a resident or otherwise. They are simply concerned with excessive increase in the profits of the taxpayer's eligible business.

On the necessity to have 'arranged' business terms between the enterprises leading to excessive profits to trigger off section 80-IA(10):

- Section 80-IA(10) of the Act was a deeming provision⁷ and had to be strictly construed. Unless in the first instance 'arrangement' or 'manipulation' was shown to exist, which had resulted in excessive profits of the eligible business, there could be no question of discarding the actual profit declared by the taxpayer and substituting it with a 'reasonable profit'.
- There could be various reasons resulting in increase in profits like increase in efficiency or reduction in cost. The TO could not simply treat high profits earned by the taxpayer as a reason to invoke section 80-IA(10), without demonstrating the existence of such specific 'arrangement' between the taxpayer and its AEs. 'Arrangement' needs to be the 'cause' and higher profit its 'effect' to trigger section 80-IA(10).

On proviso to section 80-IA(10) of the Act dispensing the need to establish such 'arrangement' by the TO:

- The Tribunal noted that the proviso was inserted w.e.f. April 1, 2013 and hence could not be applied for AY 2009-10, the year under consideration.
- Only profit from 'specified domestic transactions' were covered by the proviso for determination of reasonable profits on the basis of the

⁷ The Tribunal noted the following judicial pronouncements for this principle - *Supreme Court in CIT v. Amarchand N. Shroff* [1963] 48 ITR 59; *CIT v. Mother India Refrigeration Industries Private Limited* [1985] 155 ITR 711 (SC); and *Bombay High Court in CIT v. Ace Builders Private Limited* [2006] 281 ITR 210 (Bombay)

arm's length price. The crux of this proviso, thus, was that *where the course of business between two connected resident taxpayers was so arranged that the business transacted between them produced more than ordinary profits to the taxpayer carrying on the eligible business, the reasonableness of the profits so charged should be judged with reference to the arm's length price of such transaction.*

- The requirement of determination of 'arrangement' between the parties intending to move excessive profits to the eligible business needed to exist as a pre-requisite to invoke section 80-IA(10) of the Act, even after insertion of this proviso. Mere reliance on the TP study report did not determine that the taxpayer had earned excess profit.

The takeaway

- The ruling comes as a welcome relief for taxpayers who have been earning excessive profits compared to their peers. There could be various reasons for increased profits and thus, excessive profits cannot lead to an inference that the parties have 'coloured' arrangements in order to gain tax benefits.
- The decision further assumes paramount importance for its observations regarding insertion of the proviso to section 80-IA(10) of the Act. The language of the proviso clearly states that the arm's length price is to be used for determination of reasonable profits of the eligible business only with respect to specified domestic transactions. The meaning of this proviso cannot be extended to international transactions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Tax & Regulatory Services – Direct Taxes

Shyamal Mukherjee, Gurgaon
+91-124 330 6536
shyamal.mukherjee@in.pwc.com

Ketan Dalal, Mumbai
+91-22 6689 1422
ketan.dalal@in.pwc.com

Rahul Garg, Gurgaon
+91-124 330 6515
rahul.garg@in.pwc.com

Our Offices

Ahmedabad

President Plaza
1st Floor Plot No 36
Opp Muktidham Derasar
Thaltej Cross Road, SG Highway
Ahmedabad, Gujarat 380054
+91-79 3091 7000

Bangalore

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bangalore 560 008
Phone +91-80 4079 7000

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai 600 006
+91 44 4228 5000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th
Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Andhra Pradesh
Phone +91-40 44246000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata - 700 091, West Bengal
+91-033 2357 9101/
4400 1111

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road(Station Road),
Bandra (West), Mumbai - 400 050
+91-22 6689 1000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City, Gurgaon
Haryana -122002
+91-124 330 6000

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006+91-20
4100 4444

For more information

Contact us at
pwctr.knowledgemanagement@in.pwc.com

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