Bloomberg BNA

TRANSFER PRICING FORUM

Transfer Pricing for the International Practitioner

VOLUME 4, NUMBER 4 >>> December 2013

www.bna.com

India

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Issue One

Whether making such creditworthiness adjustment is regarded as being contrary to the arm's length principle.

In the initial years of transfer pricing in India, non-binding bank quotations were used for benchmarking inter-company financial transactions. As the acceptance of quotations is becoming difficult with increasing sophistication of the revenue authorities, taxpayers are shifting towards the systematic approach for benchmarking the financial transactions. In their analysis, taxpayers undertaking systematic analysis have determined the arm's length price for financial transactions by evaluating the creditworthiness of the borrower on a standalone basis factoring the implicit support. As the gradual shift to the more sophisticated approach for benchmarking loans and guarantees and the embedded implicit support is recent, it has not yet been confirmed or rejected by the Indian Judiciary.

However, in general there have been continuous discussions in India whether there should be consideration for a shareholder service, which could include the more active and visible participation by the parent in the nature of stewardship activity or the understated passive association or implicit support. In India where there is significant reliance on the text of the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing guidelines, 2010, the following paragraphs are frequently adopted to agree on the chargeability or non-chargeability of any service, and the same should happen at the time of adjudicating on the implicit support.

> ". . .no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefited from the group's reputation deriving from global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group."[1]
> "the question whether an intra-group service has been rendered (. . .) should depend on whether the [guarantee] provides a group [company] with economic or commercial value (. . .). This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the [guarantee]."[2]

There is no clear ruling on passive association in the context of financial transactions, however, there has been a detailed ruling for the more active and visible participation by the parent in the nature of stewardship activity. In this regard the decision of the Supreme Court of India in the case of *M/s DIT (International Taxation), Mumbai vs Morgan Stanley & Co. Inc*.[3] suggests no charge for stewardship activity. The matter had arisen before the Court on the basis of an Special Leave Petition filed by both the Revenue and Applicant, who had applied for a Ruling with reference to the ruling given by the Authority for Advance Ruling in the case of *Morgan Stanley & Co. vs Unknown* in February 2006. In the matter under discussion the Applicant, which is part of the leading investment banking group providing financial advisory services, corporate lending and securities underwriting, was a non-resident company and a taxpayer in USA. A group company was incorporated in India to support the group's front office across the world as support services. The applicant intended to send US staff to India for stewardship activity to ensure high quality standards were met at the time of rendering services. The Supreme Court of India finally prescribed a no charge for stewardship activity.

> "14. Article 5(2)(l) of the DTAA applies in cases where the MNE furnishes services within India and those services are furnished through it employees. In the present case we are concerned with two activities namely stewardship activities and the work to be performed by deputationists in India as employees of MSAS. A customer like an MSCo who has worldwide operations is entitled to insist on quality control and confidentiality from the service provider. For example in the case of software PE a server stores data which may require confidentiality. A service provider may also be required to act according to quality control specifications imposed by its customer. It may be required to maintain confidentiality. Stewardship activities involve briefing of MSAS staff to ensure that the output meets the requirements of the MSCo. These activities include monitoring of the outsourcing operations at MSAS. The object is to protect the interest of the MSCo. These stewards are not involved in the day to day management or in any specific services to be undertaken by MSAS. The stewardship activity is basically to protect the interest of the customer. In the present case as held hereinabove the MSAS is a service PE. It is in sense a service provider. A customer is entitled to protect its interest both in terms of confidentiality and in terms of quality control. In such a case it cannot be said that MSCo has been rendering the services to MSAS."

In the ruling, there is an acknowledgement of a no charge for the more active and visible participation by the parent in the nature of stewardship activity, although not in the context of a financial transaction. It is anticipated in future that the principle of no charge for stewardship activity would be extended to the understated passive association or implicit support in case of financial transactions. Hence, the impact of passive association of an entity with a Group while estimating the credit worthiness is depictive of arm's length behaviour, which may eventually culminate in a notching up of the rating for a beneficial borrowing rate or increase in capacity to undertake excess funding by the subsidiary.

