Thin Capitalization Rules

"Debt Equity and Tax can no longer be tossed"

By CA Maneet Pal
maneet@capasricha.com
www.capasricha.com

Any and every business needs some kind of finance to invest in business opportunities and get rewards out of it in form of profits. Many Foreign Companies eye India as great business opportunity for expanding its operations and increase the kitty of its ultimate Foreign/ Holding Company.

With the decision of entering in Indian markets, Companies have to take decision on their capital structure. Companies prefer to invest/ bring money into India by way of lending loan to its Indian Counterpart, there keeping high Debt-Equity Ratio. Companies borrowing large amount of loans enjoys tax deduction on the interest paid thereby on such loans. But companies may no longer be able to enjoy this huge deduction on their taxable profit as the government is planning to implement the ***"Thin Capitalization Rule"*** to avoid such tax evasion. Many consultants suspect government to introduce the rules in Financial Budget 2012. Although relevant suggestion on thin capitalization have already been made in draft Direct Tax Code.

Before we proceed towards the Rules, let's just have a look at what does the term "Thin Capitalization" means. The definition hereby goes as, "when a company's capital is made up of a much greater proportion of debt than equity, that is, its leverage or gearing is too high, it is said to be thinly capitalized".

For a company to function, it needs to first take the decision of best available financing options. There are largely two sources of finance:

- Issue of shares in equity; and
- Other is by borrowing.

The source by which the company raises its finance affects the Finances and taxation of corporate income. However, generally in practice we see companies raising finance partly by equity and partly by loans that is "debt". Interesting part, in case of raising money is that many companies prefer to raise money through loan or debt as it is deductible from the company's taxable profit.

Now let's analyze the equity points, if a company's finance has large portion of equity then the shareholders or the owners have to be rewarded from the profits of the company which is essentially NOT deductible from tax! Therefore some companies sought to raise higher proportion of their funds through loans which means rather than paying a large a sum of money to their owners and not receive any tax benefit they raise large proportion of their capital through debt (preferably from their Holding company) in which they receive tax benefit as the "interest on loan" is deductible from the taxable profits of the company.

<u>THE FINANCE EFFECT</u>

For example ABC ltd raises it capital by issue of shares and debt, the equity capital consists of Rs 10,00,000 and Rs. 16, 00,000 in the form of borrowing. The bank lends the loan at 10.5% pa. Now suppose the company makes the profits of 1,00,000/- during the year, out of which it has to pay, the dividend amounting to Rs 90,000. We know that at the end of the year the company has to bears a 10.5% interest on its debt which comes out to be Rs 168,000. This favours the equity shareholders since a highly geared firm will have more surpluses to distribute amongst

less number of equity shareholders. Therefore the returns will be higher as compared to a less leveraged firm since debt is a cheaper source of finance than equity.

If shareholders have a nominal proportion of capital in comparison to the total finance, then the company has lower financial reserves and lenders bear the risk of solvency of company as it's the company which has to eventually pay off large amounts of its capital (debt) with interest. There are large risks involved of failure of company to pay off the interest and debt that may lead it to declare insolvency. This will adversely impact the economy growth and reputation of company in markets.

THE TAXATION EFFECT

Taking the same illustration into consideration as mentioned above we can now deduce the tax effect as well. The real benefit of the company can be seen while analyzing the tax effect, since the company has raised more of its capital through debt the interest on raising such debt can be availed as a deduction from the company's taxable profit. Whereas if the company had raised capital through equity the dividend paid couldn't have been used as an expenditure that'll give the benefit of deduction from tax.

Generally the companies, who prefer to maintain high Debt to Equity ratio, borrow funds from their foreign holding company, so as to dilute the overall negative effect of financial imbalance and gain the benefits of taxation convention.

Now where is the problem in all of this for tax and economic regularities?

There are two major problems, when a company's capital is made up of higher proportion of debt than equity:

- Credit Risk
- Taxability

Credit Risk

Now in all of the above discussed work wherein companies raising a greater part of its capital through “debt” and claiming deduction on “interest on loan” All this would mean that the company has low financial reserves to meet its needs. Since most part of the finance of the company comes through debt it means that the company would have to repay it unlike equity.

Taxability

Many companies would use this higher debt as a tax saving mechanism since dividend is not deductible from the taxable profit and on the contrary interest on borrowed capital is, therefore this phenomenon may be used in saving tax. ***Also Thin capitalization is considered as a best and most tax efficient mode of repatriation of funds to the foreign companies by their Indian counterparts.***

Many foreign countries like USA, UK, Netherlands, China, Poland, Russia have introduced this rule to put a grip on the gearing ratio. Like in the UK, the Revenue’s guidelines are debt/equity of 1:1 and profit before interest and tax (PBIT) of at least three times interest where debt is intra-group or guaranteed by a parent. In India also, the government is planning to introduce “Thin Capitalization Rules” to dodge such tax evasions and believe to have introduced the rules in Direct Tax Code (DTC).

It would be exciting to see how and what measures does government bring in to evaluate and identify high leveraged firms. Some of the ways in which High leveraged firm can be identified are:

- Debt to Equity Ratio
- Subjective approach
- Hidden profit distributions

<u>Debt to equity ratio</u>

Debt equity ratio = total liabilities/shareholders equity

In this approach if the company’s portion of debt exceeds by a fixed amount specified the interest on loan on the excess of the loan will be disallowed from the deduction of taxable profit.

Subjective approach

The basis on which the principle which works here is to analyze the terms and nature of the contribution of debt and the circumstances under which the financing has been made and decide whether the real nature of funds is debt or equity.

Hidden Profit Distributions

The very basic idea here is to if the loan amount exceeds an arm's length situation that is "that the both parties in the deal are acting in their own self interest and not subject to any pressure from other party" the lender here must be considered to have an interest in the profitability of the enterprise and the loan, or any amount in excess of the arm's-length amount, must be seen as being designed to procure share in the profits.

In conclusion we could say that it will be a big change in India if Thin Capitalization Rule gets implemented. The companies will now need to vitally review their debt to equity as the time for implementation comes closer. However the big hurdle still needs to be solved as to what ratio of debt to equity would be agreeable and what amount precisely would be feasible for tax deduction.

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