INDIAN BUDGET

INCOME TAX

2003

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To,
Clients & Friends,

Dear Sirs,

1. We are presenting herewith, our brief analysis of the Finance Act, 2003 (Budget, 2003). As in the past, we have given our analysis after the Finance Act has been passed. Hence this note covers the changes in the income tax act as finally approved by the parliament.

2. Among the most significant changes were in the definition of the status of “Not Ordinarily resident”. A settled issue for more than 6 decades has now been changed. Further, dividend has again been made tax free in the hands of the shareholders and unitholders. Instead the company or the mutual fund which distributes the dividend, will pay tax @ 12.5% of the dividends.

3. We have grouped the paragraphs in the following parts:

A: Non-residents

B: Corporate / Business matters

Hope, you will find the same useful.

With Best Regards,

Yours sincerely,

Rashmin Sanghvi and Associates

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Income Tax

Tax rates

The new maximum marginal rates including surcharge are:

For Individuals
income upto Rs. 8,50,000 – 30.0%

income above Rs. 8,50,000 - 33.0%

Firm 35.875%

Company 41.0%

The basic tax rates have remained unchanged except for surcharge.

The surcharge of 5% has been changed as under:

Person		Surcharge
For individuals	– Income upto Rs. 8,50,000	Nil
	- Income above Rs. 8,50,000	10%
Others	- Entire income	2.5%

Now the surcharge is payable by non-residents & foreign companies also (from A. Y. 2002-03).

A. Non-residents

1. Not Ordinarily Resident – Section 6(6)

1.1 India has a unique status for persons who return to India after being a non-resident. Essentially, the old section provided that if a person became a non-resident for two years, on returning to India, he would become a Not Ordinarily Resident (NOR) for next 9 years. As an NOR, his foreign income was exempt from tax in India (except in very limited cases). This provision has been there for the past 6 decades. While the language of the section is quite confusing (due to use of three negatives), the above interpretation was an accepted position.

1.2 Purpose of the NOR status

The status was introduced during the British rule in 1939. The purpose of NOR status was that British officers who were posted in India (or any other people who wanted to stay in India) would initially be liable to pay income tax in India only on their Indian income. When they could be said to be settled in India, the Indian Government would charge tax on their world wide income. A time period of 9 years was considered to be reasonable to decide. Hence if the person stayed for 9 years in India, it would be considered sufficient to levy world wide tax.

1.3 Misuse of NOR Status

As it happens with several beneficial provisions, this status of NOR was misused. People would go abroad for about 13 months spread over 2 years, and become non-residents. Then they would return to India and claim the NOR status and not pay any tax on foreign income. They would transfer their undeclared Indian income abroad through havala channels, and claim the same as foreign income.

1.4 Committee reports

The government had proposed to remove the status of NOR some years ago. But due to several protests the status was restored. Now however the government had appointed a committee under the Chairmanship of Dr. Vijay Kelkar. The committee recommended that such a status does not exist anywhere in the world. The same should be removed. Even the subsequent Vijay Mathur committee report recommended the removal of the status.

1.5 New definition of NOR Status

The government has not removed the status completely but modified it substantially. Now it is provided that:

1.5.1 A person will be an NOR for only 1 year, if he has been a non-resident for 9 years. He will be an NOR for 2 years, if he is non-resident for 10 or more years.

OR

1.5.2 He will be an NOR if he is in India for less than 730 days in the last 7 years.

Both the conditions are alternative. In other words, to be an NOR, one has to fulfill any one condition only. Not both.

1.6 What are the implications?

1.6.1 An Indian resident cannot go abroad only for 2 years, and claim NOR status. He will have to become a non-resident for atleast 9 years.

The 'NOR' planning is now plugged.

The ingenuity of tax payers always find some ways / modifications to continue planning.

New doors have been opened long before the old ones are closed.

Further, he will get the benefit for only 2 years at the most if he has been a non-resident for atleast 10 years. This will prevent misuse of the status.

