IN THE INCOME TAX APPELLATE TRIBUNAL
"B" BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENT
AND MS. PADMAVATHY S, ACCOUNTANT MEMBER

Appeal Nos. and Assessment Year	*Appellant*	*Respondent*
ITA No.2332/Bang/2019 2016-17	M/s. Enzen Global Solutions Pvt. Ltd., No.90, Hosur Road, Madiwala, Bengaluru – 560 068. **PAN: AABCE 5868 J**	ITO, Ward – 2(1)(4), Bengaluru.
ITA No.2550/Bang/2019 2016-17	DCIT, Circle – 2(1)(2), Bengaluru.	M/s. Enzen Global Solutions Pvt. Ltd., Bengaluru – 560 068. **PAN: AABCE 5868 J**

Assessee by	:	Shri V. Chandrashekar, Advocate
Respondent by	:	Shri Manjunath Karkihalli, CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	15.09.2022
Date of Pronouncement	:	19.09.2022

O R D E R

Per N. V. Vasudevan, Vice President:

ITA No.2332/Bang/2019 is an appeal by the assessee while **ITA No.2550/Bang/2019** is an appeal by the Revenue. Both these appeals are directed against the Order dated 17.09.2019 of CIT(A) - 2, Bengaluru, to Assessment Year 2016-17.

2. First, we shall take up for consideration ITA No.2332/Bang/2019, being appeal by the assessee. The only issue that arises for consideration in this appeal by the assessee is as to whether the Revenue authorities were justified in adding a sum of Rs.17,09,02,887/- being notional premium receivable on preference shares

as income of the assessee. The grievance of the assessee in this regard is projected in ground Nos.3 to 5 raised by the assessee before the Tribunal, which reads as follows:

> 3. *The learned Commissioner of Income Tax (Appeals), has erred in confirming the addition of Rs.17,09,02,887/- made by the learned assessing officer on the facts and circumstances of the case.*
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> 4. *The Assessee denies itself to be liable for the addition of Rs.17,09,02,887/- being notional premium receivable at the time of redemption of Preference Shares, held by the Assessee on the facts and circumstances of the case, in as much any appreciation received in the investment is taxable only at the time of redemption and not at any time before as also is subject to tax u/s 45 of the Act, subject to provisions thereof a is not a revenue receipt, chargeable to tax under the head 'Income From Other Sources' on the facts and circumstances of the case.*
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> 5. *Without prejudice, the learned Commissioner of Income Tax (Appeals), failed to appreciate that the Interest Income from Other Sources on the ground that dividend/interest accrued on account of investment is taxable only at the time of redemption by treating the same as Capital Gains on the facts and circumstances of the case.*

3. The facts with regard to the aforesaid grounds of appeal are that during the year the assessee invested an amount of Rs.130,00,00,000 in 13,00,00,000 preference shares of M/S. Ensource Consulting Private Limited with a face value of Rs.1000/- per share. In terms of the allotment, the Preference shares are to be redeemed at the end of 20 years, from the date of allotment, at a premium equivalent to 16.5% p.a on of the face value of the shares. The entire amount, i.e., Principal and Premium, shall be paid at the time of redemption. In the original return of income, the assessee declared an amount of Rs.17,09,02,857/- as "Premium accrued on Redeemable Preference shares" under the head "Income from

Other Sources". But subsequently the assessee filed a revised return of income on 14/03/2018 reducing this amount of Rs.17,09,02,857/- from the net profit. The assessee claimed in the revised return of income that the Premium, which is to be received only on redemption is liable to be offered for tax at the time of redemption of shares under the Capital Gains, only to the extent actually received. Thus, the said sum ofRs.17,09,02,857/- the same which was originally offered as income for the year, stood withdrawn.

4. The Assessing Officer (AO) did not accept the contention of the assessee for the reason that Preference shares subscribed to by the assessee contains features of equity and debt as the dividend payments to preference shareholder (assessee) is fixed from the beginning. Like a bond or debenture, the receipt of financial benefit/interest/premium is assured from the beginning. The assessee maintains books of accounts on mercantile basis. Therefore, the taxability of the same does not depend upon receipt of the premium or otherwise. What is important here is that the rate of dividend or rate of interest is 8% on cumulative basis or 14% interest on IRR basis, which is fixed in the offer document subscribed to the assessee. Cumulative Preference shares ensures that missed out dividend payments are carried forward. The fixed rate ensures the dividend due to the investor during the year. Its' payment may be uncertain, but its accrual is certain in case of a cumulative preference shares. Therefore, income need to be taxed on due basis. For the above reasons, the AO treated the cumulative preference shares as akin to debt instrument on which the assessee is entitled to a fixed rate of premium/ dividend The AO therefore, treated the dividend on Preference share as equal to interest.

5. The AO also made an alternative case by observing that if the cumulative preference share is considered as an equity instrument, the dividend will accrue to

the investor irrespective of the fact that the company has declared dividend or not. This income has to be paid in future out of the accumulated profits. Presuming that at the time the dividend distribution, dividend distribution tax is duly deducted by M/S. Ensource Consulting Private Limited, dividend may be claimed as exempt by the investor (i.e., the assessee). According to the AO, loan was taken by the assessee from M/ S KKR Capital for the purpose of subscribing to preference shares. So, if dividend is considered as having accrued to the assessee on accrual basis, then following matching principle, interest expenses incurred for that specific investment can also not be allowed because the interest expense would be expenditure incurred to earn exempt income. Therefore, expenses claimed towards subscribing preference shares, is not allowable as well u/s 14A.

6. Therefore, according to the AO, the sum of Rs. 17,09,02,857/- has to be either taxed as interest income accrued to the assessee or it has to be regarded as expenditure incurred in earning exempt income and therefore should be disallowed u/ s. 14A r.w.r.8D. In either case i.e., taking preference share as debt instrument or equity instrument, the accrued premium needs to be taxed and the interest incurred for the purpose of earning the dividend need to be disallowed.

