IN THE INCOME TAX APPELLATE TRIBUNAL

DELHI BENCH "F" NEW DELHI

BEFORE SHRI A.D. JAIN, JUDICIAL MEMBER

AND

SHRI SHAMIM YAHYA, ACCOUNTANT MEMBER

I.T.A. No. 2320, 2321 AND 2322/Del/2008

A.Y. 2002-03, 2003-04 & 2004-05

Perot Systems TSI (India) Limited, Plot No. 3, Sector-125, Noida- 201301 (UP) (PAN : AAA CH 1925Q) **[Appellant]**	Vs.	Dy. CIT, Circle-14(1) New Delhi **(Respondent)**

Appellant by : Shri Mukesh Butani, FCA & Shri Manih Khanna, ACA

Respondent by : Sh. Navneet Soni, CIT(DR)

ORDER

PER SHAMIM YAHYA, AM

These appeals by the assessee are directed against the separate orders of the CIT(A) for the respective assessment years. Since the issues involved in these appeals are common and connected, and these appeals were heard together, these are being consolidated and disposed of together by this common order.

2. One common issue raised is that the CIT(A) erred in not accepting the interest free loan extended to the associated concerns as at arm's length.

3. The facts of the case are as under:-

Perot Systems TSI (India) Private Limited (PSTSI) is engaged in the business of designing and developing technology enabled business transformation solutions

and providing business consulting, systems integration services and software solutions and services.

The assessee extended two foreign currency loans to its associated enterprises, 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.

During the course of assessment proceedings for assessment years 2002-03, 2003-04 and 2004-05, the international transactions entered into by the assessee were referred for scrutiny to the Transfer Pricing Officer (TPO). The TPO held that the international transactions 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 years financial years. In addition to the adjustment made by the TPO, the Assessing Officer (AO) also made adjustment under section 14A of the Income Tax Act, 1961 (Act), for the assessment years 2002-03 and 2004-05.

4. Since all the orders of the authorities below for these years are on similar lines, the matter is being adjudicated with reference to the orders for assessment year 2002-03.

4.1 The revenue authorities have not accepted the assessee's arguments that loan transaction with sub-companies was not debt. The assessee's contention before the lower authorities was on the following points:-

- Loan extended to HPS Bermuda and HPS Hungary.
- Loans were in the nature of quasi-equity.
- Both the entities were start-up with no significant business activities.
- No lender would have lent money to start-up's

- Funds were used for making long term step down investments in subsidiaries.

- The intent by extending loans to subsidiaries was to earn dividends and not interest.

- The subject loan was granted after obtaining the requisite approval from RBI.

- On grant of HPS Hungary had a 'debt' of USD 4.6 million Vs equity of merely USD 15,000. This reflects debt equity ratio much higher than the normal average.

  * Under the thin capitalization rules in Hungary, any debt in excess of three times the equity of a company is treated as equity and not debt.

  * The Hungarian thin capitalization rules fortify the stand that the funds extended to the subsidiaries were in the nature of equity and not loan.

5. The TPO's conclusion are summarized as under:-

"(i) If there is no relation between the two persons other than the normal business relation, no person will give loan without charging any interest. Whenever, a person advances a loan to other person, it forgoes its income which it would have earned if the same amount would have been invested in some other financial instrument or deposit.

(ii) Besides foregoing income, the lender also undertakes the risk of loosing the entire amount if the borrower defaults in repayment of loan. Under the arm's length condition no persons would undertake such a big risk without expecting any return.

iii) The risk/reward matrix of a loan transaction and that of equity subscription is totally different.

- In the case of a loan, the return of the lender can never exceed a pre-determined rate and it is not entitled to any share in profits of the borrower.
- In case of equity participation, the stake holder is entitled to share in profits which can be much higher as compared to the interest.

- In addition to the regular return, the share holder can also gain by way of appreciation in value of shares.
- Besides the financial returns, the shareholder also gets voting right to exercise management control over the company.

iv) One of the AEs is situated in Bermuda which is a tax heaven, i.e., the profit of the AE's are not taxable at all. Non-charging of the interest by the assessee from the AEs would result in higher income in the hands of AE in Bermuda and the income of the assessee in India would be reduced by the corresponding amount. This would bring down the overall tax incidence of the group by shifting profit from Indian jurisdiction to Bermuda which is a tax heaven country with zero rate of tax on corporate profit. It is a classic case of violation of transfer pricing norms where profits are shifted to tax heavens or low tax regimes to bring down the aggregate tax incidence of a multi national group.

v) It is not sure whether that subsidiary would generate sufficient profits to enable it to declare dividends. Secondly, even if the subsidiary makes profits, it is not mandatory for it to declare dividends, i.e. it may retain the profits in Bermuda for further investments in group companies. In case no dividend is declared, i.e., profits are held back in Bermuda, the tax incidence in India would come down as the assessee would show lower profits in India.

vi) These interest free loans have been used for making investment in the group entities. There appears to be no reason to route these investments through AEs in Bermuda other than the shifting of profits from Indian Jurisdiction to Bermuda to bring down the tax burden of the assessee's group companies."