1.6.2 However there is another condition – that is, a person will be an NOR if he is in India for less than 730 days in 7 years. Thus a person can be a non-resident for 4 years by being completely outside India. Then for 3 years he can be in India for about 240 days per year (or less than 730 days in three years). He will thus be a resident, but an NOR for 3 years. From the 4th year, he will be an ordinary resident. In other words, for becoming an NOR, it is not necessary to be a Non-resident for nine years. Even four years' stay abroad may be adequate. And, if a person cannot be wholly outside India, he may extend the period to five years. This situation has not been visualised by many people.

A person can acquire the NOR status by just becoming a NR for four years instead of nine years.

1.7 **Expatriates**

The major implication will be for expatriates who come to India on short term assignments. They will be liable to tax on global income once their NOR status expires. Normally they will become ordinary residents from the 3rd years onwards. However if they can be in India for less than 730 days in the 7 years before coming to India (see para above), they can be NOR for 3 years.

Once their status of NOR expires, they will have to submit their worldwide income to tax in India. They will of course get credit for any taxes paid in foreign countries. However claiming credit for foreign taxes has its own administrative problems.

It is also possible that these persons will be treated as "Residents of two countries – the country of their domicile; and India. They will have to consider the "tie-breaking" provisions.

2. Double Tax Avoidance Agreements – Section 90

DTA benefit will be available if a person is liable to tax in the other country, even if tax is not actually paid due to tax relief.

Treaty shopping remains prohibited.

2.1 The double tax avoidance agreements which India has entered with tax havens, has generated a lot of heat. Let us briefly see the scene.

2.2 Indian government has been empowered to enter into a DTA under section 90 of the income tax act. Historically, India had never entered into a DTA with a country which had no taxes or very low taxes. With Mauritius, India had entered into a DTA in 1983. At that time, Mauritius was not a tax haven. In 1991, Mauritius became a tax haven. However after 1991, India has entered into DTAs with UAE, Cyprus, Malta, and Oman. All the countries either do not levy any income tax, or levy very low taxes.

2.3 Tax havens are used by residents of other countries to take advantage of the beneficial DTA provisions of tax havens. People try to take advantage of DTAs between countries of which they are not residents. e.g. A resident of UK, instead of investing directly in India, sets up a company in Mauritius. The Mauritian company invests in India. There is a DTA between India and UK. However the DTA between India and Mauritius is more favourable in some respects. This is treaty shopping. The most used (*or abused*) DTA has been Mauritius DTA in the Indian context. The income tax department does not want the benefits to be available to persons of other countries. Treaty shopping is also not favoured by the OECD. That is a valid argument.

Against that issue, there is another angle to it. If India does not want DTAs with tax havens, why did it enter into DTAs with tax havens?

2.4 While there have been some decisions on this issue, the most recent one has been in the Public Interest Litigation filed by Mr. Shiva Kant Jha and Azadi Bachao Andolan. The Delhi High Court has ruled that treaty shopping is illegal. The Honourable Court struck down a circular issued by CBDT facilitating Mauritian companies. Government is in appeal in the Supreme Court. We understand that hearing is over. The decision may be announced soon. Government had appointed a committee under the Chairmanship of Mr. Vijay Mathur. The committee has also recommended that there should be specific provisions against treaty shopping. Though in this budget, there was no specific provision on treaty shopping, probably it will soon come.

Some other important decisions on application of DTAs with Tax havens have been discussed below.

2.5 Cyril Pereira's ruling stated that only if there is income tax chargeable in the other country, India can enter into a DTA. This was in the context of India-UAE DTA. If there is no double tax, there is no question of DTA relief. The ruling had questioned the powers of Indian government to enter into a DTA for purposes other than to avoid double tax. UAE has a tax law only for companies. Factually, it levies income tax only on oil and banking companies. UAE does not have an income tax law for any one else (like individuals). As there is no tax payable by individuals, there is no question of DTA application. Thus even though there is a DTA with UAE, relief is not available. This decision generated a lot of debate.

2.6 Prior to this ruling, there was a ruling in the case of M.A. Rafik. This was also on UAE DTA. There, the Authority for Advance Ruling had held that although there is no income tax on individuals in UAE, still a DTA has to be given a meaning. When India has consciously entered into a DTA, it must be for better mutual economic relations.

