Commission for Corporate Guarantee provided – The Conundrum Continues…

Applicability of transfer pricing provisions on providing of corporate guarantee to subsidiaries has been a vexing issue. The question assumed larger importance after the decision of the Canadian Federal Court in the GE Capital Canada wherein the Court confirmed that providing corporate guarantee to subsidiary is a covered transaction for Transfer Pricing and allowed charging of commission by the parent company on the corporate guarantee given by it towards the borrowings of the subsidiary. Correspondingly, similar transactions in India, especially in case of outbound investments, also came under a much focused scrutiny with the Revenue authorities contending that the Indian parent company ought to have charged commission/fees of the guarantee given by it for their overseas subsidiaries. Consequently, many companies which have guaranteed the borrowings of their overseas subsidiaries and have not charged fees for the same have been facing transfer pricing adjustments. Read on to know more…

(Contributed by the Committee on International Taxation of the ICAI. Comments can be sent to citax@icai.org)

The earlier definition of international transaction contained under the Indian transfer pricing provisions did not cover corporate guarantee specifically as an international transaction. Consequently, many taxpayers challenged bringing corporate guarantee within the transfer pricing net and given the definition of international transaction, a few succeeded too. This saw an amendment to the definition of International transaction vide Finance Act 2012 and among other transactions, corporate guarantee too was specifically brought within the transfer pricing purview (and within a retrospective effect too...!).

While the specific inclusion of corporate guarantee in the definition of international transaction has brought clarity on the scope of international

transaction, disputes are likely to continue on the method to benchmark the arm's length consideration to be charged for providing corporate guarantee as well as the quantum of consideration.

In this article, we visit the important milestones in the journey of transfer pricing adjustments on corporate guarantee transactions.

1. Ruling of the Federal Court of Canada in the Case of GE Capital 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 of 1% 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.
- In the initial ruling by the Canadian Tax Court, the 1% guarantee fees paid by GE Canada were not deemed to be excessive and considered to be meeting the arm's length price. This ruling was contested by the Revenue Authorities before the Federal Court.
- 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.

Ruling:

- In course of the appeal proceedings, impact of the guarantee was sought to be determined. For this purpose, the credit ratings of GE US and GE Canada were sought. The credit rating of GE US was determined to be 'AAA' whereas the rating for GE Canada too was determined to be 'AAA'. However, it was agreed both by GE Canada and the experts, that the higher credit rating was due to the implicit support of GE US.
- Based on the details put on record, the yield curve approach was determined to be the most appropriate method to determine the guarantee fee. The method would enable comparison of interest rates at which GE Canada could borrow money with guarantee vis-à-vis without guarantee and hence, would provide a proper reflection of the benefit accrued due to the explicit corporate guarantee.
- The standalone credit rating of GE Canada was determined which was found to be substantially lower than the credit rating GE US. It was only on account of the explicit guarantee given by GE US did GE Canada enjoy a better credit rating and therefore, got benefit of a lower rate of interest. Various estimates put the benefit to be between 1% to 3%. Even the experts requisitioned by the Canadian Revenue Authorities agreed that some benefit did occur, though their estimates were put between 0.15% to 0.24%.
- Ultimately, a reasonable benefit in lowering of interest rates was determined to be 1.83%. Given the same, the Federal Court upheld that the guarantee fee of 1% charged by GE US from GE Canada would comply with the arm's length principle.

Key Takeaways from the Ruling:

- The yield method can be adopted as a suitable method to understand the benefit which a company enjoys by way of a higher credit rating which a company enjoys on account of an explicit guarantee and the credit rating without such guarantee. The difference in the interest-rates on account of the varying credit ratings is the benefit that an entity enjoys on account of explicit guarantee. This benefit is the maximum fee that could be charged for providing corporate guarantee.

  Here, it may however, be noted that the result provided by the yield method only provides the maximum rate which could be charged as fee for the corporate guarantee; however, it need not necessarily be construed as the rate which an independent third party would have charged in similar circumstances and hence, not necessarily be considered to be the arm's length price or the market price.
- In determining the arm's length price, all factors have to be considered, including the implicit support that the subsidiary enjoys on account of

its parent company. This principle of implicit support also finds mention in another tax ruling rendered by the Canadian court in the case of GlaxoSmithKline.

2. Hindalco Industries – Providing of Guarantee is Furtherance of Shareholder's Interest

While the writ petition filed by Hindalco Industries in the Bombay High Court was concerned with the maintainability of the transfer pricing proceedings initiated by the Transfer Pricing Officer in relation to its transaction of providing corporate guarantee on behalf of its subsidiary, a special purpose vehicle ('SPV') created for acquisition of the Canadian aluminum major, Novelis, the arguments presented by Hindalco for not charging of fees/commission for providing corporate guarantee are worth noting.

