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Managing Director's remuneration should be allocated between tax holiday units; implications under domestic transfer pricing provisions need to be considered

In brief

In a recent ruling in the case of Nahar Spinning Mills Ltd.[1] (assessee or company), the Chandigarh Bench of the Income-tax Appellant Tribunal ruled against the assessee and held that the remuneration paid to the managing director is a common expenditure**.** Accordingly**,** it should be allocated between the non-tax holiday units and the tax holiday units to determine the eligible profits under section 10B of the Income-tax Act, 1961 (the Act).

Background

- The assessee company is engaged in the manufacturing and trading of different kinds of yarn, hosiery goods and knitted cloth.
- During assessment year (AY) 2007-08, out of the nine different units, the assessee claimed deduction under section 10B of the Act for two units (referred to as 'tax holiday units' or 'eligible units').
- The managing director's (MD) remuneration was debited to the main unit and no part of this expense was allocated to the tax holiday units.

[1] Nahar Spinning Mills Ltd. *v.* JCIT [TS-622-ITAT-2012(Chandi)]

- The assessing officer (AO) held that the assessee has claimed higher deduction by not allocating the MD's remuneration and recomputed the tax holiday profits.

- The Commissioner of Income-tax (Appeals) upheld the order of the AO.

Assessee's contentions

- The assessee was claiming tax holiday for several years and no such re-allocation was made in any earlier year.

- The assessee had maintained separate books of account for each unit.

- Sections 80-IA(8) and 80-IA(10) of the Act were not applicable to the present case.

Tribunal ruling

- Sections 80-IA(8) and 80-IA(10) of the Act are not applicable in the present case.

- Section 80-IA(8) of the Act applies where goods and services held for the purpose of eligible business are transferred to any other business carried on by the assessee (or *vice versa*). In the assessee's case, goods and services have not been transferred between the units of the assessee and accordingly section 80-IA(8) of the Act should not apply.

- Section 80-IA(10) of the Act refers to the close connection between the assessee carrying on eligible business and any other person. Accordingly, a transaction of re-allocation of the MD's remuneration from one unit of the assessee to another is not covered under section 80-IA (10) of the Act.

- However, under the provisions of section 10B, all expenditure relating to the eligible unit should be deducted for computing the eligible profits derived from the undertaking. Thus, the remuneration paid to the MD, being a common expenditure, should be allocated to the eligible units for computing the tax holiday profits.

PwC observations

The above ruling suggests that the allocation of common expenditure to tax holidays units, to the extent that this does not qualify as 'provision of services', is not covered under Section 80-IA(8) of the Act.

Consequently, while taxpayers would need to adopt a scientific approach to determine the allocation of common expenses and to maintain documentation supporting them, such transactions may not be covered under the recently introduced specified domestic transaction provisions and resulting compliance.

In such cases, taxpayers are recommended to develop and maintain the following documents which would help them in defending the allocation:

- an appropriate cost allocation policy;
- a description of the nature of costs and an explanation as to why these do not qualify as "provision of services".

The above approach will help taxpayers address the implications of the onerous compliance requirements enforced through the domestic transfer pricing provisions.

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