



## Corporate guarantee adjudged as shareholder service under exceptional circumstances; Interest on outbound loans to be determined applying sophisticated manner of loan benchmarking

### Background

Recently, the Kolkata Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Tega Industries Limited<sup>1</sup> (the taxpayer) has churned out a favourable ruling on Transfer Pricing issues. The issues relate to:

- **Corporate guarantee furnished by the Indian parent company** to a financial institution for extending a loan to a foreign subsidiary company (SPV), which was set up to acquire step down operating companies
- **Arm's length testing of interest on outbound loans as per sophisticated manner of loan benchmarking**, with reference to credit ratings and comparability of third-party loan agreements.

### Facts of the case

- The taxpayer is a closely held company engaged in the business of inter alia manufacture of rubber, specialising in the design, production and application of water resistant rubber lining.
- The taxpayer had set up a special purpose vehicle (SPV) in the Bahamas, Tega Investment Ltd. (Tega Bahamas) with an equity funding of mere INR23 lakh for undertaking acquisition of two operating companies based in South Africa worth around INR5.5 crore.

- The taxpayer also provided a shareholder loan of INR80 lakh to Tega Bahamas and a corporate guarantee to ICICI Bank, U.K. of INR500 lakh, in order to make adequate funds available to Tega Bahamas for acquiring the South African entities for a total consideration of ZAR8,500,000 i.e. approximately INR5.5 crore.
- The shareholder's loan and guarantee were provided by the taxpayer as a substitute for equity funding to Tega Bahamas for furthering its own intent of acquiring the two South African entities. Accordingly, the taxpayer classified the loan as performing a shareholder function, thus warranting no charge, and guarantee as shareholder service meriting no consideration.
- The taxpayer placed reliance on guidelines of Australian Tax Office (92/11), OECD and U.K. Inland Revenue to hold that in the instant case, no third party financier would have lent money to the SPV without the guarantee having been extended by the parent company, having regard to its skewed debt-equity ratio; and that no benefit actually accrued to the SPV, for which it would be willing to pay any guarantee commission.
- The Transfer Pricing Officer (TPO) and Dispute Resolution Panel disregarded the taxpayer's contention (both in connection with the provision of loans and guarantees) and computed an additional charge on both.

<sup>1</sup> Tega Industries Ltd. v. DCIT [ITA No. 1912/Kol/2012] – Taxsutra.com

- In addition to the guarantee, the taxpayer had provided working capital loans to its AEs (operational and not SPVs) in Australia (Tega Industries Australia Pty Ltd. – Tega Australia) and USA (Tega Industries Inc. – Tega U.S.) on which it charged an arm's length interest on the basis of sophisticated manner of loan benchmarking, with reference to credit ratings and comparability of third party loan agreements.
- The TPO during the course of the assessment proceedings disregarded the taxpayer's approach by determining credit rating on the basis of bias selection of financial ratios and subjectively downgrading the rating determined through quantitative parameters.

### Tribunal's ruling

- In the context of loan and corporate guarantee provided to its SPV which was set up to acquire step down operating companies, the Tribunal appreciated that the taxpayer's expectation from provision of loan and guarantee are not that of a lender or guarantor i.e. to earn a market rate of interest or guarantee fee, rather, the expectation was of a shareholder to protect its investment interest and help it to achieve acquisition of the South African entities for furtherance of its own business interest and get a return in terms of appreciation in value and dividends. The Tribunal was considerate to the evidence brought on records that no third party would have agreed to grant loans on an independent basis to the tune of INR5 crore to Tega Bahamas given its skewed debt-equity ratio reflected in the balance sheet with equity funding of mere INR23 lakh. Therefore, in the present case, the loan was considered to be as quasi-equity and guarantee a shareholder service meriting no charge.
- The Tribunal also addressed the issue on working capital loans advanced by the taxpayer to its AEs (operational and not SPVs). The matter has been set aside to the file of the TPO for re-adjudication of the issue as per sophisticated manner of loan benchmarking, with reference to the credit ratings and comparability of third party loan agreements as has already been provided by the taxpayer.

