

THIN CAPITALIZATION



SECTION 94B OF INCOME TAX ACT 1961

LIMITATION ON INTEREST DEDUCTION IN CERTAIN CASES.

SUB SECTION (1) OF SECTION 94B

- 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 Rs. 1 Crore**
- which is deductible in computing income chargeable
- under the **head “Profits and gains of business or profession”**



SUB SECTION (1) OF SECTION 94B (CONT..)

- 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)**



PROVISO TO SUB SECTION (1) OF SECTION 94B

- 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.



SUB SECTION (2) OF SECTION 94B

- For the purposes of sub-section (1),
- the **excess interest shall mean**
- an amount of **total interest paid or payable**
- **in excess of 30% 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.**



SUB SECTION (3) OF SECTION 94B

- **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.**



SUB SECTION (4) OF SECTION 94B

- 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**



SUB SECTION (4) OF SECTION 94B (CONT..)

- 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)**



PROVISO TO SUB SECTION (4) OF SECTION 94B

- Provided that
- no interest expenditure shall be carried forward under this subsection
- for more than **8 assessment years**
- immediately succeeding the assessment year
- for which the excess interest expenditure
- was first computed.



SUB SECTION (5) OF SECTION 94B

- For the purposes of this section, the expressions—

Clause (i)

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



CLAUSE (II) OF SUB SECTION (5) OF SECTION 94B

- **"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";**



CLAUSE (III) OF SUB SECTION (5) OF SECTION 94B

- "permanent establishment"
- includes
- a fixed place of business
- through which the business of the enterprise
- is wholly or partly carried on



SYNOPSIS

- Introduction
- Pre existing position
- TC in other countries
- Applicability of section 94B(I)
- Meaning of 'interest'
- Meaning of 'debt issued' and deeming proviso

SYNOPSIS

- Computation of excess interest
- Meaning of EBITDA
- Extent of disallowance under section 94B(1) v. Excess interest
- Associated enterprises v. Deemed international transaction
- PE

SYNOPSIS

- Exceptions
- Carry forward under section 94B(4)
- Non discrimination
- Reciprocal adjustment

SYNOPSIS

- Prioritisation between sections 94B, 95, 92, 14A, 36(1)(iii), 40a and 43B
- Explanation (a) to section 9(1)(v) v. 94B
- Section 94B v. section 92CE



INTRODUCTION

NEED FOR SECTION 94B - MEMORANDUM

Finance bill, 2017

- Interest is allowed as deduction, dividend not deductible
- Debt is more tax efficient method of finance than equity
- to **counter cross-border shifting of profit** through excessive interest payments
- initiative of the G-20 countries
- in line with the recommendations of OECD BEPS Action Plan 4
- to target only large interest payments i.e. > 1 crore
- effect from 1st April, 2018 (assessment year 2018-19 and subsequent years).



PRIOR AMENDMENT - RE-CHARACTERIZATION OF LOAN TRANSACTION WAS NOT PERMITTED.

- **DIT v. Besix Kier Dabhol SA [2012] 210 Taxman 151 (Bombay)(MAG.)**
- **Topsgrup Electronic Systems Ltd. v. ITO [2016] 157 ITD 1123 (Mumbai - Trib.)**
- **Aegis Ltd. v. Addl. CIT [IT Appeal No. 1213 (Mum.) of 2014, dated 27-7-2015]**
- **Parle Biscuits (P.) Ltd. v. Dy. CIT [2014] 46 taxmann.com 11 (Mum.)**



PRIOR AMENDMENT - RE-CHARACTERIZATION OF LOAN TRANSACTION WAS NOT PERMITTED.

- **Mylan Laboratories Ltd. v. Addl. CIT [2014] 46 taxmann.com 76 (Hyd. - Trib.)**
- **Allcargo Global Logistics Ltd. v. Asstt. CIT [2014] 150 ITD 651/47 taxmann.com 188 (Mum.)**
- **Prithvi Information Solutions Ltd. v .Asstt. CIT [2014] 49 taxmann.com 176 (Hyd. - Trib)**
- **Tooltech Global Engg. (P.) Ltd. v. Dy. CIT [2014] 51 taxmann.com 336 (Pune)**



BRIEF HISTORY OF THIN CAPITALIZATION

- **Early adopters included Canada in 1972 and France in 1979**
- **Followed by Australia, Indonesia, the United Kingdom, and the United States in the 1980s**
- **Other countries enacted their thin capitalization rules after 1990**



