IN THE INCOME TAX APPELLATE TRIBUNAL
'A' BENCH : BANGALORE

BEFORE SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER
AND
SMT. BEENA PILLAI, JUDICIAL MEMBER

IT(TP)A No. 520/Bang/2022
Assessment Year : 2016-17

M/s. CAE Flight Training (India) Pvt. Ltd., Survey No. 26 & 27, Bandaramanahalli Village, Anneshwara Panchayat, Kasaba Hobli, Devanahalli Taluk, Bengaluru – 562 110. **PAN: AADCC1248A**	**Vs.**	The Deputy Commissioner of Income Tax, Central Circle – 2 (2), Bangalore.
APPELLANT		**RESPONDENT**

Assessee by	:	Shri Ketan Ved, CA
Revenue by	:	Shri Sumer Singh Meena, CIT DR-1

Date of Hearing	:	02-08-2022
Date of Pronouncement	:	02-08-2022

ORDER

PER BEENA PILLAI, JUDICIAL MEMBER

Present appeal is filed by assessee against assessment order dated 12/04/2022 by the Ld.DCIT, Central Circle – 2(2), Bangalore on following grounds of appeal:

> *"Based on the facts and circumstances of the case and in law, M/s. CAE Flight Training (India) Private Limited (hereinafter referred to as the "Appellant") respectfully craves leave to prefer an appeal under section 253 of the Income-tax Act, 1961 ("the Act") against the order passed by The Deputy Commissioner of Income-tax, Central Circle*

2(2), BLR ("Assessing Officer" or "AO") dated 12 April 2022 in pursuance of the Directions issued by the Dispute Resolution Panel ("DRP") - 1, Bengaluru dated 11 March 2022, on the following grounds:

That on the facts and in the circumstances of the case and in law and based on the directions of the DRP:
1. The Ld. AO erred in law and on facts, in assessing the total income at INR 9,50,76,864/- as against returned income of INR Nil.

The Appellant prays that the adjustment be deleted.

Grounds of appeal relating to transfer pricing adjustment of INR 9,50,76,864/-
2. The Ld. AO and Ld. Transfer Pricing Officer ("TPO") erred in law and on facts, in making an upward adjustment of INR 9,50,76,864 to the total income of the Appellant in relation to the international transactions of payment of interest on Compulsory Convertible Debentures ("CCDs") by re-characterizing the CCDs as 'equity' and re-determining the arm's length price ("ALP").
2.1 The Ld. AO and Ld. TPO erred in law and on facts, in disregarding the ALP and rejecting the methodical benchmarking analysis carried out by the Appellant in its Transfer Pricing Study Report using Comparable Uncontrolled Transaction ("CUP") Method undertaken in accordance with Section 92C and Section 92D of the Income-tax Act, 1961 ("the Act") read with Rule 10B, 10C and 10D of the Income-tax Rules, 1962 ("the Rules"), without providing the cogent reason.
2.2 The Ld. AO, Ld. TPO and Ld. DRP erred in la vrant rrZFinot following the Hon'ble ITAT's order in Assessee's own case, for earlier assessment years having similar facts, accepting the CCDs as debt and thereby erred in re-determining the ALP as 'Nil'.
2.3 The Ld. AO and Ld. TPO erred in law and on facts, in not appreciating the fundamental difference between a CCDs and an Equity while re-determining the ALP for payment of interest on CCDs by re-characterizing the CCDs as 'Equity'.
2.4 The Ld. AO and Ld. TPO erred in law and on facts, in not appreciating that CCDs are nothing but debt till the date of conversion and the said view is supported by several judicial precedents.
2.5 The Ld. AO and Ld. TPO erred in law and on facts, in making reference to transfer pricing guidelines of foreign countries i.e., United Kingdom and Australia on thin capitalization, in contravention to confining the assessment

based on the principles provided in the Act and the Rules and completely disregarding observations of Hon'ble ITAT in Assessee's own case for earlier assessment years having similar facts.

2.6 The Ld. AO and Ld. TPO erred in law and on facts, in placing reliance on FEMA/FDI Regulations to recharacterize the CCDs to Equity and thereby failed to appreciate that the treatment of CCDs under FEMA/FDI Regulations cannot determine/change the character of the instrument when it comes to other regulations including the Income-tax Act and completely disregarding observations of Hon'ble ITAT in Assessee's own case for earlier assessment years having similar facts.

2.7 The Ld. AO and Ld. TPO erred in law and on facts, in arbitrarily determining the ALP of payment of interest to AE on CCDs as 'Nil' on ad-hoc basis and thereby not following the provisions relating to determination of ALP as prescribed in the Act and the Rules.

