CORPORATE GUARANTEE – A DEEP DIVE

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Overview

With the rise of globalization and the blurring of national borders in business operations, financial transactions between Indian companies and their international counterparts have increased. Considering the current litigation landscape surrounding financial transactions, it is crucial to ensure that these transactions are conducted with full transparency, at an arm's length price, and with the necessary approvals. One common type of related party transaction is financial guarantees, where one entity guarantees the obligations of another group entity seeking funds from a financial institution. Often, these guarantees are provided without any consideration, leading tax authorities to scrutinize their reporting and tax implications more closely. Apart from direct tax implications, guarantee is viewed critically from indirect tax perspective – levy of GST on guarantee as a service. In transfer pricing, tax authorities

have become more aggressive on determining the arm's length application on such transactions, taxpayers face difficulties in determining the taxability and valuation of these arrangements.

Corporate guarantee involves a holding company assuring the financial obligations of a subsidiary or another affiliated entity within the same group. This guarantee helps the subsidiary to secure loans with competitive interest rates.

1. What is a Corporate Guarantee?

A financial guarantee involves a commitment by the guarantor to cover specific financial obligations if the guaranteed party fails to meet them. Various terms describe different forms of credit support within a multinational group, ranging from formal written guarantees to mere implicit support due to group membership (passive association). In this context, a guarantee is defined as a legally binding promise by the guarantor to fulfil the obligations of the guaranteed entity in the event of a default.

2. Transfer Pricing Perspective on Corporate Guarantees

Financial transactions are a significant source of transfer

pricing disputes between taxpayers and tax authorities. In MNC group, a guarantor provides guarantees to its affiliated entities because it has a vested interest in the subsidiary's performance. The provision of such guarantees by global multinational enterprises has led to contentious issues in financial transactions.

The Organisation for Economic Co-operation and Development(OECD) Guidelines in the 2022 edition has covered a new section on the financial transactions including guarantees. In order to evaluate the transfer pricing implications of a financial guarantee, it's crucial to first comprehend the specifics of the guaranteed obligations and their impact on all involved parties, accurately delineating the actual transaction. Some key aspects are given below:

Economic Benefits of Financial Guarantees

An understanding of the economic benefits that the borrower gains, which go beyond the benefits of mere group membership is critical. Financial guarantees can influence borrowing terms. For instance, having a guarantee might enable the borrower to secure a lower interest rate or access a larger loan amount due

to the lender's assurance of reduced risk.

Enhancement of Borrowing Terms: For a lender, a guarantee means that the guarantor legally commits to covering the borrower's debt in case of default, potentially lowering the lender's risk. This might allow the borrower to obtain loan terms as if they had the guarantor's credit rating rather than their own. Pricing methodologies for such guarantees are akin to those used in loan pricing.

Borrower's Cost Evaluation: If an intra-group guarantee reduces the borrower's cost of debt, the borrower might be willing to pay for the guarantee if it does not worsen their overall position. The costs associated with obtaining the guarantee should be compared with the cost of borrowing without the guarantee, considering any implicit support. The guarantee could also impact other loan terms, depending on the specific circumstances.

Increased Borrowing Capacity: When a guarantee allows the borrower to secure a larger loan than possible without it, the guarantee impacts both the borrowing capacity and the interest rate. This scenario raises two questions: whether part of

the loan should be considered as a direct loan to the guarantor (and subsequently as equity from the guarantor to the borrower) and whether the guarantee fee for the remaining portion is at arm's length. Analysis may reveal that the guarantee fee should apply only to the portion accurately deemed a loan, with the rest treated as a capital contribution from the guarantor.

Key considerations while providing a guarantee include whether group membership provides implicit benefits, whether an explicit guarantee qualifies as a shareholder activity or service, the associated costs of the guarantee, and the likelihood of securing a loan without the guarantee. Explicit guarantee is legal binding and usually provides the relevant rights to the creditor to enforce commitment.

