

Allowability of Interest Cost on fund acquired for Immovable Property under Various Heads & Sections of Income-tax Act, 1961



Currently, we are passing through the scenario of recession in the real estate sector. Many people have made investment in properties like house, plots, land etc. by forecasting that the return will be high as yield in past. However, the return is very less as compared to forecasted. Many of them have borrowed fund from banks, NBFC's, other sources on which interest is required to be paid. Now what shall be the treatment of interest paid?

The Objective of the analysis is the treatment of interest paid on acquisition of immovable property, as the interest is governed by various heads and sections depending upon the use and treatment of the property. How the interest cost is treated differently under different situations is discussed in this article.

Income House Property

Section 22 of Income-tax Act, 1961 (the Act) requires "The annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property as assessee may occupy for the purposes of any business or profession carried on by him the profits of which are chargeable to income-tax, shall be chargeable to income-tax under the head "Income from house property".



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Here, the words “*property consisting of building or land appurtenant thereto*” is under scope of Section 22 of the Act. All other types of property are excluded from scope of Section 22 of the Act. This means, income from letting of vacant plot not appurtenant to any building is not chargeable under Section 22 of the Act.

Even though the business of assessee is letting of house property, income earned by assessee out of business of letting of house property is taxable under the head income from house property.

Moreover, it will also not make any difference if the property is stock in trade for assessee. Meaning, if the assessee is engaged in the business of purchase and development of property, any income derived by the assessee from vacant house property which is not sold, shall be taxable under the head income from house property.

Annual Value of house property is computed with reference to provisions of Section 23 of the Act.

Section 24 of the Act provides that income under the head 'house property' shall be computed after making the following deductions, namely:

- (a) Standard deduction *i.e.* Sum equal to 30% of annual value as determined as per Section 23,
- (b) where the property has been acquired, constructed, repaired, renewed or reconstructed with borrowed capital, the amount of any interest payable on such capital.

Section 24(b) lays down the word interest payable on acquisition, construction, repair, renovation or reconstruction of property. Any property which is covered by provision of Section 22 if acquired, constructed, repaired, renovated or reconstructed with borrowed fund, then the interest shall be governed by Section 24(b). Moreover, if the fund is borrowed for acquisition of land and building is constructed with own capital, then the interest on borrowing of land is allowable as deduction subject to *proviso* to Section 24(b).

This means, under the head ‘income from house property’, interest in respect of only immovable property consisting of building or land appurtenant thereto is allowable, which is not used by assessee

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in his business or profession subject to provision Section 23(2).

Profit and Gain from Business and Professions

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

Before the insertion of the *proviso* to Section 36(1)(iii), interest paid in respect of capital borrowed for business and profession can be claimed as deduction. The same was settled by various decisions *e.g.*

- *CIT vs. Associated Fibre & Rubber Industries (P.) Ltd. [1999] 102 Taxman 700 (SC)*
- *Dy. CIT vs. Core Health Care Ltd. [2008] 167 Taxman 206 (SC)*
- *Jt. CIT vs. United Phosphorus Ltd. [2008] 167 Taxman 261 (SC)*

However, with effect from 01-04-2004 following *proviso* has been inserted to Section 36(1)(iii) which is as under:

“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 capitalised 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.”

The objective behind the insertion of the *proviso* is to make the Section more clear and clarify all the doubts behind this. However, the *proviso* has the possibility of different meanings of various words in it.

- i. “Asset” - *Proviso* says ‘interest paid in respect of capital borrowed from acquisition’ of an **asset**. Definition of asset is neither given in the Act or Section. In general terms, asset means all the assets including current asset, investment and fixed assets.
- ii. “Capitalisation” - The word 'Capitalisation' has also not been defined in the Act. In general terms, 'Capitalisation' means expense is not treated as revenue shall be shown in balance sheet.

Proviso nowhere talks of capitalisation of interest cost incurred in respect of capital borrowed for acquisition of an asset. It only says that interest

shall not be allowable in respect of capital borrowed for extension of existing business or profession 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.

Moreover, *Explanations* 8 to Section 43(1) only says that the actual cost of asset shall not include the cost of interest on acquisition of asset as so much of amount as relatable to period after such asset is first put to use. Explanations only talk of non-addition of cost of interest on acquisition after the date asset is put to use. It never talks of capitalisation cost of interest relating to the period before asset is first put to use.

