

**IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION**

INCOME TAX APPEAL NO.266 OF 2017

The Principal Commissioner of
Income Tax-3

.... Appellant

versus

M/s India Debt Management Pvt. Ltd.

... Respondent

.....

- Mr.A.R. Malhotra a/w Mr.N.A Kazi, Advocate for Appellant.
- Mr.Jehangir Mistri, Senior Counsel, a/w Mr.Sameer Dalal, Advocate for Respondent.

**CORAM : AKIL KURESHI &
SARANG V. KOTWAL, JJ.
DATE : 15th APRIL, 2019.**

P.C. :

1. This Appeal is filed by the revenue to challenge a judgment of Income Tax Appellate Tribunal. Following questions were presented for our consideration;

(a) Whether, on the facts and in the circumstance of the case and in law, the Hon'ble Tribunal erred in comparing the overall average rate of interest of 11.30% during the year without appreciating that

each series of debentures issued in different years was a separate international transaction and each transaction was required to be benchmarked separately?

- (b) *Whether, on the facts and in the circumstance of the case and in law, the Hon'ble Tribunal erred in not appreciating the fact that the amount of disallowance u/s 14A of the Act has to be computed as per Rule 8D of the I.T. Rules, 1962 as held in the order of the Hon'ble High Court in the case of M/s Godrej & Boyee Manufacturing Co. Ltd.?*
- (c) *Whether, on the facts and in the circumstance of the case and in law, the Hon'ble Tribunal erred in deleting the addition on account of interest accrued from (1) Brandhouse Retails Ltd. (2) Sanghi Inds Ltd. and (3) Ganesh Benzoplast Ltd. holding that these three parties had become NPA?*

2. Regarding question (a) -:

The issue relates to assessment year 2010-2011. The Respondent-Assessee is a company registered under the Companies Act and it is a Non-Banking Finance Company

(‘NBFC’ for short). The assessee is engaged in the business of identifying the investment opportunities in financially distressed companies, which otherwise have inherent viable business proposition. The assessee acquires and invests in such medium size enterprises which are in financial distress. This essentially makes the investments of the assessee company a high risk investment. The credit rating of the assessee company therefore is categorized as ‘BBB-’. The assessee raised funds through debt instruments from group companies by issuing compulsory convertible debentures. The rate of interest of such borrowing from its Associate Enterprises (‘AE’ for short) by the assessee was the subject matter of transfer pricing adjustments. It was noticed that the assessee had issued such debentures by paying interest at the rate of 7% in the year 2006. Later borrowings were at higher rate of interest ranging from 9.75 to 14%. Average interest rate of such CCDs came to 11.30%.

The Transfer Pricing Officer undertook Arm’s length adjustments and held that the interest paid by the assessee to

the AEs was not at Arm's length. He made adjustment of a sum of Rs.48.53 out of total interest payment 98.44 crores paid by the assessee. This issue was therefore carried by the assessee before the tribunal. Tribunal by the impugned judgment deleted the addition making following observations;

"13. Now coming to the issue, whether the arm's length interest rate arrived at by the TPO and endorsed by the DRP by adopting USD Corporate Bond Rate and LIBOR interest rate based on external commercial borrowing is justified in the present case or not. First of all, as stated in the foregoing paragraphs and reiterated several times that the CCDs have been issued in INR denominated debt and the interest paid / payable is also in terms of INR. Once the tested transaction is in INR denominated debt, then interest rate must necessarily be based on economic and market factors affecting Indian currency and data available for debt issuances in India or INR denominated rather than foreign currency rate or external data. The base rate on which interest rate depends is directly related to the currency or denomination of issuance and, therefore, it should be taken into account according to the market conditions prevalent in the country of such currency, here in this case India. The market conditions capable of capturing best of the rates do not depend much on any place but rather on currency concern, because the supply and demands of funds in a specific currency the price/interest rates for funds denominated in that currency. Hence, cost of borrowing funds

denominated in INR or lending rates based on INR loans/debt instrument issuances is more reliable and ideal base for benchmarking similar transactions undertaken by the companies or entities with similar ratings.

