Interest Deduction Limitation u/s. 94B - Probable Pitfalls

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Multi-National Enterprises ['MNEs'] enjoy considerable leeway while structuring their investments amongst the group entities. Their decision on choosing debt v/s equity as a means of financing a controlled entity within the MNE group is often perceived to have been influenced by an objective of minimizing the overall tax burden by taking advantage of the tax policies of the jurisdiction in which the group entities operate. Domestic tax laws of countries generally have different taxation rules for dividend and interest. Interest on borrowings is normally tax deductible for payee and subject to normal tax rates for recipient. Dividends and other returns on equity are not allowable business expenditure. This coupled with the fluidity and fungibility of money does offers a simple profit shifting technique to MNEs which operate in cross border landscape by leveraging related party debt in entities situated in high tax jurisdictions and receiving interest income in entities located in low or no tax jurisdictions. Such an arrangement distorts the tax revenue of the country from which the interest expense flows.

To deal with the aforesaid, at the global level, as part of the OECD/G20 Base Erosion and Profit Shifting project, the OECD's came up with an update in 2016 on Limiting Base Erosion involving Interest Deduction and other Financial Payments Action 4. The said report contained recommendations for a best practice approach to tackle base erosion and profit shifting involving interest.

In line with the recommendations of OECD's BEPS AP4, in 2017 India introduced section 94B in Chapter X of the Income Tax Act, 1961 ['the Act'] to provide that interest expenses claimed by an entity which is paid to its associated enterprise ['AE'] shall be restricted to lower of (a) 30% of its earnings before interest, taxes, depreciation and amortization ['EBITDA'] or (b) interest paid or payable to the AE. Interest which is sought to be disallowed as above is termed as excess interest. The provisions of section 94B are applicable to an Indian company ['I.Co.'], or a permanent establishment ['PE'] of a foreign company which may be a borrower. Interest expense in respect of any form of debt taken or deemed to have been taken from the AE by the said borrower shall fall within the ambit of section 94B. The section also contains a deeming provision which provides that a debt shall be deemed to be treated as issued by an AE where the said AE provides an implicit or explicit guarantee to a third party lender or deposits a corresponding and matching amount of funds with the lender. The disallowed interest expense is allowed to be carried forward to eight assessment years immediately succeeding the assessment year for which the disallowance was first made and allowed a deductible expenditure against the income computed under the head 'Profits and gains of business or profession' to the extent of maximum allowable interest expenditure. The provision also contains a threshold of interest expenditure of Rs.1 crore below which the said section shall not apply to the I.Co/PE.. Banks and Insurance business are outside the ambit of the said provisions keeping in view of special nature of these businesses. The provisions of section 94B are applicable from assessment year 20181-9 onwards. Section 94B starts with a non-obstante clause and overrides all other provisions of the Income Tax Act. What India has adopted is the fixed ratio rule based on a benchmark interest/EBITDA.

The objective behind introduction of section 94B is clearly to deal with the loss of tax revenues arising from excessive allowability of interest in the hands of the Indian companies or the permanent establishments of the foreign companies.

It may be noted that no empirical data is available in public domain in respect of interest expenditure of I.Cos/PEs which may fall within the meaning of excess interest u/s 94B nor is there any information on the quantum of tax revenues which are sought to be protected by introduction of section 94B. However, it is assumed that wherever the interest expenditure of a I.Co/PE would have come within the ambit of the definition of excess interest warranting disallowance, the said MNC group may already have taken remedial measures such as restructuring their investments, arrangements either by way of reducing the debt and/or reducing the rate of interest etc..

In this article a humble attempt has been made to highlight the relevant changes in Indian tax laws and tax rates which have been introduced subsequent to insertion of section 94B in 2017 and which may have a bearing on an MNCs decision on structuring investment in its Indian arms. Apart from the aforesaid, there are some obvious and not so obvious issues which are likely to arise from section 94B and may be encountered by tax payers and tax administrators in near future during the process of tax scrutiny for assessment year 2018-19 which is the first year for application of section 94B.

