



## Capital surplus on account of waiver of loan is neither taxable nor can be included in computation of book profit under the provisions of MAT

### Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of JSW Steel Limited<sup>1</sup> (the taxpayer) held that capital surplus in respect of waiver of loan amount cannot be regarded as amount available for distribution through the profit and loss account. A mere disclosure of an extraordinary item in the profit and loss account does not mean that the said item represents the 'working result' of the company. Accordingly, it has been held that waiver of loan being capital receipt cannot be taxed as 'book profit' as envisaged under the provisions of Section 115JB of the Income-tax Act, 1961 (the Act).

The Tribunal held that the waiver of loan borrowed for acquisition of capital asset cannot be treated as income under Section 41(1) of the Act since the pre-requisite condition for invoking the provision of Section 41(1) of the Act has not been satisfied. The Tribunal also held that an allowance of depreciation is not related to waiver of a loan taken to purchase an asset in question, since the transaction of borrowing of money for purchase of a capital asset and the transaction of purchase of capital asset are themselves two independent transactions. Accordingly, Section 41(1) of the Act does not apply to the facts of the present case as depreciation is neither a loss nor an expenditure.

### Facts of the case

- The taxpayer is a public limited company engaged in the business of manufacturing of hot rolled steel sheets and steel plates. During the year under consideration<sup>2</sup>, the taxpayer had availed rupee and foreign currency loans from various financial institutions<sup>3</sup> and banks for setting up of integrated steel plants. The loan was utilised for the purchase of plant and machinery for setting up of steel plant i.e. for the acquisition of the capital asset.
- Subsequently, the taxpayer incurred a huge loss due to the economic recession in general, and the steel industry was under severe financial crisis. Hence, the taxpayer was unable to meet its financial commitments in respect of the said loans. Accordingly, the taxpayer entered into a financial restructuring package, in respect of loans taken from various Indian and foreign financial institutions.
- After negotiations with the foreign lenders, the taxpayer entered into agreements to settle the dues, pursuant to which the principal and interest payable were reworked and part of the principal and interest were waived. Accordingly, the entire amount was credited to the profit and loss account as an exceptional item on account of waiver of the

<sup>1</sup> JSW Steel Limited v. ACIT (ITA No. 923/Bang/2009) – Taxsutra.com

<sup>2</sup> Assessment Year 2004-05

<sup>3</sup> Domestic and foreign lenders

principal and interest payable thereon with a specific note in 'Notes to Account' that the exceptional item represents a waiver of dues on a settlement with certain lenders.

- The taxpayer while computing the book profit under Section 115JB of the Act has included the exceptional items of receipts on account of waiver of loan, and same was not taken to 'capital reserve' or excluded by the taxpayer from the net profit as per profit and loss account. Instead, in the computation of income, the taxpayer by way of a note gave a caveat that the amount on account of waiver of loan represents capital receipt and it is not in the nature of profit and gains of business and therefore, is not includable in the book profit under Section 115JB of the Act.
- The Assessing Officer (AO) while computing the book profit under Section 115JB of the Act considered the figure as given in the profit and loss account and did not agree to reduce the waiver of dues as stated by the taxpayer in the 'notes' as well as in the accountant's report. The AO also held that the waiver of the loan went to reduce the cost of the asset purchased out of such losses and therefore, excess depreciation already allowed in the previous year was held to be taxable under Section 41(1) of the Act.
- The Commissioner of Income-tax (Appeal) [CIT(A)] upheld the order of the AO.

## Tribunal's decision

### ***Taxability under the provisions of MAT***

- The provisions of the Companies Act, 1956 requires a broad disclosure of exceptional items or non-recurring transactions. If for some reason or the other they have been accounted for in the profit and loss account, the said provisions do not require that those items necessarily be accounted as part of the profit and loss account. Separate disclosure is intended to ensure that the reader of the profit and loss account gets a fair and clear picture of the result of the working of the company.
- Accounting Standard 9 (revenue recognition) excludes the cases of remission of liability, because it is nothing but gains realised from the discharge of an obligation at less than carrying amount, which in the present case is gain on

account of waiver of part of an obligation to repay the loan. Further, Accounting Standard 5 (AS-5) also states that, extra-ordinary items should be disclosed separately in the profit and loss account. A con-joint reading of the both AS suggests that, there are two types of compulsions while preparing annual accounts, one are accounting compulsions and second are disclosure compulsions.

