INTEREST ON OVERDUE RECEIVABLES

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Introduction

In the recent era of imposing innovative transfer pricing adjustments by the tax authorities, "Interest on overdue receivables" holds a prominent position. In a TP environment, long overdue receivables (O/R) often being alleged as deemed loan/ capital financing / working capital finance among Associated Enterprises ("AE") thereby construed as an international transaction u/s 92B by the tax authorities.

Trade receivables (T/R)/ Accounts receivables (A/R) represent the money a business is entitled to receive from its customers for the sale of goods or services. The A/R arising on account of international transactions with the AEs are being critically viewed by the tax authorities as an international transaction, pursuant to a retrospective amendment (w.e.f 1.4.2002) in Section 92B. However there is still no clarity whether the overdue receivables to be treated as a Deemed interest free-loan and if yes, whether

interest imputed for providing such loan can be brought under the purview of "International transaction".

Given this background, in the forthcoming sections we will be discussing about the following:

- Treating Accounts receivable as an International transaction
- Re-characterisation of A/R as loan
- Various approaches adopted by tax authorities to impute interest on the O/R
- Outcome of jurisprudence by various tax forums
- Similar positions taken by other foreign tax jurisdictions

A. Accounts Receivable – an international transaction

In order to analyze whether Accounts Receivable is an international transaction or not, we may have to draw references from explanation given in Section 92B of the Income Tax Act, 1961 ("the Act")

Explanation – For the removal of doubts, it is hereby clarified that –

(i) the expression "international transaction" shall include –

(a)………

………

(c) capital financing, including any type of long-term or short-term borrowing, lending or guarantee,

purchase or sale of marketable securities or any type of advance, payments or deferred payment ***or receivable or any other debt arising during the course of business;***

The above explanation commences with capital financing and inter alia include any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business. Capital financing by definition refers to raising funds for purposes such as acquiring assets, expanding operations, or undertaking projects, and often support the core capital structure of a company. Though capital financing is typically long term and strategic in nature, the explanation also includes receivable or any other debt arising during the course of business.

Further reference may be drawn from "The Institute of Chartered Accountants of India (ICAI) Guidance Note on Report under Section 92E of The Income-Tax Act, 1961 (ICAI Guidance Note)" which throws light on Transfer Pricing compliance in India. Even though ICAI Guidance note has not specifically commented on the fact whether A/R needs to be treated as a separate international transaction or not, it discusses on the aspect of capital financing transactions and notes that receivable arising on account of a principal

transaction will have to be analysed and ensure that there is no repetition / double counting of the principal transaction and the corresponding balance.

Based on combined reading of the above, it may perhaps be inferred that the intent of law is to cover the Receivable as an international transaction, especially pursuant to the retrospective amendment to Section 92B of the Act vide Finance Act 2012.

The A/R balances remaining typically arise out of the primary international transaction i.e., Sale/Service and accordingly the taxpayers, by adopting aggregation approach, contend that when the said sale/service transaction is concluded to be at arm's length price, no separate analysis is warranted for the receivable balances.

Having said that, the tax authorities often adopt a contrary position that the accounts receivables outstanding for a longer period partakes the character of a loan and thereby attempt to impute interest on such overdue balances.

B. Re-characterisation of Overdue receivables

The overdue balances are recharacterized as Interest-free loans provided by taxpayer to

the AE and are accordingly subject to interest adjustments by the tax authorities.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2022 ("OECD Guidelines") provide for recharacterization of the transaction, based on the actual functional analysis (Analysis of Functions performed, Assets deployed and Risk assumed). The following is the extract from the OECD Guidelines:

"1.140. *In performing the analysis, the actual transaction between the parties will have been deduced from written contracts and the conduct of the parties. Formal conditions recognised in contracts will have been clarified and supplemented by analysis of the conduct of the parties and the other economically relevant characteristics of the transaction.* ***Where the characteristics of the transaction that are economically significant are inconsistent with the written contract, then the actual transaction will have been delineated in accordance with the characteristics of the transaction reflected in the conduct of the parties.***"

The OECD Guidelines provide for recharacterization in the context that when there exists differences between actual

conduct vis-à-vis contractual terms, the conduct of the parties will be considered, and the contractual terms will be disregarded.

The key aspect of recharacterizing O/R as interest free loan is business circumstances / economic relevance surrounding the international transactions. These business circumstances include the following:

- Whether the service provider is a debt-free company
- What is the credit period offered to third parties in comparison with that of the AEs
- What is the industry practices followed in which the taxpayer operates
- Whether the interest component is embedded in sale price, etc.,

For the issue of overdue accounts receivable being treated as loan, it is therefore necessary to understand the position of the Tax authorities, as well as the jurisprudence on this issue.

