CORPORATE FINANCING – DEBT V. EQUITY, INTEREST

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ADVANCED DIPLOMA IN CORPORATE TAXATION

NALSAR UNIVERSITY OF LAW

AGENDA FOR THE SESSION

1. Introduction to Corporate Finance
2. Major financial and tax considerations
3. Debt v. Equity
4. Various Issues in Debt
5. Various issues in Equity
6. Conversion of debt into equity
7. Interest and deductibility
8. Interest under ITA v. DTAA
9. Various issues around Interest

CORPORATE FINANCING

CORPORATE FINANCING

- Usually a huge commercial decision
- To be evaluated from a CFO's lens
- Commercial and tax viewpoints
- Internal accruals are not adequate
- Corporate financing in two broad forms – Debt and Equity
- Ratios !
- Combination?

CORPORATE FINANCING - DEBT

- Borrowing + Interest
- No stake involved
- No control involved (Some restrictions though)
- Less complication
- Cash flow necessary!
- Debt Equity Ratio
- Debt Service Coverage Ratio
- Interest paid is “Tax deductible”

CORPORATE FINANCING - EQUITY

- Sale of shares in exchange for capital
- Returns – generated in capital value appreciation and/ or dividends
- No headache of interest payments
- Dilution of stake ☹
- Complicated
- Call/ Put options in Equity – whether it is purely equity?

CORPORATE FINANCING – DEBT V. EQUITY

- Short answer - Depends on the intention of the Company
- Debt availability
- Cash flow statement, Projected financials
- Tax considerations

TAXATION OF DEBT V. EQUITY

- "Interest is tax deductible"
- "Debt is tax efficient"
- Debt involves payment of interest – for which tax deduction is usually available
- Equity involves payment of dividend – for which tax deduction is not available
- Interest paid irrespective of profits, dividend paid only from profits
- Dividend is not tax efficient as there is dual taxation

TAXATION OF EQUITY

- Moneys received as capital contribution – Equity – Capital Receipt
- General rule of capital receipts
- Whether issue of shares gives rise to an "Income" in an "International Transaction" and to be reported as such in Form 3CEB?
- Vodafone India Services Pvt. Ltd. V. UOI (WPNo.871 of 2014, Bombay HC)
- Accepted by the Government of India (Press Release)
- Dividend taxation

ISSUES IN EQUITY TAXATION

- Section 56 of the Income-tax Act, 1961 provides that if the income is not chargeable under any head as specified in section 14 then it will be chargeable under the head ‘Income from other sources’.
- Clause (viib) of sub-section (2) of section 56 of the Income-tax Act, 1961 deals with issue of shares by a company at a premium in which public is not substantially interested.
- Section 56(2)(viib) is also known as Angel Tax.
- This clause does not apply where the consideration for shares is received by a Venture Capital Undertaking (VCU) from a Venture Capital Company (VCC) or Venture Capital Fund (VCF) or specified fund or from a class/classes of person notified by the government.

ISSUES IN EQUITY TAXATION

- This clause will not be applicable when any consideration is received by any company from entity notified by the Central Government in this behalf.
- “Venture capital company”, “Venture capital fund” as defined u/s 10(23FB) and “Specified fund” means the amount received from category I & II registered Alternate Investment Fund (AIF).
- The Finance Act 2023, brought in an amendment to bring the consideration received from non-resident (NR) for issue of unlisted shares under the ambit of section 56(2)(viib)

ISSUES IN DEBT TAXATION – WHAT IS INTEREST

- Section 2(28A) defines Interest -
- *“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 utilised*

- Inserted vide Finance Act 1976
- Any payment with nexus to interest included – to be paid to borrower
- However, middleman/ facilitation fee is excluded (Ceat Ltd Del HC decision)

ISSUES IN DEBT TAXATION – INTEREST IN DTAA

- Interest as per Article 11(3) of India-Singapore DTAA –
- *3. 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 and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.*

- Definition under DTAA is narrow
- Benefit of DTAA not to be taken only basis rate of tax but can also be taken basis scope

ISSUES IN DEBT TAXATION – SECTION 36(1)(III)

- Section 36(1)(iii) provides specific deduction for interest paid -
- *(iii) the amount of the interest paid in respect of capital borrowed* ***for the purposes of the business or profession*** *:*
- *Provided that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.*
- *Explanation.–Recurring subscriptions paid periodically by share-holders, or subscribers in Mutual Benefit Societies which fulfil such conditions as may be prescribed, shall be deemed to 3be capital borrowed within the meaning of this clause;*

ISSUES IN DEBT TAXATION – 36(1)(III)

- Three conditions in this clause-
- *There should be a borrowing*
- *For the purpose of business or profession*
- *Interest should be paid or payable*

- Very fact specific exercise to determine whether borrowing for the purpose of business or not
- Loan for expansion of current facilities covered as well
- Pre-commencement interest not covered. Can be capitalized as per Challapalli Sugars Ltd v. CIT (SC) 1975

CAN CLAIM DEDUCTION UNDER SECTION 37?