- The accounting compulsion comes into play since there is a double entry system of accounting. The disclosure compulsions merely require the taxpayer to disclose the material items in the profit and loss account. A mere disclosure of an extraordinary item in the profit and loss account does not mean that the said item represents the 'working result' of the company.
- The profit and loss account contains income and expenditure of a company in respect of the period covered by the account, and therefore, there cannot be any question for including a capital surplus in that account which cannot be reckoned as income. Only those items can be regarded as part of the profit and loss account which are in respect of the similar type of transaction and not which are exceptional in nature. Waiver of a loan certainly cannot be reckoned as a transaction of a kind usually taken, but it is an item of exceptional and non-recurring nature.
- A capital surplus on account of waiver of loan in no way can be recorded as operational profit or profit which is to be included in the profit and loss account. There can be absolutely no question for accounting in the profit and loss account something which cannot be regarded as income, profit or gain.
- Clause (ii) of Explanation 1 to Section 115JB of the Act, requires exclusion from the book profit all that amount of income which are exempt and are not in the nature of income, if any such amount is credited to the profit and loss account, then on same logic it would be inconceivable that this provision intends that 'book profit' should include something which is in the nature of a capital surplus on account of waiver of a loan.

- Even if a company has credited the amount of remission to its profit and loss account, then such a profit and loss account needs to be adjusted with the amount of remission so as to arrive at the net profit as per the profit and loss account prepared in accordance with provisions of the Companies Act, 1956 and this is what has been envisaged in the operating lines of Explanation-1 to Section 115JB, that, 'book profit' means the net profit as shown in the profit and loss account for the relevant previous year.
- Net profit as per the profit and loss account can never mean to include capital reserve or capital receipts. The object of enacting of Section 115J, 115JA and 115JB was never to fasten any tax liability in respect of something which is not income at all or even if it was income but is not taxable under the normal provisions of the Act.
- The provisions of Section 115JB cannot be so interpreted so as to require an accounting of what in substance is capital in nature to the credit of the profit and loss account and get indirectly taxed under book profit. Accordingly, surplus resulting in the books of the taxpayer consequent upon waiver of loan amount is not required to be credited to the profit and loss account for the year in which waiver is granted.
- The entries in the books of account or in the profit and loss account is not a determinative factor for taxing the income because income can be taxed only by the express provisions of law. The decision of the Supreme Court<sup>4</sup> relied on by the tax department is distinguishable on the facts of the present case. Accordingly, it has been held that capital receipt cannot be taxed as 'book profit' as envisaged in terms of Section 115JB of the Act.

### ***Taxability of interest on waiver of loan***

- The reasoning given above will not only apply to waiver of principal loan but also to the waiver of interest payable to UTI since it is not taxable as per the provision of Section 41(1) of the Act since the taxpayer has not claimed the said amount as deduction in the earlier years in view of the provisions of Section 43B of the

<sup>4</sup> Apollo Tyres Ltd. v. ACIT [2002] 255 ITR 273 (SC)

Act. Once it has not been claimed as a deduction, then there is no question to be offered for tax under Section 41(1) of the Act. It is part of the capital surplus arising out of waiver of dues, and hence it forms part of the capital reserve which cannot be treated as a part of net profit while computing the book profit under Section 115JB of the Act.

- The provision of Section 41(1) of the Act is a deeming provision and the fiction cannot be extended either to the provisions of Section 115JB of the Act or to the provisions of the Companies Act, because the waiver of a liability for interest on loan is not required to be credited to the profit and loss account of the year of the waiver. Thus, the waiver of interest payable to UTI will also not be includable in the book profit, and the same has to be deducted.
- On perusal of various decisions<sup>5</sup> it indicates that on similar nature of issues there are divergent views of various benches of the Tribunal. However, one common point/ratio permitting through all the decisions is that if the taxpayer is in receipt of a 'capital receipt', it does not fall within any of the charging section or can be classified under any heads of income under the Act. The same cannot be treated as part of net profit as per profit and loss account or reckoned as 'working result' of the company of the relevant previous year and consequently, cannot be held to be taxable as 'book profit' under Minimum Alternate Tax (MAT) in terms of Section 115JB of the Act.
- Accordingly, the capital surplus on account of waiver of dues is neither taxable nor can be included in the computation of book profit under Section 115JB of the Act.

