# INTEREST TAXATION

BY CA PRERNA PESHORI

# Interest Deemed To Accrue Or Arise In India

- Section 9(1)(v) provides for deemed accrual of interest

| Payer | Deemed Accrual |
|---|---|
| Government | Deemed Accrual in India |
| Resident | Deemed Accrual in India<br>**Exceptions:**<br>A) interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India or<br>B) for the purposes of making or earning any income from any source outside India |
| Non-resident | Deemed Accrual in India **if interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India.** |

# Interest Taxability Under Act

- Section 2(28A) 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*
- Section 2(28B) defines interest on securities to mean (i) Interest on Govt (State or Central) securities; (ii)interest on debentures or securities issued by company, Govt (State or Central or Provisional) corporation or local authority
- Interest income typically taxable under Income from Other Sources and taxable at applicable slab corporate tax rate
  - Section 56(2)(id) – Interest on securities, if not taxable under PGBP
  - Interest earned in the course of business PGBP vs Income from Other Sources whether inextricably linked to the business
  - Taxability of interest earned by Partner - PGBP
- Section 145A- Taxable as per cash/mercantile system followed by the tax payer
  - Exception Interest received on compensation enhanced compensation deemed to be income in the year of receipt Section 56(2)(vii)

# Interest Taxability Under Act

- Certain interest are exempt
  - Interest on NRE account
  - Interest on lease of aircraft paid by unit in IFSC
  - Interest on FCNR or RFC account
- Tax Rate

| Interest | Rate |
|---|---|
| Interest on forex loans or rupee denominated bonds, payable to NR or Foreign Co or Business trust u/s 194LC | 5% |
| Interest on RDB or Govt security to FII/QIB u/s 194LD | 5% |
| Interest payable by business trust to unit holder u/s 194LBA | 5% |
| Other Interest u/s 115A | 20% |

# Section 94B – Thin Capitalisation

Borrower/Guarantor

- Indian company or
- PE of foreign company
- Other than Banking or Insurance business

Lender

- Non-resident

Interest

- Exceeds Rs. 1 Crore
- Deductible under PGBP

Excess shall mean lower of:
A) Total interest paid or payable in excess of 30% of EBITDA
or
B) Interest paid or payable to AE

C/fwd for 8 years

# INTERST TAXATION AS PER TAX TREATY

# Article 11 – Interest

| | |
|---|---|
| Sharing of taxing rights | • Article 11(1) – Residence State right<br>• Article 11(2) – Source State right |
| Definition | Article 11(3) – Meaning of Interest |
| PE Exception | Article 11(4) |
| Source Rules | Article 11(5) |
| Special Relationship | Arm's Length Condition |

# Article 11 - Interest

| OECD Model | UN Model |
|---|---|
| 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. | 1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State |
| 2. However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation. | 2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation. |
| 3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. | 3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. |

# Article 11 - Interest

| OECD Model | UN Model |
|---|---|
| 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply. | 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply. |
| 5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated. | 5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated. |
| 6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention. | Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention. |

# Article 11(1) – Residence Country Right

- Article 11(1) - Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State
- Country of residence of interest receiver has the first right to tax
- Right is not exclusive – Source Country may also tax it
- Arise in a Contracting State
  - Art. 11(5)

Meaning of the term 'paid'

- Means the fulfillment of the obligation to put funds at the disposal of the creditor in a manner required by contract or custom
- Section 43(2) of the Act as discussed earlier
- According to the Commentary on Article 11 of the OECD Model, the term 'paid' has a very broad meaning, covering any "fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom"

