

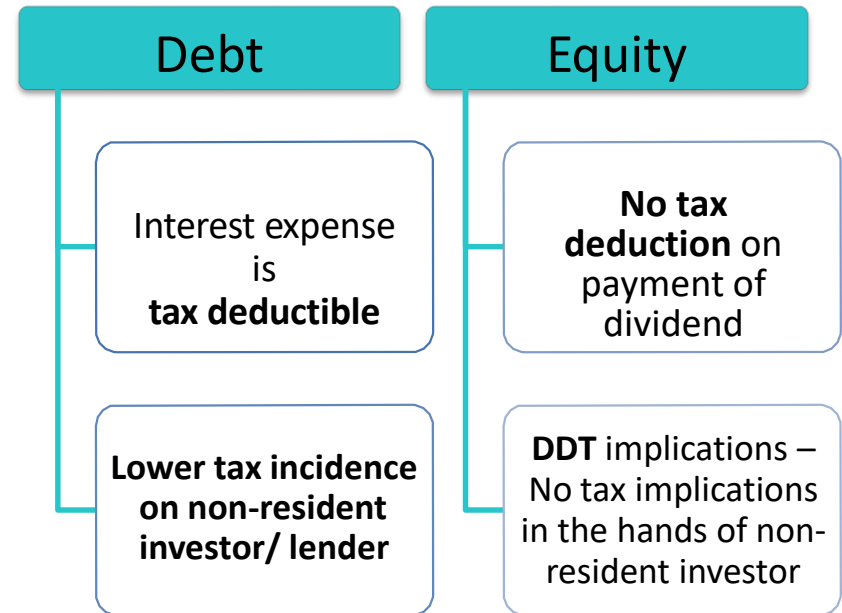
Understanding S 94B

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THIN CAPITALISATION - CONCEPT

- Forms of investments in Indian companies – Debt / Quasi-debt & Equity
- Foreign investment in Indian companies, inter alia through debt/ quasi debt structures has been popular, especially in capital intensive businesses
- Use of debt instruments has inherent advantages from a tax and ease of repatriation perspective
- Thin-capitalization: A measure to rationalize structuring of various MNCs who target to obtain seamless benefit from debt investments



Thin Cap Rules – now in India

- Introduction of **thin capitalization rules** can be said to one of the most significant changes introduced by Budget 2017
- This ‘anti-abuse’ provision has been introduced through the insertion of **section 94B** under the Income tax Act, 1961 (“Act”) and seeks to curb abusive tax structures adopted by MNEs to obtain seamless benefit from debt and quasi-debt instruments, which have been unchecked thus far
- More importantly, this change is being brought in parallel with the General Anti-Avoidance Rules (“GAAR”) which is going live on April 1, 2017 and the introduction of secondary transfer pricing adjustment, which is the other big change that Budget 2017
- India’s thin cap rules are **largely based on Action Plan 4** as per the best practice recommended by BEPS
- The ‘**fixed ratio rule**’ as used by India is also adopted by Finland and Norway
- The move to introduce thin cap rules once again fortifies a clear and apparent trend on India’s tax laws rapidly aligning with the overall BEPS agenda

THE CONTEXT

- A broad comparison between India's thin cap rules and BEPS Action Plan 4 is as follows:

Sr. No	Parameter	BEPS Action Plan 4	Proposed section 94B
1	Approach	<ul style="list-style-type: none"> Recommend Interest to EBITDA ratio (10% -30%) and supplements 'worldwide group ratio rule' 	<ul style="list-style-type: none"> Interest to EBITDA ratio of 30%
2	Threshold for application	<ul style="list-style-type: none"> Recommended, amount not specified 	<ul style="list-style-type: none"> Interest payments to AEs must exceed INR 10 Million
3	Carry forward of disallowed interest	<ul style="list-style-type: none"> Discussed but period not specified 	<ul style="list-style-type: none"> Allowed for 8 years
4	Deemed interest from AE	<ul style="list-style-type: none"> Not specifically covered, however guarantee fee is considered as interest equivalent 	<ul style="list-style-type: none"> Recognized deemed interest from AE based on guarantee/ money deposit by borrower's AE with Lender
5	Exclusions	<ul style="list-style-type: none"> Discussed need of specific rules for banking and insurance companies 	<ul style="list-style-type: none"> Excludes banking and insurance companies

