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Bank guarantees and corporate guarantees distinguished / Naked bank quotes not good external CUPs

In brief

A recent ruling in the case of Glenmark Pharmaceuticals Limited¹ by the Mumbai Bench of the Income Tax Appellate Tribunal (the Tribunal) held that naked bank guarantee quotes given on public websites are not good external Comparable Uncontrolled Prices (CUPs) unless adequate adjustments as per Rule 10B of the Income-tax Rule, 1962 for various factors such as the risk profile/ financial position of the applicant, terms of the guarantee, securities involved, etc. are made to make the two comparable. Further, the Tribunal also ruled on the conceptual distinction between bank guarantees and corporate guarantees. The Tribunal also relied upon the previous rulings on the issue (Asian Paints Ltd, Everest Kanto Cylinder Ltd, and Reliance Industries Ltd),

wherein the Tribunals had rejected the use of naked bank quotes as acceptable external CUP. Keeping in mind all the above, the Tribunal concluded that the guarantee fee rates charged by the taxpayer at 0.53% and 1.47% for the loan and the L/C respectively, were at arm's length.

Facts

- The taxpayer is primarily engaged in the business of manufacturing and marketing pharmaceutical products and related Research and Development activities.
- The international transaction in dispute was a guarantee fee charged by the taxpayer from its Associated Enterprises (AEs) in connection with the

¹ Glenmark Pharmaceuticals Ltd v. Addl. CIT [TS-329-ITAT-2013(Mum)-TP]

loans availed, and the Letter of Credit (L/C Facility) availed by the AEs from third party banks, and guaranteed by the taxpayer.

- For the guarantee provided, the taxpayer charged a guarantee fee at 0.53% for the loan facility, and 1.47% for the L/C facility, based on an analysis undertaken by it using the “Interest Saved Approach”.
- The TPO rejected the arm’s length guarantee fee as determined by the taxpayer, and gathered information on guarantee commission rates charged by various banks (HSBC, Allahabad Bank, Exim Bank of USA, and Dutch State- FMO) from their websites.
- From the information gathered, the TPO found that guarantee commission rates ranged from 0.15% to 3% per annum (across all the quotes considered from the aforementioned banks). Using the 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 preferred an appeal to the Tribunal.

Tribunal ruling

- In its ruling, the Tribunal has held that the guarantee commission rates available on the websites of various banks (which were referred to by the TPO as external comparables) were not good comparables. This decision placed reliance on two essential factors, viz. (i) conceptual difference between a bank guarantee and a corporate guarantee, and (ii) verdict pronounced by the Tribunal in previous cases wherein naked bank quotes used by the TPO as comparables were rejected.
- The Tribunal ruled that there existed a conceptual distinction between bank guarantees and corporate guarantees. Corporate guarantees, which are given to the banks for safeguarding the interests of the bank, are not given on commercial considerations, unlike bank guarantees. Corporate

guarantees are issued in order to safeguard the financial health of their AE, and provide it support.

- For banks, providing a bank guarantee is a part of their general course of business and their charges/ rates are always on the higher side. Further, bank guarantees are foolproof instruments of security for the customer, and failure to honour the guarantee is treated as a deficiency of services of the bank under the banking laws. On the other hand, corporate guarantees are not foolproof, even though the guarantor is bound by contract law, and can be sued by the company/ bank in court. Additionally, one also had to keep in mind that bank quotes are subject to negotiations, based on the relationship shared between the customer and the bank (and other factors, including the equivalent cash deposits made in the guaranteeing bank by the guarantor, etc.).
- The Tribunal opined that naked bank quotes available on public websites could not be used as external CUPs, unless adequate adjustments for various factors such as the risk profile/ financial position of the applicant, terms of the guarantee, securities involved, etc. were made to make the two comparable. It observed that naked quotes obtained from banks’ websites could not therefore be used as direct comparables without adequate adjustments to factor in the difference of the two forms of guarantee.
- The Tribunal also relied upon previous rulings on the issue (Asian Paints Ltd², Everest Kanto Cylinder Ltd³, and Reliance Industries Ltd⁴), wherein the Tribunals had rejected the use of naked bank quotes as acceptable external CUPs.
- The Tribunal further held that all the aforementioned cases further corroborated the contention that naked quotes, with no adjustment to account for the difference in the nature of bank guarantees and corporate guarantees, and with no relevance given to the tested transaction in

