Analysis and Impact Of Extending Scope Of Concessional Rate Of Tax On Overseas Borrowing

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As per a report by the Reserve Bank of India (RBI), external borrowings of Indian companies fell by about 41 percent to USD 1.46 billion in May this year compared to the same month last year[1]. Reasons for this sharp decline in foreign borrowings could be twofold: a) regulatory hassles with respect to issuance of External Commercial Borrowings, and b) relatively costlier loans due to the rising rupee. This year, the RBI made some relaxations to the ECB policy, and the rupee has also stabilized. The Union Budget 2014-15has taken this one step further, by extending the lower withholding tax rates of 5% on long-term foreign borrowings to all foreign currency loans taken between April 1, 2013 and April 1, 2017. In line with the overarching focus on infrastructure, the sunset period for long term infrastructure bonds has also been extended to 2017.

Previous provisions: Earlier, section 194LC provided for a lower withholding tax at the rate of 5% on interest payments made by an Indian company to non-residents on foreign currency denominated borrowings by it under a loan agreement (obtained under Foreign Exchange Management (Borrowing or Lending in Foreign exchange) Regulations 2000 or “ECB regulations”) or through the issuance of long-term infrastructure bonds provided that the interest is not more than State Bank of India’s prime lending rate (PLR) plus 500 basis points. This section was introduced through Finance Act, 2012 with a sunset clause for expiry on July 1, 2015.

Amended regime: The Finance Bill, 2014 seeks to extend this lower withholding tax rate to long term foreign currency borrowings taken before July 1, 2017. It also seeks to widen the scope of the benefit provided, and proposes to extend the lower withholding tax rate of 5% toany kind of long-term foreign currency bond issued on or after October 1, 2014 but before July 1, 2017.Thus, as per the extended scope, all types of long term corporate bonds such as foreign currency convertible bonds, and foreign currency exchangeable bonds shall also be able to take benefit of the 5% withholding tax rate.

Further, in line with the pass-through tax system introduced for Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs), the new provision intends to provide for a reduced withholding tax of 5% in case of non-resident unit holders, and 10% in case of resident unit holders.

Impact & issues: The Finance Minister, Arun Jaitley in his budget speech has indicated that this measure is one of the many, proposed to boost Indian capital markets, as well as the financial services sector. The Memorandum to Finance Bill, 2014, further substantiates the intent behind extension of this clause, stating that the lower withholding tax rate should help "*tofurther incentivize low cost long-term foreign borrowings by Indian companies*".Thus, this move should incentivize long term foreign borrowings, and lift some pressure from domestic banks especially since FCEBs and FCCBs (which also fall within the ECB regime and are available for limited sectors) shall also be subject to the lower withholding tax rate.

Interestingly, the lower withholding tax rate is only available to foreign currency denominated bonds, and a withholding tax of 20% (under domestic law) continues to apply to any rupee-denominated bond issued to FIIs and FPIs. This Bill has not extended the lower withholding tax rate available under Section 194LD of the Income Tax Act, when such interest income was payable on or after June 1, 2013 but before June 1, 2015. Thus, while this move may encourage ECBs, denial of lower withholding tax rate to rupee denominated bondsis likely to disincetivize growth of domestic debt capital markets, which were pegged as a priority by the previous Finance Minister.

Rupee denominated loans such as subscription to/ purchase of listed non-convertible debentures issued by Indian companies form a major chunk of foreign debt investment in the real estate space.It was expected that the concessional withholding tax rate would be extended beyond the original sunset period of June 1, 2015. However, the Bill has left section 194LD unchanged. In the absence of such extension, interest payments to FIIs / FPIs are otherwise subject to a withholding tax rate of 20% subject to benefits that may be available under the provisions of a tax treaty entered into between India and the jurisdiction in which the FII / FPI is resident. On the other hand, non-FPIs/ non-FIIs shall be subject to a withholding tax of 40% in respect of rupee- denominated bonds, under Indian domestic law.

Despite this minor glitch, the move to reduce withholding taxes for long term foreign borrowings comes as a welcome move and is in line with the bigger picture that this Budget seeks to achieve– rationalization and promotion of the Indian capital markets.

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[1] May 2013-"Data on ECB/FCCB for the month of May,2013, available at: http://rbidocs.rbi.org.in/rdocs/ECB/pdfs/ECB05072013DT.pdf"; May 2014-"Data on

ECB/FCCB for the month of May, 2014, available at:
http://rbidocs.rbi.org.in/rdocs/ECB/pdfs/IERP402014FLR.pdf"