

# **Base Erosion and Profit Shifting (BEPS)**

**Action 4: Limiting base erosion Involving interest deductions and other financial payments**

# Introduction

The recent few years has seen clarity in tax policy measures in India which, bolstered by a reasonable GDP growth and positive market outlook has resulted in significant capital infows. In the context of a multinational enterprise, one of the key measures for improving the ease of doing business for an MNE is to support them by way of seamless flow of capital between entities within the multinational group.

In this backdrop, companies are resorting to funding (inbound and outbound) by way of a mix of debt, equity and hybrid instruments. Debt, in addition to being a funding option, is also being viewed as a cash repatriation mean, thereby attracting the scrutiny of revenue authorities and the consequent litigation. With every country, including India embracing the OECDs BEPS action plans, putting in place a defensible and consistent transfer pricing policy for financial transactions becomes critical.

# Need for BEPS Action Plan

The term "base erosion and profit shifting" means, tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low .

## ***What is BEPS?***

- Shifting of profits /income to low-tax jurisdictions or other locations enabling a more favorable tax treatment
- Arrangements involving double non-taxation or less than single taxation
- Transfer of intangibles to favorable tax jurisdictions
- Stripping legal entities of business functions, assets and risks
- Use of "tax attributes" such as tax credits, loss-carry forwards, etc
- Use of intermediary companies/ jurisdictions in investment and financing structures
- Use of hybrid arrangements to exploit mismatches in tax treatment

## ***BEPS – Causes***

- Existence of loopholes, gaps or mismatches in the interaction of domestic tax laws of countries
- Inadequacy of current treaty provisions to effectively deal with innovative business models
- Ineffectiveness or lack of anti-abuse measures in some tax jurisdictions

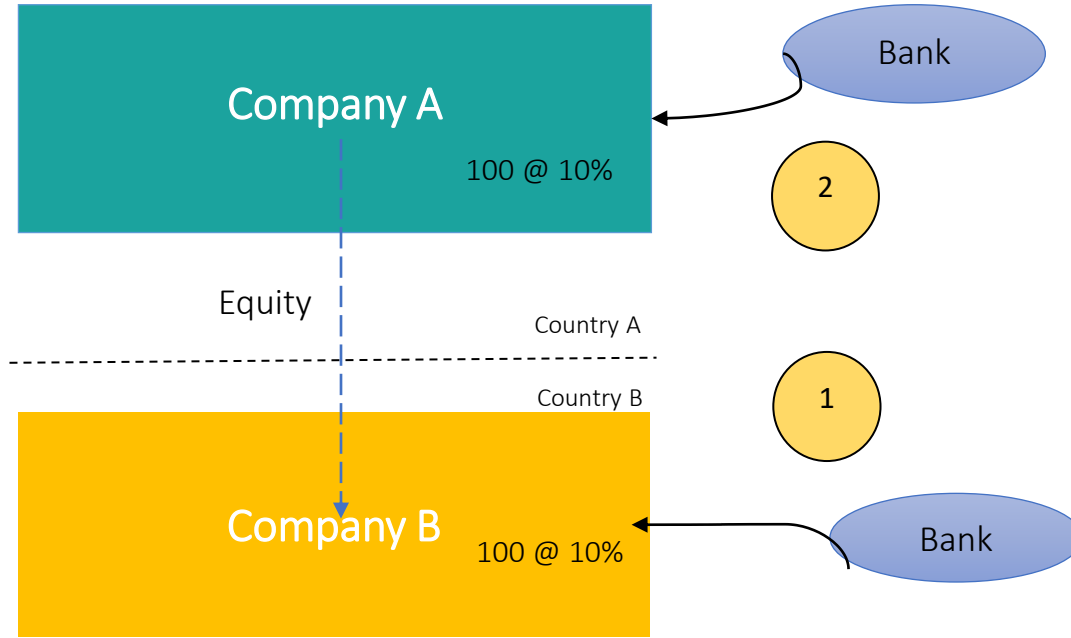
## Need for Action Plan - 4 Limiting base erosion Involving interest deductions and other financial payments

**Companies can easily multiply the level of debt at the level of individual group entities by intra-group financing and broadly achieve the following:**

- 1 • favorable tax results by adjusting the amount of debt in a group entity,
- 2 • place higher level of third party debt in high tax jurisdictions/ Interest income in low or no tax jurisdictions,
- 3 • Intra group financing to fund tax exempt income.

