To Guarantee or not to Guarantee - That is the question

While GST was launched as a ship set to sail while being built, it is now nearly 7 years and the ship is sailing in the ocean. As any sailor would know, the calm of the ocean is only transient and there are interludes of thunder and storms making the ship wrestle the massive waves while trying to navigate and stay afloat. One such thunderstorm has arisen in the GST ocean in the form of taxation of Corporate Guarantees given by parent companies to its subsidiaries or group companies. To make the waves even higher and terrifying is the not-so-subtle provision in the GST law to even tax transactions where there is no consideration involved if related parties are involved.

Understanding Corporate Guarantees

Corporate guarantees play a crucial role in project financing, primarily determining the financing, structuring and feasibility of large-scale ventures. Guarantee or corporate guarantee has not been defined in the GST law. Therefore, reference can be taken from Indian Contract Act, 1872 where in Section 126 guarantee is defined as a contractual agreement where one party takes on the liability or fulfils obligation of a third party in the event of default by the third party. In the common banking parlance, a corporate guarantee is an agreement where a company agrees to fulfil the obligation of another company taking loan from a bank or financial institution in case that company defaults in its repayment. Corporate guarantees given without consideration are quite common where holding company issues corporate guarantee to financial institutions or banks for the credit facilities availed by its subsidiaries. These guarantees are unsecured and are not tied to any asset of the holding company providing the guarantee..

The Tax Landscape before GST

In the Service Tax regime prior to July 1, 2017, a transaction qualified the definition of service if it had following attributes:

(i) There must be an activity
(ii) Such activity must be carried out by one person for another person
(iii) Activity is carried out for a consideration

Due to the necessary condition of existence of consideration, corporate guarantees provided without consideration were out of the scope of levy of service tax. This view was taken by the Apex Court in case of **Edelweiss Financial Services Ltd (Civil Appeal 001769 of 2023, dated March 17, 2023),** where the Hon'ble Court observed that the consideration forms a necessary concomitant for making an activity taxable. In absence of consideration, even the provision for valuation becomes inapplicable.

GST brought in the storm

The judgment, initially perceived as a boon for taxpayers with pending litigation on the same subject matter under the Service Tax regime, unfortunately, turned into a bane for taxpayers under the GST regime. How? Let's understand. The taxable event under the GST law is the

'supply of goods or service.' The definition of Supply, as provided under Section 7 of the CGST Act, includes activities specified under Schedule I of this Act, which are carried out without any consideration. Now the entry 2 of the said Schedule includes 'supplies between the related parties or distinct persons when made in the course & furtherance of business'. Therefore, any transaction between the related person even if made without any consideration shall qualify the definition of supply and shall be subject to tax under GST. But on what value ? And for how long ? So, the storm began, as answers were missing in the GST law.

To provide a solution, based on the recommendations made in the 52nd GST Council meeting, a new sub-rule was notified on October 26, 2023, governing deemed value for corporate guarantees, which was the higher of following:

(a) 1% of the guarantee offered
(b) Actual Consideration

The insertion of the sub-rule triggered a cascade of complexities leaving numerous loose ends and raising questions about the efficacy and comprehensiveness of the Rule.

However, the very next day, a circular was issued **No. 204/16/2023-GST dated October 27, 2023,** aimed to rectify the ambiguities and uncertainties stemming from the newly introduced sub-rule. But instead of delving into the maze of complexities and addressing a few, if not all, the Circular merely clarified that the activity of providing corporate guarantee shall be treated as supply of service. The Circular failed to clarify whether the sub-rule would also apply to personal guarantee, surety bonds, performance guarantee or any guarantees provided to third parties other than banking company or financial institution, since the new sub-rule specifically dealt with deemed valuation for corporate guarantee for related party transactions only..

The Dark Clouds over Corporate Guarantees

Corporate Guarantee being an Actionable Claim

Schedule III of the CGST Act provides the list of activities which are neither treated as supply of goods nor services, Actionable Claims being one of them. As the lawmakers are normally prone to do, here too, they did not choose to define what Actionable Claim means. Taking reference from the Transfer of Property Act, 1882 Actionable Claims mean a claim of any debt other than debt secured by mortgage of immovable property or by hypothecation, which the Civil Court recognise as affording ground for relief. Now, it is pertinent to note that even a Corporate Guarantee represents a claim to a debt that guarantor owes to the bank or financial institution, the liability to pay only arising when the borrower defaults on the payment.

Tax payment – one time or recurring

Guarantees can be spanning across multiple financial years and they are renewable too, based on the nature of the guarantee given. Consequently, the question arises whether tax payments on such guarantees should occur annually or only one-time when the guarantee agreement is executed. What happens at the time of renewal of a guarantee ? Tax to be paid again ?

Point in Time for the levy

There is no clarity as to when such a service is to be taxed, whether at the time of executing the agreement, or at the time when guarantee is invoked due to default. Taxing at the first instant may result in a fallacy if the guarantee is never invoked and merely remains an agreement providing a fall-back to the financiers.

Letters of Comfort

Also a common practice in the corporate world, a Letter of Comfort is issued to the bank / financial institution in place of a guarantee. Now, this is significantly different as herein the provider of the Letter of Comfort does not specifically undertake a liability and responsibility to pay in the event of a default. While the general view is that these would not fall under the ambit of taxation, in the absence of anything specific in the law, the authorities, in all likelihood, would leave it to appellate authorities to adjudicate.

Rationale of 1 per cent

The government just decided to put a number here. 1 per cent. One wonders what could have been the math here. While it may look innocuous, in the era of burgeoning economic growth and activity, this 1 per cent can result in a very large amount of tax, affecting the cash flow, as well as the cost, depending upon the duration in which such tax can be offset against future tax liabilities.

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