

Corporate Guarantee - Is there a Guaranteed Approach? - Part II

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In continuation to our previous segment of this article, Part I, where we have focused in-depth on the circumstances where there can be no chargeability for an implicit or explicit support through Corporate Guarantee from India and Global viewpoint, this segment of the article, Part II, attempts to elaborate on instances where Corporate Guarantee would be considered as a service and hence, chargeable to a guarantee fee. Further, the different approaches that could be adopted for benchmarking the guarantee transaction once it has been determined that a guarantor will require compensation for provision of guarantee service is articulated in the ensuing sections.

A. Explicit Guarantee requiring a service fee

Once the factors of implicit support and shareholder functions are ironed out, and it is established that explicit guarantee is provided, the question of determination of arm's length guarantee fee payment for the service rendered by the guarantor to the bank/financial institution becomes relevant. The stance of different tax jurisdictions regarding considering Corporate Guarantee as a service and levying arm's length charge emanates from the underlying assumption of an economic benefit being derived by the group company by way of availing beneficial interest rates with the provision of guarantee and the same is analysed below:

A.1. Global TP provisions/ guidance on benchmarking of guarantee

While most of the countries have clearly stipulated that a passive association will not require charge of guarantee fee, there is no distinct regulation in many countries that require a charge of guarantee fee for explicit financial guarantees provided by one group entity to another.

- **United States:** The existing IRS Treasury regulations and guidance issued under the US Regulation do not adequately address the application of Section 482 transfer pricing principles in circumstances where a company provides financial guarantees or other forms of credit support services to a member of the same group of controlled entities. The US Regulations have expressly carved-out financial transactions, including guarantees, from application of the Services Costs Method in the regulations and left open the question as to whether, and to what extent, Section

482 should apply to financial guarantees.

- **United Kingdom:** The UK Manual has unambiguously entailed the application of TP on guarantee transaction in the event where economic benefit is derived from the borrower from such guarantee.
- **The Netherlands:** The Netherland Decree provides that only in a condition where more favourable terms of loan is attainable due to explicit loan guarantee, an appropriate guarantee fee should be charged, thereby being in consensus with the OECD Guidance.

A.2. Approach adopted in India

- As discussed above, the transfer pricing regulation in India included Corporate Guarantee as an international transaction by introducing retrospective amendment in the Income Tax Act by appending clause “c” to explanation (i) in Section 92B of the Act through Finance Act 2012, thereby requiring an arm’s length charge. The matter of contention before inclusion of corporate guarantee as international transaction was qualification of corporate guarantee as an international transaction. Post amendment, the issue of eligibility as an international transaction continued to evolve, with addition of newfound arguments centred around the validity of retrospective amendment, interpretation of explanation to Section 92B of the Act in conjunction with the section itself.
- Mumbai Tribunal, in the case of **Siro Clinpharm Pvt. Ltd** [\[TS-144-ITAT-2016\(Mum\)-TP\]](#), struck down retrospective application and the Delhi Tribunal, in the case of **Bharti Airtel Ltd** [\[TS-76-ITAT-2014\(DEL\)-TP\]](#), held that Corporate Guarantee cannot be considered as international transaction. The Tribunal held that issuance of guarantee did not involve any costs and there was no impact on profits, income, losses or assets of the taxpayer, a pre-condition laid by Section 92B(1) of the Act to constitute an international transaction.

B .Guarantee fee benchmarking

By providing an explicit guarantee that is legally committed, the guarantor is exposed to additional risks, and an arm’s length compensation should be determined in compliance with transfer pricing regulations to compensate the guarantor for the risks assumed. Such arm’s length consideration of guarantee fee can be determined by deploying different methods. The selection of Most Appropriate Method (“MAM”) for benchmarking the Corporate Guarantee is one of the exceedingly disputed subjects of TP.

OECD provides an elaborate Guidance on the methods that can be adopted to determine ALP of corporate guarantee, however, such guidance is yet to be adopted as TP regulation by many countries. The ensuing paragraphs focus on throwing light on how the context of corporate guarantee took shape over the years in both the realms of legislation and jurisprudence in the Global and Indian TP regime and also on determining ALP of such explicit guarantees.