BRIEF HISTORY OF THIN CAPITALIZATION

	Related Party Debt	All Debt
Fixed Debt-Equity Rule	Argentina (1999); Belarus (2013); Brazil (2011); Canada (1972); Chile (2012); China (2008);* Czech Republic (2007);* Ecuador (2007); Egypt (2005); El Salvador (2012); France (2007), ² * Ghana (2000);* Gibraltar (2010); Japan (1992); Kenya (2006); ³ * Korea, Republic of (1997);* Lithuania (2002); Macedonia;* Mexico (2005); ⁴ Mongolia (2005); Mozambique (2008); Namibia (2012); Oman (2012); Peru (2007); Poland (1999); ⁵ Rwanda (2008);* Slovenia (2005); Sri Lanka (2006); Taiwan (2011);* Turkey (2006); Uganda (2013); United States (1989); Venezuela (2007); Yemen (2010)	Albania (2000);* Australia (1997); ⁶ * Bulgaria (2006); Colombia (2013); Croatia (2005); Denmark (1998); ⁷ Dominican Republic (2013); Georgia (2018);* Hungary (2000); Indonesia (2016);* Latvia (2003); New Zealand; Papua New Guinea (2013); Romania (2006); ⁸ Serbia (2001); Zimbabwe (2011)
Fixed Interest-Income Rule (Earning Stripping Rule)	Finland (2013); Norway (2014)* Slovakia (2015)	Germany (1994); Greece (2010); Italy (2003); Portugal (1996); ⁹ Spain (1996) ⁹
Arm's-length Rule	Kazakhstan (2008); South Africa (1995); United Kingdom (1999)	

Source: 'Tax Policy, Leverage And Macroeconomic Stability' published by IMF on Oct 2016

BEPS ACTION PLAN - 4

- Focuses on excessive interest deduction
- Debt funding of outbound and inbound investment
- Negative impact on Capital Ownership neutrality
- Deductible interest expense in high tax jurisdictions and Interest income in low or no tax jurisdictions or Development of hybrid instruments
- Creates issues for developing countries
- BEPS Action plan 4 – expressly allows the application of thin capitalization rule – as anti-abuse rule



APPROACHES FOLLOWED BY DIFFERENT COUNTRIES

- As discussed in BEPS Action -4 – **Six Approaches** (individually or combined)
 1. Arm's length tests
 2. Withholding tax on interest payments
 3. Rules disallowing a specified percentage of the interest expense
 4. Rules limiting the level of interest expense or debt as fixed ratio such as debt/equity, interest/earnings, interest/total assets – **(EBITDA -preferred by most of the countries)**
 5. Rules which limit the level of interest with reference to the group's overall position.
 6. Targeted anti-avoidance rules



BEPS ACTION PLAN - 4

- Rules to tackle interest on all forms of debt and financial payments – country to determine the legal form (P.35 & 36)
- Should apply to all entities that are part of a multinational group. May also to include entities in a domestic group and /or standalone entities which are not part of a group (P.43 & 85)
- Rule should apply to entity's net interest and supplement general interest limitation rules (P. 62 & 63)



BEPS ACTION PLAN – 4 (CONT..)

- **Fixed ratio rule –**

- (EBITDA) - best practice approach since directly linked to its economic activity (P. 18)
- it is a blunt tool (does not consider the sector) (P. 24 & 115)
- Should be complimented with group ratio test (P. 24 & 116)
- Suggests carry back & forward (P.27)
- Countries are free to apply stricter rules (P. 31)
- Rules to tackle interest on all forms of debt and financial payments – country to determine the legal form (P.35 & 36)
- Rule should apply to entity's net interest to avoid double taxation (P. 62)



BEPS ACTION PLAN – 4 (CONT..)

- Fixed ratio rule (Cont..) –
 - EBITDA v. EBIT – **EBITDA recommended** (P.82)
 - Interest only upto fixed ratio allowed; excess disallowed (P.85)
 - **Process of Computation (P.88 to 92)**
 - Calculating the measure of earnings
 - Applying the statutory benchmark fixed ratio to earnings
 - Comparing maximum deductible interest expense with actual interest expense
 - **Disallowance of Interest = Net interest expenses - maximum deductible interest**
 - 10% to 30% of ratio recommended (P.97)





PRE-EXISTING
POSITION

PRE EXISTING POSITION

- No thin capitalization rules
- Section 14A
- Section 36(1)(iii)
- Section 40a(i)/(ia)
- Section 40A(2)
- Section 43B
- Section 92
- Section 94A - NJA





