*** IN THE HIGH COURT OF DELHI AT NEW DELHI**

+ ITA No. 233/2014

Reserved on: 13th February, 2015
% Date of Decision: 27th March, 2015

COMMISSIONER OF INCOME TAX-I …Appellant
Through Mr. Rohit Madan, Sr. Standing Counsel

Versus

M/s COTTON NATURALS (I) PVT. LTD. …Respondents
Through Mr. Ved Jain with Mr. Pranjal Srivastava, Advocates.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE V. KAMESWAR RAO

SANJIV KHANNA, J.

The question raised in the present appeal by the Revenue under Section 260A of the Income Tax Act, 1961 (Act, for short) relates to determination of arm's length rate of interest, paid to the assessed, i.e. Cotton Naturals (I) Pvt. Ltd., by their subsidiary M/s JPC Equestrian, a company registered in the United States of America. The appeal emanates from the order of the Income Tax Appellate Tribunal (Tribunal, for short), dated 30th October, 2013, and pertains to the assessment year 2007- 08.

2. On the basis of the contentions raised by the parties, the following substantial question of law needs to be answered and decided:

1. Whether the Income-Tax Appellate Tribunal was right in following their earlier order for the assessment year 2008-09, dated 8th February, 2013 in ITA No. 5855/Del./2012 and in holding that the interest @ 4% p.a. charged by the respondent assessee from its subsidiary i.e. the Associated Enterprise was arm's length rate of interest and the adjustment made in the Assessment Order determining the arms' length rate of interest at 12.20% was unwarranted?

3. With the consent of the counsel, we had heard them on the aforesaid substantial question.

4. The respondent assessee, an Indian company was engaged during the relevant period, in the business of manufacture and exports of rider apparels like riding breeches, jodhpurs, socks, riding jackets, horse blankets, fly sheets, riding boots, shirts, saddle pads and riding helmets. The Headquarter of the assessed was located in Delhi, India with presence in 10 countries through designated channel partners and distributors. However, for the purpose of marketing and promoting their exports to USA, the respondent assessee had incorporated the aforesaid subsidiary, which was wholly owned by them and their two shareholders.

5. As per 3CEB report and Transfer Price documents, the following international transactions between the respondent assessee and the Associated Enterprise i.e. M/s JPC Equestrian (hereinafter referred to as an AE), were disclosed:

Equestrian Apparel sold to JPC Equestrian Inc.	Rs.24,438,153/-
Loan provided to JPC Equestrian Inc	10,50,000 $
Interest Received	Rs.20,52,101/-

6. The respondent assessee had selected the Comparable Uncontrolled Price method (CUP method, for short) to benchmark sale of equestrian apparels and the interest received on the loan. The respondent assessee had declared that the interest received at the rate of 4% was comparable with the export packing credit rate obtained from independent banks in India.

7. The Transfer Pricing Officer (TPO, for short) in his report enumerated several reasons, which we are not highlighting at this stage to avoid repetition, to hold that the arm's length interest rate should be taken as 14% p.a. He computed arm's length interest on the loan at Rs.71, 82, 354/-, in the place of interest received of Rs.20,52,101/-. The aforesaid upward revision was made as per the following table/ chart:-

"**CUP Rate is thus arrived at as under:**

Basic interest rate for the credit rating of the AE	LIBOR+400 basis points
Add: Transaction Cost	300 basis points
CUP Rate	LIBOR + 700 basis points
Add: Adjustment for security	Not computed
Final CUP Rate	> LIBOR + 700 basis points

As the currency in which the loan is extended to the AE is GBP, 6-month GBP LIBOR (sic) is considered. These rates are given as per Annexure - A. The average 6-month GBP LIBOR (sic) is arrived at 5.224% p.a. Thus the CUP rate is arrived at as under.

CUP Rate	>	LIBOR + 700 basis points
	>	5.224%+7%

> 12.224%

Keeping in view that no security is offered by the subsidiary and also that the taxpayer is not into lending and borrowing money, a reasonable interest rate of 14% p.a. can be considered."

8. The respondent assessee filed objections before the Dispute Resolution Panel (DRP, for short) against adoption of 14% rate of interest as suggested by the TPO. DRP while substantially rejecting the contentions, granted partial relief in the form of reduction of rate of interest to 12.20%, recording that the loan was given on fixed rate of interest out of shareholder funds. Funds had flown from one shareholder to another, and the reality being that both set of shareholders were the same, the security aspect was embedded by default in the transaction. The DRP also noted that the Prime Lending Rate (PLR, for short) fixed by the Reserve Bank of India, ranged from 10.25% to 10.75% in April, 2006 to 12.25% to 12.50% in March, 2007. In view of the above stated, the upward revision of interest rate i.e. the arm's length interest was computed as Rs.62, 58, 908/-, in place of Rs.20,52,101/-. On the basis of the directions issued by the DRP, an assessment order was passed, making an addition of Rs.42, 06, 807/- by way of transfer pricing adjustment.

9. The respondent assessee succeeded before the Tribunal who preferred to follow their earlier order dated 8th February, 2013 in ITA No. 5855/Del/2012 relating to the subsequent assessment year 2008-09. The reasoning in this order dated 8th February, 2013 has been reproduced in the impugned order and for the sake of convenience we would also like to quote the same:

"11. We have carefully considered the submissions and perused the records, we find that the assessee company in this case is a leading manufacturer of

rider apparel. Assessee entered into international transaction as under:-

Equestrian Apparel sold to JPC Equestrian Inc	48191540/-
Loan provided to JPC Equestrian Inc	10,50,000 $