Issue Two

Whether the practices of credit rating agencies or of banks would be accepted by the tax authority as being a sound basis for making such adjustments.

The approach adopted by banks in India is not public information and hence would not be good hard evidence and therefore difficult to substantiate any claim before the Indian Judiciary. On the contrary the approach adopted by credit rating agencies is more visible in the form of hard evidence and is likely to have high acceptance by the Indian Judiciary adjudicating Indian transfer pricing matters. Therefore, it is important to first know the standing of credit rating agencies in the Indian financial fraternity and their approach to capturing implicit support, before one can evaluate the possibility of acceptance. The Indian credit rating industry has evolved over a period of time and is widely used by corporates as well as banks in India at the time of negotiating financial instruments. The Indian credit rating industry mainly comprises of CRISIL, ICRA, CARE, ONICRA, FITCH & SMERA.

CRISIL is the largest credit rating agency in India with more than half the credit rating business in India. It was established in 1987. The world's largest rating agency, Standard & Poor's, now holds a majority stake in CRISIL. To date it has rated more than 5178 SMEs across India and has issued more than 10,000 SME ratings.[4] It is interesting to note that Standard & Poor's, as well as its Indian subsidiary CRISIL, have given due recognition to implicit support.

> "Standard & Poor's approach essentially comprises three stages:
> - Undertake a consolidated and unconsolidated group analysis to allow us to confidentially assign notional group ratings across the entire group as though it were a single corporate entity
> - Establish confidential stand-alone ratings for each individually rated entity within the group
> - Complete the analysis by designating each rated entity within the group as core, strategically important, or nonstrategic to the ultimate parent group and adjust the final public rating accordingly to reflect the appropriate level of group support.
> . . .If the credit quality of a subsidiary is higher than that of the parent, the ability of the parent to control the unit typically caps the rating at the parent level. Exceptions are made in the case of bankruptcy-remotes special purpose vehicles for securitisation, regulated entities, independent finance subsidiaries, and the rare instances that have extremely tight covenant protection"[5]
> "While arriving at the rating of a firm, CRISIL factors in the credit linkages it has with its parent (if any). CRISIL may consider support from a higher rated parent and notch up the standalone rating of the subsidiary to arrive at the final rating. CRISIL's approach for notching-up a subsidiary's rating reflects the distress support that can be expected from the parent to the subsidiary, which in turn depends on the level of business and financial integration between the parent and the subsidiary. CRISIL notches up ratings for parent support on the understanding that a firm's creditworthiness is not only dependent on its own business and financial strengths but also on its lineage and the relationship that it enjoys with its parent. To capture such linkages from a credit perspective, CRISIL employs a comprehensive framework to decide whether the rating needs to be notched up for parent support and if yes the extent of notch-up. The framework is based on a set of economic factors, aspects of moral obligation, parent's corporate status and track record of the parent's support to subsidiaries.
> "CRISIL determines the extent of notch-up by assessing the level of business and financial integration between the parent and subsidiary. In cases where CRISIL believes that there is no or limited business or financial integration between the parent and subsidiary, CRISIL does not factor in any parent support and the rating reflects CRISIL's assessment of the entity's standalone credit profile. Conversely, when there are very strong business and financial linkages between the parent and subsidiary, CRISIL considers equating the subsidiary's rating with the rating of the parent. If the assessed level of integration between parent and subsidiary is neither too high nor too low, the final rating of the subsidiary lies somewhere between the standalone rating and the parent's rating. For instance, if on an overall maximum score of 100, CRISIL assesses the score on integration at 60, the rating of the subsidiary can be notched up by 60 per cent of the differential between the standalone rating and the parent's rating. . ."[6]

ICRA was established in 1991 by leading Indian financial institutions and commercial banks. International credit rating agency, Moodys, is the largest shareholder. ICRA has a dedicated team of professionals for the MSME sector and has developed a linear scale for MSME sector which makes the benchmarking with peers easier.[7] Similarly, Moodys as well as its Indian subsidiary ICRA have also given due recognition to implicit support.

