Section 94B – Tuning into BEPS Action Plan 4

'Thin Capitalisation' refers to a tax advantage that entities of multinational groups get on account of different tax treatments of debt and equity. These differential tax effects along with variances on account of local tax legislations have been exploited by enterprises resulting in base erosion and profit shifting. BEPS Action Plan 4 – 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments' comes with a detailed report on the best recommended practices to be adopted by nations on a consistent basis along with exhaustive guidance on several related issues. India has introduced Section 94B in the Income Tax Act, 1961 w.e.f. AY 2018-19 as part of its commitment to adhere to and implement the BEPS Action Plans. It speaks of disallowance of excessive interest expense deduction which exceeds an overall fixed percentage of EBDITA of the entity. Read on to know more…

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Any entity is said to be thinly capitalised when the level of debt in that entity is substantially higher than that of its equity capital i.e., the entity has a high debt equity ratio. It is also called a highly leveraged or geared entity.

Domestic tax legislations of most countries across the globe have different taxation regimes for debt and equity. Interest on debt is generally a deductible expense of the payer and taxed at prevalent rates in the hands of the payee. Dividends, or any other form of equity returns, on the other hand, are generally not deductible in the hands of the payer and are typically subject to some form of tax relief (exemption, exclusion, credit, etc.) in the hands of the payee. Thus, multinational groups may achieve favourable tax results by adjusting the amount of debt in a group entity. When multi-national groups exploit these opportunities, it reduces the revenues available to governments and affects the integrity of the tax system. This also has a negative impact on capital ownership neutrality, creating a tax preference for assets to be held by multinational groups rather than domestic groups.

Base Erosion and Profit Shifting (BEPS) risks related to Thin Capitalisation may arise in three basic scenarios:

- Groups placing higher levels of third-party debt in high tax countries so as to maximise interest expense for that entity thereby reducing taxable corporate profits.
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third-party interest expense.

- Groups using third party or intragroup financing to fund the generation of tax-exempt income.

Base Erosion and/or profit shifting can thus usually result from either:

a) Use of intermediary intra-group debt structures to create interest expense,

Or;

b) Use of third-party debt wherein one entity of the group bears an excessive proportion of the group's total net third party interest expense.

Let us examine this with the help of practical examples:

Example 1: X Ltd., Y Ltd. and Z Ltd. are companies of the same group located in different tax jurisdictions.

Effect of thin capitalisation can be explained by looking at the figures below:

(₹ in crores)

Sr. No	Particulars	X Ltd	Y Ltd	Z Ltd	Total
(A)	Tax Rate	25%	30%	35%	
(B)	*Without Intra group Debt*				
1)	Profit Before Tax	100	100	100	300
2)	Less: Income Tax [B (1) * A]	25	30	35	90
3)	Profit After Tax [B (1) – B (2)]	75	70	65	**210**
(C)	*With Intragroup Debt*				
1)	Intra group Debt taken from X Ltd		400	400	
2)	Given by X Ltd	800			
3)	Interest cost @ 10% [C (1) * 10%]		40	40	
4)	Interest Income	80			
5)	Revised Profit Before Tax [B (1) + C (4)- C (3)]	180	60	60	300
6)	Less: Income Tax [C (5) * A]	45	18	21	84
7)	Revised Profit After Tax	135	42	39	**216**

Thus, from the above table, it can be seen that by merely introducing an intra group debt structure, the total taxes paid by the Group reduced from ₹ 90 crores to ₹ 84 crores consequently resulting in increase in the overall profit of the group from ₹ 210 crores to ₹ 216 crores.

Example 2: Consider a group ABC Ltd where in A Ltd, B Ltd and C Ltd are group entities, located in different tax jurisdictions. A is the Holding Company. A Ltd is set up in a country which exempts foreign sourced dividend income.

