Thin Capitalization - Restriction of Interest under Section 94B – Next Litigation Saga

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Background:

The concept of 'thin capitalization' draws utmost attention in the modern group structuring of MNE[1]. Many multinational groups resort to thin capitalization model in order to minimize group's net tax liability. A company is said to be thinly capitalized when such company is having more debt-equity ratio. Having more debt-equity ratio may cause shifting of profits from one country to other in order to reduce tax liability of the entire group.

The Indian avatar of elimination of abusive strategy of 'thin-capitalization' can be seen in the form of Section 94B of ITA[2], which we will be detailing at length at appropriate place. In these series of articles, we intend to cover the background of introduction of thin-capitalization, reasons for introduction of Section 94B and the various issues springing out of inadequate language of Section 94B. In this part, we cover the background and overview of Section 94B and the subsequent parts, the issues will be covered in much detail.

Before proceeding further, lets take a step back and understand the abusive strategy adopted by MNEs by structuring the capital in a high debt-equity ratio. In other words, let us understand, how MNEs shift profits from high tax jurisdiction to low tax jurisdiction with the following example:

Example 1:

'A Co' is a company incorporated in country A in which corporate tax rate is 15%. 'A Co' has incorporated wholly owned subsidiary 'B Co' in country B in which corporate tax rate is 35%. 'B Co' has earned net profit, after payment of third party interest of INR 50 on which tax at the rate of 35% is payable. In this scenario, assuming that there are no other transactions in 'A Co' during the year, group is liable to pay tax of INR 17.50 and group arrived at net after tax profit of INR 32.50.

Particulars	A Co	B Co	Group Level
Corporate Tax Rate	15%	35%	-
Operating Profit	-	150	150
Profit Before Interest and Tax	-	150	150
Interest paid to Third Party	-	100	100
Interest paid to A Co	-	-	-
Profit Before Tax	-	50	50
Corporate Tax	-	17.50	17.50
Profit After Tax	-	32.50	32.50

[1] Multi National Enterprises
[2] Income Tax Act, 1961

Continuing with the above example, by deploying the abusive strategy of thin capitalization, let us assume 'A Co' has planned to give loan of INR 1,000 to 'B Co' instead of investing completely though equity. 'A Co' has provided loan to 'B Co' at an interest rate of 10% which is deductible in country B while computing tax in the hands of 'B Co'. In such scenario, let us see the numbers:

Particulars	A Co	B Co	Group Level
Corporate Tax Rate	15%	35%	-
Operating Profit	-	150	150
Interest Income from B Co	100	-	100
Profit Before Interest and Tax	100	150	250
Interest Paid to Third Party	-	100	100
Interest paid to A Co	-	100	0
Profit Before Tax	100	(50)	50
Corporate Tax	15	(17.5)	(2.5)
Profit after Tax	85	(32.5)	52.5

By proving loan to 'B Co', 'A Co' has leveraged the investment in 'B Co' by which group tax liability is reduced to INR (2.50) and net after tax profit is increased to INR 52.50. This leveraged investment option by MNEs has created concern to tax administrations across the world. By adopting this strategy, MNEs were able to lower their group level taxes, thereby increasing the post-tax cash reserves. Though, whether to invest in a subsidiary vide equity or loan is a commercial decision, tax authorities thought it would be necessary to interfere into such decision making, especially, in situations where there is a complete lack of commercial justification. To curb this abuse of tax planning, OECD[3]/G20 through BEPS[4] inclusive framework has recommended to insert best practice approaches to limit the interest deductions as elucidated in Action Plan-4.

BEPS Action Plan - 4 provides various options to countries in order to implement best practice approaches to limit the interest deduction while computing the tax liability in a particular jurisdiction. The best practice approach is based around a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, tax, depreciation and amortization (EBITDA). This is a straightforward rule to apply and ensures that an entity's interest deductions are directly linked to its economic activity. It also directly links these deductions to an entity's taxable income, which makes the rule reasonably robust against tax planning.

