

Limitation of Interest deduction u/s. 94B – An Analysis

Western India Regional Council of the Institute of Chartered Accountants of India
Mumbai
10th June, 2017

CA Rutvik Sanghvi

Presentation Layout

Sr. No.	Particulars
1	Base Erosion from interest deductions and action under the BEPS Project
2	Introduction to Section 94B & its Applicability
3	Borrowings from Third-Party Lenders
4	Quantum for Disallowance of Interest
5	Carry Forward of Disallowed Interest
6	Interplay with other SAARs, GAAR & DTAAAs

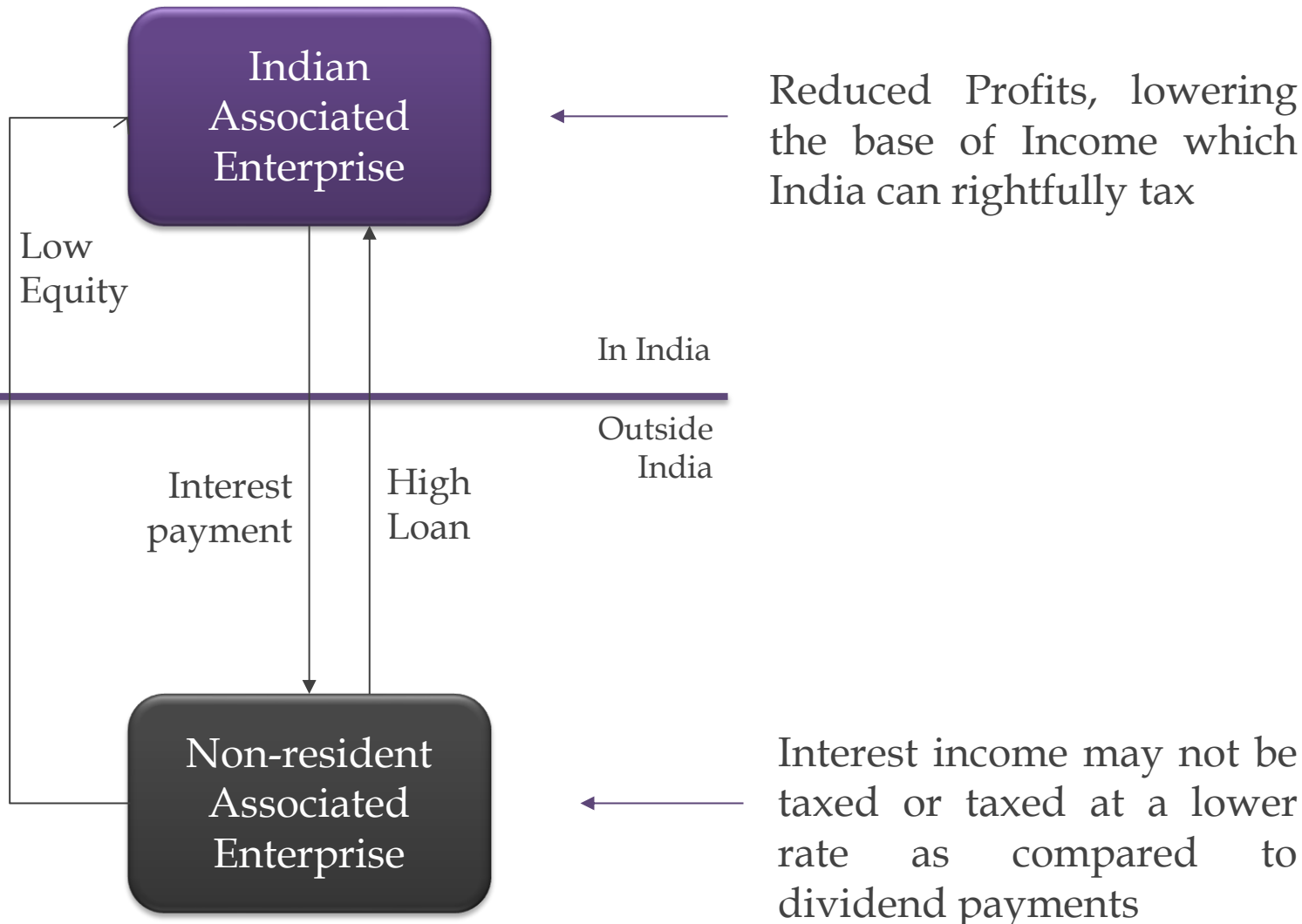
**Base Erosion from interest deductions and
action under the BEPS Project**

Base Erosion from Interest Deductions

- ▶ Base Erosion: The concept of actions which reduce a country's tax base in favour of another's
- ▶ Comparison between dividend and interest payments:

Sr. No.	Particulars	Interest Income	Dividend Income
1.	PBIT	100	100
2.	Less: Interest	(30)	-
3.	PBT	70	100
4.	Less: Corporate Tax @ 30%	(21)	(30)
5.	PAT	49	70
6.	Less: Dividend	-	(30)
7.	Less: DDT @ 20.358%	-	(6)
8.	Reserves	49	34
9.	Total Tax Collected (4+7)	21	36

Base Erosion from Interest Deductions



BEPS Actions

- ▶ Sec. 94B born out of recommendation from Report on Action 4 of the BEPS Project
 - ▶ Important to understand Report on Action Plan 4
- ▶ “Base Erosion & Profit Shifting” Project initiated by OECD
 - ▶ Concerted action by countries against tax avoidance strategies
- ▶ Changes suggested in domestic laws and treaties
- ▶ Changes already incorporated in India
 - ▶ Country by country reporting
 - ▶ Equalisation Levy
 - ▶ Multi-lateral convention signed on 7th June 2017 which will change all Indian DTAAAs
- ▶ Sec. 94B on Limitation for deduction of interest expense further step in this direction

BEPS Action Plan 4

- ▶ BEPS Action Plan 4: “Limiting Base Erosion involving Interest Deductions and Other Financial Payments” initiated to tackle the issue of high interest pay-outs
- ▶ Recommendation to countries to introduce provisions in domestic tax laws to limit deduction from interest expenditure

Recommendation under Report on Action Plan 4

Fixed ratio rule

- Set limit of amount that can be claimed as deduction

Group Ratio Rule

- Limit for the group as a whole

Carry forward / backward Rule

- Disallowed interest or unused interest capacity allowed to be used in other years

de Minimis monetary threshold

- Provision only to apply to transactions above set limit

Targeted Rules

- To prevent circumvention of the provision

Specific Rules

- To cover risks not addressed by this provision

Introduction to Section 94B & its Applicability

Section 94B

- ▶ Introduced by Finance Act 2017 and applicable from Financial Year 2017-18
- ▶ Limits deduction of interest expense incurred on payment towards debt from Non-resident (NR) AE
 - ▶ Debt from non-AE also covered if based on guarantee or funds provided by an AE
- ▶ Provides for disallowance of:
 - ▶ Total interest paid/payable above 30% of EBITDA; or
 - ▶ Interest paid/payable to AE;
 - ▶ whichever is lower


For example:
If EBITDA is Rs. 1,000 and
interest payment to AE is Rs. 400,
interest deduction will be limited to Rs. 300.