### Our comments

The Kolkata Tribunal was pleased to consider guidelines of the Australian Tax Office (92/11); OECD; and U.K. HMRC, to hold that in the said case, no third party financier would have lent money to the SPV, having regard to its skewed debt equity ratio, without the guarantee been extended by the parent company.

The ruling was pronounced by the Tribunal on the basis of qualitative parameters having regard to the facts and circumstances of the case i.e. a skewed debt equity ratio of the SPV which emanates from the principle that such activity performed by the taxpayer is solely because of its ownership interest in capacity of a shareholder and no third party in comparable circumstances would be willing to pay for such activity.

One could supplement the said principle also on the basis of quantitative parameters i.e. review the clauses relating to financial covenants in the agreements of such transaction, demonstrate through sophisticated manner of benchmarking study that beyond the implicit support no benefit in terms of reduction in the rate of interest on the loan actually accrued in favour of the SPV, etc.

The present ruling has captured the concept of shareholder's service in the context of corporate guarantees and quasi-equity in the case of the loan in a more detailed manner than any other ruling so far delivered in India.

The dictum on shareholder's function in the context of financial guarantees was entirely based upon the facts of the case of the taxpayer, and cannot be applied in all cases as a matter of rule. Further, it is always advisable to defend such cases with reference to both qualitative and quantitative arguments.

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#### Ahmedabad

Commerce House V, 9th Floor,  
902 & 903, Near Vodafone House,  
Corporate Road,  
Prahlad Nagar,  
Ahmedabad – 380 051  
Tel: +91 79 4040 2200  
Fax: +91 79 4040 2244

#### Bengaluru

Maruthi Info-Tech Centre  
11-12/1, Inner Ring Road  
Koramangala, Bangalore 560 071  
Tel: +91 80 3980 6000  
Fax: +91 80 3980 6999

#### Chandigarh

SCO 22-23 (1st Floor)  
Sector 8C, Madhya Marg  
Chandigarh 160 009  
Tel: +91 172 393 5777/781  
Fax: +91 172 393 5780

#### Chennai

No.10, Mahatma Gandhi Road  
Nungambakkam  
Chennai 600 034  
Tel: +91 44 3914 5000  
Fax: +91 44 3914 5999

#### Delhi

Building No.10, 8th Floor  
DLF Cyber City, Phase II  
Gurgaon, Haryana 122 002  
Tel: +91 124 307 4000  
Fax: +91 124 254 9101

#### Hyderabad

8-2-618/2  
Reliance Humsafar, 4th Floor  
Road No.11, Banjara Hills  
Hyderabad 500 034  
Tel: +91 40 3046 5000  
Fax: +91 40 3046 5299

#### Kochi

Syama Business Center  
3rd Floor, NH By Pass Road,  
Vytilla, Kochi – 682019  
Tel: +91 484 302 7000  
Fax: +91 484 302 7001

#### Kolkata

Unit No. 603 – 604,  
6th Floor, Tower – 1,  
Godrej Waterside,  
Sector – V, Salt Lake,  
Kolkata 700 091  
Tel: +91 33 44034000  
Fax: +91 33 44034199

#### Mumbai

Lodha Excelus, Apollo Mills  
N. M. Joshi Marg  
Mahalaxmi, Mumbai 400 011  
Tel: +91 22 3989 6000  
Fax: +91 22 3983 6000

#### Noida

6th Floor, Tower A  
Advant Navis Business Park  
Plot No. 07, Sector 142  
Noida Express Way  
Noida 201 305  
Tel: +91 0120 386 8000  
Fax: +91 0120 386 8999

#### Pune

703, Godrej Castlemaine  
Bund Garden  
Pune 411 001  
Tel: +91 20 3050 4000  
Fax: +91 20 3050 4010

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