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TAX FLASH NEWS

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Write-off of investment in loss making overseas subsidiaries is allowed as business loss

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Maneesh Pharmaceuticals Ltd.[1] (the taxpayer) dealt with the issue of the allowability of written-off investment in the loss making overseas subsidiaries. The Tribunal held that write-off of investment in loss making overseas subsidiaries is allowed as business loss since the investments were made out of commercial expediency and in furtherance of taxpayer's business. The investments had direct nexus with taxpayer's business and any loss arising therefrom would be an allowable deduction.

The Tribunal also held that the write-off of advance made to an Indian entity is eligible for business deduction since these advances were lost during the course of business. The advances were given in the normal course of business out of commercial expediency which would have improved the profit-making apparatus without disturbing the capital setup of the taxpayer. Hence, it is allowable as business deduction.

Facts of the case

The taxpayer is engaged in manufacturing and distribution of pharmaceutical products. The taxpayer had made investment in two overseas subsidiaries entities i.e. SHBV, Netherlands and LASA, Brazil. However, due to consistent uncertain market conditions, the subsidiaries could not achieve the targets and accumulated heavy losses over a period of time which ultimately wiped off their respective net worth. Accordingly, during the Assessment Year 2011-12 and 2012-13, the investments were written-off and claimed as 'business loss' by the taxpayer while computing business income.

Similarly, the taxpayer made certain advances to an Indian entity to obtain technical know-how for manufacturing of six drug formulations. They were also required to assist the taxpayer in marketing of these products in various regions. Unfortunately, Indian entity did not fulfil its promise. Accordingly, the taxpayer written-off the amount during the year which was claimed as deduction.

The Assessing Officer (AO) treated in foreign investments as capital investments which would be chargeable under the head capital gains. Accordingly, the AO denied the claim of business loss. The AO relied on the decision of Ahmadabad Tribunal in APS Stare Industries Limited[2] to support the said conclusion. With respect to the advances made to Indian entity, the AO held that since the taxpayer could not sufficiently explain the same during assessment proceedings, the same was disallowed by the AO in terms of Section 36(1)(vii) read with Section 36(2) of the Income-tax Act, 1961.

The Commissioner of Income-tax (Appeals) [CIT(A)] held that the taxpayer made investments in Netherlands based entity exclusively for the purpose of marketing its products. The taxpayer had set up enough manufacturing facility and it required presence in foreign market. Therefore, the loss incurred therein could not be held to be capital loss but an allowable revenue loss. The conditions as stated in the cited decisions were fulfilled in case of investments made in SHBV and accordingly, the write-off would be an allowable deduction.

However, with respect to investment made in LASA, Brazil, the CIT(A) observed that it was an existing company having its own manufacturing and packing units and therefore, the investments were not exclusively for the business of the taxpayer. Once the

[1] DCIT v. Maneesh Pharmaceuticals Ltd. (ITA No.4024/Mum/2019) – Taxsutra.com
Note: This decision deals with various issues. However, this flash news deals with the issue of allowability of write-off of investment in loss making overseas subsidiaries.

[2] APS Stare Industries Limited v. DCIT [2003] 86 ITD 182 (Ahd)

investments were made, it was for the investee company to utilise the same according to its own need. There being no proximate direct nexus between the investment made by the taxpayer and the business of the taxpayer, the write-off for this entity could not be allowed as deduction.

Further with respect to advances given to an Indian entity, the same were treated as non-trade advance, and CIT(A) confirmed the action of AO. Aggrieved, the tax department as well as the taxpayer filed an appeal before the Tribunal.

Tribunal's decision

Allowability of write-off of investment in loss making overseas subsidiaries

The investments in the two entities were guided by commercial expediency in view of the fact that the taxpayer had enough installed capacity for manufacturing various pharmaceutical products of wide range. There was a need to push the sales in the international market so as to achieve optimum utilisation of manufacturing facilities. Hence, with a view to expand business in overseas markets especially in Europe and Africa and to establish business connections in these markets, the taxpayer had set up various subsidiaries as well as acquired various companies.

These investments had enabled the taxpayer to gain access to foreign markets. Undisputedly, as a foreign entity, it would be difficult for the taxpayer to comply with various regulatory requirements of FDA in foreign countries and creation of subsidiaries in these markets would have enabled the taxpayer to have better regulatory as well as marketing benefits.

These entities had all the worldwide certifications from WHO, USFDA etc. The creation of these entities has enabled the taxpayer to get more export orders which has ultimately enabled the taxpayer to fully utilise the manufacturing facilities available at its disposal in India. The same is evident from the fact that the taxpayer earned good export revenues, interest income, other gains etc. from SHBV and its step-down subsidiaries in earlier years which was offered to tax. Similarly, the second entity i.e. LASA enabled the taxpayer to have better packing facilities for its products in foreign market which ultimately has benefitted the taxpayer in marketing its products in those markets. The taxpayer has similarly earned export revenue from this entity in earlier years. All these facts would lead to a conclusion that the investments were in furtherance of business interest of the taxpayer and were made out of commercial expediency.

The main purpose of investment was not to acquire any manufacturing capacity or any infrastructural capacity, but the main purpose was to boost taxpayer's sales. Therefore, the investments could not be said to be in capital field rather the same were meant to improve the top line of the business by way of higher revenue profits.

It has been observed that the net worth of investee entities had been eroded to a greater extent which was supported by their financial statements as supplied by the taxpayer during appellate proceedings. The given factual matrix would support the taxpayer's claim that the investments had direct nexus with taxpayer's business and any loss arising therefrom would be an allowable deduction.

