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Corporate Guarantee – Certainty in taxation not guaranteed!

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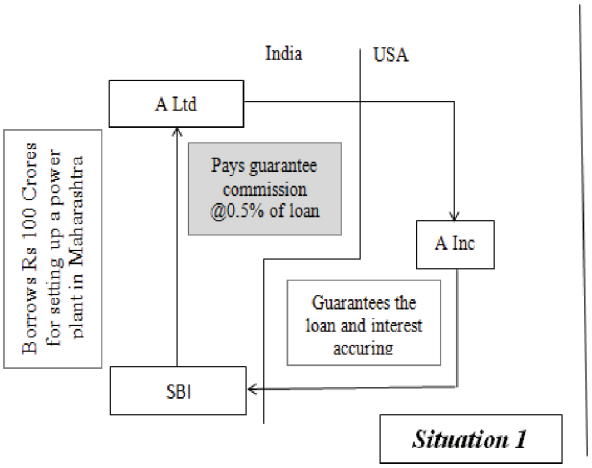
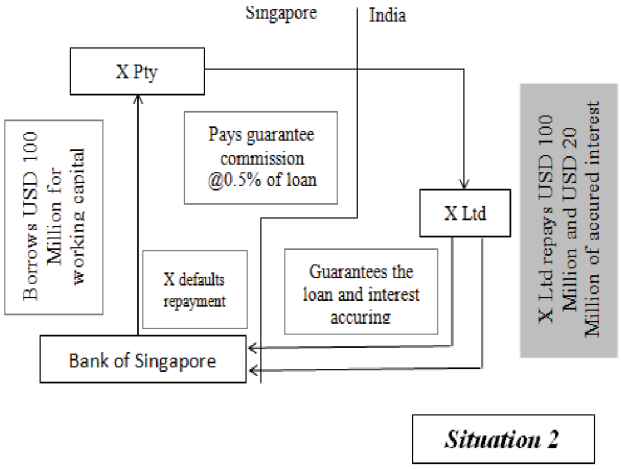
Affiliates of Multi National Enterprises ('MNEs'), in the recent past, are moving more towards functioning independently from their parent, operational and financial. The freedom given in managing their own affairs in growing economies like India, has helped the affiliates to grow faster in the local markets. However, when it comes to financing their capital requirements or for gaining the goodwill of a customer, the affiliates are forced to look back to their parents for a guarantee.

Indian banks, when lending to Indian affiliate of a MNE insist on a guarantee from its parent company, or in any case, the guarantee results in a significant saving on the lending rate. Similarly, while awarding high value turnkey contracts or while entering into concession agreements, the awarders, primarily Government entities or Public Sector Undertakings, require a performance guarantee to be executed by the parent company of the MNE affiliate.

The vice versa is also true. Indian MNCs operating in foreign jurisdiction, seek to take advantage of the low cost of borrowing in their home jurisdiction, rather than borrowing from its parent at twice the local market rates. The borrowing is however required to be guaranteed by the Indian parent. Similarly, performance guarantees are as well given by Indian parent to its overseas subsidiaries in many cases.

This article seeks to address tax implications of various transactions arising out of a contract of guarantee between Associated Enterprises ('AEs'). For easier understanding, the following fact situations are proposed.





A. Issues in Fact situation 1

In the first fact situation, the transaction of payment of guarantee commission by A Ltd to its AE, A Inc would raise the following questions for examination

(i) Is the guarantee commission taxable in India under the Income Tax Act, 1961 ('the IT Act')?

(ii) Would the act of guarantee be regarded

as shareholder activity, thereby denying deduction for the guarantee commission paid?

Taxability of guarantee commission received by A Inc

A contract of guarantee for a borrowing is a collateral contract to answer to the lender for the debt of the borrower in case of his default. The guarantor would have to be a person with reliable credit worthiness. Not every person's guarantee would be accepted by a lender. The primary criteria for accepting a guarantee by the lender would be the asset base of the guarantor. Guarantee commission is a consideration paid by the person seeking the guarantee to the guarantor for undertaking the risk of default by that person.

