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TAX TRIBUNAL (SPECIAL BENCH) UPHOLDS APPLICABILITY OF TRANSFER PRICING PROVISIONS ON ENTITY ELIGIBLE FOR TAX EXEMPTION

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Introduction

In a recent ruling in *Doshi Accounting Services Pvt. Ltd v/s DCIT, (ITA No. 1352/Ahd/2011, 1285/Ahd/2012 and 1822/Ahd/2014)*, (Ruling), a special bench of the Income Tax Appellate Tribunal, Ahmedabad (Special Bench), has ruled that the transfer pricing provisions (TP provisions) would apply to an entity claiming tax exemption/holiday under Section 10A of the Income-tax Act, 1961 (IT Act). The Special Bench held that even if a taxpayer is eligible for tax exemption, the arm's length price (ALP) for transactions undertaken by the taxpayer has to be determined in accordance with the TP provisions under the IT Act.

Background

Doshi Accounting Services Pvt. Ltd (Taxpayer) was engaged in the activity of 'Business Process Outsourcing' (BPO) services in the field of accounting and taxation. Mr Dhiren Doshi who was majority shareholder of the Taxpayer, was also the sole proprietor of the firm M/s Doshi & Co, an entity established in the United Kingdom (UK), which was an Associated Enterprise (AE) of the Taxpayer under the Indian TP provisions.

During the year under consideration, the Taxpayer provided services to its AE from its unit located in Baroda that was eligible for tax exemption/tax holiday under Section 10A of the IT Act (Section 10A provides a profit linked deduction to undertakings located in Free Trade Zones subject to certain conditions)

The Taxpayer benchmarked its transactions with its AE by applying the internal Comparable Uncontrolled Price (CUP) a method prescribed under the transfer pricing rules and arrived at a conclusion that transactions with its AE were at arm's length.

During the course of its transfer pricing assessment proceedings, Transfer Pricing Officer (TPO) disagreed with CUP method adopted by Taxpayer and held that the CUP method required high degree of comparability such as the volume, credit terms, timing and geographical areas of services etc. and thus, is not the most appropriate method in the present case. The TPO, thus, considered Transactional Net Margin Method (TNMM) to be the most appropriate method and made ALP adjustment to the Taxpayer's income.

Being aggrieved, the Taxpayer challenged this before the Ahmedabad bench of the Income Tax Appellate Tribunal (Ahmedabad Bench), where the Taxpayer took a plea for the first time that since it was already eligible for tax exemption and that income

was not actually chargeable to tax in India, there cannot be any motive to shift the profit outside India, thus, TP provisions were not applicable to the transactions between the Taxpayer and its AE. Since different benches of the Income Tax Appellate Tribunal had taken contradictory views on this plea of Taxpayer, a Special Bench was formed by Ahmedabad Bench to adjudicate on the following question of law:

“Whether or not the TP provisions can be invoked in a situation in which ‘income’ of the assessee is eligible for tax exemption or tax holiday and thus not actually chargeable to tax in India, or in a situation in which there cannot be any motive in manipulating the prices at which international transactions have been entered into with AE?”

Judgment

The Special Bench held as follows with respect to the applicability of the TP provisions to income which is not taxable in India:

- ***Re Taxpayer’s argument that there is no motive or objective to shift profits outside India and purposive interpretation should be used for interpreting TP provisions:***

The Taxpayer argued that the fundamental object to introduce the TP provisions was to ensure that India’s tax base should not erode or profits taxable in India should not be shifted to other tax jurisdiction. In the present situation where there is no motive or object to shift the taxable profits, there is no requirement to determine ALP of the transactions because the very object of introducing the TP provisions would frustrate. The Taxpayer also contended that reasonable construction must be followed, and a literal construction of provisions of law should be avoided if it defeats the object and purpose of the Act.

The Special Bench observed that the purpose behind the TP provisions was to determine true profits/income as if such transaction had been entered into with an unrelated party, irrespective of the fact that the income of the Taxpayer was eligible for exemption. The Special Bench observed that the language used in the TP provisions is clear, unambiguous and does not lead to any absurd meaning and thus, reiterated that if the language used in the statute is clear and free from ambiguity, the object or intention of the legislature should not be used as an aid of interpretation while interpreting the provisions. The Special Bench further observed that if the purpose or object of the TP provisions are defeated, then, it is for the legislature, to reconstruct the law as per the required object. The Special Bench accordingly held that principles of purposive or object-based rules of interpretation should not apply in the present case.