2.7 In case of Mauritius, there is an Income tax Act under which all residents (including offshore companies) are liable to pay tax. However due to various provisions in the Income tax Act of Mauritius, an offshore company may pay a low tax in Mauritius. While there is a tax law in Mauritius, its reputation as a tax haven has generated controversies.

2.8 To settle the controversy, now the Government has amended S.90 to provide that India can enter into a DTA to promote mutual economic relations, trade and investment. However there should be tax 'chargeable' in India **and** the other country. (*See para 2.9 also*). Therefore the DTA relief in case of Mauritius and Cyprus will be available. (They have tax laws.) Even if there is no tax payable in the other country, DTA relief will be available, as long as there is a "charge" of tax. For UAE and Oman, the relief may not be available as they do not make the individuals' incomes chargeable to tax.

2.9 It will be interesting to know that when the Finance Bill 2003 was introduced on 28th February 2003, it was proposed that India can enter into DTA to promote mutual economic relations for tax payable in India **or** the other country. However, at the time of passing the bill into Act, the conditions of payment of taxes in both countries has been made cumulative by replacing the word "or" with the word "and". Under the Finance Bill provision, India could enter into a DTA to provide relief even if tax was payable in one country. Thus relief would have been available under the UAE and Oman DTAs also as tax would have been paid atleast in one country - India. Now, the relief won't be available for countries that do not charge tax. How a change of one word can change the entire meaning of legal provision!

2.10 The amendment applies from A.Y. 2004-05. Does it mean that it will apply to DTAs entered into after 1st April 2003, or relief will be available to even old DTAs? It is more likely that relief will be available to incomes earned from 1st April 2003; irrespective of the date of entering into a DTA.

3. Royalty and Fees for Technical services – Sections 44D, 44DA and115A

3.1 So far, foreign companies were liable to pay tax on gross basis on Royalties and Fees for Technical Services. Now tax can be paid on net profit basis (i.e. after deduction of expenses) under certain conditions. The details are discussed below.

If a non-resident has a branch in India, income from royalty and fees for technical services will be taxable after deduction of expenses.

3.2 If a foreign company earns Royalty or Fees for Technical Services (FTS) from an Indian resident, tax is levied on gross basis. i.e. no expenses are allowed.

To summarise a lengthy & controversial issue – Because of some legal provisions; and interpretations by the Honourable AAR, in Bechtel & Ericsson's cases, the tax position for foreign companies earning royalty or FTS was that whether they had a PE in India or not, the tax would be @ 20% (in some situations, even 40%) on gross.

3.3 Foreigners other than foreign companies are taxable on net profits at the specified rates. (Ignoring, for the time being, DTA.)

3.4 The principle is that in case of a non-resident, it is difficult to determine the expenses incurred abroad. It is even more difficult to produce evidence for expenses.

3.5 Even if the foreign company has an office or branch in India and Royalty and FTS pertain to the branch, still expenses were not allowed.

3.6 This issue of gross taxation has been addressed to some extent. The amendment in sections provides that if a non-resident earns Royalty or FTS based on an agreement after 31st March, 2003, then the treatment will be as under:

i. If the non-resident has a Permanent Establishment in India, and if Royalty and FTS are effectively connected with the PE, then expenses incurred wholly and exclusively for earning the income will be allowed. Proper books of account will have to be maintained and audit will have to be done.

ii. If the non-resident does not have a PE, no expenses will be allowed and tax will be payable at 20% on gross fees.

Further these provisions apply to all non-residents whether they are foreign companies or not.

This takes care of the problem of 40% tax on gross fees. Now either the rate is normal prescribed rate on net profits, or a gross rate of 20%. (Add surcharge to both the rates.)

3.7 However the problem for agreements entered into prior to 1st April, 2003 continues. For such agreements, gross basis of taxation continues. Probably the Government should have permitted net taxation even for old agreements.

3.8 Another issue is regarding agreements entered into after 31st March 2003. If the non-resident does not have a PE, tax is levied at a gross rate of 20%. However it is necessary that the agreement is either approved by the

Government, or it is under the Industrial Policy of India)approved agreement). If however the agreement is not an approved agreement, then what happens?

