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# Thin Capitalization Rules in India: Interest(ing) Limitations


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## INTRODUCTION

It is a common practice among multinational companies globally to lessen their tax outgo by resorting to extensive use of legal arrangements for parking profits in low- or no-tax jurisdictions, formally coined as base erosion and profit shifting (BEPS). One of the simplest profit-shifting techniques available in international tax planning is by way of interest payments and therefore, specific Action Plan, viz., Limiting Base Erosion Involving Interest Deductions and Other Financial Payments ("BEPS Action Plan 4") has been devoted by the OECD to tackle BEPS through payments in the nature of interest and payments economically equivalent to interest. In BEPS Action Plan 4, OECD has set out the best practice approaches for countries to prevent erosion of their tax base by way of excess interest deductions claimed by multinational group entities. BEPS Action Plan 4 is focused on the use of third-party, related-party, and intragroup debt to obtain "excessive" deductions or to "finance the production of exempt or deferred income."

## PROVISIONS INTRODUCED BY INDIA TO TACKLE THIN CAPITALIZATION

Adopting the recommendations of BEPS Action Plan 4, India introduced section 94B in the domestic tax law, viz., Income-tax Act, 1961 ("the Act"), as an anti-tax avoidance provision to restrict deduction of interest paid to nonresident associated enterprises (AEs). Provisions of the said section, enacted w.e.f. 01.04.2018, to the extent relevant to this article, are reproduced hereunder:

> 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, 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.
>
> (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.”

The Explanatory Notes to the Provisions of the Finance Act, 2017 as reported vide Circular No.2 of 2018 dated 15.02.2018 issued by Central Board of Direct Taxes explained the import of the provisions of section 94B as under:

46. Limitation of Interest deduction in certain cases.

46.1 A company is typically financed or capitalized through a mixture of debt and equity. The way a company is capitalized often has a significant impact on the amount of profit it reports for tax purposes as the tax legislations of countries typically allow a deduction for interest paid or payable in arriving at the profit for tax purposes while the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus the amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity.

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46.3 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.

………………..

46.6 In order to target only large interest payments, the said section also provides for a threshold limit of interest expenditure of one crore rupees exceeding which the provision would be applicable.

## OVERVIEW OF PROVISIONS RELATING TO THIN CAPITALIZATION

On a plain reading of section 94B(1) of the Act, it would be appreciated that the Legislature intends to disallow payments of “excess interest” made by an Indian company or the permanent establishment (PE) of a foreign company in India, being the borrower, if following conditions are satisfied:

- Aggregate expenditure incurred by the borrower by way of interest or expenditure of similar nature exceeds the **de minimis** threshold, i.e., Rs.10,000,000 (INR 10 million), in respect of any debt issued by a non-resident, being an AE of such borrower; and

- Said expenditure is deductible in computing income chargeable under the head “Profits and gains of business or profession” — in other words, business income.

The proviso, further, by way of deeming fiction, expands the scope of section 94B(1) of the Act by providing that where debt is issued by a lender which is not an AE but an AE 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 AE.

### ‘Excess Interest’

OECD in BEPS Action Plan 4 recommended limitation on deduction of interest expenditure to a fixed ratio rule, i.e., ratio of interest expenditure to earnings before interest, tax, depreciation and amortization (“EBITDA”) of the taxpayer. OECD further recommended the fixed ratio to be in the range of 10% to 30%. As per the Action Plan, the fixed ratio approach could be supplemented by countries with a worldwide group ratio rule as well as certain targeted rules.

The OECD recommends linking the interest deduction to taxable EBITDA and does not as such talk about restricting the disallowance only to inter-group borrowings. Paragraph 23 of BEPS Action Plan 4 states that “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, taxes, depreciation and amortisation (EBITDA) based on tax numbers. This is a straightforward rule to apply and ensures that an entity's interest deductions are directly linked to its economic activity.”

Under the rules introduced by India, section 94B(2) of the Act provides for the meaning of the expression “excess interest” to mean the amount of total interest paid or payable by the taxpayer in excess of 30% of EBITDA or interest paid or payable by the taxpayer to its AEs, whichever is less.

