IN THE INCOME TAX APPELLATE TRIBUNAL
AHMEDABAD C BENCH, AHMEDABAD

[Coram: Pramod Kumar AM and S.S. Godara JM]

I.T.A. No.: 262 (Ahd) of 2012
Assessment year: 2007-08

Soma Textile & Industries Limited ***…….Appellant***
Rakhial Road, Ahmedabad 380 023
[PAN: AADCS 0405 R]

Vs.

Additional Commissioner of Income Tax
Range 8, Ahmedabad ***…. ……Respondent***

Appearances by:
Gyan Pipara, *for the appellant*
Sonia Kumar, *for the respondent*

Date of concluding the hearing: July 1, 2015
Date of pronouncing the order: July 7, 2015

O R D E R

Per Pramod Kumar:

1. By way of this, the assessee appellant has called into question the correctness of order dated 25th November 2011 passed by the learned CIT(A), in the matter of assessment under section 143(3) of the Income Tax Act, 1961, for the assessment year 2008-09.

2. In first and second grounds of appeal, which we will take up together, the assessee has raised the following grievances:

> **1. The Ld. CIT (A) has erred in law and on facts in dismissing the appellant's ground challenging the order u/s. 143(3) r.w.s. 144C(1) of the Act more particularly the action of the A.O. in referring the case to Addl. CIT (Transfer Pricing), Ahmedabad for computation of arms length price in relation to alleged international transaction with Soma Textile FZE, a 100% subsidiary of the appellant company. In view of elaborate facts and**

submissions filed, the provisions of transfer pricing not applicable t the appellant company, the assessment order ought to have been quashed on this ground itself.

2. The Ld. CIT (A) has erred in law and on facts in confirming the addition of Rs.19,92,355/-being Arms Length Price of loan interest made by the AO while relying upon the findings of the ACIT (TPO) in his order dated 14-10-2010. In view of elaborate facts and submissions filed, more particularly keeping in view the fact that the amount given to Soma Textiles FZE is not a loan but merely contribution towards capital and/or Quasi Equity Capital of the said subsidiary, the order of the ACIT (TPO) is bad in law and consequently the impugned addition of Rs.19,92,355/- requires to be deleted.

3. Briefly stated, the relevant material facts are like this. The assessee is engaged in the business of manufacturing of textile cotton fabrics. During the course of the scrutiny assessment proceedings, it was noticed that the assessee has established a wholly owned subsidiary, by the name of Soma Textiles FZE, in the United Arab Emirates (UAE). The assessee had invested Rs 21,71,723 in share capital of Soma Textiles FZE and the assessee had also advanced Rs 16,75,88,215 to this company. The Assessing Officer was of the view that these transactions are covered by the scope of 'international transactions', as defined under section 92CA(3) of the Act, and, accordingly, a reference was made to the Transfer Pricing Officer for ascertaining the arm's length price of these transactions. In the proceedings before the TPO, the basic contention of the assessee has been that the entire amount of Rs 16.75 crore advanced to the Soma Textiles FZE was out of the foreign exchange proceeds of assessee's Global Depository Receipts (GDRs) issue and that it was in nature of "contribution towards quasi capital of the said company". The commercial expediency of this interest free loan was also pointed out. None of these arguments, however, impressed the Assessing Officer. He was of the view that commercial expediency of the transaction was not relevant inasmuch as what is to be examined, while ascertaining the arm's length price, is the price at which such transactions would have been entered into by the parties if these parties were independent enterprises. As regards the claim for the advance being in the nature of quasi capital, the TPO referred to, and relied upon, a coordinate bench's decision in the case of

Perot Systems TSI Vs DCIT [(2010) 130 TTJ 685 (Del)]. In the said case, it was held that "the argument that the loans were in reality not loans but quasi capital cannot be accepted because the agreements show them to be loans and there is no special feature in the contract to treat them otherwise". It was in this backdrop that the TPO proceeded to treat LIBOR plus 2% as arm's length price of this loan and make an adjustment in respect of the same. Aggrieved, assessee carried the matter in appeal before the CIT(A) but without any success. Learned CIT(A), while confirming the stand of the AO, also noted that "the submission of the appellant that it is not a loan but capital contribution is prima facie not acceptable on facts", that "the company has not shown amount given as capital but it has been shown as loan to the company" and that "the appellant has also not given any evidence to show that the amount was not loan but the intention was to treat the same as capital contribution". Learned CIT(A) also held that the rate of LIBOR+ 2% was very reasonable by any standard and that it would be the minimum rate at which the AE could have borrowed in UAE in an arm's length transaction. The arm's length adjustment was thus upheld in principle as also in quantum. The assessee is not satisfied and is in further appeal before us.

