Tax Flash News

7 May 2024

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Premium received on redemption of debentures is interest income; not capital gains

Executive summary

The characterisation of the premium received on the redemption of debentures as capital gains or as interest income has been a debatable issue.

The Mumbai bench of the Tribunal in the case of *Khushaal C Thackersey*[1] held that the premium received on the redemption of non-convertible debentures (NCDs) is interest income where the NCDs carried zero per cent interest rate and the redemption premium was fixed to yield a specified percentage of return. Such premium is not in the nature of capital gains.

The Tribunal also held that the redemption of debentures is the repayment of a debt, and it is not an extinguishment of any rights in a capital asset so as to treat it as a transfer of a capital asset.

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[1] *Khushaal C Thackersey* v. *ACIT* (ITA No. 3679/Mum/2015) (Mum) - Source: Taxsutra

Facts of the case

In 2004-05, pursuant to a rehabilitation scheme approved by the BIFR[2] under SICA[3], two companies issued the NCDs to the banks against their outstanding loans. These NCDs were issued at the face value.

The NCDs carried zero per cent interest rate and were redeemable at a premium after five years[4]. The redemption premium was fixed to yield a specified percentage of return.

In 2006, the taxpayer purchased the NCDs from the banks at a price which was higher than the face value.

During the year under consideration (i.e., financial year 2009-10), the NCDs were redeemed at a premium.

The taxpayer treated the difference between the amount received upon redemption and the purchase price as a long-term capital gain (LTCG) and claimed a deduction from the LTCG by investing such gains in the specified assets[5].

The Revenue held that the excess amount received on the redemption of NCDs is not capital gain, but an interest income taxable as 'income from other sources'. Accordingly, the Revenue denied the deduction claimed by the taxpayer.

The taxpayer contended that the debenture is a 'capital asset'. Its redemption resulted in the extinguishment of rights in a capital asset and thus amounted to a transfer[6] of a capital asset. The taxpayer relied on the following to support its claim:

- The Supreme Court's decision in the case of *Anarkali Sarabhai*[7] where the redemption of preference shares was held as a transfer of a capital asset and the decision in the case of *Mrs. Perviz Wang Chuk Basi*[8] where the redemption of the bonds upon maturity was held as a transfer of a capital asset.
- Section 50AA of the Income-tax Act, 1961 (the Act) under which the gains arising on transfer, redemption, or maturity of 'market linked debentures' (MLDs) are deemed as capital gains arising from the transfer of short-term capital assets.

[2] Board for Industrial and Financial Reconstruction

[3] The Sick Industrial Companies (Special Provisions) Act, 1985

[4] The companies were not required to pay interest during the tenure of NCDs, but a premium was payable on the redemption.

[5] Under section 54F (construction of a residential house) and section 54EC (investment in Rural Electrification Corporation (REC) bonds)

[6] The expression 'transfer' in relation to a capital asset includes sale, exchange or relinquishment of asset or extinguishment of rights in a capital asset - section 2(47) of the Act

[7] *Anarkali Sarabhai v. CIT* [1997] 224 ITR 422 (SC)

[8] *Mrs. Perviz Wang Chuk Basi v. JCIT* [2006] 102 ITD 123 (Mum)

- Fourth proviso to section 48 which provides that the benefit of indexation is not available to debenture which suggests that the Act itself recognises ‘debenture’ as a capital asset.

Tribunal’s decision

The Tribunal held that the difference between the amount received by the taxpayer upon redemption of the NCD and the purchase price was interest income taxable as ‘income from other sources’ and not as ‘capital gains’.

In the case of a deep discount bond, the face value of a bond is discounted by applying a particular interest rate, so that the maturity proceeds equal to the face value[9]. In the case of NCDs, they are redeemable at a premium which is determined by applying a particular interest rate. Both the discount and the premium are ‘interest’ only. The companies issuing such types of bonds/debentures claim the discount/premium as interest expenditure which has been allowed as a deduction in a few decisions[10].

Section 50AA applies to MLDs on which the interest rate is not determined at the time of issuing the debenture. The rate of interest on MLDs is dependent on the performance of an underlying market index or instrument. The NCDs are significantly different from MLDs and thus deeming fiction of section 50AA is not applicable to the NCDs.

