



Whether Interest paid on borrowed funds for acquiring a Controlling Interest in a company be allowed as deduction?

The allowance of deduction u/s 57(iii) for interest paid on loan availed for acquiring the controlling interest by purchasing shares of the company is matter under debate.

Issue:

When loan is taken for making investment in shares of the company which results into acquiring of the controlling interest of that company, whether deduction of interest paid on such loan would be allowed as per sec 57(iii) of the Act.

Proposition:

It is submitted that the interest expenditure incurred on loan taken for acquiring the shares to be allowed as deduction under sec 57(iii) as the interest and dividend income earned against such expenditure was chargeable to the tax. As per sec 57 of the Act, the income chargeable under the head 'Income from other Sources' shall be computed after making following deductions; wherein sub-section (iii) states that any other expenditure (not being an expenditure of capital nature) laid out or expended wholly and exclusively for the purpose of making or earning such income would be allowed as deduction.

View against the Proposition:

1. When the primary intention of acquiring the shares was having a control over the other company and not earning interest or dividend income, the expenditure incurred for acquiring the control would constitute to be of capital nature and accordingly to be disallowed u/s 57(iii).
2. It is provided in sec 57(iii) that 'expenditure laid out or expended wholly and exclusively for the purpose of making or earning such income' would be allowed as deduction.

However, in present case, the investment in shares was made to acquire the control along with earning interest income and thus the investment was not fully and exclusively for earning interest and dividend income.

Let me now refer to the decision of CIT v. Amrita R. Shah 238 [ITR] 777 (Bom). Their lordship of Bombay High Court decided that the interest paid by the assessee in this case does not fall within the purview of Section 57(iii) of the Act and hence the same is not an allowable deduction in computation of the income of the assessee. Deduction under Section 57(iii) is allowable only of expenditure laid out or expended wholly or exclusively for the purpose of making or earning the income referred to in that section, i.e., "income from other sources". The object of the acquisition of shares being acquisition of controlling interest in the company, the expenditure incurred on the loan obtained for that purpose could not be regarded as expenditure incurred wholly and exclusively for the purpose of making or earning income from other sources.

View in Favour of Proposition:

It is submitted that as the income arising is taxable under the Act, the expenditure related to such income should be allowed as deduction.

The Supreme Court in the case of Vodafone International Holdings B.V. v. UOI, held that if the dividend income is taxable during the year under consideration, the interest is allowable as deduction under section 57(iii).

It was observed by the Hon. Supreme Court that:

- Controlling interest forms an inalienable part of the share itself and cannot be traded separately unless otherwise provided by the statute.
- The argument that controlling interest is an identifiable or distinct capital asset independent of holding of shares, cannot be accepted.

Controversies

- It was inherently a contractual right and not a property right and cannot be considered as a capital asset unless the statute stipulates otherwise.
- Acquisition of shares may carry the acquisition of controlling interest, which is purely a commercial concept and tax is levied on the transaction, not its effect.

Further, the Bombay High Court in case of CIT v. Srishti Securities Pvt. Ltd. did not agree with their previous decision and held that the object of the loan was irrelevant and the interest on investment would be allowed as deduction.

Let me now refer to the decision of CIT v. Srishti Securities Pvt. Ltd. (2010) 321 ITR 498 (Bom). Their lordships of Bombay High Court held as under:

“The learned Tribunal addressed itself to the question, as to whether the assessee is entitled to deduction in respect of interest liability either under Section 36(1)(3) or under Section 57(3) of the Income Tax Act. Reliance was placed on the judgment of this Court in the case of Commissioner of Income Tax Vs. Lokhandwala Construction Industries Ltd.

260 ITR 579 (Bom) for the proposition that when the assessee claims deduction of interest paid on capital borrowed, all that the assessee has to show is that the capital which was borrowed was used for the business purpose in the relevant year of account and it does not matter whether the capital was borrowed or not to acquire revenue asset or capital asset. The learned Tribunal also relied on the judgment of the Calcutta High Court in the case of CIT Vs. Rajeeva Lochan Kanoria 208 ITR 616 (Cal) where the Calcutta High Court took a view that under the provisions of Section 36(1)(3) of the Income Tax Act, the only enquiry to be made is whether the payment of interest was in respect of capital borrowed for the purpose of assessee’s business or profession. Such amount borrowed, if for the purpose of business or profession may be utilized for the purpose of acquisition of stock in trade or for the purpose of acquisition of capital asset.

The learned court took a view that under Section 36(1)(3) there is no bar for allowance of interest paid in respect of capital borrowed which has been utilized for the purpose of acquisition of capital assets. Considering this the learned I.T.A.T. held that if the funds are borrowed by an investment company for making investment in shares which may be held as investment or as stock in trade or for the purpose of controlling interest in other companies, interest paid on such borrowed funds will be deductible u/s. 36(1)(iii) of the Income Tax Act.”