<sup>5</sup> Tax dept - CIT v. Veekaylal Investment Co. (P) Ltd. [2001] 249 ITR 597 (Bom), Kopran Pharmaceuticals Ltd. v. DCIT [2009] 121 TTJ 77 (Mum), Hindustan Shipyard Ltd. v. DCIT [2010] 130 TTJ 213 (Vizag), Duke Offshore Ltd. v. DCIT [2011] 45 SOT 399 (Mum), B & B Infotech Ltd. v. ITO (ITA No. 726/Bang/2014, dated 8 September 2015)

Taxpayer - Shivalik Venture (P) Ltd. v. DCIT [2015] 173 TTJ 238 (Mum), ACIT v. Shree Cement Ltd. (ITA Nos.614, 615 & 635/JP/2010), ACIT v. L. H. Sugar Factory Ltd. (ITA Nos. 417, 418 & 339/ LKW/ 2013, dated 9 February 2016), CIT v. Binani Industries Ltd. (ITA No.144/Kol/2013, dated 15 February 2016), DCIT v. Garware Polyester Ltd. (ITA No. 5996/ Mum/ 2013)

### ***Taxability of waiver of loan under Section 41(1) of the Act***

- Under the Act, only those receipts which are in the nature of income can alone be subject to tax and such a nature of income should fall within the charging section as provided under the Act. All the receipts by the taxpayer would not necessarily be deemed to be income of the taxpayer for the purpose of income tax and the question whether the particular receipt is income or not will depend upon the nature of the receipt as well as the scope and effect of the relevant taxing provision.
- On a perusal of Section 41(1) of the Act, it indicates that remission or cessation of liability shall be treated as income if it is a trading liability for which an allowance or deduction has been made in the assessment for an earlier year. In the present case, the liability on account of the principal amount of loan borrowed by it was on a capital account. Therefore, it cannot be reckoned as a nature of trading liability as envisaged in Section 41(1) of the Act and its remission cannot be deemed as income under the said provision.
- When a remission of a particular liability cannot even be deemed as income pursuant to a provision which has been enacted specifically for the purpose of treating it as a deeming income, then it cannot be treated as income for the purpose any other provisions of the Act, unless specially provided to be taxed under any provision.
- In the present case, the pre-requisite condition for invoking the provision of Section 41(1) of the Act has not been satisfied/fulfilled. The pre-component of borrowing for the acquisition of capital asset has neither been allowed as allowance nor as a deduction in the earlier years and being for the purpose of acquisition of a capital asset any waiver thereof will not constitute income under Section 41(1) of the Act. The aforesaid proposition is also well supported by various decisions<sup>6</sup>.

<sup>6</sup> Mahindra & Mahindra v. CIT [2003] 261 ITR 501 (Bom), CIT v. Softworks Computers Pvt. Ltd. [2013] 354 ITR 16 (Bom), Solid containers Ltd. [2009] 308 ITR 417 (Bom)

### ***Taxability of depreciation claimed on capital assets acquired out of loans***

- The AOs relying upon the decision of the Bombay High Court in the case of Nectar Beverages<sup>7</sup> held that provisions of Section 41(1) of the Act are applicable since the taxpayer has claimed depreciation in the earlier years on the loan taken for acquisition of capital asset. However, Supreme Court has reversed the decision of Bombay High Court.
- In any event, an allowance of depreciation can in no way be related to waiver of a loan taken to purchase of the asset in question, since the transaction of borrowing of money for the purchase of a capital asset and the transaction of purchase of capital asset are themselves two independent transactions. This has been held so by the Supreme Court in the case of Tata Iron and Steel Company Ltd<sup>8</sup>.
- Further, Explanation 10 to Section 43(1) of the Act will not apply to the facts of the present case since it is applicable only where there is a subsidy or grant of reimbursement which is not the case here. Even otherwise also Section 43(1) of the Act is applicable only in the year of purchase of machinery and in the present case the purchase of capital asset was not in the Assessment Year (AY) 2004-05.
- Accordingly, it has been held that Section 41(1) of the Act does not apply to the facts of the present case as depreciation is neither a loss nor an expenditure.

### **Our comments**

The issue with respect to computation of book profit under the provisions of MAT vis-à-vis routing of capital receipts through profit and loss account has been a matter of debate before the courts/Tribunal.

<sup>7</sup> Nectar Beverages v. DCIT [2004] 139 Taxman 70 (Bom)

<sup>8</sup> CIT v. Tata Iron and Steel Company Ltd [1998] 231 ITR 285 (SC)

The Mumbai Tribunal in the case of Shivalik Venture (P.) Ltd observed that if a receipt does not constitute a taxable income under the normal provisions, the same should also not be considered while reckoning book profits under MAT. The Allahabad High Court in the case of Lal Chand Gopal Das<sup>9</sup> observed that under the Act only income is taxable and not a mere receipt. Every receipt is not taxable under the Act.

