IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX APPEAL NO.502 OF 2015

Pragati Aroma Oil Distillers Private Ltd.
(formerly known as M/s. Hindustan
Essential Oil Company)
A company incorporated under
The Companies Act, 1956
Having its office at R. No.6, 2nd Floor,
Anand, Bhanva, 17, Babu Genu Road,
Mumbai-400021 … Appellant

Versus

The Deputy Commissioner of
Income Tax-14(2)
Having his office at
Room No.302, 3rd Floor,
Earnest House,
Nariman Point, Mumbai-400 021 …. Respondent

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Adv. Naresh Jain a/w Adv. Mansvi Singh, Adv. Priyanshi Jain and Adv. Bhavesh Bhatia, for the appellant.
Adv. Sushma Nagaraj (through VC) a/w Adv. Abhinav Palshikar, for the respondent.

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CORAM : M. S. KARNIK &
S. M. MODAK, JJ.

DATE : 23rd APRIL, 2026

JUDGMENT (PER M. S. KARNIK, J.) :

1. This is an appeal filed under Section 260A of the Income Tax Act, 1961 ("the IT Act", for short), preferred by the appellant-

assessee challenging the order dated 25th November 2014 passed by the Income Tax Appellate Tribunal ("ITAT", for short), in ITA No.873/Mum/2013 for the Assessment Year ("AY", for short) 2009-10, dismissing the appeal filed by the appellant.

2. This appeal was admitted on the following substantial question of law:

> "Whether in the facts and circumstances of the case and in law, the Appellate Tribunal was justified in comparing and adopting net profit margin of sister concern Pragati Aroma Oil Distillers Pvt. Ltd. (as existed during the relevant Assessment Year), even in the absence of any arrangement as contemplated in Section 10B (7) read with section 80IA (10) of the Income Tax Act, 1961?"

3. The appellant is a private limited company incorporated under the Companies Act, 1956, engaged in the manufacture and export of perfumery compounds and essential oils. The appellant was originally known as M/s. Hindustan Essential Oil Company and was later converted into a private limited company. With effect from 1st April 2009, the company was amalgamated with Pragati Aroma Oil Distillers Private Limited. For the purposes of this appeal, "the appellant" refers to M/s. Hindustan Essential Oil Company.

4. In Financial Year 2002-03, the Appellant had set up a new 100% Export Oriented Unit ("EOU", for short) at Nilakottai, Tamil Nadu for producing perfumes/fragrances. Deduction was claimed by the appellant on the profit of the said unit. During the previous year 2008-09, the appellant had claimed a deduction of an amount of Rs.2,32,48,056/- under section 10B of the IT Act.

5. The appellant filed return of income on 29th September 2009, declaring a total income of Rs.7,13,460/- for the Assessment Year 2009-10. However, the income was assessed by the Assessing Officer ("AO", for short) at Rs.3,78,64,804/- vide order dated 9th December, 2011.

6. The substantial discrepancy between the returned income and the assessed income primarily arose from the deduction claimed by the appellant under Section 10B of the Income Tax Act in respect of profits from the Tamil Nadu Unit, which was disallowed by the AO on the following grounds:

(i) Although the Commissioner of Income Tax (Appeals) ("CIT(A)", for short) and the ITAT had allowed

the Appellant's claim under Section 10B for AY 2003-04, AY 2004-05, AY 2006-07 and AY 2007-08, the AO disallowed the same for the relevant assessment year vide order dated 9th December 2011, on the basis that the claim had been disallowed in earlier assessment proceedings and that the Revenue's appeal against the said relief is pending before the High Court.

(ii) The AO further held that the claim of deduction under Section 10B was in contravention of Section 10B(7) read with Sections 80-IA(8) and 80-IA(10) of the Act, alleging the use of non-market factors to inflate the profits of the eligible unit, on the following grounds:

(a) The Appellant did not charge interest at arm's length rates on loans advanced by partners.

(b) The Appellant reported an abnormally high gross profit of Rs.2,32,72,277/- on sales of Rs.5,83,65,060/-, with substantial purchases made from group entities or concerns directly or indirectly controlled by such entities.

(c) There was no clear correlation between inputs and outputs; the activity undertaken appeared to be in the nature of mere processing rather than manufacturing, thereby calling into question the eligibility of the unit for deduction under Section 10B of the IT Act.

