

आयकर अपीलीय अधिकरण, मुंबई न्यायपीठ 'के' मुंबई

IN THE INCOME TAX APPELLATE TRIBUNAL

"K" BENCH, MUMBAI

श्री विजयपाल राव, न्यायिक सदस्य, एवं श्री बी. आर. बासकरण, लेखा सदस्य के समक्ष

BEFORE SHRI VIJAYPAL RAO, JUDICIAL MEMBER AND

SHRI B.R. BASKARAN, ACCOUNTANT MEMBER

आयकर अपील सं. / ITA no.7757/Mum./2012

(निर्धारण वर्ष / Assessment Year : 2007-08)

Asstt. Commissioner of Income Tax
Circle-2(2), Aayakar Bhavan
101, M.K. Road, Mumbai 400 020

..... अपीलार्थी /
Appellant

बनाम v/s

Information Systems Resource
Centre Private Limited
9th Floor, Magnus Tower
Mindspace, Malad Link Road
Malad (W), Mumbai 400 064
PAN - AAAC13613G

..... प्रत्यर्थी /
Respondent

प्रत्याक्षेप सं. / C.O. no. 282/Mum./2013

(आयकर अपील सं. 7757/Mum./2012 से उद्भूत)

(Arising out of ITA no. 7757/Mum./2012

(निर्धारण वर्ष / Assessment Year : 2007-08)

Information Systems Resource
Centre Private Limited
9th Floor, Magnus Tower
Mindspace, Malad Link Road
Malad (W), Mumbai 400 064
PAN - AAAC13613G

..... प्रत्याक्षेपक /
Cross Objector

बनाम v/s

Asstt. Commissioner of Income Tax
Circle-2(2), Aayakar Bhavan
101, M.K. Road, Mumbai 400 020

..... प्रत्यर्थी /
Respondent

राजस्व की ओर से / Revenue by : Shri N.K. Chand

निर्धारिती की ओर से / Assessee by : Shri Arun Chhabra

<http://www.itatonline.org>

सुनवाई की तारीख /
Date of Hearing – 26.05.2015

आदेश घोषणा की तारीख /
Date of Order – 29.05.2015

आदेश / ORDER

विजयपाल राव, न्यायिक सदस्य के द्वारा /
PER VIJAYPAL RAO, JUDICIAL MEMBER

The present appeal by the Revenue and the cross objection by the assessee are directed against the impugned order dated 9th October 2012, passed by the Commissioner (Appeals)-15, Mumbai, for the assessment year 2007-08.

2. We first proceed to dispose off the appeal filed by the Revenue being ITA no.7757/Mum./2012, for the assessment year 2007-08, vide which, following grounds have been raised by the Revenue.

"1. On the facts and in the circumstances of the case and in law the learned CIT(A) erred in applying the LIBOR based interest rate overlooking the fact that such rate may be applied where Indian entities borrow loans from overseas whereas the position is totally reverse in the present case and the A.O. had correctly applied SBI PLR based interest rate."

3. The assessee is engaged in providing the software development and allied services to its group companies. During the course of proceedings before the Transfer Pricing Officer, it was observed that the assessee provided a credit period of 60 days to all its A.Es. While examining the details in this regard, Transfer Pricing Officer observed

that the assessee has provided additional credit period beyond 60 days mutually agreed for sale transaction without charging any interest on the same. The assessee was asked as to why the interest be not charged in computation of arm's length price in respect of such transaction. The assessee filed its submissions and justified that no interest adjustment was required considering the facts of the case and even any adjustment has to be made the same should be through working capital adjustment by adjusting the profits margin of the comparables. The Transfer Pricing Officer turned down the submission of the assessee and made an adjustment of ₹ 10,87,343, on account of the arm's length interest on the credit period provided by the assessee to its A.E. in realisation of sale proceeds. The Transfer Pricing Officer applied Primary Lending Rate (PLR) of State Bank of India as arm's length interest.

