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TAX FLASH NEWS

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Premature redemption of secured premium notes is not a colourable device. Premium paid on the same is allowed as a deduction under the Income-tax Act

Background

Recently, the Gujarat High Court in the case of Nirma Ltd[1] (the taxpayer) held that premium on premature redemption of Secured Premium Notes (SPNs) is allowed as a deduction under Section 36(1)(iii)[2] of the Income-tax Act, 1961 (the Act). The High Court observed that early redemption of SPNs would not be enough to hold that from the inception there was a device created by the company to defeat the tax department's interests. If the claim of the investors is not genuine, it is always open for the tax department to disallow it. If the claim is otherwise genuine, the entire scheme can be seen as a clever but permissible tax planning and not a sham or a colourable device. There is always a line though not always clear, between legitimate tax planning, and sham or bogus device. Accordingly, the premature redemption of SPNs is not a colourable device.

Facts of the case

- The taxpayer is engaged in the business of manufacturing of detergent powder, detergent cake, toilet soap, shampoo and other consumer products. The taxpayer also manufactures some of the intermediary chemicals for its end products. The taxpayer has several manufacturing plants situated in India.
- During the Financial Year (FY) 1996-97, the taxpayer had decided to set up a soda ash manufacturing plant, a product which would be used for the manufacture of soaps and detergents. For setting up the said plant, the taxpayer would require sizeable capital investment estimated at INR1037.28 crore.
- The taxpayer would raise such amount through various sources such as the rupee term loan and foreign currency loan from IFCI, internal accruals and funds raised from shareholders of one NCL upon the scheme of amalgamation coming into effect. All these sources would still leave a residue of INR162.83 crore which the taxpayer decided to raise through the rights issue of NCD and Secured Premium Notes (SPN) with share warrants. The company had decided to issue NCDs or SPNs of INR200 each to the shareholders of the company on the rights basis in the ratio of one NCD/SPN for every two equity shares held by them on 9 August 1996, referred to as the record date.
- NCDs would receive 17 per cent interest six monthly from the first year itself. SPNs would receive no return for the first four years, but the holders would receive a premium of INR60, INR60, INR60 and INR70 at the end of fourth, fifth, sixth and seventh years. The mode of returning the principal sum of INR200 deposited by NCD/SPN holders was identical so also the share allotment options. Approximately, 70 per cent of the fund was received from SPN subscribers, the rest 30 per cent from NCD subscribers. The promoters and Nirma group entities had contributed to nearly 96 per cent of the SPN subscription.
- NCDs and SPNs were both redeemed prematurely under the board resolution dated 24 January 2000. The record date which was fixed after receiving the consent of the 3/4th of the subscribers was fixed at 10 March 2000. NCD holders would receive a sum of INR237 per debenture which would include INR200 of the principal amount, INR15.46 towards interest between 1 October 1999 to 14 March 2010 and INR 21.54 as a premium for earlier redemption.

[1] Nirma Ltd v. ACIT (Tax Appeal No. 1219 of 2006) – Taxsutra.com

[2] During the relevant period of time, the section did not contain a proviso which was inserted by the Finance Act, 2003 effective from AY 2004-05. It provides that interest on capital borrowed for acquiring asset '*for extension of existing business or profession'* for any period beginning from the date of borrowing till date on which asset was first put to use, shall not be allowed as deduction. However, the word '*for extension of existing business or profession'* was removed by the Finance Act 2015 effective from AY 2016-17.

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In case of SPN on the face value of INR200 each, subscribers would receive INR361 which would include principal amount plus INR 123.14 towards the premium payable upto 14 March 2000 and INR 37.86 towards prepayment premium.