In case where assessee has acquired immovable property consisting of building and land appurtenant thereto and if the same is not used by assessee during the concerned financial year then in that case property is treated as house property and same shall be governed by provision of Section 22 to Section 25 because Section 22 clearly covers the property which is consisting of land and building and other than such portion which assessee may occupy for the purpose of business and profession. Here, one has to also consider *proviso* to Section 36(1)(iii) *i.e.* whether such property is acquired for extension of existing business or not. Moreover, one has to also consider situation where assessee is engaged in business of purchase and development of property and income is earned by assessee out of vacant house property, and what shall be the treatment of interest paid for acquisition of property. The same shall be allowable under the head 'house property' or profit and gain from business and profession?

Capital Gain

Section 48 specifies the mode of computation of Capital Gain. As per Section 48,

"The income chargeable under the head "Capital gains" shall be computed, by deducting from the full value of the consideration received

or accruing as a result of the transfer of the capital asset the following amounts, namely :-

- (i) expenditure incurred wholly and exclusively in connection with such transfer,
- (ii) the cost of acquisition of the asset and the cost of any improvement thereto."

The expression 'expenditure incurred wholly and exclusively in connection with transfer' means expenditure necessary to effect the transfer.

Cost of acquisition of an asset is the value for which it was acquired by the assessee. All the expenses incurred for acquiring title to property are includible in cost of asset. The expression "cost of acquisition" has not been defined in Section 48; while Section 55(2) defines it only in particular cases.

Now the question arises 'whether Interest on amount borrowed for acquisition of capital asset is includible in cost of acquisition or not'?

As held by the various Courts that interest incurred for acquisition capital asset shall form part of cost of asset. For example:

1. *CIT vs. Sri Hariram Hotels (P) Ltd.* 188 *Taxman* 178 (Kar.)

"The Tribunal is justified in granting the relief to the assessee since the property has been purchased out of the loan borrowed from the Directors and any interest paid thereon is to be included while calculating the cost of acquisition of the asset."

2. *CIT vs. Raja Gopala Rao (2001) 252 ITR 459 (Mad)*

"4. Here, there can be no doubt that the cost of acquisition to the assessee was not merely the amount that he had paid to the vendors but also the cost of the borrowing made by him for the purpose of paying the vendor and obtaining the sale deed. Without the money borrowed, the assessee would not have been in a position to buy the property. Payment of consideration for the sale indisputably having been made with the borrowed funds, the borrowing directly related to the acquisition and, interest paid thereon would form part of the cost of acquisition."

So, in case where the assessee had acquired immovable property consisting building and land appurtenant thereto out of borrowed fund for

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Any Property which is covered by provision of Section 22 if acquired, Constructed, repaired, renovated or reconstructed with borrowed fund then interest shall be governed by section 24(b).

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business and profession and the same is not used by the assessee for his business and profession, then in that case interest in respect of such borrowing can be capitalised.

One has to consider the allowability of same interest cost under the head of income, e.g. income from house property or income from other sources. Meaning, whether interest is allowable under the head Income from house property/Income from other sources or shall be added to cost of asset of both? Whether double deduction of interest is allowable under both heads?

In a recent judgment, the Chennai Tribunal in the case of *ACIT vs. C. Ramabrahmam (2012) 27 taxmann.com 104 (Chennai – Trib.)*, interest on housing loan which was claimed as a deduction under Section 24(b) (while computing income from house property) was also deducted by the assessee under Section 48 (as cost of acquisition while computing capital gains from sale of such house property). Such treatment was upheld by the Tribunal.

Tribunal allowed the claim for deduction in respect of housing interest under both the provisions. While concluding so, it observed as under:

- Deduction under Section 24(b) and computation under Section 48 are covered by different heads of income;
- Both these provisions do not exclude the operation of other;
- Section 24(b) is claimed only when income is offered under the head 'house property', whereas the cost of the same asset is taken into consideration when the property is sold and capital gains are computed under Section 48; and
- Interest on housing loan is expenditure in acquiring the asset.

