NEWSLETTER | INDIA BRANCH | WESTERN CHAPTER

LETTER FROM THE EDITOR

Dear Readers,

It gives me immense pleasure to share with you the second edition of IFA India Branch - Western Region Newsletter for the year 2017.

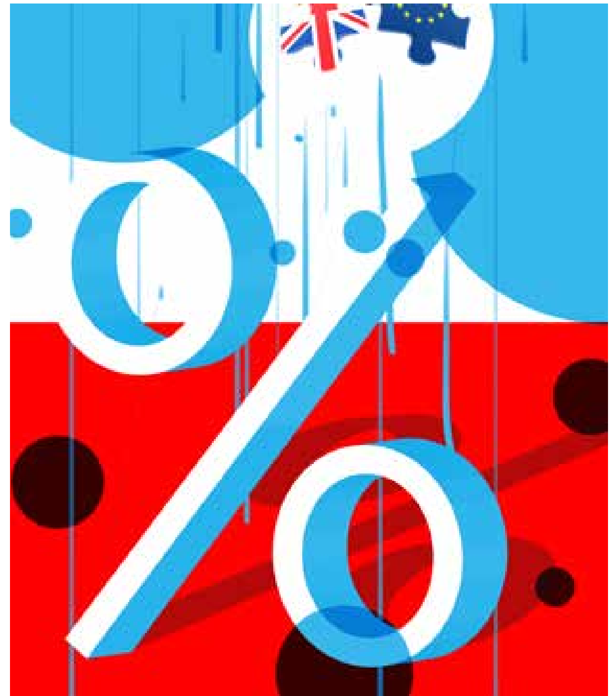
How tax-attitudes around us change, with time, and around the world. For one, most of the economies are now being seen as co-operating for adoption of more consistent anti-tax avoidance measures, embraced under the OECD Base Erosion and Profit Shifting Action Plans (BEPs), by aligning local laws and inter-governmental policies. At the same time, UK sent a stern message to the world last year with a momentous vote for Brexit. The economic implication of which is being debated intensely.

This newsletter covers an article on the likely tax implications in a post Brexit UK - for businesses, by our contributor, Mr. Kannan Raman (UK tax expert). It also covers a detailed analysis on the newly introduced law in India on 'Limitation on Interest Deduction for MNCs' under Section 94B of the Indian tax law, by Mr. Rutvik Sanghvi. Is this India's final response to the Action Plan 4 Report under the OECD BEPs initiative?

Lastly, who doesn't care for a bit of sparkle – diamonds. Read how Belgium's Carat Tax has put an end to complexity faced in verification of taxable profits of diamond traders. Should India adopt the same? – By our contributor, Pallavi Bakshi

I hope you find these articles timely and useful.

By- Paresh Parekh



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ABOUT IFA

The International Fiscal Association (IFA), established in 1938 with its headquarters in the Netherlands, is the only non-governmental and nonsectoral international organization dealing with fiscal matters. IFA has played an essential role both in the development of certain principles of international taxation and in providing possible solutions to problems arising in their practical implementation. The membership of IFA now stands at more than 12,000 from 106 countries. In 62 countries, including India, IFA members have established IFA Branches. For further information on

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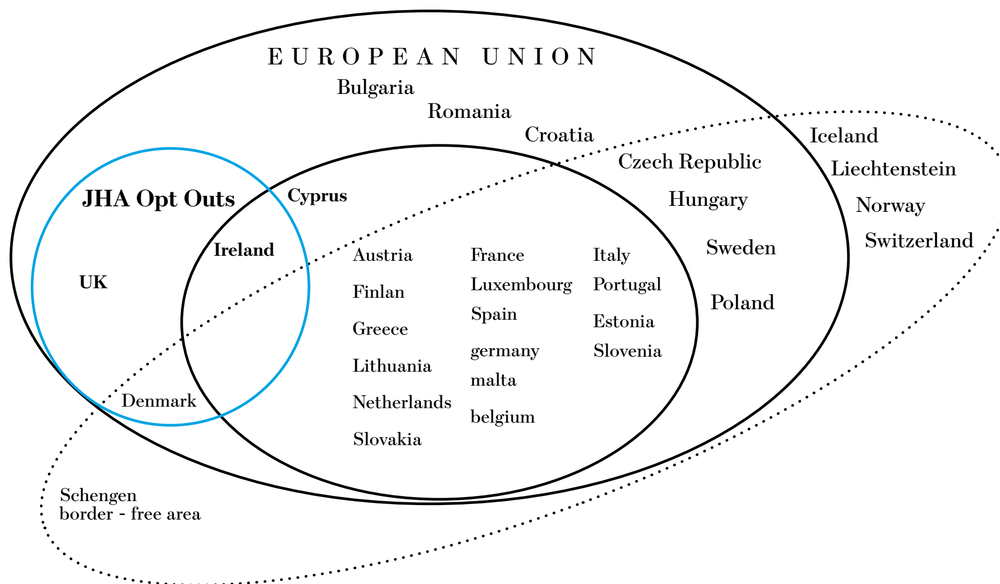
THE UK POST BREXIT: WHAT ARE THE LIKELY IMPLICATIONS FOR TAX?

– By Kannan Raman

THE EUROPEAN UNION: WHAT EXACTLY IS IT?

The European Union (EU) is a political and economic union made up of 28 European countries, including the UK. The EU, which has its origins in the European Coal and Steel Community, was founded by six European states after the Second World War. However, its remit has evolved and is much broader today. The EU facilitates cooperation between Member States on a wide range of objectives, such as trade, protecting the environment, security and development overseas. The EU has created the world's largest single market, enabling the free movement of goods, services, people and capital. The below picture depicts the current arrangements as they relate to Europe and the European Union.

EUROPE AND THE EUROPEAN UNION



The UK's relationship with the EU has evolved over the four decades of the country's .EU membership and this includes tax matters

WHAT MAKES THE UK ATTRACTIVE TO INTERNATIONAL INVESTORS?

Based on EY's 2016 Attractiveness Survey, the UK maintained its lead as Europe's top foreign direct investment (FDI) destination. 2015 also saw a 58% increase in projects from India, making the country one of the largest foreign investors into the UK. However, a recent update to the survey suggested that the UK had a short window of opportunity to develop and implement policies that would help maintain and build on this lead, with investors appearing concerned about how the country's attractiveness would develop over the next three years. The update did find Asian investors to be the most positive about the UK's future attractiveness. Around one in three Asian investors expected an improvement over the next three years, with about one quarter believing there would be a drop.

KEY FEATURES OF THE UK IN THIS CONTEXT INCLUDE:

- A low headline statutory rate of corporation tax – currently 19% from April this year (2017) reducing to 17% in April 2020.
- A patent box regime that provides for a 10% corporate tax rate for income from patented products and processes.
- No or reduced UK withholding taxes (WHT) - dividends paid by UK resident companies are not subject to withholding tax under UK domestic law. WHT on interest payments may apply, but the rate is reduced under tax treaties. It is also reduced to zero if the debt qualifies for certain UK statutory exemptions.
- Low WHT (zero in many cases) applies on dividends from overseas

subsidiaries to the UK based on the extensive tax treaty network.

• Exempt dividend income - a dividend or other income distribution received by a UK company is generally exempt from UK corporate tax under domestic law, provided the conditions of the dividend exemption are satisfied.

• Overseas branches of UK companies - it is generally possible to exempt the profits or losses of overseas branches of UK companies from UK corporate tax, ie the overseas branch of the UK company will be exempt from UK corporation tax.

