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Compulsorily Convertible Debentures: Debt or Equity?

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Introduction

A business entity requires sufficient capital, as much as a business plan, to successfully implement the plan and run the business. Accessibility to adequate capital at the right time is therefore the backbone of any business entity. The capital of a company primarily comprises of equity capital and debt capital. While the equity capital refers to the capital raised through issuance of shares, the debt capital refers to the capital raised through assumption of debt, repayable after agreed time. There are varied forms in which the said capital can be acquired by the company. One of the ways to raise capital is by issuing Compulsorily Convertible Debentures ('**CCDs**').

CCDs, as the name suggests, are debentures which are to be compulsorily converted into equity after a certain time period. That is, CCDs are hybrid instruments, being debt at the time of issue along with a certainty to get converted into equity. Being of such nature, the guidelines on Foreign Direct Investment ('**FDI**') treat CCDs as equity for the purposes of reporting to the Reserve Bank of India ('**RBI**'). In this context, a question arises as to whether CCDs would be regarded as equity capital under all other laws as well. The question is more relevant from the perspective of income-tax law, as the return on debt and equity have distinct treatment, both in the hands of the lender/ investor and the borrower/ issuer. But, before looking into the income-tax implications, few points fundamental to CCDs have been discussed in the following paragraphs.

Corporate law framework governing issuance of CCDs

Section 2(30) of the Companies Act, 2013 ('**Comp. Act**') defines a 'debenture' to *include debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not*. That is, a debenture is a debt instrument for the company.

Section 71 of the Comp. Act lays down the conditions attached to debentures. The relevant part reads as under:

> *"(1) A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption:*
>
> *Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a special resolution passed at a general meeting.*
>
> *(2) No company shall issue any debentures carrying any voting rights…."*

While the Comp. Act specifically provides for the issuance of convertible debentures, it also mandates that such issue shall be required to be approved by a special resolution. The fact that the Comp. Act deals with convertible debentures in the provisions relating to debentures, indicates that the statute seeks to regulate CCDs as debentures. Furthermore, debentures shall not carry any voting rights in the company.

As per Section 129 (Financial Statement) read with Schedule III (General Instructions for Preparation of Balance Sheet and Statement of Profit and Loss of a Company) of the Comp. Act, a company is required to *inter alia* provide appropriate disclosures with respect to debentures and the rate of interest and particulars of conversion thereof.

CCDs and the regulatory framework

The investment by a non-resident in an Indian Company, in any form, is regulated by the Foreign Exchange Management Act, 1999 read with Foreign Exchange Management (Transfer or Issue of a Security by a Person Resident outside India) Regulations, 2017 ('**FEMA Regulations**')[1]. The regulations prescribe the manner, limit, period, etc. of such investments. In other words, investment by a non-resident in a manner not prescribed, or in excess of the limits, etc. cannot be made in an Indian Company.

Regulation 2(xviii) defines 'Foreign Investment' to mean *any investment made by a person resident outside India on a repatriable basis in 'capital instruments' of an Indian company or to the capital of an LLP*. 'Capital instruments' have been defined under Regulation 2(v) to *mean equity shares, 'debentures', preference shares and share warrants issued by an Indian company*. The Explanation further provides that the expression *'Debentures'* means *fully, compulsorily and mandatorily convertible debentures*. Thus, the CCDs which are fully and mandatorily convertible into equity, are considered as 'capital instruments' being at par with equity shares. Accordingly, investment in the CCDs by a non-resident would be subject to sectoral caps or the investment limits for equity investments[2].

As fully, compulsorily and mandatorily convertible debentures alone are regarded as capital instruments, optionally convertible or partially convertible debentures are treated as debt instruments under the FEMA Regulations. These debentures which do not fall within the ambit of 'capital instruments' would have to conform to the guidelines on External Commercial Borrowings, i.e. Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000.

Treatment of CCDs as equity under income-tax law: Whether permissible?

Having said that the CCDs (fully, compulsorily and mandatorily convertible debentures) are treated as equity rather than debt under FEMA regulations from the date on which the CCDs are issued, the article now seeks to examine as to whether the basic character of CCDs as being a debt instrument till the date of their conversion, can be recharacterised as equity under the income-tax laws, by drawing reference from the afore-mentioned treatment under FEMA Regulations.

Before probing into the said question, it is relevant to first understand as to why a company may prefer to raise capital through a debt instrument (debenture) over equity. *Firstly*, a debt instrument does not dilute the ownership proportion of existing shareholders, *secondly*, a debt instrument does not carry voting rights and therefore, there is no interference in the management of the company and *lastly*, interest, unlike dividends, is generally allowed as deduction from the taxable profits of the company.

