

Transfer Pricing e-Alert

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Transfer Pricing And Characterisation Of Debentures

The Indian Income Tax Appellate Tribunal (**the Tribunal**), in a joint appeal involving CAE Flight Training (India) Pvt Ltd, has recently decided that a debenture may only be characterised as equity if it meets all the essential characteristics. Further, the Tribunal has held that the policy of a national bank may not be relied on for the purpose of taxation.

Background Facts

CAE Flight Training (India) Pvt Ltd (**the Appellant**) issued Compulsorily Convertible Debentures (**CCD**), a legally accepted and duly approved instrument by the Reserve Bank of India (**RBI**),¹ to its associated international enterprises. Under the issuance of the CCD, the Appellant would make interest payments at the rate of 15% to those enterprises. Such interest payments would amount to cross-border transactions.

Hence, when an assessment proceeding² was conducted on the Appellant in relation to its cross-border transactions, the matter was referred to a transfer pricing officer to determine the arm's length price. The transfer pricing officer had to consider if the CCD, from which the interest payments arose from, were a debt or equity. This is because if the CCD were not a debt, then the payments would then not be of interest in nature.

Based on the basic principles associated with the issuance of the CCD, the Appellant argued that the CCD is debt. Regardless, in considering the issue, the transfer pricing officer took into account, among other things, the following:

- The thin capitalisation principles under the transfer pricing guidelines in the United Kingdom (**UK**) and Australia as opposed to the principles provided in the Indian transfer pricing regulations.

¹ India's central bank.

² An assessment proceeding is equivalent to an audit conducted by the Inland Revenue Board of Malaysia.

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- The view that no third party would have provided credit to the Appellant as a borrower as the Appellant is highly geared.
- The RBI's policy issued in 2007 which stated that fully and mandatorily convertible instruments are considered to be foreign direct investment and hence, equity.
- The decision of the Tribunal in *Ashima Syntex Ltd v Assistant Commissioner of Income Tax (Ashima Syntex)*, which held that convertible debenture is merely an instrument to raise capital by way of equity shares.

Accordingly, the transfer pricing officer characterised the CCD as equity and disallowed the interest payments. Aggrieved by this ruling, the Appellant appealed to the Commissioner of Income Tax (Appeals) and the Dispute Resolution Panel. Nevertheless, both forums ruled against the Appellant, resulting in an appeal to the Tribunal.

Decision

The Tribunal, ruling in favour of the Appellant that the CCD is debt, decided, among other things, the following:

- The thin capitalisation principles adopted by the transfer pricing officer based on the transfer pricing guidelines of the UK and Australia were not applicable as such principles are not based on the relevant legislation of India.
- *Ashima Syntex* can be distinguished from this appeal. In that case, the debentures were converted on the date of allotment and the issue relates to the allowance of expenses incurred on the issuance of the debentures. In the current appeal, however, the debentures would only be converted on the expiry of 15 months from the date of allotment and the issue relates to the allowance of interest expenses on the debenture prior to conversion.

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- The policy of the RBI must be considered in the context in which it was issued. The policy was issued to govern the exercise of control on future repayment obligations in convertible foreign currency. Under the RBI's policy, where there is no repayment obligation, the debenture would be considered as equity. However, the relevant context in this case concerns the tax treatment in relation to the allowance of interest on such debentures during the pre-conversion period, and not the exercising of control on future repayment obligations. As such, the definitions in the policy could not be applied in this appeal.
- Interest can be allowed as a deductible expense until the date of conversion as:
 - (i) No dividend can be paid on the CCD before conversion; and
 - (ii) No voting rights at par with the voting rights of shareholders were conferred upon the holders of the CCD during the pre-conversion period.

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Conclusion

CAE Flight Training (India) Pvt Ltd has shed light on several issues, such as the methods to be employed for determining the arm length's price must be within the confines of local taxation statutes. Also, debentures may only be characterised as equity if these meet the criteria, i.e. a dividend is paid prior to the conversion and voting rights at par with the voting rights of shareholders are conferred upon the holders of the debenture. Lastly, it provides that the policy of a national bank may only be relied on for taxation purposes if it is issued specifically to address the issue of tax treatments.

If you have any queries pertaining to transfer pricing disputes, please contact our tax partners, **Datuk D P Naban** or **S Saravana Kumar**, at tax@lh-ag.com

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