

**BEFORE THE AUTHORITY FOR ADVANCE RULINGS (INCOME TAX)
NEW DELHI**

21st Day of March, 2012

A.A.R. No.1048 of 2011

PRESENT

Mr. Justice P.K.Balasubramanyan (Chairman)
Mr. V.K. Shridhar (Member)

Name & address of the applicant	Z
	<u>Address in India</u> S.R.Batliboi & Co., Chartered Accountants Authorised Representative – Z Mauritius Golf View Corporate Tower B, Sector42, Sector Road, Gurgaon-122 002, Haryana
Commissioner concerned	Director of Income-tax (International Taxation)- II, New Delhi
Present for the applicant	Mr. Vinay Mangla, CA(S.R.Batliboi Co.) Mr. Gaurav Kanwin, (S.R.Batliboi Co.) Mr. Percy Pardiwala, Senior Advocate Ms. Preeti Goel, Advocate
Present for the Department	Ms. Poonam Khara Sidhu, DIT(Intl.Taxn.)- II, New Delhi. Mr. R.K.Kakar, Jt. Director of Income-tax Circle2 (2), New Delhi.

RULING

(By V K Shridhar)

Applicant (Z) is a company incorporated under the laws of Mauritius and is a tax resident of Mauritius. It invested alongwith V Ltd. (V), an Indian company, in S Ltd. (S), an Indian company. It is stated that S is undertaking the development of a Project in India, admeasuring about 'x' lac sqft of land. Applicant has made a total investment of Rs.'y' crores to acquire yy% ownership interest in S in the following manner:

- (i) A No. equity shares of face value of Rs.10 each at an amount of Rs.AAA
- (ii) B No. Compulsory Convertible Debentures (CCDs) of face value of Re.1 each at an amount of Rs.BBB.

The investment was made as per the Share Holders Agreement (SHA) and Securities Subscription Agreement (SSA), both dated 11.8.2007, entered into amongst **Z**, **V** and **S**.

2. Applicant states that as per the terms of SHA, CCDs are to be fully and mandatorily converted into equity shares @ Rs.C per equity share after the expiry of 72 months from the investment date, CCDs held by the holder. Prior to the mandatory conversion date, **Z** was given the put option to sell specific number of shares and CCDs on specified dates to **V**. A call option was also given to **V** to purchase the said shares and CCDs from **Z**. **Z** further states that **V** has exercised the said option and proposes to purchase the entire stake held by it in **S** to **V** for a total consideration of approximately Rs.CCC crores. The applicant's submission that capital gains arising to it from transfer of securities held in **S** are exempt from tax in India under Article 13.4 of the Indo-Mauritius DTAA and no tax is required to be withheld was not accepted by the assessing officer and **V** was asked to deposit withholding tax on the capital gains that arose from the sale of shares and CCDs.

3. The applicant seeking advance ruling from this Authority has raised following question:

Whether on the facts stated in the application and in law, gains arising to the applicant, being a resident of Mauritius on sale of equity shares and Compulsory Convertible Debentures (CCDs) held by the applicant in S Ltd., an Indian company, are exempt from capital gains tax in India under Article 13.4 of Double Taxation Avoidance Agreement (DTAA) between India and Mauritius.

4. Revenue submits that the recitals in SHA would reveal that to compensate normal interest income from debentures, the concept of optional conversion rate has been incorporated, which in truth is loan and interest thereon. As per SHA and SSA, only a small portion of the investment comprises of equity shares and the rest is in the form of CCDs. To characterize the gains to have arisen on account of transfer of a capital asset is improper. The CCDs recognize the existence of a debt till repaid or discharged¹. The two agreements are entered into to camouflage the true character of income from that of loan and interest, to capital gains. Relying on a number of authorities, it is submitted that the essence of the agreements as a whole needs to be taken into account while interpreting the said agreements and not merely their form. Without prejudice to the above, the Revenue has also submitted in the alternative that the nature of the income arising from the present transaction is a business income. For this, revenue relies on the submission of the Applicant that it is engaged in the real estate business but its only transaction in India is an investment of Rs.'y' crores in S. Further, the agreements were signed in India and one of the directors in S is its representative.

