

Interest on borrowings, Foreign exchange fluctuations and their Deferred Tax Impact

In this discussion, we would understand the accounting and taxation treatment of interest on funds borrowed for acquisition of capital assets. We will analyse the provisions of relevant Accounting Standards and the provisions of Income Tax Law along with the Deferred Tax impact of differences between both the provisions.

Interest on borrowings

❖ Treatment of interest on borrowings as per Accounting Standards

The treatment of Borrowings Costs in books of accounts is governed by the Accounting Standard 16 – 'Borrowing Costs'. First of all it is necessary to understand definition of certain terms as given in AS 16.

- **Definitions**

- i) Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.
- ii) A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Explanation:

What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered.

Accounting Treatment

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised a part of the cost of that asset.

Other borrowing costs should be recognised as an expense in the period in which they are incurred

❖ Treatment as per Income Tax Law

- Interest paid on borrowed capital is an allowable expenditure as per section 36 (1) (iii) of the Income Tax Act, 1961 (the Act), provided that the funds are used for the purpose of business/profession of the assessee.
- The borrowed money may be used in the acquiring of capital assets or stock-in-trade or expansion of the business. It is essential that the money should have been utilised in the assessee's business or profession.

- The amount of interest on capital borrowed for acquisition of new asset or for extension of existing business or profession, for the period between the date of availing loan and the date on which asset is first **put into use** forms a part of the cost of that asset.
- However, as per explanation 8 to the section 43(1) of the Income Tax Act, 1961, the interest pertaining to the period after the asset is put to use must be claimed as revenue expenditure and cannot form a part of actual cost of the asset.

Foreign Exchange fluctuations

❖ **Treatment of foreign exchange fluctuations as per Accounting Standards**

➤ **Provisions of Accounting Standard 11**

Paragraph 46 and 46A of Accounting Standard 11- Effects of changes in foreign exchange rates every entity has the following option-

- Foreign exchange difference on **long term monetary items** relating to **depreciable assets** can be added/deducted to/from the cost of the respective asset (and depreciated over life of the asset)
- For the purposes of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of **12 months or more** at the date of origination of the asset or liability
- The option once adopted is irrevocable

➤ **Provisions of Accounting Standard 16**

- **Paragraph 4(e) of AS 16- Borrowing Costs** covers exchange differences on the principal amount of foreign currency borrowings to the extent of the difference between interest rates on local currency borrowings and interest rates on foreign currency borrowing
- This component of foreign exchange differences is considered to be in the nature of borrowing costs. The reason for this provision was to permit entities that borrowed in foreign currency at lower rates but then incurred foreign exchange losses, to capitalise additional exchange differences to the extent of interest costs that would have been incurred had they borrowed locally at higher interest rates
- While this allowed for such exchange differences to be capitalised during the construction period if they pertained to construction of a qualifying asset, such exchange differences were required to be charged to the profit or loss account if they did not relate to qualifying assets and in all post-construction periods.

➤ **Effect of circular 25/2012 dated 09.08.2012**

- Ministry of Corporate Affairs issued circular 25/2012 which clarifies that para 4(e) of AS 16 will not apply to Companies adopting the alternative treatment as per Para 46 of AS 11.
- Until the circular was issued, Companies that elected the capitalisation option under paragraphs 46 and 46A of AS 11 could not capitalise exchange differences covered by paragraph 4(e) of AS16. Instead, they were required to assess such exchange differences under the more restricted capitalisation requirements of AS 16. However, this scenario has changes after issuance of circular 25/2012.

❖ **Treatment of foreign exchange fluctuations related to acquisition of asset as per Income Tax Law**

Section 43 A of Income Tax Act, 1961 provides provisions regarding foreign exchange fluctuations on actual repayment of Principal and actual repayment of outstanding interest on foreign currency loan or foreign supplier's credit related to acquisition of an asset.

Section 43 A of the Act is applicable subject to fulfilment of all of the following conditions

- i) Asset is acquired from a country outside India
- ii) Asset is acquired through a loan in foreign currency or foreign supplier's credit
- iii) Asset is used for the purposes of business/profession

If all the above conditions are fulfilled, the foreign currency fluctuation (Gain/loss) at the time of **actual payment** of the cost of asset or **repayment** of the principal and interest of the loan obtained for acquisition of asset shall be treated as follows

- Foreign currency gain shall be **deducted from** the WDV of the block of Asset.
- Foreign currency loss shall be **added** to the WDV of the block of Asset.

