

**IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH 'I': NEW DELHI**

**BEFORE SHRI J.S. REDDY, ACCOUNTANT MEMBER
AND
SHRI GEORGE GEORGE K., JUDICIAL MEMBER**

**ITA No. 6814/Del/2014
Assessment Year 2010-11**

Kusum Healthcare Pvt. Ltd.
D-158A, Okhla Industrial Area,
Phase-I,
New Delhi.

Vs.

ACIT, Range-5
New Delhi.

(PAN : AAACK7043B)

(Appellant)

(Respondent)

Date of hearing : 26.03.2015
Date of Pronouncement :03.2015

Appellant by : Shri Tarun Arora, CA
Respondent by : Shri J. James, Standing Counsel DR

ORDER

PER SHRI GEORGE GEORGE K, JM:

This appeal, at the instance of the assessee, arises out of the order of assessment passed u/s 143(3) r.w.s. 144C of the Act. The relevant assessment year is AY 2010-11.

2. The solitary issue that is raised in this appeal is whether the AO/DRP is justified in enhancing the income of the assessee by Rs.93,69,275/-, on account of notional interest charged on receivables outstanding beyond 180 days.
3. Brief facts of the case are as follows.

The assessee is a company, which manufactures and markets pharmaceutical products. It is engaged in export of pharmaceutical products to its overseas associated enterprise (“AE”) as well as third parties. During the relevant assessment year, the assessee was involved in export of pharmaceutical products (manufactured as well as traded) to its AE. The said international transaction was benchmarked in the transfer pricing (“TP”) study using Transactional Net Margin Method (“TNMM”) as the Most Appropriate Method (“MAM”). The segmental profitability of the assessee from its manufacturing and trading segment was compared with margin earned by comparable companies engaged in performing similar manufacturing and trading functions respectively. The results of the benchmarking analysis undertaken by the assessee are provided in the table below:

International Transactions	Profit level Indicator	Appellant’s margin	Comparables margin
Export of manufactured medicines	Operating Profit/Total	46.33%	10.23%
Export of traded medicines	Cost (‘OP/TC’)	17.44%	5.31%

3.1 Since the operating profit margin of the assessee in both the segments was higher than the comparable companies considered in respective segments, the international transactions were considered to be undertaken at arm’s length price.

4. During the course of assessment proceeding, the above 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%), with regard to receivable outstanding for a period exceeding 180 days. Thus, the TPO made a transfer pricing adjustment of Rs.1,57,54,943/-. The Assessing Officer incorporated the Transfer pricing adjustment in the draft assessment order. Against the draft assessment order, the assessee filed its objection before the DRP as provided u/s 144C of the Act. The DRP concurred with the TPO and held that the TPO was justified in considering the impugned transaction as an international transaction and benchmarking its separately by applying comparable uncontrolled price (CUP) method. Further, in respect of rate of interest to be used, the DRP directed the TPO to apply SBI base rate (as on 30th June of the relevant previous year) plus 150 basis points instead of 14.88% applied by the TPO. The DRP also directed to TPO to allow relief for interest forgone on outstanding receivable balances with non-AEs/third parties. Pursuant to the DRP directions, the TPO revised the addition to Rs.93,69,275/- and the same was incorporated by the AO in the final assessment order dated 14.11.2014.

5. Aggrieved by the assessment completed the assessee has preferred the present appeal. The summary of submissions given by the assessee with reference to imputation of notional interest on the receivable outstanding beyond 180 days are as follows:-

“1. A working capital adjustment takes into account the impact of outstanding receivables on the profitability

- ***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.***

- *A working capital adjustment takes into account the impact of outstanding receivables on the profitability. Thus, appropriate adjustments need to be considered to bring parity in the working capital investment of the Appellant and the comparables rather than looking at the receivable independently.*
- *The above position is also supported by OECD, which prescribes that, "Making a working capital adjustment is an attempt to adjust for the differences in time value of money between the tested party and potential comparables with an assumption that the difference should be reflected in profits. "*
- *In this regard, the Appellant would like to place reliance on the following rulings wherein the need to undertake working capital adjustment has been appreciated by the Hon'ble ITAT:*
 - *Mercer Consulting India Pvt. Ltd. [TS-170-ITAT-2014(DEL)]*
 - *Sony India (Pvt.) Ltd. [2011- TII/-43-ITAT-dEL- TP]*
 - *Mentor Graphics (Noida) Private Limited [109 ITD 101J]*
 - *Capgemini India Private Limited [TS-45-ITAT-2013(Mum)- TP]*
 - *Micro ink Ltd [TS-216-ITAT-2013 (Ahd)-TP]*

