Exploring Corporate Guarantee Matters within the Framework of GST

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'Corporate Guarantees' are quite common in trade parlance where the holding or parent company issues a guarantee to the financial institutions as a security for extending credit facilities on behalf of its subsidiary company. The issuance of corporate guarantee is governed by specific provisions outlined in the Indian Contract Act, Reserve Bank of India (RBI) regulations, and the Companies Act, collectively providing a comprehensive framework for issuance of corporate guarantee.

Despite the common use of the term 'Guarantee' or 'Corporate Guarantee' in trade transactions, the Goods and Services Tax (GST) law does not explicitly define these terms. However, Section 126 of the Indian Contract Act 1872 defines a 'Contract of Guarantee' as a contract to perform the promise, or discharge a liability, of a third person in case of his default.

The taxability of corporate guarantees under the GST regime has been a subject of prolonged litigation. It gained significant attention after the Supreme Court (SC) judgment in the case of ***Edelweiss Financial Services Limited*** *[2023 (4) TMI 170]*, which ruled out service tax applicability on corporate guarantees provided on behalf of group entities without consideration. Subsequently, significant amendments have been introduced under the GST framework. This analysis aims to delve into the relevant provisions, understand the tax implications, address post-amendment issues, and explore the positions adopted globally on this matter.

Position under the Service Tax Regime

The taxability under the service tax regime was intricately tied to the term 'services', defined as any activity carried out by one person for another for consideration. The pivotal element triggering the levy of service tax was the 'receipt of consideration'.

Primarily, in case of corporate guarantee arrangements, the Reserve Bank of India (RBI) issued guidelines pertaining to the invocation of guarantees and the payment of guarantee commissions. In certain scenarios, banks obtain an undertaking from both the borrowing company and the guarantor, explicitly confirming the

absence of direct or indirect consideration associated with the corporate guarantee.

Building on these considerations, the SC in the matter of ***Edelweiss Financial*** (Supra) emphasized that consideration is pre-requisite for imposing service tax on a corporate guarantee. In the absence of consideration, no service tax liability arises since there is no concept of deemed valuation. Consequently, when no consideration is involved, service tax applicability is negated.

However, at this juncture, it is crucial to highlight that the SC did not question the applicability of 'service' in the aforementioned matter.

The education guide issued by CBEC, while examining the scope of service by interpreting the word 'activity', stipulates that the term 'activity' encompasses a broad range of meanings, including an act done, work done, or execution of an act, provision of a facility, etc. This interpretation underscores the extensive connotation of the term 'activity', encompassing both active and passive elements.

Based on this interpretation, the SC did not categorically classify corporate guarantees as not constituting a service. Instead, the court centered its discussion on the absence of consideration as the decisive factor for exempting it from the service tax liability.

Position under the GST regime

Under the GST law, the supply of goods or services is the trigger point for the purpose of levy the tax. For an activity to be treated as 'supply' under GST, there are essentially three parameters –

- Supply of goods or services
- For a consideration
- In the course or furtherance of business

In terms of Schedule I of the CGST Act, the supply of goods or services between related persons in the course or furtherance of business even without consideration qualifies as 'supply'. Accordingly, the judgment of SC in Edelweiss Financial holds no significance under the GST regime on account of deeming fiction.

Since the inception of GST law, there have been varied perspectives with respect to taxability and classification of corporate guarantee arrangements. The CBIC, vide *Circular No. 34/8/2018-GST dated 01.03.2018,* had clarified that the service provided by the Central Government/State Government to any business entity, including PSUs, by way of guaranteeing the loans taken by them from financial institutions against the consideration in any form, including guarantee commission, is taxable. However, subsequently, the GST council in its 28th meeting recommended to exempt such services by way of guarantees given by central / state government to their undertakings and PSU's. Later on, under *Circular No.154/10/2021-GST, dated 17.06.2021,* it was re-iterated that guaranteeing of loans by the Central or State Government for their undertaking or PSU is specifically exempt.

However, the circular had not touched on the aspect that in most of the cases, no consideration is typically charged in corporate guarantee arrangements because of the RBI guidelines. Even if such arrangements constituted supply, the main concern revolved around the valuation of such supply, given the absence of a benchmark, as every arrangement tends to be unique.

Consequently, the GST council in its 52nd council meeting provided clarity on the taxability of corporate guarantees and proposed substantial changes in the valuation rules to introduce specific methodologies for valuing corporate guarantee transactions.

The CBIC, vide *Circular No. 204/16/2023-GST dated 27 October 2023* (Circular), affirmed that corporate guarantee is a 'supply of service' even without consideration and therefore, liable for GST.

Furthermore, a new sub-rule under Rule 28 was also introduced, effective from 26 October 2023, to govern corporate guarantee transactions. Our discussion will now be bifurcated from a valuation standpoint to encompass relevant aspects of both pre and post amendment situations.

