Corporate Guarantees and Transfer pricing

ePoints 2

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Corporate Guarantees – Whether a leg that fits into the shoes of Transfer pricing??

1. Introduction

At a time where World's almost every economy is going through a period of crisis, Government of every country is trying their best to provide stimulus to their economy. As a result, every Government / Country wants their share of revenue (taxes) in a Global Economy. That's where recently we see a number of discussions taking place on Base Erosion & Profit Shifting (BEPS). Be it the discussion paper on BEPS by OECD, seminars taking place amongst the professionals etc… More practically the Global firms such as Starbucks, Google and Amazon have been in the limelight for avoiding paying tax on their British sales.

India too seems to feel the pressure of such economic crisis which has resulted into a large number of retrospective amendments to Finance Act, 2012 which mainly centered on international transactions. One such amendment was made in the transfer pricing provisions wherein the definition of the term International Transaction was clarified to have a wider scope to even cover capital financing transactions.

2. Issue

In view of the same it is debated as to whether a corporate guarantee by an Indian parent to its foreign subsidiary falls within the ambit of the clarified definition of International Transaction and consequently is subjected to Indian Transfer Pricing Law???

3. What the courts have to say

A. Indian Court Rulings

Indian courts have, on the basis of different line of arguments & facts & circumstances of the case largely held in favour of the revenue (income tax officer) & treated Corporate Guarantee as International transaction & subjected to Indian Transfer Pricing law. There are some Indian rulings which have held that Corporate Guarantees are not covered within the definition of International transaction (***before amendment as well as post amendment***).

i) Ruling in favour of assessee before amendment

(a) **M/s Foursoft Ltd. vs. DCIT (Hyd ITAT) – 62 DTR 308:**

One of the first rulings from an Indian judiciary on the issue of applicability of transfer pricing provisions on providing of corporate guarantee by a parent to its subsidiary company, in this ruling, the Hyderabad bench of the Income-tax Appellate Tribunal ('ITAT') has adjudicated on the transfer pricing issues arising on loans and guarantees given by parent company. The ruling is briefly explained below:

Facts:

The taxpayer, M/s Foursoft Ltd had provided corporate guarantee to a third party in relation to the moneys borrowed by its overseas Associated Enterprise ('AE'). However, it did not charge any fee/commission for providing such corporate guarantee.

The contention raised by the Transfer Pricing Officer (TPO) was that by providing the corporate guarantee, the taxpayer, has assumed an obligation and if the AE were not to honour its obligations, the taxpayer being the guarantor would be liable to fulfill the obligations of its AE and pay the amount to the third parties.
Given the same, the TPO considered provision of guarantee as a service and determined a commission of 3.75% as the arm's length price under the Comparable Uncontrolled Price ('CUP') method on the basis of the commission charged by a Bank as a benchmark.

Ruling of the ITAT:

Not covered by definition

The ITAT concurred with the arguments of the taxpayer and held that the definition of international transaction did not specifically cover transaction for providing corporate guarantee and hence, in absence of any charging provision enabling application of TP regulations to the said transaction, the same would be outside the purview of transfer pricing.

Incidental to the main business of tax payer

Further, ITAT also accepted that the provision of corporate guarantee by the taxpayer to its AE is incidental to the business of the taxpayer and hence, cannot be compared to the transaction of providing guarantee by banks is in their regular course of business.

ii) Ruling in favour of assessee post amendment

(a) Bharti Airtel Limited vs. ACIT (ITAT Delhi) (*March 2014*)

Facts:

The assessee issued a corporate guarantee to Deutsche Bank on behalf of its associated enterprise, Bharti Airtel (Lanka), whereby it guaranteed repayment for working capital facility. The assessee claimed that since it had not incurred any cost on account of issue of such guarantee, and the guarantee was issued as a part of the shareholder activity, no transfer pricing adjustment could be made. However, the TPO held that as the AE had benefited, the ALP had to be computed on CUP method at a commission income of 2.68% plus a mark-up of 200 bp. This was upheld by the DRP by relying on the retrospective amendment to s. 92B which specifically included guarantees in the definition of "international transaction".

Ruling of the ITAT:

Transaction not having bearing on profits, incomes , losses or assets

A transaction between two enterprises constitutes an "international transaction" u/s 92B only if it has a bearing on profits, incomes, losses, or assets of such enterprises". Even the transactions referred to in the Explanation to s. 92 B, which was inserted with retrospective effect (which includes giving of guarantees under clauses (c)), should also be such as to have a bearing on profits, incomes, losses or assets of such enterprise;

Impact on real basis and not on contingent or hypothetical basis

The onus is on the revenue to demonstrate that the transaction has a bearing on profits, income, losses or assets of the enterprise. The said impact has to be on real basis, even if in present or in future, and not on contingent or hypothetical basis. There has to be some material on record to indicate, even if not to establish it to hilt, that an intra AE international transaction has some impact on profits, income, losses or assets;

No additional cost

When an assessee extends assistance to the AE, which does not cost anything to the assessee and particularly for which the assessee could not have realized money by giving it to someone else during the course of its normal business, such an assistance or accommodation does not have any bearing on its profits, income, losses or assets, and, therefore, it is outside the ambit of international transaction u/s 92B (1).

