ASA

Recharacterization of 'guarantee commission': Apex Court settles the debate, but whether entirely?

Contextual preface: Taxability of cross-border guarantee fees/commission

In recent years, the Indian tax landscape has witnessed a surge in disputes surrounding the characterization and taxability of cross-border payments, especially in the context of intra-group financial arrangements. One such recurring and contentious issue is the taxability of guarantee commissions paid by Indian subsidiaries to their foreign parent entities on account of guarantees provided towards borrowings by Indian subsidiaries from foreign banks. Historically treated inconsistently by taxpayers, this subject finally reached the Indian Supreme Court (SC) in Johnson Matthey Public Ltd. Co. v. CIT[1], where pivotal questions on characterization, source, and taxability were examined.

The dispute stemmed from the characterization of guarantee fees received by a UK-based parent from its Indian subsidiary under an Intra-Group Parental Guarantee and Counter Indemnity Agreement. The core debate was whether such income constituted 'interest', 'other income' or 'business income, and whether the same was taxable in India in the absence of a Permanent Establishment (PE).

The ruling establishes a crucial precedent for MNCs operating in India, with far-reaching consequences on how group-level guarantees are structured, priced, and disclosed. This article aims to decode the judicial reasoning, highlight critical implications, and explore remaining structuring possibilities beyond the judgment's ambit.

Conventional tax positions: divergent treatments of guarantee fees in India

In the absence of a specific statutory framework governing the taxability of guarantee commissions in cross-border contexts, taxpayers and tax authorities have historically adopted divergent interpretations. These interpretations span multiple heads of income and are often dictated by strategic considerations. To aid clarity, the table[2] below summarizes typical characterizations considered in practice:

Business Income	The commission being received in pursuance of guarantee provided in favour of Indian subsidiary for the purpose of business, however, in the absence of PE such an income shall not be taxable in India as per relevant provisions of DTAA.[3]	DTAA - Nil if no PE Otherwise -MMR[4]	DTAA - Article 7 r/w Article 5 ITA[5] - Section 5(2), 9(1)(i), Explanation 1(a);

[1] *2024] 167 taxmann.com 395 (SC)*
[2] *This table is illustrative, and outcomes may vary based on specific facts such as the existence of a loan agreement, the nature of the guarantee, privity of contract, and whether the guarantee is a core or incidental business activity*
[3] *Double Taxation Avoidance Agreement*
[4] *Maximum Marginal Rate*
[5] *Income tax Act, 1961*

Interest Income	Characterized as interest income being linked to borrowed funds – taxable as income from other source.	DTAA - 10 - 15% ITA - 20%[6]	DTAA - Article 12 ITA – Section 2(28A), 5(2), 9(1)(v);
Other Income	Treated as miscellaneous income arising in India - most conservative and revenue-friendly approach.	35% (unless DTAA relief available)	DTAA - Article 23 (typically) ITA - Section 5(2), 9(1)(i);
Outside the scope of Total income	Income does not accrue/ arise in India since services and risk situated outside India	Nil	ITA - Section 5(2), Explanation 1(a)

This landscape of approaches has historically led to compliance ambiguities and increased the risk of litigation. Against this backdrop, the ruling in Johnson Matthey Public Ltd. Co. v. CIT has become pivotal in settling some of these interpretational ambiguities.

Judicial analysis: SC's ruling in the case of Johnson Matthey Public Ltd. Co. v. CIT[1]

A. Case background and transactional framework

The Assessee, Johnson Matthey Public Ltd. Co., a tax resident of UK, is engaged globally in the manufacture of specialty chemicals, including catalysts used across a variety of industrial applications. The Assessee had multiple subsidiaries, including in India.

During AY 2011-12, the Assessee entered into an Intra-Group Parental Guarantee and Counter Indemnity Services Agreement dated 29 March 2010 with its Indian subsidiary. Under this arrangement, the Assessee agreed to provide corporate guarantees to overseas financial institutions, thereby enabling its Indian subsidiary to access credit facilities.

In return, the Indian subsidiary agreed to compensate the Assessee via guarantee fees, computed quarterly at an agreed rate of 1.125% per annum on the outstanding guaranteed amounts.

B. Judicial journey of guarantee fee classification - Assessee vs. Revenue:

- The Assessee characterized the guarantee fees as 'interest' under Article 12 of the India-UK DTAA and offered the same to tax at the concessional rate.
- The Assessing Officer (AO), however, reclassified the same under Article 23(3) as 'other income', taxable at MMR.
- The Dispute Resolution Panel (DRP) upheld the AO's view.
- The Income Tax Appellate Tribunal (ITAT) affirmed the recharacterization, while also holding that the income had accrued or arisen in India under Section 5(2) of the ITA.
- On appeal, the Delhi High Court (HC) framed the following two issues:
  - Whether the guarantee fee income was taxable in India under Section 5(2) of the ITA?;
  - Whether such fees constituted 'interest' under Article 12(5) of the India-UK DTAA?

