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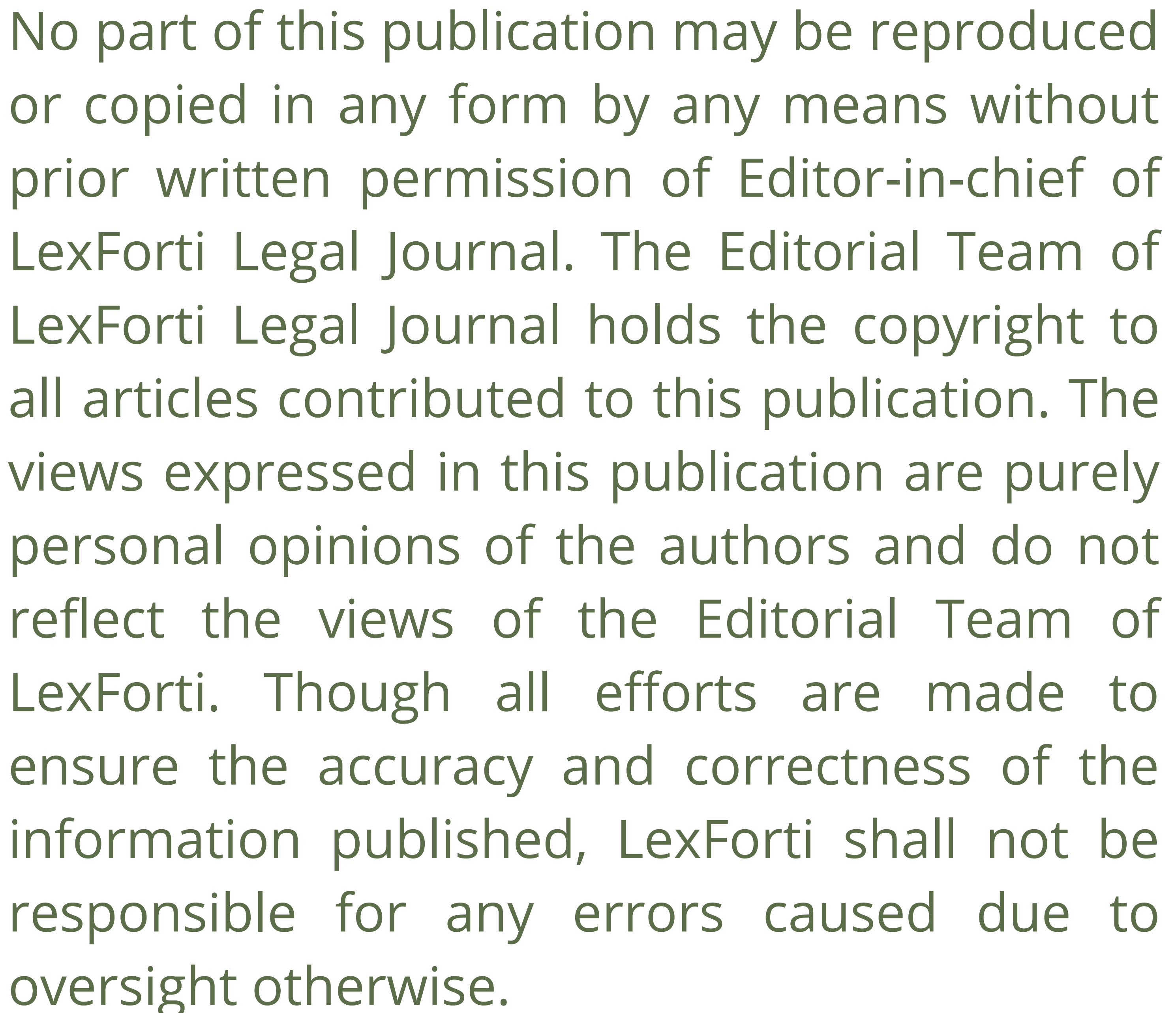