Three types of explicit guarantees are commonly used 1) Downstream guarantees: a parent company issues a guarantee to external creditors for the benefit of one of its subsidiaries when that subsidiary enters into agreements with external creditors (typically used in decentralized business structures or when the location

of the subsidiary is more attractive for obtaining external financing); 2) Upstream guarantees: a group company issues a guarantee to external creditors for the benefit of its parent company where the latter enters into agreements with the external creditors (typically used when the external financing is obtained at a parent or holding level or when the parent company performs central treasury functions); and 3) Cross guarantees: Several group companies issue guarantees to external creditors for the benefit of each other with the effect that they can all be considered as one single legal obligor (typically used in cash pooling).

Implicit guarantee on the other hand is deemed to be present once the borrower is part of a MNC Group (passive association) and has the financial backing of the Group. This implicit group support or guarantee can enhance the credit rating, potentially lowering its financing costs (interest rates) or increasing its borrowing capacity. Since this incidental benefit arises from the controlled entity affiliation with the group, no payment is required for such implicit guarantees. Comfort letters/ letters of intent include a promise (generally not legally binding) provided, in most cases, by a parent company to

an MNE company which states that the former will oversee the latter's affairs in order to be in accordance with the group strategies and rules, and refrain from taking adverse actions that would compromise the financial stability of another group company. Agreements which include a declaration provided, in most cases, by the parent company to an MNE company which states that the former will provide the latter with additional capital to prevent the risk of its default. However, these generally do not transfer risk and generally are not considered as financial guarantees that require an arm's length payment.

3. Corporate Guarantees as International Transactions

Initially the definition of International Transaction was restricted to *"a transaction between two or more associated enterprises, either or both of whom are non residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service*

or facility provided or to be provided to any one or more of such enterprises."

Most of the taxpayers took a position that it was not an international transaction in the first instance and then went on to about the need for a consideration for such guarantee. The issuance of corporate guarantee was considered in the nature of shareholder activity/quasi capital and not having bearing on profits, income, losses or assets of an enterprise and thus could not be included in the provision of services. In the case of Micro Ink Limited *([TS-568-ITAT-2015(Ahd)-TP] - November 27, 2015)* ITAT deletes the Transfer pricing adjustment in respect of corporate guarantee considering the issuance of corporate guarantee was in nature of shareholder activity capital and thus could not be included within ambit of 'provision for services' under definition of 'international transaction' u/s.92B.Also in the case of Delhi Bench Tribunal in Bharti Airtel Ltd v. Addl. CIT*(I.T.A. Nos.: 5636/Del/2011 March 11,2014)*, found that guarantee provided by the assessee does not have any bearing on profits, income, loss or assets of the assessee and hence it is not international transaction.

The scope of definition of international transaction has been extended in Finance Act 2012 with retrospective effect from 1st April, 2002. Various international transactions that were earlier outside the scope of transfer pricing have been brought within the ambit of Indian Transfer Pricing regulations through inserting Explanation to section 92B. The expanded definition included the below:

c. Capital financing, including any type of long term or short term borrowing, lending or guarantee, purchase or sale of marketable securities or any type of advance, payments or deferred payment or receivable or any other debt arising during the course of business;

It gives substantial clarity to the statute that corporate guarantee is included under the ambit of 'international transaction' under Section 92B as the word 'guarantee' is used under explanation of clause (c) of Section 92B.

For the assessment years after the aforementioned amendment, Tribunals and Courts have ruled guarantee as an international transaction.

4. Benchmarking approaches

OECD guidelines describe several approaches to determining market values for circumstances in which the guarantee payment is considered appropriate.

Companies should consider adopting an appropriate benchmarking analysis for arriving at the Arm's Length Price of corporate guarantees fees. One could adopt any of the below 5 approaches to price corporate guarantees.

CUP Method

The CUP (Comparable Uncontrolled Price) method is applicable when there is external or internal comparables, such as independent guarantors providing guarantees for similar loans or when the same borrower has other comparable loans with independent guarantees.

