

Private Credit: Interest on NCDs recharacterized as dividends

Key Takeaways

- Tax authorities recharacterized interest income on NCDs as dividends
- Interest recharacterization has not taken place under GAAR
- Investors can prevent such mischaracterization by demonstrating the nature of the underlying instrument, periodicity of payments, maturity date, management rights, etc.

Introduction

The income tax department (***Revenue***) has held that interest income derived from non-convertible debentures (***NCDs***) was 'fictious' in nature and had not been appropriately offered to tax. In its reassessment order dated 29th March 2022, the Revenue claimed that the interest income was, in fact, a dividend.

Recharacterization of interest into dividends by tax authorities poses significant concerns for offshore debt investors as well as investee companies. If recharacterized, the investee company loses the tax deductions on interest expense and may also be liable to pay dividend distribution tax (***DDT***). The investor on the other hand may also be liable to pay taxes if the Indian investee company has not paid DDT.

Background

Genpact Luxembourg (***GL***), an offshore entity based in Luxembourg, subscribed to NCDs floated by its India-based group entity, Genpact India Private Limited (***GIPL***). On 11th March 2022, the Revenue issued a reassessment notice to GL alleging that the interest income derived from NCDs during the assessment year 2018-19 was 'fictious' in nature and had not been appropriately offered to tax due to 'mischaracterization of income'. In its reassessment order dated 29th March 2022, the Revenue claimed that the interest income received by GIPL was, in fact, in the nature of a *dividend*.

Notably, the Revenue did not clarify why the interest income was 'fictitious' in nature or the basis for the recharacterization, and GL has filed a Writ Petition in the Delhi High Court challenging the decision on grounds that the un-reasoned order violates principles of natural justice. In any event, GL argued that the recharacterization order should have been raised against GIPL (in India) since the liability to pay the additional tax on dividends distributed, i.e., dividend distribution tax, was on the entity distributing the dividend and not the recipient (GL). The High Court is yet to decide the case on merits and has stayed the reassessment order in an interim ruling.

The (super)power to recharacterize

Prior to GAAR coming into force in 2017-18, scope for intervention in transactions was limited to colourable or sham transactions. Post 31 March 2017, however, tax authorities gained broad powers to challenge the nature of instruments and question an arrangement if they deemed it to be an 'impermissible avoidance arrangement', i.e., an arrangement, "*the main purpose of which is to obtain a tax benefit*",[1] and which fulfils one of four other requirements: (a) creation of rights/obligations which are not at arm's length; (b) resultant

[1] Please see Part A of the Annexure for the definition of 'tax benefit' per the ITA.

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misuse or abuse of the Income-tax Act, 1961 (***ITA***) provisions; (c) lack of commercial substance;[2] or (d) the transaction has been entered into by means which are not ordinarily employed for bona fide purposes.[3]

Would the introduction of GAAR with effect from 2017-18 mean that investments made prior to 2017-18 are protected from GAAR provisions? Only partially – per the Income Tax Rules,[4] "*income accruing or arising to or deemed to accrue or arise to, or received or deemed to be received by, any person from transfers of investments made before the 1st day of April 2017*" have been grandfathered i.e., GAAR provisions would not apply to capital gains-benefits arising from arrangements/transactions set up prior to 1st April, 2017. However, GAAR would still apply to tax benefits obtained after 1st April 2017, arising from any arrangement/transaction, irrespective of when the arrangement was entered into.[5] As a result, interest and dividend pay-outs after 1st April 2017, for any transaction or arrangement may still be re-examined and recharacterized.

It's unclear whether the NCDs in Genpact were issued prior to 1st April 2017, but insofar as the interest payments and deduction therefrom were paid in financial year 2017-2018 (and can be viewed as obtaining a "tax benefit"), the GAAR rules would be applicable to it. GAAR provisions provide for a specific procedure prior to their application i.e., reference by assessing officer to the tax commissioner, followed by comments from the commissioner and a review by an approving panel. The Revenue's order in Genpact was made pursuant to the general power of reassessment under Section 148 of the ITA, purportedly based on principles of anti-avoidance evolved by Indian courts.