2.8 The Ld. TPO erred in law and on facts, in transgressing his jurisdiction by questioning a genuine transaction and commercial expediency, and there by, concluding that CCDs are controversial instrument used to erode the base and shift profit, as the Ld. TPO is empowered only to determine the ALP as per the provisions under Section 92C of the Act by applying any one of the methods stipulated in sub section (1) of Section 92C of the Act as the most appropriate method.

2.9 The Ld. AO and Ld. TPO erred in law and on facts, in concluding that interest on CCDs is not allowable as deduction u/s 36(1)(iii) of the Act from total income by re-characterizing CCDs as 'Equity'.

2.10 The Ld. AO and Ld. TPO erred in law and on facts, in disregarding the without prejudice contention of the Appellant for bench marking the international transaction of payment of interest on CCDs by applying SBI Prime Lending Rate, on alternative basis and consequently taking a divergent view from the approach followed by the Ld. TPO for AY 2009-10 to AY 2013-14 in benchmarking the aforesaid transaction pursuant to order of the Hon'ble ITAT.

3. Set-off of brought forward business loss and unabsorbed depreciation

3.1 The Ld. AO has not granted credit for brought forward business losses and unabsorbed depreciation for the year under consideration.

4. Levy of consequential interest under section 234B and 234D of the Act

4.1 The Ld. AO erred in levying interest under section 234B and 234D of the Act which is consequential to the grounds of appeal in above paras;

The Appellant submits that each one of our above grounds is without prejudice to the other.

The Appellant craves leave to add, modify, amend, alter or delete, any or all of the above grounds of appeal during the course of hearing and to submit such statements, documents and papers as may be considered necessary either at or before the appeal hearing."

2. Brief facts of the case are as under:

2.1 The only issue raised by assessee is in respect of treating CCDs as equity and holding that no interest is payable on equity capital thereby computing the ALP of interest as Nil.

3. The Ld.AR submitted that identical issue on similar facts have been considered by *Coordinate Bench of this Tribunal* for A.Ys. 2009-10 to 2013-14 in case of *M/s. CAE Flight Training (India) Pvt. Ltd.* in *ITA No. 2006/Bang/2017, IT(TP)A Nos. 63 & 84/Bang/2015, 599, 2060 & 2178/Bang/2016 & C.O.Nos. 83/Bang/2017 & 09/Bang/2018* by order dated *25/07/2019.*

4. The Ld.AR submitted that for the year under consideration, it is the same CCD that is continuing and has not yet been converted into equity shares. He submitted that the DRP has not considered the view adopted by this *Tribunal.*

5. On the contrary, the Ld.DR relied on orders passed by authorities below.

6. We have perused the submissions advanced by both sides in the light of records placed before us.

7. Nothing has been brought on record by revenue factually in order to deviate from the above view.

8. We note that the *Coordinate Bench of this Tribunal* in assessee's own case (supra) has considered the issue by observing as under:

> *"21. Now we first decide the First and most important issue i.e. this that CCDs are Debts or equity and interest on it is allowable or not? On this issue, in the order of CIT (A) para 4 in the first year i.e. A. Y. 2009 - 10 is relevant and therefore, this Para is reproduced for ready reference hereinbelow.*
> *"4. Transfer pricing adjustment of Rs. 7,68,26,983:*
> *4.1 The Transfer Pricing Officer, to whom the case was referred, noticed that the appellant had issued compulsory convertible debentures (CCDs)in December 2008 to its associated Enterprises in Mouritius, Dubai and Hungary at the rate of 15% interest on the funds borrowed'as detailed in the TP order dated 29.1.2013. The total payment of Rs. 7,68,26,983 was treated to be at Arm's length by the appellant in its TP Study by comparing it with 4 uncontrolled comparables (though of multiple years) by CUP method. However, the TPO was of the view that the comparison with non-convertible debentures of years other than the relevant FYs was not valid comparisons and therefore, the ALP determined by the appellant on the interest paid was rejected by the TPO. Also, the TP Officer examined whether the 'interest' paid of Rs. 7,68,26,983 was in the nature of `interest' at all. The Assessing officer concluded that the CCDs were actually equity and not debt since it was compulsorily convertible to equity shares and that the Reserve Bank of India also recognised CCDs as equity instruments. Also, the TPO was of the view that the appellant had junk credit rating, having no operating income or source of cash flow to service the interest payable at 15% and that no third party would make investment in CCDs and that the arrangement amounted to this capitalisation. Holding this, the amount of Rs. 7,68,26,983 was held to be not in the nature of 'interest' and ALP of the transaction by CUP method was held as Nil and adjustment of Rs. 7,68,26,983 was determined u/s 92 CA (3) of Income tax Act, 1961.*
> *As grounds No. 1 and 2 are general in nature these do not require adjudication. The relevant grounds of appeal raised by the appellant are "3. That on the facts and in the circumstances of the case, the Learned AO/Learned TPO erred in making adjustment to the transfer price of the Appellant' international transactions with related parties by INR 7,68,26,983 for interest on debentures and considering the same to be nil.*

