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TAX FLASH NEWS

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Quasi capital transaction, not an interest simplictor and notional interest adjustment deleted

Background

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Cadila Healthcare Limited[1] (the taxpayer) has differentiated quasi-capital transaction from an act of simply giving money to the borrower. It was observed that true reward/consideration for such a quasi-capital transaction is not an interest simplictor on amount advanced but opportunity to own capital on certain favourable terms and at favourable prices and accordingly such transaction cannot be compared with a simple loan transaction where sole motivation and consideration for the lender is to earn interest on such loans. Thus, it is held that the very foundation of impugned Arm's Length Price (ALP) adjustment is devoid of legally sustainable basis. Further, the adjustment on account of corporate guarantee commission was also deleted following Micro Inks ruling[2].

Facts of the case

- The taxpayer is one of the leading pharmaceutical companies in India and it has entered into various international transactions with its Associated Enterprises (AEs). The Transfer Pricing Officer (TPO) made Transfer Pricing (TP) adjustment on account of various international transactions including *inter alia* charging of notional interest on optionally convertible loan and guarantee fees.

Notional interest on convertible loan

- The taxpayer advanced optionally convertible loans to its subsidiary, Zydus International Pvt Ltd, Ireland (ZIPL). The tenure of these loans was five years and the lender had an option for repayment of loan along with interest from the date of grant of loan or for conversion of loan into equity at par at any time during the tenure of the loan. No repayment had taken place during the year under consideration and accordingly no interest was recorded in the books.

Corporate guarantee fees

- The taxpayer provided certain corporate guarantee to the bankers, in respect of borrowings by its AE and charged guarantee commission at 1 per cent from its AEs. However, in case of two of its AEs, the taxpayer did not charge any guarantee fees, contending that these loans had been availed by AEs for strategic acquisitions in furtherance of the taxpayer's inorganic expansion strategy, which had benefited the taxpayer rather than its AEs.

Taxpayer's contentions

Notional interest on convertible loan

- With respect to the above transaction, the taxpayer explained that the convertible loan is at the option of the taxpayer at any time till the date of maturity. The same has been utilised for

[1] Cadila Healthcare Limited v. ACIT [2017] 80 taxmann.com 24 (Ahd)
[2] Micro Ink Ltd v. ACIT (2016) 157 ITD 0132 (Ahd)

acquisition of step down subsidiaries and the intrinsic value of the shares was much more than the conversion rate. Therefore by not charging interest, the taxpayer had kept its option of conversion intact which is beneficial to them.

- The taxpayer stated that the interest income can be said to have accrued to us only once the right to receive the interest as per the terms of the agreement accrues. Since no interest has accrued in terms of the agreement between the taxpayer and its AE, during the year under consideration, no income is chargeable in our hands under Section 5 of the Income-tax Act, 1961 (the Act).

- In view of the same, the taxpayer firmly believed that notional interest should not have been charged on these optionally convertible loans.

Corporate guarantee fees

- Various contentions have been raised by the taxpayer, main being that guarantee on which no commission was charged to AEs was for inorganic expansion of the taxpayer's business. This transaction of corporate guarantee, is in the nature of shareholder activity conducted by the taxpayer as the Group Parent Company. In view of the same, no charge is warranted.

Tax department's contentions

Notional interest on convertible loan

- The TPO was of the view that for the above arrangement, the taxpayer should have charged and provided interest in the books of accounts. Mere fact that the loan has been converted into equity in subsequent years does not alter its character as loan as at the relevant point of time. In view thereof, the benchmarking of loan is to be conducted as per the prevailing market rate.

- The TPO further noted that AE, ZIPL, had unduly benefited from this transaction in the form of receipt of interest and dividend from various entities to which the monies were given as capital or loan and on the other hand the taxpayer has not been paid any interest.

- The TPO also contented that it is wholly immaterial as to whether or not the taxpayer, by the virtue of this transaction, is entitled to subscribe to capital of the AE on certain concessional terms, because, in any case, the AE is a wholly owned subsidiary of the taxpayer and no one else can subscribe to the AE's capital.

- Lastly, the TPO placed reliance on the U.S. Supreme Court's decision in the case of Pepsi Cola Bottling Co. of Puerto Rico Inc (Docket Nos 13676-09, 13677-09, order dated 20 September 2012) which had discussed certain tests on whether the debentures are in the nature of debt or equity and accordingly concluded that the character of the instrument was predominantly debt rather than equity.

- The TPO thus computed interest on the said loans and accordingly proposed TP adjustment. The same was confirmed by the Dispute Resolution Panel (DRP).

Corporate guarantee fees

- The TPO disregarded the taxpayer's contention by placing reliance on OECD TP Guidelines and decisions of the U.S. and Canadian tax courts and held that provision of guarantee by the taxpayer is a service rendered. The TPO adopted 3 per cent as arm's length guarantee commission for all the guarantees issued by the taxpayer, which was computed on the basis of credit rating variation between the taxpayer and its AEs, as adjusted for currency risk.