In terms of section 94B(2), “total interest paid or payable” is required to be taken into consideration for the purpose of computing the amount in excess of 30% of EBITDA and not only the interest paid to AEs. Thus, whether interest is paid (i) to only nonresident AE(s), or (ii) to nonresident AEs and third parties, section 94B provides for a limitation on the deduction of total interest paid or payable to the extent of 30% of EBITDA.

However, it is pertinent to note that the method of computation of limitation on deduction provided under the Indian thin capitalization rules would ensure that only the interest paid to the AEs, over and above the overall ceiling for the total interest expense (paid qua AE and third-party loans) of 30% of EBITDA would stand disallowed, and no part of interest paid to a third party would be disallowed under section 94B. The aforesaid may be illustrated as follows:

| **Particulars** | **I** | **II** | **III** |
|---|---|---|---|
| Interest expense on amount borrowed from AEs (**A**) | 50 | 30 | 10 |
| Interest expense on amount borrowed from third party (**B**) | 0 | 20 | 40 |
| Total interest expense (A+B = **C**) | 50 | 50 | 50 |
| EBITDA (**D**) | 100 | 100 | 100 |
| 30% of EBITDA (30% of D = **E**) | 30 | 30 | 30 |
| Amount of total interest paid in excess of 30% of EBITDA (C – E = **F**) | 20 | 20 | 20 |
| **“Excess interest” not deductible (Lower of A or F)** | **20** | **20** | **10** |

### Carryforward and Set Off of ‘Excess Interest’

It is, further, provided in section 94B(4) of the Act that the excess interest so disallowed shall be eligible for carryforward for eight assessment years immediately succeeding the assessment year for which it was disallowed as “excess interest” and shall be allowed as deduction from the business income, to the extent of maximum allowable interest expense in accordance with section 94B(2).

## FEW ISSUES ARISING FOR CONSIDERATIONUNDER SECTION 94B

The intent behind section 94B(1) is straightforward inasmuch as the same provides for restriction of allowance of interest expenses paid outside India to the AE(s), thereby, reducing the prospects of BEPS. However, the provisions of section 94B, as they are presently worded, may give rise to ambiguous and divergent interpretations, as discussed hereunder:

### Meaning of the Expression ‘Expenditure by Way of Interest or of Similar Nature’

Section 94B(1) provides that where “expenditure by way of interest or of similar nature” in respect of debt issued by a non-resident lender, which is an AE, exceeds the threshold limit of INR 10 million, the “excess interest” shall not be deductible.

The issue which, in the opinion of the authors, is bound to arise and lead to conflict in opinion between the taxpayer and the tax authorities is which expenses would be covered within the scope of the expression “expenditure by way of interest or of **si milar nature**” for determining breach of the aforesaid threshold.

Referring to Chapter 2 of BEPS Action Plan 4, [1] it may be noted that the OECD too, recognizes that each country assigns a different meaning to the term “interest” and has therefore, provided a non-exhaustive list of examples of the types of payment that should be covered by the rules introduced by a country in their respective local laws to tackle BEPS by way of such expenditure. While it is left to each country to determine how best to enact provisions to cover interest payments and other financial payments that are economically equivalent to interest for attracting disallowance of deduction, OECD has given examples of the following payments which should, as a best practice rule, be covered by the jurisdictions while introducing specific measures in their local laws:

• payments under profit participating loans;

• imputed interest on instruments such as convertible bonds and zero coupon bonds;

• amounts under alternative financing arrangements, such as Islamic finance;

• the finance cost element of finance lease payments;

• capitalized interest included in the balance sheet value of a related asset, or the amortization of capitalized interest;

• amounts measured by reference to a funding return under transfer pricing rules, where applicable;

• notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;

• certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;

• guarantee fees with respect to financing arrangements; and

• arrangement fees and similar costs related to the borrowing of funds.

