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Impairment Loss Treated as Non-operating for Transfer Pricing Analysis

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Introduction

Chennai ITAT **("ITAT" or "Tribunal")** held impairment loss as non-operating in nature in its recent ruling in the case of M/s. DIAB Core Materials Pvt. Ltd. V DCIT[1]. The impairment loss was on account of closure of manufacturing operations after devaluation of plant and machinery due to a breach of contract by the assessee's customer, who did not purchase the quantity committed by them prior to setting up of plant resulting in capacity underutilisation.

Tribunal's Ruling

The Tribunal noted that the assessee has incurred impairment losses during the year and the same was added back by the assessee in its computation of income, i.e., the impairment loss was treated by the assessee as non-tax deductible due to being non-operative in nature. The Tribunal took consideration of the fact that the assessee's customer did not purchase the quantity committed by them prior to setting up of plant, as a result of which, the assessee was unable to utilize its facilities to its full capacity and had to discontinue manufacturing operations. The Tribunal ruled that this could not be said to be a part of routine business activities since the same would substantially dent assessee's financial position. The Tribunal held that the impairment losses arose due to extra-ordinary circumstances which had been adequately highlighted by the assessee in its financial statements, i.e., depreciation and amortization (including impairment loss) has jumped from Rs. 222.43 Lacs in earlier year to Rs.677.93 Lacs in the relevant previous year. No such losses had been observed in the summarized financial statements of the comparable entities as extracted by the Transfer Pricing Officer in its order.

1. ITA No.2176/Chny/2017

Therefore, the Tribunal held that impairment losses were to be treated as non-operating expenditure and the same was to be excluded while computing assessee's Profit Level Indicator ("**PLI**"), i.e., Operating Profit / Operating Income. The Tribunal placed reliance on the Delhi ITAT's decision in Imsofer Mfg. India Pvt.[2] Ltd. to support the view that the impairment losses were not related to normal business operation and therefore, could not be treated as operating expenditure to compute assessee's PLI.

Amicus Comments

The Ruling discusses the concept of operating profit relied upon for transfer pricing benchmarking while applying profit-based methods. Though the term, "operating profit" is not defined in the Indian transfer pricing regulations, it has been interpreted by the Courts and Tribunals as profits directly arising from core business activities. Hence, only items of recurring nature and pertaining to core business activities are accounted for while computing operating profit.

Another factor to be borne in mind is parity with respect to comparable companies. Due to data unavailability/ constraints, if an item is excluded or included from the computation of operating profit of the comparable companies, then the same treatment is to be accorded to the computation of operating profit of the assessee and vice-versa. In this ruling, referring to the extraordinary and non-recurring nature of the losses arising due to a contract breach by the customer, the Tribunal rightly excluded the impairment loss from the assessee's operating profit for a fair and proper assessment.

2. ITA Nos.5158/Del/2015

The principle of “operating” v “non-operating” assumes particular significance in recent times as due to the pandemic there have been a number of one-time expenses incurred by most of the companies. The guidance provided in the above Ruling can also be used to analyse the nature of such one-time covid expense for the purpose of transfer pricing impact analysis.

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