Section 5(2) of the IT Act provides that a non-resident would be liable to tax in India only on such income as is received or deemed to be received in India or accrue or arise or so deemed to in India.

Place of accrual of an income is where the activities generating that income are carried out e.g. place of factory in case of manufacturing business. However in cases where the generation of income does not require any continuous activity then it could be place of its source. Source can be an asset and location of that asset would be the place of accrual of rents and royalties arising therefrom. If the royalty is on commercial exploitation of the intangible asset then the place of such commercial exploitation can be the situs of accrual of income.

Before deciding the situs, it is important to characterise the income as different rules apply to different kinds of incomes. Section 9 of the IT Act *inter alia* deems income to accrue in India if (a) it arises out of a business connection in India or (b) from a source in India or (c) it is in the nature of interest paid by a person resident of India of the purpose of carrying on business in India.

For a payment to be classified as interest, there should be a borrowing of money. Guarantee of a debt does not in itself result in a debt hence guarantee commission is not 'interest' for the purpose of income tax. It would thus be in the nature of business income and not taxable unless there exists a business connection.

For the existence of a 'business connection', as held by the Supreme Court in *R D Agarwal*[1], the person sought to be taxed should be carrying on some activity in the taxable territories of India.

The Privy Council in *Chunilal Mehta*[2] observed that profits gathered as a result of contracts, as in the case of dealing in future, accrued at the place where the income producing contracts were entered into.

In the case of *Container Corporation*[3] the US Tax Court, held the source of guarantee commission to be the assets of guarantor which provided it strength to give a guarantee.

1 *CIT* v. *R D Agarwal and Co.* [1965] 56 ITR 20 (SC)
2 *CIT* v *Chunilal B. Mehta* [1938] 6 ITR 521 (PC)
3 *Container Corporation* v *Commissioner of Internal Revenue 134 T.C. No. 5* (February 17, 2010).

Though the judgment is of a Court of United States, the preposition laid down therein would equally apply to India as the concept of accrual of income in India and United States are similar. It will be worthwhile to note that the Indian Supreme Court in *Siddheshwar Sahakari Sakhar*[4] followed the judgment of the United States Supreme Court in *Indianapolis Power & Light Co*[5] to determine accrual of income in India.

The Inland Revenue Board of Malaysia in its recent Public Ruling[6] has clarified guarantee fee payable to non-resident will not be regarded as accruing in Malaysia and accordingly not liable to deduction of tax.

The position in India is not well settled, however it can be said that if the assets of guarantor are outside India and the guarantee contract is executed outside India then the income would not be taxable in India. In a case where Indian bank signs the guarantee contract in India while the guarantor signs in India, then determination of the place of its execution itself is a challenging legal question.

Would the act of guarantee be regarded as shareholder activity, thereby denying deduction for the guarantee commission paid?

Income Tax regulations across the globe provide for deduction of expenses incurred for the purposes of the business carried on by an entity from the income earned by it. In other words, no deduction would be allowable for payment made towards activities carried out by the parent company for securing the investment made by it.

The1979 report of the Organization for Economic Co-operation and Development ('OECD'), suggested that, for the purpose of deductibility of expenses, the service recipient should justify that 'a real benefit accrued to the enterprise' and that the benefit had not accrued merely due to the association of the entity to the MNE group.

However, in 1995, the OECD revisited the 'justification of benefit test' laid down earlier and observed that intra-group service are rendered when *'the activity provides a respective group member with economic or commercial value to enhance its commercial position'*[7]. The 1995 report also provided that the determination of rendition of intra-group services can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed by an independent enterprise or would have performed the activity for itself in-house.

