



TAX FLASH NEWS

Share premium cannot be regarded as part of the issued share capital, but Foreign Currency Convertible Bonds are treated as ‘debentures’, for computing capital employed while allowing deduction under Section 35D of the Income-tax Act

Background

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Subex Ltd.¹ (the taxpayer) held that the share premium cannot be regarded as part of the issued share capital while computing ‘capital employed’ for the purpose of allowing deduction under Section 35D² of the Income-tax Act, 1961 (the Act). Capital employed in the business of the company is the aggregate of three distinct components, namely, share capital, debentures and long-term borrowings. It does not include reserves and surplus of the company.

The Tribunal held that Foreign Currency Convertible Bonds (FCCBs) are treated as ‘debentures’ and can be considered as part of ‘capital employed’ for allowing deduction under Section 35D of the Act. In the light of the definition of ‘debentures’ provided under Section 2(12) of the Companies Act, 1956 (the Companies Act) and considering the fact that the FCCBs are in the nature of bonds as defined in the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, FCCBs can be considered as part of capital employed for allowing deduction under Section 35D of the Act.

Facts of the case

- The taxpayer is engaged in the business of development and export of various software products for the telecommunication industry.
- During the assessment year 2008-09, the taxpayer incurred expenditure to set up a new industrial unit and was entitled to claim deduction of such expenditure by amortising the said expenditure over a period of five years in accordance with the provisions of Section 35D of the Act. The taxpayer chose the option of claiming a deduction of 5 per cent of capital employed in the business of the company.
- The expenditure was incurred in connection with acquiring shares of two companies. The controlling interest in these two companies was acquired by the taxpayer consequent to the acquisition of shares of the companies mentioned above.
- The Assessing Officer (AO) while passing an assessment order did not call for any explanation with regard to the basis on which the taxpayer opted for deduction under Section 35D of the Act. There was no disallowance on account of the claim made by the taxpayer and it was accepted by the AO without any dispute.
- The Commissioner of Income-tax (CIT) was of the view that the deduction under Section 35D of the Act has been allowed in excess of what the taxpayer is entitled to. The CIT held as follows:
 - The definition of ‘cost of project’ under Section 35D of the Act referred to ‘actual cost of the fixed assets, being land, buildings, leaseholds, plant, machinery, etc. which are shown in the books of the taxpayer. The cost of acquisition of two businesses were shown as ‘Investments’ by the taxpayer in its balance sheet and it cannot be treated as ‘Fixed Assets’ and therefore deduction in this regard cannot be accepted.

¹ Subex Ltd. v. CIT (ITA No.689/Bang/2014) – Taxsutra.com

² Amortisation of certain preliminary expenditure

- The share premium cannot be regarded as a part of the capital employed. The CIT placed reliance on the decision of the Delhi High Court in the case of Berger Paints India Ltd.³ The premium, if any, collected by the company on the issue of its share capital does not constitute a part of capital employed in the business of the company for the purpose of quantification of deduction under Section 35D of the Act.
- Since the taxpayer had not produced any evidence to support the claim, the FCCBs cannot be considered as 'debentures' and therefore cannot be taken as a part of capital employed for allowing deduction under Section 35D of the Act.

Tribunal's ruling

Allowability of deduction on the basis of 'Cost of project' under Section 35D(3)(a) of the Act

- The definition of 'cost of project' indicates that it is only the fixed assets, being land, buildings, leaseholds, plant, machinery, furniture, fittings and railway sidings (including expenditure on development of land and buildings), which are acquired or developed in connection with the extension of the industrial undertaking or for setting up of the new industrial unit, that should be considered.
- The taxpayer issued Global Depository Receipts (GDRs) and FCCBs and incurred expenditure in this regard. The proceeds of the issue were used to acquire shares of two foreign companies and thereby gain control of these two foreign companies. Therefore, no fixed assets were acquired or developed in connection with the extension of the industrial undertaking or setting up of the new industrial unit of the taxpayer.
- Shares acquired by the taxpayer cannot be treated as land or building, plant or machinery, etc., and therefore cannot be treated as 'cost of project' for the purpose of allowing deduction under Section 35D of the Act.

Whether share premium can be regarded as a part of the issued share capital while computing capital employed

- The Delhi High Court in the case of Berger Paints India Ltd. held that as per the Explanation to Section 35D(3) of the Act, capital employed in the business of the company is the aggregate of three distinct components namely, share capital, debentures and

long-term borrowings. It does not include reserves and surplus of the company. Therefore, premium, if any, collected by the company on the issue of its share capital does not constitute a part of capital employed in the business of the company for the purpose of quantification of deduction under Section 35D of the Act.

