

Tax Alert | Delivering clarity

10 January 2020

High Court held front-end fee is interest and so deductible over the loan period, and unrealised foreign exchange gains is taxable income

Front-end fee being interest deductible by spread over the loan period. Unrealised foreign exchange gains at year-end taxable as mercantile system of accounting followed.

The Kolkatta High Court in *Kesoram Limited*¹ (the taxpayer) held that front-end fees paid on loan availed is interest and so it is deductible over the loan period, and unrealised foreign exchange gains at year-end is taxable income as the taxpayer follows mercantile system of accounting.

Facts of the case:

Front-end Fees

- The taxpayer had paid Rs. 61,69,000 as front-end fees to obtain new loan. Such expenses were claimed for the AY 2004-05 by the taxpayer under section 35D of the Income-tax Act, 1961 (the Act) over a period of 10 years.
- According to the tax officer, this expenditure could be claimed once and could not be spread over a period of ten years under Section 35D. This expense, according to them was not one which would fall within the conditions stipulated in Section 35D(1) and (2) of the said Act.
- The Tribunal followed its earlier year's order and dismissed the tax department's appeal, which was challenged before the High Court.

Unrealised foreign exchange gain

- The taxpayer had claimed the year-end unrealised foreign exchange gains as not taxable being notional gains. The tax officer added Rs. 7,20,12,49 on account of unrealised foreign exchange gain since the taxpayer was following the mercantile system of accounting and they could not avoid the said amount being assessed as its income during the relevant financial year.
- The Commissioner of Income Tax, Appeals deleted the addition.
- The Tribunal had upheld the decision of Commissioner of Income Tax, Appeals and dismissed the tax department's appeal, which was challenged before the High Court.

Decision of High Court:

Front-end fees

- The High Court was of the opinion that the facts of this case were very similar to those before the Supreme Court in [Madras Industrial Investment Corpn Ltd. vs CIT](#)². The Supreme Court had held that discount on issue of debentures was allowable as deduction over the tenure of the debentures. The High Court observed that the front-end fee is part of interest under Section 2(28A) of the said Act and such expenditure was revenue and not capital in nature. So according to the Supreme Court decision, the taxpayer is entitled to amortize it.

¹ Commissioner of Income-tax, Kolkata II v. Kesoram Industries Ltd. [2019] 112 taxmann.com 356 (Calcutta)

² *Madras Industrial Investment Corpn. Ltd. v. CIT* [1997] 225 ITR 802/91 Taxman 340

- As the Tribunal had merely followed its order in the preceding year, the High Court set aside the order of the Tribunal with a direction to re-determine the issue by considering *Madras Industrial Investment Corpn. Ltd. (supra)* and determine the allowable revenue expenses of the taxpayer for the relevant assessment year.

Unrealised foreign exchange gains

- The learned Senior Advocate appearing for the taxpayer conceded that the ground was in favour of the Revenue in view of the Supreme Court decision in the case of [CIT v. Woodward Governor India \(P.\) Ltd³](#).
- The Supreme Court had held that "valuation is a part of the accounting system and having come to the conclusion that business losses are deductible under [Section 37\(1\)](#) on the basis of ordinary principles of commercial accounting and having come to the conclusion that the central government has made Accounting Standard-11 mandatory, the "loss" suffered by the assessee on account of the exchange difference as on the date of the balance sheet, is an item of expenditure under [Section 37\(1\)](#) of the 1961 Act and allowable as deduction.
- Thus, the unrealised foreign exchange gain as at year-end credited to the profit and loss account as per the mercantile system of accounting followed by the taxpayer, should be taxable.

Observation:

The High Court has relied on the Supreme Court judgements for both grounds of appeal. The decision should be relevant for the principles of accrual under the Indian Accounting Standards (IND AS) adopted by Indian companies and the Income Computation and Disclosure Standards (ICDS) provided under the Income-tax Act, 1961.

³ CIT v. Woodward Governor India (P.) Ltd. [2009] 312 ITR 254/179 Taxman 326



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

This material and the information contained herein prepared by Deloitte Touche Tohmatsu India LLP (DTTI LLP) is intended to provide general information on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This material contains information sourced from third party sites (external sites).

DTTI LLP is not responsible for any loss whatsoever caused due to reliance placed on information sourced from such external sites. None of DTTI LLP, Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this material, rendering professional advice or services. This information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this material.

©2020 Deloitte Touche Tohmatsu India LLP. Member of Deloitte Touche Tohmatsu Limited