Volume-79 February-2021 Pages 1-26

SBS Wiki

monthly e-Journal

By

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CONTENTS

Dear Readers,

Greetings for the season!

In this edition, we bring you an article on the second part on the prevention of abusive strategy of thin capitalisation, which deals with various issues. The next article is on the eligibility of credit with respect to supplies which are made as part of promotion schemes and discharge of CSR obligations.

I hope that you will have good time reading this edition and please do share your feedback. I will also urge clients to mail us topics or issues on which you want us to deliberate in our future editions, so that we can contribute to the same.

Thanking You,

Suresh Babu S
Founder & Chairman

GST

BLOCKED CREDIT ON FREE OF COST SUPPLIES— THE GLOOMY PICTURE AND A GLIMMER OF HOPE

Contributed by CA Sri Harsha & CA Manindar

Introduction:

One of the objectives for implementation of GST in India is to ensure seamless flow of credit among business to shift the entire tax burden to ultimate consumers of the supply. In line with this objective, Section 16(1) of the CT Act[1] facilities input tax credit ('ITC'/'Credit') availment by a registered taxable person on all inward supply of goods or services that are used in the course or furtherance of his business. However, Section 17(5) blocks credit availment on certain inward supply of goods and services specified thereunder. Clause (h) of section 17(5) provides blocks credit on goods lost, stolen, destroyed, written off or disposed by way of gifts. The presence of this clause in section 17(5) coupled with the Revenue's perception on the meaning of the term 'gift' let the taxpayers into defense. They are forced to forego credit on certain expenditure to avoid potential litigation. These expenditures include expenses incurred towards incentives and promotional schemes, promotional gift articles, dairies, pens etc.,to promote brand name and expenses towards Corporate Social Responsibility ('CSR') Activities. In the humble opinion of the paper writers, credit is available on this expenditure and are not covered by section 17(5)(h).An attempt is made in this article to bring out the reasons why credit can be claimed on these expenditures.

'disposed of by way of gift or free samples' and the possible rationale:

As mentioned above, credit is blocked on goods disposed of by way of gift or free samples under section 17(5)(h). The exact words in which Section 17(5)(h) was laid as is *'goods lost, stolen, destroyed, written off or **disposed of by way of gift or free samples'.***

In view of the above extracts of Section 17(5)(h), goods which are lost, stolen or destroyed or otherwise disposed of by way of gift or free sample shall not be available as credit. The phrase 'disposed of by way of gift or free samples' is preceded by the words 'goods lost, stolen, destroyed, written off' which indicate that the goods involved can no longer be used in the course or for furtherance of business or commerce. Applying the 'Noscitur a Sociis' interpretation rule, the meaning of subsequent phrase 'disposed of by way of gift or free samples' would also be limited to those goods which can no longer be used in the course or for furtherance of business or commerce and are taken away from business.

Further, the words 'gift' or 'free samples' is preceded by the words'disposed of'. The contextual dictionary meaning[2] of the word 'disposed of' means to ***get rid of somebody/something that you do not want or cannot keep.*** This implies that goods which are procured in the course of or furtherance of business or commerce which no longer required for business and when they are removed as gifts or free samples for no consideration, then would come under the ambit of the phrase 'disposed of by way of gift or free samples'.

[1]Central Goods and Services Tax Act, 2017

[2]https://www.oxfordlearnersdictionaries.com/definition/english/dispose-of?q=dispose+of

In view of the above understanding of the clause (h), one can envisage that the rationale for blocking ITC under this clause is for the reason that the ***goods involved can no longer be used in the course of or for furtherance of business or commerce. As no tax is payable on the output for the reason that the goods involved are taken away from business, no ITC can be claimed of the tax paid on these goods when procured.***

Further, the term 'gift' has not been defined in CT Act. The meaning given under Gift Tax Act, 1858 is as under:

'Gift' means ***the transfer by one person to another*** *of any existing* ***movable or immovable property voluntarily and without consideration*** *in money or moneys worth…*

In the case of Sonia Bhatia vs State of UP[3] , the Supreme Court held that 'gift' has been held to be a voluntary transfer of property by one to another, without any consideration or compensation therefor. ***A 'gift' is a gratuity and an act of generosity and does not require a consideration; if there is a consideration for the transaction, it is not a gift.*** In the same case, it was also held that a gift is a transfer which does not contain any element of consideration in any shape and form - Love, affection, spiritual benefit and many other factors may enter in the intention of the donor to make a gift but these filial considerations cannot be called or held to be legal considerations as understood by law.

In the case of Commissioner of Taxation (Cth) Vs. McPhail[4] , the Australian High Court held that ***to constitute a 'gift' the property should be transferred voluntarily and not as a result of a contractual obligation***. In this case a person agreed to give a donation to a school in return of school charging less fees for the education of the child of said person. Hence, the Court held that such donation cannot be termed as 'gift' as it was made under a contractual obligation wherein school was required to charge lower fees against the donation made.

In view of the above references to the meaning of 'gift', it can be understood that it involves transfer of movable or immovable property voluntarily out of gratuity or generosity without any consideration. Further, it should not arise out of contractual obligation.

Incentives and Promotional schemes:

It is quite a regular feature for many businesses to incur business promotional expenditure in the form of incentives and gifts to dealers and distributors who achieve the specified targeted sales. Revenue was not allowing the ITC availment on this expenditure incurred towards these incentives/gifts by referring to section 17(5)(h).

[3] [1981] 2 SCC 585

[4] [1968] 41 ALJR 346

In order to promote their sales, various schemes are promoted by companies among their dealers/distributed to achieve desired sales targets. The dealers/distributors who achieve the sales target will be given various gift items like TVs, refrigerators, washing machines, laptops, gold coins etc. Sometimes, under the schemes, the dealers/distributors are entitled for free tours as arranged by the companies at their own cost by taking tour operator, air travel, hotel accommodation and other services on which appropriate tax has been charged by vendors. These items are considered by Revenue as gifts extended by company to dealers/distributors which were given on free of cost basis and credit was being disallowed in the hands of company.

