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TAX FLASH NEWS

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Corporate/bank guarantee fees received by a foreign holding company cannot be treated as interest in view of 'Other Income' article under the India-U.K. tax treaty and it is taxable under the Income-tax Act

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Johnson Matthey Public Ltd. Company[1] (the taxpayer) held that the payment received by a foreign holding company from an Indian subsidiary on account of corporate/bank guarantee was accrued and received by the taxpayer in India and hence such a receipt is taxable in India. Such fees do not fall within the expression 'interest' in view of 'other income' article under the India-U.K. tax treaty (tax treaty). In the absence of any specific provision dealing with corporate/bank guarantee fees, the same has to be taxed in India as per the provisions of the Income-tax Act, 1961 (the Act).

Facts of the case

- The taxpayer is the ultimate parent company of both Johnson Matthey India Private Limited (JMIPL) and Johnson Matthey Chemicals India Private Limited (JMCIPL). The taxpayer provides various types of guarantees in relation to the business of its subsidiaries companies.
- During the Assessment Year (AY) 2011-12, the taxpayer provided guarantees to support credit facilities extended to JMIPL and JMCIPL by banks in India. Guarantees provided to HSBC and Citibank on a global basis outside India include a guarantee for the facilities extended to JMIPL and JMCIPL. The taxpayer also received a sum of INR5 million from JMIPL on account of the services rendered by senior management employee seconded by the taxpayer to India.
- While filing its return of income for AY 2011-12, the taxpayer treated the guarantee fees received from Indian subsidiaries to be in the nature of interest income under Article 12 (Interest article) of the tax treaty and offered tax at the beneficial rate at 15 per cent. Further, the payment on account of the seconded employee was treated as reimbursement and accordingly not offered to tax.
- The Assessing Officer (AO) treated the guarantee fee taxable under Article 23[2] (other income article) of the tax treaty and charged to tax at 40 per cent. The AO rejected the beneficial rate offered by the taxpayer under interest article of the tax treaty. The AO held that payment of INR5 million received on account of reimbursement of salary cost on behalf of Indian Associated Enterprise (AE) is taxable as Fee for Technical Services (FTS) under Article 13 of the tax treaty.
- However, during the course of the appeal, the taxpayer raised an additional ground stating that since the source of guarantee fee, received for providing a guarantee for its AEs to foreign banks is outside India, it cannot be held to be taxable in India.
- The taxpayer contended that since it does not have a Permanent Establishment (PE) in India, the income earned in the form of fees charged for providing bank guarantee/corporate guarantee, in the normal course of business, would not be chargeable to tax in India. The taxpayer relying on the decision of Capgemini S.A.[3] contended that

[1] Johnson Matthey Public Ltd. Company v DCIT (ITA No.-1143/Del/2016) – Taxsutra.com

[2] Under Article 23 of the India-UK tax treaty income is taxable at 40% plus surcharge and education cess

[3] Capgemini S.A. v. ADIT (ITA No. 7198/Mum/2012, dated 28 March 2016)

when the Indian subsidiaries avail credit facilities pursuant to the corporate guarantee agreement entered into by the foreign parent outside India with a financial institution, the guarantee commission received by the foreign parent does not accrue nor does it deem to have been accrued in India and, therefore, not taxable in India under the Act.

Tribunal's decision

Taxability of guarantee fee

- The Tribunal following the ratio laid down in the case of NTPC[4] admitted the additional ground.
- While as per Section 4 of the Act, income-tax shall be charged in accordance with, and subject to the provisions of the Act in respect of the total income of the previous year of every person, Section 5(2) of the Act states that, the total income of any previous year of a person who is a non-resident shall include all income from whatever source derived which is received or is deemed to be received in India in such year by or on behalf of such person; or accrues or arises or is deemed to accrue or arise to him in India during such year. In the cases covered under Section 5(2) of the Act, there are no escapes for the receipts from being included in the total income of the non-resident Indian.
- It is not the entering of the global corporate agreement outside India that occasions the taxpayer to charge the guarantee commission, but it is the act of the subsidiary is availing the loan that accrues the guarantee commission to the taxpayer.
- So long as there is no denial that the loan transaction took place in India, it is not open for the taxpayer to contend that no income accrued to them in India. The Tribunal relied on the decision of the Supreme Court in the case of Kanchanganga Sea Foods Pvt. Ltd[5].
- Accordingly, the Tribunal observed that the parental/bank guarantee commission was accrued and received by the taxpayer in India and hence such a receipt is taxable in India.

