

# Certificate Course on MLI

Limitation on interest expenditure

BEPS AP 4 & section 94B

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Where Passion Delivers Value

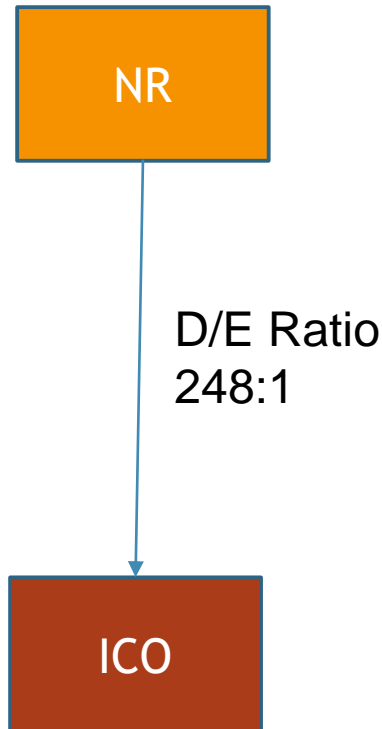
# Agenda

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- 1 Overview of BEPS AP 4
- 2 Provision of section 94B
- 3 Issues in scope of provision
- 4 Issues in computation
- 5 Carry forward and set off provisions
- 6 Non-Discrimination Clause

# Pre BEPS – Bom HC decision\*

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## Facts:

- Skewed debt/equity ratio of 248:1
- Tax authorities tried to characterise debt as equity and disallowed expenditure
- Tribunal held that in India as the law stands there are no rules with regard to thin capitalization so as to consider debt as an equity

## HC Ruling

- In absence of thin capitalisation rules, interest payment on debt cannot be disallowed

DIT v Basix Kier Dabhol SA (2012) 26  
taxmann.com 169

# AP 4 outcome

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## BEPS concerns

- Groups placing higher level of third party debt in high tax countries
- Groups using intragroup loans to generate interest deductions in excess of groups actual third party interest expense
- Groups using third party or intragroup financing to fund the generation of tax exempt income



## AP 4 recommendation

- fixed ratio rule to limit interest and payments economically deduction to 10 % to 30% of EBITDA
- Optional supplement of fixed ratio rule with group ratio rule
- Carve out in terms of de minimis threshold, special treatment for public-benefit project, insurance and banking sector and carry forward of interest

# Explanatory memorandum to FB 2017

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- Capital structure of company has significant impact on taxable profits
- MNC are able to structure their financing arrangements to maximise tax benefits
- Section 94B inserted in line with OECD BEPS AP 4
- Restricts interest expenses to claimed by an entity to AE to 30% of EBITDA or interest paid or payable to AE whichever is lower
- Amendment applicable from AY 2018-19

# Provisions in brief

## Scope

### Applicability

- Borrower has to be Indian company or PE of foreign company
- Interest or other expenditure exceeds 1 crs
- Lender has to be NR
- Said expenditure is deductible under head 'PGBP'
- Also applies if debt is issued by lender which is not AE but AE:
  - Provides implicit or explicit guarantee
  - Deposits a corresponding or matching amount

## Computation of excess interest

### Computation

- Excess shall mean lower of:
  - Total interest paid or payable in excess of 30% of EBITDA (Limb 1) or
  - Interest paid or payable to AE whichever is less (Limb 2)

# Provisions

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## Exclusion

### Exclusion

- Specified assessee engaged in business of banking or insurance

## Carry forward of interest

### Carry forward

- Excess interest not set off can be carried forward for 8 AYs

## Definition

### Debt

- 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 under the head PGBP

# Issues in scope of provision

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## Payment AE wise or aggregate

- ICO pays following interest expenditure to AEs:
  - US CO: 90 L
  - UK Co : 90 L
- Issue : Whether section 94B applies if interest payment to each AE does not exceed 1 cr but in exceeds 1 cr on aggregation

## Meaning of similar expenditure

- Section 94B(1) applies only if expenditure by way of interest or similar nature is incurred on debt issued by NR
- Interest is defined under [section 2\(28A\)](#)
- [AP 4 recommends](#) application of fixed ratio rule to a) interest b) payment equivalent to interest c) expenditure in connection with raising finance



# Issues in scope of provision

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## Deductibility of expenditure