7. In this regard, the AO also made reference to Circular No.2/ 2002 issued by the Central Board of Direct Taxes (CBDT), in which it has been laid down that "Every person holding a Deep Discounting Bond will make a market valuation of the bond as on the 31^{St} March of each Financial Year (hereafter referred to as the valuation date) and mark such bond to such market value in accordance with the guidelines issued by the Reserve Bank of India for valuation of investments. For this purpose, market values of different instruments declared by the Reserve Bank

of India or by the Primary Dealers Association of India jointly with the Fixed Income Money Market and Derivatives Association of India may be referred to. The difference between the market valuations as on two successive valuation dates will represent the accretion to the value of the bond during the relevant financial year and will be taxable as interest income (where the bonds are held as investments) or business income (where the bonds are held as trading assets). According to the AO, though the Circular No.2/ 2002 specifies Deep Discount Bonds and Strips, it has a bearing on the assessee's case which is holding of Preference shares, which is hybrid of both debt and equity instrument.

8. For the above reasons, the sum of Rs. 17,09,02,857/ - credited to the books of accounts as premium on preference shares was brought to tax under the head ‘Income from Other Sources’, by the AO.

9. Aggrieved by the aforesaid addition made by the AO, the assessee preferred before the first appellate authority, Commissioner of Income Tax (Appeals) [CIT(A)]. Before CIT(A), assessee submitted that the view taken by the AO is not correct for the following reasons:

1. The assessee had in its return of income originally filed, had mistakenly, offered the premium to tax on an annualized basis. On realizing its mistake, it promptly filed a revised return, well in time, by withdrawing the same as income. The assessee did not make any other change in its revised return.
2. The act of Redemption of Preference Shares amounts to a transfer of a Capital Asset u/s 2(47) of the Income Tax Act As natural corollary Premium, if any, received at the time of redemption, is not a revenue receipt, but a Capital receipt, which is exigible to tax under the head

'Income from Capital Gain s' in accordance with the provisions related to the same. The assessee relies upon the decision of the Hon'ble Supreme Court in the following cases wherein the Hon'ble Supreme Court has held that Redemption of Preference Shares amounts to transfer of a Capital Asset u/s 2 (47) of the Act, viz., (a) Anarkali Sarabhai vs CIT 224 ITR 522; (b) Karthikeya Sarabhai vs CIT 228 ITR 163;

3. The assessee also relied upon a decision of the Income Tax Appellate Tribunal, Mumbai Bench, in the case of Parle Biscuits Pvt Ltd vs ACIT (TS-477-ITAT-2011-Mum), wherein the ITAT, following the decisions of the Supreme Court in the above cited cases of Anarkali &. Karthikeya Sarabhai, held that at the time of redemption of preference shares, the assessee is allowed indexation benefit on the original investment, to arrive at the cost and difference between the indexed cost and the redeemed price shall he taxed as Capital gains or Capital loss, as the case may be. In that particular case the assessee claimed capital loss, contending the indexed cost of acquisition exceeded the redemption price, which was allowed by the ITAT.

4. The assessee submitted that in the year under consideration, no premium is due and receivable. The same is to be received at the time of redemption and there is no guarantee that the promised premium will be received at the end of 20 years. Under these circumstances it is wholly unjust to tax an amount which may or may not be received at the end of 20 years. The liability to pay the same arises to the company allotting the shares only at the time of redemption 86 not at any time earlier.

5. The assessee submitted that the AO is not correct in equating Redeemable Preference Shares with Deep Discounting Bonds and Debentures as they are not one and the same. They belong to different

Genres. Deep Discounting Bonds and Debentures are liabilities to the recipient, whereas Redeemable Preference Shares are part of Capital. The assessee relied upon the decision of the Bombay High Court in the case of CIT vs Enam Securities 345 ITR 64, wherein the High Court held that Preference Shares are different from Bonds and Debentures and being Capital in nature is eligible to benefit of indexation.

6. The assessee, submitted that the alternate case made out by the AO, by applying the provisions of Sec.14A of the act, cannot be sustained because, the premium on redemption is exigible to tax under the head 'Income from Capital Gains' and is not exempt from tax. Further the investment in preference shares is to be regarded as an investment in an unlisted and unquoted security & is therefore definitely exigible to tax. Section 14A comes into play only in the case of investment, income from which, is completely exempt from tax. Hence the question of any disallowance u/s 14A in respect of interest paid on loans, which are utilised to make the investment, is to be allowed as a business expenditure. If the same is claimed and allowed as a business expenditure, the same cannot be treated as part of cost of investment and be allowed for indexation while determining cost at the time of redemption of the shares.

10. The CIT(A) however concurred with the view of the AO. He formulated the issue that he has to decide viz., Whether the AO was right in adding the share premium to the income of the assessee on accrual basis under the head 'Income from other sources' treating it as revenue in nature. He observed that it is important to examine the nature of non convertible redeemable

preference shares, whether it is a debt instrument or an equity instrument. Preference shares carries characteristics of fixed interest paying securities such as bonds/debentures and offers possible appreciation of the capital as in the case of regular equity shares. Preference shares are generally issued with a fixed rate of premium/interest/dividend, by whatever name called, and premium is paid out of the accumulated profits of the company. Even if the premium is not paid in any particular financial year due to any reason, it will accrue and get accumulated and paid in future if the preference shares are cumulative in nature as in the instant case. Apart from the assured premium/interest/dividend, preference shares holders are also entitled to any capital gains on any appreciation on the face value/issue price of the preference shares realized at the time of redemption. These characteristics give preference shares the nature of a hybrid instrument, i.e., a combination of both debt and equity instruments. If the preference shares are treated as debt investment, the premium accrued should be treated like interest income and should be taxed under the head 'Income from other sources'. If it is treated as an equity instrument, the premium accrued will be in the nature of dividend which is an exempt income for taxation in which case the interest expenditure on the investment should be disallowed u/s 14A of the Income tax Act. The CIT(A) did not address the argument raised by the assessee that premium on redemption of preference shares is taxable and is not an exempt income and therefore the question of applying provisions of Sec.14A of the Act, does not arise.