> "Moody's approach to rating non-guaranteed subsidiaries starts with the determination of stand-alone ratings for both the parent and the subsidiary. . .The likelihood of support has two components – willingness and ability to support. . .When rating financial institutions, certain additional factors may also be considered. . .Financial institutions generally have a high degree of confidence sensitivity. . .In addition, financial institutions are often highly regulated, and as such a parent may choose to support a subsidiary to avoid suffering adverse regulatory consequences. . .Moody's believes that in many cases financial institutions will be more likely to support weaker affiliates or subsidiaries than non-financial corporations. Thus ratings lift may often be greater for financial institutions"[8]
> *"ICRA's Risk Analysis Framework for Steel Companies*
> . . .This note highlights some of the key factors that are specifically evaluated while assessing the credit quality of a steel company. For analytical convenience, these factors may be grouped under the following heads. . .
> *Management Quality and Corporate Governance*
> . . .Management quality is one of the most important factors that ICRA evaluates in assigning ratings, but is an intangible and difficult to quantify. For steel players, ICRA looks at management strategies with respect

to the company's cost position and product portfolio. ICRA also evaluates how the management responds to the cyclical behaviour of the industry, i.e. strategies followed to mitigate the risks arising out of such cyclicality. Generally speaking, a record of conservative financial philosophy provides an extra level of comfort for the rating. Some of the other points assessed are:
- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- The issuer's policies on leveraging, interest risks and currency risks
- Strength of the other companies belonging to the same group as the issuer
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required. . ."[9]

Therefore, the notching up on account of implicit support is a common financial industry practice in India and internationally, but it does not come as a default to every multinational group or as a default to every subsidiary to the same multinational group and needs to be analysed taking several parameters into consideration. The commonly adopted parameters have been listed as:

- common business of parent and subsidiary
- size of investments in the subsidiary
- economic incentive to the parent
- industry
- shared name with the entity
- shareholding of the promoter group or the control over the entity
- legal and regulatory obligations for the parent to support subsidiary
- implicit support/letter of comfort
- parent and subsidiary domiciled in the same country
- listed/unlisted
- track record of the group of supporting other companies
- parent's rating
- ease of providing support from the parent.

To understand this better, an example could be seen in Indian corporate history where two of India's big corporates reacted differently regarding the facts of a transaction:

> ". . .The company says it also means that when the wheels come off, there are traditions to fall back on for guidance. When Tata Finance collapsed in 2002 with debts of several hundred million dollars, Ratan Tata, group chairman, did not hesitate to make the information public — in line with the group's historical emphasis on trustworthiness. "I felt that if we did not . . . then we were implicitly saying that this sort of behaviour was tolerable," he said. Tata pledged repayment of all losses. The financial cost was severe, but by going back to its root values, Tata avoided a scandal that could have wrecked its reputation. State Bank of India is another organisation that consciously harks back to the past. In 2009, the company ran an advertising campaign featuring images of important figures from Indian history who had also been SBI customers. This reminded not only customers but employees and other stakeholders of SBI's values..."[10]
>
> ". . .The global economic slowdown has caught up with the country's most valued firm Reliance Industries Ltd. It said on Wednesday that one of its units in Europe had filed for bankruptcy. Reliance said that its European textile unit, Trevira, had applied in a German court to start insolvency proceedings with a restructuring plan. "The move follows major efforts by the company to overcome the impact of industrial slowdown in Europe, particularly in the automotive and textile sectors to whom it is an important supplier," Reliance said in a statement to the BSE. The company said Trevira had recently appointed a chief restructuring officer as its managing director who had many years of experience with a legal firm specialising in restructuring. "European textiles manufacturers are currently facing a considerable drop in demand for their products, while the cost of production and employment is increasing and competition from Asian and Eastern European industries is stronger than ever," RIL said..."[11]