C. Approaches adopted by tax authorities – imputing interest adjustments

As discussed in the preceding paragraphs, the position of the

Transfer Pricing authorities at a lower level is that the O/R constitute a separate international transaction. The moot argument placed by the TPOs are that pursuant to amendment by the Finance Act, 2012 to Section 92B, the Income Tax Act unequivocally provides that overdue accounts receivable is an international transaction, and therefore the said international transaction should be at arm's length i.e., an arm's length interest should be charged for the loan provided to the AEs.

With regard to the issue on O/R with AEs, customarily the tax authorities adopt the following process:

- Evaluating the credit period offered to the AEs and computing the excess credit period
- Re-characterization of excess credit period to the AEs as deemed financing transaction
- Selection of transfer pricing method
- Computing the arm's length interest - arriving at the transfer pricing adjustment

i) Credit period evaluation

Examination of credit period of the A/R of the AEs is undertaken through review of

general ledger of the AEs comprising of invoice-wise listing for the respective AEs. With the invoice wise listing, the credit period offered is compared with the actual realisation to arrive at the difference. Alternatively, taxpayers provide the aging for the outstanding accounts receivable as at the year-end for the relevant assessment year.

The arm's length credit period taken by the TPO is observed to be ranging from 30-60 days, varying due to the stand taken by the TPO for the particular assessment year. Nevertheless, the stand taken by the Revenue in previous year may set a precedence. Though the basis of arriving at the arm's length credit period viz., 30-60 days is not provided through a robust analysis, references to jurisprudence is cited, at times, in defence of their position.

Based on the above, the TPO proceeds to arrive at the value to accounts receivable that was received / to be received beyond the stipulated arm's length credit period (30-60 days), along with the tenure of excess credit (viz., number of days beyond the 30-60 day credit period).

ii) Re-characterisation – Deemed Loan

The quantum arrived at in the previous step is re-characterised as a loan given to the AEs by stating that such excess credit period may not be made available by the parties in an uncontrolled situation, as it is in the best interest of the independent party to timely collect such receivable to facilitate smooth working capital.

Further no independent party would grant any excess credit period unless any benefit accrues for the business. The delay in such collection meant the AEs were provided a line of credit for management of the AEs working capital. Therefore, the TPO may contend that such excess credit provided to the AEs would partake the nature of loan granted to the AEs, which is squarely covered under the explanation to Section 92B amended vide Finance Act, 2012 – Capital financing. This credit facility offered to the AEs, a deemed loan, would have to earn an arm's length consideration viz., Interest.

iii) Selection of TP method

Since consideration / compensation for any

transaction will have to be under the tenants of transfer pricing, the next step is to select the appropriate transfer pricing method to benchmark the transaction. By and large the authorities adopt CUP method similar to traditional financial transactions such as loans.

iv) Computation of Arm's length price

In audit proceedings as discussed above, the tax authorities call for debtors ageing and in the event of O/R falls due beyond the credit period (industry standards), they tend to impute notional interest on the basis of SBI Prime Lending Rate (PLR) / LIBOR (ARR) plus BPS, etc.,

TPOs initially arrive at the interest based on SBI PLR, which is shared at the time of issuance of show cause notice to taxpayer. Indian benchmark rates are selected by the TPO as the taxpayer operate in India and the Indian benchmark rates are higher than their foreign counterparts. TPO at times select interest rates issued by the Reserve Bank of India (RBI), when considering use of Indian based benchmarks. Unlike

Indian benchmark rates, where foreign benchmark rates are considered for computing the interest, spread of 200 – 400 basis points (bps) is added. The spread is dependent on the judgment of the TPO, and jurisprudence is given due weightage.

With the benchmark rates, the excess credit period as tenure and corresponding invoice value as principal, the interest is computed by the TPO. This imputed interest is stated as the transfer pricing adjustment in the show cause notice and, as the case may be, in the Transfer Pricing Order for the taxpayer

D. Indian judicial precedence

The amendment to Section 92B of the ITA, by bringing 'receivables' under the purview of TP sparked the controversy on alleging O/R as a deemed loan. Having said that the Indian courts held that receivable mentioned under Explanation to Sec. 92B does not mean accounts receivable and thus the O/R cannot be treated as an independent transaction for TP audit.

Various judicial precedents have shed some light on this particular issue, wherein the following cases were ruled in favour of the taxpayers:

CASE REFERENCE	FORUM	PREMISE
Bechtel India Pvt Ltd [TS-591-SC-2017-TP]	Supreme Court	The Hon'ble Supreme Court (SC) have set aside the Special Leave Petition (SLP) filed by the Revenue against Delhi Highcourt (HC). Assessee being Debt-free company, no question of interest adjustment arise
Kusum Healthcare (P.) Ltd [TS-412-HC-2017(DEL)-TP]	Delhi High Court	Hon'ble High Court upheld the view of the ITAT that outstanding receivable is not a separate international transaction and hence not required to be benchmarked independently. Further, it was demonstrated that the impact of excess credit period on working capital was factored in the pricing.