On one hand in the Courts/Tribunal<sup>10</sup> have held that waiver of loans availed for acquiring capital assets is not taxable as deemed income under Section 41(1) of the Act since waiver of loan liability was not on account of trading liability. On the other hand<sup>11</sup> it has held that waiver of loan will be charged taxed under Section 41(1) of the Act since the waiver was on account of trading liability. In the present case, the Tribunal has held that the waiver of loan taken for acquisition of a capital asset cannot be taxed under Section 41(1) of the Act, as it is neither on revenue account nor a remission of a trading liability so as to attract tax in the year of remission.

In the present case, the Tribunal observed that an allowance of depreciation is not related to waiver of a loan taken for purchase of an asset, since the transaction of borrowing of money for the purchase of a capital asset and the transaction of purchase of capital asset are themselves two independent transactions. Therefore, Section 41(1) of the Act does not apply as depreciation is neither a loss nor expenditure.

The Hyderabad Tribunal in the case of Binrajka Steel Tubes Ltd<sup>12</sup> has held that benefit of depreciation availed by the taxpayer in earlier years could not be taxed under Section 41(1) of the Act since depreciation is neither a loss nor expenditure nor a trading liability. However, the Hyderabad Tribunal has held that the depreciation claimed by the taxpayer in the earlier years, is taxable under Section 28(iv) of the Act since it is a value of benefit arising from the business of the firm.



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<sup>9</sup> Lal Chand Gopal Das [1963] 48 ITR 324 (All)

<sup>10</sup> Polyflex (India) (P.) Ltd. v. CIT [2002] 257 ITR 343 (SC), CIT v. Chetan Chemicals (P.) Ltd. [2004] 139 Taxman 301 (Guj), ITO v. Ahuja Graphic Machinery (P.) Ltd. [2007] 109 ITD 71 (Mum) (TM), Accelerated Freez & Drying Co. Ltd. v. DCIT [2009] 31 SOT 442 (Coch)

<sup>11</sup> Logitronics (P.) Ltd. v. CIT [2011] 197 Taxman 394 (Del), ACIT v. Cosmo Films Ltd [2009] 28 SOT 353 (Del)

<sup>12</sup> Binrajka Steel Tubes Ltd v. ACIT [2011] 130 ITD 46 (Hyd)

**Ahmedabad**

Commerce House V, 9th Floor,  
902 & 903, Near Vodafone House,  
Corporate Road,  
Prahlad Nagar,  
Ahmedabad – 380 051  
Tel: +91 79 4040 2200  
Fax: +91 79 4040 2244

**Bengaluru**

Maruthi Info-Tech Centre  
11-12/1, Inner Ring Road  
Koramangala, Bangalore 560 071  
Tel: +91 80 3980 6000  
Fax: +91 80 3980 6999

**Chandigarh**

SCO 22-23 (1st Floor)  
Sector 8C, Madhya Marg  
Chandigarh 160 009  
Tel: +91 172 393 5777/781  
Fax: +91 172 393 5780

**Chennai**

No.10, Mahatma Gandhi Road  
Nungambakkam  
Chennai 600 034  
Tel: +91 44 3914 5000  
Fax: +91 44 3914 5999

**Delhi**

Building No.10, 8th Floor  
DLF Cyber City, Phase II  
Gurgaon, Haryana 122 002  
Tel: +91 124 307 4000  
Fax: +91 124 254 9101

**Hyderabad**

8-2-618/2  
Reliance Humsafar, 4th Floor  
Road No.11, Banjara Hills  
Hyderabad 500 034  
Tel: +91 40 3046 5000  
Fax: +91 40 3046 5299

**Kochi**

Syama Business Center  
3rd Floor, NH By Pass Road,  
Vytilla, Kochi – 682019  
Tel: +91 484 302 7000  
Fax: +91 484 302 7001

**Kolkata**

Unit No. 603 – 604,  
6th Floor, Tower – 1,  
Godrej Waterside,  
Sector – V, Salt Lake,  
Kolkata 700 091  
Tel: +91 33 44034000  
Fax: +91 33 44034199

**Mumbai**

Lodha Excelus, Apollo Mills  
N. M. Joshi Marg  
Mahalaxmi, Mumbai 400 011  
Tel: +91 22 3989 6000  
Fax: +91 22 3983 6000

**Noida**

6th Floor, Tower A  
Advant Navis Business Park  
Plot No. 07, Sector 142  
Noida Express Way  
Noida 201 305  
Tel: +91 0120 386 8000  
Fax: +91 0120 386 8999

**Pune**

703, Godrej Castlemaine  
Bund Garden  
Pune 411 001  
Tel: +91 20 3050 4000  
Fax: +91 20 3050 4010

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