- Vogel (1997) - Article 11 of the OECD Model does not cover fictive interest, which is neither paid nor earmarked for future payment.
- The Gerechtshof 's-Hertogenbosch (Court of Appeal of 's-Hertogenbosch (the Netherlands), GHH)) determined in its decision of 2003 that no tax could be levied on deemed interest income, as article 21 and not article 11 of the Belgium-Netherlands Income and Capital Tax Treaty (1970)[359] applied to deemed interest, which was not charged and therefore was not paid.
- Decision of 2004 of the Hoge Raad (Supreme Court of the Netherlands, HR) confirmed this interpretation of the tax treaty. Specifically, the HR held that notional interest that is neither paid nor charged is not interest for the purposes of the tax treaty.
- In contrast, the Tribunal Supremo (Supreme Court of Spain, TS) held in 2003 that the application of the presumption that interest is paid on a loan between associated parties is not incompatible with article 11 of the France-Spain Income and Capital Tax Treaty (1995). The TS, therefore, indirectly held that an actual payment is not required by article 11 of the tax treaty but that the payment can be presumed or deemed in certain situations.

# Meaning Of Paid

- Mumbai ITAT in case of Ampacet Cyprus Ltd v DCIT [2020] 119 taxmann.com 277 refers to Special Bench

"In all the coordinate bench decisions, there is no discussion whatsoever to the connotations of the expression 'paid' and these decisions simply proceed on the basis that because the expression 'paid' is used article 11(1) of Indo Cyprus tax treaty, the taxability of interest can only be on cash basis . The expression "paid" is admittedly not defined in the treaty …What essentially follows is that unless the context otherwise requires, the definition of the undefined treaty term, under the domestic law of the source country i.e. India and preferably under the domestic tax laws, is to be adopted."

It is in this context, Section 43(2) of the Income tax Act, 1961 may perhaps be relevant …While it is indeed true that this meaning cannot be imported in the tax treaty mechanically, without any application of mind and as a sort of automated process, undoubtedly a call is to be taken by the bench as to whether or not this domestic law meaning of the expression 'paid' will be relevant."

Special Bench holds that the reference made to SB to decide upon Article 11 is irrelevant since no interest was actually paid

# Article 11(2): Source State Taxing Right

- However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
- Right to Source State
  - Provides right to tax interest to Source State as per the domestic laws or at the concessional tax rate subject to fulfilment of following conditions:
  - Recipient of interest - resident of other State
  - Beneficial owner of interest
  - Taxation of gross basis – no deduction can be claimed
- DTAA's wherein interest is taxable only in the state of Source subject to fulfilment of conditions – Austria, Finland, Greece, Libya, Malaysia

# Article 11(2): Taxability Of Interest In Source Country

- Many treaties provide for exemption from tax if the recipient of the interest is the government of the other state or a government agency or a government owned bank
- Most treaties provide for exemption or concessional rate of tax if the recipient is a bank

3. Interest arising in a Contracting State shall be exempt from tax in that State provided it is derived and beneficially owned by:
(a) the Government or a local authority of the other Contracting State ;
(b) any agency or entity created or organised by the Government of the other Contracting State

Exemption in the India - UK Treaty
3(b) where the interest is paid to the Government of one of the Contracting States or a political subdivision or local authority of that State or the Reserve Bank of India, it shall not be subject to tax by the State in which it arises.

# Article 11(3): Meaning Of The Term Interest

- Article 11(3) of the UN Model reads as follows: "The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

- Exhaustive definition of interest - covers all kinds of income which may be regarded as interest in various domestic tax laws - No reference made to the domestic tax laws while defining the term interest (as opposed to the article on dividends)

- Debt claim of every kind – Broad meaning
  - Sum of money which is now payable or will become payable in future by reason of a present obligation
  - Liability depending upon a contingency is not a debt till the contingency happens
  - Debt even if amount to be ascertained provided liability is certain and only quantification of the amount remains
  - Includes cash deposits, security in form of money, Govt. securities, bonds & debentures, mortgage interest, loans