- The Ahmedabad Tribunal in the case of Sirhind Steel Ltd.⁴ in the context of Section 35D of the Act, was of the view that share premium has to be considered as a part of 'Issued Share Capital'. However, the Delhi High Court in the case of Berger Paints has taken a contrary view.
- The aforesaid decision rendered in the context of Section 254(2)⁵ of the Act and the regular assessment proceedings cannot be applied in the context of provisions of Section 263 of the Act. The power under Section 263 of the Act is a supervisory power and protection of the interest of the revenue owing to an erroneous order is the salutary purpose of those provisions.
- The provisions of Section 78 of the Companies Act on which the decision of Sirhind Steel Ltd. proceeded provide for a limited fiction of treating share premium as part of paid up capital for the purpose of reduction of the same. Section 78(2) of the Companies Act prohibits the use of share premium for any purpose other than the purposes set out therein. Therefore, share premium cannot be regarded as part of the 'issued share capital' for allowing deduction under Section 35D of the Act.
- There was no merit in the contention of the taxpayer that share premium should be regarded as part of the issued share capital for allowing deduction under Section 35D of the Act.

Whether FCCBs can be considered as 'debentures' and taken as a part of capital employed for allowing deduction under Section 35D of the Act

- Section 2(12) of the Companies Act defines 'debentures' to include debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not.

⁴ JCIT v. Sirhind Steel Ltd. [2005] 97 ITD 502 (Ahd)

⁵ Dealing with the orders of the Income-tax Appellate Tribunal.

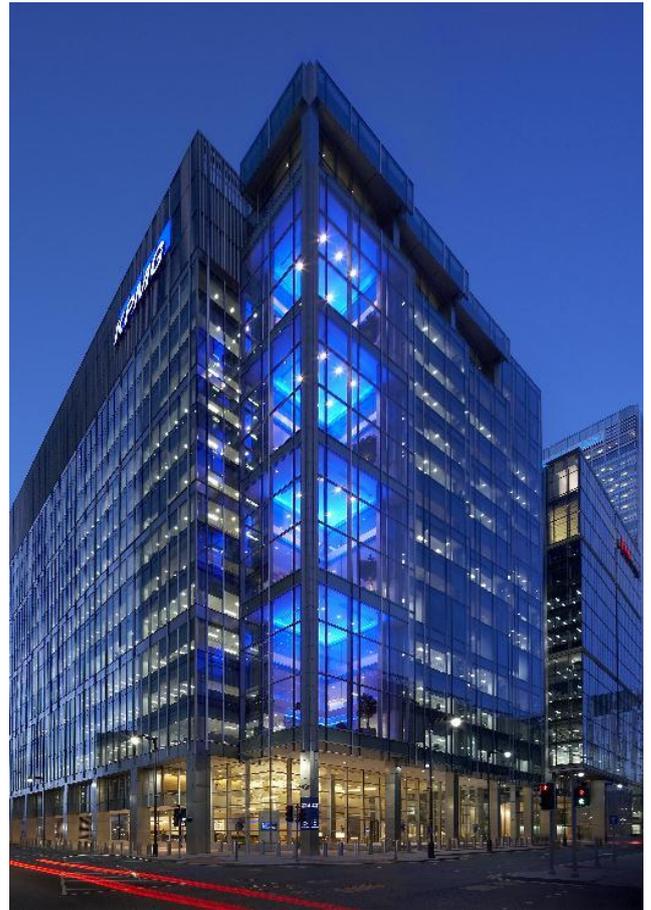
³ Berger Paints India Ltd. v. CIT [2007] 292 ITR 658 (Del)

- FCCB is a bond and therefore it is within the meaning of the term 'debenture' for the purpose of Section 35D of the Act. FCCBs were issued under the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993. There the meaning of FCCB is given as bonds issued in accordance with the said scheme and subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner, either in whole, or in part, on the basis of any equity related warrants attached to debt instruments.
- In view of above, it was held that FCCBs are to be regarded as debentures and consequently be considered as a part of 'capital Employed' for allowing deduction under Section 35D of the Act.

Our comments

The meaning of the phrase 'capital employed in the business' assumes significance in the context of Section 35D of the Act. In the present ruling, the Bangalore Tribunal has held that share premium cannot be regarded as part of the issued share capital while computing capital employed for the purpose of allowing deduction under Section 35D of the Act since capital employed in the business of the company is the aggregate of three distinct components, namely, share capital, debentures and long-term borrowings. It does not include reserves and surplus of the company.

The Tribunal also held that FCCBs are treated as 'debentures' and can be considered as part of capital employed for allowing deduction under Section 35D of the Act since the Companies Act, and Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 provide 'debentures' to include debenture stock, bonds and any other securities of a company.



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