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

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

IT(TP)A No.191/Bang/2022
Assessment Year : 2017-18

M/s. TE Connectivity Services India Private Limited, 59/2, 1st Floor, Gurudas Heritage, Block-B, 100 Feet Ring Road, Banashankari 2nd Stage, Bengaluru – 560 070. **PAN: AAFCT 3474 R**	Vs.	National Faceless Assessment Centre, Delhi.
APPELLANT		RESPONDENT

Assessee by	:	Shri. Sriram Seshadri, CA
Revenue by	:	Dr. Manjunath Karkihalli, CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	14.09.2022
Date of Pronouncement	:	16.09.2022

O R D E R

Per N. V. Vasudevan, Vice President :

This is an appeal by the assessee against the final Order of Assessment dated 27.01.2022 passed by the National Faceless Assessment Centre, Delhi, under section 143(3) r.w.s. 144C(13) read with section 144B of the Income Tax Act, 1961 (hereinafter called 'the Act'), relating to Assessment Year 2017-18.

2. Ground No.1 raised by the assessee is general in nature and calls for no adjudication. Ground No. 2 raised by the assessee relates to the addition made to the total income of the assessee on account of determination of

Arm's Length Price (ALP) in respect of an international transaction entered into by the assessee with its Associated Enterprise (AE). The assessee has also raised additional ground No.14 which is nothing but a facet of the argument of the assessee in connection with the determination of ALP viz., companies with high turnover cannot be taken as a comparable company for comparing profit margins of the assessee. The specific contention in this regard is that the lower authorities erred in not applying an upper limit of turnover upto INR 200 crores for selection of comparable companies for benchmarking. At the time of hearing, learned Counsel for the assessee submitted that if some of the comparable companies that remain after the order of the Dispute Resolution Panel (DRP) are excluded then he would not press for adjudication of other grounds with regard to determination of Arm's Length Price. Accordingly, we proceed to decide the issue with regard to determination of ALP.

3. The factual details with regard to the determination of ALP are that the assessee was incorporated on May 18, 2015, as a wholly owned subsidiary of Tyco Electronics Singapore Pte Ltd, Singapore, which is ultimately held by TE Connectivity Ltd., Switzerland. The assessee is a captive service provider and is engaged, inter-alia, in the business of providing shared services in the areas of Information Technology, Finance back-office, Human Resource, customer support, etc. to the TE Group entities across the globe i.e., Information Technology enabled Services [ITeS].

4. Since the aforesaid transaction of rendering of ITeS was an international transaction, income from the aforesaid transaction has to be determined having regard to the ALP as laid down in section 92 of the Act.

In support of the assessee's claim that the price it received from its AE for rendering ITeS was at ALP, the assessee filed transfer pricing analysis choosing Transactional Net Margin Method (TNMM) as the most appropriate method for determining ALP. The operating margin of the assessee as computed in the TP study and as computed by the Transfer Pricing Officer (TPO) in his order was as follows:

(All amounts in INR Crores)

Particulars	**Appellant**	**TPO**
Operating Revenue (A)	**64.45**	**64.54**
Operating Cost	54.37	57.64
Less: Bank Charges	-	0.0089
Less: CSR	-	0.0207
Less: Finance cost	-	1.56
Revised operating cost (B)	**54.37**	**56.07**
Operating Profit (A -B)	**10.08**	**8.37**
OP/TC	**18.54%**	**14.92%**

5. There is no dispute that the Profit Level Indicator (PLI) chosen for the purpose of comparison was operating profit on total cost i.e., OP/OC. The assessee chose 11 comparable companies and the median of the profit margin of those comparable companies was 10.89%. The assessee therefore claimed that the profit margin of the assessee was comparable with that of the comparable companies and therefore the price received in the international transaction has to be regarded as at arm's length.

6. The Transfer Pricing Officer (TPO) to whom the AO made a reference for determination of ALP u/s.92CA of the Act, did not accept the

TP study of the assessee. The TPO chose 13 comparable companies and the median profit margins of those companies was 24.37% as per the following details:

Sl. No.	Name of the Company	Weighted Avg. OP/TC* (%)
1.	Sundaram Business Services Ltd	2.08
2.	Jindal Intellicom Ltd	7.41
3.	Fuzen Software Pvt Ltd	15.93
4.	Microland Ltd	17.53
5.	Tech Mahindra Business Services Ltd	22.37
6.	Datamatics Business Solutions Ltd	22.64
7.	Infosys BPM Services Ltd	24.37
8.	Vitae International Accounting Services Pvt Ltd	27.13
9.	Manipal Digital Systems Pvt Ltd	27.41
10.	CES Ltd	29.00
11.	Ultramarine & Pigment Ltd	34.41
12.	SPI Technologies India Pvt Ltd	36.95
13.	Inteq BPO Services Pvt Ltd	39.51
	35th Percentile	**22.37%**
	Median	**24.37%**
	65th Percentile	**27.41%**

** Not adjusted for working capital differences*

7. Based on the aforesaid comparable companies and their median profit martin, the TPO computed the ALP of the international transaction as follows:

> *"20.4.1 The median of the weighted average Profit Level Indicators is taken as the A Length margin. Please see Annexure-A for details of computation of PLI of the comparabl Based on this, the Arm's Length Price of the services rendered by the Taxpayer to its A is computed as under:*

ITeS SEGMENT		
Particulars	*Formula*	*Amount (in Rs.)*
Taxpayers operating revenue	*OR*	*64,45,04,000*
Taxpayers operating cost	*OC*	*56,07.00,000*
Taxpayers operating profit	*OP*	*8,37,04,000*
Taxpayers PLI	*PLI=OP/OC*	*14.92%*
35th Percentile Margin of comparable set		*Yes*
Adjustment Required (if PLI< 35th Percentile)		*22.37%*
Median Margin of comparable set	*M*	*24.37*
Arm's Length Price	*ALP=(1+M) OC*	*69,73,42,590*
Price Received	*OR*	*64.45.04.000*
Shortfall being adjustment	*ALP-OR*	*5,28,38,590*

20.4.2 The above shortfall of Rs.5,28,38,590/- is treated as transfer pricing adjustment u/s 92CA in respect of IT enabled servicesegment of the taxpayer's international transactions."