- The DRP provided partial relief to the taxpayer and directed the TPO to accept 1 per cent as arm's length guarantee commission.

Issue before the Tribunal

Notional interest on convertible loan

- Whether impugned adjustment on account notional interest on optionally convertible loans is justified considering facts of the case.

Corporate guarantee fees

- Whether impugned adjustment on account corporate guarantee fees where the taxpayer depicts the same as a shareholder activity is justified.

Tribunal's ruling

Notional interest on convertible loan

- The Tribunal duly considered the facts of the case and held that the transactions in question are not simple loan transactions. The amounts advanced to the AE, ZIPL, are attached with an obligation on AE to issue share capital, in case the taxpayer exercises such an option, on certain conditions, which are admittedly more favourable to the taxpayer, and at an agreed price, which is admittedly much lower, vis-à-vis the conditions and prices which independent enterprise would normally agree to accept. The lending in the present case was considered to be in the nature of quasi-capital in the sense that substantive reward, or true consideration, for such a loan transaction is not interest simplictor on amount advanced but opportunity to own capital on certain favourable terms.

- With respect to the connotation of 'quasi-capital' in the context of ALP determination, the Tribunal relied on the coordinate bench decision in the case of Soma Textile & Industries Ltd[3] and observed that the relevance of 'quasi-capital', so far as ALP determination under the TP regulation is concerned, is from the point of view of comparability of a borrowing transaction between the AEs. Reliance was placed on Rule 10B(1)(a) of the Income-tax Rules, 1962 (the Rules), and it was held that considerations for extending a loan simplictor are materially distinct and different from extending a loan which is given in consideration for, or mainly in consideration for an option to convert the same into capital on certain terms which are favorable vis-à-vis the terms available to an independent enterprise. In view of the same, the Tribunal disregarded the comparison made by the TPO.

- The Tribunal also considered the U.S. Tax Court's decision in the case of Pepsi Cola Bottling Co and observed that it had been wrongly referred by the TPO as the U.S. Supreme Court's decision but in fact was a decision of the U.S. Tax Court, broadly at the same level of judicial hierarchy as the Indian Tribunal. Further, it distinguished this case on the ground that it deals with particular deduction provision and not a provision relating to determination of ALP.

- On the TPO's contention that it is wholly immaterial as to whether or not the taxpayer, by the virtue of this transaction, is entitled to subscribe to capital of the AE on certain concessional terms, because, in any case, the AE is a wholly owned subsidiary of the taxpayer and no one else can subscribe to the AE's capital, the Tribunal observed that what has been overlooked, however, in this process of reasoning is that the very concept of ALP is based on the assumption of hypothetical independence between AEs.

- Further, on the TPO's contention that since ZIPL has earned huge profits, the taxpayer should have charged interest on commercial rates, the Tribunal observed that it is incomprehensible as to what role profits earned from the funds raised can have in determining arm's length consideration of raising funds itself – which is neither the commercial practice nor the case before the Tribunal.

- The Tribunal observed that in case the taxpayer's right to convert the loan into equity comes to an end, the taxpayer is entitled to interest on the commercial rates. In view of all the above observations, the Tribunal directed the TPO to delete the impugned adjustment.

Corporate guarantee fees

- The Tribunal directed the TPO to delete the TP adjustment on account of corporate guarantee fees by placing reliance on the decision of coordinate bench in the case of Micro Ink (supra) wherein it was held that corporate guarantees issued in the nature of 'shareholder activities'/'quasi-capital' could not be included within the ambit of 'provision

[3] Soma Textile & Industries Ltd. v. ACIT [2015] 154 ITD 745 (Ahd)

for services' under definition of 'international transaction under Section 92B of the Act, as they did not have 'bearing on profits, income, losses or assets'.

- The Tribunal agreed with the views expressed by the coordinate bench, however it has stated that the case is already pending before the Hon'ble High Court, it is, therefore, no longer in the right forum to sit in judgement whether or not in view of the arguments of the revenue, this decision of Micro Ink needs to be revisited. Accordingly, based on decision of the coordinate bench, the Tribunal deleted the TP adjustment on account of corporate guarantee.

Our comments

This is indeed a welcome ruling by the Tribunal, wherein the concept of quasi-capital has been duly recognised. The concept of quasi-equity had its reference in the observations made by the Australian Tax Office in a 'Discussion Paper on Intra-group finance guarantees and loans – Application of Australia's transfer pricing and thin capitalization rules', however the same was withdrawn and never saw the light of day. The ruling clearly brought out that a transaction which is quasi-capital in nature cannot be compared with a simple loan transaction and notional interest should not accordingly be impugned on such quasi-capital transaction.

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