The Special Bench further stated that even on purposive interpretation of the TP provisions, it cannot be said that the TP provisions should not apply to the Taxpayer claiming tax exemption under the IT Act. In this regard, the Special Bench observed that:

- Proviso to Section 92C(4) of the IT Act prohibits tax exemption on the income that has been enhanced on account of adjustment of ALP (provision prohibiting tax exemption benefit) and accordingly reflects the intent of the lawmaker that TP provisions will apply to all cases of ‘international transactions’ including the income qualified for tax exemption.
- TP provisions and provisions of Section 10A of the IT Act cannot be read in isolation and this is reflected by the provision prohibiting tax exemption benefit.

- Spirit behind introducing Section 10A of the IT Act was to bring foreign exchange in India and granting tax exemption was an incidental objective. Any amount that is not in accordance with ALP will adversely affect inflow of foreign exchange in India and thus object of inserting Section 10A would stand unaccomplished.
- Indian AE could have manipulated transaction price and transferred sum outside India which otherwise could have been distributed as dividend and thus could have escaped from the liability of payment of dividend distribution tax. Thus, lawmakers were very much aware of such possibility of manipulation while inserting the provision prohibiting tax exemption benefit.

➤ **Re Taxpayer's argument that 'income' is sine qua non for applying TP provisions:**

The Taxpayer contended that 'income' is sine qua non to apply the TP provisions and once the 'income' is eligible for 100% tax holiday under Section 10A, artificial income cannot be taxed by applying machinery provisions of transfer pricing.

The Special Bench observed that there is a difference between 'income' and 'total income' as defined under the IT Act. The word used in TP provision is 'income' and not 'exempted income'. The Special Bench stated that any gain accruing from any activity will first be construed as 'income,' and after that, due to the applicability of any particular provision under the IT Act, it may get qualified as 'exempted income' as in the case in hand, i.e. due to Section 10A of the IT Act. Therefore, even when the income of the Taxpayer is exempted under Section 10A of the Act, it will fall within the definition of 'income' under the IT Act irrespective of the fact that the income accrued by the Taxpayer from export of services is exempted on account of provisions of the IT Act.

➤ **Re Taxpayer's argument that there was no reason to shift profits outside India:**

The Taxpayer argued that the tax rates in the UK are higher than the tax rate in India, thus there was no reason for the Taxpayer to shift its profit to a foreign country having higher tax rate than India. The Special Bench rejected this argument and noted that tax laws in India cannot be subjected to tax laws of a foreign country. In order to maintain harmony and to avoid double taxation, India has already entered into Double Taxation Avoidance Agreement (DTAA) with various countries.

➤ **Re Taxpayer's argument that the provisions of Section 10A should be given preference over TP provisions:**

The Taxpayer further argued that since neither Section 10A nor TP provisions start with a non-obstante clause exhibiting the overriding effect given to any of the provisions, provisions of Section 10A being substantive provisions and also a machinery provisions should override the TP provisions. The Special Bench rejected this contention and held that although Section 10A is a self-contained code, it is limited for computing the deduction from the income of the eligible tax holiday unit. TP provisions do not obstruct the manner of the computation of deduction under Section 10A of the Act, but provide the mechanism to determine the true ALP qua the sale price of the concerned 'international transaction'.

Comments

Applicability of TP provisions in cases where there is no income chargeable to tax in India (by virtue of some exemption/beneficial provisions in the IT Act or by virtue of beneficial provisions of applicable tax treaty) has been a contentious issue. The taxpayers have consistently argued for non-applicability of TP provisions in cases where there is no income, while the tax authorities have maintained that TP provisions

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should apply to any income that arises in an 'international transaction'. The fundamental requirement for application of TP provisions is that any 'income' should arise in respect of an 'international transaction'. The Special Bench has applied this principle in this Ruling.

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