

IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

TAX APPEAL NO.240 of 2007

FOR APPROVAL AND SIGNATURE:

HONOURABLE MR.JUSTICE AKIL KURESHI Sd/-

and

HONOURABLE MR.JUSTICE Z.K.SAIYED Sd/-

1	Whether Reporters of Local Papers may be allowed to see the judgment ?	NO
2	To be referred to the Reporter or not ?	NO
3	Whether their Lordships wish to see the fair copy of the judgment ?	NO
4	Whether this case involves a substantial question of law as to the interpretation of the Constitution of India or any order made thereunder ?	NO

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COMMISSIONER OF INCOME TAX AHMEDABAD-I....Appellant
Versus

M/S CORNERSTONE EXPORTS PVT. LTD....Opponent(s)

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pppearance:

MR MR BHATT, SR. COUNSEL, with MRS MAUNA M BHATT,
ADVOCATE for Appellant(s) No. 1

RULE SERVED BY DS for the Opponent(s) No. 1

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CORAM: HONOURABLE MR.JUSTICE AKIL KURESHI
and

HONOURABLE MR.JUSTICE Z.K.SAIYED

Date : 15/02/2016

ORAL JUDGMENT

(PER : HONOURABLE MR.JUSTICE AKIL KURESHI)

- (1) The appeal is filed by the revenue challenging judgment of the Income Tax Appellate Tribunal dated 31.07.2006.

- (2) After hearing the learned Senior Counsel for the revenue, we modify the substantial question of law for the purpose of this tax appeal as under:

"Whether on the facts and circumstances of the case, the Appellate Tribunal was right in deleting the additions made by the Assessing Officer and confirmed by the CIT (Appeals) towards the interest paid on loans which, in turn, were advanced to the several companies at lower rate of interest?"

- (3) The respondent assessee is a company registered under the Companies Act, 1956, and was engaged in the business of trading in fabrics as well as shares and securities. For the Assessment Year 1995-96 the assessee company had filed its return of income declaring loss of Rs.4,80,562/-. The return was processed under scrutiny. One of the issues examined by the Assessing Officer during such assessment was with respect to the assessee's claim of deduction of interest under Section 36(1)(iii) of the Income Tax Act, 1961, ('the Act' for short). The Assessing Officer noticed that during the year under consideration, the assessee had borrowed huge amounts from various group companies and had, in turn, advanced large amounts to certain companies. On the interest paid by the assessee on the borrowings so made, the claim of deduction of interest was made under Section 36(1)(iii) of the Act. The Assessing Officer called for the details of the borrowings and the lendings of the assessee

company during the relevant period. The Assessing Officer noticed that the amount borrowed by the assessee company was at an interest rate much higher than the rate of interest on which the assessee company had made lendings to other companies. The Assessing Officer found that the company had borrowed a sum of Rs.25.30 crores (rounded off) from various group companies, out of which a sum of Rs.16.88 crores (rounded off) was advanced to other companies.

- (4) The Assessing Officer noted that out of the said sum of Rs.16.88 crores, a sum of Rs.15.80 crores was lent to various companies having a common address at 77, Kali Javi Thavi, Jammu. The assessee pointed out that when such advances were made the assessee company had no connection with the said companies, however, conceded that later on these companies had merged with the group companies of Lalbhai Group, to which the assessee company belonged.

Under such scenario, the Assessing Officer questioned the advances made by the assessee company to various companies at a rate of interest lesser than what the assessee company had paid on its own borrowings. The Assessing Officer found that the same amount borrowed by the assessee company came to be advanced on the same day at a lower rate of interest.

