ELECTIVE PAPER 6C- INTERNATIONAL TAXATION

SUGGESTED SOLUTION – CASE STUDY 1

I. ANSWERS TO OBJECTIVE TYPE QUESTIONS

1. (b) Banking and Insurance business

2. (d) ₹ 1 Crore

3. (c) A Inc., USA; A LLC, Cyprus; and AA Ltd., China.

4. (d) 30%

5. (c) ₹ 95 lakhs

6. (d) ₹ 1 lakh – fixed penalty

7. (c) A.Y.2027-28

8. (d) 90 days from 30th November of the assessment year

9. (c) A.Y.2018-19 and the amount of primary adjustment is ₹1.05 crore

10. (c) Deemed loan approach

II. ANSWERS TO DESCRIPTIVE QUESTIONS

1. Section 94B is applicable to an Indian company or a permanent establishment of a foreign company in India, being the borrower who pays interest in respect of any form of debt issued by

- non-resident, being an associated enterprises (AE) of such borrower or
- by a lender which is not an AE but where the AE provides either implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender, then such debt would be deemed to have been issued by an AE.

In order to determine the interest disallowance amount under Section 94B, the interest paid to non-resident AEs and deemed AEs needs to be determined. Payment of interest to resident AEs is not to be considered for disallowance since the interest payment made to non-resident AEs alone are to be taken into account for such purpose. In the present case,

the interest disallowance and permissible interest deduction under the head "Profits and gains from business or profession" would be -

Particulars	Amount (₹ in crores)
Interest paid to A LLC Cyprus [See Note (i)]	80.00
Interest paid to Bank of Chennai based on guarantee provided by A Inc, USA [See Note (ii)]	8.00
Guarantee Fee paid to A Inc, USA [See Note (iii)]	0.50
Interest paid to TN Mercantile bank based on letter of comfort by director of A Ltd. [See Note (iv)]	Nil
Interest paid to Union City Bank, India [See Note (v)]	Nil
Interest paid to Bank of Taiwan [See Note (vi)]	Nil
Guarantee fee paid to AAA Ltd., Taiwan [See Note (vi)]	Nil
Interest paid to Wells Cargo Bank based on deposits made by A Inc, USA [See Note (vii)]	Nil
Interest paid to Bank of USA based on deposits made by A Inc, USA [See Note (viii)]	12.00
Interest paid to AA Ltd, China, being interest on delayed payment to creditor [See Note (ix)]	1.00
Interest paid or payable to non-resident AE	**101.50**
EBIDTA	200.00
Excess Interest: lower of the following would be disallowed	**41.50**
- Interest paid or payable to non-resident AE in excess of 30% of EBIDTA [₹ 101.50 crores - ₹ 60.00 crores] ₹ 41.50 crores	
- Interest paid or payable to non-resident AE ₹ 101.50 crores	
Therefore, interest paid or payable allowable as deduction under the head "Profits and gains of business or profession" would be ₹ 76.25 crores [₹ 60 crores (₹ 101.50 crores – ₹ 41.50 crores), being the amount paid or payable to non-resident AE ***plus*** ₹ 16.25 crores, being the amount paid to other entities].	76.25

Notes:

(i) Interest paid to a non-resident AE falls within the scope of section 94B. A LLC is deemed to be an AE of A Ltd., since the loan advanced by it constitutes not less than

51% of the book value of total assets of A Ltd. Hence, interest paid to A LLC is to be considered for the purpose of limitation of interest deduction under section 94B.

(ii) The proviso to Section 94B(1) states "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**."

Since A Ltd., India is a wholly owned subsidiary of A Inc., USA, A Ltd. and A Inc. are AEs.

Thus, the debt issued by Bank of Chennai would be deemed as issued by the A Inc. USA, being the AE, hence, the amount of interest paid on such debt has to be considered for the purpose of limitation of interest deduction under section 94B.

(iii) As per section 94B(5)(ii), debt means, *inter alia,* any loan that gives rise to interest which is deductible while computing business income.

Though guarantee fee is not specifically referred to in the meaning of the term "debt" defined under section 94B(5)(ii), the term 'interest' is defined in section 2(28A) of the Income-tax Act, 1961 to mean 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." Therefore, given the wide definition that interest partakes, guarantee fee can be classified as interest. Accordingly, the same has to be considered for the purpose of limitation of interest deduction under section 94B.

(iv) Since the loan is obtained based on a letter of comfort provided by a resident director of A Ltd., the said interest will not be factored for the purpose of excess interest disallowance under section 94B.

(v) Since loan was obtained by A Ltd independently from a third-party lender Union City Bank of India, interest paid on such loan shall not be considered for the purposes of Section 94B, as the same is paid to an enterprise which is not a non-resident AE.

(vi) Since A Ltd.'s voting power in AAA Ltd., Taiwan is less than 26%, AAA Ltd., Taiwan is not an AE of A Ltd. Since loan was obtained by A Ltd from Bank of Taiwan, Indian

branch, for which guarantee was given by an enterprise, not being an AE, this interest shall not be considered for the purposes of section 94B. Likewise, guarantee fee paid to AAA Ltd. shall also not be considered for the purposes of section 94B.