4. That the Learned AO/Learned PO erred in rejection of comparability analysis undertaken in the Transfer Pricing documentation by the Appellant in accordance with the provisions of the Act read with the Income tax Rules, 1962 ((the Rules").
5. That the Learned AO/Learned TPO erred in reclassifying the debenture issued by the appellant form CCD to equity. The Learned YPO during the course of the hearing had not contended on the nature f the intercompany funding and had queried only on the rate of interest charged. Accordingly, the Learned TPO failed to provide to the appellant adequate opportunity to argue on the proposed classification of CCD as equity. The Learned TPO went beyond the brief of arbitrating only on the arm's Length pricing related to the rate of interest, and proceeded to question the nature of the inter-company funding.
6. That the Learned AO/Learned TPO proceeded to apply the principle of thin capitalisation, as contained in the Legislation from UK and Australia, in contravention to confining the assessment based on the principles provided in the Indian Transfer pricing regulations (as provided in the Act and the Rules).
7. The Learned TPO as part of the TP order did not refer to nor had any dispute on the rate of interest charged, and thereby making the TP order erroneous.
These are taken up together in determining whether the TP adjustment made by the TPO is correct. The relevant issues raised in the above grounds are as under:
i) Whether TP study has been rightly rejected?
The comparisons made by the appellant with transactions of cases of other years and in respect of non-convertible debentures was not correct. The said comparisons in the TP document was therefore rightly rejected by the Transfer Pricing Officer as detailed in the order dated 29.1.2013.
ii) Whether borrowing is debt or equity; Whether thin capitalisation rules apply?
The Assessing Officer has in effect held that CCDs amount to equity, and that the case is of thin capitalisation as the appellant has shown the funds as debt rather than equity although, the debt equity ratio has not been discussed in the order of the Transfer Pricing Officer.
In the case of Besix Kier Dabhol, SA vs DDIT (I Tax),Circle-3(2), Mumbai, ITAT, Mumbai in their order in ITA No.4249/Mum/07 dated 20.11.2010 have held on similar facts that in absence of specific thin capitalisation rules in India, recharacterisation of debt capital as equity capital and accordingly disregarding the interest payments as tax deductables is not in order. Drawing support from the

above, I hold that the conclusion of the AO that the CCDs is equity and that interest payment is not allowable cannot be upheld.

iii) Whether rate of interest charged is at arm's length? It is on record that the funds which have been raised by the appellant through CCDs and have been utilised for the business of the appellant. The appellant has paid 15% as the rate of interest to its AEs for this purpose. It is been that PLR for A.Y.2008-09 as seen from SBI corporate website varies from 12.25% as on 1.1.2009 to 13.00% as on 10.11.2008. At an average, the same can be taken at 12.6% as against 15% claimed by the appellant. Under such facts, the interest paid of Rs.7,68,26,983/- at @ 15% is certainly not at arm's length and is also evidently in excess of the +/- 5% margin allowable. The AO/TPO is therefore required to rework the ALP taking into account, 12.62% rate of interest as the Arm's Length rate of interest on the borrowing i.e. CCDs and rework the addition made u/s 92CA accordingly. It is held accordingly."

22. As per above para, it is noted that it is noted by CIT (A) that as per the tribunal order of Mumbai Bench rendered in the case of Besix Kier Dabhol, SA vs. DDIT as reported in 131 ITD 299 in which the issue was decided in favour of the assessee on this basis that in the absence of specific Thin capitalization Rules in India, recharacterization of Debt Capital as equity Capital and disregarding of interest is not in order. We reproduce the relevant paras of this tribunal order i.e. para 18 to 30.

"18. That takes us to objection of the Revenue authorities to the effect that the borrowings by the assessee, on which interest has been claimed as deduction, are in fact part of the capital of the assessee which is brought in the garb of borrowings purely on tax considerations. Our attention is pointed out to the fact the ratio of debt to the equity is 248 : 1 which is unusually high by any standard and that such a highly geared company only shows that equity is brought in the garb of debt, and it is contended that since what is termed as borrowing by the company is de facto minimum required capital to carry out the business in India, interest cannot be allowed as a deduction on the same. In other words, Revenue's objection is that the assessee company is so thinly capitalized that its debt capital is required to recharacterized as equity capital for the purpose of examining claim of deduction for interest on such debt capital.

