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Tax alert: Guarantee fees from subsidiary, taxable as income from other sources

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The Kolkata Bench of the Income-tax Appellate Tribunal, based on the facts of the case, has held that guarantee fees earned from Indian subsidiary company, is taxable under the head income from other sources, as per Article 21 of the India-Finland tax treaty.

In a nutshell

The activity of giving of guarantee was only a routine activity. It was an obligation to its subsidiary being the owner of the subsidiary. Hence, it was more likely to be a shareholders' obligation/service, instead of being a business activity.

Except its subsidiary, the taxpayer had not given bank guarantee to anybody else, which could establish that it was engaged in the business of providing bank guarantees. It was only safeguarding the business interest of a subsidiary.

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Background:

- The taxpayer[1] is a Finland based company. During the Financial Years (FYs) 2017-18 and 2019-20, corresponding to Assessment Years (AYs) 2018-19 and 2020-21, the taxpayer received guarantee fees from Indian subsidiary company (I Co) for standing as a corporate guarantee qua the loan obtained by I Co.
- During the course of audit proceedings, the Assessing Officer (AO) held that the guarantee fees was taxable in India as income from other sources under section 56 of the Income-tax Act, 1961 (ITA), read with Article 21(3) of the India-Finland tax treaty [relating to Other Income].
- The taxpayer filed following objections before the Dispute Resolution Panel (DRP) against the AO's draft order:
  - The taxpayer had earned guarantee fees from I Co on account of parent company guarantee under its Articles of Association, which defined the scope of the line of business of the company. The Articles permitted the company to engage in business of providing guarantees to its subsidiaries on a regular basis.

    To facilitate the same, the taxpayer had negotiated with a syndicate of banks, whereby in connection with the above services, the bank charged fees at the rate of X% per annum of the guarantee fees, and the taxpayer subsequently recharged the cost to I Co together with a premium of Y% per annum. The activity of provision of guarantees was a continuous systematic activity which had a direct impact on the revenue of the company.
  - Section 5 read with section 9(1)(i) of the ITA provides that income shall accrue or arise in India if the same is earned through any business connection in India. The Supreme Court (SC) in an earlier ruling[2] had held that carrying on activities in India was essential to make non-residents have business connection in India.

    In the case under consideration, the taxpayer was not carrying any activity in India in connection with the guarantee fee charged from I Co. Hence, there was no presence of business connection in India and no scope for attributing income to Indian operations. Further, income derived from guarantee fees was governed by Article 7 of the India-Finland tax treaty [relating to Business Profits] and since it did not have a fixed place of business in India, the question of permanent establishment (PE) in India did not arise.

  Therefore, guarantee fees earned by the taxpayer could not be taxed under Article 7, read with Article 5 of the India-Finland tax treaty, and such income fell outside the scope of Article 11 [related to interest income] and Article 21 [related to other income] of the India-Finland tax treaty.
- The DRP rejected the objections of the taxpayer and upheld the order of AO on the following key basis:
  - The activities carried out by the taxpayer, amongst others, of giving guarantees were only in furtherance of the taxpayer's business of providing innovative and environmentally sound solutions in metals processing industries.
  - The corporate guarantee was given for the business of I Co, with the invoicing address for the costs related to bank guarantee being that of I Co. In other words, the situs of utilisation of the service of providing corporate guarantee was in India, with the income arising therefrom in the form of corporate guarantee fee, arising in India and falling within the scope of Article 21(3) of the India-Finland tax treaty.
- Aggrieved, the taxpayer filed an appeal and in the course of appellate proceedings the matter reached before the Kolkata Bench of the Income-tax Appellate Tribunal (ITAT).

[1] Metso Outotec OYJ v. DCIT (International Taxation) [2023] 153 taxmann.com 723 (Kolkata - Trib.]

[2] Carborundum Co v. CIT [1977] 108 ITR 335 (SC)

Relevant provisions in brief:

Relevant extract of Article 21 of the India-Finland tax treaty

"…3. Notwithstanding the provisions of paragraphs 1 and 2 of this Article, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Agreement and arising in the other Contracting State may be taxed in that other State."

Decision of the ITAT:

The ITAT noted /observed the following:

- As per Article 2 of the Article of Association of the taxpayer, the main line of business was to carry on, by itself or through its subsidiary the design, manufacture, construction of a trade, machinery, devices etc.
- The activity of giving of guarantee was only a routine activity. It was an obligation to its subsidiary being the owner of the subsidiary. Hence, it was more likely to be a shareholders' obligation/service than business activity.
- Except its subsidiary, the taxpayer had not given bank guarantee to anybody else, which could establish that it was engaged in the business of providing bank guarantee. It was only safeguarding the business interest of a subsidiary and providing them this type of guarantee.
- Thus, the commission income earned by the taxpayer on providing corporate guarantee was taxable under the head 'income from other sources'.

In view of the above, the ITAT confirmed the findings of the DRP to tax the corporate guarantee fee under the head 'income from other sources' as per Article 21 of the India-Finland tax treaty.

Comments:

Provision of guarantee by non-resident group company on behalf of Indian group companies is a common transaction. The taxability of guarantee fee has been a litigative issue. This ruling has held the following:

- The activity of giving of guarantee was only a routine activity. It was an obligation to its subsidiary being the owner of the subsidiary. Hence, it was more likely to be a shareholders' obligation/service, instead of being a business activity.
- Except its subsidiary, the taxpayer had not given bank guarantee to anybody else, which could establish that it was engaged in the business of providing bank guarantee. It was only safeguarding the business interest of a subsidiary.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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