SECTION 94B – ANALYSIS

- [Section 94B](#) is proposed to be inserted from **April 1, 2017** for limiting interest deduction paid to AEs to 30 percent of the borrower's EBITDA or interest paid or payable to AEs, whichever is lower

• **Condition 1**

Borrower is an Indian Company or PE of a foreign company

• **Condition 2**

Pays interest or similar consideration exceeding INR 10 million which is deductible in computing income chargeable under the head "Profits and gains of business or profession"

• **Condition 3**

- In respect of any debt issued by a non-resident being a AE; or
- In respect of any debt which is issued by a lender which is not an AE but where the AE provides implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender

- NA to Foreign Co if resident under POEM Rules
- Interest paid > 10 million in aggregate, or to NR AE?
- Is debt issued by the lender or the borrower?
- Implicit guarantee vs. implicit support
- Matching: What if there is margin retained by lender?

SECTION 94B – ANALYSIS

- **Debt** is defined to mean any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges *which are deductible under* Profits and gains from business or profession
 - **AE** as referred to above shall have the meaning assigned to it for **Transfer Pricing related provisions** (sub-section (1) and sub-section (2) of section 92A)
 - **“Excess interest”**, is the lower of
 - Total interest paid or payable in excess of 30 per cent of EBITDA of the borrower in the previous year or
 - Interest paid or payable to AEs for that previous year

Note: EBIDTA not defined – Tax EBIDTA or as per books?
 - **Carry forward of disallowed interest** – Interest disallowed under section 94B can be carried forward for 8 succeeding assessment years and set-off against business income subject to this section
 - **Exclusions** from applicability of this section – Banking and insurance companies
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KEY TERMS USED IN THE SECTION

“Guarantee”

- The term “guarantee” as such is not defined under section 94B or in the Act
- Section 94B seeks to cover situations where the AE has provided either an **implicit or explicit guarantee**
- The Indian Contract Act, 1872 defines guarantee as *“A contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default”*
- While explicit guarantee could be understood as an express agreement or a contract of guarantee, implicit guarantee would have a wide coverage of corporate actions
- **Can** pledge, collateral, surety, letters of comfort, reciprocal arrangements be regarded as guarantee?
- Court and tribunals have examined the issues of letter of comfort qualifying to be a “guarantee” under the current transfer pricing provisions – while some guidance may be available, interpretation can potentially be litigation prone

“Interest”

- The term “interest” is defined under section 2(28A) of the Act
- Interest" means interest payable in **any manner** in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and **includes any service fee or other charge** in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized“
- Can be construed that interest would include incidental charges / commitment charges for the purposes of section 94B of the Act (Treaty definition relevant?)

INTERPLAY WITH TP AND GAAR

- Section 94B is essentially a Specific Anti-abuse Rule (“**SAAR**”) dealing with excessive interest deduction
- Under the current law, interest payments to AEs are **also subjected to arms’ length test** - TP provisions for ascertaining arm’s length interest rate, effectively mean that another specific SAAR is also in existence
- GAAR is set to come into effect from April 1, 2017 – Interestingly, as per the recent circular clarifying issues related to applicability of GAAR, it has been clarified that both GAAR and SAAR can coexist on a premise that SAAR may not be able to address all situation of abuse
- Where an arrangement is held to be covered under GAAR, such arrangement can be disregarded and necessary consequences will follow (disallowance of real expenditure, assessment of notional income, etc.)
- Situations may emerge where taxpayers may be subjected to SAAR as well as GAAR in respect of thin capitalization. For instance -
 - Transfer pricing adjustment on the **interest rate** on debt
 - **Thin capitalisation** adjustment
 - **Treating debt as equity** by application of GAAR
 - Interest disallowance u/s 14A or 36(1)(iii)

INTERPLAY WITH TP & GAAR

Issue 1: Whether TP adjustment on account of higher interest rate paid to AE be reduced from the interest considered for disallowance under section 94B?

