Limiting the Benefit of Interest Deduction

Thin capitalisation has a significant impact on the profitability and the consequent taxability of a company. In recent times, a consequential fallout of 'thin capitalisation' is the reduced taxability of interest income in the hands of a lender. In order to stimulate the economic growth of India, the Government has allowed concessional tax rate[1] on certain borrowings in foreign currency from a source outside India. Also, various tax treaties entered into by India with other countries grant concessional tax rate on the interest earned. Due to such lucrative tax benefits, some Multi-National Companies (MNCs) have highly geared the capital of their group company in India, and such gearing is generally more than reasonable or the average standards of the relevant industry. In such cases, it may become evident that the main purpose of having a high proportion of interest-bearing funds is to reduce the tax liability of the Indian company. In order to counter such tax avoidance, recently, the Finance Act, 2017 has introduced the provisions of Section 94B in the Income-tax Act, 1961 (the Act) to limit the interest deduction under certain circumstances. Read on to know more…

Background

Typically, capital employed by a company to run its business consists of own and borrowed capital. Own capital i.e. share capital and reserves, do not have interest liability, whereas borrowed capital, whether long term or short term, requires interest to be paid to external parties. Such interest cost, unless capitalised, is debited to the profit and loss account, and generally, allowed as a deduction under the domestic tax laws applicable to a company. If a company is highly geared i.e. having very high borrowed capital as compared to own capital, it shall

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[1] For e.g. under Section 194LC of the Act

incur high interest cost, and such capitalisation-mix is generally referred to as 'thin capitalisation'.

Thin capitalisation has a significant impact on the profitability and the consequent taxability of the company. On the other hand, if capital is financed by shareholders' funds, the return on share capital is in the form of the dividend, and constitutes a below the line item in the books, and is not deductible from the taxable income of the company. Many MNCs have operations in India through their subsidiaries or Associated Enterprises (AE), wherein the debt funding may be more favoured since it reduces the tax liability of the Indian entity.

In recent times, a consequential fallout of 'thin capitalisation' is the reduced taxability of interest income in the hands of a lender. As per the provisions[2] of the Act, the total income of a non-resident includes the interest income, which accrues or arises or is deemed to accrue or arise in India. If the interest is payable by an Indian entity, except where it is payable in respect of money borrowed and used, for a business carried on by such person outside India or for making or earning any income from any source outside India, such interest is included in the total income of the lender.

In order to stimulate the economic growth of India, the Government has allowed concessional tax rate[3] on certain borrowings in foreign currency from a source outside India. Also, various tax treaties entered into by India with other countries grant concessional tax rate on the interest earned. Consequently, the interest income in the hands of a non-resident is taxed at a lower rate. This results in a double-edged sword, wherein the interest expenditure reduces the taxable income in the hands of an Indian entity, and the interest income is sparingly taxed in the hands of a non-resident, which substantially dents the exchequer.

Due to such lucrative tax benefits, some MNCs have highly geared the capital of their group company in India, and such gearing is generally more than reasonable or the average standards of the relevant industry. In such cases, it may become evident that the main purpose of having a high proportion of interest-bearing funds is to reduce the tax liability of the Indian company. In order to counter such tax avoidance, recently, the Finance Act, 2017 has introduced the provisions of Section 94B in the Act to limit the interest deduction under certain circumstances.

Prior to the amendment by the Finance Act, 2017, various courts/tribunal have allowed the interest expenditure in thin capitalisation cases. The Mumbai Tribunal held that under the General Anti-Avoidance Rule (GAAR) that is proposed as a part of the Direct Taxes Code Bill, 2010, *'any arrangement entered into by a person may be declared as an 'impermissible avoidance arrangement', and the consequences, under this Code, of the arrangement may be determined by recharacterising any equity into debt or vice versa'*. That is the first step taken by the India's tax administration in the direction of having formal thin capitalisation rules in India.

Position Prior to the Finance Act, 2017

Prior to the amendment by the Finance Act, 2017, various courts/tribunal have allowed the interest expenditure in thin capitalisation cases.

For instance, in the case of *Besix Kier Dabhol SA*[4], the taxpayer, a non-resident company carried out certain construction project in India, and thus formed a Permanent Establishment (PE) in India. This PE raised debt directly from shareholders, and same was not routed through its head office, and this resulted in an abnormal debt-equity ratio of 248:1. The tax department re-characterised debt as equity, and the interest payment was disallowed.