12. As per the TP document, CUP method has been chosen to benchmark the sale of apparel as well as interest received on loan. The TPO accepted the assessee's submission qua sale of apparel that the same was at arms length. As regards interest the assessee mentioned that it has received interest at a rate of 4% which was comparable with the export packing credit rate obtained from independent banks in India. The TPO was not in agreement with the above contention of the assessee. He observed that it is to be seen that what the assessee would have earned by giving loans in the Indian market. He noted that lending or borrowing is not one of the main businesses of the taxpayer. He opined that what is to be considered is the prevalent interest that could have been earned by advancing a loan to an unrelated party in India with the same financial health as that of the tax payer's subsidiary. The TPO further observed that the taxpayer has not submitted the financial of the subsidiary, hence the financial healthy of the subsidiary cannot be judged. The TPO further noted that while deciding the interest rate that may be charged on receivables from AE's, Libor rate for calculating interest is not proper. He opined that instead of US rate, Indian rate is to be adopted. He observed that an independent person in India would expect the maximum return on its investment, and if the lending rate is higher in Indian currency then he would not lend in foreign currency where the lending rate is not so attractive. The TPO further noted that it should not be forgotten that, had the AE of the assessee company would have got loan from any bank or financial institution in the place of residency at Libor rate, then why it did not avail of loan at such a rate. Assessing Officer observed that, no company in India would like to invest in the form of loan outside India and that also without security as the interest returns in India would be higher than those prevailing in developed markets. Finally, Assessing Officer held that interest rate at 17.26% would be fair and reasonable.

13. Before the DRP assessee inter-alia contended that comparison has to be made with respect of advance or loan in USA and not based on Indian conditions. The comparison could also be with rate of interest being paid by the multinational companies or banks in respect of money borrowed from India. However, the DRP agreed with TPO 's point of view. But, it held that further addition on account of security is not needed. It opined that Arm's length interest rate may be taken as the PLR of RBI for the financial year 2007-08. In accordance with the above decision, the TPO adopted 13.25% as the rate of arms length interest rate.

14. We note that CUP method is the most appropriate method in order to ascertain arms length price of the international transaction as that of the assessee. We agree with the assessee's contention that where the transaction was of lending money in foreign currency to its foreign subsidiaries the comparable transactions, therefore, was of foreign currency Tended by unrelated parties. The financial position and credit rating of the subsidiaries will be broadly the same as the holding company. In such a situation,- domestic prime lending rate would have no applicability and the international Rate Mixed being LIBOR should be taken as the benchmark rate for international transactions.

15. The above view is duly supported by following case laws relied upon by the assessee's counsel. In Siva Industries and Holding Ltd. vs. ACIT Supra it was held by ITAT that the assessee had given the loan to the associate enterprise in U.S. dollars, and in such a situation when the transaction was in foreign currency, and the transaction was an international transactions, then the transaction would have to be looked upon by applying the commercial principles in regard to international transactions. In such a situation domestic prime lending would have no applicability and the international rate fixed being LIBOR rate would have to be adopted.

16. Similar view as above was expressed by the ITAT in the case of M/s Four Soft Ltd., Hyderabad vs. DCIT Supra, Dy. C.I.T vs. Tech. Mahindra Supra, Tata Autocomp Systems vs. ACIT Supra.

17. We further note that assessee has arrangement, for loan with Citi Bank, for less than 4%. However, for loan

provided to its AE's it has charged 4% p.a. interest. Hence, adjustment suggested by the TPO is not warranted.

18. We further note that assessee's profits are exempt u/s. 10B. Hence, there is no case that assessee would benefit by shifting profits outside India. This view is supported by Bangalore Tribunal decision in this case Philips Software Centre P Ltd. vs. ACIT Supra and Mumbai Tribunal in the case of I.T.O. vs. Zydus Altana Health Care P Ltd. Supra.

19. We further note that in this case the loan agreement was for fixed rate of interest. The LIBOR has been accepted in decision referred above as the most suitable bench mark for judging Arms' length price in case for foreign currency loan. Hence, adjustment as made by the TPO is not warranted.

20. In the background of the aforesaid discussions and precedents, we hold that the rate of interest charged by the assessee for the loans transactions with the AE was Arms Length Price. Hence, no transfer pricing adjustment is called for."

10. The aforesaid quotation refers to several decisions of the Tribunal starting from ***Siva Industries & Holdings Ltd. vs. ACIT,*** which is a decision by the Chennai Bench of the Tribunal in ITA No. 2148/Mds/2010. In the instant case it has been held:

> "11. We have considered the rival submissions. A perusal of the order of the TPO clearly shows that the assessee had raised the funds by way of issuance of 0% optional convertible preferential shares. Thus it is noticed that the funds raised by the assessee company for giving the loan to India Telecom Holdings Ltd., Mauritius, which is its Associated Enterprises and which is the subsidiary company, is out of the funds of the assessee company. It is not borrowed funds. The assessee has given the loan to the Associated Enterprises in US dollars. The assessee is also receiving interest from the Associated Enterprises in Indian rupees. Once the transaction between the assessee and the Associated Enterprises is in foreign currency and the transaction is an international transaction, then the transaction would have to be looked upon by applying the commercial principles in regard to international transaction. If this is so, then the domestic prime lending rate would

> have no applicability and the international rate fixed being LIBOR would come into play. In the circumstances, we are of the view that it LIBOR rate which has to be considered while determining the arm's length interest rate in respect of the transaction between the assessee and the Associated Enterprises. As it is noticed that the average of the LIBOR rate for 1.4./2005 to 31.3.2006 is 4.42% and the assessee has charged interest at 6% which is higher than the LIBOR rate, we are of the view that no addition on this count is liable to be made in the hands of the assessee. In the circumstances, the addition as made by the Assessing Officer on this count is deleted."

