Tax Hotline

May 14, 2024

ITAT HOLDS THAT REDEMPTION PREMIUM RECEIVED ON NON-CONVERTIBLE DEBENTURES TAXABLE AS INTEREST INCOME (NOT CAPITAL GAINS)

- The Mumbai ITAT holds that premium received by the taxpayer on redemption of debentures is interest income and not capital gains
- Redemption of debentures is realization of debt and not extinguishment of rights. Hence, such redemption cannot be a transfer for the purposes of Income-tax Act,1961
- Capital gains can only arise on such redemption when debentures are sold in open market

BACKGROUND

In a recent ruling[1] the Mumbai bench of the Income Tax Appellate Tribunal, Mumbai ("**ITAT**") held that premium received by the Taxpayer[2] on redemption of debentures is interest income. In this context, it was held that redemption of debentures is nothing but repayment of debt and the same cannot fall under the category of extinguishment as interpreted by various courts in the case of equity/preference shares.

FACTS OF THE CASE

During financial year 2004/2005, two Indian companies, namely Bhishma Realty Limited ("**BRL**") and Capricorn Realty Limited ("**CRL**") (hereinafter referred to as "**Indian Companies**") issued redeemable non-convertible debentures ("**NCDs**") on a private placement basis to nationalized banks. As per the terms and conditions, two types of NCDs i.e., NCD -1 for the creditors holding first charge and NCD-2 for the creditors holding second charge were issued. Further, the NCDs were to be redeemed within a period of 5 years along with redemption premium to yield an IRR. The Indian Companies were not required to pay interest either quarterly, half yearly or annually during the tenure of the NCDs. During the year 2006, the banks started pressurizing the directors of the companies for payment of NCDs. Hence, the Taxpayer (being one of the directors in CRL) purchased the NCDs from the banks. Premium was payable on the redemption of NCDs on maturity.

During the year 2009, the Indian Companies redeemed the NCDs acquired by the Taxpayer. The maturity proceeds were received by the Taxpayer and the Taxpayer offered the gain of Rs. 276.50 lakhs as long term capital gains ("**LTCG**"). The Taxpayer invested the maturity proceeds in purchase of a flat under construction. Accordingly, an exemption under section 54F and 54EC of the Income-tax Act, 1961 ("**ITA**") was claimed in his return of income. The Assessing officer ("**AO**") observed that the Taxpayer did not get the possession of the flat within the prescribed period of three years. Hence, the AO took the view that the Taxpayer has not complied with the conditions prescribed under section 54F and accordingly rejected the claim for deduction. In the appellate proceedings, the Commissioner of Income-tax (Appeals) ("**CIT(A)**") held that the redemption of NCDs would not give rise to LTCG and held that the difference between the maturity proceeds upon redemption of NCDs and cost should be considered as 'interest income' in hands of the Taxpayer. Further, since the Taxpayer did not earn any LTCG, the question of allowing deduction was not considered in the appellate proceedings.

DECISION OF THE ITAT

The ITAT while considering and concluding on the question - whether the gains arising to Taxpayer on redemption of NCDs is in the nature of capital gains or is in the nature of interest income observed the following.

- Meaning of debentures: As per section 2(30) of the Companies Act, 2013, debenture includes 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. Hence, even though the debentures would fall under the definition of securities, yet they are essentially debt instruments evidencing a debt.
- Applicability of CBDT Circular No. 002 of 2002 ("**Circular**"): The revenue argued that the Circular issued by Central Board of Direct taxes ("**CBDT**") clarifying the tax treatment of gains realized on redemption of deep discount bonds ("**DDB**") should be considered. The Circular inter-alia provided that upon redemption of DDB on maturity, the difference between the redemption price and the value as on the last valuation date immediately preceding the maturity date will be taxed as interest income in the case of investors, or business income in the case of traders. The ITAT held that both the amount of discount on DDBs and the premium amount, in effect, are "interest amounts".

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- Section 50AA of the ITA not applicable: The Taxpayer relied on the recently introduced section 50AA of the ITA which provides that the gains arising on transfer, redemption or maturity of market linked debentures ("**MLDs**") shall be deemed to be capital gains arising on transfer of short-term capital asset. The Taxpayer argued that ITA itself considered debenture as 'capital assets'. In this context, the ITAT observed that section 50AA is applicable only to MLDs wherein interest rate payable on them is not determined at time of issuance. The return on MLDs is determined on the basis of performance of the underlying market index or instrument. NCDs acquired by the Taxpayer are materially different from MLDs. The ITAT therefore held that the legal fiction introduced in section 50AA to deal with taxation of MLDs cannot be applied to the facts of the instant case.

