# Budget Talk – Walk Through Some Provisions on International Taxation

*The Union Budget 2017 has been unique in not only changing the age-old tradition of being presented on the last day of February but also taking in its fold the Railway Budget. Amidst huge expectations in the post-demonetisation and looming political scenario, the Budget was well directed. The Finance Minister appears to have fairly managed an equitable balance between populist and fiscal prudence measures, addressing concerns of the foreign investors, and at the same time, made an honest attempt to enhance the tax base by incentivising digital economy. There are over 90 proposals on the direct tax front. While the fine print offers an exhaustive narration on all proposals, we have provided an insight on those impacting businesses with an international focus. Read on to know more….*

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## Thin Capitalisation Rules-Limitation on Interest Deduction

This Budget carries the baton from 2016 when India chose to follow the OECD in implementing the BEPS action plan. After introduction of Country by Country (CbC) reporting, a patent-box regime and equalisation levy last year, the government has proposed a new regulation through Section

94B to limit the excessive interest deductions by multinational enterprises.

In taxation parlance, the norms to restrict interest deductions of a corporate are known as 'Thin Capitalisation' rules. It refers to a situation where a company is highly leveraged i.e. its capital structure comprises a higher proportion of debt in comparison to equity. In a situation where the claim of interest on debt is not capped, the MNE groups with highly leveraged capital structures, get an opportunity to reduce their profit in high tax jurisdictions. Many developed countries including Australia, Canada, Germany, France and UK have adopted Thin Capitalisation rules to protect their tax base. While some disallow tax deductibility of the corresponding interest expense, others treat excessive debt as equity.

Presently, there is no specific law in India with regard to Thin Capitalisation. Interest on debt is fully deductible if it meets the arm's length criteria (generally LIBOR plus/ SBI rate is acceptable) and provides enough commercial substance to avoid a potential re-characterisation of debt as equity under the General Anti Avoidance Rules ('GAAR')[1] provisions.

The Budget has proposed to introduce Thin Capitalisation rules within the Income-Tax Act, 1961 ('the Act') by restricting the interest expense on Associated Enterprise ('AE') borrowings to 30% of Earnings before Interest, Depreciation, Tax and Amortisation ('EBIDTA'). In other words, interest to AE in excess of 30% of EBIDTA is not deductible. The intent clearly is to disallow excessive interest payments on account of interest on AE borrowings.

**Illustration: Application of Section 94B**

| Particulars | Case 1 | Case 2 | Case 3 |
|---|---|---|---|
| EBIDTA | 100 | 100 | 100 |
| Total Interest | 45 | 30 | 15 |
| Interest to AE | 10 | 10 | 10 |
| Excess Interest u/s 94B is lower of | | | |
| a) Total interest less 30% of EBIDTA; or | 15 | 0 | (15) |
| b) Interest paid to AEs | 10 | 10 | 10 |
| **Interest Disallowed** (excess interest) | **10** | **Nil** | **Nil** |
| **Total Interest Allowed** | **35** | **30** | **15** |

**The Budget has proposed to introduce Thin Capitalisation rules within the Income-Tax Act, 1961 ('the Act') by restricting the interest expense on Associated Enterprise ('AE') borrowings to 30% of Earnings before Interest, Depreciation, Tax and Amortisation ('EBIDTA').**

This rule is applicable to an Indian company[2], or a Permanent Establishment ('PE') of a foreign company, who owes interest of INR 1 Crore or more on any form of debt issued by an AE. Debt includes deemed borrowings where the AE has provided an implicit or explicit guarantee to the lender or has deposited corresponding funds with the lender. In that sense, the borrowings would include third party funds when backed by an AE. The excessive interest, not absorbed in one year, can be carried forward to eight subsequent assessment years.

It is noteworthy that Section 94B only restricts the amount of interest payments using a percentage of EBIDTA as a threshold. It has no impact on arm's length computation of such interest. Therefore, in a situation where the interest payments have been capped under Section 94B, the taxpayer may still face a transfer pricing adjustment if the ALP norms are not met adequately. Other than transfer pricing, an issue which is seemingly unresolved is application of Section 94B in a situation where EBIDTA is negative. As per the existing definition of 'excess interest', the entire interest expense may be disallowed unless the revenue authorities allow specific use of the Group Ratio Rule ('GRR')[3] as suggested under BEPS Action Plan 4 of the OECD.

**The introduction of Section 94B is a clear indication of India's willingness to walk along the BEPS action plan of the OECD. However, specific consideration may be required to address the concern that may arise in large capital intensive industries with longer gestation periods and as such, are more dependent on borrowed capital.**

[1] GAAR provisions will come into play from April 1, 2017
[2] Other than Insurance and Banking companies
[3] GRR is used to limit the interest expense disallowance through a benchmark fixed ratio linked to earnings of the MNE group as a whole

The introduction of Section 94B is a clear indication of India's willingness to walk along the BEPS action plan of the OECD. However, specific consideration may be required to address the concern that may arise in large capital intensive industries with longer gestation periods and as such, are more dependent on borrowed capital.