11. The aforesaid view has been subsequently followed by different Benches of the Tribunal for almost identical reasons in ***DCIT vs. Tech Mahindra Ltd.*** – ITA no. 1176/Mum./2010, dated 30th June, 2011; ***M/s Four Soft Ltd. Hyderabad vs. DCIT***- ITA No. 1495/Hyd/2010, dated 9th September, 2011; ***Tata Autocomp Systems Ltd. vs. ACIT*** – ITA No. 7354/Mum/2011, dated 30th April, 2012; ***M/s Aurobindo Pharma Ltd. vs. ACIT*** – ITA No. 1866/Hyd/2012 dt. 29th November, 2013; ***Siva Ventures Ltd. vs. ACIT*** - ITA No. 2161/Mds/2011, dated 27th June, 2013; ***Apollo Tyres Ltd. vs. ACIT*** - ITA No. 616/Coch/2011 dated 20th December, 2013; ***Hinduja Global Solutions Ltd. vs. Addl. CIT*** – ITA No. 254/Mum/2013, dated 5th June, 2013; ***M/s PMP Auto components P. Ltd. vs. DCIT*** – ITA No. 1484/Mum/2014 dated 22nd August, 2014; and ***VIP Industries Ltd. vs. Addl. CIT*** – ITA No. 526/Mum/2014 and its cross appeal titled ***Dy. CIT vs. VIP Industries Ltd.***, ITA No. 881/Mum./2014 dated 10th December, 2014.

12. In some of the cases, the Tribunal has applied a mark up on the London Interbank Offered Rate (LIBOR for short) and Euro Interbank Offered Rate (EURIBOR, for short). LIBOR is calculated and published by Thomson Reuters, on behalf of British Bankers'

Association. The rate is calculated on inter-bank offers for lending rates from banks in a reasonable market place. The highest 25% and lowest 25% of the values offered are eliminated, and the rate is determined on the remaining 50%. EURIBOR is also calculated and published each day and 15% of the lowest and the highest interest rates quoted by the panel of European banks are eliminated and the remaining 70% form the basis of calculation.

13. The reasoning given in the decision relied upon by the Revenue for applying PLR, namely ***Logic Micro Systems Ltd. vs. ACIT,*** ITA No. 423/Bang/2009, dated 7th October, 2010 records as under:

> "22. Another important direction given by the Commissioner of Income-tax(A) is to adopt LIBOR/US-FED rate for calculating the interest. This proposition has been made by the Commissioner of Income-tax(A) on the premise that the ALP factor of interest is to be computed with reference to the benefit that would have been earned by the AE in USA. On the other hand, in calculating the cost factors of the assessee in India, it is more appropriate to consider the potential loss suffered by the assessee in India by not bringing the receivables within the normal period. In fact, the said potential loss of the assessee in India is the ALP factor which contributes to the additional income attributable to the assessee. Therefore, instead of the US rate, the TPO is justified in adopting the Indian rate.
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> 23. While adopting the Indian rate, it is not proper to rely on PLR of the State Bank of India. This is because if the funds were brought in time and those funds were properly deployed, the assessee company may earn an income at the maximum rate applicable to deposits and not at the rate applicable to loans. Therefore, we vacate the direction of the TPO to adopt the PLR rate of 10.25%. Instead we find it appropriate to adopt a reasonable rate that would be available to the assessee on short-term deposits.
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> 24. We have held that the period chargeable to interest has to be recomputed and a reasonable deposit rate has to be applied for calculating the interest. Taking into consideration all aspects of the case like interest-free period and piece-meal remittance of the receivables, we fix the

ALP interest rate at 5% and direct the Assessing Officer to compute the additional income at the rate of 5% on Rs.5,52,24,261/- as against 10.25% adopted by the Assessing Officer."

(emphasis supplied)

14. In another decision, ***Nimbus Communications Ltd. vs. ACIT*** ITA No. 6597/Mum/2009, it stands observed that LIBOR is relevant in only cases of lending, borrowing of fund and not in cases of commercial overdues. The said decision would however not be relevant to the extant case as ***Nimbus Communications Ltd.***(supra) is a case of debt balance not paid in a commercial transaction. We do not have to answer the said question/ aspect.

15. The case of the appellant-Revenue finds lucid exposition in the following table quoted by the Transfer Pricing Officer, pointing out the difference between lending and borrowing:

"The difference between lending and borrowing when dealing at arm's length is given in the below table (Assuming X is in India and Y is outside India).

Sl. No.	Aspect	Lending money b X to Y	Borrowing Money b X from Y
1	Primary Consideration	The primary consideration for X is to maximize its return in terms of interest keeping in view the risk involved.	The primary consideration for X is to minimize its rate of interest keeping in view the risk involved.
2	Interest Rate	Interest rate depends on the tenure, credit rating of Y, and	Interest rate depends on the tenure, credit rating of X, and

		security offered.	security offere
3	Benchmarking	X would see what the maximum return he gets in India and spread required for taking the risk of losing money (depends on the credit rating of Y) as well as security being offered by Y. Independent party would not lend outside India if it can get higher return in India. Thus the benchmarking would be based on the interest rate receivable in India for giving loans to parties with similar credit rating as that of Y (like corporate bonds) and also the level of security offered by Y.	X would see what the minimum interest rate it can borrow from Y as interest rates in India are higher when compared to the interest rates charged in ECB loans. Thus the bench marking is based on LIBOR + some basis points depending on the credit rating of X.

Indian companies go for External Commercial Borrowings as the interest rates on ECB loans are generally cheaper than the prevailing interest rates in the domestic market. Thus as can be seen from above, while borrowing money by X (in India) from Y (outside India), the interest rates are benchmarked with LIBOR and the interest rate above LIBOR is decided by the stand alone credit rating

of X. On the contrary, no company in India would like to investme in the form of loan outside India and that also without security as the interest returns in India would be higher than those prevailing in developed markets. Thus while lending money by X (in India) to Y (outside India), the interest rates would be bench marked against those prevailing in India for investing in corporate bonds (which are without security)."

16. We would first like to deal with the aforesaid table and the reasoning given in the case of ***Logic Micro Systems Ltd.*** (supra) before we advert to other facets of the issue.

