

[2018] 100 taxmann.com 108 (Article)Date of Publishing: **November 19, 2018****Ambiguities in provisions related to Thin Capitalisation****SURABHI AGARWAL**

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Introduction

1. Debt and equity are the primary sources of raising funds for any business organisation. The way a company is funded often has a significant impact on the taxable profit, as various countries allow deduction in respect of interest expenses and on the other hand prohibit dividend on equity capital while arriving at profit for taxation purpose.

Enterprises with global presence generally adopt high leveraged capital structure and avail of undue tax advantage by shifting profits from high tax jurisdictions to low tax jurisdictions. The issue of excess interest deduction by multinational enterprises was considered by the Organisation for Economic Co-operation and Development (OECD) to curb practises of Base Erosion and Profit Shifting (BEPS). OECD in its BEPS action plan 4 'Limiting Base erosion involving Interest deductions and other financial payments' recommended various rules such as 'fixed ratio rule' or 'group ratio rule' and suggested best practises.

Following the recommendation of OECD, India has introduced concept of "Thin Capitalisation" based on 'fixed ratio rule' with insertion of section 94B in the Income-tax Act, 1961. Thin capitalisation refers to a situation when the level of debt is relatively higher than its equity capital. The section provides for limitation on interest deduction in certain cases. Let us now decode various aspects of thin capitalisation provision-

2. Applicability and threshold in thin capitalisation

- ◆ Section 94B is attracted in the case where:
 - an Indian Company, or
 - a Permanent Establishment of a foreign company in India
- ◆ Incurs any expenditure in the nature of interest or alike in excess of INR 1 crore in respect of any debt issued by a non-resident.
 - Associate Enterprises, or
 - Third party to whom AE either provides implicit or explicit guarantee or deposits a

matching amount of funds with the lenders

- ◆ Such expenditure is deductible under the head Profit and Gains of Business and Profession (PGBP) during the year beginning from previous year 2017-18

Disallowance

3. The excess interest, which is lower of the following, shall not be deductible in computation of income under the head PGBP

- ◆ An amount of total interest paid or payable in excess of 30% of Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA) during the financial year, or
- ◆ Interest paid or payable to associate enterprises for that financial year

Carry forward

4. The interest expense so disallowed shall be allowed to be carried forward for a maximum period of 8 assessment years immediately succeeding the assessment year in which excess interest is disallowed. However, total deduction (including past year's carried forward interest and current year's excess interest) in any year cannot exceed the limit of 30% of EBITDA.

5. Analysis

- ◆ Section 94B is applicable only in case of corporate entities which are not engaged in the business of banking and insurance.
- ◆ In a case where no interest has been paid or payable to non-resident AE or interest paid or payable is less than prescribed threshold of INR 1 crore, provisions of section 94B would not be attracted.
- ◆ Section 94B would come into play only when interest is deductible under the head PGBP. Accordingly, interest payments that are deductible under other heads of income would not get covered by this provision.
- ◆ As per section 94B(5), debts mean any loan, financial instrument, finance lease, finance derivative, or any arrangement that gives rise to interest, discounts or other finance charge that are deductible in the computation of income chargeable under the head PGBP.
- ◆ Though the section does not expressly provide for corporate guarantee commission, yet guarantee commission may also get covered within the ambit of section 94B.

6. Existence of ambiguities

- ◆ Absence of computation methodology, *i.e.*, whether EBITDA is computed as per books of account or as per provisions of the Income-tax Act, 1961?
- ◆ The reading of the section leaves an ambiguity as to whether the interest payment made to an Indian resident-bank by an assessee for a debt which is borrowed based on guarantee provided by Non-resident AE would be covered by section 94B or not? As the payment of interest is not to a non-resident, a view may be taken that the same would not be covered by section 94B.
- ◆ In case of carry forward of excess interest of year 1, there is an ambiguity as to which amount needs to be reduced first from the limit of 30% in year 2? A possible view could be to first adjust the amount that is carried forward from year 1 since excess interest of year 2 can be carried forward to next 8 AYs.
- ◆ *Interplay between Transfer Pricing (TP) provisions and Section 94B*: The amount adjusted as

per arm's length would be considered for the purpose of thin capitalisation adjustment or the actual amount has again a question mark.

- ◆ Interplay of section 40(a)(i) and section 94B needs more clarification in respect of which section would prevail over other?
- ◆ Section 94B talks about expenditure that is deductible under the head PGBP.
- ◆ Interest expense to non-resident is deductible only when TDS is deducted at source, otherwise interest would be disallowed under section 40(a)(i).
- ◆ Further, section 94B is starting with *non-obstante* clause overriding the whole Act whereas section 40(a)(i) has limited *non-obstante* provision.
- ◆ Applicability of "Thin-capitalisation provisions" where loan availed for capital expenditure and clubbed with the cost of the prospective assets eligible for depreciation.
- ◆ Meaning of term "implicit or explicit guarantee" is undefined under section 94B and may lead to litigation.

Concluding remarks

7. In the above scenario, when the tax audit filings are due, both the Auditor and the Assessee are in dilemma. The assessee is advised to thoughtfully proceed. A clarification from the Governmental Authorities would be highly appreciated.

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