Tax Hotline

April 03, 2003

RECENT RULING OF THE SUPREME COURT OF INDIA COULD BE REVERSED IF THE PROPOSALS OF THE FINANCE BILL 2003 GET ENACTED

Currently, under the Indian Income Tax Act, 1961 ("ITA"), interest paid on borrowings for expansion of the existing business is allowed as a deduction against the taxable profits of the payer company. A recent ruling of the Supreme Court holds that this deduction would be available even in case of borrowings made by the taxpayer to set up new units of existing business.

Tata Chemicals (part of a leading Industrial Group in India) had set up an additional manufacturing unit in a different geographic location (Babrala, Uttar Pradesh), which, the company claimed was only an expansion of its existing plant in Mithapur, Gujarat. The company contented that the setting up of the plant was part of its expansion plan. However, the tax department contended that the Babrala unit was an independent unit and thus interest on borrowings for setting up of this unit would not qualify for deduction since the ITA permitted deduction only on expenditure incurred for expansion of existing units. Interest expense for setting up of new units should, in view of the revenue authorities, be added to the cost of setting up of the new unit. The Income Tax Appellate Tribunal and the High Court had ruled in favour of the company. At the time of ruling, the High Court had taken into consideration various factors which, inter alia, included common administration of the units, flow of funds, unity of management and unity of accounting. It concluded that all of these factors indicated a functional integration between the two units. Aggrieved by the High Court order, the revenue authorities appealed before the apex court of India. However, the Supreme Court declined to interfere with the ruling given by the High Court.

It needs to be noted that the Finance Bill, 2003 has already suggested a provision which would upset the ratio of the above decision. Albeit, going forward, the Finance Bill proposes that interest paid in respect of capital borrowed for acquisition of new asset for extension of existing business or profession till the time the asset is first put to use, will not be allowed as a deduction. It would appear that the denial for deduction would not apply if the asset acquired for existing business or profession was second hand or if it was in the normal course of replacement due to normal wear and tear of the asset.

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