8. The AO passed a Draft Assessment Order wherein he incorporated the addition suggested by the TPO of Rs.5,28,38,590/- on account of determination of ALP. The assessee filed objections before the DRP against the Draft Order of Assessment. The DRP gave the following directions :

i. Consider bank charges as operating in nature while computing the Profit Level Indicator ('PLI') margin of the comparables;

ii. *Verify margin computation of the following comparable companies, namely, Sundaram Business Services Limited, Fuzen Software Private Limited, Vitae International Accounting Services Private Limited and Manipal Digital Systems Private Limited;*
iii. *Include Crystalvoxx Ltd and Suprawin Technologies Limited in the set of comparable companies used for benchmarking analysis; and*
iv. *Exclude Ultramarine and Pigment Limited in the set of comparable companies used for benchmarking analysis.*

9. Consequent to the directions of the DRP, the AO passed the final Order of Assessment whereby the addition as made in the draft Assessment Order was retained.

10. Aggrieved by the final Order of Assessment, the assessee has preferred the present appeal before the Tribunal raising the ground which we have already set out in the earlier paragraphs. At the time of hearing, learned Counsel for the assessee submitted that the assessee's turnover was only a sum of Rs.64,45,04,000/-. It was submitted by him that the following 3 comparable companies viz., Tech Mahindra Business Services Ltd., Infosys BPM Services Pvt. Ltd., and SPI Technologies India Pvt. Ltd., has a turnover of more than Rs.200 Crores. It was submitted by him that this Tribunal has been taking a consistent stand that companies whose turnover is less than 200 Crores cannot be compared with companies whose turnover is more than 200 Crores. In this regard, our attention was drawn to decision of the ITAT, Bengaluru Bench, in assessee's own case for Assessment Year 2016-17 in IT(TP)A No.300/Bang/2021, order dated 26.05.2022, wherein this Tribunal took the view that companies having a turnover of less than Rs.200 Crores cannot be compared with companies having a turnover of more than 200 Crores. He also highlighted the fact

that the TPO applied a filter of excluding companies whose turnover was less than one Crore but by the same logic should have applied to the upper turnover filter also which he failed to do. Learned DR submitted that high turnover cannot be criteria to reject a company as a comparable company, if the said company is functionally comparable.

11. We have considered the rival submissions. On the issue of application of turnover filter, we have heard the rival submissions. The parties relied on several decisions rendered on the above issue by the various decisions of the ITAT Bangalore Benches in favour of the assessee and in favour of the Revenue, respectively. The ITAT Bangalore Bench in the case of Dell International Services India (P) Ltd. Vs. DCIT (2018) 89 Taxmann.com 44 (Bang-Trib) order dated 13.10.2017, took note of the decision of the ITAT Bangalore Bench in the case of *Sysarris Software Pvt. Ltd. Vs. DCIT (2016) 67 Taxmann.com 243 (Bangalore-Trib)* wherein the Tribunal after noticing the decision of the Hon'ble Delhi High Court in the case of *Chryscapital (supra)* and the decision to the contrary in the case of *CIT Vs. Pentair Water India Pvt. Ltd., Tax Appeal No.18 of 2015 dated 16.9.2015* wherein it was held that high turnover is a ground to exclude a company from the list of comparable companies in determining ALP, held that there were contrary views on the issue and hence the view favourable to the assessee laid down in the case of *Pentair Water (supra)* should be adopted. The following were the conclusions of the Tribunal in the case of Dell International (supra):

> *"41. We have given a very careful consideration to the rival submissions. ITAT Bangalore Bench in the case of Genesis Integrating Systems (India) Pvt. Ltd. v. DCIT, ITA No.1231/Bang/2010, relying on Dun and Bradstreet's analysis, held*

grouping of companies having turnover of Rs. 1 crore to Rs.200 crores as comparable with each other was held to be proper. The following relevant observations were brought to our notice:-

> *"9. Having heard both the parties and having considered the rival contentions and also the judicial precedents on the issue, we find that the TPO himself has rejected the companies which .ire (sic) making losses as comparables. This shows that there is a limit for the lower end for identifying the comparables. In such a situation, we are unable to understand as to why there should not be an upper limit also. What should be upper limit is another factor to be considered. We agree with the contention of the learned counsel for the assessee that the size matters in business. A big company would be in a position to bargain the price and also attract more customers. It would also have a broad base of skilled employees who are able to give better output. A small company may not have these benefits and therefore, the turnover also would come down reducing profit margin. Thus, as held by the various benches of the Tribunal, when companies which arc loss making are excluded from comparables, then the super profit making companies should also be excluded. For the purpose of classification of companies on the basis of net sales or turnover, we find that a reasonable classification has to be made. Dun & Bradstreet & Bradstreet and NASSCOM have given different ranges. Taking the Indian scenario into consideration, we feel that the classification made by Dun & Bradstreet is more suitable and reasonable. In view of the same, we hold that the turnover filter is very important and the companies having a turnover of Rs.1.00 crore to 200 crores have to be taken as a particular range and the assessee being in that range having turnover of 8.15 crores, the companies which also have turnover of 1.00 to 200.00 crores only should be taken into consideration for the purpose of making TP study."*

42. The Assessee's turnover was around Rs.110 Crores. Therefore the action of the CIT(A) in directing TPO to exclude companies

having turnover of more than Rs.200 crores as not comparable with the Assessee was justified. As rightly pointed out by the learned counsel for the Assessee, there are two views expressed by two Hon'ble High Courts of Bombay and Delhi and both are non-jurisdictional High Courts. The view expressed by the Bombay High Court is in favour of the Assessee and therefore following the said view, the action of the CIT(A) excluding companies with turnover of above Rs.200 crores from the list of comparable companies is held to correct and such action does not call for any interference."