(1) Any expenditure (not being expenditure of the nature described in sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended ***wholly and exclusively for the purposes of the business or profession*** *shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession".*

CONDITIONS FOR DEDUCTION UNDER SECTION 37

- 1. Not governed by section 30 to 36
- 2. Wholly and exclusively for the purpose of business or profession
- 3. Expenses should not be personal
- 4. Expenses should not be capital
- 5. Expenditure not for a purpose which is an offence or prohibited by law (Explanations 1 and 3)

EVOLUTION OF SECTION 37

- Exists since inception of the law
- Similar to section 10(2)(xv) of the Income-tax Act, 1922
- Earlier, the only tests were “wholly and exclusively” and “for the purpose of business”
- Evolved to restrict scope and certain types of expenses
- Example – Representation charges before the Assessing Officer (CA/ Lawyers fees)
- Initially, generally allowed under section 37(1)
- 1976 - - introduction of section 80VV – capped at Rs 5,000 -- withdrawn
- 1992 - - introduction of section 40A(12) – cap increased to Rs 10,000 – withdrawn
- Back to initial status – now generally allowed!

COMMERCIAL EXPEDIENCY

- Commercial → for business
- Expediency → Convenient rather than morally right or proper
- Commercial Expediency ?
- “wide import and includes expenditure which a prudent businessman incurs for the purpose of business”

  Patna High Court – in the case of Ram Bahadur Thakur, 1975
- Whether a bribe is commercial expediency?

COMMERCIAL EXPEDIENCY FOR SECTION 36(1)(III)

- As per Sec 36(1)(iii), Deduction shall be allowed for "The amount of interest paid in respect of capital borrowed **for the purposes of business or profession**"
- Commercial expediency test to be fulfilled
- **Landmark** case laws –
- S.A. Builders Ltd. Vs. Commissioner of Income Tax (Appeals) (2007) (SC)
- Held that interest deduction can be claimed even when the monies borrowed has been given to its sister concern as an interest -free loan if it was commercially expedient to do so.
- Also laid down the concept of proportionate commercial expediency - in the case of CIT v. H.R. Sugar Factory (P) Ltd., the asseessee company borrows funds @ 20 % and lends it to director @ 8%. As per the concept of proportionate commercial expediency 12% interest is to be disallowed.

COMMERCIAL EXPEDIENCY FOR SECTION 36(1)(III)

- **Landmark** case laws –
- A.C.I.T v. Tulip star Hotels Ltd. (2012)(SC)
- Similar facts as S.A. Builders except loan was used to subscribe to shares of subsidiary company
- The Apex Court has realised that the principle laid down in S. A. Builders Ltd vs. CIT is too wide and sets the boundaries too loose to have a effective interpretation and implementation of the principle of commercial expediency.

ISSUES IN DEBT TAXATION – SECTION 57

- If deduction is disallowed under section 36/ 37, can deduction be claimed under IFOS?
- Does section 57 permit?
- Confusion in language on allowability of interest
- Grey area

ISSUES IN DEBT TAXATION – THIN CAPITALISATION

- Section 94B
- Debt issued by non-resident Associated Enterprise or debt guaranteed by NR AE
- Interest exceeding 30% of EBITDA is disallowed
- Sub-issue - Accounting EBITDA or Tax EBITDA?

CONVERSION OF DEBT INTO EQUITY

- One method of refinancing
- Whether Section 56(2)(viib) will apply?
- Contrasting judicial decisions
- Milk Mantra Dairy (P.) Ltd. (Kolkata Tribunal) 2022 - in favour of Revenue - Consideration has wider import than money
- Rankin Infrastructure Pvt. Ltd. (Mum Tribunal) 2022 – in favour of assessee – as there is no receipt of monetary consideration
- I.A. Hydro Energy Pvt. Ltd (Chandigarh Tribunal) 2022 – in favour of assessee – legislative intent of section 56(2)(viib)
- Legal position not settled

THANK YOU

PLEASE FEEL FREE TO ASK QUESTIONS

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