- Section 94B is applicable if specified taxpayer incurs interest or similar expenditure which is 'deductible' in computing income chargeable under head PGBP
- Excludes interest which is deductible say under head HP or other sources
- Treatment of following expenditure disallowed under:
  - Section 36(1)(iii)
  - Capitalised under section 32
  - Section 40(a)(ia)
  - Section 14A
  - Section 43B
  - Section 92
- Allowability of said expenditure in subsequent year i.e. year of payment

# Issues in scope of provision

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## Extended scope of section 94B

- Proviso to section 94B makes provision applicable where debt is not issued by AE but AE provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with lender
- Meaning of implicit and explicit guarantee
- Should guarantee meet requirement of section [126 of Indian Contract Act](#)
- Can affiliation with international group result in implicit guarantee ?
- International jurisprudence
  - [OECD Transfer pricing guideline](#)
  - [UK HMRC](#)

# Issues in scope of provision

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## Debt issued by ICO on guarantee provided by NR

- ICO obtains loan from ICICI Bank on strength of guarantee provided by NR? Whether section 94B is applicable
- Section 94B(1) is applicable only if debt is issued by NR. Proviso merely deems debt which is issued by lender which is non AE on strength of implicit or explicit guarantee or deposit or matching and corresponding amount as one deemed to be issued by AE
- Proviso does not displace the requirement of debt to be issued by NR

# Issues in scope of provision

## Debt issued by ICO on guarantee provided by NR

- Applicability matrix

Sr No	Residence of lender	Residence of lender referred in proviso	Applicability
1.	Non-Resident	-	YES
2.	Non-Resident	Non-Resident	YES
3.	Non-Resident	Resident	YES
4.	Resident	Non-Resident	NO
5.	Resident	Resident	NO

# Issues in computation

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## EBITDA – accounting or tax

- AP 4 proposes considering tax EBDITA to computed fix ration rule
- However, considering EBDITA is well recognised accounting concept, better view of the matter is to consider accounting EBDITA

## Disallowance whether restricted to interest

- Section 94B(1) is applicable only if deductible interest or similar nature exceeds 1 crs
- Section 94B(2) which provides for computation of excess interest only refers to 'interest' – whether expenditure of similar nature need not be considered for disallowance?
- Does context require interpretation of 'interest' dehors of section 2(28A)?

# Issues in computation

## Disallowance formula - mismatch in literal reading vis-à-vis Circular

- ICO incurs following interest expenditure

Lender	Amount
ICICI Bank	250
Resident AE	50
NR AE	150
Total	450
EBITDA	1200

Issue :

- Whether total interest needs to be considered or only interest paid or payable to AE needs to be considered
- Whether interest paid to NR AE needs to be considered or interest paid to all AE needs to be considered

# Issues in computation

## Disallowance formula - mismatch in literal reading vis-à-vis Circular

<b>Literal reading</b>	
Excess interest shall mean	Excess interest lower of:
<ul style="list-style-type: none"> <li>Total interest paid or payable in excess of 30% of EBITDA (Limb 1)</li> </ul>	<ul style="list-style-type: none"> <li>90 [450 – 360 (30% of 1200)]</li> </ul>
<ul style="list-style-type: none"> <li>Interest paid or payable to AE whichever is less (Limb 2)</li> </ul>	<ul style="list-style-type: none"> <li>150</li> </ul>
<b>Circular 2 of 2018</b>	
Excess interest shall mean	
<ul style="list-style-type: none"> <li>30% of EBITDA or</li> </ul>	360 [30% of 1200]
<ul style="list-style-type: none"> <li>Interest paid or payable to AE</li> </ul>	150

# Issues in computation

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## Negative EBITDA

- Computation of excess interest in case of negative EBITDA



# Computation of excess interest

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**Step 1:** Compute excess interest of respective previous year in accordance with section 94B(2)

**Step 2:** If interest paid or payable to AE is in excess of 30% of EBITDA – carry forward excess to subsequent year

**Step 3:** If 30% of EBITDA is higher in Step 2 – find out the difference which is maximum allowable interest available for set off in terms of section 94B(2)

**Step 4:** Set off carried forward interest to the extent available in Step 3. Unabsorbed interest to be carried forward