4. We have heard the rival contentions, perused the material on record and duly considered facts of the case in the light of the applicable legal position.

5. As learned counsel for the assessee rightly points out, so far as **Perot System's case** *(supra)* is concerned, the argument of loan being in quasi capital was rejected on facts, though the core legal issue, i.e. whether ALP adjustments will also be warranted in case of interest free loans extended as quasi capital, was left open. It was stated so in the case of **Micro Inks Ltd Vs ACIT [(2013) 157 TTJ 289 (Ahd)]**. The question, however, arises as to what are the connotations of expression 'quasi capital' in the context of the transfer pricing legislation.

6. Hon'ble Delhi High Court, in the case **Chryscapital Investment Advisors India Ltd Vs ACIT [(2015) 56 taxmann.com 417 (Delhi)],** has begun by quoting the thought provoking words of Justice Felix Frankfurter to the effect that "**A phrase begins life as a literary expression; its felicity leads to its lazy repetition; and repetition soon establishes it as a legal formula, undiscriminatingly used to express different and sometimes contradictory ideas**". The reference so made to the words of Justice Frankfurter was in the context of the concept of "**super profits**" but it is equally valid in the context of concept of "**quasi capital**" also. As in the case of the super profits, to quote the words of Their Lordships, "**many decisions of different benches of the ITAT indicate a rote repetition (in the words of Felix Frankfurter J, quoted in the beginning of this judgment a "lazy repetition") of this reasoning, without an independent analysis of the provisions of the Act and the rules**", the same seems to be the position with regard to "quasi capital". There are several decisions of this Tribunal, including in the cases of **Perot Systems TSI Vs DCIT [(2010) 130 TTJ 685 (Del)]**., **Micro Inks Ltd Vs ACIT [(2013) 157 TTJ 289 (Ahd)]**, **Four Soft Pvt Ltd Vs DCIT [(2014)149 ITD 732 (Hyd)], Prithvi Information Solutions Pvt Ltd Vs ACIT [(2014) 34 ITR (Tri) 429 (Hyd)],** which refer to the concept of 'quasi capital' but none of these decisions throws any light on what constitutes 'quasi capital' in the context of transfer pricing and its relevance in ascertainment of the arm's length price of a transaction. Lest we may also end up contributing to, as Hon'ble Delhi High Court put it, "rote repetition of this reasoning without an independent analysis of the provisions of the Act and the Rules", let us take briefly deal with the connotations of 'quasi capital', and its relevance, under the transfer pricing regulations.

7. The relevance of 'quasi capital', so far as ALP determination under the transfer pricing regulation is concerned, is from the point of view of comparability of a borrowing transaction between the associated enterprises.

8. It is only elementary that when it comes to comparing the borrowing transaction between the associated enterprises, under the Comparable

Uncontrolled Price (i.e. CUP) method, what is to be compared is a materially similar transaction, and the adjustments are to be made for the significant variations between the actual transaction with the AE and the transaction it is being compared with. Under Rule 10B(1)(a), as a first step, the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified, and then such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market. Usually loan transactions are benchmarked on the basis of interest rate applicable on the loan transactions *simplictor* which, under the transfer pricing regulations, cannot be compared with a transaction which is something materially different than a loan *simplictor*, for example, a non-refundable loan which is to be converted into equity. It is in this context that the loans, which are in the nature of quasi capital, are treated differently than the normal loan transactions.

9. The expression 'quasi capital', in our humble understanding, is relevant from the point of view of highlighting that a quasi-capital loan or advance is not a routine loan transaction *simplictor*. The substantive reward for such a loan transaction is not interest but opportunity to own capital. As a corollary to this position, in the cases of quasi capital loans or advances, the comparison of the quasi capital loans is not with the commercial borrowings but with the loans or advances which are given in the same or similar situations. In all the decisions of the coordinate benches, wherein references have been made to the advances being in the nature of 'quasi capital', these cases referred to the situations in which (a) advances were made as capital could not subscribed to due to regulatory issues and the advancing of loans was only for the period till the same could be converted into equity, and (b) advances were made for subscribing to the capital but the issuance of shares was delayed, even if not inordinately. Clearly, the advances in such circumstances were materially different than the loan transactions *simplicitor* and that is what was decisive so far as determination of the arm's length

price of such transactions was concerned. The reward for time value of money in these cases was opportunity to subscribe to the capital, unlike in a normal loan transaction where reward is interest, which is measured as a percentage of the money loaned or advanced.