(₹ in crores)

Sr. No	Particulars	A Ltd	B Ltd	C Ltd	Total
(A)	Tax Rate	35%	30%	25%	
(B)	*Option 1:*				
1)	Third Party Debt	200	200	200	600
2)	Profit Before Interest and Tax (PBIT)	100	100	100	300
3)	Less: Interest @ 10% [B(1) * %]	20	20	20	60
4)	Profit Before Tax (PBT) [B (2) – B (3)]	80	80	80	240
5)	Less: Income Tax [B (4) * (A)]	28	24	20	72
6)	Profit After Tax (PAT) [B (4) – B (5)]	52	56	60	**168**

(C)	*Option 2:*				
1)	Third Party Debt	600	-	-	600
2)	PBIT	100	100	100	300
3)	Less: Interest @ 10% [C (1) * %]	60	-	-	60
4)	PBT [C (2) – C (3)]	40	100	100	240
5)	Less: Income Tax [C (4) * (A)]	14	30	25	69
6)	PAT [C (4) – C (5)]	26	70	75	**171**

This is a straight forward and direct method which links interest deductions to both, the level of economic activity and the profit/income of the entity.

Thus, just by restructuring the third-party debt within the group, the overall profits of the group increase from ₹168 crores to ₹ 171 crores. A Ltd., in turn, infuses the funds into its subsidiary companies B Ltd. and C Ltd. through equity and satisfies the fund requirements of those entities. Further, the dividend it receives from its subsidiary companies will also be exempt for A Ltd. Further, B Ltd. and C Ltd. also have to possibly shell out lesser dividend distribution taxes, the overall tax rates in those countries being on the lower side.

Global Scenario

Existing Thin Capitalisation Rules in various countries across the globe fall mainly under the following 6 categories:

1) Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.

2) Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction.

3) Disallowance of a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made.

4) Limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets.

5) Limit the level of interest expense or debt in an entity with reference to the group's overall position.

6) Targeted anti-avoidance rules which disallow interest expense on specific transactions.

The OECD report on BEPS Action Plan 4 contains detailed analysis regarding each of the above measures to determine the most suitable and practically viable recommendations.

Recommended Best Practice by BEPS Action Plan 4:

The best recommended practice advocates the implementation of a fixed ratio rule in conjunction with a group ratio rule.

a) Fixed ratio Rule :

A fixed ratio rule limits an entity's net deductions for interest and payments economically equivalent to interest to a fixed percentage of its profit usually in the form of its earnings before interest, taxes, depreciation and amortisation (EBITDA). This is a straight forward and direct method which links interest deductions to both, the level of economic activity and the profit/income of the entity. Alternatively, the countries also do have an option to use earnings before interest and taxes (EBIT) or net asset values instead of EBITDA. The recommended approach includes a corridor of possible ratios between 10% - 30% along with factors which countries should take into account in setting their fixed ratio within this corridor.

b) Group Ratio Rule :

Recognising that some groups are highly leveraged with third party debt for non-tax reasons, the recommended approach proposes a group ratio rule alongside the fixed ratio rule. A group ratio rule implies that an entity which exceeds the fixed ratio rule is permitted to claim deduction of net interest expense up to the level of the net third party interest/EBITDA ratio of its worldwide group. For example, if the fixed ratio rule states a permissible net interest/EBITDA of say 30%, and an entity's percentage comes to 38%, then one should look at the ratio of third-party interest to EBITDA of the entire group. If that comes to say 35%, the entity is eligible to claim interest expense up to 35% of its EBITDA. In calculating the group's ratio, a country may also apply an uplift of up to 10% to the group's net third party interest

expense, which means it may permit interest deductions up to 110% of the interest expense of the group.

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For the purpose of eliminating timing differences between the incurring of interest expense and the generation of corresponding income out of those debt investments, it is recommended that a country may permit entities to carry forward disallowed interest expense for use in future periods, or carry back disallowed interest expense into earlier periods with a ceiling limit on this period.

