



Unrealised foreign exchange loss on loan obtained for indigenous purchase of assets is 'revenue loss' and therefore allowed as deduction under Section 37(1) of the Income-tax Act

Background

The Chennai Bench of the Income Tax Appellate Tribunal (Tribunal) in the case of Hyundai Motor India Limited¹ (the taxpayer or HMIL), passed its judgment for the Assessment Years (AY) 2009-10 to 2011-12 inter-alia on the following grounds:

- Disallowance under Section 40(a)(i) of the Income-tax Act, 1961 (the Act)
- Time period for taxability of export incentives
- Unrealised loss on purchase of assets within India - applicability of Section 43A of the Act

Disallowance under Section 40(a)(i) of the Act

Facts of the case

- The taxpayer had taken certain loans from two Mauritius based entities, namely, HSBC Mauritius and Standard Chartered Bank Mauritius. In respect of these loans, the taxpayer paid interest to the said Mauritius based entities.

Tax Department's contention

- The AO observed that the loan agreements were signed in India at the local offices of the aforementioned banks. Considering that the base work for the transaction took place in India through fax facility and since the Indian branches were acting as

guarantors for the transaction, the AO contended that the transaction was carried out through the Permanent Establishments (PE) of the aforementioned banks in India. Consequently, the tax department contended that the interest income was accrued in India and therefore, tax was required to be deducted at source on the interest payment made to the banks.

Taxpayer's contention

- The taxpayer, relying on Article 11 of India Mauritius Double Tax Avoidance Agreement (DTAA), contended that the interest on these loans are not taxable in India.

Tribunal's ruling

- The Tribunal observed that Agency PE cannot be established in the taxpayer's case considering that Indian branches were not acting exclusively for the Mauritian entities nor did the branches habitually exercise authority to conclude contracts on behalf of the Mauritian entities. Mere presence of branch in India and the fact that these branches also had some role to play does not automatically result in a PE in India.
- The Tribunal stated that an analysis of the provisions of Article 5(1) of the India-Mauritius DTAA shows that three criteria are required to be satisfied for determination of the existence of the PE in India:

¹ Hyundai Motor India Limited v. DCIT (ITA No. 853/Chny/2014 and 563/Chny/2015) – Taxsutra.com

1. Physical criterion i.e., existence of physical location
 2. Subjective criterion i.e., right to use that place and
 3. Functionality criterion i.e., carrying out of business through that place.
- It is only when these three conditions are satisfied, a PE can be established. In light of the above and placing reliance in the case of the Co-ordinate Bench in Western Union Financial Services Inc.², the Tribunal held for a PE to be established in India, the place of business should have been at the disposal of the foreign enterprise for the purpose of its own business activities. The Tribunal has therefore followed the approach adopted by the Special Bench of the Delhi Tribunal in the case of Motorola Inc.³
 - The Tribunal further stated that even if there was a place of business in India at which the Mauritian entities carried on any work, the same cannot be treated as a PE unless it is demonstrated by the tax department that these entities had the right to the aforementioned facilities. It was also held that the onus to demonstrate the satisfaction of conditions precedent for the existence of PE lies with the tax department.
 - It was also held that a non-resident company having a PE in India, by itself, does not lead to taxability in India unless some profit can be attributable to such a PE. Accordingly, disallowance under Section 40(a)(i) of the Act cannot be made unless it is shown by the tax department that the interest income belongs to the PE in India.
 - Article 11(1) of the India-Mauritius DTAA states that interest income is not taxable in source jurisdiction but only in residence jurisdiction provided it is derived and owned by a bank carrying on a bonafide banking business in Mauritius. Considering that the tax department did not provide any evidence to show that the beneficial owner of the interest income was not the Mauritian entities, the Tribunal held that no disallowance is required under Section 40(a)(i) of the Act since the interest payment is not subject to tax in India.

² Western Union Financial Services Inc. v. ADIT [2007] 104 ITD 34 (Del)

³ Motorola Inc. v. DCIT [2005] 95 ITD 269 (Del)(SB)

Time period for taxability of export incentives

Facts of the case

- The taxpayer availed benefits under the Focus Market Scheme and Focus Product Scheme of the Foreign Trade Policy for the relevant period which entitled the taxpayer to receive various incentives upon verification of the same by the relevant government authorities. This income was recorded in the books of accounts considering that the prescribed conditions have been satisfied. This notional income was treated as taxable income by the AO before actual receipt of the same.