10. Learned counsel wants to take the concept of 'quasi capital' to a different level now. His contention is that whenever it can be said that the loan transaction is in the nature of quasi capital, its arm's length price should be 'nil' rate of interest, and to decide what is 'quasi capital', he refers to the academic literature on the issue. Learned counsel has taken pains to explain that the grant of loan was intended to be a long term investment in the subsidiary which has a crucial role to play in its business plans. He submits that the arm's length price of this quasi capital investment by the assessee in Soma Textiles FZE should be treated at 'nil'.

11. We are unable to see any merits in his line of reasoning. As the learned counsel himself accepts, on a conceptual note, several types of debts, particularly long term unsecured debts, and revenue participation investments could be termed as 'quasi capital'. So far as arm's length price of such transactions are concerned, this cannot be 'nil' because, under the comparable uncontrolled price method, such other transactions between the independent enterprises cannot be at 'nil' consideration either. Nobody would advance loan, in arm's length situation, at a nil rate of interest. The comparable uncontrolled price of quasi capital loan, unless it is only for a transitory period and the *de facto* reward for this value of money is the opportunity for capital investment or such other benefit, cannot be nil. As for the intent of the assessee to treat this loan as investment, nothing turns on it either. Whether assessee wanted to treat this loan as an investment or not does not matter so far as determination of arm's length price of this loan is concerned; what really matters is whether such a loan transaction would have taken place, in an arm's length situation, without any interest being charged in respect of the same. As for the contention regarding crucial role being played by, or visualized for, this AE, there is no material on record to

demonstrate the same or to justify that even in an arm's length situation, a zero interest rate loan would have been justified to such an entity. A lot of emphasis has also been placed on the fact that the loan was out of the GDR funds, and, for this reason, the interest free loan was justified. We are unable to see any logic in this explanation either. Even when the loan is given out of the GDR funds held abroad, the arm's length price of the loan is to be ascertained. The source of funds is immaterial in the present context. We have also noted that the assessee has not offered any assistance on the quantum of ALP adjustment in respect of this loan transaction, and that in the subsequent assessment years, the assessee himself has accepted ALP adjustment by adopting the LIBOR + 2% interest rate. In this view of the matter, no interference is warranted on the quantum of the ALP adjustment either. In view of these discussions, we confirm the stand of the authorities below on this issue and decline to interfere in the matter.

12. Ground nos. 1 and 2 are thus dismissed.

13. Ground no. 3 is not pressed.

14. In ground no. 4, the assessee has raised the following grievance:

> **The ld. CIT (A) has erred in law and ion facts in confirming the addition of Rs.15,02,592/- made by the AO on account of disallowance of 1/5th of GDR Issue expenses claimed by the company as allowable deduction u/s. 35D of the Act on the ground that the expenses incurred for issue of share capital is capital loss to the company. In view of facts and submissions filed as well as legal position, the impugned addition of Rs.15,02,592/- requires to be deleted.**

15. So far as this grievance of the assessee is concerned, the relevant material facts are like this. During the course of the assessment proceedings, the Assessing Officer noted that the assessee has incurred expenses of Rs 75,12,960 on GDR issue and the treated the same as preliminary expenses eligible for amortization under section 35D of the Act. However, the

Assessing Officer declined the deduction of Rs 15,02,592, claimed by the assessee under section 35D, by observing that "it is settled law that whatever expense is incurred for issue of share capital is capital loss to the company and is neither revenue expenditure nor a capital expenditure for the purposes of business". Aggrieved, assessee carried the matter in appeal before the CIT(A) but without any success. While rejecting the contention of the assessee, learned CIT(A) observed that, "the facts of the case are also squarely covered by the Supreme Court decision in the case of Brooke bond India Ltd Vs CIT (225 ITR 798)", that "these expenses are not in nature of preliminary expenses and are, therefore, not allowable as per the provisions of Section 35D", and that "the appellant has given a loan out of this amount to its subsidiary in UAE and, therefore, it has not been used for any of the purposes under section 35D of the Act". The assessee is aggrieved and is in further appeal before us.

16. We have heard the rival contentions, perused the material on record and duly considered facts of the case in the light of the applicable legal position.

17. We find that, as held by Hon'ble Supreme Court in the case of Brooke Bond Limited *(supra),* the expenses on issuance of share capital are capital expenses in nature and that these expenses cannot be allowed as a deduction as revenue expenses. However, as long as these expenses, even if capital in nature, satisfy the conditions set out in Section 35D, these expenses are eligible for amortization under Section 35D. One of the conditions in Section 35D(1), as it stood at the material point of time, is that either the eligible expenses should be incurred before the commencement of the business, and, in a situation in which the expenses are incurred after the commencement of business, the expenses should be incurred for extension of his undertaking or setting up of a new industrial undertaking. This condition is clearly not satisfied on the facts of the present case as the expenses are incurred after the commencement of the business and it is not even assessee's case that the expenses are incurred for extension of his

undertaking or for setting up of new industrial undertaking. As for the decision of a coordinate bench, in the case of Mahindra & Mahindra Ltd Vs JVIT [(2010) 36 SOT 348 (Bom)], this decision was in the context of foreign currency convertible bonds which were debt instruments, though convertible into equity at a later stage. That decision has no bearing on the facts of this case. In view of these discussions, we see no merits in this grievance of the assessee either. The stand of the authorities below does not call for any interference.

