Govt plans to bring corporate guarantees under tax net

The government may impose tax on companies giving guarantees for overseas acquisitions, but its efforts to plug a loophole may upset corporates eager to snap up cheap foreign assets. The Income-Tax Department reasons that corporate guarantees are given at a cost.

Typically, a charge or fee is payable if a company gives a guarantee to unrelated parties. However, when such guarantees are given to an associated enterprise or a related party for the purpose of an acquisition, the parties involved make adjustments.

As a result of this adjustment, the charges payable on such guarantees, "become invisible," the authorities say leading to a loss of revenue for the government. "We have brought such (corporate) guarantees under the transfer pricing net of the Income-Tax Act," confirmed R N Dash, director-general (Transfer Pricing).

"We have identified a number of intangible transactions and corporate guarantees given to associated enterprises for acquiring companies abroad is one of them," he said, adding that the exercise will yield substantial revenue.

He didn't elaborate. The move will affect a lot of companies including some well-known names such as Tata Motors and Hindalco, an Aditya Birla group company. They may face a higher tax outgo as the tax department has included charges on the guarantees as part of its tax assessment.

The Tata Group did not comment for this story. An Aditya Birla Group spokesperson also declined to comment. The department's transfer pricing division is required to pass an order by October 31 for all such transactions done in 2008. If the draft order is uncontested by the concerned company, then it is included in the overall tax assessment for that company.

Typically, transfer pricing refers to the amount used when accounting for transfer of goods or services from one company to another in the same business group. Corporate guarantees have so far not been included in TP calculations. Companies had also liberally made use of them, especially when buying a large asset or a company overseas.

The way it works is as follows: A company floats an overseas special purpose vehicle (SPV) which raises money for completing the acquisition. Since the SPV does not have any asset or revenue stream it relies on a guarantee by the parent.

The tax department has now started to view the guarantees as a service provided by the parent to the international subsidiary which is making the acquisition. The charges payable for such guarantees are calculated and added to the income of the party concerned.

The move, aimed mainly to shore up dwindling tax collections, is likely to act as a deterrent for outbound acquisitions at a time when most large Indian corporates are targeting firms in the Europe and the US due to lower valuations.

The I-T department raised Rs 20,000 crore last year from transfer pricing and is aiming to generate at least 50% more in the current fiscal year. It has also brought in expenditure on brand building, under the transfer pricing net. In 2008, Indian companies did acquisitions worth $30.19 billion, spread over 836 deals, according to data sourced from Bloomberg.

Although this was lower than the $47.33 billion worth of transactions done in the previous year, 2008 was a time when significant transactions from India, including Hindalco's acquisition of Novelis and Tata Motors' buyout of Jaguar Land Rover, were completed.

According to Ketan Dalal, joint leader (tax and regulatory service) at PricewaterhouseCoopers, "Several new dimensions have emerged this year on the transfer pricing front and many of them are at variance with global practices. This casts a significant amount of uncertainty both for global and Indian multinationals," he added.

Vispi T Patel of Vispi T Patel & Associates said this would hamper the emerging Indian corporate who wants to go global by acquiring companies abroad. The transfer pricing cell of the I-T Department, which is pursuing this matter, feels that such "masking" of charges is done even when a foreign subsidiary is floated for the purpose of acquiring an international company or for raising working capital.

The department has levied a guarantee charge of 2.4% of the total loan amount taken for the acquisition, benchmarked on the commission typically charged by banks for providing guarantees. Industry executives said this charge is impractical as it would account for half of the cost of borrowing in 2008.

"Moreover, the guarantees charged by a bank is different from that issued by a parent company," said the group CFO of a Mumbai-based conglomerate which has done large international transactions in 2008.

"A parent company is a shareholder of the subsidiary. How can it be described as a service when it is for the growth of the group," he added.

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