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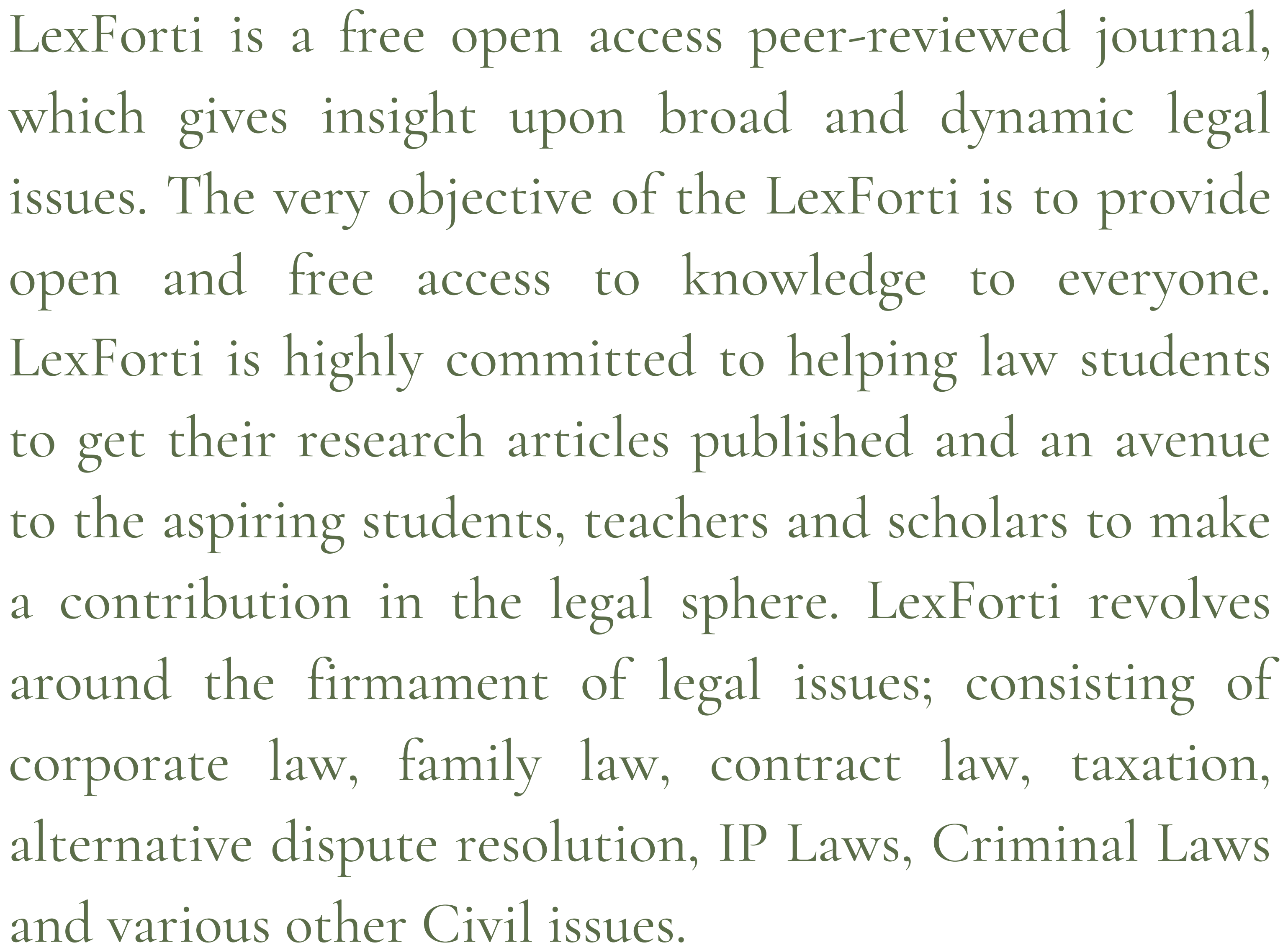

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Re-characterising Debt Capital of a Company as Equity Capital for Taxation

Sofiya Mhaisale

INTRODUCTION

Sections 30 to 36 provide the basic deductions available to expenses incurred on business income under the head, 'Profits and Gains from Business and Profession'. Section 36(1)(iii) states the following:

> *36(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28 –*
>
> *(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession*

Therefore, in order to avail the benefit of any deduction, it is necessary that the expense must be for an "interest", paid in respect of a "capital borrowed".

