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Working capital adjustment in Arm's length price determination

Exploring Provisions

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PREFACE

This document tutors the Transfer pricing regulations, its application of prices to transactions that are steered within the precincts or structure of an enterprise and how effective it is in preventing the menace of transfer pricing manipulation. With an incessant annual surge in intra-firm transactions, transfer pricing regulations can only acquire greater, not lesser attention. This is in furtherance to our issue of May 2013 with emphasis on importance of Working capital adjustment in arm's length price determination. May 2013 issue is also available on our website www.dailytaxreporter.com

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Purpose of this Document

This document aims to enlighten how the transfer pricing regulations in India, OECD and other countries function

Table of Contents

I. Working capital adjustment in arm's length price determination

If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made under rule 10B (3) to the price of the uncontrolled transaction according to the comparability method chosen under sub-rule (1). In Mentor Graphics (Noida) (P.) Ltd. v. Deputy Commissioner of Income-tax, Circle 6(1), New Delhi (2007) 109ITD101 the Delhi bench of ITAT held that depending on facts of the case, final set of comparable may need to eliminate differences by making adjustments for the following:

a) working capital
b) adjustment for risk and growth
c) adjustment of R&D expenses.

II. Recent Judgments on Working capital differences/adjustments

1. **Capgemini India P. Ltd. v. Assistant Commissioner of Income tax (2013)27ITR (Trib) 74 Mum.**

Working capital adjustments are required to be made because these do impact the profitability of the company

On the validity of claim for working capital adjustments the bench held the following (pg 104-105):

> The assessee has also requested for working capital adjustment. The case of the assessee is that working capital does have an impact on the profitability of the company and more accounts receivable in case of a company would mean relatively lower profit. Therefore, the companies could be considered as fully comparable if they hold the same level of account receivable and account payable. The Transfer Pricing Officer has, however, rejected the

claim of working capital adjustment which has been upheld by the Dispute Resolution Panel. The reason given by the authorities below is that the assessee had not made any claim for working capital adjustment in its the transfer pricing study and that it is not possible to make accurate adjustment on this account as it is difficult to find the account receivable/payable at different points of time during the year. Learned senior counsel has referred OECD guidelines as per which if the account receivable/payable on the last date do not give a representative level of working capital for the whole year, average may be used if it reflects the better level of working capital over the year.

In our view, working capital adjustments are required to be made because these do impact the profitability of the company. Rule 10B(2)(d) also provides that the comparability has to be judged with respect to various factors including the market conditions, geographical conditions, cost of labour and capital in the market. Accounts receivable/payable effect the cost of working capital. A company which has a substantial amount blocked with the debtors for a long period cannot be fully comparable to the case which is able to recover the debt promptly. In our view, the average of opening and closing balance in the account receivable/payable for the relevant year may be adopted which may broadly give the representative level of working capital over the year. Even if there is some difference with respect to the representative level, it will not affect the comparability as the same method will be applied to all cases. Working capital adjustment cannot be denied to the assessee only on the ground that the assessee had not made any claim in the transfer pricing study if it is possible to make such adjustment. In our view, working capital adjustment will improve the comparability. We, therefore, direct the Assessing Officer/Transfer Pricing Officer to make the working capital adjustment after necessary examination in the light of the observations made above and after allowing opportunity of hearing to the assessee.

2. **Vodafone India Services P. Ltd. v. Deputy Commissioner of Income-tax (2014) 30ITR (Trib) 218 MUM**

Working capital adjustment to be made to improve comparability

"Working capital adjustment and adjustment on account of other costs"

The assessee has requested for adjustment on account of working capital. It has been submitted that the assessee was receiving money in advance whereas in other cases receivable may be pending for a long-time which affect the sale price as well as the margin. It has therefore, been requested that working capital adjustment may be allowed. The learned Commissioner of Income-tax (Departmental representative) on the other hand submitted that in case working capital adjustment was considered appropriate, the adjustment may be made as per the OECD guidelines and not as per the method adopted by the assessee. In other words the adjustments should be made in relation to both payables and receivables.