4. The assessee challenged the action of the Transfer Pricing Officer before the learned CIT(A). The learned CIT(A) though confirmed the transaction of extending the credit period subject to transfer pricing provisions, however, instead of PLR as an arm's length interest, it was directed that LIBOR based interest rate should be taken as arm's length interest rate for the purpose of computing the adjustment. Thus, the Revenue as well as the assessee are aggrieved by the impugned order of the learned CIT(A), whereby the LIBOR based

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interest is applied for the purpose of adjustment instead of PLR whereas the assessee is aggrieved against the finding that the credit period extended to the A.E. is a separate international transaction subject to arm's length price as per the transfer pricing provisions.

5. We have considered the rival submissions as well as the relevant material on record. At the outset, we note that the issue of adopting the PLR of the public sector banks or LIBOR for the purpose of arm's length interest has been considered by this Tribunal in the series of decisions. The decision of the Tribunal, Ahmedabad Bench, in *Micro Inc. Ltd. v/s ACIT*, ITA no.1668/Ahd./2006, vide order dated 6th August 2013, has considered an identical issue in Para-17 and 18, which is reproduced below:-

"17. As is evident from the above discussions, the relationship between the assessee and its step down subsidiary Micro USA was simply that of a lender and a borrower. Not only the Micro USA was a significant part of the marketing apparatus of the assessee, and the assessee and the Micro USA had significant commercial relationship on that count, the assessee was a de facto and de jure promoter of the Micro USA. In the light of this undisputed position, and in the light of the admitted position that, even as per revenue authorities, the transaction is at best for advance of money by holding to step down subsidiary, let us examine the correctness of the arm's length price adjustment in this case. In such a case, CUP method can be applied and the LIBOR or other bank rate linked rate is generally taken as a rate for comparable uncontrolled transaction. As has been held in a large number of cases, including in VVF (supra) and Perot Systems (supra), in the cases of arm's length prices of loans and advances, costs of funds have no relevance and it is only the rate applicable for comparable uncontrolled transaction that is to be taken into account. However, even while applying CUP method, one has to bear

in mind the fact that in terms of Rule IOB (1) computation of ALP under the CUP method is a three step process which requires that

(i) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;

lii) such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market:

(ii) The adjusted price arrived at under sub-clause (ii) is taken to be an arms length price in respect of the property transferred or services proved in the international transaction;

(Emphasis by underlining supplied by us)

18. Therefore, even when we take LIBOR plus rate as the base rate for an advance in step 1 of the above computation process, such base rate will have to adjusted inter alia for the differences..... (a) between the international transaction and the comparable uncontrolled transaction. and (b) between the enterprises entering into such transactions, which could materially affect the price in the open market". On both of these counts, adjustments will have to be necessarily made in the LIBOR plus rate. While the international transaction before us is that of advancing an interest free unsecured loan for helping a entity overcome its teething problems and pending the approval for capital subscription is received from the Reserve Bank of India, a typical LIBOR plus rate transaction is the transaction in which banks gives secure advances, for making profits out of so lending the money, to its customers. Strictly - speaking, there is no parity between these two types of transactions. Secondly, we are dealing with a situation in which the two enterprises are mutually dependent for commercial reasons. While Micro USA is dependent on the assessee for its sheer existence, the assessee is dependent on Micro USA for its business. Let us assume for a while that Micro USA is unconnected with the assessee so far as its management, capital and control is concerned, but even then and without this management, capital and control relationship, the assessee, as an independent enterprises, will make sense in giving interest free advances to Micro USA so as to ensure its continued market access in USA and for other commercial reasons. This is quite unlike a typical transaction on LIBOR plus rate in which only

motivation for giving advance is earning interest. Clearly, thus, LIBOR plus rate cannot be adopted in this situation for two fundamental reasons - (i) first, that it is not a simplicitor financing transaction between the assessee and Micro USA, as it is a transaction of investing in a step down subsidiary as quasi capital pending formal capital subscription with the approval of Reserve Bank of India; and (ii) second, that it is not a case of granting advance to a business concern without significant and decisive commercial considerations, as the monies are given for strengthening assessee's marketing apparatus in US and to keep alive its biggest exports customer. There is a difference in the nature of transaction and there is also a difference in the nature of the enterprises, including their inter se commercial relationship, entering into this transaction. The differences are so fundamental that these differences, to use the phraseology employed in Rule 10B(1)(a)(ii), "could materially affect the price in the open market". On account of these peculiar factors, the application of LIBOR plus rate or, for that purpose, any bank rate will be inappropriate to this case."