6. Upon assesse's appeal the CIT(A) elaborately considered the issue. He referred the copy of loan agreements in this regard and remarked that it cannot be said it relates to equity transaction.

7. The ld. CIT(A) concluded as under:-

"A careful examination of the analysis carried out in Table-4 above reveals that both the transactions relating to extension of the loans were nothing but debt simplicitor. This fact is borne by the clauses of the loan agreement, repayments of the loans, description of purpose given in the

approval applications. In respect of the loan extended to HPS Hungary, the real character of the transaction becomes evident when it was found that the appellant had simultaneously made applications for approval both for equity subscription as well as for remittance of the loan amount. The above documents conclusively prove the nature of transactions between the appellant and two sub-companies as one of debt. Therefore, it is not only the form but also the economic substance of the two transactions, is debt in nature.

The appellant's reliance on various other arguments is also misplaced. The rebuttal of the appellant's various arguments is summarized below:-

i) Reliance on Para 1.37 of the OECD Guidelines is misplaced because the analysis contained in the para is from the perspective of the borrower and that of the recipient country. The tax administration in the recipient country can lift the veil of a loan transactions even if it satisfies the arm's length standard for invoking the thin-capitalization rule. In the instant case, the analysis has to be done from the perspective of the lender country in order to ascertain whether the transfer pricing regulations have been complied with or not.

ii) Even reference to the Tonnage Tax Manual of UK is misplaced because there again the perspective is that of a tax administration which is examining compliance to thin-capitalization as well as the transfer pricing rule. In the instant case, the perspective is exclusively from the transfer pricing perspective. In any case, the loan transactions had not performed an equity function.

iii) Reliance on Hungarian thin-capitalization rule is again misplaced because the rule for only disallowance of interest expense in order to ensure compliance with thin-capitalization rule. There is no restriction in respect of outward remittances in respect of debt finance. Therefore, the appellant's reliance on "Impossibility of Performance" is totally misplaced.

iv) There is no violation of provisions of Rule 108(2)(d) of the Rules as the Hungarian thin-capitalization rule no way interfere with the charging of interest and the remittance of the same as contended by the appellant. Thus, the appellant misread the legal restrictions imposed by the Hungarian thin-capitalization rule.

v) Ex-ante documentation by way of ODA application form correctly characterized the transaction as working capital loan. Therefore, the appellant's reliance on various features for treating a transaction as loan/equity mentioned at Para 6.3 of this order is also misplaced. The fund was meant for working capital requirement, the loan agreement provided for repayment on demand and charging of interest. All these factors are pointers to the fact that the transaction was debt in nature and not informal capital or quasi-equity.

vi) RBI's approval does not put a seal of approval on the true character of the transaction from the perspective of transfer pricing regulation. The purpose, guidelines and rules for RBI's approval and the Transfer Pricing rules under the IT Act are completely different. This fact is evident from the undertaking given by an applicant requesting for outward remittance of foreign currency under the rules of FEMA, 1989. The concern of the RBI for allowing outward remittances is conservation of the foreign currency. Therefore, the same set of rules cannot be applied for the purpose of transfer pricing. Under the transfer pricing regulation, the emphasis is on relative valuation based on comparability analysis of similar transactions entered into between independent parties based on the arm's length principles.

In view of the foregoing analysis and after taking into account the TPO's reasoning, I am of the considered view that the TPO had correctly characterized the transaction between the appellant and its two sub-companies as debt and not informal capital or quasi-equity. The following are the salient features of the loan:

i) The debt was a short term working capital loan repayable on demand.
ii) Being repayable on demand, it would mean that the loan is renegotiated on an annual basis.
iii) There was provision for charging of interest by the lender in the loan agreement itself."