Hence, the anticipated conduct of the parent as captured by credit rating agencies and banks would be their reading of the reputational risk for sharing a common name or if both the parent and the subsidiary are domiciled in the same country or the subsidiary may not be having a strong business or financial linkage with the business of the Parent or several other factors in combination. The matter of strong financial and business linkage being a key criteria has also found acceptance in Crest Animation Studios ltd. vs ACIT 11(1):[12]

> ". . .in selecting the comparables it has to be ensured that the comparable parties entering into uncontrolled transactions are also having similar business relationship so as to make them fully comparable."

Broadly, one can infer from the public information in the market is that the notch up criteria will have to consider the parent's own credit rating, its willingness to extent support to the subsidiary depending upon the level of integration between the parent and subsidiary along with parent's ability to extend support to the subsidiary.

Most of the judicial precedents in India are in situations where the taxpayers adopted bank quotations or rates available in bank websites as comparable. The systematic approach of benchmarking transactions which involves estimation of credit worthiness and determination of appropriate comparables is yet to be tested before the Indian Judicial authorities even though there have been comments in some of the rulings suggesting a systematic approach, like *Aithent Technologies Pvt Lt vs Income Tax Officer*:[13]

> ". . .we are of the opinion that CUP method is the most appropriate method in order to ascertain arm's length price of the aforesaid international transaction by taking into account prices at which similar transactions with other unrelated parties. For that purpose assessment of the credit quality of the borrower and estimation of a credit rating, evaluation of the terms of the loan e.g. period of loan, the amount, the currency, interest rate basis and any additional input such as convertibility and finally estimation of arm's length terms for the loan based upon the key comparability factors and internal/and or external comparable transactions are relevant. None of these inputs have anything to do with costs, they only refer to prevailing prices in similar unrelated transactions instead of adopting the prices at which the transactions have been actually entered into the same transaction, are taken into account. . ."

However, as the sophistication level of the revenue authorities is increasing, they are questioning the simplistic approach of benchmarking loans and guarantees through the appropriate methodology. This is more evident from one of the Indian rulings on financial transactions, where the Indian revenue and judiciary have attempted to adopt the best practices but could not make much headway due to the adhoc assumptions it would have to undertake in absence of adequate skill sets and tools. But this highlights the keenness of the Indian Revenue and judiciary to move towards sophistication.

> ***Hinduja Global Solutions Ltd. vs Addl CIT, Circle 6(3), Mumbai***[14]
> "The Transfer Pricing Officer was of the opinion. . .In this regard he observed that the financial institutions generally weigh four elements in determining whether or not to issue loans i.e.
> - Financial Risk: It is based on debtor's financial position by taking into consideration the Balance Sheet and Income Statement;
> - Credit Risk: Availability of guarantees, the purpose of the loan, the loan's term and maturity period of the loan are taken into consideration;
> - Business Risk: The lender's view on the industry in which the debtor operated its business is taken into account; and
> - Structural Risk: The qualification of external rating agencies awarded to the debtor are weighed"
> ***Tata Autocomp Systems Limited vs The ACIT, Cir. 2(3), Mumbai***[15]
> ". . .Consequently the TPU held that it will be more relevant to see that how the assessee would have behaved in uncontrolled transaction like this between unrelated parties, interest would have been charged taking into account credit worthiness of the AEs, margins, security or any other consideration relevant for deciding the financial solvency of the borrower."
> ***Asst. Commissioner of Income Tax 11(1) vs M/s Nimbus Communications Ltd.***[16]
> "The ld. CIT(A) decided this issue vide para . . . which read as under. . .It is pertinent to note factors considered by Banks while providing loans/bank guarantee there are various alternative factors considered by the banks which are as below:
> - credit rating/risk profile of the recipient of Guarantee
> - financial position of the entity
> - terms of guarantee like provision of security, etc;
> - amount of guarantee provided;
> - period of guarantee provided;
> - past history of the customer i.e. whether the customer has made any default in repayment of principle/interest earlier;
> - market dynamic and competition;
> - margins recovered by the banks over its own overheads; and
> - negotiation and relationship with banks",
> ***Cotton Natural (I) Pvt. Ltd. vs DCIT***[17]
> "The DRP considering the objections of the assessee . . .on the following reasoning:
> . . .The loan has flown from one set of shareholders to another set of shareholder. 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. . ."
> ***Glenmark Pharmaceuticals vs Addl CIT***[18]
> ". . .From the above orders of the Tribunal, it is adequately clear that the 'naked quotes' of the bank guarantee commission rates kept in the website of the banks should not be applied in the TP studies without adjustments to various factors of the transactions. These factors may be risk related ones, time related guaranteed amount, financial strength of the AEs, background of the customers and relationship of the AEs with parental companies etc. . ."