5. Learned counsel submits that the applicant has made an investment in equity and CCD of S. It has not lent the money. CCDs were not loan or advances². There is no lender -borrower relationship³ with S. Even assuming that S is a borrower but what the applicant has received is a consideration for the sale of assets from V. If any amount is received over and above the purchase price, it cannot be income from interest⁴. The calculations of purchase price are as per SHA. Reliance placed by the Revenue on the ruling in LMN India Ltd⁵ is misplaced as in that case the debenture carried interest on it. The applicant is an investor and has no place of

¹LMN India Ltd. 307 ITR 40

² Sahara India Savings and Investment Corpn.Ltd., 321 ITR 371 (SC)

³ Ferro Alloys Corpn.Ltd.,1993 AIR 2005

⁴Vijaya Bank Ltd., 187 ITR 541

⁵ 307 ITR 40

business in India and the fact that the agreements were signed in India would not create a permanent establishment of the applicant in India.

6. Further written submissions were made by the Revenue stating therein that Govt. policy on FDI mandates that investment in optionally and partly convertible debentures and preference shares will not constitute FDI but External Commercial Borrowing (ECB), where end-use restrictions are more stringent. Debenture recognizes the existence of a debt which remains so till it is discharged⁶. It does not cease to be a debt just because it is redeemed not by returning the money but by getting shares of the equivalent value. The legal character of CCD as debt does not change. Here, the conversion is to be at the behest of V. Till the conversion of CCD, the investment is purely in debentures secured by V against the land owned by it through put option. To get around the restrictions, SSA and SHA have been entered into. What in essence is ECB at a fixed rate of interest, has been contrived to look like CCD conversion into equity in the agreements. Though there is no legal taboo against treaty shopping but a transaction where “documents are not bona fide in order to be acted upon but are used only as a cloak to conceal a different transaction” stands on a different footing as held in ‘Azadi Bachao Andolan’⁷. Where parties have a common intention not to create legal rights and obligations which they give the appearance of creating, the transaction is sham, as held in B.C.Srinivas Shetty⁸. Applying these principles, the SHA giving fixed rate of return, the applicable rate for call option, were all predetermined in 2007 for an option to be exercised 6 years later. The Revenue then submits that there is no commercial purpose in support of the view that equity valuation could be based on rate of conversion of ECBs into equity after a particular period or guaranteeing a minimum

⁶ LMN India Ltd. 307 ITR 40

⁷ 263 ITR 706 (SC)

⁸ 128 ITR 284

rate of return irrespective of whether the company makes profit or not. The transaction clothed as a purchase of equity and CCDs in a joint venture, is sham, designed for avoidance of tax. It is to take advantage of the Article 13.4 of the DTAA with Mauritius to claim exemption from capital gains.

7. In a rejoinder, the applicant reiterated that in law it cannot be disputed that a CCD is in the nature of a debt till the time it is converted into equity. When the Revenue took a stand in *Ashima Syntex*⁹ that a CCD is in the nature of share capital, it is not open to the Revenue to contend that the debenture is in the nature of debt instrument. There is no borrowing by **V** for incurring of debt by **V** from the applicant. The commercial intent of the transaction was never to provide a loan to **V**. There is no dispute of the fact that interest on CCDs paid by **S** will qualify as interest. The applicant is transferring its investments in **S** to **V** and the question is regarding the taxability of gains arising on sale of debentures. The foreign investment made is in compliance with the prescribed FDI Regulations. The gains on sale of CCDs have arisen because underlying asset in CCD is equity share and the value of CCD is because of equity share. It is submitted that **V** and **S** are two separate legal entities. **V** is a holding and operating company with various subsidiaries. **S** is a subsidiary of **V** with applicant as second shareholder. The well settled legal principle is that a holding company and a subsidiary are considered as separate and legal entities¹⁰ and the business of the subsidiary is not the business of the holding company. The purchase of CCDs by **V** from the applicant cannot be regarded as redemption of CCDs by **S**. The applicant and **V** are totally unrelated parties. There is no reason for the parties involved, to share a common intention to create a legal facade, as benefit on account of tax avoidance for any of the reason in the hands of one would not result in any corresponding

⁹ 100 ITD 247

¹⁰ 344 ITR 1(SC)

benefit in the hands of other. As V cannot urge that any part of the price paid¹¹ by it to acquire CCD can be regarded as a interest, the Revenue cannot also argue that a part of the consideration received by the applicant must be regarded as interest received by the applicant. The applicant submits that had it been a loan transaction it would not have been possible to make additional equity payment, representation on the board of directors of S and decision making in S as a equity share holder. Without prejudice, the applicant submits that the method of payment would not determine the character of payment but it is the quality of payment¹² that is decisive of its character.

