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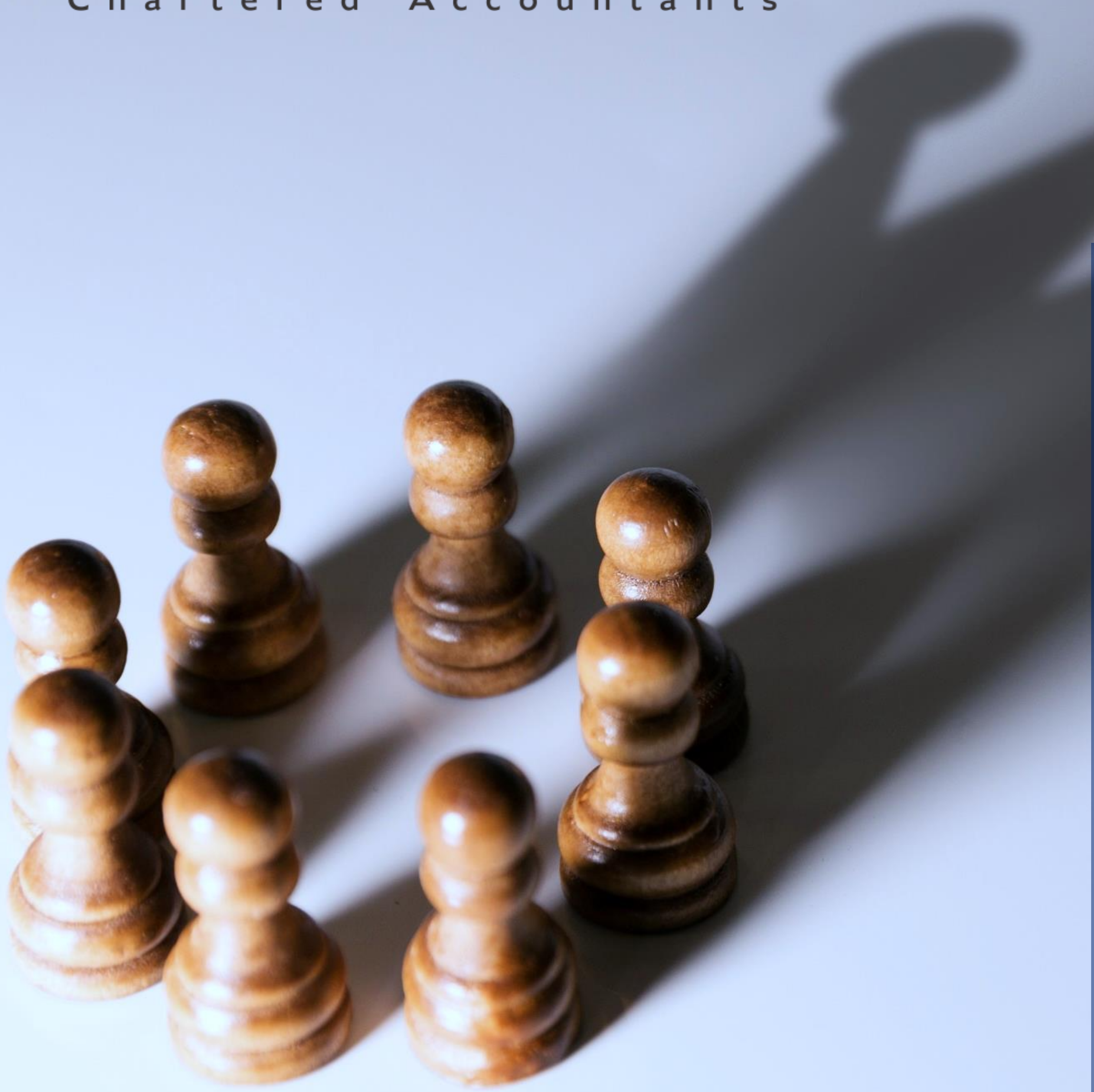

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Corporate Tax

Expenditure for Raising Capital

Whether Revenue Expenditure?

July 10, 2020

Snapshot

Background and Coverage

"Money often costs too much" said Ralph Waldo Emerson, the 19th century American philosopher. The quote exemplifies the philosophy that there is always a cost associated to money and it does not come free.