While most of the Indian judicial precedents are hold a simplistic and adhoc approach to benchmarking, in some cases there are observations of the Tax Tribunal on the relationship between the credit rating of the parent and subsidiary company. There are judicial precedents in India in the case of VVF Ltd vs Dy Commissioner of Income Tax, Circle – 7 (3), Mumbai[19] and Cotton Natural (supra), where it was observed that the credit rating of the subsidiary company will be broadly the same as the holding company. The statement may have acceptability in a particular industry due to the regulatory framework for an industry or strong business and financial linkages between the parent and subsidiary, but seems to have been generalised by the Indian Judiciary:

> ***"Key Rating Drivers***
> High Probability of Support: India Ratings' ratings of financial institution (FI) subsidiaries of banks usually factor in a high probability of support from parent institutions. This reflects the fact that performing parent banks have very rarely allowed FI subsidiaries to default. It also considers the often high level of integration between parent banks and subsidiaries, and owners' typically strong business, financial and reputational incentives to avoid subsidiary defaults.
> Equalisation or Notching: An FI subsidiary's issuer rating may be equalised with its parent bank where India Ratings views the subsidiary as 'core'. A 'strategically important' subsidiary is likely to be rated one to two notches below its parent, and a subsidiary of 'limited importance' at least two notches lower. In determining the notching, India Ratings will also consider the subsidiary's integration with its parent, where the subsidiary is incorporated, the relative size of parent and subsidiary, the parent's stake, any support commitments, and the parent's track record of support. . ."[20]

Hence, the thought of implicit support from the parent is there in principle, however, interpreted to extreme benefit of taxpayers in some rulings, and it should get balanced in the passage of time. These rulings have to be analysed in light of the fact that these are some of the initial rulings on the subject. While there is no clear observation on the concept of implicit support in these rulings, it can be inferred that the Tribunal has acknowledged the fact that the credit rating of the parent company has an impact on the credit rating of the subsidiary company. It is noteworthy that in audit cases, where the Indian revenue authorities are conducting a systematic analysis for guarantee fee determination, extensive reliance has been placed on the ruling of *General Electric Capital Canada Inc* (Tax Court of Canada, 2009). However, the issue of implicit support has not yet been discussed. With the revenue authorities placing extensive reliance on GE Canada, taxpayers are now taking into account the impact of implicit support while benchmarking financial transactions.

Issue Three

Whether the effect of implicit support should be viewed in the same way as the effect of a formal guarantee, so that its impact on the quantum of debt should be disallowed.

The acknowledged principle across developed tax jurisdictions in the world (UK, Netherlands, Australia and US), that a guarantee is not considered a service for which a fee is due when the borrower is not able to attract funds on a stand-alone basis without the presence of a guarantee, has limited level of awareness in India at the moment.