12. The Tribunal in the case of Autodesk India Pvt. Ltd. Vs. DCIT (2018) 96 Taxmann.com 263 (Banglore-Tribunal), took note of all the conflicting decision on the issue and rendered its decision and in paragraph 17.7. of the decision held as that high turnover is a ground for excluding companies as not comparable with a company that has low turnover. The following were the relevant observations:

"17.7. We have considered the rival submissions. The substantial question of law (Question No.1 to 3) which was framed by the Hon'ble Delhi High Court in the case of Chryscapital Investment Advisors (India) Pvt.Ltd., (supra) was as to whether comparable can be rejected on the ground that they have exceptionally high profit margins or fluctuation profit margins, as compared to the Assessee in transfer pricing analysis. Therefore as rightly submitted by the learned counsel for the Assessee the observations of the Hon'ble High Court, in so far as it refers to turnover, were in the nature of obiter dictum. Judicial discipline requires that the Tribunal should follow the decision of a non-jurisdiction High Court, even though the said decision is of a non-jurisdictional High Court. We however find that the Hon'ble Bombay High Court in the case of CIT Vs. Pentair Water India Pvt.Ltd. Tax Appeal No.18 of 2015 judgment dated 16.9.2015 has taken the view that turnover is a relevant criterion for choosing companies as comparable companies in determination of ALP in transfer pricing cases. There is no decision of the jurisdictional High Court on this issue. In the circumstances, following the principle that where two views are available on an issue, the view favourable to the Assessee has to be adopted, we respectfully follow the view of the

Hon'ble Bombay High Court on the issue. Respectfully following the aforesaid decision, we uphold the order of the DRP excluding 5 companies from the list of comparable companies chosen by the TPO on the basis that the 5 companies turnover was much higher compared to that the Assessee.

17.8. In view of the above conclusion, there may not be any necessity to examine as to whether the decision rendered in the case of Genisys Integrating (supra) by the ITAT Bangalore Bench should continue to be followed. Since arguments were advanced on the correctness of the decisions rendered by the ITAT Mumbai and Bangalore Benches taking a view contrary to that taken in the case of Genisys Integrating (supra), we proceed to examine the said issue also. On this issue, the first aspect which we notice is that the decision rendered in the case of Genisys Integrating (supra) was the earliest decision rendered on the issue of comparability of companies on the basis of turnover in Transfer Pricing cases. The decision was rendered as early as 5.8.2011. The decisions rendered by the ITAT Mumbai Benches cited by the learned DR before us in the case of Willis Processing Services (supra) and Capegemini India Pvt.Ltd. (supra) are to be regarded as per incurium as these decisions ignore a binding co-ordinate bench decision. In this regard the decisions referred to by the learned counsel for the Assessee supports the plea of the learned counsel for the Assessee. The decisions rendered in the case of M/S.NTT Data (supra), Societe Generale Global Solutions (supra) and LSI Technologies (supra) were rendered later in point of time. Those decisions follow the ratio laid down in Willis Processing Services (supra) and have to be regarded as per incurium. These three decisions also place reliance on the decision of the Hon'ble Delhi High Court in the case of Chriscapital Investment (supra). We have already held that the decision rendered in the case of Chriscapital Investment (supra) is obiter dicta and that the ratio decidendi laid down by the Hon'ble Bombay High Court in the case of Pentair (supra) which is favourable to the Assessee has to be followed. Therefore, the decisions cited by the learned DR before us cannot be the basis to hold that high turnover is not relevant criteria for deciding on comparability of companies in determination of ALP under the Transfer Pricing regulations under the Act. For the reasons given above, we uphold the order of the CIT(A) on the issue of application of turnover filter and his action in excluding companies by

following the ratio laid down in the case of Genisys Integrating (supra).”

13. In view of the aforesaid discussion, we hold that the following 3 companies whose turnover is more than Rs.200 Crores as listed in the chart below should be excluded from the list of the comparable companies.

(Amounts in INR Crores)

S.No.	Company	Turnover
1.	Tech Mahindra Business Services Ltd.	707.60
2.	Infosys BPM Ltd.	2,940
3.	SPI Technologies India Pvt Ltd.	397.65

14. The learned Counsel for the assessee submitted that if the aforesaid 3 companies are included, the assessee’s profit margin would be at arm’s length and therefore no other ground needs to be adjudicated. We, therefore, direct the TPO to compute the ALP of the international transaction as per the directions in this order, after affording the assessee opportunity of being heard.

15. We shall now deal with other additions to the total income of the assessee that are challenged by the assessee in this appeal. Ground No.10 raised by the assessee reads as follows:

10. Notional interest income on CCD liability recognized in the statement of profit and loss as per IndAS

- *That on the facts and circumstances of the case, the Learned AO / DRP have erred in equating the CCD issued with equity and thereby denying deduction of interest payment.*

- *That on the facts and circumstances of the case, the Learned AO / DRP have erred in rejecting the deduction of interest expenditure amounting to INR 4,53,11,205 which was not charged to profit and loss by adopting Ind AS 109 notified under the Companies (Indian Accounting Standards) Rules, 2015. In holding so, learned AO has erroneously disregarded (a) the fact that an amount of INR 4,53,11,205 has actually been paid out as interest expenditure after duly deducting tax at source thereon; (b) real income theory and (c) the principle that accounting treatment is not decisive for tax treatment.*

- *The Learned AO has erred in rejecting the interest expense claimed in the computation of income, considering it as an actual interest income in the hands of the Company. In holding so, the learned AO has ignored the fact that CCD is a liability for the Company and hence, there cannot be any interest income arising out of the same in the hands of the Company*

