



TAX FLASH NEWS

Outstanding receivables from the services rendered are not ‘Capital financing’ warranting levy of hypothetical and notional interest

Background

The Hyderabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Pegasystems Worldwide India Private Limited¹ (the taxpayer) held that on the facts and principles of law, there is no need for bringing to tax notional interest on outstanding receivables and accordingly the addition made on a hypothetical and notional basis was deleted. Further, the Tribunal excluded five comparable companies selected by the Transfer Pricing Officer (TPO) on functionality grounds and remitted four companies to the TPO, which were not presented before the lower authorities for undertaking a fresh analysis based on the taxpayer's submission.

Facts of the case

- The taxpayer is a wholly owned subsidiary of Pegasystems, USA its Associated Enterprise (AE) and rendered software development services to it. The Arm's Length Price (ALP) of the international transaction of software development services was determined by applying the Transactional Net Margin Method (TNMM) and taking Operating Profit to Operating Cost (OP/OC) ratio as the Profit Level Indicator (PLI). The PLI of the taxpayer was determined at 14.03 per cent whereas the average PLI of 21 comparable companies selected by the taxpayer was 11.26 per cent.
- The TPO rejected the Transfer Pricing (TP) study of the taxpayer and carried out a fresh benchmarking analysis. The TPO selected 18 comparable companies and proposed an adjustment by computing the mean PLI of the comparable companies at 25.08 per cent (including a negative working capital adjustment of 2.39 per cent) as against a PLI of 14.03 per cent of the taxpayer. Further, the TPO observed that the taxpayer had outstanding receivables amounting to INR 210,753,864 which were not reported in the accountant's report and no benchmarking analysis was carried out in the TP study. The TPO imputed interest on the outstanding receivables at the rate of 12 per cent amounting to INR 12,640,592, thus proposing a total TP adjustment of INR 40,557,159.
- The Dispute Resolution Panel (DRP) upheld the adjustment made by the TPO subject to: a) Exclusion of Infosys Technologies Limited from the set of 18 comparable companies selected by the TPO, b) directing to delete the negative working capital adjustment of 2.39 per cent made by the TPO.
- With regard to the interest on receivables, the DRP did not accept the argument of the taxpayer that the outstanding receivables related to the provision of services and are not in the nature of advance/loans and thereby no interest should be levied. However, the DRP accepted the alternate plea of the taxpayer of charging interest at the rate of LIBOR plus 250 basis points on outstanding receivables from its AE.
- Aggrieved by the final order of the Assessing Officer (AO), the taxpayer and the Revenue filed an appeal before the Tribunal.

¹ Pegasystems Worldwide India Private Limited v. ACIT (I.T.A. No. 1758/HYD/2014)

Taxpayer's contentions

Interest on outstanding receivables

- The taxpayer contended that the outstanding receivables relate to the provision of services and are not in the nature of any advance/loans. The taxpayer is a debt free company and the AE took care of its funding, hence it does not have any working capital risk and there is no interest payment thereby.
- The taxpayer relied on the order of the Tribunal in the case of Evonik Degussa India P. Ltd². (Evonik), wherein it was held that TP adjustment cannot be done on hypothetical issues. Further, the taxpayer relied on the decision of Logix Micro Systems Ltd³ wherein it was held that a reasonable period should be provided for outstanding receivables as interest-free period and no interest should be calculated for such period.
- Under the provisions of the Income-tax Act, 1961 (the Act), the explanation brought by the Finance Act, 2012 to the definition of international transactions, even though retrospective, does not cover the taxpayer's transaction as the word 'capital financing' used there, particularly refers to loans or advances given for capital financing, whereas in the taxpayer's case, these are receivables for the services rendered which cannot be construed as capital financing.
- Further, the taxpayer contended that working capital adjustments are being made while analysing the operational performance of the companies, therefore an outstanding amount on account of receivables gets adjusted due to working capital adjustments and another separate addition on the outstanding amount is not warranted under the TP provisions.

