Budget 2017 - Curbing Thin Capitalisation

Why in news?

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The steps were taken in Union Budget 2017 to address the issue of thin capitalisation.

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What is Thin Capitalisation?

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When a local company has more debt than equity, then the arrangement is called thin capitalisation.

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Why is thin capitalisation bad?

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- Generally interest paid for a debt is not taxed.
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- Therefore an Indian unit would pay high interest to the foreign associated firm to avoid tax.
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- Also the interest paid by the local company to the foreign associate was taxable at a lower rate when the foreign company was registered in a tax treaty country.
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What is EBITDA?

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- Earnings before interest, tax, depreciation and amortization (**EBITDA**) is a measure of a company's operating performance.
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- It is a way to evaluate a company's performance without having to include financing decisions, accounting decisions or tax environments.
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What are the measures taken?

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- Section 94 B of the Finance Bill, 2017 increased the tax burden on local company with thin capitalisation.
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- If the interest paid by a local company is more than 30% of Ebitda, it will not beallowed any tax exemption.
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- Section 94 B is applicable to an Indian firm or MNC operating via permanent establishment in India, which has debt from a non-resident associated enterprise and pays interest or similar consideration of over Rs 1 crore to the associated enterprise.
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What are the consequences?

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- Introduction of thin capitalisation rules is in line with **international practice**.
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- But it also has some negative effects.
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- Tax payment of several companies with high debt and low Ebitda could increase, **reducing their profitability**.
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- This provision could have an adverse impact on capital intensive and highly leveraged companies.
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- This will affect the **capacity of a borrower to repay** the interest on borrowings and therefore it is a negative for banks too.
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- New companies setting up branches or subsidiaries will also need to factor in the thin capitalisation limitations while determining their funding structure i.e might **deter new investments**.
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Source: Business Standard

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