

# Gujarat High Court allows expenditure on premium, on premature redemption of Special Purpose Notes, as interest

November 8, 2017

## In brief

In a recent decision, the Gujarat High Court (HC)<sup>1</sup> has held that premium, including additional premium on premature redemption of Special Purpose Notes (SPN), is deductible as interest under section 36(1)(iii) of the Income-tax Act, 1961 (Act). While holding so, the HC observed that if the claim was genuine but was not acceptable by the revenue, it did not make the entire scheme a sham or colourable device, it should have been seen as a permissible tax planning.

## In detail

### Facts

- The taxpayer was a public limited company engaged in the business of manufacturing consumer products.
- The taxpayer had decided to set up a soda ash manufacturing plant.
- To set up the plant, the taxpayer estimated a sizeable investment. The taxpayer chose to raise some amount of funds through issue of Non-Convertible debentures (NCD) and SPN to the shareholders.
- NCD would carry interest at the rate of 17% payable half yearly. The redemption would be in four equal instalments at the end of fourth, fifth, sixth and seventh year from the date of allotment.
- On the other hand, SPN would not carry any interest for the first three years; however, it would receive a premium along with return of the principal amount.
- The terms of the prospectus empowered the Board of Directors to call for an early redemption on payment of additional premium. Both NCD and SPN were transferable.
- The taxpayer redeemed NCD and SPNs along with the interest and premium as per the terms of issue.
- The yearly premium including the additional premium paid on early redemption of such NCD and SPN was claimed as “interest” allowable expenditure under section 36(1)(iii) of the Act.
- The taxpayer’s claim for amount paid as premium, including additional premium on redemption of SPN was rejected by the Tax Officer, Commissioner of Income-tax (Appeals) and the Income-tax Appellate Tribunal (Tribunal).
- Aggrieved by the ruling of the Tribunal, the taxpayer appealed before the HC.

### Issue before the HC

Whether the Tribunal was right in holding that premium paid on early redemption of SPN was to be disallowed when the premium was in respect of the capital borrowed for the purposes of the business?

<sup>1</sup> Tax Appeal No. 1219 of 2006

### Revenue's contentions

- The borrowing was for capital expenditure; therefore, interest on such borrowing was not an allowable deduction.
- The taxpayer was in the process of setting up a new business; thus, the expense was not for expansion or extension of existing business.
- The liability had not accrued and was merely a contingent liability.
- The entire scheme of issuance of SPN was a sham transaction and colourable device to avoid tax. The SPN was transferred to financial institutions/ banks before redemption and was claimed as long-term capital gain by promoters.

### Taxpayer's contentions

- Setup of soda ash and lab manufacturing plant was part of the existing business or by way of extension of the existing business, concluded in the taxpayer's own case.<sup>2</sup>
- The interest expenditure could always be claimed as business expenditure, even if the principal borrowed was for capital expenditure.<sup>3</sup>
- The question of accrual of interest had already been settled.<sup>4</sup>
- The option was given to all the shareholders, promoters and non-promoters whether to subscribe to NCD or SPN.
- The rates of return on NCD and SPN were similar, only the pattern of payment was different.
- Premature redemption was done in both the cases, NCD as well as SPN, based on market forces.

- The decision of premature redemption was already announced when the SPN holders sold their notes to banks and financial institutions.
- The decision to foreclose NCD and SPN issues early was a *bona fide* decision taken by the company, as the rate of interest in the market had gone down over a period of time and it was possible for the company to raise fresh funds from the market at lower rate of interest.

### High Court's decision

- As per section 36(1)(iii) of the Act, it was a necessary condition that the capital must have been borrowed for the purpose of business on which interest had been paid. The provision does not distinguish between money borrowed for capital or revenue purposes.
- The new facility had been started for captive consumption, i.e., for the purpose of its existing business.
- Reliance was placed on the decision in the case of Taparia Tools<sup>4</sup> to hold that the taxpayer had paid accrued return and premium for early foreclosure and claimed the entire expenditure by way of interest liability during the year under which the same was expended.
- It was not the case of contingent liability, as it would absolve future payment of such liability.
- In what manner the taxpayer raises its required funds was essentially a case of business decision and the Revenue could not certainly question the priority of the taxpayer in

this respect.