Applying these principles to the present facts, guarantee commission would be allowed as a deduction in computing the taxable income of A Ltd only if A Ltd is able to establish, either

(i) Issuance of guarantee by A Inc was a pre-requisite for the bank granting the advance; or

(ii) Issuance of guarantee by A Inc resulted

[4] *Siddheshwar Sahakari Sakhar Karkhana Ltd* v *CIT* [2004] 270 ITR 1 (SC)

[5] *Commissioner of Internal revenue* v. *Indianapolis Power & Light Co.* 493 US 203

[6] Public Ruling 1/2014 dated 23.01.2014

[7] Para 7.6 of 1995 Guidelines

in some benefit to A Ltd, like a reduced cost of borrowing.

If A Ltd is not able to establish any of the above, it is possible that Indian Revenue Authorities may dis-allow any claim for deduction of guarantee commission paid to A Inc.

B. Issues in Fact situation 2

Fact situation 2 again raises two significant issues

a. Is any part of the sum paid by X Ltd to Bank of Singapore liable to tax in India?

b. Would the sum paid be allowed as a deduction in computing the taxable income of X Ltd?

Taxability in India on encashment of guarantee

The sum recovered by encashing guarantee may include two components, namely original capital borrowed and interest accrued thereon.

The amount of guarantee encashed would be subjected to tax in India only to the extent of 'income component' comprised in it. The amount representing interest component of the principal debtor being repaid by the guarantor, can be the only amount which might be subjected to tax. The taxability is however not free from doubt.

Section 9(i)(v) of the IT Act provides for taxation of income in the nature of 'interest' in India, if it is paid by a resident of India, except when such payment is for the purpose of business carried on by such person outside India. Section 2(28A) of the IT Act defines 'interest' to mean any interest payable in respect of 'monies borrowed' or 'debt incurred'. The meaning of the word 'interest' has been a subject matter of debate in numerous cases. In *Euro Hotel*[8], it was observed that before an amount may be regarded as interest, there must exist an indebtedness to which the 'interest' is ascertained and a debtor/creditor relationship. The interest component represents a compensation for debt incurred by the borrower but not a debt incurred by guarantor. If the nature of payment is examined from the perspective of payer then based on a set of judicial rulings the same cannot be characterized as interest. However there are other set of rulings wherein it has been held that the fact that debt is incurred by someone other than payer is irrelevant and compensation for deprivation of the recipient from usage of his money is interest in all cases. According to these cases the payment would be in the nature of interest even if paid by guarantor.

The Australian Tax Office has considered the different opinions taken by the Courts in Australia and Europe and seems to have taken the view that interest component of a guarantee payment would not be regarded as 'interest' taxable in Australia so long as it is not paid for use of money by the payer and that it does not become payable over a period of time by the guarantor.

Considering the difference of opinions amongst judiciaries existing for close to a

[8] Euro Hotel (Belgravia) Ltd (1975) 51 TC 293

century, and the development in common law taxing laws over the years, it seems a more plausible view to treat the interest component of payment made by the guarantor pursuant to the default of the principal borrowed as income in the nature of interest and taxable in India if paid by resident of India.

Allowability of deduction

An expenditure incurred by a person, not being in the nature of capital expenditure, laid out wholly and exclusively for the purpose of business, shall be allowed as a deduction under Section 37 of the IT Act. The Supreme Court in *Birla Bros*[9] observed that a guarantee payment, *sans* a contractual obligation or statutory requirement or custom, would not be allowed as a deduction, even if the tax payer is engaged in the business of advancing guarantee. In *A V Thomas*[10], where a holding company had advanced certain sums to its subsidiary for carrying out the latter's object, the write off of the advance by the holding company was held to be not in the ordinary course of business of the lender and hence not allowable.

However, in *Essen Ltd*[11], where the taxpayer engaged in managing agency business has paid the loans taken by the companies managed by it under a guarantee agreement, the Supreme Court held the expense to be incurred for the purpose of the managing agency business and hence allowed the expense as a deduction. Accordingly, it can fairly be concluded that a payment of sums guaranteed by the holding company for the default of the subsidiary, would be allowed as a deduction only if the transaction had some commercial relevance for the payer.

