



## Tax alert: Management/processing fees paid for borrowing loan qualifies as interest for taxation purposes

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The Delhi Bench of the Income-tax Appellate Tribunal (ITAT), based on facts, has rendered its decision that management/ processing fee received by the taxpayer (on External Commercial Borrowing advanced) was covered under Article 11(3)(b) of the India-Germany tax treaty and hence, not taxable in India.

### In a nutshell



Definition of 'interest' under the domestic law i.e. ITA, covers all kinds of payment attached to the loan.



Management fee is of similar nature as commitment fee and documentation fee as it is closely linked to the loan granted.



Management fee partakes the character of interest under section 2(28A) of the Income-tax Act, 1961. Hence, it would be exempt from tax in India under Article 11(3)(b) of the India-Germany tax treaty.



Scroll down to read the detailed alert

## Background:

- The taxpayer<sup>1</sup> is a non-resident banking company incorporated in the Federal Republic of Germany and is a tax resident of Germany.
- During the Financial Year (FY) 2015-16, corresponding to the Assessment Year (AY) 2016-17, the taxpayer had advanced External Commercial Borrowing (ECB) loan to certain Indian entities, which were guaranteed by Hermes Deckung<sup>2</sup>. The taxpayer had received interest along with connected fees, such as, management /processing fee, documentation fee and commitment fee.
- The taxpayer contended that the interest along with various fees received in connection with loan granted were not taxable in India and were exempt under Article 11(3)(b) of India-Germany tax treaty [relating to certain interest not taxable in hands of taxpayer resident of Germany].

As per Article 11(3)(b) of the India-Germany tax treaty, ***“interest arising in the Republic of India and paid to the Government of the Federal Republic of Germany, the Deutsche Bundesbank, the Kreditanstalt für Wiederaufbau or the Deutsche Investitions-und Entwicklungsgesellschaft (DEG) and interest paid in consideration of a loan guaranteed by HERMES-Deckung shall be exempt from Indian tax.”*** <<emphasis supplied>>

- During the course of the audit proceedings, the Assessing Officer (AO) agreed with taxpayer’s claim with regard to the interest earned on loan and certain other fees. However, with respect to the management/processing fee, the AO observed that it was not covered under the definition of ‘interest’ under Article 11 of the India-Germany tax treaty.
- Accordingly, the AO held that the management/processing fee received by the taxpayer was in the nature of fees for technical services (FTS), and taxable under Article 12 of the India-Germany tax treaty [relating to Royalties and FTS] as well as under section 9(1)(vii) of the Income-tax Act, 1961 (ITA) [relating to income deemed to accrue/arise in India in case of a non-resident taxpayer] and accordingly, treated such fees as taxpayer’s income for the year under consideration.
- Aggrieved, the taxpayer raised objections before Dispute Resolution Panel (DRP) which directed the AO to consider the taxpayer’s claim in the light of the certain rulings. Ultimately, the AO passed the final assessment order after adding the management /processing fees to taxpayer’s taxable income.
- Aggrieved, the taxpayer filed an appeal before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

## Relevant provisions in brief:

Extracts of section 2(28A) of the ITA:

### ***“Section 2. Definitions.***

***“2(28A) “interest” means 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 ;”***

Extracts of Article 11 of the India-Germany tax treaty:

***1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.***

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<sup>1</sup> AKA AUSFUHRRKREDITGESELLSCHAFT MBH vs. ACIT 1(1)(1), New Delhi [2024] ITA No. 783/Del/2023 (Delhi- Trib.)

<sup>2</sup> Export credit guaranteed by the German Federal Government

2. However, such interest may also be taxed in Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

3. Notwithstanding the provisions of paragraphs 1 and 2—

(a) interest arising in the Federal Republic of Germany and paid to the Government of the Republic of India, the Reserve Bank of India, the Industrial Finance Corporation of India, the Industrial Development Bank of India, the Export-Import Bank of India, National Housing Bank and Small Industries Development Bank of India shall be exempt from German tax;

(b) **interest arising in the Republic of India** and paid to the Government of the Federal Republic of Germany, the Deutsche Bundesbank, the Kreditanstalt für Wiederaufbau or the Deutsche Investitions- und Entwicklungsgesellschaft (DEG) **and interest paid in consideration of a loan guaranteed by HERMES-Deckung shall be exempt from Indian tax.**

**4. 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.**

.....”

#### **Decision of the ITAT:**

The ITAT noted that the question for their consideration was with regard to the nature and character of management/ processing fee received by the taxpayer on the loan advanced to Indian entity.

In this regard, the ITAT noted / observed as follows:

- As per the terms of the agreement, the loan granted was protected by Hermes Cover, i.e. the loan was protected by Hermes acting jointly for and behalf of Federal Republic of Germany securing the repayment up to 95% of the loan granted and a substantial part of the interest payable by the borrower. The borrower was required to pay interest on the loan at the rate of interest applicable to the loan from time-to-time.

Further, as per the terms of the loan agreement, the borrower was required to pay:

- Commitment fee @ 0.55%;
  - Non-refundable management fee @ 1.25%; and
  - Non-refundable documentation fee of EURO 20,000/- flat.
- As per Article 11(4) of the India-Germany tax treaty, interest has been defined to mean, income from debt claim of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, income from Government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures, except, penalty charges for late payment would not be regarded as interest.
  - As per section 2(28A) of the ITA, the term 'interest' 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.

Thus, even the definition of interest under the domestic law, covers all kinds of payment attached to the loan. In the present case, the AO accepted the taxpayer's claim that interest along with other fees, such as, commitment fee, documentation fee attached to the loan granted were exempt under Article 11(3)(b) of the India-Germany tax treaty.

Therefore, even management fee was of a similar nature and not distinguished from commitment fee and documentation fee, as it was closely linked to the loan granted.

- Accordingly, the management fees partook the character of interest under section 2(28A) of the ITA and hence, was exempt from taxation in India under Article 11(3)(b) of the India-Germany tax treaty. Reliance was also placed in an earlier ruling<sup>3</sup> in this regard.

In view of the above, the ITAT held that the management/ processing fee received by the taxpayer (on loan advanced) was covered under Article 11(3)(b) of the India-Germany tax treaty and hence, not taxable in India.

#### **Comments:**

In case of loan arrangements, banks may charge management / processing fee to the borrower. A question arises whether such fees would qualify as 'interest' or 'FTS' under the provisions of the ITA or the relevant tax treaty and subjected to tax accordingly.

The ITAT in this ruling, while dealing with the classification of management / processing fee (paid on ECB loan to the lender) as FTS or interest, has held as follows:

- Definition of 'interest' under the domestic law i.e. ITA, covers all kinds of payment attached to the loan.
- Management fee is of similar nature as commitment fee and documentation fee, as such fees are closely linked to the loan granted.
- Management fee partakes the character of interest under section 2(28A) of the ITA. Hence, it would be exempt from tax in India under Article 11(3)(b) of the India-Germany treaty.

It may be pertinent to note that the Mumbai Bench of the ITAT in an earlier ruling<sup>4</sup> has held that arranger's fees paid by Indian company to non-resident company for arranging loan facility, would not fall under the definition of 'interest' under section 2(28A) of the ITA.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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<sup>3</sup> DCIT vs Sisecam Flat Glass India Ltd ITA No.2475/Kol/2019 (Kol-Trib.)

<sup>4</sup> Idea Cellular Ltd vs ADIT (International taxation)-3(1), Mumbai [2015] 58 taxmann.com 101 (Mumbai - Trib.)

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