Incentive and promotional schemes announced by companies to their dealers/distributors signifies a contractual obligation between them. It is a promise to the dealers/distributors that they will be rewarded with the specified monetary or non-monetary items if they put in those extra efforts and achieve the targeted sales. Considering the above understanding of the meaning and scope of the phrase 'disposed of by way of gift or free samples', one can understand that items given to dealers/distributors under sales promotion scheme cannot be considered as disposed of by way of gifts for the following reasons:

- The items involved are given based on the terms of the schemes. They are not of the nature that they are no longer required for business to dispose of as gifts. They are procured for the purpose of the schemes and accordingly used.

- The items involved are not given voluntarily and they are given only to those dealers/distributors who have achieved targeted sales by putting extra efforts. The items given under schemes results into indirect consideration which is contingent by way of increase in sales revenue on which applicable GST is collected from buyers and paid to Government.

- Promotional schemes announced by companies involves contractual obligation between companies and their dealers/distributors and thereby the items given under these schemes cannot be called as gifts.

Therefore, as items given under promotional schemes are not of the nature of gits, it can be said that the restriction placed under section 17(5)(h) is not applicable and ITC can be claimed on these items.

However, as mentioned above, Revenue perception on the meaning of 'gift' is different and are of the view that it includes every kind of supply on free of cost basis without considering the commercial motive and business objectives surrounded by such transactions. CBIC[5] vide Circular 92/11/2019-GST dated 07.03.2019, clarified as under:

Further, clause (h) of sub-section (5) of section 17 of the said Act provides that ITC shall not be available in respect of goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples. Thus, ***it is clarified that input tax credit shall not be available to the supplier on the inputs, input services and capital goods to the extent they are used in relation to the gifts or free samples distributed without any consideration****. However, where the activity of distribution of gifts or free samples falls within the scope of 'supply' on account of the provisions contained in Schedule Iof the said Act, the supplier would be eligible to avail of the ITC.*

[5] Central Board of Indirect Taxes and Customs

Further, the said issue was examined by various Advance Ruling Authorities and have taken adverse view disallowing ITC on items given to dealers/distributors on free of cost basis under incentive schemes. A few are referred hereunder:

a) In Re: Biostadt India Limited[6]
b) In Re: M/s Sanofi India Limited[7]
c) In Re: M/s Page Industries Limited [8]
d) In Re: MokshAgarbatti Co[9]

The above clarification issued by CBIC circular and the adverse advance rulings resulted into confusion over availability of ITC on items given to dealers/distributors on free of cost basis under the promotional schemes. In order to avoid litigation with department, many taxpayers have foregone ITC on the items involved in these promotional schemes though they have given these items with commercial intention to increase their sales and are not convinced that the items involved are gifts.

Having said this, the Appellate AAR in the case of In Re: M/s. Sanofi India Limited[10] created a ray of hope to the taxpayers to believe that they claim ITC on these items and can successfully defend their claim when the same is objected by the Revenue. The Appellate AARexamined the issue and allowed ITC by setting aside the ratio laid down by the AAR. It was held as under:

28. As regards the AAR findings that there is no consideration, whatsoever, involved in the transaction related to the supply of the promotional goods and services as per the "ShubhLabh Trade Loyalty Program" by the Appellant to the wholesalers, it is observed that though there is no direct consideration in the monetary terms, received by the Appellant from the beneficiary Wholesalers against providing the promotional goods and services under the Subject scheme, but it is conspicuous from the subject scheme that the subject transaction i.e. ***provision of the promotional goods and services under the subject scheme is the consequence or the outcome of the antecedent, which is the purchase of the Appellant's pharmaceutical products by the wholesalers in order to claim more and more rewards points under the ShubhLabh Trade Loyalty Program, leading in the sales volume of the Appellant's products, which in turn result in the increased income/consideration. Thus, it is clearly seen that there is an involvement of the consideration,*** *although indirect, in the impugned transactions carried out under the ShubhLabh Trade Loyalty Program, whereas the Hon'ble Supreme Court judgment, relied upon the AAR had explicitly held as under:*

"........A 'gift' is a gratuity and an act of generosity and does not require a consideration; if there is a consideration forthe transaction, it is not a gift........"

[6] 2019 (3) TMI 540— AAR, Maharashtra
[7] 2019 (6) TMI 1305 –AAR, Maharashtra
[8] 2020 (12) TMI 902—AAR, Karnataka
[9] 2020 (4) TMI 593— AAR, Gujarat
[10] 2019 (10) TMI 1384— App. AAR, Maharashtra

Further, it is manifest that the Appellant's act of providing the promotional goods and services under the subject scheme is certainly not an act of generosity, as the Appellant is not giving these goods and services to each and every wholesalers, but only to such participating wholesalers, who have achieved their sales targets and accumulated adequate reward points to fetch such promotional goods and services in terms of the catalogue prescribed by the Appellant. ***<u>There is presence of the pure commercial intention of the Appellant in the said scheme i.e. to increase their business and sales.</u>***

29. In view of the above discussions, ***<u>it is clearly established that the provision of the promotional goods and services by the Appellant to the eligible wholesalers under the ShubhLabh Trade Loyalty Program is not gift, as the same does not satisfy the essential ingredients of the gift as envisaged by the above cited Hon'ble Supreme Court Judgment. Accordingly, the provision of the section17(5)(h) of the CGST Act, 2017, which proposes to disallow the ITC on the goods disposed by way of gift, will not be applicable in the transaction under question."</u>***

The above Appellate AAR is really welcoming development on this issue. The Appellate AAR has considered the Supreme Court decision in the case of Sonia Bhatia (Supra)and held that the items given under promotional schemes are not of the nature of gifts to attract the restriction under section 17(5)(h) in order to disallow the ITC.

<u>Promotional gift articles dairies, pens to promote brand name:</u>

Further, business entities procure promotional gift articles, diaries, pens etc. with their brand name printed/embossed on them. These promotional items are given to customers, vendors, dealers, distributors etc. without any charge on free of cost basis as their brand reminders. These are inputs to the business and are procured with an objective of brand promotion. These are distributed with a commercial motive. Thereby, they are said to have consumed in the business and cannot be said that these are disposed of as gifts voluntarily out of generosity.

