IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH "B", NEW DELHI
BEFORE SHRI R.P. TOLANI, JUDICIAL MEMBER
AND
SHRI SHAMIM YAHYA, ACCOUNTANT MEMBER
I.T.A. No. 5855/Del/2012

A.Y. : 2008-09

Cotton Naturals (I) Pvt. Ltd., E-28, Connaught Place, New Delhi – 110 001 (PAN: AABCC2214J) **(Appellant)**	vs.	DCIT, CIRCLE 3(1), NEW DELHI **(Respondent)**

Assessee by : Sh. Ved Jain, CA
Department by : Sh. Tarun Seem, Sr. D.R.

ORDER

PER SHAMIM YAHYA: AM

This appeal by the Assessee is directed against the order of the Assessing Officer dated 19.10.2012 passed u/s. 143(3) read with section 144C of the I.T. Act.

2. The grounds raised read as under:-

1. On the facts and circumstances of the case, the order passed by the learned Assessing Officer under Section 143(3) read with Section 144C of the Act is bad both in the eye of law and on facts.

2. On the facts and circumstances of the case, the Assessing Officer has erred, both on facts and in law in assessing the income of the appellant ₹ 67,46,180/-

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as against income of Rs. 20,75,768/- declared by the assessee.

3. On the facts and circumstances of the case, the learned AO has erred both on facts and in law in making an addition of Rs.47,45,416/- as difference in arm's length price determined by Transfer Pricing Officer (TPO) in pursuance of DRP's order & the appellant.

4. On the facts and circumstances of the case, the Hon'ble DRP has erred both on facts and in law In determining reasonable interest rate at 13.25% as against 4% determined and levied by the assessee in respect of loan advanced by it in US Dollar to its subsidiary company in U.S.A.

5. On the facts and circumstances of the case, the Hon'ble DRP has erred both on facts and in law in ignoring the contention of the appellant that the comparison made by the Transfer Pricing Officer for determining the rate of interest on a transaction of a loan availed by an Indian entity is unjustified.

6. On the facts and circumstances of the case, the Hon'ble DRP has erred both on facts and in law in ignoring the contention of the appellant that for the purpose of determining the rate of interest the currency in which the loan has been advanced has to be taken into consideration and the rate of interest

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cannot be based on the PLR rate of Reserve Bank of India in respect of Indian Rupees.

7. On the facts and circumstances of the case, the Hon'ble DRP has erred both on facts and in law in ignoring the contention of the appellant that the interest rate in respect of international transaction in foreign currency has to be in accordance with LIBOR.

8. On the facts and circumstances of the case, the Hon'ble DRP has erred both on facts and in law in the contention of the appellant that the adjustment on account of transaction cost by the TPO is per se on wrong assumption of facts.

9. On the facts and circumstances of the case, the Hon'ble DRP has erred both on facts and in law in ignoring the contention that this loan having been advanced at a fixed rate way back in the year 2002 and 2003, the interest rate cannot be varied or changed in the year under consideration.

10(i) That the above said addition has been made ignoring the detailed transfer pricing study made by the appellant for determining the arm's length price.

(ii) On the facts and circumstances of the case, the learned AO has erred both on facts and in law in making the above-said addition without qualifying comparable instance for rate of interest on the comparable transaction.

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11. On the facts and circumstances of the case, the learned AO has erred both on facts and in law in ignoring the contention of the assessee that the variation of 5%, plus-minus arm's length interest determined will not be applicable in the case of the assessee ignoring the specific provisions of the Act.

12. On the facts and circumstances of the case Hon'ble DRP has erred hath on facts and in law in ignoring the contention of the appellant that the loan being advanced by parent company to the subsidiary company there was no need to make adjustment on account of security.

13. That the appellant craves leave to add, amend or alter any of the grounds of appeal.

3. The assessee in this case is a leading manufacturer of rider apparel. As per the 3CEB Report and TP document, the following are the details of the international transactions entered into by the taxpayer with its associated enterprises during the year 2006-07:-

Equestrian Apparel sold to JPC Equestrian Inc	₹ 48191540/-
Loan provided to JPC Equestrian Inc	10,50,000 $
Interest received	₹ 20,52,072/-

3.1 As per the TP document, CUP method has been chosen to bench mark the sale of apparel as well as interest received on loan. The assessee has contended that since the sale of apparel to uncontrolled enterprises are at a lower ate, the same are at Arm’s Length. In the

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case of interest, the assessee has mentioned that it has received interest at a rate of 4% which is comparable with the export packing credit rate obtained from independent Banks in India.