6. We further note that the number of other cases, the Tribunal has taken a similar view. Accordingly, to maintain the rule of consistency, we do not find any error or illegality in the order of the learned CIT(A). Accordingly, the grounds raised by the Revenue are dismissed.

7. राजस्व की अपील खारिज की जाती है।

7. In the result, Revenue's appeal is dismissed.

We now proceed to dispose of the assessee's cross objection being C.O. no. 282/Mum./2012, which is arising out of the appeal in ITA no.7757/Mum./2012, filed by the Revenue. The grounds raised in this cross objection are extracted below:—

"1. On the facts and in the circumstances of the case and in law the learned CIT(A) erred in upholding an adjustment of interest

levied on selective trade receivables received from related parties. The learned CIT(A) also erred by ignoring the fact that for any disparity with respect to receipt of receivables within a stipulated credit period, working capital adjustments were undertaken by the assessee thereby eliminating the need to undertake separate interest adjustment.

2. On the facts and in the circumstances of the case and in law the learned CIT(A) erred in upholding the levy of interest and using the London Interbank Offered Rate (LIBOR) based rate for selective receipts from trade receivables and not using the interest rate as nil."

8. The learned Counsel for the assessee submitted that the transaction of sale with the A.E. has been accepted by the Assessing Officer at arm's length, therefore, no separate adjustment can be made on account of credit period provided by the assessee to the A.E. for realisation of sale proceeds. He further contended that the credit period provided to the A.E. is not a separate international transaction but it is a closely linked transaction with the sale transaction with the A.E., therefore, this transaction has to be considered along with the international transaction of the assessee in respect of sale with the A.E. In support of his contention, he has relied upon the following decision:—

- i) Goldstar Jewellery Ltd v/s JCIT, ITA no.6570/Mum./012, order dated 14.1.2015; and*
- ii) Kusum Healthcare Pvt. Ltd. v/s ACIT, ITA no.6814/Del./2014, order dated 31.3.2015.*

9. The learned Counsel for the assessee has submitted that the Tribunal in Gold Star Jewellery Ltd. (supra), while dealing with an identical issue, has held that the transaction of allowing credit period to A.E. on realisation of sale proceeds is not an independent international transaction but it is a closely linked or continuous transaction along with the sale transaction to the A.E. Therefore, the credit period extended by the assessee to the A.E. cannot be examined independently but the same has to be considered along with the international transaction being sale to the A.E. He has further pointed out that the Tribunal, Delhi Bench, in Kusum Healthcare Pvt. Ltd. (supra), held that instead of making a separate adjustment on account of credit provided to the A.E. only working capital adjustment for the operating margin of the comparable company has to be worked out. Thus, the learned counsel submitted that only the differential impact of working capital has to be taken into account.

10. On the other hand, the learned Departmental Representative has submitted that insofar as the credit period provided by the assessee in terms of the agreement between the parties and as per the terms of the sale, the same may be considered as part of the international transaction of the sale. However, the assessee has given extra credit period over and above 60 days which is given to the A.Es, the same has to be treated as a separate international transaction because it

was not agreed between the parties at the time of sale but it is a post facto decision of allowing the credit to the A.E. The learned Departmental Representative has further contended that the assessee has not produced any evidence to show that the extension of the credit period is as per the terms of the sale between the parties. It has not been provided in the invoice of sale transaction, therefore, the assessee has failed to demonstrate from the record that the extra credit period provided by the assessee to the A.E. was part of the sale transaction. The interest on the credit is compensation for delayed payment and based on the principle of time value in money. Therefore, the over due of receivable has to be considered as a separate international transaction of providing the credit to the A.E.

