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# Article

## Guarantee Fee – No interest on lending credit-worthiness

By **Subhashree R**

*'The payments relating to debt claims, service fee or other charge, could be characterized as interest provided there is privity of such contract.'*

In its recent ruling, *Johnson Matthey Public ltd. Company v. DCIT, [2017] 88 taxmann.com 127 (Delhi-Trib.)* on taxability of guarantee fee received by a foreign parent, ITAT Delhi, held that guarantee fee will not qualify as interest under the India-UK DTAA (the Treaty) or the Income Tax Act, 1961 (the Act), since it can relate only to payment by a person who has received some amount pursuant to a loan transaction. The appellant -assessee had entered into a global guarantee agreement outside India with two banks. In terms of the agreement, the banks advanced loans to the Indian subsidiaries of the assessee and the assessee received guarantee fee. It offered the sum to tax as interest though it was of the opinion that the income did not arise in India and was not taxable in India. Alternately, the assessee also contended that the income was either business income or FTS in terms of Treaty. The Assessing Officer however made an addition of the income holding that the income did not qualify as interest and since there was no specific provision in the Treaty dealing with guarantee fee, the same was taxable as Other Income (Article 23).

The assessee sought to rely on an earlier ruling of ITAT, Mumbai dated 28-3-2016 in *Capgemini SA v. DCIT (International Taxation), ITAT No. 7198/Mum/2012* wherein the Tribunal had held that guarantee fee paid to overseas parent under the terms of a global agreement for corporate guarantee, as not taxable in India since the income arose outside India. However, the Delhi Tribunal arrived at a different decision based on the following reasons.

### *It is necessary that the assessee should be a party to the loan transaction that gives rise to 'guarantee fee'*

A debt may be understood as an obligation to pay a sum of money at present or at a future date. A claim can be understood as an assertion of a right (in relation to the debt).

Article 12 of the India-UK DTAA defines interest as below:

'*term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from Government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures but, subject to the provisions of paragraph 9 of this Article, shall not include any item which is treated as a distribution under the provisions of Article 11 (Dividends) of this Convention*

The definition as per Section 2 (28A) in the Act is wider and includes any service fee or other charge in respect of moneys borrowed. The Explanatory note to the OECD Model Convention states that interest is the remuneration received for making capital available. This is in conformity with the classic economic definition of interest being the reward for capital. However the wider definition in the Act would include service charges in respect of the debt.

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The ITAT held that to qualify as interest, the payment must be made by the borrower to a person who has privity with the contract of loan. In the instant case, The assessee had not provided any loan and there was no indebtedness on part of the payer to the assessee.

One view is that guarantee fee is business income and hence it is taxable in India only if the non-resident has a Permanent Establishment (PE) in India. Different arguments have been advanced both by assessees and the Revenue to contend that guarantee fee is taxable as FTS, Interest and so on. For instance, in *Idea Cellular Ltd v. DCIT, [2015] 58 taxmann.com 101 (Mum-Trib.)*, the Revenue contended that the payment was inextricably connected with the loan and that the definition as per the Act was wide enough to cover guarantee fee which is in relation to the loan but the ITAT did not agree with this. It held that the definition is not wide enough to bring within its ambit any third party who has not given any money and that in order to qualify as interest the sum paid should be part of the loan itself.

Tribunals and Courts have generally concluded that guarantee fee cannot be interest. In *GMAC Financial Services, 2011 SCC Online ITAT 12377,* ITAT Chennai, relied on the case of *Vijay Breaking Corporation* to conclude that the term debt-claims used in the DTAA is narrower and would cover only loans since it is further qualified by '*whether or not secured by mortgage'.* Thus the use of the term debt claim of every kind does not expand the scope of interest to include every payment in relation to the transaction.

The reasoning of the ITAT is also in line with the ruling in *Container Corp. v. Comr., 134 T.C. No. 5 (2/17/10)* wherein it was held that guarantee by itself is not a loan or interest but it is a payment for services which may be performed in future. The Mexican parent company had guaranteed the loans availed by its US subsidiaries in USA and charged a fee on the guarantee. The US Court further held that the income arose in Mexico and was not taxable in US and no withholding obligations arose at the hands of the US subsidiaries.

### *Guarantee fee falls under Article 23 of India-UK DTAA*

The ITAT upheld the stand of the Revenue that guarantee fee was taxable @40% as Other Income. It held that the assessee was not in the business of extending guarantees and hence the income did not fall within the ambit of Article 7 and it did not qualify as FTS since no skill or knowledge was 'made available' to the payer. Since there was no specific entry dealing with taxation of guarantee fee, it would be covered by Article 23 as income arose in India. The ITAT held that guarantee fee arose only when the loan transaction happened in India and not on entering into an agreement outside India. Thus, the source has been held to be in India. This is at variance with the decision in Container Corp discussed above as regards situs of the source of income. The ITAT relied on the ruling of the Apex Court in *Kancheanganga Sea Foods P Ltd vs CIT [2010] 325 ITR 540 (SC)* to hold that in terms of Section 5(2), all income received or deemed to be received, arising, accruing or deemed to arise or accrue in India would be taxable at the hands of the non-resident.