14. *The TPO and DRP in our opinion have committed a fallacy, firstly, by considering the AE as a “tested party” and secondly, relying upon USD Corporate Bond Rates to benchmark the ALP of the interest rate because the interest rates for bonds or loan has to be seen from the point of view of borrowers creditworthiness and not the lender’s creditworthiness. Thus, the entire approach of the TPO/DRP in applying USD Corporate bond rates to benchmark the interest transaction in a blanket manner is not correct. As pointed out by Ld. Senior counsel, now, Hon’ble Delhi High Court in the case of **Cotton Naturals P Ltd. (supra)** have held that, arm’s length interest rate should be computed based on market determined interest rate applicable to currency in which loan has to be repaid. The relevant observation of the Hon’ble High Court in this regard reads as under:-*

“39. The question whether the interest rate prevailing in India should be applied, for the lender was an Indian company/assessee, or the lending rate prevalent in the United States should be applied, for the borrower was a resident and an assessee of the said country, in our considered opinion, must be answered by adopting and applying a commonsensical and pragmatic reasoning. We have no hesitation in holding that

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40. The aforesaid methodology recommended by Klaus Vogel appeals to us and appears to be the reasonable and proper parameter to decide upon the question of applicability of interest rate. The loan in question was given in foreign currency i.e. US \$ and was also to be repaid

in the same currency i.e. US \$. Interest rate applicable to loans granted and to be returned in Indian Rupees would not be the relevant comparable. Even in India, interest rates on FCNR accounts maintained in foreign currency are different and dependent upon the currency in question. They are not dependent upon the PLR rate, which is applicable to loans in Indian Rupee. The PLR rate, therefore, would not be applicable and should not be applied for determining the interest rate in the extant case. PLR rates are not applicable to loans to be re-paid in foreign currency. The interest rates vary and are thus dependent on the foreign currency in which the repayment is to be made. The same principle should apply”.

If we apply the same ratio, then arm's length interest rate should be based on INR in which CCDs has been issued and the currency in which interest is being paid and not on any foreign currency lending rate. Thus, respectfully following the aforesaid ratio, we reject the TPO's application of USD Corporate Bonds Rate as well as the LIBOR rate for benchmarking the interest transaction in this case.

15. *The last leg of the controversy is, whether the benchmarking analysis done by the assessee is correct or not and whether the average rate of interest of 11.30% paid by the assessee to its AE is at ALP or not. So far as the assessee's benchmarking*

analysis as done in TP Study report based on external data using Thomson Reuters' DealScan, and Bloomberg Database, we find that such an approach is not correct, firstly, there are no INR denominated debt issuance available on such databases and; secondly, in absence of such a data the assessee has to carry out huge adjustments on account of country risk, currency risk and tenor risk. With all these factors of adjustments, it would be difficult to arrive at an appropriate arm's length range of price; therefore, in our opinion such an approach of the assessee for benchmarking the arm's length interest rate may not be correct. However, as regards the search undertaken for comparable debt issuances in BSE data, we find that the assessee has shortlisted two comparables namely; Starlight Systems Private Limited and Share Microfin Limited which have a coupon rate of 15% and 13.75%. Since these data belong to year 2013, the assessee had made minor tenor adjustment to factor the time period to arrive at interest rate of 15.97% and 14.05% giving a mean rate of 15.01%. Though the assessee was required to benchmark its transaction by taking the financial year data for year 2009-10, but, if such a data were not available then it cannot be held that such a tenor adjustment for taking into time period cannot be made under CUP, if it has been made quite accurately taking into account the material factors relating to time of the transaction affecting the price. We though agree that, a high degree of comparability is required under CUP, but in absence of such a comparable data, a minor adjustment can be made to eliminate the material effect of time difference for arriving at a comparable uncontrolled price. Now before us, the assessee had filed two

