

Analysis of Corporate Guarantees under International Transfer Pricing Provisions



With the increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to its associated entities (AEs) abroad, where the Indian parent, as guarantor, agrees to pay the entire amount due on a loan instrument on default by the borrower. The guarantee helps an AE of the Indian multi-national enterprise (MNE) to secure a loan from the bank. The Indian transfer pricing administration generally determines the arm's length price (ALP) of such guarantee under comparable uncontrolled price (CUP) method. In most cases, interest rates quotes and guarantee rate quotes available from banking companies are taken as the benchmark rate to arrive at the ALP of such guarantees. This article analyses the treatment of such corporate guarantees under the international transfer pricing provisions and also discusses some recent judicial judgments on this subject. Read on...



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What is Corporate Guarantee?

Corporate guarantee is a guarantee given by a company on behalf of a borrower-company ensuring repayment of loan advanced by a lender in case of default in repayment by the borrowing company.

As per the explanation inserted retrospectively with effect from 1st April, 2002 in Section 92B by the Finance Act 2012, guarantee has been defined as an international transaction. The relevant extract is as under:

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

(i) *the expression “international transaction” shall include—*

(c) *Capital financing, including any type of long term or short term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;*

Hence, corporate guarantee given by an Indian company to its associated enterprise outside India is an international transaction for which arm's length price has to be determined as per the provisions of Section 92 of the Income-tax Act, 1961 ('Act').

It is to be noted that providing of corporate guarantee does not involve any actual inflow or outflow to/from AEs or transfer of any asset or liability to/from AEs but when one enterprise (guarantor) provides guarantee, the banks take into account the credit rating of such enterprise before lending the money to the other associated enterprise (borrower). As a result of which, the borrower is not only benefited by way of loan but also saves cost as the same are provided at a lesser rate of interest. Had there been no guarantee, the borrower either may not obtain a loan or even if obtained, at a much higher rate of interest in line with its own credit rating. The level of guarantee will be influenced by the interest saved by the borrower and the risk assumed by the guarantor. Therefore, the guarantor incurs cost (risk assumed) on one side and the borrower saves cost (interest saved) on the other side. Hence, inclusion of corporate guarantee by the Finance Act, 2012 is a logical and justifiable act.

Computation of Arm's Length Price

Generally, CUP is applied as the most appropriate method considering interest rates quotes and guarantee rate quotes available from banking companies. However, yield approach considering interest saved by the borrower can also be applied to arrive at the arm's length price.

Judicial judgments where contrary stand has been taken but was held that Corporate Guarantees are not covered within the definition of International Transaction

In the case of *Bharti Airtel Limited vs. ACIT (ITAT*

Delhi) (March 2014), it was held that, “there can be a number of situations in which an item may fall within the description set out in clause (c) of Explanation to Section 92B, and yet it may not constitute an International transaction, as the condition precedent with regard to the ‘bearing on profit, income, losses or assets’ set out in Section 92B(1) may not be fulfilled. For example, an enterprise may extend guarantees for performance of financial obligations by its associated enterprises. These guarantees don't cost anything to the enterprise issuing the guarantees and yet they provide certain comfort levels to the parties doing dealings with the associated enterprise. These guarantees, thus, do not have any impact on income, profits, losses or assets of the assessee... The situations can be endless, but the common thread is that when an assessee extends an assistance to the associated enterprise, which does not cost anything to the assessee and particularly for which the assessee 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.

In any event, the onus is on the Revenue authorities to demonstrate that the transaction is of such a nature as to have “bearing on profits, income, losses or assets” of the enterprise, and there was not even an effort to discharge this onus. Such an impact on profits, income, losses or assets has to be on real basis, even if in the present or in the future, and not on contingent or hypothetical basis, and 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.”

In the case of *Redington (India) Ltd vs. JCIT (Chennai Tri.) (July 2014)*, it was held that, “Corporate guarantee granted by the assessee to its AEs is to enable them to secure funds for their working on competitive rates in the relevant overseas jurisdictions. In the absence of such locally sourced funding, the assessee would have to support its AEs' business operations by providing funds through equity or otherwise. Accordingly, the transaction can be said to be one of quasi-equity or shareholder's activity. The well-being of the AEs is of deep interest to the assessee, especially where the business of the subsidiary generates synergies for the assessee. It

is in the best interest of the group that the assessee has provided corporate guarantees to its AEs. The learned senior counsel relied on the decision of ITAT, Delhi Bench, rendered in the case of *Bharti Airtel Ltd vs. Addl. CIT [2014]*, wherein it has held that providing corporate guarantee does not involve any cost to the assessee and it is not an “International transaction”, even under the definition of the said term as amended by the Finance Act, 2012, as it does not have any bearing on “profits, income, losses or assets” of the assessee company.

On the basis of the above mentioned judgments, it can be concluded that if a corporate guarantee is given to associate enterprise in the nature of parental obligation or shareholder’s activity for the best interest of overall group and the assessee is able to establish that providing corporate guarantee does not involve any cost to the assessee, then, such corporate guarantee is outside the ambit of the “international transaction” definition as per Section 92B even after the amendment by the Finance Act, 2012.

Here, we also need to understand how this issue is dealt with in international transfer pricing practices followed globally. As per OECD Transfer Pricing Guidelines 2010, “Chapter VII – Special Considerations for Intra-Group Services” discusses about the issues that may arise in determining for the transfer pricing purpose.

