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Various factors to be evaluated while pricing guarantee commission - universal application of a particular rate rejected, and instead, internal CUP accepted

In brief

Everest Kanto Cylinder Ltd.[1] (the taxpayer) provided a guarantee for a loan taken by its associated enterprise. For this, the taxpayer charged 0.5% guarantee commission from the associated enterprise. The Transfer Pricing Officer (TPO) rejected 0.5% and applied 3% as the arm's length guarantee commission. On this issue, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) held as follows:

- In view of the amendment to the definition of international transaction, brought by the Finance Act, 2012, provision of guarantee is an international transaction, and thus the methods prescribed in the statute become applicable for determining its arm's length price.

- Charging of guarantee commission varies from transaction to transaction, and is dependent on terms and conditions of the loan, risk undertaken, relationship between the bank and the client, economic and business interests, etc.

[1] Everest Kanto Cylinder Ltd. v. DCIT [TS-714-ITAT-2012(Mum)-TP]

- A universal application of 3% for guarantee commission cannot be upheld in every case, and the use of a naked quote, available on the website, as an external comparable, is uncalled for.

- Guarantee commission of 0.5% charged to the associated enterprise was accepted based on an internal comparable of 0.6% guarantee commission paid by the taxpayer to its local bank for a letter of credit arrangement. The difference of 0.1% was ignored as it was considered to be on account of difference in the rate of interest charged under the two arrangements.

Facts

- The taxpayer was primarily engaged in manufacturing high pressure seamless gas cylinders, and entered into various international transactions with its associated enterprises.

- The only international transaction in dispute was that of guarantee commission charged by the taxpayer to an associated enterprise in Dubai (the AE).

- The AE had obtained a loan from ICICI Bank, Bahrain branch (the Bank), for which, the taxpayer provided the Bank a corporate guarantee. For this, the taxpayer charged the AE a 0.5% guarantee commission.

- The taxpayer did not benchmark the guarantee commission and considered the arm's length price (ALP) to be Nil on the pretext that it had not incurred any cost in providing the bank guarantee to the AE.

- The TPO rejected 0.5% commission, and gathered information on guarantee commission rates charged by various banks (including HSBC, Allahabad Bank, Exim Bank, etc.).

- From the information gathered, the TPO found that guarantee commission rates ranged from 0.15% to 3%. Using Comparable Uncontrolled Price (CUP) method, the TPO considered 3% to be the arm's length guarantee charge.

- Aggrieved, the taxpayer appealed to the Commissioner of Income-tax Appeals (CIT(A)), who upheld the adjustment, aggrieved with which, the taxpayer then appealed to the Tribunal.

Taxpayer's contentions

The taxpayer mainly contended that it was not required to recover the guarantee commission from the AE, as provision of guarantee was a strategic business decision. Further, there was no real financial burden or risk on the taxpayer for giving the guarantee. Also, the AE had not significantly benefited from the guarantee. Yet the taxpayer had charged 0.5%. In support of these contentions, the taxpayer put forth the following:

- The guarantee given to the Bank could be invoked only after the charged assets were liquidated. The charged assets were 2.7 times the loan value. The loan was thus a "least risk loan".

- The AE had obtained the loan as per the prevailing market rate in the AE's country. Thus, there was no benefit of lower interest rate derived by the AE due to the corporate guarantee furnished by the taxpayer.

- The AE had a low debt-equity ratio, and based on this any company could have availed loan without third party interference, and at the prevailing market rate.

Other contentions of the taxpayer were as follows:

- Corporate guarantee given by the taxpayer is not an international transaction (reliance placed on the Tribunal ruling in the case of Four Soft Ltd.[2]). Also, there is no method prescribed under the Indian statute to benchmark such a transaction.

- The guarantee commission rates ranged between 0.15% and 3%. However, the TPO had not provided any reason for applying 3% and not 0.15%. Further, the taxpayer was not a banking company, and therefore the CUPs considered by the taxpayer were not applicable. In specific, the rate of 3% charged by Allahabad Bank was an Indian rate and cannot be applied to an international transaction.

- To disregard the 3% rate used by the TPO, reliance was also placed on the Tribunal ruling in the case of Asian Paints Ltd.[3], wherein it was held that charging of guarantee commission at the rate of 3% on the basis of rates available on the website of Allahabad Bank, HSBC Bank and ICICI Bank, cannot be upheld.

- The taxpayer had an independent sanction letter of credit arrangement with ICICI Bank India, wherein, under a guarantee scheme, commission of 0.6% p.a. was paid by the taxpayer for the bank guarantee provided by ICICI Bank India in favour of the taxpayer. When such an internal CUP was available, there was no need to look for external CUPs.

Revenue's contentions

- The AE is a new and unknown entity, and thus has a low credit rating. Since the taxpayer was a reputed company with sound financial strength, the guarantee provided an advantage to the AE in obtaining credit facilities from banks on better terms. Had it not been for the guarantee provided by the taxpayer, the Bank would not have lent the money, or might have lent at a much higher rate.

- The taxpayer may not have incurred any apparent cost, but there is an inherent cost to the extent that the overall risk exposure of the taxpayer increases by the amount of guarantee. The taxpayer would not have taken such a risk for a third party. Provision of the guarantee makes the taxpayer more leveraged. This increases its debt equity ratio, which in turn affects its cost of borrowing. Therefore, a mark-up indicative of risk involved should have been charged from the AE. For this purpose, the difference between the Bank Rate and the Prime Lending Rate (PLR) may be used as an indicator of the risk perception of banks[4].