[1] OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 —– 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. https://dx.doi.org/10.1787/9789264241176-en

From the above, it is vivid that the OECD has encouraged countries to cover various payments, partaking the nature of (i) interest on all forms of debt; (ii) payments economically equivalent to interest; and (iii) expenses incurred in connection with the raising of finance.

However, in absence of an exhaustive or inclusive definition of the meaning of the expression “expenditure by way of interest or of similar nature,” the question regarding breach of threshold of INR 10 million for invoking the thin capitalization rule is highly likely to be a bone of contention between the taxpayers and the tax authorities.

For instance, disputes may arise where consultancy charges, charges in the form of arranger fees, pre-loan documentation fees, etc., have been paid to third parties or to AEs for obtaining loans. In such scenarios, for the purposes of invoking the thin capitalization rule, the tax authorities may direct inclusion of such expenses within the ambit of the expression “expenditure by way of interest or of similar nature” holding the same to be in the nature of interest.

Similarly, where an Indian borrower obtains loan from a non-resident, non-AE lender and guarantee is provided by the non-resident AE in respect of such loan, question may arise as to whether, for determining if the threshold limit of INR 10 million is breached, should the interest paid to the lender as well as guarantee charges paid to the non-resident AE be included? In other words, can guarantee charges be treated to be expenditure of a nature similar to that of interest?

Applying the age-old rule of **ejusdem generis**, the words “or of similar nature” as appearing in section 94B(1) of the Act, would derive colour from the preceding words “expenditure by way of interest.” Therefore, expenses which may be covered within the scope of said section would, at best, be of **nature similar** as that of interest.

Reference in this regard is made to section 2(28A) of the Act which defines “interest” to mean, 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. Therefore, **stricto sensu** , only expenses such as fee or charges, etc., which are relatable to any **debt or borrowing** , shall be covered within the scope of section 94B of the Act.

However, it may be mentioned that in India, interpretation of the term "interest" itself has been subject matter of prolonged litigation. In that view of the matter, loosely worded expression extending the reach of thin capitalization rule to expense of similar nature as that of interest is only bound to result in further controversy.

Few examples of different kind of payments which have been disputed to be taxable as "interest" by the tax authorities are illustrated hereunder:

(i) In the case of CIT vs Cargill Global Trading (P) Ltd. [2011] *335 ITR 94* (Del), the tax authorities alleged that **discounting charges** paid for getting export sale bills discounted to were in the nature of "interest" within meaning of section 2(28A) of the Act. After several rounds of litigation, the Delhi High Court held that such charges were not paid in respect of any debt incurred or money borrowed, instead, taxpayer had merely discounted sale consideration on sale of goods and therefore, the same could not be classified as "interest."

(ii) The Delhi Bench of the Income-tax Appellate Tribunal ("the Tribunal") in the case of Johnson Matthey Public Ltd Company, [2017] 88 taxmann.com 127 (Del. Trib.), examined the issue whether receipt of **guarantee charges** by the taxpayer, a non-resident AE and an entity which was separate and distinct from the lender, from its Indian subsidiaries could be brought within the ambit of "interest" as defined in section 2(28A) of the Act. In the said case, guarantee charges were paid by the Indian subsidiaries to the AE for providing guarantee to various banks to extend credit facilities to the said subsidiaries. The Tribunal held that since the AE was a stranger to the privity of contract of loan between the Indian subsidiaries and the banker, the guarantee charges could not be held to be in the nature of interest.

(iii) In the case of Idea Cellular Ltd vs ADIT (International Taxation), [2015] 172 TTJ 540 (Mum. Trib.), the Mumbai Bench of the Tribunal held that **arranger fee** paid to a foreign bank for arranging loan facility was not in the nature of "interest."

There are a host of other cases, not mentioned herein for sake of brevity, wherein the interpretation of the term "interest" itself is disputed. Therefore, the phrase "expenditure by way of interest or of similar nature," in the opinion of the authors, is likely to lead to subjectivity and protracted litigation. Section 94B, however, primarily being an anti-tax avoidance provision, demands strict construction and thus, clarity in language of the section would augur well.