(iii) That the said claim of deduction was in contravention of Section 10B(7) read with Section 80-IA(8) and section 80-IA(10) of the IT Act.

7. Aggrieved by the said order of the AO dated 9th December 2011, the appellant filed an appeal with the CIT(A).

8. The CIT(A) vide order dated 31st December 2012, partly allowed the order of the Appellant and held that the Respondent should cap the claim under section 10B to 19.06% of sales i.e. at the profit earned/disclosed by the sister concern Pragati Aroma Oil Distillers Pvt. Ltd. (as existed during the relevant AY), having same activity, excluding foreign exchange gain if any, against Rs.2,32,48,056/- as claimed by the appellant on the profit of EOU,

as profit reasonably deemed to have been derived from the unit for the purpose of deduction under Section 10B of the IT Act and remaining profit shall be liable to be taxed as per normal rate of taxation.

9. Aggrieved by the order of the CIT(A) dated 31st December 2012, the appellant filed an appeal with the ITAT. The ITAT, vide order dated 25th November, 2014 dismissed the appeal of the appellant, recording that the contention of appellant that no comparable case was examined by the AO has no merit as it has been noted that on asking of the AO, the appellant furnished the GP/NP of the last three years of the sister concern and found that in the instant year the net profit earned by the sister concern itself was 19.03%, which led the ITAT to the conclusion that the appellant had disclosed profit in excess of what could be reasonably expected.

10. Aggrieved by the ITAT order dated 25th November, 2014, the present appeal was filed, challenging the said order.

11. Mr. Naresh Jain, learned counsel appearing on behalf of the appellant advanced the following submissions:

(i) That Section 80-IA(10) could not be applied to the present case, as it requires for there to exists some arrangement between the assessee and other persons which results in an artificial inflation of profits by the EOU and the tribunal, while holding Section 80-IA(10) applicable, failed to provide any finding of arrangement between the assessee and its sister concern, which led to the supposed inflation of profits.

(ii) That extraordinary profits alone cannot lead to the conclusion that there is an arrangement between the parties and that drawing such a conclusion would be akin to penalising efficient functioning.

(iii) That the amalgamation of the assessee with its sister concern Pragati Aroma does not amount to existence of an arrangement between them in terms contemplated under Section 80-IA(10), considering that

the said amalgamation took place at the end of the Assessment Year in question and was effective from 1st April, 2009 and that for the entire year, the assessee operated independently.

(iv) That the comparison between the profits of the appellant, which owns an EOU operating in foreign market with the profits of its sister concern Pragati Aroma Distillers Private Ltd. operating in the domestic market is wholly misconceived and untenable in law, given that an EOU is not subject to custom duty on its purchase whereas domestic suppliers are subject to custom duty on its imports. Any comparison of profitability between the two without accounting for the differences in statutory benefits and cost structures is thus legally unsustainable.

(v) Learned counsel for the Appellant relied on the following decisions to substantiate his arguments:

i. **Commissioner of Income Tax-7 vs. Schmetz**

India (P.) Ltd.[1]

ii. **A. T. Kearney India (P.) Ltd. vs. Additional Commissioner of Income-tax, Range-1, New Delhi**[2]

iii. **Aquila Software Services Hyderabad (P.) Ltd. vs. Deputy Commissioner of Income-tax, Circle-10(2), Hyderabad**[3]

12. Per Contra, Ms. Sushma Nagaraj, learned counsel for the respondent-revenue made the following submissions:

(i) That, in the context of the applicability of Section 80-IA(10), the ITAT has rightly applied the said section by observing that the Assessee and Pragati Aroma Oil Distillers Pvt. Ltd. shared a close relation, being regulated under the same management and dealing in the same business and that, as such, the course of business was so arranged that the business transaction between them produced more than ordinary profits.

(ii) That, mere absence of a formal or written

1 [2012] 26 taxmann.com 336 (Bom.)
2 [2014] 50 taxmann.com 26 (Delhi-Trib.)
3 [2015] 61 taxmann.com 106 (Hyderabad-Trib.)

arrangement between the parties would not render Section 80-IA(10) inapplicable, considering that what has been contemplated under the said section is that the course of business must be so arranged that the business transaction between them produces profits to the assessee that are more than what may be ordinarily expected to arise in such eligible business.