To determine if controlled and uncontrolled transactions are comparable, all factors affecting the guarantee fee should be considered. These factors include the borrower's risk profile, the guarantee's terms, the underlying loan's specifics (e.g., amount, currency, maturity, seniority), the credit rating difference between the guarantor and the guaranteed party, and prevailing market conditions. When available, guarantees from uncontrolled transactions are generally the most reliable for establishing arm's length guarantee fees.

Conversely, there are financial instruments that can be used as proxies to determine the price of

these transactions, for example, letters of credit, bank guarantees, surety bonds (similar to guarantee rates), guarantee contracts.

The challenge with using the CUP method is the scarcity of publicly available information on sufficiently similar credit-enhancing guarantees between unrelated parties, as such guarantees are rare.

Yield Approach

This approach quantifies the profit the secured party receives from the guarantee in terms of lower interest rates. The method calculates the spread between the interest rate the borrower would pay without the guarantee and the interest rate payable with the guarantee.

First step involves determining the interest rate the borrower would have had to pay on his/her own merits, considering the impact of implicit support due to his/her membership in the economic group.

Then, determine the interest rate payable with the benefit of the explicit guarantee. The interest rate can be used in quantifying the benefit gained by the borrower as a result of the guarantee. In determining the extent of the benefit provided by the guarantee, it is important to distinguish the impact of an

explicit guarantee from the effects of any implicit support as a result of group membership. The benefit to be priced is not the difference between the cost to the unguaranteed borrower on a stand-alone basis and the cost with the explicit guarantee but the difference between the cost to the borrower after taking into account the benefit of any implicit support and the cost with the benefit of the explicit guarantee.

The result of this analysis establishes a maximum guarantee rate that the recipient of the guarantee will be willing to pay. The difference of the saved interest is shared between the guarantor and borrower. The interest differential attributed to the guarantor is the maximum guarantee fee payable by the borrower.

It should be noted that this approach is often used to price financial guarantees due to its simplicity and transparency.

Cost Approach

This method estimates the value of a guarantee by calculating the additional risk borne by the guarantor, which could be based on the expected loss or the capital required to support the risk.

Various models can estimate expected loss or capital

requirements. Some pricing models, like option pricing or credit default swap models, treat the guarantee as a financial instrument to approximate the default risk and determine the fee. The accuracy of these models depends on the assumptions used, and the cost method sets a minimum fee, which may not reflect an arm's length transaction on its own.

The most widely used models for market pricing under this approach are based on the premise that financial guarantee is equivalent to another financial instrument and sets the price of the alternative, for example, by treating the guarantee as a put option or a CDS. In this regard, publicly available CDS spreads data can be used to approximate the default risk associated with the loan and, consequently, the guarantee fee.

This approach sets a minimum fee that the guarantor should be willing to accept.

Valuation of Expected Loss Approach

This approach calculates the guarantee's value by estimating the probability of default and adjusting for the expected recovery rate. This valuation is then applied to the nominal

amount guaranteed to determine the cost of the guarantee, which can be priced using commercial models such as the Capital Asset Pricing Model (CAPM). Examples: probabilistic methods, Value at Risk

Capital Support Method

The capital support method is used when the risk profile difference between the guarantor and borrower can be addressed by adding capital to the borrower's balance sheet. First, determine the borrower's credit rating without the guarantee but with implicit support, then identify the amount of additional notional capital needed to match the guarantor's credit rating. The guarantee can then be priced based on the expected return on this additional capital, reflecting only the impact of providing the guarantee rather than the overall activities of the guarantor.

Companies should choose an appropriate benchmarking method for determining the arm's length price of guarantee fees.

5. Litigation and Corporate Guarantees

Given Corporate guarantee is litigative in nature it is advisable for the tax payers to have the supporting documentation. This should

include information on the nature of the corporate guarantee, its purpose (whether as a shareholder activity or service), how the funds are utilized, thorough benchmarking analyses, and other relevant comparable data.

Some taxpayers do not charge a guarantee fee or set it at a very low level arguing that such fees are related to shareholder activities. Others determine the rate for corporate guarantees on an ad hoc basis or rely on judicial precedents without considering the specific facts of their case.

