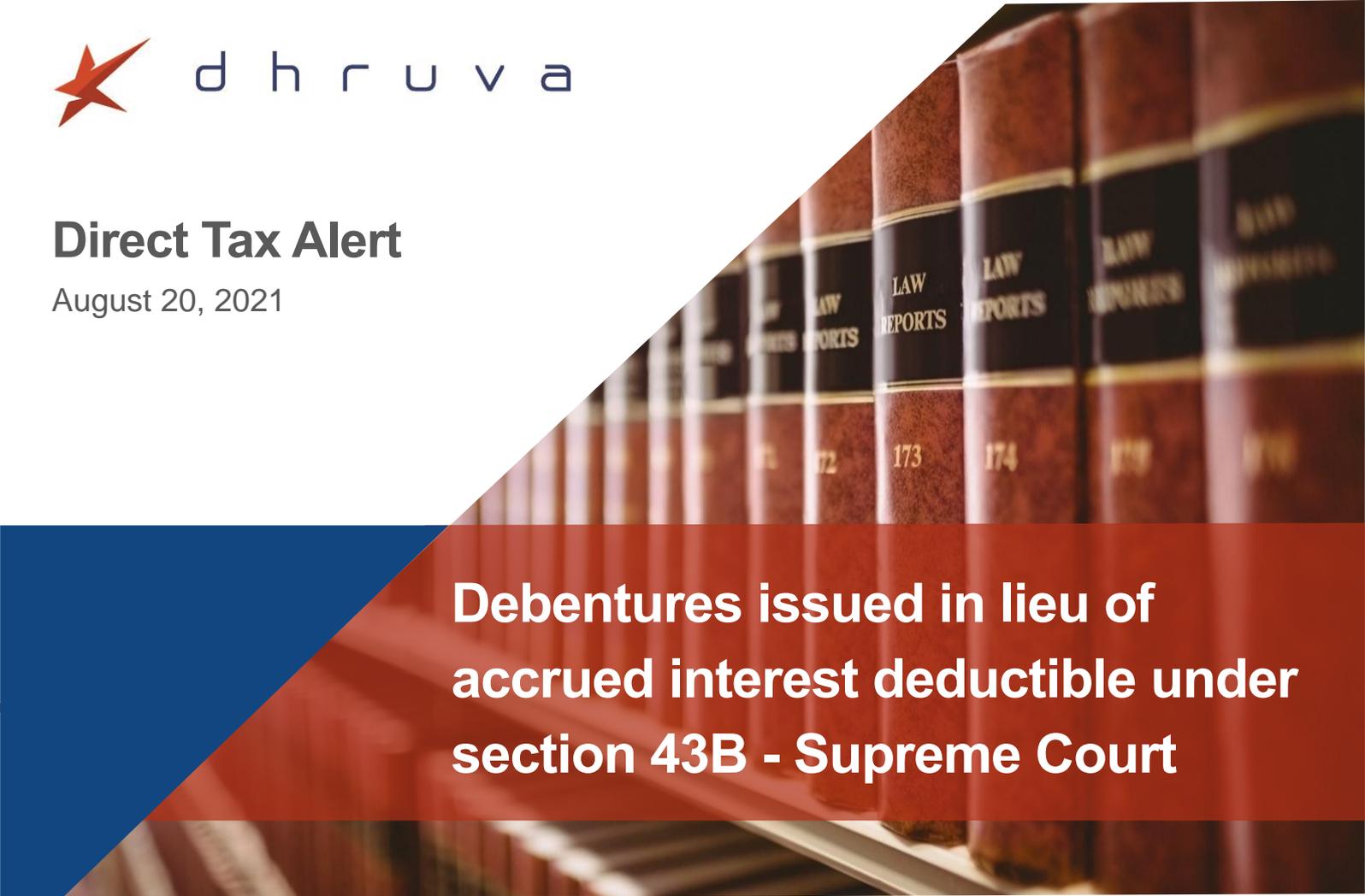


Direct Tax Alert

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Debentures issued in lieu of accrued interest deductible under section 43B - Supreme Court

The Supreme Court in a recent ruling in the case of **M.M. Aqua Technologies Ltd¹** (“the Taxpayer”) has ruled that issuing of debentures in lieu of liability for accrued interest amounts to “actual payment” for the purposes of section 43B of the Income-tax Act, 1961 (“the Act”), which allows a deduction for certain specified expenses only on actual payment.