A. Valuation Prior to Amendment

The corporate guarantee, being an arrangement between the parent/holding company and subsidiary company/group entity to act as 'guarantor' on behalf of such subsidiary company/group entity and make payment in the event of default, is a transaction

between the related parties. Consequently, the valuation is governed by the Valuation Rules instead of Section 15.

Prior to the amendment of Rule 28 of the CGST Rules, which comprises the manner of determining the value of services between related persons, prescribed the value of services shall be determined as follows:

The determination of the taxable event for corporate guarantee services raises questions regarding the frequency of the liability to pay GST i.e. whether it occurs on an annual, quarterly, or monthly basis.

- Open Market Value (OMV) of such services
- In case OMV is not available, value of supply of services of like kind and quality
- In case of non-availability of the above, 110% of the cost of provision of services or by best judgment method

Pertinently, the term 'Open Market Value' has been defined under explanation to Rule 35 as the full value in money which is payable by the supplier and recipient where they are unrelated and the price is the sole consideration, excluding the GST. Given that transactions involving corporate guarantees are not typically encountered in the ordinary course of business, determining the value based on OMV becomes challenging.

However, the second proviso to Rule 28 provides that where the recipient is eligible for full input tax credit (ITC), the value as declared in the invoice shall be deemed to the OMV of the services. Accordingly, one may take the benefit extended by the said proviso to specify a suitable value in the invoice at the time of providing such guarantee which may be deemed as the OMV, subject to availability of ITC. However, in case ITC is not allowable for the related recipient then valuation poses a big challenge though the activity of giving a guarantee is taxable.

B. Valuation w.e.f. 26 October 2023

Rule 28(2) was introduced vide, *Notification No. 52/2023-CT w.e.f. 26 October 2023*, prescribing the value of corporate guarantee to be higher of:

- 1% of the value of the corporate guarantee offered; or
- Actual consideration received

Accordingly, the taxability and valuation aspects of corporate guarantees have been clarified to some extent. For all guarantee contracts executed post 26 October 2023, the valuation would be deemed to be 1% of the guarantee amount in the absence of consideration.

While the recent amendments introduced a specific and standardized approach to the valuation of corporate guarantees, there remain several open issues that require interpretation by the taxpayers leading to diverse positions and litigation by the GST authorities. Some of the key aspects that pose challenges to businesses and need urgent clarification are highlighted below:

- **Amount on which GST is to be paid**

The critical consideration pertains to determining the value on which GST is applicable, particularly when there is a disparity between the amount of the guarantee extended to the bank and the credit facility availed by the subsidiary company. Pertinently, Rule 28(2) of the CGST Act provides that the value of supply shall be 1% of the guarantee offered in the absence of consideration. Accordingly, in cases where the holding company has given a guarantee for INR 100 crore while the credit facility availed by the subsidiary company is INR 20 crore, GST liability would still arise on 1% of the entire INR 100 crore value going by the strict interpretation of the law. The taxpayers may find themselves subject

to GST liability on a higher value than the actual economic benefit derived from the transaction, highlighting the need for further clarity or potential amendments to address such discrepancies.

- **Taxable event in case of guarantee services i.e. on annual or quarterly or monthly basis**

The determination of the taxable event for corporate guarantee services raises questions regarding the frequency of the liability to pay GST i.e. whether it occurs on an annual, quarterly, or monthly basis.

Based on the clarification issued by CBIC, it may be inferred that the intention behind taxing corporate guarantees under the category of 'supply of service' indicates that extending a corporate guarantee on behalf of a subsidiary company is considered a taxable event in itself. Accordingly, the liability to pay tax should not arise immediately after the guarantee is executed; rather, it may be triggered only when the guarantee is renewed, typically on an annual basis.

This perspective suggests that the act of providing a corporate guarantee is not a recurring monthly or quarterly taxable event but rather a single event with potential tax implications arising at the time of renewal. Further clarity or specific guidelines may be necessary to delineate the timing and frequency of GST liability for corporate guarantee arrangements.

A letter of comfort, letter of intent, or commitment letter shares similarities with a corporate guarantee but has distinct characteristics. These documents are typically issued by a stakeholder of a company, such as a parent or subsidiary company, to a lending institution.

- **Taxability in case of long-term guarantee arrangements executed under the service tax regime but continuing under GST regime**

The taxability of long-term guarantee arrangements that were initiated under the service tax regime and continue under the GST regime raises specific considerations. In the service tax era, the provision of a corporate guarantee by a holding company on behalf of its subsidiary was recognized as a service. However, if no consideration was charged, such services were not subject to tax.