comparable transactions for the year 2009, that is, for the same financial year in the case of Shriram Transport Financial Company Ltd. and Tata Capital Ltd., wherein, for credit rating of AA Enterprises the coupon rate of interest per annum was between 11% to 12% for a tenor of 60 months. The yield on redemption is also around 11.25% to 12%. If for a credit rating company AA or AA(+) the interest rate is ranging between 11% to 12%, then in the case of the assessee which is admittedly BBB(-) credit rating company, 11.30% interest paid by the assessee to its AE is much within the arm's length rate. This data/document from public domain now made available before us is worth relying to benchmark and analyze the current transaction of coupon rate of interest paid/payable on CCDs issued by the assessee. Accordingly, we hold that 11.30% interest rate is at arm's length price. Thus, in our conclusion, the transfer pricing adjustment made by the TPO and as confirmed by the DRP at Rs.48,53,19,310/-stands deleted and consequently ground no. 1 is allowed."

3. Having heard learned Counsel for the parties and having perused the materials on record, we are broadly in agreement with the view of tribunal. The significant features of the assessee's case were that the assessee was mainly engaged in identifying the companies in financial distress whose products were otherwise viable and taking over or financing of such

companies. The business of the assessee was thus fraught with inherent risks. Its credit rating therefore was relatively low of 'BBB-'. The assessee was raising funds for such investments through issuance of debentures to its AEs. The tribunal even on comparison found that the average rate of interest of 11.30% paid by the assessee to its AEs was not excessive and was in any case lower than in the comparable instances. The tribunal rejected the transfer pricing adjustment comparing the rate of return for the assessee's US based AE. This later conclusion of the Tribunal is supported by following decisions.

4. Division Bench of Delhi High Court in case of *Commissioner of Income Tax Vs. M/s Cotton Naturals (I) Pvt. Ltd., reported in (2015) 55 Taxmann.com 523*, had held and observed as under;

“39. The question whether the interest rate prevailing in India should be applied, for the lender was an Indian company/assessee, or the lending rate prevalent in the United States should be applied, for the borrower was a resident and an

assessee of the said country, in our considered opinion, must be answered by adopting and applying a commonsensical and pragmatic reasoning. We have no hesitation in holding that the interest rate should be the market determined interest rate applicable to the currency concerned in which the loan has to be repaid. Interest rates should not be computed on the basis of interest payable on the currency or legal tender of the place or the country of residence of either party. Interest rates applicable to loans and deposits in the national currency of the borrower or the lender would vary and are dependent upon the fiscal policy of the Central bank, mandate of the Government and several other parameters. Interest rates payable on currency specific loans/deposits are significantly universal and globally applicable. The currency in which the loan is to be re-paid normally determines the rate of return on the money lent, i.e. the rate of interest. Klaus Vogel on Double Taxation Conventions (Third Edition) under Article 11 in paragraph 115 states as under:-

"The existing differences in the levels of interest rates do not depend on any place but rather on the currency concerned. The rate of interest on a US \$ loan is the same in New York as in Frankfurt-at least within the framework of free capital markets (subject to the arbitrage). In regard to the question as to whether the level of interest rates in the lender's State or that in the borrower's is decisive, therefore, primarily depends on the currency agreed upon (BFH BSt. B1. II 725

(1994), re. 1 AStG). A differentiation between debt-claims or debts in national currency and those in foreign currency is normally no use, because, for instance, a US \$ loan advanced by a US lender is to him a debt-claim in national currency whereas to a German borrower it is a foreign currency debt (the situation being different, however, when an agreement in a third currency is involved). Moreover, a difference in interest levels frequently reflects no more than different expectations in regard to rates of exchange, rates of inflation and other aspects. Hence, the choice of one particular currency can be just as reasonable as that of another, despite different levels of interest rates. An economic criterion for one party may be that it wants, if possible, to avoid exchange risks (for example, by matching the currency of the loan with that of the funds anticipated to be available for debt service), such as taking out a US \$ loan if the proceeds in US \$ are expected to become available (say from exports). If an exchange risk were to prove incapable of being avoided (say, by forward rate fixing), the appropriate course would be to attribute it to the economically more powerful party. But, exactly where there is no 'special relationship', this will frequently not be possible in dealings with such party. Consequently, it will normally not be possible to review and adjust the interest rate to the extent that such rate depends on the currency involved. Moreover, it is questionable whether such an adjustment could be based on Art. 11 (6). For Art. 11(6), at least its wording, allows the authorities to