Under the liberalised current account – FEMA regime, there are several payments which can be made which do not require an approval from the government, nor these are under the industrial policy. For example, royalty for books can be made under the current account rules without any approval from government. Further as this does not involve technical collaboration, this matter is not dealt with under industrial policy. In such a case, will the tax be @ 40% plus surcharge for foreign companies? Or will it be that expenses will be allowed despite the fact that there is no PE? This issue can create difficulties.

In fact, Vijay Mathur committee has recommended that reference to approval from government and industrial policy should be deleted. If there is any income earned due to royalty and FTS, tax should be on gross basis @ 20%. If there is a branch in India, then the tax will be as per specified rates, but on net profits.

3.9 While the government will permit expenses in case of royalty and FTS also, the non-residents will have to keep proper documents, bills and vouchers to claim the expenses. Accounts will have to be audited.

While for FTS, it is easier to establish a link between expenses and income, for royalties, there may be some difficulties. For example, a technology is developed in 1995 by a resident of UK. A licence is given in 2002 to an Indian resident. The UK company also licenses the product to many persons around the world. Which expenses can be claimed? Will a proportionate cost be allowed from the Indian income? How should the proportion be computed. The language of the section provides that expenses incurred wholly and exclusively for earning the income will be allowed as a deduction. Expenses of the Indian branch will be allowed. However will it be said that development costs are not incurred wholly and exclusively for earning the income, and therefore those expenses will not be allowed?

Even the Mathur committee report had recommended that net profit taxation should be for FTS but not for royalty. However the government has provided for net profit taxation even for royalty.

3.10 A better way could have been that non-residents are given a choice. Non residents can pay tax on gross basis. However if they wish to pay tax on net profit basis, then they may keep accounts, etc. (see para 4 above). However currently, if the non-resident has a PE, then the tax will be mandatorily on net profit basis.

4. Presumptive taxation – Sections 44BB and 44BBB

For some businesses of non-residents, a presumptive tax system applies. i.e. a fixed percentage of gross turnover is considered as profit. This is largely to avoid difficulties in assessments, production and maintenance of documents, etc. However if profits are lower than what has been prescribed, then it was not possible to claim a lower profit and pay lower tax.

A non-resident who earns less than the prescribed rate of profit in the specified business, can substantiate the same by keeping proper records.

Now it has been provided that if a non-resident who is engaged in business of oil exploration, civil construction in turnkey power projects, claims that his profits are less than the prescribed percentage of sales, then he has an option. He can keep proper books of account, get the same audited and file a return of income with lower profits. The income tax officer will then conduct a scrutiny assessment, and if he is satisfied, he will pass appropriate assessment order.

This is a welcome provision and can help the non-resident in bonafide circumstances.

B. Corporate / Business matters

5. Dividend on shares and mutual funds – Sections 10(34), 10(35), 115-O

Dividend from companies and mutual funds is exempt from tax in recipient's hands. Now the companies and mutual funds will have to pay the tax on dividends paid.

5.1 The government has again changed the tax policy for dividend on shares and mutual funds. Shareholders and unitholders will be exempt from tax. Instead the companies and mutual funds will pay tax on distribution of dividends.

5.2 Prior to financial year 1st June 1997, dividend on shares was taxed in the hands of shareholders. After 1st June 1997, dividend became tax free in the hands of the shareholders. Instead the company declaring dividend was liable to pay tax on dividend distributed. This made the dividend tax easier to collect.

From 1st June 1999, tax on mutual fund dividend was also abolished in the hands of unitholders. Instead tax was levied on mutual funds.

5.3 Then in between for one year – 1st April 2002 to 31st March 2003, tax liability was shifted again on the shareholders and unitholders. The reason given was, that of equity. If the company paid tax, the tax was a constant percentage – irrespective of the income of the shareholder. However if shareholders pay tax, then the tax rate varies according to the amount of income a person earns. Higher the income, higher the tax rate. There were however administrative difficulties of collecting TDS certificates, getting credit, etc. The paper work was tremendous.