17. In our opinion, the reasoning recorded therein suffers from a basic and fundamental fallacy. Transfer pricing determination is not primarily undertaken to re-write the character and nature of the transaction, though this is permissible under two exceptions. Chapter X and Transfer Pricing rules do not permit the Revenue authorities to step into the shoes of the assessee and decide whether or not a transaction should have been entered. It is for the assessed to take commercial decisions and decide how to conduct and carry on its business. Actual business transactions that are legitimate cannot be restructured. It is not uncommon for manufacturers cum exporters to enter into distribution and marketing agreements with third parties or incorporate subsidiaries in different countries for undertaking marketing and distribution of the products. The Delhi High Court in ***Commissioner of Income Tax versus EKL Appliances Limited***, (2012) 345 ITR 241 (Delhi) referred to the Paragraphs 1.36 to 1.38 of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010 published by the Organization for Economic Cooperation and Development (OECD, for short) and held as under:-

> "17. The significance of the aforesaid guidelines lies in the fact that they recognise that barring exceptional cases, the tax administration should not disregard the actual transaction or substitute other transactions for them and the examination of a controlled transaction should ordinarily be based on the transaction as it has been actually undertaken and structured by the associated enterprises. It is of further significance that the guidelines discourage re-structuring of legitimate business transactions. The reason for characterisation of such re-structuring as an arbitrary exercise, as given in the guidelines, is that it has the potential to create double taxation if the other tax administration does not share the same view as to how the transaction should be structured.
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> 18. Two exceptions have been allowed to the aforesaid principle and they are (i) where the economic substance of a transaction differs from its form and (ii) where the form and substance of the transaction are the same but arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner."

18. This judgment was referred to by us in ITA No. 16/2014, ***Sony Ericsson Mobile Communications India Private Limited (Now known as Sony India Limited) versus Commissioner of Income Tax-III*** and other connected cases decided on 16th March, 2015 and it was held as under:-

> "147. Tax authorities examine a related and associated parties' transaction as actually undertaken and structured by the parties. Normally, tax authorities cannot disregard the actual transaction or substitute the same for another transaction as per their perception. Restructuring of legitimate business transaction would be an arbitrary exercise. This legal position stands affirmed

in EKL Appliances Ltd. (supra). The decision accepts two exceptions to the said rule. The first being where the economic substance of the transaction differs from its form. In such cases, the tax authorities may disregard the parties' characterisation of the transaction and re-characterise the same in accordance with its substance. The Tribunal has not invoked the said exception, but the second exception, i.e. when the form and substance of the transaction are the same, but the arrangements made in relation to the transaction, when viewed in their totality, differ from those which would have been adopted by the independent enterprise behaving in a commercially rational manner. The second exception also mandates that actual structure should practically impede the tax authorities from determining an appropriate transfer price. The majority judgment does not record the second condition and holds that in their considered opinion, the second exception governs the instant situation as per which, the form and substance of the transaction were the same but the arrangements made in relation to a transaction, when viewed in their totality, differ from those which would have been adopted by an independent enterprise behaving in a commercially rational manner. The aforesaid observations were recorded in the light of the fact in the case of L.G. Electronics (supra). Commenting on the factual matrix of L.G. Electronics case (supra) would be beyond our domain; however, we do not find any factual finding to this effect by the TPO or the Tribunal in any of the present cases. However, in L.G. Electronics decision (supra), it is observed that if the AMP expenses and when such expenses are beyond the bright line, the transaction viewed in their totality would differ from one which would have been adopted by an independent enterprise behaving in a commercially rational manner. No reason or ground for holding or the ratio, is indicated or stated. There is no material or justification to hold that no independent party would incur the AMP expenses beyond the bright line AMP expenses. Free market conditions would indicate and suggest that an independent third party would be willing to incur heavy and substantial AMP expenses, if he presumes this is beneficial, and he is adequately compensated. The compensation or the rate of return would depend upon whether it is a case of long-term or short-term association and market conditions, turnover and ironically international or worldwide brand value of the intangibles by the third party."

19. It would also be appropriate at this stage to reproduce the following portion from the UN Model Double Taxation Convention Between Developed and Developing Countries, wherein reference

was made to the OECD Model Convention Commentary on Paragraph 6 of Article 11, in the following words:

> "22. This paragraph reproduces Article 11, paragraph 6, of the OECD Model Convention, the Commentary on which reads as follows:
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> 32. The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of interest in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last-mentioned amount and that the excess part of the interest shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.
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> 33. It is clear from the text that for this clause to apply the interest held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.
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> 34. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest.
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> 35. With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in

such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary to as a minimum to remove the limiting phrase "having regard to the debt-claim for which it is paid". If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds". Either of these alternative versions would apply where some or all of an interest payment is excessive because the amount of the loan or the terms relating to it (including the rate of interest) are not what would have been agreed upon in the absence of the special relationship. Nevertheless, this paragraph can affect not only the recipient but also the payer of excessive interest and if the law of the State of source permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the interest, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not alter its general purport.

36. Should the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

23. When this issue was last considered, some members of the former Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of Article 11 through, inter alia, creation or assignment of debt claims in respect of which interest is charged. While substance over form rules, abuse of rights principle or any similar doctrine could be used to counter such arrangements, Contracting States which may want to specifically address the issue may include a clause on the following lines in their bilateral tax treaties during negotiations, namely:

> The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment."