Dispute on comparable companies

The taxpayer primarily contended the inclusion of the following seven companies as proposed by the TPO, stating that these are not fit to be considered for reasons such as: they are functionally different, non-availability of segmental information, rejection of these companies by other judicial precedents

- E infochips Bangalore Limited (E infochips)
- Comp-U-Learn Tech India Limited (Comp-u-learn)
- Kals Information Systems Ltd (Kals)
- Persistent Systems and Solutions Ltd (Persistent)
- Tata Elxsi Ltd (Seg) (Tata Elxsi)
- Sasken Communication Technologies Ltd (Sasken)
- L&T Infotech Ltd (L&T)

² Evonik Degussa India P. Ltd. v. ACIT (ITA No. 7653/Mum/2011, dated 25 November 2011)

³ Logix Micro Systems Ltd v. ACIT [2010] 42 SOT 525 (Bang)

Besides, the taxpayer also contended for the inclusion of two companies rejected by the TPO viz. Akshay Software Technologies Ltd (Akshay), CG VAK Software and Exports Ltd (CG VAK), which are functionally similar and satisfies all the filters of the TPO.

Tax department's contention

- The tax department observed that the taxpayer had receivables worth INR 210,753,864 at the end of the year 31 March 2010 and considering the overdue receipts, they proposed to charge interest at the rate of 12 per cent on the outstanding receivables. Further, since the taxpayer has realised the outstanding amounts after 31 March 2010, the tax department levied interest for the supposed delay, not only during the year but also for the period beyond the concerned assessment year.

Tribunal's ruling

Interest on outstanding receivables

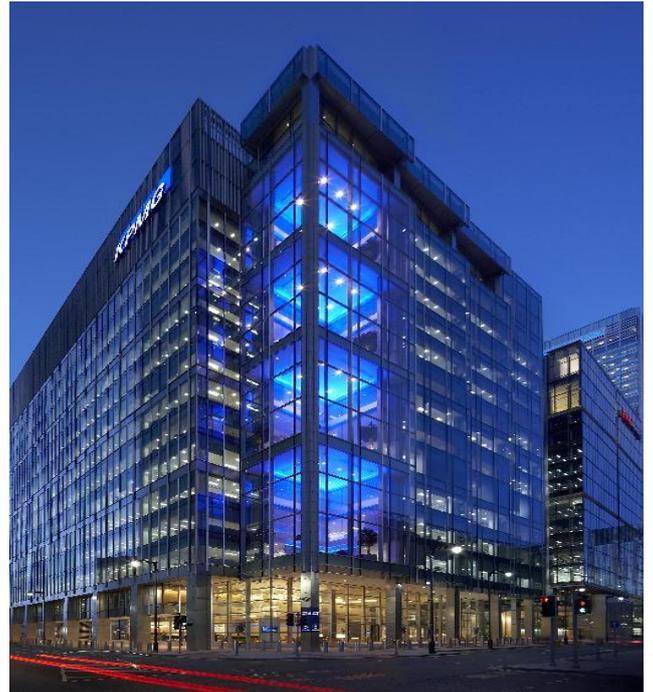
- The Tribunal held that there is no need to tax notional interest on outstanding receivables and deleted the interest on outstanding receivables computed by the TPO. In this regard, the Tribunal has observed the following:
 - Relying on the Evonik ruling, the Tribunal held that TP adjustment cannot be made on a hypothetical and notional basis, until and unless there is some material on record to show that there has been under charging of real income.
 - Since there has been no delay in realisation of invoices in earlier months and that the taxpayer has no interest liability, no notional interest can be brought to tax under the provisions of TP.
 - The outstanding receivables on account of services cannot be equated with capital financing as per the retrospective amendment to the explanation to the definition of international transactions in the Finance Act, 2012.
 - Relying on Logix Micro Systems Limited's order, the Tribunal observed that certain interest-free period for receiving the outstanding receivables should be allowed to the taxpayer for receiving the outstanding service charges.

Dispute on comparable companies

- The Tribunal directed to exclude E infochips, Kals, Tata Elxsi, and L&T from the final list of comparable companies and restored Comp-u-learn, Persistent, Sasken and CG VAK to the file of the TPO/AO for fresh verification.
- It also rejected the tax department's ground on the rejection of Infosys as a comparable by the DRP and the taxpayer's contention on the inclusion of Akshay as a comparable company.

Our comments

The ruling delivered by the Tribunal clarifies the ambiguity created by the explanation to the definition of international transactions inserted by the Finance Act, 2012 by adjudicating that outstanding receivables arising from the services rendered to AEs cannot be characterised as 'capital financing'. The ruling further strengthens the position that no notional TP adjustment can be made unless it is factually demonstrated that there has been undercharging of real income.



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Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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