19. Thin capitalization refers to a situation in which capital of a business is made up of greater portion of debt than equity, and its such gearing or leverage ratio i.e. debt equity ratio, is too high. The tax treatment being given to *the equity capital and debt capital being fundamentally different, it is often more advantageous in international context to arrange financing of a company by loan rather than by equity. It does affect the legitimate tax revenues of the source country in which business is carried out because while dividends and interest are generally taxable at the same rate in the hands of the recipient in the source country, e.g. under India Belgium tax treaty WHT rate on interest, other than bank interest, as also dividend is at uniform 15 per cent, interest is tax deductible and that results in lower corporate taxes in respect of PE profits. These tax benefits could be further optimized by hybrid financing instruments such as profit participating loans, convertible loans or where instrument is treated as debt in the source country of the income (i.e. resulting in tax deductible interest) and as equity in the residence country of the lender (i.e. where lender may claim the participation exemption of interest income because of its characterization as distribution of profits). That is how tax considerations at times do result in a company being too thinly capitalized, or, to put it differently, financed by a disproportionate ratio of debts. In order to protect themselves against such erosion in their legitimate tax base, several tax jurisdictions enact rules to counter this vulnerability and these rules are termed as 'thin capitalization rules'.*

20. It is for this background that many jurisdictions take several legislative anti-abuse measures including limiting deduction on interest when the company is considered to be too highly geared under applicable tax regulations. India has woken up now to neutralize this kind of manoeuvring and the Direct Taxes Code Bill, 2010, does seek to provide a legislative framework for remedial measures to counter erosion of tax base by thin capitalization. Under s. 123(1)(f) of the proposed Direct Taxes Code Bill, 2010 (Bill No. 11 of 2010 as introduced in the Parliament on 30th Aug., 2010) as a part of the general anti-avoidance rule, "any arrangement entered into by a person may be declared as an impermissible avoidance arrangement and the consequences, under this Code, of the arrangement may be determined by recharacterising any equity into debt or vice versa". That is the first step taken by the India's tax administration in the direction of having formal thin capitalization rules in India. However, it is not in dispute that as at the material point of time, India did not have any thin capitalization rules, nor does it have any thin capitalization rules even at present.

21. Interestingly, however, thin capitalization rules do exist in Belgium which perhaps explains, for the reasons *we shall now set out, the peculiar capital structure may have been adopted by the assessee. As per the Country Survey Report on Belgium, as published by the International Bureau of Fiscal Documentation, Amsterdam (based on information as on 19th Dec., 1995) Belgium applies two sets of thin capitalization rules. Firstly, a 1:1 debt/equity ratio applies to loans granted by individual directors, shareholders and non-resident corporate directors to their company [art. 198(10) IR/WIB]. Interest relating to debt in excess of this ratio is recharacterized into a non- deductible dividend. Furthermore, the interest rate may not exceed the market rate. Secondly, a 7:1 debt/equity ratio applies to debt if the creditor (resident or non-resident) is exempt or taxed at a reduced rate in respect of the interest paid on the debt. Interest relating to debt in excess of this ratio is considered a non-deductible business expense [art. 198(11) IR/WIB]. In a 2008 IBFD publication "International Tax Planning and Prevention of Abuse" (by Dr Luc De Broe : ISBN 978-90-8722-035-08; @ p. 502), these thin capitalization rules are summed up as follows :*

"Belgium has five domestic law provisions that are relevant for the discussion of thin capitalization, i.e. art. 26 BITC; art. 54 BITC; art. 198, 11° BITC, art. 18, 4° BITC and the Belgian GAAR. Articles 26, 54 and 198 belong to the first group of aforementioned rules. The deduction of interest is denied if the statutory conditions for deductibility are not satisfied. Articles 26 and 54 are not concerned with the question whether the borrower is undercapitalized but only whether the interest charged is at arm's length. Excessive interest (i.e. interest charged above the prevailing market conditions) is not deductible. Article 198, 11° is concerned with undercapitalized companies. Interest is not deductible if the statutory 7 : 1 debt/equity ratio is exceeded. Article 18, 4° BITC belongs to second group of aforementioned rules; it recharacterizes certain interest payments into dividends both for corporate tax purposes of debtor and for withholding tax purposes, while curiously it does not recharacterize debt into equity (neither for corporate tax, nor for capital duty purposes). In certain circumstances, the Belgian GAAR may have the potential to recharacterize purported debt into equity. In that case, it also belongs to the second set of rules."