THIN
CAPITALISATION IN
OTHER
COUNTRIES

Country	Thin Capitalisation Rules	Carry forward of disallowed interest
United States	Rules known as “Earning Stripping Rules”, which are invoked following examination on a case-by-case basis. Interest deduction is restricted in case of debts owed to or guaranteed by non-US-related parties. In April 2016, the US treasury department proposed draft thin capitalization (thin cap) rules, but they are subject to finalisation.	Excess interest is allowed to be carried forward to future years. However, set off is subject to limitation of 50% of taxable EBDITA.
Germany	Germany moved from traditional thin capitalisation rules, based on a maximum debt-equity ratio, to earnings-stripping style rules in 2008. Thin cap rules are not in place; however, interest in excess of 30% of EBDITA is non-deductible. The threshold limit for the restriction is euro 3 million.	Carry forward of excess interest is allowed for future years. Not allowed in a case where there is a change in the shareholding.
France	Thin cap rules apply to interest payments made to associated enterprises (AE) and also loans guaranteed by related parties. Interest deduction is limited to maximum of prescribed limits. However, there is an exemption in cases where the debt equity ratio of the group is higher than that of the French company.	Carry forward allowed to future years (reduced by 5% each year from the second year).
United Kingdom	No specific thin cap rules are prescribed. It is considered as part of the transfer pricing rules.	NA



APPLICABILITY OF
SECTION 94B

APPLICABILITY OF SECTION 94B

- Applicable only to Indian company / PE of foreign company in India, being a borrower
- Does not apply to non-corporate assessee/PE of non corporate assessee
- Incurs expenditure by way of interest or of similar nature exceeding Rs.1 Cr : This de minimus threshold is at entity level though AP4 recommends this to be at local group level
- Such expenditure is deductible in computing income chargeable under the head “profits and gains of business or profession”
- Such expenditure is in respect of any debt issued by non resident AE



APPLICABILITY OF SECTION 94B

- Section 92 A (2) may trigger both TP as well as section 94B
- ECBs could also trigger AE relationship if lending exceeds 51% of book value of total assets : sec 92A(2)(c)
- Similarly, any gurantee exceeding 10% of total borrowing would trigger AE relationship : sec 92A(2)(d)



SECTION 94B – DOMESTIC PAYMENTS

- A domestic company may pay interest in INR to branch of a foreign Bank [which is AE of DC]

Eg: Ezanda Leasing Pvt. Ltd paying interest to Bangalore branch of ANZ Grindlays [Ezanda and ANZ Grindlays are AEs]

- A PE of a FC paying interest to PE of another FC where both FCs are AEs

Eg : Indian branch of Microsoft Inc paying to Indian Branch of Bill Gates Research PLC

- Runs contrary to objective as per Memorandum as there is no cross border flight taking place





MEANING OF
INTEREST

MEANING OF INTEREST

- Section 94B(1) uses the language *'interest or of similar nature'*
- BEPS Action Plan 4 uses the language *'interest and payments economically equivalent to interest'*
- Section 2(28A) 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 which has not been utilised



INTEREST V. SIMILAR NATURE

1. Section 94B(1) uses 'interest or of similar nature' while determining the threshold, but uses 'interest' while providing for disallowance
2. Section 94B(2) uses 'interest' while determining the excess interest in both limbs
3. Section 94B(4) also uses 'interest'
4. Memorandum uses 'interest'



INTEREST V. SIMILAR NATURE

1. AP 4 uses interest and interest equivalent
2. Amendment to form 3CD – column 30B (b)(iii) is contrary to section 94B(2) as it uses ‘similar nature’ even for the purpose of sec 94B(2)

MEANING OF INTEREST : GROSS OR NET

- There is no provision in section 94B to be taking net interest i.e. interest expenditure reduced by interest income
- AP4 recommends net interest – para 62 in Chapter 4



MEANING OF INTEREST

- Whether 'discounts or other finance charges' referred in Section 94B(5)(ii) defining 'debt' fall under expression 'of similar nature'
- Debt defined under Section 94B(5)(ii):
 - 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"



MEANING OF INTEREST : AP4

- Para 36 of BEPS Action Plan 4 states that 'Interest Expense' should apply to :
 - (i) interest on all forms of debt;
 - (ii) Payments economically equivalent to interest; and
 - (iii) expenses incurred in connection with the raising of finance.



MEANING OF INTEREST : AP4

- It is also stated that the above items should include but not restricted to, the following:
 - 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



MEANING OF INTEREST

- the finance cost element of finance lease payments
- capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised 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



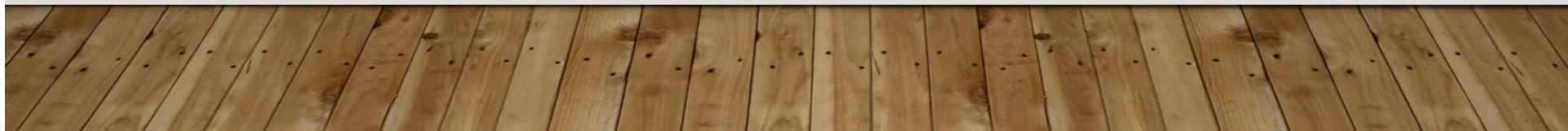
MEANING OF INTEREST

- certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance
- guarantee fees with respect to financing arrangements
- arrangement fees and similar costs related to the borrowing of funds



MEANING OF INTEREST : AP4

- Para 39 of BEPS Action Plan 4 states that rules set out in Action Plan 4, should not limit deductions for items such as:
 - foreign exchange gains and losses on monetary items which are not connected with the raising of finance
 - amounts under derivative instruments or hedging arrangements which are not related to borrowings, for example commodity derivatives
 - discounts on provisions not related to borrowings
 - operating lease payments
 - royalties
 - accrued interest with respect to a defined benefit pension plan.