5.4 Representations were made to go back to the old system. Even Kelkar committee also recommended that dividend should be exempt from the hands of the shareholders.

5.5 Now again it has been provided that the dividends will be not be taxable in the hands of the shareholders and unitholders. The companies and mutual funds will pay the tax @ 12.8125% (including surcharge).

This will do away with a lot of paper work, collecting TDS certificates, etc. We hope now this policy remains constant.

5.6 **Non-residents - Credit for tax**

A non-resident is normally liable to pay tax in his home country on dividends earned in India. Credit is available against his home tax, for tax paid in India. If the shareholder himself pays the tax on dividend, there is no difficulty in getting tax credit. However now the tax will be paid by the company and not the shareholder. Therefore whether tax credit will be available to the shareholder or not becomes controversial. Some countries like Mauritius and UK have permitted credit against such taxes. In the Double Tax Avoidance Agreements, this issue is not clarified. The credit will depend on the non-resident's home country tax law.

6. **Export Oriented Units – Sections 10A and 10B**

Transfer of EOUs will not affect the relief which they enjoy under the Income tax Act.

6.1 Export Oriented Units (EOUs) and units in Export Processing Zones have been granted tax holiday upto A.Y. 2010-11 (except units in Special Economic Zones where relief can be available even beyond A.Y. 2010-11).

One of the conditions prescribed is that the undertaking should not be transferred. Further if the undertaking was owned by a private limited company, then atleast 51% of the shareholding should be continued to be held by the same shareholders who held the shares when the undertaking was set up.

These conditions are now deleted. <u>This is welcome</u>. This proposal establishes that relief goes with the undertaking, whoever may be the owner.

However this deletion of condition should have been made with effect from earlier years. For undertakings which have been transferred prior to 31st March, 2003, relief will not be available for earlier years. However from now, the relief will be available.

6.2 Further it is also clarified that in case of amalgamation or demerger, relief will be available to the entity to which the undertaking is transferred. It will not be available to the transferor company. This however was not necessary. If one considers that the relief is qua the undertaking, and conditions regarding transfer of undertaking have been removed, then clarification regarding amalgamation and demerger was not required. In fact, by providing that relief will not be available to transferor company, there can be legal problems. For example, an undertaking is transferred in amalgamation from Company A to Company B on 1st July 2003. In such a case, profits upto 30th June 2003 belong to Company A. After 30th June, profits of the undertaking belong to Company B. The amendment provides that relief will not be available to company A (i.e. for the entire year); and relief will be provided to Company B. Now profits from 1st April 2003 upto 30th June 2003 belong to Company A (which has been barred from relief). Company B is entitled to relief from 1st July 2003. Thus profits of the 3 months legally do not get relief.

6.3 It has also been provided that relief will be available for cutting and polishing of diamonds.

6.4 Units in Special Economic Zones (SEZs) get a deduction of 100% of the profits for first 5 years. For next 2 years, they are entitled to a deduction of 50% of the profits.

Now the relief has been increased further. For next 3 years, a deduction will be available equal to that much amount which is transferred to a special reserve called "Special Economic Zone Re-investment Allowance Reserve Account". Upto a maximum of 50% can be transferred to the special reserve. The reserve is to be utilised for buying new plant and machinery within a period of 3 years from the year of creating the reserve. Till it is used for buying the plant, it should used for regular business.

However, it cannot be used for declaring dividend, or for remitting profits outside India or for creation of assets outside India.

7. Carry forward of losses in case of amalgamation – Section 72A

7.1 The benefit of carrying forward of losses in case of amalgamations has been extended to hotels and banks. Further, some conditions have been prescribed for amalgamated companies. Details are discussed below.

7.2 In case of amalgamations, losses and accumulated depreciation of the amalgamating company, can be carried forward and set off in the hands of the amalgamated company. The carry forward facility is permitted in case of industrial undertakings and ships. Industrial undertakings means undertakings which are engaged in:

i. manufacture and processing of goods.

ii. manufacture of computer software.

iii. business of generation or distribution of power.

iv. business of providing telecommunication services.

v. mining.

vi. construction of ships, aircrafts or rail systems.