Under Income Tax Act, 1961, in the case of PHL Pharma Private Limited ,[11] the Mumbai Tribunal examined the allowability of expenditure towards promotional items as business expenditure. The Tribunal held that these items cannot be reckoned as freebies. The relevant extracts:

"Coming to the gift articles and free samples of medicines, it is seen that the assessee gives various kind of articles like, diaries, pen sets, calendars, paper weights, injection boxes etc. embossed with bold logo of its brand name and the product name so that the doctors remembers the brand of the assessee and also the name of the medicine. ***<u>All the gift articles, as pointed out by the assessee before the authorities below and also before us are very cheap and low cost articles which bears the name of assessee and it is purely for the promotion of its product, brand reminder, etc. These articles cannot be reckoned as freebies given to the doctors."</u>***

[11] 2017 (1) TMI 771 - ITAT MUMBAI

Thus, items given as brand reminders cannot be considered as gifts. Therefore, the ITC involved on the same cannot be said to be blocked. Having said this, the advance ruling authorities under GST law, ignored the commercial motives involved and considered these items as gifts given without consideration. The following are for reference in this regard:

a) In Re: BMW India Private Limited[12]
b) In Re: Biostadt India Limited[13]
c) In Re: M/s Sanofi India Limited[14]
d) In Re: M/s Page Industries Limited[15]

However, the Appellate AAR in the case of In Re: M/s. Sanofi India Limited(supra) examined the issue and has overturned the ruling of the AAR. It was held as under:

"30. Now, we will examine the final issue (f), which is whether the promotional goods e.g. pen, notepad, key chain, etc., embossed with the brand 'Sanofi', which are given free of cost by the Appellant to its distributors or doctors as brand reminders can be construed as gift for the determination of the applicability of section of the CGST Act, 2017.

31. The Advance Ruling Authority, on this above issue, has ruled that the goods e.g. pen, notepad, key chain, etc., embossed with the brand 'Sanofi', which are given free of cost by the Appellant to its distributors or doctors as brand reminders are in the nature of gifts, as these goods have been transferred in the absence any contractual obligation between the Appellant and its wholesalers, and without any commercial consideration, thereby satisfying the parameters of a gift, which have been laid out by the Hon'ble Supreme Court in the case of the Sonia Bhatia vs. State of UP (supra)

32. As regards the above AAR observation, it is stated that the AAR has completely ignored the advertising potential of the such goods given by the Appellant to its distributors or doctors as brand reminder, thereby holding the subject goods duly embossed with brand Sanofi as any other general goods, which may not have been embossed. This is certainly not the case here. ***The goods embossed with the Sanofi is clearly distinct from the goods which are not embossed as such. Further, it has already been established in para 22 above that the subject goods, given free of cost to the distributors or doctors as brand reminders are nothing but inputs for the Appellant in terms of the provision of section 2(59) of the CGST Act, 2017, as the same fulfill the advertisement need of the Appellant and its products.*** *Hence, it can reasonably be concluded that these goods are given to the distributors or doctors with a purpose or motive, which is clearly commercial in nature i.e. The appellant is providing these goods to the distributors or doctors with an implicit commercial motive related to the growth in the sale of their products with the aid of their distributors and doctors.* ***Thus, it can be deduced that the act of the Appellant, wherein they supply the subject goods to their distributors or doctors, is anything but generous, and there is certainly an element of the commercial consideration involved into this.*** *Therefore, the provision of the subject goods cannot be held to be gift, as interpreted by the above cited Supreme Court Judgment. Accordingly, the provision of the section 17(5)(h)of the CGST Act, 2017, which proposes to disallow the ITC on the goods disposed by way of gift, will not be applicable in the transaction under question."*

[12] 2019 (4) TMI 1943— AAR, Haryana
[13] 2019 (3) TMI 540— AAR, Maharashtra
[14] 2019 (6) TMI 1305 –AAR, Maharashtra
[15] 2020 (12) TMI 902—AAR, Karnataka

In view of the above excerpts of the decision of Appellate AAR, the commercial motive involved in giving the brand promotion items as gifts are noticed and it is clearly observed that such items distributed on free of cost basis is anything but not generous and cannot come under the ambit of 'gift' in order to block the corresponding ITC by referring to the restriction under section 17(5)(h). Therefore, as Appellate AAR accepted the view that items given as brand reminders are not gifts and entitled for ITC, it gives a ray of hope for the industry to claim ITC on these items and defend their claim.

Expenditure towards CSR activities:

Section 135 of the Companies Act, 2013 requires every company having a specified net worth or turnover or profit, to contribute at least two per cent of its average net profit towards activities of Corporate Social Responsibility. Further, Schedule VII of the Act and the Companies (Corporate Social Responsibility) Rules, 2014 provide for certain conditions and guidelines which are geared towards advancing CSR objectives.

Question is about the eligibility of ITC involved in incurring the expenditure towards CSR activities. The Revenue's contention is that these activities involve supply of goods on free of cost basis without any charge from beneficiaries and there by no ITC can be claimed in view of the restriction imposed under section 17(5)(h) of the CT Act. This view is also supported by AAR, Kerala in the case of In Re: M/s. Polycab Wires Private Limited .[16]

In the said case, the Kerala State Electricity Board has requested from the distributors of the applicant to supply electrical goods for the restoration of power supply at flood ridden areas. These materials are supplied by the distributors at free of cost being CSR Activity for reinstating connectivity in flood ridden areas. In addition to this supply to Kerala State Electricity Board, the applicant has distributed electrical items like, switches, fan, cables etc. to flood affected people under CSR expenses on free basis without collecting any money. The AAR referred to the provisions of section 17(5)(h) of the CT Act and held that ITC cannot be claimed as goods are disposed on free of cost basis for CSR activities.

Having said this, the issue was examined by Mumbai Tribunal under CENVAT Credit Rules, 2004 in the case of Essel Propack Ltd. v. Commissioner of CGST[17] , wherein the Honorable CESTAT held as under:

"CSR not only holistic approach but integrating core business strategy since same address well-being of all stake holders and not just company's shareholders, also CSR not charity as same having direct bearing on manufacturing activity of company that is largely dependent on smooth supply of raw materials- CSR also augmenting credit rating of company as well as its standing incorporate world-Hence, sustainability of company dependent on CSR without which companies cannot operate smoothly for long period as they are dependent on various stakeholders to conduct business in economically, socially and environmentally sustainable manner.

