

# ***Tribunal holds that formative conditions for claiming deduction by SEZ units to be examined only in first year of claim***

March 8, 2018

## ***In brief***

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal) has held in the taxpayer's case<sup>1</sup> that formative conditions for claiming deduction under section 10AA could be examined only in the first year of claim. If deduction has been allowed in the first year of claim, it could not be withdrawn in subsequent assessment years (AYs).

## ***In detail***

### ***Facts***

- The taxpayer was engaged in the business of providing back office support services to its associated enterprises and was operating from two separate units (EOU and SEZ unit) during the AY 2013-14. The taxpayer claimed deduction under section 10AA of the Act for the SEZ unit.
- During assessment proceedings the tax officer (TO) noted that the taxpayer had been claiming deduction under section 10B/ 10A in the past for its EOU unit and the last year of deduction for the EOU unit was AY 2011-12.
- The TO also noted that the operations of the SEZ unit had commenced during financial year (FY) 2010-11,

and accordingly, the taxpayer claimed deduction under section 10AA of the Act from AY 2011-12 onwards.

- The TO held that the SEZ unit was formed by splitting-up and reconstructing the existing EOU unit, and therefore, disallowed the deduction claimed under section 10AA of the Act.

### ***Issues before the Tribunal***

- i. Whether the taxpayer had complied with the conditions prescribed for claiming deduction under section 10AA of the Act?
- ii. Whether the deduction of profits under section 10AA of the Act could be withdrawn in the third year, once the claim had been accepted in the first and second year of deduction?

### ***Revenue's contentions***

- The SEZ unit was formed with the intent of shifting business from the EOU to the SEZ unit, as the period for claiming deduction under section 10B was reached.
- The taxpayer failed to submit copies of the agreement with customers to substantiate how the agreements in both units were different in terms of nature of business and content of the agreement.
- The growth in the EOU business was -3% and 7% in FYs 2011-12 and 2012-13, respectively, against growth in the SEZ business of 1166% and 33%, respectively. The growth in employee hiring of the EOU unit was -16% and 5% in FYs 2011-12 and 2012-13,

<sup>1</sup> ITA No. 6794/ Del/ 2017

respectively, against 370% and 21% for the SEZ unit.

- Based on the above, the SEZ unit was formed after splitting up and diversion of existing business from the EOU unit. In view of the provisions of section 10AA, there was splitting and diversion of existing business from the EOU unit to the SEZ unit, and therefore, deduction under section 10AA was disallowed.

#### ***Taxpayer's contention***

- AY 2013-14 was not the first year of operations of SEZ unit nor was it the first year of claim of deduction under section 10AA.
- The issue whether the SEZ unit was created by splitting up or restructuring the business could only be examined in the first year of claim of deduction and not in the third year.
- The expansion of business through a new and integrated undertaking does not tantamount to splitting up or reconstruction of the existing business. A new undertaking that satisfied the following conditions could not be said to have been formed by splitting

up or reconstruction of an existing business:

- Separate and distinct identity of the new undertaking;
  - Fresh investment in the undertaking;
  - Employment of requisite manpower therein;
  - Manufacture of articles or rendering of services from such undertaking; and
  - Earning of profits clearly attributable to said undertaking.
- The SEZ unit was established with new investment after seeking approval from the SEZ Authority and had its own assets and employees.
  - There was consistent growth in revenue of the EOU unit also, since the inception of the SEZ unit.
  - The taxpayer had complied with the conditions mentioned in circular 14/ 2014 for hiring of new employees.

#### ***Tribunal's ruling***

- Following the ratio laid down in various judgements<sup>2</sup>, the Tribunal held that once the eligibility of deduction under

section 10AA of the Act has been accepted in the first year of claim, it could not be withdrawn in subsequent years for a breach of conditions that were required to be seen in the first year of claim.

- Even on merits, the Tribunal held that the taxpayer had not violated any of the conditions prescribed in section 10AA on account of the following:
  - There had been a substantial increase in the revenue of the EOU unit even after setting up the SEZ unit.
  - The taxpayer had continued to make additions to the fixed assets in the SEZ unit.
  - The majority of employees in the SEZ unit were new hires.

#### ***The takeaway***

The formative conditions provided under section 10AA of the Act are to be examined in the year of formation.

#### ***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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<sup>2</sup> CIT v. Heartland Delhi Transcription Services Private Limited [2014] 270 CTR 373 (Delhi), CIT v. Western Outdoor Interactive (P) Limited [2012] 349 ITR 309

(Bombay), CIT v. Tata Communication Internet Services Limited [2012] 251 CTR 290 (Delhi),

CIT v. Arts & Crafts Exports [2012] 22 taxmann.com 53 (Bombay), CIT v. Macbrou Engineering (P) Limited [2014] 52 taxmann.com 219 (Bombay)

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