3.2 The Transfer Pricing Officer noticed from the balance sheet of the tax payer for the A.Y. 2008-09 that certain amounts given as loans by the taxpayer to its associated enterprises were outstanding as on 31.3.2007. The amount of loan which has also been reported in Form 3CEB is $ 10,50,000. The TPO further observed that in a situation where Indian company has been chosen as the tested party, the comparable rates for benchmarking the interest have to be selected from the Indian domain. He observed that it is to be seen that what the assessee would have earned by giving loans in the Indian market. It cannot be compared with the rate of interest that the AE would have paid to some third party. The TPO held that the assessee cannot be compared to the Barclays Bank. That one has to see what the independent parties in comparable transactions would do i.e. if the same loan transactions takes place between two independent entities, what they would expect in terms of compensation for the loan transaction entered into between them. The Assessing Officer issued notices and obtained details from the tax payer. Assessing Officer observed that the tax payer has not submitted the financials of the subsidiary in the U.S. TPO summarized his views as under:-

> "The above arguments of the Department can be summarized as under:-
>
> a) The tax payer has extended loan to its associated enterprise at 4%.

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b) Lending or borrowing is not one of the main businesses of the taxpayer.
c) Two independent enterprise in the similar circumstances as that of the tax payer and its subsidiary would have charged arm's length interest as compensation for the financial facility provided by one party to another keeping in view the financials of the subsidiary and no security being offered.
d) But for the relationship between the tax payer and its subsidiary, the tax payer would have earned interest on the loan extended by it in terms that an independent enterprise would have earned.
e) The business prudence or necessity of advancing loans to subsidiary is not relevant for computing arm's length price in unrelated party transactions."

3.3 Transfer Pricing Officer further observed that tax payers has made loan to its AEs at @ 4% interest. That similar uncontrolled transaction would have provided for interest which is at arm's length. That the circumstances in which the tax payer and its subsidiary is operating i.e. what is the interest that would have been earned if such loans were given to unrelated parties in similar situation as that of subsidiary. TPO further observed that since the tested party is tax payer, the prevalent interest that could have earned by the tax payer by advancing a loan to an unrelated party in India with the same financial health as that of the tax payer's subsidiary is to be considered. However, the TPO noted that the tax payer has not submitted the financials of the subsidiary, the financial health of the subsidiary cannot be judged.

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3.4 Assessing Officer further observed that it has been held that while deciding the interest that may be charged on receivables from AE's, Libor rate for calculating interest is not proper, as for calculating the cost factor of the assessee in India, the potential loss suffered by him is to be considered. Instead of US rate, Indian rate is to be adopted. Assessing Officer further 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. Had the AE of the assessee been the tested party, then the labor rate would have been of any significance. That it should also not be forgotten that, had the AE of the assessee company would have got loan from any bank or FI in its state of residency at Libor rate, then why it did not avail of loan at such a rate. In view of the above, Assessing Officer proposed interest rate of 17.26% per annum (average yield on unrated bonds for the F.Y. 2007-08) to be adopted as the uncontrolled interest rate to arrive at the interest charged at arm's length.

3.5 TPO further observed that 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. That thus as can be seen that 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. That on the contrary, 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. Thus, while lending money by

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X (in India) and Y (Outside India), the interest rates would be benchmarked against those prevailing in India for investing in corporate bonds (which are without security). Thus the benchmarking rate for lending would be different from that of borrowing.

3.6 Assessing Officer further observed that if loan given to foreign entity is to be benchmarked with LIBOR or FCNR loan rates, then following is the manner in which the arm's length price would be arrived at:

i) The prevailing rate of interest for foreign currency loans extended by Banks in India for companies with similar credit rating as that of the AE on stand alone basis.

ii) The additional transaction costs for the tax payers to get similar loan by a Bank in India.

iii) Adjustments needs to be made for the tax payer for credit risk/ single customer risk as it is not into lending and borrowing money. Banks spread their risk various customers whereas the same is not possible for the tax payer in its loan transactions. Thus the taxpayer has higher risk than the banker in lending money to its related party.

iv) Adjustment needs to be made for no security offered by the related party. Banks generally ask for security even for foreign currency loans. But in the loan transaction between the taxpayer and the AE, there is no security provided by the AE to the tax payer.