In Para 7.6 and Para 7.7 of the OECD Guidelines, it is explained how to determine whether an intra-group service has been rendered. Para 7.6 is reproduced here: *“Under the arm’s length principle, the question whether an intra- group service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm’s length principle.”*

Para 7.7 says, *“The analysis described above quite clearly depends on the actual facts and circumstances, and it is not possible in the abstract to set forth categorically the activities that do or do not constitute the rendering of intra- group services.”*

On the basis of the above mentioned judgments, it can be concluded that, if a corporate guarantee is given to Associate enterprise in the nature of parental obligation or shareholder’s activity for the best overall interest of the group, and the assessee is able to establish that providing corporate guarantee does not involve any cost to the assessee, then such corporate guarantee is outside the ambit of “International transaction” definition, as per Section 92B, even after the amendment by the Finance Act, 2012.

However, some guidance may be given to elucidate how the analysis would be applied for some common types of activities undertaken in MNE groups.”

In Para 7.10 of OECD guidelines, shareholder’s activity is explained in the following manner: *“The following examples (which were described in the 1984 Report) will constitute shareholder activities, under the standard set forth in paragraph 7.6:*

- a) *Costs of activities relating to the juridical structure of the parent company itself, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the supervisory board;*
- b) *Costs relating to reporting requirements of the parent company including the consolidation of reports;*
- c) *Costs of raising funds for the acquisition of its participations.*

In contrast, if for example, a parent company raises funds on behalf of another group member which uses them to acquire a new company, the parent company would generally be regarded as providing a service to the group member. The 1984 report also mentioned “costs of managerial and control (monitoring) activities related to the management and protection of the investment as such in participations”. ***Whether these activities fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether, under comparable facts and circumstances, the activity is one that an independent enterprise would have been willing to pay for or to perform for itself.***

Para 7.13 of the Guidelines explains the existence of intra-group service if an enterprise enjoyed a better credit rating due to a guarantee by another group member: “Similarly, 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."**

On the basis of the above, it can be said that the issue of corporate guarantee quite clearly depends on the actual facts and circumstances, and it is not possible to categorise the activities that do or do not constitute the rendering of intra-group services in case of corporate guarantee given to associated enterprise.

Let us understand the application of analysis described above on hypothetical facts under two different scenarios:

Scenario 1:

Facts: B Inc (USA) which is a subsidiary of AB Ltd (India) independent of Indian business of AB Ltd obtain a loan of \$100 million guaranteed by AB Ltd without any charge @4.50% p.a. However, in the absence of such assistance by AB Ltd, B Inc could acquire required funds @ 5.25% p.a.

Now, under the above scenario, it can be clearly identified that due to guarantee by AB Ltd, B Inc had benefited by saving of interest which would otherwise be payable. Any other entity would have obtained the loan @5.25% on its own or would be willing to pay for the guarantee provided by a non-related entity. Hence in this scenario, it can be established that an "intra group service" is provided by AB Ltd (India) to B Inc (USA) and such transaction should be

considered under the arm's length principle. Arm's length price can be determined by considering yield approach and/or CUP as the most appropriate method.

Scenario 2:

Facts: AB Ltd (India) on successful bidding acquires a coal mine in USA which requires a huge capital base of \$ 1,200 million involving fund raised from banks and financial institutions. The acquisition can be done directly by AB Ltd or through a 100% subsidiary, considering the business prudence. AB Ltd instead of setting up an offshore branch or unit, created 100% subsidiary B Inc (USA). Since, B Inc (shell company) is newly created and has no worth of its own to acquire coal mine, required capital base is provided by AB Ltd by way of equity contribution and a \$ 250 million loan @ 5.25% p.a. (prime lending rate of USA) was raised from bank for which a corporate guarantee is given by AB Ltd.

Under this scenario, in a realistic manner, since B Inc is a shell company, no bank would offer loan to B Inc unless it is backed up by a guarantee and also no other independent entity would offer guarantee for the loan taken by B Inc or may offer, but on very high charges which B Inc cannot afford. Hence, the act of providing guarantee to the bank by AB Ltd is justifiable in the nature of shareholder's activity as mentioned at Para 7.10 of OECD Guidelines stated above: *"Whether these activities fall within the definition of shareholder activities as defined in these Guidelines would be determined according to whether under comparable facts and circumstances the activity is one that an independent enterprise would have been willing to pay for or to perform for itself"*. Hence, it can be said that by providing guarantee to banks for lending loan to B Inc (USA), no intra group service is provided by AB Ltd (India) to its 100% subsidiary B Inc (USA) and such transaction is not required to be considered under the arm's length principle.

Conclusion:

The above stated study and analysis leads to only one conclusion, that transactions relating to providing of corporate guarantees are difficult to characterise for transfer pricing purpose and a comprehensive analysis of facts and circumstances of each case should be undertaken to determine the need of charge of guarantee fee and if yes, what would be the most appropriate method to determine the arm's length price. ■

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On the basis of the above, it can be said that the issue of corporate guarantee quite clearly depends on the actual facts and circumstances, and it is not possible to categorise the activities that do or do not constitute the rendering of intra- group services in case of corporate guarantee given to associated enterprise.

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