B.1. Guidance by OECD

Though the ideal scenario will be the application of Comparable Uncontrolled Price (“CUP”) Method, the availability of publicly available information reflecting a similar credit rating enhancement guarantee is limited. Accordingly, the taxpayers may have to resort to other indirect methods as described by OECD:

- **Yield approach:** This is the most common method being considered across the globe. This method takes into consideration maximum fee which a borrower would pay, resulting from the spread between the interest rate that would have been payable by the borrower without guarantee (including implicit support) and with guarantee. This has been upheld in the GE Capital case wherein the FCC has held Yield approach as the most appropriate method to benchmark the explicit guarantee provided to GECC by its parent. Also, the UK Manual discusses the computation of fee for the benefit derived by the borrower which could be dependent on the value of that particular guarantee and calculation of yield (i.e. interest savings).
- **Expected Loss approach:** Under this method, guarantee fee shall be calculated by deploying the statistical models for ascertaining the probability of default taking into consideration expected recovery rate, guaranteed amount and the expected return for the guarantor.
- **Capital Support (“CS”) Method:** This method involves bringing notional capital into the borrower’s balance sheet required to establish the borrower’s rating at par with the guarantor.

Thereafter, the guarantee fee could be priced based on expected return on such capital capturing the consequences of the provision of capital. However, the application of the method would require determination of credit rating of the borrower on a standalone basis.

- **Cost Approach:** Cost approach factors into account the value of the estimated loss that the guarantor would bear in case the obligation materializes for benchmarking the Guarantee transaction. Alternatively, capital required by guarantor for supporting such risk is also considered. Different modelling process can be implemented for determination of expected loss or capital requirement such as Option models, Credit Default Swap ("CDS") etc.

Employment of indirect methods can pose a great challenge for both the taxpayer and the Tax administration in identification of arm's length fee for guarantee transaction. For instance, the application of yield method only proposes the maximum benefit accrued to the guarantee recipient however the extent to which such benefit represents a guarantee fee is still a question. Further, both the yield and capital support method require ascertainment of borrower's individual credit rating which could prove be a strenuous activity in case the borrower is an unlisted entity besides having subjective acceptance of credit rating as determined by the credit rating agency. Also, the application of methods such as CS, CDS, Option Models etc., requires a complex analysis and will be extremely complicated to explain the method before the Court.

B.2. Global TP provisions/ guidance on benchmarking of guarantee

- **United States:** The US Regulation does not stipulate any guideline on determining ALP of guarantee fee, however, it mentions that the Service Cost Method ("SCM"), which evaluates the amount charged based on total service cost with no markup for the controlled service transaction, shall not apply to financial transactions including guarantee. Further, in accordance to author such exclusion from SCM cannot be inferred as non-consideration of financial guarantee as provision of services for TP purposes.
- **United Kingdom:** The UK Manual recommends application of yield approach before embroiling into the case of contesting ALP of guarantee fee charged and consider the impact of implicit guarantee in line with Canadian case, GE Capital Canada Inc. v. Her Majesty the Queen, 2009 DTC 563.
- **The Netherlands:** The Netherland Decree on Transfer Pricing is analogous to the broad principles provided by OECD Guidance. It requires evaluation of arm's length condition by determining if the borrowing entity would have obtained the guarantee and paid fee for it, and also provides that the fee payable cannot be higher than the difference between interest rate corresponding to derivative rating (that considers only implicit support of the group) and group credit rating.
- **South Korea:** Korean ministry of Finance has amended the Law on the Coordination of International Tax Affairs ("LCITA") in 2013 to introduce new clauses i.e. Articles 6-2(3) and 6-2(4). It provides that Corporate Guarantee fee be determined (a) based on guarantor's expected risk and cost; (b) based on guarantee's expected benefit to overseas affiliates; or (c) based on both a and b, being broadly in line with OECD Guidance. Also, the amendment has brought two Safe Harbor rules where guarantee fee shall be deemed to be arm's length (i) Where the fee is computed based on yield method by finance company providing the loan; and (ii) Fee is computed in accordance with conditions prescribed Tax commissioner based on guarantee's expected benefit.
- **Other APAC Countries:** Tax code of Countries in the APAC region such as China, Hong Kong, Japan, Singapore, etc., also do not contain any exhaustive guidance. Having said that, as a general principle China is consistent with the OECD Guidance i.e. explicit guarantee fee should be charged if economic benefit accrue to the borrower using most commonly reduced cost of funding approach i.e. Yield method.

