

## Take care of tax treatment of interest on loans taken to purchase shares



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For tax certainty in deductibility of interest, it is best to treat the IPO application as a business

Many investors avail of loans to acquire shares, often through an application in an initial public offering (IPO), and at times for acquisition of shares in the secondary market. They hope to benefit by earning a greater rate of return on their investment in the shares, than the rate of interest that they pay on the loan, thereby having a positive return. Often, what they forget is that while computing their net returns, they also need to factor in the tax treatment of the interest that they pay on their loans, as this tax has the potential to convert a gain into a loss. What is this tax treatment?

Till a couple of years ago, dividend income you earned on shares was exempt. Tax authorities would, therefore, routinely disallow any claim for deduction of interest on loans taken for acquisition of shares, on the grounds that the loan was taken to earn an exempt income, and the interest could not be claimed while computing taxable income.

Now that dividend has become taxable, one would have thought that the interest will be deductible. Unfortunately, the law now provides that the deduction for interest would be restricted to 20% of the dividend earned during the year. So, if you have not earned any dividend, or a negligible dividend during the year, the major part of the interest paid by you on the loan would not be deductible. Fortunately, the provision seems to be vis-à-vis the entire dividend income, and not income from a particular scrip. Therefore, if a loan is taken for buying a particular scrip, which yields no income during the year, but dividend has been earned on other scrips, interest would be allowed to the extent of 20% of the total dividends earned.

What is the fate of the remaining interest, which is not allowed as a deduction from the dividends? Is that lost, or can one claim a deduction in any other manner? There have been quite a few decisions, mainly of the tribunal but also of a high court, which have held that such interest which has not been allowed as a deduction from dividends can be claimed as part of the cost of acquisition of the shares, while computing capital gains on sale of the shares. The deductibility of the interest is, therefore, postponed to the year of sale of the shares. Also, in such a case, the

interest on the loan has to be identified with the particular shares acquired out of the loan and claimed against capital gains on sale of those shares only. The tax department, however, does not accept this view.

What is the position of persons applying for shares in IPOs through loan funding, where the shares are sold immediately on allotment? In these cases, the money is deposited by the financier into a bank account in the investor's name, for which a power of attorney is executed in favour of the financier. The loan amount is disbursed into this bank account, and a lien is marked on that under the ASBA process of applying for IPOs. In case of some financiers, such bank accounts earn an interest, while in case of others, it does not. Most financiers charge an interest on the loan amount plus take the interest earned on the bank account. On allotment of shares, the shares are sold, and the loan plus interest is withdrawn by the financier, and the balance is paid out to the investor.

In case of persons who claim that such application for shares through IPO is an investment activity, where interest is earned on the bank account, it is possible to take a stand that the interest paid on the loan funding is deductible against such bank interest, which is taxable. The earning of the bank interest would not have been possible without such borrowing, and therefore it is an expenditure incurred for earning that income. However, interest on the loan to the extent of the allotment money of the shares for the period from the date of allotment of shares till the date the sales proceeds of the shares are received, may not be so deductible, as it would be attributable to the holding of shares. Here, an investor may wish to claim that such interest is deductible while computing the capital gains on sale of the shares.

However, if tax certainty is desired for deductibility of the interest, it is best to treat such IPO application activity as a business, and claim the interest as a business expenditure. Of course, care would have to be taken to ensure that tax is deducted at source on the interest paid, if applicable.

One has to, therefore, examine where one is better off—by claiming short-term capital gains and possibly end up not getting a tax deduction for interest paid, or paying full normal rate of tax on gains net of interest.

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