11. We have considered the rival submissions as well as the relevant material on record. In the present case, the sale transaction of the assessee with its A.E. have been accepted by the Transfer Pricing Officer / Assessing Officer at arm's length and no adjustment has been made in respect of the sale transaction. However, the Transfer Pricing Officer has made the adjustment on account of credit period provided by the assessee to the A.E. on realisation of sale proceeds. At the outset, we note that an identical issue has been considered by the co-ordinate bench of the Tribunal, Mumbai Benches, in Goldstar Jewellery Ltd. (supra), vide Para-8, held as under:-

"8. We have considered the rival submissions and relevant material on record. The assessee has reported international transaction in its TP report regarding sale to its AE from manufacture of jewellery units and diamond trading unit. The TPO accepted the price charged by the assessee from AE at arm's length. However, the TPO has made the adjustment on account of notional interest for the excess period allowed by the assessee to AE for realization of dues. The TPO applied 18.816% per annum as arm's length on the over due amounts of AE and proposed adjustment of Rs. 2,49,95,139/-. The DRP though concurred with the view of the Assessing Officer/TPO on the issue of international transaction, however, the adjustment was reduced by applying the interest rate of 7% instead of 18.816% applied by the TPO. The first issue raised by the assessee is whether the aggregate period extended by the assessee to the AE which is more than the average credit period extended to the non-AE would constitute international transaction. We are of the view that after the insertion of explanation to section 92B(1), the payment or deferred payment or receivable or any debt arising during the course of business fall under the expression international transaction as per explanation. Therefore, in view of the expanded meaning of the international transaction as contemplated under clause (i) (e) of explanation to section 92B(1), the delay in realization of dues from the AE in comparison to non-AE would certainly falls in the ambit of international transaction. However, this transaction of allowing the credit period to AE on realization of sale proceeds is not an independent international transaction but it is a closely linked or continuous transaction along with sale transaction to the AE. The credit period allowed to the party depends upon various factors which also includes the price charged by the assessee from purchaser. Therefore, the credit period extended by the assessee to the AE cannot be examined independently but has to be considered along with the main international transaction being sale to the AE. As per Rule 10A(d) if a number of transactions are closely linked or continuous in nature and arising from a continuous transactions of supply of amenity or services the transactions is treated as closely linked transactions for the purpose of transfer pricing and, therefore, the aggregate and clubbing of closely linked transaction are permitted under said rule. This concept of aggregation of the transaction which is closely linked is also supported by OECD transfer pricing guidelines. In order to examine whether the number of transactions are closely linked or continuous so as to aggregate for the purpose of evaluation what is to be considered is that one transaction is follow-on of the earlier transaction and then the subsequent transaction is carried out and dependent wholly or substantially on the earlier transaction. In other words, if two

transactions are so closely linked that determination of price of one transaction is dependent on the other transaction then for the purpose of determining the ALP, the closely linked transaction should be aggregated and clubbed together. When the transaction are influenced by each other and particularly in determining the price and profit involved in the transactions then those transactions can safely be regarded as closely linked transactions. In the case in hand the credit period extended to the AE is a direct result of sale transaction. Therefore no question of credit period allowed to the AE for realization of sale proceeds without having sale to AE. The credit period extended to the AE cannot be treated as a transaction stand alone without considering the main transaction of sale. The sale price of the product or service determined between the parties is always influenced by the credit period allowed by the seller. Therefore, the transaction of sale to the AE and credit period allowed in realization of sale proceeds are closely linked as they are inter linked and the terms and conditions of sale as well as the price are determined based on the totality of the transaction and not on individual and separate transaction. The approach of the TPO and DRP in analyzing the credit period allowed by the assessee to the AE without considering the main international transaction being sale to the AE will give distorted result by disregarding the price charged by the assessee from AE. Though extra period allowed for realization of sale proceeds from the AE is an international transaction, however, for the purpose of determining the ALP, the same has to be clubbed or aggregated with the sale transactions with the AE. Even by considering it as an independent transaction the same has to be compared with the internal CUP available in the shape of the credit allowed by the assessee to non AE. When the assessee is not making any difference for not charging the interest from AE as well as non-AE then the only difference between the two can be considered is the average period allowed along with outstanding amount. If the average period multiplied by the outstanding amount of the AE is at arm's length in comparison to the average period of realization and multiplied by the outstanding from non AEs then no adjustment can be made being the transaction is at arm's length. The third aspect of the issue is that the arm's length interest for making the adjustment. Both the TPO and DRP has taken into consideration the lending rates, however, this is not a transaction of loan or advance to the AE but it is only an excess period allowed for realization of sales proceeds from the AE. Therefore, the arm's length interest in any case would be the average cost of the total fund available to the assessee and not the rate at which a loan is available. Accordingly, we direct the Assessing Officer/TPO to re-do the exercise of determination of ALP in terms of above observation."