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3.7 After discussing the above facets the Assessing Officer concluded as under:-

"CUP rate is thus arrived at as under:-

Basic interest rate for the credit rating of the AE		*9.88%*
Add: Transaction cost		*395 basis points*
CUP rate		*13.83%*
Add: Adjustment for security		*Not computed*
Final CUP rate	>	*13.83 + Adjustment for security + risk adjustment for single customer.*

Keeping in view that no security is offered by the subsidiary and also that the tax payer is not into lending and borrowing money, if the adjustments for risk of single customer, for security/ collateral, credit rating of AE of the assessee is also made, then the interest rate would reach almost the same rate of interest at 17.26%, which has been arrived at, in the 'primary' analysis done above, by relying upon the Bond Yield data supplied by the CRISIL.

The assessee has also not challenged / objected to the credit rating of the AE taken by the TPO at highest of the range (BB to D). Therefore, even going by the alternative calculation, the rate of interest arrived at 17.26% is fair and reasonable.

6. Computation of Arm's Length Price :

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Based on the above, the arms length price of the international transactions entered into by the tax payer (providing financial facility in the form of working capital loan to its associated enterprises) is computed as under:-

6.1 Computation of Arms Length Price :

The amount on which interest of ₹ 2052072 at 4% has been received	*INR 5,13,01,800/-*
Arms Length Interest Rate	*17.26% p.a.*
Arms length price @ 17.26% p.a. on the amount of ₹ 5,13,01,800/-	*₹ 88,54,691/-*

6.2 Price received vis-a-vis the Arms Length Price :

The price charged by the tax payer at ₹ NIL in the form of interest to its Associated Enterprises is compared to the Arms Length Price or interest as under:-

Arms length interest - ₹ 88,54,691/-

Interest received - ₹ 20,52,072/-

Shortfall being adjustment u/s 92CA- ₹ 68,02,619/-

The above amount of ₹ 68,02,619/- is treated as an adjustment u/s. 92CA."

4. Against the above order the Assessee filed objections before the DRP.

5. The assessee inter-alia submitted that the comparison has to be made with respect of advance or loan in USA and not based on Indian

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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. After considering the various objections of the assessee the DRP concluded as under:-

> *"7.2 We have examined the issue and we agree with the TPO that no security was offered by the subsidiary and the main business of the assessee was not lending and borrowing money. We find that the AE being new did not have adequate credit rating in USA so the Indian parent company gave the loan; hence a transaction cost needs to be loaded. This factor would have to be taken into account for computing arms's length price. Further, loan was given on fixed rate of interest out of share holders. In reality both sets of shareholders are same and security aspect is therefore, embedded by default in this transaction. In the circumstances, there is no requirement for further addition on account of security. However, we are of the opinion that the Arm's length interest rate may be taken as the PLR of RBI for the financial year 2007-08. The TPO is directed accordingly.*
>
> *9. Directions under section 144(c) of the I.T. Act.*
>
> *The DRP after considering all arguments of the assessee and submissions of TPO /Assessing Officer as well as evidences on record has passed the above order.*
>
> *In view of discussion on each of the grounds of objection, the Assessing Officer is directed to complete the*

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assessment according to the direction of the DRP as above. The objections of the assessee are disposed off as above."

6. In pursuant to the directions from the DRP, TPO recomputed the ALP on interest as under:-

The amount on which interest of ₹ 2052072 at 4% has been received.	₹ 5,13,01,800/-
Arm's length interest rate as directed by DRP	13.25%
Arm's length price of the above interest	67,97,488

The total adjustment as per the DRP directions is as below:-

Arms length interest @ 13.25%	₹ 67,97,488/-
Interest received	₹ 20,52,072/-
Shortfall being adjustment u/s. 92CA	₹ 47,45,416/-

7. Against the above order the assessee is in appeal before us.

8. We have heard the rival contentions in light of the material produced and precedent relied upon.

9. The assessee's submissions are as under:-

"1. The assessee is a company engaged in the business of manufacturing & export of Ready made Garments. During the asstt. year 2008-09 following were the transactions with its associated enterprises -