• Territorial CFC rules - the UK controlled foreign company rules are narrow in application by design. The purpose of the rules is broadly to only impose a CFC charge in the UK on the "artificial" diversion of UK profits from the UK.

• Capital gains exemption – the UK has a Substantial Shareholding Exemption (SSE) which exempts from UK tax any capital gain or loss on certain disposals of more than a 10% interest in share capital.

• Flexible loss utilization rules.

• A mature and generous R&D incentive offering, including both an above-the-line Research & Development Expenditure Credit for revenue expenditure and Research & Development Allowances for capital expenditure.

THE UK REFERENDUM OF 23 JUNE 2016 AND BREXIT: WHERE ARE WE NOW?

On 23 June 2016, the people of the UK voted in a referendum to leave the European Union. While the referendum is not legally binding on the UK Government, Prime Minister Theresa May, who replaced David Cameron after the latter stood down following the result, confirmed that she would activate Article 50 (the mechanism which will trigger the exit process) on 29 March 2017. Article 50 provides for two years of negotiations from the point of notification before a country formally exits the EU. Until that exit, all EU directives, regulations, and the treaties themselves will remain in force in respect of the UK. The UK's decision to leave the EU marks a significant change for the UK and Europe, taking us into unchartered waters, and the outcome of UK negotiations over the next couple of years will determine the future UK trading model.

While there are many possible scenarios for a post-Brexit UK, it is becoming clear that some areas and sectors are likely to be more impacted than others. For tax, the key areas are indirect taxes and mobility. From a regulatory perspective, immigration will be an important area to watch and pharmaceuticals and financial services are likely to be two key sectors impacted.

INDIRECT TAX

General Value Added Tax ("VAT") implications: VAT is an EU tax and the EU VAT directives would cease to apply in the UK after the formal exit. However, the EU directives have been transposed into UK law and it is likely that the UK will largely retain the current system of VAT on leaving the EU. The UK Government could also 'grandfather' interpretations, commission decisions and judgements of the European Court. However, once the UK has left the EU, taxpayers would no longer have a right of appeal to the European Court and European Court decisions will no longer be binding on the UK (although they may remain persuasive). The UK Government would therefore have additional flexibility on setting the rates and scope of VAT. Some UK amendments are likely to be needed to help companies manage cash flow issues on exit and in the future the UK VAT regime could diverge further from the EU regime. Leaving the EU therefore presents an opportunity for companies to engage with the Government around changes to the current VAT treatment of certain supplies that could be beneficial to the country as a whole.

GOODS: For VAT purposes, intra-community acquisitions/supplies will become imports/exports resulting in an increase in costs and customs controls when shipping between the UK and EU, due to the need to complete import/export declarations. There are currently simplifications and indirect tax reliefs available as a result of the UK's EU Membership, which may be withdrawn. This could result in, for example, potential customs duties which will increase paperwork and border delays, and will result in more cost. From a goods perspective, the largest impact is likely to be from a customs duty and regulations perspective as the UK negotiates changes to the Customs Union across the EU and pursues trade agreements with other countries.

SERVICES: From a services perspective, the vote to leave the EU may result in the loss of use of existing EU indirect tax simplifications for cross-border transactions, including registration schemes such as the Mini One Stop Shop, and will result in more cost and overseas VAT registrations. This may also result in greater controls imposed by EU countries, increasing the number of VAT audits.

We would expect the UK to do all it can to ensure it is not at a disadvantage, seeking to introduce "relaxations", including in new areas. Exceptions may arise, however, in areas seen as unfairly benefiting a taxpayer or where the UK has never fully agreed with the EU position. In this case the UK could introduce domestic law to restore what the UK tax authorities would see as the correct position.

In particular, this issue (and cost) may arise where there is a current UK/EU easement from which UK businesses operating with the EU will no longer be able to benefit. Subject to what is agreed between the UK and the EU (if anything), it is unlikely that the EU will make special provisions for the UK to continue to benefit from these. For example, the EU could impose Import Duty on UK goods moving into

the EU (and the UK could do the same for imports into the UK from the EU). E-services companies making B2C supplies also benefit from an EU "One Stop Shop" (OSS) which simplifies VAT registration and reporting of sales across the EU. Post-Brexit, the UK would not be part of this scheme on an EU level and businesses using the UK as a hub for the OSS may need to consider also registering for VAT in a remaining EU country.

MOBILITY AND IMMIGRATION

Brexit implications in the employer, payroll and employment taxes sphere are closely aligned with considerations around talent - in particular, UK attractiveness and immigration.

EMPLOYMENT RELATED TAXES: These have traditionally been the realm of UK domestic legislation and subject to the network of bilateral Double Taxation Agreements which the UK has in place. Wholesale change in this area is not expected, although the issue of UK attractiveness does pose interesting questions in the area of expatriate and mobility related tax reliefs. Tax reliefs in this area, including the treatment of non-domiciled individuals, have been gradually restricted in recent years. These reliefs can reduce the tax due by employees and executives and, under the tax equalisation arrangements often adopted by international companies, these can result in substantial savings to employers. It remains to be seen if the UK government will consider enhancing these tax breaks to support the attractiveness to host talent post Brexit.

SOCIAL SECURITY: This is a considerable employer cost and very important to employees as it can impact their state benefits and pension provision. The current European rules and network of bilateral social security agreements govern how social security becomes due, prevents double contribution costs and covers how social security contributions in different countries may be "totalised" to determine entitlements. The UK is heavily reliant on the European rules for employees moving between Member States and it remains to be seen how this will work post Brexit. Double contribution costs and a confusing picture on how contributions totalisation will work are foreseeable.

IMMIGRATION: This subject was a prominent feature of referendum debate and the status of EU citizens who are already in the UK, as well as those who wish to come to the country to work after the UK leaves the EU, remains unclear. A number of industries (agriculture, leisure, finance and hospitality) are heavily reliant on a European workforce so changes may have a substantial impact on their current business models. An immediate action for most employers is to consider undertaking a review of their workforce to understand to what degree it is made up of EU citizens in the UK and where applicable British citizens working elsewhere in the EU. Businesses will need to start considering what talent supply in a post Brexit environment will look like and consider the impact on their workforce planning. Businesses should also consider whether to build European immigration advisory support into their existing mobility programmes, in order to best support their EU staff.

PHARMACEUTICALS

Life sciences companies, either headquartered or with substantial operations in the UK, must now begin to plan for a future outside the European Union (EU). There are about 70,000 people working in the life sciences industry in the UK. Approximately 7% of these workers are non-UK EU nationals. What will Brexit eventually mean for them? The question of whether free movement of labour should be possible between the UK and other European countries was an issue at the heart of the referendum debate. Until the exact terms of the exit are known, the employment rights and options for that 7% remain uncertain.

While there are a number of tax aspects that are relevant to the pharma sector, the key issue will be about regulatory and legal framework post Brexit. From a regulatory and legal standpoint, life sciences companies will want to plan for and take action in the following areas:

• Marketing authorization: If the UK remains part of the European Economic Area (EEA), it may continue to retain the same benefits as the EU, meaning the centralized marketing authorization procedure will continue to apply, and drugs that have been approved in the UK will also be approved across Europe. It is possible, however, that there may be additional controls that would require negotiation. This could slow regulatory approvals.

• Regulatory strategy: The EU regulations enable pharmaceutical companies to go through a single approval process managed by the European Medicines Agency (EMA), significantly reducing the cost of drug approvals. Since the EMA is currently headquartered in London, many international companies have positioned their European regulatory operations in the UK. On leaving the EU, the EMA will have to move. It anticipated that the regulatory European centres of many of these companies will do the same.