11. The CIT(A) thereafter went on to examine Indian Accounting Standards (Ind AS)-32 issued by Institution of Chartered Accountants of

India (ICAI) which talks about financial instruments. The relevant portion that mentions about preference shares is extracted hereunder;

> "AG25 Preference shares may be issued with various rights. In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preference share that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the share. The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. An option of the issuer to redeem the shares for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.
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> AG26 When preference shares are non-redeemable, the appropriate classification is determined by the other rights that attach to them. Classification is based on an assessment of the substance of the contractual arrangements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preference shares, whether cumulative or noncumulative, are at the discretion of the issuer, the shares are equity instruments."

According to CIT(A), the factor of obligation to redeem give redeemable preference shares a distinct character of a financial liability which otherwise generally is in the nature of an equity instrument. The obligation to redeem coupled with non-convertibility of the preference shares in the instant case heavily tilts the nature of the instrument towards debt rather than the equity

This fact becomes even more emphasized when seen in the backdrop that these preference shares were issued without any voting rights and with a fixed rate of premium which shall accrue on a year on year basis as laid out in the annexure to the share subscription agreement under the head 'Terms of preference shares'. Hence this is not just a case of preference shares in general, but the fact that then preference shares are redeemable and non-convertible and were issued with a fixed yearly premium has given them a distinct colour of a debt instrument. The assessee duly following the accounting standard had shown the accrued premium as income in its books of accounts and declared as income from other sources in the original return of income filed. But the assessee made a volte-face when the case was selected for scrutiny and filed a revised return stating that it did not receive any premium during the year and the accrued premium will be liable to tax only when it will be redeemed in the future i.e., after 20 years that too as capital gains.

12. The CIT(A) further held that argument of the assessee that the premium should not be taxed yearly on accrual basis and will be liable to tax only when it will be actually redeemed and should be taxed as capital gains, is incorrect because accrual of the fixed premium will not result in any appreciation in the capital asset. If there will be any appreciation in the capital asset in the form of higher redemption price per share compared to its issue price which in the instant case is Rs.1,000/- per share, in addition to the tax on the accrued premium on yearly basis, the assessee will be liable to pay capital gains tax on it or can claim if there is any capital loss after computing indexed cost of acquisition. The CIT(A) also distinguished the two decisions of Hon’ble Supreme Court in the cases of Anarkali

Sarabhai Vs CIT 224 ITR 422 and Karthikeya Sarabhai Vs CIT 228 ITR 163 and the decision of ITAT Mumbai in the case of M/s Parley Biscuits Pvt Ltd Vs ACIT in support of its argument by observing that all these case laws address the issue of whether redemption of preference shares would amount to transfer within the meaning of Section 2(47) of the Income-tax Act. In these cases, the investment of the assessee in preference shares were redeemed which resulted in some capital gains to the assessee because the shares were redeemed at a higher price compared to the issued price and the assessee was contesting that it was not liable to pay capital gains tax as there was no capital gain since the redemption of preference shares did not amount to transfer u/s 2(47) of the Income tax Act. The Supreme Court ruled that the redemption of preference shares amounted to transfer within the meaning of Section 2(47) of the Income tax Act and the assessee was liable to pay the tax on capital gains it received. But the issue in dispute in the present appeal is totally different and distinguishable from the issue that was addressed in the above case laws cited by assessee. The CIT(A) was of the view that in the present case, there was no redemption of investment. The assessee has subscribed to the redeemable preference shares on 04/06/2015 and the redemption will happen in future on completion of 20 years from the date of allotment. Here, the premium on preference shares has been brought to tax on accrual basis by the AO and the Assessee is contesting this in appeal saying that the premium can be brought to tax only on redemption in future and not on year on year basis as is being done by the AO. Thus, the above case laws cited by the Assessee have no bearing on the issue at hand in the present appeal.

13. For the above reasons, the CIT(A) held that the AO has done the right thing by treating the non-convertible redeemable preference shares as a debt instrument and taxing the premium on accrual basis under the head 'Income from other sources'.

14. Aggrieved by the order of the CIT(A), the assessee is in appeal before the Tribunal. Learned Counsel for the assessee drew our attention to the provisions of section 55 of the Companies Act, 2013, and pointed out that as per the aforesaid provisions, irredeemable preference shares cannot be issued. The maximum period of redemption cannot exceed 20 years from the date of issue. He pointed out that redemption of preference shares can be made only out of profits of the Company which will otherwise be available for dividends or out of proceeds of the fresh issue of shares. He also drew our attention to the provisions of section 123 of the Companies Act, 2013, which lays down that dividends can be declared by a company only out of profits of the Company or out of its free reserves. In the light of the aforesaid provisions, the first submission made by the learned Counsel for the assessee was that by no stretch of imagination, the preference shares can be treated as a debt of the company. The preference shareholders have a preference in terms of return of capital over the equity shareholders and but for this difference, the preference shareholders cannot be regarded as a debtor of the company and the preference shares cannot be regarded as a debt. The decisions which were cited before the CIT(A) were also cited before us. Further, learned Counsel placed reliance on the decision of the Hon’ble Bombay High Court in the case of Aditya Prakash Entertainment Pvt. Ltd., Vs. Magikwand Media Pvt. Ltd., CP No.404/2016, judgment dated 05.03.2018. In the aforesaid decision, the preference shareholders filed a petition for winding up of the company under section 433(e) of the Companies Act, 1956, to wind up the company on the ground that the company is unable to pay its debts. It was a case of the petitioners that they were holders of

redeemable preference shares and despite exercising of option to redeem the preference shares, the company did not make payment and despite the fact the company had profits. The Hon'ble Bombay High Court, on consideration of several decisions, held that when a company issues redeemable preference shares, it is not obtaining loan as it could by issuing debentures. There is a fundamental difference between the capital made available to a company by issue of a share and money obtained by a company under a loan or a debenture. Respective incidences and consequences of issuing a share and borrowing money on loan or on a debenture are different and distinctive. Relying on the said decision, the learned Counsel reiterated his plea that the action of the Revenue authorities in treating redeemable preference shares as akin to debt and consequently holding that dividend / interest income has accrued to the assessee cannot be sustained.