Particulars	Amount (INR)
Interest on Debt @ 10 percent	1,000
Interest arm's length rate determined at @ 5 percent	500
Accordingly, TP adjustment	500
EBITDA	2,000
30% of EBITDA	600



Disallowance under section 94B		
Particulars	View 1	View 2
Lower of: (A) Excess interest paid over 30 percent of EBITDA	Nil (500-600)	400 (1000-600)
(B) Interest paid to Non-resident AE	1,000	1000
94B disallowance (lower of (A) or (B))	Nil	400
Total disallowance (TP + 94B adjustment)	500	900
Carry forward under section 94B	??	400

INTERPLAY WITH TP & GAAR

Issue 2: Can TP adjustment, interest disallowance and GAAR apply on the same transaction?

Particulars		Amount (INR)
EBITDA		1,000
30 percent of EBITDA	A	300
Interest paid to Non-resident AE for debt issued @ 10 percent	B	1,000
Arm's length rate determined on related party debt by transfer pricing officer		5 percent
TP adjustment under section 92C for excess interest paid to AE [(1,000/0.1)*0.05]	C	500
Assuming TP adjustment is reduced from AE interest, balance interest that can be subject to disallowance under section 94B	D=B-C	500
Excess interest	E=D-A	200
Balance interest	B-C-E	300

Some thoughts

- Interest disallowed under 94B ought not to automatically qualify as dividend
- GAAR could however be invoked if the nature of the instrument is akin to equity or if the capital structure is excessively leveraged (say 99:1)

- Similar issues would arise with reference to other SAARS.
- Interest can also be disallowed u/s 14A or u/s 36(1)(lii)
- Interest can also be disallowed due to non deduction of TDS u/s 40(a)(ia)
- Interest may also be capitalized or included in valuation of inventory – e.g. in case of real estate companies
- No clarity about :
 - Whether application of any one SAAR will mean other SAAR will not apply?
 - Which SARR will trump other one?
 - What will be the order of application of each SAAR
 - How will section 94B work in case of capitalized / inventorised interest, as while the interest paid to NR AE will be higher than interest claimed while working out EBIDTA (meaning non disallowance), the impact in year of charging the interest to P&L a/c – whether as depreciation (for capitalized interest) or as part of COGS (where inventorised) is not clear.

SCOPE OF THE SECTION

Borrower	Lender	Guarantor	Will 94B apply?
Indian Company / PE	Non-resident AE	No guarantee	Yes
Indian Company / PE	Resident AE	No guarantee	No
Indian Company / PE	Non-resident	Non-resident AE	Yes
Indian Company / PE	Non-resident	Resident AE	Going by strict interpretation of the bill, 94B will be triggered. However, arguably, this does meet the intent of avoiding the base erosion / profit shifting
Indian Company / PE	Resident	Non-resident AE	Arguably no (since debt is not from a Non- resident AE)
Indian Company / PE	Resident	Resident AE	Arguably no (since debt is not from a Non- resident AE)
Foreign company (with POEM in India)	Non-resident AE	No guarantee/ Guarantee by AE	No

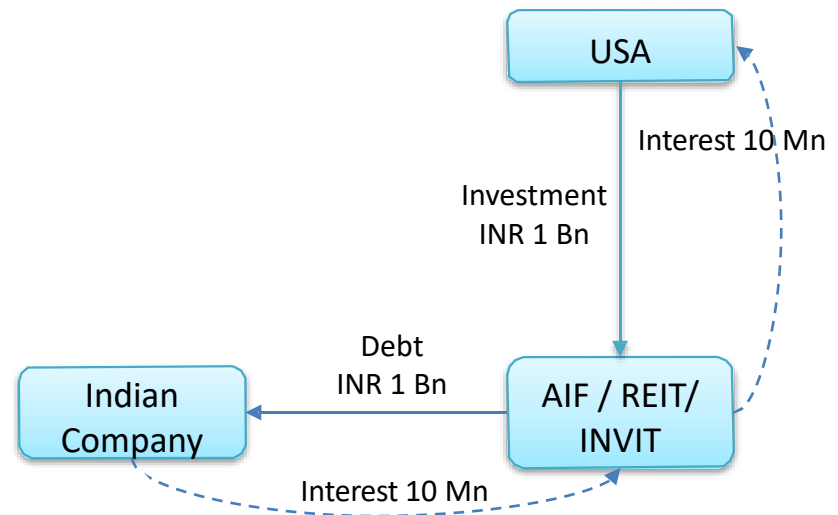
SCOPE OF THE SECTION - REIT / AIF STRUCTURES