# Illustration

Sr No	Particular -	Amount (in INR million)
A	Excess interest carried forward from AY 18-19	50
B	Interest payable to AE in AY 19-20	10
C	EBIDTA	100
D	Computation of interest limitation	
E	30 % of EBIDTA	30
F	Interest payable to AE in AY 19-20	10
G	Limitation on interest u/s 94B(2) [lower of E or F]	10
H	Excess interest of AY 18-19 which can be set off in AY 19-20 [E-G]	20
I	Excess Interest of AY 18-19 carried forward to subsequent year. i.e. AY 20-21 [A– H]	30

# Non discrimination clause

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➤ Article 24(4) of OECD Commentary:

Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State”

*Thank You*

# Section 2(28A) - Interest

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 utilised

Not considered as interest	Considered as interest
Arranger fees for availing loan [Idea Cellular v ADIT (2015) [58 Taxmann 101]	Usance interest [CIT vs. Vijay Ship Breaking Corporation (2003) (SC)[129 Taxmann 120]
Appraisal fees[DIT vs. Commonwealth Development (2012) [24 Taxmann 154]	
Bill discounting charges[CIT vs. Cargill Global Trading Pvt Ltd.(SC)] [335 ITR 0094]	



# Extract from AP 4

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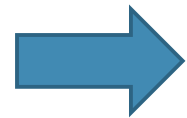
- These should include, but not be restricted to, the following:
  - payments under profit participating loans
  - imputed interest on instruments such as convertible bonds and zero coupon bonds
  - amounts under alternative financing arrangements, such as Islamic finance
  - the finance cost element 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
  - 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 deductible

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- Allowable as a deduction [WG & L Tax dictionary]
- That which may be taken away or subtracted. In taxation, an item which may be subtracted from gross income or adjusted gross income in determining taxable income (e.g. interest expenses, charitable contributions, certain taxes, etc.)  
[Advanced Law Lexicon, 4th Edn. Vol – 2 (D-I), P. Ramanath Aiyar]



# Meaning of incur

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- CIT v. Swadeshi Cotton & Flour Mills (P.) Ltd., (1964) 53 ITR 134 (SC):

“... the meaning of the word "incur" includes "to become liable to”

- Belpahar Refractories Ltd. v. CIT, (1994) 77 TAXMAN 625 (Ori)

“The word 'incur' means to become liable to, e.g., to incur debt, loss, etc. When an expenditure is said to have been incurred, it may connote actual payment or it could be that the person concerned has merely become liable for payment but has not actually made payment. When a person has made advance payment but has not become liable for the payment, he cannot be said to have incurred any expenditure”





# Section 126 of Indian Contract Act 1982

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“A contract of guarantee’ is a contract to perform the promise, or discharge the liability of a third person in case of his default. The person who gives the guarantee is called the ‘surety’; the person in respect of whose default the guarantee is given is called the ‘principal-debtor’, and the person to whom the guarantee is given is called the ‘creditor’. A guarantee may be either oral or written”.



# OECD TP guidelines – para 7.13

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“Similarly, an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed. For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit rating higher than it would if it were unaffiliated, but an intra – group service would usually exist where the higher credit rating was due to a guarantee by another group member, or where the enterprise benefitted from deliberate concerted action involving global marketing and public relations campaigns. In this report, passive association should be distinguished from active promotion of the MNE group’s attributes that positively enhances the profit – making potential of particular members of the group. Each case must be determined according to its own facts and circumstances”



# UK HMRC – INTM 501050

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“If a guarantee is only implicit, the lender will not be able to sue the guarantor in the event that the borrower defaults on a loan. The guarantor may not have taken on a risk to which a price can be attached. Even a comfort letter from the UK parent may not be sufficient to create a measurable guarantee, unless it binds the issuer in the event of its subsidiary’s default. Expectation in such circumstances may count for as much as a legally binding commitment

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*It may come down to what evidence there is that the guarantor will make good its implicit guarantee. It may have a track record of supporting or abandoning subsidiaries which get in trouble; it may have a reputation for defending its name and standing by its subsidiaries.*

# UK HMRC – INTM 501050

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*“A lender is not going to set much store by an unenforceable “letter of comfort” unless it can have confidence that the signatory keeps their word. It is a matter of weighing up the likelihood of an implicit guarantee being honoured and the effect that would have on the borrowing terms of the borrower”*



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