13. Heard learned counsel for the parties.

14. Section 10B of the IT Act provides incentive to promote exports by granting tax benefit to 100% EOUs. Section 10B of the IT Act reads thus :-

> "**SECTION 10B(1)**
>
> **Special provisions in respect of newly established hundred per cent export-oriented undertakings.**
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> 10B. (1) Subject to the provisions of this section, a deduction of such profits and gains as are derived by a hundred per cent export-oriented undertaking from the export of articles or things or computer software for a period of ten consecutive assessment years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things or computer software, as the case may be, shall be allowed from the total income of the assessee:

Provided that where in computing the total income of the undertaking for any assessment year, its profits and gains had not been included by application of the provisions of this section as it stood immediately before its substitution by the Finance Act, 2000, the undertaking shall be entitled to the deduction referred to in this sub-section only for the unexpired period of aforesaid ten consecutive assessment years :

Provided further that for the assessment year beginning on the 1st day of April, 2003, the deduction under this sub-section shall be ninety per cent of the profits and gains derived by an undertaking from the export of such articles or things or computer software:

Provided also that no deduction under this section shall be allowed to any undertaking for the assessment year beginning on the 1st day of April, 2012 and subsequent years:

Provided also that no deduction under this section shall be allowed to an assessee who does not furnish a return of his income on or before the due date specified under sub-section (1) of section 139.

(2) This section applies to any undertaking which fulfills all the following conditions, namely :-

(i) it manufactures or produces any articles or things or computer software;

(ii) it is not formed by the splitting up, or the reconstruction, of a business already in existence :

Provided that this condition shall not apply in respect of any undertaking which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as is referred to in section 33B, in the circumstances and within the period specified in that section;

(iii) it is not formed by the transfer to a new buishness of machinery or plant previously used for any purpose.

> Explanation. – The provisions of Explanation 1 and Explanation 2 to sub-section (2) of section 80-I shall aply for the purpose of clause (iii) of this sub-section as they apply for the purposes of clause (ii) of that sub-section."

15. Section 80-IA(10) empowers the AO to recompute the profits if there appears to be a close connection between the assessee and another entity and such connection produces more than ordinary profits. It is an anti-abuse provision to prevent assesses from seeking deduction on artificially inflated profits. For the facility of convenience, Section 80-IA(10) has been extracted below :-

> "**80-IA**
>
> **Deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development, etc.**
>
> (10) Where it appears to the Assessing 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 profits which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits 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 profits from such transaction shall be determined having regard to arm's length price as defined in clause (ii) of section 92F."

16. Thus, on a plain reading of Section 80-IA(10) of the IT Act, it is clear that the provision requires findings on (i) close connection between parties, (ii) an arrangement between them, and (iii) that such arrangement has resulted in more than ordinary profits.

17. The AO, in the assessment order, held that the assessee and its sister concern are closely connected, being engaged in the same business and run by the same management. The AO observed that the assessee made substantial purchases from related parties without establishing that they were at market value, and had also received large interest-free loans from partners/group entities. On this basis, the AO concluded that the assessee had avoided tax and inflated profits of the EOU by disregarding cost of capital and entering into related-party transactions. The AO also noted lack of correlation between inputs

and outputs and held that pricing was arbitrary, concluding that the business was arranged to show more than ordinary profits.

18. The CIT(A), in its order dated 31st December 2012, held that the AO failed to substantiate allegations regarding non-market purchases or related-party transactions. It observed that interest-free loans are permissible, but may attract Section 80-IA(10) if they lead to excess profits. The CIT(A) held that the AO was right in invoking Section 80-IA(10) of the IT Act, but erred in not determining reasonable/ordinary profits using comparables. By comparing with the sister concern, the CIT(A) found that the assessee had earned more than ordinary profits. Accordingly, deduction under Section 10B was restricted to 19.06%, and the excess was taxed.

19. The ITAT, in its order dated 25th November 2014, observed that the AO's conclusions, based mainly on low manufacturing expenses and high profit margin, were largely presumptive and not supported by proper evidence or comparables. However, ITAT agreed that the assessee and its sister

concern were in the same line of business under common management, and that the assessee had disclosed higher profits. The ITAT therefore upheld the approach of the CIT(A) in using the sister concern as a benchmark and sustained the restriction of profits to about 19%, holding the adjustment to be reasonable and justified.