After recording this finding, it held that the interest expenditure is allowable under Section 36(1)(3) and therefore, disallowance to the extent sustained by the C.I.T.(A) was directed to be deleted.”

Following authorities have also taken the same view:

- a) CIT v. Lokhandwala Construction Inds Ltd [2003] 260 ITR 579 (Bombay)
- b) India Cements Ltd. v. CIT [1996] 60 ITR 52 (SC)

Summation:

At the outset, it is submitted that the interest expenditure is to be allowed as deduction and there is no question of treating the same as capital expenditure.

In the case of Srishti Securities Pvt Ltd, the Bombay High Court, relying on the decision of Lokhandwala Construction Inds Ltd v. CIT [2003] 260 ITR 579 (Bom) and the decision of India Cements Ltd v. CIT [1966] 60 ITR 52 (SC) held that the object of the Loan was irrelevant and the interest which was disallowed to the extent of investment would have to be allowed.

The decisions relied in the case of Srishti Securities Pvt Ltd were applicable to the facts of the present case since in those cases also the loan was taken for acquiring the controlling interest in the company. In the present case also, the loan was taken for acquiring shares of the company and after acquiring shares of the company, the taxpayer had got controlling interest of the company.

In the decision of the Amitaben R. Shah the Bombay High Court held that interest was not allowable if the loan was taken for acquiring controlling interest. However, when two views were possible then the view beneficial to the taxpayer had to be considered as held by the Supreme Court in the case of Vegetable Products Ltd [1973] 88 ITR 192 (SC)

In the case of Vodafone International Holdings B.V. the Supreme Court has observed that

- Ø Controlling interest forms an inalienable part of the share itself and cannot be traded separately unless otherwise provided by statute.
- Ø Control is an interest arising from holding a particular number of shares and cannot be separately acquired or transferred.
- Ø Controlling interest was not an identifiable or distinct capital asset independent of holding of shares.
- Ø It was inherently a contractual right and not a property right and cannot be considered a capital asset unless statute stipulates otherwise.
- Ø Acquisition of shares may carry the acquisition of controlling interest, which is purely a commercial concept and tax is levied on the transaction, not on its effect.
- Ø Controlling interest which stood transferred to Vodafone from HTI (BVI) Holdings Ltd. accompanied the CGP (Cayman Islands company) share and cannot be dissected so as to be treated as transfer of controlling interest of Mauritian entities and then that of Indian entities and ultimately that of Hutchison Essar Ltd (The Indian Telecom Company).
- Ø Thereafter, the Supreme Court held that capital gain chargeable under section 45 and their computation is to be in accordance with the provisions that follow section 45 and there is no notion of indirect transfer in section 45.

The ratio in case of Vodafone International Holdings B.V. was applicable to facts of the present case since acquiring of controlling interest in the company does not bear any income or expenditure, to be assessed or not to be allowed.

Since the interest was paid on borrowed funds for acquiring the shares of a company and the dividend income was taxable during the last year under consideration, the interest was allowable as deduction under section 57(iii) or under section 36(1)(iii) of the Act.

Our Comment:

In present case the Tribunal relied on the decision of the Supreme Court in the case of Vodafone where it was held that the controlling interest forms an inalienable part of the share itself and it cannot be traded separately unless otherwise provided by the statute. Accordingly, the Tribunal did not accept the contention of the Tax Department that the main purpose for making investment was to acquire controlling interest in the company and not to earn dividend. Consequently, the Tribunal held that the interest, of a company is allowable as deduction under section 57(iii) or under section 36(1)(iii) of the Act.

In the case of Off Shore India Ltd. v. DCIT [1996] 59 ITD 652 (Cal), the Calcutta Tribunal held that the motive to acquire the controlling interest of a company by acquiring shares of such company by the taxpayer was a wholly irrelevant consideration for judging allowability of interest payment on borrowings under section 57(iii) of the Act. Accordingly, the interest paid by the taxpayer on borrowings for purchasing shares was allowable as deduction even though no dividend was received on those shares during the year under consideration.

In the case of Model Manufacturing Co. (P) Ltd v. CIT [1980] 122 ITR 767 (Cal), the Calcutta High Court held that though ultimate motive of the taxpayer might have been to acquire controlling interest, yet immediate purpose for acquisition of shares was to earn income from dividends thereof and therefore, the taxpayer was entitled to deduction under section 57 of the Act. Further, the Mumbai Tribunal in the case of Ultimate & Pigments Ltd V. ACIT (IT A no. 2775/Mum/2005) held that interest on borrowings made for acquiring shares in Malaysian company along with controlling interest is allowable under section 57(iii) of the Act.
