



## INTEREST EXPENSES – DEDUCTION & ITS ASSESSMENT UNDER I.T. ACT

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### Introduction

1. The Income-tax Act, 1961 (hereinafter "the Act") provides detailed provisions to claim a deduction of expenses incurred for earning business income. Sections 30 to 36 of the Act deal with deductions for computing profits and gains of business or profession and also prescribes certain conditions to avail of such deductions. The amount of interest paid with respect to capital borrowed for the purposes of business or profession is one among them. Deduction of Interest Expenses, no doubt, also opens contentious issues while completing Assessment proceedings. Clause (iii) of sub-section (1) of Section 36 makes an allowance in respect of interest paid on capital borrowed for the purpose of the business or profession, however, the transaction if found "sham", the assessee cannot avail of the deduction. Following paragraphs throw some light on such areas.

### Ingredients of the Provision

2. The Section, *in a summarized form*, reads as follows:

#### Other Deductions

2.1 36(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in Section 28 –

(i) & (ii)\*\*

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(iii) *the amount of the interest paid in respect of capital borrowed for the purpose of the business or profession:-*

**Provided** that any amount of the interest paid, in respect of capital borrowed for acquisition of an asset for extension of existing business or profession (whether capitalized in the books of account or not) for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, shall not be allowed as deduction.

Clause (iii) of the said Section contains three ingredients, namely, Interest, Borrowed and Purpose of Business. Let us understand them in general parlance as well as in the light of Hon'ble Supreme Court's verdict in *Madhav Prasad Jatia v. CIT* [1979] 118 ITR 200/1 Taxman 477 (SC).

#### Interest – Meaning of

3. The first ingredient of the section is "Interest". It is a consideration paid either for use of money or for forbearance in demanding it after it has fallen due. The word 'Interest' is an inclusive definition and includes interest on unpaid purchase price, payable in any manner which would include interest payable by means of an irrecoverable letter of credit. *CIT v. Vijay Ship Breaking Corpn. v. CIT* [2003] 129 Taxman 120/261 ITR 113 (Guj.) and *Vijay Ship Breaking Corpn. (supra)*

The word "Interest" in a given context –

Summarized provisions of Section 2(28A) and Section 36(1)(iii) of the Act as follows,

Section 2(28A) *Interest payable in any manner in respect of any sums of money borrowed or debt incurred.....*

Section 36(1)(iii) *The amount of the interest paid in respect of capital borrowed for the purpose of the business or profession.....*

Section 2(28A) defines Interest in a wider sense whereas Section 36(1)(iii) in a restrictive manner and extends only to "Money Borrowed" and not "on debt incurred."

### **Borrowed - Concept of**

4. The second ingredient of the section is "Borrowed." Provisions of Section 36(1)(iii) concern with capital borrowed but no other liabilities. A borrowed capital is undoubtedly a debt but all debts have not involved a loan or borrowal.

In one of the oldest precedents, the Hon'ble Supreme Court held that the term borrowed money must be construed in its natural and ordinary meaning and implies a real borrowing and a real lending. *Lakshmanier & Sons v. Income Tax and Express Profits Tax Commissioner (AIR 1953 SC 145)*

Hon'ble Supreme Court's observation in *Bombay Steam Navigation Co. Private Ltd. v. CIT [1965] 56 ITR 52*, held that the Legislatures intention is just to permit interest paid on borrowed capital 'exclusively' for the purpose of the business and in that context, borrowed capital means money and not any other asset purchased on credit.

The Hon'ble Gujarat High Court in *Arun Family Trust v. CIT 298 ITR 437* clearly states that the existence of a loan transaction or a loan agreement between parties with an established role of creditor and debtor is a pre-condition under Section 36(1) (iii).

### **Purpose of Business - Meaning of**

5. The third but most important ingredient of the Section is "Purpose of Business."

Again, in one of the oldest precedent, the Hon'ble High Court of Calcutta *Standard Vacuum Oil Co. v. CIT AIR 1967 Cal 68, 73* held that the expenditure incurred shall be for carrying on the business and the assessee shall incur the expenditure in his capacity as a person carrying on the business.

Whether similar expression found in clause (iii) of Section 57 has same intention of Legislatures?

The Section, *in a summarized form*, reads as follows:

#### **57. Deductions**

(i) & (ii)\*\*

\*\* \*\*

(iii) Any other expenditure (not being the capital expenditure) expended wholly or exclusively for purpose of earning such income.

No., The Hon'ble Supreme Court in *Madhav Prasad Jatia (Supra)* case held that the expression under Section 36(1)(iii) has a wider scope than the expression found in Section 57(iii). Hence, probabilities of allowing a deduction under former Section is much wider than the later one.

Since one of the most important ingredients to determine whether a particular expenditure is allowable or not, the Hon'ble Supreme Court in *S A Builders Ltd. v. CIT* [2007] 288 ITR 1/158 Taxman 74 (SC), *very first time* coined a word "Commercial expediency". New definition says that "an expression of wide import and includes such expenditure as prudent businessman incurs for the purpose of business. Also opined that expenditure may not be incurred under any legal obligation, yet it is allowable as business expenditure.

