Thin Capitalisation Rules in India

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Gregory Mankiw, an American macroeconomist, has written about the 10 Principles of Economics. One of these principles, accordingly to him, is that "People respond to incentives". People, and therefore the businesses and governments run by these people, will make decisions based on benefit and detriment. A planner will pursue that course of action where he thinks the marginal utility is the greatest. Tax administrations have often demonstrated that when it comes to policy decisions, they have little understanding or regard for this principle of economics. What follows are unintended consequences of significant proportion.

One such policy decision by many tax administrations around the globe has been the differential treatment of debt and equity. Equity-holders are treated as owners and the returns they received are treated as the distribution of post-tax profits. Debt-holders on the other hand, are treated as external stakeholders and the returns on debt are considered to be a tax deductible expense.

In India, corporate profits are first taxed at 30%. Subsequently, when these profits are distributed to shareholders, the revenue-hungry tax man demands a further 20% cut in the form of the dividend distribution tax ("DDT"). It doesn't end here – if resident shareholders (other than companies) earn more than Rs. 10 lakh a year as dividend, they have to part with another 10% of the already twice-taxed dividend. Not only this, if funds are borrowed or expenditure is incurred to invest in equity, no deduction of interest etc. is granted against the dividend income due to artificial provisions like section 14A, making it worst for a business. Therefore, effectively almost 75% of profits are taken away by the government, leaving hardly anything for the businesses.

Interest however, is an allowable deduction in the hands of the payer, thereby reducing the payer's tax bill. Although interest is then taxed at 30% in the hands of the debt-holder, the debt-holder is allowed to deduct expenses and pays tax only on the surplus. Apart from this differential tax treatment, the risks that debt and equity entail are significantly different. Investors and entrepreneurs take significantly greater risk as compared to debt-givers – providing debt in most situations is relatively risk free. This creates a distortion regarding debt-funding from a tax-cost perspective, leading to a peculiar situation where the tax laws, rather economics, drive debt or equity decisions.

In such a scenario, it is not surprising that capital structures tend to be highly geared, especially where there is scope for internally generated debt. It would be irrational for businesses not to do so. Normally, debt would (and should) only be taken on when the management is sure that they have the ability to bear such debt. But this holds true only

for externally raised debt. If additional funds are required and the owners of an enterprise have the ability to provide it, why would they not prefer to structure the funding as debt rather than equity?

In international tax planning, the fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity and shift profits to cash rich entities in the group that are located in low tax countries. Such tax planning has been employed by multinationals for decades resulting in significant tax revenue losses and is now being addressed, not only through changing domestic tax laws but also through joint global action like the Base Erosion and Profit Shifting ("BEPS") project by the OECD and the G-20.

After creating incentives in the law that nudge businesses towards debt, the tax administrations have made several attempts to address higher gearing. However, instead of removing this incentive in order to correct the imbalance, the Indian government has chosen to create disincentives to discourage debt-funding.

Already existing, transfer pricing rules in India require that debt taken from associated enterprises ("AEs") must carry interest which is at arm's length to third-party debt. Such rules are justified – they prevent business from paying higher interest to AEs merely to reduce the overall tax cost to the group as a whole (either because the Indian AE enjoys a preferential domestic tax regime or because the AE is a foreign entity based in a lower tax jurisdiction). Such transfer pricing rules prevent companies from shifting profits to lower tax AEs by not allowing them to pay an abnormally higher rate of interest on debt. What they fail to do however, is prevent entities from tweaking the capital structure to be debt heavy and therefore tax economical.

To deal with this, the tax code of many countries, which now includes India, contain "Thin Capitalisation" rules in some form. The BEPS Action Plan 4, which deals with "Interest Deductions and other Financial Payments" aims to reconcile these difficulties and trade-offs by suggesting measures and best practices with respect to thin cap rules. The Indian Thin Capitalisation rules, introduced by this year's Budget and in the wake of the BEPS project, limit the deductibility of interest paid to AEs to what is considered to be acceptable levels in comparison to the profit of the entity. The rules are based on the "earnings stripping approach", i.e. the principle that excessive interest payments to AEs should not be allowed to strip profits and erode the tax base. These 'thin cap' rules prescribe what the government feels ought to be the reasonable interest expenditure with respect to the earnings of a business – having interest expense above such level means that the entity must be thinly capitalised and that earnings are being artificially stripped. The other approach to 'thin cap' rules involves setting an acceptable ratio of debt to equity and disallowing interest on any debt above this ratio, irrespective of the profit of the entity. Both approaches have their own strengths and shortcomings.

One can either be critical of the approach adopted by the Indian government, arguing that it amounts to regulatory overreach, or one can approve of the step and argue that it is vital to protect the interests of Indian tax revenue. However, it would be better to recognize that there are several difficulties and trade-offs involved with introducing a thin capitalisation regime and seek to create rules that protect the interests of the Revenue and at time same time do not deter investment.