Action Plan 4 seeks to prevent base erosion through use of interest expense. This is done by limiting an entities net deductions for interest (and payments economically equivalent to interest) to a fixed percentage of earnings.

# Illustration on how favorable tax results can be achieved by re-structuring financial transactions:

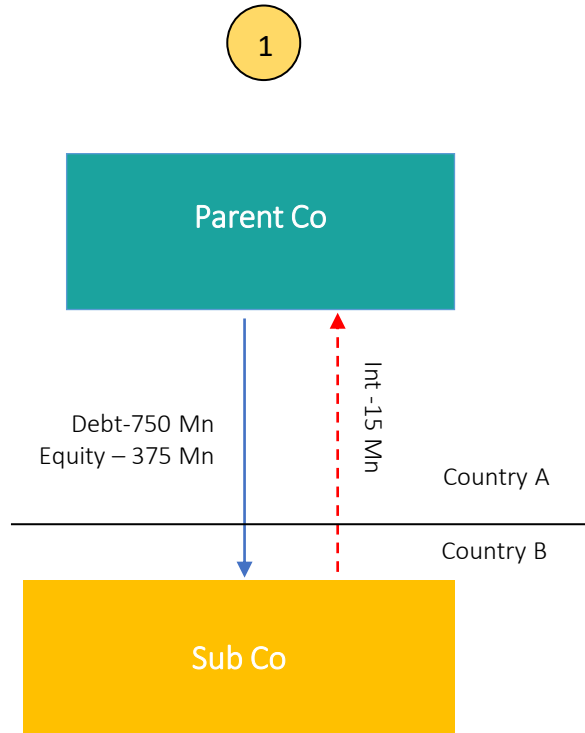


- Country A – 35% tax rate and exempts foreign source dividends
- Country B – 15% tax rate

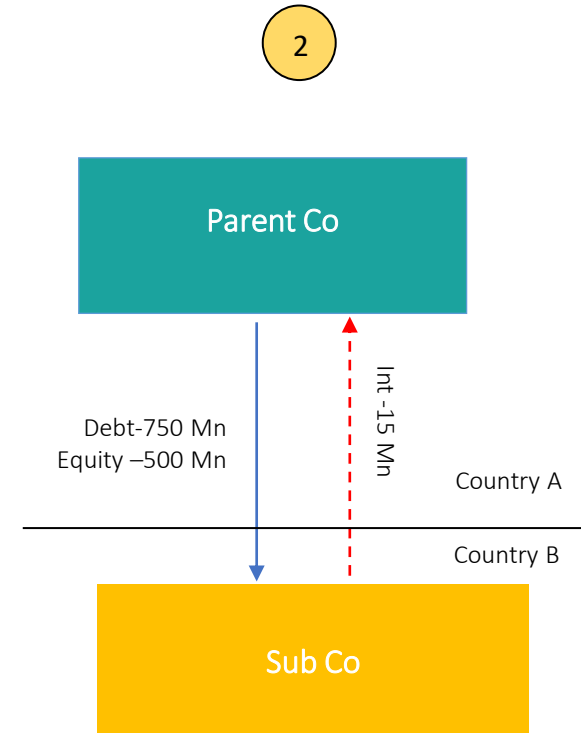
Particulars	Case 1
	B Co
Operating Profit	15.00
Deduction of interest payments	(10.00)
Post interest taxable profits	5.00
Tax @ 15%	0.75
<b>Post tax profit</b>	<b>4.25</b>