Interestingly, after the Hon'ble Supreme Court's elaborative definition, the Hon'ble Delhi High Court in *Punjab Stainless Steel Industries v. CIT* [2010] 324 ITR 396/[2011] 196 Taxman 404 widens the said definition further. In a summarized words, "*The commercial expediency would include such purpose as is expected by the assessee to advance its business interest and may include measures to taken for preservation of its business interests, however, same has to be distinguished from the personal interest of its directors or partners.*"

To avail of deductions, the said three ingredients or conditions are must and same has been summarized as follows:

1. *The capital must have been borrowed*
2. *Interest must have been paid*
3. *Must have been borrowed for the purpose of business.*

### **Key Amendments – In Brief**

6. To disallow interest paid on money borrowed for acquiring a capital asset, the Central Government, *vide* Finance Act, 2003 w.e.f. 1-4-2004 inserted a suitable proviso to the said Section.

"Any amount of the interest paid in respect of capital borrowed for acquisition of an asset whether capitalized or not for any period beginning from the date on which the capital was borrowed for acquisition of the assets till the date on which such asset was put to use shall not be allowed as deduction."

### **Prior Position**

6.1 Prior to the amendment, interest paid on capital borrowed for expenditure for expanding a business was allowable deduction, although the assets brought were not put under actual use in the relevant accounting year.

### **Whether newly inserted "Proviso" operates retrospectively or prospectively?**

6.1.1 As Hon'ble Supreme Court held that "the newly inserted proviso will operate prospectively." *Dy. CIT v. Core Health Care Ltd.* [2008] 298 ITR 194/167 Taxman 206.

Further, the Central Government *vide* Finance Act, 2015, amended the said provision by omitting the words "*for extension of existing business or profession*" w.e.f. 1-4-2017 or Assessment year 2016-17 and subsequent assessment years.

Impact –Interest paid on capital borrowed for acquisition of an asset for any period beginning from the date on which the capital was borrowed for acquisition of the asset till date on which such an asset was put to use shall not be allowed as deduction.

### **7. Issues Involved in Assessment**

7.1 Whether Burden of proof lies on the assessee or the Revenue?

There is no doubt that the burden of proof lies on the assessee. The assessee is under an obligation to prove beyond reasonable doubt that the sums of money borrowed have all the ingredients of the given provisions and were not used for non-business purposes.

### **Whether Assessing Officer can question the rate of interest?**

7.2 As affirmed in last issue and assessee proved its genuineness, the answer is No. Assessing Officer does not have any power to question the rate of interest or to disallow the deduction by stating grounds like a rate of interest is unreasonable or is charged less rate of interest on monies which he lent.

### **Whether interest- free loans to sister-concern allowable as a deduction?**

7.3 Allowable, but same rests on whether the interest - free loan was given by assessee as a measure of "Commercial Expediency". In other words, the assessee diverted the borrowed money to his sister concern. The Hon'ble Supreme Court in *S A Builders (supra)* held that the Revenue cannot decide how much is reasonable expenditure having regard to the circumstances of the case.

### **Whether any presumption can be drawn between "own funds" and "borrowed funds" while providing an interest-free loan to sisterconcern?**

7.3.1 The Hon'ble Bombay High Court in *CIT v. Reliance Utilities & Power Ltd.* [2009] 313 ITR 340/178 Taxman 135 (Bom.) held that a presumption can be made that the advances for non-business purposes have been made out of the own funds and that the borrowed funds have not been used for business purpose.

### **Whether interest on borrowings to purchase of a revenue asset allowable?**

7.4 The said provision does not make any distinction between revenue asset or capital asset. All that is required is to confirm the said three ingredients of the Section. However, subsequent "Section 37 – General" of the Act expressly excludes an expense of a capital nature.

### **Is there any restrictions to put to use an asset brought on borrowings in the same financial year?**

7.5 Interest paid in respect of borrowings on capital assets not put to use in the concerned financial year is an allowable deduction as it stood till 31-3-2004.

### **Whether interest on borrowings used for earning exempt income is allowable?**

7.6 The answer is in the Negative. The basic condition of the section is that the interest is paid on capital borrowed for the purpose of business or profession. Interestingly, the Central Government amended the Act suitably by inserting Section 14A by the Finance Act, 2011 with retrospective effect from 1-4-1962 to safeguard the interest of the Revenue. Hence, expenditure should not be considered in the computation of total income, else same will result in double advantage to the assessee.

### **How to treat Interest on borrowed capital in the case of Firms?**

7.7 Yes, Can claim allowance but with a rider..!!

To have a clear picture, Section 36(1) (iii), read with Section 40(b)(iv). Even if the assessee is entitled to a deduction under Section 36(1)(iii), the firm will not be allowed or entitled to claim a deduction for interest payment exceeding 12 Per cent. *Munjal Sales Corp. v. CIT* [2008] 298 ITR 298/168 Taxman 43.