II. Aggregation of closely linked transactions

- *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.*
- *Differential impact of working capital of the Appellant vis-a-vis its comparables has already been factored in the pricing! profitability of the Appellant and therefore, any further adjustment to the margins of the Appellant on the pretext of outstanding receivables is uneconomical, unwarranted and wholly unjustified.*
- *In this regard, reliance is placed on the recent ruling of Hon'ble Delhi High Court in case of Sony Ericsson Mobile Communication India Pvt. Ltd and several other connected matters [TS-96-HC-2015(DEL)-TP].*

III. No interest charged to non-group companies

- *No interest has been charged on the overdue balances from unrelated third parties as is the case for outstanding receivables from AEs. It is also pertinent to mention that AE is the key customer of the Appellant and the sales made by Appellant to its AE amounts to 88% of the total turnover of the Appellant. Therefore, charging of interest on outstanding receivable from the AE is not warranted.*
- *In support of the above contention, reliance is placed on inter alia, the following decisions by the Hon'ble ITAT wherein it was held that in case no interest is charged from AEs as well as non-AEs on outstanding receivables, no addition on account of such interest can be made. -*

- Indo American Jewellery Limited vs. DCIT [ITA No.5872/Mum/2009]- (upheld by the Hon'ble Bombay High Court ((ITA No. 1053 of 2012))
- Tech Mahindra Limited (2011) 46 SOT 141
- Lintas India Pvt. Ltd. Vs. ACIT-3(2), Mumbai [ITA No.2024/Mum/2007
- Nimbus Communications Limited [(2010) 38 SOT 246]

IV. Re-characterization of outstanding receivables as unsecured loans advanced by the Appellant to its AE is not permissible under the Act

- *It is respectfully reiterated that the Ld. TPO/AO has re-characterised the outstanding receivables as unsecured loan extended by the Appellant to its AE and imputed a notional interest on the period of delay exceeding 180 days. In this regard, the Appellant humbly submits that computing notional interest on a fictional transaction is not permissible under the Act. The law only requires actual transactions to be at arm's length and does not permit imputation of arm's length price based on further notional transactions.*
- *In this regard, reliance is placed on the following rulings which barred re-characterization of a genuine transaction –*
 - Bharti Airtel Limited Vs. ACIT (TS-76-ITAT-2014(DEL)- TP)
 - Vodafone International Holdings BV vs Union of India (2012) 17 taxmann.com 202 (SC)
 - Sony Ericsson Mobile Communication India Pvt. Ltd and several other connected matters [TS-96-HC-2015(DEL)- TP]
 - Evonik Degussa India Private Limited (ITA No. 7653/MUM/2011)
 - CIT vs M/s Sutlej Cotton Mills Supply Agency Ltd (1975) 100 ITR 706
 - CIT vs Niraj Amidhar Surti - Tax Appeal No. 836 of 2009.

V. Devaluation of foreign currency

- *The Appellant would also like to highlight that during the year 2009 the home currency of the AE i.e. Hryvinia ('UAH') had strikingly devaluated which resulted in increase of liability for AE towards the Appellant. It is respectfully submitted that the Appellant invoices its AE in the USD and its liability arises in USD whereas, the AE bills its customers in the UAH.*
- *Your Honours would appreciate that the AE undertaking routine distribution functions is entitled to a routine return vis-a-vis the Appellant which is a manufacturer. Such a distributor in an arm's length scenario would not assume such increased liability arising out of foreign exchange fluctuation. Any third party distributor would have asked for a discount or waiver for the same.*

VI. Business model of Kusum India needs to be appreciated

- *The business model of the Appellant and the geographic region where it sells its goods is such, where the revenue cycle is usually longer and it takes longer time to recover the proceeds.*