Case 2			
B Co		A Co	Total (Mn)
15.00			
0			
15.00	Pre tax interest Cost	10	
2.25	Tax break @35%	3.5	
<b>12.75</b>	Post tax cost	<b>6.5</b>	<b>6.25</b>

# Illustration on how favorable tax results can be achieved by re-structuring financial transactions:



- Subsidiary Co. Country follows Thin Capitalization Rule (TCR) of 1.5:1
- Subsidiary Co. Debt/Equity ratio is 2:1
- Therefore, interest disallowance of 3.75 Mn and total allowance of 11.25 Mn



- Further issue of equity of 125 Mn
- Sub Co uses these funds and grants short term loan to the parent Co. – 125 Mn at 1% P.A. and receives 1.25 Mn as Interest income
- No interest disallowance as Subsidiary Co. is compliant with TCR
- Net interest allowance is 13.75 (=15-1.25)

## Existing Laws/Approaches

### ➤ Transfer Pricing regulations

- An arm's length test requires consideration of an individual entity's circumstances, amount of debt, terms of debt, etc. The Process is resource intensive and time consuming
- Arm's length test recognizes that entities may have different level of interest expense depending on circumstances. However, *addresses only "Rate of interest and not "quantum" of interest.*

### ➤ Withholding tax – allocate taxing rights at source state

- Unless the withholding tax rate is same as corporate tax rate, opportunities for BEPS remain

### ➤ Specific Anti Avoidance Rules – Rules which disallow specified percentage of interest etc.

### ➤ Rules which limit level of interest expense or debt with reference to group's over all position

# Existing Laws/Approaches – India perspective

## SECTION 94B – ANALYSIS

Section 94B is applicable from AY 2018-19 limiting interest deduction to 30 percent of the borrower's EBITDA

**Conditions  
triggering interest  
limitation**

- **Condition 1**  
Borrower is an Indian Company or PE of a foreign company
- **Condition 2**  
Incurs any expenditure by way of interest or of similar nature 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 an AE; or
  - In respect of any debt issued by a lender which is not associated but an AE provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender



# Existing Laws/Approaches – India perspective

## 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
- **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

# Key terms used in Section 94B of the Act

## “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 for the purposes of section 94B of the Act

## Scope of section 94B of the Act

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, as 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

# BEPS Action Plan 4 v/s Section 94B

A broad comparison between section 94B and BEPS Action Plan 4 is provided below:

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

# Certain issues under Section 94B of the Act

*Issue 1: Whether interest which is capitalized as per section 36(1)(iii) of the Act can be considered for disallowance under section 94B?*

- It may be noted that section 94B of the Act clearly states “interest which is **deductible** in computing income chargeable under the head “**Profits and gains of business or profession**”.
- Given that capitalized interest is not deductible in computing the income chargeable under the head “Profits and gains of business or profession”, it can be argued that the interest capitalized shall not be considered for disallowance under section 94B

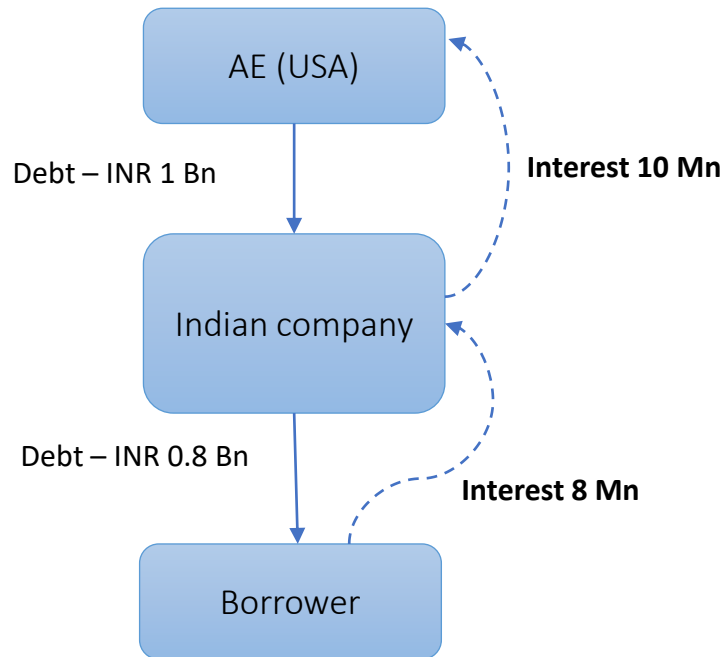
*Issue 2: Whether brought forward interest disallowed in previous years is to be deducted first in the 30% allowable limit or the interest incurred of the current year?*