16. The factual details in so far as the aforesaid ground of appeal is concerned are that during the Assessment Year 2016-17, the assesee issued 6,50,00,000 Compulsory Convertible Debentures (CCD) of Rs.10/- each to TE Connectivity, Singapore, by way of rights issue. The CCDs are subject to a simple interest of 3 months MIBOR+ 150 Basis points, capped to 9.75% per annum. For the year under consideration, the assessee submitted that the average interest rate is 9%. During the F.Y.2015-16, the assessee incurred interest expense of Rs 4,52,61,650/- and the same was charged to the P/L Account and claimed as deduction which was allowed by the AO. The interest payable during the Year 2016-17 on these CCDs was Rs 6,09,40,660/-. Out of the said interest payable on CCD's, the assessee debited to the profit and Loss Account only a sum of Rs 1,56,29,455/- and the remaining sum of Rs 4,53,11,205 was shown in the Balance Sheet by way of reducing the same from the outstanding

amount on CCDs. Since the sum of Rs.4,53,11,205 was not debited to the profit and loss account, this sum was claimed as deduction in the computation of total income while computing income from business. The assessee explained before the AO that the entire sum of Rs.6,09,40,660/- was deductible interest expenditure and has to be allowed as deduction and the accounting treatment adopted by the assessee was in compliance with the Indian Accounting Standards(IndAS) and that will not be a bar to claim deduction of an expenditure which is otherwise to be allowed as deduction in law. The assessee pointed out that CCDs are recognized as debt instruments and the payouts were treated as interest payments duly eligible as deduction as interest expense. However IndAS 109 read with IndAS 32 and 107 prescribe a fair value accounting for the CCDs. The accounting Methodology prescribed by these accounting standards is that the total interest outflows over the tenure of the debt period of the CCD (period before conversion) will be ascertained. A discounting factor will be determined based on the interest prevailing on the Non convertible debt instruments. The present value of the interest outflows will be arrived at by using the said discounting factor. This amount of the present value will be recognized as the debt incurred by issuing the CCDs. The remaining portion of the liability incurred by issuing the CCDs will be recognized as the equity component of the debt Instrument. So the total interest payable in the CCD will be split into two components. An amount will be computed by applying the Pure debt interest rate (PDIR) on the debt component of the instrument which is recognized as the interest expenditure in the P&L Account. The remaining amount of the

liability will be debited to the debt component of the CCD instrument disclosed in the Balance sheet by reducing the outstanding amount. -

The assessee worked out the two components as under:

Interest expense(by applying PDIR on Debt component)	Dr. 1,56,29.455/-
Debt Component of the CCD instrument	Dr. 4,53,11,205/-
Interest Payable (actual interest incurred during the year)	Cr 6,09,40,650/-

17. The assessee pointed out that as the amount charged to the P&L Account was a lower sum, the remaining amount of Rs 4,53,11,205/- was claimed as deduction by the assessee as a separate it item in its computation of income. The assessee submitted CCDs constitute debt instruments and the interest payable **thereon is a deductible** expenditure till the same is converted into equity. The assessee **relied on the decisions** rendered in M/s CAE Flight Training India Pvt Ltd by ITAT **Bangalore and Zaheer** Mauritius Vs DIT, 270 CTR 244, Delhi High Court.

18. However, the AO allowed a deduction of Rs 1,56,29,445/- only and the balance amount of Rs 4,53,11,205 was denied the deduction. The DRP upheld the order of the AO on the reasoning that under Section 36(1)(iii) of the Act, deduction is allowed only for amounts borrowed for business purposes and since CCD's are in the nature of Equity, no deduction is permissible for return paid on equity instruments. According to the DRP, as per Thin Capitalization Rules, debt instruments can be

treated as equity. The DRP also observed that RBI treated the CCDs as Equity under the Foreign Direct Investment (FDI) policy. The RBI's FDI Policy was guided by the requirement to control future repatriation obligations of the country in convertible foreign currency. Since in the case of CCDs, there is repatriation obligation in foreign currency, as the debentures would at a defined time be converted into equity, the same is being treated as equity by the RBI for the purposes of FDI policy. On the reliance by the assessee on the decision of the ITAT Bangalore Bench in the case of CAE Flight Training (supra), the DRP distinguished the said decision by pointing out that the facts in the aforesaid case were that the CCD holders prior to conversion into equity shares did not have voting rights and dividend pay out. Hence in that case, the Tribunal concluded that CCDs cannot be treated as equity under the Act. The DRP went on further to explain that CCDs, as the name suggests, are debentures which are to be compulsorily converted into equity after a certain time period. That is, CCDs are hybrid instruments, being debt at the time of issue along with a certainty to get converted into equity. Being of such nature, the guidelines on Foreign Direct Investment (`FDI') treat CCDs as equity for the purposes of reporting to the Reserve Bank of India (`RBI'). The DRP went on to analyse whether CCDs would be regarded as equity capital under all other laws as well. The DRP made reference to Section 2(30) of the Companies Act, 2013 (`Comp. Act') which defines a 'debenture' to include debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not, which makes it clear that a debenture is a debt instrument for the company. The DRP referred to Section 71 of the Companies Act which lays down that a company can issue debentures

