

IN THE INCOME TAX APPELLATE TRIBUNAL
PUNE BENCH, 'C' PUNE – VIRTUAL COURT

BEFORE SHRI R.S. SYAL, VICE PRESIDENT AND
SHRI S.S. VISWANETHRA RAVI, JUDICIAL MEMBER

आयकर अपील सं. / ITA No.2252/PUN/2017
निर्धारण वर्ष / Assessment Year : 2013-14

GL&V India Private Limited, GL&V House, Plot No.2C, S.No.162/4A-5A, Off D.P. Road, Aundh, Pune 411 007 PAN : AACCG4425A	Vs.	DCIT, Circle-1(2), Pune
Appellant		Respondent

Assessee by Shri Ajit Jain and
Shri Siddhesh Chaugule
Revenue by Shri Mahadevan A.M. Krishnan
Date of hearing 22-06-2021
Date of pronouncement 24-06-2021

आदेश / ORDER

PER R.S.SYAL, VP :

This appeal by the assessee is directed against the order passed by the CIT(A)-13, Pune on 26-07-2017 in relation to the assessment year 2013-14.

2. The ld. AR pressed only ground Nos.1.4 and 1.5 from the revised set of grounds. As such, all other grounds stand dismissed as not pressed.

3. The two surviving grounds deal with the solitary issue of the transfer pricing addition. Succinctly, the factual panorama of the case is that the assessee is a wholly owned subsidiary of GL&V

Inc., Canada. The assessee is engaged in the manufacture and designing of equipments used in Pulp and Paper industry (almost 90%) and water treatment covering Municipal, Power and Industrial sector (around 10%). In addition, the assessee is also rendering designing services to its Associated Enterprises (AEs). The assessee reported certain international transactions in Form No. 3CEB. The AO made a reference to the Transfer Pricing Officer (TPO) for determining their Arm's Length Price (ALP). The TPO accepted other international transactions at ALP except the transactions relating to the Manufacturing operations, thereby covering the transactions of purchase of raw material and sale of products. The assessee employed the Cost Plus Method (CPM) in its Transfer pricing analysis for benchmarking the Manufacturing transactions. The TPO rejected the CPM and deployed the Transactional Net Margin Method (TNMM) as the most appropriate method with the Profit Level Indicator (PLI) of Operating Profit/Sales. He, accordingly, worked out the assessee's PLI at 2.35%. Out of eight companies chosen by the assessee as comparable, the TPO rejected four. With the remaining four companies, having average PLI at 6.43%, the TPO worked out the transfer pricing adjustment of Rs.1,03,82,325/-. The Assessing Officer (AO) finalized the

assessment u/s.143(3) r.w.s. 144C(3) of the Income-tax Act, 1961 (hereinafter also called 'the Act') with the transfer pricing addition of the equal amount. The Id. CIT(A) partly allowed the appeal and the assessee has come up before the Tribunal.

4. We have heard both the sides through Virtual Court and gone through the relevant material on record. Though the assessee initially applied the Cost Plus method for benchmarking the international transactions under the Manufacturing activity, but it is not aggrieved by its substitution by the TPO with the TNMM as the most appropriate method. To be more specific, the grievance of the assessee is only two-fold, namely improper working capital adjustment and wrongful exclusion of Fives Cail KCP Ltd. on improper application of one of the accepted filters.

A. Working Capital Adjustment:

5.1. The assessee did not claim any working capital adjustment in its Transfer pricing study report. No such claim was made before the TPO as well. It was for the first time that the assessee lodged such a claim before the Id. CIT(A) by furnishing calculations of its working capital and that of the comparable companies. In such calculation, the assessee included two items, which are subject matter of dispute, viz., Advances to suppliers and Advances from

customers. The Id. CIT(A) restored the matter to the AO directing him: “*to adopt the method of working capital adjustment as provided in the example provided in the Annexure to Chapter III of the OECD transfer pricing Guidelines, 2010.*” The case of the assessee is that in the hypothetical example of working capital calculation given in the OECD Guidelines, the items of Advances to suppliers and Advances from customers do not find any place, which should be included.

5.2. We have heard the rival submissions and gone through the relevant material on record. There is no dispute as to the *per se* granting of working capital adjustment. The controversy revolves around only its computation, and that too, *qua* the two items of Advances to suppliers and Advances from customers.

5.3. The example in the Annexure to Chapter III of the OECD transfer pricing Guidelines, 2010 contemplates adding up Trade receivables and Inventories and then reducing Trade payables so as to constitute numerator with the denominator of sales. It does not *ex facie* imbibe Advances to suppliers and Advances from customers.