_eliminate hypothetically' the special relationships only in regard to the level of interest rates and not in regard to other circumstances, such as the choice of currency. If such other circumstances were to be included in the review, there would be doubts as to where the line should be drawn, i.e., whether an examination should be allowed of the question of whether in the absence of a special relationship (i.e., financial power, strong position in the market, etc., of the foreign corporate group member) the borrowing company might not have completely refrained from making investment for which it borrowed the money." "

5. Similarly this Court in case of **Commissioner Income Tax-2, Vs. Tata Autocomp Systems Ltd., reported in 374 ITR 516**, had observed as under;

“7. We find that the impugned order of the Tribunal *inter alia* has followed the decisions of the Bombay Bench of the Tribunal in cases of *VVF Ltd. v. Dy. CIT (supra)* and *Dy. CIT v. Tech Mahindra Ltd. (supra)* to reach the conclusion that ALP in the case of loans advanced to AEs would be determined on the basis of rate of interest being charged in the country where the loan is received/consumed. Mr. Suresh Kumar the learned counsel for the Revenue informed us that the Revenue has not preferred any appeal against the decision of the Tribunal in *VVF Ltd. v. Dy. CIT*

(supra) and Dy. CIT v. Tech Mahindra Ltd. (supra) on the above issue. No reason has been shown to us as to why the Revenue seeks to take a different view in respect of the impugned order from that taken in VVF Ltd. v. Dy. CIT (supra) and Dy. CIT v. Tech Mahindra Ltd. (supra). The Revenue not having filed any appeal, has in fact accepted the decision of the Tribunal in VVF Ltd. v. Dy. CIT (supra) and Dy. CIT v. Tech Mahindra Ltd. (supra). ”

6. Before closing this issue we may note that the tribunal in the impugned judgment has made certain observations suggesting that the identification of the “tested party” is imperative while applying other methods from comparison for transfer pricing and not while applying CUP method. Our non-consideration of the revenue’s Appeal in the present case, should not be seen as putting our seal on such observations of the tribunal. In other words, we keep such question open to be examined in an appropriate case. In the present case, independent of such observations of the tribunal, we find that the conclusions arrive at, are based on evidence on record which conclusions call for no interference.

7. Regarding question (b) -:

The issue is no longer res-integra. The facts are that the assessee had not earned any exempt, income during the year under consideration. As held earlier Delhi High Court which judgment is also followed repeatedly by our Court, in case of *Chemvinvest Ltd. Vs. Commissioner of Income Tax, reported in 378 ITR 33*, in such a case disallowance of expenditure under section 14A of the Act would not be permissible. The decision of Delhi High Court was carried in the appeal by the revenue. The SLP has been dismissed by the Supreme Court.

8. Regarding question (c) -:

We find that such an issue has been examined by this Court. The question is of taxing interest on NPA on accrual basis as argued by the revenue. The assessee however argues that it was under the directives of RBI not to recognize interest of such NPAs on accrual basis but to offer the receipt on actual basis which the assessee in the later year had done and offered it to tax.

