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DECODING TAXABILITY OF GUARANTEE CHARGES IN INDIA

The Delhi High Court in the judgment rendered recently in the case of ***Johnson Matthey Public Ltd Company vs CIT, International Taxation*** **[2024] 162 taxmann.com 865 (Delhi)** has held that guarantee charges received by a non-resident company from Indian subsidiaries for acting as guarantor to various banks to extend credit facilities to said Indian subsidiaries would be taxable in India as 'Other Income'. The High Court has categorically held that such guarantee charges cannot be said to partake the character of 'interest' either under section 2(28A) of the Income-tax Act, 1961 ("**the Act**") or under Article 12 of the India-UK Double Taxation Avoidance Agreement ("**DTAA**"). It has further held that such guarantee charges 'accrue' or 'arise' in India and thus, the same are taxable in India. The judgment conclusively settles long-standing controversy regarding the character and taxability of 'guarantee charges' in India, while dwelling upon the all-important aspect of such receipts 'accruing' or 'arising' in India.

<u>Origin of the dispute</u>

In the said case, the assessee acted as guarantor on behalf of its Indian subsidiaries, for which the assessee received guarantee charges. Initially and out of abundant caution, the assessee classified these charges as 'interest' income taxable under Article 12 of the DTAA. However, the assessing officer and the Dispute Resolution Panel categorized the said amount as 'Other Income', taxable in India under Article 23(3) of the DTAA.

<u>Appeal before the Tribunal</u>

In appeal before the Tribunal, it was held that for the receipts to qualify as 'interest', the recipient must be party to the loan agreement or there must be privity of contract of furnishing guarantee and receipt of guarantee fee in lieu thereof, to the loan transaction. It held that any payments made to a stranger to the loan transactions (i.e., the assessee in the present case) between the Indian subsidiaries and lenders, under an independent contract of payment of guarantee fee would not be covered within the ambit of 'interest'.

As regards the issue whether the guarantee charges could be characterized as income 'accruing' or 'arising' in India, the Tribunal held that it was not the act of entering into an agreement for payment of guarantee charges that resulted in accrual of guarantee charges to the guarantor but

the act of the Indian subsidiaries in availing the loan. The Tribunal, accordingly, held that since the loan transaction was undertaken in India, the income from guarantee charges had 'accrued' and 'arisen' in India.

The Tribunal further held that as the assessee was not engaged in the business of providing corporate or bank guarantees, the guarantee charges could not be classified as 'Business Profits' under Article 7 of the DTAA.

Judgment rendered by the Delhi High Court

In further appeal, the High Court upheld the decision of the Tribunal holding guarantee charges not to be in the nature of 'interest' under the Act or the DTAA, on the ground that the guarantee charges were neither received by the assessee in respect of any debt owed by the Indian subsidiaries nor were the same income derived from claims that the assessee may have had against its Indian subsidiaries. Since the assessee was neither a party to the loan agreements (between the Indian subsidiaries and lenders) nor was there any privity of contract that could be said to exist, the High Court held that the receipts were not in the nature of 'interest'.

The facts which weighed with the High Court were that the assessee had received the guarantee charges as remuneration for the assurance that it had offered to lending entities who had extended credit facilities to its Indian subsidiaries; the debt that the assessee owed was to such financial institutions whereas the Indian subsidiaries did not owe any debt to the assessee which could classify the guarantee charges as 'income derived from a debt or claim' or 'in respect of any moneys borrowed or debt incurred', which are the determinative factors for applicability of Article 12 of the DTAA and section 2(28A) of the Act respectively.

In essence, the High Court affirmed the finding of the lower authorities that guarantee charges would partake the nature of 'Other Income' under Article 23 of the DTAA, taxable in India.

As regards the guarantee charges 'accruing' or 'arising' in India, it was the submission of the assessee that guarantee charges received were receipts for bearing the risk of default by the Indian subsidiaries and since this risk was borne outside India, where coercive proceedings could be initiated against its overseas financial assets, it fell outside the scope of section 5(2) of the Act. On the other hand, the Revenue contended that since the underlying loan transaction for which the guarantee was provided took place in India, the income 'accrued' and 'arose' in India as per section 5(2) of the Act.

On consideration of certain landmark judgments of the Supreme Court, including in the case of ***ED Sassoon & Co Ltd vs CIT*** **[1954] 26 ITR 27 (SC)** and ***Seth Pushalal Mansinghka (P) Ltd*** **[1967] 66 ITR 159 (SC)**, the High Court held that the expressions 'accrue' and 'arise' could be interpreted to mean a periodical monetary return being received with some regularity; once the right to receive income exists, it can be said to have 'arisen' or 'accrued', irrespective of whether the same has been 'received'.