5.4. In order to appreciate the inclusion or otherwise of advances to/from suppliers/customers, we first need to understand the rationale behind allowing working capital adjustment. Under the

TNMM, operating profit margin (in percentage terms) of an assessee is compared with that of the comparables so as to ascertain if the assessee's international transaction is at ALP. Assesseees adopt different policies for conducting their business. One assessee may have a policy of allowing less time to trade debtors for payment or may have only cash sales with no debtors, while another may be allowing more time with the ultimate effect of less or more trade debtors. When a company allows more time to the trade debtors for payment, it naturally pushes up the sale price so as to include corresponding interest cost in it. In case of cash sale, the price charged is relatively screwed because of having no element of interest cost in the sale price. Thus in a case of allowing more time to trade debtors for payment, sale price and the resultant profit from sale increases in comparison with a company which allows lesser time to trade debtors for payment. Similar is the position as regards purchases. More the amount of trade creditors means costly purchases followed by lower profit and *vice versa*. Ergo, relatively high working capital of a company indicates that it allowed more time to trade debtors with the increased sales price and the corresponding swelled profit. In the like manner, it also means that it paid the trade creditors early and made cheap purchases with the

resultant more profit. If for benchmarking, we compare naked and unadjusted profit of a comparable company with the assessee - in the face of a difference in working capitals of the two - it would show skewed results and tarnish the comparability.

5.5. Rule 10B(3) of the Income-tax Rules, 1962 provides that: 'An uncontrolled transaction shall be comparable to an international transaction ... if(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences.'. In order to bring the companies with high or low working capitals at the same level playing field, it becomes essential that a company with higher working capital should face reduction in its profit correspondingly so as to become eligible for comparison with the assessee company and *vice versa*. It is for such high or low working capitals employed by an assessee and comparables that need for adjusting the profit margin arises, which is carried through the working capital adjustment.

5.6. Ordinarily, working capital is computed by adding the amount of Inventories and trade receivables and then reduced by the amount of trade receivables. Reverting to the facts of the instant case, it is seen that the apparent effect of the direction given by the Id. CIT(A) is to consider only Trade receivables and Trade

payables, in addition to inventory and not Advances to suppliers or Advances from customers that have been contested before the Tribunal. Higher amount of advances to suppliers indicates that an assessee-buyer made more advance payments and made cheap purchases. There is no qualitative difference between a situation of higher amount of advances to suppliers and a situation of lower amount of trade payables insofar as its impact on the profit margin is concerned. Both the situations affect the profitability and the working capital in the same manner. In the like scenario, higher amount of advances from customers deciphers that an assessee-seller made cheap sales. Again, there is no qualitative difference between the higher amount of advances from customers and lower amount of trade receivables insofar as its impact on the profit margin is concerned. Thus, advances to suppliers and advances from customers are integral part of working capital adjustment in the same way in which there are trade receivables and trade creditors. Such advances, ergo, cannot be excluded in computing the working capital adjustment. Reference to trade receivables and trade payables in the example given in Annexure to Chapter III of the OECD transfer pricing Guidelines, 2010 should be construed as including advances to suppliers and advances from customers. It is

only for simplification purpose that the example refers to trade receivables and trade payables to the exclusion of advances to suppliers and advances from customers. We, therefore, amplify the direction of the Id. CIT(A) to the AO/TPO for adopting the method of working capital adjustment as provided in the example given in Chapter III of the OECD Guidelines by also considering Advances to suppliers and Advances from customers, in the same way as Trade receivables and Trade payables.

5.7. The figures of Advances to suppliers and Advances from customers, as given by the assessee for the first time before the Id. CIT(A) pertaining to self and the comparables, have not been verified by any authority. These need to be examined and evaluated by observing that only advances to or from customers/suppliers should be included in the computation of working capital of the assessee as well as the qualifying comparables. In other words, no advance or outstanding other than relating to purchase or sale of goods should find its place in the computation of working capital. We order accordingly.

B. Filter of Manufacturing sales more than 75% of total sales -
Fives Cail KCP Ltd.

6.1. The assessee used one of the filters, namely, 'Companies having manufacturing sales comprise < 75% of their total sales were excluded' and accordingly included Fives Cail KCP Ltd. in the list of comparables with PLI at (-) 41.54% . The TPO rejected this company on account of exceptionally low profit (loss). When the matter came up before the Id. CIT(A), he reversed the reasoning of the TPO by holding that loss making companies *per se* cannot be excluded. He, however, noted that the Revenue from sale of services of this company stood at Rs.8.31 crore as against Revenue from sale of products at Rs.38.58 crore. In the absence of any segmental information available in the Financial statements, the Id. CIT(A) held that this company cannot be compared with the assessee company that is engaged only in Manufacturing under the segment under consideration. The assessee is aggrieved by the exclusion of this company.

6.2. After considering the rival submissions and perusing the relevant material on record, we find that the original reason adduced by the TPO for the rejection of this company, being exceptionally low profit (loss), has been overturned by the Id. CIT(A), which need not be delved into. The *raison d'être* which needs to be gone into is the argument of the Id. AR about this company passing all the filters

including having manufacturing sales not less than 75% of its total sales. It was stated that percentage of manufacturing sales to total revenue of this company is about 83% and hence it qualifies for the inclusion.