12. Thus, it is clear that the Tribunal has taken a view that the transaction of allowing the credit period to the A.E. on realisation of sale proceeds has to be considered along with the main international transaction in respect of sale to A.E. A similar view has been taken by the Tribunal, Delhi Bench, in Kusum Healthcare Pvt. Ltd. (supra), wherein the Tribunal, vide Para-7 to 10, held as under:-

“7. We have heard rival submissions and perused the material on record. 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 this regard, the reliance is placed on the following rulings wherein the need to undertake working capital adjustment has been appreciated by the Hon’ble Tribunals :

- *Mercer Consulting India Pvt. Ltd. [TS-170-ITAT-2014(DEL)]*
- *Mentor Graphics (Noida) Private Limited [109 ITD 101]*
- *Egain communication (P) Ltd. [ITA No. 1685/PN/2007]*
- *Sony India (Pvt.) Ltd. [2011-TII-43-ITAT-DEL-TP]*
- *Capgemini India Private Limited [TS-45-ITAT-2013(Mum)-TP]*

8. In view of the above, a working 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 are more than the working capital adjusted margin of the comparables, then additional imputation of interest on the outstanding receivables is not warranted.

9. The assessee had undertaken a working capital adjustment for the comparable companies selected in its transfer pricing report which was also submitted with the Ld. TPO. A snapshot of the result is provided below:

Segment Name	Appellant's Margin (OP/TC)	Working capital adjusted margins of comparables (OP/TC)
Manufacturing Activity	46.33%	11.84%
Trading Activity	17.44%	8.36%

10. The above analysis empirically demonstrates that the differential impact of working capital of the 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."

13. Following the orders of the Tribunal, we set aside this issue to the record of the Assessing Officer / Transfer Pricing Officer and direct to re-do the exercise of determination of arm's length price in the light of the above decisions of the Tribunal. The grounds raised in this cross objection are allowed for statistical purposes.

14. परिणामतः राजस्व की अपील खारिज की जाती है एवं निर्धारिती की प्रत्याक्षेप सांख्यिकीय उद्देश्य के लिए स्वीकृत की जाती है।

14. In the result, appeal of the Revenue is dismissed and cross objection of the assessee is allowed for statistical purposes.

Order pronounced in the open Court on 29.5.2015

Sd/-
बी. आर. बासकरण
लेखा सदस्य
B.R. BASKARAN
ACCOUNTANT MEMBER

Sd/-
विजयपाल राव,
न्यायिक सदस्य
VIJAYPAL RAO
JUDICIAL MEMBER

मुंबई MUMBAI, दिनांक DATED: 29.5.2015

आदेश की प्रतिलिपि अग्रेषित / Copy of the order forwarded to:

- (1) निर्धारिती / The Assessee;
- (2) राजस्व / The Revenue;
- (3) आयकर आयुक्त(अपील) / The CIT(A);
- (4) आयकर आयुक्त / The CIT, Mumbai City concerned;
- (5) विभागीय प्रतिनिधि, आयकर अपीलीय अधिकरण, मुंबई / The DR, ITAT, Mumbai;
- (6) गार्ड फाईल / Guard file.

सत्यापित प्रति / True Copy
आदेशानुसार / By Order

प्रदीप जे. चौधरी / Pradeep J. Chowdhury
वरिष्ठ निजी सचिव / Sr. Private Secretary

उप / सहायक पंजीकार / (Dy./Asstt. Registrar)
आयकर अपीलीय अधिकरण, मुंबई / ITAT, Mumbai