INTEREST FOR PURPOSE OF SECTION 94B

- 1. Section 94B is a deeming fiction requiring stricter interpretation**
- 2. Interest or similar nature would be reckoned only for the purpose of testing limit of Rs.1 Crore**
- 3. For the purpose of disallowance, computation for excess interest, carry forward etc., only 'interest' would be considered**



PREMIUM OR DISCOUNT ON NCD

1. **Sec 2(28A)**
2. **Interest and similar charges – ejusdem generis**
3. **Debt defined in section 92B(5)(ii)– NCD may be a debt but premium cannot by inference be interest**

OTHER EXAMPLES

Lease rental under Finance Lease : AS 19, Ind-AS 17, Circ 2 of 2001

ABB 154 Taxman 512 SC & ICDS Ltd 350 ITR 527 SC

Lease rental v. Equipment royalty

Board Circular No. 9 dated March 23, 1943 on Hire Purchase

Does not apply to interest payable to trade creditors



INTEREST AS PER DTAA

1. DTAA defines interest for the purpose deciding taxing jurisdiction and not for the purpose allowing deduction – Eg Article 11(4) of Indo USA DTA
2. Therefore, such definition may not apply for the purpose of section 94B

The slide features a white background with a wooden floor texture at the bottom. A large red square is centered on the left side, containing the title text in white. The text is arranged in four lines: 'MEANING OF DEBT', 'ISSUED', 'AND', and 'DEEMING PROVISIO'.

MEANING OF DEBT
ISSUED
AND
DEEMING PROVISIO

MEANING OF DEBT ISSUED AND DEEMING PROVISO

- Section 94B(1) applies when expenditure by way of interest or of similar nature is incurred in respect of any debt issued by NR AE
- Proviso : Where the debt is issued by a lender which is not associated but an AE either provides 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
- Proviso is not restricted to NR AE : If Resident AE is covered by the Proviso, section 94B(1) is not applicable



MEANING OF DEBT ISSUED AND DEEMING PROVISO

- Does Proviso negate application of section 94B(1) if a Non AE or a Resident AE guarantees a debt issued by a NR AE?
- Example 1 : X Ltd., borrows from its NR AE Y Inc., which is guaranteed by an unrelated bank, whether Indian or Foreign
- Example 2 : X Ltd., borrows from its NR AE Y Inc., which is guaranteed by A Ltd., an Indian Company but an AE of X Ltd.



■ **IMPLICIT OR EXPLICIT GUARANTEE**

- Rule 10TA(c) defines 'corporate guarantee' to mean explicit corporate guarantee extended by a company to its wholly owned subsidiary being a non-resident in respect of any short-term or long-term borrowing.
- Explanation to said Rule provides that for the purposes of this clause, explicit corporate guarantee does not include letter of comfort, implicit corporate guarantee, performance guarantee or any other guarantee of similar nature
- Bank guarantee and solvent surety are different : See Smt. Premlata Purshottam Paldiwal 406 ITR 254 - para 4(c)



■ **IMPLICIT OR EXPLICIT GUARANTEE**

- Does implicit guarantee imply counter guarantee or back to back guarantee



- **DEPOSITS A CORRESPONDING AND MATCHING AMOUNT OF FUNDS WITH THE LENDER**
- Corresponding and matching amount – conjunctive
- Literal meaning of matching – not tolerant to short/excess
- Funds v. offering securities viz mortgages, hypothecation, pledge etc., but short of guarantee
- Unlike in guarantee where implicit guarantee is included, indirect deposit of corresponding and matching funds is not included



PROVISO EFFECT

- Whether Section 94B will apply in case an Indian company makes the interest payment to a resident lender for debt guaranteed by an associated enterprise.
- Rationale for introducing Section 94B as per the Memorandum to counter 'cross-border shifting of profits' through excessive interest payments, and that it aims to protect a country's tax base
- **If AE is a non resident, debt shall be deemed to be issued by NR AE and section 94B(1) applies**
- **If AE is a resident, debt shall be deemed to be issued by resident AE and section 94B(1) does not apply**





COMPUTATION OF EXCESS INTEREST

COMPUTATION OF EXCESS INTEREST : 94B(2)

- Excess interest is lower of
 - a) Total interest paid or payable – 30% of EBITDA of the borrower in the PY OR
 - b) Interest paid or payable to AEs for that PY
- In computing excess interest, there is no reference to expenditure of similar nature
- In Limb (a), enterprise interest irrespective of whether payee is AE or not is considered.
- Similarly, EBITDA is considered at enterprise level