Implementation in India

- ▶ Fixed Ratio Rule proposed in Action 4 Report adapted for formulating Sec. 94B
 - ▶ Fixed Ration Rule has been narrowed down and customised
- ▶ Sec. 94B in variance with Action 4 Report:

Recommendations of Action 4 Report	As per Sec. 94B
Fixed Ratio Rule	Yes, but narrower
Group Ratio Rule	Not present
Rule for carry forward	Yes
Rule for carry back	Not present
Monetary threshold	Yes, at Rs. 1 crore
Specific Rules	No new rule
Targeted Rules	No new rule

Applicability of Section 94B

- ▶ Governed by Section 94B(1) and (3) 
- ▶ Restriction on interest expenditure applicable only when all the following conditions are applicable **cumulatively**:

Payer

- Indian Company, other than Banking or Insurance Company
- PE of a Foreign Company

Payee

- NR AE
- Third-party lender to whom NR AE has provided guarantee or matching funds

Amount of Interest

- Excess of INR 10 million in the particular Financial Year

Nature of Interest

- Deductible expenditure against income taxable under the head Profits & Gains from Business or Profession

Non-applicability of Section 94B

- ▶ No applicability of Section 94B in following cases:
- ▶ Interest is paid by a non-corporate entity
- ▶ No interest is paid to a NR AE
- ▶ Total interest paid to NR AE is not above Rs. 1 crore
- ▶ Interest paid is not deductible from Profits or Gains from Business or Profession (PGBP)

Payments deductible under the head PGBP

- ▶ Only expenditure deductible under the head “Profits & Gains from Business or Profession” are covered u/s. 94B
- ▶ Some payments that will not get covered:

Nature of Interest Expenditure	Example	Comments
Interest expenses which are not claimed as deductible business expenditure	Interest expenditure which is capitalised in the books (added to cost of assets)	Report on Action 4 covers capitalised interest payments in the coverage of its “best practice” approach to limit such deductions
Interest payments deductible under the head “Income from Other Sources”	Debt provided by NR AE parked in bank deposits or interest-bearing bonds until final utilisation in business	This would lead to claim of interest expenditure against interest income which is not taxable under the head PGBP
Interest expenditure for rental income taxable under the head “Income from House Property”	Interest on debt borrowed for property given on rent	Such interest expense would have restrictions as specified in Section 24 and not as per Section 94B

“Interest” defined

- ▶ Expenditure by way of interest or of similar nature in respect of any debt is covered under Section 94B.
- ▶ Debt has been defined in sub-section 5 of Section 94B 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”.
- ▶ Section 94B does not define the term “interest” or expenditure of similar nature.
 - ▶ Meaning as per Act and Report are different (next slide)
 - ▶ Definition under DTAAs (as per Article 11) not relevant as it is for computing income of lender and not deduction for borrower

“Interest” defined

Interest as per Sec. 2(28A)

“Interest” means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized

Interest as per Action Report 4

Provides for inclusion of interest and payments economically equivalent to interest.

As per ‘best practice’ approach includes :

- interest on all forms of debt;
- expenses incurred in connection with the raising of finance;
- imputed interest on convertible & zero coupon bonds;
- capitalised interest;
- notional interest amounts under derivative instruments or hedging arrangements;
- certain foreign exchange gains & losses on borrowings;
- guarantee fees for financing arrangements

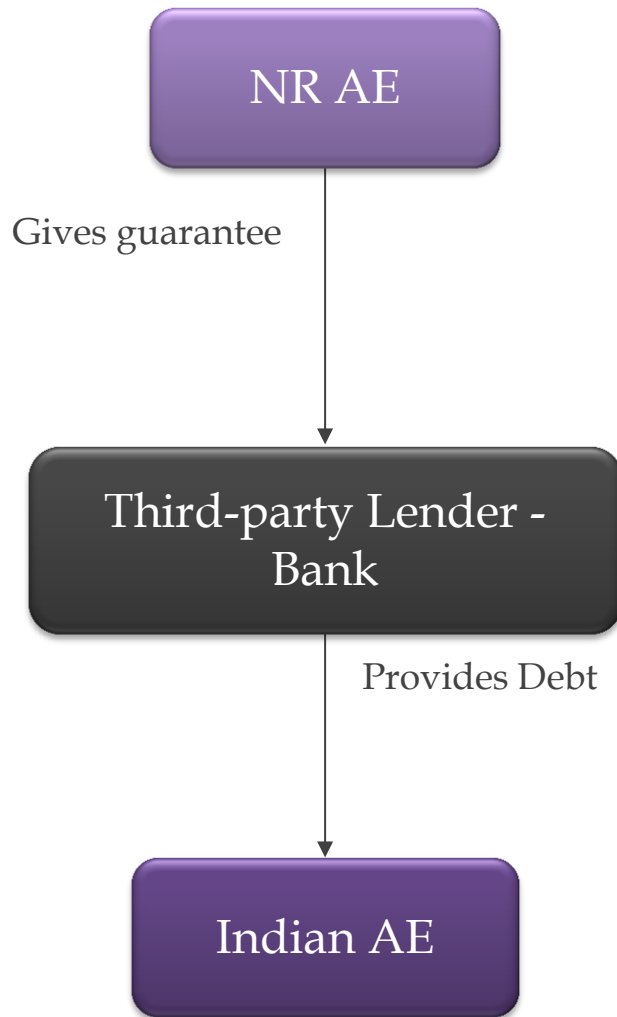
**Definition of interest under the Act
does not cover many of the items
mentioned in the Report**

Borrowings from third-party lenders

Borrowings from third-party lenders

- ▶ Proviso to Sec. 94B(1):
 - ▶ 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.
- ▶ Covers instances where debt is issued by a third-party, but based on guarantee or matching funds provided by the AE
- ▶ Provision **deems** such debt as debt issued by an AE

Borrowings from third-party lenders



- ▶ NR AE does not give loan to its Indian AE
- ▶ The loan is given by a bank to the Indian AE
- ▶ The loan is given based on:
 - ▶ Guarantee given by the NR AE; or
 - ▶ Matching funds provided by the NR AE
- ▶ It will be deemed that the debt is made by the NR AE to the Indian AE
- ▶ Section 94B limitation will apply to indirect debt given to AE