Countries may introduce a 'De minimis' threshold to exclude low risk entities from the scope of the fixed and/or group ratio rule. This will allow the tax administrations to focus on the groups posing material risks resulting in saving resources both in terms of time and administration costs. It will also mean effective compliance cost saving for low risk entities. This threshold should be ideally based on the total net interest expense of all entities in the local group and should be relatively simple to apply.

As a minimum these recommended practices should be made applicable to entities in multinational groups and if the country's tax authorities so decide, then also to domestic groups.

Indian Context

In the past few years, India has been extremely proactive on the designing, discussion, introduction and implementation of the recommendations laid down under the BEPS Action Plans. The first step towards mitigation of Base Erosion and Profit Shifting through Thin Capitalisation was taken by the Finance Act, 2017 in the form of the introduction of Section 94-B in the Income Tax Act, 1961 (hereafter called the Act). Prior to the incorporation of the said section in the tax legislation, there were no formal Thin Capitalisation rules in India and as such, a disallowance of disproportionate interest payments could be made only through transfer pricing provisions for International Transactions or Specified Domestic Transactions under section 40A(2)(b) of the Act, i.e., by examination of the interest expense by the Arms' Length Principle. The said section has been introduced with a prospective effect from 01st April 2018, i.e., from Assessment Year 2018-19 onwards. The significance of the section reflects right in its opening lines. It begins with a non-obstante clause and as such, has the power to over-ride all the other sections of the Act. The section aims to create a disallowance for that component of interest expense which will be deemed to be excess interest calculated as per the various provisions of the section.

Applicability:

a) Type or nature of expense :

Any expenditure by way of interest or of similar nature on debt incurred is covered.

The term 'interest or of similar nature' is not specifically defined anywhere in the section. Section 2(28A) does give a definition of interest. There are numerous judgements wherein it has been examined by the judicial authorities as to whether a particular payment would classify as interest or not. BEPS Action Plan 4 also contains guidance about several instances or types of payments which can be said to be equivalent to interest.

It is not clear as to whether recourse can be taken to any of these references while classifying any expense for the purpose of this section.

Another important point to note is that the section never talks about payment but expense. Hence, actual payment of the said sum is not a necessary condition.

Interestingly, the section does define the term 'debt' in subsection 5(ii) as:

"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".

To qualify as debt, the financing arrangement has to possess the following two main characteristics:

a) any financial arrangement irrespective of its form, terms, the type of instrument issued (like bonds/debentures etc) or the mode.

b) It has to result in generation of interest/discount or finance charge. Thus,

gratuitous payments like gifts will not get covered.

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Both the wordings of sub-section 1 of Section 94-B as well as this definition iterate the same principle that the interest expense should be deductible in computing income chargeable under the head 'Profits and gains from business or profession'. Thus interest claimed as deduction under any other income head (e.g. Income from other sources) is not covered.

b) *Payer-Payee:*

Any payer/borrower of debt being Indian Company or a Permanent Establishment of a foreign Company in India is covered by the section. The payee has to be a non-resident and also an associated enterprise of the borrower/payer. The section thus eliminates all third-party borrowings made from independent parties. The section thus correctly eliminates all borrowings made from independent parties. Such debts are made only after due evaluation of the entity's needs, performance and capability and are not tax planning tools. Subsection 5(i) makes a reference to Section 92A(1) and (2) for the interpretation of the term Associated Enterprises.

Thus, interest expense made by related parties and covered under section 40A(2)(b) (Specified Domestic Transaction) or between multiple local (Indian) entities of the same multinational group has been excluded from the ambit of this section. Similarly, it also appears that interest expense between entities which may belong to the same multinational group but do not qualify as associated enterprises in India are not covered.

