Deloitte.

Tax alert: Conversion of accrued interest on debentures into equity shares is taxable

6 November 2026

The Madras High Court (HC) has held that the accumulated interest on zero-coupon debentures, converted into equity shares, is taxable and the exemption provisions relating to conversion of debentures do not alter or exempt the character of interest income embedded in the conversion transaction.

In a nutshell

The zero-coupon debentures carried an implicit interest component payable upon redemption or settlement. Upon premature conversion, I Co discharged its obligation by issuing equity shares which explicitly included amount towards accumulated interest.

By accepting equity shares representing this accumulated interest, the taxpayer received economic value satisfying the debt.

Section 47(x) of the ITA excludes conversion of debentures into shares from being treated as a "transfer" for computing capital gains. However, it does not alter or exempt the character of interest income embedded in the transaction, which remains taxable under the head Income from Other Sources.

On double taxation, the cost of acquisition of converted shares must be interpreted alongside the tax treatment of the interest component. Once the interest component is brought to tax upon conversion, that taxed interest forms part of the cost basis of the shares acquired, eliminating double taxation upon subsequent sale.

©2026 Deloitte Touche Tohmatsu India LLP

Background:

- The taxpayer individual[1] is a director and a shareholder in an Indian company (I Co). During Financial Year (FY) 2009-10, the I Co had issued zero-coupon debentures with a face value (of say INR 100 per debenture) and a nine-year tenure to some of its directors. The taxpayer received certain zero-coupon convertible debentures during the said FY.
- Thereafter, during FY 2012-13, I Co prematurely converted these debentures into equity shares, which were allotted to the debenture holders. The shares were allotted against the initial face value of the debentures plus total accrued interest up to the date of conversion.
- For the taxpayer's debentures, the breakdown was, say:
  - Initial face value: INR 100,
  - Total accumulated interest (from 2009 to 2012): INR 75
  - Total allotment value of equity shares: INR 175
- During FY 2012-13, I Co deducted tax at source (TDS) on the interest portion accruing for that specific FY (say INR 15 out of INR 75). In taxpayer's return of income, it reported total interest income of say INR 15 (reflecting the single-year accrued interest grossed up for TDS) and claimed full credit for the TDS deducted by I Co of say INR 2. However, the taxpayer did not offer the balance accumulated interest of say INR 60 [i.e. INR 75 – INR 15).
- During the course of reassessment proceedings, the Assessing Officer (AO) examined the non-reporting of the balance interest amount of INR 60.
- The taxpayer argued that she maintained her accounts on a cash basis and received no actual cash upon conversion; and conversion of debentures into shares was exempt from being treated as a *'transfer'* for capital gains purposes[2].

  These explanations were accepted by the AO and no additions were made to the reported income.
- The Principal Commissioner of Income-tax (PCIT) reviewed the assessment order and found AO's acceptance of the return of income erroneous and prejudicial to the interests of the Revenue. The PCIT passed an order[3] and observed that the AO failed to examine the interest component embedded in the conversion, noted that other directors who underwent scrutiny were assessed for their proportionate accrued interest, set aside the reassessment order, and remanded the matter to the AO for a fresh determination.
- Aggrieved, the taxpayer filed an appeal before the Chennai Bench of the Income-tax Appellate Tribunal (ITAT) which was dismissed, holding that conversion into equity shares realized the accrued interest value, that claiming full TDS credit while omitting the underlying accumulated interest was legally unsustainable, and that the revision order of the PCIT was valid.
- Aggrieved, the taxpayer filed an appeal before the Madras High Court (HC).

Relevant provisions of Income-tax Act 1961 (ITA)

Section 47

"(47) Nothing contained in section 45 shall apply to the following transfers:—

...

