Tax Hotline

September 26, 2012

GOVERNMENT ON REFORMS PATH

LOW COST FOREIGN BORROWINGS MADE EASY

On the back of a series of reforms relating to Foreign Direct Investment into India (Read our hotline titled India breaks the FDI shackles: Multi Brand Retail Trading and other sectors liberalized) and a strong address by the Prime Minister of India where he stressed the need for radical economic reforms [1], the Government of India now has acted to facilitate and smoothen the process for Indian companies seeking to borrow from outside India in the form of either loan agreements i.e. External Commercial Borrowings ("ECBs") or in the form Infrastructure Bonds. The Government has prescribed a clear all-in-one process to "lower the compliance burden and reduce the time lag which would [otherwise] arise on account of case-by-case approval." [2]

BACKGROUND

Earlier this year, the Finance Bill, 2012 lowered the rate of withholding tax at the rate of 5% (from the earlier rate of 20%) on payment by way of interest paid by an Indian company to a non-resident in respect of borrowing made in foreign currency from sources outside India. However, the borrowings and the rate of interest on such borrowings would have to be under a loan agreement approved by the Central Government (separately) and would only be allowed with respect of Indian companies engaged in the business of one of the eight specified sectors, which were predominantly infrastructure in nature.[3] Further, only borrowings made between period of July 1, 2012 and July 1, 2015 ("Borrowing Period") were eligible for this lower rate of withholding.

Subsequently, amendments made in the process of passage of the Finance Act, 2012 being passed ("Finance Act") in the Parliament resulted in this lower withholding tax being extended to all sectors. Further, this rate was also extended to funds raised in foreign currency outside India by Indian companies through long term infrastructure bonds complying with the Foreign Exchange Management (Borrowing or Lending in Foreign exchange) Regulations 2000 ("ECB Regulations") as approved by the Central Government.

Corresponding additions were made to the Income Tax Act, 1961 ("ITA") in the form of Section 115A (a) (iiaa) and Section 194LC. Section 194LC of the ITA provides the rate of tax required to be deducted to be 5% at the time of payment of interest to a non-resident by an Indian Company with regard to monies borrowed in foreign currency from sources outside India either by way of a loan agreement or by way of issue of long-term infrastructure bonds as approved by the Central Government in this regard. Section 115A (a)(ii) of the ITA further reduced the tax on income by way of interest in case of borrowing referred to in Section 194LC from 20% to 5%.

However, the above conditions required the Central Government to approve the borrowings themselves as well as the rate of interests on the borrowings.

EASING COMPLIANCE

The Central Board of Direct Taxes has issued Circular 07 of 2012 (" the Circular") along with the Press Release by the Ministry of Finance, dated September 21, 2012, by which the Government has smoothened the process for obtaining the benefit of a reduced rate of tax. Instead of requiring specific approval of the Central Government, all borrowings by way of loan agreement or long term infrastructure bonds satisfying certain conditions are now allowed to avail the lowered rate of tax.

The Government also allowed the interest rates referred to under Section 194LC/ Section 115A (a)(ii) of the ITA to be any rate of interest within the All-in-cost ceilings specified by the RBI from time to time.

The conditions as specified in the Circular are as follows:

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Conditions in relation to monies borrowed under a loan agreement

- The borrowing has to be under a loan agreement in compliance with the ECB Regulations;
- The borrower has obtained a Loan Registration Number from the Department of Statistics and Information Systems ("DSIM"), Reserve Bank of India. This is already mandated under the ECB Regulations as being required prior to the draw-down of the loan.
- No part of the borrowing has occurred prior to the July 1, 2012.
- The borrowing is not merely restructuring of an already existing arrangement for borrowing in foreign currency which has been carried out solely for the purpose of benefitting from the concession tax regime.
- The end use of funds is in compliance of applicable rules and regulations as issued by the RBI under the ECB Regulations or otherwise for the entire period of the borrowing.

Monies raised in the form of long-term infrastructure bonds

The term long-term infrastructure bond is not defined under the ITA nor is it defined specifically under the ECB Regulations. However, reading the Circular in conjunction with the ECB Regulations one may understand a long-term infrastructure bond to mean a bond having a maturity period of three years or more issued under the ECB Regulation the end use of whose proceeds would be utilized for infrastructure sectors. 'Infrastructure Sectors' has been clarified in the Explanation to Section 1(iv)(A)(a) of the ECB Regulations to refer to mean- (i) Power; (ii) Telecommunication; (iii) Railways; (iv) Road including Bridges; (v) Sea port and Airports; (vi) Industrial Parks; (vii) Urban infrastructure (water supply, sanitation and sewage projects); and (viii) Mining, exploration and refining. The conditions for availing the lowered rate in relation to these bonds are -

- The bond issue must also have obtained a Loan Registration Number from DSIM, Reserve Bank of India.
- The bonds must have a maturity of three years or more and its proceeds must only be utilized in the infrastructure sector.

However, in case of long-term infrastructure bonds issue not covered under the ECB Regulations, the Government would allow the lowered rate for interest paid on the bonds on a case-by-case approval basis. The approval would be provided on application to Member (IT), Central Board of Direct Taxes with the relevant details of the purpose, period and rate of interest.

CONCLUSION

It is important to note that this move will apply to fresh borrowings and not earlier borrowings. In the infrastructure sector, there are instances of several companies who have previously issued long-term infrastructure bonds and are looking to restructure their issues. The Circular issued appears to indicate that any such re-structuring undertaken in respect of earlier borrowings may not be eligible to the benefit of the lower withholding tax rates provided. While on an overall basis, this is a positive move, it remains to be seen whether it provides the much needed boosts to companies as intended.

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You can direct your queries or comments to the authors

[1] Text of the Prime Minister Manmohan Singh's address to the nation, September 21, 2012, The Economic Times, available at http://economictimes.indiatimes.com/news/politics/nation/text-of-prime-minister-manmohan-singhs-address-to-the-nation/articleshow/16493642.cms (last visited on September 21, 2012).

[2] Press Release, Ministry of Finance, 21 September 22, 2012.

[3] Specifically, these eight sectors were - (i) generation or distribution or transmission of power; (ii) operation of aircraft; (iii) manufacture or production of fertilizers; (iv) construction of road including toll road or bridge; (v) construction of port including inland port; (vi) construction of ships in a shipyard; or (vii) construction of dam;

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