Intra-group credit guarantees in Transfer Pricing: 
Does India agree with the rest of the world?

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Intra-group credit guarantees in Transfer Pricing: Does India agree with the rest of the world?

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# Table of Contents

1. Background .......................................................................................................................... 4
2. The concept of guarantee .................................................................................................... 4
3. Approach of the OECD ....................................................................................................... 5
   Applicability of the arm’s length principle to financial transactions .......................... 5
   Intragroup services - Impact of association with multinational group .................. 6
   OECD’s Base Erosion and Profit Shifting Project .................................................. 8
4. Indian TP regulations and the tax authorities’ approach .............................................. 10
   Applicability and definition of international transaction ........................................... 10
   Indian TP authorities’ position as stated in the UN Practical Manual on TP for developing countries .......................................................... 11
5. The Indian tax courts approach ....................................................................................... 12
   Application of the separate entity approach ............................................................... 12
   The ITAT, Mumbai had occasion to consider various aspects such as commercial expediency, application of the credit rating of the parent company to the subsidiary, etc. in the context of interest free loans provided to subsidiaries by a parent company in the case of VVF Limited vs. DCIT. The taxpayer attempted to defend the arm’s length price of interest free loans on account of commercial expediency and the lending had been made out of interest free funds. However, the tribunal rejected these arguments and held that, the credit rating of the parent could be applied to the subsidiary and that the interest rate applicable to the taxpayer parent could be used to benchmark the interest rate applicable to the subsidiary under the internal Comparable Uncontrolled Price method. .................. 12
   Interpretation of the old definition of international transaction ..................................... 12
   Considerations in determining arm’s length price for Guarantee Fees ...................... 13
   Interpretation of the amended definition ...................................................................... 14
6. International Guidance and Jurisprudence .................................................................... 16
   United States .................................................................................................................... 16
   Canada .............................................................................................................................. 16
   The Netherlands .............................................................................................................. 17
   Australia .......................................................................................................................... 19
7. Conclusion ......................................................................................................................... 20
Bibliography .......................................................................................................................... 22
1. **Background**

In a 2012 report on “black money”\(^1\) published by the Indian Government, Transfer Pricing (“TP”) and shifting of profits to tax havens were named as two of the biggest causes of the creation of black money in India. Therefore, it should come as no surprise that the enforcement of TP is rather aggressive and often considered an attack on *bonafide* taxpayers. The approaches adopted by the Indian tax authorities in the course of TP audits is often considered as extreme by the industry, with reports showing that there has been a year on year increase of almost 100% in the total value of TP adjustments carried out in the recent past.

One of the more recent controversies which are being fought out in Indian tax courts in appeals pertain to international transactions which are in the nature of intra-group financing. Broadly speaking, this could cover borrowing/ lending of a short term/ long term nature, provision of guarantees as a requirement for loans from financial institutions, issue of shares and debentures, etc.

Intra-group financing in transfer pricing refers to the provision of the financing facilities (using any of the means described above) by one of the members of a multinational group to another member located in another country. As a consequence, the transaction would be required to adhere to the arm’s length principle. In the Indian context, there is much debate on whether certain financing facilities constitute a “transaction” which would be subject to TP and secondly, if a particular transaction is subject to TP, on how to apply the arm’s length principle.

The objective of this essay is to critically examine the controversy surrounding intragroup credit guarantees in India from the angle of whether it is a service or not and compare this analysis with the perspectives of other jurisdictions as may be codified in their respective statutes or with reference to judicial precedents from their respective tax courts. However, this essay does not deal with the determination of arm’s length price in respect of credit guarantees.

2. **The concept of guarantee**

Black’s law dictionary, 2nd edition defines a guarantee as “A contractual agreement where one party (the guarantor) provides payment to a second party (the beneficiary) should the contracting party default on its obligations. Through the provision of the guarantee, the obligations of the contracting party assume the credit rating of the guarantor, often a highly rated bank or insurer.” As a corollary, one may state that the effect of the guarantee is that the credit rating of the beneficiary is improved and therefore, he may avail a loan under more favourable terms than he would been able to had the guarantee not been provided by the guarantor.

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\(^1\) “Black money” can be defined as assets or resources that have neither been reported to the public authorities at the time of their generation nor disclosed at any point of time during their possession. [http://finmin.nic.in/reports/WhitePaper_BackMoney2012.pdf](http://finmin.nic.in/reports/WhitePaper_BackMoney2012.pdf) refer paragraph 2.1.1
Further, a guarantee may be either explicit or implicit. Explicit guarantees are those in which a guarantor explicitly (mostly, in a black and white in agreement) provides an assurance to the lender that in case of default by the borrower, all the claims would be settled by the guarantor.