(5) In view of such facts the Assessing Officer came to the conclusion that the assessee company had merely acted as a conduit and there was no business expediency on the part of the assessee company in making such advances at a lower interest rate. He therefore concluded that the money borrowed by the assessee company had not been utilized for the purpose of assessee's business. The Assessing Officer disallowed the differential portion of interest and added a sum of Rs.91.41 lacs (rounded off), against such disallowance making the following observations:

"5.9. The other two cases as quoted by the assessee i.e. Brilla Gwalior Pvt. Ltd. Vs. CIT (44 ITR 847) and decision of Madra High Court in the case of CIT Vs. Pudukottai Co. Pvt. Ltd. (84 ITR 788) have been rendered in the context of the Indian Income Tax, 1922. Further also the facts and circumstances of the case in those cases were entirely different in as much as the amount borrowed and not been lend to any interested parties as is clearly the case of the assessee. The assessee company has merely acted as a conduit as discussed later and in any case no business expendency or reasons could be advanced by the assessee for borrowing at higher rate and lending the same amount on the same day at a lower rate. Further also the nexus regarding the borrowing of funds at a higher rate and lending of the same on the same date itself to another interested parties / group concerns at a lower rate has clearly been established in the case of the assessee. Therefore, on the facts and circumstances of the case the assessee the above quoted judgments are not applicable to the case of the assessee.

5.10 Still further the reliance of the assessee in the case of Addl. CIT Vs. Laxmi Agency Pvt. Ltd. (supra) is misplaced in the sense that what the Hon'ble Court had held in that case was that the monies should be utilised for the purposes of the assessee's business. In the case of the assessee what has been found is that the monies have not been

really utilized for the purposes of the assessee's business and assessee company has in a way acted as conduit by advancing of loans to other companies as becomes clear from Annex-A. Hence, the said case is not applicable to the facts & circumstances of the case of the assessee."

- (6) The assessee carried the matter in appeal before the CIT (Appeals). CIT (Appeals) concurred with the view of the Assessing Officer and rejected the appeal in the following terms:

"12. After going through the facts of this issue, I am of the opinion that the action of the Assessing Officer in this case is absolutely justified. In the present case, the situation is not one of the genuine business transactions since the assessee company has merely acted as a conduit in advancing loans on lower rates. An analysis of the transactions reveals that there is no case of any business expediency made out. There is no valid reason why the assessee should lend money at lower rate. What is more interesting is that borrowings and lendings are both on the same date.

But the rates of interest are unfairly disproportionate for which there is no justification. One can understand advancing of money at lower rate if the same is for the purposes of assessee's business. But in the present case, the moneys are not borrowed for assessee's business but these are borrowed for some body else's benefits. In the present case, the Assessing Officer has been able to establish that the moneys have not been really utilized for the purpose of assessee's business since the assessee company has only acted as a conduit by advancing loans to other related persons. The position of law in this regard is very clear. When moneys are borrowed at a higher rate and same are lent to sister concerns, interested parties, partners in firms, directors in companies as well as even otherwise, then the difference of claim has to be held as not allowable as admissible business expenditure. The case law in this regard has been referred at Page 6 of the appellate order. If one care to go through the case law cited, no doubt remains in any body's mind as to what the final finding should be on an issue like this. The Assessing Officer has done well by preparing a

complete chart in this regard. In the chart all relevant details find place. A mere glance at the chart clarifies the whole proposition by bringing out on record the fact that the moneys have not been really used for the purposes of business and the claim to the extent disallowed by the Assessing Officer is proper."

- (7) The assessee carried the matter in further appeal before the Income Tax Appellate Tribunal. The Tribunal allowed the assessee's appeal and reversed the decisions of the Assessing Officer as well as the CIT (Appeals). The Tribunal observed that expression "*for the purpose of the business*" used in Section 36(1) (iii) of the Act is wider in scope than the expression "*for the purpose of earning income*". In the opinion of the Tribunal only if the capital borrowed is used for a purpose other than that of the business then the assessee's claim for interest could be disallowed. The Tribunal recorded that the Assessing Officer had in fact allowed part of the interest claimed by the assessee. Once the Assessing Officer allowed such deduction on the only funds so borrowed, the Assessing Officer could not have made disallowance of part of the interest applying the principles of Section 40A(2) of the Act. The Tribunal observed as under:

"5.1 In view of these facts we are of the view that the chart prepared by the assessee in respect of interest is based on nominal working and does not represent interest actually received and paid by the

assessee. Section 36(1)(iii) allows the deduction in respect of the amount of interest paid in respect of capital borrowed for the purpose of the business or profession. There is no dispute that the assessee has borrowed the funds. There is no dispute that the assessee has paid the interest during the year on the funds so borrowed. The word "for the purpose of the business" is wider in scope than the expression 'for the purpose of earning income'. Thus, the interest paid on borrowed capital will be allowed as deduction only if the capital was borrowed and used for the purpose of business and if it is used for the purpose other than the business then the interest to the extent to which the capital was so used will not be allowed, The Assessing Officer has allowed the deduction of the interest on all the capital borrowed for the purpose of the business but what the Assessing Officer has done in this case he did not allow the whole of the interest because he was of the view that the assessee has borrowed funds at the higher rate while it had lend the funds at the lower rate and he accordingly computed the interest which could be allowed deduction U/s 36(1)(iii) in his view. In our opinion once the Assessing Officer has allowed the deduction of the interest on whole of the funds borrowed. The Assessing Officer has accepted that the assessee has borrowed the funds for the purpose of the business. Under the section, in our opinion, the Assessing Officer does not have any power to decide the rate of interest at which the deduction should be allowed to the assessee. Once he has accepted that the assessee has borrowed the funds for the purpose of the business. The Assessing Officer cannot allow part of the interest incurred by the assessee on the capital borrowed. The Assessing Officer can only disallow the interest in respect of capital which has not used for the purpose of the business. This is only Section 40A(2)(a) which empowers the Assessing Officer to disallow part of the expenditure if the Assessing Officer found that the expenditure was excess and unreasonable. The payment has been made for such expenditure to any person referred to any clause (b) of Section 40A(2) and the Assessing Officer is of the opinion that the expenditure so incurred is more than the fair market value of the goods, services or facilities for which the payment is made. For this the finding is to be given that the assessee has incurred the expenditure on the persons as fall within Clause (b) of Section 40A (2). In this case no such finding has been mentioned by the Assessing Officer that the assessee has borrowed the funds from the person as referred to in Clause (b) of Section 40A(2). The Assessing Officer has disallowed the expenditure on the basis

that the assessee has borrowed the funds at a higher rate while the assessee has advanced the money to its group concerns at a lower rate of interest. The provisions of Section 40A(2) are also not applicable in this case."

- (8) Learned Senior Counsel for the revenue submitted that the Tribunal has committed serious error in reversing the decisions of the revenue authorities. The facts of the present case were eloquent. The assessee had borrowed funds at a higher rate of interest and advanced the very same funds to other companies at a much lower rate of interest. Nothing was brought on record to suggest that such advances were made for the purpose of business. No business expediency was demonstrated for making such advances at a concessional rate of interest. He drew our attention of the decision of the Supreme Court in the case of S.A. Builders Ltd. Vs. Commissioner of Income-Tax (Appeals) & Anr., [2007] 288 ITR 1 (SC) to point out that in such decision the Supreme Court while allowing the claim of the assessee of deduction of interest when interest free advances were made to the sister concerns observed that whether the interest free advance made by the assessee to the sister concern was for the purpose of business or not is also a question of fact to be judged on the basis of evidence on record.
- (9) None appeared for the assessee though served.