7.3 Now it is proposed to include the business of hotel and banking companies also. Thus if a company running a hotel business merges with another company, the losses if any of the amalgamating company will be available to the amalgamated company. Similarly if a banking company merges with another specified bank, it will also get the benefit of losses of the amalgamating company. However currently the relief will be available to banks if the amalgamated company is a nationalised bank. For merging into the new private sector banks, the relief is not available.

7.4 There are further conditions prescribed for amalgamated companies. So far, there were no conditions prescribed for amalgamated companies. Now the amendment has prescribed following conditions for amalgamating companies:

For carrying forward of unabsorbed losses, conditions have been prescribed for amalgamated companies.

i. The company has been engaged in the business in which the loss occurred for atleast 3 years.

ii. The company has held <u>continuously</u> as on the date of amalgamation, at least 75% of the book value of the fixed assets held by it two years prior to the date of amalgamation.

The requirement of holding fixed assets is perhaps with the reason that the amalgamating company should not have sold off the assets prior to amalgamation. However the language of the section could have been better, For example, the value of fixed assets can go down, due to the provision of depreciation, writing off of unusable assets, etc. Further the meaning of book value of fixed assets has not been explained. Logically it should mean the 'gross cost' of fixed assets. Thus if 75% of the fixed assets in terms of cost are being held, then the condition should be considered to be satisfied. One may have to wait for clarifications.

8. **Long Term Capital Gain on sale of listed shares – Section 10(36)**

Long Term Capital Gain in case of specified shares purchased between 1st March 2003 and 29th February 2004, will be exempt from tax.

Complete exemption has been given for Long Term Capital Gains on sale of specified shares if the same are purchased between 1st March 2003 and 29th February 2004.

The stock market has been in a bad shape for the past 4 or 5 years. There are several reasons for the same. One of the reasons is that the small investors have lost interest in the shares. To revive the stock market, relief has been given for <u>Long Term Capital Gain</u> on sale of equity shares which are listed on a stock exchange. The relief is proposed only if the equity shares are <u>purchased</u> between 1st March 2003 and 29th February 2004 (specified period) and sold after holding the same for more than one year. Thus the relief will start applying only after 29th February 2004, when the period of 12 months is over. The relief is not for old shares i.e. held prior to 1st March 2003.

The relief is available for equity shares which form a part of list of BSE-500 index. The list includes all major shares. If the shares are allotted through a public issue after 1st March 03, and listed before 1st March 04, then also the shares are eligible for relief.

It should be noted that sale can take place at any time. i.e. After acquiring the shares between the specified dates and holding the same for atleast one year, sale can take place after 5 years or 50 years (unless the law is changed). The relief is thus given for purchasing the shares between the specified period.

9. TDS on payment to non-residents – Section 40(a)(i)

If payment is made in India to a non-resident, and tax is not deducted at source, deduction of expenses will not be available. Earlier the disallowance was only in case of payments abroad.

9.1 Under the existing provisions, if any amount is payable to a non-resident outside India, tax is required to be deducted at source. If tax is not deducted, the payer will not get the amount allowed as expenditure. Now the amendment provides that even if payment to a non-resident is made in India, and tax is not deducted at source, expenses will be disallowed. Whenever tax is deducted and paid, expenses will be allowed. This consequence is over and above the other consequences.

9.2 Thus for example, payment may be made to foreign airlines, or foreign tour operators where the actual payment is to their agents in India. If tax is not deducted at source, expenses will be disallowed. Normally, under Double Tax Avoidance Agreements (DTA), a foreign airline or a foreign shipping company would not be liable to tax in India. The payer must examine whether DTA is applicable or not.

It should be noted that for any payment to a non-resident, tax is required to be deducted at source (if the non-resident is taxable in India). It is immaterial whether payment is for personal or business purpose. If tax is not deducted at source: (i) there are penal consequences for non-deduction of tax at source. (ii) Further the payer can be treated as an agent of a non-resident, and tax payable by the non-resident can be recovered from the resident payer. (iii) Apart from the above, if payment is for a business purpose, deduction is not allowed. Thus there are 3 potential consequences for non-deduction at source from payments to non-residents. Now the third consequence has been extended for payments made to non-residents in India.