20. Reverting to the reasoning given, we record that t respondent-assessee had incorporated a subsidiary in United States for undertaking distribution and marketing activities for the products manufactured by them. It is obvious that this was done with the intention to expand and promote exports in the said country and was a legitimate business decision. The transaction of lending of money by the respondent-assessee to the subsidiary, should not be seen in isolation, but also for the purpose of maximising returns, propelling growth and expanding market presence. The reasoning ignores the said objective facet. Transfer pricing rules treat the domestic AE and the foreign AE as two separate entities and profit centres, and the test applied is whether the compensation paid for the products and services is at arm's length, but it does not ignore that the two entities have a business and a commercial relationship. The terms and conditions of the commercial business relationship as agreed and undertaken are not to be rewritten or obliterated. Transfer pricing is a mechanism to undo an attempt to shift profits and correct any under or over payment in a controlled transaction by ascertaining the fair market price. This is done by computing the arm's length price. The purpose is to ascertain whether the transfer price is the same price which would have been agreed and paid for by unrelated enterprises transacting with each other, if the price is determined by market forces. The first step in this exercise is to ascertain the international transaction, which in the present case is payment of interest on the money lent. The next step is to ascertain the functions performed under the international transaction by the respective AEs. Thereafter, the comparables have to be selected by undertaking a comparability analysis. The comparability analysis should ensure that the functions

performed by the comparables match with the functions being performed by the AE to whom payment is made for the services rendered. These aspects have been elucidated in detail in ***Sony India Ltd.*** (supra) by referring to the OECD Guidelines as well as United Nations Practical Manual of Transfer Pricing for Developing Countries.

21. Appropriate in this regard would be reference also to Rules 10B and 10C of the Income Tax Rules, 1962. Rule 10B (2) reads:-

> **"10B.** xxx
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> (2) For the purposes of sub-rule (1), the comparability of an international transaction *or a specified domestic transaction* with an uncontrolled transaction shall be judged with reference to the following, namely:—
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> (*a*) the specific characteristics of the property transferred or services provided in either transaction;
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> (*b*) the functions performed, taking into account assets employed or to be employed and the risks assumed, by the respective parties to the transactions;
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> (*c*) the contractual terms (whether or not such terms are formal or in writing) of the transactions which lay down explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the respective parties to the transactions;
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> (*d*) conditions prevailing in the markets in which the respective parties to the transactions operate, including the geographical location and size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition and whether the markets are wholesale or retail."

Equally important is sub-rule (3) to Rule 10B, which reads:-

"**10B.** (3) An uncontrolled transaction shall be comparable to an international transaction *or a specified domestic transaction* if—

(*i*) none of the differences, if any, between the transactions being compared, or between the enterprises entering into such transactions are likely to materially affect the price or cost charged or paid in, or the profit arising from, such transactions in the open market; or

(*ii*) reasonably accurate adjustments can be made to eliminate the material effects of such differences."

Similarly, Rule 10C (1) reads:-

"**10C.** (1) For the purposes of sub-section (1) of section 92C, the most appropriate method shall be the method which is best suited to the facts and circumstances of each particular international transaction *or specified domestic transaction*, and which provides the most reliable measure of an arm's length price in relation to the international transaction *or the specified domestic transaction, as the case may be*.

(2) In selecting the most appropriate method as specified in sub-rule (1), the following factors shall be taken into account, namely:—

(*a*) the nature and class of the international transaction *or the specified domestic transaction*;

(*b*) the class or classes of associated enterprises entering into the transaction and the functions performed by them taking into account assets employed or to be employed and risks assumed by such enterprises;

(*c*) the availability, coverage and reliability of data necessary for application of the method;

(*d*) the degree of comparability existing between the international transaction *or the specified domestic transaction* and the uncontrolled transaction and between the enterprises entering into such transactions;

(*e*) the extent to which reliable and accurate adjustments can be made to account for differences, if any, between the international transaction *or the specified domestic transaction* and the comparable uncontrolled transaction or between the enterprises entering into such transactions;

(*f*) the nature, extent and reliability of assumptions required

to be made in application of a method."

22. The aforesaid Rules indicate factors that ought to be taken into account for selection of the comparables, which necessarily include the contractual terms of the transaction and how the risks, benefits and responsibilities are to be divided. The conditions prevailing in the market in which the respective parties to the transactions operate, including the geographical location and the size of the markets, the laws and Government orders in force, costs of labour and capital in the markets, overall economic development and level of competition, are all material and relevant aspects. If we keep the aforesaid aspects in mind, it would be delusive not to accept and agree that as per the prevalent practice, subsidiary AEs are often incorporated to carry on distribution and marking function. This is not an unusual but common. Once this is accepted, then we cannot accept the reasoning given by the TPO that the transfer pricing adjustment could restructure the transaction to reflect maximum return that a party could have earned and this would be the yardstick or the benchmark for determining the interest payable by the subsidiary AE. This is not what Chapter X of the Act and Rules mandate and stipulate. The aforesaid provisions neither curtail the commercial freedom, nor do they bar or prohibit a legitimate transaction. They permit transfer pricing adjustment so as to bring to tax what would have been paid for the transaction in the same or similar comparable circumstances by an independent third party.

23. This ratio and rationale, when applied to the facts of the present case, would mean that the transfer pricing determination would decide what an independent distributor and marketer, on the same

contractual terms and having the same relationship, would ha earned/paid as interest on the loan in question. What an independent party would have paid under the same or identical circumstances would be the arm's length price or rate of interest. What the assessed would have earned in case he would have entered into or gone ahead with a different transaction, say with a party in India, is not the criteria. What is permitted and made subject matter of the arm's length determination is the question of rate of interest and not re-classification or substitution of the transaction. The position would have been different, if the two exceptions carved out in the case of ***EKL Appliances*** (supra) were applicable.