22. It is thus only under the Belgian tax laws, which inter alia restrict the interest deductions only to the extent of debt capital ratio of 1:7 in sharp contrast to the debt ratio in the present case which is 1:248, that the mode of borrowings, i.e. via GE or via PE, may have some tax *implication even though at somewhat superficial level. That perhaps explains as to why the borrowings are claimed to have been resorted to by the Indian PE and not the Belgian GE directly. If these borrowings were resorted to by the Belgian GE directly, prima facie the thin capitalization rules would have restricted the interest disallowance in excess of borrowings exceeding seven times the equity capital, whereas in the present case borrowings are two hundred forty-eight times the equity capital. As the capital is structured now, and the borrowings having been resorted by the Indian PE directly, it could possibly be said, or at least argued, that there is no debt capital in the assessee company--i.e. the Belgian entity, and this debt capital is confined to borrowings directly by the PE. Be that as it may, it cannot be open to us to apply these thin capitalization rules in the hands of the assessee company while computing its taxable income in India, because so far as taxability in India is concerned, the limitation to be placed on deduction of expenses has to be limitation under the laws of the State in which PE is situated i.e. India. It may be useful to recall that in terms of the provisions of art. 7(3)(b) of Indo-Belgian tax treaty, "In the determination of the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the PE including executive and general administrative expenses so incurred, whether in the State in which the PE is situated or elsewhere, subject to the limitations of the taxation laws of that State". Admittedly, there are no limitations on deduction of interest expenses on borrowings, which can be attributed to thin capitalization rules, in India.*

23. The question then arises whether even in the absence of any specific thin capitalization rules in India, it could be open to the Revenue authorities to recharacterize the debt capital as equity capital and, accordingly, disregard the interest payments as tax deductibles.

24. We find guidance from Hon'ble Supreme Court's judgment in the case of Union of India & Anr. vs. Azadi Bachao Andolan & Anr. (2003) 184 CTR (SC) 450 : (2003) 263 ITR 706 (SC) wherein their Lordships have, inter alia, observed as follows :

"111. In para 3.3.1 after noticing the growing practice amongst certain entities, who are not residents of either of the two Contracting States to try and avail of the beneficial provisions of the DTAAs and indulge in what is popularly known as 'treaty shopping', the report says :

'3.3.1 ..there is a need to incorporate suitable provisions in the chapter on interpretation of DTAAs, to deal with treaty shopping, conduit companies and thin capitalization.

These may be based on UN/OECD Model or other best global practices.'

112. In para 3.3.2 the working group recommended introduction of anti-abuse provisions in the domestic law.

113. Finally, in para 3.3.3 it is stated 'the working group recommends that in future negotiations, provisions relating to anti-abuse/limitation of benefit may be incorporated in the DTAAs also.'

114. We are afraid that the weighty recommendations of the working group on non-resident taxation are again about what the law ought to be, and a pointer to the Parliament and the executive for incorporating suitable limitation provisions in the treaty itself or by domestic legislation. This per se does not render an attempt by resident of a third party to take advantage of the existing provisions of the DTAC illegal.

(Emphasis, by underlining, italicized in print, supplied by us)

25. It is thus clear that merely because a suitable limitation provision in the treaty or the domestic legislation is considered desirable, and attempts are being made to legislate the anti-abuse provisions subsequently, it would not render the effort to take advantage of existing provisions of the treaty illegal. We are thus unable to accept the plea of the Revenue authorities, and we uphold the claim of deduction of interest in respect of capital borrowed from the shareholders or joint venture partners by the assessee.

26. Even otherwise, it is also important to bear in mind the fact that as the law stands now under s. 90 of the Indian IT Act, the provisions of a tax treaty override the provisions of the Indian IT Act--except to the extent the latter are beneficial to the assessee and this treaty override is unqualified, save and except for clarification that charge of tax in respect of a foreign company at a rate higher than the rate at which domestic company is chargeable, shall not be regarded as less favourable charge or levy in respect of such foreign company. Just in case there were any doubts on this fundamental legal position, the CBDT, vide Circular No. 333, dt. 2nd April, 1982 [(1982) 81 CTR (TLT) 18 : (1982) 137 ITR (St) 1], has set the same at rest. This circular deals with the question as to what the AOs will do when they find that the provisions of the DTAA are not in conformity with the provisions of the IT Act, 1961. Then it was laid down by the Board in the said circular as follows :

"The correct legal position is that where a specific provision is made in the DTAA, that provision will prevail over the general provisions contained in the IT Act, 1961. In fact the