[16] 2019 (4) TMI 111, AAR- Kerala
[17] 2018 (362) E.L.T. 833 (Tri.-Mumbai)

Hon'ble Tribunal has further observed that ***<u>CSR which was a mandatory requirement for the public sector undertakings, has been made obligatory also for the private sector and unless the same is to be treated as input service in respect of activities relating to business, production and sustainability of the company itself would be at stake”</u>***

Despite the above legal position laid down by Honorable Mumbai Tribunal, doubts were raised over the applicability of the said decision under GST regime as erstwhile CENVAT Credit Rules, 2004 does not have a clause similar to that of section 17(5)(h) of the CT Act.

Having said this, recently, the Uttar Pradesh AAR in the case of in the case of In Re: M/s Dwarikesh Sugar Industries Limited[18] examined this issue and ruled in favor of taxpayers. it was held as under:

“As regard to the question whether free supply of goods as a part of CSR activities is restricted under Section 17 (5) (h) of CGST Act, 2017, we observe that the applicant supplies of furniture/ fittings such as tables, chairs etc. and electrical goods to be used in the school under the CSR activity, free of cost. In this regard, we observe that Section 17 of the CGST Act, 2017 talks about apportionment of credit and blocked credits. Further, as per Section 17(5)(h) of the CGST Act, 2017, input tax credit shall not be available in respect of

“goods lost, stolen, destroyed, written off or disposed of by way of gift or free samples.”

The aforesaid section restricted credit of the goods which were written off or disposed off by way of gift or free samples. Now the moot question before us is to decide whether the furniture / fittings such as tables, chairs etc. and electrical goods supplied by the applicant are to be treated as gift or not. The term ‘Gift' has not been defined under the CGST Act, 2017, however in common parlance gift is provided to someone occasionally, without consideration and which is voluntary in nature. Further, the applicant has also relied upon the Judgment of Hon'ble Supreme Court of India, in the case of Ku. Sonia Bhatia v. State of UP, where in Hon'ble Court has cited the definition of 'gift' from Corpus Juris Secundum, Volume 38 in the following words: “A 'gift' is commonly defined as a voluntary transfer of property by one to another, without any consideration or compensation therefor. A 'gift' is a gratuity and an act of generosity and not only does not require a consideration, but there can be none.” Citing the definition, it has been observed by the Hon'ble Court that

“The concept of gift is diametrically opposed to the presence of any consideration or compensation. A gift has aptly been described as a gratuity and an act of generosity and stress has been laid on the fact that if there is any consideration then the transaction cease to be a gift.”

In view of above discussion, ***<u>we are in unison with the applicant that a clear distinction needs to be drawn between goods given as 'gift' and those provided / supplied as a part of CSR activities. While the former is voluntary and occasional, the later is obligatory and regular in nature. CSR expenses incurred by the applicant have been mandated under the Companies Act, 2013. It is the applicant's obligation to incur such expenses in order to be in compliant with the law. Since CSR expenses are not incurred voluntarily, accordingly, we are of the opinion that they do not qualify as 'gifts' and therefore its credit is not restricted under Section 17(5) of the CGST Act, 2017”</u>***

[18] 2020 (1) TMI 1430— AAR, Uttar Pradesh

In view of the above excerpts of the decision of AAR, one can strongly argue that CSR activities are generally undertaken under statutory obligation and they cannot be considered as gifts given without any charge to disallow ITC under section 17(5)(h).

Conclusion:

Basis the above discussion, it can be understood that ‘gift’ is an act of generosity and gratuity and does not involve any consideration. It does not include those items which are distributed on free of cost basis with commercial or business motives or under contractual or statutory obligation. However, the Revenue perception is that anything and everything given on free of cost basis would come within the meaning of ‘gift’. The circular issued by CBIC as well as the presence of AARs in favor of Revenue forced the taxpayers to forego ITC on these expenditures to avoid potential litigation. Having said this, the recent rulings in favor of taxpayers certainly be considered as glimmer of hope to taxpayers to believe that they can claim ITC on these expenditures and can successfully defend their claim if questioned by Revenue.

This article is contributed by CA Sri Harsha Vardhan K & CA Manindar K, Partners of SBS and Company LLP, Chartered Accountants. The authors can be reached at harsha@sbsandco.com & manindar@sbsandco.com

INCOME TAX

THIN CAPITALIZATION - RESTRICTION OF INTEREST UNDER SECTION 94B – NEXT LITIGATION SAGA – PART II

Contributed by CA Sri Harsha & CA Narendra

In the earlier part of the article, we have discussed background of Section 94B and basic interpretation of various terms defined thereunder. In this part, we have dealt with specific issues while computing the interest limitation under Section 94B.

Issue	Analysis	Conclusion
Forex fluctuation on deferred payment on interest	• The starting point for the response would be from understanding the term 'interest or similar nature'. The exact phrase has not been defined either under IT Act or under Section 94B. Hence, in order to understand whether the foreign exchange (for brevity 'forex') gain or loss is to be taken into consideration while arriving the quantum under Section 94B, it is important to understand whether such forex gain/loss can also be said 'interest' or at least would qualify to fall under the ambit of 'similar nature'. Now, let us proceed to examine, the ambit of 'interest or similar nature' separately or jointly. • Section 2(28) of ITA defines 'interest' to mean interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised. However, the definition of 'interest' under Section 2(28) has to be taken with a pinch of salt. This is for the reason that Section 2 opens with a caveat that 'In this Act, unless the context otherwise requires'. In other words, what is laid in Section 2 is not sacrosanct and cannot be universally applied. However, for the sake of taking this forward, let us assume the context in which 'interest' is defined under Section 2(28), applies equally to the context under Section 94B.	• In our view, the tax payer's stand has to win because of the fact that the benefit of forex fluctuation is not passed on to the lender to qualify such amounts as 'interest or similar nature'. • However, there is a possibility for the courts to state that the forex gain or loss should be seen in the same colour of the source and accordingly may hold to include the forex fluctuation in the ambit of 'interest or similar nature' given the jurisprudence evolved in different areas dealing with forex fluctuation. • We advise that whatever stand taken by the tax payer, it has to be consistently maintained, at least to plead on such ground.