with an option to convert such debentures into shares but such issue has to be approved by a special resolution passed at a General meeting of shareholders. According to the DRP, the fact that the Company Act deals with convertible debentures in the provisions relating to debentures, indicates that the statute seeks to regulate CCDs as debentures. The DRP then made a reference to Section 129 of companies Act (Financial Statement) read with Schedule III (General Instructions for Preparation of Balance Sheet and Statement of Profit and Loss of a Company) which requires to inter alia provide appropriate disclosures with respect to debentures and the rate of interest and particulars of conversion thereof. The DRP also made a reference to investment by a non-resident in an Indian Company, in any form, which is regulated by the Foreign Exchange Management Act, 1999 read with Foreign Exchange Management (Transfer or Issue of a Security by a Person Resident outside India) Regulations, 2017 (FEMA Regulations'). The regulations prescribe the manner, limit, period, etc. of such investments. In other words, investment by a non-resident in a manner not prescribed, or in excess of the limits, etc. cannot be made in an Indian Company. Regulation 2(xviii) defines 'Foreign Investment' to mean any investment made by a person resident outside India on a repatriable basis in 'capital instruments' of an Indian company or to the capital of an LLP. 'Capital instruments' have been defined under Regulation 2(v) to mean equity shares, 'debentures', preference shares and share warrants issued by an Indian company. The Explanation further provides that the expression 'Debentures' means fully, compulsorily and mandatorily convertible debentures. Thus, the CCDs, which are fully and mandatorily convertible into equity, are considered as 'capital instruments' being at par with

equity shares. Accordingly, investment in the CCDs by a non-resident would be subject to sectoral caps or the investment limits for equity investments. As fully, compulsorily and mandatorily convertible debentures alone are regarded as capital instruments, optionally convertible or partially convertible debentures are treated as debt instruments under the FEMA Regulations. These rules which do not fall within the ambit of 'capital instruments' would have to conform to the guidelines on External Commercial Borrowings, i.e. Foreign Exchange Management (Borrowing and Lending in Foreign Exchange) Regulations, 2000. The DRP therefore concluded that compulsorily convertible Debentures are to be regarded as equity rather than debt. The DRP went on to hold that even under the Act, compulsorily convertible debentures have to be regarded as equity rather than debt. The DRP went on to examine as to why the companies prefer debentures rather than equity. It went on to observe that a company may prefer to raise capital through a debt instrument (debenture) over equity. Firstly, a debt instrument does not dilute the ownership proportion of existing shareholders, secondly, a debt instrument does not carry voting rights and therefore, there is no interference in the management of the company and lastly, interest, unlike dividends, is generally allowed as deduction from the taxable profits of the company. Section 36(1)(iii) of the Income-tax Act, 1961 (`IT Act') provides for deduction of interest paid in respect of capital borrowed by a tax payer for its business. That is, if CCDs are treated as capital 'borrowed' for the purposes of the Act, then the interest paid thereon shall be allowable as deduction, whereas if the same is treated as 'equity', no deduction would be permissible for return paid on equity investment.

19. The DRP thereafter went on to justify as to why the revenue prefers re-characterise CCDs as equity and the disallowance of the interest expenditure claimed thereof. The DRP observed that RBI has treated the CCDs as equity under FDI Policy. In the case of assessee, CCDs are equity and not debt. No independent/ un-related party would subscribe to the CCDs of the assessee. It is an investment in equity and not debt. The investment by the AE with the assessee by subscription of CCD is not payable back to the AE, as the amount invested gets compulsorily converted into equity in the due course. When the amount invested is not repaid/ repayable, it loses the character of a debt. In the debt instruments like short term/ long term loans there is an agreement, contractual understanding between the lender and receiver of the funds on a legal terms and conditions for the interest payments. The DRP gave examples like banking interest rates regulated by RBI, LIBOR (London Inter Bank Offer Rate) are bench mark interest rates for many adjustable-rate mortgages, business loans, and financial instruments traded on Global Financial Markets. In the case of assessee in the third-party scenario, no independent entity would lend any funds to the company, if the debt equity ratio is highly skewed as it makes the investment debt very risky. In CCDs the principal amount is never received back as entire funds are converted into Equity. Therefore, once the conversion option is exercised, it becomes an equity investment. Since the conversion is compulsory, it shall be treated as equity rather than debt. As the CCDs are hybrid instruments, they do not come under ECB guidelines and hence they are to be treated as equity. For the above reasons, the DRP upheld the action of treating CCDs as equity.

The DRP also held that the case laws relied by the assessee are different in facts and law and are not applicable in the present case.

20. Aggrieved by the directions of the DRP, assessee has preferred ground No.10 before the Tribunal.

21. We have heard the rival submissions. Learned Counsel for the assessee reiterated submissions made before the revenue authorities. It was submitted that it has been judicially a well settled proposition that CCDs constitute debt and interest payable thereon is a deductible expenditure till the time the same are converted into equity. In this regard, reliance was placed on the decision of the Coordinate Bench of this Tribunal for A.Ys. 2009-10 to 2013-14 in the case of M/s. CAE Flight Training (India) Pvt. Ltd. in ITA No. 2006/Bang/2017, IT(TP)A Nos. 63 & 84/Bang/2015, 599, 2060 & 2178/Bang/2016 & C.O. Nos. 83/Bang/2017 & 09/Bang/2018 by order dated 25/07/2019. Besides the above, reliance was also placed on the following decisions laying down proposition that a debt can never be characterized as equity/capital viz., Embassy One Developers Pvt. Ltd., ITA No.2239 & 2240/Bang/2018 order dated 26.11.2020 and IMS Health Analytics Services Pvt. Ltd. ITA No.1549/Bang/2019 order dated 19.6.2020. It was submitted that the law is well settled that income tax is leviable on real income. Real income can be ascertained by deducting real expenditure. It was reiterated that the real expenditure was INR 6.09 Crores and not merely INR 1.56 Crores, the former has to be allowed as a deduction irrespective of the fact that the amount charged to P&L is only INR 1.56 Crores. It was submitted that accounting entries are not determinative for tax liability and only real income can be taxed. Reference was made to the decision of the Hon'ble Supreme Court in the case of **Kedarnath Jute Mfg. Co. Ltd. 82 ITR 363 (SC)**, wherein it was held that, the way in which entries are made

by an assessee in his books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss. For the proposition only real income is taxable, the learned counsel for the assessee relied on the decision of Hon'ble Supreme Court in the case of **Shoorji Vallabhdas & Co. 46 ITR 144 (SC),** wherein the Hon'ble Court held that if income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a hypothetical income, which does not materialise. It was submitted that the assessee is entitled to deduction of entire amount of interest expense being INR 6.11 Crores. The learned DR reiterated the stand of the DRP and the reasoning given by the DRP.