15. Learned DR, on the other hand, submitted that as per the share subscription agreement, it is specifically provided that "preference shares shall be redeemed at such price, so as to net a premium of 16.5% p.a. Such premium shall accrue on a year-to-year basis and shall be payable on the redemption date". He also pointed that that in the event of liquidation of the company, preference shareholders rank lower than creditors but higher than equity shareholders. These features according to the learned DR show that the assessee was entitled to the dividend / interest income and on the basis on the accrual and therefore under the mercantile system of accounting, the assessee ought to have offered the income attributable to the previous year as its income and the AO is therefore justified in making the impugned addition.

16. We have carefully considered the rival submissions. It is seen that the Ensource Consulting Pvt. Ltd., made an invitation to the assessee to subscribe for non-convertible redeemable cumulative preference shares of 13,00,000 Nos. of

Rs.1,000/- each. The offer was dated 26.05.2015 and as per the offer letter, the rate of dividend / the rate of interest is mentioned as 8% P.A. on cumulative basis 14% on overall IRR basis. The assessee subscribed to the offer and terms of the subscription of preference shares are evidenced by an agreement dated 04.06.2015. As per the terms of the agreement, the issue date means the date on which the company allots and issues preference shares to the assessee. The redemption date was 20 years from the date of issue. The terms of the preference shares are contained in Annexure A to the agreement and the same reads as follows:

Annexure A

<u>TERMS OF PREFERENCE SHARES</u>

1.	*Aggregate Quantity*	*13,00,000 (Thirteen Lakh) Non-Convertible Redeemable Preference Shares.*
2.	*Face Value per Preference Share*	*INR 1,000/- (Rupees One Thousand Only) each.*
3.	*Issue price per Preference Share*	*INR 1,000/- (Rupees One Thousand Only) each.*
4.	*Redemption Premium*	***<u>Preference Shares shall be redeemed at such price, so as to net a premium of 16.5% per annum. Such premium shall accrue on a year on year basis and shall be payable on the Redemption Date.</u>***
5.	*Voting*	*The Shareholder shall not have the right to receive notice of, or to attend and vote at a shareholders/general meeting of the Company.*

6.	*Redemption Methodology*	*At any time after the date of issue of the Preference Shares, the Company, subject to the approval of the Board of Directors, may redeem all or part of the Preference shares at a redemption price equal to the face value of the Preference Shares.*
7.	*Liquidation*	*In the event of liquidation or winding-up of the Company, each Shareholder shall be ranked lower than creditors but higher than equity shareholders and shall have priority of payment of capital over the equity shareholders.*

17. A reading of the terms of the agreement clearly shows that what was ultimately agreed to be paid was only a premium on redemption which was quantified at 16.5% P.A not any return as per the terms of offer letter dated 26.5.2015. The fact remains that the assessee was only a preference shareholder and by no stretch of imagination can it be said that the assessee was a debtor of the company issuing redeemable preference shares and was entitled to claim the redemption premium as a matter of right. As rightly pointed out by the learned Counsel for the assessee, the payment of redemption premium can be only out of profits of the company or out of reserves. Even if one were to be regarded the premium as akin to dividend, the assessee cannot claim dividend as a matter of right and it is for the directors of the Company to declare dividend which needs to be approved by the shareholders in an Annual General Meeting (AGM). Therefore, by no stretch of imagination can it be said that the preference shares issued by the assessee is in the nature of equity. It is only when the assessee has a right to receive periodic payments can it be said that income has accrued to an assessee under the mercantile system of accounting. For example, if the sum paid by the

assessee is loan and as per the terms of the loan agreement, certain rate of intereset is payable by the borrower every year then it can be said that under the mercantile system of accounting, interest accrues to the assessee as income, irrespective of actual receipt of payment. In the case of preference shares, such an inference cannot be drawn and the repayment of the face value of the preference shares as well as the premium on redemption is uncertain. In such circumstances, the action of the Revenue authorities in making the impugned additions cannot be sustained. We, therefore, hold that the income brought to tax by the Revenue authorities cannot be sustained and the said addition is directed to be deleted.

18. The next question is whether the revenue authorities can overlook the legal effect when a person holds cumulative preference shares and treat as loan instrument rather than a share capital/equity instrument. In our view the revenue authorities cannot disregard the legal effect of issue of cumulative preference shares and say that the same is akin to debt and therefore the cumulative preference shares which is a capital instrument is a debt or in the nature of debentures. A similar question arose for consideration before the Hon'ble Bombay High Court in the case of Enam Securities Pvt. Ltd. (supra). The facts of the case before the Hon'ble Bombay High Court were that the assessee in that case had subscribed to the purchase of 4 lakh preference shares each of Rs.100/- of an aggregate value of Rs.4 crores from a company by the name of Enam Finance Consultants Pvt. Ltd. in 1992. The preference shares were to carry a dividend of four percent per annum and were to be redeemable after the expiry of ten years from the date of allotment. During the course of Assessment Year 2001-02, the assessee redeemed three lakh shares at par and claimed a long-term loss of Rs. 2.73 crores after availing of the benefit of indexation. The Assessing Officer disallowed the claim of set off of long-term capital loss that arose on redemption against long term capital gain on the sale of other shares on the ground that (i) Both the assessee and the Company in which the assessee held the preference shares, were managed by the same group of

persons; and (ii) There was no transfer and that the assessee was not entitled to indexation on the redemption of non-cumulative redeemable preference shares. The CIT(A) on the other hand, allowed the benefit which was claimed by the assessee. The Tribunal affirmed the view of the CIT(A) holding that the genuineness and credibility of the capital transaction was not disputed for the previous ten years. Both the Companies were juridical entities; the fact that the Companies were under common management would not indicate that the transfer was sham and that the view of the Appellate Authority was purely based on surmises and conjectures. The Tribunal has followed the judgment of the Supreme Court in Anarkali Sarabhai vs. CIT, in holding that the redemption of preference shares results in a transfer within the meaning of Section 2(47). Finally, the Tribunal has held that the non-cumulative redeemable preference shares cannot be equated with debentures or bonds. According to the Tribunal, share capital issued in the form of non-cumulative redeemable preference shares can never be regarded as debentures or bonds. A debenture is a loan taken by the Company. On further appeal by the revenue, the Hon'ble Bombay High Court, the Hon'ble Bombay High Court while answering Question D which reads as follows:

> "D. Whether on the facts and in the circumstances of the case and in law, the Tribunal is right in allowing indexation benefit on redemption of non-cumulative preference shares to the Assessee Company even though such non-cumulative preference shares are in the nature of 'debt' and therefore fall into the category of bonds and debentures as envisaged by the third proviso of section 48 of the Income Tax Act."