	• OECD in its report on 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments - Action 4' has provided detailed discussion about 'interest and payments economically equivalent to interest'. Under OECD's report, interest shall also include any other expenses incurred in connection with the raising of finance, including arrangement fee and guarantee fees. OCED has recommended that the interest shall include interest on all forms of debt, payment economically equivalent to interest and expenses incurred in connection with raising of finance. • By juxtaposing the above definition and recommendation of OCED, we can conclude that interest deduction as specified under Section 94B is in line with the recommendations of OECD. Now, with this understanding of the ambit of 'interest or similar nature', let us proceed to examine the issue. • As discussed above, to include the forex gain or loss within the purview of section 94B, such amount should fit within the phrase 'interest or similar nature'. • On a strict reading of the definition of 'interest', OECD commentary and the general understanding of ambit of 'similar nature', we can argue that the payments that would fit under the description of the 'interest or similar nature' is certainly such amounts which the borrower should be benefitted. • In case of forex loss or gain, the borrower would absorb such loss or enjoy the gain and the lender cannot be said to be effected in anyway and a view can be taken that forex gain or loss should not enter into the ambit of 'interest or similar nature' to fall under the threshold of Section 94B.	

	• It is important to understand that the tax payer would definitely like to keep the forex loss outside the purview of Section 94B since addition of same would lower the threshold of deduction. • As a contrary, the tax authorities would definitely try to include the forex loss stating that such forex loss is directly linked to the interest amount paid to AE and accordingly it should enter the threshold calculations and thereby propose to disallow the interest qua forex loss. • There are number of judgments including those of apex courts wherein it was held that, the colour of forex gain or loss would be the same as the source transaction and it would not be ascribed a different or new colour. The tax authorities might use all these judgments to support their view that forex loss stands included for arriving the maximum amount allowed as deduction under Section 94B. Some of the judgments are as under: ❖ Universal Radiators[1] ❖ Sutlej Cotton Mills Limited [2] ❖ Pentasoft Technologies Limited[3] ❖ Infosys Technologies Limited[4] ❖ Novell Software Development (I)(P) Limited[5] ❖ Westfalia Seperator India Private Limited[6] • However, the tax payer can take a stand that the rationale delivered by the above judgements would not be applicable under the context of Section 94B. The tax payers can also take a stand that the basic requirement that is satisfaction of an amount as 'interest or similar nature' could not be satisfied with the case of forex fluctuation and accordingly get him distinguished from the above judgments.	

[1][1993] 68 Taxman 45 (SC)
[2][1979] 116 ITR 1 (SC)
[3][2013] 33 taxmann.com 570 (Madras)
[4][2012] 18 taxmann.com 169 (Karnataka)
[5][2013] 35 taxmann.com 414 (Karnataka)
[6]ITA No. 4446/Del/2007

	• The tax payer can also use the judgments like the Bombay High Court in the matter of Ballarpur Industries Limited [7], wherein it was held that gain arising on realisation of income in subsequent year cannot be equated with original income but same would be considered as other income to take home the point that the forex gain or loss emanating from actual interest paid should be seen in a different hue but not the same as the interest.	
Forex Fluctuation on Outstanding Loan	• As discussed above, an amount would fit under Section 94B, if assessee incurs any expenditure by way of interest. In all cases, where the expenditure does not satisfies the conditions mentioned in Section 94B, then such expenditure is not deductible while computing the income. Now, let us proceed to examine the nature of forex fluctuation on outstanding loan. • In this regard, we need to understand the provisions of AS -16 (Ind AS-23) which states that exchange difference on outstanding amount to the extent of difference between the cost of borrowing in functional currency and in foreign currency shall be adjusted to interest expense. • In other words, that foreign exchange difference on principle outstanding to some extent shall be treated as interest expense in the books of account in accordance with the Indian GAP. Now the question is whether the additional amount which is recognized as interest expenses in books of account in compliance with Indian GAP also enters the ambit of Section 94B. • On a plain reading of Section 94B, the tax payer has to incur expenditure to fall under the ambit of Section 94B and in case of interest expense being recognized in compliance with accounting standards, the tax payer does not incur any expenditure. It is only a mere recognition of certain part of forex fluctuation as interest expense and not an actual outgo of interest.	• The portion of forex fluctuation which is to be treated as interest expense in accordance with AS-16 would not enter into the ambit of Section 94B.

[7] [2017] 84 taxmann.com 61 (Bombay)

	• Further, IT Act does not contain any such provisions to treat certain portion of forex fluctuation on outstanding amount as interest. The treatment prescribed in AS-16 cannot be applied to the tax computation since the said standard do not have any applicability for computing the income under the IT Act. • The treatment of forex fluctuations under the provisions of IT Act are majorly dealt by Section 43A, Section 43AA and ICDS-VI. The treatment prescribed by AS-16 is not specified anywhere in Section 43A, Section 43AA or ICDS – VI. Hence, we can conclude that such forex fluctuation which is treated as interest expense as per AS-16, would not enter into the ambit of Section 94B. • Further, provisions of Section 94B or section 2(28) does not contain any such treatment. In the absence of specific adjustment in relation to foreign exchange difference on outstanding amount, it may not be possible to hold that such exchange difference as interest expense. • Further, Action Plan – 4 states that certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance shall be treated as interest for deduction.	
Interest paid for Trade Credit also fall under Section 94B?	• It is common in businesses, to obtain trade credit on import of goods or services from related parties. The buyer would pay certain interest to the vendor/banker for the extended period of payment of purchase consideration. • Trade Credit in ordinary terms means extension of time by the provider of goods or services for payment of consideration against such supply. Trade credit is defined under FEMA Regulations to mean credit extended by overseas supplier or banks / financial institution subject to satisfaction of other conditions.	• Interest paid towards facility of trade credit also enters into the mechanism of Section 94B.

