LEGAL Q&A

The Supreme Court has held that interest payout should be treated as part of the overheads in accordance with normal rules of accountancy

Interest impact

Now that availing finance for the purchase of properties has become easier and more prevalent than ever before, an important question that arises is as to how the interest for the purpose of income tax be treated.

Going by examples

Let us take an example. Mr. X takes a loan of Rs.1 crore at an interest rate of 8% p.a. If he buys commercial premises for his own use, he would get a deduction of Rs. 8 lakhs against his normal income from business.

If he buys commercial or residential premises and lets out the same, then the entire interest paid, of Rs. 8 lakhs, would be allowable as a deduction against the rental income.

If, however, he buys residential premises that are used for self-occupation, then under Section 24(b) of the Income-tax Act, 1961, he will get a deduction only to the extent of Rs. 1,50,000. This may be set off against his other income of the year.

In this last situation, what happens to the amount of Rs. 6,50,000 that he has paid by way of interest and not been able to claim as a deduction each year?

Step by step

To determine the quantum of Capital Gain, the steps, as laid down under Section 48, are as follows:

* From the gross sale proceeds, deduct the expenses for sale. This results in the figure of Net Sale Proceeds.
* The cost of acquisition or the indexed cost of acquisition has to be deducted from the net sale proceeds.
* The balance is the Capital Gain.

Cost of acquisition

Sec.55 (2) defines "cost of acquisition". This does not specifically refer to interest. However, there are several Court decisions on this issue.

The Delhi High Court, in the case of CIT vs. Mithlesh Kumari, 92 ITR 9 (Del.), was concerned with the situation where an assessee bought a plot of land in 1957 with the aid of a loan and paid interest over the next three years and sold the property and claimed the interest as a part of her cost of acquisition. The High Court noted that she had not claimed the interest under the head "Income from house property" in these three years, and therefore the amount could not be excluded from the computation of actual cost. The Department's Counsel contended that the actual cost of the capital asset to the assessee was the actual cost on the date of acquisition and does not include an expenditure which the assessee may have incurred subsequently, except that the cost of improvement incurred subsequently would be allowed.

Including factors

The High Court held that no justification was needed for limiting deduction like that. By putting such a construction, the Court would be qualifying the words used by the Legislature. The High Court, therefore, held that it would be reasonable to include the interest and other actual costs incurred by the assessee for acquiring the capital asset as distinct from the items of expenditure, which were incurred for retaining or maintaining the capital asset.

This decision was followed by the Andhra Pradesh High Court in the case of Additional CIT vs. K.S. Gupta, 119 ITR 373 (A.P.), and a similar decision was taken by the Madras High Court in the case of CIT vs. K. Rajagopalarao, 252 ITR 459 (Madras).

Supreme decision

Another relevant decision is that of the Supreme Court of India in the case of Challapalli Sugars Ltd. vs. CIT, 98 ITR 167 (S.C.). In this case, the assessee had purchased plant and machinery and borrowed funds and claimed that the interest paid for the period before the commencement of production was to be capitalized and depreciation and development rebate granted. Here also the interest paid related to the period after the date of acquisition, but that upto the date of commencement of production. The assessee itself did not claim that the interest be capitalized for the period after the date of commencement of production, as this would be claimed as revenue expenditure. The Supreme Court therefore was concerned with post acquisition interest cost and held that it was in accordance with normal rules of accountancy and that the interest be treated as part of the cost. The SC noted that the expression "actual cost" had not been defined in the Act but held that it should be construed in the sense that no commercial man would misunderstand.

Following footsteps

Following the SC decision, the Kerala High Court in the case of CIT vs. Travancore-Cochin Chemicals Ltd., the Madras High Court in the case of CIT vs. South India Steels & Sugars Ltd. 109 ITR 348 (Mad.), and CIT vs. Simco Meters Ltd. 111 ITR 113 (Mad.), and Punjab & Haryana High Court in the case of CIT vs. Oswal Spinning & Weaving Ltd., 160 ITR 426 (P&H), also held on the same lines.

On this basis, it is clear that the interest paid could be treated as part of the cost of acquisition. However, in the example given above, if any amount has been allowed as a deduction under "Income from House Property" that ought not to be capitalized as that would amount to a double deduction as decided by the Karnatake High Court in the case of CIT v/s. Maithreyi Pai 152 ITR 247 (Kar).

The last question

The next question that arises is whether the cost so incurred yearly by way of interest can itself be indexed for inflation in accordance with sec.48. Although there do not appear to be any reported case on this point, once an amount incurred is treated as part of a cost of acquisition, then that amount should also be indexed for the purpose of arriving at the Indexed cost of acquisition.

So, if an assessee has purchased a residential house for Rs. 1 crore and has been paying at the rate of 8 per cent per annum, and if he has claimed Rs. 1,50,000 per annum as a deduction, then he could claim that the remaining Rs. 6,50,000 per annum would get added to his cost of acquisition and he may claim also to index it from the year of incurring the same upto the year of sale. ■

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