COMPUTATION OF EXCESS INTEREST : 94B(2)

- In Limb (b), interest paid or payable to AE irrespective of whether such AE is resident or not is considered.
- Although, in a given case, excess interest may include interest paid to resident AE, the disallowance under section 94B(1) is only 'the interest' as arising from excess interest is disallowed.
- Use of definite article 'the' before 'interest' makes an obvious reference to 'interest' used in the earlier part of section 94B(1)
– Vegetable Products 88 ITR 192 SC
- Interest used in earlier part is in respect of debts issued by NR AE



94B(2) V. AP4

- AP4 suggests fixed ratio rule to be supplemented by a worldwide group ratio
- This would allow a bandwidth from fixed ratio upto group ratio
- AP4 also suggests a further uplift of upto 10% to the group's net third party interest expense to prevent double taxation
- AP4 suggests that if a country does not apply group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without discrimination.
- Section 94B does not provide for the above

■ PROVISIO TO 94B(1) V. 94B(2)

- Proviso only deems debt issued by AE
- Section 94B(2) : second limb refers to interest paid or payable to AEs
- While determining the second limb under section 94B(2), whether the fiction of proviso to section 94B(1) applies?
- In other words, is interest paid to Non AE also reckoned by pressing proviso wherever it applies?
- V.S.Dempo **387 ITR 354 SC**





MEANING OF
EBITDA

MEANING OF EBIDTA

- EBIDTA is at enterprise level
- EBIDTA represents book profits or tax profits
- AP4 Chapter 7 read with Annexure D Examples 8(a), (b) and (c) provide for three alternatives:
 1. Apply Tax EBIDTA
 2. Apply Accounting EBIDTA
 3. Apply a blended approach

MEANING OF EBIDTA

- **EBIDTA is at tax payer's level and not aggregate at local group level**
- **In other words, several domestic companies belonging to same group : No aggregation of EBIDTA**

WHEN WHETHER IS LOSS

- If there is loss, taxman's view could be full disallowance under section 94B
- AP 4 – Para 77 in Chapter 5 recognizes this risk and states that this risk could be addressed by suitably defining the earnings or allowing carry forward
- Aggressive view could be that section 94B(2) fails to operate and excess interest cannot be computed
- Earning v. Profits and Profits v. Losses and Income v. Loss [Harprasad 99 ITR 118 SC]



EXTENT OF
DISALLOWANCE
UNDER SECTION
94B(1)
V.
EXCESS INTEREST

EXTENT OF DISALLOWANCE

1. Different parameters exist for (a) applicability of 94B, (b) computation of excess interest and (c) determining disallowance
2. In section 94B(1) payee should be AE NR
3. In section 94B(2), while determining excess interest, in the second limb, interest paid or payable to all AEs, whether resident or non resident are considered.
4. However, disallowance under section 94B(1) is only to the extent the interest arises from excess interest
5. See Illustration



ASSOCIATED
ENTERPRISES
V.
DEEMED
INTERNATIONAL
TRANSACTION

ASSOCIATED ENTERPRISES V. DEEMED INTERNATIONAL TRANSACTION

- Section 92B(2) deems a non AE transaction as an international transaction if there is a prior arrangement between third party and the AE or if terms are in substance agreed between the two.
- However, section 92B(2) falls short of calling assessee and third party as Aes [**V.S.Dempo 387 ITR 354 SC**]
- Therefore, a lending covered in section 92B(2) may not be hit by section 94B(1)
- Only exception is by application of proviso to section 94B(1) – Guarantee or placing corresponding and matching funds with the lender by the AE





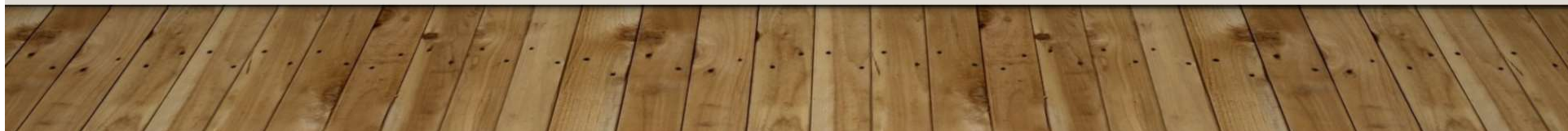
PE

PE

1. Section 94F(ii)
2. AE defined under Section 94B(5)(ii)
3. PE defined under Section 94B(5)(iii)
4. India PE cannot be AE of HO : Aithent Tech TS-752-ITAT-2016(DEL)
5. Cases where a PE could be regarded as AE of its enterprise : Section 92A(2)(g)/(h)/(i)
6. 92B may fail but 94B may apply

