



Unconnected windmill revenue to be treated as non-operating and forex fluctuation as operating in nature

Background

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Rajratna Metal Industries Limited¹ (the taxpayer) considered Foreign Exchange Fluctuation Gain/Loss as an operating item, not to be excluded for the purpose of computing Arm's Length Price (ALP). The Tribunal also held that the income accruing to the taxpayer on account of a business division that has nothing to do with its international transactions should not be considered as an operating income and needs to be excluded for the purpose of computing ALP. However, considering the taxpayer's proposition, the Tribunal agreed to exclude the corresponding expenditure for the computational purpose.

Facts of the case

- The taxpayer had installed windmill(s) for generating wind power and thereafter had entered into a wheeling agreement with the state electricity undertaking to sell the above generated wind power to its manufacturing division in lieu of payment of transmission cost, computed at the rate as is charged by the state undertaking.
- During the year under consideration, the taxpayer had entered into various international transactions with its overseas associated enterprises (AEs) namely purchase of raw materials, return of packaging material and sale of finished goods pertaining to its steel manufacturing division. The taxpayer adopted the Transactional Net Margin Method (TNMM) to benchmark the said international transactions and included the windmill income as an operating item for the purpose of determining ALP.

- The Transfer Pricing Officer (TPO) considered the above windmill income as a non-operating income for the purpose of determining ALP. The same was upheld by Commissioner of Income-tax (Appeals) [CIT(A)]. Aggrieved by the order of CIT(A), the taxpayer appealed before the Tribunal.
- Further, the TPO also treated certain foreign exchange gain/loss as non-operating in nature and excluded the same while determining ALP².

Issue before the Tribunal

- Whether the windmill income and foreign exchange fluctuation gain/loss should be included as operating income/expense for computation of ALP.

Taxpayer's contentions

Windmill income

- The taxpayer contended that it had sold its captive power from one division to other as eligible for deduction under Section 80IA of the Income-tax Act, 1961 (the Act) instead of generating revenue from open market and the windmill income has already been taken as business income for the purpose of computing the corresponding deduction under Section 80IA of the Act. Accordingly, the income should be considered as operating in nature and should be included in computing the ALP.

¹ ACIT v. Rajratna Metal Industries Ltd. [ITA No. 1050/Ahd/2015 with CO No. 91/Ahd/2015, AY: 2010-11] – Taxsutra.com

² This fact is not specifically mentioned in the order, but inferred from the conclusion mentioned by the Tribunal and included from completeness perspective.

- Without prejudice to above, if the windmill income is not included as operating, corresponding expenditure should not be considered as operating in nature.

Foreign Exchange Fluctuation Gain/Loss

- The taxpayer quoted a plethora of case laws arguing that foreign exchange fluctuation gain/loss should be treated as operating in nature for the purpose of computing ALP.³

Tax department's contention

- For both the components (i.e. windmill income and foreign exchange fluctuation gain/loss), the authorities contended that they should not be considered as operating in nature for the purpose of determining the ALP and had accordingly proposed a transfer pricing adjustment for the same.

Tribunal's decision

Windmill income

- The Tribunal observes that both the above stated divisions of windmill and steel manufacturing are altogether separate without having any interwoven element embedded therein and the mere fact that the windmill income has been accepted under the head of business income would not make it as income derived from manufacturing division. Hence, the Tribunal concludes that the windmill income should be excluded from the operating income while computing the ALP.
- The Tribunal placed reliance on a materially identical situation in the case of Marubeni India Private Limited⁴ (Marubeni Ruling), wherein the interest income arising out of the investment of surplus funds which were not required for the core business of the taxpayer was not considered to be its operating income.
- On a without prejudice basis, the taxpayer then drew the Tribunal's attention towards clause (g) of Marubeni Ruling wherein not only the interest income but also the corresponding interest expenditure was excluded from the calculation of ALP. This alternate plea of the taxpayer that both windmill income and expenditure should be treated as non-operating for computing the ALP was accepted by the Tribunal, and accordingly, the TPO was directed to re-finalise the consequential computation of ALP.

Foreign exchange fluctuation gain/loss

- The Tribunal upheld the decision of the CIT(A) in treating the foreign exchange fluctuation gain/loss as an operating item to be included for the purpose of computing ALP since the tax department could not present a rebuttal to the judicial pronouncements relied upon by the taxpayer.

Our comments

Often in transfer pricing, the foreign exchange fluctuation gain/loss is considered as non-operating for the purpose of computing ALP. Even the current safe harbour rules state that income or expense arising from foreign exchange fluctuation should be excluded from operating revenue or expense (irrespective of the fact that foreign exchange fluctuation is on revenue or capital account). Despite the favourable decisions held by a number of judicial precedents, often situations of genuine inclusion of foreign exchange gains/losses are ignored. Further, even OECD TP Guidelines provide for inclusion of foreign exchange gains/losses in TNMM to a transaction in which the foreign exchange risk is borne by the tested party.

This ruling is an addition to the plethora of cases providing relief for the taxpayers in cases where the foreign exchange gains/losses are arising directly in connection with the main operations of the taxpayer.

Another observation deriving from this ruling is in the case where income from a division (which has nothing to do with the international transactions relating to another division) is considered as non-operating, the corresponding expenditure should also be excluded for computation of ALP.

³ Fiserv India Pvt Ltd [TS-437-HC-2016(DEL)-TP], Amerprise India Pvt Ltd [TS-174-HC-2016(DEL)-TP], NEC Technologies India Ltd [TS-221-ITAT-2016(DEL)-TP], Subex Ltd [TS-181-ITAT-2016(Bang)-TP], Visa Consolidated Support & Services [TS-162-ITAT-2016(Bang)-TP], SAP Labs India Pvt Ltd v. ACIT [2012] 145 TTJ 521 (Bang), Four Soft Ltd (ITA No. 1495/HYD/2010)(Hyderabad ITAT), Trilogy E Business Software India Pvt Ltd v. DCIT [2013] 23 ITR(T) 464 (Bang), Capital IQ Information Systems (India) Pvt Ltd v. DCIT [2013] 25 ITR(T) 185 (Hyd), S. Narendra v. ACIT [2013] 32 taxmann.com 196 (Mum), Cordys R & D (India) (P.) Ltd v. DCIT [2014] 149 ITD 587 (HYD), Techbooks International Pvt Ltd v. ACIT [2014] 150 ITD 162 (Del)

⁴ Marubeni India Private Limited v. DIT [2013] 354 ITR 638 (Del)

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