[1] Sanjjay Saumyha vs. PCIT [2026] 190 taxmann.com 832 (Madras HC)

[2] Exemption under section 47(x) of the ITA [section 70(1)(z) of the Income-tax Act, 2025] relating to transactions not treated as transfer

[3] Relating to revision of orders prejudicial to Revenue under section 263 of the ITA [section 377 of the Income-tax Act, 2025]

©2026 Deloitte Touche Tohmatsu India LLP

*(x)**any transfer by way of conversion of** bonds or **debentures**, debenture-stock or deposit certificates in any form, of a company **into shares** or debentures **of that company.....;"***

Decision of the HC:

- The zero-coupon debentures carried an implicit interest component payable upon redemption or settlement. Upon premature conversion, I Co discharged its obligation by issuing equity shares which explicitly included amount towards accumulated interest. By accepting equity shares representing this accumulated interest, the taxpayer received economic value satisfying the debt.
- The taxpayer's reliance on the cash system of accounting[4] could not defer tax liability when an asset of clear monetary value (equity shares) was received in discharge of accrued interest.
- Receipt of income need not take the form of physical cash; settlement through allotment of valuable shares constituted constructive receipt in law. Furthermore, the taxpayer claimed credit for the full taxes deducted at source (TDS) on this interest income. A taxpayer could claim credit for TDS[5], while disclaiming taxability of the underlying income in the same AY.
- Section 47(x) of the ITA excludes conversion of debentures into shares from being treated as a "transfer" for computing capital gains[6]. However, section 47(x) does not alter or exempt the character of interest income embedded in the transaction, which remains taxable as Income from Other Sources[7]. The AO failed to apply these statutory provisions and accepted the return of income without proper analysis.
- On contention of the taxpayer relating to double taxation, the cost of acquisition[8] of converted shares must be interpreted alongside the tax treatment of the interest component. Once the interest component is brought to tax upon conversion, that taxed interest forms part of the cost basis of the shares acquired, eliminating double taxation upon subsequent sale.

The HC dismissed the taxpayer's appeal and held that the AO's failure to conduct proper inquiry and apply law correctly rendered the reassessment order erroneous and prejudicial to the Revenue. The PCIT correctly exercised revisionary jurisdiction[9].

Comments:

While the ITA provides for tax neutrality on conversion of debentures to equity shares, this case involved tax treatment accumulated interest on zero-coupon debentures upon its conversion into equity shares. The ruling also, inter-alia, considered the scope of PCIT's revisionary powers under section 263 of the ITA, where the AO had accepted the return without adequately examining the relevant tax implications.

The HC, has inter-alia upheld the following:

- The zero-coupon debentures carried an implicit interest component payable upon redemption or settlement. Upon premature conversion, I Co discharged its obligation by issuing equity shares which explicitly included amount towards accumulated interest.

  By accepting equity shares representing this accumulated interest, the taxpayer received economic value satisfying the debt.

[4] Under section 145 of the ITA [section 276 of the Income-tax Act, 2025]

[5] Under section 199 of the ITA [section 390 of the Income-tax Act, 2025]

[6] Capital gains under section 45 of the ITA [Section 67 of the Income-tax Act 2025]

[7] Under section 56 of the ITA [Section 92 of the Income-tax Act 2025]

[8] Cost of acquisition under section 49(2A) of the ITA [Section 73 of the Income-tax Act 2025]

[9] Under section 263 of the ITA [Section 377 of the Income-tax Act 2025]

©2026 Deloitte Touche Tohmatsu India LLP

- Section 47(x) of the ITA excludes conversion of debentures into shares from being treated as a "transfer" for computing capital gains. However, it does not alter or exempt the character of interest income embedded in the transaction, which remains taxable under the head Income from Other Sources.
- On double taxation, the cost of acquisition of converted shares must be interpreted alongside the tax treatment of the interest component. Once the interest component is brought to tax upon conversion, that taxed interest forms part of the cost basis of the shares acquired, eliminating double taxation upon subsequent sale.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

©2026 Deloitte Touche Tohmatsu India LLP

Deloitte.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), its global network of member firms, and their related entities (collectively, the “Deloitte organization”). DTTL (also referred to as “Deloitte Global”) and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see http://www.deloitte.com/about to learn more.

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which is a separate and independent legal entity, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Bengaluru, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Mumbai, New Delhi, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

This communication contains general information only, and none of DTTL, its global network of member firms or their related entities is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

No representations, warranties or undertakings (express or implied) are given as to the accuracy or completeness of the information in this communication, and none of DTTL, its member firms, related entities, employees or agents shall be liable or responsible for any loss or damage whatsoever arising directly or indirectly in connection with any person relying on this communication.

© 2026 Deloitte Touche Tohmatsu India LLP. Member of Deloitte Touche Tohmatsu Limited