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EY Tax Alert

Mumbai Tribunal rules premium received on redemption of debentures is taxable as interest and not "capital gains"

Executive summary

EY Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (ITAT), in the case of Khushaal C. Thackersey (Taxpayer)[1] wherein the issue before the ITAT was whether the excess amount realized by the Taxpayer on redemption of debentures is in the nature of capital gains or in the nature of interest income under the Indian Tax Laws (ITL).

The ITAT held that amount received on redemption of debenture is realization of money advanced by creditor. The event of redemption does not give rise to capital gains. The excess realized by the Taxpayer on redemption of debenture on account of premium is in the nature of interest income and is taxable under the head "Income from other sources".

[1] [TS-293-ITAT-2024(Mum)]

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Background

- Under the provisions of the ITL, profits and gains arising from "transfer" of capital asset is taxable under the head "Capital Gains" in the year of transfer. The term "transfer" is defined widely to, *inter alia,* include sale, exchange or relinquishment of the asset or the extinguishment of any rights therein. Capital gains taxation is subject to various exemptions available under the ITL including roll over exemption for long term capital gains for reinvestment into residential house or specified bonds. Furthermore, tax rate on long term capital gains is generally lower than regular income like interest income.

- Under the provisions of the ITL, the term "interest" is defined widely to mean interest payable in any manner in respect of any moneys borrowed or debt incurred and includes any service fee or other charges in respect of the moneys borrowed or debt incurred. Interest income earned by the Taxpayer is either taxable under the head "'Profits and gains of business or profession" or "Income from other sources".

- Commercially, non-convertible debentures (NCDs) are fixed-income instruments issued by companies/corporations. Unlike convertible debentures, NCDs cannot be converted into equity shares of the issuing company. NCDs have a fixed maturity date and a bear coupon either on recurring basis or at the time of redemption.

- Vide Finance Act, 2023, a special provision is inserted under the ITL to provide for specific capital gains treatment on transfer or maturity or ***redemption*** of market- linked debentures (MLD) and certain specified mutual funds. The capital gains on such instrument are deemed to be short-term capital gains even if those instruments are held for long term. Such special treatment extends even to redemption of such instruments.

Facts

- In tax year 2004-05, Bhishma Realty Ltd. (BRL) and Capricorn Reality Ltd. (CRL), domestic companies undergoing corporate insolvency resolution, issued NCDs to bankers against their outstanding loan. The issuance of NCDs were under the rehabilitation scheme sanctioned by Board for Industrial and Financial Reconstruction (BIFR). The terms of the NCDs were:

  - Tranches – Issued in two tranches.

  - Coupon - 0% interest rate. However, premium was payable on redemption was payable.

  - Face value - INR0.1 million each

  - Tenure – NCDs were redeemable after five years from date of issue.

  - Premium on redemption – INR0.12 to 0.15 million each

- Post issuance of NCDs, bankers pressed for recovery of NCDs from the directors of the companies. During the tax year 2005-06, the Taxpayer being one of the directors of companies, bought 130 NCDs of BRL and 155 NCDs of CRL for a total consideration of INR37.34 million at amount higher than their face value.

- Subsequently, in tax year 2008-09, both the companies viz. BRL and CRL redeemed NCDs as per the terms of the issue. On redemption, the Taxpayer received a sum of INR64.99 million in total. As against the investment made of INR37.34 million, the Taxpayer realized excess of INR27.65 million. The Taxpayer offered to tax such surplus received as long-term capital gains income. Further, the Taxpayer claimed exemption under capital gains chapter investing the amount in certain specified bonds and purchasing a residential property[2].

- Tax authority rejected the capital gains exemption claim of the Taxpayer by raising doubts over the genuineness of the entire transaction of issue and redemption of NCDs.

- Aggrieved by the order of the tax authority, the Taxpayer filed an appeal before first appellate authority (FAA) who held that redemption of NCDs does not give rise to capital gains income and the excess realized by the Taxpayer on redemption is interest income. Consequently, FAA also denied capital gains exemption claim but by recharacterizing the income as interest income.

- Aggrieved by the order of FAA, the Taxpayer filed further appeal before Mumbai ITAT.

Taxpayer's contentions before ITAT

- Debenture is a capital asset and redemption thereof result in extinguishment of right. Hence, gains are covered by capital gains head.

- Reliance was placed on Mumbai Tribunal ruling in case of Mrs. Perviz Wang Chuk Basi v JCIT [[2006] 102 ITD 123] wherein it was held that redemption of capital investment bond after maturity is considered as transfer of capital asset giving rise to capital gains.

- Reliance was also placed on Supreme Court ruling in case of Anarkali Sarabhai v CIT [[1997] 224 ITR 422] which held that redemption of preference shares results in extinguishment of rights and transfer of capital asset. Reliance was also placed on Supreme Court ruling in case of Karthikeya

[2] Exemption under sections 54F and 54EC of ITL

Sarabhai v CIT [[1997] 228 ITR 163] which held that reduction in share capital results in extinguishment of rights and transfer of capital asset.

