taxnotes® international

Volume 85, Number 12 ■ March 20, 2017

How India's Finance Bill Could Affect Private Debt Investments

by Shashwat Sharma and Mansi Seth

Reprinted from *Tax Notes Int'l*, March 20, 2017, p. 1093

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

PRACTITIONERS' CORNER

How India's Finance Bill Could Affect Private Debt Investments

by Shashwat Sharma and Mansi Seth

Shashwat Sharma

Mansi Seth

Shashwat Sharma is an associate with Nishith Desai Associates in Mumbai and Mansi Seth heads the firm's U.S. practice.

In this article, the authors discuss amendments to the Income Tax Act, 1961, proposed in India's Finance Bill, 2017, which would affect private debt investments in India.

The Indian 2017-2018 budget was announced February 1. The Finance Bill, 2017, has been mostly well received by various stakeholders and includes several proposals that could affect foreign investors.

Investing in Private Debt in India

The Reserve Bank of India (RBI) regulates overseas borrowing by Indian companies. Those borrowings are classified as external commercial borrowings (ECB). Historically, for foreign investors looking to invest into India, the debt route was fraught with challenges. Those challenges arose as a result of the regulatory regime applicable to ECBs stipulating stringent conditions for obtaining ECBs, such as narrow lists of eligible borrowers and lenders, strict end-use restrictions on borrowed funds, and all-in cost ceilings. Debt instruments, which were compulsorily convertible into equity, have been treated as equity from an Indian regulatory perspective, and therefore are not subject to those restrictions. However, because they are treated as debt from an Indian tax perspective, the below discussion also applies to them.

Over the last few years, private debt investments have become increasingly popular in India, primarily because of RBI's significant liberalization of the debt regime to allow Indian corporations to access overseas borrowings that are rupee-denominated with minimal restrictions. Private debt is usually in the form of structured debt instruments such as non-convertible debentures (NCDs), which are subscribed by foreign portfolio investors, or redeemable debentures or shares, which are subscribed to under the foreign venture capital investment route. Those instruments can be structured to meet commercial needs with an annual coupon, or a coupon paid based on company cash flow or another triggering event. The amount of coupon payable can also be a function of underlying equity price; earnings before interest, taxes, depreciation, and amortization; or other variables.

Taxing Interest Payments

Under India's Income Tax Act, 1961, interest payments for foreign lenders are subject to withholding tax obligations that can be as high as 40 percent for rupee-denominated borrowings. Generally, interest payable for foreign-currency-denominated borrowings is subject to withholding tax at the rate of 20 percent. More recently, and complementing the regulatory relaxations, the government has carved out situations in which a lower 5 percent rate might apply:

For more *Tax Notes International* content, please visit www.taxnotes.com.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

- interest payable to a nonresident company for foreign-currency-denominated borrowings borrowed through issuance of a long-term[1] bond, including long-term infrastructure bonds issued on or after October 1, 2014, but before July 1, 2017, by an Indian company;[2] and
- interest payable to a foreign portfolio investor on or after June 1, 2013, but before July 1, 2017, by an Indian company for a rupee-denominated bond.[3]

Those provisions were introduced to support debt investments and sectors like real estate and infrastructure. The beneficial rate is available if the interest does not exceed the corresponding interest rate approved by the government.[4]

From an Indian borrower's perspective, interest payments are deductible from its corporate income (taxable at 30 percent) without restriction and are not subject to the distribution tax of approximately 15 percent that applies to dividend distributions by Indian companies.

In *Besix Kier Dabhol*,[5] the Mumbai Bench of the Income Tax Appellate Tribunal had to decide whether to allow a Belgian company's permanent establishment to deduct its interest expenditure when it was very thinly capitalized with a debt-equity ratio of 248 to 1. The Indian tax authorities argued that such an unusually high debt-equity ratio indicated that the company's shareholders had infused capital into the company in the form of debt as opposed to equity solely to benefit from the tax arbitrage. They sought to deny those tax benefits by treating the PE's debt as equity capital. The tribunal rejected those arguments and upheld the deduction, saying that at the time at issue, India did not have any thin capitalization or general antiavoidance rules in force, and that the tax authorities did not have the power to recharacterize debt as equity. The Bombay High Court upheld that decision on appeal.[6]

Investments From Treaty Jurisdictions

Under the ITA, if an Indian nonresident is resident in a country that has a tax treaty with India, the taxpayer may choose to be taxable under the provisions of the treaty or the ITA, whichever is more beneficial. Relief under a tax treaty should be available as long as the nonresident entity satisfies the relevant eligibility criteria, while the ITA requires a valid tax residency certificate issued by the country of residence. When foreign lenders are unable to take advantage of the reduced 5 percent interest withholding tax rate and are taxed at higher rates, they can rely on any relevant treaties for a comparatively lower rate. For instance, under the India-U.S. tax treaty, interest payments should be subject to a 15 percent rate.

