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Issue of corporate guarantee is in nature of 'shareholder activities'/'quasi capital' and thus, could not be included within the ambit of 'provision for services' under the definition of 'international transaction' under Section 92B of the Income-tax Act, 1961

Background

Recently, the Ahmedabad Income-tax Appellate Tribunal (the Tribunal) in the case of Micro Ink Limited[1] (the taxpayer) held that issuance of corporate guarantee by parent company to subsidiary was not in the nature of 'provision for service' and was not to be included in the definition of 'international transaction' under Section 92B of the Income-tax Act, 1961 (the Act)[2].

Facts of the case

- During Assessment Year (AY) 2006-07, the taxpayer issued various corporate guarantees on behalf of its subsidiaries, without charging them any consideration. The stand of the taxpayer was that these guarantees did not cost the taxpayer anything, nor any charges were recovered for the same, and that the 'said guarantees were in the form of corporate guarantees/quasi capital and not in the nature of any services'.

- The Transfer Pricing Officer (TPO) had made an adjustment by computing the arm's length price (ALP) of the corporate guarantee at two per cent on the basis of following reasoning:

  - Guarantees are chances that someone will have to pay for them, if chance is 100 per cent, i.e. in all cases one has to pay for it, guarantee fees will be simply equal to the guarantee amount. However, if it is only a probability, and only in few cases it will have to be paid, its charges are just a percentage of it. Banks normally compute guarantee charges on the basis of their experience in handling such situations.

  - Guarantees given by the taxpayer makes its own borrowing costlier; as its assets get used in guaranteeing, it has to raise costlier capital without being able to use its own those very assets. There cannot be a direct link to the guarantees given for the purpose of computing cost, but the fact remains that there was cost to the guarantor. In view of the above discussions, guarantee fees is calculated at two per cent, which is the prevalent market rate for guarantee fees.

- Aggrieved by the TPO order, the taxpayer filed objections before the Dispute Resolution Panel (DRP). The DRP rejected the objection raised by the taxpayer, referred to and relied upon the 'OECD Transfer Pricing Guidelines for Multinational Permanent Establishments' and the decision of the Tax Court of Canada in the case of G E Capital Canada[3]. The Assessing Officer (AO) thus proceeded to make the ALP adjustment in respect of corporate guarantee at INR2.32 crores.

Issue before the Tribunal

- Whether the adjustment of INR2.32 crores on account of corporate guarantee given by the taxpayer to its subsidiaries is justified.

[1] Micro Ink Limited v. ACIT (ITA No. 2873/Ahd/10)
[2] While the judgment covers other issues as well, this news flash is restricted to the key issue relating to corporate guarantees
[3] G E Capital Canada v. Her Majesty the Queen [2009] TCC 563

- Transfer pricing report categorically stated that 'guarantees issued by the taxpayer are said to be in form of corporate guarantees/quasi capital and not in the nature of services' and that accordingly, 'these transactions are not considered as international transactions'.

- Relied on the decision of Bharti Airtel[4] which holds that corporate guarantee issued for the benefit of Associated Enterprise (AE), not involving any costs to the taxpayer and not having any bearing on profits, income, losses or assets of enterprise or assets of enterprise, are required to be kept outside the ambit of 'international transaction' and there are number of decisions[5] of the coordinate benches following the same proposition.

- It was argued before the Tribunal that the tax legislation in general may have retrospective effect, even though presumption is in favour of the law being prospective. Tax legislation in nature of anti-abuse legislation cannot be made retrospective as it would amount to an impossibility for the taxpayer to comply with the same. The same observations were made by the Tribunal in case of Bharti Airtel.

- Further reliance placed on the decision of Vatika Townships Pvt Ltd[6] wherein it is held that 'the rule against retrospective operation is a fundamental rule of law that no statute will be construed to have a retrospective operation, unless such a construction appears very clearly in the terms of the Act, or arises by necessary and distinct implication'.

- The taxpayer further argued to the question of the Tribunal as to why issuance of corporate guarantee cannot be treated as intra group services in the light of the OECD guideline; that the issuance of corporate guarantee cannot be treated as a service and even if it treated as a service, in order to come within the ambit of international transaction, the service should have 'a bearing on profits, income, losses or assets of the enterprise' and the said condition is not fulfilled in the present case.

- It was further submitted that the revenue authorities cannot lean to the OECD guidelines when the plain words of the statute are in favour of the taxpayer.

Tax department's contentions

- The DRP, in his directions, had referred and relied upon the decision of tax court of Canada in case of G E Capital Canada, wherein the DRP noted that the group company issuing the guarantee (i.e. the guarantor) would, in principle, at least need to cover the cost that it incurs with respect to providing the guarantee, and these costs may include administrative expenses as well as the costs for maintaining an appropriate level of cash equivalents, capital, subsidiary credit lines or more expensive external funding conditions on other debt finance. In addition, the guarantor would want to receive the appropriate compensation for the risk it incurs.

- Relying on the decision of Everest Kanto Cylinders Limited[7], the AO argued that the payment of guarantee fee is included in the expression 'international transaction' in view of the Explanation i(c) of Section 92B of the Act, by the amendment brought by the Finance Act, 2012 with retrospective effect, and the same has been approved by the Bombay High Court.

- The tax department further also relied on the decision of Vodafone India Services Limited[8] which holds that the effect of the amendment will have to be considered and cannot be brushed aside.