- Almost all the promoters, SPN holders sold their SPNs to banks and financial institutions on or around 2 March 2000 at a price ranging from INR356 to INR 358 per SPN.
- During the Assessment Year (AY) 1999-2000, the taxpayer claimed the entire expenditure on premium and additional premium on premature redemption of NCDs and SPNs by way of interest expenditure under Section 36(1)(iii) of the Act.
- The Assessing Officer (AO) held that such deductions were not allowable. The AO referred to the order of assessment in case of the taxpayer for the AY 1998-99 where such expenditure was disallowed. The AO observed that out of 107 lakh SPNs issued by the taxpayer, majority were held by the promoters and non-promoters of the taxpayer mainly the family members of the promoter, sister concerns of Nirma Ltd. and trusts floated by Nirma group.
- The AO held that in the assessments of Nirma group entities, they had not shown the income on year on year basis while the taxpayer claimed the expenditure for the earlier FYs 1997-98, 1998-99 and 1999-2000 on the accrual basis. The AO observed that the taxpayer claimed expenditure of a total premium amount of INR163.57 crore during these years.
- Before 15 March 2000, SPN holders who had transferred the SPNs to the banks and financial institutions claimed that the difference between the base price and the sale price was their capital gain. Subsequently, the banks and financial institutions offered the difference between their cost of acquisition and the redemption price of INR361 of SPNs to tax by way of profit.
- The AO held that the decision to issue SPNs was premeditated and predetermined plan to avoid tax. On the one hand, Nirma would claim the premium as expenditure on the accrual basis, and on the other, the subscribers would not offer the same amount to tax. The AO disallowed the total expenditure on the SPNs for the AY 1999-2000.
- The Commissioner of Income-tax (Appeals) [CIT(A)] held that the expenditure for which the amount was borrowed[3] was a capital expenditure and was not for the same business or extension of the existing business. While exercising the right of premature redemption of SPN, it could not be stated that the liability of pay out accrued during the year under consideration. If at all, it was a contingent liability. The entire transaction was a sham transaction
- The Tribunal observed that redemption of SPNs even before the first installment of premium fell due meant that there was no accrual of liability and the claim of expenditure was based on contingent liability. It was upto the company how to raise funds. However, the company cannot be allowed to design a scheme by which the benefit would flow only to the promoters and relatives. The transaction was a non-genuine transaction. In view of such conclusions, the Tribunal did not opine on the question whether the project was part of the same business or extension of existing business of the taxpayer and whether there was an accrual of interest liability. Accordingly, the Tribunal held the decision in favour of the tax department.

High Court's decision

Whether the amount borrowed is for the purpose of the business

- With respect to the taxpayer's claim of deduction[4] under Section 36(1)(iii) of the Act, the High Court observed that in order to claim the deduction, the capital must have been borrowed by the taxpayer and it must have been borrowed for the purpose of business. Further, the taxpayer must have paid interest on the borrowed amount. The High Court relied on the Supreme Court decision in the case of Core health Care Ltd.[5] It was observed that all that is relevant is whether the borrowing was, or was not, for the purpose of the business. It was held that the provision does not make any distinction between money borrowed to acquire a capital asset or a revenue asset. Therefore, the taxpayer is eligible to claim of deduction under Section 36(1)(iii) of the Act while computing the income under Section 28 of the Act.

Whether borrowing was for the purpose of expansion or extension of the existing business

- The issue is squarely covered by the decision of the Gujarat High Court in taxpayer's own case[6]. Further, the Gujarat High Court in the case of Alembic Glass Industries Ltd[7] held that the expenditure was in connection with the expansion of the

[4] The deduction of the amount of interest paid in respect of capital borrowed for the purpose of the business or profession would be a deduction expenditure
[5] DCIT v. Core Health Care Ltd [2008] 298 ITR 194 (SC)
[6] CIT v. Nirma Ltd. [2014] 367 ITR 12 (Guj)
[7] CIT v. Alembic Glass Industries Ltd [1976] 103 ITR 715 (Guj)

[3] By way of NCD and SPN

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existing business. In the said decision, the High Court has laid down tests for ascertaining whether a business was part of the existing business or the taxpayer was starting a new unit. It was held that merely because the unit was coming to a distant point by itself would not mean that it was a new business.

