* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

Orders reserved: 4th October, 2007
Date of decision: 12th October, 2007

\+ **ITA No. 84 of 2005**

M/S KASHMIR ARTS ..... Appellant
Through Mr. Gyan Prakash, Advocate.

Versus

COMMISSIONER OF INCOME TAX VII ..... Respondent
Through Ms. P.L. Bansal, Advocate.

CORAM:
HON'BLE MR. JUSTICE MADAN B. LOKUR
HON'BLE DR. JUSTICE S. MURALIDHAR

1. Whether Reporters of local papers may be allowed to see the judgment? Yes
2. To be referred to the Reporter or not? Yes
3. Whether the judgment should be reported in Digest? Yes

: <u>Dr. S. Muralidhar, J.</u>

1.1 This appeal under Section 260 A of the Income Tax Act, 1961 ('Act') is directed against the order dated 7th October, 2004 passed by the Income Tax Appellate Tribunal ('Tribunal'), Delhi Bench "G", New Delhi in M.A. No.159/Del/2004 in ITA No.3523/Del/1997. By the said impugned order the Tribunal dismissed the application filed by the Appellant before it under Section 254(2) of the Act seeking rectification of its order dated 30th September, 2003 by which it dismissed the Assessee's appeal.

1.2 It requires to be noticed that the Appellant had challenged the main order dated 30th September, 2003 passed by the Tribunal dismissing ITA No. 3523/Del/1997, in ITA No.34 of 2005. However, on 18th February, 2005 the

appellant withdrew the ITA No. 34 of 2005 and accordingly this Court dismissed the said appeal as withdrawn on that date. Further this Court framed the following question of law for consideration in the present appeal :

> "Whether the Income Tax Appellate Tribunal was correct in law in holding that the assessee is entitled to reduce interest paid by it from the interest received by it, while calculating deduction under Section 80-HHC (3A) read with Explanation (baa) of the Income Tax Act, 1961?"

Upon perusing the orders in the present matter and hearing submissions of counsel, we find that the question ought to be re-formulated in the following manner:

> "Whether the Income Tax Appellate Tribunal was justified in declining to entertain the rectification application and consequently the Assessee's contention that it is entitled to reduce the interest paid by it from the interest received by it, while calculating deduction under Section 80-HHC (3A) read with Explanation (baa) of the Income Tax Act, 1961?"

2. The facts relevant for the present appeal are that for the Assessment Year 1993-94 the Assessee, which is in the business of exporting carpets, filed a return on 12th October, 1993 showing an income of Rs.12,04,030/-. Later on 3rd September, 1995 the Assessee filed a revised return disclosing an income of Rs.12,82,976/-. The case was processed by the Assessing Officer ('AO') under Section 143 (1) (a) of the Act.

3. While the assessment proceedings were in progress, the Assessee by its letter dated 19th September, 1995 claimed deduction of Rs.3,62,76,246/- (revised) under Section 80HHC of the Act. In addition, the Appellant furnished an explanation that it had deducted 10% of the receipts amounting to

Rs.50,48,648/- from the total indirect cost while calculating the said deduction.

4. The AO held that the Assessee's claim for a deduction of 10% of the receipts from the total indirect cost was not correct and disallowed the same. The AO further took the view that the Assessee had debited a sum of Rs.4,03,422/- to the Profit & Loss Account ('P&L Account') as interest on Fixed Deposit Receipts ('FDRs'). The details produced revealed that the Assessee had paid a sum of Rs.12,54,280/- as interest to the bank on the credit facilities enjoyed by it and received a sum of Rs.8,50,858/- as interest on FDRs kept as margin money with the bank. After 'netting' the interest earned against the interest paid, the difference was debited by the Assessee to the P&L account. The AO held that that the interest paid and the interest received were two separate transactions. Since the Assessee had utilised the loans from the bank for business purpose and the same not having used for making fixed deposits, there was no correlation between the loan taken by the Assessee from the bank and the fixed deposits kept with the bank. Accordingly the AO directed that the amount of Rs.8,50,858/- constituting the interest received on FDRs should be deducted from the profits and gains of the business in terms of Explanation (baa) (1) to sub Section (4A) of Section 80HHC.

5. Aggrieved by the order of the AO, the Assessee filed an appeal before the Commissioner of Income Tax (Appeals) ['CIT(A)']. The CIT(A) by his order dated 18th March, 1997 held that "since interest was paid and received from the same bank, the net amount of the two transactions has to be considered while computing business income under Section 28 to 44."

6. The Revenue then filed an appeal to the Tribunal. By an order dated 30th September, 2003 the Tribunal followed the dictum of the Kerala High Court in ***K.Ravindranathan Nair v. CIT 262 ITR 669*** where in similar circumstances it was found that "the interest from short-term deposits received by the appellant was not the direct result of any export of any goods or merchandise" and that "the interest income received on the short term deposit though it could be attributed to the export business could not be treated as income **derived** from the export business." Accordingly the appeal filed by the Revenue was allowed.