Equestrian Apparel sold to JPC Equestrian Rs.4,81,91,540/-

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Inc. USA	
Loan provided to JPC Equestrian Inc. USA	$10,50,000
Interest received	Rs. 20,52,101 /-

2. The CUP method was chosen to bench mark the sale of apparel as well as interest received on loans.

3. The case was referred to the Transfer Pricing Officer. The Ld. TPO vide its order dated 28.10.2011, determined the arm's length price. In its order, the Ld.TPO accepted the arm's length price determined by the assessee in respect of the sale of apparel to the Associated Enterprises. However, in respect of interest on the loan advanced by the assessee to its Associated Enterprise @ 4% per annum was considered to be not at arm's length. The Ld. TPO by making comparison with uncomparables like government bonds and the amount advanced by the Indian banks in foreign currency to entities in India and by making arbitrary additions of transaction cost, security and risk etc. to such rate determined the arm's length rate of interest at 17.26% per annum and proposed an addition of RS.68,02,619/-.

4. The assessee carried the matter to DRP and made detailed submissions (PB Pg 278-293). The DRP ignoring all the contentions surprisingly held that loan is in Indian currency hence LIBOR is not the relevant rate and ordered that PLR (Prime Lending Rate of RBI for FY 2007-08 be applied. AO accordingly applied the PLR of 13.25% and made addition of Rs 47,45,416 which is subject matter of appeal. This is the only point of dispute.

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5.0 Arm's Length Rate of Interest in case of amount advanced in foreign currency

5.1 The points ON THIS ISSUE which emerge from the decisions of Hon'ble Tribunal in various cases discussed hereinafter are :-

CUP method is the most appropriate method in order to ascertain arm's length price of the aforesaid international transaction. (In this case also, the method adopted is CUP method)

Where the transaction was of lending money, in foreign currencies, to its foreign subsidiaries, the comparable transaction, therefore, was of foreign currency lended by unrelated parties.

The financial position and credit rating of the subsidiaries will be broadly the same as the holding company.

If that was so, then the domestic prime lending rate would have no applicability and the international rate fixed being LIBOR would come into playas it is the mostly used and recognised benchmark rate for international loan.

5.2 In the case of Siva Industries & Holdings Ltd. v. Asstt. C.I.T. [2011] 11 taxmann.com 404 (Chennai - ITAT), the assessee had granted a loan of Rs. 50 crores to its subsidiary in Mauritius for the purpose of making investments and had charged interest at the rate of 6 per cent per annum. The issue was referred to the

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TPO. Before the TPO it was submitted that the average of 12 months US $ denominated LIBOR rate for the period 1-4-2005 to 31-3-2006 was 4.42 per cent and consequently no addition on account of the arm's length interest rate was liable to be made. The Assessing Officer had taken a view that the US$ denominated LIBOR rate could not be considered as the loan was given from India and the prime lending rate in India was to be considered. Consequently, the Assessing Officer had determined the rate at 11.75 per cent and the difference to the extent of Rs. 45,23,817.53 was added to the assessee's income. The assessee submitted that the prime lending rate was a domestic rate and the transaction done by the assessee was an international transaction for which the LIBOR rate was to be applied. It further submitted that the RBI had also given directions wherein it was specifically mentioned that the LIBOR rate was to be applied. Therefore, it prayed for the deletion of addition to the total income as made by the AO. The Tribunal held that the assessee had given the loan to the associated enterprises in US dollars, and assessee was also receiving interest from the associated enterprises. Once the transaction between the assessee and the associated enterprises was in foreign currency and the transaction was an international transaction, then the transaction would have to be looked upon by applying the commercial

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principles in regard to international transaction. If that was so, then the domestic prime lending would have no applicability and the international rate fixed being LIBOR would come into play. In the circumstances, the view that LIBOR rate had to be considered while determining the arm's length interest rate in respect of the transaction between the assessee and the associated enterprises was to be upheld. As it was noticed that the average of the LIBOR rate for 1-4-2005 to 31-3-2006 is 4.42 per cent and the assessee had charged interest at 6 per cent which was higher than the LIBOR rate, no addition on this count was liable to be made in the hands of the assessee. In the circumstances, the addition made by the Assessing Officer on this count was deleted.