We have perused the records and considered the matter carefully. Under the provisions of rule 10B(2)(d) the comparability has to be judged with respect to various factors such as marketing conditions, geographical locations, cost of labour and capital in the market, accounts receivable/payable affect the cost of working capital. The more accounts receivable would mean more capital blocked with debtors which may also mean higher sale prices. Therefore, in our view it will be appropriate to make working capital adjustment to improve the comparability. Further we agree with the submissions of the learned Commissioner of Income-tax (Departmental representative) that while making the working capital adjustment guidelines framed by OECD must be followed.

3. **Mercer Consulting (India) (P) Ltd. v. Dy CIT (2014) 108DTR (Trib) 348 Del**

On the subject of entitlement to working capital adjustment the Delhi bench held as follows:

16.1. The next issue raised by the ld. AR is against
non-granting of working capital adjustment claimed by the assessee for the first time before the TPO. The assessee requested the TPO to grant working capital adjustment. The assessee's claim was jettisoned on the ground that the assessee failed to demonstrate that there was a difference in the levels of working capital employed by it vis-a-vis the comparables. The TPO further observed that : "The claim of working capital adjustment is not a matter of right." He further went on to add that the issue of working capital can be relevant when there is a situation of inventory remaining tied up or receivables being held up and such situation will not be relevant to the service industry. That is how the assessee's contention on this issue was repelled. The DRP also followed the suit by noticing that the working capital adjustment is difficult to apply due to the lack of accurate and reliable data. It also held that the issue of working capital would be relevant only when there is a situation of inventory remaining tied up or receivables being held up. The assessee contests the non-granting of the working capital adjustment.

16.2. Having heard the rival submissions and perused the relevant material on record, we find that the viewpoint canvassed by the authorities below is sans merit. Working capital adjustment is ordinarily confined to inventory, trade receivables and trade payables. If a company carries on high trade receivables, it would mean that it is allowing its customers a relatively longer period to pay their amount which will result into higher interest cost and the resultant less profit. Similarly, by carrying high trade payables, a company benefits from a relatively longer period available to it to pay back its suppliers which lowers the interest cost and accelerates profits. To have a level playing field, it is sine qua non that the working capital adjustment should be carried out to bring two otherwise comparable cases at par with each other. We are unable to comprehend any reason or rhyme to restrict the grant of working capital adjustment only in the case of manufacturers or traders. What is true for these categories of businesses, is fully true for a service provider as well.

It is a different matter that in the case of service provider, no working capital adjustment would be required towards higher or lower inventory, but the same may be warranted in respect of higher or lower trade receivables/payables. Since the authorities below have rejected the assessee's contention for grant of working capital adjustment at the threshold, which in our considered opinion is not correct, we set aside the impugned order and remit the matter to the file of the TPO/AO for examining the assessee's claim for grant of working capital adjustment on merits and thereafter, allow the same, if it is available. Needless to say, the assessee will be allowed an adequate opportunity of hearing.

III. OECD 2010 Transfer Pricing Guidelines on working capital adjustment with example

A.6 Comparability adjustments

3.47 The need to adjust comparable and the requirement for accuracy and reliability are pointed out in these Guidelines on several occasions, both for the general application of the arm's length principle and more specifically in the context of each method. As noted at paragraph 1.33, to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Whether comparability adjustments should be performed (and if so, what adjustments should be performed) in a particular case is a matter of judgment that should be evaluated in light of the discussion of costs and compliance burden at Section C.

A.6.1 Different types of comparability adjustments

3.48 Examples of comparability adjustments include adjustments for accounting consistency designed to eliminate differences that may arise from differing accounting practices between the controlled and uncontrolled transactions; segmentation of financial data to eliminate significant non comparable transactions; adjustments for differences in capital, functions, assets, risks.

3.49 An example of a working capital adjustment designed to reflect differing levels of accounts receivable, accounts payable and inventory is provided in the Annex to Chapter III. The fact that such adjustments are found in practice does not mean that they should be performed on a routine or mandatory basis. Rather, the improvement to comparability should be shown when proposing these types of adjustments (as for any type of adjustment). Further, a significantly different level of relative working capital between the controlled and uncontrolled parties may result in further investigation of the comparability characteristics of the potential comparable.

