No TP adjustment on pretext of outstanding receivables when working capital adjustment is already made

Summary – The Delhi ITAT in a recent case of Kusum Healthcare (P.) Ltd., (the Assessee) held that where in transaction with AEs, assessee earn significantly higher margin than comparable companies and such higher margin compensates for credit period extended to AEs no further TP adjustment was required

Facts

- The assessee-company was engaged in manufacture and export of pharmaceutical products to its overseas associated enterprise ('AE'). The said international transaction was benchmarked in the transfer pricing ('TP') study using Transactional Net Margin Method (TNMM).
- During the course of assessment proceedings, the international transactions of the assessee were accepted by the TPO at arm's length price. However, the TPO imputed a notional interest based on SBI Prime Lending rate + 300 basis points (resulting in interest rate of 14.88 per cent), with regard to receivable outstanding for a period exceeding 180 days. Thus, the TPO made certain transfer pricing adjustment to the assessee's ALP.
- The DRP directed the TPO to apply SBI base rate plus 150 basis points instead of 14.88 per cent applied by the TPO. The DRP, thus, granted partial relief to the assessee.
- On appeal:

Held

- An uncontrolled entity will expect to earn a market rate of return on its working capital investment independent of the functions it performs or products it provides. However, the amount of capital required to support these functions varies greatly, because the level of inventories, debtors and creditors varies. High levels of working capital create costs either in the form of incurred interest or in the form of opportunity costs. Working capital yields a return resulting from a) higher sales price or b) lower cost of goods sold which would have a positive impact on the operational result. Higher sales prices acts as a return for the longer credit period granted to customers.
- Similarly, in return for longer credit period granted, a firm should be willing to pay higher purchase price which adds to the cost of goods sold. Therefore, high levels accounts receivable and inventory tend to overstate the operating results while high levels of accounts payable tend to understate them thereby necessitating appropriate adjustment. The appropriate adjustments need to be considered to bring parity in the working capital investment of the assessee and the comparables rather than looking at the receivable independently. Such working capital adjustment takes into account the impact of outstanding receivables on the profitability.

- In view of the above, a working capital adjustment appropriately takes into account the outstanding receivable. Therefore, the assessee has undertaken a working capital adjustment to reflect these differences by adjusting for differences in working capital and thereby, profitability of each comparable company. Accordingly, while calculating the working capital adjusted, operating margin on costs of the comparable companies, the impact of outstanding receivables on the profitability has been taken into account. If the pricing/profitability of the assessee is more than the working capital adjusted margin of the comparables, then additional imputation of interest on the outstanding receivables is not warranted.
- It was noted from records that the differential impact of working capital of the assessee *vis-a-vis* its comparables has already been factored in the pricing/profitability of the assessee which is more than that working capital adjusted margin of the comparables. Hence, any further adjustment to the margins of the assessee on the pretext of outstanding receivables is unwarranted and wholly unjustified.
- Further, the principle of aggregation is a well-established rule in the transfer pricing analysis. This principle seeks to combine all functionally similar transactions wherein arm's length price can be determined for a number of transactions taken together. The said principle is enshrined in the transfer pricing regulation itself and has also been advocated by the OECD Guidelines.
- From the above analysis, it is clear that the assessee had earned significantly higher margin than the comparable companies (which have been accepted by the TPO) which more than compensates for the credit period extended to the AEs. Thus, the approach by the assessee of aggregating the international transactions pertaining to sale of goods to AE and receivables arising from such transactions which is undoubtedly inextricable connected is in accordance with established TP principles.
- For the aforesaid reasons, the appeal of the assessee is allowed.