News Flash– Analysis Of Recent ITAT Decision On Transfer Pricing on Taxability Of Interest Free Loan By Indian Company To Group Companies Situated Outside India

PEROT SYSTEMS TSI (INDIA) LTD Vs. DCIT [2010-TIOL-51-ITAT-DEL DECIDED ON 30 OCTOBER, 2009]

In the above recent decision on transfer pricing, the Hon'ble Delhi Tribunal has held that lending or borrowing money between two Associated Enterprises ('AEs) comes within the ambit of "International Transaction" ('ITs) and whether the same is at Arm's Length Price ('ALP') has to be considered. Thus, in the case of interest free loans to foreign AEs, the amount of notional interest shall be determined having regard to ALP for taxability in the hands of Indian enterprise.

Facts of the case:

- The Appellant, Perot Systems TSI (India) Private Limited ('PSTSI') is an Indian Company engaged in the business of providing business consulting and IT enabled services.
- The Appellant extended two **interest free** foreign currency loans to its 100% Wholly Owned Subsidiaries ('WOS') namely, HPS Global Systems (Bermuda) Limited ('HPS Bermuda') and HPS Global Systems Hungary Liquidity Management LLC ('HPS Hungary') worth USD 1.5 million and USD 4.6 million respectively in January-February 2001 for meeting the short term working capital requirements.
- During the course of assessment proceedings for assessment years ('A.Y') 2002-03, 2003-04 and 2004-05, the ITs entered into by the assessee were referred for scrutiny to the Transfer Pricing Officer ('TPO'). The TPO held that the ITs undertaken by the assessee, in relation to the interest free loan were not at arm's length and undertook an upward adjustment to income for all the three financial years.
- Since all the orders of the authorities for these years are on similar lines, the matter is being adjudicated with reference to the orders for A.Y. 2002-03.

Appellant's Contentions:

- Both the AEs were start-up with no significant business activities and no lender would have lent money to start-ups. Thus, it was commercially expedient for assessee to advance interest free loans to the AEs and that since no interest has actually been charged, there is no real income exigible to tax.
- Appellant relied on the decision of *CIT Vs. KRMTT Thiagaraja Chetty & Co. 24 ITR 525 (SC)* & *Morvi Industries Ltd. Vs. CIT 82 ITR 835 (SC)* to support that liability to tax can arise only when there is income. No tax can be charged as notional income on accrual. Appellant also relied upon transfer pricing decisions of the AAR in the case of *Veneburg Group B.V. Vs. CIT 727 of 2006 and Sony India Ltd. 114 ITD 448 to support its contentions.*

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- Appellant further argued that Transfer Pricing document maintained by the assessee clearly mentioned that these loans/advances are in the nature of **quasi-equity** and hence, the transaction of granting interest free loan is at arm's length.

- Appellant argued that the loan had been duly granted as per the approval of the RBI. The Income Tax Act, 1961 ('IT Act') and OECD guidelines support the contention that the effect of government control/ intervention should be considered while determining the ALP.

- Under the thin capitalization rules, no deduction was allowable to the Hungary entity for payment of interest and therefore, there existed impossibility of performance with regard to payment of interest by Hungary entity. Economic circumstances of the subsidiaries did not warrant the charging of interest from subsidiaries.

- The Appellant contended that the AO had not allowed the variation of +- 5% from the arm's length interest computed and proviso to section 92C(2) of the Act gives a right on the assessee to demand such an adjustment.

Department's Contentions:

- If there is no relation between the two persons other than the normal business relation, no person will give loan without charging any interest. Under the arm's length condition, no persons would undertake risk without expecting any return.

- One of the AEs is situated in a tax haven and not charging of the interest by the assessee from the AEs, would result in higher income in the hands of the AEs, and the income of the assessee in India would reduce by the corresponding amount, thereby shifting profit from Indian jurisdiction to Bermuda which is a tax haven country with zero rate of tax on corporate profit.

- Even if profit are sufficient, it is not mandatory for AE to declare dividend. The same may be retained as profit in Bermuda for further investment in group companies.

Decision and observations of the Hon'ble Delhi Tribunal:

The Hon'ble Delhi Tribunal decided the case in favour of Revenue and held that in the case of interest free loans to foreign AEs, the amount of notional interest shall be determined having regard to ALP for taxability in the hands of Indian Company. The important observations made by the Hon'ble Delhi Tribunal while giving the above decision are briefly given below:

- There is no case that any special feature in the contract makes the transaction as capital in nature. This is not a case of ordinary business transaction. Hence the contention of having actually not earned any income cannot come to the rescue of the assessee in this scenario.

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- The case laws from the Apex Court cited by the ld. Counsel of the assessee are not in the context of Chapter-X of the IT Act, which relates to special provision relating to computation of income from ITs having regard to ALP. Other case laws cited by the assessee are not germane to the facts of this case. Hence, in our considered opinion, they do not help the case of the assessee.
- The transaction of lending or borrowing money to/from AEs is specifically covered in the definition of ITs under section 92B of the Act and whether the same is at ALP has to be considered.
- The Hon'ble Tribunal also accepted the TPO's contention that one of the AEs is situated in a tax haven Bermuda and not charging of the interest by the assessee from the AEs, would result in shifting profit from Indian jurisdiction to Bermuda.
- Even, reliance by Appellant on Hungarian thin-capitalization rule is again misplaced because the rule is for only disallowance of interest expense and there is no restriction in respect of outward remittances in respect of debt finance. Further, the purpose, guidelines and rules for RBI's approval and the Transfer Pricing rules under the IT Act are completely different.
- Finally as regards adjustment of +-5% variation to the ALP, TPO has applied the monthly LIBOR during the financial year 2001-02 for US dollar loan at 2.39%. On that LIBOR, the AO added average basis point charged by other companies, the arithmetic mean of which came to 1.64%. Accordingly, the AO computed the arms length rate to be LIBOR + 1.64% using CUP method.
- The Hon'ble Tribunal held that there are not more than one price in respect of each of the transaction, as specific one year LIBOR rate has been held to be arm's length price for the transactions. Therefore, 5% allowance itself is infructuous.

WAY FORWARD

- It is advisable to check whether any interest free loans or advances are given to the foreign AEs. If the answer is in affirmative, it is advisable to charge interest in respect of such transaction to the foreign AE at an Arm's length rate of interest.
- Please note that even if the money lent is shown in accounts under some other head say 'Share Application Money' and no shares have been allotted against the said application money within the time prescribed under the rules of the country of AEs or the shares application money is outstanding for long time, then the possibility of considering the same as interest free loan can not be ruled out.

Scope and Limitations

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