

Internal TNMM for determining ALP couldn't be rejected merely because size of uncontrolled transactions was small

Summary – The Hyderabad ITAT in a recent case of Srinu Pharmaceuticals Ltd., (the Assessee) held that While determining ALP by applying internal TNMM, size of uncontrolled transactions, i.e., transactions with non-AEs, is being smaller by itself, does not make those transactions uncomparable with transactions in controlled condition

Facts

- The assessee-company was engaged in manufacture and sale of various drugs and pharmaceuticals. During relevant year, assessee exported to its AE to the extent of Rs. 53.4 crores, which was 93 per cent of the total sales and exported to non-AE to the extent of Rs. 4.25 crores, which was 7.35 per cent of the total sales. Further, the sales recorded during the year was only 30 per cent of the utilization of the total capacity installed.
- In transfer pricing proceedings, the assessee adopted internal TNMM to determine ALP of its international transactions entered into with AE. The TPO refused to consider internal TNMM considering the turnover recorded with non-AE exports comparatively a minuscule segment of the exports. Thereupon, certain addition was made to ALP on basis of profit margin earned by external comparables adopted by TPO.
- The DRP confirmed said addition.
- On appeal:

Held

- The assessee has made exports to its AE for Rs. 53.14 crores and exported to non-AE for Rs. 4.23 crores as well as made domestic sale to non-AE to the extent of Rs. 2.28 crores and it has arrived the profit margin of 1.19 per cent, (-) 31 per cent, 58.89 per cent to sales relating to AE, export to non-AE and domestic sales to non-AE respectively. The profit margin is arrived with the help of a Cost Accountant after observing the total cost without factoring for idle capacity.
- In various judicial pronouncements, it has been directed that for consideration of comparables there has to be an adjustment for idle capacity utilization which will have a bearing on the final outcome of the ALP. At the same time, the Bench has also considered the option of adopting internal TNMM as a comparable for determining ALP. In the given case, the question is whether the quantum of turnover of non-AE, i.e., uncontrolled transactions with total turnover has to be considered for treating as comparables. In the case of *Lummus Technology Heat Transfer BV v. Dy. CIT* [2014] 42 taxmann.com 342/64 SOT 47 (URO) (Delhi - Trib.) the coordinate Bench at Delhi has adjudicated that

the size of the uncontrolled transactions are being smaller by itself, does not make those transactions uncomparable with the transactions in controlled condition.

- The size of the turnover does not matter in entities level comparison because of scale of operations substantially vary and so does the underlying profitability factor, but, in a transaction level comparison within the same entity mere difference in size of the uncontrolled transaction does not render transaction uncomparable. Therefore, the Bench is in agreement with the above decision and also it is noticed that in the above case of *Lummus Technology Heat Transfer BV (supra)*, assessee has submitted segmental accounts reflecting business with AEs, business with non-AEs and idle capacity separately.
- Hence, the Bench has properly appreciated that there is no bar in adopting uncontrolled transaction for the purpose of internal TNMM. Whereas, the assessee has submitted that assessee's capacity utilization is only 30 per cent, even though it has not maintained records to indicate the unabsorbed overhead, which relates to under-utilization of the capacity. The profitability of the organization will have an impact when there is huge underutilization of the capacity. There has to be an adjustment internally within the organization by allocating overhead to the segment, for which, capacity was utilized and for idle capacity. Otherwise, there has to be an adjustment of idle capacity when compared with outside comparables.
- In the instant case, assessee has not properly maintained allocation of overheads, even though, assessee has relied on the services of Cost Accountant, who has allocated the overheads only to the segments, in which, turnovers were recorded and failed to allocate for the idle capacity. Therefore, assessee has to submit the segmental results based on the absorption of overhead on capacity utilization and idle capacity. The results will be different when assessee submits the revised profitability report based on the capacity utilization. At present, assessee has declared negative profitability of AE and non-AEs and after reallocation of overheads on the basis capacity utilization, it will not be a negative profit. This is imperative that assessee allocates manufacturing overhead, administrative overhead and other fixed overheads on the basis of capacity utilization.
- It is advisable for the assessee to submit segment-wise report, *i.e.*, export to AE, export to non-AE, domestic sales to non-AE and idle capacity. Considering the above factual matrix, the TPO/Assessing Officer is directed to consider the above revised segmental profit and loss reports of the assessee and arrive at the ALP adjustment by considering non-AE transactions as one of the comparable in determining ALP by following TNMM method afresh.
- In the result, the appeal of the assessee is treated as allowed for statistical purposes.