
WORKING CAPITAL ADJUSTMENT: AN OVERVIEW

A. Background

Transfer Pricing is the determination of the Arm's length price in connection with related party transactions by comparing them with similar third-party transactions.



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In an ideal scenario, the nature of the comparables will only differ from the tested party to the extent it does not have any material impact on prices. Such comparables are not always available, and comparables have differences which have material impact on prices. Adjustments to comparables can be made to eliminate these differences if they can be reliably measured.

The taxpayer must provide reasonable justification that effecting the adjustment materially improves the comparability with the tested party and that difference does not indicate a fundamental difference from the tested party.

One of the most common adjustments is working capital adjustment to neutralize the impact of working capital deployed on the profitability of comparables. The adjustment is applied regularly

as working capital levels can be reliably measured and difference in working capital structures are common within industry

Working capital intensity affects the margins of a company; in a competitive market, interest and opportunity cost of offering credit to customers and maintaining inventory are accounted for in the sales price. For instance, a product sold at cash will be sold at a lower sales price than the same product sold on 60-day credit and the explicit cost of working capital, interest paid, is passed on the customer through an increase in price.

In comparability analysis, operating profit does not consider interest expenses or income however, as this cost is passed on to the customer, this will be reflected in the operating income of the seller and the operating expenses of the buyer.

Hence, for the similar business activity undertaken by both the tested party as well as the comparable companies (including scale of operations, cost structure and market factors), there would be a variance in the profitability due to differences in the working capital structure.

Working capital adjustment aims to neutralize this variation in profitability caused by differences in working capital intensity

between the tested party and comparable companies. The adjustment is mostly applied for TNMM but is also applicable for CPM and RPM.

These differences in price represent an implied interest either earned or paid by the company which have an impact on the net profitability of companies. Working capital adjustment aims to neutralize the effects of these implied interest income or expense on the PLI margins of the comparable to improve the comparability.

For working capital adjustment, the comparables are adjusted to reflect margins at the level of tested party or to zero working capital levels.

Working Capital Adjustment is commonly adopted economic adjustment, however, the OECD Guidelines cautions that it should not be considered to be a routine or mandatory basis¹. The adjustment can only be made as long as it improves comparability, and the taxpayer has to justify the same for the year it chooses to apply the application.

Researchers have suggested that as working capital adjustment is based on the axiom of credit period and sales price being correlated.

¹ OECD Guidelines, 2022 -3.49

In oligopolistic market, this correlation may weaken and the application of WCA will not lead to improvement in the comparability of WCA.²

B. Mechanism for Working Capital Adjustment

OECD

The OECD Transfer pricing guidelines has provided a simplified example for the computation of Working capital adjustment however the guidelines note that other approach of adjusting for working capital can also be used. The UN practical manual on transfer pricing has also used the below approach for its discussion on working capital adjustment.

The approach adjusts the margins of comparable companies to reflect the margins the comparables would have earned if it had the same working capital intensity as the tested party but an approach where all the working capital level of the comparable companies are brought to zero and the margins is thus adjusted to the level earned if no working capital is used.

²The Need for Working Capital Adjustments In A Transfer Pricing Setting: A Theoretical Note, Dr. Jamal Hejazi

The formula for Computing the Working Capital intensity (WCI) Ratio is as follows -

$$\frac{\text{Accounts Receivables} + \text{Inventory} - \text{Accounts Payables}}{\text{Base of PLI (Operating Income, Operating Cost etc)}}$$

Then the WCI Ratio of comparables is deducted from the tested party WCI Ratio. The difference obtained is multiplied by the interest rate. The product of the operations is added to the Unadjusted PLI of the Comparable.

$$(\text{Tested WCI} - \text{Comparable WCI}) * \text{Interest Rate} + \text{Comparable PLI}$$

Interest in the above formula refers to the prevailing interest of short-term loans available for similar enterprises in the market the tested party operates in. The OECD guidelines have indicated the possibility for computing interest for Trade receivables, Inventory and Account Payables with different applicable interest rate; however, OECD has parallelly cautioned that adopting this approach will dramatically increase the complexity of carrying out this adjustment.

As the accounting data required for the computation are basic, data availability is usually not a constraint.

The Accounting standards and accounting choices by comparable company possesses a challenge. If the comparables are being selected on a regional or global basis, it becomes necessary to ensure that the difference in accounting standards is minimal and will not result in significant differences in valuation of inventory, payables and receivables.

In case of inventory, the choice between FIFO method and LIFO method may create material differences in inflationary environments. The criteria used for recognizing provisions and writing off bad debt should also be similar. The adjustment may not be feasible if the accounting standards are too divergent.