Whether guarantee fee is taxable as 'interest' or 'other sources'

- On a bare reading of the definition of interest provided under Section 2(28A) of the Act and Article 12(5) of the tax treaty, it indicates that either the debt claims of any kind or the service fee or other charge in respect of moneys borrowed or debt incurred, refer to the payments relating to the debt proper, whether or not there is any relationship of debtor-creditor or borrower-lender.
- The Tribunal observed that words and phrases employed in any provision of statute or tax treaty have to be understood in the context of their usage and with reference to the company of other words or phrases they keep in. Too much of expansion of the literal meaning, in disregard to the context or privity of the contract would lead to absurdity or negation of the purpose of the provisions. The word 'interest' as provided in Article 12(5) of the tax treaty and Section 2(28A) of the Act, shall have to be understood contextually and with reference to the other words and phrases in whose company it is to be found.
- Though the words 'claims of any kind', or 'service fee or other charge' are to be found either in the tax treaty or in the Act, with reference to interest, every periodical payment or remuneration for service in the context of a loan cannot be treated as 'interest'. The term interest, with its widest connotations, indicate the payments, whatever may be the name that is called with, relates to the payments made by the receiver of some amount, pursuant to a loan transaction.
- A loan transaction is also a species of contract. Article 12(5) of the tax treaty and Section 2(28A) of the Act extend the scope of such payments. However, payment or re-payment pursuant to any loan to be qualified as 'interest', necessarily have to be within the context of the loan and shall relate to the parties to the privity of contract. In this context only, the expressions 'claims of any kind', 'service fee or other charge' have to be understood. So also the expression 'whether or not there is the relationship of creditor-debtor or lender-borrower exists'
- It is only in the context and privity of contract, the payments covered by Article 12(5) of the tax treaty or Section 2(28A) of the Act would be qualified to be treated as interest, even if there is no semblance of a relationship between the parties like that of creditor-debtor exists. However, it does not take into its fold any payments made to a stranger to the privity of loan transactions, though such payments have to be made incidentally in relation to such loan.
- Undoubtedly, the taxpayer is a stranger to the privity of loan transactions inasmuch as the contract of loan is different from the contract of guarantee. In our considered opinion, the expression of 'debt claims

[4] NTPC v. CIT [1998] 229 ITR 383 (SC)
[5] Kanchanganga Sea Foods Pvt. Ltd v. CIT [2010] 325 ITR 540 (SC)

of any kind' or 'the service fee or other charge in respect of money borrowed or debt incurred' does not stand extended to the payment of guarantee commission received by the taxpayer in India.

- The payments relating to debt claims, service fee or other charge, could be categorised as interest provided they are privity of such contract. The thin line that separates the payment of interest from other payments will be missing and the payments towards consultancy charges, expenditure incurred for the purpose of pre-loan documentation and the host of expenditure incurred with third parties and not relatable to the loan transaction proper, will have to be treated as 'interest'. Certainly, it cannot be the intention of the legislature or treaty-makers.

- The Tribunal held that, so long as the taxpayer is a stranger to the privity of the contract of the loan between the Indian entity and the banker, they cannot categorise the corporate/bank guarantee recharge amount as interest for the purpose of taxation.

Taxability of bank guarantee as business income

- The Tribunal observed that the taxpayer is manufacturing technologically advanced chemicals known as catalysts used in automobile and other industries. It manufactures a variety of precious metal containing catalysts and chemical products which are used in a wide range of industrial applications. From the facts of the case, it indicates that the taxpayer was not involved in the business of providing corporate/bank guarantee recharge to earn income on a regular basis. The global corporate guarantee that was entered into by the taxpayer is only for the limited purpose of securing loans to its subsidiaries, and the recharge income is only an incidental one. In these circumstances, the Tribunal observed that it is difficult to accede the argument that the corporate/bank guarantee recharge would be a business profit, for the application of Article 7 of the tax treaty.

Taxability of bank guarantee as FTS

- With respect to the contention of the taxpayer that the corporate/bank guarantee recharge could be regarded as FTS, the Tribunal observed that the payment does not relate to the tendering of any technical or consultancy service and the question of making available any knowledge, experience, skill know-how or process or consist of any development or transfer of a technical plan or a technical design. At the same time, it does not also meet the requirement of Explanation to Section 9(1)(vii) of the Act. Therefore, the Tribunal observed that guarantee recharge amount is not FTS.

Having examined the issue of corporate/bank guarantee recharge with reference to Article 12(5) of the tax treaty and Section 2(28A) of the Act, the Tribunal is of the opinion that the lower authorities are correctly justified in concluding that the payment does not fall within the expression of interest and in view of other income article of the tax treaty, in the absence of any specific provision dealing with corporate/bank guarantee recharge, the same has to be taxed in India as per the provisions of the Act.

Taxability of secondment fees

- The Tribunal agreed with the taxpayer that applicability or otherwise of the ratio of the jurisdictional High Court in the case of Centrica India Offshore (P.) Ltd.[6], is a fact-specific question to be determined with reference to the functions performed and the conduct of the duty of the seconded employee with reference to the business of the taxpayer and the Indian entity. The principles laid down by the jurisdictional High Court in the case of Centrica are that the secondment agreement was required to be examined in the light of certain questions[7]. These questions are to be answered with reference to the secondment contract, secondment agreement, employment contract and salary reimbursement agreement, which, when read together point out either points of similarity or distinction between these two cases and more particularly, whether the employees have been released from their work and subsequently they entered into a separate local employment agreement with Indian AE.

