# TAX FLASH NEWS

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## Debentures issued in lieu of outstanding interest liability amounts to 'actual payment' and is deductible under the Income-tax Act

### Executive summary

Recently, the Supreme Court in the case of M.M. Aqua Technologies[1] (Taxpayer) dealt with the issue of whether deduction can be allowed for payment of outstanding interest by way of issue of debentures to lender financial institutions under the provisions of the Income-tax Act, 1961 (the Act). The Supreme Court observed that the interest was to be considered as 'actually paid' by issue of debentures as it extinguished the liability to pay interest and is allowable as a deduction under the Act.

The Supreme Court held that introduction of Explanation 3C to Section 43B[2] with retrospective effect from 1 April 1989 is not applicable in the present case since Explanation 3C, which was introduced for the 'removal of doubts', only made it clear that interest that remained unpaid and has been converted into a loan or borrowing shall not be deemed to have been actually paid. In the present case, issue of debentures by the taxpayer was, under a rehabilitation plan, to extinguish the liability of interest altogether.

The Explanation was introduced to plug a loophole whereby taxpayers were misusing Section 43B by not actually making the interest payment but converting it into a fresh loan and claiming the deduction. However, in the present case, no misuse of Section 43B was found by the first and the second appellant authorities.

[1] M.M. Aqua Technologies Ltd. v. CIT (Civil Appeal Nos. 4742-4743 of 2021) – Taxsutra.com

[2] A deduction of any sum, being interest payable, shall be allowed if such interest has been actually paid and any interest which has been converted into a loan or borrowing shall not be deemed to have been actually paid

### Facts of the case

The taxpayer had taken loans from various lenders. The original agreements with the financial institutions provided for conversion of 20 per cent of the amount in default into equity capital of the taxpayer at the option of the lenders. The agreements also provided for the repayment of the principal and the interest, in default as per the revised terms and conditions stipulated by the lender at the time of default.

During Assessment Year 1996-97, the taxpayer was not in position to pay the interest and liquidated damages. It approached the lead Financial Institutions which on behalf of all the institutions approved the Rehabilitation Plan. While the lenders did not exercise the option of conversion into equity, they agreed on a 'rehabilitation plan' pursuant to which the taxpayer issued convertible debentures to the lenders in lieu of the outstanding interest and other charges. As a result of these debentures issue, interest of INR 28.4 million was paid to the lenders and the amount was claimed as deduction by the taxpayer in its tax return for that year.

The Assessing Officer (AO) rejected the taxpayer's contention and observed that issuance of debentures does not amount to an 'actual payment' of interest. The issuance of debentures was not as per the original terms and conditions on which the loans were granted and subsequent change in the terms of the agreement would be contrary to Section 43B.

The Commissioner of Income-tax (Appeals) [CIT(A)] held the decision in favour of the taxpayer. Since the lenders had accepted the debentures as effective discharge of interest liability of the taxpayer, it would amount to actual payment of interest under Section 43B.

The Income-tax Appellate Tribunal (the Tribunal) upheld the order of the CIT(A). The Tribunal held that when both the creditor and debtor agree that the conversion of the outstanding interest liability into fully paid debentures would discharge their liability, then to hold that notwithstanding the contract between the two it was open to the income tax authorities to say that the interest liability had not been discharged, would not only be opposed to the contextual perspective of Section 43B but would also do violence to the language used.

When the matter reached before the High Court, Explanation to Section 43B was introduced in the Act with retrospective effect from 1 April 1989. The High Court held that the issue is squarely covered by the Explanation and it negates the taxpayer's contention that interest which has been converted into a term loan is deemed to be 'actually paid'. In light of the insertion of the Explanation, the taxpayer cannot claim deduction under Section 43B.

## Supreme Court's decision

The object of Section 43B, as originally enacted, is to allow certain deductions only on actual payment. This is made clear by the non-obstante clause contained in the beginning of the provision, coupled with the deduction being allowed, irrespective of the years in which the liability to pay such sum was incurred by the taxpayer according to the method of accounting regularly employed by it.

In other words, only 'actual payment', as contrasted with incurring of a liability, can allow for a deduction. Further, Section 43B does not refer to the mode of payment, as is a requirement for claiming deduction of certain other statutory payment to be paid in cash or cheque or draft or any other mode.