The broader implication however is concerning insofar as a recharacterization purely on facts indicates that tax authorities are keen to recharacterize transactions even outside of GAAR's ambit. If upheld by the court, it furthers the unravelling of precedents set in *Vodafone* and *Azado Bachao Andolan*, in favour of the approach highlighted in cases such as *AB Mauritius*[6] and *Aditya Birla Nuvo*[7]. In both cases, capital gains exemptions were denied to Mauritian instrument-holders on account of the fact that they were interposed merely to gain a tax benefit, and the ultimate beneficiaries were the parent entities based in foreign jurisdictions. These cases were decided purely on facts, and in spite of the fact that the test of 'beneficial ownership' (discussed below) does not apply to capital gains

[2] Please see Part B of the Annexure, for the meaning of 'lack of commercial substance' per the ITA. Notably, this provision is only a deeming fiction, and 'lack of commercial substance' may still be deduced from other facts, as discussed below.
[3] Section 96(1), ITA.
[4] Rule 10U(1)(d), Income Tax Rules.
[5] Per Rule 10U(2), Income Tax Rules, "Without prejudice to the provisions of clause (d) of sub-rule (1), the provisions of Chapter X-A shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017".
[6] AB Mauritius, In re, 2017 SCC OnLine AAR-IT 6.
[7] Aditya Birla Nuvo v. DDIT 2011 SCC OnLine Bom 899.

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that the test of 'beneficial ownership' (discussed below) does not apply to capital gains per the respective double taxation avoidance agreement (***DTAA***).

What's at risk?

Foreign investors prefer to invest through debt instruments on account of their tax optimal benefits. Relevant factors in choosing between the investment forms include:

a. Interest deductions. Borrowers can claim interest deductions on capital borrowed for the "purposes of business".[8] This benefit is not available when a company is paying dividends to its investors. While financial investors/investees may prefer debt instruments for a variety of commercial reasons (lower risk, stable returns etc.), such investors may consider debt instruments to be tax optimal in the case of intra-group investments in light of the interest-deductions that their Indian subsidiaries can claim.

b. Pre-2020 challenges surrounding DDT. The significant net DDT hit on returns, coupled with the lack of deductions, made equity instruments an especially unfavourable preference for investments pre-2020. Companies which declared, distributed or paid dividends prior to 31st March 2020 were required to pay an additional tax of 15% on the gross dividends distributed. Since the liability to pay the DDT fell on the distributing company, non-resident shareholders earning the dividends were unable to claim foreign tax credit for the DDT paid by the Indian company in the absence of enabling language in the relevant DTAA.[9]

c. Participation exemption regimes. Several countries, primarily in Europe, offer their residents 'participation exemptions' i.e., exemptions from taxation on certain sources of income (usually dividends and capital gains) if such income has already been taxed in the source state. If the payment is treated as dividend in the source state but as interest in the resident state, it is unclear if the recipient would be able to avail a participation exemption in the residence state as treaties generally do not provide for any secondary adjustment provisions except in case of transfer pricing (i.e., provisions that take into account recharacterizations in the source state and make corresponding adjustments in the resident state).

   Where such secondary adjustment provisions do not exist, and a residence state does

[8] Section 36(ii), ITA.

[9] It is also not clear whether companies paying DDT could benefit from the concessional tax rates available under tax treaties. While the income tax appellate tribunal has in several decisions (e.g., Van Oord India Pvt. Ltd., vs. DCIT in IT(TP)A No.720/Mum/2015 dated 11/11/2019; and ITD Cementation India Ltd, TS-338-ITAT-2021(Mum) clarified that the DTAA rate should apply, these decisions have been appealed, and there remains ground for dividend recipients to be denied the benefit of the DTAAs.

