Share application money cannot be recharacterized as interest-free loans

The recent order issued by the Income-Tax Appellate Tribunal (ITAT), Delhi bench, in the case of Bharti Airtel, has dealt with another important issue by holding that payment of share application money to various overseas subsidiaries cannot be partly treated as interest free loans to these subsidiaries.

The issue came up for hearing before the ITAT relating to the assessment year 2008-09. The taxpayer (Bharti Airtel) had issued share application money to various overseas subsidiaries aggregating to Rs 110 crore.

Background: In this matter, the transfer pricing officer (TPO) did not question the character of payment — in other words he didn't dispute that the transactions in question were capital contributions towards share application.

A transfer pricing adjustment was made by the TPO because after the initial advancement of money as share application, shares were not allotted for a considerable long period of time - almost 13, 16 and 14 months had lapsed from the date of advancement in the cases of share application money advanced to Airtel's subsidiaries in UK, US and Hong Kong.

The TPO was of the view that "any independent entity would not have left the amount in the hands of another entity without the same being converted into equity within a reasonable period or receiving interest on the same". It was in this backdrop that the TPO proceeded to treat these amounts as interest free loans extended to the subsidiaries (which in transfer pricing parlance would be referred to as Associated Enterprises). The Dispute Resolution Panel agreed with the TPO's views and held: "We agree with the TPO that capital locked up for want of transfer of shares for a reasonably long period would partake the nature of loan."

Tribunal's order: The ITAT observed that the TPO treated the transactions partly as an interest free loan - for the period between the dates of payment till the date on which the shares were actually allotted, and partly as capital contribution, i.e. after the subscribed shares were allotted by the subsidiaries in which capital contributions were made. "No doubt, if these transactions are treated as in the nature of lending or borrowing, the transactions can be subjected to ALP adjustments, and the ALP so computed can be the basis of computing taxable business profits of the taxpayer. But the core issue before us is whether such a deeming fiction is envisaged under the scheme of the transfer pricing legislation or on the facts of this case. We do not find so, we do not find any provision in law enabling such deeming fiction," said the ITAT in its order.

The ITAT held: It is not open to the TPO to re-characterise the transaction unless it was found to be a sham or bogus transaction, in the present case, the transaction was genuine as subscribed share capital had been allotted to Bharti Airtel. The ITAT added that there was no finding by the TPO as to what constituted a reasonable and permissible time period for allotment of shares. At best, the TPO could have treated the share application money as an interest free loan only for the period of 'inordinate delay' and not the entire period between the date of making the payment and the date of allotment of shares. The TPO also did not substantiate what interest an unrelated share applicant would have received for the period between paying the share application money and actual allotment of shares to it. The very foundation of the transfer pricing adjustment made by the TPO was held to be devoid of legally sustainable merits. The ITAT ordered deletion of the transfer pricing adjustment of Rs. 19 crore.

PwC in its communique sounds a word of caution, it states: For corporate guarantees issued to overseas related parties (such as subsidiaries), apart from resorting to legal arguments as taken by Bharti Airtel, it would nonetheless be advisable for taxpayers with similar transactions to agree the terms based on commercial and transfer pricing principles. In this regard, international best practices of considering shareholding nature of functions, creditworthiness of borrower, implicit or explicit support, comparable intra-group financial arrangements, may be considered. It would be prudent to follow such an approach also because the verdict of the ITAT in this case is based on legal principles, which could possibly be overturned by either clarifications or amendments to the law (as has happened in the past) or by intervention at higher judicial forums.

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