9. In a recent judgment dated 02/04/2019 in Income Tax Appeal No.237/17 and connected Appeal in case of ***Principal Commissioner of Income Tax-5 Vs. Bajaj Finance Limited***, this Court in context of a similar issue had held as under;

“6. Gujarat High Court in case of ***Principal CIT Vs. Mahila Sewa Sahakari Bank Ltd***¹ had held that in case of a co-operative bank, the interest on NPAs would not be chargeable to tax on mere accrual. The Court referred to and relied upon the decision of the Supreme Court in the case of ***Southern Technologies Ltd Vs. Joint CIT***². We may note that the decision concerns the assessment year 2010-11 when a co-operative bank was not included under Section 43D of the Act which was inserted by Finance Act, 2017 w.e.f 1.4.2018.

7. In case of ***CIT Vs. Deogiri Nagari Sahakari Bank Ltd & Ors.***³, this Court had expressed a similar view. We may further clarify that in the said case, the Court was concerned with a similar claim raised by the co-operative bank and the Court did record that the assessee was a co-operative bank and not NBFC. However, this distinction may not have much significance now in view of the fact that this Court in case of ***CIT Vs. M/s. KEC Holdings Ltd*** (Income

Tax Appeal No. 221 of 2012 decided on 11.6.2014) held and observed as under:-

"8. The assessee had credited only an amount of Rs.38,57,933/-as interest on loans. The Assessing Officer was of the view that the interest accrued on the entire loans should have been shown as income. The details as to how the interest income on accrual basis should have been disclosed are, therefore, referred to by the Tribunal. The Tribunal held that the said income was not realized. It held that the assessee follows the mercantile system of accounting. The Tribunal held that the loan advanced by the assessee which was in NBFC had become non-performing asset. That is how following judgments rendered by the Hon'ble Supreme Court and the Delhi High Court, the Tribunal has eventually held that once there is no dispute that the interest considered as accrued was a non-performing asset as per Reserve Bank of India guidelines, then, the income from this interest did not accrue to the assessee. It is in such circumstances, that this income in question was not and cannot be assessed on accrual basis.

We do not find that the Tribunal has either misdirected itself in law or its order can be termed as perverse warranting interference in our appellate jurisdiction. We find that the view taken by the Tribunal accords with the Reserve Bank of India guidelines and which are not

in any way in conflict with the Income Tax Act, 1961, the Hon'ble Supreme Court has held in the case of UCO Bank that the interest income would have been brought to the Profit and Loss Account provided it was actually realized, that in case of Nationalized Bank it treated something which is doubtful, and therefore, kept it in a suspense account, was held to be a permissible exercise. In respect of the loans which are advanced, recovery of some of them if considered doubtful, then, even the interest on the loans advanced may not be realized. That is how the amount is not brought to the profit and loss account because they are not likely to be realized by the bank or a NBFC as well. It is permissible therefore to disclose or to show them as income in assessment year in which either the interest amount or part of it is recovered. The Tribunal in this case, namely, of the assessee before us, has precisely followed this course. We do not find that the course permitted and upheld by the Tribunal is in any way in conflict with any legal provisions or the settled principles. Rather as held by us, it is in accordance with the same. Once the view taken by the Tribunal was possible and in the given facts and circumstances the income has not been realized by the assessee, the addition was rightly deleted. We, therefore, do not find that the appeal raises any substantial question of law. It is accordingly dismissed. No costs."

8. *Delhi High Court in case of CIT Vs. Vasisth Chay Vyapar Ltd⁴ held that interest on NPAs cannot be taxed on accrual basis. It was noted that NBFC would be governed by the directions issued by the Reserve Bank of India and RBI directives provided that under certain circumstances, a loan or advance would be treated as NPA. The Court on the real income theory held that such interest would not be taxable. We notice that the decision of the Delhi High Court in case of Vasisth Chay Vyapar Ltd (supra) was carried in the appeal by the Revenue before the Supreme Court. The Supreme Court in the judgment reported in [2018] 253 Taxman 401 (SC) approved the decision of the High Court and dismissed the appeal. Under these circumstances, this question is not entertained.”*

10. In the result the Income Tax Appeal is dismissed.

(SARANG V. KOTWAL, J.)

(AKIL KURESHI, J.)