24. This is clear and lucid when we examine the methodology prescribed in Rule 10B (1) (a), which prescribes the manner of computing arm's length price under CUP method. Rule 10B (1) (a) reads:-

> "**10B.** (1) For the purposes of sub-section (2) of section 92C, the arm's length price in relation to an international transaction [55a]**[***or a specified domestic transaction***]** shall be determined by any of the following methods, being the most appropriate method, in the following manner, namely :—
>
> (*a*) comparable uncontrolled price method, by which,—
>
> (*i*) the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified;
>
> (*ii*) such price is adjusted to account for differences, if any, between the international transaction *or the specified domestic transaction* and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;
>
> (*iii*) the adjusted price arrived at under sub-clause (*ii*) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction *or the specified domestic transaction*

xxx "

25. The comparison, therefore, has to be with comparables and not with what options or choices which were available to the assessed for earning income or maximizing returns. Importantly, the TPO, DRP and the Assessing Officer have all accepted that the respondent assessee had adopted and applied CUP Method for computing arm's length interest payable by the subsidiary AE. To this extent, there is no *lis* or dispute.

26. The TPO has noticed the contractual terms and referred to the following facets: The advance given by the parent company i.e. the assessed to M/s JPC Equestrian Inc. was to meet the working capital requirements of the subsidiary AE. He noted that when independent enterprises transact with each other, their business relations are determined by the market forces operating, i.e. what is the amount of interest that would have been earned had such an advance been given to an unrelated party placed in a similar position as that of the subsidiary AE. The TPO had asked for the audited financial accounts of the subsidiary. Credit rating would be relevant. He accepted that there was a sense of commercial expediency and related benefits in the loan transaction but the assessed had not been able to demonstrate that the interest charged satisfied the arm's length standard. He observed that business prudence or necessity of advancing loan to the subsidiary was not relevant for computing arm's length price (i.e. rate of interest in this case) in unrelated party transactions. This aspect, he held, would not take precedence over the arm's length nature of interest.

27. Several aspects enunciated above, reflect the correct legal position. We, however, express our inability to accept that commercial expediency and related benefits have no connection or relationship with the rate of interest. In terms of Clause (c) and (d) to Rule 10B (2), contractual relations or terms, and other material facts should be recognized. Having said so, we do accept the force of the alternative argument advanced that this fact could be of marginal significance and effect. It would be for the assessed to show and prove that a transaction separately benchmarked, included consideration for the lower interest rate being paid.

28. We do not agree with the finding recorded in paragraph 5 of the TPO's order that the comparable test to be applied is to ascertain what interest would have been earned by the assessed by advancing a loan to an unrelated party in India with a similar financial health as the taxpayer's subsidiary. The aforesaid reasoning is unacceptable and illogical as the loan to the subsidiary AE in the instant case is not granted in India and is not to be repaid in Indian Rupee. It is not a comparable transaction. The finding of the TPO that for this reason the interest rate should be computed at 14% per annum i.e. the average yield on unrated bonds for Financial Years (FY, for short) 2006-07, has to be rejected.

29. The TPO has referred to the decision of the Tribunal in the case of ***Perot Systems TSI (India) Limited versus DCIT*** and ***VVF Limited versus DCIT***, 2010-TIOL-55-ITAT-MUM wherein LIBOR plus 1.64% i.e. 4.03% and LIBOR plus 3% respectively, were accepted as the arm's length rate of interest. But these decisions, he held, were unacceptable for the reasons set out in paragraph 6.1 of the TPO's

order (the table has been quoted above). We have rejected t reasoning given in the table.

30. However, the TPO was right in rejecting computation of arm's length interest on the basis of Reserve Bank of India Master Circular dated 1st July, 2006 and 2nd July, 2007, fixing a ceiling on the interest rate on export credit at LIBOR plus 100 basis points etc. The reasoning given is correct and befitting. These were special schemes floated by the Reserve Bank of India for encouraging and facilitating exports with the said object and purpose. Export credit interest was available only for limited number of days and for specific purposes. The rates fixed did not reflect comparable market rates.

31. On the question of adjustment, the TPO referred to the FCNR loan advanced by the Power Finance Corporation to the Indian company i.e. Jindal Thermal Power Company Ltd. of US$ 44.50 million. Interest charged in the said case was US LIBOR plus 350 basis points for a company which had been given BB+ credit rating. However, full facts like the nature of transaction; risk factors etc. are not elucidated. He has also referred to the Bank of Baroda website that the rate of interest on FCNR loan were between 350-650 basis points over LIBOR for the FY 2006-07. TPO held that in view of the financial health of the subsidiary AE, interest rate could be taken as the average of six months LIBOR plus 400 basis points. On the question of transaction cost, it was stated that it was mandatory for the bank to insist that the borrower must book forward contracts to hedge their position. The TPO referred to the premium payable for undertaking the said hedging transactions and added a cost of 3% per annum as premium, which should have been paid. At the same time,

the TPO acknowledged that the taxpayer was not in the business lending or borrowing money and observed that the taxpayer's risk was higher in advancing loan to a single customer, *vis* a bank which spreads its risk among various customers. Banks spread their risk when loans are/were advanced to various consumers, but this does not happen when a loan is given to a single customer.

32. On the question of adjustment made on account of the transaction cost, we do not appreciate the reasoning given by the TPO and find it difficult to accept. The transaction or hedging cost is borne and paid by the borrower. These are undertaken when they take loans in US Dollars or other foreign currencies because the borrower wants to cover any loss on account of the depreciation of the Indian Rupee *vis- a- vis* the foreign currency. The assessee in the present case is not the borrower, but the lender. Transaction cost is not, therefore, applicable in the case in question, as the loan had to be repaid in US Dollars. Mark up towards the transaction cost is exorbitant and even comparison with banks is unsound and unintelligible. Risk factor adjustment is also stretched, for it ignores the close relationship between the two AEs and the funds were the shareholder funds, and not borrowed money.

33. The DRP accepted the addition of 700 basis points on account of credit rating and transaction costs, but the suggested third adjustment of 1.776 basis points was not accepted as loan was given out of the shareholder funds, which flowed from one set of shareholders to another set of shareholders. The security aspect it was held was embedded by default in the transaction. Thus, there was no requirement to make further addition on account of security.

