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Extraordinary profits does not necessarily imply that business transacted was 'arranged' so as to result in high profits

In brief

Schmetz India Pvt. Ltd.[1] (the taxpayer) claimed deduction under section 10A of the Income-tax Act, 1961 (the Act), which was restricted by the assessing officer (AO), who contended that the taxpayer had earned more than ordinary profits from exports to its holding company. The Mumbai High Court (HC) agreed with the conclusion of the Income-tax Appellate Tribunal (the Tribunal) and decided the case in favor of the taxpayer. In doing so, the HC laid down the principle that extraordinary profits earned by a tax holiday unit from transaction/s with closely connected person/s cannot lead to the conclusion that there is an 'arrangement' between the parties. Further, if an arrangement is alleged by Revenue, then it has to be proved.

Facts

The taxpayer is a subsidiary of a German company and operates two divisions in India. One of the divisions is in Kandla in the Kandla Free Trade Zone and is engaged in the manufacture and export of industrial sewing machine needles. This division exports its entire production to its holding company in Germany. In respect of this division, the taxpayer claimed 100% deduction under section 10A of the Act.

[1] CIT *v.* Schmetz India Pvt. Ltd. [TS-702-HC-2012 (Bom)]

During the course of assessment proceedings, the AO concluded that the Kandla division had earned abnormal profits and this view was strengthened by the fact that the other division had shown a loss. The taxpayer submitted various commercial reasons to explain why profits of the Kandla division were high. However, the AO invoked the provisions of section 10A(7) of the Act read with section 80IA(10) of the Act and recomputed the profits of the taxpayer. Section 80IA(10) of the Act reads as follows[2]:

"Where it appears to the assessing officer that, owing to the ***close connection*** *between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of* ***business between them is so arranged that*** *the* ***business transacted*** *between them* ***produces*** *to the assessee* ***more than the ordinary profits*** *which might be expected to arise in such eligible business, the assessing officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom."*

The Commissioner of Income-tax Appeals (CIT(A)) upheld the AO's approach. Aggrieved, the taxpayer appealed before the Tribunal, which ruled in favor of the taxpayer.

Tribunal ruling

The Tribunal held as follows:

- Just because the taxpayer earns extraordinary profits, it would not lead to the conclusion that business was organised/arranged. This would penalise efficient working of the unit.

- The AO has not proved that there was any arrangement between the parties so as to result in extraordinary profits.

- Since the entire production of the taxpayer was sold to its associated enterprise (AE), it did not have any expenses of marketing, etc. This resulted in reduced cost of operation, and thus higher profits.

High Court ruling

Aggrieved by the Tribunal's ruling, the Revenue appealed to the HC. The HC held as follows:

- The Tribunal correctly held that extraordinary profits cannot lead to the conclusion that there is an arrangement between the parties. This would penalise efficient functioning.

- The authorities also recorded a finding that the industrial sewing machine needles imported and traded by the other division are different from those manufactured and exported by the Kandla division. Consequently, this also negates any arrangement between the parties to show extraordinary profits in respect of its Kandla division so as to claim deduction under Section 10A of the Act. These are findings of fact, and the Revenue had not been able to show that the findings are perverse or arbitrary.

Therefore, in the circumstances, substantial questions of law do not arise in the present facts.

PwC observations

1. The HC has picked on a very pertinent aspect of section 80-IA(10) of the Act and has held that even if it appears to the AO that a taxpayer has earned more than ordinary profits, it does not automatically imply that business has been 'arranged' in a manner so as to result in such profits. In fact, it is the other way

[2] Prior to amendments introduced by the Finance Act, 2012.

round, whereby the AO is required to prove that there is an 'arrangement' which has led to 'more than ordinary profits'.

2. Having said that, if we were to now consider what constitutes 'more than ordinary profits', then in the current date, the recent amendments introduced by the Finance Act, 2012 become pertinent. These amendments have made the existing transfer pricing regulations applicable to determination of profits from transactions of tax holiday units with closely connected person/s. In this regard, the following proviso has been inserted in section 80-IA(10) of the Act by the Finance Act, 2012.

   "*Provided that in case the aforesaid arrangement involves a specified domestic transaction referred to in section 92BA, the amount of profits from such transaction shall be determined* ***having regard to arm's length price*** *as defined in clause (ii) of section 92F of the Act .*"

   As per the proviso, profits from transactions of tax holiday units with closely connected person/s are to be determined 'having regard to arm's length price'. As per the transfer pricing regulations, computation of arm's length price leads us to the concept of 'arithmetic mean' with a very narrow tolerance band. Therefore, as a corollary, profits from transactions of tax holiday units with closely connected person/s would need to be determined 'having regard to' the 'arithmetic mean' with a very narrow tolerance band.

   A safe interpretation of the terminology 'having regard to' would be that it does not imply 'shall be taken to be' or 'shall be equal to'. In fact, a liberal interpretation could be to construe 'having regard to' to mean a 'range' beyond the permitted tolerance band. The taxpayers certainly hope that such a liberal interpretation is adopted by tax authorities which would provide the much needed flexibility not currently offered by the arithmetic mean concept.

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