# Article 11(3): Meaning Of The Term Interest

- OECD Model
  - Payments under non-traditional financial instruments (interest rate swaps) not included.
  - Penalty charges for late payment not included as interest
- Interest vs Dividend
  - Interest on participating bonds or on convertible bonds should not be considered as dividend until such time the bonds are actually converted into shares. But the interest on such bonds should be considered as dividend if the loan effectively shares the risks run by the debtor company.
  - Hazard of credit risk (not being able to enforce debt claim / debt irrecoverable) vs hazard of business risk of the borrower
  - Klaus Vogel - Interest is no more than the remuneration received for making capital available subject to repayment, and does not include profits from providing funds in cases where the provider accepts the hazards of the borrower's business

# Article 11(3): Meaning Of The Term Interest

- Guiding Principles as per NA General Partnership & Subsidiaries, Iberdola Renewables Holdings Inc. & Subsidiaries vs. Commissioner of Internal Revenue [2012] 22 taxmann.com 245 (TC-IS)

Type of certificate issued (Promissory Note vs. Share Certificate)

Absence or presence of Fixed Maturity Date

Whether or not repayments are contingent on earnings

Presence or absence of obligation to repay

Increase in management rights

Status equal to or inferior to regular corporate creditors

Parties Intent

Inadequate capitalisation

Sole shareholder's advance

Lack of interest payments

Ability to obtain comparable loan from other institutions

# Article 11(3): Meaning Of The Term Interest

- **Services Charges on credit card** – Does not constitute interest as they are for credit facility
- **Bill of exchange discounting charges** – Not in the nature of interest - supported by ABC International Inc. [2011] 241 CTR 289 (AAR) and CIT vs. Cargill Global Trading (P.) Limited [2011] 335 ITR 94 (HC Delhi) as no creditor-debtor relationship; They are for the purpose of discounting
- **Interest on Income-tax Refund**
- The HC in B. J. Services Co Middle East Ltd (380 ITR 138)(Utt). ruled that:
  - The interest was paid under the Act at the statutory rate fixed hence arises a debt claim; and
  - The interest is effectively connected with the permanent establishment
  - Accordingly, Article 12(6), which provides that the provisions of Article 7, which relate to Business profits, of this Convention, as the case may be, shall apply
- Contrary View in Delhi ITAT in Clough Engineering [TS-184-ITAT-2011(DEL)] and Mumbai ITAT in Bechtel International Inc. [TS-72-ITAT-2012(Mum)] and Transocean Offshore International Ventures Ltd [TS-56-ITAT-2022(DEL)] – Interest on tax refund is taxable on gross under Article 11 as it was not effectively connected with PE
  - Ansaldo Energia SPA [TS-279-HC-2016(MAD)] – Arising out of debt claim but exempt under India-Italy DTAA
  - MFN benefit extended in India-NL treaty - Koninklijke Philips N.V [TS-699-ITAT-2022(Kol)]

# Article 11(3): Meaning Of The Term Interest

- **Interest Paid by branch to HO -** Diverging views

(a) Interest paid by PE is deductible and taxable at concessional rate prescribed under the Income-tax Act or applicable tax treaty in the hands of HO;

(b) Interest paid by PE is payment to self, hence not deductible and not taxable in the hands of the HO; and

(c) Interest paid by PE is payment to self, hence not deductible but taxable in the hands of the HO at either the concessional rate or at the rate applicable to foreign company.

Sumitomo Mitsui Banking Corporation vs. DDIT [2012] 136 ITD 66 (MUM.)(SB) in the context of India-Japan and India-Belgium DTAA, which specifically provided for deduction in respect of interest paid by Indian Branch of banking company to its HO

- Interest paid to the HO by its PE is though not deductible as expenditure under the domestic law being payment to self, the same is deductible while determining the profit attributable to the PE as per Article 7(2) and 7(3) of the Tax Treaty;
- The interest paid by the PE to its HO / Offshore Branches is not income chargeable to tax in India as being payment to self which cannot give rise to income that is taxable in India as per the domestic tax law. Further, the tax implication under the tax treaty was not examined as interest is per se not taxable under the Act (domestic law).
- Separately, since the income is not chargeable to tax in India, provisions of section 195 are not attracted and there being no failure to deduct tax at source from the payment of interest by the PE, the interest is held allowable as deduction for the Indian Branch.