- **Assessee's arguments:**
  - The commission was for bearing credit risk, which would arise only upon default and enforcement outside India. Hence, the income did not accrue or arise in India and was outside the scope of Section 5(2) of the ITA. Also:
    - Relied on the decisions in Capgemini S.A. v. ADIT (International Taxation)7 and Capgemini SA v. Dy. CIT (International Taxation)8, wherein the Mumbai ITAT held that similar guarantee commission payments were not taxable in India.
    - Relied on *Container of Corporation v. Commissioner of Internal Revenue*[9], wherein it was held that services relevant to secondary obligation were to be performed outside the taxing jurisdiction thereby resulting in foreign-sourced income. Accordingly, invoked Explanation 1(a) to Section 9(1)(i) of the ITA i.e. income from activities outside India should not be taxed in the absence of a PE in India.
  - Even if it is considered to fall within the scope of total income as per Section 5(2) of the ITA, the income should qualify as 'interest' under Article 12 of the DTAA.

[6] *Plus Surcharge and Cess*
[2] *Paragraphs 8.13 to 8.15 - OECD Model Commentary on Article 15 - Concerning the Taxation of Income from Employment*
[3] *Double Taxation Avoidance Agreement*
[4] *Maximum Marginal Rate*
[5] *Income tax Act, 1961*
[6] *Plus Surcharge and Cess*
[7] *TS-177-ITAT-2016(Mum)*
[8] *[2016] 72 taxmann.com 58/160 ITD 13 (Mum.)*
[9] *[USTC No. 3607-05,dated 5-02-2011]*

- The Assessee also advanced below additional argument before the ITAT, though this was not specifically framed as a question of law before the HC:
  - The commission should be classified as 'business income' under Article 7 of the DTAA and, in the absence of a PE in India, should not be subject to tax in India.

- **Revenue's arguments:**
  - The guarantee fees were linked to Indian borrowings, and the right to receive such income arose in India. Cited *E.D. Sassoon & Co. v. CIT*[10] for the proposition that income accrues the moment a legal right to receive arises.
  - The Assessee entered into a separate agreement with its Indian subsidiary for a guarantee commission. Since the
  - Assessee only acted as a guarantor under the subsidiary's loan agreement with a foreign bank, without any direct exposure debt claim, the income could not be treated as 'interest' under Article 12 of the India-UK DTAA or Section 2(28A) of the ITA.
  - The payment was not related to a debt claim, but for services rendered by the Assessee i.e. provision of corporate guarantees to third-party banks. No monies were borrowed from the Assessee.
  - Article 23(3) of the DTAA was thus applicable as a residuary head, and the income was rightly taxed as 'Other Income'.

- **Delhi HC's ruling - ruled in favour of Revenue:**
  - Guarantee fees do not qualify as 'interest' under Article 12(5) of the India-UK DTAA, as they do not arise from any debt-claim owed by Indian subsidiary to the Assessee. The Assessee acted merely as a guarantor, with no privity of contract or credit involvement.
  - Relying on precedents including E.D. Sassoon10, the HC held that the right to receive such fees constituted income accruing in India under Section 5(2) of the Act.
  - The payment was to be considered as remuneration for service rendered in the form of giving guarantee to foreign banks in favour of Indian subsidiary.
  - The payments were categorized as service fees, taxable as 'other income' under Article 23 of the DTAA.
  - With respect to taxability as business income per Article 7 of the DTAA, the HC has kept the issue open to address in appropriate case, as no specific question was framed in this regard by the Assessee before the HC.

C. SC's ruling - final affirmation:

The SC dismissed the Special Leave Petition (SLP) filed by the Assessee, vide a non-speaking order. The SC observed no reason to interfere with the HC's decision, thereby putting to rest the controversy.

Key takeaways - clarity from the SC decision of Johnson Matthey

The SC's affirmation of the Delhi HC ruling in Johnson Matthey provides judicial clarity on multiple fronts, which could serve as guiding precedent in future disputes relating to the taxability of guarantee commissions. The key settled principles include:

- Guarantee fees ≠ Interest. Unless there is a debt claim owed by the Indian payer to the foreign recipient, guarantee fees cannot be classified as 'interest' under Section 2(28A) of the ITA or relevant Article under the DTAA.
- Where the right to receive the guarantee fee arises in India, and the service is rendered for the benefit of an Indian resident, such income is held to accrue or arise in India under Section 5(2) of the ITA, notwithstanding where the guarantee is enforced or where risk resides.
- In the absence of a more specific head of income under the DTAA, Article 23 (i.e. other income) serves as a residuary clause, making such guarantee commissions taxable in India.

This decision significantly narrows the interpretive leeway previously available to foreign entities in treating guarantee fees as business income or interest income, unless the transaction is appropriately structured with supporting contractual and operational substance.

