Amendment in Budget 2017 relating to Thin Capitalisation

Budget 2017 has taken another step towards implementation of Base Erosion and Profit Shifting (BEPS) recommendations, this time under BEPS Action item 4 titled, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments". Earlier also, some action points in the BEPS Reports such as equalisation levy, country-by-country reporting, lower rate of taxation for income from patents had been introduced in the statute through the Finance Act 2016. Read on to know more....

Finance Bill 2017 proposes to insert a new Section 94B, in line with the recommendations of OECD BEPS Action Plan 4, to provide that:-

"(1) Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, pays interest or similar consideration 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 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).

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.

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(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.

(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."

In view of the above, interest expense claimed by an assessee which is paid to its associated enterprise(s) shall be restricted to 30% of EBITDA or interest paid or payable to associated enterprise, whichever is less.

Example: ABC Ltd., is a tax resident in Country A, borrows an amount from XYZ Ltd, being a tax resident of Country X. The corporate tax rate in Country A is 35% and in Country X is 15%. On the interest expenditure, ABC Ltd. would be able to claim deduction and reduce tax liability @35%, however, XYZ Ltd. shall pay tax at the rate of 15% on the interest income. Hence, the group will be able to save tax of 20% on the interest income, thus shifting profits and eroding the base in the form of reduction of tax base in country A.

The rationale behind the amendment is that the companies are typically financed through mix of debt and capital. Dividend paid on equity is not tax deductible whereas interest on debt is tax deductible. Therefore, debt is often a more tax efficient method to finance than equity and multinational groups are often able to structure their financing arrangements to maximise this benefit. Thus, this amendment aims to control this cross-border shifting of profit through excessive interest payments.

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Though the amendment is proposed to protect the country's tax base, however, the section is not very well drafted and would result in litigation and undue disadvantage to the assessees. Few observations in this regard are:-

- From the reading of section, any payment of interest or similar consideration which is deductible under the head Profits and gains of business or profession shall be included for determining the interest claim. The term 'similar consideration' has not been defined. Hence, the expenses that would get covered under the provisions is not clear.
- The section does not give Grandfathering provisions for existing debts.
- The provisions include both implicit and explicit guarantee within its ambit. Such inclusion of the term "implicit guarantee" would unfairly burden genuine business transactions of a Taxpayer.
- Allowability of interest expenditure based on EBIDTA would impact the industries which are cyclical in nature and also the loss-making start ups in the initial years.

Thus, the introduction of these new provisions is a positive step to tackle the challenge of BEPS, however, the amendment in the proposed form will result in litigation and will defeat the entire purpose of the amendment. Further, it does not take care of certain industries which are financed through debt such as large infrastructure projects. Distinction should be drawn between cases where there is an element of profit shifting as compared to genuine cases. ■