

Financing the Future






**Limitation on Interest deduction,
BEPS Motivated domestic challenges,
ATAD and MLI**

ICAI - National Conference on
International Tax

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December 2019

Financing the Future - Agenda

1	The Context – why are financing arrangements under increased focus?	
2	Overview of developments that impact debt financing	
3	BEPS Measures – detailed analysis	
4	ATAD & its impact	
5	The Future of Financing – Key takeaways	

Why are financing transactions under increased focus?

- Several advantages of Debt – retention of ownership and management, control over post-interest profits, tax deductibility of interest payments etc.
- Dilution of ownership and control over profits - not relevant in intra-group debt financing
- Quantum and location of debt within multinational groups largely influenced by tax considerations:
 - Placing higher levels of third party debt in high tax countries
 - Use of intra-group loans generating interest deductions greater than group's actual 3rd party interest
 - Use of debt financing to fund the generation of tax exempt income
- Exploitation of interest deductibility rules seen as resulting in reduced tax collections and affecting the integrity of the tax system

*Use of third party and related party interest .. most simple of profit-shifting techniques in international tax planning
Fluidity and fungibility of money makes it easy to adjust the mix of debt and equity in a controlled entity*

BEPS Action 4 (2015 Final Report)

Overview of developments that impact debt financing

1. BEPS and related measures

Action 4 – Limiting base erosion involving interest deductions and other financial payments

India's adaptation of Action 4 recommendations – Section 94B

Action 2 – Neutralising the effect of hybrid mismatch arrangements

Ongoing BEPS initiatives – impact of Pillar 2 proposals

2. EU's Anti-Tax Avoidance Directive (ATAD)





BEPS Measures - detailed analysis



BEPS Action 4- Limiting base erosion involving interest deductions

- Action 4 recommends designing rules to prevent base erosion through the use of interest
- Recommended approach – use of a fixed ratio rule to limit deduction for interest to a percentage of EBITDA:
 - To apply (at a minimum) to entities in multinational groups
 - Ratio of between 10% and 30% proposed
- Group-ratio rule also proposed alongside the fixed ratio rule - entities with net interest expense above a country's fixed ratio to be allowed to deduct interest up to the level of the net interest / EBITDA ratio of its worldwide group
- Guidance on *de minimis* thresholds, and other sector specific carve outs provided

India's Adaptation of BEPS Action 4 - Section 94B

To whom and to what does it apply?

- Applies to an Indian company or a PE of a foreign company
- Applies in respect of interest on debt from a non-resident associated enterprise (AE)
- Also applies in respect of interest on debt from a non-AE which is guaranteed (explicitly or implicitly) by an AE (Proviso to section 94B(1))
- 'Debt' widely defined to include finance lease, derivatives and other arrangements that give rise to interest, discounts or other finance charges
- Applies to Interest deductible under the head 'Profits and gains of business or profession'

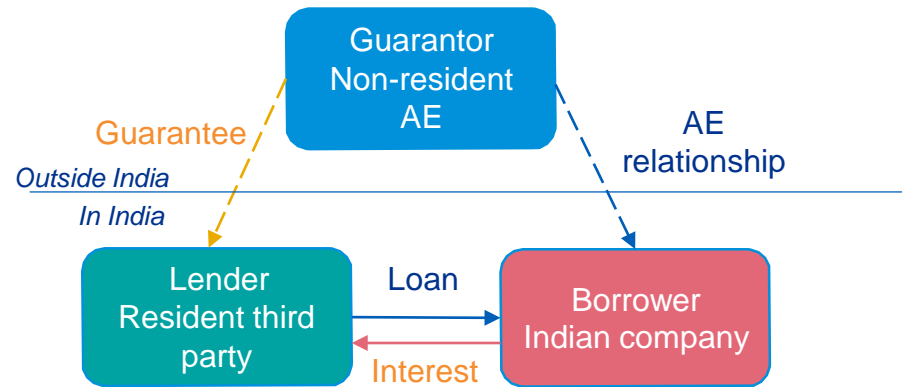
Issues

- Applicability to 'guarantee fees'?
- Is a letter of comfort an implicit guarantee?
- Scope of fiction in Proviso (see examples in the next slide)