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not recognize the source state's recharacterization of a debt instrument into an equity instrument, instrument holders may also face challenges in satisfying the conditions for claiming the participation exemption in the residence state (e.g., the requirement to hold at least 5% of the payor's share capital).

d. Accounting treatment. Investors may find greater accounting flexibility when recording interest income. Typically, accounting principles e.g., GAAP provide that once dividends are earned, they are required to be directly shown on the profit and loss statement of the earning company. In the case of interest income however, interest earnings may be amortized i.e., even when interest payments accrue to the investor, they may not be immediately recorded on the accounts of the company, but over a period of time, allowing for flexibility in revenue recognition, and in turn, flexibility in determining when the taxes become payable.

   There is also an added challenge with respect to how, or whether, a recharacterization is required to be recorded in the recipient's books / accounts. Where alignment is not required or not undertaken, the resultant mismatch between accounting and tax records may attract liabilities under securities and corporate law.

Other key considerations include jurisdictional analysis, beneficial ownership and transfer pricing, which we have explored in detail elsewhere.

How can investors mitigate against reassessment risk?

The Revenue's order follows the trend of tax and regulatory authorities blurring the lines between debt and equity in their assessments. Given the uncertainty created by GAAR's broad reach, how should investors structure their instruments?

Primarily, investors must keep in mind the distinctions between debt and equity – while Indian jurisprudence has been limited in this regard, US jurisprudence provides some guidance through the 'Mixon Factors'.[10] Some of these key factors have been summarized below:

a. Date of maturity. The existence of a fixed date for repayment indicates a debt instrument. It is well-known that a maturity date is at the core of any debt-oriented arrangement. On the other hand, the lack of a fixed date for repayment, points towards the possibility of the instrument being equity oriented.

b. Source of repayment. If repayment is sourced through sale of assets, cash flow or re-financing, the instrument will usually be characterised as debt. Typically, payments made through business profits (say, in the form of dividend) characterise equity. For

[10] Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972).

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example – if a company makes a loss during a certain period of time, it would ideally not be required to pay its shareholders any dividends for that period, due to the lack of profits. However, if the same company also had an outstanding loan, as per the loan agreement it can be mandated to pay the requisite amounts towards interest repayment for that period of time.

c. Rights of enforcement. The existence of a right to enforce the payment of interest and/or capital is a significant factor. The presence of a definite obligation to repay that can be enforced by law is generally indicative of a debt instrument. Under equity, a right of enforcement is generally not available in case dividends are not paid i.e., the law does not backstop assured returns on equity.

d. Management participation. Typically, in debt investments, the investors do not get rights to participate in the management. That being said, minor/insignificant participation in management should not be characterized as equity. As a general observation, most equity instruments involve the investor gaining management participation power (in terms of voting rights, board seats etc.) in proportion to their shareholding in the company. The absence of the same points towards a debt investment.

e. Intent of parties. The intention of the parties before and at the time of the transaction is a key factor in determining the debt versus equity question, especially where other factors are ambiguous. Courts may inter alia look at the books/records of the company and language used in statutory and stock exchange filings, apart from the underlying agreement in order to infer the intent of parties.

f. Debt-to-equity ratios. If the company is thinly capitalised, the investment is more likely to be categorised as equity rather than debt, as the investor is likely to be exposed to the risks of an equity investor in such entities. Courts may view a debt advance as equity in cases of a skewed debt-to-equity ratio in a thinly capitalised company.

   Note: Thin capitalisation rules are especially relevant for investors deciding on the most optimal form of intra-group financing. Thin capitalisation rules limit interest expense deductions on borrowings from 'associated enterprises'[11] in other jurisdictions (to 30% of the borrower's EBIDTA in the previous year, or the interest paid by the borrower to associated enterprises in the previous year, whichever is lessor), with the aim of preventing transfers of debt to related entities in order to maximize interest deductions

[11] 'Associated enterprises' exist where one enterprise is directly or indirectly involved in the management or control of the other enterprise, or if there is common management or control between the two enterprises. Enterprises which are deemed to be 'associated enterprises' include (amongst others), (a) shareholders with more than 26% voting power, (b) enterprises who have advanced loans having a value greater than 50% of the other recipient's assets, or (c) enterprises having the power to nominate majority of the board on other enterprises, etc. (Section 92A, ITA).

