Corporate Guarantee – Certainty in taxation not guaranteed!

By S. Sriram

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.

\(^1\) CIT v. R D Agarwal and Co. [1965] 56 ITR 20 (SC)
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. 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.

The 1979 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

\(^{2}\) 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).
\(^{4}\) 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
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 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*, 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

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8 *Euro Hotel (Belgravia) Ltd (1975) 51 TC 293*
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 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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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)