(vii) The proviso to section 94B(1) provides 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."

Here, the loan of $ 10 million taken by A Ltd and the amount of $ 5 million deposited by A Inc., USA with Wells Cargo Bank can be viewed as not corresponding and matching to the amount of issued debt, hence, such debt is **not** deemed to have been issued by an AE.

Alternate view *– It is also possible to take a view that interest on loan to the extent of the deposit made by the non-resident AE has to be considered for the purposes of section 94B. In such a case, ₹ 3 crores being interest corresponding to loan of $ 5 million would be considered for the purposes of section 94B.*

(viii) In the given case, the loan taken by A Ltd and the amount deposited by A Inc. USA in Bank of USA is US $ 20 million. Since A Inc. USA, being an AE has **deposited a corresponding and** matching **amount of funds** with the lender, the debt issued by Bank of USA shall be deemed to have been issued by A Inc., being an AE. Thus, the amount of interest paid on such debt to Bank of USA would be considered for the purpose of limitation of interest deduction under section 94B.

(ix) Section 94B(5)(ii) defines the term "debt" as 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".

In the present case, interest paid is towards delayed payment to AA Ltd China, being its creditor for supply of raw material can be considered as an arrangement that gives rise to interest or other finance charges that are deductible in computation of Income under the head "Profits and gains of business or profession[1]".

[1] *CIT v. Vijay Ship Breaking Corporation decision of Supreme Court [2008] 175 Taxman 77 (SC)*

Further, since 90% of raw materials required by A Ltd. is supplied by AA Ltd., China and price and other conditions for supply of raw material are also influenced AA Ltd., China, AA Ltd., is deemed to be an AE of A Ltd. Thus, the amount of interest paid towards delayed payment has to be considered for the purpose of limitation of interest deduction under section 94B.

ALTERNATE ANSWER:

Section 94B(1) of the Income-tax Act, 1961, provides that 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).*

As per section 94B(2), the excess interest shall mean an amount of ***total interest paid or payable*** *in excess of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or interest paid or payable to associated enterprises for that previous year, whichever is less.*

As per Explanatory Memorandum to the Finance Bill, 2017, the 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. It implies that "excess interest" means the amount

- *interest paid or payable by an entity to its non-resident associated enterprises in excess of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or*
- *interest paid or payable to non-resident associated enterprises for that previous year,*

whichever is less.

The intent behind insertion of this section also appears to restrict the interest paid to non-resident AE to 30% of EBITDA. In the above solution, the excess amount is computed in line with the intent expressed in section 94B(1) read with the Explanatory Memorandum.

However, an alternate view may also be possible on the basis of the interpretation as per the plain reading of section 94B(2).

On a plain reading of provisions of section 94B(2), it appears that the "excess amount" has to be computed by taking–

- ***total interest paid or payable** by the borrower in excess of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA) of the borrower in the previous year or*
- *interest paid or payable to associated enterprises for that previous year,*

whichever is less.

Accordingly, the interest disallowance and amount of interest paid or payable by A Ltd allowable as deduction under the head "Profits and gains of business or profession" would be –

Particulars	Amount (₹ in crores)
Interest paid to A LLC Cyprus	80.00
Interest paid to Bank of Chennai based on guarantee provided by A Inc, USA	8.00
Guarantee Fee paid to A Inc, USA	0.50
Interest paid to TN Mercantile bank based on letter of comfort by director of A Ltd.	4.00
Interest paid to Union City Bank, India	3.00
Interest paid to Bank of Taiwan	3.00
Guarantee fees paid to AAA Ltd., Taiwan	0.25
Interest paid to Wells Cargo Bank based on deposits made by A Inc, USA	6.00
Interest paid to Bank of USA based on deposits made by A Inc, USA	12.00
Interest paid to AA Ltd., China being interest on delayed payment to creditor	1.00
Total interest paid or payable by A Ltd.	**117.75**
Interest paid or payable to non-resident AE (computed above)	**101.50**
EBIDTA	200.00
Excess Interest: lower of the following would be disallowed,	**57.75**
- Total interest paid or payable in excess of 30% of EBIDTA ₹ 57.75 crores **[i.e., ₹ 117.75 crores – ₹ 60.00 crores]**	
- Interest paid or payable to non-resident AE ₹ 101.50 crores	
Therefore, interest paid or payable allowable as deduction under the head "Profits and gains of business or profession" would be ₹ 60 crores (₹117.75 crores – ₹ 57.75 crores)	60.00

2. (a) (i) A company is typically financed or capitalized through a mixture of debt and equity. The manner in which company raises capital has a significant impact on the amount of profit it reports for tax purposes. This is due to the reason that tax legislations of countries typically allow a deduction for interest paid or payable in arriving at the profit for tax purposes while the dividend paid on equity contribution is not deductible. Therefore, the higher the level of debt in a company, and thus, the amount of interest it pays, the lower will be its taxable profit. For this reason, debt is often a more tax efficient method of finance than equity. Since in such a structure, equity financing is less, it is referred to as Thin Capitalization. Thin capitalization, thus, refers to the process of funding an entity by debt instead of equity with a view to take advantage of interest deduction benefits.