• Supply chain flow: From a supply chain perspective, and in case of "hard exit" (a scenario that would see the UK opt out of the single market), the physical flow of drugs between the UK and the EEA would be deemed importing or exporting, requiring new operating licenses and quality controls.

• Regulatory organization: Depending on what decisions are made regarding regulatory strategy and supply chain, life sciences companies will likely

need a new setup for their regulatory organizations. Specifically, they may need to move people. Additionally, companies will have to rethink their contractual agreements around pharmacovigilance and quality.

• Clinical trials: UK pharmaceutical companies may lose the benefit of a single process application for their clinical trials across Europe.

• IP rights, data privacy and contracts: Contract implications will revolve around whether a Brexit clause would trigger termination. A significant question for life sciences companies is whether Brexit would be considered a material adverse change in a transaction. In addition to renegotiating contracts, life sciences companies will need to think about the legal implications of IP rights (which could affect the parallel market) and data privacy.

FINANCIAL SERVICES

• Passporting: Currently, banks operating in the UK benefit from rights grounded in EU law which facilitate their access to other EU countries as well as Norway, Iceland and Lichtenstein which together constitute the EEA. In particular, 'passporting' allows banks authorised in any EEA country to carry out an activity covered by one of the EU's Single Market directives without needing separate authorisation in each country. Such banks can either (i) set up a branch in another EEA country (an 'establishment' or 'branch' passport), or (ii) provide cross-border services (a 'services' passport) from its EEA home country. Banks with entities situated in the UK or other EU jurisdictions have relied on passporting rights and the right of establishment to operate across borders, without needing to seek separate authorisation for each of these separate entities, with all of the additional costs this would entail. However, these rights are now in doubt in a post-Brexit world if the UK leaves the EU with no equivalent arrangement in place. Passporting has made the UK a desirable location for establishing a platform to operate throughout the EEA, underpinned by a favourable time zone, language, stable legal system, infrastructure, access to supplies of professional services and quality of life.

• Markets in Financial Instruments Directive (MiFID II): The UK may seek to negotiate a settlement which establishes an equivalence agreement with the EU to rely on their supervision framework. Subject to the UK satisfying all the necessary equivalence requirements, the second Markets in Financial Instruments Directive (MiFID II), which covers wealth- and investment-related activities (but not deposit-taking or lending), will come into force in January 2018. It may provide some, but not full, access for banks located in the UK when undertaking certain wealth and investment-management activities in relation to non-retail clients. For example securities trading together with ancillary services like margin loans are covered under MiFID II, but normal corporate lending and other banking services are not. Therefore, as the legislation currently stands, banks located in the UK seeking to continue to provide services in the EEA will need at the very least to apply directly to the appropriate regulator(s) in at least one EEA country for permission to conduct regulated business there, from which they can then apply for passporting.

• Indian banks will typically operate in the UK through a branch structure. This branch will allow them to provide services or advice to clients in any EEA country. If the passport rights are no longer enjoyed by their UK branches going forward, Indian banks will need to consider whether a new company needs to be incorporated into an EEA country in order to continue to benefit from passporting rights across the EEA. Many banks operating in the UK have the country's regulator (the Prudential Regulation Authority or "PRA") as the lead regulator for the entirety of their EEA business. If the UK leaves the EU and no equivalent arrangement is put in place, it is likely that another lead regulator will be required for any business located in the EEA.

The legal framework under which the UK will withdraw from the EU

As a matter of EU law, Article 50 of the Lisbon Treaty provides the only mechanism for withdrawal. Under Article 50:

• It is up to the UK to notify the European Council of its decision to withdraw – the EU cannot start withdrawal proceedings itself

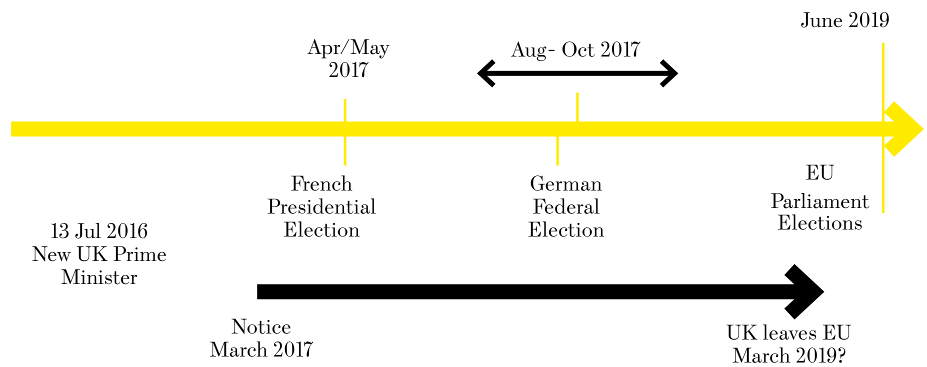
• The European Council must negotiate an agreement with the UK "setting out arrangements for its withdrawal, taking account of the framework for its future relationship with the [EU]"

• The agreement must be approved by a qualified majority of the Council (excluding the UK) after receiving the consent of the European Parliament; and, depending on its nature, may require additional ratification by every national parliament in the EU

• If no agreement has been reached within two years of the UK's formal notification under Article 50, the UK will exit the EU without any framework for their future relations. That two-year period can only be extended by a unanimous decision of the European Council (acting without the UK) and separately agreed by the UK

ARTICLE 50 – POTENTIAL TIMELINE

- Once notice given, negotiations start and clock is running - when to give notice? Government committed to March 2017 at the latest.
- Treaty provides for two years could be shorter if agreed or longer if extended by unanimity



WILL THE UK CHOOSE THE 'HARD' OR 'SOFT' OPTION?

The UK Government will decide a basis upon which to negotiate the exit. Will it be a soft, hard or somewhere-in-between approach? Under a soft exit, the UK would potentially adopt a position similar to Norway's, departing from the EU but not the European Economic Area (EEA). Retaining EEA membership would allow the UK to share some of the same benefits as EU member states. A hard exit, on the other hand, would result in considerably more extensive changes than in a soft exit. Additionally, a hard exit could lead to greater instability and fluctuations in financial markets.

WHAT AREAS SHOULD BUSINESS REVIEW?

As businesses prepare for the UK to leave the EU, it is important that they consider the tax implications, including:

- The immediate foreign currency, liquidity and trade impacts that have already occurred or will occur
- Dividend and interest flows and associated withholding tax costs that would result from the UK being outside EU; and the related impact on group structure
- Supply chains and how EU trade flows and tariffs may increase costs
- The tax impact of any restructuring and relocation
- Issues relating to the cross-border movement of staff

TAX IMPACT – A DISCUSSION

As noted above, finalizing the terms of the UK's exit is likely to take two years from when the UK formally notifies its intention to leave. While this means that there will be some uncertainty surrounding the framework for future dealings between the UK and the EU, it is important to note that the UK's attractiveness is rooted in the UK's commercial attractiveness to international investors and its domestic tax and regulatory framework and is not solely dependent on the UK's membership of the EU.

On leaving the EU, the UK is aiming to achieve greater flexibility in determining its fiscal and global trade policies. A renewed focus by the UK Government on improving the UK's attractiveness for business through targeted incentives (subject to any continuing EU state aid restrictions) and greater government support for inbound businesses is to be expected. The UK will also look to ensure that its laws on employment and wage determination remain competitive compared to other European countries.