Held:

> "7. As regards question (D), Section 48 provides that the income chargeable under the head "capital gain" shall be computed by deducting VBC 6 itxa5372.10-27.4 from the full value of the consideration received or accruing as a result of the transfer of a capital asset: (i) The expenditure incurred wholly and exclusively in connection with such transfer; and (ii) The cost of acquisition of the asset and the cost of any improvements thereto.

The second proviso to Section 48 provides for indexation where long term capital gain arises from the transfer of a long term capital asset. The third proviso, however, stipulates that nothing contained in the second proviso shall apply to long term capital gain arising from the transfer of a long term capital asset being bonds or debentures other than capital indexed bonds issued by the Government. The Assessing Officer was of the view that the principal characteristic of a bond is a fixed holding period and a fixed rate of return. According to him, the four percent non-cumulative redeemable preference shares which the assessee redeemed also had a fixed holding period and a fixed rate of return and on this basis denied the benefit of cost indexation to the assessee.

8. The entire basis on which the Assessing Officer denied the benefit of cost indexation was in our view flawed and was justifiably set right in the order of the Tribunal**. The Income Tax Act, 1961, does not contain a definition of bonds or debentures. Both those concepts have a well settled connotation in law, particularly in the provisions of the Companies' Act, 1956.** Section 2(12) of the Companies' Act, 1956 defines the expression "debenture" to include debenture stock bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. Under Section 80(1) a company limited by shares may, if so authorised by its articles, issue preference shares which are, or at the option of the company are to be liable, to be redeemed. Section 85 provides that 'preference share capital' means, with reference to any company limited by shares, whether formed before or after the commencement of the Act that part of the share capital which fulfills the following requirements, namely:

> "(a) that as respects dividends, it carries or will carry a preferential right to be paid a fixed amount or an amount calculated at a fixed rate, which may be either free of or subject to income-tax; and
>
> (b) that as respects capital, it carries or will carry, on a winding up or repayment of capital, a preferential right to be repaid the amount of the capital paid up or deemed to have been paid up, whether or not there is a preferential right to the payment of either or both of the following amounts, namely:-
>
> > (i) any money remaining unpaid, in respect of the amounts specified in clause (a), up to the date of the winding up or repayment of capital; and

(ii) any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company.

Explanation.- Capital shall be deemed to be preference capital, notwithstanding that it is entitled to either of both of the following rights, namely:-

(i) that, as respects dividends, in addition to the preferential right to the amount specified in clause (a), it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid;

(ii) that, as respects capital, in addition to the preferential right to the repayment, on a winding up, of the amounts specified in clause (b); it has a right to participate, whether fully or to a limited extent, with capital not entitled to that preferential right in any surplus which may remain after the entire capital has been repaid."

Section 86 provides that the share capital of a company limited by shares shall be of two kinds only namely : (i) Equity share capital; and (ii) Preference share capital.

9. **There is fundamentally as a matter of first principle and in law a clear distinction between bonds and debentures on the one hand, and preference share capital on the other.** A bond includes "any instrument whereby a person obliges himself to pay money to another on condition that the obligation shall be void if a specified act is performed, or is not performed, as the case may be". Debt securities typically are regarded as consisting of notes, debentures and bonds. Technically, a 'debenture' is an unsecured corporate obligation while a 'bond' is secured by a lien or mortgage on corporate property. However, in commercial parlance, the expression "bond" is often used indiscriminately to cover both bonds and debentures. As a matter of fact, the Companies' Act, 1956 in Section 2(12) defines 'debenture' to include debenture stock bonds and any other securities of a company, whether or not they constitute a charge on the assets of the Company. A bond is a formal document constituting the acknowledgement of a debt by an enterprise and normally contains a provision regarding repayment of principal and interest. There is a clear distinction between bonds and share capital because a bond does not represent ownership of equity capital. Bonds are in essence interest bearing instruments which represent a loan. This distinction has been accepted by the Supreme Court in R.D. Goyal vs. Reliance Industries Ltd. The Supreme Court noted that a debenture is simply an instrument of acknowledgement of

> debt by a company whereby it undertakes to pay the amount covered by it and till then it undertakes to pay interest to the debenture holders. The expression "share" has been defined in Section 2(46) of the Companies' Act, 1956 to mean share in the share capital of a company.
>
> On the other hand, a debenture is an instrument of debt executed by the Company acknowledging its liability to repay the amount represented therein at a specified rate of interest. In other words, a debenture is a certificate of a loan or a bond evidencing the fact that the Company is liable to pay an amount specified with interest. Though the amount which is raised by a Company through debentures becomes a part of its capital structure, it does not become part of share capital.
>
> 10. Section 48 denies the benefit of indexation to bonds and debentures other than capital indexed bonds issued by the Government. The four percent non-cumulative redeemable preference shares were not bonds or debentures within the meaning of that expression in Section 48 of the Income Tax Act, 1961. In these circumstances, the Tribunal was correct in its decision to that effect.
>
> 11. We accordingly, answer question (D) in the affirmative and in favour of the assessee. The appeal shall accordingly stand disposed of in the aforesaid terms. There shall be no order as to costs."
>
> (Underlining by us for Emphasis)