5.3 In the case of M/s Four Soft Ltd, Hyderabad v. DCIT (ITA No.1495/HYD/2010), Hon'ble Tribunal held as below:

> "We have considered the rival submissions and perused the materials available on record. We do not find any merit in the arguments of the learned departmental representative as we find that the ALP is to be determined for the international transaction, that is, on international loan and not for the domestic loan. Hence, the comparable, in respect of foreign currency loan in the international market, is to be LIBOR based

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which is internationally recognised and adopted. In our considered view, the DRP rightly directed the assessing officer to adopt the LIBOR plus for the purpose of TP adjustment. Our view is fortified by the decision of the Madras Bench in the case of Siva Industries [supra}. We do not find any merit in the arguments of the learned counsel for the assessee that the DRP should have adopted the EURIBOR for the purpose of the TP adjustments, as we find that the mostly used and recognised benchmark rate for international loan is LIBOR based. Hence, the DRP rightly directed the assessing officer to adopt the LIBOR rates. We confirm the directions of the DRP. However, by considering the contentions of the learned counsel for the assessee that the actual LIBOR was 4.42% as against the 5.78% approved by the DRP, we find it proper to restore this issue to the file of the assessing officer, to verify the correctness of the claim made by the assessee company. In view of this matter, we remit this matter to the file of the assessing officer to verify the actual average LIBOR prevailed in the financial year relevant to the assessment year under consideration and adopt the interest rate 4.42% if the claim of the assessee is found correct. The ground raised by

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the assessee on this issue is partly allowed for statistical purpose. "

5.4 The Mumbai Bench in case of Dy. ClT v. Tech Mahindra Ltd. [2011] 46 SOT 141 (URO)/12 taxmann.com 132 (Mum.) for Assessment Year (AY) 2004-05, held that the arm's length price in case of interest on extended credit period allowed to an Associated Enterprise (AE) based in USA shall be determined on the basis of USD London Inter Bank Offer Rate (LIBOR) instead of applying the rate of interest pertaining to EURO denominated loan charged to AE based in Germany since the AE was based in USA. The facts of the case were that the Assessee in that case was a joint venture between Mahindra & Mahindra Limited (Indian company) and British Telecommunications (UK Company), was engaged in rendering of software services relating to telecommunication, internet technology and engineering etc. During the previous year, the taxpayer had extended credit beyond the stipulated credit period to its AE based in USA without charging any interest on such extended credit period. During the assessment proceedings, the TPO rejected taxpayer's arguments and determined the arm's length interest for such extended credit period to US AE at the rate of 10 percent per annum. The TPO determined this rate based on the rate of interest charged by the taxpayer on Euro denominated loan granted to its German AE. The resultant transfer

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pricing adjustment amounted to INR 1.87 crores. The AO adopted the adjustments made by the TPO. Aggrieved by the decision of the AO, the taxpayer filed objections before the Commissioner of Income Tax (Appeals) [CIT(A)). The CIT(A) confirmed the transfer pricing adjustment, however, restricted the same to 2 percent based on the USD LIBOR rate plus 80 basis point mark-up. Aggrieved by the order of the CIT(A), that AO filed an appeal before the Tribunal. The Tribunal held that the TPO made an error in selecting the transaction of charging of interest to German AE on loan granted at the rate of 10 percent per annum as internal comparable. Following the position settled in case Skoda Auto India and Rule 10B(1(a) of the Income-tax Rules, 1962, to be,. an internal comparable under the Comparable Uncontrolled Price (CUP) method, the transaction needs to occur between the taxpayer and an independent party. Even assuming that the adjustment for extended credit was necessary, USD LIBOR is more appropriate basis than the rate of interest on Euro denominated loan considering the fact that the AE is based in USA and commercial principles and practices related to USD denominated extended credit. The Tribunal has also made a crucial point that the arm's length interest rate should be taken from the country of the borrower/debtor, i.e. the rate of interest to be used for benchmarking shall be the rate of interest in respect

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of the currency in which the underlying transaction has taken place in consideration of economic and commercial factors around the specific currency denominated interest rate.