The UK's exit from the EU may have different degrees of impact for trade between the UK and the EU in different sectors. Depending on other potential changes (such as to tax treaties), the tax impact is not expected to be significant for the following:

- UK-based holding company and sub-holding company activity
- UK-based treasury centers
- Regional management hubs
- Unregulated service centers
- Regional intangible assets holding activity in unregulated sectors

The UK's exit from the EU is expected to have a more significant impact on the UK's physical trading hubs, with significant UK/EU trade in physical goods, and most significantly in the context of regional hubs for regulated financial services (especially banking, insurance and asset management).

India is one of the largest foreign investors into the UK and there is substantial trade between the two countries. There appears to be a clear recognition of this with the UK's business secretary making a visit to India shortly after the EU referendum and the more recent and high profile visit by the UK Prime Minister to India; both of which had a significant focus on discussing how the India-UK trading relationship might work after Brexit. The UK government remains positive that Brexit presents the UK with an unprecedented opportunity to improve on its already strong position as a global hub across sectors. The significant reductions to the UK's corporate tax rate and various other incentives are not expected to be impacted by Brexit and reinforces the message that the UK is 'open for business'.

LIMITATION OF INTEREST DEDUCTION UNDER SECTION 94B – AN ANALYSIS

– CA Rutvik Sanghvi

The last few years have witnessed a global upheaval in terms of cooperative and concentrated action by many nations to bring in anti-tax avoidance measures. The Base Erosion and Profit Shifting **("BEPS")** project and resultant final Action Reports issued by OECD have resulted in changes in domestic laws of various countries. India was also a part of this Project and has incorporated measures related to Country by Country Reporting under Transfer Pricing and Equalisation Levy in the past year. This year, Finance Act 2017 has introduced another measure with regard to deductibility of interest expense which is explained in detail below.

1. BASE EROSION FROM INTEREST DEDUCTIONS AND ACTION UNDER THE BEPS PROJECT:

1.1 One of the ways in which a non-resident can remit profits out of India without tax or by suffering lower tax (as compared to dividend payments) is by charging interest expense to its Indian Associated Enterprise (AE). The expense in the Indian AE reduces its profits. The interest income in the hands of the Non-Resident Associated Enterprise **("NR AE")** may not be taxed or may be taxed at lower tax rate. This results in Base Erosion in India, i.e., it lowers the base of income which India can rightfully tax. G20 & OECD have under the BEPS Project made attacking many such Base Erosion arrangements as their fundamental objective. There can be several ways in which higher interest payouts are made between associated entities.

1.2 BEPS Action Plan No. 4 on **"Limiting Base Erosion Involving Interest Deductions and Other Financial Payments"** was initiated to tackle this issue. The Final Report on Action 4 has recommended countries to introduce in their domestic tax laws provisions to **limit deduction from interest expenditure.**

Action Report 4 recommends a **"best practice approach"** as some or a combination of the following measures:

i) A **Fixed ratio** rule which allows an entity to deduct net interest expense up to a benchmark net interest/ Earnings before Interest, Tax, Depreciation and Amortisation **("EBITDA")** ratio; coupled with

ii) An optional **Group ratio** rule which allows an entity to deduct net interest expense up to its group's net interest/ EBITDA ratio where this is higher than the benchmark fixed ratio; and

iii) An optional rule for **Carry forward** of disallowed interest /unused interest capacity and/or carry back of disallowed interest; along with

iv) An optional de **minimis monetary threshold** to remove low risk entities.

This can be supported with "Targeted rules" to aid general interest limitation rules and address specific risks; as also "Specific rules" to address issues raised by the banking and insurance sectors.

1.3 Government of India has adopted the Fixed Ratio rule from this BEPS Report in formulating its provision for restriction on deductible interest expenditure by way of Section 94B. However, the rule has been appropriately narrowed down and is in variance from the recommendations of the Report in some manners. These differences and other notable points of interpretation are brought out in the analysis below.

2. Section 94B:

2.1 The Finance Act 2017 has introduced Section 94B to limit the interest which can be allowed as an expense under the Act. The provision is applicable from Financial Year 2017-18.
As per this Section, deduction for interest expense is restricted when interest expense is incurred by a company on payment towards debt from a NR AE. Interest expenses on debt from an unassociated enterprise which is based on guarantee or funds provided by an AE are also covered. This restriction also applies to a Permanent Establishment of a non-resident in India.
In the above-mentioned cases, the total amount of interest paid over and above 30% of the EBITDA; or the actual amount of interest paid to the Associated Enterprise; whichever is lower, is disallowed.

2.2 The broad layout of Section 94B is:
The above provisions are discussed in detail below.

Applicability of the provision	Sub-sections 1 & 3
Computation of disallowance	Sub-section 2
Carry-forward of disallowed amount	Sub-section 4
Definitions of terms used	Sub-section 5

The above provisions are disacussed in detail below.

3. Applicability of Section 94B:

Section 94B(1) and Section 94B(3) which provide for the applicability of these provisions are reproduced below:
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.

3.1 As per the above provisions, the restriction on interest expenditure is applicable only when all the following conditions are applicable cumulatively:

(i) Interest is payable by an Indian company; or by permanent establishment of a foreign company in India. (Non-Corporate assessees are not covered.) Banking or Insurance companies are not covered.

(ii) Interest is payable to a NR AE or to a third-party lender to whom such NR AE has provided guarantee or matching funds as explained in para *3.2 below.*

(iii) Interest incurred towards debt from AEs or above-mentioned lenders is in excess of INR 10 million in the particular Financial Year.

(iv) Interest is claimed as deductible expenditure against income taxable under the head "Profits & Gains from Business or Profession".

As the above conditions are to be applied cumulatively, there will be no applicability of Section 94B in any of the following cases:

(i) If interest is paid by a non-corporate entity; or
(ii) If no interest is paid to a NR AE; or
(iii) If interest paid is not deductible from profits or gains from business or profession; or
(iv) If the total interest paid to NR AE is less than INR 10 million.

3.2 Borrowings from third-party lenders:

3.2.1 A non-resident AE may arrange loans to its Indian AE differently. The loan may be given to the Indian AE by an unassociated enterprise based on or relying on:

(i) a guarantee given by the NR AE; or
(ii) funds provided by the AE to a third-party lender.

Proviso to Section 94B(1) states that in such cases where interest is paid to an unassociated entity, it will be deemed that the payments are made to an AE. Accordingly, Section 94B can apply.

3.2.2 For example, the foreign parent company provides a guarantee – implicit or explicit - to an unassociated lender, which then lends funds to the Indian AE; such a transaction will also be considered to be a transaction with an AE.
The term "guarantee" is not defined under section 94B or in the Act. The Indian Contract Act defines guarantee 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.
While explicit guarantee could be understood as an express agreement or a contract of guarantee, implicit guarantee would have a wide coverage. For transfer pricing provisions, tribunals have examined the issue of letter of comfort qualifying to be a "guarantee". However, the term "guarantees" being undefined can lead to litigation going forward.

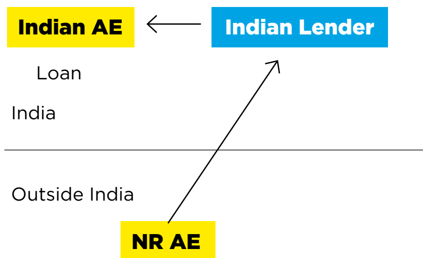
3.2.3 Similarly, if the NR AE deposits funds with a lender, which then provides the loan to the subsidiary, such debt transactions will also be covered. However, in such a case, the funds deposited by the NR AE must correspond and match the debt provided by such lender.

