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Corporate guarantee not an international transaction

In a recent ruling in the case of Bharti Airtel Ltd.[1] (the taxpayer), the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) has opined on two key transfer pricing related issues. These are in the context of corporate guarantee issued on behalf of an associated enterprise (AE), and share application money paid to an AE. Each of these issues have been discussed below.

Issue 1 - Corporate guarantee

Facts

The taxpayer issued a corporate guarantee to a bank on behalf of its AE, for which it did not incur any costs. In its TP study, the taxpayer determined 0.65% p.a. to be an arm's length commission for issuing the guarantee, which the TPO rejected and instead determined the arm's length commission to be 4.68% p.a. This was upheld by the Dispute Resolution Panel (DRP). Aggrieved, the taxpayer appealed to the Tribunal.

One of the key arguments taken by the taxpayer before the Tribunal was that a corporate guarantee issued by a taxpayer, which did not involve any costs to the taxpayer, could not be subjected to arm's length price (ALP) adjustment as it did not come under the ambit of Indian transfer pricing regulations. The Tribunal considered only this ground and ruled in favour of the taxpayer, thereby deleting the TP adjustment. The Tribunal's ruling is summarised below.

Tribunal ruling

While ruling in favour of the taxpayer, the Tribunal held as follows:

- In order to attract the ALP adjustment, a transaction had to be an 'international transaction' under section 92B of the Income-tax Act, 1961 (the Act). The Explanation to section 92B, inserted with retrospective effect from April 1, 2002, was clarificatory in nature and hence did not alter the basic character of the definition of 'international transaction' under section 92B. Therefore, this explanation must be read in conjunction with the main provisions embodied in section 92B.
- The international transactions in clauses (a), (b) and (d) of the Explanation were already explicitly covered in section 92B(1). It was only the clauses (c) and (e) of the Explanation that were not explicitly covered, and thus fell under the residuary clause that covered "any other transaction having a bearing on profits, incomes, losses, or assets of such enterprises". Therefore, if a transaction had to

be covered by clauses (c) and (e), the transactions had to be such as to have a bearing on profits, incomes, losses or assets of such enterprise. When a taxpayer extended assistance to an AE, which did not cost it anything, and for which the taxpayer could not have realised money by giving it to someone else during the course of its normal business, such an assistance or accommodation did not have any bearing on its profits, income, losses or assets, and, therefore, was outside the ambit of 'international transaction' under section 92B(1).

- In any event, the onus was on the revenue authorities to demonstrate that the transaction was of such a nature as to have "bearing on profits, income, losses or assets" of the enterprise. There was no effort made to discharge this onus in the instant case. There had to be some material on record to indicate, even if not to establish it to the hilt, that an intra-group international transaction had some impact on profits, income, losses or assets.
- The impact on profits, incomes, losses or assets could be immediate or in future [as contemplated in clause (e)], but it could not be contingent or hypothetical – it had to be on a real basis. In the context of guarantee, a liability could arise for the guarantor if a default took place – however, this was a hypothetical situation and, based on this hypothesis, the guarantee could not be said to be an international transaction.
- There had been decisions taken in the past which dealt with quantum of ALP adjustments in guarantee charges, but in none of these cases had the scope of 'international transactions' under section 92B(1) come up for examination. A judicial precedent could not be an authority for dealing with a question which had not even come up for consideration in that case[2]. Accordingly, the conclusion reached in the instant case was based on interpretation of the legal provisions under section 92B. Further, no judicial precedent contrary to such interpretation of the legal provisions had been cited by the Revenue.

Issue 2 – Share application money

Facts

The taxpayer made payments to its AE towards share application money, which did not get converted into equity for a long time after the initial payment. The TPO objected to the taxpayer not having earned any interest for the period before which the allotment of shares eventually took place. Since the capital was blocked for a long time, the TPO deemed the share application money to be an interest-free loan to the AE for the period from the initial payment to the date on which the shares were actually allotted, and ALP adjustment was made for interest thereon. This was upheld by the DRP. Aggrieved, the taxpayer appealed to the Tribunal.

Tribunal ruling

The Tribunal ruled in favour of the taxpayer and held that it was unreasonable and inappropriate to treat the transaction as being in the nature of interest-free loan to the AE. In concluding so, the Tribunal made the following observations:

- The situation in the current case was not the same as an interest-free loan granted on commercial basis between the share applicant and the company to which capital contribution was made. There was also no provision in the law enabling a deeming fiction, so as to deem share application money to be interest-free loan.
- The transaction under consideration was of capital subscription, and its character was not in dispute. Yet, it has been treated as being in the nature of interest-free loan. It was not open to the revenue authorities to recharacterise the transaction unless it was found to be a sham or bogus transaction. There were no specific powers vested in the TPO to recharacterise the transaction. Recharacterisation could be done by revenue authorities when the transactions were found to be substantially at variance with the stated form. In the present case, it could not be held that this was a bogus transaction because the subscribed share capital had indeed been allotted to the taxpayer. The

transaction was thus genuine.

- There was no finding, in the instant case, as to what was the reasonable and permissible time period for allotment of shares. Thus, even if one was to assume that there was an unreasonable delay in allotment of shares, the capital contribution could have, at best, been treated as an interest-free loan for the period of 'inordinate delay' and not the entire period between the date of making the payment and date of allotment of shares.
- Even if ALP had to be determined in respect of such deemed interest-free loan on allotment of shares under the Comparable Uncontrolled Price method, as has been claimed to have been done in this case, it should have been done on the basis of what would have been interest payable to an unrelated share applicant if, despite having made the payment of share application money, the applicant was not allotted the shares. This could be determined by the relevant statute. However, the TPO, in the instant case, had not brought on record anything to show what interest an unrelated share applicant would have received for the period between making the share application payment and allotment of shares. Thus, the very foundation of the ALP adjustment was devoid of legally sustainable merits.
- Decisions in cases of VVF Ltd.[3] and Perot Systems TSI India Ltd.[4] could be distinguished as they were not cases in which capital contribution was deemed to be an interest-free loan.

PwC observations

For corporate guarantees issued to overseas AEs, apart from resorting to legal arguments as taken by the taxpayer in the instant case, it would nonetheless be advisable for taxpayers with similar transactions to agree the terms based on commercial and transfer pricing principles. In this regard, international best practices of considering shareholding nature of functions, creditworthiness of borrower, implicit/ explicit support, comparable intra-group financial arrangements, etc. may be considered. It would be prudent to follow such an approach also because the verdict of the Tribunal in the instant case is based on legal principles, which could possibly be overturned by either clarifications/ amendments to the law (as has happened in the past) and/ or by intervention at higher judicial forums.

As for the transaction of share application money, the decision of the Tribunal is certainly welcome as the Tribunal dissented to its re-characterisation as a loan, and appreciated the legitimacy and substance of the transaction.

1. Bharti Airtel Limited *v.* ACIT (ITA No. 5816/Del/2012, [2014] 43 taxmann.com 150 (Delhi-Trib.), AY 2008-09)
2. Supreme Court in the case of CIT *v.* Sun Engineering Works P. Ltd. [1992] 198 ITR 297 (SC)
3. VVF Limited *v.* DCIT (ITA No.673/Mum/2006, ITAT Mumbai, AY 2002-03)
4. Perot Systems TSI India Limited *v.* DCIT [2010] 37 SOT 358 (Delhi-Trib)

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