When the interest deduction is directly linked with earnings of a company, the risk of shifting interest to other tax jurisdictions comes down. If a company to wish to claim more interest in a particular jurisdiction, it

[3] Organisation for Economic Co-operation and Development
[4] Base Erosion Profit Shifting

has to book more earnings in such jurisdiction. When earnings come down, amount of interest deduction also comes down automatically.

However, OCED has felt that fixed ratio rule does not take into consideration the fact that group operating in particular sector may require high leveraged investment and even some groups are highly leveraged for non-tax reasons. Hence, Action Plan – 4 has recommended the countries to implement best practice approaches with the following options:

Overview of the best practice approach

***De minimis* monetary threshold to remove low risk entities.**
Optional
Based on net interest expense of local group

+

Fixed Ratio Rule
Allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio.
Relevant factors help a country set its benchmark ratio within a corridor of 10%-30%

+

Group Ratio Rule
Allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio
Option for a country to apply an uplift to a group's net third party interest expense of up to 10%

Option for a country to apply a different group ratio rule or no group ratio rule.

+

Carry forward of disallowed interest/unused interest capacity and/or carry back of disallowed interest.
Optional

+

Targeted rules to support general interest limitation rules and address specific risks.

+

Specific rules to address issues raised by the banking and insurance sectors.

Back In India:

Following the recommendation made under Action Plan - 4, through Finance Act, 2017, a new section vide 94B was inserted to limit the interest deduction. The said section is as under:

(1) Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, incurs any expenditure by way of interest or of similar nature 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.*

(1A) Nothing contained in sub-section (1) shall apply to interest paid in respect of a debt issued by a lender which is a permanent establishment in India of a non-resident, being a person engaged in the business of banking.

(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.”

Understanding of Section 94B:

Section 94B has been inserted in order to tackle the issue of shifting of profits to reduce tax liability of a group. Section 94B was inserted through Finance Act, 2017. Explanatory Memorandum to Finance Bill, 2017 states that -

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 base erosion and profit shifting by way of excess interest deductions by the MNEs in Action plan 4. The OECD has recommended several measures in its final report to address this issue.

*In view of the above, **it is proposed to insert a new section 94B, in line with the recommendations of OECD BEPS Action Plan 4,** to provide that interest expenses claimed by an entity to its associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less.*

From the above comments in Memorandum to Finance Bill, it is evident that the Government has inserted Section 94B in line with the recommendations made under Action Plan-4. If there is any ambiguity while interpreting the provisions of Section 94B, it is naturally that attention may be drawn to OECD's report on Action Plan-4.

Descriptions of Significant Expressions used under Section 94B

Expression	Description
Disallowance of interest	Interest or similar nature payable to non-resident associated enterprise (AE) is not deductible while computing income chargeable under the head PGBP, if such interest is arising from excess interest. The provisions of Section 94B shall not be applicable if such interest payable to non-resident AE does not exceed INR One Crore.
Borrower	The borrower should be either an Indian company or PE of foreign company. Apart from the said borrowers, the provisions of Section 94B does not apply to any other persons in India.
Exception to borrower	The provisions of section 94B do not apply to a borrower being an Indian company or PE of foreign company which is engaged in the business of banking or insurance.
Lender	Non-resident AE of the borrower. Further, if lender is a third party and AE has provided explicit or implicit guarantee to such lender or AE deposits a corresponding and matching amount of funds with the lender, such debt is deemed to have been issued by AE.
Exception to lender	The provisions of section 94B do not apply to a lender being a PE of non-resident in India which is engaged in the business of banking.
Nature of Expenditure	Any expenditure by way of interest or similar nature. The word 'interest or similar nature' is not defined under section 94B of the Act.
Nature of Borrowing	Any debt issued by a non-resident AE, which means that lender shall be AE of the borrower and such AE is a non-resident in India. The word debt is defined under section 94B to mean 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.
Excess Interest	Excess interest means total interest minus 30% of EBITDA or interest payable to AE whichever is less.
Carry Forward	Assessee can carry forward disallowed interest to following assessment years and get deductions within the limits as specified. However, such carry forwarding is allowed up to 8 assessment years and not beyond that.