8. Against this order the assessee is in appeal before us.

9. Before us, the ld. Counsel of the assessee contended that income means real income and not fictitious income and since the assessee has not earned any income, the same cannot be taxed. Reliance in this regard has been placed upon in the case of CIT Vs. KRMTT Thiagaraja Chetty & Co. reported in 24 ITR 525 (SC) & in the case of Morvi Industries Ltd. Vs. CIT reported in 82 ITR 835 (SC) for the proposition that liability to tax can arise only when there is income. No tax can be charged as notional income on accrual. Further reliance has been placed upon the ruling of Authority for Advance Rulings delivered in the case of Veneburg Group B.V. Vs. CIT 727 of 2006 for the proposition that in the absence of any income, Transfer Pricing provisions being machinery provision shall not apply. It has further been 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. The loan agreements mentioned that these are interest free loans. Reliance in this regard is placed upon the decision of Delhi Tribunal in the case of Sony India Ltd. 114 ITD 448 Para 100 that "under fiscal loans actual transaction as entered between the parties is to be considered. Authorities have no right to re-write the transaction unless it is held that it sham or bogus or entered into by the parties to avoid and evade taxes." Further reference has been made to para 1.37 of 1995 of OECD guidelines for the proposition that it is legitimate to consider that economic substance of the transactions. The transactions has been said to be commercially expedient and loan granted to support the subsidiary and obtain returns in future. The assessee had full control over its subsidiary which reduce the credit risk. The loan had been duly granted by the approval of the RBI. The Income Tax Act, 1961 and OECD guidelines support the contention that the effect of government control/ intervention should be considered while determining the arm's length price. Under the thin capitalization rules, no deduction was allowable to the Hungary entity for payment of interest therefore, there existed impossibility of performance with regard to payment of

Hungary entity. Economic circumstances of the subsidiaries did not warrant the charging of interest from subsidiaries. The ld. Counsel for the assessee further relied upon the Apex Court decision in the case of M/s S.A. Builders Ltd. Vs. CIT(Appeals) and others 288 ITR 1 (SC).

9.1 The ld. DR for the revenue on the other hand relied upon the orders of the ld. CIT(A), he claimed that the ld. CIT(A)'s order was a speaking order and it has rebutted all the arguments of the assessee.

10. We have carefully considered the submissions and perused the records. The primary contention before us, as submitted by the ld. Counsel of the assessee is that 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. As observed by the ld. CIT(A) the agreements show that these are loan amount given by the assessee to Associated Enterprises (AEs). This in fact is an admitted position. There is no case that any special feature in the contract make the transaction as capital in nature. It is also an admitted proposition that the assessee has extended the loan to its AE's who are 100% subsidiaries. The Assessee's case is that it has actually not earned any interest and it was commercially expedient to extend these interest free loans. Now it is noted that this is not a case of ordinary business transaction. The question relates to scrutiny of international transaction to determine whether or not the same it as arm's length. The principle of transfer pricing aims at determining the pricing in the situations of cross border international transactions, where two enterprises which are subject to the same centre or direction or control (associated enterprise) maintain commercially or financially relation with other. In such a situation, the possibility exist that by way of intervention from the centre or otherwise, business conditions must be accepted by the acting units which differs from those which in the same circumstances would have agreed upon between un-related parties. The aim is to

examine whether there is anomaly in the transaction which arise out of special relationship between the creditor and the debtor. Hence the contention of having actually not earned any income cannot come to the rescue of the assessee in this scenario. The case laws from the Apex Court cited by the ld. Counsel of the assessee are in the context of the proposition that only the real income has to be taxed and interest free advances can be given by companies (domestic) to their subsidiaries on the ground of commercial expediency. But these decisions are not in the context of Chapter-X of the IT Act which relates to special provision relating to computation of income from international having regard to arm's length price. 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.

11. The first objection of the TPO is that no two persons in normal business situation would grant interest free loan to the other persons. This is a fairly settled position. The assessee's contention in this regard is that no one would have given the AEs loan at that point of time as they were in a start-up stage and that debt ratio was not comfortable. Now, even if one is to accept this argument, there is no case for not providing or charging any interest, if assessee is coming to the rescue of the AEs. We have not come across any feature in the agreement to accept the contention of the counsel that loan was quasi capital. It is also not the case that there was any technical problem that loan could not have been contributed as capital originally if it was actually meant to be capital contribution. If the assessee's contention that whenever interest free loan is granted to associated enterprises, there should not be any adjustment is accepted, it will tantamount to taking out such transactions from the realm of section 92(1) and section 92B of the IT Act. Section 92(1) mandates that any income arising from an international transaction shall be computed having regard to the arm's length price. Section 92B defines international transaction as under:-

"92B(1) For the purposes of this section and sections 92, 92C, 92D and 92E, "international transaction means a transaction between two or more associated enterprises, either or both of whom are non-resident, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section(1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other person and the associated enterprise."