22. We have carefully considered the rival submissions. The first aspect which needs to be considered is as to whether the revenue authorities were justified in treating the CCDs as Equity and disallowing claim for deduction of interest paid on CCD's. We are of the view that CCDs till such time they are converted into equity are in the nature of loans and therefore any interest paid on borrowings for the purpose of business has to be allowed as a deduction u/s. 36(1)(iii) of the Act. In this regard, we find that the ITAT Bangalore 'A' Bench in the case of ACIT v. M/s. CAE Flight Training (I) Pvt. Ltd. in IT(TP)A No.2060/Bang/2016 dated 25.7.2017 has exhaustively dealt with the issue and addressed all the issues raised by the DRP in it's directions. The DRP has disregarded the said decision on the ground that facts in the aforesaid case were that the CCD holders prior to conversion into equity shares did not have voting rights and dividend payout. From the offer letter dated 26.6.2015 copy of which is at page 358 of the assessee's paper book it is clear that the CCD in the case of the Assessee did not have voting rights prior to its conversion into equity nor were dividend payable on the CCD's and only interest at 9.75% p.a was

payable. Therefore the very basis on which the DRP distinguished the decision in the case of CAE Flight Training (supra) is unsustainable. The issue for consideration in the aforesaid case of CAE Flight Training (supra)decided by the Bangalore Bench was with regard to the interest paid on CCDs. The contention of the revenue was that though the nomenclature CCD is used, yet they are in the nature of equity. The revenue sought to raise the above contention on the basis of the Thin Capitalisation rule which was not applicable for the assessment year which was under consideration before the Tribunal. Even for the present appeal which relates to AY 2017-18, thing capitalization rules laid down in Sec.94B of the Act are not applicable and those provisions are applicable only from 1.4.2018 i.e., from AY 2018-19 onwards. The Tribunal firstly held in the case of CAE Flight Training (I) Pvt. Ltd. (supra) that Thin Capitalisation principle was not applicable till such time those principles were recognised by way of statutory provisions. Thereafter, the Tribunal examined whether the question, interest paid on CCDs should be allowed as a deduction. The Tribunal held as follows:-

> "23. As per above paras of this tribunal order, it comes out that even if Thin capitalization Principle is on Statute book of the other country, no disallowance can be made in India by applying this Principle. To this extent, we uphold the finding of CIT (A) by respectfully following this tribunal order. But the issue still remains because, the objections of AO/TPO are not merely on the basis of Thin capitalization Principle. Their basic objection is this that since the interest is paid on CCDs, this is not an interest on debt but on equity and hence, not allowable. On page 11 of his order for A. Y. 2009 - 10, the TPO has reproduced certain comments of RBI in 2007 Policy on convertible debentures in which it is stated that fully and mandatorily convertible debentures into equity within a specified time would be reckoned as equity under FDI policy. In view of this

RBI Policy, the TPO concluded that these CCDs are equity and not debt and therefore, interest on it is not allowable u/s 36 (1) (iii). This finding of TPO is not by invoking Thin Capitalisation principle and therefore, it has to be decided independently. We find that the decision of TPO is bases on RBI policy of FDI. We all know that RBI policy of FDI is governed by this that what will be future repayment obligation in convertible foreign currency and since, CCDs does not have any repayment obligation, the same was considered by RBI as equity for FDI policy. Now the question is that such treatment given by RBI for FDI policy can be applied in every aspect of CCDs. Whether the holder of CCDs before ins conversion can have voting rights? Whether dividend can be paid on CCDs before its conversion? In our considered opinion, the reply to these questions is a BIG NO. On the same logic, in our considered opinion, till the date of conversion, for allowability of interest u/s 36 (1) (iii) of Income tax Act also, such CCDs are to be considered as Debt only and interest thereon has to be allowed and it cannot be disallowed by saying that CCDs are equity and not debt. We hold accordingly. This issue is decided.

24. After examining the applicability of the Tribunal order rendered in the case of Besix Kier Dabhol, SA vs. DDIT (supra), we now examine the applicability of the decision of Special Bench of the Tribunal rendered in the case of Ashima Syntex Ltd. Vs. ACIT as reported in 100 ITD 247 (Ahd.) (SB) on which reliance has been placed by ld. DR of revenue in the written submissions filed by him as reproduced above. From the facts noted by the Tribunal in this case, it is seen that in that case the assessee issued convertible debentures for subscription at the rate of Rs. 75 per debenture and these were in two parts; Part-A of Rs. 35 to be compulsorily converted into one equity share of the face value of Rs. 10 each at a premium of Rs. 25 per share on the date of allotment of the debenture and Part-B of Rs. 40 to be compulsorily converted into one equity share of the face value of Rs. 10 each at a premium of Rs. 30 per share on the expiry of 15 months from the date of allotment of the debenture. Part-B debenture was to carry an interest at the rate of Rs. 14 per annum till the date of conversion payable half yearly on 30th June and 31st December each year and on conversion. The issue in dispute in that case was regarding the allowability of expenses incurred on issue of such debentures and the issue in that case was not

of interest on debentures before its conversion as in the present case. This is also an important aspect of the matter of that case that one part of the debenture was to be converted on the date of allotment of debenture itself, second part of the debenture has to be converted only on expiry of 15 months from the date of allotment of debenture and under these facts, it was held by Special Bench of the Tribunal in that case that the expenses incurred on issue of such debentures has to be considered as expenses incurred for issue of shares because it was found that first part of the debentures was to be converted into shares on the date of allotment itself and the second part was to be converted after expiry of 15 months from the date of allotment of debenture and therefore it was held that expenses incurred were actually incurred for issue of shares and not issue of debentures. In the present case, the issue is not regarding expenses incurred on issue of shares. In the present case, the dispute is regarding interest on CCDs for a period before conversion. Hence in our considered opinion, this decision of special bench of the Tribunal is not applicable in the facts of present case because the issue in dispute is different. In that case the issue in dispute is regarding expenditure incurred on issue of convertibles whereas in the present case the issue is regarding allowability of interest ITA No.1549/Bang/2019 expenditure on convertible debentures for the pre-conversion period. Hence we hold that the revenue does not find any support from this decision of Special Bench of the Tribunal in that case.

