



Tax alert: Guarantee fees taxable but not as 'interest'

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The Delhi High Court, based on the facts of the case, has held that guarantee fees received by the taxpayer from Indian subsidiaries in lieu of guarantee provided to overseas financial institutions who extended credit facilities to Indian subsidiaries, would accrue or arise in India but would not qualify as 'interest' under Article 12 of the India-UK tax treaty.

In a nutshell



Guarantee charges were not received by the taxpayer in respect of any debt owed to it by its Indian subsidiary. It was also not income derived from claims that the taxpayer may have had against its Indian subsidiaries. The guarantee charges were remuneration for the assurance that the taxpayer had offered to lending entities and who may have extended credit facilities to its Indian subsidiaries.



The expression 'arise' or 'accrue' as appearing in section 5 of the Income-tax Act, 1961 (ITA) are interpreted to mean a periodical monetary return being received with some regularity. In the context of ITA, income accruing would not be dependent upon actual receipt but would be governed by the principle of a 'right to receive'. Thus, the moment a right to receive came into existence, income would be deemed to have arisen or accrued.



The taxability of income was concerned solely with income accruing or arising. It was not concerned with the ultimate destination of that income or the use to which it may be put.



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Background:

- The taxpayer¹ is a tax resident of the United Kingdom (UK) and is engaged in the business of manufacture of specialty chemicals.
- During the Financial Year (FY) 2010-11, corresponding to Assessment Year (AY) 2011-12, the taxpayer in terms of Intra Group Parental Guarantee and Counter Indemnity Services Agreement (Intra Group Agreement), received guarantee charges in lieu of guarantee provided by it to various overseas branches of foreign banks on a global basis in relation to credit facilities extended by those financial institutions to its Indian subsidiaries. In connection with the same, the taxpayer and its various Indian subsidiaries had executed the Intra Group Agreement.
- In the return of income for the year under consideration, the taxpayer characterized the guarantee fees as 'interest' taxable under Article 12 of the India-UK tax treaty.
- During the course of audit proceedings, the Assessing Officer (AO) held that the guarantee charges were taxable under Article 23(3) of the India-UK tax treaty being in the nature of 'Other Income'.
- Aggrieved, the taxpayer filed objections with the Dispute Resolution Panel (DRP) / appeal and in the course of appellate proceedings the matter reached before the Delhi High Court (HC).

Relevant provisions in brief:

Relevant extract of section 2(28A) of the Income-tax Act, 1961 (ITA)

“‘interest’ means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised”

Relevant extract of Article 12 of the India-UK tax treaty

“(5) The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from Government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures but, subject to the provisions of paragraph 9 of this Article, shall not include any item which is treated as a distribution under the provisions of Article 11 (Dividends) of this Convention.”

Relevant extract of Article 23(3) of the India-UK 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 Convention, and arising in the other Contracting State may be taxed in that other State.”

Decision of the HC:

The HC noted /observed the following:

Whether guarantee charges could be taxed as 'interest'?

- 'Interest' is defined under Article 12(5) of the India-UK tax treaty to mean income from 'debt-claims of every kind' irrespective of whether they be secured by a mortgage or carry a right to participate in the debtor's profit.

¹ Johnson Matthey Public Limited v. Commissioner of Income-tax, International Taxation [2024] 162 taxmann.com 865 (Delhi HC)

- The guarantee charges were not received by the taxpayer in respect of any debt owed to it by its Indian subsidiary. It was also not income derived from claims that the taxpayer may have had against its Indian subsidiaries.
- The guarantee charges were received in connection with the credit facilities which were extended by the overseas branches of foreign banks to its Indian subsidiaries. Since the taxpayer had guaranteed the repayment of the loans so extended to its subsidiaries, it received charges as per the stipulations contained in the Intra Group Agreement.
- The taxpayer was neither a party to the loan agreements that may have been executed nor was there any privity of contract that could be said to exist.
- Even the assertion of guarantee fees being interest as per section 2(28A) of the ITA was not sustainable as the expression 'interest' under section 2(28A) of the ITA is defined to mean amounts payable in respect of any monies borrowed or debts incurred. In the case under consideration, the taxpayer had not borrowed any monies.

Thus, the guarantee fees neither fell within the ambit of Article 12 of the India-UK tax treaty nor section 2(28A) of ITA.

Whether guarantee charges could be said to 'accrue' or 'arise' in India?