### **Whether deduction allowed under Section 36(1)(iii) or section 37(1)?**

7.8 Section 36(1) (iii) limits allowance only on capital borrowed whereas the other Section allows any debt incurred. The assessee can utilize the borrowed amount to procure a capital asset for the purpose of business, whereas the other section won't allow utilizing the same amount to procure a capital asset.

For instance, interest paid on the purchase of debentures will be allowed under Section 37(1) and not under Section 36(1)(iii). *Eastern Investments Ltd. v. CIT* [1951] 20 ITR 1 (SC)

However, there will be no double deduction for one and the same amount.

### 7.9 What may be the position in following cases?

- **Pre-commencement of business**

The Calcutta High Court in *Ritz Continental Hotels Ltd. v. CIT* [1978] 114 ITR 554 held that no deduction under said provisions can be claimed.

- **Cessation of business**

The Hon'ble Guwahati High Court in *Assam Biscuit Mfg. Co Ltd. v. CIT* [1990] 185 ITR 535 held that no deduction can be claimed in respect of interest on borrowings.

- **Sham transactions**

If the object of the borrowing is just sham and proved itself, the provisions have no application. As held in *Govan Bros. v. CIT* [1963] 48 ITR 930 (All.)

### Whether any inferences can be drawn from Companies Act, 2013 provisions?

**7.10** The Companies Act, 2013 has made it very difficult to borrow or lend money to its group or sister concerns. Sections 185 - 186 of the said Act and Companies (Meetings of the Board and its Powers) Rules, 2014, extensively dealt with all the relevant issues under Company Laws. The Department can utilize those provisions and make good assessments in the interest of the revenue.

## 8. Leading Pronouncements – In Brief

### 8.1 In favour of assesses -

#### 8.1.1 Hero Cycles Private Ltd. v. CIT

The Hon'ble Supreme Court in *Hero Cycles Private Ltd. v. CIT* [2010] 323 ITR 518/189 Taxman 50 (Punj.&Har.) by applying its own principles laid down in *S. A. Builders Ltd. (supra)*, held that interest - free loans advanced to a subsidiary company, satisfies the test of "commercial expediency" and entitled the assessee to deduct interest expenses.

#### *Taparia Tools Ltd. v. JCIT*

**8.1.2** The Hon'ble Supreme Court in *Taparia Tools Ltd. v. Jt. CIT* [2015] 372 ITR 605/231 Taxman 5/55 taxmann.com 361 (SC) held that when interest was actually incurred by the assessee, who followed mercantile system, on application of the said provision, the assessee would be entitled to deduct full amount of interest expenses in assessment year in which it was paid.

### 8.2 In favour of Revenue

#### *Bombay Steam Navigation Company Pvt. Ltd. v. CIT*

**8.2.1** The Hon'ble Supreme Court in *Bombay Steam Navigation Co. Pvt. Ltd. (supra)* ruled in favour of revenue by stating that payment of interest by the assessee on an unpaid price of the assets taken over is not an affordable expense.

#### *Lachhiram Puranmal v. CIT*

**8.2.2** The Hon'ble Madhya Pradesh High Court in *Lachhiram Puranmal v. CIT* [2001] 119 Taxman 1 held that interest paid on borrowed capital was held not deductible since the borrowed sums of money were spent on agricultural land which was not a business investment.

### ***East India Pharmaceuticals Works Ltd. v. CIT***

**8.2.3** The Hon'ble Supreme Court in *East India Pharmaceuticals Works Ltd. v. CIT* [1997] 224 ITR 627/91 Taxman 185 rightly disallowed the interest expenses. *The interest paid on borrowed sums of money to discharge income-tax liability is not deductible.*

Similarly, the Hon'ble Supreme Court in *Bharat Commerce and Industries Ltd. v. CIT* [1998] 230 ITR 733/98 Taxman 151 did not allow to deduct interest while discharging Voluntary Disclosure of Income Scheme (VDIS) liability with interest as business expenditure.

### ***Indian Express Newspaper (Madurai) (P.) Ltd. v. CIT***

**8.2.4** Brief Facts – The assessee transferred the borrowed sums of money to an investment company floated by the assessee itself. Thereafter the said investment company transferred to an associate company which was originally engaged in construction business. Since the borrowed money was not spent for the assessee's business, the Hon'ble Madras High Court did not allow deducting the expenses.

Citation: *CIT v. Indian Express News Papers (Madurai) (P.) Ltd.* [1999] 238 ITR 70/104 Taxman 578.

### **Conclusion**

**9.** Section 36 of the Act is also one of the most debated as well as contentious one like Section 68 or 69. Deducting expenses incurred for earning business income is no doubt an essential element, however, same shall be within the premise of the Tax Laws. Since the law is well-settled, the Revenue is expected to make good assessments.