DELHI HIGH COURT CLARIFIES THE LAW RELATING TO ELIGIBILITY OF 10A DEDUCTION AND LAYS DOWN IMPORTANT GUIDELINES FOR TRANSFER PRICING BENCHMARKING

The Delhi High Court, in the recent ruling of ***Birlasoft Ltd.,***[1] while dismissing the appeal the Revenue challenging the order passed by the Income-tax Appellate Tribunal ('ITAT') for assessment year ('AY') 2004-05, has clarified and explained the legal position with regard to important corporate tax and transfer pricing issues under the Income-tax Act, 1961 ('the Act'). The issue-wise analysis of the detailed judgment passed by the High Court is outlined as under:

(1) ISSUE I: Eligibility of deduction under section 10A in respect of STP Unit

The principal dispute before the High Court related to the eligibility of a new STP unit set-up by the assessee for the purposes of claiming deduction under section 10A of the Act.

It was the case of the assessing officer/ Revenue that the said unit in respect of which deduction under section 10A was claimed, was a mere extension of the existing (eligible) unit of the assessee, and was thus, not eligible to the benefit of section 10A of the Act, by virtue of the embargo under clauses (ii) and (iii) of sub-section (2) thereof, since:

(i) The new unit in respect of which deduction was claimed was engaged in the same line of business as the existing eligible unit(s);

(ii) The new unit was located in the very same building, where the existing eligible unit of the assessee was operating from;

(iii) Since the tax holiday of the existing eligible unit was due to lapse in 2005, the assessee had set-up a so-called new unit merely to claim additional benefit of deduction under section 10A starting from AY 2002-03.

On the other hand, it was the assertion of the assessee, which came to be accepted by the first appellate authority as well as the ITAT [and remained factually undisputed by the Revenue], that the said new unit was set-up in furtherance of the aggressive business plan of the assessee to grow its business; the assessee, in the course of setting-up the said new unit had made significant investment for creation of a new facility, which has resulted in doubling of the gross block of assets; additionally, in order to set-up the said unit, the assessee had obtained a separate space on long-term lease; furthermore, due to setting-up of the new unit, the total seating capacity of the STP units of the assessee had more than doubled, and as a result, the turnover of the new unit was multiple times that of the existing STP unit.

The **High Court,** while taking note of and affirming the aforesaid factual aspects recorded by the first appellate authority as well as the ITAT, negatived the contentions of the Revenue, outlining the following important legal principles:

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[1] ***CIT vs. Birlasoft Ltd.*** **2024: DHC: 9318-DB**

(a) First and foremost, the High Court took note of the undisputed factual matrix and the circumstances relating to the setting-up and operation of the new unit to conclude, on facts, that the Revenue had been unable to establish that the said unit/ undertaking has been formed by shifting the business from an existing STP unit at the far end of the tax holiday period, solely for the purpose of continuing to avail the benefit of section 10A;

(b) The High Court clarified that, it does not flow from the language of section 10A, nor is it imperative that in order to be eligible for deduction under the said provision, the new "undertaking" must be engaged in a different field of business;

(c) The High Court, applying the tests enunciated by earlier judicial pronouncements,[2] i.e., *whether the new unit is a new and identifiable undertaking separate and distinct form the existing business*, concluded that the new unit set-up by the assessee, was a separate and distinct undertaking eligible for deduction under section 10A in its own right in terms of the Apex Court ruling in *Yokagawa*;[3]

(d) Lastly, the High Court clarified that the issue relating to the assessee's eligibility for deduction under section 10A is required to be examined and agitated in the "initial year of operation" – thus, once the Revenue accepts, in the initial year of operation, that a new undertaking has been set-up, which does not fall within the exclusion under section 10A(2), the controversy must, following the rule of consistency and certainty in matter of taxation, rest for future years as well in the absence of any change in circumstances or new fact coming to light.

(2) ISSUE II: Transfer Pricing benchmarking of international transaction relating to provision of Software Development Services

On the Transfer Pricing front, the dispute before the High Court related to the determination of the appropriate methodology for benchmarking the international transactions of the assessee, i.e., whether the arm's length analysis is required to be undertaken considering the net profit margin at "entity-level" or separately for each of the STP units of the assessee.