5.5 Mumbai Tribunal in the case of Tata Autocomp Systems Ltd. v. Asst. C.I.T. [2012] 21 taxmann.com 6 (Mumbai - Trib.) also held that lending or borrowing money between two associated enterprises comes within the ambit of international transaction and whether the same is at arm's length price has to be considered. The question of rate of interest on the borrowings is an integral part of arm's length price determination in this context. The fact that the loan has the 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 arm's length or not. Further, CUP is the most appropriate method for determining ALP in the present case. In this case the Tribunal held as below:

> "In the present case the AE is a German company. Eurobior rates are based on the average interest rates at which a panel of more than 50 European banks borrow funds from one another. There are different maturities, ranging from one week to one year. These rates are

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considered to be the most important rate in the European money market. The interest rates do provide the basis for the price and interest rates of all kinds of financial products like interest rate swaps, interest rate futures, saving account and mortgages. We find that the RBI in respect of export credit to exporters at internationally competitive rates under the scheme of pre-shipment credit in foreign currency (PCFC) and Rediscounting of Export Bills abroad (EBR), has permitted banks to fix the rates of interest with reference to ruling LIB OR, EURO LIBOR or EURIBOR, wherever applicable and thereto appropriate percentage ranging from 1% to 2%. The reference to the said circular is at page -80 of the Assessee's paper book. In our view the claim of the Assessee to adopt EURIBOR rate as stated before the TPO is reasonable and deserves to be accepted. Following the ruling of the tribunal in the aforesaid cases, we are of the view that the claim made by the Assessee in this regard has to be accepted. The AO is directed to work out the TP adjustment accordingly.

6.0 DRP makes a wrong (reverse) comparison of a loan availed by Indian entity in India

6.1 The DRP has misdirected itself by observing that is Indian Currency. As is evident from the agreements

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(PB Page 162-167) the loan is in US $ advanced to an entity even interest is to be computed in US$. Thus the application of PLR of RBI which is a bench mark for interest rate in rupee and that too in India is not correct. The DRP instead of making the comparison with the comparables, made a comparison with the loan advanced in India by an entity in foreign currency ignoring that the comparison is to be made not of a loan in India but of loan in the US. The comparison was to be made with respect to interest rate prevalent in the US.

7. Assessee has availed loan at much lower rate from Citi Bank

7.1 In the present case, Cotton Natural (I) Pvt Ltd. has arrangements for loan with Citi Bank for less than 4% However, for the loan provided to its AEs, it has charged 4% p.a. interest (Page No. 162-167 of the Paper Book). Another company also had taken loan from Citi Bank at 4% (Page No. 179 onwards of the Paper Book shows interest rate of 3.37%. Hence both internal and external rate of interest is available. Applying the ratio, no adjustment was called for.

7.2 Labor Rate in March, 8 – 2.7088%

The LIBOR rate during the March 08 was 2.7088% and which being less than the interest charged by assessee no adjustment is required in ALP.

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8.0 The loan agreement with AE is entered into 2002 and 2003 with fixed rate of interest.

8.1 The assessee has entered into following loan transactions with its associated enterprises -

AE	Loan amount	Date	Rate of interest (fixed)	LIBOR annual average rate (relevant month ending)
JPC Equestrian Inc. (USA)	$1,50,000	13.04.2002	4%	2.613%
JPC Equestrian Inc. (USA)	$50,000	7.09.2003	4%	1.286%
JPC Equestrian Inc. (USA)	$50,000	7.9.2003	4%	1.286%

8.2 The CUP method was chosen to bench mark interest received on loans. As per the transfer pricing study and the audit, the international transaction entered into by the assessee both in respect of sale of

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apparels as well as interest of loan advanced to its subsidiary was found to be at arm's length.