DTAAs which have been entered into by the Central Government under s. 90 of the IT Act, 1961, also provide that the laws in force in either country will continue to govern the assessment and taxation of income in the respective country except where provisions to the contrary have been made in the agreement."
27. In the case of UCO Bank vs. CIT (1999) 154 CTR (SC) 88 : (1999) 237 ITR 889 (SC), their Lordships of Hon'ble Supreme Court had an occasion to survey the judicial precedents on the question of binding nature of the CBDT circulars. After elaborately dealing with Hon'ble Supreme Court's judgments in the cases of Navnit Lal C. Jhaveri vs. K.K. Sen, AAC (1965) 56 ITR 198 (SC) and K.P. Varghese vs. ITO & Anr. (1981) 24 CTR (SC) 358 : (1981) 131 ITR 597 (SC), their Lordships concluded that the CBDT circulars inter alia can tone down the rigour of the law and such benevolent circulars are binding on the field authorities. It cannot therefore be open to a Revenue authority to disregard the CBDT circular even if it deviates from the law--as long as it is beneficial to the assessee. Thus, where a DTAA provided for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the IT Act. Where there is no specific provision in the agreement, it is the basic law, i.e., the IT Act, that will govern the taxation of income. When no such limitations on benefits or anti-abuse provisions are set out in the tax treaty, it cannot be open to the Revenue authorities to apply the anti-abuse provisions based on the Judge made law in India--which is essentially to be treated as a part of the IT Act as it is based on the interpretation of provisions under the IT Act and apply the same. As observed by this Tribunal, in the case of Motorola Inc. vs. Dy. CIT (2005) 96 TTJ (Del)(SB) 1 : (2005) 95 ITD 269 (Del)(SB), a tax treaty is an alternative tax regime. It has to be treated as a complete code in itself, in that sense. There are thus no legally sustainable merits in learned Departmental Representative's passionate plea for invoking principles laid down by Hon'ble Supreme Court in McDowell & Co. Ltd. vs. CTO (1985) 47 CTR (SC) 126 : (1985) 154 ITR 148 (SC), which, inter alia, holds that "colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by restoring to dubious methods" and that "it is the obligation of every citizen to pay the taxes honestly without resorting to subterfuge". It is thus not even necessary to examine whether or not the finance structure in question constituted colourable device or sort of subterfuge. As long as finance structure adopted by the

assessee was not specifically prohibited by the applicable tax treaty provisions, and as long as there was no specific anti-abuse provision to deal with the same in the tax treaty itself, the effect of the finance structure could not be ignored.

28. It is interesting to take note of the paradigm shift with regard to the treaty override, as introduced in s. 129(9) of the Direct Taxes Code Bill 2010, which provides that notwithstanding the treaty override provisions in s. 129(8) [which are in pari materia with s. 90(2) of the Indian IT Act, 1961] the provisions of the Direct Taxes Code "relating (a) general anti-avoidance rule under s. 123; (b) levy of branch profit tax under s. 111; or (c) control foreign company rules referred to in the Twentieth Schedule, shall apply to the assessee referred to in sub-s. (8), whether or not such provisions are beneficial to him". The treaty override is thus quite restricted in scope in this new paradigm. Unlike in the proposed code and in sharp contrast to this paradigm, the treaty override in the IT Act, 1961, save and except for the higher tax rate being permitted for the foreign companies, is unqualified. In the scheme of things, as it exists in the Indian IT Act, 1961, the treaty override over domestic law is much wider in scope. We cannot interpret the treaty provisions in such a manner so as to curtail, dilute or otherwise tinker with this comprehensive treaty override over the domestic tax law.

29. It is also important to bear in mind that when there are no thin capitalization rules vis-a-vis domestic thin capitalization situations and in the light of the s. 90(2) as it exists at present any attempts to neutralize thin capitalization vis-a-vis PEs of Belgian enterprise will be clearly contrary to the scheme of non-discrimination envisaged by art. 24(5) which provides that, "enterprises of a Contracting State, the capital of which is wholly or partly-owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other, or more burdensome, than the taxation and connected requirement to which other similar enterprises of that first-mentioned State are or may be subjected in the same circumstances and under the same conditions". In this view of the matter, it cannot be open to the Revenue authorities to put any limitation on deduction of interest, in respect of funds borrowed by the PE, while computing income in accordance with the provisions of art. 7 of Indo-Belgium tax treaty, when no such limitations are placed on the domestic enterprise.