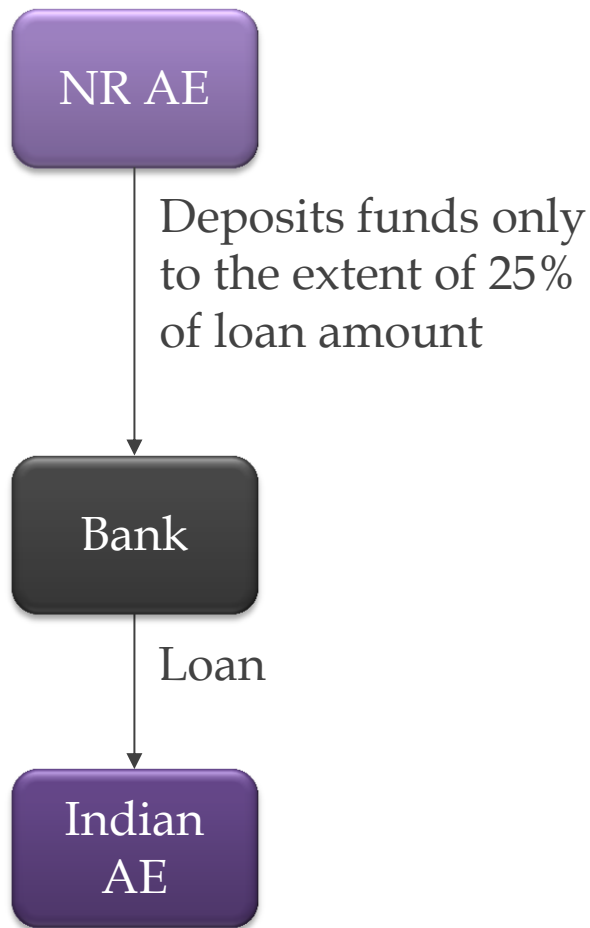
Guarantee to Third-party lender by AE

- ▶ “Guarantee” not defined under section 94B or in the Act
- ▶ “Guarantee” defined in Indian Contract Act as
 - ▶ A contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default
- ▶ Explicit & Implicit Guarantee:
 - ▶ Explicit Guarantee could be understood as an express agreement or a contract of guarantee
 - ▶ Implicit Guarantee would have a wide coverage
 - ▶ Is letter of comfort a “guarantee”?
- ▶ Undefined terms can lead to unnecessary litigation going forward

Depositing of funds with Third-party lender by AE

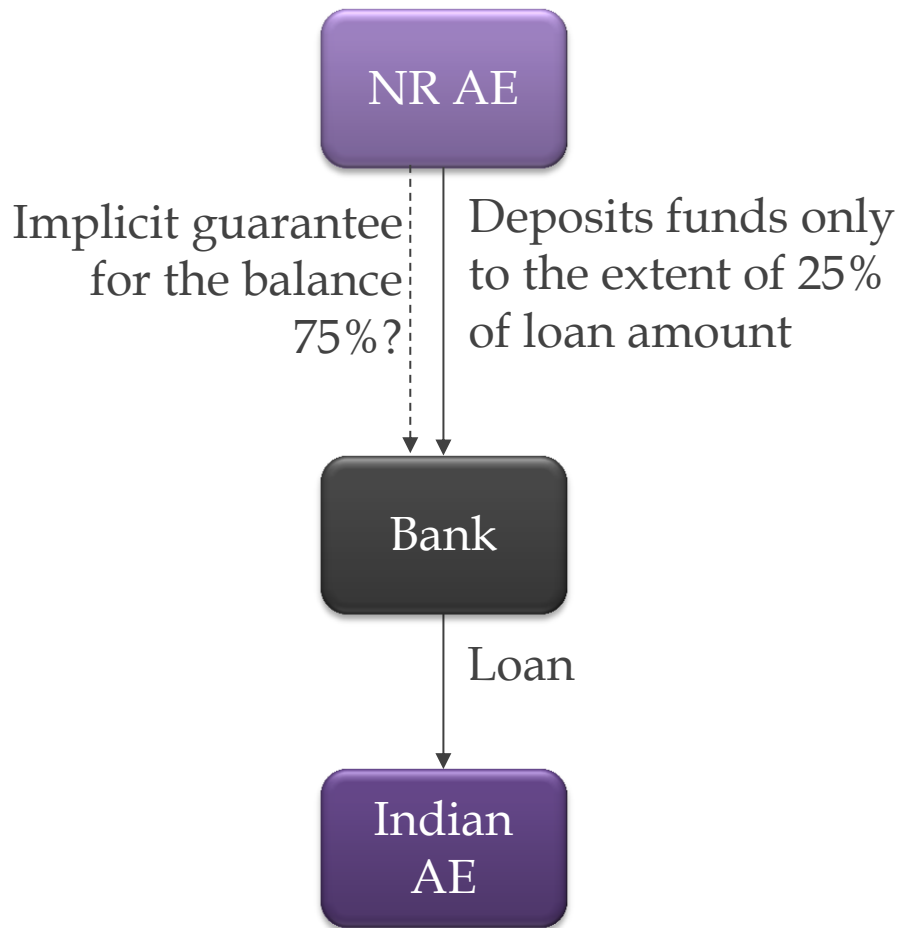
- ▶ If the AE deposits funds with a lender, which then provides the loan to the subsidiary, such debt transactions will also be covered by Sec. 94B
- ▶ The funds deposited by the NR AE must correspond and match the debt provided by such lender
- ▶ Can there be a mix of guarantee and funds?

Case Study 1 – Mix of Guarantee and Funds



- ▶ A bank provides loan to an Indian company based on deposits provided by such company's foreign parent
- ▶ Deposit provided is only to the extent of 25 per cent of the loan amount
- ▶ The bank is comfortable that in case the subsidiary defaults, parent company will make good the default
- ▶ Will interest paid to the bank be covered under Section 94B?

Case Study 1 – Mix of Guarantee and Funds

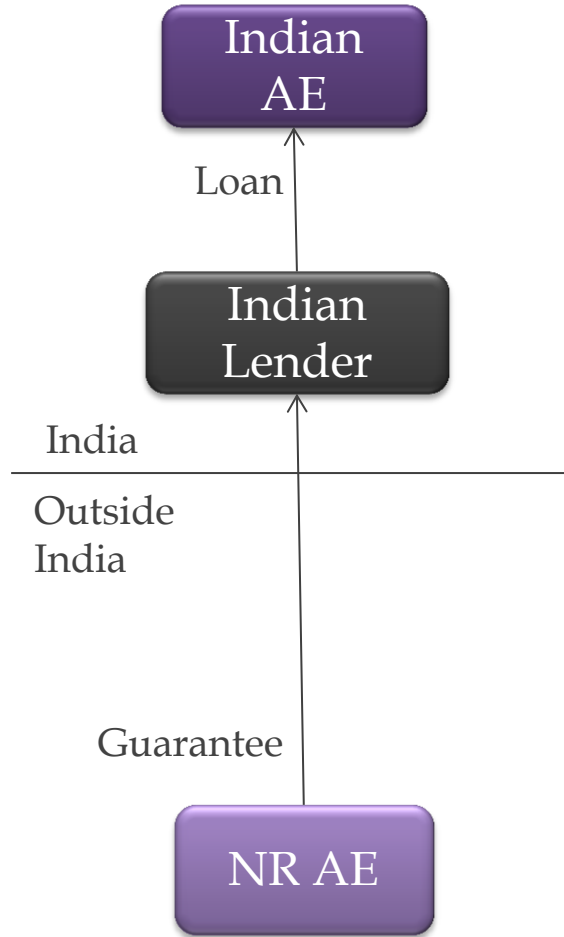


- ▶ Guarantee need not be in form of a contract
- ▶ It is “implicit” that the parent company is providing a guarantee for the balance 75% of the debt
- ▶ While Section 94B states that the funds provided by the NR AE should correspond and match the debt, it does not similarly qualify guarantees
- ▶ Therefore, a guarantee for even part of the debt may result in Section 94B being attracted
- ▶ Therefore, payment of interest to the bank will be covered by Section 94B.