20. In our considered opinion, the ITAT has failed in giving any categorical finding as to the arrangement between the parties that led to the inflation of profits beyond what could have been ordinarily expected. The deduction was restricted by the ITAT solely on the ground that the net profit rate of the assessee operating in the export market at 25.09% was higher than that of its sister concern operating in the domestic market, having a net profit of 19.55%. In *Commissioner of Income Tax-7 vs. Schmetz India (P.) Ltd.* (supra) this Court held that extraordinary profits alone cannot lead to the conclusion that there is an arrangement between the parties as this would penalise efficient functioning. The paragraph No.8 of the decision is quoted below for ready reference :-

> "8. So far as questions (a) & (b) are concerned, we find that the Tribunal has considered the entire evidence and on facts come to the conclusion that the profits earned by Kandla division of the respondent-assessee is not abnormally high due to any arrangement between the respondent-assessee and its German Principal. The Tribunal correctly held that extraordinary profits cannot lead to the conclusion that this is an arrangement between the parties. This would penalize efficient functioning. Further, the authorities have also recorded a finding that the industrial sewing machine needles imported and traded by the Mumbai division are different from those manufactured & exported by the Kandla division. Consequently, this also negatives any arrangement between the parties to show extraordinary profits in respect of its Kandla division so as to claim deduction under Section 10A of the Act. These are findings one of fact. The appellant-revenue have not been able to show that the findings are perverse or arbitrary. In the circumstances, questions (a) and (b) as formulated by the appellant/revenue do not raise substantial questions of law in the present facts and are therefore dismissed."

21. As regards the close connection between the assessee-appellant and its sister concern, we agree with the submission of the learned counsel for the appellant that merely the fact that the appellant merged with its sister concern does automatically indicate an arrangement between them to invite the rigours of Section 80-IA(10), considering that the Assessee's amalgamation with its sister concern took place at the end of the Assessment Year and was only effective from 1st April 2009 and amalgamation at

the end of the relevant financial year cannot be considered as an arrangement for the purpose of Section 80-IA(10).

22. Section 10B is an incentive provision intended to promote exports by granting tax benefits to 100% EOU, thereby encouraging foreign exchange earnings and industrial growth. At the same time, Section 80-IA(10) serves as an anti-abuse safeguard to ensure that such tax incentives are not misused by inflating profits through arrangements with closely connected parties. It empowers the authorities to recompute profits to a reasonable level where more than ordinary profits are derived due to such connections. Read together, while Section 10B provides the benefit, Section 80-IA(10) ensures that the benefit is restricted to genuine and reasonable profits and not artificially enhanced ones.

23. It is our considered view, drawing a comparison between the profits of the Assessee which owns an EOU and operates in the foreign market with the profits of its sister concern operating in the domestic market without accounting for the material

differences in statutory benefits and cost structures is untenable in law and it does not serve as an appropriate approach in determining a reasonable profit, especially without the CIT(A) or ITAT ascertaining what would amount to ordinary/reasonable profit. The capping of the profit share of the Assessee on which deduction under Section 10B could be claimed at 19% solely on the basis of the sister concern having earned/disclosed a profit of 19.03%, and holding the remainder to be taxable is arbitrary and does not stand the test of law.

24. The product manufactured by the appellant company and the sister concern is the same. However, admittedly the appellant is a 100% EOU whereas the sister concern operates in the domestic market. The ITAT has capped the claim under Section 10B of the IT Act to 19.06% of sales i.e. at profit earned/disclosed by the sister concern Pragati Aroma Oil Distillers Pvt. Ltd. In our opinion the error committed by the ITAT and the CIT(A) is that it computed the Gross Profit/Net Profit of the sister concern for three previous years for determining what could be the reasonable profit derived by the appellant. This may have been a correct approach

provided that in the first instance it records a categoric finding that in terms of Section 80-IA(10), the course of business between the EOU and the entity with whom the business is transacted produces to the assessee more than the ordinary profits which might be expected. There is absolutely no material qua the entity with whom the business was transacted to show that such arrangement is producing the assessee more than the ordinary profits.

25. For the aforesaid reasons the substantial question of law is decided in favour of the appellant-assesseee and against the respondent-revenue. Therefore, the impugned order dated 25th November 2014 passed by the ITAT is quashed and set aside. The appeal stands allowed in terms of prayer clauses (a) and (b). No order as to costs.

(S. M. MODAK, J.) **(M. S. KARNIK, J.)**