India's adaptation of BEPS Action 4 - Section 94B

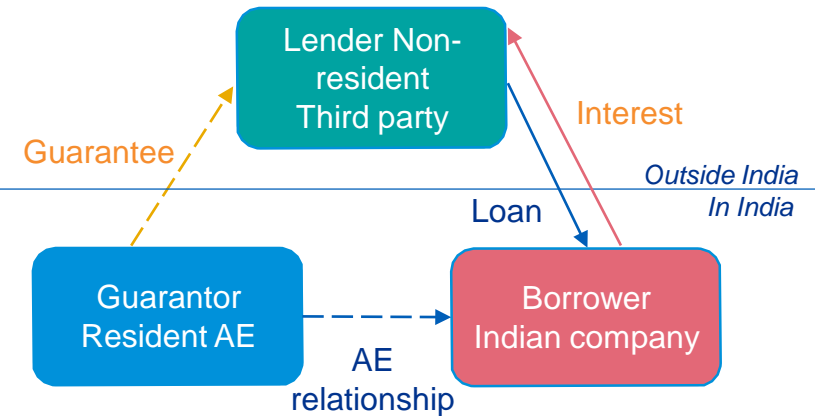
To whom and to what does it apply? (Contd.)

Scenario I



- Interest payment to resident lender liable to tax in India - no base erosion

Scenario II



- Whether proviso to be read with the main section and only non-resident AE guarantor covered?

India's adaptation of BEPS Action 4 - Section 94B

How does it apply?

- Interest not deductible to the extent it is “excess”
- “Excess” interest means lower of the following:
 - Total interest paid or payable in excess of 30% of EBITDA; or
 - Interest paid or payable to the AE
- Excess interest can be carried forward and deducted over 8 assessment years upto Sec 94B limit

Issues

- Does ‘total interest’ include both AE and non-AE interest?
- Should EBITDA be calculated under accounting principles or tax rules?
- Interplay between Section 40(a)(i) and Section 94B
- Impact of amalgamations / demergers on carried forward “excess” interest

India's adaptation of BEPS Action 4 - Section 94B

Carve-outs

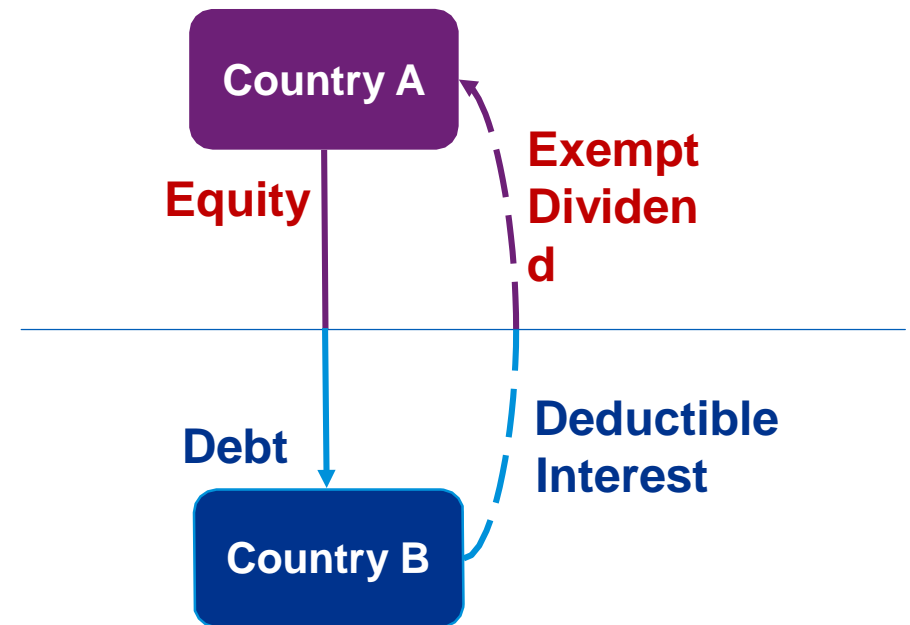
- Does not apply to interest expenditure below INR 1 crore
- Sector specific carve outs – not applicable to Indian companies or PEs of foreign companies engaged in:
 - Banking
 - Insurance

Issues

- Does the INR 1 crore threshold apply only to interest paid to AEs or to total interest?
- Should NBFCs be excluded?
- Can non-discrimination be invoked to exclude the applicability of Section 94B?