EKL Appliances Ltd. [(2012) 345 ITR 241]	Delhi High Court	When the receivables are factored in the working capital adjusted margins, no further adjustment in the form of interest is warranted, as it will falsify the nature of transaction and re-characterise it.
Msource (India) Pvt Ltd [TS-581-ITAT-2017 (Bang)-TP	Bangalore Tribunal	The transaction needs to be analyzed from the perspective of being undertaken in an uncontrolled situation in order to impute any interest on O/R from AE
Seaways Liner Agencies [TS-71-ITAT-2021(HYD)-TP] AY 2014-15 and ADP Private Ltd [TS-172-ITAT-2021 (HYD)-TP] (AY 2015-16)	Hyderabad Tribunal	Due consideration need to be given to the outstanding amount by Assessee to AE / instances where receivables from AEs were settled well within the due date

The key features transpired from the above rulings were:

1. Re-characterising O/R as an interest free loan is unwarranted
2. Delineating O/R from the main transaction (Sale) in the event of exceeding credit period is unjustified
3. Imputing notional interest on Debt-free companies is unjustified
4. No additional imputation of interest on O/R is warranted if the pricing/ profitability of taxpayer is more than working capital adjusted margin of comparables companies
5. Transaction needs to be looked into from the angle of uncontrolled situation – between unrelated parties
6. Due consideration to be given to Accounts payables with AEs and the receivables settled within due date

In-spite of having various judicial precedence in favour of the taxpayers in this subject matter, there have been decisions which have ruled against the taxpayer by treating Interest on Overdue receivables as an international transaction and thereby emphasizing separate benchmarking for the same. Since there still exists some ambiguity in dealing with this issue, the tax authorities continue to impose adjustments during the transfer pricing audit.

E. Position taken by other tax jurisdictions

Globally, few countries like UAE, Korea, etc., in their law also impose arm's length compensation from the taxpayers i.e., interest, in case the receivables are not settled consistently.

UAE Transfer pricing guide - Corporate tax Guide CTGTP1 ("UAE corporate Law") opines that there should be a reasonable mechanism between Related Parties or Connected Persons on raising intercompany invoices and the time period of settlement. Hence in case of any extended credit period offered, it could be regarded as an "Advancement of loan" and accordingly interest could be imputed as a compensation.

Similarly, Korean tax Tribunal in a ruling [1] held that the tax authority's imputation of an arm's length rate of interest on overdue accounts receivable from the taxpayer's foreign affiliate was reasonable, because inspite of overdue accounts receivables, the taxpayer continued to sell goods to its affiliate on credit without developing any measure to collect the accounts receivable.

[1] (2022 Joong 2863, 20 March 2023)

Concluding remarks

This issue has been subject matter of various tax proceedings and as detailed in the preceding sections, various principles have emanated from the tax rulings. Considering the same, some of the key pointers one needs to evaluate are as below:

- Transaction needs to be looked into from the angle of uncontrolled situation – between unrelated parties- charging interest to third parties
- Whether the taxpayer is paying any interest in case of delayed payment on overdue payables to AEs and option of knocking off of such overdue payables with that of the overdue receivables can be explored as a defense strategy
- Taxpayers can resort to claiming working capital adjustment as additional imputation of interest on O/R is not warranted if the pricing/profitability of taxpayer is more than working capital adjusted margin of comparables companies
- In case of debt free companies one could take a position that there is no opportunity cost on account of delayed realisation of receivables

- O/R cannot be treated as a separate transaction as it originates from the main transaction of Sale, which has already been benchmarked
- The actual outcome of O/R needs to be aligned with the terms of the agreement

Further, taxpayers' nature of business (manufacturing/ trading/service) has a strong bearing on O/R and hence it has to be treated accordingly. For eg., Service recipient gets benefitted as soon as Service provider renders the work, whereas in case of manufacturing & sales, though invoice is raised immediately, the buyer (in case of overseas sales) will not make any payment before the goods are received. So one needs to also factor in the shipping lead time before imputing such interest for product sale companies.

In a nutshell, as the treatment of overdue receivables varies from case to case basis, at this juncture it is imperative to have a clear understanding of the business model, market dynamics and third party receivables of the taxpayer which might help in arriving at a conclusion whether to or not to deem the Accounts receivable as an advance subject to interest charge.

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