The proviso to sub-section 1 tries to cover an indirect arrangement that might be entered into by associated enterprises for interest expense by interposing a third-party unrelated entity between them and thus avoid the disallowance. Consider for instance that A Ltd. and B Ltd. are associated enterprises. A Ltd. being an Indian Company wants to borrow from B Ltd. a Foreign company. However, instead of direct funding from B Ltd., C Ltd., a third entity again being a foreign company of the same group which is not an associated enterprise of A Ltd. lends the said money to A Ltd. and earns interest from A Ltd. In turn, B Ltd. gives an equivalent loan or some sort of corporate guarantee to C Ltd.

Both implicit and explicit guarantees are covered in the proviso. However, interpreting the term of implicit guarantee or disproving the existence of the same in a financing arrangement with associated enterprises in absence of any clarity on the issue becomes subjective and hence likely to become a matter of debate ahead.

Exceptions/Exemptions:

Sub-section 1 lays down a basic threshold of Rs 1 crore on the interest expense. If the aggregate interest expense does not exceed this threshold, it will not be subject to the provisions of this section. There might result litigation on the issue of how to calculate the aggregate amount of interest expense since there are no specific guidelines on the same. E.g. whether the same applies per payer-payee combination, per borrowing transaction or as a blanket amount for entire interest expense made by payer to all its associated enterprises together is not really clear.

Another relevant issue might also arise here in cases where as per relevant terms of agreement of financing between the associated enterprises, the interest expense is incurred/expressed/calculated in foreign currency terms. There is no clarity as to the exchange rate that will have to be adopted for conversion of the interest expense in INR for the purpose of this section. In the Income Tax legislation, there are a few Income Tax rules which enumerate conversion rates. For instance, Rule 115 specifies rate of exchange for income items expressed in foreign currency while Rule 115A addresses conversion issues during computation of capital gains. Rule 26 determines exchange rates for tax deduction. Thus, all these rules speak of exchange rates for income items and not expenses. As a result, whether the same principles would prevail here or the principles laid down by Accounting Standards will also be valid or the taxpayer will be free to choose a third principle remains a grey area.

Sub-section 3 clarifies that the said section is not applicable to entities engaged in banking and/or insurance business.

Quantification of disallowance:

Sub-section 2 specifies that the quantification of disallowance shall be the amount of excess Interest. Excess Interest = Total Interest expense paid/payable

(-) 30% of EBDITA of the borrower in the previous year.

However, the disallowance is restricted to the actual amount of interest expense actually paid or payable.

The quantum of disallowance is prescribed in the form of a straight-jacket formula applicable to all types of entities. It neither does take into consideration any industry specific financing requirements nor any entity specific circumstances. For instance, some capital-intensive industries requiring heavy investment in machinery/ technology will always need a higher capital inflow in their gestation years. Consequently, such entities are likely to have substantial capital infusion from its foreign parent leading to heavy interest costs. In such genuine instances where high leverage is on account of non-tax reasons, this formula is likely to result into double taxation.

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Secondly, the term EBDITA – i.e., Earnings Before Interest, Depreciation, Amortisation and Taxes is not specifically defined or the computation mechanism for the same not described. This is likely to lead to taxpayers coming up with different versions of calculation of the same along with varying treatments as to the inclusion or exclusion of certain items of income/expense. Here,

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the tax payer can possibly take reference of the guidance on the interpretation and computation of EBDITA contained in BEPS Action Plan 4 report.

Carry forward provision –

Sub-section (4) provides for carry forward of the excess interest expense not deductible in a particular year for a maximum period up to 8 subsequent Assessment Years for the purpose of claiming as deduction against the said entity's income from business profession in those years subject to the fulfilment of maximum ceiling limit on interest expense in each of those years. However, there is no priority or special tax treatment benefits provided for this set-off like in case of unabsorbed depreciation.

Section 94B vs. BEPS:

On examination of the BEPS best recommended practice as well as Section 94B, it seems that the Indian Tax administration has drafted the provisions of the section within the parameters and as per guidance laid down under BEPS. Several issues mentioned in Action Plan find a suitable mention in the section. Presently, India has only adopted a fixed ratio rule within the prescribed corridors without introducing any group ratio rule.