30. For the reasons set out above, we are of the considered view that the assessee is indeed justified in claiming deduction on account of interest paid on borrowings from its shareholders/joint venture companies. The international consensus that the AO has referred to is for the need of thin capitalization rules, but then just because it is desirable to curb thin capitalization, the AO cannot disallow the interest paid on debt capital in the cases of thinly capitalized companies. The AO was clearly ahead of his times in disallowing the expenses based on his notions of thin capitalization rules, when such rules had not even reached the drawing board stage in India. Learned CIT(A) also did not follow the correct legal position by leaning upon restriction placed in Explanation to s. 37 of the Act, which is not applicable in respect of deduction on interest under s. 36(1)(iii) and in leaning upon restriction placed in art. 7(3)(b) on intra-organization notional payment of interest on capital, whereas the interest payment in the present case did not constitute an intra-organization transaction at all. Even if these interest payments were to be treated as intra-organization transactions by treating the same as payments made to the GE, and not to the joint venture partners, these payments cannot be viewed as notional payments because in such a situation the GE will have corresponding liability to pay the same to the joint venture partners. We have also noted that the interest paid by the assessee may have been contrary to the spirit, if not letter of the RBI guidelines, but then this fact, by itself and particularly in view of Explanation to s. 37 being confined to the amounts admissible as deduction under s. 37, does not render the interest paid by the assessee as not deductible, and it is not even necessary to examine the scope of Explanation to s. 37. 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. In view of these discussions, it is clear that the impugned disallowance is indeed contrary to the scheme of the law as it exists; the grievance of the taxpayer deserves to be upheld. We, therefore, direct the AO to delete the impugned disallowance."

23. As per above paras of this tribunal order, it comes out that even if Thin capitalization Principle is on Statute book of the other country, no disallowance can be made in India by applying this Principle. To this extent, we uphold the finding of CIT (A) by respectfully following this tribunal order. But the issue still remains because, the objections of AO/TPO are not merely on the basis of Thin capitalization

Principle. Their basic objection is this that since the interest is paid on CCDs, this is not an interest on debt but on equity and hence, not allowable. On page 11 of his order for A. Y. 2009 - 10, the TPO has reproduced certain comments of RBI in 2007 Policy on convertible debentures in which it is stated that fully and mandatorily convertible debentures into equity within a specified time would be reckoned as equity under FDI policy. In view of this RBI Policy, the TPO concluded that these CCDs are equity and not debt and therefore, interest on it is not allowable u/s 36 (1) (iii). This finding of TPO is not by invoking Thin Capitalisation principle and therefore, it has to be decided independently. We find that the decision of TPO is bases on RBI policy of FDI. We all know that RBI policy of FDI is governed by this that what will be future repayment obligation in convertible foreign currency and since, CCDs does not have any repayment obligation, the same was considered by RBI as equity for FDI policy. Now the question is that such treatment given by RBI for FDI policy can be applied in every aspect of CCDs. Whether the holder of CCDs before ins conversion can have voting rights? Whether dividend can be paid on CCDs before its conversion? In our considered opinion, the reply to these questions is a BIG NO. On the same logic, in our considered opinion, till the date of conversion, for allowability of interest u/s 36 (1) (iii) of Income tax Act also, such CCDs are to be considered as Debt only and interest thereon has to be allowed and it cannot be disallowed by saying that CCDs are equity and not debt. We hold accordingly. This issue is decided.

24. After examining the applicability of the Tribunal order rendered in the case of Besix Kier Dabhol, SA vs. DDIT (supra), we now examine the applicability of the decision of Special Bench of the Tribunal rendered in the case of Ashima Syntex Ltd. Vs. ACIT as reported in 100 ITD 247 (Ahd.) (SB) on which reliance has been placed by ld. DR of revenue in the written submissions filed by him as reproduced above. From the facts noted by the Tribunal in this case, it is seen that in that case the assessee issued convertible debentures for subscription at the rate of Rs. 75 per debenture and these were in two parts; Part-A of Rs. 35 to be compulsorily converted into one equity share of the face value of Rs. 10 each at a premium of Rs. 25 per share on the date of allotment of the debenture and Part-B of Rs. 40 to be compulsorily converted into one equity share of the face value of Rs. 10 each at a premium of Rs. 30 per share on the expiry of 15 months from the date of allotment of the debenture. Part-B debenture was to carry an interest at the rate of Rs. 14 per annum till the date of *conversion payable half yearly on 30th June and 31st December each year and on conversion. The issue in dispute in that case was regarding the allowability of expenses incurred on issue of such debentures and the issue in that case was not of interest on debentures before its conversion as in the present case. This is also an important aspect of the matter of that case that one part of the debenture was to be converted on the date of allotment of debenture itself, second part of the debenture has to be converted only on expiry of 15 months from the date of allotment of debenture and under these facts, it was held by Special Bench of the Tribunal in that case that the expenses incurred on issue of such debentures has to be considered as expenses incurred for issue of shares because it was found that first part of the debentures was to be converted into shares on the date of allotment itself and the second part was to be converted after expiry of 15 months from the date of allotment of debenture and therefore it was held that expenses incurred were actually incurred for issue of shares and not issue of debentures. In the present case, the issue is not regarding expenses incurred on issue of shares. In the present case, the dispute is regarding interest on CCDs for a period before conversion. Hence in our considered opinion, this decision of special bench of the Tribunal is not applicable in the facts of present case because the issue in dispute is different. In that case the issue in dispute is regarding expenditure incurred on issue of convertibles whereas in the present case the issue is regarding allowability of interest expenditure on convertible debentures for the pre-conversion period. Hence we hold that the revenue does not find any support from this decision of Special Bench of the Tribunal in that case.*