A.6.2 Purpose of comparability adjustments

3.50 Comparability adjustments should be considered if (and only if) they are expected to increase the reliability of the results. Relevant considerations in this regard include the materiality of the difference for which an adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.

3.51 It bears emphasis that comparability adjustments are only appropriate for differences that will have a material effect on the comparison. Some differences will invariably exist between the taxpayer's controlled transactions and the third party comparables. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison. On the other hand, the need to perform numerous or substantial adjustments to key comparability factors may indicate that the third party transactions are in fact not sufficiently comparable.

3.52 It is not always the case that adjustments are warranted.
For instance, an adjustment for differences in accounts receivable may not be particularly useful if major differences in accounting standards were also present that could not be resolved. Likewise, sophisticated adjustments are sometimes applied to create the false impression that the outcome of the comparables search is “scientific”, reliable and accurate.

A.6.3 Reliability of the adjustment performed

3.53 It is not appropriate to view some comparability adjustments, such as for differences in levels of working capital, as “routine” and uncontroversial, and to view certain other adjustments, such as for country risk, as more subjective and therefore subject to additional requirements of proof and reliability. The only adjustments that should be made are those that are expected to improve comparability.

A.6.4 Documenting and testing comparability adjustments

3.54 Ensuring the needed level of transparency of comparability adjustments may depend upon the availability of an explanation of any adjustments performed, the reasons for the adjustments being considered appropriate, how they were calculated, how they changed the results for each comparable and how the adjustment improves comparability. Issues regarding documentation of comparability adjustments are discussed in Chapter V.

Example of a Working Capital Adjustment

See Chapter III, Section A.6 of these Guidelines for general guidance on comparability adjustments.

The assumptions about arm’s length arrangements in the following examples are intended for illustrative purposes only and should not be taken as prescribing

adjustments and arm's length arrangements in actual cases
of particular industries. While they seek to demonstrate the principles of the sections of the Guidelines to which they refer, those principles must be applied in each case according to the specific facts and circumstances of that case.

This example is provided for illustration purposes as it represents one way, but not necessarily the only way, in which such an adjustment can be calculated. Furthermore, the comments below relate to the application of a transactional net margin method in the situations where, given the facts and circumstances of the case and in particular the comparability (including functional) analysis of the transaction and the review of the information available on uncontrolled comparables, such a method is found to be the most appropriate method to be used.

Introduction

1. This simple example shows how to make an adjustment in recognition of differences in levels of working capital between a tested party (Test Co) and a comparable (Comp Co). See paragraphs 3.47-3.54 of these Guidelines for general guidance on comparability adjustments. Working capital adjustments may be warranted when applying the transactional net margin method. In practice they are usually found when applying a transactional net margin method, although they might also be applicable in cost plus or resale price methods. Working capital adjustments should only be considered when the reliability of the comparable will be improved and reasonably accurate adjustments can be made. They should not be automatically made and would not be automatically accepted by tax administrations

Why make a working capital adjustment?

2. In a competitive environment, money has a time value. If a company provided, say, 60 days trade terms for payment of accounts, the price of the goods should equate to the price for immediate payment plus 60 days of interest on the

immediate payment price. By carrying high accounts receivable a company is allowing its customers a relatively long period to pay their accounts. It would need to borrow money to fund the credit terms and/or suffer a reduction in the amount of cash surplus which it would otherwise have available to invest. In a competitive environment, the price should therefore include an element to reflect these payment terms and compensate for the timing effect.

3. The opposite applies to higher levels of accounts payable. By carrying high accounts payable, a company is benefitting from a relatively long period to pay its suppliers. It would need to borrow less money to fund its purchases and/or benefit from an increase in the amount of cash surplus available to invest. In a competitive environment, the cost of goods sold should include an element to reflect these payment terms and compensate for the timing effect.

4. A company with high levels of inventory would similarly need to either borrow to fund the purchase or reduce the amount of cash surplus which the company is able to invest. Note that the interest rate might be affected by the funding structure (*e.g.* where the purchase of inventory is partly funded by equity) or by the risk associated with holding specific types of inventory.