Implicit guarantees are those where being part of a multi-national group makes it possible to secure a loan or secure more favourable terms, which one might not have been able to obtain as an independent entity. In these instances, the bank perceives that the parent entity of the group would intervene in the case of any default.

3. **Approach of the OECD**

The OECD’s approach may be looked at from the perspective of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines) issued in 2010 and as updated by the reports issued under the Base Erosion and Profit Shifting (BEPS) project.

**Applicability of the arm’s length principle to financial transactions**

The OECD recommends the application of the arm’s length principle to transfer pricing of cross-border transactions. This is enshrined in Article 9 of the OECD Model Convention which reads as below:

[When] conditions are made or imposed between two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Further, paragraph 1.6 of the Guidelines reads:

By seeking to adjust profits by reference to the conditions which would have been obtained between independent enterprises in comparable transactions and comparable circumstances (i.e., in "comparable uncontrolled transactions"), the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business. Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members. (Emphasis supplied).

Therefore, based on a joint reading of the above paragraphs, it would be important to analyse financial transactions, such as a guarantee, under the separate entity approach, i.e. an enterprise is distinct from the multinational group of which it is a part. There is also a general international consensus in
this regard that credit guarantees would be treated as being subject to the arm’s length principle.

Intragroup services - Impact of association with multinational group

In the Guidelines, the OECD has included a chapter specifically pertaining to the provision of services by companies in a multinational group in chapter VII, entitled “Special Considerations for Intragroup Services”.

They key considerations in this chapter are:

(i) Determining whether an intra-group service has been rendered?
(ii) If yes, determining the arm’s length charge for the intragroup services.

The Guidelines qualify an activity by a group member as a (chargeable) service if the activity provides another group member with “economic or commercial value to enhance its commercial position”. This benefit test is coupled with an arm’s length test: would an independent party in comparable circumstances have been willing to pay for the activity concerned (or have performed the activity in-house for itself)? As to the benefit test, the Guidelines seem to focus on the receiver of a service, requiring a specific benefit for which an unrelated party would be willing to pay.

The Guidelines discuss categories of activities and benefits for which no charges should be made such as for shareholder activities and activities that provide incidental or affiliation benefits. The Guidelines qualify these categories as generally not resulting in a benefit for the other party.

The scope of shareholder activities is often a point of discussion between taxpayers and tax administrations. These are activities that a group company performs solely because of its ownership interest in one or more other group members, i.e. in its capacity as shareholder even though those members do not need the activity and would not be willing to pay for it. The Guidelines explain in Para. 7.9 the term “stewardship activity” is to be distinguished from shareholder activity. The Guidelines quote the following examples of shareholder activities: (a) costs of activities relating to juridical structure of the parent itself, such as meetings of its shareholders, issuing of shares in the parent and costs of the supervisory board; (b) costs relating to reporting requirements of the parent, including consolidation of reports; and (c) costs of raising funds for the acquisition of participations.

Incidental benefits arise from activities meant for other group members. As an independent enterprise would not be willing to pay for such benefits no charges should be made. The Guidelines focus on the recipient stating that a recipient would not be prepared to pay an uncontrolled party to perform an activity yielding an indirect or remote benefit only.

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2 Para. 7.10 of the Guidelines
3 Para. 7.12 of the Guidelines
Intra-group credit guarantees in Transfer Pricing:
Does India agree with the rest of the world?

In the context of intragroup services, it becomes important to determine whether a service has been rendered on account of an implicit guarantee, i.e. where on account of association with a multinational group, a company in the group is entitled to a higher credit rating than, had it not been associated with the group.

In paragraph 7.13, the Guidelines state as follows:

“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.” (Emphasis supplied)

The following inferences may be drawn from the above paragraph:

- No intra-group service can be recognized in the event of merely being a member of a larger concern, without any specific activity being performed for that member\(^4\).

- Only when this is due to a guarantee given by another group member or as a result of a group’s reputation deriving from public relations campaigns, the benefit is more than incidental.

The first inference seems to indicate that implicit support may be likened to passive association. However, where the associated enterprise derives a higher credit rating on account of the concentrated efforts of the multinational enterprise, implicit guarantee may be considered as a service on account of “active promotion”. Also, implicit guarantee may be distinguished from passive association, where, the group company, on account of whose affiliation an associated enterprise’s rating is higher, would not be expected to remedy a situation of default of repayment of loan from the perspective of the lender.

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\(^4\) The term “halo effect” is popularly used to capture the adjustment to a subsidiary’s credit rating that would result from the passive benefits of being part of a multinational group.
OECD’s Base Erosion and Profit Shifting Project

The BEPS Project aims to provide governments with clear international solutions for fighting corporate tax planning strategies that exploit gaps and loopholes of the current system to artificially shift profits to locations where they are subject to more favourable tax treatment.

