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SC rules that upfront interest payment on debentures is allowable in the year of payment and is not required to be deferred over the term of the debentures.

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Synopsis

The Supreme Court in the case of Taparia Tools Limited[1] has held that the entire upfront interest payment on debentures would be entitled to deduction in the year in which the amount is actually paid.

Facts

- The taxpayer had issued debentures to its subscribers/ debenture holders with the following two options as regards payment of interest:
  - Under the first option, the subscribers could opt to receive interest periodically i.e. every half yearly at the rate of 18% per annum over a period of five years.
  - Under the second option, the subscriber could opt to receive one time upfront payment of Rs.55 per debenture.
- Of the six subscribers, two subscribers opted for the second option during assessment years 1996-97 and 1997-98 respectively. Accordingly the taxpayer made upfront interest payment of Rs.27,225,000/- and Rs.5,500,000/- during assessment years 1996-97 and 1997-98 respectively.
- Following the mercantile system of accounting, the taxpayer considered the upfront interest payments as deferred revenue expenditure in the accounts to be written off over a period of five years. However, in the return of income for the assessment years 1996-97 and 1997-98, the entire upfront interest was claimed as deduction in the year of payment.
- The assessing officer (AO) denied the taxpayer's claim and chose to spread it over a period of five years on the basis that it was "deferred revenue expenditure".
- The order of the AO was upheld by the Commissioner of Income-tax (Appeals), Income-tax Appellate Tribunal and the High Court.

[1] Civil appeal Nos. 6336-6368 of 2003 and 6946-6948 of 2004

Issue before the Supreme Court

Whether the liability of the taxpayer to pay the interest upfront to the debenture holder is allowable as a deduction in the first year of payment or it is to be spread over a period of five years, being the life of the debentures.

Ruling of the Supreme Court

- The Supreme Court observed that in order to be entitled to have deduction of the upfront interest payment, the only aspect which needed examination was as to whether provisions of Section 36(1)(iii) read with Section 43(ii) of the Income-tax Act,1961 (the Act) were satisfied.
- As per section 36(1)(iii) of the Act, any amount on account of interest paid becomes an admissible deduction under Section 36 if the interest was paid on the capital borrowed by the taxpayer and this borrowing was for the purpose of business or profession. The AO did not dispute that the expense on account of interest was genuinely incurred.
- The definition of “paid” is contained in section 43(ii) of the Act to mean actually paid or incurred according to the method of accounting. Even if the amount is not actually paid but “incurred” according to the method of accounting, the same would be treated as “paid”.
- The Supreme Court held that the High Court’s action of upholding the AO’s view of spreading the interest expense over a period of five years based on the term of the debentures is not tenable. By allowing only 1/5th of the upfront payment actually incurred, though the entire amount of interest is actually incurred in the very first year, the AO, in fact, treated both the payment options at par and accordingly tampered with the terms of issue, which was beyond his domain.
- The Supreme Court also dismissed the High Court’s finding that under the mercantile system of accounting, book profits are liable to be taxed and in order to determine the net income of an accounting year, the revenue and other incomes are to be matched with the expenses. The Supreme Court held that the High Court had wrongly applied the principle of “Matching Concept”.

- The Supreme Court also disagreed with the High Court regarding its observation that the upfront payment was a case of deferred interest option. The Supreme Court clarified that there is no concept of deferred revenue expenditure in the Act as explained in various judgments except under specified sections, i.e. where amortization is specifically provided, such as Section 35D of the Act.
- The Supreme Court referred to its own decision in the case of Bharat Earth Movers v. Commissioner of Income-tax[2] wherein it was held that if a business liability has arisen in an accounting year, the deduction should be allowed even if such a liability may have been quantified and discharged at a future date. In case of the tax payer there is no dispute that the interest has been "paid" during the relevant year. The Supreme Court observed that the tax payer's case is on a stronger footing since the liability has not only arisen in the assessment years under consideration but was quantified and discharged during the same assessment years.
- Normally the ordinary rule is to be applied, namely, revenue expenditure is to be allowed in the same year in which it is incurred. However, in cases where the tax payer wants to spread the expenditure over a period of ensuing years it can be allowed only if the principle of "matching concept" is satisfied.
- In the instant case the taxpayer did not want to spread the interest over a period of five years. In its income tax return it chose to claim the entire expenditure in the year in which it was incurred. This course of action was permissible in law as it was in consonance with the provisions of the Act. There is no estoppel against the Statute and the Act enables the tax payer to claim the entire expenditure in the manner it is claimed.
- Merely because a different treatment was given in the books of accounts cannot be a factor which would deprive the taxpayer from claiming the entire expenditure as a deduction. Entries in books of accounts are not determinative and the matter is to be examined on the touchstone of provisions contained in the Act[3].