8. The contention of the Revenue is twofold: CCDs are ECBs, a debt carrying a fixed rate of return; the transaction clothed as a purchase of equity and CCDs is sham, designed for avoidance of tax.

The applicant's contention is that the consideration received is for the sale of assets and the amount received over and above the purchase price is not interest income.

9. At the outset, it is stated by the applicant that the CCDs issued by S were not loan or advances following the decision in Sahara India Savings and Investment Corporation mentioned supra, wherein it was held that when an assessee buys Bonds and Debentures of approved nature of non-banking company, they constitute investment and cannot be treated as loans and advances and hence interest on such investment cannot be taxed under the Interest Tax Act, 1974. It is pointed out that the decision is in the context of Interest Tax Act, 1974, where the Debentures of approved nature were not to be treated as loans and advances and hence the reliance placed has no application, other than under the said Act.

¹¹ Vijaya Bank 187 ITR 541

¹²Senairam Doogarmal 42 ITR 392

10. The facts noted by us are as follows. **S** and **V** are two Indian companies. **S** was incorporated on 4.7.2007 and is a subsidiary of **V**, whereby, **V** got 9999 shares and its nominee 1 share. The shares are of the face value of Rs.10/- each. **Z** is a Mauritius based company in which **Z Holding Mauritius**, and **XE LLC Mauritius**, has equal participation. **Z**, **V** and **S** have entered into a Share Holders Agreement (SHA) on 11.8.2007, within 35 days of the formulation of **S**. It is stated in the SHA that on the basis of representation, warranties and indemnities provided by **V** and **S**, **Z** agreed to invest in **S**. The manner of investment is set out under SSA. **Z**, **V** and **S** entered into both the agreements on the same date. **S** and **V** operate from the same address and have common facsimile and email address. The recitals in the Share Holders Agreement provide *interse* relations amongst them. It is stated that the commercial purpose behind the investment in **S** is the transfer of development rights of over x lac sqft. of land owned by **V** to **S**. **V** has independently developed and is developing large projects in its real estate business. It had earlier borrowed funds to own the said development rights. Upon the transfer of the said rights from **V** to **S**, **Z** invested Rs.DDD crore in **S**, for which **S** issued A No. of equity shares of face value of Rs. 10 and B No. zero percent Compulsory Convertible Debentures (CCDs) of Rs.1 each. These Debentures are convertible at Rs.4447 per share at the end of 6 years from the date of first closing i.e. November 6, 2007. A part of the Debentures are also convertible earlier at the option of the Debenture holder at the end of 42 months, 48 months, 54 months and 60 months from the date of first closure. Thus, **V** and **Z** became the shareholders in **S**. Three nominees of **V** and two nominees of **Z** became directors of **S**, with the Chairman of the Board of **S** being one of the three directors nominated by **V**. The Chairman of the Board of **S** was not given right of casting vote.

11. On 8.4.2010, V exercised partly its call option under the call option agreement with Z dated 4.9.2009. Pursuant to the exercise, V purchased A-1 equity shares of Rs.10 and B-1 zero percent CCDs of Re.1 each held in S from Z for a total consideration of Rs. ‘y-1’ crores. The transaction took place in less than 42 months from the first closing date i.e. 6.11.2007. The Balance sheet as at March 31, 2011 reflects the call option having been exercised on 8.4.2010.

After the exercise of the call option, Z was left with A-2 **equity shares** and B-2 **CCDs**. The part of the call option relating to CCDs, have already taken place before 31.3.2011, as is evident from schedule 15(iii) of the schedules forming part of the financial statement for the year ending March 31, 2011. All the debentures totaling to BBB are under the ownership of V, the Holding Company, as on 31.03.2011. Thus, after the sale of all CCDs in FY 2010-11, the applicant is left with A-2 equity shares which are available for sale on or after 1.4.2011. We, therefore, note that in the fact statement, the applicant is seeking a ruling on three transactions, two of which were already undertaken in FY 2010-11. As the application is filed on 16.02.2011, we assume that the proposed transaction has taken place at a time when no return of income for the accounting year ended March 31, 2011 was filed, and, would not be hit by the bar under the first proviso to section 245R(2) of the Income-tax Act, 1961 (Act).