Historically, most direct investments into India have been through jurisdictions such as Mauritius, the Netherlands, and Singapore — established financial centers that have favorable tax treaties with India. In addition to the favorable tax treatment at exit for equity investments,[7] the tax treaties with Singapore and the Netherlands provided for lower interest withholding of 15 percent and 10 percent, respectively.

The India-Mauritius tax treaty, which was used for almost 40 percent of investments into India, did not have a favorable interest provision, and interest payments to Mauritius were subject to higher domestic rates. As such, India generally did not receive debt investments from Mauritius. The India-Mauritius tax treaty was amended in May 2016 to remove the beneficial provisions regarding capital gains. However, as a trade-off, a lower withholding rate of 7.5 percent for interest payments was included. Thus, Mauritius still continues to be attractive for foreign investors looking to make debt investments.

Cyprus was also a popular investment holding jurisdiction, providing for a 10 percent interest withholding tax rate; however, India blacklisted it over problems regarding the exchange of information. Although Cyprus has been removed from the blacklist, its treaty with India has been amended to remove the tax benefits at exit without providing any additional benefits for debt.

---

[1]The phrase ''long-term'' means that the bond to be issued should have an original maturity term of at least three years.

[2]ITA section 194LC.

[3]*Id.* at section 194LD.

[4]For foreign currency borrowings, the central government has approved the interest rate as any rate within the all-in cost ceiling specified by the RBI under the ECB regulations, having regard to the tenure of the borrowing. The interest rate ceiling is: 300 basis points per year over six month LIBOR (for ECBs with average maturity periods of three to five years); 450 basis points per year over six month LIBOR (for ECBs with average maturity periods of more than five years); or 500 basis points per year over the benchmark (for ECBs with average maturity periods of at least 10 years). Per the notification issued by the Central Board of Direct Taxes, the coupon rate on NCDs should not exceed 500 basis points over the base rate of the State Bank of India applicable on the date of issue.

[5]*Besix Kier Dabhol SA v. Deputy Director of Income Tax (International Taxation) Circle 3(2), Mumbai*, [2011] 131 ITD 299 (Mumbai).

[6]*Director of Income-tax, International Taxation-II, Mumbai v. Besix Kier Dabhol SA*, [2012] 26 taxmann.com 169 (Bom.).

[7]India has recently renegotiated its tax treaties with Cyprus, Mauritius, and Singapore, all of which affect the tax treatment at exit. However, other than the interest provisions, the amendments are not relevant for this article.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes International* content, please visit www.taxnotes.com.

Proposals Affecting Debt Investments

5 Percent Rate on ECBs Extended

Section 194LC provides a 5 percent withholding rate for ECBs and foreign currency long-term bonds (including long-term infrastructure bonds) issued before July 1, 2017. Based on representations made by various stakeholders, the finance bill proposes to extend the term of the interest rate to July 1, 2020.

Boost to Rupee-Denominated Bonds

An amendment has also been proposed to section 194LD, which prescribes the lower 5 percent rate on interest payments to foreign portfolio investors. All interest payments on their investments in rupee-denominated bonds made before July 1, 2020, will be eligible for that rate. That is of particular significance to the debt market because the issue of NCDs to foreign portfolio investors has become one of the most prevalent modes of fundraising in India.

In addition to the extension of the sunset clause on section 194LD, a retrospective amendment has been proposed with effect from April 1, 2016,[8] to extend the 5 percent beneficial rate of rupee-denominated bonds (Masala Bonds) issued to nonresidents (other than foreign portfolio investors). The finance bill also proposes that transfers of an Indian company's Masala Bonds by a nonresident to another nonresident will not be considered a transfer under the ITA. That will make investments in Masala Bonds more attractive for nonresident taxpayers who will no longer have to pay capital gains tax on the profits from transfers to other nonresidents.

