

IN THE HIGH COURT OF JUDICATURE FOR RAJASTHAN
AT JODHPUR.

D.B.Income Tax Appeal No.133/2006

Commissioner of Income Tax-II V/s Shri Ramesh Chandra Bhati

Date of Judgment::-

14.7.2015

PRESENT

HON'BLE CHIEF JUSTICE MR.SUNIL AMBWANI
HON'BLE MR.JUSTICE VIJAY BISHNOI

Mr.Sunil Bhandari for the appellant-Department.

JUDGMENT

(Reportable) **BY THE COURT (Per Hon'ble Sunil Ambwani, CJ)**

1. We have heard learned counsel appearing for the Department.
2. The appeal was admitted on 12.12.2006, after which, it could not be listed as the service on respondent was not found to be sufficient. The Department has applied and carried out publication of notice in the newspaper for service on respondent. The office reported that the notice has been published in the Rajasthan Patrika, which has a wide circulation in the State of Rajasthan and thus, service is complete.
3. We are satisfied with the service of summons on the private respondent and thus, we proceed to hear and decide the matter.
4. The appeal was admitted on the following substantial question of law:-

"Whether, on the facts and in the circumstances of the

case, the learned ITAT was legally justified in holding that the deduction on account of payment of interest on interest was allowable under section 36(i)(iii) and Section 37(1) of the Act of 1961?"

5. The facts of the case are that a return declaring income of Rs.38,590/- was filed on 2.12.1996 alongwith the statement of total income, copies of trading and P/L account, balance-sheet and its annexures. The audit report was also filed under section 44AB of the Income Tax Act, 1961 (for short, "the Act"). The assessee did not submit satisfactory explanation on the claim for deduction of interest of Rs.3,82,187/-. The Assessing Officer (Assistant Commissioner of Income Tax) observed as follows:-

"The assessee has claimed total interest of Rs.382187, however, he failed to give break up of interest attributable to interest on interest and the interest attributable to original Principal. From the accounts it is seen that the amounts more than the principal loan stand repaid, therefore, the credit balance represents only cumulative interest on interest for the past so many years, therefore, the interest liability claimed is wholly referable to interest on interest. Since interest amounting to Rs.14985/- had already been disallowed on ingenuine credits, the balance amount of Rs.3,67,202/- is disallowed in view of the judgments cited supra."

6. The Appellate Authority (Commissioner of Income Tax (Appeals)), partly allowed the appeal of the assessee on the claim of interest on the ground that the provisions of Section 36(1)(iii) and Section 37(1) entitle such deduction; the AO was not justified in disallowing the claim and in

adding the interest on interest.

7. The Income Tax Appellate Tribunal (ITAT) has dismissed the appeal with the findings:-

“The right to interest on interest was recognized in CIT Vs. Narendra Doshi (2002) reported in 254 ITR 606 in the case of Hon'ble Supreme Court. Although this interest was to be charged on the refund amount in relation to Sec.214 of the Act, in our opinion the Assessing Officer disallowed this claim of the assessee as according to him the assess was not entitled to deduction in respect of interest on interest, and that the assessee was not able to compute the element of interest on interest included in the total claim of Rs.3,82,187. But the Assessing Officer has no where refuted the claim of the assessee that the assessee had utilized the borrowed fund only for the purpose of business. That being the case, when the interest was paid on the interest, the same becomes allowable u/s 36(1)(iii) and Sec.37(1) of the Act. The facts of the Hon'ble Supreme Court's decision and the Hon'ble Gujarat High Court decision relied by the Assessing Officer are not relevant because in whose cases only computation of income from house property and income from other sources were in question. Therefore, the last ground of appeal also fails.”

8. Learned counsel appearing for the Department has relied on the judgment of the Supreme Court in **Shew Kissen Bhattar V/s Commissioner of Income Tax, West Bengal** (1973 ITR (Vol.89) 61), in which the Supreme Court considering the question of payment of interest on interest for which the claim was made under section 9(1)(iv) of the Act held as follows:-

“The question is whether the assessee is entitled to deduct the compound interest payable by him in accordance with

the terms of the contract referred to earlier or whether he is only entitled to deduct simple interest at the rate of 6-3/4% per annum. It must be borne in mind that what the law permits is the deduction of the 'amount of any interest. on such mortgage or charge'. The interest payable by the assessee on the capital charge was at the rate of 6 3/4% per annum. But if he fails to pay that in accordance with the terms of the contract, he was liable to pay compound interest. In other words, if he fails to pay interest in accordance with the contract, he was liable to pay interest on interest. Or to put it differently, when the interest payable is not paid, the same became a part of the principal and thereafter, interest has to be paid not only on the original principal but also on that part of the interest which had become a part of the principal. It cannot be said that the interest which became a part of the principal can be considered as the capital charge. What the assessee is entitled to deduct is the interest payable by him on the capital charge and not the additional interest which because of his failure to pay the interest on the due date had been considered as a part of the loan. In fact, the real capital charge is that which was originally due. The other portion is merely an interest on which the assessee has agreed to pay interest. Hence we are unable to accept the contention of the assessee that the interest paid on interest is an interest paid on the capital charge. Mr. Chagla, the learned counsel for the assessee, contended that the law permits his client to deduct any interest paid by him on the capital borrowed or charged and 'any interest' included compound interest also. This, to our minds, appears to be a fallacious argument. The compound interest is payable not on the capital charge but on that part of the interest on which he has agreed to pay interest. That is not the capital taken note of by [section 9](#) (1) (v). If we accept Mr. Chagla's contention as correct, then the door will be open for evasion of tax. All that the debtor need do is not to pay interest regularly but utilise that amount for other purpose and make the Revenue pay compound interest payable by him and thus derive advantage out of his own omission. Such an interpretation is impermissible."