Section 36(1)(iii) of the Income-tax Act, 1961 ('**IT Act**') provides for deduction of interest paid in respect of capital borrowed by a tax payer for its business. That is, if CCDs are treated as capital 'borrowed' for the purposes of the IT Act, then the

[1] Notification No. FEMA 20(R)/2017-RB, dated 7 November 2017.
[2] Regulation 5 of FEMA Regulations.

interest paid thereon shall be allowable as deduction, whereas if the same is treated as 'equity', no deduction would be permissible for return paid on equity investment. The re-characterisation of CCDs as equity and the disallowance of the interest expenditure claimed thereof, has been an issue for consideration on a few occasions.

In *CAE Flight Training*[3], the Revenue raised the following arguments to deny the deduction for interest expenditure:

- The debt investment was to be treated as equity investment, in line with thin capitalisation[4] rules in Belgium, being the country of residence of the lender.
- The RBI has treated the CCDs as equity under FDI policy.

Regarding the first argument, the Tribunal relied on *Besix Kier Dabhol*[5] to hold that the thin capitalisation principle cannot be invoked in India, in absence of specific provisions under the IT Act at the relevant time, even though the same is on the statute book in the lender's country.

Regarding the second contention, the Tribunal noted that mere characterising of a debt as equity as the RBI's Policy would not affect the treatment of interest paid, under the IT Act. RBI's FDI policy is guided by the requirement to control future repatriation obligations of the country in convertible foreign currency. Since in the case of CCDs, there is no repatriation obligation in foreign currency, as the debentures would at a defined time be converted into equity, the same is being treated as equity by the RBI for the purposes of FDI policy.

Regarding the query if the treatment given by RBI for FDI policy can be applied in every aspect of CCDs, the Tribunal put forth two basic questions regarding the nature of CCDs prior to their conversion into equity - whether the holder has voting rights and whether dividend can be paid to the holder. Since the answer to these questions was in negative, the Tribunal concluded that the CCDs cannot be treated as equity under the income-tax law.

Accordingly, the Tribunal held that the interest paid thereon is an allowable deduction under Section 36(1)(iii) of the IT Act. The said view has also been adopted in *Embassy One Developers*[6]*.*

Despite the fact that the debt equity ratio was far higher than the industry norms and the limits prescribed by RBI[7], the Tribunal in *Kolte Patil Developers*[8] held that debt cannot be treated as equity, in the absence of General Anti-Avoidance Rules ('**GAAR**')[9] and thin capitalisation rule. The Tribunal held so, despite the fact that huge interests were paid to associated enterprises, with the debt equity ratio as skewed as 1:23.

The above orders endorse the well-established principle that if a certain act is not prohibited under the relevant statute, it is impliedly permitted thereunder. Therefore, since the IT Act did not provide for re-characterizing of a transaction prior to 1 April 2018 despite huge debts being borrowed so as to claim higher interest expenditure, the deduction claimed by the borrower was held to be allowable so long as the borrowed sum was used in the business of the borrower.

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[3] *ACIT* v. *CAE Flight Training (India) Pvt. Ltd*. - IT(TP)A No. 2060/Bang/2016, Order dated 25 July 2019.

[4] Thin capitalisation refers to the situation when a company has higher debt than the equity, i.e. when the debt to equity ratio is high.

[5] *Besix Kier Dabhol, SA* v. *Dy. DIT* - [2010] 8 taxmann.com 37 (Mum.).

[6] *Embassy One Developers Pvt. Ltd.* v. *DCIT* - ITA Nos. 2239 and 2240/Bang/2018, Order dated 26 November 2020.

[7] RBI Master Circular No.07/2009-10 dated 01-07-2009 stipulating Debt Equity ratio of 4:1 on ECB.

[8] *DCIT* v. *Kolte Patil Developers Ltd*. - ITA No.2111 and 1980/PUN/2017, Order dated 8 December 2020.

[9] GAAR is an anti-avoidance tool to deal with the transactions designed solely for the purpose of obtaining tax benefit(s), by re-characterising the transaction, amongst others.

Conclusion

While the aforementioned cases have decided against treatment of CCDs as equity relying on the RBI policy on FDI, it is to be noted that these pertain to a period during which the income-tax law had no provision to re-characterise the transaction. With effect from 1 April 2018, GAAR and thin capitalisation rules have been implemented in India *vide* Chapter X-A and Section 94B of the IT Act respectively, and accordingly, one has to be mindful of the implications that may arise thereunder.