- The tax department argued that in case of Bharti Airtel, which was relied on by the taxpayer, it was not requested by the contesting parties to decide whether the provision of guarantee fee was a service or not and added that 'various Tribunal decisions have already held that provision for bank guarantee is a service and, as such, it needs to be benchmarked' and that 'whether the service has caused any extra cost to the taxpayer should not be the deciding factor to determine whether it is an international transaction'.

Tribunal's ruling

- The Tribunal observed that similar issues have already been covered by the decision in the case of Micro Inks Ltd[9]. Wherein the Ahmedabad Tribunal observed that similar products are not sold to any other concern, at the same price or even any other price, and interest is levied on the similar credit period allowed to those independent parties, but not to Micro USA. The question of excess credit period arises only when there is a standard credit period for the product sold at the same price and the credit period allowed to the AEs is more than the credit period allowed to

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[4] Bharti Airtel Limited v. ACIT [2014] 63 SOT 113 (Del)
[5] Redington India Limited v. ACIT [2014] 49 taxmann.com 146 (Chennai)
Redington India Limited v. JCIT [2015] 61 taxmann.com 312 (Chennai)
Videocon Industries Ltd v. ACIT [2015] 55 taxmann.com 263 (Mum)
[6] CIT v. Vatika Townships Pvt. Ltd [2014] 367 ITR 466 (SC)
[7] CIT v. Everest Kanto Cylinders Limited [2015] 119 DTR 394 (Bom)
[8] Vodafone India Services Limited v. Union of India [2013] 37 Taxmann.com 250 (Bombay)
[9] Micro Inks Ltd Vs ACIT [2013] 144 ITD 610 (Ahd)

independent enterprises. That is not the case here. The credit period for finished goods cannot be compared with credit period for unfinished goods and raw materials, and in any case, when products are not the same, there cannot be any question of prices being the same.

- The Tribunal held that issuance of corporate guarantee was in the nature of 'shareholder activities'/'quasi capital' and thus could not be included within the ambit of 'provision of services' under the definition of 'international transaction' under Section 92B of the Act.

- It distinguished the revenue's reliance on Bombay High Court judgment in Everest Kanto wherein guarantee commission was actually charged by the taxpayer, unlike in the present case. The grievance against the issuance of corporate guarantee being held to be an international transaction could not have come up for consideration.

- In the case of Vodafone India Services, applicability of retrospective amendment to Section 92B of the Act had been considered in context of 'transfer' and not 'international transaction'. The amendment clarifies the two aspects of transfer - the asset itself and the manner in which it is dealt with. The issue considered by the High Court was prior to the amendment, whereas in the present case, it is the amended definition which would have to be considered. In the present case, we do not find either necessary or proper to indicate the application of Section 2(47) of the Act as amended to the present proceedings. In view of the above discussions, the decision is equally misplaced and devoid of legally sustainable merits.

- Further, the Tribunal also distinguishes the Canadian decision of G E Capital Canada relied upon by the revenue authorities stating:
  - The same did not even deal with the fundamental question as to whether issuance of a corporate guarantee is an international transaction at all; and
  - The provisions of the Act and the Canadian Income Tax Act, 1985 are so radically different that just because a particular transaction is to be examined on ALP in Canada, that alone cannot be a reason enough to hold that it must meet the same in India as well.

- The Tribunal held that revenue cannot seek to widen the net of transfer pricing legislation by taking refuge of the best practices recognised by the OECD work.

- The Tribunal analysed the business model of bank guarantees, with which corporate guarantee are sometimes compared, in the context of benchmarking the ALP of corporate guarantee. A bank guarantee is a surety that the bank, or the financial institution issuing the guarantee, will pay off the debts and liabilities incurred by an individual or a business entity in case they are unable to do so. Even when such guarantees are backed by one hundred percent deposits, the bank charges a guarantee fees. Whereas in case of corporate guarantees, it is issued without any security or underlying assets. There is no recourse available with the guarantor if there is any default. Such guarantees are issued based upon the business needs and not risk assessment or underlying asset which generally the banks asks for. In general, therefore, bank guarantees are not comparable with corporate guarantees.

- Further relying on the decision of EKL Appliances[10], states that even if issuance of corporate guarantee is accepted as 'provision for service', such service needed to be re-characterised to bring it to tune with commercial reality, as 'no independent enterprise would issue a guarantee without an underlying security as has been done by the taxpayer' and also states that issuance of corporate guarantees is covered by the residuary clause of Section 92B definition.

- However, in the decision in Bharti Airtel, the Delhi Tribunal has explained in detailed, the legal position of the Section 92B of the Act and has specifically brought that the onus is on the Revenue to demonstrate that the transaction is of such nature so as to have a bearing on its profits, income, losses or assets. Such impact should be on a real basis and not on contingent or hypothetical basis. These conditions are not satisfied in the present case. It was held that, 'when the taxpayer extends an assistance to the AE, which does not cost anything to the taxpayer and particularly for which the taxpayer could not have realised 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 under Section 92B(1) of the Act' and deletes transfer pricing adjustment.

Our comments

The decision of the Ahmedabad Tribunal is a welcome decision for the taxpayers.

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[10] CIT v. EKL Appliances Ltd [2012] 345 ITR 241 (Del)

The decision specifically brings out distinguishing features between ‘corporate guarantees’ and ‘bank guarantees’, as well as ‘provision of guarantee services’ and ‘shareholder activity’/‘quasi capital’ which shall give significant clarity in examining similar transactions.

While the facts of each case need to be examined before the judgment could be applied, the judgment does cognisance to corporate and business realities, and reiterates the need to take into account business dynamics in conducting a transfer pricing analysis.

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