

TAX FLASH NEWS

Interest adjustment on advances made to associated enterprise upheld and the meaning of quasi capital elucidated

Background

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Soma Textile & Industries Limited¹ (the taxpayer), upheld the interest adjustment on the loan advanced to its Associated Enterprise (AE). The Tribunal observed that the comparable uncontrolled price of quasi capital loan cannot be 'nil', unless it is only for a transitory period and the de facto reward for the value of money advanced is the opportunity for capital investment or such other benefit. The Tribunal also noted that determination of Arm's Length Price (ALP) would be warranted irrespective of the source of funds.

Facts of the case

- The taxpayer was engaged in the business of manufacturing of textile cotton fabrics. During the assessment proceedings, it was noticed that the taxpayer has established a wholly owned subsidiary, Soma Textiles FZE (WOS), in the United Arab Emirates (UAE). The taxpayer had invested INR21.71 lakhs in the share capital of its WOS and had also advanced INR16.75 crore to this company.
- In the proceedings before the Transfer Pricing Officer (TPO), the taxpayer contended that the entire amount of INR16.75 crore advanced to the WOS was out of the proceeds of taxpayer's Global Depository Receipts (GDRs) issue and that the advance was in nature of 'contribution towards quasi capital of the said company'. The taxpayer argued on the basis of commercial expediency of an interest free loan.

- However, the TPO argued that commercial expediency of the transaction was not relevant while ascertaining the ALP and the test should be made on the price at which such transactions would have been entered into by independent parties. The TPO placed reliance on Delhi Tribunal ruling in case of Perot Systems TSI² wherein the Tribunal rejected the argument of treating the loan as quasi capital since the agreements treat them as 'loans' and not otherwise. Thus, TPO proceeded to treat LIBOR plus 2 per cent as the ALP and made an adjustment.
- Aggrieved, the taxpayer preferred an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)] wherein CIT(A) confirmed the actions of the Assessing Officer on the ground that the taxpayer himself has classified the advance as 'loan' and not as 'capital'. The CIT(A) also observed that the submission of evidence made by the taxpayer fails to show that the amount funded was not in nature of loan but the intention was to treat the same as capital contribution. Also, the rate of LIBOR plus 2 per cent was confirmed by CIT(A) stating that it would have been the minimum rate at which the AE could have borrowed in UAE in an arm's length scenario.
- The matter therefore was appealed before the Tribunal.

Taxpayer's contentions

- The taxpayer contended that the entire amount of INR16.75 crore advanced to the WOS was out of foreign exchange proceeds of its GDR issue and that it was in the nature of quasi capital and was commercially expedient.

¹ Soma Textile & Industries Limited v. ACIT - ITA 262 (Ahd) of 2012 (Assessment Year: 2007-08)

² Perot Systems TSI v. DCIT [2010] 130 TTJ 685 (Del)

- Further, the taxpayer argued that, since the grant of loan was intended to be a long term investment in the WOS which has a crucial role to play in its business plans, the ALP of such quasi capital investment shall be 'nil'.

Tribunal's ruling

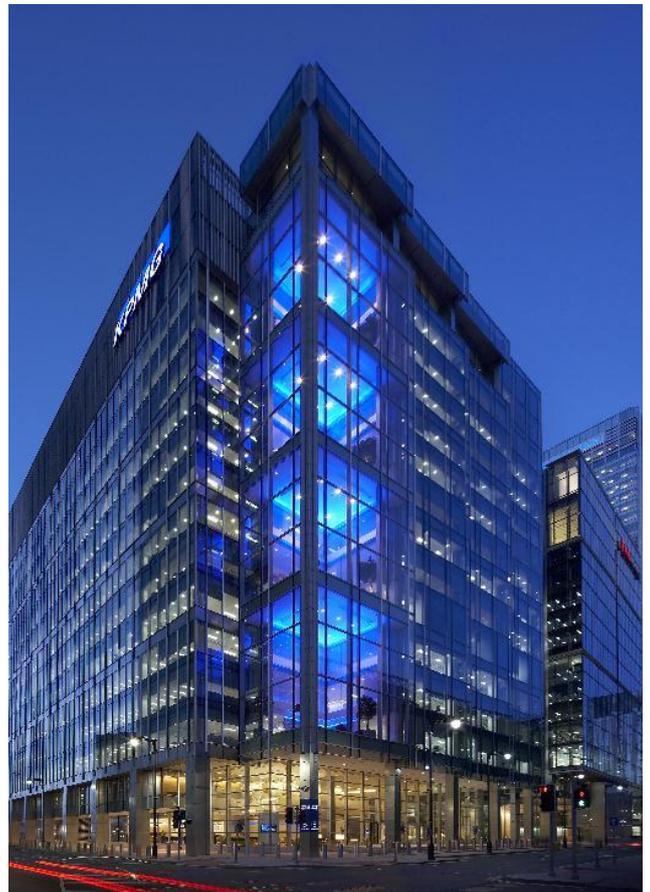
- While deciding on the appeal, the Tribunal observed that while determining the ALP of the transaction which is in the nature of 'quasi capital', one has to review the transaction as a borrowing transaction between the AEs.
- The Tribunal observed that loan/commercial borrowings transactions are benchmarked on the basis of interest rate applicable on the loan transactions, which under the transfer pricing regulations, cannot be compared with a transaction which is something materially different than a loan transaction, for example, a non-refundable loan which is to be converted into equity. It is in this context that the loans, which are in the nature of quasi capital, are treated differently than the normal loan transactions.
- The Tribunal specified that the expression 'quasi capital' loan or advance was not a routine loan transaction. It stated that in case of quasi capital, the substantive reward for an advance would not be 'interest' but opportunity to own capital. Therefore, the comparison of the quasi capital loans should not be done with the commercial borrowings but with the loans or advances which are given in same or similar situations.
- The Tribunal pointed out that in all the other Tribunal decisions, where references have been made to advances in the nature of quasi capital, following situations were referred:
 - (a) Advances were made as capital could not be subscribed due to regulatory issues and the advancing of loans was only for the period till the same could be converted into equity, and
 - (b) Advances were made for subscribing to the capital but the issuance of shares were delayed.
- The Tribunal observed that the comparable uncontrolled price of quasi capital loan cannot be nil, unless such loan is only for a transitory period and the reward for the value of money advanced is the opportunity for capital investment or such other benefit.
- The Tribunal pointed out that the relevance of quasi capital, so far as ALP determination is concerned, should be from the point of view of comparability of the borrowing transaction between AEs and source of funds shall be immaterial. It would be important to determine the ALP of the loan even when the loan is given out of funds from GDR issues abroad.

- The Tribunal also observed that there was no material on record to demonstrate/justify that in an arm's length situation, a zero interest loan provided to similar entities (similar to AEs) would have been justified.
- In light of the above reasoning, the Tribunal upheld the decision of CIT(A) and confirmed the adjustment by adopting the LIBOR plus 2 per cent interest rate as ALP of this loan.

Our comments

Through this ruling, the Tribunal has set out clear parameters regarding the concept of 'quasi capital'. It lays down important factors which shall be given due consideration while determining whether any funds advanced between AEs would be considered as loan or quasi equity and whether the same would be subjected to arm's length interest charge or not. The ruling clearly identifies that, quasi capital loan or advance is not a routine loan transaction, as the essential reward for such a transaction is not interest but an opportunity to own capital.

The ruling provides guidance on the characterisation and the determination of ALP for the 'quasi capital' transactions.



Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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