7 April 2023

EY Tax Alert

Mumbai Tribunal holds reclassification of fully equity instrument to "Other Equity" on convergence to Ind-AS is not liable to MAT

Executive summary

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This Tax Alert summarizes a recent Mumbai Tribunal (Tribunal) decision in case of Reliance Industries Investment and Holdings Ltd.[1] (Taxpayer) wherein issue arose whether under minimum alternate tax (MAT) provisions of the Indian Tax Laws (ITL), reclassification of optionally/compulsorily convertible debentures on convergence to Ind-AS[2] as "Other Equity", was includible in "transition amount" and hence, taxable under MAT over five years.

The Tribunal held that on convergence to Ind-AS, only those adjustments in "Other Equity" which would otherwise impact Profit and Loss Account (P&L) are includible in "transition amount". A reclassification of a fully equity instrument as per Ind-AS to "Other Equity" is not includible in "transition amount". The Tribunal also held that, in the facts of the Taxpayer's case, considering the terms and conditions of convertible debentures, they were not classifiable as "compound financial instruments", in absence of a liability component embedded therein – rather they were fully equity in nature. Although, the Taxpayer initially presented the instruments under "Other Equity", hey were rightly classified by the Taxpayer as "Instruments entirely equity in nature" separate from "Other Equity" in the revised Balance Sheet as per the Guidance Note[3] issued by Institute of Chartered Accountants of India (ICAI)[4]. Therefore, in absence of any adjustment in "Other Equity", the amount of these debentures could not be included in "transition amount".

[1] ITA No. 1065/Mum/2022
[2] IFRS converged Indian Accounting Standards
[3] Guidance Note on Division II – IND AS Schedule III to the Companies Act, 2013
[4] Regulator of the accounting profession in India

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Background

- MAT provisions apply to a company and provide for taxation based on "book profit". MAT is triggered when tax liability, computed at a specified percentage of book profit, is higher than the tax liability under normal computation. The book profit is computed by adopting the net profit as per P&L, prepared in compliance with the relevant provisions of the Companies Act (CA), 2013 and further adjusting it by upward and downward adjustments as specified under MAT provisions.

- Prior to the Finance Act (FA), 2017, accounting standards formulated by the ICAI and notified by the Ministry of Corporate Affairs (MCA) in 2006 (popularly known as IGAAP), formed the basis of preparation of P&L and, hence, MAT was levied on book profit as per IGAAP.

- Pursuant to notification of Indian Accounting Standards (Ind-AS) by the MCA in 2015 for certain class of companies, FA 2017 amended the existing MAT provisions to provide a separate framework for computation of book profit for Ind-AS compliant companies, effective from 1 April 2017 [i.e., tax year (TY) 2016-17].

- The Ind-AS MAT framework provides for adjustments in two parts viz., (a) convergence/transition adjustments made on convergence date[5] to "Other Equity" and (b) post convergence adjustments in P&L or Other Comprehensive Income (OCI) (including under a scheme of demerger).

- Furthermore, the convergence date adjustments to "Other Equity" are also divided into two parts viz.,

    - Specific types of adjustments to "Other Equity" (e.g., gain/loss on revaluation of property, plant and equipment or fair valuation of financial instruments through OCI) are included in book profit at an appropriate point of time, when they are either reclassified to P&L or realized.

    - Other adjustments to "Other Equity" form part of residual "transition amount", to be included in book profit by spreading over five years starting from the first year of Ind-AS convergence. The Tribunal, in the present case, was concerned with this part of adjustment.

- To illustrate in simple terms, if a compound financial instrument of INR 100 is reclassified as financial liability of INR 70 and equity of INR 30 on the convergence date, the Ind-AS and MAT treatment is as follows:

    - The equity component of INR 30 usually represents discounting of the financial liability payable in future to net present value. It is classified in "Other Equity" on convergence date and financial liability of INR 70 is reflected separately as a liability in the Balance Sheet.

    - The discount of INR 30 is subsequently unwound by debit to P&L over the remaining tenure of the instrument to bring the liability of INR 70 to INR 100 on the date of its repayment. The debit to P&L forms part of book profit for MAT purposes and hence taxpayer gets deduction in MAT over the remaining tenure of instrument.

    - To neutralize the above deduction, the discount of INR 30 recognized in "Other Equity" on convergence date is included in "transition amount" and one-fifth thereof (INR 6) is included in book profit of five years beginning with the year of convergence to Ind-AS.

