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India Proposes Thin Cap Rules For Foreign Loans

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By Siri Bulusu

The Indian government's proposed thin capitalization rule has caught the attention of foreign companies currently using interest deductions to create tax savings in India.

The proposed change was included in the Finance Bill 2017 in accordance with the OECD's plans to combat base erosion and profit shifting, or tax avoidance. It targets outbound investments involving group structures or inbound investments where the location of the interest expense can be used to obtain a tax benefit.

Finance Bill 2017, published Feb, 1, is currently under review by standing committees in India's upper and lower parliamentary houses.

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The "thin cap" provision would cap the interest deductible at 30 percent of a company's EBITDA —the upper limit of the OECD's recommendation of capping interest deductible between 10 percent and 30 percent.

Banking, Insurance Firms Exempt

Banking and insurance companies are exempt from the provision, which would apply only to foreign lenders in cases where the interest deductible is over 10 million rupees ($149,000).

“India has taken a very liberal stand by capping interest deductible at 30 percent of EBITDA but the problems lie in the details,” Meyyappan Nagappan, senior associate of tax practice at Nishith Desai Associates, told Bloomberg BNA Feb. 7.

Parent companies and their associated enterprises reduce their taxable profits in high-tax jurisdictions by transferring debt and equity through business-to-business loans. Often a parent company will finance an associated enterprise by giving it a loan, which then becomes tax-deductible in its location.

Nagappan said the thin cap rule is a productive measure to limit abusive practices to create tax savings for multinational corporations. However, he warned that the provision could have unintended consequences for genuine third-party lenders.

Associated enterprises are usually defined as those entities which are made up of loans constituting more than 51 percent of the book value of a company’s assets. Assets of thinly capitalized or highly leveraged companies are usually lower than their market value, which makes it easy for lenders—a parent company or a third party—to cross that threshold.

Real Estate Sector Affected

“The scope of the provision is so wide it could impact third-party lenders,” Nagappan said, adding that the real estate sector will be affected the most in the short to medium term since companies in that sector are commonly leveraged five or six times their book value.

Infrastructure projects can take 15 to 20 years and have high initial expenses, allowing the companies that manage the infrastructure projects to take deductions for tax discounts. Tax practitioners said those companies will have to renegotiate how to fulfill their loan obligations without tax discounts.

“Large, capital intensive companies with long gestation periods in terms of profitability might be severely inconvenienced and impacted through implementation of such measures, in having to pay taxes in the initial years due to losses,” Rahul K. Mitra, partner at KPMG India, told Bloomberg BNA in an e-mail Feb. 7.

Mitra said for a developing country like India, where infrastructure projects are the most patronized area for the government, an interest deduction limitation should be introduced for at least four years.

Eight-Year Carryover

One slight reprieve in the provision is an eight-year carryover period for excess interest that surpasses the 30 percent threshold. Tax practitioners said the allowance is helpful for companies

that reduce their debt-to-income ratio and carry over a previous year's excess interest, but feel that won't happen in most cases.

Mitra said another issue with the provision is the lack of clarity on the term "implicit" in reference to "implicit or explicit guarantees" provided by an associated enterprise.

"Without any specific clarification around the word 'implicit,' revenue officers may be tempted to color any and every loan taken by the Indian subsidiary of a foreign multinational corporation from third-party banks as being backed by 'implicit' guarantee provided by the foreign parent," Mitra said.

Tax practitioners expect the Indian tax authorities to provide a clarification on the word "implicit" in the coming months.

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For More Information

Details of the proposed limit can be found on page 15 of the Finance Bill: http://indiabudget.nic.in/ub2017-18/fb/bill.pdf

The OECD's recommendation for interest deductions can be found here: https://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf

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