The issue is only whether interest can be said to have been actually paid by the mode of issuing debentures. In the present case, as per the rehabilitation plan agreed between the parties, debentures were accepted by the lenders in discharge of or 'in lieu of' the debt on account of outstanding interest. Further it is also clear that there was extinguishment of liability to pay interest, not only from the accounts produced by the taxpayer but also from the accounts of the lenders, which reflect the amount received by way of debentures as its business income. This support that interest liability has been 'actually paid' by means of issuance of debentures in the year under consideration.

Explanation to Section 43B introduced with retrospective effect is not applicable in the present case since Explanation 3C, which was introduced for the 'removal of doubts', only made it clear that interest that remained unpaid and has been converted into a loan or borrowing shall not be deemed to have been actually paid. In the present case, issue of debentures by the taxpayer was, under a rehabilitation plan, to extinguish the liability of interest altogether.

The Explanation was introduced to plug a loophole whereby taxpayers were misusing Section 43B by not actually making the interest payment but converting it into a fresh loan and claiming the deduction. However, in the present case, no misuse of Section 43B was found by the first and second appellant authorities. Thus, the Explanation cannot be brought to the aid of the tax authority in the facts of present case.

The decision relied on by the tax department in the case of CIT v. Gujarat Cypromet Ltd.[3] is distinguishable on facts of the present case.

The Supreme Court observed that even if there is ambiguity in the interpretation of the Explanation, the following interpretations support the taxpayer:

- Since the Explanation was introduced with the object of plugging a loophole i.e., misuse of Section 43B, bona fide transactions of actual payment are not meant to be affected by it. Reliance was placed on the decision of K.P Varghese[4].
- A retrospective provision which is for the removal of doubts cannot be presumed to be retrospective if it alters or changes the law as it earlier stood. Reliance was placed on the Supreme Court's own ruling in the case of Sedco Forex International Drill. Inc[5]. To this extent, the Explanation should be considered as only explaining the purport of Section 43B and not adding any new condition to it.
- Any ambiguity in the language of the Explanation shall be resolved in favor of the Taxpayer. Reliance was placed on the ruling of Cape Brandy Syndicate v. Inland Revenue Commissioner[6], as followed in Vodafone International Holdings BV[7].

Accordingly, the Supreme Court set aside the High Court's order and allowed the deduction in favour of the taxpayer.

## Our comments

This is a welcome decision by the Supreme Court. The Supreme Court has held in favour of the taxpayer by allowing a deduction on payment of outstanding interest by way of issue of debentures in terms of the rehabilitation plan.

The Supreme Court observed that the introduction of retrospective Explanation under Section 43B relating to conversion of outstanding interest into a loan was not applicable to the taxpayer as the issue of debenture in lieu of interest payment was accepted by both parties as a discharge of interest liability.

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[3] CIT v. Gujarat Cypromet Ltd. [2019] 412 ITR 397 (SC)
[4] K.P. Varghese v. ITO [1981] 131 ITR 597 (SC)
[5] Sedco Forex International Drill v. CIT [2005] 279 ITR 310 (SC)
[6] Cape Brandy Syndicate v. Inland Revenue Commissioner [1921 (1) KB 64]
[7] Vodafone International Holdings BV v. UOI [2012] 341 ITR 1 (SC)

The ruling upholds the doctrine of ‘substance over form’. It also seems to suggest that the tax officer cannot rewrite the transaction entered into by the two parties. The ruling makes it clear that Explanation 3C to Section 43B should not impact genuine transactions of acceptance of a debenture in lieu of interest due in case of defaults. The Supreme Court also reaffirms an important principle that a retrospective provision under the Act which is ‘for the removal of doubts’ cannot be presumed to be retrospective, even where such language is used, if it alters or changes the law as it earlier stood.

Explanation to Section 43B provides a restriction on deduction where interest liability is converted into ‘loans’ or ‘borrowing’. It is important to note that the terms ‘loans’ or ‘borrowing’ can have various meanings and there are several Court decisions on the application of this Explanation to the conversion of interest liability into fresh loans, debentures, shares, etc.

This decision can be helpful to corporates in such similar cases provided the lender recognises such interest payment in its books and pays tax on it. The principles laid down by the Supreme Court will help the taxpayers while substantiating their arguments under Section 43B. However, it will depend upon the facts and circumstances of each case.

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