Applying the aforesaid ratio, the High Court observed that in the facts of the present case, the guarantee charges received by the assessee were indelibly linked or connected with the extension of services by the assessee in India for the benefit of its Indian subsidiaries inasmuch as the guarantee charges were payable irrespective of default or failure on the part of the Indian subsidiaries to discharge its obligations to the lenders. The High Court noted that the guarantee charges were recompense for the assessee acting as guarantor on behalf of the Indian subsidiaries for the latter availing credit facilities from overseas lenders. It was further noted that the only parties to the Intra Group agreement for guarantee, which was the foundational source of the said payments, were the assessee and the Indian subsidiaries; the obligation to pay was incurred in India; was in respect of services utilized in India and was periodical in nature. In that view of the matter, it was held that guarantee charges 'accrue' and 'arise' in India. Negating the arguments raised on the side of the assessee, the High Court observed that coercive measures being taken by financial institutions against the assets of the assessee situated overseas, in the event the Indian subsidiaries were to default, was irrelevant consideration for determining whether the guarantee charges 'accrued' or 'arose' in India.

The High Court also held that the ultimate destination of income or the use to which the income may be put is not determinative of the taxability of such income.

Key takeaways & our analysis

The consequence of the judgment rendered by the High Court is that guarantee charges received by a non-resident company would be taxable in India as 'Other Income' under the respective DTAA and under the head 'Income from Other Sources' under the Act. The controversy regarding such guarantee charges being in the nature of 'interest' has been put to rest decisively inasmuch as this is the first decision of any High Court in the country dealing with the said issue.

The question which remains to be answered, albeit in an appropriate case, is whether such guarantee charges would partake the nature of ‘Business Profits’ under Article 7 of the respective DTAA, which will have to be demonstrated by the taxpayer on facts. This question will also assume significant importance in a case where the applicable DTAA does not contain ‘Other Income’ Article, such as, the India-Netherlands DTAA. In such a situation, question will arise as to whether items of income such as guarantee charges, which are not dealt with separately in other Articles of the DTAA, can be classified as ‘Business Profits’; if not, whether such guarantee charges will be taxable as ‘Income from Other sources’ under the Act itself. In the latter situation, the fallout would be that the guarantor would be doubly taxed on the same income as the non-resident guarantor would not be eligible to claim benefit of foreign tax credit on account of income not being charged to tax in India ‘in accordance with the provisions’ of the DTAA.

One of the other key takeaways of the judgment is the deliberation on the determination of ‘place of accrual’ of income. As held by the Judicial Committee in ***CIT vs Chunilal B Mehta*** **[1938] 6 ITR 521 (PC)**, it is impossible to lay down any general test to determine the place where the profits of the business accrue. In the present case, the High Court has held the ‘place of accrual’ of income to be within India on the basis that the guarantee charges were fundamentally connected with extension of services by the assessee in India for the benefit of the Indian subsidiaries. The High Court has laid much emphasis on the fact that the obligation to pay guarantee charges was incurred in India and was in respect of services utilized in India. Thus, it can be deciphered that the High Court has been guided by the principle that the place of accrual of income is the place where right to receive that income arises, with the corresponding liability to make payment of the same there, as was also held by the Rajasthan High Court in the case of ***Mansinghka Bros (P) Ltd vs CIT*** **[1984] 147 ITR 361 (Raj)**.

The judgment of the Delhi High Court, while affirming the unanimous view taken by various benches of the Tribunal that guarantee charges are not in the nature of ‘interest’ or ‘Fees for Technical Services’, has breathed fresh perspective into the issue by holding the receipts to be in the nature of ‘Other Income’. To rule out applicability of ‘Other Income’ Article in the DTAA (wherever present) and consequent taxability of guarantee charges in India, it will be imperative for non-resident taxpayers to demonstrate that acting as guarantor on behalf of their Indian counterparts is a systematic business activity and receipts generated therefrom constitute ‘Business Profits’ under Article 7 of the applicable DTAA.

AUTHORS:

Mr. Aditya Vohra
Associate Partner

Mr. Shashvat Dhamija
Junior Associate

The views expressed above are personal and not of Vaish Associates. The same do not constitute legal advice.

If you have any questions regarding this article or any other aspects of law, please write to aditya@vaishlaw.com

Corporate, Tax and Business Advisory Law Firm

DELHI

1st, 9th, 11th Floor,
Mohan Dev Building, 13, Tolstoy Marg,
New Delhi, 110001 (India)

+91-11-42492525
delhi@vaishlaw.com

MUMBAI

106, Peninsula Centre,
Dr. S.S. Rao Road, Parel,
Mumbai, 400012 (India)

+91 22 42134101
mumbai@vaishlaw.com

BENGALURU

105 -106, Raheja Chambers,
#12, Museum Road,
Bengaluru, 560001 (India)

+91 80 40903588/89
bangalore@vaishlaw.com

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