



Thin Capitalization Rules – Limitation on Interest Deduction in Certain Cases – Section 94B



Authors – CA Jinesh R Bhagdev &
CA Srilakshmi Pai

Simplify > Accelerate > Grow

Thin Capitalization Rules – Limitation on Interest deduction in certain Cases – Section 94B

The Finance Bill 2017 has proposed to introduce thin capitalization rules within the Income-tax Act (“**ITA**”) to curb companies from enjoying excessive interest deductions, while effectively being akin to an equity investment. This move would have a significant impact on investments into India through the debt route – both in respect of Compulsorily Convertible Debentures (“**CCDs**”) and Non-Convertible Debentures (“**NCDs**”) and External Commercial Borrowings (“**ECBs**”) as well which are widely used methods for funding into India.

The Finance Bill proposes the introduction of Section 94B (“**Thin Capitalization Rules**”) to provide that where an Indian company or PE of a foreign company makes interest payments (or similar consideration) to its associated enterprise, such interest shall not be deductible at the hands of the Indian company/ PE to the extent of the “**Excess Interest**”.

As per the proposed Section 94B(1), these provisions will be applicable to:

Borrower: either an Indian company, or a permanent establishment (“PE”) of a foreign company in India. However, these provisions will not be applicable if these are engaged in the business of banking or insurance.

Lender: interest is paid in respect of any debt issued by a non-resident, being an associated enterprise (“AE”) of such borrower.

The definition of AE as provided under sub-section (1) and sub-section (2) of section 92A shall apply for the purposes of this section also.

- **Threshold:** The amount of interest or similar consideration exceeds INR one crore rupees
- **Nature of expense:** interest or similar consideration exceeding one crore rupees paid by the borrower which is deductible in computing its income chargeable under the head "Profits and gains of business or profession"

Points for Consideration :

- **Associated enterprise:**

Firstly, though the provisions are aimed at related party debt, and intra-group transactions, the meaning of 'associated enterprises' is fairly wide under section 92A of the ITA which could potentially cover third party lenders who advance a loan constituting more than 51% of the book value of the total assets of the other enterprise and also a guarantor who guarantees 10% or more of the total borrowings of the other enterprise.

Further, the rules also covers third party lenders who provide a loan / financial assistance to an Indian company or PE of a foreign company in Indian on the basis of either provision an explicit or implicit guarantee to such third party lender or depositing or a corresponding amount with the lender by associated enterprise of such entities. This is to cover situations where indirect deposits / guarantees are made by associated enterprises with financial institutions on the basis of which a loan is provided by the financial institution to the assessee.

- **Meaning of Debt:**

The definition of 'debt' as provided in 94b(5)(ii) is wide and covers any loan, financial instruments, financial lease, financial derivative or any other arrangement giving rise to interest, discount or other financial charges. This could potentially cover debt instruments like masala bonds, NCDs, CCDs, ECBs etc.

- **Excess Interest:**

Excess Interest means an interest amount that exceeds 30% of the Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") of the Indian company / PE. In the event the interest payment payable/ paid is less than Excess Interest, the deduction will only be available to the extent of the interest payment payable/ paid.

The impact of the above illustration

Particulars	Case 1	Case 2
Interest Expense on amount borrowed from associated enterprises (A)	2,00,00,000	2,00,00,000
Interest on amount borrowed from third parties (B)	50,00,000	50,00,000
Total interest expenses (C = A+B)	2,50,00,000	2,50,00,000
Earnings before Tax, Interest, Depreciation and Amortization ('EBITDA') (D)	5,00,00,000	-50,00,000
30% of EBITDA (E = 30% of D)	1,50,00,000	00**
Amount of total interest paid in excess of 30% of EBITDA (F = C - E)	1,00,00,000	2,50,00,000
Amount of interest paid to associated enterprise (G)	2,00,00,000	2,00,00,000
Excess interest not deductible (Lower of A & F)	1,00,00,000	2,00,00,000

** No interest deduction will be allowed as EBITDA is negative

- **De minimis threshold:**

Interest payments which are less than INR 10 million (approx. USD 150,000) are exempt from the above requirement (on a per assessment year basis).

- **Exception:**

An exception has been carved out for Indian companies / PE of foreign companies engaged in the banking or insurance business.

- **Carry forward of interest deductibles:**

Section 94B(4) provides for a carry forward of interest expenditure which is not wholly deductible against income under the head 'profit or gains arising from business' to the next assessment year (for eg. In case of a loss making Indian company). The carry forward of interest deductible is available for eight assessment years but cannot exceed the Excess Interest.

Our Comments :

While the proposals are in line with the BEPS Action Plan 4, there are significant issues that may arise out of their introduction.

For instance, it is not uncommon for start-ups to face a loss situation in its initial years. Also, these companies usually need guarantees from its AEs to obtain loans from third-party banks, which will be treated as related-party debt under these provisions. The new provisions may create an interest deductibility challenge for these companies due to a low EBITDA or cash losses. Even though the provisions allows for a carry forward of the disallowed interest expense for eight years, it may impose additional tax burden on these companies.

Similar situation may also arise in cases where a project is under development and consequently does not generate any significant EBITDA or adequate cash profits which may result into complete interest disallowance. Eventually will affect the free flow of foreign investment into India which affect the long term development of the economy.

While it is understandable that an explicit guarantee results in the application of the Thin Capitalization Rules, it is unclear as to what is meant by implicit guarantee and what constitutes implicit guarantee. Questions such as whether comfort letters or similar undertakings, whether legal binding or otherwise, can be treated as an implicit guarantee arises and we have to wait for the answer as the law evolves.

About Author :

CA Jinesh R Bhagdev, heading transfer pricing practice of Pierian Services Private Limited, is an expert in the field of transfer pricing and cross border taxation. CA Jinesh Bhagdev is a regular speaker at various CPE study circle organized by the Institute of Chartered Accountants of India, Bombay Chartered Accountant Society. He regularly contributes to the tax fraternity by contributing articles on various public forums like taxguru, linkedin, caclubindia, etc. The author can be reached at jinesh.b@pierianservices.com

CA Srilakshmi Pai, Manager – Transfer Pricing at Pierian Services Private Limited, is an expert in the field of transfer pricing. She can be reached at Srilakshmi.h@pierianservices.com

Disclaimer

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Thank you



Strategy	Consulting	Outsourcing
Cloud	Mobile	Analytics

Phone : +91-80-42424747
Email ID : info@pierianservices.com
Web : www.pierianservices.com