The OECD work is based on a BEPS Action Plan endorsed by the G20 in July 2013, which identified 15 key areas to be addressed by 2015; with 7 actions to be delivered in September 2014. One of the Action Plans, i.e. Action Plan 8, is entitled “Guidance on Transfer Pricing Aspects of Intangibles”. The report contains revisions to the OECD Transfer Pricing Guidelines to align transfer pricing outcomes with value creation in the area of intangibles. The changes clarify the definition of intangibles and provide guidance for related parties; including transactions involving intangibles and the transfer pricing treatment of local market features and corporate synergies.

The report also clarifies the approach towards intangibles by way of examples. In the context of corporate guarantees, examples 1 and 2 contained in the section pertaining to the amendments to Chapter I-III are relevant as these examples deal with the synergies arising out of association with a multinational group.

The amended paragraph 1.98 as contained in the revised report recognises that group synergies may arise as a result of increased borrowing power, inter alia. It recognises that such synergies may heighten the profits earned by the group members, depending on whether such synergies have actually resulted in cost savings to the group. The subsequent paragraph 1.99 refers to the paragraph 7.13 discussed above and clarifies the meaning of the term incidental benefits used therein. The term “incidental benefits” is clarified to mean benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit.

Before moving to the examples, the guidelines state that the benefits or detriments arising out of important group synergies should be shared between the members of the MNE group in proportion to their relative contributions or comparability adjustments could be made, if such synergies resulted out of concerted action of the members of the group.
Intra-group credit guarantees in Transfer Pricing: Does India agree with the rest of the world?

In example 1, the guidance examines the case of a subsidiary of a financial services group, whose parent has a credit rating\(^5\) of “\(A\)” based on the strength of the consolidated balance sheet of the group. The subsidiary's stand-alone balance sheet supports a rating of “\(Baa\)”\(^1\). However, on account of the subsidiary's membership in the group, independent lenders are willing to lend to it at a rate lesser than a rate that would have been entitled to as per its lower credit rating. If the subsidiary borrowed from both, an independent lender and a group company, the same amount for the same period and terms, then, the transaction between the subsidiary and its associated enterprise could be considered at arm's length because:

(i) it is the same rate charged to the subsidiary by an independent lender in a comparable transaction; and

(ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of the subsidiary to borrow from independent enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from the MNE group membership alone and not from any deliberate concerted action of members of the MNE group.

Example 2 proceeds with the facts provided in example 1, with the following modifications:

The independent lender would lend to the subsidiary at the rate applicable to a borrower with the credit rating of \(A\). However, the parent company of the group provides an explicit guarantee to the lender, because of which the interest rate on the loan given to the subsidiary is reduced to that what would have been applicable to borrower with the credit rating of \(AAA\).

In this regard, the Guidelines clarify that on account of the concerted action of the members of the MNE group, the subsidiary would be required to pay the parent company a guarantee fee. Additionally, the guidelines clarify that the fee charged should be reflective of the benefit derived from raising the credit rating to \(AAA\) from \(A\) and \(AAA\) from \(Baa\). This is due to the fact that the concerted action has only resulted in changing the credit rating from \(A\) to \(AAA\) and the rise in the rating from \(Baa\) to \(A\) was on account of passive association.

We can infer from the above that the Halo effect has been considered and inferred to not be a service as per the OECD's stand.

\(^{5}\) In principle, credit rating is a formal evaluation of a company’s capability of repaying its financial obligations, i.e. its fundamental creditworthiness. Credit ratings are publicly available for many companies with a history of previous participation in the capital markets. In this context, “credit ratings” refer to ratings that are assigned by internationally recognized credit rating agencies (e.g., Moody’s, Standard and Poor’s or Fitch). The Rating “\(A\)” is higher than “\(B\)” or “\(B\)” suffixed by another alphabet, sign or number.
4. Indian TP regulations and the tax authorities’ approach

Applicability and definition of international transaction

In India, the application of transfer pricing is governed by Chapter X of the Income-tax Act (“the Act”), 1961 in sections 92 to 92F. Section 92 of the Act provides that any income arising from an international transaction entered into by a taxpayer with its overseas associated enterprises shall be computed having regard to the arm’s length price.

Section 92B (1) defines an international transaction to mean a transaction between two or more associated enterprises, either or both of whom are non-residents and includes a transaction in the nature of 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 (hereinafter referred to as the “old definition” in the this essay).

Taxpayers took shelter under this definition for non-disclosure of certain transactions such as corporate guarantees and receivables arising in the normal course of business with associated enterprises to rebut the position of tax authorities. The Income-tax Appellate Tribunal (“ITAT”, an Indian tax court for appeals) upheld the position of the taxpayer in certain cases. The cases are discussed in the succeeding paragraphs.

