

# Tax deduction of interest expense not allowed on its conversion into a fresh loan: SC

Issued on: 17 April 2019

## Summary

Under the provisions<sup>1</sup> of the Income-tax Act, 1961 (the Act), certain expenses (including interest) are allowed as a deduction in the year in which they are actually paid. The provisions were amended<sup>2</sup> to provide that 'interest' shall not be construed as actually paid if it is converted into a fresh loan. Relying on the amended provisions, the Hon'ble Supreme Court (SC) in a recent decision<sup>3</sup> has held that where outstanding interest is adjusted from a fresh funded interest loan, the said interest shall not be treated to have been actually paid and hence not allowable as a deduction for tax purposes.

## Facts of the case

- The taxpayer was engaged in the manufacture of non-ferrous metal pipes and tubes. It had outstanding interest liability payable to a bank.
- During tax year 2000-01, the taxpayer obtained a fresh loan and instructed the bank to adjust its outstanding interest liability against the fresh loan. The taxpayer claimed a deduction of the said interest in its tax return for the year.
- The tax officer disallowed the claim by holding that conversion of interest into loan is not regarded as actual payment of interest.
- The taxpayer challenged the order before the first appellate authority<sup>4</sup>. The authority allowed the claim of the taxpayer by holding that upon receipt of the fresh loan, the balance of outstanding interest was reduced to nil and hence it could be treated that the interest has actually been paid.

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<sup>1</sup> Section 43B of the Act

<sup>2</sup> Vide Finance Act 2006 with retrospective effect from 1 April 1989

<sup>3</sup> CIT v Gujarat Cypromet Ltd. [2019] 103 taxmann.com 346 (SC)

<sup>4</sup> Commissioner of Income-tax (Appeals)

- The order of the first appellate authority was later also upheld by the Income Tax Appellate Tribunal and the Gujarat High Court (HC). Thus, the Tax Department took the matter before the Supreme Court (SC).

## **Tax Department's arguments**

- Before the SC, the Tax Department argued that the amendment in the provisions is specifically targeted to cover cases where interest is converted into loan.
- Reliance was also placed on the plethora of HC decisions<sup>5</sup> wherein it has been held that conversion of interest amount into loan shall not be deemed to be regarded as 'actually paid' for claiming deduction.

## **Held by the SC**

- The SC noted the amended provisions and various High Court judgements. The SC further noted that the statutory "Explanation 3C" inserted by the Finance Act, 2006 is squarely applicable in the facts of the present case and it appears that the attention of the High Court was not invited to this Explanation.

## **Our comments**

It is important to note that in this case, the question of law before the Apex Court was treatment of 'conversion' of interest in loan. While interest payable was being adjusted with the additional loan raised by the taxpayer, no arguments have been advanced before the court to draw a distinction between conversion of interest and payment of interest through additional debt funding. Hence, this issue has not been specifically addressed by the court.

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<sup>5</sup> Eicher Motors v CIT [2009] 315 ITR 312 (MP), CIT v MM Aqua Technologies Ltd. [2015] 376 ITR 498 (Delhi) and CIT v Pennar Profiles Ltd. [2015] 376 ITR 355 (AP)

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