(ii) Multinational groups are often able to structure their financing arrangements to maximize these benefits. To prevent tax erosion on account of such arrangements, country's tax administrations often introduce rules that place a limit on the amount of interest that can be deducted in computing a company's profit for tax purposes. Such rules are designed to counter cross-border shifting of profit through excessive interest payments, and thus aim to protect a country's tax base. Under the initiative of the G-20 countries, the Organization for Economic Co-operation and Development (OECD) in its Base Erosion and Profit Shifting (BEPS) project had taken up the issue of base erosion and profit shifting by way of excess interest deductions by the MNEs in its Action plan 4. The OECD has recommended several measures in its final report to address this issue. In view of the above, section 94B has been inserted in the Income-tax Act, 1961, in line with the recommendations of OECD BEPS Action Plan 4, to provide that interest paid or payable by an entity to its non-resident associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to non-resident associated enterprises, whichever is less.

(iii) Section 94B(4) provides that interest amount disallowed in a particular assessment year shall be carried forward and allowed as deduction against

the profits and gains, if any, ***of any business*** carried on by the assessee. Therefore, based on the same, it can be concluded that A Ltd shall be eligible to carry forward the disallowed interest amount and claim the same as a deduction against the profits and gains from any business or profession carried on by it.

(b) **(i)** Section 92CE, provides that where a primary adjustment for an amount exceeding ₹ 1 crore has been made by the Assessing Officer in respect of A.Y.2017-18 or thereafter, which has been accepted by the assessee, a secondary adjustment shall be made. In the first scenario, where the assessee has not gone on an appeal against the order passed by the Assessing Officer, it may be considered that the adjustment made by the Assessing Officer has been accepted by the assessee. Hence, secondary adjustment has to be made by A Ltd. in the A.Y.2018-19. Further, if the "excess money" (i.e., ₹ 40 crores, in this case) which is available with A LLC., Cyprus is not repatriated to India within 90 days from the date of order of the Assessing Officer then, such excess money would be deemed to be an advance made by the A Ltd. to A LLC, Cyprus and interest on such advance shall be computed in the prescribed manner.

In the second scenario, where the assessee files an appeal before the CIT(Appeals) it is evident that the primary adjustment made by the Assessing Officer is not accepted by the assessee and therefore, secondary adjustment is not required.

(ii) If the CIT (Appeals) increases the Arm's Length Price determined by the Assessing Officer to ₹ 50 crores by considering the arm's length interest rate to be 5% (instead of 4%) and the same is accepted by A Ltd., then, A Ltd. has to make secondary adjustment and the "excess money" [i.e., ₹ 30 crores, (₹ 80 crores – ₹ 50 crores)] has to repatriated to India within 90 days from the date of the order of CIT (Appeals).

3. **(a)** As an anti-avoidance measure, section 94A was introduced in the Income-tax Act, 1961 with respect to transactions with persons located in a Notified Jurisdictional Area (NJA). As per section 94A, the Central Government may, having regard to the lack of effective exchange of information with any country or territory outside India,

specify the said country or territory as a notified jurisdictional area in relation to transactions entered into by any assessee. Any payment made to a person located in a NJA shall be liable for withholding tax @ 30% or the rate prescribed in the Act or the rates in force, whichever is highest.

The Central Government invoked the provisions of section 94A of the Act and notified Cyprus as a NJA in November, 2013 owing to inadequate exchange of information by Cyprus tax authorities. However, in December 2016, the Central Government has rescinded the said Notification, thereby removing Cyprus as a NJA with retrospective effect from the date of original notification. Therefore, since the provisions of section 94A will not be applicable in respect of payment made to a person located in Cyprus, A Ltd. is justified in deducting tax at the rate of 10% being the most beneficial rate contained in the DTAA between India and Cyprus.

(b) Safe Harbour Rules specified under Section 92CB(2) may be opted by an assessee in respect of an ***eligible international transaction***. Advancing of loan is covered within the definition of eligible international transactions. However, receipt of intra-group loans by the Indian entity do not form part of eligible international transactions and hence, A Ltd shall not be eligible to opt for safe harbor rules in respect of the loans taken from its AEs.

(c) Indian Transfer Pricing regulations provide that any income arising from an international transaction shall be computed having regard to arm's length price. However, section 92(3) provides that transfer pricing provisions shall not apply in cases where such application results an increase in the expenditure or decrease in the revenue of the Indian entity. In the given case, as interest payment to the AE would only result in an increase in the expenditure of A Ltd. and subsequent reduction of profits, transfer pricing provisions under the Income-tax Act, 1961 shall not apply.