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If the loan is taken and is invested in the shares of subsidiary company, whereby the controlling interest is acquired whether interest on such loan is capital expenditure or revenue expenditure?

Issue:

XYZ Ltd. had taken loan from ABC Bank Ltd. and invested in shares of its subsidiary company. RST Ltd.

whereby it has acquired controlling interest, In assessment proceedings the AO is of the view that interest paid to ABC Bank Ltd. on loan is capital expenditure as against the claim of the assessee that it is revenue expenditure.

Proposition:

Though ultimate motive of the assessee company was to acquire controlling interest, yet immediate purpose for acquisition of shares was to earn income by way of dividends on such shares and therefore, the assessee was entitled to deduction u/s. 57 of the Income Tax Act, 1961 and hence the same is to be treated as revenue expenditure.

View against the Proposition:

Payment of interest on borrowed fund is allowable as deduction either u/s. 36(i)(ii) or u/s. 57(iii) of the Income Tax Act 1961 which provide that when the assessee claims deduction of interest paid on capital borrowed it has to show that the capital which was borrowed was used for the business purpose in the relevant year. The sections provide as under:

- 1. Section 36(i)(iii):** the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession.
- 2. Section 57(iii):** any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income.

The Hon. Bombay High Court in the case of CIT Vs. Amritaben R. Shah (238 ITR 777) has held as under:

“The expenditure incurred by way of interest on the loan taken by the assessee for the said purpose could not be held to be expenditure incurred wholly and exclusively for the purpose of earning income by way of dividends. From the nature of transaction, it was clear that the expenditure was not for the purpose of earning income by way of dividends but for the purpose of acquiring controlling interest in the company and, therefore, it would not be allowable as a deduction u/s. 57(iii) of the Act.”

The Mumbai ITAT in the case of LLOYDS Steel Industries Ltd V/s. ACIT Range 6(3) Mumbai, 20 SOT 40 (Mum) following the Bombay High Court case (Supra) has held that, “the assessee had made the investment of the borrowed funds in the subsidiary companies to have a controlling interest and not to earn a dividend income. Since the investment in shares of subsidiary companies for controlling interest therein was not a part of the business activities of the assessee, the interest expenditure could not be allowed u/s. 37(1). This expenditure could only be examined u/s. 57(iii), but in the light of the judgment of the judgment of the Bombay High Court in the case of Amritaben R. Shah (Supra), in which it has been held that in order to get deduction u/s. 57(iii), the expenditure should be incurred wholly and exclusively for the purpose of making or earning the income from other sources and that it should not be in the nature of capital expenditure, as the investment was made to have controlling shares in the subsidiary companies.

View in favour of the Proposition:

In the case of CIT V/s. Srishti Securities Pvt. Ltd. (321 ITR 498) had notes are as under:

“The assessee acquired shares in the financial year 1993-14. They were shown as investment in the balance sheet as on March 31, 1995 and March 31, 1996 they were shown as stock-in-trade. The assessee had borrowed funds on which the assessee paid total interest of Rs. 14,37,255/- for which deduction was claimed u/s. 57(iii) of the Income Tax Act, 1961. During the course of assessment proceedings, the assessee claimed deduction u/s. 36(1)(iii) of the Act. The assessing officer disallowed the entire interest u/s. 36(1)(iii) on the ground that the primary object of acquiring shares was not to earn dividends but to acquire controlling interest in the company. In an appeal preferred before the Commissioner (Appeals), the Commissioner (Appeals) bifurcated the interest on pro rata basis between investment and stock-in-trade. He held that to the extent the borrowed funds were used for acquiring shares by way of stock-in-trade, the assessee was entitled to deduction of interest and on that basis allowed interest at Rs. 96,040. The balance interest was considered as neither allowable u/s. 57(iii) nor u/s. 37(1) of the Act. The Tribunal held that the interest expenditure was allowable u/s. 36(1) (iii) and therefore, directed disallowance to the extent sustained by the Commissioner (appeals). On appeal to the High court:

Held, dismissing the appeal that the object of the loan was irrelevant and the interest which was disallowed to the extent of investment would have to be allowed.”