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and erode the borrower's Indian tax base.[12]

g. Interest-earning relationship. If interest payments are expected regardless of future earnings, the investment is more likely to be characterised as debt. Where interest payments are conditional on earnings and future profits, the investment is more likely to be characterised as equity. Further, the amount involved in periodic interest payments is generally fixed, whereas the dividend paid to any shareholder is usually dependent on their shareholding and the amount of profit earned during the period of time.

h. Credit risk. Whether a company would be able to borrow from other institutions at the time of entering the transaction indicates creditworthiness. In case the investment termed as a loan is speculative in nature, it is likely to be categorised as equity rather than debt. Though not fully determinative, courts may look at whether a reasonable creditor would encourage advancement of a loan to the company based on the credit risk involved.

i. Payment history. The history of payments made to the debtor is another factor which courts may use to analyse whether the parties intended the investment to be debt or equity. If the books of accounts of the company show periodical payment of a fixed interest amount as envisaged in the loan agreement, it would likely be classified as debt.

These factors are likely to guide tax authorities and courts in determining whether an advance from an investor is to be construed as debt or equity. Keeping the above in mind would be greatly beneficial to avoid unnecessary scrutiny from the tax and regulatory authorities.

Conclusion

While we are yet to see clear a rationale underlying the Revenue's decision in the case of Genpact, there are a variety of measures that investors can take to protect against exercises of GAAR and any other recharacterizations. Investors would do well to adopt these measures, especially until significant jurisprudence surrounding the exercise of such powers develops.

For any queries, please write to taxteam@resolutpartners.com.

[12] Disallowed interest expenses can however be 'carried forward' i.e., the excess interest expenses may still be deductible in the 8 assessment years following the year in which the interest expenditure was first computed.

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Annexure – Relevant Definitions

A. Meaning of 'Tax Benefit' under the ITA

Per s.102(10) of ITA:

"tax benefit" includes,—

a. a reduction or avoidance or deferral of tax or other amount payable under this Act; or

b. an increase in a refund of tax or other amount under this Act; or

c. a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or

d. an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or

e. a reduction in total income; or

f. an increase in loss,

in the relevant previous year or any other previous year;"

B. Meaning of 'commercial substance' under the ITA

Per s. 97 of the ITA:

"(1) An arrangement shall be deemed to lack commercial substance, if—

a. the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

b. it involves or includes—

i. round trip financing;

ii. an accommodating party;

iii. elements that have effect of offsetting or cancelling each other; or

iv. a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

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c. it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party; or

d. it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained (but for the provisions of this Chapter).

2. For the purposes of sub-section (1), round trip financing includes any arrangement in which, through a series of transactions—

a. funds are transferred among the parties to the arrangement; and

b. such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter),

without having any regard to—

A. whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

B. the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

C. the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

3. For the purposes of this Chapter, a party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

4. For the removal of doubts, it is hereby clarified that the following may be relevant but shall not be sufficient for determining whether an arrangement lacks commercial substance or not, namely:—

i. the period or time for which the arrangement (including operations therein) exists;

ii. the fact of payment of taxes, directly or indirectly, under the arrangement;

iii. the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.”

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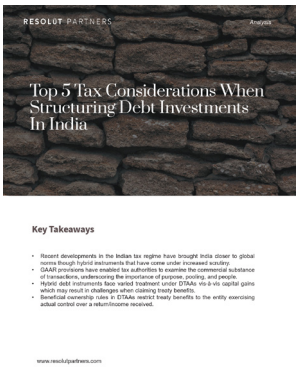

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