With the above remarks, let us proceed to analyse the applicability of provisions of section 94B under various scenarios.

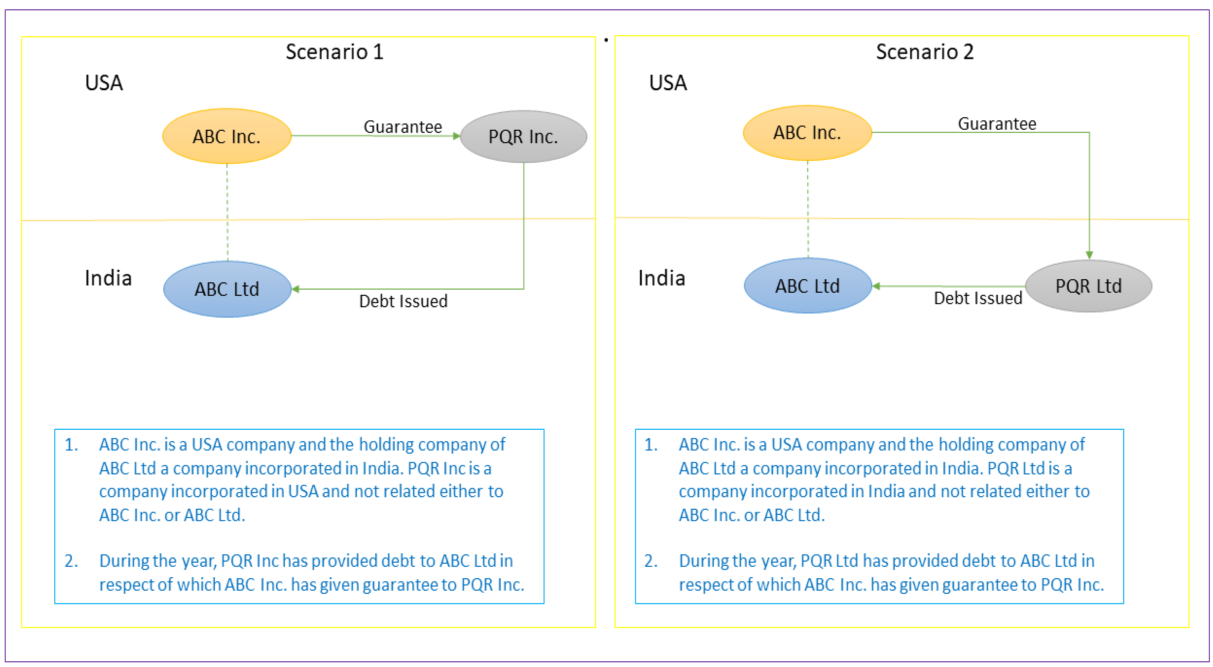
Issue #1 – Guarantee issued by Non-Resident AE to Resident and Non-Resident Lender:

As described earlier, Section 94B triggers only when the debt is issued by a non-resident being an AE of the borrower. However, proviso to Section 94B(1) states that when the debt is not issued by the AE but an AE either provides an explicit or implicit guarantee to such lender or deposits corresponding and matching amount of funds with the lender, such debt is deemed to have been issued by an AE.

From the facts of the case study, it is evident that in Scenario 1, the debt is issued by non-resident entity, which is not an AE to ABC Limited, but the guarantee for such debt is provided by ABC Inc which is AE of ABC Limited. However, in Scenario 2, the debt is issued by resident entity to ABC Limited, which is guaranteed by ABC Inc.