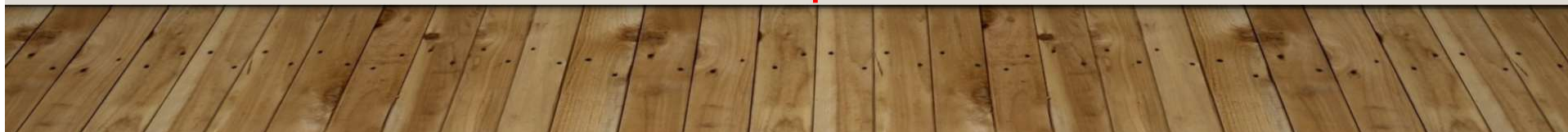
PE PAYING INTEREST TO HO IS PAYMENT TO SELF

- SUMITOMO [2012] 19 taxmann.com 364 (Mum. - ITAT) (SB) & ABN Amro Bank NV 343 ITR 91 Cal
- Explanation(a) to section 9(1)(v) deals with interest paid by PE to its non resident enterprise carrying on banking business
- Explanation(a) does not apply to PE paying to other NR AEs, whether carrying on banking business or not
- Such PE would be covered by sec 94B except when PE is carrying on banking or insurance business



PE PAYING INTEREST TO HO IS PAYMENT TO SELF

- PE may pay interest to its HO or other overseas branches :
 1. In such case, section 94B does not apply as interest is a self payment
 2. Article 7(2) and 7(3) of DTA [particularly article 7(3) of Indo USA DTAA] may not permit interest deduction
 3. Where PE pays to its HO or other overseas offices carrying on banking business : Explanation (a) to sec 9(1)(v) applies
- PE may pay interest to other Non Resident AEs
 1. In such case, PE is covered by section 94B(1)
 2. EBIDTA is of PE or of enterprise?



HO ALLOCATING THIRD PARTY INTEREST TO PE

- PE may not as such incur interest
- HO/overseas PE may incur third party interest
- Such interest may be attributed to PE as per article 7(2)
- As long as such attribution is in respect of interest to third parties, section 94B does not apply
- If however, such interest is paid by HO/overseas PE to an NR AE, section 94B is attracted to the extent of attributed interest
- In such case, whether EBIDTA is of PE or of enterprise?



PE V. SEC 94B

- PE's profit to be computed as per article 7(2) and 7(3)
- Indo US DTAA article 7(3) says expenses will be allowed in accordance with and subject to the limitations of taxation laws of PE's State
- Any subsequent restriction on executive and general administrative expenses shall not reduce the same below what was allowable at the time the DTAA is signed [Protocol II.AD Article 7]
- Article 7(3) allows expenses incurred for business of PE, including reasonable allocation of executive and general administrative expenses, R&D expenses, interest and other expenses





EXCEPTIONS

EXCEPTIONS

- Section 94B(3) excludes Indian company / PE carrying on banking business or insurance business
- NBFCs are however not exempt
- Explanation to section 9(1)(v) deals with interest paid by PE to non resident carrying on banking business
- Non corporate assessee or PE of non corporate assessee
- Where Expenditure by way of interest or of similar nature does not exceed Rs.1 Cr
- Incomes computed under heads other than “Profits and gains of business or profession”



EXCEPTIONS

- Expenditure of similar nature not being interest
- Interest to residents, whether to AEs or otherwise
- Interest to non AE non residents



**CARRY FORWARD
UNDER SECTION
94B(4)**

CARRY FORWARD

- Allows carry forward for 8 years [AP4 does not put such limit]
- Does not allow carry backward
- Limit for set off of brought forward interest is maximum allowable under sec 94B(2) : lower of 30% of EBITDA or actual
- Whether limit applies on an overall basis – current plus brought forward or applies separately
- Whether limit applies to each year's brought forward interest or will apply to aggregate of brought forward interest



CARRY FORWARD

- All pervasive : compare 94B(4) with section 32(2)/72(1)
- Applies to all disallowance under the Act (Sections 40(a)/40A/92 etc)
- Set off against any business
 - Carried forward interest shall be allowed as a deduction against the profits and gains, if any, of any business or profession carried on – there is no reference to the ‘head’ : Therefore, deduction is permissible against any business income irrespective of head under which the same is computed [Cocanada Radhaswamy Bank 57 ITR 306 SC]



CARRY FORWARD

- Language used in section 94B(4) is not 'set off' but 'deduction'. Hence, such deduction may result in negative also.
- At what stage is the carry forward and deduction is permissible –
 - In chapter IV
 - After chapter IV but before Chapter VI
 - After chapter VI
 - After chapter VIA
- No provision dealing with the case of amalgamation, merger and other succession of business



CARRY FORWARD

- Deduction is not contingent upon filing return
- No provision similar to sections 78 and 79
- No carry forward of delta [though recommended in AP4]