- As noted by the Supreme Court (SC) in earlier rulings², the expression 'arise' or 'accrue' as appearing in section 5 [relating to scope of total income] of the ITA, were interpreted to mean a periodical monetary return being received with some regularity. In the context of ITA, it was held that that income accruing would not be dependent upon actual receipt but would be governed by the principle of a 'right to receive'. Thus, the moment a right to receive came into existence, income would be deemed to have arisen or accrued.
- On perusal of the Intra Group Agreement, it was noted that:
 - The foundational source of payments was the taxpayer's agreement to provide the service of parent company guarantees and counter indemnification facilities. These were services offered to the Indian subsidiaries to avail for their 'own commercial benefit'.
 - The guarantee charges became leviable every quarter at an annual rate agreed upon by the parties on the recipient's (Indian subsidiaries) outstanding balance of parent company guarantees and counter indemnification obligations as at each quarter day. Thus, not only was the payment ordained to come from a specified source, but it was also envisaged to become payable with sufficient regularity.
 - In case the Indian subsidiary failed to honor any invoice raised in respect of guarantee charges, it was open for the taxpayer to discontinue the service of extending guarantees.
 - The arrangement between the parties was independent of any other legal obligation or liability with the taxpayer may have taken over or owed to a lending institution.
 - The obligation to pay was incurred in India, was in respect of services utilized in India and was agreed to arise with regularity as per the stipulations forming part of the Intra Group Agreement.
 - The charges were payable irrespective of a default or a failure on the part of the Indian subsidiary to discharge its obligations to the financial institution from which it may have received credit.
 - The taxpayer had not extended any credit or lent capital to its Indian subsidiaries. The guarantee charges were solely on account of the taxpayer having guaranteed repayment of debts owed to third parties by the Indian subsidiaries.

² E.D. Sassoon and Company Ltd. v. CIT [1954] 26 ITR 27 (SC), Seth Pushalal Mansinghka (P.) Ltd. v. CIT [1967] 66 ITR 159 (SC) and M.K. Brothers Private Limited v. CIT [1972] 86 ITR 38 (SC)

Thus, the source and fountainhead of the receipt was indelibly connected and confined to the Intra Group Agreement and the obligations of the taxpayer in connection therewith.

- If the Indian subsidiaries were to default, the financial institutions may be compelled to adopt measures of recourse against the assets of the taxpayer situated overseas, however, that could not be viewed as being either relevant or determinative of section 5 of the ITA.

The taxability of income was concerned solely with income accruing or arising. It was not concerned with the ultimate destination of that income or the use to which it may be put. Reliance was placed on an earlier SC ruling³ in this regard.

Thus, the guarantee charges were founded principally and solely upon the Intra Group Agreement and consequently, right to receive was also based on that agreement. The ultimate impact of any guarantee extended or any adverse consequence which the taxpayer may ultimately face or bear would not be determinative of the question of where the income had arisen or accrued.

In view of the above, the HC held that:

- The guarantee fees was not taxable as 'interest' under Article 12 of the India-UK tax treaty; and
- The income had accrued or arisen in India.

Comments:

This ruling based on facts of the case has held / upheld the following:

- Guarantee charges were not received by the taxpayer in respect of any debt owed to it by its Indian subsidiary. It was also not income derived from claims that the taxpayer may have had against its Indian subsidiaries. The guarantee charges were remuneration for the assurance that the taxpayer had offered to lending entities and who may have extended credit facilities to its Indian subsidiaries.
- The expression 'arise' or 'accrue' as appearing in section 5 of the ITA, are interpreted to mean a periodical monetary return being received with some regularity. In the context of ITA, income accruing would not be dependent upon actual receipt but would be governed by the principle of a 'right to receive'. Thus, the moment a right to receive came into existence, income would be deemed to have arisen or accrued.
- The taxability of income was concerned solely with income accruing or arising. It was not concerned with the ultimate destination of that income or the use to which it may be put.
- The guarantee charges were founded principally and solely upon the Intra Group Agreement and consequently, right to receive was also based on that agreement.

Further, the HC has (based on facts of the case under consideration) distinguished the ruling⁴ of the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) which had, while examining a similar transaction, held that guarantee commission could not be said to have arisen or accrued in India. It has taken note of the ruling⁵ of the Delhi Bench of the ITAT which has taken a contrary view.

Separately, the Delhi HC in this ruling has kept the issue of whether guarantee charges would constitute business income and fall within the ken of Article 7 of the India-UK tax treaty, open to be addressed in an appropriate case.

It may be pertinent to note that the Kolkata Bench of the ITAT in case of *Metso Outotec OYJ v. DCIT (International Taxation)* [2023] 153 taxmann.com 723 (Kolkata - Trib.) held that guarantee fees earned from Indian subsidiary

³ Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT [1997] 227 ITR 172 (SC)

⁴ Capgemini S.A. vs. ADIT(International Taxation) [ITA No. 7198/Mum/2012] and Capgemini S.A. vs DCIT (International Taxation)-2(1)(1), Mumbai [ITA No. 888/Mum/2016] (Mumbai ITAT)

⁵ Lease Plan India (P.) Ltd. v. Dy. CIT [2020] 117 taxmann.com 343 (Delhi - Trib.)

company, would be taxable under the head income from other sources, as per Article 21 of the India-Finland tax treaty.

<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-gbt-guarantee-fees-from-subsiary-noexp.pdf>

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

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