Pre-operative expenses- Meaning and Treatment

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Most foreign investors venturing into Indian markets have questions as to the optimal financing methodology. A Wholly Owned Subsidiary ('WOS'), takes times and cost from the date of initiation till the time the Indian entity could be brought to a stage of functionality. Usually, until incorporation, followed by reporting of capital subscription money, such WOS is supported financially from the headquarters. The capital subscription money is technically available for use only after the WOS is incorporated and has an operative bank account. Until then, invariably the headquarters invests its time in planning and also spends towards the initial set-up costs & execution of preliminary tasks, which are necessarily to be undertaken on behalf of WOS. These expenses are often referred to as pre–incorporation and pre–operative expenses.

Pre-incorporation expenses are those expenses which are incurred by the promoters till the time the Indian entity obtains its legal existence and is registered with the government authorities. While pre – operative expenses are expenditures incurred by the promoters after the entity is set up and till the time the company commences actual production / operation.

The challenge that often arises for the headquarters is to identify a viable manner through which such costs, which are incurred on behalf of WOS, are accounted for. Such costs, being attributable to WOS, are often contested by authorities in the home country. Therefore, such costs and expenses, which are incurred over and above the capital commitment, cause financial burden on the headquarters i.e. neither can they be retained in the books of headquarters (as expenses) nor can they be deferred until WOS is financially operational. These expenses therefore become additional funding for the headquarters over and above the capital commitment, thereby causing financial mismatch for the headquarters.

To reduce the distress and burden of such foreign promoters, the conversion of pre-incorporation and pre-operative expenses, into equity share capital is a viable solution. The Reserve Bank of India ('RBI'), vide Notification No. FEMA.373/2016-RB dated October 24, 2016, permitted Indian WOS, incorporated under the automatic route of Foreign Direct Investment ('FDI'), to issue securities to promoters in lieu of the pre–operative and pre–incorporation expenses, subject to certain conditions. WOS therefore are permitted to issue equity shares or preference shares or convertible debentures or warrants to the promoters against pre – incorporation and pre – operative expenses up to a limit of 5 per cent of its capital or USD 500,000 whichever is less.

The regulatory perspective under various regulations are summarized below:

FEMA perspective	Audit perspective	Tax perspective
WOS issuing securities in lieu of pre-incorporation and pre-operative expenses should comply with below conditions: i. Within 30 days from the date of issue of securities but not later	Accounting Standards 26 (AS26) issued by the Institute of Chartered Accountants of India deals with pre-operative expenses	Section 35D of the Income Tax Act, 1961 deals with amortization of preliminary expenses. Companies incurring expenditures either before commencement of business or after commencement

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than one year from the date of incorporation, the company should file Form FC-GPR for intimation of issuance of securities ii. The valuation of securities shall be in accordance with Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 [*i.e., Fair valuation as per internationally accepted principles at arms' length*] iii. Statutory auditor should confirm the utilization of amount received towards pre-incorporation and pre-operative expenses It shall be noted that pre-incorporation or pre-operative expenses shall include amounts remitted to any consultant, attorney or to any other material or service provider for expenditure relating to incorporation or expenditure necessary for commencement of operations.	and preliminary expenses. Where expenditures are incurred by an organisation to provide for future economic benefits, but no recognizable intangible asset is created, such expenditures are realized as an expense during the year in which they are incurred. This provision is in line with FEMA requirements of filing the auditor's certificate for usage of expenses in Form FC-GPR within one year from the date of incorporation.	but in connection with the setting up of a new unit, are allowed a deduction of an amount equal to 20% of such expenditure over 5 successive years beginning with the year in which the business commences or the year in which extension of the undertaking commences production or operation. Amortization of the following expenses are permitted under the Income Tax Act, 1961: i. Expenses towards feasibility studies, project reports, market surveys, engineering services ii. Expenses incurred for registering the company under the provisions of the Companies Act, 2013 iii. Legal charges for drafting and printing Memorandum and Articles of Association The aggregate amount of expenses incurred on the above shall not exceed 5 per cent of aggregate of share capital, debentures and long-term borrowings.

Conclusion

Through prior planning and with aid of various legislative provisions as highlighted above, promoters can plan the capital structuring and funding arrangement in an optimal manner. Especially, foreign investors can better plan an India entry strategy which would ensure that no unwanted costs are incurred by them during the process of entry.