NON-
DISCRIMINATION

Non-Discrimination

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graph TD; A[Non-Discrimination] --> B[Recipient]; A --> C[Payer]; B --> D[Article 26(1) may not help]; C --> E[Article 26(3) would apply];
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Recipient

Article 26(1) may
not help

Payer

Article 26(3) would
apply

NON-DISCRIMINATION

- AP4 suggests that if a country does not apply group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without discrimination.
- However, section 94B does not take care of above
- Provisions similar to article 26(3) are not found in all DTAA's
- In such case, payer will have no recourse





RECIPROCAL
ADJUSTMENT

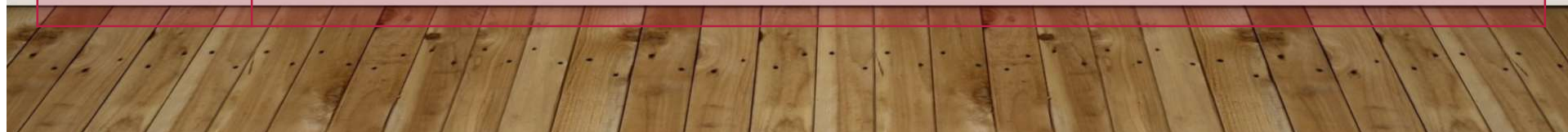
RECIPROCAL ADJUSTMENT FOR RECIPIENT NR

1. Absence of Sections 92(3)/92C(4)
2. Have already passed test of Sections 95/92/40A(2)/36(1)(iii)/37
3. Spirit of Article 9 of DTAA
4. Spirit of Article 26(1) of DTAA though not directly applicable
5. Reciprocal claim – Is 94B(4) a hurdle?



**PRIORITISATION
BETWEEN
SECTIONS 94B, 95,
92, 14A, 36(I)(III),
40A AND 43B**

Sections	Language Used
94B	Notwithstanding anything contained in this Act,..
95	Notwithstanding anything contained in the Act,
40A(1)	.. notwithstanding anything to the contrary contained in any other provision of this Act relating to the computation of income under the head "Profits and gains of business or profession".
40	Notwithstanding anything to the contrary in sections 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head "Profits and gains of business or profession"
43B	Notwithstanding anything contained in any other provision of this Act, a deduction otherwise allowable under this Act in respect of



■ SECTION 40(A)(I) V. SECTION 94B

1. 94B applies after passing section 40a(i)
2. Take a case of Section 40(a)(i) disallowance in Y1 followed by allowable in Y2
3. 94B does not apply to Y1 as interest is not allowable
4. In Y2, it is not 'incurred' and hence Section 94B is not applicable
5. There is no provision similar to Section 40A(3A)
6. 'Incurs' should relate to current PY because it is benchmarked with 'earning' which relates to current year



SECTION 43B V. 94B

1. Foreign bank's branch can be a scheduled bank – II Schedule to RBI
2. Section 43B(e) applies.
3. Section 43B uses the language '*deduction otherwise allowable*', whereas Section 94B uses '*which is deductible*'
4. Principle of '*generalia specialibus non derogant*'
5. Section 94B(3) – Totgar's ratio 395 ITR 611 Kar
6. Same implications as section 40a(i)

SECTIONS 40A(2) V. 92 V. 94B

1. Section 40A(2) is taken care by Section 92, hence no scope
2. Special Bench decision on Section 40A(2) v. Section 92 in in Aztech 107 ITD 141 SB – para 19
3. Section 92(1) read with Explanation would first apply and aligns the interest to its ALP
4. Section 94B then steps into further disallow the ALP interest to the extent of excess interest
5. Different interest figures are to be applied in 94B – See illustration



SECTION 94B V. 92A

- Section 92 A (2) may trigger both TP as well as section 94B
- ECBs could also trigger AE relationship if lending exceeds 51% of book value of total assets : sec 92A(2)(c)
- Similarly, any gurantee exceeding 10% of total borrowing would trigger AE relationship : sec 92A(2)(d)



SECTION 94B V. 14A

- Section 94B applies after determining the disallowed portion under section 14A
- However, for the purpose of section 94B(2), total interest as well as interest paid or payable to AEs as the case may be have to be taken and not what was allowed under section 14A



SECTION 94B V. 36(1)(III)

- Section 94B applies after the tests of sec 36(1)(iii) are passed
- Section 94B applies only to expenditure and does not apply to 'allowance' [for e.g. depreciation – Nector Beverages 314 ITR 314 SC]
- Proviso to Section 36(1)(ii) mandates capitalization and thereby saves an assessee from Section 94B
- Intelligent capitalization may help to avoid Section 94B