19. The above decision of the Hon'ble Bombay High Court is a complete answer to the question that the revenue authorities cannot disregard the legal effect of a document evidencing a debt and that which evidences holding shares in a limited liability company. The legal consequences thereof cannot be ignored and a share characterized as a debt instrument. Such a course is permissible under the thin capitalization rules which were introduced w.e.f. 1.4.2018 by virtue of the provisions of Sec.94B of the Act, but those provisions are applicable only in the case of transactions with Associated Enterprise which is not a tax resident of India. It is a common practice among multinational companies globally to lessen their tax

outgo by resorting to extensive use of legal arrangements for parking profits in low or no-tax jurisdictions, formally coined as base erosion and profit shifting (BEPS). One of the simplest profit-shifting techniques available in international tax planning is by way of interest payments and therefore, specific Action Plan, viz., Limiting Base Erosion Involving Interest Deductions and Other Financial Payments ("BEPS Action Plan 4") has been devoted by the OECD to tackle BEPS through payments in the nature of interest and payments economically equivalent to interest. In BEPS Action Plan 4, OECD has set out the best practice approaches for countries to prevent erosion of their tax base by way of excess interest deductions claimed by multinational group entities. BEPS Action Plan 4 is focused on the use of third-party, related-party, and intra group debt to obtain "excessive" deductions or to "finance the production of exempt or deferred income." Adopting the recommendations of BEPS Action Plan 4, India introduced section 94B in the domestic tax law, viz., Income-tax Act, 1961 ("the Act"), as an anti-tax avoidance provision to restrict deduction of interest paid to non-resident associated enterprises (AEs). As already stated, the said provisions are applicable only when interest is paid to non-resident associated enterprises and such a feature is absent in the present case.

20. With regard to the alternate case made out by the AO by placing reliance on the provisions of Sec.14-A of the Act, we find that the assessee had contended before the CIT(A) that premium on redemption of debentures is taxable in the year of redemption and hence there was no exempt income whatsoever warranting invocation of the provisions of Sec.14-A of the Act. The CIT(A) has not addressed the issue at all. The law is clear that premium on redemption is exigible to tax under the head 'Income from Capital Gains' as laid by the Hon'ble Supreme Court in the case of Anarkali Sarabai (supra) and Karthikeya Sarabai (supra) and is not exempt

from tax. Further the investment in preference shares is to be regarded as an investment in an unlisted and unquoted security and is therefore definitely exigible to tax. Section 14A comes into play only in the case of investment, income from which, is completely exempt from tax. Hence the question of any disallowance u/s 14A in respect of interest paid on loans, which are utilised to make the investment, is to be allowed as a business expenditure. If the same is claimed and allowed as a business expenditure, the same cannot be treated as part of cost of investment and be allowed for indexation while determining cost at the time of redemption of the shares. Therefore, the disallowance cannot be sustained even by application of the provisions of Sec.14-A of the Act.

21. For the reasons given above, we hold that the Revenue authorities were not justified in adding a sum of Rs.17,09,02,887/- being notional premium receivable on preference shares as income of the assessee. The appeal of the assessee is accordingly allowed.

22. ITA No.2550/Bang/2019 (Appeal of the Revenue) : In so far as the appeal of the Revenue is concerned, the first ground of appeal of the Revenue reads as follows:

> *1. The learned CIT(A) erred in holding that interest on delayed remittance of TDS is not in the nature of Penalty, and thus allowable under the provisions of Income Tax Act, 1961. The Ld. CIT(A) further failed to appreciate that such interest partakes the character of tax and hence is not an allowable deduction as held in the decision of CIT's Chennai Properties & Investment Ltd. [1999] 105 Taxman 346 (Madras).*

23. The factual details in so far as Grd.No.1 above are that the assessee has debited an amount of Rs, 1,27,53,372/- towards Interest paid on delayed payment of tax in the Profit and Loss account, which was disallowed by the AO. The

assessee, during the course of assessment proceedings, clarified that the nomenclature that Interest Paid on Delayed Payment of Tax is misleading and the actual components of the same are as under:

Particulars	*Party*	*Amount*
Interest on Delayed Payment to Vendor	*Adecco India P. Ltd*	*23,33,200*
Interest on short term loan	*Kotak Mahindra*	*1,02,115*
Interest on delay in repayment of loan	*National Small Investment Corporation*	*2,62,362*
Interest on delayed remittance of PF	*PF department*	*14,31,625*
Interest on short term loan	*Religare*	*6,62,318*
Interest on delayed remittance of service tax	*Service Tax Department*	*4,69,326*
Interest on delayed remittance of service tax	*Service Tax Department*	*31,44,545*
Interest on delayed remittance of TDS	*Income Tax Department*	*38,32,459*
Interest on delayed remittance of VAT	*VAT Department*	*18,955*
Interest on Vehicle Loan	*Axis Bank*	*3,05,467*
Interest on delayed payment to Vendor	*Vaibhav Tivari*	*1,91,000*
Total		*1,27,53,372*

24. Before the CIT(A), the assessee filed the details of the above payments called for during the course of the appellate hearing before the CIT(A). Before the CIT(A), the assessee placed reliance on the decision of the Kolkata bench of the ITAT in the case of DCIT vs. Narayani Ispat Pvt Ltd in ITA No.2127/KoI/2014, by order dated 30/08/2017, wherein the ITAT, following the decision of the Hon'ble Supreme Court in the case of Lachmandas Mathura vs CIT 254 ITR 799, held that interest paid for reasons of delay in remittance of Service Tax & TDS is compensatory in nature and not in the nature of Penalty. The ITAT held that remittance of TDS is not the same as payment of Income tax.

25. The CIT(A) agreed with the contention of the assessee and held that from the details furnished it was clear that there is not a single payment which is in the nature of penalty. The interest paid is on delayed payment to Vendors, Delayed remittance of statutory liabilities such as PF, VAT, Service Tax & TDS. Further interest is paid on loans borrowed from Banks & NBFC's. Further the assessee has not claimed any payment of interest u/s 234 A, B or C as an item of expenditure. The entire claim is seen to be in order. The disallowance made by the AO was deleted by the CIT(A).