In business, money comes through regular operations of the business and through raising funds for carrying out the said operations. When the funds are raised, the costs associated are of 2 types -

i) Pre-Funding Cost &
ii) Post-Funding Cost

Pre-funding costs are the costs which are to be borne before the funds are provided to the entity. These costs are incurred for facilitating and implementing the funding process. Whereas Post-Funding Cost are generally in the nature of interest and dividend which is to be paid to the person/entity providing the funds.

Funding has become more lucrative in recent years considering the constantly increasing popularity of Start-ups and the Government's move to relax FDI Norms in various sectors. Hence, it would also be important to understand the tax implications of costs involved in funding process.

In this publication, we would be discussing various tax aspects of costs associated with Pre-funding and Post Funding Cost relating to interest.

Expenditure on Issue of Shares- Can it be claimed as Revenue Expenditure?

An entity may be required to incur various costs for issue of share capital. These costs can be Filing fees with Registrar of Companies, Stamp Duty, Legal Fees etc. These costs are to be incurred to facilitate the funding process and hence are Pre-Funding Costs. Further, these costs are incurred to increase the capital base of the entity and hence a question arises whether such costs are deductible as revenue expenditure.

The Supreme Court in the case of Brooke Bond India Ltd. v. CIT (225 ITR 798) held that any costs incurred for expanding the capital base of the company are capital in nature and not deductible. This legal position was reiterated by the Apex Court in the case of Punjab State Industrial Development Corpn. Ltd. v. CIT (225 ITR 792).

Hence, based on the above decisions of the Supreme Court, the expenditure on issue of shares cannot be claimed as Revenue Expenditure.

What if shares are issued for working capital?

An entity may issue shares for procuring funds to be used for working capital requirements. This would mean that funds are raised for day to day operations of entity. Hence, can an entity claim that since funds are raised for day to day operations, the cost for raising such funds is revenue in nature?

The Third Member Bench of Chennai ITAT in the case of Lakshmi Auto Components Ltd. v. DCIT (101 ITD 209) has dealt with similar issue wherein it was held that Supreme Court's decision in the case of Brooke Bond India Ltd. (*supra*) does not deal with a situation where shares are issued for working capital requirements.

Further, on the basis of above finding of Third Member Bench, the Mumbai ITAT in the case of Navi Mumbai SEZ (P.) Ltd. v. ACIT (152 ITD 828) has held that decision in the case of Brooke Bond India Ltd. (*supra*) cannot be applied when the share capital was utilized for purchasing trading stock and accordingly it allowed the expenditure on issue of shares as revenue expenditure.

However, it is pertinent to note that there are decisions of certain High Courts wherein it has been held that even if funds are raised for working capital requirement, expenditure incurred thereon would not be allowable as a deductible expenditure. The Calcutta High Court in the case B.S.L Ltd. v. CIT (267 ITR 754) held that the decision of Supreme Court in the case Brooke Bond India Ltd. (*supra*) was clear enough and that the question of object of raising capital did not remain open. Even if shares were issued for working capital, the expenditure incurred thereon were to be treated as capital expenditure in view of findings of Supreme Court in the case of Brooke Bond India Ltd. (*supra*).

It can be appreciated that the Revenue may contend that the decision of Brooke Bond India Ltd. (*supra*) is applicable even when shares issued for working capital and claiming deduction of share issue expenditure in such cases may lead to litigation.

Section 35D - Is it covering all Pre-Funding cost?

Section 35D of the Income Tax Act, 1961 ("the Act") allows to a resident person deduction by way of amortization of certain preliminary expenses which includes certain expenditure incurred on issue of shares. As per the said section, 1/5th of the expenditure would be amortized over a period of 5 years.

Section 35D provides for deduction in respect of expenditure incurred before commencement of business and expenditure incurred after the commencement of business. However, if the expenditure is incurred after the commencement of business, it must be incurred for extension of undertaking of the Taxpayer or for setting up of a new unit.

Now, funds can be raised before as well as after the commencement of business. If funds are raised after the commencement of business, to claim the benefit of section 35D, the funds raised are to be utilized for extension of undertaking or setting up of new unit.

Under section 35D(2), an exhaustive list of expenditures is provided on which deduction u/s 35D can be claimed. This list includes certain expenditure that would be incurred on issue of shares. It is pertinent to note that the provisions of the Act do not specify that all the expenditure on issue of share are deductible but mentions only a specific expenditure on which deduction u/s 35D can be claimed. The expenditure specifically mentioned is expenditure incurred for issue of shares/debentures, *for public subscription*, *being* underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of prospectus.