The question that now arises is, whether the interest payment made by ABC Limited to PQR Inc in Scenario 1 and PQR Limited in Scenario 2 would attract the obligations under Section 94B. Let us proceed, to examine the same.

Case Study #1



As stated earlier, the proviso to Section 94B(1) states that if the debt is not issued by AE but a guarantee is provided by AE, then such debt is deemed to be given by AE to the Indian company, that is ABC Limited in this case study. However, the question, which arises is, to what extent the deeming fiction would apply. Whether the deeming fiction of treating the loan extended by non-AE would be deemed to be given by AE, thereby irrespective of the fact that the actual lender is resident or non-resident, the interest payment would trigger obligations under Section 94B? There are two views for the said issue.

Views	Description
View #1	In both the scenarios, even though the debt is issued by the third party, by virtue of proviso to section 94B (1), such debt is becoming the debt issued by the original AE i.e., ABC Inc. Hence, in the both the scenarios, interest payable on debt borrowed by ABC Ltd is treated as interest payable to non-resident AE and hence, such interest shall be deductible subject to the limits specified under section 94B.
View #2	Even though the debt issued by the third party is becoming the debt issued by AE, such deeming fiction shall be restricted only to treat that such debt is deemed to have been issued by AE and shall not treat that such debt is issued by original AE i.e., ABC Inc. Hence, in scenario 1, as PQR Inc is a non-resident, interest payable on such debt is covered under section 94B. However, in Scenario -2, even though the debt is deemed to be issued by AE, as PQR Ltd is not a non-resident and hence, interest payable to PQR Ltd is not covered under Section 94B.

The above view #2 is also garnering support from the recent changes to the Section 94B through Finance Act, 2020. Vide the amendment, an exception is created to make it clear that the provisions of Section 94B shall not be applicable when interest payment is made by borrower for a debt issued by PE of a foreign banking company, guaranteed by non-resident AE.

The explanatory memorandum to the Finance Bill 2020 states that '*Representations have been received to carve out interest paid or payable in respect of debt issued by a PE of a non-resident in India, being a person engaged in the business of banking for the reason that as per the existing provisions a branch of the foreign company in India is a non-resident in India.'*

From the above explanation to Finance Bill, 2020, it can be understood that intention of legislature is to apply Section 94B only with respect of non-resident AE or third party non-resident, when AE provides guarantee or deposits amount with such third party.

That is the reason why, as loan given only by PE of non-resident bank is subject to limitation under section 94B, Section 94B has been amended through Finance Act, 2020 to exclude such transaction from the ambit of Section 94B. If that is not the intention of legislature, loans given by Indian Bank would also have been excluded from the ambit of Section 94B. As Section 94B is not applicable to third party located in India, no need to specifically excluded from the ambit of section 94B.

Hence, by reading of explanatory memorandum to Finance Bill 2020, it can be understood that when third party is located in India and non-resident AE provides guarantee to such third party, loan given by such third party located in India shall not be covered under section 94B.

Even though both views are having strong arguments, View #1 may be the appropriate view as loan given by third party is backed by another AE. However, View #2 is supported by the memorandum of explanation to Finance Bill, 2020. Hence, it is required to provide appropriate clarifications/explanations by the legislature to avoid unwanted litigation.

Summary of Outcome in Various Scenarios

Scenario	Debt by	Guaranteed by	View 1	View 2
Scenario 1	NR Third Party	NR AE	Applicable	Applicable
Scenario 2	Resident Third Party	NR AE	Applicable	Not Applicable
Scenario 3	NR Third Party bank having PE in India	NR AE	Not Applicable	Not Applicable
Scenario 4	Resident Third Party Bank	NR AE	Applicable	Not Applicable
Scenario 5	NR Bank	Resident AE	Not Applicable	Applicable
Scenario 6	NR Third Party	Resident AE	Not Applicable	Applicable
Scenario 7	Resident Third Party	Resident AE	Not Applicable	Not Applicable