- In deference to representations by stakeholders to clarify apprehensions on double taxation and/or hardships arising under the amendments, the Central Board of Direct Taxes (CBDT)[6] issued a Circular No. 24/2017 dated 25 July 2017 (Circular) which clarified 14 issues by way of FAQs[7]. In terms of FAQ 7 of the Circular, share application money pending allotment, that is not refundable by the company may be reclassified to "Other Equity" would not be considered for the purpose of computing the transition amount. Further, FAQ 9 of the Circular clarifies that, equity component of certain financial instruments such as, non-convertible debentures, interest-free loan etc. would be included in the transition amount.

Facts

- The Taxpayer converged to Ind-AS from 1 April 2016 i.e., from TY 2016-17. As of 31 March 2016, the Taxpayer had outstanding zero coupon optionally fully convertible debentures (OCDs) and zero coupon fully convertible debentures (FCDs), issued to its holding company. The terms of these debentures as of 31 March 2016 were as follows:

    - The tenure was fixed. They did not carry any interest.

[5] i.e., first day of Ind-AS reporting period as defined in Ind-AS 101
[6] The apex administrative body of direct taxes in India
[7] Refer EY Alert titled 'Indian tax administration issues clarifications to compute book profit for Minimum Alternate Tax (MAT) levy for Ind-AS companies' dated 26 July 2017.

- At any time, the Taxpayer and debenture holder both had an option of unilaterally converting the debentures into fixed number of equity shares (based on higher of book value or face value of equity shares as of 31 March 2015)
- Absent conversion, one series of debentures were redeemable at par (while another series at premium of 5%) not later than 15/25 years. The Taxpayer and holder may mutually agree for early redemption. Without mutual agreement, the instruments could not be redeemed.
- Under IGAAP, the Taxpayer had classified these debentures as a liability, under the head "long term borrowings". On convergence to Ind-AS, as guidance evolved, these debentures were re-classified differently in following financial statements (FS) prepared by the Taxpayer for TY 2016-17, at different points of time as per the table below but for the full amount of debentures. (i.e., INR 100 as per above illustration without any discounting):

Nature of FS	**Date of approval of FS**	**Classification of debentures in Ind-AS Balance Sheet**		
		Main head (on the face of Ind-AS Balance Sheet under "Shareholder's funds")	**Sub head (in schedules)**	**Disclosure in notes to accounts**
Original FS prepared for first time as per Ind-AS	18 April 2017	Other equity	Instruments classified as Equity	All convertible instruments issued by the company are considered as "Other Equity" under the head "Equity component of compound financial instruments" (ECCFI)
Revised FS prepared to give effect to an amalgamation, having appointed date falling in TY 2016-17	15 March 2019			
Re-casted FS prepared to give effect to ICAI Guidance Note (ICAI GN) issued in July 2017 on format of FS for Ind-AS compliant companies under CA 2013	28 July 2021	Instruments entirely equity in nature	Instruments classified as Instruments entirely equity in nature (IEEN)	All convertible instruments issued by the company are in the nature of IEEN.

- In the tax return, the Taxpayer computed book profit for MAT purposes without including the amount of debentures in "transition amount". The assessing Tax Authority[8] accepted this treatment in original assessment proceedings.
- However, the superior Tax Authority[9] invoked revision proceedings on the ground that there was an error committed by the assessing Tax Authority which was prejudicial to the Revenue. In the course of such revision proceedings, the superior Tax Authority disputed the Taxpayer's classification of these debentures as IEEN in the re-casted FS. According to the Tax Authority, since the holder had an option to convert these debentures into equity shares, the debentures were compound financial instruments (having both liability component and equity component) and not pure equity. Therefore, the Tax Authority held that, under Ind-AS, these debentures were classifiable under the head "Other Equity" and sub-head of ECCFI (as classified by the Taxpayer itself, in the original and revised FS above). Under the Ind-AS MAT framework, residual adjustments to "Other Equity" form a part of "transition amount", and one-fifth thereof was required to be added to book profit of TY 2016-17.
- Aggrieved, the Taxpayer appealed to the Tribunal on the following issues:
    - Whether, based on terms of the instruments, OCDs and FCDs were compound financial instruments or purely equity? If purely equity, whether they could be included in "Other Equity" to form part of "transition amount" liable to MAT over five years?
    - Whether the amount of debentures, being capital receipts, were taxable under MAT provisions?

Tribunal's ruling

Whether, based on present terms of the instruments, OCDs and FCDs were compound financial instruments or IEEN? If purely equity, whether they could be included in "Other Equity" to form part of "transition amount" liable to MAT over five years?