[9] CBDT Circular no. 2 of 2002 dated 15 February 2002

[10] *ACIT v. Cleta Real Estate (P) Ltd* [2022] 145 taxmann.com 76 (Delhi)

The decision in the case of *Mrs. Perviz Wang Chuk Basi* was related to the capital investment bond issued by the Government of India and not to the debentures issued on a private placement basis and did not apply to the facts of the case.

Shares and debentures stand on different footings as they carry different rights. The decisions relied upon by the taxpayer relating to the share are distinguishable on the facts of the present case.

The face value of shares and of debentures remain static, and the possibility of generating capital gains arises if their market value are different from their face value. The market value of debenture would depend upon the fluctuation in the prevailing general interest rates and capital gain may arise when the debentures are sold in the open market. However, as far as the company issuing the debt instrument is concerned, the market value is irrelevant.

As per Companies Act[11], even though the debenture would fall within the definition of 'securities', it is a debt instrument. The redemption of debentures was the repayment of a debt, and it cannot fall under the category of 'extinguishment' as interpreted by the Courts while dealing with the shares.

The redemption of debenture in the instant case was the realisation of money advanced by a creditor. The question of the generation of capital gains will not arise when the debentures are redeemed by the issuing company.

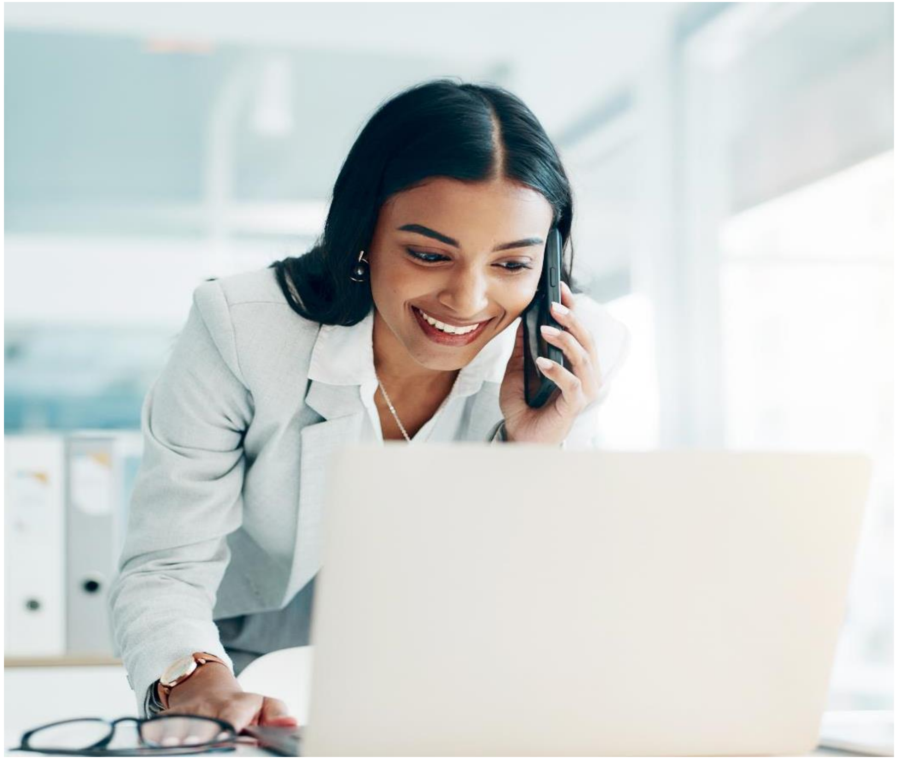
As the premium received by the taxpayer was in the nature of interest income, the taxpayer would not be entitled for any deduction which is available on the capital gains.

[11] Section 2(30) of the Companies Act, 2013

Our comments

The characterisation of the premium received upon the redemption of debenture as an interest income or capital gain is a fact-specific issue and depends upon the terms of the issue of the debenture. For instance, whether the interest payable during the tenure of the debenture represents a reasonable commercial rate of return, whether the redemption premium is paid towards the capital risk.

The instant decision has not dealt with the issue as to whether the interest income was taxable on an annual basis (based on the accrual principal) or whether the entire interest income is taxable at the time of redemption.



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