Hence, it can be appreciated that there are no general provisions which allows deduction for any expenditure on issue of shares. Hence, a bare reading of the provision gives a meaning that apart from the specific expenditures mentioned, no other expenditure on issue of shares can be claimed as deduction.

Private placement of shares excluded

As per section 35D(2)(c)(iv), the issue of shares/debentures must be for public subscription. This means the funds are to be raised through public issue of shares to claim the benefit of section 35D on the expenditure incurred for such issue of shares.

Private issue of shares would be excluded from the scope of section 35D by virtue of the language used in section 35D(2)(c)(iv). Hence, expenditure incurred for raising funds through private issue of shares would not be allowed as deduction u/s 35D.

Section 35D(2)(d) provides for any other expenditure *as may be prescribed*. However, till date such other expenditure has not been prescribed by the Board. Hence, it cannot be said that the expenditure on private issue of share is covered under section 35D(2)(d). The Madras High Court in the case of CIT v. Ennar Steel and Alloy (P) Ltd. (261 ITR 347) held that when the power reserved to include other items of expenditure has not been exercised by the authority who has been conferred with that power, it is not correct to include items of expenditure in the scope of section 35D which have not been included by the Parliament.

Are all items of expenditure on public issue of shares deductible under section 35D(2)(c)(iv)?

A question may arise that if an entity has carried out public issue of shares, would such entity be eligible to claim deduction u/s 35D in respect of all the items of expenditure incurred on such public issue of share or would it be restricted to the items of expenditure specifically mentioned i.e. underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of prospectus.

The Madhya Pradesh High Court in the case of CIT v. Shree Synthetics Ltd. (162 ITR 819) held that use of the word *"being"* in section 35D(2)(c)(iv) is for giving illustration and is not meant for restricting the scope of deduction to the items of expenditure which are specifically mentioned. Hence, by virtue of this decision, any expenditure on public issue of shares is allowable u/s 35D(c)(iv).

However, the Madras High Court in the case of CIT v. Ashok Leyland Ltd. (349 ITR 663) rejected the above mentioned decision of Madhya Pradesh High Court and held that the item of expenditure covered under section 35D(2)(c)(iv) would be only those items which are specifically mentioned therein and nothing beyond.

In case one doesn't prefer to venture into the rigours of interpreting the word *"being"*, one may refer to the decision of Bombay High Court in the case of CIT v. Mahindra Ugine & Steel Co. Ltd. (250 ITR 84) wherein it has been held that expression used in section 35D(2)(c)(iv) is a very wide expression.

The above decision of the Bombay High Court is in respect of stamp duty paid on issue of shares, however, the findings of the High Court can be used to claim that any expenditure on public issue of share will be covered under section 35D(2)(c)(iv). The Bombay High Court has stated stamp duty, despite not being specifically mentioned, forms part of section 35D(2)(c)(iv), but has not clarified on other type of expenditure which would be covered under section 35D(2)(c)(iv) apart from Stamp Duty.

Hence, if any person is required to claim deduction for any other item of expenditure which is not specifically mentioned in section 35D(2)(c)(iv), then such claim may be made on the basis of the above decision of the Bombay High Court, however, the such claim may be subject to litigation.

If 35D not applicable, can deduction be claimed u/s 37(1)?

As per the provisions of section 37(1), a business expenditure, which is not a capital expenditure is allowable as deduction. As we have discussed earlier, the expenditure on issue of shares is a capital expenditure by virtue of Supreme Court decision in the case of Brooke Bond India Ltd. (*supra*) and hence, deduction u/s 37(1) cannot be claimed on the ground that the provisions of section 35D are not applicable.

What if investment in shares is made by AIF or VCF?

The emergence of the Start-Up scene in India and the push provided by the Government to become "Self- Reliant", has resulted in an increased excitement for new businesses which are coming up or would be coming up in this new decade. This excitement for new businesses has only strengthened with the tax friendly measures of the Government such as providing a lower corporate tax rate of 15% for new manufacturing companies and abolishing of Minimum Alternate Tax (MAT).

The excitement is not only with the entrepreneurs but also with various investment firms being AIFs and VCFs. AIFs and VCFs have emerged as formidable players in making investments in various highly lucrative entities and thus providing the funds necessary for their growth. Accordingly, it is necessary to understand whether expenditure incurred for raising funds through AIF or VCF is deductible.