The nature of funds that are received by a company may be of two forms: Equity Capital and Debt Capital. Equity capital is formed by the sale of stock to investors, and Debt capital is formed by raising money through borrowing from a source outside the company. When the capital comprises of Equity, a dividend is payable to the investors, and this is taxed in the hands of the company. However, when the Capital comprises of Debt, there is an interest payable on Debt, which is deductible under Section 36(1)(iii). Therefore, in order to avail deductions under section 36(1)(iii) and avoid the Dividend Distribution tax, companies prefer to borrow debt to form their Capital, rather than issuing shares and forming Equity Capital.

In case of Equity shares, it gives a clear picture that it comprises the Equity Capital of the Company, and incase of Debentures, it clearly forms part of the Debt Capital. But there are certain hybrid instruments like Compulsory Convertible Debentures, which possess both debt like, and equity like characteristics. The company would always allege that these instruments should be considered as Debt capital, as the interest would be tax deductible. However, the Revenue would press for such instruments to be governed as the Equity Capital of the Company.

In order to prevent the above-mentioned practice by companies, the OECD Model Action Plan 4 introduced the concept of Thin Capitalisation. This paper will deal with the tax treatment given to hybrid instruments like Compulsory Convertible Debentures and exhaustively analyse the case of CAE Flight Training v. ACIT, which dealt with the above, and would discuss the OECD model and Indian Jurisprudence with regard to Thin Capitalisation.

COMPULSORY CONVERTIBLE DEBENTURES (CCD)

CCD is a type of debenture in which the whole value of the debenture must be converted into equity by a specified time. The compulsory conversion of debentures to equity is, in fact, a method used by a company to pay off its debt by paying its debenture holders in kind, that is, equity.

The payment in kind consists of repayment of principal and payment of interest.

Some CCDs, which are usually considered equity, are structured in a manner that makes them more like debt. Often, the investor has a put option which requires the issuing companies to buy back shares at a fixed price. Unless converted into equity, CCDs are not considered as part of the share capital of a company.

The issue of treatment of CCDs as Debt or Equity was raised in the case of CAE Flight Training v. ACIT.

CAE FLIGHT TRAINING V. ACIT:

Assessee issued CCDs to three of its Associated Enterprises abroad, and paid an interest of 15% on issue of such debentures. These transactions were referred by the Assessing Officer to the Transfer Pricing Officer ("TPO") for determination of the Arm's Length Price. However, the TPO invoked the principles of Thin Capitalisation and held the CCDs must be characterized as Equity, not debt, as the balance sheet of the company was so skewed that no independent lender would have offered a loan to the Assessee.

The TPO had stated the following reasons for treating the CCDs as Equity, and not Debt

1. CCDs are considered similar to equity as on conversion of CCDs into equity, it adds to the equity capital of the company, hence it should be seen as an equity investment.
2. Even before conversion of CCDs into equity, it is equity investment because the circumstances of the borrower when lender had subscribed in CCDs were such that no independent lender would have provided credit to the borrower.
3. As per the RBI Policy, 2007, Only fully and mandatorily convertible instruments are considered to be FDI. RBI had banned debt structures like partially convertible preference shares, and stated that only compulsory convertible preference shares (CCPS) and compulsory convertible debentures (CCDS) would be permitted since these are equity instruments.
4. By invoking the Principles of Thin Capitalisation, the TPO stated that debt-equity ratio is skewed as evident on perusal of its balance sheet

The CIT(A) held overruled the decision of the TPO and treated the CCDs as Debt, not Equity

- Transfer Pricing Officer has a limited fiduciary role and jurisdiction confined to determination of arm's length price

- The Transfer Pricing Officer has misdirected the process completely by invoking the concept of Thin Capitalization which has not yet seen the light of the day in the Indian Tax Laws and Jurisprudence.
- The inherent character of a Compulsory Convertible Debenture is that it remains a debenture till such time it is converted in to equity at a future appointed date
- RBI- applicable to Optionally or Partially Convertible Debentures and other Hybrid Instruments, because their conversion in to equity at a future appointed date remains an uncertainty being non compulsive in nature, shall be treated as debt and not equity.
- "*It is also quite possible that tax considerations may have played a role in assessee's planning the capital structure, but an element of planning in structuring capital does not transform a tax-deductible expense of interest into an expense that is non-tax deductible.*"

On similar facts that in absence of specific thin capitalisation rules in India, in the case of Besix Kier Dabhol, SA vs. DOT (ITA No.- 4249/Mum/2007) recharacterisation of debt capital as equity capital and accordingly disregarding the interest payments as tax deductables is not in order.