In 2012, as part of the Transfer Pricing rationalisation measures, the Government made an amendment to the definition of international transaction by inserting a specific explanation to section 92B of the Act with retrospective effect from April 01, 2002, which provides that the term “international transaction” shall include capital financing, including any type of long-term or short-term borrowing, lending or guarantee (hereinafter referred to as the “amended definition in this article”). However, no further guidance was provided with regard to the differentiation between implicit and explicit guarantees or any methods to benchmark the guarantee.

Safe Harbour Rules:

The Finance Act of 2009 introduced section 92CB in the Act that empowered the Central Board of Direct Taxes (CBDT), the body for administration of Indian direct taxes, to issue transfer pricing “safe harbour” rules. A “safe harbour” is defined in the Act as circumstances in which the Tax Authority shall accept the transfer price declared by the taxpayer. The CBDT on 14 August 2013 released draft safe harbour rules for public comments. After considering comments of various stake-holders, on 18 September 2013, the CBDT issued the final safe harbour rules. Among others, the rules contain the prescribed safe harbour for provision of an explicit guarantee by a taxpayer to its wholly owned subsidiary.
The threshold limits and the prescribed safe harbour margins are provided in the table below:

- Up to INR 1 billion: The commission or fee declared in relation to the international transaction is at the rate of 2% or more per annum on the amount guaranteed

- Above INR 1 billion, provided the WOS has been rated to be of adequate to highest safety by a rating agency registered with SEBI: The commission or fee declared in relation to the international transaction is at the rate of 1.75% or more per annum on the amount guaranteed.

**Indian TP authorities' position as stated in the UN Practical Manual on TP for developing countries**

The UN published a practical manual on transfer pricing for developing countries in 2013. In the said document, the tax authorities of certain developing countries (such as China, Brazil and India) state their positions and rationale behind key TP controversy issues in their respective jurisdictions.

In paragraph 10.3.10, dealing with financial transactions, the Indian tax authority recognises credit guarantee fees as an issue in the Indian TP system. In the context of increase in outbound investments, the Indian transfer pricing administration has come across cases of corporate guarantees extended by Indian parents to its associated entities 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 MNE to secure a loan from the bank. The Indian transfer pricing administration generally determines the ALP of such guarantee under the comparable uncontrolled price 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. The Indian tax administration also uses the interest rate prevalent in the rupee bond markets in India for bonds of different credit ratings. The difference in the credit ratings between the parent in India and the foreign subsidiary is taken into account and the rate of interest specific to a credit rating of an Indian bond is also considered for determination of the arm's length price of such guarantees. However, the Indian transfer pricing administration is facing a challenge due to non-availability of specialized database and transfer price of complex cases of inter-company loans in cases of mergers and acquisitions which involve complex inter-company loan instruments as well as implicit element of guarantee from parent company in securing debt.
5. The Indian tax courts approach

Application of the separate entity approach

The ITAT, Mumbai had occasion to consider various aspects such as commercial expediency, application of the credit rating of the parent company to the subsidiary, etc. in the context of interest free loans provided to subsidiaries by a parent company in the case of VVF Limited vs. DCIT. The taxpayer attempted to defend the arm’s length price of interest free loans on account of commercial expediency and the lending had been made out of interest free funds. However, the tribunal rejected these arguments and held that, the credit rating of the parent could be applied to the subsidiary and that the interest rate applicable to the taxpayer parent could be used to benchmark the interest rate applicable to the subsidiary under the internal Comparable Uncontrolled Price method.

The arm’s length test in transfer pricing is based on the fundamental principle that related parties should be evaluated as if they were operating as separate and independent of the group of which they are a part. It may not be correct to state that a favourable financial position of the parent company could be automatically applied to the subsidiary. This represents a clear deviation from the separate entity approach which is key to the application of the arm’s length principle.

Interpretation of the old definition of international transaction

The earliest ruling available is the judgement of the ITAT, Hyderabad, in the case of M/s Four Soft Limited. In this case, the taxpayer had provided a guarantee to a financial institution for granting loan to the taxpayer’s subsidiary. However, the taxpayer did not charge any fee from its subsidiary any fee towards the guarantee provided to the bank. During the course of audit, the tax authorities made an adjustment based on information available on a bank’s website. The ITAT observed that, under the old definition:

“We find that the TP legislation provides for computation of income from international transaction as per Section 92B of the Act. The corporate guarantee provided by the assesse company does not fall within the definition of international transaction. The TP legislation does not stipulate any guidelines in respect to guarantee transactions. In the absence of any charging provision, the lower authorities are not correct in bringing aforesaid transaction in the TP study. In our considered view, the corporate guarantee is very much incidental to the business of the assesse and hence, the same cannot be compared to a bank guarantee transaction of the Bank or financial institution.”