Beyond SC's decision of Johnson Matthey: Unresolved questions and structuring considerations

Unresolved Questions and Planning Opportunities:

While the ruling closes several gaps, it does not address all fact patterns. Potential areas where different tax outcomes may still be arguable include:

Unresolved issue	Analyses	Scope for differentiation
Can guarantee fees be treated as business income (Article 7)?	The Delhi HC left this question open, as it wasn't framed for adjudication. The ITAT had held that since the taxpayer was not in the regular business of providing guarantees, the income was not 'business income'.	Where the foreign entity is in the business of financial support or guarantee provision, or where such support is routinely extended across the group, could there be a basis to argue that the guarantee fees are integral to its business, and hence eligible for Article 7 protection i.e. (non-taxable in absence of PE)?

[10] *(1954) 1 SCC 992*

Would privity of contract change tax character?	In Johnson Matthey case, the foreign entity had no privity of contract with the lender. The Indian subsidiary entered into the loan agreement with the bank; the foreign entity merely provided a side guarantee.	If the foreign entity is a direct party to the lending arrangement, or extends a loan facility or standby line of credit, could the relationship be seen as a debt claim, triggering 'interest' characterization under Article 12?
Guarantee issued as part of overall funding structure, not a standalone agreement?	Johnson Matthey's fee arose solely from guarantee agreement.	Could integrated fee with other financing arrangement support be characterized as 'interest' or 'business income'?
Could cost-plus recharges avoid higher taxability?	Some groups structure guarantee support as part of a broader management services agreement, with allocations made on a cost-plus basis.	If the economic rationale is defensible, and the recharge is bundled within broader service flows (with appropriate TP documentation), could there be room to avoid standalone taxation of guarantee fees?
Guarantee fees tied to performance-based outcomes or contingent events?	Johnson Matthey case, involved fixed quarterly fee regardless of default	Could contingent/ variable fee delay or eliminate accrual in India?
Use of intermediary jurisdiction with beneficial DTAA terms	India-UK DTAA lacks explicit exemption on other income	Could the existence of a favourable 'Other Income' article under certain DTAAs (e.g., with Germany) offer a viable route to mitigate tax exposure?

Cautionary note: the options and unresolved issues outlined above warrant a careful evaluation of the specific facts and circumstances of each case. A critical consideration in mitigating tax risk lies in ensuring robust commercial substance, maintaining contemporaneous documentation, and preserving consistency in contractual arrangements - all of which are essential to substantiate and defend alternative characterizations before tax authorities.

Compliance roadmap - navigating the way forward:

In view of the SC's ruling, cross-border intra-group guarantees require careful structuring backed by commercial substance, precise documentation, and proactive compliance to ensure tax efficiency.

Below is a structured matrix setting out key compliance considerations for both the Indian and the foreign entity, depending on the tax characterization of guarantee fees:

A. Indian entity

Compliance requirement	When applicable	Why this is needed
TDS under Section 195	When fees are taxable in India (as 'other income' or 'interest')	To ensure withholding compliance and avoid disallowance under Secion 40(a)(i)
Form 15CA/CB Filing	For all remittances to non-residents	Required under Rule 37BB for payments chargeable to tax in India
Transfer pricing (TP) documentation (Section 92D)	If aggregate value exceeds prescribed threshold	To justify arm's length price and avoid penalty on non-compliance
TP auditor certification - Form 3CEB	If international transaction is recorded	Mandatory for TP reporting

B. Foreign entity

Compliance requirement	When applicable	Why this is needed
Income Tax Return Filing in India	Where income is taxable under the ITA and no specific exemption from return filing is available	Mandatorily required under Section 139(1) r.w.s. 115A of the ITA
TP documentation (Section 92D)	If aggregate value exceeds prescribed threshold	To justify arm's length price and avoid penalty on non-compliance
TP auditor certification - Form 3CEB	If international transaction is recorded	Mandatory for TP reporting

Advisory note : where entities seek to continue characterizing guarantee fees as 'business income' or 'interest', it is imperative to document commercial rationale, functional profiles, and risk assumption - all of which were found lacking in Johnson Matthey case.

Conclusion - towards clarity, with caution:

The Supreme Court's Johnson Matthey ruling is a key milestone in defining the tax treatment of guarantee commissions in the hands of non-resident recipient. It clarifies that, without a lending relationship, such commissions are not 'interest' but taxable as 'other income'.

While the ruling offers clarity, it does not entirely rule out the possibility of alternative structuring. It also underscores that taxability is ultimately determined by the underlying business substance, the clarity of contractual terms, and the enforceability of obligations. Where these elements indicate a strong connection to India, tax exposure is likely unavoidable.

For tax leaders and CFOs, the takeaway is clear: revisit existing structures and ensure future arrangements align legal form with functional and economic reality. Tax certainty now depends on thoughtful, substance-driven structuring.

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