It was the argument of the Revenue that the international transaction(s) relating to provision of Software Development Services by the assessee to its associated enterprises ('AEs'), was required to be benchmarked separately in respect of each of the (3) STP units, being separate international transactions; conversely, it was the assertion of the assessee, which came to be accepted by the first appellate authority and the ITAT, that the aforesaid international transaction(s) ought to be clubbed, and benchmarked considering net profit margin at entity-level since:

(i) There was no significant functional difference in the software services rendered by the different STP units;

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[2] *Textile Machinery Corporation Ltd. vs. CIT* [1977] 107 ITR 195 (SC); *Bajaj Tempo Ltd. vs. CIT* [1992] 196 ITR 188 (SC); *CIT vs. Indian Aluminium Co. Ltd.* [1973] 88 ITR 257 (Cal)

[3] *CIT vs. Yokogawa India Ltd.* [2017] 391 ITR 274 (SC)

(ii) The services were rendered by each of the STP units to the very same AEs;

(iii) The terms and conditions for the provision of services was governed by a single / common agreement between the assessee and its AEs;

(iv) There was interlacing of funds and unity of management in respect of operation of the different STP units, due to which independent functional analysis of each unit was not practical;

(v) Lastly, the Revenue, while advocating for unit-wise benchmarking of the international transaction(s) of the assessee, had itself computed arm's length price applying entity-level comparability results.

The **High Court,** while upholding the exercise of "entity-level" benchmarking of the international transactions relating to provision of Software Development Services by the assessee [through its STP units] to its AEs, as contended by the assessee and accepted by the first appellate authority as well as the ITAT, clarified the law on the subject, outlining the following important principles:

(a) First and foremost, placing reliance on the UN Transfer Pricing Manual, 2021, the High Court emphasised the importance of abiding by the "arm's length principle" to ensure that transactions between unrelated entities are benchmarked under comparable circumstances after making appropriate adjustments to correct deviations in functionality, etc.;

(b) The High Court, placing reliance on the observations made in the ruling of *Sony Ericsson,*[4] clarified that although the phraseology of section 92B employs the expression in singular, reference to an international transaction would include multiple inter-liked transactions for the purposes of benchmarking under Rule 10A(d) of the Income-tax Rules, 1962 ('the Rules');

(c) Most crucially, the High Court, taking note of the distinction in phraseology employed under clause (iii) of section 92F of the Act vis-à-vis clause (aa) of Rule 10A of the Rules, opined that the term "enterprise" bears different meanings in respect of international transactions as opposed to specified domestic transactions – in respect of the former, the term "enterprise" has been defined under clause (iii) of section 92F to mean "a person", which is required to be construed in the context of the charging provision of section 4, and is thus required to be understood as a taxable entity; consequently, while a 'unit' or an 'undertaking' of a person may fall within the meaning of "enterprise" for the purposes of specified domestic transactions, the same does not hold true for the purpose of computation of arm's length price of an international transaction, wherein the term "enterprise" is required to be construed as a "person", i.e., a taxable entity or the company as defined under section 2(31);

(d) In terms of the aforesaid position, the expression "net profit margin" realised by an "enterprise" for the purposes of applying Transactional Net Margin Method under Rule

[4] *Sony Ericsson Mobile Communication India Pvt. Ltd. vs. CIT* [2015] 374 ITR 118 (Del)

10B(1)(e) of the Rules, net profit margins earned from international transactions required to be considered are those of the "enterprise" and not of any sub-unit or division thereof;

(e) The High Court, however, also clarified that in certain cases, viz., where different international transactions entered into by an enterprise may not be similar or connected, it would be possible to benchmark such transactions considering 'net profit margin' earned by the 'enterprise' at "segmental level" subject to availability of data, allocation of common costs on scientific basis and the possibility of making reasonably accurate adjustments to account for deviations in comparability – however, while undertaking such segmental analysis, it is imperative to ensure that uncontrolled transactions are determined/ adjusted to have the same parameters as controlled/ tested transactions.

After enunciating the aforesaid principles, the High Court, in the facts of the given case, concluded that the international transaction of provision of Software Development Services by the assessee [through its STP units] to its AEs, ought to be benchmarked considering net profit margin at "entity-level", and not split between the respective units.

VA Comments

The decision rendered by the High Court is an important development in clarifying the legal position and settling the controversy with regard to the grant of tax holiday benefit under sections 10A/B of the Act; additionally, the High Court has also clarified the legal position and laid down important guiding principles for undertaking Transfer Pricing benchmarking analysis for the taxpayers and the Transfer Pricing Officers.

The matter was successfully represented by **Mr. Neeraj K Jain, Mr. Aniket D. Agrawal, and Mr. Abhisek Singhvi,** Advocates.

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