There is no consensus for the inclusion of other working capital items such as advances to customers, Advance to suppliers or Contract asset or liabilities, the economic rationale for their inclusion can be made, however, including these items may lead to increased scrutiny from tax authorities, and at times, rejection of the adjustment.

IRS Method

The IRS also follow the OECD approach, but their APA study guide³ also provides for using an approach wherein the comparables' operating revenue / operating cost is adjusted to reflect level of

³IRS APA study guide

working capital used by the tested party, as against the OECD approach wherein the PLI is directly adjusted – without impacting the operating revenue / operating cost. IRS also requires all comparables to use FIFO method and to make adjustment for LIFO using FIFO reserve, in order to neutralize the effect of LIFO.

In the IRS method, the percentage of Trade balances to the PLI base of the tested party is multiplied by the PLI Base of the comparable and then the trade balance of the comparable is deducted. This difference is multiplied by the effective interest rate based on the holding period⁴.

$$\text{Receivables Adjustment} = \left(\left(\frac{AR_t}{PLI_t} \cdot PLI_c \right) - AR_c \right) \cdot \frac{i}{1 + i \cdot hc}$$

$$\text{Payables Adjustment} = \left(\left(\frac{AP_t}{PLI_t} \cdot PLI_c \right) - AP_c \right) \cdot \frac{i}{1 + i \cdot hc}$$

Where,
$$\text{Inventory Adjustment} = \left(\left(\frac{INV_t}{PLI_t} \cdot PLI_c \right) - INV_c \right) \cdot i$$

AR = Average Trade Receivables

AP = Average Trade Payables

INV = Inventory

PLI = Profit Level Indicator

i = Interest

h = Average holding period of trade balances as fraction of the year

⁴ https://www.irs.gov/pub/irs-apa/study_guide_exhibit_d.pdf

Further,

Adjusted Sales = Sales of Comparable + Receivable Adjustment

Adjusted COGS = Cost of Goods sold + Payables Adjustment -
Inventory Adjustment

Regression based Method

Certain research papers have found empirical evidence establishing the relationship between working capital levels and profitability in more scientific manner - quantitative methodology based on dynamic panel data, regression model⁵. Models such as these can be used to quantify the impact of working capital on profitability in a scientific and robust manner. However, one will have to bear in the mind the acceptability of such scientifically rigorous methodologies with the respective tax authorities⁶.

Balance Sheet PLI

For Balance sheet PLI like ROCE and ROA, the trade balances of the tested party, accounts receivable and accounts payables are adjusted and brought up to the industry average and then the operating profit and operating cost are adjusted for the implicit interest income receivable or payable for the trade balances.

⁵ <https://www.ijbmer.com/docs/volumes/vol12issue4/ijbmer2021120401.pdf>

⁶ <https://www.tandfonline.com/doi/full/10.1080/23311975.2022.2049671>

C. Indian Context

Working capital adjustment is generally accepted by the Indian tax authorities. As it is a common adjustment, there are settled judicial precedents on controversies relating to aspects of working capital adjustments. Some of the key aspects / issues in the Indian transfer pricing litigation arena are as follows:

- **Working capital computed using daily balances**

In certain instances, the TPO has used the non-availability of daily capital balances to reject the working capital adjustment computed by the taxpayer.

ITAT rulings in the cases of Huawei Technologies India Pvt, Yahoo Software Development⁷, Bangalore ITAT referenced OECD TPG to reject TPO's requirement for the working capital to be computed based on the average of daily working capital balance over the year and ruled that using average computed based on opening balance and closing balance for the financial year is a valid methodology to compute working capital adjustment.

⁷ Huawei Technologies India Pvt Ltd [TS-1318-ITAT-2018(Bang)-TP], Yahoo Software Development India Pvt Ltd [TS-191-ITAT-2020(Bang)-TP]

Mumbai ITAT, in the case of Red Hat India Private Limited⁸ has also rejected the requirement for daily working capital balances placed by the TPO.

- **Inclusion of other Current asset/ liabilities**

In the Case of GL&V India Private limited⁹, CIT(A) had directed the TPO to compute the WCA as per the example given in the annexure to chapter III of the OECD Transfer Pricing guidelines. The taxpayer appealed the decision since it had significant advances to suppliers and advance from customers on its books. The Pune ITAT ruled that the advances in question should be included for WCA and the OECD TPG should be construed to include advances to suppliers and advances from customers.