- Shares vs Debentures: The Taxpayer while relying on multiple case laws[3] contended that redemption of preference shares or reduction of face value of shares results in extinguishment of rights held by a shareholder and hence amount paid to the shareholder is exigible to capital gains tax. The ITAT observed that the ratio of decisions rendered in the case of equity/preference shares cannot be applied to debt instruments. There is no dispute that they are two different types of instruments having different types of rights and liabilities. A shareholder is considered to be one of the owners of the company with certain rights. On the contrary, a debenture holder is a financial creditor to the company and is entitled to receive only interest as per agreed terms. Debenture holders do not have any right over the surplus arising on liquidation of company. Hence, shares and debentures stand on different footing.

- Possibility of Incidence of capital gains in case of debentures: The ITAT observed that the holder of the debenture is only entitled to receive interest from it and the said interest can be taxable under the head income from other sources or business income. Similarly, in the case of shares, the shareholder gets dividend income and the same is taxable as above. The ITAT held that the possibility of capital gains in case of NCDs may only arise if their market value is difference from their face value and this kind of variation may arise only when they are sold in open market (i.e., to a third party). The market value of the debentures would depend upon the fluctuation in the prevailing general interest rates. Hence, if market value of debentures increases, the gain realized by the person is assessable as capital gains.

  While linking the above logic to the facts of the instant case, the ITAT observed that NCDs under consideration are privately placed debentures and they are not listed on the stock exchange. Further, the NCDs are not sold in the open market, and they have only been surrendered for redemption. Thus, it is only a case of realization of money advanced by a creditor and the question of capital gains will not arise when the debentures are redeemed by the issuing companies.

NDA ANALYSIS

Taxability of premium on the redemption of NCDs is a contentious issue. Typically, interest payable during the tenure of debt instruments represents a commercial rate of return and redemption premium is paid towards the capital risk being borne by the investor. Courts have delved upon this in two contexts – (i) allowability of redemption premium as expense to the issuer company and (ii) characterization and taxability of redemption premium received by the investor. The Supreme Court of India has held that the character of payment in relation to the payer can be different from the character of that payment in hands of recipient.[4] In the instant case, the ITAT was dealing the issue of characterization and taxability of redemption premium in hands of the Taxpayer.

The ITAT has come to the conclusion that redemption premium is taxable as interest considering the terms on which the NCDs were issued. The ITAT also noted that there were no periodic interest payments being made to the Taxpayer and the Taxpayer was getting the premium amount upon maturity of the NCDs. Importantly, the decision by the ITAT does not consider the definition of interest under the ITA. As per section 2(28A) of ITA, "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 charge in respect of moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized". On the plain reading of the aforesaid definition, it is observed that 'interest' under section 2(28A) does not specifically cover redemption premium. While in this case, the Taxpayer was an Indian resident, in case of non-resident taxpayer, interplay of definition of 'interest' in ITA and relevant tax treaty will also be important to examine. Several Indian tax treaties specifically includes redemption premium in its ambit.

Interestingly, the ITAT has also laid down the scenario when income from debt instruments may be considered as capital gains. The ITAT has emphasized existence of 'transfer' is a pre-requisite for characterization of proceeds as capital gains. Section 2(47) of the ITA defines "transfer" to inter-alia include, "….the sale, exchange or relinquishment of the asset; or…..the extinguishment of any rights therein……". While the ITAT has distinguished the cases relied by the Taxpayer on the ground that the cases were in relation to redemption of preference shares or reduction of equity capital, the ITAT has not examined why redemption of debenture cannot be considered as extinguishment of rights.

Taxation of debt instruments continues to be controversial with specific amendments being made to ITA in relation to certain debt instruments like MLDs. Determination of tax implication in hands of the borrower and investor is a fact specific exercise and should be done considering the nature and terms of the debt instruments.

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You can direct your queries or comments to the authors.

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[1]Khushaal C. Thackersey vs ACIT, I.T.A. No. 3679/Mum/2015 (A.Y. 2010-11)

[2]Khushaal C. Thackersey

[3]Anarkali Sarabhai vs. CIT (1997) (90 Taxman 509) (SC), Kartikeya V Sarabhai vs CIT (1997) (95 Taxman 164) (SC), Sath Gwaldas Mathuradas Mohata Trust vs. CIT (1987) (33 Taxman 328) (Bom).

[4]M/S Madras Industrial Investment Corporation Ltd. vs CIT [1997] 225 ITR 802 (SC)

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