

The income tax dilemma for banks, NBFCs

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It has been seen, of late, that the Income Tax Department is re-characterising various hybrid instruments issued by banks and NBFCs—like perpetual debentures, perpetual bonds, etc—as ‘equity’ since there is no obligation on the issuer to repay the principal amount. This has resulted into dis-allowance of interest paid on such instruments while computing taxable income of banks and NBFCs.

The world of financial instruments is more complex today than ever. One can no longer say that all financial instruments can either be termed as pure ‘equity’ or ‘debt’. Hybrid instruments like perpetual debentures or perpetual bonds exhibit both debt-like and equity-like features. These perpetual debt instruments (PDIs) have become more popular with banks and NBFCs since last few years after [RBI](#) permitted such instruments to qualify as tier-1 capital base under the capital adequacy norms. Thus, various banks and NBFCs have issued PDIs for meeting these requirements and strengthening their balance sheets.

These PDIs offer a fixed rate of interest in the form of periodic coupon payments to subscribers/lenders. Though lenders may not have the right to enforce repayment of the principal, the issuer (bank/NBFC) has the call option, i.e. right to redeem PDIs from lenders after the expiry of a predefined time period (say, 10 years). Nevertheless, listing of these instruments on stock exchanges provides subscribers with an exit opportunity. In spite of the same, the Income Tax Department has started contending that since PDIs do not provide the subscriber with any means to enforce repayment of the principal amount, it is akin to ‘equity’ and not ‘borrowings’ or ‘debt’.

The department claims that what is allowable as an expenditure under Section 36(1)(iii) of the Income-tax Act, 1961 (I-T Act) is the “amount of interest in respect of capital borrowed”. A legal weapon in the department’s armoury to allege such re-characterisation is a judgement of the Punjab & Haryana High Court in the case of Pepsu Road Transport Corporation (1981), wherein it is observed that an element of refund or repayment is a must in the concept of borrowing, and when there is no obligation on the issuer to refund the capital provided, interest on such capital is not deductible under the I-T Act.

Hybrid instruments	Debt-like features	Equity-like features
Nature of interest acquired in issuer entity	No right to participate in profits of the issuer	Voting rights and ownership interest in the issuer
Pay-out of returns on the instrument	Obligation to pay fixed, periodic and non-discretionary coupons	Discretionary distribution of surplus, contingent on the profits of the issuer
Repayment of principal	Issuer has a call option to redeem the instrument and a 'step-up in interest rate' feature after expiry of a pre-defined time period (say, 10 yrs)	No fixed maturity date of the instrument and repayment can be enforced only on liquidation

While this judgment was rendered in the context of statutory capital contribution required by the central and state governments to a state-owned corporation and the payment of interest on such capital contribution, the facts of this case are clearly distinguishable and therefore render the judgment inapplicable in relation to issue of PDIs by banks and NBFCs.

It is frightening to ponder whether after considering PDIs as equity and disallowing interest expense, the department would treat these periodic coupon payments made to lenders as dividend and subject them to the dividend distribution tax?

The view contended by the department seems to be too far-fetched. There is an obligation on the issuer to make a periodic coupon payment to lenders irrespective of profits or losses incurred by the issuer in the relevant year, thereby supporting debt characterisation of PDIs. Subscribers to PDIs do not acquire a proportion of ownership interest in the company or have voting rights, unlike equity shareholders. They are also not required to be entered into the register of shareholders maintained under the Companies Act. PDIs generate a fixed return for subscribers in the nature of interest and therefore the payment ought to be tax deductible for the issuer. The 'step-up in interest rate' feature applicable after the expiry of a predetermined tenure also supports the debt-like character of these instruments as it results in higher cost, enticing the issuer to exercise its call option to redeem the instrument. PDIs are listed and tradeable on the 'debt market segment' on stock exchanges. Credit rating agencies

rate PDIs on the same rating scale as conventional 'long-term debt instruments'. Even the Indian Accounting Standards require that PDIs be generally classified under the head 'long-term borrowings' and not under the head 'share capital' in financial statements.

In the case of compulsorily convertible debentures (CCDs)—which get converted to equity ultimately, courts have held that interest on such instruments is allowable as a deduction until CCDs are actually converted into equity. Considering this, PDIs are on an even better footing as they will never get converted into equity and will remain in the nature of 'borrowings'.

Additionally, it can be pointed out to the Income Tax Department that interest paid to subscribers of PDIs is subject to tax in the hands of subscribers as interest income, and disallowing the corresponding expense in the hands of the issuer would lead to double taxation.

PDIs are thus recognised as debt under various regulatory laws as discussed above. In the absence of any specific provisions under the I-T Act for re-characterising a genuine issue of PDI as equity and not allowing the deduction of interest expenditure actually incurred will cause severe hardships to issuers.

Jurisdictions like Singapore and the UK have published detailed guidelines in relation to tax treatment of hybrid instruments and have treated them as 'debt' or 'equity' on the basis of the features discussed above. It's time India follows suit and brings in more clarity and certainty in the tax law to spare the overburdened courts from another controversy and relieve taxpayers from the pain of protracted litigation.

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(Views are personal)