BEPS Action 2- Neutralising the effect of hybrid mismatch arrangements

- Action 2 - contains recommendations to address mismatches in tax outcomes for hybrid financial instruments
- Intended to apply when a financial instrument is treated as:
 - Debt in one country (leading to deductibility of 'interest' payments); and
 - As equity in another (leading to say a participation exemption on such 'dividend')
- BEPS recommendation - *Deduction for payment should be disallowed to the extent it is not taxed in the recipient's country*
- No specific rules adopted in India but debt-to-equity recharacterization envisaged under GAAR



Ongoing BEPS initiatives - 'GloBE' or Pillar Two Proposals

- Part of the expanded scope of work under Action 1 (Taxation of the Digitalised economy)
- Aimed at targeting shifting of profits to no / low tax countries – effectively establishing a global minimum tax
- Components of the GloBE (Global Anti-base erosion Proposal) could affect debt financing structures involving no / low taxed countries:
 - The **undertaxed payments rule** – no deduction for related party payments if payment not subject to tax at or above a minimum rate in the other country
 - The **subject to tax rule** - withholding tax or limitation on treaty benefits if payment not subject to tax at a minimum rate in the other country
- Mechanics of the GloBE proposal are currently under discussion – no clarity on the intended 'minimum' rate of tax

European Union Anti-Tax Avoidance Directive ('ATAD')



The EU 'ATAD'

- EU Anti-Tax Avoidance Directive ('ATAD') framed in response to the BEPS Project
- ATAD lays down minimum standards for EU Member States to be implemented in domestic tax laws - effective in 28 Member States from 1 January 2019
- ATAD consists of 5 rules substantive anti-tax avoidance rules (3 BEPS related measures and 2 other measures)

CFC rules	Interest limitation	Exit Taxation
Hybrid Mismatches	GAAR	

- Interest Limitation and Hybrid Mismatch rules could affect Financing Structures

Interest Limitation & Hybrid Mismatch Rules under ATAD - Summary

Interest Limitation Rules

- Net borrowing costs deductible only upto 30% of EBITDA
- Carve-outs apply to:
 - Standalone entities (i.e. not part of a group)
 - Borrowing costs upto EUR 3 million
- Members can further provide exclusions for:
 - Pre - 17 June 2016 loans (but not subsequent modifications thereto)
 - Loans used to fund public infrastructure projects
 - Carry forward of excess borrowing costs
 - Financial undertakings
- States can further provide for exclusions based on either group-wise borrowing-to-EBITDA or asset-to-equity ratios

Hybrid Mismatch Rules

- Similar to BEPS Rule on Hybrid Mismatches
- To the extent hybrid mismatch results in deduction without inclusion, the Member State of the payer is required to deny the deduction of such payment

Even though ATAD does not apply to India, it may affect Indian headquartered groups with financing arrangements within the EU

The future of financing - Key takeaways



The future of financing - Key Takeaways

- BEPS recommendations on interest limitations have been widely (though inconsistently) implemented

Key areas of differences:

- Use of Worldwide group ratio (not adopted by India)
 - Flexibility to justify higher interest deduction (available in China)
 - No carryback of excess interest allowed (e.g. in India)
 - Applicability to both related party and non-related party debt (Germany and Italy)
- Globally implemented thin capitalization norms erode several advantages of debt financing:
 - Could have a significant effect on tax costs
 - Though this could be somewhat mitigated by the overall reduction in tax rates in India
 - Impact may be harsh in select sectors like infrastructure where higher levels of debt financing are typical
 - In cases where interest income is fully taxed in the hands of the lender, a loss of deduction could be harsh (exacerbated if GloBE proposals are implemented)
 - Impact of interest limitation provisions may be more if interest rates increase - more companies may end up breaching the 30% threshold – Indian Provision has retrospective implications

Thank you