Lack of any judicial pronouncement on the guarantee issue around the region with some countries such as Japan being member of the OECD and Singapore broadly following the standards promulgated in the OECD Guidance, it can be reasonably concluded most countries prescribe to OECD Guidance to determine ALP of Corporate Guarantee fee.

B.3. Approach adopted in India

Benchmarking the Corporate guarantee is a highly arraigned issue in the Indian Transfer Pricing landscape. Corporate guarantee issue in India is almost zeroed in on one side i.e., provision of corporate guarantee by an Indian parent to its overseas subsidiary, given the soaring outbound investments of India. Further, as touched upon in our Part I, the Indian Government has provided an alternate approach to mitigate the litigative nature of the transaction by including corporate guarantee fee under SHR. SHR as introduced for AY 2013-14 (that was applicable till AY 2017-18), considered commission or fee @2% per annum as at arm's length where the guarantee amount did not exceed INR 100 crore and commission of 1.75% as arm's length in a scenario where guarantee amount exceed INR 100 crore subject to highest credit rating of the borrower. The SHR were amended and the differential guarantee rates have been condensed to 1% irrespective of the guarantee amount, however, the TP principles applied to determine the rate of 1% is unspecified. Though the SHR has offered relief to the Taxpayer to avoid unwarranted litigation, the primary question of the classification of guarantee as implicit or explicit support and what portion needs to be considered for benchmarking still remains unanswered. Some of the key rulings to be considered while determining the ALP of Corporate Guarantee to be charged by such Indian parent companies are enumerated below:

The Tribunals have in the judgements such as **Everest Kanto Cylinders Ltd.** [\[TS-714-ITAT-2012\(Mum\)-TP\]](#), **Asian Paints Ltd.** [\[TS-297-ITAT-2013\(Mum\)-TP\]](#) and **Britannia Industries Ltd.** [\[TS-359-ITAT-2018\(Kol\)-TP\]](#) have upheld that internal CUP is the most preferred method for determining the ALP of a guarantee fee. Though internal CUP has been upheld as most preferred method followed by external CUPs, finding such CUPs are practically challenging. The tax authorities have been considering naked quotes of bank guarantee rates as external CUP, however, the Tribunal in the aforementioned rulings have rejected such naked quotes as comparables along the lines of OECD Guidance. In the absence of CUP, the Tribunals have resorted to adopting ad hoc rate in the range of 0.25% to 1% as ALP guarantee fee rate without applying any scientific or OECD recommended method to determine the arm's length rate.

One of the key challenges cited by the Indian Tax Administration in the India Chapter of UN TP Manual 2021 is non-availability of specialized tools and of comparable prices for cases of complex inter-company loans and mergers and acquisitions that involve complex inter-company loan instruments as well as an implicit element of guarantee from the parent company in securing debt. Thus, benchmarking of Corporate Guarantee is still a contested topic in India despite various rulings from different appellate authorities owing to near absent legislative provision, lack of comparables and being bereft of guidance.

D. Conclusion

The OECD and UN has provided an elaborate Guidance on the qualification and methods to determine ALP of Corporate Guarantee. While the principle of excluding charge of guarantee fee for benefits obtained from passive association or providing guarantee as part of shareholder activity has been concurred with and established through legislations by many countries, there is a lack of consensus on benchmarking analysis. The benchmarking analysis of Corporate Guarantee is inherently a complex pursuit and the fallout of uniqueness of Corporate Guarantee being issued only for a related entity is lack of comparables. Further, perpetual evolution of financial instruments by financing sectors only instigates obscurity in the benchmarking analysis.

In the absence of any settled position in connection with the benchmarking analysis of the Corporate Guarantee transaction, the taxpayers are under ambiguity for appropriate application of methodologies in the context of arm's length standard. With the release of OECD and UN guidance regarding the treatment of financial transactions, a constructive and consensus position from the major economic countries including India is an absolute necessity to moderate the contentious issue and provide a guaranteed approach to the guarantee transaction.