Existence of arrangement which results in more than ordinary profits is necessary to invoke section 80IA(10)

Facts

Zydus Nycomed Healthcare Pvt. Ltd.[1] (the taxpayer, formerly known as Zydus Altana Healthcare Pvt. Ltd.) is a joint venture company (50% held by Atlanta Pharma AG, Germany and 50% by Cadila Health Cab Ltd., India). The taxpayer has claimed deduction under section 10B of the Income-tax Act, 1961 (the Act) in respect of profits on exports to Atlanta Pharma AG, Germany (APAG), one of the JV partners. There was no dispute on 'eligibility to deduction' or on APAG having a 'close connection'.

The Tax Officer (TO) invoked the provisions of section 80-IA(10) of the Act, and held that profits earned by the taxpayer were more than ordinary for all the years under consideration (i.e., AY 2003-04, AY 2004-05 and AY 2005-06) when compared to the first year of the eligible business, viz. AY 2002-03 (considered to be 'normal profits' by the TO). The basis of his conclusion was essentially a comparative analysis of the ratio between total turnover and cost of sales for these years. Certain supplementary analyses were also undertaken by the TO to support his conclusion. The TO disallowed the taxpayer's claim in respect of what he computed as more than ordinary profits. The adjustment made by the TO was deleted by the Commissioner of Income-tax(Appeal) [CIT(A)]. Aggrieved, the Revenue appealed before the Income-tax Appellate Tribunal (the Tribunal).

Tribunal Ruling

1. To invoke provisions of section 80IA(10) of the Act, the TO is required to show that profits shown by the taxpayer for all three years under consideration were actually more than ordinary profits, and that such extraordinary profits were the result of the course of eligible business having been so arranged between the concerned parties so as to produce such extraordinary profits for the taxpayer.

2. It is pertinent to note that in this case, APAG was a JV partner in the taxpayer having 50% share only and it is difficult to comprehend as to how and why it will enter into any sort of arrangement to allow the taxpayer to make more than ordinary profits at its own cost, knowing that the benefit of such arrangement as a result of any excess profit could be shared by it only to the extent of 50%, and the balance 50% would go to the other JV partner. Further, in the case of Digital Equipment

India Ltd.[2], cited by the taxpayer, it had also been held that mere substantial profit by itself would not give rise to a conclusion that there could be any such arrangement to produce more than the ordinary profits to the taxpayer from eligible business.

3. The ratio of total turnover and cost of sales worked out by the TO was not a proper profit level indicator (PLI), because the figure of net profit was not considered at all in the working; and the entire cost of sales was taken into consideration, including expenses that were not variable in nature. A comparison using this ratio would have led to misleading results. Instead, net profit and gross profit rates were the proper PLIs to be considered for comparison.

4. Computation of gross profit for AY 2002-03, AY 2003-04, AY 2004-05 and AY 2005-06 shows that the gross profit has increased by an increasing percentage in each of the three years under consideration, as compared to the gross profit of AY 2002-03. The reasons for this increase were: (i) increase in capacity utilisation over the years; (ii) decrease in depreciation cost as a percentage of sales; (iii) reduction in cost of raw material as a percentage of sales due to reduction in price of one of the major raw materials; and (iv) appreciation of the Euro *vis-a-vis* INR, which led to increased sales realisation. Therefore, the increase in gross profit rate for the years under consideration as compared to AY 2002-03, which was taken by the TO as the year of ordinary profits, was properly explained by the taxpayer based on relevant facts and figures. Therefore, the CIT(A) was justified in holding that the taxpayer's profits for the years under consideration could not be regarded as more than ordinary.

PwC Observations

1. A critical takeaway emanating from this ruling is that to invoke provisions of section 80IA(10) of the Act, it is not only necessary for profits to be high, but there must also exist an arrangement between the concerned parties which results in more than ordinary profits. Impliedly, there should first be an arrangement which leads to more than ordinary profits, and then the need would arise to evaluate whether or not those profits were in fact 'more than ordinary'. Further, the onus to prove both these conditions lies with the tax authorities.

2. What is considered to be 'more than ordinary' profits by tax authorities, may in reality be a result of genuine business and commercial reasons. If so, taxpayers, at their end, should maintain documentation to explain the rationale for high profits, as was successfully done and accepted in the instant case.

3. To ascertain what would qualify as 'more than ordinary', taxpayers would expect a more liberal interpretation. Rather than using a singular benchmark to determine what is 'ordinary', it would certainly be more reasonable to use a range. In fact, the terminology used in section 80IA(10) of the Act and also in its proviso, which was introduced to cover specified domestic transactions[3], may support such an approach.

    - Notably, the terminology used in section 80IA(10) of the Act and in its proviso is 'ordinary profits' or 'profits' (in plural) rather than just 'ordinary profit' or 'profit' (in singular), thereby implying the use of a 'range' rather than a single reference point. This interpretation, if adopted, would hold good for both, international transactions and specified domestic transactions (SDT).

    - In addition, for SDT in particular, a safe interpretation of the phrase 'having regard to' [used in the proviso to section 80IA(10) of the Act] would be that it does not imply 'taken to be' or 'equal to'. In fact, a liberal interpretation could be to construe 'having regard to' to mean a 'range' beyond the permitted tolerance band.

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.

[1] [ITA No. 4343/Mum/2009 (AY 2003-04), ITA No. 4013/Mum/2008 (AY 2004-05), ITA No. 4206/Mum/2009 (AY 2005-06), TS-553-ITAT-2013(Mum)]

[2] [2006] 103 TTJ 359 (Bang.)

[3] The text of section 80IA(10) and its proviso is as follows:

*"Where it appears to the Tax 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 profit**s** which might be expected to arise in such eligible business, the Tax Officer shall, in computing the profit**s** and gains of such eligible business for the purposes of the deduction under this section, take the amount of profit**s** as may be reasonably deemed to have been derived therefrom:*

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

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