iii) Ruling against assessee before amendment

(a)M/s Nimbus Communications Ltd Vs. ACIT (34 taxmann.com 298) (Mumbai ITAT) & (b) **Hindalco Industries (India) Ltd** have on similar facts held that corporate guarantee transaction is an international transaction by relying on OECD transfer pricing guidelines 2010.

iv) Ruling against assessee post amendment

(a) **M/s Everest Kanto Cylinder Ltd. vs DCIT** (ITA No. 542/Mum/2012) (Mumbai Tribunal) & (b) **Technocraft Industries (India) Ltd. vs. ACIT**, Mumbai ***(Mumbai ITAT) (January 2014***) have on similar facts held that post amendment there remains no scope for debate on whether providing of corporate guarantee is an international transaction under the Indian transfer pricing regulations and have made following observations:

Amended definition

In view of the amended definition of International Transaction, transfer pricing regulations are specifically applicable to a guarantee transaction.

Benchmarking as per appropriate methods

Further, as the transaction is specifically included as an international transaction, then the methods prescribed under the statute also become applicable for benchmarking the said transaction. Hence, the existing methods specified under the statute could be very well utilised to benchmark the transaction of corporate guarantee.

Cost or benefit always involved in Corporate Guarantee Transaction

While providing a corporate guarantee, there is always a case of an element of benefit or cost involved. Hence, the taxpayer's argument that no costs were incurred would not hold good. Otherwise, also the taxpayer had itself charged a guarantee commission of 0.5% from its AE. Therefore, it cannot be said to be a case where the taxpayer has contested charging of guarantee commission from its AE.

B. Foreign Court Ruling

GE Capital Canada (Federal Court of Canada):

Perhaps the most contentious ruling on the issue of corporate guarantee fees, this ruling was widely followed across the world by taxpayers and revenue authorities alike. The ruling is briefly discussed below:

Facts:

The taxpayer, General Electric Capital Canada Inc ('GE Canada') had paid guarantee fee at the rate of1% p.a. on the value of corporate guarantee given by its parent company, General Electric Capital Corporation ('GE US') which amounted to over $135 million over a period of five years from 1996 to 2000.
Payment of such guarantee fees by GE Canada to GE US was picked up for transfer pricing scrutiny by the Canadian Revenue authorities. After a detailed transfer pricing scrutiny, the Canadian Revenue authorities determined that GE Canada did not obtain any economic benefit from the guarantee and hence, such fees were held to be not at arm's length and thus, not allowed.

Key arguments by Revenue Authorities

The key arguments raised by the Revenue Authorities is that providing of a corporate guarantee only provided an implicit benefit to the GE Canada and providing of an explicit guarantee provided no value to GE Canada.

Key Observations of the Federal Court:

Implicit guarantee surely benefits the borrower

Guarantee fees paid to AE(parent co) by WOS for explicit guarantee furnished by parent co to WOS's lenders cant be disallowed on the grounds that no arm's length person benefiting from implicit guarantee would pay for explicit guarantee.

The argument that credit rating of a WOS would be equalized with credit rating of its parent by reason of affiliation in the absence of a guarantee arrangement and WOS would be able to borrow at same terms as parent cannot be accepted.

- **Adoption of Yield Approach**

Yield approach should be adopted for computing the value of benefit provided by the explicit guarantee and to compute ALP for the guarantee fees paid. This involves comparison, based on recognized credit rating criteria, the credit rating associated with implicit support and the credit rating associated with explicit support.

4. What the OECD has to say

As per OECD transfer pricing guidelines 2010 there is a specific chapter on intra group services **"Chapter – VII Special Considerations for Intra-Group Services** which discusses about the issues that may arise in determining for transfer pricing purposes whether

services have been provided by one member of an MNE group to other members of that group and, if so, in establishing arm's length pricing for those intra-group services. Para 7.13 of the guidelines talks about the benefits of associating with a group and reads as follows:

"*An associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated,* ***but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefitted from the group's reputation deriving from global marketing and public relations campaigns****.* ***In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group.*** *Each case must be determined according to its own facts and circumstances.*

5. Conclusion

The transactions relating to providing of corporate guarantee are difficult to characterize for Transfer Pricing purpose for they many times involve an analysis of mixed elements of the time value of money and shareholder activity. Guarantee transactions may further raise the question of whether the facility actually confers a specific benefit on the recipient or there is only an implicit benefit. Accordingly, the issue of whether a charge should be imposed for provision of guarantee is primarily a question of fact.

The important principles emanating from the above rulings are the acceptance of the fact that guarantee does result in an implicit support to the recipient entity, yield approach based on the differential credit ratings and therefore interest savings could be an appropriate way of determining the appropriate fees for guarantee and in case an internal comparable transaction is available to benchmark the payment of guarantee fee then such transaction should be given preference over undertaking a search for identifying an external comparable.

Given the same, taxpayers would be well advised to undertake a review of the facts and circumstances of their specific case to determine the need of charge of guarantee fee and based on such analysis determine the most appropriate method to benchmark the arm's length nature of such fees which could be done by utilizing the yield approach and/or such other comparative benchmarks which may be available depending upon the facts of their individual case. However, given the general inadequate guidance available in India, the taxpayers in India should also keep an eye on the evolving international practices.