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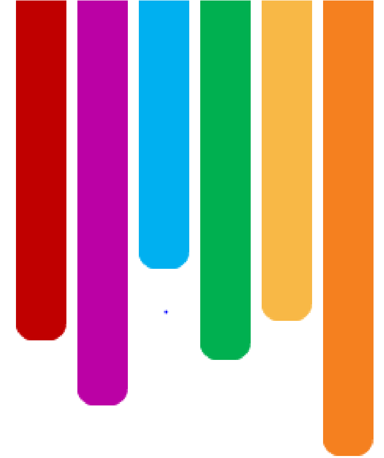

Thin Capitalization

Certificate Course on International Taxation, Chennai

Arpit Jain

Director – International Tax

- Tax avoidance Issues…
  - Sham transaction
  - Step transaction
  - Abuse of law
  - Form over substance
- Ways to fix it…
  - General Anti-abuse Provisions
  - Specific Anti-abuse Provisions
    - Section 93, 94
  - Transfer Pricing
  - Controlled Foreign Corporation
  - Thin Capitalization

Tax aspect of Capital Structure

- Equity
  - Stamp duty or similar provision
  - Distributed profit (dividend) not deductible
  - Dividend is generally subjected to economic double taxation
  - Difficulty in getting money back
- Debt
  - No stamp duty
  - Interest is tax deductible item
  - No economic double taxation

Debt financing is preferred over equity financing

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Thin Capitalization

- When more debt is used than "normal" as compared to equity, then the same amounts to gearing the capital structure for taking undue tax advantage and possibly thin capitalisation rules will trigger
- Actually, thin capitalisation is nothing but hidden equity capitalisation through excessive loans [OECD, 1987]
  - Though the loan may be at market rate, the quantum not justified based on bona fide business considerations.
  - Excess interest payment will be hidden distribution
- Provision mainly to have a check on excess funding through debt
  - And thereby excessive claim of deduction on account of interest
- Used to prevent erosion of tax base by thin capitalization structure
  - Reducing artificial interest deduction from taxable income from operating activities

Approaches for Thin Cap

- Fixed Ratio Approach
  - Debt from shareholders having substantial participation if specified debt/equity ratios are exceeded
    - Then deduction of excess interest is denied
- Subjective Approach
  - Case to case basis analysis is to be done to see whether such financing arrangement is usual or not
  - Loan agreement & consideration with independent parties
  - Comparison with Debt Equity ratio, Interest Coverage ratio etc. of comparables

- Re-characterization Approach
  - Special relation between lender and borrower
    - E.g. Associated Enterprise
  - Interest is re-characterized as dividend
- No Special Rules
  - Covered by General Anti-abuse Provisions

- Germany
  - No Thin Capitalization Rules but Interest Deduction Limits apply
  - Interest in excess of 30% of taxable EBDITA is non-deductible
  - Applicable to interest paid to unrelated parties as well
  - Exception (i.e. full interest deductible, if) –
    - Net interest payment is less than EUR 3mn; or
    - Taxpayer is not part of Group of Companies; or
    - German company's equity ratio is better than the Group
      - Variation of 2% permitted
  - Treatment of Excess Interest
    - Carried forward to Future Years
    - Partial / Complete forfeiture of carry forward in case of change of shareholding
    - Double Taxation as no corresponding effect in taxation of lender

Position in Select Countries

- France
  - Applies to interest payment to AE
    - Also includes loans guaranteed by related parties w.e.f. 2010
  - Interest deduction limited to highest of
    - Interest on AE Debt = 1.5 x AE Equity
    - Max. Interest Deduction : 25% of Adjusted Current Profits
    - Interest Received from AE
  - Limit on interest deduction does not apply if -
    - Debt : Equity ratio of Group is higher than French Company; or
    - Excess Interest is less than EUR 150,000

Positions in Select Countries

- France
  - Treatment of Excess Interest
    - Carried forward to Future Years
      - Deduction subject to above limits
    - Annual 5% Reduction in Carry Forward Interest (Year 3 onwards)
    - No withholding tax on excess interest if it is at arm's length
  - Additionally, from 2013 Interest Deduction Limits also introduced (similar to Germany)
    - Net Interest Expense deduction capped at 75% (for 2014 and onwards)
    - However, not applicable for net interest expense < EUR 3 million