What is to be seen here is whether the provisions of section 35D are applicable in respect of expenditure incurred on issue of shares to AIF or VCF. As we have discussed earlier, only public issue of shares is covered under section 35D(2)(c)(iv) and hence a question arises whether shares issued to AIF or VCF can be treated as a public issue of shares?

There are certain decisions wherein it has been held that shares issued to a Qualified Institutional Buyer (QIB) is to be treated as a public issue of shares. The rationale behind this is that a QIB forms part of public and hence issue of shares to such QIB would be treated as public issue of shares. Refer decision of Hyderabad ITAT, in the case of DCIT v. Deccan Chronical Holdings Ltd. (60 taxmann.com 240).

Hence, what is to be seen is whether the AIF or VCF is registered as a QIB. As per section 2(zd) of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, QIB includes an AIF or VCF which is registered with Securities and Exchange Board of India (SEBI). Hence, to treat and AIF or VCF as an QIB, it must be first ascertained whether the said entities are registered with SEBI. If the AIF or VCF is registered with SEBI, it can be treated as a QIB and benefit of section 35D(2)(c)(iv) may be claimed.

Does it make difference if it is a rights issue?

An entity may issue right shares to raise additional capital from its existing shareholders. In such case, rights are given to the shareholders to subscribe the shares of the entity at a special price, which is often a price lower than the prevailing market price. Hence, a question that may arise is whether the decision of Supreme Court in the case of Brooke Bond India Ltd. (*supra*) also applicable in the case of issue of right shares?

The Gujarat High Court in the case of Digvijay Cement Co. Ltd. v. CIT (138 ITR 45) held that expenditure incurred on issue of right shares is not revenue expenditure and the same is not allowable. Further, the Gujarat High Court in the case of Ahmedabad Mfg & Calico (P.) Ltd. v. CIT (162 ITR 800) relied upon the decision in the case of Digvijay Cement (*supra*) to hold that expenditure incurred on issue of bonus share is also a capital expenditure considering right shares and bonus shares are not different from each other.

However, the Supreme Court in the case of CIT v. General Insurance Corporation (286 ITR 232) reversed the order of Gujarat High Court in the case of Ahmedabad Mfg. & Calico (P.) Ltd (*supra*) and held that expenditure on issue of bonus shares is revenue expenditure. Now since, Gujarat High Court had held bonus shares are not different from rights share, can we contend that the Supreme Court decision on the case of General Insurance Corporation (*supra*) is also applicable to issue of right shares.

The Supreme Court in the case of General Insurance Corporation (*supra*) held that since issuance of bonus shares does not result in any inflow of fresh funds or increase in capital employed, the capital employed remains same. On this basis, the Supreme Court treated the expenditure on issuance of bonus shares as revenue expenditure. Unlike Bonus Shares, in case of Right Shares there is an inflow of fresh funds into the company and consequently there is an increase in capital employed. This feature distinguishes the right shares from bonus shares and since the finding of the Supreme Court are based on this peculiar feature of bonus shares, claiming of deduction in respect of expenditure on issue of right shares may lead to litigation.

Expenditure on Issue of Debentures - Revenue Expenditure?

An entity may issue debentures if it is required to raise funds without diluting the existing equity stake of the shareholders of the Company. The entity may be required to incur certain expenditure for facilitating the issue of debentures which would be Pre-Funding Expenditure. Can the entity claim such Pre-funding expenditure on issue of debentures as revenue expenditure?

It can be appreciated that debentures are 'debt' or 'loan' for the entity issuing the same. The sum received on issuing debentures does not form part of the capital base of the entity. The Supreme Court in the case of India Cements Ltd. v. CIT (60 ITR 52) held that loan cannot be treated as an asset or advantage for enduring benefit. Loan is a liability which must be repaid and the same cannot be considered as an asset. Considering the same, the Supreme Court allowed the expenditure incurred on such loan as revenue expenditure

The Rajasthan High Court in the case of CIT v. Secure Meters Ltd. (321 ITR 611) reiterated the legal position laid down by Supreme Court in the case of India Cements (*supra*) and held that expenditure incurred on issue of debentures is to be treated as revenue expenditure.

The High Court held that decision of the Supreme Court in the case of Brooke Bond India Ltd. (*supra*) was not applicable in case of issue of debentures since the case before Supreme Court was that of issue of shares and debentures is in the nature of loan and not share capital.