**Illustration for set off mechanism**

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 brought 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

**Issue 3: 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

*Issue 4: Whether total interest in excess of 30 percent or AE interest in excess of 30 percent be disallowed?*

Particulars	Amount
EBITDA	100
30 percent of EBITDA	30
Interest paid to AE	40
Interest paid to others	20
Disallowance as per the Memorandum	10
Disallowance as per the Bill	30

- While the [memorandum](#) brings out the intent of restricting related party interest to 30 percent of EBITDA, the Act reads '[total interest](#)'.
- Better view seems to be to compute disallowance with reference to total interest in line with the language of the Finance Bill



### Issue 5: Computation of EBITDA under Ind-AS

Particulars	Amount
Profit / loss before tax (SI No VII in Profit and Loss)	XXX
<b>Add:</b> Depreciation and amortization (Part of SI No IV in Profit and Loss)	XXX
<b>Add:</b> Profit / loss before tax from discontinued operations (SI No X in Profit and Loss)	XXX
<b>Add:</b> Other Comprehensive income (before tax) (SI No XIV in Profit and Loss)	XXX
<b>EBITDA</b>	<b>XXXX</b>

- Since the term “EBITDDA” or any part of it is not defined in the Act, the EBITDA as per financials is to be considered for the purpose of Section 94B
- Though dividend on preference shares is treated as finance cost under Ind-AS, the same would not be added back for arriving at EBITDA and will not be considered as “interest” while evaluating the 30 percent threshold

*Issue 6: Sequence of set-off of brought forward losses – indicative sequence provided in table below*

Particulars	Amount	Amount
PGBP income for the year (excluding speculative business income and specified business income <b>(A)</b> )		XXX
Speculative business income for the year <b>(B)</b>	XX	XXX
<b>Less:</b> Set-off of brought forward speculative business loss	(XX)	
Income from specified business under Section 35AD <b>(C)</b>	XX	XXX
<b>Less:</b> Set-off of brought forward specified business loss	(XX)	
<b>Net business income before set-off of loss brought forward under Section 72 and 94B (A+B+C)</b>		<b>XXX</b>
<b>Less:</b> Set-off of brought forward interest under Section 94B [set-off before brought forward loss as this set-off relates to a specific deduction (one view)]		(XX)
<b>Less:</b> Set-off of brought forward business loss under Section 72		(XX)
<b>PGBP income taxable</b>		<b>XXXX</b>

*Issue 6 (Contd.): Sequence of set-off of brought forward losses*

- To begin with, the b/f losses of specified business / speculative business must be set-off against respective business incomes of current year in order to arrive at the net specified business / speculative business incomes
- Thereafter, set-off the brought forward deduction under Section 94B as it relates to a specific deduction as opposed to business loss under Section 72
- Thereafter, set-off brought forward business loss under Section 72

# Interplay with GAAR

- Section 94B is essentially a Specific Anti-abuse Rule (“SAAR”) dealing with excessive interest deduction
- GAAR has 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

