



## TAX FLASH NEWS

### **Bombay High Court held that the considerations applied for issuance of a corporate guarantee are distinct and separate from that of a bank guarantee and such comparison is not appropriate**

#### Background

Recently, the Bombay High Court (High Court) in the case of Everest Kento Cylinders Ltd<sup>1</sup> (the taxpayer), upheld the deletion of adjustment on account of guarantee commission by the Income-tax Appellate Tribunal (the Tribunal) and held that the considerations applied for issuance of a corporate guarantee are distinct and separate from that of a bank guarantee and such comparison is not appropriate.

#### Facts of the case

- The taxpayer was engaged in making high pressure gas cylinders and compressed natural gas cylinders. During the financial year (FY) 2006-07 the Associated Enterprise (AE) of the taxpayer had taken a loan of USD 20,000,000 from ICICI Bank for which the taxpayer provided a corporate guarantee and charged a guarantee commission at 0.5 per cent.
- The Transfer Pricing Officer (TPO) found the provision of guarantee to be an international transaction as defined under Section 92B of the Income-tax Act, 1961 (the Act) and held that the transaction would have a bearing on the profits, income, losses or assets of the taxpayer.

<sup>1</sup> CIT v. Everest Kento Cylinders Ltd. [ITA NO.1165 OF 2013 (Bom)] – Taxsutra.com

- The TPO observed that the taxpayer became more leveraged with an increase in its overall risk exposure due to the corporate guarantee provided which would ultimately effect the cost of borrowing. Further, the AE was newly established and had a low credit rating. Thus, the TPO concluded that without the taxpayer's guarantee, ICICI Bank would not have given the loan to the AE. The TPO further held that banks and companies were charging at least 3 per cent for providing guarantees and therefore, the Arm's Length Price (ALP) for the guarantee given by the taxpayer to ICICI for the benefit of the AE was 3 per cent of the amount of guarantee and made a Transfer Pricing (TP) adjustment accordingly. The Assessing Officer (AO) incorporated the adjustment proposed by the TPO besides making certain tax related adjustments.
- The Commissioner of Income-tax (Appeals) [CIT (Appeals)] held that the return of 3 per cent arrived at by the TPO was justified. The taxpayer approached the Tribunal which inter-alia deleted the TP adjustment.

#### Proceedings before the High Court

- The tax department contended that without corporate guarantee, the AE would not have been granted the loan at all and that the ALP for the bank guarantee should be 3 per cent of the amount of guarantee for which it relied on various guarantee commissions charged inter-alia by HSBC Ltd and Allahabad Bank.

- With regard to the tax department's contention that AE could not borrow money without the taxpayer's guarantee, the taxpayer contended that the AE could have borrowed money as per prevailing rate in AE's countries which was around 5.5 per cent per annum. The taxpayer submitted that during the said period, AE had borrowed at the rate of London Interbank Offered Rate (LIBOR) + 0.83 per cent for term loan for working capital purpose. The taxpayer submitted that the prevailing LIBOR rates were ranging from 5.3 per cent and effective rate of borrowing was at 6.13 per cent for term loan and 5.8 per cent for working capital loan, which was in line with normal rates prevailing in the AE's country.
- The taxpayer further contended that AE had obtained a loan from its bankers on first charge towards fixed assets and further hypothecation of inventory and book debts. The taxpayer submitted that against an outstanding loan of USD 10 million as on 31 March 2007, assets were available to the tune of USD 27.4 million. Thus, there was no question of the AE not being able to obtain a loan without the corporate guarantee issued by the taxpayer.

### Issue before the High Court

Whether on the facts and in the circumstances of the case and in law the Tribunal was right in deleting the TP adjustment on guarantee commission?

### High Court's ruling

- The adjustment made by the TPO was based on instances restricted to commercial banks providing guarantees and did not contemplate the issue of a corporate guarantee. Commercial banks issue bank guarantees which are easily encashable in the event of default and hence in case a bank guarantee is obtained from a commercial bank, a higher commission can be justified; but in the present case, it is the taxpayer that is issuing a corporate guarantee.
- The High Court held that the considerations which are applied for issuance of a corporate guarantee are distinct and separate from that of bank guarantee and cannot be compared as done by the TPO. The comparison is not between like transactions but between guarantees issued by the commercial banks as against a corporate guarantee issued by a holding company for the benefit of its AE, a subsidiary company. Accordingly, the High Court ruled that there was no substantial question of law and dismissed the appeal.

### Our comments

This High Court ruling comes as a relief for taxpayers facing TP adjustments by TPOs on similar basis i.e. comparing guarantee rates of commercial banks to corporate guarantees provided by taxpayers. The ruling re-iterates that guarantee rate obtained by merely relying on data from banks without carrying out any comparability adjustments cannot be applied in a blanket manner to corporate guarantees.

While the basic issue of whether a corporate guarantee is a transaction covered under the scope of the transfer pricing regulations in India can now be considered to be a settled issue with the retrospective amendment to Section 92B of the Act, a more important issue of benchmarking a corporate guarantee transaction continues to be a debatable issue. While the High Court ruling does not fill in the gaps in providing any guidance on the manner of benchmarking corporate guarantee commissions, it at least lays down that bank guarantee commissions cannot simply be used to make adjustments to transaction prices.

Internationally, the topic of guarantee commission involves complex issues relating to performance guarantee/financial guarantee; explicit guarantee/implicit guarantee; shareholder activity, quasi-equity considerations/intra group services. As regards the benchmarking approach, while the interest saving approach may be used widely, certain circumstances may merit a risk of default loss approach. Further, for benchmarking the transaction, Indian taxpayers can also avail the specific safe harbour rates of SBI Base rate plus 150 or 300 basis points for any guarantees that may be covered under the prevailing Safe Harbour rules.

Finally, by dismissing the appeal, the High Court has also indicated that benchmarking of guarantees is a factual issue and does not merit any review from a legal standpoint. Therefore, taxpayers may indeed need to consider their specific facts and circumstances and various practical considerations in benchmarking their corporate guarantee transactions. This High Court ruling comes as a relief for taxpayers facing TP adjustments by TPOs on similar basis i.e. comparing guarantee rates of commercial banks to corporate guarantees provided by taxpayers. The ruling re-iterates that guarantee rate obtained by merely relying on data from Banks without carrying out any comparability adjustments cannot be applied in a blanket manner to corporate guarantees.

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