- Banks/ companies charged up to 3% guarantee commission. However, the cost of risk undertaken was not reflected in these rates because these guarantors obtain adequate security before providing guarantees. In the instant case, the taxpayer had not obtained any security from its AE. Therefore, the arm's length commission should have been much more than the rate charged by banks.

- In view of the amendment brought by the Finance Act, 2012, with retrospective effect, by way of Explanation to section 92B of the Income-tax Act, 1961 (the Act), it is clear that guarantee commission is now an international transaction. Further, the only method which can be applied is the CUP method, and the TPO has applied external CUP, using data available in public domain.

[2] Four Soft Ltd. *v.* DCIT [2011] 62 DTR 308 (Hyd)
[3] Asian Paints Ltd *v.* CIT [ITA No. 408/Mum/2010]

[4] The Bank rate is the rate at which the Reserve Bank of India lends money to the banks, and PLR represents the rate at which Banks lend money to customers.

Tribunal ruling

- In view of the amendment brought by the Finance Act, 2012 with retrospective effect from 1-4-2002, payment of guarantee fee is included in the expression 'international transaction' in view of the Explanation i(c) of section 92B of the Act. Once the guarantee fee falls within the meaning of 'international transaction', then the methodology provided in the rules also becomes applicable. Further, the taxpayer in its transfer pricing study report and also the TPO, have accepted that it is an international transaction and that CUP is the most appropriate method for it.

- A universal application of 3% for guarantee commission cannot be upheld in every case, as the charge for guarantee commission depends upon the individual transactions and the mutual understanding and relationship between the parties. Guarantee commission is largely dependent on the terms and conditions of the loan, risk undertaken, relationship between the bank and the client, and economic and business interests. In the instant case, while applying external comparables, i.e., guarantee commission rates charged by banks, the TPO has not brought anything on record regarding the terms, conditions and circumstances, under which banks have been charging a rate of 3%.

- The use of a naked quote, available on the website, as an external comparable, is uncalled for in the present case.

- It cannot be agreed that there could not be any cost or charge of providing a corporate guarantee, as there is always an element of benefit or cost while providing such kind of guarantee to AE. The taxpayer has itself charged 0.5% guarantee commission from its AE.

- In an independent transaction, the taxpayer has paid 0.6% guarantee commission to ICICI Bank India for its credit arrangement. This could be a very good parameter and an internal comparable for the transaction of the taxpayer with the AE. The charging of 0.5% guarantee commission from the AE is quite close to 0.6%. The difference of 0.1% can be on account of differential rate of interest[5] charged on the two underlying loans and can be ignored.

In view of the above, the Tribunal deleted the adjustment on account of guarantee commission.

PwC observations

In view of the amendment to the definition of international transaction, brought by the Finance Act, 2012 (with retrospective effect), the Tribunal has, at the outset, rightly discarded the taxpayer's plea that provision of guarantee is not an international transaction and that there is no method to benchmark it.

The Tribunal has also aptly reject the arbitrary and blanket application of 3% rate of guarantee commission. In doing so, the Tribunal has fully appreciated the pertinence of various underlying factors which could impact the fee for providing a guarantee. However, the factors listed by the Tribunal could be very specific to every transaction, and this may result in wide variations in a given sample. Therefore, finding an appropriate external comparable is bound to be a challenge.

Having said that, even an internal comparable must be carefully selected. In the instant case, the Tribunal has accepted the internal comparable of a guarantee given by an independent bank to the taxpayer under a letter of credit arrangement, to be an appropriate benchmark. However, this transaction could be said to be different from the guarantee given by the taxpayer to the AE in more than one

[5] The rate of interest on which ICICI Bank, Bahrain Branch has given loan to the AE is at 5.5%, whereas the taxpayer is paying interest of more than 10% on its loan taken from ICICI Bank, India.

ways. Firstly, the nature of the two underlying financing arrangements is itself dissimilar (i.e., a letter of credit arrangement is different from a loan arrangement). Further, the credit rating of the taxpayer could be much higher than the AE on a standalone basis. Also, the business and economic interests of the parties to the transaction could be quite diverse. Such differences would have a direct impact on the pricing of guarantee commission.

This ruling does not prescribe the methodology for determining guarantee commission. However, provision of guarantee always entails a risk for the guarantor and a benefit for the receiver of the guarantee. Therefore, pricing of guarantee fee must be a function of both or either of these factors. The benefit to the receiver of the guarantee is typically in the form of savings in the interest cost owing to the presence of an explicit underlying guarantee. Accordingly, the "interest savings approach" to measure the benefit derived from an explicit guarantee is a scientific approach which can be resorted to, and which is also in line with international best practices. Other internationally accepted approaches to price financial guarantees include "risk of loss approach", or a combination of "risk of loss approach" and "interest savings approach".

A guarantee provided by one AE to another, would typically entail a certain level of risk (cost) for the provider and benefit for the recipient. This has also been acknowledged by the Tribunal in the instant case. Nonetheless, owing to the AE relationship, it may also be possible to argue, but only in some circumstances, that the provision of guarantee is not in the nature of a service, but a shareholder's function and thus not requiring a charge. However, any such contention would have to be based only on an evaluation of the specific facts of each case.

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