Action Report 4 and Sec. 94B deemed transaction

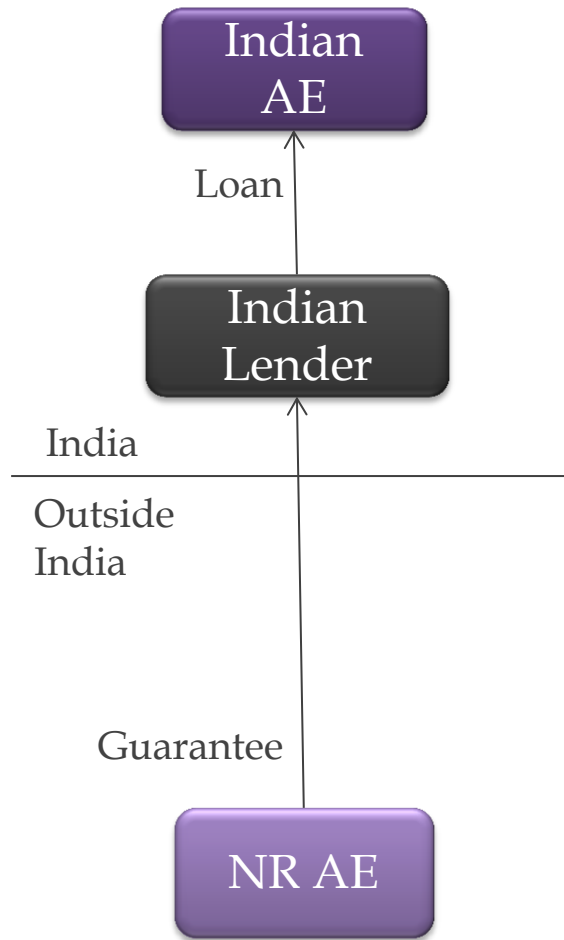
- ▶ Section 94B deems transactions involving third parties where guarantee or funds are provided by AE as transactions with the AE itself
- ▶ Action Report 4 does not directly provide for inclusion of such deemed transactions involving third-party lenders
 - ▶ But all interest payments made by an entity, whether to related or third-party lenders, are subject to the overall limit of Fixed Ratio
 - ▶ Thus, no need for separately deeming interest payments to third-party lenders as those by related parties
- ▶ Sec. 94B in that sense is narrowed down version of best practice advocated by Action 4 Report

Case Study 2 – Resident third-party lender



- ▶ Interest payments are made by an Indian Company to an Indian Bank for debt which is borrowed based on guarantee provided by a NR AE
- ▶ Interest payments are made within India only
- ▶ Proviso to Section 94B(1): Payments made to third-party lender will be **deemed** to be payments made to an **AE**
- ▶ Section 94B(1) states that only payments made to a **NR** AE are covered
- ▶ Will provisions of Section 94B apply in such a case?

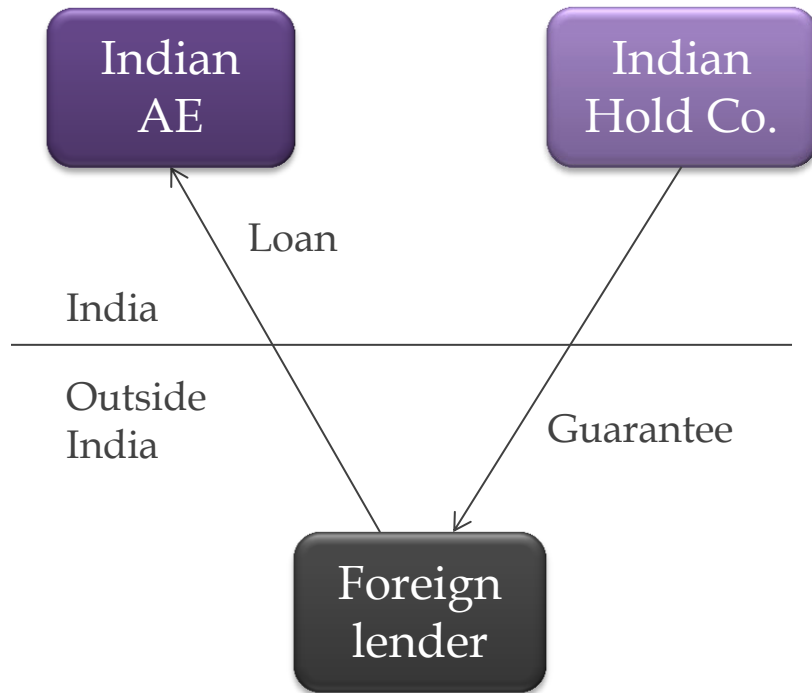
Case Study 2 – Resident third-party lender



- ▶ Payments made to the Indian Bank will be deemed to be payments made to an AE
- ▶ However, the payments are deemed to be made to a resident AE and not a non-resident AE
- ▶ Only payments made to a NR AE covered in Sec. 94B
- ▶ Proviso does not extend the deeming fiction to state that the payments to resident third-party lenders will be deemed to be payments made to a non-resident AE

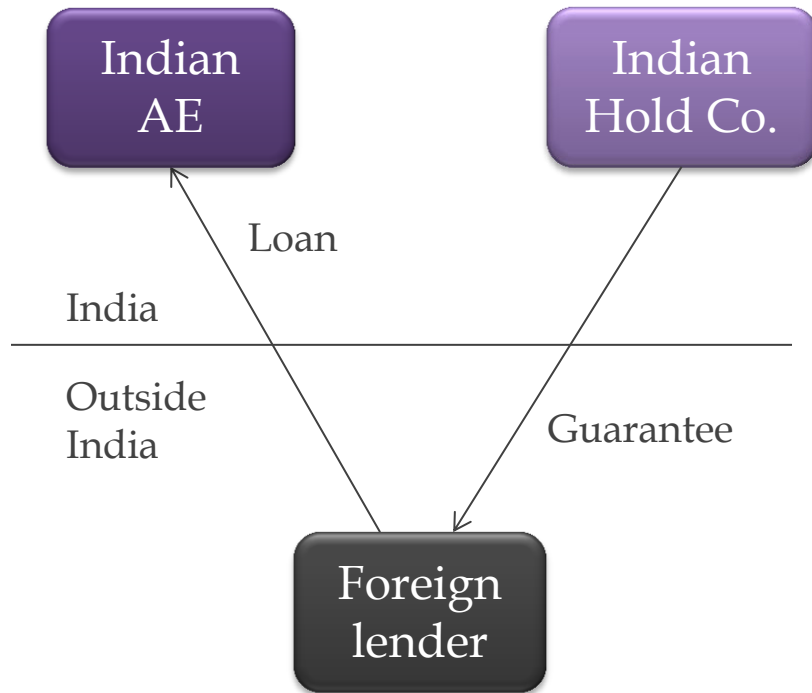
- ▶ **In this situation, Sec. 94B will not be applicable**
- ▶ Payments made within India to a third-party would not lead to Base Erosion in India
- ▶ **Alternate view:** Sec. 94B will still apply as intention is to cover transactions with AE, whether payment is made to a resident third-party lender or a non-resident third-party lender

Case Study 3 – Guarantee by Resident AE



- ▶ Foreign bank provides loans to an Indian company for which guarantee is provided by the Indian company's holding company in India
- ▶ Both the associated enterprises are residents of India
- ▶ Will Section 94B be attracted in this case even though no NR AE is involved in the transaction?

