



Western Region Chapter
International Fiscal Association – India
Branch

WEBINAR ON “PRACTICAL ISSUES IN APPLICATION OF SECTION 94B”

Date	Thursday, 20th September, 2018
Time	6.00 pm – 7.30 pm
Speaker	Mr. Padam Khincha, Bangalore
Moderator	CA Nilesh Kapadia, Mumbai

LIMITATION ON INTEREST DEDUCTION IN CERTAIN CASES.

94B. (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.

(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.

(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.

(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.

(5) For the purposes of this section, the expressions—

"associated enterprise" shall have the meaning assigned to it in sub-section (1) and sub-section (2) of [section 94A](#);

"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";

"permanent establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

THRESHOLD OF 1 CRORE

On reading sub section (1), it is seen that a threshold of Rs 1 crore has been stipulated.

The language thereof leaves a doubt whether the said threshold is with reference to

- (i) the aggregate interest paid by the assessee, or
- (ii) the quantum of interest paid to its non resident associated enterprise.

DEBT ISSUED BY – BORROWER OR LENDER

The proviso refers to a debt issued by the lender.

In practice, it is the borrower who issues the debt, for example, a debt by way of issue of debentures. If this view is taken, can it be contended that the proviso is not capable of being complied, and hence is to be treated as non est.

QUANTUM OF FUNDS WITH BANK

The same proviso refers to a **corresponding and matching amount** of funds being placed with the lender. Normally a lending bank would retain its margin while relending, and the amount of funds placed with the lender will be more than the amounts of funds lent to the borrower. Can it be argued that the funds placed with the lender, not being same as the amount of the loan, the proviso is not applicable.

In a few cases, having regard to the relationship with the banker, a lesser amount is placed with the lender. Is it arguable in such a case whether the said proviso is not applicable.

RESIDENT LENDER

The proviso to section 94B(1) provides that where the borrowing is from a non-resident third party but the debt is implicitly or explicitly guaranteed by an associated enterprise or an associated enterprise has deposited a corresponding and matching amount of funds with the third party, then the non-resident third party shall be deemed to be associated enterprise.

If a loan given by a resident third party is guaranteed or funds are provided by an associated enterprise then is the interest covered by section 94B(1)?

RESIDENT LENDER

On a combined reading of section 94B(1) and the proviso, the understanding of the applicability and otherwise of section 94B is explained in the table below for various situations:

Sr. No.	Status of lender	Status of AE which is guarantor / fund provider	Whether section 94B applicable?
1	Non-resident	-	Yes
2	Non-resident	Non-resident	Yes
3	Non-resident	Resident	Yes
4	Resident	Non-resident	No
5	Resident	Resident	No

PARENTAL SUPPORT

Parental support would be expected to be provided by the parent even in the absence of any legal obligation (for example, guarantee) arising from the entity's affiliation with the parent. Merely because the borrower is a wholly owned subsidiary does it mean the parent has given implicit guarantee?

(a) Can it be argued that unless there is a 'guarantee', the question of it being implicit or explicit does not arise?

(b) Section 126 of the Indian Contract Act reads as follows:

A 'contract of guarantee' is a contract to perform the promises, or discharge the liability, of third person in case of his default. The person who gives the guarantee is called the 'surety'.

Is this required to be fulfilled even in case of implicit guarantee? In other words, even in case of implicit guarantee, the guarantor should have agreed to discharge the liability of the borrower.

In view thereof, whether a mere letter of comfort would also get covered?

WHETHER INTEREST

Are the following covered by section 94B:

- (a) loss on account of foreign exchange fluctuation in respect of debt from associated enterprises.
- (b) guarantee commission to the associated enterprise giving a guarantee

FX FLUCTUATION ON INTEREST

Whether foreign exchange fluctuation relating to the interest payout will form part of interest for the purpose of section 94B. Consider the following example.

- ▶ Loan from parent: \$ 1 million, @ 5% pa
- ▶ Due dates for payment of interest: end of each calendar quarter.
- ▶ Interest payable for quarter ended 30th June : @ 12,500
- ▶ Rate of exchange on 30th June: INR 68 = \$ 1
- ▶ Interest due in INR: Rs. 8,50,000
- ▶ Interest paid on 5th September 2018, when INR 72 = \$ 1.
- ▶ Interest actually remitted: Rs. 9,00,000
- ▶ Amount debited to FX fluctuation a/c : 50,000 (9,00,000 less 8,50,000)
- ▶ Whether this amount of Rs. 50,000 will also be required to be considered as interest for the purpose of section 94B?

INTEREST – TREATY DEFINITION

The definition of interest in section 2(28A) widens the scope of the said term, by providing that it 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. This inclusion is not present in many Double Tax Avoidance Agreements (DTAA) signed by India. Example is the DTAA with Japan. Para 5 of Article 11 of the said DTAA defines interest as-

The term 'interest' as used in this article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from Government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.

On perusal of the said definition, it is noticed that the expanded scope in respect of service charges / fees of the type referred to in section 2(28A) is not present. Hence, while applying section 94B to an assessee who has the non-resident associated enterprise in Japan, is it possible to apply the definition of the DTAA. By doing so, the service fees or other charges mentioned in section 2(28A) can be excluded from the rigors of section 94B.