### *To conclude*

It may be possible to argue that guarantee fee should be part of business profits and be taxed in terms of Article 7. The Explanatory note to the OECD Model Convention states that every independent activity may constitute a business if it is not covered by other Articles relating to independent personal services, income for use of immovable property etc. Thus, even in the instant case, the fact that the assessee was not in the business of extending guarantees need not take

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it out of the ambit of Article 7. However, ITAT,Delhi has held conclusively that guarantee fee arises in India, it is not interest, business income or FTS and is taxable as other income.

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# Ratio Decidendi

## Non-receipt of royalty from overseas subsidiary can be subject to TP adjustment

The petitioner was aggrieved by the addition of royalty income in the year it had ceased to receive royalty from its subsidiary. The contention of the petitioner was that prior to the overseas entity becoming a subsidiary, royalty was payable by the overseas entity for use of brand name and technical knowhow and the income had been duly accounted. After the overseas entity became a 100% subsidiary, it was used by the assessee to manufacture its products abroad. The High Court however, agreed with the reasoning of the lower authorities that as long as there was no change at the entity level in terms of complete identity between the assessee and the overseas entity, the non-receipt of royalty for use of brandname could be brought under the ambit of international transaction. [*Dabur India Ltd* v. *Pr. CIT*, ITA 1142/2017 & CM No. 45221/2017., Delhi High Court judgement dated 13-12-2017]

## Income on cessation of liability arises if no consideration passes to creditor for the same

The department sought to tax the sum of share application money which was adjusted against sums due to the assessee as income from cessation of liability. The holding company had advanced share application money which was lying as a deposit with the subsidiary. In the previous year, the assessee (subsidiary) adjusted the sum towards dues for sale of goods to the holding company. The department contended that since the liability to the holding company had ceased, the sum was taxable in terms of Section 41. However, the High Court held that Section 41 applies to a transaction where the liability owed by the assessee is done away with without any consideration passing to the creditor. In the instant case, the transaction was not one of cessation of liability but discharge of liability and hence it was not taxable under Section 41. [ *CIT* v. *Indo Widecom International*, ITA No 715 of 2012, Allahabad High Court judgement dated 7-12-2017]

## LOB cannot be invoked since entity would have been eligible for similar benefits under another treaty

At issue was eligibility to treaty benefits in case of a shipping company which was incorporated in UAE and its entire share capital was held by two German entities. The Department contended that the assessee was not a 'resident' of UAE since he was not liable to pay taxes there, the incorporation in UAE was a device to get treaty benefit and applying the tie-breaker rule, the assessee was a resident of India on account of its Place of Effective Management (PoEM) being in India. However, the ITAT held that so long as there was question as to the assessee being resident in India and UAE the Assessing Officer had no occasion to invoke Article 4(4) of the India-UAE DTAA to determine residence. On the

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basis of the Tax Residency Certificate (TRC), it had been established that the assessee was resident of UAE. The Assessing Officer had invoked Article 29 of the India-UAE DTAA to deny treaty benefits reasoning that purpose of the incorporation in UAE was only to obtain treaty benefits.

However, the ITAT held that in order to invoke Article 29, it must be established that but for the incorporation, the entity would not be able to obtain the benefit. In the instant case, shipping income of the entity would not have been taxable in India even if it had been incorporated in Germany by virtue of a similar Article 8 in the treaty and hence it was not established that the incorporation in UAE was for the purpose of obtaining a treaty benefit. [*ITO* v. *Martrade Gulf Logistics FZCO-UAE*, ITA No. 7 to 9 / Rjt/2011, ITAT, Rajkot, Order dated 28-11-2017]

## Agreement to part with profits alone is not a case of diversion of income by overriding title

In terms of a MoU, the assesse parted with about 12% of its earnings from the real estate business which was paid to an entity which had initially advanced loan for purchasing the land. The assesse did not offer this sum to tax and contended that it was a case of diversion of income by overriding title. However, the ITAT held that since as per the terms of the agreement the other entity was to receive only a share in the profits which remained after deduction of all expenses and did not share in the losses, it was a case of application of income. The ITAT referred to various judgements including the judgement of the Supreme Court in *CIT v. Sitaldas Tirathdas, 41 ITR 367* and held that the income must be diverted by an obligation before it reaches the assesse and it must not be application of income to discharge an obligation. Factually, in the case of the assesse, there had been repayment of the loan in the years prior to the assessment years in question, the other entity did not offer the income to tax in certain years and had not recorded the assessee as a debtor in its books. Thus, the ITAT held that since the obligation to part with income was not connected with the property and it arose from a mutual agreement between parties, the sum was taxable at the hands of the assessee. [*Kamineni Builders* v. *ACIT*, ITA 149/Hyd/ 15, 2010-11& ITA 1486/Hyd/ 16, 2009-10, ITAT Hyderabad, Order dated 30-11-2017]

# News Nuggets

### US set to bring in new tax system with major overhaul

On December 19, the US passed the Tax Cuts and Jobs Bill, H.R.1 which is being described as a major overhaul of the tax rates and provisions affecting both individuals and corporations. One of the biggest changes is the lowering of the corporate tax rate from 35% to 20%. Other provisions include increasing the standard deduction for individuals, limiting mortgage interest deduction, deletion of penalty for not being adequately insured as per Affordable Care Act besides certain restriction on carry over of operating losses for business.

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