	• The question that arises is whether payment of interest against trade credit facility granted by the supplier would also fall under the ambit of Section 94B on an assumption that all other conditions laid out therein are satisfied. • It is beyond doubt that interest paid against trade credit falls under the ambit of 'interest or similar nature'. However, the question that has to be raised is whether such interest is arising from a 'debt' as defined in Section 94B. Now, let us proceed to examine the ambit of 'debt'. • Under Section 94B,'debt' includes any loan, financial lease, financial instrument, financial derivate or ***any such arrangement.*** Trade credit is nothing but a financial arrangement between the supplier and buyer for making payment against the supply of good or material by charging a fixed rate of interest on outstanding amount. • Hence, we can conclude that the payment of interest against trade credit facility would fall under the ambit of Section 94B. • However, it is not out of place to mention that for withholding tax on interest paid on trade credit, the provisions of Section 194LC would not be applicable and the other provisions would apply. This is for the reason that Section 194LC deals with interest pay-outs arising from monies borrowed and not other arrangements. • Hence, for withholding obligations for interest on trade credit, the provisions of Section 194LC would not apply and this should not be treated as basis for not taking into account for the purposes of Section 94B.	

Interest Paid to Third Party	• Section 94B(2) defines the word excess interest to mean total interest minus thirty percent of EBITDA or interest payable to associated enterprise whichever is less. • On reading of the above, a question that may arise is while computing the 'excess interest', whether interest payable to third party shall be considered in total interest or interest payable only to associated enterprise alone is to be considered? • As usual there is no single answer for this. There are two views which are discussed as under. • The memorandum explaining the Finance Bill, 2017 states that 'to provide that ***interest expenses claimed by an entity to its associated enterprises*** shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less.' • Further, while making amendment to Section 94B thorough Finance Act 2020, memorandum to Finance Bill 2020 states that 'Section 94B of the Act, inter alia, provides that deductible interest or similar expenses exceeding one crore rupees of an Indian company, or a permanent establishment (PE) of a foreign company, ***paid to the associated enterprises (AE) shall be restricted to 30 per cent.*** of its earnings before interest, taxes, depreciation and amortisation (EBITDA) or interest paid or payable to AE, whichever is less.' • From the reading above memorandums, it is clear that interest payable to associated enterprise shall alone be considered for computing excess interest.	• We are of the view that the interest paid to third parties should not enter into the ambit of Section 94B. This is for the reason there is no specific language to suggest the same in Section 94B.

	• However, there can be another view basis that since Section 94B has been inserted in line with the OECD recommendations and OECD in its report on Action Plan -4 in various occasions mentions that total interest including third party interest shall be restricted to certain percentage of EBITDA.	
Determination of EBITDA	• For this issue, we try to raise three sub-issues. The first one is whether EBITDA has to be calculated based on tax numbers or accounting numbers? Let's try to analyse the same: **<u>Tax EBITDA vs. Accounting EBITDA:</u>** • 'EBITDA' is not defined under Section 94B of Act. There is always a difference between the tax EBITDA and accounting EBIDTA for a simple reason that expenditure claimed under income tax is different from that of accounting principle viz. non-deduction of tax at source disallows the expenditure under income tax whereas the same is considered as expense for accounting purpose, depreciation under income tax is different from depreciation under accounting principles, foreign exchange loss on outstanding loan is treated as expenditure under accounting principles whereas same is to be adjusted to outstanding balance under income tax etc. • BEPS Action Plan-4 aims to reduce the shifting of profits by group companies which resort to thin capitalisation. One of the primary reasons to directly link the interest expense to EBITDA is to compel the tax payer to book more profits in a particular jurisdiction in order to claim more interest deduction. Hence, it is more appropriate to consider tax EBITDA for the purpose of computing the interest disallowed under Section 94B. Further, the definition of term 'interest' is different from accounting principles and income tax. If one consider accounting EBITDA, computation of interest may not be correlated with taxing profits in a particular jurisdiction which is the ultimate reason for inserting Section 94B.	

	• However, the argument of accounting EBITDA also has a base as EBITDA is directly related to accounting principle and EBITDA is not defined in IT Act. Whenever there is a requirement to compute any deduction based on the profits/income, respective provisions have defined those terms for example profits under Section 40(b), book profits under section 115JB etc. • In view of above analysis, in our view, even though the term is not defined under the provisions of IT Act, invoking such term from accounting principles may not be appropriate. If one goes with accounting principles, it is hardy difficult to match the computation of interest limitation with booking appropriate profits in India for the purpose of tax which is the ultimate objective of Section 94B. **<u>Treatment of Exempt Income from EBITDA:</u>** • The second issue would be whether exempt income is to be included while computing EBITDA? Let us proceed to examine the same • Under Section 14A of the Act, any expense which is incurred for the purpose of earing exempt income is not deductible while computing the total income. When such exempt income is included in EBITDA computation, tax payer will get more deduction of interest expense despite the fact that no expense is deductible from exempt income. Further, as Section 94B specifically applies to income computed under the head profits and gains from business or profession, other income which is chargeable under other heads should also not form part of EBITDA computation. Further, OECD also in its reports mentioned that exempt income shall not be included while computing EBITDA.	

	Expenses disallowed under other provisions Act: • In the earlier para, it is concluded that exempt income shall not form part of EBITDA. Now, the next question is what it is the treatment of expenses which are disallowed under other provisions of the Act. If one takes the view that tax EBITDA is to be considered for the purpose of disallowing the excess interest, expenses disallowed under other sections shall not be considered as expense for determination of EBITDA. However, if such expense is subsequently allowed as expense, same can be considered while computing EBITDA in the year in which such disallowed expense is allowed.	
Interest which is capitalised	• The next issue while dealing with Section 94B is that what would be the treatment of interest which is capitalised instead of debiting the same to profit and loss account. Section 36(1) (iii) read with Section 43(1) states that interest on borrowed capital for the purpose of acquisition of capital asset shall be capitalised up to the point in time such asset is put to use. • In such a circumstance, even though the tax payer has incurred interest expense, as such interest is not deductible for the purpose of computation of income under the head profits and gains from business or profession, would not be covered under the limits specified in Section 94B. • Further, once the interest is capitalised, depreciation allowance on capitalised interest cannot be brought under Section 94B as such expense has changed its characterisation from interest to depreciation allowance.	