12. From the above, it is clear that lending or borrowing money between two associated enterprises comes within the ambit of international transaction and whether the same is at arms length price has to be considered. The question of rate interest on the borrowing loan is an integral part of arms length price of determination in this. context. Thus, clearly the assessee contention seeks to add text to the clear legal position as embodied in statute. Such an interpolation is not permissible, that when an interest free loan is given to the AEs, income on account of interest cannot be attributed from the point of view of arms length consideration. In this regard we also draw support from the Hon'ble Apex Court in the case Smt. Tarulata Shyam and Others Vs.

CIT, West Bengal in 108 ITR 345 wherein it was held that when the language of the Act is clear and unambiguous, there is no scope of interpolation.

12.1 Another argument of the TPO is that one of the AEs is situated in a tax heaven 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. Thus this would bring down the overall tax incidence of the group by shifting profit from Indian jurisdiction to Bermuda which is a tax heaven country with zero rate of tax on corporate profit. It is a classic case of violation of transfer pricing norms where profits are shifted to tax heavens or low tax regimes to bring down the aggregate tax incidence of a multi national group. Further as observed by the TPO even if profit are sufficient it is not mandatory to declare dividend the same may be retained as profit in Bermuda for further investment in group companies. We find considerable cogency in this argument.

13. Further, the ld. CIT(A) has very categorically considered all the issues raised by the assessee including reliance on para 1.37 of OECD guidelines, the reference of Tonnage Tax Manual of UK and the reliance on Hungarian thin-capitalization Rule and has given an elaborate finding that the reliance on the same is misplaced and they did not come to the rescue of the assessee in granting interest free loans to the associated enterprises. We find ourselves in full agreement thereof. Furthermore, as rightly observed by the ld. CIT(A) RBI's approval does not put a seal of approval on the true character of the transaction from the perspective of transfer pricing regulation as the substance of the transaction has to be judged as to whether the transaction is at arms length or not.

14. In the background of the aforesaid discussion and precedent, we uphold the order of the authorities below and decide the issue in favour of the revenue.

15. Another ground raised is that on the facts and circumstances of the case and in law, the Assessing Officer/TPO/CIT(A) has erred by not providing the appellant the benefit of 5% range as provided by the proviso of section 92C(2) of the Act.

15.1 Though the ld. Counsel of the assessee did not put his arguments on this issue, we deem it appropriate to deal with the same as it is there in the grounds of appeal.

15.2 We can gainfully refer here the relevant provisions of section 92C(2) of the IT Act.

> "Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.

15.3 The TPO in this case has applied the monthly LIBOR (London International Bank Official Rate) downloaded from the British Bankers Association website. During the financial year 2001-02 LIBOR for US dollor loan was 2.39%. On that LIBOR the Assessing Officer added average basis point charged by other companies and for this purpose he took rate for 5 companies. The arithmetic mean which came to 1.64%. Accordingly, Assessing Officer computed the arms length rate to be LIBOR + 1.64% using CUP method.

15.4 The assessee agitated before the ld. CIT(A) that the Assessing Officer had not allowed the variation of +- 5% from the arms length interest computed and for this the assessee's argument was that proviso to section 92C(2) of the ACT gives a right on the assessee to demand such a adjustment. The ld. CIT(A) found that first and foremost reason for not allowing deduction of 5% from the arms length interest is the fact 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 arms length price for the transactions. Therefore, he held that 5% allowance itself is infructuous.

15.5 We have carefully considered this aspect, we find ourselves in agreement that no more one price has been used for each transaction. Only one LIBOR rate has been applied which has been adjusted for some basis points as required. This cannot be equated with more than one price in respect of each transaction. Hence, we uphold the ld. CIT(A)'s order on this issue.

16. In the result, all the three appeals filed by the assessee are dismissed.

Order pronounced in the open court on 30/10/2009.

[A.D. JAIN]
JUDICIAL MEMBER
Date: 30/10/2009

[SHAMIM YAHYA]
ACCOUNTANT MEMBER

SRB

Copy forwarded to: -

1. Appellant 2. Respondent 3. CIT 4. CIT (A)
5. DR, ITAT

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By Order,

Deputy Registrar,
ITAT, Delhi Benches