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# EY Tax Alert

Delhi High Court rules on allocation of expenses between tax holiday qualifying unit and other units



## Executive summary

This Tax Alert summarizes a recent decision of Delhi High Court (HC) in case of CIT v. S.T. Micro Electronics Pvt. Ltd. (Taxpayer) [2011-TIOL-449-HC-DEL-IT] in which the issue before the HC was allocation of expenses between unit enjoying tax holiday and other units. The Taxpayer, engaged in software export business, had allocated the direct expenses on actual basis and allocated common expenses on the basis of ratio of head-count of employees working in respective units. The Tax Authority sought to adopt hybrid criteria of actual expenditure, turnover ratio and employee head-count ratio for both direct as well as common expenses to reduce the quantum of profits eligible for tax holiday by allocating higher expenses to unit enjoying tax holiday. Upholding the allocation made by the Taxpayer, the HC held that direct expenses need to be considered on actual basis and the employee head-count ratio adopted by the Taxpayer for allocating common expenses, being a reasonable and conservative method in the Taxpayer's facts, could not be disturbed by the Tax Authority.

## Background and facts

- ▶ The Taxpayer had two units, viz.,
  - ▶ 100% export oriented unit (EQU) at Noida, engaged in export of software (Software division) eligible for tax holiday; and
  - ▶ Service & Maintenance (S&M) division which was not eligible for any tax holiday.
- ▶ For the year under reference, the turnover of Software division was 97.55% of the total

turnover of the Taxpayer and the proportion of employees working in that division was marginally higher at 98.35% of the total employees.

- ▶ Comparative basis of allocation of expenditure between the two units adopted by the Taxpayer and the Tax Authority were as follows:

Nature of expense	Taxpayer's basis of allocation	Tax Authority's basis of allocation
Direct expenses <sup>[1]</sup>	Actuals	Hybrid basis of actuals, turnover ratio or head-count ratio to different items of expenses comprising both direct and common expenses
Common expenses	Head-count ratio	

- ▶ By changing the basis of allocation of expenses between the two units, the Tax Authority reduced the quantum of deduction of profits from Software division eligible for tax holiday as claimed by the Taxpayer.
- ▶ The Taxpayer appealed to the first appellate authority who upheld the Taxpayer's allocation of expenses.
- ▶ On further appeal by the Tax Authority, the Tribunal confirmed the first appellate authority's decision and accepted the Taxpayer's basis for allocation of common expenses.

[1] Salaries, Provident Fund contribution, Staff welfare, Hire charges, Travelling etc.

- ▶ The Tax Authority preferred further appeal before the Delhi HC.

## HC's ruling

The Delhi HC ruled in favour of the Taxpayer by holding as follows:

- ▶ The Taxpayer was right in its approach of apportioning only common expenses on the basis of the head-count ratio. The direct expenses cannot be allocated and need to be considered on the basis of actuals.
- ▶ In the Taxpayer's facts, the head-count ratio (98.35%) adopted by the Taxpayer resulted in a conservative allocation of expenses between the two units as compared to the turnover ratio (97.55%). Had the Taxpayer adopted the turnover ratio, the allocation in favour of S&M division would have been higher and the Taxpayer could have claimed higher tax deduction in respect of the profits of Software division. Since the Taxpayer had itself adopted a conservative ratio, there was no need to disturb the allocation in this case by applying hybrid criteria of different methods.
- ▶ In case of common expenses, reasonable and conservative system would be more appropriate than a hybrid criteria of different methods.

## Comments

In the absence of specific rules, the allocation of expenses between units qualifying for tax holiday and other units of a taxpayer is an issue where there could be disagreement between taxpayers and the Tax Authority. The issue has relevance to the determination of correct profits eligible for tax incentives either in the form of income-linked deduction or investment-linked deduction. The present HC ruling provides guidance that expenses of a direct nature cannot be apportioned. Furthermore, with reference to common expenses, if a reasonable method is applied by the Taxpayer, it should be accepted by the Tax Authority.

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