The court further relied on the following cases to assert the following facts:

- Secure Meter Ltd. (CC 10548/2009) : Compulsory Convertible Bonds represent the loan funds and thus represent the debts.
- India Cements Ltd. vs CIT (1966 AIR 1053) : the debentures when issued is a loan, and therefore, whether it is convertible, or non-convertible, does not militate against the nature of the debenture, being loan
- DCIT vs. Modern Syntex India Limited (95 TTJ JP 161), the Honble ITAT Jaipur, has also very clearly held that debenture is nothing but just another form of loan on which interest is payable.
- Vodafone India Services Private Limited vs. Union of India (368 ITR I), the Honble Bombay High Court very clearly has ordered that the TPO/AO cannot disregard any apparent transaction and substitute it by re-characterizing the said transaction without any material or exceptional circumstances indicating that the Assessee has tried to conceal the real transaction

ITAT RULING

- The objections of AO/TPO are not merely on the basis of Thin capitalization Principle- interest is paid on CCDs is not an interest on debt but on equity
- RBI policy of FDI is governed by this that what will be future repayment obligation in convertible foreign currency-allowability of interest on such debentures during pre-conversion period or regarding payment of dividend on such convertible debentures during

pre-conversion period or regarding granting of voting rights to the holders of such convertible debentures before the date of conversion

- The holders of CCDs do not have voting rights before coversion
- Dividend cannot be paid on CCDs before conversion

Hence the court refused to characterize the CCDs as equity capital of the Company

CONCEPT OF THIN CAPITALISATION

Before dealing with the case further, we would now understand the concept of thin capitalization. Thin capitalization refers to a situation where the company's capital comprises more of debt than equity. The company increases its borrowing more than equity capital in order to avoid taxes, as interest payments can be claimed as deductions, but dividends are taxable in the hands of the company. The OECD put forward various tests and methods to deal with transactions of thinly capitalized companies in BEPS Action Plan 4:

1. Fixed Ratio : Rules that limit the level of interest expense or debt in an entity, with reference to a fixed ratio of debt/equity, interest/earning, etc.
2. Arms length basis : Test that compares the level of interest or debt in an entity with the position had the company been dealing entirely with third parties.
3. Specified percentage: Rules that disallow a specified percentage of interest expenses in an entity irrespective of the nature of the payment
4. Anti-avoidance Rules: Targeted anti-avoidance rules that disallow interest on specific transactions

Various countries enacted various rules for determination of thin capitalization. For example, Australia laid down the following rules:

1. The legal effect of the transaction
2. Repayment of principal
3. Purpose of the contribution
4. Debt equity ratio
5. Factors affecting the form of investment
6. Ability to obtain finance from an unrelated third party

If the above criteria lead to an understanding which portrays the company to the thinly capitalized, the transfer is assumed to be an equity, and not debt transfer, hence taxing it as deductible dividend, and not interest.

THIN CAPITALISATION IN INDIA:

In India, the concept of thin capitalization was included in the Income-tax Act, 1961 in 2016, under section 94B of the Act. The section applies under the following pre-requisite conditions:

1. If the borrower is either an Indian Company or a permanent establishment for a foreign company in India.
2. If the lender is a company that is located abroad and is an Associate Enterprise within the aspects mentioned under Section 92A of the Income Tax Act.
3. If the expense is deductible under the head Profits and Gains of Business or Profession.
4. If the expense is like interest, discount or any other similar finance charges and includes the debt in the form of a loan, financial lease, financial instrument, financial derivative or other arrangements that give rise to the expenses mentioned above.
5. If the minimum value of the transaction is equal to more than Rs. 1 Crore.

Due to the absence of thin capitalization rules in India during the CAE Flight training case, the court ruled in favour of the assessee.