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No Transfer Pricing adjustment if the exempt income is lower than the income determined in accordance with the arm's length principle

In brief

In a recent order in the case of Motif India Infotech Private Limited¹ (Motif), the Ahmedabad bench of the Income-tax Appellate Tribunal (the Tribunal) has ruled that no transfer pricing adjustment is required to be made to the exempt income since the exempt income declared is lesser than the income determined in accordance with the arm's length principle. The Tribunal based its ruling on the

premise that there is no erosion of the tax base and hence, no adjustment is necessitated.

Furthermore, the Tribunal held that where the international transactions entered into by a taxpayer give rise to an exempt income, the provisions contained in the Indian Transfer Pricing Regulations (ITPR) would need to be applied to ensure that the profits claimed as exempt by the taxpayer are not in excess of the profit determined in accordance with the arm's length price (ALP).

¹ Motif India Infotech Private Limited v. ACIT [TS-88-ITAT-2014(Ahd)-TP]

Facts

- Motif operated as an offshore business process outsourcing service provider rendering services to its associated enterprises (AEs).
- Motif had claimed deduction under section 10A of the Income-tax Act, 1961 (the Act) in its return of income for AY 2006-07.
- Motif's case for the said assessment year was referred to the Transfer Pricing Officer (TPO) by the Tax Officer (TO).
- During the course of the transfer pricing assessment proceedings, Motif contended that the ITPR did not apply to it since it was enjoying a tax holiday under section 10A of the Act. Reliance in this regard was placed on the ruling given by the Bangalore Bench of the Income-tax Appellate Tribunal in the case of Philips Software Centre (P.) Ltd.²
- The TPO rejected the taxpayer's contention citing the provisions of section 92C(4) of the Act. The TPO held that the margin earned by the taxpayer (i.e. 17.89%) was lower than that of comparable companies (i.e. 34.26%), and hence proposed a Transfer Pricing (TP) adjustment for the difference in the margins.
- The TO passed the draft assessment order incorporating the adjustment proposed by the TPO.
- Motif filed its objections against the draft assessment order before the Dispute Resolution Panel (DRP). The DRP rejected the contentions of Motif and passed directions upholding the TP adjustment.

- Aggrieved with the DRP's directions, Motif preferred an appeal before the Tribunal.

Tribunal ruling

- There was no specific provision contained in the Act which provided that the ITPR were not applicable where the income is exempt under section 10A of the Act.
- In a situation where the income from an international transaction was exempt from tax in India, it could not be alleged that the taxpayer had arranged its affairs in a manner so as to show lesser taxable income in India. However, it could be alleged that the taxpayer has arranged its affairs in a manner so as to reflect more exempt income in India.
- A harmonious reading of the provisions contained in section 92C(4) of the Act and the CBDT Circular No. 14/2001 indicated that in a case where international transactions entered into by a taxpayer resulted in income which was exempt from tax in India, the ITPR had to be applied to ensure that no excess exempt income was disclosed by the taxpayer and the deduction under section 10A was allowed only to the extent of profit computed in accordance with the arm's length principle.
- On the basis of the above, the Tribunal held that in the instant case, the taxpayer had declared lesser exempt income, and no taxable base in India was eroded since it earned a lesser margin *vis-a-vis* the comparable companies. Hence, no transfer pricing adjustment needed to be made in the instant case.

² Philips Software Centre (P.) Ltd. v. ACIT [2008] 26 SOT 226 (Bang-Trib)

PwC observations

- This ruling seems to differ from the previous judicial precedents on this issue. The Tribunal has ruled that in the case of a taxpayer having an exempt income (by virtue of enjoying a tax holiday), the provisions of ITPR would be applicable to determine whether any excess exempt income has been disclosed by the taxpayer, on which the tax holiday should be denied. However, where such a taxpayer's transfer price is less than the ALP resulting in lesser profits (i.e. excess exempt income is not declared), then no TP adjustment needs to be made on the difference, since there is no erosion of the tax base in India.
- The above interpretation would however result in rendering the specific provisions contained in section 92C(4) redundant. The language of section 92C(4) is clear that no deduction shall be allowed with respect to the income enhanced on account of determination of ALP under the TP provisions. When the language of section 92C(4) is very clear, there ought not be any need to interpret the provision of section 92C(4) by looking at the intent of the legislation to introduce TP provisions.
- Furthermore, the provisions under section 80-IA(8) and 80-IA(10) of the Act seek to ensure that there is no excess income which is claimed as deductible under the tax holiday provisions by the taxpayer. It seems that the Tribunal has not taken cognizance of the aforesaid provisions while commenting that the TP provisions would help in ascertaining if the taxpayer has claimed any excess exempt income.
- The observation of the Tribunal in this ruling seems to suggest that in the case of a taxpayer enjoying a tax holiday, the profit determined in accordance with the ALP should be assumed to be the ordinary profit for computing the exemption. In this regard it would be pertinent to note that Tribunals in

various cases have held that the ALP as determined under the ITPR cannot be equated with the term, 'ordinary profits' and consequently deduction under section 10A of the Act cannot be restricted to the arm's length profit determined by the TPO.³

- In view of the above, this ruling by the Tribunal may have a far-reaching impact and could result in TOs placing reliance thereon for disallowing profits earned by taxpayers enjoying a tax holiday in cases where the exempt profit declared exceeds the profit computed in accordance with the ALP determined by the TPO. Taxpayers having tax holiday units need to consider the impact of this ruling, especially where the eligible profit for a tax holiday is more than the profit determined in accordance with the ALP.

³ Visual Graphics Computing Services (India) Pvt. Ltd. v. ACIT [TS-274-ITAT-2012 (Chny)]; Weston Knowledge Systems & Solutions India Pvt. Ltd. v. ITO [TS -269-ITAT-2012 (Hyd)]; Tweezerman (India) Pvt. Ltd. v. ACIT [2010] 133 TTJ 308 (Chennai-Trib)

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