TAX FLASH NEWS

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Tested party shall be selected with reference to the entity which has undertaken the transaction. Market determined interest rate applicable to currency in which loan has to be repaid shall be considered at arm's length

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal), in the case of India Debt Management Pvt Ltd [1] (the taxpayer), held that selection of tested party shall be done with reference to the entity which has undertaken the transaction. Further, the Tribunal held that the interest rate on borrowings should be market determined and should be applicable to the currency in which loan is borrowed/repaid, to be considered at arm's length.

Facts of the case

- The taxpayer is a non-banking finance company (NBFC) registered in India and a subsidiary of Mauritius Debt Management Ltd., which holds 75 per cent of equity share capital of the taxpayer. The taxpayer is engaged in the business of identifying investment opportunities in financially distressed companies which otherwise have an inherently viable business proposition and had a low credit rating of BBB(-). These investments were funded through intra-group financing, wherein taxpayer raises money through debt instruments i.e. Compulsory Convertible Debentures (CCDs) from group companies.
- The CCDs issued by the taxpayer to its Associated Enterprise (AE) can be divided into two tranches - issuance of CCDs prior to June 2007 bearing a fixed-interest-charge of 7 per cent; and issuance of CCDs post June 2007 bearing annual resettable interest rate, which varied from 9.75 per cent to 14 per cent. Accordingly, the average interest rate on the above CCDs issued by the taxpayer was determined at the rate of 11.30 per cent.
- In the Transfer Pricing Study report (TP study), in order to benchmark the Arm's Length Price (ALP) of the interest rate on the CCDs, the taxpayer adopted Comparable Uncontrolled Price (CUP) method as Most Appropriate Method (MAM). Since there was no internal CUP available, the taxpayer analysed the External Market Data using Thomson Reuters' DealScan and Bloomberg Database in order to find external CUP. As the taxpayer had issued CCDs in terms of INR and interest was also payable in terms of INR, since India being the borrowing region, no comparables were found in the search for Indian region of INR denomination for loans/bonds, and therefore, the search was expanded to include other

[1] India Debt Management Pvt Ltd v. DCIT [IT(TP)A No. 7518/Mum/2014] – Taxsutra.com

geographical regions or currencies. Based on this search, after carrying out certain adjustments for differences in comparables risk profiles, 14 comparable transactions were selected with arm's length interest rate of 14.50 per cent as against interest rate of 11.30 per cent paid by the taxpayer.

- Alternatively, the taxpayer also conducted the corroborative search using Bombay Stock Exchange (BSE) data on INR denominated debt issuances. After various qualitative analysis, taking into consideration the credit rating of the borrower and the time of issuance, two comparable transactions were identified and after making a tenor adjustment, the average margin of 15.01 per cent was arrived.
- Further, in its TP study, in order to justify its interest payment of 11.30 per cent, the taxpayer assimilated information on interest rates quoted by various public sector banks on their websites, for loans taken from lenders in the Indian market, whereby the average rate offered to BBB rated entities or below with a loan amount of more than 10 crores was reflected at 14.96 per cent as on May 2013. Since pre-dated data in the websites was not available, the taxpayer made a tenor adjustment for a time period difference, by considering the relevant difference between the Prime Lending Rate prevalent during the Financial Year (FY) 2009-10 and arrived at an average interest rate of 12.13 per cent. Therefore, the taxpayer contended that its average interest rate of 11.30 per cent is at arm's length.
- During the assessment proceedings, the Transfer Pricing Officer (TPO) rejected the entire methodology adopted by the taxpayer, on the ground that it did not pointed out anywhere in its TP study, whether it has taken the taxpayer or the AE as a 'tested party'.
- Further, the TPO made the following observations:
  - The taxpayer neither looked for comparable companies in India or the comparables from the region where AE is located. The taxpayer took the data for the bond rates used in different geographical locations, other than the AE and thereafter, made various adjustments which gave skewed results.
  - As regards the reliance on data available from BSE site for identifying the comparable transactions which had issued debt instruments in INR, the TPO observed that, there were hardly any company which had a credit rating below 'A' and no data for two comparables identified by the taxpayer, were available on the website for FY 2009-10.
  - If the taxpayer was treated as the tested party, then interest benchmarking should have been done by using LIBOR rate. Hence, the TPO held that ALP of interest should be 8.5 per cent based on the RBI circular for External Commercial Borrowings (ECBs) of maturity of 5 years and data from newspapers.
  - If AE was treated as the tested party, the TPO held that AE would have earned interest based on USD Corporate Bond Rates for FY 2009-10 and made a TP adjustment of INR48.53 crores after adopting arm's length interest rate of 5.68 per cent.
- The Dispute Resolution Panel (DRP), reiterated the same reasoning given by TPO for benchmarking the interest payment. With respect to the selection of tested party, the DRP referred to the Organization for Economic Co-operation and Development (OECD) guidelines as well as United Nations Practical Manual on Transfer Pricing

(UN TP Manual). The DRP also observed that taxpayer's TP study was very sketchy to prove that international transactions were at arm's length, and even Functions, Assets, and Risks analysis had not been carried out. Referring to Delhi Tribunal decision in Ranbaxy Laboratories Ltd.[2] and other decisions on the concept of 'tested party', the DRP upheld the TP adjustment made by TPO.