In the case of Pistabhai Rikhabchand Kothari the Mumbai ITAT Bench IT Appeal No. 4649 (Mum.) of 2008 has held that:

We have heard the rival submissions and considered them carefully. After considering the submissions and perusing the material on record. We find that assessee deserve to succeed on the issue involved. In the case of Srishti Securities (P.) Ltd. (supra) the Hon’ble Bombay High Court has held that the assessing officer disallowed the entire interest u/s. 36(1)(iii) on the ground that primary object of acquiring share was not to earn dividend but to acquire controlling interest in the company. In this

case, the Commissioner bifurcated the interest on prorata basis between investment and stock-in-trade. He held that to the extent the borrowed funds were used for acquiring the shares by way of stock-in-trade, the assessee was entitled to deduction of interest and on that basis allowed the interest at Rs. 96,043/-. The balance interest was considered as neither allowable u/s. 57(ii) nor u/s. 37 of the Act. The Tribunal held that the interest expenditure was allowable u/s. 36(1) (iii) and therefore, directed to delete the disallowance to the extent sustained by CIT(A). On an appeal by department, the Hon’ble Bombay High Court while dismissing the appeal held that object of the loan was irrelevant and the interest which was disallowed to the extent investment would have to be allowed. While holding so, the Hon’ble Bombay High Court has considered another decision of Bombay High Court in the case of CIT Vs. Lokhandwala Construction Inds. Ltd. (2003) 260 ITR 579/131 Taxman 810 (Bom.) and the decision of India Cements Ltd. Vs. CIT (1966) 60 ITR 52 (SC). Learned D.R. has stated that these decisions are not applicable on the facts of the present case. In our view, the decisions are very much applicable as the loan was taken for acquiring the controlling interest in the company. In the present case also, loan was taken for acquiring shares of the company and after acquiring shares of the company. Assessee got controlling interest of the company. No doubt in earlier decision the Hon’ble Bombay High Court has held that interest is not allowable if the loan is taken for acquiring control interest. When two possible views are there, then the view beneficial to the assessee has to be considered as held by the Hon’ble Supreme Court in the case of CIT Vs. Vegetable Products Ltd. (1973) 88 ITR 192 (SC). We further noted that in case of Vodafone International Holdings B.V. (Supra) the Hon’ble Supreme Court has observed at page 13, Para (v) of its order that controlling interest forms an inalienable part of the share itself and cannot be traded separately unless otherwise provided by the statute. Control is an interest arising from holding a particular number of shares and cannot be separately acquired or transferred. Controlling interest is not an identifiable or distinct capital asset independent of holding of shares. It is

Controversies

inherently a contractual right and not a property right and cannot be considered 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 on its effect. Controlling interest, which stood transferred to Vodafone from HTL accompanied the CGP 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 HEL. Thereafter, the Hon'ble Supreme Court has held that capital gain chargeable u/s. 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. Meaning thereby, the Hon'ble Supreme Court has held that controlling interest cannot be that any income offered explained is allowable or not allowable if they are not provided specifically on the statute. The ratio of this decision can be easily imported on the facts of the present case as acquiring of controlling interest in the company does not bear any income or expenditure is to be assessed or not to be allowed. The interest is paid on borrowed funds for acquiring the shares of a company and the dividend income is taxable during the year under consideration. Therefore, in our considered view, the interest income is allowable as deduction u/s. 57(iii) or u/s. 36(1) (iii) of the Act. We, Order accordingly.

Summation:

In the case of Srishti Securities Pvt. Ltd., the Bombay High Court, relying on the decision of Lokhandwala Construction Inds Ltd and the decision of India Cements Ltd, held that the object of the loan was irrelevant and the interest which was disallowed to the extent of investment would to be allowed.

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

shares of the company, the assessee 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.

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

Controlling interest forms an inalienable part of the share itself and cannot be traded separately unless otherwise provided by the statute.

Control is an interest arising from holding a particular number of shares and cannot be separately acquired or transferred.

Controlling interest was not an identifiable or distinct capital asset independent of holdings of shares.

It was inherently a contractual right and not a property right and cannot be considered 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 on its effect.

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).

Therefore, the Supreme Court held that capital gain chargeable u/s. 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.

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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 year under consideration, the interest was allowable as deduction u/s. 57(iii) or u/s. 36(1) (iii) of the Act.

In the case of Pistabai Kothari, the Tribunal relied on the decision of 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 paid on borrowed funds for acquiring controlling interest, of a company is allowable as deduction u/s. 57(iii) or u/s. 36(1)(iii) of the Act.

In the case of Off Shore India Ltd., 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 u/s. 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. 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 u/s. 57 of the Act. Further, the Mumbai Tribunal in the case of Ultramine & Pigments Ltd. held that interest on borrowings made for acquiring shares in Malaysian company along with controlling interest is allowable u/s. 57(iii) of the Act.
