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Transfer Pricing
Insight with information

ITAT rejected TP adjustment for notional interest on outstanding receivables

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Executive Summary

The Delhi Bench of the Income Tax Appellate Tribunal (Tribunal) recently pronounced its ruling in case of Kusum Healthcare Pvt. Ltd (the taxpayer) on transfer pricing (TP) adjustment in respect of excess credit period extended to its associated enterprises (AEs). The Tribunal held that when the underlying transaction of sales to AEs have been held to be at arm's length based on working capital adjusted arm's length margin under Transactional Net Margin Method (TNMM), no further TP adjustment for interest on outstanding receivables is warranted.

Facts

- The taxpayer was engaged in manufacturing and trading of pharmaceutical products. Major portion of its sales revenue was from export to its AEs.
- The taxpayer substantiated the arm's length nature of its transaction with AEs using TNMM and compared the segmental profitability of manufacturing and trading activity with margin earned by comparable companies engaged in similar manufacturing and trading functions respectively.
- The Transfer Pricing Officer (TPO) accepted the arm's length nature of the international transaction of sale of goods but imputed notional interest on the outstanding receivables exceeding credit period of 180 days based on SBI Prime Lending rate plus 300 bps (14.88%) by applying Comparable Uncontrolled Price (CUP) method.
- The Dispute Resolution Panel (DRP) provided marginal relief to the taxpayer and directed the TPO to apply SBI base rate plus 150 basis points instead of 14.88% applied by the TPO.
- Aggrieved by the final assessment order, the taxpayer filed an appeal before the Tribunal.

Issue before the Tribunal

- Whether separate adjustment for notional interest on outstanding receivables is required when profit margins earned by taxpayer (after undertaking adjustment for working capital) is greater than that earned by independent comparables?

Observations & Ruling of the Tribunal

- The Tribunal observed that any independent party will expect to earn an extra return for the credit period extended to its customers in the form of higher sales prices. Similarly, an independent entity would be willing to pay higher purchase price for the grant of extended credit period by the supplier.
- In view of the above, the Tribunal appreciated the interlink between high levels of accounts receivable and inventory resulting in overstated operating results and high levels of accounts payable resulting in understated margins. Thus, to bring the taxpayer and comparable companies to parity, the Tribunal held that appropriate working capital adjustments are necessary to remove the impact of outstanding receivables on profitability.
- The Tribunal held that if the profitability of the taxpayer is more than the working capital adjusted margin of the comparables, the additional imputation of interest on the outstanding receivables is not warranted.
- The Tribunal also placed reliance on an earlier ruling in case of Micro Ink[1] wherein the adjustment for outstanding receivables was rejected on the ground that the specified credit period was a part of the sales contract and the cost of funds blocked in the credit period were inbuilt in the price.
- The Tribunal also held that the transaction of sale and the resulting realization are intrinsically connected to each other and thus bundled together for the transfer pricing analysis. Once the TPO accepts that taxpayer has earned significantly higher margins than the comparable companies, which more than compensates for the credit period extended to the AEs, no further adjustment on account of notional interest charge would be required.[2]

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[1] Micro Ink Ltd.(TS-216-ITAT-2013(Ahd)-TP)

[2] Reliance was placed on the HC Ruling in case of Sony Ericsson Mobile Communications India Pvt Ltd and others (TS-96-HC-2015(Del)-TP)

Conclusion

In India, tax authorities have been making adjustment on receivables outstanding at the end of the year from AEs by re-characterizing them as an implied loan/advance and thereby imputing notional interest without considering the economic justification for such outstandings. This is a welcome ruling for the large number of taxpayers in India. The ruling reinstates the considerations of economic justifications and all the surrounding circumstances for the arm's length analysis under Transfer Pricing.

Source : M/s Kusum Healthcare Pvt. Ltd. Vs ACIT, Delhi Tribunal, ITA No. 6814/Del/2014; dated 26 March 2015

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