Case Study 3 – Guarantee by Resident AE



- ▶ Proviso to Section 94B deems borrowing by an Indian AE from an unassociated lender as borrowing from an AE, if guarantee is provided by an AE
 - ▶ Therefore, debt by NR lender will be deemed to be from NR AE.
 - ▶ AE providing guarantee can be resident or non-resident
- ▶ This transaction will be covered by Sec. 94B
- ▶ Both the AEs are Indian residents, but payment by Indian AE is to a NR
- ▶ Leads to Base Erosion

Disallowance of Interest under Sec. 94B

Disallowance of Interest

- ▶ Sec. 94B(1) provides for disallowance of “excess interest” if transaction is covered
- ▶ Sec. 94B(2) provides for the computation of “excess interest”:
- ▶ (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 (EBITDA) of the borrower in the previous year or interest paid or payable to associated enterprises for that previous year, whichever is less.
- ▶ Thus, there will be no disallowance under Section 94B if:
 - ▶ no interest is paid to a NR AE, or
 - ▶ the total interest paid is less than 30% of EBITDA

Disallowance of Interest

- ▶ Excess Interest means:
 - ▶ an amount of total interest which exceeds 30% of EBITDA in the previous year; or
 - ▶ interest paid or payable to AEs in the previous year;
 - ▶ whichever is lower
- ▶ There are at least two other possible views on computation of excess interest
- ▶ The views are derived by splitting the operative limbs of Section 94B(2) in a different manner



Quantum of Excess Interest – varied meanings

First View	Second View	Third View
Excess Interest means:	Excess interest means:	Excess interest limited only to payments made to NR AEs
(i) an amount of total interest which exceeds 30% of EBITDA in the previous year; or	(i) an amount of total interest which exceeds 30% of EBITDA in the previous year; or	The “total interest” mentioned in Section 94B(2) is to be limited to only interest paid to AEs.
(i) interest paid or payable to AEs in the previous year;	(i) <i>“an amount of total interest which exceeds”</i> interest paid or payable to AEs in the previous year;	This is because Section 94B(2) starts with the phrase “For the purposes of subsection (1)...”.
- whichever is lower.	- whichever is lower.	

Case Study 4 – Quantum of Excess Interest

- ▶ The differing views on computation of excess interest result in varying amount of disallowance
- ▶ Taking an example:

Particulars	INR in Millions
EBITDA	1000
30% of EBITDA	300
Total interest	500
Interest paid to AE	150
Interest paid to unassociated enterprises	350

Case Study 4 – Analysis of the three views

Particulars	View 1	View 2	View 3
Amount as per First Limb:			
Views 1 & 2: Total interest (including interest paid to unassociated enterprises) exceeding 30% of EBITDA [500-300]	200	200	
View 3: Total interest <u>paid to AE</u> exceeding 30% of EBITDA [(500-150)-300]			50
Amount as per Second limb:			
Views 1 & 3: Interest paid to AE	150		150
View 2: <u>Total interest exceeding</u> interest paid to AE [500-150]		350	
Amount of excess interest, i.e., disallowance is lower of amounts as per first and second limb	150	200	50

Case Study 4 – Quantum of Excess Interest

- ▶ Objective of Section 94B is to limit Base Erosion on account of interest payments to a NR AE
- ▶ Second and third view do not conform to the above objective
- ▶ Therefore, computation of “excess interest” should be as per First View
- ▶ First view also supported by the Memorandum to Finance Bill 2017 which states that:
 - ▶ “interest expenses claimed by an entity to its associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less.”

Gross Interest vs. Net Interest

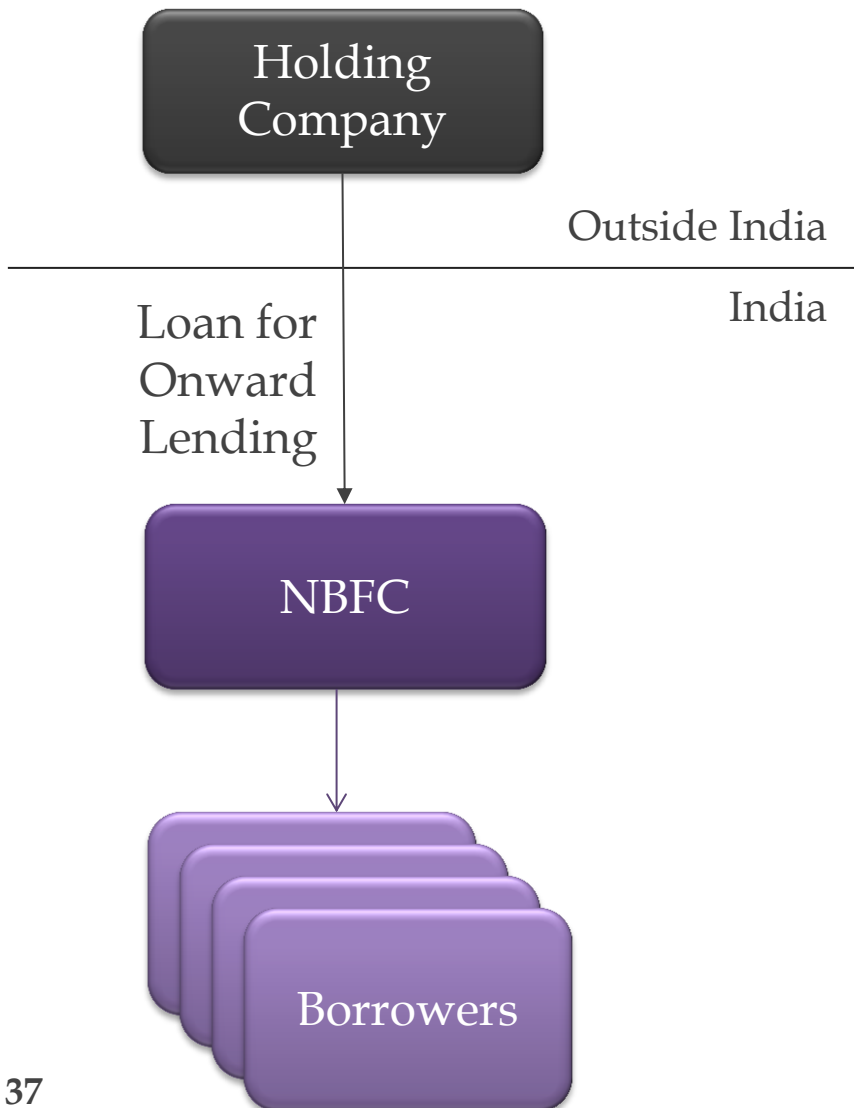
▶ Recommendation of Action Report 4:

- ▶ Limitation of interest deduction should apply to the net interest payment made to NR AE
- ▶ Gross interest expense option would be simpler to apply and is likely to be more difficult for MNC groups to circumvent through planning.
- ▶ Recommended approach is to apply the limitation rules to net interest expense and supplement the net interest limitation rule with targeted provisions to cover specific situations

