TPO can apply TNMM to compute ALP even if comparable Co. isn't manufacturing exactly the same product

Summary – The Kolkata ITAT in a recent case of Epcos Ferrites Ltd., (the Assessee) held that Unlike CUP Method TNMM does not require that comparable company has to manufacture exactly same product as that manufactured by tested party

Companies which were manufacturing and selling electronic components, Electronic radiators, Soft ferrite, Electronic printed circuit boards, Aluminium electrolytic capacitors, Electronic capacitor grade metalised polypropylene film, etc., were functionally comparable to assessee-company manufacturing soft ferrites components

Application of 'cash profit margin', under TNMM, in manufacturing industry is appropriate for reason that same eliminates impact on profitability of differences in respect of technology, age of assets used in production, capacity utilization and depreciation expenses and its policies and interest expenses

Facts

- The assessee-company was engaged in the business of manufacture and sale of electronic component, namely, soft ferrites components.
- Out of the fourteen comparable companies selected by the assessee-company, the TPO retained only two companies and rejected twelve companies. The TPO by using the TNMM and two comparable companies made ALP adjustment.
- On appeal by the assessee, the Commissioner (Appeals) selected nine companies as comparables (including the comparable companies retained by the TPO and deleted the ALP adjustment.
- The Commissioner (Appeals) accepted the cash profit margin as appropriate net profit indicator (PLI) as applied by assessee before CIT(A) after considering the facts and circumstances of the case so that the tested party (*i.e.* assessee company) and the comparable companies are placed on the same foothold after eliminating the impact on profitability of the differences in respect of technology, age of assets used in production, capacity utilization and depreciation expenses and interest expenses.

Held

Comparables

- TPO rejected seven companies primarily on product comparison. The TPO accepted Cosmo Ferrites Ltd. as comparable as the company manufactured the same product as that manufactured by the assessee-company. However, the product mix of Continental Devices was broadly comparable to that of the assessee-company. The comparable companies which are manufacturing and selling electronic components, electronic radiators, Soft ferrite, Electronic printed circuit boards, Aluminium electrolytic capacitors, Electronic capacitor grade metalised polypropylene film, Semi-conductor diodes, silicon-controlled rectifiers, power rectifiers are functionally comparable to the assessee-company. Unlike the CUP Method, the TNMM does not require that the comparable company has to manufacture exactly the same product as that manufactured by the tested party. Hence, the TPO, while adopting the TNMM, erroneously rejected the aforesaid seven companies based on product comparison between the assessee-company (tested party) and the aforesaid independent companies. In the TNMM, what is to be seen is functional comparability and not the product comparability. The TPO ignored the comparability criterion laid down for application of TNMM. Hence, the contention of the department for the revenue and the nine comparable companies selected by the Commissioner (Appeals) was to be rejected.

- The assessee demonstrated the reason for selecting cash profit margin as an appropriate financial indicator under the TNMM for the relevant financial year. It was explained that the assessee increased production capacity substantially from 2900 MT in FY 2001-02 to 3400 MT in FY 2002-03. Inspite of the increase in capacity, the sales of the assessee decreased from INR 550,440 thousands in FY 2001-02 to INR 5,31,300 thousands in FY 2002-03. On the other hand, the provision for depreciation increased from INR 70,693 thousand in the FY 2001-02 to INR 84,582 thousand in FY 2002-03. The assessee was not in possession of capacity related information regarding comparable companies for the FY 2002-03 so as to enable it to make capacity utilization adjustment in the comparable companies. In view of this, the selected cash profit margin as an appropriate financial indicator under the TNMM and computed the same for itself and comparables companies based on the financial information already submitted to the TPO so that the tested party and all the comparable companies can be placed on the same foothold.
- For determining the fair and true profit for the purpose of the application of the TNMM, it is appropriate that the effect of the depreciation must be excluded out of the operating profit for determining the operating profit ratio. The best way of computing operating profit would be compute profit before depreciation in respect of each of the comparable company. It would take out the inconformity or the variation in the profit level of the comparables arising due to adoption of different method of charging depreciation.
- The use of cash profit margin by the assessee for placing the tested party and the comparable companies on equal footing. The assessee has demonstrated that the cash profit margin of the assessee was 8 per cent (approximately), whereas the arithmetic mean of the cash profit margins of the aforesaid nine comparable companies stands at 12.41 per cent. It is noted that the net profit margin of the tested party was (-) 6.70 per cent, whereas the cash profit margin of the tested party stood 8 per cent thereby indicating that the loss was caused by a considerable increase in provision for depreciation. The assessee was justified in applying cash profit margin as more appropriate financial indicator than net profit margin.