12. Let us examine the law on the issues before us. First, let us see, what is meant by the term ‘Debenture’ and ‘Convertible Debenture’. Debenture is not a term of art and has no precise meaning. In Black’s Law Dictionary, the following meanings are given: (in re AAR No.769 of 2007)

“Debenture”: 1. A debt secured only by the debtor’s earning power, not by a lien on any specific asset. 2. An instrument acknowledging such a debt. 3. A Bond that is

backed only by the general credit and financial reputation of the corporate issuer, not by a lien on corporate assets. - Also termed debenture bond;

“Convertible debenture: a debenture that the holder may change or convert into some other security, such as stock”

In Halsbury’s Laws of England, 4th edition, 7th volume, at paragraph 813, the meaning of “debenture” is given as under:

“No precise definition of the word ‘debenture’ can be found, but various forms of instruments are called debentures. A debenture is a document which either creates or acknowledges a debt. A document may be a debenture although under its terms, the debt is only to be repaid out of a part of the profits.”

In SEBI (Disclosure and Investor Protection) Guidelines, 2000, a ‘debt instrument’ is defined to mean “an instrument which creates or acknowledges indebtedness and includes debenture, stock, bonds and such other securities of a body Corporate, whether constituting a charge on the assets of body Corporate or not.

The Companies Act, 1956 has an inclusive definition of debenture. ‘Debenture’ includes debenture stock, bonds and any other security of a company whether constituting a charge on the assets of the company or not”. The Company Law Committee gave the meaning of ‘debenture’ as a document which either creates or acknowledges a debt¹³.

In the case of *Shree Rajasthan Syntex Ltd vs. CIT*¹⁴, a division bench of the Rajasthan High Court quoted the following observations of Chitty J. in *Edmonds vs. Blaina Furnaces Co.*¹⁵:

¹³vide A Ramaiya’s Guide to the Companies Act (16th Edition, Part-I, page 38).

¹⁴ 269 ITR 461

¹⁵ [1887] 36 Ch. D.215

“The term itself imports a debt – an acknowledgement of a debt – and speaking of the numerous and various forms of instrument which have been called debentures without anyone being able to say the term is incorrectly used, I find that generally, if not always, the instrument imports an obligation or covenant to pay. This obligation or covenant is in most cases at the present day accompanied by some charge or security.”

The High Court then observed that “in the ordinary business sense, a debenture is generally understood to be a document....., acknowledging a debt and securing repayment thereof by mortgage or charge on the Company’s property and providing that until repayment, interest will be paid thereon at a fixed rate usually either half-yearly or on fixed dates”. The High Court further clarified that redemption is a method by which the Company obliterates its obligation to repay its debt to the debenture-holders or debenture stockers or by itself repurchasing the debentures.

In *Laxman Bharmaji vs. Emperor*¹⁶, a division Bench of Bombay High Court pointed out that notwithstanding the fact that the bonds are not styled as debentures, the substance of the instrument has to be looked into. The test of creation or acknowledgment of debt was applied.

In *Narendra Kumar Maheswari vs. UOI*¹⁷, the Supreme Court observed that ‘debenture’ is essentially an acknowledgement of a debt with commitment to repay the principal with interest. The Supreme Court further observed that a compulsorily convertible debenture does not postulate any repayment of the principal. Therefore, “it does not constitute a ‘debenture’ in its classic sense”. The expression ‘repayment of principal’ has been used obviously in the sense of repayment in cash.