However, the Apex Court in the case of *Escorts Ltd & Another vs. Union of India (1993) 199 ITR 43 (SC)* gave its observations on possibility of claiming double deductions under the Income-tax statute:

“In our view, there was no difficulty at all in the interpretation of the provisions. The mere

fact that, a baseless claim was raised by some over-enthusiastic assessee who sought a double allowance or that such claim may perhaps have been accepted by some authorities is not sufficient to attribute any ambiguity or doubt as to the true scope of the provisions as they stood earlier....

...A double deduction cannot be a matter of inference; it must be provided for in clear and express language regard being had to its unusual nature and its serious impact on the revenues of the State.”

[Headnote in Escorts Limited case]

“There is a fundamental, though unwritten, axiom that no Legislature could have at all intended a double deduction in regard to the same business outgoing. If such double deduction is intended, it will be clearly expressed. In other words, in the absence of clear statutory indication to the contrary, the statute should not be read so as to permit assessee two deductions.”

The Karnataka High Court in the case of *CIT vs. Maithreyi Pai (1985) 152 ITR 247 (Kar)* observed as under:

“Mr. Bhat, however, submitted that section 48 should be examined independently without reference to Section 57. Section 48 provides for deducting from the full value of consideration received the cost of acquisition of the capital asset and the cost of improvements, if any. The interest paid on borrowings for the acquisition of a capital asset must fall for deduction under Section 48. But, if the same sum is already the subject-matter of deduction under other heads like those under Section 57, we cannot understand how it could find place again for the purpose of computation under Section 48. No assessee under the scheme of the I.T. Act could be allowed deduction of the same amount is already allowed under twice over. We are firmly of the opinion that if an amount is already allowed under Section 57 while computing the income of the assessee, the same cannot be allowed as deduction for the purpose of computing the “capital gains” under Section 48. “

Income from other sources

Section 57(iii) reads as ‘any other expenditure (not being in the nature of capital expenditure) laid out

or expended wholly and exclusively for the purpose of making or earning such income.' This means, any expenditure incurred wholly and exclusively for the purpose of making or earning such income, then such expenditure shall be allowable subject to condition that the expenditure is not of capital nature. For the purpose of claiming deduction under this clause, it is not necessary that expenditure should result in earning of income as held by decision of *CIT vs. Rajendra Prasad Moody 115 ITR 519 (SC)*.

Income from letting of vacant plot or income from letting of machineries, plant or furniture belonging to assessee and building, where letting of building is not separable from letting of machineries, plant or furniture, then in that case, income from renting of such property is covered under the head income from other source if the same is not a business of the assessee. In case where assessee has acquired such vacant plot of land or building which is integrated with plant and machineries out of borrowed fund, then in that case whether interest incurred on acquisition of such property shall be allowable or not? One has to see the objective of the assessee behind the acquisition and actual circumstances. Whether the same was acquired by the assessee for value increment of earning rent income? One has to also consider whether interest cost can be added to cost of asset or not (double deduction)? If the same was acquired for earning income then interest shall be allowable otherwise shall be added to cost of asset. One has to also consider the *Explanation 8* to Section 43(1).

Case Study

Assessee presently in the business of trading has purchased property consisting of factory building and land appurtenant for the expansion of existing business. The same is purchased by assessee out of borrowed capital from various parties. However, the assessee is not able to use the same due to reason of receipt of higher business contract in trading business. As the assessee is not able to utilise the purchased factory building, assessee had let out the building and land appurtenant there to other party. Assessee is paying interest regularly to the parties from whom fund has been borrowed.

Questions:

1) Source under which such income is taxable?

As per Section 22, annual value of property

consisting of building or land appurtenant thereto of which assessee is owner other than such portion of property as assessee may occupy for purpose of any business and profession as carried on by assessee the profit of which are chargeable to income tax, shall be taxable under head income from house property. Hence, shall be taxable under the head Income from house property which shall be computed as per the provisions of Section 23 and Section 24.

2) Whether interest paid for acquisition of property is allowable u/s 36(1)(iii) or not ?