[2] (2000) 6 SCC 645
[3] Kedarnath Jute Manufacturing Co.Ltd v. Commissioner of Income tax (Central), Calcutta (1972) 3 SCC 252
Tuticorin Alkali Chemicals & Fertilizers Ltd., Madras v. Commissioner of Income tax, Madras (1997) 6 SCC 117
Sutlej Cotton Mills Ltd. v. Commissioner of Income tax, Calcutta (1978) 4 SCC 358
United Commercial Bank, Calcutta v. Commissioner of Income tax, WB-III, Calcutta (1999) 8 SCC 338

Comments

The Supreme Court in this decision has reiterated that if a business liability has arisen in an accounting year the deduction should be allowed irrespective of when the liability is quantified and discharged. The Supreme Court has also made a welcome clarification that there is no concept of “deferred revenue expenditure” under the Act except under specified sections and where a tax payer himself wants to spread an expenditure over a period of ensuing years it can be allowed only if the principle of “Matching Concept” is satisfied. Lastly, the Supreme Court has held that the accounting treatment of an expenditure is not conclusive and that its allowability under the Act should be examined on the touchstones of provisions of the Act.

Source: Supreme Court decision in the case of Taparia Tools Limited vs. JCIT (Civil appeal Nos. 6336-6368 of 2003 and 6946-6948 of 2004)

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Contacts

Ahmedabad
Heritage, 3rd Floor,
Near Gujarat Vidyapith,
Off Ashram Road,
Ahmedabad – 380 014.
Tel: + 91 (079) 2758 2542
Fax: + 91 (079) 2758 2551

Bangalore
Deloitte Centre, Anchorage II,
100/2, Richmond Road,
Bangalore 560 025.
Tel: +91 (080) 6627 6000
Fax: +91 (080) 6627 6010

Chennai
No.52, Venkatanarayana Road,
7th Floor, ASV N Ramana Tower,
T-Nagar,
Chennai 600 017.
Tel: +91 (044) 6688 5000
Fax: +91 (044) 6688 5050

Coimbatore
Shanmugha Manram
41, Race Course,
Coimbatore
Tamil Nadu - 641018
Tel: + 91 (0422) 439 2801
Fax: +91 (0422) 222 3615

Delhi/Gurgaon
Building 10,
Tower B, 7th Floor,
DLF Cyber City,
Gurgaon 122 002
Tel : +91 (0124) 679 2000
Fax : + 91 (0124) 679 2012

Hyderabad
1-8-384 and 385, 3rd Floor,
Gowra Grand S.P.Road,
Begumpet,
Secunderabad – 500 003.
Tel: +91 (040) 6603 2600
Fax:+91 (040) 6603 2714

Kolkata
Bengal Intelligent Park Building Alpha,
1st floor, Block EP and GP Sector V,
Salt Lake Electronics Complex,
Kolkata - 700 091.
Tel : + 91 (033) 6612 1000
Fax : + 91 (033) 6612 1001

Mumbai
Indiabulls Finance Centre,
Tower 3, 28th Floor,
Elphinstone Mill Compound,
Senapati Bapat Marg, Elphinstone (W),
Mumbai – 400013
Tel: + 91 (022) 6185 4000
Fax: + 91 (022) 6185 4101

Pune
106, B-Wing, 7th Floor,
ICC Trade Tower,
Senapati Bapat Road,
Pune – 411 016.
Tel: + 91 (020) 6624 4600
Fax: +91 (020) 6624 4605

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