¹⁶ AIR 1946, Bombay, 18

¹⁷ AIR, 1989 SC, 2138 AT 2178

In Stroud's Judicial Dictionary of Words & Phrases (5th Edition, Volume 2), while stating that the term 'debenture' has no definite meaning, it refers to the observations of Charles J. in *Brown v. Inland Revenue Commissioners* (64 L.J.M.C. 211), which are quite apposite. The learned Judge said: "*A debenture, though never, I believe, legally defined, is included under one or other of the three descriptions laid down by Bowen L.J., in English & Scottish Trust v. Brunton [1892] 2 Q.B. 700, as: (1) a simple acknowledgement under seal of the debt; (2) an instrument acknowledging the debt and charging the property of the company with repayment; (3) an instrument acknowledging the debt, charging the property of the company with repayment, and further restricting the company from giving any prior charge.*"

After referring to the above definitions it was concluded that there is an "inseverable relation between debenture and debt. An acknowledgement of indebtedness is inherent in it." While answering the question whether by reason of execution of debenture for the moneys advanced, a debt was incurred, it was ruled that:

"Issuance of debentures is a mode of borrowing money. The raising of funds by means of fully convertible debentures is a well known commercial and business practice. Debenture, as already noted, creates or recognizes the existence of a debt which remains to be so till it is repaid or discharged.Does it cease to be a debt merely because the bonds are redeemed not by returning the money but by getting shares of the equivalent value? Does convertibility of debentures affect the characteristic of debt and transform it into something else? We do not think so. If the mode of discharging the debenture debt is by issuing equity shares in lieu of payment in cash, it does not in any way detract from its legal character as debt." The legal

position has been succinctly stated by the Supreme Court in *CWT vs. Spencer & Co*¹⁸. The Supreme Court observed thus:

“In respect of the assets purchased by the assessee from Kellners the assessee had not paid a part of the consideration, i.e. Rs.31,26,000. Prima facie that part of the consideration is a debt due from the assessee to the kellners. The fact that under certain circumstances the assessee, instead of paying back the debt in cash, could discharge the same by transfer of shares, as provided in the resolution quoted above, does not change the character of the liability. The mode of discharging a liability does not change its true character.”

The same view was taken by the Supreme Court in *Eastern Investments Ltd. vs. CIT, West Bengal*¹⁹.(In re AAR No.769 of 2007)

In view of the facts before us, and the law laid down by the Hon’ble Supreme Court, we are of the view that the CCD creates or recognizes the existence of a debt, which remains to be so, till it is repaid or discharged.

13. The next question to be answered is: Whether the sale proceeds realized on the sale of CCDs in terms of the two agreements, SHA and SSA, include a component of income by way of “interest” under the Act or the DTAC?

Section 2 (28A) of the Income tax Act, 1961 defines “interest” as follows:-

“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 utilized;”

Article 11 of the DTAC with Mauritius defines “interest” as follows:-

“(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 or prizes attaching to such securities, bonds, or debentures.....”

¹⁸ 88 ITR 429

¹⁹ 20 ITR 1

Both the definitions are substantially similar. However, Article 11.5 specifically includes any type/form of ‘income from bonds or debentures’ within the ambit of ‘interest’. We note here that the term interest has been defined both in the Act and in the DTAC to mean any type of income that becomes payable on a debenture.

14. Let us examine how the “purchase price” is to be calculated under the agreements and analyze whether the component of ‘interest’ is embedded in the sale proceeds of CCDs.

As per SHA, Z is to pay the first, second, third and fourth subscription amounts of Rs. ‘y-2’ crore, Rs.’y-3’ crore, Rs.’y-4’ crore and Rs.’y-5’ crore respectively, in consideration of which equity shares and CCDs as envisaged in the SSA are to be allotted. Accordingly, Z was allotted A-3, A-4, A-5 and A-6 equity shares and B No. CCDs. Out of these equity shares and CCDs, the applicant made sale of A-1 equity shares and B-1 CCDs for a consideration of Rs.’y-1’ crores on 8.4.2010 to V. The terms of the agreement specifically lay down that only V can purchase the investor’s equity securities. Since V exercised the call option from the second anniversary of the first closing date, the “Purchase Price” was a sum of the following as per para 10.1 (b) of SHA:

- i. The investor investment amount (less any bought back subscription amount)
- ii. Amount equal to the accrued return till the completion date
- iii. Equity payment
- iv. An amount equal to 8% per annum of the investment amount (less any bought back subscription amount) calculated from the 2nd anniversary of the first closing date till the completion date less the V return if any.