SECTION 94B V. 95

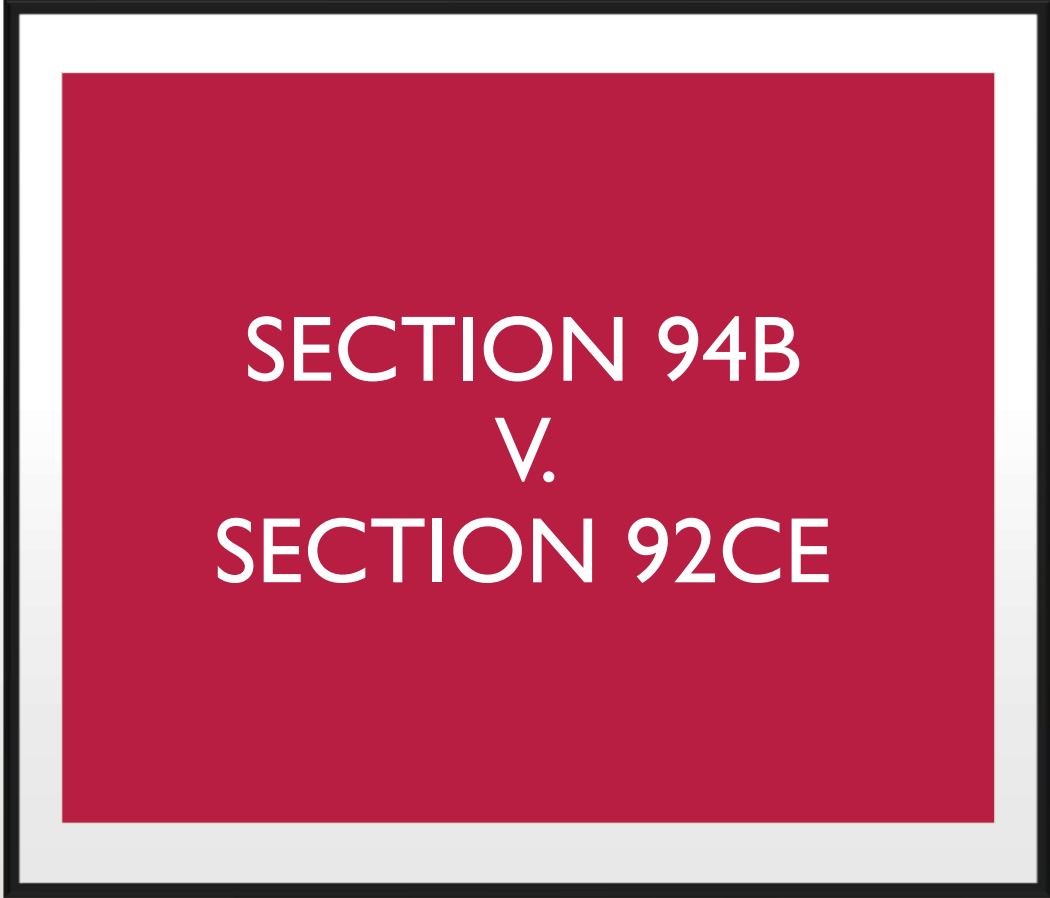
- Section 94B applies after passing GAAR scrutiny
- If under section 98, interest is reallocated or treated as capital, section 94B would apply accordingly
- If under section 98, interest is treated as dividend, section 94B would not apply to such sum
- If under section 98, a non AE accommodating party interposed between assessee and its AE is ignored or treated same as assessee, this triggers an AE transaction. In such case, section 94B would apply



EXPLANATION (A)
TO SECTION
9(I)(V) V. 94B

EXPLANATION (A) TO SECTION 9(I)(V) V. SECTION 94B

- Explanation (a) applies only to interest payments by Indian branch to banks
- Fiction at the end of Explanation(a) does not apply in case of non banks
- Thus, 94B should not apply to interest paid by PE to HO's AE outside India in case of non banks
- Explanation (a) applies only in respect of interest payment by Indian branch to its HO or other overseas offices
- Interest paid to other local branches is not covered by Explanation (a)



SECTION 94B
V.
SECTION 92CE

SECTION 94B V. SECTION 92CE

- Secondary Adjustment – No accrual/arisal
- If Section 92CE is complied with, there is earning by way of income
- Section 92CE v. income ‘received’ without accrual
- Subsequent receipt v. earning under Section 94B:
 - Current year or
 - Year of receipt



SECTION 94B V. SECTION 92CE

- Section 92CE(2) deals with interest on advance
- Rule 10CB(2) prescribes the manner of determining the interest
- Section 94B is invoked in case of excess interest
- When interest on advance is determined in accordance with Rule 10CB(2), it cannot be regarded as 'excess interest' under Section 94B





OTHER ISSUES

OTHER ISSUES

Disallowance under sec 94B becomes eligible for tax holiday :
circular no. 37 of 2016 dated 2.11.16

When as per ICDS 2&6, interest is inventorised, Sec 94B may
not apply





Thank you

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