▶ Implementation in India

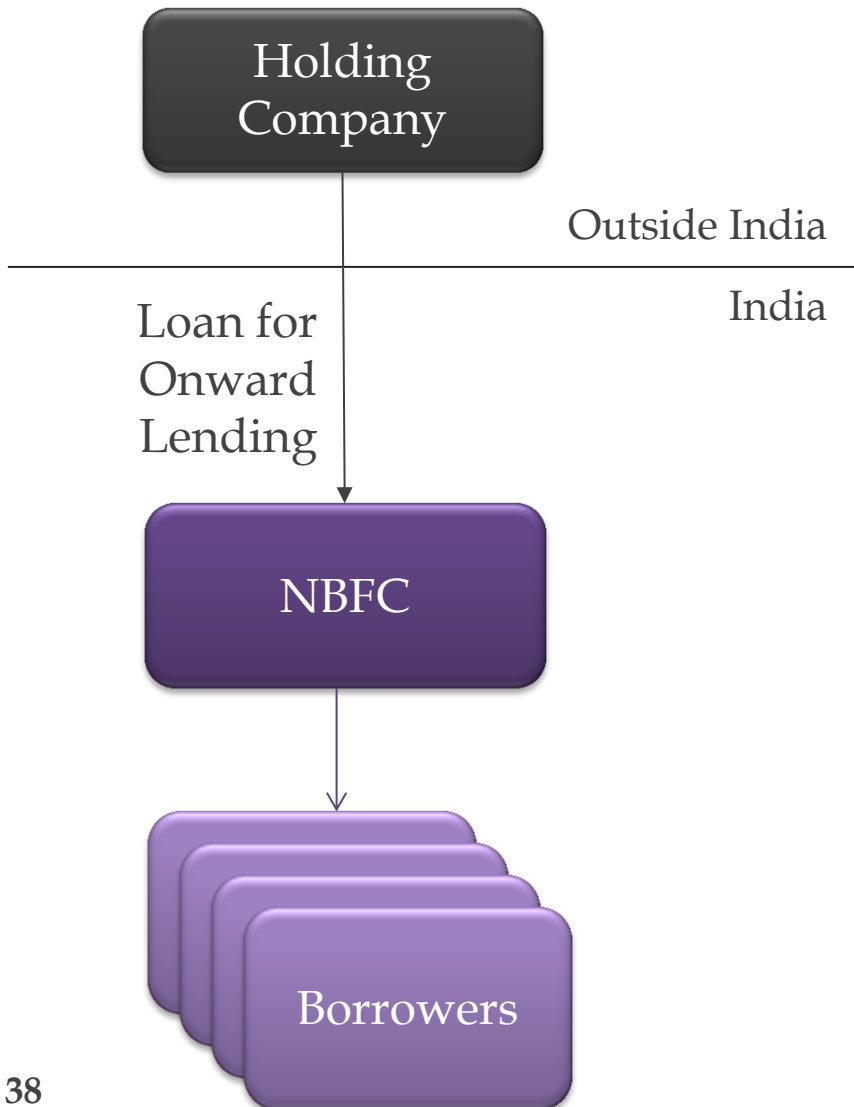
- ▶ Section 94B provides that the excess interest has to be computed based on the gross interest payments and not the net interest
- ▶ Results in double taxation to the extent of interest income being fully taxed while deduction for interest expense is restricted
- ▶ Foreign exchange regulations restrict on-lending by Indian companies which obtain foreign loans except for NBFCs

Case Study 5 – NBFCs set up by Non-residents



- ▶ Consider an NBFC set up in India by non-residents
- ▶ NBFC has been lent funds by its NR holding company for onward lending
- ▶ Disallowance of excess interest under Sec. 94B will be on the basis of *gross* interest payments made by NBFC to its NR AE
- ▶ What will be the tax implication on such NBFC as per Section 94B?

Case Study 5 – NBFCs set up by Non-residents



- ▶ NBFCs do not qualify for exemption in Section 94B(3) as they are not considered to be in the 'business of banking'
- ▶ Interest income earned from lending operations will not be allowed as a set-off before computing disallowance under Section 94B
- ▶ While there will be a restriction on deductions for interest payments, interest incomes would be fully taxable
- ▶ Double-whammy as interest expense for NBFCs would be higher than limit of 30% of EBITDA under Sec. 94B
- ▶ **Businesses carried on by NBFCs should be excluded from restrictions under Sec. 94B**

Fixed Ratio of 30%

Recommendations as per Action Report 4	Implementation as per Sec. 94B
BEPS Action Report 4 discusses several ways in which excess interest can be disallowed, 'Fixed Ratio' rule being one of them	More countries are adopting a Fixed Ratio rule as adopted by India in Section 94B. Fixed ratio rule is objective and simple and avoids difficulties of finding the market rate of interest, debt-equity ratio, etc.
BEPS has recommended that countries may fix the maximum allowable interest deduction ratio between 10 to 30% of EBITDA	India has adopted a ratio of 30% - perhaps considering the higher interest rates in India
The Report also provides for application of a 'Group Ratio'.	Section 94B does not provide any such group ratio

EBITDA

- ▶ What is to be considered for EBITDA?
 - ▶ Earnings as per Accounting Standards?
 - ▶ Earnings as per IND-AS?
 - ▶ Earnings as per the Act?
 - ▶ Earnings as per ICDS?
- ▶ BEPS Report on Action 4 states that EBITDA can be as per tax law or accounting standards as the country may provide
 - ▶ It also states that incomes which are exempt from tax (like dividend) should not be considered to compute EBITDA
 - ▶ Section 14A of the Income-tax Act provides a similar disallowance while computing taxable income
- ▶ No provision is made in the Finance Act 2017 specifying which books are to be considered for the purposes of EBITDA
- ▶ It will be better to have clarity on this aspect

Carry forward of disallowed interest

- ▶ In case interest expenditure is not wholly deducted, the amount of interest that has not been deducted can be carried forward to subsequent years for set off against profits of those years (Sec. 94B(4))
- ▶ Total deduction (for past years' interest and current year's interest) in any year cannot exceed the limit of 30% of EBITDA
- ▶ The carry forward facility is allowed for a maximum of 8 years immediately succeeding the year in which excess interest is disallowed
- ▶ However, the wording of the provision can lead to two views for amount of interest to be set-off in future years



Case Study 6 – Carry forward of disallowed interest

Particulars	Year 1	Year 2
EBITDA	(200)	500
30% of EBITDA	Nil	150
Total Interest	100	100
Interest paid to AE	100	100
Interest disallowed under Section 94B	100	Nil
Carry forward of disallowed interest	100	50

- ▶ Issue:
- ▶ Which amount needs to be reduced first from the limit in Year 2 –
 - ▶ the amount carried forward from Year 1
 - OR**
 - ▶ the interest expense of Year 2
- ▶ This issue comes out from a combined reading of sub-sections (4) and (1) of Section 94B

Case Study 6 – Carry forward of disallowed interest

Particulars	View 1	View 2
Total interest allowable in Year 2	150	150
Less: Disallowed interest carried forward from Year 1 which is set-off in Year 2	(100)	(50)
Year 2 interest claimed as deduction	50	100
Interest of Year 2 to be carried forward	50	-
Interest of Year 1 to be carried forward	-	50

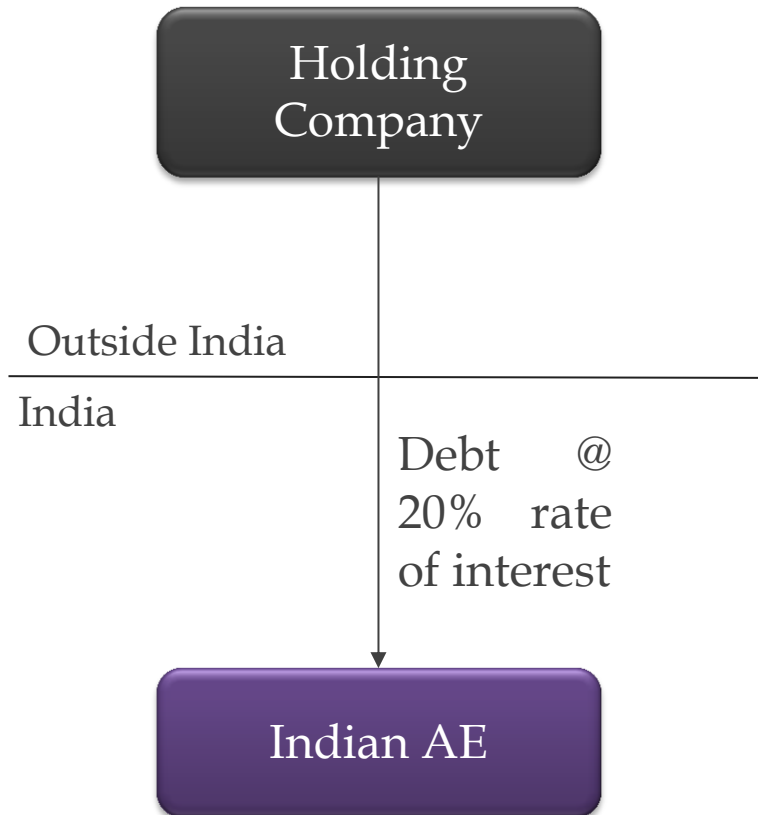
- ▶ A better view is to first claim set-off of maximum amount of brought-forward interest from Year 1 in Year 2
- ▶ Interest of Year 2 which stands disallowed on this account can then be carried forward for further 8 years
- ▶ However, no provision has been made in Section 94B specifying which interest is to be set-off first

Interplay with other SAARs, GAAR & DTAAs

Interplay with other SAARs and GAAR

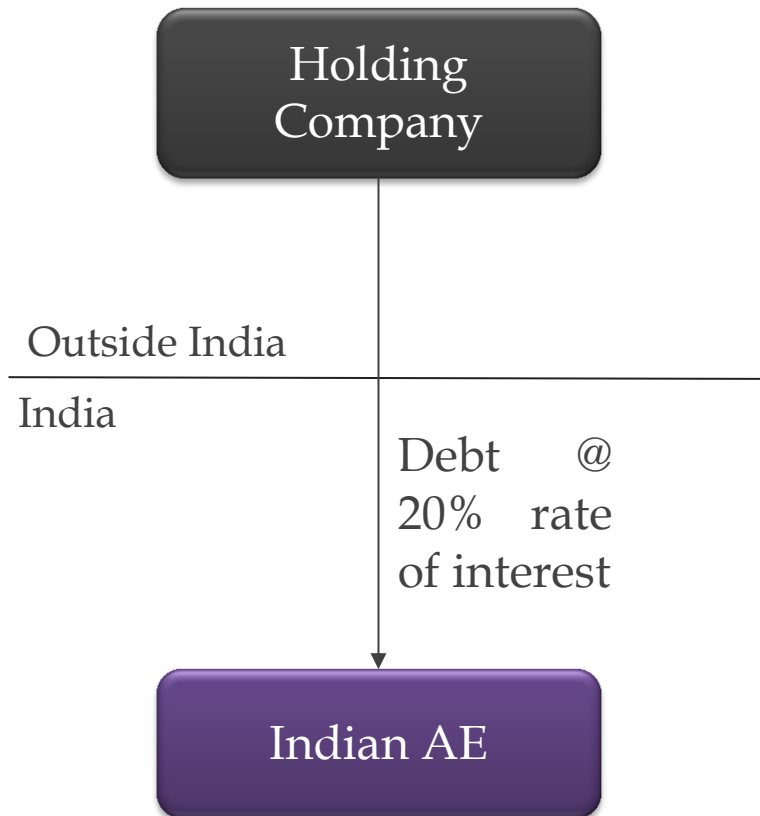
- ▶ Section 94B is not the only provision restricting claim of interest expenditure
- ▶ There are other Specific Anti-Avoidance Rules (“SAARs”):
 - ▶ Section 14A
 - ▶ Section 36(1)(iii)
 - ▶ Section 40(a)(i)
 - ▶ Transfer Pricing provisions
- ▶ General Anti-Avoidance Rules (“GAAR”) also provide their own conditions and implications for interest deductions

Interplay of Transfer Pricing Rules & Sec. 94B



- ▶ A MNC holding company provides debt at a rate of interest of 20% instead of at the arm's length rate of 5%
- ▶ Even after charging interest @ 5%, the total interest paid is beyond 30% of EBITDA

Case Study 7 – Interplay of Transfer Pricing Rules & Sec. 94B



Particulars	INR in Millions
Debt from NR AE	15,000
Interest on Debt @ 20 percent	3,000
Interest at arm's length rate of 5 percent	750
EBITDA	2,000
30% of EBITDA	600

- ▶ Will the disallowance be for:
 - ▶ Adjustment under TP rules; or
 - ▶ Restriction on total interest under Section 94B; or
 - ▶ Both amounts?

Case Study 7 – Interplay of Transfer Pricing Rules & Sec. 94B

Particulars	INR in Millions
TP adjustment: 3,000 – 750	2,250
94B disallowance : (Lower of (A) or (B))	
(A) Excess interest paid over 30 percent of EBITDA: (750–600)	150
(B) Interest paid to NR AE	750
94B disallowance: lower of 150 and 750	150
Total disallowance: (2,250 + 150)	2,400

- ▶ Both Rules can apply simultaneously
- ▶ On application of TP rules, the interest deduction is adjusted to the amount computed at the ALP
- ▶ This *adjusted* interest deduction will be analysed for disallowance u/s. 94B
- ▶ Under TP rules target for disallowance is the interest paid over the ALP
- ▶ Disallowance u/s. 94B is to limit the deduction from interest paid to AE to 30% of EBITDA
- ▶ Both have differing objectives
- ▶ The carry-forward u/s. 94B(4) will be only of the amount of excess interest computed after adjustment under TP

GAAR and Thin Capitalisation Rules

- ▶ To gain tax benefit, non-residents resort to arrangements where debt provided to its AE in India is much higher than the AE's capital
- ▶ High debt on a base of low equity capital (thin equity) results in "Thin Capitalisation"
- ▶ To counter this, many countries have introduced Thin Capitalisation Rules
- ▶ Under Thin Capitalisation Rules, usually, there is a limit on maximum debt-equity ratio that a company can have
- ▶ If loan provided by the NR is in excess of permitted debt-equity ratio, then interest corresponding to excess debt is considered as dividend for income-tax purposes
- ▶ As a result of this recharacterisation
 - ▶ Interest expense is disallowed in the hands of the borrower; and
 - ▶ the non-resident is taxed as if it has earned dividend

Thin Capitalisation Rules – Provisions in India

- ▶ Section 94B does not prescribe any disallowance for high debt-equity ratio – only for high interest payment
 - ▶ It is not a Thin Capitalisation Rule
- ▶ TP rules do not provide a specific adjustment for high-debt equity ratio
 - ▶ Besix Kier Dabhol SA – absence of Thin Cap Rules pointed out
- ▶ GAAR provisions applicable from FY 2017-18 may apply to such avoidance arrangements
 - ▶ Any equity may be treated as debt or vice versa as per Sec. 98(2)
 - ▶ Good chance that Thin Capitalisation arrangements may get covered under GAAR

