# Controversies

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## Interest on loan taken for acquiring fixed assets

**Issue:**

The Assessee is an existing manufacturing company. It obtains term loan from bank for acquiring plant and machinery. Important dates are as under:

1. Date of invoice – 01/01/2011
2. Disbursement of loan – 15/01/2011
3. Installation of plant and machinery – 25/01/2011
4. Date of put to use – 01/03/2011

The A.O. is of the view that interest pertaining to period between disbursement of loan i.e., 15/01/2011 and the date of actual put to use of plant and machinery i.e., 01/03/2011 is required to be disallowed as per the provisions of proviso to section 36(1)(iii) of the I.T. Act, 1961.

**Proposition**:

It is submitted that interest paid on loan taken for acquiring fixed asset cannot be disallowed. The proviso to section 36(1)(iii) will be applied only when there is substantial period of time between the loan obtained and the asset being put to use. Even otherwise, it is submitted that if the situation is not covered by section 36(1)(iii) such deduction is permissible u/s 37(1) as the interest expenditure is wholly and exclusively incurred for the purpose of business.

**View against the proposition:**

When the asset is acquired out of borrowed funds, interest on the term loan is required to be capitalized from the date of disbursement of loan till such date on which the plant and machinery is put to use in the business of the assessee company.

Section 36(1)(iii) of the I.T.Act provides for the allowability of expenditure incurred on account of interest on borrowed capital for the purpose of business. As such, if any interest expenditure is incurred for the purpose of the profits and gains of the business, then the same is an allowable expenditure out of profits and gains of business. However, proviso to section 36(1)(iii) states as under:

"*Provided that any amount of 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 such asset was first put to use, shall not be allowed as deduction.*"

It is submitted that when assessee acquired plant and machinery during the year by obtaining term loan, the interest expenditure on such term loan is required to be capitalized till the date on which such asset is actually put to use. Such interest cannot be treated as revenue expenditure even if the interest for such period is written off to profit and loss account.

**View in favor of the assessee:**

The expression "purpose of business" is comprehensive enough to cover expenditure of revenue nature as well as of capital nature because both the types of expenditure can be incurred for the business purposes. Therefore, even if a borrowing is made for incurring an expenditure of capital nature, it remains borrowing for the purpose of business.

Calico Dyeing & Printing Works vs. CIT (1958) 34 ITR 265 (Bom).

Addl. CIT vs Laxmi Agents Pvt. Ltd. (1980) 125 ITR 227 (Guj.)

CIT vs. Granulated Fertilizers & Feeds Pvt. Ltd. (1982) 137 ITR 715 (Guj)

CIT vs. Alembic Glass Industries Ltd. (1976) 103 ITR 715 (Guj)

CIT vs. Shah Theatres Pvt. Ltd. (1987) 169 ITR 499 (Raj).

CIT vs. TaralDevelpoment Corp. (1994) 205 ITR 421 (All)

ITO vs. Reliable Chemicals (1982) 4 TTJ (Bom) 497

What sub-clause (iii) emphasizes is the user of the capital and not the user of the asset which comes into existence as a result of the utilization of the borrowed capital.

Calico Dyeing & Printing Works Ltd. Vs. CIT (1958) 34 ITR 265 (Bom)

CIT vs. Insotex Pvt Ltd. (1984) 150 ITR 195

Let me now refer to the effect of amendment by which proviso is added to section 36(1)(iii).

This section has been amended w.e.f 1st April, 2004 by insertion of a proviso to it. According to the said proviso, no deduction will be allowed in respect of any amount of interest paid in respect of capital borrowed for acquisition of an asset for the period beginning from the date on which capital is borrowed for the acquisition of asset till the date on which the asset acquired by using such borrowed capital is first put to use. However, let me now refer to Accounting Standard 16 (AS 16) on Accounting for Borrowing Cost.

- AS-16 deals with the accounting treatment of borrowing cost in relation to the <u>Qualifying Assets</u>
- A <u>Qualifying Asset</u> (QA) is an asset that necessarily takes a substantial period of time to get ready for its intended use.
- In Para 3 of AS-16, Borrowing Costs are described to include interest and other costs incurred by an enterprise in connection with the borrowing of funds
- Para 6 of AS-16 provides for recognition of Borrowing Costs as: "Borrowing costs that are directly attributable to the acquisition, construction or production of a <u>qualifying asset</u> should be capitalized as part of the cost of that asset. The amount of borrowing cost eligible for capitalization should be determined in accordance with this statement. Other borrowing costs should be recognized as an expense in the period in which they are incurred."

Following are the three important issues relevant in the context of a QA

a) Commencement of capitalization

b) Suspension of capitalization and

c) Cessation of capitalization

According to Para 14 of AS-16, the capitalization of borrowing costs, as part of the cost of a <u>qualifying asset</u>, should commence when all the following conditions are satisfied

a) Expenditure for the acquisition, construction or production of a <u>qualifying asset</u> is being incurred

b) Borrowing costs are being incurred and

c) Activities that are necessary to prepare the asset for its intended use or sale are in progress.

From the above mandate of Accounting Standard, it is very clear that the borrowing cost has to be treated as revenue expenditure in the year in which same are incurred except where the borrowing is directly connected with acquisition, construction or production of a <u>qualifying asset.</u> As per the Accounting Standard, the <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use. When the asset is ready for use, it is no more a <u>qualifying asset</u> and hence the interest cost cannot be capitalized to the cost of fixed asset.

**<u>Summation:</u>**

It is submitted that there is always a short time lag between the disbursement of loan and asset being put to use in a manufacturing concern. If the time lag is substantially long, then only the question of disallowance of interest arises. When the asset is acquired, it is also necessary that the view can be taken that the asset is ready for use. Actual user will take place after the trials have been taken and looking to the facts of the case it can be observed that the time period for disbursement of loan and actual user is very short which is practical and imperative in respect of every asset in a manufacturing organization.

As per the mandate of Accounting Standard 16 (AS-16) on Accounting for Borrowing Cost, it is specifically provided that interest can be capitalized only in respect of "qualifying asset". And it states that a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. Assets which are ready for the intended use when acquired are not qualifying assetand hence the assessee cannot capitalize interest to the cost of qualifying asset and the same has to be written off to the profit and loss account and the deduction u/s 36(1)(iii) cannot be denied. If it is not done, there would be breach of As-16 which will make the financial statement untrue and unfair. The time lag in our case between the loan disbursed and the asset used is very short and hence it is not possible to capitalize the cost of interest.

It is further submitted that in my opinion assessee is otherwise entitled to deduction of such interest u/s 37(1) as such situation is not covered by section 36(1)(iii). As per section 37(1), any expenditure incurred wholly and exclusively for the purpose of business is required to be allowed as deduction u/s 37(1).

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