**The Budget has introduced Section 92CE which permits secondary adjustments under specific situations. Secondary Adjustments are those transactions in the books of accounts of the taxpayer and its Associated Enterprise which demonstrate the actual allocation of profits between parties pursuant to a Primary Adjustment.**

## Transfer Pricing ('TP')

### Scope of Domestic TP Restricted

The Domestic TP provisions were brought into statute in 2012, giving effect to the directions of the Hon'ble SC in *Glaxo Smithkline ruling*[4] which emphasised the need to extend TP provisions to domestic transactions which may potentially lead to profit-shifting and tax evasion. Accordingly, Section 92BA was inserted to define 'specified domestic transactions' to include (i) payments made to related persons specified under Section 40A(2)(b) of the Act and (ii) Inter-unit/Inter-company transactions that are eligible for tax holidays. The current Domestic TP provisions with respect to the first category of transactions, apply to certain situations between two related parties even when they are tax-neutral and does not result into base-erosion. For instance, payment of directors' remuneration, sitting fees etc. to residents are tax neutral yet subjected to arm's length evaluation. This caused genuine hardship to taxpayers.

The Budget has removed this hardship by excluding from the scope of Domestic TP, the transactions of expenditure in respect of payment to persons specified under Section 40A(2)(b). Post amendment, only the second category of transactions i.e. where one of the entities in the transaction enjoys profit-linked deductions are now subjected to Domestic TP provisions. This is a welcome step. Both the taxpayers and revenue authorities are benefitted with reduced compliance and administrative burden.

### Primary and Secondary Adjustments Introduced

The Budget has introduced Section 92CE which permits secondary adjustments under specific situations. Secondary Adjustments are those transactions in the books of accounts of the taxpayer and its AE which demonstrate the actual allocation of profits between parties pursuant to a Primary Adjustment. Secondary Adjustment is a globally recognised concept which is essentially meant to pass on the actual cash benefit which accrues to the Indian taxpayer consequent to a Primary Adjustment.

Section 92CE provides that a Primary TP adjustment of more than INR 1 Crore in the hands of an Indian taxpayer, under specific situations, would require a Secondary Adjustment. These situations arise when the Primary Adjustment is:-

- Voluntarily undertaken by the taxpayer in the tax return;
- Proposed by the tax officer and accepted by the taxpayer;
- Agreed under APA proceedings;
- Undertaken as per Safe Harbour Rules and;
- Settlement under MAP proceedings.

The computation of Secondary Adjustment would require actual repatriation of funds, equivalent to the amount of adjustment to taxable income by the concerned foreign AE of the taxpayer within a time limit to be prescribed. The funds not remitted within the time limit are treated as interest-bearing advances made by the taxpayer in favour of its foreign AE. The interest which arises on such advance is the Secondary Adjustment which is subjected to tax in hands of the Indian taxpayer.

***Illustration:*** An Indian company provides services to its foreign AE for a consideration of INR 80. The Transfer Pricing Officer ('TPO') computes Arm's Length Price ('ALP') of the said transaction at INR 100. In the instant case, the difference between ALP and transaction value of INR 20 (INR 100 less 80) represents the Primary Adjustment which is subjected to tax in hands of the Indian

[4] CIT vs. Glaxo SmithKline Asia (P.) Ltd. [2010] 195 Taxman 35

company. Should the Indian company accept ALP at INR 100, for carrying out Secondary Adjustment, Primary Adjustment at INR 20 is deemed as an advance by Indian company to its AE. Notional interest on INR 20 would accrue to the Indian company and is as such, termed as the Secondary Adjustment.

Presently, a Secondary Adjustment is required in situations where Primary Adjustment has attained finality either voluntarily or pursuant to an assessment made by the tax authorities. It is not clear whether such an adjustment is necessary in respect of matters that are decided in appeals, and at what level? Again, if the remittance is not completed even during subsequent years, would a Secondary Adjustment apply perpetually? If yes, the manner of computing such adjustment be provided.

These are issues which would likely get addressed once the revenue authorities provide specific rules or guidelines in determination of Secondary Adjustment. Additional clarification may be necessary under the Foreign Exchange Management Act, 1999 ('FEMA') to define a timeline for receiving such funds from the overseas AE.

## FPIs in Category I and II Exempted from Tax on Indirect Transfers

Taxability of Indirect Transfers was introduced in 2012 by a retrospective amendment to Section 9(1)(i). By virtue of this amendment, transfer of capital assets, being shares or interest in a foreign company which substantially derive, directly or indirectly, their value from assets located in India, were subjected to capital gains tax in India.

In 2016, the Central Board of Direct Taxes ('CBDT') constituted a Working Group to examine the scope and applicability of Indirect Transfer provisions. Based on the recommendations, the CBDT issued a Circular[5] stating clear views on applicability of Indirect Transfers in specific situations through an exhaustive FAQ. In respect of Foreign Portfolio Investors ('FPIs'), the Circular clarified that Indirect Transfer provisions would apply in respect of direct or indirect portfolio investments held by such FPIs. This resulted into double taxation and thus emerged as a concern area, more so in case of multi-tier funds. Aggressive representations were made and in January, the Circular was kept in abeyance.