Auditors' obligations:

Presently, the Transfer Pricing Report in Form 3CEB only requires the disclosure of financing arrangements and any sort of lending or borrowing of money (Clause 14) or guarantee transactions (Clause 15) and its related details. There is no explicit clause wherein the Transfer Pricing Auditor has to comment on the existence or computation of disallowance under section 94B. Hence, the transfer pricing auditor is required to examine the borrowing/debt/financing arrangement among associated enterprises on the Arms' Length principle. Acceptability of the thresholds or limits laid down under section 94B as a valid parameter of deciding whether the interest expense is at Arms' Length by choosing 'Any other method' as the best method is an area which needs thorough deliberation.

On the other hand, the onus of reporting on this issue has been cast on the tax auditor. Clause 30B requires the tax auditor to state whether the client has incurred expenditure during the previous year by way of interest or of similar nature exceeding one crore rupees as referred to in sub-section (1) of Section

94B. Further, if yes, he also has to furnish the following details:

(i) Amount (in ₹) of expenditure by way of interest or of similar nature incurred;

(ii) Earnings before interest, tax, depreciation and amortisation (EBITDA) during the previous year (in ₹);

(iii) Amount (in ₹) of expenditure by way interest or of similar nature as per (i) above which exceeds 30% of EBITDA as per (ii) above

(iv) Details of interest expenditure brought forward as per sub-section (4) of Section 94B Assessment Year wise; and

(v) Details of interest expenditure carried forward as per sub-section (4) of Section 94B: Assessment Year wise.

The main tasks involved in the above will include:

a) To obtain group structure from the client which will help in determination of entities which qualify as non-resident associated enterprises.

b) Determine whether any debt taken from any of such enterprises and the details of interest expense incurred thereon. This can be done by examination of books of accounts, Financial Statements and relevant agreements and correspondences. In cases of guarantee transactions, it is always advisable to obtain a management declaration from the entity since regular audit procedures may not always lead to identification of such non-monetary relationships and transactions.

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c) Calculation of EBDITA of the entity. Audited Financial Statements can be considered the basis for obtaining this figure. Proper workings and calculations should be maintained to justify the figure used by the auditors while arriving at this amount.

d) Calculation of Net Interest expense/EBDITA ratio of the entity.

The main challenges which he is likely to encounter include:

a) Whether some payments which may seem like equivalent to interest to be included or not.

b) Identification of indirect financing arrangements or non-monetary transactions.

c) Inclusion or exclusion of certain items during calculation of EBDITA.

Thus, the tax auditor will have to exercise diligence and take due care in obtaining all the relevant information from his clients along with supporting declarations and representations before commenting under the said clause. It is also always advisable to maintain proper documentation in support of the stand taken which will enable the entity as well as the auditor to corroborate their calculations or defend the quantum of disallowance if any.

Road Ahead:

Different countries have introduced several different types of Thin Capitalisation rules, including overall limits or targeted specific transaction ones. However, unilateral action by countries is failing to tackle some of the underlying problems. There is also the threat of that country losing its attractiveness for foreign investments and business. Hence, it is increasingly necessary that a consistent approach utilising best international practices be adopted collectively by nations across the globe to efficiently and effectively address the key issues.

In the Indian context, until the introduction of Section 94B in the Income Tax Legislation, disallowances on account of excessive interest deductions for highly geared or leveraged companies could be done only through the mechanism of application of transfer pricing methods and justification of Arms' Length Price. Recently, a Company called Siemens Gamesa Renewable Power Pvt Ltd has challenged the validity of Section 94B(1) in the High Court and the case has been admitted. With the cases of Section 94B coming up for assessment in the coming years, the path ahead seems definitely interesting and sure to generate lot of food for thought. The extent of validity and/or acceptance by the Income Tax Authorities of references to OECD's BEPS Action Plan 4 and its related material in addressing domestic controversies also remains to be seen. ■