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Notifications and Circulars

Vivad se Vishwas Scheme – Clarifications

In continuation to the its earlier Circular dated 22 April 2020, CBDT has issued Circular No. 21/2020, dated 4 December 2020 under Sections 10 and 11 of the Direct Tax *Vivad se Vishwas* Act, 2020, to provide answers to certain FAQs. Some of the important clarifications are as under:

1. If the appeal is pending or the time for filing an appeal has not expired as on 31 January 2020 but subsequently the appeal is disposed off by the appellate authority, then the amount payable under the Act shall be computed in line with the position of appeal on 31 January 2020.
2. Assessee would be eligible under the Act in case the enforceability of the assessment order passed by the AO is stayed by the High Court, irrespective of whether the appeal has been filed or not against the assessment order.
3. Appeal against order passed under Section 263 of the IT Act would be eligible under the *Vivad se Vishwas* Scheme only of the order contains specific directions and income is quantifiable.
4. Main appeal is required to be settled along with cross objections filed and pending as on 31 January 2020.
5. Appeal, writ or SLP in respect of block assessment is eligible if the disputed tax is not more than INR 5 crores.
6. If MAP resolution is pending or the decision thereby has not been accepted, then the related appeal shall be eligible under *Vivad se Vishwas*.
7. Assessee is not eligible if prosecution has been instituted for TDS default.

8. In case of appeals pending against addition on the same issue in both, assessment and reassessment, the higher of the tax liability shall be considered for computing the disputed tax.
9. Declaration may be revised any time before the certificate under the Scheme is issued.

CBDT to validate UDIN generated by CAs from ICAI portal

Pursuant to the objective of liaising the Income-tax Department with other Government departments, the income-tax e-filing portal has been integrated with the Institute of Chartered Accountants of India ('**ICAI**') portal for validating the Unique Document Identification Number ('**UDIN**') generated by Chartered Accountants ('**CAs**') from ICAI portal for documents certified/ attested by them under the IT Act. As per reports, this will help in weeding out fake or incorrect Tax Audit Reports not duly authenticated with the ICAI.

Real Estate – Tolerance range under Section 43CA set to be increased

The tolerance range under Section 43CA of the IT Act has been announced to be further revised from 10% to 20% for the period from 12 November 2020 to 30 June 2021. Section 43CA deems the stamp duty value to be the sale consideration for the transfer of property, in case the stamp duty value exceeds the actual sale consideration. The Finance Act, 2018 had provided a tolerance range of 5% in respect to the difference between the values, which was further revised to 10% *vide* Finance Act, 2020. As per Ministry of Finance Press Release dated 13 November 2020, consequential relief shall also be available to the buyers under Section 56(2)(x) as regard the purchase consideration.

Ratio Decidendi

Discount in allotment of shares under ESOP scheme allowable as deductible expenditure

Under an Employee Stock Ownership Plan ('**ESOP**') scheme framed by the taxpayer company, certain shares of the company were transferred to a Trust settled by the company, at its face value. The shares were to be intended to be transferred to eligible employees of the company, upon fulfilment of certain conditions specified in the ESOP scheme. The tax payer claimed the difference between the fair market value of the shares transferred to the Trust and the face value of the shares, as its business expenditure. The Revenue Authorities treated the expenditure as a notional loss, not being in the nature of an expenditure, and denied the claim. While in appeal before the Tribunal, considering the conflicting judgments of the question of allowability of discount on shares offered under ESOP scheme, the question was referred to a Larger Bench of the Tribunal. The Larger Bench of the Tribunal concurred with the taxpayer and held that such difference is a part of remuneration to employees which is paid in order to compensate them for the continuity of their services to the company and therefore is to be treated as allowable expenditure.

On appeal, the Karnataka High Court affirmed the judgment of the Special Bench of the Tribunal, holding that the discount at which shares were allotted to the ESOP Trust was a business loss incurred to secure the employment services of the employee. The High Court also held that loss is not notional, but an accrued expenditure. It followed the principle laid down by the Supreme Court in *Bharat Earth Movers* and *Rotork Controls India Pvt. Ltd*. [*CIT* v. *Biocon Ltd*. - ITA No. 653/2013, Order dated 11 November 2020, Karnataka High Court]

Proportionate deduction under Section 80IB(10) permissible

The Tax payer had developed two residential towers, comprising a total 195 residential units. The profits derived from the development of the residential units was claimed as a deduction under Section 80IB(10) of the IT Act. The Revenue Authorities however denied the deduction claimed by the tax payer on the ground that 8 of the 195 residential units exceeded the maximum permissible area for each residential unit prescribed in Section 80IB. The Appellate Authorities however allowed the deduction for profits in proportion to the units that did not violate the limit prescribed in the statute. The Revenue Authorities challenged the order before the High Court, on the ground that the statute does not permit proportionate allowance of deduction, and that if a tax payer violates any of the conditions specified in the statute, it shall not be entitled to any deduction at all.