Introduction of Thin Cap Rules

Two common tests for determining whether a company is thinly capitalized are reference to the arm's-length principle and reference to a fixed debt-equity ratio.[9] Globally, the capital structure of a company is designed with excessive debt because interest payments are considered a company expense and are deductible from the total profits. Dividends or other equity returns, on the other hand, are generally not deductible.

In India, a company is subject to a dividend distribution tax of approximately 15 percent at the time of distributing profits to its shareholders, in addition to the corporate tax of 30 percent. The dividends received by a nonresident shareholder in an Indian company are exempt from further Indian tax. However, because the dividend distribution tax is a corporate-level tax, nonresident shareholders often face difficulty in getting foreign tax credits in their country of residence against the amount paid by the company as dividend distribution tax. As a result, infusing money in the form of debt through compulsorily convertible debentures (CCDs) and NCDs provides a considerable tax arbitrage and is attractive to investors. As discussed, there are no thin capitalization rules or limitations on interest deductions under the ITA.

The finance bill proposes to introduce thin capitalization rules to prevent companies from using a distorted capital structure to benefit from excessive interest deductions. It introduces new section 94B to limit interest deductions in specific cases. Under that section, interest or similar consideration paid by (and deductible for) the Indian borrower for debt issued by a nonresident that is an associated enterprise of the Indian borrower will not be deductible if it is excess interest, defined as an amount that exceeds 30 percent of the EBITDA of the Indian borrower. Some of the key aspects of the thin capitalization rules are:

- The Indian borrower could be an Indian company or PE of a foreign company. Indian companies or PEs of foreign companies engaged in banking or insurance are excluded.
- Because of the wide definition of the term "debt," the provisions apply to any loan; financial instrument, lease, or derivative; or any other transaction or arrangement giving rise to interest, discount, or other financial charges.
- There is a de minimis threshold of INR 10 million (approximately $150,000) — that is, the provisions will apply for interest paid beyond that limit.
- The term "associated enterprise" will have the same definition as that under the Indian transfer pricing provisions.[10] The definition is wide and lists several situations when enterprises are deemed to be associated enterprises.
- Debt issued by a third-party lender on the basis of explicit or implicit guarantee or corresponding deposit provided by an associated enterprise of the Indian borrower is deemed to be debt issued by an associated enterprise.
- Interest expenditures that are not wholly deductible against a company's business income may be carried forward the next eight assessment years but are deductible only up to limits discussed above — that is, 30 percent of EBITDA in the relevant year.

The genesis of section 94B can be traced to action 4 of the OECD's base erosion and profit-shifting project. India, being an active contributor to the BEPS initiative, has already introduced rules to adopt recommendations such as country-by-country reporting and the equalization levy to address the digital economy. The introduction of thin capitalization rules is more proof of India's commitment to pursue and implement the BEPS agenda.