Apart from Japan, the term interest is similarly defined in few other DTAA signed by India as well.

Interest deductible Vs. deducted

- Part of interest paid is disallowed under the Transfer Pricing provisions, on the premise that the interest rate paid is higher than that payable on an arm's length basis.
- Portion of debt has been treated as equity under the GAAR provisions.
- Part of interest paid is disallowed under
 - Section 14A
 - Section 36(1)(iii)
 - Section 40(a)(i)
 - Section 43B (e.g. when I Co obtains loan from Indian branch of a foreign bank, against guarantee of parent)

INTERPLAY WITH S.40(A)(I)

In case any amount of interest is disallowed under section 40(a)(i) due to non payment of TDS, and due to the TDS being paid in the subsequent year, whether the interest of the first year will again be subject to the limitation under section 94B if the same is allowable in that year due to TDS having been paid. Consider the following example.

Year	EBIT DA	Interest to AE	Disallowable u/s 40(a)(i)	Net interest deductible	Deferral u/s 94B
1	400	250	125	125	5 (125 - 30% of 400)
2	500	250	0	375 (250 + 125 of year 1)	225 (375 - 30% of 500)

If interest paid to a lender covered by Section 43B(e) is disallowed due to non payment within the time limit laid down in that section, whether the interest of the first year along with the interest of the second year will need to be filtered under section 94B. Consider the following example.

Year	EBITDA	Interest to AE	Disallowable u/s 43B	Net interest deductible	Deferral u/s 94B
1	400	250	250	0	0 (as interest deductible is 0)
2	500	250	0	500 (250 + 250 of year 1)	350 (500- 30% of 500)

In case part of interest paid to the non-resident associated enterprise is not claimed as an expenditure, say because it is capitalized, or added to the value of inventory, how will the section apply.

Here, though interest is paid to the non-resident associated enterprise, the same is not claimed as an expense in the year of payment. Whether Section 94B will get attracted even in such a case

INTEREST CAPITALIZED / INCLUDED IN INVENTORY

PRIORITY OF C/F AMOUNT

- Sub section (4) provides for carry forward of excess interest. Consider the following case.

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

For the interest carried forward from Year 2 to Year 3, there can be two views to interpret the same. These are:
Your view is sought as to which of the two views can be followed.

Particulars	View 1	View 2
Total interest allowable in Year 2	150	150
Interest paid to AE		
Carry forward from year 1 which is set-off	100	50
Current year interest claimed as deduction	50	100
Current year interest carried forward	50	-
Year 1 interest to be carried forward	-	50

Your view is sought as to which of the two views can be followed.

INTEREST PAID

Excess interest which is not deductible, is total interest paid or payable, less lower of

(a) 30% of earnings before interest, taxes, depreciation and amortization (EBITDA); or

(b) interest paid or payable to associated enterprise. [section 948(2)]

Total interest paid or payable (first component) -

(a) The computation of excess interest in section 94B(2) involves determination of "total interest paid or payable". What is used here is the term 'interest' and not "of similar nature" [as mentioned in section 94B(1)]. Can it be argued that the amount of expenditure of similar nature cannot be considered in computing excess interest?

(b) On a literal reading, the term "total interest" would include the entire interest paid by the specified entity including interest to residents, non-associated enterprises, etc. and paid or payable on a debt or a borrowing or even an unpaid amount. Is this the correct interpretation?

(c) Whether the interest to associated enterprise will include interest to all associated enterprises (including resident) or only to the non-resident associated enterprises, as mentioned in section 94B(1)?

THE METHOD OF DETERMINATION OF EXCESS INTEREST LIMIT (OF 30% OF EBIDTA) APPEARS TO BE INCONSISTENT BETWEEN THE FINANCE ACT AND THE MEMORANDUM.

CONSIDER THE FOLLOWING CASE:

Particulars	Amount
EBIDTA	150,000
30% of EBIDTA	45,000
Interest payment to third party	30,000
Interest payment to AE	40,000
Total interest payment	70,000

View I - Excess interest to be reckoned relative to interest payment to AE

Interest payment to AE	:	40,000
30% of EBIDTA	:	45,000
Excess interest	:	Nil

View 2 - Excess interest to be reckoned relative to total interest payment, but disallowance applicable to AE alone

Total interest payment to third party and AE	:	70,000
30% of EBIDTA	:	45,000
Excess interest	:	25,000

As the total interest payment is greater than 30% of EBIDTA, so much of the excess as is the payment to the AE, is 25,000, is disallowed. The Section seems to suggest this treatment.

Which of the two views is the correct view?

DICHOTOMY

(a) EBITDA (second component) - whether "earnings" represent taxable profits and gains or earnings as per profit and loss account?

(b) In calculation of EBITDA, does the term 'interest' includes all interest whether paid to associated enterprise or not and whether paid to a non-resident or a resident?

EBITDA

- Can an assessee argue, relying on Non discrimination article in DTAA, where it is similar to Article 24(4) of the OECD Model Convention, that section 94B should not apply to him.

NON DISCRIMINATION

▶ THANK YOU ALL