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More profit from related than unrelated parties does not itself make it 'more than ordinary' (Electricity Board rates also used as support); profit comparison to be done for 'individual' related parties

In brief

OPG Energy Pvt. Ltd.[1] (the taxpayer) claimed deduction under section 80-IA of the Income-tax Act, 1961 (the Act), which was restricted by the Assessing Officer (AO), who claimed that the taxpayer had earned more than ordinary profits by selling to related parties at a higher price than that charged from unrelated parties. The Chennai bench of the Income-tax Appellate Tribunal (the Tribunal), while deciding the case in favour of the taxpayer, laid down the following principles:

- If taxpayer earns more profit from related parties in comparison to unrelated parties, that does not by itself make the profit from related parties 'more than ordinary'.
- Profit realised by the taxpayer by charging rates to related parties which are lower than the rate charged by a government undertaking (a State Electricity Board), cannot be said to be 'more than ordinary'.
- Comparison of profit realised from one or more related parties must be undertaken for each party separately.

[1] OPG Energy Pvt. Ltd. *v* DCIT, Chennai [TS-382-ITAT-2012 (CHYN)]

Facts

- The taxpayer was engaged in the business of generation and distribution of power, and sold power to related parties as well as unrelated customers. The taxpayer was eligible for deduction under section 80-IA of the Act in respect of the profit derived from the said undertaking, and had claimed the deduction.

- The assessing officer (AO) reduced the deduction claimed by the taxpayer to the extent of the excessive receipts earned from sale to related parties *vis-a-vis* sale to unrelated customers, as the AO claimed that the taxpayer had earned more than ordinary profits by selling power to related parties at a higher price (at INR 3.364 per unit) than to unrelated parties (at INR 3.266 per unit).

- The Commissioner of Income-tax (Appeals) upheld the AO's actions. Aggrieved, the taxpayer appealed before the Tribunal.

Taxpayer's contentions

- Prices charged by the Tamil Nadu Electricity Board (TNEB) were higher than the prices charged by the taxpayer from its related parties.

- The taxpayer had charged a higher rate of Rs. 3.40 per unit from most unrelated parties, except one party (Meridian Industries) which had been charged a lower rate due to a different pricing basis. Since the rate charged to this party lowered the average, this party should not be considered.

Revenue's contentions

- Meridian Industries cannot be excluded, as claimed by the taxpayer, because maximum sale has been made to this unrelated party and ignoring the same would distort the picture. Further, no documentary evidence has been furnished by the taxpayer with regard to exclusion of Meridian Industries. There may be various reasons for contracting different sale rates with different customers but the onus is on the taxpayer to evidence the same, which in the instant case, the taxpayer has failed to do.

Tribunal ruling

The Tribunal ruled in favour of the taxpayer on account of the following:

- Section 80-IA of the Act does not provide that if the taxpayer earns more profit from related parties in comparison to unrelated parties, then the allowance of deduction is to be restricted to the profits derived from unrelated parties.

- The average rate charged by the taxpayer from related parties was less than the rate at which power was sold by TNEB. Thus, profit realised by charging rates which are lower than the rate which is charged by a government undertaking, cannot be said to be 'more than ordinary'.

- Comparison of profits realised from one or more related parties must be undertaken for each party separately.

In the absence of rates charged from individual related parties, the Tribunal held that it was not in a position to adjudicate the issue completely. Thus, the Tribunal restored the matter back to the AO for fresh adjudication in light of the above observations.

PwC observations

- While comparing profit of the taxpayer, the Tribunal has considered profits derived from rates charged to unrelated parties and those charged by a State Electricity Board. Profit of the taxpayer lies in between, i.e., higher than the former and lower than the latter. The Tribunal, therefore, in essence considered a 'range' of profits to conclude that the taxpayer was not earning 'more than ordinary profits'.

  Notably, the terminology used in section 80-IA(10) of the Act is also 'ordinary profits' (in plural) rather than just 'ordinary profit' (in singular), thereby implying the use of a 'range' rather than a single reference point. Hence, it may be inferred that the legislation itself endorses the use of the 'range'.

  However, in light of the recent amendments made vide Finance Act, 2012, the existing transfer pricing regulations have been made applicable to determination of profits from transactions of tax holiday units with closely connected person/s. The regulations provide for a concept of 'arithmetic mean' with a very narrow tolerance band. In fact, it could have been detrimental for the taxpayer, had the 'arithmetic mean' concept been applied in the instant case, instead of the approach actually adopted by the Tribunal.

  Accordingly, from a taxpayer's perspective, one would expect a liberal interpretation of the transfer pricing regulations when applied to determine the 'more than ordinary profits' earned by tax holiday units.

- Comparison of profits realised from 'individual' related parties as has been contemplated by the Tribunal in the instant case, may pose practical difficulties and may not always be feasible or even required to be undertaken.

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