Some question whether India required thin cap rules at this juncture. However, one cannot deny that multinationals have been taking advantage of, some would even say abusing, the gaps in the tax laws. Repatriating funds in the absence of profits is not possible under pure equity funding – add debt funding to the mix and interest has to be paid even in the absence of profit. Even to the detriment of other stakeholders. Discouraging unnecessary or abnormally high debt funding also protects the country's economy from capital flight in response to short term volatility, since debt is easier to repatriate than equity – it also ensures that stock markets and exchange rates are less volatile. This justifies rules to limit debt and interest payments. It also encourages and develops the domestic credit market, since domestic entities will reduce their reliance on foreign debt and that gap would have to be filled by Indian lenders.

On the other hand, consider a situation where an entity requires funding, and a foreign AE is able to raise finance overseas at lower costs and re-lend these to the domestic AE. Or where domestic institutions are unwilling or unable to lend additional funds to a company due to its low profits or already high level of debt and such entity has a cash rich foreign AE which is willing to provide this funding. Or a situation where a foreign AE is willing to provide additional investment only through debt instead of higher-risk equity funding. Or where the interest paid to AEs is higher than the threshold of 30% of earnings, but the debt is not significantly disproportionate to equity. Or a situation where a company's revenue has suffered due to business slowdown, cyclical vagaries of the economy or some extraordinary event. In all such events, limiting interest deductions is unwarranted.

An inconsistency in the approach taken by both business and tax administrations is the 'shareholder function' and 'stewardship' argument. Businesses argue that extending no-cost debt to an underperforming or newly set up subsidiary is done in order to protect the interests of the investing entity. They also argue that a company and its management have a responsibility to a provide funds to a group entity in order to protect the interests of the group and its shareholders as a whole. When such funding is done by way of debt, especially when the loan giving entity has sufficient surplus cash, the same need not necessarily carry interest, since the protection of the group's financial condition is consideration enough. However, businesses readily refute this logic and vehemently reject

any such argument when it is cited by tax administration in order to limit debt or disallow interest payments to AEs.

The fact that there are strong arguments both for and against thin capitalisation rules is testament to how difficult it is to have rules that will satisfy all parties involved. This does not mean that the rules should be left as they are – what is required is that the rules are rationalised.

Rationalising any rule first requires introspection of the provisions and the admission that flaws, which need correcting, actually exist. The Indian thin cap rules have several limitations and flaws which need to be addressed.

From the very outset, the threshold to invoke section 94B has been set too low – an interest payment to foreign AEs exceeding Rs 1 crore triggers these provisions. Most multinational groups invest large sums in India, often in the form of debt, would be covered by the thin cap rules at this threshold. This increases the cost of doing business in India, reducing the attractiveness of the country as a whole.

Further, the concept of 'implicit guarantee' included in the provisions is excessively vague and wide. This concept incorporates the stewardship argument into the thin cap rules by treating any third part debt which is implicitly guaranteed by a foreign AE at par with actual third party debt. However valid the stewardship argument may be, under the implicit guarantee concept it is possible to wrongly assume that a third party has given a loan to an Indian AE of financially stronger foreign AE because this AE *must have* provided a guarantee to the third party lender. Another issue is that implicit guarantee is not a well-defined concept and therefore provides extensive discretion to the Indian tax authorities in invoking such an argument to disallow interest on third-party debt. The stewardship argument can at most be taken to mean an implicit support – not an implicit guarantee. Guarantees are matters of contractual obligations. To hold that a guarantee has been provided in the absence of any such contract is erroneous. There is often a substantial difference between an explicit guarantee and implicit support since implicit support may be limited to the hope that the parent company will act even though it is not legally bound to do so. There are many examples where parents walk away from subsidiaries in financial difficulty, which indicates that implicit support assumption by a subsidiary's external creditors can, in practice, be worthless.

Another flaw in the Indian thin cap provisions is the discrimination – between related parties and third parties and between Indian AEs and foreign AEs. BEPS Action 4 which provides guidance on the implementation of thin cap rules does not distinguish between third party and AE debt. It also doesn't differentiate between domestic AEs and foreign AEs. India, however, in its approach, seeks to limit interest only with respect to debt extended by foreign AEs. This could easily lead to a situation where such treatment is

challenged, citing the non-discrimination provisions contained in double tax avoidance agreements ("DTAA"). Doing so would have merit – section 94B is clearly discriminatory since it specifically targets interest paid to non-residents, while no such restriction is placed on interest paid to residents. Further, by keeping third-party debt out of the purview of these rules, tax planning arrangements involving third party debts would still not be addressed.