1. *Relevant changes in domestic tax law and tax rates subsequent to insertion of section 94B* - As is said, the only constant in life is change. If there is facet of life to which the said saying could most aptly be applied, it is the Indian Income Tax. It would become evident from the following part of this para, the changes in Indian tax law and tax rates made over the last three years since insertion of section 94B may make the MNCs take a re-look at the mix of debt and equity in their Indian arms.

§ With the introduction of newly inserted section 115BAA the Indian domestic companies have the option of being taxed at 22% as against 30% tax rate, subject to satisfaction of certain conditions. The concessional tax rate being optional and subject to the domestic companies forgoing various other tax concessions, the impact analysis on whether or not to opt for the same must, amongst various other factors, also take into account the fact that in tax terms, the limitation on allowance of excess interest u/s 94B may become less onerous under the concessional tax regime.

§ Section 115A of the Act provides for taxation of interest income of non-resident companies arising on account of foreign currency loans advanced to Indian companies at the rate of 20%. The reduced spread between the concessional corporate tax rate of 22% (discussed above) at which an I.Co may be taxed and 20% at which the recipient foreign company ['F.Co.'] may be taxed, also becomes a relevant factor for MNCs to consider while structuring their investments.

§ With the withdrawal of provisions of dividend distribution tax enshrined in section 115O the burden of tax on dividend has shifted to shareholder. The dividend income of non-residents from their Indian entity is taxable in India at the rate of 20% under provisions of section 115A. The aforesaid amendment in India's domestic law relating to taxation of dividend income would also allow the F.Cos to avail foreign tax credit in their countries of residence for taxes paid in India which may make dividend income more attractive from the tax angle.

§ It must further be borne in mind that the aforesaid provisions shall have to be read along with the provisions of applicable tax treaties. The concessional tax rates for taxation of dividends and/or interest, if any, prescribed in respective tax treaties may further reduce the Indian tax liability of F.Cos.

The aforesaid only provides a broad perspective of impact that the recent changes in India's domestic tax laws and tax rates may possibly have on an MNCs debt leveraging strategies in their Indian arms from purely a tax perspective.

2. *Interest paid to resident lenders* - Further, the first proviso to section 94B states that the debt shall be deemed to be treated as issued by an AE, where it provides an implicit or explicit guarantee to the lender (who is not associated) or deposits a corresponding and matching amount of funds with the lender. It may be a plausible argument that when AE provides guarantee to the lender, base erosion and profit shifting should practically be limited to guarantee fees, if any, paid by the borrower I.Co/PE to its non-resident AE. However, the said proviso introduces a deeming fiction and treats debt provided by non-AEs in aforesaid circumstances as having been made by an AE and therefore disallows excess interest paid on such third-party debts also. The proviso seeks to check the possibility of base erosion by routing the transaction of lending money through non-AEs. There could be situations where the third party lender to whom interest is paid by the I.Co/PE is also a non-resident. Here the issue is, should the interest limitation provisions be applicable to cases where the interest is paid/payable in respect of payments to third party lender which are Indian banks/FIs/NBFCs etc.? Interest payments to resident lenders may not result in base erosion and profit shifting and therefore the disallowance of excess interest in such cases result in another instance where the relevant provision travels beyond the stated objective behind introduction of the said provision.

3. *Interplay with transfer pricing provisions* - Arm's length principle is the international transfer pricing standard required to be used by MNEs for tax purposes. In the context of intra-group loans, the said principle is required to be satisfied from two angles. Firstly, the interest on intra-group loans must be at such rate at which independent parties in similar circumstances dealing at arms' length would lend/borrow. Secondly, whether availing of the loan by an entity from its AE per se confirms to the arms' length principle, for example, whether the borrowing entity has the capacity to bear the borrowers risk, the credit rating to justify the terms and conditions of loan, the decision making power on whether or not to take the loan etc. During the transfer pricing audit, there could be a disallowance of interest payment if it is found to be not at arm's length. Explanation to section 92(1) specifically states that allowance of expense/interest arising from an international transaction is also subject its conformity with the arm's length price. A debatable issue is whether and to what extent disallowance of 'excess interest' u/s 94B would be made after the TPO's findings on the arm' length price of such interest expense. Vice versa, in case of suo moto disallowance of excess

interest by the tax payer in its return of income u/s 94B, what would by the view of TPO with regards to ALP of such interest payments. In our view section 94B has been introduced in Chapter X of the Act which deals with computation of income from international transactions having regards to the arm's length price. Accordingly, there may not be any conflict between explanation to section 92(1) and section 94B - excess interest under the latter provision may be considered at variance with the arm's length price.