3.2.4 Mix of guarantee and funds: Depending on the comfort level of the bank, the amount deposited may be less than the loan amount. For example, a bank provides loan to an Indian company based on deposits provided by such company's foreign parent. However, the 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. In such a case, will interest paid to the bank be covered under Section 94B?
A view can be that it is "implicit" that the parent company is providing a guarantee for the balance 75 per cent of the debt. The guarantee need not be in form of a contract. Such loans provided on the basis of a mix of guarantee and funds would also get covered under this provision.
It should also be noted that 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. It need not match the debt amount.

3.2.5 It should be noted that the Report on Action 4 does not directly provide for inclusion of such deemed transactions. However, as part of the "best practice" advocated by it, all interest payments made by an entity are subject to the overall limit of Fixed Ratio. Therefore, there seems to be no need for separately deeming interest payments to third-party lenders as those by related parties. The Report cites similar provisions in France and USA where such third-party transactions are included in the coverage of general interest limitation rules.

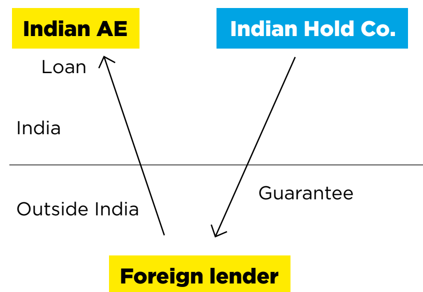
3.2.6 Resident third-party lender: Consider an example. Interest payments are made by an Indian Company to an Indian Bank for debt which is borrowed based on guarantee provided by a NR AE. Interest payments are made within India only. Will provisions of Section 94B apply in such a case?



The proviso to Section 94B(1) states that payments made to a third-party lender in such a case will be deemed to be payments made to an AE. However, the main provision in Section 94B(1) states that only payments made to a non-resident AE are covered. The proviso does not extend the deeming fiction to state that the payments to third-party lenders will be deemed to be payments made to a non-resident AE. In such a case, the payments made to the Indian Bank will be deemed to be payments made to an AE. However, the payments are still made to a resident AE and not a non-resident AE.
In this situation, Section 94B will not be applicable. This will also be in line with the objective of this provision to target only arrangements which

Table III.B.1. of the Report "General interest limitation rules based on a financial ratio"
lead to Base Erosion. Payments made within India to a third-party would not lead to Base Erosion in India.

3.2.7 Guarantee by Resident AE: Another example: 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?



The proviso to Section 94B deems borrowing by an Indian AE from an unassociated lender as borrowing from an AE, if guarantee or funds are provided by an AE – whether resident or non-resident. Further, the payment by the Indian AE is to a non-resident. Therefore, Section 94B will apply.

Strictly speaking, the proviso extends the application of Section 94B to cases where guarantee or funds are provided even by a resident AE.

Again this is in line with the objective of tackling Base Erosion. While both the AEs are Indian residents, it is still leading to lowering of tax base in India as payments are being made to a non-resident.

3.3 "Debt" and "Interest" defined: Expenditure by way of interest or of similar nature in respect of any debt is covered under Section 94B.

3.3.1 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".

3.3.2 Further, Section 94B does not define the term "interest" or expenditure of similar nature. The term "interest" is defined under section 2(28A) of the Act:

"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.

3.3.3 The Report on Action 4 provides for inclusion of interest and payments economically equivalent to interest. Chapter 2 of the Report provides that under the 'best practice' approach, following payments should be included:

(i) interest on all forms of debt;
(ii) payments economically equivalent to interest; and
(iii) expenses incurred in connection with the raising of finance.

It further states the that the above should include among other items imputed interest on convertible bonds & 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; and similar costs.

It should be noted that the definition of interest under the Act does not cover many of the items mentioned in the Report.

3.3.4 Interest is also defined under Double Tax Avoidance Agreements ("DTAA") and can have a different meaning from that as per the Act. The OECD Model in Article 11(3) defines

interest. However, it must be noted that Article 11 is for computing income earned by a lender, while Section 94B relates to computation of expense claimed as deduction by the borrower. Therefore definition as per DTAA has no relevance for Section 94B.

3.4 Payments deductible under the head "Profits & Gains from Business or Profession":

It should be noted that only expenditure deductible under the head "Profits & Gains from Business or Profession" are covered. Therefore, following payments will not get covered under Section 94B:

3.4.1 Interest expenses which are not claimed as deductible business expenditure. For example, interest expenditure which is capitalised in the books (added to cost of assets). Such interest cost forming part of assets will be allowed as depreciation and not deducted as expenditure from business income.
However, it should be noted that Report on Action 4 covers capitalised interest payments in the coverage of its "best practice" approach to limit such deductions as mentioned in para 3.3.3 above.

3.4.2 Interest payments deductible under the head "Income from Other Sources". For example, debt provided by NR AE is 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 "Profits & Gains from Business or Profession". Section 94B would not apply in such cases.

3.4.3 Similarly, interest expenditure for rental income taxable under the head "Income from House Property" would have restrictions as specified in Section 24 and not as per Section 94B of the Act.

4. Disallowance of interest:

4.1 Section 94B(1) provides for disallowance of "excess interest" in case all the conditions mentioned in para 3.1 above are met. Section 94B(2) provides the computation of excess interest which is to be disallowed:

(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.

As mentioned above, the excess interest is to be computed by comparing the amount of total interest exceeding 30% of EBITDA with the amount of interest paid to AE. However, there are at least two other possible views on computation of excess interest which are explained below.

4.2.1 Second view:
Splitting the operative limbs of Section 94B(2) in a different manner can lead to another interpretation. This is shown as part of a comparative table below:

First View (Para 4.1)	Second View (Para 4.2.1)
Excess Interest means:	Excess interest means:
(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
(ii) interest paid or payable to AEs in the previous year;	(ii) an amount of total interest which exceeds interest paid or payable to AEs in the previous year;
- whichever is lower.	- whichever is lower.

In simple words, 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.

Therefore, there are two limits, the lower of which is to be applied for computation of disallowance from interest deduction.

One issue is clear: There will be no disallowance under Section 94B if no interest is paid to a NR AE; or if the total interest paid is less than 30% of EBITDA.

There are some points in relation to computation of excess interest which are mentioned below.

4.2 Quantum of excess interest:

The second view is also possible if the provision is read differently. An example is provided in para 4.2.3 bringing out the difference in computation of excess interest over all the interpretations.

4.2.2 Third view:
There is another view that the "total interest" mentioned in Section 94B(2) is to be limited to only interest paid to AEs. This is because Section 94B(2) starts with the phrase "For the purposes of sub-section (1)…".

As sub-section (1) of Section 94B refers only to a restriction on interest paid to NR AE, computation of disallowance must also be restricted only to amounts of interest paid to AEs. In short, as interest paid to unassociated enterprises is

not targeted in Section 94B(1), the computation of 'excess interest' also must not include such interest amounts.

4.2.3 The above differing views on computation of excess interest result in a varying amounts of disallowance which can be understood better by an example:

PARTICULARS	INR IN MILLIONS
EBITDA	1000
of EBITDA 30%	300
Total interest	500
Interest paid to AE	150
Interest paid to unassociated enterprises	350

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 paid to AE exceeding 30% of EBITDA [(500-150)-300]			50
Amount as per Second limb:			
Views 1 & 3: Interest paid to AE	150		150
View 2: Total interest exceeding 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

As can be seen from the above table, different interpretations of the same provision can lead to disallowance of higher or lower amounts as compared to View 1.