	• A strict interpretation needs to be given to Section 94B which is applicable only with respect to interest expense which is deductible while computing the income from profits and gains from business or profession. Once the characteristics of the expenses have been changed, bringing the amount of such depreciation allowance within the ambit of Section 94B is hard.	
Gross Interest or Net Interest (For illustration, see Case Study #1 at the end of the article)	• Section 94B requires the tax payer to disallow the excess interest paid to non-resident associated enterprise. The reason behind disallowing the excess interest is that international group to eliminate potential shifting of profits to low tax jurisdictions as interest is tax deductible expenditure. • OECD in its report on Action Plan-4 has recommended the countries to apply net interest approach for limiting the interest deduction. The reason behind the OECD's recommendation is that when a company has borrowed an amount from AE1 to provide loan to another AE2, interest payable to AE1 on loan borrowed is restricted under Section 94B in addition to that interest income on loan given to AE2 is subject to tax which results in double taxation. Hence, OECD has recommended to apply net interest concept. • However, section 94B does not specifically provides for such type of relief. Hence, in the absence of specific provision in section 94B, it is prudent to consider gross interest while limit the interest deduction.	

Disallowance of interest under other provisions	• When the interest paid to non-resident AE is disallowed under other provisions of the Act, a question arises as to whether such interest is to be considered again for limiting the interest deduction Section 94B of the Act. • For example, interest paid to non-resident AE is not at arm's length principle and such interest is disallowed under Section 92 of the Act. Section 94B uses the word '**which is deductible** in computing income chargeable under the head profits and gains from business or profession.' When such interest expense is already disallowed under other provisions of the Act, it may not be appropriate to consider such interest under Section 94B. • However, Section 94B(2) states that excess interest shall mean total interest paid or payable in excess of 30 percent of EBITDA or interest payable to AEs whichever is less. By reading the Section 94B(2), it appears that for the purpose computing the excess interest, total interest needs to be considered whether or not such interest is allowed under other provisions of the Act. • By following the above principle, after the computation of excess interest, one needs to go back to Section 94B(1) and limit the interest payable to non-resident AE only if such interest in not disallowed under other provisions of the Act. • Further, if such expense which is disallowed under other provisions is subsequently allowed as expense then, it needs to be evaluated whether such interest is to be allowed subject to the limits specified in Section 94B. Section 94B states that where an Indian company or PE of a foreign company 'incurs any expense by way of interest or similar nature' and 'which is deductible in computing income chargeable...'	

	• Expense which was disallowed in one year and subsequently allowed in another year would has the same characteristics of 'interest' and as the tax payer has incurred such expense hence, same may needs to be covered within the limits specified under Section 94B. • The argument that the tax payer has not incurred such interest 'during the year' in which such expense is subsequently allowed does not bear any base as Section 94B does not warrant the tax payer to incur the interest expense during the previous year. Such requirement to incur expense during the previous year is provided in Section 94B (2) for the purpose of computation of excess interest. • Further, the priority in disallowing the interest would be given to other provisions first as the interest limitation under Section 94B is not permanent and tax payer can carry forward and setoff in future. However, disallowance of such interest under other provisions may be permanent in nature.`	
Payment of Interest by PE (For illustration, see Case Study # 2 at end of this article)	• Section 94B is applicable to an Indian company or PE of a foreign company. The issue revolves around the PE is what would be the treatment of interest paid by PE of foreign company to its head office. Whether such interest payment would cover under Section 94B?	

	• Before analysing the treatment under Section 94B, it is pertinent to understand the computation of income in respect of branch of foreign company. Income Tax Act states that Income of the branch in India is to be computed as if such branch is an independent entity. However, payments made by the branch to its head office is not allowed as deduction under the Act as it is the payment being made to itself. This view is upheld by many judicial fora and some of them are provided below: ❖ Sumitomo Mitsui Banking Corpn[8] ❖ Royal Bank of Scotland N.V[9] ❖ JP Morgan Chase Bank N.A.[10] • Given the above, payment made by PE of a foreign company to its head office is not deductible as expenses while computing the income from business under the provisions of IT Act. • Further, in the context of India -USA DTAA, Para 3 of Article 7 states that while computing the income of a PE, no deduction shall be allowed in respect of payment of expense by branch to head office or other offices which are in the nature of royalties, FIS except in the case of banking business, or by way on interest by such PE. Hence, when such income is not deductible while computing the income under the hear PGBP under the IT Act as wells as DTAA between India and USA, the requirement to invoke Section 94B does not arise.	