The Indian thin cap rules also do not consider the interest income that an Indian entity might be earning – under the BEPS Action 4 the limitation applies to a deduction of net interest expenses, wherein interest expenses, net of interest income, are considered for deductibility purposes. The OECD has acknowledged that a gross interest rule could lead to double taxation, where an entity is subject to tax on its full gross interest income, but part of its gross interest expense is disallowed.

Furthermore, BEPS Action Plan 4 discusses that, rather than linking an entity's ability to deduct net interest expense to economic activity in a single year, the impact of short term volatility could be reduced through the use of average EBITDA of few years. The OECD also recommends carry-forward and carry-back of disallowed interest expenses, wherein the disallowed interest expenses in the current year are allowed to be set-off against future profits and past profits. The Indian rules are silent the manner of calculating the profit for purpose of limiting interest, the wordings of the provisions make it unlikely that 'averaging' has been envisaged. While the rules allow carry-forward of disallowed interest, carry-backs are not permitted.

The thin cap rules are no doubt required in the current global economic scenario. The rollout would have been smoother had the government distributed the proposed thin cap rules and invited feedback and suggestions. The criticism for the thin cap rules would not have been as sharp and perhaps the rules themselves may have been amended. In addition to this, the government could have also simultaneously rationalised the taxation of dividends and adopted other global best practices that favour and help the taxpayers. However, the government chose a selective approach, and adopted just some of the global best practices, without fully understanding their rationale and suitability for India.

Instead of looking towards developed countries, the Indian government could have looked closer at countries such as Mexico, South Africa, China, Indonesia, Malaysia or Brazil – countries which are more similar in economic development and growth to India. The thin cap rules in South Africa do not apply if the interest paid is subject to withholding tax. In China the interest limitations do not apply if contemporaneous documentation is provided to demonstrate that interest paid was at arm's length. Indonesian and Malaysian thin cap rules both employ the debt-equity approach with a safe harbour ratio of 4:1, while Mexico has a 3:1 ratio as the benchmark for determining interest limitations. Brazil interestingly maintains a black-list and a grey-list and has different interest limitation

criteria for loans taken from lenders domiciled in low-tax jurisdictions and non-low tax jurisdictions – thereby targeting debt from conduit entities or cash-boxes based on tax havens, effectively addressing BEPS concerns.

Apart from these drawbacks inherent in the thin cap rules, both in principle and in the form in which they have been introduced in India, there are certain peculiarities in the Indian tax provisions that demand attention, especially in light of the thin cap rules.

One such area which needs attention is the higher tax burden on equity as compared to debt. Today, a foreign AE investing in its Indian AE would prefer investing by way of debt to avoid the higher tax cost of equity. If the Indian tax laws want to discourage excessive debt through thin cap rules, these rules should be supplemented by reducing the tax cost of equity funding. Abolishing the dividend distribution tax would provide relief to equity funding by rationalising the taxation of profits and dividends, and allowed companies to substitute debt with equity without suffering a hefty tax hit. It is also important to note that when the foreign AE has to pay tax in its jurisdiction on dividend earned from India, DDT is not allowed as foreign tax credit against such tax, since the DDT is paid by the Indian company and not by the foreign AE – this results in economic double taxation and increases the cost of equity funding.

By introducing Thin Cap Rules, the Indian government has tried to counter an incentive by creating a disincentive. What would have been more effective, however, is if the original incentive had been removed, i.e. by bringing the tax treatment of debt and equity at par. Alternatively, in addition to the disincentive of thin cap rules, the government could have provided a counter-incentive by removing or reducing DDT, thereby encouraging companies to switch from debt to equity. Then, maybe, companies could have decided between debt and equity as a method of funding without having the distraction of tax arbitrage, and the desired objective of ensuring that companies have reasonable level of debt would perhaps be achieved.

However, the way things stand, it is likely that the thin cap rules may still not deter excessive debt – tax planning will simply get more creative and aggressive. Loss aversion, another principle of economics and decision theory, refers to people's tendency to prefer avoiding losses. This means that when faced with a disincentive (thin cap rules), companies will try and find a way to circumvent the rules and avoid the potential loss. This reaction is reinforced by the incentive provided by preferential treatment debt receives over equity – companies cannot be expected to ignore a strong incentive without resistance and simply reduce debt due to the disincentive brought in.

As the Indian tax authorities have in the past, the manner in which the thin capitalisation rules have been implemented demonstrate their adversarial attitude towards tax payers. These rules result in a negative impact on the ease of doing business in India and in the

attractiveness of India as an investment jurisdiction. The selective adoption of a part of the suggested provisions of thin cap rules has added to the hotchpotch of tax laws in India dealing with international taxation. The tax authorities should realise that they cannot be selective in adopting one-sided measures, and if they truly wish to ape developed countries, they must do so in entirety and also adopt other tax provisions as a complete package. The policy makers must abandon the present spirit in which they draft laws and instead deploy more lateral and rational thinking if they truly wish to bring India's tax laws at par with the best global provisions.