Dismissing the appeal of the Revenue, the Bombay High Court observed that the view taken by the Commissioner (Appeals) and the ITAT was consistent with the view taken by the High Courts of Madras, Delhi, and Karnataka. Bombay High Court decisions in the cases of *Brahma Associates*, *Vandana Properties* and the Supreme Court decision in the case of *Britannia Industries Ltd*., as relied by the revenue authorities, were distinguished. [*Devashri Nirman LLP* v. *ACIT* - Order dated 26 November 2020 in Tax Appeal Nos. 4 to 8 of 2016, 49 of 2016 and 52 of 2016, Bombay High Court]

Re-sellers margin is not akin to commission, not liable to deduction of tax under Section 194H

The tax payer, engaged in the business of manufacturing of pharmaceuticals products, sold the goods manufactured by it to its stockiest at a discount to the re-sale price of the goods. The stockiest would then re-sell the goods to retail stores, who would then sell the products to the ultimate consumer. The Revenue Authorities alleged that the stockiest were acting as agents of the tax payer and that margin earned by the stockiest through re-selling the goods to retail stores is nothing but commission paid by the tax payer to the stockiest. The Revenue Authorities accordingly held that the tax payer ought to have deducted tax at source on the margins earned by the stockiest, failure of which resulted in the tax payer being regarded as an assessee in default.

On appeal, the ITAT Mumbai held that the transaction between the tax payer and the stockiest was that of sale of goods, and wherever there is transfer of title in goods to the stockiest, the stockiest cannot be regarded as agent of the tax payer. When the tax payer and the stockiest acted on a principal to principal basis, the margin earned by the stockiest cannot be regarded as commission earned by the stockiest. The order holding that the tax payer ought to have deducted tax at source, treating the margin as commission, was thus set aside. [*ACIT* v. *Pfizer Ltd.* - ITA No. 534/Mum/2019, Order dated 27 November 2020, ITAT Mumbai]

Consideration paid for acquisition of technical know-how, even if termed as annual royalty payment, is capital expenditure

The Tax payer was set up as joint venture between an Indian company and a Japanese company for manufacturing goods. The goods were manufactured using technical know-how licensed by the Japanese company and were sold under the trade name licensed by the Japanese company. The Tax payer paid annual royalty to the Japanese company for the use of technical know, trade name and other intellectual properties belonging to the Japanese company and claimed it as revenue expenditure. The Revenue Authorities dis-allowed the claim, on the ground that the expenditure, though annual in nature, resulted in enduring benefit to the tax payer, and hence had to be regarded as capital expenditure.

On appeal, the Karnataka High Court observed that in consideration for payment of annual royalty, the tax payer had obtained a right to manufacture the equipment using the technology and trade name of the Japanese company for a period of 7 years, and that the term of the arrangement has been further extended between the parties. It held that the right to manufacture the equipment was in itself a capital asset, which had given an enduring benefit to the tax payer and hence, the consideration paid therefor, even if it was annual payment, would have to be regarded as capital expenditure. [*Telco Construction Co. Ltd. (now known as Tata Hitachi Construction Machinery Co. Pvt. Ltd)* v. *ACIT* - ITA No. 101/2016, Order dated 20 November 2020, Karnataka High Court]

Reimbursement of salary expense of deputed employee is not a consideration for rendition of technical services

The tax payer had entered into service agreements with its Associated Enterprise (‘**AE**’) in UK for rendition of certain services to it. At the request of the tax payer, the AE had deputed few of its employees to the tax payer. The employees continued on the payroll of the AE but worked under the control and supervision of the tax payer. The remuneration to the employees were paid by the AE and then reimbursed by the tax payer to the AE. The tax payer did not deduct tax of the sums reimbursed by it. The Revenue Authorities treated the reimbursement of expenses as consideration paid for making available highly skilled employees and regarded the tax payer as assessee in default for not deduction of tax.

On appeal, the Karnataka High Court observed that the seconded employees, under the agreement between the tax payer and the AE, had to work at such place and under the control, direction and supervision of the tax payer. The deputed employees were also required to function in accordance with policies, rules and guidelines applicable to employees of tax payer, and hence for all practical purposes, the tax payer had to be treated as the employer of seconded employees. It held that hence the salary cost of these employees met by the AE can be reimbursed by the tax payer without deduction of tax. [*DIT (IT)* v. *Abbey Business Services India (P.) Ltd*. - ITA No. 214/2014, Order dated 1 December 2020, Karnataka High Court]

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