Background and facts of the case

- Section 43B of the Act provides that the deduction for certain specified expenses shall be allowable only on “actual payment”. One of the expenses to which this provision applies is any interest payable on any loan or borrowing from any public financial institution. Therefore, a deduction for such interest is allowed only when the interest is actually paid.
- An explanation was inserted in section 43B by the Finance Act, 2006 with retrospective effect from April 1, 1989, to provide that deduction for interest payable to any public financial institution shall be allowed only if such interest has been actually paid and that conversion of such interest into a loan or borrowing shall not be deemed to be “actual payment”.
- In the present case, the Taxpayer had availed loans from multiple financial institutions. In the tax year 1995-96, the Taxpayer was not in a position to pay the accrued interest and other charges on account of financial stress. They approached the lead Financial Institution, which on behalf of all the institutions approved a rehabilitation plan. According to the agreed

¹ [2021] 129 taxmann.com 145 (SC)



rehabilitation plan, the Taxpayer had issued convertible debentures in lieu of outstanding interest payable by it.

- The Taxpayer claimed a deduction in respect of their interest liability discharged by the issue of convertible debenture in their tax return for the tax year 1995-96 under section 43B of the Act.
- The Tax Officer rejected the claim of the Taxpayer on the basis that the issue of debentures in lieu of the accrued interest did not amount to “actual payment”. Furthermore, it was contended by the Tax Officer that the issue of debentures was not as per the original terms, and that any subsequent change in terms would be contrary to section 43B of the Act and would render the amount ineligible for deduction under section 43B of the Act.
- The Taxpayer preferred an appeal to the Commissioner (Appeals), who allowed the claim of the Taxpayer for deduction of accrued interest under section 43B of the Act based on the following:
 - The issue of convertible debentures was in lieu of outstanding interest and other charges.
 - On the issue of debentures, outstanding interest was effectively paid and had been acknowledged by the financial institutions.
 - It would be incorrect to say that debenture is a piece of paper and issue of debenture in lieu of interest is merely a postponement of the payment of the liability.
- On Revenue’s appeal to the Income-tax Appellate Tribunal (“ITAT”), ITAT upheld the order of the Commissioner (Appeals) based on the following:
 - It would not be open for tax authorities to argue that the interest liability has not

been discharged, especially where parties have agreed otherwise.

- Conversion of outstanding interest liability into debentures was accepted by the parties as the method of discharge of the liability. This agreement and arrangement cannot be rewritten by the tax authorities.
 - The payment of interest by conversion into debentures is a real substantial and effective payment i.e. the requirement of the word “actual” is met and the payment cannot be said to be fictional or illusory. This is further supported by the fact that the Taxpayer did not claim any deduction in the year of redemption of such debentures.
 - ITAT held that in the present case, provisions of section 43B of the Act cannot be invoked.
- Against the aforesaid Judgement of ITAT, Revenue filed an appeal before the High Court. The High Court held that Explanation 3C to Section 43B of the Act having retrospective effect covers the case of the Taxpayer, and given the explanation, the Taxpayer cannot claim the deduction for interest liability discharged by the issue of debentures under section 43B of the Act.
 - Aggrieved by the above decision, the Taxpayer preferred an appeal to the Supreme Court.

The issue considered by the Supreme Court

- Whether the issue of debenture in lieu of accrued interest outstanding is tantamount to “actual payment”, as per the provisions of section 43B of the Act.

Arguments of the Taxpayer

- The conclusion reached by the High Court was based on an incorrect question of law recorded by it wherein it was stated that the



interest amount was funded by way of a term loan, whereas the facts of the case involve an issue of debentures.

- Based on findings of the facts by the Commissioner (Appeals) and ITAT debentures that were issued were not towards any future payment of liability, but actual payments to financial institutions.
- Explanation 3C to section 43B of the Act which was introduced with the retrospective effect have no application in the facts of the present case as the interest was not converted into any loan or borrowing. The judgement of the High Court is erroneous on this account since it has ignored vital facts found by lower authorities.
- The Taxpayer relied on the ruling of *Cape Brandy Syndicate v. Inland Revenue Commissioner*² to argue that fiscal and tax statutes have to be strictly construed and that since the word “debenture” is not specified in Explanation 3C, it cannot be read into it.

