



Transfer Pricing Insight with information

Landmark HC ruling for
ALP determination of
interest rate on
intercompany loan
transactions

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Executive Summary

The Hon'ble Delhi High Court (HC) recently pronounced its ruling in the case of Cotton Naturals (I) Pvt. Ltd. (the taxpayer), wherein the HC laid down important guidance in determining arm's length interest rate in case of intra group loan transactions. The HC held that ***“interest rate should be market determined interest rate applicable to the currency concerned in which the loan has to be repaid. Interest rate should not be computed on the basis of interest payable on the currency or the legal tender of the place or the country of residence of either party”***.

Further, the HC also made an important observation that the Revenue authorities cannot re-characterize the legitimate commercial business relationship between the taxpayer and its associated enterprises (AEs). The scope of Transfer Pricing (TP) analysis should be restricted to determining the arm's length price of the intercompany transactions in view of similar transactions between unrelated parties.

Facts

- The taxpayer was engaged in the manufacture and export of rider apparels. It incorporated a wholly owned subsidiary in USA for the marketing and promotion of its exports in USA.
- The taxpayer advanced loan to its subsidiary in USD during FY 2002-03 at an interest rate of 4% p.a. The same loan had been continuing in the assessment year (AY) 2007-08 also.
- The taxpayer substantiated arm's length nature of the rate of interest based on the prevailing export packing credit rate in India during the year.
- The Transfer Pricing Officer (TPO) determined the arm's length interest rate by comparing the rate of interest that the taxpayer would have earned from making similar loan to unrelated parties in India. The TPO adopted LIBOR rate adjusted for currency differential, transaction cost and underlying security to arrive at an interest rate of 14% as against 4% charged by the taxpayer and made TP adjustment for the differential tax rate.

- The DRP granted partial relief to the taxpayer by computing the arm's length rate of interest at 12.20%.
- In further appeal before the Tribunal, the Tribunal noted that the facts of the case were similar to the Co-ordinate Bench ruling for AY 2008-09 in taxpayer's own case. Accordingly, the Tribunal followed the order in taxpayer's own case for subsequent year and deleted the transfer pricing adjustment proposed by the TPO.
- Aggrieved by the order of the Tribunal, the Revenue preferred an appeal before the HC.

Main issue before the High Court

- Whether the Tribunal was right in deleting the TP adjustment by relying on the Co-ordinate Bench ruling in the taxpayer's own case for AY 2008-09 and in holding that the interest @ 4% p.a. charged by the taxpayer from its AE was at arm's length rate of interest?

Observations & Ruling of the High Court

- The HC rejected the approach of the TPO of determining arm's length interest rate based on the alternative investment opportunities in India. The HC held that the Revenue authorities cannot re-write the transactions. Legitimate business transactions cannot be re-written or re-structured by the tax authorities. Such re-structuring is permissible only in exceptional circumstances. The purpose of TP analysis is only to ascertain the arm's length nature of the transaction.
- The HC held that the arm's length analysis of the transaction of lending money by the taxpayer to the subsidiary should also take into consideration the purpose behind advancing loans such as maximizing returns, propelling growth and expanding market presence
- The HC further held that the arm's length interest rate should be determined on the basis of terms and conditions of the transactions and the market determined interest rate applicable to the currency in which the loan is repayable instead of the interest rate

payable on the currency of the place of residence of the borrower or lender. **It observed that the currency in which the loan is repaid normally determines the rate of return on the money lent.** While holding this position, HC relied on several Tribunal rulings¹ which held the similar principles.

- The HC also noted that similar parameters and reasoning should be applied for determining arm's length interest rate for outbound as well as inbound loans.
- The HC rejected the reliance placed by the Revenue on Chapter 10 of the United Nations Transfer Pricing Manual, as it merely gives an individual country's view point and its experiences for the information of the readers and does not reflect the opinion of the Manual itself.
- The HC observed that the interest rate charged by the taxpayer on the long term loan granted to the AE was much higher than the prevailing LIBOR interest rate.
- In view of the above, the HC ruled in favour of the taxpayer and dismissed the appeal of the Revenue.
- The HC also rejected the approach followed by the taxpayer for substantiating the arm's length interest rate. The HC held that the export credit rate relied on by the taxpayer is not acceptable as this rate was for the special scheme introduced by the Government of India for the purpose of promotion of exports in India.

Conclusion

This is an important ruling by the Hon'ble HC laying down principles for determining arm's length interest rate in case of intra group loan transactions. For last several years, many companies in India have been facing TP adjustment on the interest rate receivable by them for granting loans to overseas AEs. Detailed guidance from the HC will benefit all those taxpayers which have been in TP dispute with Indian Revenue authorities for interest received by them from overseas AEs and also the proposed intercompany funding arrangements being planned by outbound corporate houses in India.

Source : CIT- I Vs Ms. Cotton Naturals (I) Pvt. Ltd. (ITA.No. 233/2014) (Delhi High Court) dated 27th March 2015

¹ Siva Industries & Holdings Ltd. vs ACIT (ITA No. 2148/Mds/2010), DCIT vs Tech Mahindra Ltd. (ITA No. 1176/Mum/2010), M/s Four Soft Ltd. Hyderabad vs DCIT (ITA No. 1495/Hyd/2010), Tata Autocomp Systems Ltd. vs ACIT (ITA No. 7354/Mum/2011) etc.

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