4.2.4 In my view, the objective of this provision is to limit Base Erosion on account of interest payments to a NR AE. This limit has been set at 30% of EBITDA. Hence, interest paid to NR AE will be restricted to 30% of EBITDA as a maximum limit. If the interest paid to such AE is lower than 30% of EBITDA, no disallowance is required.

Both the other views mentioned in paras 4.2.1 and 4.2.2 do not conform to the above objective.

Therefore, computation of "excess interest" should be as per View 1. This view is 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."

However, it is a case of unclear drafting of law and to avoid unnecessary litigation, a circular clarifying the intent of the legislature would provide much needed clarity.

4.3 Gross vs. Net Interest:

4.3.1 The Report on Action 4 provides that the limitation of interest deduction at the Fixed Ratio should apply to the net interest payment made by the tax payer to its NR AE. Interest payments made by the borrower would be netted off from the interest incomes earned by it. The limit would be applied on the resultant net amount of interest paid.

4.3.2 However, Section 94B provides that the excess interest has to be computed based on the gross interest payments made by the Indian borrower company and not the net interest. This results in double taxation to the extent of interest income being fully taxed while deduction for interest expense is restricted.

4.3.3 The Report on Action 4 provides that the gross interest expense option would be simpler to apply and is likely to be more difficult for MNC groups to circumvent through planning. However, it goes ahead to provide that the recommended approach is to apply the limitation rules to net interest expense. It further recommends countries to supplement the net interest limitation rule with targeted provisions to cover specific situations.

4.3.4 The Finance Act 2017 has provided for gross interest expense and has done away with further specific anti-avoidance rules. Therefore, the disallowance under this Section is to be made from the total interest payments made by a company. This is simpler to apply. In any case, foreign exchange regulations restrict on-lending by Indian companies which obtain foreign loans except for Non-banking Finance Companies ("NBFCs").

4.3.5 Implications on NBFCs:

NBFCs are particularly hit by Section 94B. NBFCs do not qualify for exemption from Section 94B(3) as they are not considered to be in the 'business of banking'. It should be noted that the phrase 'business of banking' has not been defined in this provision or the Act. However, NBFCs are not covered within the definition of 'banks' and are regulated under the RBI Act, and not the Banking Regulation Act.

In quite a few cases, NBFCs are set up in India by non-residents. Such

NBFCs may have been lent funds by their holding companies or group companies for onward lending. In such cases, disallowance as per Section 94B will apply to gross interest payments made by NBFCs to their NR AEs. Interest income earned from lending operations will not be allowed as a set-off before computing disallowance under Section 94B.

Therefore, while there will be a restriction on deductions for interest payments, their interest incomes from deployment of these same funds would be fully taxable. This can lead to a double-whammy as interest expense in most cases would be higher than limit of 30% of EBITDA under Section 94B. An amendment should be brought to exclude businesses carried on by NBFCs from the restrictions under Section 94B.

4.4 Fixed Ratio Rule:

4.4.1 The BEPS report discusses several ways (or combination of ways) in which excess interest can be disallowed. More countries are adopting a Fixed Ratio rule as adopted by India in Section 94B. BEPS has recommended that countries may fix the maximum allowable interest deduction ratio between 10 to 30% of EBITDA. Interest deduction above this ratio will be disallowed.

4.4.2 India has adopted a ratio of 30% - perhaps considering the higher interest rates in India compared to developed countries where the rates are much lower. The thought behind applying a fixed ratio is that it is objective and simple. It avoids other difficulties of finding the market rate of interest, debt-equity ratio, etc.

4.4.3 Further, the Report on Action 4 also provides for a Group Ratio Rule. This ratio would provide a limit on interest deduction for the group as a whole as against a particular entity in the group. Section 94B does not provide any such group ratio.

4.5 EBITDA:

What should be considered for EBITDA? Does it refer to earnings as per accounting standards or earnings as per the Act? The law does not provide for the same.

4.5.1 The BEPS Report on Action 4 states that EBITDA can be as per tax law or accounting standards as the country may provide. Further it also states that incomes which are exempt from tax (like dividend) should not be considered to compute EBITDA. This is logical. If the income is exempt, the expenses pertaining to such income also cannot be allowed. By not considering such incomes for EBITDA, automatically the interest to be allowed is restricted. Section 14A of the Income-tax Act provides a similar disallowance while computing taxable income.

4.5.2 Further, Income Computation and Disclosure Standards (ICDS) which are applicable from 1st April 2017 mandate capitalisation of borrowing costs which are slightly different from provisions of Ind-AS or Indian GAAP. This may result in differences in claim of interest expenditure for tax purposes as compared to those incurred as per books of accounts. These differences would not be captured under Section 94B.

4.5.3 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 in this aspect.

5. Carry forward of disallowed interest:

5.1 Section 94B(4) provides that 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. The total deduction (for past years' interest and current year's interest) in any year cannot exceed the limit of 30% of EBITDA as per Section 94B(2).

The carry forward facility is allowed for a maximum of 8 years immediately succeeding the year in which excess interest is disallowed.

5.2 However, the wording of the provision can lead to two views which are mentioned below. For example, the factual pattern is as follows:

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**

In the above scenario, the issue is 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? Both views can be tabulated as follows:

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

This issue comes out from a combined reading of sub-sections (4) and (1) of Section 94B. 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.

6. Interplay with other SAARs & GAAR:

Section 94B is not the only provision restricting claim of interest expenditure. There are other Specific Anti-Avoidance Rules ("SAARs") namely – Section 14A, Section 36(1)(iii), Section 40(a)(i), Transfer Pricing provisions, etc., & General Anti-Avoidance Rules ("GAAR") which provide their own conditions and implications for interest deductions. Interplay between Section 94B and these provisions are discussed in detail below:

6.1 Transfer Pricing (TP):

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. Will the disallowance be for:

- Adjustment under TP rules?; or
- Restriction on total interest under Section 94B?; or
- Both amounts?

It seems both the Rules can co-exist and apply simultaneously as shown below:

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

On application of TP rules, the interest deduction is adjusted to the amount computed at the arm's length rate. This adjusted interest deduction is then analysed for disallowance under Section 94B as under:

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**

Under the TP rules the target for disallowance is the excess interest paid over the arm's length interest rate. Disallowance under Section 94B is to limit the deduction from interest paid to AE within 30% of EBITDA. Both have differing objectives and hence both need to be applied to work out the total amount of disallowance. The carry-forward under Section 94B(4) will be only of the amount of excess interest computed after adjustment under TP.

6.2 GAAR & Thin Capitalisation Rules:

6.2.1 Higher the debt, more the interest which can be claimed as an expense. To increase the tax benefit through high interest payments, non-residents resort to arrangements where debt provided to its AE in India is much higher than the AE's capital. In fact, debt takes place of capital. High debt on a base of low equity capital (thin equity) results in "Thin Capitalisation".

6.2.2 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 the loan provided by the non-resident is in excess of the permitted debt-equity ratio, then the interest corresponding to excess loan is considered as dividend for income-tax purposes. As a result of this treatment (i) Interest expense is disallowed in the hands of the borrower; and (ii) the non-resident is taxed as if it has earned dividend. In this manner, if any undue tax benefit is attained through high debt, it stands reversed.

6.2.3 Section 94B does not prescribe any disallowance for high debt-equity ratio – only for high interest payment. Even the Report on Action 4 states that Thin Capitalisation Rules are separate from the recommendations of the Report. In fact, it recommends introduction of Thin Capitalisation Rules in addition to the rule on Limitation of Interest Deduction.