❖ **Impact of Deferred Tax with reference to borrowings cost and forex fluctuations relating to depreciable assets**

➤ **Key differences in provisions of Accounting Standards and Income Tax law which may lead to need for accounting of Deferred Tax Asset/Liability**

- Income tax law does not differentiate the treatment of capitalisation of interest based on the time taken for the asset to become ready to use. The concept of **qualifying assets** exists only in Accounting Standard 16. Irrespective of the time taken for an asset to get ready for use the income tax law allows capitalisation of interest on borrowed funds till the date asset is put to use.
- The AS 11 gives an option for adjustment of foreign exchange gain/loss on **accrual basis** to the cost of **depreciable asset** only in case where the asset is acquired against **long term** foreign currency liability. If an depreciable asset is acquired against an foreign currency liability with an short term duration, the said option is not available.

However, as per section 43 A of the Income Tax Act, 1961 the foreign exchange gain/ loss on foreign currency liability related to acquisition of asset can be adjusted to the cost of asset only on **actual payment** but **irrespective of the duration** of the foreign currency liability. Section 43 A applies even if the duration of foreign currency liability is short term (lower than a period of 12 months)

- Further, treatment under Para 46/46A of AS 11 is optional but the provisions of section 43 A of IT Act, 1961 are mandatory.
- The provision for capitalisation of exchange differences regarded as an adjustment to interest costs (as referred in para 4 (e) of AS-16) is not available in Income Tax Act.

➤ Let us understand deferred tax impact of the items discussed above

Sr no.	Nature of expense	Treatment in books of accounts	Treatment as per Income Tax law	Deferred tax Impact
1	Interest on borrowings- Interest on capital borrowed for construction/acquisition of Asset which can be termed as a Qualifying Asset as per definition of AS 16.	Interest on capital borrowed for construction/acquisition of Asset which can be termed as a Qualifying Asset as per definition of AS 16 is added to the cost of the asset	No difference in treatment as per IT Act or AS 16. Interest is added to the cost of asset till the asset is put to use.	Not applicable
2	Interest on borrowings- Interest on capital borrowed for construction/acquisition of Asset which can not be termed as a Qualifying Asset as per definition of AS 16.	Interest on capital borrowed for construction/acquisition of Asset which can not be termed as a Qualifying Asset as per definition of AS 16 is charged to statement of profit and loss.	Interest up to the date when asset is put to use can be capitalised as per provisions of Income Tax Act	If interest is capitalised in Income Tax books but not capitalised in books of accounts it warrants recognition of Deferred Tax Asset in books of accounts.
3	Foreign exchange fluctuation arising on reinstatement/payment of short term foreign exchange liability towards procurement of asset from any country outside India	Gain/loss due foreign exchange rate fluctuation related to short term liability is charged to statement of profit & loss	Foreign exchange gain/loss attributable to foreign currency liability towards procurement of capital asset arising on actual payment is adjusted to Cost of Asset irrespective of whether the liability is short term or long term. However, similar forex gain/loss on reinstatement of liability has no tax treatment since it is an expense of capital nature.	i) Reinstatement of short term foreign currency liability towards acquisition of Capital Asset from outside India- No deferred tax impact since the difference would be of permanent nature. ii) Forex gain/loss on Actual payment- Deferred Tax Asset needs to be created in books of accounts since the gain/loss is adjusted to cost of asset as per IT act but expensed out in books of accounts.
4	Foreign exchange fluctuation arising on reinstatement/payment of long term foreign exchange liability towards procurement of asset from any country outside India	If option under Para 46/46A of AS 11 is opted for then the forex gain/loss on long term forex liability is adjusted to the cost of respective depreciable asset	Foreign exchange gain/loss attributable to foreign currency liability towards procurement of capital asset arising on actual payment is adjusted to Cost of Asset irrespective of whether the liability is short term or long term. However, similar forex gain/loss on reinstatement of liability has no tax treatment since it is an expense of capital nature.	i) Reinstatement of long term foreign currency liability towards acquisition of Capital Asset from outside India- No deferred tax impact since the difference would be of permanent nature ii) Actual payment- No Deferred Tax impact since in both the cases forex gain/loss is adjusted to the cost of asset

By CA Kunal Narwadkar

Email: kunal.narwadkar@pnca.in

website: www.pnca.in

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