Bad debts of acquired co. don't form part of operating cost for computing operating profit

Summary – The Kolkata ITAT in a recent case of Philips Medical Systems (P.) Ltd., (the Assessee) held that where relevant bad debts related to sales made in earlier years by company acquired by assessee, same could not be added as part of operating cost for computing operating profit of assessee

Facts

- The Assessing Officer found that a provision of Rs. 4.13 crores made for bad and doubtful debts during the year under consideration was not considered by the assessee-company as a part of operating expenses. According to him, the same was liable to be added back to work out the operating profit margin on sales. In this regard, the explanation offered by the assessee that the said provision had been made in respect of bad debts relating to HSG business acquired by it during the year under consideration pursuant to the global acquisition of the HSG group by the parent company and, thus, represented an extraordinary item, was not found acceptable by the Assessing Officer. The Assessing Officer held that a provision for bad and doubtful debts was a normal operating expense of any business and there was no reason for excluding the same for the purpose of determining the operating profits of a Company.
- On appeal, the Commissioner (Appeals) affirmed the order of the Assessing Officer.
- On further appeal to the Tribunal:

Held

- The amount in question provided for bad and doubtful debts was entirely related to HSG business, which had been acquired by the assessee during the financial year 2001-02 and this position clearly evident from the relevant details furnished by the assessee is not disputed even by the revenue. As submitted by the assessee, the debtors of HSG were taken over by the assessee-company as a part of the said acquisition and the amount of such debts to the extent could not be recovered was provided for as bad and doubtful debts. It is, thus, clear that the provision in question made for bad and doubtful debts was not with respect to sales made by the assessee-company during the year under consideration but the same was with respect to sales made during the earlier year and that too by HSG.
- In the case of *Marble India (P.) Ltd.* v. *ACIT* [CIT Appeal No. 2173 (Bang.) of 2017, dated 6-4-2018], the Bangalore Bench of this Tribunal held that provision for doubtful debts cannot be reduced for determining the operating profit for the purpose of transfer pricing analysis either in the case of tested party or comparables. The Tribunal took a note of the whole purpose of transfer pricing analysis as well as the method followed for determining the arm's length price including TNMM and held that if the provision for doubtful debts made with respect to the sale of the earlier year is

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reduced from the profit of the subsequent year, the numerator is reduced but the denominator is not reduced because corresponding sale stood considered in earlier year, which could not be considered in the subsequent year. It was held that such provision for bad and doubtful debts has to be ignored and added back to the operating profit of the tested party or of the comparables as the case may be for determining the operating margin while making the transfer pricing analysis.

- As already noted, the relevant bad debts for which the amount in question was provided for by the assessee-company in the year under consideration were not only in respect of sales made in the earlier years but the same were related to HSG business, which was acquired by the assessee-company in the financial year 2001-02. Keeping in view this undisputed factual position and the decision of the Bangalore Bench of Tribunal in the case of *Marble India (P.) Ltd.* (*supra*), it is to be held that the provision for bad and doubtful debts amounting to Rs. 4.13 crores cannot be treated as a part of operating cost for the purpose of computing operating profit of the assessee-company for the year under consideration. Accordingly, the Assessing Officer/Transfer Pricing Officer is directed to re-compute the operating margin of the assessee.
- The Assessing Officer/TPO is further directed to re-compute the difference between the arm's length price of the international transactions of the assessee-company with its AEs as determined by them and the price charged by the assessee-company by taking its operating margin after excluding the provision for bad and doubtful debts and if the same is found within the tolerance limit of 5 per cent, the addition made on account of transfer pricing adjustment is to be deleted.

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