Bloomberg
BNA

TAX PLANNING INTERNATIONAL

ASIA-PACIFIC FOCUS

International Information for International Business

VOLUME 16, NUMBER 1 >>> January 2016

www.bna.com

India Tribunal Holds Corporate Guarantee Not Subject to Transfer Pricing Adjustments

T.P. Janani and Joachim Saldanha
Nishith Desai Associates, India

In a recent ruling, the India Income Tax Appellate Tribunal has dealt with a contentious issue regarding the applicability of transfer pricing provisions in the context of corporate guarantees given by a holding company without charging any guarantee commission.

Transfer pricing provisions seek to assign an independent or arm's length value to transactions that take place between associated entities. The India Income Tax Appellate Tribunal ("Tribunal") has held that such corporate guarantees given for the benefit of a subsidiary and which do not have a "bearing on profits, incomes, losses, or assets" of the holding company, are in the nature of shareholder activity/quasi-capital (as opposed to provision of services), and is therefore not subject to arm's length adjustments.

I. Background

The taxpayer, Micro Inks Ltd ("MI India") is a leading ink manufacturer in India. MI India has a wholly-owned subsidiary in Austria named Micro Inks GmbH ("MI Austria"), which in turn has a subsidiary in the U.S. named Micro Inks Co ("MI USA"). MI India also has trading subsidiaries in China and Hong Kong.

MI India had issued various corporate guarantees on behalf of its subsidiaries without charging any consideration, e.g. a guarantee fee, for the same. MI India submitted before the Transfer Pricing Officer ("TPO") that the giving of guarantees to its subsidiaries should not be subject to an arm's length pricing ("ALP") adjustment. MI India further submitted that it had neither incurred any cost on providing these guarantees, nor did it recover the same from MI USA, and that the guarantees should be regarded as quasi-capital and not as services. The TPO rejected the submissions and subjected the transaction to an ALP adjustment on account of notional charges for the corporate guarantees issued by MI India.

Following MI India's unsuccessful objection before the Dispute Resolution Panel ("DRP") the Assessing Officer ("AO") made an addition to the total income of MI India. Aggrieved, MI India approached the Tribunal in appeal.[1]

II. Issue

The key issue involved in this case was whether a corporate guarantee given on behalf of a parent company

T.P. Janani is a Senior Associate and Joachim Saldanha is an Associate at Nishith Desai Associates, India

01/16 Copyright © 2016 by The Bureau of National Affairs, Inc. TPAF ISSN 1478-5129

to a subsidiary without charging a guarantee fee qualifies as an "international transaction" as defined for transfer pricing purposes.

III. Legislative Background

Section 92(1) of the Income Tax Act, 1961 ("ITA") states that "any income arising from an international transaction shall be computed having regard to the arm's length price." An ALP adjustment, under the scheme of international transfer pricing set out in the ITA can only be done in respect of a transaction that qualifies as an "international transaction" as defined in section 92B[2] of the ITA. The Finance Act, 2012 introduced a clarificatory Explanation to section 92B ("Explanation") with retrospective effect from April 1, 2002 ("2012 Amendment") which specified certain types of transactions which would be included within the definition of "international transaction". Importantly for this case, clause (i)(c) of the Explanation includes capital financing, including any type of long-term or short-term borrowing, lending or guarantee, and clause (i)(e) of the Explanation includes transactions of business restructuring or reorganizing, within the definition of "international transaction".

IV. Ruling

The Tribunal held that a corporate guarantee issued for the benefit of its subsidiaries, not involving any cost to the holding company and not having any bearing on profits, income, losses or assets of the holding company, is outside the ambit of "international transaction."

The Tribunal came to this conclusion on the basis of the opening words of the Explanation added by the 2012 Amendment "for the removal of doubts". As the Explanation is only intended to be clarificatory in nature, the Tribunal held that the Explanation is required to be read harmoniously with the main provisions and cannot alter the basic character of the definition of "international transaction" prior to the 2012 Amendment. Therefore, the Tribunal held that transactions that involve "capital financing" and "business restructuring or reorganization" (which are two categories of transactions mentioned in the Explanation added by the 2012 Amendment) do not reflect any of the specific transactions identified in the definition of "international transaction" prior to the 2012 Amendment. Therefore, such transactions can qualify as an "international transaction" only if they have a "bearing on the profits, income, losses or assets of such enterprises". Such "bearing" or impact may happen in the future, but would not cover situations where the impact is contingent. The Tribunal referred to earlier rulings in the case of Bharti Airtel Ltd,[3] and others[4] in coming to such conclusion.

