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F. No.153/86/2006-TPL  
Government of India  
Ministry of Finance  
Department of Revenue  
Central Board of Direct Taxes  
(TPL Division)

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New Delhi, the 17<sup>th</sup> July, 2006

To

All Chief Commissioners of Income-tax  
All Director Generals of Income-tax

**Subject: Clarification regarding deduction of interest under section 43B in view of clarificatory amendments to section 43B through the Finance Act, 2006.**

Section 43B of the Income-tax Act, 1961 was amended by the Finance Act, 2006 inserting therein two clarificatory Explanations, namely; Explanation 3C and Explanation 3D. Both the Explanations clarify that any sum payable by the assessee as interest on any loan or borrowing or advance shall be allowed as deduction if such interest has been actually paid and any interest which has been converted into a loan or borrowing or advance but has not been actually paid shall not be allowed as deduction in the computation of income. The clarificatory explanations only reiterate the rationale that conversion of interest into a loan or borrowing or advance does not amount to actual payment.

2. Clarifications have been sought from certain quarters regarding the manner in which the converted interest will be allowed as deduction.

3. As clarified in the Memorandum Explaining the provisions in the Finance Bill, 2006 (Page 3 thereof), the interest converted into loan or borrowing or advance shall be allowed if such interest has been actually paid and any interest which has been converted into a loan or borrowing or advance, shall not be deemed to have been actually paid on account of its conversion into loan, etc. The unpaid interest whenever actually paid to the

bank or financial institution will be in the nature of revenue expenditure deserving deduction in the computation of income. Therefore, the converted interest, by whatever name called, in the wake of its conversion into a loan or borrowing or advance, will be eligible for deduction in the computation of income of the previous year in which the converted interest is actually paid. In other words, nomenclature of the sum of converted interest will make no difference as the sum of converted interest whenever is actually paid will not represent repayment of the principal. The following Illustrations will enable the Assessing Officers and assesseees to allow or to claim correct amount of deduction, in terms of section 43B, on account of actual payment of interest:

<b>I.</b>	Name of the assessee	:	M/s. ABC
	Loan taken from Bank on 31-03-2003	:	Rs.2,37,81,000/-
	Interest unpaid upto 31-03-2005	:	Rs.35,90,000/-

In the restructuring arrangement entered into in this case, the unpaid interest of the above amount of Rs.35,90,000 has been converted into a Funded Interest Term Loan (FITL) which has been shown separately from the original loan and no interest is chargeable on FITL. This converted interest (i.e. FITL) is to be paid in eleven instalments from 01-04-2010. Each instalment worked out to an amount of Rs.3,26,364/-. In this case, deduction to the extent of the amount actually paid against the payment of instalment of FITL of Rs.3,26,364/- under section 43B shall be allowed in the relevant assessment year when it is actually paid. Needless to add that the interest on the original principal of Rs.2,37,81,000/-, if any, actually paid will be independently allowable under section 43B.

<b>II.</b>	Name of the assessee	:	M/s. XYZ
	Loan taken from Bank in February, 2003	:	Rs. 34.21 lakhs
	Interest unpaid upto 31-03-2005	:	Rs. 10.93 lakhs

In this case, out of the sum of unpaid interest of Rs. 10.93 lakhs, Rs. 2.93 lakhs is waived by the Bank against which no deduction is to be allowed under section 43B. The original principal of Rs. 34.21 lakhs is converted

into a Running Cash Credit Account with a limit of Rs. 21.21 lakhs and a Working Capital Term Loan of Rs. 13 lakhs, each carrying interest at the rate of 10.25%. The balance of unpaid interest (Rs.8 lakhs remaining after waiver of Rs.2.93 lakhs) is converted into a Funded Interest Term Loan (FITL) (which is separate from the original loan of Rs.34.21 lakhs). The FITL of Rs. 8 lakhs does not carry any interest and is payable in four instalments from 01-04-2005. The amount to the extent actually paid towards the instalment of FITL of Rs.2 lakhs will be eligible for deduction under section 43B in the relevant Assessment Year. The interest paid on Running Cash Credit Account and Working Capital Term Loan will also be allowable only on actual payment in the relevant Assessment Year.

**III.** Name of the assessee : M/s. PQR  
Loan taken by the assessee from a Term Lending Institution in May, 2002 : Rs. 14.95 crores  
*Interest paid up to April, 2004 but default in payment of interest started in the quarter April June, 2004.*

In this case, the original principal of Rs.14.95 crores was given under a deferred plan, repayment of which was to begin from 01-04-2008. The interest for the quarter April June, 2004 when not paid was converted into an FITL. Interest on FITL is charged at the rate of 10.25%. The accounting practice followed by the Term Lending Institution is that, for every quarter, interest receivable is converted into a principal loan outstanding and the interest receivable amount is booked as income. Such interest receivable by the Term Lending Institution

in every quarter is required to be paid by the assessee and has two components (i) payment of Funded Interest Term Loan (FITL) and (ii) interest on FITL. Both the components i.e. FITL for the quarter and interest on FITL in every quarter will be allowed as deduction on actual payment under section 43B in the relevant Assessment Year. Needless to add that interest to be paid on original principal which is under a deferred plan is allowable on actual payment in the respective Assessment Years.