In practice, tax officers often challenge these ad hoc corporate guarantee fee determinations by applying higher fee rates or comparing them to bank guarantee rates, which are generally higher. Currently, litigation concerning corporate guarantees focuses on determining arm's length pricing. Tribunal decisions generally support a corporate guarantee fee ranging from 0.5% to 0.85% as being at arm's length. Bombay High Court in *Everest Kento Cylinders Ltd ([TS-200-HC-2015(BOM)-TP] - May 8, 2015)* found that a 0.50% fee was appropriate based on the facts of those cases. Conversely, the Madras High Court in *Redington (India) Limited (T.C.A.Nos.590 & 591 of 2019 -*

10-12-2020) determined that a 0.85% fee was appropriate based on its case specifics. Numerous decisions from Income Tax Appellate Tribunals have also upheld the 0.50% rate.

6. Global Perspectives on Corporate Guarantees

The current US Treasury Regulations do not fully address transfer pricing for financial guarantees. There is ongoing review on whether guarantees should be treated as a service and how to apply valuation methodologies to ensure arm's length pricing. The IRAS in Singapore has expanded its guidance to include financial guarantees. Taxpayers must adhere to the arm's length principle for financial transactions, including guarantees, and follow the OECD Transfer Pricing Guidelines for pricing such transactions. Recently UAE has implemented Corporate Tax along with Transfer pricing. UAE has included Financial Guarantee in the transfer pricing regulations and hence tax payers in UAE need to be vigilant while considering corporate guarantee.

7. Global Jurisprudence

One of the most important cases isCanada vs. General Electric Capital*(2010 FCA 344)* is a landmark decision in the realm

of transfer pricing, particularly for financial transactions. It highlighted the complexities involved in pricing corporate guarantees and a strong credit rating(implicit support) even without the explicit guarantee can be consider when applying the arm's length principle. It also upheld the view that the valuation of the explicit guarantee was excessive. The pricing of the explicit guarantee should have been lower than the CRA's assessment due to the implicit support enjoyed.

In few rulings, justification was provided for not compensating the guarantee transaction when it linked to shareholder activity. In the case of Germany vs. Hornbach-Baumarkt AG*((Case No. 1 K 1472/13 august 2023),* the ruling reinforced the principle that intra-group financial arrangements must be priced at arm's length, but it also established that companies can argue economic justification for non-arm's length transactions, especially when linked to shareholder interests. The decision emphasized the importance of providing sufficient evidence of economic necessity when defending intra-group transactions that deviate from the arm's length principle.

Also there are decisions which underlines the importance of understanding that intercompany agreements,

especially non-arm's length transactions such as guarantees, must meet tax authorities' documentation standards. In the case of *Poland vs. A. Sp. z o.o.(Case No. I SA/Rz 1178/18 (March 2019),* the decision reinforces the obligation for multinational companies operating in Poland to ensure proper transfer pricing documentation that reflects the full scope of financial interactions between related parties.

8. Interplay between GST and Transfer pricing

The application of GST to corporate guarantees has been a controversial topic. The primary issue has been whether providing corporate guarantees constitutes a service under GST regulations. Previously, under the service tax regime, courts suggested that corporate guarantees did involve a service component. With the introduction of GST, Rule 28(2) of CGST rules 2017 was established, setting the value of corporate guarantees at a maximum of 1% of the borrowed amount or the actual consideration, whichever is higher. It can be noted that reference of 1% cap is also present in the Safe Harbour rules issued by CBDT for transfer pricing. Indian tax

authorities, both direct and indirect, are coordinating to interpret the definition of corporate guarantees and determine the applicable percentages. Effective documentation is crucial for taxpayers to manage risks related to Transfer Pricing and GST and to avoid conflicts with tax authorities.

9. Conclusion

Corporate guarantees play a significant role in financial transactions and transfer pricing. The proper classification, valuation, and documentation of these guarantees are crucial for compliance and dispute resolution. Understanding the nuances of local and international regulations can help companies navigate these complex issues effectively.

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