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TAX FLASH NEWS

30 September 2016

Share issue expenditure is allowed under Section 35D of the Income-tax Act. Bonus deposited in trust and eventually paid to employees is allowed under Section 36(1)(ii) of the Act- Supreme Court

Background

Recently, the Supreme Court in the case of Shasun Chemicals and Drugs Ltd[1] (the taxpayer) allowed the share issue expenditure under Section 35D of the Income-tax Act, 1961 (the Act).

The Supreme Court also dealt with the issue of allowability of bonus expenditure under Section 36(1)(ii) of the Act read with Section 43B of the Act. The Supreme Court allowed the bonus expenditure though it was deposited in the trust and after the end of the dispute with the employees it was paid to them.

Facts of the case

- The taxpayer is a public limited company engaged in the business of manufacture and sale of bulk drugs and intermediates.

Share issue expenditure

- The taxpayer went in for public issue of shares in order to raise funds to meet the capital expenditure and other expenditure relating to expansion of its existing units of production both at Pondicherry and Cuddalore and for expansion of its research and development activity.
- The taxpayer issued to public 15,10,000 equity shares of INR10/- each for cash at a premium of INR30/- per share aggregating to INR6.04 crore.
- The aforesaid issue was opened for public subscription during the financial year ending 31 March 1995 relevant to the Assessment Year (AY) 1995-96. The taxpayer, in the prospectus issued, clearly stated under the column projects that the production capacity of its existing products would increase.
- The taxpayer incurred a sum of INR45,51,890/- towards the aforesaid share issue expenditure and claimed 1/10th of the aforesaid share issue expenditure each year under Section 35D of the Act from the AYs 1995-96 to 2004-05. The Assessing Officer (AO) allowed the claim of the taxpayer for the initial AY being the AY 1995-96 after examining the materials produced. However, the AO disallowed the expenditure for the AY 1996-97 on the ground that the share issue expenditure are not eligible for deduction in view of the decision of the Supreme Court in the case of Brook Bond India Ltd.[2] stating that the expenditure incurred is capital in nature and hence not allowable for computing the business profits.
- The taxpayer filed an appeal before the Commissioner of Income Tax (Appeals) [CIT(A)] who directed the AO to verify physically the factory premises of the taxpayer and find out whether there were any additions to the plant and machinery at the factory and whether there were any additions to the buildings at the factory whereby any expansion has been made to the existing industrial undertaking to justify the claim made by the taxpayer.

[1] Shasun Chemicals & Drugs Ltd. v. CIT [2016] 73 taxmann.com 293 (SC)

[2] Brook Bond India Ltd. v. CIT [1997] 225 ITR 798 (SC)

- The AO after making due physical verification of the factory premises and on being satisfied with the expansion of the facilities to the industrial undertaking duly allowed the claim of share issue expenditure.
- Thereafter the AO has taken a different stand for the AYs 1997-98 to 2004-05 with respect to the claim of share issue expenditure under Section 35D of the Act and has disallowed the said expenditure on the basis that the expenditure is capital in nature relying on the decision of Brook Bond India Ltd.
- In the aforesaid backdrop, the taxpayer again claimed amortisation of expenditure under Section 35D of the Act for the AY 2001-02 which was disallowed for the same reason. However, the CIT(A) allowed that expenditure. The order of CIT(A) was affirmed by the Tribunal. However, the High Court has reversed the order of the Tribunal.

Allowability of bonus expenditure

- In the return filed by the taxpayer for the AY 2001-02, it was mentioned that the taxpayer had paid bonus to its employees and, therefore, it claimed deduction under Section 36(1)(ii) of the Act.
- However, invoking the provisions of Section 40A(9) of the Act the said expenditure was disallowed on the ground that it was not paid in cash to the concerned employees.
- The CIT(A) allowed the expenditure and the same view was taken by the Tribunal but the High Court has reversed the view of the Tribunal.