Facts:

- In 2008, Hindalco acquired Novelis for $3.48 billion through its wholly-owned subsidiary, a SPV created in the Netherlands.
- In order to arrange for the funds for acquisition purpose, Hindalco provided a corporate guarantee on behalf of its SPV to enable it to arrange for the necessary finance for acquisition. The total value of guarantee given was equivalent to ₹15,988 crore.
- Hindalco did not charge any fees or commission from its subsidiary for providing such guarantee. Consequently, the transaction was referred to the TPO for determining the arm's length consideration for the same.
- After a detailed inquiry into the transaction spanning eight hearings, the TPO finalised the consideration for providing corporate guarantee.

Summary of Arguments Presented by Hindalco:

- As a part of its global expansion strategy, Hindalco decided to acquire the Canadian company, Novelis Inc. As the borrowing for acquisition was arranged from international lenders, Hindalco created SPV outside India where the borrowing was made and which ultimately acquired Novelis on behalf of Hindalco.
- It was the contention of Hindalco that the acquisition of Novelis was a part of its global expansion strategy and therefore, being the 100% parent of the SPV which acquired Novelis, it was the full responsibility of Hindalco itself to arrange for the necessary finance to fund the acquisition.

  To fulfill this responsibility as a parent and shareholder only, Hindalco instead of directly funding the SPVs provided a corporate guarantee to the international lenders which enabled borrowing of the necessary finance at the SPV level.
- Further, it was stated that the acquisition was aimed at increasing the global reach of the parent company, Hindalco and strengthen Hindalco's position as a globally integrated aluminium producer with low-cost alumina and aluminium production facilities combined with high-end aluminium rolled product capabilities. Thus, the benefit accrued on account of the corporate guarantee was only to the account of Hindalco itself and not the SPVs.
- In view of the above, Hindalco contended that no service has actually been provided to its SPV and hence, it would be inappropriate on the part of Hindalco to charge a fee from its SPV. Hence, looking at the overall substance of the transaction, no guarantee fee was charged. Alternatively, in such a case, NIL guarantee fees would conform to the arm's length principle.

Comments:

The arguments forwarded by Hindalco provide an alternative line of argument which is for not charging any guarantee commission or fee. Many times parent company creates a SPV for furtherance of its own business objectives with no specific benefit or only an incidental benefit occurring to the subsidiary. Further, many times providing of guarantee is only an alternative method for discharging the parent company's obligation for financing its subsidiary.

In such cases, where the parent company by providing guarantee is only discharging its own functions or acting for furtherance of its own business objectives, then in such cases, it may be possible to explore the arguments of a shareholder or stewardship function in support of non-charging of any consideration from the subsidiary. Such arguments also find support in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

issued by the Organisation for Economic Co-operation and Development ('OECD').

Though the above arguments were not accepted at the adjudicating level and an adjustment made in case of Hindalco towards guarantee fee, it needs to be seen what view is adopted by the judiciary at the higher level. A final credible view on the acceptance of shareholder argument is likely to be reached only once a ruling is delivered by the higher forum.

3. 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 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.

Arguments Raised by the Taxpayer

- The transfer pricing regulations prevalent in India provide for computation of income from international transactions. The term International transaction as defined under the statute (in-force at the time of the ruling) does not specifically include corporate guarantee as an international transaction.

  In absence of any charging provision, such transaction cannot be brought within the ambit of transfer pricing regulations.
- Additionally, it was also contended that by providing corporate guarantee no benefit has accrued to the AE in the form of a lower rate of interest; rather it is the taxpayer itself who has significantly benefited from providing such guarantee. Accordingly, providing of guarantee was only incidental to the main business of the taxpayer.

Ruling of the ITAT:

- 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.
- 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.

4. Amendment in the definition of International Transaction by Finance Act 2012

The crux of the argument made in the above ruling centered on the fact that the definition of international transaction as it existed in the statute did not specifically cover transaction relating to corporate guarantee.

Taking note of this lacuna, the Finance Act 2012 amended the definition of International transaction to clarify the intent of the legislature. The amended definition was made effective retrospectively from 1st April, 2002 (i.e. the date from which transfer pricing regulations became effective). The revised definition of international transaction is quite elaborate in scope and enumerates numerous transactions between a taxpayer and its AE which could now be covered under the ambit of International Transaction.

Relevant extract of the Explanation to Section 92B which explains International Transaction is reproduced below:

Explanation. — For the removal of doubts, it is hereby clarified that—

(i) the expression "international transaction" shall include—

(a) ...

(b) ...

*(c) capital financing, **including any type of** long-term or short-term borrowing, **lending or guarantee, …..**"*

Thus, to avoid any further ambiguities and to plug the perceived drafting lacuna in the definition of International Transaction, the amended definition covers within its scope a wide range of transactions, including corporate guarantee, which a taxpayer may enter into with its AEs.

While the amendment, though expanding the scope of international transaction and therefore, may be viewed as unfavourable by many taxpayers who are likely to be adversely affected by the same, would be generally welcomed by the fraternity as it brings clarity in the interpretation of the law. However, the retrospective nature of the amendment by making it effective from 1st April, 2002 is likely to create a grouse for many of the taxpayers as they may face possible adjustments to their transfer price for the past years.