Issue: Will section 94B apply when debt investments are made through pass through entities, specifically in case of REITs/ INVITs / AIFs

As per section 10(23FBA)/ 10(23FC) read with section 115UB/ 115UA, pass through status has been granted to REIT/ INVIT and interest paid by Indian Company to REIT/ INVIT will be taxable in the hands of AE(USA) directly.

In the given scenario, will thin capitalization norms apply to disallow interest paid by Indian company to such REIT/ INVIT?

It seems that mere insertion of pass through entity will not mean that section 94B will not apply



COMPUTATION OF INTEREST DISALLOWANCE

Issue: Whether total interest in excess of 30 percent or AE interest in excess of 30 percent be disallowed? While the memorandum clearly brings out the intent of restricting related party interest to 30 percent of EBITDA, the Act reads 'total interest'.

Type of debt	Principal	Interest (10%)
From AE	1,000	100
External	500	50
Total	1,500	150

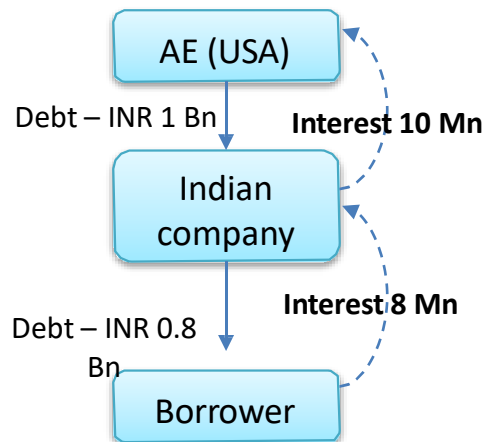
Particulars	Return on investment scenarios		
	20%	15%	(3%)
EBITDA	300	225	(45)
30% of EBITDA	90	68	(14)

Disallowance Particulars	As per the Memorandum			Disallowance As per the Bill			
	20%	15%	(3%)	Particulars	20%	15%	(3%)
a) AE interest less 30% EBITDA	10	33	114	a) Total interest less 30% of EBITDA	60	83	164
b) Interest paid/payable to the AE	100	100	100	b) Interest paid/ payable to the AE	100	100	100

- Better view seems to be to compute disallowance with reference to total interest in line with the language of the Finance Bill

COMPUTATION OF INTEREST DISALLOWANCE

Issue: Gross vs Net disallowance - If debt has been forwarded by the Indian company on which interest is earned, whether the entire interest or only the net amount should be subject matter of disallowance?



View 1: Gross

- INR 10 million to be considered for disallowance on a gross basis

View 2: Net

- INR 2 million to be considered by netting-off the interest receipt of INR 8 million against interest paid of INR 10 million

- Plain reading suggests that the interest disallowance should be on the basis of gross interest

CARRY FORWARD AND SET-OFF

Issue: Computational provisions for carry forward of interest not very clear

- (4) Where for any assessment year, the interest expenditure is not wholly deducted against income under the head “Profits and gains of business or profession”, so much of the interest expenditure as has not been so deducted, shall be carried forward to the following assessment year or assessment years, and it shall be allowed as a deduction against the profits and gains, if any, of any business or profession carried on by it and assessable for that assessment year to the extent of maximum allowable interest expenditure in accordance with sub-section (2):
- Set off mechanism in year 2

Particulars	Year 1	Year 2
Interest paid to AE	100	100
EBITDA	(200)	500
30% of EBITDA	-	150
Total interest disallowed under 94B	100	-
Carry forward of interest	100	50

Particulars	View 1	View 2
Total interest allowable in Year 2	150	150
Interest paid to AE		
Carry forward from year 1 which is set-off	100	50
Current year interest claimed as deduction	50	100
Current year interest carried forward	50	-
Year 1 interest to be carried forward	-	50

PROVISIONS OF SECTION 94B

94B(1) Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, pays interest or similar consideration exceeding one crore rupees 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, being an associated enterprise of such borrower, the interest shall not be deductible in computation of income under the said head to the extent that it arises from excess interest, as specified in sub-section (2): Provided that where the debt is issued by a lender which is not associated but an associated enterprise either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, such debt shall be deemed to have been issued by an associated enterprise.