- (10) As noted, the sole controversy in this appeal concerns disallowance of interest made by the Assessing Officer, which was claimed by the assessee company under Section 36(1)(iii) of the Act. As is well known, Section 36(1)(iii) of the Act permits deduction in computing income of the assessee of the amount of interest paid in capital borrowed for the purpose of business or profession.
- (11) In this context the Supreme Court in the case of *S.A. Builders Ltd.* (supra) had reiterated that the expression "for the purpose of business" occurring in the said provision is wider in scope than the expression "for the purpose of earning profits". Supreme Court opined that the correct test in such a case is whether the advance made is as a measure of commercial expediency. In the said case the assessee had diverted the interest bearing funds to its sister concern without charging interest. In this context it was observed that the amount borrowed by the assessee was not utilized for its own business, however, the same was advanced as interest free loan to its sister concern. While allowing the assessee's claim for interest on the principle of commercial expediency, in the said case the Supreme Court made it clear that it is not as if in every case interest on borrowed loan has

to be allowed if it is made to a sister concern and it would depend on the facts and circumstances of each case. If such amount is utilized by the directors of the sister concern for their personal benefit, obviously it cannot be said that money was advanced for commercial expediency.

(12) Two things thus become clear – first that the expression “for the purpose of business” occurring in Section 36(1)(iii) of the Act has wider import than the expression “for the purpose of earning income.” This is settled since long. The second aspect is that in *S.A. Builders Ltd.* (supra) the Supreme Court had applied the principles of commercial expediency in judging the claim of interest. This was made in the background of the interest borrowing funds being diverted by the assessee to its sister concern without charging interest. It was in this background that the Supreme Court observed that what has to be seen is whether transfer of funds to a sister concern on the ground of commercial expediency.

(13) The facts in this case are some what peculiar. As recorded by the Assessing Officer and which facts are not disturbed by the Tribunal, the assessee, during year under consideration, borrowed Rs.25.30 crores from various group companies at a higher interest rate, in most

cases @ 21%. Amount of Rs.16.88 crores out of such funds was advanced to the various companies, mostly @ 14% interest. In many cases funds borrowed on the same day were used for making advances. Out of advances of Rs.16.88 crores, Rs.15.08 crores was made to various companies having common address at Jammu. By assessee's own account when such advances were made these borrowing companies were completely unrelated, however, subsequently these companies merged with the group companies of Lalbhai Group. At no stage the assessee pointed out any business expediency in making advances at a lower interest rate than the rate at which the assessee company had borrowed the money. It is undoubtedly true that Section 36(1)(iii) of the Act permits deduction of interest paid on capital borrowed for the purpose of business or profession and the expression "for the purpose of business" is seen wider than the expression "for the purpose of earning income". Nevertheless the assessee had to point out the business expediency which prompted the assessee to make advances at a lower rate of interest. The assessee failed to bring on record any such material or even plead before the Assessing Officer any business expediency.

- (14) Without upsetting the factual findings of the Assessing Officer, in our opinion, the Tribunal

committed two errors in reversing the decisions of the revenue authorities – the first was of applying the principles “for the purpose of business” being wider than “for the purpose of earning income” in abstract. Such principles had to be applied in the context of business expediency if the same was demonstrated which, as recorded by us earlier, was not done. The second error committed by the Tribunal was to hold that the Assessing Officer had applied the principles of Section 40A(2) of the Act which, according to the Tribunal, was not permissible. In other words, view of the Tribunal was that the Assessing Officer could have either allowed or disallowed the entire interest component relatable to a particular borrowing of the assessee. However, once the Assessing Officer decided to grant deduction of interest on a particular loan, it was not open for the Assessing Officer to disallow the portion of interest component.

- (15) In this context, we do not find that the Assessing Officer applied the principles analogous to Section 40A(2) of the Act by holding that the interest paid by the assessee was excessive. In fact the Assessing Officer applied the deduction to the extent the rate of interest at which the advances were made by the assessee. However, the action of the assessee company to make advances at a lower rate of

interest than the interest liability discharged by the assessee company in borrowing such funds was not shown to be in any manner actuated by business expediency. The Assessing Officer was perfectly justified in disallowing such component of interest.

(16) In the result, the question is answered in favour of the revenue. Appeal is allowed, the judgment of the Tribunal on this issue is reversed. Appeal is disposed of accordingly.

Sd/-
(AKIL KURESHI, J.)

Sd/-
(Z.K.SAIYED, J.)

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THE HIGH COURT
OF GUJARAT

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