It may be stated that the applicant did not initially provide the details under these four items how it arrived at the purchase cost of Rs. ‘y-1’ crores on the sale of shares and CCDs. Be that as

may, we refer to the terms: “*Investor Investment Amount*”, “*Investor Securities*”, “*Accrued return*”, “*Applicable Rate*”, “*Equity Payment*” as defined under SHA and try to understand what these terms mean in the context of “*Purchase Price*”.

“*Investor Investment Amount*” shall mean the aggregate of all the subscription amounts paid by the investor from time to time in relation to the investor securities. “*Investor Securities*” shall mean collectively all the investors equity shares and the investor convertible debentures subscribed to by the investor pursuant to the assessee and shall include any equity share issued to the investor upon conversion of the CCD

It means that for the purpose of calculation of purchase price, the amount of CCDs will be considered, as the investor securities include CCDs.

“*Accrued Return*” shall mean an amount that would provide to the investor a cumulative annual rate of return equal to the applicable rate compounded quarterly on the investment amount.

It means that the amount of rate of return is to be compounded quarterly as per the applicable rate.

“*Applicable Rate*” shall mean:

- (a) 20%, if the call option is exercised or a Buy Back Offer is made on or prior to the expiry of 42 (forty two) months from the First Closing Date;
- (b) 22%, if the call option is exercised or a Buy Back Offer is made on or after the expiry of 42 (forty two) months but prior to the expiry of 48 (forty eight) months from the First Closing Date;

- (c) 24%, if the call option is exercised or a Buy Back Offer is made after the expiry of 48 (forty eight) months from the First Closing Date;
 - (d) 24%, if the put option is exercised by the investor or if a Drag Along Notice is delivered by the investor pursuant to Article 11.2,
- provided that notwithstanding the foregoing, the applicable rate in relation to any portion of the investor investment amount that was contributed by the investor as Investor Shortfall Contribution pursuant to Article 9.4 of the subscription agreement, if any, shall be 30%.

It means that the Applicable Rate is different for different period of investment in the project and is ranging from 20% to 24% or even extends to 30%.

“Equity Payment” shall mean an amount equal to 10% of the project value. The project value “shall mean an amount equal to the entire project (except the excluded building) gross value, as determined by the appraiser, plus any proceeds received (including by way of lease rentals) till the date of exercise notice (other than proceeds relating to the excluded building) less the sum of (a) total cost to built the assets (other than the excluded building; (b) the investor subscription amount; and (c) the amount of accrued return.

It means that the amount equal to gross value of the entire project whether completed or not as determined by the appraiser plus proceeds received including rental / lease value till date of exercise notice but excluding total cost to build assets, investor subscription amount and amount of accrued return. Through this clause an arbitrary figure can be derived in determining the value of gross amount of project value by the appraiser even on the un-executed part of the project.

We notice from the above that the calculation of the purchase price is almost entirely dependent on period of holding the investment. Rates ranging from 20% to 24% or even 30%, is applied and to be compounded quarterly as per the applicable rate. The applicant's own calculations in the computation²⁰ of call option purchase price exercised by V on 8.04.2010 totaling to Rs.'y-1' crores is itself serves as proof. Is it not how 'interest' on an investment is calculated? We are inclined to think so.

We have also noted that the call option is of A-1 equity shares and B-1 CCDs for a total consideration of Rs. 'y-1' crores. As the redemption value of a CCD will remain the same, out of the consideration of Rs.'y-1' crores, the consideration for CCDs is Rs. B-1 and balance Rs. 'y-6' is the value for A-1 equity shares. Thus the purchase price has two components: equity share and CCD. The income derived from sale of equity shares would fall under capital gains and on CCDs as interest, CCD being a debt instrument. In the present case, these CCDs do not carry any interest, but instead, give option for the conversion into share at a different price. While calculating the purchase price, the conversion rates vary depending upon the period of holding these CCDs. This is nothing else but "interest" falling within the meaning of section 2(28A) of the Act as well under Article 11 of the DTAC with Mauritius. The Revenue and the Applicant have also given a computation of the purchase cost of A No. shares (which were received by way of investment) and A-7 shares receivable on conversion of CCDs, by considering the average value of each share at Rs. AV-1 and Rs. AV-2, respectively.