- *Majority of the revenue earned by the Appellant is from AE (i.e. 88%, INR 70.09 crores during the year). Keeping in view the strong presence of and volume of business with AE, no third party would be willing to charge interest on amount receivable from such a key customer and would rather invest in relationship by allowing better credit terms in expectation of more business and profits.*
- *It is also important to highlight that the AE has accounted for majority of the sales and profit of the Appellant in the subsequent period as well. Based on the aforesaid, non-charging of interest by the Appellant on outstanding receivable from its AE is prudent from a businessmen's perspective and does not warrant any adjustment.*
- *AE is one of the established distributors of medicinal products in Ukraine. Due to its major presence in the country, the AE is in a position to sell its products at a premium than its competitors. Keeping that in view, the Appellant is in position to sell its products to the AE at a premium in comparison to sales made to the non-group company. This allows the Appellant to offer better credit terms to the AE in lieu of higher profits which the Appellant generates from the sales made to the AE.*
- *In this regard, reliance is placed on the ruling of Mastek Limited vs. Addl. CIT, Range 4, Ahmedabad [ITA No. 3120/Ahd/2010], wherein the Hon'ble Tribunal while deciding as similar issue, noted that a commercial consideration and market practice has to be taken into account.*

VII. Without prejudice to above contentions of the Appellant, if interest is to be imputed, then LIBOR rate should be applied for imputing interest.

- *Without prejudice to the above contentions, it is respectfully submitted that computation of imputed interest on outstanding receivables based on SBI PLR plus 150 basis points is wholly unjustified and unwarranted. LIBOR rate should be applied on an international loan for computing interest, which has been upheld in the following rulings:*
 - **Kohinoor Foods Ltd. (TS-224-ITAT-2014(DEL)- TP)**
 - **Siva Industries & Holdings Ltd (ITA No. 2148/Mds/2010),**
 - **Four Soft Ltd. (ITA No. 1495/HYD/2010)**
 - **Varroc Engineering Pvt. Ltd. (I.T.A No. 2482/PN/2012)**
 - **Tricorn India Ltd. (TS-266-ITAT-2014(MUM)-TP)**
- *Accordingly, the approach of the Ld. AO is grossly incorrect and void and it is respectfully submitted that keeping in view the above contentions, factual position as well the judicial precedence, any adjustment to on the pretext of outstanding receivables is wholly unjustified and therefore, the proposed adjustment should be withdrawn.*

6. The Ld. DR, Shri J. James submitted that the argument of the assessee that

the transaction in question has been recharacterised is incorrect. He submitted that at the first instance itself, the TPO has characterised the amount due from the A.E. beyond 180 days, as a loan, for the reason that the agreement between the parties stipulate that the credit period shall be only for a period of 180 days. He referred to page 16 of the assessee's paper book and to page 249 as well as 255 to drive home his point that the assessee itself has characterised the dues from A.E. and Non-A.E. as debtors and that it is an interest free loan given to an A.E. To the other propositions argued by the assessee, he submits that the D.R.P. at page 20 dealt with the issue of clubbing. On the reliance placed by the assessee on recent Jurisdictional High Court judgement in the case of Soni India Pvt.Ltd. and others, he submitted that the issue considered by the Hon'ble High Court was whether expenditure incurred on advertising and marketing intangibles can be separately bench marked or not when TNMM is adopted. He submitted that the issue on hand is distinct and this judgement cannot be relied upon for the reason that interest free advances given to sister concerns, A.Es have been considered as separate international transactions by a number of decisions. He argued that CUP has been adopted as the most appropriate method. Without prejudice he relied on page 22 of the DRP's order. He submitted that the order of the DRP may kindly be sustained.

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.