**Proviso to Section 94B(1)——Not in Consonance With the Avowed Intent of Anti-Tax Avoidance**

Another issue that may lead to wide-ranging dispute is the scope of applicability of the proviso to section 94B(1) of the Act, which extends its reach to cover routine third-party debts that are guaranteed by the AE or for which the corresponding amount is deposited by the AE with the lender.

The stated objective of the Indian Legislature behind introduction of section 94B is to curb thin capitalization and the shifting of tax base. However, the proviso to section 94B(1), in the opinion of the authors, in certain situations, may be invoked/interpreted in a manner contrary to the true intent of the Legislature, resulting in undue hardship to the otherwise law-abiding, genuine taxpayers.

In terms of the proviso, where a non-AE lender issues debt to an Indian borrower and the same is guaranteed by an AE, such debt shall be deemed to have been issued by an AE. Put simply, by way of proviso, the Legislature has sought to disallow interest payments even where an AE does not provide the loan directly but does so through a third-party lender and the AE guarantees to the loan for such lender. However, absence of the words "non-resident" before the word "lender" in the first line of the proviso results in direct conflict with the stated objective of acting as an anti-tax avoidance measure inasmuch as the law, as it stands, shall also impact payments in the nature of interest to banks/financial institutions which are resident in India and would include such interest income in their total taxable income in India. To summarize, even cases where there is no shifting of profits from India to another jurisdiction would be hit by the rigours of the thin capitalization rule.

The aforestated intricacy may be better understood in the context of the following situations:

I. Indian company takes loan from a **bank situated outside India**, and guarantee in respect of the same is provided by non-resident AE of the borrower.

II. Indian company takes loan from a **bank situated in India**, and guarantee in respect of the same is provided by resident/nonresident AE of the borrower.

In situation I, the proviso to section 94B(1) would squarely apply as the Indian borrower would make payment of interest to a non-AE lender situated outside India and to that extent, there may be element of base erosion and shifting of profits. By way of the said deeming fiction, the interest payment would be considered to have been made to an AE, triggering disallowance of excess interest.

However, if the proviso is applied to cover situation II, it would completely defeat the objective of section 94B inasmuch as the interest expenditure incurred by the borrower would become income in the hands of the resident lender and would still be taxed at the maximum marginal rate in India. In such a situation, monies in the form of interest expense would not move out of the country and would still be taxed in India, albeit as interest income of the lender and not as business income of the borrower.

One may argue that the proviso cannot be read in isolation and will have to be read along with section 94B(1) before any disallowance can be made and that therefore, because in said sub-section the words “associated enterprise” are qualified by the words “non-resident,” the proviso will not have any applicability in situation II where the lender is a resident of India. However, it would be wishful to think that in such cases bearing facts similar to situation II, the issue will be given a go-by in the assessment proceedings as the letter of the law itself provides a handle for making disallowance.

In that background, it would have been prudent on the part of the Legislature to draft the wording of the proviso in a manner such that applicability of the same would have been restricted to situation I and not have an all-encompassing sweep.

## CONCLUSION

To conclude, it is evident that section 94B of the Act was introduced by the Legislature in pursuance of the recommendations of BEPS Action Plan 4 to limit the artificial shifting of profits to low- or no-tax locations outside India by way of payment of interest on loans taken from non-resident AEs. However, section 94B as presently worded raises certain issues likely to become fount of fresh litigation. The section is already subject matter of challenge in a writ petition filed before the Madras High Court challenging the constitutional validity of the proviso to the said section, considering its probable impact on transactions where there is no possibility of base erosion or profit shifting in cases such as situation II illustrated above, wherein interest is paid by an Indian company is in respect of loan issued by a lender situated in India itself. An expeditious adjudication by the Honorable High Court or clarification from the Central Board of Direct Taxes regarding scope and ambit of applicability of the thin capitalization provisions would go a long way in bringing certainty to the field within which such anti-tax avoidance provisions would operate and in reducing avoidable litigation. The same would be more than welcome and would certainly help assuage the concerns of various multinational groups.