34. In the present case, the loan was granted in the year 2002-20 and not during the period relevant to the assessment year in question. The agreements in respect of loan was entered into on 13th April, 2002, 7th May, 2003 and then on 8th September, 2003. The agreements fixed the rate of interest at 4% per annum on the principal sum. The said rate has been accepted in the earlier assessment years and, as noticed above, even in the subsequent assessment year 2008-09.

35. The LIBOR rate plus markup or the interest rate prevailing in the United States at that time, i.e. 2003 have not been examined and are not the basis on which the TPO made the adjustment and compute the interest rate for the transaction under consideration. It claimed that the LIBOR rates in the year 2002 varied between 1.447 % to 3.006 % and in the year 2003 between 1.201% to 1.487%. Rates in the year 2004 were again marginal, with the highest at 3.100% and the lowest at 1.340%. The LIBOR rate of 5.224% quoted in the TPO's order, it is pointed out, was the rate received on the investment made during the assessment year in question by the assessed. Thus, it was argued that the present case is of a long-term loan granted to the AE and the rate of interest charged was much higher than the then prevailing LIBOR interest rate. There is no finding of the TPO, the DRP or the Assessing Officer questioning the long-term transaction as such.

36. Under sub-rule (4) to Rule 10B, the data used for comparability of the uncontrolled transaction should be the data relating to the financial year in which the international transaction has been entered into. The proviso permits consideration of data, not more than two years prior to the financial year, if such data reveals

facts which would have influenced determination of transfer price relation to the transaction being compared. The transaction in question was entered into in the year 2002-03 when the loans were granted to the AE. This was the financial year of the international transaction. Payment of interest is also an international transaction but would have reference to the year in which the loan was granted in case of a long term loan. However, in such situations, question may arise whether the case would fall under the second exception mentioned in the case of ***E.K.L. Appliances (supra),*** when an AE has the right to recall and ask for repayment of loan. These aspects have not been considered and applied by the TPO, DRP and the Assessing Officer. Neither has this ground been argued before us on behalf the Revenue. We, therefore, would not proceed to examine the said aspect and leave the question open. Similarly, we have not expressed any opinion on the issue or question of "thin capitalization" which does not arise for consideration in the present case.

37. We observe that whatever the Revenue argues and submits in the case of outbound loans or for that matter what we have observed would be equally applicable to inbound loans given to Indian subsidiaries of foreign AEs. The parameters cannot be different for outbound and inbound loans. A similar reasoning applies to both inbound and outbound loans. Revenue has erroneously argued that different parameters would apply for inbound and outbound loans, which is not acceptable .

38. The DRP referred to the PLR rates fixed in India. It is evident that the PLR rates were not the basis for fixing the arm's length price. Both TPO and the DRP have referred to the PLR rates only by way of

analogy so as to state the prevailing interest rates in India, but wh applying CUP method for comparability, they had applied LIBOR rates prevailing and had applied a mark-up of 700 points on account of low credit rating of the subsidiary AE and the cost of transaction.

39. The question whether the interest rate prevailing in India should be applied, for the lender was an Indian company/assessee, or the lending rate prevalent in the United States should be applied, for the borrower was a resident and an assessee of the said country, in our considered opinion, must be answered by adopting and applying a commonsensical and pragmatic reasoning. We have no hesitation in holding that the interest rate should be the market determined interest rate applicable to the currency concerned in which the loan has to be repaid. Interest rates should not be computed on the basis of interest payable on the currency or legal tender of the place or the country of residence of either party. Interest rates applicable to loans and deposits in the national currency of the borrower or the lender would vary and are dependent upon the fiscal policy of the Central bank, mandate of the Government and several other parameters. Interest rates payable on currency specific loans/ deposits are significantly universal and globally applicable. The currency in which the loan is to be re-paid normally determines the rate of return on the money lent, i.e. the rate of interest. Klaus Vogel on Double Taxation Conventions (Third Edition) under Article 11 in paragraph 115 states as under:-

> "The existing differences in the levels of interest rates do not depend on any place but rather on the currency concerned. The rate of interest on a US $ loan is the same in New York as in Frankfurt-at least within the framework of free capital markets (subject to the arbitrage). In regard to the question as to whether

the level of interest rates in the lender's State or that in the borrower's is decisive, therefore, primarily depends on the **currency agreed upon** (*BFH* BSt.B1. II 725 (1994), re. 1 § AStG). A differentiation between debt-claims or debts in national currency and those in foreign currency is normally no use, because, for instance, a US $ loan advanced by a US lender is to him a debt-claim in national currency whereas to a German borrower it is a foreign currency debt (the situation being different, however, when an agreement in a third currency is involved). Moreover, a difference in interest levels frequently reflects no more than different expectations in regard to rates of exchange, rates of inflation and other aspects. Hence, the choice of one particular currency can be just as reasonable as that of another, despite different levels of interest rates. An economic criterion for one party may be that it wants, if possible, to avoid exchange risks (for example, by matching the currency of the loan with that of the funds anticipated to be available for debt service), such as taking out a US $ loan if the proceeds in US $ are expected to become available (say from exports). If an exchange risk were to prove incapable of being avoided (say, by forward rate fixing), the appropriate course would be to attribute it to the economically more powerful party. But, exactly where there is no 'special relationship', this will frequently not be possible in dealings with such party. Consequently, it will normally not be possible to review and adjust the interest rate to the extent that such rate depends on the currency involved. Moreover, it is questionable whether such an adjustment could be based on Art. 11 (6). For Art. 11(6), at least its wording, allows the authorities to 'eliminate hypothetically' the special relationships only in regard to the level of interest **rates** and not in regard to other circumstances, such as the choice of currency. If such other circumstances were to be included in the review, there would be doubts as to where the line should be drawn, i.e., whether an examination should be allowed of the question of whether in the absence of a special relationship (i.e., financial power, strong position in the market, etc., of the foreign corporate group member) the borrowing company might not have completely refrained from making investment for which it borrowed the money."