Tribunal's ruling

- The Coordinate Bench ruling in the taxpayer's own case for the AY 2007-08 relied on the Supreme Court ruling in the case of Excel Industries⁴ which stated that notional income computed cannot be treated as taxable income. The Coordinate Bench further observed that the taxpayer would be entitled to such benefit only after verification of the taxpayer's claim and issuance of license by the relevant governmental authorities.
- In light of the above, the Tribunal held that upon actual receipt of the said export incentive, the same shall be offered to tax during the relevant previous year as per the provisions of the Act.

Unrealised loss on purchase of assets within India - applicability of Section 43A of the Act

Facts of the case

- The taxpayer had incurred unrealised foreign exchange loss on account of ECB loan taken for the purpose of purchase of assets within India.

Taxpayer's contention

- The taxpayer claimed that Section 43A of the Act is applicable only where assets are acquired outside India. Where the assets are

⁴ CIT v. Excel Industries Ltd. (Civil Appeal No. 125 of 2013)(SC)

purchased within India, foreign exchange loss, if any, should be allowed as deduction under Section 37(1) of the Act.

Tax Department's contention

- The AO had relied upon the ruling of the Supreme Court in the case of Woodward Governor⁵, and held that the loss due to fall in value of foreign exchange cannot be adjusted in the value of asset nor can it be allowed as a revenue loss as it was a notional loss in the capital field.

Tribunal's ruling

- The Tribunal placed reliance on the Coordinate Bench ruling in the case of Cooper Corporation Pvt. Ltd⁶ wherein it was held Section 43A of the Act comes into play only when assets are acquired outside India. Further, Section 43A of the Act deals only with realised exchange gain/loss.
- The Coordinate Bench also placed reliance on the Supreme Court ruling in the case of Tata Iron and Steel Co. Ltd⁷ wherein it was held that the cost of an asset and cost of raising money for purchase of the asset are two different and independent transactions. Further, the Coordinate bench stated that Section 36(1)(iii) of the Act also does not distinguish between utilization of a loan for capital account or revenue account for allowability of interest expense.
- The Coordinate bench held that a conjoint reading of Section 145 of the Act and Section 211 of the Companies Act, 1956 mandate that the taxpayer is required to follow the accounting standards prescribed. Reliance was also placed on the Supreme Court ruling in the case of Woodward Governor (supra.) (which was relied upon by the tax department), which stated that AS-11, which requires foreign exchange differences to be charged to the profit and loss account, is mandatory in nature.
- Therefore, in light of the above, it was held that Section 43A of the Act shall not apply in the present case and in the absence of any other provision in the Act, the claim of the taxpayer in

accordance with generally accepted accounting principles and CBDT notification⁸, that the unrealised foreign exchange loss is revenue in nature was upheld by the Tribunal.

Our comments

The Tribunal has ruled that the onus to demonstrate the satisfaction of conditions precedent for the existence of PE lies with the tax department. The tax authorities would need to provide adequate reasoning for the conclusion arrived.

With respect to the taxability of export incentives, the Tribunal has ruled that notional income cannot be taxed by the tax department and export incentives will become taxable income in the year of actual receipt.

The Tribunal's decision that, unrealized loss on loan obtained for purchase of assets within India can be claimed as a deduction under Section 37(1) of the Act, is well reasoned out. This decision further supports the Pune Tribunal decision in the case of Cooper Corporation (supra) thereby offering considerable support to taxpayers to adopt this position.

Further, this position is also in line with generally accepted accounting principles and the Income Computation and Disclosure Standards issued by the Government of India.

⁵ 5CIT s. Woodward Governor India Pvt Ltd [(2009) 312 TR 254 (SC)]

⁶ Cooper Corporation Pvt Ltd v. DCIT [2016] 159 ITD 165 (Pune)

⁷ CIT v. Tata Iron and Steel Co. Ltd. [1998] 22 ITR 285 (SC)

⁸ CBDT notification S.O. 892(E) dated 31 March 2015

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