- Aggrieved, the taxpayer preferred an appeal before the Tribunal.

Taxpayer's contentions

- The taxpayer placed reliance on OECD guidelines as well as UN TP Manual and contended that the concept of 'tested party' will apply only when Cost Plus Method (CPM) or Resale Price Method (RPM) or Transactional Net Margin Method (TNMM) is applied. It also submitted that under the CUP method, only the transactions has to be seen and not who is the tested party.
- The taxpayer, relying on the decision of Delhi High Court in the case of Cotton Naturals India (P) Ltd[3] argued that the benchmarking analysis of the TPO based on ECB rate and US Corporate bond rate is erroneous as such data had no nexus to India, especially when interest payment by an Indian borrower is on the basis of INR denominated debt and hence, the INR lending data to an Indian borrower having same or similar credit rating shall be considered.
- The taxpayer submitted that, without prejudice to its search on external databases, its benchmarking by analysing the BSE listed companies should be accepted.
- The taxpayer further filed a copy of the public issue of secured and non-secured debentures issued by Shriram Transport Finance Co. Ltd. and Tata Capital Ltd. in the year 2009, wherein for AA and AA+ credit rating, the range of average yield of interest was from 11 per cent to 12 per cent. Thus, the taxpayer contended that it being BBB(-), the average interest rate of 11.30 per cent is within the arm's length range and hence, no TP adjustment shall be made.

Tax department's contentions

- The tax department observed that there is a huge difference of interest rate in the same financial year itself from 9.75 per cent to 14 per cent i.e. an increase of around 43 per cent in one year and contended that under TP analysis, one has to see whether in the third party situation such a huge increase and variation could have been justified or not.
- The tax department submitted that under the CUP method, strict comparability, and least adjustments are required and that the taxpayer's benchmarking of the comparables based on 2013 year data cannot be accepted.
- Further, the tax department urged that the matter should be restored back to the TPO to carry out proper analysis under CUP method after considering the Indian databases since information on the two comparable transactions given at the time of hearing before the Tribunal in the case of Shriram Transport Company Ltd. and Tata Capital Ltd. was not considered by the TPO as well as by the DRP.

Tribunal ruling

- The Tribunal stated that the foremost issue under consideration was the necessity to identify 'tested part,' while applying the CUP method.

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[2] Ranbaxy Laboratories Ltd. v. ACIT [2008] 110 ITD 428 (Delhi)
[3] CIT v. Cotton Naturals India (P) Ltd [2015] 55 Taxmann.com 523 (Delhi)

- The Tribunal observed that although, Indian TP regulations do not lay down any specific procedure or guidelines for choice of 'tested party', however, OECD guidelines provide that, as a general rule, tested party should be the one to which TP method can be applied in most reliable manner and for which most reliable comparables can be found. Therefore, the Tribunal noted that the tested party ought to be the enterprise that offers the high degree of comparability and requires least amount of adjustment i.e. the one that has least complex functional analysis.
- The Tribunal observed that under CUP method, the price at which a controlled transaction is carried out shall be compared to the price obtained in a comparable uncontrolled transaction under similar conditions.
- Further, the Tribunal stated that product comparability is the 'key factor' under CUP method unlike the other methods like CPM, RPM or TNMM wherein financial indicators like markup on costs, gross margin or net profit is tested with an appropriate base. Hence, the Tribunal observed that under these other methods, the choice of the 'tested party' becomes far more imperative which is envisaged by para 5.3.3 of the UN TP Manual and para 3.18 of the OECD guidelines, with no such reference of the tested party under CUP method.
- The Tribunal noted that the transaction to be benchmarked was interest payment by the taxpayer to its AE i.e. transaction undertaken by the taxpayer and not vice-versa. It observed that if the transaction was undertaken by AE, then similar transaction by AE with the third party or independent similar transaction in the place of AE could have been analysed to arrive at an ALP.
- The Tribunal observed that there is no premise for the conclusion arrived by the TPO as well as by the DRP in holding that entire benchmarking analysis done by the taxpayer is vitiated, simply because the taxpayer has not identified the 'tested party'.
- Regarding USD Corporate Bond Rate and LIBOR interest rate based on ECBs endorsed by the department for arriving at the ALP interest rate, the Tribunal observed as under:
  - As the tested transaction was in INR denominated debt, the interest rate must necessarily be based on economic, and market factors affecting Indian currency and data available for debt issuances in India or INR denominated rather than foreign currency rate or external data. The base rate on which interest rate depends is directly related to the currency or denomination of issuance, and therefore, it should be taken into account according to the market conditions prevalent in the country of such currency, here in this case India.
  - The market conditions capable of capturing best of the rates did not depend on any place but rather on currency concern as the supply and demand of funds is in a specific currency. Therefore, the cost of borrowing funds denominated in INR or lending rates based on INR loans/debt instrument issuances was more reliable and ideal base for benchmarking similar transactions undertaken by the companies or entities with similar ratings.
  - The TPO/DRP committed a fallacy, by considering the AE as a 'tested party' and by relying upon USD Corporate Bond Rates to benchmark the ALP of the interest rate because the interest rates for bonds or loan has to be seen from the point of view of borrowers creditworthiness and not the lender's creditworthiness. Thus, the Tribunal held that the entire approach of the TPO/DRP in applying USD Corporate bond rates to benchmark the interest transaction in a blanket manner is not correct.