In India there has not been a reported case where it has been represented in a manner to reflect the impact of borrower's apparently limited ability to borrow at arm's length to test whether the borrower would have taken a lesser sum or nothing.

At the moment the Indian Revenue does not have the wherewithal to test the amount that any borrower would have been able to borrow in its own right to disregard guarantees in issues like an increase in the level or extent of overall debt due to the guarantee. However, it is anticipated that with the passage of time as a more sophisticated approach for benchmarking loans and guarantees is adopted, the following questions would also be addressed, in addition to the credit rating exercise and comparable loan searches:

a. whether the loan or guarantee would have been made at all in the absence of special relationship
b. the effect of a guarantee could also be a larger loan obtainable, and this may be more than the borrower would be able to or willing to take on at arm's length
c. whether as independent parties, the lender and borrower could have entered into such an arrangement and whether they would have done so
   - "could" argument - what a lender would have lent and therefore what a borrower could have borrowed
   - "would" argument - what a borrower acting in the best interests of their own business would have borrowed
d. whether the loan or the guarantee is performing an equity function and therefore the interest or any guarantee should not be charged.

It is also heartening to see that with regard to circumstances when a loan or guarantee is performing an equity function and therefore the interest or any guarantee should not be charged, although in the context of 'inability to lend' coupled with 'business expediency' and not the 'ability to borrow', has found sound acknowledgement from the Indian Judiciary in Micro Inks Ltd vs ACIT.[21]

Therefore, it needs to be first observed with what scope, manner or mechanism for determination and the consequent tax effect for the excess quantum of debt due to explicit guarantee finds acceptance in India, and then one can infer the extension of such effect into implicit support.

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NOTES

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[3] *DIT Mumbai vs Morgan Stanley And Co. Inc.* (2007-TII-01-SC-TP) – Para 14
[4] smallb.in/-20/fund-your-business-20/credit-rating-20/msme-rating-20/rating-agencies-india
[5] *Standard & Poor's, Criteria for Financial Institutions, General Group Methodology,* April 22, 2009 and *Standard & Poor's Corporate Ratings Criteria* 2006
[6] *Crisil Ratings, Criteria for notching up standalone ratings of companies based on parent support,* May, 2013
[7] smallb.in/-20/fund-your-business-20/credit-rating-20/msme-rating-20/rating-agencies-india
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[10] *The Indian Express Mumbai,* Express News Service, Saturday, July 16, 2011, 2:12 hrs, Companies bank on history to prepare for the future
[11] *The Indian Express Mumbai,* Express News Service, Thursday, June 4, 2009, 23:30 hrs, Reliance unit files for bankruptcy
[12] *Crest Animation Studios ltd. vs ACIT*(ITA NO. 5212/Mum/2007 & ITA NO. 5348/Mum/2007) – Para 2.4.4
[13] Aithent Technologies Pvt. Ltd. vs Income Tax Officer (2011-TII-134-ITAT-DEL-TP) – Para 7
[14] *Hinduja Global Solutions Ltd. vs Addl. CIT* (2013-TII-122-ITAT-MUM-TP) – Para 12
[15] *Tata Autocomp Systems Limited vs The ACIT* (2012-TII-49-ITAT-MUM-TP) – Para 11
[16] *Asst. Commissioner of Income Tax vs M/s Nimbus Communications Ltd.* (2013-TII-132-ITAT-MUM-TP) – Para 6.2
[17] *Cotton Naturals (I) Private Limited vs DCIT* (2013-TII-34-ITAT-DEL-TP) – Para 5
[18] *Glenmark Pharmaceuticals vs Addl. CIT*(ITA No 5031/Mum/2012 & ITA No. 5488/Mum/2012) – Para 23
[19] *VVF Limited vs DCIT* (2010-TIOL-55-ITAT-MUM) -Para 7
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ISSN 2043-0760