Hence, it can be concluded that issue of debentures, being in the nature of loan, is exempted from the rigours of the decision of Supreme Court in the case of Brooke Bond India Ltd. (*supra*) and it can be contended that expenditure on issue of debentures is revenue expenditure, allowable as deduction.

Mention of 'debentures' in section 35D(2)(c)(iv)

It is interesting to note that section 35D(1) read with section 35D(2)(c)(iv) provide for amortization of certain specific expenditure incurred on public issue of share and debentures. Such specific expenditure are underwriting commission, brokerage and charges for drafting, typing, printing and advertisement of prospectus. Does that mean that the above specific expenditure cannot be claimed as revenue expenditure and are compulsorily required to be amortized over a period of 5 years?

The CBDT Circular No. 56 dated 19-03-1971 has clarified that provisions of section 35D would not impact the expenditure which is allowable on issue of debentures by virtue of decision of Supreme Court in the case of India Cements Ltd. (*supra*). The Circular clarifies that the provision for amortization is not intended to supersede any other provision of the Act under which expenditure is allowable as deduction. Hence, based on this Circular, the decision of Supreme Court in the case of India Cements Ltd. (*supra*) is still valid for expenditure on issue of debentures and such expenditure can be claimed as revenue expenditure.

The above legal position has also been considered by Calcutta High Court in the case of CIT v. East India Hotels Ltd. (252 ITR 860) wherein it was held expenditure on issue of debentures was allowable as revenue expenditure and insertion of section 35D could not impact the allowability of the said expenditure.

What if Debentures issued are Convertible in nature?

We have discussed that the expenditure on issue of debentures is allowable as revenue expenditure considering that the debentures are loan and the same does not result into expansion of capital base of the entity. However, in case Debentures issued are convertible in nature and can be converted into equity shares, can it still be said that it does lead to expansion of capital base of the entity?

The Rajasthan High Court in the case of CIT v. Secure Meters Ltd. (*supra*) held that expenditure on issue of debentures would be revenue expenditure irrespective of fact that such debentures are convertible or not. Hence, as per this decision of Rajasthan High Court, since the basic nature of debentures is loan, it would not make any difference if the debentures are convertible or non-convertible and expenditure incurred on issue of the same would always be allowed as deduction.

The above legal position was also held by Mumbai ITAT in the case of Mahindra & Mahindra Ltd. v. JCIT (36 SOT 348) wherein the issue was pertaining to Foreign Currency Convertible Bonds (FCCB). The ITAT relied upon the decision of Rajasthan High Court in the case of Secure Meters Ltd. (*supra*) and held that expenditure on debentures is allowable irrespective of it being convertible or non-convertible.

However, there is a contrary decision of Gujarat High Court in the case of Torrent Pharmaceuticals Ltd. v. ACIT (230 Taxman 204) held that issue of convertible debentures is directly related to expansion of capital base and expenditure incurred on issue of the same is capital expenditure. Hence, it can be appreciated that this decision of Gujarat High Court is completely contrary to the decision of Rajasthan High Court in the case of Secure Meters Ltd. (*supra*).

Hence, the issue of deductibility of expenditure on issue of convertible debentures is litigative in nature.

Section 35D benefit available?

The Mumbai ITAT in the case of Ganesh Banzoplast Ltd. v. ACIT (111 TTJ 385) dealt with the issue of amortization of expenditure on issue of convertible debentures. In this case there were 2 types of debentures- Part A and Part B. Part A debentures were converted on the date of allotment itself and Part B were converted after 1 year from allotment. It was held that expenditure incurred on Part B till date of conversion was allowable as revenue expenditure. Whereas expenditure on issue of Part A debentures was capital expenditure which was eligible for amortization u/s 35D of the Act.

It is interesting to note that ITAT in the above case held that since expenditure was capital in nature, benefit of section 35D was available without considering whether the expenditure was specified in section 35D or not. Hence, this decision may be used to claim amortization of expenditure on convertible debentures u/s 35D if the same is held to capital in nature.

What is the treatment of Interest on Loan?

We have discussed till now the Pre-Funding Costs which are the expenditure incurred for facilitating the funding process. Now we will look at Post-Funding Costs which are the costs to be borne by the entity after the funds are received by it. One of the most common Post-Funding Cost is the Interest cost. Interest Cost is to be borne when funds are received in form of 'debt' or 'loan'. We have already discussed the Supreme Court's decision in the case of India Cements (*supra*) wherein it has been held that expenditure relating to loan is allowable as revenue expenditure and this includes interest expenditure. However, there are other aspects to be considered while dealing with deductibility of interest cost.