The Supreme Court in the case of Patnaik & Co. Ltd.[3] held that where the government bonds or securities were purchased by the taxpayer with a view to increase its business, the loss incurred on the sale of such bonds or securities was allowable as 'business loss'. Relying on this decision as well as its earlier decision in Investa Industrial Corp. Ltd.[4], the Bombay High Court in the case of Colgate Palmolive India Ltd.[5] held that loss in investment out of commercial expediency would be an allowable deduction. Subsequently, Courts in various cases[6] held that the loss arising out of investment in joint venture during the course of carrying on of business would be an allowable business loss.

In view of the above, the Tribunal held that since the investments were made out of commercial expediency and in furtherance of taxpayer's business, any losses arising therefrom would be an allowable 'business loss'. Consequently, the stand of the CIT(A) with respect to investment made in SHBV, Netherlands stand confirmed whereas the confirmation of disallowance of investment loss of LASA, Brazil stand reversed.

Allowability of advances written-off in the books of account

It has been observed that the taxpayer had given certain advance to an Indian entity pursuant to an understanding in normal course of its business so as to acquire limited right to use and exploit the know-how for manufacturing of six drug formulations. However, the taxpayer was already in the business of manufacturing pharmaceutical products and the technical know-how was only in respect of six drug formulations and to get technical information which would have enabled the taxpayer to set up new product lines to the existing business. Nevertheless, no new manufacturing unit would have come into existence and no new asset was proposed to be acquired by the taxpayer. The advances were given in the normal course of business out of commercial expediency which would have improved the profit-making apparatus without disturbing the capital setup of the taxpayer. There was no dispute that the said advances became irrecoverable and accordingly, the same were written-off in the books of accounts.

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[3] CIT v. Patnaik & Co. Ltd- [1986] 161 ITR 365 (SC)
[4] CIT v. Investa Industrial Corporation Ltd [1979] 119 ITR 380 (Bom)
[5] CIT v. Colgate Palmolive India Ltd [2015] 370 ITR 728 (Bom)
[6] Camlin India Pvt. Ltd. (ITA No.928/Mum/1988), Siemens Nixdorf Informations Systeme Gmbh v. DDIT [2016] 158 ITD 480 (Mum), ACE Designers Ltd. v. ACIT [2020] 120 Taxmann.com 321 (Kar), Sahara Global Vision Pvt. Ltd. v. ACIT (ITA No.2514/Del/2014)

Further, it has been observed that the claim has been examined by the AO only in terms of Section 36(1)(vii) read with Section 36(2) whereas the taxpayer's claim fall under Section 37(1) as well as under Section 28(i). The Supreme Court in the case of Assam Bengal Cement Co. Ltd.[7] held that it would be the aim and object of the expenditure which would determine its true character. If the expenditure was made for running the business with a view to produce profits, it would be revenue in nature. On the other hand, it the expenditure was made for acquiring or bringing into existence an asset or advantage for the enduring benefit of the business, it would be in the capital field.

The Bombay High Court in the case of Kirloskar Tractors Ltd.[8] held that the taxpayer had only a right to use know-how but it could not assign, encumber, let or sub-lease the same and the know-how continued to be the property of the supplier. Therefore, since the taxpayer did not acquire the know-how, the expenditure incurred in this respect was allowable as revenue expenditure. Courts in various Courts[9] held on a similar line.

The ratio of all the stated decisions support the conclusion that advances lost during the course of business would be business losses and hence, an allowable deduction. Accordingly, the deduction of amount written-off was granted to the taxpayer.

Our comments

A large number of Indian companies have set up their subsidiaries outside India to boost their sales in the international market. The deductibility of loss/expenditure incurred in connection with such subsidiaries has been subject matter of litigation.

The Karnataka High Court in the case of ACE Designers Ltd.[10] held that write-off of investment made in wholly owned subsidiary (for the purpose of extension of business activity/business purpose) is a business loss. However, the Ahmedabad bench of the Tribunal in the case of APS Stare Industries Limited[11] held that investment made by the taxpayer in the acquisition of shares with the ultimate purpose of merging the another entity with itself constitutes capital investment and any loss arising from writing off of the investments in its books could not be construed as either business loss or revenue expenditure.

One can observe from the above decisions as well as from the decisions relied on by the taxpayer in the present case that, investment should be inextricably linked to the business of the taxpayer for putting forth a claim that the loss arising from sale / write off thereof should be treated as 'business loss'.

In the present case, the investments had direct nexus with taxpayer's business and thus loss arising therefrom was allowed as a business loss.

Further, the Tribunal held that the advance made to an Indian entity is eligible for deduction since these advances were lost during the course of business. The advances were given in the normal course of business out of commercial expediency.

Claiming losses on account of sale of shares as 'business loss' continues to remain a debatable issue and more importantly, an extremely fact driven exercise and position. In the process, a proper evaluation of inextricable linkage between investments and business needs to be carried out.

[7] Assam Bengal Cement Co. Ltd. v. CIT [1955] 27 ITR 34 (SC)
[8] CIT v. Kirloskar Tractors Ltd. [1998] 231 ITR 849 (Bom)
[9] Binani Cement Ltd. v. CIT [2016] 380 ITR 116 (Cal), DCIT v. Honda Cars India Ltd. [2020] 180 ITD 235 (Del), Hero Honda Motors Ltd. v. JCIT [2005] 95 TTJ 782 (Del), Pik Pen Private Ltd. v. ITO (ITA No.6847/Mum/2008), Jackie Shroff v. ACIT [2019] 174 ITD 770 (Mum)
[10] ACE Designers Ltd. v. ACIT [2020] 120 Taxmann.com 321 (Kar)
[11] APS Stare Industries Limited v. DCIT [2003] 86 ITD 182 (Ahd)

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