In re AAR 769, the bonds are convertible into equity shares at the end of five years. The interest on bonds at a specified rate is payable by the applicant on half yearly basis irrespective of the fact whether the applicant makes profit or not. While answering a question this Authority ruled

²⁰ Refer applicant's letter dated 13.3.2012

that when the money is advanced and debentures are issued and till they are converted into shares, what is received is interest on the amounts covered by debentures. The interest is paid in respect of a debt. Though an obligation to repay the amount is embedded in the concept of debt, the repayment need not be in the form of cash, it could be in kind. The conversion of debentures into equity shares at the end of the specified period at the conversion price amounts to constructive repayment of debt. So there is no escape from the conclusion that there is a debt and what is paid is as interest towards that debt. The debt is extinguished on making over fully paid equity shares at the agreed price and at the agreed time to the debenture holder. It was held that the ingredients of section 2(28A) are clearly satisfied. This applies on all fours to the applicant before us.

15. Applicant contends that the consideration received is for the sale of assets and the gains arising are exempt from tax under Article 13.4 of the Indo-Mauritius DTAA. We need to apply the “look at” test to ascertain the true legal nature of the transaction. While doing so, we need to look at the substance of the transaction, *inter se* relation amongst the parties to the SHA and SSA, and the transaction as a whole, to appreciate the true nature of the consideration received. This is discussed as under.

16. We must look at the understanding that the parties have amongst them under the two agreements, SHA and SSA. Under the Company Law, the management and control of a company vests with the Board of Directors and not with the shareholders. We notice the following from the recitals in the Share Holding Agreement (SHA):

- i) The DR Agreement, Power of Attorney, Construction Contract, Asset Management Agreement, Agreements relating to Project Land and other documents designated as ‘project documents’ by Z and V form the core of the documents on the basis of which

the **S** is developing the project. It is on the basis of these agreements that the management of **S** would be monitoring the progress of construction activities and would be taking appropriate decisions. That is why all these documents have been included in the definition of “Project Documents”. But Clause 4.9.1 takes away the right to manage the affairs of **S** from the hands of the directors of **S**. In any Board meetings, **V** directors are to refrain from participating in any discussion concerning the exercise of **S**’s rights under any project documents, unless **Z** agrees. The acts of **Z** would be binding on **S**. It is further provided that any decision, consent, approval relating to project documents has to be with the written approval of **Z** or the directors nominated by **Z** (4.9.2). It shows that control and management of **S** is not in its own hands.

- ii) Though **Z** and **V** are shareholders and have their nominees as directors in **S**, it is **Z** and **V** who have decided to have their own independent representatives who would have access to all the facilities, properties, tax returns and records of **S** during normal business hours (6.2).
- iii) The auditors are appointed by the Board of directors of **S** who assume all responsibilities required to be discharged as Auditors, leaving no scope to appoint a parallel qualified accountant by a third party to keep watch on the statutory auditors Ernst& Young and internal auditors. However, **Z** and **V** have the right to appoint a qualified accountant to inspect **S**’s accounting records (6.4). Exercise of such power shows that the affairs of **S** are not managed by its Board of Directors.
- iv) **Z** and **V** are given the right to be consulted by the management of **S** with regard to any material development affecting the business of the projects (6.3). Normally, **S** may be

persuaded in its decision making process but conferring right to be consulted by Z and V amounts to obliterating the authority vested in the Board of Directors of S.

- v) V is required to furnish financial statements, debt servicing status, repayment or payment of interest to its lenders, progress of construction work and such other reports that Z may request from time to time (7.3). When the CCDs are issued by S, it is S who through its Board of Directors should look into these details rather than Z asking about the affairs of V.
- vi) The decision making process by S in respect of a transaction with the related party is required to be with the consent of Z and V (8.1). This shows that the Board of Directors of S are not at the helm of its affairs and not been given free hand to run its business.
- vii) The management of S run by the Board of Directors can release any payment under the construction contract only after such payments are authorised in writing by the Asset Manager i.e. Project, altogether an outsider (9.7).
- viii) In the event that V does not exercise the call option before maturity or does not pay the option price to Z, then V would cause the S to perform certain rights mentioned in 11.1(a).
- ix) Z does not want it to be identified as a promoter of S (9.8).
- x) In para 4 of schedule 15 forming part of the financial statement for the year ended March, 2011, it is stated therein that S has maintained a running account with V. It is V who incurs construction costs, interest costs, and other project related expenses and even collects money from the customers on behalf of S. That is why the auditors in the annexure to the Audit Reports in para ii(a) have stated that no physical verification of

inventories of stores, spare parts, raw materials and finished goods was performed and that the inventory comprises of development rights and project expenses incurred on the real estate projects. **S** in its financial statement is only reflecting the net position of the running account. It is obvious that **V** is in total charge of running the business of **S**.