(2) For the purposes of sub-section (1), the excess interest shall mean an amount of total interest paid or payable in excess of thirty per cent of earnings before interest, taxes, depreciation and amortisation of the borrower in the previous year or interest paid or payable to associated enterprises for that previous year, whichever is less

(3) Nothing contained in sub-section (1) shall apply to an Indian company or a permanent establishment of a foreign company which is engaged in the business of banking or insurance.

(4) Where for any assessment year, the interest expenditure is not wholly deducted against income under the head “Profits and gains of business or profession”, so much of the interest expenditure as has not been so deducted, shall be carried forward to the following assessment year or assessment years, and it shall be allowed as a deduction against the profits and gains, if any, of any business or profession carried on by it and assessable for that assessment year to the extent of maximum allowable interest expenditure in accordance with sub-section (2):

Provided that no interest expenditure shall be carried forward under this sub-section for more than eight assessment years immediately succeeding the assessment year for which the excess interest expenditure was first computed.

(5) For the purposes of this section, the expressions—

(i) “associated enterprise” shall have the meaning assigned to it in sub-section (1) and sub-section (2) of section 92A;

(ii) “debt” means any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in the computation of income chargeable under the head “Profits and gains of business or profession”;

(iii) “permanent establishment” includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.’

METHODS UNDER DIFFERENT APPROACHES

Approaches	Method	Description
Excessive debt approach	Arm's length approach	<ul style="list-style-type: none"> Maximum amount of "allowable" debt - Debt that an independent lender would be willing to lend to the entity i.e. the amount of debt that a borrower could borrow from an arm's length lender Typically considers the specific attributes of the entity in determining its borrowing capacity (i.e. the amount of debt that entity would be able to obtain from independent lenders)
	Ratio approach	<ul style="list-style-type: none"> Maximum amount of "allowable" debt – Debt on which interest may be deducted for tax purposes is established by a pre-determined ratio, such as the ratio of debt to equity
Earnings stripping approach	Fixed ratio rule	<ul style="list-style-type: none"> Limits entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA)
	Group ratio rule	<ul style="list-style-type: none"> Allows an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group

BEPS ACTION PLAN 4

Fixed Ratio

- Limit net interest deduction to a fixed percentage of EBITDA
- The percentage to be somewhere between 10% to 30%

Group Ratio

- Group ratio is to supplement the fixed ratio rule
- Entity with net interest expense above the fixed ratio could be allowed to deduct such interest up to the interest/EBITDA ratio of the worldwide group to which it belongs
- The same can also be capped at additional 10% from the fixed ratio

Other recommendations

- Adopting an equity escape rule which allows interest expense so long as an entity's Debt : Equity ratio does not exceed that of the group
- Providing for carry forward and/or carry back of disallowed interest expense, within limits
- Providing exclusions for interest paid to third party lenders on loans used to fund public benefit projects

COMPARISON OF THIN CAPITALISATION IN DIFFERENT COUNTRIES

Jurisdiction	Approach	Debt included	Additional information
Canada	Excessive debt	Related party debt	<ul style="list-style-type: none"> • Permissible Debt : Equity ratio is 2:1
United States of America	Earning stripping and excessive debt	Both Internal and External debt	<ul style="list-style-type: none"> • Interest paid to related parties, if the interest in the hands of the recipient is not taxed, is disallowed • Applicable to corporations having Debt : Equity ratio exceeding 1.5:1 and when such corporation has excess interest expense
China	Ratio method	Related party debt	<ul style="list-style-type: none"> • However, it provides flexibility of the ratio when the taxpayer is able to justify the high ratio
United Kingdom	Arms length method	Related party debts	<ul style="list-style-type: none"> • Focuses on special relationship and whether the loan would have been accorded had there been no special relationship
Germany and Italy	Fixed ratio	All debts	<ul style="list-style-type: none"> • Limits the deductibility to 30% of EBITDA

Thank You

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