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News Alert
29 January 2014



Loss on redemption of investment in units of Mutual Fund incurred on account of commercial expediency, deductible as expenditure under section 37(1) of the Act

In brief

In the present case, the taxpayer invested in units of a mutual fund (that was settled by it) to protect its goodwill. Since the entire amount was invested to protect its goodwill, following the principle of 'commercial expediency', the loss incurred on redemption of the units was held to be allowable as 'business expenditure' under section 37(1)¹ of the Income-tax Act, 1961 (the Act).

¹ According to section 37 of the Act a taxpayer can claim a deduction of an expenditure (for which a specific deduction is not available) incurred by it wholly and exclusively for the purpose of its business, so far as the expenditure is not capital or personal in nature, and is not in violation of a law.

Facts

- The taxpayer, Canara Bank², a nationalised bank, had set up a Trust viz., Canbank Mutual Fund (the Trust), for carrying on the activities of a mutual fund in India. The taxpayer was the principal trustee and the settler of the Trust.
- The Trust had issued units of a mutual fund scheme called 'CANSTAR' to investors, and committed to redeem these units at an agreed value. However,

² Canara Bank v. ACIT [TS-685-HC-2013(KAR)]

owing to its inability to generate income, the Trust could not fulfill its commitment.

- Given the close association of the taxpayer with the Trust, there was a possibility that the public could lose confidence in the taxpayer, which would have been detrimental to its business of banking. Also, there was an imminent threat that the Securities and Exchange Board of India (SEBI) would debar the taxpayer from dealing in the capital market. Given these factors, the pressure from the Finance Ministry and the regulatory authorities, and to mitigate the hardship caused to the investors, the Board of directors of the taxpayer decided to purchase the units of CANSTAR.
- Consequently, the taxpayer, although not legally bound, purchased the units of CANSTAR from the investors for a price higher than the Net Asset Value of CANSTAR. The units were later redeemed at a value lower than the purchase price, thus leading to a loss on redemption.
- The taxpayer recorded the investment in units of CANSTAR as 'current investments' in its books and claimed a deduction for diminution in the value of these investments. Also, it claimed that in the year of redemption of the CANSTAR units the loss incurred on redemption be allowed as a business loss/expenditure.
- The above claims were not allowed by the lower authorities, and therefore the taxpayer preferred an appeal before the High Court (HC).
- Separately, during the assessment years 1998-99 and 2000-01, the taxpayer had earned dividends, interest of tax free bonds and interest on long term finance to infrastructure companies, which were exempt from tax. The tax officer (TO) held 5.4% of the exempt income as expenditure incurred in relation to the said income and disallowed the same under section 14A of the Act. On appeal, the Commissioner of Income-tax (Appeals) [CIT(A)] reduced the disallowance to 2% of the exempt income, which was confirmed by the Tribunal. The taxpayer preferred an appeal on this issue also before the HC.

Taxpayer's contentions

- The taxpayer contended that since the nature of investment was that of a current investment, akin to stock-in-trade, it was eligible to claim a deduction for diminution in the value of these investments during the years in which there was a diminution in the value of investments. Further, in the year of redemption, the taxpayer claimed that the loss incurred by it was eligible for deduction as business loss or business expenditure while computing the total income of the taxpayer.
- Alternatively, the taxpayer submitted that if the investments were considered 'permanent investments' by the tax authorities and deduction for diminution in the value of investments was not allowed on this basis, then, in the year of redemption, the taxpayer was eligible to claim the entire difference between the original purchase price and the redemption price as capital loss.

Revenue's contentions

- The taxpayer was not legally liable to purchase the units of CANSTAR.
- The intention of the taxpayer was not to invest in the units as stock-in-trade but to hold them as a permanent investment since the units of CANSTAR were never sold or traded by the taxpayer.

High Court's ruling

- The HC held that the claim of the taxpayer for diminution of the value of the asset or loss sustained in the business would not be appropriate. The taxpayer would, however, be entitled to the claim difference between the purchase price and redemption price as expenditure³ incurred for the purpose of business because the entire amount was invested due to commercial expediency (i.e. with the intention of preserving their goodwill).

³ While the High Court held that the loss incurred by the taxpayer was not deductible as a 'business loss' under section 28(1) of the Act, but as a 'business expenditure' under section 37(1) of the Act, from a taxpayer's perspective, both business losses and business expenditure are broadly treated similarly under the provisions of the Act.

- While arriving at this decision, the HC relied on the following principles emerging out of certain decisions of the Supreme Court:
- The expression “for the purposes of its business or profession” could be construed as expenses incurred, among others, for the purpose of protection of its assets and property from expropriation, coercive process or assertion of hostile title.
- The expression “wholly and exclusively” used for allowing business expenditure does not mean that the expenditure ought to have been incurred “necessarily”. Ordinarily, it is for a taxpayer to decide whether any expenditure should be incurred in the course of his or its business.
- One of the tests of determining the allowability of an expense is whether the transaction is properly entered into as a part of the taxpayer’s legitimate commercial undertaking, in order to facilitate the carrying on of its business. It is immaterial that a third party also derives benefits from such expenses.

- As regards disallowance of expenditure under section 14A of the Act, the HC held that since the dividend and interest income earned by the assessee were directly credited to its bank account, the taxpayer did not have to incur any expenditure. Consequently, no notional expenditure could be disallowed.

PwC observations

- This judgement should be of relevance to taxpayers that may be required to extend financial support to their group entities in circumstances that could impact their own business.
- As regards disallowance under section 14A of the Act, it is pertinent to note that the HC has taken cognisance of the non-relevance of notional disallowances in the wake of modernisation of technology for receiving income such as dividends, interest, etc.

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