# Article 11(3): Meaning Of The Term Interest

- **ABN Amro Bank, N.V. vs. CIT [2012] 343 ITR 81 (HC Cal.)**
  - Branch & PE are distinct & separate
  - Deduction allowed to branch
  - Interest not taxable in the hands of HO
- **Circular 740 of 1996** on "Taxability of interest remitted by branches of banks to the head office situated abroad, under the Foreign Currency Packing Credit Scheme of Reserve Bank of India".
  - Branch & HO separate entities

Explanation to Section 9(1)(v)

- In case of non-resident, engaged in the business of banking, any interest payable by the PE in India to the HO or any PE shall be deemed to accrue or arise in India and shall be chargeable to tax in addition to any income attributable to the PE in India
- The PE in India shall be deemed to be a person separate and independent of the non-resident person of which it is a PE and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery shall apply accordingly.

# Meaning Of Interest

- **Guarantee Fees -** Payment towards guarantee fee cannot be regarded as income from debt claim
  - ACIT vs GMAC Financial Services Pvt Ltd [2012] 25 taxmann.com 4143(Chennai ITAT)
  - Vetas Wind Technology(2016)(69 taxmann.com 382)
  - Container Corp v Comr 134 TC No 5 (2/17/10)
  - Neo Sports Broadcast (P) Ltd (2016) 159 ITD 136
  - Johnson Matthey Public Ltd. Company (2018) 191 TTJ 1 (Del ITAT)
- **Interest on Compensation -** Goldcrest Exports v. ITO [2010] 134 TTJ 355 (ITAT Mum.)
  - Interest partakes the character of the compensation (under the arbitration) under judgement debt, which was not taxable in India as per Article 7(1) of the treaty.
- **Upfront Appraisal Fees -** DIT vs. M/s. Commonwealth Development [ITA No. 1058 of 2011, HC Bombay]
  - The fee is not payable in respect of any money borrowed or debt incurred.
  - The fees was paid irrespective of loan being granted or not
  - Therefore, not interest, but business income

# Meaning Of Interest

- **Interest on Bid Money -** Cauvery Spinning and Weaving Mills Limited vs. DCIT [2011] 238 CTR 55 (HC Chennai)
  - Interest was to be paid as fixed percentage of instalments of bid
  - Not interest as it was not on any debt or borrowing
- **Usance Charges** –Interest
  - Interest CIT vs. Vijay Ship Breaking Corporation [2008] 314 ITR 309 (SC)
  - ACIT vs Indian Furniture Products Ltd [2015] 53 taxmann.com 440 (Panaji ITAT)
  - ACIT v. Bhavani Enterprises [2014] 52 taxamn.com 489 (Panaji – Trib.)
  - Uniflex Cables Ltd. V. DCIT [2012] 136 ITD 374 (Mumbai)
  - For assessees in ship breaking activity – exempt Explanation 2 was added to section 10(15)(iv)(c)
- **Interest on Convertible Bonds -**Interest
  - LMN India Limited [2008] 307 ITR 40 (AAR) – Interest

# Meaning Of Interest

- **Sale of Compulsory Convertible Debentures -** Zaheer Mauritius vs DIT [2014] 47 taxmann.com 247
  - Mauritius Co entered into SHA & SSA with Vatika
  - The agreement provided for a call option and a put option to Vatika to purchase or sell the CCDs
  - Vatika exercised call option & purchased CCDs
  - Delhi HC held that gain by Mauritius company from sale of CCD's in JV Company to Indian Partner under exit option was not "interest" u/s 2(28A) but "capital gains" even if the exit option assures a minimum assured return.
  - Whether a CCD is a loan simplicitor or whether it is in the nature of equity, depends entirely on whether the debentures are capital assets in the hands of its holder.
- **Interest on Capital Gains -** Genesis Indian Investment Co. Ltd. V. CIT[2013] 36 com 300 (Mumbai – Trib.)
  - Interest on delayed payment in the nature of sale consideration & not interest