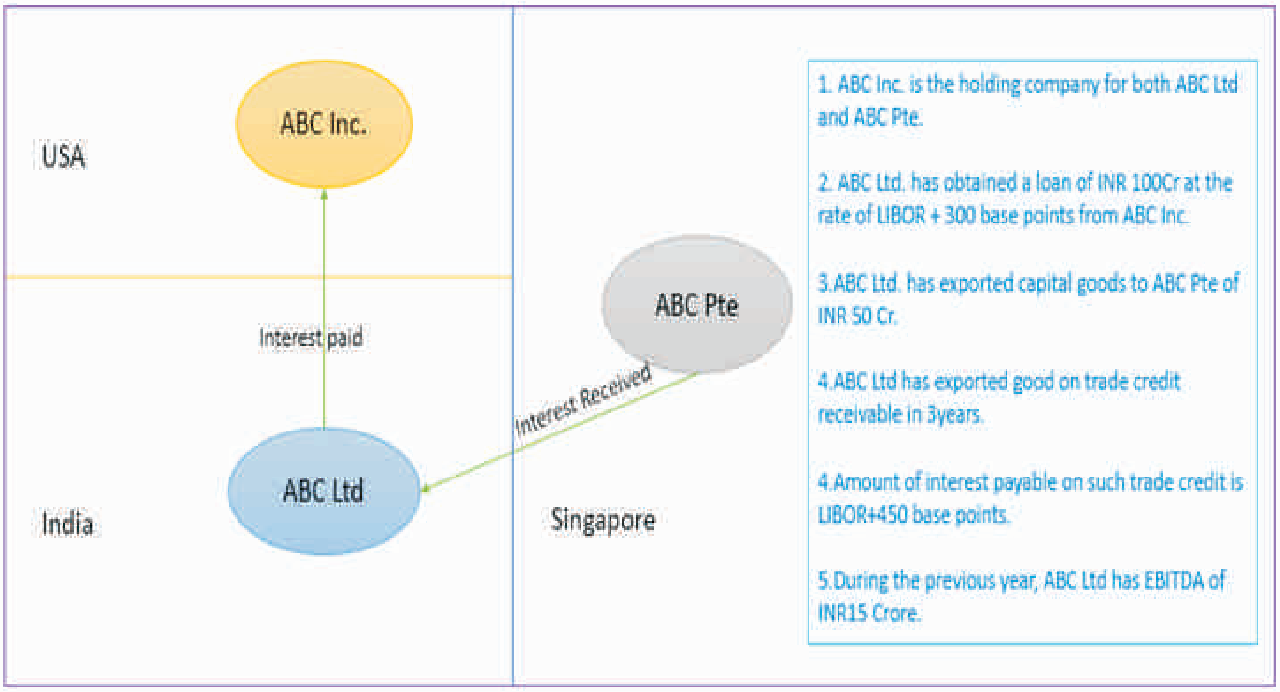
[8][2012] 19 taxmann.com 364 (Mum.) (SB)
[9][2016] 76 taxmann.com 91 (Kolkata - Trib.)
[10][2020] 114 taxmann.com 700 (Mumbai - Trib.)

Carry forward of disallowed interest	• Section 94B (4) states that where the interest is not wholly allowed as deduction, tax payer can carry forward such disallowed interest to the following assessment years and deduct as expenses subject to the limits specified under section 94B(2). • In other words, that earlier years' disallowed interest is to be set off against the current year's income only if such interest is withing the limit of interest computed under section 94B (2). • Further, section 94B (4) uses that word 'any business or profession carried on by it', means assessee can setoff such disallowed interest against income from any other business or profession not necessarily against business income from which interest expense originates.	

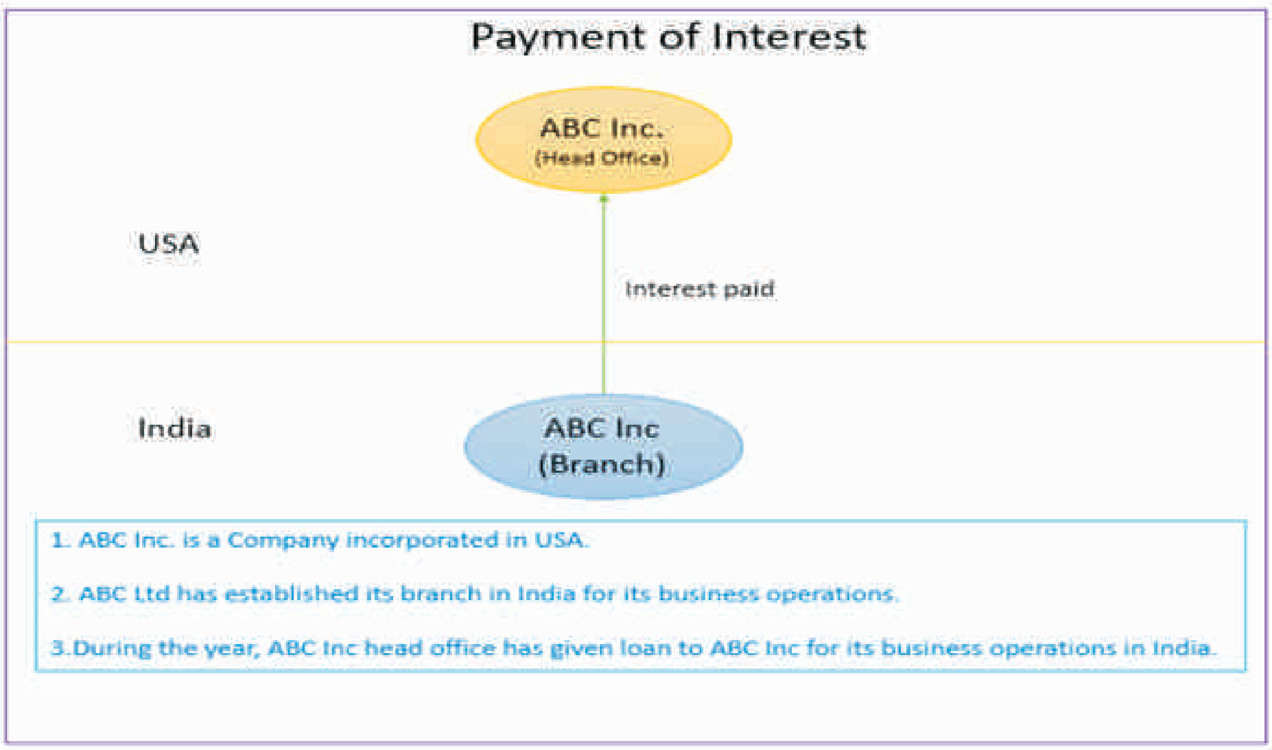
Based on the above discussion, practical approach to claim the deduction under Section 94B would be as follow and this approach is also supported by Action Plan -4:

Step 1: Income before tax	Computation of taxable income under the head 'profits and gains from business or profession' without considering the interest under Section 94B. Taxable income is to be computed after disallowing the expense, if any.
Step 2: EBITDA	EBITDA is to be arrived by adding interest expenses, depreciation and amortisation expenses to income before tax.
Step 3: Excess interest	(Total interest payable - 30% of EBITDA) or interest payable to associated enterprise whichever is less.
Step 4: Interest disallowed	Disallowance of interest payable to non -resident AE provided such Interest is arising from excess interest.
Step5: Carry forward	Such disallowed interest can be carried forward to next assessment year to the maximum of 8 assessment years.

Case Study #1



Case Study #2



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