- Furthermore, reliance was placed on the newly inserted provision under the ITL vide Finance Act 2023 that deems gains arising on transfer or maturity or redemption of MLDs as short-term capital gains income. Accordingly, the ITL itself recognizes debentures as capital asset and any transfer including redemption thereof is to be considered as capital gains.

- The ITL carves out an exception for debentures[3] from indexation benefit which supports that debentures are capital assets and are otherwise entitled to indexation benefit but for such specific carve out.

Tax authority's contentions before ITAT

- NCDs are debt instruments and is one of the ways of borrowing money from the market or through private placement. Thus, premium payable on such debentures bears the nature of interest.

- NCDs carried 0% coupon rate but were redeemable at a premium. Premium was calculated in a particular manner. Hence, the premium paid on such redemption is in the nature of interest.

- Reference was drawn to Central Board of Direct Taxes (CBDT) Circular 2/2002 dated 15 February 2002 (Circular) which was issued in respect of deep discount bond. The Circular state that difference between redemption price and cost of purchase of the bond by the intermediate purchaser is taxable as interest or business income.

ITAT ruling

Ruling in favour of the tax authority, the ITAT held that on redemption of NCDs there is a realization of money advanced by a creditor. The event of redemption of NCDs does not give rise to capital gains. Further, the excess amount realized by the Taxpayer as premium on redemption of NCDs is in the nature of interest income. In absence of capital gains income, the ITAT upheld the denial of capital gains exemption for reinvestment in residential house and specified bonds.

The ITAT adopted following line of reasoning:

- As per the provisions of Company Law[4], debenture includes debenture stock, bonds or any other instrument of company evidencing debt. Though debentures fall under securities, it is a debt instrument.

- In case of deep discount bonds, bonds are issued at less than face value. In case of deep discount bonds, the bonds are issued at a discount to the face value by interest rate such that maturity proceeds are equal to face value of the bonds. NCDs which are redeemable at a premium is determined by applying a particular interest rate on the face value. Hence, discount on deep discount bond and amount paid as premium on redemption of debentures are effectively the same.

- Companies issuing discount bonds or debenture with premium payable are allowed deduction of the amount paid as interest expenditure.

- MLDs are materially different compared to conventional non-convertible debentures. The rate of return on MLDs is linked to performance of underlying market index or instrument. Taxation on MLDs is governed by a legal fiction introduced by the ITL. The legal fiction applicable to MLD is not applicable to NCDs.

- Shares and debentures are two separate instruments with separate rights and liabilities. Equity shareholder of a company is considered as an owner and has a right over the surplus available on liquidation. A debenture holder is a financial creditor of the company. Debenture holder does not have right to receive surplus on liquidation of company. Hence, decisions rendered in the context of redemption of preference shares or reduction of capital cannot be applied in case of redemption of debentures.

- The decision in case of Mrs. Perviz Wang Chuk Basi *(supra)* is also not applicable as NCDs are different from capital bonds involved in that case.

- On redemption, debentures are surrendered to company and there is a realization of money advanced by the creditor. Hence, no capital gains arise when the debentures are redeemed.

- Premium received on redemption of debenture is in the nature of interest and such income is assessable under the head "Income from Other sources".

- Capital gains can arise on debentures if they are transferred in the market to third party prior to maturity/redemption.

[3] As per the fourth proviso to section 48 of the ITL

[4] Companies Act, 2013

Comments

The present Mumbai Tribunal ruling clarifies on first principles that redemption of debentures does not give rise to capital gains in absence of "transfer". The redemption of debenture is a realization of debt and not an extinguishment of right therein. Further, the premium payable on redemption of debenture is in the nature of interest income. It also clarifies that capital gains can arise on such instrument if they are transferred to third party prior to maturity. Taxpayers need to consider such distinction while determining the tax treatment of such instruments.

The present Mumbai ITAT seem to align with recent Delhi ITAT ruling in case of BCP v. Singapore FVCI Pte. Ltd. [TS-27-ITAT-2024(DEL)] wherein non-resident taxpayer had subscribed the NCDs of an Indian company. The interest income on NCDs was offered to tax. Subsequently, per terms of issue, NCDs were redeemed and redemption proceeds were repatriated outside India. In the year of redemption of NCDs, non-resident taxpayer did not file return of income. Reassessment proceeds were initiated on the ground that taxpayer was required to file return of income and did not file the same. Taxpayer challenged the reassessment proceedings. Delhi ITAT held that no income accrues or arises on redemption of debenture and, hence, there is no escapement of income which is an essential requirement for issuing the reassessment notice. Delhi ITAT quashed the reassessment notice in absence of escapement of income.

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