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Interest free loans: Tribunal acknowledges economic substance

Facts

Micro Inks Limited[1] ('MIL' or 'the taxpayer') is engaged in the business of manufacturing and sale of printing inks and other intermediate and allied products. The taxpayer, through its wholly owned subsidiary, Micro Inks GmbH, Austria, set up a company by the name of Micro Inks Corporation Inc., ('MIC USA') in the USA. MIC USA was set up for carrying out manufacturing activities with ingredients, supplied by the taxpayer.

During the course of the transfer pricing assessment proceedings (AYs 2002-03, 2003-04, 2004-05) the transfer pricing officer ('TPO') proposed an adjustment on account of interest free loan provided by the taxpayer to its associated enterprise ('AE') and interest charge on outstanding receivables from the AE.

The taxpayer had provided an interest-free loan amounting to USD 3,170,000/- to its step-down subsidiary, MIC USA, during the AY 2002-03. An additional interest-free loan of USD 1,000,000/- was provided in September 2003. The taxpayer contended that these loans were in the nature of quasi-capital contributions and they would not warrant any interest payment. The TPO rejected the taxpayer's stand and adopted the weighted average cost of funds of the taxpayer (11% as per the financial statements) as the arm's length interest rate and made an adjustment to this effect. The Commissioner of Income-tax (Appeals) ('CIT(A)') confirmed the TPO's addition on merits, but restricted the adjustment

[1] Micro Inks Ltd. *v.* ACIT [2013] 36 taxmann.com 50 (Ahd - Trib)

by proposing to apply international bank rates, i.e., either LIBOR or the American rate of interest.

Taxpayer's contentions

- The taxpayer contended that the loans given to its AE were in the nature of quasi-capital contributions. The taxpayer substantiated this argument by contending that it needed approvals from Reserve Bank of India ('RBI') to infuse funds as equity investment and thus had advanced money from its Exchange Earnings Foreign Currency ('EEFC') account in the form of loans as a stop-gap arrangement. The loan was converted into equity as soon as the approvals from RBI were obtained.

- Further, commercial expediency was substantiated by demonstrating that the taxpayer was the sole vendor of raw material and semi-finished goods to MIC USA, whereby the taxpayer accounted for 90% of exports and 50% of total sales to this AE. In light of the financial position of the AE, i.e MIC USA, it was necessary for the taxpayer to increase capital support to ensure sustainability of the company as both, the taxpayer and the AE were mutually dependent on each other. Keeping these economic circumstances in mind, no interest charge was warranted on the loans before conversion to equity.

- The taxpayer placed reliance on the OECD Guidelines which provide that where the economic substance of a transaction differs from its form, the tax administration may disregard the form and re-characterise the arrangement in accordance with the substance of the transaction.

Revenue's contentions

- As regards the loan transaction, the relationship of the taxpayer and its AE was that of a borrower and lender. The rights and obligations of the taxpayer were not the same as those of shareholders for the relevant transactions.

- The form of the transactions was a loan and it would be inappropriate to re-characterise the same as capital contribution.

- In the absence of a specific mention in the loan agreement about conversion into equity, the loan cannot be presumed to be in the nature of quasi-capital contribution.

Tribunal Ruling

The Tribunal accepted the taxpayer's contention that the loan provided was in the nature of quasi-equity. While doing so, the Tribunal commented on the aspects as set out below:

Treatment of interest-free advance as quasi-capital contribution

- The Tribunal appreciated the fact that the taxpayer was unable to infuse capital in the AE due to regulatory restrictions (RBI approval in the instant case) and thus was forced to provide money in the form of a loan through EEFC account held abroad, for which no approval was required. Further, immediately after obtaining RBI approval, the loans had been converted into shares (except for an amount of USD 10,000). Also, the RBI approval for conversion of loan into equity had been sought from the date when remittance was made. Based on these facts, the Tribunal held that the loan provided by the taxpayer should be treated as quasi-capital contribution.

- The Tribunal differentiated the facts of the case from existing rulings in the case of Perot Systems[2] and VVF Ltd.[3] In the case of Perot Systems, it had been observed that if the intention of taxpayer was to treat the loan as capital contribution, it could have originally infused the money in the form of equity as there was no restriction for the Company in doing so. Differentiating the facts from the current case, the Tribunal observed that unlike in the Perot case,

[2] Perot Systems TSI India Ltd *v.* DCIT [2010] 130 TTJ 685 (Delhi – Trib)
[3] VVF Ltd *v.* DCIT (2010 TII 4 ITAT MUM TP)

the taxpayer in this case had regulatory restrictions in infusing money in the form of capital, on account of which the taxpayer was forced to provide a loan.

- Further, in the case of VVF Ltd., the argument of commercial expediency in advancing interest-free funds was derived on the basis of ownership and control of subsidiary being in the hands of the assessee. The Tribunal in the instant case considered such commercial expediency to be irrelevant as the impact of any such inter-relationship should be neutralised by arm's length treatment.

- The Tribunal observed that in the present case, the relationship on account of lending of money could not be considered in isolation from the commercial business considerations between the entities. The taxpayer had a significant proportion of its transactions with its AE in USA. The sustainability of the US entity was crucial to the taxpayer's business interests. Thus, it would be inappropriate to compare the relationship to that of a lender and borrower.

- The Tribunal further observed that while a LIBOR-plus rate would be appropriate for a loan transaction which was undertaken for earning profits from lending money, a similar rate would not be appropriate in the current situation, because the money has been invested as a quasi-capital contribution for significant and decisive commercial considerations. The Tribunal held that the difference in the nature of the two transactions, i.e. lending of money and quasi-capital contribution, was so fundamental that application of LIBOR or any other bank rate would be inappropriate in the present case.

- The Tribunal rejected the Revenue's contention that the loan agreement originally did not have the provision of conversion of loan into equity. It was observed that as the taxpayer was unable to infuse capital due to lack of RBI approval, it would have been inappropriate to have such a conversion clause in absence of a formal approval.

- Considering the above, the Tribunal regarded the loan as a quasi-capital contribution.

PwC Observations

This ruling from the Tribunal is an important and welcome pronouncement in the context of inter-company financial transactions involving the issue of provision of interest-free loans being treated as quasi-equity. This ruling provides much needed guidance to taxpayers, being one of the first rulings that lays down principles for considering loans as quasi-equity. The Tribunal has clearly differentiated the facts of this case from the prior rulings (i.e. VVF Ltd. and Perot Systems) thereby laying down a principle that in cases where the taxpayer infuses money in the form of loan, against the backdrop of regulatory restrictions, it is the substance of the transaction, that needs to be appreciated. It is noteworthy that the Tribunal has taken into account the conversion of loan into equity post regulatory approvals and commercial considerations between entities while adjudging the loan as quasi-capital contribution.

For taxpayers faced with such situations of interest-free loans, it would be important to carefully consider the nature of commercial considerations, terms of conversion, and any regulatory dimensions that have a bearing on intra-group financial arrangements.

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