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6 2010-TIOL-55-ITAT-MUM
7 142 TTJ 358
Subsequently, in the case of *Mahindra & Mahindra Limited*\(^9\), the ITAT, Mumbai remanded back the matter to the tax officer for re-consideration of the matter in light of the proposed new definition. The ITAT referred to the decision of Four Soft Limited (supra) and stated explicitly that while that judgement may have been passed under the old definition, the matter had to be reconsidered in light of the amendments brought in by the Finance Act, 2012 and the decision in the case of Four Soft may not apply.

This paved the way for possible alternative interpretations on account of the amended definition. The amended definition assumed greater significance in the case of ongoing appeals because of its retroactive nature. Therefore, even though the definition of international transaction did not include at the time of taxpayers adopting their positions while filing their returns, it was deemed to have been in existence since the commencement of TP legislation in India.

In the case of *Everest Kanto Cylinder*\(^10\) the ITAT restricted itself to the question of determination of the arm’s length charge for a guarantee fee since the definition of international transaction had already been passed. Based on facts, the ITAT held that the rate of guarantee fee charged by the taxpayer from its associated enterprise was at arm’s length on based on an internal comparable rate and concluded that an external benchmark was not required. There were similar facts and conclusions in the case of *Asian Paints Limited*\(^11\).

By and large, there have been rulings from the Tribunal which have importantly examined the arm’s length nature of the guarantee fee (to have been) charged, on account of the amended definition. Therefore, due to lack of judgements, one may not conclusively say, whether the transaction of corporate guarantee would have been viewed as a service by the ITATs under the old definition. Although, based on a review of the facts presented in some cases, even though taxpayers in India had provided explicit guarantees to their affiliates, they viewed this as a shareholder activity and a charge was levied as a matter of abundant caution.

**Considerations in determining arm’s length price for Guarantee Fees**

An interesting pattern of facts emerged in the case of *Glenmark Pharmaceuticals Limited*\(^12\). In the instant case, the taxpayer had charged guarantee fees from its affiliates for explicit guarantees and had chosen not to press in the appeal on whether it was an international transaction or not on account of the amended definition. The tax authorities proposed an adjustment to the transfer price using external comparable guarantee rates provided by

\(^{9}\) TS-394-ITAT-2012(Mum)  
\(^{10}\) ITA No.542/Mum/2012  
\(^{11}\) TS-297-ITAT-2013(Mum)-TP  
\(^{12}\) TS-329-ITAT-2013(Mum)-TP
banks. The taxpayer defended its position by reasoning that it would be unreasonable to charge the rates being charged by the banks since the “naked quotes” available on banks were subject to negotiation and consideration of the amount guaranteed. It was also pointed out that the naked quotes using which the adjustment was sought to be made pertained to amounts which were only a fraction of the amount guaranteed by the taxpayer. Therefore, applying the principle that the guarantee commission charged would reduce as the amount guaranteed increases, the taxpayer opined that no further adjustment was warranted. Also, a “naked quote” would not take into consideration the differences in the risk involved as regards a particular loan guaranteed. On this basis, the ITAT distinguished a “corporate guarantee” and a “naked guarantee” and stated various factors as stated below would need to be considered in the pricing of guarantee fees:

(i) risk profiles of the respondents for the guarantee,
(ii) financial position of the loan applicants,
(iii) terms of the guarantee,
(iv) securities involved,
(v) quantum of guaranteed amount,
(vi) period of guarantee,
(vii) past history of the customers,
(viii) Bank guarantee vs corporate guarantee, etc.

The ITAT accepted that the two quotes could not be directly compared and reasonable adjustments would be required to be made for the effective application of the CUP method. The corporate guarantees, given to the banks for safeguarding the interests of the AEs, are not given on commercial consideration, unlike banks, which provide guarantees with a profit motive. For banks, providing guarantees was in the ordinary course of their business and their charges / rates are always on the higher side on account of the embedded profit element. Therefore, the ITAT concluded that “naked quotes” would need to be adjusted for risks and functions and cannot be directly compared. This judgement considered the other judgements ratio with regard to the arm’s length charge and reiterated the key conclusions on the selection of comparable prices for the purpose of determining the arm’s length price.

**Interpretation of the amended definition**

The ITAT, Delhi, in a ruling in the case of M/s. Bharti Airtel Limited\(^\text{13}\) adjudicated on transfer pricing issues arising from the issuance of a corporate guarantee to associated enterprises among others. In this case, the taxpayer, an Indian company, provided a guarantee to a third party bank on behalf of its foreign subsidiary for which it did not charge a fee. The taxpayer contended as it did not incur any costs in providing the guarantee, there was no requirement for it to

\(^{13}\) ITA No. 5816/Del/2012
Intra-group credit guarantees in Transfer Pricing: Does India agree with the rest of the world?

charge a fee to the subsidiary under the transfer pricing provisions. During assessment proceedings, the tax officer imputed an arm's length guarantee fee by applying the CUP method and considered the commission charged by independent banks as a benchmark. The ITAT, considering the facts of the case, held that the corporate guarantee provided by the Taxpayer, which does not involve cost to the Taxpayer, does not have a bearing on profits, incomes, losses or assets of the Taxpayer and hence the transaction does not fall within the ambit of the amended definition of “international transaction”.