8.3 The Agreement is for fixed rate of interest and when the agreement was entered into with AE, the L1BOR, which is the accepted by the Hon'ble Tribunal in all cases as the most suitable benchmark for judging ALM in case of foreign currency loans, was well below the rate fixed by the taxpayer in this case. The L1BOR for two years are given below:

1 Year USOR

Month	2002	2003
Jan	2.420%	1.477%
Feb	2.496%	1.368%
Mar	3.006%	1.340%
Apr	2.613%	1.362%
May	2.634%	1.221%
Jun	2.251%	1.201%
Jul	2.070%	1.279%
Aug	1.943%	1.471%
Sep	1.813%	1.286%
Oct	1.664%	1.455%
Nov	1.705%	1.487%

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Dec	1.447%	1.458%

8.4 At that time the rate of interest was declining. Hence it was in the best interest to go for fixed rate of interest. At that time, rate of interest was much less than 4% in USA for which comparable was also provided. In the present case, Cotton Natural (I) Pvt Ltd. has also arrangements for loan with Citi Bank for less than 4%. However, for the loan provided to its AEs, it has charged 4% p.a. interest. Another 'group company also had taken loan from Citi Bank at less than 4%. It is not the case of revenue that the agreement is SHAM or TAX AVOIDANCE agreement.

9.0 Loan Agreement is valid and can't be ignored.

9.1 Business is done through agreements and contracts. What is paid or what is received by the assessee is dependent on the terms of agreements. The question may arise as to whether the Assessing Officer has power to disregard the agreement and disallow any payment even if the same is as per the terms of agreement. The Supreme Court in Union of India v. D. N. Revri & Co. AIR 1976 SC 2257 have observed that a contract being a commercial document between the parties must be interpreted in such a manner as to give efficacy to the same rather than to invalidate it, and that it would not be right while interpreting a contract entered into between the two parties to apply the strict rules of construction which are ordinarily

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applicable to a conveyance and other formal documents. The meaning of such a contract must be gathered by adopting a commonsense approach and it must not be allowed to be thwarted by a narrow, pedantic and legalistic interpretation.

9.2 In the case of Dharamvir Dhir v. CIT [1961J 42 ITR 7 (SC) the assessee entered into a coal raising contract and because of insufficient funds, he entered into an agreement with a trust to procure finance, and agreed to pay, in addition to interest, portion of the profits. The lender could withdraw its money at any time, and was not responsible for losses. The assessee showed the payment not in his 'profit and loss account', but in his 'profit and loss appropriation account'. The question was whether the payment was an expenditure of the assessee or whether the method of accounting showed that the assessee was only parting with the share of profits. The genuineness of the document had not been challenged. The Supreme Court held that the case had to be decided on the tenor of the document as it stood and in view of the circumstances of the case. Hence, the assessee was not parting with share of profits, but the payment made by it to the trust was an expenditure laid out wholly and exclusively for the purposes of business.

9.3 In CIT v. Motors & General Stores (P.) Ltd. [1967J 66 ITR 692 it was held by the Supreme Court that in the

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absence of any suggestion of bad faith or fraud, the true principle was that the taxing statute had to be applied in accordance with the legal rights of the parties to the transaction. When the transaction is embodied in a document, the liability to tax depends upon the meaning and content of the language used in accordance with the ordinary rules of construction.

9.4 In ClT v. B.M. Kharwat [1969J 72 ITR 603 the Supreme Court again reiterated that the legal effect of a transaction cannot be displaced by probing into the substance of the transaction. It was further held that the taxing authorities were bound to determine the true legal relation resulting from a transaction, where the legal relation was recorded in a formal document or it had to be gathered from evidence and the conduct of the parties to the transaction.

9.5 Very recently in a landmark decision, Hon'ble Supreme Court in the case of Vodafone International Holdings B. V. vs. UOI [2012] 17 taxmann.com 202 (SC) held that when, it comes to taxation of a Holding Structure, at the threshold, the burden is on the Revenue to allege and establish abuse, in the sense of tax avoidance in the creation and/or use of such structure(s). In the application of a judicial anti-avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish on the basis of the facts and

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circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant. To give an example, if a structure is used for circular trading or round tripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity. Similarly, in a case where the Revenue finds that in a Holding Structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such inter-positioning of that entity. However, this has to be done at the threshold. In this connection, one may reiterate the "look at" principle enunciated in W.T. Ramsay Ltd. case (supra) in which it was held that the Revenue or the Court must look at a document or a transaction in a context to which it properly belongs to. It is the task· of the Revenue/Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it should apply the "look at" test to ascertain its true legal nature.....Applying the above tests, it can be said that every strategic foreign direct investment coming to India, as an investment destination, should be seen in

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a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the Holding Structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; the continuity of business on such exit. In short, the onus will be on the Revenue to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device.