- xi) Under 11.1 of SHA, in the event that **V** does not exercise the call option on or before the fifth anniversary of the first closing date or does not pay the option price pursuant to the exercise of an option on the completion date in respect of such option, then **V** undertakes to sell all its right title and interest in project land to **S** which would be purchased for a consideration of Re.1. The directors of **V** would also resign from the Board of Directors to make the directors of **Z** a majority in the Board. Thus **V** stands as a guarantor of the investment **Z** has made in **S** and also to own and run the affairs of **S**.

17. What we observe from the above is that **S** and **V**, though independent juridical persons, **S** exercises no powers in managing its own affairs. It is *de facto* under the control and management of its parent company, **V**. It is **V** who is developing and running the real estate business of **S**. It is **V** who is standing as a guarantor of the investment made by **Z**. **V** rather than **S**, acknowledges the CCDs as debts. The relationship between them as a parent and subsidiary is on paper: they are one and the same entity. The Hon'ble Supreme Court in the case of Vodafone International Holdings BV²¹ has held that: "in a proper case of lifting of corporate veil it should be proper to say that the parent company and the subsidiary form one entity". "Thus, even though a subsidiary normally complies with the request of the parent company it is not just a puppet of the parent company. The difference is between having power or having a persuasive position". "The fact that parent company exercises shareholders influence on its subsidiaries cannot obliterate the decision-making power or authority of its (subsidiary's)

²¹ 334 ITR 1 (SC)

directors. They cannot be reduced to puppets. The decisive criteria is whether the parent company's management has such steering interference with the subsidiary's core activities that subsidiary can no longer be regarded to perform those activities on the authority on the executive directors". "It is the task of the court to ascertain the true legal nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach". That being the law, the acknowledgement of debt with commitment to pay is factually upon **V** and the role of **S** is reduced to a puppet of **V**. In the above context, the argument that the sale of CCDs is not to the debtor, but to a third party and what is realized cannot be said to include interest, has no force.

18. Let us refer to the cases, mentioned supra, relied by the learned counsel for the applicant. In the case of M P Financial Corpn., it was held that the gains on the sale of bonds are assessable as Capital Gains and not as business income. In the case of Vijaya Bank Ltd., as the purchase price of securities included interest, it was held that the entire payment was a capital outlay. It was not a case where the securities purchased were at face value and there was a gain on its sale. In the case Ferro Alloy Corpn., it was held that without a debtor-creditor relation, income under "interest" would not arise. In the applicant's case, such a relation did exist. Lastly, in the case of Ashima Syntex, the issue was whether expenditure on issuance of wholly convertible debentures is allowable as revenue expenditure. We find that none of the cases on which the applicant has placed reliance would be of any help in giving a ruling in its favour.

19. In conclusion, Article 11 deals with the treatment of income from debt-claims of every kind, whereas, Article 13 deals with gains from the alienation of any property. Article 11 being a specific provision will be applicable in the present case where **V** has paid a fixed predetermined return to the Applicant. Here we may note that in our opinion, **V** and **S** are one and the same. Hence the amount paid by **V** is clearly towards the debt that was taken by **S** from

the Applicant. Hence the appreciation in the value of CCDs is clearly payment of “interest” and is taxable under the provision of Article 11 of the DTAC.

20. We, accordingly, answer the question that the entire gains arising to the applicant on the sale of equity shares and CCDs are not exempt from capital gain tax in India under DTAC with Mauritius. The gains arising on the sale of CCDs being interest within the meaning of Section 2(28A) of the Act and Article 11 of the DTAC and are taxable as such.

Accordingly, ruling is given and pronounced on 21st day of March, 2012.

Sd/-
(P.K. Balasubramanyan)
Chairman

Sd/-
(V.K.Shridhar)
Member