# Meaning Of Interest

- Prepayment Discount – Interest
  - DCIT vs Kothari Food & Fragrances [2014] 50 taxmann.com 213 (Lucknow Trib)
- Interest on Government Securities and taxability of consideration towards the sale of securities as interest or capital gains under the India - Cyprus Tax Treaty
  - The sale proceeds upon transfer of the security arise not from but on account of and represent the debt-claim/ security itself. The subsequent words of Article 11(4) of the tax treaty 'in particular, income from Government Securities and income from bonds or debentures' constitute merely an inclusive provision which by way of illustration refer to Government Securities.
  - DIT vs. Credit Suisse First Boston (Cyprus) Limited [2012] 23 taxmann.com 424 (HC Bombay)

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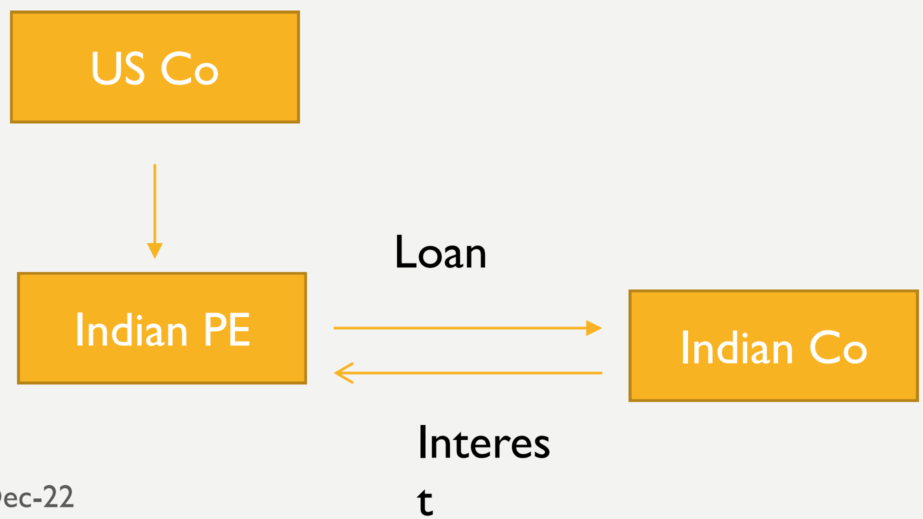
# Article 11(4): Permanent Establishment Situation

- Article 11(4) of the UN Model reads as follows: "The provisions of paragraphs 1 and 2 shall not apply if the **beneficial owner of the interest**, being a resident of a Contracting State, **carries on business in the other Contracting State** in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the **debt claim in respect of which the interest is paid is effectively connected with** (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of **Article 7 or Article 14**, as the case may be, shall apply."




**Marubeni Corporation, Japan [TS-485-ITAT-2022(Mum)]**
'Effective Connection' with PE, prerequisite for taxability of interest under Art.7

# Article 11(5): Source Rule

- Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State.
- Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated
- The OECD Commentary (Para 27 Article 11) has cited a few possible situations where the above principle laid down by Paragraph 5 of Article 11 can be examined:

(a) The management of the PE has contracted a loan which it uses for the specific requirements of the PE; it shows it among its liabilities and pays the interest thereon directly to the creditor.

(b) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a PE situated in another country. The interest is serviced by the head office but is ultimately borne by the PE.

(c) The loan is contracted by the head office of the enterprise and its proceeds are used for several PE's situated in different countries.

# Thanks !

THANKS !

CONTACT:
+919730166366

PRERNAPESHORI@PESHORICONSULTANTS.COM

WWW.PESHORICONSULTANTS.COM