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## News Alert
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### Borrower's credit analysis core to loan decision - Tribunal upholds profit attribution to PEs of banks @ 20% of fee component

#### In brief

A recent ruling in the case of M/s Credit Lyonnais[1], the Mumbai Bench of the Income-tax Appellate Tribunal ("the Tribunal") held that the role played by the Indian bank branch in relation to credit analysis of Indian borrower are core to the overseas co branch for taking decisions on granting loans to the Indian borrowers. Accordingly, the Tribunal attributed 20% of the fee component received by the overseas co branches to the Indian bank branch for the credit analysis function. The Tribunal held that since the Indian bank branch had not contributed to the loan amount, (which was provided by the syndicate of banks outside India), interest income earned on the loan cannot be considered for attribution of income towards role played by the Indian bank branch.

As per Article 7(2) of Indo-France DTAA and Para 4 of the Protocol between France and India, no profit can be attributed to a permanent establishment (PE) on account of facilitation[2] of conclusion of foreign trade or loan agreements or the mere signing thereof. The Mumbai Bench held that the role played by the Indian bank branch would not fall under such exception. The Tribunal held that the credit analysis performed by the Indian bank branch was core to taking decisions on granting the loan. Accordingly, the Tribunal held that a part of fee income charged by overseas co branches can be attributable to Indian bank branch.

[1] Credit Lyonnais *v.* ADIT (International Taxation) Rg-1 [ITA No.1935/Mum/2007, and ITA No.2032/Mum/2007, Assessment Year 2002-03] and [ITA No.2401/Mum/2009, ITA No.2384/Mum/2009 andC.O.No.205/Mum/2009 for Assessment Year 2003-04]

[2] The taxpayer cited the dictionary meaning to mean "render easier the performance"

## Facts

- The taxpayer (an Indian banking branch) is a multinational bank engaged in banking operations in India. During Financial Year ("FY") 2001-02, the taxpayer facilitated certain foreign currency loans granted to two of its clients based in India by the head office/overseas co-branches outside India.

- The role played by the taxpayer in connection with the foreign currency loans was limited to providing credit analysis of borrower, general market conditions and regulatory environment in India. All other activities, such as client negotiations, final decision-making for granting of loan, execution of loan documents, etc., were performed by the overseas co-branch of the taxpayer outside India.

- The taxpayer contended that no income should be attributed to it for the support provided in connection with the foreign currency loans since its support was merely in the nature of facilitation of conclusion of a loan agreement or signing of such agreement. Accordingly, no specific service was rendered having regard to the Article 7 of Indo-France DTAA and para 4 of the Protocol between France and India.

- During transfer pricing ("TP") assessment proceedings, the transfer pricing officer ("TPO") did not accept the taxpayer's contentions and computed the arm's length price as being 25% of the interest income and fees earned by overseas co-branches on the loans made to the Indian borrowers (which were the taxpayer's existing clients).

- The Commissioner of Income-tax (Appeals) ['CIT(A)'] observed that the TPO made the adjustment on the basis of estimation without any supporting evidence and therefore reduced the adjustment from 25% to 20% of the interest and fee amount.

## Taxpayer's contentions

- As per Article 7(2) of Indo-France DTAA and Para 4 of the Protocol between France and India, no profit could be attributed to a permanent establishment (PE) on account of facilitation[2] of conclusion of foreign trade or loan agreements or the mere signing thereof.

- Since the taxpayer's role was to provide certain information which facilitated the loan agreement or signing thereof, as per Para 4 of the Protocol, no profit could be attributed to the Indian branch on account of such limited support.

- The taxpayer also contended that since it did not perform any functions of an agent or arranger of the loan facility, nor did it fund the loan, it would not be appropriate to attribute any fees related to such functions.

- Since the loan was extended by overseas co-branches to two existing clients of the taxpayer, information relating to the clients' credibility analysis provided by it was already available and no specific effort was undertaken towards providing such information.

