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News Alert
21 May 2013



Tribunal rules that LIBOR is an average rate

In brief

In a recent ruling in the case of The Development Bank of Singapore¹, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) has held that the benefit of the 5% range² is available to the taxpayer since the LIBOR³ is an average rate and not a single rate.

¹ The Development Bank of Singapore v. DDIT (IT) [TS-112-ITAT-2013(Mum)-TP]

² As per the first proviso to section 92C(2) of the Income-tax Act, 1961 (the Act) which is valid for assessment year 2002-03.

³ The LIBOR 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 10 currencies. It is essentially a benchmark giving an indication of the average rate at

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.

In addition to the above, the Tribunal has made important references to the amended proviso to section 92C(2) of the Act and the availability of its benefit to taxpayers even where one price is determined as the arm's length price (ALP).

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.

Facts

- The taxpayer is a multinational bank engaged in banking operations in India. During financial year (FY) 2001-02, the taxpayer had entered into lending and borrowing transactions with its head office and branches where it has received interest/ made interest payments. The benchmarking of the interest payments on borrowings was not disputed.
- With respect to interest received, the taxpayer had earned interest income of INR 2.776 million at varying rates. The taxpayer benchmarked the interest rate charged on a transaction by comparing it to the relevant LIBOR rate on the transaction date as extracted from the Reuters database.
- There was no transaction where the difference in the rate actually charged and the LIBOR rate was greater than 5%.
- During transfer pricing (TP) assessment proceedings, the transfer pricing officer (TPO) did not dispute the applicability of LIBOR as a basis for benchmarking. However, it was concluded that the LIBOR was a single rate and therefore the benefit of the 5% range should not be available to the taxpayer.
- The TPO proceeded to make an adjustment of INR 0.05 million, being the differential arrived at for lending transactions where the rate charged was lower than the LIBOR rate.
- However this addition was subsequently deleted by the Commissioner of Income-tax (Appeals).

Taxpayer's contentions

- The LIBOR rate is not a rate in itself but an average of the rates submitted by various banks. Therefore, it cannot be considered to be a single rate and the benefit of the 5% range should be available to the taxpayer.
- Since there was no transaction where the difference in the rate actually charged and the LIBOR rate was greater than 5%, the prices of all lending transactions were in accordance with the arm's length standard.

Revenue's contentions

In order to avail of the benefit of the 5% 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 TPO treated as a single price), the benefit of the range was denied and a resultant addition made by the TPO.

Tribunal Ruling

While adjudicating the appeal on this ground, the Tribunal has essentially given its comments on two aspects which are outlined below:

LIBOR being an average rate

- The Tribunal has held that the benefit of the 5% range should be available to the taxpayer and stated that the deletion of the adjustment by the Commissioner of Income-tax (Appeals) was justified.
- This is on account of the fact that the LIBOR cannot be considered a rate in itself at which a bank is willing to borrow/lend, but an average of rates at which various banks offer to borrow/lend. Based on the documents placed on record by the taxpayer and the Revenue, the definition of LIBOR (source : Wikipedia) and how LIBOR rates are calculated has been dwelt upon in detail by the Tribunal.
- As a result of the above, the Tribunal deduced that the LIBOR is nothing but an arithmetical mean of rates and cannot be characterised as one price determined under the CUP method.

Single price ALP also entitled to tolerance band

- 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 vide the Finance (No. 2) Act, 2009⁴, which is effective from 1 October 2009

(including for any assessment or reassessment proceedings open as on that date).

- Keeping in view the language used in the amended proviso, the Tribunal has noted that the benefit of the range⁵ 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.
- However, since the taxpayer's case was relevant to assessment year 2002-03, it would be governed by the single proviso to section 92C(2) as it stood prior to such amendment.

PwC Observations

This ruling of the Mumbai Tribunal is an important and welcome pronouncement in the context of benchmarking of financial market transactions and other similar 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 due to which there would be variations from the benchmark rates extracted/ captured at different points of 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..
- Though the 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 the 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 single price.

⁴ The relevant excerpts of the section have been reproduced below:

“(2) The most appropriate method referred to in sub-section (1) shall be applied for determination of arm's length price, in the manner as may be prescribed:

[Provided that where more than one price is determined by the most appropriate method, the arm's length price shall be taken to be the arithmetical mean of such prices:

Provided further that if the variation between the arm's length price so determined and price at which the international transaction has actually been undertaken does not exceed [such percentage of the latter.....], the price at which the international transaction has actually been undertaken shall be deemed to be the arm's length price]”

⁵ Erstwhile tolerance band of 5% substituted vide notification no. 30/2013 [F.NO.500/185/2011-FTD-I], dated 15-4-2013 whereby for FY 2012-13 notified - 1% for wholesale traders and 3% for others

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Our offices

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Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	Bangalore 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	Chennai 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006, India Phone +91 44 4228 5000	Hyderabad #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600	Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-033 - 2357 9101/4400 1111 Fax: (91) 033 - 2357 2754
Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	Gurgaon Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	Pune GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, <pwctr.knowledgemanagement@in.pwc.com< p=""> </pwctr.knowledgemanagement@in.pwc.com<>	

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