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[2] Section 5 and 9 of the Act
[3] For e.g. under Section 194LC of the Act
[4] *Besix Kier Dabhol SA vs. DIT [2010] 8 taxmann.com 37 (Mum)*

Subsequently, the Bombay High Court[5] upheld the Tribunal's order in the above case. Various benches of the Tribunal[6], especially in transfer pricing related cases, have followed this order of the Bombay High Court.

However, the transfer pricing provisions are applicable in the case of interest payment to AEs so as to allow arm's length interest payouts, based on LIBOR/SBI rates plus a certain percentage markup.

Base Erosion and Profit Shifting - OECD

Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of excess interest deductions by the MNCs in Action Plan 4 (AP4). In October 2015, OECD issued a report on Action Plan 4 (AP 4) – *'Limiting base erosion involving interest deductions and other financial payments'*, and it seeks to develop recommendations in designing of the rules to limit the deductibility of interest and other economically equivalent payments made to third parties and related parties.

This common approach directly links an entity's net interest deduction to its economic activity, which is based on taxable Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA). This approach includes three elements, i.e. (a) a 'fixed ratio rule', which is based on a benchmark net interest/EBITDA ratio, (b) a 'group ratio rule', which allows an entity to more interest deductions based on the position of its worldwide group, and (c) targeted rules to address specific risks. The 'fixed ratio rule' restricts an entity's net interest deductions to a fixed percentage of its EBITDA calculated using tax principles.

Section 94B provides that if an Indian company, or a PE of a foreign company in India, being the borrower, incurs any expenditure by way of interest or of similar nature, which is deductible in computing income chargeable under the head 'Profits and gains of business or profession' in respect of any debt issued by a non-resident AE, the interest shall not be deductible under the said head to the extent that it arises from the 'excess interest'.

In 2016, further work was completed on two aspects of the common approach. The first covered the key elements of the design and operation of the 'group ratio rule', focusing on the calculation of net third party interest expense, the calculation of group-EBITDA, and approaches to address the impact of entities with negative EBITDA. The second work identifies features of the banking and insurance sectors.

Introduction of Limitation of Interest Deduction by the Finance Act, 2017

In line with the recommendations of OECD BEPS Action Plan 4, the Finance Act, 2017 introduced a new Section 94B in the Act, to address the issue of excess interest deductions by the MNCs. Though Section 94B is not a case of classical thin capitalisation, it has some insignia of the same, inasmuch as the section limits interest deductions involving creditors, who are non-resident AEs.

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Further, the debt shall be deemed to be treated as issued by an AE, where it provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender. Such disallowed interest expenditure shall be carried forward till following eight assessment years, and it shall be allowed as a deduction against the profits and gains of any business or profession carried on by the company, to the extent of maximum allowable interest expenditure.

In order to target only large interest payments, a threshold of interest expenditure of one crore rupees is provided. Further, banks and insurance businesses are excluded from the ambit of the said provisions keeping in view the special nature of these businesses. These provisions are applicable for FY 2017-18 and subsequent years.

[5] *DIT vs. Besix Kier Dabhol SA [2012] 26 taxmann.com 169 (Bom)*

[6] *Aditya Birla Minacs Worldwide Ltd. vs. DCIT (2015) 56 taxmann.com 317 (Mum), ACIT vs. Patel Engineering Ltd. [2017] 78 taxmann.com 45 (Mum), Topsgrup Electronic Systems Ltd. vs. ITO [2016] 67 taxmann.com 310 (Mum),*

Working of these provisions is illustrated as follows:

Sr. No.	Particulars	FY 2017-18 (millions)	FY 2018-19 (millions)	FY 2019-20 (millions)
1	EBITDA	100	100	200
2	Interest paid/payable to a non-resident AE	15	35	50
3	Interest paid/payable to unrelated parties	35	15	0
4	Total interest expenditure (2+3)	50	50	50
5	30 per cent of EBITDA (allowable limit)	30	30	60
6	Interest paid/payable during FY over the allowable limit	20	20	0
7	Excess interest is least of (2) and (6)	15	20	0
8	Interest of the current year allowed [Total interest - Excess interest (i.e. (4) - (7)]	35	30	50
9	Disallowed interest is carried forward to succeeding 8 years [(4) - (8)] and set-off to the extent of allowable limit	15	35 (20-current year add 15 -earlier years)	(10) [10 (set-off of b/f disallowed interest), 25 (c/f to succeeding years)
10	Total interest deduction allowed under the head 'Profit and gains from business and profession' during the FY [(8) add set-off under (9)]	35	30	60