- The taxpayer through its existing administrative mechanism started a new facility for production of soda ash and had also set up facility for production of a material called lab for its captive consumption for the purpose of its existing manufacturing business. It is no doubt that the taxpayer is engaged in the business of manufacture of soap and the soda ash and lab so produced is used by way of captive consumption. Accordingly, the High Court held that the expenditure was not in the nature of pre-operative expenditure

Contingent liability

- With respect to the Tribunal's/CIT(A) observation of contingent liability, the High Court observed that the present case was squarely covered by the decision of the Supreme Court in case of Taparia Tools Ltd[8] since the Supreme Court examined a similar situation to the facts of that case. The Supreme Court held that by making payment in advance, the taxpayer was discharging the interest liability in that year thereby avoiding recurring liability of interest for the remaining life of the debentures. The Court further held that the taxpayer who had in the books of account spread over the interest over the entire span of five years was not estopped from claiming the entire interest in the year in which it was paid.
- In the present case, a similar situation has arisen. The taxpayer resolved to redeem the SPNs prematurely which was one of the options retained by the company. While doing so, the taxpayer paid the accrued return added by the premium for early foreclosure and claimed the entire expenditure by way of interest liability during the year under which the same was expended. It was not a case of contingent liability since in the process the company would avoid liability for future payment of such SPNs.

Whether the entire transaction was a sham transaction

- Though the CIT(A) touched on the question of the advisability of raising funds through the issuance of NCDs and SPNs, the same has not been thereafter elaborated. The High Court observed that there was no material suggesting that the funds were not required for the purpose of business. The prospectus for the issuance of NCDs and SPNs itself gave a break-up of such total requirement of INR1037.28 crore. It also gave the breakup of how such amount would be raised. In what manner, the taxpayer should raise its required funds is essentially a business decision and the tax department certainly cannot question the priority of the company in this respect.
- The High Court observed the two sets of terms and conditions. Broadly, NCDs would carry interest every six months, SPNs would give no return for first four years. Last three years, subscribers would get accumulated higher amounts. This by itself does not make one instrument more favourable than the other. Even if it was so, this was a free option given to all the shareholders.
- The fact that all promoter shareholders' overwhelming preference of one over the other by itself would not be indicative of any hidden design. Either because of commonality of financial advisors, common thinking or preference which may be different from individual investors, if the entire group behaved in the same fashion, by itself, would not mean that these promoter investors had an insight which the individual investors did not.
- The transfer of the SPNs took place at the time, when the decision of the company of early redemption and the terms on which such early redemption would be resorted to, was within the public domain. The decisions were already taken and made public. When the promoters transferred their SPNs to the banks and the financial institutions, the banks and the financial institutions were very much aware about the price at which such SPNs would be redeemed and the date on which the same would be done.
- Had the decision of the company to resort to premature redemption and terms on which such redemption would be done was not taken or announced, the tax department, in the opinion of the High Court, could build a strong case for viewing the entire transaction as a colourable device.

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[8] Taparia Tools Ltd v. JCIT [2015] 372 ITR 605 (SC)

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- The company, investors, banks and financial institutions were aware that the SPNs would be foreclosed and that the company would pay out a sum of INR361 per SPN. The fact that NCDs and SPNs were both freely transferable is not in dispute. If the promoters SPN holders and the banks and financial institutions, therefore, traded in such SPNs, the same would not indicate any colourable device of tax planning.
- If the claim of the investors is not genuine, it is always open for the tax department to disallow it. If the claim is otherwise genuine but is not liked by the tax department, the entire scheme can be seen as a clever but permissible tax planning and not a sham or a colourable device. There is always a line though not always clear, between legitimate tax planning and sham or bogus device.
- The High Court has not called upon to decide the validity of the claim of the investors including the banks and the financial institutions. The High Court was only called upon to judge the taxpayer's claim of expenditure. The observations made in this respect would, therefore, be confined to present tax appeal and would neither harm the case of the tax department nor of the individual taxpayers in the proceedings.