The term 'Interest' is defined u/s 2(28A) of the Act and as per the definition, it includes any service fee or any other charge in respect of monies borrowed. This means that the nomenclature of the expenditure incurred on borrowing would not determine the nature of expenditure for tax purpose. Any expenditure, by whatever name called, incurred on borrowing would be treated as interest and provision of the Act would apply to such expenditure as they apply to interest expenditure.

The Mumbai ITAT in the case of Township Real Estate Developers (India) P. Ltd. v. ACIT (51 SOT 411) held that processing charges on availing the loan were to be treated as interest as per the inclusive definition u/s 2(28A) and accordingly deduction under section 24 was allowed to the Taxpayer. Hence, considering the inclusive and wide definition of Interest u/s 2(28A), other expenditure incurred on borrowing would be treated as Interest u/s 2(28A) and other provisions of Act may apply to such as expenditure as they apply to Interest. Some of the important provisions of the Act applicable to Interest expenditure are discussed hereunder.

Section 36(1)(iii)

Interest on borrowing for business is specifically allowable as business expenditure under section 36(1)(iii) of the Act if the money has been borrowed for the purpose of the business. However, if the borrowing is for acquisition of an asset, interest expenditure would be capitalized till date on which such asset is put to use. Depreciation u/s 32 may be claimed on such capitalized interest since the interest cost would be added to the actual cost of the asset as per Explanation 8 to section 43(1).

Section 57(iii)

If the borrowing is taken not for business but for earning income from other source such as interest from deposits, dividends etc., then in such deduction would be available under section 57(iii) and not under section 36(1)(iii). It must be noted that by virtue of Finance Act, 2020, dividend income is no longer exempt w.e.f. AY 2021-22. Hence, in case borrowing is utilized to make investment in shares, then in such case the interest expenditure would be allowed as deduction against the dividend income. However, such deduction of interest is restricted to 20% of the gross dividend amount.

Section 94B

The provisions of section 94B provides for a limitation on deduction of interest expenditure where interest pertains to a borrowing from a non -resident Associated Enterprise (AE) or any other lender where the AE has provided a guarantee on such borrowing. Section 94B provides for restriction of deduction of interest expenditure to 30% of Earnings before Interest, Taxes Depreciation and Amortization (EBITDA)

Differing accounting treatment of expenditure incurred on fund raising

It may happen that expenditure on issue of shares/debentures is treated differently in the books of accounts. For example, expenditure on issue of debentures which is claimed as revenue expenditure is adjusted against capital reserve in the books of accounts and thus is not routed through Profit & Loss Account. In such case, can the Department contend that since the expenditure is adjusted against capital reserve, it cannot be allowed as revenue expenditure?

The Supreme Court in the case of Kedarnath Jute Mfg. Co. Ltd. v. CIT (82 ITR 363) held that the allowability of deduction of any item would depend on the provisions of the law and not on the accounting treatment given by the Taxpayer. Hence, as per this decision of Apex Court, even if expenditure on issue of debentures is adjusted against capital reserve, it may still be treated as revenue expenditure for tax purpose.

The Ahmedabad ITAT in the case of ITO v. Atul Limited (ITA No. 939/Ahd/2002) held that expenditure on debentures was allowable as revenue expenditure even though such expenditure was debited to share premium account. It was held accounting entries cannot decide the allowability of expenditure which is claimed within 4 walls of Income Tax Act.

It is to be noted that in Ind-AS era, certain pre-funding cost is required to be adjusted from the fund amount itself in books of account. In such case it is interesting to evaluate the position of claiming of such cost as deduction while computing book profit u/s.115JB of the Act if such adjustment is neither debited to profit and loss account nor forming part of "Transition Amount" .

Concluding Remarks

We have discussed taxability of various costs which may arise on fund raising. These costs are pre-funding and post-funding cost. There exists a litigation for claiming certain pre-funding cost as deductible expenditure as discussed in this publication. Understanding of such issues not only help in determining the taxable income but also assist in determining the nature of funds to be used for carrying the business or even when expanding the business. These issues are also pertinent for the new manufacturing companies looking to exploit the beneficial tax rate of 15% and are in the process of setting up their business.

It may also be noted that the legal points discussed in this publication are based on general reading of the law and various judicial pronouncements. However, a fresh legal perspective can be developed based on the peculiar facts of the case.

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