4. *Cost plus entities* - There are arrangements within MNCs wherein low risk entities are often remunerated on a cost-plus basis. The fixed/operating cost of an I.Co. on which mark-up is computed may also include interest costs which are considered as part of fixed/operating costs. In some such cases the arrangement between an I.Co. and F.Co may even have the blessings of APA. Excess interest in such cases may also get disallowed by invoking section 94B even though the arm's length test is satisfied by the I.Co.

5. *Low/negative EBITDA in unforeseen economic downturns* - During sudden economic downturns such as the one caused by COVID-19 businesses are staring at erosion of revenues and profits and therefore may have lower/negative levels of EBITDA. Consequently, in such year(s), the deduction for interest would get restricted due to unforeseen circumstances. A high debt leveraged I.Co./PE may end up paying taxes on account of interest disallowance u/s 94B even though otherwise it may be having low/nil taxable profits. The carry forward entitlement for disallowed interest may not bring the desired relief. To address such situations, the best practice approach of the OECD advocates computing EBDITA based on tax profits as against accounting profits of an entity. However, section 94B is silent on this issue. Accordingly, the likely disallowance of excess interest may be a factor to be reckoned with today even while estimating taxable income and advance tax instalments for AY 2021-22.

6. *De minimis threshold, qua assessee or qua PE* - Section 94B(1) of the Act provides a de minimis interest cost threshold of Rs. 1 crore to an I.Co/PE of a foreign company in India and in case the interest cost of the said I.Co/PE is below the said threshold provisions of section 94B shall not apply. Another question may arise in situations where a F.Co. has multiple PEs (for example many construction PEs) in India and each of them has incurred an interest expense of over Rs. 1 crore. It is settled law that the taxable entity is the foreign company and not its PE in India and therefore the financials of all PEs may have to be aggregated for computing the limitation u/s 94B. One plausible view could be that the limitation u/s 94B is qua assessee and not qua PE. Yet, a plain reading of section 94B(1) suggests that threshold of Rs. 1 crore may apply to each PE separately. Here it may also be pertinent to point out that India has not introduced anti-fragmentation rule which recommends that where the group has more than one entity in the country the threshold should take into account the total interest expense of the entire local group. Hence, in an MNCs value chain where there are multiple India subsidiaries which are separate taxable entities in India, the threshold of Rs. 1 crore may apply to each one of them.

7. *Capitalised interest etc*. - There may be situations wherein interest paid to the non-resident AE is not claimed as a deductible expenditure for computing the business income of an I.Co./PE, say because it is capitalized, or added to the value of inventory (e.g. in case of real estate companies). Section 94B limitation may not get attracted to such interest payments which are capitalised or form part of inventory.

8. *Deemed income* - Non-residents engaged in certain specific businesses in India, such as shipping business, operation of aircraft, oil and gas business etc. can offer their income to tax under special provisions of the Act wherein their income is deemed at fixed rates. Special provisions relating to computation of income of non-residents like sections 44B/44BB/44BBA start with a non-obstante clause and prevail over certain specific sections of the Act though apparently not over section 94B. Some Courts in India have taken a view that TP provisions do not apply where income of a non-resident is computed and taxed under special provisions of the Act. Yet, as stated above, section 94B also starts with a non-obstante clause which overrides all other provisions of the Act. This may lead to another question, whether actual interest paid by an I.Co./PE to its AE would fall under the limitation envisaged u/s 94B even though such a company is taxed under the deeming provisions of the Act?

9. On a parting note, it is sincerely hoped that section 94B does not start a fresh wave of litigation for MNCs and nor does it become another impediment when the Country is earnestly seeking inbound investments in these extra-ordinary times.

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