# GAAR Applicability

Facts	Whether GAAR would apply	Reasons / Points for discussion
<b>Debt vs equity</b>		
Raising of funds through borrowings (as against equity) from jurisdiction where tax rate on interest is lower than domestic rates.	✘	<ul style="list-style-type: none"><li>▪ Use of debt instead of equity left to commercial judgement of taxpayer</li><li>▪ No specific provisions dealing with <b><u>thin capitalization</u></b> in domestic law</li></ul>
Interest rate linked to rate of return or profits of the borrowing entity.	✔	<ul style="list-style-type: none"><li>▪ Main purpose to obtain tax benefit – dividend payment being claimed as interest payment</li><li>▪ Tainted element – abnormal manner of the transaction – not <i>bona fide</i></li><li>▪ Tax consequence –<ul style="list-style-type: none"><li>- Re-characterization of debt into equity</li><li>- Re-characterization of interest into dividend</li><li>- DDT on interest payouts</li><li>- Interest not allowed as deduction</li></ul></li></ul>

# Interplay with TP Provisions

Section 94B is a non-obstante clause and should override the effects of transfer pricing proceedings. The overriding effect should exist irrespective of the fact that both provisions fall within the scope of the same Chapter (Chapter X) in the Act.

## *Illustration:*

Particulars	Amount
EBITDA	100
30 percent of EBITDA	30
Interest paid to AE	10
Interest paid to others	25
TP disallowance	2
<b>Maximum allowable disallowance under Section 94B</b>	<b>3</b>

- Section 94B – excess interest ***deductible under PGBP*** shall be disallowed
- Once a TP adjustment is made, the interest so reduced (Rs 2 in this case) is rendered not allowable under PGBP and therefore, the excess interest is only to the extent of Rs 3 (33-30)
- This view is further supported by Section 92CA(4) of the Act which requires the AO to compute the total income of the assessee ***in conformity with the TP order***. However, the AO could take a view that the actual interest in excess of 30 percent of the EBITDA should be disallowed irrespective of the TP adjustment

# Miscellaneous Issues

- Whether forex difference forms part of interest for the purpose of computing disallowance under section 94B?
- What is the scope of “financial instruments” used in the definition of debt?
- ***Definition of financial instrument*** – Ind AS 32 defines ‘financial instrument’ in a broad manner to include any agreement which creates a financial asset for one entity and financial liability for another – such wide definition cannot be used in this context
- Further, as per the principle of *noscitur-a-soccis*, where a word is used in between two words of a similar nature, it must take the meaning similar to those words – the term ‘financial instrument’ used in between ‘loan’ and ‘finance lease’ indicates that financial instrument means a debt instrument
- Brought forward deduction under Section 94B can be set off against ***any*** business income

# Conclusion

Factors such as the manner of financing, contractual terms, type of instrument etc. are important considerations since the same will define the return expected out of the transaction. In addition, the introduction of the provision on limitation on interest deductibility is another factor worth considering while structuring financial transactions.

It is well recognized in the context of financial transactions that although they may need to be structured once, they are likely to have an impact on the profitability/tax outgo of the taxpayer over the entire tenure of the arrangement. In this backdrop, MNE's can consider APA's as a means to achieve certainty on intercompany financing transactions and avoid potential risks arising on account of scrutiny in this current BEPS environment.



***Thank You***

## SECTION 94B (1/2)

'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 nonresident, 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.

## SECTION 94B (2/2)

(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.’.

## MEMORANDUM (1/2)

### **Limitation of Interest deduction in certain cases.**

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. Multinational groups are often able to structure their financing arrangements to maximize these benefits. For this reason, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base.

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.

## MEMORANDUM (2/2)

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.**

The provision shall be applicable to an Indian company, or a permanent establishment of a foreign company being the borrower who pays interest in respect of any form of debt issued to a non-resident or to a permanent establishment of a non-resident and who is an 'associated enterprise' of the borrower. Further, the debt shall be deemed to be treated as issued by an associated enterprise where it provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender.