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Analysis

Ambiguity with thin cap norms: Private credit players risk significant tax leakage

Key Takeaways

- Accurate reading of thin capitalization norms is highly relevant to maximize IRRs, especially in asset heavy sectors
- Currently, norms interpreted such that sometimes the entire interest paid to foreign related parties is disallowed for the target (as expense)
- This interpretation seems contrary to legislative intent and to the explanation issued by tax department
- Counter-view is to only disallow a portion of interest paid to foreign related parties (in excess of a prescribed limit)
- The counter is logical, has strong legal foundation and in line with the spirit of law

Governments are usually wary of attempts by companies planning their tax affairs by shifting income across jurisdictions. A particular area of concern has been interest payments. Since interest payments are tax deductible in India, any movement of income by way of interest has the potential to reduce or eliminate taxes in India.

To combat excessive shifting of income to lower tax jurisdictions through tax efficient interest payments, the Indian government introduced thin capitalization norms. These norms are premised on a simple assumption, the merits of which are not for this article, that interest payments to foreign associated enterprises[1] (which can be broadly identified on the basis of control) must be within reasonable limits. Interest pay outs above such limit are not barred, but will not enjoy the same tax benefits that are otherwise available to interest payments.

Implementation

The stated intent of the legislature, from the explanatory notes to the Finance Act of 2017, is very clear:

> "*… a new section 94B has been inserted in the Income-tax Act so as to provide 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.*"

In effect, when an Indian entity raises debt from its affiliates offshore, it would not be allowed to deduct any interest paid to these affiliates (known as associated enterprises and broadly covering parent entities/ entities with control/ significant influence) beyond a certain ceiling. Interest paid above this limit is called "***excess interest***". The ceiling has been fixed as a ratio to the company's EBITDA. Only the interest that is paid above this is seen as excess interest for which the Indian entity cannot claim deductions for income tax purposes.

"Total Interest" - the ambiguity

The wording of the provision on excess interest in The Finance Act, 2017 has led to some confusion. The Act defines "excess interest" as the lower of:

a. "*Total interest paid or payable in excess of thirty per cent of EBITDA of the borrower*"; or

b. "*Interest paid or payable to associated enterprises*".

[1] As per s. 92A of the Income-tax Act, 1961, 'Associated Enterprises', includes, amongst others: enterprises holding >26% voting power in another enterprise; enterprises participating in management/ control over another enterprise; enterprises which advance loans >50% of book value of the total assets of another enterprise; the right to appoint more than half of the board of directors; influence over prices and conditions of sale; >90% of raw materials required by one enterprise are received from another enterprise, etc.

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There are two ways in which the provisions relating to thin capitalization norms can be read, with vastly different implications on the Indian entity's tax liability. While this may have largely been confined to a policy debate, the wording of the provision deviates slightly from the Explanatory Notes to the Finance Act 2017. This has led to two distinct ways to calculate excess interest. One is adopted by the majority, which can lead to the entire interest paid to foreign affiliates being disallowed. The other is a minority view (which we argue is the correct view), which disallows only a portion of the interest paid.

Scenario 1 (Majority view):

This view does not account for the intent of the legislature (clearly laid out in the Explanatory Note to the Finance Act of 2017 and a subsequent explanatory note to the Finance Act of 2020). It says that excess interest, which is disallowed, is the lower of:

a. total interest paid to all lenders in excess of 30% EBITDA; or

b. interest paid to foreign associated enterprises.

This would essentially conflate two items – all interest paid by that entity including to other domestic entities (which interest would be taxable in India) and interest paid to foreign associated enterprises.

Assume a Company A which has EBITDA of INR 100 and pays INR 40 as interest to a foreign associated enterprise and INR 40 as interest to a domestic bank.

Taking the construct above, Company A may only be able to claim INR 40 as interest expense, while the excess interest would be INR 40.

This is calculated as below:

The excess interest = lower of: (a) total interest paid by Company A reduced by 30% of its EBITDA, i.e., INR 50. This is calculated as INR 80 (sum of interest paid to foreign associated enterprise and domestic banks) reduced by INR 30 (30% of EBITDA); or (b) interest paid to foreign associated enterprise, i.e., INR 40.

Therefore, excess interest = ***INR 40*** *[lower of (a) or (b)].*

Effectively, the entire interest paid to the foreign associate enterprise has been disallowed as interest expense.

Scenario 2 (Minority view):

The alternative is straightforward. In this computation, effectively, any interest paid to foreign associated enterprises which is above 30% of EBITDA is disallowed. This view interprets

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the provision in accordance with the explanation clearly provided under the Explanatory Note to Finance Act, 2017. Here, excess interest, is the lower of: (a) interest paid to foreign associated enterprises which is above 30% of EBITDA; or (b) interest paid to foreign enterprises.

The difference in returns due to the constricted reading of the provision can be significant, as illustrated below.

Assume a Company A which has EBITDA of INR 100 and pays INR 40 as interest to a foreign affiliate and INR 40 as interest to a domestic bank.

Here, the Company A may be able to claim INR 70 as interest expense. The excess interest would be only INR 10.

This is calculated as below:

The excess interest = lower of: (a) total interest paid to a foreign affiliate entity reduced by 30% of the EBITD, i.e., INR 10. Calculated as INR 40 (the total interest paid to foreign associated enterprise) reduced by INR 30 (30% of EBITDA); or (b) interest paid to foreign associated enterprise, i.e., INR 40.

Therefore, excess interest = ***INR 10*** *[lower of (a) or (b)]. The Company A can claim interest expense of INR 70 (INR 30 paid to foreign affiliate and INR 40 paid to domestic bank).*

In this illustration, Company A can claim INR 70 as interest expense, while under the 'majority view', Company A can only claim INR 40 as interest expense. The taxes payable for the latter are nearly 2 times than the former. So, there is a clear benefit in adopting the minority approach.

The Finance Act of 2020

The crucial difference is how total interest is understood. While the majority view looks at it as all interest paid, the minority view looks at total interest as total interest paid to foreign associated enterprises. The intent of the legislature seems to be clear – cap the deductibility on interest paid out to a foreign associated enterprise. The majority view would mean that in some cases such deductions are completely barred or that the cap on such deductions can be eaten up by domestic debt payments.

Interestingly, the legislature's understanding of the deductibility cap seems to differ from the majority view. This discrepancy is evident in the explanatory note to a subsequent legislation (extract below), where the legislature seems to be of the view that the cap on interest deductibility applies as laid out in the minority view.

The explanatory note (in the Finance Act of 2020) reads as follows:

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"Section 94B of the Act, inter alia, provides that deductible interest or similar expenses exceeding one crore rupees of an Indian company, or a permanent establishment (PE) of a foreign company, paid to the associated enterprises (AE) shall be restricted to 30 per cent. of its earnings before interest, taxes, depreciation and amortisation (EBITDA) or interest paid or payable to AE, whichever is less."

How does the law interpret ambiguity?

This reading of total interest, as interest paid to foreign associated enterprises seems to be a probable interpretation, and it is settled law that when there is more than one way to read a tax law, the reading favoring the taxpayer ought to be preferred.[2]

While courts have previously held that ambiguities in laws (which aim to prevent tax leakages/ tax evasion) should be interpreted in favour of the tax department, these findings are predicated with the caveat that the original intent of the law should be adhered to.[3]

Conclusion

Adopting a broader than required interpretation essentially means that interest payments to domestic lenders would eat into deduction limitations which have been set up explicitly to limit interest payments to foreign associated enterprises.

For companies operating in fields which are not capital intensive, there may not be a material difference in their tax liability, irrespective of the interpretation they adopt, as they may not have significant debt to begin with.

However, companies operating in capital intensive businesses, such as infrastructure, do not enjoy this benefit. These businesses are largely centered on leverage, with external debt used to tax optimize returns and access the large capital required to execute such projects. Use of shareholder debt is important to efficiently extract returns due to the nature of such industries which can involve project-specific companies and multiple layers of upstreaming.

The limitations on interest deductibility, going by the majority view, risks dampening investor participation in capital intensive industries. The limitation directly eats into their return on equity and leads to fewer projects meeting their viability threshold.

This seems to be far from the mischief the legislature has sought to address. Therefore, it seems there is a strong footing to read total interest as only including interest paid to foreign associated enterprises.

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[2] See Mysore Minerals v. Comm. of Income Tax, Karnataka (1999) 7 SCC 106 and CIT v Vatika Township (2015) 1 SCC 1.

[3] See State of Tamil Nadu v. M. K Kandaswami, AIR 1975 SC 1871.

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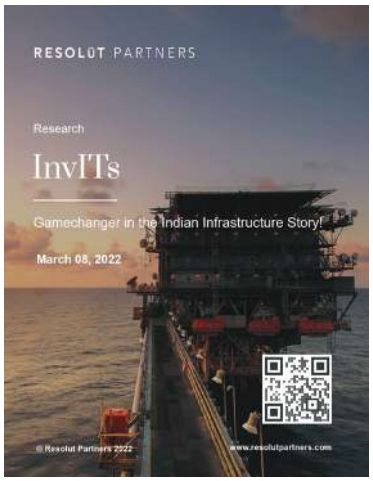

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