It would be significant to note that, the ITAT took into cognizance the variations brought in under the amended definition and held that the precondition of a transaction having bearing on profit, losses or assets of an enterprise cannot be dispensed with even after the explanations added to the definition of the international transaction by the Finance Act of 2012 since such explanations are merely clarifications. The Tribunal further held the onus is on the tax authorities to demonstrate the transaction has a “bearing on profits, income, losses or assets” of the enterprise. Such an impact on profits, income, losses or assets has to be on a real basis, whether in the present or in the future, and not on a contingent or hypothetical basis. Furthermore, there has to be some evidence on record to indicate, even if not to fully establish, that an international transaction has some impact on profits, income, losses or assets.

Taking into consideration the facts of the case, the Tribunal held that such conditions were not satisfied. The ITAT accordingly ruled that under the facts of the case, transfer pricing provisions do not apply to the provision of the guarantee and therefore the TP adjustment imputing an arm’s length guarantee fee is not warranted.

This judgement seems to be a departure from the OECD’s approach in the sense that the shareholder incurring a cost would not normally be considered in determining whether a service has been provided or not. The fact that would need to be considered is 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. Therefore, from the perspective of the recipient, if it were not something that he would have paid for, the activity should normally not be considered as an intra-group service under the arm’s length principle. Given that Indian TP law differs from the OECD’s approach in certain aspects with respect to the application of the arm’s length principle, it would not be out of place to state that this judgement highlights one of them.
6. International Guidance and Jurisprudence

United States

The applicability of transfer pricing in the US is governed by section 482 of the Internal Revenue Code and the accompanying treasury regulations. It is enforced by the Internal Revenue Service (“IRS”). The arm’s length standard is codified in the US regulations as below:

“In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result)”\(^{14}\)

Given that the US is one of the earliest nations to adopt transfer pricing rules in its taxing statues, one may think that the regulations may include specific guidance on pricing of guarantees. However, there is no such guidance. The U.S. regulations are silent regarding specific guidance for intercompany guarantees. One finds only a cursory reference to guarantees within the U.S. service regulations. But that reference establishes merely that “financial transactions, including guarantees” are “excluded activities” for purposes of pricing certain low margin services at cost. In other words, financial guarantees are not eligible for the “services cost method” under the U.S. regulations. Other than that reference, the U.S. regulations are silent on the TP treatment of guarantee fees. Although the IRS has promised to provide specific guidance on this issue, there has been no such guidance till date.

There have been judgements which have considered the nature of income of guarantee fees and the source of income (whether US source or Foreign source) to determine taxability of guarantee fees and the withholding tax rate for such fees. However, TP jurisprudence is little to nothing.

Canada

Canada is one of the nations with a very highly developed transfer pricing legislation. Section 247 of the Income Tax Act contains the legal framework for transfer pricing in Canada. In the context of credit guarantees, the ruling of the Tax Court of Canada (“TCC”) in the case of General Electric Capital Canada Inc. vs. The Queen\(^{15}\) is the most popular even in the international context due to the examination of implicit support in determining whether a service was rendered to support a payment of guarantee fees.

During the years under appeal, General Electric Capital Canada Inc. (the taxpayer) was a financial services company that carried on a number of businesses in Canada,

\(^{14}\) Treas. Reg. §1.482-1(b)(1)
\(^{15}\) 2009 TCC 563
including equipment, vehicle and real estate financing and technology management services. It was a wholly-owned, indirect subsidiary of General Electric Capital Corporation (GECUS), a US corporation.

The taxpayer financed its operations by borrowing funds from capital markets through the issue of debt in the form of commercial paper and unsecured debentures. GECUS began guaranteeing the taxpayer’s debt in 1988, but only started charging guarantee fees calculated at a rate of 1% per annum of the principal amount of debt outstanding, in 1995.

The taxpayer claimed deduction for the guarantee fees that became payable to GECUS for the tax years 1996 to 2000. The deductions claimed by the taxpayer were disallowed by Canada’s Revenue Agency (CRA). CRA argued that the guarantee fees should be zero due to the implicit guarantee inherent in the parent-subsidiary relationship between GECUS and the taxpayer.

The TCC differed from the CRA’s position that GECUS controlled the capital structure of taxpayer and therefore, could choose the amount of equity invested and control taxpayer’s debt to equity ratio. TCC stated that this contradicts the well-accepted principle that a corporation is a separate person whose existence provides limited liability protection to its shareholders such that the extent of a shareholder’s exposure is limited to the amount of capital the shareholder chooses to invest.