26. It can be seen from the table given above that out of the sum of Rs.1,27,53,372/- appearing under the nomenclature “interest paid on delayed payments of tax” only a sum of Rs.38,32,459/- relates to interest on delayed remittance of TDS. It is clear from ground No.1 raised by the Revenue that it is only this amount which is challenged by the Revenue in ground No.1 in this appeal. In so far as the nature on the interest on delayed remittance of TDS is concerned, this Tribunal has been taking a consistent view following the decision of the Hon’ble Madras High Court in the case of CIT Vs. Chennai Properties and Investments Ltd., 239 ITR 435 that interest paid takes colour from the nature of principal amount required to be paid but not paid in time and this principal amount being income tax, interest was also in the nature of direct tax and cannot be regarded as a compensatory payment and allowed as business expenditure. Following the aforesaid decision, this Tribunal in the case of Velankani Information Systems Ltd., (2018) 97 taxmann.com 599 (Bangalore Tribunal) in the case of Jindal Aluminium Vs. DCIT in ITA Nos.31 to 33/Bang/2019, order dated 25.08.2021, has taken a view that interest paid on delayed remittance of TDS is not allowable / deductible expenditure. Following the aforesaid decision, we reverse the order of the CIT(A) in so far as it relates to the sum of Rs.38,32,459/- being

remittance of delayed TDS and hold that the said sum is not an allowable deduction.

27. Ground no.2 raised by the Revenue reads as follows:

> 2. *In the facts of the case, the learned CIT(A) ought to have remanded additional evidences w.r.t. disallowance of trade payable made by the AO of Rs.8,09,73,776/- before admitting and accepting the same.*

28. The AO added the following amounts of Sundry creditors/Trade Payables outstanding as on 31/03/2016 viz., a sum of Rs.8,09,73,776/- as per the following details:

Adecco India Pvt Ltd	2754297
NERC Systems Pvt Ltd	20070200
Megaspace IT Solutions	420018
Trishitha Consltancy	941417
iDeccan Systems	5853634
Hexoct Geospatial	1902224
Wipro	19758387
Esyasoft Technologies Pvt Ltd	20646026
IBM India Pvt Ltd	8627573

The AO made the aforesaid addition of Rs.8,09,73,776/- to the total income of the assessee on the ground that the assessee failed to prove the genuineness and creditworthiness of the credits, in spite of repeated reminders.

29. Before CIT(A), the assessee has produced the ledger account extracts, confirmation of balances, PAN No's, Addresses & reconciliation statement, where required of the sundry creditors. Before CIT(A), the assessee submitted that in all these cases, the bills raised on the assessee are subjected to Sales Tax or Service Tax as the case may be and are all genuine transactions. Most of the entities are highly reputed organizations and the question of suspecting the genuineness of

these transactions does not arise. The payments made to these entities are all through banking channels. The transactions are audited and certified by the Statutory Auditors of the Company and there are no adverse observations in their report. The Assessee submitted that it was also subjected to Tax audit u/s 44AB of the Act.

30. The CIT(A) considered additional evidence filed by the assessee and went on to observe that almost all these creditors have been having business & commercial relationships with the assessee earlier to the impugned assessment year and continue to have the same even after. He went on to analyze the details provided by the assessee and observed that the balances outstanding as on 31/03/2016 have been paid subsequently through banking channels and there is continuing relationship with most of them. Thereafter he gave finding with regard to each of the sundry creditors, and deleted the addition made by the AO. The following were the findings of the CIT(A):

> "7,5.2 A brief analysis of the same is as under:
> Addecco India Pvt Ltd:
>
> The balance as per the Assessee's books is Rs. 5,46,09,874/-
>
> The Balance as per confirmation received is Rs. 5,18,55,577/-
>
> Difference Rs. 27,54,297/-
>
> The AO has added the entire difference amount of Rs.27,54,297/-. The Assessee has filed a reconciliation statement, explaining the difference. It is seen that the Assessee has credited the Creditor with various amounts as per the bills raised by the said creditor amounting to Rs. 27,54,205/-on 31/03/2016. These bills are accounted by the creditor in the subsequent accounting year. The difference is only Rs.92/-.
>
> NERC Systems Pvt ltd:
> The AO has added the entire closing balance of Rs. 2,00,70,200/- as on 31/03/2016. The Assessee has filed a balance confirmation letter from the

Creditor. The Assessee has made payment of Rs. 92,17,384/- to the Creditor in the A.Y. 2017-18 and the balance 43utstanding as on 31/03/2017 is Rs. 1,08,52,816/-.

Mega Space IT Solutions Pvt Ltd:
The AO has added the entire closing balance of Rs. 4,20,018/- as on 31/03/2016. The Assessee has made payment of Rs. 4,20,018/- to the Creditor on 02/06/2016, through banking channels, along with other payments due in A.Y. 2017-18.

Trishitha Consultancy:
The AO has added the entire closing balance of Rs. 9,41,417/- as on 31/03/2016. The Creditor had billed the Assessee a sum of Rs.15,82,235/- in the A.Y. 2015-16, which included Service Tax of Rs.1,74,052/-. The Assessee after deducting TDS of Rs.1,40,818/- was due to pay an amount of Rs. 14,41,417/-. The Assessee has made payment of Rs. 5,00,000/- to the Creditor and the balance o/s as on 3.1/03/2016 is Rs. 9,41,417/-. Further this amount is also the opening balance due as on 01/04/2015 and cannot be added in this impugned assessment year.

iDeccan Systems:
The AO has added the entire closing balance of Rs. 58,53,634/- as on 31/03/2016. Further this amount is also the Opening balance due as on 01/04/2015 and cannot be added in this impugned assessment year in any case. However, the Assessee had a dispute with the Creditor on the quality of work done by the Creditor and has had to incur a sum of Rs. 51,47,916/- in the A.Y. 2018-19, as a result of lapses on the part of the Creditor and has debited the Party by this amount. The addition made is deleted.

Hexoct Geospatial:
The AO has added the entire closing balance of Rs. 19,02,224/- as on 31/03/2016. The Assessee has made payment of Rs. 10,00,000/- to the Creditor on 02/06/2016, Rs. 5,00,000/- on 12/09/2016, Rs.2,00,000/- on 18/00/2017 & Rs.2,02,224/- on 23/10/2017, all through banking channels.