6.2.4 In the Indian context, the TP rules do not provide a specific adjustment for high-debt equity ratio. The Bombay High Court in Besix Kier Dabhol SA upheld the decision of the Mumbai ITAT wherein a claim for deduction of interest was allowed in a similar situation. In this case, the assessee had a very high debt-equity ratio of 248 : 1 and was hence clearly thinly capitalised. However, the ITAT held that in the absence of any specific thin capitalization rules in India, it could not be open to the revenue authorities to recharacterize the debt capital as equity capital, and, accordingly, disregard the interest payments as tax deductible.

6.2.5 However, the GAAR provisions which are also applicable from FY 2017-18 may cover such arrangements under clauses (a), (b) or (c) of Section 96(1) which defines an impermissible avoidance arrangement. A hint can be gleaned from the fact that Section 98(2) which provides for consequences states that for the purposes of 98(1), any equity may be treated as debt or vice versa. Therefore, there is a good chance that Thin Capitalisation arrangements may get covered under GAAR.

6.2.6 Disallowance of interest under Section 94B is a SAAR. Having applied this specific rule, can GAAR also apply? The recent circular by CBDT states that GAAR can apply even if there is a SAAR applicable to the same arrangement. By this logic, other SAARs can also apply.

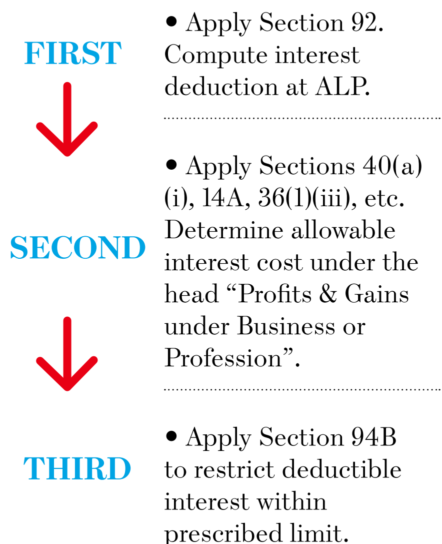
6.3 Section 40(a)(i):

6.3.1 Section 40(a)(i) provides for disallowance of interest payments to a non-resident where taxes have not been deducted at source. This limits the interest deduction for computing profits from business and profession. There can still be disallowance under Section 94B if the deductible interest exceeds the prescribed limits.

6.3.2 Similarly, Section 36(1)(iii) restricts deduction for interest payments made towards acquisition of an asset. Such interest costs are to be added to the cost of the fixed asset. Here again, Section 94B will apply only to the interest amount deductible after disallowance.

6.4 Order of applicability of SAARs:

6.4.1 Considering all the above provisions, which SAAR is to be applied first? Can we say that the provisions apply in the following hierarchy:



In case of impermissible avoidance arrangement, GAAR can also apply. In such a case, the consequence can be reduction or re-characterisation of interest expense. Then the above provisions will apply considering such lower amount of interest.

6.4.2 There can be two views on the order of disallowance between Section 40(a)(i) and Section 94B.

Section 94B prescribes disallowance for interest deductible under the head "Profits and gains of business or profession". Therefore, one view is that interest amount which is deductible under this head must be computed before resorting to Section 94B. In such a case, disallowances under Sections 40(a)(i) would be made first. Section 94B would then apply only on such deductible interest amount.

6.4.3 Let us take an example to understand the order of applicability between Section 40(a)(i) and Section 94B.

In this case, the limitation for interest deduction under Section 94B will apply to only those interest amounts which are deductible for tax purposes after application of Section 40(a)(i).

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

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**	

6.4.4 There can be another view that restriction under Section 94B must be applied before disallowing any interest under Section 40(a)(i). This view stems from the fact that Section 94B is a non-obstante provision starting with the phrase "Notwithstanding anything contained in this Act...". Contrast this with the fact that 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.

Further, the word 'deductible' only means that Section 94B would apply as long as there is any interest amount which qualifies for deduction before applying Section 40(a)(i). Therefore, one needs to consider those interest amounts which are deductible and not those which are in fact deducted after application of Section 40(a)(i).

View 2: Apply Section 94B first	**INR**	**INR**
Total interest		500
94B disallowance (Lower of (A) or (B)):		
(A) Excess of total interest over 30 percent of EBITDA: (500–300)	200	
(B) Interest paid to NR AE	150	
94B disallowance: Lower of 200 and 150		**150**
Interest after 94B disallowance		**350**
Less: Disallowance under Section 40(a)(i)		(100)
Interest allowable for deduction		**250**
Interest to be carried forward under Section 94B for 8 years	150	
Interest allowable as deduction in future years when tax deducted at source under Section 40(a)(i)	100	

6.4.5 Both the above views seem possible. However, in my opinion, the 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.

The Report on Action 4 also suggests that other targeted and general interest limitation rules should be applied before the fixed ratio rule . However, domestic laws can always override what is specified in the Report.

It should be noted that 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.

6.4.6 As can be seen above, there can be a lot of unnecessary confusion in application of Section 94B vis-à-vis other provisions impacting the same transaction. It would be better if clarity is provided in law itself as to the order of applicability of the various disallowance provisions.

7. Application of Foreign Exchange Regulations:

Foreign Exchange Management Act ("FEMA") has its own restrictions on External Commercial Borrowings ("ECBs"), i.e., foreign loans. Under FEMA, it is possible for a foreign shareholder to provide loan to the Indian investee company. However, there are restrictions on borrowers, end-uses and maximum interest rates. Specifically, foreign loans are not allowed for on-lending.

The Directions provide for an "ECB Liability : Equity" ratio of 4:1 under the Automatic Route (without need for an approval) and a ratio of 7:1 under the Approval Route if total ECBs exceed USD 5 million. Further, it also states that the borrowers would be governed by debt : equity ratio prescribed, if any, by the concerned sectoral or prudential regulator.

8. Non-discrimination:

8.1 Article 24 of the OECD Model Tax Convention on Income and on Capital provides for "Non-discrimination" rules. This Article provides for elimination of discrimination in tax provisions in certain specific circumstances. Therefore, two countries entering in to a treaty agree to a set of non-discrimination rules whereby tax provisions will not be cumbersome just on account of factors like nationality, situs of a permanent establishment, etc.

8.2 Paragraph 4 of Article 24 of the OECD Model Tax Convention provides for a deductibility non-discrimination rule. As per this rule, discrimination resulting from restrictions on payers claiming deduction from their taxable profits of interest, royalties and other payments to non-residents are sought to be eliminated. It should be noted this rule applies to the deductor and not the income-earner.

The objective is that a tax payer making payment from India to non-residents must not be worse-off when claiming a deduction for such payments, as compared to the deduction available if the same payments were made to Indian tax residents.

This principle of deductibility non-discrimination has been considered while providing relief to the deductor in case of Section 40(a)(i) in DCIT v. Gupta Overseas .

8.3 Article 24 clarifies that this rule does not prohibit a country from applying domestic rules on thin capitalisation as long as they are compatible with Article 9(1) or Article 11(6). Article 9(1) refers to transfer pricing rules while Article 11(6) mandates that the amount of interest paid between related parties cannot exceed an amount which would be paid between unrelated parties. This is similar to the Transfer Pricing rules under the Act.

Section 94B provides for a broad limitation on interest deduction, irrespective of the rate of interest. Therefore this provision would not be covered within the exclusions cited in

Articles 9(1) and 11(6).