25. Apart from relying on this decision of Special Bench of the Tribunal, the ld. DR of revenue in written submissions as reproduced above has mainly reiterated the same arguments which are adopted by the TPO in its order i.e. regarding RBI Master Circular on Foreign Investment in India dated 02.07.2007 and 01.07.2008. We would like to observe that such circular in the context of FDI policy of RBI is in a different context i.e. regarding future re-payment obligations in convertible foreign currency and to have control over such future re-payment obligations, the RBI is exercising strict and control so that such future re-payment obligations does not go beyond a point and since in the case of fully convertible debentures, there is no future re-payment obligation, the same was considered as equity for the purpose of FDI policy. In our considered opinion, any definition of any term is to be considered keeping in mind the context in which such definition was given. This definition of convertible debentures

> given by RBI is in the context of FDI policy to exercise control on future re-payment obligations in convertible foreign currency. In our considered opinion, such definition of the term convertible debentures cannot be applied in other context such as allowability of interest on such debentures during pre-conversion period or regarding payment of dividend on such convertible debentures during preconversion period or regarding granting of voting rights to the holders of such convertible debentures before the date of conversion. If you ask a question as to whether dividend can be paid on such convertible debentures in a period before the date of conversion or whether such holders of convertible debentures can be granted voting rights at par with voting rights of share holders during pre-conversion period, the answer will be a big NO. On the same analogy, in our considered opinion, the answer of this question is also a big NO as to whether interest paid on convertible debentures for pre- conversion period can be said to be interest on equity and interest on debentures allowable u/s. 36(1)(iii) of the IT Act."

23. In the light of the aforesaid decision of the Tribunal which addresses all the issues raised by the DRP, we are of the view that the disallowance of interest expenses cannot be sustained on the basis that CCDs were in the nature of equity. The Tribunal has ruled that the definition of convertible debentures given by RBI is in the context of FDI policy to exercise control on future re-payment obligations in convertible foreign currency. Such definition of the term convertible debentures cannot be applied in other context such as allowability of interest on such debentures during pre-conversion period or regarding payment of dividend on such convertible debentures during preconversion period or regarding granting of voting rights to the holders of such convertible debentures before the date of conversion. The same principle will apply to the other corporate laws cited by the DRP in its directions.

24. On the question whether on the basis of book entries by which the interest was not debited in the profit and loss account but claimed in the

computation of income, the disallowance can be sustained. On this aspect, the law is well settled and laid down by the Hon'ble Supreme Court in the case of **Kedarnath Jute Mfg. Co. Ltd. 82 ITR 363 (SC)**, wherein it was held that, the way in which entries are made by an assessee in his books of account is not determinative of the question whether the assessee has earned any profit or suffered any loss. It is undisputed that the assessee has deducted TDS on the entire interest expenditure. The assessee while benchmarking interest payment to Associated Enterprise for the purpose of Sec.92 of the Act has benchmarked the entire interest amount of Rs.6.09 Crores. Thus, looked at from any perspective, the claim of the assessee for deduction of the sum of Rs.4,53,11,205 deserves to be accepted. The disallowance of the said sum of interest expenses and the consequent addition to the total income is therefore deleted. The relevant ground of appeal of the assessee i.e., Ground No.10 is accordingly allowed.

25. Ground No.11 raised by the assessee reads as follows:

> ***11. Disallowance of actual RSU cost recharge made to the holding company on account of allotment of its shares to the employees of the Company***
>
> - *That on the facts and circumstances of the case, the Learned AO / DRP erred in disallowing an amount of INR 10,60,575 incurred towards cross-charge of Restricted Stock Units ('RSU') allotted to the employees of the Company by its ultimate holding Company alleging that (a) no expenditure has been incurred by the Appellant and (b) the expenditure is notional, disregarding the payment by the Appellant to its group entity in relation to RSU.*
>
> - *The learned AO has erred in observing that basis of computation of the amount of INR 10,60,575 has not been*

provided while the computation was very well furnished before the learned AO and learned DRP.

- *The Learned AO has erred in rejecting the expense claim under section 37 of the Act alleging that the shares are granted to employees to either receive securities premium of a lower amount or no securities premium and it is a capital expenditure ignoring the fact that the expenditure is essentially a remuneration to employees to compensate them for their services towards the Appellant and hence in the nature of salary.*

- *The Learned AO has erred in observing that the decision of Bangalore ITAT Special Bench in the case of Biocon Ltd. on the similar issue is pending with the Karnataka High Court whereas the Karnataka High Court has already delivered its verdict in the favour of the taxpayer.*

26. The facts in so far as ground No.11 raised by the assessee are that the assessee floated a share option plan scheme for its executives and senior employees. These options are given by the ultimate holding company i.e., TE Connectivity Limited, Switzerland ("TEL"), to the employees of assessee. The stock option plan granted to the employees during the current period is Restrictive Stock Options ("RSU"), which are assessed, managed and administered by the ultimate holding company. During the relevant FY 2016-17, assessee debited an amount of Rs.10,60,575 in the profit & loss account pertaining to costs relating to 236 shares vested during the year under consideration. The entire amount was cross charged to the assessee by the ultimate holding company, as the RSUs are allotted at free of cost to the employees of the assessee. In other words, the employees of the assessee were given option to invest in shares of the market value of the shares and the price at which the shares were issued to the employees was

paid by the assessee to its holding company and such difference was claimed as employee cost of the assessee in the profit and loss account.