40. The aforesaid methodology recommended by Klaus Vogel appeals to us and appears to be the reasonable and proper parameter to decide upon the question of applicability of interest rate. The loan in question was given in foreign currency i.e. US $ and was also to be

repaid in the same currency i.e. US $. Interest rate applicable to loa granted and to be returned in Indian Rupees would not be the relevant comparable. Even in India, interest rates on FCNR accounts maintained in foreign currency are different and dependent upon the currency in question. They are not dependent upon the PLR rate, which is applicable to loans in Indian Rupee. The PLR rate, therefore, would not be applicable and should not be applied for determining the interest rate in the extant case. PLR rates are not applicable to loans to be re-paid in foreign currency. The interest rates vary and are thus dependent on the foreign currency in which the repayment is to be made. The same principle should apply.

41. Counsel for the Revenue had made reference to Chapter 10 of the U.N. Transfer Pricing Manual, relevant portion of which reads:-

> "**10.4.10. Financial Transactions**
>
> **10.4.10.1.** Intercompany loans and guarantees are becoming common international transactions between related parties due to the management of cross-border funding within group entities of an MNE group. Transfer pricing of inter-company loans and guarantees are increasingly being considered some of the most complex transfer pricing issues in India. The Indian transfer pricing administration has followed a quite sophisticated methodology for pricing inter-company loans which revolves around:
>
> - Examination of the loan agreement;
> - A comparison of terms and conditions of loan agreements;
> - The determination of credit ratings of lender and borrower;
> - The identification of comparable third party loan agreements: and
> - Suitable adjustments to enhance comparability.
>
> **10.4.10.2.** The Indian transfer pricing administration has come across cases of outbound loan transactions where the Indian parent

has advanced to its associated entities (AE) in a foreign jurisdiction either interest free loans or loans at LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate). The main issue before the transfer pricing administration is benchmarking of these loan transactions to arrive at the ALP of the rates of interest applicable on these loans. The Indian transfer pricing administration has determined that since the loans are advanced from India and Indian currency has been subsequently converted into the currency of the geographic location of the AE, the Prime Lending Rate (PLR) of the Indian banks should be applied as the external CUP and not the LIBOR or EURIBOR rate.

10.4.10.3. A further issue in financial transactions is credit guarantee fees. With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to its associated entities abroad, where the Indian parent as guarantor agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an associated entity of the Indian parent to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the Comparable Uncontrolled Price Method. In most cases, interest rates quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of Indian bonds is also considered for determination of the arm's length price of such guarantees.

10.4.10.4. However, the Indian transfer pricing administration is facing a challenge due to non-availability of specialized databases and of comparable transfer prices for cases of complex inter-company loans as well as mergers and acquisitions that involve complex inter- company loan instruments as well as an implicit element of guarantee from the parent company in securing debt."

42. The first paragraph quoted above, rightly stipulates that inter-company loans would require examination of the loan agreement, comparison of the terms and conditions of loan agreements, the determination of credit rating of the lender and the borrower,

identification of comparable third party loan agreements and suitat adjustments should be made. In addition to the aforesaid factors, the comparability analysis should also take into account the business relationship and the functions performed by the subsidiary AE for the parent company. In the present case, we are not concerned with paragraph 10.4.10.3 of the United Nations Transfer Pricing Manual. However, we are unable to agree with the position set out and asserted in paragraph 10.4.10.2 of the Manual. The reasoning given therein is contrary to the accepted international tax jurisprudence and the rules adopted and applied. There is no justification or a cogent reason for applying PLR for outbound loan transactions where the Indian parent has advanced loan to an AE abroad. Chapter 10 of the United Nations Practical Manual on Transfer Pricing relates to country practices. The said Chapter sets out an individual country's view point and its experiences for the information of the readers. The said Chapter does not reflect the view of the Manual. Paragraph 10.1 of the United Nations Practical Manual on Transfer Pricing for Developing Countries reads:-

> "**10.1. Preamble by the Subcommittee on Transfer Pricing: Practical Aspects**
>
> **10.1.1.** In the first nine chapters of this Manual, the Subcommittee has sought to provide practical guidance on the application of transfer pricing rules based on Article 9(1) of the UN Model Tax Convention and the arm's length principle embodied in that Article. With regard to chapters one through nine, the Subcommittee has discussed and debated the merits of the guidance that is provided and, while there may be some disagreement on certain points, for the most part the Subcommittee is in agreement that the guidance in those chapters reflects the application of the arm's length principle as embodied in the UN Model Tax Convention.

> **10.1.2.** The Subcommittee recognizes that individual countries, particularly developing and emerging economies, struggle at times with the details of applying these treaty-based principles in a wide variety of practical situations. It therefore seemed appropriate to allow representatives of individual countries an opportunity to set out their individual country viewpoints and experiences for the information of readers. Those individual country views are contained in this chapter. It should be emphasized that it does not reflect a consistent or consensus view of the Subcommittee."

43. Normally there would be a difference between the lending rate and borrowing rate in each country. Some authors and writers suggest that the average or mid-point between the two should be taken. However, others like Klaus Vogel, have suggested that economic purpose and substance of the debt-claim or debt for which granting of credit calls for the lending rate would be determinative. Thus, in case of a capital investment, the borrowing rate will apply, whereas in case of credit allowed to a customer on sale of goods, the lending rate would apply. We do not deem it necessary to enter into this controversy and express our view as regards the same.

44. We are also not expressing any view on adjustment for lack of security as this issue does not arise for consideration in terms of the observations of the DRP.

45. In the light of the aforesaid discussion, the substantial question of law mentioned above has to be answered against the appellant i.e.

the Revenue and in favour of the respondent-assessee. The appeal accordingly disposed of. There will be no order as to costs.

(SANJIV KHANNA)
JUDGE

(V. KAMESWAR RAO)
JUDGE

March 27th, 2015
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