25. Apart from relying on this decision of Special Bench of the Tribunal, the ld.DR of revenue in written submissions as reproduced above has mainly reiterated the same arguments which are adopted by the TPO in its order i.e. regarding RBI Master Circular on Foreign Investment in India dated 02.07.2007 and 01.07.2008. We would like to observe that such circular in the context of FDI policy of RBI is in a different context i.e. regarding future re-payment obligations in convertible foreign currency and to have control over such future re-payment obligations, the RBI is exercising strict and control so that such future re-payment obligations does not go beyond a point and since in the case of fully convertible debentures, there is no future re-payment obligation, the same was considered as equity for the purpose of FDI policy. In our considered opinion, any definition of any term is to be considered *keeping in mind the context in which such definition was given. This definition of convertible debentures given by RBI is in the context of FDI policy to exercise control on future re-payment obligations in convertible foreign currency. In our considered opinion, such definition of the term convertible debentures cannot be applied in other context such as 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. If you ask a question as to whether dividend can be paid on such convertible debentures in a period before the date of conversion or whether such holders of convertible debentures can be granted voting rights at par with voting rights of share holders during pre-conversion period, the answer will be a big NO. On the same analogy, in our considered opinion, the answer of this question is also a big NO as to whether interest paid on convertible debentures for pre-conversion period can be said to be interest on equity and interest on debentures allowable u/s. 36(1)(iii) of the IT Act.*

26. Now we have to decide the second issue i.e. ALP of such interest on CCDs.

We find that in the order of TPO and AO for the initial year i.e. A. Y. 2009 - 10, there is no discussion or decision on ALP aspect. Learned CIT (A) in that year has held in a very cryptic manner that 15% interest claimed by the assessee is not at arm's length because as per SBI Corporate Office Website, it is 12.25% on 01.01.2009 and 13.00% as on 10.11.2008. He directed the AO/TPO to rework the ALP at 12.62% which appears to be average of these two lower and upper rates of SBI PLR as noted. In later years, DRP has adopted ALP of interest at LIBOR plus but in those years also, TPO has not decided the ALP aspect. This is also a claim of the assessee that ALP of interest should be decided in A. Y. 2009 - 10 only being the initial year in which CCDs were issued. There is no decision of any of the lower authorities in any year. Considering all these facts, we feel it proper to restore the ALP aspect to AO/TPO in all of these years for a decision as per law after providing adequate opportunity of being heard to the assessee. We do not make any comment on this issue."

9. We note that in the preceding assessment years, the issue has been considered in favour of the assessee by observing that before the date of conversion, the interest paid on convertible

debentures cannot be treated as interest on equity and that such interest paid on the debentures are allowable as expenditure u/s. 36(1)(iii) of the Act.

10. Further the determination of ALP of the transaction has also been remanded by the *Coordinate Bench of this Tribunal* in para 26 reproduced hereinabove.

11. Respectfully following the same, we also direct the Ld.AO/TPO to compute the ALP of the interest for the year under consideration in accordance with the transfer pricing provisions.

Accordingly, Ground nos. 2-2.3 raised by assessee stands allowed for statistical purposes.

12. Nothing has been argued by the Ld.AR in respect of Ground no. 3 and accordingly the same is not adjudicated herewith.

13. **Ground no. 4** is consequential in nature and therefore do not require adjudication.

In the result, the appeal filed by the assessee stands partly allowed.

Order pronounced in the open court on 02nd August, 2022.

Sd/-	Sd/-
(CHANDRA POOJARI)	(BEENA PILLAI)
Accountant Member	Judicial Member

Bangalore,
Dated, the 02nd August, 2022.
/MS /

<u>Copy to:</u>

1. Appellant	4. CIT(A)
2. Respondent	5. DR, ITAT, Bangalore
3. CIT	6. Guard file

By order

Assistant Registrar,
ITAT, Bangalore