27. The AO rejected the claim of the Assessee on the ground that the Employee Stock Option Plan (ESOP) expenditure being a capital expenditure. The DRP also upheld the order of the AO on the ground that the similar issue on ESOP was pending before the Hon'ble Supreme Court and the addition was upheld just to keep the issue alive.

28. We have heard the rival submissions. The learned counsel for the assessee submitted that the assessee had incurred expense by way of payment to its parent company which has in-turn issued shares to the employees of the assessee. He placed reliance on decision of the decision of the Hon'ble **Jurisdictional Karnataka High Court** decision in the case of **Biocon Ltd. 430 ITR 151(Karn.)** which upheld the decision rendered by the Jurisdictional Special Bench1 in the case of BIOCON 25 ITR (Tribunal) SB Bangalore. The Hon'ble High Court had observed that:

> *"10. From perusal of section 37(1), which has been referred to supra, it is evident that an assessee is entitled to claim deduction under the aforesaid provision if the expenditure has been incurred. The expression 'expenditure' will also include a loss and therefore, issuance of shares at a discount where the assessee absorbs the difference between the price at which it is issued and the market value of the shares would also be expenditure incurred for the purposes of section 37(1) of the Act. The primary object of the aforesaid exercise is not to waste capital but to earn profits by securing consistent services of the employees and therefore, the same cannot be construed as short receipt of capital. The tribunal therefore, in paragraphs 9.2.7 and 9.2.8 has rightly held that incurring of the expenditure by the assessee entitles*

him for deduction under section 37(1) of the Act subject to fulfilment of the condition."

(Emphasis Supplied)

Further, the same reasoning has been adopted in the following decisions rendered by various other High Courts/Tribunal, viz.,

Decision	Forum
PVP Ventures Ltd. 23 Taxmann.com 286 (Mad)	High Court, Madras
Lemon Tree Hotels Ltd 2015 (11 TMI 40 (Delhi)	High Court, Delhi
Novo Nordisk India Private Limited 63 SOT 242 (Trib.-Bang)	Tribunal, Bangalore

29. Learned DR, however, placed reliance on the directions of the DRP in which the DRP referred to the fact that there was a view expressed in some decisions that ESOP expenses are not allowable as deduction. The decisions referred to in this regard were that of the Delhi ITAT in the case of ACIT Vs. Ranbaxy Laboratories ITA No 2613 & 3871 wherein it was held that the ESOP expense debited to P&L is notional in nature since the assessee has neither laid out or expended any amount while choosing to receive no/ lesser securities premium. Accordingly, the Hon'ble ITAT took the view that the receipt of securities premium being a capital receipt is not chargeable to tax, and in same breath, it observed that any short collection of securities premium should also be considered as a capital outlay and not allowable as expenditure relying on Eimco K.C.P Ltd Vs CIT 159 CTR 137 (Supreme Court) and CIT Vs. Reinz Talbros Pvt Ltd 252 ITR 637 (Delhi HC). The above views of Hon'ble Delhi ITAT in the case of Ranbaxy (supra) were also followed subsequently by the Hon'ble Hyderabad ITAT in the case of Medha Servo Drivers Limited ITA No 1114n-1yd/2008, the Hon'ble Mumbai Tribunal in the cases of DCIT Vs Blow Plast Limited ITA

No 512/Mum/2009; Mahindra & Mahindra Vs DCIT ITA No 8597/Mum/2010; M/s VIP Industries Vs DCIT ITA No 7242/Mum/2008.

30. We have carefully considered the rival submissions. It is clear from the facts on record that there was an actual issue of shares of the parent company by the assessee to its employees. The difference, between the fair market value of the shares of the parent company on the date of issue of shares and the price at which those shares were issued by the assessee to its employees, was reimbursed by the assessee to its parent company. This sum so reimbursed was claimed as expenditure in the profit & loss account of the assessee as an employee cost. The law by now is well settled by the decision of the Special Bench of the ITAT Bangalore in the case of Biocon Ltd. in ITA No.248/Bang/2010, A.Y. 2004-05 and other connected appeals, by order dated 16.07.2013, wherein it was held that expenditure on account of ESOP is a revenue expenditure and had to be allowed as deduction while computing income. The Special Bench held that the sole object of issuing shares to employees at a discounted premium is to compensate them for the continuity of their services to the company. By no stretch of imagination, we can describe such discount as either a short capital receipt or a capital expenditure. It is nothing but the employees cost incurred by the company. The substance of this transaction is disbursing compensation to the employees for their services, for which the form of issuing shares at a discounted premium is adopted. The said decision has been upheld by the Hon'ble Karnataka High Court in the case of BIOCON Ltd. (supra). Therefore the issue in so far as this Bench of ITAT is concerned is concluded by the decision of the Hon'ble Jurisdictional High Court. Pendency of identical issue before the Hon'ble Supreme Court cannot be the

basis not to follow decision of jurisdictional High Court. In the present case, there is no dispute that the liability has accrued to the assessee during the previous year. There is no reason why this expenditure should not be considered as expenditure wholly and exclusively incurred for the purpose of business of the assessee. We therefore hold that the claim of the assessee has to be allowed. Grd.No.11 is accordingly allowed.

31. In the result, the appeal by the assessee is partly allowed.

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

Sd/-	Sd/-
(PADMAVATHY S)	**(N.V. VASUDEVAN)**
Accountant Member	**Vice President**

Bangalore,
Dated: 16.09.2022.
/NS/*

Copy to:

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

By order

Assistant Registrar,
ITAT, Bangalore.