TCC recognized the difference between implicit support, which does not provide for a guaranteed recourse, and an explicit guarantee which provides much stronger protection and legally enforceable recourse to the lender.

TCC concluded that the yield approach (interest saving approach) was the appropriate methodology for ascertaining the economic value of the explicit guarantee and accordingly, the 1% guarantee paid represents an arm’s length price.

The Netherlands

The transfer pricing rules and the arm’s length principle\textsuperscript{16} in the Netherlands are codified in the Corporate Income Tax Act, 1969. The latest Transfer Pricing decree\textsuperscript{17} issued by the Dutch tax authorities which came into force on November 27\textsuperscript{th}, 2013 deals with intragroup financing transactions (among other things) and is meant to clarify the Dutch tax authorities position on certain issues. The decree also provides more certainty in the form of specific guidance about the level of substance the government expects in transfer pricing transactions.

\textsuperscript{16} Article 8b
\textsuperscript{17} Transfer pricing decree No. IFZ2013/184M
The decree indicates that financial guarantees may be issued for the following reasons, among others:

- the lender is not willing to issue a loan (or is willing to issue a loan only for a lower amount) without a guarantee;
- the lender is willing to issue the loan under less favourable terms without a guarantee; or
- the financial guarantee is required by the lender in order to preclude any potential moral hazard issues (for example, the borrowed funds are diverted from the original purpose, hence the loan may not be serviced as originally envisioned by the lender).

Starting from the assumption that a financial guarantee should be characterized as a service, the decree also elaborates on how to price arm's-length compensation for the issuance of a financial guarantee.

The decree indicates that when determining the benefit provided to the recipient of the guarantee, one must consider the recipient's stand-alone credit rating as well as the credit rating of the group. This consideration should be for the purpose of making a comparability adjustment to correct the price for any possible influence deriving from the "implicit support" provided to the subsidiary because of its being part of a multinational enterprise. The Dutch Ministry of Finance takes a firm position in stating that the notion of implicit support is to be considered for transfer pricing purposes as a matter of fact. The decree further indicates that strategic importance of a subsidiary is the relevant aspect to consider in determining the magnitude of the credit rating adjustment as a result of implicit support.

The Dutch Minister for Finance also drew reference to a Dutch Supreme Court Ruling in which the loss incurred by a Dutch taxpayer on account of provision of guarantee to a consortium of financial institutions for borrowings by its parent company.

According to the Supreme Court, if a company provides a guarantee for a bank loan entered into by its parent whereby that company runs a bad debt risk that would not have been accepted by an independent party, the company must be assumed to have accepted the risk with the intention of serving only the interests of its shareholder absent exceptional circumstances. The tax inspector defended the conclusion that the loss from the guarantee could not be deducted from the taxpayer's result, as the bad debt risk accepted by the taxpayer was not at arm's length. The tax inspector said a reasonably shared burden of proof supports the claim that a third party would not have accepted the bad debt risk run by the taxpayer from the guarantee. The Supreme Court concluded the loss resulted from the shareholder relationship and thus it was not deductible for Dutch corporate income tax purposes on account of Article 8(1) of the Corporate Income Tax Act which requires taxpayers to disallow expenses which result on account of shareholder relationship in computing the taxable income.
Intra-group credit guarantees in Transfer Pricing: Does India agree with the rest of the world?

Australia

In Australia, transfer pricing is enforced by the Australian Taxation Office (ATO). The ATO released a discussion draft of a paper on “Application of Australia's Transfer Pricing and Thin Capitalization Rules to Intra-group Finance Guarantees and Loans”.

The paper recognised implicit parental support and states that it is necessary to account for "implicit credit support" potentially provided by a parent when pricing an intragroup loan or credit guarantee. The paper defines "implicit credit support" to include:

- a letter of comfort or similar statement of intent which does not constitute a contractually binding commitment; and
- credit support obtained as an incidental benefit from the taxpayer's passive affiliation with the multinational group, its parent, or another group member.

While the ATO notes that the fact that financial markets might analyse financial arrangements "on a group basis may not be determinative since such an approach may defeat the purpose of the statutory rules," it is necessary to incorporate into a transfer pricing analysis any "incidental benefits from association with a larger group where the market accords those benefits without an associated company actually providing an economic service" that provide a benefit to the recipient of a loan or credit guarantee (i.e., to account for the impact of passive association). The ATO argues that such incidental benefits are not chargeable.

The ATO states that it views guarantees as constituting a "service" and notes Taxation Ruling TR 1999/1, which addresses "intra-group services," uses an "expected benefit" test to evaluate whether a service should be chargeable. As guarantees represent a service, the ATO argues that it is necessary to examine the provision of a credit guarantee from both the perspective of the provider and the recipient. With these arguments as context, the ATO argues that guarantees that, in substance, serve as a replacement for a contribution of equity to allow a subsidiary to be self-sufficient should not be chargeable, questioning whether "an independent party would provide a guarantee to support the borrowing of the company that could not borrow in its own right."