- The taxpayer also made an alternative contention that the adjustment made by the CIT(A) using 20% of combined interest and fee income was highly arbitrary. Further, it contended that even if a part of the income be attributed, it should be restricted to the fees earned by the overseas co-branches, and that too, not more than 10%. The taxpayer also made another alternative submission that even if one were to attribute a part of the combined interest and fee income to the taxpayer, it should be in the range of 2% to 5%.

## Revenue's contentions

- The role of the taxpayer was to facilitate the loan transaction by providing the crucial financial analysis of the borrowers, and such activity was not in the nature of "facilitating the loan agreement or signing of loan agreement", but was directly linked to the loan transaction itself (i.e. core to taking the decision of granting the loan). Accordingly, Para 4 of the Indo-France Protocol was inapplicable in the taxpayer's case.

## Tribunal's Ruling

- Rejecting the taxpayer's argument on applicability of Para 4 of the Protocol, the Tribunal observed that " the role of the assessee is not merely facilitation of conclusion of loan agreement or signing thereof but the services provided by the taxpayer are the core-basis for taking the decision of granting the loan by the syndicate. The taxpayer provided the services regarding client's creditability analysis, its capacity so as to consider the capacity to repay the loan and risk involved in the loan transaction. Therefore, the role of the taxpayer in providing such a crucial service is inevitable for taking the decision of providing loan and as such cannot be said to be a mere facilitation of conclusion of the loan agreement or signing thereof."

- The Tribunal held that since the taxpayer's role in providing services was the core basis of taking the decision of granting loan, such services would not fall under the terms of facilitation of conclusion of loan agreement or signing of such agreement for the purpose of Para 4 of the Protocol. Therefore, the Tribunal held that income was attributable to Indian PE.

- The Tribunal observed that since the taxpayer had not contributed to the loan amount, which was provided by the syndicate outside India, interest income should not be attributed to the taxpayer. However, since the taxpayer had provided services, arm's length consideration needed to be determined under TP provisions for the fee received by the overseas co-branches.

- The Tribunal held that the TPO as well as CIT(A) had not used any comparables for determining ALP, but had instead considered total income comprising interest as well fees charged by the overseas co-branches, for allocation/ attribution to the taxpayer.

- The Tribunal therefore directed the TPO to determine ALP by considering only the fee component received by overseas co-branches from the Indian borrowers. The Tribunal held that estimation made by the CIT(A) at 20% was just and proper since the taxpayer and the revenue had both failed to provide any suitable comparables.

## PwC Observations

This ruling of the Mumbai Tribunal is the first of its kind on the subject where Indian bank branches are seen to provide support to their overseas co-branches in connection with foreign currency lending made to Indian borrowers. Our key observations are summarised below:

- Taxpayers should examine their specific fact patterns, and specifically, the role played by the Indian branch involved in the lending transaction, with the objective of identifying the significant functions performed and the revenue base that needs to be considered for profit attribution. In this regard, it is pertinent to note that the Tribunal has not discussed the relative importance of other value-adding functions performed by the persons involved, and the impact of such functions on the attribution of profits.

- Taxpayers should also consider conducting a thorough benchmarking analysis using internal/ external data to support the income that needs to be attributed to their Indian bank branches, with the objective of avoiding any arbitrary attribution to PEs. In this context, the Tribunal has not provided any guidance with respect to suggested comparability analysis.

- The exclusion from attribution provided in the India-France treaty in respect of 'facilitation' services is unique to this treaty and does not exist in treaties which India has signed with other countries. Hence, the observation of the Tribunal on this aspect would be relevant only for French residents. Banks that are residents in other countries would not be able to take a similar defence.

- Being one of the first rulings on the subject, one will need to evaluate the applicability of the same on a case-to-case basis and also note further guidance emerging on this subject in future rulings, particularly with respect to treatment of key functions and appropriate level of attribution based on benchmarking. It would also be interesting to see whether the revenue takes the matter further to higher authorities.

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