---

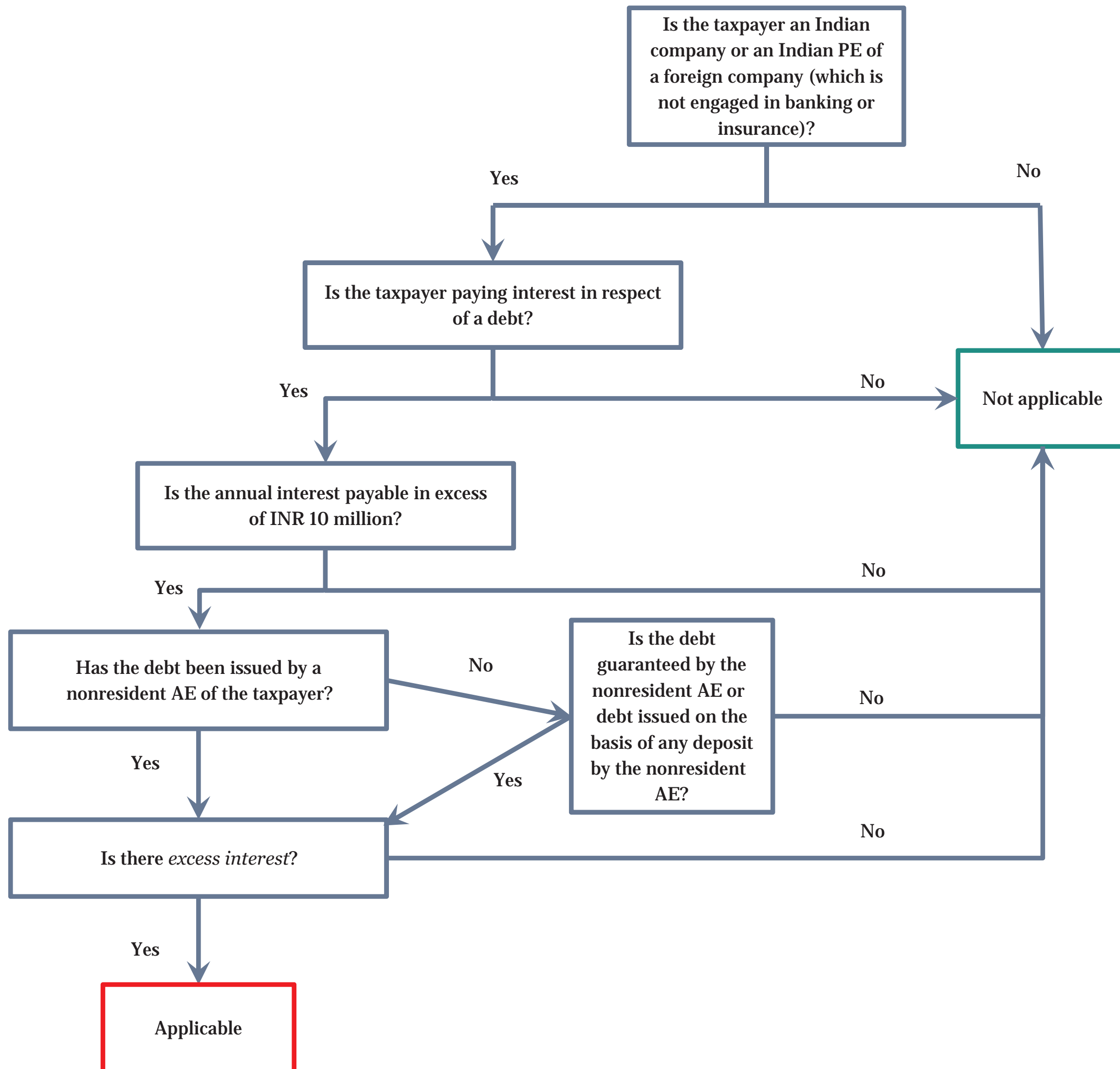
[8]On October 29, 2015, the government issued a release stating that it agreed to industry suggestions to extend that benefit to Masala Bonds. The retrospective amendment was proposed to give effect to that agreement.

[9]IBFD Tax Glossary (2005).

[10]ITA section 92A.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes International* content, please visit www.taxnotes.com.



While the proposed thin cap rules include some of the "at minimum" recommendations in action 4, they have some idiosyncrasies. They apply only to interest payments made by Indian borrowers to lending associated enterprises. However, if a third-party lender issued the debt based on a guarantee or a corresponding deposit by an associated enterprise, that debt will also fall within the scope of the rules. A guarantee may be explicit or implicit,[11] although no clarification has been provided regarding what might constitute an implicit guarantee.

Further, the rules apply only to payments made to nonresident associated enterprises. Regarding whether the interest limitation rule should apply on gross or net interest expense, action 4 recognizes that limiting gross interest could result in double taxation and recommends net interest expense. That is similar to the interest limitation rule under the EU anti-tax-avoidance directive (COM(2016) 26), which defines excessive borrowing costs as those exceeding taxable interest revenue. The thin capitalization rules look at total interest payable or paid. Also, while action 4 allows countries to implement exclusions for public-benefit projects, the proposed Indian thin cap rules do not include a similar exclusion (barring that for the banking and insurance companies).

[11] Proviso to section 94B(1).

For more *Tax Notes International* content, please visit www.taxnotes.com.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Although the government has been liberalizing the private debt route, the proposal will affect investments into India through that route, irrespective of whether they are foreign direct investments made through CCDs, EBCs, or NCDs. In particular, foreign investments in Indian real assets are likely to be affected because they more often take the debt route. Moreover, linking of interest disallowance to a company's EBITDA is problematic for companies in industries or sectors that are cyclical in nature.