The ATO also states that, at arm's length, independent borrowers would not pay fees for arrangements that result in an overall detriment to them, nor would they pay fees for benefits that are already available. Therefore, the ATO asserts that in order to justify a charge for a guarantee, a taxpayer would need to demonstrate that the arrangement did not result in a net disadvantage to the subsidiary or replicate a benefit already available.

As with loans, the ATO argues that it has the power under the transfer pricing provisions to determine an appropriate price for a credit guarantee arrangement "in circumstances where no independent party would have done so."
7. Conclusion

Without even getting into determination of the arm’s length price of a credit guarantee (which is, by itself a separate controversy), the controversies and approaches surrounding the recognition of guarantees as services are varied. Indian TP enforcement has been steadily improving and has received an impetus especially after the introduction of the Advance Pricing Agreement (APA) program in 2012.

In a technical context, the definition of an international transaction requires that the international transaction under consideration have an impact on the income, profits, losses or assets of either of the enterprises. Therefore, the impact of the guarantee may not only need to be viewed from the perspective of the guarantor, but also, from the perspective of the other enterprises to the transaction, viz. the beneficiary. Therefore, the conclusion of the ITAT in the context of Bharti Airtel, that, since the guarantor has not incurred any cost to provide an explicit guarantee, it is not an international transaction, may have to be revisited in light of the above interpretation of the definition of international transaction. The Bombay High Court in the case of Vodafone India Services Pvt. Ltd. has concluded that there must be income arising or affected or income potentially arising or affected for the Indian TP regulations to apply. Hence, TP provisions would apply to the transaction and income that could potentially arise would need to be determined having regard to arm’s length principles.

With regard to implicit support, one may need to delve into the meaning of the implicit support in order to understand whether a fee would become payable or receivable as the case may be. For example, implicit support may be inferred in the case of issuance of a letter of comfort to a financial institution. By issuing a letter of comfort, the issuer would merely indicate that the principal debtor is a part of the group or that it a shareholder and there is no undertaking regarding the repayment of a loan by the issuer of such a letter. Therefore, assuming that there is no reasonable expectation by the lender that the issuer of the letter would be willing to repay in the event of a default, it would not be considered to be a service which is covered by the Indian TP regulations, since it results in a passive benefit to the borrower. It may be useful to note that Indian regulations do not provide any guidelines in this regard and it may have to be decided having regard to international best practices. Given the multiple perspectives involved in analysing whether the implicit support constitutes a service, it may not be possible to develop a straitjacket formula in order to arrive at a final response.

Another perspective is whether a guarantee could be in the nature of a shareholder activity. The authority in this context is the Supreme Court’s ruling in the case of DIT vs Morgan Stanley and Co. Inc. which ruled on the existence of a services permanent establishment for a foreign company in India under the Double Taxation

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18TS-320-HC-2013(BOM)-TP
19 292 ITR 416
Intra-group credit guarantees in Transfer Pricing:  
Does India agree with the rest of the world?

Avoidance Agreement ("DTAA") between India and the USA. The Supreme Court ruled that if a customer takes steps protect its interests, then, it cannot be said to be services provided to the person who had received the services. In the context of the ruling, the activities under consideration were in the nature of quality control activities of the activities carried on in India. The Supreme Court ruled that stewardship activities would not fall under the coverage of Article 5(2)(l) [Services PE article]. In addition, para 7.10 of the Guidelines includes “costs of raising funds for the acquisition of its participations” as a shareholder activity.

In comparison to the tax jurisdictions referred above, it may be safe to say that the Indian tax authorities’ position on recognising guarantees as a service when it is inbound is still unclear and leaves room for debate. Although they have expressed concerns and positions with regard to outbound guarantees, it would appear that there is still no guidance implicit support and said guidance cover only explicit guarantees. In addition to the above, the methods to be used to determine arm’s length price need to be based on international best practices since there is domestic guidance in this regard as well.

So, does India agree with the rest of the world? The only correct answer to this question may be, “not yet”. Stakeholders may be inclined to adopt a wait and watch approach to see how matters progress. The speed at which key issues are being disposed of by higher level courts provide an indication that the matters involving TP are being taken by the Indian judiciary more seriously, with the national objective of promoting inbound and outbound investments.

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20 Recently, the Bombay High Court pronounced its ruling on the popular “Vodafone Share issue” controversy and the hearing on marketing intangibles adjustment is underway at the Delhi High Court at a rapid pace!
Intra-group credit guarantees in Transfer Pricing: 
Does India agree with the rest of the world?

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