In the above illustration, the interest payments to a non-resident AE in FY 2017-18 is less as compared to interest payments to unrelated parties i.e. 30 % of total interest expenditure, which indicates that eroding tax base of India may not be the main purpose of the taxpayer. However, the interest paid to such AE shall be disallowed u/s 94B, which seems to be an unintended burden on an Indian entity.

In light of this amendment, a reliance on the Bombay High Court ruling in the case of Besix Kier Dabhol SA may be impaired.

Key Analysis and Insight on These Developments

Intra-group financial transactions, especially with non-resident AE, in relation to interest and similar payments, have been a subject matter of debate before courts/tribunal. Accordingly, the Companies should maintain robust documentation, as the commercial expediency arguments of the taxpayer are often rejected by the tax authorities.

This amendment brings forth certain issues which may create uncertainty in the minds of the taxpayers and the revenue authorities on its implementation. For instance, whether the disallowance made under the transfer pricing provisions is mutually exclusive or in addition to the disallowance of the 'excess interest'. Also, which payments made by the taxpayer need to be included in the term 'interest or of similar nature'. A proper explanation should be provided with respect to the term 'implicit or explicit guarantee'

since it may be difficult for a taxpayer to convincingly prove to the tax department that an implicit guarantee does not exist.

This amendment may have a significant impact on the Indian companies having high level of interest expense and high interest/EBITDA ratio, even if the interest payments to a non-resident AE are less as compared to unrelated parties. In the above illustration, the interest payments have shifted from unrelated parties to non-resident AEs, over the years; still, there is no disallowance u/s 94B in FY 2019-20, when total interest payments are made only to non-resident AEs. In such a scenario, a question may arise whether the provisions of GAAR can be applied. Under Section 98 of the Act, if an arrangement is declared to be an 'impermissible avoidance arrangement', then, such arrangement or any part of it may be disregarded or recharacterised, and any debt may be treated as equity. Consequently, the tax department may want to treat the debt from non-resident AE as equity, and disallow the interest deduction thereon. Such a possibility has already been enunciated by the Tribunal in the case of *Besix Kier Dabhol SA*, which has been discussed above. On the other hand, a taxpayer may argue that since Specific Anti-Avoidance Rules (SAAR) in the form of Section 94B of the Act, are existent, the provisions of GAAR should not be applied. One may be mindful of the fact that CBDT vide its Circular dated 27-1-2017 has clarified that the provisions of GAAR and SAAR can co-exist and shall be applicable on the basis of facts and circumstances of the case. However, as the issue may not be free from doubt, the Government may consider to provide clarification on the same.

On the positive side, as compared to certain other options suggested in Action Plan 4, provisions of Section 94B provides a straight forward approach and ensures that an entity's net interest deductions are directly linked to the earnings generated by its economic activities.

Action Plan 4 of the BEPS, in relation to prevention of base erosion through the use of interest expense, recommended the approach of 'fixed ratio rule', and considered it as a minimum of the best practices, which should be applied to entities of MNCs. Further, it prescribes a corridor of possible ratios between 10 % and 30 % of E BITDA, for disallowing such interest. Section 94B prescribes disallowance of such interest on

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the basis of 30 % of EBITDA, and hence, gives the highest allowable limit based on the international tax practice, therefore, it may be considered as a taxpayer-friendly anti-avoidance measure.

The amount of interest and payments economically equivalent to interest paid to a non-resident AE, is also affected by the transfer pricing rules. BEPS Action Plans 8 to 10 limit the amount of interest payable to group companies lacking appropriate substance to no more than a risk-free return on the funding provided, and the tax department may take a similar view under the domestic transfer pricing rules. A coordinated implementation of the provisions of thin capitalisation under the Act and the transfer pricing rules, may succeed to counter the cross-border shifting of profit through excessive interest payments and protect the country's tax base. ■

Set your goals high, and don't stop till you get there. - Bo Jackson