- The Tribunal, relying on the decision of Delhi High Court in the case of Cotton Naturals India (P) Ltd, wherein it was held that arm's length interest rate should be computed based on market determined interest rate applicable to currency in which loan has to be repaid, held that the arm's length interest rate should be based on INR in which CCDs has been issued and the currency in which interest is being paid and not on any foreign currency lending rate.
- Regarding the benchmarking analysis done by the taxpayer, the Tribunal held as under:
  - The search based on external data using Thomson Reuters' DealScan and Bloomberg Database is not correct as there was no INR denominated debt issuance available on such databases and in the absence of such data, the taxpayer made huge adjustments on account of country risk, currency risk and tenor risk.
  - The search undertaken for comparable debt issuances in BSE used data for the year 2013 with minor tenor adjustment in the absence of such data for FY 2009-10 to arrive at a mean rate of 15.01 per cent. The Tribunal held that if such a data were not available, then such a minor tenor adjustment for considering time period can be made to eliminate the material effect under CUP, if it has been made quite accurately taking into account the material factors relating to time of the transaction affecting the price, although a high degree of comparability is required under CUP method.
  - As regards the 2 comparable transactions for the year 2009 wherein for credit rating of AA or AA(+) Enterprises, the interest rate per annum is between 11 per cent to 12 per cent for a tenor of 60 months, then in the case of the taxpayer with BBB(-) credit rating, 11.30 per cent interest paid to its AE is much within the arm's length rate.
- Based on the above, the Tribunal held that 11.30 per cent interest rate is at ALP and thus, deleted the TP adjustment.

Our comments

This ruling provides clear directions or guidance on the issue and importance of selection of tested party, in the case of CUP method vis-à-vis the other methods prescribed under the Income-tax Act, 1961 with reference to the relevant provisions of the UN TP Manual and the OECD guidelines. This could enable taxpayers in carrying the benchmarking analysis appropriately, especially in case of CUP method.

The above decision is principally in line with the decision of Cotton Naturals (Supra) and reiterates the important principle laid down by the ruling relating to the basis of benchmarking the rate of interest on loan lent or borrowed by the taxpayer in India which has been perceived as a controversial topic.

A CCD is like a traditional debt, wherein the final repayment is through the issuance of common equity to investors, based on fixed conversion rate (or in a band). CCD is a mix of debt and equity features. The risk and return profile of such security is entirely dependent on the characteristics or feature of the instrument in question. The moot point here is the recognition of the fact that these instruments possess not only the feature of the equity but the debt as well. In the present case, the taxpayer has characterised the CCD as a pure debt instrument and went on to apply CUP as an appropriate method using loan data from LPC, Bloomberg, and BSE data, etc., to benchmark the transaction. It has adopted a simple and high-level analysis in benchmarking a complex hybrid instrument. As such, the TPO was right to question the appropriateness of the applicability of CUP as the MAM. The MAM for benchmarking hybrid instruments like CCD is the 'other method', as in the majority of the cases, finding the comparable instrument in publicly available databases becomes a major challenge, as such applicability of CUP is ruled out.

The Tribunal inferred that the 2 comparable transactions wherein for credit rating of AA or AA(+) Enterprises, the interest rate per annum is between 11 per cent to 12 per cent for a tenor of 60 months, then in the case of the taxpayer with BBB(-) credit rating, 11.30 per cent interest paid to its AE is much within the arm's length rate. However, the credit rating for comparables is as per Indian rating agencies. The credit rating for the taxpayer is as per S&P and is on par with the sovereign rating of India BBB(-). Therefore, the AA or AA+ rating assigned to the selected deals by local credit rating agencies has to be lower than that of the taxpayer which has an S&P rating of BBB(-). Therefore, based on the AA and AA+ rating the assumption that the transaction is at arm's length may not be accurate.

CCDs are unique and complex instruments. The OECD guidelines and UN TP manual are silent on the exact methodology to be adopted in undertaking the benchmarking process for financial instruments in general and hybrid instruments like CCDs in particular. The Tribunal ruling in this matter has been a step towards the right direction. However, in order to appreciate the complexities involved in analysing and benchmarking such transactions, understanding the nuances involved in such instruments is imperative.

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