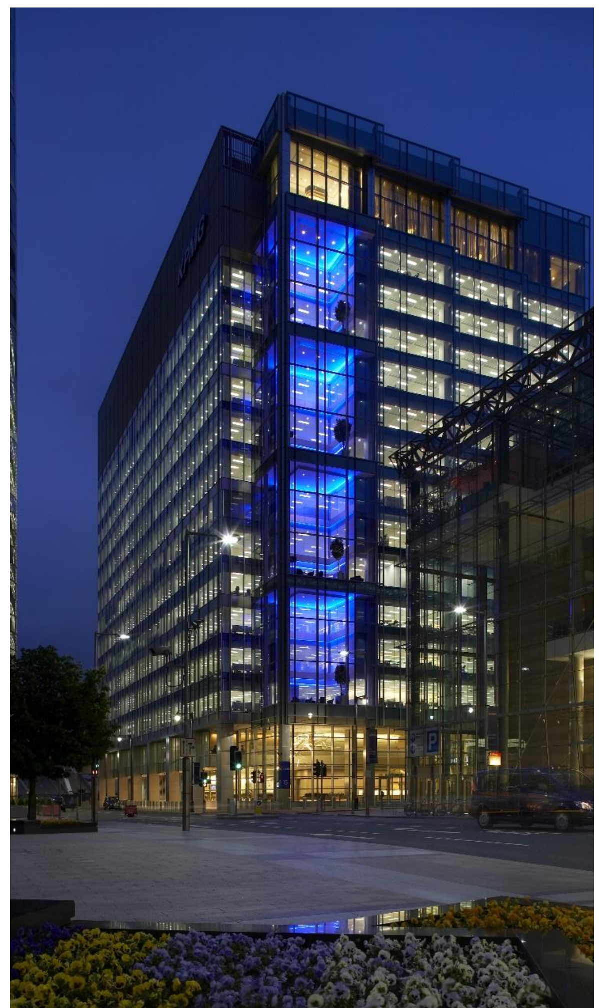
Our comments

The Supreme Court in the case of Vodafone International Holdings B.V.[9] dealt with the issue of tax planning vis-à-vis tax evasion and observed that the McDowell[10] decision cannot be read as leading to a conclusion that all tax planning is illegal, illegitimate or impermissible. The tax department cannot start with the question as to whether the impugned transaction is a tax deferment/saving device, but it should apply the 'look at' test to ascertain true legal nature of the transaction.

The Madras High Court in the case of High Energy Batteries (India) Ltd1[11] while reiterating the observations of the Supreme Court in the case of Vodafone B.V. observed that in ascertaining the legal nature of the transaction one has to 'look at' the entire transaction as a whole and not adopt a dissecting approach particularly if there is nothing contrary on records to prove the genuineness of the transaction.

The Gujarat High Court in the present case observed that mere early redemption of NCD/SPN would not be enough to hold that; from the inception, there was a device created by the company to defeat the tax department's interests. If the claim of the investors is not genuine, it is always open for the tax department to disallow it. If the claim is otherwise genuine but is not liked by the tax department, the entire scheme can be seen as a clever but permissible tax planning and not a sham or a colourable device.

In the instant decision, the High Court has given importance to the application of judicially settled principles on tax planning where the courts have upheld legitimate tax planning within the framework of law without involving any colorable devices or sham transactions. It would be interesting to see how the tax authorities will deal with such transactions under the provisions of General Anti Avoidance Rule (GAAR).



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[9] Vodafone International Holdings B.V. v. UOI [2012] 341 ITR 1 (SC)
[10] McDowell & Co. Ltd. v. CTI [1985] 154 ITR 148 (SC)
[11] CIT v. High Energy Batteries (India) Ltd. [2012] 348 ITR 574 (Mad)

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