² Asian Paints Ltd. [ITA No. 408/Mum/2010 and ITA No. 1937/Mum/2010, AY 2005-06, ITAT Mumbai]

³ Everest Kanto Cylinder Ltd v. DCIT [TS-714-ITAT-2012(Mumbai)-TP]

⁴ Reliance Industries Ltd. v. ACIT (ITA No.4475/ M/ 2007 & Others AY 2003-04 to 2005-06)

particular (with respect to term of the loan, securities involved, nature of loan etc.), could not be deemed as acceptable external comparables.

- The Tribunal also ruled that the ruling in case of Technimont ICB P Ltd, ITA NO 6394/m/2012 wherein naked bank quotes were accepted, was an aberration, and the background facts of this case were distinguishable from the instant case.
- Keeping in mind all of the above, the Tribunal concluded that the guarantee fee rates charged by the assessee at 0.53% and 1.47% for the loan and the L/C respectively, were at arm's length.

PwC's observations

- At the outset it is pertinent to highlight a critical point – in the instant case, the Tribunal has, for the first time, established a conceptual and legal difference in the nature of bank guarantees and corporate guarantees. The Tribunal has made this distinction on account of various factors which are as follows: (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 the guaranteed amount, (vi) period of guarantee, and (vii) past history of customers. Two facts could be deduced from this distinction:
 - (a) Bank guarantees and corporate guarantees are given under different motivations. While corporate guarantees are issued in order to support the AE, bank guarantees are issued by banks in the general course of their business. Thus, commercial considerations in the two cases differ. In the case of a corporate guarantee, the purpose is to support the AE and derive long term benefit, while in bank guarantees, the service is rendered in the general course of its business, and the benefit derived by the bank is towards the profit element associated with the rendered service. The guidance one may infer from this approach is that the functional nature of guarantee in any two situations may be different, and hence their direct comparison for comparability analysis

is not feasible. For comparability, requisite adjustments must be made to account for the difference in the functional nature of the guarantees, as well as for the terms and conditions of the tested transaction.

- (b) Naked bank quotes on a website are generic in nature, not specific to any particular transaction that has been carried out. Thus, not only are they negotiable, they also vary depending on the terms and conditions of the transaction, and the relationship between the banks and the customer. Hence, they cannot be used directly to represent the guarantee fee charged on a particular tested transaction.
- While there has been no specific discussion in the ruling on the merits of use of the “Interest Saved Approach” to quantify the guarantee fee, the Tribunal, by accepting the guarantee fee charged by the taxpayer (which was determined using the interest saved approach) did seem to acknowledge the appropriateness of that approach.
 - Lastly, in this ruling, as well as in previous rulings with respect to guarantee fee charge, there has been no explicit discussion on the appropriateness of the various approaches (such as the Interest Saved Approach, and the Risk of Loss Approach amongst others) which are used to determine the arm's length price internationally. Whereas the use of naked bank quotes from their websites has been rejected on account of not being acceptable external comparables, the discussion now needs to centre around the various approaches and comparables that can be used in the benchmarking analysis. It is important to consider the global precedents in this case⁵ and address the appropriateness and reliability of various approaches in order to pave the way for future cases around guarantee fee charge.

⁵ In *General Electric Capital Canada v. Her Majesty the Queen* (2009 TCC 563 Date: 20091204), the method of calculation of the guarantee fee was under dispute and discussion as well

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