The Tribunal also observed that, in a majority of circumstances, such corporate guarantees given to subsidiaries cannot be compared with bank guarantees as an ALP adjustment with respect to a transaction presupposes that such a transaction is possible in arm's length situation. Banks may not be willing to provide guarantees to the subsidiaries if they do not have adequate financial standing of their own and do not have any underlying assets which can be given as security to the bank and if there are no deposits with the bank which can be appropriated for payment of guarantee obligations. In the case of corporate guarantees, the risk is entirely entrepreneurial in the sense that it seeks to maximize profitability through shareholding in the subsidiaries. The Tribunal held that such guarantees are in the nature of shareholder activity/quasi-capital and do not qualify as "international transactions." It also held that the "provision for services" is restricted to services rendered and it does not extend to the benefits of activities per se.

Further, on the question of retrospective application of the 2012 Amendment to section 92B of the ITA, the Tribunal noted (in line with its earlier ruling in *Bharti*[5]) that anti-avoidance measures like the transfer pricing provisions are not primarily a source of revenue as they mainly seek compliant behavior from the taxpayer vis-à-vis certain norms and these norms cannot be given retrospective effect. However, the Tribunal did not rule on this point as it was not required to do so in the specific fact circumstances.

V. Analysis

This ruling covers some important general and specific principles. General principles re-iterated by the Tribunal in relation to interpretation of clarificatory amendments and validity of retrospective amendments in the context of anti-avoidance provisions could impact a wide variety of circumstances, For example, in the context of the infamous clarificatory explanations introduced in 2010 and 2012 in relation to indirect transfer of shares and in relation to payments being treated as "royalty" if made for software license arrangements or for right, property or information irrespective of whether possession or control of the same is with the payer and in relation to payments being treated as "fees for technical services" if made for services rendered outside India, etc., the principle that clarificatory explanations are required to be read in conjunction with the primary provisions and cannot extend the scope of the primary provisions may largely minimize the impact of the amendments.

Further, the Tribunal has emphasized that the "benefit" theory (which is recognized in OECD jurisprudence) is not relevant from an Indian transfer pricing perspective and has focused on whether transactions have a definite bearing on the income, profits, losses and assets of the taxpayer. It may be noted that tax authorities have referred to the 'benefit' theory as the basis of making ALP adjustments for notional charges in several circumstances—including notional interest on issue of shares by an Indian company to its foreign parent company at less than the fair market value of the shares, which was struck down by the Bombay High Court in cases such as *Shell* and *Vodafone*.

Specifically, the ruling on corporate guarantees recognizes the economic reality that parent companies grant corporate guarantees primarily in furtherance of their interests as a shareholder to improve the profitability of the subsidiary. This should come as a sig-

nificant boost to Indian companies in the process of expanding operations overseas, particularly, coupled with the recent relaxation in case of grant of credit facilities by Indian banks to second level or further step-down offshore subsidiaries of Indian companies.

However, it may be noted that in other cases involving a guarantee fee being paid to the holding company, it has been held that the guarantee fee will be subject to transfer pricing provisions as they have a bearing on the income, profits, losses and assets of the taxpayer.[6]

T.P. Janani is a Senior Associate and Joachim Saldanha is an Associate at Nishith Desai Associates, India

Notes

[1] It may be noted that this case also dealt with whether notional interest may be charged on the excess credit period given to an associated enterprise, as was done in this case. On the basis of its earlier ruling involving the Taxpayer, the Tribunal rejected the ALP adjustment of the TPO and held that the question of making an ALP adjustment for an excess credit period arises only when the prices of the product and the product are the same, and the credit period allowed to the associated enterprise is more than the credit period allowed to independent enterprises.

[2] Section 92B(1) defines an "international transaction" as a "transaction between two or more associated enterprises, either or both of whom are non-residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises."

[3] (2014) 63 SOT 113 (Del).

[4] *Redington India Ltd v. JCIT*, (2014) 49 Taxman 146 (Chennai); *Videocon Industries Ltd. v. ACIT*, (2015) 61 Taxman 312).

[5] See fn. 3 above.

[6] *Everest Kanto Cylinders Ltd v. DCIT* (2012) 34 Taxman 19 (Mum); *Aditya Birla Minacs Worldwide Ltd v. DCIT,* (2015) 56 Taxman 317 (Mum).

01/16 Copyright © 2016 by The Bureau of National Affairs, Inc. TPAF ISSN 1478-5129