7. After the decision of the Special Bench of the Tribunal in ***Lalsons Enterprises v. Deputy CIT (2004) 89 ITD 25 (Del) [SB]***, the assessee filed an application before the Tribunal under Section 254 (2) of the Act for rectification stating that it was entitled to netting of interest in terms of that decision. By its order dated 7th October, 2004 the Tribunal dismissed the application on the ground that the judgment in ***Lalsons Enterprises*** had been rendered after the decision dated 30th September 2003 of the Tribunal in the Assessee's appeal and that therefore this did not constitute a ground for rectification.

8. The learned counsel for the Assessee submitted that in view of the judgments of this Court in ***Commissioner of Income Tax v. Shri Ram Honda Power Equip [2007] 289 ITR 475 (Del)*** and ***CIT v. Punjab Stainless Steel Ind. [2007] 162 Taxman 9 (Del)*** the Assessee is bound to succeed. Since according to him the AO had held that the interest income was business

income, netting had to follow.

9. We are unable to accept the submission made on behalf of the Assessee. We find that the decision of the Special Bench of the Tribunal in ***Lalsons Enterprises*** as explained and modified by this Court in ***Shri Ram Honda Power Equip*** does not help the Assessee at all. We may recall what was said in the said decision (ITR, p.506):

> "....we entirely agree with the following formulation of the Special Bench of the Tribunal in ***Lalsons*** (ITD, p. 62):
>
> > "If the interest received is found to have a nexus with the business, still it remains to be excluded from the profits of the business by virtue of Explanation (baa) (1), but the claim is that the quantum of such interest income to be excluded must be determined in accordance with the computation provisions relating to business by allowing expenditure by way of interest which bears a nexus with the interest receipt. The computation provisions include Section 37 (1) under which any expenditure incurred or laid wholly and exclusively for the purpose of the business is to be allowed as a deduction. Therefore, any expenditure incurred which has a connection or nexus with the interest receipt has to be allowed as a deduction and only the balance can be excluded from business profits."
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> To the above, we may add a few lines by way of clarification. It will bear examination whether obtaining the loan and paying interest thereon (laying out the expenditure by way of interest) was "wholly and exclusively" for the purpose of earning the interest on the fixed deposit, to draw an analogy from Section 37. **This nexus will have to be shown by the assessee for application of the netting**

principle." (emphasis supplied)

This Court in ***Shriram Honda Power Equip*** further concluded (ITR, p.509):

"(i) to (iii) xxxxxxxx

(iv) Where surplus funds are parked with the bank and interest is earned thereon it can only be categorised as income from other sources. This receipt merits separate treatment under section 56 of the Act which is outside the singe of profits and gains from business and profession. It goes entirely out of the reckoning for the purposes of section 80HHC.

(v) Interest earned on fixed deposits for the purposes of availing of credit facilities from the bank, does not have an immediate nexus with the export business and therefore has to necessarily be treated as income from other sources and not business income.

(vi) and (vii)xxxxxxx

(viii) The word 'interest' in clause (baa) of the Explanation connotes 'net interest' and not 'gross interest'. Therefore, in deducting such interest, the AO will take into account the net interest i.e. gross interest as reduced by expenditure incurred for earning such interest. The decision of the Special Bench of the ITAT in ***Lalsons*** to this effect is affirmed. In holding as above, we differ from the judgments of the Punjab & Haryana High Court in ***Rani Paliwal*** and the Madras High Court in ***Chinnapandi*** and affirm the ruling of the Special Bench of the ITAT in ***Lalsons***.

(ix) Where, as a result of the computation of profits and gains of business and profession, the AO treats the interest receipt as business income, then deduction should be permissible, in terms of Explanation (baa) of the net interest i.e. the gross interest less the expenditure incurred for the purposes of earning such interest. The nexus between obtaining the loan and paying interest thereon (laying out the expenditure by way of interest) for the purpose of earning the interest on the fixed deposit, to draw an analogy from Section 37, will require to be shown by the assessee for application

of the netting principle."

It may be recalled that this Court in fact followed the line of reasoning adopted by the Kerala High Court in ***K.Ravindranathan Nair***.

10. Turning to the case on hand, the first question is whether the interest earned by the Assessee on FDRs kept with the Bank for the purpose of margin money as a condition for availing credit facilities could be termed as business income? If the answer to this is in the affirmative the second question is whether netting is to be permitted? For the second question to be answered in the affirmative, the assessee will have to show that there is a nexus between the interest paid on the credit facilities availed from the Bank and the interest earned on the FDRs kept with the Bank. Nowhere in the Assessment Order has the AO found that the interest earned by the Assessee was business income. Therefore the first question stands answered against the Assessee in view of the categorical pronouncement in ***Shriram Honda Power Equip*** that interest earned on FDRs kept for availing credit facilities is not business income but 'income from other sources.' The decision in ***Punjab Stainless Steel Ind.*** where the AO had held the interest income to be business income and which finding was not challenged is therefore of no assistance to the Assessee. Also, in view of the finding by the AO in the instant case that there is no nexus between the interest paid and the interest earned by the Assessee, the second question will also have to be answered against the Assessee.

11. In view of the above discussion, the question of law as re-framed by us

in Para 1.2 above is answered in the affirmative, that is, against the Assessee and in favour of the Revenue.

12. The appeal is dismissed.

S. MURALIDHAR, J

MADAN B. LOKUR, J

OCTOBER 12, 2007
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