As per Section 36(1)(iii), deduction shall be allowed in respect of interest paid on capital borrowed for the purpose of business and profession. Before 01-04-2004 interest paid for business purpose shall be allowed as deduction. However, with effect from 01-04-2004 due to insertion of *proviso* to section 36(1)(iii), Deduction shall not be allowed in respect of interest paid on capital borrowed for extension of existing business for any period beginning from the date of acquisition till date when such asset is put to use, shall not be allowable as deduction. The same is supported by decision of *Nahar Poly Films Ltd vs. CIT (2011) 41 (1) (P&H)*. Hence, Interest paid shall not be allowed as deduction under Section 36(1)(iii).

3) Whether interest cost can be capitalised to the cost of building and land?

As per Section 48(ii), cost of acquisition of an asset is the value for which it was acquired by assessee. All the expenses incurred for acquiring title to property are includible in cost of asset. As held by the various Supreme Court decisions, interest incurred for acquisition of capital asset shall form part of cost of asset. However, one has also to consider the double deduction i.e. allowability under the head income from house property as well as addition to cost of asset. One has also to consider *Explanation 8* to Section 43(1) i.e. non

Under the head 'income from house property', interest in respect of only immovable property consisting of building or land appurtenant thereto is allowable, which is not used by assessee in his business or profession subject to provision Section 23(2).

addition of interest cost to capital asset after the date when asset is first put to use.

4) What shall be the treatment of interest in Property that is fully vacant?

Tax under the head income from house property is not a tax upon rent of Property. It is tax on inherent capacity of building to yield the income. Annual Value shall be computed as per the provisions of Section 23. As the property is vacant during the whole year, and same is covered by Section 23(1) Gross Annual value shall be arrived at Nil. Even though the Gross annual value is Nil, Interest paid on acquisition shall not be denied. It shall be allowable under Section 24(b). Hence, even though property remain vacant during the entire year, interest paid shall be allowable under head income from house property.

5) What shall be the answer to the above question if the property was only land?

Section 22 covers only building or land appurtenant thereto of which assessee is owner. Here, the property is only land. Property only consisting of only land is not covered under house property. Hence, income shall be chargeable under the head income from other source or Profit and gain from business profession.

Section 57(iii) allows that any expenditure incurred (Other than capital expenditure) wholly and exclusively expended for the purpose of making or earning income. Here, one has to consider the objective and circumstances of acquisition of land and circumstances whether the same was acquired for the purpose of renting or investment or for business purpose. If the land was acquired only with the objective of renting purpose, then interest shall be allowable as deduction against rent income from land. If the same was acquired as investment then interest cost should be capitalised to cost of land. However, if acquired for business purpose i.e. for using in business or as stock-in-trade for land and property developers/Purchasers, then same shall be allowable as deduction. However, if the same is acquired for using in business, but not used due to some circumstances, then interest shall be added to cost of land. One has to also consider explanation to Section 43(1).

6) In the original case, if assessee has borrowed amount not specifically for the acquisition of

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property and at that time capital balance of capital account of the assessee was less than that of cost of property. After two years, assessee's capital balance and interest free fund is in excess of that cost of property by bringing more interest free amount and profit from business. Moreover on application side assessee has not advance any interest free loan for other purpose. Is it necessary for assessee to claim the same under house property?

Here, at a time of acquisition of property, assessee capital balance is less than that of cost of property. But after two years assessee's capital balance is in excess to that of cost of asset. At a time of acquisition of property generally it can be said that assessee has borrowed amount for acquisition of property. Hence, interest paid can be allowed under Section 24b. In case where assessee by bringing amount through interest free loan profit from business, after two years, the assessee may claim the interest paid under Section 36(1)(iii) because assessee may opt that the capital balance is utilised for acquisition of property which is not used by assessee. If amount is borrowed for other purpose and utilised for business purpose, then in that case, interest so paid shall be allowed as deduction under Section 36(1)(iii). It is not necessary to establish a nexus between fund borrowed and utilised.

7) What shall be the treatment of interest paid if assessee is using such property for the purpose of storage goods?

Here, the objective of the assessee for acquisition of property is for extension of existing business. To claim expenditure under Section 36(1)(iii) it is the only condition that asset should be used for business purpose. Hence, interest paid shall be allowable under Section 36(1)(iii).

Reference:-

Professional Edition book of Taxmann (Author V. K. Singhania, Kapil Singhania), Various online sites e.g. CA Club India, ITAT Online, BCAS, Income Tax Act, 1961, Income tax Rules. ■