- The taxpayer's decision of early redemption and the terms on which such early redemption would be resorted to, was within the public domain.
- The decisions were already taken and made public.
- Merely because certain tax treatment on the respective expenditures and gains had been claimed, it would not be a determinative factor insofar the claim for interest expenditure under section 36(1)(iii) of the Act was concerned.
- If the claim of the taxpayer was otherwise genuine but was not acceptable to the revenue, the entire scheme could have been seen as permissible tax planning and not a sham or colourable device.
- There was always a line, although not always clear, between legitimate tax planning, even exploiting legal loopholes and sham or bogus devices to defeat the genuine claims of the Revenue.

### The takeaways

This decision reiterates that both yearly premium and additional premium are to be treated on same footing, as interest, and deduction under the Act is available in both the cases.

The provision of section 36(1)(iii) does not make any distinction between money borrowed for capital or revenue purposes. The decision pertains to assessment year prior to insertion of proviso to section 36(1)(iii) which restricts claim of interest on capital expenditure

The decision also affirms that as long as commercial/ business

<sup>2</sup> Tax Appeal No. 811 of 2013 dated January 27, 2014

<sup>3</sup> DCIT v. Core Health Care Limited [2008] 298 ITR 194 (SC)

<sup>4</sup> Taparia Tools Limited v. JCIT [2015] 372 ITR 605 (SC)

expediency exists for incurring an expenditure, the same should be considered as permissible expenditure.

Though this decision is

favourable to taxpayers in many ways but has to bear in mind that these tax planning strategies may be subjected to provisions of General Anti Avoidance Rules under the present regulations.

***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

## Our Offices

### Ahmedabad

1701, 17th Floor, Shapath V,  
Opp. Karnavati Club,  
S G Highway,  
Ahmedabad – 380051  
Gujarat  
+91-79 3091 7000

### Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th  
Floor, Road No. 10, Banjara Hills,  
Hyderabad – 500034,  
Telangana  
+91-40 44246000

### Gurgaon

Building No. 10, Tower - C  
17th & 18th Floor,  
DLF Cyber City,  
Gurgaon – 122002  
Haryana  
+91-124 330 6000

### Bengaluru

6th Floor  
Millenia Tower 'D'  
1 & 2, Murphy Road, Ulsoor,  
Bengaluru – 560 008  
Karnataka  
+91-80 4079 7000

### Kolkata

56 & 57, Block DN.  
Ground Floor, A- Wing  
Sector - V, Salt Lake  
Kolkata – 700 091,  
West Bengal  
+91-033 2357 9101/  
4400 1111

### Pune

7th Floor, Tower A - Wing 1,  
Business Bay, Airport Road,  
Yerwada, Pune – 411 006  
Maharashtra  
+91-20 4100 4444

### Chennai

8th Floor  
Prestige Palladium Bayan  
129-140 Greams Road  
Chennai – 600 006  
Tamil Nadu  
+91 44 4228 5000

### Mumbai

PwC House  
Plot No. 18A,  
Guru Nanak Road(Station Road),  
Bandra (West), Mumbai – 400 050  
Maharashtra  
+91-22 6689 1000

### For more information

Contact us at  
[pwctr.knowledgemanagement@in.pwc.com](mailto:pwctr.knowledgemanagement@in.pwc.com)

## About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 223,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at [www.pwc.com](http://www.pwc.com).

In India, PwC has offices in these cities: Ahmedabad, Bengaluru, Chennai, Delhi NCR (Gurgaon), Hyderabad, Kolkata, Mumbai and Pune. For more information about PwC India's service offerings, visit [www.pwc.com/in](http://www.pwc.com/in)

PwC refers to the PwC International network and/or one or more of its member firms, each of which is a separate, independent and distinct legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details.

©2017 PwC. All rights reserved

## Follow us on:



For private circulation only

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwCPL, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. Without prior permission of PwCPL, this publication may not be quoted in whole or in part or otherwise referred to in any documents.

© 2017 PricewaterhouseCoopers Private Limited. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers Private Limited (a limited liability company in India having Corporate Identity Number or CIN : U74140WB1983PTC036093), which is a member firm of PricewaterhouseCoopers International Limited (PwCIL), each member firm of which is a separate legal entity.