9.3 This provision has also been extended for salary payments in India to non-residents. Thus even for salary payments in India to non-residents, if tax is not deducted at source, deduction of salary expenses will not be allowed.

9.4 There is a further removal of anomaly. Normally due to accrual system of accounting, expenses accrued upto the year end, but not paid upto the year end, are provided for in the accounts. However tax deducted at source is actually paid after the year end – i.e. in the subsequent year. Hence in the year of accrual, as tax deducted, is not paid, deduction of expenses is not allowed. When tax is paid in subsequent year, deduction is allowed. This creates an undue lag in claiming expenses. Now it is provided that if TDS is paid within the time allowed (normally within 2 months from the month of accrual), then deduction of expenses will be allowed in the year of accrual. If tax is not paid in time, but is paid even later; then whenever tax is paid, deduction will be allowed.

10. **Interest on borrowed capital – Section 36(1)(iii)**

10.1 It has been provided that if loan is taken for assets for extension of business, interest from the date of taking the loan and till the fixed assets are put to use, will not be allowed as a deduction.

If loan is taken for expansion of business, interest from the date of taking the loan and till the fixed assets are put to use, will not be allowed as a deduction.

10.2 Interest on loan taken for business is a business expense. However deduction of the same depends on certain factors.

When a person is in the process of setting up a new business, and funds are borrowed for the purpose, the interest is required to be capitalised as fixed assets. This is because unless the business commences, no deduction of any expenses (including interest expenses) can be claimed.

However once the business is set up, and if loans are taken for new projects, is the deduction of interest allowable?

10.3 The assessees and income tax department were always on opposite sides. The department would not allow the deduction as the interest pertained to projects which had yet to commence. Whereas the tax payers claimed that u/s 36(1)(iii), if loan is taken for business, then deduction is available. Loan for a new project is also loan taken for a business and hence it should be available as a deduction. The court decisions were mostly in favour of the assessees.

As per the accounting standard of the Institute of Chartered Accountants of India, interest on such new business has to be capitalised. Hence there was a different treatment for interest on new projects as per accounting standards and as per income tax act.

It should be noted that if there are other expenses for the project e.g. staff costs involved in setting up a new project, the same could not be claimed as expenses. Such expenses had to be capitalised.

10.4 Now it has been provided that if loan is taken for assets for extension of business, interest from the date of taking the loan and till the fixed assets are put to use, will not be allowed as a deduction. Primarily one cannot object to this. A major cause of dispute is difference between accounting treatment and income tax treatment. However the language of the amendment could have been better.

10.5 The amendment provides that interest on loan for any asset for extension of business will not be allowed as a deduction. The word "asset" includes stock-in-trade. If interest is paid on working capital loan taken for stocks, it is a business expense and is an allowable expense. However if one were to take a strict legalistic view, interest on loan for current assets may be disallowed.

10.6 Further the use of the phrase "extension of business" can lead to difficulties. Consider some examples:

(a) A department in Delhi store sets up another store in Bangalore.

(b) A person has a business in Mumbai, and to service the customers, he sets up warehouses in Delhi by taking a loan.

(c) A consultancy firm sets up a communication infrastructure (computers, servers, communication equipments), conference hall and a library with help of a loan.

The situation covered in example (a) is clearly extension of business. Hence interest will not be allowed till the department store in Bangalore starts functioning. However situations in examples (b) and (c) cannot be called "extension of business". They are for providing better services to clients. However with the present language of the section, interest may be disallowed.

10.7 Probably it would have been better to provide that interest for setting up new business, or setting up new undertakings will not be allowed. The concepts of “new business” and “new undertakings” are recognised concepts. Under accounts also, the expenses on loan for new business and new undertakings are capitalised and not considered as expenses.

Summary

There are constant changes which are happening as India is opening up. There are several issues which are not tested in India. In fact, many issues are not tested even internationally. We have a constant stream of decisions which are perhaps not in tune with international thinking. It may be a few years till things are settled.