

### **Corporate guarantee provided to associated enterprises is not an international transaction**

Recently, the Hyderabad Bench of Income-tax Appellate Tribunal (the Tribunal) held that corporate guarantee given by Four Soft Ltd<sup>1</sup> (the taxpayer) on behalf of Associated Enterprises (AEs) is not covered within the scope of international transactions under Section 92B of the Income-tax Act, 1961 (the Act).

The Tribunal further held that application of transfer pricing provisions is to be restricted to the AE business segment of the Taxpayer and London Inter Bank Offered Rate (LIBOR) is an appropriate benchmark, to ascertain the Arm's Length Price (ALP) of a cross border intercompany loan transaction.

#### **Facts of the Case**

- The taxpayer rendered Information Technology (IT) and Information Technology enabled Services (ITeS) to its AEs during Assessment Year (AY) 2006-07.
- Besides IT and ITeS services it had also entered into following international transactions with its AEs:
  - Payment of management allocation expenses
  - Reimbursement of expenses (paid/received)
  - Interest received on loan given to AEs
- The taxpayer also provided corporate guarantee on behalf of its overseas subsidiary company.

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<sup>1</sup> Four Soft Ltd v. DCIT (ITA No.1495/HYD/2010)

- The Transfer Pricing Officer (TPO) proposed adjustments by :
  - Re-computing the the value of international transactions on account of IT and ITeS services rendered by the taxpayer to the AEs
  - Application of corporate bonds interest rate (14 percent) on loans given by the taxpayer to AEs
  - Application of 3.75 percent as commission rate on corporate guarantee given by the taxpayer on behalf of its AEs
- On appeal the Dispute Resolution Panel (DRP) rejected the use of corporate bond rate for benchmarking interest on loans to AEs and directed the use of LIBOR.

### **Issues before the Tribunal**

- Adjustment to the price of IT and ITes services rendered by the taxpayer under Transactional Net Margin Method (TNMM).
- Determination of arms length interest for loans given to AEs
- Determination of ALP for corporate guarantee provided on behalf of AE

### **Taxpayer's contentions**

- To ascertain the ALP of IT and ITeS services rendered by the taxpayer, TPO had erroneously considered total cost of the taxpayer (including cost incurred towards Non-AE business segment). The taxpayer apportioned its expenses between AE and Non-AE business segment in the ratio of segmental sales.
- The taxpayer contended that certain expenses like bad-debts, R&D expenses, etc, are specifically allocable to Non-AE business segment and cannot be considered in AE segment. The taxpayer further demonstrated to the Tribunal that after removing bad debts and reimbursement, the profit earned by AE business segment is comparable to the mean arm's length profit determined by the TPO.
- The taxpayer also contended that exchange fluctuation gain arising in the normal course of business transactions is to be considered in computation of Profit Level Indicators (PLI).
- In respect of TP adjustment on interest on loans to AE, the taxpayer contended that the AE was operating in Netherlands where the bank lending rates are based on European inter-bank offer rates, i.e., EURIBOR and hence EURIBOR of 3.44 percent is to be used for benchmarking the interest on loan to the AE. The taxpayer further highlighted that actual average LIBOR for the year is lower than the LIBOR opted by the DRP.

- With respect to adjustment made on corporate guarantee given by the taxpayer on behalf of its overseas subsidiary to bankers, the taxpayer contended that corporate guarantee does not fall within the definition of international transaction under Section 92B of the Act. TP provisions do not stipulate any guidelines on guarantee transactions. The taxpayer also contended that overseas subsidiary company has not received any benefit in form of lower interest rate by virtue of corporate guarantee given by the taxpayer.

#### **Tax department's contentions**

- The tax department contended that the taxpayer had not taken a specific ground in the grounds of appeal stating that segmental financials prepared by the taxpayer should be adopted for the purpose of arriving at ALP.
- The tax department contended that the TPO was justified in adopting interest rate on corporate bonds at 14 percent per annum which represents opportunity cost of such funds since the taxpayer can earn a higher rate of interest in India.
- The tax department contended that corporate guarantee **is an obligation and if the principal debtor fails to honor the obligation, the guarantor is liable for such failure**. The TPO rightly determined commission at the rate of 3.75 percent under comparable uncontrolled price (CUP) method on the basis of commission charged by independent banker as a benchmark.

#### **Tribunal's ruling**

- ***TP provisions to be applied only on AE transactions:***
  - The Tribunal held that for the purposes of transfer pricing analysis, only the costs attributable to AE business segment are to be considered.
- The Tribunal held that foreign exchange gain/loss arises in the normal course of business activities and is to be considered while calculating PLI.
- After considering AE business segment profitability (including foreign exchange gain) prepared by the taxpayer, the price charged by the taxpayer for the IT and ITeS services rendered was within arm's length range as determined by the TPO. Hence the rest of the grounds were not addressed by the Tribunal.
- However, the Tribunal directed the Assessing Officer (AO) to verify the veracity of the segmental financials submitted by the taxpayer.
- ***Use of LIBOR***
  - The Tribunal distinguished between the cross border

intercompany loan transaction and a domestic loan. Thus disregarded the stand of the tax department to use corporate bank rate as an appropriate ALP benchmark with respect to the border loan transaction.

- The Tribunal agreed to the action of DRP to opt for LIBOR as an appropriate benchmark for ALP on the premise that LIBOR is internationally recognised and accepted.
- The Tribunal further restored the matter to the file of the AO for limited purpose of verifying the claim of the taxpayer regarding use of erroneous average LIBOR by DRP.

- ***Corporate guarantee***

- The Tribunal ruled that the corporate guarantee given by the taxpayer on behalf of the AE does not fall within the scope of international transaction under Section 92B of the Act. The TP legislation does not stipulate any guidelines in respect to guarantee transactions. No TP adjustment is required in respect of corporate guarantees.
- Further, the Tribunal also opined that corporate guarantee is incidental to the business of the taxpayer and it cannot be compared to a bank guarantee transaction of a bank or financial institution

### **Our comments**

The Hyderabad Tribunal's ruling, in case of restricting the ALP analysis to AE business segment and use of LIBOR for benchmarking interest on intercompany cross border loan is in line with the rulings given by other benches of Tribunal across the country.

On the question of corporate guarantee, the decision of the Tribunal is a positive step for India headquartered companies. However, this is a vexed issue and it is possible that going forward there could be differing judicial interpretations from the Tribunals/Courts on this matter.

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