

# Preparatory activities sufficient to constitute business set up – AMC's expenditure from incorporation date allowed

October 31, 2018

## In brief

In a recent ruling<sup>1</sup>, the Mumbai bench of the Income-tax Appellate Tribunal (Tribunal) reaffirmed the principle that “setting up” of business, and not “commencement” thereof, is relevant under the Income-tax Act, 1961 (the Act) for the purpose of claiming revenue expenditure as deductible.

The taxpayer was incorporated to manage assets of a mutual fund regulated by the Securities and Exchange Board of India (SEBI). Upon incorporation, it took various steps to commence its business activities. Revenue expenditure incurred by the taxpayer after incorporation was deductible.

## In detail

### Facts

- The taxpayer was incorporated as a private limited company on 30 September, 2006 and engaged in the business of asset management.
- Upon incorporation, the taxpayer undertook the following activities:
  - Complying with SEBI requirements, as per the terms of in-principle approval and preparation of final application to SEBI for registration of the fund;
  - Identifying a new office location and finalising the office lease;
  - Setting up office infrastructure;
  - Hiring key employees;
  - Developing product literature; and
  - Negotiations with R&T Agent, Custodian, Fund accountants.
- The taxpayer entered into an investment management agreement (IMA) with a trustee company on 15 December, 2006.
- The taxpayer also undertook preparatory work to launch a mutual fund scheme, which included:
  - Filing a new fund offer document with SEBI;
  - Obtaining approval from SEBI to launch new schemes;
  - Giving presentations to distributors;
  - Setting up additional branches for better penetration;
  - Empanelling distributors across India; and
  - Putting a marketing campaign in place.
- While the taxpayer successfully launched its first scheme in May 2007, it claimed deduction for revenue expenditure incurred since the date of its incorporation in the return filed for assessment year 2007-08 (relevant to financial year 2006-07). However, the tax officer (TO) rejected the taxpayer's contention and observed that during the year under consideration, the taxpayer

<sup>1</sup> ITA No. 2470/ Mum/ 2011

was not engaged in any business, and hence, disallowed the expenses claimed.

- The taxpayer alternatively contended that expenses incurred subsequent to the date of signing the IMA should have been allowed. The TO rejected this contention on the ground that the IMA did not confer the taxpayer to any expenditure without getting corresponding reimbursement. The TO observed that the books of account did not reflect any expenses being reimbursed.
- On appeal, the Commissioner of Income-tax (Appeals) [CIT(A)] upheld the TO's actions and confirmed the disallowance.
- Aggrieved, the taxpayer preferred an appeal before the Tribunal.

### ***Issue before the Tribunal***

Whether the TO was justified in disallowing the revenue expenditure claimed by the taxpayer subsequent to “setting up” of its business after incorporation?

### ***Tribunal's ruling***

- The Tribunal observed that the TO failed to appreciate the business of the mutual fund industry. The business activities of an asset management company (AMC) are regulated by the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations). The MF Regulations require the AMC to undertake various activities, which include launching schemes, managing funds, providing quarterly reports, maintaining books of

accounts, etc. The Tribunal observed that the expenses incurred by the taxpayer was routine in nature incurred to conduct its business as an AMC, and was incurred in accordance with the MF Regulations.

- The Tribunal noted that upon incorporation, the taxpayer took various steps to commence its business such as hiring people, applying to the SEBI, organising for space, etc. These actions amounted to “setting up” of business.
- The Tribunal also observed that the TO erred in holding that entering into an IMA did not confer upon the taxpayer to expend without obtaining any corresponding reimbursement of expenses. The Tribunal stated that entering into an IMA was sufficient to carry on business.
- Drawing attention to the judicial pronouncements<sup>2</sup> cited by the taxpayer in its submissions, the Tribunal observed that there is a distinction between “setting up” of business and “commencement” of business. It stated that “setting up” of business is relevant under the Act and not “commencement” of business. The expression “setting up” means “to place on foot” or “to establish” in contradiction to the expression “commence.” Certain essential activities in the course of carrying on a business could be said to be determinative of whether the business had been “set up” and that it was “ready to commence.” The criteria for determining when a business can be said to have been set up would be based on the facts of

each case and dependent on type of business.

- The Tribunal noted that it was necessary to enter into an IMA to act as an AMC for the mutual fund, which was done in the instant case. In addition, other processes to launch the fund were also started and the taxpayer launched the first scheme later. The Tribunal observed that the taxpayer had undertaken preparatory work to launch the mutual fund scheme. Thus, by undertaking the aforesaid activities, it could be said that the business activity of the taxpayer had “commenced” and expenses were allowable.
- The Tribunal concluded that the TO was unjustified in not accepting the claim of the taxpayer that its business activities commenced from the date of its incorporation. Accordingly, the Tribunal directed the TO to verify the expenses and allow the same as per the provisions of the Act.

### ***The takeaways***

Determination of the date of setting up/ commencement of business and deductibility of revenue expenditure thereafter has been a vexed issue. The Tribunal ruling supports a view that in the context of the service sector, undertaking various steps to commence business could tantamount to “setting up” of business. Hence, revenue expenditure incurred thereafter should be allowable.

### ***Let's talk***

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

<sup>2</sup> CIT v. Axis (P.) Equity Limited [2017] 391 ITR 370 (Bombay)  
Multi Act Realty Enterprises Private Limited v. ITO [ITA No. 7274/Mum/2011 dated 28 August, 2015]

HSBC Securities India Holdings Private Limited [ITA No. 3181/Mum/99 dated 28 November, 2001]

Axis Private Equity Limited v. DCIT [ITA No. 3045/Mum/2013 dated 19 August, 2013]

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