5. Judicial Precedent Post-Amendment in the Definition of International Transaction

Recently, the Bombay Tribunal in the case of *M/s Everest Kanto Cylinder Ltd. vs DCIT (ITA No. 542/Mum/2012)* had the opportunity to consider the issue of charging of fees for providing corporate guarantee. The case assumes importance as it has considered the amended definition of international transaction and held that in view of the amended definition, there remains no scope for debate on whether providing of corporate guarantee is an international transaction under the Indian transfer pricing regulations. The ruling is briefly explained below:

Facts:

- The taxpayer, M/s Everest Kanto Cylinder Ltd. is a manufacturer of high pressure seamless gas cylinders. During the period under consideration, its subsidiary based in Dubai had obtained loan from a bank which had been counter-guaranteed by the taxpayer.
- In lieu of providing corporate guarantee, the taxpayer charged a fee of 0.5% p.a. on the value of corporate guarantee. The rate of 0.5% was based on an independent sanction letter of credit arrangement that the taxpayer had with the same bank wherein the taxpayer was paying a guarantee fee of 0.6% to the bank.
- The rate of fee/commission charged by the taxpayer was deemed to be not at arm's length by the Revenue Authorities. Correspondingly, based on an external search, the Revenue Authorities considered that the arm's length fee for corporate guarantee should be 3%, which was the rate that some banks were charging for providing guarantee.

Arguments Raised by the Taxpayer:

- Relying on the ruling of the Hyderabad ITAT in the case of FourSoft (referred above), the taxpayer argued that providing of a corporate guarantee was not an international transaction itself.
- Even otherwise, it was argued by the taxpayer that it had only provided a corporate guarantee which did not entail incurring of any costs. Further, it was also required to be noted that the AE had sufficient assets of its own which were hypothecated against the loan obtained by it. Thus, providing of corporate guarantee was not detrimental to the taxpayer.
- As the taxpayer has not incurred any costs in providing the corporate guarantee, no benchmarking was required to determine the arm's length price.
- The Indian transfer pricing regulations do not prescribe any method for benchmarking the transactions relating to corporate guarantee and hence, in absence of any method, the provisions would not apply.
- In any case, the taxpayer relying on the decision of the Mumbai ITAT in the case of Asian Paints Limited (ITA No. 408/Mum/2010) and the decision of the Hyderabad in the case of Four Soft Ltd. (supra), argued that the rate of 3% determined by the Revenue Authorities cannot be upheld.

Arguments Raised by the Revenue Authorities:

- The ruling of the Hyderabad Tribunal of FourSoft is not valid anymore in view of the amendment of the definition of International Transaction inserted vide the Finance Act 2012. In view of the amendment, corporate guarantee is now specifically covered as an international transaction.
- Further, considering that the taxpayer has itself disclosed corporate guarantee as an international transaction and benchmarked the same by

using CUP method, its argument that it is not an international transaction and no method has been prescribed for benchmarking the same does not hold good.

- Once CUP method has been accepted as the method to benchmark the transaction, the same could be done by using External CUP or Internal CUP. In the present case, the Revenue Authorities have adopted external CUP for determining the arm's length price of the guarantee and hence, the same should be considered valid.
- Given the same, the rate of 3% utilised by the Revenue Authorities based on the generally prevailing market rates should be accepted.

Ruling of the ITAT:

- In view of the amended definition of International Transaction, transfer pricing regulations are specifically applicable to a guarantee transaction. Hence, the ruling of Four Soft and the taxpayer's reliance on the same would not hold good.
- 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.
- 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.
- However, on the use of the rate charged by banks, the ITAT held that charging of guarantee commission is a fact-specific exercise and would vary upon the facts of each individual case and the mutual understanding between the two parties involved. It is also practically seen that many times banks do not charge guarantee commission from their clients based on their relationship with them.

  Given the same, universal application of 3% rate for guarantee commission cannot be upheld in every case as the rate to be charged would depend upon the terms and conditions of the borrowing, risks undertaken, relationship between the bank and the client, economic and business interest, etc.

  Further, considering the taxpayer's assertion that it has not incurred any costs nor undertaken any risks, applying the rate of 3% on the guarantee commission based on external comparables and that to based on a naked quote given on a website is not proper. Hence, the adjustment made by the Revenue Authorities was deleted.
- Additionally, the ITAT noted that the taxpayer had itself obtained a guarantee in respect of its Indian borrowing from the same bank at the rate of 0.6%. Considering the same, rate of 0.5% charged by the taxpayer is adequate.

Way Forward

The transactions relating to providing of corporate guarantee are difficult to characterise for TP 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.

Further, the above rulings also do not lay down any method conclusively as the method most appropriate to benchmark the transaction relating to corporate guarantee. However, 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 utilising 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. ■