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Tribunal rules that Libor is an average rate

The London InterBank Offered Rate better known as Libor is essentially a benchmark giving an indication of the average rate at which a leading bank can obtain unsecured funding in the London interbank market for a given period, in a given currency. It therefore represents the lowest real-world cost of unsecured funding in the London market. It is calculated each day by Thomson Reuters, to whom major banks submit their estimated cost of borrowing unsecured funds for 15 periods of time (ranging from overnight to 12 months) in ten currencies.[1]

Libor forms the basis of many of our transfer pricing benchmarks relating to both banks and corporate financial transactions. Some of the transactions include inter-bank short-term borrowing/lending, corporate short-term borrowing/lending and interest rate derivative transactions.

This is because Libor is the primary benchmark for short-term interest rates globally. It is written into standard derivative and loan documentation such as the ISDA[2] terms, and is used for an increasing range of retail products such as mortgages and college loans. It is used as a barometer to measure strain in money markets and as a gauge of market expectation for future central bank interest rates. It is also the basis for settlement of interest rate contracts on many of the world's major futures and options exchanges.

In this context, its application and acceptability before the Indian Revenue authorities takes on significance especially given the current transfer pricing audit environment. A recent development in this regard, is in the case of The Development Bank of Singapore[3], where the Mumbai Bench of the Income-tax Appellate Tribunal "the Tribunal" has held that the benefit of the 5 percent range is available to the taxpayer since Libor is an average rate and not a single rate. The subject transaction relates to the lending of funds by the taxpayer to its associated enterprises (AEs) and the receipt of interest thereon. The interest receipt was benchmarked using the comparable uncontrolled price (CUP) method with the Libor rate as extracted from the Reuters database forming the CUP. All transaction rates were either favourable or fell within the 5 percent range.

Relevant transfer pricing regulations

The relevant regulations as per the Indian Income-tax Act, 1961 (the Act) and Income-tax Rules, 1962 (the Rules) have been summarised in brief below.

CUP method as per Rule 10B of the Rules

The CUP method considers the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions and any differences materially affecting the price are adjusted for.

Proviso to section 92C(2) of the Act

Where more than one price is determined by the most appropriate method under the Act, the arm's length price (ALP) is taken to be the arithmetical mean of such prices, or, at the option of the taxpayer, a price which may vary from the arithmetical mean by an amount not exceeding 5 percent of such arithmetical mean.

In essence, the benefit of the range would be available only where more than one comparable price has been identified. However, it may be noted that the amended proviso, though not effective for the year under consideration gives the benefit of the range where even a single comparable price has been identified.

Proceedings before the transfer pricing officer

During transfer pricing assessment proceedings, the transfer pricing officer (TPO) did not dispute the applicability of Libor as a basis for benchmarking. However, it was concluded that Libor was a single rate and therefore the benefit of the 5 percent range should not be available to the taxpayer. The TPO therefore proceeded to make an adjustment, being the differential arrived at for lending transactions where the rate charged was lower than the Libor rate.

It is pertinent to note that the issue at hand was not principally whether the Libor rate is an average rate since that is quite apparent. Rather, it was the contention of the Indian Revenue that in order to avail of the benefit of the 5 percent range, it is necessary that there should be more than one price determined by the most appropriate method as per rule 10B of the Income-tax Rules, 1962 (the Rules), which should then be averaged. Since the taxpayer had only submitted Libor rates as comparable transactions (which the transfer pricing officer treated as a single price), the benefit of the range was denied and a resultant addition made by the TPO.

Tribunal ruling

However, the Tribunal ruled that the Libor cannot be considered a rate in itself at which a bank is willing to borrow/lend but is an average of rates at which various banks offer to borrow/lend. This was based on the documents and explanation provided by the taxpayer and the Indian Revenue.

Furthermore, while deliberating on the issue at hand, the Tribunal has also given its observations on the amended proviso to section 92C(2) of the Act substituted by the Finance (No. 2) Act, 2009, which is effective from October 1, 2009 (including for any assessment or reassessment proceedings open as of that date). Keeping in view the language used in the amended proviso, the Tribunal has noted that the benefit of the range shall extend not only to a situation where more than one ALP is determined by the most appropriate method, but also where only one price is determined as the ALP.

Observations

This ruling of the Mumbai Tribunal is an important and welcome pronouncement in the context of benchmarking of financial market transactions and situations where a single published market rate is used as a CUP. However, there are certain important aspects which would need to be kept in perspective based on industry practices and the manner in which banks normally operate.

Market prices move during the day. There are, therefore, variations from the benchmark rates extracted/ captured at different points in time. In such situations where the transacted rate falls outside the tolerance band, banks should seek recourse to their internal control procedures to demonstrate the ALP. Banks have internal control mechanisms which govern the rate at which they undertake financial market transactions such as lending/borrowing. There is usually a pre-defined tolerance band beyond which a transaction cannot be undertaken and in the event this threshold is crossed (for reasons such as sudden market volatility); there is a requirement for clarification/substantiation. These mechanisms are applicable to both third parties and AEs and help ensure that such transactions are entered into at market rates.

Similar to the analysis undertaken to determine whether Libor is a single rate or an average rate, an evaluation would need to be undertaken for other financial market transactions where the rate is derived from a database. This would include rates for foreign exchange transactions (such as spot and forward contracts), fixed deposits, debt instruments, etc.

Although Libor continues to be the primary benchmark for short-term interest rates globally, one would need to observe the developments in this area closely, given the recent controversy surrounding the Libor rate.

Other than the primary outcome, with respect to Libor being an average and not a single rate, the observations of the Tribunal on the amended proviso to section 92C(2) of the Act are also very significant, especially for taxpayers who have been denied the benefit of the tolerance band on account of having identified only a single price.

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The views expressed in this article are those of the authors and not necessarily those of the firm.

NOTES

[1] http://www.bbalibor.com/bbalibor-explained & Bloomberg Database.

[2] International Swaps and Derivatives Association, Inc. which is the global trade association for over the counter (OTC) derivatives and maintains the standard documentation for the industry.

[3] The Development Bank of Singapore vs. DDIT (International Taxation) 1(2) (ITA No. 6631/Mum/2006 & CO 248/Mum/2009: Assessment Year 2002-03).