Arguments of the Revenue

- The Revenue argued that the interest deduction ought not to be allowed since section 43B of the Act, which starts with a non-obstante clause, does not permit deduction based on the mercantile system of accounting but on an actual payment being made.
- Relying on the decision of the Supreme Court in the case of *National Rayon Corpn. Ltd. v. CIT*³ the Revenue argued that a loan would also include a debenture and therefore in the facts of the present case Explanation 3C to Section 43B of the Act is squarely applicable. The Revenue also relied on another decision of the Supreme Court in *CIT v. Gujarat Cypromet Ltd*⁴ in support of the argument that

Explanation 3C to Section 43B of the Act is applicable.

The ruling of the Supreme Court:

- The Supreme Court noted that the object of section 43B of the Act is to allow certain deductions only on actual payment. Therefore, merely incurring a liability deduction cannot be allowed. The Supreme Court also noted that the mode of payment for the purpose of clause (d) of section 43B of the Act was not specified.
- Certain important findings of the facts by both the Commissioner (Appeals) and the ITAT to the effect that as per the rehabilitation plan agreed to between the lender and the borrower, debentures were accepted by the financial institution in the discharge of the debt on account of outstanding interest, were noted. It was also noted that this fact was very clear from the accounts produced by the Taxpayer as well as the assessment of the financial Institution which reflected the amount received by way of debentures as its business income. Based on these findings of the facts it was stated that the interest was “actually paid” by means of issuance of debentures.
- On the aspect of applicability of Explanation 3C to Section 43B of the Act, the Supreme Court concluded that the said explanation cannot be brought to the aid of the revenue. This was based on three well-established canons of interpretation as under:
 - **First Principle** - Explanation 3C was added in 2006 with the object of plugging a loophole – i.e. misusing Section 43B by not actually paying interest but converting interest into a fresh loan; essentially, *bona fide* transactions of actual payments are not meant to be affected by

² [1921 (1) KB 64]

³ [1997] 7 SCC 56

⁴ (2020) 15 SCC 460



Explanation 3C. In this regard, the Supreme Court relied on its earlier decision in the case of *K.P. Varghese v. ITO*⁵ wherein in the context of section 52(2) of the Act it was held that the said section will not have any application in case of an honest and *bona fide* transaction.

- **Second principle** - a retrospective provision in a tax 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. Reliance was placed on the Supreme Court’s earlier decision in the case of *Sedco Forex International Drill. Inc. v.CIT*⁶. The Supreme Court held that Explanation 3C is clarificatory, it only explains Section 43B(d) as it originally stood and does not purport to add a new condition retrospectively.
- **Third principle** - any ambiguity in the language of Explanation 3C shall be resolved in favour of the Taxpayer as held in *Cape Brandy Syndicate v. Inland Revenue Commissioner*⁷ and followed by the Supreme Court in the case of *Vodafone International Holdings BV v. Union of India*⁸.
- The decision of *National Rayon Corpn. Ltd.* which was relied on by the Revenue was found to be of no relevance to the issue involved in the present case. Revenue’s reliance on another Supreme

Court decision in the case of *Gujarat Cypromet Ltd* was also found to be distinguishable on facts by the Supreme Court.

- Consequently, the Supreme Court set aside the judgement of the High Court and restored the earlier order of the ITAT, thereby allowing the deduction for interest under section 43B of the Act to the Taxpayer.

Dhruva Comments

The decision of the Supreme Court makes it clear that a *bona fide* transaction involving the discharge of interest liability by the issue of debentures is not covered by Explanation 3C and therefore a deduction in respect of such interest should be available under the provisions of section 43B of the Act.

This ruling of the Supreme Court is very welcome and may come to the aid of Taxpayers who are in financial distress and undergoing debt restructuring including restructuring under the provisions of the Insolvency and Bankruptcy Code, 2016 depending on the specific facts and circumstances of such Taxpayers.

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For any queries in relation to this regulatory alert, please feel free to reach out.

⁵ (1981) 4 SCC 173
⁶ (2005) 12 SCC 717

⁷ [1921 (1) KB 64]
⁸ (2012) 6 SCC 613



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