The Tribunal ruled in favor of the Taxpayer and held as follows:

- CA 2013 requires FS to (a) give a true and fair value of company's state of affairs, (b) comply with notified Ind-AS, and (c) be drawn as per format specified under CA 2013. The said format specifies the components of "Other Equity", which *inter alia* includes ECCFI. The ECCFI requires the instrument to be in the nature of compound financial instrument. The issue in present case was, whether debentures could be classified as ECCFI?
- A compound financial instrument has both liability component and equity component – and it is the equity component which is treated as part of "transition amount". The liability component is the net present value of aggregate future payments of principal and interest, and the residual after deducting liability component from the amount of debentures issued represents equity component. However, in absence of liability component, there cannot be a compound financial instrument. A liability component can arise only if either of the following conditions are satisfied, namely, (1) there should be a contractual obligation on the issuer to settle by paying cash (or delivering any other financial asset), or (2) the issuer can settle by exchanging a variable number of the issuer's own equity shares. On the other hand, a financial instrument is an equity instrument only if both the aforesaid conditions are not satisfied.
- In the present case, since the issuer (i.e., Taxpayer) could unilaterally convert debentures into fixed number of equity shares, there was no contractual obligation on the issuer to pay cash, and hence, there was no liability component. Furthermore, there was no obligation to redeem the debentures unless mutually agreed between Taxpayer and holder of instrument. Merely because subsequently the redemption happened with mutual consent would not change the characterization on the date of issue/convergence date. The Taxpayer had also not paid any interest or premium on redemption, which also supports absence of liability component. Accordingly, debentures were not classifiable as compound financial instrument (or ECCFI) under Ind-AS, albeit they were classifiable as IEEN as per ICAI GN. The full amount (INR 100, in the above illustration) was equity in nature. In such case, there will also be no debit of notional finance cost (INR 30, in the above illustration) to P&L towards unwinding of liability component.

Whether issue proceeds of debentures, being capital receipts, were taxable under MAT provisions?

The Tribunal agreed with Taxpayer's contentions and held as follows:

- The nomenclature "transition amount" presupposes that the adjustments in "Other Equity" would have otherwise impacted P&L – and their inclusion in book profit as "transition amount" avoids distortion to book profit due to transition from IGAAP to Ind-AS. (In terms of illustration considered earlier, INR 30 is included in "transition amount" to be included in book profit over five years since the same amount is subsequently debited to P&L over balance tenure of the instrument as notional finance cost which reduces the book profit)
- Merely because the debentures were initially classified as ECCFI under the head "Other Equity", would not automatically result in inclusion in

[8] Assessing Officer

[9] Commissioner of Income tax (CIT)

"transition amount". For inclusion in "transition amount", the amount should be in the nature of reserves or income; and should never be in the nature of a capital liability already recognized in the Balance Sheet under IGAAP before convergence. The definition of "transition amount" under ITL itself excludes capital reserve and securities premium, though they are part of "Other Equity", since they are of capital nature and earmarked for specific purposes under CA 2013. FAQ 7 of CBDT's Circular also supports that an already recognized capital liability (in the nature of share application money pending allotment) cannot be included in "transition amount".

Comments

Mumbai Tribunal's decision is the first welcome ruling on treatment of adjustments in "Other Equity" on convergence to Ind-AS under the Ind-AS MAT framework. The Tribunal held that, in the facts of the Taxpayer's case, since the debentures did not have any liability component, they were not compound financial instruments, and hence, there could not be any adjustment to "Other Equity" to warrant inclusion in "transition amount".

The Tribunal ruling reinforces the intent of the Ind-AS MAT framework for convergence date adjustments by way of inclusion in "transition amount" spread over five years. Such adjustment is warranted for items which have an impact on P&L in subsequent years and hence capable of distorting the book profit of subsequent years. The adjustment is not required for items which have no such impact in subsequent years.

The Tribunal ruling also highlights the significance of analysis of the terms and conditions of financial instruments and consequential classification under Ind-AS as liability, equity or compound financial instrument based on relevant Ind-AS definitions.

Incidentally, due to introduction of concessional tax regime (CTR) for corporates in 2019, Indian companies opting for CTR by foregoing specified deductions and exemptions are not liable to MAT. On opting for CTR, apart from other carried forward allowances relatable to specified deductions and exemptions, such companies have to also forfeit MAT credit. Hence, the issue dealt in the present ruling is more likely to be relevant to past tax years when Indian companies converged to Ind-AS in different phases.

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