It is the well-established legal principle that when the levy was not in existence at the time of the removal of goods or services, tax cannot be imposed at subsequent stages. This principle is supported by the decisions of the Supreme Court on similar issues. In the context of long-term guarantee arrangements initiated under the service tax regime, reliance may be placed on this principle to argue GST taxability in such case.

- **Bank Guarantee as a benchmark for valuation of supply prior to amendment**

Since service tax era, there have been divergent views on equating bank guarantee similar to corporate guarantee for the purpose of valuing such supplies basis the bank guarantee commission. CESTAT Delhi in case of M/s **Olam Agro India Limited [2018 (8) TMI 102]** held the nature of a corporate guarantee similar to that of a bank guarantee. Both are used to facilitate the lending of funds. CESTAT Mumbai in case of ***HINDUSTAN CONSTRUCTION COMPANY*** *[2023 (8) TMI 1144]* held similar view.

However, Chennai CESTAT in case of ***M/s STERLITE INDUSTRIES INDIA LTD*** *[2019 (2) TMI 1249]* held that bank guarantee and corporate guarantee are not same. Relevant extract is quoted below:

'a bank guarantee is given by a bank on behalf of the customer to the beneficiary bank guaranteeing the payment in case of default by customer. A corporate guarantee is a guarantee given by the corporate to cover their own exposure or exposure of some other related entity to their bank. Bank guarantees are issued by Bank on a regular basis as part of their business of Banking. It is nobody's case that appellant is doing the business of providing corporate

guarantee on a regular basis. The corporate guarantee that was entered into by appellant is only for the limited purpose of securing loans to its subsidiaries. Corporate guarantees are issued in order to safeguard the financial health of their associate enterprises and to provide it support. For banks, providing bank guarantee is part of their regular course of business and they charge rate on the higher side. Further, these are fool proof instruments of security of the customer and failure to honour the guarantee is treated as a deficiency of services of the bank under banking laws. Corporate guarantee is actually an in-house guarantee and is not issued to customers generally.'

Even under the direct tax precedents, courts have held that the arm's length price of corporate guarantee cannot be determined based on bank guarantee**.** Accordingly, the rate charged by the bank for furnishing a guarantee cannot be taken as a base for determining the value of a corporate guarantee. Accordingly, the clarity may come at higher levels.

- **Letter of Comfort, Letter of Intent, Commitment Letter similar to Corporate Guarantee**

  It is important to highlight that a letter of comfort, letter of intent, or commitment letter shares similarities with a corporate guarantee but has distinct characteristics. These documents are typically issued by a stakeholder of a company, such as a parent or subsidiary company, to a lending institution. The purpose is to provide financial assurance and support by the company.

  Unlike a corporate guarantee, a letter of comfort or letter of intent does not necessarily imply a direct obligation on the entity issuing it. Instead, it serves as a form of assurance towards the lending institution that the principal debtor will fulfill their payment obligations promptly.

  In the context of the Insolvency and Bankruptcy Code, there have been legal precedents where the HC has held that a Letter of Comfort would be considered a guarantee only if, upon examining the terms as a whole and considering the conduct of the parties, the requirements under Section 126 of the Contract Act are met. This implies that the classification or nomenclature of the document is inconsequential, and each document should be independently assessed based on its terms and the intent of the parties involved.

  Therefore, while these instruments may bear similarities to corporate guarantees, their legal implications and obligations can vary, and a thorough examination of each document is essential to determine its nature and legal standing.

Having explored the various issues and key aspects surrounding the taxability and valuation of corporate guarantees, it becomes evident that a definitive clarification from the government is essential to address the challenges faced by taxpayers and ensure a consistent application of tax provisions. While the introduction of Rule 28(2) has provided some resolution to the disputes, there remain areas that necessitate further clarity.

The recent challenge to the validity of Rule 28(2) before the Delhi High Court adds an intriguing dimension to the ongoing discussions on the legislative powers of the GST Council. The court's interpretation and final decision on this matter will be closely watched, considering the potentially wide-ranging ramifications it could have on the taxation of corporate guarantees. Notably, under transfer pricing regulations, a 0.5% guarantee commission has been widely accepted by the courts. The introduction of new GST valuation rules may appear to be in conflict with transfer pricing valuation guidelines.

An intriguing point of consideration is the global perspective on indirect tax laws. In jurisdictions like Australia and Canada, the provision or receipt of corporate guarantees is categorized under financial services, resulting in exemption from indirect tax laws. This international approach adds an interesting dimension to the ongoing discussions on the taxation of corporate guarantees.

Conclusion

In conclusion, while Rule 28(2) has brought some resolution to the disputes surrounding taxability and valuation, there are lingering issues that demand further clarity from the GST Council. Addressing these uncertainties will not only contribute to a more transparent and efficient tax regime but also foster a conducive environment for businesses engaged in corporate guarantee transactions.

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