Wipro Ltd:
The AO has added the entire closing balance of Rs. 1,97,58,387/- as on 31/03/2016. The Balance confirmed by the Creditor as on 31/03/2016 is Rs. 1,97,00,135/-. The Difference is Rs. 58,352/-, which the Assessee is unable to explain. It is also seen that the Assessee has made payment of

Rs. 40,00,000/-on 02/06/2016, Rs. 20,00,000/- on 19/10/2016, Rs.20,00,000/- on 29/12/2016, Rs.20,00,000/-24/05/2017 and Rs.50,00,000/- on 23/10/2017, all through banking channels. The addition made to the extent of Rs.58,352/- is sustained and the balance addition of Rs.1,97,00,135/- is deleted.

Eyasoft Technologies Pvt Ltd:
The AO has added the entire closing balance of Rs. 2,06,46,026/- as on 31/03/2016. The Balance confirmed by the Creditor as on 31/03/2016 is Rs. 2,06,81,808/-, which is more than the amount due as per the Assessee by Rs. 35,782/-.

IBM India Pvt Ltd:
The AO has added the entire closing balance of Rs. 86,27,573/- as on 31/03/2016. The amount represents lease charges for computers taken on lease from the creditor vide agreement dated 19/09/2006. The Assessee has subsequently terminated this agreement with the creditor by a final settlement agreement dated 18/07/2016, wherein the creditor transferred the ownership of the assets to the Assessee & terminated the lease arrangement. The Assessee has paid a total amount of Rs.1,47,00,000/- on termination, which includes lease rentals due of Rs.86,27,573/- balance of Rs. 60,72,427/- as purchase value of the Computers.

Thus, in conclusion out of the total addition of Rs. 8,09,73,776/- made by way of Unexplained Trade Creditors, a sum of s.58,352/- stands confirmed and the balance amount of Rs. 8,09,15,424/- is deleted."

31. Aggrieved by the order of the CIT(A), the revenue has raised ground No.2 before the Tribunal. The limited grievance of the Revenue is that in terms of Rule 46A of the Income Tax Rules, 1962 (hereinafter called 'the Rules'), the CIT(A) was obliged to confront the additional evidence filed before him to the AO and obtain a remand from the AO. Without doing so, the CIT(A) ought to have allowed relief to the assessee. Learned Counsel for the assessee submitted that as per the provisions of section 250(4) of the Act, the CIT(A) before disposing any appeal has a power to make further enquiry as it thinks fit. This is in exercise of this power that the Commissioner has made the enquiry and therefore no fault can be found in

the action of the CIT(A). It was further submitted that the Hon'ble Karnataka High Court in the case of CIT Vs. Sanu Family Trust (2012) 209 Taxman 529 (Karnataka) has taken a view that rigors of the Rule 46A(1) to (3) will not be attracted when the Commissioner exercises his inherent power under 46A(4) of the Rule and calls for evidence for the purpose of deciding an issue in the appeal. Learned DR pointed out that in the present case, the additional evidence was filed by the assessee by itself and the CIT(A) did not call for any additional evidence under the Rule 46A(4) of the Rules and therefore the decision cited by the learned Counsel for the assessee will not be applicable to the facts of the present case.

32. We have given a very careful consideration to the rival submissions. It is no doubt true that under section 250(4) of the Act, the CIT(A) hearing an appeal can make such further enquiries as it thinks fit. But the aforesaid provision cannot be construed in a manner to say that the CIT(A) should not follow the procedure laid down in Rule 46A of the Rules, except with an exception provided in Rule 46A(4) of the rules. The appellate proceedings before the CIT(A) are also quasi-judicial proceedings and the rule of nature justice demand that the parties before the CIT(A) should have equal opportunity of being heard. Rule 46A of the Rules prescribes the procedure for filing additional evidence before the CIT(A) and the circumstances under which the additional evidence can be filed before the CIT(A). Rule 46A(1) lays down that additional evidence shall be admitted by the CIT(A) only for reasons stated therein and Rule 46A(2) lays down that only after recording in writing reasons for admitting additional evidence, can additional evidence be admitted. Further, Rule 46A(3) specifically provides that CIT(A) shall not take into account any additional evidence produced under Rule 46A(1) of the Rules unless AO has been allowed reasonable opportunity to examine the additional

evidence to produce evidence in rebuttal. Thus, in the present case, there is a clear violation of the mandate laid down in Rule 46A(3) of the Rules.

33. In so far as the argument of the learned Counsel for the assessee that under 46A(4) of the Rules, the CIT(A) can call for additional evidence on his own to decide the controversy in appeal and in such event, he need not follow the requirements of 46A(3) of the Rules is concerned, we find that the CIT(A) in the present case has not called for additional evidence on his own and it has been produced only by the assessee before the CIT(A). In such circumstances, we are of the view that the assessee cannot place reliance on the decision of the Hon'ble Karnataka High Court in the case of CIT Vs. Sam Family Trust (supra). In the given facts and circumstances of the case, we are of the view that it would be just and appropriate to set aside the order of the CIT(A) on the issue raised in ground 2 to the AO for fresh consideration with a direction to the AO to consider the additional evidence filed by the assessee before CIT(A) and also such other evidences the assessee may seek to rely on in support of its claim. The AO will decide the issue after affording opportunity of being heard to the assessee.

34. In the result, the appeal of the assessee is allowed while appeal of the Revenue is partly allowed.

Pronounced in the open court on the date mentioned on the caption page.

Sd/-	Sd/-
(PADMAVATHY S) **ACCOUNTANT MEMBER**	**(N. V. VASUDEVAN)** **VICE PRESIDENT**

Bangalore,
Dated: 19.09.2022.
/NS/*

Copy to:

1.	Assessees	2.	Respondent
3.	CIT	4.	CIT(A)
5.	DR	6.	Guard file

By order

Assistant Registrar,
ITAT, Bangalore.