10.0 Assessee's profits are exempt under section 10B

10.1 In the case of Perot Systems TSI (India) Ltd. v. Dy. CIT [2010] 37 SOT 358/130 TTJ 685/5 ITR (Trib.) 106 (Delhi), on which the Ld. TPO put reliance, Hon'ble Delhi Tribunal held that lending or borrowing money between two associated enterprises comes within the ambit of international transaction and whether same is at ALP, has to be considered. It was held that not charging of interest on loan by assessee from AEs resulted in higher income in hands of AEs and income of assessee in India was reduced by corresponding amount. Hence, it made loan transaction in question violative of TP provisions as mentioned under section 92B and the contention of having actually not

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earned any income could not come to the rescue of assessee.

10.2 In this case one of the arguments of the TPO was that one of the AEs was 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 the Indian jurisdiction to Bermuda which was a tax heaven country with zero rate of tax on corporate profit.

Hence, as per Hon'ble Tribunal, it was a classic case of the violation of transfer pricing norms where profits were shifted to tax heavens or low tax regimes to bring down the aggregate tax incidence of a multinational group.

10.3 This is not the position in present case. While the substantial income of assessee is tax exempt u/s 10B, the AE is also not situated in tax heaven. There was no incentive to shift Indian income to AE.

10.4 Hon'ble Bangalore Tribunal in the case of Philips Software Centre (P.) Ltd. v. Asstt. CIT, Circle 12(2) [2008] 26 SOT 226 (Bang.) held that the basic intention behind introducing transfer pricing provisions in the Act is to prevent shifting of profits outside India and where an assessee is entitled to claim benefit under section 10A. transfer pricing provisions ought not to be applied. Hence, unless TPO/AO has established that assessee has manipulated prices to

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shift profits outside India, as per CBDT Circular No. 14/2001, transfer pricing provisions ought not to be applied to such a case.

The assessee is not contesting that transfer pricing provisions are not applicable but only arguing that it has no intention to avoid taxes.

10.5 Hon'ble Mumbai Tribunal very recently in the case of ITO v. Zydus Altana Healthcare (P.) Ltd. [2011] 44 SOT 132 (Mum.), observed that the assessee's submission that its profits were 'exempt under section 10B carried lot of substance because the assessee was in no way benefited by charging 5 per cent mark-up as against 17.14 per cent fixed by the TPO because. in any view of the matter, the profits were exempt. The assessee had also pointed out that the profits by the AEs had been subjected to tax in the respective overseas jurisdiction and, therefore, there was no necessity for the assessee to transfer the profits to any overseas jurisdiction. This aspect should not have been lost sight of while examining the issue. In view of above, there was no infirmity in the order of the Commissioner (Appeals) and, accordingly, the same was to be upheld.

10.6 In the present case also, the assessee's substantial profits are exempt under section 10B and AEs are not situated in tax heavens but in US where the tax rates are at par with India or may be more than that.

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10.7 As per the CBDT Circular (Circular No. 12/2001, DATED 23-8-2001), the intention underlying the provision is to prevent avoidance of tax by shifting taxable income to a jurisdiction outside India by an associate enterprise controlling the prices charged in intra-group transactions. The CBDT circular explains the objective of this provision in following manner:

> "The new provision is intended to ensure that profits taxable in India are not understated (or losses are not overstated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances. The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The new section 92 is, therefore, not intended to be applied in cases where the adoption of the ALP determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction.

10.8 Hence, erosion of Indian tax base is one of the prime objectives behind insertion of new TP Provisions. In the

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present case, as discussed above, there is no erosion of tax base in India."

10. Ld. Departmental Representative relied upon the order of TPO and the DRP.

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 bench mark 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 business 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

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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

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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 lended 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 fixed 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.

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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

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transactions with the AE was Arms Length Price. Hence, no transfer pricing adjustment is called for.

21. In the result, the Assessee's appeal is allowed.

Order pronounced in the open court on 08/2/2013.

Sd/- Sd/-

[R.P. TOLANI]
JUDICIAL MEMBER

[SHAMIM YAHYA]
ACCOUNTANT MEMBER

Date 08/2/2013

"SRBHATNAGAR"

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By Order,

Assistant Registrar,
ITAT, Delhi Benches

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