11. In this regard, we would also like to place reliance on the judgement of Micro ink Ltd [TS-216-ITAT-2013(Ahd)-TP] wherein the ITAT upheld the above principle and deleted the adjustment on account of alleged excess credit period allowed to AE. The Hon'ble ITAT observed the following in the judgment:

"Para 20 - The only other ALP adjustment in appeal before us is with respect to what the authorities below have treated as, excess credit period allowed to Micro USA. This adjustment must be deleted for the short reason that it was part of the arrangement that specified credit period was allowed and thus the cost of funds blocked in the credit period was inbuilt in the sale price. "

12. Accordingly, keeping in view the above factual position as well the judicial precedence, any separate adjustment on the pretext of outstanding receivables while accepting the comparables and transfer price of underlying transaction i.e. sale of goods by application of TNMM is unjustified. In this regard, the recent ruling of Hon'ble Delhi High Court in case of Sony Ericsson Mobile Communication India Pvt. Ltd. and several other connected matters [TS-96-HC-2015(DEL)-TP], where the Hon'ble jurisdictional HC while concluding the judgment held as under :

"(v) Where the Assessing Officer/TPO accepts the comparables adopted by the assessed, with or without making adjustments, as a bundled transaction, it would be illogical and improper to treat AMP expenses as a separate international transaction, for the simple reason that if the functions performed by the tested parties and the comparables match, with or without adjustments, AMP expenses are duly accounted for. It would be incongruous to accept the comparables and determine or accept the transfer price and still segregate AMP expenses as an international transaction,"

13. The above principle was also clarified by the Hon'ble Jurisdictional High Court by way of an example which is reproduced below:

“At Para 93: An example given below would make it clear:

Particulars	Case 1	Case 2
Sales	1000	1,000
Purchase Price	600	500
Gross Margin	400 (40%)	500
Marketing Sale promotion	50	150
Overhead expense	300	300
Net profit	50 (5%)	50 (5%)

The above illustrations draw a distinction between two distributors having different marketing functions. In case 2, a distributor having significant marketing functions incurs substantial expenditure on AMP, three times more than in case 1, but the purchase price being lower, the Indian AE gets adequately compensated and, therefore, no transfer pricing adjustment is required. In case we treat the AMP expenses in case 2 as Rs.501-, i.e. identical as case 1 and AMP of Rs. 1001- as a separate transaction, the position in case 2 would be:

Particulars	Case 2
Sales	1,000
Purchase Price	500
Gross Margin	500
	(50%)
Overhead expenses	300
Marketing expenses	50
Net profit	150 (15%)

It is obvious that this would not be the correct way and method to compute the arm's length price. The purchase price adjustments/set off would be mandated to arrive at the arm's length price, if the AMP expenses are segregated as an independent international transaction”

14. As mentioned earlier, 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 and therefore, any further adjustment to the margins of the assessee on the pretext of outstanding receivables is unwarranted and wholly unjustified.

15. 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.

16. In this regard, reliance is placed upon the recent ruling of Hon'ble Delhi High Court in case of Sony Ericsson Mobile Communication India Pvt. Ltd and several other connected matters (Supra) in respect of aggregation of closely linked transactions. The relevant portion of the judgment is reproduced below :-

"In case the tested party is engaged in single line of business, there is no bar or prohibition from applying the TNM Method on entity level basis. The focus of this method is on net profit amount in proportion to the appropriate base or the PLI. In fact, when transactions are inter-connected, combined consideration may be the most reliable means of determining the arm's length price. There are often situations where closely linked and connected transactions cannot be evaluated adequately on separate basis..... "

"Where the Assessing Officer/TPO accepts the comparables adopted by the assessed, with or without making adjustments, as a bundled transaction, it would be illogical and improper to treat AMP expenses as a separate international transaction, for the simple reason that if the functions performed by the tested parties and the comparables match, with or without adjustments, AMP expenses are duly accounted for. It would be incongruous to accept the comparables and determine or accept the transfer price and still segregate AMP expenses as an international transaction. "

17. From the above analysis, it is clear that 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 as well as ratio laid down by the Hon'ble jurisdictional High Court in the case of Sony Ericson Mobile Communication India Pvt. Ltd. (supra). For the aforesaid reasons, we allow the appeal of the assessee. It ordered accordingly.

The decision was pronounced in the open Court on 31st March, 2015.

Sd/-
(J.S. REDDY)
Accountant Member

sd/-
(GEORGE GEORGE K.)
Judicial Member

Dated : the 31st day of March, 2015
TS

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1. Appellant
2. Respondent
3. CIT
4. CIT(A)
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Asst. Registrar, ITAT, New Delhi