In the case of Eversendai Construction Private limited¹⁰, The Chennai ITAT held that working capital adjustment should be based on the tested parties actual operating cycle and relevant current assets/ liabilities which impact the operating cycles such as unbilled revenue, prepaid expenses and advances should be included in the calculation of working capital adjustment

⁸ Red Hat India Private Limited [TS-10-ITAT-2026Mum-TP]

⁹ GL&V India Limited [TS-255-ITAT-2021(Pun)-TP]

¹⁰ Eversandai Construction Private limited [TS-20-ITAT-2026CHNY-TP]

- **Complexity**

In the case of TE Connectivity Services India Pvt Ltd¹¹ where the company had used the OECD method to compute the Working capital, The TPO and DRP rejected working capital partially on account of difficulty in accurately measuring the adjustment. The Bangalore ITAT ruled that a working capital adjustment could not be rejected for its complexity alone, a complex WCA with material difference with comparables should be granted if the adjustment does improve comparability.

- **Captive Service Providers**

For captive service providers with high level of trade receivables, the TPO would carry out working capital adjustment¹². This had the impact of usually increasing the ALP range by increasing the margins of comparable companies. This adjustment has been consistently struck down by ITAT benches. As captive service providers are fully funded by the AEs and do not bear any working capital risks and as such it would be inappropriate to make a comparability adjustment.

¹¹ TE Connectivity Services India Pvt Ltd [TS-480-ITAT-2025(Bang)-TP]

¹² Adaptec India Pvt Limited [TS-112-ITAT-2015(HYD)-TP], Cognizant Technology Solutions India P. Ltd [TS-478-ITAT-2024(CHNY)-TP], Intuit India Product Development Centre Pvt Ltd [TS-213-ITAT-2024(Bang)-TP]

- **Interest on Receivables**

In the case of Kusum Health Care Pvt limited¹³, The Delhi High court affirmed ITAT ruling which ruled that Working capital adjustment adjusted for the effect of high receivables balances and an interest on overdue adjustment could not be made along with a working capital adjustment.

- **Year on Year adjustment**

In a peculiar instance, Transfer pricing officer has raised the question if working capital adjustment can be effected on an annual basis. In the case of Dowoon Automotive systems India Private limited¹⁴, TPO had observed that working capital adjustment could not be accepted year on year, however, ITAT followed precedence on the company's own case to grant working capital adjustment.

Global Context

The Australian Tax authority's guidance for practical aspects of Transfer pricing¹⁵ relies on OECD TPG guidance and takes similar stances on comparability adjustments. Working capital adjustments can be made if the taxpayer can reasonably justify that the difference in working capital creates a material difference in comparability.

¹³ Kusum Health Care Pvt. Ltd [TS-412-HC-2017(DEL)-TP]

¹⁴ Doowon Automotive Systems India Pvt. Ltd [I.T.A. No. 3061/Chny/2017]

¹⁵ Taxation Ruling TR 97/20

Similarly, United Kingdom¹⁶ also refers to the OECD TPG for Arm's length Price and comparability adjustment. However, the internal manual published by HMRC does warn that complicated, multivariable transactions and cautions that use of year-end figures for trade receivables may not be appropriate if the business is seasonal.

The tax authorities in Singapore (IRAS) have also referred to the OECD TPG for carrying out working capital adjustment¹⁷. WCA is accepted if they improve reliability. IRAS prefers the use of interest rate paid by commercial enterprises in the same market as the tested party but has made provision for the use of actual interest incurred by the tested party, interest from banks, yield curves, IMF rates or base reference rate plus the appropriate spread.

Conclusion

Working Capital Adjustment is a commonly used comparability adjustment which can be applied across various jurisdictions without major modification in methodology. Many jurisdictions use the OECD guidelines as a reference for working capital adjustments. Taxpayer must keep in mind that they have to justify the reason

¹⁶ <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm485110>

¹⁷ Transfer Pricing Guidelines (Eighth Edition)

why WCA improves comparability and mere presence of difference in working capital level may not be enough to justify the adjustment.

For captive service providers, the working capital position of the company vis-à-vis the comparable companies will have to be analysed while evaluating opting for working capital adjustments. Notably, the tax authorities usually have agreed about 30 days as the arm's length credit period, especially in case of technology related service where the delivery is online / through the digital mode.

For other entities, it may not be possible to control the average working capital position, but it would be prudent to align average working capital used for related party transactions with average working capital used for similar sales with third party.

As with any economic adjustment, businesses will have to maintain robust documentation, backed by contractual agreements as well as the actual conduct of the parties. This will support businesses to make an effective claim for working capital adjustment.

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