Daily Tax Report: International
Oct. 16, 2023, 12:30 PM GMT+5:30

LIBOR Transition in India Should Prompt Businesses to Prepare

Rahul Charkha, Arpita Choudhary, and Saurabh Bora of Economic Laws Practice look at the impending transition from LIBOR to alternative reference rates from an Indian tax and transfer pricing perspective.

The London Interbank Offered Rate, a benchmark that underpinned financial transactions for decades, is being phased out due to several concerns. In its wake, alternative reference rates or ARR, emerge as the chosen successor—a suite of reference rates designed to be more robust, transparent, and reflective of the current financial markets.

Transition

LIBOR is an interest rate based on the average reported interest rate at which major global banks can borrow from each other on an unsecured basis. It's published for five currencies—the euro, Swiss franc, Japanese yen, pound sterling, and US dollar.

In the fallout of the global financial crisis of 2008, questions around LIBOR's validity as a benchmark rate arose. Consequently, the Intercontinental Exchange Benchmark Administration decided to cease publication of LIBOR in a phased manner from Dec. 31, 2021 to June 30, 2023. Post June 30, the publication of LIBOR rates has completely ceased for all maturities—overnight and one, three, six, and 12 months.

After the cessation of LIBOR, each jurisdiction has published its own ARR, such as the Secured Overnight Financing Rate in the US, the Sterling Overnight Index Average in the UK, Euro Short-Term Rate in the euro zone, Swiss Average Rate Overnight in Switzerland, and Tokyo Overnight Average Rate in Japan.

Notably, European Central Bank regulations were also amended to insert ARR as a "benchmark rate" for the computation of the all-in-cost ceiling after the cessation of LIBOR.

The Reserve Bank of India requested in 2021 that banks frame a broad plan to address the risk arising from the cessation of LIBOR and begin preparation for adopting the ARR.

The Reserve Bank urged banks to consider ARR as a benchmark rate instead of LIBOR for entering new contracts and to amend existing contracts—by way of a fallback clause that defines what happens if LIBOR becomes unavailable or is no longer representative, which would then provide reference to ARR.

In India, the Mumbai Interbank Forward Outright Rate, or MIFOR, provides reference to LIBOR as one of its components. On June 23, the Reserve Bank of India granted approval for publication of a modified MIFOR that may be used as a "significant benchmark" after the cessation of LIBOR.

Transfer Pricing

From a transfer pricing perspective, financial assistance in the form of debt between associated enterprises is treated as "international transactions" and required to be at arm's length. For the determination of arm's length price, prevailing market rates are considered. Historically, foreign currency loans are benchmarked at LIBOR plus spread.

Further, safe harbor rules in Rule 10TD of the Income Tax Rules, 1962 (extended to assessment year 2023–24 by Central Board of Direct Taxes notification of Aug. 9) and secondary adjustment rules (Rule 10CB) provide reference to LIBOR for benchmarking of interest on intragroup foreign currency loans.

The existing legislation and rules don't acknowledge the need for use of ARR for benchmarking foreign currency loans. However, due to the cessation of LIBOR, practically, foreign currency loans from associated enterprises would now be benchmarked at the relevant foreign currency ARR.

Way Ahead

It's important to ensure detailed documentation is produced towards the transition from LIBOR to ARR, keeping the following recommended steps in mind.

Identified loan agreements should be amended by way of fallback clauses to incorporate ARR as the reference rate.

While preparing transfer pricing study reports beyond financial year 2023–24, benchmarking of inter-company loans should be carried out according to suitable foreign currency ARR instead of LIBOR. Initial challenges could include scarcity of comparables, so it becomes relevant to provide a detailed note in the function asset and risk analysis justifying the benchmark rate and its alignment with policies.

It may be relevant to include details such as interest rate differentials, market conditions, and other factors affecting the determination of the new rate.

In the case of floating rate loans, evaluation may be required for impact of thin capitalization rules.

Section 194LC of the Income-tax Act, 1961 provides a concessional tax rate (5% plus applicable surcharge and cess) for interest income earned by nonresidents or a foreign company on account of a loan agreement entered on or before June 30. Interest income arising from loan agreements entered after this time would be taxed at 20% (plus applicable surcharge and cess).

To avoid any challenge to the concessional tax rates, it's critical to ensure that existing loan agreements are amended by way of addendum with reference to the existing agreement and background for change in terms of interest.

Appropriate disclosures may be required in the financial statements and the statutory audit report on impact on finance cost due to the change in the benchmark rate while discounting the contractual cash flows arising from existing contracts.

As we find ourselves on the verge of this transformative shift, it's imperative to prioritize detailed documentation and compliance. Comprehensive records are crucial for substantiating this change and for safeguarding the company's transfer pricing practices in the face of assessments, audits, and reviews.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.

Author Information

Rahul Charkha is a partner, Arpita Choudhary is principal associate, and Saurabh Bora is an associate with Economic Laws Practice Advocates & Solicitors.

We'd love to hear your smart, original take: Write for us.

© 2023 Bloomberg Industry Group, Inc. All Rights Reserved