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Ratio decidendi

Services in nature of sales and marketing do not 'make available' technology – not taxable under Fee for included services: The ITAT Bangalore has recently, in the context of Article 12(4) of the Indo-US treaty, held that unless there is a transfer of technology involved in technical services extended by the US based company, the 'make available' condition in the definition of 'fees for included services' is not satisfied. Relying on the ratio in the case of *De Beers India (P) Ltd* [12], the ITAT held that the phrase 'make available' has specific legal connotations. The ITAT held that services which were mainly in the nature of sales and marketing, pricing, and product development strategy, do not make available technology to the AEs and hence were not taxable under Article 12(4) of the treaty.

The DRP had also opined that the trading transactions of the non-resident carried out through the AEs constituted a Dependent

[9] *CIT* v *Birla Bros Pvt Ltd* [1970] 77 ITR 751 (SC)
[10] *A V Thomas & Co Ltd* v *CIT* [1963] 48 ITR 67 (SC)
[11] *Essen Pvt Ltd* v *CIT* [1967] 65 ITR 625 (SC)
[12] *CIT* v. *De Beers India (P) Ltd* [2012] 346 ITR 467 (Kar)

Agent PE, and such services would be taxable in light of such PE. The ITAT held that such services are of different nature and cannot be attributed to the PE. Further, relying on *Set Satellite*[1] case, it was held that the agents having been remunerated at arm's length already, no further liability would arise. [*ABB Inc. v. DDIT (International Taxation)* - [2015] 59 Taxmann.com 159 (Bangalore-Trib)]

AMP expenses to be scrutinized even when overall profit margin is at par with comparables: On the much debated issue of AMP expenses, the ITAT Delhi has recently held that addition towards AMP expenses cannot be deleted on the plain logic that the taxpayer's profit margin matched with those of comparables. As such, the ITAT held that AMP expense is a separate international transaction and hence the functions performed under such a transaction have to be separately compared with similar functions performed by a comparable case. The ITAT has followed the reasoning in the recent judgment of Delhi High Court in the case of *Sony Ericsson*[2]. Further, the ITAT has held that the subsidy or reimbursement received from AEs is not to be netted off from AMP expenses at the stage of computation of ALP. It held that the contention of the assessee to reduce the amount of subsidy even before the determination of ALP would mean that to that extent no service of brand building has been rendered to the AE, which is not acceptable. [*Casio India Co. P. Ltd. v. DCIT - [2015] 58 Taxmann.com 375 (Delhi-Trib)*]

No taxability if sale of equipment concluded outside India, even if equipment subject to inspection in India: The taxpayer, a German company, sold equipment to an Indian customer on high seas, and the consideration also was received outside India. Some balance amount was payable on inspection of the equipment in India. The ITAT Kolkata, on these facts, held that the sale was concluded outside India and hence was in the nature of offshore sale. As such, no taxability of such offshore sales arose in the given circumstances. The Tribunal also held that the acceptance tests were in the nature of warranty provisions and the balance payment was only in the nature of deferred payment. Further, on the issue of supervisory PE, it was held that as per Art 5(2)(i) of the Indo-German treaty, supervisory PE had to be examined separately for each of the projects. [*Qutotec GmbH v. DDIT - [2015] 58 Taxmann.com 232 (Kolkata-Trib)*]

Section 43B disallowance attracted even if income offered on presumptive basis: ITAT Panaji has held that even in a case where the taxpayer has opted for the presumptive taxation scheme, disallowance for non-payment of statutory liability under Section 43B of Income Tax Act, 1961, would be attracted. For this, the Tribunal examined the construction of Section 44AF and Section 43B of the Act. It held that the non-obstante clause in Section 44AF precluded the operation of only Sections 28 to 43C, while the preclusion in Section 43B was much wider as it said

[13] *SET Satellite (Singapore) Pte Ltd v DDIT* [2009] 307 ITR 205 (Bom)
[14] *Sony Ericsson Mobile Communications India Pvt Ltd v CIT* [2015] 374 ITR 118 (Delhi)