Interplay of GAAR & Sec. 94B

- ▶ Disallowance of interest under Section 94B is a SAAR
- ▶ Having applied this specific rule, can GAAR also apply?
- ▶ CBDT Circular No. 7 of 2017 states that GAAR can apply even if there is a SAAR applicable to the same arrangement
- ▶ By this logic, other SAARs including Sec. 94B can apply notwithstanding applicability of GAAR to the same transaction

Interplay of Sec. 40(a)(i) & Sec. 94B

- ▶ Provides for disallowance of interest payments to a non-resident where taxes have not been deducted at source
- ▶ There can still be disallowance under Section 94B if the deductible interest exceeds the prescribed limits
- ▶ There can be two views on the order of disallowance between Section 40(a)(i) and Section 94B

Interplay of Sec. 40(a)(i) & Sec. 94B

View 1

- ▶ Section 94B prescribes disallowance for interest deductible under the head PGBP
- ▶ Hence, interest amount which is **deductible** under this head must be computed before resorting to Section 94B
- ▶ As a result, disallowances under Sections 40(a)(i) would be made first

View 2

- ▶ Section 94B is a **non-obstante provision** starting with the phrase “Notwithstanding anything contained in this Act...”
- ▶ Section 40(a)(i) has a limited non-obstante clause: “Notwithstanding anything to the contrary in sections 30 to 38....”
- ▶ Therefore, Section 94B overrides Section 40(a)(i) and hence is to be applied first

Case Study 8 – Interplay of Sec. 40(a)(i) & Sec. 94B

Sr. No.	Particulars	INR in Millions
(i)	EBITDA	1000
(ii)	30% of EBITDA	300
(iii)	Total interest	500
(iv)	Interest paid to AE	150
(v)	Interest paid to AE on which tax is not deducted at source	100

Case Study 8 – Interplay of Sec. 40(a)(i) & Sec. 94B – View 1

Sr. No.	View 1: Apply Section 94B after other SAARs	INR	INR
(a)	Total interest		500
(b)	Less: Disallowance under Section 40(a)(i) [as per (v)]		(100)
(c)	Interest claimed as deduction under the head “Profits and gains of business or profession”		400
	Of the above total deductible interest of 400:		
(d)	Interest paid to AE [(iv) – (b)]	50	
(e)	Interest paid to unassociated enterprises [(c) – (d)]	350	
(f)	94B disallowance (Lower of (A) or (B)):		
(g)	(A) Excess of total interest over 30 percent of EBITDA: (400–300) [(c) – (ii)]	100	
(h)	(B) Deductible Interest paid to NR AE (150-100) [(d)]	50	
(i)	94B disallowance: Lower of 100 and 50		(50)
(j)	Interest allowable for deduction		350
(k)	Interest to be carried forward under Section 94B for 8 years	50	
(l)	Interest allowable as deduction in future years when tax deducted at source under Section 40(a)(i)	100	

Case Study 8 – Interplay of Sec. 40(a)(i) & Sec. 94B –View 2

Sr. No.	View 2: Apply Section 94B first	INR	INR
(a)	Total interest		500
(b)	94B disallowance (Lower of (A) or (B)):		
(c)	(A) Excess of total interest over 30 percent of EBITDA: (500–300)	200	
(d)	(B) Interest paid to NR AE	150	
(e)	94B disallowance: Lower of 200 and 150		150
(f)	Interest after 94B disallowance		350
(g)	Less: Disallowance under Section 40(a)(i)		(100)
(h)	Interest allowable for deduction		250
(i)	Interest to be carried forward under Section 94B for 8 years	150	
(j)	Interest allowable as deduction in future years when tax deducted at source under Section 40(a)(i)	100	

Case Study 8 – Sec. 40(a)(i) & Sec. 94B - Order of Applicability

- ▶ First view is better whereby restriction under Section 94B applies only to interest amount claimed as deduction after considering disallowance under Section 40(a)(i)
- ▶ The *non-obstante* provision in Section 94B is to ensure that no other section of the Act can allow what is otherwise disallowed as per this provision.
- ▶ It is not to ascertain the order of applicability.
- ▶ Both the manners of computation of disallowance will only lead to a timing difference
 - ▶ Unless the disallowed payments are carried forward beyond a period of 8 years

Order of Applicability of Sec. 94B, SAARs & GAAR

First

- In case of impermissible avoidance arrangement GAAR will apply

Second

- Apply Section 92. Compute interest deduction at ALP

Third

- Apply Sections 40(a)(i), 14A, 36(1)(iii), etc. Determine allowable interest cost under PGBP

Fourth

- Apply Section 94B to restrict deductible interest within prescribed limit

Sec. 94B vs. Non-Discrimination clause under Treaties

- ▶ OECD Model Tax Convention Article 24 on Non-discrimination
 - ▶ Both treaty countries agree to non-discrimination rules whereby tax provisions will not be cumbersome just on account of factors like nationality, situs of a permanent establishment, etc.
- ▶ Deductibility non-discrimination rule forms part of a few Indian treaties
 - ▶ No discrimination against person vis-à-vis payments made to non-residents as compared to payments made to residents
 - ▶ This principle has been considered while providing relief to deductor in case of Section 40(a)(i) in Gupta Overseas [2015] 153 ITD 357
- ▶ Can this apply to counter Sec. 94B disallowance?

Sec. 94B vs. Non-Discrimination clause under Treaties

▶ Action Report 4

- ▶ Does not deal with Non-discrimination rules directly
- ▶ Recommends that if a country chooses to apply only Fixed Ratio Rule, it should be applied without discrimination to both domestic and multinational groups
- ▶ Therefore no discrimination envisaged under Action Report 4 recommendations

▶ Section 94B

- ▶ Applies only to deductions from payments to non-residents
- ▶ Is not covered within exceptions to Non-discrimination rules under treaties
- ▶ Thus, application of Sec. 94B can be contested where DTAA contains deductibility non-discrimination rule

Conclusion

- ▶ Section 94B, while introduced on the recommendation of BEPS Report on Action 4 has been suitably modified for the Indian context
- ▶ Targeted more specifically to Base Erosion from payments to non-residents
- ▶ Issues can crop up based on the wording of the provisions
- ▶ Lack of clarity on certain terms can lead to litigation

Thank You

- ▶ rutvik@rashminsanghvi.com
- ▶ www.rashminsanghvi.com

- ▶ Acknowledgements: Rashmin Sanghvi & Naresh Ajwani
- ▶ PPT assistance: Hinaye Davda

Applicability of Section 94B – 94B(1) & (3)

- ▶ Limitation on interest deduction in certain cases. –
- ▶ (1) Notwithstanding anything contained in this Act, where an Indian company, or a permanent establishment of a foreign company in India, being the borrower, incurs any expenditure by way of interest or of similar nature 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.
- ...
- ▶ (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.



Computation of Disallowance u/s. 94B

- ▶ Text of the provision:
- ▶ (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.



Carry Forward of Disallowed Interest

- ▶ Text of the provisions:
- ▶ (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.



Definitions

- ▶ (5) For the purposes of this section, the expressions –
 - ▶ (i) "associated enterprise" shall have the meaning assigned to it in sub-section (1) and sub-section (2) of section 92A;
 - ▶ (ii) "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";
 - ▶ (iii) "permanent establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