Positions in Select Countries

- United States
  - Highly complex rules commonly known as 'Earnings Stripping Rules'
    - Needs examination on case to case basis
  - Generally, interest deduction restricted in case of debts owed to or guaranteed by non-US related party
  - Restriction applies only where
    - Debt : Equity exceeds 1.5 : 1; and
    - Interest is in excess of 50% of taxable EBDITA
  - Treatment of Excess Interest
    - Carried forward to Future Years
    - Set off subject to limitation of 50% of taxable EBDITA

Position in Select Countries

- United Kingdom
  - No Specific Thin Cap Rules
  - Administered as part of Transfer Pricing
  - No pre-determined limits or ratios
    - Subject to negotiation with tax authorities
  - Need to justify the capital composition to tax authorities
    - Excess interest is not deductible (but not characterised as dividend)

Position in Select Countries

- Belgium
  - Debt : Equity ratio of 5:1
  - It applies to -
    - Intra-group loans
    - Where financing obtained from entity enjoying substantial advantageous tax treatment on interest
  - Treatment of Excess Interest
    - Non-deductible for Tax purposes
  - Notional Interest Deduction
    - Notional interest payable on capital is tax deductible
    - Interest rate notified by Belgian Government based on 10-year Govt Bond Rate

Position in Select Countries

- Czech Republic
  - Related Party Debt : Equity ratio of 4:1
    - Loan received from unrelated party under back-to-back arrangement covered
  - Treatment of Excess Interest
    - Non-deductible for Tax purposes
    - Re-characterised as hidden distribution / dividend
      - Withholding tax applicable to dividend applies
    - Hidden distribution rule do not apply to EU resident

- No Thin Cap Rules under Tax Law

- Limited protection under Exchange Control Regulations
  - Debt : Equity of 4:1 permitted where external commercial borrowings exceed USD 5mn
  - Higher Debt permitted with approval of RBI

Issues of Implementation in India

- Treatment of Excess Interest
  - Only Treated as Tax Non-deductible
    - Debt infusion may still be favourable
      - If interest is not re-characterised as dividend and Underlying Tax Credit not available
    - No difference for companies paying MAT
      - MAT is governed by Accounting Profits
  - Example:
    - Funding Alternative: Debt / Equity
    - Profit before Interest: 100
    - Interest: 60

Comparison of Alternatives

Equity

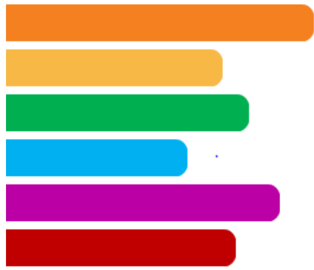
- Corp Tax (IN) 30
- DDT (IN) 10
- Dividend Paid 60
- Dividend Tax (FC) 18
- Net Income 42

Debt (Interest Not Tax Deductible)

- Corp Tax (IN) 30
  - PBIT 100
  - PBT 40
  - PAT 10
- DDT (IN) 1
- Interest TDS 6
  - Dividend Paid 9
  - Interest Paid 54
- Dividend Tax (FC) 3
- Interest Tax (FC) 12
- Net Income 48

Arpit Jain
Director

Office: +91 79 4032 6400
Mobile: +91 96876 00207
Email: arpit.jain@kcmehta.com



K C Mehta & Co.

Chartered Accountants

Vadodara: Meghdhanush, Race Course, Vadodara 390 007, INDIA
Phone: +91 265 2341 626 / 3086 400 Fax: +91 265 3086 444/455/466

Mumbai: 101, Cosmos Court, Above Waman Hari Pethe, S.V. Road, Vile Parle (west), Mumbai 400 056 INDIA Phone: +91 22 261 25 834

Ahmedabad: 308, Aaryan Workspaces, St. Xaviers' College Corner, Umashankar Joshi Marg, Navrangpura, Ahmedabad - 380 009, INDIA Phone: +91 79 403 26 400

e-mail: office@kcmehta.com; **website:** www.kcmehta.com