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Tax Bulletin

Vol. 3 Issue No. 5

17th January, 2019

Section 94B – Interest limitation deduction – Practical considerations

India being a part of Base Erosion and Profit Shifting ("BEPS") initiative of Organisation for Economic Co-operation and Development ("OECD") and as a key member of the G20 nations has been proactively adopting and implementing recommendation made in the BEPS action plans. The OECD has identified 15 specific Actions Plans to prevent BEPS. These 15 set of action plans recognize the importance of the borderless digital economy and propose to develop a new set of standards to prevent BEPS.

In last few years, India has proactively followed measures made by the OECD in its BEPS action plans and accordingly implemented such recommendations by amending its domestic tax law. Significant one being –

- introduction of a new levy called Equalisation Levy on certain digital transaction: Action plan 1;
- taxing royalty income from patents at a concessional rate: Action plan 5;
- introducing Country-by-Country Reporting (CbCR) for transfer pricing: Action plan 13;
- introducing thin Capitalization rules: Action plan 4;
- concessional rate of tax @ 15 percent u/s 115BBD of the Income Tax Act, 1961 ("Act') for dividends received by Indian companies from specified foreign companies: Action plan 3;
- introducing LOB clause in India-Mauritius tax treaty: Action plan 6;
- adding Low Value Adding Intra Group Services @ 5 percent within the ambit of safe harbour rules: Action plan 8-10.

One of the BEPS recommendation which India has introduced recently by Finance Act, 2017 was "Limitation on interest deduction in certain cases" by inserting section 94B in the Act. This provision sets the norms according to which an Indian company or a PE of a foreign company shall be eligible to claim a deduction of the interest expenses against its taxable income. Important points are:

- Applies only if the interest charge claimed exceeds one crore rupees;
- Applies to interest costs or similar consideration in respect of debts issued by a non-resident;
- The non-resident should be an Associated Enterprise (AE) of the borrower;
- Interest will be tax deductible only to the extent of 30 percent of earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower;
- Any interest in excess of the above (termed as "excess interest") will be allowed to be carried forward for eight assessment years immediately succeeding the assessment year for which the excess interest expenditure was first computed.

Further, if an overseas parent extends a guarantee on behalf of the Indian subsidiary to a third-party lender (say, a bank), then such interest costs will also be covered by the new provisions. Another case is where the overseas parent deposits funds with an overseas bank who in turn requests its Indian branch to extend the loan to the Indian subsidiary.

Section 94B of the Act Vs. Recommendations in the BEPS Action Plan 4

BEPS Action Plan 4: "Limiting Bases Erosion involving Interest Deductions and Other Financial Payments" mainly focuses on restricting multi-national corporations who use intragroup financing to with a motive to generate tax exempt income. In order to achieve the objectives of BEPS AP 4, Finance Act, 2017 introduced section 94B into the Act which largely mirrors the best practices as given under BEPS AP 4 of the OECD.

Recommendation as per BEPS AP 4	Section 94B of the Act
A minimum monetary threshold to carve out entities which have low level of interest expense	A threshold of one crore has been set to for applicability of this section. Further Banking and insurance sectors have been excluded.
Fixed ratio rule – which allows an entity to deduct net interest expense in the range of 10 -30 percent.	Threshold of 30 percent of the EBIDTA allowed.
Provision to carry forward or carry back of disallowed interest in a given year.	Carry forward for 8 succeeding assessment years allowed, however no provision for carry back is available.

Practical issues faced –

- From a plain reading of the section 94B of the Act, any payment of interest will be reviewed for the threshold. Now, if a Company has borrowed the sum for funding its capital expenditure from its AE, and the interest element is capitalized, technically, should the 30 percent be computed in proportion to the depreciation claimed or the entire cash outflow on account of interest paid should be considered.

- FEMA regulations in India prescribe a debt-equity ratio for ECB. However, the income-tax Act does not prescribe such ration but merely restricts the interest deductibility.

- In another case where a transaction is entered into by an Indian borrower company with a third-party lender which is guaranteed by the overseas parent, then such transaction is deemed to be a debt issued by an AE. Under this scenario, the question would be whether the guarantee commission payments will be reviewed in arriving at the threshold. Particularly, since the guarantee commission transaction is not a debt under the new provisions.

- What happens in case of a company having losses at the operating level. It will have a negative cash flows in such cases and given the provisions of section 94B it would still require to make an adjustment to this effect.

- The restriction applies to interest or similar consideration in respect of debt. The term “similar consideration” is not defined and hence creates ambiguity to the extent that what should be included and excluded in the computation for determining the limit.

- There is no clarity on the FOREX rate that should be adopted for arriving at the 30 percent deduction on foreign currency denominated loans.

- The section only excludes Banking and Insurance companies. However, there many other sectors/financial institutions (E.g. Infrastructure companies) which generally have heavy interest outflow.

- With the recent introduction of General Anti-Avoidance Rules (“GAAR”), a doubt may arise as to whether these transactions after having passed the rigours of section 94B, will be subjected to GAAR provisions. Thankfully, the recent clarification issued by the CBDT indicates that transactions will be reviewed under GAAR for aspects which are not explicitly covered in Specific Anti-Avoidance Rule (SAAR).

With implementation of GAAR, Place of Effective Management Provisions, now the Thin Capitalisation provisions, the focus seems to be shifting to a “substance over form” approach. While the implementation of BEPS Action plan 4 is expected to counter cross-border shifting of profit through excessive interest payments, and protect India’s tax base at the same time they may unduly affect and cause a lot of hardship to some genuine taxpayers especially start-ups. Such genuine taxpayers shall face an interest disallowance in India however at the same time pay taxes overseas on the interest income in the hands of the AE.