GAAR and Thin Capitalization Rules

GAAR provisions were originally proposed to be introduced in India through the draft Direct Taxes Code, 2010, which was meant to overhaul the ITA but was never enacted. Subsequently, the Finance Act, 2012, introduced GAAR into the ITA; those provisions will come into force on April 1. GAAR confers broad powers on Indian tax authorities to deny tax benefits, including those applicable under tax treaties, that arise from impermissible avoidance arrangements.

The thin capitalization rules are essentially special antiavoidance rules (SAAR) to prevent multinational groups from structuring their Indian subsidiaries or PEs in a way that achieves maximum benefit of tax-deductible expenses without having to pay dividend distribution tax on the upstream of profits. With the introduction of those rules into the ITA, tax authorities should no longer resort to the GAAR provisions to recharacterize debt as equity. The Central Board of Direct Taxes issued Circular 7 on January 27 to provide clarity to taxpayers regarding when the GAAR provisions may be applied. The board has said that because SAAR may be inadequate to address all situations of tax abuse, invocation of GAAR provisions may occur even when SAAR provisions exist.

While the proposed thin capitalization rules should adequately address the tax authorities' concern regarding profit shifting through excessive interest payments to a nonresident associated enterprise, the language of the GAAR circular is not encouraging. The open-ended language in the ITA and the circular could lead to a tax officer subjecting a transaction that does not fall foul of the thin capitalization rules to GAAR.

Secondary Adjustment in Transfer Pricing Matters

So far, transfer pricing adjustments in India have involved only a primary adjustment of income. The Finance Bill, 2017, proposes to introduce secondary adjustments when the actual allocation of profits is effected between an Indian company and its associated enterprise to align the Indian transfer pricing regulations with OECD guidelines. The rationale behind that secondary adjustment is to remove the imbalance between the cash account of and the actual profits earned by an Indian company. The adjustment requires that any excess money paid by an Indian company to its associated enterprise abroad (determined during the primary adjustment as the difference between the arm's-length price and the actual consideration paid) is paid back to the Indian company. If the excess consideration is not repatriated to India within a prescribed time, it will be deemed an advance payment made by the Indian company to its associated enterprise, and interest will be payable on the amount until it is repatriated. The government will prescribe how to calculate the rate of interest to be applied. Those provisions should apply not just when a tax officer makes a primary adjustment but also when a primary adjustment is made by a taxpayer while filing his income tax returns, under an advance pricing agreement, under ITA safe harbor rules, or as a consequence of any mutual agreement procedure initiated under a tax treaty.

For debt investments, secondary adjustments become relevant when a primary adjustment is made to the amount of interest payable by an Indian company to its overseas associated enterprise. That could arise if a tax officer considers the rate of interest paid by the Indian company excessive. In that case, interest in excess of the transfer price could be treated as an advance by the Indian entity to the associated enterprise, which if not paid back by the enterprise in the prescribed time will accumulate interest. Therefore, it becomes important for investors to ensure that the coupon rate on debt investments are arrived at having due regard to the market practice.[12]

Conclusion

With the international tax landscape evolving, India's tax regime is also undergoing a sea of changes. The Indian government is committed to aligning its tax system with international practices, and this discussion highlights some of its efforts in that direction.

Debt investments are tax efficient, and with relaxation of Indian regulations could offer flexibility to a foreign investor that Indian equity investments might not be able to. Various domestic tax provisions and favorable tax treaties provide tax arbitrage and encourage debt investments.

However, the combined effect of limiting interest deductibility under the proposed thin capitalization rules, the possibility of secondary adjustments in transfer pricing cases, and the implementation of GAAR is bound to put pressure on investment and financing structures. The judicial approach has been form over substance, as made clear in *Besix Kier Dabhol*, in which the court allowed interest deductions in the absence of GAAR and thin cap rules. With GAAR coming into force, India will witness a marked shift to the substance-over-form approach, which could require reexamining the debt investment structures used in India. ◆

[12]For instance, for CCDs, while the foreign exchange regulations do not provide for a fixed rate of coupon payment, it is market practice to fix the coupon at a percentage that is 300 basis points above the benchmark prime lending rate as fixed by the State Bank of India.

For more *Tax Notes International* content, please visit www.taxnotes.com.

(C) Tax Analysts 2017. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.