'notwithstanding anything contained in any other provisions of this Act'. [*Good Luck Kinetic* v. *ITO - [2015] 58 Taxmann.com 267 (Panaji-Trib)*]

Installation services are covered by Service PE under specific provisions Article 5(3) and not Article 5(6): In a case where the taxpayer had undertaken installation and construction activities in respect of certain projects, the ITAT Mumbai has recently held that PE determination shall be governed by Article 5(3) and not Article 5(6) of the India-Singapore treaty. It has been held that Article 5(3) is a specific provision dealing with 'service PE' on account of construction, installation or assembly projects, and provides for constitution of such PE if the activities continue for more than 183 days in a financial year. Article 5(6), on the other hand, provides for the constitution of a PE in case of other services which continue for more than 90 days. It was further held that there cannot be overlapping of activities carried out within the ambit of Articles 5(3) and 5(6). Both provisions should be read independent of each other. [*Kreuz Subsea Pte. Ltd.* v. *DDIT - [2015] 58 Taxmann.com 371 (Mumbai-Trib)*]

Tribunal may extend stay of demand beyond 365 days if delay not attributable to assessee : The Gujarat High Court has held that it is not the legislative intent behind Section 254(2A) to restrict the power of the Tribunal to grant stay of demand beyond 365 days even if delay was not attributable to the assessee. Under consideration was the third proviso to Section 254(2A) of the Act. The High Court, after considering several reasons due to which the Tribunal may not be in a position to decide the appeals when the delay was not attributable to the assessee, has held that there cannot be an intent to punish the assessee for the same. It is worth commenting here that the Delhi High Court also recently in the case of *Pepsi Foods*[3], has struck down the amendment to the section which introduced the words 'even if delay in disposing of appeal is not attributable to assessee', being violative of Article 14 of the Constitution. [*DCIT TDS* v. *Vodafone Essar Gujarat Ltd - [2015] 58 Taxmann.com 374 (Gujarat)*]

Actual gain from sale of shares, and not the capital gain, to be considered while computing book profit u/s 115JB: While computing book profit under Section 115JB of the Act, whether profit arising from the sale of shares ought to be taken or income by way of long term capital gain is to be considered, was the question before ITAT Mumbai recently, which has been answered in the favour of Revenue. It was held that from a harmonious reading of Section 10(38) and its Proviso, it is evident that firstly, the book profit shall be reduced by the amount of income to which provision of Section 10 applies. However, income under the provisions contained in Section 10(38) will not be reduced. In light of the *Explanation* to Section 115JB, which provides that only amounts credited to P&L account are to be used while computing the book profit, the concept of indexation for computing capital

[15] *Pepsi Foods (P) Ltd* v *ACIT* [2015] 57 Taxmann.com 337 (Delhi)

gains cannot be imported into computation of book profit under Section 115JB. Thus, the income or actual gain from sale of shares is to be included in the book profit. [*Dharmayug Investments Ltd v. ACIT - [2015] 58 Taxmann.com 116 (Mumbai-Trib)*]

ALP determination and selection of comparables: The Delhi Bench of ITAT has recently held in a transfer pricing case, that if the assessee shows presence of some specific expenses confined to initial phase which are absent in regular phase of business, adjustment if any, can be made to the profit margin of its comparables and not to the profit margin of the assessee. The ITAT has further held that a company which is functionally different and has experienced extraordinary circumstances such as change in Government policy and retrenchment of employees, cannot be used as a comparable in ALP determination. On another question on comparables, it was held that where a company had several segments, the fact that all products made by one segment were passed to another segment thereby impacting profitability, would not rule out such company from being a comparable. If such company had declared segmental results, the functionally similar segment should be taken as a comparable in ALP determination. [*JCB India Ltd v. ACIT - [2015] 59 Taxmann.com 211 (Delhi-Trib)*]

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