Supreme Court's ruling

Share issue expenditure

- Once, the position of the taxpayer is accepted by the AO in favour of the taxpayer, it had to complete the entire period of 10 years and benefit granted in first two years could not have been denied in the subsequent years as the block period was 10 years starting from the AY 1995-96 to AY 2004-05.
- The High Court, however, disallowed the same following the decision of the Supreme Court in the case of Brook Bond India Ltd. In the said case it was held that the expenditure incurred on public issue for the purpose of expansion of the company is a capital expenditure. However, in spite of the argument raised to the effect that the aforesaid decision was rendered when Section 35D was not on the statute book and this provision had altered the legal position, the High Court still chose to follow the said decision.
- It was here where the High Court went wrong as the instant case was to be decided keeping in view the provisions of Section 35D of the Act.
- In the instant case under Section 35D of the Act benefit was allowed for the first two AYs and, therefore, it could not have been denied in the subsequent block period. The Supreme Court held that the taxpayer was entitled to the benefit of Section 35D for the relevant AYs.

Allowability of bonus expenditure

- In the relevant AY in question the workers of the taxpayer had raised a dispute of quantum of bonus which had led to the labour unrest as well. Because of this the workers had finally refused to accept the bonus offered to them. Faced with this situation, the taxpayer had made the payment to the Trust to comply with the requirement of Section 43B of the Act, as the said provision makes it clear that deduction in respect of bonus would be allowed only if actual payment is made.
- Pertinently, the dispute was settled with the workers well in time and for that reason payment of bonus was made to the workers. This happened before the expiry of due date by which such payment was supposed to be made in order to claim deduction under Section 36 of the Act. However, since the payment was made from the Trust, the AO took the view that as the payment was not made by the taxpayer to the employees directly in cash, it was not allowable in view of the provisions of Section 40A(9) of the Act.
- Section 40A(9) deals with deductions in respect of the amount paid by the taxpayer as an employer towards the setting up or formation of, or as contribution to, any fund, trust, company etc. The condition is that such sum has to be paid for the purpose and to the extent provided by or under clause (iv) or clause (iva) or clause (v) of Sub-section (1) of Section 36 of the Act. However, instant case is dealing with the payment of bonus which is not covered by any of the aforesaid clauses of Section 36(1) of the Act but is allowable as deduction under Section 36(1)(ii) of the Act. Therefore, Section 40A(9) has no application.
- Insofar as the provisions of Section 43B are concerned, they are also not applicable inasmuch as clause (b) of Section 43B refers to the sum payable by way of contribution to any provident fund or superannuation fund or gratuity fund or any other fund for the welfare of employees. Thus, this provision also does not mention about bonus.

- There was no dispute that this bonus was paid by the taxpayer to its employees within the stipulated time. Embargo specified under Section 43B or 40A(9) of the Act does not come in the way of the taxpayer. Therefore, the High Court was wrong in disallowing this expenditure as deduction while computing the business income of the taxpayer and the decision of the Tribunal was correct.

Our comments

The issue of allowability of share issue expenditure has been a matter of debate before the courts. The Supreme Court in the case of Brook Bond India Ltd. while dealing with the AY 1969-70 disallowed the said expenditure. Subsequently, Section 35D has been introduced in the Act with effect from AY 1971-72. The Supreme Court while dealing with AY 2001-02 observed that the decision of Brook Bond India Limited was rendered when Section 35D was not on the statute book and this provision had altered the legal position. The Supreme Court held that under the Section 35D of the Act benefit was allowed for the first two AYs and, therefore, it could not have been denied in the subsequent block period of 10 years.

While dealing with the issue of allowability of expenditure on bonus paid to employees, the Supreme Court observed that since there was a dispute between the taxpayer and its employees, the taxpayer had deposited the bonus amount in the trust and after the end of dispute, the same has been paid to employees. Accordingly, the Supreme Court allowed the expenditure on bonus paid to employees.

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