5. 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. The underlying reasoning is that**:**

- A company will need funding to cover the time gap between the time it invests money (*i.e.* pays money to supplier) and the time it collects the investment (*i.e.* collects money from customers)
- This time gap is calculated as: the period needed to sell inventories to customers + (plus) the period needed to collect money from customers – (less) the period granted to pay debts to suppliers.

6. The process of calculating working capital adjustments:

a) Identify differences in the levels of working capital. Generally trade receivables, inventory and trade payables are the three accounts considered. The transactional net margin method is applied relative to an appropriate base, for example costs, sales or assets (see paragraph 2.58 of the Guidelines). If the appropriate base is sales, for example, then any differences in working capital levels should be measured relative to sales.

b) Calculate a value for differences in levels of working capital between the tested party and the comparable relative to the appropriate base and reflecting the time value of money by use of an appropriate interest rate.

c) Adjust the result to reflect differences in levels of working capital. The following example adjusts the comparable result to reflect the tested party's levels of working capital. Alternative calculations are to adjust the tested party's results to reflect the comparable levels of working capital or to adjust both the tested party and the comparable results to reflect "zero" working capital.

IV. A practical example of calculating working capital adjustments:

The following calculation is hypothetical. It is only to demonstrate how a working capital adjustment can be calculated.

Test Coy	year 1	year 2	year 3	year 4	year 5
Sales	$179.5m	$182.5m	$187m	$195m	$198m
EBIT	$1.5m	$1.83m	$2.43m	$2.54m	$1.78m
EBIT/Sales (%age)	o.8%	1.00%	1.30%	1.30%	0.90%
Working capital (at end of 1 yr)					
Trade Receivables ®	$30m	$32m	$33m	$35m	$37m
Inventories(I)	$36m	$36m	$38m	$40m	$45m
Trade Payables (P)	$20m	$21m	$26m	$23m	$24m
Receivable ® + Inventories (I)minus Payables (P)	$46m	$47m	$45m	$52m	$58m
(R+I-P)/Sales	25.60%	25.80%	24.10%	26.70%	29.30%

Comp Coy	year 1	year 2	year 3	year 4	year 5
Sales	$120.4m	$121.2m	$121.8m	$126.3m	$130.2m
EBIT	$1.59m	$3.59m	$3.15m	$4.18m	$6.44m
EBIT/Sales (%age)	1.32%	2.96%	2.59%	3.31%	4.95%
Working capital (at end of 1 yr)					
Trade Receivables ®	$17m	$18m	$20m	$22m	$23m
Inventories(I)	$18m	$20m	$26m	$24m	$25m
Trade Payables (P)	$11m	$13m	$11m	$15m	$16m
Receivable ® + Inventories (I)minus Payables (P)	$24m	$26m	$35m	$31m	$32m
(R+I-P)/Sales	19.90%	20.60%	28.70%	24.50%	24.60%

Working Capital Adjustment	Year 1	Year 2	Year 3	Year 4	Year 5
Test Coy (R+I-P)/Sales	25.60%	25.80%	24.10%	26.70%	29.30%
Comp Coy (R+I-P)/Sales	19.90%	20.60%	28.70%	24.50%	24.60%
Difference (D)	5.70%	5.10%	-4.70%	2.10%	4.70%
Interest rate (I)	4.80%	5.40%	5.00%	5.50%	4.50%
Adjustment (D*i)	0.27%	0.28%	-0.23%	0.12%	0.21%
Comp Coy EBIT/Sales %	1.32%	2.96%	2.59%	3.31%	4.95%
Working capital adjusted EBIT/sales for Comp Coy	1.59%	3.24%	2.35%	3.43%	5.16%

V. Conclusion:

The done principle is therefore

Always press for claim of working capital adjustment and also for other adjustments which might have a bearing on the price viz, intangible, forex risks, date of transaction, contractual terms such as scope of warranties, sales/purchase volumes, credit terms, transport terms, geographical market conditions, level of the market viz. wholesale or retains, consumer preferences, income levels, varying taxes, at the time of preparation of transfer pricing report

VI. Relevant rule for adjustments

Rule 10B

Determination of arm's length price under section 92C:

(3) An uncontrolled transaction shall be comparable to an international transaction if—

(i) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or
(ii) reasonably accurate adjustments can be made to eliminate the material effects of such differences."

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