18. Ground no. 4 is also dismissed.

19. In ground no. 5, the assessee has raised the following grievance:

> **The Ld. CIT (A) has erred in law and on facts while giving a finding that the loss due to foreign fluctuation amounting to Rs.2,73,28,718/- is a capital loss as against revenue loss claimed by the company. In view of the legal position and facts of the case, the said loss requires to be considered in revenue in nature.**

20. The relevant material facts are like this. During the course of the scrutiny assessment proceedings, the Assessing Officer noticed that the assessee has shown an amount of Rs 2,73,28,718 as a loss as extraordinary item. This debit, as the Assessing Officer noted, was for “exchange rate fluctuation on account of funds raised by the GDR issue, which are lying in foreign bank account in the form of deposits”. It was also noted that the said amount was to be capitalized in new project at the time of commencement of commercial production. The Assessing Officer was of the view that this amount could not be capitalized. However, that had no impact on the computation of taxable income since the assessee had not claimed any deduction in respect of this loss. Aggrieved by the observations made by the Assessing Officer, assessee carried the matter in appeal before the CIT(A). In appeal, the assessee contended that revenue deduction should be allowed in respect of the said loss of Rs 2,73,28,718 as not claiming this loss as deduction was an inadvertent error on the part of the assessee. Learned CIT(A) declined to consider this claim as no revised return was filed by the

assessee to make this claim. He, however, did not leave it at that, and proceeded to reject the claim on merits as well. He noted that in the case of Oil and Natural Gas Corporation Vs CIT [(2010) 322 ITR 180 (SC)], which was relied upon by the assessee, the loss was held to be deductible as the borrowing was for revenue purposes whereas, in the present case, the funds are used for capital purposes. The assessee is not satisfied by the stand of the CIT(A) and is in appeal before us.

21. We have heard the rival contentions, perused the material on record and duly considered facts of the case in the light of the applicable legal position.

22. The issue involved is a legal issue and just because the assessee has not claimed the deduction in the income tax return, the assessee cannot be debarred from seeking adjudication on the same, on merits, before us. In any event, learned CIT(A) has already examined the matter on merits. We, therefore, proceed to examine the matter on merits. We have noted that, in note no. 24 to the annual accounts, this item of extraordinary loss is explained as follows:

> **Extraordinary item consists of the exchange rate fluctuation on account of funds raised by GDR issue which are lying in foreign bank accounts in the form of deposits, earmarked for the purposes of acquisition/ joint venture and on account of transfer from Escrow account; it is considered as distinct from ordinary activities of the company.**

23. Clearly, therefore, the loss is entirely notional inasmuch as no foreign exchange is brought in India which is required to be repatriated in terms of higher rupee value. In both the Hon'ble Supreme Court judgments relied upon by the learned counsel, namely **CIT Vs Woodward India Limited [(20009) 312 ITR 254 (SC)]** and **Oil and Natural Gas Corporation Vs CIT [(2010) 322 ITR 180 (SC)]**, the additional liability had arisen in rupee terms since the funds were brought into India but, on account of fluctuation in exchange

value, making the repayment of these loans required higher rupee payments. In the present case, however, since the amount is lying abroad in foreign exchange denominated accounted, the exchange rate fluctuation has no additional liability for repayment. There is no real loss as such. The loss is purely an accounting loss due to conversion of foreign currency obligations on the basis of different rates. In the light of these discussions, as also bearing in mind entirety of the case, we approve the conclusions arrived at by the CIT(A) and decline to interfere in the matter.

24. Ground no. 3 is also, therefore, dismissed.

25. In the result, the appeal is dismissed. Pronounced in the open court today on 7th day of July, 2015.

Sd/xx ***Sd/xx***
S. S. Godara **Pramod Kumar**
(Judicial Member) (Accountant Member)

Ahmedabad, the 7th day of July, 2015

Copies to: *(1)* *The appellant* *(2)* *The respondent*
(3) *Commissioner* *(4)* *CIT(A)*
(5) *Departmental Representative*
(6) *Guard File*

By order etc

Assistant Registrar
Income Tax Appellate Tribunal
Ahmedabad benches, Ahmedabad