



Tax and Transfer Pricing Alert Insight with information

**Every outstanding
“receivables” does not
constitute an international
transaction.**

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Executive Summary

The Delhi High Court recently pronounced an important ruling in the case of Kusum Healthcare Pvt. Ltd. (Kusum, the taxpayer, the company) on the treatment of outstanding receivables as international transaction.

The High Court held that every outstanding invoice beyond the credit free period cannot be classified as a separate international transaction under the explanation to Section 92B of the Income Tax Act, 1961 (the Act).

Further, once the taxpayer has factored in the impact of working capital requirement due to outstanding receivables in its pricing/profitability, no further adjustment on account of outstanding receivable is required.

Facts

- The taxpayer manufactures and markets pharmaceutical products. During the relevant period, the company exported pharmaceutical products to its overseas associated enterprise ("AE") as well as to third parties.
- The said international transaction of export of pharmaceutical products was benchmarked in the transfer pricing ("TP") study using Transactional Net Margin Method (TNMM).
- During TP assessment proceedings, the Transfer Pricing Officer (TPO) accepted the price of export of pharmaceutical products and considered it to be at arm's length. . But, he made an adjustment on outstanding receivables by imputing a notional interest on that for a period exceeding 180 days (which was the credit free period extended by the company to both AEs and non AEs).
- The Dispute Resolution Panel (DRP) concurred with the TPO and upheld the benchmarking of the above transaction on a standalone basis, applying comparable uncontrolled price (CUP) method.
- Aggrieved, the taxpayer filed an appeal before the Income Tax Appellate Tribunal (ITAT).
- The ITAT in its order arrived at the following conclusions:-
 - In an uncontrolled situation an entity will expect to earn a return on its working capital investment. However, the amount of capital required to support the working capital requirements varies greatly due to variations in the level of inventories, debtors and creditors between parties. Accordingly, appropriate adjustments need to be undertaken to bring parity in the working capital investment of the taxpayer and the comparables. Accordingly, once a working capital adjustment is undertaken it also takes into account the impact of outstanding receivables on the profitability. So no further adjustment is required to be undertaken.
 - As the impugned transaction is resultof the primary transaction of sale of pharmaceutical products, accordingly, as a natural corollary, the impugned transaction is inextricably linked to the primary transaction and thus has been correctly aggregated for benchmarking.

- Since in the present case the taxpayer has undertaken an adjustment to account for differences in working capital requirements and the adjusted mean margin of comparables is lower than the margin earned by the taxpayer, the impugned transaction is concluded to be at arm's length.

Issue before the High Court

Whether the ITAT was correct in disagreeing with the TPO who had characterised outstanding receivables as an international transaction which required benchmarking on a standalone basis.

Observations and Ruling of the High Court

- The inclusion in the Explanation to Section 92B of the Act of the expression "receivables" does not mean that *de hors* the context, every item of 'receivables' appearing in the accounts of an entity, which may have dealings with foreign AEs would automatically be characterised as an international transaction.
- Delays in receipt of payment beyond the agreed credit period can be due to a variety of factors which will have to be investigated on a case-to-case basis and the impact of the same on the working capital of the taxpayer will have to be studied.
- There has to be a proper inquiry by the TPO by analysing statistics over a period of time to discern a pattern which would indicate that vis-à-vis the receivables for the supplies made to an AE, the arrangement reflects an international transaction intended to benefit the AE in some way.
- While making the above observations, the HC held that the entire focus of the AO was on just one AY and the figure of receivables in relation to that AY can hardly reflect a pattern that would justify a conclusion that receivables beyond 180 days constitute an international transaction by itself.
- The HC also highlighted that when the taxpayer has already factored in the impact of receivables in its working capital, any further adjustment on the basis of the outstanding receivables would distort the picture and re-characterise the transaction. The HC while relying upon the ruling of Delhi HC in case of *CIT v. EKL Appliances Ltd. (2012) 345 ITR 241 (Delhi)* mentioned that such action of the TPO was impermissible in law.

Conclusion

This is a significant ruling on the vastly litigated issue of imputation of notional interest on outstanding receivables from AEs. Treatment of outstanding receivables as an international transaction has gained prominence in recent years and there have been several rulings on the subject.

The present case is relevant as it has questioned the mechanical approach adopted by the TPO in treating outstanding receivables from AEs as an international transaction. The court observed that the TPO should first undertake a detailed enquiry to discern a pattern which indicates an arrangement between parties intended to benefit the AE.

With respect to use of working capital adjustment by the taxpayer for demonstrating the impugned transaction to be at arm's length, the court agreed with ITAT's conclusion and observed that as the taxpayer has already factored in the impact of receivables in its pricing/ profitability, any further adjustment would distort the picture. It would re-characterise the transaction which is impermissible in law.

Source: Pr. CIT vs Kusum Healthcare Pvt. Ltd. (I.T.A. No. 765/ 2016)

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