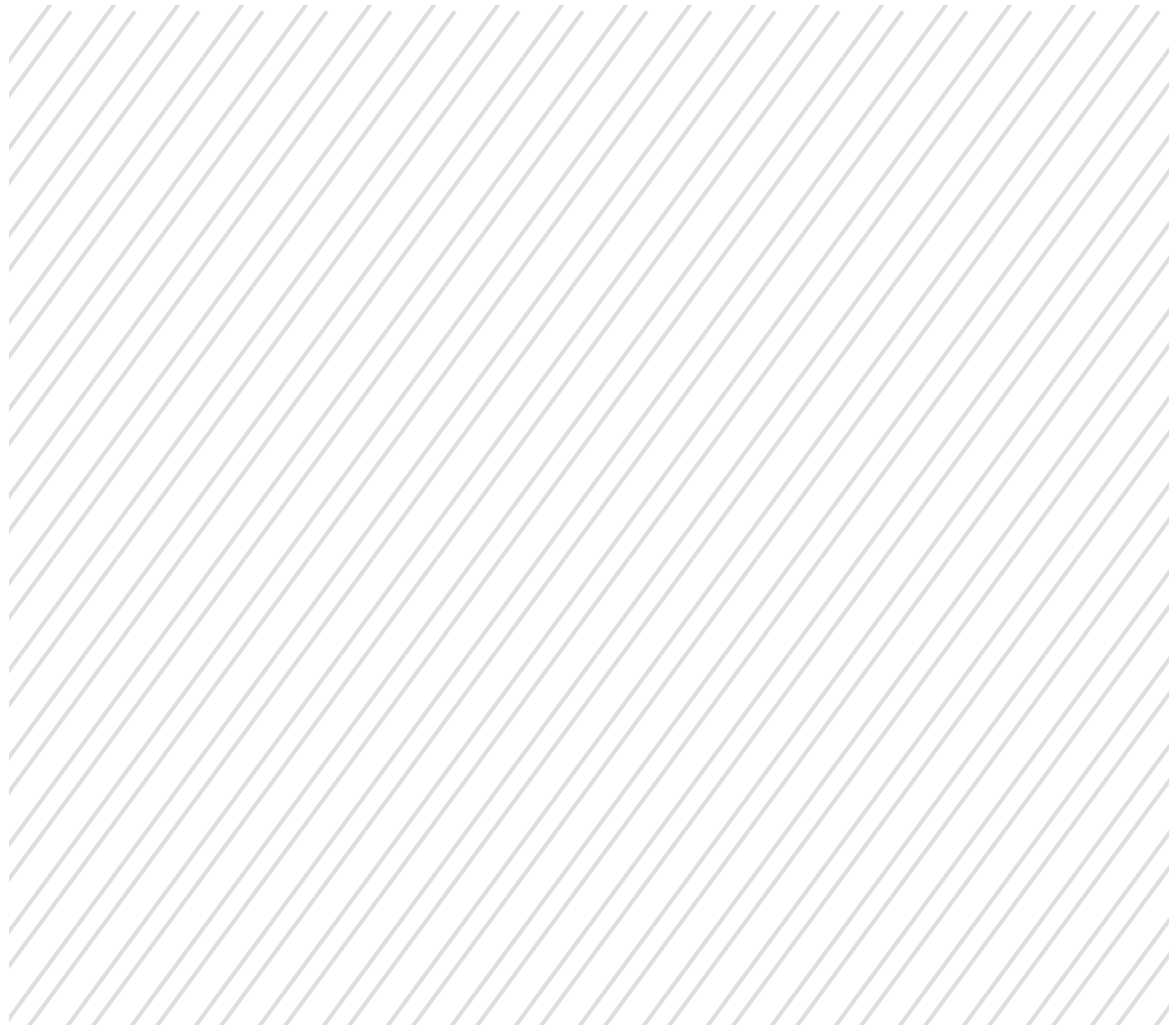
8.4 The Report on Action 4 does not deal with Non-discrimination rules and their impact on its recommendations directly. However, it recommends, more than once , that if a country chooses to apply only the Fixed Ratio rule, it should apply the same consistently and without improper discrimination to both domestic as well as multinational groups. Hence, it does not envisage any discrimination between residents and non-residents in its best practice approach.

8.5 However, the restriction under Section 94B applies only to deductions from payments to non-residents. The proviso to Section 94B(1) which covers unassociated enterprises also applies only to non-resident lenders as discussed in para 3.2.6 above.

Therefore, there can be a view that restriction on deduction under Section 94B would not apply where payments are made to a resident of a country with which India has entered in to a DTAA which contains this deductibility non-discrimination rule. It should be noted that not all DTAAs entered in to by India provide for such a non-discrimination rule.

9. Conclusion:

From the above analysis, in my view, Section 94B, while introduced on the recommendation of BEPS Report on Action 4 has been suitably modified for the Indian context. It is targeted more specifically to Base Erosion from payments to non-residents. However, several issues can crop up based on the wording of the provision which makes this provision prone to litigation. It may be useful to have clarity from the tax department on such issues.



BELGIUM CARAT TAX - ANSWER TO INDIAN DIAMOND INDUSTRY'S TP WOES?

– By Pallavi Bakshi

The Belgian Government has put an end to complexity faced in verification of taxable profits of diamond traders, given the difficulties in the valuation and follow-up of individual stones in the accounts.

In December 2016, Belgium has enacted a new income tax regime specifically tailored to qualifying registered diamond traders in Belgium generating diamond "trade" income. The new regime seeks to address the difficulty of diamond traders by introducing a method to calculate the taxable profit of diamond traders that does not require the tax authorities to review the valuation of diamonds in the Belgian trader's accounts.

Under the new diamond regime, a qualifying trader's gross profit margin is "fixed" at 2.1% of its turnover. Subsequently, expenses and tax deductions can be deducted, although the net taxable income after deductions cannot be lower than 0.55% of the turnover (during the first year of the implementation of the diamond tax regime, this percentage is slightly higher, i.e. 0.65%). The net taxable income is subject to Belgium's statutory corporate income tax rate of 33.99%.

APPLICABILITY

The targeted audience for the new regime is qualifying diamond "traders". It is generally "only" applicable to traders who are selling diamonds out of their "own" inventory and accordingly, as a rule, the regime does not apply to brokers or agents. The regime is also not compulsory for mining companies and their sales offices.

The regime is applicable for Assessment Year 2017 (i.e. financial years ending between 31 December 2016 and 30 December 2017, both dates inclusive). The diamond tax regime intends to ring-fence all diamond related profits. All non-diamond business related profits (e.g. services, real estate, etc.) will continue to be taxed under the standard Belgian corporate income tax regime.

INDIAN 'TAKE'

Most of diamond players in India have faced huge transfer pricing related adjustments and penalties in last few transfer pricing assessments because of stock valuation issues and profitability on related party transactions with group companies in Belgium, Hongkong, USA, UAE, etc. Industry sometimes struggles to satisfy all the onerous requirements of 'segmental data' and precise 'one to one' correlation of purchased stock and Sold stock to related party to the complete satisfaction of transfer pricing officer at field level. Also inventory valuation sometimes becomes a subjective and vexed issue in this industry.

In light of this, there is a need to 'balance' tax officer's requirements and to 'promote the industry to enable job creation etc'. Else Indian businesses will be motivated to move trade / work to other favourable jurisdictions. Hence, should India also consider some kind of 'presumptive tax' to mitigate litigation and promote this sector? Belgium's Carat tax provides one of the approaches available in this regard with appropriate tailoring to Indian business and other circumstances.