The Budget has now addressed this concern by keeping well-regulated FPIs i.e. Category I (Sovereign Funds) and Category II (Broad Based Funds) established under the SEBI Act, outside the scope of Indirect Transfer provisions. An explanation 5A has been inserted to Section 9(1)(i) to this effect retrospectively from AY 2012-13.

This clarification effectively addresses genuine concerns of specific foreign investors and at the same time, provides reasonable certainty in tax position on an epic issue.

## Tax Neutral Demerger: Cost of Acquisition to Non-residents

The Budget has provided a specific clarification in respect of determining cost of acquisition of shares of an Indian company, which are acquired by a foreign company under a demerger which is tax-neutral in India.

In effect, it has been proposed to amend Section 49 to provide that cost of acquisition of the shares of the Indian Company which are consequently transferred to the resulting foreign company shall be the same as it was for the previous owner of the shares i.e. the demerged foreign company. This is a welcome change that brings the treatment of cost of acquisition in the case of demerger of Indian Company at par with that of foreign company.

## Foreign Tax Credit (FTC)-Amendment Pursuant to Rule 128

In June 2016, the CBDT had introduced Rule 128 to specify the manner and extent of claiming credit in respect of taxes, surcharge and cess paid by taxpayer outside India. These were termed Foreign Tax Credit ('FTC') rules and introduced vide a Notification[6] which now comes into play on April 1, 2017.

**The Budget has provided a specific clarification in respect of determining cost of acquisition of shares of an Indian company, which are acquired by a foreign company under a demerger which is tax-neutral in India.**

[5] Circular No. 41 of 2016 dated December 21, 2016
[6] Circular No. 54 of 2016 dated June 27, 2016

There are two proposals in the Budget which have been introduced in line with FTC rules introduced earlier:-

(i) Section 155 that provides a procedure for amendment of assessment order is amended. A new sub-section (14A) has been introduced. It provides for a mechanism and empowers the tax officer to grant credit of disputed taxes when approached by the taxpayer within six months from the month in which such dispute stands resolved. In making such claim before the tax officer, the taxpayer must provide evidence of dispute settlement, payment of taxes and an undertaking that the said tax has not been claimed elsewhere. This is a significant relief to those taxpayers who were earlier made to forego such claim in absence of specific provisions empowering the tax officer to pass such an order.

(ii) Section 115JAA and 115JD are amended to restrict the carry forward of FTC under Minimum Alternate Tax ('MAT')/Alternate Minimum Tax ('AMT') regime. In other words, to the extent that MAT/AMT credit contains an element of excess FTC claimed, the same shall not be allowed to be carried forward to subsequent years.

**Illustration: Carry Forward of FTC Under MAT**

| Particulars | Normal Provisions | MAT/AMT |
|---|---|---|
| Tax Liability | 50 | 100 |
| Less: FTC relief | 50 | 80 |
| Tax Payable | Nil | 20 |

Since an additional INR 30 (INR 80 less 50) of FTC has been claimed under MAT, as per amended provisions, such FTC of INR 30 is not eligible for carry forward under MAT. Accordingly, MAT credit is allowed only to the extent of INR 20 (INR 100 less 50 less 30).

## Extension of Concessional Rate Benefits and Clarification on Taxability of Capital Gains on Rupee Denominated Bonds

In September 2015, the Reserve Bank of India ('RBI') allowed Indian corporates to issue Rupee Denominated Offshore Bonds *(popularly known as masala bonds)* outside India. Through a press release in October 2015, the concessional rate of TDS at 5% was extended to interest income from such bonds. In order to provide a legislative

backing to this press release, the Budget has retrospectively amended Section 194LC to include within its scope of concessional rate of TDS at 5%, the interest earned on Rupee Denominated Bonds. Such benefit is available in respect of bonds issued until June 30, 2020.

The validity of concessional rate under Section 194LD has also been extended until June 30, 2020 in respect of Foreign Institutional Investors ('FIIs') and Qualified Foreign Investors ('QFIs') on their investments into government securities and Rupee Denominated Corporate Bonds.

The Budget has also amended Section 47 to provide that transfer of Rupee Denominated Bonds between non-residents shall not give rise to a taxable event and thus not subjected to capital gains tax.

Clearly, the aim is to align Indian economic policies with global standards. The introduction of IFRS as Ind-AS, rehaul of the Companies Act, bringing a global outlook to addressing bankruptcy matters through an Insolvency and Bankruptcy Code and aligning our myriad indirect tax regime into a streamlined GST–the government is clearly on a path to bring international best practices into laws and policies which were much overdue of an overhaul. The recent efforts to renegotiate ineffective tax treaties is another good example. This Budget continues in that very direction and gives a booster shot to simplification and ease of doing business. ■



*If not us, who? If not now, when?* - John F. Kennedy