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News Alert  
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## Amounts paid to Banks and Financial Institutions as ‘guarantor’ of a joint venture company, not deductible as business expenditure

### In brief

The Mumbai Income-tax Appellate Tribunal (Tribunal), in the case of LML Limited<sup>1</sup> (the taxpayer), has confirmed disallowance of amounts paid as ‘guarantor’ for honouring guarantees. The sums being paid were in relation to promoting a new Company. The Tribunal has held the same to be capital in nature. Furthermore, the sum paid was held to be a ‘debt’ by treating the taxpayer as principal lender.

<sup>1</sup> LML Limited v. JCIT [TS-280-ITAT-2014(Mumbai)] The decision covers certain other issues as well. However, this news alert covers the primary issue pertaining to deductibility of expense/ loss incurred as guarantor.

### Facts

- The taxpayer, an Indian public company, was engaged in the business of manufacturing two wheelers. The taxpayer received a Letter of Intent (LoI) from Piaggio Cspl Italy (its technical collaborator) for manufacturing additional scooters and three-wheelers.
- For this purpose, the taxpayer formed a new joint venture company named Vespa Car Co. Ltd. (VCCL) alongwith Piaggio, and sub-leased the LoI to it.
- The share capital of VCCL was held by the taxpayer, Piaggio and the public in the proportion of 32%, 28% and 40% respectively.

- The taxpayer also furnished guarantees to different banks/ financial institutions against extension of credit facilities to VCCL.
- VCCL did not perform well, and as a result, the guarantee devolved on the taxpayer, who settled the same by way of a one-time settlement (OTS) entered into with the loan creditors.
- The taxpayer paid the required amount to VCCL and recorded the amounts as advance to VCCL in its books of accounts.
- The taxpayer claimed the amounts paid as revenue expenditure, which was not allowed by the tax officer and by Commissioner of Income-tax (Appeal).
- Being aggrieved, the taxpayer approached the Tribunal.

### Issue

Deductibility of the sums paid towards honouring guarantees (principal and interest thereon) extended to banks/ financial institutions.

### Taxpayer's contentions

- The formation of joint venture (JV) was a mode of conducting business and guarantees to banks/ financial institutions were in the normal course of business.
- The deduction was claimed as a revenue expenditure on the premise that the action of discharging the guarantees was guided by business considerations.
- Failure to honour the guarantee would have caused reputational risk for the taxpayer and would also have made it difficult to obtain working capital for VCCL in future.

### Revenue's contentions

- There was no direct link between guaranteeing of loans to VCCL, a separate legal entity, and the taxpayer's business.
- The guarantee given was towards promoting a new company for setting up a new project, and hence was on capital account.
- The consequences of non-honouring of the guarantee could not alter the character of the amount paid to VCCL to revenue expenditure.

### Tribunal ruling

- The taxpayer and VCCL were two separate legal entities. The Tribunal rejected the taxpayer's contention that the furnishing of guarantee was in the course of its business, for the following two reasons:
  - The taxpayer was not in the business of 'promoting other companies', and therefore, the sums advanced towards honouring of guarantees could not be treated as business expenditure due to absence of any link between the guaranteeing of loans and the taxpayer's business.
  - Even from the perspective of maximising shareholders' value, the taxpayer has assumed much higher financial risks as against the JV Partner although the parties have almost equal equity participation. The taxpayer was thus doing a disservice to its shareholders by trying to claim such ventures as part of its business purpose.
- The taxpayer's active involvement in the promotion of the new company, its equity participation as well as other arrangements, viz., furnishing of guarantees to lenders, transfer of technology, sub-licensing project, etc., unequivocally exhibit it as a promoter, with its interest being long-term and capital in nature.
- An analogy between the guarantees given and the advancing of loans/ contributing to equity capital could be made. Carrying this analogy further, write-off of the loan/ equity capital as irrecoverable could not be treated as

deductible business loss; the repaying of loans also needed to be viewed in the same light, and therefore treated as only a capital loss.

- Furthermore, the sum advanced to VCCL continues to appear as 'outstanding loan' in the books of the taxpayer and thus cannot be considered or presumed as a case of loss arising on account of the debt becoming irrecoverable. Accordingly, the amount paid is still a 'debt' receivable by the taxpayer.
- On the disallowance of interest, the same treatment and consideration applicable to the principal amount would hold true. Accordingly, the consequent interest on the loan will also be considered as capital in nature.

### **PwC Observations**

The Tribunal in the current case, based on a specific fact pattern, has held that loss due to devolvement of guarantee given for a JV company cannot be considered to be business expenditure for a taxpayer. In doing so, the Tribunal has looked at various aspects and treated this as capital loss akin to an irrecoverable loan.

This decision, based on facts, would have implications for claim of losses incurred as guarantor.

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