**IV. Name of the assessee** : M/s. XYZ  
Loan taken by the assessee from a Term Lending Institution : Rs.100 crores  
Rate of interest : 11%  
Interest unpaid for three years, i.e., upto 31-03-2006 : Rs.33 crores

Certain banks and financial institutions during interaction with them clarified that restructuring arrangements do not generally provide for merger of interest with the original principal and both continue to retain their separate identities. However, they did not rule out a restructuring arrangement providing for merger of interest with the principal. In the light of the possibility of merger of interest with the principal, the repayment instalment will comprise of payment of interest as well as repayment of part of the principal. In such situations, the amount of deduction on account of actual payment of interest will have to be calculated on a proportionate basis. For example, out of the aforesaid amount of merged interest and the principal of Rs.133crores, Rs.20 crores is repaid in the first year and the amount of interest comprised therein is not distinguishable. The amount of deduction in the computation of income on account of actual payment of interest will be worked out in the following manner:

$$\frac{20 \times 33}{133} = 4.962 \text{ Cr.}$$

Out of the repayment of Rs.20 crores in the first year, deduction of Rs.4.962 crores will be admissible in terms of the provisions of section

43B as deduction, as Rs.4.962 crores out of Rs.20 crores actually paid represents interest component. Balance Rs.15.039 crores representing repayment of the principal shall not be admissible as deduction in the computation of income.

In a restructuring arrangement in which the amount of interest of Rs.33 crores is not merged with the original principal of Rs.100 crores and is separately payable from the repayment instalments out of the principal of Rs.100 crores, deduction on account of actual payment of interest shall be allowed as under:

Repayment out of the loan amount of Rs.133 Cr. will have the following three components

- (a) Repayment of the principal of Rs.100 Cr. X
- (b) Interest on the principal of Rs.100 Cr. . Y
- (c) Repayment of interest of Rs. 33 Cr. Z  
(converted into Funded Interest Term Loan)

In the above arrangement, the amount of Y & Z will be admissible as deduction under section 43B if these amounts of interest are actually paid. The amount of X, representing repayment of the principal, will not qualify for deduction in the computation of income.

A restructuring arrangement may even provide for payment of interest first, until it is fully paid. In such cases, the whole amount of interest, actually paid, will be allowed as deduction in terms of section 43B.

4. The above illustrations would show that the converted interest, by whatever name called, in the wake of its conversion into a loan or borrowing or advance, will be eligible for deduction in the computation of income in respect of the previous year in which the converted interest is actually paid. In other words, the change of name of the sum of converted interest to FITL, etc. should not make any difference because actual payment of interest by the borrower to the lender represents revenue expenditure in terms of the

provisions of section 36(1)(iii) and in no way does it represent repayment of the principal.

5. In cases of waiver of interest as seen at II above, no deduction is admissible under the Income-tax Act, 1961 as waiver does not represent actual payment.

6. According to Banks and financial institutions, there may be innumerable variations in repayment arrangements/schedules entered into between the lenders and borrowers. It may, therefore, not be possible to visualize all kinds of arrangements which may be entered into between the borrowers and the lenders in this regard. The fundamental principle, however, remains that once an amount has been determined as interest payable to the banks or financial institutions, any subsequent change of nomenclature of interest will not affect its allowability and deduction in terms of section 43B will have to be allowed on its actual payment. The Assessing Officers would, therefore, be justified in seeking a certificate from the assessee to be obtained by assessees from the lender bank or financial institution, etc. as evidence of actual payment of interest to banks or financial institutions.

Yours faithfully,

(D.P. Semwal)  
Director (TPL-III)

Copy to:

1. The Chairman, Members and all other officers in the CBDT of the rank of Under Secretary and above.
2. All Chief Commissioners of Income-tax and Directors General of Income-tax
3. The DIT(RSP&PR), Mayur Bhawan, New Delhi for printing in the quarterly tax bulletin and for circulation as per usual mailing list.
4. The Comptroller and Auditor General of India (40 copies)
5. The Joint Secretary and Legal Advisor, Ministry of Law & Justice, New Delhi.
6. Director General of Income-tax, NADT, Nagpur.

(D.P. Semwal)  
Director (TPL-III)