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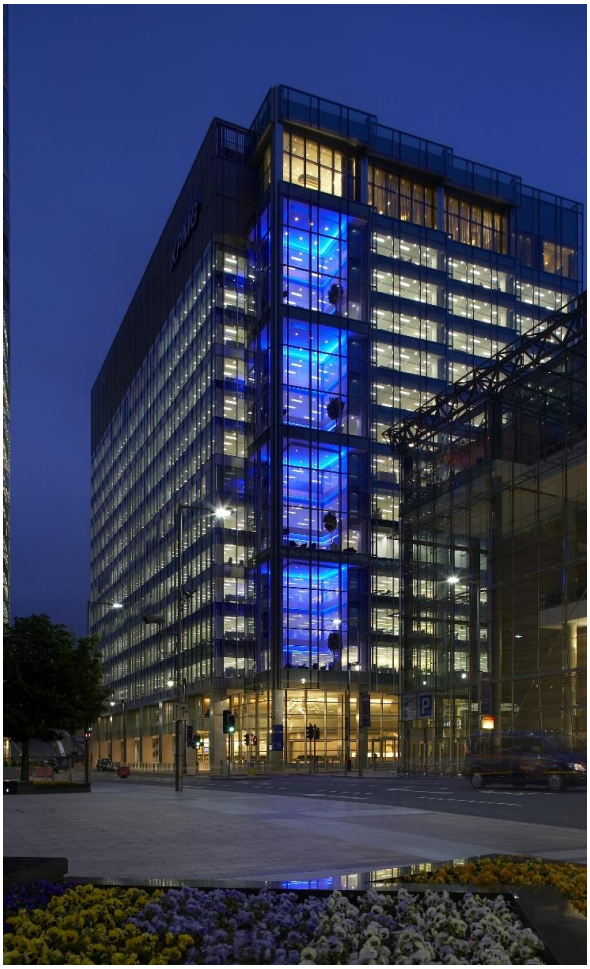
[6] Centrica India Offshore (P.) Ltd. v. CIT [2014] 364 ITR 336 (Del)

[7] i.e. (i) Who bears the responsibility or risk for the results produced by the employee's work? (ii) Who has the authority to instruct the worker regarding the manner in which the work has to be performed? (iii) Who has control and responsibility over the place where the work is performed? (iv) Who puts the tools and materials necessary for the work at the employee's disposal? (v) Who determines the number and qualifications of the employees? (vi) Who has a right to terminate the contractual arrangements entered into with that individual? (vii) Whether there is a right to impose disciplinary sanctions related to the work of that individual? (viii) Who determines the work schedule of that individual?

- The documents filed by the taxpayer do not shared any light on these questions. The inference that could be drawn from the documents filed by the taxpayer scarcely distinguish the present case from Centrica and the documents produced by the taxpayer are no substitute for the secondment contract and secondment agreement, and for the failure of the taxpayer in the discharge of its burden of proof. Therefore, the Tribunal directed the taxpayer to produce the relevant documents before the AO and set aside the issue to the file of the AO to give a fresh finding after looking into the documents to be produced by the taxpayer.



Our comments

The issue with respect to the taxability of corporate/bank guarantee fees received by a foreign holding company from an Indian subsidiary has been a matter of debate before the Courts/Tribunal.

The Delhi Tribunal in the present case held that corporate/bank guarantee fees received from an Indian subsidiary are taxable under ‘other income' article. It was held that such corporate/bank guarantee is neither in the nature of ‘interest' or ‘FTS' which could be taxed at beneficial rate nor in the nature of business income.

The taxpayer relied on the decision of Mumbai Tribunal in the case of Capgemini S.A.[8] wherein it was held that guarantee commission received by a foreign company did not accrue in India nor it can be deemed to be accrued in India, therefore, not taxable in India under the Act. Further, as per Article 23(3) of India-France tax treaty, income can be taxed in India, only if it arises in India. The Mumbai Tribunal held that the income arises in the overseas country since the guarantee was given by the foreign taxpayer in the foreign country and, therefore, Article 23(3) of the India-France tax treaty does not apply as income does not arise in India. However, the Tribunal in the present case has held that the bank guarantee commission was accrued to and received by the taxpayer in India. It is not the entering of the global corporate agreement outside India that occasions the taxpayer to charge the guarantee commission, but it is the act of the Indian subsidiary availing the loan that accrues the guarantee commission to the taxpayer.

[8] Capgemini S.A. v. ADIT (ITA No. 7198/Mum/2012, dated 28 March 2016)

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