6.3. We have gone through the Annual report of this company, whose copy is available in the paper book. Page 394 is its Profit and loss account which gives figures of Revenue from sale of products at Rs.38.58 crore; Revenue from sale of services at Rs.8.31 crore (about 17%); and Other operating revenue at Rs 0.39 crore. Thus it is palpable that the overall PLI of this company at (-) 41.54% imbibes the effect not only of its manufacturing activity but also that of rendering services, which is not minuscule. On a pertinent query, the Id. AR fairly conceded that no independent Manufacturing segmental information of this company is available. As against that, the segment of the assessee under consideration is only Manufacturing. We have noted above that the assessee also entered into the international transaction of rendering services. However that transaction was benchmarked separately by the assessee and the TPO did not dispute that it was at ALP. Thus, the only segment of the assessee under consideration is that of Manufacturing *de hors* Services. In that view of the matter, the

companies doing Manufacturing only or having an independent manufacturing segment qualify for comparison. Since the Revenue from sale of services of Fives Cail KCP Ltd. constitutes a substantial portion in the overall kitty, it does not qualify as a good comparable.

6.4. Now we turn to the main plank of the submissions of the Id. AR that since this company's sale from Manufacturing activity at around 83%, passes the filter of Manufacturing sales more than 75% of total sales, the same should be included. There is a basic fallacy in this argument. The comparable selection process in the ALP determination envisages broadly two levels of comparisons: company level and transaction level. In order to qualify for inclusion in the list of comparables, a company must first pass the company level comparison and then transaction level. The broad nature of activity under which the transaction of an assessee-company under consideration for benchmarking, falls, facilitates in selecting comparables at the company level. Such nature of activity sets up the parameters of predominant similarity of the companies to be selected at the first level. Then comes the transaction level comparison, which requires selecting such companies, out of those qualifying from the company level comparison, which are engaged

in the transactions similar to the transaction under consideration. If a company selected at the first level is engaged solely in the transactions akin to the international transaction under consideration for benchmarking, then that qualifies for inclusion. If on the other hand, a company chosen from the company level comparison, has multiple transactions and one of them is similar to the international transaction under consideration, then such a company will call for inclusion only if its results from the comparable transaction are separately available, namely, the segmental information of the concerned transaction or segment is identifiable and available. It is only on passing the second level of comparison at the transaction level, that such either a fully comparable company or its separately identifiable comparable transaction/segment will pass the test of final inclusion.

6.5. The filter under consideration - 'Manufacturing sales not less than 75% of the total sales' - applies at the first level of company selection so that only the companies engaged mainly in manufacturing activity get selected at the entry level. It has no application at the second level of transaction level comparison. If a company has passed the filter and entered the first level, it will have to pass the transaction level comparison also so as to get eligible for

inclusion in the final list of comparables. In order to become comparable to an international transaction of Manufacturing, a company will get included only if it is either exclusively in Manufacturing or if it is not so exclusively in manufacturing (having 75% or more as manufacturing), but its segmental information of the Manufacturing is separately available.

6.6. Adverting to the facts of the extant case, we find that Fives Cail KCP Ltd. passes the filter of Manufacturing sales not less than 75% of the total sales and *ex consequenti* the company level test is through, but it fails the transaction level test inasmuch as it is albeit largely a manufacturing company but also has service income of 17% of its total revenue and admittedly no segmental information for the Manufacturing activity is available. So, this company having manufacturing activity at 83% cannot be considered as comparable to the international transaction under consideration of 100% Manufacturing activity. We, therefore accord our imprimatur to the exclusion of this company from the list of comparable.

7. To sum up, we set aside the impugned order and send the matter back to the AO/TPO for redetermining the ALP in conformity with directions given hereinabove. Needless to say, the assessee will be allowed reasonable opportunity of being heard.

8. In the result, the appeal is partly allowed for statistical purposes.

Order pronounced in the Open Court on 24th June, 2021.

Sd/-
(S.S. VISWANETHRA RAVI)
JUDICIAL MEMBER

Sd/-
(R.S.SYAL)
VICE PRESIDENT

पुणे Pune; दिनांक Dated : 24th June, 2021
सतीश

आदेश की प्रतिलिपि □ त्रेषित/Copy of the Order is forwarded to:

1. अपीलार्थी / The Appellant;
2. प्रत्यर्थी / The Respondent;
3. The CIT(A)-13, Pune
4. The PCIT-5, Pune
5. DR, ITAT, 'C' Bench, Pune
6. गार्ड फाईल / Guard file.

आदेशानुसार/ BY ORDER,

// True Copy //

Senior Private Secretary
आयकर अपीलीय अधिकरण ,पुणे / ITAT, Pune

		Date	
1.	Draft dictated on	22-06-2021	Sr.PS
2.	Draft placed before author	24-06-2021	Sr.PS
3.	Draft proposed & placed before the second member		JM
4.	Draft discussed/approved by Second Member.		JM
5.	Approved Draft comes to the Sr.PS/PS		Sr.PS
6.	Kept for pronouncement on		Sr.PS
7.	Date of uploading order		Sr.PS
8.	File sent to the Bench Clerk		Sr.PS
9.	Date on which file goes to the Head Clerk		
10.	Date on which file goes to the A.R.		
11.	Date of dispatch of Order.		

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