9. The Gujarat High Court in **Jaswantraji P.Mehta V/s Commissioner of Income-tax** ((1992) 61 Taxman 71 (Guj.)) with reference to Section 57(iii) of the Act held that the interest paid on account of failure to pay interest for preceding year cannot be considered as expenditure laid out or expended wholly

or exclusively for purpose of making or earning income.

10. The Bombay High Court in **Commissioner of Income Tax V/s Hindustan Conductors (P) Ltd.** ((2000) 108 Taxman 258 (Bom.)) considered the same question with respect of allowability of the interest on interest under section 36(1)(iii) of the Act and held in paragraphs 8 and 9 as follows:-

“8. We have also given our careful consideration to the submission of Mr. Mehta that the ITO has no power under [Section 36\(1\)\(iii\)](#) to examine the reasonableness of the rate of interest paid by the assessee on borrowings and to disallow any part of the amount which is paid by the assessee as interest on borrowings. We find it difficult to accept the above contention because, in our opinion, the ITO is undoubtedly entitled, while considering the claim for deduction under [Section 36\(1\)\(iii\)](#), to examine whether the amount paid as interest is really ‘interest’ and if he finds that it is not wholly interest but partly interest and partly payment for extra commercial consideration to allow only that part of the so-called interest which in his opinion is ‘interest’ and disallow the balance which is for extra commercial considerations. It is true that in the normal course the ITO cannot disallow any part of the interest on the ground that the rate of interest is high but that does not mean that he has to allow anything and everything claimed by the assessee as interest on amounts borrowed, even if he finds that in fact all that has been paid is not ‘interest’.

9. ‘Interest’ is the return or compensation for the retention by one person of a sum of money belonging to or owed to another. As the essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had use of the money, or conversely, the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for the deprivation. (per Lord Wright in *Riches v. Westminster Bank Ltd.* [1947] AC 390 at 396, 398 HL). It is only interest in the above sense which is

deductible under Section 36(1) (iii). If in the garb of interest something more is paid over and above 'interest', that something cannot be allowed as deduction under this section. It will not be correct to say that once a claim is made for deduction of any amount by way of interest on the amount borrowed for the purpose of business, the ITO has no power even to examine whether the amount claimed as 'interest' is really an interest, wholly or in part, and if he finds that it is not wholly interest to ascertain that part of it which is interest and restrict the allowance of deduction under Section 36(1)(iii) only to that part which represents interest and to disallow the balance. In our opinion, under Section 36(1)(iii), the assessee is entitled to deduction only of that part of the amount paid by him for money borrowed which can genuinely be regarded as interest. Any and every payment in the garb of interest in excess of what can really be termed as 'interest' cannot be allowed as a deduction under that section."

11. In the present case, the assessee had failed to give break up of the interest attributable to interest on interest and the interest attributable to original principal. It was seen from the accounts that the amounts more than the principal loan stood repaid. The credit balance represented only cumulative interest on interest for the past so many years and therefore, the AO held that the interest liability claimed is wholly referable to interest, which is not permissible under section 36(1)(iii) of the Act. The deduction of interest claimed was thus not attributable directly to business. Section 36(1)(iii) allows deduction of only that part of the amount paid as interest, which is the interest on money borrowed, which can be genuinely regarded as interest. When the principal amount borrowed stood repaid, the interest on interest was not a genuine amount, even if it was payable to the creditor which will qualify for deduction.

12. We do not find that the Appellate Authority and the ITAT have given sufficient and cogent reasons in holding that the assessee is entitled to deduction under section 36(1)(iii) of the Act and Section 37(1) of the Act. The ITAT has relied on the judgment of the Supreme Court in CIT V/s Narendra Doshi (2002) reported in 254 ITR 606, which was related to the issue of interest to be charged on the refund amount and not interest on interest. Section 37(1) is not applicable in view of specific Section 36(1)(iii) under which the assessee could have claimed the amount of interest and which provides that the amount of interest paid in respect of capital borrowed for the purposes of the business or profession, can be claimed as permissible deduction. Interest on interest is payable either on default contemplated under the agreement or by way of penalty or the amount shown in the account books to be paid for the settlement of the account. In either of the case, it is not deductible as the assessee is in default.

13. Further, we are of the view that interest on interest cannot be said to be a benefit extended in carrying on the business. It is an element of default, which attracts the interest by way of penalty and which is not permissible deduction.

14. In the present case, there is an additional feature that assessee failed to explain the amount which was claimed to be deducted under section 36(1)(iii) of the Act. It was found that the entire capital was paid and what was remaining in the account was interest on which the interest was shown and which was sought to be deducted. The AO was not satisfied with the

genuineness of the entry. He observed that since the interest amounting to Rs.1,49,85/- has already been disallowed on ingenuine credits, the balance amount was also disallowed. He had rightly relied on the judgment of Supreme Court in Shew Kissen Bhattar V/s Commissioner of Income Tax, West Bengal (supra) and judgment of Gujarat High Court in Jaswantraai P.Mehta V/s Commissioner of Income-tax (supra).

15. In view of the aforesaid discussion, the question is returned in favour of the Department and against the assessee. The Department will proceed accordingly.

(VIJAY BISHNOI),J.

(SUNIL AMBWANI),CJ.

Parmar